5-2023

Benefits of Impact Investments for Financial Advisors and Their Clients

Jacob Eason
University of Arkansas, Fayetteville

Benefits of Impact Investments for Financial Advisors and Their Clients

by

Jacob Graham Eason

Advisor: Dr. Cash Acrey

An Honors Thesis in partial fulfillment of the requirements for the degree Bachelor of Science in Business Administration in Finance

Sam M. Walton College of Business
University of Arkansas
Fayetteville, Arkansas

May 13, 2023

Introduction

As society has become more focused on addressing environmental and social issues, interest in impact investing has grown dramatically to a total asset value of $444 billion dollars (Global Sustainable Investment Alliance, 2021). As a result, financial advisors could benefit from incorporating these investments into their service offerings. However, like all financial questions, there is no universal answer for all clients. By exploring existing academic literature, this review seeks to highlight the benefits of impact investments, reveal the downsides, and discover strategies to manage them. Ultimately, this literature review will demonstrate how offering impact investments can be beneficial for both advisors and their clients.

Socially Responsible Investments

The concept of using money to further good causes is by no means a new idea. Both early Jewish law and Wesleyan teachings identified money as a powerful tool for positive change and specified how to use it responsibly (Schueth, 2003). Islamic principles lay out similar guidelines as well, and forbid investments that involve usury or other exploitative practices (El-Zoghbi & Tarazi, 2013). Teachings like these have influenced the philosophies of religious and non-religious groups alike, forming the basis for people's desire to be charitable.

The most fundamental way people express this charitable desire is through traditional philanthropy: the act of donating money or gifts without any expectation of receiving something in return. While philanthropy has long been recognized as a powerful means of effecting positive change, its usefulness for individuals is typically rather limited. Many people may wish to support causes they believe in, but they must also prioritize their own financial security. For this reason, individuals may only be able to donate a fraction of their income and must save the majority. This does not mean that philanthropy should be abandoned, but rather indicates a need for a supplemental strategy. In fact, both individuals and philanthropic organizations themselves can benefit from socially responsible investing. This is particularly pertinent with philanthropies, who are increasingly conscientious about the effects of their principal investments (Zolfaghari & Hand, 2021).

Gaining initial momentum from the civil rights and anti-war movements of the 1960s (Schueth, 2003), SRI began to fill this need and allowed individuals to align their investments with their values without compromising a financial return. This class of investments has continued to be a popular option, especially in recent years, with SRI investments now making up one-third of all managed assets in the US (Global Sustainable Investment Alliance, 2021). This growth promises to have a positive effect on the world by encouraging companies to clean up their report cards to compete for investor capital. However, traditional SRIs primarily focus on generating monetary returns, and the bar for impact is relatively low. Simply not being a tobacco company is a significant step toward earning a socially responsible label (Statman & Klimek, 2007).

ESG Evolution and Greenwashing

The most recent evolution of these sustainable investing initiatives is ESG, representing environmental, social, and corporate governance issues. A variety of ratings agencies such as Sustainalytics, Moody's, and S&P have begun to evaluate companies on many factors such as board diversity, labor practices, clean energy use, and many other areas. Aggregating these various ratings gives investors an overall idea of a firm's environmental and social impacts, and promotes a new dimension of competitive improvement in firms. This has proven to be a very successful way for companies to differentiate themselves, and investors have responded in kind. In their 2022 annual report, the Principles for Responsible Investment Association reported nearly 4,400 investors, representing an estimated $121 trillion in AUM, having pledged to incorporate ESG criteria into their investment decisions (Principles for Responsible Investment, 2023).

However, ESG has still faced significant criticism, with the most concerning issue being greenwashing. Given the high demand for sustainable investments and increasing public awareness, many companies have used ESG and other criteria to feign sustainability while continuing harmful practices behind the scenes (Yu et al., 2020). By parading their equal opportunity hiring practices and solar powered factories, companies can boost their ESG scores to obscure the negative effects of the cigarettes they sell.

Additionally, there is no generally accepted set of factors to include in ESG, and as a result, different ratings agencies have developed their own sets of criteria. This makes it very difficult to get a true apples to apples comparison of firms when one rating heavily punishes child labor and another ignores it. Research on this divergence of criteria has shown that the extent of the variance is so great that at times the ratings are arguably useless. Between two ratings agencies, a firm could be rated in the top 10% by one and below average by another, simply due to differing criteria (Berg et al., 2022).

These issues effectively stem from the fact that ESG still places the focus on profit. Firms are still beholden to the financial goals of their shareholders, and even those firms that do genuinely try to be sustainable are often unable to change their core business. Oil companies can make marginal improvements to their operations, but they're still oil companies. This leaves many investors seeking options that truly focus on the benefits and correctly align incentives.

Impact Investments

Impact investments fulfill this need by aiming to achieve a blended return of both financial and social or environmental outcomes. Beyond simply avoiding harm or creating unplanned benefits, these businesses are designed with positive impact at the core of their mission (Flynn et al., 2015). Many investors have viewed these social or environmental returns as a portion of the overall return from the investment and expect to sacrifice some financial return. However, new entrants into the market are beginning to view impact investments much more optimistically with expectations of market or above-market financial returns (O’Donohoe et al., 2010). Even when viewed conservatively, the non-financial benefits are enough to attract socially conscious investors who seek to make an impact in a specific area they feel passionate about.

In the broad realm of impact investments there are many such areas in which investors can contribute. However, a J.P Morgan report found that the majority of impact investments seek to improve the lives of people living at the bottom of their economic pyramid (BoP) by creating jobs, improving energy efficiency, facilitating asset accumulation, and utilizing BoP suppliers. This can generate improvements in many different areas including agriculture, water, housing, education, health, energy, and financial services (O’Donohoe et al., 2010).

Affordable Housing

One of the current issues facing the United States and many other countries is housing affordability. As more of our population consolidates in cities, housing prices can often see sharp increases. San Francisco, CA and New York, NY are some of the most extreme examples of this rapid supply and demand squeeze. However, rent inflation is not limited to only the largest cities but affects small and medium size cities as well. Shortages in land, stricter zoning laws, increased construction expenses, and higher borrowing costs are among the factors raising rents across the country (Anacker, 2019). This leads to increased financial pressure on low-income households and amplifies the challenges already faced by those living in poverty.

Combating this trend is therefore an area of focus for many impact investors who want to help their communities thrive. One avenue for making these investments is through community development corporations and community development financial institutions. These entities have been improving housing options in underserved communities for decades by pooling private investments with government funding to finance affordable housing developments which otherwise could not secure traditional financing (Phillips, 2016).

Renewable Energy

Another great application of impact investment which many investors are drawn toward is renewable energy. Climate change is perhaps one of the most severe threats we currently face, and switching away from fossil fuels is the most important step we need to take to avoid irreversible damage. The International Energy Agency has forecasted that meeting zero emissions targets will require global fossil fuel use to drop by more than half before 2030. This in turn will require significant investment in alternative energy sources such as solar, wind, hydro and nuclear (International Energy Agency, 2023).

Should the energy sector step up to this task, we would expect to see massive growth in renewables industries. To further catalyze this transition, public awareness has begun pressuring governments to pass policies both requiring renewables investment and partially financing it. This huge impact investment opportunity is a big reason industry P/E ratios expect renewable energy stocks to grow 61% over the next 5 years, compared to just 7% for the traditional power industry (Damodaran, 2023).

Growth in SRI and Impact Investments

The rise of socially responsible investments demonstrates a fundamental shift in the way people view investing, leading people to look for more ways to put their money toward financial products that align with their values and beliefs. This shift is not limited to an isolated group of individuals, but rather it represents a universal wave of socially conscious investors seeking to tackle social and environmental issues. Over just the past few years, the growth in SRI assets has been impressive. From 2016-2018, the socially responsible investment market grew by 21% in response to the increasing demand. Even more impressive is the subset of impact investments which expanded by a staggering 79% during the same period to a total asset value of $444 billion (Global Sustainable Investment Alliance, 2021). As impact investments become more mainstream, the continued potential for growth is harder to deny. A report by UBS noted that of the many drivers for this growth, increased awareness of issues such as pollution, climate change, and water conservation were among the most significant. Additionally, they found that the tangible nature of issues like these has driven investors in countries like Brazil and China toward impact investments specifically. As these issues become more pressing, we will continue to see more investors direct their investments toward creating direct impacts, though passive ESG screening is still the most popular in the US (UBS, 2018).

SRIs and impact investments have seen significant growth in recent years with more and more investors looking to support a wide range of evolving social issues. Mapping the demographics of sustainable investors reveals some of the societal trends that are behind this evolution of investor sentiment. One of these key demographic factors influencing the growth of sustainable investment is age. It is generally believed that younger individuals tend to be more socially and environmentally conscious which would make them more likely to invest sustainably. Empirically, this seems to be the case with one study finding individuals between the ages of 30 and 59 to have 6-7% higher rates of SRI investment compared to those 60 and older (Junkus & Berry, 2010). This suggests that as younger individuals continue to accumulate wealth and approach retirement age, we can expect to see increased demand for socially responsible investments and impact investments in particular.

Another important factor that is likely to contribute to higher levels of social and environmental awareness is education. The younger generation of investors is far more educated than their predecessors, largely due to the orchestrated push for college enrollment over the past decades. This push resulted in a large increase in enrollment from 30% to 44% over the 40 years from 1980-2019 (National Center for Education Statistics, 2022). Research clearly demonstrates that more education results in a higher likelihood to value social and environmental issues in investing. Specifically, Junkus and Berry determined that postgraduate degree holders were the most socially conscious with 41% owning sustainable investments compared to just 31% of high school graduates (Junkus & Berry, 2010). These findings have important implications for the future of impact investing. As younger, more educated individuals become increasingly interested in making ethical investments, we can expect to see continued growth in this area.

Lack of Options from Financial Advisors

Despite this growing demand for socially responsible options, many financial advisors are not incorporating SRIs or impact investment options into their portfolios, and even those that do are often reluctant to recommend them to clients. A 2006 study of financial advisors found that none voluntarily offered any information about sustainable investments until the client had expressed interest, and 19% still had no information to offer even after direct inquiry (Schrader, 2006). Furthermore, when advisors did present information regarding characteristics such as investment policy and ethical strategy, it was very limited at best (Schrader, 2006). This lack of guidance has had a noticeable impact on investor portfolios, with only 39% of investors surveyed by UBS reporting owning sustainable investments, despite 65% expressing a desire to make the world a better place (UBS, 2018). Furthermore, the strong majority indicated financial willingness to invest sustainably, expecting equal or higher returns than traditional investments, but found the terms confusing (Strauß, 2021; UBS, 2018). Clearly a growing number of investors are open to impact investment options but lack guidance from their advisors to make informed decisions. Given that these individuals are unlikely to act without qualified advice (Strauß, 2021), this puts the responsibility on advisors to meet the growing interest.

Despite this demand for sustainable options, many advisors remain largely unaware of the gap in their offerings, and attribute few client inquiries to low demand for socially responsible or impact investments (Heinemann et al., 2018). Rather, many socially conscious clients either aren't aware of these options or, due to an often-limited understanding of investments, default to their advisor's recommendation (Heinemann et al., 2018). To better serve their clients, it's important for advisors to realize that many of their clients would be eager to invest with impact regardless of whether they explicitly mention it. Incorporating values related questions into their existing know-your-client routine is an excellent first step for advisors to take a more proactive approach. This is incredibly important as advisors have often been ascribed a key role in advancing sustainability efforts (Linciano et al., 2020; Strauß, 2021).

Often, the biggest challenge preventing advisors from being more proactive is a general lack of understanding about sustainable investing. Specifically, many advisors are simply not aware of the benefits provided by SRIs and impact investments or don't have enough information to feel comfortable offering them to clients (Heinemann et al., 2018). This is especially true for advisors working within retail banks, who may not be provided adequate literature about the bank's portfolio of ethical investment options (Schrader, 2006). To address this lack of understanding, it's critically important to increase the training and education advisors receive on impact investments. Given their clients reliance on them for guidance (Nilsson et al., 2010), advisors must be able to offer comprehensive advice to cover a wide range of client needs, including ethical ones. Most importantly, this increased awareness is necessary for continued growth in the sustainability field, and allows financial advisors to play a key role in making finance more impactful.

Benefits of Impact Investment Offerings

The benefits of impact investments are the main reason why their growth is so significant for the industry. Beyond just their stated social and environmental objectives, impact investments offer additional benefits to both advisors and their clients. Based on the growing demand for sustainable options, advisors who actively promote impact investments can likely attract an increasing number of socially conscious clients. For clients, aligning their investments with their values can help them feel more confident about where their money is invested and boost their overall level of happiness. Additionally, advisors and clients who embrace impact investments can both benefit from bringing these investments into the mainstream and reaping the social and environmental benefits they provide.

Financial advisors and their clients share a unique relationship, as the importance of financial stability leads clients to evaluate advisors on more factors than just financial return. In one study, trust was found to be the most important quality in this relationship, and clients tended to stay with their advisors for many years once this trust was established (Rossi & Utkus, 2020). However, as social and environmental issues are coming to the forefront, availability of impact investment options is also becoming important: 40% of investors said they very much consider social and environmental effects in their financial decision making (Linciano et al., 2020). Given this shift, proactively informing clients about impact investments options will foster trust and strengthen the advisor-client relationship in the long run.

Clients of advisors can also benefit from impact investing in several ways. Because of the gap between the number of investors wanting to do good, and those that are actually invested sustainably (UBS, 2018), incorporating impact investments into regular discussions can help clients actualize their values in ways they previously weren't aware of. Additionally, knowing that you're making a valuable impact can have important psychological benefits, especially when the good deeds fall in line with your personal values and identity (Hitlin, 2007).

Downsides of Impact Investments

Accompanying these benefits are several downsides that make it difficult for financial advisors to incorporate impact investment. Because of the relative novelty of the field, strategies to accurately measure and compare the social and environmental impacts are still developing. Impact investments exist at an intersection between financial investments and philanthropy, both of which have established metrics for evaluating performance, but combining the two presents some new challenges. Specifically, impact-focused firms operate in many different fields, so the performance metrics for various firms are often very different (Reeder et al., 2015). Greenhouse gas reductions from a solar panel manufacturer and apartments provided by an affordable housing developer are virtually incomparable. It may seem that the best solution would be to express impact in a more universal unit such as dollars, but Reeder cautions against this approach as well, pointing out that subjective measurements often do better at capturing intangible benefits like happiness (Reeder et al., 2015). For advisors, this can lead to significant confusion regarding the performance and makes it difficult to keep clients informed about the impact their money is making.

In addition to measurement, the implementation of impact investment options brings its own unique set of difficulties. Many investors are hesitant to incorporate them into their portfolios due to a lack of supporting infrastructure for origination and management of these investments and the additional due diligence required in evaluating impact (Ormiston et al., 2015). Furthermore, institutional investors in particular tend to have concerns over legal and fiduciary requirements given that they must tailor their portfolios to meet the needs of large groups of investors. Financial advisors, however, are much freer in this regard considering their ability to recommend impact investments best suited for each client (Ormiston et al., 2015).

Managing These Downsides

Fortunately, there are solutions to these barriers. Addressing the implementation challenges of impact investments requires a collaborative approach because while financial advisors may have certain advantages for recommending impact investments to clients, they may lack the necessary infrastructure to make it happen. This is where the growing market of institutional investors and impact-focused firms have come together to amass the necessary ecosystem of investors, intermediaries, and issuers of impact investments (Ormiston et al., 2015). Furthermore, Ormiston identifies groups such as the Global Impact Investing Network (GIIN) that have been very beneficial in this regard by streamlining due diligence processes and bringing together all market participants to facilitate deal origination.

Additionally, these initiatives have made great progress toward standardized impact measurements such as the Impact Reporting and Investment Standards (IRIS) and the Global Impact Investing Rating System (GIIRS). In his discussion of the measurement issues, Reeder identifies formal standards like these as the best compromise between consistency and subjectivity (Reeder et al., 2015). Furthermore, it's worth reiterating that the impact investment market is actively growing and developing. With anything, there are growing pains, but the market is rapidly moving towards better solutions and accessibility for a wide range of socially conscious investors.

Conclusion

The world is changing, and so are the demands and values of investors. As interest in impact investments continues to grow, financial advisors who recognize this interest will be well-positioned to differentiate themselves from competitors and meet the evolving needs of their clients. Impact investments do come with unique challenges, but the rapid progress in measurement standards and market building are quickly making these downsides less significant. As younger and more educated individuals continue to grow wealth, there will be increasing pressure and incentives for advisors to make the necessary adjustments to offer these investments. By doing so, advisors can help their clients align their investments with their values, benefit from the positive psychological effects, and make the world a better place. Impact investments are a promising opportunity for both investors and financial advisors, and those who embrace them will be better equipped to thrive in the evolving landscape of socially conscious investing.

References

Anacker, K. B. (2019). Introduction: Housing Affordability and Affordable Housing. *International Journal of Housing Policy*, *19*(1), 1–16. https://doi.org/10.1080/19491247.2018.1560544

Berg, F., Kölbel, J. F., & Rigobon, R. (2022). Aggregate Confusion: The Divergence of ESG Ratings. *Review of Finance*, *26*(6), 1315–1344. https://doi.org/10.1093/rof/rfac033

Damodaran, A. (2023). *PE Ratio by Sector*. https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/pedata.html

El-Zoghbi, M., & Tarazi, M. (2013). Trends in Sharia-Compliant Financial Inclusion. *Focus Note*, *84*. https://www.cgap.org/sites/default/files/Focus-Note-Trends-in-Sharia-Compliant-Finanicial-Inclusion-Mar-2013.PDF

Flynn, J., Young, J., & Barnett, C. (2015). Impact Investments: A Literature Review. *Centre for Development Impact*. https://opendocs.ids.ac.uk/opendocs/handle/20.500.12413/6820

Global Sustainable Investment Alliance. (2021). *Global Sustainable Investment Review 2020*. https://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf

Heinemann, K., Zwergel, B., Gold, S., Seuring, S., & Klein, C. (2018). Exploring the Supply-Demand-Discrepancy of Sustainable Financial Products in Germany from a Financial Advisor's Point of View. *Sustainability (Switzerland)*, *10*(4). https://doi.org/10.3390/su10040944

Hitlin, S. (2007). Doing good, feeling good: Values and the self's moral center. *Journal of Positive Psychology*, *2*(4), 249–259. https://doi.org/10.1080/17439760701552352

International Energy Agency. (2023). *Clean Energy Report*. https://www.iea.org/topics/tracking-clean-energy-progress

Junkus, J. C., & Berry, T. C. (2010). The demographic profile of socially responsible investors. *Managerial Finance*, *36*(6), 474–481. https://doi.org/10.1108/03074351011042955

Linciano, N., Soccorso, P., Capobianco, J., & Caratelli, M. (2020). *Financial advisor-investor relationship Mirroring survey on sustainability and investments*. https://ssrn.com/abstract=3752806

National Center for Education Statistics. (2022). *Digest of Education Statistics*. https://nces.ed.gov/programs/digest/d22/tables/dt22_302.10.asp

Nilsson, J., Nordvall, A. C., & Isberg, S. (2010). The information search process of socially responsible investors. *Journal of Financial Services Marketing*, *15*(1), 5–18. https://doi.org/10.1057/fsm.2010.5

O'Donohoe, N., Leijonhufvud, C., Saltuk, Y., Bugg-Levine, A., & Brandenburg, M. (2010). *Impact Investments*. https://core.ac.uk/download/pdf/71352133.pdf

Ormiston, J., Charlton, K., Donald, M. S., & Seymour, R. G. (2015). Overcoming the Challenges of Impact Investing: Insights from Leading Investors. *Journal of Social Entrepreneurship*, *6*(3), 352–378. https://doi.org/10.1080/19420676.2015.1049285

Phillips, R. (2016). Impact Investing and Community Development. *Maine Policy Review*, *25*(1), 63. https://doi.org/10.53558/UCIT6353

Principles for Responsible Investment. (2023). *Annual Report 2022*. https://www.unpri.org/annual-report-2022

Reeder, N., Colantonio, A., Loder, J., & Jones, G. R. (2015). Measuring impact in impact investing: an analysis of the predominant strength that is also its greatest weakness. *Journal of Sustainable Finance and Investment*, *5*(3), 136–154. https://doi.org/10.1080/20430795.2015.1063977

Rossi, A. G., & Utkus, S. (2020). *The Needs and Wants in Financial Advice: Human versus Robo-advising*. http://dx.doi.org/10.2139/ssrn.3759041

Schrader, U. (2006). Ignorant advice - Customer advisory service for ethical investment funds. *Business Strategy and the Environment*, *15*(3), 200–214. https://doi.org/10.1002/bse.525

Schueth, S. (2003). Socially Responsible Investing in the United States. *Journal of Business Ethics*. https://doi.org/10.1023/A:1022981828869

Statman, M. (2007). *Socially Responsible Investments*. http://dx.doi.org/10.2139/ssrn.995271

Strauß, N. (2021). Communicating sustainable responsible investments as financial advisors: Engaging private investors with strategic communication. *Sustainability (Switzerland)*, *13*(6). https://doi.org/10.3390/su13063161

UBS. (2018). *Investor Watch: Return on Values*. https://www.ubs.com/content/dam/ubs/microsites/ubs-investor-watch/IW-09-2018/return-on-value-global-report-final.pdf

Yu, E. P. yi, Luu, B. Van, & Chen, C. H. (2020). Greenwashing in environmental, social and governance disclosures. *Research in International Business and Finance*, *52*. https://doi.org/10.1016/j.ribaf.2020.101192

Zolfaghari, B., & Hand, G. (2021). Impact investing and philanthropic foundations: strategies deployed when aligning fiduciary duty and social mission. *Journal of Sustainable Finance and Investment*. https://doi.org/10.1080/20430795.2021.1907090