Value-Chain Analysis: Partnership for a Carbon Efficiency Strategy

Oxford Impact Investing Programme
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1BNY Mellon Investment Management EMEA Limited (“BNYMIM EMEA”) is the distributor of the capabilities of its investment managers in Europe (excluding funds in Germany), Middle East, Africa and Latin America. Investment managers are appointed by BNYMIM EMEA or affiliated fund operating companies to undertake portfolio management services in respect of the products and services provided by BNYMIM EMEA or the fund operating companies. These products and services are governed by bilateral contracts entered into by BNYMIM EMEA and its clients or by the Prospectus and associated documents related to the funds.
This case is part of a teaching series that examines the strategies global leaders use to tackle the world’s most complex problems. According to the World Economic Forum’s annual Global Risks 2015 report, these are threats that keep world leaders across sectors awake at night—interstate conflict; water crises; social instability; unemployment; extreme weather events and weak climate change adaptation strategies; and cyber-attacks.¹

To help leaders be more successful in their efforts to tackle these seemingly intractable challenges, a Wicked Problems framework was developed over four decades ago. Since its inception, much has been learned about what it takes for leaders to address the world’s most difficult problems successfully. If Wicked Problems were easy, they would have been solved. Because each complex problem is unique, it requires leaders to make choices. Do they command solutions as in a crisis? Do they manage a problem through a collection of déjà vu experiences? Do they become adaptive leaders who adjust and recalibrate their strategy based on open reflection of what is and isn’t working? Do they put their egos aside and challenge themselves through collaborative decision-making and seek solutions where one might least expect them?

Deliberate Leaders as defined as those who act with the intention and recognition that they not only accept the risk of the challenge ahead, but also the consequences of their actions. In this case study series, examples of Deliberate Leaders are compiled to help guide 21st century leaders as they seek out solutions to the biggest challenges of our time. Each case study offers a unique approach that is intended to serve not as a prescription, but as a way to stimulate thinking and discussion among leaders facing similar challenges.

The Carbon Efficiency Strategy case study uses the Deliberate Leadership framework to identify the social, financial, and collaborative pillars needed to create a market-oriented product that is designed to meet the growing demand for environmentally conscious investing.

This analysis was supported by BNY Mellon, Mellon Capital Management (MCM), and The McKnight Foundation (McKnight or Foundation) and illustrates how these organizations are part of an ambitious movement to redefine the field of social investing. The methodology included 15 confidential interviews with key staff from BNY Mellon, MCM, McKnight, and McKnight advisors Mercer and Imprint Capital. Interviewees were identified and agreed upon by the partners, and interviews were conducted either in person or by phone by pfc Social Impact Advisors staff and/or consultants from the MaRS Centre for Impact Investing (MaRS). The case study team also reviewed background documentation provided by all stakeholders and conducted desk research on partners, products, and opportunities in social investment.
Opportunity Meets Urgency

In late October 2014, Gabriela (Gabby) Franco Parcella, chairman, president, and CEO of Mellon Capital Management, and Kate Wolford, president of The McKnight Foundation, spoke to Bloomberg Business about the launch of an exciting new social investment product they believed would add another option for investors concerned about climate change. The joint venture was the Carbon Efficiency Strategy (CES), a portfolio in lower-carbon investments seeded by The McKnight Foundation that was the culmination of 10 months of intensive discussion and co-creation. It represented a landmark product for MCM and offered McKnight and other carbon-conscious investors a more proactive way to shift institutional investments towards companies whose practices could reduce carbon emissions exposure in investment portfolios.

Parcella and Wolford share a commitment to innovation, and both are known and respected as open, collaborative, and risk-taking leaders. Working together to push the financial envelope and develop an investment product that could potentially yield social and environmental returns without sacrificing strong financial performance came as no surprise.

For Parcella and MCM, the CES developed for McKnight is consistent with the firm’s 20-year history of meeting responsible investment mandates. Parcella describes MCM as a systematic manager “skilled in taking an idea and building a model that expresses it quantitatively.” About the CES, Parcella comments, “We place our values into three broad categories: global, insightful, engaged. The CES cuts across all three.”

For Wolford and The McKnight Foundation, the CES represents another milestone in the Foundation’s journey to, as Wolford says, “walk the talk” by aligning its programmatic and endowment investments with its mission to “improve the quality of life for present and future generations and...to use our resources to attend, unite, and empower those we serve.” Wolford believes that the CES “helps fill a gap in the universe of investment products by demonstrating responsiveness to the demand by an institutional investor and sends a signal to the market about carbon emissions.” The CES is expected to reduce the Foundation’s emissions intensity profile in this particular investment account by more than 50 percent relative to investments with a more standard index exposure.
Introduction

But getting to this launch was not easy. Wolford and Parcella and their colleagues had to resolve a number of questions individually and together: How does a financial services company with little expertise in climate change develop products that are well informed and will support a client’s social and environmental mission? How does an institutional investment manager participate in such an effort while maintaining its core mandates and fiduciary responsibilities? How can diverse partners collaborate to develop a successful social investment product while managing internal trade-offs and competing partner objectives?

This case study examines the challenges and lessons learned during the 10 months of development of the CES, offering these experiences to other innovators as they consider creating new financial products that balance financial returns and social outcomes with the added dimension of a carbon-specific focus. The case explores these issues by looking at how the value chain of relationships across the unique communities of BNY Mellon, MCM, and McKnight merged to develop and take to market a new product: a US$100 million Carbon Efficiency Strategy designed to promote the reduction of carbon emissions exposures in investment products, while providing a financial return to the satisfaction of all the partners.

Growing Demand to Bridge Market and Mission

Over the last thirty years, a number of factors have influenced growing demand for socially responsible investment options, growing from early socially responsible and below-market-return investing to more recent impact investing opportunities. The momentum is driven by critical social and environmental challenges that are increasingly being met with market-based solutions. Impact investments can help identify new opportunities that may not be captured through evaluation of investments on financial terms alone. However, valuing social and/or environmental dimensions adds complexity to traditional financial valuation, requiring specialists with additional knowledge and skill sets within existing traditional financial intermediaries to enable deal flow and strengthen the market place.

While estimating and pricing the impact investing market is challenging, there is an observable growth trend as new entrants from diverse financial management companies, investors, and intermediaries drive momentum. In the area of responsible investing, assets under management by signatories to the United Nations Principles for Responsible Investment (UN PRI) stood at more than US$45 trillion in 2014, up from US$4 trillion at the UN PRI’s launch in 2006. According to the World Economic Forum, in 2013, an estimated US$13.6 trillion of global funds were invested in sustainable and responsible strategies. A 2014 survey of impact investors by JP Morgan and the Global Impact Investors Network (GIIN) found 124 respondents collectively managing US$46 billion in investments and anticipating an additional US$12.7 billion in 2014, an increase over the US$10.6 billion deployed in 2013.

Researchers predict the growth in impact investing will continue as younger investors, who will inherit a pending intergenerational transfer of wealth estimated at US$41 trillion over the next 50 years, look to allocate nearly US$6 trillion towards social issues.

Addressing the challenges of climate change has become a focal point for many impact investors, and with good reason. According to the UN Intergovernmental Panel on Climate Change (IPCC), whose fifth biennial assessment was released in April 2014, emissions grew more quickly between the years 2000 and 2010 than in each of the three previous decades. Ottmar Edenhofer, Co-Chair of Working Group III of the IPCC, states, “There is a clear message from science: To avoid dangerous interference with the climate system, we need to move away from business as usual.”
Introduction

While political efforts to address climate change have advanced in regions like Europe and stalled in regions like North America (despite progress made at the state/local and regulatory levels), the global business community has been steadily increasing the connection between profitability and sustainability as it assesses the future of its bottom line. Groups such as the World Business Council on Sustainable Development, We Mean Business Coalition, US Climate Action Partnership, Institutional Investors Group on Climate Change, Investors Network on Climate Risk, and Risky Business Project, represent just a handful of the national and international efforts business leaders are taking on to confront the predicted impacts of climate change on their companies.

Corporations have many reasons for this interest in climate change. In the 2013 report GEO-5 for Business: Impacts of a Changing Environment on the Corporate Sector, spearheaded by the UN Environment Programme, the authors noted that, “The business need is...clear: assessing environmental trends across the life cycle and understanding their impacts on operations, markets, policy, and reputation is essential for companies to effectively manage risk, capture opportunities, and create long-term competitive advantage.” The report complements this risk assessment with a list of market-building opportunities that have arisen to address identified challenges, with an emphasis on clean energy alternatives to current business practices.

While responses to climate change have varied across the social, business, and government sectors, overall demand for alternative solutions that bring diverse partners together to confront climate change consequences is clearly on the rise.

How to Partner for Climate Efficiency?

As research and debates about the interplay between business outcomes and social outcomes in climate change have evolved in recent years, BNY Mellon, MCM, and McKnight were quietly amplifying their own approaches to achieving a low-carbon future. Each followed its own path, but they all came together to develop a lower-carbon investment product.

The McKnight Foundation

For 60 years, The McKnight Foundation has helped nonprofit organizations and public agencies improve the quality of life for all people, particularly those in need. Founded by William L. McKnight, one of the early CEOs of the 3M Corporation, the Foundation today has assets of approximately US$2.2 billion. Its program areas include the Arts, Education and Learning, International, Midwest Climate and Energy, Minnesota Initiative Foundations, Mississippi River, Neuroscience, and Region and Communities. In 2014, McKnight awarded grants totaling US$88.3 million: 72 percent within Minnesota, 8 percent to projects both along the Mississippi River corridor and outside the state, and 12 percent to global work.

Internationally, McKnight’s goal is to promote strong rural livelihoods and food security, with a regional focus on Southeast Asia and a Collaborative Crop Research Program (CCRP) it established in 1983. Through the CCRP, McKnight has allocated over US$100 million to small-farmer-led research in the Andes and Eastern, Southern, and West Africa, as well as cross-cutting projects.

In the entrepreneurial spirit of William L. McKnight and his family (members of which continue to serve on the board), the Foundation prides itself on maintaining a culture of innovation and testing new approaches to social change. More recent generations of the family have brought new conversations to the table that prompted consideration of how the Foundation could use all of its capital to advance its mission.
For example, along with the Ford and MacArthur foundations, McKnight was one of the early adopters of Program-Related Investments (PRIs), beginning in the 1980s to support urban renewal and affordable housing with loans at below-market rates. The Foundation has also looked at ways to blend impact investing with more of its programs and practices. Since 2008, McKnight has applied ISS (formerly RiskMetrics), a decision support tool for institutional investors, to vote proxies on its managed financial accounts and has employed eight investment firms—representing over US$1.3 billion of its portfolio—who are signatories to the UN Principles for Responsible Investment.

The Foundation’s next step in innovative investment practices came in October 2013, when the board of directors approved the establishment of an impact investing program. The adoption of the impact investing policy by the full board enabled McKnight to move towards a deeper alignment of practices across the Foundation. As board Chair Ted Staryk commented about the launch of the impact investment program, “Over time, we expect a triple bottom line of financial returns, program impact, and deep program learning.”

This choice demonstrates McKnight’s willingness to take informed risks to further link its portfolio with its primary mission. The decision to create an impact investing program representing approximately 10 percent of the endowment was made only after board, staff, and advisors had engaged in a yearlong research and vetting process. The Foundation is committed to a rigorous assessment of its impact investments to ensure both financial return and alignment with its program goals. But McKnight’s commitment to calculated risk-taking did not stop with simply establishing the impact investing program. Its long-standing relationship with MCM helped it expand beyond an impact investing “carve out” to opportunities in the rest of its endowment that advance its environmental goals.

**BNY Mellon**

MCM has managed a portion of The McKnight Foundation’s investments since 1987. Currently it manages approximately US$600 million, or 27 percent of McKnight’s US$2.2 billion endowment. MCM is a wholly-owned subsidiary of BNY Mellon, one of the world’s largest and most established financial services corporations. BNY Mellon safeguards US$28.9 trillion—one-fifth of the world’s assets—reflecting its brand as the “investments company for the world.” It has approximately US $1.6 trillion in assets under management and operates in 100 markets globally, leveraging the reach of its 13 affiliates like MCM that function as separate entrepreneurial distribution units and service providers.

Like McKnight, BNY Mellon and MCM undertook a journey to become more intentional about their social and environmental profile. BNY Mellon’s corporate social responsibility (CSR) strategy was formally established in 2007, when Mellon Financial Corporation merged with The Bank of New York Company, forming BNY Mellon, and a CSR committee of the board of directors was created. At the time, the company’s CSR priorities were focused on traditional “nice to do” activities—employee engagement, community support, and environmental sustainability.

While McKnight was evolving its investment strategies and refining its focus in the area of climate change, both BNY Mellon and MCM were on their own paths to move beyond innovative investment products to incorporate social responsibility across the firm.
Introduction

Unbeknownst to McKnight, BNY Mellon was engaged in a redesign of its CSR framework during the time McKnight was refining its own social investment approach. This trajectory was critical to shaping a receptive environment at MCM for the creation of the CES.

Anna Kearney, associate director of social finance at BNY Mellon, notes that the early CSR program “... followed traditional topic areas like so many other companies, but was somewhat ancillary to our firm’s core business strategy.” But then the CSR team undertook two quick rounds of strategic review, led by management and the CSR board committee, to determine material places where BNY Mellon’s core business activity could impact society. This process led to a redefinition of how BNY Mellon would engage in CSR.

This was an important step because it meant Kearney and John Buckley, the global head of CSR, could move this work into the strategic aspects of the company. In March 2013, BNY Mellon announced a new CSR strategy that focused on three key themes:

- **Invested in market integrity:** Contributing to the health of global markets through the resiliency and effectiveness of its operations, as well as upholding the highest standards of integrity and responsibility in its practices and products.
- **Invested in its people:** Providing its talented, diverse workforce with the opportunities and training they need to grow and succeed.
- **Invested in its world:** Making local communities better places to live and work, and contributing to solutions for important global issues.  

Importantly, the new strategy indicated not just a commitment to employee development and community engagement, but also, according to Buckley, “the important role BNY Mellon plays in the integrity of the global financial markets.”

In addition to looking at how BNY Mellon could become a CSR leader, the BNY Mellon CSR team also recognized the level of public distrust in the financial sector in the post-2008 world and the need to be responsive to the changing expectations of stakeholders.

In that second round of strategic review, the CSR board committee posed the question, “What will BNY Mellon be known for as the investments company for the world?” At that time, the team sought an answer that not only addressed internal motivations, but also satisfied the growing demand from investors to better understand social and environmental risks and opportunities. For these reasons, as Kearney noted, BNY Mellon formalized a focus on Social Finance that truly integrated CSR into the firm’s core business and expertise. Today, BNY Mellon defines Social Finance as “investment activities that include both financial and positive social and/or environmental impact.”

BNY Mellon’s Social Finance approach is intentionally holistic, capturing some US$22 trillion in assets. It is focused on helping increase investors’ understanding of the breadth and depth of the market and providing a wider range of investment opportunities to mainstream investors. Strategies include socially responsible investing, environmental finance, impact investing, and development finance.
The evolution of BNY Mellon’s CSR program to include Social Finance was swift and involved a variety of stakeholders along the way. Kearney and her team did “pressure testing” to make sure they were talking to the right people inside and outside of the BNY Mellon network and to see if the approach resonated with and appeared attractive to its client base. It is important to note that BNY Mellon has always recognized its role as, first and foremost, an investments firm. The team needed to make sure that Social Finance was “…a business driven program.” As Kearney points out, “We wouldn’t achieve scale...without being driven fundamentally by business, with good social impact, as dual objectives.”

BNY Mellon’s next major step in the Social Finance process was the release of an organization-wide white paper on BNY Mellon’s position titled Social Finance at Scale: Creating Value for Investors. In addition to offering insight into key trends in Social Finance and outlining the value of Social Finance for investors, the white paper hones in on key conditions for scale and offers recommendations for how investors can work alongside actors in the investment value chain to address those conditions for scale. Rehana Nathoo, social finance project manager at BNY Mellon, says of the study, “Our goal with the report is to enable the investment community to advance social finance by addressing the barriers that are preventing capital from being unlocked. The report suggests that investments must generate financial returns for mainstream investors as well as long-term social and environmental performance.”

As one of the largest investment firms in the world, the team hopes BNY Mellon’s current capabilities in and strategic vision for Social Finance will lend weight and guidance to a growing field.

Mellon Capital Management
MCM, though a subsidiary of BNY Mellon, is free to pursue practices that meet its clients’ needs and improve its market position. Increasingly, that means pursuing responsible and impact investing strategies. Founded in 1983 and headquartered in San Francisco, MCM manages more than US$352 billion in total assets through offices in the US, India, Hong Kong, and London. Approximately US$43.7 billion of that is in socially responsible investments (SRI) and environmental, social, and governance (ESG) investments on behalf of its clients. In 2013, it became a signatory to the UN PRI and in 2014 it signed on to the CDP (formerly known as the Carbon Disclosure Project). Both actions deepened its commitment to incorporating ESG strategies into investment practice. According to Parcella, “Our clients and colleagues are interested in how ESG issues impact our world and the economy.... Becoming a signatory to UN PRI signals our commitment to remain focused on these long-term risks.”

These actions support a growing sense that responsible investment strategies are going mainstream. As Mitchell E. Harris, president of BNY Mellon Investment Management, noted upon MCM’s joining the UN PRI, “Including Mellon Capital, there are now [five] BNY Mellon investment boutiques which have become UN PRI signatories.... ESG factors may influence long-term returns. They no longer are a niche studied only by sustainable investment specialists.”

The array of products offered by MCM has grown organically from its roots in indexing to include Global Tactical Asset Allocation (GTAA®), active equity, commodities, tactical asset allocation, and other products. Additionally, the firm has managed over US$56.7 billion in strategies where ESG issues are incorporated into the philosophy and methodology of the process.

In 2014, McKnight and MCM’s evolving commitments to socially weighted investments came together to create the CES. The process through which they did so surfaced important lessons in the ups and downs of collaboration across sectors.
Creating a Carbon Efficiency Strategy

The McKnight Foundation

McKnight had set the stage for the CES portfolio through an evolving commitment to impact and responsible investing paired with a long-standing programmatic commitment to the environment and addressing climate change. Though it had mostly promoted work in the Midwest, McKnight’s global program and national support of environmental projects (which has totaled over US$125 million for climate alone since 2005) offered a platform for advancing its mission. In 2009, it had made a five-year, US$65 million investment in ClimateWorks Foundation, a US$1 billion collaborative funding effort to address climate change through grantmaking, policy change, and promoting energy efficiency in the highest greenhouse gas-emitting sectors and countries around the world.39 Using the lessons learned from this experience, McKnight refined its strategic focus toward helping the American Midwest become a leader in the transition to a low-carbon future.40

While the McKnight climate program was modifying its focus, the Foundation’s board was beginning to consider how to do more with its investments. The Foundation is intended to work in perpetuity, so investment returns are needed to support its grantmaking activity, which is at least 5 percent of assets annually. However, the younger generation of family board members wanted to leverage the rest of the endowment to address Foundation goals. Board chair Ted Staryk suggested that the financial team meet with Imprint Capital (Imprint41), an impact investment advisory firm that had worked on social investment issues with several large foundations across the US, including the W.K. Kellogg Foundation of Michigan and the David and Lucile Packard Foundation of California.

In October 2012, Rick Scott, McKnight’s vice president of finance and compliance, met with John Goldstein, managing director of Imprint, to learn more. Impressed with reports from this meeting, the Foundation’s investment committee decided to meet with Imprint in December 2012. Imprint was then invited to McKnight’s full board meeting in May 2013 to join the discussion about what McKnight could achieve through impact investing. Supported by the technical expertise of Imprint and applying a careful process of research and consultation involving buy-in from all stakeholders along the way, the Foundation developed an impact investing program that was approved by the entire board in late 2013. This decision, says Scott, was “very, very important” in helping set the stage for board involvement in discussion, debate, and the eventual launch of the CES.
Creating a Carbon Efficiency Strategy

Sparking the Idea

As noted, McKnight’s impact investment strategy planning included a variety of stakeholders. An additional important voice was that of Mercer, a global consulting leader in talent, health, retirement, and investments with 130 global offices and over US$4.2 billion in revenue, which advises McKnight on its investments. Mercer provides annual reviews of investment policy and asset allocation and quarterly reviews of the Foundation’s investment performance. It is responsible for reviewing investments with each of McKnight’s 22 managers, including MCM.

In December 2013, McKnight’s investment committee and the MCM team, along with staff from Mercer, met at MCM’s office in San Francisco. Vice president of finance Rick Scott; investment committee chair David Crosby; and other board members represented McKnight. Alexander “Lex” Huberts (then-president) and Kristen Fontaine, vice president for global consultant relations at MCM, attended on behalf of MCM, and Laura Kunkemueller represented Mercer.

The McKnight team shared the Foundation’s decision to implement an impact investing strategy and their engagement of Imprint Capital to support the process. During the meeting, the McKnight board members also raised the issue of the Foundation’s carbon exposure, leaving open the question of what might be done to bring the investments closer to mission and values.

Kunkemueller, a principal at Mercer, had already been thinking about the Foundation’s exposure in the climate and energy space. In a Foundation investment committee meeting earlier that year, McKnight’s leadership had raised the topic of aligning investments with initiatives. At that time, Kunkemueller had returned to her office and asked her team to analyze the carbon footprint of McKnight’s entire portfolio. These early findings had been presented to McKnight when the team visited Mercer for its annual manager-monitoring trip. The report showed each investment manager’s exposure to companies named in the original Carbon Tracker 200 (CT200) and Filthy 15 (F15) lists, as well as additional energy exposure. While there were significant gaps in the data, the analysis indicated that the Russell 3000 Index® held by MCM (then valued at US$58.5 million) had the highest exposure to companies on those two lists.

Thinking through the changes at McKnight, the questions posed by its board, and the carbon exposure information reviewed earlier that year, Kunkemueller left the December 2013 meeting with some new ideas for how McKnight could advance its climate and energy goals. Soon after the December meeting, Kunkemueller invited Fontaine to talk about socially responsible investing options for McKnight. In particular, Kunkemueller asked what MCM could do about the carbon exposure in the Russell 3000 Index®. Fontaine agreed to have a sample portfolio of Mellon’s Broad Market Index run, removing the companies listed in the Carbon Tracker 200 and Filthy 15. Kunkemueller wanted to understand the differential in fees, returns, and tracking error.

This started a series of carbon exposure conversations between McKnight and MCM, with Mercer working as intermediary. MCM indicated that other clients and potential clients had asked similar questions, so perhaps now was the time to look into developing a product that would meet their needs for reduced carbon exposure.
Creating a Carbon Efficiency Strategy

McKnight gave MCM the first chance at building an investment product. If it came up with a good model with a fee structure in the range of the existing one, McKnight would consider seeding a fund. Kunkemueller shared with MCM that she had begun working with the ESG research team at Mercer and that they believed a potential collective fund in the low-carbon space would have a lot of traction. This got the ball rolling.

Thinking back, Wolford admits that McKnight did not exactly know what success would look like when it embarked on this process. Still, according to Scott, the McKnight staff felt, “If we can do something interesting and not create tracking error, why not do this?” He noted that in its discussions with Mercer and MCM, McKnight made clear it did not want window dressing, but rather a substantive product.

Creation Is a Process

Getting to “yes” can be an iterative and contentious process, even for partners who want the same result and who have built a trusted relationship over the course of several decades. It was no different for McKnight and its three advisors, MCM, Mercer, and Imprint.

In early 2014, conversations to move product development began in earnest. Product development was led by Kristen Fontaine and Karen Wong, managing director, head of equity portfolio management at MCM, who embarked on early discovery to understand the requirements of such a product and the resources available. Fontaine’s first task was to educate herself and Wong about ESG and impact investing broadly. She researched investor initiatives, proxy voting, and the fossil fuel divestment movement. Wong worked to understand the data available and how that would guide their approach.

Initial conversations in January 2014 between Fontaine and Kunkemueller focused on processing the implications of the sample portfolio MCM had run excluding the CT200 and F15 companies. This led to discussions about the potential for a collective fund, something that could also be attractive to an audience beyond McKnight.

Kunkemueller invited colleague Craig Metrick, then head of US ESG research at Mercer, to help the product development team discuss the potential approaches to a product. In particular, they aired their concerns about the data in the F15 and CT200, which was already three years old and relatively static. They found both lists contained too much ambiguity with regard to company selection criteria, were potentially politically motivated, and included companies that had gone out of business. The team needed to consider what other data sources could be used. They also covered the importance of benchmarking to a well-known index and which direction to use in terms of the research, given options like engaging companies on their carbon emissions versus excluding them because of it.

In a subsequent conversation, which also included Wong, Metrick helped the development team dig into the trend of fossil fuel free investing and the need for options for interested clients. In particular, there seemed to be a niche for products that were not solely exclusionary, but rather sought to reduce exposure to companies emitting the most carbon while keeping risks and returns together. MCM managed McKnight’s Russell 3000 Index® investment, which held the Foundation’s highest exposure to fossil fuels emissions, so the team turned to consider how they could keep index-like exposure without the exposure to the fossil fuels. Returning to the data source conversation, Wong suggested using MSCI, with which MCM had a strong relationship, rather than the F15 and CT200.
Later discussions in the spring of 2014 deepened the team’s focus on carbon emissions, rather than carbon reserves, as their own knowledge evolved. Yet they still stayed true to finding a solidly pragmatic approach for McKnight and the broader market. The stumbling block they encountered, however, was that MSCI was only able to provide data for 600 companies of the 3000 in the Russell Index, including both reported and estimated data. Keeping this data question in mind, the model started to take shape with a focus on excluding the top 20 carbon emitters, which could potentially reduce emissions exposure by 75 percent (versus the stated benchmark) with 40 basis points (bps) of tracking error. There were still discussions about the details of the model, such as the number of companies to exclude, the criteria for doing so, and the consequences, but the team felt this approach would help meet McKnight’s desire for something that was simple and effective.

Imprint became involved in the product development process in April 2014 with a call between Goldstein and Adam Gromis, Imprint’s client relations manager, and the rest of the development team to discuss the available research and early model options. Imprint’s background helped the team make progress on evaluating the CT200 and F15 lists within a given strategy and see how the model could include sustainable proxy voting guidelines. The team soon completed work on a model that was called the Carbon Emissions Reduction Strategy (CERS).

Mercer and MCM presented the Carbon Emission Reduction Strategy to McKnight senior staff, board, investment committee members, and to Imprint on May 2nd. The presentation shared five different scenarios using the model, which proposed lowering the absolute level of carbon emissions by removing large companies in emissions-intensive sectors, such as fossil fuel production, from the portfolio. The five scenarios showed different methods for seeing between 75 and 95 percent reductions in exposure compared to the same expected tracking error. The emission metric employed was the most recent carbon emissions data as reported by MSCI ESG Research. The presentation compared the model to the CT200 and the F15, and also proposed sector optimization to compensate for the large underweight in the energy and utilities sectors caused by divestment. (See Figure 1 below).

**Figure 1. Carbon Emission Reduction Strategy**

<table>
<thead>
<tr>
<th>Carbon Emission Reduction</th>
<th># of Companies Excluded</th>
<th>% Mkt Weight Excluded</th>
<th>INITIAL (vs. R3)</th>
<th>OPTIMIZED (vs. R3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Barra Risk %</td>
<td>Barra Risk %</td>
</tr>
<tr>
<td>75%</td>
<td>38</td>
<td>7%</td>
<td>0.55</td>
<td>0.40</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-3.44</td>
<td>-0.05</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-1.79</td>
<td>-0.05</td>
</tr>
<tr>
<td>80%</td>
<td>45</td>
<td>9%</td>
<td>0.63</td>
<td>0.44</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-3.71</td>
<td>-0.05</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-1.79</td>
<td>-0.05</td>
</tr>
<tr>
<td>85%</td>
<td>55</td>
<td>10%</td>
<td>0.69</td>
<td>0.47</td>
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<td></td>
<td></td>
<td></td>
<td>-4.09</td>
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</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-1.80</td>
<td>-0.05</td>
</tr>
<tr>
<td>90%</td>
<td>72</td>
<td>13%</td>
<td>0.82</td>
<td>0.53</td>
</tr>
<tr>
<td></td>
<td></td>
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<td>-0.05</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-1.90</td>
<td>-0.05</td>
</tr>
<tr>
<td>95%</td>
<td>102</td>
<td>19%</td>
<td>1.11</td>
<td>0.83</td>
</tr>
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<td>-5.61</td>
<td>-0.05</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-2.07</td>
<td>-0.05</td>
</tr>
</tbody>
</table>

The presentation of this first model allowed for a full discussion of the immediate feedback from all parties. For McKnight, it was important that Imprint be involved to ask questions and share its expertise so that the model could continue to evolve with a balanced emphasis on social and financial returns. In all, the full group was encouraged by the first take and felt that as the data improved the strategy would increase its impact. However, the development team still felt as though they wanted a stronger narrative to
Creating a Carbon Efficiency Strategy

help define marketability, the value proposition, sector balance, and the weight of tracking error. The development team decided to start outlining its own narrative for a product in order to have a more focused model.

Charlie Dolan, BNY Mellon’s senior investment strategist in the Investment Strategy & Solutions Group, was enlisted at this point to support the development process. With a background in mathematics and computer science and a high-level view of the strategies and tactics being applied by all the BNY Mellon boutiques and by the field at large, Dolan was in an excellent position to help the team understand the field into which the product would be placed.

Dolan himself found the project exciting, noting that the field could move in a certain direction, but only when the asset owners started insisting on alternatives would the ESG space reach a tipping point. McKnight’s actions could leverage just this type of tipping point.

In early June, a second version of the Carbon Emission Reduction Strategy was shared with McKnight’s staff and leadership at the MCM offices in San Francisco. This version had grounding in the impacts of the model: Immediate, Effective, and Engaged. It outlined a goal of achieving a 90 percent reduction in emissions exposure versus the benchmark.

At this meeting, some of the previous concerns with the model were revisited, including the value of the CT200 and the F15. McKnight also brought up the idea of taking coal companies out of the strategy entirely if it would not impact the tracking error. This was new and created a bit of frustration within the development team, and some tension among the consultants in terms of wanting to emphasize an executable investment model and also wanting a product with better data and a clearer investment thesis.

Clean and usable data was critical to the product, and Wong proposed meeting with MSCI to discuss improving the data they offered. Imprint had suggested other companies that specialized in analyzing carbon and climate-related data from corporations, but MCM felt it important to continue working with MSCI. In part, this was because MCM felt it had natural leverage flowing from its long-standing relationship with MSCI which could help influence the overall direction of MSCI’s approach to data provision.

Wong met with MSCI soon after the June meeting, and MSCI shared that it was, in fact, moving towards improved data and would publish this within the next month. McKnight agreed to give MCM a month to wait for a new dataset from MSCI.

Reflecting on the Carbon Emission Reduction Strategy

The response to the progress of the models after this second meeting was less than enthusiastic within McKnight. Kate Wolford described it this way: “It wasn’t as robust as we had hoped, which was disheartening. It was simply a negative screen with weak data.” Wolford explained, “Our investment committee, foundation staff, and Imprint were disappointed. I didn’t think we were going to go forward.”

McKnight and Imprint found that the strategy of removing the largest carbon emitters from the list made it function more like an investment screen, which many investors had used for years to filter out companies that were not aligned with their values. The proposed model created a bias against company size—bigger companies have bigger greenhouse gas footprints, but this does not mean those companies are the least desirable operators.
McKnight and Imprint discussed suggesting a focus on underweighting both poor performance and non-reporting companies. McKnight was excited by this idea of having a tool with which to push companies in the index to opt to report and/or provide more robust reporting.

McKnight leadership, joined by new Impact Investing Program Director Elizabeth McGeveran, decided to follow up on the meeting with a phone call. Though the new ideas (including the removal of coal from the model) posed additional work for the development team and led to some confusion about what McKnight wanted, McKnight staff underscored the need to have an open process for tweaking the model and making sure the product would advance the multiple objectives McKnight and similar foundations embraced. The call was difficult, but necessary.

As Wolford recalls, “To MCM’s credit, they stepped up and said ‘let’s take another shot.’ There was a good chance the CES would have ended there—but MCM staff believed they could iterate the right product for us. We agreed to go forward.”

Wolford continues, “The first thing we did was for each of us to begin by describing our needs and goals with the fund. In hindsight we should have set up a meeting with all involved, including Imprint, at the outset of the project. Fortunately, the relationship with MCM was strong enough that McKnight staff and board could voice their concerns, and Mercer and MCM were supportive about going back to the drawing board.”

McKnight sent a memo to the team via Mercer on July 21st. For the first time, this memo put to paper McKnight’s goals for the strategy:

1. Overweight strong greenhouse gas performers and underweight weak ones using apples-to-apples industry sectors, based on relative performance not size.

2. Include strong integrated proxy voting and shareholder engagement.

3. Exclude coal.51

Just before the phone call and memo, MSCI had released the improved data.52 With this new and expanded data, the development team saw they would need to exclude so many companies to reach the proposed 90 percent reduction strategy that tracking error would be severe. Deciding the CERS was no longer practical, the team started over. In the end, everyone saw that the data issue had to be resolved because of the limited availability of quality reporting, and the best approach to this strategy was to find ways to motivate companies to report. A redesign began in earnest in late July 2014.

Poking and Prodding

Despite the CERS model’s initial shortcomings, all the participants felt they were on the right track. McKnight’s leadership believed that the development team understood what the Foundation wanted and would develop a smart product to bring to market. In the end, the team’s primary mandate was to build a product that would meet the twin objectives of reducing carbon exposure in McKnight’s portfolio and serving a similar financial and risk function to what it was currently producing.

The development team reached out to partners to undertake a complete refinement of the model. In addition to the work with MSCI, Wong and Fontaine consulted with Huberts, who helped the team land on appropriate carbon reduction and tracking error targets.
Creating a Carbon Efficiency Strategy

Imprint continued as a partner in the refinement process, helping raise questions that might not otherwise have been put on the table. Imprint also provided an alternative viewpoint on the investment thesis, the methodology, and relative meaning and quality of data from different sources. Recalls Goldstein, “In some ways our value add was to identify questions and poke and prod until we found what made sense.”

As noted, there were tensions throughout the development process. Stakeholders admit that during the early stage and in the initial presentations in particular, there was some confusion about roles and responsibilities. Imprint was formally invited to join the process after Mercer and MCM had begun developing the first model. As Goldstein shares, “I would have had the initial design be more collaborative. Rather than being seen as ‘early thought partners,’ we may have been viewed as ‘late to the party.’ It was awkward at this first meeting. It’s easier to bat around ideas before people put their hearts in something.”

Creating strong working relationships was also part of the development and refinement process. All the participants brought unique and important strengths to the table, and the product likely would not have been as strong had there been fewer or more similar points of view in the discussions. Buckley underscores this, saying, “If you create something on your own, it is often not as compelling. As good as it might be, when you say a product was co-developed, other people will see how it is different. It is a double power.” Ultimately, the advisors were all able to come together to craft a solid product for McKnight and for the field of social investing. The group worked hard to develop a clearer and more collaborative process for sharing ideas and information and produced a new model.

**The Carbon Efficiency Strategy**

In August 2014, the development team presented version 2.0, the Carbon Efficiency Strategy. The main objective of the Carbon Efficiency Strategy was to provide broad equity exposure cost-effectively while assessing, recognizing, and supporting strong climate performance. This would be achieved by using a combination of screening, rewards, and penalties for climate-related behaviors and proxy voting in support of shareholder resolutions and other corporate initiatives related to climate risk, performance, and disclosure. Such a strategy would potentially enable investors to send a strong signal of climate-change-related action and engagement while maintaining a beta investment profile and managing climate-related investment risk.53

The model was based on the following criteria:

1. Coal companies were screened out.

2. Within each sector, companies were scored based on their carbon intensity (Carbon Intensity Score), which is calculated by assessing their greenhouse gas emissions normalized by revenue. This determined whether to overweight, hold neutral, or underweight each company when compared to its peers using its Global Industry Classification Standard (GICS) sector classification.
   a. Companies with low-carbon intensity within their sectors were overweighted.
   b. Companies with high-carbon intensity within their sectors were underweighted.
3. Each company’s Carbon Readiness score was used to determine how much to overweight efficient companies and underweight inefficient ones. The Carbon Readiness Score measures the extent to which every company in each sector addresses/manages the carbon emissions risk inherent in its business, relative to its peers.54

a. A high score indicates a company that addresses its carbon emissions risk in a positive way. It receives a larger overweight or smaller underweight. The maximum individual over/underweight is 20 basis points (bps).

b. A low score means a company did not take sufficient action to manage its carbon risk and is therefore given a larger underweight or smaller overweight.

4. Additional controls were incorporated to construct a balanced portfolio. The overall objectives were to: 1) seek to reduce exposures to carbon emissions by over 50 percent (versus the stated benchmark) and 2) minimize tracking error to less than 50 bps versus the Russell 3000 Index®.55

The strategy took two main approaches. First, it recognized strong climate performers through a reward and penalty system that assessed a company’s environmental performance within its peer sector rather than by its size. For instance, financial companies would not be compared to energy companies because they are in different sectors. In this way, the strategy would address poor environmental behavior across the size spectrum on a relative basis using carbon intensity.

Second, it encouraged engagement through proxy voting on relevant issues and also promoted better company reporting through the weighting process. Underweighted companies would appear less attractive to investors, and, in theory, would be motivated to improve their reporting and other climate-relevant practices.

The presentation of the Carbon Efficiency Strategy took place via conference call in August 2014. This time, the group agreed that the model was much stronger and clearly described its objectives and methodology. The McKnight participants discussed the model with the Foundation’s full board and the McKnight group agreed that the investment in the index fund should be increased from US$70 million (initially proposed internally) to US$100 million. They wanted to give MCM a strong start.

The investment committee approved the investment at its August meeting, with the understanding that McKnight staff would review the final detailed model in September and return to the committee if necessary.

In September 2014, the final pitch book for the CES was shared via conference call. Participants included Wolford, Scott, and McGeveran from McKnight; Kunkemueller and Metrick from Mercer; Goldstein from Imprint; and Wong, Fontaine, and Mike Terzich (former MCM director of consumer solutions and main point of contact for the MCM-McKnight relationship) from MCM. The development team was given approval by the McKnight team for this final version.

Later in October, the McKnight investment committee met by phone and was briefed on the final details of the model. The Carbon Efficiency Strategy received its first investment from McKnight on October 31, 2014.

This occurred just a few weeks after BNY Mellon and CSR team received approval to proceed with the Social Finance initiative.
In some ways, McKnight’s search for carbon-efficient investments reflected larger shifts in the financial markets. Roughly around the time of the Carbon Efficiency Strategy’s initial entry into the marketplace, two other low-carbon products were launched, both tracking the MSCI ACWI Low Carbon Index. State Street Global Advisors released its SPDR MSCI ACWI Low Carbon Target ETF (LOWC) in late November 2014.56 BlackRock’s iShares also announced its MSCI ACWI Low Carbon Target ETF in early December 2014.57 These examples provide a glimpse into the responses designed by financial management firms working to meet the demands of clients seeking stronger alignment between their values and their investments. They represent significant progress from the “greed is good” ethos that prevailed in the financial world of the 1980s and 1990s.

As already described, the inside story of how the Carbon Efficiency Strategy developed by McKnight and MCM and their partners was not without its bumps. From this story, we learn that innovations sometimes take commitment, time, determination, and a bit of serendipity.

Forging a New Path

How Do Partners Learn to Work Together?

The MCM team faced internal skepticism when they began to develop the CES with McKnight and its other advisors. This may have reflected the natural circumspection and conservative outlook present in several areas of the financial sector. It may also have been a product of the field at that time, which was moving slowly into impact investing, an area considered by many to be high on hype, but lacking in quantitative outcomes.58

At the same time, BNY Mellon boutiques had the freedom to design and develop their own strategies and act upon them. While they pursue their goals within the broader leadership and mission of BNY Mellon, they also contribute a special brand of entrepreneurship to BNY Mellon as a whole, and MCM, especially under Parcella’s leadership, is no exception to this dynamism.
Behind the Scenes

Though Wong and Fontaine did not have training in environmental or climate change issues nor experience working directly on ESG products, they embraced the challenge. They both understood the growing need for alternative investment products. For Fontaine, this project hinged on knowing their client and building a strategy and message that worked for all parties involved. She noted, “The way we connect [with our clients] is that we still want to make the point that we are investment managers first because we have a fiduciary responsibility. But we want to work with you, we are on your side, and we will accomplish what you state as a priority along with your investment return.... We want to be that manager that says ‘we will do our best to minimize risk and accomplish any environmental or ESG element you mandate.”

With a new project, getting this balance right was tricky. MCM viewed McKnight (and foundation clients in general) as having a conservative risk profile. MCM at the time managed some of McKnight’s most conservative investments. This meant finding the right nexus between a conservative investment perspective and the risk-tolerance needed to launch a new venture like the CES.

There were also some frustrations in the creation of the CES, especially because the McKnight team was still deciding on what they wanted. McKnight welcomed the back and forth of the development process, though at times this meant introducing new ideas that the development team would need to consider and refine.

The work among partners was collaborative, even though there were many perspectives and organizational objectives in the mix. Partners had bi-weekly check-ins or spoke more often if the research and changes in the approach demanded it. Some strains were inevitable; like Goldstein, Fontaine recalls the tensions when Imprint became more involved a few months after the work between Mercer and MCM had begun. Imprint was new to this table and brought more direct experience in carbon emissions investment strategies for foundations than did the other players. Imprint asked questions and played devil’s advocate, which was difficult at first. At times the different partners weren’t sure where their responsibilities ended and another partner’s began. Eventually, the group worked through its “growing pains” and came together as a team. As Fontaine states, “…there were times when tones were strained, and then there were times when the light came on, and everyone connected and came to an understanding, and we had new appreciation for each other.” The history between McKnight and MCM (as well as Mercer) helped frame this process as one of discussion and debate, not division.

With the CES launched, the concept now has strong support from across the BNY Mellon network and active interest from internal resources in helping the CES make a mark in the carbon efficiency space. It doesn’t hurt that the other products from BlackRock and State Street came out soon on the heels of the CES. With more competition, BNY Mellon and MCM can see the expanding market for carbon efficiency and new opportunities for CES.
Behind the Scenes

Does Culture Matter?
How were such different partners able to forge a strong working team and bring their project to fruition? In addition to the market and mission drivers, there were other conditions that facilitated the development and launch of the CES. These were grounded in culture, leadership, and organization on the part of all partners. McKnight’s Wolforde explained it this way, “First, was trust. We had worked with MCM for more than 28 years. We respected their capabilities and felt very comfortable telling them clearly what we needed to make this work.”

“Second, we had buy-in and commitment from our board, staff, and investment consultants—Mercer and Imprint Capital. Collaboration is an important part of our culture, we are inclusive, and we ensured that we were listening to concerns along the way. This included program staff and our investment committee.”

“Third was openness. We wanted a low-cost product that wasn’t simply a negative screen. As the process progressed, we were able to share our concerns candidly, listen to the unique perspectives of others, and iterate to the best solution. We wanted to get it right because we believe that by our actions, the Foundation can signal to the market that an appetite exists for products that are more carbon efficient.”

Rick Scott also commented on the value of the teamwork behind CES. “Laura Kunkemueller…first proposed the idea to McKnight and MCM. Because we had confidence in our partners—Mercer and MCM—we were willing to take a risk and try something new.”

Scott further added that the process of getting McKnight’s board to support the CES included the evolution towards a more mission-oriented investment policy. Scott explained it as a convergence of factors: “The Foundation had been making grants for years to accelerate the transition to a low-carbon economy. Then we made a commitment to impact investing and hired Elizabeth McGeveran, the Foundation’s first impact investing program director. Later, I met John Goldstein from Imprint Capital, and it was an opportunity for us to bring their expertise into the conversation.”

This culture of values and collaboration was mirrored at BNY Mellon and MCM, whose staff members wanted to ensure thoroughness and quality throughout the process. Wong touched on the importance of bringing products quickly to market, but also emphasized, “...it’s important to do something that is of high quality. This was McKnight entrusting us. This was many years of relationship, trust, and a lot of money... We saw products coming out, there was an urge to race, but we stepped back and talked about the right strategy.... We took the right approach. We were not the first to come out with this.... but the feedback so far from consultants, clients, and prospects from the US, Canada, Australia, Sweden, and Hong Kong...is so positive. That it [CES] is thoughtful and meaningful helps us know we did the right thing.”

The CES also created transformations within MCM at the personal and professional level.

Parcella remarked on the influence the project had on the organization: “It’s been great to see the engagement of employees and the firm in the push behind doing this. Now, people want to know what’s next. What other strategies can we be thinking about?”

Wong had similar comments, “This plane has taken off.... We may get turbulence, we may need to refuel, but I feel personally very good about this strategy, especially thinking about my young family and will they enjoy the nice weather we have now? Will there be energy for them? This is a product people can really invest in.”
Questions for Consideration

1. What leadership characteristics are necessary when forming and sustaining a diverse partnership?

2. How can interests be aligned with partners who have diverging or competing objectives? How can differences be harnessed to create greater value in products and services?

3. When should leaders lead, and when should they follow?

4. How can social finance bridge mission, values and financial requirements? Are there contexts or issues in which this strategy is better suited?

5. What role should financial institutions play in promoting socially-oriented investments? How do they get over the knowledge gap and ensure fiduciary responsibilities and high environmental/social quality products are offered to the market?
The concept of Wicked Problems emerged from the field of urban planning in the early 1970s, and is now used widely by business leaders, particularly in the development field. It was proposed in 1973 by Berkeley professors Horst W.J. Rittel and Melvin Webber to describe “wickedly” complex social problems. Wicked Problems are large, messy, complex, and systemic and include many of the most challenging issues we face today, from global issues of poverty and climate change to local issues of failing education systems and lack of financial security and stability. There are no easy solutions to Wicked Problems, and though enormous progress can be made in alleviating them, they will remain with us.

When discussing the complexities of our warming planet, academics, advocates, and policy makers worldwide have found that climate change is not just a Wicked Problem, but a “Super-Wicked Problem.” Looking at climate change as a Wicked Problem, we see interdependencies and conflicting goals for those involved; different definitions being used by different stakeholders; unforeseen consequences; a constantly evolving problem and context; and the lack of a clear solution. Furthermore, Wicked Problems are so complex socially that they can be overwhelming, cross boundaries across organizations and issues, create changing behaviors and responses that lead to challenges, and are characterized by chronic policy failure.

If, however, the challenge is a Super-Wicked Problem like climate change, then leaders will encounter four additional concerns:

1. “Time is running out,”
2. “Those who cause the problem also seek to provide a solution,”
3. “The central authority needed to address the problem is weak or non-existent,” and
4. “Irrational discounting occurs that pushes responses into the future.”
Deliberate Leadership and Climate Change

As John Fitzgibbon and Kenneth O. Mensah point out in *Climate Change as a Wicked Problem*, there is a “deficiency in our technical and social capabilities to be able to deal with a phenomenon with multiple sources, actors, stakeholders, cross-scale influences (externalities), and linkages.”

Deliberate Leadership (DL) is a response to the challenges posed by Wicked and Super-Wicked Problems. It is a framework for leaders to use in tackling problems with no easy or consensus solutions. Each characteristic of DL is based on proven business and social sector theories and practices. They are recognized leadership strategies used in creating lasting positive change within companies and organizations and in the lives of people most affected by the consequences of Wicked Problems.

The Seven Core Characteristics of Deliberate Leaders—As an institution and as individuals in that institution, leaders and their partners must consistently display seven core characteristics (the 7 C’s) in order to deal effectively with Wicked Problems:

- **Courage**—to embrace risk and live with the ambiguity. Deliberate Leaders recognize that simple solutions are insufficient to address complex challenges. They also realize that risk is inherent to Wicked Problems; solutions must be tried, tested, and allowed to evolve.

- **Collaboration**—to seek out and listen to divergent viewpoints. Deliberate Leaders recognize that building collaborative solutions may be slow and uncomfortable but essential to understanding options, gaining new knowledge, and building powerful solutions.

- **Community**—to build solutions together from the ground up. Deliberate Leaders recognize that answers to tough issues may already reside in Positive Deviants. They seek uncommon answers to difficult solutions and put people at the center of decision making.

- **Candor**—to speak the truth about what is working and what isn’t. Deliberate Leaders embrace failure and success equally—to manage risk and allow for recalibration and innovation.

- **Creativity**—to imagine a new future and move beyond the constraints of the past. Deliberate Leaders look for “big ideas” and evolving practices through scenarios that envision a different future.

- **Capital**—to examine how financial resources are invested and impact is analyzed.

- **Compassion**—to understand how empathy and partnership, not ego, impact the power dynamics within and surrounding an organization.

**The Three Phases**—The seven characteristics of Deliberate Leadership apply equally across all three phases of the process by which an organization learns and adapts in order to deal successfully with Wicked Problems. Moreover, learning is important at both the program and the operational levels; the reflection process must apply to both. The three phases of organizational learning and change are: Phase I—Partner and plan; Phase II—Act and assess; and, Phase III—Reflect and recalibrate (see Figure 2 next page). They can be clearly identified in the story of the Carbon Efficiency Strategy.
Deliberate Leadership and Climate Change

Figure 2. Deliberate Leader Learning Process

The three phases can be seen in the manner in which the CES stakeholders approached its development and launch.

<table>
<thead>
<tr>
<th>Partner</th>
<th>map stakeholders and partners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listen</td>
<td>to community, threat-opportunity analysis</td>
</tr>
<tr>
<td>Plan</td>
<td>develop theory of change, learning framework</td>
</tr>
<tr>
<td>Act</td>
<td>implement framework</td>
</tr>
<tr>
<td>Reward</td>
<td>candor and risk</td>
</tr>
<tr>
<td>Assess</td>
<td>document impact, numbers and nuance</td>
</tr>
<tr>
<td>Share</td>
<td>learn with partners</td>
</tr>
<tr>
<td>Reflect</td>
<td>on impact</td>
</tr>
<tr>
<td>Recalibrate</td>
<td>strategies, assumptions</td>
</tr>
</tbody>
</table>

Is Process as Important as Product?

Phase 1: Partner and Plan

When The McKnight Foundation first started thinking about a low-carbon investment strategy, Wolford reflects, “We didn’t know what we didn’t know. For example, the question of robust data became more crucial as we got deeper into the process.” Yet the Foundation was willing to think creatively about alternatives that could advance its objectives and those of other funders and investors addressing climate change. Though the path was not clear, McKnight trusted its advisors to offer the best guidance and options.
And, indeed, it was Mercer (also a partner of McKnight since the 1980s) that started the process of crystallizing the idea and taking it to the next level. Teaming up with MCM to leverage its expertise, Mercer was able to form a small and dedicated team that worked to meet McKnight’s financial and social needs.

The path had some obstacles. This is to be expected of any group process, but more so when an additional partner is introduced at a later stage. Imprint had become a trusted partner to McKnight, but was less familiar to Mercer and not very well known by MCM. This shifted the dynamic, especially given the experience Imprint had in responsible investing and in social and environmental issues. It was understandable that there were conflicts and feelings of uncertainty about how the process would move forward once Imprint and McKnight began to critique the first model.

Ultimately, though the stakeholders uniformly agreed that the integration process was uncomfortable at the beginning, McKnight’s culture and relationships helped ease a transition to a better group dynamic. Kunkemueller notes, “The McKnight group is a uniquely functional group. They are good at listening to others, stating opinions, coming to consensus, and moving on if others are not able to get there. There is leadership to remind those involved of why they are doing this.”

Though there was no formal plan for developing the product, MCM, Imprint, and Mercer all had a well-established process for creating new tools and resources for their clients, and the creation of CES followed these steps. Moreover, all three advisors prized communication and feedback from internal and external collaborators in order to design the most effective product for McKnight (and potentially for other investors).

**Phase II: Act and Assess**

One important factor that contributed to the development of the CES was, in fact, partnership. With so many stakeholders, this could have become a difficult process, with stops and reconfigurations at multiple turns. However, as Kunkemueller comments, “It was important to let the iterations happen.” So the group did come up with various models, and, while it is never easy to go back to the drawing board, having models in place allowed for more practical critique and re-design. This was a new approach, a new model, and a new kind of offering for institutional investors. It had to be “poked and prodded.”

For McKnight, leadership really had to see what the model did and did not do in order to understand if it would meet their goals. Staff and board members were involved all along to review and put forth their concerns.

Again, there were tensions in the stakeholder group and even within the partners. McKnight’s opinions about what such a product should do evolved, and McKnight leadership agreed that the approach should be practical and meaningful. But particulars were discussed, debated, and refined as the project unfolded. They were not pre-determined.

There was also skepticism within MCM as to whether ESG was a trend or a forward looking strategy, with some colleagues uncertain of the value of the project. But the development team was committed to its client and persisted.
In the end, the CES went through three significant iterations. In this part of the journey, it was important that everyone at the table had their voice heard. McKnight relied on its advisors to help marry mission and money, especially Imprint’s counsel which helped pinpoint and articulate McKnight’s concerns and offer alternative solutions to problems as well. McKnight needed not only Mercer and MCM, but also a partner like Imprint with specialized knowledge that could bring a different perspective.

Once the group was able to step back and clarify the roles and the end goal, they were able to be honest about providing and accepting feedback to create a fitting product.

**Phase 3: Reflect and Recalibrate**

When the product launched in late 2014, it was soon joined by other firms with comparable products. To the group, this meant they were in line with and able to respond to a growing demand from investors wanting to blend their financial and social interests.

The index has now had its one year anniversary and there is one year’s worth of data to indicate that that, yes, the CES does follow the index and does indeed serve the same purpose in the portfolio. Over time, McGeveran expects to see the CES hew to the index, with no wild over- or under-performance. More broadly, McGeveran also wants to see interest in the product drive a demand for better data, which will lead to better information for decision-makers. But she also cautioned against a single interest in linear measures, “This is an ecosystem. We are making a contribution to an ecosystem.”

Rick Scott offered similar comments, stating, “This is a process. We are not at the end yet. It will take time to get this in place. It’s a living thing.”

All parties agreed that the product was a good start, but not perfect. Wong commented that, as the world evolved and the data improved, this product would change with it.

While it is too soon to tell if the CES will be successful in the long-term, the stakeholders are pleased with the product they developed and continue to receive positive feedback and interest from funders, investors, and investment firms.

**How is Deliberate Leadership Practiced?**

Across the three phases, the key stakeholders exhibited the characteristics of Deliberate Leadership in ways that were true to their organizational cultures. The following analysis of the choices made and lessons learned by the teams at MCM, BNY Mellon, and McKnight offers insights for other leaders confronting Wicked Problems in new and creative ways.

**Collaboration.** As noted throughout the case, the spirit of collaboration was what allowed the CES to become a product that could be taken to the market confidently. MCM and McKnight had an honest relationship with opportunities for discussion throughout the year. The level of trust was high, as was the level of respect for each organization’s ethics and contributions to their field. In fact, one of the critical conditions BNY Mellon has identified for scaling Social Finance is collaboration. Through partnerships and technical guidance, BNY Mellon believes Social Finance will be able to spur innovations, test new products, and mitigate risk.
McKnight also had a strong relationship with Mercer that, in turn, helped facilitate the high degree of teamwork between Mercer and MCM.

Additionally, McKnight was confident enough in its relatively new partnership with Imprint to bring that group into this process. This did ruffle some feathers, but the partners all demonstrated a willingness to listen and learn from each other. And everyone soon overcame differences of opinion to focus on the end goal.

It is important to note that within McKnight, the value placed on engagement and involvement helped mitigate any serious roadblocks that could have been put up by internal stakeholders. As Scott remarks, “To include everyone and get 100 percent buy-in is part of our culture.” McKnight created a working group with investment committee members of the board, executive staff, and program staff, who all contributed to raising awareness, addressing concerns in a non-confrontational manner, and getting skeptical board members to become impact investing, and later CES, champions.

A final note on collaboration touches on communication. The CES development team was in frequent contact and reached out to others as needed for guidance and critique. One lesson the BNY Mellon and MCM teams learned about communication came about during product development itself. While MCM was working with Mercer, McKnight, and Imprint, the CSR team was not aware of the process and did not learn about the CES until it was launched. BNY Mellon was still in the process of refining its Social Finance approach, which now allows for greater partnership across BNY Mellon entities, but this communications challenge points out the importance of thinking broadly about making sure to seek out allies in both expected and unexpected places when launching a new venture.

Candor. Closely related to the partners’ ability to collaborate effectively was the trust they all felt in being able to speak honestly about what was and was not working. In similar situations, groups like Mercer, MCM, or Imprint might hesitate to be completely honest with clients about their knowledge and abilities in order to remain competitive.

Likewise, a client like McKnight, working with a group of its advisors, might hesitate to bring them together. Or it might worry about offending partners they have gotten to know over years of working together. But it was precisely the depth of the professional relationships involved in the group that allowed ideas to be presented, challenged, and refined. McKnight did not back away when the first iteration of the CES did not fully reflect its aspirations. Instead, it demanded a better product and was a supportive partner in accomplishing this task.

Importantly, Mercer and MCM were open and willing to hear the strong concerns that were raised about the first integration and adapt in response.
Courage. Throughout the CES development process, the partners showed courage in taking on new endeavors, learning, making mistakes, and getting back to work. Throughout the CES development process, the partners showed courage in taking on new endeavors, learning, making mistakes, and getting back to work. BNY Mellon took on the task of looking beyond impact investing to make Social Finance a core part of its business model. This has been accompanied in practice with the launch of a comprehensive CSR strategy and more detailed annual CSR reports that track BNY Mellon’s performance across a specific set of metrics. These actions created an enabling environment in which models like the CES could become a key learning and market development opportunity.

Within MCM, Wong and Fontaine personally and professionally took up the challenge of developing a new product addressing issues with which they were not familiar. Rather than seeing this as just another service to a client, they saw an opportunity to contribute to MCM’s history of innovation in the financial field. Wong also took on the work of speaking with MSCI to encourage the collection of better data in this space. Rather than move to another data provider, MCM sought to leverage its relationship and use its influence to create change within MSCI.

For McKnight, courage is seen as part of the strategy for serving its communities in the US and globally. The staff and board were comfortable testing something new, being out in front with a different approach to climate change and investing, and using the Foundation’s position to influence others. Since the CES launched, McKnight has reached out to 170 companies that do not report on their carbon emissions, asking them to submit their reporting to help investors make better decisions. Ten companies have so far responded to McKnight, some with data and some without. While slow, this is progress and proof that more and more investors rely on carbon emissions reporting to make investment decisions.

Community. In creating the CES, the partners all demonstrated their willingness to tackle a problem using unconventional means. They consulted widely, listened to different ideas, involved unlikely allies, and created something that not only met their professional needs and ethical obligations, but also something that had the potential to drive new sectors towards more responsible action on climate. Dolan notes that in general, few investment clients are willing to fund new products, so McKnight’s interest in a solution that went beyond McKnight’s portfolio to serve as a tool for others highlights its capacity for seeking solutions in different places.

MCM also sought out diverse points of view as the CES was in development, and Wong notes that they will continue to discuss the product with partners and clients across the globe to continue to refine it.
Creativity. Several years ago, both BNY Mellon and McKnight began a process of envisioning a new future for the communities they served. BNY Mellon wanted to create an investments company that was not just business as usual, but a leader in integrity and global service. McKnight wanted to be a foundation that went beyond grantmaking to look at how it could use all of its assets to create change. By accepting the scale and urgency of climate change, both partners acted with the intention of influencing the marketplace towards a low-carbon economy. All of the partners then got to work building, reconsidering, and rebuilding to enable a product that would be an influencer in the field.

Capital. In the development of the CES, all the partners were willing to put their money into play to develop a product that could help attain a low-carbon future. McKnight invested US$100 million to seed the fund and paid for its creation. MCM and Mercer invested their time and knowledge to get the project going, and Imprint brought its expertise to ensure the CES was on target to make a difference realistically as an investment alternative. With the product on the market, the partners will see, over time, how their investments fare in terms of financial and environmental outcomes.

Compassion. In the context of Deliberate Leadership, compassion is about humility, about listening to others and understanding their experiences so that the most appropriate solution to a problem can be explored. But letting go of ego takes courage. There was a high level of trust among the partners, but each individual also had to examine his or her personal interests and biases in this process. Each entity had to weigh its organizational interests against the greater good of a low-carbon future. The partners had to acknowledge what they knew and what advantages and perspectives the others brought to the table. Through this process, people had to let go of their ideas and adapt in order to get to a solution they all could stand behind confidently.
Conclusion

With the CES, McKnight’s Wolford sought to “to fill a gap in the universe of investment products.” This was no easy task, and the partners knew from the beginning that this was a unique project that would be difficult to undertake. The process involved multiple partners, divergent interests, strong opinions, conflicting values, confusion about responsibilities, and a context that was both urgent (climate change) and reluctant (the traditional financial sector and the traditional philanthropic sector).

Yet, the CES process allowed the partners to reach their stated goals and open up new opportunities for their work. For McKnight, working on CES helped enhance the Foundation’s commitment to converging around common goals. The CES itself will allow the Foundation to exert more fully its leverage in the financial world by applying new tactics as a consumer of financial services, as an asset owner, as a shareholder of public companies, and as a leader in the foundation community. As McGeveran comments, “CES...means we were looking for a way to reflect our thinking about what needs to be happening in the economy today in order to move towards a low-carbon economy tomorrow.”

For MCM and BNY Mellon, the CES is a new product placed in a dynamic and expanding market, proof that the Social Finance approach is an actionable strategy. It also means new skills and abilities in ESG and Social Finance for the team and greater depth of experience working with nontraditional partners and communicating with clients about the future of responsible investing.

For Imprint, it demonstrates the value of specialized knowledge and the importance of exchanging ideas with others, perhaps even competitors, in order to create a new market-based solution for one of our most daunting social challenges.

For Mercer, the CES was an extension of its strong history in responsible investing. The development of the CES allowed the firm to further demonstrate its ability to help clients articulate their specific objectives, partner effectively with solution providers, and facilitate the process of honing an investment strategy to a mutually beneficial outcome.

While the final story about the impact of the CES is not yet known, the partners have already begun to benefit from what they have learned about collaboration, managing team conflicts, navigating internal resistance to change, exploring ways to blend financial and social returns, and mapping out a process for taking a new idea and shaping it into a market-ready product. The partners can now begin to ponder what’s next?

“When you encounter something messy, go in up to your elbows and try not to get your shirt dirty.”

– CHARLES DOLAN, SENIOR INVESTMENT STRATEGIST, BNY MELLON
According to Porter, competitive advantage is created when the value of a product exceeds the cost of developing and providing it. Analysis of the contributing components of an organization helps it understand how to improve value creation and, thus, competitive advantage.

This case study uses the Global Impact Investing Network’s definition of impact investing as “investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return.” From the Global Impact Investing Network website: http://www.thegiin.org/impact-investing


According to UN PRI, responsible investing “…recognizes that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental, and economic systems. It is driven by a growing recognition in the financial community that effective research, analysis, and evaluation of ESG issues is a fundamental part of assessing the value and performance of an investment over the medium and longer term, and that this analysis should inform asset allocation, stock selection, portfolio construction, shareholder engagement and voting.” Source: "Introducing Responsible Investment," http://www.unpri.org/introducing-responsible-investment/

The UN PRI is an international network of investors that work together to put the six Principles for Responsible Investment into practice. The goal of the network is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices. "PRI Fact Sheet," Principles for Responsible Investment, http://www.unpri.org/news/pri-fact-sheet


Work at the local levels inside the US is important to highlight, and The McKnight Foundation has been a strong supporter of many of the on-the-ground efforts in the Great Lakes in particular. However, the lessons of local efforts to address climate change fall outside of the scope of this case study.

For more on how other regions are addressing climate change, see the European Climate Change Programme and the work of the European Climate Foundation and the European Environment Agency.


As of 12/31/2015


"International," McKnight Foundation, https://www.mcknight.org/grant-programs/international/collaborative-crop-research

ISS is the formal name of Institutional Shareholder Services, Inc.


Ibid.


Notes

28 Ibid.
29 Ibid.
32 Ibid.
34 Numbers as of December 31, 2015. Kristen Fontaine, email message to pfc, September 29, 2015
35 “Responsible Investing Policy Draft” provided by BNY Mellon. The Carbon Disclosure Project is a global environmental disclosure system that engages companies to help them become and remain transparent about their carbon intensity output.
37 Ibid.
41 During the writing of this case study, Imprint Capital entered into an agreement to be acquired by Goldman Sachs Asset Management. At this time no change in name has been issued, so the case will refer to this firm as Imprint throughout.
43 This excludes the private equity portfolio.
44 During the development of the case study, Laura Kunkemueller moved on from her position at Mercer. All quotes and insights attributed or related to Kunkemueller represent her time with Mercer only.
45 The Carbon 200 [now called the Carbon Underground 200] is a list developed by the Carbon Tracker Initiative to help investors become familiar with the top 100 public coal companies globally and the top 100 public oil and gas companies globally as ranked by the potential carbon emissions content of their reported reserves. The Filthy 15, produced by As You Sow, focuses on naming the US coal companies emitting the most CO2.
46 When the case study research process began, Metrick had already left Mercer. Comments related to Metrick refer only to his time with Mercer.
47 Carbon reserves are those volumes that are expected to be produced economically using today’s technology, often associated with a project that is already well-defined or ongoing. Their by-products are emissions.
48 MSCI is an independent provider of research-driven insights and tools for institutional investors. MSCI ESG Research is a part of MSCI’s overall ESG integration strategy.
49 Graphic courtesy of MCM, from their April 24, 2014 Carbon Emission Reduction Strategy PowerPoint.
50 Number of companies excluded refers to those excluded from the Russell 3000 Index® in order to reach the stated Carbon Emission Reduction level. Barra Risk Percentage represents the expected tracking error of the portfolio as of March 31, 2014. The Initial v R3 columns refer to McKnight’s investment in the Russell 3000 Index® excluding the companies in column two. Optimized information represents the portfolio rebalanced with the sector underweights.
51 Memo from Rick Scott [The McKnight Foundation] to Laura Kunkemueller and Craig Metrick [Mercer], July 21, 2014
52 Several interviewees noted that data in this sector from all providers remains imperfect and incomplete, though with improvements whenever there is greater demand from investors.
54 Both the Carbon Intensity Score and the Carbon Readiness Score are proprietary MCM scores.
Notes

63 John Fitzgibbon and Kenneth O. Mensah, Climate Change as a Wicked Problem (Sage Publications, 2012), http://sgo.sagepub.com/cont ent/2/2/215824401244848
64 At the conclusion of this case (November 2015), the product has been on the market for approximately one year.
66 Detailed information about BNY’s CSR and Social Finance strategies and reporting can be found at https://www.bnymellon.com/us/en/who-we-are/social-responsibility/index.jsp
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### Interview Participants

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<thead>
<tr>
<th>Name</th>
<th>Organization</th>
<th>Position</th>
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<tbody>
<tr>
<td>John Buckley*</td>
<td>BNY Mellon</td>
<td>Global Head of Corporate Social Responsibility</td>
</tr>
<tr>
<td>Charlie Dolan</td>
<td>BNY Mellon</td>
<td>Managing Director for Manager Research and Investment Solutions</td>
</tr>
<tr>
<td>Kristen Fontaine</td>
<td>Mellon Capital Management</td>
<td>Vice President, Global Consultant Relations</td>
</tr>
<tr>
<td>John Goldstein*</td>
<td>Imprint Capital</td>
<td>Managing Director</td>
</tr>
<tr>
<td>Anna Kearney</td>
<td>BNY Mellon</td>
<td>Associate Director, Social Finance</td>
</tr>
<tr>
<td>Laura Kunkemueller*</td>
<td>Mercer</td>
<td>Principal</td>
</tr>
<tr>
<td>Elizabeth McGeveran</td>
<td>The McKnight Foundation</td>
<td>Program Director, Impact Investing</td>
</tr>
<tr>
<td>Craig Metrick*</td>
<td>Principal and US Head of Responsible Investment</td>
<td>Mercer</td>
</tr>
<tr>
<td>Rehana Nathoo</td>
<td>BNY Mellon</td>
<td>Social Finance Project Manager</td>
</tr>
<tr>
<td>Gabriela Franco Parcella</td>
<td>Mellon Capital Management</td>
<td>Chairman and CEO</td>
</tr>
<tr>
<td>Rick Scott</td>
<td>The McKnight Foundation</td>
<td>Vice President of Finance and Compliance</td>
</tr>
<tr>
<td>Mike Terzich*</td>
<td>Mellon Capital Management</td>
<td>Director, Consumer Solutions</td>
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<tr>
<td>Kate Wolford</td>
<td>The McKnight Foundation</td>
<td>President</td>
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<tr>
<td>Karen Wong</td>
<td>Mellon Capital Management</td>
<td>Managing Director</td>
</tr>
<tr>
<td>Aimee Witteman</td>
<td>The McKnight Foundation</td>
<td>Program Director, Midwest Climate &amp; Energy</td>
</tr>
</tbody>
</table>

* Interview participant moved on from listed position before or during the writing of this case. Their listed position reflects their role during the timeframe described in the case narrative.