Reconciling alpha with sustainability in impact investing

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For over a decade, the investment world has undergone a true paradigm shift. Led by ethically minded pension funds, endowments, and a new generation of investors, this shift reflects a growing commitment to investments that support businesses tackling environmental and social challenges.

Despite this momentum, the debate around impact investing persists, with some voices arguing for a sole focus on financial metrics, dismissing the relevance of extra-financial attributes. Detractors are most often worried about "impact-washing", a term that has gained traction alongside "greenwashing", and about the perceived trade-off between impact (social and environmental return) and alpha generation.

Do investors have to choose between doing good (impact) and doing well (financial return)?

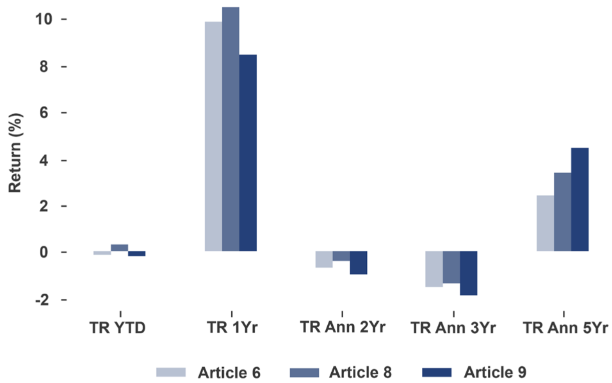
Impact investing sits at the intersection of the Venn diagram. It is the only investment philosophy where the interests of all stakeholders (People, Planet, Prosperity) are aligned, in harmony and without compromise. The concept of Triple Bottom Line (or Triple P) challenges the perennial dilemma of impact versus return and implies that Impact Investing is not a zero-sum game. In other words, **caring about sustainability does not mean ignoring fundamentals**, but it does indeed limit the size of the investment universe as only the heart of the Venn diagram exhibits purity.

The histogram shows an empirical comparison of total returns by SFDR (Sustainable Finance Disclosure Regulation) classification as compiled by J.P. Morgan with Morningstar data in March 2024. We use Article 9 funds as a proxy for impact funds because they meet the most stringent sustainability constraints as defined by the SFDR (even though not all Article 9 funds in the market are impact funds, arguably). The first observation is that dark green funds significantly outperform both light green and traditional investment strategies over the long term (five-year horizon). In contrast, the second observation is that impact funds underperform their peers in the short term (three years or less).

Impact funds' sector biases, particularly their tilt towards healthcare, industrials, and utilities, have been responsible for short-term underperformance when technology was highly favoured. In the short term, hawkish monetary policies were also highly detrimental to renewable energy stocks, a classic overweight in Article 9 funds. However, these are only temporary setbacks in the history of impact investing. Long-term overperformance is driven by a growing consensus among companies and asset managers alike to align with key public issues and regulation, using frameworks such as the UN SDGs and the emerging EU taxonomy. This alignment not only mitigates risk but also capitalises on the growing demand for sustainable secular trends, thereby enhancing long-term financial returns.

Impact investing is a strategic endeavour. It reflects a deep understanding of market trends, where companies that prioritise ESG (Environmental, Social, Governance) criteria exhibit stronger resilience and profitability in the face of global challenges. For example, **using natural resources wisely can improve profits**, while effective waste and **emissions management** can lower the risk of regulatory issues and reputational damages. Businesses embracing **circular economy** practices by designing products for longevity, reuse, and recyclability foster goodwill and may also benefit from a more stable operating environment, local government support, and a loyal customer base. **Good talent management practices** can improve the retention of employees who drive innovation and growth. Each of these examples is supported by a large body of academic research. They underscore the potential for impact investing to deliver better long-term risk-adjusted portfolio returns by proactively addressing environmental and social issues relevant to business success.

Figure 2: Total returns by SFDR classification



Source: Sustainable Funds Monthly Chartbook, J.P. Morgan, Morningstar, 21/03/2024
Date of return calculation: 21st March, 2024
Number of funds: Article 6: 12,982 funds ; Article 8: 10,948 ; Article 9: 1014
Geographic Exposure: All ; in types of mandates and domiciles
Asset Class: All (Equity, Fixed Income, Allocation)

In conclusion, the narrative of impact investing is one of **convergence** rather than compromise. By meticulously selecting companies that not only promise but deliver on their impact goals, investors can achieve both societal good and financial gain. While we debunk the mythical trade-off between impact and alpha, we must acknowledge the crowding effect in popular impact equity plays.

Critiques of impact investing often mention a premium on high-demand, impact-labeled stocks, potentially reducing returns. While this concern is valid in some cases, it overlooks the nuanced landscape of sustainable investing, where untapped opportunities abound.

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