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Impact Insight

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IMPACT INVESTING: THE NEW FRONTIER

During the past 10 years, sustainable investing has grown tremendously. According to a 2016 report by the Global Sustainable Investment Alliance[1], 53% of professionally managed assets in Europe and 22% of those in the US are adopting sustainable investment strategies. While the numbers vary by country, this overall trend is clear. Contributing to this trend is the coming transfer of global wealth from one generation to another. Multiple studies have shown that this next generation of investors will not only inherit enormous wealth but will also favour this type of sustainable investing in place of traditional investing. One of the newest methodologies to emerge and gain market traction is impact investing.[2] With its mantra of "doing well while doing good", impact investing has captured the imagination of people worldwide.

Impact Investing in the Historical Context of Sustainable Investing

Historically, impact investing can trace its origins to the spectacular growth of microfinance. Over the last 10 years, microfinance has become an accepted investment option for investors globally and especially in Switzerland, where 40-50% of microfinance portfolio managers are based. Independent to the development of impact investing, Socially Responsible Investing (SRI) began with publicly listed securities much earlier. Initially, this approach added a "values" lens to the investible universe selection process by excluding sectors such as alcohol, tobacco, pornography, gambling and weapons producers as well as excluding investments in developing countries which had controversial policies. With time, SRI investors began developing methodologies to include more company data in the investment analysis, which developed into Environmental, Social and Governance (ESG) data collection and analysis we have today. With ESG increasingly gaining acceptance in the asset management community as rule, not the exception, it has provided a solid foundation for impact investing to flourish today.

Impact vs. ESG/SRI

For financial professionals that are new to sustainable investing who are being asked by their clients about the topic, these multiple acronyms pose a challenge. To help clarify this, this is how I explain it to our clients. SRI investing began as a way for investors to exclude certain companies or sectors based on financial returns and social parameters. Weapons manufacturers or tobacco companies are simple examples of excluded sectors. The evolution of SRI investing is ESG investing, which include non-financial information, i.e. environmental, social and governance issues, in the decision-making process. ESG has evolved into three principal methods including; 1) best in class, 2) norms-based screening and 3) ESG integration. Each method uses ESG data in a slightly different way in the investment process[3]. Thematic investing, which also uses ESG data, focuses on specific sectors directly linked to sustainability such as renewable energy or water infrastructure. Lastly, direct shareholder engagement is used by investors to encourage certain ESG standards to be adopted or expanded by portfolio companies. Most ESG data being used by investors is collected by 3rd parties such as MSCI, Bloomberg and Sustainalytics, who have gathered the data directly from companies via surveys. The data collected covers a wide range of topics from carbon emissions to maternity leave policies at the company level and adds another layer of analysis to a traditional investment process. The end result is that individual companies and bonds are scored based on this data and the final investment selection takes this score into account. Most Swiss asset managers and banks offer this type of strategy to their clients and recent research by Swiss Sustainable Finance and others has shown that this trend is increasing. One point usually missing from a discussion on ESG is that since the ESG data collected is historical, as with traditional financial statements information, the analysis is historical in nature. While financial analysts project revenues, earnings, etc. into the future, ESG data is not easily manipulated into a forward-looking analysis.

Looking towards the future is exactly what differentiates impact investing from ESG and make it so much more compelling to me. The three core criteria of impact investments are: 1) investment made with intention to create a positive social or environmental impact, 2) measuring these output and outcomes, and 3) generating market rate financial returns. The key is the idea of intentionality and this is what sets impact investing apart from SRI/ESG. But this idea of intentionality can be a challenge because it is not part of traditional financial. To understand a company's intentions, I look at their business model to assess if their model was originally designed to generate positive social or environmental impact while generating a profit. They must go in parallel.

For example, organic food producers started with the idea that sustainable farming practices are better than industrial farming and have built a business model to promote this idea by selling organic food. Microfinance banks focused on low income populations from the start that had been typically excluded from financial services markets. Renewable energy companies generate profits while providing an alternative to fossil fuels. While these examples are different in nature, they all show the development of successful business models where positive social or environmental outcomes and market rate returns were built into the core business model and not just a corollary benefit. *This is the key difference to SRI/ESG*. Impact investors like myself take this as a signal that over time these companies will be better positioned to meet customer needs and will therefore perform better over the long term. Without this element of intentionality at the company's core, it is excluded from further analysis. ESG analysis, on the other hand, simply scores companies regardless of their core intentions.

A few words on the important topic of reporting. I, along with most impact investors, use metrics developed by IRIS, a non-profit organization that created a catalogue of generally accepted impact performance metrics. These metrics have become the industry standard for investors to measure the social, environmental and financial performance of an investment and are built around specific sectors. Using these metrics, one can show how much "impact" was generated by the investment. While not easy, this can be done both with private and public companies but requires an added layer of expertise. Finally, these results go alongside tradition asset management metrics of risk, return, etc. I, along with my colleagues at MainStreet Partners, recently released our 2016 impact report, where our reporting process is made available.

The future of Impact?

In my view, impact can only continue to grow. Why? Environmental and resources constraints will only continue to increase in the future. We can see this everywhere. This will force us to reconsider externalities, such as carbon emissions or water use. As these "extra" costs are taxed or make their way into a company's financial statements, impact investing will become more prevalent. Why? Because once companies begin paying for these externalities, they will become normal cost. And those companies best positioned to manage this transition, will simply be better investments. Conversely on the revenue end, consumers are looking at corporate behaviour much more closely in our hyper transparent world. Their buying habits and expectation will continue to shift toward these "responsible" companies.

[1] http://www.gsi-alliance.org/members-resources/trends-report-2016/

[2] https://www.morganstanley.com/ideas/sustainable-socially-responsible-investing-millennials-drive-growth

[3]http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf

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