Why a shift to Impact Investing will create big winners and big losers

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Across the globe, Covid-19 has brought massive disruption in all areas of our lives, mostly for the worst. One of the positives that came up from the pandemic has been the increased focus on various forms of inequalities and climate change and the need to tackle them with a different approach than the ones that created them, or what some might call Stakeholder Capitalism.

Investments aiming at reducing inequality and climate change fit neatly under the broader category of Sustainable, Responsible, Impact (SRI) investing. We first find mentions of SRI investing in religious traditions dating back to 1,500 BCE, so nothing new under the sun! However, the impact investing philosophy goes nowadays way beyond investments solely focusing on SRI-based business models, such as Cleantech. By taking into consideration SRI results jointly with financial results when allocating capital, investors are now extending impact investing from its original niche to the entire universe of public and private companies.

Still slow-moving pre-Covid-19, the pandemic has fueled a fast-growing interest in impact investing from institutional and retail investors, both in public and private markets. We can make a first parallel between this acceleration and the one we have seen in the technology space with the rapid adoption of digital tools across the globe that was also enabled by the crisis.

Impact or SRI investing is taking over from Environmental, Social and corporate Governance (ESG) methodology that was developed in previous decades. ESG was criticized for its lack of teeth — loose standards and only accounting for the "good stuff" enabling green washing (making people believe that your company is doing more to protect the environment than it really is). However, with all its flaws, ESG was a necessary step to enable SRI investing… one needs to learn how to walk before running, or in this instance to crawl before to walk.

As an investor, why should you care about Impact Investing? Impact investing is simply the biggest wave you can ride and also the biggest risk you should manage

You should care for multiple reasons, and I will not preach here the goodness of SRI Investing.

As technological innovations have been permeating every industry at an increasing pace since the industrial revolution creating big winners and losers, SRI has been and will be doing the same for the foreseeable future at an ever-faster pace.

We will see an upending of industries with the extinction of some and organizations unable to transform, the creation of new champions, the disruption of the allocation of capital and massive impacts on ROI.

In the grand scheme of things, these tectonic shifts are still in their infancy but they are definitely real: 1) asset managers call for more sustainable investment, such as Blackrock's Larry Fink, and Canadian Pension Funds; 2) companies, such as Peabody Energy Corp., the biggest US coal producer is warning of potential bankruptcy; 3) capital is reallocated to companies scoring high SRI results, such as Blackstone's $200M investment in Oatly; 4) PE-VC impact-focused funds are going mainstream, such as Impact Engine, Renewal Funds, Social Impact Capital; 5) multiplication of impact-focused retail investments solutions, such as impact mutual funds, green bonds, ETFs,…; 6) the price of carbon in the world's biggest, most liquid market is soaring; 7) Stakeholder Capitalism championed by the likes of Klaus Schwab is gaining traction; 8) multiplication of companies aligned with the SRI agenda, such as Impak Finance, Long Game, or FrontFundr in the Fintech space.

These are only a few examples of how impact investing is picking up steam globally across all fields.

In an atypical situation, Europe is way ahead of the impact investing game while Asia is way behind. In North America, with the US having just rejoined the Paris agreement, should catch up to Europe in ~3–5 years assuming their respective levels of engagement stays the same, while Canada is likely to follow in the US footsteps.

Europe has been a bright light re SRI investing, the EU emissions trading system (EU ETS) is a cornerstone of the EU's policy to combat climate change and its key tool for reducing greenhouse gas emissions cost effectively. It is the world's first major carbon market and remains the biggest one.

In parallel, many national initiatives in European countries have supported the European Green Deal. In France, the financial markets regulators have been very active on the topic of impact investing leading the charge with regulations requiring greater disclosure re SRI for investment funds and have been working on reporting standards for public companies. These initiatives are not anecdotes and will have massive impacts on industries and companies' profitability;

1) Implementing a carbon tax (carbon border adjustment mechanism) in Europe — and then globally — will decimate some industries, while boosting others. By creating pressure on companies' profitability, it will support innovation with the creation and inclusion of new solutions by some of the companies, while producing a slow decline for others. Entire industries will be created or decimated, while the competitive positioning of individual companies will be severely impacted based on their ability to embrace change and quickly transform. From a monetary perspective, inflation as well as lowering of purchasing power should also be at play.

2) Including SRI results in financial analysts' recommendation reports will ultimately generate different return profiles for industries and companies. Using the Impak Score methodology to rank the companies of the CAC40 (French Stock Market Index) gives us an interesting perspective of the relative strengths and weaknesses of the different companies from SRI perspective. I must mention that I am a very happy investor and board member of Impak Finance, the leading independent impact rating agency behind the Impak Score!

Smart capital in the private and public markets is already taking notes of these changes and reallocating its positions to cut investment risk and boost potential returns.

From an industry perspective, it seems obvious that avoiding the polluting industries such as coal to privilege cleantech is a no-brainer. However, there is way more than meets the eye. Some industries that may seem pretty innocuous from a carbon perspective (compared to coal) will be ranked very poorly from an overall SRI perspective. As an example, the hospitality industry has been struggling with huge challenges linked with its workforce, such as human trafficking, working conditions and insufficient pay. So, picking the "winning" industries from an overall financial and SRI perspective will require deep analysis.

From a company perspective, once investors have selected their industries of predilection, they will face an interesting task of selecting the companies within these target areas. This is where the overall picture might become quite distorted versus a traditional finance-only approach. Staying with the impact analysis of the CAC40 and focusing on financial services, there is a wide gap between a company such as AXA (Score of 254) and BNP Paribas (Score of 164) — maximum score is 1,000. So, while the financial performance might have been in favor of BNP Paribas, an asset manager will now have to take into account a lower SRI score in her/his recommendation.

Private companies are by definition always more opaque, nevertheless the same rational stands.

Moreover, there is a two-factor punch for public companies, once regulations kick in re the inclusion of SRI results, listed companies will be analyzed on their SRI results in conjunction with their financials (while more and more will also be supporting the costs of the carbon tax). Once this first wave of refreshed analysis is done by financial analysts, companies' prospects and recommendations should look quite different. Then, the second step comes when these companies that are now at the bottom of the capital allocation list in their industry decide to whether work towards transforming themselves to regain their competitive positioning or slowly fall into oblivion.

While technology shifts permeated through most industries, despite their disruptive changes, the market (and analysts) gradually adjusted their valuation methodologies to account for the changing landscape; a very different approach when new mandated reporting requirements kick in. Consequently, the changes are going to be more drastic and brutal vs. what we witnessed with technology innovation and it impacted valuations. Public companies — at least in North America — are today absolutely not prepared to: 1) comply with future SRI reporting requirements, 2) deal with their results. North American portfolio

managers and analysts on the buy- and sell-side are no more prepared than the companies they cover.

Globally, retail investors, pensioners and public opinion are shifting in favor of SRI investing with a focus on climate change and inequality reduction; hence, resistance is futile. In ~3–5 years the return profile of some industries and companies will be quite different and in 10 years it will be drastically different for all of them. Asset managers in public and private markets have the opportunity to be on their "front foot" while these changes are slowly being implemented to minimize risks and maximize returns. The time to do so is now.

And there will come a time, maybe not too far ahead, when all externalities (not just carbon) will be taken into consideration in the pricing of items paid by the end consumer. This is when a t-shirt from a dollar store that is today sold for only a few dollars will become more expensive than a t-shirt from Chanel after accounting for child labor, pollution, disastrous working conditions and so on.

This dynamic will create another massive storm in: 1) international trade (producing in far-away low-cost geographies with poor working conditions would become very expensive); 2) monetary policy (inflation), 3) financial markets (new competitive positioning); 4) potential rise of social inequality and instability (what percentage of the population can afford Chanel t-shirts?).