Impact Investing

The next revolution?

At the core of the idea of impact, should be the desire to bring about beneficial change to society. As an example, the widespread investment into the technology revolution of the early 2000s yielded tangible and quantifiable improvements to the quality of life in the 21st century. Since then, investors have slowly shifted their attention, and funds, to ESG-compliant investments. ESG investments now account for nearly half of the $100 trillion-dollar global investment industry. Despite this, ESG investments have failed to have as significant an impact as technology. A key issue underpinning this shortcoming has been the lack of standardisation around what ESG investing is. Issues with measuring the impact of ESG investing have only served to compound the issue. Recently, because of the Covid-19 pandemic, the appetite for ESG investments has grown even stronger and with it, the calls to ensure that these investments yield a lasting impact. This report explores whether this quest for a more sustainable world will drive the next revolution. More importantly, what needs to be done to ensure that the world shifts its focus towards measuring the impact of these investments.

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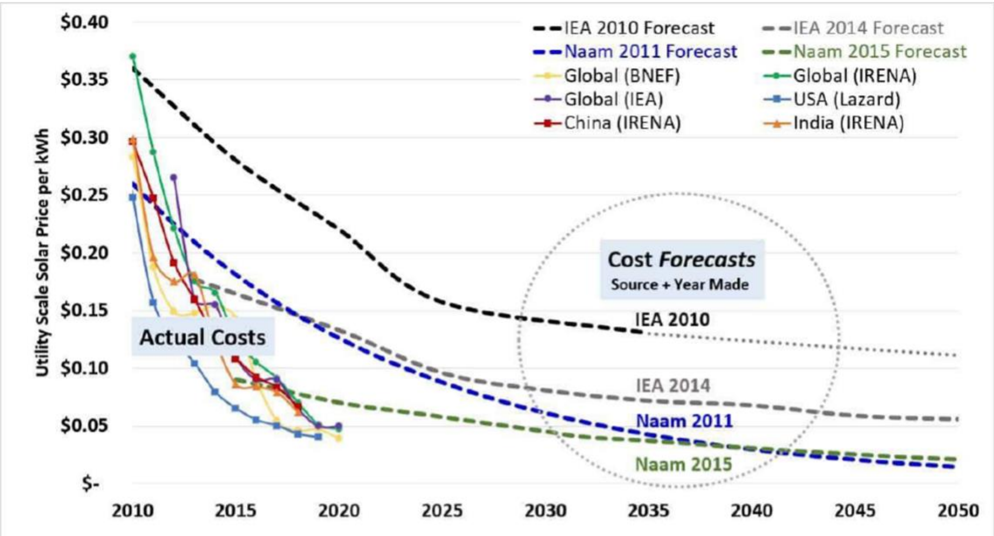
Impact Investing: The Next Revolution?

Natura non facit saltum – "Nature does not make leaps". Darwin's theory of evolution formed the basis of this profound statement which first appeared in his 1859 book, The Origin of Species. The process of evolution is described as gradual, because of the steady, slow, and continuous changes which take place over time. However, modern science recognizes that technological progress does not necessarily occur slowly. Sometimes, real advancement does not evolve. It revolts.

The quest for a better life set into motion in the Middle Ages, found expression in the Industrial Revolution of the 1700s. This was a period of significant economic development and technological advancement. While the industrial revolution propelled the extraordinary advancement of humanity, it also marked a turning point in the relationship between people and planet. This impact was so significant that the post-industrial society is creaking under the burden of the negative consequences incurred on a large scale. Relentless consumption has resulted in significant injury to the environment (soil, air, and water). As a result, governments around the world will need to spend copious amounts of money to try reverse the damage.

The dawn of the new millennium has resulted in the growing popularity of disruptive business practices, in which companies eschew current profitability for long term investments in holistic outcomes (e.g., energy sector). This has led to an increase in climate-friendly companies looking to innovate greener alternatives across multiple industries. The appetite for greener alternatives has grown even stronger aided by technological advancements and declining cost curves. The figure below shows the evolution of solar cost curves relative to the initial forecasts. It can be seen below that the actual cost of solar implantation has proven to be well below the decade-old forecasts.

Figure 1: Solar Cost Curves are Decades Ahead of Forecasts



Source: Naam R, 2020

This development could propel a revolution that will someday rival the utility of the tech revolution to mankind since 2000. For that to happen, companies must establish a causal link between the impact of their operations on society and their profits. Only then can companies re-orient both their operations and investments in a direction that enables beneficial change to society.

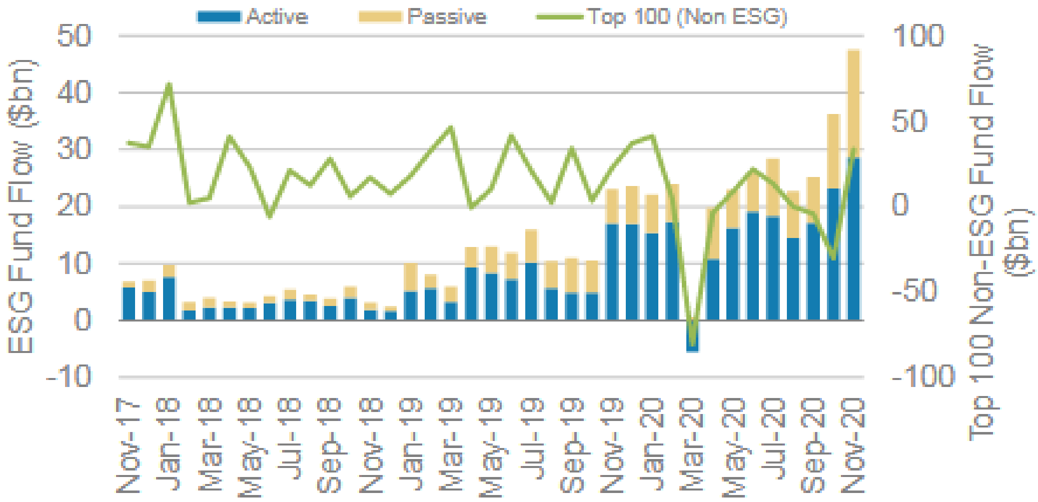
Sir Ronald Cohen asserts in his book, Impact, that no sector of the economy will be untouched by the ambition of young entrepreneurs. In a world that demands companies do better, businesses are figuring out, at warp speed, how to harness the power of human ingenuity to minimise the social harm and environmental degradation arising from their business operations.

The false dichotomy between Returns and Sustainability

Environmental, Social, and Governance (ESG) defines a set of standards applied to companies as a measure of sustainability. Historically, whenever ESG issues surfaced, it has been because of an unexpected breakdown in non-financial factors resulting in often irreversible destruction of shareholder value. Various stakeholders now recognize that these non-financial factors, encapsulated in the term, ESG, pose a real and present danger to the financial sustainability of a company. One of the constraints to sustainable investing, of course, has been the belief that imposing ESG parameters on investment managers diminishes the universe of stocks they can invest in and results in inferior return outcomes relative to broader market indices. Fabozzi, et. al (2008), argue that there is no relationship between societal values and economic value, as evidenced by the outperformance of "sin stocks" over time. A 2020 study by Morningstar refutes this claim, showing that 6 out 10 ESG funds delivered higher returns than equivalent non-ESG funds over a 10-year period. The outperformance highlights the ability of ESG funds to deliver strong returns, especially in an uncertain environment.

The demand for ESG-compliant investments has certainly surged in recent years. The figure below shows that while demand for the Top 100 non-ESG funds has trended down over the last three years, ESG fund flows have gained momentum. What is interesting is that despite the apparent improvement in investor awareness, many continue to treat these two concepts as if they were mutually exclusive and as a result, have chosen to pledge their allegiance to one or the other. To some investors, avoiding the appearance of impropriety in their quest to make money is just as important, and as such these investors will content themselves with box-ticking exercises.

Figure 2: Global Monthly ESG Flows since 2017



Source: RMB Morgan Stanley,2020

At the core of this false dichotomy is the idea that generating superior returns means chasing profits at any cost, while sustainability requires companies to sacrifice profits for societal good. This could not be further from the truth - sustainable business practices that are aligned to superior judgements on holistic perspectives can lead to superior returns for investors. This is because companies with sustainable practices stand to benefit from strong tailwinds in the form of favourable regulation (as governments attempt to solve societal issues and increasing consumer demand (younger consumers are more concerned about ensuring sustainable consumption). For many supporters of the sustainability movement, Elon Musk's brief ascend to the top of the rich list should be nothing short of a resounding victory - after all, it only makes sense that the world's richest person should be someone whose business model is in service of the planet.

Integrating ESG into the Investment Process

As ESG has gained prominence as an important determinant of the long-term financial performance of an organisation, investors have been hard-pressed to find a way to meaningfully incorporate it into their investment processes. In doing so, investors have faced numerous challenges. For one, ESG issues are broad and varied, making it difficult to derive a single comprehensive list to encompass these issues. Second, issues relating to ESG are inter-linked and relatively subjective.
The greatest challenge, perhaps, faced by organisations around the world in trying to address ESG issues is in defining what ESG is. The ambiguity surrounding the definition of ESG further compounds the issue. Over the years, numerous catchphrases have emerged to refer to some or other ESG phenomenon. These include, but are not limited to, Corporate Social Investment (CSI), Responsible Investing (RI), Impact Investing, and Sustainable Investing.

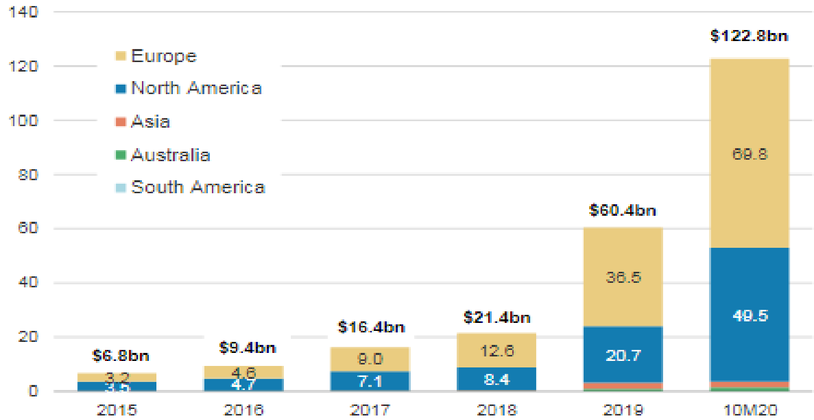
Access to data forms the foundation for the integration of ESG metrics into company analysis. Data collection methodologies vary significantly across providers which often results in notable differences in ESG ratings assigned to a company. This presents a real challenge for investors. One of the reasons for the lack of comprehensive and standardised data is that companies were not previously required to report on their ESG metrics. And for the most part, ESG metrics remain self-reported and are often unverified. While there is no shortage of reporting standards – the United Nations Global Compact (UNGC), Sustainability Accounting Standards Board (SASB), and the Global Reporting Initiative (GRI) –, without universal standardization, enforcement is impractical.

While most people may disagree on what ESG is, there is consensus that something needs to be done. Take the issue of climate change for example; there are very few people in the world brave enough to deny its existence. It is considered by many experts to be the greatest single existential threat facing mankind today. In response to the growing threat of climate change, countries around the world have pledged to reduce greenhouse gas emissions as signatories of the Paris Agreement. The objective of the Paris Agreement is to reduce the warming of the planet to 2-degrees Celsius below pre-industrial age temperatures by the year 2100. Despite this, efforts of governments and other stakeholders have not been consistent with the desire to effect any real change. Perhaps this is because, for some, there are misgivings about the loss to the economy (jobs and wages, tax revenue) in pursuit of such lofty gains.

The Paris Agreement recognised that countries that contributed the least to climate change would face the brunt of the consequences of climate change. As part of the pact, developing nations committed to contributing $100 billion a year until the year 2025 (since 2009). Thus far, the collective contributions have fallen short of this target, with only $79 billion collected in 2019. According to a 2020 study published in the Nature Communications Journal, the global upfront climate investment required for the world to "break-even" in its climate plan would be around $18-113 trillion. Faced with such a monumental task, many stakeholders may ask themselves whether the cost of being sustainable is worth it. That is, is it worthwhile for businesses to sacrifice short-term profits in a futile attempt to delay the inevitable?

To do nothing, of course, is NOT the answer. The costs of delaying to implement necessary changes rise every year. It is estimated that costs associated with delays increase by 0.6 trillion USD every year from 2020. Instead, we need to ensure that what we do is highly effective – this is the idea of impact. The Covid-19 pandemic, which has altered life as we know it, may just be the straw that breaks the camel's back. The pandemic has, without a doubt, accelerated the trends toward sustainable investments and living. The figure below shows that the AUM of ESG ETFs more than doubled over a 10-month period in 2020.

Figure 3: ESG ETF AUM by Region ($bn)



Source: RMB Morgan Stanley, 2020

In a world where "ESG beauty is in the eye of the beholder" (the absence of a universally agreed standards), efforts of investors will continue to be fragmented and outcomes fragile. For all the promise ESG investing holds, it has thus far been unable to produce results at scale. This can be explained through the concept of economic selection, which like natural selection in biology, will choose to allocate capital to the most economically favourable strategies. The more successful a strategy becomes, the more capital it attracts.

So how then, do we go about ensuring that efforts to achieve a more sustainable planet are co-ordinated and meaningful? In simple terms, how can we go about developing a universally accepted framework for integrating ESG issues into the investment process?

The SDGs: The Blueprint for a Sustainable World

In 2015, The United Nations (UN) put forward the 2030 Agenda for Sustainable Development. This framework, known as the Sustainable Development Goals (SDGs), encapsulates the most pressing sustainability issues facing the world today. The SDGs represent a concerted attempt to coordinate the efforts of different stakeholders including governments, big business, philanthropists, and other organisations to pool resources into ESG investments in a manner that will allow them to operate at scale.

Figure 4: The 17 Sustainable Development Goals

Source: The United Nations, 2020

The SDGs represent both a disruptive force and a compelling opportunity. According to a report by the Business & Sustainable Development Commission (January 2017), estimates put the business opportunities associated with sustainable business practices and contributions to the SDGs at ~12 trillion US Dollars by 2030. The 17 developmental goals are comprehensive and can serve as a tool to help many businesses identify and target the sustainability issues that best align with their business operations. Underlying the goals are 169 hard targets and 232 indicators which companies can use to further orient their impact ambitions. For asset managers, like ourselves, the SDGs offer a tool to measure companies' commitment and tangible action to achieving sustainability. By investing in companies whose business operations generate a positive SDG impact, we can allocate capital in a manner that significantly moves the needle toward a more sustainable world.

Achieving the 17 SDGs will require an additional annual investment of $33 trillion. It might be useful to put this figure into context to gauge the potential contribution of the asset management industry to achieving this goal. The total global assets under management topped the $100 trillion mark in 2019 (Thinking Ahead Institute, 2020) and according to a 2020 report by JP Morgan, the "broadly defined" ESG market was expected to reach $45 trillion in AUM by the end of 2020. This broad classification of ESG funds includes funds which are considered to "follow ESG principles". By contrast, the total AUM of dedicated ESG funds is substantially lower at just $1 trillion. This disparity leaves open questions as to whether this rapid adoption of ESG principles in the asset management industry is in fact building a solid, structural base for expansion. The bar is simply too low.

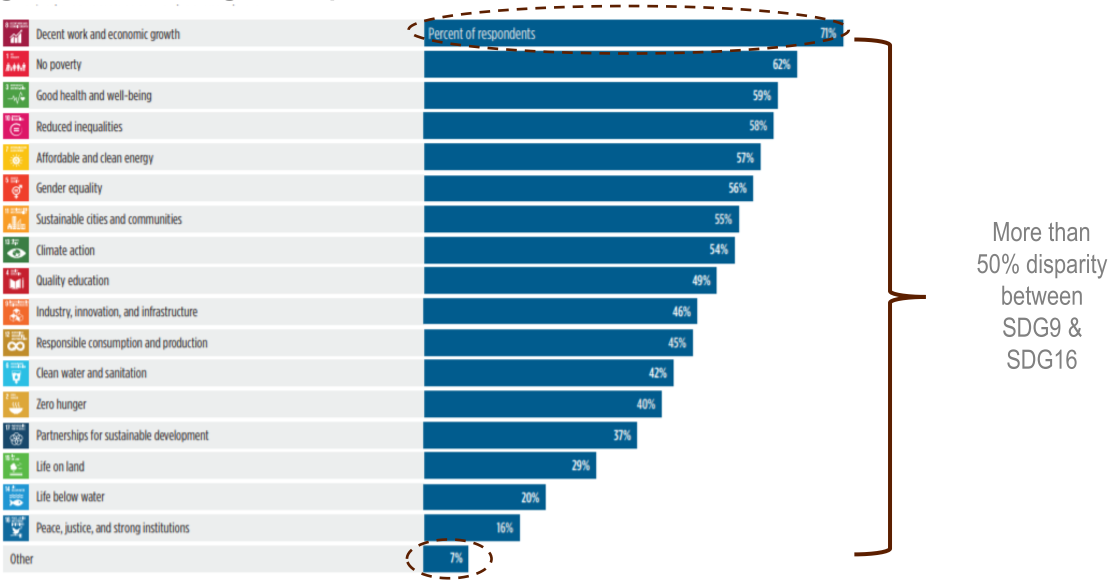
Unlike other frameworks which came before, the SDGs have enjoyed strong adoption by companies across the world. A 2020 survey conducted by the Global Impact Investing Network (GIIN) shows that the SDGs have enjoyed a high level of adoption across the world with ~73% of respondents indicating that they use the SDGs as a tool to either set their impact objectives or report their impact performance. By comparison, the second-most used framework, the IRIS Catalog of Metrics, was only adopted by ~46% of respondents. Other well-known frameworks including the United Nations Principles for Responsible Investing (UNPRI) and the Sustainability Accounting Standards Board (SASB) were adopted by ~29% and ~9% of respondents, respectively. We believe that the SDGs will emerge as the dominant feature across various approaches to ESG integration. Ultimately, this would give rise to much-need standardisation and provide reasonable basis for a universally accepted framework.

That said, the SDG framework is not without weaknesses and much care is required in assessing the performance of companies using this framework. It is our view that the "cherry-picking", and "green impact washing" practices are the two most material vulnerabilities for the SDG framework.

Vulnerability #1: Cherry-Picking

The growing popularity of ESG investing has resulted in a pressing need for companies to better understand, quantify, and communicate their societal and environmental impact. This has proven to be a very difficult task for companies, and many have opted for the easy way out. As a result, some SDGs have been left out in the cold. The figure below shows that there is a ~56% disparity in the percentage of companies aligning to SDG 9: Decent work and economic development (77%) versus those aligning to SDG 16: Peace, justice, and strong partnerships (16%). According to the United Nations Global Compact (UNGC), there has been a noticeable trend of companies setting goals and targets based on which SDGs are easiest to align to. Since the elected goals often do not address a material aspect of the business's operations, the impact of these efforts is often inconsequential. Another reason for this disparity is that some companies solely view the SDGs as a great business opportunity, and as such, have chosen to hone into those SDGs which offer the best prospects for growth.

Figure 5: SDGs targeted by Investors.



Source: GIIN Annual Investor Survey, 2020

Vulnerability #2: Green Impact-Washing

The SDG framework has not been immune to a swarm of companies that claim alignment by superficially retrofitting existing efforts to their chosen development goals. Often, these companies are unable to show how these efforts have contributed to closing the SDG gap. We believe there are two questions which can be useful in identifying green-washing practices when assessing company alignment to the SDGs:

1. Are the efforts incremental? i.e., the efforts would not have been undertaken anyway.
2. Are the efforts measurable? i.e., the efforts can be quantified in a credible manner.

It has been estimated that funding the SDGs will require an additional annual investment of $30 trillion. For the efforts to be considered incremental, companies must pivot their operations in a direction that both allows them to minimise any negative impact while simultaneously endowing a lasting positive SDG impact on society and the environment. For the efforts to be measurable, there must be broad consensus on the standards of measurement to be used. In the past, there has been great disagreement about measurement standards between the companies charged with upholding ESG standards, and the community activists, environmentalists and indigenous groups who have had to bear the brunt of the negative outcomes.

The European Union (EU) has made the greatest progress in addressing this vulnerability with the introduction of the Sustainable Finance Disclosure Regulation (SFDR). The SFDR is a set of EU rules aimed at increasing comparability and reducing greenwashing among financial products. This disclosure regulation forms part of the EU's Sustainable Finance Action Plan (SFAP) which was adopted as part of the "European Green Deal". Articles 6, 8 and 9 of the SFDR set out the criteria for the classification of sustainable funds. The criteria make a distinction between funds with a sustainable investing objective, financial products which promote environmental or social characteristics and funds which simply assess sustainability risk. The regulation came into effect in March 2021.

Turning Action into Impact

For the ESG efforts to have impact, there needs to be a clear translation of actions into outcomes. Companies which successfully implement strategies to bring about beneficial change to society can deliver superior shareholder returns. By considering the impact of social and environmental innovations on competition and value creation, companies can establish a causal link between impact and profit.

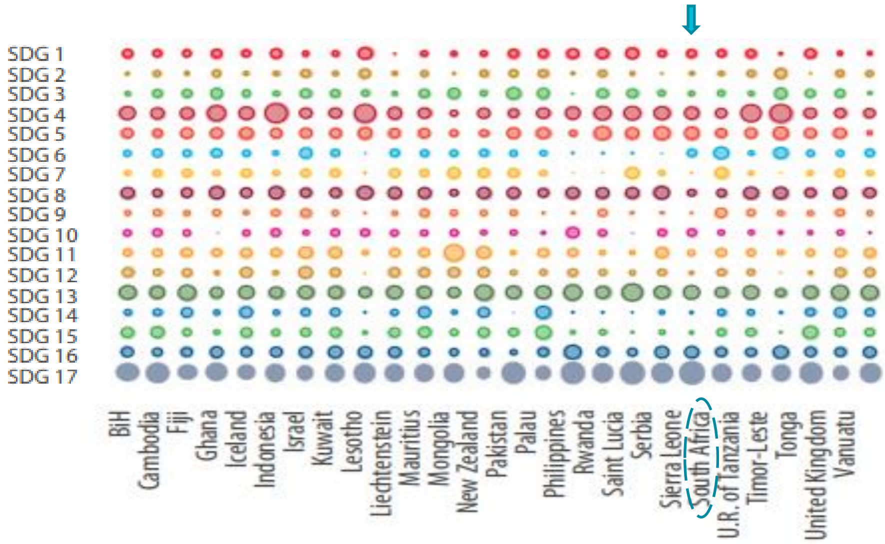
Porter et. al (2019) argue that there is compelling evidence that superiority in identifying and harnessing selected social and environmental issues relevant to the business can, over time, have a substantial economic impact on companies and even entire industries. The authors note that the companies included in Forbes' annual "change the world" list are companies which do not typically score very highly using ESG rankings, nor do they have any significant presence of SRI funds in their share registry. Yet the publicly listed counters on this list from 2015 through 2017 outperformed the MSCI World Stock Index by an average of 3.9 percent in the year following publication. Not only that, sell-side analysts have repeatedly underestimated the profitability of these companies. The authors found that three-out-of-four had one or more earnings surprises in the 12 months following publication.

Ultimately, achieving this impact objective depends on two factors: the willingness and ability of companies to do so. Willingness speaks to a desire by the company to be responsive to the local context i.e., act with local interests in mind. The ability to do so is determined by the company's flexibility in passing on the cost of ESG onto consumers i.e., the ability to convert it into a profitable cost.

Localisation

Globalisation has resulted in greater integration of countries and people, but it has also resulted in ESG issues spreading to all parts of the globe as companies expanded their operations in search of growth. Despite the far-reaching consequences, the figure below shows that the relative importance of these issues today varies from one country to another (e.g., SDG 2, 6, 7, and 14).

Figure 6: SDG Priority by country



Note: The size of the bubble is proportional to its corresponding SDG score
Source: United Nations (2019)

Take SDG 6 (Access to clean water and sanitation) as an example; according to the United Nations, over 800 million people globally do not have access to clean water while an estimated 2.4 billion people lack access to improved sanitation facilities. The growth in the global population will result in growing demand for water. The UN estimates that up to 40% of the world's population will be living in seriously water-stressed areas by 2035.

The correlation between the availability of water and economic growth is undeniable since virtually every sector of the economy relies on some access to water for its operations. Indeed, the statistics for water use in production chains are startling. For example, it takes around 1,800 litres of water to make 1kg of bread and 15,000 litres to make 1kg of beef. The agricultural sector alone accounts for ~70% of global water withdrawals. It should follow then that the responsibility to ensure the sustainability of water sources should lie with those industries whose pursuit for profit has thrust the world into distress.

There is growing awareness among investors for the need to map water risks in their portfolios however, there are some challenges in doing so. One of the main problems with this is that water risk is very localised and unlike other prized commodities, water cannot be easily transferred from one country to another. This means that solutions must be localised – even for a multinational company operating in a globalised world. Willingness on the part of the company and buy-in from local stakeholders must result in a sweet spot of mutual benefit being created for all stakeholders. This means fully embracing the so-called "Triple Bottom Line", a concept that requires companies to embrace people and the planet alongside profits.

In his book Impact, Sir Ronald Cohen provides several examples how of localisation can be achieved. Social Impact Bonds (SIBs), as they are known in the United Stated are outcome-based contracts for service issued by "outcome payers" who commission purpose driven organisations to achieve certain outcomes. A third party, such as a socially motivated investor would then provide the funding for delivering the desired outcomes. The investor is compensated with their initial investment plus a return when the project outcomes have been met. This approach addresses one of the biggest constraints to sustainable investing – performance measurement. This is because traditional market benchmarks are not suitable for socially or environmentally motivated endeavours and as such, require custom benchmarks which speak to the objectives they aim to fulfil.

Profitable Costs

To remain competitive and sustainable well into the future, companies will need to undertake potentially costly improvements to pivot their operations towards more sustainable approaches. This will undoubtedly put pressure on the profitability of companies that cannot successfully pass on this added layer of costs onto their customers.

The nature of companies in cyclical industries is such that they are at the mercy of the economic cycle and therefore face compounded revenue risk in the event of a significant economic downturn. While the presence of a good management team and strategic initiatives can certainly reduce a company's exposure to fluctuations in the economic cycle, it is unlikely to fully insulate a company. Natural resource companies, for example, are "price-takers" since they can only sell their output at the prevailing market price. As such, these companies will see their revenues rise and fall with the commodity cycle. This volatility is further amplified at the operating income level due to the typically high operating leverage. The high-fixed nature of the industry is particularly burdensome, and the cost of halting operations can be exorbitant which means that these companies must keep their shafts operational even during commodity cycle downturns. The lack of pricing power inherent in cyclical industries means most cyclical companies may need to pivot to sustainable operations at the time that commodity prices may very well have collapsed.

Because of this, natural resource companies often fail to reach consensus with other stakeholders about what constitutes adequate effort in addressing ESG issues. A perfect example of this is the refusal by mining companies to address concerns relating to Scope-3 emissions. Mining companies maintain that they should not be required to set reduction targets for scope 3 emissions since these are beyond their control. This means that based on scope 1 and scope 2 emissions, mining companies are not considered highly pollutive and as such, have very little desire to change anything.

Companies in cyclical industries are also faced with a substantial threat from disruptors who are willing to endure losses in the short-term enroute to capitalizing on emerging trends and materially disrupting the status quo. Disruptive pressures have grown stronger aided by technological advancements and declining cost curves which have made them more attractive. Cyclical companies often have a limited scope of converting their businesses into entities that can withstand the pressures of disruption. By contrast, high-quality companies that are endowed with pricing power will be better positioned to invest for impact given their natural ability to pass on costs onto their customers.

Conclusion

While the old-age rules of investing which dictate investors increase their allocation to cyclical stocks following a recession, it is highly likely that the road to economic recovery will be vastly different this time around.

If there is anything to be gleaned from the recent fiscal stimulus packages announced by various governments around the world, it is that the measures that governments will employ to re-ignite their economies will favour greener alternatives (EVs and other low-carbon solutions) and technological infrastructure (5G networks and Cyber security). As part of its EUR750bn stimulus package, the European Commission has pledged to finance renewable energy and generation initiatives including the installation of 1 million electric vehicle charging stations.

In September 2020, Chinese President Xi Jinping announced an ambitious target for carbon-neutrality by 2060. The country also introduced new infrastructure policies targeting next generation information networks, 5G and EV charging stations. In United States, democrats have turned their attention towards a $4 Trillion dollar clean-energy technologies and infrastructure package.

The increased focus on ESG investing will be propelled further partly by the desire of corporates to assert their "purpose" in society. Post the Covid-19 crisis, we are likely to see there will be an acceleration of some of the disruptive trends which have been observed across various sectors of the economy. Companies operating in these, and other adjacent industries are the most likely to benefit from subsidies, tax incentives and direct government expenditure.

The drivers of the post Covid-19 economic recovery are firmly stacked in favour of bolstering the wave of ESG investing. Investments of unprecedented size will provide further scope for ensuring that ESG investments to become scalable. ESG investing can no longer be simply dismissed as just another "fad".

Witness the revolution!

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