Guide to Mission-Aligned Investing

Fiducient Advisors

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FiducientAdvisors.com

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ADDITIONAL CONSIDERATIONS

This report is intended for the exclusive use of clients or prospective clients (the "recipient") of Fiducient Advisors and the information contained herein is confidential and the dissemination or distribution to any other person without the prior approval of Fiducient Advisors is strictly prohibited. Information has been obtained from sources believed to be reliable, though not independently verified. Any forecasts are hypothetical and represent future expectations and not actual return volatilities and correlations will differ from forecasts. This report does not represent a specific investment recommendation. The opinions and analysis expressed herein are based on Fiducient Advisor research and professional experience and are expressed as of the date of this report. Please consult with your advisor, attorney and accountant, as appropriate, regarding specific advice. Past performance does not indicate future performance and there is risk of loss.

What is Mission-Aligned Investing?

Mission-Aligned Investing is the concept of aligning an investor's investment capital with their mission or values. These values can vary widely, drawn from a variety of principles including religious beliefs, environmental interests and social justice. Over the last decade, interest in Mission-Aligned Investing has increased within our client base, along with associated investment opportunities.

Key Elements of Our Mission-Aligned Investing Philosophy

Our approach to assisting our clients with Mission-Aligned Investing is threefold: 1) We rely on our clients to share their beliefs with us, rather than us telling them what their beliefs are or should be; 2) We seek a practical approach to implementation; and 3) We strive to avoid sacrificing return in order to align capital with beliefs.

- **Beliefs are given, not received** – Our role is to help our clients express their beliefs through the investments we make together. We are not able to tell our clients why they should believe something, nor can we determine what they should believe. Constructive dialogue to develop a true understanding of interests and priorities is an important first step for any long-term material implementation in portfolios, and we are here to help.

- **Pragmatic, not dogmatic** – *"Don't let perfect be the enemy of good"* is a helpful expression when allocating capital around beliefs. Beliefs may change and evolve over time; in that sense, ways to express such beliefs in portfolios might also change over time, all while capital markets dynamically price opportunities and risks. Finding practical ways to express what is most meaningful encourages creative solutions and enables the investor to move beyond platitudes toward a more rewarding and sustainable Mission-Aligned Investment philosophy.

- **Align beliefs with returns rather than compromise them –** The pool of capital you are overseeing has a purpose. It may support a school, fund a nonprofit organization's operating budget or help individuals retire. With a clear understanding of beliefs and a pragmatic approach to implementing them, there is no reason to undermine the purpose of this pool by reducing return or adding risk. Moreover, we believe the true path to sustaining a long-term Mission-Aligned Investing approach is only achievable by **not** making risky or otherwise inhibitive sacrifices.

Our Process

Our proprietary Mission-Aligned Investing process outlines the following steps, which can be applied to any type of investor:

1. **Define** – First, we help our clients articulate and define their values. Understanding the motivation behind the interest in pursuing Mission-Aligned Investing can help add clarity to the objective. We believe this is a crucial first step that ultimately guides all subsequent steps on the best ways to approach allocating the portfolio.

2. **Approach** – Next, we explore the various investable approaches available to our clients based on the values they have articulated. The three main categories of approaches include:

   A) Integration
   B) Values-Based Screening
   C) Impact

3. **Implement** – After determining the approach, we outline practical actions and a due diligence checklist before initiating a final implementation plan to incorporate Mission-Aligned Investing into a portfolio.

4. **Measure** – Once a portfolio is implemented, we believe that it is important to measure the effectiveness and success of the program over time through monitoring. This includes analysis of performance from both an absolute and a relative perspective. It also includes assessment of mission alignment amid increasing data disclosures and ongoing evolution of the underlying investment strategies.

Define Values—Broad vs. Specific

There are many different types of Mission-Aligned Investing values that investors may consider incorporating into their portfolio. One of the most common acronyms within this space is ESG, which stands for **Environmental, Social and Governance**.

Environmental

- Green Building Smart Growth
- Climate Change/Carbon
- Clean Technology
- Pollution/Toxics
- Sustainable Natural Resource/Agriculture
- Water Use & Conservance

Social

- Human Rights
- Avoidance of Tobacco or Other Harmful Products
- Community Development
- Diversity and Anti-Bias Issues
- Workplace Benefits
- Labor Relations
- Workplace Safety

Corporate Governance

- Corporate Political Contributions
- Executive Compensation
- Board Diversity
- Anti-Corruption Policies
- Board Independence

While these broad categories cover many of the well-known considerations, such as those outlined above, in-and-of themselves they do not necessarily align with an investor's specific set of values. Some Mission-Aligned Investing investors seek to avoid negative externalities (pollution, worker exploitation, poor safety conditions, etc.) while others seek to support what they believe to be positive externalities (energy efficiency, pay equality, shareholder rights, etc.). Many clients want to invest according to their specific mission or set of values. To find investments that explicitly align with investor values, it is important to be specific. The United Nations' Sustainable Development Goals (UN SDGs) is a framework by which to articulate specific values. Below is the full list of UN SDGs. While not all the goals may be "investable," investors often find them quite helpful, especially during this early stage of defining their particular preferred values.

SUSTAINABLE DEVELOPMENT GOALS

VALUES—FAITH-BASED MANDATES

A cornerstone of Mission-Aligned Investing for many is faith-based investing. Faith-based investing is also referred to as Socially Responsible Investing (SRI), Biblically Responsible Investing (BRI) or even Morally Responsible Investing (MRI). At its core, faith-based investing is a values-based screening strategy that aligns investment dollars with the investor's religious faith. Screening approaches may be negative (exclusionary) or positive (inclusionary), and faith-based investment strategies can be found in both public and private markets as well as in a wide variety of diverse investment vehicles, from mutual funds, commingled funds, exchange-traded funds (ETFs) and separately managed accounts through private investments.

Faith-based investing originated as an avoidance strategy whereby "sin stocks" (alcohol, tobacco, gambling, etc.) considered at odds with religious beliefs were excluded from a portfolio. As faith-based investing has expanded, so have the methods to implement it. While much of faith-based investing still focuses on excluding industries and sources of revenue, strategies can also incorporate positive screening, in addition to integration and impact approaches.

Approach

As mentioned above, the three main categories of approaches to Mission-Aligned Investing include:

1. Integration
2. Values-Based Screening
3. Impact (which can include shareholder engagement and proxy voting)

INTEGRATION

ESG integration is the inclusion of non-financial factors into the investment decision process. ESG integration is generally incorporated during a manager's fundamental research process and reflects the manager's view of the value or risks associated with a certain investment.

ESG integration can be difficult to define and assess, as it is easy to claim without requiring material changes to assess the investment process to back it up. With investor interest in the ESG space growing significantly, asset managers have an economic incentive to characterize themselves as ESG investors in hopes of attracting new capital. In assessing ESG integration practices, we generally ask ourselves these three primary questions:

1. *Is it observable in the investment process?*
2. *Is it material to the investment process?*
3. *Is it additive to the investment process?*

In other words, through due diligence, can you distinctly observe the incorporation of additive ESG factors within a money manager's investment process?

Historically, in order to align their portfolio with ESG principles, investors may have needed to make significant changes to their holdings, vehicle types and/or asset allocation. With ESG integration becoming increasingly more common, an overhaul of one's portfolio may no longer be necessary in this way. Investors with ESG interests may be pleasantly surprised to find "non-ESG" strategies in their portfolios have already incorporated some of these ESG factors.

However, a greenwashing effect is likely to persist for some time as the industry comes to terms with common integration definitions and better sources of data. Therefore, in our opinion it is extremely important to conduct an extensive review of strategies that claim to incorporate ESG criteria to assess whether integration is meaningful and authentic.

VALUES-BASED SCREENING

Values-based screening applies the core values of an individual or organization to the decision-making process. It can be incorporated into an investor's portfolio construction process in three primary ways:

1. **Negative screening –** The process of screening out companies or industries that do not align with an investor's values.
2. **Positive screening –** The process of tilting an investor's portfolio to the best-in-class companies as defined by the investor's values.
3. **Thematic investing –** A top-down investment approach that incorporates broad themes in conjunction with a values-based focus in selecting a portfolio of companies. Common themes within the industry include sustainability and clean energy.

As it pertains to negative and positive screening, the larger the list of values to incorporate, the greater the impact on an active manager's ability to select securities of interest and the more difficult it will be for a passive mandate to track a benchmark. Investors may use one of the above methods, or a combination of some or all of these methods, to strive to achieve their goals.

IMPACT

Shareholder Engagement and Proxy Voting

Shareholder engagement and proxy voting are ways to use the benefits afforded to owners of a security to pursue positive change. Proxy voting is an investor's primary method of voicing opinions and affecting company decisions. Proxy voting is a form of shareholder engagement wherein voting power is delegated to a representative. It enables investors to establish a bloc of likeminded voters by selecting a single representative to vote on their behalf. Since voter influence is determined by the size of their stake in a company, a unified voting segment established through proxy voting exercises greater influence. Investment funds that invest in accordance with certain values can help facilitate this collaboration and cohesion of likeminded smaller investors because the fund acts as the representative responsible for voting on behalf of fund shareholders.

Another impact-focused approach is company engagement, which is the establishment of a direct dialogue with companies to encourage them to change or improve their environmental, social and governance practices. Frequently, the shareholder engagement process simply entails large stakeholders (such as mutual funds) interacting with company management to share their concerns and suggest ways to improve. The implication is if company management does not make improvement and progress in the areas of concern, large investors may withdraw their funds. Company engagement allows investors to use their assets – their "seat at the table" – to enact change.

Impact Investing (Private Markets)

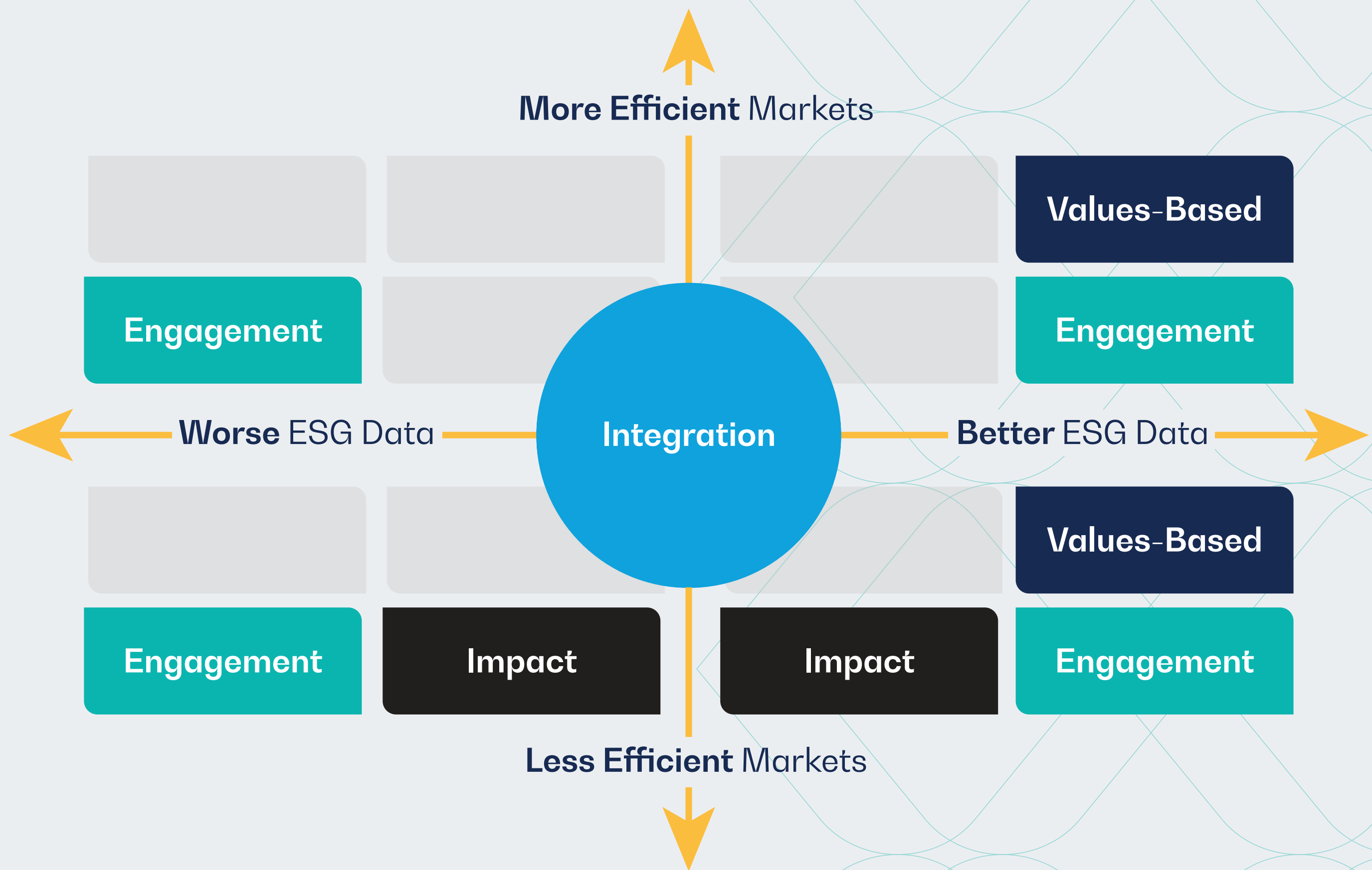
While much of the implementation around Mission-Aligned Investing has been focused in public markets, there is growing adoption within private markets as well. Impact investing entails making investments in companies with the explicit intention of generating both positive change and strong financial returns. This is a natural extension within private markets as the general partner often has majority control of a business allowing for greater alignment with, and influence over, the organization's priorities and growth plans. Impact investing often targets specific outcomes – a greener environment, more diverse workforce, access to education, veteran support, etc. – and investors' funds can be dedicated to one or more impact initiatives.

There are numerous reasons why private markets are conducive to investors seeking material change, including:

- The focus on impact is made perfectly clear from the outset and companies are purchased with a particular goal in mind.
- Private companies compared to larger public peers often have a more targeted business line, making their alignment with certain values clearer. Often, public companies may have a mix of business lines, some of which investors may find less attractive, but they have no opportunity to segregate those lines of business.
- Impact investors can act as patient and long-term providers of capital, supporting businesses as they scale over time. They can have direct influence, working alongside management teams as well as contributing their own operational expertise.
- There is also greater transparency into how a specific outcome will be achieved through a general partner's value-add playbook and historical deal experience.
- Ultimately, there is intentionality to bring about positive change and foresight into how that will be accomplished.

Building an impact-oriented private markets portfolio is an interactive, collaborative and dynamic process. The interpretation of an investor's mission may change over time as new investment strategies and measurement data become available. This information may lead to greater understanding of the mission and the necessary modification of that mission over time.

CHOOSING AN OPTIMAL APPROACH



For illustrative purposes only.

Given the current environment around ESG reporting standards and disclosures, we recommend different implementation approaches depending on market efficiency and data quality, as shown above.

1. For large capitalization markets where data quality and availability is greater, values-based investing, particularly a negative and/or positive screening approach, may be utilized most effectively.

2. Conversely, for less efficient markets where data quality is poor and availability is scarce, an impact and/or engagement-focused approach may be most effective. In those cases, investment managers can engage corporate leadership and executives on ESG-related issues and provide a path for improved ESG policies and better ESG disclosures, thus increasing visibility and influencing key issues material to the company's business operations.

3. Lastly, an ESG integration approach involves employing investment managers who integrate ESG factors into the investment thesis. This approach can be employed throughout the investable universe, in essentially all areas of the market.

Notably, unique or specific investor situations have the potential to dictate a specific approach. For example, if an organization is facing public pressure to divest from fossil fuels, this would directly lead to a values-based approach, specifically negative screening, as the availability and quality of data allows.

Implement

Once an investor has defined their values (Step 1: Define) and determined the most efficient approach to express their interests in portfolios (Step 2: Approach), the next step is to develop an implementation plan.

Developing an implementation plan begins with compiling a list of investment options that support the chosen Mission-Aligned Investing goals. We believe the evaluation of this list becomes critical as it will help determine where each investment might fall within the portfolio's target asset allocation or investment menu.

Regarding the construction of a fully diversified portfolio, there may be some instances in which a Mission-Aligned Investing option is not feasible, either due to asset class considerations, size of asset pool, the particular mission, or some combination of factors. It is important for an investor to make a conscious decision whether the entire portfolio must be built according to Mission-Aligned Investing considerations, or whether partial adherence is sufficient. If full alignment is required, an investor must acknowledge that certain asset classes may not be accessible, and that diversification benefits may be lost.

Once the list of potential investment options for each asset class has been determined, we believe an investor would benefit from the following points of additional due diligence in finalizing the implementation plan:

1. **Optimal Approach –** Given the complexities discussed above, determine which approach (i.e., integration, values-based or engagement/impact) is most optimal within each asset class.

2. **Investment Philosophy –** Evaluate whether the desired investment philosophy by asset class is being adequately maintained with each Mission-Aligned Investing option. For example, our research suggests that an investor is better served by being passive in U.S. Large Cap Equities. Therefore, we would advise adhering to a passive approach within this space and not shifting to an active Mission-Aligned Investing option. To learn more about this topic, please click here to read our research paper on Active vs. Passive Investing.

3. **Vehicle Structure –** Will a new Mission-Aligned Investing option require a change in the vehicle structures within the portfolio, and are there any consequent potential administrative and/or tax burdens? For example, will a separately managed account be required if exposure is currently accessed via a mutual fund?

4. **Portfolio Costs, Investment Minimums, Liquidity –** Of the possible Mission-Aligned Investing options, are minimum requirements per specific self-determined mandates being met; are there any liquidity constraints; and will the change in investments either increase or decrease the overall management cost of the portfolio (or investment lineup)?

5. **Tax Implications –** For taxable investors, will switching from the original investment to a Mission-Aligned Investing option trigger the realization of any embedded capital gains? If so, are there any other tax planning strategies that could be utilized to offset the tax costs?

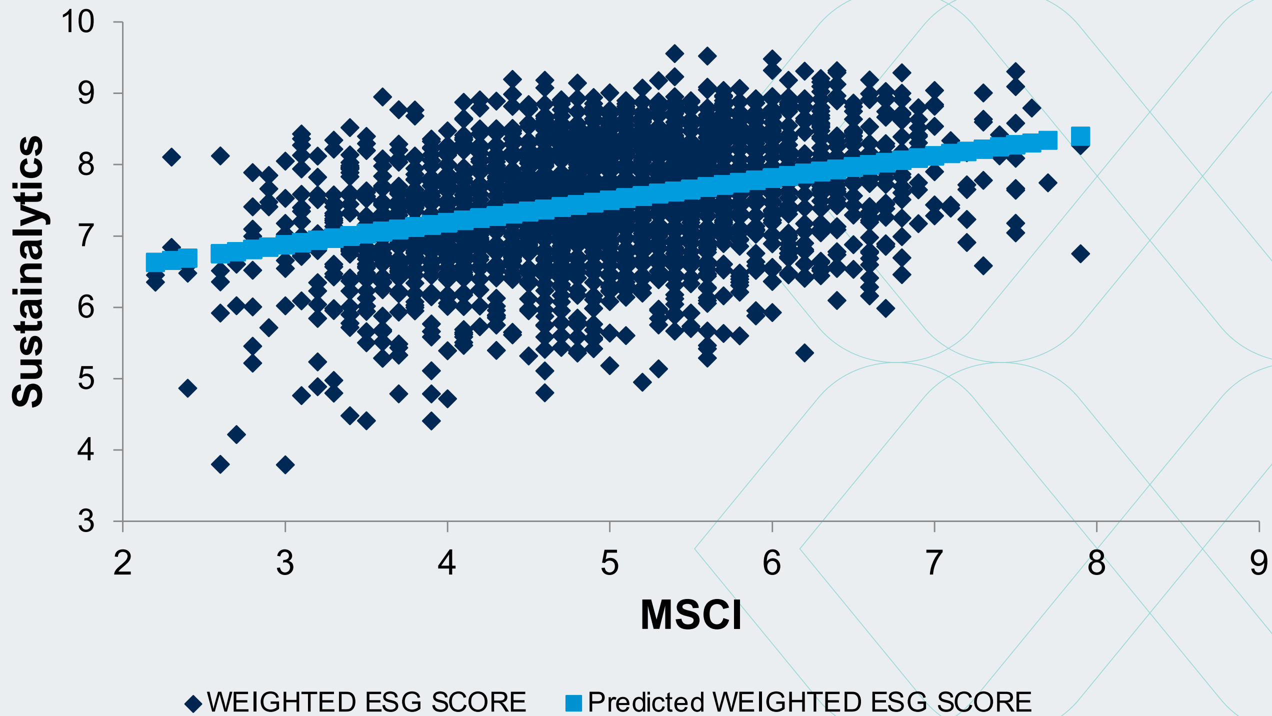
In completing the aforementioned due diligence, an investor will be sufficiently prepared to formulate a well-conceived and meticulous implementation plan for their Mission-Aligned Investing portfolio.

An investor is not expected to go through this exercise alone – a competent investment consultant will help shepherd their clients through this process. We at Fiducient Advisors regularly guide our clients through these steps.

Measure

As ESG and Mission-Aligned Investing continue to gain traction in the marketplace, so too has the influence of ESG ratings agencies on how investors consider ESG factors. Quickly evolving and fueled by a recent influx in demand, the marketplace has become fiercely competitive. The ESG ratings industry is highly fragmented with dozens of ratings agencies and data providers covering thousands of companies and issuers globally. However, it seems reasonable to conclude that having a shared purpose may not lead to shared interpretations.

Individual agencies' ESG ratings can vary dramatically. The scatterplot below charts the Sustainalytics ESG rating against the MSCI ESG rating for domestic stocks in the Russell 3000 Index. As you can see, there is very little correlation between ratings – a company that scores very well according to Sustainalytics' ESG rating may score very poorly on MSCI's scale, and vice-versa.



Source: MSCI, Morningstar, December 2022.

Use of Indices and Benchmark Return Indices cannot be invested in directly. Index performance is reported gross of fees and expenses and assumes the reinvest dividends and capital gains. Past performance does not indicate future performance and there is a possibility of a loss. See disclosure page for indices representing each asset class. See disclosure page for indices representing each asset class.

CHAPTER FOUR

As discussed earlier, we believe a major challenge with ESG is the quality and availability of germane data due to:

- **Timeliness –** ESG ratings and corporate sustainability reports are often issued on an annual basis.
- **Lack of Accountability/Unaudited Data –** ESG data is self-reported, and companies can selectively disclose only their successes.
- **Size –** Smaller companies have fewer resources to dedicate to ESG data reporting.
- **Subjectivity –** Some data points cannot be quantified and must be qualitatively assessed.

Furthermore, data points and metrics reported by companies are inconsistent across industries because of the lack of standardization. Corporate ESG reporting includes an abundance of anecdotal information but not many data points, as a lack of quantifiable, verifiable, relevant data is one of the major challenges in ESG reporting for investors. The majority of the reports do not clearly demonstrate a link between ESG factors and financial performance. Therefore, it is difficult to compare sustainability performance between companies — or even over time.

Despite all the challenges associated with measuring the effectiveness of a Mission-Aligned Investing program, one way investors can measure such efforts is through the assessment of an investment manager's impact and engagement activities. Two key factors investors can measure are reach and impact, with the former being the number of portfolio companies engaged and the latter being the number of portfolio companies that made positive change. Positive change could encompass such issues as board diversity, lobbying, climate change, ESG reporting, equal employment opportunity disclosure or LGBT non-discrimination.

Once an investor decides to pursue a Mission-Aligned Investing approach, it is important to revisit that approach and gauge its efficacy over time. This involves evaluating absolute and relative performance (both the portfolio as a whole and the underlying investment strategies individually), as well as making a holistic assessment regarding whether the investor's goals and objectives are being met from a Mission-Aligned perspective.

Additional Considerations

DIVERSITY, EQUITY, INCLUSION AND BELONGING/ DIVERSE AND EMERGING MANAGERS

Organizations of all types are placing a greater focus on Diversity, Equity, Inclusion and Belonging (DEIB), either in their own practices to advance their mission. It should come as no surprise that many of these organizations also want to do business with companies that share similar values. In fact, many organizations have policies that require reviewing the DEIB policies and metrics of their vendors, including their investment managers. Whether it is a formal policy or not, many investors care about building wealth in alignment with DEIB values.

A common approach to expressing DEIB values in an investment portfolio involves intentionally investing with managers who have demonstrated a strong commitment to organizational diversity across the employee population, portfolio management teams, executive leadership, board composition and/or ownership structure. Data on representation of women and minorities across these metrics can be collected, synthesized and tracked, with the objective of steering capital to managers who demonstrate strong DEIB values, a commitment to transparency and improving their diversity metrics over time.

However, some organizations desire to further their mission by increasing opportunities for investment firms owned or led by underrepresented groups – women and people of color. While there is abundant research across many industries identifying the economic benefits of diversity, the investment management industry has historically struggled with a lack of diverse managers. A major obstacle for diverse managers lies in the traditional asset manager due diligence framework, which is inadequate for assessing diversity outcomes, thus making it more difficult for diverse and emerging managers to be considered.

For this reason, Fiducient Advisors is committed to taking a forward-thinking and more inclusive approach to investment research. We can assist organizations in framing their specific objectives, while developing thoughtful approaches and manager rosters to meaningfully integrate a DEIB lens into their investment practices.

DEFINED CONTRIBUTION PLANS

Within the defined contribution space, the focus has been primarily on broad ESG investing rather than a more specific Mission-Aligned Investing process. Defined contribution retirement Plan Sponsors, both corporate and tax-exempt, have exhibited material interest in exploring whether ESG investments can enhance their retirement plan offering. This intensified interest is largely due to heightened participant inquiry and demand, regulatory attention, product development and data reporting, among other factors. In terms of introducing ESG options to retirement plans, in our opinion some important considerations are as follows:

- **Discovery Discussion –** Plan fiduciaries should conduct an initial discovery discussion to develop an understanding of ESG investing and ESG investing trends within the context of defined contribution plans. Additionally, it is important to discuss how ESG investments will impact current plan structure and objectives.

- **Fiduciary Governance Documents –** Plan Sponsors who implement ESG investments into their retirement program should evaluate if their Investment Policy Statement needs to be updated to include language regarding ESG.

- **Implementation –** There are a variety of approaches that Plan Sponsors can utilize to implement ESG options. When considering the most appropriate implementation strategy, Plan Sponsors will want to consider philosophy regarding investment menu design and participant utilization. Potential strategies include:
  - Full integration (all investment options)
  - Creation of an ESG tier (addition of multiple funds across multiple asset classes)
  - Access via a Self-Directed Brokerage Window

Each implementation method has different implications for Plan Sponsors and participants.

- **Fund Selection and Monitoring –** Similar to other plan investment options, it is critical that Plan Sponsors have a consistent and well-documented process for selecting and monitoring ESG funds. Investment evaluation criteria for ESG and "non-ESG" plan investments should be consistent, and all investments should be chosen based on investment merit.

As the marketplace continues to evolve, we encourage Plan Sponsors to engage in discussion regarding ESG generally, the regulatory landscape, participant interest and overall philosophy. We also strongly recommend that ERISA counsel be included in discussions on this important topic.

INVESTMENT POLICY STATEMENTS

We believe an investor's approach to Mission-Aligned Investing should be incorporated in the Investment Policy Statement (IPS). IPS language can be basic or detailed, depending on the investor's preference and the complexity of the approach. If an investor is incorporating specific investment screens or adhering to certain guidelines (e.g., an environmentally focused investor who wants to divest from fossil fuels, or a faith-based investor looking to align with their values), such specifics should be denoted within the IPS.

Importantly, we believe any separately managed accounts (SMAs) should have an individual IPS or Investment Management Agreement (IMA), wherein any Mission-Aligned Investing guidelines or criteria are captured. Separate account managers should sign the IPS/IMA, acknowledging that they understand and will abide by the guidelines.

Mutual fund or commingled trust investments will be screened according to predetermined criteria identified in the fund's prospectus. Since investors have no control over a mutual or commingled fund's investment guidelines, the IPS should avoid overly specific language. Organizations should understand the investment guidelines used by a mutual or commingled fund before selecting that fund. We suggest making sure to reconcile any conflicting IPS language before investing.

The inclusion of Mission-Aligned Investing language in the IPS helps ensure the values and beliefs of the client are consistently reflected in the portfolio. In our opinion, the investment committee or other governing body should review the IPS holistically, as well as the Mission-Aligned language specifically, on a regular basis.

CONCLUSION AND OUTLOOK

The world of Mission-Aligned Investing is complex and nuanced. There is no single quintessential, “one-size-fits-all” approach that will work for every investor. Mission-Aligned Investing (or ESG Investing, Sustainable and Responsible Investing, Socially Responsible Investing, etc.) has many different iterations. From ESG integration to values-based investing (which may incorporate negative and/or positive screens) to impact investing, there are myriad ways in which investors may reflect their values in their portfolio holdings.

We are committed to helping our clients navigate the challenging and complex world of Mission-Aligned Investing. A hallmark of the Fiducient Advisors’ approach to investment consulting is the customized and personalized attention with which we approach each client relationship. This individualized care extends to our Mission-Aligned Investing process. We acknowledge that a faith-based organization will likely prioritize different values and will implement different solutions than a family foundation that may prioritize environmental sustainability. Our customized approach and our due diligence process allows us to strive to meet our clients’ unique needs and objectives.

Mission-Aligned Investing is far more than a passing trend. It is a secular shift in the marketplace and will only become more prevalent over time. Partnering with an investment consulting firm that has a structure and process to help you define your motivation and values, determine the right approach, implement appropriate solutions and measure the effectiveness of the selected approach is of the utmost importance.

For additional information or perspective on Mission-Aligned Investing, please contact any of the professionals at Fiducient Advisors.

Click Here to Contact Us

Comparisons to any indices referenced herein are for illustrative purposes only and are not meant to imply that actual returns or volatility will be similar to the indices. Indices cannot be invested in directly. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect our fees or expenses.

• Russell 3000 is a market-cap-weighted index which consists of roughly 3,000 of the largest companies in the U.S. as determined by market capitalization. It represents nearly 98% of the investable U.S. equity market.

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