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insights

LISTED IMPACT

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chicken before egg

Aline Reichenberg Gustafsson, CFA
Editor-in-Chief
NordSIP

Chicken or egg, what came first? In my experience, when you are hungry, the question is kind of irrelevant. You just want to know what will be on the menu.

When it comes to listed impact, the questions are often similarly philosophical while the answers are simultaneously obvious to some and ambiguous to others.

Let's start with the basics. Is listed impact as good as unlisted impact? Well, yes, of course, or it depends: what is it we want to achieve with impact? What is 'good'?

Ok then, let's get more technical: is there additionality in listed impact? Well, is there additionality in unlisted impact? How do we measure it?

Ok, let's try another direction: Is Article 9 beneficial to listed impact funds? That question typically unleashes a whole new set of arguments. Some welcome the question, while some try to get away by praising the regulator's efforts.

So, one sunny day of August, we assembled five specialists around a delicious menu (of neither eggs nor chicken) and let the discussion run. From beta exposure to transition investments, from the sustainable development goals to engagement, the time flew, and all had fun.

In short, skeptics can say what they want, there are some managers out there who do what they believe in: invest in listed companies profitably, with a long-term horizon and a purpose beyond financial returns.

Increasingly, investors are also looking for these opportunities to do well by doing good. As confusing as they may be, regulatory labels do seem to make it easier for listed impact funds to explain what they are. It is not to say that all funds are born equal, far from it. Impact washing is a new station in the green laundry which is getting quite busy these days. So, do not put all your eggs in the same basket and don't be a chicken: read on and find out from these committed investors how listed impact is far from second best, after all.

who is who?

Martin Todd, CFA
Portfolio Manager, Sustainable Global Equities, Impact Opportunities
Federated Hermes

Martin Todd, CFA joined as a senior analyst on the European Equities team in March 2013 and is now lead portfolio manager of the Sustainable Global Equity strategy, and co-portfolio manager of the Impact Opportunities strategy.

Prior to joining, he was an investment director at Scottish Widows Investment Partnership. Martin joined SWIP as a graduate and spent eight years there, with spells investing in UK, US and Japanese equities. Martin graduated from the University of St Andrews with an MA in Economics & Modern History and is a CFA charterholder.

Mathilda Herlin
ESG Analyst
Söderberg & Partners

Mathilda Herlin joined Söderberg & Partners as ESG Analyst in October 2021 where she works together with the team in charge of sustainability analysis of investment products.

Prior to working for Söderberg & Partners, Mathilda spent three years at SEB in Stockholm, and previously held various positions at Apple, Sandell Asset Management and Corsair Pacific Capital in New York.

Mathilda graduated Magna Cum Laude with a B.A. in Financial Economics at Columbia University (New York).

Philip Mitchell
Senior Sustainability Advisor
Formue

Since April 2022, Philip Mitchell has worked as Senior Sustainability Advisor for Norwegian- headquartered wealth manager Formue which consolidated its presence to Sweden earlier this year by integrating local subsidiary Burenstam & Partners.

Prior to joining Formue, Philip was a fund manager at Swedish pension fund AP1 before submerging himself in environmentally- related finance from January 2020, working for Carbon Intelligence, Bankers without Boundaries and as an independent consultant.

Philip previously held various positions at Citigroup, Nomura, Lehman Bros. JP Morgan and Schroders in London. He holds a BA in Economics from Durham University.

Seb Beloe
Partner, Head of Research
WHEB Asset Management

Seb Beloe heads the Research team at WHEB Asset Management since 2012. He leads on the identification and characterisation of sustainability investment themes and the integration of ESG issues into investment research.

Before working at WHEB, Seb joined Henderson Global Investors as Head of SRI Research after 7 years at global think tank and advisory firm SustainAbility.

Seb holds a MSc in Environmental Technology from Imperial College London and a BSc in Environmental Science from the University of East Anglia.

Tim Crockford
Senior Fund Manager, Head of Equity Impact Solutions
Regnan

Tim Crockford leads the Regnan Global Impact team which he joined at the beginning of 2020. He previously spent ten years at Hermes Investment Management, where he became lead portfolio manager of the Hermes Europe ex-UK Equity Fund in 2015 and formed the Impact team in August 2016, which launched the Hermes Impact Opportunities Fund in December 2017.

Prior to joining Hermes, Tim worked at Execution Limited and then joined Sourcecap. He graduated from the University of Malta in 2006 with a Bachelor of Accountancy (Hons) degree, as well as a Bachelor of Commerce degree.

From left to right: Martin Todd, Luke Bridges, Aline Reichenberg Gustafsson, Tim Crockford, Magnus Kristensen, Mathilda Herlin, Seb Beloe, Fanny Ruighaver, Philip Mitchell, Olivia Mahr

Listed Impact

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The coming of age of listed impact

Achieving positive societal or environmental impact alongside a healthy financial return has long been the Holy Grail of sustainable investing. Having enough power and influence to significantly change companies' business models or strategies for the better is something private markets investors can consider, thanks to majority ownership stakes and direct oversight of management. This has led to a growth of impact investing in the private space, where the setting of defined outcomes, or intentionality is genuinely feasible, and where direct positive impact, or additionality can be accurately measured and reported.

However, private markets investing is a specialist area, and offers limited scalability at a time when huge volumes of institutional capital are needed to face up to the urgent global sustainability challenges we face. How then to address impact within public markets? Partly thanks to a loose definition of the term, a growing number of listed impact strategies have been launched in the last few years. In some cases, liberal use of the impact label has given rise to accusations of greenwashing, although regulatory bodies are seeking to nip this trend in the bud by setting clearer guidelines and reporting frameworks. Is listed impact coming of age to become a credible conduit for sustainable investors?

The birth of a new *strategy class*

For **Tim Crockford**, the last three years have seen the term impact gain more traction and understanding in the public eye: "I believe the strategy class - I'm hesitant to call it an asset class - has broadened out to reach and catch the eye of the end retail investor. I think that listed equity is a great platform to allow them to do better with their capital." This comes with its own set of difficulties, Crockford continues: "As more and more people have moved into this listed equity space, the challenge that has emerged is that there is no one definition of impact. As the industry grows the real challenge, three years down the line, is how do you strike that balance of setting the bar high enough that impact investing is actually generating the intended impact without making it an exclusive, unscalable club. Because ultimately, we all want more capital to move into this space."

The growing attraction of the word

Public perception is indeed evolving rapidly, agrees **Seb Beloe**. "The language has evolved a long way. When we started at WHEB back in 2012, sustainability was a word that marked you out as being a little bit strange, certainly a bit of a niche. In the 10 years since then, sustainability has become a word that everybody wants to attach to their new fund launch, so in a way the power of that word has been diminished, because not everybody is actually investing in a way which is consistent with sustainability. We need to be very careful as a community and make sure that we develop standards that define more clearly what is expected if you call yourself an impact investor. Otherwise, the same thing will happen with the word impact. It will become a very attractive word to use in your marketing, but if we don't have standards around what it should mean in practice, then it will be diminished over time as well."

"We need to be very careful as a community and make sure that we develop standards that define more clearly what is expected if you call yourself an impact investor."

The fundamentals of impact investing

For **Martin Todd,** it is important to look at the right parameters when analysing potential impact investments. "I don't think it has been quite as distorted as the ESG acronym has been, or maybe sustainable investing, in that people see a million different definitions of that. I think impact investing, while still a nascent concept is still a bit clearer in people's eyes. When identifying companies that we think are impactful, we look at the balance between the positive impact and some of the negatives. It's a trade-off, or net benefit, so we need to consider that. We also need to consider the additionality, the extent to which this company is creating impact that might not otherwise have been achieved." For **Todd,** it is crucial to have a deep understanding of each company's business. "The intentionality and materiality within that business, how core is it? To what extent are they investing to grow that impact? These are the kind of parameters that we are thinking about for each company to stay true to impact investing. Otherwise, there is a greater risk that it goes the way of ESG, and you get more cynical use of the term impact."

The scarcity of authentic managers

The spectre of greenwashing – or more specifically impact washing is never far away. **Philip Mitchell** has been researching the fund market and has uncovered some surprising results. "I looked into a list of 360 Article 9 equity funds, and while I admit I didn't go through every single one with a fine-tooth comb, I only found about 10 or 11 that I would say are really driving an active, impact strategy and not just having Apple, Amazon, Tesla, etc. as their biggest holdings. This was a real shock to me, but even quite a few that had impact in their title were basically an index proxy."

The price of impact

Impact investing and beta exposure

When designing a strategy, asset managers may be tempted to stride away from their initial impact goals to satisfy demand from their investors which often orient their choice along the traditional criteria, including their desired level of beta exposure. For **Mathilda Herlin,** setting the dial right in terms of market beta versus sustainability goals should be up to the client. "When we recommend funds to clients and speak to advisors, I wouldn't say we primarily have an impact focus," she says**.** "It is more about integrating sustainability along risk and return considerations according to the client's preferences. In cases where clients want to put sustainability first and are willing to be exposed to eventual concentration risks, we will take that into consideration in the advisory process."

Beta does come into it to a degree, according to **Crockford**, but with significant differentiation. In his view, if you are doing it properly "you are not going to put your money in a bunch of FAANG stocks, which is perhaps where most of the global equity beta is concentrated. Ultimately there are going to be different factor exposures. It should be smaller cap, almost by definition, and therefore our clients find it fits nicely within their broader asset allocation. But you have to make that clear, it isn't for people who have a very low risk tolerance or who want income, as these are growth businesses. I think more and more people understand that now than they did three years ago, certainly."

Can we really do well by doing good?

The pioneers of the investment style have always promoted the rationale of doing well while doing good while for traditional investors, the appeal of impact tends to bring up a fear of missing out on returns. Within the marketplace, even impact investors sometimes admit that they encounter trade-offs. However, there impact and returns do not present a trade-off for **Seb Beloe** who firmly believes that recurring question displays "a lack of understanding of what it's really about."

"When we talk about delivering better returns through impact, it's because the companies are delivering impact, which makes them attractive investments. I think the quote about doing well ***while*** doing good is a misquote. It's doing well ***by*** doing good. You're doing well because the product that you're selling has a positive impact, and that's why it's attractive in the market. That's why it's growing. So, it's not seeing these two things as in balance or separate. You get one through doing the other, so there isn't a tension there at all."

Putting performance in perspective

Nevertheless, the recent poor performance of impact strategies has made some investors question the wisdom of investing in these types of products. As long as people properly understand the characteristics of these strategies, explains **Crockford**, they should be happy to ride the typical ups and downs. "These are long duration investments, typically in smaller companies. Both of those factors mean these types of investments generally tend to struggle when financial conditions tighten. If you think about risk purely in traditional relative terms, then yes, they perhaps are higher risk investments perhaps. However, in terms of capital preservation, when things get bad I would argue that actually it's much less risky to put your money in businesses that are part of the new economy and the new economic system that we're building rather than hanging with threads onto the old world that we don't need."

Meeting the anti-ESG movement

Alongside the performance headwinds there are growing pockets of resistance to the whole concept of sustainable investing, for instance in certain US states. **Todd** believes the economic arguments is strong enough to resist this. "One of the effects of higher energy prices is that it should stimulate investment in innovation, in decarbonising technologies and building capacity in renewable energy. So I think some of the trends that we're seeing now in what is a difficult performance environment for impact funds, could nonetheless accelerate the medium to long-term growth opportunity for a lot of these companies and themes that we're investing in."

Todd also believes impact investors must learn to ride out the short-term blips: "This year time horizons have really shortened, given the volatility. I think one of the things that we're very clear about with all our clients is that impact funds are a long-term investment and that we're very confident in delivering good returns on that time scale. It would be very dangerous to look at year to date performance and extrapolate that too much. Let's not forget as well that most impact funds performed very strongly in 2020."

Herlin's clients represent the full range of views on sustainability, including devotees and those with no interest. This requires a dialogue aimed at educating them not only about the positive impact of sustainability integration, but also about the risks of a business-as-usual approach. "We try to be as objective as possible. Despite some hurdles, the market is still heading that way. In the long run, you want to be invested in the new economy, and it's almost riskier not to follow that trend because you are exposed to transition and regulatory risks. Whether you take an impact focus or a more risk mitigation approach, it is a challenge clients must face." It remains a difficult subject to get across in the retail space, she adds, explaining that "Getting the trust from clients is hard when balancing the complexity of financial regulations and different investment strategies and explaining it all in a straightforward manner. I think it's important to develop a common way of communicating in really simple language within the industry to gain the support from retail clients."

Luke Bridges points out that there will always be pockets of resistance to sustainability. "There was an interesting survey done on attitudes to electric cars in the UK recently. Roughly 20% of people said they will never buy an electric vehicle, despite electric vehicle owners being quite evangelical about them, because they drive so well. Even committed 'petrol heads' find them a better experience. But there are some people who just said no. I don't think we should design our products and our marketing interactions around that laggard sector, because it is actually only 20%, and you've got the other 80% to focus on."

The positives of deflating the hype

Crockford believes the recent performance hit could be beneficial to the impact sector in terms of dampening down the hype. "There was a bit of a wave that was surfed up, and you could see that by the number of new managers that were jumping on the bandwagon. Not just for impact, but anything with sustainability in the title. There was also a period around the pandemic when anything that was broadly sustainability related was getting a premium. I think it's healthy that the market is normalising, and we are being reminded that you actually have to be a good fund manager. This is a very much an active manager skill set area, and it becomes all the more important to make sure that you can prove you can pick stocks, rather than ride the beta wave that we alluded to earlier on."

From listed impact to Article 9

The power of regulation

The challenge of keeping both retail and institutional investors on board in a confusing ESG and impact fund market is a real one. Cases of greenwashing can cause lead to a reluctance to invest, jeopardising the flow of capital that is needed to address the Sustainable Development Goals (SDGs). With that in mind, the European Union (EU) is gradually implementing its new Sustainable Finance Disclosure Regulation (SFDR), which aims to inject some clarity and rigour into the fund market. Listed impact products would most likely aim to comply with the highest level of Article 9.

A false sense of security

Crockford believes there is still work to be done to make the new regulations effective. "I understand that it's good from a fund buyer point of view, especially in markets that are still playing catch up. The problem is that there's the risk that in its current form it sells a false sense of security, and actually facilitates greenwashing or impact washing, as opposed to doing what it's supposed to do and reducing it. This is because the rules are so focused on defining outputs without any definition of what the inputs are, i.e. what sustainability actually is, and what a sustainable investment is. At the end of the day the fund buyer still needs to do the work. As Philip mentioned earlier with that list of Article 9 strategies, you still will find that many of them will not be what you expect when you open the hood and look at the underlying holdings." He remains optimistic, adding "I think it will improve because the market will drive it to improve. We are already starting to see this now with many funds changing designation from 9 to 8 or 8 to 6."

A work in progress

The introduction of SFDR has been broadly welcomed but brings with it some implementation challenges for managers. For **Todd**, obtaining the relevant data for all holdings is proving impossible. "It is a problem finding data for the Principal Adverse Impacts (PAIs). There are many of those metrics where you have fewer than a quarter of companies actually reporting. Beyond Europe it drops a bit further and the accuracy of the data differs, to put it mildly. The requirement for companies in Europe to disclose on all these data points also doesn't come in for two or three years, so that's another challenge."

Despite the problems Todd is broadly supportive and sympathetic towards the policymakers: "The intention is obviously to provide more disclosure, more transparency on a strategy level, which is good. I hope that it's an evolutionary process. In time as we start to work through it and we learn from experience then I'm hopeful that it will become a bit clearer and easier to implement. It will transparency for the end investor what kind of product they're actually investing in. I don't envy the regulators at all, they've got an impossible job and there are challenges in implementation, but I think it's probably right to leave more room for interpretation initially, rather than be too prescriptive."

Square pegs in round holes

Adhering to the new regulations is a challenge for managers that are new to the sustainable space. However, it can be even more problematic for impact veterans with a tried and tested process that might not exactly fit the new specifications. **Beloe** explains, using a geometrical analogy: "We have built a 'square' system over the course of the 17 years that the strategy has been run, and the [EU] commission has come along and said 'No, it needs to be a triangle'. We have had to try and make sure that

it meets the 'triangle' requirements while not fundamentally changing our philosophy and methodology. This is a bit unfair, but it's almost like being compliant with requirements is an exercise in administrative efficiency. If your business is very efficient at administering these regulations and responding to them, that makes Article 9 easier. That's where the onus is, rather than the actual underlying philosophy of the fund. Everyone expects us to do an Article 9 fund, so we have to do whatever it takes, but it is an exhausting process because you're producing so much paperwork and it's not really clear."

This administrative burden can favour firms that have larger resources at their disposal, says **Crockford**. "Part of the challenge is that you're going to have a natural bias towards the bigger companies in the universe, and this is why ESG screens don't work on impact investing. All the big companies have teams of people who report data when the small ones don't. in fact, one of our main engagement objectives with every company in the portfolio is try and get them to improve their reporting and the resources around it."

Crockford also questions the decision-making process behind the new regulations. "The other annoying thing about SFDR, to use your square and triangle analogy, is that the reason why it's a triangle is not driven by whether it is good for the client. It seems to have been designed to benefit some of the loudest voices that have perhaps lobbied for it to be that way, which is a bit of a disappointment. You've seen that with SFDR to some extent and with the taxonomy being broadened out, and now of course giving up on the social taxonomy which is a bit of a shame."

Looking at the broader picture

Many asset managers are responding to the new reporting burden by implementing standardised and automated procedures, which can have their drawbacks. Herlin explains: "The guidelines have been so vague, with many different ways to comply with Article 8 or 9 requirements. I think it has at least trained a lot of fund managers who maybe wouldn't fill out so much information before to have a standardised way of communicating. In our fund analysis, we try to raise additional questions and make as

independent a judgment as possible of their sustainability work by looking at the broader picture. What kind of incentives do they have within the firm? What resources do they have to engage with and analyse holdings? We have analysed different Article 8 and 9 funds at several fund companies and they tend to write that they work in similar ways within each category. We respond that surely you work in different ways with different asset classes or strategies, but they really try to keep to the protocol. It's like they are hesitating to develop any further than what's in the reporting standard."

Calling out Artificial Intelligence

The growing trend for automation in this area is particularly concerning for **Crockford**. "One extra level of danger that's coming in now, which I think is a reaction to this ambiguity, is various software packages that are being sold to firms, which claim to have AI capabilities. You're taking a kind of faulty data set and overlaying it with this black box of AI that claims to know what you're doing. We meet these companies to try to learn their process, and then eventually it comes to this: it's an AI thing that does it all. It is scary, and it will be very interesting to see how much those take off. And that's why, from both a fund selection and asset manager point of view, you have to put that active slant on it. You have to show that you're actually doing what you say on the tin."

"If you invest on the basis of a certain market cap or a certain sector profile, there is no impact question in that thesis. If you buy the top holdings in the MSCI world and then do engagement, that's not impact."

Funds that do not do what they say on the tin were the subject of **Mitchell's** investigation, as he explains: "I would look at a lot of the prospectuses and at their top 10 holdings, that would be the first test. If the top 10 correlate with NASDAQ, then you know that's basically not right. I would be trying to find some description of their process, and the number of holdings is normally a pretty good initial indication. If there are more than say sixty, they are very unlikely to be doing the job properly. It's also very easy to spot quant run profiles as well. Quant probably could be impact, but it relies so much on the data that's going into it. I think everyone here would understand that you cannot beat meeting companies, looking them in the eye and setting up your own database based on your own engagement rather than buying something off the shelf."

The missing link to transition investments

For **Mitchell**, the definition of impact should include strategies that focus on turning "brown" companies "green" via engagement. He believes that quant strategies might be able to work hypothetically, using data from organisations like ClimateAction 100+, CDP and TPI. Beloe cautions that "The key thing is it must be part of the investment case. If you invest on the basis of a certain market cap or a certain sector profile, there is no impact question in that thesis. If you buy the top holdings in the MSCI world and then do engagement, that's not impact. For me, it must be part of the investment case. You are trying to change that company because you think it will be a better company from a returns point of view, once they have changed. Take the example of Engine No 1, if they had failed to get their people on the Exxon Mobil board, they really should have sold. Their thesis was 'if we can change this business, it's going to be a great investment'. If you can't change the business, then you should sell on that basis. That is what makes it an impact investment."

Crockford concurs: "That's where the return is. It's not about being angelic and 'holier than thou.' The reason why impact investing is desirable, in our opinion at least, is for the end client to get the maximum exposure possible to the impact that is being generated by that company. That translates to exposure to the opportunity that delivering that impact brings. I think that's often forgotten."

Engaging tangibly

For **Herlin**, impact strategies need to have norms-based engagement processes that have clear KPIs. Ideally, she says, "Not a purely reactive, but a proactive and thematic engagement that could lead to better returns. Because if you hold dialogues over a long enough time period, the company will likely improve on the chosen metrics and therefore become more valuable. What differentiates engagements that make a difference is a good escalation process, which could perhaps mean collaborating with other investors on a vote before resorting to selling the stock."

Engagement can also mean fine-tuning companies that are considered good to make them great, according to **Todd**. "We have a very focused SDG engagement strategy where we talk to companies about how they can manage their business and how they can align their strategies with the SDGs. We take a very long-term view, and engagement does take time, but the engagements have very clear objectives to achieve. Conversely, we also have the impact opportunity strategy, which I co-manage, in which we invest in companies that are already having that positive impact. That is a different kind of impact, but I think it's important to delineate between the two. We still engage with the companies in the impact strategy, but they are already dark green companies, so to speak. That means there is less to discuss with them, whereas for the SDG engagement strategy, there is a lot more focus on how changes can be realised by and within businesses in line with the SDG's to create impact."

Fine-tuning already green companies can work alongside a strategy aimed at drastically improving companies where there is potential to do far more around sustainability, according to Todd: "There is huge potential there. If you invest in the biggest laggards, then you have possibly got the biggest room for change. A key part of the process is assessing the openness and willingness of the management team and the board to discuss ideas and strategy. Some companies are laggards for the very reason that they aren't listening to anyone outside their core leadership – the greatest opportunity lies in those companies where there is significant improvement potential and a receptivity to engagement".

For **Herlin**, it is about promoting the companies contributing to the new low-carbon economy, while working to improve the companies in the old economy that produce goods that remain essential to the current economy.

The challenges of measuring successful engagement

Meanwhile, **Mitchell** points out the problem in attributing engagement success: "One of the issues with the engagement is always going to be proving that it's your engagement that makes a difference. It's quite easy to hitch your trailer to some other people and buy the same stock, and then you will probably pop up in some statistics showing that you have been engaged with this company. However you might not have done the heavy lifting. I think that's going to be a constant problem." Engagement techniques are one aspect of impact investing, but how does one prioritise the choice of impact objectives among the multitude on offer? Do social and environmental impacts sometimes clash?

Customer preferences are a good place to start, according to Mitchell: "We are now getting more data on customer preferences and, from the other side, should eventually start getting better data from companies via the Corporate Sustainability Reporting Directive (CSRD). This

"There is no perfect solution. There are always going to be issues, but you've got that central thesis around the change that you're trying to deliver, and then you can engage to mitigate the other negative impacts."

means we can get a better match in terms of what the customers really want to invest their money into in terms of impact."

Fund providers also need to be clear about their goals and methods, Mitchell argues: "Going back to my investigation into which impact funds were really doing their job, I really liked those that would list out the impact they are having with their own choice of metrics. I realise this makes it complicated and there is a lack of standardisation. Nevertheless, a fund that can say 'our holdings have helped take out X million tons of CO_2, but also saved X number of children from poverty in Brazil' is the kind of impact that is attractive to retail investors."

The partial truth of quantitative measurement

Selecting the right impact metric can be very complex, as **Crockford** explains. "We have a business in the portfolio which is helping the transition by producing a metal via recycling rather than mining. recycling it. It is taking material that would otherwise be disposed of through landfill, extracting the zinc content and refining it back into a usable metal. The reason I'm bringing that particular company up is because if you look at it purely through the lens of the easiest and most comparable data available, that would be emissions. It is the most energy intensive business in the entire portfolio, so it is scored very badly on that front. However, if you look at it using a lifecycle analysis of the business, you would actually score it very well. The net impact of its contribution to the system is definitely more net positive from an emissions point of view than the data would suggest. Interestingly then, when it comes to engagement the most material negative impact in this European listed business is its energy footprint. Most people we see are therefore engaging with them on that issue. We decided to deprioritise that and focus our engagement on other areas of business. They also score particularly badly on the social side, because actually it's a business where employees are handling a hazardous material, and there is a very high injury rate. Rather than trying to balance different types of impacts, positive and negative, that affect different stakeholders, we need to really step back and see how these companies fit into the broader system in which they are operating in, and how they can help change the system for the better, as opposed to just trying to improve a single output from that company."

"Ultimately, the overall portfolio is a result of the individual stock picks, the most compelling ideas, the most impactful businesses."

A unique solution to each problem

For **Beloe**, it is important to have a clear rationale for each holding: "We have a theory of change for each of our investments, based on the specific problem that we have identified, whether that's the need to increase energy efficiency on an annual basis by 4% in order to achieve net zero emissions by 2050, or to address a particular therapeutic area in terms of diseases. The theory of change links the activities of the company in terms of the products it sells with that initial problem statement. That's the core of the investment. However, businesses that make insulation for buildings can be very energy intensive or use a process based on petrochemicals. There can also be issues around the safety of the products, for instance in terms of flammability, as we have seen in the UK. There is no perfect solution. There are always going to be issues, but you've got that central thesis around the change that you're trying to deliver, and then you can engage to mitigate the other negative impacts. How can we help this business address its energy footprint? How can we help the business address its health and safety? So long as you have that core thesis, and that's positive, then you can try and mitigate the other impacts that are associated with the company."

The Sustainable Development Goals as an investment framework

The UN SDGs are a good way of contextualising both environmental and social impacts, according to **Todd**. "We use the SDGs as part of our framework, and they are a combination of social and environmental goals. We see all of them as being important. They're all very interlinked, which is a long way of saying that we don't necessarily prioritise environmental over social. We have a number of themes, and we consider them all equally impactful and important. Ultimately, the overall portfolio is a result of the individual stock picks, the most compelling ideas, the most impactful businesses. There can often be a trade-off, meaning you are providing an environmental solution, but possibly there's a social cost to that or vice versa. Similarly to Seb and Tim, we think

"It is a common framework that is used almost everywhere now. You can pick and choose, depending on the preferences of the clients. You can target specific SDGs with clear KPIs or take a holistic approach."

about both the positive impact of a company but we also consider some of the cost trade-offs. That means considering the operations, the emissions involved, some of the social aspects, but also looking at the solution being provided at the end use phase. That calculation allows us to identify those areas where there is a bit of a trade-off, perhaps providing an opportunity to engage or perhaps that stops us from investing. I think having that holistic view is important."

"We are big fans of the SDGs. What we really like about them though, is not so much the goals themselves, but the specificity of the underlying targets."

Herlin sees the SDGs mainly as a common language. "It is a common framework that is used almost everywhere now. You can pick and choose, depending on the preferences of the clients. You can target specific SDGs with clear KPIs or take a holistic approach. The fact that they were agreed upon by so many countries makes them a gold standard. Not necessary for portfolio managers to rely on completely, but rather as a means of communication to clients."

Beloe is less keen on the SDGs as an investment tool. "I appreciate their value, but they were primarily written for governments. They are not really for investors. There are quite a few those goals which aren't investible. Can you invest in partnerships? Not really. I believe they are flawed as an investment framework because they were not written as an investment framework. They still have value because of that role in terms of translating sustainable development down into practical things such as water management and climate action, but I wouldn't be too dogmatic about how we apply them, because then I think you get into trouble because a lot of the goals actually apply to public authorities, not to companies."

The key may be to dig down into the extensive list of sub goals that underly the main SDGs. **Crockford** explains: "We are big fans of the SDGs. What we really like about them though, is not so much the goals themselves, but the specificity of the underlying targets. When we started this process up, we built what we call our SDG taxonomy, whereby we have linked which underlying activities are actually investible through public listed companies to specific targets rather than use the overriding goal. For example, for SDG 3 health and wellbeing, does that mean that Purdue Pharma, basically the creator of the US opioid crisis, was an SDG 3 company? No, of course not. But if you dig into the goals, the good thing about them that you certainly don't get with SFDR or the EU taxonomy, is a list of 169 specific targets. So far, we have only found 50 of these for which there are actually listed equity companies selling a product of service that helps contribute towards that target.

So most of them aren't investible, but you do get objectivity from them. You know that a particular underlying SDG is specifically focused on non-communicable diseases. You can then identify companies that have a therapy or medical device against a specific non-communicable disease. I think there is no perfect framework, and I doubt there will ever be one. I agree with Seb that it's hard to find a better broad framework to give you that objectivity right now."

More prospective clients are using the SDGs as a reference point for defining mandates, according to **Todd**. "We have had more requests from prospects about tailoring our strategies to specific SDGs and increasingly niche areas. I think one of the things to recognise is that the active share or the tracking error, if that's what the end client is thinking about, is already pretty high in typical impact funds. That's only going to increase the more you target specific SDGs. As much as we use it as that framework, we don't think there's much to be said for reporting exactly how much revenue from our portfolio is exposed to any one of the 17 SDGs. If that helps the end client understand the exposure of the fund, then that's fine, but I think what we always remind our clients is that it is the additionality, the impact that is created on these SDGs that is the more important thing rather than purely the revenue line."

dessert

What to expect: the optimist's view

Impact investing remains a relative niche, but do the specialist managers want to keep it that way? If it becomes too mainstream, might they lose their Unique Selling Point? That would only be a positive development, for **Beloe**: "What a wonderful world that would be, for a start. In a way, that would make me overjoyed if we've achieved that, that would be wonderful. Our strategy is designed to really focus on enabling businesses. So as Mathilda mentioned earlier, there are 'every-day' products and services that we will continue to need for the foreseeable future. We don't invest in them directly, instead we invest in the companies that help those companies make those products more sustainably."

"The agenda keeps moving forward. There was a time not so long ago when LED lights were considered to be a really impactful investment. Now you can't buy anything else. It's no longer impactful, but there are always new technologies coming through that are better from an impact point of view. I think there will always be a role for specialist impact managers."

Beloe continues with a note of optimism: "We have probably seen peak global greenhouse gas emissions from industry and transport. It's amazing that that has happened, so there are reasons to be hopeful. I would also hope that in two years' time, we will have seen further penetration by the low impact technologies of the key markets around energy, buildings, transport, and agriculture. If that's the case, then our strategies will have done very well."

Crockford also believe impact investing will always have a role to play. "I think the only constant is change, to quote the old cliché. I think the whole essence of impact investing is, as we discussed earlier on, finding the companies that are enabling that systemic change, and every new system brings a new set of challenges. The obvious example we've been using a lot is green hydrogen, because it requires huge amounts of purified water. I don't want to end on a negative note, but I don't think we will ever get to a single point where we say our job here is done. There will always be a need for an improvement somewhere to make something more sustainable."

Looking ahead, **Crockford** continues: "Particularly in Europe, there's always been a very big focus on some of the major environmental issues we face. I hope we will start to focus more on some of the social issues. I think we're on the cusp of a revolution in healthcare. The pandemic, as horrible as it was, brought to light some of the solutions we have available to us, particularly in the life sciences and diagnostic space. I really think that over the next five to ten years, we are going to see leaps and bounds being made in how we not just treat, but how we can diagnose at an earlier stage, both communicable and non-communicable diseases."

There is still much room for progress in the impact arena, explains **Todd**: "We need to remember impact investing is still at a nascent stage. It's still a relatively small part of the investment universe. Some of the data I've seen suggests Article 9 funds are a maximum 5% of AUM in Europe, probably even less for impact funds of the type that we're talking about today. If we become obsolete and everyone's an impact investor in two years, I'd be very

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surprised. But arguably we've done our job if we've stimulated that movement and capital towards the impactful businesses. I'm hopeful that governments will work with the corporate world to provide the right sort of regulation framework, incentives for businesses to invest in decarbonised technologies and to address the SDGs. That's the part that perhaps needs a bit more work. Public equity markets are enormous and so they can play a huge role, but governments need to do so as well. I am hoping for more sensible, logical interaction between governments and the corporate world."

Herlin is particularly concerned about the political backlashes in some circles resulting from social concerns about the transition. "Climate change is actually happening, with more natural disasters, droughts and floods. We need to work on mitigation, but also on adaptation to minimize the social challenges that can ultimately feed into those political backlashes." ESG and in particular impact investing can play a role here too.

Mitchell hopes for regulatory progress and to spot more good news appearing. "In the next two years there is potential for lots of really good things to happen. I'm relatively optimistic CSRD is going to help launch much better data for everyone who is in our business, especially around CapEx plans of companies, not just revenue-based data. I'm hoping there is going to be more regulation around offsetting, which is a ridiculously unregulated market and needs to be tightened up enormously. Every so often on LinkedIn I respond when I see some good news, because we really need it. Sometimes bad things have to happen to get the world's awareness to a level where they will react, for instance to get us off Russian gas."

"There have been so many of those negative things happening that I'm hoping we're getting to a tipping point where consumers start behaving in a way that can affect corporate behaviour, and then the whole system starts changing."

"I read something very interesting recently about American farmers, who have generally been climate deniers because they think that most of their peers don't believe in climate change. However the reality is that 65% of them do believe in climate change. They think they are a minority, so none of them want to speak up. Once the group think turns and you want to join the big gang, then it all happens very quickly. I just hope that the next two years we get a bit of that rolling over."

coffee

about our partners

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