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Sustainable and Impact Investing

Investing for a fairer, more sustainable future

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Executive Summary

Sustainable and impact investing approaches have the capacity to deliver a real difference in the human quest for a fairer, more sustainable future. The power of the virtuous circle of responsible consumption, sustainable production and long-term governmental planning is profound, and ESG-centric investing is a key tool to influence enterprises which need capital. Further than this, investors are discovering that doing the "right" thing doesn't come with a cost, and in fact is likely to lead to better risk-adjusted returns over the long term.

There is momentum behind the interest in ESG-orientated investing and we feel that capital will increasingly be directed at strategies that pursue more sustainable environmental or social outcomes. As ESG-centric investing becomes the norm it is important to identify credible solutions that are best placed to outperform as economies transition to more sustainable development paths

How can we help?

We survey the market on an ongoing basis to identify ESG-strategies that we feel can add most value to institutional investors' portfolios.

We can help you navigate this fast-moving space to identify solutions that align with your chosen responsible investment approach and implement ESG-ideas across a diversified investment portfolio.

Moving up the Responsible Investing (RI) spectrum

Investors have become more aware of how ESG factors affect their investments and are moving up the RI spectrum towards sustainable and impact approaches. This paper focuses on these two approaches as we feel these are the sweet spot for ESG integration, where clients can maximise their long-term returns as well as their ESG goals.

For more details on the spectrum see our **RI spectrum** paper on our website.

This paper defines sustainable and impact investing approaches, explains why you might undertake either of these approaches, and finally discusses how you can implement them within your investment portfolio.

Understanding sustainable investing

Sustainable investing involves making a positive tilt towards investments that exhibit superior performance in terms of their ESG characteristics. A sustainable approach aims to reduce the financial risk posed by ESG factors and whilst providing undiminished investment returns over the long-term. This differs to ethical investing which screens out investments according to ethical criteria but without the accompanying financial rationale.

Key features of sustainable investing

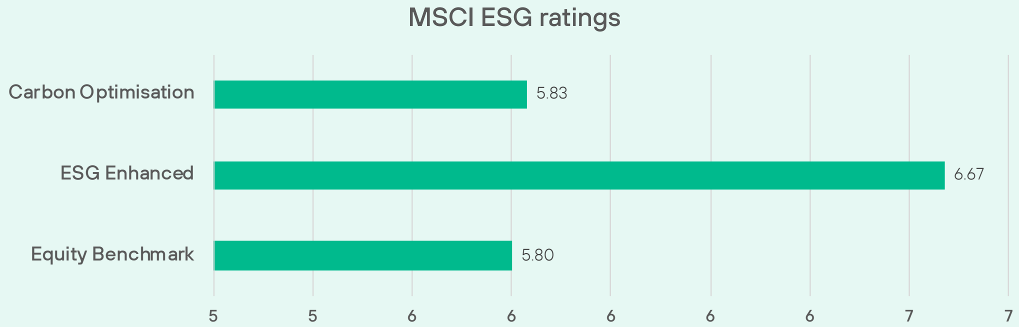
Sustainable tilting
investing in companies with superior ESG characteristics

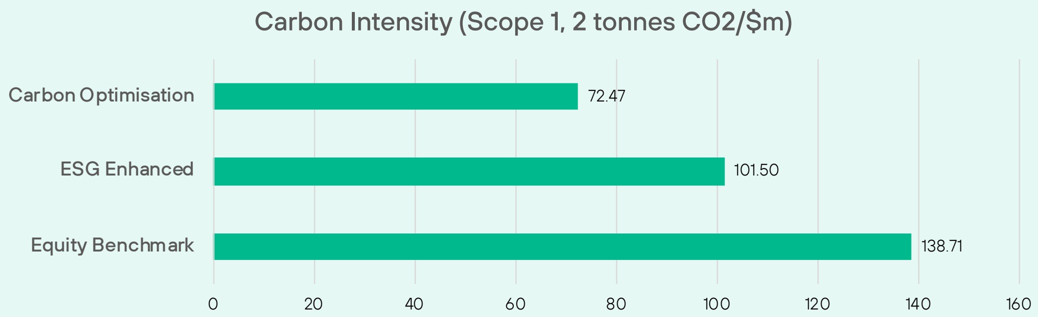
Improved ESG metrics
better performance in terms of environmental or social metrics than other funds

Stewardship principles
a well-established process for engaging with companies on ESG issues

Case study examples of sustainably tilted equity indices

The below charts present ESG metrics for two equity indices versus the wider equity benchmark. The ESG enhanced index aims to maximise exposure to companies with the highest MSCI ESG rating. The carbon optimisation index aims to reduce carbon emissions whilst minimizing the tracking error relative to the equity benchmark.





Source: MSCI

Notes: The MSCI ESG Rating is a score between 0-10, where 0 is the lowest ESG quality score and 10 is the highest ESG quality score

Scope 1 and 2 CO_2 emissions are all direct and indirect emissions associated with a company's business activity

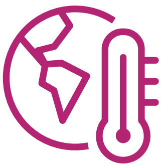
Understanding impact investing

An **impact investing** approach goes one step further than sustainable investing as it explicitly seeking positive and often measurable ESG outcomes. This approach will have at its core, an intention to make a positive change by directing capital towards investments that have clear environmental or social impacts and provide solutions to key issues we are facing. It is important to differentiate this approach from philanthropy, where a lower return or no return is accepted in pursuit of ESG impact. In contrast, an impact investment approach still seeks to maximise risk-adjusted return, identifying opportunities that will outperform as economies move towards more environmentally sustainable and socially equitable development pathways.

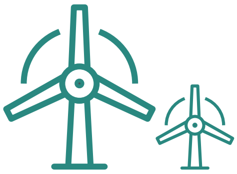
Key features of sustainable investing

SUSTAINABLE DEVELOPMENT GOALS

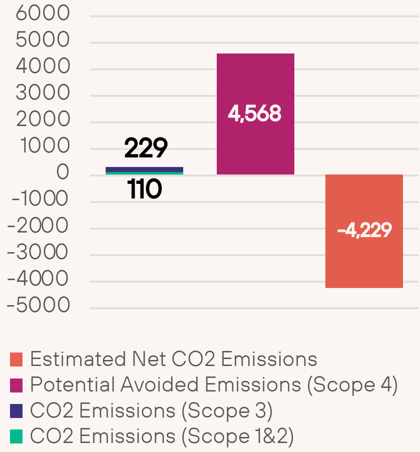
Intentionality:
impact funds will have environmental or social targets alongside traditional financial objectives. A common impact framework is the UN Sustainable Development Goals (UN SDGs)



Measurability:
impact funds must be able to report on how they have delivered on their impact objectives



Additionality:
impact funds should increase environmental or social value through their activities



Case study of example impact equity fund focussed on clean energy

- **Strategy:** Invests in companies that produce wind and solar energy.
- **ESG factors considered:** Environmental themes especially climate action. Social aspects are important as many companies provide jobs to communities.

ESG impact result

- **Intentionality:** Displacing carbon intensive energy production with assets that produce renewable energy.
- **Measurability:** Measurement of carbon emissions displaced by non-polluting forms of energy generation.
- **Additionality:** Carbon emissions avoided are c. 4500 tonnes CO_2 per €1m invested.

Source: Sample investment manager, Carbon data from ISS
Notes: Scope 3 CO_2 emissions are emissions in a company's value chain
Scope 4 CO_2 emissions are all direct and indirect emissions associated with a company's business activity

Why should you consider sustainable and impact investing?

There are 3 main reasons why we feel that sustainable and impact investing approaches should be considered.

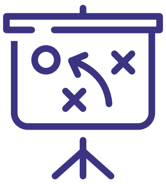
1. Achieving better risk-adjusted returns

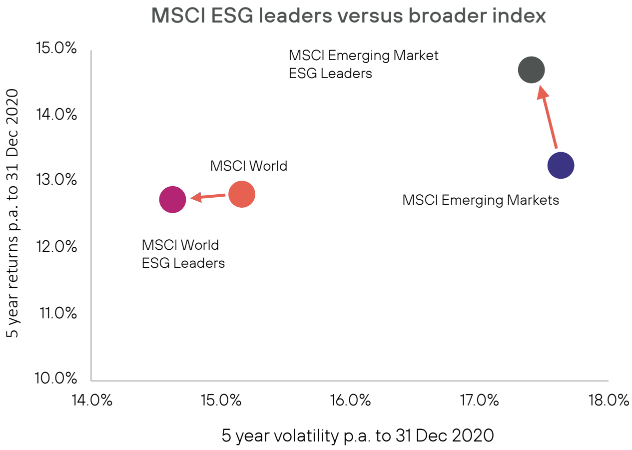
Although past performance doesn't necessarily guide the future, incorporating ESG considerations into investment decision-making has shown improved risk-adjusted returns across a variety of asset classes.

Equity funds that tilt towards positive ESG factors have performed better on a risk-adjusted basis in the past

This makes intuitive sense as companies that are ESG leaders are often seen as being better governed with more positive impacts on the environment and society in which they operate than ESG laggards. Investors view them as more responsible stewards of capital. We find that equities with positive ESG attributes tend to:

- Exhibit less volatility over the longer term
- Protect value in times of market crisis with lower maximum drawdown experienced





Source: MSCI

Credits issued by companies with higher ESG performance can be linked to better risk-adjust returns

A whitepaper1 recently issued by Fidelity Investments examined the importance of ESG factors in credit markets and paper found that issuers with the most positive ESG attributes:

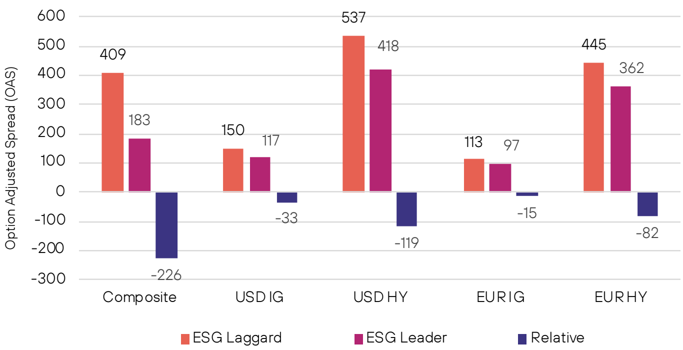
- are less exposed to downside risk
- are less likely to default than issuers in the lowest quintile in terms of an ESG rating
- are generally more liquid even in times of market stress

Further work done by MSCI, a data provider, supported this. As the chart on the right shows, issuers that are ESG Leaders have lower option-adjusted spread relative to ESG Laggards.

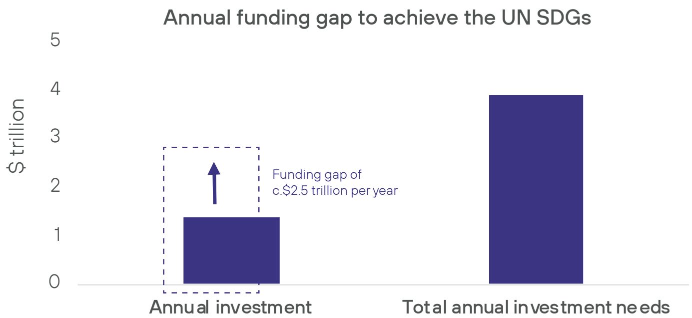
The bulk of the research we see points to a view that higher ESG ratings are correlated to better risk-adjusted returns in credit investments.

Option-adjusted spreads (OAS) of ESG Leaders versus Laggards

The OAS is the yield on bonds over the yield on risk free bonds. A lower OAS generally means that the bond is considered lower risk.



MSCI Investment Grade (IG) and High Yield (HY) Corporate Bond Indexes January 2014 to July 2020 Source: MSCI Inc. Copyright 2021. Not for further redistribution



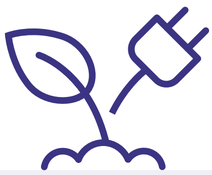
2. Playing to the funding gap and identifying opportunities early

United Nations Conference on Trade and Development (UNCTAD) estimated that there is a funding shortfall of $2.5 trillion to meet the United Nations Sustainable Development Goals by 2030. Due in part to regulatory tail winds, as well as the urgency of issues such as climate change, private investors have started to flood into this space. We think the momentum will continue and investors increasingly want to pursue strategies with positive environmental and social outcomes. There is an opportunity to be ahead of the curve by allocating to sustainable and impact funds aiming to meet the UN SDGs.

3. Investing in our planet's future

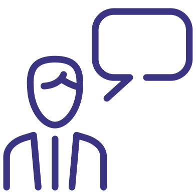
Many investors realise that "doing the right thing" doesn't ned to come with a cost and can in fact improve long-term returns. Integrating ESG factors into investment decisions directs capital to reverse the effects of climate change, as well as bringing about a fairer society. Below are a few opportunities that provide both an investment return as well as enhance social and environmental capital:

Empowerment of women
Investing in companies with high female participation in senior positions



Climate transition
Investment in companies or infrastructure supporting climate transition

Affordable housing
Investment in housing to provide accommodation to lower income groups and people with disabilities



The financial markets have the power to bring about positive change for the environment and our society. It is an important time to invest in our planet's future.

How do you access sustainable and impact investments?

There are a large range of sustainable and impact funds available across all asset classes. Below is our latest market map which we update on an ongoing basis. Our market map covers nearly 500 sustainable or impact strategies which are available to UK institutional investors:

Our advice is to first start with the "quick wins"

Many clients are taking their first steps in implementing sustainable or impact strategies via their portfolio, below are some examples:

Equity: replace your equity with a sustainable passive equivalent to enhance risk-adjust returns

Real Assets: investment in renewable energy infrastructure closes the funding gap and offers strong asset security as well as long-term income streams

DC schemes: implement sustainable equity and credit funds in your default strategy and provide sustainable and impact fund options within the self-select range

Isio's approach

The ESG fund space has grown rapidly with a myriad of strategies being launched every month. It can be confusing to know which are credible options with authentic ESG goals. Our consultants advise you on sustainable and impact funds for your portfolio and help you implement your ESG approach.

We would recommend the following steps:

1. Start with the quick wins, to replace existing funds with similar sustainable alternatives
2. Implement an impact framework across a selection of ESG metrics targeting specific impact goals
3. Evolve your investment strategy to cycle out of funds that are misaligned with your ESG impact goals and into funds that meet your ESG goals more effectively

We can shape ESG objectives into actions and help implement ESG-integrated strategies across a diversified investment portfolio across all client-types whether you are a DB or DC scheme, or a charity or family office.

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