First Trust

MENSURAM BONAM AND THE USCCB CATHOLIC SOCIAL TEACHING GUIDELINES, PERFORMANCE, AND FIDUCIARY DUTIES

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Overview

In November of 2022, the Vatican's Pontifical Academy of Social Sciences, or PASS, released "Mensuram Bonam, Faith-Based Measures for Catholic Investors: A Starting Point and Call to Action". Mensuram Bonam (MB), Latin for 'Good Measure', is a reference to Jesus's Sermon in the Plain, in which Jesus instructs us:

> *"...give and it will be given to you. A good measure, pressed down, shaken together, running over, will be put in your lap. For the measure you give will be the measure you get back." (Lk 6:38)*

In Mensuram Bonam, the Academy takes the eight principles of Catholic Social Teaching (CST), those being, The Human Person & Human Dignity, The Common Good, Solidarity, Social Justice, Subsidiarity, Care for our Common Home, Inclusion of the Most Vulnerable, and Integral Ecology, and considers these as they relate to the stewardship of investments for a new generation of what it calls 'integral investors' building an 'ethically integral economy'. In the Academy's opinion, 'the pandemics of hunger and violence and climate change' require investors to integrate their faith *into* their investing, relying on *both* faith and reason, under the guidance of the Holy Spirit. Therefore, for MB, investing today requires *both* 'technical expertise *and* prayerful reflection' because the "view of the world formed by numbers and analytics is forever incomplete."

It's important to note what MB *isn't*, as well as what it *is*. Cardinal Peter Turkson, head of the Academy, observed Mensuram Bonam has "no proscriptive power or force." Rather, it is 'a starting point', a 'call to action', for Catholics and other investors of faith to *apply* their faith in the act of investing.

MB is divided between two chapters. Chapter 1 sets out Principles, or 'ethics of investing'. Here we see CST is to be applied to all investment decisions. Note, however, as Jean-Baptiste du Franssu, an author of MB and chairman of the Vatican Bank, has explained, CST is *not* the same as Environmental Social Governance (*ESG)*. MB's Chapter 2 sets out Practical Guidance and provides a list of Exclusionary Criteria.

In addition to screening companies, the Academy recommends investors consider engaging with companies through proxy voting or other means and enhancing their portfolios with positive investments, including impact investing. Exclusions like the following, are investors' last option.

We review briefly herein three topics relating to MB—principal areas of agreement and disagreement between MB and the United States Conference of Catholic Bishops (USCCB), performance measurement of portfolios screened for MB and USCCB guidance relative to commonly-used equity benchmarks, and fiduciary duties required of investors screening for CST issues.

Screening Comparisons: USCCB & Mensuram Bonam

It is interesting to take a critical look at the differences in exclusions between the guidance from the USCCB and that of Mensuram Bonam.

Exclusions Recommended by Both MB & USCCB

In a nutshell, of the 32 significant areas of exclusions identified by either MB or the USCCB, the two agree in principle on sixteen, or half. These are exclusions for investments in companies involved in:

- Abortion
- Abortifacient drugs
- Addictive substances and services (although MB includes *alcohol*)

- Biodiversity loss
- Clean water
- Contraceptives
- Destructive climate change
- Exploitation of the environment
- Hazardous chemicals
- Human fetal and embryonic research
- Human rights violations
- Labor law breaches
- Mining and mineral commodities speculation
- Pornography
- Weapons of mass destruction (although MB states "the mere *possession* of nuclear weapons is immoral", which may bring into question Treasury bills, notes, and bonds)
- Workplace discrimination

USCCB Exclusions Omitted From Mensuram Bonam.

The USCCB guidance recommends against investing in seven areas not addressed by MB, or just over a fifth of the significant exclusions. These are investments in companies involved in:

- Assisted suicide
- Euthanasia
- Human cloning
- In-vitro fertilization
- Makers of handguns not manufactured for use by the military or police
- Media corporations resisting the Church's human rights policies
- Surgeries and drugs or hormones for the purpose of expressing a gender identity incongruent with one's biological sex

MB Exclusions Omitted From USCCB.

MB's exclusionary guidance is divided among four categories: these are Upholding the Intrinsic Dignity of Life, Avoiding Destructive Behaviors, Recognizing Global and Sustainability Impacts, and Securing Environmental Protection. Within these, MB discourages investments in nine areas omitted from the USSCB, or about a quarter of the significant areas for investment exclusions identified by MB.

In brief, MB recommends avoiding investments in companies involved in:

- Animal experimentation (beyond that required by medical science, e.g., the cosmetics industry)
- Bribery and Corruption (i.e., the few get rich at the expense of the many)
- Capital punishment (pharmaceutical companies manufacturing drugs intended to end life)
- Food and agricultural commodities speculation (since the right to food and water is rooted in the human person)

- Green/genetic engineering (concerns are the undefined risks relative to traditional plant breeding and possible consequences for food security, and for multinational groups to dominate markets through seed patents)
- Overlooked rights of indigenous peoples at the margins of society
- Totalitarian violence and oppressive military dictatorships
- Toys and computer games glorifying violence
- Unfair or unethical business practices (such as insider trading, cartel formation, money laundering)

The Academy has identified these as areas warranting negative screening for companies involved. Unlike the USCCB approach, MB does not utilize materiality thresholds.

Performance Measurement of Portfolios Employing CST

Any time one alters a portfolio relative to a public index by excluding certain securities or even industries, as we do with a portfolio screened for CST, the returns of the screened portfolio will differ from those of the original index. These returns may, over time, outperform or underperform their respect index, depending on the relative performance of the excluded securities. We think it is appropriate to maintain as our performance benchmark the original index the client was tracking.

Creating a New Index?

Some investors approach this differently, by creating a new index which mirrors the *post*-screened one: in other words, the original index *minus* the screened securities. The notion is a screened portfolio should not be charged with earning *pre*-screened index performance; rather, it should be charged with earning the same return as the index *less* the stocks removed by the screens.

Problems with New Index Approach

Of course, this is accurate, as far as it goes. However, it overlooks the fact that the investor started with an unscreened benchmark, which presumably was one of the building blocks in the investor's asset allocation. Typically, the construction of an investor's asset mix is carefully engineered by the investor or their consultant, to take into account each asset class's estimated future returns, the standard deviation of those returns, and the correlation coefficients of those returns to all other asset classes in the portfolio. Changing the benchmark for the screened portfolio to represent a new, screened benchmark will mask the performance of the screened portfolio relative to the original benchmark. If the screened portfolio systematically underperforms the original benchmark through time, by measuring performance to the new custom index, the investor may not realize this is occurring. Meanwhile, their returns suffer.

As a result, we think it is better to maintain performance measurement relative to the benchmark the investor originally selected and do our best to minimize the tracking error of the client's screened portfolio to that (unscreened) benchmark.

Performance Variability

The degree of expected variance relative to the index is known as the "Tracking Error", or "TE". For exclusions under the USCCB and Mensuram Bonam, most analysts believe long-term portfolio returns should closely track those of the public indices, especially if the manager employs techniques to optimize the survivors (net after the negative screening) back to the original benchmark.

To provide additional insight into what this means in practice, we estimated the tracking errors for Mensuram Bonam and the USCCB by applying an estimate of exclusionary screens suggested by each, across three major benchmarks, the S&P 500, MSCI EAFE, and MSCI ACWI. In each case, to measure the *maximum* extent of possible differences, we screened the benchmark based on a relatively *expansive*, rather than *restrictive*, reading of Mensuram Bonam. Given MB's non-proscriptive intent, individual institutions or investors should keep in mind they may certainly adjust any and

all of these screens to suit their own preferences and reflect their own beliefs. As a result, the following statistics should be taken with a large grain of salt.

Example 1: Performance Relative to the S&P 500 Benchmark

In the S&P 500, MB may exclude up to half again as many companies as the USCCB, or an additional 48 companies (for a total of 127 excluded companies). This results in twice the benchmark weight being eliminated (29.60% vs. 15.30%) and creates a tracking error twice that of the S&P 500, at 1.40% as opposed to 0.68%. These exclusions represent primarily companies producing fossil fuels and electric utilities, as well as companies producing alcohol. Interestingly, Microsoft is excluded due to their recent acquisition of Activision, a company producing violent computer games. Again, bear in mind this is estimated expansively.

S&P 500	#Names Excluded	Benchmark Weight	Tracking Error
USCCB	79	15.30%	0.68%
Mensuram Bonam	127	29.60%	1.40%

Example 2: Performance Relative to the MSCI EAFE Benchmark

Relative to **MSCI EAFE**, MB may exclude about 40.31% more companies, or an additional 64 companies. However, these represent only about a third more of the starting benchmark weight, and result in only a slight increase in tracking error, from 1.21% to 1.38%. These additional exclusions come from companies involved in alcohol, energy, and metals and mining.

MSCI EAFE	#Names Excluded	Benchmark Weight	Tracking Error
USCCB	136	29.80%	1.21%
Mensuram Bonam	200	40.31%	1.38%

Example 3: Performance Relative to the MSCI ACWI Benchmark

Finally, relative to **MSCI ACWI**, MB may exclude more than twice as many companies as USCCB, or an additional 342 companies. Most of these additional exclusions come from excluding China from ACWI's Emerging Markets allocation. The additional exclusions represent almost half again as much of the starting benchmark weight as the USCCB excludes (30.61% vs 18.82%). These additional exclusions cause a 50% increase in tracking error, from 0.61% to 0.96%. However, it is important to note that this tracking error, in the context of a global equity portfolio containing emerging market securities, is not unreasonable.

MSCI ACWI	#Names Excluded	Benchmark Weight	Tracking Error
USCCB	373	18.82%	0.61%
Mensuram Bonam	715	30.61%	0.96%

These scenarios are intended to illustrate the potential impact of the number of holdings on the predicted tracking error of a portfolio in a direct indexing strategy that tracks the chosen benchmark(s) above. This information is provided for illustrative purposes only. The results do not represent actual portfolios. Actual investment results will vary and could be materially different from the results portrayed in this presentation. No representation is being made that any investment will achieve the results similar to that presented herein. Nothing contained herein should be construed as investment advice, either on behalf of a particular security or an overall investment strategy.

Reshaping Portfolio Exposures

In the context of performance measurement, it may be worth mentioning that faith-based screening also presents an opportunity to reshape portfolio exposure. A screened custom benchmark would presumably re-allocate screened weight pro-rata into eligible names. If instead, an investor takes a systematic factor approach towards portfolio analysis and rebalancing, it is possible to improve the portfolio's expected returns by taking an active approach to how screened weight is re-allocated. Whether or not the re-allocation method is pro-rata or active may impact how you choose to measure relative performance.

Fiduciary Duties and Catholic Social Teaching

Typically, institutional trustees, and their investment managers, serve funds as fiduciaries of the institutional investments they direct. However, this does not restrict them from exercising their best judgment to ensure the portfolio is in alignment with the mission and purpose of the institution. Some regulations, such as UPMIFA (The Uniform Prudent Management of Institutional Funds Act) deem trustees to have a specific *duty* to consider the charitable purposes of the institution in making management and investment decision.

CST screening, for many Catholics, includes avoiding companies providing abortions and access to abortifacient drugs, companies involved in stem cell research on human fetuses or embryos, companies providing gender modification surgery, companies producing most of their revenues from tobacco, gambling, or pornography, and companies producing non-conventional or other weapons of mass destruction.

For some Catholics, CST screens could also include environmental focus, such as reducing the portfolio's carbon footprint, avoiding biodiversity loss, avoiding companies with large fossil fuel dependence or reserves, or companies contributing to environmental destruction.

Estimated TEs Are Reasonable

All these are well within the scope of reasonable and prudent investment management by trustees of institutional funds. So long as the expected performance of the investor's screened portfolio is in line with that of their benchmark, such as where the tracking low is low, screening a portfolio for Catholic values should not raise concerns. The estimated tracking error statistics provided earlier confirm that all of MB's exclusions may be considered together with those of the USCCB in a portfolio without breaching fiduciary duties. Put differently, these estimated results should not preclude a reasonable fiduciary from considering or applying both MB and the USCCB guidance in CST screening.

Impact Investments & Fiduciary Duties

Different issues are raised when investors consider private investments in less liquid investments designed to achieve particular social goals or objectives. Here, the investor may be interested in building a long-term investment sleeve or allocation designed to accomplish specific social goals in line with CST. These may include goals such as developing sustainable agriculture, providing access to clean water, to basic education and medicine, to affordable housing, decent jobs with a living wage, and/or collective bargaining.

Often, the prospective returns of these investments are more difficult to forecast than those of public liquid investments, so investors seek assurance, through their due diligence, that such investments will be a constructive part of the return stream of their portfolios. Ordinarily, unless articulated differently, investors expect these investments to provide *market rate* returns over the long-term, at least in the aggregate. *Concessionary* or *philanthropic* returns (i.e., below market returns) are best left to charities in the philanthropy business.

In the context of an investor's fiduciary duty, the opportunity to engage with corporate management is also important. Both the USCCB and Mensuram Bonam encourage investors to engage with corporate management through calls or letters to management, board members, and

others, or through voting the company's proxy, or unless ownership of the company is to be avoided altogether. Of course, full divestment necessarily means the investor no longer has a vote in the direction of the company.

Corporate engagement may also apply to companies that do not yet exhibit bad behavior: an investor's ability to engage with portfolio companies can help steer management teams away from decisions that would require divestment.

Conclusions

Investors have a broad range of investment decisions which fall within the reasonable bounds of fiduciary behavior, including CST, whether guided by the USCCB, MB, or both. In addition, faith-based investors should strive to ensure corporate management evidencing poor practices or services, or manufacturing harmful products, are made aware of their concerns.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

For more information, contact Dennis Hammond, dhammond@ftportfolios.com

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