PICTET
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Asset Management

Thematic equities as impact investments

FOR PROFESSIONAL INVESTORS ONLY

1805

Introduction

Impact investing is generally considered the purest form of responsible investment. Modelled on ideas developed in the 1970s by social entrepreneur Muhammad Yunus, it has traditionally involved directing capital to specific ecological or socially-responsible projects.

The approach has twin aims: to generate financial returns and to deliver material environmental and social benefits.

The range of activities financed under the impact investing umbrella is wide. Recent examples include land rewilding, construction of wind farms, improvement of water networks and development of orphan drugs.

Impact investing's targeted approach on specific topics explains why it tends to be seen as the preserve of private finance. It is widely deemed to be at odds with the broad diversification imposed by risk management principles in the management of mainstream global equity or corporate bond strategies. Yet recent developments in sustainable finance suggest this interpretation is in need of some revision.

Impact investing is, in any case, defined by its objectives not by the type of asset or transaction. According to the Global Impact Investment Network (GIIN), the primary aim of impact investing is to deliver a positive, measurable social and environmental impact alongside a financial return irrespective of whether that is through a public or private transaction. A key feature, therefore, is the explicit intention to contribute to positive societal or environmental outcomes.

Reinforcing that point is research by Kölbel et al. (2020),[1] which suggests positive impact in public markets can be generated across two fronts – by the issuer of securities (a company, for example) and by the investor.

1 "Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact", Kölbel et al. (2020).

These observations have important investment implications. They provide a roadmap indicating how investors can apply the concepts of impact to listed stocks. While impact investing in publicly-traded companies might seem more challenging to demonstrate than via private markets, it is nevertheless vital given the scale of the problems the approach is seeking to address.

But impact investing via listed firms comes with several caveats. First, for the approach to work, it must target listed businesses with strong positive environmental or societal contributions, or firms with the potential to improve across those two fronts. Second, success also depends on what follows once investments are made. Portfolio managers that can exert an ongoing positive influence on the companies they invest in are better able achieve their financial and sustainable goals. Third, those positive contributions must be reported.

While many conventional equity strategies integrate environmental, social and governance (ESG) principles, few possess the characteristics that impact investors deem the most relevant to bring about lasting change. Thematic portfolios that have an environmental or societal focus are a potential exception. Not only do such strategies focus on companies directly involved in the building of a sustainable, more equitable economy, but they also play a role in embedding responsible investment principles across the broader financial ecosystem.

This report explains how.

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What is impact investing?

The contours of impact investing have become increasingly well-defined thanks to the efforts of several international bodies. Perhaps the most detailed definition comes from GIIN. It describes impact investments as those "made with the intention to generate positive, measurable social and environmental impact alongside a financial return".

More specifically, GIIN[2] says impact investments should:

— Intentionally contribute to positive societal and environmental impact
— Use evidence and impact data in investment design
— Manage impact performance
— Contribute to the growth of impact investing

Effective measurement of non-financial factors is also critical. GIIN states impact investing requires investors (portfolio managers) to measure and report on the social and environmental performance of underlying investments.

A similar definition comes from the International Finance Corporation (IFC, 2019), the private sector arm of the World Bank. A pioneer in impact investing, the IFC defines impact investors as having the following attributes:

— Intent
— Contribution
— Measurement

While most experts agree that impact investing requires "intent" and "measurement", there are differences in how "contribution" is defined. The IFC's definition, for instance, is somewhat broader in scope. It says such activities amount to the pursuit of a "credible narrative, or thesis, which describes how the investment contributes to achievement of the intended goal – that is, how the actions of the impact investor will help achieve the goal. In this case, contribution is considered at the level of the impact investor and can take financial or non-financial forms."

Some academics have proposed more stringent definitions of investor contribution. A study by Stanford University,[3] for example, argues investors can only be regarded as impact investors if they can demonstrate "additionality" – or that the positive outcomes achieved would not have materialised but for their investments. While attractive in principle, the concept of additionality is difficult to use in practice as it requires determining a counterfactual scenario. We prefer instead to apply an adaptation of the GIIN definition to both public stocks and our own investment approach: in other words, impact investments are those made with the intent to generate measurable positive environmental or societal contributions alongside attractive risk-adjusted investment returns.

2 thegiin.org/impact-investing and thegiin.org/characteristics
3 "When Can Impact Investing Create Real Impact?", Brest, P. and Born, K. (2013).

EU sustainable finance disclosure regulation (SFDR)

Since March 2021, the EU investment industry has been subject to more stringent rules covering sustainable finance. The SFDR is designed to provide investors with greater transparency by requiring financial organisations to make specific disclosures on the sustainability of their funds.

The SFDR distinguishes between mainstream investment products that do not integrate sustainable factors (Article 6), products that incorporate environmental or social considerations (Article 8), and those for which sustainability is an explicit investment objective (Article 9).

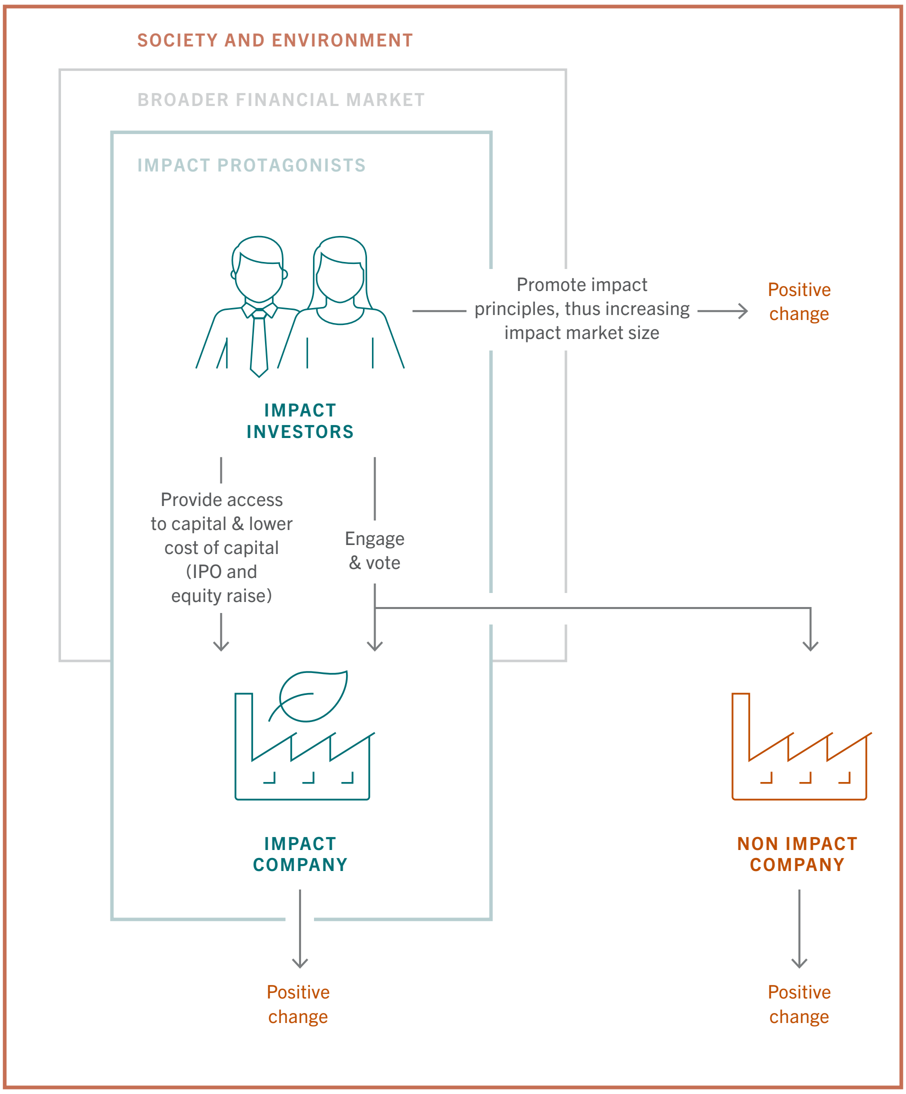
The requirements for Article 9 instruments are the most demanding and involve transparency on sustainability-related positive contributions, which is closely aligned with the company impact concept that features in definitions of impact investing. While Article 9 funds are relatively sparse, many sustainable thematic equity strategies fall under this category.

How to think about impact within listed equities

Building on the framework developed by Kölbel et al, it is possible to describe listed equities' positive impact as being attributable to two factors – the company and its investors.

FIG.1

IMPACT INVESTING IN LISTED EQUITIES



Source: Pictet Asset Management

1. Company impact

Broadly speaking, the corporate world can have a positive impact on society and the environment in two ways.

The first route, open to virtually every business irrespective of the industry it operates in, involves reducing the negative environmental or social impact of companies' operations. Ideally, this should be guided by a holistic perspective of a firm's impact through a life cycle assessment that sums up the effects of a company's supply chain, production, distribution, products utilization and disposal.[4]

Companies that seek to reduce the negative environmental or social impact of their operations are the investment staples of "best in class" ESG portfolios, which invest across all industry sectors.

The second path to achieving a positive impact is product specialisation. Companies that follow this route develop and sell products and services that are central to the creation of a more sustainable economy.

An important feature these specialist firms share is that their products have an outsized positive impact on the environment or society.

Take the example of a firm that develops and sells technologies that cut waste in manufacturing. Should its products prove commercially successful, it can potentially reduce the environmental footprint of entire industries - from consumer durables through to fashion.

Thematic investment strategies tend to focus on companies whose influence is systemic (see box for an illustration).

This is in contrast to mainstream "best in class" strategies, which select companies almost exclusively on the sustainability of their operations rather than the impact of their products and services.

For the thematic approach to achieve positive impact, however, fundamental and primary research is vital – not least because the process requires classifying economic activities according to their capacity to bring about positive ecological or societal change.

This demands expert judgment in combination with science-based frameworks and data.

4 See Butz et al. (2018)

CASE STUDY

Company impact with Beyond Meat

Pictet AM's investment in Beyond Meat, the non-meat burger company, is an example of how such an approach works in practice. Making burgers may not be an obvious route to positive environmental change, but the thematic investment team analysis shows that the company is an exception. By catering to a growing consumer market for vegetarian, vegan and low-meat diets, Beyond Meat introduces a high protein convenience food that does not rely on livestock farming. Compared to traditional meat companies, and for the same protein content, the firm requires less energy, less water, less fertilizer, less land and therefore places significantly less pressure on the ecosystem/biodiversity. It is an excellent example of a firm's business model providing multiple environmental dividends.

This security does not represent all securities bought, sold or held during that period. It should not be assumed that securities held in the future will be profitable or will equal the performance of the securities in this list.

2. Investor impact

Impact investing also places great emphasis on investors themselves being agents of change.

Investors in listed companies can make a positive contribution in three ways. First, through enabling access to and lowering the cost of capital of companies with environmental or societal products or services. Second, equity investors can bring their influence to bear via active ownership, including direct engagement with company management and proxy voting. Third, by promoting impact investments and research, investors can disseminate new knowledge and embed the principles of impact investing across the broader financial ecosystem.

a) Effect on the access to and the cost of capital

Equity investors' impact is most direct in initial public offerings (IPO) and rights issues. Taking part in such transactions is a form of direct finance that provides businesses with positive environmental or societal contributions the means to expand their activities.

During IPOs, companies tend to issue their stock at a discount to entice broad investor participation, which then has the benefit of creating a more liquid secondary market. Companies therefore face a trade-off between their cost of capital during the IPO and secondary market liquidity. This has been extensively documented in academic research.[5] It follows that by actively participating in the IPO market and thus strengthening demand, investors contribute to alleviating this trade-off and improve the issuer's funding conditions in both the primary and secondary market.

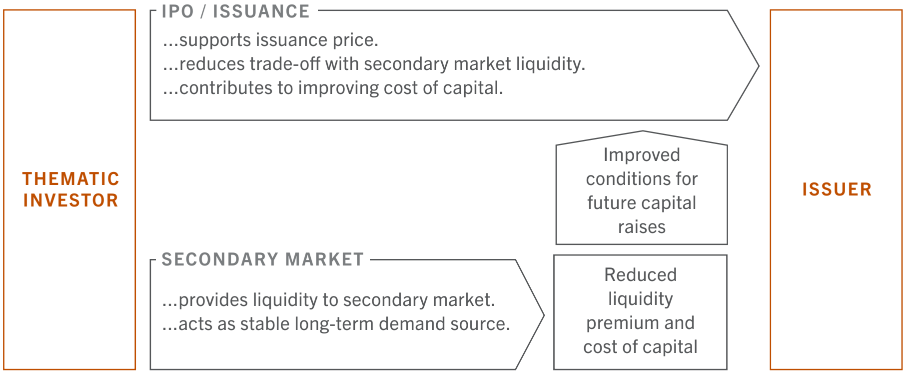
Even in oversubscribed IPOs, anchor-style investors[6] that indicate interest in participating at an early stage of the share sale can have a disproportionate impact on the success of the transaction. This is because interest begets interest in the new issue market. Specialised – or thematic, investors are particularly likely to play such a role.

Moreover, an investor that actively participates in IPOs is not only supporting the issuer but also the share prices of other companies operating within the same sector. Indeed, there is evidence that, in some illiquid secondary markets, IPOs can depress the stock price of other companies that possess similar characteristics to the IPO issuer.[7] Hence an IPO investor contributes to supporting the price of companies beyond the issuer.

5 See for example Booth and Chua (1996), Ellul and Pagano (2006), Hahn et al. (2013).
6 Institutional investors that are invited to subscribe for share ahead of IPOs.
7 Braun and Larrain (2009).

FIG.2

IMPACT OF THEMATIC INVESTORS ON ISSUERS' ACCESS TO AND COST OF CAPITAL



Source: Pictet Asset Management

Thematic investors can also help lower companies' cost of capital through the secondary market by providing liquidity as well as supporting the shares of companies they deem long term investments. Research shows that companies whose shares are most liquid tend to enjoy lower cost of equity capital.[8] A study of stocks across 52 countries revealed that the difference in the cost of equity between stocks in the most liquid 25th percentile and those that ranked in the 75th percentile was 109 basis points.[9]

This can make a big difference. Over the last century, the liquidity premium for US stocks, one of the most liquid markets in the world, has been estimated to lie in the range of 1.7-2.1 per cent[10] – suggesting a significant spread between the cheapest and the most expensive funding. In less liquid markets, the gap would be wider still.

The length of an investor's commitment to a company can also have positive effects. Empirical evidence shows that the presence of institutional investors with long-term investment horizons within a company's shareholder base tends to lower that firm's cost of equity capital by a considerable margin. The research finds that the greater the proportion of institutional investors in a company's ownership structure (relative to retail ownership),[11] and the longer the time horizon of the owners, the lower that firm's capital costs tend to be.[12] That is an important observation for anyone considering investments in thematic equities, for which investment horizons are longer than average.

8 See for instance Acharya and Pedersen (2005).
9 Saad and Samet (2017).
10 Hagströmer et al. (2013).
11 Huo et al. (2021).
12 Attig et al. (2013).

Conversely, divestment of public companies that have a negative impact on society and the environment or weak sustainability characteristics can increase firm's cost of capital. When divestment is carried out by large institutional investors in particular, research has shown such actions can lower a company's share price, at least in the short run.[13] While it is difficult to prove that any single investor can have such an effect, evidence from co-ordinated divestment campaigns involving broader coalitions of investors shows that aggregate effect can be significant. For instance, during the wave of fossil fuel divestments over the last decade, researchers have found such activity reduced capital flows to oil and gas companies operating in countries where divestment was being carried out.[14] And perhaps more importantly, divestment announcements appear to have a lasting influence on fossil fuel companies' stock prices; the effect appears to have increased in recent years.[15] Similar results have been found for the Sudan divestment campaign in the early 2000s.[16]

b) Shareholder engagement and proxy voting

The second way in which equity investors can bring about positive change is through active ownership.

Numerous studies have analysed the effects of shareholder engagement by active asset managers.[17] Here is a summary of what they have found:

- Dedicated investors can be successful in raising concerns on ESG matters with companies. While the rate of success varies widely, depending on a number of factors including investor skill and size, academic research has shown that it can be as high as 60 per cent.[18]
- Successful engagement with a company typically leads to an improvement in its ESG ratings, in particular for companies with low initial ratings.

13 See Atta-Darkua (2020) for a study of the Norwegian Sovereign Wealth Fund.
14 Cojoianu et al. (2021).
15 Dordi and Weber (2019).
16 Ding et al. (2020).
17 Notable recent studies are Barko et al. (2018), Dimson et al. (2015), Dimson et al. (2020), Hoepner et al. (2021).
18 Dimson et al (2015): 18% success, Hoepner et al. (2021): 31% success, Barko et al (2018): 60% success.

CASE STUDY

IPO participation with OX2

Pictet AM's thematic investment teams frequently take part in IPOs. The IPO of Sweden-based renewable energy developer OX2 is a recent example. Ahead of the firm's June 2021 listing, the portfolio managers of Pictet AM's Clean Energy strategy held three meetings with company management. During these discussions, it became clear that there was a strong thematic alignment between the firm's executive board and our own investment team. The meetings also gave us the opportunity to put forward proposals that would help OX2 broaden its appeal among environmentally-focused investors.

As a result, the Clean Energy investment team decided to become an anchor-style investor in the IPO. This, in combination with the company's desire to have a long-term and partnership-oriented investor on board, helped the book-building process, leading to an oversubscribed offering. In return, Pictet AM received a full allocation during the IPO, thus becoming a top three shareholder in the company.

The proceeds from the IPO will allow OX2 to keep up with ever growing demand for renewable energy capacity, strengthening its ability to develop and sell solar and wind farms and accelerating the transition to a net zero carbon economy.

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Moreover, the same studies found successful engagement campaigns have a number of distinguishing features:

- Successful engagement is an often complex and drawn-out process that can take several years to bear fruit.
- Engagement repetition: successful engagement campaigns are often the result of multiple engagements with the same company.
- Engagement collaboration: when a single investor's holding in a company is limited, collaboration with other shareholders increases the likelihood of successful engagements. Examples include the Climate Action 100+ coalition.

Thematic investing is particularly effective at generating such investor impact as thematic investment managers create focused portfolios and are long-term investors across their investable universe. This establishes lasting relations with companies built on trust, which facilitate engagement discussion. In addition, larger thematic portfolios are often a top twenty shareholders of their investees, which adds clout to engagement discussions.

c) Contributing to the spread of ideas and mobilising capital

The third lever of impact investors is the broad promotion of impact principles.

As stewards of global capital, investors are in a strong position to influence the entire financial ecosystem. Asset managers that invest to meet environmental or societal goals promote such approach to asset owners, peers and other members of the financial community. By financing and disseminating research and information, asset managers can become an agent of change in the building of a sustainable economy.

This is in essence what the Impact Management Project (2018)[19] refers to as "signalling that impact matters".[20]

19 A project that gathered a range of different organisations to build a global consensus on how to measure, assess and report impacts on people and the environment.

20 See Buffle (2017) or Roessing and Freedman (2020) for examples of educational contributions in investment industry publications.

CASE STUDY

Engagement with Veolia

The Water strategy has held Veolia for the last 22 years and is currently a top 10 investors in the company. Hence, discussions with the board of directors and management are ongoing.

Veolia, a large water utility, came under the spotlight when its subsidiary was affected by a water contamination incident that unfolded in Flint, Michigan, in 2014. Although the company was not involved in the scandal, portfolio managers of the Water strategy met the company's executive team to press the case for better oversight of subsidiaries by the Board of Directors, as well as a strategic review. Pictet AM held several meetings over a number of years until, in 2020, Veolia unveiled a set of very strong environmental and social targets, materially integrated into incentive compensation plans. The investment team was satisfied by the extent and speed of initiatives taken by the company, which represent a long-term commitment to strengthening corporate responsibility. Indeed, Veolia is now an above average performer according to environmental and social indicators. To the investment managers of the Water strategy, controversies are an input in the ESG analysis and can serve as a basis for corporate engagement.

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Impact measurement and reporting

To demonstrate investments meet their societal or environmental objectives, transparent reports must be generated regularly. Indeed, estimating impact is a central principle of impact investing. Ideally, this should include information on all the steps implemented by the impact investor to reach its declared intent.

At the very least, reporting should include:

- A declaration of intent describing the positive contribution to be made through the investment, as well as a disclosure of positive impacts of the underlying portfolio holdings (in particular those arising through the companies' goods and services), and information on the mitigation of any potential negative impacts from their activities.
- Performance of portfolio holdings across a broader set of ESG metrics (e.g. environmental footprint). This can also serve as the basis for establishing progress linked to shareholder engagement initiatives.
- The scope and nature of active ownership activities, including shareholder engagement topics, progress made on these initiatives, as well as proxy voting statistics.
- Information on collaborative initiatives and relevant promotional or educational activities signalling that impact matters.

It is crucial to point out that the sum of the above information represents the overall "measure of impact" of an investment strategy. This measure cannot be simplified and aggregated into one single number; it is a collection of information that demonstrates the steps taken by the impact manager to deliver on his/her sustainability objectives.

CASE STUDY

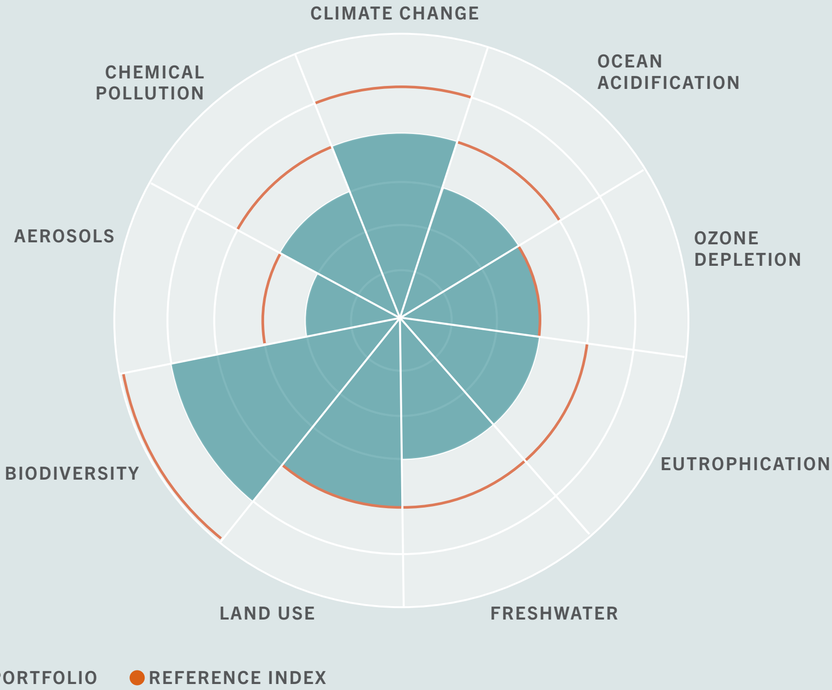
Estimating impact of portfolios with the planetary boundaries framework

One approach devised by Pictet AM that aims to quantify industry and company impact involves the application of the Planetary Boundaries (PB) model – a framework developed by a group of environmental scientists in 2009 – to an investment setting. The model identifies the nine environmental dimensions that science shows are critical to maintaining a healthy planet – among them climate change, freshwater use, land use and biodiversity.

By fusing this framework with life-cycle assessment (LCA), a tool that measures the environmental footprint of companies across every part of their supply, production and distribution chain, Pictet AM's investment managers can gauge the ecological footprint of firms on the nine dimensions. The approach can also be used to determine which business models contribute to alleviating environmental pressures. The tool is used for both portfolio construction and impact reporting.

FIG.3

PORTFOLIOS USING THE PLANETARY BOUNDARIES AND LIFE-CYCLE ASSESSMENT FRAMEWORKS



Source: Pictet Asset Management

CASE STUDY

Estimating the link between portfolios and SDGs[21]

To assess how closely holdings are related to the UN Sustainable Development Goals (SDGs), a rule-based, data-driven analysis is performed relying on a combination of artificial intelligence (AI) and qualitative assessments from the investment managers. The final SDG score for the portfolios consists of equal contributions from the fundamental and quantitative analysis.

For the quantitative calculations, a proprietary AI engine uses natural language processing to analyse transcripts of company earnings calls, analyst reports, products and financial databases of each firm. The engine seeks to identify common keywords, providing insight into the company's activities. The system then screens the keywords to focus on ones which are connected to the SDG concepts. It takes into account their relative importance to estimate the extent to which companies are related to the 17 SDGs and their 169 sub-goals.

The team's fundamental analysis, meanwhile, focuses on the impact of the products and services companies offer rather than their operations. So, for example, to get a good score for "Quality Education" (SDG 4), a company would need to commercialise a public education programme; training its own staff would not qualify as an "impactful" activity.

The output of the SDG mapping is an estimate of the relative degree to which a company's activities are associated to each SDG, however it cannot be considered a measure of impact in isolation.

21 17 global goals aiming to be a "blueprint to achieve a better and more sustainable future for all". Please see more information on https://sdgs.un.org/goals.

From theory to practice: impact and thematic equities

As demonstrated above, impact investing is not the exclusive preserve of private finance. Thematic equity strategies that direct investments to specialist listed companies can also fulfil societal and environmental goals. Pictet AM believes that the following steps are key for thematic equity managers to be positive change agents:

— **Intentionality** > A thematic impact investment strategy is one that explicitly and openly claims its focus to be positive societal or environmental impact alongside competitive financial returns. Significant resources are dedicated to researching and identifying sustainable thematic investment universes and avoiding companies engaged in harmful or controversial activities.

— **Capital allocation to impact companies** > Stocks and their weights in thematic impact portfolios are determined by the share of products and services with positive environmental or societal contribution, fundamental ESG considerations, and financial quality and valuation metrics. Direct capital allocation and share purchase contribute to decreased cost of capital for investees.

— **Active ownership** > Having identified ESG topics that need to be brought to a company's attention, investment teams prioritise engagements based on the materiality of the issue – both for the company's long term financial results and the wellbeing of its stakeholders. This, along with proxy voting, is part of the investor effort to improve companies' operations or/and exposure to positive impact activities.

— **Promotion of impact principles** > Media and web presence, white papers, participations in client events, industry conferences and seminars promote thematic impact investing.

— **Amplifying impact across asset classes** > Some key societal and environmental impact topics have been identified at the Pictet group level and the declaration of intent is firm-wide, encompassing all asset classes, operations and philanthropic activities. In this cases, the respective thematic impact investment teams act as centres of expertise for the group.

— **Impact reporting** > Regular reports on metrics most material to the thematic investment approach and claimed intent are published. In particular, information must pertain to all the steps discussed above. The methodology by which the information has been generated must be transparently disclosed.

Reporting should report on all the above.

Concluding remarks

Thematic equities, then, can serve as a viable liquid alternative for those investors who wish to have a positive impact on particular environmental or societal issues. It offers investors the opportunity to channel investment to companies whose products and services benefit the environment or society, thereby contributing to lowering their cost of capital. As thematic investing requires a long-term commitment, the approach encourages investors to develop deeper ties with their investees and actively engage with them which fosters further improvement in corporate behaviour and long term performance.

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