OUT OF THE ORDINARY

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The positive impact myth

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Regular readers of the Weekly Digest will know that we often talk about the importance ESG (environmental, societal and governance) factors in our investment decision-making. This is because they can be materially financially relevant to the investments we make on behalf of our clients. However, an increasingly relevant area of investment thinking is the area of impact. Any clear positive impact that an investment has on society should be measured and incorporated into our decision-making because that clear positive impact also has a positive value that can underpin or enhance the investment's value, just as harmful activities can have a negative value effect on investments.

It is worth reiterating that the vast majority of our clients have not authorised us to compromise on maximising their risk-adjusted returns to “do good”, however defined. That being said, actively considering the potential harm that some investments can do to society is a crucial part of our investment analysis, as such outcomes can negatively impact the future prospects of a business if they incur the wrath of its regulators, suppliers, employees or customers. Extending that thinking to considering the potential benefits that some investments have on society is just the other side of the same coin, and potentially just as relevant.

To properly consider impact in investment analysis, intentionality is key. If positive impact is a by-product of other investment criteria, it is logical to assume that impact focus will be less secure than an investment philosophy that has the identification and measurement of positive impact at its heart. In addition, stewardship is critical. Buying a share in a high positive impact company by definition means someone has sold that share. There has been no net increase in the capital available to that company to put towards its high positive impact activities. Buying the shares of positive impact companies is not enough, in two ways. Firstly, investors in positive impact companies should engage with management to support and grow its positive impact behaviour. Secondly, investors should not limit their investments to high positive impact companies but also to less positive impact companies and then engage with management to educate them on the benefits to shareholders of creating more positive impact.

We know that our clients are increasingly recognising that the world has changed and that companies that have historically thrived on maximising profit at the expense of society will find it increasingly hard to do so as governments and other stakeholders force them to internalise their externalities. (Industry jargon for ensuring that, through taxation or regulation or the actions of stakeholders such as customers taking their business elsewhere, the negative “costs” of their activities are brought onto their balance sheet so they “pay” to some extent for them.) Society’s problems are growing, but the amount of government cash available to solve them isn’t. This is leading to both regulation and the smart direction of limited government resources to have the maximum possible positive impact.

Impact is already a crucial focus of many, if not most, investment strategies and will become increasingly so. We see many of our asset management partners starting to devote serious amounts of time to identifying and measuring impact. Positive impact can reduce the risk of a business by reinforcing its brand, customer loyalty or regulatory risk profile and therefore the security and longevity of the cash flows it generates from creating positive impact. Finally, positive impact can be a risk diversifier with business practices that seek to solve a societal problem often not correlated with the economic cycle. Thus even if creating positive impact doesn’t generate a particularly high return, it might be a relatively stable or uncorrelated one.

One may be forgiven for thinking that incorporating impact into investment decision-making sounds too good to be true, just as incorporating sustainability is as well. The most sustainable companies are also the best investments. Companies with the most positive impact are also the best investments.

You no longer have to choose between being a making money and having a clean conscience. There are no hard choices to be made. No trade-offs. We have found the holy grail. Right?

What are the challenges of investing in companies with a positive impact?

Dead wrong. Firstly, even if we all agreed on the potential investment benefits of positive impact, identifying and measuring that impact is fiendishly complex. There will always be scope for a healthy debate around the scope, nature, intentionality and durability of any positive impacts created by corporate activity. Secondly, this is not a black and white debate. Investments don't typically fit neatly into "good" companies and "bad" companies. All companies are on a spectrum, with a range of positive and negative impacts. For example, we might (or might not) agree that air travel needs to address the negative impact it has on climate change. But does anyone seriously believe that air travel should cease? (This is probably the logical consequence of no one ever owning shares in airlines again.)

So what do we expect of our fund managers who manage our clients' money on our behalf?

1. Rigorous, systematic and analytical incorporation of impact – positive and negative – into asset valuation and/or risk assessment. For example, can a company that gives its employees days off work to for volunteering work, measure not just the social impact of the volunteering, but the additional employee satisfaction derived from this activity, which benefits the company?

2. Not confusing good business practices with positive impact. Can the fund manager demonstrate the ability of an investment to internalise a positive externality from its business. For example, can a property fund manager that invests in sprucing up the public realm to increase local footfall demonstrate that this would not have otherwise been the case?

3. As with all aspects of our qualitative assessment of third party asset managers, we have a keen focus on demonstrating the efficacy of approach. Analysis by anecdote or example is not analysis. If an equity fund manager invests in a house builder with a good record of delivering affordable housing, can they equally apply that thought process systematically across the entire portfolio?

4. As with many other areas of investing, there is rarely much money to be made in following the crowd. So with a focus on positive impact and the need for robust measurements, so asset managers might be tempted to focus on the areas where positive impact can be most easily measured. Greenhouse gas removals from the atmosphere and benefits from health goods and services spring to mind. Harder is measuring positive impact from sectors such as telecoms. Perhaps more money is to be made, from generating just as much societal good, from these less obvious areas.

The trend towards incorporating positive impact into investment decision making has already begun. This is good for Investec Wealth & Investment, as we believe that we should live in society, not off it. This means we are naturally sympathetic to the risk and return benefits from positive impact.

Economic Commentary

FTSE 100 weekly winners

Melrose Industries PLC	15.7%
AVEVA Group plc	9.9%
Just Eat Takeaway.com N.V.	7.7%
Whitbread PLC	1.8%
Severn Trent Plc	1.8%
GSK plc	1.7%
BP p.l.c.	1.4%

FTSE 100 weekly losers

Abrdn plc	-9.4%
Standard Life Aberdeen	-8.5%
Standard Chartered PLC	-8.1%
Flutter Entertainment Plc	-7.7%
CRH Plc	-7.7%
3i Group plc	-7.1%
Royal Mail plc	-7.1%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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