Impact investing or investing with impact?

A call for rigor and transparency on impact in public equity investing

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About Espiria

Espiria manages funds that invest in global and Nordic markets. Espiria's equity and fixed income strategies aim to generate good risk-adjusted returns based on fundamental analysis in the long term, with a clear focus on sustainability and the SDGs. Espiria is part of East Capital Group, a global asset management group that comprises several strategies and specialisations to offer active management solutions in equities, bonds and real estate assets with a clear ESG framework.

Impact investing as an economically-scalable approach in addressing global challenges

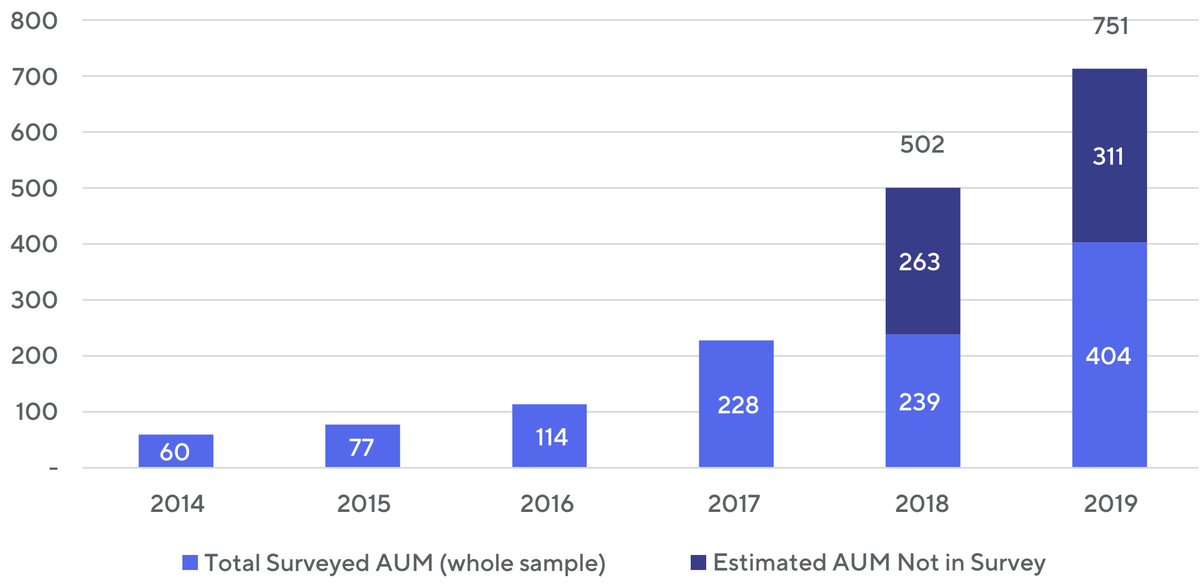
It's been 14 years since the term impact investing was first coined at a conference convened by the Rockefeller Foundation in Bellagio, Italy, in 2007. The goal was to discuss the need for and means of building a global industry striving for investments with a positive social and environmental impact.

Admittedly, impact investing was at first largely a specialist or niche investment approach, and was confined to a small group of market participants such as foundations, development finance institutions (DFIs), and family offices. However, since 2015, when the OECD described the social impact market as being in its early stages, the impact investing market has grown rapidly.

Measuring the size of the impact investing market is subject to some complications, such as what definition of impact is adopted and to what extent the actual market deviates from surveyed figures. However, a widely-cited figure comes from Global Impact Investing Network (GIIN), who now bases its market size figure on both surveyed impact investing AUM and estimations. According to GIIN, impact investing market size measured by AUM globally had reached USD 751 billion at the end of 2019, and the annual growth rate of surveyed AUM was as high as 51% between 2015 and 2019.

The International Finance Corporation (IFC, part of the World Bank Group), realising the limitation of market size figures based on surveys, took a different approach. It estimates the total appetite for impact investments from an asset owner point of view, by looking at their financial assets across all asset classes[1]. According to the IFC's estimation in 2018, the appetite for impact investing from private institutions and household investors - by which they seek to generate positive impact for society alongside fully commercial returns – potentially amounted to as much as USD 26.5 trillion, of which USD 5.1 trillion was from private market investments, and USD 21.4 trillion from public market investments.

Global Impact Investing AUM based on GIIN Survey and estimation (billion USD)



Source: Global Impact Investing Network (GIIN), East Capital

[1] Creating Impact - The Promise of Impact Investing, The International Finance Corporation, 2019

Impact investing started to mainstream

Besides asset size being in rapid growth, some structural developments showed that the impact investing approach has started to mainstream in the last 2-3 years.

5 years ago, impact investments were more commonly seen in private equity and private debt transactions, carried out by investors with AUM size averaging USD 500 million. Today, the approach of impact investing has attracted significantly larger investors (with average AUM of USD 1.4 billion) to invest in more diversified asset classes, including public equity, publicly-traded debt, equity-like-debt and real assets. The interest in impact investing is coming from a notably larger circle of asset owners today, with significant asset contribution from pension funds, diversified financial institutions, insurance companies, individuals, and family offices. In addition, large financial market players, such as KKR, TPG, Allianz Global Investors, JP Morgan, BlackRock, have launched their respective impact investing strategies in recent years.

Interest from retail investors in impact investing has also been on the rise in recent years, showing an increased awareness and attractiveness of the impact investing approach.

In 2018, Longitude[2] ran a survey on 200 individual investors with USD 100,000+ of investable assets and found that among the retail investors who were aware of impact investing, the vast majority (78%) stated that they were actively making impact investments.

The appetite is also expected to grow among global family offices, as wealth is taken over by the younger asset owners. According to USB's Global Family Office Report 2020, the next-in-line generations are more likely to increase the level of sustainable investment, and the younger generations have a greater affinity for impact investing than the older generation. 61% of the next-in-line generations are regarded as "engaged" (with environmental and social issues), compared to 47% of their parents.

Despite the ongoing shift of individual investors' appetite towards impact investing, the product and service side seem to be lagging behind. The lack of quality investment opportunities (funds and direct investments) with track record remains 4th in the top ranked challenges in GIIN's 2020 Impact Investor Survey results. But the situation may alter quickly as market players increase the pace of innovation and financial market regulators provide further support.

An ongoing shift in mindset

The drivers behind impact investing's rise are numerous, but its growth indicates a clear shift in mindset, especially among private individuals, businesses, and the mainstream financial market. Several intertwined realities are being increasingly recognised as this shift occurs.

- Our current socio-economic model, with its aim of increasing prosperity measured in terms of growth in quantity, fails to deliver on its promise in many ways. Such a growth trajectory cannot be sustained because of the challenges it causes, including for instance environmental destruction and social disturbances.

- To address these challenges, systematic changes need to be brought about at scale, meaning that commercially-viable and scalable solutions are indispensable.

- The private sector, including commercial businesses and the financial market, has a critical role to play in achieving development goals like the United Nations Sustainable Development Goals (SDGs). But for this to materialise, there must be enhanced transparency on how impact is created through businesses or investment activities; be it negative or positive, intended or unintended.

The impact investing approach perfectly fits into these realities. With a clear intention to contribute on pre-defined social or environmental outcomes, impact investors finance commercially-scalable opportunities that are inherently aligned with their impact objectives – for a return ranging from below the market rate to a risk-adjusted market rate - and they are expected to actively manage impact through proper data collection, measurement, reporting and engagement.

[2] An FT Group company

Sustainability and impact as part of fiduciary duty and stewardship

Fiduciary duties exist to ensure that those who manage other people's money act in their beneficiaries' interests, rather than serving their own interests. Obviously, how fiduciary duties are defined was one of the first challenges facing all asset managers who consider sustainable investing strategies, including impact investing.

While some institutional investors believed that environmental, social and governance (ESG) issues were not relevant to their portfolio value, and were therefore not consistent with their fiduciary duties. This assumption is no longer supported.

According to the final report of a 4-year project jointly launched in 2015 by the United Nations Environment Programme Finance Initiative (UNEP FI) and the Generation Foundation, it was demonstrated that there is extensive evidence showing the critical importance of incorporating ESG standards into regulatory conceptions of fiduciary duty. Investors who fail to incorporate ESG issues are failing their fiduciary duties and are increasingly likely to be subject to legal challenges.[3]

Following the adoption of the 2015 Paris Agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the EU Commission has expressed in the Action Plan for Financing Sustainable Growth, its intention to clarify fiduciary duties and increase transparency in the field of sustainability risks and sustainable investment opportunities.

With this intention, the EU commission has put froward a package of sustainable regulations, including the EU Taxonomy Climate Delated Act, the Corporate Sustainability Reporting Directive (CSRD), and the EU Sustainable Finance Disclosure Regulation (SFDR). SFDR, effective since 10 March 2021, especially emphasises the duty of financial market participants and financial advisers to include all relevant sustainability risks and opportunities that might have a relevant material impact on the financial return of an investment or piece of advice. According to SFDR, financial market participants and financial advisers should provide pre-contractual and ongoing disclosure about how they integrate sustainability risks, the consideration of adverse sustainability impacts, the promotion of environmental or social characteristics, and sustainable investment.

On 21 April 2021, the EU Commission also introduced the assessment of clients' sustainability preferences in existing delegated acts under the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD), as a top-up to the suitability assessment. With this in place, *"Insurance and investment advisers will be required to obtain information not only about the client's investment knowledge and experience, ability to bear losses, and risk tolerance as part of the suitability assessment, but also about their sustainability preferences. By amending existing rules on fiduciary duties in delegated acts for asset management, insurance, reinsurance and investment sectors, the EU Commission is clarifying the current rules to also encompass sustainability risks such as the impact of climate change and environmental degradation on the value of investments."*[4]

Similar sustainability-related duties can hold true in many more countries outside the EU. Based on a survey across 11 jurisdictions, conducted jointly by PRI, UNEP and Generation Foundation, and the published report that ensued, it is believed that *"negative sustainability outcomes can clearly be a threat to the long-term prosperity of any business. And some sustainability crises, such as climate change, pose systemic risks that are likely to damage the prosperity of whole business sectors and societies. This is the main reason for a potential obligation to consider engaging in instrumental investing for sustainability impact (IFSI)."* Furthermore, the report suggests that an asset owner should act to *"take reasonable steps*[5] *to bring about specific sustainability impact goals that can reasonably be expected to (1) help influence the relevant sustainability factor(s) or the exposure of investee enterprises to it/them; and (2) do so in ways that mitigate the financial risk for the portfolio, or even create potential for value growth"*[6].

While the SFDR does provide an option to explain why sustainability risks are not relevant and thus do not need to be considered (comply or explain), it is believed by some that, in most cases, not considering sustainability risks may not be a prudent approach and may be considered a breach of fiduciary duties of asset managers.[7]

These regulations and legal discussions have laid the initial ground for investors to consider sustainability and impact as part of investor fiduciary duty and stewardship.

[3] Fiduciary Duty in the 21st Century, Final Report, 2019, UNEP Finance Initiative
[4] EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal, COM(2021) 188 final, 21 April 2021
[5] E.g. through for example using investment powers, stewardship activities
[6] A Legal Framework for Impact, Sustainability impact in investor decision-making, PRI, UNEP and Generation Foundation, July 2021
[7] Stephan Geiger, ESG Lead Financial Services, Switzerland, EY. 2020

Impact investing or investing with impact?

A consensus-based definition of impact investing

The definition of impact investment can vary, depending on where investors decide to put their focus. But to have a unified view on what defines a new field such as impact investing has been critical to its development.

From a field-building perspective, to clearly define the field of impact investing was not an easy task, since this was an area where financial investments join hands with social development, private sector meets with public interest, and where market participants rarely meet to have dialogues on the same topic, such as non-profit organizations and financial market institutions.

Despite this, a good level of global consensus has been reached today across sectors and regions, thanks to efforts made by many pioneer impact investors, as well as foundations and service organisations who worked hard to help build common ground on impact investing – the so-called impact investing field-builders.

Generally, we believe a good definition for a new term (such as impact investing) should serve to provide balance between rigor and scope, so that it provides high clarity while allowing for sufficient diversity within the field. With this in mind, we find that the definition by Global Impact Investing Network (GIIN) strikes such a balance well, and it is representative of broad views shared by global industry players.

According to GIIN, **"Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return."** GIIN further clarifies this definition by complementing it with 4 tenets of 'core characters' of impact investments, including intentionality, financial returns (ranging from below market rate to risk-adjusted market rate), range of asset classes (all) and impact measurement. This also establishes baseline expectations as to what impact investments look like.

The nuances

For a young industry such as impact investing, confusions may nevertheless arise when people interchangeably use similar terms, such as "impact investing" and "investing with impact". While the latter may also reflect the 4 core characters defined by GIIN, it is not a term that has been rigorously defined the same way as 'impact investing' has. For this reason, while any investor may invest with impact, all are not impact investors.

Besides, it is worth noting that even among impact investors, the extent to which certain best practises are adopted in their investment process can vary greatly – an area that has so far largely depended on investors' conscious effort or self-discipline, but with increasing calls for standards and harmonization.

As a result, there have been various standards and initiatives to form discipline within the impact investing field. Operating Principles for Impact Management ("the Impact Principles") is one such example. It was initiated by the IFC to instil a discipline around impact investing, and to *"assist investors in identifying investments that are being managed for impact, and help reduce the dilution of the term "impact" in the marketplace."*[8] This set of 9 principles guides impact investors in the design and implementation of their impact management system, to ensure that impact considerations are integrated throughout the investment lifecycle. In following these principles, signatories to the Impact Principles publicly demonstrate their commitment to implementing a global standard for managing investments for impact.

"We believe 5 key words - namely "intentionality," "materiality," "measurability," "accountability" and "additionality" (see chart below), can be used as a good rule of thumb to distinguish impact investing from other investment activities"

To draw on the essence of the most widely-recognised best practices in the industry, such as Impact Principles, and on the definition of impact investing, we believe 5 key words - namely "intentionality," "materiality," "measurability," "accountability" and "additionality" (see chart below), can be used as a good rule of thumb to distinguish impact investing from other investment activities, as well as to capture potential nuances among different impact investors.

[8] Operating Principles for Impact Management, website

Impact investments: investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return

4 Defining Core Characters (by GIIN)

Intentionality	An investor's intention to have a positive social or environmental impact through investments is essential to impact investing.
Investment with return expectations	Impact investments are expected to generate a financial return on capital or, at minimum, a return of capital.
Range of return expectations and asset classes	Impact investments target financial returns that range from below market (sometimes called concessionary) to risk-adjusted market rate, and can be made across asset classes, including but not limited to cash equivalents, fixed income, venture capital, and private equity.
Impact measurement	A hallmark of impact investing is the commitment of the investor to measure and report the social and environmental performance and progress of underlying investments, ensuring transparency and accountability, while informing the practice of impact investing and building the field.

Example of best practices in impact investing

Materiality	The desired outcomes in pursue should be financially material to the investee business.
Accountability	The process to measure and manage impact is logical, effective, and accountable. For example, to have a 'theory of change' in place could make the impact measurement and management process easily accountable.
Additionality	An impact investor seeks to produce positive social or environmental outcomes that would not have occurred without her specific investment or intervention.

Source: Global Impact Investing Network, East Capital

Impact investing differs from ESG investing

ESG investing often refers to a basket of specific strategies that takes ESG factors into account in an investment process, such as negative or norm-based screening, best-in-class screening, ESG integration and engagement. Impact investing strategies clearly distinguishes between these, especially on investors' intentionality.

Impact investors actively pursue specific, pre-defined environmental and social outcomes as the objectives themselves to achieve. With these, they focus on delivering intentional contributions towards these targeted outcomes.

ESG investing strategies however usually lack such clear intention or pre-defined social or environmental outcomes to achieve. Their focus tends to be 'Do-no-harm' and risk mitigation, rather than intentional contribution, taking E, S and G factors into consideration to help mitigate long-term financial risks and therefore enhance risk-adjusted returns.

While an ESG investing strategy largely remains within the conventional 2-dimensional risk-return optimisation framework – despite adding new factors to the classic capital asset pricing model - impact investing strategy takes up the challenge to optimise investment decisions based on 3 dimensions: financial return, risk and impact.

"While any investor may invest with impact, all are not impact investors."

Impact investing is one of the sustainable investing strategies

Broadly speaking, impact investing can be viewed as one element in the sustainable investing strategy basket, together with positive or negative screening, norm-based screening, corporate engagement and shareholder action, ESG integration etc, according to Global Sustainable Investment Alliance (GSIA).

Notably, recent developments within sustainable investing have brought a certain type of sustainable investing activities one step closer to the impact investing approach. Specifically, the EU Taxonomy and Sustainable Finance Disclosure Regulation (SFDR) further strengthened the case that impact investing overlaps with article 9 sustainable investing strategies, especially in one core characteristic: contribution to a social or environmental objective that is measured.

		Sustainable Investment						
					Investing with impact			
	Traditional	ESG Screening	ESG Activism	ESG Integration	Sustainability Themed Investing	Impact investing (market rate)	Impact Investing (concessionary rate)	Philanthropy
					Targeted social and/or environmental impact			
	Competitive financial returns							
Focus	Limited or no focus on ESG factors or underlying investment	Negative or exclusionary screening and positive or best-in-class screening, norm-based screening.	Employing shareholder power to influence corporate behaviour, including through direct corporate engagement (i.e.,communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, andproxy voting that is guided by comprehensive ESG guidelines.	The systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis.	Investing in themes or assets specifically contributing to sustainable solutions - environmental and social -(e.g., sustainable agriculture, green buildings, lower carbon tilted portfolio, gender equity, diversity).	Investing to achieve positive, social and environmental impacts - requires measuring and reporting against these impacts, demonstrating the intentionality of investor and underlying asset/ investee, and demonstrating the investor contribution.		Focus on one or a cluster of issues where social and environmental need requires 100% trade-off.
						Aiming to achieve market rate financial returns, i.e. no financial trade-off.	Expects some financial trade-off.	

Impact investing in the public equity space

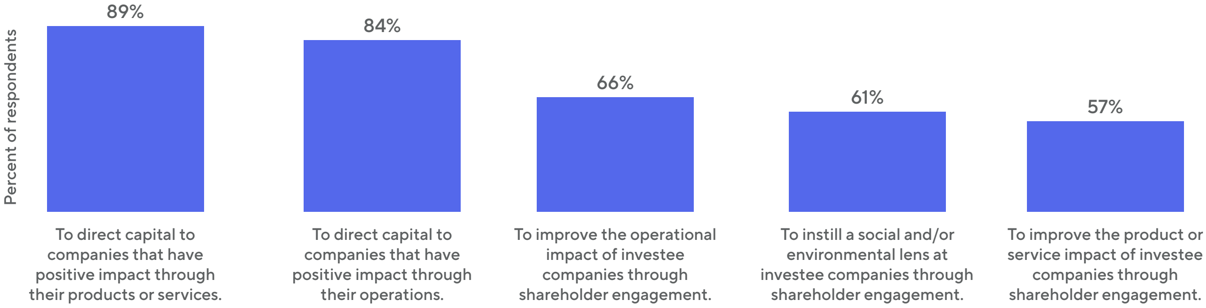
As noted earlier, one of the most important developments in impact investing is its mainstreaming in recent years. With that comes the rapid rising of public equity as an impact investing asset class.

According to GIIN's Annual Impact Investor Survey 2020, public equity had become the second-largest asset class among all surveyed impact investors by the end of 2019, reaching 19% of their total AUM[9]. As new public equity impact investors continued to join the space, the 78 impact investors surveyed repeatedly during 2015-2019 also grew their AUM allocations in public equity at 33% CAGR in this period. On specific impact investment strategy, a significant majority of the surveyed investors opted to invest in companies that deliver positive impact through their products or services and operations. Shareholder engagement has also been a common theme.

"As a public equity asset manager ourselves, we are tremendously excited with what the impact investing approach has achieved and its tremendous potential, not yet fully explored."

Strategies for generating impact through listed equities investments

n = 61; optional question. Includes respondents that currently seek to generate impact through listed equities.



Source: GIIN, 2020 Annual Impact Investor Survey

Public equity investing to bring impact at scale, alongside attractive returns

The rationale behind impact investing through public equities is convincing.

Firstly, given the high level and complexity of global sustainable development challenges, impact investing can only achieve its mission when it is done on a sufficiently-large scale. Given its huge market size, to invest with impact through public equity brings more hope of achieving systematic changes at the global level, and nicely supplements other forms of impact investments that have an edge for solving local challenges.

Furthermore, the public equity asset class has what it takes to democratise impact investing, making it widely accessible to all investors, including those with smaller asset sizes, allowing them to participate in opportunities that can achieve long-term capital gain while delivering scalable impact at the same time.

Lastly, given the increasing number of listed companies with business strategies inherently aligned with sustainability development objectives, it would be simply wrong to ignore such strong forces for making positive changes. Taking climate change challenges as an example, collectively viewed, whether listed companies align their products or services with the needs to mitigate or adapt to climate change makes a huge difference to the end outcome. And given the world's determination to minimise climate risks, to align capital purposefully towards such needs means structural opportunities, and is a sensible move to take.

[9] The largest asset class remains private debt, and the 3rd largest was private equity.

Reflections over challenges in impact investing through public equities

A widely-recognised challenge facing impact investing is impact measurement and management (IMM), despite its overall progress in the past decade[10]. While this especially holds true for public equity impact investors who mainly rely on public data availability, we believe investors need to properly deal with multiple challenges to generate real impact through public equity investments.

Although it is challenging, as a public equity asset manager ourselves, we are tremendously excited with what the impact investing approach has achieved and its tremendous potential, not yet fully explored.

We also believe that it serves a strong purpose to reflect carefully over several key challenges, in seeking effective results and best practices to impact invest via public equity. These are:

- The faith to deliver market-rate (or beyond) financial return with intended impact, i.e. attractive financial gains and impact being achieved without a trade-off between the two
- The practice of establishing a logical, verifiable causal relationship between an investment and investors' intended impact
- To use material and consistent data to measure and manage impact
- To clarify investor contribution and prove additionality

Reflection 1. The faith to deliver market-rate (or beyond) financial return with intended impact

We realise that impact investing at its roots aims to challenge a series of presumptions that the private sector has not challenged enough or tested for long enough. With this, we decided to first reflect over another highly-relevant question:

Can the concept of value (creation) be redefined?

One way to start putting the question into perspective is to look at economic activities around us. To what extent is our economic prosperity and growth driven by a linear economic model based on increased throughputs? How many of the objects and materials we manufacture are meant for single use or for a limited lifetime, instead of for keeping their economic value and utility as high as possible for as long as possible?[11]

Another way to reflect over value creation is to think about how the purpose of a business is defined and delivered. Despite an increasing share of companies that take broader stakeholder benefits into consideration, either to 'not lose their social license to operate,' or to purposely deliver their enterprise mission beyond the scope of shareholder value creation (both motivations could justify them as companies embracing 'stakeholderism,' according to a Financial Times article[12]), gaps between purposeful statements and the actual effects still exist. In a 2019 McKinsey survey comprising a representative sample of more than 1,000 participants from US companies, 82 percent affirmed the importance of purpose, but only 42 percent reported that their company's stated "purpose" had much effect.[13] If employees within an organisation perceive a big gap, imagine the perception of others who are outsiders. Such gaps also explain why some companies take stakeholderism as far as to clarify this through a so-called benefit certification (such as B Corp certification), or to guarantee it through the company's legal format (such as public benefit corporations).

The biggest question the company executives face daily in their 'stakeholderism' embracement is how to solve the issue in the interests of various stakeholders simultaneously, including employees, communities, suppliers, the environment, customers, and shareholders, and to know whether there is a trade-off in maximising total value of the firm.

Logically, this is identical to our question in focus: Can financial and impact goals be achieved at the same time, without having to see a trade-off between the two? Alternatively put, is there a possibility to make market returns (at a non-concessionary rate) while delivering a tangible positive social or environmental impact?

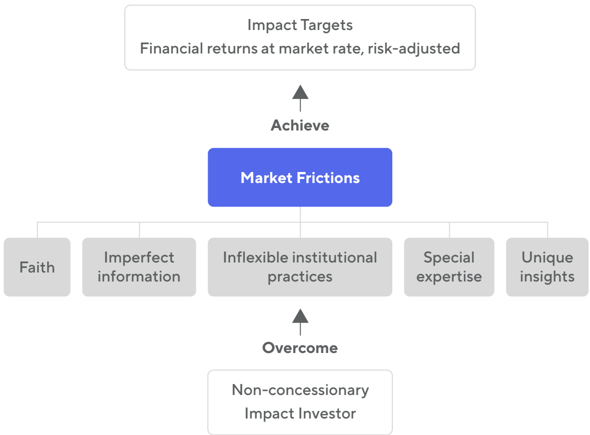
While this "trade-off or not" debate was intense at the creation of the impact investing concept, over time, more explanations have surfaced and a good amount of evidence has been built to support the less obvious case, where trade-off is not a must.

"Over time, more explanations have surfaced and a good amount of evidence has been built to support the less obvious case, where trade-off is not a must."

[10] According to GIIN's 2020 Annual Impact Investor survey
[11] Based on the definition of circular economy as described by Water Stahel in The Circular Economy – A User's Guide, 2019
[12] Jonathan Ford, We should beware the rise of stakeholderism, Financial Times article, 8 March 2020
[13] McKinsey Organizational Purpose Survey of 1214 managers and frontline employees at US companies, October 2019

On the academic side, Brest and Born[14] pointed out that there are several "domains of friction" that could allow socially-motivated investors to reap both social impact and non-concessionary financial returns. These market frictions could include imperfect information, faith[15], inflexible institutional practices, small deal size, limited liquidity, as well as areas that require special expertise or intelligence on the ground. The successes of some double or triple-bottom line investors with reasonably long track records has already provided initial support to these theoretical explanations.

Taking one step back, it is wise to put aside any initial scepticism towards impact investors' claimed intentions to achieve market rate returns, and ask instead an alternative question: **to what extent do their investments deliver intended impact that is also material, measurable, accountable and additional?**



Reflection 2. The practice of establishing a logical, verifiable causal relationship between an investment and an investor's intended impact

While the choice of intended impact is a question of personal values and preferences, it is also a question of priority in the context of limited resources and the need to address global sustainability challenges in a timely manner.

Since the establishment of the United Nations Sustainable Development Goals (SDGs) in 2015, the SDGs have become a common language on how people, planet and prosperity targets are communicated globally. Although not designed to serve as a guide on specific investments, the SDGs happen to be useful in identifying where capital is needed the most, or where capital can make the biggest difference.

[14] Paul Brest and Kelly Born, Unpacking the Impact in Impact Investing, Stanford Social Innovation Review, 2013

[15] i.e. impact investors achieve attractive financial returns when others let go potentially good investments due to their scepticism about achieving both financial returns and social impact.

Extra notes on using the SDGs as an outcome guidebook

Since the UN SDGs were not created in the first place to guide private investments, extra care is necessary when using them as a guidebook in investment practices. Agenda 2030 consists of a total of 17 goals and 169 targets, which are outlined across the areas of people, planet and prosperity. While the 17 goals are often too broad categories to aim for in the context of impact investing, many of the 169 targets are concrete and investable outcomes – where private capital can be invested for an expected financial return. Obviously, what targets are deemed investable and relevant could vary depending on investors' specific focus or preferences.

It is worth noting, that while many SDG targets guide people towards seeking solutions within specific industry sectors or through companies' operational practices, some general enabling factors in achieving the SDG goals should not be ignored either, despite the fact that they may not be attributed to one specific industry.

One example is 'innovation'. SDG clearly states innovation as a goal to aim for (Goal 9). But the path towards innovation goes beyond one single industry. Innovation is indicated in the SDG framework across multiple targets, including both "Outcome targets" (e.g. SDG targets 8.2, 9.5, 17.8) and "Means of implementation targets" (e.g. SDG targets 9.b, 12.a, 14.a). While not all targets aiming to achieve innovation are directly investable, it is clear to us that those that lay an important foundation for innovation to happen can be directly investable, such as necessary technical infrastructures (including services), education and up-skilling.

Mapping is easy, verifying causal relationships is hard

Given the wide adoption of SDG terminologies in sustainability-related communication among corporates and investors, service providers such as ESG data providers, investment banks, and wealth managers have played along. Many started to provide thematic screening products to help their clients navigate investment around SDG, or sustainability in general. A frequently-seen methodology of such screening is sector-based mapping.

By breaking down a company's revenue, we can analyse and attribute its respective revenue stream to one or multiple sustainability objectives (or specific SDG goals), given certain cut-off thresholds are met (e.g. 60% of revenue is related to SDG goal 9). Such mapping can be done on a sector classification basis (such as GICS), by some financial service providers for example, or on a more granular level basis of economic activities, such as the EU Taxonomy (NACE[16] based).

A harder part of the work however is to demonstrate and verify the causal relationship between a certain business or investment activity and the claimed impact.

Typically, a full causal relationship in the context of impact includes a full chain of elements leading to impact.

As previously discussed, impact investors always start with a clear intention to generate pre-defined social or environmental impact. Then they work in steps to achieve this, alongside financial returns, forming a closed loop of events that happen in order. This process can also be reversed as a way of planning, which is best demonstrated with the so-called Theory of Change (ToC).

Theory of Change (ToC): a planned route to impact

In essence, the 'theory of change,' a logic model, is no more than a planned route to outcomes, and consequently impact, *where it shows how and why a desired change is expected to happen in a particular context*[17]. By working backwards, we can identify all the conditions that must be in place for the targeted impact to occur, including necessary inputs, business activities, outputs, outcomes and impact, as the long-term effect of positive change.

By using an articulated theory of change, either a simplified or a complex one, companies and investors can bring rigor to any causal statement between their activities and intended impact, making it verifiable and the impact more accountable. Equally important, the feedbacks that is received in the loop can be useful to realign activities with the intended impact, to avoid mission-drift in the process.

"By using an articulated theory of change, either a simplified or a complex one, companies and investors can bring rigor to any causal statement between their activities and intended impact, making it verifiable and the impact more accountable."

A simple demo of Theory of Change: case of D.Light, a company selling affordable, quality home lighting products for home use, targeting the African market.

Source: D.Light, www.dlight.com/social-impact/

Input: Solar panel, battery, control electronics, human capital etc

Output: If more people living on Tanzania farms use **off-grid solar lantern**

Outcome:

- Less use of kerosene lantern, less fire accidents or respiratory disease → Increased average rural lifespan, Increased productivity from better health
- children at home can have longer study hours → Increased test scores and better grades

Impact (long term effect):

- Improved economic situation
- Increased education levels

[16] Known as "statistical classification of economic activities in the European Community".
[17] According to definition by Impact Management Project (IMP)

Reflection 3: Using material and consistent data to measure and manage impact

As the hallmark of impact investing is to measure and manage impact, one could not overstate the importance of using appropriate data.

The main source of non-financial information needed by public equity impact investors is companies' own disclosure. And thanks to the development of ESG reporting in recent years, availability, quality, and consistency of non-financial disclosure are improving. Standards such as GRI (Global Reporting Initiative), SASB (Sustainability Accounting Standards Board), CDP (Climate Disclosure Project) and TCFD (Climate Related Financial Disclosures) etc., also make these data more comparable across companies.

However, despite the benefits of data abundancy and standardisation, since impact takes many different forms as companies businesses vary, impact investors seeking material indicators in relation to certain impact may still struggle, for instance when such data goes beyond what universal standards would require, and companies may have not yet chosen to disclose them.

In the absence of companies' own disclosure, impact investors face several choices: to go ahead with available data that may be somewhat compromised in materiality or consistency; to do proprietary research and construct estimates based on well-grounded reasoning; or to take further active action to obtain the data needed, such as through company engagements.

"A good principle may be to stick with data materiality criteria, be aware of any potential discrepancy between expectation and reality, and be fully transparent with it."

Regardless of what an investor chooses to do, a good principle may be to stick with data materiality criteria, be aware of any potential discrepancy between expectation and reality, and be fully transparent with it.

Meanwhile, further support on impact measurement and management (IMM) is on the horizon, regarding both impact data availability and tools to facilitate investors in the IMM process.

For instance, for companies based in the European Union or non-EU companies with EU subsidiaries, as many as nearly 50,000 companies will soon be obliged to make more comprehensive disclosure on sustainability related metrics, as the Corporate Sustainability Reporting Directive (CSRD) becomes effective from 2022, and becomes applicable for the first time for the fiscal year beginning on or after 1 January 2023.

Meanwhile, existing IMM frameworks and tools are being optimised, and there are ongoing harmonisation efforts across standards, benefitting investors who use them in combination. For example, in July 2020 SASB and GRI announced a collaborative workplan to show how companies can use both sets of standards together. The IRIS+ has already built in compatibility with IMP 5-dimentions, SDGs, and IFC on launching Joint Impact Indicators (JII), and it recently started harmonising with SASB as well.

Examples of existing frameworks and tools to measure and manage impact

IMPACT MANAGEMENT PROJECT

IMP 5 dimensions of impact: a thinking model to capture impact and measure it according to impact from 5 dimensions. The so called "5 dimensions of impact," initiated by the Impact Management Project (IMP) since 2016, is a set of global consensus (or "norms") based on a practitioner community of over 2000 enterprises and investors, on how to talk about, measure and manage ESG risks and positive impact. By measuring impact across 5 dimensions, namely WHAT, WHO, HOW MUCH, CONTRIBUTION AND RISK, investors also become more confident in fully understanding the outcome, target beneficiary, scale (scope, depth) and contribution made by companies and investors, as well as the potential uncertainties on expected impact not achieved. A set of metrics can therefore be chosen to best capture these 5 dimensions.

IRIS+

IRIS+: As a generally-accepted system for measuring, managing, and optimising impact, developed with the support of GIIN, IRIS+ has been a reliable go-to reference for many leading impact investors. It provides guidance on impact metrics related to an impact category or theme, that have a standard definition and are backed by scientific research evidence, so that the causality relationship between a chosen metrics and specific targeted outcome is verified. Besides, like IMP's 5 dimensions of impact, IRIS+ promotes philosophies that impact metrics work better in sets. Although the IRIS+ still has limitations on the scope of activities covered, the metrics included in the catalogue continue to expand.

Impact Dimension	Impact questions each dimension seeks to answer
What	• What outcome is occurring in the period? • Is the outcome positive or negative? • How important is the outcome to the people (or planet) experiencing them?
Who	• Who experiences the outcome? • How underserved are the affected stakeholders in relation to the outcome?
How much	• How much of the outcome is occurring - across scale, depth and duration?
Contribution	• Would this change likely have happened anyway?
Risk	• What is the risk to people and planet that impact does not occur as expected?

Source: Impact Management Project

Reflection 4: To clarify investor contribution and prove additionality

It is not always straightforward to clarify impact investors' positive contribution on social or environmental targets, for several reasons.

Firstly, certain baselines are needed.

While market participants have already become familiarised with the "do no significant harm," i.e., the negative side of impact, many questions may arise on how to clarify a positive impact contribution – which if not addressed, increase the risk of people seeing empty claims on sustainability contribution or impact; so-called impact washing.

In the 5 dimensions of impact model, contribution is analysed and measured against certain baselines, where any factors undermining impact should also be considered. Similarly, the EU Taxonomy adopts a set of technical thresholds as baselines to assess whether a certain economic activity makes significant contributions, or does any harm, to a specific sustainability objective.

The size of the business or investment also plays a role in the contribution assessment. All else being equal, a larger company (in terms of revenue, volume, geographic coverage etc.) is likely to generate a bigger impact than a smaller company does. But impact attributable to an investor should be rescaled by the size of its investment to a percentage of the investee company's total contribution.

A bigger challenge arises when investors wish to prove their impact is "additional," that is to say – impact that otherwise would not happen if such investments did not take place. This is especially true for public equity investors, where the number of investors willing to provide companies with capital purely for financial gains (through buying publicly-traded shares) is abundant.

While public equity investors can prove "additionality" via capital allocation alone, the circumstances where they can do so are limited to a few: when they invest in markets with lower liquidity, when they play a critical role in making a company more investable, or through participating in IPOs where they create a better marketplace for impact companies seeking a responsible exit from private investors.

But contributions by public equity investors can also go beyond capital allocation alone, where certain ownership actions create additional value.

"Investors with a long-term approach can potentially catalyst impact through active ownership, using their investor power to influence companies to deliver better impact results beyond what they are already doing."

Since lasting impact and systematic change take time to materialise, investors with a long-term approach can potentially catalyst impact through active ownership, using their investor power to influence companies to deliver better impact results beyond what they are already doing. Areas such as collaborative impact measurement and management, to foster better disclosure on impact with a focus on materiality and consistency, executive incentive alignment with impact, are examples where investors' active engagements can add value, both in terms of impact and financially.

Through being supportive to companies that are willing to collaboratively improve their impact measurement and management process, investors are likely to achieve better understanding on investee businesses where financial materiality of their impact resides. And with successful engagements, investors are likely to see companies maximise opportunities alongside their impact creation, and minimise sustainability risks, which will ultimately make investee companies more future-proof, realise a lower cost of capital, and generate attractive long-term financial returns.

Conclusion

With its unique focus on the nexus where economic value and impact join hands, the impact investing field is young, but rapidly developing. As an investment approach, impact investing has evolved from a niche to being adopted by more and more mainstream financial investors, driven by an ongoing mindset shift among businesses, asset owners, asset managers, regulators, and the public.

To be able to invest with impact used to be exclusive to a select few with limited options. But as the underlying appetite grows among a larger base of asset owners, this powerful investment approach is finding a firm ground from which to mainstream.

We believe the further mainstreaming of impact investing lies in the hands of public equity investors.

As many new purposeful companies are created, and an increasing number of listed companies are now aligning or realigning their businesses with material sustainability goals; specific strategies developed through the lens of impact have become highly relevant and are gathering momentum.

Public equity investors with such strategies often intend to deliver the promise of tangible impact alongside market-rate financial returns. In this process, multiple challenges need to be addressed, with the highest level of duty and care.

The biggest challenge of all, in our view, is public equity investors' ability to implement a robust investment process where impact creation, as well as impact measurement and management, are fully integrated. The core features of impact investment, summarised in 5 key words in this paper (intentionality, materiality, accountability, measurability, additionality), mark the route for any investor who wants to create impact in a meaningful way. But since this is still a developing area, investors may need to mature their processes in multiple iterations. And although multiple impact measurement and management standards and frameworks already exist, how investors adopt them in practise remains largely discretionary – it's an issue that reflects their purpose and commitment.

Regardless of which strategy and process an investor chooses, rigor and transparency are critical standards to be maintained in order to reduce the overall risk of impact washing. More importantly - only in this way can public equity investments create meaningful impact, and accelerate the sustainability transition the world needs by building an economic system where people, planet and prosperity truly thrive.

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