



FOCUS ON ESG, IMPACT INVESTING ALL PART OF HOLISTIC APPROACH FOR NORTHERN TRUST

BY COLIN RAJALA | JANUARY 26, 2017

Growing interest and demand from investors seeking strategies that contribute to social goals while supporting financial objectives has led Northern Trust Company to further develop its capabilities within the environmental, social and governance and impact investment arenas.

Northern Trust's Foundation and Institutional Advisors Group has been at the forefront of those developments as it works with foundation and endowment clients to construct portfolios, invest assets to achieve positive outcomes tied to their goals and missions and build out their grant making scope through impact investments.

In the group's role as an outsourced cio, it has seen growing demand and interest in environmental, social and governance investments and has developed and continues to build out its own proprietary products as well as multi-manager products, according to Emily Lawrence, ESG senior product specialist.

Lawrence was hired last year from MSCI to support the growth and development of ESG investing among the firm's foundation and institutional advisors group clients, as well as its private wealth and global family office clients.

"In the U.S., ESG assets under management grew 77% from 2012 through 2014 and another 33% from 2014 through 2016," Lawrence said, citing the most recent US SIF Foundation report on U.S. Sustainable, Responsible and Impact Investing Trends. "...For institutions that have dipped their toes into the water and started to implement strategies, Northern Trust can expand upon the already implemented strategies to help organizations understand how the ESG investments fit or how to move forward to find investments that make sense in their portfolios."

The firm, which has approximately \$55 billion in assets under management specifically related to its globally diverse set of ESG strategies, has found that many of the larger institutional investors have already defined how they want to approach ESG investing and the momentum in the space is shifting toward smaller foundations and endowments with help from constituents, staff or members of the board. With the smaller institutions looking to get involved in the space, Lawrence has found many of the institutions to be involved in

the "discovery phase," which has led herself and Northern Trust to focus on helping clients get the information they need to hone their objectives and scale their portfolios to determine the best way to begin investing with ESG factors in mind.

ON ESG MANAGER RESEARCH

When institutions are ready to begin implementing ESG investments into their portfolios, Lawrence advocates easing into allocations with one-to-two investments to see if they are a good fit and meet their goals. She has found that "it is easier to reevaluate how to expand ESG investing into other asset classes" after seeing it on a smaller scale within portfolios.

To ensure that Northern Trust has appropriate products to create a portfolio that meets clients' needs, the firm provides a rigorous assessment of managers' strategies in order to determine if the outside ESG products are going to work in concert with its proprietary products and previously vetted strategies with investment managers, she said.

In detailing the comprehensiveness of the firm's proprietary products, its Quality ESG strategy "marries an engineered equity approach with a best-in-class ESG analysis, with the idea being you'll find a happy marriage between companies that are rated well through Northern Trust's proprietary quality score and also score highly in a best-in-class ESG analysis," Lawrence said. The strategy

also has an overlay of removing tobacco and civilian firearms producers from a negative screen perspective, as well as a carbon footprint overlay, with the firm looking to identify “the best of both worlds with a high quality company that meets rigorous ESG standards.”

When reviewing external ESG products to include on its platform alongside its proprietary products, the firm seeks strategies that employ top-down and bottom-up approaches to integrating ESG, according to Lawrence.

“We see ESG analytics as a tool in the tool box for evaluating fund performance and risk/reward tradeoff,” Lawrence said. “In the end, our goal is to make sure we have a thoughtful manager research process that is going to drive solid portfolio construction targeting risk management that is best for our clients targeting their specific goals.”

She also noted that Northern Trust will look at third-party ESG ratings for background information to confirm that a product’s assessment is in line with the firm’s expectations.

Northern Trust’s manager research process is extensive, as all ESG products go through the same due diligence process as any other investment strategy as a baseline to determine if it’s a strong fit for its platform, according to Lawrence.

The strategies are assessed by the firm’s multi-manager team, which has extensive experience vetting externally-managed products and could be considered by some as a “pioneer in the space,” Lawrence said. She noted that the multi-manager team, which is led by Senior V.P. and CIO Chris Vella, includes ESG specialists who periodically review what products are available in the space and what specific needs investors are focusing on.

The firm also has an ESG council, which includes Lawrence, and is comprised of members of different parts of the organization that guide and advise the firm’s investment professionals through the development of proprietary products and enforcement of externally-managed products.

Products are also reviewed by Northern Trust’s investment advisory committee, which is comprised of key members of the firm’s wealth management leadership, including Senior Portfolio Manager

John Massey, who primarily serves the firm’s foundation and institutional advisory group clients. The committee helps determine if the product meets the firm’s stand-alone requirements and is also in line with its broader motivation to bring clients an optimal blend of investment products.

When it comes to assessing the ESG strategies, the firm employs a number of qualitative and quantitative factors, with particular attention being paid to the third party firm’s business model, investment process, operational risk, internal controls, performance, retention

rate and experience, Lawrence said.

“There are some more nuanced elements in our screening of ESG managers and strategies as we seek to understand the depth and breadth of the ESG factors being integrated into a given strategy, including its decision making, to determine how disciplined and repeatable the ESG processes are,” Lawrence said. “We hold a number of interviews and take a deep dive beyond the initial interviews, including on-site visits and frequent interviews to understand the products. We

pay close attention to a strategy’s results to confirm that they are in line with our expectations based off the holdings of said strategy.”

One of the key components to making the firm’s list of approved products is “demonstrating not only strength of the discipline of investment process, the risk control process and the strength of team and business model, but having strong integration of ESG issues that show the ESG process is just as robust and disciplined,” Lawrence said.

ON PROVIDING HOLISTIC SOLUTIONS

Beyond the foundation and institutional advisors group providing outsourced investment management and investment consultant services, the firm offers customized holistic solutions to clients that look to reduce the time and resources spent on aspects of the organization that are not core to their missions. Those solutions, aimed at areas lacking the most resources, include philanthropic advice, planned giving, valuing special assets and impact investments.

“Nonprofits are constantly facing the reality of doing more with less, which means a staff wearing different hats and feeling pressure to increase efficiency,” said Darius Gill, national practice executive of the foundation and institutional advisors group. “Nonprofits are well-intentioned, but their staffs are often stretched too thin. We can fill in the blanks for the resource-constrained and provide institutional memory when boards and committees turn over.”

The firm’s philanthropy advice includes working with board members, committee members and staff on best practices in fulfilling their fiduciary role in the areas of governance, education and donor cultivation and support, while planned giving encompasses gift administration, trustee services and charitable tax services.

Gill noted that beyond aligning investments and assets with an organization’s mission, the firm has expertise in valuing special assets when donors gift anything from oil and gas rights to real estate and farmland. Gill finds that not many nonprofits are accustomed to this type of scenario, but should be open to it as the assets can be monetized for maximum value with the firm handling the oil and gas rights or managing the property to ensure they retain their value over time.



Darius Gill



Emily Lawrence

“Our holistic approach helps nonprofits be as efficient as possible,” Gill said. “We take a look at everything from the organization’s entire operations and how its mission is articulated to how the mission is tied to the investment policy statement and how the investments are in sync and reflect the mission.”

ON IMPACT INVESTING

Another area Northern Trust provides solutions in is the impact investing arena, which is relatively new to the nonprofit space, but an area where the firm has seen increased interest. The firm feels it is poised to leverage more than 20 years of experience in its community development activities, which has provided innovative capital structures and solutions to clients, according to Gill.

“Impact investing strikes a balance between philanthropy and for-profit investment because investors now understand that they do not have to be mutually exclusive,” Gill said. “Previously, investors sought to make as much money as possible investing to increase the amount they could give away, but now aligning investments with their mission is quite doable.”

Northern Trust uses a “but for” test to determine if an investment falls under its criteria for an impact investment, according to Gill, who gave the example of “but for new housing, but for a new drug program or but for a new recycling initiative, the impact or result would not have happened.”

The “but for” test is designed to question the notion that without a particular investment, would the societal or environmental outcome have still been realized.

The firm finds that it sees most opportunities in the impact investment space with institutions between \$10 million and \$300 million in assets, but has gone below and above those thresholds to work with clients, Gill said.

For foundations and endowments looking to tie their investments to their mission, institutions need to have a “meeting of the minds” among operational staff, investment staff and the board, according to Gill.

Those meetings give constituents an opportunity to iron out their goals and strike a balance between current and future needs, according to Gill, who said he has found it difficult for institutions to balance staff trying to create an immediate impact in the community where they live or work and the organization’s governing boards being more mindful

of creating multi-generational equity.

“There is no right or wrong way with impact investing. We show nonprofits how we’ve done it different ways by giving them blueprints and examples of our stories, and then we work from there,” Gill said. “What’s most important is not how we label or define the program, but rather that it moves a nonprofit’s investments in sync with its mission or values.”

Deborah Kasemeyer, senior v.p. and director of community development and investments at Northern Trust, suggests that foundations and endowments look at their community over time to identify specific issues they can solve. The firm assists clients in this area through a “community scan” where it looks at the demographics across the community. From there, the firm and nonprofit work together to overlay the demographic data on other important statistics from the community to identify “hotspots” that may be tied to community development issues such as substandard housing or unemployment.

Before the organization moves further into the process of creating an impact strategy, Kasemeyer has found it is beneficial to be specific in defining the intended impact to track over time to ensure all parties involved understand the impact investment’s risks, successes and failures.

The firm has implemented impact investments through Community Development Financial Institutions (CDFIs), direct investments in nonprofits or through newer structures such as Pay for Success transactions, also known as social impact bonds, according to Kasemeyer.

“Being an early adopter in community investment tools, we are able to use our expertise to help clients build a program that gives their boards and committees comfort in knowing that they have a good process in place,” Kasemeyer said, noting that the firm deploys its own capital as it looks for impact investments to be sustainable and create positive change over time.

She sees CDFIs as a great avenue for investors to make real impacts within their communities because the private financial institutions aggregate capital and deploy it by making loans such as mortgages, small business loans and nonprofit real estate loans. She noted that Northern Trust has been investing in CDFIs for more than 20 years as part of its community development activities and has seen “very strong results with very limited losses and significant positive impact.”

Social impact bonds are a newer impact strategy being used throughout the country, with only 11 having been created as of the end of 2016, Kasemeyer said. Northern Trust has been an investor in two of the bonds and anticipates closing on two more in the near future.

The most recent social impact bond saw Northern Trust act as an investor and partner with the City of Denver to create a funding source for a preventive program for the chronically homeless.

Working with the Colorado Coalition for the Homeless and the Mental Health Center of Denver, the city contracted for the delivery of housing and “wraparound social services.” Northern Trust and other investors front funded the cost of the services with the idea of being paid back by the city if the impact levels in the contract were met. Those impact levels include housing stability outcomes where every day of housing maintained by an individual over a specific threshold



Deborah Kasemeyer

created a repayment of the investment, according to Kasemeyer.

“Social impact bonds...allow us to participate in financial solutions to complex problems,” Kasemeyer said.

As financial institutions and nonprofits move further into impact investments via avenues like social impact bonds, challenges still surround quantifying the impact of the investments, according to Kasemeyer. There has been efforts in the standardization of identifying the impact via groups such as the Global Impact Investing Network, but it is too soon to tell if the standardization will be successful, according to Kasemeyer.

She finds that at this point, nothing beats being “very clear in defining what specific impact we are trying to make,” whether it is job creation, improved wage benefits or women- and minority-owned business support at the start of the investment. Beyond making a clear definition for the impact, the participating organizations that are partnering or investing in the initiative need to sign off that they have the same understanding of the programs' definitions, according to Kasemeyer.

The firm does not currently utilize other investment managers or products within their impact investing plans, Gill said. The main issue the firm has found with external managers is that their products labeled as “impact” are not necessarily creating any new impact or have not been able to properly quantify the impact that occurred.

Lawrence finds that impact investing, to date, has been considered by foundations and endowments as an alternative to grant mak-

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ing activities rather than a new investment strategy. She noted that the firm continuously assesses investment opportunities and as clients grow in their impact investing activities, it may eventually be something to consider as part of the investment portfolio construction process.

“I don't think that impact investing and portfolio construction are necessarily mutually exclusive,” Lawrence said. “We are focused on continuous improvement and being on the forefront of innovative and interesting investment ideas. As the space evolves and impact investing strategies and products become more prevalent, we will assess the opportunities.”