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SRI Deconstructed – and Reconstructed

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A look under the bonnet of Sustainable and Responsible Investing and what it can achieve.

There is always a well-known solution to every human problem – neat, plausible, and wrong. ”

H.L. Mencken

The United Nations estimates that until 2030, around $5-7 trillion of investments are required per year to achieve the Sustainable Development Goals (SDG)[1]. Bearing this in mind, adapting the rules of the game on the financial markets in favour of those sectors of the economy catering to the SDG seems to be of the essence.

The objective of this paper is to provide some clarity in an increasingly dogmatic and fuzzy discussion on the recipes that may foster change towards a more sustainable economy. It tries to offer a look beyond the seemingly obvious and simple remedies that are available to tackle the vast and complex topic of the effects of Sustainable and Responsible Investing (SRI) in listed equities[2].

Since poor and superficial analysis risks leading to flawed instructions for action, we need to get a hold on fundamental key linkages to derive actionable and effective concepts that will further the objectives of sustainable finance.

1. The promise

When it comes to the topic of Sustainable and Responsible Investments (SRI) the generally accepted interpretation seems to be that by investing in virtuous companies while actively avoiding less virtuous and controversial ones, financial market participants can induce change towards a more sustainable economic equilibrium and help realising the SDG.

This stance is bolstered through many channels:

– Sales brochures from investment managers and banks describe a greener future in conjunction with SRI and imply that the investment community can be a driver of the evolution towards this improved equilibrium. In some instances, investors are offered impact calculators that provide insights into the number of hospital beds, or the number of solar power KWh generated per investment of € 1 million.
– The European Commission provides a similar implication. Introducing the EU Taxonomy of environmentally sustainable activities, the internet site of the European Commission states[3]: “In order to meet the EU’s climate and energy targets for 2030 and reach the objectives of the European green deal, it is vital that we direct investments towards sustainable projects and activities. (...) The EU taxonomy would provide companies, investors and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable. In this way, it should create security for investors, protect private investors from greenwashing, help companies to become more climate-friendly, mitigate market fragmentation and help shift investments where they are most needed.” This implies that the financial community is one driver of in the push to meet the objectives of the Green Deal.

– The Sustainable Finance Disclosure Regulation (SFDR) – which was introduced in 2019 and took effect in March 2021 – sets the stage for sustainable investments. It commits investment managers to report on the percentage of sustainable investments they hold in their portfolios. In a recent Q&A, the European Securities Market Association (ESMA), the highest financial regulatory body in the EU has stated that investment products that wish to be classified under article 9 SFDR may only invest in sustainable assets. The implication[4] is simple: Why should a regulatory body issue this kind of constraint unless it should help reach the goal stated in the EU Green Deal?

Since there seems to be such broad consensus, shouldn't there be some truth to it?

But is it that simple? Is the implementation of proper SRI strategies that abide by the spirit of regulation the solution to the complex and interconnected issues in the likes of climate change, biodiversity loss or irreversible resource depletion?

The bad news: it is not that simple.

The good news: the investment community disposes of ways to tackle the challenges at hand. However, the required efforts are a match to the complexity of the issues we face and their effects are much more indirect that we would like them to be.

2. Reality: Most equity investments are made on the secondary markets

Investment funds, private portfolios, ETFs invest in equities through the stock markets[5]. Most of those transactions take place on the secondary markets which allow market participants to buy and sell equity securities. For a trade to take place, you need a seller who wishes to dispose of an equity holding and a buyer who agrees to buy it at the quoted price. The key realisation in this context is the fact that the company that issued the equity securities is not directly involved in the described transaction.

Indeed, stock ownership[6] changes without the issuing company receiving any new capital. The company received the cash payment when it first issued the stocks. Hence, the transaction is neutral for the activity of the company and any real-world effects it may have [7].

The consequences are significant for investors seeking impact: since company activities happen independently of any investor on the secondary markets, it is not possible to attribute any impact the investee company may have in the real economy to these investors. In other words: any investment on the secondary market does not provide any additionality [8].

If an investment is intended to generate an additional real-world impact, it must enable a company to deliver more positive effects (or less negative effects) than it would in the absence of said investment. Otherwise, the status quo will remain, and no development towards a more sustainable status will occur.

One of the core objectives of SRI is to make the economic tissue evolve towards a more sustainable equilibrium that will allow current generations to provide for their needs without jeopardising future generation's ability to provide for theirs [9]. To reach this goal, additional impact must be created.

The Global Impact Investment Network (GIIN) has proposed a simple and practicable definition of impact investing: "Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return."[10]

There are three key elements to this definition:

– Intentionality,
– Measurable Impact / additionality,
– Financial return (in opposition to philanthropy).

Within this framework, investors seeking impact must ask whether their investment enables the targeted company to deliver more positive impact than what it would in the absence of the investment. If the answer to this question is no, the positive impact will not materialise – independently of the positive intent there might have been.

Interestingly, the effective relationship between an investee company and the investor is the other way around. While the investment in listed equities does not affect the investee company (as well as its impacts), the investee's behaviour impacts the investor. By taking on a stake in a company, the investor becomes co-responsible for the company and entitled to his/her due share of income from the company. In that sense, the behaviour of the investee company should matter to the investor. But ultimately, the only effect of investing in a virtuous company is the "Warm Glow[11]" of the quiet conscience of co-owning a virtuous company and that the income earned is clean. Unfortunately, there is no real-world effect.

While the alignment between an investor's values and portfolio holdings is very easy to achieve by investing in companies that share these values and divesting from companies that don't, generating the real world impact an investor might seek is much less simple.

One important implication of the statements above is that excluding equities of companies from certain sectors or based on controversy screening does not change anything in the real economy over the short and medium term[12]. Bill Gates seems spot-on saying that "Divestment, to date, probably has reduced about zero ton of emissions"[13]. Indeed, when divesting from a company, the former owner no longer has a stake in the company while the activity of the company continues unabated, albeit under the ownership of the next shareholder.

The story could end here. If financial investors on the secondary markets are fundamentally unable to be active stakeholders in the transition towards a more sustainable equilibrium by investing in listed equities, why bother?

3. Why bother despite major drawbacks?

Turning away from the issue at the realisation that its resolution is not as simple as hoped might not be the right reaction. If intuition proves wrong, it is worthwhile asking how to address the topic differently to achieve the sought impacts despite the described drawbacks.

The challenge remains pressing: as stated in the introduction, the UN estimates that approximately $5-7 trillion are needed per year until 2030 to achieve the SDG. We have shown that by simply reallocating those sums per year on the secondary markets from companies providing negative impact to those providing positive impact will not be effective. This would largely be a zero-sum game. The stated figures correspond to net new capital and credit[14] that needs to be made available and ingested by the economy[15].

So far, we only scratched the surface of relatively straightforward linkages and have discovered that the a priori obvious path to generate change through investment and divestment will not lead to the sought outcomes. Let's shed light on the dimensions

of SRI that do add value for the investors as well as on the dimensions that will ultimately generate real-world effects. It will become clear that while they can be achieved, they are less direct and less imminent than we would like them to be. However, SRI, done properly, can be part of the transition towards a more sustainable economy and add value for financial investors.

We will develop three arguments showing transmission channels through which SRI can add value and/or generate real-world effects.

- Consideration of material extra-financial risks;
- Distinction between investor and company impact;
- Federating effect of the regulatory framework.

3.1. Consideration of extra-financial risks and opportunities

The consideration of extra-financial risks and opportunities in investment decisions is a first application of SRI that might generate material effects. While this dimension of SRI will not necessarily generate any significant effects on the real-world economy, it has the potential to add value to investment strategies and to provide sense to the effort.

Considering extra-financial risks within an investment strategy is fundamental to grasp all material issues a company may face. Indeed, extra-financial risks when ignored may rapidly morph into serious financial impacts for the company – and its investors. Asset managers are well-advised to identify these risks early and react accordingly. Just considering the cash-flow strengths of a tobacco company for instance will no longer be able to show the future stock price performance potential.

Other examples of extra-financial risks with potentially significant financial consequences may include:

- Companies that revert to ongoing corruption to attain their financial objectives face legal action by the authorities;
- A brewery that operates in a geographic area with severe risks of draught due to the climate change risks going out of business;
- Companies that offer poor products that lead to injuries, leading to potential legal action;
- Coal producers facing political risks of phasing out coal.

Systematically analysing these risks with a long term view, assessing their materiality for the company as well as the quality of the related risk management within the company enables investors to make better informed investment decisions and protect the value of their investments in case identified risks materialise.

The consideration of ESG risks in the investment decisions is part of the fiduciary duty of investment managers to generate sustainable performance over the long term.

3.2. Distinction between investor and enterprise impact

Moving on to the concept of generating real-world impact of investment activities, matters become somewhat more complex. Distinguishing between investor and enterprise impact helps disentangling two concepts that render the analysis unnecessarily complex. Considering them separately provides more clarity.

The previous comments imply that in many if not most cases, investors are neither directly responsible for the positive nor for the negative impacts generated by the companies they invest in generate. Indeed, investors do not generate the impact of the companies they invest in. The companies do. However, the investors may influence the companies to generate more positive or less negative impact.

We can distinguish three categories of impact – one that is attributable to companies and two that are attributable to investors[16]:

- Enterprise Impact: social value of goods, services or other benefits provided by the investee company;
- Investment Impact: investor's financial contribution to the social value created by the company;
- Non-monetary Impact: other contributions that investors make to the company's social value.

3.2.1. Enterprise Impact

Enterprise Impact corresponds to the change that the operations as well as the goods and services of a company create in social and environmental parameters[17].

The methods for assessing enterprise impact are relatively well understood[18] and are constantly improving. As of today, a multitude of data providers – MSCI, S&P Trucost, Matter, to name only a few – offer insights into the level of contribution of enterprise activity to the SDG, helping investment managers to choose and monitor their investment targets.

As stated above, investors in the secondary markets cannot directly claim the impact that is being generated by the companies they invest in. However, company impact analysis provides meaningful insights to investors seeking impact. Indeed, the evaluation of positive and negative corporate impact provides investors guidance in terms of where to invest or where to set the cursor for their non-monetary interactions with companies. To illustrate the reasoning, consider a company that produces tangible positive impact while exhibiting significant growth. Should this company propose the issuance of new equity to finance the growth of the impactful business line, informed investors seeking impact may participate in the new public offering. On the other hand, company impact analysis may reveal easily remediable negative impacts created by the company, providing investors[19] elements about which to seek dialogue with the company and encourage it to improve.

In essence enterprise impact analysis enables investors to identify where to apply their lever to encourage change – be it increasing positive impact or reducing negative impact.

3.2.2. Impact des investisseurs

In the first and second chapters of the paper, we have established that there is no direct transmission mechanism between investors and the impact of investee companies. The interactions are much less direct and much more complex than implied by "The Promise" we posed in the first chapter.

Effective impact is about change: an investor generates an impact only if he enables the investee company to generate more positive or less negative impact. How can this be achieved?

An investor has two separate ways to influence a company:

- Through non-monetary contributions: engaging the companies informally through direct dialogue or formally at general meetings;
- Through financial interactions: investment or divestment.

Non-monetary contributions of shareholders

Academic research deems shareholder engagement as the most reliable mechanism for investors seeking real-world impact [20].

To understand this high level of confidence, it is helpful to consider the fundamental status of a corporate shareholder. An investor in a company is a co-owner of that company. As an owner his voice counts for the company. Ultimately, a company is run by company management, but how they should run it is up to the company owners to decide.

Contact can be direct by reaching out to investor relations or formal through voting at the general meetings. An individual investor might wonder what good it could do to engage enterprises in this way – and rightly so. The weight of individual investors may not be sufficient to foster any significant change at corporate level – which may even be true for large institutional investors. The influence a shareholder may have on a company directly depends on the stake held in a company.

While this appreciation is fundamentally true, there have been several developments over recent years that enable investors to reach unprecedented levels of influence. The advent of collaborative engagement platforms and the creation of proxy voting services have fundamentally changed the equilibrium of the interaction between companies and shareholders.

Historically companies knew the "activist" investors that had a high stake in the company and that were using their power to change companies from within. After identifying these investors, companies were in the position to negotiate with them and reach an agreement. This situation has changed.

Today, collaborative engagement platforms enable investors to interact, pool their interests, create alliances and enter into close dialogue with companies. With proxy voting services significantly simplifying the process of voting at general meetings, these alliances may have the possibility to change companies from within with their combined voting power.

Therefore, at first glance, collaborative engagement – be it through dialogue or votes – might seem a very compelling and effective way to further fundamental change towards more sustainability. A closer look however reveals several drawbacks:

- Good collaborative engagement requires thorough preparation, which is very time-consuming, and specialised knowledge;
- It may be challenging to find partners for the collaborative engagement that share the same objective;
- The bigger the company, the bigger the potential effect but also the more challenging to reach a quorum for change;
- Targeted companies may not respond favourably to engagement;
- Financial and sustainability objectives may be conflicting.

A successful engagement strategy does not necessarily need to be in the form of high-profile shareholder motions at general meetings or collaborative dialogue with the companies. It can also be achieved by sending a letter to investor relations asking for supposedly accessible changes to implement – such as the signature of the UN Global Compact, adherence to SBTi [21] or the publication of relevant environmental indicators. Indeed, the simpler and cheaper a request can be implemented, and the more beneficial the change will be from the company's perspective, the higher the probability of success of the engagement.

It goes without saying that depending on the complexity of the chosen engagement campaign, the process can be very time-consuming. As a consequence, it is important to thoughtfully choose the engagements that will be put into action to avoid wasting time and resources without tangible effects. There are several ways to increase the prospects of success for an engagement:

- By choosing the right companies in terms of size and openness to engagement;
- By choosing topics that are beneficial for the engaged companies while providing positive impact;
- By choosing topics that are cost-effective to implement;
- By being competent and well-prepared;
- By participating in collaborative engagements that are proposed on collaboration platforms.

Change happens step by step – even if the individual steps are very small.

The idea here is not to challenge companies just for the sake of challenging. The objective is to invite companies to provide more positive or less negative impact, which in the end will be beneficial for all stakeholders – including the concerned companies.negotiate with them and reach an agreement. This situation has changed.

Financial interactions: investment or divestment

We have established that investment or divestment [22] does not foster any material change in the real world. So why revisit the topic? While the general finding remains true, there are some very specific instances where those financial interactions may lead to real-world effects.

On June 4th, 2022, the Global Impact Investors Network (GIIN) has published a consultation paper [23] that draws the outlines of the way investors can achieve impact in listed equities. In line with academic research, the GIIN clearly differentiates between the impacts of the investees (avoiding GHG emissions, creating hospital beds, improving biodiversity...) and the impacts of the investors.

Apart from engaging the companies to foster change, the GIIN considers "patient" investment strategies that may provide stability to the stock price as one means to generate real-world impact.

The logic is simple. The patient investor who does not sell his holding at the first bursts of volatility and who remains invested even in the face of economic adversity provides stability to the stock price, which helps the company to raise new capital on favourable terms, allowing it to continue delivering its impact and expand its reach. This approach may be particularly successful for smaller companies that are in their early stages of development. These strategies require thorough research to identify a solid investment case in terms of extra-financial and financial quality. The objective of the "patient investor" cannot be to endure permanent capital losses on a recurrent basis.

One additional means for investors to enable already impactful companies to deliver more impact is the participation in their capital increases. Indeed, companies may occasionally need new capital to finance their growth. Should an impactful company issue new capital to finance a new (impactful) business line, investors will have the opportunity to directly provide fresh capital to the company, helping it to deliver more positive impact. In this case, the condition of additionality seems to be met [24].

As stated above, individual divestment strategies will have little to none effect [25] in the short or medium term. The narrative will change however over the long term in case many investors pursue the same divestment strategies [26]:

- Stock prices of concerned companies will suffer and;
- Affected companies will have difficulties issuing new capital at attractive prices.

Indeed, various academic studies confirm the long-term effect of divestment, but its magnitude varies among studies. Considering these effects, it is possible to develop an argument that divestment may incentivise management to adopt a more virtuous stance, scaling down environmentally or socially harmful activities to improve stock performance. Shareholder value-oriented management has incentives to adopt a corporate strategy that is not detrimental to the performance of the stock price.

However, while it is possible to imply that a decreasing stock price may lead to changes in corporate behaviour, these linkages are yet not sufficiently researched [27].

3.3. Federating effects of the regulatory framework

Individual investment strategies targeting virtuous companies or excluding certain companies based on actual or perceived misbehaviour risk cancelling out. Indeed, while a company might look virtuous to one investor based on certain business lines it boasts, it might look unacceptable to another based on e.g., its greenhouse gas emissions.

This is where regulation comes into play as it provides a common framework by which all actors must abide – if they do not want to be sanctioned for non-compliance. The recent efforts by the European Union in the form of SFDR as well as the EU Taxonomy of environmentally sustainable activities represent a major federating effect for SRI. These two regulations provide common terminology, common reporting standards as well as a common framework about which activities can be considered sustainable and responsible and which are not.

The regulatory framework can be considered as a beam of light that provides a common direction for the sustainability effort in the financial markets.

The rationale behind the whole regulatory body for sustainable finance is not entirely innocent – albeit well-intentioned. The European Commission has understood that the commitments made at the COP 21 in Paris cannot be met by only relying on the European Investment Bank. To reach the target, private capital must join in the game.

With the ruleset in place, it is now the turn of market forces to take effect. When SFDR invites the financial industry to disclose the percentage of sustainable assets they intend to hold, actors in the financial markets need to define the concept of "sustainable investments". The first step many actors will consider is to exclude controversial economic sectors (such as coal, oil, weapons, alcohol, tobacco, ...) from the investment universe of sustainable investments – it's low-hanging fruit. Since most (if not all) actors will do this, these sectors will be progressively cut from financing, fostering change.

The European Taxonomy of environmentally sustainable activities will have a similar effect: it clearly defines the conditions when an economic activity is acceptable from the vantage point of sustainable development. Since SFDR requires producers of financial products to disclose the percentage of taxonomy-compliant issuers, the financial industry will follow the template laid out by regulation.

Every actor will move in the same direction, implementing the sustainability strategy of the European Union – some quicker, some slower, but the direction is set. In fact, the regulatory framework provides for different speeds of implementation of the concept. SFDR supplies four distinct levels of adherence to sustainable finance:

- The basic level is represented by investment products classified under Article 6: these consider basic sustainability risks in their investment methodology – typically through simple exclusion strategies.
- Article 8 investment products "promote" sustainability factors in their investment strategies: sustainability elements are considered among other factors in the decision-making process. This "promotion" will lead to a positive bias towards virtuous companies.
- Article 8 investment products may additionally commit to a certain proportion of "sustainable" investments in their portfolios and as such adhere even more to the spirit of the EU Green Deal.
- Article 9 investment products represent the pinnacle of consistency with the framework laid out by the European Union by exclusively holding sustainable investments.

The drawback of the setup is that its effects will need time to deploy. Indeed, unless a company strategy is influenced by the (under) performance of its stock price, the regulation will only "bite" if a company needs to issue new capital, slowing down the drive towards more sustainability.

But beware: the finance industry will not be able to fully claim being at the origin of this impact for change – without the intervention of the European Commission who initiated the regulation the ensuing impact would not materialise. The impact is shared: without the regulatory "beam of light", the individual efforts risk cancelling out – but without the adherence of the financial community to the concept, no effect would materialise. It is a joint effort resulting in shared impact.

EC has changed the rules of the game. They have created an ecosystem that has the potential to lead to concrete results. Whether it will be enough quickly enough – time will tell. But a few years forward we will not be able to blame the regulators for lack of trying.

4. Conclusion

The intuitive approach of investing in virtuous while avoiding less virtuous companies generates the "Warm Glow" of a good deed. Unfortunately, while this feels good, the effect on the real world is limited at best.

If the efforts in terms of sustainable finance are not to be just another intellectually stimulating but ultimately vain exercise, other strategies need to be taken into consideration.

Engaging investee companies offers the best prospects of success nudging companies towards more sustainability. The engagement effort can take several forms – some of which may be combined:

- Individual engagement;
- Collaborative engagement;
- Influence through voting at general assemblies.

One interesting realisation is that the prerequisite for any form of engagement is to be invested in the targeted company – a strong argument against too widespread exclusion lists. Indeed, the prospects of success to reduce negative externalities seems higher in less virtuous companies. Excluding them ex ante bars the interested investor from engaging them.

The current regulatory framework – SFDR, EU Taxonomy of Environmentally Sustainable Activities, and others – provides significant help to push the economy towards more sustainability by providing a common

template in terms of sustainable finance and committing financial market participants to play by common rules. Time will tell whether the efforts will be sufficient and deploy their effects quickly enough – but the foundations are set.

While the SRI effort may be seen as the attempt to push the real economy towards more sustainability, the consideration of extra-financial risks and opportunities has the potential to add value to the financial community by highlighting risks that may create permanent capital losses or by helping to identify opportunities that may materialise in the transformation of the economy towards more sustainability.

Avoiding the pitfalls of simple but wrong solutions and using the scarce resources in a way that generates effective impact will provide sense to the many efforts that are currently undertaken in the realm of Sustainable and Responsible Investing.

1. https://www.un.org/sustainabledevelopment/development-agenda/
2. Private equity and credit markets are also well-suited for SRI strategies. However, since the rationale as well as the fundamental consequences for those asset classes differ a lot from those in listed equities, we deliberately limited the scope of this analysis to listed equities.
3. https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en
4. Heuristics: instead of thinking things through, humans tend to take shortcuts: "When this then that". This is extremely useful in everyday life but may lead to wrong conclusions when treating complex and often counterintuitive concepts.
5. Private equity investments are left out on purpose.
6. And as a consequence, ownership of the company capital represented by the stock.
7. There is one area where the company is not indifferent: if many investors are interested in the company, its stock price performs better. The company is less at risk of being taken over and in the event of a new capital issue, the additional public offering will have more prospects of success. In addition, share price performance will matter to shareholder value-oriented management.
8. See e.g. discussions on the concept of additionality on www.IFC.org
9. Definition of sustainable development according to the "Brundtland Report": Brundtland, G. (1987). Report of the World Commission on Environment and Development: Our Common Future. United Nations General Assembly document A/42/427.
10. www.thegiin.org
11. James Andreoni: «Impure Altruism and Donations to Public Goods: a Theory of Warm Glow Giving." The Economic Journal, I00, no 401 (June 1990), pp 464-477.
12. The story may change over the long term if many actors move in the same direction.
13. https://www.ft.com/content/21009e1c-d8c9-11e9-8f9b-77216ebe1f17
14. In this context, newly issued credit may not be used to repay maturing former debt.
15. As much as the investment community needs to provide the new capital and debt, the economic actors need to be able to process the provided investments in real-world projects.
16. These definitions echo those provided by Brest & Born in their paper Unpacking the Impact in Impact Investing", Stanford Social Innovation Review, 2013
17. Kölbel et al: "Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact" p. 555, Sage. 2020
18. Paul Brest, Hal Harvey Kevin Low: "Calculated Impact" SSIR, 2009
19. Only investors that have made actual investments in a company are legitimate sparring partners for a company. The bigger the stake they hold in the capital of the company, the stronger their voice will be.
20. See e.g. Kölbel et al: "Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact" p. 555, Sage. 2020
21. The Science-Based Target initiative (SBTi) is a partnership between CDP, the United Nations Global Compact, World Resources Institute (WRI) and the WWF. It shows companies and financial institutions how much and how quickly they need to reduce their greenhouse gas (GHG) emissions to prevent the worst effects of climate change.
22. This statement relates exclusively to the money flows linked to investing or divesting. For any engagement activity to be possible, an investment in the targeted company must been made.
23. https://thegiin.org/research/publication/impact-investing-in-listed-equities-strategies-for-pursuing-impact/
24. Severe proponents of the concept of additionality may object in case the issuer has no trouble finding financing. In this case, the additionality of an individual investor may be questioned as the project in case would be pursued even in absence of the capital provided by a specific investor.
25. Some market price effect can be expected should a very big investor decide to divest from a company – be it for SRI or financial reasons.
26. Effect will be exacerbated if there is a federating effect such as regulation – SFDR, EU Taxonomy – that pushes the investor community in a common direction.
27. Kölbel et al: "Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact" p. 555, Sage. 2020

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