

# INTERIM REPORT BY THE ADVISORY COMMITTEE ON SOCIALLY RESPONSIBLE INVESTING

## INTRODUCTION AND RECOMMENDATION

The Advisory Committee on Socially Responsible Investing (ACSRI) is charged with guiding the Finance and Investment Committee of the Board of Trustees, “regarding ethical, social, and environmental issues that might influence the management of the university’s endowment.” We submit this interim report to explain our work to date and advance a set of recommendations for moving forward. We consider this an “interim” document insofar as our recommendations call for further study in a number of areas.

Recognizing the broad character of its mandate, ACSRI decided to structure its work according to requests coming from the AU community. We established criteria for considering appeals to ensure that they were broadly representative. Fossil Free AU submitted a request that fulfilled these criteria and which called for divesting AU’s endowment from fossil fuel companies.

In evaluating the request, the committee considered the following questions:

1. Can the endowment be used to express social values? Would doing so be consonant with the Board of Trustees’ fiduciary responsibilities?
2. Is climate change an issue so closely aligned with AU’s core mission that it would justify using the endowment as a vehicle for expressing a position on the issue?
3. How can the endowment be used to address climate change? Would doing so result in below-market returns or other financial losses?
4. Can the endowment be an effective tool for addressing climate change?

## RECOMMENDATION

Based on the most current scientific evidence and political analysis, the ACSRI finds the idea of fossil fuel divestment compelling and worthy of AU’s consideration. The key question is whether the Board of Trustees can undertake divestment in a way that upholds its fiduciary responsibilities. Our analysis of AU’s mission and core purposes suggests that the Board would, indeed, fulfill its fiduciary responsibility by adopting a strategy of divestment. Our analysis of the university’s endowment portfolio *suggests* that divestment might also correlate with the Board’s fiduciary responsibility. Preliminary research recommends that a fossil free portfolio would offer competitive returns (i.e. minimal to no impact on endowment performance) with marginal increases in management fees—a conclusion that we believe meets the criterion of *de minimis* costs. Further analysis would have to be done to assess risk-adjusted returns and management fees with regard to AU’s unique portfolio holdings.

Given the compelling character of the appeal, a strong consensus that divestment fits AU’s core mission, and the likelihood that divesting might be financially sound, we recommend the university adopt a roadmap toward a divestment policy. The roadmap consists of a set of actions that, *contingent on further financial analysis*, the university would pursue. The roadmap can be summarized as “Divest, Invest, and Engage.” It aims overall toward a prudential decarbonization of the endowment. We recommend that Cambridge Associates perform an analysis focusing on both risk-adjusted returns and management fees.

The following describes the elements of the roadmap:

## Divest

### 1. Reallocate investments in the “Real Assets” category to investments in clean energy and associated technologies.

Replace current holdings in the “Real Assets” category (which constitutes approximately 5% of the endowment but contains 39% of AU’s fossil fuels exposure) with investments in clean energy technologies.

### 2. Implement a negative screen on separately managed accounts.

Instruct managers with separately managed accounts to remove investments in the top publicly traded fossil fuel companies as identified by Cambridge, MSCI or the Carbon Tracker Initiative and continue to screen future investments accordingly.

### 3. On a yearly basis, assess options for fossil-free investment vehicles for commingled assets.

- a. Monitor the market for new fossil-free investment opportunities to replace heavy concentrations of fossil investments, such as vehicles that benchmark the currently held S&P 500 Index Fund.
- b. Actively seek replacements for each asset class as they became available in the marketplace.

## Invest

### 4. Create a “Green Investment Fund.”

Create a designated vehicle aimed directly at green technology investment. Donors can specifically target their donations to the fund.

## Engage

### 5. Commit to shareholder engagement

- a. Join CERES, a coalition of 130 member organizations, to effectively engage fossil fuel companies.
- b. Provide opportunities for proxy voting and other engagement activities for students and other members of the AU community.

## CAN THE ENDOWMENT BE USED TO EXPRESS SOCIAL VALUES?

The ACSRI advances the above strategy based on its understanding of fiduciary responsibilities. This understanding comes from Mary Kennard’s November 4, 2013 memorandum.<sup>1</sup> In the memo, Kennard notes that, “Although some social investment strategies would likely violate the Board’s fiduciary duties, it may be possible, depending on the particular circumstances, to craft a socially responsible investment strategy that complies with the Board’s fiduciary duties.”

Kennard suggests that a strategy could fit fiduciary responsibilities if it fulfills the Duties of Care and Loyalty. At the heart of these two duties is a commitment to manage and invest the endowment “with the care an ordinary prudent person in a like position would exercise” and to do so “solely in its [the corporation’s] best interest, not as a vehicle for promoting [directors’] personal beliefs or causes.” With regard to the Duty of Loyalty, Kennard’s letter further explains that trustees “would not violate the duty of loyalty by considering an investment’s social consequences when ‘the costs of considering such consequences are *de minimis*.’”

The ACSRI interprets this to mean that any socially responsible investment strategy must align closely with the university’s core purpose and that the costs are so minor as to merit disregard. As you will see below, the committee believes that a divestment policy meets these criteria.

(It should be noted that, in recent history, AU has twice used the endowment to express a position on social issues. In 1997, the university issued a Resolution on Investments in Burma, citing the university's Statement of Common Purpose. With specific regards to the endowment, the resolution resolved that the university will "Seek 'Burma-free' investments, reserving the right to divest from companies conducting business in Burma." In 2006, the AU Board of Trustees issued a Resolution on Investments in Sudan, adopting a divestment policy from companies doing business in the oil and gas sector in Sudan.)

### **IS CLIMATE CHANGE CLOSELY ALIGNED WITH AU'S MISSION?**

Climate change is the most pressing global challenge of the day. Climate change has already undermined the lives of many and threatens to alter the fundamental organic infrastructure that supports all life on earth. The science is clear. Every reputable scientific study based on peer-reviewed data has confirmed anthropogenic climate change. The question is no longer whether climate change is happening or whether we need to act. As President Obama put it in his June 23, 2013 speech, "[t]he question now is whether we will have the courage to act before it's too late."<sup>2</sup>

American University has taken courageous steps to address climate change and this suggests that the university appreciates the severity of the issue and has assumed responsibility for responding.

AU's many efforts include:

- President Kerwin's 2010 commitment to AU achieving carbon neutrality by 2020;
- Building LEED Gold buildings and retrofitting existing buildings to become LEED certified;
- Reducing greenhouse gases by composting organic materials (thus avoiding methane emissions) and running bus shuttles on biodiesel;
- Replacing fossil energy with renewable sources both on and off campus. This includes installing solar panels (for both energy and water), sourcing 100% of its energy through wind and solar, and piloting carbon sequestration in Costa Rica to offset emissions from university related air travel.
- Offering over 1,000 courses related to sustainability as part of designated programs or clustered courses in every school (e.g., SIS's Global Environmental Politics; SPA's Center for Environmental Policy; Kogod's Sustainability Management, SOC's Center for Environmental Filmmaking; WCL's environmental law program, and CAS's Environmental Science);
- Including sustainability as part of the AU 2030 vision for university-wide excellence.

These efforts have made AU a leader in campus sustainability and environmental education in general, and in climate efforts in particular. They have resulted in the highest rankings and ratings from organizations including the Princeton Review, Sierra Club, US EPA Green Power Partnership, and the Association for the Advancement of Sustainability in Higher Education.

In addition to actions, AU operates according to a set of principles that suggest that climate efforts align with the university mission. The university's Statement of Common Purpose emphasizes turning "ideas into action and action into service" and cites a "commitment to social justice" as a "hallmark of the institution."<sup>3</sup> According to the ACSRI, understanding the scientific imperative of climate science, the injustices that accompany climate hardship (wherein the poor disproportionately suffer), and courageously acting on behalf of public welfare represent the epitome of turning ideas into action and a dedication to

social justice. Additionally, AU’s Strategic Plan acknowledges and praises the politically and socially active character of the university and commits the institution to provide “rich opportunities for service” which include “an active pursuit of sustainability.”<sup>4</sup>

Given AU’s many climate efforts and its guiding principles, a divestment policy appears clearly to align with the university’s core purpose.

**WOULD ALTERING THE ENDOWMENT TO ADDRESS CLIMATE CHANGE BE LIKELY TO RESULT IN BELOW-MARKET RETURNS OR OTHERWISE INVOLVE FINANCIAL COSTS?**

Although it is impossible to predict the future results of investment strategies with certainty, the committee reviewed investment literature to assess the potential consequences of removing fossil fuel holdings from the endowment.

A wide body of research exists on socially responsible investing in general. A 2007 UN literature review shows that of 30 separate studies, 13 showed a positive relationship between Environment, Social, and Governance (ESG) factors and portfolio performance, 14 showed a neutral relationship, and 3 found a negative relationship, with some of the latter claiming that socially responsible investing of any general type reduces returns.<sup>5</sup>

Fossil free investing as a specific strategy is relatively new, so the body of research is smaller. Four recent studies compare the hypothetical returns of portfolios containing and excluding fossil fuel investments, as well as the risks a “carbon bubble” resulting from stranded carbon assets.<sup>6</sup> According to the studies, returns over 5 years may have been higher (by 1.2%) while returns over the past 10 years may have been slightly lower (by 0.16%). Overall, the research suggests that the impact of fossil fuel divestment might be negligible. In addition to returns, there would be fees related to altering each particular asset in the endowment, ranging from minimal to potentially significant.

AU’s current endowment investment strategy includes allocations in private investments, separately managed funds, and commingled funds. Table 1 lists components of the endowment accompanied by the percentage of exposure to companies listed in the Carbon Tracker Initiative listing of the top 200 fossil fuel companies by carbon content of their reserves.<sup>7</sup>

**Table 1: American University Endowment Composition and Exposure to Carbon Tracker 200 Companies (as of September 30, 2013)<sup>8</sup>**

	Total	% of Endowment	Exposure to Fossil Fuels	% Exposed
<u>Private Investments &amp; Hedge Funds</u>	<u>\$111,219,917</u>	<u>20%</u>	<i>de minimis</i>	<i>de minimis</i>
<u>Separately Managed</u>	<u>\$114,344,753</u>	<u>25%</u>	<u>\$2,388,857</u>	<u>0.5%</u>
<u>Commingled</u>	<u>\$280,897,623</u>	<u>55%</u>	<u>\$18,143,127</u>	<u>3.6%</u>
Real Assets	\$25,788,212	5.1%	\$8,049,755	1.6%
US Equity	\$84,650,212	16.7%	\$5,488,077	1.1%

Global ex US Equity	\$86,842,696	17.1%	\$2,590,979	0.5%
Total Emerging Markets	\$28,663,200	5.7%	\$1,565,897	0.3%
Bonds	\$54,953,303	10.9%	\$448,419	0.1%
<u>Total</u>	<u>\$506,462,293</u>	<u>100%</u>	<u>\$20,531,984</u>	<u>4.1%</u>

As shown in Table 1, 4.1%, or \$21.5m, of the American University endowment is exposed to fossil fuels, with exposures ranging from 1.6% (Real Assets) to 0.1% (Bonds). Since fossil fuel stocks cannot be directly divested from commingled funds, complete divestment would require reassessments of approximately 70%, or \$395m, of currently invested funds.

According to Cambridge Associates, the separately managed funds (\$114m and 0.05% exposed) can accommodate screens on fossil fuels, whereas the commingled funds (\$281m and 3.6% exposed) would need to be sold and replaced with fossil-free alternatives. Cambridge estimates that replacing all of the commingled funds with fossil free alternatives would incur an additional \$1.1m in annual fees and may be technically challenging in the current marketplace. Cambridge notes that the marketplace for fossil-free investment vehicles is rapidly evolving, and investment vehicles are emerging that may address those technical challenges.

Thus, at this time, complete divestment would certainly incur fees but may not necessarily result in below market returns looking forward. Therefore, a prudent strategy could minimize disruption to the endowment while maximizing divestment by first reducing exposure in Real Assets and separately managed funds, and then addressing other commingled funds as successful alternative investment vehicles become available over time. By replacing the Real Asset funds with investments in clean technology and renewable energy, and screening separately managed funds, we would reduce fossil fuel exposure by 50%, minimize additional fees (Cambridge estimates ~\$100k/year), and carry low risks of potential below-market returns. These steps would also reduce exposure to fossil fuel related industries such as pipelines, while shifting to investments in climate-related solutions. We believe that Cambridge is well-situated to recommend the most prudent specific approaches for implementing screens and selecting alternative investments that maintain asset allocation goals while balancing fees against potential returns.

**Table 2: Assessment of Endowment-Based Strategies for Addressing Climate Change**

Strategy	Tactic	Estimated Cost	Justification
Divest	Replace current investments in the Real Assets category with investments in clean technology.	\$90k in estimated additional annual management fees (Request that Cambridge recommend investments with competitive, historical, risk-adjusted returns).	The Real Assets category contains 39% of current exposure to fossil fuel companies in addition to investments in associated infrastructure (pipelines, refineries, etc.) but only represents 5% of the endowment. In recent years, it has not performed as well as other asset classes and investments have recently been reallocated in this category to reflect the fact. Based on estimates from Cambridge, divestment and reinvestment in this category would incur

			the least fees related to other asset classes while addressing a significant portion of AU's fossil fuel exposure.
	Screen out fossil fuels from separately managed funds	Relatively low additional management fees. (Request that Cambridge recommend investments with competitive, historical, risk-adjusted returns).	A negative screen is the simplest first step and incurs the fewest additional fees. Unlike commingled accounts, separately managed accounts can accommodate an immediate negative screen on top publicly traded fossil fuel companies.
	Monitor the marketplace for new opportunities to replace funds holding fossil fuels with funds excluding them.	Request that Cambridge recommend investments with competitive, historical, risk-adjusted returns.	Immediate divestment and reinvestment might not be feasible with commingled accounts given the limited quantity of appropriate market alternatives for fossil-free investment vehicles. As such, Cambridge will regularly evaluate alternatives and make recommendations to divest and reinvest, and annually report such efforts to the Board of Trustees.
Invest	Establish Green Investment Fund	Unknown	A Green Investment Fund complements a divestment policy by providing an opportunity for positive investment in green technologies. This fund would be a prospective fund with designated future donations. The objective would be to both move capital into innovative green technologies as well as demonstrate to investment fund managers the potential demand for such products.
Engage	Shareholder engagement	Negligible	Join CERES, vote proxies to support action on climate change, and provide opportunities for students and others to attend shareholder meetings.

Our conclusion is that it is possible to divest from fossil fuels without an expectation of below-market returns, but that fees will be incurred, and some of the current funds might not currently have competitive equivalent fossil free alternatives. Therefore, we recommend a phased approach to reducing fossil fuel exposure by screening separately managed funds and replacing Real Assets funds with investments in clean technology, while monitoring the marketplace for competitive alternatives for other fossil fuel holding funds, with a goal of achieving full divestment from fossil fuels. We recommend commissioning Cambridge to evaluate each of these actions.

#### COULD THE ENDOWMENT BE USED AS AN EFFECTIVE TOOL FOR ADDRESSING CLIMATE CHANGE?

“People of conscience need to break their ties with corporations financing the injustice of climate change.” *Archbishop Desmond Tutu*<sup>9</sup>

ACSRI recognizes that divestment may not alter the financial fate of specific companies or the economic landscape of the fossil fuel industry. The purpose of ACSRI's proposed divestment strategy is politically symbolic: it aims to alter the balance of legitimacy surrounding fossil fuels.

The international community currently lacks any significant effort to address climate change at the scale required as outlined by the Intergovernmental Panel on Climate Change. The same is true at the domestic level. The US Congress is not debating any significant piece of legislation aimed at addressing climate change. Civil society can play a crucial role in spurring governmental action by de-normalizing the use of fossil fuels and associating fossil fuel companies with climate disruption. The proposed roadmap positions AU to act as a leader in galvanizing colleges, universities, municipalities, companies, and industries to use their portfolios as vehicles of political expression and thus build civil society momentum for transitioning to a post-fossil fuel economy.

A divestment and investment policy would assist in such a transition by legitimizing and practically assisting in the advancement of green energy. While large fossil fuel companies may be insulated from minor shifts in investments, small sustainable energy companies are particularly in need of greater capital. Altering AU's portfolio in ways that lead to greater investment in wind, solar, hydroelectric, and other renewable sources of energy would help advance the green technological revolution.

In short, the proposed divestment policy aims not to bankrupt fossil fuel companies or have a direct effect on those companies' ability to do business. Rather, it seeks to alter the balance of legitimacy regarding carbon-based fuels and spur innovation in green technologies.

## **CONCLUDING REMARKS**

AU is outstanding among institutions of higher learning in its stated commitment to public service, global welfare, and social justice. AU has already devoted itself to minimizing the institution's contributions to climate change through infrastructural improvement, curricular content, and institutional practices. It is time to take the next step and publicly announce an endowment policy of divesting, investing, and engaging to move the world to a responsible climate future.

Our aim in this document is to demonstrate that a divestment policy aligns with AU's purpose and may incur only negligible financial costs (to be explored further by Cambridge). We hope this provides justification for AU Trustees to pursue the divestment strategy outlined above with confidence that they are fulfilling their fiduciary responsibilities.

AU Trustees possess a unique historical opportunity. You can and must steward AU into a prosperous future in which financial resources are available to advance the educational and service missions of the university. You can also, however, establish a legacy that will serve the institution in perpetuity. Such an effort will help us all meaningfully answer the question our grandchildren will one day ask, "What did we do about climate change?" By committing to divest, invest, and engage, we can reply that we followed the deep wisdom of AU's hallowed mission: we did everything we could.

## Members of the ACSRI

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<sup>1</sup> Mary Kennard, *Fiduciary Duties and Socially Responsible Investing ("SRI")*, November 4, 2013.

<sup>2</sup> President Barack Obama, *Remarks by the President on Climate Change*, Georgetown University, June 25, 2013, <http://www.whitehouse.gov/the-press-office/2013/06/25/remarks-president-climate-change>

<sup>3</sup> American University, *Statement of Common Purpose: American University's Mission*, adopted 1994, updated 2010, <https://www.american.edu/president/statement-of-common-purpose.cfm>

<sup>4</sup> American University, *Strategic Plan*, approved November 2008, <https://www.american.edu/strategicplan/>

<sup>5</sup> UNEP FI, *Demystifying Responsible Investment Performance: A review of key academic and broker research on ESG factors*, UN Environment Programme Finance Initiative, 2007,

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<sup>6</sup> Aperio Group, *Building a Carbon-Free Portfolio*, 2013,

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<sup>7</sup> Carbon Tracker Initiative, *Unburnable Carbon – Are the world's financial markets carrying a carbon bubble?* March 2012, <http://www.carbontracker.org/wp-content/uploads/downloads/2011/07/Unburnable-Carbon-Full-rev2.pdf>

<sup>8</sup> Cambridge Associates, endowment status as of September 30, 2013.

<sup>9</sup> Desmond Tutu, *We need an apartheid-style boycott to save the planet*, The Guardian, April 10, 2014,

<http://www.theguardian.com/commentisfree/2014/apr/10/divest-fossil-fuels-climate-change-keystone-xl>