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Hewlett
Foundation

Environment Program Request for Proposal: Aligning Passive Investment with Paris Climate Goals

Key Dates 2020

30 January: Release Request for Proposal. Preliminary proposal form available on the Hewlett Foundation website.

6 February: Webinars

- 7:00-8:00 AM PST (4:00 - 5:00 PM Central European Time): Informational call to answer questions. Please RSVP using this link: https://hewlettrfp.eventbrite.com/.
- 4:00-5:00 PM PST (8:00 - 9:00 AM China Standard Time, 7 Feb 2020): Informational call to answer questions. Please RSVP using this link: https://hewlettrfp.eventbrite.com/.

We strongly encourage all applicants to participate in the scheduled calls, as we will not conduct one-on-one conversations with applicants.

March 26: Preliminary proposal due by 11:59 PM PST

April 21: RFP review complete; request for full proposals sent to selected applicants.

May 29: Full proposals due. (Please note that the full proposal will be a different document than preliminary proposal form.)

June 5: Initial award decisions; 2020 grant(s) awarded thereafter.

Purpose

The purpose of this Request for Proposal (RFP) is to generate ideas and fund solutions that address climate change problems associated with passive asset management, where a fund's portfolio mirrors a market index that is not low-carbon. In 2019, the Hewlett Foundation issued a new climate finance strategy, which has a charitable goal to activate climate solutions through innovative finance and the systemic decarbonization of capital, from consumers to corporate financial institutions. Specifically, the Hewlett Foundation aims to support the development of robust environmental, social and governance (ESG)-driven, climate-friendly passive funds and efforts that remove climate change causing investments from products. We seek to expand the levers by which our funding recipients can shift passive investment capital into climate solutions.

The Passives Problem

On September 18, 2019, for the first time passively managed U.S. equity funds overtook their actively managed counterparts. This was the culmination of a multi-decade trend that is inextricably intertwined with the consolidation in the asset management industry. As asset managers get larger and more concentrated, and increasingly drive customer investment into low-fee, broad-based passively managed index or exchange traded fund (ETFs) products, this trend is expected to keep growing.

The rise of passive investing is not confined to the United States. European equity markets are now approximately 33% passive and Asian equity markets about 50% passive. In China, passive equities are growing faster than any sector, currently at around 10% of the market, with estimates that this number will double within the next five years. This trend extends beyond the equity market. In 2017, growth in passive fixed income products totalled 30% of the market in the U.S.; 18% in Europe; and 10% in Asia.

The problem with the growing wave of passive investing is that it has come with a destructive consequence. It is setting our economy on autopilot and is feeding the climate crisis. Key features of the passives problem:

- **Passive investing creates a consistent flow of capital to carbon-intensive companies that can artificially raise the valuation of those companies.** By virtue of tracking entire indices or themes, passive investing bakes in significant new and consistent capital flows for coal, oil, gas, and carbon intensive agriculture and transportation. That's why the largest firms offering passive investments are also the largest investors in carbon-intensive companies. These companies include fossil fuel reserve holders, deforestation drivers (palm, pulp, paper, soy, cattle, rubber), and downstream sectors like auto manufacturers and utilities.

- **Passive investing weakens climate leadership in corporate governance by concentrating voting power with those whose incentives are not aligned with climate action.** The Big Three asset managers (BlackRock, Vanguard, and State Street Global Advisors) collectively vote on average 25 percent of the shares of S&P 500 companies while holding at least 5 percent in the vast majority of publicly listed companies. Market concentration in asset management leads these companies to own more and more of the market and wield ever greater control over companies via their shareholder power—a power that is often not aligned with climate goals. Empirical evidence shows that conflicts of interest inherent in the asset management industry often distort investment managers' stewardship incentives.

- **Passive investing is rearranging power in the financial system**—away from asset owners to asset managers. The average asset owner is now so small relative to the total assets under management (AUM) of the largest asset managers that they have little control over allocation strategies. As a result, asset owners seeking change in their investment strategies, particularly on ESG issues, are often frustrated by a lack of action from their asset managers.

- **Historic industry norms make change seem impossible.** Managers offering passive products routinely make the case that they cannot screen out companies like oil and gas in the index-tracking funds they sell. In fact, both index rules and the acceptance of tracking errors allow for funds to make small to moderate deviations from indices. This incorrect assumption makes it very difficult for asset managers to offer mainstream, screened climate-friendly products, and for investors to access them. Nordic countries are already offering passive funds that screen out climate drivers and screen in climate solutions, as recent offering from the Norgwegian Sovereign Wealth Fund and Storebrand show.

- **Passive investing systemically influences financial flows to carbon intensive industries.** A growing number of financial experts are warning of a rapid re-pricing of fossil fuel assets and associated losses as the world gets serious about addressing climate change. As active investment exits the fossil fuel industry due to these warnings, passive investors are becoming the "holders of last resort" ensuring that these losses will be borne overwhelmingly by average investors, savers, pensioners, and retirees.

While demand for sustainable investment has grown to new heights, and ESG offers one window of opportunity for integrating climate change risk and impact, many ESG products still contain companies driving climate change. Many investment offerings steeped in various social and environmental criteria, like the NAACP ETF, leave in many companies still driving structural inequality and exacerbating climate injustice.

Given the speed of change needed to fight climate change, passive investments must recognize the risk of holding assets exposed to greenhouse gas intensive industries..

Solving the Passives Problem

The purpose of this RFP is to identify approaches to aligning the passive asset management sector with Paris Accord climate goals. Organizations are invited to apply and articulate how they can help address this challenge by conducting charitable activities. Intervention areas can include (but are not limited to) the following solution sets and strategic approaches: switching the menu of default investment options towards climate friendly funds, creating a standard taxonomy of climate friendly investment options, aligning commonly-used indices and benchmarks with a well-below-two-degrees scenario, investigating legal fiduciary duty questions and strategies, evolving modern portfolio theory, creating the behaviorial change needed for asset managers to shift their investment options through educational approaches, and tackling shareholder engagement, including asset owner vs. manager challenges, by addressing market ownership concentration.

As a result of this process, we aim to:

- Deepen the understanding of the problems of passive investments for the low-carbon transition among key stakeholders within the finance sector (e.g. index providers, regulators, asset owners, asset managers, wealth managers), as well as stakeholders adjacent to the sector (e.g. think-tanks, journalists, and the philanthropic community);
- Identify solutions for using passive investments to both shift capital out of greenhouse gas intensive industries and for moving more capital into companies driving climate solutions;
- Pilot innovative work streams in this sector;
- Build an coalition of actors focused on driving change in passive investing.

Who Should Apply

The following are guidelines (not requirements):

1) Organizations that advocate for, research, analyze, and/or pursue the practical applications of sustainable investment geared towards climate mitigation solutions.

2) Organizations new to climate finance with an established track record of working on adjacent issues, or issues with similar levels of complexity.

Requirements for Who Should Apply

Organizations located in or focused on at least one of the following regions: United States, China, and the European Union.

Note about multi-organization applicants: The Hewlett Foundation strongly encourages organizations to apply in partnership with other organizations if they 1) do very similar work (e.g. use a similar approach with a similar audience), or 2) could better scale through a partnership with other organizations. Organizations applying in partnership will each submit the same proposal and must designate a lead partner. Grants to organizations applying as a partnership will take into account and offset the added cost of working in partnership. We are not planning to fund multiple proposals that take on the same task.

We also seek to avoid funding duplicative efforts as a part of this process.

Hewlett Foundation Programmatic Objective

The goal of the Climate Initiative at the Hewlett Foundation is:

> *To limit global warming emissions enough to keep global average temperature increase below 2° C above pre-industrial levels, in order to protect the planet from the worst effects of human induced climate change and help promote human prosperity and health around the world.*

We want, in short, to build clean, low-carbon economies.

This Request for Proposal focuses on passive asset management oriented work that helps achieve the charitable goal outlined above.

Criteria for Decision-Making

The Hewlett Foundation will assess the strength and relevance of programs/projects from eligible applicants based on the following criteria:

1. **Address Key Barrier(s) Or Solution(s)**

Does the initiative identify and address a new, compelling barrier or solution?

2. **Impact**

Would the impact of the initiative, if fully realized, meaningfully shift passive capital in line with Paris goals?

3. **Strategy**

Do the interventions outlined plausibly add up to the goal or impact the proposal seeks to address?

4. **Diversity, Equity and Inclusion**

Would this potential organization and their strategic approach add to the diversity of voices and perspectives engaged on the passives problem and its solutions?

5. **Scalability**

Does this proposal's strategic approach have potential to scale rapidly if proven effective? And if so, what is the path to scale (e.g. network effect, force multiplication, influence on media narrative, access to influential actors…)?

In addition to the above criteria, proposals that broaden the field, enrich the ecosystem of actors engaging in the issue, or that help ensure a wide spectrum of idea-stages (from seed, to scaling) will be strongly considered.

Submission Requirements:

- Completed application form ("single-organization applicant" form or "multi-organization applicant" form as appropriate.
- Online demographic survey:
  https://www.surveymonkey.com/r/AssetRFPDemographics
  Note that this demographic survey has no impact on current or future grants. It is intended to serve as an information-gathering exercise by which we can learn more about our potential grantee organizations. This survey will be collected and reviewed by a third party (Hovland Consulting) and data will be aggregated for the Foundation after funding decisions for this RFP are made, so to avoid any bias.

Frequently Asked Questions

How long will grants be? Program/project grant(s) made in connection with this RFP will be awarded in 2020 (time period can be for one year or multiple years).

What geographies will be covered? Organizations located in the US, the EU or China are welcome to apply. Organizations based outside of those geographies with proposals specifically focused on those geographies are also welcome to apply.

Can we apply for a single-organization and multi-organization grant? Yes, but please limit the total applications to three (one organization should appear in no more than three separate proposals). Also, keep in mind our priority is to fund work that can scale. In some cases, scaling will be more likely as a partnership than as an individual organization.

How many organizations can be in a multi-organization applicant? No more than four.

Can we apply if our organization is not only focused on climate finance? Yes.

Does the organization need to be a non-profit to apply? No. The work proposed must be charitable in nature and without excess private benefit.

Please reach out directly to ClimateFinance@hewlett.org for any questions