T. ROWE PRICE INSIGHTS
ON IMPACT INVESTING

How Impact Investing Can Help Address ESG Skepticism

Using measurement and engagement to tackle ESG fractures head-on.

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Hari Balkrishna
Portfolio Manager, Global Impact Equity Fund

KEY INSIGHTS

- Greenwashing, performance issues, and the polarization and politicization of environmental, social, and governance have caused fractures in the industry. Our belief is that impact investing can help solve for some of those concerns.
- By nature, impact investing applies a high bar of qualification and therefore reduces the risk of greenwashing in our view. We also believe that impact investments offer better business models and, therefore, better long-term prospects.
- The opportunity to own businesses that can create a positive environmental or social impact is greater than ever before in public equity markets.

While the last decade has seen an intensifying focus on environmental, social, and governance (ESG) policymaking and implementation, the past two years have exposed some ESG fractures in the industry. We have seen challenges arise to the shared objective of improving ESG standards—in corporate behavior, security research, and reporting dimensions. While not an exclusive solution, we believe impact investing can help solve for some of those concerns.

Addressing the Problem of Greenwashing

One of the primary negatives that has sparked debate and controversy is the issue of greenwashing—misstating or overstating ESG principles or outcomes. It is clear there have been corporations and asset managers that have failed to apply proper controls in their processes related to ESG investing. Some financial providers have spuriously labeled their products as ESG without measuring up to their sustainable credentials. Within this debate, however, we should not lose sight of the critical objectives of clear and material ESG policymaking. Understanding ESG factors within a portfolio is an extension of good research and broadens risk management to include very real ESG risks that will influence financial returns in the future. This represents progress and a formalization of the reality that corporate governance and business risk management have always mattered to financial returns.

Clearly, there have been concerns over greenwashing, however, as ESG labels have been broadly applied in an era of mass adoption. In response, regulation is being tightened and the clarification of standards and evidence of application will be a considerable influence

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on the ESG processes, as well as ESG labeling going forward. We expect disclosure standards to deepen and regulatory frameworks to evolve, with a forward-looking perspective on ESG implementation from all stakeholders.

Polarization, ESG Fractures, and Performance Headwinds

As ESG has found its way into the political forum, we have seen a polarization of perspectives evolve, particularly in the U.S., as the presidential election cycle begins in earnest. This has dovetailed with notable concerns about the financial return impact of ESG investing in some quarters, specifically whether investing with an ESG focus can truly bring better financial outcomes. This was brought into sharp focus when Russia invaded Ukraine, sending energy and commodity stocks higher and creating a period of material underperformance for many commodity-light ESG-oriented investment approaches.

The particular nature of markets in 2022 engendered an ESG backlash in some quarters, with the armed conflict in Europe spurring some energy transition advocates to take a step back. The outbreak of war has presented new frictions on economic and societal dimensions, with energy security replacing energy transition as the focus for governments in the short term. With extreme outcomes becoming commonplace in 2022, this undoubtedly has caused some investors to reassess their capital deployment strategy. The key question is whether this is temporary or permanent.

Impact Investing—Measurement and Accountability

When considering whether impact investing can be a useful tool to address the tensions above, it is important to distinguish between the roles of ESG integration and impact investing. At T. Rowe Price, ESG integration involves the incorporation of ESG factors into consideration as part of our wider investment analysis in identifying investment opportunities and managing investment risk. It is not exclusionary, but inclusionary, and requires qualitative and quantitative insights to execute successfully.

Similarly, our definition of impact investing is explicit in nature. Impact investing is the intention to generate positive environmental or social impact, alongside a financial return. It is focused on finding companies that we believe can compound both positive impact and financial returns in the future. It excludes companies that do harm, as well as those that have no material positive impact on the environment or society. Importantly, by nature, impact investing applies a high bar of qualification and disclosure with respect to impact candidacy and therefore reduces the risk of greenwashing in our view. Impact investing also offers a direct way to influence and address the challenges of measurement as impact investors typically go even deeper by adding measurability and engagement.

Impact Investing and ESG Fractures

Impact investors measure outcomes and progress through impact-oriented key performance indicators, alongside financial targets. These are recorded, documented, and measured for progress over time, providing a clear impact and financial return thesis that aims to improve the clarity and reporting of the investment case. That contrasts with ESG integration, which is part of the security analysis process, helping evaluate the E, S, and G risks of a company's operations. Put simply, impact investing focuses on the external effects of one company's business activities on societal and environmental issues. ESG focuses predominantly on the company's internal operations.

As investors assess their ESG policymaking and implementation in light of the frictions within the sector, we believe impact investing will play a material role in furthering analytical

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and reporting standards within the industry and, ultimately, helping to improve investor confidence that their capital is invested as intended.

From a financial return perspective, we also have conviction in the business models and compound growth prospects of the stocks we own. Given the importance of evidencing impact processes, there are times when questions may arise about whether impact investing involves a sacrifice of potential returns. In direct response, we target companies that we believe are growing and compounding financial returns alongside and, often, because of the impact case and associated demand for the respective products and services provided. Sustainability and growth of financial returns, quality businesses, and industry growth are all strong foundations from which to facilitate impact as a style of investing in aiming to deliver competitive returns.

We Remain Excited by the Opportunities Available to Impact Investors

The pressures and fractures that have evolved are clearly testing the resolve of investors and the ESG community alike. But impact investing's ability to demonstrate clear alignment, measurement, and engagement helps to address some of those concerns. Impact investing's ability to align investments and measure against social and environmental outcomes is tangible and a clear differentiator.

Importantly, we believe the opportunity to own businesses that can create a positive environmental or social impact is greater than ever before in public equity markets. We are seeing companies increasingly shift investment to address environmental and societal pressure points. Being on the right side of this societal and environmental change creates a real opportunity to select stocks that will convey a positive impact profile and, with it, the added return potential that this can bring. Finding the winners that are leading the charge and putting capital behind those accelerating the move toward positive outcomes will be key.

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