O'Meara, Ferguson, Whelan, and Conway

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Morally Responsible Investing for the Catholic Institutional Investor

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By Philip Ashton

In the oft quoted parable of the talents, (1) the servant that 'played it safe' and buried the 'talent' was treated sternly by the Master. Is the lesson to place "double or nothing" bets? Of course not, and we know that investing is not betting. We are, however, prompted to make sure we use our talents in helping build the Kingdom of God here on earth.

With today's unprecedented, real-time access to global investments, Catholic institutions face a number of challenges in developing and applying Morally Responsible Investing (MRI) guidelines to their financial assets. The United States Conference of Catholic Bishops (USCCB) has published and revised guidelines that provide some direction, but out of respect for the subsidiary authority of those entities looking to these guidelines and in recognition of the complexity involved in the prudent application of any formal set of rules, adapting and implementing an actual investment policy based on these guidelines is a task left to each individual diocese, religious order, or other entity. The development, implementation and maintenance of an effective investment policy that is in keeping with Church teachings while providing the required financial returns, entails a significant investment of thought and effort. It is difficult to strike the appropriate balance between sound temporal goods administration and the application of modern financial concepts addressing risk/reward, asset allocation and investment portfolio optimization. There is complexity and effort involved, but the effort involved should not cause us to shy away from our responsibility for MRI oversight nor should it be seen as an excuse to "bury one's talents" and avoid the responsibility to act as stewards of these assets. Although this responsibility usually falls on the shoulders of an already stretched diocesan Finance Director, CFO or a community's Bursar with some degree of oversight or guidance from lay advisors from the Finance Council or other like body, it must be addressed either internally or externally. A first order question for an organization developing MRI screens and processes is whether it has the staff time and expertise to set-up the needed framework.

The USCCB published the most recent revision of its Socially Responsible Investment Guidelines in November 2003. The guidelines expand on some basic themes originally addressed in the pastoral letter *Economic Justice for All*. In particular, it is expected that as part owners of a company, Catholic shareholders in U.S. corporations must see to it that invested funds are used responsibly, and these shareholders should not serve as passive actors in the companies in which they invest but rather should utilize their rights and influence to actively encourage firms to serve the common good. The strategy would therefore be a combination of avoidance (refusing to invest in, or divesting from, companies that promote activities contrary to the Catholic Church's moral and ethical teachings), and active corporate participation (seeking to influence corporate action in a positive manner wherever possible, such as through proxy voting). The Guidelines suggest that while pursuing these goals, proper stewardship nonetheless requires one to obtain a reasonable rate of return on investments (citing the Conference's expectation that its managers "perform at least at the level of the market"), while at the same time exercising ethical and social stewardship in its investment policy.

The USCCB Guidelines serve as a useful starting point for an investment policy but leave many more detailed questions unanswered, such as:

• *How does the ownership responsibility inherent in equity (stock) investments translate to other securities such as bonds, options, etc.?*
• *What is to be done about corporations that are active in multiple lines of business, some of which may be objectionable? In other*

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words, where do we draw the line – is a hotel chain offering adult programming off limits? Does an apparel manufacturer paying low wages, by 'developed' country standards, in a 'developing' country constitute a violation of the dignity of the individual?

• *How should pooled products such as mutual funds or exchange traded funds where there is limited ability to influence individual security selection be treated?*

• *What is the "market return" for a Catholic institution?*

• *How will the exclusion of certain investment opportunities impact returns, and ultimately stewardship?*

Applying MRI guidelines to equity investments in individual U.S. corporations requires a level of diligence and professional expertise, but is a fairly easily understood endeavor. First, the investor must determine those behaviors that would be considered objectionable, screen potential investments and deselect companies engaged in such activities. Over time, companies' activities must be monitored for changes in their business that could cause concern and lead to divestment. Lastly, investor rights should be utilized for positive change, primarily through the proxy voting mechanism (i.e. voting on corporate matters in accord with Catholic moral values and attempting to bring votes on such issues). While the corporate rights and operational transparency that are required of U.S. companies are not always the norm in other areas of the world, informed decisions can usually be made on foreign equity securities in much the same way.

Most Catholic investors would similarly extend this level of investment responsibility to ownership of corporate fixed income securities (bonds). A bond is, at its core, a contractual basis for a loan and it does not carry with it the rights and responsibilities of ownership, but it is a fairly direct method for financing a company's operations and activities. The issuance of a corporate bond in an embryonic stem-cell company, for example, provides the capital to develop that business and the bond will only retain its investment value and provide a return insomuch as that company is successful in continuing to operate and profit from its business. An argument can clearly be made that purchasing that bond on issuance would violate the spirit, if not the letter, of the USCCB guidelines. Even in the case of a bond that is purchased on the secondary market (i.e. it was bought from another investor rather than from the company itself); although the payment for the bond is directed to someplace other than the company, the interest payments to be received and expectation of payment at maturity are still dependent on the company's performance. Furthermore, the company would likely not have been able to issue the bond and obtain the capital it needed without the original investors' expectation that a secondary market would develop. Purchasing the bond in the secondary market is therefore supportive of that market and in effect funding the objectionable activities.

When it comes to decision making on companies that are involved in multiple lines of business, only a portion of which may be objectionable, the guidelines are a bit less clear. The USCCB refers to these companies as representing "mixed investments" and suggests that "by **prudently** applying traditional Catholic moral teaching, and employing traditional principles on cooperation and toleration, as well as the duty to avoid scandal, the Conference can reflect moral and social teaching in investments" (emphasis mine). The Guidelines further state that in areas that may cause confusion or scandal, "**prudence** would be the guiding principle" (emphasis mine). In this case prudence would appear to require consideration of both the nature and materiality of the potential offense. For instance, in its own investment policy regarding abortion, the USCCB, recognizing the nature of the offense, allows no materiality test – "In view of the nature of abortion, the investment

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policy of the USCCB should remain as it is, namely, *absolute exclusion* of investment in companies whose activities include direct participation in or support of abortion." In contrast to this, the Conference's policy directed toward curbing pornography does consider materiality, stating "[t]he USCCB will not invest in a company that derives a significant portion of its revenues from products or services intended exclusively to appeal to a prurient interest in sex or to incite sexual excitement."

Similar questions arise when considering investments made through pooled products such as mutual funds or exchange traded funds which offer the benefits of diversification and scale to stewards of Church assets. Just as for the company engaged in multiple lines of business, these represent "mixed investments", and once again prudence dictates that both the nature of the objectionable activity and materiality must guide investment decisions. The only way to fulfill this standard is through a diligence process that looks through the pooled structure to the underlying investments and makes informed decisions based on rigorous analysis and research.

It is sometimes assumed that a Catholic institution investing under an MRI mandate must sacrifice returns in order to accomplish its mission-driven goals, but most of the academic literature and empirical studies do not support this notion. While little to no research has directly examined Catholic MRI investing, a number of studies have examined the broader world of Socially Responsible Investing, which employs similar screening methods (although using different criterion and targeting different outcomes), and in which one would expect to see similar performance impacts. In fact, Lloyd Kurtz in a review of the academic literature in 2005 (2) found that not only was there no evidence of social screening having a negative impact on risk-adjusted return, but most of the studies in the areas of environment, employee relations, and governance seemed to show a small positive influence. Other major studies in support of social screening include Stone, Gultekin, and Adams who showed that the returns of actively managed, value focused portfolios were not harmed by the implementation of social screens over a 13 year time-frame (3) ,and Bauer, Koedijk, and Otten who measured the risk-adjusted performance of 103 German, U.S. and U.K. screened mutual funds between 1990 and 2001 and found no statistically significant differences between their returns and those of unscreened funds (4).

One of the more noteworthy developments in the world of institutional investing in recent years has been the increasing use of "alternative" asset classes. These assets, defined as much by what they are not (traditional equity and fixed income) as by what they are, include hedge funds, private equity, commodities, real estate, and more esoteric strategies. Those institutions that have chosen to include alternative assets in their portfolios generally believe that these investments will be less correlated with the remainder of their portfolio than additional traditional investments – that is, they will not necessarily move up when other assets move up, nor will they move down when others move down. Modern Portfolio Theory posits that this lack of correlation allows for the construction of portfolios that provide higher expected returns for the same level of risk, or similar expected returns for lower risk. As with anything else, however, alternative assets add additional challenges, particularly for the Catholic investor. In particular, alternative investments are usually accessed in the form of pooled vehicles, presenting many of the challenges discussed above, with the additional hurdle of limited transparency hindering fully informed MRI decision making.

So the question then becomes why not simply screen out alternative investments like any individual equity security. A key distinction that is easily overlooked is that there is a fundamental difference in the substitutability of individual securities and

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asset classes. If one decides to exclude Playboy stock on MRI grounds there are any number of other equity securities which offer a similar risk and return level and provide similar covariances (a similar concept to correlation) with other securities in a portfolio; that is, we can find a substitute for Playboy. If, on the other hand, alternative asset classes as a whole are excluded based on the difficulty of implementing MRI guidelines, it will not be possible to find similar, less correlated assets to act as substitutes in a portfolio. This, in turn, collapses the efficient frontier and lowers the risk-adjusted return which is available to the investor. If one considers the "market return" for a Catholic institution to be similar to that for other non-profit, institutional investors of comparable size, risk tolerance, and investment horizons, it is difficult to see how one's call to stewardship can be fulfilled and an expected market return can be achieved while disregarding alternative assets.

If many alternative asset managers are reluctant to incorporate direct MRI guidelines and provide limited transparency, and bypassing opportunities in alternative asset classes entirely is not the answer, what is the Catholic institution to do? The only solution we see is to establish a rigorous process that evaluates and monitors both managers and strategies. The Catholic institution must research and invest with managers whose mandates and track record give confidence that MRI principles will be upheld, closely monitor managers and prudently divest from funds whose managers have diverged from MRI guidelines. With sufficient scale, an institution can look to negotiate MRI principles into managed accounts. For most Catholic institutions it may be difficult to dedicate sufficient internal resources to implement this process, so one solution is to pool investments through a Catholic Fund of Funds structure while still retaining each participants' ownership interest. In such a structure, the pooled vehicle, regardless of size, should provide the expertise and skills to prospectively evaluate a particular manager's likelihood to pose MRI conflicts – in addition to the evaluation of such manager's operational and financial soundness and other internal workings. Prudent and informed decisions can be made by researching the underlying managers' investment mandates and their historical investment behavior, conducting personal interviews and understanding the mechanics of the particular strategy. Importantly, this process cannot be a single effort conducted at the time of investment, but must be part of regular, ongoing oversight and monitoring to detect any changes over time. Whether the process is conducted through a pooled vehicle or directly by a Catholic institution, it should be noted that transparency is negotiable and even a mid-sized investor should be able to demand periodic reports on a manager's exposure to certain companies or sectors. Additionally, if divestment from offending managers becomes necessary, it should be done "prudently, with care taken to minimize the financial impact and possible other negative consequences" as stated in the USCCB guidelines. Ironically, the Church's sense of time – and eternal outlook – is a strength not optimized. As secular society demands ever greater investment returns over shorter time horizons, investment managers may affix a premium to long-term investors.

Whether the Catholic institution chooses to pursue its investment strategy internally or by outsourcing some or all of the process, it has the challenge of a dual mandate of pursuing a fair market return while pursuing good and avoiding evil. Despite the difficulties involved in accessing the broader investable universe with which we are now confronted, the effort should be undertaken as we strive to both adhere to the Church's teaching and practice good stewardship over the Church's financial assets.

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(1) Matthew 25:14-30.

(2) Lloyd Kurtz. “Answers to Four Questions”. *The Journal of Investing*, Fall 2005

(3) Stone, Guerard, Gultekin, Adams. “Socially Responsible Investment Screening: Strong empirical evidence of no significant cost for actively managed value-focused portfolios”. June 2001

(4) Bauer, Koedijk, and Otten. “International Evidence on Ethical Mutual Fund Performance and Investment Style”. November 2002

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