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# Partnering for Impact: Developing The McKnight Foundation's Carbon Efficiency Strategy

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# Partnering for Impact: Developing The McKnight Foundation's Carbon Efficiency Strategy

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### *Key Points*

- This case study challenges us to redefine our definitions of community and philanthropic practice as we tackle global climate change — one of the most Wicked Problems facing our planet and our people. Driven by a deep commitment to "walk the talk," CEO Kate Wolford and McKnight Foundation leadership committed $100M of the foundation's endowment to find solutions to global warming. This bold step required building a new type of partnership with McKnight's team of financial advisors — Mellon Capital Management, Mercer, and Imprint Capital (now Goldman Sachs). McKnight and Mellon Capital had to build a new cross sector partnership that would change the roles of philanthropy and the private sector to develop new market-driven solutions — specifically, a Carbon Efficiency Strategy.
- Using a Deliberate Leadership framework, the case follows the partners' journey as they seek to build community and find collaborative solutions. We witness their tensions and evolution in their thinking and relationships.
- While the case seems unusual, it is represents future trends in which impact investing is a drawing a new pool of funders — beyond traditional grantmakers — into innovative social change solutions to address global Wicked Problems. In addition, next-generation family funders are moving away from geography-based communities to issue-based communities.


## Introduction

### *Opportunity Meets Urgency*

In late October 2014, Gabriela (Gabby) Franco Parcella, chairman, president, and CEO of Mellon Capital Management (MCM), 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

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*When considering how changing communities impact the future of philanthropy, it is worth rethinking how communities are defined. The four organizations in this case came together, not just as partners in business but as allies working to change the financial sector, the community in which they work.*

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" (McKnight Foundation). 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.

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 can diverse partners collaborate to develop a successful social investment product while managing internal trade-offs and competing partner objectives? 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?

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 undertaking unexpected partnerships or building professional communities to create new financial tools or products that balance financial returns and social outcomes. When considering how changing communities impact the future of philanthropy, it is worth rethinking how communities are defined. The four organizations in this case came together, not just as partners in business but as allies working to change the financial sector, the community in which they work. As future funders continue to shift the investment priorities of corporations and foundations towards promoting social and environmental wellbeing as well as profit, impact investing can serve as a valuable tool for financial communities wanting to address large, complex issues like climate change.

It exemplifies how shifting priorities in philanthropy and the increasing focus on investment which promotes social and environmental wellbeing will shape collaborations between partner organizations working to address new challenges across the sector.

The case explores these issues by looking at how the value chain of relationships[1] 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

[1]For the purposes of this case, the concept of the value chain analysis used is one based on Michael Porter's discussion of how value is created by an organization in his book Competitive Advantage: Creating and Sustaining Superior Performance (New York, NY: The Free Press, 1985). 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.

investment products, while providing a financial return to the satisfaction of all the partners and those to whom they are accountable.

## Deliberate Leadership and Climate Change

Climate change is, without a doubt, a Wicked Problem. A concept first proposed in 1973 by Berkeley professors Horst W.J. Rittel and Melvin Webber to describe social problems without simple answers, Wicked Problems are large, messy, complex, and systemic (Rittel & Webber, 1973). The concept includes 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. 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" (Fitzgibbon & Mensah, 2012).

Deliberate Leadership is a response to the challenges posed by Wicked Problems. It is a framework for leaders to use in tackling problems with no easy or consensus solutions. Each characteristic of Deliberate Leadership 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 Deliberate Leadership framework describes 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 1 — Partner and plan; Phase 2 — Act and assess; and, Phase 3 — Reflect and recalibrate. (See Figure 1.) They can be clearly identified in the story of the Carbon Efficiency Strategy.

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## 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." Still, 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 through its longstanding support for environmental projects.

During a recent period when 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 (Imprint[2]), an impact investment advisory firm that had worked on social investment

[2]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.

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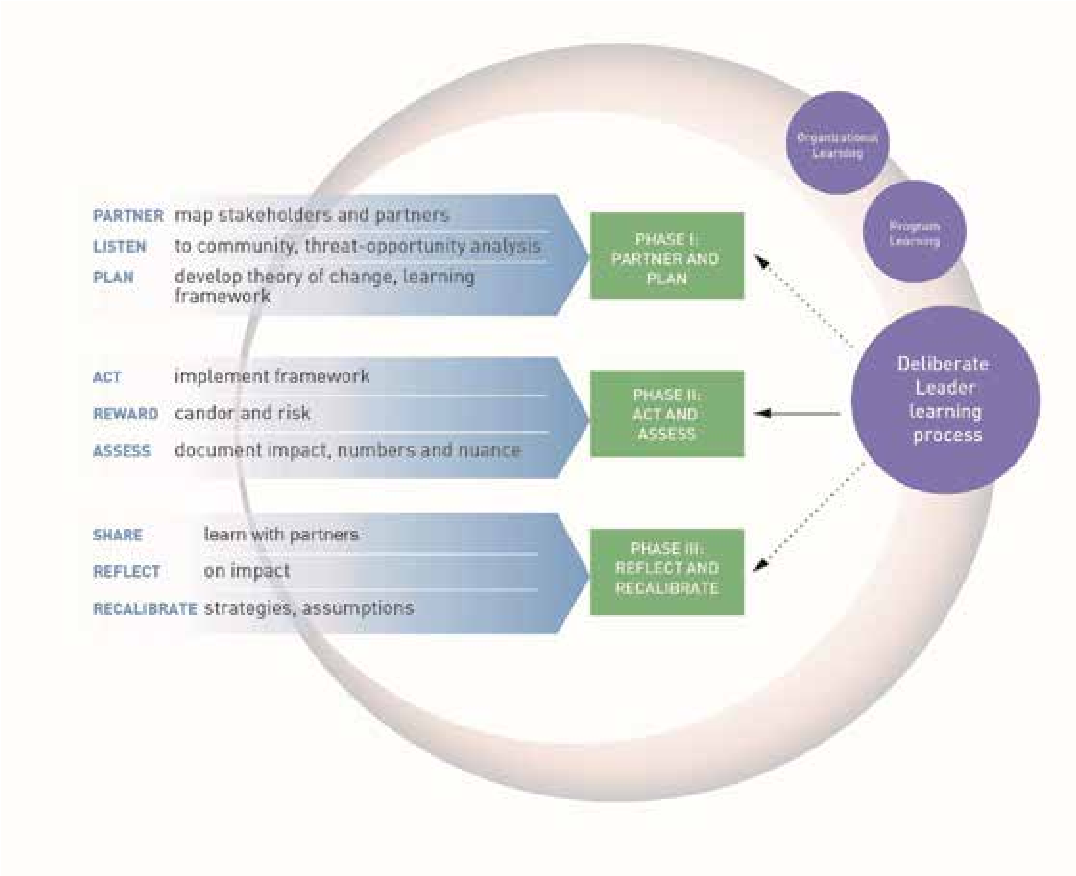
**FIGURE 1** Phases of Organizational Learning and Change




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.

After initial discussions between McKnight's investment team and Imprint regarding the potential of social investment at the end of 2012, Imprint advised McKnight in developing an impact investing program that was approved by the Foundation's board in late 2013. This decision, says Rick Scott, McKnight's vice president of finance and compliance, was "very, very important" in helping set the stage for board involvement in discussion, debate, and the eventual launch of the CES.

### *Forming the Partnership*

While the early stages of McKnight's impact investment strategy planning were largely directed by the Foundation and Imprint, creating the actual model for investment required including a variety of stakeholders in the process. In December 2013, McKnight's investment committee met with staff from MCM, a subsidiary of BNY Mellon which manages a portion of McKnight's investments, and from Mercer, a global consulting leader in talent, health, retirement, and investments, 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. 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.

Laura Kunkemueller, then 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 Carbon Tracker 200 (CT200) and Filthy 15 (F15) lists, which detail companies with high carbon emissions, as well as additional energy exposure. While there were significant gaps in the data, the analysis indicated that the investments in the Russell 3000 Index® held by MCM (then valued at US$58.5 million) had the highest exposure to companies on those two lists.

Soon after the December meeting, Kunkemueller invited Kristen Fontaine, vice president for global consultant relations at MCM, 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.

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 environmental, social, and governance (ESG) investment 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.

While the partners in this scenario were all interested in working toward the same result and had built a trusted relationship over decades, the partnership was not without its tensions. One of these tensions was McKnight's inclusion of Imprint in the project in April 2014, after MCM and Mercer had already begun developing the model. 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.

In addition, it quickly became clear to MCM and Mercer that they were not fully aware of McKnight's goals and priorities for the model, which resulted in revisions of the model that may not have occurred if these goals had been known from the start.

## Phase 2: Act and Assess

### *Innovation Through Iteration*

In early 2014, conversations to move product development forward began in earnest. Initial conversations in January 2014 between MCM and Mercer 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.

Initially, there were concerns about the data in the F15 and CT200, which were already three years old and relatively static. In addition, the product development team 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. Karen Wong, managing director and head of equity portfolio management at MCM, suggested using MSCI, with which MCM had a strong relationship, rather than the F15 and CT200. However, MSCI only had data for a limited number of companies, which raised questions about the usefulness of the index for this project.

The process of developing the model was not always smooth, and the product development team's first two attempts at a model, which they called the Carbon Emission Reduction Strategy (CERS), turned out not to be quite what McKnight was looking for. Kate Wolford said, "It wasn't as robust as we had hoped, which was disheartening. It was simply a negative [investment] screen with weak data … Our investment committee, foundation staff, and Imprint were disappointed. I didn't think we were going to go forward."

When the team presented the second version of the model, 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.

However, despite the additional work revamping the model would require of the development team and the existence of some confusion about what McKnight wanted from the model, MCM agreed to push forward.

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 (R. Scott, 2014):

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.

### *The Carbon Efficiency Strategy*

In August 2014, the development team presented version 2.0, the Carbon Efficiency Strategy. 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.

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. After final approval from the McKnight investment committee, the Carbon Efficiency Strategy received its first investment from McKnight on October 31, 2014.

### Phase 3: Reflect and Recalibrate

When the product launched in late 2014, it was soon joined by two other firms with comparable products. State Street Global Advisors released its SPDR MSCI ACWI Low Carbon Target ETF (LOWC) in late November 2014 (State Street Corporation, 2014). BlackRock's iShares also announced its MSCI ACWI Low Carbon Target ETF in early December 2014 (Businesswire, 2014). To the McKnight 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, Elizabeth McGeveran, McKnight's impact investing program director, 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."

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.

*First, while any new partnership will face challenges, communication and shared priorities go a long way in helping the partners to reach their goals. Second, it is important to have an understanding of differences between the organizational cultures of the various partners, as well as an understanding of the culture created by the partnership itself.*

### Forging a New Path

This case offers valuable lessons for forming and sustaining diverse partnerships to address complex, Wicked Problems like climate change. First, while any new partnership will face challenges, communication and shared priorities go a long way in helping the partners to reach their goals. Second, it is important to have an understanding of differences between the organizational cultures of the various partners, as well as an understanding of the culture created by the partnership itself.

#### *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 (Ruttman, 2012).

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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.

With any new project, striking a balance between minimizing investment risk and fulfilling the social and environmental goals of the client can be 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.

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; 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.

### *Does Culture Matter?*

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 Wolford 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.

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.

## Lessons for Smaller Funders

While the organizations included in this case are large and have significant financial resources at their disposal to develop an innovative investing model, impact investing is not just for the big funders. McKnight, MCM, and the others were focused on changing the tools available to financial sector as a whole; however, smaller or more locally focused funders can use impact investing to have a more immediate impact, to invest in small businesses and grow their local economy, or to prioritize investments that have a positive social or environmental outcome as well as being financially viable (CGAP, 2013).

On the other hand, an increase in impact investing may also reframe the way community grantees, such as nonprofits or small businesses, think about how they raise funds and the broader impact of their work, in particular, by considering not just how the money they receive is distributed throughout their budget but the social and environmental value they create through their work (The Bridgespan Group, n.d.). This is not to suggest that impact investing will ever replace philanthropy entirely, especially considering how new impact investing is as a concept. Rather, it offers a new source of funding for social and environmental programs, as well as providing private funders and corporations a way to engage in social change, from global efforts to small-scale community projects (Flower, 2012).

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## 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).

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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. 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?

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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.

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