

Environmental, Social and Governance Glossary

Impact investing, environmental, social and governance (ESG) and sustainable investing have become increasingly hot topics over the last several years. However, despite the recent boom in socially conscious investments, some confusion remains when it comes to defining certain terms and acronyms. To that end, for your convenience, our team put together a glossary of frequently used words and phrases.

But first, why has ESG become such a hot button topic?

There are several reasons:

- Investors are seeking to align their assets with values/missions.
- Investors are increasingly concerned about their impact on the broader environment.
- ESG-related disclosures by publicly traded companies are driving conversations.
- Better data and product availability has allowed investors the ability to conduct greater due diligence in identifying ESG products that align with their values/mission.
- Many investors believe that companies that follow best practices for ESG matters have the potential to avoid risks that can be easily managed, thereby avoiding some of the risks that could lead to significantly negative financial impact.
- Millennials tend to be passionate about this subject. In fact, according to an article published by McKinsey & Company, "sustainable investing strategies seem to have particular appeal among younger generations: some two-thirds of high-net-worth millennials surveyed in the United States agreed with the statement, 'My investment decisions are a way to express my social, political or environmental values.'"¹ Furthermore, this cohort is slated to inherit \$30 trillion over next 10 years, which in turn is increasingly driving the discussion.^{2, 3}



¹ <https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal>.

² Deloitte, 2014.

³ Achieve, 2014.



Glossary

Community Development Finance Institution (CDFI)

A community development financial institution is a financial institution that provides credit and financial services to underserved markets and populations. A CDFI may be a community development bank, a community development credit union (CDCU), a community development loan fund (CDLF), a community development venture capital fund (CDVC), a microenterprise development loan fund or a community development corporation. Broadly speaking, a CDFI is defined as a financial institution that has a primary mission of community development, serves a target market, is a financing entity, provides development services, remains accountable to its community and is a non-governmental entity.⁴

Environmental, Social and Governance (ESG)

ESG are standards for a company's operations related to sustainability and ethical impact that investors use as a screen. ESG rating agencies determine a company's ESG rating based on its exposure to various sub-factors that make up the ESG factors. Investments can be made through an exclusionary (negative) screen (excluding certain companies) or through a positive screen (simply selecting the companies with positive ESG attributes or lower ESG risk to invest in).

- **Environmental standards** and scoring are often based upon a company's impact on the environment through hazardous waste management, biodiversity and land use and carbon emissions (among other factors).
- **Social factors** by which a company is measured include human rights records, gender diversity, consumer protection efforts and product safety records.
- **Governance scoring** is often predicated upon a management team's structure, executive compensation, employee relations and overall stewardship (among other factors).

Green Bonds

A Green Bond is a debt security issued to raise capital to support climate-related or environmentally friendly projects. Green Bonds can be issued by tax-exempt entities such as federal, state or local governments. Additionally, the World Bank has issued Green Bonds to support large scale projects that address climate change. The proceeds from the issuance of Green Bonds are used to fund 'green' projects across a variety of sectors and by a variety of issuers. The security for most Green Bonds is the same as that of non-Green Bonds issued by the same government entity.⁴

Impact Investing

Investments made into companies, organizations and funds with the intention of generating measurable mission-aligned impact alongside a financial return.⁵

Mission-Related Investing (MRI)

Direct investment by a foundation in a business, nonprofit or investment fund that aligns with its charitable mission while seeking competitive returns. Usually structured as a loan, a loan guarantee, an equity or real estate investment.

⁴ <https://www.confluencephilanthropy.org/Impact-Investing-101>.

⁵ The Global Impact Investing Network (GIIN).



Place-Based Investing

Refers to a set of techniques for investing capital locally, through community ownership and access mechanisms, such as local banks, crowdfunding, municipal bonds or participation. Place-based investing especially targets local business and anchor institutions and outcomes for families and neighborhoods.⁵

Principles for Responsible Investment (PRI)

The United Nations-supported PRI initiative is a network of international investors working together to put the six Principles for Responsible Investment into practice. The PRI were devised by the investment community and reflect the view that ESG issues can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors if they are to fulfill their fiduciary (or equivalent) duty. In implementing PRI, signatories contribute to the development of a more sustainable global financial system.^{6,7}

The six principles are:

Principle 1 - We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2 - We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3 - We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4 - We will promote acceptance and implementation of the Principles within the investment industry.

Principle 5 - We will work together to enhance our effectiveness in implementing the Principles.

Principle 6 - We will each report on our activities and progress towards implementing the Principles.

Program Related Investing

Program related investing is identical to MRI, except it applies only to private foundations and financial returns must be at below market rates. Like a recyclable grant, repayment may be recycled for another charitable purpose and count as part of grant budget (5% IRS rule).

The IRS defines a PRI as any investment by a foundation that meets the following three tests:

1. Primary purpose to further some aspect of the foundation's charitable mission
2. Structured to produce "below market returns" on a risk-adjusted basis
3. May not be used to support any lobbying

Shareholder Engagement

Shareholder engagement is a term used to describe the process allowing investors (shareholders) to influence companies on a wide range of topics including ESG practices through shareholder resolutions and proxy voting.⁴

Socially Responsible Investing (SRI)

Investors filter-out or exclude sectors and/or companies they do not wish to invest in (also referred to as "negative" or "exclusionary" screening). Sectors that are often excluded by SRI investors may include alcohol, fossil fuels, genetically modified organisms (GMO), tobacco and weapons/firearms.

⁶ <https://www.unglobalcompact.org/take-action/action/responsible-investment>.

⁷ <https://www.unpri.org/pri>.



UN Sustainable Development Goals (SDGs)

The Sustainable Development Goals are a universal call to action to end poverty, protect the planet and improve the lives and future prospects of the citizens of every country. The 17 SDGs were adopted by all UN Member States in 2015, as part of the 2030 Agenda for Sustainable Development, which set out a 15-year plan to achieve the goals.⁸

Final Thoughts

The availability of investments that allow investors to align their capital with mission is rapidly growing, as is the volume of data to track impact. This means that implementation is becoming easier over time, and the risk of potentially having to sacrifice returns in order to implement impact investing is gradually dissipating.

Since 1975, PFM has provided customized fixed income investment solutions for its clients to help meet their evolving needs across the investment spectrum. To discuss our ESG solutions, or how PFM may be of assistance, please contact your PFM representative.

⁸ <https://www.un.org/sustainabledevelopment/development-agenda/>

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