Impact investing's growing attraction

By Bernard Drotschie

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The principles of environmental, social and governance (ESG) investing are capturing the growing attention of mainstream investors who are seeking attractive returns but also a new social contract with all stakeholders.

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This is contributing to the significant increase in flows out of traditional equity funds, and into ESG-focused funds. Assets in sustainable funds globally hit $1.652bn by the end of December 2020, up 29% from the previous quarter, according to figures from a recent Morningstar report.

With more investors choosing to funnel their money into investments that address some of the world's greatest development challenges, there has been an explosion of ESG product offerings. Morningstar's research shows that ESG product development in the fourth quarter hit an all-time high, with 196 new offerings, including 37 countries outside of Europe and the United States.

It has also been proven that those companies and management teams that abide by high standards of ESG principles tend to grow their profits at a faster, more sustainable rate than traditional counterparts – even during times of crisis. When the pandemic escalated in early March, ESG-focused companies outperformed other stocks by up to 5.7%, figures from HSBC show.

ESG criteria

The changing regulatory environment is also driving the increase in allocations to ESG investments. Europe is leading the charge in this regard, where asset managers may be mandated by the industry to invest into companies that meet a minimum "ESG criteria", governed by the EU Taxonomy. Not only is the private sector initiating this regulatory wave but increasingly governments too. China, for example, is working towards net zero emissions by 2060 while the United States will re-enter the Paris Agreement under the Biden administration.

While ESG offerings may have provided players within the asset management industry with a competitive advantage in the past, it is now part and parcel of managing money. Increased investor appetite for ESG offerings and a changing regulatory environment are pushing asset managers to take their fiduciary responsibilities a lot more seriously.

Different approaches

A standard ESG strategy involves pricing beyond traditional financial factors such as cash flow and return on equity. Rather, investors will consider traditional factors in accordance with environmental, social and governance factors when valuing a company and price for what is known as non-traditional risk.

Whereas some investors may adopt more progressive ESG strategies, which would then dictate their capital allocation. In this scenario, they would focus on investing only into the companies that are trying to improve their ESG scores by considering these scores when making their business decisions.

Impact funds

Investors are taking this a step further by investing for impact. Impact funds have emerged that consider and invest into companies where there is actual intent to solve environmental and societal challenges. In other words, these companies are not just aware of the challenges but actively trying to improve and solve them by aligning their business models accordingly.

While ESG investing has reached the mainstream, a key differentiator for asset managers now and in the medium-term future will be providing options for investors who want to invest for impact.

The United Nations Sustainable Development Goals (SDGs) have become an integral part of the impact investing space; they have become guiding principles for impact investors, as they offer a good starting point for developing an investment thesis. The SDGs are also used as a foundation of measurement frameworks.

The target set out by the UN for reaching these goals, such as no poverty, zero hunger, addressing climate change and good health and wellbeing, is end of 2030. As we edge closer to this date, a significant amount of investment from both government and the private sector will be required.

This means that we will see a wall of investment going into companies that are generating a positive impact. This will not only allow further access to capital to invest in activities leading to more sustainable and positive outcomes but also, provide attractive returns for shareholders, creating shared value for all.

ABOUT THE AUTHOR

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