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CAN IMPACT INVESTING MAKE AN IMPACT?

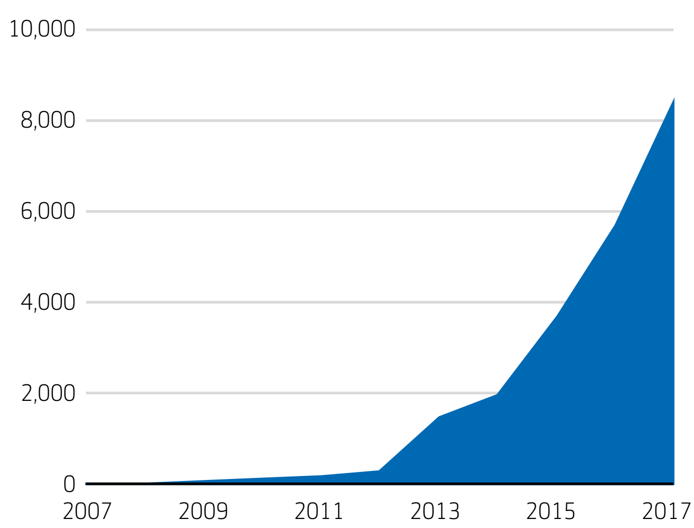
By Brunno Maradei, CFA, Global Head of Responsible Investment

The responsible investment industry has become infatuated with impact. This new buzzword is appearing everywhere in the investment industry. As investors are focusing on risks and opportunities, many are also searching for purpose, meaning, outcomes and real-world results. We spoke with Brunno Maradei, CFA, Global Head of Responsible Investment, to learn more about impact investing.

Before we dive in, what is impact investing?

Impact investing is founded on the notion that investors can pursue financial returns alongside positive and measurable social and environmental effects. In other words, investors can possibly "do well" and "do good" by pursuing dual objectives of financial returns and impact. While impact investing is respectable if done properly, this segment is prone to greenwashing concerns as well as subpar measurement and reporting techniques, leaving many investors wondering if they are truly able to change the world through their investments.

Exhibit 1: News articles containing "Impact Investing" 2007-2017



Source: Global Impact Investing Network

What do you make of the shift to impact investing?

I find the industry's pivot to impact investment encouraging, but not without challenges. It reminds me of my time at the European Commission's development department, working on a common framework for measuring development impact for concessional finance. At the time, only European development finance institutions were eligible to access these cheap financing envelopes. Yet even among these specialist institutions, consensus on the impact framework was gruelling to achieve over two years. Similarly, at veteran impact investment institutions International Finance Corporation (IFC) and European Investment Bank (EIB), there was much anxiety about demonstrating and measuring impact. Further, the topic of "additionality," or the specific value-add of the investment in contributing to impact, would routinely fuel fiery debates around questions like, "Would this project have happened without us?" This anxiety about measuring and demonstrating impact seems to be largely absent among the growing body of impact investors in the private sector.

Is impact investing just a marketing ploy or fad?

My cynical alter ego would argue that the new impact trend is just about obfuscation and an attempt to differentiate in an increasingly crowded ESG investing space. Witnessing investors get ever savvier about sustainable or green investment while regulators work toward standards and data improves, some asset managers might be looking for frontier terrain, where they might differentiate by claiming positive impact without worrying too much about evidence to back up their claims. I have read many "impact" reports that demonstrate no real measurable impact; sometimes they are merely last year's responsible investment (RI) or sustainability report simply relabelled with the new buzzword.

My optimist self, however, believes there is real, measurable value in impact investing. I joined the development finance world in 2007 partly because I worried about how little impact the responsible investment industry could achieve in the real world. I am encouraged to see the industry now refocus on quantifying and demonstrating its contribution to a more sustainable future. It is not an easy task; the first step is to conceptually recognize both the potential impact of our industry and its limits.

Responsible investors cannot change the world alone, but their impact can be significant.

Can responsible investment practices accelerate positive change?

Critics have long questioned the ability of RI practices to modify company behavior. In its infancy, RI practices grew largely out of boycott movements that, until the late 1980s, were considered fringe protest activities. Then came the anti-apartheid movement, where capital flight due to investor boycotts is acknowledged to have played a significant role in pressuring the South African government to change.

Numerous divestment campaigns have tried to emulate this success, on topics such as Darfur, occupied territories, tobacco, and most recently coal. As capital markets have grown and become ever more global, however, the tipping point for divestment campaigns to achieve real impact on cost of capital has arguably become ever harder to reach. As some investors divest, others are willing to take the risk, thereby negating any real financial impact on the issuers targeted. For example, so-called sin funds are funds set up to profit directly from the under-pricing of tobacco and other "sin" stocks due to their systematic exclusion from institutional investor portfolios.

Nevertheless, in the case of tobacco, more investors are excluding than actively investing in tobacco stocks, and this has resulted in a persistent and measurable impact on relative cost of equity. But divestment has not achieved the desired outcome even with a clear cost of capital impact – tobacco firms continue to exist, be profitable and finance themselves successfully. Sure, smoking rates are declining worldwide, but can that be attributed to investors? This result is more likely due to public health campaigns and advertising restrictions. In the absence of global regulation to materialize the ESG issue at stake such as global restrictions on tobacco products or a global carbon tax, divestment campaigns may not achieve their intended outcomes.

More achievable objectives, such as modifying certain operational practices, certifying supply chains, or pulling out of marginal but controversial businesses, could be attained through a divestment approach, although not necessarily by impacting cost of capital. A cost of capital impact may not strictly be necessary to influence corporate behavior—the mere risk of such an impact might be sufficient to influence behavior.

Hasn't the responsible investment industry moved beyond exclusionary approaches?

That's right, we have, and I am much more positive about the potential impact of engagement, and encouraged by the depth, breadth and quantity of investor engagement initiatives we have seen in the last decade. We have Institutional Investors Group on Climate Change (IIGCC), Principles for Responsible Investment (PRI), ShareAction and numerous other organizations to thank for this, as well as some leading asset owners who invested in establishing productive dialogues. An engagement approach with a credible escalation to divestment has a much higher impact potential than negative screening, but this depends on the issue at stake. Convincing state-owned Chinese oil firms to pull out of countries where we see systemic human rights breaches is very unlikely and may best be dealt with through divestment for those investors who do not want to be involved in such practices. Encouraging a large oil company to get serious about its climate transition strategy is a more realistic objective where divestment would likely be counterproductive, and engagement could have tangible impact.

It seems impact measurement and reporting are key. Can we report on the impact of engagement?

Unfortunately, measuring the impact of investor engagement can be even more challenging than estimating the cost of capital effects of an exclusionary approach. For a start, reporting on engagement activity is highly diverse in quantity and quality. Many conversations happen behind closed doors. Different jurisdictions impose different rules on how and what investors can talk to companies about. Companies in emerging markets have limited capacity and obligation to engage. Most engagement is still led by shareholders, but public equity markets represent only a limited proportion of economic activity, particularly when you exclude state-controlled companies. Engagement on ESG topics led by bondholders remains less systematic, and in the case of sovereign issuers, almost non-existent despite some of the key ESG challenges remaining firmly in the hands of the public sector, particularly in developing countries.

A carefully managed, targeted engagement approach can undoubtedly have a positive impact, even if this remains hard to quantify and attribute. Corporate management is increasingly aware that engaged investors are more willing to call their bluffs, to vote with their feet, or divest. The growth of collaborative engagement has helped present a united front to large issuers that historically worried about balancing different shareholders' priorities.

> The impact of positive screening on real world outcomes is likely marginal, but many marginal decisions in the right direction can add up to great impact over time.

Can positive screening drive real impact?

Academic evidence of the impact of such strategies is harder to come by, probably due to the much smaller volume of assets pursuing such strategies. However, there are investments favored by an increasing number of investors due to their real or perceived positive impact on society or the environment, often outside of ESG or impact-labelled portfolios. Renewable energy is one example. There are nascent signs that such investments are receiving relatively more favorable financing terms than comparators, such as tighter spreads on green bonds. Every little bit helps, but financing costs are often only a small piece of the puzzle in the investment decision. Advances in renewable energy cost reductions, for example, are far more attributable to lower costs of technologies involved than to lower financing costs. The impact of positive screening on real world outcomes is likely marginal, but many marginal decisions in the right direction can add up to great impact over time.

What does this mean for investors pursuing real impact?

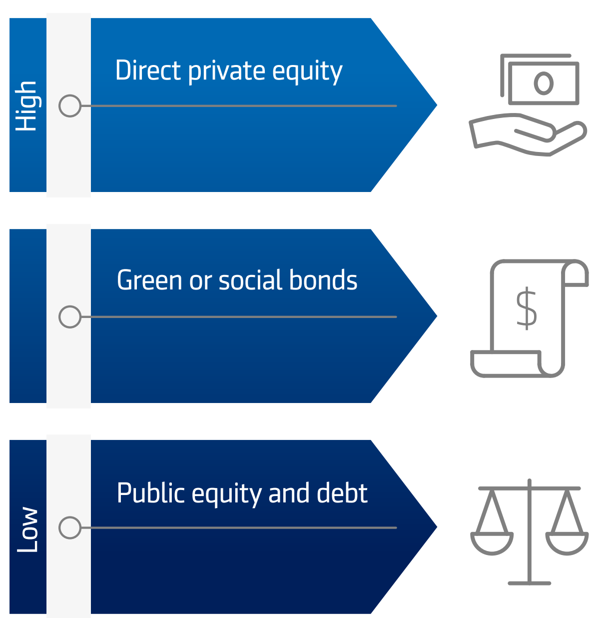
The key to impact investing, in our view, is reasonable expectations. Impact investing is an exciting field, and investors can indeed have a significant positive impact on the key global sustainability challenges. But don't expect silver bullets and be wary of overly positive reporting.

We view impact investing on a continuous scale of potentiality and certainty. At one end of the spectrum, we can place direct private equity and debt investments. These provide close to full confidence on the use of proceeds; impact metrics and reporting can be agreed upfront as part of investment agreements. Impact reports from development finance institutions demonstrate what good impact measurement and reporting should look like. Good examples are DEG, which developed its own Development Effectiveness Rating and closer to the private sector, Actis.

Further down the spectrum, consider green and social bonds with clear use of proceeds and reporting requirements. Best practice here is defined by the veterans of the industry—IFC's impact reports for its green and social bonds and EIB's disclosure of granular project-level impact data for its Climate Awareness Bonds.

At the other end of the spectrum, we might place investments made through public markets using negative or positive screening approaches, where the contribution towards real impact is more marginal, less certain, measurable and attributable, but can nevertheless make a positive contribution over time as they reach scale. Impact at this end of the spectrum is harder to trace and measure, and we therefore see impact reporting for this kind of impact investing as still experimental, but nevertheless potentially interesting.

Confidence Level: Impact and Use of Proceeds



For illustrative purposes only.

Engagement is critical to boost the impact of such approaches, particularly since cost of capital effects are hard to achieve through pure negative or positive screening approaches in global capital markets. Differentiation between primary and secondary markets, refinancing versus new investments, and supply chain positions can all contribute to the likelihood an investment may have on the intended positive impact, as does the quality of engagement.

How do you approach impact investing at Aegon Asset Management?

At Aegon AM, we recognize that all investments have impact, and we embrace a pragmatic approach to impact investing. We firmly believe impact investors can generate meaningful environmental and social impact without forgoing competitive financial results. The key is to develop realistic expectations within the context of available data and industry standards. Through close collaboration with the client, we aim to better understand their objectives and develop tailored reporting.

Looking ahead, we expect the conversation may continue to shift from "returns" to "impact" as investors increasingly aspire to use their capital to effect measurable positive change. Additionally, we expect companies will place a greater importance on serving the needs of various stakeholders—customers, employees, shareholders, suppliers, and local communities—as they strive to go beyond delivering financial returns to shareholders. But the question remains—can responsible investors change the world? Not alone, but they can have a tremendous impact.

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