Pooled Funds: The Invisible Wall Standing Between Your Foundation and True Mission Alignment

By Dana Lanza and Sarah DeNicola

Since 2008, the field of mission-related investing has expanded beyond what anyone imagined. At Confluence Philanthropy, we have participated in the movement of more than $2 billion in institutional commitments to the practice as foundations "carve out" portions of their endowments to test the overall premise of managing investment portfolios along social and environmental criteria, and with positive financial returns.

While many foundations are highly motivated by the notion of creating "impact" beyond what could be achieved with grant dollars through the use of concessionary capital with the potential to leverage other kinds of investments, others are concerned primarily with being responsible investors[1] in the way in which they manage investments. As with many things in the world, subtle lines are drawn around the value and influence of these two approaches, neither of which is mutually exclusive, because deep in our hearts we know that every charitable organization should be doing both.

Yet, the discourse tends to pivot around these two polarities, completely sidestepping one of the most pressing issues in mission-related investing today: the pooling of funds. The current way in which many pooled funds are managed is the invisible wall that stands between empowered, mission-aligned investors and their intentions.

Most foundations hold investments in pooled funds, which aggregate investments from many individual investors – offering lower trading costs, portfolio diversification and lower-cost professional money management.[2] However, as more foundations seek to align their investments with their values, they come up against institutionalized barriers and find that they have lost key mechanisms of influence. For example, foundations seeking to vote their stocks along environmental, social or governance guidelines may not be able to do so within certain funds because ownership is held in the collective. A second case in point: endowments seeking to divest from certain fossil fuel companies or sectors of the industry may not be able to do so because they cannot select individual investments in a pooled fund.

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Since funds from multiple investors are aggregated into one pool of money, fund managers vote proxies on behalf of *all* the investors according to their definition of fiduciary duty. This means that the power a foundation holds as a shareholder is effectively stripped, and its own investment dollars, more often than not, will contribute to unsustainable business practices and outcomes.

At Confluence, it is our experience that a majority of foundations, and especially small to midsize foundations, are invested (often heavily) in pooled fund structures. In many cases, these investments were made prior to the new era in mission-related investing and without much consideration for questions of ownership or investor influence. The elusive promise of low fees and financial return often has been cited as the motivation for such sorts of investments.

It is of utmost importance for foundations to *know what they own*. In a small-sample landscape analysis by Confluence Philanthropy's Proxy Stewardship Initiative of 50 foundations that practice mission-related investing, approximately one-fourth of survey respondents reported that they did not know if their foundation was invested in pooled funds, or that it was too difficult to obtain the information.[3] Simply getting full and transparent information from investment advisors can be quite difficult for foundations.

The uncomfortable reality is that the invisible wall of pooled funds not only prevents foundations from true mission alignment, it also hamstrings the ability to truly know and take responsibility for what you own, unless you are in funds specifically managed along environmental, social and governance (ESG) criteria. Most endowments are heavily invested in the fossil fuel industry (in some cases approaching even 7 percent of assets), and others may be in surprising investments such as the prison industry, GMO-producing agribusiness or, gosh, even adult entertainment! Yet, hopefully, very few donors, were they able to make intentional investment choices, would ever choose these forms of investment.

This invisible wall effectively prevents asset owners from exercising their rights and responsibilities as shareholders. This has deep implications for one of what we believe to be the central tenets of mission-related investing: *knowing* what you own and *owning* what you own. For impact investing to deliver on its promises, impact investors must take responsibility for the entirety of their investments, beginning with tackling the sticky issue of pooled funds.

DIFFERENCES IN DEFINITIONS: Mission-Aligned, Impact Investing, Socially Responsible Investing

While terms like "impact investing" and "responsible investing" often are used interchangeably, important distinctions must be made. Confluence Philanthropy refers to the true potential of impact investing as "mission alignment," wherein all of an organization's assets are in alignment with its mission and values. Mission-driven investments are those created primarily for social or environmental performance (although they may be below or market rate investments).

"Impact investing," as it's currently being deployed, usually refers to direct investments in private equity or concessionary loans such as program-related investments, angel investments or loan guarantees. "Socially responsible investment (SRI)" refers to how cash is managed, proxy voting, shareholder engagement and positive and negative screening. However, it is important to note that multiple definitions are in use in this field and consensus has yet to be reached. The *Stanford Social Innovation Review's* Fall 2013 cover article displays a range of definitions with fundamental differences. Paul Brest and Kelly Born's assertion that an "impact investor seeks to produce beneficial social outcomes that would not occur but for his investment in a social enterprise" sparked a flurry of responses, and the jury is still out.[4]

THE CONFLUENCE PHILANTHROPY APPROACH: MISSION ALIGNMENT

Confluence Philanthropy works to move the field of philanthropy toward mission alignment. This means the use of high-impact, mission-driven investments when possible and prudent, and the practice of responsible investment along ESG guidelines everywhere else.

So, how can foundations ensure that their investments, at the very least, are not working in opposition to their mission and values? Even further, how can foundations actually harness their power as asset owners to contribute toward the social and environmental outcomes they seek?

Confluence Philanthropy's Proxy Stewardship Initiative works to address the issue of pooled funds and to support

endowments in being able to vote their proxies in accordance with their own values. The initiative aims to provide endowments with a deeper understanding of what pooled funds are, how they are used and how foundations and individuals can take action toward aligning their money with their missions.

The initiative has developed a set of universal proxy voting guidelines that endowments can collectively bring to fund managers, as well as a set of tools and resources to support these efforts. At a minimum, these voting guidelines and tools will help foundations to initiate these important conversations, which often can set change in motion. However, without addressing the problem of pooled funds, true mission alignment cannot be achieved and impact investing may be falling into the same traps as the original 95 percent – wherein the majority of power is held in large and untouchable investment structures and a small portion of funds is allocated to creating positive impact.

Ultimately, more work is needed to increase the ability of foundations to practice discretion in their portfolios and to truly *own what they own*. Not only must philanthropy change, but the frightening reality is that so must the financial industry. Yet, without doing so, regrettably, there will never be comprehensive market moving, and impact and impact investing will remain an ornament on the investment portfolios of progressive endowments. ■

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Notes

1. By "responsible investing", we refer to the use of screened funds, proxy voting, shareholder engagement, active ownership and the ways in which cash is managed.
2. See www.investopedia.com.
3. "Proxy Stewardship Project: Landscape Scan." Proxy Stewardship Initiative (NY and Oakland: Confluence Philanthropy, Fall 2013).
4. Paul Brest and Kelly Born, "When Can Impact Investing Create Real Impact?", *Stanford Social Innovation Review*, Vol. 11, No. 4, pp. 22–31, Fall 2013.

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Questions? Contact Kourtney Ginn at kginn@ncrp.org or (202) 387-9177 x16.