



We must approach public equities with an 'impact' mindset

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When asked about 'impact', the first reaction of many investors is to point to private markets. We argue that, if we are indeed to achieve the massive social and environmental objectives that are needed, we must enlist the public markets, specifically public equities. It is only by leveraging the heft and breadth of this enormous pool of money that we will move the needle on impact goals. Put differently, the idea that we should limit our 'impact' mindset to a subset of asset classes is completely contrary to achieving the daunting mission at hand!

The Global Impact Investing Network (GIIN) 2020 Survey estimates that impact investment assets under management totalled \$715 billion at the end of 2019¹. While this seems like a sizeable sum -- and one that has indeed grown significantly in recent years -- Morgan Stanley estimated that a whopping \$50 trillion in investments in new technology is needed to bring emissions to net zero by 2050 -- addressing but *one* of many impact goals². UN Secretary General, António Guterres, sums up the shortfall in stark terms in the latest Sustainable Development Goals Report by saying, 'It is abundantly clear that a much deeper, faster and more ambitious response is needed to unleash the social and economic transformation needed to achieve our 2030 goals'³.

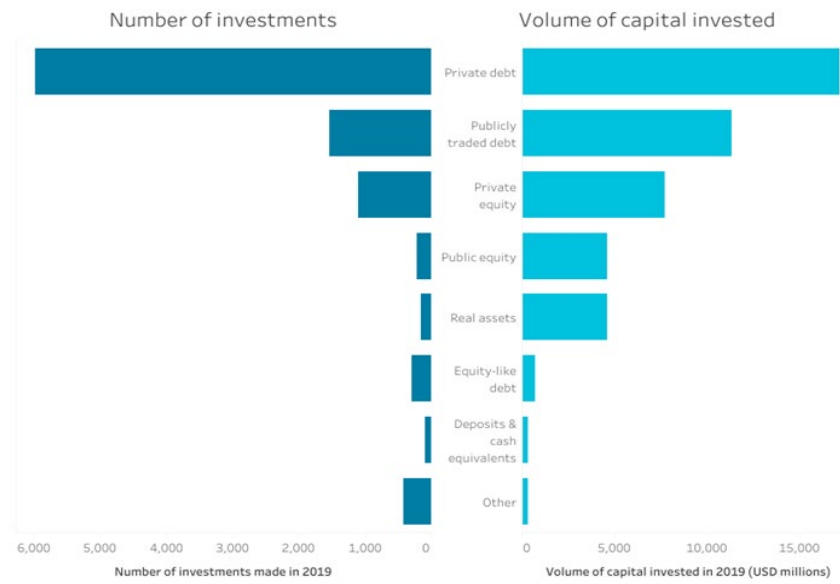
Currently, very little 'impact' investment resides within public equities. The graphic below shows the allocation, by asset class, of investments by 279 firms representing \$47 billion across 9,807 investments in 2019. While we can bemoan the current miniscule allocation to public equities, we should also imagine the vast potential that is available to investors were they to allocate proportionally more to the asset class over the coming years. While only 2% of 'impact' investments are in public equities today, 10% of the invested capital resides in the category thanks to comparatively larger deal sizes. By broadening their investable universe to include public equities, impact investors can put more money to work, which is important... so long as public equities can deliver impact.

¹ <https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf>

² <https://www.morganstanley.com/ideas/investing-in-decarbonization#:~:text=Although%20getting%20there%20won%27t, costs%20to%20decarbonize%20are%20substantial>

³ <https://unstats.un.org/sdgs/report/2019/The-Sustainable-Development-Goals-Report-2019.pdf>

Impact investment activity in 2019



Source: GIIN, Annual Impact Investor Survey 2020

Defining 'impact'

Impact investing, as distinct from traditional investing and philanthropy, has two objectives: positive and demonstrable social or environmental outcomes, and competitive financial returns. Investors have aligned around the UN Sustainable Development Goals (UNSDGs), as a framework for impact. The growing interest in the UNSDGs on the part of asset owners is a clear signal to companies that the investor community is rapidly and acutely becoming sensitized to how firms' products and practices affect the living world.

We can approach public equity investing with some simple questions that underlie the concepts of intentionality, additionality, and access – all litmus tests for achieving 'impact':

- does the investor and the investee company itself seek to create positive change for society or the environment?
- what is the social or environmental effect of the investment?
- does the investment help meet an unmet need?
- how many people (or animals or ecosystems) does the investment benefit?

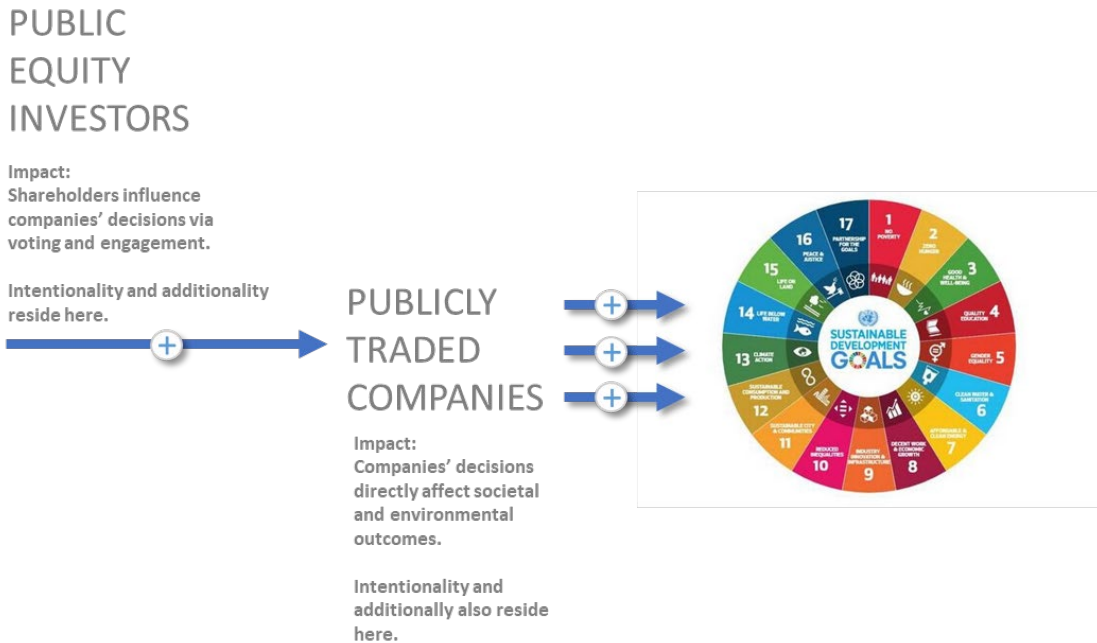
Unlike the 'additionality' arguments of other asset classes, in public equities we cannot argue that investing in shares of a company is the same as providing capital to a project that otherwise would not be funded⁴. Therefore, we must be very careful about how we apply the language of 'impact' to

⁴ In the case of public company IPOs, there would be impact resulting from investors buying shares because it does provide working capital to a company. But the bulk of equity market investing is not IPO-focused.

public equity markets. The good news is that both public equity investors as well as listed companies themselves do have effective tools to not only speak to the questions above but actually *cause* positive change along each dimension.

Is impact possible in public equities?

We would argue yes, but the necessary causation that is at the heart of impact investing comes about in two ways. In listed equities, investor impact comes via active stewardship -- engagement and voting. Through these actions shareholders influence decisions made by management and corporate boards, pushing them toward outcomes that benefit society, the environment, capital markets, and – as we would argue – long-run investment returns. In this way, investors demonstrate intentionality, achieve additionality, and can point to tangible changes that have resulted from their influence. Importantly, listed companies themselves, even in the absence of investor pressure, make impactful decisions through their allocation of capital (e.g. new product lines, starting or stopping certain practices, relocating physical operations), so it is conceivable to think about 'intentionality' and 'additionality' as residing both with public markets investors and within companies⁵.



Source: Radiant ESG, United Nations Sustainable Development Goals, 2020

In sum, voting and engagement are the mechanisms for investor impact, and capital allocation decisions are the mechanism for company impact, with the two being intertwined in many instances.

⁵ This duality is fundamentally different than what we see in private equity or venture cap, for example, in which capital allocation to an impact-producing activity is dictated by investors alone.

Two types of companies tick the box

We must acknowledge that not every public equity investment presents equal 'impact' potential. We identify two types of companies that meet our 'impact' definition, passing the hurdles of the intentionality, additionality, and access questions presented above. The first and most obvious type are companies with a significant portion of their products and services aligned to positive impact. This is typically determined by a percentage of revenue that is UNSDG-aligned. While many companies have a sliver of revenue that can be mapped to one of the SDGs, the kinds of firms we allude to here are those with a significant portion of their business in products that legitimately seek to replace fossil fuels, work to provide basic healthcare and nutrition, or preserve biodiversity, as a few examples. Of critical importance is the demonstration of impact intent on the part of company management itself. Many companies in this category are pure-play firms that we believe will play a transformational role in collective mission to radically improve *stakeholder* outcomes. As investors, we also believe that these companies will benefit from the changes in regulation and consumer preferences, as well as the resource constraints that we see on the horizon. These companies can be large or small but are often younger than the market average.

The second type of companies are those with dramatically evolving operational practices that give rise to positive social or environmental effects. Impact, within this category, arises via the resource allocation decisions made by companies that are typically larger and more established, choosing to evolve their business practices. This can mean switching to entirely green fleet delivery, stopping the production of single-use plastics, or embarking upon an ambitious circular business model, for example. There is a school of thought that more 'impact', in the aggregate, may be achieved via operational changes within larger firms than from the smaller 'pure green' players. Within this category of company we also look for 'intent' statements that are backed up by observable, measurable changes. Firms that are legitimately transitioning large parts of their operations may or may not have significant revenue that can be mapped to an SDG, so we must look to other sources of information to get a sense of the magnitude of operational evolution in order to gauge this type of impact.

Not without challenges

A challenge to public equity investors is that the two types of companies identified above represent only a subset of a larger investment universe. And this is before we even consider company fundamentals. Recall that the goal is to achieve *both* real world change *and* strong investment performance, so we can't just ignore concepts like earnings growth and valuation. At the end of the day some of the very legitimate impact candidates will not make it into a portfolio for purely financial reasons. The good news is that, even with these necessary limitations on starting universe, the investable opportunities pool is still far larger than what exists in other asset classes. Other challenges involve the potential for concentration and crowding. The former working to increase volatility when the number of positions in a portfolio is very low, and the latter working to decrease portfolio returns if all investors rush into the same 'impact' stocks. There is also the double-edged sword of liquidity. It is a positive in that public equities are, by and large, extremely liquid and can be traded easily and cheaply. The negative is a function of the asset class itself –

during times of crisis public equities are the first port of call for investors needing to raise cash. And in more typical times, it is poor performance that will lead to outflows. There are instances of listed equity managers using gating or monthly redemption terms, but nothing like the actual lock-ups we see in other asset classes. Put differently, the liquidity profile of listed equities calls into question whether investors will reap the long-run benefits of an impact strategy.

Given these challenges, it is imperative that we build public equity impact strategies that are as broadly diversified as possible (while still passing our crucial tests for impact), targeting stable, equity market-like performance with relatively low fees. In this way, investors will be able to not only deploy a significant amount of capital in impact-oriented portfolios, they will be more likely to actually stick with the strategy over many years.

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Approaching public equities with an 'impact' mindset

To achieve the ambitious goals that will benefit society, the environment, and our economy we must leverage the sheer size of the public equity market to accelerate change. While real impact is possible within public equities, the category is dramatically underutilized when it comes to impact investing. We believe that active stewardship paired with a strategy that seeks companies that are both intentionally and demonstrably contributing to the SDGs (via their products or evolving operations) will allow public equities investors to achieve the two-fold goal of societal or environmental gains and competitive financial returns.

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