17 96

LOMBARD ODIER
INVESTMENT MANAGERS

Impact Investing: Dispelling the Myths

May 2017

At a glance

- Discussion of the increasingly important topic of impact investing remains beset by a number of myths and misconceptions. In this paper we attempt to dispel some of these myths, and describe what impact investing means to Lombard Odier and how we integrate it into our practice.
- Myth 1: Impact investing involves giving up returns or taking on more risk in exchange for doing good in the world.
- Myth 2: Impact investing is all about excluding "sin stocks," rather than pursuing investment opportunities and positive real-world impact.
- Myth 3: Impact investing can only ever be a worthy niche.
- Myth 4: ESG analysis is fine for making sure all the right boxes are ticked, but it ignores the real-world impact of those measures.
- Myth 5: There is not enough reliable data available to be effective as an impact investor, and the industry is not interested in creating it.
- Myth 6: Asset managers like to "talk the talk" on impact investing, but none of them really "walk the walk."

The growing sophistication of impact investing

p.02

Impact investing

- A positive effect on performance p. 03
- More than "negative screening" p. 03
- Bringing impact into the mainstream p. 04
- Integrating impact and ESG analysis p. 04
- Putting data quality top of the agenda p. 04
- Impact at LOIM p. 05

While impact investing began life as "ethical investing," it has since become an integral part of fundamental securities analysis.

Publication of Lombard Odier Investment Managers

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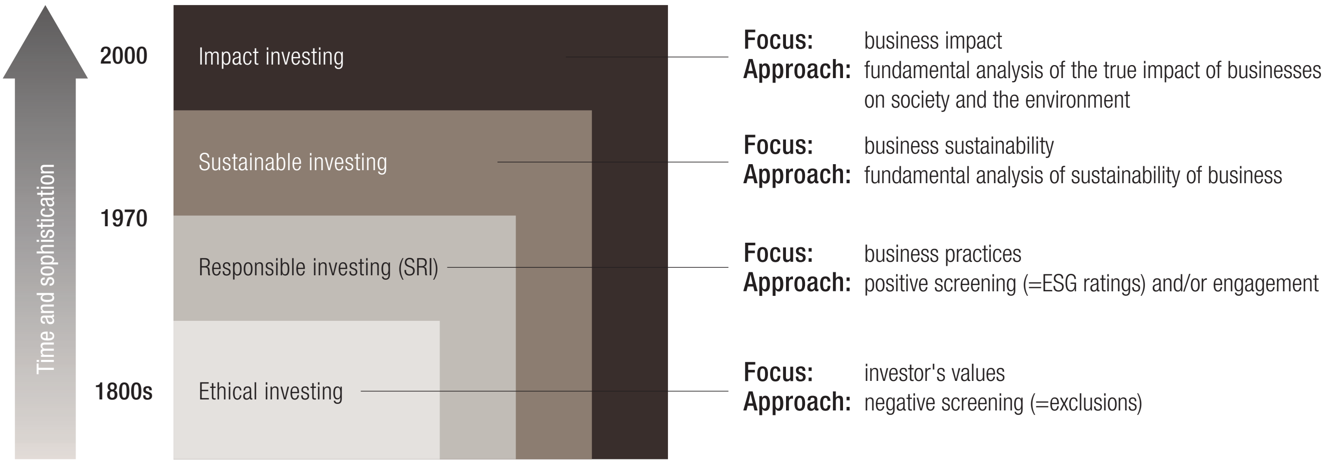
Important information

Please see important information at the end of this document.
Data as at 31 May 2017

FIG. 1 THE GROWING SOPHISTICATION OF IMPACT INVESTING



Source: Lombard Odier. For illustrative purposes only.

People have long invested in accordance with their ethical values, but the concept became institutionalised through the 19th century as religious organisations, in particular, saw that their wealth should be deployed consistently with their mission. The solution was to exclude certain investments, and it was called **"Ethical investing."**

Soon, investors wanted to identify "good" investments as well as avoiding "bad" ones, and they started looking at business practices to determine which were which. Environmental, Social & Governance ratings (ESG) were developed for that purpose, ushering in the era of **"Responsible investing"** (or SRI).

Those investors recognised that focusing on business practices was good, but insufficient. A fundamental analysis of the sustainability of the business they were investing in should also be performed. This brought us **"Sustainable investing."**

Most recently, **"Impact investing"** gave us the ultimate step in this evolution. Now, the objective is to understand, measure and analyse not just the sustainability and practices of businesses, but the true impact they and their products have on the environment and society, in order to invest in the businesses with the biggest positive impact.

In short, approaches to "ethical," "responsible," "sustainable" or "impact" investing have evolved and become more sophisticated over time, to meet investors' needs – and not only their ethical needs, but their risk-management and return needs, too.

Nonetheless, discussion around this increasingly important investment topic remains beset by a number of myths and misconceptions. In this paper we attempt to dispel a handful of the myths that we hear, as well as describing what impact investing means to Lombard Odier, and how we integrate it into our practice as a firm.

THE SIX MYTHS

- **Myth 1:** Impact investing involves giving up returns or taking on more risk in exchange for doing good in the world.
- **Myth 2:** Impact investing is all about excluding "sin stocks," rather than pursuing investment opportunities and positive real-world impact.
- **Myth 3:** Impact investing can only ever be a worthy niche.
- **Myth 4:** ESG analysis is fine for making sure all the right boxes are ticked, but it ignores the real-world impact of those measures.
- **Myth 5:** There is not enough reliable data available to be effective as an impact investor, and the industry is not interested in creating it.
- **Myth 6:** Asset managers like to "talk the talk" on impact investing, but none of them really "walk the walk."

Myth 1: Impact investing involves giving up returns or taking on more risk in exchange for doing good in the world.
Nobel laureate Milton Friedman reportedly said that if people wanted to invest in a socially-responsible way that was their business: "Such investing is neither harmful nor helpful."

Academic analysis of the empirical data – and there has been a lot of it over the course of more than 30 years – does not support his assertion.

> The empirical evidence suggests that impact investing can have a positive effect on performance.

It's a complex question that does not lend itself to simple consensus, due to the wide variation in what the relevant studies have considered. Are they comparing actual mutual funds, or indices created for the research itself? Do the SRI portfolios they test negatively screen, positively screen, or both? Are the markets considered global or regional? Is relative performance measured in returns, alpha, or some kind of risk-adjusted return? Are these studies measuring the performance of SRI fund managers, or the performance of sustainable and responsible companies?

Nonetheless, metastudies show that the weight of positive evidence is building. A good recent summary 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."[1] That is a statistically relevant bias in favour of a positive impact on performance.

Common sense should have a say, too. From the accounting scandals at Enron and Parmalat, through the global banking crisis of 2007-09, the Macondo oil-well disaster, and recent vehicle emissions-testing controversies, many "ESG" failures have had devastating financial consequences for companies and investors.

It's also important to recognise that this damage was often inflicted on businesses and brands previously considered robust and sustainable. As Friedman implied, if all ESG risks were priced in they would be irrelevant to relative performance – but very often they are not. Like many impact-conscious asset managers, Lombard Odier monitors a "Controversy Radar": when we looked at environmental and governance controversies, we found that whenever a stock jumped from a low category on the Radar up to the most severe controversy-level four or five, it lost an average of 4.5% 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 12.5%. Can investors do anything about this? Apparently so: even a crude approach of excluding the bottom quintile of companies based on our ESG ratings more than halved the probability of a portfolio experiencing a peak in the Controversy Radar.

Portfolio managers are adopting these tools because they see the positive impact that "extra-financial" analysis has on their risk management and return generation. While investing began life as "ethical investing," it has since become an integral part of fundamental securities analysis.

Myth 2: Impact investing is all about excluding "sin stocks," rather than pursuing investment opportunities and positive real-world impact.
This was really only true until the 1950s and 60s, when the remit of impact investors began to broaden and de-couple from institutional, often religious missions. At this point investors grew more interested in the opportunities that impact investment afforded, as well as the risks that "irresponsible" investment posed, and ESG ratings were developed to help identify good practice as well as bad.

> Impact investing is much more than simple "negative-screening."

Over the past 20 years, investors have started to focus more on the true impact that companies have on the environment and society – which is usually a question of what their products do, rather than simply the processes they have in place to create them. This led to the development of classic "impact investing," which is dedicated entirely to positive impact in the real world: examples include investment in companies that address the underserved needs of the economically-excluded; microfinance; or Green Bonds issued specifically to finance environmental solutions.

[1] Gordon Clark, Andreas Feiner and Michael Viehs, "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Performance." (Oxford University Smith School of Enterprise and the Enviornment, Arabesque Asset Management: March 2015).

Myth 3: Impact investing can only ever be a worthy niche.
Classic impact investing did lead investors into smaller, often private investments, partly because it is easier to isolate and assess the beneficial impact of such an investment; and partly because an investment of private capital represents a genuine addition of resources to a company making a difference, whereas buying a publicly-listed equity is merely a financial interest changing hands.

Things are changing, however. Green Bonds were an important innovation: by enabling entities to "carve out" climate-friendly projects and issue bonds to finance them directly, household names among multilateral organisations, financial institutions and corporates opened up to direct allocation of capital from impact investors.

Practitioners are creating solutions that bring impact investing into the mainstream.

In addition, investors are increasingly demanding the integration of some of the key performance indicators that impact investors use – the carbon intensity, water intensity and social returns of products and services, for example – into mainstream ESG analysis of larger, listed companies. Which brings us to myth number four.

Myth 4: ESG analysis is fine for making sure all the right boxes are ticked, but it ignores the real-world impact of those measures.
There is a kernel of truth in this myth – but this is precisely why investors are trying to integrate impact performance indicators into ESG analysis.

High scores in an ESG analysis do not necessarily imply high beneficial outcomes for the environment, society, or portfolios. You may be surprised to learn that Tesla has a relatively poor ESG score in most models, simply because it is a young, fast-growing company that has yet to formalise its governance, code of ethics, certification standards, and other processes. At the same time a company like Total scores very well despite the fact that its core product is a leading contributor to greenhouse gas emissions.[2]

Practitioners are integrating impact-investing factors into ESG analysis to enhance results.

That's why at Lombard Odier our impact analysis doesn't stop with the ESG score. For example, we overlay this score with our "Consciousness, Action & Results" rating mechanism (CAR). 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. CAR allows us to keep track of a company's progress towards making a greater positive impact.

In addition, we analyse our database of stocks for carbon intensity, and we are working on similar analyses for water intensity and employee satisfaction.

Myth 5: There is not enough reliable data available to be effective as an impact investor, and the industry is not interested in creating it.
ESG analysis clearly rests upon high-quality data. ESG analysis informed by impact performance indicators, which require sophisticated, ongoing monitoring and reporting of real-world outcomes across thousands of businesses and products, is even more dependent on high-quality data. And it is true that, today, data on impact performance indicators is poor, incomplete, non-standardised, inaccessible, or plentiful but irrelevant. Specialist consultants are working to address some of these shortcomings, but they are creating intellectual property that resists standardisation and accessibility.

The asset management and securities industries have put data quality and accessibility at the top of the agenda.

[2] 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.

But if poor data quality is not a myth, the idea that our industry is not determined to improve it certainly is. At Lombard Odier we believe that the best results will come from industry collaboration on "open-source" data, and a collective effort to raise corporate consciousness of end-investors' demands for ESG and impact reporting. One of the reasons we have established our Impact Office is for it to become our centre for engagement on data quality and accessibility with bodies such as the UN Principles for Responsible Investment's Collaboration Platform, the UN's Sustainable Stock Exchanges initiative, and the UN Sustainable Development Goals initiative.

Myth 6: Asset managers like to "talk the talk" on impact investing, but none of them really "walk the walk."

At Lombard Odier, we've been walking the walk on impact investing for more than a hundred years. Through the nineteenth century the banking arm of the Lombard Odier Group was involved in supporting labour rights and contributed to the foundation of what would become the Red Cross. We created our first impact investment models 20 years ago and got involved in development finance in 2001; we were one of the earliest signatories of the UN Principles for Responsible Investing (UNPRI), a founding member of the Global Impact Investing Network (GIIN), and we collaborate with some of the leading names in the sector.

> Our work in ESG and impact investing demonstrates how our business aligns with the six UN Principles for Responsible Investing.

Our work in ESG and impact investing demonstrates how our business aligns with the six UN Principles. We have been incorporating ESG factors into **"investment analysis and decision-making"** since 1997. We are an **"active owner"** with a clear voting policy, a signatory of the UK Stewardship Code, and a participant in engagement initiatives such as the UNPRI Collaboration Platform. We actively **"seek appropriate ESG disclosure"** from our portfolio companies, and we support the UN's Sustainable Stock Exchanges initiative, which aims to have stock exchanges adopt standardised non-financial reporting guidelines for the companies they quote. We **"promote"** ESG in our industry and **"work together for ever better implementation"** through our participation in a range of sustainable investing associations and initiatives, from Sustainable Finance Geneva to the Carbon Disclosure Project. And, finally, we provide **"transparency on our own activity and implementation progress"** by completing the annual UNPRI questionnaire and delivering detailed reporting to clients on ESG scores, carbon intensity data, industry exclusions, environmental and social impact, and action on controversies. Upon request, we send detailed histories of how we exercised voting rights for clients.

The 20 years of progress since we created our first impact investing model in 1997 has culminated in the creation of our Impact Office, Lombard Odier's centre of expertise dedicated to putting impact at the heart of everything we do.

Impact-enhanced ESG analysis informs the research for many of our **equity** strategies. It has five pillars: first, it excludes companies involved in the production or distribution of controversial weapons (this is a Group-level policy that applies to all strategies); second, it combines the monitoring and assessment of short-term controversies with negative and positive screening on longer-term ESG factors, which includes our proprietary CAR scores; third, it calculates the carbon footprint for each stock; fourth, it implements our voting and engagement policy; and finally, it provides ESG and impact reporting to the client. In 2017 we launched a dedicated, systematic Global Responsible Equity strategy that selects stocks based on five traditional risk factors and two impact factors (the "Results" component of our ESG analysis, and carbon intensity). A decade earlier, we partnered with Generation Investment Management to launch the Generation Global Fund, which remains one of the biggest and best-performing funds in its peer group.[3]

In **fixed income** and **convertible bonds**, since 2011 we have complemented our Fundamental Fixed Income approach, which takes investors away from market-capitalisation benchmarks towards higher-quality credit portfolios, with our impact-enhanced ESG analysis and low-carbon factors. And in 2017, Lombard Odier partnered with impact-investing specialist Affirmative Investment Management to launch a **Global Climate Bond Fund**.

In **private debt**, Lombard Odier developed the first open-ended strategy offering access to a selection of impact-investment funds focused on fair trade and microfinance.

With our Impact Office in place, Lombard Odier will continue to work to deepen the integration of impact investing across its range of strategies, create new impact investing solutions, and enter into new partnerships with like-minded, innovative and impact-focused names in the field.

3 The UCITS Generation Global 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.

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17 96

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