



* The Responsible
Endowment Project

RESPONSIBLE RETURNS:

*A Modern Approach to Ethical Investing
for the Yale Endowment*

TABLE OF CONTENTS

Introduction	2
The Endowment: 1972	4
Simple to Understand	4
The Power of Shareholder Voting	7
Implicit Transparency	7
The Modern Endowment: Changes Since 1972	9
Foreign Equity	11
Private Equity	11
Absolute Return	12
Real Assets	13
Yale’s Values	15
The Environment	15
Social Issues	16
Corporate Governance	16
A Modern ACIR	18
ESG	18
Active Ownership: Beyond Screening and Divestment	19
The New ACIR	22
Transparency	23
New Structure	24
Conclusion	26
Summary of Proposed Changes	27

INTRODUCTION

In 1972, Yale University's adoption of the guidelines outlined in *The Ethical Investor*—a landmark book on responsible institutional investing by three Yale professors—demonstrated an institutional commitment to an ethically invested endowment portfolio. The New York Times described this as a “shift from an acquiescent to a participatory role as a major stockholder” and said that it represented “a significant policy change for Yale that is considered certain to influence the actions of other institutional investors.”¹ That prediction proved accurate as Yale’s Advisory Committee on Investor Responsibility (ACIR) became the model for similar councils at other universities across the United States. Over the past 37 years, these committees have voted on shareholder resolutions on a range of social issues and made policy regarding apartheid and genocide.

However, while financial markets and institutional investing have changed dramatically over the past 37 years, the ACIR has remained essentially the same. As the endowment has grown in size and complexity, the committee’s structure, methods, and resources have remained unchanged. The same New York Times article cited above described Yale’s endowment in 1972 as having “\$500-million in assets” with “[m]ost of the total invested in common stock, representing ownership and voting power in the nation’s corporations.”² Since that era the endowment has grown to almost seven times that size in real dollars and has seen the introduction of three new asset classes, and now it includes investments that span the globe. The huge increase in complexity associated with these changes necessitates a change in method of ethical oversight. In its current form the ACIR is no longer capable of successfully addressing issues of social responsibility in the Yale endowment.

This increase in sophistication is associated with the success of David Swensen ’80 PH.D., Dean Takahashi ’80, ’83 MPPM, and the Yale Investments Office in generating exceptional returns. These returns have done unequivocal good in the Yale community by providing a modern campus, bolstering the work of talented professors, and supporting enhanced financial aid that makes attaining a Yale education a question of merit rather than background. Far from just sup-

porting our university, the success of the “Yale Model” or “Swensen Model” has provided returns for educational institutions around the world. For this reason, as The Responsible Endowment Project has developed a modern framework for ethical institutional investing we have strived for a solution that interferes only minimally with the work of the Investments Office. It is our hope that by providing a new model that serves as a strong complement rather than an impediment to the Yale Model of institutional investing, our solution can be effectively implemented by Yale and later adopted by other universities that look to Yale as a leader in this area.

THE ENDOWMENT: 1972

In order for an oversight body to function effectively, it must be tailored to the particular organization that it oversees. The Advisory Committee on Investor Responsibility was formed to oversee the Yale endowment as it existed in 1972. The defining feature of the endowment at that time was that over 70% of the portfolio was invested in domestic equities. This focus had three implications that were crucial to the functioning of the ACIR: (1) the average member of the Yale community could understand the structure of the endowment and its impact on society, (2) proxy voting was an effective tool for engaging with the majority of endowment holdings, and (3) transparency of endowment holdings was implicit in the structure of the endowment.

In the late 1960s, there was a trend among university endowments of moving money out of fixed income securities—which had been central to institutional portfolios since the Great Depression—and into domestic stock. In 1967, McGeorge Bundy, then President of the Ford Foundation, accused universities of being too timid in their investment decisions, saying, “caution has cost our colleges and universities much more than imprudence or excessive risk-taking.”³ This push combined with the desire to increase returns led Yale to invest the majority of its endowment in publicly traded U.S. companies. In 1967, 68% of the Yale endowment was invested in domestic equity.⁴ This number continued to increase into the 1970s, peaking just a few years after the ACIR was formed.⁵ By 2008, the domestic equity allocation had fallen to 10% (see figure 1-1), the implications of which will be discussed later in this report.

Simple to Understand

One of the implications of a portfolio focused on domestic equity was that most members of the Yale community could understand the structure of the endowment and its ethical impact. In the 1970s students, faculty, and alumni were comfortable interacting with large companies like General Motors, Eastman Kodak, and ABC News, and could think about how Yale’s partial ownership—though small—made it partially responsible for the impact of these companies on the country and the world. Furthermore, the idea of a corporate proxy resolution was no more diffi-

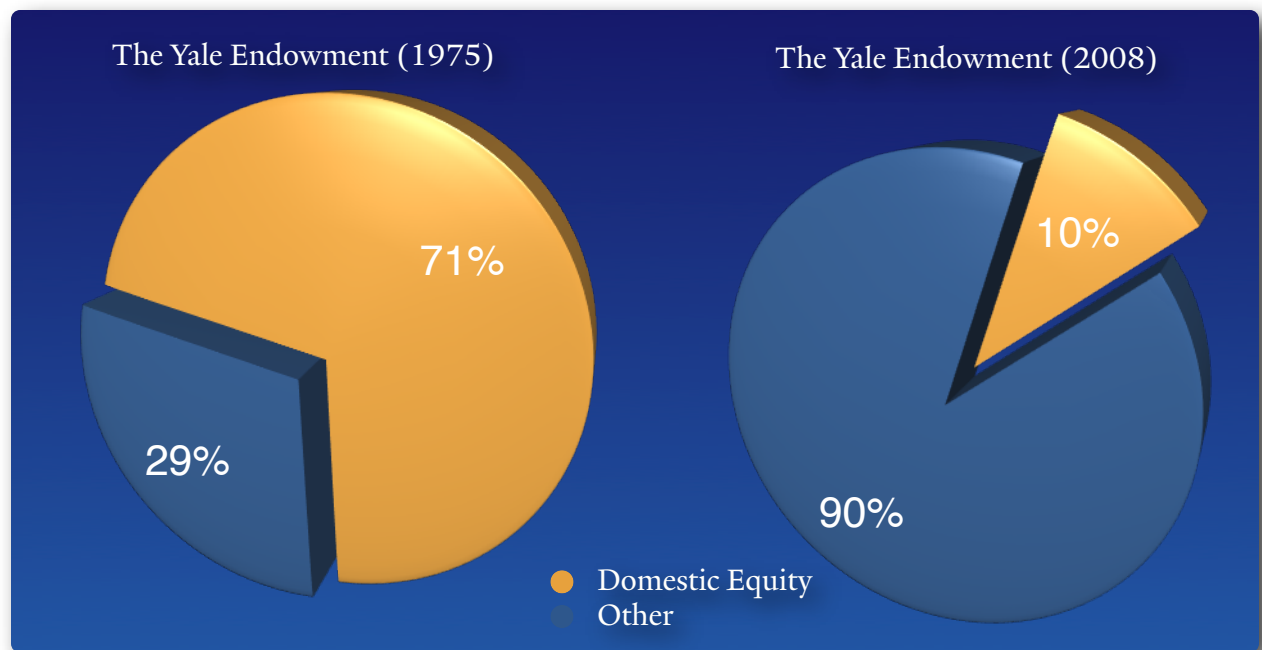


Figure 1-1: Domestic equity allocation of the Yale Endowment in 1975 and 2008

cult to understand than that of a town ballot resolution. While the endowment did include bonds and real estate, these investments made up less than thirty percent of the total endowment during the 1970s and once again, these assets were reasonably familiar to the Yale community.

In 1972, Endowment Management & Research—an external management company that was fully owned by Yale University—was responsible for the everyday work of investing the endowment.⁶ The company invested the money directly, not through a variety of external fund managers. This structure was simple for both the members of the ACIR and the Yale community as a whole to understand.

When reading *The Ethical Investor*, it is clear that the authors assumed at least a basic understanding of the endowment by the Yale community and a full understanding by the ACIR. The first item listed under the suggested guidelines for the ACIR states that the “guidelines establish criteria and procedures pursuant to which the university will respond to requests from members of the university community that the university take into account factors in addition to maximum economic return.”⁷ Community requests were the basis on which the ACIR was made to function. If the university community had been unable to understand the social impacts of investments, it would have been futile for it to be the initiator of the process of endowment oversight. A section of the *The Ethical Investor* is dedicated to hypothetical cases that illustrate the ways the authors intended the ACIR to respond in a variety of situations. The majority of the cases are

based on scenarios where Yale community members bring a concern to the committee, which then investigates the matter further and eventually takes action. For this process to function effectively, the community must have been able to understand the general workings of the endowment, and the committee must have had the knowledge and comprehension to investigate the matter fully.

Members of the current ACIR have described the difficulty of fully understanding the structure of the modern endowment due to both the diversity of asset classes and the array of external fund managers. Particularly for student members who serve only one year terms, by the time members feel comfortable discussing the ethical impact of investments, their terms are nearly over. Furthermore, the lack of information that is available to committee members on current holdings makes it nearly impossible for them to determine their ethical impact. Currently, committee members only have access to those domestic companies where they can propose votes on shareholder resolutions. In 2008, these investments made up 10.1% of the total endowment.⁸ When students, faculty, or alumni express concern regarding the other 89.9%, the ACIR knows no more than these other groups and is not in a position to respond effectively. Later in the report we will explain this further and propose solutions that help both committee members and the general public to maintain a better understanding of the endowment, one more in line with the understanding that was assumed in 1972.

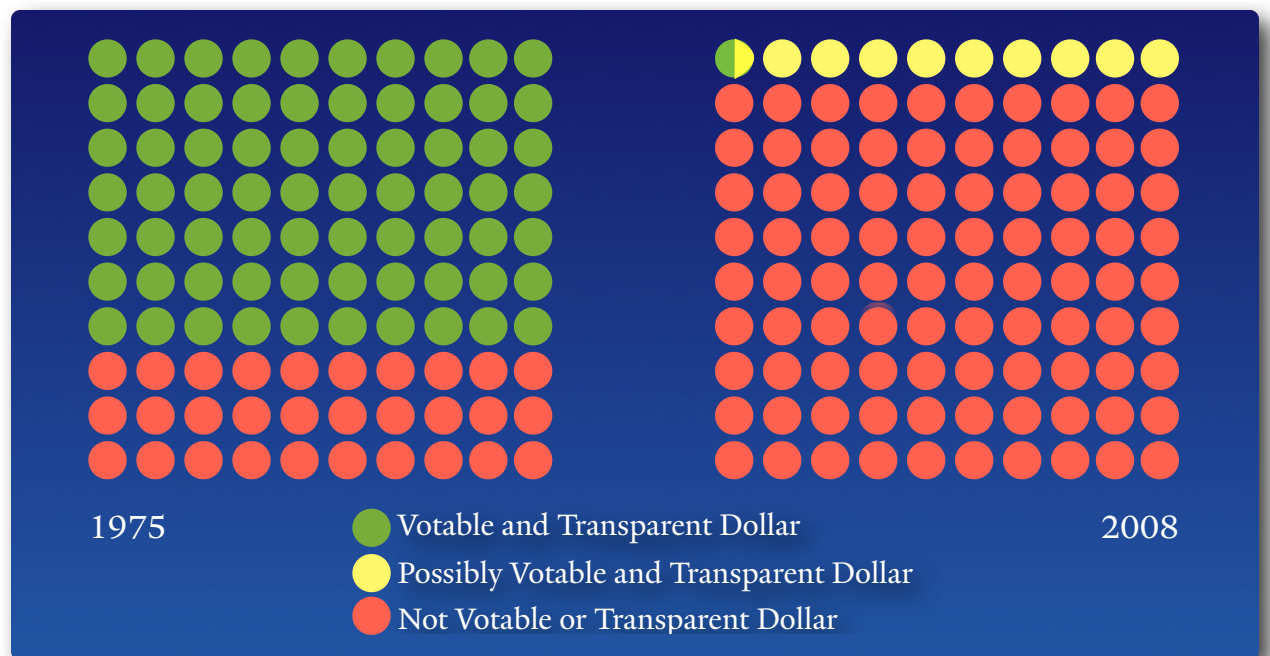


Figure 1-2: Voting power and transparency of a representative \$100 of the Yale Endowment in 1975 and 2008

The Power of Shareholder Voting

The second implication of the strong bias toward directly held publicly traded companies was that shareholder voting was an effective tool for remedying any negative impact of the portfolio. *The Ethical Investor* emphasizes that voting on shareholder resolutions is the central role of the ACIR. In fact, over the past 37 years, proposing votes on resolutions has been the chief concern of the committee. When considering a 1972 portfolio where 70% of the holdings are shares that can be voted annually, shareholder proxies are powerful tools for making a positive social impact. However, when evaluating a modern endowment with only 10.1% invested in domestic equities, this tool is much less effective. In fact, the portion of the endowment that is currently invested in votable shares is actually much smaller than this 10.1%, because external managers invest much of the domestic equity asset class and retain voting rights. According to SEC filings, as of December 31st, 2008, less than \$100 million of the domestic stock of the Yale endowment was owned directly by the university.⁹ Although Yale may retain voting rights for funds of which it is the sole beneficial owner, some portion of the domestic equity asset class is invested in pooled funds where voting rights stay with the manager. This suggests that the ACIR votes shares accounting for between 0.5% and 10.1% of the total value of the endowment portfolio (see figure 1-2). Therefore, while a focus on shareholder voting made sense when the ACIR was formed, it no longer has the potential to make a significant impact. The changes proposed later in this report account for this shift by outlining tools that are suitable for ethical oversight of a modern endowment with six diverse non-cash asset classes invested by external managers.

Implicit Transparency

The third implication of the large domestic equity allocation of the 1972 endowment was that there was transparency implicit in the structure of the endowment, both to ACIR and to the general public. The guidelines in *The Ethical Investor* state: “The council will have access to the lists of the university’s current holdings of endowment securities and to all data compiled by or on behalf of the university with respect to companies in which an investment has been made or contemplated.”¹⁰ This is no longer the case. As was mentioned earlier, the current ACIR only has access to between 0.5% and 10.1% of the total portfolio (once again, see figure 1-2).

In 1972, due to yearly updates from the Yale Treasurer, most of the endowment holdings were publicly available. Publications ranging from the *Yale Daily News* to the *New York Times* regularly discussed Yale’s investment choices. For example, a *New York Times* book review of *The Ethical*

Investor mentions Yale's investment in "Gulf Oil, a company under attack for its policies in the Portuguese colonies of Africa; Warner-Lambert, whose advertising for Listerine has been consistently under fire; Kennecott Copper, a target of ecology groups, and Southern California Edison, a utility that has been cited as one of the most discriminatory of all California companies."¹¹ Whether or not they were reflecting on the ethical nature of these investments, these articles helped the public understand how Yale's endowment functioned and the impact that it had on people's lives. This access provided a service to the ACIR, as alumni, students, and members of the public could easily approach the committee with their concerns about the endowment. Since the ACIR has never had the resources to research the ethical impact of every asset in the endowment, it depends on these outside sources to present important issues for further investigation. The public feels the impact of endowment holdings, not the ACIR. Therefore, the public is the best source for information regarding the ethical nature of the portfolio.

Trying to translate this step in the oversight process into a system that works with the modern endowment is particularly difficult. Beyond the additional knowledge required to understand a modern endowment, secrecy now plays an important role in the financial world. This is the result of the development of a financial climate in which asymmetric information is essential to outperforming the market. Especially at Yale, which is dependent upon finding new managers before the larger institutional investing community does, some secrecy is essential to success. As David Swensen explains in *Pioneering Portfolio Management*, it is necessary to find managers when they are "small, entrepreneurial, and independent." One reason for this is that, for managers, "[a]sset gathering creates diseconomies of scale for investors, decreasing the possibility of achieving superior performance."¹² In other words, since finding the best managers is what gives Yale its competitive edge, and they are often competitive only when managing a relatively small amount of money, it is important that Yale's manager selection cannot easily be copied. In light of these realities, the Responsible Endowment Project has spent a significant amount of time developing a solution that works to protect Yale's competitive advantage while allowing the Yale community and public to fill an important role in the resource-intensive task of endowment oversight.

THE MODERN ENDOWMENT: CHANGES SINCE 1972

The decade from 1970 to 1980 was a period of economic instability during which the investment principles outlined in *The Ethical Investor*, and consequentially Yale's ACIR were developed. Double-digit inflation, poor investment returns and high spending levels continued to deplete Yale's endowment funds. It was the external, decade-long fundraising Campaign for Yale that saved the Endowment from ruin, managing to raise \$182 million in new gifts. As previously explained, Yale placed its investments within what are now understood as traditional, more conservative asset classes for institutional investors. Aligning the portfolio with national investment trends focused on just two asset classes: U.S. equity and fixed income.

The ACIR was created based on *The Ethical Investor* in 1972, the same year that the T. Rowe Price Associates was selected to manage some of the endowment's assets. This was one of Yale's first moves toward diversifying its portfolio. Three years later, control of investment decisions was given to the newly created Corporation Investment Committee, whose responsibilities included overseeing endowment management, controlling endowment depletion, and reviewing asset allocation policies and strategies proposed by Investments Office staff.

It was most likely the pressures of difficult financial conditions that prompted Yale to consider diversifying its endowment portfolio. Precedent set before 1980 (before David Swensen became Chief Investments Officer in 1985) includes a 1973 commitment to Leveraged Buyouts, a 1976 experiment with venture capital, and a 1978 initiation of a movement to create a professional staff for the supervision of external management of assets under the supervision of new Director of Investments David Storrs '67. With an eye toward the landmark influence of Mr. Swensen's strategy, the period between the creation of the ACIR in 1972 and his first involvement with Yale saw initial experimentation with operating outside of the institutional mainstream of short-horizon, uncontroversial opportunities as well as a movement toward more active management strategies.

In 1985 Yale’s Endowment took a new turn when David Swensen became head manager. Dean Takahashi joined Swensen in the investments office along with an expanded staff and the continued input of the now decade-old ACIR and CCIR. Experimenting creatively with the balance between traditional and alternative asset classes, Swensen immediately pioneered new and unprecedented investment strategies, with the general goal of creating greater diversification of holdings and moving away from a dependence on mainstream assets of marketable stocks and bonds. To him, sacrifices in liquidity made sense as justification to pursue bargains in less efficient markets. During the first four years of Swensen’s leadership, alternative investments such as private equity, real estate, and absolute return leapt to constitute as much as 48% of Yale’s endowment, a much greater change than seen anywhere else

Each new asset class introduced as Swensen developed the Yale Model brought new opportunities for diversification and economic gain for Yale (see figure 2-1). However, with the opening of each new asset class the ACIR maintained an approach to responsible investing that was designed for domestic equity alone. That said, each asset class presents opportunities for successful active ownership that need not interfere with the work of the Yale Investments Office.

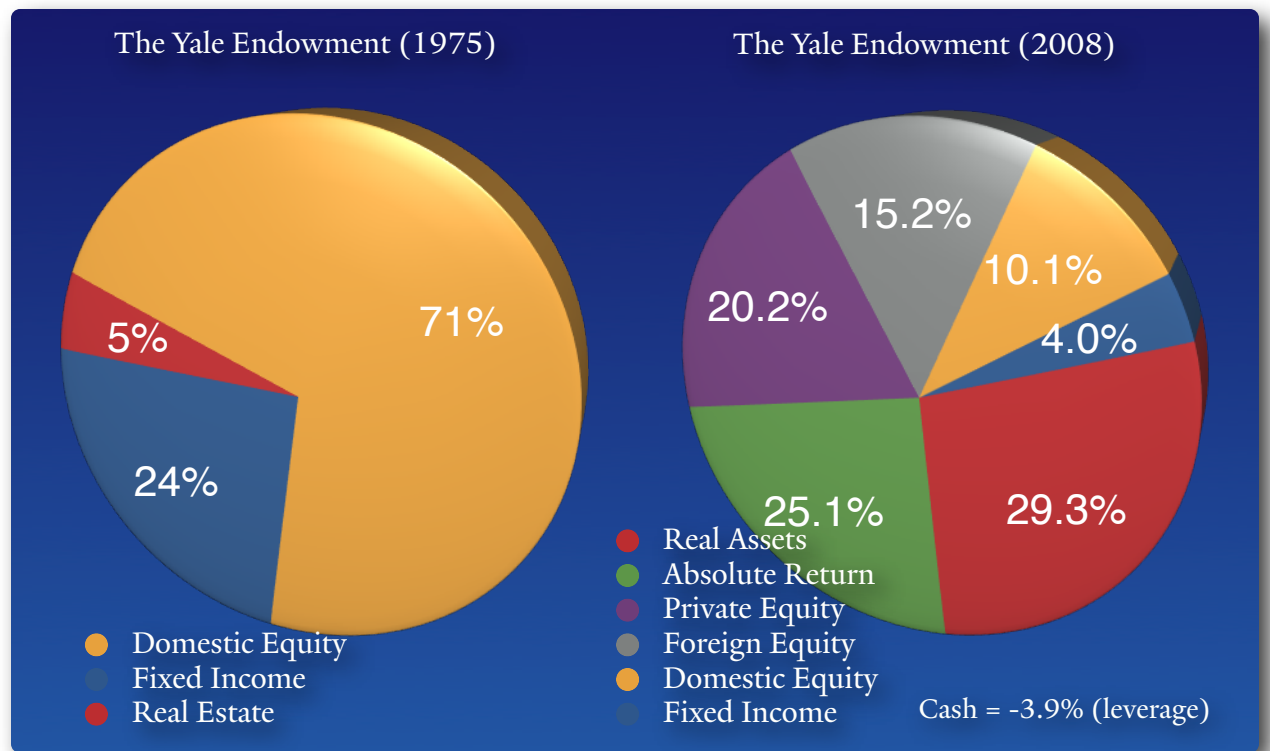


Figure 2-1: Breakdown of the Yale Endowment by asset class, 1975 and 2008

Foreign Equity

While foreign equity is similar to U.S. equity in principle – in this case representing a share of the ownership in a foreign company – it has two differences that are particularly relevant to ethical oversight: different regulations apply to businesses in foreign countries, and methods for interacting with management vary across borders.

Foreign companies are not subject to the same regulations as are companies based in the United States. This applies both to their financial statements, which do not necessarily require the same degree of transparency as the Securities and Exchange Commission does in the United States, and to regulations regarding labor and environmental practices. A modern ACIR might approach this problem by developing standards that are country-specific or by researching the major differences between various legal systems. However, both of these options would quickly become overwhelming. Fortunately, two alternatives exist. First, some of this lack of information could be remedied by news sources and foreign analysts. A number of analytic databases provide information on foreign companies despite the lack of legal disclosure requirements. For example, TruCost, an analyst that publishes in-depth environmental data on companies, has a database with information on 4,500 companies worldwide including all of the constituents of the MSCI All World Developed, FTSE All-Share, ASX 200, and Nikkei 225 indices.¹³ Second, the managers who are investing Yale's endowment in foreign stocks must be knowledgeable about the companies they invest in. If the ACIR finds that a particular company warrants closer scrutiny, a conversation with the fund manager could provide useful information.

Another major difference between domestic and foreign companies is that the latter do not necessarily use proxy voting as a means of interacting with shareholders. In some countries proxy votes are only required on certain issues and there is no means by which shareholders can propose their own resolutions. For this reason, dialogue with a company's management can be the only means for a shareholder without a large stake in a company to influence company practices. In this situation as well, fund managers can play a powerful intermediary role.

Private Equity

Private Equity, which was introduced to the Yale Endowment in 1986, consists of fund managers who invest in private companies.¹⁴ Often these managers fall into one of two categories: venture capital or leveraged buyout. Both of these strategies offer the ACIR opportunities for successful engagement. In fact, dialogue with the ACIR is likely to be more effective with private equity

than with the domestic equity asset class because Yale often has a much larger stake in private than in public companies.

Venture capital firms offer seed capital to entrepreneurs in exchange for a significant stake in their fledgling businesses. These firms aim to add value in some way by assisting the entrepreneur in growing his or her business. For example, Kleiner Perkins Caufield & Byers (KPCB) – a Silicon Valley venture capital firm in which Yale invested during the late 1990s¹⁵ – gave early capital to Google as well as to other successful technology startups.¹⁶ By being invested in a KPCB fund, Yale benefitted from these successes. Since venture capital firms work closely with entrepreneurs and have significant control over how their companies develop, the ACIR could easily engage with managers if any of their portfolio companies were developing in a way that was in conflict with Yale’s values.

A firm that engages in a leveraged buyout strategy searches for public companies that are being run in such a way that the private equity firm can add value. The firm then buys the company (in many cases with borrowed money in addition to investors’ capital), makes changes to structure, management, or some other area, and eventually sells the company. As with venture capital, Yale probably has a larger stake in these companies than it would in a single public company, and thus the ACIR can more easily engage with these companies.

Absolute Return

Absolute Return – which became an asset class in 1991 and made up over 25% of the 2008 Yale Endowment – consists of hedge funds that follow strategies that aim to generate returns that do not correlate with the stock market. When successful, these funds offer significant diversifying power to the endowment during events when equities fall in value. This is one of the most difficult asset classes for the ACIR to oversee and consider ethically because investments do not correspond to traditional views of ownership. The ACIR will have to spend time considering the proper standards for applying Yale’s values to these investments. The committee might begin by considering the two broad categories that absolute return strategies fall under: event-driven and value-driven.

Funds that use event-driven strategies attempt to identify particular occurrences such as mergers, restructurings, or bankruptcies earlier (or with a higher degree of certainty) than does the market. They then attempt to use this knowledge to make a profit. For example, merger arbitrage is a strategy in which the fund manager tries to “predict the probability that a deal will close, its

likely timing, and the expected value of the consideration for the transaction.”¹⁷ By buying the stock of the target company and in some cases taking a short position in the purchasing company the firm can make a profit when the deal closes.

As with other event-driven strategies, fund managers who do merger arbitrage do not necessarily own a company’s stock for a significant period of time and may employ the use of short positions and derivatives. It is unclear how to assess the ethics of these transactions, and the authors of this report defer to the future ACIR on this issue.

Unlike event-driven strategies, value-driven strategies require managers to hold their positions for periods of time comparable to those of traditional active managers of equities. Often embodied in a “long-short fund,” these strategies require managers to take long positions in companies they think will do well and short positions in companies they expect to do poorly. A skilled manager will balance these positions such that fluctuations in the stock market as a whole do not affect the value of the portfolio. For example, a drop in the market would ideally lead to the long positions decreasing in value while the short positions increase. Therefore, the portfolio is shielded from market changes and will appreciate or depreciate solely based on the skill of its manager in predicting the prospects of particular companies.

When considering long positions, the ACIR should be able to use the same standards that it would apply to traditional marketable equity. However, short positions will require the same kind of discussion about standards as the event-driven strategies. With time, the ACIR should come to conclusions about how best to judge each of these strategies.

Real Assets

Real Assets – the largest asset class at 29.3% of the 2008 portfolio – is an incredibly broad category that includes real estate, commodities, and timber. While these assets differ substantially from each other, real assets investment strategies tend to resemble those of traditional ownership. In each case, the ACIR can consider the ethical implications of owning a particular type of asset. That said, when considering standards it makes sense to divide this asset class into its constituent parts.

With commercial real estate, Yale shares in the profits of fund managers who purchase office buildings or other commercial space and then rent them to businesses. For example, as of December 31st, 2008, Yale owned about \$24 million of a Real Estate Investment Trust called

Acadia Realty Trust.¹⁸ This fund “specializes in the acquisition, redevelopment, operation, management and leasing of retail properties primarily anchored by necessity-based and value-oriented tenants.”¹⁹ More generally, they own shopping centers across the United States. However, what counts as commercial property can vary dramatically. In addition to shopping malls, it may include hotels, office buildings, and apartments. Because of the wide range of possible investments in this area, the ACIR will probably do best to focus on the particular areas that are included in Yale’s portfolio.

Yale also invests in timber and commodities. The ACIR can examine these commodities and the industries that produce them as it would any other case of ownership. However, in the case of timber, there seems to be an opportunity to use the resources of the Yale School of Forestry and Environmental Studies to supplement research by the committee itself.

Conclusion

The significant changes in the endowment since the ACIR was founded represent an opportunity to reexamine the oversight process, taking advantage of new tools and approaches suitable for modern asset classes. While the committee itself will be responsible for developing those specific processes, the final two sections of this report will examine the values of the university and outline a framework for applying them to the modern endowment.

YALE'S VALUES

Yale's values as an investor should match its values as an educator and institutional citizen. While the values of members of the Yale community vary, the institution has shown a desire and a commitment to make a positive impact on the world in a number of areas. The authors of this report in no way intend this section to be a comprehensive analysis of these values, but rather an overview that the ACIR can use in considering standards for judging the ethicality of investments. A good starting point might be President Richard Levin's inaugural address to the Yale community in 1993, in which he said, "We live in a wider world beyond the ivy walls, a world in which we bear enormous responsibility." These words embody one of the most important aspects of Yale's mission as a university: a dedication to serving society.

Since the University's foundation, public service has been central to of Yale's goals. In 1701, Yale's original charter established a university "wherein Youth may be instructed in the Arts and Sciences [and] through the blessing of Almighty God may be fitted for Publick employment both in Church and Civil State."²⁰ Since that charter was granted, Yale has grown enormously. With each new addition, however, Yale has maintained its commitment to global citizenship in many different spheres, including environmental sustainability, social advocacy, and business ethics.

The Environment

In its mission statement, the Yale School of Forestry and Environmental Studies declares that it exists to "prepare new leadership and create new knowledge to sustain and restore the long-term health of the biosphere and the well-being of its people." The school recognizes that "environmental challenges are increasingly international," and therefore it "seek[s] to build a truly global school of the environment."²¹ This statement suggests that both environmental impact and environmental solutions must be considered on a global scale.

Yale has already taken steps to reduce its environmental impact in many aspects of its operations. In a recent speech President Levin said that in "demonstrat[ing] best practices in limiting carbon emissions we are teaching our students, who are full participants in this campus-wide effort, how

to be responsible citizens of the world.”²² He takes the thought a step further and shows that Yale already considers the dual goals of maximizing monetary and environmental returns when he says “Together, we are learning how to balance near-term economic considerations against the long-term health of the environment and future human generations.”²³ Yale already incorporates the value of environmental stewardship into its educational policies and campus operations; it should extend this practice to its institutional investments.

Social Issues

The Yale Law School is also dedicated to serving the common good. Former Dean Harold Koh has affirmed that “commitment to public service has long been a part of the culture of [Yale Law] School, a culture that believes that every lawyer has a duty to work actively toward a good greater than private gain. This belief, and the commitment that goes with it, are at the very heart of the Yale Law School’s traditions.” Yale University’s own mission statement, endorsed in 1992 by the Yale Corporation, makes its primary mission “to promote the scholarship, high character, values, and leadership which can be directed towards sustaining and improving society.”²⁴ These statements emphasize the idea that Yale has a fundamental commitment to serving society.

More specifically, the Orville H. Schell, Jr. Center for International Human Rights at Yale “coordinates a diverse program of human rights activities that...contribute to the development of the human rights community locally and internationally.”²⁵ Additionally, various community organizations on campus, such as Dwight Hall, the Yale Office of New Haven & State Affairs, and the Yale President's Public Service Fellowship Program, allow Yale to push forward both within New Haven, and abroad.

Corporate Governance

In the area of responsible business practices, the Yale School of Management’s slogan of “educating leaders for business and society” speaks to the university’s belief that while seeking profit, companies should honor their responsibilities as corporate citizens.²⁶ The mission statement of the Yale’s Millstein Center for Corporate Governance and Performance says that a “corporation is an institution that is expected to enhance society” and that “[c]orporations strive to improve the welfare of their constituents – primarily shareholders, as well as employees, suppliers, and customers – and thus contribute to the aggregate welfare of the broader community.”²⁷ The School of Management and the university at large see businesses as entities

that exist to serve society in ways beyond just maximizing profit.

Conclusion

Yale has strong convictions in the areas of the environment, social issues, and corporate governance. The proposed changes to the ACIR presented in the next section take these ideas into account in considering a new model of ethical investing. While this report cannot speak for the beliefs of the entire university community, we believe that these values offer a starting point for the ACIR as it develops criteria for evaluating investments. In addition to the three specific categories discussed above, it is worth noting the international nature of Yale's values as evidenced by its commitment to acting on them both on campus and in the world at large. The next section outlines a modern framework for endowment responsibility, based on the approach outlined thus far.

A MODERN ACIR

The reforms proposed in this report were not conceived solely by The Responsible Endowment Project. These changes are based on the extensive work of many organizations that make up a growing global movement for responsible finance. We have researched and borrowed heavily from the efforts of other institutional investors, investment management firms, NGOs, and the United Nations. This section will describe the latest advances in environmental and social performance metrics as well as sustainability reporting. These resources can greatly improve the ACIR's ability to effectively carry out its duties in today's global economy.

ESG

Led by the UN Environment Programme Finance Initiative, consensus is growing around the importance of environmental, social, and governance (ESG) factors to company value and long-term investment return. Once considered immaterial to financial performance and beyond the fiduciary duty of asset managers, ESG factors are gaining recognition as valuable indicators of a company's exposure to long-term risks such as negative environmental externalities, labor strife, corruption, and human rights abuse. By analyzing ESG factors, fund managers can identify competent and insightful management and avoid exposure to companies that create reputational risks in the public domain.

The UN Principles of Responsible Investment has 362 signatories representing over \$14 trillion in assets under management as of May 2008.²⁸ The first principle is “We will incorporate ESG issues into investment analysis and decision-making processes.”²⁹ However, integrating ESG factors into investment decision-making is a new and rapidly developing field. The European-led Enhanced Analytics Initiative is an international collaboration between asset owners and asset managers to improve investment research, especially on the effects of extra-financial issues on long-term investment. The amount of data available is not yet sufficient to enable the degree of comparative analysis required by all investors who invest in a variety of asset classes. However, some companies – such as RiskMetrics and KLD – have developed ESG

metrics for evaluating publicly traded corporations.

Demand for ESG information has led to increased social responsibility reporting from corporations. The General Reporting Initiative, a multi-stakeholder governed institution, has developed the world's most widely adopted sustainability reporting framework. These “Sustainability Reporting Guidelines,” detailed in their most recent version, G3, can be used to “benchmark organizational performance with respect to laws, norms, codes, performance standards and voluntary initiatives; demonstrate organizational commitment to sustainable development; and compare organizational performance over time.”³⁰

Sustainability reporting tools such as the G3 guidelines and the integration of ESG into investment decision-making are effective tools for working toward a socially and environmentally sustainable economy. Given the ultimate necessity of a fully sustainable economy, improvements such as the adoption of ESG standards and the G3 guidelines are likely to be widely adopted in the future.

Active Ownership: Beyond Screening and Divestment

The thinking behind ESG standards and the G3 guidelines has influenced large pension funds in the United States and Europe to adopt these ESG principles in their investment decision-making. These funds are the current leaders in ethical investing, incorporating their values into multi-billion dollar portfolios with diverse asset classes and hundreds of external managers. They have begun using their power as investors to raise social and environmental standards worldwide. Previous conditions that allowed these funds to easily divest from firms that did not meet their standards have changed. Due to their large ownership stakes in many companies and their public prominence, major public pension funds risk disrupting a company's stock price if they sell their shares.³¹ This “lock-in” tension has led funds to pursue the use of “voice” to influence companies and raise standards. Many believe that higher social and environmental standards lower risk and increase profitability in the long-term.

These funds pursue a variety of ethical investment strategies, the most promising of which is an active ownership strategy that engages companies based on standards such as ESG performance, compliance with international norms, and environmental transparency. Known as “responsible engagement” or “active ownership,” this strategy takes many forms, going beyond voting on shareholder resolutions at publicly-traded companies. Dialogue and meetings with management, as well as collaboration with other investors, are all used as part of a form of

“quiet diplomacy” that seeks solutions without bad publicity and negative impacts on returns.

In the past, many of these funds, such as the California Public Employees' Retirement System (CalPERS) have succeeded in increasing shareholder value through corporate governance engagement strategies. The CalPERS Corporate Governance Investment Program seeks partners who employ an “active engagement strategy to unlock value through operational, strategic, and governance changes.”³² The success of past corporate governance campaigns has demonstrated the ability of funds to monitor and improve firm behavior in a way that benefits shareholder value. As a result, many funds are now moving to broaden the scope of their engagement strategies to incorporate social and environmental issues.

The Dutch public pension fund manager PGGM works with F&C Investments, a UK company that pursues a responsible engagement strategy with the companies held by its clients. F&C's 16-person team of governance and sustainable investment specialists monitors the portfolio and pursues engagement with companies all over the world. They report having engaged 249 companies in the fourth quarter of 2008.³³ As an asset manager that also provides engagement services to funds like PGGM, F&C uses the combined shareholder power it represents to address issues such as corruption, climate change, threats to biodiversity, HIV/AIDS, and human rights with companies operating all over the world.

The Swedish National Pension Funds (AP1-4) have established a Joint Ethical Council that has analyzed the entire holdings of all four of its funds. After examining 3,500 companies globally for environmental and ethical compliance with international conventions, the Council identified 14 companies to engage during 2007. For example, the Council initiated a dialogue with Haliburton regarding “business ethics failings and bribery in Iraq and Nigeria contrary to the UN Convention against Corruption.” The Council also traveled to China to investigate how Chinese companies view social responsibility and to show that foreign investors are willing to help solve China's environmental problems and improve working conditions in its factories.³⁴ The actions of the Joint Ethical Council demonstrate the potential for a fund to be an active owner and pursue a responsible engagement strategy in a way that sets a global example. The Council's 2007 annual report offers a model example for what the results of a responsible engagement strategy would look like and the sort of annual report that the ACIR could release.

ESG analysis, sustainability reporting, and responsible engagement strategies are based upon a dual-logic of improving long-term financial returns and social and environmental justice. The first justification is outside of the purview of this report. The financial importance of social and

environmental criteria is something best determined by David Swensen and the Yale Investments Office. However, the movement involving ESG, G3 and responsible engagement has redefined ethical investing in several ways. It has become a movement for increased reporting and transparency, as well as raised environmental and social standards, all supported by active ownership and engagement efforts. The world of investing is changing. In December 2008 Denmark passed a law requiring mandatory Corporate Social Responsibility reporting for the largest 1100 companies in the country by 2010.³⁵ This movement needs to grow faster if the world is to successfully transition to a socially and environmentally sustainable economy before damaging the Earth irreparably.

Today's responsible investor is information-hungry and an active advocate for social, environmental and governance improvement. In many ways, the principles followed by these funds today reflect those laid out in *The Ethical Investor*. One could argue that Sweden's Joint Ethical Council follows a model similar to the ACIR, but adapted and equipped for today's global economy.

For Yale to maintain its position as a leading institutional citizen, it should take action and set an example for Universities around the world. If Yale acts now, it will begin an institutional learning process to position it far ahead of its peers on these issues. A new and up-to-date ACIR that takes advantage of leading ESG research and pursues responsible engagement strategies would ready Yale for the future of responsible finance.

Yale's current policy on ethical investing, described in *The Ethical Investor* requires that a company not inflict "social injury", defined as a "violation or frustration of domestic or international legal norms meant to protect against deprivations of health, safety, or basic freedoms". The ACIR is severely limited in its ability to apply it to the entire endowment. As was mentioned earlier, Yale's holdings are not transparent, so relying on the public to bring complaints to the ACIR is an imperfect system.

Currently, the ACIR has few options for carrying out its duties. Negative screens and divestment are costly and ineffective strategies for improving the responsibility of the endowment. In both cases, if Yale chooses to screen out or divest from a company, it forfeits any shareholder power that could be used to pressure the company to improve. If a company's operations are considered questionable, not investing in them simply opens the door for other investors with less incentive to improve the company's responsibility to do so instead. There is also a high cost of action for implementing a screen or divesting from a company. In the case of screening,

comprehensive guidelines can be difficult to establish and costly for the Investments Office to implement. This interferes with their operations and can cause negative financial and social impacts. While divestment may seem like a straightforward solution, it can cost Yale large sums of money and unless it is part of a broader movement rarely has a significant social impact. The Responsible Endowment Project believes that divestment should be seen as an absolute last resort in dealing with an ethically questionable company. There are other choices available to Yale that would make the endowment more responsible without sacrificing entire investments. The primary focus of any effort to improve the responsibility of the endowment should be an approach that maximizes both social and monetary returns.

The New ACIR

In order for the ACIR to be upgraded to contemporary standards of ethical institutional investing, two important changes need to take place. First, the ACIR should actively screen the endowment's holdings for companies in violation of Yale's values on an annual basis. Second, the ACIR should pursue an active engagement strategy to raise the social and environmental standards of companies held by the endowment to meet those of the University. Through these mechanisms, the standards of the endowment can be brought into alignment with the broader goals of the University.

In order to pursue active ownership strategies, the ACIR will need expanded access to resources. The Committee should be able to request funds from the Corporation Committee on Investor Responsibility to subscribe to ESG databases and contract third party auditors and consultants. Equipped with sufficient resources and access to the entire endowment, the ACIR will be able to actively screen the list of holdings and choose a certain number of companies to engage each year. Through collaboration with the Investments Office, the ACIR can create an Engagement Plan that uses Yale's power as a shareholder to influence companies to improve their operations. Models like the G3 Sustainability Reporting Guidelines would provide the ACIR with mechanisms to ensure compliance.

Engagement would take a variety of forms suitable for different types of investments. Efforts such as shareholder resolutions for publicly-held corporations, collaboration with other institutional investors, and the "quiet diplomacy" of privately approaching management are all options that the Investments Office and the ACIR would consider when developing an Engagement Plan. A responsible engagement strategy would give the ACIR the flexible and

effective tools required to carry out its duties without implementing costly negative screens or calling for divestment.

Determining which companies to engage should be up to the Yale community represented by the membership of the ACIR. The guiding policy of the ACIR's responsible engagement strategy must be approved by the Corporation Committee on Investor Responsibility. It should reflect Yale's values, making the actions of the ACIR a process of upholding those values wherever Yale's money is invested.

These recommendations are designed with the current economic crisis in mind. Note that the core of this report recommends changes that require no new employees, no change in investment strategy, and no added risk. Instead, by implementing the changes described in this report, Yale will be making an intellectual investment in a learning process that will prepare it for changes to come.

Transparency

In order for the ACIR to be able to carry out an effective responsible engagement strategy it will need access to information regarding all of the Yale endowment's holdings. The Sustainable Endowments Institute's 2009 College Sustainability Report Card awarded Yale an "F" on endowment transparency. The grades are determined on a curve. Yale fell far behind Amherst and Dartmouth's "A" grades, Columbia's "B," and Harvard's "C".³⁶ Currently, the Committee only has access to Yale's public investments, which only account for a tiny fraction of the endowment's total holdings. This greatly limits the options open to the Committee in terms of taking action against potentially unethical investments. While the ACIR can vote on shareholder resolutions for public companies, it can do nothing to investigate the rest of the endowment.

Instead, it is limited to hearing complaints brought before it by others who have reason to believe that Yale may be privately invested in something unethical. These restrictions leave the ACIR unable to actively improve the endowment's ethical impact. If the ACIR is given access to the entire endowment, it will be able to carry out its mission in a meaningful way. It is not enough that the committee exists to hear those who come to argue before it. A responsible engagement strategy requires that the ACIR be able to analyze endowment holdings and select those companies that it considers most appropriate to engage.

The second form of transparency needed for effective monitoring of the university's investments

is the degree of information available to the public. Yale's investments affect the lives of people around the world, so it is important that the university open itself to hearing about their experiences and opinions. A member of the public with concerns about a specific company or fund ought to be able to see if Yale is an investor, so that he or she might be able to address those concerns with Yale or with the fund manager itself. The ACIR will never be able to fully monitor the activities of all companies held by the endowment. However, increased transparency to the public will create a bottom-up flow of information that will help improve the effectiveness of the ACIR.

We believe that the release of all fund managers' names on a one year delay is the best way to accomplish the dual objective of making the endowment accountable to the public in a manner that will not harm its rate of return. Yale's competitive advantage lies in the Investments Office's ability to find new, unknown, and talented money managers. If they prove successful, these managers are eventually discovered by the rest of the industry. Therefore, the one year delayed transparency would ensure that by the time that the managers' names were released, the advantage Yale would have gained from secrecy would have lapsed already anyway.

Yale would not be alone in releasing information about its endowment to community members. Recently, Amherst College released the names of all of its fund managers to students working to form an investor responsibility committee much like the ACIR. Harvard regularly publishes its shareholder voting record, complete with the arguments for each vote. Dartmouth releases its proxy voting record and fund managers to members of the college community on a password-protected website. Columbia provides a list of all of its fund managers at its Investments Office.

The model of transparency that this report proposes gives the ACIR the access it needs to provide meaningful oversight of the endowment. It also creates a means through which members of the public can find out whether Yale is involved in activities that affect them. Full and current transparency to the ACIR, coupled with delayed transparency of fund managers to the university community will greatly improve the responsibility of the Yale endowment without compromising the Investments Office's ability to add value to and augment the endowment at an unrivaled rate.

New Structure

Fulfilling this more active role will require a new membership structure. Expanding the membership of the ACIR to two undergraduates, two graduate students, two faculty, two staff,

and two alumni will be a useful first step toward a more balanced and active committee. Additionally, the term lengths should be extended to two years, with the terms offset so that there is always one junior and one senior member within each demographic. This system will provide the flow of information and opportunity to share experience that are crucial to understanding the complexities of a modern endowment. In light of the committee's role as an ethical arbiter representing the entire Yale community, it is important that its members be elected by their peers. Online elections could be held for each position, raising the public stature of the committee as well as the accountability of its members.

CONCLUSION

Currently, the ACIR's actions consist of voting on shareholder resolutions and addressing concerns brought before it by the community. While this sort of committee was unprecedented when introduced, the ACIR today is passive and ineffective when measured against current standards of ethical investing. The ACIR must be given the access and resources required to truly analyze the entire endowment. This means an expanded and elected membership, longer terms, and improved communication with both the Investments Office and the Corporation Committee on Investor Responsibility. After analyzing the endowment, the ACIR must actively seek out and engage companies that do not meet Yale's standards of ethical responsibility. This active engagement strategy should aim to work with at least five companies per year and the results should be reported annually. Lastly, on a delay of one year, Yale should release the names of all fund managers that invest the endowment to the public on the Investments Office website. This will direct public responses to unethical company behavior back to Yale, where they can be addressed by the ACIR. Yale must be accountable to the public. It can do so while maintaining the structure and returns associated with a modern endowment. Yale's position as a responsible investor has been slipping since 1972. It is time for the University to demonstrate leadership once again.

Proposed Change

Explanation

In addition to advising on shareholder voting, the ACIR will screen the endowment annually and select five companies or assets whose activities the committee deems to be in violation of Yale's values. With the approval of the Yale Corporation, the ACIR will then initiate dialogues with fund managers and/or company management, advising each company of actions necessary to meet Yale's ethical standards. The ACIR will continue to monitor each company's improvement and will seek the support of other investors if additional pressure is needed.

Reason for Change

The ACIR's current tools (shareholder voting, negative screening, divestment) make little social impact, are not adequate for most asset classes, and can harm investments. Active ownership is the modern alternative, used by many large funds, that has none of these consequences.

1

Active Ownership

2

Increased Transparency

The ACIR will have full access to the latest endowment portfolio each quarter including both fund manager names and assets. Members of the council will sign nondisclosure agreements and any request to disclose information not available to the public must be approved by the CCIR. The public will have access to names of the fund managers Yale invests with subject to a one year delay in a list available on the Investments Office website. Any managers which no longer invest Yale's money will not be included.

The ACIR currently has access to investments representing between 0.5 and 10% of the total endowment, leaving the committee unable to keep the other 90% in alignment with Yale's values. Without transparency to the community and public, the committee loses a source of information and credibility.

3

New Membership

All members of the ACIR will be elected by their constituency (alumni will elect alumni, undergraduates will elect undergraduates, etc.). All members will serve two year terms and may run for reelection. Elections will be staggered such that senior members can pass on knowledge to junior members. The council will consist of two professors, two alumni, two staff members, two undergraduates, and two students from graduate or professional schools.

Members need longer terms to gain a understanding of the many complex issues and to pass on this information to their successors. Elections will make the ACIR representative of the Yale community. Additional students will allow the committee to handle more work.

4

Enhanced Reporting

The ACIR will release a report at the end of each academic year detailing and the actions that they took that year and the reasoning behind them. They will also publish their positions and reasoning on shareholder voting. The fund manager list from the previous year will be appended. The report will be available on the ACIR's website at the end academic year and will be accessible to the public.

The Yale community currently has no regular access to information regarding the actions of the ACIR. Reporting will keep the university more involved in the work of the committee that is responsible for representing their values in the Yale endowment.

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