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Placing a value on impact investing

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Investors are willing to accept lower financial returns in order to generate positive externalities. How much less? Up to almost four percentage points

Do investors value sustainability? That is a question often asked in financial circles, and it is also the title of a 2019 paper by Sam Hartzmark and Abigail Sussman at the University of Chicago Booth School of Business, looking at the impact of the Morningstar Sustainability Rating that was launched in 2016. The abstract indicates it being so: "[B]eing categorised as low sustainability [of one-globe] resulted in net outflows of more than US$12 billion while being categorised as high sustainability [five-globe] led to net inflows of more than US$24 billion".

In the keynote address at the recent 9th Annual SKBI Conference on Sustainable Finance, **Brad Barber**, Professor of Finance at the University of California at Davis, further elaborated on the effects of fund flows after the introduction of the Morningstar Sustainability Rating in March 2016.

"Over the course of the next six months, [cumulative fund flow into high sustainability funds increased] by three to five percent," he explains. "In other words, you're having these funds move by three to five percent because they have a 5-globe rating, whereas the low-rated funds have even higher levels of exodus. This is capital being reallocated because of the social impact that these funds are having."

"So clearly, there's a demand for this type of sustainable finance and how investors think about allocating their capital," he adds.

WHAT IS IMPACT WORTH?

Barber made those observations in his address titled "What Academic Research shows about Sustainable Finance", and expanded into investor interest and activity in impacting investing "to generate a positive externality for society". Pointing to his own research to analyse the returns and the demand for impact funds versus traditional VC funds, Barber highlights the difference in the types of industries VCs and impact funds invest in.

45 percent of traditional VCs in his research invested in IT companies, compared to just six percent for the impact funds. The next highest concentration of VCs were in healthcare (22 percent v six percent).

VCs also put their money into diversified companies (27 percent) but that figure is dwarfed by the 48 percent figure for impact funds.

"Some of these impact oriented investments might be looking to create jobs for the poor," Barber observes, citing the example of CalPERS's investment in Galaxy Dessert to generate jobs in the Richmond area in California. "That's not about industry necessarily, but about creating companies that can employ the poor or having minority or women-owned businesses might impact they're trying to generate. That leads to a more diversified tilt, if you will, and that comes out clearly in the data."

But the big question remains: how do investors value impact? Can it be measured? Barber's research found that impact funds earn 4.7 percent lower internal rates of return (IRR), and willingness-to-pay (WTP) models show that investors accepted 2.5 percent to 3.7 percent lower IRRs for impact funds versus pure investment funds.

"What's the value of impact? Let's call it a willingness to pay, but I'll refer to that as the value of impact," Barber explains. "We calculate expected return and convert it into percentile ranks and we get a coefficient of 0.17. What does that mean?

“Percentile rank is just ranking performance from zero to 100 and a 0.17 means that impact is valued at the equivalent of 17 percentile ranks of performance. That's from like going from a middle 50 performer to a 67th percentile performer.

“I'm not saying those funds do that. I'm saying that that's the value that impact has to investors, so it's quite valuable to investors. They like these impact funds and this is sort of giving you a sense for how much they like those impact funds,” he says.

WHO VALUES IMPACT?

Barber also presented findings that showed Asia-Pacific investors placing the lowest value on impact while African, Latin American, and Eastern European ones were on the opposite side of the spectrum. Barber also pointed out funds that face political pressure or having a social mission as most likely to place value on impact funds, while that are restricted by law in doing the opposite.

“What we argue here is, banks and insurance companies face pressure to have impact because of things like the Community Reinvestment Act in the US, or state regulations that insurance companies face,” he details. “These organisations are compelled, somewhat, to think about impact.

“We also argue public pension funds also face political pressure because of the constituents that they have in their funds. The classic example in California is CalPERS, which faces tremendous pressure from their board to think about these issues and others they may have.”

About companies that appear to negatively value impact, Barber says thus:

> *“Another interesting result that pops out here is the negative willingness to pay, i.e., a reluctance to invest in impacts, based upon laws. It does not necessarily mean the organisation cannot invest in impact, but it certainly sets a framework that will cause them to focus more on financial returns than the impact of the investments they make.”*

Brad Barber was the Keynote speaker at the 9th SKBI Conference Sustainable Finance, co-organised with the TBLI Group that was held on November 7-8 2019 at Singapore Management University.

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