How Can Endowments Invest Responsibly and What's Stopping Them?

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Abstract: Endowment funds are increasingly focusing on responsible investing in light of ESG concerns. These funds invest in various assets to generate returns, while facing pressure to align investments with their social missions. Though responsible investing can bolster ESG objectives, it poses challenges, such as reduced returns and conflicting sustainability standards among stakeholders. Despite progress in ESG implementation, a variety of issues present ongoing barriers to the full realisation of responsible investing.

Introduction

Environmental, social, and governance (ESG) concerns have reached a pinnacle of importance as humanity strives to create a more sustainable future on our planet. This has impacted the way we live as individuals, how companies have evolved in their operations, and even recently branched into how investment funds may wish to allocate their assets. Endowments are often at the forefront of this shift towards responsible investment due to their role in educating and supporting young students and since their students, professors, and even donors can tend to be particularly socially conscious. Responsible investing, though laudable, incurs an additional set of challenges which begs the question: how do endowments invest responsibly and is it worth it?

What is an endowment?

An endowment fund is a large pool of funds typically belonging to academic institutions such as Universities which use the funds to advance their purposes; these may include awarding bursaries to students, funding research projects, paying current staff, etc. Initially they are largely funded by donations and legacies within wills, with these consisting of large cash sums, land, or any number of financial assets; while long ago these funds would have merely been kept in a bank until the right project requiring financing appeared, endowments have since started investing their funds as a way to acquire additional capital and ensure longevity.

How do they invest?

Institutional investors seek to pool money from clients and subsequently invest in stocks & shares, bonds, derivatives and other financial assets such as private debt, as well as commercial and residential property and other alternative assets. In doing so, they expect a return on their investment where, to be feasible, greater risk or volatility expected will necessitate a higher rate of return. Through diversifying an investment portfolio, fund managers can eliminate a significant amount of risk. Once a fund has determined an acceptable level of risk they can bear, they will create a portfolio which – according to their data – should maximise their possible returns.

Endowment funds operate on the same principle of maximising risk-adjusted returns as other large investors; however this is achieved through different means. institutional investors will often invest in liquid assets such that they can, as their short term liabilities fall, acquire funding as necessary. Endowments, however, have significantly fewer short term liabilities and must consider the longevity of their purpose; they can thus plan for future by tying up their assets for even decades at a time. They forgo the benefit of liquidity and, in doing so, are able to gain greater returns through an 'illiquidity premium'.

Why should endowment funds practice responsible investing?

These endowment funds, however, should be regarded differently as to how one might regard a large private equity fund or hedge fund. The latter are usually solely concerned with the maximisation of risk-adjusted returns and in the pursuit thereof can be brutal as they wish. We must importantly remember that endowments exist ultimately as a vehicle to fund and advance the purpose in question.

If we consider a hypothetical endowment with a goal to advance public health, instinctively it would seem that purchasing stocks in a tobacco company would run contrary to their purpose. Firstly, it may harm the ability to attract donations to the endowment if potential donors can see investments contrary to their morals. Economically it may be argued that such an investment through the secondary capital markets does not provide any direct cash benefit to said tobacco company and thus does not directly obstruct the objective of the endowment to advance public health. However, by providing demand and liquidity in the secondary market the stock's value is supported which provides value to the tobacco company and thus may go against the pursuit of this goal. By choosing instead to invest in ESG friendly companies, the endowment can also signal these growing sustainability concerns to the market and instigate change within companies as they seek to maintain their value and maximise profit.

How responsible investing can be implemented.

It is not a given that every single endowment will practice responsible investing and as such they may not consider ESG at all; however, as noted above, this may harm both their goals and their capacity to raise funds. Assuming that an endowment wishes to invest responsibly, there are various ways in which ESG concerns may impact investment strategy.

A common approach is for endowment fund managers to avoid investments which run contrary to the goal in mind. Moreover, the fund managers can use third party agencies (such as MSCI ESG ratings) to further inform and measure their decision-making and avoid problematic investments.

Alternatively, it may be argued that merely avoiding certain investments is not enough to further a particular purpose. Consequently it would be the duty of these endowment funds to provide positive impactful change through engagement with their

investments in line with their purpose; to accomplish this a fund may, for instance, acquire a controlling stake or insert conditions into any capital investment, thereby gaining the power to actively change and remove any ESG concerns.

Problems with responsible investing.

If endowment funds were capable of advancing their purposes through responsible investing while still seeing adequate returns on their capital, then this approach would be ubiquitous and there would be no need for me to write any of this. Unfortunately responsible investing is neither simple nor unproblematic.

If we consider two identical endowment funds and stipulate that fund I must invest responsibly while fund II has no such restrictions, it seems instinctively that greater returns will accrue to fund II. Firstly, fund I may be precluded from a particularly lucrative investment. Secondly, where fund I seeks to improve ESG aspects of a company, it will incur greater agency costs as it monitors any commitments made. Although some may argue that sustainable companies will outgrow others and, in the long run, non-responsible investments such as into oil companies will become worthless, this only occurs where global demand reaches zero, which we may consider unlikely or so far into the future that the fund can drop these investments when they start to fall. Consequently, where one fund constrains themselves then, ceteris paribus, they should expect to forgo some level of return.

While external ESG ratings help in discerning and tracking the sustainability of numerous investments, there exists a problem earlier in the investment process. People have varying standards on sustainability – therefore the fund faces a challenge on whose sustainability preferences they should adopt between; the priorities of donors could contrast with those of beneficiaries, moreover standards within the beneficiaries can differ. Naturally the fund manager will seek to appease all parties, though this may not be possible – particularly considering Universities and the incredibly diverse and strong views among students, professors, and donors; in such situations difficult choices ensue. Clear management and conflict resolution structures can alleviate this problem – however these may still anger certain parties if the terms are considered unfavourable.

Moreover, having looked at the annual report of a University endowment which will remain anonymous, various other problems arise. The investments are so diversified that there might be no meaningful ability to commit to making an impact on the behaviour and culture of a company; moreover, the underlying investments are so remote as the money may be delegated through numerous other funds before reaching its destination that it can be challenging to collect enough information to rate such investments. As a result of this, while this fund had set ESG targets according to MSCI ESG ratings and surpassed these, their investments in private equity funds – which constitute over a third of the discretionary investment portfolio – are not ESG rated and thus potentially undermine the efficacy of their new 'Responsible Investing Policy'. Even if there were ESG ratings provided on these investments, the significant diversification through other funds also renders any such commitments susceptible to the threat of greenwashing.

Conclusion

Overall it seems as though endowments should tend towards investing responsibly in order to further their goals which will have the added benefit of signal to the market the increasing significance behind ESG concerns. At the very least endowment fund managers should seek to divest any problematic assets. Engagement with a company to actively improve existing problems would likely provide greater positive change towards any goal though this may incur further costs and thus an endowment may understandably avoid this where the costs are deemed excessive. Perhaps the hardest task of the responsible fund manager is to sufficiently appease the donors and beneficiaries in a world of increasing social polarisation.

It is clear that responsible investing is increasingly being implemented – and somewhat successfully as demonstrated by the anonymous endowment largely exceeding their sustainability goals; however there will exist a flaw in this implementation as long as private equity investments persist as ESG unrated. This, unfortunately, is likely to be a long time due to difficulties in collecting enough information on such a diverse and remote pool of funds.

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