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Generations Fall 2023 - ESG and Impact Investing: A Panel Discussion

Part II

On May 31, Erik Bergman, a partner in Day Pitney's Private Equity and Finance department, moderated a panel discussion with Dale Galvin, founder and CEO of Deliberate Capital; Anna Alemani, managing partner of Pinnacle ESG Services; and Kirstin Etela, a partner in Day Pitney's Environmental practice. The topic was environmental, social and governance (ESG) and impact investing. Part I of this panel discussion appeared in the Spring/Summer edition of Day Pitney's Family Office Newsletter *Generations*. This article is Part II of that discussion, in which the panelists discuss the types of ESG and investment opportunities in the market, how to implement an ESG or impact investing strategy, and how to assess the effectiveness of the investments made.

Erik Bergman: Let's shift gears for the next section of the panel and talk about current opportunities. What types of ESG and impact investment opportunities are available that you see in your professional capacities?

Anna Alemani: the term "ESG investments" refers to a wide range of investment products. On one side of the spectrum, there are index funds or exchange-traded funds offered by brokerage firms and mutual fund companies. These are funds that invest in companies or assets considering certain factors beyond financial returns, like climate change, labor management, corporate governance, and many others. Some of them may screen companies using positive or negative criteria. For example, they may exclude some industries like tobacco or fossil fuels or companies with poor human rights records. Those are more passive ESG investment products. Then you have more active ESG investment products. Like Dale said, these imply a more proactive and engaged approach to ESG, investing in portfolio managers who are actively selecting investments based on analysis of non-financial factors. And then you have more direct investment, where you invest in a product that has a certain social or environmental goal as part of its value proposition, such as "green bonds," which are fixed-income products that have combined environmental goals and investment goals. On the other side of the spectrum, you have impact investing, which is when a positive social or environmental goal is part of your value proposition to investors. Then there is thematic investing. These are strategies that focus on a specific trend or theme. For example, clean energy is a very popular area for family offices. Accessible and innovative healthcare is another area. Within the ESG-focused strategies, you can also have engagement and active ownership. For example, a private equity fund which owns a majority stake in a company might look to influence that company by engaging in a discussion with the company's leaders or using proxy votes to move them toward these ESG issues. It's a very wide range, but those are the main areas.

Dale Galvin: Anna mentioned green bonds. I think that's an interesting example of the market and product opportunity. This is an asset class that grew from nearly zero 10 years ago to cumulatively having issued over 2 trillion dollars worth of green bonds to date. There are standards that green bonds adhere to, called the "green bond principles," which provide a consistent way of evaluating their "greenness." Basically, what it means is that the bond proceeds are used for environmentally friendly projects or investments. They can be issued by governments, corporations or development banks.

They have become extremely popular and are often oversubscribed. Their interest rates track the equivalent non-green bond for a given duration and credit rating. The prices do get impacted a bit by the extent of the demand for these products. They may be backed by, say, the World Bank, and have an AAA credit rating and have the same return as an AAA-rated non-green bond. This is driving their popularity, especially among corporations and investors that would like to achieve environmental goals. That popularity has led to new kinds of products, for instance, "blue bonds," which target oceans or water, or "social bonds," which target social outcomes rather than environmental outcomes. There are "sustainability-linked bonds" that have a pay-for-performance aspect. In other words, the issuer might get an interest rate discount if it achieves certain impact goals or, on the other hand, a penalty if it does not. People are getting quite creative. Any retail investor can buy these products, like any other bond or fund, but not a lot of folks outside the industry know about them. Many investors are surprised to hear that this kind of product exists.

Erik Bergman: How does one go about implementing these investment programs?

Anna Alemani: I would say the first step is to develop an ESG policy. This should address your purpose as an organization and the core values that guide your investments as well as the kinds of principles by which you operate. This also means looking at some of the processes you follow before making an investment. When selecting your investments and doing operational due diligence, what kind of issues do you look at? What are the factors and indicators you look at when evaluating a company's performance? Some of the things your organization is already doing as an organization could be formalized in an internal policy. For example, on the governance side, there are a lot of risks that we talk about that might already be part of your due diligence, for example, how do you evaluate the risk culture of the company? Do we look at the compensation mechanisms at a company? How does this company manage cybersecurity risk? so it doesn't mean that you have to put in place a lot of new processes. It's just being more intentional, more aware and more structured about how you approach these risks. And then you want to construct a portfolio that is aligned with these best practices. The point is to start simple. Look at what you're already doing.

Erik Bergman: Can you do this in-house? Can you do this with the people on staff, or should you outsource the implementation?

Kirstin Etela: Given the lack of clarity in the legal environment and the evolution of regulation on these fronts, it makes sense to supplement in-house capabilities with outside advisers who can provide assistance through data, access and scale of understanding. There is a constant evolution of information, and you could spend all day trying to figure out where things are evolving on the spectrum of regulatory activities or policy developments and how those developments affect you as an investor or as an opportunity in the investment community. There are many people who are investing multiple resources to help people figure this out. I've found it valuable to look to outside advisers who are on the front lines of these program developments and the evolutionary aspects of all of this to understand where I fit into that process, where my company fits into that process or where I should be focusing my investment dollars in that process. Also, Anna has mentioned a few times the importance of internal policies, whether it's your policy to direct your decision-making from an investment perspective or from a policy perspective. I think outside resources can be very helpful there to assist with these decisions, such as whether a target investment has established internal controls that can help determine whether this company is actually addressing your ESG goals. We talk about governance in terms of fraud, bribery and transparency, but a critical component of governance is ensuring that there's oversight of how these policies are being implemented. I think it's important to be able to hold that governing body accountable for how they're allowing these programs to evolve and how governance decisions are being made under those policies so that you can be assured that your ESG investment objectives are going to be met.

Anna Alemani: I agree with everything that Kirstin just said. The advantage of a third-party consultant is the ability to get an independent assessment of what's currently being done and to identify potential gaps and red flags. A third party can also

give you more insights on what are the best practices in the industry, so you can fold these into your experience, as well as what your peers are doing to address some of these concerns. When you move toward implementation and measuring your actual impact in social or environmental areas, I think that becomes a bit more challenging if you don't have internal resources to do that in a systematic and consistent way. When you have to collect data from your portfolio investments and build processes to measure your impact, that's where it may be valuable to rely on external resources to assist with the data collection, analysis and reporting. That can help you build a framework that is feasible and practical but at the same time meets your goals.

Erik Bergman: Let's talk a little bit about assessing ESG investments. What sort of tools are available? How can you make good decisions when it comes to selecting investments or investment managers?

Anna Alemani: I go back to what we said about internal controls. The focus needs to be on due diligence. This will depend on what asset class we're considering, what industry we're considering, and what kind of access to data you can obtain. If you have a green bond, a public bond, you might have access to a lot of public information. If you have private equity investments, you might have more insights and access to data from the portfolio companies. It varies greatly, but in general, I would say in order to avoid "green washing," or at least minimize the risk, you look at a few key elements. One is strong governance. Another one is a systematic reporting process where there is a systematic use of nonfinancial factors in addition to financial factors to evaluate an investment's performance. There is a control process in place, so somebody within the organization is accountable for this reporting. Also, they must use quantifiable metrics. A company should set goals, and these goals should be measured by factors and quantitative metrics. There should be some level of sophistication in their ESG reporting. These factors might be a part of a commonly accepted framework or might be a combination between management-driven performance indicators and external standards that are used in the industry. Also, you look at core board engagement and whether senior members of the management team are involved in ESG oversight.

One indication of strong ESG practices is the use of an independent external assurance. This is when a third party verifies the accuracy of ESG reporting similar to what an audit does on financial reporting. Is the ESG performance or the impact performance of an investment, being communicated to investors in a transparent and accurate way, or is it more like compliance?

Erik Bergman: Let's say you are getting your data from your investment opportunities. How do you assess the data?

Anna Alemani: It can be done as you do [it] regularly for any investment. You can look at ESG reporting with a third-party assurance similar to how you would look at audited financial statements. We all look at financial metrics and get more comfort when the company has gone through an audit. That's one way. When analyzing these data, you also need to consider the specific industry the company is operating in and compare it with companies that are in the same industry. If you're dealing with thematic investing, you can look at industry benchmarks. The data can be quite difficult to obtain, but I think that there are some industries that are becoming more proactive in adopting this type of reporting and therefore there are more data available for comparison. Eventually, you will be able to access more industry data that you can use to do more analysis and benchmarking.

Dale Galvin: On the private side, impact reporting can be hugely variable. There are even fewer agreed-upon frameworks, although that's changing rapidly, especially in Europe. Investors need to be careful that the reported results are credible, preferably vetted by a neutral third party. Also, remember that creating credible impact reports is not a trivial exercise. When you think about it, even for nonprofit development groups that do this kind of thing for a living, monitoring and evaluating outcomes can be costly and difficult to implement. There aren't very many standards on the outcome side if you are thinking about poverty or biodiversity goals, as opposed to, say, under the climate mitigation side, measuring units of carbon dioxide.

This is the case with many social and environmental goals that private funds pursue. So as an investor, you should certainly have an expectation that a fund that makes claims of any kind of impact goal is held accountable. That also needs to be tempered with a realistic sense of the cost and time required for data collection and the burden that puts on funds' portfolio companies, which are generally the ones that are on the hook to deliver that information. This is where partnerships with credible groups, including governments and nongovernmental organizations, can be very useful. There are also non-dilutive pools of capital called technical assistance funds that can be deployed for monitoring and evaluation and relieve portfolio companies and funds of some of this burden.

Erik Bergman: Let's wrap up with everybody's thoughts about the future. Where is ESG investing going?

Dale Galvin: Despite the recent politicization of ESG-based investment considerations, I think we've made it clear that ESG investing makes sense, no matter what your political affiliation is, and that impact investing is here to stay. I think every successive generation is going to care more about aligning their values with their investments, whatever those values are. If, for instance, income disparity continues to grow as climate impacts become more costly, the needs become self-evident. There are more tools to understand and democratize all sorts of investment decisions that weren't available in the past. Moreover, retail investors are becoming more sophisticated in how they think about aligning their money with their values, as shown by their demand for, say, certain investment products within their 401(k) plans. There will always be misfires. There will always be challenges and issues. But even now, there are enough credible places to put your money. I have no doubt that the exponential growth of ESG and impact investing will continue into the foreseeable future.

Anna Alemani: The growth of sustainable investing is fueled by systemic changes like the evolving role of the private sector in promoting sustainable development. In the past, addressing global issues, like poverty or climate change, was a prerogative of the government and the public sector. Today, private investors are more actively engaged in addressing some of these issues and private companies are accountable to a broader set of stakeholders - not just the shareholders of a particular company but also employees, customers, and society in general. The public sector is considering forming partnerships with the private sector to address some of these societal issues. As governments have traditionally used, for example, tax incentives to encourage or punish corporate behavior, there could be a new paradigm where government could be incentivizing additional forms of good corporate behavior. For example, a company that provides better healthcare benefits to its employees results in improved overall health and well-being of its workforce. This decreases the burden on the public health system and government-funded healthcare, so government could incentivize companies with better employee healthcare benefits to reduce public healthcare spending. Overall, I think this is the new paradigm, where society is expecting the private sector to be more actively involved in addressing global issues.

Kirstin Etela: There is a new regulation that has been published in the European Union called the Corporate Sustainability Reporting Directive. It replaces what was previously known as the Non-Financial Reporting Directive. It is going to be a game changer, and this is going to be an important development for investors because it will improve certainty and consistency. This directive makes certain social value judgments regarding what ESG issues are. Within the three pillars of E, S and G, companies are going to have to report how they're meeting certain targets that are defined in the directive. In the past, the Non-Financial Reporting Directive, even though it touched on these things for public companies in the U.S., had a very limited effect. The application of this new directive is probably going to impact tens of thousands of U.S. companies that meet certain revenue and volume thresholds and are doing business in EU countries. So, a large multinational company that is doing business and maybe has their own sustainability report in the U.S. is now going to have to report in the EU. This is going to drive up costs, because people are going to have to figure out how to comply with this new directive. It's really driving everything down to the quantitative data that people need to make these investing decisions and also to understand what companies are doing. This really goes to what Anna has been talking about, with the whole aspect of social values

driving these decisions and forcing companies to make different decisions around these aspects. This is something that's going to take some time to implement, and compliance will be costly. Companies that don't have voluntary efforts will fall short.

Additionally, the concept of sustainability, however you define that, is increasingly showing up in transactions and business decisions of all kinds, as we've seen in this country. States and the federal government require various climate resiliency and environmental justice reviews, not only of agency actions but also the business decisions being made. We've talked a bit about how insurance companies evaluate risks. We are seeing that insurance companies are writing policy exclusions or declining coverage where they believe the environmental risk is too great. I've seen real estate and corporate transactions, both large and small, in which the participants evaluate an ability to comply with future sustainability standards. That mandates change—and that's going to be particularly true if you're going to be subject to the CSRD—so up and down the supply chain, entities are evaluating their business partners to determine who can help them achieve their own sustainability goals. These societal value shifts are having a very real economic impact on business decision-making and how that translates into the real returns of particular investments. So the future is here. It's moving fast. And there's going to be a lot of change.

Erik Bergman: Well, thank you all. This really has been a great discussion. I appreciate all the time and effort that all three of you put into this and making yourselves available for this today. Thank you.

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