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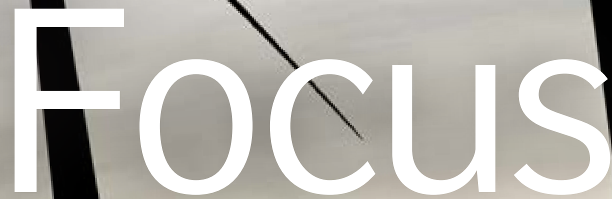

Focus

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A new era for measuring non-profit performance and impact?

By Donald Summers
Founder, Altruist Partners

The non-profit sector comprises over 5% of U.S. GDP and over 9% of U.S. salaries and wages.[1] Each year, over 1.5 million charitable organizations in the religious, arts, education, healthcare, human services, and environmental domains receive approximately $810 billion in individual gifts, and grants from governments, foundations, and corporations. Further, these same organizations earn an additional $700 billion via contracts, fees, and other revenue-generating activities.[2,3]

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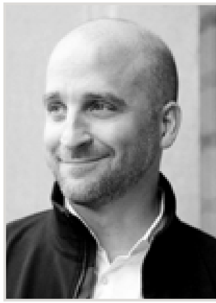
Editor's Corner

Lisa Schneider, CFA
Managing Director, Non-Profits and Healthcare Systems

Welcome to the summer edition of Russell Investments' non-profit newsletter! In this edition, we have a special guest: Donald Summers, founder of Altruist Partners, who sheds light on how non-profits can command the right data to attract capital, enhance their performance, and drive social impact. Meanwhile, our colleagues Emily Steinbarth and Scott Bennett discuss why materiality in responsible investing matters, and share a new Environmental, Social, and Governance (ESG) scoring metric that targets sustainability issues financially important to a company, and serves as a more reliable signal for investment decision-making than traditional ESG scoring metrics. Finally, Michael Auger recounts a success story about how we helped one of our clients, a large health system, reduce the investment and organizational complexity they faced following a wave of consolidation activity.

We hope you enjoy this edition! We are open to your feedback and suggestions for future topics.



Donald Summers
Founder, Altruist Partners

Despite these enormous capital flows, there is little consensus on how to measure non-profit impact, let alone gauge organizational performance. This lack of clear, robust, and independent reporting standards is perhaps the chief constraint to non-profits' progress towards addressing urgent social problems. This is compounded by two factors. First, funders such as charitable foundations or local governments often demand that non-profits fulfill onerous, idiosyncratic reporting requirements, which can take a year or longer to deliver. Second, the recipients of services are usually third parties, often the poor or vulnerable, who have little or no voice to validate claims or provide feedback.

This leads to an environment where funders, individual donors, and non-profit organizations are left without clear, consistent, and validated metrics to evaluate effectiveness.

Encouragingly, this is beginning to change. Some of the highest-growth and highest-impact non-profit organizations are utilizing robust planning, financial, and measurement frameworks that generate clear and compelling signals about their organizational performance and value. And, because these innovators can do this, they are attracting capital and scaling their work in a manner that far outpaces the rest of the sector. In the last two decades, non-profits such as City Year, Teach for America, and charity:water have used entrepreneurial approaches and data-driven decision-making to achieve levels of organizational growth and service delivery previously found only in the private sector. More recently, organizations such as Treehouse in Seattle, Washington, have used data to break down silos between schools, caregivers, and service partners, which has achieved dramatic gains in educational performance for foster youth in just a few years' time.[4]

> "Organizations that command the right data and use it correctly are in a unique position to present a compelling message to the marketplace: Entrust us with your capital—it will be deployed with effectiveness, transparency, and accountability."

The common thread is the selection of and access to the right data across the entire organization. Not to mention, frequent, clear, and consistent analysis of that information to drive performance improvements. These pioneering organizations may be charities, but functionally, they possess the teams, discipline, and focus of the most ambitious for-profit enterprises. And it's not hard to see how they define and hold themselves accountable to key performance indicators: They have clear, concise, and intuitive dashboards and scorecards, all in the right places. For example, Treehouse's monthly one-page executive dashboard presents the following metrics:

- Program breadth (number of youth served)
- Depth (changes in attendance, grades, behavior, and development)
- Finance (budget versus actual, cash reserves)
- Revenue (marketing and fundraising forecasts)

This one-pager, under continuous scrutiny by Treehouse's board and executives, rolls up component scorecards from each business and program unit, where managers lead teams in frequent, data-driven continuous improvement cycles. For example, individual educational support staff members receive real-time reports on the status of youth in their care, and teams examine the data together each week to determine whether the right interventions are being quickly and accurately delivered.

With this at-a-glance performance and accountability, non-profits not only drive needed levels of social impact; they inspire confidence in partners and supporters. Organizations that command the right data and use it correctly are in a unique position to present a compelling message to the marketplace: *Entrust us with your capital—it will be deployed with effectiveness, transparency, and accountability*. With these few bright examples well established, the long-standing opacity of the social sector appears to be giving way to a new era guided by clear social impact signals. Will institutions, governments, funders, and donors take notice and encourage other social-impact organizations to follow suit?

About the Author: Donald Summers is the founder of Altruist Partners, a global non-profit and social-enterprise advisory firm. A graduate of Harvard University, Summers is a frequent keynote speaker and author, with scholarship and articles published by the American Academy of Arts and Sciences, *The Chronicle of Higher Education*, and the *Stanford Social Innovation Review*.

Emily Steinbarth
Quantitative Analyst

Scott Bennett
Director of Equity Strategy and Research

Materiality matters—not all ESG issues are equally important

Investing based on environmental, social, and governance (ESG) factors has mushroomed in recent years, enjoying a 135% growth in assets under management to $8.72 trillion since 2012.[5] With this increase in assets over the years, ESG scoring has evolved as well. Many investment managers, including Russell Investments, have found that traditional ESG scores tend to incorporate factors that are not related to financial performance. In the spirit of the Department of Labor's recent guidance to focus on investment impact,[6] we believe adopting a targeted ESG scoring methodology that gives greater weight to the ESG issues material to a company's bottom line will provide investors with more finely tuned sustainability insight than a traditional scoring approach. We're calling this new approach "materiality matters."

You might ask, "Why does materiality matter in the first place?" In a recent study by Khan, Serafeim, and Yoon,[7] the authors present evidence that investing in sustainability issues can lead to financial outperformance—but only when those issues are financially material to the firm. For example, fuel efficiency has a much bigger impact on the bottom line of an airline than it does on an investment bank, while data security and customer privacy are more important to a cloud computing company than to an automobile manufacturer. Interestingly, the authors found that companies that spent significant resources on immaterial sustainability issues generated lower financial performance than those that spent significant resources on material sustainability issues. This means an airline that spends money increasing the fuel efficiency of its fleet or reducing its greenhouse gas emissions would have better financial performance than one that invests heavily in less financially material issues, such as fair advertising and product packaging.

Building on this research, our equity strategy and research team looked at the traditional ESG scores assigned to organizations by ESG ratings companies, and found that most of them are based on issues that are not material to their businesses.[8] In fact, for two-thirds of all securities in the Russell Global Large Cap Index universe, less than 25% of the data items in the "traditional" score are considered material. In other words, many of the ESG issues currently used in setting ESG scores don't have meaningful impact on a company's bottom line. This means that traditional ESG scores may not be the most accurate predictors of investment return.

To tackle this conundrum, our research analysts have developed a new ESG metric that focuses on those sustainability issues that are financially important to a company, and can be used as a reliable signal for investment decision-making. In our new scoring methodology, we took 145 sustainability subcategories from Sustainalytics, and compared those to the 30 material issues identified in the Sustainability Accounting Standards Board's (SASB) materiality map.[9] In Exhibit 1, we illustrate SASB's materiality map, concentrating on the healthcare sector and a few select underlying industries.

"We believe adopting a targeted ESG scoring methodology that gives greater weight to the ESG issues material to a company's bottom line will provide investors with more finely tuned sustainability insight than a traditional scoring approach."

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The subcategories from Sustainalytics that did not align with SASB's 30 issues were deemed immaterial and placed out of scope for each industry. To construct the new scores, we standardized the overall traditional score for each of the 145 subcategories. Then, we aggregated the scores of the subcategories that had been identified as material before calculating the final material scores.

We found that our scores had a 65% correlation with the traditional scores. This indicates that our new material scores are positively correlated with, but meaningfully different from, the traditional scores. They also offer insights beyond what the traditional scoring approach does. Our new methodology allows our portfolio managers to distinguish companies that score high on ESG issues that are financially material to their business, from those that score high on issues that are financially immaterial.

Exhibit 1: An excerpt from SASB's materiality map focusing on the healthcare sector and select industries

	HEALTHCARE		
Issues	Biotechnology	Pharmaceuticals	Medical Equipment and Supplies
Environment			
GHG emissions			
Air quality			
Energy management	✔	✔	✔
Fuel management			
Water and wastewater management	✔	✔	✔
Waste and hazardous materials management	✔	✔	✔
Biodiversity impacts			
Social capital			
Human rights and community relations	✔	✔	
Access and affordability	✔	✔	✔
Customer welfare	✔	✔	✔
Data security and customer privacy			
Fair disclosure and labeling			
Fair marketing and advertising	✔	✔	✔
Human capital			
Labor relations			
Fair labor practices			
Employee health, safety, and well-being	✔	✔	
Diversity and inclusion			
Compensation and benefits			
Recruitment, development, and retention	✔	✔	
Business model and innovation			
Life-cycle impacts of products and services	✔	✔	✔
Environmental and social impact on assets and operations			
Products packaging			
Product quality and safety	✔	✔	✔
Leadership and governance			
Systematic risk management			
Accident and safety management			
Business ethics and transparency of payments	✔	✔	✔
Competitive behavior			
Regulatory capture and political influence			
Materials sourcing			✔
Supply chain management	✔	✔	✔

✔	A material issue for companies in the industry
	Not likely a material issue for companies in the industry

©2017 SASB™ Materiality Map™

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In order to measure the impact of our own new material ESG metric on investment performance, we tested the new scores on the Russell Global Large Cap Index over the period from December 2012 to June 2017. The test found that material ESG issues are indeed a promising signal for informing investment decisions based on ESG performance. Investors could potentially gain an additional 22 basis points (versus using the traditional ESG score) by refining stocks to those that have higher material ESG characteristics.

This is why it is so important for managers to be able to differentiate material from immaterial sustainability issues. While one ESG issue may be a good signal for future outperformance of a particular subset of an investment universe, it may not be for another. Our findings demonstrate that our material ESG scores are better, more accurate predictors of return compared to traditional ESG scores. We also found that a focus on the subset of sustainability issues that are material to a company's bottom line leads to improved investment outcomes. As investors look to incorporate ESG factors across their portfolios, understanding the connection between sustainability and investment performance is an increasingly important challenge. Our material ESG score is another useful tool we are using to help our clients incorporate ESG views into their portfolios and seek to enhance returns. ▮

For more information on our materiality research, watch this video here

Michael Auger
National Director of Healthcare Investments

A client success story: Healthcare system reduces post-consolidation complexity

Over the past five years, one of our larger healthcare clients acquired or merged with four other healthcare organizations and one university, which tripled the assets in its investment program and significantly increased the program's complexity. This activity resulted in a structure consisting of 14 different asset pools, including defined benefit plans, extended working capital pools, short-term pools, and long-term pools. Each asset pool played a different role within the investment program, and required unique strategic asset allocations, investment objectives, liquidity profiles, and time horizons. Moreover, each asset pool had its own unique suite of investment strategies—including commingled funds, separate accounts, and proprietary funds from a third-party consultant. At one point, the CIO was singlehandedly managing over 130 managers across $4 billion of capital.

Along with the numerous managers and pools of capital, the organization was juggling a complex web of vendor relationships. Each legacy investment program had its own investment advisor, auditor, trustee, and custodian. Moreover, the organization had multiple layers of costs to pay, including investment management fees, custody fees, advisory fees, internal staff oversight expenses, and investment-related audit expenses.

Managing the impact of this expansion on the larger organization, its investment program, and its financial statements took a toll on the CIO's time and resources. The CIO envisioned a solution that would help manage this complexity

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by streamlining the investment program and simplifying investment operations. The organization also desired detailed and transparent analytics, direct investments in top-tier active and passive managers, and the ability to delegate the reporting and administrative functions. All of this was intended to improve implementation, mitigate risk, and reduce costs—while increasing manager oversight.

With intimate knowledge of the organization's goals and circumstances, we helped build a customized, multi-asset solution designed to decrease operational burdens; manage multiple vendor relationships; set up a new, flexible portfolio platform; provide access to Russell Investments researched top-tier managers; and dynamically tilt the portfolio as needed. It also allowed the CIO to have the final say over which manager(s) to hire, terminate, or adjust. We took their 14 separate pools and consolidated them into four targeted asset pools, which we identified with the CIO's input. Each pool has a target risk-return profile based on its liquidity requirements.

The ultimate portfolio structure, illustrated in Exhibit 2, combines all the defined benefit plan assets into one defined benefit plan under the qualified assets bucket, and then consolidates each of the separate short-term pools, long-term pools, and extended working capital pools into three main pools of capital under the non-qualified assets bucket.

"With intimate knowledge of the organization's goals and circumstances, we helped build a customized, multi-asset solution."

Exhibit 2: New investment program

Umbrella organization	
Qualified assets	**Non-qualified assets**
A single, consolidated defined benefit plan	Short-term pool
	Long-term pool
	Extended working capital pool

Results

This solution allowed the CIO to streamline the organization's multiple asset pools, retain control where desired, decrease the complexity of the organization's investment program, and reduce expenses. By grouping the organization's various asset pools into two legal entities and four underlying consolidated asset pools, and leveraging our scale and resources, we were able to increase the client's buying power with managers and vendors, saving them over 12 basis points in fees—which represents a fee reduction of 28%. We also provided the organization with affordable access to our industry-leading manager research,[10] portfolio structure insights, and investment manager relationships, culminating in a solution that has greatly reduced the organization's administrative overhead and risk.

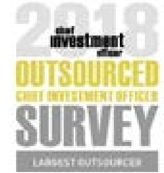
This kind of customized work has been made possible thanks to the deep relationship we have built with this organization and its team over time. Because of this project, the organization's CIO and staff now have additional time and resources to focus on higher-level, strategic, and value-creating decisions that will allow the portfolios to better support the organization's overall financial goals.

For further details about this project, read the full case study here.

Case study provided for discussion purposes only. Individual client results will vary based on individual circumstances and market events. There is no guarantee that all clients will experience the same positive results.

Industry recognition

We have some exciting news to share. We were recently named as the winner of *CIO Magazine's* 2017 Industry Innovation Award for Investment Outsourcing—an award we won for the fifth time.[11] We are also pleased to note that institutional investors increasingly turned to us for our OCIO solutions in 2017, as demonstrated by our top ranking as a global outsourced investment manager out of 34 firms in *CIO Magazine's* 2018 OCIO Survey.[12] We will continue to serve our clients with innovative solutions that help them meet their desired investment outcomes.



You can glean weekly market insights from our investment strategists here

Read more of our thought leaders' latest investment ideas and market event commentaries at our blog

[1] National Center for Charitable Statistics (2013). "Quick facts about non-profits." http://nccs.urban.org/data-statistics/quick-facts-about-nonprofits

[2] Giving USA. (2017, June 12). "Giving USA 2017: Total charitable donations rise to new high of $390.05 billion." https://givingusa.org/giving-usa-2017-total-charitable-donations-rise-to-new-high-of-390-05-billion/

[3] McKeever, Brice. (2015, October). The Non-profit Sector in Brief 2015: Public Charities, Giving, and Volunteering. Urban Institute. https://www.urban.org/research/publication/nonprofit-sector-brief-2015-public-charities-giving-and-volunteering

[4] Kamenetz, Anya. (2017, December 27). "Why foster care students in Seattle are beating the odds." NPR https://www.npr.org/sections/ed/2017/12/27/562341427/why-foster-care-students-in-seattle-are-beating-the-odds

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[6] Larson (2018, April 26). "Navigating the DoL's new ESG guidance." Russell Investments. http://fiduciary-matters.russellinvestments.com/navigating-dols-new-esg-guidance/

[7] Khan, Serafeim, and Yoon (2015). Corporate Sustainability: First Evidence on Materiality. *The Accounting Review, Vol. 91, No. 6.*

[8] Bennett and Steinbarth (2018). Materiality Matters. Russell Investments.

[9] SASB Materiality Map (2017). SASB. https://www.sasb.org/materiality/sasb-materiality-map/

[10] For the sixth year in a row, Russell Investments was voted among the top two investment providers for having the best manager due diligence practices by consultant relations professionals in a 2014 FundFire survey of nearly 100 respondents. (FundFire discontinued their survey in 2015.)

[11] In 2017, for the fifth time, Russell Investments was named as a CIO Industry Innovation Award winner in the Investment Outsourcing category. This was thanks to the firm's top client satisfaction rankings in CIO Magazine's 2016 and 2017 OCIO Vendor Ratings surveys, as well as Russell Investments' position as one of the world's largest OCIO providers. Fidelity Investments, Goldman Sachs Asset Management, Morgan Stanley, and SEI were the other finalists competing for this award. Additionally, our multi-asset investing approach was acknowledged as having transformed our OCIO relationships, as evidenced in growth from buyers across a range of institutional channels—including DB and DC plans, healthcare systems, non-profit organizations, and university endowments.

[12] Russell Investments was ranked as the top global manager of institutional outsourced assets, out of 34 firms, in CIO Magazine's "2018 Outsourced-Chief Investment Officer Survey", based on the AUM from its fully discretionary clients.

FOR MORE INFORMATION

Call Russell Investments at 866-739-7979 or visit

russellinvestments.com/nonprofits

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