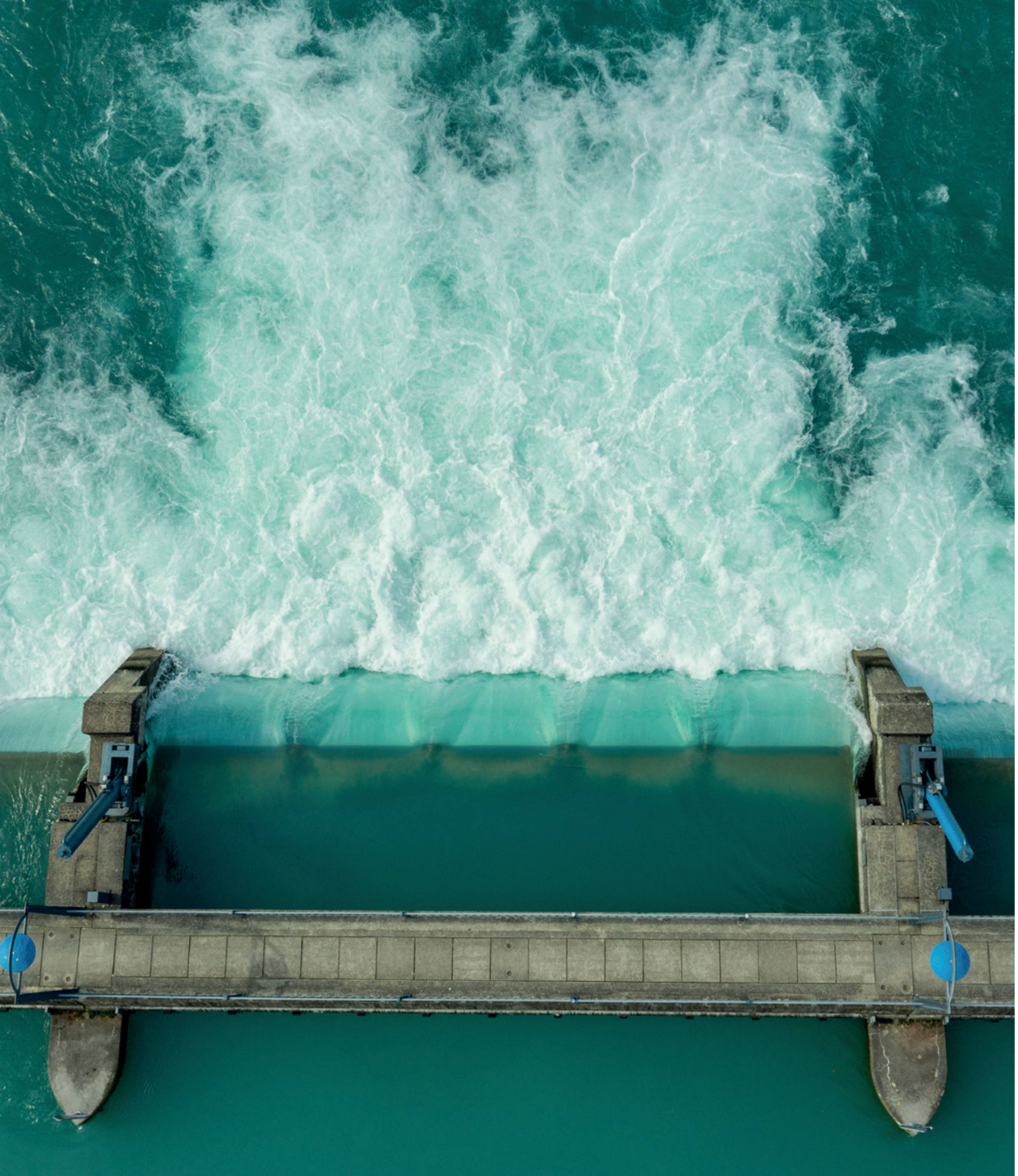
RATHBONES

INVESTING FOR GOOD

Exploring ways to create positive outcomes for society with your investments



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FOREWORD

Over the past five years there's been a global pandemic, high rates of inflation and associated cost-of-living crisis, Russia's invasion of Ukraine and conflict in the Middle East. Meanwhile, the climate crisis has become even more prominent, with 2023 being the hottest year on record after global average temperatures exceeded 1.5ºC above pre-industrial levels.[1] These events have prompted more people to ask how they can contribute to positive outcomes for society, as well as mitigate the impact of climate change on their portfolios. In particular, if they can use their investments to make a positive impact.

In our 2019 report *Responsible Capitalism*, we highlighted the ways in which the global economy, society and the environment are connected. By ignoring its own complex relationships with society and the environment, any company can harm the world around us and its own business. In order to maximise long-term shareholder value, we believe public companies need to maintain vibrant, symbiotic relationships with employees, customers, suppliers and natural resources. The necessity for these positive relationships has become even more apparent.

A growing trend

Today's companies promote their various impact initiatives, such as reducing plastic packaging, shifting to carbon neutral products or paying their employees a living wage. Increasing investor interest in improving outcomes for society and the environment is reflected in the rise in global investment in sustainable assets to $30.3 trillion as of 2022, which is an increase of 20% in non-US markets since 2020.[2]

Across the globe, authorities have been developing environmental, social and governance (ESG) regulations to further government commitments under international climate treaties and in recognition of the market's evolution. In the UK, under the Sustainability Disclosure Requirements (SDR), the regulator is proposing a new fund labelling framework, disclosure regime, naming and marketing rules, and an anti-greenwashing rule (regulation to combat unsubstantiated sustainable investment claims), signalling a significant overhaul of the market.

Meanwhile, the EU continues to fine-tune its approach by proposing a substantial review of the Sustainable Finance Disclosure Regulation (SFDR), the cornerstone of its sustainable finance strategy since 2021. At the same time, the US Securities and Exchange Commission (the SEC) is defending in court its proposed rules to enhance and standardise climate-related disclosures.

In this article we explore how and to what extent investors can have a positive impact through their investments in this rapidly evolving area.

INVESTING FOR IMPACT

An investor might choose to allocate capital towards companies that either generate beneficial outcomes or adhere to sustainable practices, motivated by the aspiration to contribute positively to society and the environment. Does such an investment strategy enable them to make a positive impact? The situation is more complex than it appears. To grasp the concept of investor impact fully, it is essential to start by defining what we mean by impact.

The academic evidence on investor impact mechanisms has recently been reviewed in an academic survey paper *Can Sustainable Investing Save the World?*[3] The authors define impact as a change in a specific social or environmental parameter that is caused by an activity. Impact can either be positive or negative.

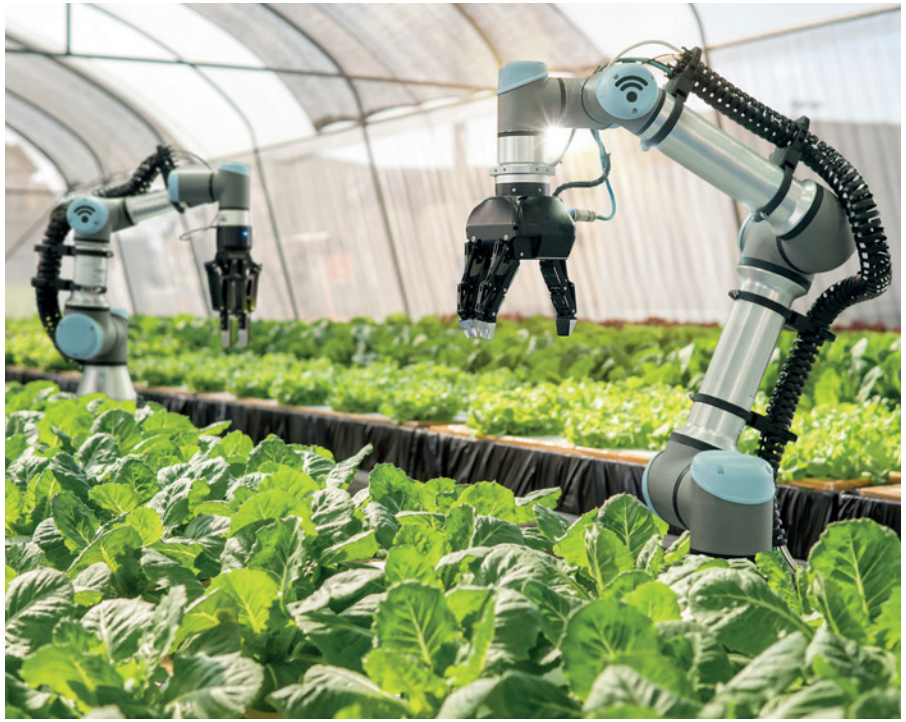
An example of a positive impact is a social enterprise building a new social housing development (the activity), which allows more vulnerable people access to safe accommodation (the change in social parameters). The social enterprise is creating a positive impact.

Assessing impact requires the ability to attribute additionality. This is the contribution to the change in social or environmental parameters. In other words, considering the extent to which this change would have happened anyway without the activity.

Company impact vs investor impact

When thinking about impact, we tend to consider things from a business perspective. Companies have a direct and visible impact on society and the environment in many ways, such as through their emissions, waste and how they treat their employees. Investors may then assume that if they want to make a positive impact, they should invest in companies that take these issues seriously.

Investors can't have an impact on society and the environment in the same way that business can. However, investors can have an impact on the companies they invest in. Investors can create impact by triggering or accelerating change in the companies in which they invest.[3] They can also create impact through investments that increase the quantity or quality of a company's social output beyond what would have occurred without the investment.[4]



Investor contribution strategies to impact

The Impact Management Project, an industry-wide collaboration (of which our Greenbank team was a part) was created to build a global consensus on how to measure, manage and report impacts on sustainability.[5]

During this process, they uncovered four strategies whereby investors can have an impact:

- Signal that impact matters
- Engage actively
- Grow new or undersupplied capital markets
- Provide flexibility on risk-adjusted financial return.

They are considered contribution strategies because investor impact is only likely in large groups or where there is a controlling shareholder or entity that owns enough shares to be able to influence a company. Read on to find out more about each strategy.

CONTRIBUTION STRATEGY 1

SIGNAL THAT IMPACT MATTERS

The first contribution strategy the Impact Management Project suggests is for investors to signal that impact matters. This approach involves investors considering positive and negative company impacts in their investment decisions and communicating their strategy to the investee company and the market at large.[6] This first strategy comprises two parts - capital allocation and advocacy.

The form of capital allocation whereby investors align their investments with their values and choose to invest in sustainable businesses or those with robust ESG practices is often called value-aligned or socially responsible investing.[7] Aligning investments in such a way may have consequences for an investor in terms of returns, diversification and cost. This topic, which we plan to examine separately later in the series, is substantial in itself. Here, we focus on whether this capital allocation decision creates impact.

Positive alignment

A 2022 study found many investors have personal values that affect their investment decisions, which results in sizeable, market-wide fund flows to sustainable investments.[8]

Demand by investors for 'sustainable' companies could encourage 'unsustainable' companies to improve their practices, thereby reducing their negative impact on society and the environment.[9] However, there are substantial caveats to the types and success rates of reforms.

Investors can screen out investments that have poor ESG practices.[3] They can also be transparent about critical ESG standards that they expect companies to meet. If investors focus on specific and transparent ESG practices that also have a low cost of implementation, companies can interpret what is important to investors and improve their practices. When companies receive mixed signals from the market about the ESG actions they value, they may underinvest in ESG improvement.[10]

If enough investors tilt their preference towards 'sustainable' companies, this could decrease their cost of capital and allow them to grow faster. 'Unsustainable' companies' cost of capital would increase, which could slow their growth rate.[9] However, this approach remains theoretical. Tangible effects on the cost of capital from such tilting may simply be too small to have meaningful impact on corporate behaviour. We will explore whether or not an investor can create impact through divestment as capital allocation in a later article.

Stronger together

It is also improbable for individual investors to affect company behaviour.[7] There is a greater likelihood of success when impact is pursued by a large coalition of investors. As well as joining forces with other investors, common ground can be found with consumers, employees, corporate activists and regulators.

This moves us into the role of broader advocacy in signalling that impact matters. This can include engaging with governments to advocate for a supportive policy framework.

If significant numbers of investors coordinate their decisions, they could encourage positive behaviour

If significant numbers of investors coordinate their decisions, they could encourage positive behaviour. For example, companies may increase disclosure on their impact and boards may become emboldened to take impact considerations into account in decision making the more it aligns with their fiduciary duties.

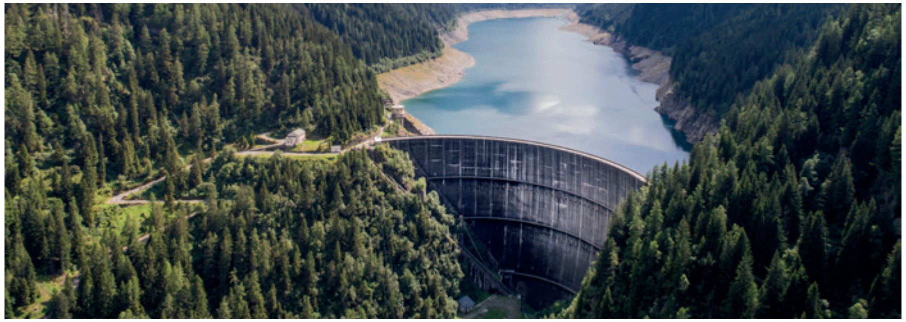
The investment industry may become more transparent about whether company impact is considered part of the investment process. They may also develop more innovative investment products and strategies that take impact into account for certain investment mandates. Cooperation could be a successful approach if investors join together to advocate for change in an aligned and coherent manner.

ENGAGE ACTIVELY

The second strategy from the Impact Management Project that investors can use to make an impact is to engage actively. Engagement is a way to influence, support and advocate to companies to reduce their negative impacts or increase their positive ones. Engagement can either be short term on a single action, such as voting for or against the board or a shareholder resolution, or long term, such as encouraging a company to establish a net zero transition strategy (a plan to balance the amount of greenhouse gas (GHG) that is produced to the amount that is removed) or human rights policy.

A study of investor impact in sustainable investing found that shareholder engagement is the most reliable mechanism for investors seeking impact as it has been the most clearly demonstrated by evidence.[3] Analysis of shareholder engagement studies found that while engagement requests do not always succeed, there is a reasonable probability they will. The acceptance of shareholder engagement proposals can also lead to an increase in ESG ratings by third-party data providers. This means the impact is validated not only by the shareholders that engaged but also by an external agency.

Some types of shareholder engagement are more likely to succeed than others. It seems the likelihood of success declines as the cost to the company of the requested change increases.[3] Furthermore, there are two other factors to affect the likely success of an engagement – investor influence and company level ESG experience. The larger the share in a company an investor holds, the more likely the engagement will succeed. Similarly, if a company has a track record of complying with engagement requests, it is more likely they will comply with others.



GROW NEW OR UNDER–SUPPLIED CAPITAL MARKETS

The third contribution strategy set out by Impact Management Project is to grow new or undersupplied capital markets, which leans towards private forms of capital.[11] Generally, public market companies are not constrained in their ability to access or grow capital.

There is an entire field called 'impact investing' whereby an investor prioritises impact above financial return (while still requiring a return, unlike philanthropy). Such strategies are not suitable for every investor, particularly fiduciaries (such as charity or pension fund trustees) who are focusing on delivering a financial return for their clients or beneficiaries.

A foundational element of this strategy is that impact is created by allocating capital to companies that would have otherwise been constrained in their growth while pursuing competitive or market-beating returns. This is most likely in small and young companies, those with intangible assets or others operating in immature financial markets.[11]

Private markets

As such, this contribution strategy is mostly limited to private equity, private debt and venture capital. For example, a venture capital investor may create impact by providing seed investment in a solar energy start-up in a developing country to generate electricity where access to energy may have otherwise been limited. An investor would not necessarily be able to create impact by investing in a solar energy company on the stock market. However, going back to the concept of additionality, if this is a sound investment with competitive returns, is it likely that there is only one willing investor?

In public markets it is generally not expected that equity transactions will be able to grow new or undersupplied markets. As previously mentioned, the dispersed ownership means it is unlikely that this will significantly alter company behaviour or influence market prices. Moreover, investments available at market rates of return are by definition unlikely to be difficult to fund.

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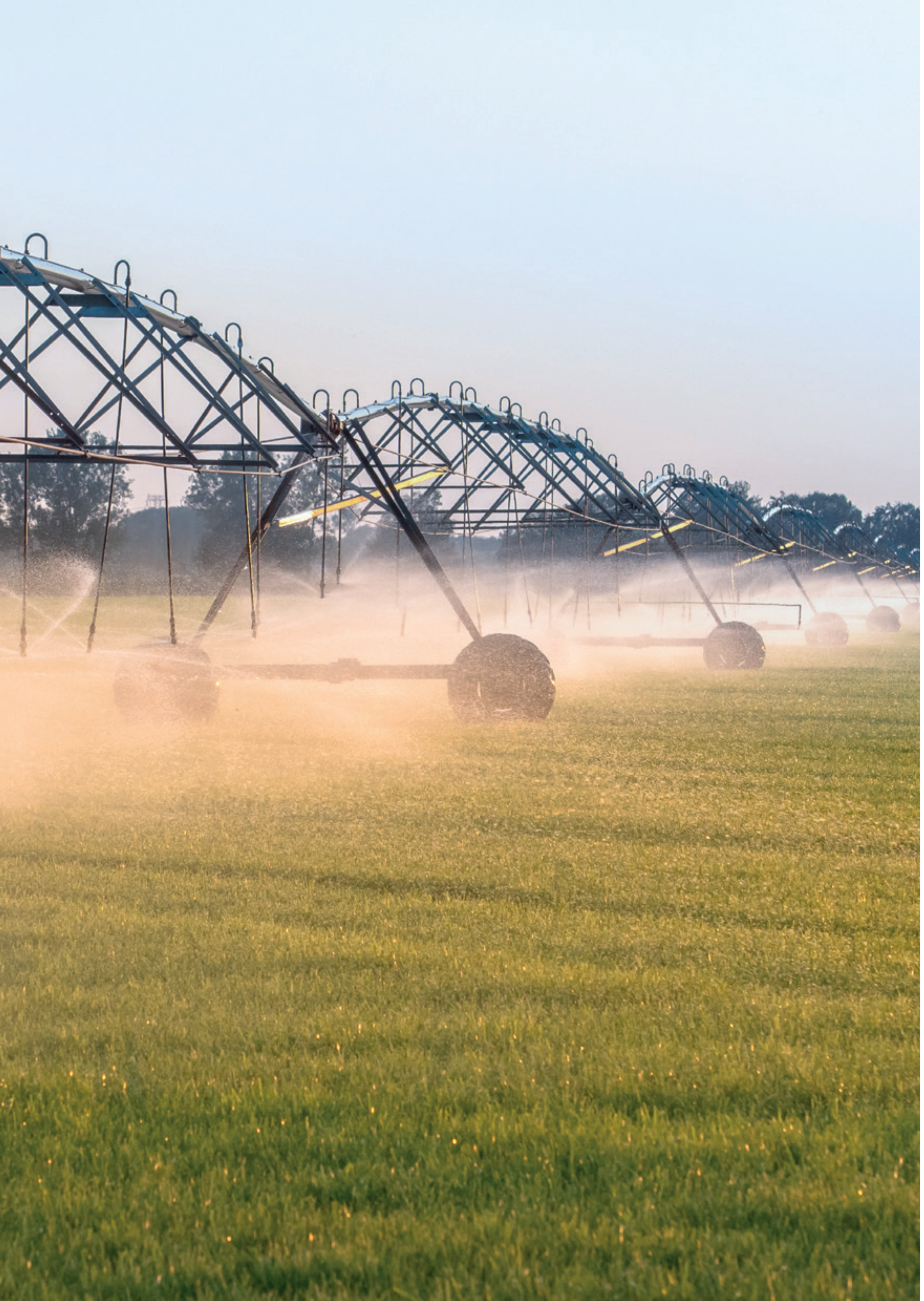

CONTRIBUTION STRATEGY 4

PROVIDE FLEXIBILITY ON RISK–ADJUSTED RETURNS

The final strategy the Impact Management Project suggests is for investors to provide flexibility on risk-adjusted financial returns. This means that investors are willing to accept lower financial return than they would with investments with similar characteristics in order to make a direct impact on society and the environment. This contribution strategy is used in addition to "growing new or undersupplied capital markets". In this instance, an investor would most likely be accepting a financial concession. This contribution strategy most closely aligns to impact investing.

So far, we have explored impact through the lens of whether an investor prioritising returns is still able to make a positive impact through their investments in predominately public markets. In contrast, impact investing is an entirely separate investment strategy from either traditional or responsible investment approaches.

For institutional investors, this would require a clear investment policy that stipulates how their impact objectives align with their fiduciary duties and, in the case of charities, their organisation's objectives. For individuals, this would still require a clear mandate for their investment manager.

This strategy aims to create impact by offering capital to companies that may not otherwise have access on commercial terms. Investors can have a direct effect on a company's output and create impact through this contribution strategy by enabling projects that would otherwise not be funded.[7]

These strategies are well established in development finance and blended finance (which combines public and private investment) and have been demonstrated to attract additional investment that may not have been otherwise available.[3] As with the strategy of growing new and undersupplied capital markets, the ability to provide flexible capital is generally only available in private markets.

Impact investing is an entirely separate investment strategy from either traditional or responsible investment approaches

DR TOM GOSLING: A SECOND OPINION

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There's an old joke about an economics professor and her student walking along the road. The student points and says: "There's a dollar bill on the pavement". The professor responds: "No there isn't – if there were, someone would've picked it up already".

Although designed as a jibe against the dismal science, there's an important lesson for investors wanting to pursue sustainability goals. If your investing activity is to have impact, there must be some reason why the impact you plan to create isn't happening already, and some reason why your investing activity enables it. Without *additionality* there is no *impact*.

Why might impactful actions not be happening already? Here are some of the possible explanations:

They aren't profitable or are too risky. A clean technology predicated on rapid near-term carbon price increases might fall into this category, as might mothballing profitable but high-emission business lines. No amount of engagement with companies will get them to undertake significantly costly activities with poor projected long-term returns. Investors can help here by providing concessionary capital with lower return or higher-risk tolerances. But this comes at a cost to the investor and is normally relevant in venture capital situations rather than public markets. In public markets, the cost of capital impacts of capital allocation decisions are just too weak to correct for environmental or social externalities.

They are inexpensive but are not being focused on. Maybe because they aren't big enough ticket for the company concerned. Addressing methane leaks in the oil and gas sector is one example, where investor engagement could help. Management teams will often prioritise relatively inexpensive requests made by their leading investors.

The policy environment is not supportive, meaning it is unclear whether the activity will become profitable in future. An example is reducing deforestation. Investors can help by advocating with policymakers for clear and consistent long-term policy signals. They can discourage the companies they invest in from undermining the policy making process through their own lobbying activities and encouraging incremental investments in innovation to seek greater profitability in sustainable practices.

There's a resource gap. A renewable energy project in an emerging market could be financed to every party's satisfaction through an appropriate blend of donor, development bank and institutional investor capital. But there may be a lack of knowledge, expertise or simply will to put the project together in the right way, dealing with multiple stakeholders in the process. A committed investor may help bridge that gap.

There's a genuine value opportunity. Maybe you really are the first person to pass the dollar bill after it was dropped. Perhaps you have an insight that others don't have into why the impactful activity is also profitable. Investors can help by actively seeking out long-term value creation opportunities in areas where we need progress, such as low carbon building, agile electricity demand management or sustainable agriculture. Markets are not 100% efficient and investors can help ensure that opportunities as well as risks are correctly priced.

Explaining change

An investor wanting to make an impact needs to be clear on why the activity is not already happening, what unique characteristic they are bringing that now makes it possible, and what extra costs or risks they may be incurring.

They also need a coherent theory of change. How will the direct impact lead to system-wide change? If an investor engages with a bank to reduce fossil fuel lending, will lending simply be recategorised from project finance to general purposes finance or made subject to very weak sustainability targets? If the lending is reduced, will the fossil fuel firm simply get the funds from another bank? If the fossil fuel firm's production is cut will this really result in less burning of fossil fuels, or will a state owned or other private actor take up the slack?

The chain of causality from investor action to company action through to system change is a rusty one with many fragile links. The investor's tools to bring about change in secondary markets investments are quite weak. Wise investors acknowledge this, not as an admission of failure, but out of resolve to focus their actions on where they can be most impactful, while meeting their fiduciary duties to clients and beneficiaries.

This often involves influencing the environment in which sustainable practices can emerge rather than trying to achieve them directly. It also means working with the grain of long-term value creation rather than forcing costly changes on companies. While this sounds less ambitious than bold impact pledges, it may be better to have a modest goal, pursued with dogged determination and effectiveness, than an ambitious one that is met in perception rather than reality.

WHAT NEXT?

For any investor, it's important to start by understanding and articulating their impact objectives. They can do this by integrating impact into their investment strategy. This should form part of setting an overall portfolio strategy. As mentioned, pursuing an impact strategy may affect the overall diversification, cost and potential returns of a portfolio. It's important to be clear about the role each of these play in your portfolio. Watch out for further articles that dive deeper into this topic.

The Global Impact Investing Network (GIIN) has produced guidance for impact in listed equities that proposes investors should start by creating a 'theory of change'. This provides a framework for how an investor expects to manage their portfolio in a way that leads to an intended set of impacts.[12] It can be used to articulate the portfolio's impact goals and how the management of investments could contribute to these.

An investor can leverage their 'theory of change' to develop engagement priorities that could accelerate the company's contributions to the impact objectives of the portfolio

An investor can leverage their 'theory of change' to develop engagement priorities that could accelerate the company's contributions to the impact objectives of the portfolio.[12]

Measuring impact

It's important to know how impact will be measured in relation to your investments. Impact is not a simple concept. There is no single metric or piece of data that can convey impact, although impact measurement is evolving rapidly. Organisations such as the Global Reporting Initiative are supporting best practice impact reporting for companies and the GIIN is developing impact measurement and reporting for investors.

As demand for measuring impact grows, so too should the transparency of impact data and industry norms of impact measurement. Furthermore, as consumer preferences and regulation shifts, company impact could affect risk and return analyses more materially. It will be exciting to see how and to what extent new impact products or strategies are developed in the coming years.

EMPOWERED DECISIONS

The world has witnessed tumultuous events over the last five years. The pace of change has been exhausting for many, leading them to question what role they can play in improving outcomes for society and the environment. More investors have been asking how they can use their investments to make a positive impact.

As we have explored, creating significant positive impacts at the scale and pace needed for the sizeable and pressing challenges the world faces is not simple.

The antidote is knowledge, which is power. The desire for change among investors is there, as we have witnessed through the substantial growth to the sustainable investing market in recent years. Investors now want to know how this can lead to real-world impact.

We've explored the various strategies available to investors to contribute to real-world impact. In public markets, it is nearly impossible for an individual investor to create impact. However, investors can still endeavour to contribute to impact through market signals and active engagement. Scale is key.

Driving change

When it comes to market signals and engagement, company behaviour is not likely to change with pressure from an individual investor. However, large pools of investment, such as those held by institutional investors or investor coalitions, have substantially more sway. Impact is more possible in private markets, with the caveat that it is most likely when an investor may be willing to accept financial concessions.

Unfortunately, these markets are not always available to every investor. However, as demand for impact increases and the investment landscape evolves it will be interesting to see what new investment vehicles become available in the coming years.

At the end of the day, it comes down to what impact an investor is trying to achieve and what, if any, financial sacrifices they are willing to make to achieve it. Most importantly, investors should be informed and feel empowered to use their investments in a way that aligns with both their values and their financial objectives.

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ADDITIONAL INFORMATION

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