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Investing for Impact – Exploring Opportunities in Listed Equity

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Introduction

In the aftermath of the COP 26 Summit, we are on the cusp of a profound sustainability revolution.

The need to address environmental and social megatrends, including the climate crisis, resource scarcity and demographic changes, is driving a worldwide industrial restructuring and shifting the basis of competitive advantage among companies. This is leading to increased pressures on pension trustees and investors to drive constructive change and address some of the world's most pressing environmental and social challenges, while continuing to deliver competitive risk-adjusted returns. Impact investing aims to support these challenges.

Most pension funds have substantial listed equity holdings, which for many may constitute the bulk of their investments. Within the context of Responsible Investment and the various approaches that can be taken, it is important for trustees to understand how their listed equities could be invested in a more impactful way, and the potential financial advantage from doing so.

What is impact investing?

Impact investments intend to provide a return for the investor while achieving a positive impact on people and the planet. In contrast to traditional financial investments, impact investments are framed with dual objectives:

- To deliver positive financial returns.
- To deliver positive social and/or environmental impact.

The key differentiator of impact investment is the principle of intentionality. That is, impact investors must have the explicit intention to drive specific positive social and environmental change with the capital they are investing. While investors would expect the return on capital to be measured in any investment, impact investors will also measure the progress of their stated environmental and social aims to ensure the investments are contributing to desired outcomes. In publicly traded equities, this measurement is often done at an aggregate level, using broader measures than would be the case in private equity.

Impact investment is growing

Impact investment is growing, driven by the increased focus on delivering Responsible Investment more broadly and to meet the challenges posed by megatrends. The Global Sustainable Investment Alliance (GSIA) published their Global Sustainable Investment Review in 2019 and showed that assets using Responsible Investment strategies continue to grow. Between 2016 and 2018, Responsible Investment assets across major markets increased by 34% from $22.9 trillion to $30.7 trillion. The latest GSIA report for 2020 shows the continuing prevalence of sustainable investment across the global investment industry, with assets under management reaching US$35.3 trillion, a growth of 15% in two years, and in total equating to 36% of all professionally managed assets across regions covered in the report.

Source: **http://www.gsi-alliance.org/**

Impact investment is one of the faster-growing segments of the Responsible Investment universe and GIIN produces a survey that focuses specifically on impact approaches. Their most recent 2020 survey shows that over the four year period from 2015 to 2019 impact investment allocations across all asset classes almost doubled from US$ 48bn to US$ 80bn. The fastest growth rate of all asset types was in Public (listed) equity allocations at a 33% compound annual rate, followed by real assets at 21%.

Change in Asset Class Allocations across Repeat Respondents for Impact Investments 2015-2019, US $ millions compound annual growth rate

Asset Class	2015	2019	CAGR
Public equity	6,420	19,968	33%
Real assets	4,532	9,762	21%
Publicly traded debt	2,513	4,476	16%
Private debt	18,851	27,600	10%
Private equity	9,938	13,831	9%
Deposits & cash equivalents	1,204	1,148	-1%
Equity-like debt	4,355	1,294	-26%.
Other	137	1,884	93%
Total	**47,948**	**79,963**	**14%**

This survey was made up of the same respondents over the four years to 2019, and while private debt remains the largest contributor there is real potential for listed equity investment to be an increasing driver for impact investing, particularly as this type of investment is an easily accessible and liquid asset class available to all investors.

Source: **https://thegiin.org/research/publication/impinv-survey-2020**

The impact opportunity set

As listed equity markets increasingly focus on sustainability, more companies will present themselves as solution providers. There is increasing momentum in terms of innovation and solutions offered, and this is set to grow. This may provide an early mover financial advantage.

Among impact-focused investors, the range of impact objectives is diverse. These can range from highly localised objectives, such as a desire to improve the lives of a specific demographic group or local region, to broader initiatives encompassing climate change, social justice and the acceleration of economic development in emerging economies, among many others.

In Aon's soon-to-be published 2021 Global Survey on Responsible Investing investors' concerns around major ESG issues continue to rise, and many are in the process of addressing at least some of these in their investment strategies. Climate change or natural disasters were listed as a primary investment concern by 61% of respondents globally, followed by socioeconomic inequality (27%), cyber risks (25%) and nationalism / protectionism (22%). More than two in five (42%) intend to align their investment portfolios to net zero emissions before 2050 — and one in six (16%) have already made this commitment.

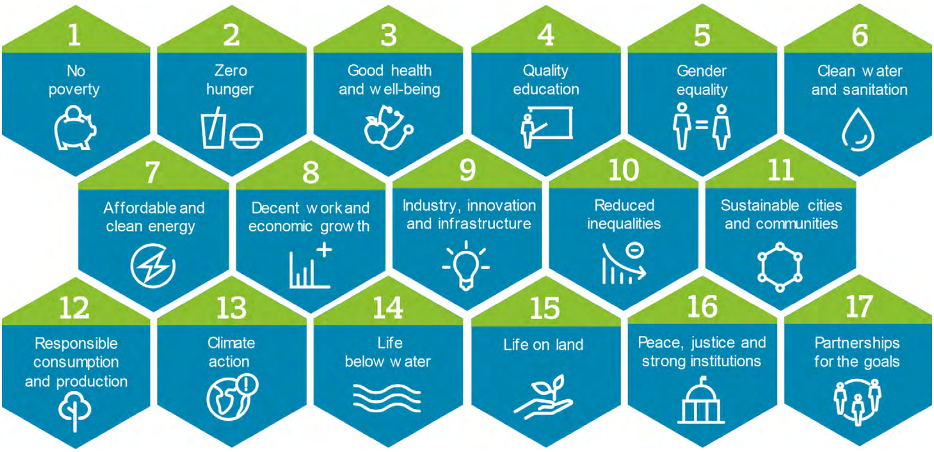
A global 'transition' to a lower carbon economy is increasingly being referred to by policymakers, with a focus on developing regulations and policy initiatives to deliver the necessary transformation. While climate change and resource scarcity are the headline sustainability megatrends facing mankind today, this is being reinforced by potent shifts in demographics, including growing populations, ageing populations and inequality. Globalisation and urbanisation are leading to shifts in economic power and consumer behaviour; this is especially true in high growth emerging economies, with China ascending towards being the biggest superpower. In addition, the increased availability and rapid advancement of technology are redefining business models across a range of industries and causing widespread disruption, which creates risks for investors as well as new opportunities.

In the past, Responsible Investment chiefly served as a means for aligning investor ideals with their capital allocations. Today, however, these global megatrends are leading to a heightened sustainability imperative felt by the financial community. For their part, many actors within finance believe there is an urgent need to direct capital to help mitigate ESG risks and drive positive change. These perspectives now dominate the stage for Responsible Investment.

Sustainable Development Goals: a framework for impact intentions

The full breadth of impact opportunities is most commonly captured by investors using frameworks that reference the Sustainable Development Goals (SDGs). The United Nations developed the SDGs in 2015, and they have gone on to gain significant traction in the investment world for Responsible Investment.

These SDGs comprise 17 goals, and while originally provided for policymakers as development priorities over the next ten years, the investment community has also adopted the goals to the extent they are able. The overall goal is one of sustainability; to build global prosperity for all over the long term and to mitigate and adapt to climate change. The investment community is increasingly guided by the SDGs, all of which are deserving, and investors can choose to address them broadly or to focus on the specific goals which are most important to them.

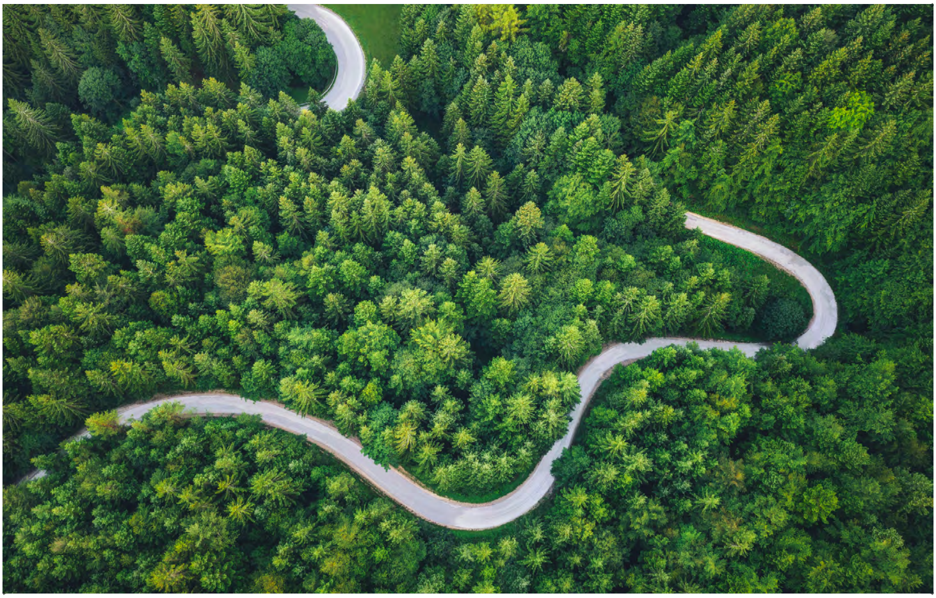


Source: United Nations

The financial case for impact investing

As global megatrends make the future world look very different to today, investors with the ability to identify and act on ESG challenges will have a fuller understanding of companies' true risk and opportunity profiles. Identifying companies that are better positioned for the future will result in superior odds of achieving improved financial performance over the medium and long-term. Current valuations may not fully reflect many of these global megatrends. Companies that are better managed for the long-term, who better consider ESG risks and their impact on society and the environment, will be better placed to withstand future volatility and the pricing in of ESG risk.

Trustees that believe financial markets have yet to fully price in ESG risks stand to benefit, not least by reducing the volatility likely to befall a transitioning economy and reducing severe event risk. Early adopters of impact investing can expect to benefit from a positive tailwind to financial returns over the short to



medium term. Increasing regulation and policy actions, and growing concerns over these megatrends and transparency, are beginning to influence investor preferences. This is increasing demand for a smaller universe of highly rated sustainable investments while lowering demand for lower-rated companies.

A primary benefit from impact investing is that, in addition to competitive risk-adjusted returns, it delivers measurable, positive change that benefits society. Organisations with a positive impact on environmental and social outcomes are better positioned to bolster economic and market performance, while fewer risks materialise than would otherwise be the case. This can result in a virtuous cycle that helps everyone, including trustees and scheme members.

This premise is not without its risks; if markets continue to price ESG risk inefficiently, actual pricing over time may not follow a predictable path. Further, impact investment funds tend to be strongly correlated with quality and may underperform during strong markets. However, during market downturns or in the event of severe market incidents, impact funds benefit from their defensive and sustainable properties.

Implementation options

There are a growing number of managers who offer impact solutions for Responsible Investment and navigating the range needs a good understanding of the required objectives. It is important to align trustees' objectives to deliver on return and impact expectations.

For trustees wanting to pursue sustainability, a broad approach towards impact investing in listed equities will be attractive. Aligning to the SDG framework shows an intent to do general good, while not being restricted to any singular purpose. The SDGs are used as a sustainability lens for both manager and stock selection while maintaining the freedom of a wide opportunity set.

At any one time, a number of the SDGs may take priority, and the focus can rotate and change as markets develop and new companies gain traction and market share. An allocation to funds or companies with a specific focus on impact could still be added to as opportunities arise.

This broad approach serves both impact and financial goals and does not preclude areas of innovation due to being overly prescriptive. A blend of manager approaches is optimal in our view, adding robustness to portfolio construction, given its inherent diversification and wide opportunity set, while offering a meaningful opportunity to have a positive, global impact on society and the planet. The recently launched Aon Global Impact Fund reflects this view. It invests in a blend of managers buy rated by Aon each with a different impact focus. The fund is designed to generate positive change alongside attractive risk adjusted returns and aims to provide a clear vision of how capital invested is contributing towards society and the planet.

For more information visit:
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The Aon Managed Global Impact Fund
INVESTING FOR THE FUTURE
Making a positive impact on people and the planet,while also generating healthy returns.
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