Brown ADVISORY
Thoughtful Investing.

The Advisory

INVESTMENT OUTLOOK FROM BROWN ADVISORY

SPECIAL EDITION

Demystifying Sustainable Investing

For many investors, the topic of sustainable investing is a jungle of jargon and vague terms. When you cut through the confusion, though, you find that sustainable investing strategies have matured and improved, and now form the core of an increasing number of investors' portfolios.

LETTER FROM THE **PRESIDENT AND CEO**

When considering whether to incorporate their values into their portfolios, investors often find themselves at a loss as they try to sort through a dizzying array of SRI, ESG and other acronym-laden choices available to them. Mike Hankin, Brown Advisory President and CEO, describes the firm's commitment to cutting through the noise to get at what matters most to clients: performance, advice and service.

In Brown Advisory's most recent annual report, I wrote that our firm is guided by a desire to solve "puzzles" for our clients—to put the right pieces together so we can answer the big questions: What do you need to successfully reach your goals? And, what do we need to do as a business so that we can help get you there?

Over the years, you have made it clear to us that one of the important pieces to that puzzle is to offer solutions in the area of sustainable investing. You may recall that in 2009, we persuaded Winslow Management Company based in Boston to join Brown Advisory. The firm had been investing successfully in companies providing sustainable solutions since 1983 and, in fact, trademarked the phrase "green investing." We were attracted to the company because of its record of investing successfully compared to a mainstream performance benchmark, versus an approach that only benchmarked against socially responsible investment (SRI) funds. Why? Long term, we think that the best solutions to environmental challenges will come from well-managed companies that perform well against their peers. The focus on sustainable investing is now an integral part of Brown Advisory, and partners David Powell and Karina Funk manage successfully a $400 million strategy that focuses on large-cap sustainable growth companies.

But, we know that the questions our clients ask are much broader than whether we can help them find a mutual fund that invests—or does not invest—in a particular type of company. From the early days of Brown Advisory, we have responded to questions from clients who are interested in reconciling their concerns and values with their investments. We have observed that this interest is especially prevalent among younger investors. The topic is also a regular agenda item for most endowment and foundation investment committees that face growing pressure to align their portfolios with their organization's values. Our clients are not alone: Investments aligned to environmental, social or governance factors surged to $4.3 trillion last year from $569 billion in 2010, according to US SIF Foundation, a Washington-based trade association promoting sustainable investing, of which Brown Advisory is a member.

The number and breadth of potential solutions has also grown in recent years, from performance-based approaches that leverage environmental research, to "screens" to validate that investment holdings do not conflict with deeply held beliefs, to enterprises that offer the prospect of making a measurable impact on communities and society as a whole. But, regardless of any particular entry point into the sustainable-investing discussion, we have found that nearly all of our clients are asking for help in understanding how much-discussed and much-debated social and environmental issues are affecting the world and how to respond within the context of their investments.

We are certainly not alone in trying to help clients solve this particular puzzle. A number of managers have focused exclusively on sustainable investing for decades, and in recent years there has been a flood of new entrants into the field. We now have "SRI" funds,

"ESG" strategies, "impact" funds, and strategies focused on renewable energy or water to name a few. Each of these may be admirable in its own right and, in fact, we believe that the universe of available sustainable-investment strategies has expanded and matured tremendously over the past decade. Investors now have many more attractive options than they had in the past. But, taken together, these solutions can form a morass of confusing choices for investors. Unfortunately, our industry has had less impact in helping clients put these pieces together as part of a full solution.

So, we have committed the full resources of our firm to helping you, our clients, achieve the strategic, financial and values-oriented success that you seek, in whatever form that may take. This topic is important enough to us that we chose to publish this special issue of *The Advisory* to discuss our sustainable-investment approach with you.

Our strategy for addressing sustainability at Brown Advisory should sound familiar to those who have been with us for any length of time: We seek to deliver first-class performance, thoughtful strategic advice and the highest level of service, all defined by the specific needs expressed by each of our clients.

Performance: We are an investment firm, first and foremost, and a central aspect of nearly all of our client relationships is our responsibility to deliver outperformance through active management. When it comes to sustainability, we consider social and environmental factors in our investment research when it is clear they have a tangible impact on performance. On page 7, Karina and David discuss how we find companies that are poised to outperform due to their environmental strategies. Erika Pagel and James Stierhoff, members of our manager research team, discuss our efforts to find external sustainable investment firms with exceptionally talented teams and strong track records. We believe that having a deep understanding of this universe of managers is an essential component of our open-architecture research.

> "WE BELIEVE ADAMANTLY THAT SUCCESSFUL INVESTING WILL REQUIRE A PROACTIVE AND SIGNIFICANT COMMITMENT TO UNDERSTANDING A SUSTAINABLE WORLD."

Advice: As I mentioned above, we know that a growing number of institutions as well as families are looking for strategic guidance: Some questions are specific, such as how to invest portfolios in alignment with their values. Some are more general and, frankly, convey a high level of frustration, such as whether one should be thinking about these issues only in the context of philanthropic choices. The process of sifting through the questions and answers can be complicated—families may feel uncomfortable or unprepared discussing the topic, institutions may have specific stakeholder concerns to address, and everyone grapples with the plethora of options available for expressing their values within their portfolios. Beginning on page 4, Dune Thorne, head of our Boston office, and Alice Paik, head of the Strategic Advisory Group, describe our experiences in walking clients through the process of creating a sustainable investing plan.

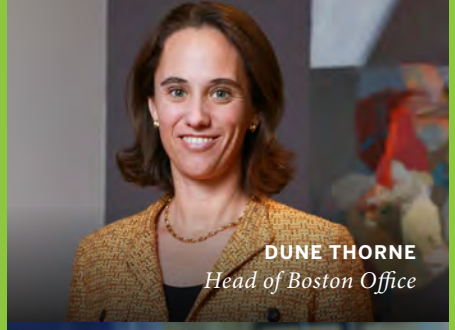
Service: Embedded in the above delivery of performance and advice is our commitment to first-class service, and we are making investments in technology and resources, from screening technology to proxy-voting systems to customized reporting solutions, to ensure that we are meeting client expectations.

If we can deliver on these three commitments, we feel confident that we can help you consider your options for sustainable investing and implement the strategies that fit with your long-term aspirations. It is an understatement to say that it is important that we do so, because we well know that our reason for existing as a firm is to help solve problems for clients. But, we believe adamantly that successful investing will require a proactive and significant commitment to understanding a sustainable world.

Sincerely,

STARTING POINTS

Even investors with strongly held convictions sometimes avoid raising with their advisors the idea of syncing their investment portfolios with their ideals. Yet by focusing on sustainability, a family or institution can achieve clarity of purpose and commit to a long-term plan—two requirements of successful investing.



DUNE THORNE
Head of Boston Office

ALICE PAIK
Head of Strategic Advisory

Many investors have deeply held beliefs and values that shape their life choices, including where they invest. The numbers tell it all: a more than sevenfold increase in investments aligned to environmental, social or governance factors from 2010 until 2014, according to US SIF Foundation.

Still, nearly three out of four investors wait for their advisors to raise the topic of sustainability in relation to their portfolios, according to a 2013 survey by Calvert Investments. Meanwhile, four out of five financial advisors wait for investors to begin the conversation, Calvert says.

That can be a mistake. We have found that clients who go through the process of clarifying their values and reflecting them in their portfolios have a better chance of successfully sticking with their investment programs for the long term. To help you figure out your family's or institution's approach to sustainability, we have identified five starting points in creating your distinct plan:

1. Identify which values to begin with. Many institutions and families share broad values such as environmental stewardship, good governance or social justice. The specific causes they focus on, though, can vary dramatically. One family we advise wants to support local businesses with a regionally focused portfolio. Another family wants to support women by only selecting female portfolio managers, while a foundation we advise avoids investing in companies related to fossil fuels. Identifying a clear goal or priority helps a family or institution narrow its focus from a wide range of views, learn the basic steps in values-based investing and begin to move forward.

2. Use sustainability to bridge generations instead of divide them. Clarifying an approach to sustainability can give institutions and families an opportunity to unify older and younger generations around shared interests and values. One client we advise skipped a generation when selecting a successor for his family foundation, choosing his granddaughter as executive director to bring fresh leadership to the organization. Working alongside her grandfather over many years, the executive director gradually took on more responsibility, first for grant making and then for the investment portfolio. During board discussions, she raised the importance of aligning the foundation's portfolio with its values. The foundation is taking incremental steps, first choosing a sustainability large-cap equity manager while reviewing sustainable investing opportunities in fixed income. The family believes that the sustainability approach has helped bring the next generation into the investment and decision-making processes.

3. Document your sustainability objectives in your investment policy statement. An investment policy statement (IPS) is a document that articulates how a family's or organization's money is to be managed. Having worked on myriad IPSs, we understand that the thought that goes into creating or modifying the statement is as important as the document itself. Asking stakeholders about their priorities can spark meaningful openness of views and clarity about what's most important to members of an institution or family.

IPSs are dynamic and evolve, so revisiting a statement to incorporate values can help maintain consensus—that is exactly what the executive director mentioned above is doing with her family foundation's IPS. Keep in mind that such revisions do not necessarily entail an all-in decision to fully align investments with values. Instead, a change to an IPS can start with a written commitment to at least discuss a values-based approach with all stakeholders.

4. Take "baby steps" before a "giant leap." Making values a cornerstone of an investment portfolio is complex, and getting there can often entail higher turnover and higher taxes. Good first steps can include easy changes to the portfolio that are uncontroversial. This could include aligning bond holdings with values, or adding a core sustainability equity strategy. Initial steps such as these can minimize disruption and help an institution or family grow comfortable with values-based investing. A calibrated approach geared to increasing the confidence of an institution or family is essential to promoting a satisfying outcome. One client we work with started three years ago by investing in a sustainability-focused mutual fund and gradually has grown more comfortable with the strategy's risk and returns. Now we are working with her to build a comprehensive sustainability plan for her entire portfolio.

5. Clarify the sometimes blurred line between philanthropy and sustainable investing. An institution or family can often most effectively make a grant through an investment structure rather than through an outright donation. This can be done through several options, including program-related investments, which are loans or equity investments supporting a charitable activity, or B-corporations, which are for-profit entities aimed at benefiting society or furthering environmental goals. For example, we recently helped a family foundation structure a program-related investment loan to a nonprofit to bridge a cash flow gap for the organization. The family received market-based interest rates while leveraging its capital to support its grant-making mission. The single transaction simultaneously met the needs of both groups.

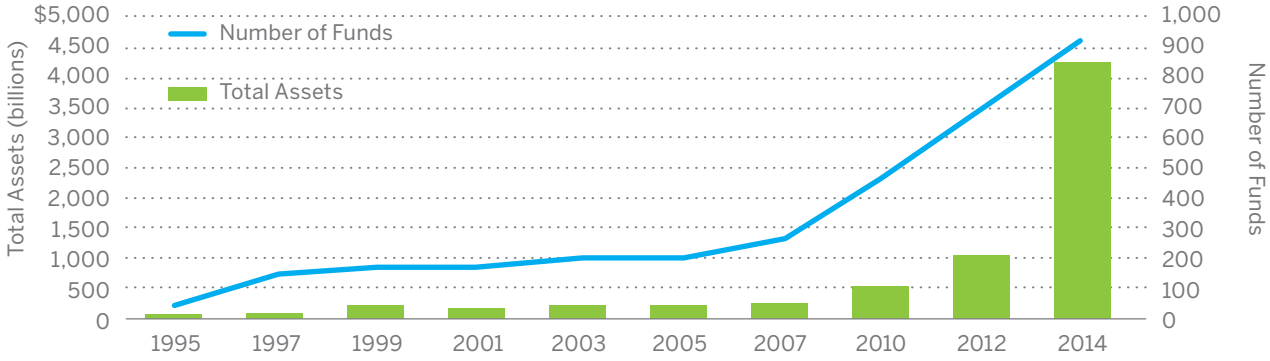
Another tool is social impact bonds, which enable investors to lend money to an organization and receive back their capital with interest if the program meets its impact goals. This is not an investment made for capital growth per se. Rather, it is an innovative structure with incentives that further an organization's mission and impact. So differentiating between philanthropy and investing is essential. A family or institution that structures grants as investments should not consider such initiatives part of its investment portfolio.

Making values a cornerstone to investing offers an opportunity to bring a family or institution together. It helps clarify objectives and builds support behind a long-term portfolio plan, two essentials for successful investing. B

Sustainability Surge

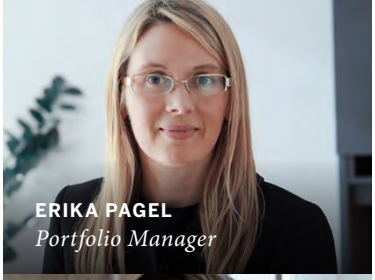
The amount of investment aligned to environmental, social or governance factors grew more than sevenfold from 2010 until 2014.

GROWTH IN ENVIRONMENTAL, SOCIAL, GOVERNANCE FUNDS, 1995–2014



SOURCE: US SIF FOUNDATION

NOTE: DATA ENCOMPASSES 925 ESG FUNDS VIEWED BY US SIF AS INCORPORATING SRI OR ESG INVESTMENT STRATEGIES, INCLUDING MUTUAL FUNDS, VARIABLE ANNUITY FUNDS, CLOSED-END FUNDS, EXCHANGE-TRADED FUNDS, ALTERNATIVE INVESTMENT FUNDS AND OTHER POOLED PRODUCTS. BOTH REGISTERED AND PRIVATE FUNDS ARE INCLUDED. ADDITIONALLY, THE DATA INCLUDES THE ASSETS OF 94 "FUNDS OF FUNDS," WHICH ARE OTHERWISE CONTROLLED FOR DOUBLE-COUNTING EFFECTS PRIOR TO AGGREGATION.



ERIKA PAGEL
Portfolio Manager

JAMES STIERHOFF
Associate Analyst

AN EXPANDING TOOLKIT

The boom in sustainable strategies has made it far easier than even five years ago to construct a sustainable portfolio across asset classes—from stocks to fixed income to compelling private equity alternatives.

No question about it, sustainable investing is a growth industry. There were 925 investment funds that incorporate environmental, social or governance factors in their approach as of the end of 2014, according to US SIF Foundation. That's up a staggering 88% from 2010.

The proliferation of sustainable investment strategies is good news, whether you want to reflect your values in your portfolio or you simply are looking for top-performing opportunities. Just five years ago, if a client wanted a fully sustainable portfolio, we could find managers we were confident in for no more than 50% of total assets. There were not enough strategies that passed our due-diligence process. Today, however, we can boost that to 80% in a balanced portfolio. Here is a tour of some compelling strategies that we use in client portfolios.

ACROSS THE ASSET SPECTRUM

For many years, equities were the only asset class where you could invest sustainably. Today, there are numerous options for the core allocations in a balanced portfolio. Some managers construct sustainability strategies by screening out categories of companies, such as those involved in the production of oil in an effort to align with fossil-fuel divestment mandates, whereas other strategies exclude investments in tobacco or nuclear energy related companies. Other managers look at a company's sustainability orientation as part of their fundamental analysis. Among global equity strategies, some managers we like focus on a specific sector, such as renewable energy, while others buy into a theme such as building efficiency. Many diversified equity managers look for sustainability themes such as "big data," or innovations in the use of real-time data to calibrate the use of water or energy. Such systems streamline the production of goods ranging from corn to steel.

The options in fixed income have expanded significantly in recent years. Now you can find top-shelf strategies that focus on affordable housing, health care and education, microfinance and even community-development programs. Recently, we have helped clients invest in projects devoted to alternative energy, mass transit and pollution clean-up. We helped a family fund a habitat-restoration project on Martha's Vineyard. A similar bond we bought for a different client helped to minimize the disruption to the environment by the construction of five buildings at the Massachusetts Institute of Technology.

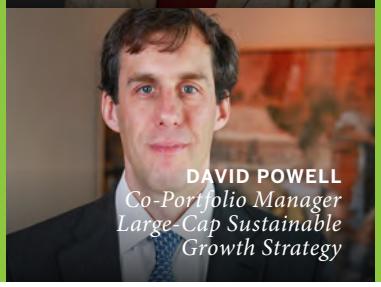
Private equity and venture capital funds invest in some of the most cutting-edge sustainability companies in industries from recycling to clean technologies. A private equity fund we know well has backed a software company that offers a program enabling a car owner to recalibrate the vehicle's engine to optimize gas mileage. Another fund includes a portfolio company that delivers locally grown vegetables in San Franciso and New Orleans.

When building sustainable portfolios, we employ myriad strategies that run the gamut of environmentally and socially centered approaches, from restoring wetlands to financing entrepreneurs in Latin America. But as much as the industry has evolved, we are still searching for high-quality sustainable options in vehicles like hedge funds and international and emerging markets stocks. We anticipate that we will soon be able to close the remaining 20% gap in quality strategies and build 100% sustainable portfolios as more compelling options arise. Given investor demand, arise they will. B

BEYOND THE USUAL SUSPECTS

CEOs across the board try to give their firms a boost by increasing revenue and cutting costs. Our focus is on finding stocks across sectors with underlying environmental business advantages. That can lead us to holdings that might surprise you.

KARINA FUNK
Co-Portfolio Manager
Large-Cap Sustainable Growth Strategy



DAVID POWELL
Co-Portfolio Manager
Large-Cap Sustainable Growth Strategy

CEOs of public companies face pressure from a wide variety of stakeholders to improve their environmental profiles: megaphone-wielding shareholders, procurement managers seeking to "green" their supply chain, as well as concerned customers and employees.

However, we have observed that the most powerful force driving companies to reduce environmental impact is not stakeholder activism but self-interest: Many sustainability initiatives create competitive advantages and lift financial performance.

Our success hinges on identifying companies that directly benefit from their environmental advantages. This sometimes leads us to invest off the beaten path of companies widely associated with sustainability.

HOSPITAL GREEN

When you think of "green" companies, health care probably doesn't come to mind. But health care CEOs worry about energy use in their buildings, disposal of medical waste, and water consumption for sanitizing equipment, operating rooms and linens. These problems create opportunities, and some of our investments provide solutions. For example, Stericycle safely disposes of medical waste, while Cerner provides information technology to reduce redundant tests and unnecessary readmissions.

A less obvious solution provider is Middleby, which produces resource-efficient food-preparation equipment for hospitals, restaurants and other institutions. One of Middleby's innovations is a waterless steamer, which can save hundreds of thousands of gallons of water and close to $1,700 in costs per year at an average-size hospital. Thanks to this and other innovations, including energy-efficient pizza ovens, Middleby has grown its annual earnings at twice the pace of its competitors.

THUMBS UP

Facebook early this decade embarked on a plan to slash energy expenditures by installing low-power servers and streamlining data centers. Its savings over three years: $2 billion, which represents about 15% of operating income within that time frame. The cost-cutting partly stems from the redesign of data centers from the ground up, with custom-built servers, power supplies, server racks and battery backup systems. The end result—a new data center in Prineville, Ore.—uses 38% less energy and costs 24% less to operate than Facebook's older facilities.

SKIPPING THE BRICKS

Visa has embarked on a project of "financial inclusion" by providing savings, credit and payment services via mobile phones to people in emerging markets with little or no access to banks. The company is leveraging the fact that among the world's 2.5 billion people who are "underbanked," an estimated 1.7 billion of them have access to mobile phones.

Visa is working with the government of Rwanda to link banks in a global system accessible with mobile phones. The program would yield savings by reducing the need for constructing bank branches and by enabling the government to make entitlement payments electronically.

Sustainability strategies are not listed in financial statements or captured by standard metrics. Yet by finding companies with environmental business advantages, we believe we can help clients find compelling investment opportunities for the coming decades.

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