Zheng Partners LLC

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# Incorporating Sustainability Into the Operations of a Financial Institution

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# Why Pay Attention to Sustainable Investing?

You could pay attention to sustainable investing because you believe that the way in which we consume and the way in which we allocate capital need to change in order to enable the only planet we have to remain habitable for future generations.

You could pay attention to sustainable investing because you believe that market based economies have not been good at pricing externalities, resulting in both environmental degradation that puts future generations at risk and excessive imbalances in wealth which endanger social stability.

However, even if you believe none of these things, now is still a good time to pay attention to sustainable investing for that most basic of market reasons – momentum.

As illustrated in Table 1, the growth in assets under management (AUM) managed to sustainable criteria has achieved considerable momentum. Further, this momentum is global.

	2014	2016	2018	CAGR 2014-2018
Europe (euro billions)	9 <i>,</i> 885	11,045	12,306	6%
United States (USD billions)	6,572	8,723	11,995	16%
Canada (DAD billions)	1,011	1,505	2,132	21%
Australia/New Zealand (AUD billions)	203	707	1,033	50%
Japan (Yen billions)	840	57,056	231,952	308%

Table 1 AUM Invested to Sustainable Criteria 2014-2018 local currency<sup>1</sup>

The momentum behind sustainable investing is the capital-allocation analogue of consumers increasing preference for sustainable products. For example, research by NYU Stern's Center for Sustainable Business found that 50% of US growth in consumer packaged goods from 2013 to 2018 came from sustainability-marketed products<sup>2</sup>.

The growing message from the global population as both consumers and savers is clear: if you want our consumption spend or our savings for capital formation, give us sustainability.

Allocating capital in three dimensions – risk, return and some type of social criteria – is not a new idea. As Chart 1 shows it can be traced back at least to the co-operative movement.

Chart 1 also shows, after a long gestation, the recent interest in sustainable investing among the large financial intermediaries. Something has caught the large investment banks' attention and Chart 2 makes that something clear as crystal.

<sup>&</sup>lt;sup>1</sup> Source: 2018 Global Sustainable Investment Review, published by the Global Sustainable Investment Alliance. Bi-annual publication. Next due 2020.

<sup>&</sup>lt;sup>2</sup> "Research: Actually Consumers Do Buy Sustainable Products", Tensie Whelan, Randi Kronthal-Sacco Harvard Business Review June 19 2019





Larry Fink's 2020 letter to CEOs is not the first time he has made the point highlighted in Chart 2. Clearly he thinks it is a point worth repeating.

What he identifies is the power of the momentum behind sustainable investing to *alter the cost of capital.* 

If you dismiss the reasons for considering sustainable investing in the first two paragraphs, as an investor concerned with risk and return this is a reason you cannot dismiss.

Chart 2 The Reason Why the Large Financial Intermediaries are Paying Attention

Over time, companies and countries that do not respond to stakeholders and address sustainability risks will encounter growing skepticism from the markets, and in turn, a higher cost of capital. Companies and countries that champion transparency and demonstrate their responsiveness to stakeholders, by contrast, will attract investment more effectively, including higher-quality, more patient capital.

Larry Fink, Chairman & CEO Blackrock Exert from 2020 Letter to CEOs

The numbers in Table 1 add up to around \$31,323 billion. Total AUM of institutional investors (pension funds, sovereign wealth funds, insurance companies, foundations) is around \$82,500 billion<sup>3</sup>. The day when the sustainability profile of a company has a clearly identifiable effect on its cost of capital – and so its share price – cannot be too far into the future.

Some may reason that the need to meet risk and return requirements presents investors with a constraint on how much of total AUM can be managed to sustainable criteria. However, I think an investor who relies upon this perceived constraint to shield the value of their favorite non-sustainable company from the momentum of sustainable investing will be as successful as Canute in holding back the tide.

<sup>&</sup>lt;sup>3</sup> Source: PWC, Author estimates

There are two reasons to think this.

The first is that the pressure to adopt sustainable business models is a pincer movement coming from both consumers and investors. Changes in consumer demand create both new growth areas and areas of contraction and business models need to adapt to these shifts. The supply of capital rewards growth and penalizes contraction.

The second is that by employing a relative approach to sustainability rather than an absolute approach, there is a considerable amount investors can do to rebalance their total AUM in more sustainable configurations without having to breach their existing risk and return requirements.

An initial exercise modeling the effect on portfolio allocation of including impact (one of the strategies under the broader heading of sustainability) as a decision variable in an optimization framework resulted in a significant increase in the allocation of capital to more impactful assets, while remaining within the constraints set by risk and return requirements<sup>4</sup>.

Chart 3 shows the results of this initial experiment.





Initially, constraints were set to keep the asset allocation within the bounds of the typical asset class exposures of a US institution with over \$1 billion in assets. The initial optimization only considered risk and return and excluded impact.

The risk and return profile selected in the initial optimization was then used as a constraint (risk could not be higher nor return lower) on future optimizations in which the model sought to

<sup>&</sup>lt;sup>4</sup> Source: "Pricing Impact. Extending impact investing to price externalities and lower the cost of capital to impactful investments" David Wilton, 2019. Downloadable from https://zhengpartners.co/

achieve successively increased targets for the impact score. The consistent flat lines representing risk and return in Chart 3 indicate that these constraints were met.

At the point at which the model could identify no further opportunities to increase impact, the impact score had been increased by 27% and around 40% of the portfolio had been re-allocated to assets with higher impact scores than the original assets.

Clearly this is only a modeling experiment and frictions in real markets are likely to reduce the extent of rebalancing. None-the-less, it suggests that there is significant scope for rebalancing to improve the sustainability profile of portfolios without altering risk and return objectives.

Appeals to economic philosophy are also unlikely to preserve the value of non-sustainable businesses. Surely the Business of Business is Business?

The Business of Business is not simply Business, even according to Friedman.

Chart 4 highlights an exert from Friedman's famous article in the New York Times Magazine in which Friedman recognizes that shareholders can have objectives beyond making as much money as possible, including charitable objectives. The corporate manager's job is to execute on the objectives determined by the shareholders.

The Business of Business is what the shareholders want it to be and right now an increasing number of shareholders want it to be the management of risk, return *and* sustainability.

Chart 4 The Business of Business is What the Shareholders Want it to Be

A Friedman doctrine- The Social Responsibility Of Business Is to Increase Its Profits	IN a free-enterprise, private-prop- erty system, a corporate executive is an employe of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accord- ance with their desires, which gen- erally will be to make as much money as possible while conforming to the basic rules of the society, both
By MILTON FRIEDMAN Exert from the article in the New York Times Magazine September 13 <sup>th</sup> , 1970 commonly referred to as "The Friedman Doctrine"	those embodied in law and those em- bodied in ethical custom. Of course, in some cases his employers may have a different objective. A group of persons might establish a cot- poration for an eleemosynary pur- pose—for example, a hospital or a school. The manager of such a cor- poration will not have money profit as his objective but the rendering of certain services. In either case, the key point is that, in his capacity as a corporate executive, the manager is the agent of the individuals who own the cor- poration or establish the eleemosy-
	nary institution, and his primary re- sponsibility is to them.

If you are not already doing so, now might be a good time to consider sustainability in the context of your portfolio.

#### What is Sustainable Investing?

Sustainable investing is an umbrella term for four distinct investment strategies which share the objectives of reducing exposure to non-sustainable activities and increasing exposure to sustainable activities.

These four approaches to sustainable investing are outlined in Chart 5. They are quite distinct from each other and are not always completely compatible.

Socially Responsible Investing (SRI) Values Alignment	ESG (Environmental, Social, Governance)	Thematic Exposure	Impact Investing
Screen by values. Avoid investments in 'objectionable' companies or industries. Not actively seeking environmental and social impact.	Back companies with good systems to actively manage ESG risks and achieve good standards in Environmental, Social and Governance issues.	Invest in companies with exposure to high impact social and environmental Themes.	Back enterprises that will create positive social or environmental outcomes during the holding period.



#### Minimize negative impacts

#### **Target positive impacts**

*Socially responsible investing* (SRI) is the oldest approach to sustainable investing and is based on *excluding investments* which are considered to have objectionable characteristics (e.g. forced labor, armaments, coal).

Unlike other approaches to sustainable investing SRI seeks neither to manage risk nor to identify opportunities to create positive outcomes. It is a simple like/in dislike/out approach.

*Environmental, Social and Governance* (ESG) methodologies are used in three ways: (i) to *manage the risk* of negative social or environmental outcomes, (ii) to *identify opportunities* to improve the company's sustainable profile and (iii) to *take a snapshot* of the current ESG profile of a company in order to manage portfolio exposure to the ESG profile of assets.

An operational approach to ESG can meet all three uses while ESG ratings meet the exposure management use only.

*Operational* ESG is an active approach to managing ESG risks at the firm or project level. It is implemented by integrating an environmental and social management system (ESMS) into the daily operations, management information system (MIS) and key performance indicators (KPIs) of the company to identify, monitor and remediate environmental, social and governance issues.

Operational ESG is well established as a discipline and is the most standardized of all the approaches to sustainability: multiple practitioners will respond to similar situations in similar ways. Guides to operational ESG can be found at the websites listed in Chart 6.

Chart 6 - Operational ESG Guidance at DFI websites.



In addition to identifying and managing ESG risks, operational ESG can be used to improve the sustainability profile of a company or project by identifying opportunities for more efficient energy use, improved labor conditions and better governance. When used thoughtfully in this way, operational ESG creates impact. Chart 7 illustrates a fund manager using operational ESG to monitor the energy use and CO2 footprint of its portfolio.

Chart 7 Using Operational ESG to Identify and Monitor Energy Use and CO2 Emissions<sup>5</sup>



<sup>&</sup>lt;sup>5</sup> Source: Reproduced with kind permission of Aqua Capital

*ESG Ratings* provide a snapshot of the ESG profile of a company at a point in time that enable investors to identify and support companies with better overall ESG profiles and to avoid companies with negative profiles.

Compared to operational ESG, ratings are a passive approach as while they inform investors of a company's ESG profile relative to other companies, they do not provide a mechanism within the company with which to identify and manage ESG risks and opportunities.

Unlike operational ESG, the ESG ratings of different providers do not provide similar answers and have low correlation, an issue discussed further below.

An ESG strategy can identify and manage ESG-related risks, lead to the creation of impact via improvement in risk factors such as CO2 emissions and labor conditions and help investors to manage their exposure to the ESG profile of assets. However, ESG does not seek to identify assets whose *business model* has the potential to create additional positive outputs such as additional access to socially beneficial things and more efficient energy use.

If our objective is to create additional impactful outputs, the next two approaches to sustainable investing enable us to see if a company's business model has the potential to create impactful outputs.

Seeking exposure to impactful themes, both social and environmental, is a first step toward seeking to create impact.

Thematic investing is a less rigorous approach to creating additional positive outputs than impact investing as it is satisfied simply with exposure to assets in a high impact theme such as health care, education or the environment.

Without the additional requirements of impact investing some capital will support existing stocks of high-impact-themed assets without generating additional impactful outputs and in social sectors some capital will support access to high impact things such as education, health care and housing but for populations which are not disadvantaged.

However, even simple exposure to assets in high impact themes is positive as supporting existing thematic assets can lower the cost of capital for these sectors and create further opportunities for growth.

*Impact Investing* is the only approach to sustainable investment which explicitly seeks investments which will *create additional positive outputs*, such as additional environmental effects and additional access for the disadvantaged to jobs, education and healthcare, during the holding period of the investment.

Impact investing increases the level of rigor over thematic investing by requiring both (i) the creation of additional outputs with which to achieve the UN SDGs, not simply supporting stocks of existing impactful assets and (ii) that social themes such as education and health care address disadvantaged populations.

Clearly the four approaches to sustainable investing each focus on different aspects of improving the sustainability of a portfolio: exclusion of negative output;, managing the risk of negative outputs; managing exposure to the ESG profile of assets; targeting positive themes; and creating additional outputs which are socially or environmentally positive.

This difference in focus means that to improve the sustainability profile of a portfolio the best results are achieved by using a combination of the four approaches.

Combining the four approaches requires care.

SRI is not always consistent with ESG and impact investing. For example, retrofitting a coal-fired power station with cleaner technology to reduce its carbon footprint over its estimated twenty year future life would be seen as a positive investment from an ESG and impact investing perspective, but for an investor wishing to exclude all fossil fuels it would be regarded as unacceptable.

Managing ESG risk and impact investing complement each other.

Operational ESG management by itself will identify and manage ESG risks but, without thematic or impact strategies, will fail to identify many business-model-related opportunities to create positive social and environmental outputs.

Without operational ESG management, thematic and impact strategies run the risk of failing to identify ESG risks which can result in both less net impact achieved and exposure to embarrassing, credibility-damaging, situations. Thematic and impact investing are most effective and credible when executed in tandem with operational ESG management.

# How Can an Institutional Investor Implement Sustainable Investing Across Total AUM?

To align its activities with sustainable investing an institutional investor needs to consider its operations from three perspectives:

- The investors own daily operations, such as staff and buildings.
- Apex risks, for which a standardized approach to management across all assets under management is approved as part of corporate strategy.
- The portfolio of assets.

For an organization whose business is investment the major sustainable risks and opportunities are located in the portfolio.

That this is the case is evident from the categories used to rate ESG risk by the IFC, described in Chart 8. These risk categories focus on the ESG risks and opportunities in the portfolio of the financial institution, rather than on the daily operations of the institution.

## Chart 8 IFC ESG Risk Categories

Category A: Business activities with potential significant adverse environmental or social risks and/or impacts that are diverse, irreversible, or unprecedented.

Category B: Business activities with potential limited adverse environmental or social risks and/or impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures.

Category C: Business activities with minimal or no adverse environmental or social risks and/or impacts.

Category FI: Business activities involving investments in financial institutions (FIs) or through delivery mechanisms involving financial intermediation. This category is further divided into:

FI-1: when an FI's existing or proposed portfolio includes, or is expected to include, substantial financial exposure to business activities with potential significant adverse environmental or social risks or impacts that are diverse, irreversible, or unprecedented.

FI-2: when an FI's existing or proposed portfolio is comprised of, or is expected to be comprised of, business activities that have potential limited adverse environmental or social risks or impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures; or includes a very limited number of business activities with potential significant adverse environmental or social risks or impacts that are diverse, irreversible, or unprecedented.

FI-3: when an FI's existing or proposed portfolio includes financial exposure to business activities that predominantly have minimal or no adverse environmental or social impacts.

While the portfolio is the dominant location of sustainability risks and opportunities, we will first consider investors' daily operations and apex risks as this aids the flow of the discussion.

*Investor Operations* The daily operations of an investor, its HR policies, its governance structure, the buildings it occupies, the energy and water it consumes all create a sustainability footprint. This footprint will be minor compared to the footprint of the portfolio, but it is still worth addressing for reasons of consistency of firm culture with investment policy and also to gain direct familiarity with operational ESG.

Operational ESG is the sustainable methodology best suited to assess, monitor and manage the sustainability profile of the investment firm's operations.

*Apex Risks* Apex risks are sustainability-based reputational and financial risks that are considered by the investor to be sufficiently serious that it wants to ensure that they are actively managed on a consistent basis across all AUM, regardless of the type of asset and, in the case of reputational risks, regardless of the individual mandates of clients.

Deciding to standardize some part of the approach to implementing a sustainable strategy across all AUM due to apex risks needs to be thought through carefully as it is a major decision which cuts across the mandates of all portfolios managed by the institution.

One way to consider reputational apex risks is to think of headlines in the Financial Times that would be so damaging to the financial institution's reputation that it has no desire to

contemplate them. They are risks for which the institution has zero appetite and which it wishes to exclude from the portfolio. For example exposure to forced labor, kickbacks, landmines.

These zero-appetite reputation risks are dealt with through an SRI strategy of creating an exclusion list of activities in which the institution will not invest. Neither its own capital nor the capital of clients.

There will be other reputation risks which a financial institution would prefer to not occur but which it has some willingness to manage if they do arise. These risks can be addressed through a requirement for a minimum standard of operational ESG management across all assets. This minimum standard can be tailored to address the particular risks of concern.

A minimum ESG rating could be used, but less effectively, as ratings do not correlate directly with risk management at the company level.

Unlike reputational apex risks, financial apex risks are not present for all financial institutions. They are more likely to be present for those institutions managing an asset portfolio that is required to meet the demands of contractual liabilities. For example, a general insurance company may have liabilities which are sensitive to climate change. In this case it may make sense to try to create a hedge with assets whose earnings and value come from mitigating climate change. Identifying assets with this characteristic then becomes a central thematic directive for the management of all asset classes.

*The Portfolio* We now turn to the portfolio, the location of the greatest sustainable risks and opportunities.

Bringing an institution's entire AUM into alignment with sustainable investment requires that the most suitable combination of the four sustainable strategies is used in each situation within the different parts of the portfolio.

There is no one-size-fits-all approach that can be deployed by all investors across the entire AUM.

# Strategic Considerations

At a strategic level two factors shape how an individual institution will apply the four sustainable strategies within its investment process. These factors are the size of the institution's AUM and the mandates of the institution and its clients.

The strategic issue is how the application of the four sustainable strategies affects the size of the investable universe of assets *relative* to the investor's AUM.

ESG, thematic and impact strategies can be applied as either absolute or relative approaches. An absolute approach sets a minimum standard which needs to be met before an asset can be considered for inclusion in the portfolio. A relative approach rank-orders assets and gives preference to assets based on their ranking when allocating capital.

Using ESG, thematic and impact strategies in an absolute way is an exclusionary approach which limits the investable universe of assets. At larger AUM an absolute approach will create a conundrum: if there are insufficient assets available to meet the absolute standard across the entire AUM, to what standard do you invest the remainder of the AUM?

This conundrum is a very real one for institutional investors but a less pressing one for philanthropic investors and development finance organizations (DFIs). The reason for this disparity is illustrated in Chart 9, which makes it clear that the AUM of philanthropic investors and DFIs is very small compared to the AUM of institutional investors such as pension funds, insurance companies and sovereign wealth funds.



Chart 9 AUM of Different Types of Institutional Investor<sup>6</sup>

The mandates of philanthropic investors and DFIs are likely to require them to emphasize an absolute approach and meet minimum standards across *total* AUM. The smaller size of their portfolios enables them to take an absolute approach to ESG, thematic and impact strategies and to be successful in applying this approach to total AUM.

The mandates of institutional investors are unlikely to require the adoption of an absolute approach to ESG, thematic and impact strategies. The mandate of institutional investors is likely to be to maximize sustainability within the constraints of risk and return criteria. This mandate is consistent with adopting a relative approach to the sustainable strategies.

<sup>&</sup>lt;sup>6</sup> Source: PWC and author estimates.

Given both their mandate and the size of their AUM institutional investors need to take a relative approach to applying ESG, thematic and impact strategies if they are to bring total AUM within a sustainable investment approach.

A relative approach implies no diminution of standards. A relative approach prioritizes the investment opportunities that meet the absolute standard and then, as these opportunities become scarce, enables the orderly selection of the next-best alternatives. In this way total AUM is brought under sustainable management.

If an investor with large AUM attempted an absolute approach, the result is likely to be that sustainable investment criteria are not applied to the total AUM but rather that an absolute standard is applied to a smaller carve-out portfolio while the balance of the AUM are managed to traditional risk/return criteria only.

To summarize the discussion so far, at a strategic level an institutional investor should:

- Manage the sustainable profile of its own direct operations through the use of operational ESG.
- Identify sustainability-related reputational and financial apex risks. The reputational risks should be managed through a combination of SRI exclusions and tailored minimum operational ESG standards. The financial risks can be managed through a preference for assets which hedge the risks.
- Understand that the significant majority of its sustainability profile comes from its portfolio rather than its own direct operations.
- Adopt a relative approach to implementing ESG, thematic and impact strategies in order to bring total AUM under sustainable management.

The current rate of adoption of the different sustainable strategies, enumerated in Chart 10, suggests that institutional investors may not be taking a relative approach to each of the four sustainable strategies.

Chart 10 shows the current AUM managed to a range of different sustainable strategies and it is clear that SRI and ESG (including variations on ESG) are presently much more widely used than thematic and impact strategies.

If all strategies were being applied on a relative basis one would expect to see much less difference in the rate of adoption between the four sustainable strategies.

Part of the current difference in adoption rates can be attributed to SRI and ESG being much older strategies than thematic and impact. SRI has existing for around fifty years and ESG for around 30 years while the term impact investing was coined thirteen years ago (refer Chart 1).

Beyond elapsed time, the difference in adoption rates is also due, in the case of impact, to the prevalence of initial conditions bias in impact strategies (of which more below) which leads to them being framed and promoted in absolute terms rather than relative terms. Impact has

been developed in the philanthropic and DFI worlds in which smaller AUM permits absolute forms of thematic and impact strategies to be applied to total AUM.

The much larger AUM of institutional investors requires thematic and impact strategies to be applied in relative terms to bring total institutional AUM under sustainable management.



Chart 10 AUM in Different Sustainable Investment Strategies 2016-2018<sup>7</sup>

# Asset Level Considerations

Beyond broad strategic considerations, how might an institutional investor frame the search for sustainable opportunities and risks across total AUM?

In searching for sustainable opportunities and risks we are looking for three things:

- Opportunities to create additional positive outputs with which to meet the UN SDGs.
- Opportunities to support existing stocks of sustainable assets.
- Identifying the largest sustainable risks in order to mitigate or avoid them.

A concept familiar to investors, the business life-cycle of companies, provides a useful framing device for thinking about the location of assets which create the largest quantity of additional

<sup>&</sup>lt;sup>7</sup> Source: 2018 Global Sustainable Investment Review, published by the Global Sustainable Investment Alliance. Bi-annual publication. Next due 2020.

impactful outputs, assets which hold the largest existing stock of impactful outputs and the location of the greatest risk of large negative outputs.

Table 3 outlines the six business strategies which are used in various combinations to create financial return on equity investments. Of these strategies only organic growth is directly connected to the creation of *additional* impactful outputs such as environmental effects and access to jobs, education and housing that are required to meet the UN SDGs.

These six strategies map to those used in value bridge analysis to understand the drivers of return on an equity investment. An example of a value bridge is provided in Chart 11.

Strategy	Description	Role in Impact
Organic Growth	Revenue growth driven by increased sales in existing business and internal introduction of new business. Financial return comes from increased sales.	Directly linked to provision of additional goods/services as this is what drives organic growth. Linked to job creation as company grows.
Inorganic Growth	Revenue growth created by mergers and acquisitions. Growth comes from purchasing <u>existing</u> revenue of another company. Financial return comes from cost-cutting and scale benefits.	No additional goods/services provided or jobs created by acquisition. May reduce jobs short term due to rationalization.
Efficiency Gains	Cutting costs to improve margins. Financial return comes from improved EBITDA.	No additional provision of goods/services in the short term. Short term possibly a negative effect on jobs. Medium to long term, <u>if</u> lower costs are passed on to consumers in lower prices, it could increase the access of underserved groups. If this happens, it will be captured in organic growth.
Leverage	The amount of debt the company is carrying. Larger debt relative to equity increases the return on equity but also increases risk.	No link to additional provision of goods/services or additional jobs.
Multiple Expansion	An increase in the valuation of the company, typically expressed as a higher P/E ratio. Valuation changes can be caused by the company reaching a size that makes it a more attractive acquisition target, by performance exceeding expectations and by market momentum.	No link to additional provision of goods/services or additional jobs.
Cash Extraction	Payment of cash by the company, for example as dividends, fees, royalty payments, stock buyback.	No link to additional provision of goods/services or additional jobs.

Table 3 The Six Strategies Which Create Financial Value

The contribution of organic growth to the creation of financial return declines at larger company sizes. Chart 12 provides some partial data on the relationship between the contribution of organic growth to financial returns and company size. Both sales growth (the red line) and the contribution of sales growth to returns (the dashed line) decline as companies

get larger. The implication is that as companies get larger financial returns are increasingly driven by the five non-output-creating strategies<sup>8</sup>.





Value Bridge Analysis

Chart 12 Contribution of Sales Growth to Financial Returns<sup>10</sup>



The connection between organic growth and impact suggests that one place to focus the search for assets which create additional impactful outputs is companies in the part of the business life-cycle from Start-Up to Mature Growth. This is the part of the business life-cycle in which the business model is most likely to be consistent with the creation of additional impactful outputs.

<sup>&</sup>lt;sup>8</sup> For more detail on Chart 12 refer to "The Short Version. 'Pricing Impact' written as a voyage of discovery in 43 pages". David Wilton, 2020, downloadable from <a href="https://zhengpartners.co/">https://zhengpartners.co/</a>

<sup>&</sup>lt;sup>9</sup> Source: Courtesy of AfricInvest

<sup>&</sup>lt;sup>10</sup> Source: Courtesy of Morgan Stanley AIP

The lack of a direct connection between the other five strategies for creating financial value and the creation of additional impactful outputs suggests that for larger companies in the Mature Stable and Decline parts of the business life-cycle the business model is less likely to be consistent with the creation of additional impactful outputs.

Based purely on the business model used to create financial returns, we would focus our search for assets which create *additional* impactful outputs on companies in the Start-Up to Mature Growth part of the business life-cycle.

There are however strategies which create additional impactful outputs whose financial representation in a value bridge analysis is not clear cut.

Table 4 describes the four strategies, including organic growth, which lead to the creation of additional impactful outputs.

Strategy	Description	Role in Creating Impact	Financial Value Creation Represented in Value Bridge As:	Location in the Business Life-Cycle
Organic growth	Revenue growth driven by increased sales in existing business and internal introduction of new business.	Directly linked to provision of additional goods/services as this is what drives organic growth. Linked to job creation as company grows.	Financial return comes from sales growth.	Start-up to Mature Growth
New Construction of Sustainable Asset	Construction of new assets such as green buildings, wind farms and low income housing.	Directly linked to additional carbon off- set and access to impactful things.	Not clear cut. Value of new asset will be a combination of sales (revenue from new asset) and multiple expansion from valuation multiple applied to revenue.	Start-up to Mature Growth
Transformation of Existing Asset to Sustainable Use	For example, transformation of existing non-green buildings to green status; transformation of land to sustainable use.	Directly linked to additional carbon off- set and sustainable land use.	Not clear cut. Increased value of transformed asset comes from some combination of improved margins and higher valuation multiple.	Mature Stable to Decline
Improvement in Sustainability of Existing Asset	For example, increased energy efficiency or switch to sustainable energy in production process; improvement in working conditions.	Directly linked to reduction in carbon footprint and increased access to better quality jobs.	Not clear cut. Increased value of transformed asset comes from some combination of improved margins and higher valuation multiple.	Mature Stable to Decline

#### Table 4: The Four Strategies Which Create Additional Impactful Outputs

The three strategies in addition to organic growth are new construction of sustainable assets; transformation of an existing asset to sustainable use; and improving the sustainability profile of an existing asset.

New construction is most likely to occur in the Start-Up to Mature Growth parts of the business life-cycle.

Transformation and improving the sustainability of an existing asset are most likely to occur in the Mature Stable to Decline parts of the business life-cycle.

While the business model prevalent in the later part of the business life-cycle is generally unlikely to be aligned with creating additional impactful outputs, it is possible to create transformations of assets and improvements in the sustainability of assets in the later part of the business life-cycle which generate additional impactful outputs with which to achieve the SDGs.

In growth-phase companies we are looking for alignment of the business model with the creation of additional impactful outputs.

In later stage companies we are looking for opportunities to improve the sustainability profile of the operations of the company.

While later stage companies lack the organic growth required to create additional impactful outputs, later stage companies doing business in high impact themes such as education and healthcare may be supporting a large *existing* stock of impactful outputs.

In later stage companies we are also looking for opportunities to support existing stocks of impactful outputs.

Chart 13 summarizes the relationship between impact opportunities and the business life-cycle.

The fact that sustainable outputs are created in different ways at different stages of the business life-cycle raises the question of whether or not some sustainable strategies might be better adapted to different stages of the business lifecycle than other sustainable strategies?

The answer to this question is yes.

Chart 13 How Impact is Created is Related to the Stage of the Business Life-Cycle



An impact strategy based on the general theory of impact developed in previous notes<sup>11</sup> and outlined in Chart 14 will be able to identify opportunities to create impactful outputs generated by organic growth, new construction and transformation of assets. Opportunities that are likely to be concentrated in the part of the business life-cycle from Start-Up to Mature Growth.

This approach to impact will also be able to identify existing stocks of impactful assets across the entire business life-cycle.

Using the general theory, a relative rank-ordering approach to impact will encompass thematic investing and rank opportunities as follows:

- Additional impactful outputs created via growth, new build and transformation (assets meeting all criteria in Chart 14)
- Existing stocks of impactful assets (assets meeting all criteria in Chart 14 except the contribution of organic growth)

<sup>&</sup>lt;sup>11</sup> Refer to "The Short Version. 'Pricing Impact' written as a voyage of discovery in 43 pages" David Wilton, 2020 and "Pricing Impact. Extending impact investing to price externalities and lower the cost of capital to impactful investments" David Wilton, 2019. Both downloadable from https://zhengpartners.co/

- Growth thematic assets (assets meeting all the criteria in Chart 14 except the reach to a disadvantaged population)
- Existing thematic assets (assets meeting only the exposure to a high impact theme in Chart 14)

However, the general-theory-based approach will not be able to identify opportunities to create impact through improving the sustainable profile of existing assets, such as improving energy efficiency or improving working conditions (and will also not identify sustainability risks).

These opportunities are likely to be concentrated in the part of the business life-cycle from Mature Stable to Decline.





The sustainable strategy best able to identify opportunities to improve the sustainability profile of assets is operational ESG.

Operational ESG is implemented by integrating an ESMS into the daily operations of a company, enabling the company to identify, monitor and respond to sustainability risks and opportunities.

Operational ESG is thus not an approach to sustainability that can be undertaken directly by an institutional investor (except as applied to its own corporate operations). At the portfolio level an institutional investor will seek to utilize the benefits of operational ESG by seeking out companies which have implemented an ESMS.

Turning to the identification of sustainability related risks, the probability of the occurrence of negative outputs will depend on (i) the risk category of the activity as described in Chart 8 and (ii) the quality of the company's ESMS.

The possible size of the negative outputs caused by an ESG event is likely to increase with the scale of the activity and so the greatest quantity of possible negative outputs will be located in the larger companies in the Mature Stable to Decline range of the business life-cycle.

Management of ESG risks to avoid negative outputs is most important in high risk activities and in larger assets.

Operational ESG is the sustainable strategy best suited to managing ESG risks as it both classifies risk and enables a company to actively identify, monitor and manage ESG risks.

As noted above, for investors to gain the benefit of operational ESG they need to seek companies which have implemented an ESMS.

ESG ratings are not a substitute for operational ESG in either the identification of opportunities to create impact through improving the sustainability of companies' operations or in the management of the risk of negative outputs.

In part this is because ESG ratings are not designed to be used by companies for risk management while operational ESG and ESMS are specifically designed for this purpose.

In part it is due to ratings being created by aggregating disparate pieces of information of which the quality of a company's ESMS may or may not be one but, even if it is included, the discrete information on the ESMS will be lost in the data aggregation of the rating.

In summary, in the portfolio at the asset level institutional investors should consider:

 Managing the risk of negative ESG risks through operational ESG by seeking companies which employ an ESMS (environmental and social management system) to manage sustainability risks.
 At a minimum, taking care to manage sustainability risks for assets in casters in

At a minimum, taking care to manage sustainability risks for assets in sectors in high risk categories, particularly category A, and for larger assets.

- Identifying opportunities to create additional positive impact outputs based on the business model of companies across the entire portfolio by using a general-theory-based impact strategy on a relative basis.
- Identifying opportunities to create additional positive impact in larger more mature assets through improving the sustainability profile of these assets by identifying companies which implement operational ESG through an ESMS.
- Identifying opportunities to support existing stocks of impactful assets, particularly in larger more mature assets, by using a general-theory-based impact strategy on a relative basis.

### Issues that will be Encountered Implementing a Sustainable Approach to Investing

Having outlined a broad approach to integrating sustainability into managing the operations of an institutional investor, we now address the practical problems encountered by institutional investors when implementing a sustainable investment strategy.

Financial institutions wanting to integrate sustainability into the management of their AUM face an unusual problem.

There is no single accepted template for sustainable investing that an institution can take and apply across all AUM. Sustainability is still a developing discipline and has yet to coalesce around a generally accepted approach.

The fragmentation in approaches to sustainability is pronounced, as Chart 15 illustrates. As discussed above, this fragmentation is partly functional as each of the four sustainable strategies contributes something different to an investor's approach to sustainable investment.

Chart 15 however makes two points which suggest that aspects of the current fragmentation reflect the developing nature of the discipline.

The first is the presence of 'initial conditions' bias in the methodologies for ESG ratings and impact.



### Chart 15 Sustainable Investing is presently highly fragmented

Initial conditions bias arises when the initial developers of an idea have only a partial view of all the possible applications of the idea and the needs of different users. The model they develop is tailored to the needs and uses with which they are familiar and has to be altered and

expanded to become useful to a broader user-group. Sustainability has not yet evolved to the advanced stage at which the needs of all users are catered to.

The second is the shortage of data.

Demand for sustainability data is relatively new and is yet to be clearly articulated to the accounting profession and stock exchanges who are in a position to ensure it is made available. In the absence of a deep base of data upon which to build a consensus view on the sustainability characteristics of different types of assets, it is necessary to fall back on sustainability rating methodologies which, in the absence of data, are subject to the initial conditions biases of their creators.

In time, with enough data, there will be a common basis of understanding around sustainability just as there is for risk and return.

However, until this happy state is reached, the fragmentation illustrated by Chart 15 poses unusual problems and risks for financial institutions wanting to integrate sustainability into their business.

Risks that are apparent from Chart 15 are:

- *Incomplete approach*. Adopting one of the approaches to sustainability without being aware of the contribution made by all four sustainable strategies.
- *Incompatible approach*. Adopting an approach to sustainability which is not compatible with the relevant mandate.
- *Structural weakness*. Failure to fully understand the weaknesses in methodologies or data and making investment decisions without this understanding.

An additional risk that is not apparent from Chart 15 but which is quite real for a financial institution is conflicts of beliefs or perceptions which can lead to accusations of 'sustainability washing'. The sustainability space is populated with passionate people who at this stage of the development of the discipline tend to be locked into one of the many approaches to sustainability. Lacking a broad view, enthusiasts can be critical of anyone not following their favored approach.

Before adopting an approach to sustainable investing it pays to have a broad understanding of the current state of the discipline to enable choices which are informed, appropriate and able to be explained and defended.

A key issue faced by investors implementing a sustainable investment strategy is the need to ensure that the chosen strategy is aligned with the mandate of the portfolio.

Every financial institution and each client and product of every financial institution has its own individual mandate.

Each mandate requires the tailored selection of benchmarks, exposure limits, return targets, sustainability targets and risk and liquidity requirements to focus asset allocation onto those assets which maximize the likelihood of achieving the goals of the mandate. Both financial goals and sustainability goals.

Unless the mandate is clearly understood it is not possible to select the benchmarks, the exposure limits and the other parameters which guide capital allocation decisions.

As Chart 16 illustrates the mandate of an investor affects the position of their optimal portfolio relative to the efficient frontier. The portfolios of investors with commercial mandates will be located along the efficient frontier, the exact position being dependent on the risk tolerance and return requirements of each portfolio.



## Chart 16 Investors' Missions Affect the Position of Their Portfolio

Development finance institutions will generally be more willing to take more risk to achieve a particular level of return, consistent with their need for additionality.

Philanthropies will generally be willing to take a lower return at any given level of risk, consistent with their philanthropic mission.

In finance the need to understand the mandate of a portfolio is so well understood that it may appear a little basic to be giving it so much attention here.

However, while it is straightforward to assess data on the financial characteristics of assets against mandate-relevant parameters to help achieve financial goals, it is much less straightforward in the case of sustainability goals.

The reason for this is the data shortage under which sustainability labors, the response to which has been the creation of ratings which broadly suffer from initial conditions biases.

In the absence of granular data with which to assess the sustainability characteristics of assets investors have turned to ratings and scoring methodologies which aggregate various data points to position assets relative to each other in terms of sustainability.

This aggregation leads to two issues. First, the aggregation obscures the signal from individual data points that might be more useful disaggregated. Second, initial conditions bias<sup>12</sup> in many of the rating methodologies creates problems for investors trying to construct an investment strategy which is consistent with their mandate.

Of the four approaches to sustainable investing in Chart 15, this issue affects ESG ratings and impact.

In the case of ESG ratings initial conditions bias is responsible for the low correlation between the various ESG rating systems<sup>13</sup>.

The fact that different ESG rating methodologies give very different ratings makes it likely that the outcome of investors allocating capital based on conflicting ratings will be mispricing of assets, creating both a field day for hedge funds and volatility. This is not beneficial to institutional investors seeking to meet the mandates of their own and clients' portfolios.

The underlying issue is the lack of good and plentiful sustainability data which leads to the reliance on aggregated ratings.

Avoiding this mispricing scenario is very much in the interest of institutional investors. Avoidance requires the provision of additional sustainability data to enable granular analysis of the sustainability characteristics of assets, just as the financial data currently provided by companies enables analysis of their financial risk and return characteristics.

Generating the required data is conceptually straightforward: it can be achieved if all companies adopt operational ESG and integrate an ESMS into their MIS and KPIs and report the resulting data with their accounts.

Encouraging companies to do this is a matter for those with the leverage and self-interest to drive the change: large investors, the accounting profession, stock exchanges and ultimately regulators.

In the case of impact investing most approaches to rating impact aggregate two conceptually different things into a single rating: (i) analytical data describing the general characteristics of an asset relevant to all investors and (ii) screens such as exposure limits, benchmarks and exclusions which guide individual investors to select those assets which most help to achieve the goals of their mandate.

<sup>&</sup>lt;sup>12</sup> For a discussion of this issue refer to "Measuring Sustainability. Data + Flexible Analytical Tools versus Ratings" David Wilton 2020. Downloadable from <a href="https://zhengpartners.co/">https://zhengpartners.co/</a>

<sup>&</sup>lt;sup>13</sup> For research on the origins of the low correlation between ESG ratings refer to "Exploring Social Origins in the Construction of ESG Metrics", Robert Eccles and Judith C Stroehle, Working Paper, Said Business School, University of Oxford

This aggregation runs counter to the process of capital allocation typically used in portfolio management, illustrated in Chart 17. The aggregation has the effect of combining steps 1a and 1b in portfolio optimization and steps 2a, 2b and 2c in individual asset selection. Combining these steps removes the normal and necessary separation of (i) the analysis of the characteristics of assets used by all market participants from (ii) the use of exclusions and benchmarks to screen assets to ensure those selected are suited to the mandate of a particular investor.

In effect, the aggregation assumes that particular mandate screens are relevant to the mandates of all investors, which is not the case.



Chart 17 The Process of Institutional Portfolio Capital Allocation

The general theory of impact outlined in Chart 14 is designed to focus solely on characteristics of assets which help to predict the quantity of impactful outputs assets are likely to create. An approach to impact such as the general-theory-based approach will not suffer from the problems caused by aggregating mandate-related-screens with predictive-characteristics.

However, most current approaches to impact do suffer from this aggregation problem, with two consequences.

The first consequence is that they are not able to rank-order assets based on their potential to create a quantity of additional impactful outputs. The rank-ordering of assets described at the bottom of page 21 will not apply.

The second consequence is a massive limitation on the ability of institutional investors to apply a relative approach to sustainability across all AUM.

The particular cause of this limitation is the practice of most current approaches to impact to aggregate intent and additionality into the rating methodology. As discussed elsewhere<sup>14</sup> intent and additionality are screens used to constrain capital allocation which are relevant to achieving the mandates of philanthropic entities and Development Finance Institutions respectively. They are unlikely to be relevant screens for institutional investors.

For a financial institution the effect of adopting an impact methodology which embeds intent or additionality (or any other mandate-related-screen unrelated to its mandate) is to severely limit the investible universe, as illustrated in Chart 18.





<sup>&</sup>lt;sup>14</sup> "The Short Version. 'Pricing Impact' written as a voyage of discovery in 43 pages" David Wilton, 2020 and "Pricing Impact. Extending impact investing to price externalities and lower the cost of capital to impactful investments" David Wilton, 2019. Both downloadable from https://zhengpartners.co/

The underlying logic of Chart 18 is explained in more detail elsewhere<sup>15</sup>. For now it is enough to note that (i) the general theory of impact can be used to create the map of the universe of investible assets illustrated by Chart 18 and that (ii) the mandates of different types of investor tend to constrain their activities to certain sub-parts of the investible universe, as indicated by the headings across the top of Chart 18.

Intent and additionality are part of the mandates of philanthropic organizations and Development Finance Organizations (DFIs) respectively and benchmarks and screens designed to achieve these mandate requirements constrain these organizations activities to the areas indicated in Chart 18, broadly speaking.

A financial institution which unwittingly adopts an impact metric or methodology which embeds factors which are not relevant to its mandate will find that many assets which are in fact entirely consistent with its mandate are excluded from consideration.

The immediate effect of these exclusions is to make it practically impossible to implement an impact strategy across the entire AUM of a financial institution. This makes the task of meeting clients' requests for the inclusion of sustainability in their portfolios more difficult to achieve and leads to impact becoming a niche strategy for a small part of total assets under management.

By reducing the flow of capital into the broad group of impactful assets – assets which reduce carbon and increase access to education and health care - the larger effect of these exclusions is to hinder the achievement of the SDGs and to reduce the possibility that the cost of capital for impactful assets will decline as impact becomes priced by markets.

Financial institutions entering into sustainable investing need to have a very clear understanding of their own mandate and the mandates of each client and product, both for the usual reason of developing appropriate screening tools and the impact-specific reason of examining all impact ratings and methodologies for consistency with their mandate.

Being clear about your mandate and ensuring that any impact methodology you adopt is consistent with your mandate is no small matter.

In summary, the discussion above suggests that institutional investors should:

- Have clarity on the mandate of each portfolio they manage and ensure that the ESG and impact strategies they use are properly tailored to the mandate.
- Recognize the significant problems that exist in obtaining adequate data on the sustainability profiles of assets.
- Be very aware of the limitations of ESG ratings and impact methodologies before committing to them as the basis for allocating capital.

<sup>&</sup>lt;sup>15</sup> "The Short Version" ibid

• Use their leverage as the largest allocators of capital on the planet to work with companies, accountants, stock exchanges and regulators to ensure that companies provide the sustainability data required to analyze their sustainability risks and opportunities, just as they currently provide the financial data required to analyze their financial risks and opportunities.

Table 5 collates the three groups of summary bullet points on pages 14, 22 and 29 to provide a summary of the suggestions made in this note.

	SRI	ESG Operational	ESG Rating	Thematic	Impact General Theory	Impact Aggregate-in Screens
Own Operations		Implement an ESMS			Based	
Reputational Anex Bicks	Use exclusions across					
Reputational Apex Risks	entire AUM					
Financial Apex Risks		Understand that the	majority of Sustainability (	Tilt toward assets w	which hedge the risk	
Portfolio	Use a	relative approach to in	plement ESG. Thematic ar	nd Impact strategies to ac	hieve coverage of total A	UM
	Ensu	ire that the ESG and Im	pact methodologies used a	re correctly tailored to th	e mandate of each portfo	lio
Manage risk of negative outcomes		Seek companies which have adopted operational ESG and encourage companies to adopt it				
Rank-order companies by ESG profile		Can be used	Can be used, but results of different methodologies are not strongly correlated			
Identify companies which support existing stocks of impactful outputs					Use an impact methodology which focuses solely on the characteristics of assets and does not aggregate- in mandate related screens	
Identify companies with business models likely to create additional impactful outputs					Use an impact methodology which focuses solely on the characteristics of assets and does not aggregate- in mandate related screens	
Identify opportunities to improve the sustainbility profile of existing companies		Seek companies which have adopted operational ESG and encourage companies to adopt it				
	Be very aware of data limitations. Work with Accountants and Stock Exchanges to overcome these limitations.					
Issues			Low correlation between different methodologies leads to risk of mispricing			Unable to rank-order based on the likely quantity of impactful outputs. Inability to apply a realtive approach to impact across total AUM

 Table 5
 Collation of the three groups of summary points