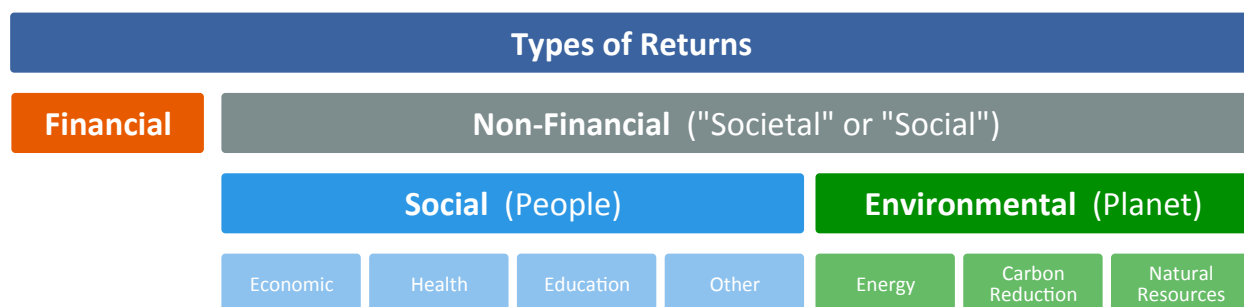


A Guide to Responsible Investing

Socially Responsible Investment, Impact Investing, Responsible Finance, ESG, CSR, Double-bottom Line, Triple-bottom Line. The responsible investing space is plagued by jargon and rhetoric. As few definitions are universally applied, many are used interchangeably, causing confusion. The differences in terminology make it hard to identify, measure and evaluate this wide-ranging asset class. This guide explains the most commonly used terms in an effort to bring clarity to the responsible investing community.

Returns: Financial vs. Non-financial

The traditional definition of *investing*, the practice of maximizing financial, risk-adjusted returns on capital, makes no mention of the concept of non-financial returns. *Non-financial returns* are any positive externalities of an investment, typically social and environmental outcomes. These positive societal benefits are most commonly referred to as *social returns*.¹



Today, the terms double and triple bottom line returns are frequently used to refer to financial, social, and environmental returns. The concept of a *double bottom line* encourages investors to look beyond purely financial returns to consider societal impact as well. Building on this theme, the *triple bottom line* considers an additional factor – environmental benefits. This approach proposes that a company’s success should be based on its behavior regarding profit, people, and the planet.

A common framework used today is ESG, which evaluates a company’s environmental, social and corporate governance (ESG) characteristics. ESG not only measures an organization’s responsibility towards people and the planet, but also the quality of corporate leadership and ethical business practices. ESG is a critical element of the United Nations Principles for Responsible Investment (the PRI). The PRI serve as a guideline to encourage institutional investors to consider the long-term interests of their beneficiaries.² Approaches like ESG are often incorporated into a company’s *corporate social responsibility (CSR)* program. CSR efforts include policies (e.g. self-regulation) or commitments from a company to ensure ethical behavior and societal benefits.

¹ “Social returns” includes both social and environmental benefits. European Venture Philanthropy Association uses the term “societal causes,” which include social, environmental, medical, and cultural causes.

² UNPRI. “The Six Principles,” 2013 <http://www.unpri.org/about-pri/the-six-principles/>.

Investing: Measuring Social Intent

Investing can be separated into three broad categories, based on social intent: “do not measure,” “do no harm,” and “do good.”



- “Do not measure” (*conventional financial investing*) – investments made with the primary goal of maximizing financial returns with no measurement of non-financial returns. These investments may have positive or negative social returns.
- “Do no harm” (*socially responsible investing*) – investments that seek a financial return while pursuing positive social outcomes. Socially responsible investments (SRIs) seek to avoid societal harm by excluding companies that are associated with harmful activities (*negative screening*) or by investing in companies with industry-leading CSR outcomes (*positive screening*).
- “Do good” (*impact investing*) – investments that target specific and measurable social returns while producing financial returns.

Responsible Investing

Responsible investing is an investment process that seeks to integrate non-financial factors (usually ESG related) into investment decision-making. A core tenet is that non-financial considerations can have an impact on financial performance. Responsible investing is the broadest category of investing that seeks to account for non-financial returns, and it includes both *socially responsible investing* and *impact investing*.

Responsible investing integrates non-financial considerations into investment decisions.

As the responsible investing market grows, so has the terminology used to define it. The table below includes the most common terms used by different stakeholders.

Responsible Investing Terminology	
<ul style="list-style-type: none"> • Blended Value Investing³ • Ethical Investing⁴ • Green Investing (focused on environment) • Mission Related Investing⁵ 	<ul style="list-style-type: none"> • Socially Conscious Investing • Sustainable Investing • Values Based Investing

³ Blended Value. "The Pursuit of Integrated Economic, Social & Environmental Value." 2013. <http://www.blendedvalue.org/>.

⁴ Bird, Lauren. "Responsible Investing". <http://europe.nxtbook.com/nxteu/posthaste/actuarialpost18/#/14>.

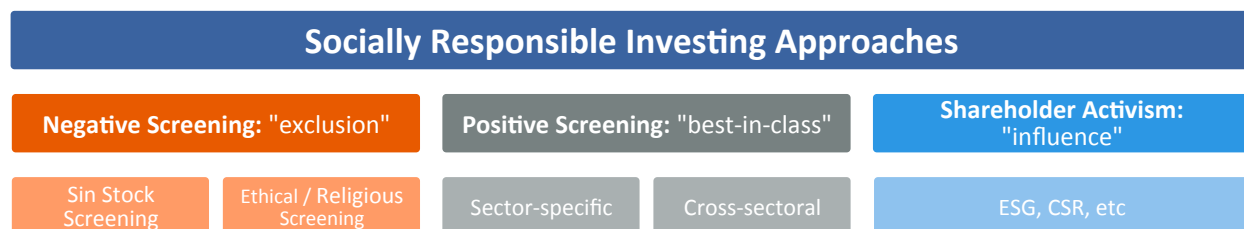
Socially Responsible Investing

Socially Responsible Investing (SRI) is the largest segment of responsible investment. In 2011, SRI assets accounted for over US\$3 trillion in the United States alone.⁶ By 2012, the U.S. market approached US\$4 trillion out of US\$13.5 trillion globally.⁷ Notably, Europe accounts for the largest share, holding 65% of SRI assets.⁸

SRI employs strategies that seek competitive financial returns and apply screening strategies to minimize harmful externalities contrary to their social objectives. These screening strategies are often related to an organization’s ESG or CSR characteristics.

Socially responsible investing seeks financial returns while pursuing positive societal outcomes.

SRI takes different approaches to ensure that their investments do no harm. The first is an *exclusion screening strategy* which involves filtering out “unethical” investments. Alternatively, a *positive screening strategy* selects companies with the highest current or potential levels of social responsibility (CSR, ESG, etc.). A *shareholder activism strategy* uses shareholder rights to influence management on ESG- or CSR-related issues in an attempt to reduce harmful externalities and improve shareholder returns.



- 1) ***Negative screening***: an investment approach that excludes companies with low ESG or CSR metrics and/or screens for companies that do not comply with certain criteria. This approach seeks to reduce the chance of *reputational risk*, where an investment is connected with a negative event or business practice. Examples of this include screening for “sin stocks” and screening to comply with ethical or religious guidelines.
 - a. *“Sin stock” screening*: excluding investment in companies considered to promote harmful societal outcomes, such as the tobacco, alcohol, gambling, adult entertainment, and armament industries. Sin stock screening can also apply to divestment from companies that do business with oppressive regimes.⁹
 - b. *Ethical or religious screening*: excluding investment in companies that violate ethical, moral, or religious standards. These criteria are applied by faith-based funds. For example, Sharia-compliant funds prohibit practices such as usury, speculation, or gambling.¹⁰

⁵ Stannard-Stockton, Sean. “Mission-Related Investing for Individuals.” Stanford Social Innovation Review. Jan. 20, 2009. http://www.ssireview.org/blog/entry/mission_related_investing_for_individuals.

⁶ Wolfe, Christopher. “Values-Based Investing Comes of Age.” Merrill Lynch Private Banking and Investment Group. August 2011. <http://www.pbmg.com/pwa/pages/values-based-investing-comes-of-age.aspx>.

⁷ Global Sustainable Investment Alliance. “Global Sustainable Investment Review 2012.” pg. 9. 2013. <http://gsiareview2012.gsi-alliance.org>.

⁸ Global Sustainable Investment Alliance. “Global Sustainable Investment Review 2012.” pg. 10. 2013.

⁹ KMPG. “European Responsible Investing Fund Survey.” pg. 8. May 2012.

<http://www.kpmg.com/LU/en/IssuesAndInsights/Articlespublications/Documents/European-Responsible-Investing-Fund-Survey-2013.pdf>.

¹⁰ KMPG. “European Responsible Investing Fund Survey.” pg. 42. May 2012.

- 2) **Positive screening:** investing in companies that have above-average or “best-in-class” ESG or CSR characteristics. A portfolio of positively screened SRI investments may be focused on a specific industry, sector (e.g. the environment) or may span a variety of sectors and industries.
- 3) **Shareholder activism:** using shareholder rights to influence a corporation to improve its practices and become more responsible. Shareholders can affect a company’s operations by electing directors with similar viewpoints, using proxy voting rights, shareholder lawsuits, or symbolically divesting from companies that do not change their policies. Environmental and social campaigns increasingly rely on shareholder status to change corporate behavior through private negotiations with management and by attracting publicity.

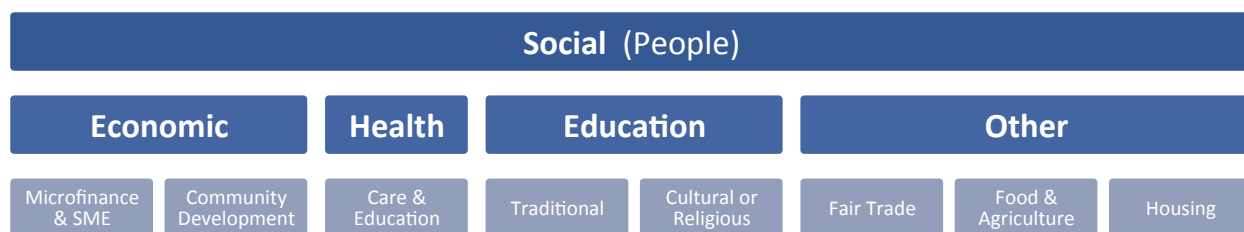
A report from the Global Sustainable Investment Alliance found that the most common SRI strategy is negative screening (US\$8.3 trillion in assets). This is followed by shareholder activism (US\$4.7 trillion) and positive screening (US\$1.0 trillion).¹¹

Impact Investing

Impact investment is the fastest-growing segment of responsible investing. As of year-end 2012, the global total was estimated at US\$89 billion.¹² This “do good” category of investing is projected to exceed US\$400 billion by 2020 in one J.P. Morgan study¹³ and US\$500 billion in another study by the Monitor Institute.¹⁴ While its growth outlook is promising, this asset class remains quite fragmented and even the term “impact investing” is not well defined within the responsible investing space.

Impact investing is a socially responsible investment where social and environmental impact is measured

Impact investments are those socially responsible investments that generate measurable social and environmental impact alongside a financial return. Impact investments can be made in one or many of the social or environmental sectors highlighted below, depending on the investor’s preferences.



¹¹ Global Sustainable Investment Alliance. “Global Sustainable Investment Review 2012.” pg. 11. 2013.

¹² Global Sustainable Investment Alliance. “Global Sustainable Investment Review 2012.” pg. 9. 2013.

¹³ O’Donohoe, Nick, Christina Leijonhufvud, and Yasemin Saltuk. “Impact Investments: An Emerging Asset Class.” J.P. Morgan. pg. 6. 29 November 2010. <http://www.rockefellerfoundation.org/uploads/files/2b053b2b-8feb-46ea-adbd-f89068d59785-impact.pdf>.

¹⁴ Freireich, Jessica, Katherine Fulton. “Investing for Social and Environmental Impact: A Design for Catalyzing an Emerging Industry.” Monitor Institute. pg. 5, 9. January 2009. http://www.monitorinstitute.com/downloads/what-we-think/impact-investing/Impact_Investing.pdf.

Environment (Planet)

- Climate Change & Renewable Energy
- Environmental & Ecological
- Carbon
- Sustainable Forestry
- Sustainable Water

The largest and one of the most well measured examples of impact investing is microfinance, a type of *economically-targeted investment*, which achieves competitive, risk-adjusted returns while assisting in the development of targeted economies.¹⁵ Microfinance has one of the longest impact investing track records dating back over three decades. Private, international assets under management in microfinance reached US\$8.5 billion by the end of 2012.¹⁶

Impact Investing Case Study: Microfinance

One of the leading examples of impact investing is microfinance. *Microfinance* is the provision of financial services such as credit, savings, insurance, and money transfers to millions of poor and low-income entrepreneurs primarily in developing countries. These services are used to support income-producing activities, build assets, stabilize consumption and protect against financial volatility. Microfinance institutions (MFIs) provide these financial services to those who are unserved or underserved. Increasingly the MFIs are funding themselves through microfinance investment vehicles (MIVs) – private entities that channel investor funding to MFIs.

Microfinance Investment Chain



Microfinance has a grass roots orientation that is ideally socially motivated and client-centered. At its best, microfinance gives people an opportunity to apply their ingenuity, create wealth and improve their livelihoods.

¹⁵ California Public Employees’ Retirement System. “Statement for Investment Policy for Economically Targeted Investment Program.” February 17, 2009. <http://www.calpers.ca.gov/eip-docs/investments/policies/shareowner/eco-target-inv-prg.pdf>.

¹⁶ MicroRate. “The State of Microfinance Investment 2013: MicroRate’s 8th Annual Survey and Analysis of MIVs.” November 2013.

Impact Investing Case Study: Microfinance (cont'd)

However, because of the driving need for sustainability and profitability, the industry experienced an increase in abuses and irresponsible practices. In response, the industry has reacted with a series of initiatives designed to encourage *responsible finance* and client protection. Industry efforts such as the PRI's Principles for Investors in Inclusive Finance, the Social Performance Task Force, MF Transparency, and the SMART Campaign were created to address and prevent these abuses.

The microfinance industry is by far the largest segment of international impact investing with microfinance and SME representing 85% of cross-border impact investing. Its lengthy track record provides investors with an example of how a key impact investment option has begun to self-correct to ensure specific and measurable social returns. This also shows how investors play a critical role in ensuring that corrections are made so that the asset class achieves its financial and social goals.

Clarity in Impact Investing

Contemporary societal trends are dictating a shift in investor outlook; making money and achieving social returns are no longer viewed as mutually exclusive. This bodes well for the responsible investment industry and impact investing in particular. The impact investing sector, while smaller than SRI, is growing much faster and is estimated to reach US\$400-500 billion in assets under management (AUM) by 2020. Yet this trend does not come without challenges.

The current supply of capital searching for impact investing opportunities exceeds the demand from those opportunities. But because the industry is highly fragmented, nuanced, and complex, it is challenging for investors to identify credible investment options let alone assess their suitability. A lack of objective information coupled with excess supply is a dangerous combination, as was made evident during the global financial crisis.

\$71 Trillion

Total global AUM¹

\$13.5 Trillion

Socially Responsible AUM²

\$89 Billion

Impact Investing AUM²

¹ TheCityUK, "Fund Management." pg.1. November 2012.
<http://www.thecityuk.com/assets/Uploads/Fund-Management-2012.pdf>.
² Global Sustainable Investment Review 2012

About MicroRate

MicroRate is the first microfinance rating agency dedicated to evaluating performance and risk in microfinance institutions (MFIs) and microfinance funds, also known as microfinance investment vehicles (MIVs). After 17 years of specializing in microfinance transparency, MicroRate is the most recognized organization of its kind. MicroRate has conducted over 750 ratings of more than 200 MFIs throughout Latin America, Africa, Europe, and Central Asia. MicroRate is a leading social rater and continues to be the premier MIV evaluator in the industry.

MicroRate offers investor services, market intelligence, and data on the microfinance and larger impact investing sectors. Using its proprietary PRSM™ methodology to analyze the financial performance, risk, social impact, and management team of each fund, MicroRate helps investors match their individual objectives with social investment opportunities by providing the tools to select, assess, and monitor Impact Investments. For more information on MicroRate's Investor Services, please contact Stephen Brown at stephen@microrate.com.

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