SUSTAINABLE STRATEGIES

Christmas came early for ESG guru Mark D. Sloss in the form of a new report on sustainable investment. Here he analyzes the tools needed for portfolio construction

MARK D. SLOSS
CHIEF EXECUTIVE, REGENERATIVE INVESTMENT STRATEGIES

Two columns ago I explored the matter of intentionality, a term borrowed from the impact investing space, in describing the environmental, social and governance (ESG) attributes of an investment strategy.

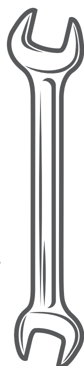
The Global Impact Investing Network uses it in describing 'investments made into companies, organizations and funds with the intention to generate social and environmental impact alongside a financial return.'

In my column I rented the notion of intentionality to describe public market portfolios deliberately constructed with the inclusion of social and environmental factors alongside financial ratios and traditional business analysis.

The question on the table now is one of how to actually evaluate intentionality in an investment process. The Investment Integration Project (TIIP) just released their latest report, 'Tipping Points 2016', a systems-level study of asset owners and managers in the sustainable investment space. Section two of that report is entitled 'The 10 Tools of Intentionality'. It was a holiday miracle. This column was going to unpack how to identify and assess intentionality, and the elves came in, did my homework, and polished my shoes on their way out.

I therefore spoke to two of the lead architects of the study, Steve Lydenberg and Bill Burckart, on how these tools are utilized in portfolio construction with my own intention to repurpose them for process and portfolio analysis.

DECONSTRUCTING ESG



We started with Adam Smith and the role of an invisible hand in the market. We examined economic efficiency, about which Lydenberg said: 'If you are driven by efficiency alone (maximizing your return) there are some things you won't do. You won't look out for the greater public good because society's assumption is efficiency in and of itself is a sufficient good. If you want to create social and environmental goods that don't just relate to risk in the portfolio, that aren't just going to be reflected in efficient price discovery, that aren't just accidental, you have to intend to do it.'

Delving more deeply, two of the 10 tools stood out as particularly useful as evaluative ways of looking at ESG managers. The first is 'additionality', defined as undertaking investments that might not otherwise have been made. This goes right to thoughts from my previous column about looking for investment processes that integrate inclusionary and exclusionary factors so the end portfolio is as much about what is as what is not owned. Typically, this is viewed as the inclusion of non-economic motivations such as to solve a societal problem or address an environmental need.

The second, 'solutions', lends purpose to additionality. According to TIIP, solutions are the investment vehicles that target particular social or environmental problems of substantial systemic importance. In private direct investment, that might be a company making and selling mosquito nets for malaria prevention in the tropical developed world.

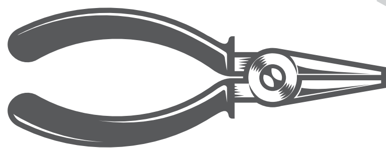
In the public markets, that could be a company addressing global access to nutrition or healthcare, or manufacturing equipment for clean energy generation. Disease, malnutrition and climate change are matters of public good, are legitimate opportunities to operate for-profit businesses, but where economic efficiency may not be optimized for the short term.

Efficiency, however, is not the antithesis of sustainability. Resource efficiency is a core virtue of good ESG business practices. But, realizing maximum price efficiency in the short term as expressed in financial performance often takes a back seat to intentionally prioritizing Lydenberg's greater public good. Over a market cycle, patient capital should also reap the full economic benefit of a virtuous

THE 10 TOOLS OF INTENTIONALITY

The **intentional** decision by investors to…

- **ADDITIONALITY** – Make investments which otherwise would not be made
- **LOCALITY** – Pursue investments which support economic activities within a defined region
- **SOLUTIONS** – Create vehicles targeting ESG problems of systemic importance
- **STANDARD SETTING** – Rule out certain transgressive investments or emphasize those with positive goals
- **POLITY** – Engage in relevant public policy debates
- **DIVERSITY OF APPROACH** – Accommodate the consideration of a diverse set of systems-level issues
- **SELF-ORGANIZATION** – Allocate resources to strengthen the financial system as a whole
- **INTERCONNECTEDNESS** – Increase flow of information about ESG and financial systems among investors or public
- **EVALUATIONS** – Place a financial value on difficult-to- quantify but potentially wealth-creating elements
- **UTILITY** – Ensure asset classes are aligned to the ESG purposes they were designed to address



circle of sustainable practices that reduce volatility and improve return.

Returning to additionality, the flow of capital is driven by a more expansive view of efficiency, that the devices of the capital markets are efficient tools for reaping non-financial returns in the short- to intermediate-term, and price returns in the intermediate- to long-term. Evaluating the end portfolios should serve as the validation stage in analyzing the intentionality of investment processes. The tools of intentionality leave fingerprints on portfolios that will persist over time.

Analysts can use TIIP's framework to deconstruct ESG investment processes to assess to what extent they satisfy investors' requirements to deliver financial returns while methodically addressing system-level societal and environmental challenges.