Tackling the Challenges of ESG Investing as Opportunities Expand Across Asset Classes

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With climate change, corporate governance failures and social challenges, such as a lack of affordable housing, capturing headlines on nearly a daily basis, it's no surprise that environmental, social and governance investing in all its forms — responsible, sustainable, impact — continues to gain traction among institutional asset owners. Gone are the days of asking whether ESG should be incorporated into investment decision-making or if impact investing is suitable for institutional investors. The questions asset owners are asking managers now is, "How do I incorporate it and can I get scale?"

That's not to say, however, that it isn't challenging. The right perspective (think long term, not short term) and articulating a set of values are key to matching an investment goal. And issues such as misinformation, scale (or lack thereof) and data gaps still need to be addressed. In this roundtable, Jeff Brenner, president and CEO of IMPACT Community Capital, Alex Bernhardt, principal and leader of responsible investment in the U.S. at Mercer, and Raj Shant, portfolio manager at Newton Investment Management, discuss different approaches to ESG and impact investing, how it has expanded across asset classes, how investors might think differently about data gaps and the benefits of ESG and impact investing, and what excites them about this rapidly growing part of the investment world.

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Pensions & Investments: What have been the most significant changes in ESG, responsible investing or impact investing that you have seen in the last 12 to 18 months?

JEFF BRENNER: Twenty years ago, when IMPACT Community Capital was founded by leading U.S. insurance companies, no one was pitching ESG or impact investing. Impact investing wasn't even a thing. If you fast-forward to today, more asset owners than ever are thinking about how they are going to do it, not so much if they are going to do it. They are considering how to make [impact investing] portfolio allocations and seeking opportunities beyond equities — which to date have been the predominant investment product — in other asset classes such as fixed income. This increased interest is why we are having more conversations with a variety of institutional investors who are seeking fixed-income alternatives that can deliver compelling risk-adjusted returns along with a societal impact through investments similar to IMPACT's private-debt platform, which is focused on affordable housing.

RAJ SHANT: Over the last few years, it has really gone, as Jeff was saying, from something very niche and very different to becoming relatively mainstream. There are increasing numbers of institutional mandates around the world where, at the [request-for-proposal] stage, it's a prescreening, it's not even a late-stage question. "Do you have responsible investing embedded into your investment process? Do you have an ESG aspect to your portfolio? Can you show how you do it? Can you demonstrate what impact that has on your investment decisions?"

One measure of how far we have come is the United Nations Principles of Responsible Investment. The number of signatories has boomed each year, and today we have trillions of assets around the world run by asset managers who are signatories to that. So I think it has become mainstream, maybe more so in other parts of the world than in the U.S.

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>
> **— JEFF BRENNER, *IMPACT Community Capital***

ALEX BERNHARDT: One of the biggest changes I have seen is that impact investing or sustainable investing, both were considered to be the domain of public equity managers or private equity managers, respectively, but in the last year or two, there has been a focus on fixed income, which is really promising given that it is the largest asset class in the world by most measures. Previously, green bonds were seen as the only opportunity, but now there is broader recognition that many public and private-debt opportunities can be impactful.

P&I: Given the growth in responsible investing, how well versed are clients and potential clients about it?

SHANT: At Newton Investment Management, we are active global equity, fixed-income and multi-asset investors, and I specialize in publicly traded global equities on the responsible investment side. We talk to clients around the world and within each region. I think you find very varying levels embracing the idea of ESG as integral to investment. It starts from the premise, "There is a lot of noise about ESG, and I need to talk to someone about it so I sound knowledgeable at the next meeting when this comes up, but at the same time, it is clearly going to be a tax on performance, isn't it?" Those conversations are one level, whereas I think in certain regions of the world, maybe Scandinavia, Benelux and France, conversations bypass all of that. Many of the trustees and certainly a lot of the advisers would have read the increasing body of research that suggests that not only can ESG help with risk mitigation, in certain regions and certain types of asset classes, it can help with returns too. So we get beyond the "Is this just a tax on returns" [question and] very quickly into, "How is this different from the old-fashioned ethical investing, simply excluding tobacco or excluding certain other sectors?" The range of conversations that we have now with new and prospective clients is richer and more diverse than at any time over recent years.

BRENNER: As Raj said, the conversations that we are having now are with new investors who are familiar with the concept of impact investing and just trying to figure out how to incorporate it into their approach. There is also an increasing understanding that impact investing doesn't require, necessarily, a risk or return tradeoff. Whether it's equity or fixed-income investments, investors can potentially achieve benchmark returns.

And institutional investors are all approaching it differently in terms of considering whether it should be a separate asset class or an important component across all asset classes. So, as investors come to better understand impact investing, their thinking about it continues to evolve.

P&I: There's a lot of news about climate change. Raj, has that been helpful when you are having these conversations, or do you find that there is a lot of misinformation out there?

SHANT: I think it is both. It is very useful, and I think it is very important that people are aware of the issues. But, of course, there is a lot of misinformation. The evidence of climate change is pretty irrefutable. And when you reduce it down to commercial terms, the companies most affected by it are the insurance companies. The world's biggest reinsurance companies like Swiss Re and Munich Re have done a lot of research in modeling climate change, and it's there. We can already see the consequences of climate change in terms of more extreme weather events, more extreme outcomes. To my mind, it is galvanizing an awful lot of people who do believe that it is worth acting on. So even to the extent that there is debate around misinformation, it is positive because it catalyzes those people who believe it is worth acting now on some of the climate-related issues rather than waiting.

P&I: Jeff, your expertise is in affordable housing. Why has affordable housing, investing in affordable housing, become such a big focus for you?

BRENNER: When you think about the big picture — much as we do when we think about the climate — what will the world that we are living in 20 to 30 years from now look like and what are the things that we can do today to have an impact on that? There is a shortage of affordable housing at crisis levels in many communities in the U.S. There is a shortage of about 7.4 million affordable and available rental homes for extremely low-income households, which works out to about 35 affordable and available units for every 100 low-income renters. So there is just this huge need, and it impacts where a company's employees live, how long it takes them to get to work and what ever other sacrifices they have to make in order to be able to go through a one- or two-hour commute to get to work. So we started trying to figure out whether we could create an investment in scale that could help address this problem. What we have seen and learned over time is that these can be very good investments, that impact investing can have positive financial and social returns.

The affordable multifamily loans that we have historically financed have produced returns — in terms of a spread over Treasuries — that have generally exceeded that of traditional fixed-income sectors like similar-quality CMBS [commercial mortgage-backed securities] or corporate bonds. Historically, they have performed across market cycles. They have provided investors with stable income and historically low correlation to other fixed-income investments. They have added diversification to investors' portfolios as well. To date, we have financed about 44,000 units of affordable housing, so it is making a contribution to the world that we live in.

P&I: Jeff, you mentioned the issue of scale. How have you managed that?

BRENNER: This is one of the biggest challenges, and we have pioneered a solution in affordable housing. Institutional investors need scale; they like to write big checks to make it economical for them. We created a debt platform that allows us to make these relatively small loans — $1 million to $2 million at a time — and then aggregate them. Once we had developed a consistent production platform, we were able to produce sufficient volume to allow us to aggregate these loans. Then we adopted a standard Wall Street tool using commercial mortgage-backed securities to pool these loans into multiple CMBS structures. That gave our investors access to scale in a pretty familiar asset class and in an investment vehicle that they were familiar with. Thus far, we have originated approximately $2 billion of investments for institutional investors.

BERNHARDT: The scale point is really important. At Mercer, we have advised investors with trillions of dollars' worth of investments globally on how to address climate change strategically from a top-down perspective. Many of them are motivated to address climate change risk and take advantage of related opportunities but remain challenged insofar as they have a hard time finding institutional-caliber fund offerings that allow them to invest in low-carbon solutions. We have seen a lot of investors make allocations to low-carbon index funds, for instance, in the U.S. market. That has been a relatively easy decision for investors to make, since equity markets are highly liquid and low-carbon indices are often optimized to minimize tracking error versus parent indices. But when it comes to allocating a portion of their private portfolio to an impact investment vehicle, oftentimes it can be hard to find investments that will meet their current underwriting criteria because they are either too small, too new or too niche.

P&I: Raj, do you ever run into that issue?

SHANT: In the publicly traded equity market it is much less of an issue. Our approach is to look at companies that aren't already great in terms of their ESG profile but are potentially improving or where we believe that constructive engagement could improve their ESG profile, and that opens up or unlocks potentially rather large areas of the equity market to us. Where there is scope for engagement, one can engage with the companies and, of course, vote one's shares actively at the [annual general meetings] to try to push, control, persuade, encourage or support management [and] executive teams to try to improve on their ESG practices over time. And that does mean that there is not really any shortage of investment opportunities. In fact, there is an abundance of opportunities, be it in equities, fixed-income or multi-asset strategies.

P&I: How are most institutional investors approaching ESG or impact investing?

SHANT: The investors that I am speaking to have decided that they do care about risk-adjusted returns, but they also care about something else as well, and that is that ESG outcome, that ESG profile. And I guess that is the point, that they wouldn't be having those conversations with us to begin with unless they had already decided, "Yes, I still care about these things because I'm not doing philanthropy or charity. I do want to have," in Jeff's case, impact, and in my case, that improving ESG profile, "alongside my financial return."

BRENNER: I think you're exactly right. Evidence is building that impact investing can add value to a portfolio - whether it's simply contributing returns or seeking to add value through lower volatility or diversification from a product that has historically shown low correlation to other fixed income investments. Investors are learning that impact investing can be accretive to their portfolios from an investment perspective.

When you're in talking to an asset owner that is focused on a real estate investment, and you're one of 10 managers that they have talked to that day or that week, if you don't start with the investment thesis, the conversation is just not going to go very far.

BERNHARDT: For the most part, I view the U.S. market as a barbell of activity. We have large public pensions on one side doing a lot of corporate governance work and now branching into ESG in their portfolios, in addition to their active-ownership programs. Then we have smaller foundations and family offices and the like that have been approaching this from a social or environmental advocacy standpoint and now are branching more holistically into ESG integration across their portfolios.

But there is still this huge "valley of indifference" in between those two pockets of more interested investors. Think about all the defined contribution plans in the U.S. and all the corporate defined benefit plans in the U.S., and how many trillions of dollars they control, and how little activity we have seen in those segments relative to foundations, for example.

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P&I: Engagement and impact are truly long-term prospects. How do you have that conversation so clients really understand it and stick with it over time?

SHANT: We have tended to take the view that if engagement with companies hasn't worked within a couple of years, it probably isn't going to. Within a two- to three-year time frame, engagement should be working, and there should be visible improvement in key performance indicators.

By starting out saying, "We want to have these multi-year engagements, and that is a key part of our investment proposition," it becomes — when we are having conversations with existing clients or prospective clients or consultants — a self-weeding garden, if you like, because people will self-select out. We target turnover rates between 20% to 33% per annum over a three- to five-year time horizon because we believe that that is the only time horizon to try to implement change in the real world and to be able to see that change. And so that is what we say at the very outset of our conversations with those clients. Publicly traded equities might be very liquid, but that's not the point of this strategy. There are many other strategies you can go to if you want to go in and out on a quarterly basis.

So those people for whom it is immediately innately uncomfortable to look at a longer-term horizon remove themselves from that conversation. And that's fine, because these strategies are not for them, and we're not the right manager for them either. So it saves everyone time if we establish those ground rules from the outset.

BRENNER: I love Raj's concept of the self-weeding garden. In the private-debt space, the investors we are talking to in most cases are matching long-dated liabilities with our long-term investments. So we are already at a good starting point for the conversation. But it always comes back to the investment thesis and the educational process that leads each investor to their unique definition of impact investing. It means a lot of things to a lot of people. But it only matters what it means to your organization, and you have to decide where it is going to fit within your investment portfolio.

It really is the upfront discussions around establishing what they mean by impact, determining the investment thesis, deciding where it is going to fit within their portfolios and then how it is going to be benchmarked. And if we get a lot of those questions done upfront, if you do the fundamentals upfront, maybe, in some ways, we have created that self-weeding garden. Because Raj is right, if we get into a conversation very early on and someone immediately says, "I'm not interested in

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impact outcomes," well, it becomes a fairly short conversation.

BERNHARDT: There are very few asset owners that I know of that claim to be short-term investors. Almost all want to be, try to be or claim that they are long-term investors. I would argue that the symbiosis between long-term investing and sustainable investing is such that they are sort of mutually dependent on each other: You can't be a sustainable investor without being a long-term investor and vice versa. So I think there is a growing recognition among the asset-owner community that those two methodologies or approaches to investing are symbiotic, and you can actually achieve long-term investment outcomes while considering sustainable inputs to the process. Some of the challenges that we come across are the dominance of old ways of doing business. For instance, in an asset allocation framework, we are tied usually to specific asset classes. Impact investing isn't an asset class, even though some investors want to treat it as such. It cuts across different asset classes. The opportunity exists in private debt, public debt, private equity and public equity.

P&I: Can these investment strategies meet different investor goals?

BRENNER: I've been reading more about long-duration liabilities in the last month than I think in the last five or eight years. At IMPACT Community Capital, we're not really providing anything sexy on the equity side, but we have built this platform that is focused on principal preservation, current income, low volatility and low correlation to other fixed-income investments. So we sit in a really good spot for investors who are looking for this kind of longer-term outlook and matching long-term liabilities.

Affordable housing investments have historically been a very stable, reliable source of income. They have not historically provided sexy peak returns, but they have been a source for a reliable, steady stream of income providing low volatility. And again, for investors that want to be able to match an investment against long-duration, long-term liabilities, they may be a good fit.

P&I: Gaps in data is one of the issues investors and managers face. How do you handle that?

SHANT: It's a huge issue, but it is a huge opportunity as well. Probably the clearest bull market in the investment world over the last five years has been ESG data vendors. There is a plethora of them. They report an awful lot of really useful data, but they also report an awful lot of misleading data. The problem with relying on that data and these data vendors, which a lot of systems do and a lot of passive funds are obliged to, is that what is reported is often completely inconsistent, it is done on a different basis from one company to another, and that data is nearly always backward-looking. So, there are huge issues around data quality.

And if these non-financial issues matter to you, and if these long-term investors have decided that the financial return and the risk-adjusted financial return matter, but they also care about something else, whether its impact in Jeff's case or the ESG impact in my case, then relying on that hard data is a very poor starting point. Really what they should be most interested in is the forward-looking evolution of these things, which comes down to [the] policy and disposition [of a company's management] toward those key factors, and how amenable and receptive they are to engagement from us on factors that can help put them on a path to enhancing their business and ESG footprint over the long term. Those factors would depend on which industry and which company within that industry you are talking to, and making a judgment on how likely they are to actually be able to implement improvements to their ESG profile.

BERNHARDT: I think there is justifiably a lot of focus on enhancing ESG data disclosure and quality. And initiatives like SASB [Sustainability Accounting Standards Board] are brilliant in this regard. We need more of that and not less. But generally speaking, even if we were to get "perfect" ESG data starting next year, we would still only have one year of such data. And to a significant extent, the financial markets hinge upon regressive financial analysis. So we can't, with one year of high-quality ESG data, prove any sort of investment thesis in the same way that we might have shown or demonstrated there is a value-investing thesis or a growth-investing thesis. And once data is fully transparent, the asymmetric investment opportunity will have largely eroded. People will be aware of any potential ESG premium in a more definitive way, and it will be traded away. Also, many of the issues that ESG integration is supposed to protect against — climate change, for instance — just haven't [fully] happened yet and aren't embedded in the historical record.

All of that is to say I think the focus on data and benchmarking is something of a red herring. We should be talking more about what our long-term, forward-looking goals are as investors, and how sustainability considerations can help us to achieve those.

P&I: It sounds like the onus is on managers to understand those companies and where they are on the spectrum of how much or how little information they report, as opposed to relying on a third-party vendor.

SHANT: Absolutely. All these ESG data systems tend to reduce complex, multi-faceted companies to a number or a letter or a score, which is really reassuring because it feels very objective. However, it can be misleading because any number, any score, has to make some value judgments and trade-offs between those positives and negatives. We use our responsible investment research analysts, collaborating with our team of global-sector analysts, to add value through fundamental research on the companies we look to invest in, to come up with a more meaningful number or data point. Ultimately, though, it really is down to the investor to look at it holistically, because no single number or letter is going to do that for you. This is also a problem for passive ESG strategies: They have to rely on some form of ESG scoring system and, by virtue of having to own the whole, or most of the market, the level of engagement they can achieve with companies is more limited.

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P&I: Jeff, when you're looking at investment opportunities, do you find data gaps too?

BRENNER: It depends on what we're measuring. The impact-investing space is a spectrum, and on one end of that spectrum is an emphasis on outcomes not just outputs. So it's not just about investing to create new units of affordable housing, it's whether the affordable housing has resulted in someone's ability to build wealth. Has it resulted in better high school graduation rates, more kids going to college? Those are really longitudinal considerations that I think, at least from the institutional-investment space, we haven't been prepared to tackle. Like Raj said, the measuring of impact is still in its infancy. People can't always agree on definitions, let alone how to measure them and then how to benchmark them.

I think that is the big challenge in conversations with institutional investors. They are used to benchmarking their investments. When we first started IMPACT Community Capital, we would meet with our investors and say, "We built 4,000 units of affordable housing last year." Then, suddenly, that became the benchmark. Then, if the next year we built 3,500, it was, "What went wrong?" And then it evolved to, "Were all of your units affordable to people making 60% of area median income, or did you make them highly affordable for people at 30% of area median income?" Then, "Are any of the housing units or housing developments that you are financing providing services like after-school care?" So definitions and measurement are evolving.

P&I: Considering the macroeconomic environment that we are in, are there particular areas of investment that you find particularly exciting right now?

SHANT: The sustainability revolution will be — is — all about doing more with less. So what really excites me isn't necessarily the most famous wind-turbine manufacturers in the world or the most famous recycling companies in the world, it's those companies that are developing the enabling technologies, the enabling ideas that will transform the way we use a molecule of carbon or a molecule of water.

I think looking at the investment opportunities with that mindset gives you an entirely different perspective on where the long-term opportunities are. And then the shorter-term cycles seem to matter a bit less.

BRENNER: I am excited because so much of the conversation around investing has been around short-term and quarterly results, but businesses, investors and asset owners are beginning to think longer term. What drives IMPACT is thinking about how what we all do impacts the world long term. I get encouraged when so many important topics, such as climate change and affordable housing, are being addressed by cities, states and companies taking up the mantle and making investments in what they think are really the long-term best interests of their companies and the world in which they operate. I really do think that is a long-term trend, and I don't think it is going to stop. There is a much more long-term focus in decision-making, and I'm excited about that. ■