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MIND THE (INVESTMENT) GAP: FOSTERING THE TRANSITION FROM ESG TO IMPACT[1]

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The daunting challenge of delivering on the SDGs requires large-scale investment globally, particularly in developing countries. According to UNCTAD, the pre-COVID/19 annual additional investment needed to achieve meaningful progress in sustainable development by 2030 was $2.5 trillion. The pandemic has had a devastating scissor effect on the investment gap by increasing the spending needs and curbing the resources available, raising it to $4.2 trillion. In all likelihood, the economic aftershocks of the war including inflation, the oncoming recession, and enhanced geopolitical tensions will further widen the investment gap to a figure in the ballpark of $5 trillion.

Where can this staggering amount of money come from? At the recent meeting in Germany, G7 countries launched the Partnership for Global Infrastructure (PGI), a pledge to mobilize $600 billion in private and public funds over five years to finance needed infrastructure in developing countries. According to a recent estimate by BCG, the asset of the global asset

1 I wish to thank David Crofts, Ya Da Tsai, Veljko Fotak, and Peter Lejre for useful comments.

management industry (including all major types of institutional investors) is worth $103 trillion, and the reported investment flows in 2021 amounted to $2.8 trillion, 3.1% of the total asset at the beginning of the year. A back-of-the-envelope calculation shows that even if advanced nations stick to PGI and if the entire global asset management industry switches from conventional to sustainable investing, we are still left with a $15 trillion gap to fill in the next 8 years.

Aiming high is certainly laudable especially when the future of the planet is at stake. However, overtly ambitious goals may look unrealistic and may discourage the desired behavior. The numbers highlighted above clearly show that meaningful progress in delivering on the SDGs can be achieved only with the engagement of the global asset management industry, and specifically of institutional investors that manage 59 percent of the total assets. At this critical juncture, analyzing the hurdles that constrain the mobilization of institutional capital along SDGs, and setting forth tentative solutions is key.

A recent survey commissioned by the UK Foreign, Commonwealth, and Development on the drivers of global institutional investment flows has highlighted a paradox: the widespread adoption of ESG considerations in forming investing policy is directing institutional capital away from the regions of the world that are grappling more seriously with sustainable development, namely emerging and frontier markets[2].

Respondents – 52 institutions from 17 countries - refer to information asymmetries as an explanation for this perverse outcome. Information asymmetries arise when insiders have private information about company performance and outside investors can only partially fill the gap by spending time and effort in due diligence and valuation. The lack of standardized metrics and frameworks has substantially increased the scope of such asymmetries in the ESG dimension. Issuers in developed markets have been able to raise their reporting standards and meet the more stringent requirements of ESG investors. Being ESG-related information particularly scarce in emerging and developing countries, the adoption of ESG considerations has crowded out investment in local issuers and thus constrained socio-economic development in the poorer regions of the world.

More specifically, the limited availability of granular ESG information at the company or project level has pushed investors to adopt a top-down approach based on country indicators. The integration of ESG screening using country-level indexes on corruption, rule of law, human rights, or environmental protection has biased capital allocation away from countries with the largest investment gaps. Furthermore, ESG frameworks have been widely adopted by institutional investors as a risk management tool to minimize reputational risk. Headline risk is very acute in emerging markets, and this has made institutional investors particularly averse to reputational losses and wary to invest in countries with poor ESG scores.

In a nutshell, any ESG benchmarking system ends up scoring emerging markets poorly and the consequent adverse screening has shrunk portfolio allocation in emerging and frontier markets. Since the global financial crisis, these target regions are typically underweight, and the small stake (around 10-15 percent) has made institutional investors reluctant to spend on research, due diligence, and monitoring markets that would not move the needle at the total fund level. ESG adoption has further trapped investors in an equilibrium characterized by low aggregate investment curbing the growth potential of developing nations.

2 https://mobilistglobal.com/wp-content/uploads/2022/06/Drivers-of-Investment-Flows-to-Emerging-and-Frontier-Markets.pdf

Finally, interesting dynamics are at play within the individual components of ESG consideration. Thanks to regulatory pressure about climate change in developed markets and better data availability, the "E" pillar of sustainability is gaining ground, tilting institutional capital towards environmentally friendly companies and projects. Emerging, frontier, and developing countries are certainly not sweet spots for green investment being still at the early stage of the energy transition. SDG challenges in these jurisdictions such as alleviating poverty, inequality, and human rights pertain to the "S" dimension, still under the radar screen mostly due to a lack of data and measurement frameworks. Within the same ESG frameworks, institutional capital is more easily attracted for example by an off-shore wind farm in the North Sea, rather than a coal-based generator in Africa that is a large employer and keeps the light on in the country.

ESG strategies are thus impending urgently needed capital flows, exacerbating the investment gap in the regions lagging behind on the SDGs. Awareness about this fundamental issue is starting to spread in the institutional investor community and large investors are becoming more conscious that a very different kind of headline risk is surfacing – the risk of being singled out for not investing in development. As scrutiny on ESG practice and outcomes intensifies, a view is growing that responsible investing should be recast in terms of impact, with the intention to generate a measurable, positive change to society along with financial returns. Currently, the assets allocated to ESG are worth $35 trillion, dwarfing total impact assets which amount to $715 billion. As of the end of 2021, total impact funds manage assets worth $225 billion. Even if in the last year a significant uptick is observed, impact investing is still in the early stage. How can this market evolve from niche to mainstream? What are the hurdles and actions that could foster the large-scale implementation of this promising investment philosophy?

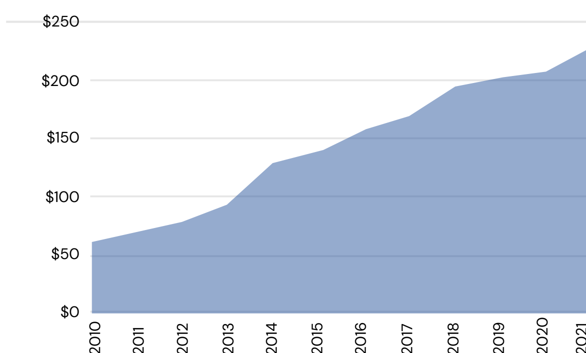
Global institutional investors typically turn a tin ear to impact investment because it rings philanthropy. Socially impactful projects have been so far considered a substitute for public investment typically carried out by foundations and charitable institutions and associated with concessionary, below-market returns. In fact, impact investing has to potential to offer even greater alpha than ESG as it can actively drive growth in more dynamic markets. But a "mindset shift" is required in the approach to impact investing by institutions, similar to the one adopted in venture capital, where the consideration is that higher risks are traded-off against higher expected returns. In the impact domain, failure may stem from the risks associated with investing in countries with poor institutions and larger information asymmetries, but returns could be exceptional if investments unlock the immense growth potential of economic backwardness.

The philanthropic "stigma" associated with impact investment is a serious roadblock to the upscaling of this investment philosophy at the institutional level. To raise awareness about its potential without scaring away investors seeking commercial returns, a rebranding exercise could serve the purpose. In this direction, a possible solution is to redefine the approach as *transition investment*, a novel and powerful concept to capture how investment can make a difference in fostering sustainable development, evoking paradigm shift and contribution.

However, a nominal change only will not move the needle. Large-scale capital deployment in emerging and developing countries will take place when the appropriate data, frameworks, and tools to measure the genuine impact performance of an investment will become available. Indeed, the famous

quote by management guru Peter Drucker "What gets measured, gets done" applies in earnest in the impact investment sector. The previously quoted institutional investor survey reports that the lack of access to data and measurement tools is a decisive hurdle in the execution of ESG and specifically impact investment strategies. However, being impact related to changes in social outcomes (such as educational attainment, health conditions, gender diversity, etc.), measuring the specific contribution of an individual project over and above government policies, time trends, or other cofounding factors is inherently difficult. Quantitatively assessing the *additionality* – i.e. the positive net benefit to society created by the investment – is indeed a challenge that requires sophisticated statistical techniques and granular data. Impact evaluation methods, however, have made significant progress recently, generating evidence about policy outcomes, and motivating change. The next critical step will be to retrofit these methodologies to meet the practical needs of institutional investors, filling the information asymmetries that prevent large-scale investment along the SDGs. Closing the investment gap will remain a long shot, but transition investment has the potential to fill it considerably, generating impact along with financial returns.

Impact Funds Asset Under Management (AUM)[3]



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He has been Executive Director of Fondazione Eni Enrico Mattei. He has advised the World Bank, the Initiative for Policy Dialogue, the Italian Ministry of the Economy as secretary of the Global Advisory Committee on Privatization, and the Italian Audit Office. He is member of the Scientific Advisory Board of Cassa Depositi e Prestiti. He is the founder of the Privatization Barometer (www.privatizationbarometer.net).

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3 Source: Pitchbook