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Swiss Finance Institute Roundups

Investing for Impact

Editorial

An increasing number of investors consider impact, alongside return and risk, as a relevant dimension in their capital allocation decisions. This SFI Roundup brings together insights from SFI professors and industry experts on this evolving space. The resulting exchange is especially captivating when contrasting viewpoints emerge. Key questions explored include: How can we quantify impact? Can fund managers be effectively incentivized using impact metrics? Is there a trade-off between financial returns and impact? Are investors truly driven by impact, or are they chasing a "warm glow" sentiment?

We wish you an enjoyable read.

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Managing Director

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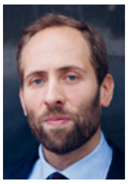

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November 2023 (Information as of October 2023 and data as of October 2023)

Facts and Figures

Alongside return and risk, impact is on its way to becoming one of the key characteristics defining an investment. What are some landmark initiatives in regards to making a positive impact on the planet, that is, on making the world a better place to live?

G. Bolliger: I view the United Nations' 17 Sustainable Development Goals (SDGs) as the largest initiative to achieve positive impact that has ever been launched. The SDGs, published in 2015, contain 169 different targets, with clear and measurable key indicators in both social and environmental areas. They allow each nation, as well as each and every one of us, to make a positive impact in one way or another.

J. Kölbel: The SDGs and the Universal Declaration of Human Rights, originally published in 1948, are often viewed as the cornerstone initiatives for making a positive impact. Although they clearly do play an important role in making the world a better place, they are "solely" political resolutions reflecting the ambitions of nations. Instead, I view the World Bank, founded in 1944, as the first true impact initiative, in that significant financial means were bundled in to ensure that it would fulfill its commitments.

P. Krüger: Within the area of the environment, Climate Action 100+ clearly stands out. This investor-led initiative, founded in 2017, focuses on getting the world's largest corporate greenhouse gas (GHG) emitters, representing more than 170 companies and a market cap of several trillion US dollars, to take necessary action on climate change, in line with the Paris Agreement. While a lot remains to be done, 75% of its focus companies have now made net zero commitments, up from 50% last year.

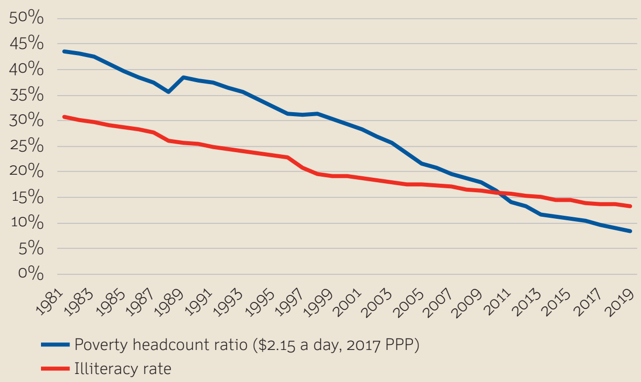
R. Sangiorgio: Building the world of tomorrow requires multiple actions from multiple players. No single initiative will be able to meet all our many layers of challenges. Education is always at the heart of the process underlying all decisions. Yet the issue with education, as for many measures, is that it takes time for its impact to materialize.

How successful have these impact initiatives been?

J. Kölbel: This question is not easy to answer, as there is no Planet B to act as a counterfactual. Ideally, we would want to compare the state of the world with an impact initiative to the state of the world without it. In practice, we have to estimate the impact, considering all alternative explanations for the results we see. There are some very clear examples of successful initiatives, such as the impact of vaccination on the eradication of smallpox. In other cases, we have less certainty about an initiative's impact. In general, such initiatives are best when they are based on a strong "theory of change," that is, on a coherent and scientifically supported explanation of why an activity should have a desired outcome.

N. Rücker: Such initiatives typically succeed in waves, both through time and across regions. Poverty, for example, was once widespread in China, while today it is close to being eradicated, thanks to intense government intervention. Unfortunately, the same trend cannot be observed in most sub-Saharan countries. When we focus on the environment, the (controversial) transition from coal to natural gas in the US helped to limit the rise in GHG emissions in a significant way. Likewise, government subsidies in China and Germany kicked off the solar boom, which today is transforming the energy systems of these countries at breakneck speed.

Worldwide poverty and illiteracy



Source: Worldbank

Note: Correlation between the two variables is of 0.96

What are the most striking facts with regards to positive impact?

L. Frésard: While the SDGs have been key in raising global awareness on a variety of the issues we are facing, in particular with regards to climate risk, most of the 17 goals will not be met by the 2030 deadline. One of the main culprits is the lack of funding—commonly referred to as "the SDG funding gap." According to the OECD, in 2030 this gap will amount to an astounding 4.3 trillion US dollars. This represents approximately 25% of the total assets under management of private markets or 3% of the total listed equity market capitalization.

P. Krüger: At the environmental level, the industrial concentration of GHG emitters is astounding. The 100 largest fossil fuel companies—infamously named the Carbon Majors—are responsible for nearly three-quarters of all industrial GHG emissions. Many of these companies are either state-owned or privately owned, meaning that investors have limited influence.

N. Rücker: For a positive impact to occur, it needs to appeal to the end users: They are ultimately the ones both making consumption choices and casting votes. For example, technology has provided us with electric cars that are superior to conventional cars in many ways. This result shows that innovation can trigger positive impacts. And that it is up to both governments and corporations to encourage and develop better products and services, which will then be picked up by the end users.

Businesses, governments, and households all have an impact. Which one is capable of making the largest difference, and who should be responsible for ensuring implementation?

G. Bolliger: Everything must start with government action. Governments must adapt their regulatory frameworks and invest in the necessary infrastructure to enable their countries to achieve the SDGs. Once they have done so, both consumers and finance can step in and contribute to generating positive impacts. The way products and services provide demonstrable and measurable contributions to the global sustainability agenda can be evaluated through the lens of the SDGs.

L. Frésard: Governments should clearly be in charge, as they have the ability to set the rules of the game through the use of laws, taxes, and subsidies. However, due to the well-known limitations of the democratic process, households are the ones who ultimately decide the course and the speed at which changes are made.

N. Rücker: While governments clearly have an important role to play, it is too easy to blame them for all of today's problems. Although governments have the ability to push things forward, the true momentum needs to come from the people. Voters and consumers, however, tend to behave in an inconsistent manner. The average Swiss voter shows quite a lot of "sustainability" at the ballot box. But Swiss consumption habits and lifestyles still come with a footprint that is totally off the "sustainability" charts.

J. Kölbel: I believe the challenges we face are sufficiently large for all actors to take a stand and to try to make the world a better place. I find that governments are best positioned with regards to internalizing negative externalities and ensuring that producers pay the true cost of production, while firms have the edge with regards to technological improvements. Finally, communities and individual people are the ones who can best work on developing better values.

Does the need for positive impact show that the current regulations are insufficient?

L. Frésard: Government regulation is, of course, one of the most powerful tools available to internalize most negative externalities, but in its current incarnation regulation is insufficient. Who is to blame? Improving the world is costly and, to this date, voters in democracies are not yet ready to pay for it. This unwillingness to pay partly explains the lack of democratic support for many government initiatives, as well as the lack of international coordination. Every country has a long list of reasons as to why other countries should be the ones bearing the cost of making the world more sustainable.

R. Sangiorgio: Regulation is only one part of the answer. We—governments, firms, and consumers—are all stakeholders when it comes to sustainability and making a positive impact on the planet. The core of the problem lies in the fact that decades of poorly designed regulations have distorted the power of the "invisible hand" of a free market economy, and that today's expectations concerning what "the market" can achieve are excessive. What we need is a constructive dialogue between lawmakers and firms, leading to a more competent government and to more coherent actions from firms.

Is the capitalist system flawed?

J. Kölbel: I believe the capitalist system, irrespective of its format, has many flaws, the most visible aspect of these being the current record level of global inequality. However, I do not envision a better system than the current one, so we need to keep on challenging it in a positive and constructive manner.

P. Krüger: I do not see any valid reason to argue that the capitalist system itself is flawed, as it has access to all the necessary tools to detect and internalize negative externalities. In the case of carbon emissions, for example, what is missing is the political and regulatory will to align a financial tax, or penalty, with the damage caused.

Impact Investing—The Theory

What is impact investing? And how does it differ from ESG?

L. Frésard: The traditional view, at least in academia, is that impact investing is the act of making a financial investment that fulfills two objectives: earning a financial return and helping achieve a positive impact, such as those measured by the SDGs. The three keywords behind impact investing are intentionality, measurability, and financial return. The expectation of a financial return, though potentially a smaller one than for other investments, is what marks the separation between impact investing and philanthropy.

G. Bolliger: In practice, impact is about "what" the firm does to the outside world, while ESG is about "how" the firm operates internally. Impact investing focuses on the ways the products and services provided by the company contribute to the SDGs; ESG focuses on how the company treats its stakeholders and on how it aligns the interests of management and shareholders through proper governance. Some companies have stellar ESG scores but carry negative impact, such as alcohol and tobacco firms; while Tesla, for example, has clearly been achieving a positive impact, but has mediocre ESG scores.

N. Rücker: The concept of impact has a special place in the broader ESG world. While ESG has been key in providing a set of tools for labeling stocks and bonds, such investments are indirect; ESG investors are sitting in the back of the company's bandwagon and have no control over where it is heading. Impact investing is typically more "interactive," as investors provide capital directly to the firm, or engage with and get involved in the firm's decision-making. Impact investing thus requires a significantly higher level of expertise and commitment than ESG investing. We could say that impact investors assume the responsibilities of a true investor.

What is the best way to measure impact?

R. Sangiorgio: Managing expectations is crucial here. On the one hand, people like quantitative results, as they are convenient when comparing projects. On the other hand, there are so many variables at play that, in many cases, it is hard to ensure anything, at least from a scientific perspective, beyond a qualitative shift. To make things more complex, we also need to include the different forms of impact which occur as we move along the value chain. For example, GHG emissions are clearly a very good measure of positive or negative impact, as they are not only straightforward to measure, but also come with a highly developed "scope" methodology that covers the value chain from the supplier all the way to the consumer. Scope 1, 2, and 3 emissions, respectively, reflect the direct emissions related to what a company burns, the indirect emissions related to the energy bought, and everything beyond that, whether on the upstream or downstream side. Yet despite this elaborate framework, huge divergences exist when measuring GHG emissions.

G. Bolliger: In the case of private firms, it is quite easy to measure impact, as investors get direct access to such information and data. In the case of green bonds, the issuer generally provides impact figures. But in the case of listed equities, things get murkier. In my impact investing firm, we developed a quantitative methodology, together with the laboratory of environmental economics at EPFL, that is based on input and output tables. Such tables report the information of the entire supply chain of the economy, as well as the externalities of each specific industry, such as water consumption, waste production, and CO_2 emissions. Such a methodology is highly detailed and enables investors and clients to assess the positive and negative impacts of each financial asset.

How is impact investing accomplished?

G. Bolliger: Impact investing can be initiated through any asset class, with each instrument having its own characteristics. Private investments, for example, tend to be better tailored to achieve impact, but scalability becomes a constraint at some point. When directing capital toward publicly listed impactful or green companies, investors can expect to reduce the overall cost of capital of the firm and also to support the buildup of its operations. Similarly, when selling the stocks and bonds of brown companies, those with a negative impact on the planet, investors can hope to increase the underlying firm's cost of capital, as well as the level of risk for the remaining capital holders.

J. Kölbel: Although impact investing is viewed as more effective when undertaken in private markets, I do not view it as a niche investment, such as, for example, supporting microfinance investments in developing countries. I believe that impact will soon become one of the many characteristics, such as return or risk, defining any type of investment. Investors need to be aware that there are significant differences between industries, with regards to making impacts. The challenge is to know which investment solution is the most efficient for achieving one's goals. Think about how complex this can be even at the household level, when we try to decide whether to buy a new e-bike, replace an old gas-guzzler car, or invest in solar panels!

R. Sangiorgio: Although we all agree that everything we do has an impact, whether positive or negative, we are unable to quantify it at the present time. This is where academics and practitioners need to place their efforts. Only once we can measure impact accurately, can we create awareness about it and give investors the information they need to decide how to allocate their capital. While investing in private markets clearly offers some upsides, in terms of additionality and more visible initiatives, shareholder activism in public markets has proven to be increasingly worthwhile. Finally, investors need to make a clear distinction between the impact they wish to have, and the impact the firm they finance is able and willing to achieve.

Are impact investment-based strategies expected to overperform or underperform the market?

P. Krüger: The general consensus is that if investors see impact as a positive attribute, as more and more of them do, then they should be willing to "pay" to achieve it, and therefore impact investments should underperform the market. To believe the opposite, one would need to be in a world where we could either solve problems for free or get paid to do so. Nonetheless, sustainable investment strategies, in particular ones in the US, have performed remarkably well in recent years. Current academic research suggests that these positive returns are abnormal and may be driven by ongoing price pressure toward sustainable funds, and not by higher expected returns, per se. If this is the case, then it raises a major red flag. Either way, I view promises of strong positive impact plus significant outperformance as suspicious.

N. Rücker: The answer essentially depends on the investment strategy you seek to pursue. If your aim is simply to engage, then you should be able to achieve a similar risk-to-return performance as that of traditional stock and bond markets, assuming you hold well-diversified and liquid assets. The sole additional cost to you would be related to investing your time in interacting with the management and voting at the general assembly. Ultimately, your engagement should transform into a financial benefit, as your voice gets heard. If you take the capital provision route, then your investment will be less diversified and less liquid. Your benchmark should then be private markets, with higher risks, higher returns, and a very long investment horizon. The relative novelty of impact investing and its instruments, such as green bonds, means that the track record is short and thus less conclusive.

Impact Investing—The Apparent Successes and Failures

What have been the most successful initiatives in impact investing?

J. Kölbel: On the one hand, microfinance and financial inclusion initiatives, such as those conducted by the Grameen Bank, have made significant and positive impacts on the lives of millions of people. On the other hand, there has been a more subtle, yet more global, shift throughout the overall economy from worker safety to chemical awareness to preventing corporate corruption.

R. Sangiorgio: Although still in its infancy, I believe blended finance has the ability to make a major difference. Its approach, through which private funds are mixed with other types of funding sources, such as government support, development finance, or philanthropic capital, has already started to move into the private sector. This hybrid framework provides the innovative element the public sector lacks, but which the private sector can provide. It also pushes the return-to-risk ratio to a level at which private capital is willing to get involved and, ultimately, the project can take off. Last but not least, blended finance bridges the gap between the short-term needs of market-oriented private investors and the long-term agenda required to generate a lasting impact.

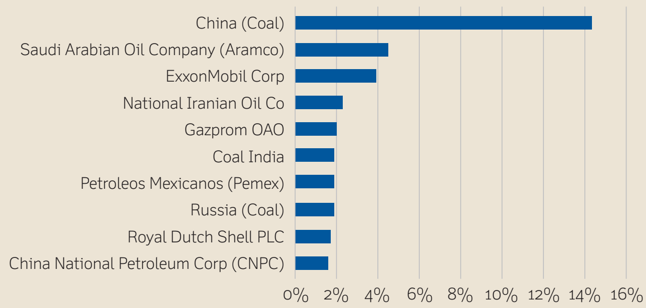
N. Rücker: This question is difficult to answer, given the great diversity of initiatives. The activist investor Engine 1 was successful in landing three eco-favorable directors on the board of ExxonMobil in 2021, with only a few employees and marginal ownership. But has the presence of these directors been effective, in terms of nudging ExxonMobil closer to a net-zero path? Various investors proclaimed their exit from fossil fuel companies, cleaning up their portfolios and shedding climate-polluting assets. But did their exit curb emissions? Clearly not. As long as someone buys coal, there will be a miner digging it out of the ground. Fossil fuel companies can survive in private hands, well outside of capital markets, through the cash flows provided by consumer demand. Success actually occurs all the time, step by step, thanks to the determined impact investors and innovative entrepreneurs who are developing solutions for a more sustainable world.

Do signatories of impact initiatives keep their promises?

P. Krüger: Empirical research provides a mixed answer to that question. For example, the signatories of the Principles for Responsible Investing (PRI), who state that they incorporate ESG into their holdings, have better ESG scores than non-PRI signatories, but only for institutions based outside the US. In the US, there is an apparent disconnect between what investors claim to do, in terms of ESG, and what they really do. This discrepancy shows that nothing can be taken for granted and highlights the need for well-targeted regulations to fight back on greenwashing.

L. Frésard: Although such initiatives are a great way to move forward, research has shown that the signatories are typically firms that have both the ability and the willingness to be more sustainable. Unsurprisingly, the largest polluters are essentially absent from the debate. To make things worse, most of these firms are either state-owned or privately owned, such as the oil and gas majors Gazprom or Saudi Aramco, or the global shipping companies CMA CGM and MSC, placing them out of the public eye and making it difficult for investors to steer them in the right direction.

Overall share of scope 1+3 global industrial GHG emissions, 1988-2015



Source: CDP

Note: Coal production in China and Russia is represented at the national level due to data limitations

In that case, have mandatory measures of ESG disclosure been effective?

P. Krüger: Mandatory ESG disclosure has been shown to have direct and clear benefits for publicly listed firms and for the environment. On the one hand, regulation improves the quality of corporate information shared, with a stark increase in stock liquidity. On the other hand, firms—in particular carbon-intensive ones—have been proven to reduce their GHG emissions through operational adjustments. These results clearly suggest that well-tailored regulation is effective.

How successful are green bonds and sustainability linked bonds?

P. Krüger: The cumulative amount of sustainability-oriented bonds issued in 2022 was nearly 4 trillion US dollars, of which the vast majority were green. This is an impressive figure. But the premium of green bonds compared to conventional bonds is small, as it is ultimately the credit risk of the underlying firm which defines the coupon, and that risk remains the same whether the bond is green or not. In the case of sustainability linked bonds (SLBs), the coupon is contingent on the borrower achieving a predetermined sustainability performance target. While data show that a premium does exist in this case, it is small. Strangely, the (average) maximum potential penalty for not reaching the target is smaller than the savings in coupon expenses related to the SLB. This suggests that SLB issuers are currently getting a "free lunch." Hopefully, the market will mature within the next few years, which should improve the disclosure of sustainable and impact measures. As of now, I view green bonds and SLBs as signaling tools for firms and investors.

G. Bolliger: The SLB market is still in its infancy; its underlying goals are not ambitious, and the penalties are marginal. Ongoing research shows that approximately one quarter of SLB issuances are overpriced. Such overvaluing leads to falling SLB prices in the secondary market and to increases in stock prices—a movement which is consistent with a wealth transfer from bond holders to shareholders. To improve market efficiency, there is a clear need for greater transparency in the bond prospectus and certification process, along with a means of obtaining information on the cost for the firm to implement the infrastructure needed to reach its objectives. At the end of the day, bond investors need to be adequately rewarded for the risks they take. Finally, SLBs should target impact achievement, not just ESG scores.

What evidence do we have regarding the financial performance of impact investing?

P. Krüger: It is too early to provide a firm answer, but more and more evidence shows that companies subject to active shareholder engagement enjoy positive abnormal returns. Another strand of research demonstrates that those in which shareholder engagement is successful also tend to be less risky. While these results point to a "bright side," there are also studies that will demonstrate that impact investing does not lead to financial success.

R. Sangiorgio: I am convinced that impact investing is profitable now and will become even more profitable when the returns we calculate include the true costs of production. The issue in today's financial world is that performance is improperly estimated, as the cost of negative externalities is not correctly valued and incorporated. In the long term, we will see that investing in solutions is more profitable than investing in problems. For example, the oil and gas sector will soon face considerable capital expenditures and will see some of its fossil fuel fields become stranded. What we observed in terms of their profits last year was not actual value creation.

Are investors willing to pay for impact investments?

L. Frésard: Some investors are. They are genuinely well-intentioned. Recent research indicates that what motivates most people who invest in impact products is a desire to generate a positive impact on the planet. Nevertheless, the magnitude of their impact seems to hold less value for them. Thus, investors allocate money to impact investments to give themselves a so-called "warm-glow feeling." There is nothing wrong with this motive, but I worry that many financial institutions are exploiting this feeling without necessarily generating true impacts. For instance, we currently see a lot of relabeling going on within the fund industry, with many existing funds suddenly adding an impact label to their names and communications. Investors need to be cautious about the real impact their money actually generates. Generating false hopes might be costly for the planet in the long run.

R. Sangiorgio: Clients I meet, whether institutional or private, are more and more interested in achieving a positive impact. They realize that their investments are more than just returns—they are our positive or negative contribution to the real economy of the near future. But nuances exist. Some people are willing to sacrifice returns to have an impact, while others believe that a positive impact can be achieved without reducing their financial returns, but instead by extending their investment horizon. Some connect positive impact with innovation and returns, others look at negative impact as a source of risk.

Many institutional investors choose to reduce the GHG emissions of their financial portfolio to demonstrate that they are committed to making an impact. How effective are these measures?

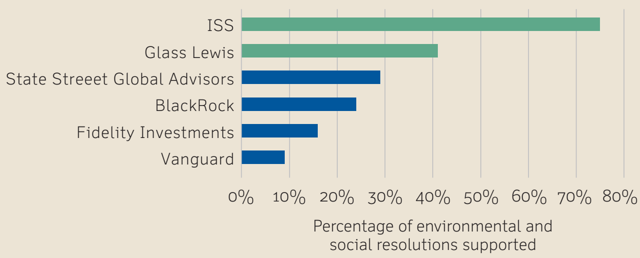
P. Krüger: Research provides a disappointing answer to this question. Although institutional investors claim to be committed to making a positive impact by decarbonizing their portfolios, the bulk of this effort is done by re-weighting their holdings toward low-emitting firms, instead of engaging with high-emitting firms and requesting that they curb their emissions. As a result, environmental problems are increasingly being pushed toward the less visible parts of the market, and likely also toward investor groups who are less motivated to tackle corporate carbon emissions. In a similar way, to appear greener, many publicly listed firms have sold the brown parts of their businesses to private investors. The negative impact and the emissions still occur, only in a less visible manner. We need to be aware that excessive pressure on investors and firms to look green is actually counterproductive, as it pushes the polluting activity out of sight.

N. Rücker: A portfolio is simply a mirror of the economy that the underlying companies and governments represent. Holding a given portfolio exposes you to that "given" economy, but it does not provide you with the ability to influence it. Reducing the GHG emissions of your portfolio might reduce your own exposure to fossil fuel prices and CO_2 costs, but it does not change much in terms of the "real" economy's emissions. The past years' mantra of lowering a portfolio's footprint makes me wince at times. As successful investors, our portfolios should represent tomorrow's economy, not today's.

What is the right course of action for investors seeking to deliver true impacts?

G. Bolliger: Shareholder activism is a powerful tool if, and only if, the activists' ownership in the company is high enough and these investors are ready to divest if the company does not change its business practices. Experience shows that medium-sized investors are sometimes very naive about the real effects of engagement. For some companies, greening their activity involves a 360° shift of their business model and a massive capital expenditure. It is typically far more complex and time consuming than many corporate governance issues. The argument that when sustainable investors sell the equity or the bond of a brown company, someone else buys it, is true. But if many investors sell, the shareholder base of the brown company becomes more concentrated, which means less risk sharing and therefore higher costs of capital. Furthermore, the statistics are quite clear that the biggest institutional investors, such as Blackrock and Vanguard, do not play the role they could. If you look at ShareAction statistics, you will see that during general assemblies they approved only a very few topics aimed at reducing the environmental footprints of companies.

Proxy voting advisor recommendations and effective asset manager voting, 2022



Source: ShareAction

Note: ISS and Glass Lewis are the world's two largest proxy voting advisors; BlackRock, Fidelity Investments, State Street Global Advisors, and Vanguard are the world's four largest asset managers

Many capital owners are not able to express their views and to engage with firms. Why is this?

L. Frésard: We collectively believe that voting is too complicated; hence, we delegate it. This belief explains why proxy advising became so popular after the turn of the century. Yet with the digital technology available today, it puzzles me why it is still so complex for the ultimate owners of firms to express their views. We use technology to express our views on nearly everything, from restaurants, hotels, and movies to university professors. It should not be so complicated to express our views concerning the assets we ultimately own, either directly or indirectly.

N. Rücker: The current system clearly limits investors' ability to engage, with regards to impact investing. Unfortunately, I do not have high expectations, even if a new system allows capital owners to vote directly. We currently have all the technology needed to allow it, but it will still require a lot of work and time to cast an educated vote. My hunch is that we will keep on seeing institutional investors voting in accordance with the opinion of their proxy advisors, and we will never really know what the preferences of the capital owners actually are.

R. Sangiorgio: We are clearly facing a legacy system, and it will require some time before we will see each and every capital owner deciding either to vote directly or to delegate the vote itself. With regards to the volume of work and analysis involved in voting, I believe artificial intelligence (AI) has a key role to play. When properly trained, AI is already able to crunch data and reports and to provide the first layer of voting recommendations, in line with the capital owners' values. I predict AI will soon facilitate the overall voting activities for investors who would like to vote, but who currently do not have the resources to do so.

INDUSTRY

Impact Investing—The Legacy of ESG, and the Challenges and Limitations Ahead

ESG ratings are notorious for disagreeing. Is this an issue?

J. Kölbel: ESG ratings across various rating agencies are indeed divergent. When breaking this divergence into the elements of scope, weight, and measurement, data show that more than half of the confusion is linked to the measurement, which occurs when different rating agencies measure the same attribute using different indicators. For example, a firm's labor practices could be evaluated based on workforce turnover, or on the number of labor-related court cases taken against the firm. Divergence is a key concern within the debate on sustainability and impact. My recommendation is for fund managers to select the one rating whose methodology is best aligned with their own objectives or else to create their own rating system based on raw data.

G. Bolliger: ESG ratings do disagree, but so what? Analysts' ratings about firms disagree as well, and nobody cares. People tend to compare ESG ratings with credit ratings. But ESG assesses the intangibles of a company, which is not at all similar to assessing its credit risk. Some investors, however, are disturbed by the disagreement among ESG ratings. I have had several discussions with pension fund investment board members who did not understand why they received different ESG ratings for their portfolios from different providers. It is the role of asset managers and consultants to understand the differences between the providers of ESG ratings and to explain to investors what they measure and do not measure.

L. Frésard: Many people see this disagreement as a bug. I see it as a fundamental feature of ESG ratings. The various ESG ratings reflect different values, and their underlying elements are very difficult to measure, so it is normal that they do not reach a consensus. When we talk about values or tastes, it is normal to disagree. We do not all vote for the same political parties or fancy the same wines. We need to get over this debate, move on, and focus on how much impact investors' capital does have on firms, on our societies, and on the planet. Answering these questions with valid indicators, such as those embedded within the SDGs, is where we need to put our resources.

N. Rücker: ESG data is largely qualitative data, subject to individual frameworks. The quantitative appearance of an ESG rating makes us overlook its essential subjective nature. To deal with this issue, in my bank we do not focus on the general scores of the various ESG data providers, but on the underlying granular data they use to generate these scores. We then dissect the various values at play, tweak them as necessary, and complement them with input from our own in-house experts. At the end of the process, we construct an analysis around four themes—climate, natural capital, human capital, and governance—where each theme receives a score, which can be negative or positive. Such an approach provides far more depth than a single ESG score within the positive range, and also ensures that we, as financial managers, control the full scoring system and are thus able to explain it.

Is the concept of bundling ESG together outdated and overly simplistic?

L. Frésard: The concept of ESG has made investors aware that there is more than just financial return and risk to an investment. It is a simple way to encapsulate various important elements. There is a growing recognition, however, of the need for greater nuance and customization in ESG analyses, as well as for continuing the ongoing efforts to refine standards and reporting practices. The key is for investors and organizations to strike a balance between simplification and the need to address the ESG challenges and opportunities relevant to their specific context.

R. Sangiorgio: Humans have always sought to oversimplify things and to summarize them with a single figure. The success of IQ scores, the Body Mass Index (BMI), and GDP growth are other examples of this trend. We need to acknowledge that sustainability and impact are complex and multidimensional, and that it is not possible to score GHG emissions, biodiversity, employee safety, and board composition with a single figure. This excessive use of numbers to simplify the process of analyzing firms and investments has generated a substantial amount of opacity. I believe words are better suited than numbers when describing the sustainable reach of a firm and the impact of an investment.

Deforestation and land use changes are estimated to contribute to up to 20% of total global warming. What are the limitations behind the seemingly obvious solution of planting trees?

N. Rücker: Planting trees is clearly an honorable act. By planting trees you are not only capturing carbon and supporting biodiversity, but also providing jobs and reducing land erosion. But there is a significant time lag between when the tree gets planted and when it begins to fulfill its purpose of capturing carbon. More importantly, it is a great challenge to restore original ecosystems, as biodiversity is multi-dimensional. Carbon offsets might bring a financial incentive for reforestation, but only with regards to carbon sequestration, implying that the many other measures needed to restore an ecosystem might not be rewarded and thus might not be pursued. Thus, we can see that there is a great degree of "fuzziness" surrounding the simple act of planting a tree.

Targets set by firms and governments are typically unambitious, while reaching net zero by 2050 will require a reduction in emissions of 10 percent per year—roughly what the COVID-19 pandemic imposed upon us. To replicate the global lifestyle of 2020 seems unrealistic. What needs to be done?

G. Bolliger: Data reveal three different types of firm behavior: Firms that set targets that are not ambitious enough; firms that set ambitious targets, but will never be able to achieve them; and, finally, firms that set ambitious targets and are on the right track to achieve them. Investors should prioritize this third group of firms by providing them with more capital. At the aggregate level, the only way to put all firms on the right track is to price carbon appropriately. But incorrect carbon pricing, combined with an incomplete number of industries covered by the current emission trading schemes, discourages the economy from moving promptly in the right direction.

P. Krüger: The current method is indeed overly permissive, as firms also have the ability to choose their base year and to focus on carbon intensity targets which measure emissions per unit of output. This system is hugely misleading. Oil producers, for example, appear to be improving their carbon intensity when oil prices go up. Tighter regulation, based on absolute targets, is urgently needed. I do have high expectations for the upcoming European standards, which will not only be mandatory but will also look beyond public firms and into private firms and subsidiaries.

Insufficient funding is often cited as the main constraint on achieving more positive impacts. Is this true?

G. Bolliger: Yes, it is. On the one hand, the funding needs have increased substantially since the COVID crisis, especially for the SDGs related to social topics. On the other hand, although the impact investing market is still small, it is growing rapidly. Finding the trillions of US dollars needed to bridge this gap will be no easy feat, as publicly listed impact portfolios are largely concentrated and have significant industry biases, which leads to an increase in tracking errors with respect to traditional benchmarks, and thus prevents some institutional investors from allocating money. Another question mark concerns the potential violation of fiduciary duties when investment managers consider impact alongside financial performance. Regulators need to jump in and require that impact be an explicit component of all institutionally managed portfolios.

N. Rücker: I do not see a funding gap. Impactful solutions, such as solar panels, electric cars, and precision farming, are not only powerful, but also commercially available and economically viable. I view the funding gap as a political tool, because mind-boggling figures prevent action. Incomplete information and laziness, as well as institutional barriers, such as the rigid market, or various social structures, are the key drags here. The renewable energy sector, for example, does not need to be subsidized to be profitable. What is needed, though, is an end to the subsidies the fossil fuel industry cashes in on, which reached an all-time high of 7 trillion US dollars last year!

R. Sangiorgio: Although the financial industry is often viewed as a bridge between players with excessive liquidity and players with insufficient liquidity, it does have the ability to nudge where capital gets allocated, based on risk considerations. In my opinion, the financial industry today is overly restrictive. The concept of risk needs to be reviewed and updated not only to include climate risk in a more widespread and rigorous manner, but also to allow for aspects of risk-mitigation to be included. Additionally, the access to private markets and illiquid investments should be facilitated. Such an approach would allocate money toward positive impact investments, which is also where the higher financial returns and lower overall risk, in its broader sense, will be in the future.

Because of trade-offs between delivering financial performance and delivering impact, how should impact be rewarded?

P. Krüger: Rewarding fund managers for both monetary profits and positive impact is a major challenge. Data covering the US financial industry show that compensation is mainly tied to economic performance and barely at all to impact performance. Interestingly, at the corporate level, a majority of S&P 500 CEOs are now seeing their bonuses tied to ESG or impact achievements. This dual system has led to large bonuses based on ESG improvements and positive impact, despite negative financial performance. I anticipate animated shareholder meetings within the next few years and a thorough review of what fiduciary duty entails.

N. Rücker: We are more comfortable assessing financial performance than impact performance because we tend to favor quantitative measures over qualitative ones. Nonetheless, I do not necessarily see a misalignment between the two objectives. For example, in the case of fund managers operating within the liquid market, we could easily include a metric covering their corporate engagement. I do not see how this would be detrimental to their financial performance. Decision makers within the corporate and political worlds have always been evaluated upon various and multiple goals. I do not understand why adding impact as an additional objective is either impossible or groundbreaking.

G. Bolliger: A promising path forward is the creation of a market for SDG allowances and the monetization of the SDG achievements, similar to what has been done for carbon allowances. This market would allow firms and projects that make a positive impact to get credit for doing so, and require those that make a negative impact to have to buy such credits. As a consequence, impact investors would get SDG credits that can be monetized, creating a win-win situation through which we can all move forward.

Beyond Impact Investing

Non-Governmental Organizations (NGOs) and philanthropies are often cited as the most successful at generating positive impact—even more successful than governments and large impact funds. Why is this?

L. Frésard: NGOs and philanthropies tend to have very simple mandates and to be given money to achieve them by finding the best available projects. These facts naturally lead them to specialize, and to gain significant expertise and efficiency. It is difficult for governments to have similar levels of specialization, focus, and expertise, as they need to target many different objectives. Let us not forget that governments play an indirect role in the size and success of the philanthropic sector. Indeed, a large amount of funds is channeled to this sector for tax reasons, granted by governmental rules. Whether this money would be better used by governments or other private entities, such as impact funds, is an open debate. However, NGOs and philanthropic actors have undoubtedly been effective in many areas, and other players in the impact space may want to pay closer attention to their practices and organization.

What do you make of the amount of money NGOs and philanthropies harvest worldwide?

J. Kölbel: The roots of charity go back thousands of years and are a cornerstone of every society and religion. Donating money provides many benefits, which range from supporting a positive cause, to feeling good about the donation, to being socially well-perceived, to getting a tax discount. When you acknowledge that time, care, and material resources can also provide positive impacts, you discover that capital flows within the financial market are not the sole means to generate impact. The success of NGOs and philanthropies in today's world shows that many people care about social and environmental issues, and support the civil society to achieve progress beyond the remit of business and regulation.

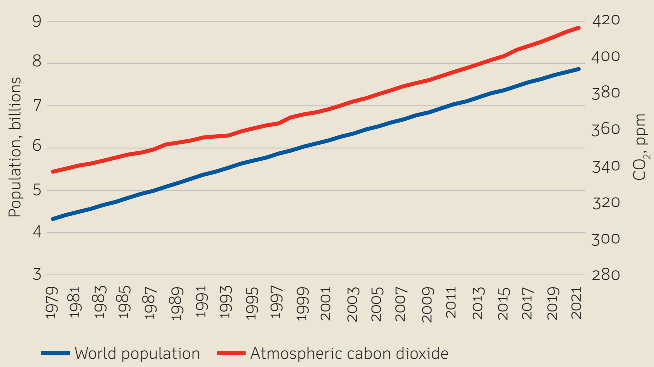
R. Sangiorgio: Although it is hard to nail down the actual number of people who donate annually to NGOs and philanthropies, the assets they own is estimated at a few trillion US dollars. This figure proves that, on the one hand, many people are willing to sacrifice financial resources to achieve positive impacts, while on the other, there is a clear need for such initiatives. What is fascinating is the flexibility and speed at which NGOs and philanthropies can operate, when it comes to bridging the gap in blended finance, pointing their fingers at the dirty parts of our economy, and also showing investors where underlying reputational risks may be lurking. I personally believe fund managers should openly embrace active exchange with NGOs and also look into the often highly valid, yet untraditional, data they gather.

What responsibility do households have to make positive impacts through appropriate consumption choices?

P. Krüger: Over the past 20 years, worldwide per capita GDP has more than doubled, which has been central in improving many of the social aspects of our lives and has allowed us to enjoy a vast variety of new products and services. But in the meantime, global population has also increased by more than 25 percent. The combined effect of more wealth and more consumers has led to increasing pressure on the environment. Better-informed consumption choices, as well as active political engagement such as voting, are clearly the responsibility of all households with regards to achieving impact.

R. Sangiorgio: Households have many ways of creating positive impact. While consumption choices and voting are the two most obvious ones, the role of education and knowledge exchange must not be underestimated. Positive impact, whether in the form of lower consumption, impact investments, or supporting a circular economy, needs to be translated into "cool success stories" and shared within social and professional circles.

World population and atmospheric carbon dioxide



Sources: NOAA and United Nations

Note: Correlation between the two variables is above 0.99

Do we still have time to act, with regards to making positive impacts on the environment, or is it already too late?

J. Kölbel: Today's problems were caused by humanity, so it is up to humanity to fix them. Although there is a dire sense of urgency, humanity is both ingenious and adaptive. Throughout history, technology has often been shown to provide swift solutions. But I must stress that the sense of urgency is not the same across all countries. With regards to global warming, for example, the situation in Switzerland should be bearable until the end of the century, which will not be the case for lowland countries or those located along the equator. So, the question really is: too late for whom?

L. Frésard: The climate is clearly changing and, in my opinion, it is changing fast—faster than our speed of reaction to contain the change. Finance professionals can work on solutions to mitigate climate change and climate risk, as well as developing incentives to steer society toward a more sustainable world. But the answer of knowing what the consequences of all our economic activity are, and whether it is too late or not, ultimately belong to the scientific community.

G. Bolliger: Time is undoubtedly running out. Based on the current trend, many SDGs will be missed by 2030, as will be net zero by 2050. While many people argue that technology still has a lot to deliver, I believe that placing all our hopes on tech-based solutions is somewhat naive. Nature-based solutions should get their fair share of attention, and households also need to acknowledge that they can make a difference every single day.

R. Sangiorgio: I believe we still have time, otherwise I would not be doing my current job. But it is now or never. We are the first generation to know we are the cause of global warming, and we are also the last who can do something about it. It is a huge responsibility. Innovation could be game-changing. For example, artificial intelligence allows us to do today what we could not even have imagined a couple of years ago. The biggest threat I perceive is "whataboutism," which can potentially undermine every step in any positive direction. As we know, perfect is the enemy of good.

Finally, how do you achieve positive impact as an individual?

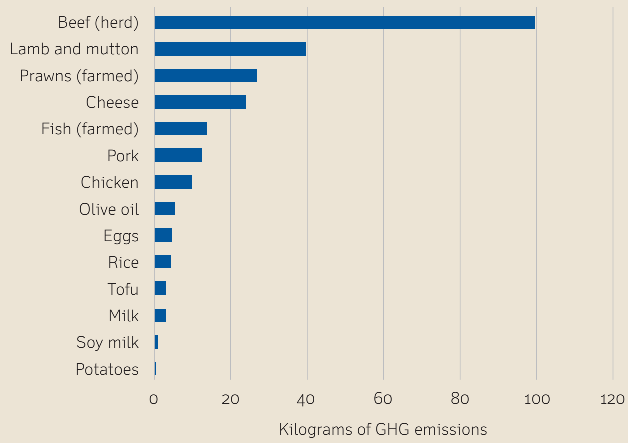
J. Kölbel: As a consumer, I can have a very direct impact, as businesses are very responsive to how money is spent. I differentiate between products, such as by buying fair-trade coffee, and I also dial-down on the consumption of products with high negative impacts, such as air travel. Ultimately, I think voting is the single most impactful thing an individual can achieve.

N. Rücker: As a family, we have a focus on the climate and have been tracking our footprint for years, while developing our awareness. Our footprint is currently above 3 tons per person per year, still exceeding the net-zero-compliant 2 tons target, but a fraction of the Swiss average of almost 14 tons. Interestingly, we do not see any sacrifices in our lifestyle.

G. Bolliger: On the positive side, I fly much less than I used to, commute with public transportation, favor local goods, and have equipped my house with solar panels. However, I continue to occasionally eat beef and to ski on mostly artificial snow, which is certainly hurting my carbon footprint.

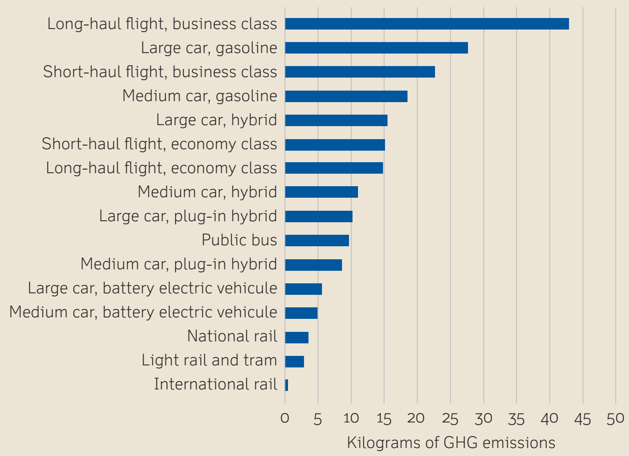
R. Sangiorgio: I ask myself and others questions, and I also educate myself further through reading. Overall, I aim to be curious. I also generate impact when at the grocery store, when dining with my family, and when booking my vacation. We must not settle for "It's not possible," "It's too complicated, " or "It must be true, because someone said so."

Kilograms of GHG emissions per kilogram of product



Source: Poore, J., & Nemecek, T. (2018). Reducing food's environmental impacts through producers and consumers. *Science*.

Kilograms of GHG emissions per 100 kilometers travelled



Source: UK Government

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