ESG ≠ Impact Investing

GLOBAL ENDOWMENT MANAGEMENT

The popularity of environmental, social, and governance (ESG) investments has been met recently with heightened public scrutiny as investors have begun to question the legitimacy, efficacy, and measurability of ESG. Whereas ESG is often positioned in the market as a strategy for driving better outcomes for people and planet, it is, in reality, a framework for evaluating how environmental, social, and governance factors can impact a company's financial performance. The interpretation and application of ESG investing has varied across the industry in ways that have left ESG investors without clearly defined criteria around what constitutes an ESG investment or how that investment contributes to social and environmental outcomes.

How, then, should investors seek to invest in alignment with their values? At Global Endowment Management (GEM), we believe that impact investing—when done well—can offer a more intentional and stakeholder-centered solution. Impact investing prioritizes outcomes on people and the planet *alongside* financial returns, and utilizes a rigorous and consistent measurement framework that provides investors with clarity and confidence around how their investments can deliver meaningful positive impact.

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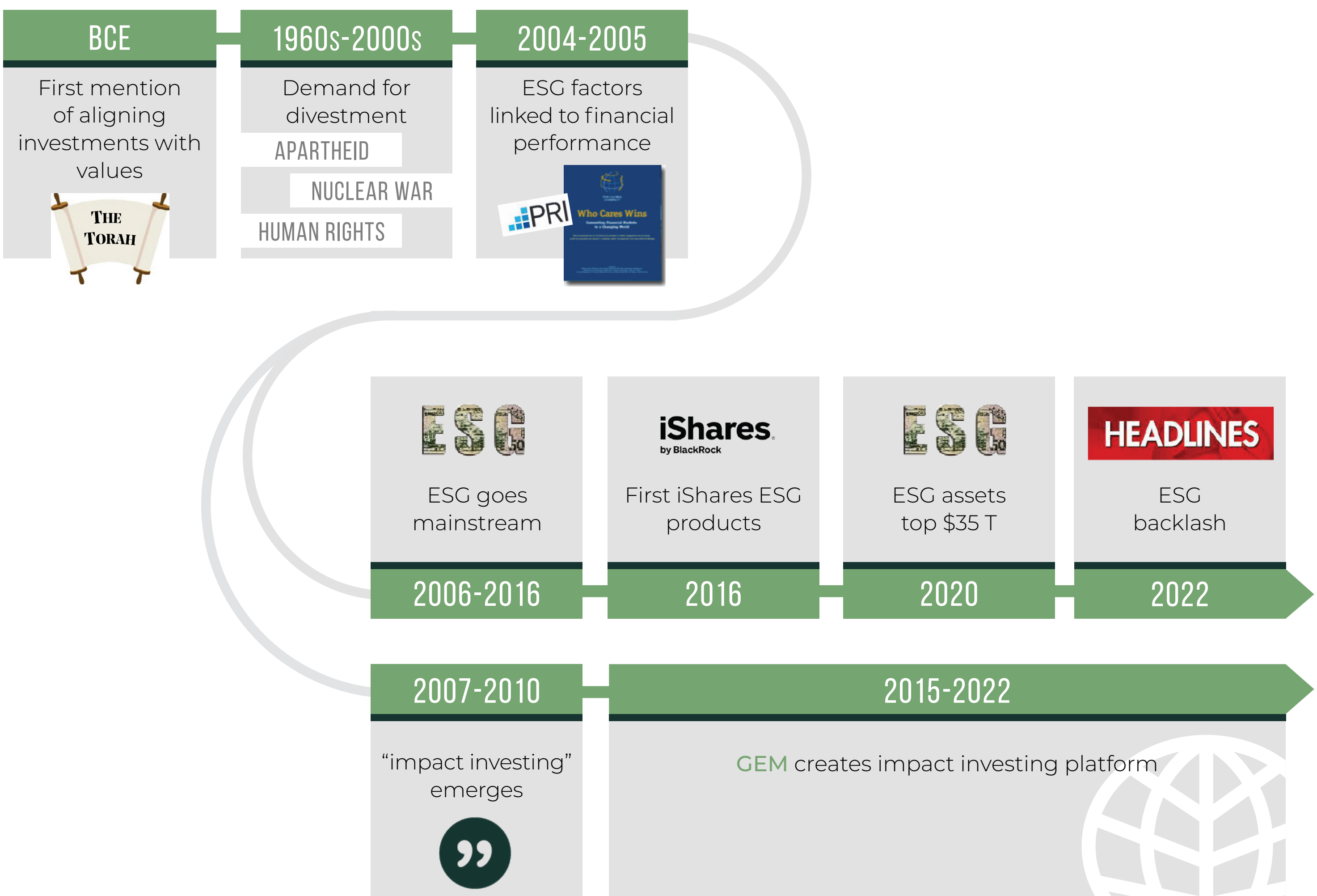
The History of ESG – A Road to Confusion

The concept of investing in alignment with values is not new—in fact, it is mentioned in some of the earliest religious texts, believed to be written as early as 1500 BC.[1] This approach continued, with support primarily from religious groups, into modern history and was adapted to more sophisticated investment approaches.

Starting in the 1960s, socially responsible investing gained popularity in the form of divestment movements, focused on divesting for moral and religious reasons. The narrative began to shift in 2004 with the publication of Who Cares Wins, a report from 20 financial institutions stating that "Companies that perform better with regard to [environmental, social, and governance] issues *can increase shareholder value....*".[2] In 2005, the United Nations launched the Principles for Responsible Investment (UNPRI), through which asset managers and corporations could commit to "incorporating ESG issues into analysis and decision-making."[3] This marked the beginning of a global effort to encourage investors to incorporate ESG considerations into investment decision-making, and to suggest that this practice could enhance investment returns. Between 2005 and 2021, ESG investments grew to more than $30 trillion—invested primarily in products that selected or avoided investments based on environmental, social, and governance factors that were deemed financially material.[4]



It is this application of ESG—considering factors only insofar as they are financially material—that underscores the disconnect between what ESG is versus how it has been marketed to investors.

Above all, the goal of ESG investing is to underwrite investment risk and enhance financial performance. Put another way, it does not necessarily equate to better outcomes for society or the environment if those outcomes are not deemed financially material.

Moreover, the ability to reliably measure the impact of ESG products is hampered by the fact that ESG products and data are inconsistent. The correlation in ESG ratings among the largest ESG ratings agencies is less than 50%, meaning that there is no single view on which environmental, social, or governance factors (or combination of factors) have a substantive impact on financial performance.[5] How ESG products leverage ESG data varies considerably — from which data provider to partner with, to which factors to incorporate, to how to construct portfolios; some products avoid certain sectors altogether while others invest across sectors but select "best in class" companies. The absence of a consistent approach makes it difficult to demonstrate the long-term efficacy of ESG. (We do not disagree that incorporating environmental, social, and governance factors can lead to better long-term investment outcomes; however, we think the data measuring performance outcomes across a range of investment products can be unreliable in demonstrating the value of ESG incorporation.)

Impact Investing = Measurable, Defined, Stakeholder-Centered Investing

ESG

Seeks to understand how environmental, social, and governance factors affect *financial performance*

versus

Impact Investing

Seeks to understand how investments impact *people and the planet*

For investors seeking values-aligned investments alongside financial returns, we believe impact investing offers a more compelling opportunity to drive positive outcomes.

Here's how GEM thinks about impact investing and how it can be implemented into a portfolio.

1. Impact investing is fully embedded into the firm's investment process and infrastructure, in contrast to firms where impact investing is separate, and often secondary, to the core work of the firm. Our impact team sits within GEM's investment team, where they underwrite the impact of every investment on stakeholders to drive portfolio decisions.[6]

2. We believe that rigor is paramount. Developed in 2019, the GEM Impact Management Project (IMP) Framework provides a structure through which we can proactively evaluate the impact of every investment on key stakeholders—customers, employees, supply chain workers, communities, and the planet—regardless of whether that impact is financially material or not.[7] In this way, our approach remains repeatable and consistent across investments and portfolios.

3. Simply put, institutional investors cannot invest for impact at the expense of financial returns. We place impact outcomes alongside investment returns and pursue both simultaneously. We believe that it is possible to seek to avoid investments that cause harm, optimize for investments that contribute to solutions, and still have a well-diversified portfolio. Moreover, we have observed that impact investments can deliver alpha by pursuing opportunities that have been overlooked or underappreciated by traditional investors.[8]

Unfortunately, the inconsistencies in ESG data, intention, and approach have muddied the waters for investors seeking to contribute to solutions to society's most pressing challenges. As the industry grapples with how to course-correct, impact investing continues to emerge as a clearer and more intentional approach to portfolio development that drives positive impact for people and the planet without sacrificing financial returns.

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About Global Endowment Management

Global Endowment Management (GEM) is a leading Outsourced Chief Investment Office (OCIO) providing institutional investment capabilities for endowments, foundations, and other long-term investors. For over fifteen years GEM has stewarded the financial assets of our clients to enable them to fulfill their missions. GEM's history is deeply rooted in endowment-style investing, with today's approach modernized to offer custom solutions tailored to each client's unique investment needs. For more information visit www.globalendowment.com

Endnotes

1. "The History of Socially Responsible Investing." Accessed November 21, 2022. https://www.mycnote.com/blog/the-history-of-socially-responsible-investing/
2. "Who Cares Wins 2005 Conference Report: Investing for Long-Term Value." Accessed November 21, 2022. https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/publications/publications_report_whocareswins2005__wci__1319576590784
3. "What are the Principles for Responsible Investment?" Accessed November 21, 2022. https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment
4. "ESG by the Numbers: Sustainable Investing Set Records in 2021." Accessed November 21, 2022. https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021
5. "ESG Ratings: Navigating Through the Haze." Accessed November 21, 2022. https://blogs.cfainstitute.org/investor/2021/08/10/esg-ratings-navigating-through-the-haze/
6. Only certain GEM funds follow an impact investment program. The firm itself and certain funds are not subject to any ESG or impact investment policy.
7. To select Impact Investments, GEM utilizes the GEM IMP Framework, a comprehensive model adapted from the Impact Management Project's Impact Management "norms" and Impact Classes, and applied by GEM to assess impact by evaluating investment strategies and managers, including but not limited to the impact of portfolio companies on key stakeholders and investment managers' contributions to impact. For more information on the Impact Management Project, please see https://impactmanagementproject.com. For the avoidance of doubt, GEM reserves the right to modify the GEM IMP Framework and its application.
8. Returns are not guaranteed.

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