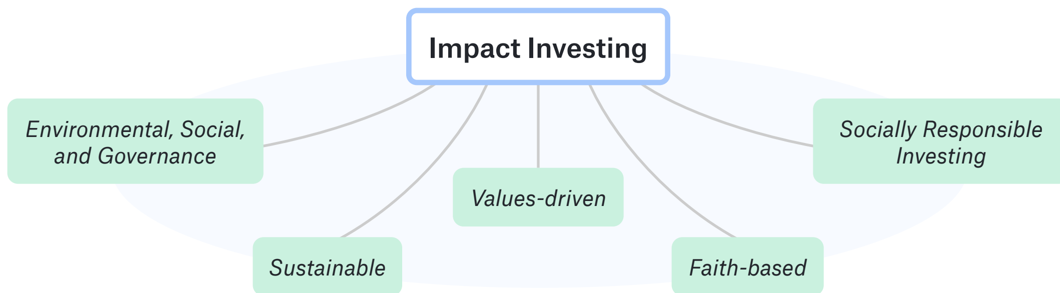
The Beginner's Guide to

Impact Investing



What is Impact Investing?

Impact investing refers to all investments, both public and private, that are intended to have positive societal benefits and are not limited to financial performance. You may have heard of Environmental, Social, and Governance (ESG) investing, sustainable investing, or Socially Responsible Investing (SRI). In general, impact investing is the most generic term, used to encompass all other related terms.

Because there is no widespread consensus, some people will use one of these terms to refer to a specific investment. Therefore, if you're having a conversation about impact investing, you may want to confirm the semantics. At the end of the day, the key point is to align your investments with your priorities. Because priorities are more focused on clearly defined themes, the acronyms should not deter anyone from implementing an impact investing strategy.

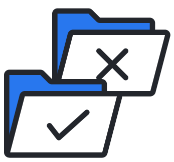
Some investors may engage in impact investing because they have a moral desire to align their finances with their values. Other investors may expect certain companies to perform better when they do social good. Whatever the reason, impact investing has gained momentum over the past decade. The Global Impact Investing Network estimates that in 2020, the global market for impact investing is approximately $715 billion.

Several common impact investing themes include fossil fuel divestment, tobacco screens, and faith-based investing. In order to implement these themes, it is necessary to have access to company data which can be updated on a regular basis. To meet this need, a variety of data providers use tools to aggregate companies based on product offerings, sources of revenue and governance standards, among others. This segmentation of companies is then used to develop new offerings. In recent years, several asset managers have launched products based on custom indexes and themes derived from these novel data sets.

With greater attention paid to impact investing from institutional to Gen Y retail investors, the amount of choices available has become overwhelming. Today, investors can implement solutions using traditional vehicles like mutual funds or exchange-traded funds (ETFs), or use more advanced technology that direct indexing platforms provide. With fund vehicles, investors interested in impact must determine and prioritize which investing criteria are most important to them.

How it works with publicly traded assets

Impact investing relies on robust data. Asset managers need to identify how companies perform applying different ESG metrics such as carbon emissions and gender diversity, in order to implement ESG investment solutions systematically. Once an asset manager has the information, they can create negative screens or positive tilts.



Negative Screens

Negative screens, as the name implies, are screens that **exclude** companies that violate the criteria requested by the investor. There are various screens, such as screens that exclude:

- Individual companies
- Companies flagged for poor performance in a particular ESG criteria
- Entire sectors

For example, you could find an impact investing index fund that excludes companies flagged for discriminatory practices, or removes companies that own fossil fuel reserves.

Positive Tilts

Positive tilts **increase** the portfolio weight of "good" companies and decrease the weight of "bad" companies. With a positive tilt for an ESG characteristic, an investment solution might still hold some "bad" companies that score poorly in that ESG characteristic. However, they would reward "good" companies by holding more of the stocks that score well.

For example, you may want a sustainable investment that includes more stocks from companies that have lower carbon emissions.

Choosing Your Approach

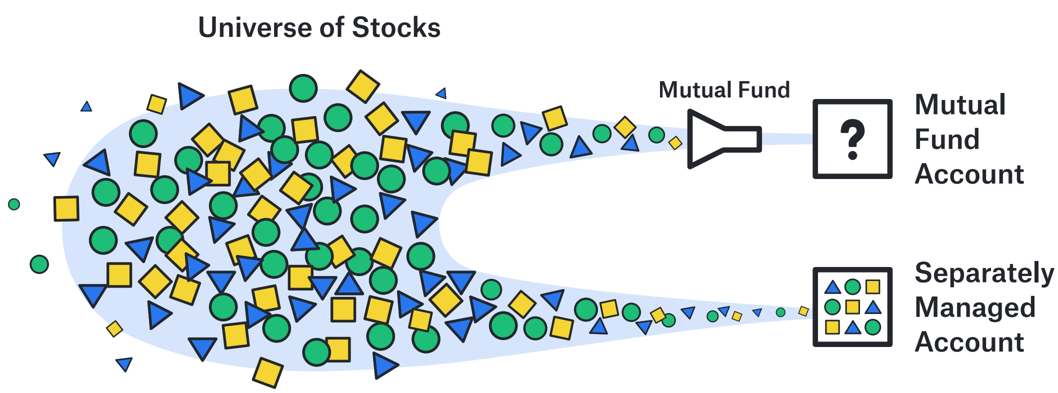
Why would you want to use a positive tilt rather than a negative screen? A negative screen offers a straightforward approach to remove companies that do not align with your values. In some cases, however, there may be nonbinary information. For example, if you want to invest in gender diversity, it may not make sense to exclude companies based on an arbitrarily chosen threshold of diversity. Instead, you could tilt towards owning more stocks from diverse companies.

Pros and Cons to ESG investment vehicles

There are three primary investment vehicles for investors who want to passively invest in ESG equity solutions: mutual funds, ETFs, and direct indexes.

Mutual funds and ETFs are common investment vehicles, but investors may not be as familiar with direct indexes. While mutual funds and exchange funds are bundles of stocks, a direct index, implemented through a Separately Managed Account (SMA), is made of those individual stocks. Thanks to improvements in technology, the investor can build and own a custom "direct index."

Mutual funds are the most established investment vehicle from an asset under management (AUM) standpoint, but ETFs are also commonly used for ESG implementation. Direct indexing via SMAs is a fairly recent innovation, made available to non-institutional investors as technology improved and trading fees dropped. Direct indexing enables targeted impact investing by providing full control over the individual stocks.



	Mutual Funds	ETFs	Direct Indexing
Range of options	Limited	Single-themed focus	Individual stocks tailored to values
Transparency	Full list of stocks undisclosed	Full list of stocks may be disclosed	Entire list of stock holdings available
Tax Benefit	Negative due to distributions	None - capital gains deferred until sale	Positive due to strategic selling to offset capital gains*

*Source: An Empirical Evaluation of Tax-Loss Harvesting Alpha

Building a Solution

Let's say that you're interested in sustainable investing. How could you invest sustainably using each investment vehicle?

Mutual Funds

You may want to buy a combination of mutual funds to reach your goals. There are several popular sustainable mutual funds, such as American Funds Washington Mutual and Parnassus Core Equity. One drawback to mutual funds is their lack of transparency on underlying securities and timing of purchasing of investment positions. Mutual funds do not share their full list of holdings with investors, so you won't know what exactly you own. Moreover, investors do not have the ability to request any negative screens or positive tilts.

ETFs

The approach with ETFs is similar to that of mutual funds, where you can find funds that match the theme you're interested in. Common options include the SPDR S&P 500 Fossil Fuel Reserves Free ETF, which excludes companies that own fossil fuel reserves, and the iShares MSCI ACWI Low Carbon Target ETF, which tilts towards companies with less carbon emissions. Unlike a mutual fund, you are able to view all the holdings within an ETF. Additionally, though you still cannot request screens or tilts, there are more options for different themes and exposures to markets.

Direct Indexes

If you're interested in aligning your finances without extensive research on investment vehicles, direct indexing can address this goal. After you choose a benchmark and the sustainable customizations you want, the right asset management program creates a diversified, customized direct index that matches your requirements and tracks an index. This approach allows you to clearly define and combine your priorities. Additionally, select providers will also produce daily reporting for full accountability and transparency.

Learn More

To learn more about impact investing, check out the following resources:

- Wikipedia's entry on impact investing
- The Case Foundation's Short Guide to Impact Investing
- US SIF's online course on sustainable investing
- ImpactAlpha: Investment news for a sustainable edge
- 9 Things Beginner Investors Should Know about Impact Investing, US News & World Report.