ESG and impact are different – and we need both!

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There is a great deal of consternation among retail and professional investors alike when it comes to incorporating environmental, social, and governance (ESG) information into investment decisions. Much of the hand wringing has focused on what is often referred to as the 'aggregate confusion' problem[1] —the lack of strong agreement as to what constitutes a 'good' or 'bad' ESG company. But at the heart of a more nuanced debate seems to be a conflation of ESG and impact ideas. The two concepts are often difficult to tease apart as there ultimately is some overlap, but we are wise to acknowledge that ESG and impact are distinct concepts with very different starting points and objectives. The practical manifestation of the problem is as follows: it is often possible to find companies that have both excellent ESG profiles and positive effects on the real economy, but more often than not, the concepts are orthogonal, meaning that good ESG does not necessarily imply positive impact (or the reverse).

This begs the questions, what is ESG and what is impact?

In its most basic form, ESG investing is primarily focused on how companies will be affected by the big changes that are afoot like climate change, societal trends, changing consumer preferences, regulatory policy, and how the management of those companies positions them to withstand (or even benefit from) these changes. There is currently little debate that the drivers of investment performance like company valuation, earnings growth, talent attraction, innovation speed, profitability, regulatory risk, tax burden, and customer retention are all affected – a lot or a little – by the concepts that fall under the ESG banner. Ultimately, we see the incorporation of environmental, social, and governance information as a way to improve the investment performance of our portfolios, via upside opportunity identification or downside risk mitigation. We strongly believe that a more robust understanding of the threats and opportunities faced by companies will give rise to more informed investment decisions. And we are not alone. The last few years have witnessed a massive uptick in the AUM nominally managed with ESG inputs. While we must acknowledge that there is wide variation across asset managers when it comes to the stringency of how ESG is applied, there is no question that companies are now acutely aware that they're being evaluated through an ESG lens. If a large swathe of investors continues to advocate for better ESG performance we should expect that, over time, positive changes will occur in the way companies manage their resources – whether those are physical resources, human resources, or something more abstract like their social license to operate (societal goodwill). Some companies will be quick to react, and others will drag their heels, but in aggregate, the use of ESG criteria in tandem with traditional financial metrics should give rise to positive change for the economy, for society, and for the

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[1] Berg, Florian and Kölbel, Julian and Rigobon, Roberto, Aggregate Confusion: The Divergence of ESG Ratings (August 15, 2019). Available at SSRN: https://ssrn.com/abstract=3438533 or http://dx.doi.org/10.2139/ssrn.3438533

environment. Nevertheless, it is important to remember that the objective and the end goal for ESG investing is fundamentally different than that of impact.

Impact investing starts with the aim of bringing about positive and demonstrable social or environmental change. This 'intentionality' is a hallmark of the practice. It is different than philanthropy in that it demands financial returns, and different than ESG investing in that, at the company level, impact investing is focused on how a company affects change in the real economy, society, and the environment. The United Nations Sustainable Development Goals (UNSDGs) have emerged as the de facto framework for impact. The UNSDG's lofty objectives like 'Clean Water and Sanitation' and 'Quality Education' would seem to be most appropriately addressed by the public sector, at first blush. But capital markets participants have every reason to aggressively pursue investing that is positively aligned to the UNSDGs. By working to solve the world's most pressing problems, we improve the aggregate economy by bolstering its support systems: the environment and society. Impact investing takes subtly different forms depending on the asset class. In public equities[2], for example, we talk about direct impact, which is accomplished via voting and engagement, and indirect impact which means investing in companies that themselves are creating positive impact through their products and services[3]. We believe that companies that are positively aligned to the UNSDGs will, all else equal, produce superior investment results over time, but unlike ESG, the starting and ending point for impact is environmental and social change.

Why does all this matter? Two reasons: to the extent investors believe that an ESG-focused investment process is a 'change the world' strategy, they may be confused by (or even disappointed in) some of the companies they are invested in through the funds they hold. While we do believe that positive real-economy changes will ultimately result from a wholesale shift to ESG integration in investment management, the process may be slower than hoped as the goal of ESG investing is not positive societal or environmental change, rather more resilient portfolios. Relatedly, we believe that a sole focus on ESG – which in its most pernicious form manifests as a singular focus on 'ESG ratings' – may actually be a distraction from the very necessary impact goals that will ultimately bring about the profound change needed to improve our collective path of travel. Put simply, ESG is absolutely necessary as part of any thoughtful investment management practice, but we must also bring an 'impact mindset' to our work if we are to improve both 'alpha' and 'Beta'.

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[2] Historically, impact investing was largely undertaken in private equity investments, but we must bring these same principles to bear on the problem using the heft and breadth of the public equity market if we are to ever achieve real change.

[3] It is common to evaluate a publicly traded company's impact potential by looking at the percentage of the company's revenue from products that are positively (or negatively) aligned to the UNSDGs. This 'revenue mapping' is tricky, and like ESG data, there is not perfect consensus on what is 'positive' or 'negative'.