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Deep impact

The next step in sustainable investing

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Impact investing has previously more been identified with private market strategies and investments in specific use of proceed bonds like green bonds or social impact bonds, where the allocation of capital is directly tied to the activity of the use of proceeds.

The impact investing sector is by far the smallest portion of the overall ESG investing universe in Australia. According to the Responsible Investment Association Australasia (RIAA)'s *Responsible Investment Benchmark Report Australia 2021*, total assets under management for identifiable impact investing strategies was $29 billion in 2020. Total managed funds in Australia at that same point in time was almost $3.2 trillion.

But as ESG investing has caught on with a range of investors, impact invest strategies are being applied to a wider range of assets, including listed companies and sustainability-linked bonds and other vehicles. The growing interest in aligning investment with positive outcomes could lead to strong growth towards funds and products that provide that outcome.

To avoid the accusation of "greenwashing" or "rainbow washing", asset managers, advisers and other financial service providers are working to demonstrate that their investment process authentically brings positive benefits through increasing access to goods and services that improve communities and/or the environment.

It is also an ongoing question as to whether deliberately seeking out positive impacts guarantees higher return, with fund managers saying that it can help identify opportunities, without having firm evidence that it is a direct signal.

Impact investing to grow

As noted earlier, RIAA's *Responsible Investment Benchmark Report Australia 2021* calculates total assets under management for identifiable impact investing strategies at $29 billion in 2020, while total managed funds in Australia at that same point in time was almost $3.2 trillion.

In Australia, the specific impact investing space is dominated by green, social and sustainability bonds. RIAA's 2021 benchmark report noted that of the $29 billion in total AUM for impact investing, green, social and sustainability bonds comprised $26 billion. Real assets including property and infrastructure made up $2.2 billion, private debt comprised $287 million, public equity made up $195 million, private equity was $97 million, social impact bonds were $66 million and all other investments made up $44 million.

The RIAA benchmark, which covered developments during 2020, noted that "discussion with investment managers and analysis of survey responses indicates that there is a grey area when classifying sustainability-themed investing and impact investing," but also noted that the impact investing space grew 46% over 2019.

Many proponents of impact investing say that leveraging public markets is key to expanding potential positive impact across capital markets.

Heidi Ridley and Kathryn McDonald, co-founders of Radiant ESG and both formerly of Rosenberg Equities, made this point in a whitepaper published in *FS Sustainability*.

"If we are indeed to achieve the massive social and environmental objectives that are needed, we must enlist the public markets, specifically public equities," Ridley and McDonald said.

"It is only by leveraging the heft and breadth of this enormous pool of money that we will move the needle on impact goals. Put differently, the idea that we should limit our 'impact' mindset to a subset of asset classes is completely contrary to achieving the daunting mission at hand!"

The Global Impact Investing Network (GIIN) 2020 Survey estimates that globally, impact investment assets under management totalled US$715 billion at the end of 2019. GIIN is an influential voluntary collaborative body that focuses on reducing barriers to impact investment to increase capital flows to enhancing social and environmental aims and has developed one of the more widely used reporting frameworks for impact investing.

Ridley and McDonald note that Morgan Stanley estimated that US$50 trillion in investments in new technology is needed to bring emissions to net zero by 2050, giving an idea of exactly how much is needed to meet environmental and social aims such as those identified in the SDGs.

Impact investing may still be a small portion of the overall ESG investment sector, but there is strong reason to believe that allocation towards strategies that demonstrate clear positive impact links will grow.

Recently, EY published the *2021 EY Global Wealth Research Report*, which surveyed 2500 wealth management clients in 21 markets, including Australians, and found that a majority (76%) of Australian respondents have personal sustainability goals, yet 41% feel their wealth manager falls short in understanding their values.

Interest in specific ESG themes has increased over the past year and is growing fastest among the industry's wealthiest clients. In total, the survey found that 72% of Australian respondents believe it is important to consider ESG parameters in their portfolios and impact investing expected to grow 14% by 2024, reaching an average adoption level of 43%, which is higher than what global peers reported.

The EY report noted that adoption rates globally are expected to exceed 50% among ultra-wealthy investors, millennials and Asia Pacific clients.

Defining impact

The investment specialists that spoke with *FS Sustainability* for this article pointed to three common concepts in defining what impact investing is and how it can be measured and generated: intentionality – the desire to contribute to solving social or environmental problems; measurability – having a framework that can demonstrate qualitatively or quantitatively that a company or investment strategy makes the problems better; and additionality – the idea that the fund manager/investment strategy provides part of that benefit through the process of investment.

It is more challenging to define positive impact in a publicly listed company, as well as to demonstrate additionality. Many fund manager point to activities like engagement and stewardship as demonstrating their additional positive impact.

"Impact is more complex in a public company," UBS Asset Management managing director and lead portfolio manager of the global sustainable equity strategy Bruno Bertocci says.

"You've got to be measuring the impact of products and services, and you have to engage with the company to improve the impact that a company has."

Impact is not synonymous with sustainability, Bertocci emphasises.

"The intentionality aspect of it is interesting in public companies – you can't confuse impact with sustainability," he argues.

"For example, you could have a perfectly sustainable candy bar company, in terms of how it's managed, the board, where the ingredients come from and how they're stored, the energy profile, but you cannot link the product to a social goal or one of the [United Nations Sustainable Development Goals] SDGs. It really has to be about the products and services, and can you map them to something that is a global issue and that solves a problem."

However, it is possible to ascribe additionality in public markets investments, Bertocci says.

"First you have to have a universe of companies that have product and services that you can credibly tie to a goal," he says.

"In our case, we started with four big areas – health, water, climate and food security. We then set about to develop science-based models to measure outcomes in the world we live in."

Melior Investment Management chief executive Lucy Steed notes that additionality is different in secondary markets.

"From a traditional, private markets perspective, additionality was focused on capital additionality –allocating the capital directly to achieve the additional impact," Steed says.

"It's quite different in public equities because you're in the secondary market. That capital additionality isn't always part of this, but the way we see additionality is through key levers – one is the impact capital, where we're looking to allocate capital to companies who have core goods and services contributing to the SDGs."

Investing in public markets can also provide impact because of the alignment between long term investment horizons and longer-term timeframes to affect positive benefits, BlackRock director – sustainable specialist for Australia Steve Monnier.

"It's also about alignment as a long-term investor to provide that patient capital to help companies to transition from private to public markets and create a spotlight as well on these types of investments," Monnier says.

"It's about providing that patient capital and being a constructive investor as well."

For investors, the point is putting their money into companies that they feel strongly about or agree with, Ethical Investment Services chief executive Michelle Brisbane says.

"They want financial gains from activities they support," she says.

"Impact to us is about aligning their investments with those goals. We take an approach to understand a client's values and investment goals. It is not about ours or a fund manager's values. We help them invest into a portfolio which is aligned with their values."

Advisers are seeking impact-oriented investments for clients, according to Steed.

"The sophistication of the adviser community is starting to increase," Steed says.

"Whether it's been driven by events such as the bushfires or pandemic, clients are asking a lot more questions. With the focus on greenwashing, they're also asking is what I'm investing in what I think I'm investing in?"

Altius Asset Management manages the Australian

The quote

The intentionality aspect … is interesting in public companies – you can't confuse impact with sustainability.

The quote

"There is a large amount of empirical evidence to suggest that engagement is one of the most reliable mechanisms for delivering impact."
Dugald Higgins, Zenith Investment Partners

Unity Green Bond Fund, which invests in a combination of green, social, and sustainable fixed interest securities with the primary purpose of helping to lower carbon emissions. The Clean Energy Finance Corporation (CEFC) is a cornerstone investor, but the fund is available to retail investors, notes Altius chief investment officer Bill Bovingdon.

"Part of the reason the CEFC were a sponsor for our fund was the halo effect of creating these funds and making them more widely available, particularly to retail investors who previously didn't have access because green bonds tend to be gobbled up and kept by the big end of town," Bovingdon says.

"It's also a pretty strong message to those companies raising capital that there is a ready market there and a bit of a "greenium" to advantage both borrowers and investors (in the secondary market)."

The fund's aim is to generate positive impact as well as financial return, and to that end, Altius' investment process puts a negative screen on investments in activities like alcohol and gambling, and that applies to the green bond fund as well. No matter the use of proceeds of the project underpinning the bond, if the company's overall strategy doesn't meet the firm's policies, they are precluded from investing, Bovingdon says.

Creating funds that assess impact in public markets is a way to democratise access to the thematic, and Monnier notes that BlackRock is exploring using their impact strategy as the basis for regional variants.

"How we might be able to take what we're doing to an even wider group as well – that's definitely something that we are working on," Monnier says.

"Access via public equities democratises impact, and how we can build on that through different variants to meet client needs is really an important next step."

The role of engagement

"When investing in secondary markets, a manager's contribution to impact is difficult, if not impossible, without stewardship and engagement," Zenith Investment Partners head of responsible investment and real assets Dugald Higgins says.

"There is a large amount of empirical evidence to suggest that engagement is one of the most reliable mechanisms for delivering impact."

Melior also creates additionality through active corporate stewardship and participating in policy driven initiatives through submissions to government.

"We're really striving to help companies, and we often connect companies to other like-minded companies, groups and individuals who are trying to drive forward solutions, as well as educate and influence," Steed says.

Being a long-term investor gives scope for engagement and stewardship activities.

"Our target is to hold positions for five plus years," Monnier says.

"There is that element around stewardship and engagement. We're obviously engaging and voting on these holdings as well, and there is the whole piece that sits with our investment stewardship team which together with the additionality that comes from the company's solutions that would not otherwise have occurred creates impact."

It is "very important" that fund managers demonstrate how they engage with companies or how they conduct stewardship activities, Brisbane adds.

"Stewardship right from the board to senior executives can influence culture and decision making," she says.

"With managed funds, one of the first things we look at is the portfolio manager. Do they believe in this or is it a money-making venture only? Indicators are the research they do, transparency of holdings, initiative to engage with companies and their proxy voting stance."

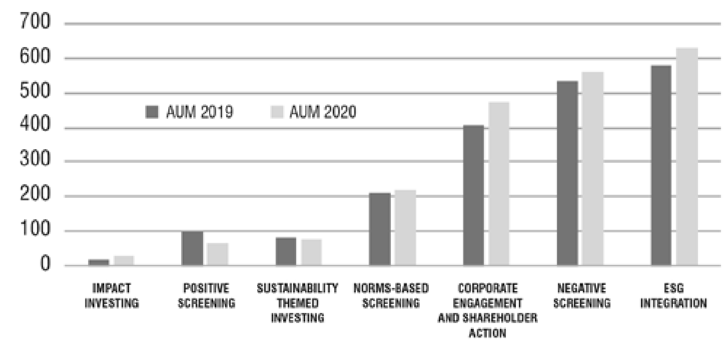
Altius uses engagement as part of its investment process. Bovingdon points to when Woolworths issued a $400 million green bond in 2019, prior to the demerger of Woolworths alcohol and gaming activities into Endeavour Group, as an example of how the firm used engagement to signal support for positive activities. Woolworths was excluded from investments because of materiality thresholds in the fund, but that exclusion changed when Woolworths announced the spin-off of the Endeavour Group.

"We had an ongoing internal debate about Woolworths when they brought their green bond," Bovingdon says.

"We had them on an exclusion list because their alcohol or gambling interests exceeded our materiality thresholds.

"Then they brought the green bond out and announced the demerger, and we wanted to support the green bond and the demerger. We intensified our engagement with Woolworths, and basically, noted that we would support the green bond as a show of faith in their stated strategy. We ended up buying it in the secondary market, after we had assurances from Woolworths that they'd move ahead with the demerger."

Figure 1. Total AUM covered by responsible investment approaches



Source: Responsible Investment Association Australasia Responsible Investment Benchmark Report Australia 2021 https://responsibleinvestment.org/wp-content/uploads/2021/08/Executive-Summary-Responsible-Investment-Benchmark-Report-Australia-2021.pdf

The UN Sustainable Development Goals (SDGs)

Fund managers frequently cite the UN Sustainable Development Goals (SDGs) as a framework for explaining how their investment process generates positive impact. The SDGs are 17 global environmental, social and economic goals designed to improve people and planet by 2030. Launched in 2015, the SDGs were meant to be a basis for government policy action and have been adopted widely by the investment management industry.

The SDGs can be useful for capturing what end investors are actually seeking in terms of impact, Brisbane says.

"The UN Sustainable Development Goals captures many aspects of impacts our clients seek to support such as renewable energy, community well-being, better care for land and marine animals and adopt sustainable approach to utilising nature's resources," she explains.

But much like concerns over greenwashing, use of the SDGs can lead to rainbow-washing – or superficial "alignment" to the colourful rendering of the SDGs, akin to greenwashing.

"Alignment to the SDGs is not sufficient to qualify as being impact," Monnier says.

"We require that companies are actually advancing the SDGs with solutions that provide additional benefit. … "To be included in the impact investible universe, the companies need to meet three impact criteria. They have to be additional, material and measurable. At least half of the company's activity must be derived from the SDGs."

Higgins of Zenith warns that there is considerable risk of "rainbow washing" – claiming positive impact aligned with the Sustainable Development Goals (SDGs) from the funds management industry.

"Our own observations are that what we see from a lot of managers, not necessarily those claiming impact, but those claiming ESG/ sustainability more generally, we do see a lot of overreach, a lot of marketing, and pretty rainbow-coloured icons, but when you pull back the layers and ask for evidence to back up the claims, you get a lot of silence and 'ok, it's aspirational,'" Higgins says.

Advisers are required to meet the client's best interest test first and foremost, but Brisbane emphasises it is also key to make sure that underlying holdings are not rainbow washing.

"Some managed fund offerings use [corporate sustainability] scoring output to justify their offering," she says.

"But when you look under the hood, it might hold junk food companies, banks that continue to fund fossil fuels and service companies that add little impact – names our client would not want to invest in anyway. Clients are quite binary – no client says they are happy with a little bit of cluster munitions."

Shedding light on reporting

Setting measureable targets and then reporting on those targets allows investors and their advisers to make sure that what fund managers promise is delivered.

That's not a simple task.

"There is no universal process for impact measurement," Higgins says.

"Also, it can be difficult to account adequately for causality, especially where cause and effect relationships are complex."

Higgins notes that key elements including measuring what is changing, who is experiencing the change, its significance and the duration of the change can apply in reporting, no matter the issue that's being measured.

"It always goes back to the fundamentals, intentionality, having measurable goals and identifying the managers contribution to the impact," he says.

"While the execution of impact strategies may vary somewhat depending on the nature of the securities (equity vs debt), the fundamentals still apply."

BlackRock measures impact using frameworks like the Global Impact Investing Network (GIINs) Iris Plus System and Taxonomy for the identification of relevant impact metric, while augmenting with internal metrics where necessary.

"This feeds into the annual report, where we make sure we are providing great transparency on our impact process and measurement through that annual report, but also how we report in line with the operating principles as well," Monnier says.

"That again provides transparency and a spotlight on the additionality of impact as an asset class which is really important."

Brisbane also cites certifications and collaborative efforts, such as the Project Drawdown which pushes for climate solutions, National Packaging Covenant, Forest Stewardship and Modern Slavery Act as other which pushes for supply chain transparency to combat human trafficking.

Does impact equal return?

While investors are seeking products and companies that align with positive social impacts, as yet there is no explicit signal that performance against the SDGs and will guarantee financial return.

While there isn't a direct link between positive impact and investment return but generating positive impact can play a role.

"If you overpaid for a company, all bets are off," Bertocci says.

"If you're thinking about the valuation of a company in a rational way, you've got to be investing in companies with valuation in mind. But if you are a company that delivers a product or service that solves a pressing need, you have a ready market.

"… Secondly, that product or service is probably something that will resist competition so the return on assets and equity are pretty durable."

Producing goods and services that impact positively on people and planet and have strong operational ESG credentials can also reduce capital costs through lower interest rates on financing vehicles such as sustainability linked notes, Steed says.

"We see these purpose-driven companies often benefitting from the megatrends of climate change, and aging populations, and companies that are focused on solving those problems are benefiting from the structural tailwinds," she says.

"They can have fewer legal issues, or increased access to capital in those areas.

"There's an increasing link between positive impact and return. The companies we speak to are aware of the potential risk if you're not paying attention to environmental and social issues, and chief executives are losing their jobs if they're not focusing on these issues." FS