ClearBridge Investments

Public Equities as Impact Investments

Key Takeaways

- Public companies create impact due simply to their global reach, deep supply chains and communities where they operate.
- Companies can make a positive impact through their intentional selection of products and services as well as their commitment to ESG best practices.
- Sustainability is material to financial results and asset managers can enhance the impact and performance of public equities by allocating to those having a positive influence on society and the planet.

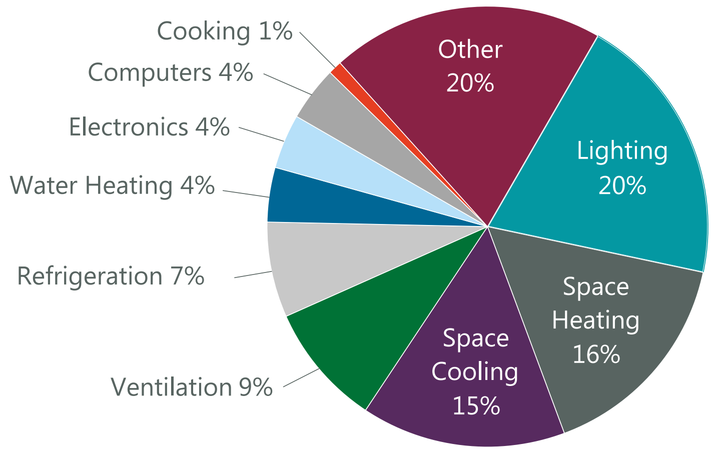
Impact investing is a relatively new term, used to describe investments made across many asset classes, sectors and regions. The Global Impact Investing Network defines impact investing as made with the intention of generating social and environmental impact alongside a financial return. There is an ongoing debate in the impact investing community as to whether public equities can count as impact investments.

Many impact investors believe that an intention to create impact is an essential qualifier ("intentionality"). Some even look to prove that the addition of their investment dollars is catalytic to the positive impact created ("additionality"). As a consequence, most impact investing dollars are concentrated in niche opportunities that fulfill these "intentionality" and "additionality" expectations. While such investment opportunities have the potential to create deep impact, many if not most are not repeatable or scalable. At ClearBridge, we believe large public companies are already having an impact at scale that can be measured, and that we can further drive impact by being intentional active investors through our allocation of capital and direct engagement with company managements.

Enterprises as Agents of Change & Impact

If we operate under the assumption that economies are built by enterprises, it then follows that enterprises are the agents of change and impact in the world. While large public companies may not be run with the primary intention of creating impact, by virtue of their size and complex stakeholder relationships across supply chains, distribution networks and communities where they operate, they have a social and environmental impact at every level. Investors who neglect to evaluate the positive and negative impact of their public equities portfolio may be neglecting the bulk of their capital's impact.

Exhibit 1: Commercial Building Primary Energy Use



Source: DOE, 2011 Buildings Energy Data Book, March 2012.

They may in fact find themselves in a situation, as do many foundations and endowments, wherein their investments are creating or fueling the very problems their grant-making and niche impact investments are trying to solve.

Not all social ills or environmental concerns can be addressed by large public companies. However, many globally relevant issues can be addressed by directing capital in the traditional public equities markets toward or away from the institutions that are central to those issues. Examples include environmental exploitation, renewable energy generation and labor rights. There is tremendous power in capital allocation. By driving capital into responsibly managed companies and away from exploitative ones, shareowners can drive change.

Impact by End Product

Large public companies can be impactful by virtue of their products or services. For example, an LED lighting company's products can help reduce the annual consumption of electrical energy by over 30%. When 20% of the world's commercial electricity consumption is from lighting products (Exhibit 1), a move from traditional lighting to LEDs (currently at less than 10% penetration) can result in annual global electricity savings of over 6%. According to the Department of Energy, by 2027, widespread use of LEDs could save about 348 TWh of electricity.[1] This is the equivalent annual electrical output of 44 large electric power plants (1,000 megawatts each), and a total savings of more than $30 billion at today's electricity prices.

Similarly, companies that are driving the growth of electric vehicles (EV) are bringing about a fundamental shift in the energy mix of the world. The burning of fossil fuels – oil, coal and gas – is a major contributor to climate change, one of the biggest challenges facing the world today. According to the Institute for Energy Research, oil currently meets 36% of U.S. energy demand with 71% directed to fuels used in transportation – gasoline, diesel and jet fuel.[2] When EVs displace traditional internal combustion engines, the demand for oil is likely to dramatically shift. Based on current forecasts for EV adoption, sales of pure combustion engine cars could peak by 2020, resulting in oil demand peaking as early as the next decade.

The adoption of electric vehicles will result in a significant increase in demand for electricity. Given projected shifts in sources of future energy production, the contribution of electric vehicles should lead to less burning of fossil fuels. We base this on an expected decline in dependence on coal from a current 40% of global electricity generation to 13% by 2030, as well as the growth of renewable energy (solar and wind) from a current 5% to a projected 40% of total generation by 2030. The relative clean energy profile of natural gas compared to coal – new, efficient natural gas power plants emit 50% to 60% less carbon dioxide than a typical new coal plant[3] – should also make a positive difference for the environment.

A public equities strategy that reduces exposure to fossil fuel-intensive companies and adds exposure to EV-related businesses can significantly move the needle when it comes to combatting climate change. This strategy could also prove to be financially advantageous as the ripple effects of this structural shift to low carbon technologies impacts incumbents in many industries including utilities, materials, energy and capital goods. A recent study by Goldman Sachs estimates as much as 25% of the MSCI ACWI universe of stocks could be impacted,[4] which adds up to over $10 trillion in market capitalization.

Impact by Net Contribution to the Environment and Stakeholders

Not all companies' products or services are inherently good or bad for the world. However large public companies often have a material environmental footprint due to their manufacturing processes or a large social impact due to their extensive employee base or long supply chain. In such cases, an analysis of how material such impacts are to a business can help determine the overall impact and financial performance of our investments.

As an example, over 2.5 billion people a day use a product from Unilever – a $150 billion enterprise that sources raw materials globally to make such items as tea, soup, ice cream, laundry detergent and beauty products. The company's commitment to sustainable sourcing can help transform potentially exploitative industries such as palm oil, tea, eggs and sugar (Exhibit 2), not just by its own measures, but by providing a strong signaling effect to its peers as well.

Costco is another compelling example of the reach and impact of public equities. About 10% of the 146 million people in the U.S. workforce are employed in the retail industry, earning a median hourly wage of $11.01.[5] Workers with such jobs often endure low pay, poor benefits, schedule changes with little notice and few opportunities for advancement. Conventional wisdom dictates that companies have no choice but to offer these low level jobs, especially in the competitive retail industry. However, research by MIT Professor Zeynep Ton shows that companies like Costco, which does not believe in the trade-off between investing in its employees and offering low prices to its end customers, can consistently demonstrate solid financial performance and better customer service than its competitors. By actively investing in a company like Costco, we are encouraging industry-leading efforts to improve the lives of retail workers through initiatives such as paying living wages (versus minimum wages); having company-sponsored health coverage for most employees; and providing internal promotion opportunities. These efforts have led to greater worker productivity, as shown in Exhibit 3, and lower turnover, characteristics supportive to financial results.

Impact via Capital Allocation

The capital markets fulfill an important role by enabling companies to access capital from a diverse base of investors. It is this ability for investors to buy and sell securities in the secondary marketplace that creates liquidity and thus lowers the cost at which a company needs to raise capital (debt or equity). As more people gain interest in a stock, demand drives up the stock price. This increase in stock price reduces the cost of capital for the company since it needs to issue fewer shares to raise the same amount. Thus, by intentionally placing capital in the hands of a company, asset owners and managers can reduce its cost of capital, which can support future growth. In contrast, by reducing the capital available to companies that are net negative contributors to society, share owners can implicitly raise those companies' cost of capital, making it harder for them to compete in the marketplace. Public equities, with their return potential, enable investors to make capital allocation decisions at scale, sending strong signals to the market about the companies and impacts they support.

Investing as an Influence Strategy

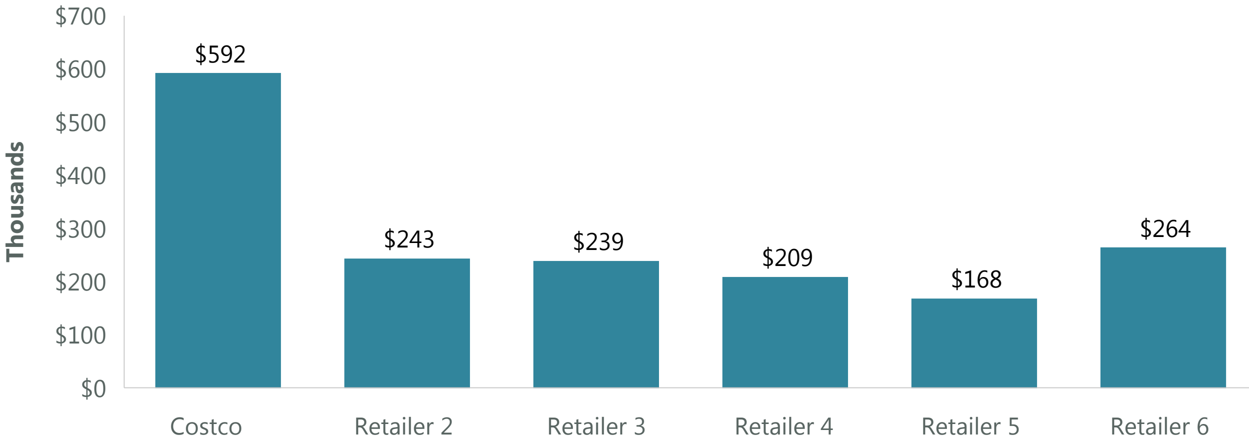
Public equity ownership can also be a powerful tool to influence companies and drive change. As active investors in the public markets, we can engage with company management on a variety of material environmental, social and governance (ESG) issues and urge them to change policies and practices. Because of our asset base and long-term focus (with an average holding period of over 15 years in some portfolios), we can have direct conversations with management over many years and influence their thinking on a variety of issues.

Exhibit 2: With Suppliers and Partners, Unilever Has Positively Impacted 570,000 Smallholder Farmers

Tomatoes from India	In partnership with the state government of Maharashtra, a female entrepreneur was able to invest in a tomato processing plant, contracting supplies which contributed to high-quality tomatoes for their Kissan Ketchup brand from 2,600 smallholder farmers
Vanilla from Madagascar	Working with sustainability manager Symrise and international NGO GIZ to deliver livelihood improvement for farmers. This impacts 4,000 smallholder farmers, 32 vanilla communities and 44 schools & colleges, impacting about 24,000 individuals.
Tea from Tanzania	An agreement with the Tanzanian government aims to positively impact the local community in Nufindi through development of 6,000 hectares of smallholder tea farms.
Palm Oil from Indonesia	A close cooperation between smallholders, the RSPO and WWF achieved the first certification as palm oil smallholders from Indonesia to comply with the sustainable palm oil management standard, impacting 763 hectares of plantations.
Black Soy Beans from Indonesia	Working with farmers to develop a high-quality sustainable supply for Bango sauce. In 2000, Unilever started working with a local university to engage local farmers, providing technical assistance and financing to help them improve productivity and boost incomes by engaging with 7,000 farmer.

Source: www.unilever.com/sustainable-living-2014/enhancing-livelihoods/

Exhibit 3: Costco's Focus on Employees Has Led to a Productivity Advantage



Source: ClearBridge Investments. Costco trailing 12 months through Aug. 2017, all others for calendar year 2016.

Impact – Water Conservation & Energy Efficiency

As a top-five shareholder in an IT hardware company, we have maintained a dialogue with the company's management for over nine years. What started out as a discussion on sustainability reporting led to the company measuring and reporting carbon emissions data and setting five-year targets to reduce emissions by 30%. Through our engagement, the company also recognized the need to address water consumption and eventually achieved 100% water recycling in its Shanghai manufacturing plant, the first facility of its kind to reach such a milestone. In 2016, the company extended this effort to its Penang facility. In addition to the environmental impact, this decision resulted in over $2 million in water utility cost savings, a direct impact to the bottom line.

Impact – Human Rights

Using our influence and access as a top-10 shareholder, we similarly engaged with an international materials company to discuss concerns about slave labor related to the Brazilian charcoal and pig iron industry. The company began to investigate the issue, joined and funded the Citizen's Charcoal Institute, signed a national pact and hired local experts to monitor the situation. Five years later, the company required that suppliers become signatories to the Institute of the National Pact to Eradicate Slave Labor (inPACTO) and by 2016, it secured three pig iron suppliers who were inPACTO-verified. We see this as a significant win for protecting human capital in the industry, in addition to enabling the company to secure an ongoing supply of a key production component without reputational risk.

Conclusion

Publicly traded enterprises are making powerful impacts all over the world. By examining the various facets of their impact and engaging with company management on material issues, we have the ability to drive positive change on a global scale while contributing to financial returns. As shared in cases above for Unilever and Costco, sustainability is material to profitability. Therefore, assessment of a company's environmental, social and governance issues is only additive to one's overall analysis of long-term risks and opportunities as well as long-term performance expectations.

To put the impact opportunity in context, the Global Impact Investing Network estimates the aggregate size of assets in the impact space to be about $114 billion.[6] The New York Stock Exchange, by contrast, represents $18.5 trillion in market capitalization and that is still only 27% of the total market of global equities. It is not difficult to imagine the capital that can be harnessed for good if investors start to think about impact investing in the context of public equities.

1 https://energy.gov/energysaver/led-lighting
2 http://instituteforenergyresearch.org/topics/encyclopedia/petroleum/
3 http://www.netl.doe.gov/energy-analyses/pubs/BitBase_FinRep_Rev2a-3_20130919_1.pdf
4 http://www.goldmansachs.com/our-thinking/pages/new-energy-landscape-folder/report-the-low-carbon-economy/report.pdf
5 https://www.bls.gov/ooh/sales/retail-sales-workers.htm
6 Based on the 208 respondents to GIIN's 2016 Annual Survey.

About the Author

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