SUSTAINABLE STRATEGIES

NAVIGATING THE MORAL MAZE OF IMPACT INVESTING

Driving change from within is a noble aim, but at what point does activism become a facade for an unsustainable investment? Mark D. Sloss examines the corporate characteristics investors should look out for

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Impact investing has, in the past couple of years, become the new 'it girl' of sustainable public-market investment.

It'll take several more articles to unpack all of the challenges of translating the concepts and language of private-market impact into the public space.

Fortunately, from an analyst's perspective, impact needs to be material and measurable, which puts it squarely in the intellectual wheelhouse of traditional manager due diligence.

Material and measurable intentionality, which I touched on previously, is also essential.

So, how do we discern the difference between principled and productive impact and window-dressing?

HOW CHANGE HAPPENS

The best place to start is with the processes of sustainable public equity investing that long pre-date this new terminology of 'impact.' Specifically, we are examining proxy sponsorship and voting, as well as advocacy and engagement.

Excluding certain companies, industries and sectors from investment may have a limited effect by depriving them of some amount of investment capital. But investors have begun to appreciate that, in certain cases, there is more power to wield by being an active holder of a company's stock.

The tools were already well established by activist shareholders, including corporate raiders, to change behaviors and structures, force change and unlock shareholder value. In sustainability terms, that value is in protecting and fostering natural resources and human dignity.

Can you espouse a progressive view of humanity and the environment and own companies that are at odds with those views in whole or in part?

For example, could you own a diversified food manufacturer that uses palm oil from unsustainable sources and produces snack foods that contribute to obesity and diabetes? Could you own an integrated oil company or a fracked natural gas producer?

Proxy, advocacy and engagement are the instruments environmental, social and governance (ESG) managers and asset owners use to nurture improvement in environmental and societal terms. Various other stakeholders have voices that can affect a company's strategic and operational decisions, from customers to suppliers to regulators.

TRUTH TO POWER

However, taking a significant ownership interest gives asset owners and managers a seat at the table across from the C-suite executives and a voice with the board and other shareholders.

Ownership provides the opportunity to sponsor or vote on shareholder resolutions on policies from executive compensation to product and workplace safety. Ownership provides the opportunity to speak truth to power, opening dialogues on subjects that may be uncomfortable or lower priority for management to address otherwise.

Therefore, a purpose-driven investment in a company could present the opportunity to impact that company in ways that are beneficial in ESG terms.

But where is the tipping point between a purpose-driven investment in a company with a poor ESG record and an unacceptable investment, and how do portfolio managers navigate it?

Does activism become a facade for an unsustainable investment? The principles of fundamental investing apply.

Portfolio managers are looking for a track record of activities in the company or on the part of a management team that could be indicators of a willingness to go further and change the character of or even reinvent the company over the long term.

That could be investments in research and development, a shifting product mix, involvement in policy, or opening new lines of business.

The company should display innovative thought, the willingness to be responsive, and the nimbleness to change.

Could that food company become the largest purveyor of healthy products sustainably produced? Could the oil company invest in alternative fuels and technologies to usher in a low-carbon economic future?

How much change is enough and over what period of time to accept a holding as a legitimate component of an ESG portfolio?

Diversified financial institutions sponsoring these strategies may further struggle with matters of activism since other areas of the business may operate at odds with the ESG portfolio manager's intent.

Another operating unit could be the investment bank for that oil company. A different portfolio manager in the same complex might own that same food company and would fight an ESG-oriented proxy.

This is where we come full circle back to impact, and whether sustainable activism legitimizes otherwise unsustainable portfolio holdings. In the end, is it material and is it measurable?