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# Generations Spring/Summer 2023 - ESG and Impact Investing: A Panel Discussion

**On May 31, Erik Bergman, a partner in Day Pitney's Private Equity and Finance Department, moderated a panel discussion with Dale Galvin, Anna Alemani and Kirstin Etela regarding environmental, social and governance (ESG) and impact investing. This article is part one of that discussion.**

**Erik Bergman (EB):** I would like to introduce our panelists—Dale Galvin, Anna Alemani and Kirstin Etela.

Dale Galvin is founder and CEO of Deliberate Capital, an impact investment manager and sustainable finance advisory group created to help solve critical development challenges through the conscientious and intentional deployment of capital along with value-added services. Deliberate Capital is the fund manager of the Meloy Fund 1 LP, the first fund targeting investments to benefit coastal communities and ecosystems, and a sub-adviser to Pegasus Capital Advisors in management of the Global Fund for Coral Reefs private equity fund.

Anna Alemani is managing partner of Pinnacle ESG Services, where she helps asset managers integrate sustainability into their investment process. She combines rigorous financial analysis with non-financial reporting to better evaluate investments risks and opportunities. Anna has held positions as corporate rating analyst and credit risk analyst specializing in renewable energy. In her role as Board member, Anna has also helped various non profits organizations build reporting framework to measure their long-term impact.

Kirstin Etela, one of my partners at Day Pitney, assists clients with complex environmental and regulatory matters, including compliance, transactions, permitting, remediation, risk mitigation and emerging issues, such as ESG initiatives and environmental justice. Kirstin has substantive experience with all major federal environmental health and safety statutes and regulations and many state law requirements, as well as experience in several foreign jurisdictions regarding chemical regulation and remediation obligations.

ESG investing is a hot topic these days. Dale, why don't you start us off by describing what ESG investing is and how it relates to impact investing?

**Dale Galvin (DG):** ESG and impact investing have come to be somewhat generic terms that mean different things to different people. Formally, ESG is a set of criteria used to assess risks. So, for example, on the environmental side, if you are an insurance company or a developer, you might want to assess climate risks. On the social side, as a manufacturer you may need to consider international labor standards. There are a few recognized and widely used frameworks for assessing and scoring those kinds of risks, and what you do with those scores as an investor puts you on a continuum that ranges from a strict, market-based kind of conventional investing strategy to "impact-first" investing, putting impact results ahead of financial results, all the way through to philanthropy. So there is a continuum of risk and returns that in this case in particular relates to how much you prioritize impact vis a vis financial returns.

Generally, there is far more capital deployed in the least-restrictive products. On one end of the continuum, you have just the minimum, i.e., seeking returns while using ESG factors to screen investments, and that might be an ESG exchange-traded fund that you find publicly traded, such as an ESG ETF or even green bonds. In these funds managers may use insights from assessing ESG factors to divest from certain industries. For example, a lot of people think about ESG as screening out fossil fuel companies, but some fossil fuel companies get relatively high scores on ESG, and therefore may be a part of some ESG portfolios.

ESG investing can involve actively managed funds or, in the case of impact investing, using capital proactively to generate positive ESG results, as we do with our funds. The level of capital available for impact investing is growing rapidly, but there is a direct relationship between the amount of capital in the market and how "deliberate" you are in pursuing an impact or ESG agenda. I want to make clear that there's not necessarily a trade-off between having financial goals and impact goals when considering ESG factors or even when pursuing a more proactive impact agenda. Some strategies, such as with our funds, explicitly do *not* make those trade-offs, though others might.

**EB:** Thanks, Dale. A lot of people might be asking, Why pay attention to ESG? As this group has discussed offline, a lot of investors are increasingly looking to align their investments with their values and allocators are moving away from the "two-pocket" model. Anna, what does "aligning investments with values" mean and how does one do it?

**Anna Alemani (AA):** There are lots of different strategies to implement ESG investing. In general, aligning your values with investing means just being very intentional and transparent about what kind of goals you're trying to achieve in addition to financial returns. A good reference that I advise people to consider is what the United Nations describes as sustainable development goals. This is a collection of 17 goals and indicators that can be used as a reference when trying to define what kind of impact you want to have through your investment. It means approaching your investing by being more systematic and intentional about your purpose, in addition to financial return. What are the core values that guide your investing? Maybe some of these are already embedded in your investment strategy, but ESG investing means being more transparent and systematic about what these values are and what principles guide your operations. What are the policies that you are implementing to make sure that you are achieving these goals?

**EB:** What about the two-pocket model? What is that? And what does it mean that investors are moving away from it?

**DG:** The two-pocket model is really the traditional approach that goes back hundreds of years, in which you make as much money as you can with one hand and you give it away with the other hand. Until recently, there wasn't much opportunity for those two sides to meet. In some cases, if you look back to, say, the robber baron era, maximizing your income can be at odds with a values-based philanthropy. Now, and especially with younger generations, there is an increasing recognition of the cognitive dissonance of this approach and, for example, supporting environmentally destructive activities with your investment capital, while supporting climate change with your philanthropy. What we're seeing now is that sophisticated family offices and other investors are increasingly questioning that disconnect and setting themselves up to align their two pockets.

**EB:** Anna, I know you had some thoughts on this as well.

**AA:** We're seeing a new kind of paradigm, where you have three goals for a portfolio: risk, return and impact. This is driven by the younger generations, who are concerned about global issues. It's also driven by more transparency in the capital markets—an increased availability of data and access to data. The younger generations are drawing on alternative data sources also, such as social media, to make investment decisions. The increased transparency and different values of younger investors are driving the growth in ESG investing, to the point where it is estimated that ESG assets will represent about a third of total assets under management globally by 2025.

**EB:** What is an example of this use of social media as opposed to more traditional data sources?

**AA:** In the past, consumers had certain avenues to express complaints or buy a product. Now you go online and you can express your opinion about a product and find opinions from many different points of view. From the perspective of an employee, it's much easier now to express opinions about the culture of your company. These developments clearly put corporations under scrutiny in areas of operations that were hidden before. Access to this type of data creates more accountability for corporations to perform well in those areas.

**EB:** Let's talk a little bit about risks related to ESG investing. What types of risks should one consider when looking at ESG investment options?

**Kirstin Etela (KE):** I think it's important for investors to know that there's a real lack of standardization. Even after all the years we've been talking about ESG and what it is, there is a lot of inconsistency. There are many different standards of measurement. There are voluntary programs that have different voluntary quantification systems. There are many definitions of what E, S and G stand for and how those concepts should be translated into company action. The big question is how do you know what you are buying? We often rely on rating agencies, data collators and others who offer those services for data and information about what ESG is and what companies are representing that they do. Even within those agencies and data collators, there are often multiple products with multiple definitions within a particular data set. For instance, you can find one data set that talks about "social" as meaning diversity or inclusion, whereas another data collator might look at a social issue as religious affiliations. So those two things go to the opposite ends of the spectrum in terms of what someone might be looking for. Because of the heightened investor interest, regulators' scrutiny of ESG disclosures has increased significantly, to make sure that investors aren't being misled.

The [Securities and Exchange Commission (SEC)] has been very active in using its enforcement authority to challenge what it believes are misleading disclosures. There have been some pretty high-profile cases, including resulting in a cease-and-desist order and a $4 million penalty for [a company] failing to adhere to its own publicized ESG process. The SEC is proposing some new rules around climate disclosure specifically as well as new rules on ESG investment advisory services. Those new rules are slow going, and we are in a political atmosphere where there's been some pushback. Without specific regulations or standards to rely on, consistency is key to credibility. That's the risk in the marketplace for investors—to find that consistency so that they understand what they're purchasing

**AA:** I would agree the lack of standardization is the biggest problem. Regulation is needed to address this. We can look at Europe as an example of how regulation could impact public companies—and as a result, private companies—because once public companies are being regulated, those reporting requirements become the industry standards. The lack of standardization can be addressed by due diligence, which is a way to avoid greenwashing.

**EB:** What are some of the risks associated with not taking ESG considerations into account?

**KE:** I think there are really three main risks arising out of not taking ESG into consideration. One is attracting and retaining talent. There is a limited employee pool, as we all know if any of us have tried to hire anybody lately. People want to work for companies where they can feel good about what those companies do and how they do it. If it's important to investors, it's also important to employees. Second, qualifications in requests for proposals from prospective customers or clients and government contracts look for their vendors to satisfy their own social responsibility requirements or expectations. Third, attracting and retaining investors, which is why we're having this conversation today. It is certainly important to understand and anticipate regulatory changes, and as we've discussed, they are coming. Stakeholders are demanding companies make those shifts more quickly.

**AA:** I would add that regulation changes over time. Regulation is a product of the political process, which reflects what society cares about. Ignoring the values that are changing in our society means you're basically ignoring a lot of the risks and opportunities that will impact the economy.

Back in 2015-16, we had some big bankruptcies of large coal-mining companies, including the largest coal-mining company in the world. This was due to some market factors, like demand from China, but it also was really driven by new regulations implemented during that time, where all of a sudden companies had to report environmental liabilities on their balance sheets. This is an example of, as Kirstin was saying, how ignoring what society, customers and the market care about can impact financial performance.

**EB:** What about concerns associated with implementing ESG investing?

**AA:** We talked offline about greenwashing, making sure the claims you are reading are not misleading. That's the number one concern, but I'd say that ESG factors are just one set of considerations investors should take into account. An investment strategy should rely on a series of factors, including ESG. ESG needs to be integrated in the overall investment process, including due diligence, research and analysis.

**DG:** Yes. I also want to comment about risk associated with not taking ESG considerations into account. Firstly, there was never a policy proposal that anyone be forced to consider ESG issues when making investment decisions. Second, considering ESG factors does not imply liberal or conservative values-based judgments. It's just assessing risks, like the risks of interest rates, or competition. For instance, again if you're an insurance company and you do not assess climate risk, it just doesn't seem like a very smart thing to do from a business point of view, no matter what your political affiliation is. I want to draw a line between that and incorporating certain interpretations of ESG factors that *do* relate to values. The question there is what are you doing with the ESG score—are you trying to reduce the risks, are you trying to promote a strategy does imply particular values, etc. It doesn't have to have a liberal viewpoint either, and there are actually conservative impact funds out there that have conservative values. That's an impact investing strategy, though not a common one to be sure. You can interpret the data and make commensurate investment decisions however you like, but I think it's critical to understand that factoring in risk from ESG type issues is similar to any other kind of investment risk assessment. It's what you do with that information that may be differentiating.

**KE:** I think that's why the standardization or lack thereof is so important, because it does go back to the fact that there are different definitions and different expectations. They can span the ideological spectrum. We don't have a specific standardization around ESG in terms of what we're looking for.

**EB:** Anna, that seems to be related to a point that you were making about ESG as a source of alpha.

**AA:** There are a lot of studies that suggest a positive correlation between better ESG practices and higher company valuations; one that comes to mind was a McKinsey survey done in 2019. They basically showed that companies with stronger ESG programs are more likely to gain a competitive advantage and that investors are willing to pay a premium for the company. For example, if you look at the "S," there is no doubt that a company with lower turnover has the ability to retain employees and keeping employees engaged and satisfied has a positive impact on productivity. Another example in the "G" category is board diversity; group thinking in boards (which is when a board reaches a consensus without critically evaluating alternative viewpoints or considering potential risks) is a common problem in boards and having a diverse board with independent directors reduces that risk. Finally, if you have strong governance practices, that clearly reduces the risk of fraud, which can translate to legal cost and fines—which has a real impact on the bottom line. There is a correlation between some of these aspects that ESG takes into consideration and better financial performance and long-term value creation.

**EB:** What are the needs and the opportunities in the market? Is there a trade-off between ESG and other strategies?

**DG:** As I mention, there's not necessarily a trade-off between maximizing financial returns and having an impact agenda, and even where there is, there are investors willing to make that trade-off. So, for instance, such investors may pursue high returns but embrace more risk, or they may say they just want their capital back but they're really trying to have a lot of impact. Those are ways that investors choose to make those trade-offs. But the vast majority of ESG investments and impact investments don't make any explicit trade-offs like that. There's a growing industry of creating new kinds of investment structures called blended finance, which basically means combining different investors who have different risk-return appetites. The goal is to catalyze more of that return-seeking capital. In general, there's a greater recognition that to solve the big social problems of the world—like poverty, hunger, climate change—tens of trillions of dollars are needed, far beyond what philanthropy or governments can provide. That's the rationale behind blended finance and impact investing. The notion is, let's bring in additional money from investors seeking high returns by blending down risk or taking risk off the table and attracting investors who are willing to pay more for the impact side of the equation. That said, there are growing opportunities to invest in ESG-positive business models that don't require any sacrifice of investment returns, something like renewable energy or electric vehicles. Those are classic examples of good investments regardless of their impact. Investing on behalf of climate and oceans, which is our focus, can also be in that category.

**EB:** Anna, I wanted to go back to your first point about how to measure impact.

**AA:** Because of the lack of standardization, there are a lot of different ESG frameworks you can use, and that makes the consistent measuring of ESG performance difficult. At the same time, this is not a reason to avoid ESG reporting entirely. Investors are looking for good nonfinancial reporting beyond the standard financial reporting. It does matter to investors to see these sorts of nonfinancial metrics. Generally accepted accounting practices (GAAP) accounting took many years to develop. Currently, traditional financial reporting does not give investors a lot of information about intangible assets, like intellectual property, human capital or social capital of a company. For example, human capital: only 15 percent of U.S. corporations report data on their workforce, like composition (part-time versus full-time, turnover, average age of employees, data on compensation) and yet these are metrics that tell us a lot about the human capital a company possesses. GAAP accounting was created in an environment where these intangible assets represented only 10-15 percent of a company's value, whereas today we know that these assets represent 90 percent of a company's value. So it will take a while, but eventually our financial reporting system will incorporate these metrics and create a more integrated approach to financial reporting.

**EB:** So there's a need for these standards. They are a little bit all over the map right now, but the markets are evolving, and we have seen this happen before in other settings.

Kirstin, what do you see as current risks from your perspective as a legal practitioner?

**KE:** The issues that have been raised are really the critical issues from a legal perspective. The law is trailing the expectations and the decision-making of companies and investors. So there's a disconnect. That creates uncertainty, and if you get it wrong, it creates risk. There are also inconsistencies among jurisdictions. We have federal agencies making decisions around enforcement, making regulatory decisions and rules that sort of trail behind those enforcement actions. And then we have international laws. Frankly, the European Union is further along this trajectory than we are. But we've also seen states in this country, as we often do on emerging issues, try and take the lead. And so, even in certain states, you can find yourself looking at inconsistent requirements, and that raises costs for companies and creates confusion for investors seeking common definitions and common metrics and for in-house attorneys or finance advisors trying to advise a company and its board in terms of where they are on the trajectory of risk. That is sort of mirrored in the auditing process. Setting reserves means forecasting liability, which has always been more of an art than a science. But when you put the ESG spotlight on these judgment calls, it becomes more challenging because the reputational risks of getting it wrong are farreaching. You may be making decisions or making disclosures and not measuring your risk properly, and suddenly you've got another risk aspect that you have to address. Certain activist groups may go through your disclosures looking for how you're forecasting your liability on the ESG spectrum. Without having that consistency and standardization, you're making a lot of judgment calls, and you're having to rely on a lot of internal policies that you have created, which is why you really need a strong internal controls program and buy-in at the highest levels. You need to have your board engaged, and you need to make sure that you can make these decisions consistently. That can be difficult, because there's turnover and companies change policy regimes. You may have to change course if you get new leadership. In my mind, the current risk is anticipating where this is going and how fast it's going to get there, and you may be ahead of where the law is.

**AA:** I think it is important for investors and companies to be intentional and structured about these policies, even if it's just starting with a statement that includes the company's purpose, the values it operates by and how it intends to implement these policies. At the beginning, implementation can be left, for example, to the investment team. At the beginning, it is common to have a high degree of flexibility on how these policies are actually implemented. That's acceptable. An ESG policy is a good start for engaging in this type of conversation and thinking about how to make those policy implementations more transparent and more systematic. Even if you are not very advanced as a company in your ESG practices, the starting point would be just to have a policy to guide your thinking about these issues and how to incorporate them into your operations.

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