What is impact investing?

Wealth Management
Dominion Securities

The topic of responsible investing is drawing a lot of attention, especially from investors. In Canada alone, responsible investing assets increased from $2.1 (CAD) trillion at the start of 2018 to $3.0 (CAD) trillion at the start of 2022, an increase of 43%.[1]

Impact investing is one term that falls under the umbrella category of responsible investing. Ask your advisor for the ESG integration, ESG screening and exclusion and thematic ESG investing definitions if you are interested in those.

Responsible investing

Responsible investing is an umbrella term encompassing the approaches used to deliberately incorporate environmental, social and governance (ESG) considerations into an investment portfolio. We believe there are four main applications of this data, and each applies this data very differently. The four applications are:

ESG integration

Systematically incorporating material ESG factors into investment decision making to identify potential risks and opportunities and help improve long-term, risk-adjusted returns.

ESG screening and exclusion

Applying positive or negative screens to include or exclude assets from the investment universe.

Thematic ESG investing

Investing in assets involved in a particular ESG-related theme or seeking to address a specific social or environmental issue.

Impact investing

Investing in assets that intend to generate a measureable positive social or environmental impact.

Impact investing — a third dimension of performance

Every organization makes an impact on the environment and has a corporate identity. Impact measure uses environmental and social data to measure a company's influences on the world. Stakeholders can include people who work for a company, use its products or exist in the community where the company operates. The question is, are these impacts positive or negative?

Impact investing attempts to net and measure the impacts using an investment portfolio. The biggest challenge to implementing impact investing in a portfolio is that there is no standardized framework or data for what a company's impacts are, or how to measure those impacts. Many of the data points that are used to perform environmental, social and governance (ESG) integration are also usable for measuring impact; but there needs to be further work on the exact framework to disclose these impacts.

Impact investing is attempting to measure the actual result of adding or removing something to a portfolio and the societal and environmental impact. Impact investing refers to investments made with the specific intent of generating positive, measurable social and environmental impact alongside a financial return (which differentiates it from philanthropy).

Impact measurement

Impact measure is at a very early stage and rapidly evolving. Because of this, it's currently difficult to measure the impact of an entire portfolio.

The Impact Management Project (IMP) is a compilation of more than 2,000 investment firms and 16 standard-setting organizations looking to standardize the process of impact measurement. The IMP defines the measure of impact as identifying what impact the company has, who the company's practices are impacting, how much the company is impacting these stakeholders if the investor contributed to changing this impact and the risk that the impact will be different than expected.The IMP framework posits that all investments have impacts and it's simply up to the investor to identify and measure those impacts in some way.

Impact investing — public versus private conflict

Historically, impact Investing was considered a form of private investment. Private investments are non-public, have long time horizons and own controlling stakes in the company. As such, the investors can shape the future of the company. In this way, investors can be intentional in identifying the impacts of the company, building a plan to lower their environmental impacts or increase their social impacts and then standardize those impacts across the company.

However, investors and regulators are increasingly demanding impact measures in public market investments. In fact, in European financial markets, the Sustainable Finance Disclosure Regulation (SFRD) of 2021 requires investors to disclose their negative impacts on the planet and people in every portfolio. As such, we are seeing the early stages of the rapid development of data and measurement frameworks for public companies.

Where problems may arise is in the size of publicly traded companies. One example of this problem is how global so many firms are. Many firms may have several businesses in many countries around the world. They likely interact with local stakeholders differently in each of their countries of operation. What is the standard for their interaction? What is the positive or negative impact they may have

Source –United Nations Sustainable Development Goals (UN.org) based on these different customs? Similarly, on the environmental side, a company may have a water business and an energy business. The water business is relatively clean, but the energy business may have negative environmental impacts. Today, there is no set standard for how to net the impacts of the two businesses.

Sustainable development goals (SDGs)

In 2015, the United Nations issued 17 sustainable development goals. (In the diagraph above) They were specifically designed to give countries a blueprint for the next 15 years of environmental and social development around the globe. Beneath the goals, there are 169 targets. For example, under goal #6, there are eight sub targets specifically identified like achieving access to safe and affordable drinking water for all by 2030.

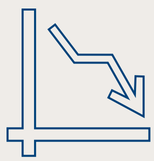
Some investors use SDGs as a way to measure a portfolio's impact. A number of the goals align with themes that investors are interested in and the SDGs offer a simple framework for discussing impact. However, it is important to note, these were designed to guide governments, not investment portfolio measure. It can often be difficult to tie quantitative measures to these goals as there is no specific guidance on what measures should be used to achieve these goals.

Some asset managers attempt to tie metrics to these goals. Using the IMP's impact measure framework, SDGs can be used as a client-friendly framework to represent what the company or portfolio may be impacting. This can be something as simple as a cursory mention that the name or portfolio has some exposure to one or more of the SDGs. Some managers have made a more concerted effort to assign some sort of metric to the goal and then measure what percent of the portfolio is exposed to this goal.

Impact investing—a third dimension of performance

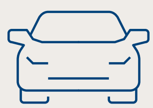
Traditional investing **Impact investing**

Generating a positive, measurable impact[3]



44.06% lower carbon emissions

One million U.S. dollars invested implied an annual emissions reduction of **34.84** tons of carbon dioxide equivalent, compared to the reference benchmark based on MSCI ESG Research analysis of portfolio companies' carbon emissions, equivalent to the annual emissions of:



86,453 miles driven by an average passenger car for one year

5.90 homes' energy use for one year

3,920 gallons of gasoline consumed

Some companies use SDGs as a framework for their corporate sustainability or ESG report. KPMG, a company offering audit, tax and advisory services, found that about 40% of the top 250 largest companies in the world are using SDGs in their corporate reporting[2]. They note that there is no standard for this reporting or the data that should be reported. This type of reporting is extremely new and is likely to continue to grow. As the process of reporting this data improves, so will the ability for asset managers to aggregate and report the impacts in their investment portfolios.

Third measure of return for a portfolio

Today, most investment portfolios have two measures applied to measure the client suitability—risk and return. Over long time horizons, you can balance the return that you seek with the risk that a client is willing to take. As impact investing grows, a third measure of return is starting to enter the conversation. If a client can achieve the risk and return profile that they desire, but their portfolio has significant negative environmental and societal impacts, there is a risk of an unhappy outcome.

Early ways to measure the impact of a portfolio

Responsible Investing strategies can help lower the negative environmental and social impacts of a portfolio simply by investing in companies that have lower environmental and social risks relative to their peers. Today, it is possible to measure the tons of carbon dioxide emitted per million USD of revenue on a portfolio.

Investment managers may start showing their portfolio impact in simple measures like the number of miles that a car would drive or the energy to heat a home. On social measures, investment managers may report the diversity of the boards of the portfolios that they hold. Others may highlight the assets that they've invested into certain causes over a certain period.

Key considerations

Impact investing is part of the larger responsible investing market. Until recently, it was only possible by investing in private equity or debt and venture capital. The definition is pivoting from a more intentional impact toward the idea that every investment has an impact, whether public or private. There is a growing field of using ESG reported data to measure impact, but it is not uniform. However, the area is expected to grow quickly with new regulations in Europe standardizing the reporting and terminology.

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[1] "Technical Report-2022 Canadian Responsible Investing Trends." Responsible Investment Association.

[2] How to report on the SDGs: What good looks like and why it matters (2018). https://assets.kpmg/content/dam/kpmg/xx/pdf/2018/02/how-to-report-on-sdgs.pdf Accessed March 2021.

[3] MSCI ESG Fund Ratings provided by MSCI ESG Research LLC as of 06/02/2020, based on holdings as of 04/30/2020. Updated annually. Holdings are subject to change.

Due diligence processes do not assure a profit or protect against loss. Like any type of investing, ESG investing involves risks, including possible loss of principal.

Past performance is no guarantee of future results.