MAKING A POSITIVE IMPACT IN LISTED EQUITY

By Victoria Leggett

Impact investing has been growing rapidly, but until recently has been largely confined to private equity. Can the approach be successfully transferred to listed equities?

The aim of impact investing is to generate a positive social and/or environmental impact as well as financial returns. Impact investments exist across a diverse range of asset classes and geographies. Underlying investment candidates should demonstrate a clear 'intentionality' in their business model, and with careful selection, it is more than possible for impact investors to find listed stocks meeting that criterion. Arguably, the inclusion of these more liquid assets will play an essential role in impact investing's evolution. This evolution comes at a critical time. As wealth transfers to the next generation, the idea no longer holds that doing good and investing wisely is mutually exclusive.

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CV

Victoria Leggett joined UBP in 2010 as an Equity portfolio manager and has 15 years of investment experience. She is Head of Responsible Investment for Asset Management. Leggett began her career in corporate finance, before joining Threadneedle in 2004 as an equity analyst and sector specialist. She achieved a 1st class degree from the University of Durham.

However, in the listed space, there is still much confusion about what defines 'impact' and what separates it from other sustainable investment strategies, such as integrating ESG into the investment decision-making process. The aim with ESG integration is to achieve superior risk-adjusted returns by analysing a company's environmental, social and governance factors alongside financial metrics. The basis for this is that non-financial issues often result in financial consequences, both good and bad. Creating a more comprehensive profile of

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a business helps investors to judge where its vulnerabilities and opportunities lie.

Although ESG factors are important in impact investing – in the same way as fundamentals and valuations are – it is not the ESG profile that drives investment decisions. ESG is typically concerned with business operations such as employee welfare, supply-chain transparency and the structure of the board, whereas impact investing is concerned with a company's output. Does the company generate revenue from products/services that help to address the world's environmental and social challenges?

A high ESG score can be achieved in almost any sector. An oil exploration company with rigorous safety mechanisms, robust maintenance capex and strong employee welfare, is less likely to experience oil spills, accidents and the ensuing fines and reparations

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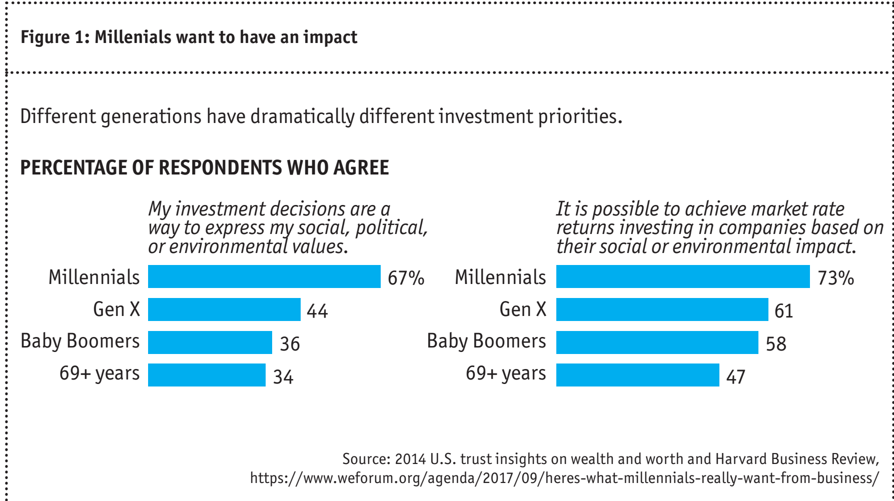

Figure 1: Millenials want to have an impact

Source: 2014 U.S. trust insights on wealth and worth and Harvard Business Review, https://www.weforum.org/agenda/2017/09/heres-what-millennials-really-want-from-business/

(not to mention environmental damage). It would justifiably be ranked 'best in class' from an ESG perspective and is likely to be a superior investment opportunity compared with its peers, due to lower risks and therefore greater certainty in terms of forecasts. However it would be very difficult to define this as a 'positive-impact' company, regardless of its strong ESG credentials, because its revenue is derived from the extraction of fossil fuels.

A cornerstone of impact investing is that non-financial performance is measured alongside financial returns. This allows end-investors to have a much more complete picture of how their holdings are performing. For example, in addition to traditionally reported metrics such as share-price performance, tracking error and the Sharpe ratio, an impact fund should disclose information on certain KPI's that illustrate the degree to which the fund is addressing the UN's SDGs (or comparable goals). Examples include how much CO_2 is avoided, how much clean energy is generated and how many tonnes of materials are recycled.

One area of concern in the impact investment community relates to data comparability and availability. Until reporting requirements are enhanced, many third-party data providers are having to rely heavily on company disclosure. This can result in a combination of estimated and unreliable data. As a result, there are no shortcuts with impact measurement: a bank of relevant and meaningful KPI's can only be built up over time and with engagement.

Engagement refers to communication between suppliers and consumers of capital and can play a critical role in the measurement process. It enables investors to understand – and in some cases shape – corporate strategy. In the case of impact investing in particular, it can also be a useful educational tool.

Engagement can and should be embedded in every stage of the investment process: from the initial investigation of an investment, to the impact measurement of a fund holding. A robust and honest bilateral relationship with a company is the most effective way to gain clarity on the true intentionality of its business. It also provides the necessary encouragement and support for that company to deepen and broaden its measurement and disclosure of non-financial KPI's that are relevant to the investor.

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To further the effectiveness of impact investment and create broader top-down change, engagement should go beyond these bilateral relationships and include collaboration with industry peers, governmental organisations, academics and specialists. Impact investing in the listed space is incredibly promising because of the sheer amount of change it could create. However, with this potential comes risk, and practitioners of impact investing must support each other to create a practical and credible framework. «

- What is impact investing and how does it differ from ESG?
- Impact measurement – show me the data!
- Why does engagement play a critical role?

This article was written by Victoria Leggett, Head of Responsible Investment for Asset Management at Union Bancaire Privée (UBP).

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