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To: President Eisgruber

From: Andrew Golden

Re: The role of social responsibility in PRINCO's investment program

Thank you for the opportunity to illuminate the role of social responsibility considerations in the day-to-day management of the PRINCO investment program. While there is much information available on the CPUC Resources Committee website and in other places on the protocols (and the reasoning behind them) for considering proposals related to divestment and disassociation, and there has been much discussion of actions taken by the University with respect to apartheid in South Africa and genocide in Darfur, there is much less awareness in the broader University community about the ways in which PRINCO takes social responsibility considerations into account on a regular basis in overseeing the investment of Princeton's endowment.

As you know, PRINCO partners with about 75 external investment management firms, each of which already is, or shows promise to become, a world-class expert in a specific investment specialty. We seek through this approach to produce the very high returns that we must perpetually compound in order to finance excellence in teaching and research, not just for today's Princeton, but for the Princeton hundreds of years from now. The mission of assuring that future Princeton students and faculty will have at least as many resources as the current generation is formidable — a small difference in annual investment gains compounds to an enormous difference in assets over time. For example, if our compound annualized returns during my 20-year tenure here were just one-tenth of one percent less than what they were, the endowment would be about $700 million smaller, which would require a cut of about $30 million from today's operating budget.

Optimizing a roster of managers requires science, craft, and art. The process involves qualitative judgment and constructive engagement with our managers so that together we can become better investors and build a superior program. The best decisions can never be made formulaically. They require consideration of social issues as well as purely economic issues, and a fine grain look at facts and circumstances specific to each case.

The endowment's mission, like the University's, is focused on the longest term. Most of the endowment's investments are purchased with the intent of being held for multiple years. As a result, it is natural for our managers, when considering investing in a company, to assess risks and opportunities that will face those companies in the future as well as those facing them today.

Consistent with this long-term perspective that we expect from our managers, PRINCO itself regularly considers how the quality of an investment might evolve over time. Making this assessment involves a collection of judgments about factors that extend beyond a company's economic positioning today. These factors include potential regulatory changes, technological evolution, alterations to the surrounding economic environment, and reputational risks. Obviously, neither we nor our investors have a crystal ball — we cannot predict how laws or technology or the economy or reputations will evolve. We believe, however, that applying an ethical perspective provides a useful guide to analyze these kinds of issues: we believe that, in many, if not most cases, where a need or an injustice exists, decent social, economic, and political systems will adjust to address it. There is nothing inevitable about this view. We adopt it as a matter of conscious choice. Some people might take a much more cynical view of the human situation. But at PRINCO we believe that these kinds of ethical judgments provide two benefits to us. First, they assure that we are sensitive to moral perspectives concerning a host of important social considerations. Second, they often illuminate considerations that ultimately have economic consequences.

Although we cannot reduce the role of ethical analysis to a simple statement, it is significant. A few examples illustrate how it affects our decision-making.

Sixteen years ago we initiated a program of timber investment. Over the course of developing this program, we had conversations with the PRINCO Board, the Trustee Finance Committee, and prospective timber managers that led us to conclude that the wise choice in this area was to require that our timber managers have their practices certified as sustainable by an external entity such as the Forest Stewardship Council (FSC) or Sustainable Forestry Initiative (SFI). In making that decision we learned that sustainable forestry practices can sometimes involve counterintuitive actions. For example, sometimes cutting more trees is better from an environmental standpoint than cutting fewer would be. While it is not always true, in this particular case having our managers engage an outside certification entity seemed an effective, efficient mechanism to help the pursuit of good stewardship and the management of reputational risk. Although it was not by any means the primary motivation driving the decision, the FSC and SFI certification also made sense economically — consumer demand was and is such that certified sustainably produced wood products result in higher profits, despite higher costs of production.

In other cases we may apply a different set of considerations. For example, consider the question of investing in companies that extract fossil fuels. Given the fact that it is impractical for fossil fuel extraction to completely cease, we might conclude that society would be better off if those who were in the business of extracting fossil fuels did so in a manner that was more environmentally protective and energy efficient, recognizing that fossil fuel extraction is one of the highest energy-intensive business activities. In that regard, let me quote from a memorandum we sent recently to the PRINCO Board, discussing a commitment we are making to an energy manager:

> Of note, [XYZ firm] stands out for its close attention to the unique environmental risks of energy investing. The firm makes stringent adherence to all health, safety, and environmental regulations a focal point of company governance... The firm recently began tracking the carbon intensity of its portfolio relative to the fossil fuel industry as a whole, and we are confident that [XYZ] exercises the utmost care in pursuit of its strategy.

I offer this quotation to provide a real-time snapshot of the types of conversations and thoughts that are part of our investment decision-making.

A key criterion in selecting managers is whether or not we can expect them to be good partners with us. We expect that managers will extend this concept of partnership to other aspects of their business, including holding the management of the companies in which they invest to a similar high standard. Our managers recognize that good company managements will consider whether they are acting in good partnership with relevant stakeholders beyond owners, including employees, customers, and the communities in which they operate. We do not expect the considerations of these constituencies to be equally weighted; we do expect though that the various constituencies will be treated fairly.

We and our managers follow the highest business ethics standards. We expect our managers and the management of companies in which they invest to follow, at a minimum, relevant "Best Practices." And while it may go without saying, we expect our managers and the management of companies in which they invest to follow the spirit, not just the letter, of laws and regulations.

Because of the complexity of considerations, it is not possible to create a simple, exhaustive, ongoing listing of dos and don'ts. Rather, what can be done is to assure that thought is given to important issues, and that we discuss these issues with our managers. A recent example of what I mean is a discussion we had with one of our venture capital firms about the fact that some aspects of a particular social network company created risk that the company's app could promote cyber-bullying. The manager identified this risk, and decided to not invest in that company for that reason. This manager is an aggressive, competitive investor, out to create high returns. Yet the firm's partners examine the full consequences of its investing and make reasonable judgments about social responsibility as well as economic return.

We do several things to assure that we are well educated in matters of social responsibility. We are involved in two different networks of peer endowment offices so that we can keep up-to-date on best practices of investor responsibility. We attend conferences on social responsibility topics. To give a sense of our proactivity, in 2003, long before fossil fuel investment attracted significant attention on this campus, I attended the Institutional Investor Summit on Climate Risk at the UN.

While it is hard to describe our approach to social responsibility with succinct generalizations, the fact is that our complex, distributed investment process does promote social responsibility, even while making superior returns our primary concern. For example, even though we operate without any requirement to promote environmental sustainability, over the past decade we have made about $1.5 billion of investments that specifically do so.

I hope the above sheds some light on how matters of investor responsibility are engaged at the micro-level as we pursue our fiduciary responsibility on a macro level to generate the resources that are essential to support the University's mission.