Society and Municipal Bonds:
The Rise in Socially Responsible Investing

This installment of Pacifica's "Society and Municipal Bonds" series will briefly discuss the history and current status of values-based investing in the United States. In recent decades, terms such as investment activism, socially responsible investing (SRI), environmental, social and governance (ESG) factors, sustainable investing, and social impact investing have become common in the corporate market and are gaining traction in the municipal bond market as well. Although the terms are often used interchangeably, the concepts actually have some material differences.

Exclusionary Investing

Values-based investing originated with religious investors. Churches and religious organizations sought to invest within certain ethical parameters and avoid investment in "sin" stocks, such as stocks and bonds supporting the use of alcohol or tobacco, gambling, or production of weapons. In the second half of the 20th century, this exclusionary style of investing spread beyond religious organizations to investors advocating for social change. In 1971, the first sustainable mutual fund to align investment with values was launched by Pax World with the goal of avoiding investment in companies contributing to the Vietnam War. In 1986, the United States Congress banned new investment in South Africa as part of the Comprehensive Anti-Apartheid Act. Throughout the 1980s and 1990s, there was moderate growth in global investments focused on climate change and exclusion of fossil fuel investments.

Exclusionary investing remains popular with values-oriented investors today. The goal is to generate financial returns while avoiding investments that conflict with personal values or ethical guidelines. Some investors continue to avoid the original "sin" stocks, while others choose to avoid investing in companies with terrorist affiliations, human rights and labor violations or negative environmental impacts.

A recent example of exclusionary investing in the municipal bond market is the divestment from bonds issued to finance legal settlements, in particular various series of bonds issued by the City of Chicago between 2010 and 2017. According to research by the Action Center on Race and the Economy ("ACRE"), in that time period, Chicago borrowed $709 million for legal settlements related to police violence. ACRE and Activest[1] wrote a letter to bondholders in 2019 in an effort to raise bondholder support for additional transparency and accountability. ACRE dubbed the bonds "Police Brutality Bonds" and in a report from June 2018 called for an end to banks and investors profiting from the payment of settlements for police misconduct, wrong death cases and civil rights violations.

ESG Investing

In 1977, Reverend Leon Sullivan developed a corporate code of conduct (now known as the "Sullivan Principles"), which was the early basis for "best in class" or socially responsible investing. The Sullivan Principles were directed at companies operating in South Africa during apartheid, and companies that

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[1] Activest is an investment research and consulting firm focused on racial justice and the municipal bond market.

failed to meet the principles were targeted for divestment. Socially responsible investing took off more broadly in the early 2000s and incorporated both negative and positive screening of investments with a focus on corporate responsibility. Today, many socially responsible investors assess companies using environmental, social and governance ("ESG") criteria derived from the Sullivan Principles.

A variety of factors may be considered within the ESG context. Environmental considerations may include climate change vulnerability; responsible usage of natural resources; avoidance of pollution and waste; and opportunities in clean tech, green building and renewable energy. Social factors include labor management; health and safety; human capital development; social opportunities; affordability: product liability; stakeholder opposition; controversial sourcing of materials; and increasing access to communications, finance, healthcare and nutrition. Governance issues include diversity in leadership; executive pay; decision-making transparency; clear and accurate accounting; management of deferred maintenance and pension and OPEB liabilities; business ethics, corruption and instability; and anti-competitive practices.

In 2000, Kofi Annan launched the United Nations Global Compact initiative. This initiative provides companies with international, independent standards on how to communicate their impact on issues such as climate change, human rights, and corruption. In 2004, Global Compact produced the "Who Cares Wins" report, which provided recommendations on how to incorporate sustainability issues into analysis, asset management, and securities brokerage. Today, over 12,000 companies have voluntarily joined the UN Global Compact to implement universal sustainability principles and to take steps to support UN goals. Following the launch of the Global Compact, Kofi Annan worked with the world's largest institutional investors to develop the United Nations Principles of Responsible Investment ("PRI"). The PRI is based on the belief that an economically efficient, sustainable global finance system will reward long-term, responsible investments and benefit the environment and society as a whole. The principles themselves are designed to provide guidance and support to investors wanting to integrate ESG issues into their investment and ownership decisions.

Investors may be drawn to ESG portfolios because they want to invest in a socially responsible or values-based manner, but financial performance remains at the heart of the ESG market. The ESG movement is grounded in the belief that positive ESG practices enhance performance and that negative ESG practices are risk factors that may inhibit financial returns, particularly over the long term.

The ESG market has grown significantly in the past decade. Europe has taken the lead in ESG investing, both in terms of the amount under investments and in regulatory support, but the market is steadily growing in the United States as well. According to the Forum of Sustainable and Responsible Investment ("USSIF"), ESG and sustainable investing assets in the United States have grown from approximately $2 trillion in 2012 to over $17 trillion 2020.[2] There is significant investor interest in ESG in the United States, and the ESG market has grown in recent years despite an unfavorable regulatory environment.

[2] USSIF 2020 Report on US Sustainable, Responsible and Impact Investing Trends. See www.ussif.org.

The natural overlap between ESG principles and municipal bonds may initially have been overlooked by the markets, but this is changing. Some credit analysts now incorporate ESG goals in their review of municipal bond offering, and municipal bond portfolios and mutual funds focusing on ESG principles are increasing in popularity.[3] Municipal bond issues can address environmental factors by financing renewable energy projects, water and sewer projects, and by utilizing LEED (Leadership in Energy and Environmental Design) certifications in new buildings. Municipal projects that advance social issues include facilities for public education, healthcare, and affordable housing. Governance factors that can be evaluated for municipalities include strong budgetary practices and financial controls, long-term debt and capital planning, and diversity of leadership.

Social Impact Investing

Social impact investing, which is sometimes described as the intersection between traditional investing and philanthropy, has represented the next evolution of values-based investment The Global Impact Investing Network ("GIIN"), which was born out of a Rockefeller Foundation meeting and launched in 2009, has championed impact investing. GIIN defines impact investments as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return." Impact investing can address global issues (such as achieving the United Nations Sustainable Development Goals) or focus on local needs. Through impact investing, private wealth can be leveraged to support sustainable agriculture, renewable energy, conservation, housing, healthcare, education, and a variety of other causes, while generating financial returns for the investors. USSIF recognizes a subsector of impact investing that it calls "community investing," which provides capital, credit and training to low-income and underserved communities.

According to GIIN, impact investments (based on assets under management) in the United States reached $98 billion in 2019 and grew at a compound annual growth rate of 17% between 2015 and 2019. Impact investing is likely to see continued growth. Millennials have received attention for being particularly socially conscious and making decisions based, at least in part, on their desire to have a positive impact on the world.[4] As millennials accrue wealth, they are expected to focus on investments that generate social and environmental benefits. However, millennials are not the only investors driving the growth in this market; surveys have shown increased interest in socially responsible investing (including ESG and impact investing) among all age groups. The municipal bond market is a natural fit for investors seeking to support the public good.

Many of the projects financed with municipal bonds are designed with the goal of having a measurable positive impact on the local community and are compatible with the goals of impact investing, including the USSIF community investing initiative. According to USSIF, "[c]ommunity investing channels public

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[3] For example, Calvert Tax-Free Responsible Impact Bond Fund, Dana Social ESG Bond Strategy, and Sage Tax-Sensitive Fixed Income ESG, Community Capital Management Intermediate Fixed Income Composite (including corporate and municipal bonds).

[4] See, for example, Greg Herlean, Forbes Media LLC, April 2, 2019, "How Millennials Are Changing the Future of Investment."

and private investment to low-income and other underserved communities in order to provide capital, credit and training that these communities would otherwise lack. While community investing spans a wide range of initiatives, some of the areas it helps to finance are:

- Needed services (healthy communities, food access, education, child care, access to transit, access to jobs, affordable housing)
- Economic development (quality job creation, infrastructure development)
- Sustainable communities (mixed use/income smart growth, environmentally-focused community investment)"

In fact, the USSIF website recognizes governmental bonds and bond funds for housing among its recommended fixed income community investment options. Money managers and analysts are also recognizing fixed income investments, such as tax-exempt bonds, as vehicles for positive impact. For instance, Community Capital Management's fixed income portfolios include assets that align with 18 impact themes, including affordable health and rehab care; affordable housing; arts and culture; disaster recovery, resilience, and remediation; economic inclusion; education and childcare; enterprise development and jobs; environmental sustainability; gender lens; government supported communities; healthy communities; human empowerment; minority advancement; neighborhood revitalization; rural community development; seniors and the disabled; sustainable agriculture; and transit-oriented development.[5]

Municipal Bonds: What's next in Values-Based Investing?

Issuers of municipal bonds should expect the focus on values-based investing to expand in the years to come. Individual investors and mutual funds may increasingly use principles of exclusionary investing, ESG factors, impact investing or a combination of these approaches to evaluate bond issues. Bonds with green or social bond labeling are gaining attention from investors, both in the United States and internationally.[6] Some investors are turning their attention to equity and justice issues, and terms like fiscal justice, racial justice and restorative finance are becoming part of the investment dialogue. In addition, the Biden administration's Build Back Better initiatives include building a modern infrastructure and an equitable, clean energy future, as well as addressing racial equity. Future legislative proposals may include financing tools that are appealing to governmental issuers as well as investors focused on socially responsible investing.

Issuers can also expect disclosure practices relating to ESG factors and other topics related to values-based investing to continue to evolve. The municipal market is already moving toward disclosing climate change risks that may be relevant to the issuer. Some issuers have added more information, and even a specific section of official statements, regarding sustainability. Some official statements contain detailed descriptions of the characteristics of the project of particular interest to green bond or social impact

[5] See https://www.ccminvests.com/impact/impact-esg-policy/.
[6] A future installment of this series will focus on labeling debt as green or social bonds.

bond investors (often with third-party review of the project through this lens). At this point, however, a standard approach to ESG and other values-based disclosure has not emerged. We expect the practice to evolve as issuers provide additional ESG disclosure, investors and industry groups weigh in with considerations, and more standard models emerge.[7]

Additional Resources:

United National Global Compact

Global Impact Investing Network

U.S. Forum for Sustainable and Responsible Investment

[7] A future installment of this series will focus on disclosure practices.

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