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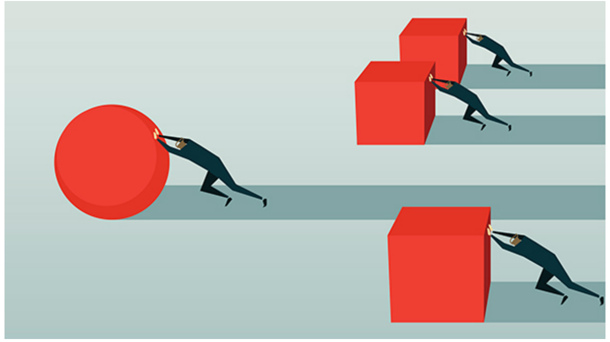
Business

Why Sustainable Investment Means Investing in Advocacy

Combining traditional impact investment approaches with investment in advocacy is the only way businesses and investors can fuel meaningful social and environmental progress.

By Alan Schwartz & Reuben Finighan | Sep. 8, 2021



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The past 25 years have seen a proliferation of investment movements promising to make capitalism sustainable. These include impact investing; socially responsible investing; corporate social responsibility; shared value; conscious capitalism; and environmental, social, and corporate governance. Yet all these movements, however promising, assume there's no need for a trade-off between returns and social and environmental impact. They are grounded in the idea that investors and corporations can achieve commercial returns while fixing our biggest problems—that we can "do good while doing well."

In a 2020 *Harvard Business Review* article, we argued that while there are indeed niche opportunities for this type of "win-win" investing at a firm level, the current regulatory framework won't support anything close to the level of investment needed to address our social and environmental challenges. For example, without a supportive regulatory framework, business would have to accept losses of about $10 trillion by 2030 to meet the Paris Agreement global warming target of 1.5 degrees Celsius. Whether it is global warming, loss of biodiversity, or poverty and social isolation, win-win investors simply are not willing to accept sub-commercial returns and will not make the required investments.

Instead, we need to pursue traditional win-win investing in tandem with "trade-off" investing that creates impact but delivers below-market returns, and investing in advocacy aimed at changing economic regulations. In this article, we look at the roles and challenges of the latter two approaches, and present a new investment strategy that is both scalable and replicable for a wide variety of investors.

The Limits of Sustainable Investment Movements

Over the past year, once-lonely critiques of sustainable investment movements have joined to form a chorus. They have also become more strident. In March 2021, Tariq Fancy, recruited by the investment firm Blackrock to push sustainable investing into the mainstream, argued instead that "sustainable investing and the narratives that surround it" are "a deadly distraction that is actively harming society." Soon after, corporate sustainability expert Auden Schendler wrote that these movements "even enable the continued dominance of fossil fuel." And in May, lecturer and advisory director to Berkshire Partners Kenneth Pucker wrote that these movements have become an "obstacle to progress," while for sustainability economist and investor Duncan Austin, they "perpetuate complacency" when we are in a "race against time." That same month, six business professors went so far as to call corporate sustainability practices a "cancer" that threatens to "kill our prospects of pulling back from environmental disaster."

"Cancer" is perhaps a step too far. Although conventional win-win investment cannot possibly reach the scale needed to solve social and environmental problems like climate change, it still does some good and is worth pursuing at the firm level. But an investor's first duty is to acknowledge that an unsupportive regulatory framework limits the potential of win-win strategies to achieve large-scale impact.

One alternative is to make trade-off investments. Root Capital's Mike McCreless argues that investors should allocate some of their capital to businesses that create positive impact, even if they will likely deliver returns below the market rate. This is effectively a form of efficient philanthropy—accepting sacrifice, while maximizing the impact per dollar sacrificed. Providing financial services to the world's hundreds of millions of smallholder farmers tends to yield below-market returns, for example, but investors may regard its positive impact on development as an acceptable trade-off.

Yet this kind of investing brings its own problems. The micro, or firm-level, problem is one of measurement and evaluation, which is important to maintaining investment discipline and accountability. When a firm focuses on commercial returns, it can say with clarity how well it did with a given investment. But when it accepts below-market returns and explicitly makes up the shortfall with social and environmental outcomes—which are affected by assumptions, baselines, and framing effects—it becomes much harder to judge performance. Just as investors can massage impact data to make ordinary and non-additional commercial investments look win-win (greenwashing), so can they make poor investment decisions look like worthwhile trade-offs. In our experience, commercial investment professionals find this inadequate accountability exasperating.

This is exacerbated by differences in culture and skillsets between business and philanthropy. Trade-off investing is a hybrid, sitting uncomfortably between these two vastly different worlds. Business-led trade-off investing tends to favor return over impact. Commercial investors focus on what they know best—financial returns—and tend to cherry-pick impact metrics that justify the most profitable investments. In contrast, philanthropy-led trade-off investment favors high-impact projects. Philanthropic investors focus on what they know best—impact—and often wear rose-colored glasses when assessing expected financial returns.

At the macro, or economy-level, trade-off investing faces the same problem as win-win investing. Trade-off investing will never achieve the scale needed to meet today's social and environmental challenges. By accepting losses on investments that mitigate climate change, reduce poverty, or improve social cohesion, trade-off investors will help tackle some of the projects that win-win investors ignore, but the appetite for philanthropy is nowhere near enough. Filling the climate gap alone would require $10 trillion in philanthropic funding. For comparison, climate philanthropy in the United States is less than $10 billion per year—less than 0.1 percent of the total needed.

For these reasons, trade-off investing will remain a bit player, albeit a laudable one.

Advocacy: How to Turn the Titanic

Neither win-win nor trade-off investing can move the needle on major social and environmental issues. They are important but niche activities within a vast economy where most commercial activity simply follows the rules of the game. While emitting carbon is tremendously costly to the planet, for example, it's largely free in the economy—and free things get overused. Similarly, investment in reducing social isolation generates positive social outcomes but no profit for the investor.

The only way to turn our titanic global economy around, therefore, is to change the rules so that addressing social and environmental problems is profitable. Putting a meaningful price on carbon emissions, for example, would greatly expand opportunities for win-win investing. A carbon price would reduce the returns on all carbon-intensive activities across all sectors to which it applied—including power and manufacturing—while increasing returns on low-carbon or carbon-capturing alternatives, such as renewable energy and low-carbon steel production. In 2019, more than 3,500 US economists, including 45 Nobel Prize winners, signed a statement in favor of a carbon price. It's the best market-based solution for unlocking investment at scale and could fully close the $10 trillion gap by making all the necessary investments profitable.

This is where advocacy comes in. For a start, businesses and investors can use their voices to press for regulatory changes. Recently, 457 investors representing $41 trillion in assets signed a Global Investor Statement calling for faster regulatory change. But while efforts like this are admirable and contribute to gradual cultural change, they don't do much to incentivize and materially change politicians' behavior. To do that, businesses and investors need to reach voters. They need to amplify their message, and amplification requires money.

The third leg of the portfolio approach we suggest is therefore investing in advocacy. Advocacy has enormous leverage. Consider: If we need $10 trillion in philanthropic subsidies for trade-off investing to solve the climate crisis, how much advocacy would we need over 10 years? One thousandth of that figure ($10 billion) would be excess to requirements—the fossil fuel lobby has caused extraordinary damage with much less.

At first glance, the idea of advocacy for win-win investors may seem even more foreign than trade-off investment: It's pure philanthropy, outcomes are impossible to measure, and advocacy is not a core business skill. But we believe the opposite may be true for three reasons:

1. Done carefully, advocacy has commercial benefits. Corporations that demonstrate leadership on social and environmental issues through advocacy are often rewarded with quality staff, more customers, and more investors. And when companies share the cost of advocacy with other, like-minded investors, the individual cost is low.
2. While advocacy impacts are difficult to measure, so are the impacts of ordinary expenses like marketing. Importantly, the measurement problems that both advocacy and marketing introduce are isolated; unlike trade-off investing, they do not contaminate investment decisions or evaluations but simply appear in the expense account.
3. Business is already highly adept at advocacy, albeit usually on the side opposite to social and environmental good. Lobbying by tobacco, coal, and gambling firms has been lethally effective. The world's five largest publicly owned oil and gas companies spend about $200 million every year on lobbying, protecting billions in annual profits by delaying and blocking climate action.

Certainly, there are serious ethical questions about the proper role of business in democracy, and corporations should be rule-takers and not rule-makers. But we are not living in a theoretical or ideal world. Corporations are already shaping the rules, often advancing the narrow interests of their shareholders at the expense of society and the environment.

A New Way of Investing for Impact

We propose a general strategy by which investors can contribute to solving social and environmental crises at the necessary scale: When special interests lobby to prolong and aggravate a social or environmental crisis, a larger mass of investors can advocate for and position themselves to profit from supporting a future we must reach—a future that includes a healthy climate and more cohesive communities.

This strategy may take different forms for different investors and businesses, but asset management firms, a category that includes most of the investors who signed the Global Investor Statement, are particularly well-positioned to implement it. They also serve a diverse range of clients, including impact investors. As Adrienne Buller and Benjamin Braun at Common Wealth observe, these firms are "the dominant shareholders in corporations throughout the global economy", and their breadth of ownership translates into significant exposure to economy-wide threats to capitalism such as climate change.

By directing a percentage of management fees toward advocacy, asset managers could offer impact investors what they want: full commercial returns, plus impact via the more powerful lever of advocacy. There are two ways to do this. A no-frills approach would be to treat advocacy investments as a substitute for marketing expenses. A large asset management firm could offer a commercial investment strategy, negatively screened for emissions-intensive investments, where advocacy is the main driver of impact. For impact investors who understand the importance of advocacy, this will be more attractive than the standard, largely non-additional, win-win investment funds. The attraction of this approach is that it carries no costs or risks for clients, it is easily scalable, and early movers may win significant attention and capital inflows from the impact investor community.

A second, more sophisticated approach is to tightly integrate investment and advocacy strategies, with the goal of producing above-market returns. For example, successfully advocating for improvements in recycling regulations may increase returns for a recycling firm. The integrated approach is harder to scale because it requires local political knowledge, but it may be highly rewarding.

As an example, here is an environmentally focused strategy that Alan (co-author of this piece) is developing at his asset management firm Trawalla Group:

- Establish a new fund or funds focused on investments that reduce carbon dioxide emissions and that offer commercial returns.
- Invest a percentage of management fees in strategic advocacy favoring science-based climate policy. This advocacy acts as a marketing vehicle to attract impact investors interested in generating systemic change.
- Integrate advocacy and investment strategies to generate above-market returns for investors in the new funds. For example, the firm could invest in electric vehicle infrastructure where it is confident the investment would contribute to a local regulatory breakthrough.
- Govern advocacy with the supervision of independent, trusted, and science-led third parties to ensure that the firm invests only when self-interest and public interest align.

This strategy naturally comes with risks and rewards. While clients can expect commercial returns, absorbing advocacy costs into management fees will reduce returns for the asset manager. The promise of impact, however, may attract more clients, yield higher capital inflows, and raise net management fees. If it succeeds, other asset managers will likely follow. If enough of the 457 investors who signed the Global Investor Statement applied this strategy to the low-carbon component of their $41 trillion in assets, it could move mountains.

A Paradox: Win-Win After All?

We believe the advocacy strategy outlined here is the only plausible means by which business and investors can truly produce a “win” for both themselves and society. And for early-moving asset managers, the growth in management fees could outstrip the costs of investments in advocacy. Indeed, win-win investing, accompanied by ethical advocacy, may lead the way to a more sustainable future after all.

Read more stories by Alan Schwartz & Reuben Finighan.

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