A Note on Pension Fund Economically Targeted Investments

Trustee Leadership Forum for Retirement Security

Overview

U.S.-based public and private pension funds have been making Economically Targeted Investments, or ETIS, since the 1960s. ETIs are investments that generate collateral benefits for communities apart from the investment return to the plan. Through ETIs pension funds have sought financial returns with positive community impact through investments in worker-friendly affordable housing, in-state businesses, infrastructure, and other projects. The practice of pension funds making ETIs has continued amidst challenges, such as the politicization of some ETIs in the 1980s and 1990s, and through significant economic downturns.

The Initiative for Responsible Investment's research partner Pacific Community Ventures (PCV) recently published a new report, *The Pursuit of Financial Return and Societal Benefit: An Examination of Pension Fund Economically Targeted Investments*, which explores pension funds' use of ETIs, and how pension funds are looking beyond ETIs to explore impact investments and investments that incorporate environmental, social, and governance (ESG) factors as part of their investment strategies.

The report includes five in-depth profiles on current pension fund ETIs:

- The Wisconsin Private Debt Program
- AFL-CIO Housing Investment Trust
- In-state Private Equity Investments
- CalSTRS Fixed Income Green Bond Program
- Dutch Pension Funds Pursuit of Social Benefit

The research builds on PCV's prior work which cataloged over 100 pension fund ETIs. PCV's ETI online catalog features information on individual ETI's investment strategy, objectives, asset class, investment size, participating investors, and publicly reported outcomes on financial and social performance.

Why take a closer look at ETIs?

ETIs are part of the universe of responsible investment options available to institutional investors, including pension funds. As investors move toward incorporating ESG factors into investment decision-making, and interest grows in impact investing, it is a good time to look at how ETIs utilize similar investment strategies to incorporate nonfinancial factors into investment analysis. Past and current pension fund ETIs may offer guidance as pension funds consider these investments within their respective portfolios – helping them to avoid past ETI pitfalls and leverage tested approaches.

Key Terms

Economically Targeted Investments
ETIs are investments that generate collateral benefits apart from the investment return to the employee benefit plan investor. Societal benefits generated through ETIs are generally of secondary importance to financial return objectives. ETIs are often focused on the state or region in which a pension fund is based and specify the type of collateral benefit the investment is seeking (e.g. environmental benefits through the financing of renewable energy projects).

Environmental, social, and governance (ESG) incorporation
ESG refers to the incorporation of environmental, social, and corporate governance criteria into investment analysis and decisions.

Impact Investing
Impact investing refers to investments made into companies, organizations, and funds with the intention to generate a measurable, beneficial social or environmental impact alongside a financial return.

Are these investments consistent with a pension fund's fiduciary duty?

While not all ETIs, impact investments, and investments that incorporate ESG factors will be appropriate for pension funds to consider, the body of law and evidence is well established that in general these types of investments are consistent with fiduciary duty, so long as they are financially prudent.

In 2015 the U.S. Department of Labor offered clarifying guidance on ETIs as part of the Employee Retirement Income Security Act (ERISA) that reaffirmed that private pension funds could pursue socially beneficial investments that are financially prudent. Furthermore, the guidance acknowledged that ESG factors may have a direct relationship to the economic and financial value of an investment. In that case, the DOL guidance advises that these factors may function as more than just "tiebreakers" among a series of investment options; rather, they are proper components of the fiduciary's analysis of the economic and financial merits of competing investment choices. For further detail see IRI's blog on the ERISA guidance.

The ERISA guidance clarification on incorporating ESG factors is also aligned with research published in 2015 by the Principles for Responsible Investment (PRI) in, *Fiduciary Duty in the 21st Century* that found that "failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty."

Why should pension funds consider ETIs, impact investments, and investments that incorporate ESG factors?

As long-term investors, pension funds are well positioned to consider ETIs, and investments that incorporate ESG factors – helping to create more resilient economies, stronger communities, and a healthier environment for plan participants and beneficiaries. Global challenges such as climate change and rising inequality may, over time, negatively impact the stability of financial markets and countries, but, simultaneously, produce new investment opportunities which seek to combat these societal challenges. As these investments grow in number, pension funds that dismiss these opportunities may risk leaving investment returns on the table.

The need for $2.5 trillion in capital annually to meet the United Nation's 17 Sustainable Development Goals (SDGs) is illustrative of the growing, global opportunity set. The SDGs outline a global agenda to end poverty by 2030, and many of the 17 goals relate to inequality, health, climate change, and the environment. Dutch pension funds and financial institutions as well as other investors see the SDGs as an attractive investment opportunity. In 2016 APG, PGGM, and other Dutch financial institutions created the Sustainable Development Goal investing (SDGI) agenda. As part of this initiative, they published *Building Highways to SDG Investing*, which outlines their plan to invest in the SDGs.

Amidst the rise of the SDGs as a framework for investment, the evidence-base on financial performance for impact investments and ESG incorporation has grown. This growing body of work demonstrates that these investments are not inherently concessionary and can generate attractive financial returns. Studies on financial performance from Oxford University and Arabesque Partners, the Wharton School, and the Global Impact Investing Network (GIIN) have opened the door for pension funds to consider these investments when they may have easily been dismissed for the limited data on financial performance in the past.

What can trustees do?

To be sure, amidst these developments, pension funds must continue to invest prudently and fulfill their fundamental obligation of promised benefits to plan participants. Furthermore, investment conventions and norms are persistent and often still disfavor ETIs, impact investments, and ESG incorporation. However, to facilitate change, pension fund trustees can take the following actions where appropriate:

Look to others who are already making these investments

- Look to other pension funds, whether in the U.S. or internationally, whose investment strategies incorporate ESG factors or make ETIs and impact investments and seek to understand what components of their strategies might be relevant within the context of your own institution.
- Utilize existing reports and resources such as *The Pursuit of Financial Return and Societal Benefit,* the online ETI catalog, and literature cited in this note to benefit from the significant history of pension fund ETIs, supporting a greater understanding of how these investments have worked in practice, including challenges and applicable lessons.

Understand your own institution's governance structure and experience

- Understand how fund governance is structured, how decision-making around the incorporation of collateral benefit happens, and how trustees fit into that structure.

- Understand prevailing perceptions surrounding these investments, including those that might impede further discussion or consideration, and assess what might be needed to overcome these barriers.
- Discuss past successes and challenges openly with staff and external investment managers, as well as whether these investments fit within your organization's current mission and strategy.

Encourage investment staff to consider these investments

- Encourage staff and asset managers to investigate place-based investment opportunities, for instance, investing in affordable housing, businesses, and critical infrastructure in places with need, both locally and globally.
- Highlight the importance, as a long-term investor, of incorporating ESG factors in investment decision-making given the well-established connection between long-term value creation and ESG factors.
- Highlight how other investors are utilizing the SDGs as an investment framework and explore how if at all the fund's existing investments may already be contributing to the SDGs. Consider the extent to which new investment opportunities might contribute to the SDGs.

Advocate for greater disclosure and reporting

- Request staff and external investment managers disclose how they are incorporating ESG factors into investment analysis and decisions across asset classes to understand where there are gaps and opportunities for improvement. For those who are not yet incorporating ESG factors connect them to the resources cited in this note and from PRI and US SIF on ESG incorporation.
- Share how pension fund investments are benefiting local communities, economies, and the environment, through reports and other news items. As examples, see the reports on CalPERS in-state investments and CalSTRS environmental-themed investments.

Identify opportunities for collaboration

- Seek opportunities to collaborate with other financial institutions who are already incorporating these investments in their strategies. The GIIN has created the Initiative for Institutional Impact Investment that is intended to support institutions seeking to enter, or deepen their engagement with, the impact investing market, by providing educational resources, performance research, and fostering a community of practice.

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Further reading

History of ETIs

Lisa A. Hagerman, Gordon L. Clark, and Tessa Hebb, "Investment intermediaries in economic development: Linking pension funds to urban revitalization," Labor & Worklife Program, Harvard Law School, February 2007.
See: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.571.9646&rep=rep1&type=pdf.

Thomas Croft and Annie Malhotra, *The Responsible Investor Handbook: Mobilizing Workers' Capital for a Sustainable World*, Greenleaf Publishing Limited, 2016.
See: http://www.heartlandnetwork.org/book-descriptions

Tessa Hebb and Jayne Zanglein, "Economically targeted investing: changing of the guard," *Cambridge Handbook of Institutional Investment And Fiduciary Duty*, eds. Hawley J, Hoepner A., Johnson K., et al., Cambridge University Press, 2013, p. 112-127.
See: https://www.cambridge.org/core/books/cambridge-handbook-of-institutional-investment-and-fiduciary-duty/economically-targeted-investing-changing-of-the-guard/31BDDF3414877E444768107C12F204B0#

Fiduciary Duty

"Principles for Responsible Investment (PRI)," *Fiduciary Duty in the 21st Century*, September 2015.
See: https://www.unpri.org/download_report/6131.

"Principles for Responsible Investment (PRI)," *Fiduciary Duty in the 21st Century*: US Roadmap, 2016. See: https://www.unpri.org/download_report/24188.

UN Sustainable Development Goals

"Building Highways to SDG Investing: Invitation to collaborate on a Dutch sustainable development investing agenda," PGGM, December 2016.
See: https://www.sdgi-nl.org/s/Building-Highways-to-SDG Investing-PDF.pdf.

Studies on Financial Performance

Impact Investments
The Global Impact Investing Network and Cambridge Associates, "Introducing the Impact Investing Benchmark," 2015.
See: https://thegiin.org/assets/documents/pub/Introducing_the_Impact_Investing_Benchmark.pdf

Jacob Gray, Nick Ashburn, Harry Douglas and Jessica Jeffers, "Great Expectations: Mission Preservation and Financial Performance in Impact Investing," Wharton Social Impact Initiative, 2015.
See: https://socialimpact.wharton.upenn.edu/wp-content/uploads/2016/09/Great-Expectations-Mission-Preservation-and-Financial-Performance-in-Impact-Investing.pdf

ESG Incorporation
Gordon L. Clark, Andres Feiner and Michael Viehs, "From the Stockholder to the Stakeholder: How sustainability can drive financial outperformance," University of Oxford and Arabesque Partners, March 2015.
See: https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf

George Serafeim, Jade Huang, Joshua Linder, Patrick Faul and John Streur, "The Financial and Societal Benefits of ESG Integration: A Focus on Materiality," The Calvert-Serafeim Series, 2017.
See: https://www.calvert.com/calvert-serafeim-series-report-materiality.php