OUTCOMES BEYOND PERFORMANCE

SHARPE THINKING

Impact investing: into the public realm

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HERMES INVESTMENT MANAGEMENT

A remarkable transformation is underway in the corporate and investment world: an awareness among businesses and shareholders of the need to create a sustainable and resilient world, combined with a recognition that this can enhance, not detract from, long-term portfolio returns. This is a significant opportunity for change, irrespective of the political forces that often seem to work in opposition to these interests, and is epitomised by the ability of the UN Sustainable Development Goals (SDGs) to capture the imagination of companies and investors.

THE SCOPE OF THE OPPORTUNITY

Andrew Parry, Head of Equities and Impact

The interest in long-term sustainability – for businesses and the planet – is indicative of a sea change in opinion on the role of environmental, social and governance (ESG) considerations in investment approaches. No longer is it a case of portfolio managers arguing why they focus on ESG issues: they must now justify why they do not. For instance, to win an equity mandate from a European asset owner, a fund manager is expected to integrate ESG research into their investment process.

In an environment of modest nominal GDP growth, addressing the unmet needs of society – as represented by the 17 SDGs – is a substantial part of the beta of future demand and represents growth that is largely independent of unconventional monetary policy. The investment industry is in a unique position to influence the debate, given the scale of the assets it manages and its broad exposure to the global economy.

The concept of ESG-aware investing is now well understood, though it is delivered in varying forms. The investment industry, however, seems keen to go one step further and embrace impact investing, an approach well established in the philanthropic, family office, non-government organisation and social enterprise world, but less understood in the mainstream.

The Global Impact Investing Network provides the following definition: "Impact investments are investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return." Existing social investors understand this concept well, but they also operate in a world where social returns generally rank higher than financial ones. In this issue of *Sharpe Thinking*, we ask: how readily can the impact philosophy be applied in public-equity strategies?

Impact investing is long-term in nature and focused on companies developing new capabilities that meet specific needs of society in a mission-led manner. It goes beyond best-in-class ESG practices or a well-developed corporate social responsibility programme, requiring investors to identify companies that are mission-led and which have a clear approach for delivering additional and measurable societal benefits that will endure over time. The three key concepts that traditional impact investing brings to the public domain are: intentionality, the intention of an investor to exert a positive social or environmental impact; additionality, fulfilling a good cause beyond the provision of private capital; and measurement, being accountable and transparent in reporting on the financial, social and environmental performance of investments. Implementing these concepts is challenging enough in private markets, but is even more onerous in public markets.

These ideas should not be allowed to fall into the too-hard basket, as they can bring significant benefits to the way traditional investors go about their business. Long-term thinking, and understanding and measuring the impacts – positive and negative – that all businesses have on society and the environment, are important aspects of investment success. This reflects the complex, interrelated nature of the ecosystem in which we operate as investors and our responsibility for sustaining that system for future generations.

Impactful: the UN sustainable development goals

STRENGTHENING THE PURPOSE OF CAPITAL MARKETS

The concept of additionality, often seen as too idealistic for mainstream investors, is worth exploring, as it zeroes in on the purpose of capital markets. The accusations of short-termism and over-intermediation levelled at the investment industry reflect the loss of a connection between capital and its commercial and societal purpose. Through additionality, impact investing can help restore that bond.

Investors can encourage and support companies to invest incremental capital, funded by shareholders if required, in long-term sustainable opportunities that address unmet societal needs in innovative ways. In doing so, these endeavours should have the potential to deliver attractive returns for all stakeholders. This is a lofty ambition, and is why impact investing in public markets should go beyond ESG investing and focus on a concentrated portfolio of purposeful companies demonstrating a commitment to long-term sustainable returns that bring real societal benefits.

Such companies will not only have a clear mission, but should also embody strong cultural values that embrace diversity and employee development, environmental awareness, and ensure that their mission is enforced repeatedly throughout their supply chains. These are features that are increasingly recognised as hallmarks of successful and resilient businesses. As such, additionality should underwrite behaviours that establish a holistic and long-term perspective that perceives short-term maximisation of profits as failure. The true goal of additionality is to encourage prosperity across society rather than create pockets of isolated wealth.

ENGAGING FOR IMPACT

One of the most powerful forces in investment is the compounding of returns. It is why sustainability is the ultimate objective of business and forms the core of long-term value-creation processes within companies. Reporting and measuring on impacts achieved is essential to fostering strong relationships between companies and their investors. Active and collaborative corporate engagement, therefore, is an essential part of the approach and results in better alignment between all stakeholders in a business and encourages investors to take a truly long-term perspective.

Passive investors can also embrace this approach: through engagement and intelligent voting across their portfolios, they can help reduce negative behaviours and reward positive actions for the long-term benefit of society. Indeed, it can be argued that constructive corporate engagement that is aligned with the UN SDGs allows all investors to be impact investors.

Traditional equity strategies cannot put societal returns ahead of financial ones, as clients will not tolerate sub-par returns from listed equities or bonds. Impact investors, therefore, need to demonstrate that they remain first and foremost good investors who see the long-term financial benefits from investing in impactful businesses, and allocate capital accordingly.

Creating investment themes linked to the detailed sub-goals of the SDGs, of which there are 169, illustrates the breadth of opportunity that impact investing represents. Access to clean water, sanitation and pollution management, food and energy security, urbanisation and climate change, preservation of biodiversity, improvement of healthcare and education, financial inclusion, promotion of a living wage and quality jobs, cyber security – and there are more – represent enormous opportunities, as well as challenges.

PROMOTING LONG-TERM VALUE CREATION

Short-term thinking is compromising the decisions made by investors and companies. An excessive focus on quarterly profit maximisation undermines the long-term health of the economy, the socio-ecological system it operates within, and also the long-term performance of companies themselves. Investing for the long term requires a shift in perspective to include seven major considerations.

Maxime Le Floch
Impact Analyst

1 A VIABLE ECONOMIC MODEL WITH A PURPOSE

Companies that are likely to be more successful in the long term are those providing innovative products or solutions to society's unmet needs. Their focus on a wider corporate purpose, rather than simply generating more profit, creates a competitive advantage over the longer term as it is connected with enduring needs.

2 INVESTMENT IN PHYSICAL AND HUMAN CAPITAL FOR FUTURE GROWTH

Sustainably run companies should invest in growing their businesses organically rather than relent to pressure to boost short-term shareholder returns and seek excessive M&A activity. They should invest not only in their physical assets, but also in their intellectual capital through research and development, and aim to attract and retain talent by fostering their skills in addition to pay.

Keeping track of how investments in human and physical capital and R&D compare with the amount of cash used to boost shareholder returns and make acquisitions is, therefore, a good measure of how much the company focuses on its future growth.

3 GENERATING REAL ECONOMIC RETURNS

In the short term, companies can appease markets with returns below the cost of capital, and boost stock returns with dividends and share buybacks that are not covered by free cash flow. This is what businesses in structurally challenged sectors, such as oil and gas, typically do. Over the long term, however, the rules of good capital management dictate the need for strong positive returns and free cash flows.

The amount of economic value that a company creates is an obvious, classical indicator of real returns. Determining whether a company's free cash flow can cover dividends and share buybacks is also a good measure of whether it can sustain the way it rewards shareholders through cash flow generation or by increasing leverage.

4 FAIR AND BALANCED DISTRIBUTION OF VALUE CREATED

To promote inclusive growth, companies should seek a healthy balance between the value created by shareholders, management and employees. Fairness is a relative concept, but investors' default assumption of an ever-higher share of the value given to capital is not sustainable. This is illustrated by consistently rising shareholder remuneration, in the form of dividends and share buybacks, compared to employee remuneration. This helps us understand how the value that a company creates is allocated between capital and labour over time. Internal measures of fairness are also useful, such as comparing CEO compensation to employee pay.

5 EXECUTIVE COMMITMENT TO A LONG-TERM VISION

Sustainable companies should be run by management teams with a long-term commitment and strategic vision, reflected in longer-than-average tenures and a compensation structure that is simple, involves low leverage and is aligned with long-term economic performance. They should also be tested. For instance, the change in total compensation relative to the economic value added over a long period could be one measure. Another useful concept is the wealth-at-risk held by the CEO, which could take the form of a significant amount of shares and could help create alignment with shareholders.

6 EARNINGS QUALITY REFLECTING TRUE PERFORMANCE

Sustainable companies generate earnings through cash flows that are reported upon transparently. They are not distorted by accounting methods, including aggressive revenue recognition or shifting items off the balance sheet. These manipulations have no positive effect over the long term, and to the contrary can sometimes damage the company's prospects.

7 COMMITMENT TO GOOD GOVERNANCE AND OPERATING SUSTAINABILITY

Finally, long-term corporate success also involves taking a more holistic view. Companies need to change decision-making processes in order to develop a long-term strategic vision underpinned by good governance and sustainable operations. In addition to corporate earnings, investors need to thoroughly assess ESG performance.

UNDERSTANDING AND MEASURING IMPACTS BY LISTED COMPANIES

Maxine Wille, Engagement Specialist – Hermes EOS

The demands of 21st-century consumers that companies act to preserve the environment and combat social problems mean they must work harder than ever before for their licence to operate. The SDGs, linked to the most daunting sustainability challenges that humanity faces, keenly illustrate these pressures on businesses. In an increasingly strained world, how companies manage their impacts should be integral to how they manage risk, stakeholder relationships and, ultimately, how they make strategic decisions.

Admittedly, assessing a company's impact is difficult. Investors struggle to find relevant data, as very few businesses meaningfully report on these outcomes. In a perfect world, impact measurement would capture the systemic change that companies create through their activities. For example, a bank could measure how its business and mortgage loans contribute to a higher standard of living for the communities in which it operates. This example shows how it is tricky to disentangle a company's impact from numerous other variables. But it would be wrong to dismiss impact measurement as a Sisyphean task.

Crucially, the SDGs provide a universal framework through which investors and companies can start thinking about their impacts. Several initiatives – like the SDG Compass, which helps corporations align their activities with and measure their contributions to the goals – have been launched. However, impact measurement should not be practised through a one-size-fits-all approach. Companies need to focus on their most material net impacts, positive and negative. After determining what these are, they should commit to tangible long-term impact targets.

For investors, focusing on impact offers a good opportunity to reflect on how the sustainability performance of a business can be measured. The rapidly growing availability of ESG data has enabled investors to make more holistic assessments of how companies create value. But for all their benefits, ESG data are criticised for not capturing on-the-ground sustainability performance. There are numerous examples of companies which are awarded high ESG scores while their actual, real-world impacts are net negative. Tesla, a company that has sustainability written all over it, has a significantly lower ESG rating than Total, the French oil and gas company, according to ESG researcher Sustainalytics.

Investors should therefore be wary of repurposing high ESG scores as evidence of impact. If they did, it could result in 'impact-washing', which is already an unfortunate by-product of the growing interest in impact investing. Instead, investors should recognise that the vast majority of existing ESG data simply do not accurately capture the impacts of companies.

Through engagement and active ownership, investors can actively encourage companies to measure impact and report meaningful data. Over a longer time period, this could spur a move away from a tick-box approach to ESG integration and result in more holistic company valuations, which better capture the social and environmental performance of companies.

INITIATING IMPACT

The growth of interest in impact investing, for which the SDGs have provided instrumental impetus, now needs to be followed by decisive action. However, the SDG targets cannot be met by governments alone. Efforts by all actors in the financial and business world, including companies and investors, need to be better aligned to increase the understanding, measurement and management of impacts.

HERMES INVESTMENT MANAGEMENT

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We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

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