GOOD INTENTIONS, PERVERSE OUTCOMES: THE IMPACT OF IMPACT INVESTING

Where's the beef?

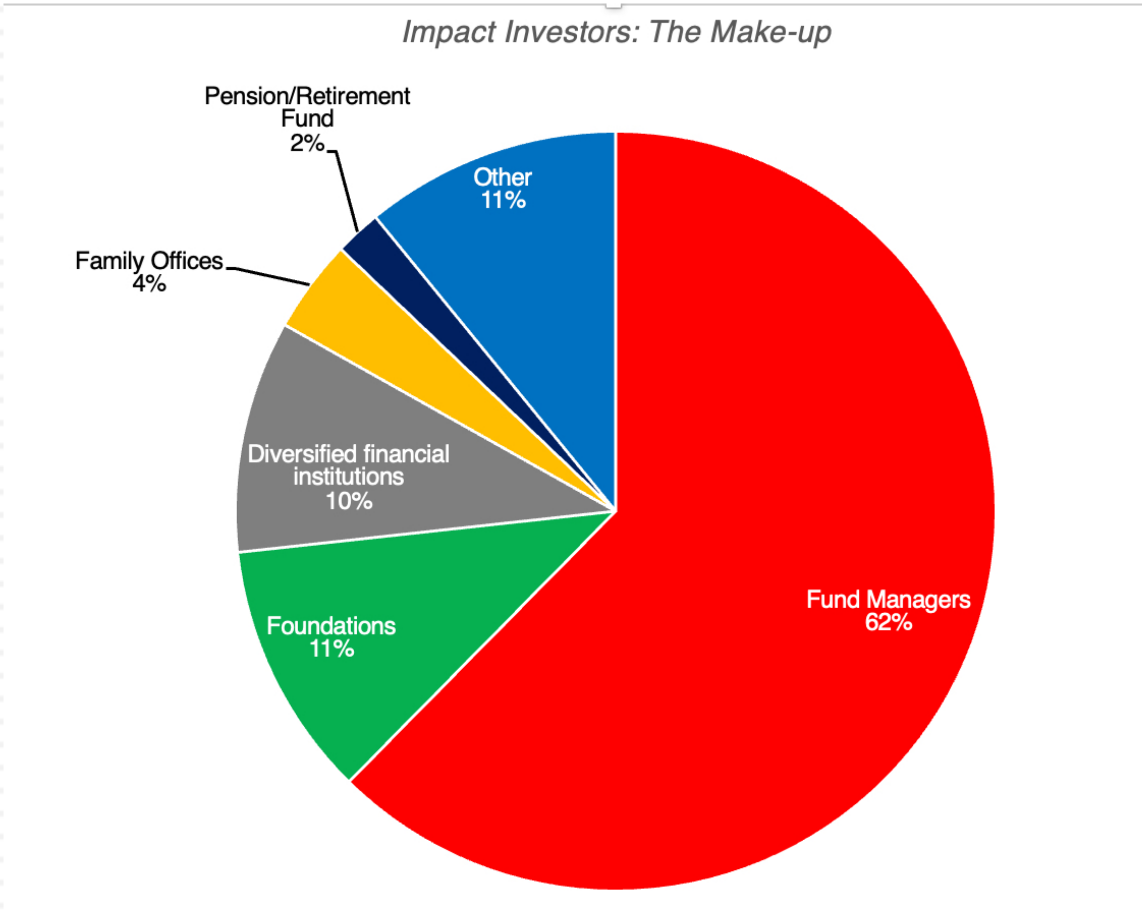
Impact Investing: A force for change?

- I have made no secret of my disdain for ESG, an over-hyped and over-sold acronym, that has been a gravy train for a whole host of players, including fund managers, consultants and academics.
- In response, I have been told that the problem is not with the idea of ESG, but in its measurement and application, and that impact investing is the solution to both market and society's problems.
- Impact investing, of course, is investing in businesses and assets based on the expectation of not just earning financial returns, but also creating positive change in society.

Setting the Table

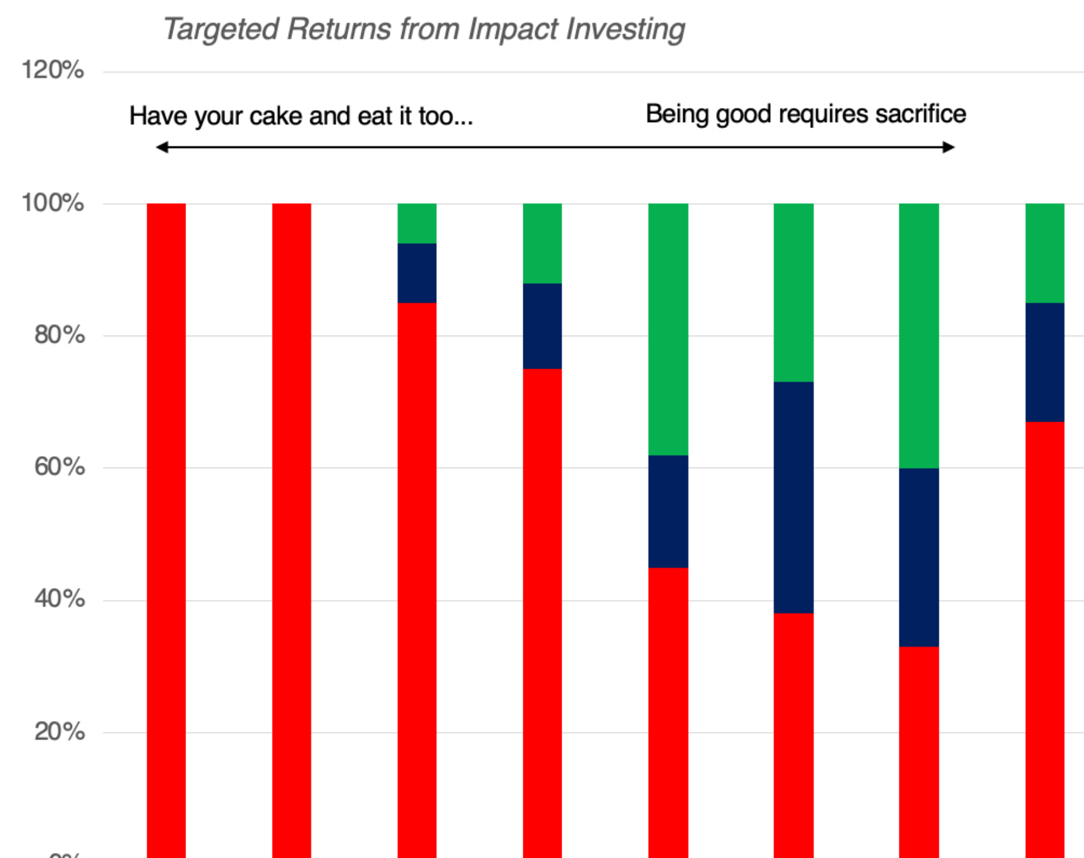
- It is human nature to want to make the world a better place, but does impact investing have the impact that it aims to create?
- I will work with two presumptions.
  - The first is that the problems for society that impact investing are aiming to address are real, whether it be climate change, poverty or wealth inequality.
  - The second is that impact investors have good intentions, aiming to make a positive difference in the world.
- I want to keep my focus on the mechanics and consequences of impact investing, rather than indulge in debates about society's problems or question investor motives.

Impact Investing: The how much and who?



In 2022, impact investors invested $1.16 trillion in the market

The why…



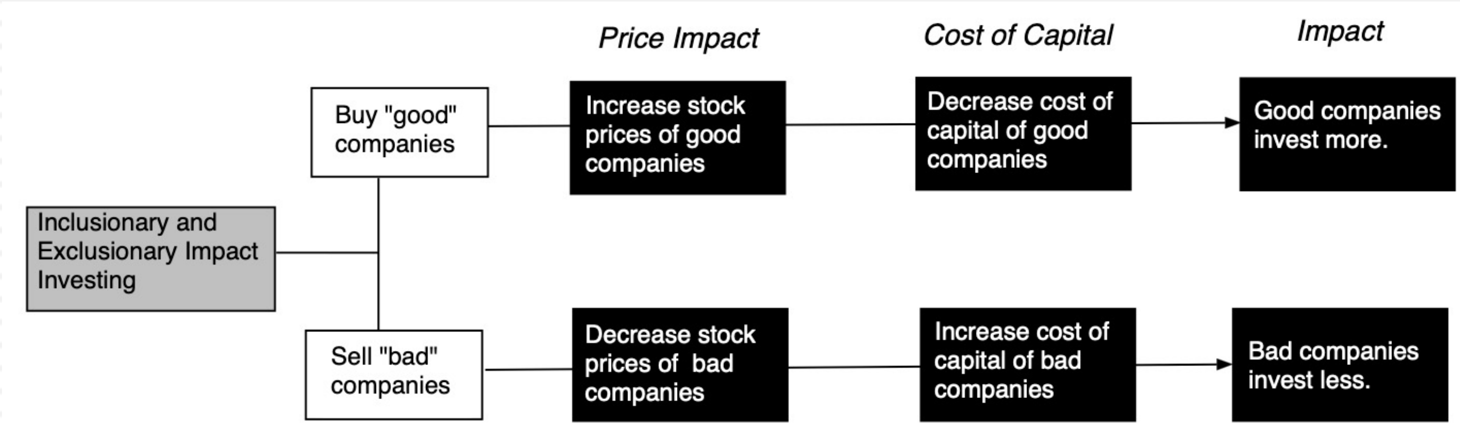
	Pension Funds	Insurance Companies	For-profit Asset Managers	Diversified Financial Institutions	Family Offices	Non-profit asset managers	Foundations	All
Preserve capital, No financial return	0%	0%	6%	12%	38%	27%	40%	15%
Below-Market Rate	0%	0%	9%	13%	17%	35%	27%	18%
Risk-adjusted Market Return	100%	100%	85%	75%	45%	38%	33%	67%

The how…

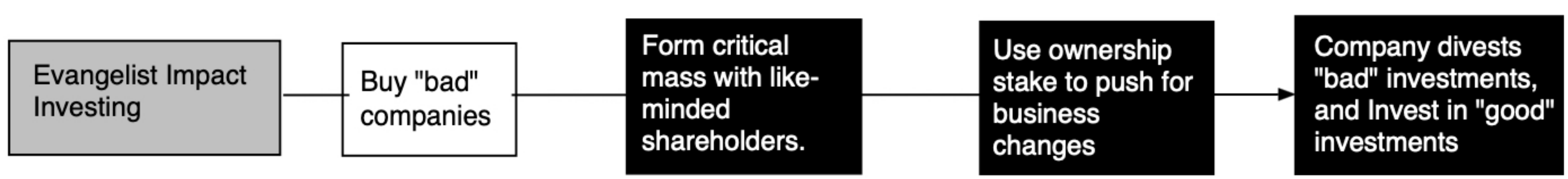
1. Inclusionary Impact Investing: On the inclusionary path, impact investors seek out businesses or companies that are most likely to have a positive impact on whatever societal problem they are seeking to solve, and invest in these companies, often willing to pay higher prices than justified by the financial payoffs on the business.
2. Exclusionary Impact Investing: In the exclusionary segue, impact investors sell shares in businesses that they own, or refuse to buy shares in these businesses, if they are viewed as worsening the targeted societal problem.
3. Evangelist Impact Investing: In the activist variant, impact investors buy stakes in businesses that they view as contributing to the societal problem, and then use that ownership stake to push for changes in operations and behavior, to reduce the negative social or environmental impact.

How impact investing works (on paper)…

- With inclusionary & exclusionary impact investing..



- With activist impact investing…



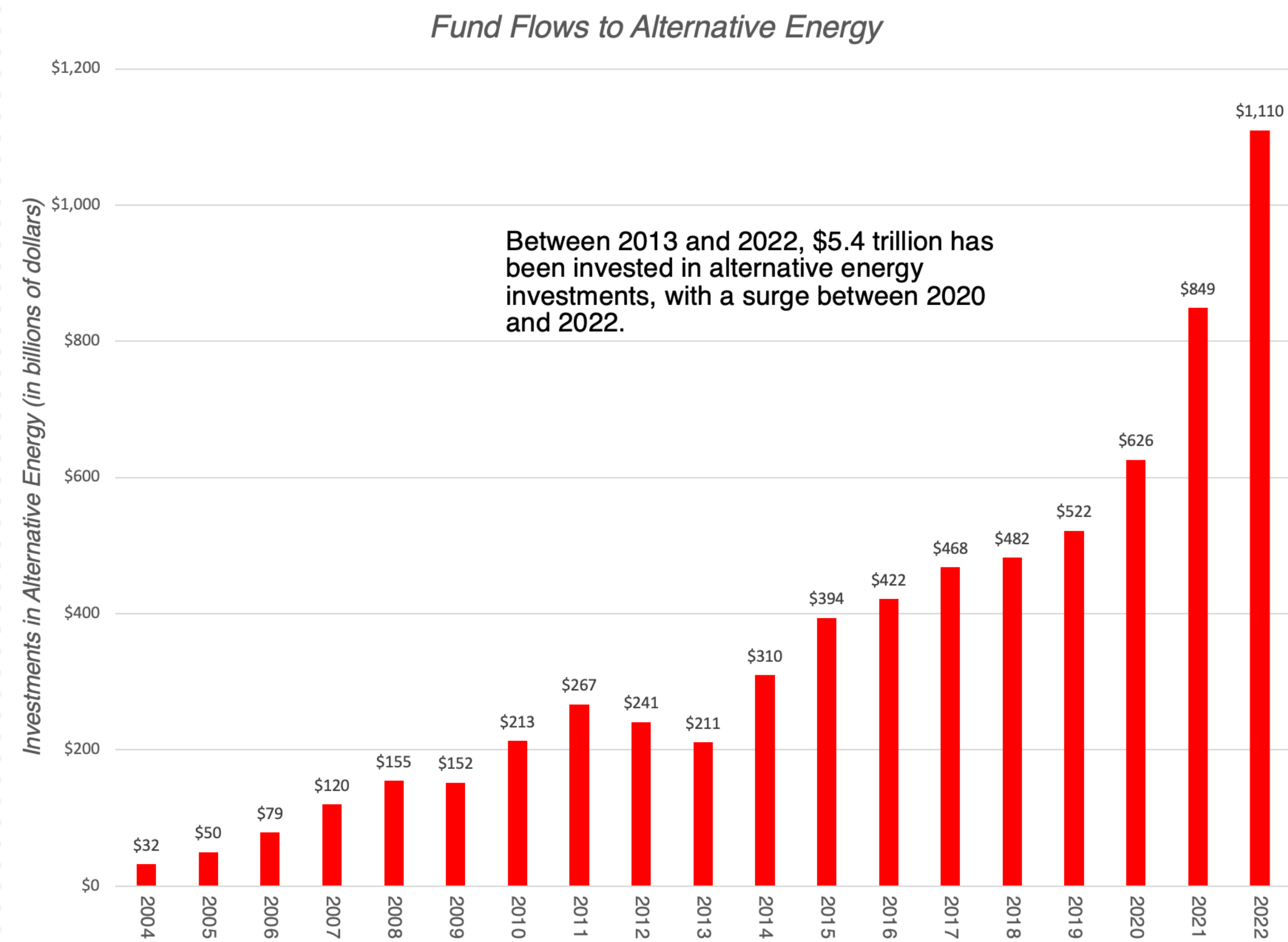
Perverse Outcomes?

The Impact of Impact Investing		
Impact Strategy	*Desired Impact*	*Perverse Consequence*
1. Buy "good" businesses	Push up stock prices of good companies; this lowers their costs of equity/capital and increases investment in "goodness".	Mis-identify "goodness", with sub-optimal or bad alternatives gaining access to capital and growing, at the expense of better ones.
2. Sell "bad" businesses	Push down stock prices of bad companies, increasing their costs of equity/capital and decreasing investment in "badness".	Increased returns for investors in bad businesses, with investing void filled by private investors or companies immune from impact investing pressures.
3. Buy "bad" businesses, and push for change in how they are run.	As activist investors, push bad businesses to divest "bad" businesses, and more in "goodness".	Competitors that don't face activist pressure and private investors buy the divested bad businesses and continue to operate them.
Illustrative Example: Climate Change Impact Investing		
Impact Strategy	*Desired Impact*	*Perverse Consequence*
1. Buy "green energy" companies	Push up stock prices of green energy companies, lowering their costs of equity/capital and increasing investments in green energy.	Pick the wrong or less effective green energy alternatives, flooding them with capital and making it impossible for non-chosen green energy alternatives to compete.
2. Sell "fossil fuel" businesses	Lower stock prices of fossil fuel companies, increasing their costs of equity/capital, and reducing investment in fossil fuels in the aggregate.	Increase returns for investors in fossil fuel companies, and the incentives for private equity to invest in fossil fuel production.
3. Buy fossil fuel businesses, and change how they are run.	Increase holdings in fossil fuel companies, and push them to invest less in or even divest fossil fuels and more in green energy.	Private investors buy divested fossil fuel assets and continue to operate them, while pressured companies invest badly in alternative energy.

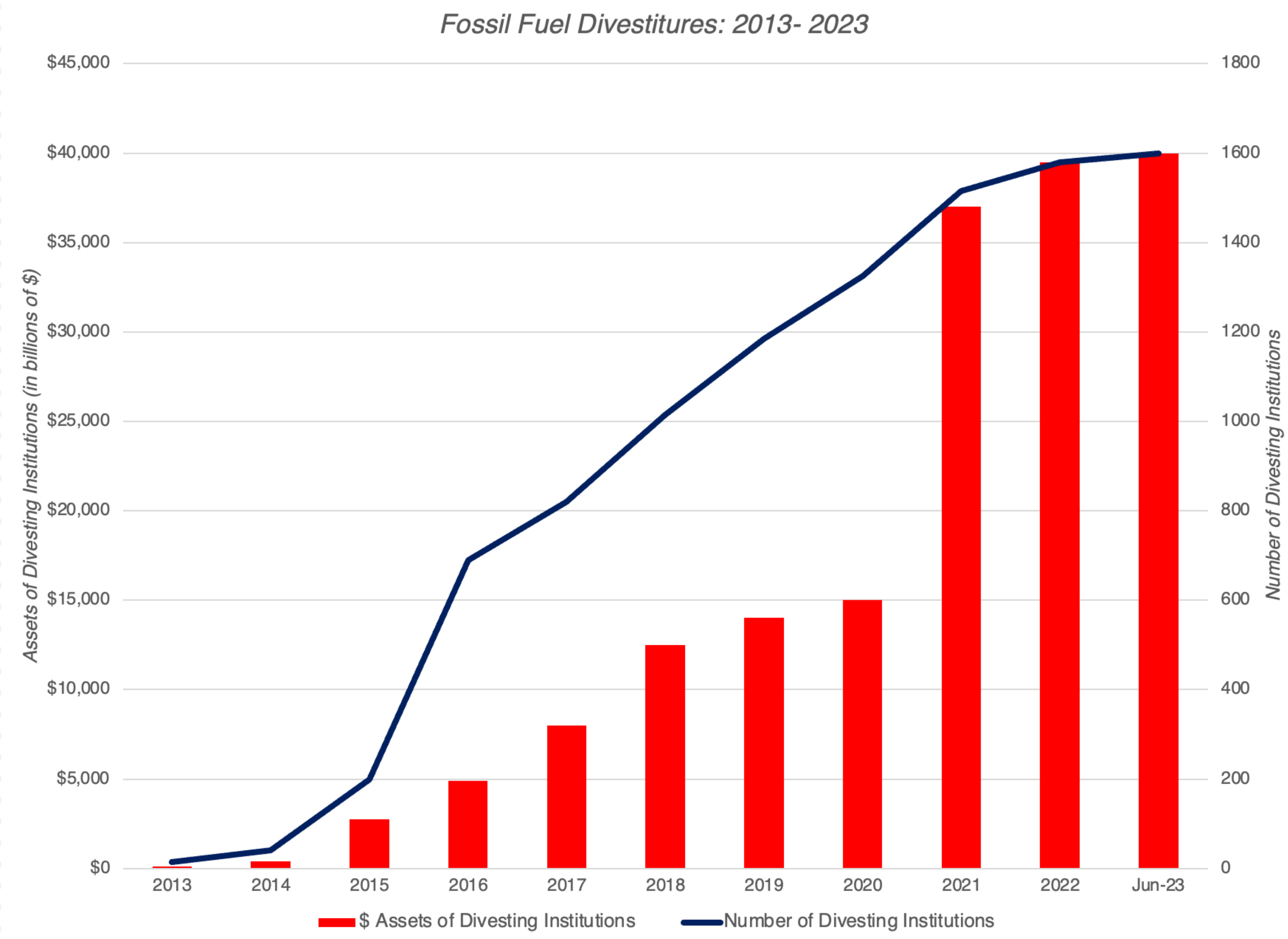
Climate Change Impact Investing

- While impact investing can be directed at any of society's ills, it is undeniable that its biggest focus has been on climate change, with hundreds of billions of dollars directed at reversing its effects.
- In many ways, climate change seems tailor made for impact investing to have an impact, since:
  - It is an existential problem, where there seems to be consensus on the problem, albeit not on solutions.
  - Many of the businesses that create the problem are publicly traded and thus easily targeted.
- As an empirical question, it is worth examining how impact investing has affected the market perceptions and pricing of green energy and fossil fuel companies, the operating decisions at these companies, and most critically, on the how we produce and consume energy.

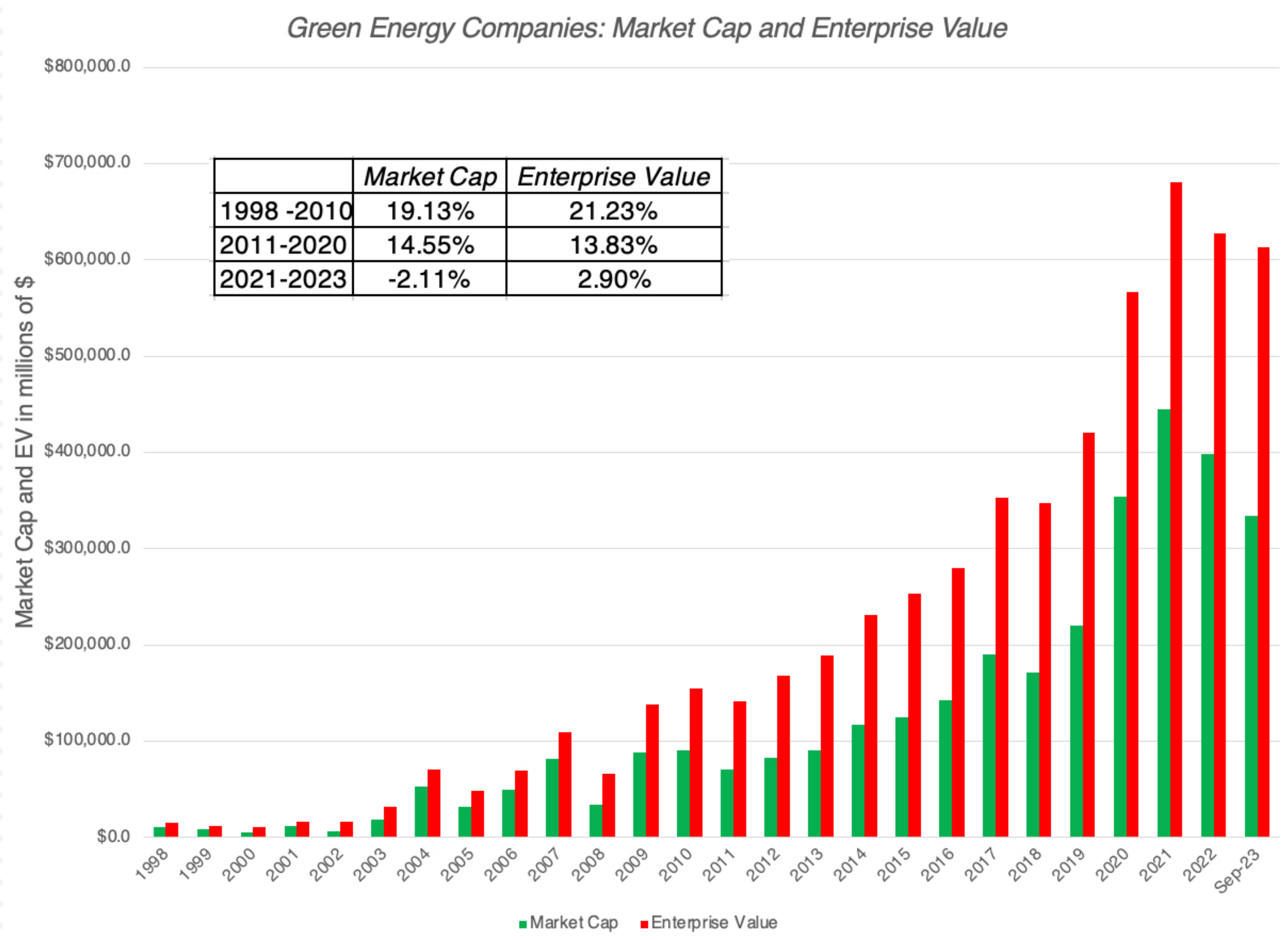
1a. Fund Flows into green energy



1b. And divestments of fossil fuel firms..

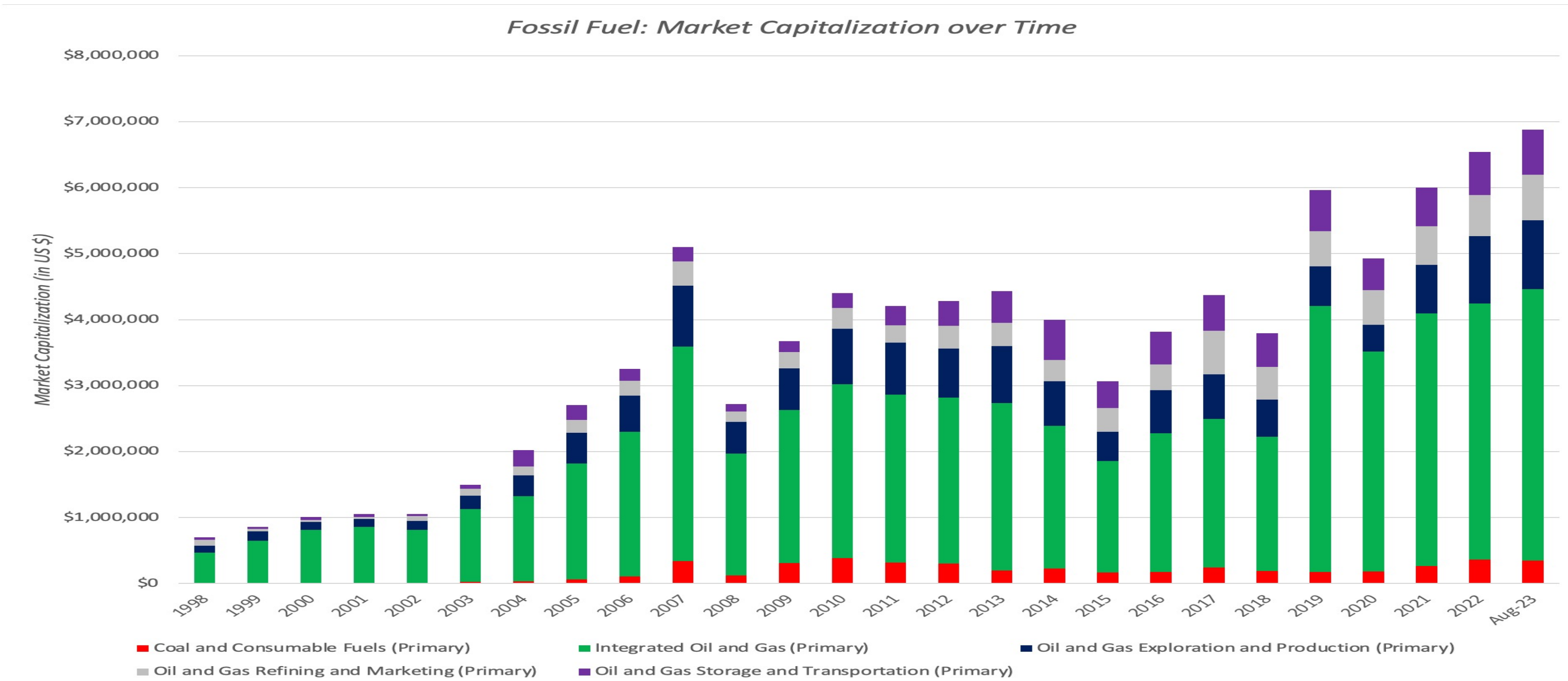


2a. Market Cap – Green Firms…



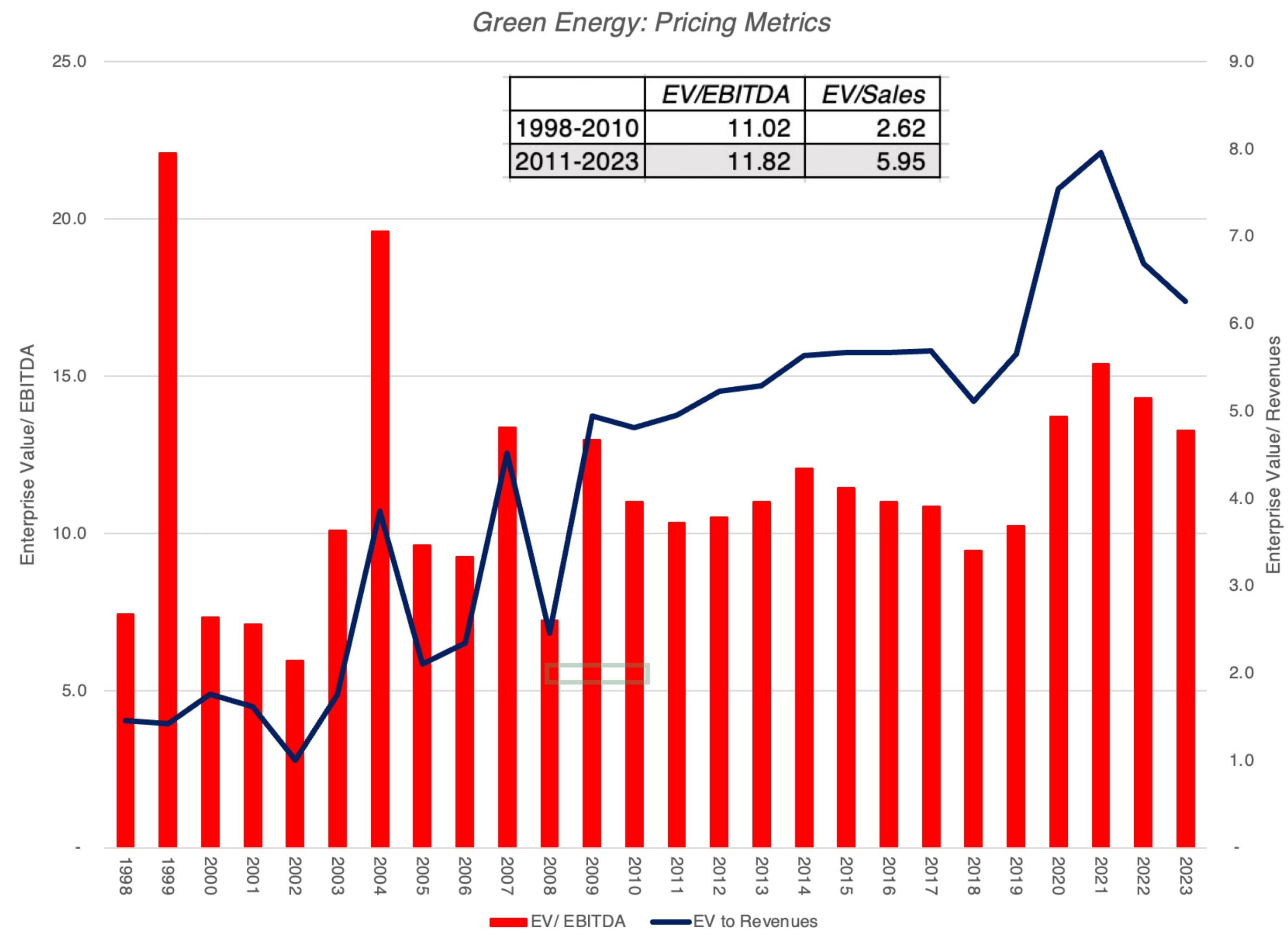
	Market Cap	*Enterprise Value*
1998 -2010	19.13%	21.23%
2011-2020	14.55%	13.83%
2021-2023	-2.11%	2.90%

2b. Fossil Fuels – Market Cap



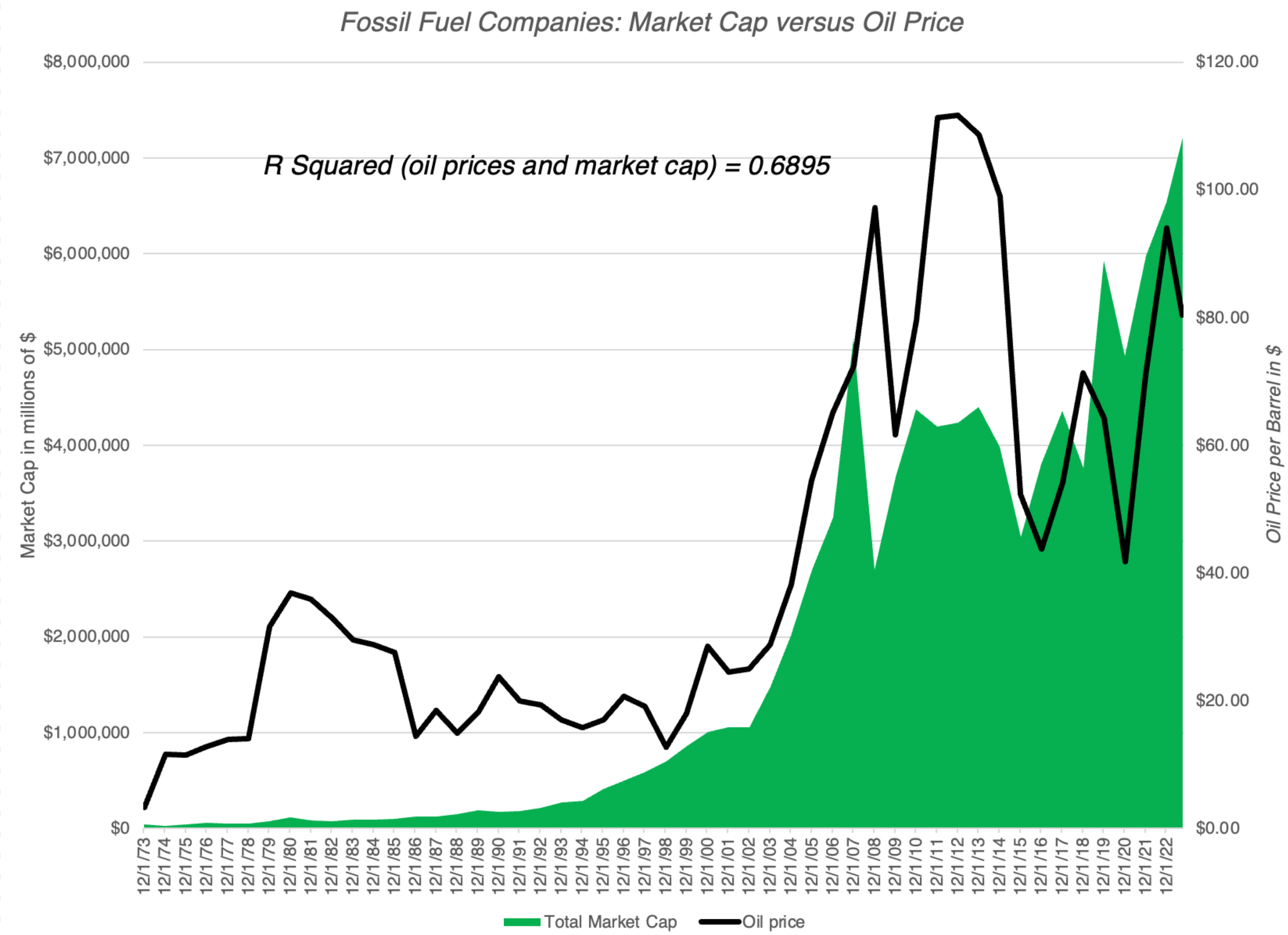
Market Capitalization (in millions of US $)						
	Coal & Consumable Fuels	Integrated Oil and Gas	Exploration & Production	Refining and Marketing	Storage and Transportation	All fossil fuel
1998	$3,839	$460,529	$107,122	$93,914	$31,838	$697,242
2003	$21,719	$1,103,363	$206,172	$107,035	$57,125	$1,495,414
2008	$123,084	$1,844,367	$478,970	$164,595	$108,722	$2,719,737
2013	$199,439	$2,532,571	$863,689	$357,142	$480,702	$4,433,544
2018	$187,954	$2,036,212	$560,689	$497,456	$514,091	$3,796,401
2023	$345,784	$4,113,126	$1,044,136	$694,826	$678,693	$6,876,565
% Chg: 98-03	41.42%	19.09%	13.99%	2.65%	12.40%	16.49%
% Chg: 03-13	24.82%	8.66%	15.40%	12.81%	23.74%	11.48%
% Chg: 13-23	5.66%	4.97%	1.92%	6.88%	3.51%	4.49%

3a. Pricing Metrics – Green Energy

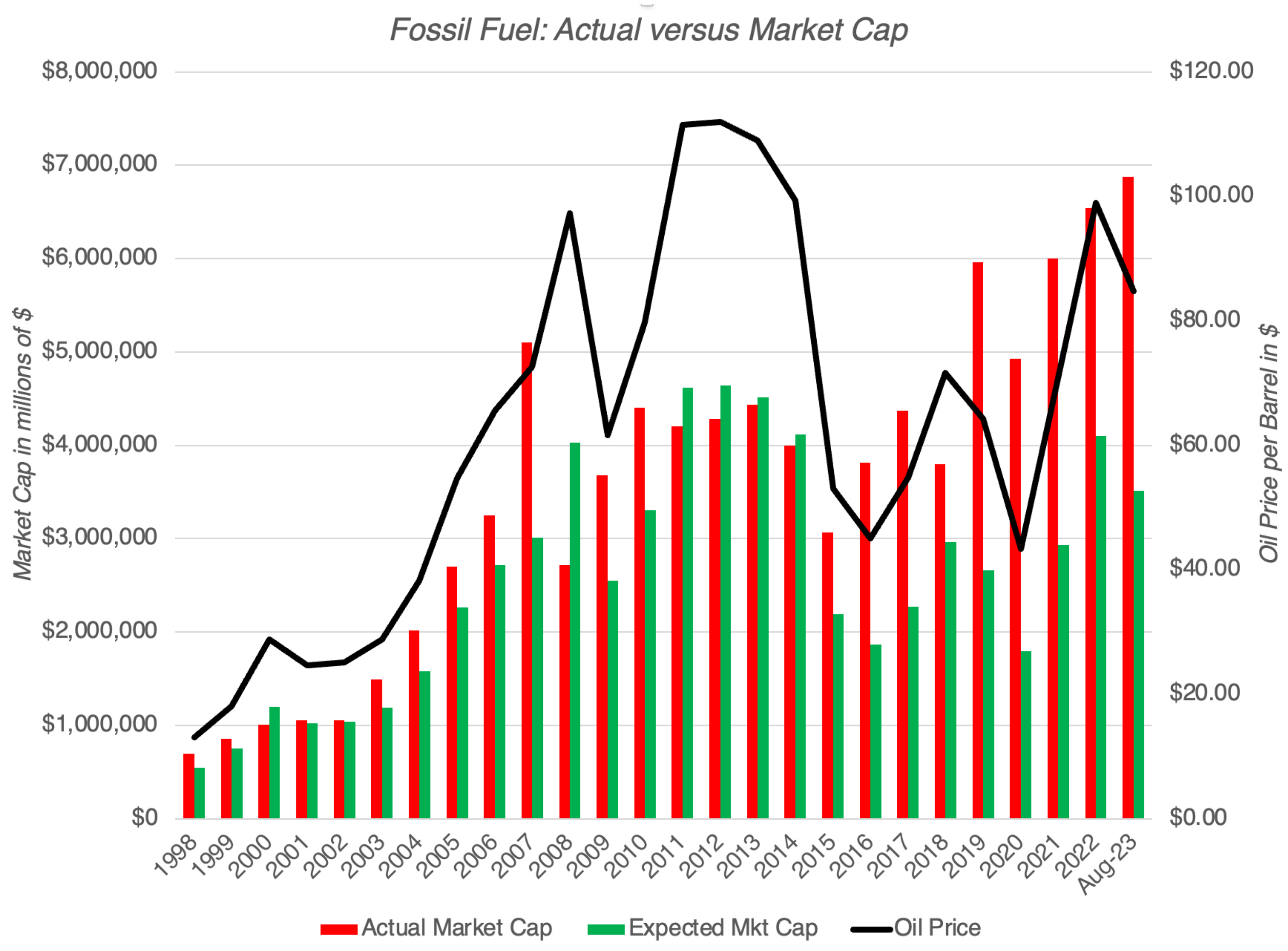


	EV/EBITDA	EV/Sales
1998-2010	11.02	2.62
2011-2023	11.82	5.95

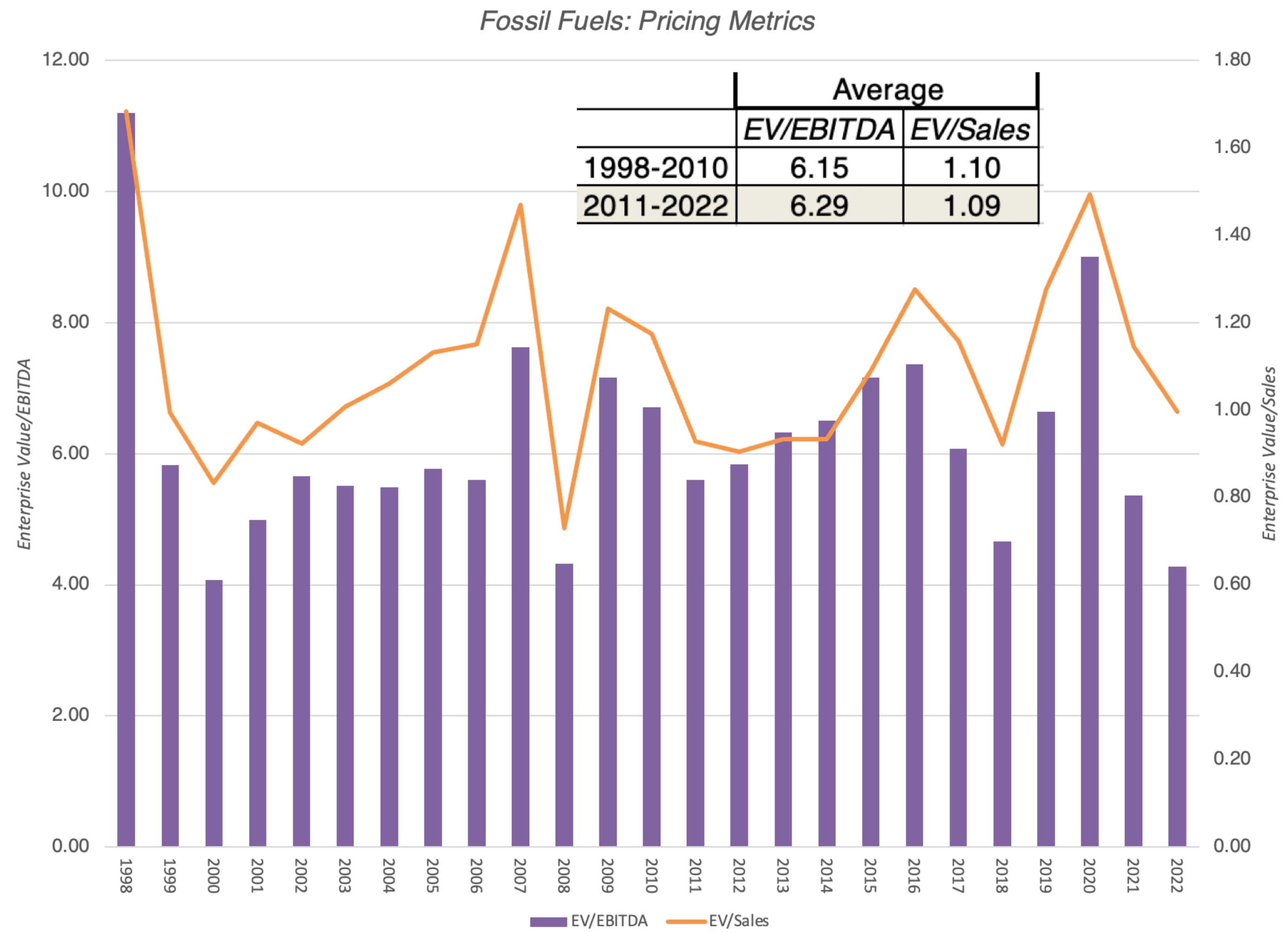
3b. Fossil Fuels – The Oil price effect



Fossil Fuels: Separating the Impact investing effect from oil prices..

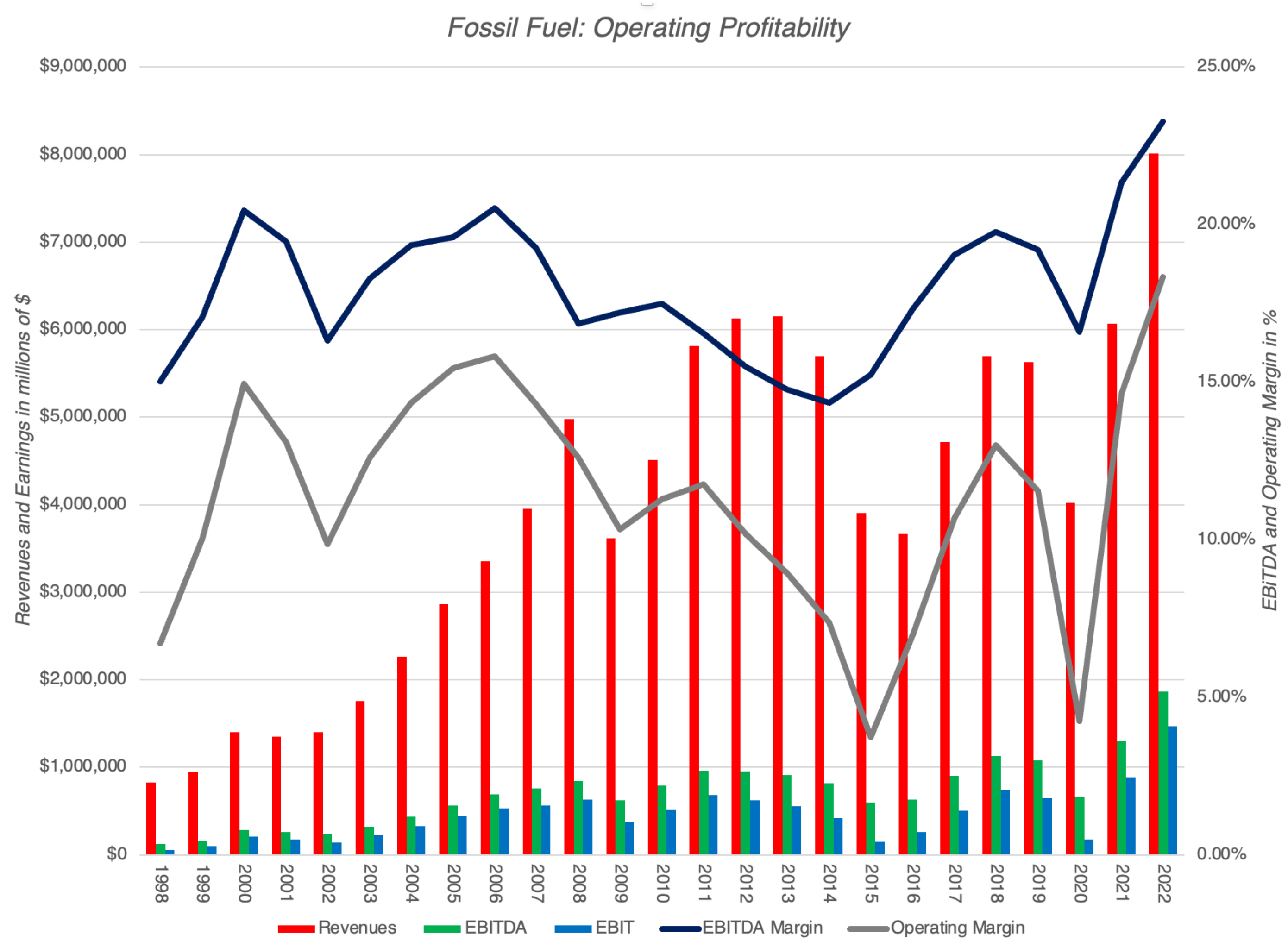


Fossil Fuels: Pricing Metrics

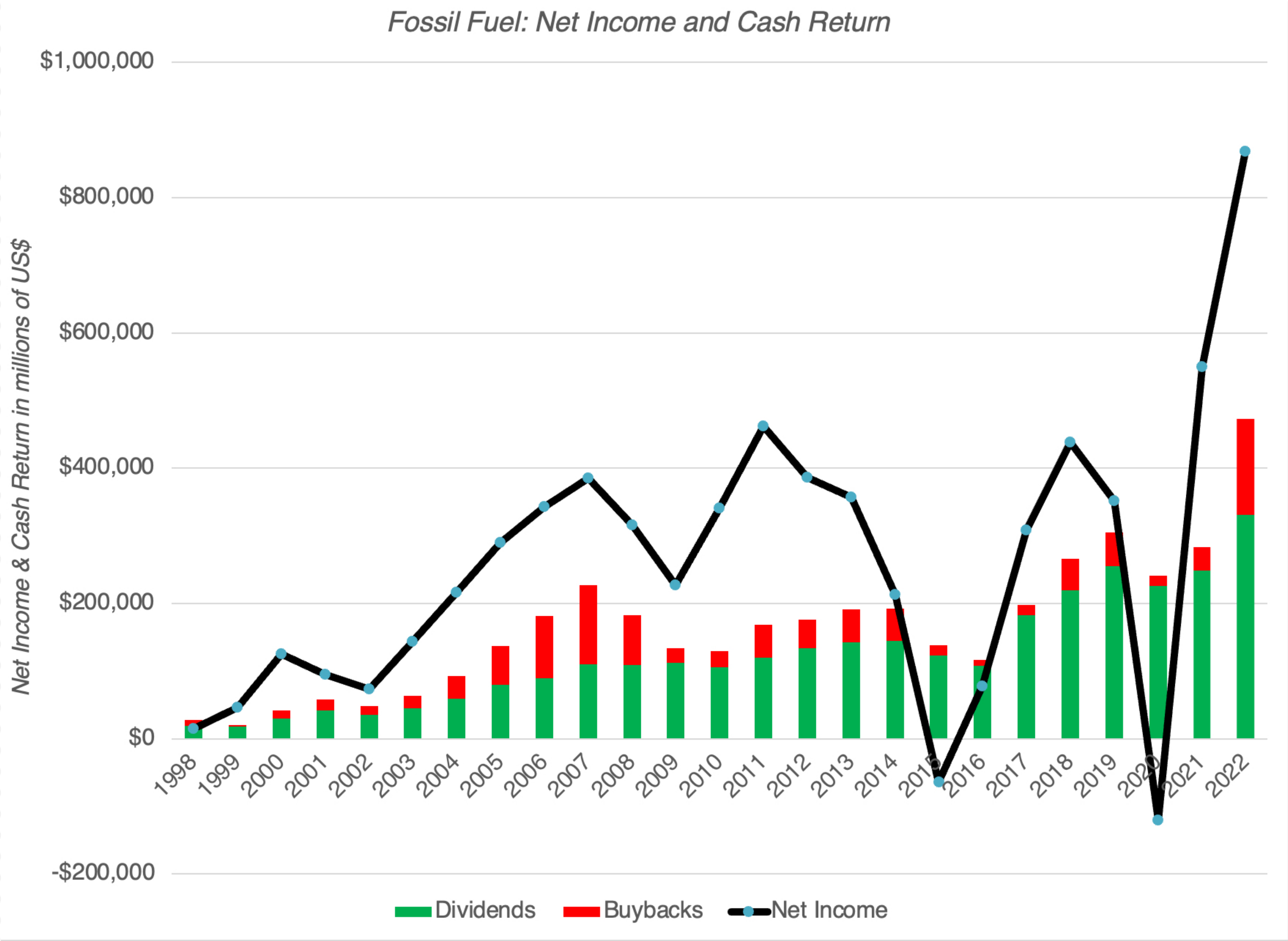


	Average	
	EV/EBITDA	*EV/Sales*
1998-2010	6.15	1.10
2011-2022	6.29	1.09

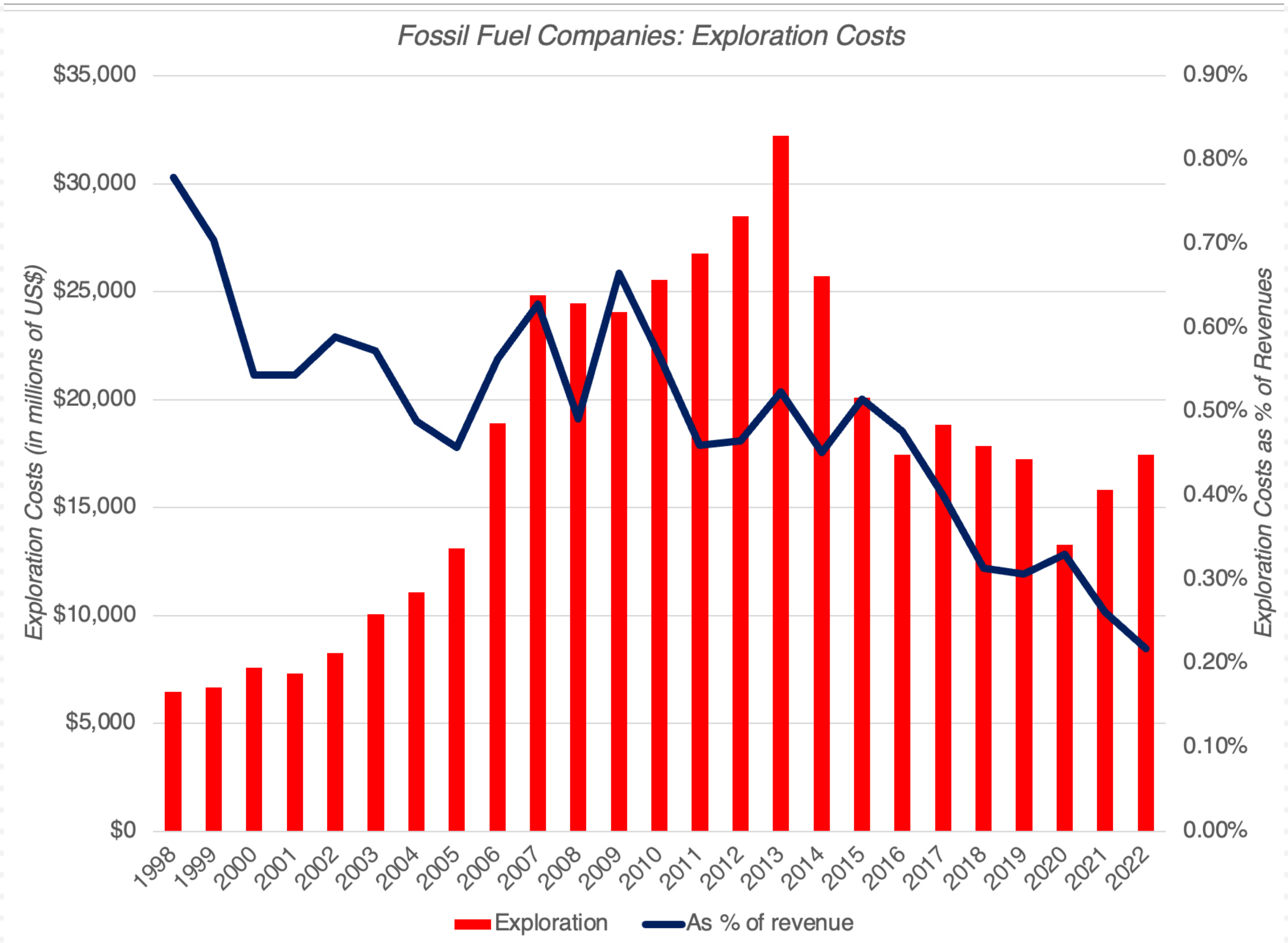
4a. Fossil Fuels - Operating profitability



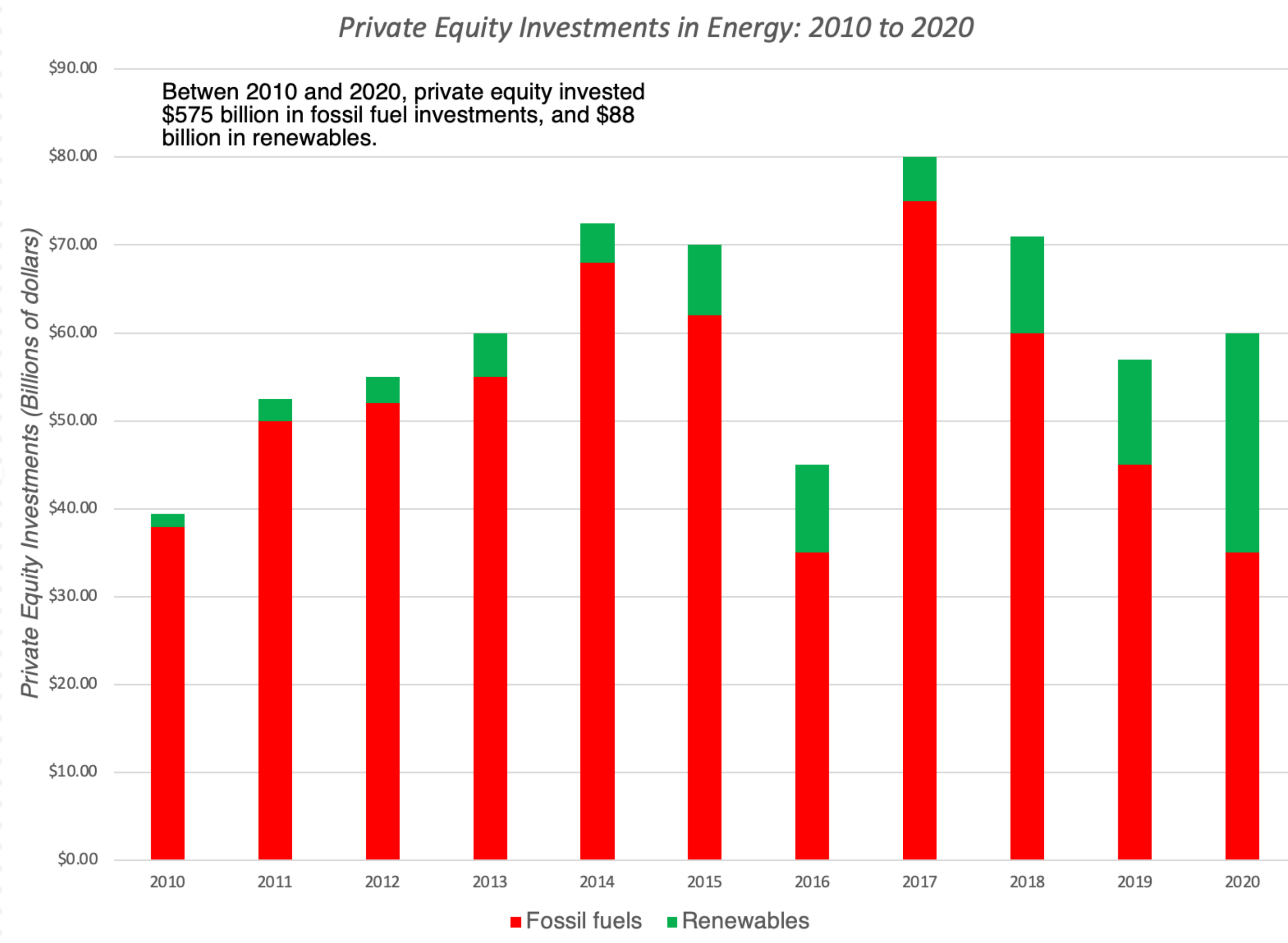
4b. Fossil Fuel – Cash Returns



4c. Fossil Fuels Exploration



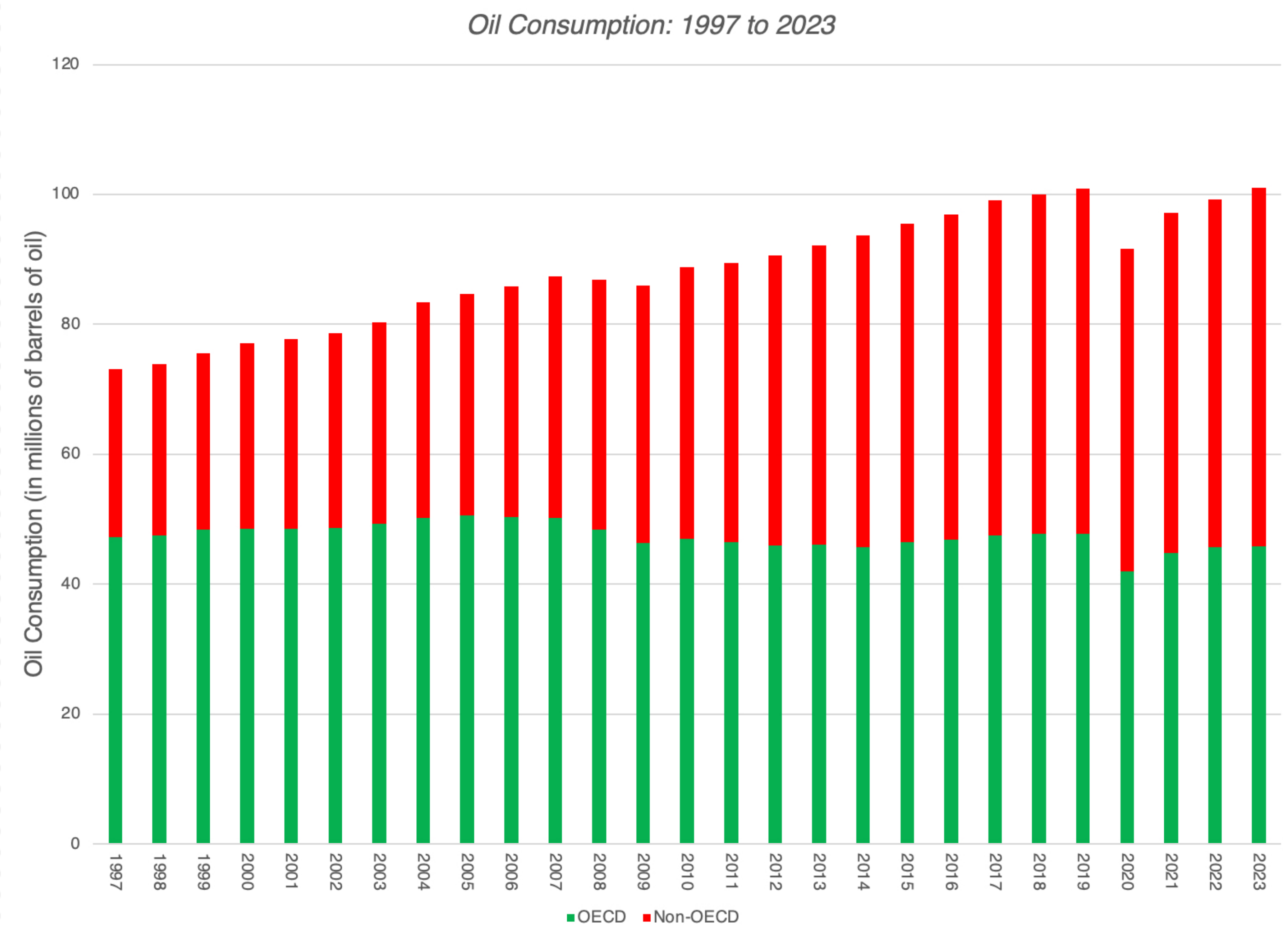
4d. Private Equity fills the void…



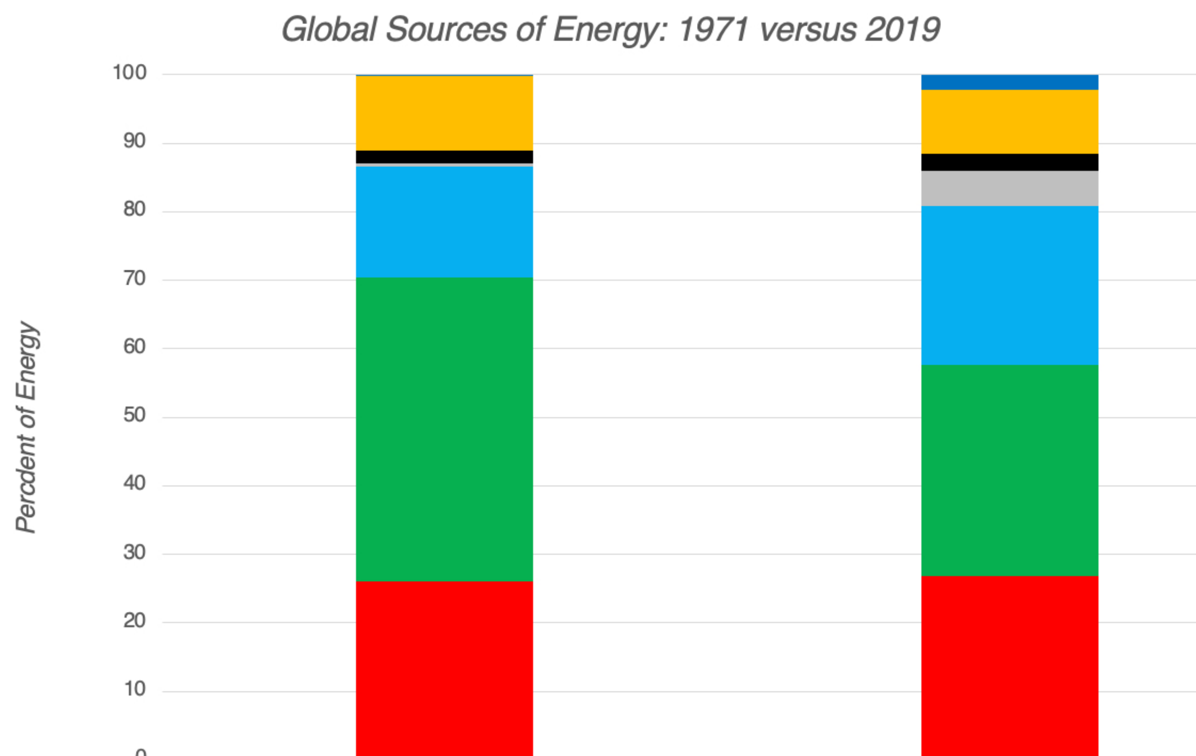
4e. Activist impact investing loses its mojo…

- While fossil fuel companies were quick to give in to pressure from impact investors for much of the last decade, the Russian invasion of Ukraine seems to have been an "emperor-has-no-clothes" moment for green energy advocates, laying bare how reliant the globe still is on fossil fuels for its energy needs.
- In the aftermath, the biggest fossil fuel companies have become bolder about their plans to stay in and grow their fossil fuel investments, with Royal Dutch taking a stake in Qatari gas field, BP announcing it will produce more oil and gas, Exxon Mobil buying Pioneer Natural Resources, a shale driller for $60 billion, and Petrobras reversing course on divestitures.
- Institutional backing for activist campaigns is lagging, as the big players (Blackrock, Vanguard etc.) step back from supporting climate change votes at annual meetings.

5a. Oil Consumption

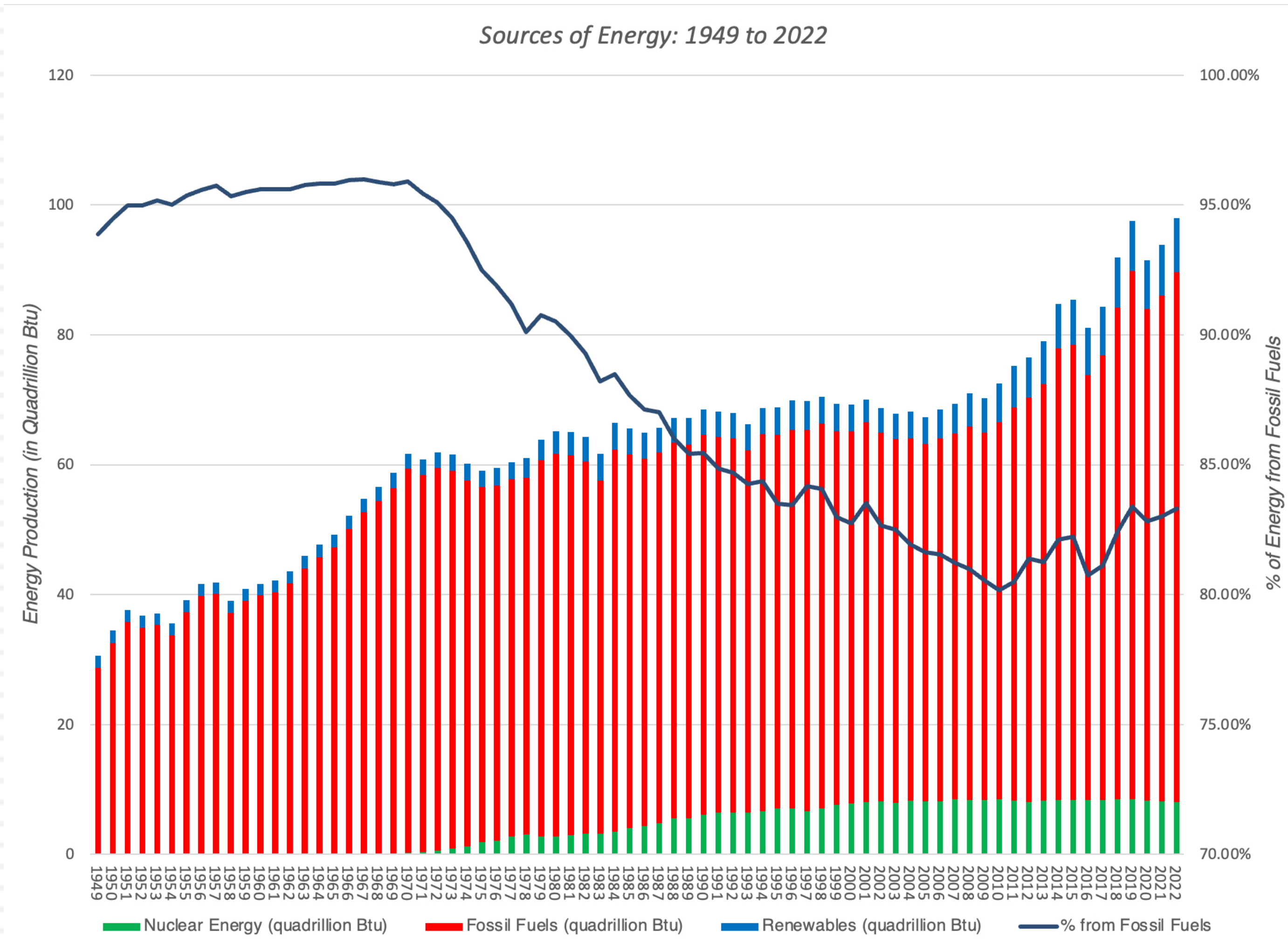


5b. Global Energy Dependence: 1971 vs 2019



	1971	2019
Other renewables	0.2	2.2
Biofuels	10.8	9.4
Hydro	1.9	2.5
Nuclear	0.5	5
Natural gas	16.2	23.2
Oil	44.3	30.9
Coal	26.1	26.8

5c. US Energy Sources



The macro impact – summing up

- After 15 years of investing, and more than $5.4 trillion invested, impact investing has hardly moved the needle on how we produce and consume energy.
  - To the impact investors' argument that it takes time, I though time was the one thing we did not have on our side in the climate change fight.
  - If this is what passes for winning in impact investing, I would hate to see what losing looks like.
- I must confess that what I see in the data is the essence of insanity, where impact investors keep throwing in more cash into green energy and more vitriol at fossil fuels, while the global dependence on fossil fuels increases.

Impact Investing: Can it be rescued?

1. With your own money, pass the sleep test: Yourinvesting should reflect your pocketbook and your conscience. It is how you pass the sleep test!
2. With other people's money, be transparent and accountable about impact: If you are investing other people's money, and aiming for impact, you need get buy in from those who are investing with you. In addition, you need to specify measurement metrics that you will use to evaluate whether you are having the impact that you promised.
3. Be honest about trade offs: When investing your own or other people's money, it is important you be honest with yourself not only about the impact that you are having, but that you consider trade offs implicit in impact investing.
4. Less absolutism, more pragmatism: For those impact investors who cloak themselves in virtue, and act as if they command the moral high ground, just stop! Be humble, be willing to experiment and be willing to change course.
5. Harness the profit motive: While it is true that the pursuit of profits may underlie the problem that you are trying to solve, the power from harnessing the profit motive can bring to solving problems, is immense.