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LOMBARD ODIER
INVESTMENT MANAGERS

THE 100%-IMPACT INVESTOR

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Once a marginal strategy used by a few pioneers in one part of their portfolios, Impact Investing is now playing a central role in the investment philosophy of a growing number of private and institutional investors. However, to really move from the margins to the mainstream, the Impact Investing industry must now rise to a double challenge:

1. Reaching out to all investors
2. Reaching out to all asset classes

In this paper, we describe how we got to where we are today and what it will take to create a community of "100%-impact investors."

What is impact?

Impact is the sum of positive and negative, direct and indirect effects that a company's operations and products have on the environment and on society.

FROM ETHICS TO IMPACT: A LONG HISTORY OF INNOVATION

To understand where Impact Investing stands today, you have to look at the long history of innovation that shaped it.

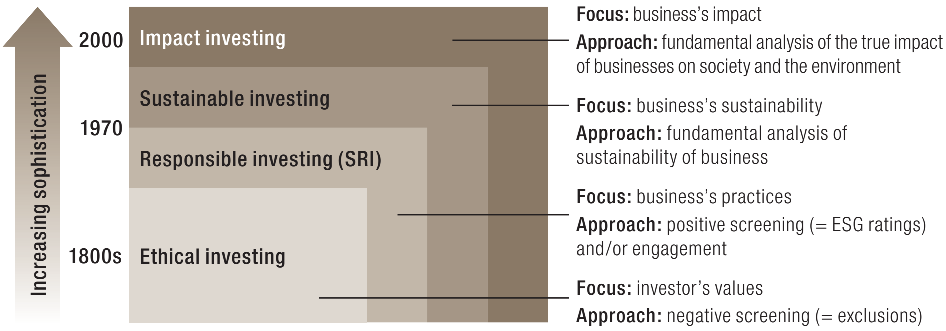
It all started more than a century ago, when religious organisations, in particular, saw that their wealth should be deployed consistently with their mission. The implementation tended to be fairly straightforward, and the techniques rather rudimentary: excluding certain companies or sectors, such as those involved in alcohol, gambling, pornography or arms production. Ethical investing was born.

For many decades, ethical investing remained both small and fairly static. But in the 1970s a new round of innovations re-invented the approach by looking beyond ethics in an attempt to assess and quantify companies' social responsibility. In addition to excluding the "bad" companies, investors tried to find ways to identify and reward the "good" ones with their capital. New methodologies were developed to rate companies according to their Environmental, Social and Governance (ESG) performance.

This was the beginning of Socially Responsible Investing (SRI), and it quickly gained traction in the investment community. As it did so, ESG-rating techniques became more accurate, infrastructure was built to collect ESG data in a standardised way, and investment processes were refined to make sure the financial performance associated with conventional approaches was maintained – or even improved upon. Success in these areas inspired a movement to integrate ESG considerations into mainstream portfolios, and not restrict them solely to dedicated SRI strategies.

Finally, at the beginning of the 2000s, some investors felt that looking at the responsibility and sustainability of companies was good, but not enough. They wanted their money to finance and support companies that not only behaved responsibly, but also provided genuine solutions to the world's most pressing challenges. They wanted their capital to be put to work for direct social and environmental impact. These investors started to look for businesses whose core mission was to provide products and services that reduced poverty or fought climate change. They developed the first microfinance funds, helped design the first Green Bonds, and created a whole series of other high-impact investment strategies. The era of Impact Investing had arrived.

FIG. 1 – THE GROWING SOPHISTICATION OF INVESTMENT STRATEGIES AND PROCESSES



Source: Lombard Odier. For illustrative purposes only.

Given this history it's not surprising that some of the concepts and terminology can cause confusion. People hear about "ethical investing," "sustainable finance," "impact portfolios." They learn about techniques such as "normative exclusions," "best-in-class selection" or "ESG integration."

For us at Lombard Odier, this abundance of terminology is evidence of the sheer pace of innovation that has hit this field, especially over the past 40 years. To those unfamiliar with the sector, these innovations might seem a little erratic. But look carefully at this evolution. Really, it is clear that there were always two major objectives at the heart of each successive innovation:

- **GETTING BROADER.** Practitioners have always tried to find ways to ease the adoption and integration of these new approaches into mainstream investment portfolios – to bring the benefits to an ever-broader range of investors, and to maximise the ultimate impact on the world around us.

- **GOING DEEPER.** Investors have consistently sought new and better ways to measure and take into consideration the direct and indirect consequences that all investments have on the environment and society: quantifying these consequences is how we progressively moved from ethics to responsibility, responsibility to sustainability, and sustainability to impact.

THE ULTIMATE DESTINATION: IMPACT AS THE THIRD DIMENSION OF INVESTING

Can impact go mainstream?

Until now Impact Investing has gone deep in niche markets but remained shallow in mainstream markets – but we think this is changing.

Combining these two objectives is not easy. "Going deeper" with impact analysis often requires investors to explore unchartered opportunities that mainstream investors tend to stay away from. "Getting broader" means taking care when we integrate impact-investing criteria into our processes, so that they do not affect the asset allocation, risk-return profile or liquidity target of our investment strategies.

However difficult this movement can be, it's clear to us at Lombard Odier what the ultimate destination of this "Getting broader, Going deeper" journey will be: impact will become a natural fixture of mainstream investing – the "Third Dimension," alongside risk and return.

To get there however, impact investors need to continue to "Get broader and Go deeper":

1. Impact should conquer all types of investors, going far beyond the first circle of enthusiastic early adopters
2. Impact must conquer all asset classes, and find its way into mainstream bond and equity investment strategies

ADOPTION BY MAINSTREAM INVESTORS

We have very good reason to believe that the first challenge is being taken up enthusiastically. Indeed, an increasing number of institutional and private investors already have an allocation to Impact Investing – albeit sometimes a modest one. We believe they will be joined by the rest of the financial community over the coming years, thanks to three powerful incentives to action.

FIG. 2 – THREE POWERFUL INCENTIVES FOR MAINSTREAM ADOPTION OF IMPACT INVESTING

Source: Lombard Odier. For illustrative purposes only.

The first is a combination of regulation and reputation. Regulatory requirements and voluntary mechanisms, from binding legislation to codes of practice and industry self-regulation, are pushing institutional asset owners and the asset management industry to pay more attention to social and environmental impact.

Supra-national initiatives such as the UN Principles for Responsible Investing (UNPRI) offer useful voluntary standards that have helped align investment managers around sustainability goals: launched in 2007, the UNPRI now have more than 1,500 signatories representing some USD 60 trillion of the world's institutional investment assets.[1]

[1] Source: https://www.unpri.org/about.

Does impact weaken returns?
The evidence suggests not – and intuitively it should both mitigate risk and provide opportunity.

Country-specific measures also contribute to creating standards. A good example is the French law on energy transition, adopted in August 2015 as Paris prepared to host the 21st session of the Conference of the Parties to the United Nations Convention (COP21), at which 223 countries agreed to take action to limit the increase in global temperature to 2°C above pre-industrial levels. This law requires the country's asset managers to show how they manage climate-related risks and integrate ESG parameters into their investment policies, so that end-investors can assess how their portfolios facilitate (or obstruct) the transition to a low-carbon economy.

The second incentive is the growing recognition that Impact-Investing criteria can help identify some of the key characteristics of sustainable financial returns. At Lombard Odier, we understood from the very beginning of our work in ESG analysis and Impact Investing 20 years ago that true impact requires scale, and that scale would never come unless we offered risk and return at least in line with the conventional market.

There has been a wealth of academic analysis of the empirical data over the past 30 years. A good recent summary from Oxford University's Smith School of Enterprise and the Environment and Arabesque Asset Management looked at 41 studies of "sustainability and its relation to financial market performance" and found that 80% of them showed that "stock price performance of companies is positively influenced by good sustainability practices."[2]

Our own track-record supports this result. Like many impact-conscious asset managers, Lombard Odier monitors a "Controversy Radar": when we looked at these categorisations alongside the returns of the 5,000 companies in our ESG database over seven years, we found that whenever a stock jumped from a low category on the Radar up to the most severe category-four or five controversies, it lost an average of 3% in one month (the two weeks before and the two weeks after its peak controversy rating). Moreover, over the past three years that average loss jumped to an astonishing 15%. Can investors do anything about this? Apparently so: even a crude approach of excluding the bottom quintile of companies based on our ESG ratings reduced the probability of a portfolio experiencing a peak in the Controversy Radar by at least half.

We believe the conclusion is clear: returns and impact can go hand-in-hand. As the financial community increasingly comes to share that view, the number one obstacle to impact integration is disappearing, leading the way to large-scale adoption.

And that is why we are seeing the biggest incentive to action by the industry: client demand itself. Responsible investing already accounts for more than one out of every five dollars managed professionally in the US, and while definitions are less clear some studies suggest that the proportion could be almost 60% for European assets.[3] This growth is poised to accelerate as a generational shift sees trillions of dollars transferred from baby-boomers to millennials over the coming decade: a 2013 World Economic Forum survey of 5,000 millennials in 18 different countries found that they thought the top priority for any business should be "to improve society."

Large pension funds, especially in Northern Europe, have also started to announce significant allocations to Impact Investing. To take just one of a number of examples, in 2015, Norway's USD 860 billion sovereign wealth fund divested from 73 companies on the grounds of corruption, environmental and social risks, and the following year it dropped another 52 that had more than 30% of their activity or sales linked to coal.

More and more investors – individual and institutional, of all sizes and across all regions – want to invest with purpose and put their capital to work for positive change.

[2] Gordon Clark, Andreas Feiner and Michael Viehs, "From the Stakeholder to the Stockholder: How Sustainability Can Drive Financial Performance" (March 2015).
[3] Data for the US industry is from US SIF, "Report on US Sustainable, Responsible and Impact Investing Trends 2016"; data for the European industry is from Global Sustainable Investment Alliance, "2014 Global Sustainable Investment Review."

Strategic partners for impact

Lombard Odier has not been alone in its journey towards impact. We have joined forces with strategic partners who share our ambition to deliver impact with uncompromised financial results.

generation_

Founded by Al Gore and David Blood in 2004, Generation Investment Management follows an investment approach based on the premise that sustainability factors will, over the long-term, determine a company's share price. It aims to invest in businesses with strong management teams that understand and respond to sustainability factors, and the greatest potential to benefit from long-term global change.

Generation and Lombard Odier signed an exclusive partnership in 2007 that led to the creation of an investment fund that quickly became a reference point in the sustainable investment space and remains one of the biggest and best-performing funds in the sector.[4]

AIM Affirmative Investment Management

Affirmative Investment Management (AIM) launched in 2014 as the first fixed income asset manager dedicated to offering strategies that target positive climate and social impact, while delivering mainstream bond-market risk and return. The founders of AIM were behind the launch of the very first Green Bond fund, making them the most experienced team in this specific field.

In 2017 Lombard Odier and AIM signed a strategic partnership to launch an investment fund that invests in Green Bonds and other climate bonds with the objective of delivering both a measurable environmental impact and financial performance that is at least equivalent to that of the conventional bond market.

TOWARDS 100%-IMPACT PORTFOLIOS

But even as more investors get involved in Impact Investing, it can still find itself stuck in their "satellite buckets" rather than spreading throughout their portfolios.

Until now Impact Investing has been almost entirely focused on private markets. Demonstrating and measuring impact when you invest in social businesses whose core mission is to create products and services that alleviate poverty or save the planet is relatively easy. It is much more difficult with a portfolio holding stocks and bonds from large, diversified multinationals. The aspiring "100%-Impact Investor" – the one who wants his entire portfolio to be invested with impact – has therefore tended to skip conventional asset classes altogether and restrict investments to private debt, private equity and real assets.

However, we believe that two major innovations should and will allow impact to become integral for all investors, finding its way into the heart of conventional equity and bond markets.

The first innovation is in the ways investors are trying to identify, isolate and ring-fence environmentally- and socially-impactful activities, products and projects within larger companies.

We have had "use-of-proceeds" bonds for a decade already. By ring-fencing the proceeds raised by a bond issued for specific projects, these bonds make it possible for investors to get away from the highly-complex task of assessing the overall impact of the issuer itself, and focus instead on analysing the impact of the projects being financed by the bond.

Green Bonds – specifically designed to finance infrastructure that helps us mitigate or adapt to the effects of climate change – are the classic example. They are issued by the same type of public and private issuers as conventional bonds, they are traded on the same markets, they benefit from exactly the same credit-rating treatment, and they offer a risk-return profile in line with conventional investment-grade bonds[5] – but the proceeds go exclusively and directly into financing climate-friendly projects, such as wind farms in Kenya, for example. That means an actively-managed portfolio of Green Bonds can give investors a high-impact solution they can use in their traditional fixed-income allocation, in our view.

The Green Bond market has grown exponentially over recent years and we fully expect the ring-fencing concept to spread to other "use-of-proceeds" impact bonds such as water bonds, social bonds and education bonds. Indeed, we are convinced that the transparency that ring-fencing brings is so compelling that the practice will ultimately spread to the entire bond market, making it possible for investors to know precisely how their capital is being used, and therefore fully integrate impact assessment throughout their fixed income investment decisions.

[4] The UCITS fund has a five-star Morningstar rating within the Global Large Cap Growth Equity universe as at 31 January 2017. Past performance is not a guarantee of future results.
[5] Bonds eligible for inclusion in the Barclays Global Aggregate Index as at 28 February 2017.

Such "use-of-proceeds" mechanisms are not applicable in the public equity market. Nonetheless, it is becoming possible for investors to analyse a company's many business lines, projects and revenue streams to determine what proportion is helping to meet the world's most pressing environmental and social challenges – and indeed what proportion is actively adding to those problems.

In environmental terms, this is what is known as a company's "green share." The COP 21 agreement calls for investors to make their best effort to calculate their portfolios' green share, and at Lombard Odier we have developed a set of tools to measure this for all of our strategies.

The second innovation will be to bring true impact data into the heart of the ESG analysis done on listed companies.

Until now, ESG analysis has been focused on business processes. It assesses how responsible companies are in their organisation and direct operations, but it doesn't say much about the real-world consequences of the products and services they put on the market. In other words, conventional ESG analysis is, to a large extent, agnostic about the activity of any business or sector.

This explains why a company like Total scores well in most ESG models, for example – despite the fact that its core product is a leading contributor to greenhouse gas emissions. At the same time Tesla, which has not yet formalised its code of ethics or implemented state-of-the-art governance, gets a fairly poor ESG rating despite its contribution to revolutionising clean transportation.[6]

At Lombard Odier, we recognise the value of the ESG approach. In fact, we have been using it for the last 20 years. It makes it relatively simple to integrate extra-financial considerations into mainstream investment processes, and offers a robust solution to investors that want to invest responsibly without changing their core investment strategies. But we also acknowledge that more can be done better to integrate impact considerations into the ESG process.

This is why we have developed an additional analytical framework for the 5,000 listed companies that we cover, called "CAR" (Consciousness, Actions, Results), which complements our ESG approach by looking beyond intentions and into concrete actions taken by companies to get measurable results.

FIG. 3 – ENHANCING ESG ANALYSIS BY FOCUSING ON "ACTIONS" AND "RESULTS"

MEASURING PERFORMANCE – THE ESG VIEW

E Preserve the Environment (33%)	S Work for Social progress (33%)	G Practice fair Governance (33%)
Emission reduction	Working conditions and union rights	Board of directors' functions and structure
Natural resource preservation	Respect for human rights	Directors' compensation policy
Product innovation	Impact on communities	Shareholder rights
Quality of policies, programmes and management systems	Client/product responsibility	Strategy integration
Use of renewable energy	Workforce diversity	Strategy against bribery and corruption
Pollution	Health and safety	Business ethics
	Supply chain monitoring systems	Transparency of CSR[7] reporting

MEASURING PROGRESS – THE CAR VIEW

C Is the company Conscious? (20%)	A What Actions are taken? (30%)	R What Results are achieved? (50%)
Setting general ESG policies	Developing reporting tools	Reducing environmental impact
Participation in and membership of international organisations and workshops	Implementation of mainstream business ESG policies	Improving social balances
Marketing and communication	Increasing transparency and reporting	Improving governance structure
	Fitting ESG into the corporate strategy	Controversies
	ESG programmes and targets	

Source: Lombard Odier. For illustrative purposes only.

[6] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.
[7] CSR: Corporate Social Responsibility.

What is "greenwashing"?

A company is "greenwashing" when it makes a big point of committing to all the right environmental and social undertakings, but fails to follow through with action or results.

Let's consider a gender equality example. When a company signs the UK's Women in Finance Charter, say, it scores points under what we call "Consciousness." This sort of thing is captured by some conventional ESG analysis. But we go further, scoring for "Action" when it sets up awareness and talent-development programs for female staff, and "Results" if it can demonstrate a consequent increase in women in senior management.

This helps us identify those companies that are genuinely taking action and those that are basically writing up nice sustainability or corporate social responsibility reports – what gets called "greenwashing" in the environmental sector.

We are now bringing a new range of core impact data into our analysis, alongside CAR. Our proprietary carbon intensity tracker creates a CO_2-equivalent data point for all greenhouse gas emissions and proxy data for non-disclosing companies, and can now be calculated for any portfolio of any conventional asset class. This allows investors to allocate more to companies with substantially lower carbon footprints immediately – and we will soon introduce similar data for water footprint and employee satisfaction.

With the integration of this new generation of impact data, the frontier between ESG investing and Impact Investing is slowly disappearing, and with that, the possibility of the mainstream 100%-Impact Investor is becoming a reality at last.

THE IMPACT OFFICE: LOMBARD ODIER'S CENTRE OF EXPERTISE

Lombard Odier has not just witnessed the evolution of the impact space over the last 20 years, it has been at the forefront of this movement towards deeper and broader impact solutions. The solutions we have designed for our clients have always tried to push the limits of a true impact focus, looking beyond the status quo when it comes to collecting and cleaning impact data, and integrating it into the heart of our investment processes. And as we engaged in this movement towards deeper impact, we always strove to design solutions that could fit easily into all our clients' portfolios, to achieve the breadth required for genuine success.

This is the mission of the Impact Office, Lombard Odier's centre of expertise dedicated to realising our ambition to "Get broader and Go deeper" with impact across our firm.

Having already integrated our CAR-enhanced ESG and carbon-intensity analyses into our fixed income, equities, convertibles, multi-asset and alternatives offerings, as well as partnering with leading names in responsible and classic Impact Investing to deliver best-in-class strategies to our clients, 2017 will see further progress on some of our key projects.

We will be integrating ESG analysis into reporting systems for private clients; exploring more classic Impact Investing opportunities beyond our existing development-finance and climate-bonds capabilities; and adding more impact criteria to complement our existing carbon-intensity tracker.

As well as enhancing our existing strategies with ESG analysis, early in the year we will add a dedicated, systematic Global Responsible Equity strategy. Its objective is to deliver excess financial performance hand-in-hand with quantifiable social and environmental impact: seeking to outperform the MSCI World Index by selecting stocks based on five traditional risk factors (value, quality, momentum, low risk and small size) complemented by two impact factors (the "Results" component of our ESG analysis, and carbon intensity).

Capital brings power, which brings even greater responsibility. Capital investment determines not only when companies will start, innovate and grow. It also helps to determine which social and economic models will prevail in the long run. At Lombard Odier, we believe that each and every investment should deliver not only strong financial performance but also solutions to the world's most pressing social and environmental challenges – indeed, in efficient capital markets, the two should go hand-in-hand. But we also believe that to achieve this we must put impact at the heart of investing, alongside risk and return.

The 100%-Impact Investor can be a reality. Because impact is in our DNA, that is our ambition.

Lombard Odier Impact Office
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