SRI & ESG, THEN AND NOW

Stephen M. Liberatore, CFA, managing director and fixed-income portfolio manager for TIAA-CREF, offers insights into the current environment for socially responsible fixed-income products and considers how the landscape for SRI/ESG (socially responsible investment/environmental, social, and governance) investing has changed over the last five years.

aiCIO: We’ve covered SRI or ESG over the years, written about Europeans versus North Americans—it seems that Europeans have been more prone to this type of approach. Has the general reticence about utilizing SRI and ESG criteria abated in the US?

Liberatore: I think it has. But it is still clearly a market filled with great educational opportunity. When I speak to potential clients or at conferences, I always have to go through the list of preconceived notions that aren’t true. The major one is that, to invest socially, you must sacrifice performance. We don’t believe that’s the case—and our performance shows that—or that these are highly illiquid securities that you can’t trade out of, that you pay a premium for owning these types of securities, things like that. That you’re not going to make a direct, positive impact by investing in public market securities is a notion that we’ve worked hard to dispel. We have a great opportunity to show investors that we have a mainstream, core fixed-income strategy that invests directly in securities that have a positive and measurable social impact or benefit to them.

aiCIO: How do you apply this to your investment process?

Liberatore: Fixed-income investments can provide financing for a variety of projects and entities that meet environmental, social, and corporate governance criteria. Investments in publicly traded fixed-income securities can support projects such as renewable energy, natural resources, community and economic development, or affordable housing. An investor could buy a municipal bond that funds a clean water project or an agency bond from the Department of Housing and Urban Development [HUD] that funds inner-city development.

aiCIO: How does TIAA-CREF identify potential SRI fixed-income investments?

Liberatore: We evaluate the macroeconomic environment and its impact on fixed-income market fundamentals. From this analysis, we identify opportunities in the eligible investment universe, established by our ESG guidelines, to construct the portfolio. ESG criteria are established at the portfolio level for all of our SRI fixed-income strategies. We seek to strike the appropriate balance between the ESG expectations of our investors and the investment opportunities we need to maintain good performance. Although the ESG criteria vary between security types, our general approach is to choose those investments that are “best in class” in these criteria.

aiCIO: The early argument against SRI, that an investor might be sacrificing return to pursue this type of strategy, has not proven to be true in the time that you’ve been working on this, correct? That is, this is not an either/or situation?

Liberatore: It’s certainly not an either/or. We manage socially responsible fixed-income mandates as mainstream core fixed-income portfolios, benchmarked...
against the Barclay’s Aggregate. We are able to show the performance that we generate, the risk measures that we take, and also the positive benefit at the end of the day from holding certain securities we find attractive.

aiCIO: Can you elaborate on Proactive Social Investments (PSI)?

Liberatore: The biggest change from 2008 until now has been the increased utilization of social criteria—ESG criteria—in a more positive manner. Not just looking at it as an exclusionary tool but as a methodology to identify the truly good and outstanding performers, and believing those entities are going to outperform over the long run.

We define PSI as investments in publicly traded fixed-income securities that provide competitive risk-adjusted return potential alongside clear and measurable social and environmental benefits and outcomes. PSI is organized around four themes: affordable housing, community and economic development, renewable energy and climate change, and natural resources. We maintain a 10% target for PSI within SRI fixed-income portfolios, with all investments subject to the same relative value framework.

Since 2007, we have made proactive social investing part of our SRI fixed-income strategies. We seek incremental returns by identifying PSI opportunities that are not included in our benchmark and are not widely followed. The independent analysis necessary to evaluate these investments aligns with our core investment strengths of identifying relative value through fundamental credit analysis.

aiCIO: Do you have a specific example of a PSI investment?

Liberatore: We took a first mortgage position on One Bryant Park, an office building in New York City, which is the first platinum Leadership in Energy and Environmental Design (LEED)-certified office building in the US. In order to secure the platinum designation, the building had to have been constructed in the most environmentally friendly and sustainable manner. Water consumption at One Bryant Park has been reduced by 50%; with an under-floor air system combined with 95% filtration, air is actually cleaner when it is exhausted from the building. Thermal ice-storage tanks in the building’s cellar produce ice at night, reducing the building’s peak demand on the city’s over-taxed electric grid. In addition, an on-site 4.6-megawatt cogeneration plant provides a clean, efficient power source for nearly 70% of the building’s annual energy requirements.

We also have a first mortgage position on one of the largest solar power projects in the U.S., Topaz Solar Farm. Once completed, Topaz will generate enough power for 160,000 average homes while displacing 377,000 tons of CO2 annually, which is equivalent to taking 73,000 cars off the road. Some of the projects we invest in have an international reach, such as “green bonds” sponsored by the International Finance Corporation. These bonds provide capital for renewable energy and other projects that serve to mitigate the impact of climate change in developing nations.

aiCIO: Let’s discuss the notion that, if companies that mitigate ESG risk and are good risk managers in that, then logic would presume they’re good risk managers elsewhere.

Liberatore: Yes. Over the long run, what you want to do in an investment-grade fixed-income portfolio, simply put, is avoid the names that have a negative change to their intrinsic risk profile. You utilize any type of criteria you can to identify an entity that may have a problem returning your money in the long run. Environmental, social, and governance are the three categories that speak to how well an entity is managed. With fixed income, over time, you get paid not for picking the winners but for avoiding the losers; that’s the nature of the market.

If you’re able to use criteria to help you identify a company that has historically been a big polluter, then you can avoid an issuer that may face potentially material fines and/or reputational damages that negatively impact the entity’s financial valuation.

We believe ESG criteria provide a competitive advantage, especially for fixed income, given the nature of the market.
**aiCIO:** Do you think this strategy should be included, or at least considered, within the core portion of fixed-income portfolios?

**Liberatore:** I completely agree with that.

Among the misperceptions we work to correct is that our socially responsible strategies sacrifice performance, are very niche or that they can’t assume a larger portion of an investment portfolio because they are illiquid; that they’re very high volatility, thus have very high tracking error; that there’s no good pricing; there’s not a good way to truly track the performance and the volatility associated with them. These are all not true.

When you look at any of our fixed-income portfolios, the characteristics look exactly like any other intermediate bond fund benchmarked to the Barclays Aggregate, but with social criteria applied to them. The tracking error guidelines used to manage our socially responsible fixed-income strategies are well within the range of the intermediate bond universe. There isn’t a significant illiquidity factor; these securities are marked on a daily basis, and we can perform relative to the Barclays Aggregate and other intermediate bond strategies that don’t have social criteria.

One of the things I enjoy when talking to our clients is discussing the direct societal benefit their investments are making. To be able to say, “You had good performance this month, but you also invested in these three or four projects”—let’s say there were wind power projects, solar power projects, thermal, energy from waste, whatever it might be—“and with your investments you directly helped lower the cost of capital for alternative energy and made it more competitive to fossil fuel,” is very satisfying.

**aiCIO:** Five years from now, what do you expect we’ll see as the biggest changes to this approach?

**Liberatore:** The biggest change will be the continued expansion and acceptance of ESG and other forms of social criteria, and the recognition that an increasing number of investors care about these issues and are focused on them from a long-term perspective. Again, ESG criteria speak to how well an entity is managed and operated. I think you’re going to continue to see this shift as more investors recognize the value that using social criteria presents from a long-term investment analysis perspective.

**aiCIO:** Are there any market trends that could have an influence on this space?

**Liberatore:** There are a number of developments under way that may help drive supply and demand for SRI fixed income. The US market has generally been slower to incorporate ESG criteria than places such as Europe, which has already established a competitive market for trading carbon emissions. Sentiment is shifting in the US, and that is being reflected in new legislation and regulations. Last year, the federal government finalized new fuel-efficiency standards for US cars and light trucks, and many states have begun to enact renewable energy requirements in their jurisdictions. These trends favoring higher environmental standards definitely point to support for SRI investing.

**aiCIO:** Is there anything that could derail this trend? What is the biggest risk to this?

**Liberatore:** I think the biggest challenge is that social investing is somewhat subjective, yet we are trying to apply objective criteria. There’s almost no way to make everybody 100% happy with everything we’re doing—that one particular social issue is no less important than another one. Our job is to apply a rigorous, a consistent and transparent framework to how we determine whether investments are eligible from an ESG perspective.

You want to lay out an investment framework an investor can look at and feel comfortable that we view things the right way, that we’re making a good faith effort to do the right thing and that our approach is sound—is replicable—and that we’re applying solid reasoning, maybe not on an individual security basis but as an overall strategy.
aiCIO: Do you think investors will see more fixed-income SRI funds over the next several years?

Liberatore: Yes. Given investor demand, we expect to see many more strategies in the market. According to the Forum for Sustainable and Responsible Investment, 84% of plan sponsors predict that the demand for SRI options will increase or remain steady over the next five years. The expansion of SRI funds across asset classes will provide new ways for investors to invest in a broadly diversified portfolio that is consistent with their values, offering access to a pool of fixed-income securities such as agency debt, asset-backed securities, commercial mortgage-backed securities, corporate bonds, mortgage-backed securities and municipal bonds.

aiCIO: Is there a natural constituency, be it public fund or university endowments, that maybe should be in this but aren’t quite yet and you expect to see in five years?

Liberatore: I think that for larger institutions it make sense—endowments and nonprofits are good examples. I think, though, that why they haven’t fully embraced these strategies to date has been the lack of mainstream products available to them to utilize. As I mentioned earlier, historically, a lot of the funds that have been available have been primarily exclusionary in their social methodology. There haven’t been a lot of fixed-income products available that are truly mainstream core, that can be utilized in a larger percentage in their portfolios, and have liquidity associated with them.

Last year we launched a mainstream product to enable more institutions to be able to invest in one, and be more open to those ideas.

aiCIO: What would you like our readers to take away from this discussion?

Liberatore: The biggest thing is that investors know that there are, again, mainstream products that will allow investors to align their investments with their values—that there are firms that have expertise in this space, and obviously we’re one of them. We provide liquid, mainstream products for investors and they’re not going to have to sacrifice performance, accept disproportionate tracking-error risk or can only have a small allocation for liquidity reasons, etc. That’s what seems to be resonating with people, especially on the fixed-income side.

That, and the shift over the last five years or so away from the mentality of pure exclusion, to using social criteria in a positive manner to help identify particular entities or investments that look attractive and look sustainable over the long run.

OUR JOB IS TO APPLY A RIGOROUS, CONSISTENT AND TRANSPARENT FRAMEWORK TO HOW WE DETERMINE WHETHER INVESTMENTS ARE ELIGIBLE FROM AN ESG PERSPECTIVE.

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Please note SRI strategies are subject to social criteria risk, namely the risk that because social criteria excludes securities of certain issuers for non-financial reasons, investors may forgo some market opportunities available to those that don’t use these criteria.

You should consider the investment objectives, risks, charges and expenses carefully before investing. Please call 877-518-9161 or log on to www.tiaa-cref.org for product and fund prospectuses that contain this and other information. Please read the prospectuses carefully before investing.

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