Impact investing in listed equities – WHEB's perspective

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Executive summary

In recent years there has been rapid growth in the volume of capital being invested in impact strategies. This growth has led to concerns that there has concurrently been a weakening of the standards of impact investing.

There is broad agreement that there are two levels of impact in the investment value-chain. That being delivered by the underlying asset ('enterprise impact') and that delivered by the investor ('investor impact' comprising investor 'intention' and 'contribution').

A traditionalistic view of impact investing focuses on the individual investor's investment and holds that an investor's impact needs to be 'additional'. That is, any positive outcome would not have occurred but for that investor's specific investment.

This traditionalistic view is necessarily restricted to philanthropic activity or at best to situations where new capital is invested in markets with very poor liquidity.

A 'holistic' approach focuses instead on investments as part of the financial system, emphasising the interdependencies between different asset classes. This view holds that investor impact is founded in the investor's intention to deliver positive impact and is then delivered through investor contributions.

This holistic view recognises the 'intense' impact generated by investments demonstrating additionality, but also embraces a spectrum of more 'diffuse' positive impact delivered through other mechanisms. These include changes in the cost of capital, engagement and wider signaling.

WHEB's investment decision is explicitly rooted in the enterprise impact of the business. Our intention is to contribute to positive impacts through enterprise and system-level contributions. We document and report on our investment intentions and contributions to underpin our claims to positive impact (see overleaf).

Establishing demanding but pragmatic standards that require clarity in investment intentions, and evidence of investor contributions, is essential if impact investment is to retain its potency. These standards will enable impact investors to harness the full potential of capital markets as a whole to drive positive impact at scale.

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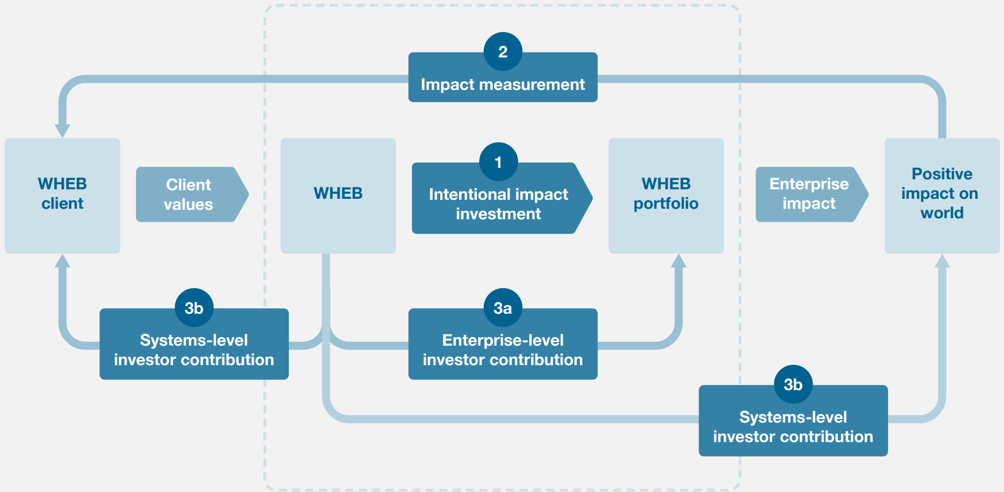
A system level view of impact investing in listed equities



Key

GIIN impact-related requirements

1. Intentional investment to generate impact
2. Investor commitment to impact measurement

Additional IFC requirement

3. Investor intention to make a contribution to impact

1. Introduction

The term 'impact investing' was first coined in 2007 by the Rockefeller Foundation.[1] The practice of impact investing however pre-dated the formal terminology by many years. Prudential Financial, a US-based financial institution, established a business unit in 1976, for example, that sought investment opportunities alongside social change as a core objective.[2] WHEB's own strategy, launched in 2005, focuses on investing in companies providing 'solutions to sustainability challenges'.

However, the approach took time to develop in a world still dominated by the 1970s doctrine of shareholder primacy. Over subsequent decades the practice attracted more support and in 2009 the Global Impact Investing Network (GIIN) was set-up to 'champion impact investing' and 'increase its scale and effectiveness around the world'. The word "impact" itself played an important role in crystalising the movement.

Expanding scope and scale

The original focus of impact investing was primarily on private markets. In a GIIN/JP Morgan annual impact investment survey in 2011, public debt and equity together accounted for just 3 out of 2,213 investments.[3] In fact, as recently as 2016, impact investments in public markets were still only receiving cursory attention in the GIIN's annual impact investor survey.[4] Of the 158 respondents to that survey, only 19 (12%) were allocating to public equity and only 13 (8%) to public debt. In terms of asset allocations, less than 4% was deployed into impact investments in public equity and less than 6% into public debt. The vast majority of the US$49.5bn of impact investments covered by the survey was being allocated to private equity and debt which accounted for nearly two-thirds of all assets. By 2019 however, although public markets still only accounted for 34% of the capital invested by respondents to that year's survey, impact investing in public equity and debt had become two of the fastest growing asset classes.[5]

Philanthropy and impact investing

Traditionally, foundations and charities separated their investment portfolio from their grant giving. This meant that most of their financial assets were not actively aligned with their mission. The first steps in blurring these boundaries were loans or investments in place of or in addition to grants. This meant that more of an organisation's assets could work in pursuit of its mission.

By making a loan or an investment, the impact achieved might not always be as great as through making a grant, but it meant that more money could be put towards achieving the endowment's mission. This became known as impact investing. By moving into new asset classes, return profiles and risk exposures, there has been a trade-off between the 'intensity' of a particular form of impact, and the proportion of a portfolio that can be mobilized towards a particular mission or purpose.

The bigger change since 2009, however, has not been the shift in the relative proportions of different asset classes, but the overall growth in the amount of capital that is devoted to impact investing. The rate of growth has risen dramatically in the last few years. The size of the global impact investing market was reported to have grown more than 40% from US$502bn in 2018 to US$715bn just one year later.[6] In Europe, Morningstar estimate that impact funds accounted for c.1% of all investment funds, worth approximately €105bn in 2020.[7] However, in terms of net fund flows in 2020, the proportion is considerably greater. According to Morningstar, approximately 5% of all net fund flows in Europe were into impact funds, representing c.€21.5bn in 2020 alone.[8]

Impact washing[9]

The rapid expansion of impact investing has been met with concern by some early practitioners. In the 2020 Annual Impact Investor Survey, for example, respondents identified 'impact washing' as the greatest challenge facing the market. Some commentators have gone further, suggesting that impact investing in listed equities is a contradiction in terms. Paul Brest of the Stanford Center on Philanthropy and Civil Society has been particularly outspoken, encouraging asset owners to *'treat the presence of any public equities in a self-styled impact fund as the thirteenth strike of the clock, which calls the others into question.'*[10]

For others, meaningful progress on critical social and environmental challenges requires the scale that only listed markets can bring. As Saadia Madsbjerg a former Managing Director at the Rockefeller Foundation put it, *'While some may be tempted to view these [new] players entering the impact investing space with skepticism, we see traditional asset managers as bringing to the table something the traditional impact investing community has thus far lacked: scale'.*[11] This point is echoed by many, not least by the GIIN who point to the US$2.5 trillion funding gap that is required to achieve the UN's Sustainable Development Goals (SDGs). *'If these listed equity strategies can be harnessed to intentionally drive positive impacts through their investments, then they can potentially deliver a substantial boost to progress on the SDGs'.*[12]

The aim of this paper

The aim of this paper is to set out WHEB's view on impact investing in listed equities.[13] We believe that it is self-evident that all assets and all investors have impact. This impact can be positive or it can be negative, or more often a messy combination of both. This paper builds on the work of others[14] and sets out the logic and narrative that underpins WHEB's approach to impact investing and presents a model for how we deliver impact.

> **"If these listed equity strategies can be harnessed to intentionally drive positive impacts through their investments, then they can potentially deliver a substantial boost to progress on the SDGs."[12]**
>
> **Global Impact Investing Network (GIIN)**

2. Different types of impact

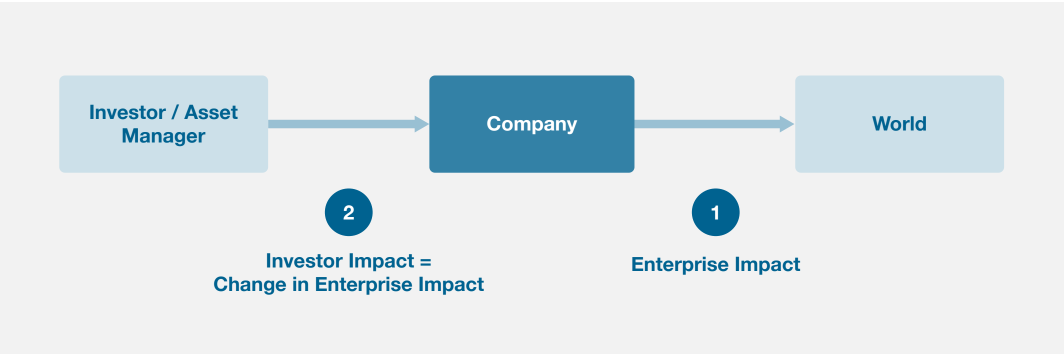
There has for some years been a vigorous debate about the appropriate definition and scope of impact investing. The GIIN has provided a widely supported definition that states that *'impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.'*[15]

This definition does however contain some ambiguity. There are in essence two types of impact to consider. The first is associated with the positive impact that is delivered by the underlying investments; the company or asset itself. This is called 'enterprise impact' because it is delivered not by the investor, but by the products and services supplied by the investee company or asset.

The second type of impact is that of the investor or the investment activity itself. This is called 'investor impact' and typically refers to changes in enterprise impact that are due to the investor or the investment activity. For example, if the investment activity changes the cost of capital, enabling the investee company to deliver more positive enterprise impact, this would be an investor impact.

We illustrate these two distinct types of impact in Figure 1 below.

Figure 1: Two types of impact



3. The traditionalistic view of impact investing

In a view that we have termed the 'traditionalistic' view of impact investing, it is not enough to simply invest in a company or asset which is delivering positive enterprise impact (e.g. a company which brings about positive change in environmental or social outcomes) to qualify as impact investing.[16]

Instead, the investment activity itself must be *increasing* the enterprise impact. Furthermore, under a strict interpretation of the traditionalistic view, a change in enterprise impact must also be directly attributable to that particular investment. This interpretation holds that impact investing only exists where *'an investor seeks to produce social or environmental outcomes that would not occur **but for their investment'**.*[17] This investor impact is conceptualized as *'additionality'*; comprising impacts where it can be demonstrated that they would not otherwise have happened without the specific intervention of that particular investor.

Within a strict traditionalistic view, it is not sufficient to measure and report positive changes in outcomes and point to a causal link – typically through a change in the cost of capital – between the investment and these outcomes. In addition, it requires a circumstance in which the investor is the only available capital provider for an asset, and that the positive impact would not materialise without their investment. This, to us, seems to be an almost impossibly high standard to attain.

Other types of investor impact beyond changes in the cost of capital, such as engagement with investee companies, also do not qualify under this strict traditionalistic interpretation. This is because documenting a causal link that asserts additionality is so difficult. It is rarely possible to attribute a specific outcome to a particular engagement activity.

4. Listed equity impact investing isn't different

A common extension of the traditionalistic view is that 'real' impact investing cannot happen in listed equities because, other than in some limited circumstances,[18] shares in listed companies are just traded between different investors.

This does not involve new capital and consequently, investee companies do not directly benefit from these exchanges. As one commentator has put it, *'Traditional impact investing… doesn't really work in public equity markets because you're just buying the shares from somebody else: you are not really affecting the company's access to capital.'*[19]

The big error to avoid in this analysis, though, is to see the listing of shares as a differentiator. Certainly, when shares trade on a listed market, ownership changes without direct capital introduction. But the same can be (and most often is) the case for transactions in private markets. The sale and purchase of shares in an unlisted enterprise, without an attending primary capital raise, is philosophically identical to a trade on a public market. In these instances, there is no difference between private and public markets.

Where there is a distinction, in our view, is between primary capital and secondary equity trading, with the former directly supporting enterprise impact. However, this form of investment would also not automatically qualify as impact investment according to the strict traditionalistic interpretation of additionality. Given a market rate of return, an individual investor will struggle to claim that his investment contributes *'beyond what would otherwise have occurred'* because, by definition, other investors would be willing to make that same investment.[20]

Secondary equity trading is nonetheless critical in indirectly supporting enterprise impact in several ways.

'The sale and purchase of shares in an unlisted enterprise, without an attending primary capital raise, is philosophically identical to a trade on a public market.'

5. The importance of secondary markets

It seems reasonable to conclude that investments demonstrating the strict traditionalistic version of additionality will be the most ‘intense’ examples of impact.[21]

Even where it is not considered additional, primary issuance will likely trump secondary trading, in impact terms. But this is not the defining quality of impact investing. Indeed, there are features of secondary markets that primary issuance cannot match for impact.

Influencing the cost of capital

The traditionalistic view holds that impact investing in listed equities is not possible because of the alleged inability for listed equity investors to influence the cost of capital of investee companies. As one market participant has previously put it, *‘In liquid markets, simply buying or selling stocks has little, if any, impact on the cost of capital of a company or anything else. You are merely swapping ownership in a big, liquid capital market.’*[22]

This contention is more a matter of degree than division. It ignores the systemic nature of finance and the economic system. It is right that individual transactions have less effect on the cost of capital as the market becomes larger and more liquid. But this is quite different from saying that those transactions have no impact. Clearly every participant has some say on where prices are set.

And as markets exhibit occasionally very volatile behaviour, there are often occasions where quite small investors control price-setting. By way of analogy, it would be ludicrous for an individual football fan to claim that it was her singing, and not the thousands around her, that inspired her team to win a game. But as a community, all singing together, fans do create an atmosphere that has a clear bearing on the outcome of a game.[23]

And again, it is not clear that the listed versus unlisted distinction is crucial here. Practically, it is arguable that the private transaction is likely to provide liquidity that is harder to find in public markets. But today many private markets do demonstrate widely available capital, compared to the scarce liquidity on junior listed markets.

By maintaining or even increasing equity prices and thus lowering the cost of capital for the investee company, trading in listed shares supports businesses in other ways too. For example, higher equity prices support the company in tangible ways such as by underpinning employee incentive structures that rely on equity prices. Companies may also be better able to undertake acquisitions by using their equity to finance deals.

Ultimately by supporting or even increasing market value, investors enable businesses to leverage their equity in pursuing more activity, in turn enabling the company to scale more quickly and deliver greater positive impact. In our view, affecting the cost of capital for a business in this way constitutes a form of investor impact.[24, 25] And it is certainly not exclusive to private markets.

Supporting the investment value chain

Secondary markets – whether private or public – support the functioning of primary investments. A primary contribution with no value realisation mechanism is a donation rather than an investment. Likewise, it is the prospect of secondary markets that encourage impact entrepreneurs to create impactful business models, allow subsequent team-members to share that success and enable them to recycle their capital and do it all over again. The impact ecosystem does not work with primary investments alone.

Additionality marginalizes impact

It is clear, in our view, that investors investing primary capital into businesses – listed or unlisted – that go on to deliver measurable positive enterprise impact are enabling this positive impact to materialise. And equally clearly, where this is genuinely *additional* investment, it is delivering exceptional impact. But this type of investment will inevitably also remain very niche. If all impact investments are to meet the strict additionality test, then impact investing would be restricted to philanthropic activity or, at most, to situations involving new capital invested in markets with very poor liquidity. In remaining niche, impact investment would inevitably fail to deliver positive impact at the scale that is required. As the CEO of the GIIN has put it, *'Requiring additionality as a defining criterion… inherently marginalizes the impact investment market, implying that it will never be robust with competing investors vying for good deals and bringing with them all the benefits of a healthy investment market. With multiple investors who might be able to make a given investment, the counterfactual to one investor closing a deal may then be that another impact investor makes the investment instead. This would be intrinsic to a well-functioning market, which is necessary to have scale and to provide competitive pricing and liquidity for investors and investees'*.[26]

Socialising and scaling impact

One of the key strengths of public markets is they are in fact, public. Listed companies are subject to disclosure regulations and governance requirements that far exceed those in private markets. These facilitate public scrutiny and access by small and large investors alike. Consequently, impact investing as a philosophy in listed markets can attract more – and more widespread – support than private markets which remain the preserve of large private investors.

Public markets also offer scale. Private equity markets have grown substantially in recent years and are expected to reach $5.8 trillion in value by 2025.[27] Public equity markets though remain a dominant part of the financial ecosystem with a value almost ten times that of private markets in 2020.[28] In order to have big, global impacts, you need big global companies, matched with big global markets. As Sir Ronald Cohen has put it *'There is no other way to cope with the scale and severity of social and environmental issues other than to attract investment capital from the $200 trillion of investable assets in our financial system'.*[29]

> **'Requiring additionality as a defining criterion… inherently marginalizes the impact investment market.'**
>
> **Amit Bouri, CEO, Global Impact Investing Network (GIIN)**

6. A holistic model of impact investment in listed equities

Having established that impact investing is not, and should not, be reserved for private markets, what are the defining characteristics of impact investing in listed equities?

Investment intent

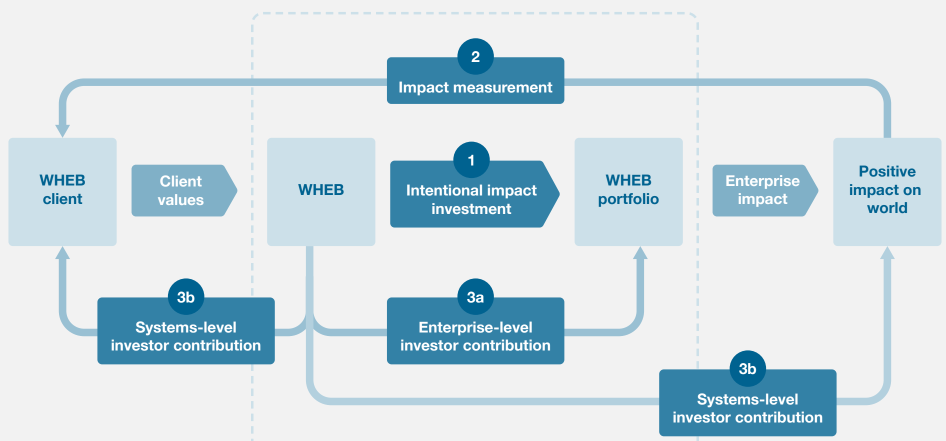
Like others, we agree that the concept of additionality *'is not a pragmatic threshold for determining whether an investor is an impact investor'*.[30] Instead of focusing on whether an investment is additional or not, a more appropriate standard – and still coupled to the GIIN and IFC definitions of impact investing – focuses on the investor's intent. Specifically, when making an investment, is the investor's intention to contribute to positive impacts?

In our view, this intention sits at the core of what it is to be an impact investor. The investment rationale and the decision itself need to be explicitly rooted in the enterprise impact of the business. In short, the impact story needs to be a significant part of the investment story and the investor needs to intend for the investment to contribute to positive impact.

At WHEB, this is also what our investors care most about. Many of our investors see their capital as an extension of themselves – a way to project their values on to the world. WHEB's role is as a conduit for this capital, enabling it to fulfill its purpose by intentionally directing it into enterprises which deliver positive impact and then measuring and reporting back on how it is aligned with this enterprise impact.

This process sits at the heart of WHEB's impact investment model and is illustrated in Figure 2 below. We use our 'Impact Engine' to analyse a company's positive impact ('1' in Figure 2). This analysis is used as a core element in the investment rationale and decision for each investment. It is also documented and shared publicly on our website. We then measure the positive enterprise impact created by the enterprise and report this as well to clients ('2' in Figure 2).

Figure 2: A system level view of impact investing in listed equities



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And investor contribution

Founded on their investment intention, listed equity investors deliver positive impact by supporting the enterprises we invest in to increase their positive impact. This is called the 'investor contribution' and is central to the definition of impact investing put forward by the International Finance Corporation (IFC).[31] This contribution is made directly to companies ('3a' in Figure 2) and is typically achieved through engagement with them. At WHEB we routinely publish short case studies on the engagement work we do with businesses. This has included working bilaterally with investee businesses as well as with coalitions of other investors on issues ranging from climate change and toxic chemicals through to gender diversity as well as better standards of corporate disclosure and governance.[32]

In addition to the contribution that investors can make at the level of an individual enterprise, we can also help shape the wider financial system to support and enable more positive outcomes. This can involve engagement downstream with regulators, policy makers and standard setters, as well as upstream back to clients and their advisers ('3b' in Figure 2). Termed 'signalling' by the IMP this activity can play an important role by indirectly supporting positive impact enterprises.[33] In the same way that the impact of a decision to divest from a business with negative impact largely hinges on the active communication of that decision, so the same is also true for positive impact investing. It is in the communication that the investment decision acquires additional currency by serving to make that company more attractive to other investors.

Practical examples of this 'system-level' contribution at WHEB include work that we have done in supporting the development of new standards on sustainable finance, bilateral and collective advocacy on the need for more ambitious public policy targets on climate change and efforts to educate and inform investors on the potential for asset management to have a positive impact.

Substantiating impact

These dimensions – the investment intention and the investor contribution – are inherently unknowable. The actual intent of an investor can only be inferred from his or her actions. And as previously stated, documenting a causal link that attributes a specific outcome to a particular engagement activity is extremely difficult.

Nonetheless, the core characteristics and approaches for impact investing are now reasonably well-documented.[34] Investors that articulate their investment intentions and corroborate how these are rooted in investment decisions, can provide a solid evidence base to support impact claims. Similarly, credible engagement strategies underpinned by documented activities and outcomes can also strengthen claims to be making effective investor contributions.[35] Ultimately what really matters is the underlying asset impact, not the attribution to individual investors.

'It is in the communication that the investment decision acquires additional currency by serving to make that company more attractive to other investors.'

7. Conclusion

The past two years have witnessed an explosion of interest in integrating environmental, social and governance (ESG) issues into investment and in sustainable and responsible investing more generally.[36] This enthusiasm has also bled into rapidly growing interest in impact investing.

Much of the interest in ESG, however, is primarily directed at meeting new compliance requirements or as an element in managing investment risk.[37] In contrast, impact investing embodies an investment philosophy that gives positive impact equivalence to risk and return at the heart of the investment decision[38] and then requires active investor contributions to amplify this positive impact. As a consequence, impact investing has established itself at the apex of the sustainable investment market. Protecting the integrity of the practice by establishing clear and demanding standards is essential if impact investment is to retain its potency.

But these standards do also need to be pragmatic if they are to harness the full potential of capital markets to drive positive impact. In our view, this will require a recalibration away from a reductionist view of the role, and 'additionality', of the individual investor.

In reality, asset managers and owners function as a part of a very large and powerful financial system. Understanding that system, including the importance of secondary markets, is the route to mobilizing impactful capital at scale.

Impact investors serve at the vanguard of a movement within this system that is pushing sustainability to the top of the business agenda. It is through the system as a whole that real scalable impact can be delivered.

End notes

1 https://www.rockefellerfoundation.org/blog/bringing-scale-impact-investing-industry/

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

3 https://thegiin.org/assets/documents/Insight%20into%20Impact%20Investment%20Market2.pdf

4 https://thegiin.org/assets/2016%20GIIN%20Annual%20Impact%20Investor%20Survey_Web.pdf

5 Op. cit. 2

6 Op. cit. 2

7 European sustainable investment funds study 2021, Alfi, zeb, Morningstar, 15 June 2021 (https://zeb-consulting.com/en-DE/press/european-sustainable-investment-funds-study-2021)

8 Ibid

9 'Impact washing is when a company or fund makes impact-focused claims in bad faith without truly having any demonstrable positive social or environmental impact'. (https://www.ids.ac.uk/opinions/is-participatory-impact-investing-the-antidote-to-impact-washing/)

10 https://ssir.org/up_for_debate/article/how_investors_can_and_cant_create_social_value

11 https://www.rockefellerfoundation.org/blog/bringing-scale-impact-investing-industry/

12 https://thegiin.org/assets/Impact%20Investing%20in%20Listed%20Equities_FINAL.pdf

13 The paper sets out the view of WHEB Asset Management. We'd particularly like to thank Jessica Harneyford for her work in helping to develop the views expressed in this paper.

14 We have drawn inspiration in particular from the work on impact investing in listed equities by the Impact Management Project and the Global Impact Investing Network.

15 https://thegiin.org/impact-investing/

16 It is worth stating that positive enterprise impact before the investment is not necessarily a prerequisite. For example, there are strategies that target negative impact companies in order to improve their enterprise impact through engagement.

17 https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing

18 For example, when shares are issued to raise new capital at initial public offerings (IPOs) or at subsequent capital raising events.

19 https://www.morningstar.co.uk/uk/news/207324/impact-investing-with-a-small-i.aspx

20 Op. cit. 17. This position is derived from the work of multilateral development banks which see their role as making investments in private sector operations that 'make a contribution beyond what is available in the market'(https://www.ifc.org/wps/wcm/connect/7d286672-0c03-47f7-ad41-fce55d3ef359/201809_MDBs-Harmonized-Framework-for-Additionality-in-Private-Sector-Operations.pdf?MOD=AJPERES&CVID=mppa97S).

21 The 'intensity' of impact is a measure of the level of change in outcomes and the contribution that the investment makes to these outcomes. WHEB's impact engine is designed to assess the impact intensity of different investments.

22 How to maximise impact when investing in public equities, Pymwymic Field Building Centre in association with Triodos Investment Management, Blue Haven Initiative, Omidyar Network, IVM Caring Capital, November 2018

23 https://www.forbes.com/sites/traversmark/2021/05/28/does-home-court-advantage-exist-without-fans-new-research-investigates/?sh=156ed2824903

24 While the academic literature is inconclusive on this point, the mechanism is clear. Investors with perspicacity anticipate that companies with a strong positive impact will enjoy higher future earnings growth and/or reduced risk. By investing in advance of this growth, they bid up the share price leading to a lower cost of capital for the business. This in turn helps realise future earnings growth which then justifies the premium. In our experience, recent history is replete with examples of impactful businesses that trade at a premium to the wider market for these reasons. For a further discussion see also https://hbr.org/2020/09/how-to-measure-a-companys-real-impact

25 There is also evidence that the inverse is true and that divestment announcements can lead to decreases in share prices (see for example 'The Impact of Divestment Announcements on the Share Price of Fossil Fuel Stocks', Truzaar Dordi and Olaf Weber, Sustainability, June 2019). 'Morgan Stanley have also reported an implied cost of equity increase of between 3-5% for oil and gas, thermal coal and tobacco over the past five years ('ESG Exclusions: Not All The Same', Morgan Stanley, 4th October 2021).

26 https://ssir.org/up_for_debate/impact_investing/amit_bouri

27 https://www2.deloitte.com/us/en/insights/industry/financial-services/private-equity-industry-forecast.html

28 https://www.cnbc.com/2020/11/12/global-stock-market-value-rises-to-a-record-95-trillion-this-week-on-vaccine-hope.html

29 'Impact, Reshaping capitalism to drive real change', Sir Ronald Cohen, Ebury Press, 2020

30 Op. cit. 26

31 The IFC defines impact investments as 'investments made in companies or organisations with the intent to contribute measurable positive social or environmental impact, alongside a financial return' (https://www.ifc.org/wps/wcm/connect/8b8a0e92-6a8d-4df5-9db4-c888888b464e/2020-Growing-Impact.pdf?MOD=AJPERES&CVID=naZESt9).

32 https://impact.whebgroup.com/engagement-case-studies/

33 https://impactmanagementproject.com/wp-content/uploads/Investor-Contribution-Discussion-Document.pdf

34 https://thegiin.org/characteristics

35 This approach has also been endorsed, albeit using slightly different terminology, by the law firm Freshfields Bruckhaus Deringer as part of their investigation into legal barriers to 'investing for sustainable impact' (IFSI) https://www.unpri.org/policy/a-legal-framework-for-impact

36 'ESG Monthly Market Trends: Inflows Into US Funds Stand Out', Morgan Stanley, 12 May 2021

37 For example, according to Morningstar, only 3% of investment funds on the European market consider sustainability as a part of their fund objective (Op. cit. 7).

38 The concept of an 'efficient impact frontier' combines the analysis of risk, return and impact (see for example https://rootcapital.org/wp-content/uploads/2018/01/Winter_17_Toward_the_Efficient_Impact_Frontier.pdf).

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