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SUSTAINABLE INVESTING

SEEING THE BIG PICTURE: INVESTING FOR IMPACT IN PUBLIC MARKETS

Impact investing is becoming a widely used tool to drive progress in society. Targeted, private investments can be a great way to produce tangible change that you can measure, but you can view impact through a wider lens and make a difference with your core equity and debt investments as well. In this article, we discuss why mobilizing more of your portfolio for impact can help unlock the capital that is truly needed to address our global sustainability challenges.

Many people and many organizations want to drive progress in society directly through their actions. One way to do that is through impact investing—a term that refers to the pursuit of positive social, environmental or other change using investment capital.

There's a misconception that you can only get "real" impact from a targeted, private investment, such as a fund that lends money to small farms or a social impact bond that targets measurable improvements for a specific issue. While investing locally is a powerful way to make an impact, thinking globally is another—we believe that the public equity and debt markets are incredibly important avenues to achieve impact on a global scale.

We need capital to truly tackle our global challenges...

Private impact investments can be excellent ways to foster change, and they let investors "see" the impact value of each dollar they are investing. But for many, the issues that small, targeted investments focus on are part of a larger global concern. For instance, a local environmental investment may represent worry over climate change, or an investment in a developing country may fit into a broader view of global poverty. To call these issues "big" is an understatement. The sheer scale of many sustainability challenges is daunting and unparalleled in history—as is the funding needed to address them.

With climate change, for example: In 2016, the International Energy Agency (IEA) stated that nearly $75 trillion would be needed by 2040—$40 trillion in energy supply investments and $35 trillion in energy efficiency—to hold atmospheric carbon dioxide to a level that the IEA believes gives us a 50/50 chance of limiting global warming to 2 degrees Celsius.

Another example is the challenge of global poverty. Despite a 14% decline since 1990, extreme poverty still plagues 800 million people, according to the United Nations. In 2015, the UN stated that $173 trillion of investment was needed over a 15-year period to meet its Sustainable Development Goals (SDGs) for ending extreme poverty by 2030.

...and current sources of funding are not enough.

In short, to address global sustainability challenges, society needs to mobilize capital on a massive scale. So massive, in fact, that the only way to get there is through the public equity and debt markets. Other channels of funding simply aren't sufficient.

Let's look more closely at the example of global poverty. There are various estimates of how much incremental investment is

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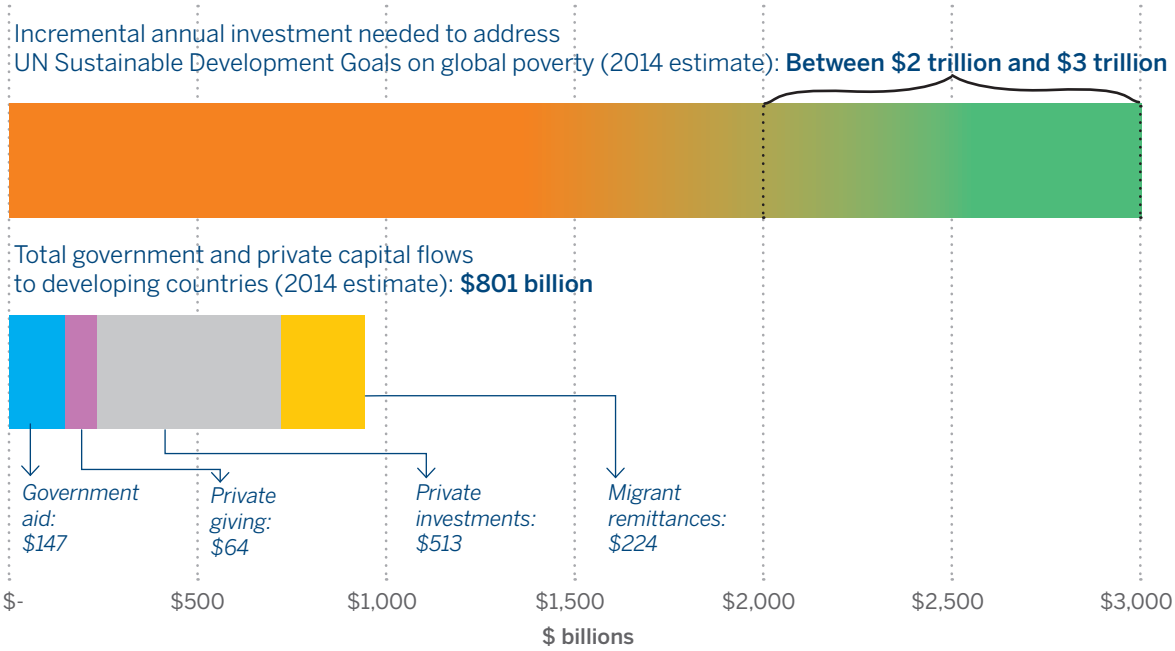
needed to achieve the UN Sustainable Development Goals; one comes from the UN Conference on Trade and Development (UNCTAD), which in 2014 cited the need for between $2 trillion and $3 trillion in incremental investment per year. Yet total global assistance to developing nations—including private capital investment, private philanthropy and government aid, and even including remittances from migrants sending money back to their home countries—was approximately $800 billion in 2014, according to the 2016 Index of Global Philanthropy and Remittances. (The research behind this index, prepared until this year by the Hudson Institute, is extremely thorough and designed to account for the large amount of funding that goes unreported in official government and philanthropic disclosures.) Another reference point: In 2016, an estimated $693 billion flowed into private capital funds, according to Preqin—that figure represents the *entirety* of all private capital fundraising, with only a sliver of that money dedicated to impact investing.

Even if we assumed that all of the funds referenced above were dedicated to poverty alleviation—obviously they are not—AND we assumed that all of that money was incremental investment

An Inconvenient Truth

Private capital has become an important supplement to government funding in addressing global issues. But to truly address the biggest sustainability challenges, far more capital is needed. This simple chart highlights the issue with regard to global poverty alleviation; the total amount of government and private funding going to developing nations is far less than the funding that many believe is necessary to address the problem.



Source: UNCTAD for estimate of annual investment needed to achieve UN Sustainable Development Goals; Hudson Institute Center for Global Prosperity for government and private capital flows.

(vs. ongoing funding), we would still not come close to the figure cited by UNCTAD. And poverty is just one of many issues that requires high levels of incremental investment to resolve.

Of course, private investments and government funds are essential sources of capital for addressing these issues. Our point is simply that more capital is needed, and barring a massive shift in government spending toward developing nations—an unrealistic hope—we believe that the only place we can find that capital is in the public markets. According to the World Bank, the market capitalization of global equities was about $65 trillion in 2016, and the global bond market topped $92 trillion in 2016, according to the Bank of International Settlements (and as we cited earlier this year in our paper on green bonds, "Income and Impact").

Steering Public-Market Capital Toward Impact

The public equity and debt markets are home to a very large amount of capital, but obviously not all of that money is invested for impact. How can individuals and institutions direct publicly invested capital in a manner that helps drive positive impact?

The answers are relatively clear but not easy to implement. First, investors can be selective and buy stock in companies with positive sustainability strategies and bonds that are funding positive sustainable projects. Second, investors can be proactive owners, and express through proxy voting and other means of engagement how they want companies to conduct their affairs.

Selective investment: With certain passive investments, investors can implement various portfolio screens or filters in their portfolio—in other words, they can steer clear of companies that they believe contribute to major sustainability issues. With more concentrated and actively managed portfolios, investors can be even more selective and target companies they believe are having a positive impact on society.

The good news is that many markets and industries are moving in the right direction—primarily because they see business opportunity in doing so. Companies are finding ways to drive growth, profits and market share through sustainable strategies; bond issuers are funding positive projects through green bonds; new industries are emerging to solve environmental challenges.

We noted several examples of impactful companies last year in our article, "Diving Deep: Achieving Outperformance through Environmental Research." ARM Holdings came to dominate the smartphone market by focusing on energy efficiency rather than pure computational power and speed, and WhiteWave Foods achieved rapid growth through its focus on organic and minimally processed foods. Both of these were sustainable businesses making a positive impact, and both demonstrated how businesses can create financial value through sustainability (both firms were acquired at premium valuations in 2016). Ecolab is another example. In 2016 alone, Ecolab helped conserve 161 billion gallons of water, 52 million pounds of waste and 11 trillion BTUs of energy—all through profitable delivery of its solutions and services to appreciative customers around the world.

And debt markets now support a burgeoning supply of green bonds, issued by governments, utilities, banks and many corporations to fund impactful environmental projects. For example, a Bank of America green bond issued several years ago funded multiple projects, including Los Angeles' LED streetlight retrofit project, which reduced the city's energy usage by 71,000 megawatt hours annually. That's the equivalent of nearly 50,000 metric tons of carbon dioxide, or the annual emissions of more than 10,000 passenger vehicles.

Proactive ownership: Equity shareholders have a variety of tools at their disposal for influencing the companies they own. Simply by voting their shares proactively, they can help steer corporate decisions on a variety of environmental, social and ordinary business proposals. Moreover, they can engage in dialogue with companies to voice their views directly on many issues; in practical terms, very few investors are big enough to engage in that dialogue themselves, but they can pledge their shares to larger negotiation efforts between companies and investment managers or investor networks. We work with many clients on strategies to help them voice their views effectively.

In short, public equity and debt markets offer a growing number of opportunities for investors to back many of the most promising ideas, practices and technologies for mitigating climate change and addressing other sustainability challenges. And these publicly traded opportunities are available to all investors, whereas private investments are generally limited to investors that meet sizable net worth requirements.

Mobilize Your Entire Portfolio

The potential for impact through public markets is enormous, and public-market capital is sorely needed to address the world's biggest sustainability challenges.

To be sure, one could critique both private *and* public investments as paths for impact. Private investments are targeted and measurable but not highly scalable. Public investments have the opposite problem: The collective decisions of many investors could potentially shift massive quantities of capital toward positive change, but it is very difficult for any single person or entity to directly see the impact of their decisions.

But rather than despairing over the shortcomings of any given approach, why not consider *all* available avenues for impact investing? In other words, if you can invest in both private and public impact opportunities—do both! Seeking to create impact from both a global and local perspective is a worthy and effective approach, and will allow you to align a far greater proportion of your portfolio with your impact priorities.

The Index of Global Philanthropy and Remittances is a comprehensive report, based on both public disclosures and primary research, detailing the sources and magnitude of global philanthropy to the developing world. It was published through 2016 by the Hudson Institute; in future years it will be published by the Indiana University Lilly Family School of Philanthropy.

*Alternative investments may be available for qualified purchasers and accredited investors only.

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