



Impact Investing: Q&A with Hari Balkrishna



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Hari Balkrishna recently sat down to discuss the Global Impact Equity strategy, why public equity markets are integral to meeting environmental and social targets, while also looking ahead to 2023 and telling us why he believes the strategy can deliver on its dual mandate of providing both impact and financial performance together.

Is impact investing really relevant in public equity markets, and do you have to sacrifice financial returns to achieve this?

In my opinion, there are three main reasons why we can deliver impact through public equity investment despite purists arguing that impact is best suited to private investing. If we really want to achieve net zero and other sustainability targets, it will be extremely difficult without the participation of listed equity markets. Currently, there is an approximate US\$3.7 trillion funding gap¹ to meet the United Nations Sustainable Development Goals by 2030. Closing that gap is not possible through government action and philanthropy alone.

The second reason, which is a much more positive one, is that when I look at the opportunity set on a global basis, I am truly excited about the growth in impact orientated activities where there is a clear

link between financial returns and positive real world impact. This has tremendous potential from an alpha generation perspective. While we start our analysis with impact analysis and a clear impact thesis, every stock that we consider for ownership has to have the potential for meaningful financial returns. In its simplest form, we are required to fully integrate how and the extent to which our health care companies are improving patient outcomes (impact thesis), while also estimating what this means for the growth and cashflow profile of each company owned (financial thesis).

Finally, we have the ability to understand the need to contribute to the impact agenda through our scale and impact perspectives. The size of T. Rowe Price tends to allow us good access to corporate management teams, allowing us to both refine our perspective, but also to engage with management and senior level executives to progress change.

¹ <https://www.unpri.org/sustainable-development-goals/closing-the-funding-gap-the-case-for-esg-incorporation-and-sustainability-outcomes-in-emerging-markets/9430.article>

Please can you describe what you are looking for when you think about potential impact?

As a starting point, we look to align our investments with the UN Sustainable Development Goals. We look to understand where corporate activities align to create the potential for positive impact, for example how much a company's revenue comes from increasing energy efficiency, or how much a company can drive financial inclusion. Currently, we are invested in a company that is increasing energy efficiency by visiting manufacturing sites and trying to find opportunities to swap out legacy equipment for more energy efficient equipment. While we often apply third party measurement to assess impact, this company has also evolved its targeting and reporting to measure impact by adopting a forward-looking target for the metric tonnes of CO₂ they want to save for their clients. That is a real-world example of a company effecting change, where that change can also provide financial returns.

In terms of social equity, we are invested in a number of banks that we believe can expand financial inclusion. In Brazil we are invested in a digital bank which only had around two million customers a few years ago, but now has almost 70 million customers that have effectively been brought into the financial system in Brazil. That can have a huge impact on individuals and society, whether through securing finance to buy a motorbike that assists mobility, investing in a business idea that creates employment, or buying a home to live in. We strongly believe that this company has the potential to transform people's lives by driving financial inclusion. However, this isn't about impact at any price. The company also needs to be attractive from a financial returns perspective.

Can you discuss your investment philosophy and how you expect to drive alpha for clients?

Our view is the market often under pays for the durability and persistence of earnings and cashflow growth. We look for minimum double-digit total return for shareholders on an annualised basis over a five-year period. Working in conjunction with our global research platform we try to identify stocks where we have a meaningful insight that is different from market consensus, but where we are not overpaying for that asset using price-to-free cashflow as our primary valuation anchor.

Because of the inconsistent presence of impact opportunities across sectors, we do take meaningful sector bets. We are zero

weighted in areas including energy, metals, and mining, as well as in developed market banks. To manage risk we have a conviction position in industrials which helps to provide an element of cyclicality. We also expect to have low exposure to consumer staples given so few companies in the sector meet our impact criteria. We offset this risk by having higher exposure to health care which helps to provide the portfolio with defensive characteristics through potential volatile times.

In terms of generating alpha, if our impact thesis evolves as expected, we expect the stock to compound total shareholder returns at a faster rate than the overall market or index. While near term volatility is always unpredictable, we also expect to benefit from macroeconomic industry trends including increased government incentivization and corporate capex. For example, in the United States we have seen companies benefit directly from the Inflation Reduction Act, while in Europe the EU green deal has provided a boon to specific industries. Importantly, we expect regulatory changes and politicians desire to meet green targets to provide a tailwind for specific areas of the market going forward.

Looking ahead to 2023, what is the outlook for markets and how will you position the strategy to ensure you achieve your dual mandate?

We couldn't be more excited about the valuation setup moving through the uncertainties of 2023. We have identified some incredible positive impact opportunities and when we look at the potential on a multi-year view these companies look very attractive.

In the near term, we expect markets to remain choppy as inflation remains elevated, but we expect inflation to start to moderate as supply/demand normalises. However, I still think the journey back to 2% inflation is going to be a long one, which would suggest that the terminal Fed funds rate probably stays a little stickier than the market would hope for.

We are focused on idiosyncratic equity stories that can deliver that double-digit earnings growth at a reasonable price, irrespective of the macro environment. Ultimately, we are investing in companies that we believe are delivering positive environmental and social impact, and that are on the right side of change when it comes to top line and bottom-line growth prospects over the next decade. If we can pick those stocks well, then we believe over time we can deliver our dual mandate of impact and financial performance together.



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Country risk (China) – Chinese investments may be subject to higher levels of risks such as liquidity, currency, regulatory and legal risks due to the structure of the local market.

Emerging markets risk – Emerging markets are less established than developed markets and therefore involve higher risks.

Currency risk – Changes in currency exchange rates could reduce investment gains or increase investment losses.

Small and mid-cap risk – Small and mid-size company stock prices can be more volatile than stock prices of larger companies.

Stock connect risk – Stock Connect is subject to higher regulatory, custody, and default risks as well as liquidity risk and quota limitations.

General Portfolio Risks

Market risk may subject the portfolio to experience losses caused by unexpected changes in a wide variety of factors.

Capital risk – the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

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Investment portfolio risk – investing in portfolios involves certain risks an investor would not face if investing in markets directly.

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