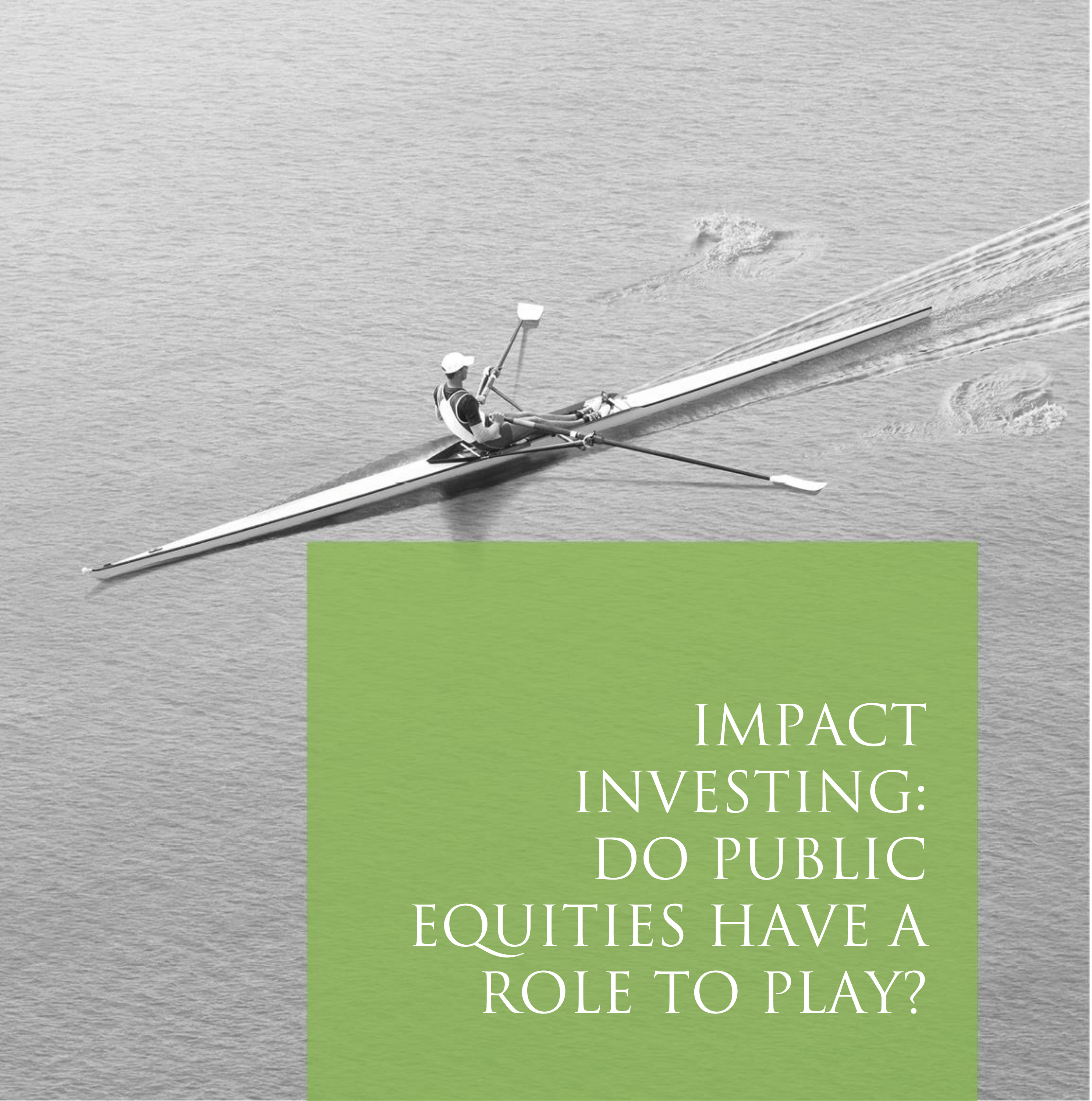

IMPACT INVESTING: DO PUBLIC EQUITIES HAVE A ROLE TO PLAY?

White Paper

UNIVERSITY OF CAMBRIDGE INSTITUTE FOR SUSTAINABILITY LEADERSHIP

Investment Leaders Group

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws

UBP

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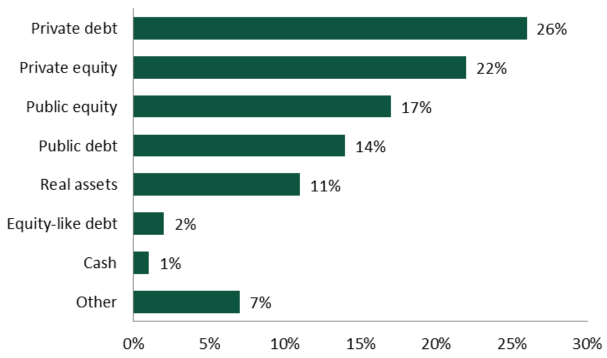
Content

- *Engagement maximises shareholders' welfare*
- *Public markets can offer scalable solutions*
- *The only vehicle which can give direct access to retail investors who demand impact is the public market*

Do public equities have a role to play in impact investing?

- In terms of asset class, impact investing has traditionally been associated with private capital. Public equities make up just 17% of the USD 502 billion in assets managed in impact strategies[1], a negligible amount compared with the size of public equity markets. In fact, some have argued that public equity markets are not suitable for impact investing due to the fact that they mainly deal in secondary capital.
- Our argument is that not only is impact investing in public equities possible, but that it is in fact essential for shareholder welfare maximisation[2] via engagement, as well as for achieving scale at the level required by potential solutions to some of the most pressing global issues.

Breakdown of impact assets under management by asset class



Source: Global Impact Investors Network (GIIN)

Engagement as a key to guiding corporate behaviour towards shareholders' values

- What is the appropriate purpose of a firm? In a 2017 paper[2], Nobel Laureate Oliver Hart argues that the function of a firm is to maximise shareholder welfare by consulting its shareholders on what they want managers to do. This is a very different conclusion from Friedman's view on profit or shareholder value maximisation as the sole aim. While Friedman's view has guided corporate behaviour during the decades since its formulation in 1970s, we believe Hart's view has gained wider acceptance in recent years, as shown by the rise of responsible and sustainable investing and an increasing focus on environmental, social and governance criteria for investing (ESGs).
- In parallel to the evolving view of the function of a firm, an increasing number of surveys are showing that most investors want to put their assets into products that are in line with their values. However, only a small minority do so, largely due to a lack of solutions and information about the impact market. For example, according to a recent survey by the UK's Department for International Development[3], 68% of people would opt for a sustainable investment if they were given the choice but only 13% currently do so. More than 60% of respondents cite reasons such as concerns about biodiversity, plastic pollution, climate change, harsh working conditions and unequal pay as motivations to make sustainable investments. The report's number one recommendation is to increase the availability of sustainable products.
- Fund managers' engagement with public companies is the essential link between the goal of shareholder welfare maximisation and investor demand for their investments to be sustainable and impactful in issues they care about. This may require a significant transformation of how asset managers view their clients and the ranges of solutions they offer.
- The fund management industry has built its product range on a two-dimensional client profile consisting of risk and return. Asset managers have collected client preference data and provided them with suitable solutions based solely on these two metrics. However, the implication of the trends mentioned above is that asset managers need to start collecting data on their clients' values as well. This would add a third dimension to client profiles in addition to risk and return, and guide fund managers in their engagement process.
- Thai Union, one of the largest fishing companies in the world, is a good example of how engagement can lead to positive change, even in emerging markets where people are most sceptical about this possibility. Two years ago, this company was the target of a Greenpeace campaign because of its destructive fishing practices and allegations of human rights violations in its supply chain.
- As a result of relentless stakeholder engagement, including from NGOs, consumers, asset owners and fund managers, the company has completely transformed its business practices. According to the World Benchmarking Alliance's Seafood Stewardship Index[4] released this year, Thai Union now ranks first out of thirty fishing companies worldwide, reflecting its leading performance in all measurement areas. The company is now leading the world with comprehensive sustainability strategies, incorporating a variety of social and

[1] "Sizing the Impact Investing Market", Abhilash Mudailar, Hannah Dithrich, Global Impact Investing Network, 1 April 2019; *Annual Impact Investor Survey 2019*

[2] "Companies Should Maximize Shareholder Welfare Not Market Value", Oliver Hart, Luigi Zingales – Department of Economics, Harvard University, Booth School of Business, University of Chicago, *Journal of Law, Finance and Accounting*, 2017.

[3] "Investing in a Better World", *Department for International Development Report*, September 2019.

[4] *Seafood Stewardship Index: Introduction, rationale and scope*, World Benchmarking Alliance, 2019

environmental targets. It monitors progress regularly and provides data annually to support its performance.

- Fund managers can work together towards more effective engagement and this has already started. As one pioneer of investor engagement said during a recent panel discussion, "We have always done engagement. What is new now is that other investors are ready to work with us. Only when we get other investors on board, can we enable change."
- The transformation of companies like Thai Union will set a new benchmark for other companies in the same sector to strive towards, which could create a virtuous circle of companies constantly moving towards higher standards of corporate behaviour.

Public equity markets are hard to match for scale and efficiency

- Some critics of public equities' role in impact investing point to the fact that public markets primarily deal in secondary capital (except for the obvious case of IPOs) and therefore cannot fund impact directly.
- We believe that this may be too narrow a view of equity markets. Equity markets are capital allocators and they determine the cost of capital for companies everywhere and in every sector regardless of whether that capital is private or public, primary or secondary. By allocating more assets to impact companies on a wider scale, investors can reduce the cost of capital for impact companies, supporting their growth and investments (what this means for investor returns in the short, medium and long term will be the subject of a future white paper).
- Without a specialised segment of the equity market focusing on impact equities, these companies would find it very difficult to attract capital on a large scale. For example, of the 98 companies we have so far identified as impact companies in emerging markets, only 26 are included in the MSCI Emerging Market Index, with a total weighting of just 1.3%. Given the increasing weighting of passive index investing in equity markets, these companies would be starved of capital without the involvement of active managers specifically allocating assets to impact investments.
- A good example of the role public equities can play in impact investing is the technology sector ecosystem in the US. An interactive ecosystem of universities, angel- and venture-capital investors, accelerators, incubators and regulators supports the founding of thousands of start-ups in the tech sector. The most successful of those feed the public equity markets via IPOs. In addition to IPOs, public equity markets reduce the cost of capital for tech companies along this value chain while enabling all types of investors to achieve attractive returns.
- We envision similar ecosystems emerging for impact investments which would include universities, non-governmental organisations, institutional development funds, foundations, charities, private equity and debt investors. Public equity would certainly play an important role in this ecosystem by determining the cost of capital along the investment chain and providing an exit route for early investors in private markets for impact companies that are most financially successful.
- Impact investing cannot reach the scale required without the involvement of public equities. For example, at UBP we use the United Nations' Sustainable Development Goals as a framework to guide us towards impact companies. The GIIN estimates that, per year, USD 3–5 trillion is required to achieve the SDGs while the UK's Department for International Development estimates this to be even higher, at USD 5–7 trillion[3].
- Against these huge numbers, the current total assets under management for the impact investment industry is estimated to be only USD 502 billion as at the end of 2018[1]. To put this figure into perspective, total assets in private markets is USD 5.8 trillion, of which USD 3.4 trillion is private equity. These are large numbers but they pale in comparison with public equity markets. Private markets' assets under management are only 7.8% of the global total, which stands at USD 74.4 trillion[5]. The current total market capitalisation of public equity markets is USD 82 trillion according to Bloomberg. In other words, only public markets have the scale to allocate the kind of capital required by some of the world's most pressing issues.
- In addition to providing scale, public markets make capital allocation more efficient by offering faster and cheaper ways to raise and allocate capital with the participation of a wider range of investors. Contrary to private markets, where fundraising is costly, custom-made, time-consuming and limited to certain types of investors, large amounts of capital can be raised or reallocated in public markets through very low-cost, fast, standardised systems and processes. The public market is the only vehicle which can give direct access to retail investors who demand that their savings make an impact.
- We believe private markets have played a pioneering role in impact investing and will continue to do so. However, only public markets have the potential to offer solutions efficiently and at the scale required to solve global issues. Equity managers must rise to the challenge by building on existing work to integrate impact data collection and assessment into their processes, by getting to know their investors' value preferences and, most importantly, by increasing engagement with companies to guide them to their shareholders' values.

Eli Koen
Emerging Markets Equity Fund Manager

Union Bancaire Privée, UBP SA - London Branch
26-37 Seymour Mews | London | W1H 6BN

[5] *Still Early Days for Private Markets*, Michael J. Cyprys, CFA, CPA, Morgan Stanley Research, 17 September 2019

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