On the Way to Impact Investment: Mind the Gap between Theory and Practice

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Contents

1. Overview

This paper:

> Reviews some of the most prominent impact management and measurement frameworks developed by leading institutions around the world with the aim of identifying a baseline for what constitutes impact investment;

> Compares the current state of "impact-branded" investment practices by listed equity investors to the criteria identified in the baseline, in order to assess the level of misalignment in the interpretation of impact in theory versus practice;

> Identifies the Sustainable Development Goals (SDGs) as a useful framework for assessing the impact of companies, which is confirmed by increased investor adoption;

> Concludes with recommendations on how the investment community – including investors, regulators, financial service providers, and non-profit organizations – can address this issue; and

> Sets the stage for further exploration of the societal value associated with the different SDGs and SDG-aligned impact from companies.

2. Impact investment and why we need it

Despite significant regulatory evolution and increase in financial flows as indicated by the growth in assets managed in accordance with the Principles for Responsible Investment (PRI)[1], many of the critical environmental and social challenges facing the world have become even more acute and have led to systemic risks emerging. The most mainstream sustainable investment (SI) practice of ESG (environmental, social, and governance) integration has been defined by the CFA Institute and PRI[2] as "the explicit and systematic inclusion of environmental, social and governance factors in investment analysis and investment decisions". However, the way in which it is being practiced has been deemed insufficient to deliver answers of the right magnitude to the issues at stake by many observers, NGOs, regulators, and investors themselves.

There are numerous interlinked systemic issues that the global community is far from resolving – climate change and wealth inequality being just two examples.

Human-induced warming reached approximately 1-degree above pre-industrial levels in 2017, increasing at 0.2-degree per decade.[3] An annual reduction of over 7% in greenhouse gas emissions (GHG) is required to stay within the 1.5-degree pathway, set by the Intergovernmental Panel on Climate Change (IPCC) as the upper limit for preventing the worst impacts of climate change.[4] However, global greenhouse gas (GHG) emissions have risen by 1.5% per year over the last decade (2010–2020). Importantly, according to the IPCC, mitigation and adaptation options consistent with 1.5-degrees pathways are associated with multiple synergies across the SDGs.[5]

In the United States, the average income of households in the top fifth of income distribution was 16.6 times as large as those at the bottom in 2019, compared to 10.3 times in 1975.[6] More importantly, financial wealth inequality - which affects income inequality through the capital income generated by wealth – is sharper than the income gap and is growing more rapidly.[7] In 2017 the three wealthiest people in the United States owned more wealth than the bottom half of the population combined, while over 19 percent, had zero or negative net worth.[8] Even these figures underestimate wealth concentration, as the growing use of off-shore tax havens, domestic tax loopholes allowing much of this wealth to not be considered "taxable income" unless assets are sold and gains realized, and legal trusts has enabled concealing of assets more than ever before.[9] For example, according to a June 2021 analysis, United States' wealthiest executives paid USD 13.6 billion in federal income taxes in a period when their collective net worth increased by USD 401 billion.[10] A similar pattern is repeated throughout Europe, if less pronounced.[11]

The "Tragedy of the Horizon" illustrated in former Governor of the Bank of England Mark Carney's seminal speech back in 2015[12] demonstrates why investors must now take into account what is known elsewhere as "double materiality" – namely, the financial impact of sustainability issues on a company's financial

1 PRI 2020. Annual report
2 CFA Institute and PRI 2018. Guidance and case studies for ESG integration
3 IPCC, 2021. Special Report – Global Warming of 1.5°C
4 UNFCCC 2020. Cut Global Emissions by 7.6 Percent Every Year for Next Decade to Meet 1.5°C Paris Target – UN Report
5 Ibid.
6 Congressional Research Service, 2021. The U.S. Income Distribution: Trends and Issues
7 Pew Research Center 2020. Trends in income and wealth inequality
8 Institute for Policy Studies 2017. Billionaire bonanza
9 Ibid.
10 The New York Times 2021. Wealthiest Executives Paid Little to Nothing in Federal Income Taxes, Report Says; FT 2021. US investigates leak of records showing billionaires pay little tax
11 Piketty, T. and Saez, E., 2014. Inequality in the long run. Science, 344(6186), pp.838–843.
12 Bank of England, 2015. Breaking the Tragedy of the Horizon – Mark Carney

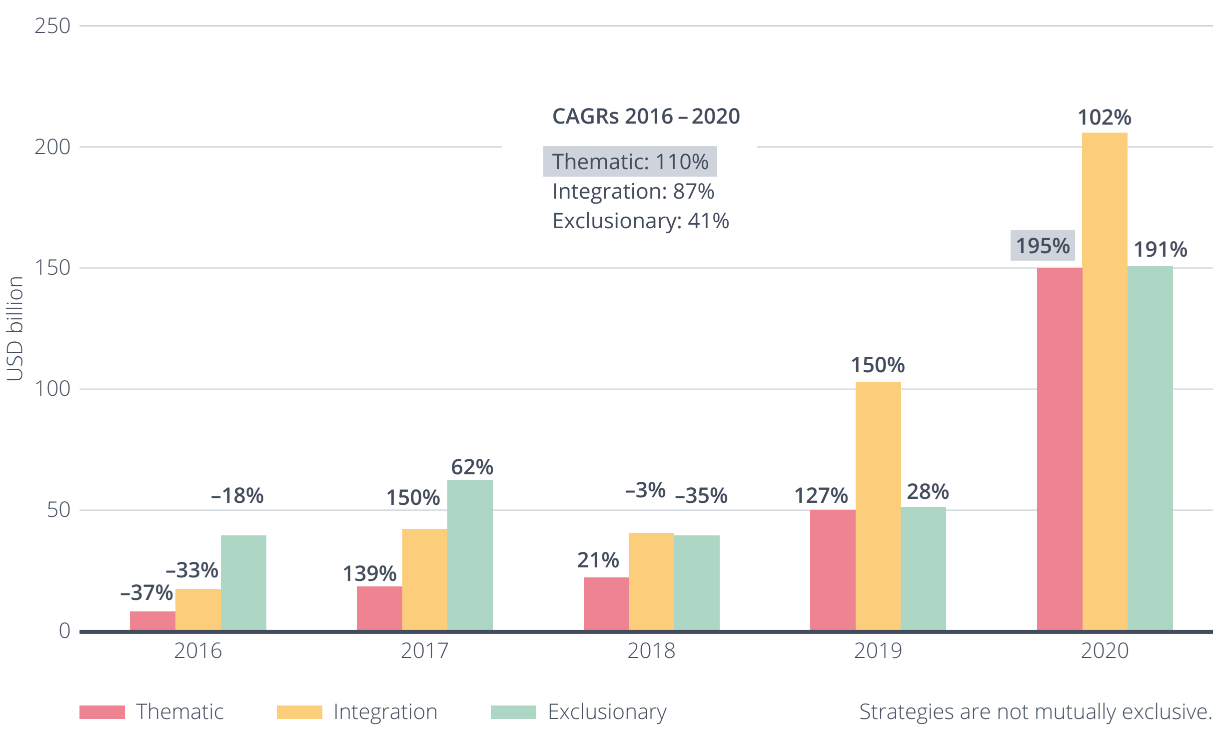
performance, as well as the company's impact on society and the environment (beyond the impact on the company itself) through its operations, products and services. As the SI market matures, financial institutions are looking beyond risk and opportunity to focus on the real-world outcomes of their investments.

3. Impact investment in theory

The most widely accepted definition of impact investment is provided by the Global Impact Investing Network (GIIN), which defines it as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return."[13] However, beyond this globally recognized definition of impact lie several different impact integration and measurement frameworks. Since these frameworks have only emerged in recent years, investors have yet to reach a common understanding of what exactly such investments are and what they are not.

In line with this divergence in understanding of impact investment, there is currently no perfect methodology for determining the size of the market. One estimate was released by the GIIN in June 2020 that put the size of the impact market at USD 715 billion.[14] Thematic SI investments, which focus on identifying opportunities in macro-level sustainability trends and themes, provide another reasonable proxy for assessing market trends for impact investment while being broader than the impact domain. Figure 1 below shows clear, sizable growth in thematic ESG fund flows since 2017.

Figure 1. Growth in annual thematic fund flows in recent years (annual fund flows and year-on-year growth by ESG strategy, global)



Sources: Morningstar, Goldman Sachs Investment Research.

[13] GIIN 2021. What is impact investment

[14] Ibid.

Meanwhile, the International Finance Corporation – a thought and practice leader in the world of impact investment – estimates that investors in public and private markets can potentially contribute USD 8.8 trillion and USD 71 billion respectively towards impact, as shown in Figure 2.[15]

Figure 2. Potential for impact investment spanning public and private markets

Private markets	**Public markets**	
Private investment fund managers*	Corporate engagement and shareholder action**	Green and social bonds***
USD 71 billion AUM	**USD 8,365** billion AUM	**USD 456** billion value outstanding

* Total fundraising from 2008–18 by private investment funds with verifiable intent for, and measurement of, impact. These funds operate only in private markets: private debt and equity, real estate, infrastructure, and natural resources such as timber. Their fundraising is equivalent to AUM under the assumption that it takes 10 years to return capital to investors.

** Value for year-end 2015.

*** Value of all green and social bonds outstanding as of year-end 2018. This includes sovereign issuance. Source: Preqin, EMPEA, ImpactBase, ImpactAsset50, Symbiotics, IRIS, B-Analytics, Gresb, HIPSO, 2016–17 DFI mobilization reports, and DFI annual reports. GSIA. PwC. ICMA. Bloomberg. Thompson Reuters.
Note: There may be double counting between these two groups, to the extent that DFIs are limited partners in, or guarantors of, private investment funds.

Source: IFC 2019. Creating Impact – The Promise of Impact Investing

In the same report, the IFC also highlights the significant increase in the Assets under Management (AuM) at "impact-branded" publicly traded funds. The phrase "impact-branded" is an important one to note at this time of rapid growth in, but slow standardization of, the impact market, as it highlights the lack of certainty as to whether what investors are calling "impact" actually qualifies as this.

Currently, several distinct SI fund labels are well established in a number of European countries. However, until May 2021 – when the revised version of the Belgian Towards Sustainability[16] ecolabel was published – not a single label encompassed impact funds. Additionally, there is significant divergence between the different labels' requirements, which is proving counterproductive to their objective and adding to the confusion, greenwashing, and costliness associated with passive ESG products.

[15] IFC 2019. Creating Impact – The Promise of Impact Investing

[16] Central Labelling Agency 2021. Towards Sustainability Quality Standard – First Biennial Revision

When using the term "impact frameworks," it is important to distinguish between those that help define and measure company impact and those that do this for investor impact. As highlighted by many (e.g., Kölbel et al. in 2020[17] and the 2 Degrees Investing Initiative on multiple occasions, including its 2019 paper)[18], investors often falsely conflate their portfolio companies' impact with their own. Figure 3 below highlights the main differences between the two types of impact and provides examples of some of the most frequently used frameworks for measuring each. Several of these standards have been developed in alignment with the SDGs framework, which was adopted by the UN in its Agenda 2030 to establish the priorities for sustainable development.

Figure 3. Distinguishing between company impact and investor impact

Company impact	Investor impact
– Minimizing harm and creating benefits through strategy, operations, products, and services	– Helping impactful companies access previously inaccessible capital – Helping companies with negative or lower than potential impact improve their strategy, operations, products, and services
Examples of frameworks: – Impact-Weighted Accounts Initiative – Impact Measurement Project's framework for enterprises – B Impact Assessment – United Nations Development Project (UNDP)'s SDG Impact Standards for enterprises – UNDP's SDG Impact Standards for bond issuers – UNEP FI's Corporate Impact Tool	Examples of frameworks: – The Impact Management Project's framework for investors – The Global Impact Investing Network's impact framework – Kölbel and Heeb's Investor's Guide to Impact[19] – UNDP's SDG Impact Standards for private equity funds – UNEP FI's Principles for Positive Impact Finance (Bankers and Investors) – PRI's Investing with SDG Outcomes framework

Source: Qontigo.

For the purposes of this paper, we analyze three widely referenced frameworks in Figure 4 (page 8) to derive a baseline consisting of the impact components considered necessary in each. The second column in the figure summarizes the frameworks' descriptions of the key defining features of impact investments, while the third column lists the mechanisms by which investors can create impact through investment processes. Finally, the fourth column outlines how these frameworks require the impact created by investments to be measured.

[17] Kölbel JF, Heeb F, Paetzold F, Busch T., 2020. Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact

[18] 2 Degrees Investing Initiative, 2019. Impact Washing Gets a Free Ride

[19] Based on: Kölbel, J., Heeb, F., Paetzold, F., Busch, T. 2020. Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact. Organization & Environment

Figure 4. Review of three prominent impact investment frameworks

Framework	How is impact defined?	How is impact delivered?	How is impact measured?
The Impact Management Project (IMP)	– Avoid harm – Benefit stakeholders – Contribute to solutions	– Send a signal that measurable impact matters – Engage actively – Grow new/ undersupplied capital markets – Provide flexibility on risk-adjusted return	– What is the goal? – Who is affected? – How much change is happening? – What is the contribution? – What does the impact risk? – How is change happening?
The GIIN's Impact Framework	– Intentionality – Use evidence and impact data in investment design – Manage impact performance – Contribute to the growth of the industry	– Define the fund or portfolio strategy to include a social or environmental problem statement and/or theory of change – Select investee companies that provide social or environmental solutions and/or generate positive impacts – Engage with portfolio companies on impact performance – Measure and manage for social and/or environmental outcomes	
Kölbel et al.'s framework	– Impact is the change in a specific social or environmental parameter that is caused by an activity	– Enable impactful companies to grow – Encourage improvement – Influence the public discourse by being vocal about what you do	– Change: Observe whether a set parameter is changing over time – Causality: An observed change is caused by your activities and not by other factors

Source: Qontigo.

Reviewing the frameworks described above, we find that despite varying approaches, there are some common elements prescribed across all three. What the GIIN describes as intentionality is observed in the other two frameworks with the IMP using "what is the goal" as a key evaluation criterion, and Kölbel et al.'s framework focusing on "causality".

Next we notice that all three frameworks include creating a measurable and observable change that would not be possible without the investment in consideration as a key criteria for it to qualify as an impact investment. A commonly used term for this is "additionality".

Finally, there is a focus across all three frameworks on who the investment is impacting, and helping provide capital to enable companies to "grow". This points towards the importance of inclusivity in who the impact capital is being supplied to and who the final beneficiaries will be.

We therefore conclude that the baseline for all the frameworks consists of the intentionality, additionality, and inclusivity of the impact resulting from the investment decisions under consideration. We present these three impact components in detail in Figure 5 below. They are then used in the next section to analyze impact-branded investor practices.

Figure 5. Key considerations in impact investment common across all frameworks

	Description	Measurement approach / performance metrics
Intentionality	An unambiguous desire to contribute to measurable social or environmental outcomes through the investment process	Key question: Did the investor set out specifically to achieve impact? Where to look: Investment policy statements, impact thesis documents Signals: Strategic impact goals, financial targets Challenge: There may be incentives to declare intentionality with no true commitment
Additionality	Increase in social or environmental benefits that would not have occurred without the investment	Key question: Does the investment lead to an additional contribution to impact that would not have occurred otherwise? Where to look: Investment process, stewardship activities and outcomes, corporate reports Signals: Engagement outcomes Challenge: Inherently difficult to observe what may have happened to a company, or who may have invested in it in the absence of the investment
Inclusivity	The benefits from impact investments flow towards underserved populations	Key question: Does the investment include emerging markets, small companies, minorities? Where to look: Portfolio constituents, corporate reports Signals: Portfolio company size, geographies represented, company ownership (diversity data), flexible capital Challenge: Hard to gather socio-economic and behavioral information and hence the magnitude of impact for groups that have been traditionally financially and socially excluded

Source: Qontigo.

Finally, it is also important to consider that impact mechanisms vary in applicability to different asset classes, based on investors':

> level of access to the issuers' strategy and operations;
> investment strategy;
> issuer profile (public, private, SMEs); and
> access to markets (both developed and emerging).

Using these criteria, we demonstrate in Figure 6 on page 10 the applicability of two impact mechanisms selected from the Kolbel et al framework across different asset classes.

Figure 6. Differences in impact mechanisms for different asset classes

	Private Equity	Public Equity	Corporate Bonds[17]	Sovereign Bonds	Infrastructure/ Real Assets
Fostering growth in impactful security issuers	***	**	**	*	Primary markets *** Secondary markets *
Engaging to improve company performance on impact	**	***	***	*	*
Reference framework	UNDP's SDG Impact Standards for Private Equity Funds		Green Bond Principles, Sustainability Bonds Guidelines		CFA AOS SDG-ESG Infrastructure investment Framework Meridiam first annual impact report UNEP FI's Real Estate Impact Analysis Tool
	GIIN, Impact Management Project, Kölbel JF, Heeb F, Paetzold F, Busch T. Investor Guide				

Source: Qontigo. **Scope of impact:** * = minimum ** = medium *** = maximum

4. Impact investment in practice

Having established intentionality, additionality, and inclusivity as the baseline for a theoretically sound impact investment approach, this paper now examines the extent to which real-world investor approaches are currently embedding these critical common components in their impact-branded products.

4.1 Methodology

The analysis is based on the PRI's publicly available signatory-reported data, which constitutes the world's largest database of responsible investment practices.[20] PRI signatories submit details of their ESG practices on an annual basis. Our analysis uses the latest available investment practices data, which was reported during 2020 by 960 PRI signatories actively managing a total of USD 21.1 trillion in listed equities.[21]

Thematic investment is one of the three approaches to ESG incorporation that demonstrate the implementation of the PRI's Principle 1[22] in listed equity (the other two are screening and ESG integration). The PRI considers impact investment to be a subset of the thematic approach to managing ESG issues in listed equities.[23] While it defines thematic investment as seeking to "combine attractive risk/return profiles with

[20] PRI 2021. https://dataportal.unpri.org/signatory/dashboard
[21] RI 2020. Listed equity snapshot 2017–2020
[22] PRI's Principle 1: "We will incorporate ESG issues into investment analysis and decision-making processes."
[23] PRI 2019. An introduction to responsible investment: listed equity

an intention to contribute to a specific environmental or social outcome", it says that impact investment aims to "ensure that investments lead to additionality of impact and requires adequate measuring and monitoring of the investment's impact on environmental or social outcomes". As a result, qualitative responses to the PRI reporting question LEI 07.2, "Describe your organization's processes relating to sustainability themed funds," that mention the term "impact" are the optimal proxy for analyzing prevalent impact investment approaches. This question was an optional indicator in the 2020 reporting framework that was triggered for signatories who reported investing in stand-alone thematic strategies.

We obtained 241 individual qualitative responses to LEI 07.2 from the PRI data portal and filtered these down to 74 that specifically referred to the word "impact".[24] This ultimate sample of qualitative individual investor responses was then manually analyzed for evidence of each of intentionality, additionality, and inclusivity – more details for each of which are presented in the following sections. In a next step, the evidence produced was awarded a score on a scale of 0–2 in each category, with 0 being no evidence and 2 being significant evidence. Other trends tracked included investment themes and measurement frameworks.

The limitations to this approach include the following:

> The voluntary nature of this indicator meant that we had to work with a relatively limited sample size of 74 signatories out of the 960 that reported on their active listed equity ESG incorporation practices. Nevertheless, in practice these 74 signatories manage a combined USD 20.5 trillion of assets across all asset classes, which means that their responses are representative.
> The qualitative nature of the indicator meant that we had to apply qualitative analysis, which is subject to human error. Also, signatories were not asked to describe specific aspects of their investment approach. As a result, where they did not describe their process in detail it was impossible to positively score them on traits, leading potentially to underscoring.
> A further iteration of this analysis could/should consider similar responses for other asset classes, including fixed income and private equity.

Despite these limitations, however, the use of this sample to demonstrate broader impact investment trends can be justified in terms of representativeness. The results are presented in the following sections.

4.2 Results

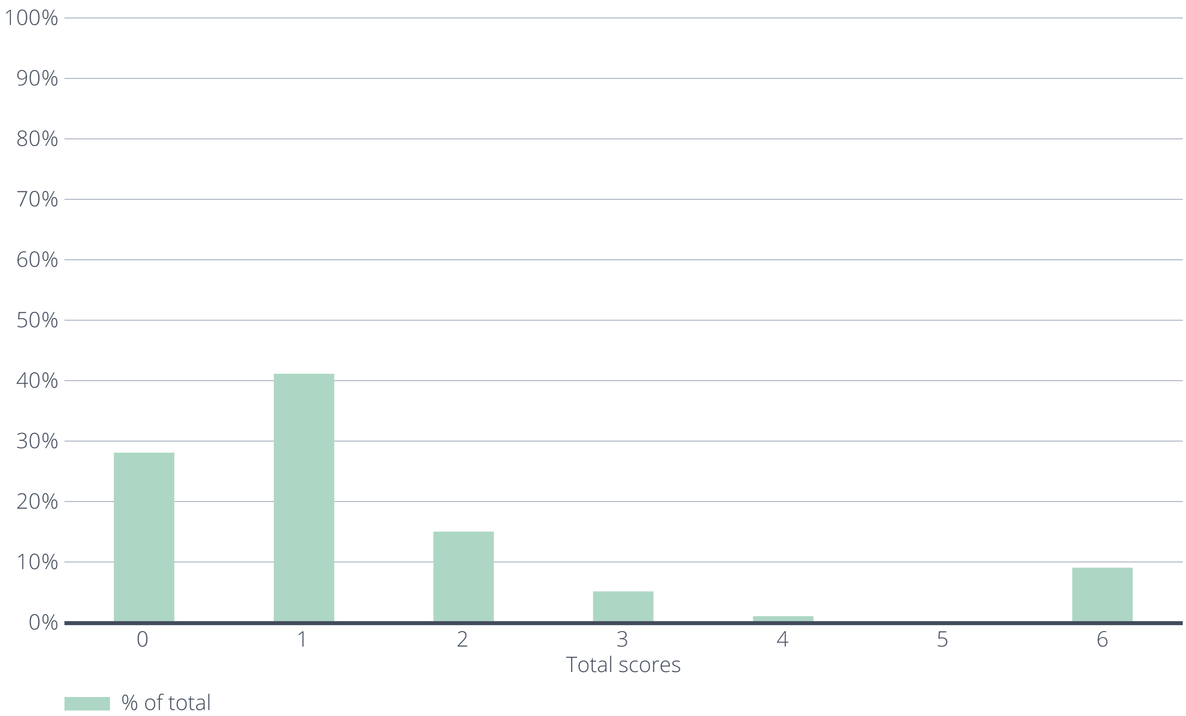
Figure 7 shows our headline results. 84% of respondents (62 investors) scored between 0 and 2 (out of 6 overall), demonstrating no or low recognition for the intentionality, additionality, and inclusivity of their impact investment process. Of these, 12% (9) were found not to be describing a thematic or impact approach at all, but instead provided generic descriptions and referred to other ESG incorporation approaches such as ESG integration and screening. We believe these poor trends are indicative of the general impact investment narrative. Confusion is common among different sustainable investing approaches at worst and within the individual pillars of investment impact creation at best.

At the other end of the spectrum, 16% (12 investors) scored between 3 and 6, with 9% (7 investors) being awarded full marks. This demonstrates that a listed equity impact investment approach that is conscious of its intentionality, additionality, and inclusivity is perfectly possible, as measured by our methodology. These are therefore those investors who through their practice demonstrate large commitments to the theory of impact investment.

The next sections explore each pillar in turn.

[24] PRI 2021. PRI data portal

Figure 7. Results distribution for the scoring of investor responses on impact investment*



Source: Qontigo. *Scores are on a scale of 0 – 6, with 6 being the best.

4.2.1 Intentionality

23 out of the 74 responses (31%) scored 0 for intentionality. In line with the PRI's definition of thematic investment, a significant majority of responses describe their investment thesis as one that combines thematic exposure and attractive returns. Exposure in most cases is seen either as driving returns or as a "nice to have" on top of already attractive financials. Representative sample responses include:

"Although these changes have been occurring for many years, we are witnessing a significant upward move in their velocity as the challenges have become more profound. We believe the universe of companies that are addressing these sustainable issues represent an attractive subset of the broader global equity universe with higher secular growth rates. As such, our investable universe consists solely of companies whose business models benefit from these changes."

and

"With the SDG mapping our aim is to gain better understanding on a company's strengths in the future. We also think that companies with a clear understanding of the businesses' alignment with the SDG's will be better at coping with the potential changes and challenges in the inevitably changing business environment."

Extracts from the top-scoring investor responses are given in Figure 8.

Figure 8. Top-scoring investors for intentionality, selected extracts

Evidence for intentionality
"The fund aims to invest in companies that have a positive impact on society. The stock selection process takes into account two dimensions of societal impact: the societal contribution of goods and services, which reflects how a company's business is aligned with major societal issues, and corporate citizenship, which reflects how a company conducts its business and the more or less positive externalities that these choices entail for society."
"The fund aims to increase the value of fund investments over the long term alongside achieving positive societal impact aligned to the UN SDGs."
"(...) spent two years researching the potential of delivering positive impact in public equities, and specifically within underserved emerging and frontier markets. (...) The culmination of this work is a concentrated portfolio of around 20 stocks that we believe can deliver positive impact – along the six themes listed below – whilst generating solid financial returns to investors."
"(...) currently has three Listed equity thematic impact funds, seeking clear alignment with UN SDGs and aiming to generate positive societal impact."

Source: PRI Data Portal.

4.2.2 Additionality

57 out of the 74 responses (77%) were scored as 0 for additionality. Since the main mechanism for generating positive impact beyond providing private capital in the listed markets is engagement, we allocated scores based on the depth of the engagement approach. Less credit was given where the signatory simply described their engagement approach in generic terms as opposed to where they are explicitly trying promote impact through active ownership. Extracts from the top-scoring investor responses are given in Figure 9.

Figure 9. Top-scoring investors for additionality, selected extracts

Evidence for additionality
"(...) uses SDGs to provide a framework for engaging to create more impactful and financially successful companies. (...) Small and mid-cap companies are largely unaccustomed to being engaged on sustainability matters. Yet these businesses, along with their supply chains, have significant potential to create positive societal impacts and strong investment returns. Engagement has the potential to unlock value for all stakeholders – investors, companies, employees, local communities and the planet – and therefore help deliver the ambitious SDGs."
"Through our engagement policy, the team maintains a constant and ongoing dialogue with the companies we invest in, especially HR teams to ensure good management of their human capital."
"(...) combines the proven stock-selection and engagement skills within its equity and stewardship teams. The investment opportunity that the strategy addresses is that engagement will enable positive change and will encourage investee stocks to create more resilient businesses, as well as tackling pressing social or environmental needs. These companies should then begin to increase market share in their industries, improve business ecosystems, and strengthen market practices."
"Monitoring these impact indicators and controversial issues within the ESG environmental, social and governance areas allows us to have a constructive dialogue with the companies to whom we propose ESG improvements that will have a real impact on their sustainability, the creation of value and therefore ultimately on the rise of their stock price."

Source: PRI Data Portal.

4.2.3 Inclusivity

57 out of the 74 responses (77%) scored 0 for inclusivity, as they did not share any evidence of a global approach inclusive of emerging markets or underserved populations. At the other end of the spectrum, extracts from the top-scoring investor responses are given in Figure 10.

Figure 10. Top-scoring investors for inclusivity, selected extracts

Evidence for inclusivity
"One of the funds is (...) with a clear long-term focus on creating long-term impact, measured against several of the UN SDGs. These funds (...) contribute to ensuring that low-income individuals have access to financial services and job opportunities, providing women with equal access to economic resources and opportunities. By financing micro, small and medium enterprises the investments support the adoption of fair, equal and safe working practices. We contribute to creating equal opportunities and incomes irrespective of age, gender, origin, religion or other status."
"(...) the portfolio is constructed to align with the UN SDG Goal 3 to "ensure healthy lives and promote well-being for all at all ages." (...) focuses more specifically on companies creating solutions for health care related issues in the following areas: 1) Access to medicines and health care services in both developed and emerging markets; (...) 4) New solutions that lead to lowering the cost of health care."
"The standards applied to the (...) Fund's portfolio focus on three key themes: 1) Increasing access to capital for those historically underserved by the mainstream financial community; 2) Creating public goods for those most in need; and 3) Filling capital gaps left by current financial practice. We look to address a broad range of issues, including affordable housing, climate change, education, community revitalization and health care."
"(...) which invests in companies that create financial and societal value by fostering gender diversity and leveraging on the increasingly important economic role of women. The Fund focuses on three of the UN SDGs; gender equality, decent work & economic growth and reduced inequalities."

Source: PRI Data Portal.

4.2.4 Other findings

The following section provides an overview of additional findings.

Measurement

As one investor clearly puts it:

"One of the great challenges with impact investing – public or private – is accurately measuring the impact of a company. Data availability is weak – particularly in emerging markets – making complex methodologies futile, and potentially even deceptive."

Nevertheless, without measurement there is no management. As such, we also tracked (without scoring) the varying approaches investors have described to measure companies' impact. Some proprietary methodologies state that they do not invest in specific securities unless it has been calculated that these have a net positive impact for a particular issue, such as alignment with the low-carbon transition. Others select the specific KPIs that are most closely aligned with their strategy (e.g., the proportion of women on the executive committee) or simplify the impact measurement process by emphasizing aspects such as reach (e.g., the number of people impacted and historic growth), criticality (e.g., current access to health care or financial services), and effectiveness (e.g., the quality of education or patient health outcomes). One thing is clear: there are currently no standardized approaches on this matter.

Themes
What, then, are the themes towards which investors most often allocate capital? We performed a simple count of approaches mentioning a framework for thematic allocation. The SDGs came out top, being referred to as a thematic framework by 39% (29) of the 74 responses, either in their entirety or in the form of selected SDGs. This is aligned with other industry findings. For example, a 2019 study found that more than half of all European asset owners had started using the SDGs as a tool to manage investment strategies.[25] The following is an example investor response illustrating an approach focused on a specific SDG:

"Responsible Consumption using a framework based on SDG12 (Responsible Consumption and Production). In this case, the strategy places a particular focus on sustainable food, urban systems, supply chains and lifestyle. We identify sustainable companies by considering the potential decoupling between their environmental impact and their economic activity: companies that we think are able to develop their activity and lower their impact in the same time. We aim at identifying these companies in order to benefit from the potential competitive advantage and risk management they have built around what we expect to be a consumption revolution, expressed by the SDG12."

Next in popularity was climate action in its various iterations, at 23% (17 explicit references). However, this is probably an undercount, since there is naturally an overlap with SDG 13, which was not explicitly extracted.

Interestingly, individual approaches referred explicitly to alignment with regulatory taxonomies such as the EU Taxonomy as a framework for their approach, while others emphasized fund labels awarded (such as the Greenfin (France) or Nordic Swan labels). As labels proliferate in the future, this may become another way to track real-world impact investment trends.

5. Reconciling the gaps between the theory and practice of impact

In Molière's famous play "Le Bourgeois Gentilhomme", the main character, Monsieur Jourdain, takes a poetry lesson and discovers with pleasure that he has been speaking in prose all his life without knowing it. As demonstrated above, there is no way investors can similarly claim to have been unconsciously implementing impact investment for years. Given the requirements of intentionality, additionality, and inclusivity, it is highly unlikely that investors stumble upon positive impact without measuring it and without actively managing portfolios to achieve it. Creating impact is much more akin to composing one of Shakespeare's sonnets than speaking in prose – it simply does not happen by chance. Below, we discuss a few practical ways investors can use to track impact measurement to reconcile the gap between the theory and practice of impact.

5.1 Using the SDGs framework

Given the importance that investors attach to the SDG framework, we explore further its use as a source of impact. The 17 different SDGs and their underlying targets offer a comprehensive template for what "impact" means in practice. As evidenced by our review, this has led to them becoming the most common framework used in public markets for steering impact investment strategies.

[25] Novethic 2019. Investing with a purpose – analysing European asset owners' contribution to the SDGs.

Over the last few years, most sustainability data providers have developed new data sets aimed at evidencing companies' revenue alignment with or contribution towards the SDGs. In such data methodologies, it is important to take account of the companies' entire value chain and measure SDG contribution where it matters. This means that for some companies it would be about the characteristics of products they sell and services they provide, for others it will be about their production process and their practices, and for others it will be a mix of both.

To develop a comprehensive and holistic view of companies' impact through the SDGs, it is also important that investors go deeper than the high-level goals to also measure company performance on the official underlying targets. Staying at the broad SDG level generates confusion and goes against the spirit of the SDGs, which do focus on additionality and inclusivity to a certain extent. However, few SDG data providers use the official SDG targets applicable to corporates in their proprietary metrics and ratings, which creates misalignment and confusion amongst investors on interpreting SDG-related scores. The challenge of providing quantitative impact data at such granular level is significant, as the required information is not readily provided by the companies themselves in their financial statement reporting. The situation is improving with the uptake of voluntary and mandatory company reporting regimes such as SASB (whose 980 financially material sustainability accounting disclosure metrics have been found to overlap with the 242 SDG country indicators by as much as 70%[26]) and recent progress with corporate sustainability reporting regimes in the EU[27].

Some data providers instead group the impact on related SDGs or use simply the degree to which different revenue streams can be associated with the pursuit of particular SDGs. The current alignment measures are valuable in that they signal whether a company does something related to impact, but does not say much about their scale.

5.2 Comparing impact across different dimensions

Beyond measuring impact on every dimension, another question for investors focused on impact is how to compare it across dimensions. In other words, how can one compare the negative impact from carbon emissions and the positive impacts from employment creation or waste reduction to obtain a holistic view of the impact that companies have?

One way of making comparisons across different dimensions of impact is to assess the impact that operations, products, and services have on each individual dimension, and to assign a common measurement unit such as monetary value to these contributions. Harvard Business School researchers have found that 56 publicly listed companies report the monetary value of their impact.[28] Nevertheless, it should be noted that monetization – particularly in a private sector context – is not a silver bullet and that the approach has shortfalls as well.[29] In order to map clearly the impact companies have on each of the SDGs and tackle the challenge of comparison across different impacts at scale, Clarity AI has developed its SDG Impact product. This is done with a proprietary methodology for estimating the societal value generated by companies in connection with the SDGs (see page 17).

[26] BlackRock 2021. Integrating the UN SDGs in investments

[27] EC 2021. Corporate sustainability reporting

[28] Harvard Business School 2021. Impact-Weighted Accounts

[29] For an overview of major monetization use cases and challenges see for example Morel et al 2018. Discussion Panel – Assessment of Externalities: Monetisation and Social LCA; Danish Ministry of the Environment 2014. Assessment of potentials and limitations in valuation of externalities and OECD 2018. Cost-Benefit Analysis and the Environment: Further Developments and Policy Use

5.3 Impact labeling

Many investors consider that maximizing their exposure to companies that perform well on SDG metrics is enough to deliver impact. As shown previously, such a strategy can miss the dimension of intentionality and additionality and exclude the dimension of active engagement – arguably the most powerful impact lever available to public market investors. In the early stages of impact measurement, data providers have downplayed these dimensions of intentionality and additionality, including active engagement, given the difficulties in measuring it. The intentions of investors cannot be established from their actions. What would happen in the absence of a particular company is inherently unobservable, so additionality is difficult to establish.

Figure 11 below highlights the market confusion and capital misallocation stemming from the mislabeling of investment products or strategies due to a failure to differentiate between "exposure to potentially impactful companies" and "impact investment". It distinguishes between two main investment strategies and the nature of the sustainability data they rely on.

Figure 11. Distinguishing between investment strategies focused solely on increasing exposure to impactful companies and those helping to grow them

		Demonstrates clear intention to drive companies' impact
Strategy	Investors are eager to maximize their exposure to companies that are contributing positively to society, while maintaining broad market exposure.	Investors are eager to find and support companies able to lead the transformation in specific sustainability-related thematics.
Data needed	Data measures companies' level of alignment with societal goals	Data is used first to qualify companies likely to drive change in their sectors and then measure the extent to which they actually do this. The magnitude of the change in impact is assessed and potentially also expressed in a single comparable unit, such as a monetary value.

Source: Qontigo

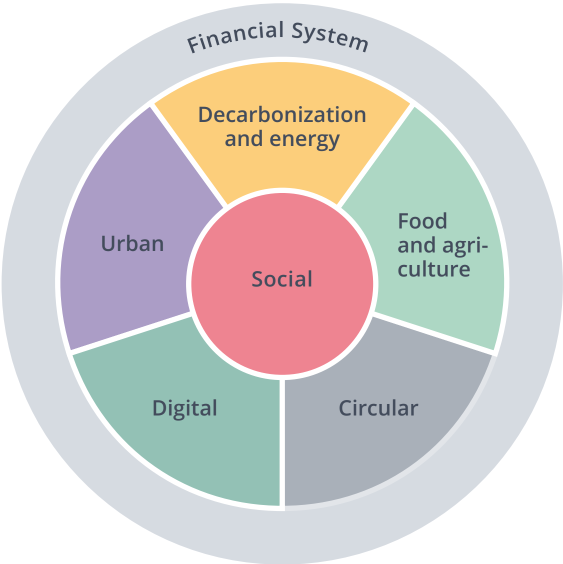
Additionally, while evaluating company level impact, providers often fail to measure the magnitude of the impact likely to be driven by the company and will consider all SDGs as equal[30].

In this context, we found that the framework provided by the World Benchmarking Alliance (WBA) and Clarity AI's SDG Impact Methodology both offer innovative approaches that are likely to reconcile the gaps.

[30] A 5% alignment with SDG 16 is considered the equivalent of a 5% alignment with SDG 2.

The WBA focuses on the seven systemic changes required to achieve the SDGs (see Figure 12).[31]

Figure 12. World Benchmarking Alliance: Seven systems transformations



Source: WBA 2021. Seven systems transformations

It then identifies "keystone" companies for each of these categories that, in a qualitative sense, impact the SDGs. The 2,000 keystone companies identified across the seven systemic transformations[32], are in a position to influence and catalyze change in their sectors in the same way that certain species do in their ecosystems. The criteria used to characterize them are presented in Figure 13.

Figure 13. The World Benchmarking Alliance principles for identifying keystone companies

- Companies that dominate global production revenues and/or volumes within a particular sector
- Companies that control globally relevant segments of production and/or service provision
- Companies that connect (eco)systems globally through subsidiaries and supply chains
- Companies that influence global governance processes and institutions
- Companies that have a global footprint, particularly significant in developing countries

Source: WBA 2021. SDG2000 Methodology

[31] Social transformation, a sustainable food and agriculture supply chain, low-carbon energy systems, a circular economy, sustainable and resilient cities, inclusive digital transformation, and sustainable finance and investment.

[32] These are headquartered in 74 countries from Algeria to Vietnam and have cumulative revenues of USD 43 trillion.

In a second step, WBA engages in an extensive consultation process to develop transformation benchmarks, which will be used to assess how well these companies are leading desired sustainable change. The WBA therefore provides a powerful framework with which investors can channel capital to support leaders and actively engage with laggards that are slowing down the necessary evolution of practices in all economic sectors.

Clarity AI's SDG Impact Methodology goes beyond measuring revenue alignment to SDGs. It focuses on measuring the size of the impact that companies create through contributing to each of the SDGs.

- In a first step, the methodology assesses for each SDG the potential contribution that can be made by the private sector, and more specifically by listed companies.
- It then identifies key metrics to estimate companies' performance for each of the 52 official UN underlying targets found to be applicable to investors. Given the nature of the SDGs, when revenues for specific products are used, these are almost always limited to sales of products or services to underserved populations (in low- and middle-income countries, for example), illustrating how inclusivity can be practically integrated into impact methodology development.
- Finally, the impact is put in monetary terms by using an assessment of the value of specific social benefits, based on peer-reviewed estimates of the value of those benefits. This enables comparison, aggregation, and optimization across SDGs.
- Over time, Clarity AI will also develop a measure of a company's transformation potential beyond its current contribution (potential impact). This will be calculated by assessing the size of the positive societal benefit (or cost) that would result if all its sector peers performed in a similar way.

Figure 14. Clarity AI's impact measurement methodology

	Current impact	Potential impact (in development)
Scores & insights	Impact/revenue (monetary value of impact as % of revenue)	Total potential impact (monetary value of impact)
Used to measure	How much **value** a **company** creates or destroys **today**	How much **value** an **industry** can create or destroy **tomorrow** *(if everyone in the industry copied the company's practices)*
Impact drivers	Products & services sold; Company **operations**	**Relative performance** of the company versus the industry's; **Diversity of practices** in the industry
Use it to	Understand and report the **impact/net contribution made by companies** to the SDGs	Understand **where to invest** to generate the **most significant change** in the world

Source: Clarity AI.

Public equity is probably the most challenging asset class in which to implement impact investment. This is because it often aggregates multiple activities across the globe and at company level, and also offers limited evidence of additionality of capital provided through investment. Despite this, meaningful impact strategies can still be implemented, as was shown in the previous "in practice" section. These require initial awareness of the trade-offs between risk, return, and impact on new efficient frontiers. Their efficiency also depends on investors' ability to actively support emerging change leaders and to engage with laggards to unlock their transformation potential.

In the late 1920s, the Italian Communist and philosopher Antonio Gramsci wrote that "The old world is dying; the new world is slow in appearing and in this chiaroscuro monsters are emerging". Today, the clock is ticking a bit faster every day, leaving less time and fewer options for us to solve unprecedented environmental and social challenges.

What must also be considered here is the importance of the legal and policy environment as an enabling or a deterring force for investors to participate in creating sustainable economic and societal growth through impact integration. A Legal Framework for Impact[33], a 2021 flagship legal analysis commissioned by the PRI, UNEP FI, and The Generation Foundation, written by Freshfields Bruckhaus Deringer, looks across 11 jurisdictions and finds that "where sustainability impact approaches can be effective in achieving an investor's financial goals, the investor will likely be required to consider using them and act accordingly". In addition, the report points that there are instances in most jurisdictions where "investors can pursue sustainability goals for their own sake in parallel with financial goals". Importantly, the analysis also highlights how investor behavior towards impact investment is greatly influenced not just by legal rules, but also market circumstances such as availability of relevant corporate data, performance benchmarks, and dominant investment theories. Therefore, to foster an environment where investors prioritize achieving positive societal impact in addition to meeting financial objectives, policymakers must provide clarity on investor duties as it relates to impact across asset classes, strengthen frameworks for disclosure and performance measurement, and facilitate collaborative action across various jurisdictions and members in the investment value chain.[34]

Sustainable investment will only deliver on its promise if it can rely on sound methodologies, data, and labels. "Impact washing" is the biggest threat to our industry at a time when it benefits from strong regulatory support and massive new net inflows of funds. There is no free lunch and genuine commitment is a must. Failure to monetize negative social and environmental externalities has allowed systemic risks to emerge while maintaining short-term private returns. Impact investment is an attempt to re-establish a sound value proposition. It is a bet that seeking as yet unmonetized collective societal benefits will eventually translate into better conditions for long-term sustainable returns.

[33] PRI 2021. Data Portal

[34] Ibid.

6. Implications and next steps

The momentum of capital allocation towards impact investment is strong. As the impact movement picks up scale and pace, it is important for investors to develop a nuanced understanding of the themes covered in this paper. These are:

> The definition of impact and what each investment decision means in terms of negative and positive societal and environmental outcomes;
> The approach taken by investors to impact investment across asset classes. This allows them to choose how they want to enable impactful companies to grow, to encourage improvement that will unleash potential untapped impact amongst their portfolio companies, and to engage collaboratively and publicly with both companies and policy makers;
> The need to redouble efforts towards best-practice impact measurement, verification, and assurance; and
> Current and potential limitations due to mislabeling and confusion about impact.

Qontigo and Clarity AI will continue to dive deeper into the SDGs as a framework for measuring the impact that companies have on society, and develop practical guidance on how an impact strategy or the SDGs can be implemented in investable products. Using Clarity AI's Current SDG Impact measurement approach, we will estimate the societal value that can be unlocked by each SDG, the sectors and types of companies that are generating or destroying value, and how investors can use the SDG impact data provided to them.

7. Contacts & Information

Learn more about how Qontigo can help you better manage risk and enhance your investment process.
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