*For professional investors only*

# Investing for Impact

## Exploring opportunities in publicly traded equity

Aon
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# Contents

# Introduction

We are on the cusp of a sustainability revolution more profound than many would suspect. The need to address environmental and social megatrends, including the climate crisis, resource scarcity and demographic changes, is driving a worldwide industrial restructuring and shifting the basis of competitive advantage among companies. This is leading to increased pressures on investors to drive constructive change and address some of the world's most pressing environmental and social challenges, while continuing to deliver competitive risk-adjusted returns.

Impact investing aims to support these challenges. The Global Impact Investing Network (GIIN) definition for impact investing is helpful:

> "Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return."

Within a portfolio of exposures across different asset classes, publicly traded equity holdings constitute a material proportion of investments. Within the context of Responsible Investment and the various approaches that can be taken, it is important to understand how publicly traded equities could be invested in a more impactful way, and the potential financial advantage in doing so.

In this paper, we show how:

- The role of impact investing is growing quickly.
- Investors looking to optimise financial returns, and have an impact on solutions for the future, should look to invest in companies that seek sustainable solutions.
- Environmental and climate change concerns feature strongly in impact agendas, alongside more localised objectives.
- The Sustainable Development Goals (SDGs), initiated by the United Nations in 2015[1], are supporting investors in how they direct and measure their impact, and address challenges with data.
- A broad approach towards impact investing in public equities will be attractive, combining managers who favour solution providers with those who focus on engagement impact.
- Investors should look to actively engage with impact investing and seek out investment opportunities, which offer rewards from future solutions, while successfully navigating today's Environmental, Social and Governance (ESG) risks.

[1] *United Nations, Sustainable Development Goals 2015*
*https://sustainabledevelopment.un.org/post2015/transformingourworld*

# Impact investment is growing

Impact investment is growing, driven by the increased focus on delivering Responsible Investment more broadly and to meet the challenges posed by megatrends. The Global Sustainable Investment Alliance (GSIA) published their Global Sustainable Investment Review in 2019[2] and showed that assets using Responsible Investment strategies continue to grow. Between 2016 and 2018, Responsible Investment assets across major markets increased by 34% from $22.9 trillion to $30.7 trillion.

Impact investment is one of the faster-growing segments of the Responsible Investment universe and GIIN produces a survey[3] that focuses specifically on impact approaches. Their most recent survey shows that publicly traded equity allocations related to impact investments grew at the second-fastest rate after real assets.

This survey was made up of the same respondents over the four years to 2018, and while private debt remains the largest contributor, there is real potential for public equity investment to be an increasing driver for impact investing.

**Growth in Instrument Allocations Among Repeat Respondents for Impact Investments (2014–2018, US$ Millions, Compound Annual Growth Rates)**

| Instrument | 2014 | 2018 | CAGR |
|---|---|---|---|
| Real assets | 1,205 | 4,362 | 38% |
| Public equity | 1,130 | 2,759 | 25% |
| Public debt | 2,392 | 4,116 | 15% |
| Private equity | 8,684 | 13,506 | 12% |
| Private debt | 15,964 | 21,234 | 7% |
| Deposits and cash equivalents | 957 | 857 | -3% |
| Equity-like debt | 4,466 | 1,944 | -19% |
| Other | 1,582 | 1,547 | -1% |
| **Total** | **36,380** | **50,325** | **8%** |

*Source: GIIN Annual Impact Investor Survey 2019*

# What is impact investing?

Impact investments intend to provide a return for the investor while achieving a positive impact on people and the planet. In contrast to traditional financial investments, impact investments are framed with dual objectives:

- To deliver positive financial returns.
- To deliver positive social and/or environmental impact.

The key differentiator of impact investment is the principle of intentionality.

That is, impact investors must have the explicit intention to drive specific positive social and environmental change with the capital they are investing. While investors expect the return on capital to be measured in any investment, impact investors will also measure the progress of their stated environmental and social aims to ensure the investments are contributing to desired outcomes. In publicly traded equities, this measurement is often done at an aggregate level, using broader measures than would be the case in private equity.

[2] *GSIA Global Sustainable Investment Review, 2018*
*http://www.gsi-alliance.org/trends-report-2018*

[3] *GIIN Annual Impact Investor Survey, 2019*
*https://thegiin.org/research/publication/impinv-survey-2019*

# The impact opportunity set

Among impact-focused investors, the range of impact objectives is diverse. These can range from highly localised objectives, such as a desire to improve the lives of a specific demographic group or local region, to broader initiatives encompassing climate change, social justice and the acceleration of economic development in emerging economies, among many others.

In Aon's 2019 global survey on Responsible Investing[4], investors showed support for many of these issues, but the clear focus was on climate-related initiatives. Here, 51% of those polled indicated that fossil fuel exposures and carbon footprint were key concerns, while 49% cited climate change and 38% renewable energy as being top priorities. A report published in 2018 by the Intergovernmental Panel on Climate Change (IPCC)[5], requested by the United Nations, ended the debate about whether climate change is occurring. The report concluded that while it is still affordable and feasible to tackle the problem of climate change, the action required to do so lies at the most ambitious end of the pledges made in the 2015 Paris Agreement. Our survey shows that investors are waking up to this challenge.

The organisation Principles for Responsible Investment (PRI) has a similar view on the level of action needed and has published a series of papers under the heading 'The Inevitable Policy Response'. Here, the PRI argues that we are far behind the urgent level of action needed to tackle climate change and that governments will be under increasing pressure to introduce regulation in response to this.

This will most likely involve an accelerating governmental response to climate change affecting macroeconomies, key industries and regions, and the world's most valuable companies.

A global 'transition' to a lower carbon economy is increasingly being referred to by policymakers, with a focus on developing regulations and policy initiatives to deliver the necessary transformation. While climate change and resource scarcity are the headline sustainability megatrends facing mankind today, this is being reinforced by potent shifts in demographics, including growing populations, ageing populations and inequality. Globalisation and urbanisation are leading to shifts in economic power and consumer behaviour; this is especially true in high growth emerging economies, with China ascending towards being the biggest superpower. In addition, the increased availability and rapid advancement of technology are redefining business models across a range of industries and causing widespread disruption, which creates risks for investors as well as new opportunities.

In the past, Responsible Investment chiefly served as a means for aligning investor ideals with their capital allocations. Today, however, these global megatrends are leading to a heightened sustainability imperative felt by the financial community. For their part, many actors within finance believe there is an urgent need to direct capital to help mitigate ESG risks and drive positive change. These perspectives now dominate the stage for Responsible Investment.

# Sustainable Development Goals: a framework for impact intentions

The full breadth of impact opportunities is most commonly captured by investors using frameworks that reference the Sustainable Development Goals (SDGs). The United Nations developed the SDGs in 2015, and the work has gone on to gain significant traction in the investment world for Responsible Investment.

These SDGs comprise 17 goals, and while originally provided for policymakers as development priorities over the next ten years, the investment community has also adopted the goals to the extent they are able.

The overall goal is one of sustainability; to build global prosperity for all over the long term and to mitigate and adapt to climate change. The investment community is increasingly guided by the SDGs, all of which are deserving, and investors can choose to address them broadly or to focus on the specific goals which are most important to them.

[4] *Aon's 2019 Global Perspectives on Responsible Investing https://www.aon.com/2019-global-perspectives-responsible-investing-growth-and-evolution/index.html*

[5] *IPCC, 2018: Special Report: Global Warming of 1.5˚C, Summary for Policymakers https://www.ipcc.ch/sr15/chapter/spm/*

## The Sustainable Development Goals


*Source: United Nations*

Several of the SDGs relate to environmental issues, and many are interrelated. Given the urgency to address climate change, and investor interest in doing so, focus here is most intense. In June 2019, the European Union's Technical Expert Group published their Taxonomy Technical Report[6], a classification system designed to accelerate the flow of capital towards achieving the environmental goals under the SDG framework.

The taxonomy helps to provide a common language between investors, issuers and policymakers and signals the type of investment activities required to meet and progress the Paris Agreement and the SDGs. While the investor community has generally welcomed the taxonomy, it is not intended as a substitute for investor judgement.

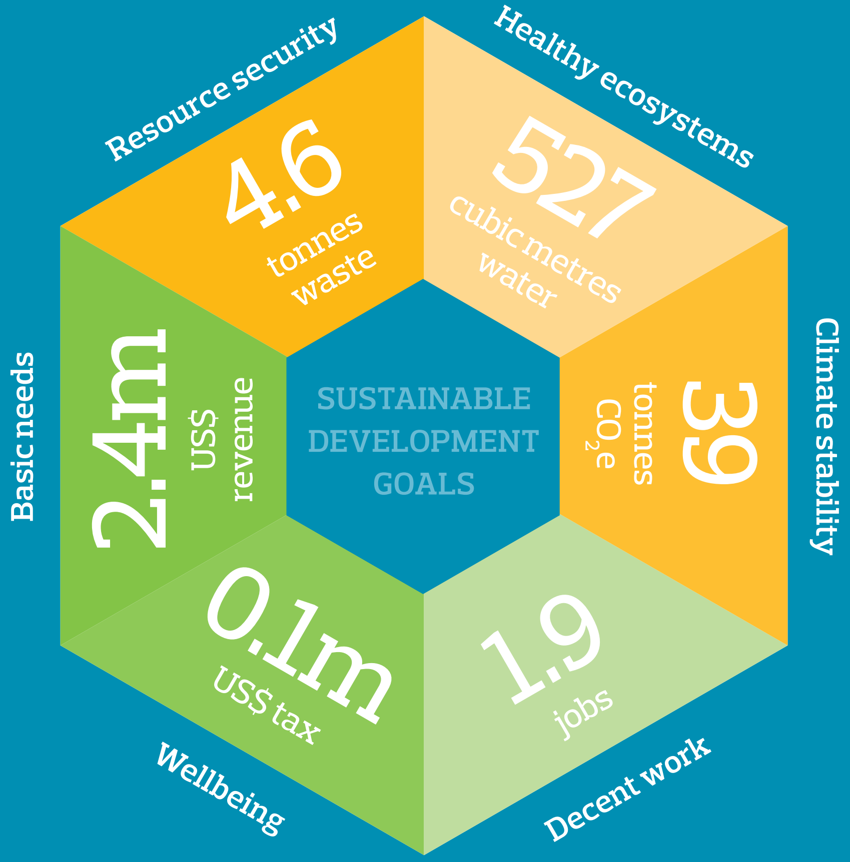
[6] *EU Taxonomy Technical Report*
*https://ec.europa.eu/info/publications/sustainable-finance-teg-taxonomy_en*

# Navigating impact measurement challenges

For capital to have a positive impact in each of the SDGs, implementation is not straightforward. To have the most impact, the type of products and services that are material to each SDG need to be understood, alongside the relevant ESG metric required to measure the intended impact. The question of which metrics are appropriate is a challenge — and solutions require nuance. Measuring impact in publicly traded markets must be more general and focussed on broader measures, due to the many differing business concerns a listed company may have.

The University of Cambridge Institute for Sustainability Leadership (CISL) Investment Leaders Group, of which Aon is a member, has developed the Investment Impact Framework. This framework identifies six core goals to resonate overall with the SDGs (three environmental goals and three social goals) and offers investors a way to distil complex information, by broadly defining how their capital impacts financial flows into the economy and the real-world impact contribution.

**The Cambridge impact dashboard and 'basic' metrics**




*Impact per US$ 1m invested*

Progress towards meeting CISL's six core goals is measured using intentionally simple metrics. These simple metrics allow investors to check alignment to their selected SDGs in a meaningful and consistent way and each of the six goals has been given their own 'basic' metric, as shown in the CISL dashboard above. For example, climate stability is measured by the total tonnes of carbon equivalent emitted by companies in a portfolio. Similarly, the goal of "decent work", is measured by the total number of full-time equivalent workers (FTEs), a metric collected by information providers today.

The assessment of whether the level of these metrics is good or bad is made by comparison to a chosen benchmark. The benchmark data, in terms of its basic metrics, is divided into quintiles and a traffic light spectrum produced, indicating the groupings from very positive to very negative.

We illustrate this on the next page, using a common benchmark (MSCI Europe). Any appropriate benchmark can be chosen to represent the universe when making relative comparisons.

## Example A: Climate stability

The example below addresses the environmental theme of 'Climate stability' and measures the appropriate basic metric of carbon emissions (Scope 1 and 2). This metric is arguably the most progressed and most large public companies in developed economies will be filing their carbon emissions data with the CDP (Carbon Disclosure Project).

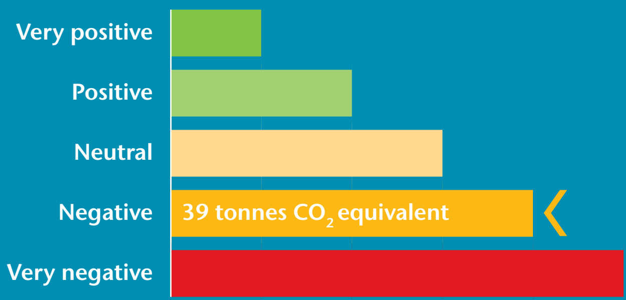
Many impact reports put the level of carbon emitted into equivalent reference terms. For carbon, this is often shown as how many (equivalent) cars could be taken off the road, to highlight relevance.

For example, new passenger cars in 2018 produced an annual average of 120g $CO_2$ equivalent/km over 20,000 km according to the European Environment Agency [7].

In our example below, the fund compared poorly relative to the benchmark by producing 39 more tonnes of $CO_2$, per $1m invested.

In terms of cars, this is equivalent to having 16 additional more cars on the road than the benchmark, per $1m invested. Other practical illustrations can be made for the other metrics offering perspectives.

**Climate stability – impact measurement results relative to MSCI Europe** (impact per US$1m invested in the fund)




## Example B: Decent work

The following example measures the basic metric for 'Decent work'. The example portfolio compares well to benchmark by providing 1.9 more full time equivalent (FTE) jobs per $1m invested. This level of job creation sits in the second-highest quintile for the MSCI Europe universes.

**Decent work – impact measurement results relative to MSCI Europe** (impact per US$1m invested in the fund)


This exercise is repeated for each of the other basic metrics shown in the impact dashboard. A summary of the basic (and ideal) metrics can be found in the Appendix, and a full description and method of the metrics can be found in CISL's paper 'In Search of Impact, 2019'[8].

The six core goals define impact as the social and environmental outcomes of investment, rather than the intentions or processes behind it. They assess real-world outcomes and make no specific claims about intentionality and additionality; nor do they determine the materiality of environmental and social impact relative to financial performance. They provide investors with a way to judge how their investments broadly relate to global sustainability aims, as framed by the SDGs and relative to a chosen benchmark.

In partnership with CISL, we intend to develop these metrics over time, as the availability of data improves. CISL's general and generic metrics are grounded in theory and have been subjected to rigorous academic and practitioner scrutiny and are a pragmatic reflection of the data currently available to measure interrelated impacts.

Additionally, more qualitative assessments are very important for a greater perspective. Scrutiny at the individual investment level gives a fuller understanding of the underlying investment rationale and provides a more nuanced view of progress towards the SDGs. Both lenses lead to better judgement concerning the outcome of an investor's impact investing intentions.

[7] *European Environment Agency, Average Co2 emissions from newly registered motor vehicles in 2018, Data https://www.eea.europa.eu/data-and-maps/indicators/average-co2-emissions-from-motor-vehicles/assessment-1*

[8] *CISL, In Search of Impact, 2019 https://www.cisl.cam.ac.uk/resources/sustainable-finance-publications/in-search-impact-measuring-full-value-capital-update*

# Moving the needle with impact investment

The world needs enormous amounts of capital to flow into impact investments if we are to shift the dial with respect to climate change and other global challenges. The IPCC estimates that over US$2 trillion[5] needs to be invested in green projects each year over the next two decades if we are to tackle climate change successfully.

To achieve the necessary levels of capital, publicly listed equity markets need to play a significant role, and both investors and financial markets will increasingly recognise the potential rewards on offer. As new opportunities arise, driven by regulation, innovation and consumer preferences, the valuation of financial assets will likely respond.

# The financial case for impact investing

As global megatrends make the future world look very different than today, investors with the ability to identify and act on ESG challenges will have a fuller understanding of companies' true risk and opportunity profiles. Identifying companies that are better positioned for the future will result in superior odds of achieving improved financial performance over the medium and long-term.

We do not believe valuations fully reflect many of these global megatrends. Companies that are better managed for the long-term, who better consider ESG risks and their impact on society and the environment, will be better placed to withstand future volatility and the pricing in of ESG risk.

Investors who believe financial markets have yet to fully price in ESG risks stand to benefit, not least by reducing the volatility likely to befall a transitioning economy and reducing severe event risk. Early adopters of impact investing can expect to benefit from a positive tailwind to financial returns over the short to medium term. Increasing regulation and policy actions, and growing concerns over these megatrends and transparency, are beginning to influence investor preferences. This is increasing demand for a smaller universe of highly rated sustainable investments while lowering demand for lower-rated companies.

This leads us to believe that managers can build impact portfolios that have similar risk-return characteristics to unconstrained actively managed equity portfolios, based on traditional financial metrics.

However, the impact portfolio has the potential to benefit from improved management of ESG risks and identification of opportunities that arise from transitioning economies, capturing premiums not visible to traditional risk-return modelling, in addition to their non-financial and impactful goals.

A primary benefit from impact investing is that it delivers measurable, positive change that benefits society, in addition to competitive risk-adjusted returns. The positive spill-over effects, which benefit all stakeholders, flow from being part of the solution. Organisations with a positive impact on environmental and social outcomes are better positioned to bolster economic and market performance, while fewer risks materialise than would otherwise be the case. This can result in a virtuous cycle that helps everyone, including investors and their stakeholders.

This premise is not without its risks, and investors will be aware that if markets continue to price ESG risk inefficiently, actual pricing over time may not follow a predictable path. Further, impact investment funds tend to be strongly correlated with quality and may underperform during strong markets. However, during market downturns or in the event of severe market incidents, impact funds benefit from their defensive and sustainable properties.

[5] *IPCC, 2018: Special Report: Global Warming of 1.5 °C, Summary for Policymakers https://www.ipcc.ch/sr15/chapter/spm/*

# Impact investment in public equity: our framework

**In publicly traded equity, we believe positive environmental and social impact can be developed in two ways:**

1. Investment in solution providers to environmental and social challenges.
2. Investing with an eye to engagement impact, where companies across all sectors are supported through active engagement to deliver meaningful improvement in sustainability metrics.

## 1. Solution providers

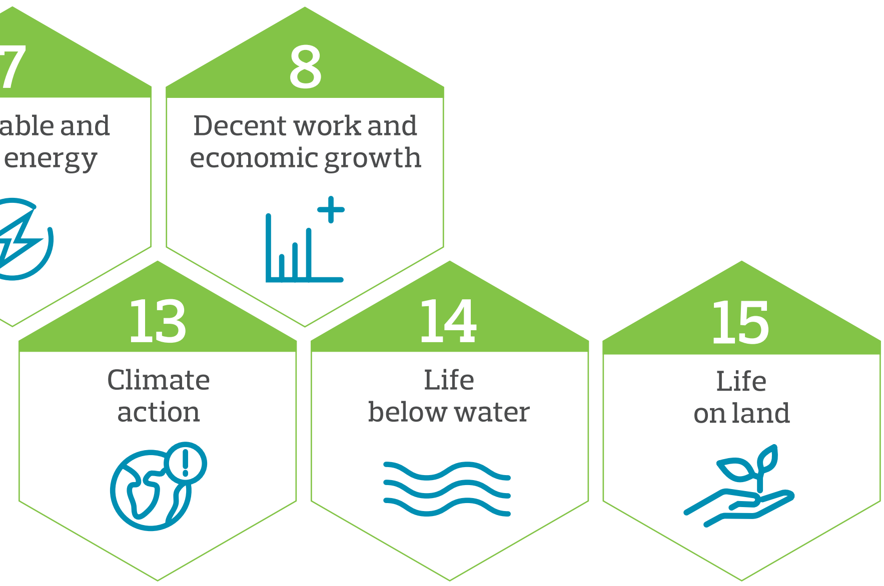
Social and environmental returns can be generated with investment in active ‘solution providers’ who look to address the SDG challenges. A typical general theme for a solution provider could be ‘mitigating and adapting to climate change’, for example. A public equity investment into a company with an explicit focus on water treatment solutions and water management delivers a financial return but also contributes to the goal of reducing water scarcity.

Similarly, a social theme could be ‘building sustainable prosperity for the long term’ which would look to address social inequalities and help people lead better quality lives.

There are many sectors and types of activity that are relevant to these themes. Below we illustrate a small number of activities that may help address the highlighted themes.

**Environmental**


## Mitigating and adapting to climate change




*Source: Aon*

**Social**


## Building sustainable prosperity for the long term


*Source: Aon*

Generally, the list of activities associated with these themes is wide-ranging and cannot be captured within a few select specific sectors. It, therefore, requires the investor to keep an open mind and retain the flexibility to invest on a pragmatic basis.

### 2. Engagement impact

A second approach is where managers deliver impact by constructively engaging with companies. Social and environmental returns can be generated via engagement with companies in the portfolio to encourage leadership and improvement in stakeholder and environmental management.

This can lead to tangible improvements in ESG profiles that lower exposure to ESG risks by increasing the sustainability of business models. This can drive return outperformance through the lowering of the cost of capital and improving the stability of cash flows.

For example, managers with a deep focus on engagement can create positive impact by working with their portfolio companies to help transform them from laggards to leaders in terms of environmental, social and governance metrics.

### Advocate for environmental stewardship

Engagement can encourage superior stewardship of environmental assets, greater consideration of biodiversity impact, promoting natural capital accounting, and alignment of the company with a sustainable economy.

### Promote stakeholder and social relations

Rather than taking a short-term profit maximising view, engagement can encourage companies to take a long-term view regarding stakeholder management in order to build mutually beneficial relationships with local communities, governments and regulators.

### Connect value creation with positive impact

Engagement can promote the intersection of long-term value creation with positive impacts on people and the planet in order to generate attractive returns for investors in the context of a world in transition to a low carbon, sustainable economy.

### Encourage disclosure

Engagement can promote disclosure on environmental, social and impact metrics to generate broader systems change. Improved and decision-useful disclosure can also help the market to identify leaders and laggards.

### Support to align portfolio companies with SDGs

Engagement can promote the understanding of Sustainable Development Goals (SDGs), and align the purpose and mission of portfolio companies with the achievement of the SDGs.

# Implementation options

There are a growing number of managers who offer impact solutions for Responsible Investment and navigating the range needs a good understanding of the required objectives. It is important to align investment objectives to deliver on return **and** impact expectations.

For investors who want to pursue sustainability, a broad approach towards impact investing in publicly traded equities will be attractive. Aligning to the SDG framework shows an intent to do general good, while not being restricted to any singular purpose. The SDGs are used as a sustainability lens for both manager and stock selection while maintaining the freedom of a wide opportunity set.

At any one time, a number of the SDGs may take priority, and the focus can rotate and change as markets develop and new companies gain traction and market share. An allocation to funds or companies with a specific focus on impact could still be added to as opportunities arise.

The approach serves both impact and financial goals and does not preclude areas of innovation due to being overly prescriptive. A blend of manager approaches is optimal in our view, adding robustness to portfolio construction, given its inherent diversification and wide opportunity set, while offering a meaningful opportunity to have a positive, global impact on society and the planet.

# Summary

- Global megatrends are driving increased demand for Responsible Investment, and investment opportunities are presenting themselves as the need for solutions and innovation grows.

- There is growing urgency for investors to find companies able to navigate a global transition given financial markets are expected to see increased volatility. Unless mitigating actions are brought forward, the impact on financial markets will be all the greater. Companies best positioned to withstand this volatility are those actively engaging with how their businesses are positioned for the transition to a greener global economy.

- Investors looking to optimise financial returns and have an impact on solutions for the future could do well by looking to invest in companies that seek sustainable solutions.

- As public equity markets increasingly focus on sustainability, more companies will present themselves as solution providers. There is increasing momentum in terms of innovation and solutions offered, and this is set to continue. This may provide an early mover financial advantage.

- In terms of which impact to have or which problem to solve, the United Nations Sustainable Development Goals have established themselves as a set of universally agreed desirable goals which together will also alleviate ESG risks and create a path towards greater levels of global sustainability. Investment strategies that are aligned with the SDGs can be flexible within public equity markets in so much as the investor can maintain a wide opportunity set and evolve with the market. Sectors within public equity markets will adapt, and innovations today will develop into the standards of tomorrow.

- Investors should look to actively engage with impact investing and seek out those investment opportunities which offer the rewards of risk mitigation, financial returns and impact. A multifaceted investment approach within public equity markets is one such optimal approach using a blend of managers while retaining diversification in a wide and liquid investment universe.

# Appendix

**Summary definitions for our Basic and Ideal ESG metrics (CISL, 'In Search of Impact')**

| Theme | **What is the ideal measure?**<br>Absolute performance with respect to SDGs<br>Whole chain value focus | **What can be measured today?**<br>Relative performance with respect to benchmark<br>Operational focus (value chains not appraised) |
|---|---|---|
| Basic needs | Total revenue from products and services addressing the basic needs of low-income groups adjusted by PPP-weighted international poverty line.<br>Unit: US$ | Total revenue from goods and services from clothing, communications, education, energy, finance, food, healthcare, housing, sanitation, transport and water.<br>Unit: US$ |
| Wellbeing | Total tax contribution, (comprising taxes on profits, people, production, property and environment but not sales) by country, adjusted by national employment rate.<br>Unit: US$ | Total tax contribution.<br>Unit: US$ |
| Decent work | Total number of open-ended employment contracts excluding jobs below 60% median wage (living wage) and jobs in poor working conditions (health and safety, discrimination, and rights of association) adjusted by national employment rate.<br>Unit: number of jobs | Total number of employees based on full time equivalent (FTE) workers.<br>Unit: number of FTEs |
| Resource security | Hard commodities: Virgin material content of end products (adjusted by scarcity) plus waste lost to the enivronment (adjusted by toxicity).<br>Soft commodities: Non sustainably certified content of end products plus waste not specifically returned to nature.<br>Unit: metric tonnes (t) | Total net waste (total waste arising minus total waste recycled).<br>Unit: metric tonnes (t) |
| Healthy ecosystems | Area of land utilised by an asset in degraded form.<br>Unit: hectares (he) | Fresh water use (surface water plus groundwater plus municipal water).<br>Unit: cubic metres ($m^2$) |
| Climate stability | Alignment to future warming scenario based on consumption of global carbon budget.<br>Unit: degrees Celcius (˚C) | Total greenhouse gas (GHG) emissions (Scope 1 and 2).<br>Unit: tonnes (t) carbon dioxide equivalent ($CO_2e$) |

# References and links


[1] United Nations, Sustainable Development Goals, 2015

[2] GSIA Global Sustainable Investment Review, 2018

[3] GIIN Annual Impact Investor Survey, 2019

[4] Aon's 2019 Global Perspectives on Responsible Investing

[5] IPCC, 2018: Special Report: Global Warming of 1.5˚C, Summary for Policymakers

[6] EU Taxonomy Technical Report

[7] European Environment Agency, Average $Co_2$ emissions from newly registered motor vehicles in 2018, Data

[8] CISL, In Search of Impact, 2019


# Further reading

- An Investor's Guide to Responsible Investment, Aon 2018
- Climate Change Challenges, Aon 2018
- CISL, In Search of Impact, 2019

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## About Aon

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