HOW TO MAXIMISE IMPACT WHEN INVESTING IN PUBLIC EQUITIES

A practical guide to get started with building an impactful public equities portfolio

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INTRODUCTION

If you are reading this report, it is likely you want your capital to work for the better of people and planet. Investing in public equities is likely to be part of your normal portfolio. But then, how can you make an impact through this asset class? Can you make an impact at all? After 25 years of experience in the field of impact investing, we are happy to share our knowledge and insights with you. The field is developing rapidly and there are ‘different shades of green’ – and even more opinions – about how much impact an investment in listed equities can actually make.

“Navigating the sustainable investment landscape can be difficult. It’s earned its own glossary of terms and acronyms, and ranges from very light, to intentional, deep impact. It’s important to know what you’re getting.” Andrea Palmer, Triodos Investment Management.

The goal of this report is to demystify the different shades of green of impact investing in public equities: what do you need to know to understand how to maximise the impact of your public equity portfolio?

BEFORE YOU GET STARTED: UNDERSTANDING THE CONTEXT

If you are rather new to investing in listed stock, or with investing in general, it may be helpful to understand a few things before you get started:

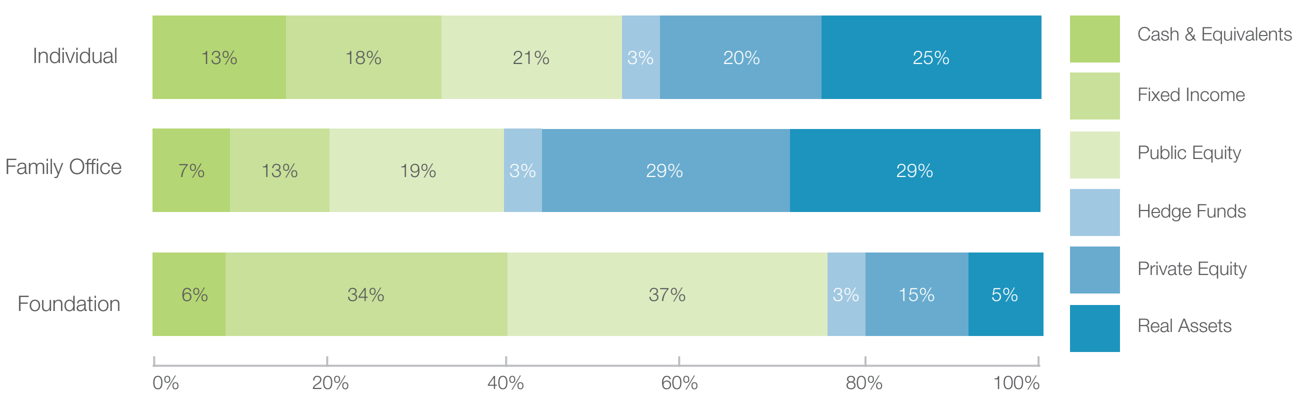
1. How do public equities fit into my impact portfolio?
2. Which instruments am I then investing in?
3. Who takes care of my listed equity portfolio?
4. Is there evidence of performance?

1 How do public equities fit into my impact portfolio?

As impact investors, we aim to invest for positive impact across all our asset classes. Public equities, or listed stock, are often a core component of a diversified investment portfolio. Research shows that impact investors on average allocate ~ 20 – 40% of their total portfolio to public equities[1] (see figure 1).

Public equities can be attractive due to various reasons. They are easily accessible through purchase of individual stocks or investment vehicles, have no restrictive barriers to entry and exit, offer high liquidity, diversify holdings across companies, industries and geographies, and may offer a regular dividend income and/or appreciation in value.

Figure 1. Average asset class allocation of impact investors[1]



2 Which instruments am I then investing in?

When investing in public equities you can invest in:

I. **Individual stocks:** Shares of a single company that can be bought by any investor through a brokerage. Asset management is the responsibility of the investor.

II. **Active fund:** Investable baskets of stocks that aim to achieve specific goals, such as specific positive impact and/or financial outperformance[2], and make use of the expertise of a fund or portfolio manager. Often, active funds will deviate from the composition of a defined market benchmark.

III. **Passive fund[3]:** Investable baskets of stocks that mirror an existing index, sub-index, particular sector, or segment of the market. These do not make use of a fund or portfolio manager's investment expertise and generally have lower management fees.

3 Who takes care of my listed equity portfolio?

As impact investors, we can build a personalised impact portfolio or hire a fund or wealth manager to manage our investments. Building our own portfolio gives full control and saves fees, but it takes time and effort to research, select and manage the portfolio. Therefore, most of us hire a fund or wealth manager. While there are both conventional and (more) impact-driven advisors, our experience is that the more values-aligned our partners are, the better they understand what we are truly looking for. Triodos Private Banking and IVM Caring Capital are examples of wealth managers with specific focus on impact. Independent consultants such as onValues, can support in choosing managers or developing a portfolio strategy.

4 Is there evidence of performance?

The first question that often comes to mind when talking about impact investing is whether financial performance is on par with the market. However, as impact investors, we need to emphasise both financial AND impact performance.

Financial performance

A growing body of evidence shows that companies with strong ESG records obtain equal or even stronger results than the market.[4] A few examples:

- Based on an 18-year study period, companies which embedded strong sustainability policies had market capitalizations of almost double those of "low sustainability" competitors[5];
- A meta study comparing over 200 sources found that companies with a high ESG score show on average better operational results (88% of cases), have lower costs of capital (90% of cases) and perform better in the stock market (80% of cases)[6];
- S&P 500 industry leaders who score higher on integrating climate change management, demonstrate 50% lower volatility of earnings (over period of ten years) and generate 18% higher ROE and 21% stronger dividend growth (over period of three years) than lower scoring peers.[7]

"In the past, there was the perception that the financial performance of listed equities with an ESG focus was below market standard. However, this can no longer be an excuse. Nowadays, it is no problem to build an equity portfolio that is focused on impact and renders comparable, or sometimes even better, results than a traditional portfolio." Ivo Knoepfel, onValues

"Companies that do not act as proper stewards of the planet are likely to lose their social license to operate, while companies that solve major sustainability challenges are poised for growth and will outperform their non-sustainable peers over the long-term" Hadewych Kuiper, Triodos Investment Management

Impact performance

In terms of impact performance there is far less data available. Where different methods exist, they differ from organisation to organisation, making it difficult to compare results. However, just because it is more difficult to reach conclusion about impact performance, it does not make it less relevant. We will need to keep developing (comparable) ways to measure impact and build evidence.

Box 1. Background: Distinguishing between enterprise and investor impact

Enterprise impact[8]: refers to the impact of the company you invest in. An enterprise can have product impact - the impact of goods or services produced - and/or operational impact - the impact of management practices - often also called ESG factors. It is possible to invest into impactful companies without having an impact on those companies.

Investor impact[9]: refers to the investor's contribution to the impact created by an enterprise – through capital allocation or active ownership. This is the case when an in investor provides additional capital or capital at lower cost, than the enterprise would otherwise have secured from other investors or when an investor actively catalyses improvements in the company impact performance that would not otherwise have happened.

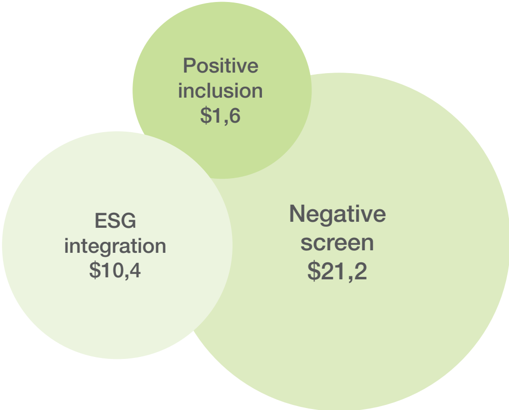
HOW TO MAXIMISE IMPACT WHEN INVESTING IN PUBLIC EQUITIES?

When investing in public equities, we often choose to invest in funds. There is a growing number of impact funds[10]. However, the degree to which these funds can really make a positive impact, may differ significantly. The main question is: what makes one public equity investment more or less impactful than another?

To answer this question, we focus on two aspects:

- Determine which stock selection method best matches your impact ambitions (enterprise impact);
- Decide on how you intend to use your rights and position of ownership (investor impact).

Figure 2. Estimate market size of screening methods in 2016[11]



DETERMINE WHICH STOCK SELECTION METHOD BEST MATCHES YOUR IMPACT AMBITION

Impact funds all use different screening methods and guidelines to select the stock they wish to invest in. Roughly stated we can distinguish three distinct screening methods that serve as the basis for most selection processes: (1) ESG risk-return optimisation, (2) negative screening, and (3) positive inclusion (see figure 3).

Over the years, these screening methods have evolved and built on each other to fulfil different goals. While older methods – exclusion-based methods – still have the largest market share, (see figure 2) the newer inclusionary methods are catching up rapidly with annual growth rates of 140 (sustainability themed investing) and 146 percent (impact/community investing).[11]

Figure 3. Basic screening methods

	ESG risk-return optimisation	Negative screens or exclusions	Positive inclusion thematic/trend
Answers the question	Are the correct institutional frameworks in place? Have we optimised our portfolio risk-adjusted return?	Are they doing any harm?	Are they active in positively impactful sectors? Do their products and services actually make positive impact?
Starting point	(Sustainable) index > best in class	(Sustainable) index > do no harm	Positive impact > bottom-up theme/ trend
Selection method	Use ESG (Economic, Social, Governance) factors as “screens” or “reweighting tools” to optimise the financial performance of your fund	Exclude entire industries or individual companies with poor environmental or social records	Select companies whose core products and services directly address specific social and environmental challenges within a theme or trend
Objective	Promote companies that align with your social and financial objective	Prevent exposure that conflicts with your social objective	Advance your social and financial objectives by targeting companies whose products and services actually make a positive impact
E.g.	Objectives on: carbon footprint, human rights, employee relations	Exclude: tobacco, arms, and alcohol industries, fossil fuels	Solutions that tackle: climate change, food security

Every individual investor, wealth manager or fund manager can formulate their own criteria based on one of these screening methods, or a combination. For the screening you can rely on external or internal data analysis. Internal research is often better aligned to your vision and priorities, but unfortunately often costlier, more time consuming and requires in-house expertise. External data is quick and easy however the scoring methodologies are often a “black box” and contain some common biases (see box 2).

Examples of external ratings agencies are Sustainalytics, MSCI, ISS Oekom, Vigeo Eiris, FTSE and GRESB. These most often score for corporate ESG. They are useful for ESG risk-return optimisation strategies, but are much more difficult to use for positive inclusion strategies. Some third-party agencies have ventured into ‘green revenue models’ and ‘Sustainable Development Goals (SDG) alignment models’, though these are in their very early phases, and may or may not align with your vision for impact.

While external ratings are helpful in selection and screening of stocks, be aware of the issues when interpreting the results and when reviewing the stock selection methodologies.

Box 2. Be aware of the shortcomings of ratings[12]

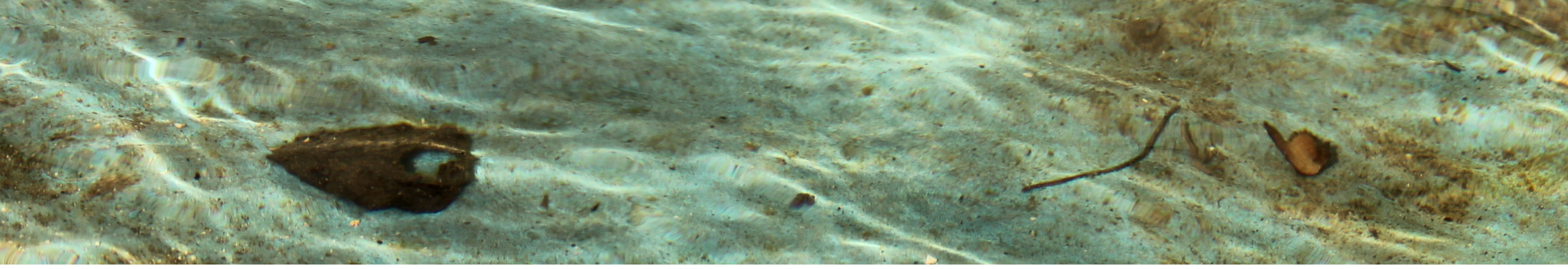
External ratings can be helpful in screening stocks. However, there are shortcomings to be aware of:

1. **Disclosure limitations and lack of standardisation;** There are no standardised rules for ESG disclosure nor is there a disclosure auditing process.
2. **Company size bias:** Companies with higher market capitalization tend to be awarded higher ratings in the ESG space than lower market cap peers as the first often have the ability to dedicate more resources to prepare more detailed ESG disclosures.
3. **Geographic bias:** Companies domiciled in Europe often receive higher ratings than peers based in the US and elsewhere. The reason why is that regulatory reporting requirements vary widely by region and jurisdiction. For example European law requires companies to report more extensively on ESG issues than other jurisdictions. In addition investors in Europe are more convinced of the materiality of ESG investing resulting more extensive ESG reporting by European companies.
4. **Industry sector bias:** company specific risks and differences in business models are not accurately captured in composite ratings.
5. **Inconsistencies between rating agencies:** Individual company ratings are not comparable across agencies due to lack of uniformity of rating scales, criteria and objectives.
6. **Failure to identify risk:** One of the purposes of ESG ratings is to evaluate risk and identity misconduct. ESG ratings do not properly function as warning signs for investors in companies that experience serious mismanagement.

Triodos Investment Management

Triodos Sustainable Equity Fund

Triodos Sustainable Equity Fund is a globally-diversified, core equity fund investing in large-cap companies that actively address global sustainability challenges through products, services and business operating models, and that demonstrate attractive financial opportunity. The fund follows an inclusionary, bottom-up stock selection approach to ensure the portfolio remains fully aligned with sustainable solutions as per Triodos Investment Management’s sustainable transition themes.



DECIDE ON HOW YOU INTEND TO USE YOUR RIGHTS AND POSITION OF OWNERSHIP

In addition to selecting our own stock, we can increase our impact through active ownership. Active ownership is the use of the rights and position of ownership to influence the activities or behaviour of investee companies. For traded stock, active ownership can be applied through shareholder engagement and voting activities. Engagement and voting practices are interlinked[13]:

I. **Shareholder engagement** captures any interactions (dialogue, monitoring, etc.) between the investor and current or potential investee companies on sustainability issues and relevant strategies with the goal of improving sustainability practices and/or disclosure. These efforts can be conducted individually or jointly with other investors. Collaborative engagements include groups of investors working together, with or without the involvement of a formal investor network or other membership organisation.

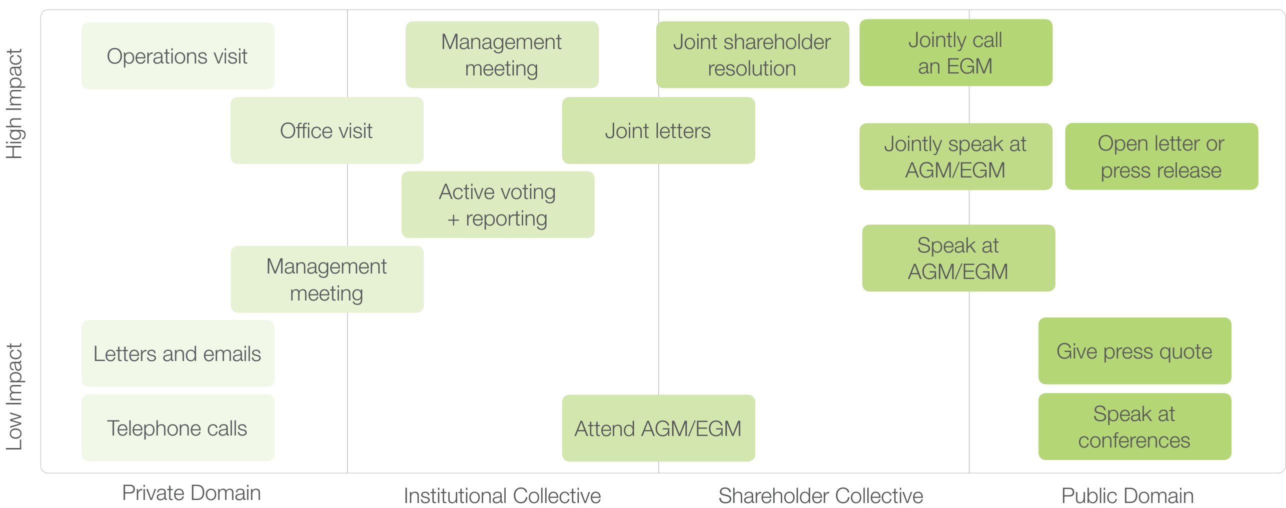
II. **Voting** refers to the exercise of voting rights on management and/or shareholder resolutions to formally express approval (or disapproval) on relevant matters. In practice, this includes taking responsibility for the way votes are cast on topics raised by management, as well as submitting resolutions as a shareholder for other shareholders to vote on (in jurisdictions where this is possible). Voting can be done in person, during an Annual General Meeting (AGM), or by proxy[14].

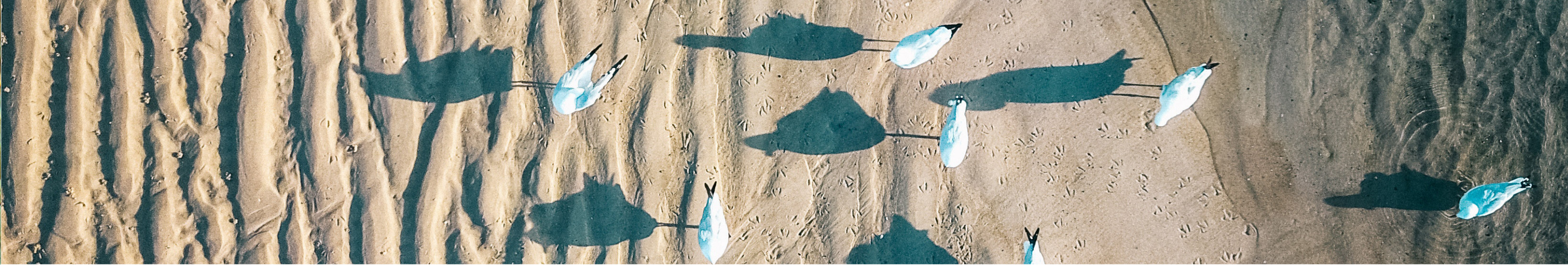
Some argue that active ownership is the only way to have investor impact when investing in public equities. As James Gifford (head of impact investing UBS) puts it: *"In liquid markets, simply buying or selling stocks has little, if any, impact on the cost of capital of a company or anything else. You are merely swapping ownership in a big, liquid capital market. Shareholder engagement is the primary mechanism of impact in public markets."*

Robert Boogaard (Effective Giving) agrees that, based on what we currently understand, the impact of investors is likely to be limited when investing in or divesting out of public equities. He argues that *"the signalling effect when large/high profile investors divest – and thus disapprove – of certain companies might be the only way to have a possible effect on the cost of capital."*

Recent academic research shows that successful engagement dialogue is not only correlated with positive returns on assets, but it also increases communication, learning and internal relationships for investors and companies.[15] In 2012, Ceres, a sustainable business and investor network, found that 50% of the resolutions resulted in commitments to action from the subject companies and more than 75% of those commitments were fully or substantially fulfilled.[16]

Figure 4. Engagement as a tool for positive change: a variety of instruments.[17]





When we are dissatisfied with the extent to which the companies we invest in are committed to serve people and planet, we can deal with this in different ways. If we believe we can make a difference through shareholder activism, we will hold on to the assets. If we believe we cannot make a difference, or feel this is not our role, we may want to divest these assets altogether.

Passive funds typically maintain their holding as long as the stock remains in the index and cannot sell their holdings if they are displeased with the (impact) performance of the company. Active funds can sell their holdings if they are displeased with the performance of the company. Or, they can choose to stick with the company and act 'as a thorn in the flesh' by putting important impact issues on the shareholder agenda.

Two examples of these approaches are the Divest Invest movement and Follow This. Both want to speed up the energy transition towards renewables instead of fossil fuels but they both use a different approach.

Divest Invest movement

"If you own fossil fuels, you own climate change"

Who?

A global network of individuals and organizations united in the belief that by using their collective influence as investors to divest from fossil fuels, and invest in climate solutions, they can accelerate the transition to a zero-carbon economy.

Approach

Collective investor movement asking a.o. individual investors, (family) foundations, pensions funds and private companies to 1) Make no new investments in oil, gas and coal companies, 2) Sell existing investments tied to these oil, gas, and coal investments within 3-5 years and 3) Invest in climate solutions, such as renewable energy, energy efficiency, sustainable agriculture, water efficiency and more.

Results so far:

As of December 2015, 1.013 institutions and 59.524 individuals divested about $ 7.2 trillion.

See www.divestinvest.org.

Follow This!

"Modern activism changing Shell from the inside"

What is it?

A group of responsible shareholders consisting of both individual shareholders and institutional investors, such as pension funds. New and existing shareholders can easily become members of Follow-This by buying a green share in Shell via their website.

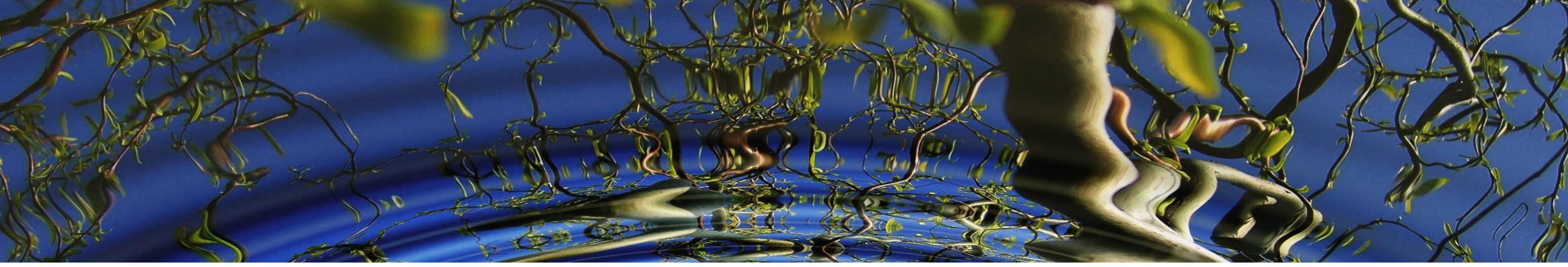
Approach

Green shareholder activism; taking collective shareholder actions such as filing shareholder resolutions, sending a supportive e-mail to the CEO and actively seeking attention in the public domain.

Results so far

Follow This now has the support of over 4.200 private shareholders and six out of the ten largest institutional investors in the Netherlands. In November 2017 Shell responded to the support for the Follow This shareholder resolution by setting an ambition on the emissions of its end products.

See follow-this.org.



CLOSING REMARKS

We developed this report to share our knowledge and provide you with practical guidelines to get you started. We intended to give a basic understanding of how to maximise your impact through investing in public equities and help you ask the right questions.

One realisation we wish to share is that our impact is far less direct when investing in public equities than it would be when investing directly into private companies. Having said that, we still all want part of our portfolio to be liquid and diversified. So, we also allocate part of our portfolio to listed equities (and other assets classes). By doing so we have two questions to answer for ourselves - which may very well exist in parallel to each other:

- Do we choose to invest in those companies which we believe already make an impact themselves, supporting their work best as we can, and / or:
- Do we invest in those companies in which we believe we can make the largest impact in being a values-driven owner, pushing them to improve their positive impact?

While writing the report, we realise that impact investing in public equities is still in development and evidence on results still needs to be gathered. We are learning by doing. This could mean we will change our opinion, our strategy and our assets in a few years' time. However, not having all the answers (yet) will not keep us from moving forward. Our aim is first and foremost, to use our capital to create real value for this earth and for future generations.

Will you join us?

Gratitude

We are grateful for the contribution of:

- Julia Balandina-Jaquier, Founder of JBJ Consult
- Robert Boogaard, Co-founder of Effective Giving
- Olivier de Guerre, President at PhiTrust
- James Gifford, Head of Impact Investing, UBS Wealth Management
- Marian Hogeslag, Partner at Double Dividend
- Ward Kastrop, Partner at Double Dividend
- Ivo Knoepfel, Founder of OnValues
- Hadewych Kuiper, Commercial Director at Triodos Investment Management
- Hans Molenaar, Partner at IVM Caring Capital
- Andrea Palmer, Product Specialist at Triodos Investment Management
- Albert van Zadelhoff, Director Private Banking at Triodos Bank

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1. T100 Powered Ascent 2018, Toniic. Link here.
2. There is debate whether active funds are able to beat the financial performance of an index. AFM (Dutch Authorities Financial Markets) concludes in a research in 2011 that after deduction of management fees of active funds, these funds, as a group, earn a lower financial return than their benchmark; while individual funds may, indeed, temporarily outperform. Link here.
3. Passive funds can be index funds or exchange traded funds (ETF's). The main difference between an index fund and an ETF is the tradeability: ETF's are considered more flexible than index funds as ETF's can be traded more easily (no special accounts and documents needed) and on continuous basis, instead of only once a day.
4. "ESG and financial performance: aggregated evidence from more than 2000 empirical studies." Link here.
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6. "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance." Link here.
7. "Climate action and profitability CDP S&P 500 Climate Change Report 2014." Link here.
8. "Unpacking the Impact in Impact Investing." Link here.
9. "How Investors Can (and Can't) Create Social Value." Link here.
10. Examples of impact funds are: Triodos Sustainable Equity Fund, Hermes Impact Opportunities Fund, Wellington Global Impact Fund, NNIP Global Equity Impact Opportunities, or Swell Investing.
11. "Estimated market size of basic screening methods in 2016." Global Sustainable Investment Review 2016. Link here.
12. Source: Ratings that don't rate, the subjective world of ESG rating agencies. Link here.
13. "A Practical Guide to Active Ownership in Listed Equity." Link here.
14. Proxy vote: Independent asset managers hold shares of a wide range of companies on behalf of their clients. These shares entitle the holders to vote on various issues. If a shareholder is unable to attend the meeting in person they may elect to vote their shares by means of a proxy ballot. The asset manager may then vote these proxies on behalf of their clients.
15. "A Practical Guide to Active Ownership in Listed Equity." Link here.
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Further reading

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