

# The transformative power of capital

Asset managers can lead in **equity impact investing**

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Impact investing has become one of the fastest-growing segments of sustainable investing by offering a tantalizing premise: meaningful improvement in global social and environmental challenges along with competitive returns.

Assets in impact investing strategies more than doubled from 2018 to 2019, to USD 502 bn<sup>1</sup>, targeting solutions for challenges including global poverty, water scarcity and climate change. We believe that incorporating the scale of a large asset manager as a force multiplier can help bring impact investing into the mainstream.

Before 2000, impact investing primarily referred to philanthropic or mission-focused investments, typically in illiquid assets or private equity that sought to achieve a goal but did not necessarily produce competitive returns. This is in contrast to sustainable investment strategies, which focus on integrating environmental, social and governance (ESG) factors into traditional financial analysis to identify companies with a sustainable competitive advantage that can improve returns over time. As long as impact investing was limited to illiquid investments, large investors could only make small allocations to these strategies, while most retail investors had no access to impact investing.

Over the last several years, impact investing has expanded to include listed equities, opening the door for investors of all types to invest with the goal of addressing global issues without sacrificing competitive returns. The launch of the UN's Sustainable Development Goals (SDGs) has also given investors a roadmap for investing capital towards solutions to seemingly

intractable problems. We believe that asset managers with market scale and highly trained specialists with expertise in the ways companies help create positive change can work together towards these goals.

Impact investing momentum is strong. A recent survey found that 80% of all asset owners expect to increase their target impact allocation over the next three years.<sup>2</sup> More than 90% of those surveyed said that achieving a positive environmental and societal impact is integral to their fiduciary duty.<sup>3</sup>

We believe that the larger asset managers have a structural advantage when it comes to impact investing. UBS Asset Management held total invested assets of USD 831 bn as of 30 June 2019. Because we own the same companies' shares across a wide variety of active and passive strategies, we often have aggregated total positions that eclipse those held by smaller 'boutique' impact funds.

Our scale, the depth and breadth of our global investment and specialist teams and existing long-term relationships with company management all enhance our ability to conduct effective engagements and influence corporate practices. In the long run, we believe this helps us trigger better financial performance and more positive long-term impact on behalf of our clients.

The collaboration between our financial and sustainable investment analysts facilitates a holistic conversation with company management that marries financial and sustainability goals. Focused resources, scale and engagement focus are critical ingredients to a successful engagement strategy.

<sup>1</sup> According to the Global Impact Investing Network's 2019 market study, the estimated size of the impact investing market reached USD 502 BN, more than double the USD 229 BN reported in 2018.

<sup>2</sup> Impact Investing Asset Owner Trend Report, Phenix Capital, April 2019.

<sup>3</sup> Ibid.

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**Exhibit 1: United Nations Sustainable Development Goals: A roadmap for change**

The 2030 Agenda for Sustainable Development, adopted by all United Nations Member States in 2015, provides a shared blueprint for peace and prosperity for people and the planet, now and into the future. At its heart are the 17 Sustainable Development Goals (SDGs).

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Source: United Nations.

### **Impact investing: Essential requirements**

In order for impact investing in listed equities to succeed long-term, it should generate a competitive financial return, equal to or better than a broad benchmark. In addition, a true impact strategy should meet three other requirements: intentionality, measurement & verifiability, and additionality.

### **Impact comes from intention**

Intentionality requires that the universe for impact portfolios consist of companies with products or services that generate positive impact (tied to the UN SDGs).

Listed companies that possess these attributes comprise a narrow slice of a broad benchmark, and exclude industries

that do not contribute to the UN SDGs and have other country, industry and factor biases. This has significant implications for investment returns, portfolio construction and risk management.

The law of active management suggests that such a selection set challenges the active investor's ability to match or exceed the benchmark return. We believe that over time, skilled managers will be able to produce competitive returns, but only by taking more risk through portfolio concentration as well as by engaging companies to improve their business models and potentially increase the positive impact further than would otherwise occur, which is what is meant by additionality.

### **Measurement & verifiability are essential**

Measurement & verifiability are critical components of impact investing because they provide the basis for demonstrating the difference of impact investing on the world. This is particularly important because the investor needs assurance that capital has been deployed effectively and that there is an incremental result of the investment. Because impact data is neither standardized nor even disclosed by many companies, there is a need to use experience and judgment to help shape the universe. Our expectation is that it will take quite some time for standards to develop and that they will likely follow parallel efforts by other groups, such as the Sustainability Accounting Standards Board (SASB), which is focusing on standards for material ESG disclosure.

UBS Asset Management has been an innovator in developing frameworks for impact measurement and verifiability. In 2016, our Sustainable & Impact Investing team began developing an impact measurement framework in conjunction with experts in the disciplines of public health and environmental science. Our ultimate goal was to develop a data-based, science-informed standardized measurement framework focused on social and environmental impacts in order to identify companies that generate a positive impact. This work formed the foundation of our Global Impact Equities Investment strategies.

We believe that the strongest emerging frameworks for impact measurement will be based on scientific evidence that a particular technology, service or product line generates impact. For example, harnessing health science to measure the effectiveness of a drug or device to treat or cure a disease has strong statistical validity. Environmental science models that reveal the impact of pollution-abating technologies or water quality-related products have real potential. These kinds of measurement models reveal that in many cases the geographical location of a product or service has implications for impact as well. A new wind turbine placed in a modern, clean utility grid produces very little impact while the same turbine displacing coal-fired capacity in a dirty grid can have significant impact. For this reason we believe that early impact measurement frameworks that link impact with product revenues alone will likely not be sufficient.

Measurement gives us a baseline for assessing whether and how much an invested company's impact continues to improve over time.

### **Additionality through engagement**

While measurement metrics for impact investing can be developed through better data, additionality has represented a unique challenge to mainstreaming impact investing in publicly traded equities. Additionality requires that an investment realizes positive change that would have otherwise not occurred, which is extremely challenging in public markets where investors provide no direct funding to companies and where liquidity entails a limited price impact from any particularly investment made. We believe that additionality can only be realized through long-term engagements with companies in the portfolio oriented around positive change.

Our engagements on impact have two primary goals: to help the invested companies generate additional positive impact on our social and environmental goals, and to help improve the financial performance of the companies through reducing risks and realizing opportunities. We believe that business model improvement can have the greatest impact by working with companies to invest in more impactful areas of the business while simultaneously improving valuation and subsequent returns. While this result is not likely to be immediate, it has the potential to help mitigate the countervailing force of a narrower universe with implicit biases on overall returns.

Most fundamentally, engagement addresses the 'so what' question about impact investing: whether capital invested in a company results in incremental or additional change. We believe informed engagement and dialogue is key to creating social and environmental value that would otherwise be absent. Consequently active engagement is essential to realizing positive impact and demonstrating the additionality of the impact investment strategy in public equities.

### **Narrowing the gap between private and public impact investing through engagement strategies**

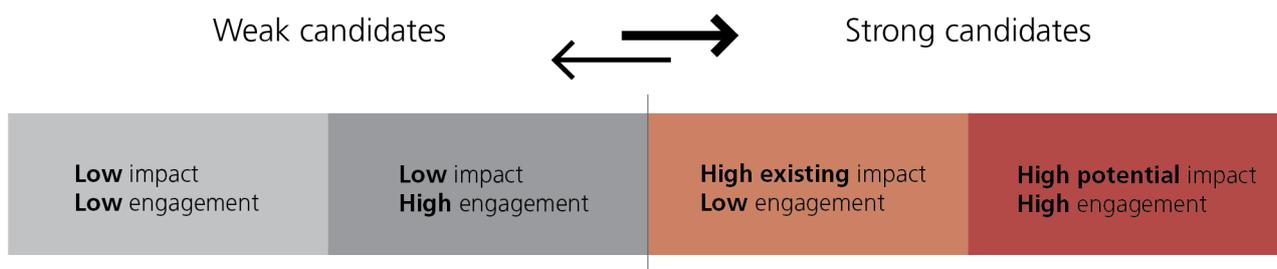
The level and range of engagement across an impact portfolio will vary but where there is opportunity for substantial business model improvement there will be a need for deep analytics, patience and focused resources. In addition, because substantive engagement is time-intensive and multi-dimensional, the number of candidates must be carefully managed—another reason to build concentrated portfolios.

We look for companies that have high existing impact or clear opportunities to create additional impact and are open to engaging with us to increase that impact. The UBS Sustainable & Impact Investing team analysts have backgrounds covering a variety of business sectors and understand best practices for sustainability; both on ESG risks and opportunity in the operations and supply chain and impacts from products and services. They have expertise working with financial analysts to identify the drivers of value in the investment case that provide the basis of formulating engagement goals that contribute to both financial and extra-financial returns. We also are often able to leverage our assets under management across investment strategies and relationships built over many years. In certain instances, small- to mid-cap innovative companies that we consider for an impact investment welcome this expertise and view us as a strategic partner.

Companies that are good candidates for an impact investing strategy are those that have existing positive impact as well as the potential to enhance positive impact through engagement. An impactful company that is self-aware and already attempting to generate additional impact can be a high performing candidate for the portfolio. An impactful company that is not self-aware may be able to create additional impact through corporate engagement; transforming the business model and generating enhanced value (alpha) in addition to the incremental environmental and social impact.

Companies that have low existing impact and low potential for increased impact through engagement are not good candidates for an impact investing strategy. Given that engagement resources must be focused, we believe that companies that have little potential to change through engagement should be avoided.

**Exhibit 2: Candidates for impact investment: High engagement can substantially increase potential impact and valuations**



Source: UBS Asset Management.

How can investors shape and assess their engagement strategy at the onset? We believe that the theory of change, a methodology for planning and evaluating progress towards a long-term goal, provides an extremely useful input to engagement strategy. The three quality control criteria driving the theory of change are 1) plausibility, 2) feasibility and 3) testability.<sup>4</sup>

We can intend to invest in a company to drive change, but is our engagement plausible? Can we design and execute a plan? And can we test the outcome? We believe that these should be key criteria embedded in the engagement strategy. Over time they can also be criteria that asset owners can use

to assess engagement effectiveness. The time-intensive nature of engagement necessitates a focus on companies where there is traction and a reasonable expectation of success.

Our team takes a long-term approach to developing and tracking our engagement objectives for each company held in the strategy. This approach usually begins with initial impact measurements and risk and opportunity analysis, setting engagement objectives in collaboration with the company and measuring the progress made over time. It can take years to reach the engagement goals; this is where the investment approach is aligned with the engagement approach, seeking to optimize financial value and impact creation.

<sup>4</sup> A. Kubisch (1997) Voices from the field: Learning from the early work of comprehensive community initiatives. Aspen Institute, Washington DC.

The language devised to guide impact investing in the private equity space can guide action in listed equities as well:

Does change actually occur in the ways the intervention proponents have expected? Are there other change dynamics or pathways at work? Are there unforeseen actors and factors which promote or constrain change? Are there obstacles that stymie or render ineffective the theory of change? How can those obstacles be minimized or eliminated altogether? These are just some of the questions that evaluators ask as they examine an intervention's theory of change. And the answers to these questions can usefully inform program managers and funders as to how they can modify the design of the intervention under review to improve outcomes, or whether the intervention should be terminated altogether.<sup>5</sup>

Viewed through the lens of the theory of change, engagement should naturally move in the direction of focusing on maximum achievable change. This focus is likely to highlight the tension between investing in companies with high ESG scores and naturally appealing product and service sets where the impact proposition is apparent and non-controversial versus investing in companies with latent potential but with a combination of ESG issues and necessary improvements to unlock value.

### **Impact investing: The investment challenge**

The projections for asset growth in impact investing are very ambitious and, as mentioned earlier, surveys suggest that there is considerable momentum for the strategy. In the end, however, if these trends are to prove out, asset owners and investors have to be satisfied that their returns are adequate and competitive. In a world of generally low returns, challenged by sub-normal interest rates and equity markets that appear more fairly valued than they were a decade ago, impact investing will be particularly challenging given its narrower selection set and inherent biases.

In addition, it may be the case that as investors sharpen the definition of impact itself, and how to measure it, that simple thematic assessments of impact will not hold water, leading to further narrowing of the selection set.

We believe that for asset managers to succeed in delivering the dual promise of social and environmental change and investment returns they will need to allocate more resources to the effort than has been done to date. First, the manager should have an excellent fundamental research platform that can deliver strong valuation input to the process.

Second, the manager should have a strong engagement capability with experience in more established ESG-focused engagement and act as a trusted advisor who can provide valuable input to help the target company achieve incremental impact.

We believe that in the end, the most successful managers will forge a new form of friendly engagement able to generate meaningful incremental impact. This will require a strong rapport with company management and other stakeholders along with the expertise to provide concrete suggestions that can create more impact and an improved business model that the market values more highly. The promise of this approach is that it may mitigate the negative effect of a narrower selection set by helping to generate offsetting positive returns. Developing a more dynamic form of active ownership that goes beyond 'light touch' methods such as proxy voting, may narrow the gap we see between investors in marketable securities and the hands-on approach of private equity. This narrowing and focused approach may help to meet the social purpose of investment management—to deliver returns, that also improve society and the world that we live in.

### **Harnessing capital and capitalism for social change**

The evolution of impact investing to listed equities holds considerable promise for the future if it harnesses the power of capitalism to deliver needed changes in society and the environment.

The challenges are great but clearly worth taking. We believe that in the years to come impact investing will lead listed companies to reassess their products and services, to align their interests better with the external world and to use the power of capital to solve problems.

<sup>5</sup> E.T. Jackson (2013) Interrogating the theory of change: evaluating impact investing where it matters most. *Journal of Sustainable Finance & Investment* 3:2, 95-110.

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