FIERA CAPITAL

Impact Investing:
A Third Factor to the Risk/Return Mindset

How Fiera Capital builds values-driven investment strategies

Traditionally, risk and return are the two most important considerations in the realm of investment management. Modern Portfolio Theory hypothesizes that investors can construct optimal – or “efficient” – portfolios which maximize expected returns by taking on a quantifiable and specific amount of risk. More than sixty-five years after it was first proposed, it continues to be the gold standard for portfolio construction.

Efficiency, however, is in the eye of the beholder. Today’s investors have become sensitive to a third factor: impact. Simply put, investors are demanding that their investments provide more than just a financial benefit, but a societal one as well. At Fiera Capital Corporation, we strive to put together investment solutions that reflect our clients’ intended risk/return objectives, while staying true to their values.

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Defining Responsible and Impact Investing

The world of responsible investing (RI) is full of acronyms and terms that lack consensual definitions. To set the foundation for any meaningful dialogue on the subject, Fiera Capital has developed its own Responsible Investing Spectrum, which helps simplify decisions for clients by mapping their impact objective: from environmental, social and governance (ESG) integration *(strategies that are adequately compensated for the amount of ESG related risk they assume)* to impact only *(strategies with intentional and measurable impact objectives like sustainable agriculture, renewable energy, microfinance or affordable basic services)*.

Responsible investing spectrum

APPROACH	ESG integration	Sustainable investing			Impact only
		Negative /Ethical screening	Positive screening /Best-in-class	Thematic & impact	
RISK & RETURN PROFILE	Sole focus	Primary focus	Dual focus		None
IMPACT PROFILE	None	Secondary focus			Sole focus
CLIENT OBJECTIVE	100% RETURNS	⟷			100% IMPACT

Source: Fiera Capital.

Each investment team is granted flexibility in the integration of ESG factors to best reflect their investment style, including how they assess materiality of ESG factors and integrating this assessment into their investment processes. But we recognized that we need to do more to offer our clients strategies that not only screen out harmful investments, but also target investments that have positive societal contributions in the form of impact investing strategies. Impact investing is done with the "intention to generate positive, measurable social and environmental impact alongside a financial return."[1] In defining our impact investing lineup, we believe that the key words in the above definition are "intention" and "measurable."

In terms of intentionality, we believe it's crucial that the company in question (be it a public company issuing equity or bonds, or a private entity seeking outside investment and/or partnership) has the intention to create a positive change through its products, services or operations – it cannot be coincidental. Why so? What this comes down to is repeatability – if the company's positive Impact was just a happy coincidence, the impact is unlikely to be repeated in later periods. As long-term investors, we strive to find investments which we can hold for many years and thus for impact-based strategies, it's critical that we invest only in those who have positive societal and/or environmental effects year in and year out.

Regarding measurability, if a portfolio manager can rank investment opportunities based on risk and return, they must be able to rank them based on impact as well. This is essential to the screening of investments suitable for an impact fund; normally, a portfolio manager considers potential risk-adjusted return when analyzing investments, but for an impact strategy, **they must consider risk-adjusted return per unit of impact**. Thus, it's crucial that the investment opportunities be quantifiable and measurable in order to allow for a ranking system.

Key Challenges

All approaches to RI – no matter where on the spectrum – come with their own challenges. For example, investment firms often rely on outside ESG data providers to analyze and rank portfolio companies on sustainability. Unfortunately, what we find is that these providers have vastly different rating methodologies. We analyzed the ESG ratings of three major vendors for all of the S&P 500 companies, and we found that correlations between corporate ESG ratings are quite low. For example, we found a correlation of 0.409 between Sustainalytics and MSCI – two of the most well-known ESG ratings providers – suggesting that ratings between the two firms are consistent for less than half the companies studied.

1 "What You Need to Know About Impact Investing." Global Impact Investing Network. thegiin.org/impact-investing/need-to-know/#what-is-impact-investing

Correlations between major ESG data providers for S&P 500 companies

	MSCI	Sustainalytics	RobecoSam
MSCI		0.409	0.367
Sustainalytics			0.651
RobecoSam			

Source: Fiera Capital, MSCI data via MSCI, Sustainalytics and RobecoSam data via Bloomberg.
As of November 15, 2019.

The low correlation across ESG rating firms does not mean that the ratings are unreliable. It does, however, mean that they are different, and thus choosing the "best" ESG provider is difficult and highly subjective. Effectively, using an outside ESG provider for all your analysis means aligning yourself with their definition of sustainability. And while some investors might be comfortable knowing that a well-known ESG rating agency has investigated and assessed a company's ESG profile, for an impact strategy, we don't think that simply having a stamp of approval is enough.

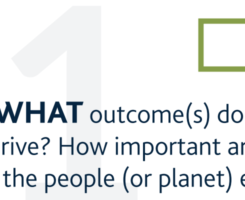
An additional challenge is the ownership structure of the potential investment – that is, whether the company is public or private. In private markets, companies may be too small or not have the resources to publicize how they're addressing sustainability issues. Public companies aren't necessarily required to disclose their sustainability initiatives, and many choose not to, making investigation into impact difficult. Those who do disclose may inflate their positive attributes while playing down the negative ones, further complicating the process. However, these issues can be mitigated by working closely with management teams – whether with public or private companies – to ensure their practices are investigated, disclosed and, if necessary, improved.

Using Consensus-Driven Norms to Analyze Impact

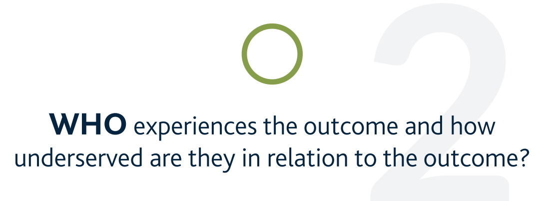
Thankfully, there are new solutions which we believe are much-improved over legacy ones. In particular, Fiera Capital is leveraging the work of the Impact Management Project (IMP), a forum that has been "building global consensus on how to measure and manage impact."[2] The IMP brings together over 2,000 organizations – including some of the largest investment managers, non-profit foundations and inter-governmental organizations such as the United Nations and the OECD – "to share best practices and agree on norms for impact measurement."

The IMP proposes that, to understand any impact on people or the planet, data should be collected across five dimensions: What; Who; How Much; Contribution; and Risk. These dimensions can be used to categorize a company's intentions or performance as "acting to avoid harm," "benefiting stakeholders," or "contributing to solutions." The IMP's norms are as practical as they are comprehensive, and set out a common logic that can be used to measure a company's positive or negative contribution to the one or more of the United Nations' Sustainable Development Goals (SDGs), a set of 17 goals which serve as "blueprint to achieve a better and more sustainable future for all."[3]

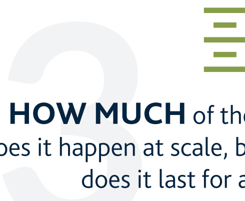
The IMP's Five Dimensions of Impact



WHAT outcome(s) do enterprise activities drive? How important are these outcomes to the people (or planet) experiencing them?



WHO experiences the outcome and how underserved are they in relation to the outcome?



HOW MUCH of the outcome occurs? Does it happen at scale, bring deep change and does it last for a long time?

CONTRIBUTION
Would this change likely have happened anyway?

What is the **RISK** to people and planet that the impact does not occur as expected?

Source: IMP, https://impactmanagementproject.com/impact-management/what-is-impact/

2 https://impactmanagementproject.com/about/
3 "About the Sustainable Development Goals." United Nations. www.un.org/sustainabledevelopment/sustainable-development-goals/

While this guidance provides an excellent starting point for understanding the impact of an enterprise, unlike with many ESG data providers, **the onus remains on the user of the IMP's guidance to do their own due diligence on the company they are investigating, and to tailor it to their particular needs**. Undoubtedly, doing your own research into an investment's potential impact makes the process much more onerous and time-consuming. Sorting through the noise – and with the increasing popularity of responsible investing, there is a lot of it – takes a significant amount of input.

Yet we see the impact due diligence process as part and parcel of our overall research process. Fiera Capital's corporate credit teams don't simply rely on credit rating agencies to determine a company's financial strength, nor do the equity teams rely only on sell-side analyst buy/sell recommendations to pick stocks. True, they may use these ratings as a starting point, but they then scrutinize them, digging deeper into company financials to find the ones that may have been mis-rated or which have better or worse value than on the surface. This is a process that all Fiera Capital portfolio managers and analysts engage in, so why shouldn't they do the same when investigating a company's impact?

The Fiera Impact Score

At Fiera Capital, we have adopted the IMP's guidance so that it can be used to quantify a company's Impact in the form of the Fiera Impact Score (FIS). We use the FIS to rate each investment opportunity in order to determine its suitability in the impact strategy.

The FIS model is built around the idea that companies may contribute to the SDGs in two forms: 1 – through the products and services they sell; and 2 – through the operations and activities in which they engage. We found that many models and ESG providers focus solely (or at the very least, too much) on the impact of products and services. But we feel that the operations used to create those goods and services must also align with the SDGs, as they can be highly beneficial or detrimental to impact goals. For example, a company operating a wind farm is contributing positively to SDG 7.2 *(Increase substantially the share of renewable energy in the global energy mix)* through their product, but if their employees are unnecessarily exposed to dangerous work conditions, then the company is highly misaligned with SDG 8.8 *("Protect labour rights and promote safe and secure working environments for all workers…")*. We thus believe it's crucial to include a company's operations in any analyses.

The first step in building the FIS is to screen for any companies that are clearly misaligned with any of the SDGs – that is, companies which may or do cause significant harm through their products. This may involve excluding certain industries (for example, the coal power generation industry) or companies which are highly misaligned because of their operations (e.g. any with a weak employee safety track record).

Examples of automatic exclusions from our impact strategy

INDUSTRY	REASON FOR EXCLUSION (SDG)
MILITARY CONTRACTING	16.1 - Significantly reduce all forms of violence and related death rates everywhere
TOBACCO	3.A - Implement the WHO framework convention on tobacco control
PREDATORY LENDING	1.2 - By 2030, reduce at least by half the proportion of men, women and children of all ages living in poverty in all its dimensions according to national definitions 10.3 - Ensure equal opportunities and end discrimination

Once those companies are screened out, the impact merits of the remaining companies – both positive and negative – are determined through a calculation that considers the contribution of the company's products and services and its operations to the SDGs. This modelized process is based on the IMP's five dimensions of impact, enabling us to determine if and how much a company's products and operations generate a positive impact.

We modified and tailored the IMP's guidance so that at the end of our analysis, the model gives us a numerical value (from 0 to 100), thus enumerating the potential investment's ability to generate a positive social and environmental return. Any company with a score below 50 is eliminated, while all others are considered as potential investments into an impact strategy. Below is an example of the output from an impact analysis of one our target companies.

The Fiera Impact Score process

COMPANY: KINGSPAN GROUP PLC	
WEIGHTING	
PRODUCTS & SERVICES	75%
OPERATIONS & ACTIVITIES	25%

PRODUCTS & SERVICES

	SDG GOAL & TARGET	% of revenue tied to SDG	Impact	Score contribution
I	7.3 & 11.6	61%	C	45.8%

OPERATIONS & OTHER ACTIVITIES

	SDG GOAL & TARGET	Scale & scope of SDG	Impact	Score contribution
II	12.5	35%	C	8.8%
III	13.2	35%	C	8.8%

	WHAT			WHO	
	DESCRIPTION	OUTCOME	IMPORTANCE	MAIN BENEFICIARIES & BOUNDARY	HOW SERVED (Vulnerable)
I	Insulation materials & technology to increase the energy efficient buildings	Positive	Important	Environment, global	Underserved
II	Use recycled plastic bottles in products & recycle waste	Positive	Important	Environment	Underserved
III	Manufacture products from 100% renewable sources by 2020 with 75 % Net Zero Energy as of date	Positive	Important	Company and world	Underserved

	HOW MUCH				CONTRIBUTION		RISK	
	SIGNIFICANCE OF THE EFFECT	SCALE	DEPTH	DURATION	COMPARE AND CONTRIBUTE TO WHAT IS LIKELY TO OCCUR ANYWAY		RISK FACTORS THAT DEVIATE EXPECTATIONS	
I	Revenue of £4.4 billion & buildings last over 60 years	Large scale	High degree of positive change	Long term	New and renovated buildings would continue to be less energy efficient	Likely better	Public company	Medium risk
II	256 million bottles recycled & 69% reduction in waste	Large scale	High degree of positive change	Long term	Bottles may end up in landfills & the ocean	Likely better	Public company	Medium risk
III	611 GWh used at the company	Large scale	High degree of positive change	Long term	Company's emissions would be higher	Likely better	Public company	Medium risk

PRODUCTS & SERVICES - SCORE CONTRIBUTION	OPERATIONS & ACTIVITIES - SCORE CONTRIBUTION	FIERA IMPACT SCORE
45.8	17.5	63.3

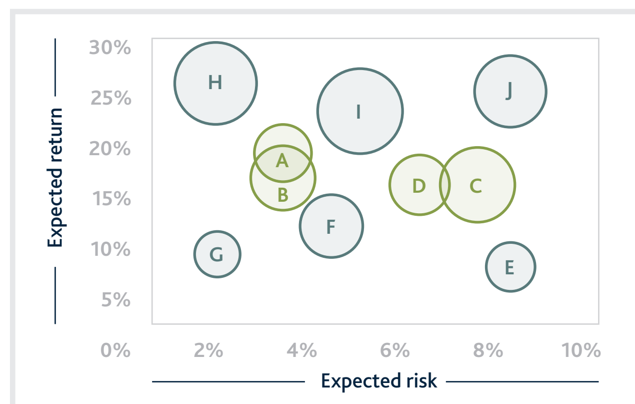
Constructing Efficient and Impactful Portfolios

Of course, the calculation of the FIS is only one part of the impact portfolio's construction process. Alongside our traditional fundamental financial research, the FIS is leveraged to build a portfolio that can actually deliver on all three factors important to the strategy's investor: risk, return and impact. This is also the step in which the FIS's reliance on impact measurability comes into play, as the portfolio manager must make decisions regarding which investments to include in the portfolio; having a quantifiable value of a company's impact strongly supports the portfolio construction process.

Still, difficult security selection decisions must be made, and the following chart helps illustrate these decisions. It plots ten hypothetical potential investments' risk and reward on the axes, while the size of the circle represents the investment's impact score. Some potential investments like Company H are clearly impressive on all three factors, while others, like Company E, are certainly undesirable for their high risk, low reward and low impact. In certain cases, however, tradeoffs are difficult.

For example, Companies A and B have the same level of risk, but while A's expected return is 2% higher than of B, its FIS is 20% less. Is the manager willing to sacrifice some return for a greater level of impact? The same difficult decision must be made between Companies C and D; while they have the same expected return, the former has slightly greater risk and greater impact.

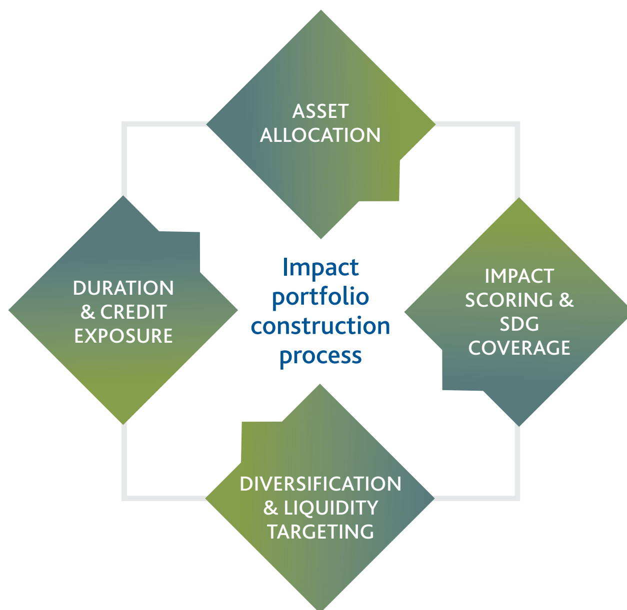
Risk, reward and impact



Source: Fiera Capital. For illustrative purposes only.

While the three factors – risk, return and impact – are the primary targets of this type of strategy, there are several additional layers that are built into the portfolio construction process. As with traditional strategies, asset allocation is a primary determinant of the underlying investments, and thus plays a crucial role in portfolio construction. The portfolio manager also ensures that the strategy is properly diversified by geography, currency and capitalization, among other things, while also targeting a minimum amount of liquidity within the portfolio. Finally, within the fixed income portfolio, duration and credit exposure are also considered.

Importantly, the portfolio construction process is a continuous one, rather than a sequential one. That is, no step is more important than another, and each analysis is consistently being performed for each current and potential portfolio investment, in order to ensure the portfolio is constantly optimized.



This is especially important as engagement by our investment teams with companies' management allows us to gauge if their impact goals are drifting or are delivering on their promises. Through discussions with management and constant reevaluation of their impact and financial targets, we seek to build the most efficient impact portfolios possible.

Personal Values and Financial Returns

For many institutional investors, their concerns for their portfolios extend beyond just financial returns into societal considerations. In this respect, impact portfolios can provide an ideal solution to address both their financial and impact objectives. To be clear, these investors certainly expect a financial return on their portfolio, but they also want their portfolio to reflect their values, mission and what they represent as an organization. For that component of the portfolio, impact cannot be an afterthought – it is considered together with a fair risk and reward dynamic.

Naturally, one of the questions on any potential impact investor's mind is how much the risk/return profile suffers – if at all – by investing in impact strategies over traditional ones. While there is no clear consensus, in general, research into the link between companies' ESG characteristics and financial performance has found that companies with better ESG ratings may outperform over time. MSCI, for example, found that "there is significant evidence that the application of MSCI ESG Ratings may have helped reduce systematic and stock-specific tail risks" and that "high-ESG-rated companies were more profitable, paid higher dividends and showed slightly higher valuation levels."[4] However, it's important to understand that ESG integration, as noted earlier, differs from impact investing, and being a relatively new reality in the financial world, there isn't much scholarly research into whether impact investing in particular means sacrificing on risk/reward metrics.

In our view, impact investing is a bias, similar to having a factor tilt such as quality, value, or low-beta. All investment biases affect the risk/reward profile of an investment strategy, and impact strategies are no different. By definition, applying any investing bias decreases the universe of available investments. For impact strategies this would be the case: certain industries would be excluded from the portfolio before the screening process even begins, while many companies would then be filtered out if their FIS is too low for our standards. Thus, the universe of available investments is smaller with in an impact portfolio than it otherwise would be. With a smaller investable universe, it's understandable that investors would think that having an impact tilt would be detrimental to the risk/reward profile.

Investment factors - some examples

VALUE	LOW BETA
GROWTH	ESG FOCUS
SIZE	IMPACT
MOMENTUM	QUALITY
LOW VOLATILITY	

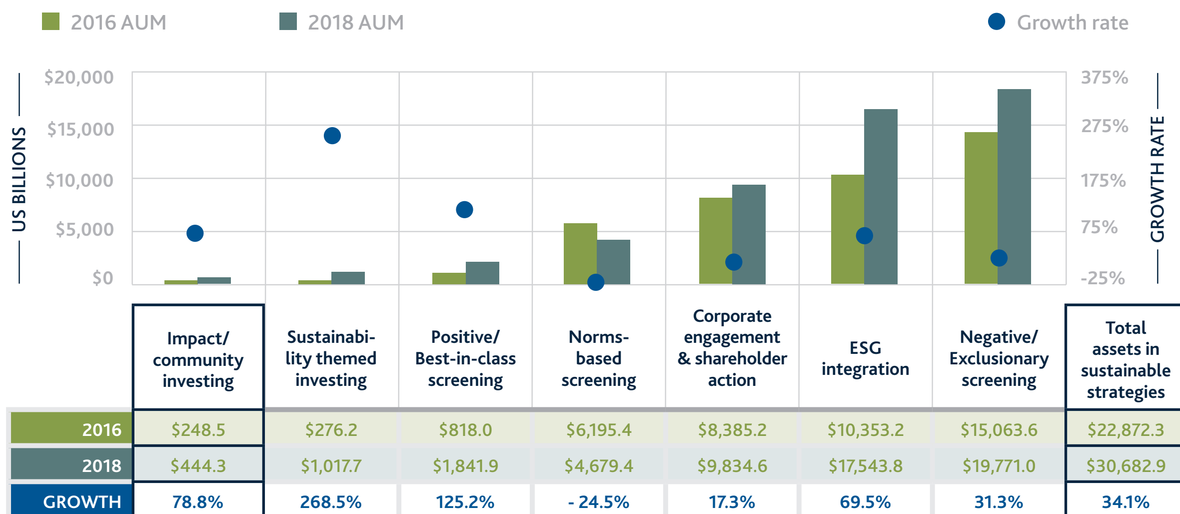
4 Giese, Guido & Lee, Linda-Elin. "Weighing the Evidence: ESG and Equity Returns." MSCI ESG Research. April 2019.

Nevertheless, there are also benefits which may aid impact strategies' performance. For example, impact strategies typically hold their investments for a longer time period than those in traditional portfolios; the societal and environmental mission of the underlying investment is a long-term endeavor, and thus it may take years for a company's intended impact to materialize. The resulting impact portfolio is also one with a high active share vs its benchmark, as the filtering and scoring will remove many possible investments from the universe. Research has shown that portfolios with these two characteristics – high active share and longer-term holding periods – have demonstrated an outperformance of over 2% versus their benchmarks, while those portfolios with the shortest holding periods underperformed their benchmarks.[5] Thus, having a long-term tilt along with high active share may in fact be beneficial.

Additional benefits to impact investors could come from government policies, which are increasingly becoming favourable to socially-responsible companies, particularly as it pertains to the environment. For example, a report by the Principles for Responsible Investment – a United Nations-supported organization that works to understand the investment implications of ESG factors and help incorporate them into firms' investment and ownership decisions – estimates that policies aimed at fighting climate change which are likely to be implemented by 2050 could permanently erase US$2.3 trillion off the valuation of a range of companies in the MSCI ACWI index. However while many companies might suffer, some will likely gain – the 100 best performers would gain 33% of current value, according to the report.[6]

Finally, with the rising popularity of investing with a conscience, more capital is flowing into these strategies than ever before. In the United States, more than a quarter of all assets under professional management are invested in sustainable, responsible and impact strategies.[7] Globally, from 2016 to the start of 2018, total assets in sustainable investing strategies grew by 34% to reach US$30.7 trillion of assets under management.[8] Impact investing, while still a small segment of the larger sustainable investing landscape, is in fact one of the fastest-growing segments, having grown by 79% to nearly $450 billion in the same time frame in the 5 major investing regions.[9]

Global growth of sustainable investing strategies, 2016 to beginning 2018



	Impact/ community investing	Sustainability themed investing	Positive/ Best-in-class screening	Norms-based screening	Corporate engagement & shareholder action	ESG integration	Negative/ Exclusionary screening	Total assets in sustainable strategies
2016	$248.5	$276.2	$818.0	$6,195.4	$8,385.2	$10,353.2	$15,063.6	$22,872.3
2018	$444.3	$1,017.7	$1,841.9	$4,679.4	$9,834.6	$17,543.8	$19,771.0	$30,682.9
GROWTH	78.8%	268.5%	125.2%	- 24.5%	17.3%	69.5%	31.3%	34.1%

Source: : "2018 Global Sustainable Investment Review." Global Sustainable Investment Alliance. Regions studied are Europe, U.S., Canada, Japan, Australia and New Zealand. All values in US$ Billions. Assets from 12/31/15 to 12/31/17 except Japan which is 3/31/16 to 3/31/18. Conversions from local currencies to US dollars were at the exchange rates prevailing at the date of reporting. The totals shown are net values after adjustments to remove double-counting, since managers may apply more than one strategy to a given pool of assets.

5 Cremers, Martijn & Pareek, Ankur. "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently." Journal of Financial Economics, vol. 122, iss. 2, Nov. 2016, pp. 288-306. SSRN, papers.ssrn.com/sol3/papers.cfm?abstract_id=2498743##

6 "Forecast Policy Scenario: Equity Markets Impacts". Principles for Responsible Investment. www.unpri.org/inevitable-policy-response/forecast-policy-scenario-equity-markets-impacts/5191.article

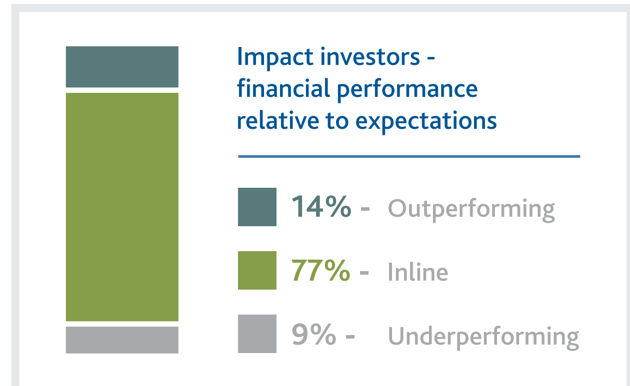
7 "Report on US Sustainable, Responsible and Impact Investing Trends 2018." US SIF: The Forum for Sustainable and Responsible Investment. 2018

8 "2018 Global Sustainable Investment Review." Global Sustainable Investment Alliance. 2018. gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf

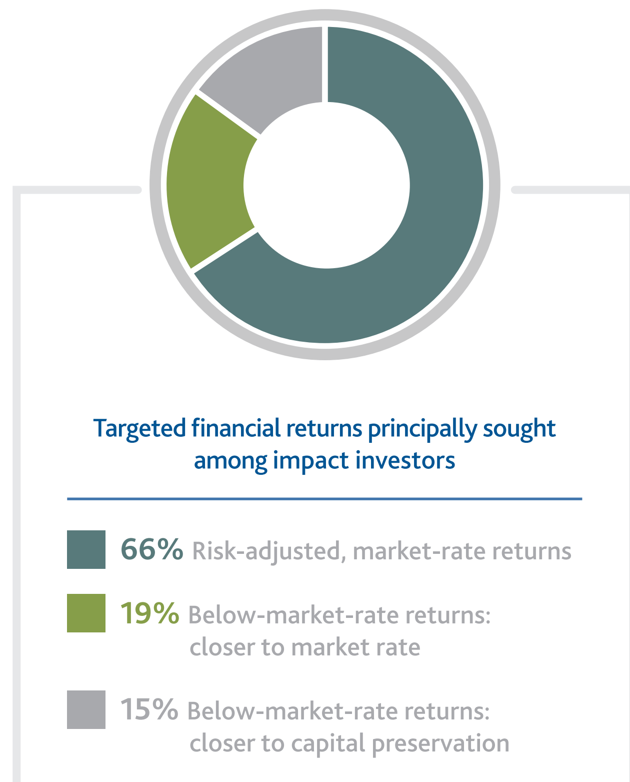
9 Ibid.

How could this benefit investors in impact strategies? As more capital flows into sustainable and impact-forward companies, their costs of capital demanded by shareholders and bondholders will likely decrease. A lower cost of capital would provide a major benefit to the company and should increase expected returns for shareholders. Thus, the increasing popularity of sustainable investing could be a boon for impact investors.

Still, data seems to suggest that the typical investor in impact strategies doesn't expect their altruism to come with much of a price. According to the Global Impact Investing Network, two-thirds of impact investors studied seek risk-adjusted, market-rate returns. Moreover, among those same group of impact investors, over 90% of respondents reported performance in line with or exceeding their financial expectations.[10] It seems that many firms have thus found that they can strike an acceptable balance between the three factors.



Source:Global Impact Investing Network, Annual Impact Investor Survey 2019.



Source:Global Impact Investing Network, Annual Impact Investor Survey 2019.

Investing for the Social Good

Risk and return have been the sole considerations for the construction of "efficient" portfolios for far too long. As social impact takes its role as the third factor of finance, the investment community has realized that it can play a role in contributing to the sustainable development. It has a long way to go – the UN estimates that the financing gap to achieve the SDGs in developing countries alone is US$2.5 – 3 trillion per year.[11] The increasing investor interest in impact strategies is a significant step in the right direction, but the money going into these strategies is only as good as actions the portfolio companies engage in.

At Fiera Capital, we don't think that impact investing necessitates a tradeoff with risk-adjusted return; there are ways of having both. The consensus agreed via the work of the Impact Management Project, in conjunction with deep research into companies' activities, can yield results that deliver from a risk, return and impact point of view. We are confident that this will prove to be a winning strategy for our investors and our society.

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Fiera Capital Corporation

10 "Annual Impact Investor Survey, 2019." Global Impact Investing Network. 2019. thegiin.org/research/publication/impinv-survey-2019
11 "World Investment Report 2014. Investing in SDGs: An Action Plan." United Nations Conference on Trade and Development. 2014. unctad.org/en/PublicationsLibrary/wir2014_en.pdf

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