Good for Harvard, good for the world: Why HMC embraced ESG with a passion

Harvard Management Corporation (HMC) signed up to the UN-supported Principles for Responsible Investment (PRI) less than a year ago, but the company that manages the $36 billion Harvard University endowment is already moving rapidly to build environmental, social and governance (ESG) factors into every investment decision it makes.

Jane Mendillo, president and chief executive of HMC, told the Fiduciary Investors Symposium at Harvard University that its embrace of ESG factors and the PRI was driven by the changing definition of what it means to be a fiduciary investor, and by a conviction that investing sustainably will improve its portfolio returns.

“We want to be smart about this,” Mendillo said.

“We want to be forward-thinking. We want to be successful investors and sustainable investors. We are convinced that doing so will be good for our portfolio and for Harvard, and it will also be good for the world.”

Mendillo said that “over time, ESG factors will be considered in every part of the portfolio”.

“We know there is more we can do as managers to push our thinking about creating a truly sustainable portfolio for Harvard as we choose our investments and manage our risks going forward,” she said.

Greater details

Harvard will also demand greater details from the managers it employs and its other service providers about their policies and approach to ESG issues, as HMC’s role as a fiduciary evolves.

“In my view, the definition of fiduciary duty is going to evolve even further; as fiduciaries we need to think not only more broadly across our portfolios, but also more broadly through time, including consideration of environmental, governance and social factors, which I believe will lead to better long-term outcomes, and stronger, more sustainable returns,” she said.
Mendillo said that building sustainable investment portfolios meant doing more than just divesting companies that did not measure up on ESG factors. Students at Harvard have protested against the endowment’s holdings in fossil fuel companies, but Mendillo said it was better to be engaged than to walk away.

“Harvard as an institution is putting considerable intellectual capital and other resources to addressing the substitutes for fossil fuels using less energy and developing regulation and systems that put a price on carbon,” she said.

“Divestment is not the answer. Realistically, the research and initiatives I just stated represent the only way to solve the problem. As investors, by remaining active owners and shareholders we have a greater chance of impacting climate change than we do by stepping away from the table.”

Mendillo said the changing definition of fiduciary was reflected in a dramatic shift in the holdings of the endowment investment portfolio.

“Our portfolios have also changed substantially and broadened as we’ve embraced further diversification, illiquid assets and other alternatives,” she said.

“From the traditional 60/40 stock/bond portfolio several decades ago, long-term investors have moved to include private equity, real estate and international and emerging markets as we continuously sought to enhance out portfolio return and improve our risk profile through new and innovative strategies.”

**Early investor**

Mendillo said Harvard was an early investor in venture capital in the 1970s and 80s; has been an investor in non-US equities for longer than most other university endowments; and in the 1990s moved into the natural resources sector, “an asset class that very few buyers knew existed and where we had real advantage because of our long-term horizon. Trees grow very slowly, after all”.

Mendillo said that broadening the endowment’s investment horizon, and experiencing many market cycles had taught HMC to “think more holistically about the factors that drive our investment performance, both in the near term and in the long term”.

“Driven by these broader views of fiduciary duty, investment opportunities and risks, some of the most successful fiduciaries and investors are now building sustainable portfolios that can stand the test of time,” she said.

This inevitably led to consideration of ESG issues, but not at the expense of lowering portfolio returns, nor lowering the bar for including assets in the portfolio.

“I’m talking about making better fundamental investment decisions,” Mendillo said.
“The stakes are high. At Harvard, contributions from the endowment are relied upon for over 35 per cent of the university’s operating budget. Over our 40-year history, HMC has contributed $23.3 billion in distributions to the university, including $11.6 billion in distributions in the past five years alone.

“As these numbers reinforce, we must generate strong sustainable returns to ensure that Harvard continues to fulfil its mission to educate the world’s brightest students and to perform cutting-edge research in fields that range from biochemistry to clean energy to nanotechnology.”

Beginning of its journey

Mendillo emphasised that Harvard is still at the beginning of its journey to incorporating ESG and sustainability factors into all aspects of its investment decisions – although that is its ultimate aim. But it has already made significant progress on a number of fronts, Mendillo said.

“In our natural resources portfolio, HMC has been responsible for planting over 100 million trees since 2005, in multiple countries, covering a combined area of approximately 300,000 acres,” she said.

“We have also set aside an additional 300,000 acres for land conservation purposes. To our knowledge, this is the largest reforestation project of any institutional investor worldwide.

These plantation clusters have been transformed into sustainable wood processing centres, and bring social and economic benefits to surrounding communities. Additionally, these 100 million trees are capable of sequestering approximately 2.5 million metric tonnes of carbon dioxide each year.

“When we consider buying property we are looking for ways of improving the assets during our holding period by upgrading forest management practices, planting more trees, and managing our forests sustainably. In our role as fiduciary we are doing this because we know it will create long-term value for Harvard. By managing a sustainable natural resources portfolio we are confident we will deliver significant economic value to Harvard over the long term and improve the environment.”

Energy-saving

Mendillo said that more than half of Harvard’s real estate portfolio is actively engaged in energy-saving initiatives, including energy-efficient HVAC systems, reduced water usage and reduced reliance on oil for heating.

“We now measure the energy consumption and the energy savings in our individual real estate investments, and ask our external managers about their approach to ESG issues and risks,” she said.
“Importantly, we are pursuing these efficiencies because they improve our economics, and because the marketplace places a higher value on assets where they are more sustainable and consume less resources, while also helping to reduce our portfolio’s carbon footprint.”

Irrespective of how an investment stacks up on ESG criteria, Mendillo said that Harvard’s drive to create a more sustainable portfolio is “not just about buying a green company or doing good”.

“This is about creating sustainable, long-term returns,” she said.

When Harvard signed up to the PRI it became the first US university endowment to do so.

“Yes, this is Harvard, but we can learn some things from others,” she said.

“We value third-party relationships that encourage and inspire us to think differently.

Three-pronged approach

“Beyond our public commitment to consider ESG issues in our investment decision-making process, our partnership with the PRI has also established the foundation to support HMC’s three-pronged approach to sustainable investment.

“That three-pronged approach is, first, ESG integration. We are incorporating material ESG factors into our due diligence, investment analysis and management processes. We are becoming more informed investors to strengthen our long-term understanding of all investments and we are implementing this ideas throughout our portfolio.

“Second, active ownership. We will exercise Harvard’s voting rights as shareholders and engage with portfolio companies on ESG risks.

And third, collaboration. We are hoping to collaborate with other global investors to develop and define ESG-integration best practices.”

Mendillo said the PRI’s six investment principles are “already unfolding internally and operationally in a number of ways”.

“We’ve embedded ESG questions into HMC’s existing operational due diligence framework for alternative investments,” she said.

“As a result, ESG-related questions are now included, and the answers assessed and considered along with other business considerations and risk factors in HMC’s investment decision-making process.”

“Additionally, we are in the early stages of establishing an ESG endowment group to further collaboration among similar investors and share best practices in incorporating ESG factors into investment and risk management processes.”
“Finally, we’re also working in conjunction with the university to assess and improve our process for evaluating proxy voting, and we’re working together to establish a revised set of proxy-voting guidelines over the next year.

“As we only signed the PRI last Spring, these are just some of our first steps. We’re excited by the prospect of further developing our approach to sustainable investment. Yet, there are challenges ahead.”

Mendillo said all investors need access to “comparable, transparent and reliable information that is rooted in materiality, in order to make informed long-term investment decisions”.

“As the other investors in this room can attest today, this information is not always available,” she said.

“Additionally, ESG factors can be very difficult to quantify. Anyone who claims this is easy is not thinking hard enough about it.”

Harvard has engaged two organisations to assist it to develop and receive this information: the Carbon Disclosure Project; and the Sustainability Accounting Standards Board [SASB].

“Our appetite for increased information on ESG factors is further supported by the research taking place right here on campus,” she said.

“Harvard is a significant player on sustainability issues, and is a leader in confronting climate change. The research conducted by the faculty will probably do more than we, or any investor, can do to alter the playing field. The university is supporting research in the vanguard of energy and climate science – from new technologies for energy strong, to solar in the developing world, to an artificial leaf that mimics photosynthesis to produce renewable fuel.

“And on its own campus, Harvard has also set an ambitious goal of achieving a 30 per cent reduction in greenhouse gas emissions from its 2006 baseline, by 2016.”

Deeply engaged

Mendillo said Harvard’s faculty are deeply engaged in a range of sustainability-related initiatives, including developing law and policy to advance sustainability and to address the hazards of climate change world-wide.

“At Harvard we strongly believe that this research and the future work of faculty and students, will have a huge long-term impact on sustainability,” she said.

“We at Harvard Management are proud to provide the financial foundation for that work.”

Mendillo said a focus on ESG factors and sustainability meant an investor had to be able to look past short-term issues.
“Clearly this focus on what we can see today, next week, next quarter or next year, is not in the best interest of our society, our environment or our world,” she said.

“It is also not in the best interests of our clients and their investment portfolios. Nor is it consistent with our fiduciary duty.

“Einstein once said, the important thing is to never stop questioning. The questions we are asking today are increasingly about the sustainability of our portfolio. This portfolio needs to last for generations. It needs to provide for students and faculty and researchers for centuries to come.

“As investors, thinking in quarters and years is not enough, when our duty as fiduciary is to protect and grow the long-term value of our asset pools.”

Mendillo said Harvard would continue to continually question the assumptions and conventional thinking underpinning its decision-making processes.

“We know for certain that in decades to come we will be looking at things differently from the way we see them today,” she said.

“We see that clearly at HMC, over both our own 40-year history as an investment management organisation, and over Harvard’s 400 years.

“Our goal, in pursuing all of our sustainable investment initiatives, in signing the PRI, in seeking more and better information on ESG risks, and on integrating ESG considerations into our investment process, is to reduce risk and to improve economic returns in an ever-evolving world – one where environmental, social and governance factors are becoming more prominent and more economically relevant, and certainly are not going away.”

© Copyright: Whole articles from this website and newsletter cannot be reproduced without permission from the editor. If you wish to publish introductions to any article please ensure that it links to original content site www.top1000funds.com.au, and that it shows clear attribution to Top1000funds.com, plus author name and date. Failure to abide by this request will be considered a breach of copyright and legal action will be taken.