



Impact Investing needs a neutral decision-making framework

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Impact Investing needs a neutral decision-making framework – here is one that all investors can use

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Many approaches to impact investing primarily focus on the definition of impact investing. These approaches frame the analysis of impact in terms of the intensity of the investor's commitment to impact and prescribe how impact should be incorporated into an investor's mandate if they are to achieve a certain level of intensity of commitment: they prescribe the level of intensity that should be present in the investor's mandate. However, these approaches provide little practical guidance on strategies that investors can use to achieve their impact goals and, by prescribing how impact should be incorporated into an investor's mandate, often lead to conflicts between the investor's financial and non-financial objectives.

This note describes an alternative framework based on the intensity of the strategies used to implement impact investments, not the intensity of the investor's commitment or impact mandate. Framing the analysis of impact in this way enables us to develop an approach which is very much like a Quality Assurance process, which guides investors on how to both *establish* and *achieve* mandate-appropriate impact goals *without prescribing* how actors should specify their impact goals.

The four dimensions of impact goals

Any impact goal can be *specified* by a combination of the four dimensions of: exposures, risks, outputs and outcomes. Likewise, *attaining* any impact goal can be achieved by *managing* these same four dimensions.

Exposures. The goal may be to eliminate exposure to very negative characteristics such as child labour or fossil fuels. The goal might be to increase exposure to high-impact themes such as climate or education. Alternatively - rather than eliminate exposure to negative characteristics in their entirety, the goal might be to manage (i.e. moderate) exposure relative to a benchmark or a recognized standard.

Risks. The operations of every asset present risks to people and planet. The risks could be generally from the operations of the asset (for example the asset's carbon footprint) or from the occurrence of specific negative events (for example a labor accident or an oil spill). The risks that are most material, for the value of the asset (financial) and/or people and planet (the ecosystem), are different for each asset. For one asset the material risk might be labor conditions, for another a chemical spill, for a third it might be the carbon footprint and for a fourth poor governance. One type of risk management goal is to reduce the probability of material negative events such as a labor accident or a toxic spill to an acceptable level. Another type of risk management goal is to use our understanding of the material negative risks to improve the operations of the asset in a way which creates impact, for example better labor conditions, a lower carbon footprint or lower water use.

Outputs. Outputs are the things which are directly created by an asset. Outputs can be both positive and negative. The goal is to increase the quantity of positive outputs and reduce the quantity of negative outputs. Examples of positive outputs are increasing the number of patients with access to healthcare, reducing the tons of CO₂ emitted by a product or increasing the tons of sustainably cultivated tomatoes produced. Examples of negative outputs are the tons of CO₂ emitted, the litres of water used in a production process and the quantity of particulate matter in the air inhaled by factory workers. Achieving the SDGs requires a substantial increase in the quantity of positive outputs combined with a substantial decrease in the quantity of negative outputs.

As noted under risks, it is possible to use risk management to improve the quality of the existing operations of an asset in ways which reduce the quantity of negative outputs created.

In addition to improving the quality of the operations of assets, we can look at how the business models of assets affect the creation of positive and negative outputs. In particular, we can use a causal model to identify and support assets whose business models are aligned with creating positive outputs, for example additional access to education or technology which reduces carbon emissions or the use of water.

Outcomes. With Exposures, Risks and Outputs our goals are managed through focusing on the characteristics of individual assets. To achieve these types of goals we only need information on individual assets. Outcomes are goals which are set beyond individual assets and focus on communities, populations and ecosystems. Examples of outcomes are the effect of our actions on the health, education or livelihood of a population or on the sustainability of an ecosystem.

Achieving outcomes clearly requires information beyond that which can be obtained from the records of assets, often substantially more.

The operational intensity of impact management

The operational intensity of the strategies used to achieve goals increases as we move from managing exposures to managing risks and then outputs and outcomes. That is, the time and resources required to implement the strategy increases.

The pay-back for employing operationally more intensive strategies is greater ability to focus on specific goals, greater ability to identify and support activities and assets which make a larger contribution to achieving the SDGs, and more certainty that goals will be achieved.

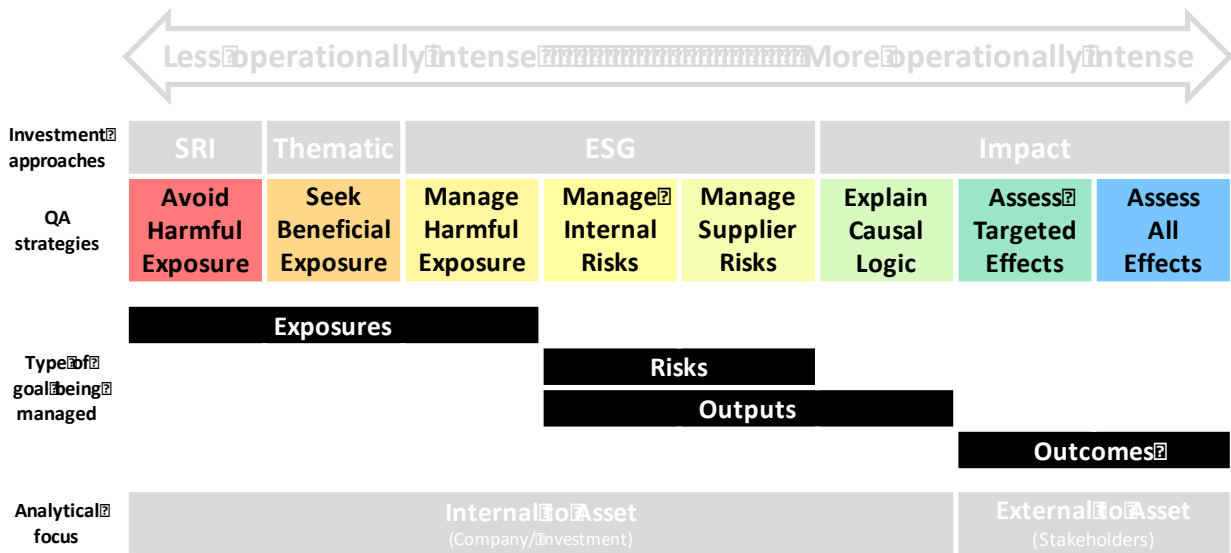
The operational intensity of the strategies used to manage impact can be used as the organizing principal for the analysis of impact.

We have identified eight strategies currently used to manage exposures, risks, outputs and outcomes (these eight strategies are described below). These strategies are self-contained and independent of each other. That is, each strategy has its own data requirements, its own reporting requirements, and allows investors using it to make a specific and unique set of valid impact claims.

The independence of the eight strategies makes them a suitable basis for a Quality Assurance approach to impact. If an investor says it is using a particular strategy or combination of strategies it is clear exactly what the investor should be doing and what impact claims it can make and this can be verified. Likewise, by observing the combination of strategies an investor is using it is possible to deduce which impact claims the investor can validly make. This leads to a very useful and verifiable definition of impact washing: impact washing is making claims beyond those which are supported by the combination of strategies being used.

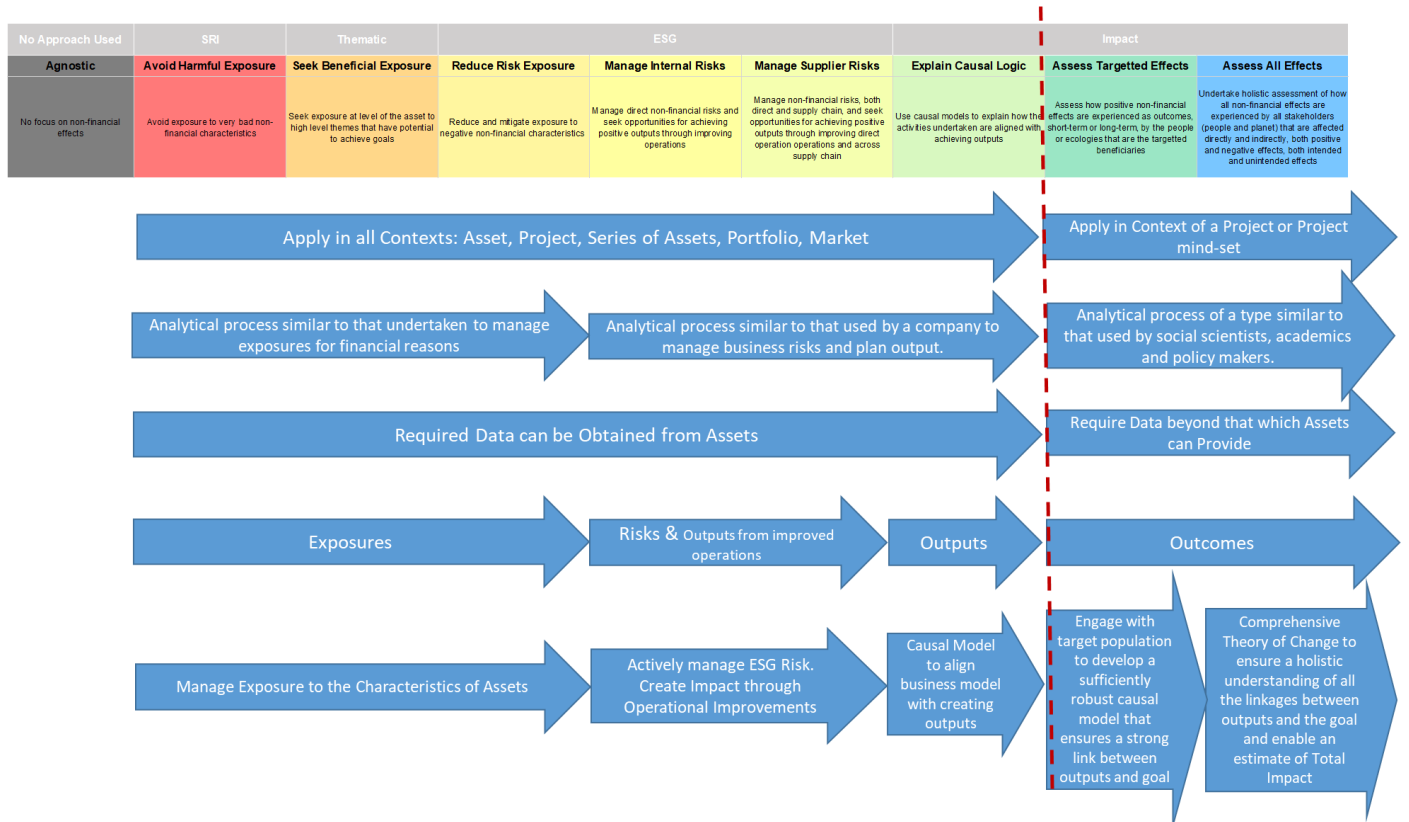
Figure 1 illustrates the Quality Assurance framework by organizing the eight strategies in ascending order of operational intensity.

Figure 1 Operational Intensity as the organizing principal: A Quality Assurance framework for analyzing Impact



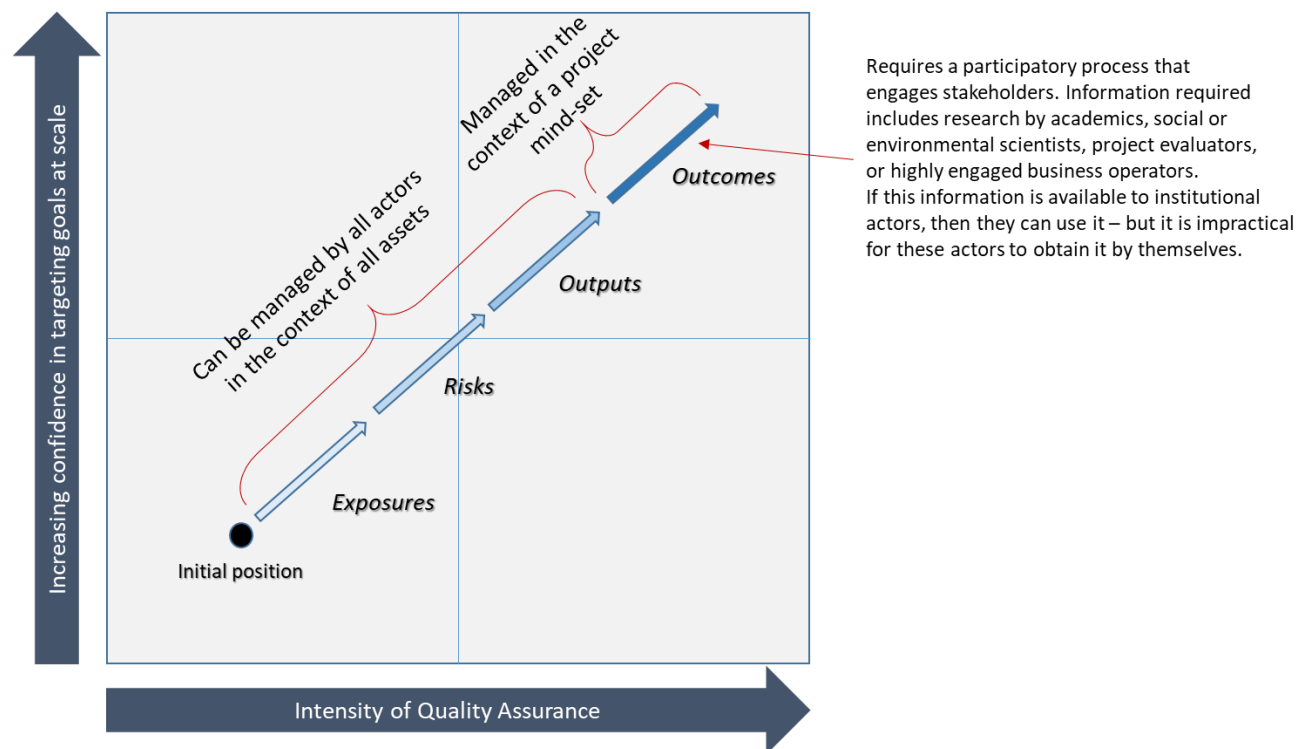
An overview of the attributes of the eight strategies is provide in Figure 2.

Figure 2 Operational Intensity as the organizing principal: The attributes of the eight strategies



Managing each dimension of exposures, risks, outputs and outcomes makes a contribution to achieving beneficial results. As the management of each successively more operationally intense dimension is added to an actor's impact practice, the actor gains greater ability to discriminate between more beneficial and less beneficial activities and greater ability to focus and achieve a larger beneficial effect with greater predictability, replicability and fewer unintended consequences. This is illustrated in Figure 3.

Figure 3 The cumulative effect of combining the management of exposures, risks, outputs and outcomes



The eight operational strategies of the Quality Assurance framework

These are the eight strategies which we have identified. There may be other strategies now or in the future which can be included.

Strategy 1: Avoid Harmful Exposure. This is a simple exclusion strategy and corresponds to what is often called Socially Responsible Investing (SRI). The actor excludes from its portfolio any exposure to pre-specified characteristics which it considers to be too objectionable. For example, characteristics commonly excluded are child labour, armaments and coal.

Strategy 2. Seek Beneficial Exposure. This strategy corresponds to the most basic version of what is often referred to as Thematic investing. The actor wishes to increase its exposure to themes which contribute positively to people and planet and does so by supporting assets focused on its favoured themes, for example health care, climate or a selection of the SDGs.

Strategy 3. Manage Harmful Exposure. An actor implementing this strategy is willing to accept some exposure to negative characteristics such as CO2 emissions and water use but wishes to moderate its exposure. The actor does this by identifying and favouring assets whose operations have relatively better characteristics and by reducing exposure to assets whose operations have relatively worse characteristics. This strategy corresponds to the types of strategies often implemented through the use of ratings systems. For example, the ESG strategy which is often implemented in publicly traded assets, using indexes or rating systems to select those assets with a relatively better ESG profile or the GIIRS rating system used by companies.

Strategy 4. Manage Internal Risks. An actor using this strategy may have two goals. The first is to manage the risk of the occurrence of negative events which might arise from the operations of an asset. For example, industrial accidents or oil spills. The second is to use its knowledge of the ESG profile of the operations of an asset to improve the ESG profile, thereby creating positive outputs. For example, by reducing the use of non-renewable energy to reduce the emission of CO2 by 10,000 tons. This strategy corresponds to the active ESG strategies implemented within companies through the use of an Environmental, Social and Governance Management System (ESMS).

Strategy 5. Manage Supplier Risks. This strategy is an extension of either a Manage Harmful Exposure or Manage Internal Risks strategy beyond the internal operations of an asset to also include the supply chain. Rather than focusing only on the internal operations of an asset, the analysis is extended to also include the supply chain.

Strategy 6. Explain Causal Logic (outputs). An actor using this strategy seeks to create a quantity of positive beneficial output. The actor achieves this by using a causal model to analyse the degree to which the business model of an asset is aligned with creating a quantity of beneficial output over the expected holding period. For example, is an asset likely to create:

- An additional one hundred places in school for disadvantaged children?

- Additional housing for five hundred families?
- A reduction in CO2 emissions of an additional 10,000 thousand tons?

Strategy 7. Assess Targeted Effects (outcomes). The first six strategies all focus on achieving goals within the context of a single asset. This is the first of the strategies to seek a goal that lies beyond a single asset. An actor implementing this strategy would like their target stakeholders to experience the positive effects of the investment as planned, and the actor seeks to avoid their actions having unintended consequences. They do this by understanding how the consequences of their actions are experienced and perceived by the population or ecology that is affected. For example, did the additional one hundred places created in school for girls actually improve the quality of life of the girls in the target population as intended?

Strategy 8. Assess All Effects (outcomes). An actor implementing this strategy wants to understand the total, aggregate, consequences of their actions in a holistic manner. To do this they develop a Theory of Change which is a nonlinear model that explains the causal path from actions to primary outputs to secondary and tertiary consequences, including feedback loops, dependencies and assumptions necessary for success, finally reaching the ultimate goal. For example, the goal of constructing a new road in an undeveloped area is to improve the life of the local community. Constructing the road will allow farmers better access to markets, which raises household income, which improves health and education with consequent inter-general effects. However, the road also opens up forest to clearance which, if it occurs, will endanger threatened wildlife and lead to erosion which threatens livelihoods. Obtaining the total holistic picture enables forward-planning which helps to achieve the desired positive effects while reducing the undesired negative effects.

As noted earlier, the eight strategies are independent of each other and the implication of this independence is that the more operationally intense strategies do not automatically embed the less operationally intense strategies. This means that for ESG and Impact practice it is often necessary to use a combination of strategies to meet our goals.

For example, if an actor's goal is to understand how the jobs created by its actions are experienced by a population the actor will implement an Assess Targeted Effects strategy and survey the target population to understand the population's experience. However, if the actor also wants to plan in advance to create the largest number of jobs possible, the actor will need to implement an Explain Causal Logic strategy and develop a causal model with which to identify the number of jobs different

assets are likely to create. The combination of the two strategies provides the actor with the understanding of both the number of jobs likely to be created and how the population experiences the jobs that are created.

Operational guidance to investors

A Quality Assurance framework based on framing the analysis of impact in terms of the operational intensity of the strategies used to achieve impact goals provides clear operational guidance to investors in terms of both how to establish and how to achieve impact objectives. This is the norm for methodologies in financial and portfolio analysis which aim to provide guidance on *both* how to *establish* mandate-appropriate goals and how to *achieve* the goals.

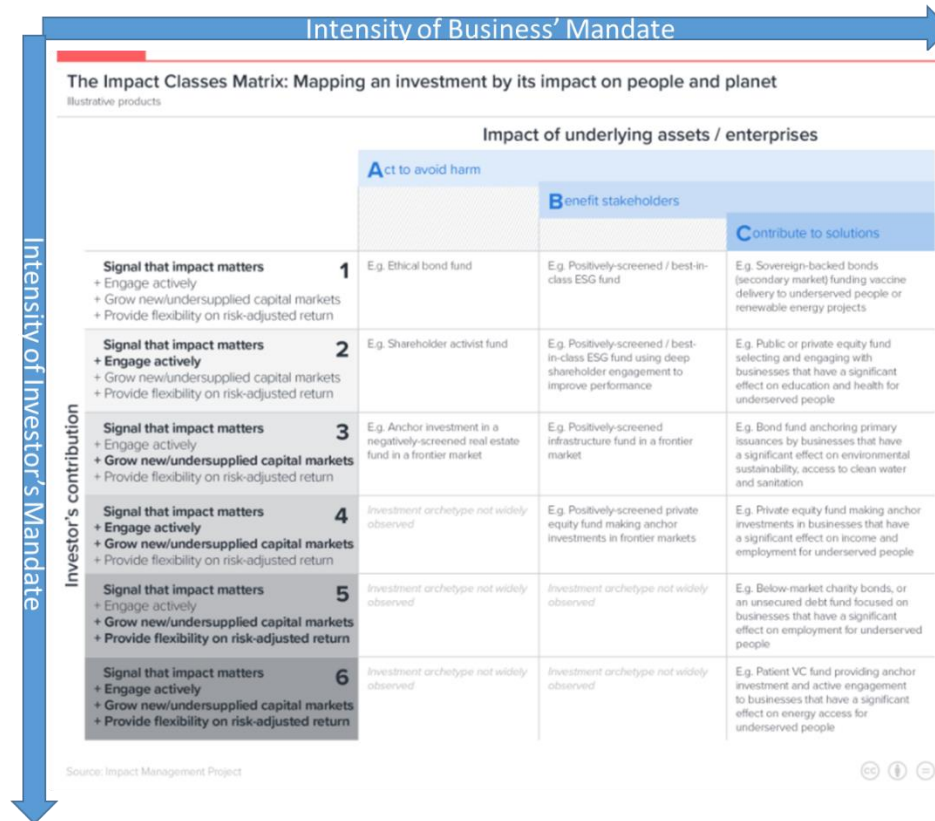
In contrast, methodologies which frame the analysis of impact in terms of the intensity of the impact mandate of actors do not provide any operational guidance to actors on how they can achieve the impact goals they establish. The lack of operational guidance is the result of focusing on the definition of impact investing, which does not include the dimensions of exposures, risks, outputs and outcomes. This can be seen by comparing Figures 3 and 9. Figure 3 charts a progression of increasing operational functionality and control while the progression charted in Figure 9 does not correlate to or suggest any particular mapping of operational functionality.

Neutral (not prescriptive) decision-making methodology

The advantages of using the operational intensity of the strategies used to achieve impact goals as the framing device for analyzing impact become apparent in a comparison with other approaches which use the intensity of an investor's commitment to impact as the framing device.

The current framing of methodologies used for the analysis of impact typically focuses on the *definition* of impact investing. Often the framing is expressed in terms of the intensity of an actor's commitment to impact, from lower commitment to higher commitment. This type of framing is exemplified by the framing of the IMP's impact landscape, illustrated in Figure 4.

Figure 4 The IMPs Impact Classes Matrix



Because the focus is on defining what impact investing is and what actors need to do in order to become impact investors, these approaches are prescriptive. They prescribe how actors should behave in order to be considered impact investors. They prescribe how the mandates of investors should be configured in regard to impact.

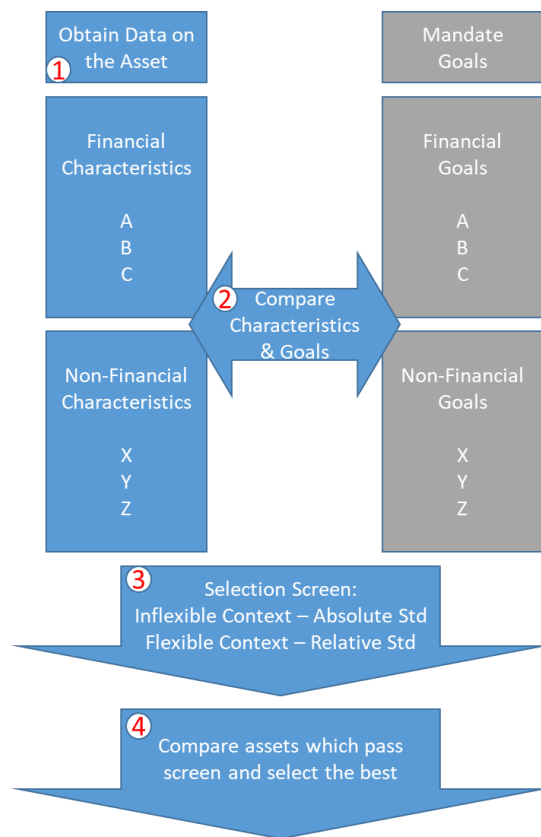
A prescriptive approach is in stark contrast to the norm in finance and portfolio management which is to design methodologies to be neutral in regard to the mandates of investors. Investment methodologies are designed to be neutral in regard to investors' mandates in order that they can be used by any investor with any mandate in the management of any type of asset.

Figure 5 illustrates a typical neutral investment decision making process in which actors:

- Obtain the information they require on the financial and non-financial characteristics of an asset.

- Compare these characteristics with the requirements of their mandate, both financial and non-financial.
- Apply either an absolute standard or a relative standard to screen-out assets whose characteristics are inadequately aligned with achieving their goals.
- Compare the assets which pass the screening process with each other to identify the most attractive options.
- Make a final decision.

Figure 5: Neutral Decision Making Process



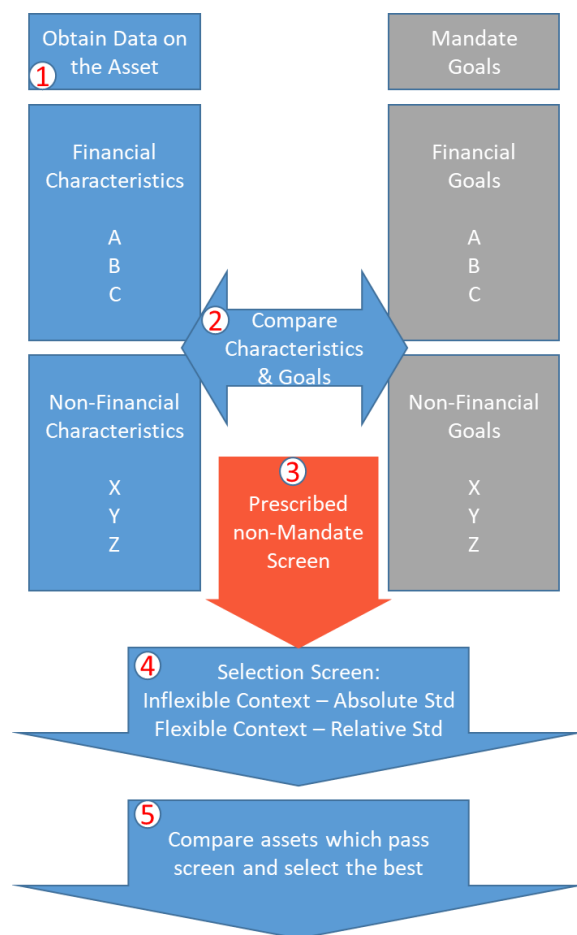
A neutral decision making process is generalizable. That is, it is adaptable to the decision making process of any and all actors because it does not prescribe what actors must do but rather enables actors to customize it to their own individual mandates and contexts.

The only data point in the process common to all actors is the information on the characteristics of the assets. The screens used in the selection process are tailored to the mandate and context of each

individual actor. It is for this reason that actors selecting from the same set of assets and possessing identical information on the characteristics of these assets will select different combinations of assets and construct different portfolios.

In designing a process for Impact investing it is important to adopt the design principle of a neutral methodology rather than a prescriptive methodology, as a neutral methodology can be used by all actors while a prescriptive methodology will be inconsistent with the mandates of some actors. To illustrate this point, Figure 6 illustrates a prescriptive methodology in which a factor which is part of the mandate of some actors but which is not part of the mandate of all actors is made a compulsory part of the decision screen used by all actors. All actors now have to screen for the compulsory factor whether it is part of their mandate or not.

Figure 6 Prescriptive Decision Making Process



Actors who have the compulsory factor as part of their mandate will not notice anything amiss and will succeed in fully allocating their capital in accordance with their mandate. Actors for whom the

compulsory factor is not part of their mandate are faced with the choice of (i) breaching their mandate in order to apply the compulsory factor to their entire Assets Under Management (AUM), (ii) applying the compulsory factor only to the extent that their mandate is not compromised, implying it will be applied to only a limited part of their AUM, or (iii) entirely abandoning the use of the prescriptive methodology.

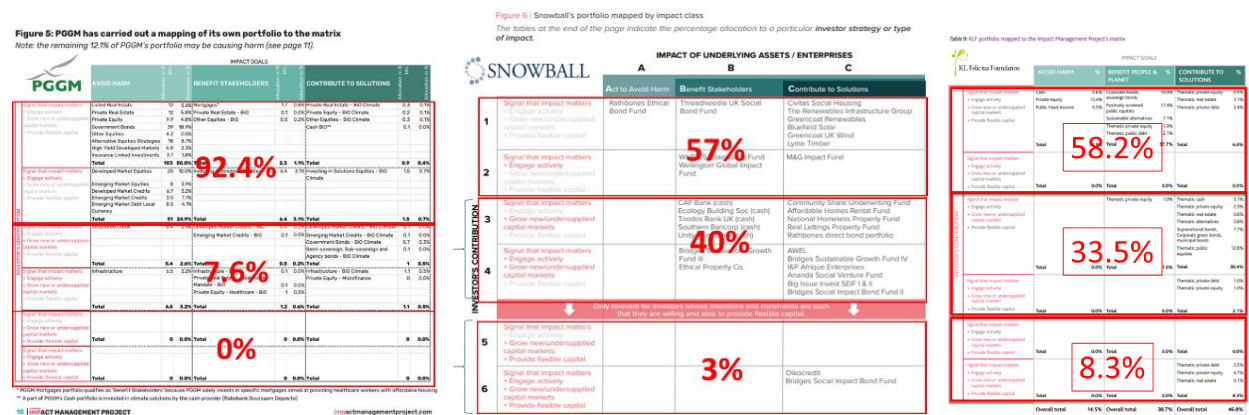
Continuing to use the IMP's impact landscape as an example:

- The first two rows of the IMP landscape do not specify any conditions which are likely to be in conflict with the mandates of actors. Consequently we would not expect to see any noticeable limitation on actors' allocation of capital to assets located in these rows.
- The third and fourth rows require actors to grow new or under-funded capital markets. Correctly or not, new and under-funded markets are often perceived as having greater risk relative to return than commercial norms. The third and fourth rows require actors to accept greater risk than they normally would. Consequently we would expect to see actors limit the capital they allocate to assets located in these rows to an extent that such allocations do not compromise the financial goals of their mandates.
- In addition to supporting the growth of new or under-funded capital markets, the fifth and sixth rows require actors to provide flexibility on risk-adjusted return. That is, accept a lower return than the commercial norm in addition to accepting greater risk. Consequently we would expect to see actors limit the capital they allocate to assets located in rows five and six to an even greater extent than they limit the allocation of capital to assets located in the third and fourth rows.

In addition to the conflict between investor's mandates and the prescriptive requirements of rows three through six, a further factor which will limit the allocation of capital to assets located in rows three through six by actors with larger AUM is that the typical size of assets associated with new and under-funded markets and concessional finance is often relatively small. New enterprises are small because they have not yet had time to grow. The types of assets which require concessional funding often require it because they have difficulty achieving scale on a sustainable basis. For efficiency reasons actors have a minimum investment size, the larger their AUM the larger the size of their minimum investment.

The expectation that actors will allocate less capital to assets in the third to sixth rows and particularly to assets in the fifth and sixth rows are borne out by the capital allocations of each of three investors shown in Figure 7 who (i) have a commitment to impact investing and (ii) seek market-rate returns. While each investor has a commitment to impact investing, the scale of their AUM is very different: PGGM 220bn euro, Snowball around 23.5m euro and KLF around 10m euro. Snowball specifically indicates that assets located in rows five and six will generally not meet the requirements of its mandate. For PGGM with 220 billion euros in AUM, minimum investment size is clearly an issue.

Figure 7 The Capital Allocations of PGGM, Snowball and KLF Mapped to the IMP Impact Landscape¹



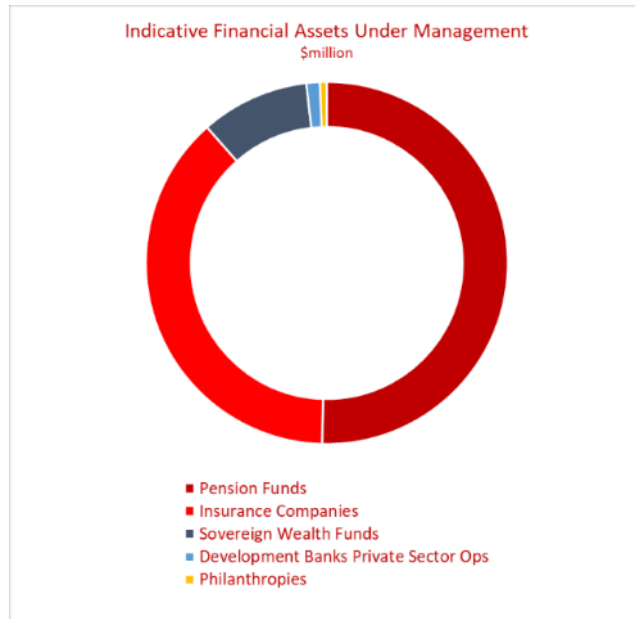
A methodology which does not enable actors to integrate impact principles across their entire AUM creates a problem for achieving the SDGs because achieving the SDGs requires the mobilization of a very large amount of capital. In particular, meeting the SDGs requires the participation of institutional investors who allocate the majority of long term global capital, as indicated in Figure 8. PGGM is an institutional investor and the concentration of the majority of its capital in the first and second rows of the IMP impact landscape indicates the extent of the problem caused by a prescriptive approach to analyzing impact.

Investor's will only use a prescriptive approach to impact investing to the extent that it does not compromise the other goals established by their mandates. Where a prescriptive impact methodology is in conflict with other goals, it is unlikely to be used and, if no other impact methodology is available

¹ Sources: "The Investor's Perspective How an asset manager can map its portfolio by the effects it has on people and planet – and what we can learn from this", "The Investor's Perspective Building an impact management process for a multi-asset class portfolio" both from the IMP. "In pursuit of deep impact and market-rate returns: KL Felicitas Foundation's journey" NPC April 2018

which is not in conflict with mandated goals, impact is unlikely to be integrated into the management of total AUM.

Figure 8 Global Financial Assets Under Management



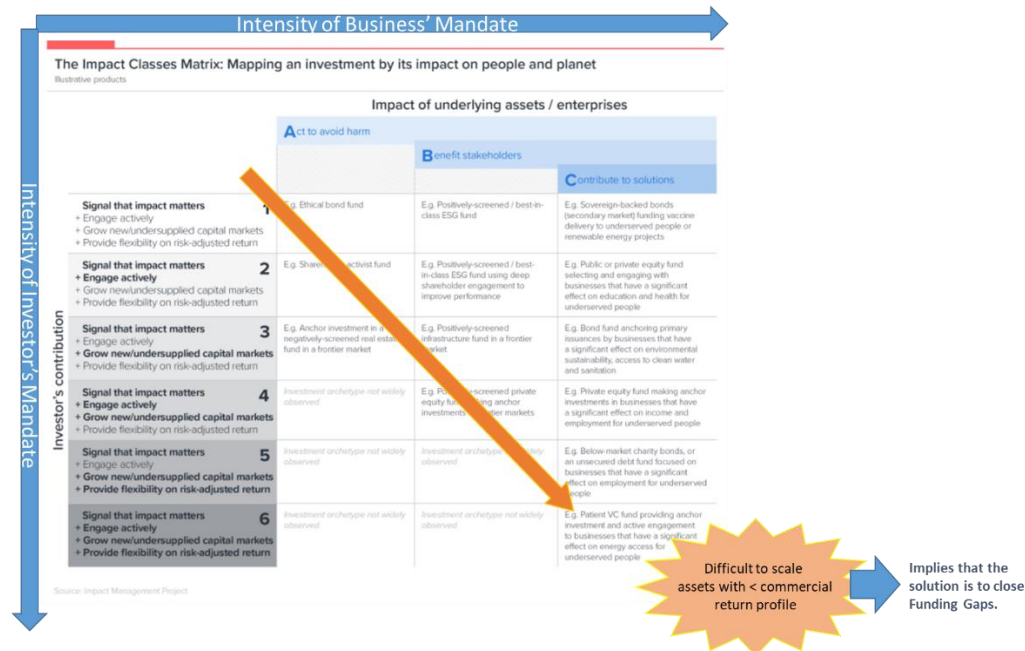
Neutrality between alternative solutions for achieving the UN SDGs

In addition to limiting the mobilization of capital with which to achieve the SDGs, framing the analysis of impact in terms of the intensity of the mandates of actors presents a further problem for achieving the SDGs. Framing the analysis of impact in terms of the intensity of actors' mandates directs actors to allocate capital to assets which have difficulty attracting funding, illustrated in Figure 9. The logical implication of this is that it must be thought that the solution to achieving the SDGs is to close funding gaps.

Privileging the closing of funding gaps as the solution to achieving the SDGs is highly problematic as it is not clear that the majority of global problems, particularly climate problems, are the result of funding gaps. Climate problems result significantly from the over-consumption of goods with negative impacts which are not properly priced by the market. That is, it is significantly a problem caused by the failure to price externalities.

Closing funding gaps does not address the failure to price externalities. Why then privilege strategies focused on closing funding gaps?

Figure 9 Framing the Analysis of Impact in Terms of the Intensity of Investors Mandates Privileges the Closing of Funding Gaps Over Other Solutions to Meeting the SDGs



Conclusion

If framing the analysis of impact in terms of the impact intensity of actor's mandates is so problematic, an alternative framing of the analysis of impact which avoids these problems would be very useful.

Framing the analysis of impact with a Quality Assurance process based on the operational intensity of the strategies used to establish and achieve impact goals meets this need as it:

- Is neutral rather than prescriptive and so can be used by all actors and tailored to the needs of all mandates.
- Does not privilege either closing funding gaps or pricing externalities as solutions with which to achieve the SDGs.
- Provides actors with concrete guidance on both how to establish impact goals which are consistent with their mandates and how to achieve their impact goals.
- Because it is a neutral framework, it is much less likely to be ignored than a prescriptive framework and so much more likely to influence actors' behaviour across their total AUM and mobilize the capital required to achieve the SDGs.