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SOCIAL INVESTING

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CONTENTS

Abstract 1

Introduction 4

Social Investing Defined 4

Determining Social Return Issues 5

Social Return Objectives 7

Social Investment Strategies Defined 8

Implications of Strategies for Achieving Social Return Goals 9

The Monetary Performance Question 12

Setting Holistic Performance Expectations and Measurement 15

Alternative Approaches to Achieving Social Investment Goals 18

Evaluating Social Investment Program Execution 18

Fiduciary and Tax Considerations 20

Determining the Locus of Responsibility for Social Investment Programs 20

Conclusion 21

Appendices

A Incorporating Broad-Based Social Return Issues into Investment Policy: An Example 23

B Fiduciary and Tax Implications 25

ABSTRACT

1. At the end of the day, it is reasonable to argue that a nonprofit endowed institution's ultimate purpose is to maximize its generation of *social* returns to the extent possible given its broader societal obligations (legal/regulatory, moral, etc.). The *monetary* returns that these institutions derive from their investments are simply a means to these ultimately social ends. However, the role *social investing* can play in helping an institution realize its ultimate objectives is an open question. This paper provides a construct for addressing the key theoretical and fiduciary questions investors must resolve as they decide whether to engage in social investing, and how they might go about doing so.

2. *If* the practice of social investing comes at some monetary cost, the key question then becomes whether the incremental social returns derived from incurring that cost outweigh the social returns that would otherwise have been generated from simply *spending* the greater monetary returns earned through "traditional" investments. Consequently, it is imperative for investors to be clear about (1) the incremental social returns they hope to generate from their social investment programs, (2) the probability that their social investments will actually generate those returns, and (3) the value of those returns relative to other institutional goals that may consequently be impaired. Given the wide range of issues, objectives, and strategies social investors might employ, it is very difficult to make blanket statements about the expected monetary performance of social investing. Each approach must be evaluated on its own merits.

3. We define social investors as investors who intend to generate both monetary and "social" returns (broadly defined) from their investments. Thus, for the social investor, the social return becomes an end in itself, whereas the traditional investor either does not consider an investment's social returns, or considers them only as a means to a pecuniary end. Because social investors view social returns as an independent component of the "holistic" total return equation for their investments (e.g., Social Return + Monetary Return = Holistic Total Return), they will theoretically engage in a particular investment if that investment's combined expected social and monetary return value is at least equal to the expected holistic total return value of a traditional investment.

4. An institution's choice of the social return issues it wishes to address through its investment program may address only those issues that pertain specifically to the organization's mission, or address social issues that are broader in scope. While it may be easier to implement and justify a mission-specific approach to selecting social return issues, a broader-based approach is not uncommon.

5. It is as important for an institution to determine and prioritize its social return *objectives* as it is to select social return *issues*, because defining objectives will help determine the institution's social investment strategy and holistic social investment performance measurement.

6. The social investment strategies used to realize the investor's social return objectives fall into two broad categories: security selection and shareholder advocacy. Security selection includes three sub-strategies: avoidance screening, qualitative screening, and proactive investments, the last of which includes the

special case of program-related investments. Shareholder advocacy includes proxy voting, filing of shareholder proposals, and other forms of dialogue.

7. If an institution's social return goal is to achieve consistency between investments and moral or aesthetic preferences, security selection is ostensibly a more appropriate choice than shareholder advocacy, since security selection enables the investor to avoid profiting from the disagreeable practices of certain security issuers. However, consistency can be difficult to attain through security selection, given both the moral complexity of security issuer behavior and the possible monetary costs of imposing certain screens.

8. If an institution's social return goal is to achieve change, both security selection and shareholder advocacy can be effective, though security selection is most effective if coupled with publicity. The relative efficacy of either approach will be dependent on a variety of factors, including the availability of substitute investments and the amount of "voice" that an institution can bring to bear. It is also possible that using security selection and shareholder advocacy in concert might be a useful approach to achieving change.

9. One potentially useful way of assessing the likely monetary performance impact of a social investment program is to consider whether a social investor's social return objectives attempt to address a market failure or a market opportunity. Theoretically, "free" markets should generate positive social returns (i.e., public benefits) as a result of market actors pursuing their own private interests, thus structurally embedding "social concern" into the market fabric. However, in the case of market failures, the pursuit of private interests results in public detriment. In some cases, social investors may generate social returns and competitive risk-adjusted monetary returns by exploiting market opportunities that had previously been overlooked due to a lack of entrepreneurial creativity. However, social investors attempting to address market failures will likely not maximize their own risk-adjusted monetary profits through such efforts until (and unless) those failures are addressed.

10. Implementation challenges will also impact monetary performance. Key factors to consider include:
    - The availability of willing, talented managers;
    - The impact of the social investment program on portfolio diversification;
    - Potentially greater social investment-related fees; and
    - Additional time spent on addressing social investment issues that may divert attention away from other portfolio management considerations.

11. Because social investors consider social returns as having "intrinsic value," one theoretical approach to setting social investment performance expectations would be to assign a monetary figure to the value of those social returns. To do this, the social investor would need to consider how much it would be willing to spend to achieve the social return goal that it is attempting to realize through its investments. Then, in order to deduce the minimum expected return required for an investor to be indifferent between achieving the goal through programmatic spending or through a social investment, the institution would

deduct its social return spending budget from the expected return on a traditional investment that it would have otherwise made.

12. Prospective social investors should, of course, consider whether there are more efficient means of achieving social return goals that either generate greater social returns per unit of cost or less cost per unit of social return. For instance, social investors who are motivated to address a market failure through their investment activity may wish to consider whether there are other means of repairing the market failure that might make traditional investment activity more consistent with their social return goals.

13. When evaluating the monetary returns of their social investment programs, institutions should assess the performance of the portfolio against both traditional benchmarks and benchmarks adjusted for the more limited opportunity set that is actually available to the social investment money manager.

14. Institutions should also monitor and evaluate the social returns generated by their social investment programs, which can range from the insignificant to the dramatic.

15. Membership selection for the oversight body charged with establishing and implementing an institution's social investment program should be primarily based on both the authority and competency of candidates. Membership should therefore be interdisciplinary in order to bring to bear the qualities necessary for calculating the holistic net benefit of the social investment program.

16. Based on Cambridge's research, it appears that both the Uniform Prudent Management of Institutional Fund Act (UPMIFA) and the Uniform Management of Institutional Funds Act provide institutions with flexibility to take program considerations into account when making investment decisions. In addition, social investments appear unlikely to run afoul of Internal Revenue Service (IRS) provisions that restrict political campaign activities and lobbying. The IRS's "jeopardizing investment" provisions are less clear, though in practice this tax code does not appear to have been invoked to tax social investments to date. Finally, it is worth noting that program-related investments, which are made primarily to advance an organization's mission, are given privileged fiduciary status by UPMIFA and the IRS. However, please note the important caveat that our comments should not be construed as either legal or tax advice. Our members should consult with their legal counsel or tax professionals for more definitive guidance.

Introduction

At the end of the day, it is reasonable to argue that a nonprofit endowed institution's ultimate purpose is to maximize its generation of *social* returns to the extent possible given its broader societal obligations (legal/regulatory, moral, etc.). These social returns will largely be defined by the institution's specific mission (e.g., educational excellence, health and social welfare improvement, etc.) The *monetary* returns that these institutions derive from their investments are simply a means to these ultimately social ends. However, the role *social investing*[1] can play in helping an institution realize its ultimate objectives is an open question.[2]

This paper attempts to provide a framework for institutions to think about whether and how social investing might contribute to their institutional objectives by focusing primarily on the critical *theoretical* questions they must resolve as they consider embarking on this path. In our view, those questions are:

- What is social investing?
- What are the social return *issues* the institution seeks to address?
- What are the social return *objectives* the institution hopes to accomplish?
- What social investment *strategies* are best suited to meet the institution's social return objectives?
- How should an institution assess the likely *performance impact* of incorporating social return issues, objectives, and strategies into its investment decision-making process?
- How should an institution set and measure its *holistic performance expectations* for its social investment program?
- What *other means* might be used to achieve the same social goals?
- How should the *execution* of social investment programs be evaluated?
- What are the *fiduciary and tax implications* of the institution's social investment approach?
- *Who* should set social investment policy and oversee its implementation?

It is important to note that this paper does not address specific social return issues (e.g., climate change). Instead it is intended to provide a broader lens through which to evaluate various approaches to social investing, regardless of the issues a particular investor hopes to address.

Social Investing Defined

In our view, social investing is an approach through which the investor *intentionally* seeks to generate monetary returns for itself *as well as social returns* for either the investor or other parties. The phrase "social returns" is meant to be broad in scope, encompassing economic, environmental, political, moral, religious, health, and/or sociological effects.

[1] The term social investing is herein used to encompass all variants, including socially responsible investing, ethical investing, sustainable investing, and mission-related investing.
[2] While this paper focuses specifically on nonprofit endowed institutions, much of its theoretical framework could be applied to families and other investor categories.

In our definition we highlight the word "intentionally" to acknowledge that while *all investments*—traditional and social—generate both monetary *and* social returns, social investors seek either to generate or avoid these social returns *as ends in themselves*, while also seeking monetary remuneration. Consequently, the social investor is concerned with the "holistic" total return of an investment, which can be defined as follows:

Social Return + Monetary Return = Holistic Total Investment Return

An important implication of this calculation is that the social investor would be willing—but not necessarily *required*—to accept lower risk-adjusted monetary returns than it would have otherwise received from another more "traditional" investment *if it believed the holistic return of the social investment was greater than the holistic return of the traditional investment*.[3]

Determining Social Return Issues

A key challenge for prospective social investors is to determine which social return issues they wish to address. The choice of social return issues centers on two factors:

1. The institution's sense of mission and/or its sense of responsibility to broader social imperatives; and

2. The potential impact on monetary performance of addressing these social issues through its investments.

Later in the paper we speak extensively about the relationship between social issues and monetary performance. For now it is simply worth noting that an institution's willingness to address a social return issue through its investments will clearly diminish to the extent that monetary investment performance is likely to suffer as a result.

As for the relationship of social return issues to the institution's sense of mission and/or responsibility, one of the chief considerations is whether to focus on either a mission-specific or broader-based array of issues. In the paragraphs that follow we explore the pros and cons of both approaches.

[3] We are using the terms "social investment" and "traditional investment" rather loosely here. In our view, as we note at the outset, the key distinction between social and traditional investments is the intention of the investor, and not any intrinsic characteristic of the investment itself. Indeed, both traditional and social investments generate social returns. Thus, it is perhaps more accurate to speak of "social investors" and "social investing" rather than of "social investments." However, since, in our experience, social investors often tend to differentiate between investments whose sole purpose is to generate monetary returns (i.e., traditional investments), and investments that have both social and monetary return objectives (social investments), it is less cumbersome to employ the terms "traditional investments" and "social investments" on occasion, as we do throughout the paper.

Mission-Specific Issues

One approach would be for an institution to focus solely on social return issues intimately tied to the purpose of the institution and/or its underlying endowed fund(s). For instance, an organization that promotes animal welfare may seek investments that it believes further, or do not conflict with,[4] its mission by adopting policies that address such issues as animal testing, factory farming, fur clothing, etc.

There are several benefits to a mission-specific approach:

- *Focus*: The narrow focus of such an approach will help prevent an institution from being distracted by the myriad other social return issues that might otherwise command its attention, thereby making this approach potentially easier to implement and evaluate.

- *Regulatory Defensibility*: Because mission-focused social return issues are more *overtly* linked to an organization's purpose, they may be easier to defend from a fiduciary and tax standpoint given the Uniform Prudent Management of Institutional Fund Act's (UPMIFA) requirement that institutions "shall consider the charitable purposes of the institution and the purposes of the institutional fund"[5] and, for private foundations, the IRS's prohibitions against investments that "jeopardize the carrying out of any of [the foundation's] exempt purposes."[6,7]

- *Organizational Comprehensibility*: Social investment decisions based on mission-specific issues may be easier to communicate and justify to an institution's board members and constituents, and easier to sustain as these parties change.

On the other hand, the narrow scope of such a values framework circumscribes the breadth of social return benefits that could result from a more broad-based issues framework.

Broad-Based Issues

An institution could address a more broad-based set of social return issues through its social investment policies and programs. For instance, a religious social welfare organization might incorporate the fullness of religious institutional values into its investment criteria. Secular organizations whose specific missions are not easily transferable into investment policy may nevertheless also include criteria related to the themes of social justice or corporate governance. While addressing a broad-based set of issues has the

[4] Incorporating values that are *aligned* with an institution's mission can be different from incorporating values that *further* an institution's mission. For instance, if values alignment impedes the portfolio's returns, then it may impede the institution's ability to maximize its overall efficacy in advancing its mission.
[5] UPMIFA, Section 3.a.
[6] Internal Revenue Code (IRC) 4944(a)(1). See text at: http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00004944----000-.html.
[7] A brief overview of the fiduciary and tax implications of social investing occurs later in the main body of this paper. For an extended treatment of the subject, please see Appendix B.

potential to generate a wider range of social return benefits, it is also arguably a more challenging exercise than the mission-specific approach for the following reasons:

- *Requires Establishment of Organizing Principles*: If an institution does not tie its social return issue coverage to the relatively narrow dictates of an organization's mission, it becomes difficult to determine how to arbitrate between the plethora of social return issues that may present themselves. A remedy for this malady would be to establish a set of organizing principles from which the various social return issues derive. This task is no small challenge for organizations whose members voluntarily come together to support the institution's main objectives, may or may not be aligned with more auxiliary goals, and will change over time.

- *Regulatory Implications*: In light of the "charitable/exempt purpose" language of the UPMIFA and Internal Revenue codes cited above, the less overtly tied a social investment program is to an organization's specific purpose, the more complicated is the defense of the incorporation of social return issues into the investment decision-making process.

- *More Complex Decision-Making Process*: By addressing a broader array of issues through its social investment programs, an institution faces a more complex decision-making process as it will need to weigh numerous, sometimes competing social and monetary return objectives. Such complexity can hinder execution and render monetary *and social* performance measurement more difficult.

While a broad-based approach is likely to be more difficult, it is not impossible and, in our experience, is relatively common. In Appendix A we summarize one such policy, developed by faculty members of Yale University and Pennsylvania State University in 1972 and articulated in their book, *The Ethical Investor: Universities and Corporate Responsibility*.[8]

Social Return Objectives

In addition to determining the *issues* to be addressed through their social investment programs, institutions must also determine their social return *objectives*. We summarize possible social objectives, none of which is mutually exclusive:

- *Consistency*: Institutions may wish to emphasize investments that are consistent with their moral or aesthetic preferences while avoiding those that are not. The desire for consistent portfolios may not necessarily coincide with a desire to change the behavior of corporations or other agents.

- *Change*: Institutions may wish to use their leverage as investors to influence the behavior of corporations, governments, or other constituencies to bring about certain social outcomes.

[8] John G. Simon, Charles W. Powers, and Jon P. Gunnemann, *The Ethical Investor: Universities and Corporate Responsibility,* Yale University Press, 1972.

- *Responsiveness to Constituent Concerns*: Institutions may seek to address their constituents' concerns about the social ramifications of their investments. These constituencies often encourage their investment staffs to pursue consistency or change through their investment programs.

Social investors may, of course, entertain multiple social return objectives. In our view it may be helpful for these investors to prioritize them in order to facilitate social investment strategy decisions. For instance, some investors might prioritize the social return objective of "change," but settle for "consistency" if change proves to be impossible.[9] Others might prioritize "consistency," but push for "change" if they have no other viable option but to invest with firms they otherwise would prefer to avoid, and/or if change seems relatively easy to achieve.

In our experience, it can be tempting for social investors to simply define the social return *issues* they seek to address through their investment programs without clearly articulating the social *returns* they hope to achieve. However, we view objective setting as critical, as it helps to determine the social investment strategies an institution might use to achieve those objectives, and it facilitates an institution's evaluation of whether it achieved its objectives.

Social Investment Strategies Defined

General Overview

Social investors generally employ one or both of two primary strategies—security selection and shareholder advocacy—for generating social returns through their investment programs.

Security Selection: The selection of managers and/or securities based on their consistency with an institution's social objectives. Substrategies include:

- *Avoidance Screening*: A security selection process characterized by the absolute avoidance of a security because of certain characteristics of the security issuer[10] (e.g., its sale of tobacco), regardless of the issuer's other more positive qualities.

- *Qualitative Screening*: A security selection process influenced by the institution's assessment of the security issuer's alignment with the institution's social objectives. Some issuer characteristics may be favored while others may be frowned upon; however, there are no absolute thresholds that predetermine inclusion or exclusion.

[9] This is, in fact, the approach recommended by the authors of *The Ethical Investor*. See Simon, pp. 173f.
[10] Throughout the paper, we have generally used the cumbersome term "security issuer" instead of the more straightforward terms "company" or "corporation" to recognize that securities may be issued by governments and nonprofit institutions as well as corporations.

- *Proactive Investments*: A variant of qualitative screening, this approach proactively seeks to carve out an allocation to investments that advance the program objectives of the institution. For instance, environmental organizations might invest a relatively large portion of their inflation hedging allocation in renewable energy investments in order to be consistent with their missions. Program-related investments (PRIs), which we describe briefly in the subsection that immediately follows and at much greater length in Appendix B, are a particularly important subset of proactive investments.[11,12]

Shareholder Advocacy: The use of one's leverage as a security holder to influence, or call public attention to, the behavior of the security issuer. Substrategies include:

- *Proxy Voting*: Voting proxies in a manner consistent with the institution's social return objectives.

- *Shareholder Proposals*: Filing shareholder resolutions with companies, at least in part to advance the institution's social return objectives.

- *Other Dialogue*: Letter writing or other dialogue intended to encourage companies (or other parties) to act in a manner consistent with the institution's social return objectives.

Program-Related Investments—A Special Case

PRIs are investments made *primarily* to advance an organization's mission rather than to generate income and capital appreciation. PRIs might best be thought of as a form of program *spending* that may nevertheless earn investment income. PRIs are given privileged fiduciary status by the UPMIFA, and, for private foundations, privileged tax status by the Internal Revenue Service (IRS) under IRC 4944(c), though the technical definition of PRI differs slightly between UPMIFA and the IRS.

Implications of Strategies for Achieving Social Return Goals

Social investment strategies should be chosen based on their ability to generate the intended social returns while also delivering an acceptable level of monetary return. This section explores the theoretical advantages and disadvantages of using the broad strategy categories of security selection and/or shareholder advocacy for achieving an institution's *social return* objectives.

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[11] Our definition of "proactive investments" was directly inspired by the Foundation Strategy Group's (FSG) term "proactive social investments." See: Mark Kramer and Sarah Cooch, *Investing for Impact: Managing and Measuring Proactive Social Investments*, January 2006, pp. 12ff.

[12] A "best in class" approach, through which investors do not exclude any business lines, but instead select the "best" companies from each industry, is another popular and related variant of qualitative screening.

Strategy Implications for Achieving "Consistency" Objective

Investors that primarily seek to invest only in those securities that are consistent with their values, and are less concerned about changing the behavior of security issuers, are *theoretically* better served by using security selection to implement their social investment objectives. Shareholder advocacy appears less attractive because it requires holding the securities of issuers whose behavior is disagreeable.

However, in practice, "consistency" can be a very difficult ideal to attain for two reasons. First, it can often be difficult to draw sharp lines between security issuers that pass or fail an investor's screening criteria. As a result, rather than simply committing to the goal of consistency, investors instead must decide *how* consistent they wish to be in the midst of a morally gray world. Second, the achievement of the social return objective of consistency could come at such a monetary cost to other institutional objectives that it might actually be better to pursue consistency through attempting *to change* the behavior of security issuers in order to make them consistent with institutional values, despite the potential values conflict that results from owning their stocks or bonds.

Strategy Implications for Achieving "Change" Objective

Security selection and shareholder advocacy could both theoretically be useful in changing the behavior of security issuers or other agents (e.g., governments in Sudan or Apartheid-era South Africa). Achieving the "change" objective would be dependent on the following factors:

- The investor's ability to make the management of security issuers aware of a socially beneficial *and yet profitable* (and/or reputation building) opportunity management would otherwise have overlooked.

- The investor's ability to raise public awareness in such a way as to alter the economic or regulatory environment in a manner that favors adoption of preferred behaviors.

- Through security selection, as distinguished from shareholder advocacy, the investor's ability to raise or lower the cost of capital for security issuers by impacting supply and demand dynamics in capital markets.

With respect to the first two points, **security selection must be coupled with publicity to be an effective agent of change.** If the social investor does not communicate the rationale for its investment decision to the security issuer, the media, or the general public, the decision by itself will send a virtually meaningless signal to the market, thereby having almost no social effect.

Since both approaches could theoretically be successful in prompting change, which one is best? The answer depends on each institution and each social return issue, and will be in large part a function of the leverage a particular institution can bring to bear using either strategy. Factors to consider include:

- Availability of substitute investments—if they are available, it may be easier to voice one's disapproval by investing in the competitor *and letting the rejected rival know the reason for that decision.*

- Availability of quality investment managers that can implement either strategy, or the institution's access to separate accounts through which it can set its own social investment parameters.

- Amount of "voice" the institution can bring to bear, either with respect to:
    - the size of its stake in the security issuer,
    - the issuer's corporate governance arrangement, and/or
    - the investor's ability to influence the opinions of the larger society, which would thereby put pressure on the issuer to conform to the investor's wishes.

- Availability of substitute capital for the security issuer.
    - For PRIs, by supplying capital either on favorable terms, or that otherwise would not be available, investors may enable target organizations to generate social returns that would otherwise have gone unrealized.
    - With respect to more traditional security issuers, their desire for a particular institution's investment (either for purely financial needs, or for more qualitative reasons like partnership building and/or reputation management) will clearly be a factor in determining the issuers' sensitivity to the investor's wishes.

- Degree to which an institution believes that exiting a security might actually exacerbate the issuer's deterioration from a social return perspective.

It is also conceivable that some combination of security selection and shareholder advocacy may be advisable to create change, since the efficacy of advocacy is arguably strengthened by the carrot-and-stick of security selection.[13]

It is important to note that the *monetary performance* of any given social investment strategy can impact the investor's ability to achieve change. Indeed, if an investor's social investments perform poorly relative to traditional benchmarks, the investor will be less likely to draw reinforcement from other social or traditional investors who might otherwise join in making these investments. Poor performance is also more likely to draw internal or external opposition to the investor's social investment program from constituents who are concerned about its financial impact, thereby threatening the program's long-term viability.

[13] This discussion of the relative advantages of security selection versus shareholder advocacy was heavily influenced by Albert Hirschman's book, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States*, Harvard University Press, 1970.

The Monetary Performance Question

As the foregoing discussion has demonstrated, there are a wide range of approaches social investors might use depending on the social return issues they wish to address, the social return objectives they hope to achieve, and the strategies they ultimately employ. This variety makes it exceedingly difficult to make blanket statements about the monetary performance of social investing, and renders past performance studies of limited use as a guide for future return expectations. Consequently, the investor must examine the monetary return implications of each social return issue and strategy on a case-by-case basis. This section examines the factors that influence the monetary performance of social investment programs with respect to both (1) the particular social issues addressed and (2) the challenges that arise from program implementation (e.g., manager selection, diversification, etc.).

Social Issues and Monetary Performance: A Political Economic Theory Perspective

At the start of this paper we observed that all investments help to generate both monetary *and* social returns, whether or not the investor intended to generate those social returns. In fact, to take that observation one step further, the sanctioning of free market systems rests on the very hope and expectation, expressed eloquently by Adam Smith's "invisible hand" metaphor, that the social returns generated from an investor's investments *will be generally positive despite investor intent*. Indeed, under ideal market conditions, investments would not be profitable *unless* their social returns were proportionately positive, thereby aligning private interests with public interests.

These expectations rest on the assumption that the transactions that occur in free markets are truly "free," which is to say that they are purely voluntary and free from coercion in all its forms.[14] Thus, all transactions in the web of relationships that support an investor's investments—between capital supplier and capital user, employer and laborer, merchant and consumer—would be entered into because they are mutually beneficial to each party that agreed to the transaction, *thus generating wealth for all involved.* In addition, parties that did not choose to participate in a given transaction neither paid any of its associated costs, nor received any of its associated benefits. In other words, transactions do not generate (material) *externalities*.

In such an idealized system, an investor's concern for the social returns generated by its investment—unless those social returns only accrue to the investor—becomes redundant to the "structural concern" that has already been designed into the system. Indeed, one would not only expect that social returns would be positively correlated with monetary returns—as many social investment advocates argue—but that the focused pursuit of maximum profitability would itself be the driving force behind the generation

[14] We are distinguishing here between a "free" market and an "unregulated" market, the latter of which is often mistaken for the former. A "free" market is not necessarily unregulated because governments retain ultimate responsibility for providing market oversight—essentially to prevent coercion—as well as "necessary" public goods that otherwise could not be provided profitably, such as military and police protection.

of positive social returns in private markets.[15] **Thus, to the extent that the market functions properly, there should generally be no conflict between social returns and monetary returns.**[16]

Of course, market systems can only approximate their theoretical ideals. With respect to free markets, failure to attain the ideal could come from two sources. First, market actors may fail to act in their economic self interest, either because they are unaware of how to maximize it, or if they are aware, they are behaving "irrationally" with respect to it.[17] Second, there may be an actual structural failure, likely caused by a government's inability or refusal to provide "adequate" *regulation*, or regulatory *enforcement*, to prevent coercion and/or material negative externalities.[18]

With regard to the second type of failure—structural market failure—the end result for markets is that the correlation between profitability and positive social returns weakens or becomes negative. In other words, it pays (more) to do harm.

Many social investors seek to address both market scenarios, i.e., the first in which investments with desirable social returns are positively correlated with monetary returns but may have been overlooked due to a failure of ingenuity and/or foresight,[19] and the second in which an actual structural failure creates a perverse incentive for businesses to operate in a manner that generates sub-optimal social returns.[20] **Consequently, whether or not a given social return issue will translate into a relatively profitable investment opportunity for the social investor depends on whether the issue is indicative of a market opportunity or a market failure.**[21] If these issues point to market opportunities, then the investor can hope for alignment between its social return objectives and its monetary interests. If the issues point to market

[15] Milton Friedman famously made this case in his aptly titled *New York Times Magazine* article, "The Social Responsibility of Business is to Increase Its Profits," 1970.
[16] For the sake of simplicity, we are bracketing the very real possibility that one investor's definition of a social return will differ markedly from another's and from that of society in general for that matter.
[17] This observation is influenced by Albert Hirschman's description of the distinction between "taut" and "slack" economies, as discussed on p. 9.
[18] We put the term "adequate" in quotes because there are obviously great differences of opinion with regard to the specific details of a government's proper role. These differences are particularly pronounced within the context of global trade and investments, as the political economies of a given country's trading partners may be the products of vastly different underlying worldviews. Consequently, a "market failure" through the eyes of the citizens of one country may be an "adequate" market structure to the citizens of another.
[19] I am indebted to C.K. Prahalad for the notion that it may be a failure of creativity and innovation that may prevent critical social needs from being met profitably. Throughout his book *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits* (Wharton School Publishing, 2006), Prahalad argues that it is this failure that, for instance, often prevents corporations from profitably selling to the poor in third world countries, and he goes on to cite examples of novel solutions to building these underserved markets. See, for instance, p. 4.
[20] For instance, the government sanctioning of slavery during this country's early history provides an obvious example of a structural market failure. Many argue today that the ecological costs of burning carbon are not adequately reflected in the price of fossil fuels, which would also imply a market failure.
[21] The usefulness of differentiating between market failures and opportunities is also explored in the FSG's *Investing for Impact* paper (cited earlier). FSG's paper explores why traditional investors may have overlooked investments of interest to social investors, focusing on how proactive social investments can serve as a testing ground for identifying and exploiting "market gaps." See Kramer and Cooch, p. 18.

failures, they should expect to lose money (in relative terms) in their pursuit of their social return objectives—or at least until (and unless) the structural market failure is corrected.[22]

Implementation Factors that Influence Monetary Performance

The relationship between the social return issue being addressed and the dynamics of the political economic structure forms the theoretical basis for predicting the monetary performance of an investor's social investment program. However, certain implementation considerations will also impact performance.

Manager Selection. It is one thing for an investor to determine an ideal set of issues to address through its social investment program, and entirely another to identify managers willing to adjust their processes to the investor's program, let alone such managers with good investment management skills. Accordingly, a common decision social investors face is whether to select a manager that actually specializes in social investing, or to go with a traditional investment manager and try to superimpose the investor's social investment mandate on the latter manager's investment process.

The advantage of going with managers that specialize in social investing is that they are more likely to be fluent with the issues of concern to the investor, and will hopefully have given more thought to how to successfully incorporate these considerations into their investment processes. However, the number of social investment specialist managers is limited, increasing the odds that the best investment managers, from a monetary *risk-adjusted* performance perspective, are not among them. We have emphasized the term "risk-adjusted" as a reminder of the many risk factors one should consider when evaluating any manager, including (but not limited to):

- Relative experience and stability of the fund management team,
- Track record of the strategy,
- Volatility of the strategy,
- The manager's role within a particular asset class's manager structure and the portfolio as a whole,
- Liquidity, and
- Fees.[23]

In addition, with respect to these managers' commingled funds, the social investment issues that these funds address may not perfectly overlap with those of a particular investor given the managers' efforts to service the objectives of multiple clients.

[22] Building on this last point, market failures ironically may sow the seeds of their own destruction by prompting the aggrieved and/or their powerful sympathizers to uncover ways of ending the coercive practices. For instance, in his book *Global Capitalism: Its Fall and Rise in the Twentieth Century* (W.W. Norton & Company, New York, 2006), Jeffry A. Frieden argues that dissatisfaction with economic arrangements has often historically led to a challenging, and at times an undoing, of those arrangements. The correction of these market failures may in turn create fertile soil for new market opportunities.

[23] Factors that could lead to higher fees for commingled social investment products include a lack of institutional pricing, disadvantageous economies of scale, additional social research or shareholder advocacy-related manager expenses, and possibly limited competition from other social investment managers.

On the other hand, hiring a traditional manager through which an investor imposes its social investment objectives should theoretically provide the investor with a broader manager opportunity set, thus increasing the probability that the best managers will be among them. However, in practice, not all traditional managers are willing to accommodate social investment mandates, and there is always the possibility that the nature of an investor's social investment objectives, or a change to a given manager's investment process, could endanger that manager's monetary performance success.

Diversification. There are two ways in which social investment portfolios may suffer from sub-optimal diversification. First, the social return issues may introduce structural style biases into a given social investment manager's portfolio (e.g., capitalization bets, sector bets) and, by extension, the investor's manager structure within an asset class.

Second, even if social investors were able to find quality managers in a given asset class, it would be exceedingly difficult to find high-caliber managers aligned with the investor's social return goals in every asset class included in a well-diversified portfolio. Thus the investor might be forced to choose between its social return objectives and its optimal target asset allocation.

Auxiliary Fees. If the investor chooses not to fully delegate socially driven security selection and/or shareholder advocacy responsibilities to its managers, it may need to either hire additional staff or purchase additional services to execute these tasks. The costs for these services should be deducted from performance results.

Time Spent Developing and Monitoring Program. Finally, the time required to identify the social return issues to be addressed, determine social investment strategies, and then execute and monitor these strategies can be considerable. As a consequence, institutions that engage in social investing may be at greater risk of not attending to their investment programs' other needs in a timely fashion (e.g., building out their hedge fund allocations, etc.), which in turn could result in sub-optimal portfolio performance. In our experience, the opportunity costs from the sheer amount of staff and committee time spent on addressing social investment issues is often underestimated.

Setting Holistic Performance Expectations and Measurement: Social Return Generation as a Form of Spending

Throughout this paper we have been careful to draw distinctions between the social investors' social and monetary return objectives. However, in reality the distinction is not so stark since monetary returns ultimately help the investor to achieve its underlying social goals (e.g., education, social welfare).

With this in mind, one approach both to setting monetary return expectations and measuring performance results is to consider the value of the incremental[24] social returns generated by the social investment and the value of the social returns that would otherwise have been attained by simply "spending" the excess risk-adjusted monetary returns that might have been generated from traditional investments. In other words, *if* there is a monetary cost to a particular institution's social investment program, the institution must decide whether the social returns generated through incurring this cost—*a cost that could essentially be considered a form of program expenditure*—outweigh the social returns that could have been generated through more traditional program spending.

For instance, consider a $10 million investment made in a fund that is designed, in part, to discourage corporations from sourcing their products from sweatshops. The investment is made by a private foundation whose mission is to support access to affordable housing. If, based on the fund's past history, the foundation estimates that the investment will earn a 9.5% annualized return, compared to the 10% annualized return it expects to get from investing in the fund's benchmark index, the opportunity cost of the social investment after ten years is approximately $1.16 million.[25] That foundation must then decide whether the fund's potential impact on sweatshop labor is worth the $1.16 million that it could otherwise have spent on affordable housing programs.[26] Clearly, such comparisons will likely never result in a precise holistic net benefit calculation. However, a qualitative judgment about the importance of the various outcomes to the foundation should nevertheless be made to help the institution navigate between competing social objectives.

With this framework in mind, an assessment of the attractiveness of a social investment would involve four steps:

1. The institution would evaluate the social investment's monetary risk/reward characteristics as it typically would for its traditional investments, and compare those characteristics to those of traditional investments it might have otherwise engaged.

2. The institution would analyze the likelihood that any particular social investment opportunity would help the institution achieve its social return objectives.

3. The investor would then determine the value of attaining these social return objectives relative to the value that would have been derived by simply spending to achieve program goals.

4. Finally, the institution could then derive minimum return expectations for its social investments by subtracting the monetary value of the investment's social returns from the monetary returns it would have otherwise attained through traditional investments, as illustrated by the following equation:

[24] As noted earlier, all investments, whether "traditional" or "social," generate social returns. Thus, ideally, the investor would consider the *incremental* social return benefit derived from the social investment relative to a traditional alternative. We expand on this concept later in this section.
[25] This calculation makes the simplifying assumption that there are no cash flows out of this investment during the ten-year period.
[26] The institution might also consider spending the excess returns on other programs, like a public awareness campaign, that might also help discourage corporate reliance on sweatshop labor—a point we briefly expand upon in a subsequent section "Alternative Approaches to Achieving Social Investment Goals."

MER[SI] = ER[TI] – (Expected Value of Social Investment's Social Returns)

Where:
MER = Minimum Expected Monetary Return
ER = Expected Monetary Return
SI = Social Investment Opportunity
TI = Traditional Investment Opportunity

A parallel equation could be used when analyzing a social investment's performance *results*:

RR[SI] = RR[TI] – (Cost of Social Returns)

Where:
RR = Realized Monetary Return
SI = Social Investment made by institution
TI = Manager, manager median, or benchmark index that would have been chosen if social returns were not taken into consideration

Then, to assess the success of one's social investments, use the following relationships:

- If (Social Return Benefits) ≥ (Costs of Social Returns), then the social investment was successful.
- If (Social Return Benefits) < (Costs of Social Return), then the social investment was unsuccessful.

There are several issues that are worth highlighting. First, as noted earlier, assigning a precise monetary value to a given social return is a very difficult exercise, which makes the actual calculation of the preceding equations imprecise at best. However, while the difficulty is hard to overemphasize, such a cost/benefit analysis is deeply similar to the creation of any budget through which institutions allocate resources to achieving program goals. Thus, as with a budget, the social investment cost/benefit analysis is both difficult and necessary.

Second, as the above equations imply, an investor must remain cognizant of the social returns generated by its social investments if it is to ultimately measure whether or not its social investment program has been successful. Thus, investors must demand both monetary and, as importantly, *social return accountability* of its social investment managers and programs.

Finally, for simplicity's sake, all of the above listed equations assume that even the social investor typically divides the universe of investment opportunities into two categories: traditional investments, where the purpose of the investment is solely to maximize risk-adjusted monetary returns, and social investments, where the purpose of the investment is to generate both social and monetary returns. However, as we noted at the outset, *all investments* generate both social and monetary returns, whether these returns were intended or not. Thus a truly holistic cost benefit analysis would solve for the following relationship:

- ER[Investment Option A] + (Net Social Return of Option A) <=> ER[Investment Option B] + (Net Social Return of Option B)

While certainly even more difficult to measure than the prior equations, the relationship above serves as a reminder that traditional investments also can produce beneficial social outcomes (e.g., employment, higher quality and lower cost goods such as clothing, food, heat, transportation, medicines, etc.). Indeed, it is reasonable to presume that nothing will preclude one's *traditional* money managers from investing in opportunities with strong social or environmental stories *if they are adequately profitable*.

Alternative Approaches to Achieving Social Investment Goals

Focusing now solely on the social return objective of achieving change, institutions should also ponder whether there might be more "efficient" ways to achieve the same (or better) social results than can be achieved through social investing. By more "efficient," we mean methods that generate greater social benefits per unit of expenditure, or lower expenditure for the same social benefit.

For instance, in the "Performance" section of this paper we noted that in many cases, the problems social investors attempt to address are the result of flaws in the fabric of the political economic system. Consequently, concerned investors should analyze the nature of those flaws to better understand what would need to change to realize Adam Smith's goal of ensuring that the pursuit of private interests promote the public good. From this perspective, an institution's investments should be viewed as but one of a number of tools available to address the problem. For example, as an alternative to social investing, institutions might consider directly funding studies, advertising, or other types of public awareness-raising campaigns that could ultimately alter the political economic landscape in which security issuers operate.

Evaluating Social Investment Program Execution

Evaluating Monetary Returns

In addition to assessing the monetary costs, if any, of social investing *relative to traditional investing*, institutions should also consider evaluating how well their staffs are executing their social investment programs *given the more limited opportunity set that is actually available to them*. Thus, as with traditional investments, the benchmark used to measure the investment staff's monetary performance should reflect that opportunity set, whether at the portfolio, asset class, or manager levels.[27]

When the benchmarks used are indices, those indices should reflect the same social screens (i.e., screens used that are *not* intended to enhance the portfolio's monetary risk/return profile) imposed on the institution's portfolio, further adjusted for any additional social return-related expenses (e.g., social research or social issue proxy voting expenses). Depending on the institution's social screens it may be difficult to

[27] For a more in-depth discussion of benchmarking, please see our paper *Benchmarking: An Introduction.*

find appropriate indices, as off-the-shelf social indices may either not include the institution's screening preferences or include others that muddy the comparison. However, holdings-based attribution analyses could be used in place of socially screened indices if they are able to highlight the relative impact of restricted securities on performance. As with the use of indices, if the benchmark used is a peer group median, the peer group should consist of managers subject to similar social screening criteria to facilitate an apples-to-apples comparison.

Evaluating Social Returns

Institutions must evaluate not only their social investment's monetary returns but also their social returns. When the expected social return is "values consistency," which is often implemented through screens, social return performance assessment should be relatively straightforward, as it will be based upon the degree to which the portfolio avoids restricted securities. However, when social change is the desired outcome, performance measurement becomes more complicated.

One of the chief difficulties is determining appropriate benchmarks for success, as social return outcomes can range from the insignificant to the dramatic. Outcomes might include:

- Getting a shareholder resolution on a proxy ballot;
- Receiving enough votes on a shareholder resolution for it to be placed on the proxy ballot again next year;
- Garnering media/public attention for an issue raised through security selection or shareholder advocacy;
- Spurring changes in consumer preferences or in the regulatory climate as a result of raising public awareness through the institution's social investment program;
- Getting other institutions to join in seeking a particular social return outcome through their investments;
- Holding discussions with corporations on social issues;
- Raising or lowering the cost of capital for certain lines of business;
- Getting target corporations to accept part or all of the institution's recommendations/demands;
- Inspiring other corporations that the institution did *not* specifically target to adopt its recommendations; and
- Improving the circumstances of those constituencies the institution sought to help through its social investment policies.

Also, the timeline for the achievement of these outcomes can be difficult to predict and potentially lengthy. (For instance, the ultimate goal of the South Africa divestment campaign took over a decade to realize.) Thus, when evaluating social return performance, institutions should give careful consideration to setting reasonable expectations in light of the likelihood and probable time horizons of potential social return outcomes.

Fiduciary and Tax Considerations

A critical step for investment committees that are considering implementing social investment programs is to become cognizant of the legal and tax codes that may have ramifications for investment activities that seek to balance monetary and social objectives. Based on Cambridge's research, it appears that both the UPMIFA and the Uniform Management of Institutional Funds Act, which offer guidance for those overseeing the management of institutional funds, provide institutions with flexibility to take program considerations into account when making investment decisions. In contrast, Section 5 of the Uniform Prudent Investors Act, which governs certain trusts, explicitly prohibits social investing if such investment activity "entails sacrificing the interests of trust beneficiaries—for example by accepting below-market returns."

As for tax implications, social investments appear unlikely to run afoul of Internal Revenue Service (IRS) provisions that restrict political campaign activities and lobbying. The IRS's "jeopardizing investment" provisions for private foundations are less clear, though in practice this tax code does not appear to have been invoked to tax social investments to date. Finally, it is worth reiterating that PRIs, which are made primarily to advance an organization's mission, are given privileged fiduciary status by UPMIFA and, with respect to private foundations, the IRS.

For a more in-depth treatment of this subject, please see Appendix B. Also, please note that our comments should not be construed as either legal or tax advice. Our members should consult with their legal counsel or tax professionals for more definitive guidance.

Determining the Locus of Responsibility for Social Investment Programs

Membership selection for the oversight body charged with establishing and implementing an institution's social investment program should be primarily based on the *authority* and *competency* of candidates.

With respect to authority, there should clearly be a role for investment committee members, who are charged with overseeing the monetary return characteristics of all investment opportunities. However, because goal setting and performance measurement will include both monetary return and social return considerations—the latter of which must be balanced against competing organizational social return/program priorities—the oversight body must also include board members with a solid grasp of program objectives *and with the authority to arbitrate between them*. In addition, if an organization's social investment program is driven by constituent concerns, the social investment oversight committee might also require board members who can serve as legitimate spokespeople for these concerns.

As for competency, there will likely be significant overlap between board members chosen for the social investment oversight committee on the basis of their authority and members chosen because of their competency to successfully navigate the issues raised by the implementation of a social investment program.

However, it is conceivable that the committee might also supplement its in-house knowledge with an internal or external advisory panel with greater understanding of various social return issues.

Conclusion

As stated at the outset, it is reasonable to argue that the ultimate goal of a nonprofit endowed institution's investments is to help the institution maximize its overall *social* returns. Social investing is one potential tool for generating social returns, whether these returns are related specifically to program goals or broader social objectives and/or obligations. However, *if* this practice comes at some monetary cost, the key question then becomes whether the incremental social returns derived from incurring that cost outweigh the social returns that would otherwise have been generated from simply *spending* the greater monetary returns earned through traditional investments. Consequently, it is imperative for investors to be clear about (1) the incremental social returns they hope to generate from their social investment programs, (2) the probability that their social investments will actually generate those returns, and (3) the value of those returns relative to other program goals that may consequently be impaired.

APPENDIX A

Appendix A

INCORPORATING BROAD-BASED SOCIAL RETURN ISSUES INTO INVESTMENT POLICY: AN EXAMPLE

In their seminal 1972 book *The Ethical Investor: Universities and Corporate Responsibility*, John G. Simon (Yale Law School), Charles W. Powers (Yale Divinity School), and Jon P. Gunnemann (Pennsylvania State University religious studies department) provide a well-reasoned example of a social investment policy that covers a broader range of issues than those encompassed by a University's narrowly defined mission to educate.

The authors argue that universities should not engage in social investing "to champion social or moral causes." Instead, social investment decisions should be limited to attempts to correct a portfolio holding's infliction of "significant social injury," which they define as "particularly including a violation or frustration of domestic or international legal norms meant to protect against deprivations of health, safety, or basic freedoms." The authors go on to note that shareholder advocacy should be the primary means of correcting the behavior of security issuers, though divestment is warranted if either (1) the behavioral corrections would result in lower returns or (2) the behavior in question results in "grave" social injury.[1]

The authors argued that their broad-based approach to addressing social return issues could be defended legally—at least in 1972. Their reasoning is fourfold. First, they note that the directors of charitable corporations enjoy discretion in managing an institution that approaches the discretion enjoyed by the directors of a business corporation, which provides the former with sufficient leeway for establishing their investment policies.[2] Second, they argue that the directors have the right to refrain from activities that may arguably be thought to hurt the public interest.[3] They reason that such investment policies are similar to, say, other institutional governance policies that are stricter than what is legally required. Third, they argue that by addressing the concerns of its constituencies, social investing can reduce organizational friction, thereby creating a better environment within which to carry out the institution's charitable purposes.[4] (This rationale is similar to the "addressing constituent concerns" rationale articulated in the "Social Return Objectives" section of this paper.) Finally, the authors did not view their social investment policy as being in violation of the jeopardizing tax or political lobbying provisions within the tax code.[5]

[1] Simon, pp. 9-11, 171-8.
[2] Ibid., pp. 143f.
[3] Ibid., pp. 144-56.
[4] Ibid., pp. 156-63.
[5] Ibid., pp. 164-8.

APPENDIX B

Appendix B

FIDUCIARY AND TAX IMPLICATIONS

Appendix B provides an overview of the permissibility of social investing in light of key fiduciary and tax codes that address the management of institutional funds, and includes an extended treatment of program-related investments (PRIs). In our view, the civil codes most germane to social investing are:

- The Uniform Prudent Management of Institutional Funds Act (UPMIFA);
- The Uniform Management of Institutional Funds Act (UMIFA);
- The Uniform Prudent Investor Act (UPIA);
- Internal Revenue Code (IRC) 4944, which deals with "Jeopardizing Investments" by private foundations; and
- IRC section 501(c)(3)'s restrictions against political campaign activities and lobbying.

We must preface this discussion with the critically important caveat that our comments should not be construed as either legal or tax advice. Our clients should consult their legal counsel or tax professionals for more definitive guidance.

UPMIFA

UPMIFA, the most current act put forth to states by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to govern the management of charitable funds,[1,2] allows for social investing in two ways.

First, UPMIFA governs only the management of institutional funds. Exempt from its definition of "institutional funds" are program-related assets, which it defines as "asset[s] held by an institution *primarily* to accomplish a charitable purpose of the institution and not primarily for appreciation or the production of income [emphasis added]."[3]

[1] On July 13, 2006, the NCCUSL adopted UPMIFA, which is intended to supersede UMIFA. Both acts apply "generally to institutions created and operated exclusively for charitable purposes, including organizations created as nonprofit corporations, unincorporated associations, and governmental subdivisions and agencies. This also includes a trust that is organized and operated exclusively for charitable purposes, but only if a charity acts as trustee." The NCCUSL created UPMIFA to modernize the 1972-enacted UMIFA. See the NCCUSL's press release at:
http://www.nccusl.org/Update/DesktopModules/NewsDisplay.aspx?ItemID=163.
Since 1972, UMIFA has been adopted into the laws of 48 states. We believe UPMIFA will enjoy a similar adoption rate and become the fiduciary framework within which institutions will develop their social investment programs. For more information on UPMIFA, see our recent paper, *Investment Committee Governance*: *Recent Developments.*
[2] For a copy of UPMIFA, including Prefatory Notes and Comments, please see:
http://www.law.upenn.edu/bll/ulc/umoifa/2006final_act.pdf.
[3] Ibid., p. 7.

Second, *subject to the donor's intent as expressed in its gift instrument*,[4] UPMIFA allows, and in fact may require, investors to consider their charitable goals when making investment decisions, even if those investments are *not* primarily made for program-related purposes. The following three passages are among the most relevant in this regard:

- Section 3.a: ". . . [A]n institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund."
- Section 3.e.1.H: "In managing and investing an institutional fund, the following factors, if relevant, must be considered: an asset's special relationship or special value, if any, to the charitable purposes of the institution."
- Section 3.e.4: "An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, *because of special circumstances*, the purposes of the fund are better served without diversification [emphasis added]."

The Prefatory Notes and Comments that accompany UPMIFA explicitly discuss how Sections 3.a and 3.e.1.H suggest that social investing may be consistent with prudence:

> Assets [other than program-related assets] may not be held primarily for program-related purposes but may have both investment purposes and program-related purposes. Subsections (a) and (e)(1)(H) [of Section 3] indicate that a prudent decision maker can take into consideration the relationship between an investment and the purposes of the institution and of the institutional fund in making an investment that may have a program-related purpose but not be primarily program-related. The degree to which an institution uses an asset to accomplish a charitable purpose will affect the weight given that factor in a decision to acquire or retain the asset.[5]

The Prefatory Notes and Comments do not make an explicit link between Section 3.e.4 (regarding diversification) and social investing, though we believe it is relevant as well since social investment programs are often characterized as much by what they choose to invest in as by the economic sectors they avoid, thereby potentially reducing the portfolio diversification that might otherwise be implemented by a traditional investor without charitable commitments.

UMIFA

While UPMIFA supersedes UMIFA, as of early December 2006 the former had not yet been adopted by any states. Instead, the 1972-enacted UMIFA persisted on the books of 47 states and the District of

[4] Ibid, p. 11 (UPMIFA, Section 3.a.).
[5] Ibid, p. 17.

Columbia and therefore currently outlines the degree to which social investing may be permissible for most charitable institutions.

UMIFA is far less direct about its views on social investing. First of all, UMIFA does not comment on program-related assets at all, which is interesting given that the IRS formally defined the term in 1969. As for more broadly defined social investing, the only hint of guidance UMIFA provides is found in Section 6, which bears some resemblance to UPMIFA's Section 3.a:

> . . . [M]embers of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing *they shall consider long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes*, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions [emphasis added].[6]

In our view, Section 6 separates the institution's consideration of its eleemosynary purposes from its consideration of other financial objectives and factors, suggesting that the former should serve as a *distinct* factor when making investment decisions. However, the Comments that attend Section 6 do not make any explicit reference to social investing, so this interpretation is entirely our own.

Given the absence of any explicit social investment reference, perhaps the main reinforcement of our interpretation of UMIFA as permitting social investing is the precedent set by the numerous institutions that have practiced social investing since 1972.

UPIA

Unlike UPMIFA and UMIFA, UPIA, which was enacted in 1994, pertains primarily to the "investment responsibilities arising under the private gratuitous trust,"[7] though it also pertains to trusts held for institutions by trustees that are themselves not an institution, or trusts that have both charitable and non-charitable interests in which the latter interests have not yet terminated.[8]

In light of the unique responsibilities trustees owe to trust beneficiaries, it is not surprising that UPIA *explicitly frowns upon social investing.* Indeed, UPIA's position on social investing is derivative of Section 5 of the Act, which obliges trustees to "invest and manage the trust assets solely in the interest of the beneficiaries." As the Comments that follow Section 5 explain:

> No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by

[6] http://www.law.upenn.edu/bll/ulc/fnact99/1970s/umifa72.htm.
[7] http://www.law.upenn.edu/bll/ulc/fnact99/1990s/upia94.htm p. 3.
[8] See UPMIFA, Sections 2.4 and 2.5.

accepting below-market returns—in favor of the interests of the persons supposedly benefited by pursuing the particular social cause.

Clearly, UPIA requires trustees under its auspices to use the same criteria in evaluating social investments as they would for traditional investments.

IRC 4944 – Jeopardizing Investments

IRC 4944, which was enacted by Congress in 1969, mandates the imposition of a tax on investments made by a *private foundation* that "jeopardize the carrying out of any of [the private foundation's] exempt purposes."[9] We italicized the term "private foundation" to highlight the fact that IRC 4944 pertains only to private foundations, and not to the endowments or quasi-endowments of colleges, hospitals, churches, etc.[10]

Treasury Regulation 53.4944-1(a)(2)(i), which provides the official interpretation of the IRC, defines "jeopardizing investments" as investments in which "foundation managers, in making such investment, have failed to exercise ordinary business care and prudence . . . in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes."[11] It is important to note here that the prudence standard, as described by the government, differs notably from that outlined in UPMIFA and UMIFA, since the latter explicitly includes consideration of the institution's charitable purpose in the investment decision-making process, while the government's prudence standard does not. Instead, when explaining the characteristics of prudent decision making, the IRS notes only that:

. . . [P]rivate foundation managers may take into account the:

- Expected return (including both income and appreciation of capital);
- Risks of rising and falling price levels; and
- Need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk, and potential for return).[12]

[9] IRC 4944(a)(1). See http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00004944----000-.html for the code's full text.
[10] See: http://www.irs.gov/charities/charitable/article/0,,id=137894,00.html.
[11] For a copy of Treasury Regulation Section 53.4944, go to:
http://www.access.gpo.gov/nara/cfr/waisidx_06/26cfr53_06.html.
[12] Section 53.4944-1(a)(2)(i).

The IRS goes on to explain that while the code does not treat any category of investments as a violation of IRC 4944 *per se*, there are a number of categories of investments and investment activities that will be viewed with special scrutiny. The list, which appears antiquated when viewed through a contemporary lens, is provided below:

- Trading in securities on margin;
- Trading in commodity futures;
- Investments in working interests in oil and gas wells;
- Purchase of "puts," "calls," and "straddles;"
- Purchase of warrants; and
- Selling short.[13]

So how does IRC 4944 pertain to social investing? First, like UPMIFA, the code explicitly exempts PRIs from 4944-related taxation.[14] The IRS defines PRIs as investments whose "*primary purpose* [emphasis added] is to accomplish one or more of the foundation's exempt purposes," and for which the "production of income or appreciation of property is not a significant purpose." In addition, PRIs cannot be made in order to "[influence] legislation or [take] part in political campaigns on behalf of candidates."[15] The IRS goes on to say that a key characteristic of these investments is that they would not be made by a for-profit entity on the same terms as they would by the private foundation in question.[16]

While the IRS is fairly clear about its exemption of program-related investing, unlike UPMIFA it does not explicitly reference those investments whose *secondary* purpose is to advance the foundation's tax exempt purpose but whose *primary* purpose is the production of income or appreciation of property. These types of (social) investments were neither listed under the aforementioned investments bearing "special scrutiny" (e.g., shorts, warrants, commodities futures, etc.), nor would they qualify as PRIs.[17]

Consequently, we are left on our own to interpret the tax implications of such investments. Our tentative read of IRC 4944(c) is that it is plausible that non-PRI social investments would avoid being labeled as "jeopardizing investments" by the IRS if the private foundation is able to make a reasonable case that the investments are likely to provide an *adequate*—though not necessarily the "best" possible—reward given their attendant risks and the foundation's financial needs—though that interpretation is entirely our own. We did, however, discuss the matter with an IRS agent in August 2006 and learned that, to the best of his

[13] Ibid. In addition, section 7.27.18.2.3 of the Internal Revenue Manual, which is the official source of administrative and operational "instructions to [IRS] staff" (see http://www.irs.gov/irm/part1/ch09s02.html#d0e158239), goes on to list "other recent investment strategies that deserve close scrutiny," including: (1) investment in "junk" bonds; (2) risk arbitrage; (3) hedge funds; (4) derivatives; (5) distressed real estate, (6) international equities in third world countries; and (7) guarantees or collateralizations (see http://www.irs.gov/irm/part7/ch12s15.html#d0e115400).
[14] IRC 4944(c) and Section 53.4944-3.
[15] The IRS provides a brief description of program-related investments at: http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html. See also Section 53.4944-3(1)(i)-(iii).
[16] Section 53.4944-3(a)(2)(iii).
[17] Section 53.4944-3(b) provides examples of PRIs, the vast majority of which are proactive, community development-oriented investments.

knowledge, there have been no cases of taxes levied because of a foundation's engagement in social investing. However, he was unwilling to provide an official comment.

Restrictions Against Political Campaigning and Lobbying for 501(c)(3) Institutions

Some social investment activity could be viewed as an implicit critique of the regulatory regime. For instance, the campaign to divest from companies doing business in South Africa during the apartheid era demanded a change in corporate behavior while also criticizing the South African government, and possibly U.S. foreign policy toward that government as well. Similarly, nuclear power, military weapons, abortion, and other such screens might also be construed as having political overtones. Given this, it is reasonable to wonder whether certain forms of social investment activity could jeopardize a 501(c)(3) organization's tax exempt status given IRS restrictions on political campaigning and lobbying. However, as we explain below, it is difficult for us to conceive of social investment activity that would run afoul of these IRS restrictions.[18] [19]

With regard to political campaigning, 501(c)(3) organizations are "*absolutely prohibited* from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office [emphasis added]."[20] While the range of potentially offending behaviors is beyond the scope of this paper, our reading of the matter is that "political campaigning" involves activities that are *clearly* linked to the election process *and clearly* encourage the public to vote for one candidate over another.[21] Positions on public policy issues *are permissible*, as long as they are expressed in a manner that does not also include "any message favoring or opposing a candidate."[22]

As for lobbying, the IRS will impose a tax on expenditures made by private foundations that attempt to influence legislation.[23] In addition, the IRS can revoke a 501(c)(3)'s tax exemption if a "*substantial* part of its activities is attempting to influence legislation [e.g., 'lobbying,' emphasis added]."[24] The IRS characterizes an attempt to influence legislation as follows:

> An organization will be regarded as attempting to influence legislation if it contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or if the organization advocates the adoption or rejection of legislation.

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[18] As noted earlier, our comments must not be construed as a legal or tax opinion, and clients should consult their legal counsel and tax professionals for more definitive guidance. We repeat this important caveat here in light of the increased regulatory scrutiny tax-exempt organizations have received in recent months. See for instance: http://www.irs.gov/newsroom/article/0,,id=154780,00.html.

[19] In writing this section, we relied heavily on recent IRS guidance, which can be found at: http://www.irs.gov/newsroom/article/0,,id=161131,00.html.

[20] See IRS Fact Sheet 2006-17 at http://www.irs.gov/newsroom/article/0,,id=154712,00.html.

[21] Ibid.

[22] Ibid.

[23] IRC 4945(d)(1).

[24] See, for instance: http://www.irs.gov/charities/charitable/article/0,,id=120703,00.html.

> Organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, organizations may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.[25]

There are two reasons why we do not believe the vast majority of social investment activities will violate the IRS's restrictions on lobbying. First, it appears unlikely that an organization's social investment policy decisions would represent an attempt to influence legislation given the IRS's description of these activities as provided above. Second, even if certain specific social investment activities by 501(c)(3)'s could arguably qualify as lobbying,[26] it is doubtful that the IRS would deem these to be "substantial" in extent.[27]

Program-Related Investments – A Special Case

It is worth highlighting that though the NCCUSL and the IRS definitions of PRIs seem quite similar, the definitions were developed independently from one another and are used to highlight different fiduciary and tax-related opportunities. The NCCUSL discusses PRIs[28] within the context of the broader universe of charitable institutions, including but not limited to private foundations. The IRS, on the other hand, focuses on PRIs made by *private foundations*, and outlines both their tax implications, which were covered in the preceding section, and their applicability as a form of "qualifying distribution."[29] With regard to the latter, one of the key attractions of PRIs for private foundations is that they can generally be counted towards the foundation's 5% annual distribution requirement in the year that they are made.[30] [31] In addition, once the investment is made, these assets are not included in the pool of assets upon which the 5% distribution requirement is calculated.[32] Thus, as David S. Chernoff, Esq., Associate General Counsel of the John D. and Catherine T. MacArthur Foundation, notes in his article, *Program-Related Investments: A User-Friendly Guide*:

> [T]here is a 'hidden' 5.0% return because the amount of a foundation's program-related investment reduces the asset base upon which the 5.0% annual distribution requirement is

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[25] See http://www.irs.gov/charities/article/0,,id=163392,00.html.
[26] For instance, the social investment guidelines proposed for universities in *The Ethical Investor* suggest that in certain rare cases, universities should encourage corporate managers to press the government to take appropriate action to prevent companies from engaging in behaviors that would result in social injury. See pp. 174.
[27] In light of the IRS's stricter stance with regard to lobbying done by private foundations, it is unclear to us how the IRS would react to a private foundation's investments in social investments that might be construed as a form of lobbying.
[28] The NCUSSL actually uses the term "program-related assets," instead of "program-related investments," to refer to the types of holdings described in this section. See UPMIFA, section 2.7.
[29] IRC 4942(g)(1). For the complete text of IRC 4942, go to:
http://www.law.cornell.edu/uscode/search/display.html?terms=4942&url=/uscode/html/uscode26/usc_sec_26_00004942----000-.html.
[30] Ibid. Also, *Program-Related Investments: A User-Friendly Guide*, by David S. Chernoff, Esq., p. 3. Chernoff's very useful article can be downloaded from http://primakers.net/resources/publications.
[31] Sections 53.4942(a)-3(a)(2)(i).
[32] IRC 4942(e)(1)(a). Also, Chernoff, p. 8.

applied. For example, instead of a stated 2.0% or 3.0% rate of return on a loan, a foundation will in effect get a 7.0% or 8.0% rate of return.[33]

Consequently, from the IRS's perspective, PRIs are essentially a form of charitable *spending* that also have the potential to earn monetary returns.

In its website article on the subject, the IRS provides several examples of PRIs, including:

1. Low-interest or interest-free loans to needy students,
2. High-risk investments in nonprofit low-income housing projects,
3. Low-interest loans to small businesses owned by members of economically disadvantaged groups, where commercial funds at reasonable interest rates are not readily available,
4. Investments in businesses in deteriorated urban areas under a plan to improve the economy of the area by providing employment or training for unemployed residents, and
5. Investments in nonprofit organizations combating community deterioration.[34]

It is worth highlighting here that, as demonstrated by item four, investments in for-profit entities may also be considered PRIs, though foundations are required to exercise "expenditure responsibility"[35] with regard to these investments. In short, foundations must make sure that the PRIs they make in non-501(c)(3) entities are actually serving the charitable purposes for which they were intended.

Clearly, from the standpoint of both UPMIFA (with regard to all institutional funds) and the IRS (with regard to private foundations), PRIs provide a unique harbor for social investing that claims special exemption from fiduciary liability (assuming the adoption of UPMIFA) and from negative tax consequences if done appropriately.

[33] Chernoff, p. 8.
[34] See http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html. For examples of program PRIs and non-PRIs, see Internal Revenue Manual 7.27.18.4.6.
[35] IRC 4945(h) See complete text at http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00004945----000-.html.