AGF INSIGHTS

MARKETS

How to choose an investment strategy that makes a true impact

8 questions to determine whether your portfolio is helping facilitate the transition to a truly sustainable economy.

By Martin Grosskopf and Jonathan Lo

Impact investing has gained significant traction over the past 10 years and today there are a number of strategies focused on the transition to a more sustainable economy. While not all of these strategies are equally committed to effecting real long-term change, those that are can often be identified by several shared characteristics.

Here are eight questions to help investors determine the impact strategies with the most potential to make a difference:

Is it off-benchmark?

Many institutional investors treat conventional benchmarks like the S&P 500 and S&P/TSX Composite Index as the ultimate gauge of what is reasonable from a risk/return perspective. As a result, deviations from these indices are rare and the bulk of public market allocation is either invested passively or through benchmark-optimized active strategies. But impact-focused strategies tend to have very high active share, by comparison, and will often invest in very different holdings than a conventional benchmark to maximize exposure in sustainability themes such as climate change.

Does it have a rigorous thematic approach?

Investment strategies that integrate environmental, social and governance (ESG) factors into their overall process are becoming more common, but their potential impact on portfolio holdings is often offset by other considerations such as short-term performance objectives. This can result in an "engaged" or "responsible" strategy justifying new investments that run counter to its sustainability goals.

By contrast, a strategy that utilizes a rigorous thematic approach to impact investing is more likely to incorporate a well thought out process for defining and always investing in a universe of companies that is truly committed to a more sustainable economy. In doing so, these strategies assume that a transition is underway but may require some financial trade-off before benefitting from it.

Impact investment spectrum

			Impact Investment		
Traditional	(RI) Responsible Investment	(SRI) Social Responsible Investing	Thematic	Impact first	Venture Philanthropy
Limited or no focus on ESG factors of underlying investment analysis and execution.	ESG risks integrated into analysis of all holdings, as a component of financial risk management. Shareholder engagement is used to influence behaviour of holdings.	Negative and positive screening of ESG risks is used to align a portfolio to specific values. Shareholder engagement is used to influence behaviour of holdings.	Focus on one or more issue areas where social or environmental need creates commercial growth opportunity for market-rate returns.	Focus on one or more issue areas where social or environmental need may require some financial trade-off.	Social enterprise funding in a variety of forms, with a range of return possibilities. Investor involvement/support is common.

Competitive Returns

ESG Risk Management

High Impact Solutions

Source: MaRS 'State of the Nation: Impact Investing in Canada', 2014.

Is the strategy taking fossil fuel exposure seriously?

Many responsible strategies will still look to maximize their cash flows from fossil fuel investments while they have the opportunity, but it is difficult to have an impact by being invested in the very source of the problem that one is trying to transition away from. By investing in (and thereby improving the cost of capital for) companies committed to sustainability, a reduction in capital allocation is needed elsewhere. Logically, that means starting with the most problematic sectors first. Even coal companies are now disclosing the divestment movement as a material risk to their cost of capital, indicating that new investors are not necessarily willing to backstop environmentally-disadvantaged business models.

Does it publish a broad set of environmental data?

Measuring the environmental impact of a portfolio is in its infancy relative to measuring its financial characteristics. The data is reported differently by many companies, even within the same sector, and its robustness can be questioned given the lack of third-party validation.

Despite these challenges, it is possible to collect data that gives a directional indication of the portfolio's environmental impact. Reporting on single-factor issues such as carbon emissions is likely an early step – but more important is an overall sense of the portfolio's environmental footprint, which will include other important factors such as water use, land management and toxic emissions.

This broader data set is also increasingly useful for ongoing engagement with companies, as even the most attractive solutions provider will still have improvements it can make to its own manufacturing footprint.

Does the investment team have specialized expertise?

Establishing the credibility of the investment team is of no less importance for sustainability-focused funds than for other investment products. In fact, we would argue that a strong background in both financial and environmental analysis is important for developing a robust process that can critically assess the various sources of data received – ESG research firms, sell-side reports and company disclosures.

For strategies with a longer tenure, expect to find environmental specialists who developed the appropriate financial skills later in their education or career. Most individuals with an early financial specialization do not have the technical knowledge of environmental issues to dig deeply into this side of the investment decision.

Is the 'sustainability' of financing a focus?

Large institutional investors usually have access to private equity opportunities that have inherently lower volatility as they are not subject to the public market price fluctuations, which are more pronounced in the emerging sustainable sectors. As a result, the players in the public equity sustainable sectors are more likely than not to be dominated by hedge funds and day traders with shorter-term incentives.

However, the success of many of the 'transition' technologies will depend on the active involvement of patient, long-term capital within both private and public markets and impact strategies should be committed to opportunities across the financing ecosystem.

Does the investment manager have a history of moving the bar forward?

The sustainable investment industry is still evolving rapidly as the products and processes adapt to changing trends and new priorities. Firms that are focused on having impact have usually been involved in industry associations and research initiatives over many years as they strive to add to the base of knowledge in the industry and strive for continuous improvement.

Does the fund have a demonstrated tenure?

True commitment to sustainable investing requires firms to support their products during periods of poor performance or lack of interest. Too many times over the years, firms have launched products with an 'impact' or 'sustainability' focus only to close them quickly if they do not immediately reach or are unable to maintain hurdle rates. Naturally, the logic is to make short-term financial targets, but the nature of these products is longer term. The need for firms to reallocate capital to the highest returns should be balanced with the need to nurture a sustainability product in a too-often fickle market.

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Martin Grosskopf has more than 20 years of experience in financial and environmental analysis. He is a former Responsible Investment Association (RIA) board member, and is a frequent public speaker on ESG issues. In addition to the portfolios that he manages, Martin provides input on sustainability and ESG issues across the AGF investment teams.

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Martin joined the financial industry after working in a diverse range of industries in the areas of environmental management, assessment and mitigation. Martin was previously Director, Sustainability Research and Portfolio Manager with Acuity Investment Management Inc. AGF Management Ltd. acquired Acuity Funds Ltd. and Acuity Investment Management Inc. in February 2011. He was a project manager with CSA International from 1997 to 2000 and prior to that, was an environmental scientist with Acres International Limited.

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Prior to joining AGF in 2012, Jonathan worked on the Institutional Equity Research team at CIBC World Markets covering the agriculture and transportation sectors. Prior to that, he worked as a consultant at a private equity firm specializing in turnarounds in London, U.K.

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[1] Does not provide investment advice or recommendations.

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Publication date: July 27, 2020

FUND1129 07-20-E