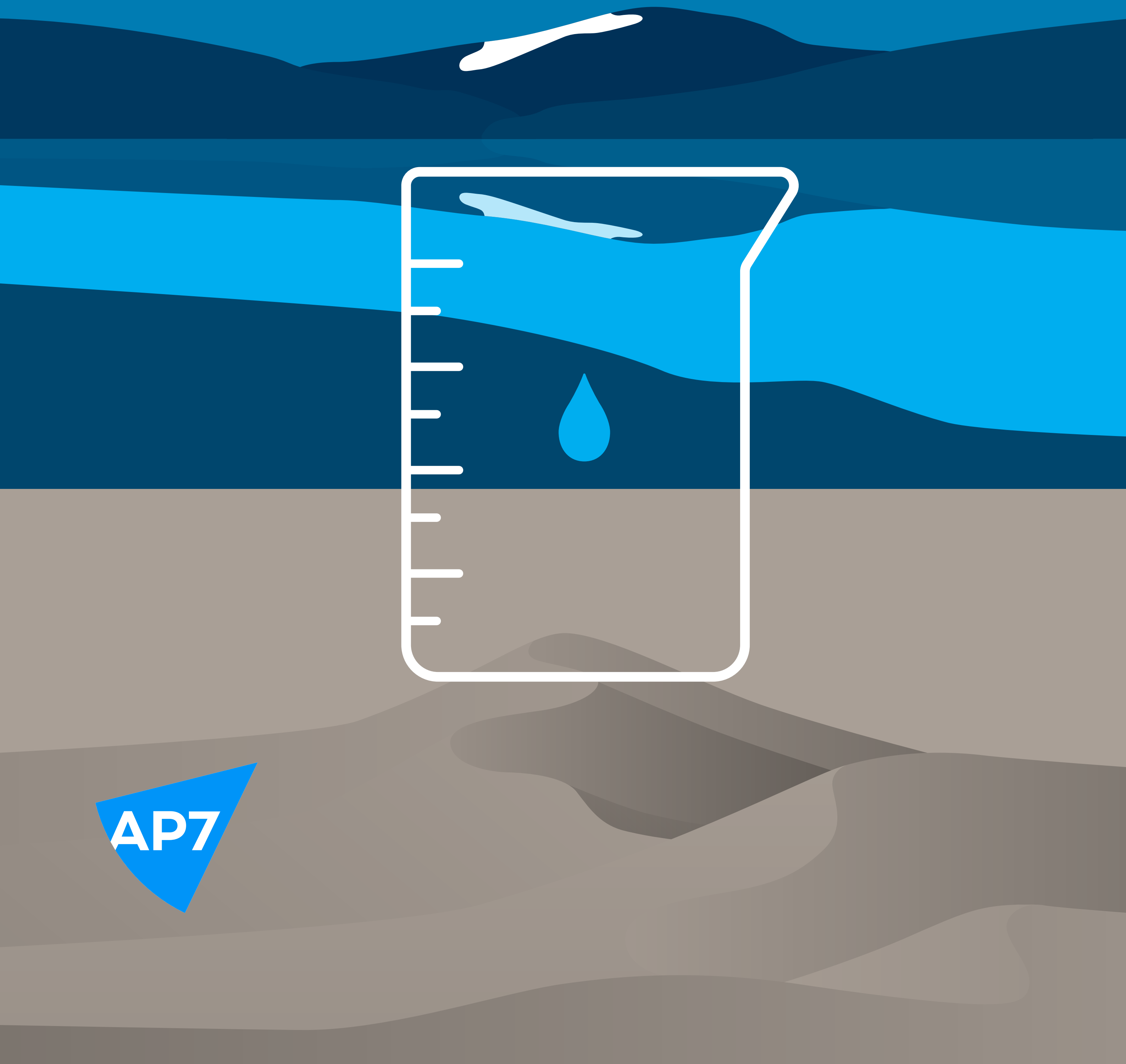
AP7

Theme Report

Sustainable Impact Measurement



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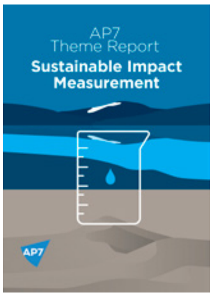


Front cover: **How can we measure the societal impact of resource use?**

One conclusion from the theme Sustainable Impact Measurement is that the data must be placed in a relevant context before its impact can be understood. An example is the difference in the effect of water consumption in the Nordic area compared with the Sahara.

AP7 IN BRIEF

Mission: Good pension from generation to generation.

Vision: A global role model for responsible pension solutions.

Target return: Continual saving in the default option will generate a long-term return that is at least 2–3 percentage points higher per year than the income pension.

AP7 is a public agency tasked with managing premium pension funds for the Swedish people. Over five million Swedes invest their premium pension in the state default option, AP7 Såfa. The total value of assets is approximately SEK 850 billion, making management a major responsibility. AP7's asset management is exclusively focused on the interests of the pension savers, both today's pensioners and those in the future.

AP7 is a universal owner. With investments in more than 3,000 companies around the world, we can function as owners on a broad front and over a long term, while considering the interests of the entire market. Through its role as an active universal owner, AP7 is securing the financial interests of both current and future savers.

AP7's active ownership work is primarily aimed at ensuring a positive effect on the long-term return for the entire market rather than for individual companies.

Managed assets: SEK 850 billion

Number of savers: over 5 million

Investment portfolio: more than 3,000 companies around the world

Number of employees: 40

(as of 30 June 2022)

Sustainable impact measurement – a practical challenge

The capital market plays a key role in sustainable societal development, but investors need reliable information if they are to make well-considered investment decisions. Within the theme, Sustainable Impact Measurement, AP7 has investigated how to report on the societal benefit of investments and active ownership – an area that brings challenges but also opportunities.

SUSTAINABLE DEVELOPMENT GOALS

The concept of impact investment gained traction in the financial sector in conjunction with the presentation of the UN Sustainable Development Goals in 2015. Until then, impact investments had mainly been associated with development projects aimed primarily at societal benefit, with low or negligible financial return.

As impact investment gained wider recognition, the basic idea was that other types of investments than development projects, such as global equity portfolios, could report their societal benefit. By definition, both financial goals and sustainability goals should be measurable if the investments are to be regarded as impact investments, and in that context many of the 17 SDGs seemed to offer an opportunity.

Over the years, the focus has turned increasingly towards the financial sector and its responsibility to contribute to a sustainable future. Legislators, investors, and savers are all calling for greater transparency and standardised reporting of higher quality to enable informed decisions. Several creative models have been developed with links to the UN SDGs, and the international standardisation work has been going on for a long time. Despite this, there is still a lack of accepted metrics.

Within the framework of the three-year theme Sustainable Impact Measurement, AP7 has been investigating how to measure the societal benefit of our investments and the effects of active ownership. Our conclusion is that measuring the societal benefit is difficult in practice, and a simple solution for producing standardised and comparable data is unlikely in the near future. Nevertheless, ambitious investors have good opportunities to find ways to contribute to sustainable development through their investments and active ownership.

Stockholm, September 2022

“Over the years, the focus has turned increasingly towards the financial sector and its responsibility to contribute to a sustainable future. Legislators, investors, and savers are all calling for greater transparency and standardised reporting of higher quality to enable informed decisions.

AP7's themes

For a number of years, AP7 has been supplementing its active ownership work with continuous themed activities. These themes deepen and interlink AP7's current working methods in selected and particularly urgent areas.

Focusing on a few themes at a time enables in-depth examination and reflection in a complex field relevant to our investments. Every year, a new theme is launched that runs over three years.

Some key criteria are applied when choosing a theme: the theme must be relevant in terms of AP7's holdings and asset classes, AP7 must be able to make a reasonable difference in a resource-effective way, and there must be suitable expert partners with whom to collaborate.

The theme guides AP7's prioritisations during the three years, and has consequences for the work with engagement dialogue and at general meetings. It also increases collaboration with other actors on advancing standards and norms within the field.

Read more about our previous themes – Private Equity, Climate, Fresh Water, Corporate Climate Lobbying, and Working Conditions in Food Supply Chains – on our website: https://www.ap7.se/hallbarhet/temaarbete/

Sustainable Impact Measurement 2019–2021

Climate Transition 2020–2022

Deforestation and Biodiversity 2021–2023

Universal Active Ownership 2022–2024

Current themes

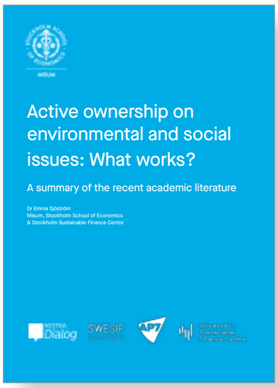
AP7 is currently working on the following three themes:

Climate Transition 2020–2022 AP7's ownership through shareholdings enables us to exert pressure on companies to make responsible decisions, and thereby help to accelerate the transition to a fossil-free society.

Deforestation and Biodiversity 2021–2023 If we are to attain the Paris Agreement target of keeping climate warming to well below two degrees, deforestation must be limited, particularly in Amazon rainforest, in view of the forest's importance for the climate.

Universal Active Ownership 2022–2024 The aim of the theme is to develop and refine AP7's activities for active ownership as universal active owner, with the focus on system-critical sustainability issues and maximising positive effects in the real economy.

Theme: Sustainable Impact Measurement 2019–2021



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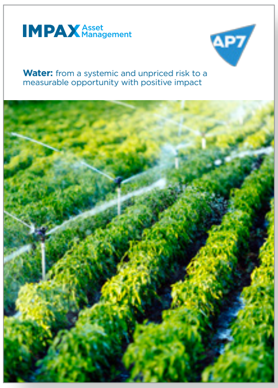
Active ownership – what works?

https://www.ap7.se/app/uploads/2020/03/active-ownership-on-environmental-and-social-issues.pdf



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Better water reporting critical in steering investments in the right direction

https://www.ap7.se/app/uploads/2021/07/water-report-impax-ap7-2021.pdf

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Holistic approach gives best guidance for investors

https://www.ap7.se/app/uploads/2022/04/kbigi-ap7-improving-measurement-of-impact-water-case.pdf

In 2021, AP7 concluded its work on the theme Sustainable Impact Measurement. The aim of the theme was to examine how to attain effective active ownership and how to ensure that the sustainability work of portfolio companies actually contributes to sustainable societal development.

Effect of active ownership

To generate a bank of knowledge for our theme work, AP7 commissioned Dr. Emma Sjöström at Stockholm School of Economics to analyse the past ten years' academic research on active ownership. The aim was to identify the most effective strategies for active ownership and to identify the success factors. The conclusions were published in the report *Active ownership on environmental and social issues. What works?*

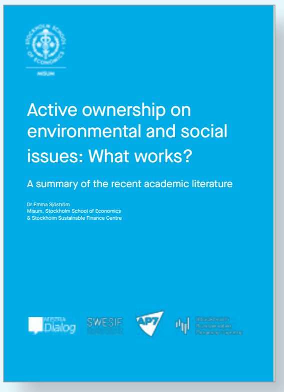
Effect of the portfolio companies' sustainability work

Together with the AP7's managers of impact funds, KBI Global Investors and Impax Asset Management, we evaluated various methods that measure the societal impact of the portfolio companies' sustainability work.

KBI looked at how investors can measure portfolio companies' positive and negative effects on the environment, while Impax examined how to effectively measure the impact of portfolio companies in areas with limited access to water. The results of these collaborations were presented in two reports, *Improving measurement of impact in listed equity* and *Water: from a systemic and unpriced risk to a measurable opportunity with positive impact.*

Active ownership – what works?

Which active ownership strategies are most effective in bringing about a desired change, and what are the success factors? Emma Sjöström at the Stockholm School of Economics examined these issues, and her findings were presented in the report *Active ownership on environmental and social issues: What works?*



The report focused on active ownership in relation to environmental and social issues, and identified the most effective strategies. The work resulted in a number of conclusions:

- Credibility and legitimacy are more important than shareholder stake for successful dialogue.
- A strong business case increases the likelihood of companies responding positively to the owner's argument.
- Investors that work together, for example through PRI, can benefit from the coalition and its good reputation.

Read the report here: https://www.hhs.se/en/about-us/news/news-from-misum/2020/active-ownership-report-emma-sjostrom/

The focus on active ownership is growing, and an increasing number of investors are becoming signatories of PRI (Principles for Responsible Investment), which is backed by the UN. Large equity owners and institutional investors are realising that they have both a great responsibility and an opportunity to promote more sustainable societal development.

Not least, the benefit of institutional capital has become relevant in terms of the climate challenges the world is facing. However, investors are also looking for ways to contribute to positive development in other areas of sustainability, such as biodiversity, human rights, diversity, and corporate governance.

For investors, there are a number of different strategies and methods available for exercising active ownership, but if they are to attain the desired result it is important to know which are most effective.

Emma Sjöström is co-director of the Sustainable Finance Initiative at Misum, Stockholm School of Economics. In 2020, she published the report *Active ownership on environmental and social issues: What works?* in which she compiles the findings from ten years of research on active ownership in relation to social and environmental issues.

The report was the result of a collaborative project, initiated by AP7 and involving SSFC, Swesif and Mistra. The aim of the project was to generate and disseminate knowledge about the real-world effects of various ownership activities, to enable investors to exercise their ownership in a more knowledge-based and effective way. This is a field in which there is a great need for more knowledge. As part of the project, a workshop was held for Nordic investors during the Nordic SIF meeting in Stockholm in 2019. The results were presented in a seminar in February 2020.

Which strategies work?

Shareholders exercise active ownership when they use their ownership position to steer a company's policies

> **One of the most important findings is that investors do not need a large shareholder stake to engage with companies and bring about a desired change.**

and business practices in a more sustainable direction. Exerting influence can take various forms, for example by engaging in dialogue with company management to try to influence how the business is run, by filing shareholder resolutions at general meetings, or by divesting shares in a company or in a sector.

In the report *Active ownership on environmental and social issues: What works?* Emma Sjöström examined the findings of research regarding the effectiveness and impact of these different strategies, and identified the success factors. The conclusions can be used both as guidance for investors and to form a basis for future research in the field.

Credibility more important than shareholder stake

One of the most important findings is that investors do not need a large shareholder stake to engage with companies and bring about a desired change. Many of the studies that Emma Sjöström refers to show that the investor's credibility, legitimacy, and reputation are more significant than the shareholder stake for successful engagement dialogue with companies. It is also important that the investor can present a convincing business case, showing that the proposed change is in the best business interests of the company. By putting forward a strong case, the investor is also showing that they have expertise in the field and an understanding of the corporate perspective.

Collaboration a success factor

Emma Sjöström also concludes that collaboration with other investors is an effective way to bring results in the dialogue work. Building coalitions with stakeholders that have the necessary legitimacy and credibility for successful dialogue increases the likelihood of a positive response from companies.

Platforms such as PRI (Principles for Responsible Investment) can be useful as a coordinating function and as a way to increase persistence in the process. They can also be a good starting point for investors who want to join forces and work to bring about a shift in norms.

Divestment or engagement – which is most effective?

A recurring question is whether it is more effective to divest holdings in a company that, for example, conducts activities that conflict with the Paris Agreement or remain as owner and engage with the company.

The research that Emma Sjöström studied has not been able to show that the price of a company's shares is depressed by divestment. Shares sold by an investor are simply bought by someone else, and the company can continue to run its business operation unaffected. However, one finding was that divestment can draw attention to a company or a sector, which in the long term can help bring about change in terms of acceptable norms.

Easier to get support for greater transparency

An investor who remains as owner is also able to engage with companies through dialogue or shareholder resolutions at general meetings. Emma Sjöström found that resolutions calling for greater corporate transparency are more likely to win support than resolutions that require operative changes. High voting figures for greater transparency also tend to actually lead to improved information and, if the resolution won high levels of support, the implementation could spread to other companies in the sector. However, she did not find that greater transparency in itself leads to improved sustainability work.

The research does show that the shareholder stake is more significant for decisions taken at general meetings than for corporate dialogue. In recent years, investors' voting decisions relate more to the companies' management of climate risks, increasing the focus on the ability of boards to work strategically with climate issues.

Ownership strategies for climate transition

The climate issue is central for active ownership, and Emma Sjöström notes that the number of shareholder resolutions relating to the climate issue has increased in recent years, and that these resolutions can win high levels of support. However, research is lacking on which types of strategies are most effective in getting fossil-fuel companies to accelerate their transition and reduce emissions of greenhouse gases.

Emma Sjöström calls for research exploring whether

> **Even if there is research that, for example, links divestment announcements with flows of capital, discussions are lacking about the link to actual emissions levels.**

restriction of debt funding to the fossil-fuel industry might be an effective way to reduce production levels and thereby curb greenhouse gas emissions – a perspective that she feels is lacking in the debate. She also feels it would be interesting to compare the effectiveness of restricting debt funding with equity divestment in fossil-fuel companies.

There is some evidence that divestment can lower the share price of fossil fuel-based companies and that it can divert cash flows away from this sector. However, as long as companies show positive cash flows, there are probably investors somewhere who are prepared to provide them with capital.

Engagement on norms and policies

Based on the difficulties of determining the effectiveness from a climate perspective of different strategies for engagement, Emma Sjöström concludes that one step for investors who want to work for a climate transition, not least universal owners, is to engage at policy level. A global carbon tax or reduced subsidies of fossil energy are two examples. Another way is to direct more financing to companies with green business models and whose business activities contribute solutions to the climate problems.

More research needed

While Emma Sjöström draws a number of conclusions regarding success factors for active ownership, she notes that the research leaves a number of questions unanswered, and some important perspectives are lacking.

In particular, the key issue of the real-economy effects of active ownership is left unresolved. Even if there is research that, for example, links divestment announcements with flows of capital, discussions are lacking about the link to actual emissions levels. She also calls for more empirical research on the effects of restricting debt financing to the fossil-fuel sector.

Another issue is which changes in corporate policies and methods of working are a consequence of the dialogue with the owners, and which changes would have been made without the dialogue.

In the report, Emma Sjöström also notes that:

- No research has addressed how different strategies can interplay with or counteract each other, nor what would be an efficient sequence of using different strategies under different conditions.
- The studies do not differentiate between incident-based engagement and proactive engagement with a more forward-looking agenda.
- It would be relevant to examine the circumstances in which blacklisting is an effective method for exerting pressure on companies to change their behaviour, as well as the real-world effects of divestment or blacklisting.
- Most studies were performed in the US, and it would be relevant to broaden the geographical scope, and possibly compare economically developed markets with emerging markets.
- Research is lacking on the effect of lawsuits initiated by shareholders, and whether such lawsuits interact with other strategies, and the extent to which the threat of a lawsuit influences corporate behaviour regarding social and environmental issues.

“Spotlight on the board’s role”

Two years have passed since Emma Sjöström published the report *Active ownership on environmental and social issues: What works?* Have there been any developments since then?

Any developments in the field of active ownership since you published your report?
One trend is a greater focus on the board’s role and responsibility in sustainability issues. I think we’ll be seeing more of this, for example through assessments of board members’ sustainability expertise, and boards will be required to take responsibility for the companies’ climate commitments and climate risks. There also seems to have been a record number of climate-related resolutions filed in this year’s general meeting season.

Do you have any examples of the boards becoming more important?
One clear example was at the 2021 general meeting of the oil giant Exxon. The small hedge fund Engine No. 1 managed to get three new members elected to the board instead of the ones that Exxon had proposed. It takes a lot to get support for this kind of proposal, but Engine No. 1 were backed by the big owners BlackRock and State Street. This illustrates what the research showed and what I emphasise in my report – that a shareholder doesn’t need a large stake to win support and drive change. However, even more important was that Engine No. 1 was able to present a strong business case and explain why the transition is important from a business perspective, that it would benefit the shareholders, and that new expertise was required on the board.

Has research in the field advanced?
I haven’t seen anyone addressing the gaps in the research I identified, but then it takes time to progress from concept to publication in the research world. However, I have read an interesting study from 2021 that examined 1,000 European pension funds* and how many had divested their holdings in fossil-fuel companies – according to the study 13 percent (corresponding to 33 percent of the assets) – and the underlying motive for the divestment.

The study showed that large, public pension funds are more inclined to divest than privately owned funds, as well as pension funds that compete for customers on the open market compared with corporate funds for the employees. The motive was everything from financial to a desire to engage through divesting or to avoid criticism.

What’s your own view on the balance between divesting or remaining as owner to engage with companies?
They’re two different mechanisms, and both methods can have impact, but in different ways. An argument against divestment of fossil-fuel holdings is that the shares can be acquired by less scrupulous investors who have no interest in engaging with or supporting the companies on reducing their emissions. During the spring we’ve seen examples of this when the Russian invasion of Ukraine led to many investors selling their Russian holdings, which resulted in the ownership power shifting to oligarchs or other Russian owners. This of course is a politically motivated decision that can seem reasonable in the circumstances, but the effect in the long term remains to be seen.

Finally, do you think sustainable impact measurement is attainable?
There’s a big demand for standardised methods for evaluating and comparing different approaches to sustainability, but integrating sustainability aspects in financial models is a great challenge. The more you learn about the field, the more you realise that it’s often a matter of trade-offs, where something that has a positive effect in one area can have negative effects somewhere else. It’s very difficult to assess these effects and quantify them for comparison without making great simplifications, which then brings the value of the models into question. More qualitative methods may be needed to express these effects.

I don’t envy those who have to come up with a solution but, as with everything to do with innovation and development, you may not crack the nut itself, but you learn a lot of valuable things on the way.

* Determinants of fossil fuel divestment in European pension funds (Florian Egli, David Schärer, Bjarne Steffen)

Future research – sustainable investments

In recent years, relevant new research has been conducted in the field of sustainable impact measurement. One study reviews the mechanisms of investor impact.

Can sustainable investments save the world? Expectations that sustainable investments will help to attain various societal goals are increasing. In the article *Can Sustainable Investing Save the World?* (see link below) the authors (Julian F. Kölbel, Florian Heeb, Falko Paetzold and Timo Busch) ask how investors can best exert influence on companies' environmental and social impact.

The study is a literature review in which three impact mechanisms are identified: shareholder engagement, capital allocation, and indirect impacts. The authors conclude that the impact of shareholder engagement is well supported in the literature, while the impact of capital allocation is only partially supported and only if certain conditions are fulfilled. Indirect impacts, such as stigmatisation through exclusion and endorsement through inclusion in a portfolio or ESG index, lack empirical support.

According to the authors, the results of the review have implications for investors, ESG data providers, and policy makers. Investors should pursue shareholder engagement throughout their portfolio, with a focus on areas where there are good chances of making an impact. It is also a matter of allocating capital to companies with a positive societal impact, but whose growth is limited by external financing conditions. The likelihood of engaging with companies that have shortcomings in their ESG work through negative screening is increased if the measures can be adopted at a reasonable cost for the company. Engagement has greatest impact if investors form coalitions, and should encompass both shares and bonds.

ESG data providers are recommended to develop metrics for investor impact. Policy makers should be aware that while sustainable investments are a powerful mechanism for improving business practice, it is unlikely that the investments can drive a deeper transformation without additional policy measures.

Can Sustainable Investing Save the World?
Reviewing the Mechanisms of Investor Impact

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Abstract

This article asks how sustainable investing (SI) contributes to societal goals, conducting a literature review on investor impact—that is, the change investors trigger in companies' environmental and social impact. We distinguish three impact mechanisms: shareholder engagement, capital allocation, and indirect impacts, concluding that the impact of shareholder engagement is well supported in the literature, the impact of capital allocation only partially, and indirect impacts lack empirical support. Our results suggest that investors who seek impact should pursue shareholder engagement throughout their portfolio, allocate capital to sustainable companies whose growth is limited by external financing conditions, and screen out companies based on the absence of specific ESG practices that can be adopted at reasonable costs. For rating agencies, we outline steps to develop investor impact metrics. For policymakers, we highlight that SI helps to diffuse good business practices, but is unlikely to drive a deeper transformation without additional policy measures.

JEL Classification: A13, G11, G12, Q51, Q56

Keywords: *sustainable investment, impact, causality, literature review, Sustainable Development Goals (SDGs)*

Acknowledgments

We gratefully acknowledge financial support from the Luc Hoffman Institute. We also acknowledge financial support from the European Union's EIT Climate KIC under the SGA2019. We thank James Gifford, Jonathan Krakow, Vincent Wolf, Alex Barkawi, Britta Rendlen, Emilio Marti, Raj Thamoteram, Tillmann Lang, Julia Meyer, David Wood, Florian Berg, Ola Mahmoud, Bert Scholtens and Paul Smeets for valuable input and discussions. We would also like to thank participants of the Luc Hoffmann Institute workshop "Shareholder Activism for Sustainability" on May 28, 2018, and of the Yale Initiative on Sustainable Finance Symposium 2018.

Read the report here:

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3289544

ESG data providers are recommended to develop metrics for investor impact.

Better water reporting critical in steering investments in the right direction

Water-related risks are increasing, and many companies are offering solutions to these global challenges. If investors are to be able to direct financing to where it has greatest benefit, transparent reporting is needed. Impax and AP7 reach this conclusion in the report *Water: from a systemic and unpriced risk to a measurable opportunity with positive impact.*

The report focuses on how to measure the impact of portfolio companies in areas with limited access to water. Conclusions included that:

- Transparent reporting is needed to help investors direct their finance to the right areas.
- There are few global standards and frameworks for measuring water impact, and none of them provide a complete picture.
- Frameworks for reporting need to be developed in terms of local context, materiality, and impact of water solutions.
- Investor engagement is valuable for investing in water solutions and helping to develop comprehensive methods to measure water impact.

Read the report here:
https://www.ap7.se/app/uploads/2021/07/water-report-impax-ap7-2021.pdf

Water is vital to life, and a strategic resource for industries and societies all over the world. Sustainable development requires reliable and continuous access to clean, fresh water, and water is one of the most regulated sectors in the world.

Water-related risks, such as drought, flooding, and rising sea levels, are expected to increase due to climate change. This will have consequences for individuals and businesses, and for society as a whole. This development comprises not only a major threat to food security and people's health, but also a major risk for the natural world and biodiversity.

Companies that develop water solutions are vital for managing these challenges, and this presents investment opportunities. However, if the financial sector is to direct capital to where benefit is greatest, investors must be given better opportunities to evaluate these companies and the effects of their solutions on the real economy and from a local perspective.

In 2019, AP7 initiated a collaboration with Impax Asset Management, which has long experience of investing in water solutions. The aim was to examine how to effectively measure the impact of portfolio companies in areas with limited access to water. Another aim was to examine how we as investors could support increased transparency. The results were published in the report *Water: from a systemic and unpriced risk to a measurable opportunity with positive impact.*

The report includes a review of existing frameworks and a case study of "net" water impact that considered the local context. The report also includes findings on effective measurement of water impact and recommendations for investors.

Investor guidelines needed

The report identifies three key areas of investment opportunities – water infrastructure, water treatment and water provision. Innovations and solutions in these areas are critical to the global economy, but knowledge is lacking about the impact of the investments on the real economy. Better measurement and reporting of water impact would give investors useful information about the risks and opportunities connected with water.

Despite the great importance of water, the companies'

“Water is vital to life, and a strategic resource for industries and societies all over the world. Sustainable development requires reliable and continuous access to clean, fresh water, and water is one of the most regulated sectors in the world.

current water data reporting is far behind the scope and quality of climate reporting. Water impact is more difficult to quantify than climate impact, and the local context must always be considered.

Gaps identified in existing water impact frameworks

At present, there are only a few global standards for measuring water impact, and they are relatively undeveloped. None of the frameworks that Impax and AP7 examined capture all the parts needed, and comparable data is lacking. To obtain a complete picture of the impact, consideration must be taken to three factors – water withdrawals, positive effect of water solutions, and local hydrological conditions. Gaps identified:

- Frameworks focus mainly on water projects and not on the importance of companies that develop solutions
- None of the frameworks include all the elements required to produce a complete picture of water impact, i.e. water withdrawals, positive water solutions, and local hydrological conditions
- Focus lies mainly on quantity, with insufficient information on water quality and pollution
- Local water circumstances, such as provision and quality, are not sufficiently evaluated.

Better metrics needed

The ability to measure corporate water impact is vital because it helps to drive investments toward the right places and the most promising technologies. If they are to serve as a basis for investor decisions existing standards and reporting must be improved, with greater emphasis on the local context, materiality, and solutions.

Local context must always be considered.

One of the challenges in assessing water risks is that they are local in their nature, which means that water can be regarded as having low overall materiality for a company, at the same times as specific facilities may have significant exposure to the risks. Information about where important physical resources are localised should enable better understanding of and price risks associated with water stress. The issue of local water quality should also be addressed, as in certain areas this can be even more important than water provision.

Greater focus on opportunities and solutions

Much reporting focuses on risk reduction and management, while information on water solutions is overlooked. Nevertheless, there are considerable opportunities to invest in solutions that can reduce water withdrawal and wastage, improve water quality, and eliminate pollution.

Materiality must be clearly defined

Because the price of water is low, many companies do not view it as a material risk, but the price in many parts of the world is heavily subsidised and does not reflect actual supply and demand. To obtain a realistic picture of risk exposure, companies can apply an alternative pricing model, in which the economic value of water in a specific place is estimated, taking into consideration local water stress, population, and different areas of use, such as farming and household. Companies should also report on indirect risks and exposure in their supply chains.

Water impact along the value chain

In order to serve as a basis for decisions, investors need access to information regarding both positive and negative water impact, and the net impact. More information regarding basic water withdrawal, localisation of data, and net impact on water are examples of data that is often difficult to access. Investors have a clear role in calling for and working for increased transparency from companies when such data becomes available.

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Water is strictly regulated in much of the world, and public agencies play an important role in protecting scarce water resources and ensuring acceptable quality.

Roadmap for investors

Investors can play a significant role in achieving positive water impact, both through active engagement with different actors and through their investments. In the study, a number of pathways are presented that investors can take, such as:

- *Investing in listed companies providing water solutions* can contribute to the growth of the market for these companies. This also strengthens the position of investors in a transition to a more sustainable economy, which can favour financial returns.

- *Active ownership of water companies* exerts influence on these to improve mapping and management of their water risks, and improve their reporting, for example by considering local aspects and net impact.

- *Collaboration with standard setters* to influence the development of sustainability frameworks, for example in terms of definitions of materiality, greater quality and comparability, and development of performance indicators linked to positive impact and solutions.

- *Collaborate with policymakers and legislators and shape opinion* on reporting requirements, regulations, and a water policy, for example linked to water quality/pollution, and pricing that considers local conditions.

Summary

Measurement and reporting of water impact can give investors useful data on which to base decisions on water risks, and emphasise the positive effects of water solutions. Investors need common performance indicators for water impact, so that these can be compared and aggregated over different investments and assessed at portfolio level. The study found the following:

Lack of standards and global frameworks

There are only a few standards and globally agreed frameworks to measure water impact, and none of these provide a complete picture. The focus is on managing negative effects, not on measuring the impact of the positive activities available. However, water data is not publicly available, particularly information on local hydrological conditions and water quality.

Alternative pricing models

In most places, the price of water is kept artificially low by regulation, so it does not reflect the actual supply and demand. Alternative models for pricing that consider local conditions give a better picture of risk exposure and the actual value of water.

Investors have a significant role ...

Investors can have a significant role by investing in water solutions, collaborating with companies and organisations that are developing frameworks, and by collaborating with policymakers and advocating robust and comprehensive methods for measuring and reporting water impact.

... as do public agencies

Water is heavily regulated in much of the world, and public agencies play a vital role in protecting scarce water resources and ensuring acceptable quality levels. However, much more is required, particularly in regulating chemical water pollution, in most parts of the world.

In conclusion, Impax and AP7 note that more studies and analyses are needed, including how water interacts with climate change and biodiversity loss, and how these can be taken into account in future water impact measurement. For companies whose water impact is material from strategic or operative perspectives, the next step is to quantify and include the information as part of their financial reporting.

IN THE PIPELINE Global standard for sustainability reporting

Currently, there is no lack of frameworks for reporting sustainability data, but there is great fragmentation, a lack of comparability, and the existing frameworks are not comprehensive. At the COP21 climate conference, IFRS presented the new organisation, the International Sustainability Standards Board (ISSB), which has been tasked with developing a global standard for sustainability reporting.

ISSB's ambition is to provide information about sustainability risks and opportunities that will enable investors to make well-informed decisions. Initial focus will lie on climate-related financial information, but over time this can be broadened to include more sustainability issues, such as water.

ISSB brings together several standard setters in sustainability, such as the Value Reporting Foundation and the Climate Disclosure Standards Board (which has specialist expertise in water), while integrating the recommendations from the framework for reporting of climate-related risks (TCFD).

The first proposals for the new standard were presented in March 2022, and feedback was collected up until 29 July. The goal is to issue the new standards by the end of 2022.

Future research – impact investments

In recent years, relevant new research has been conducted in the field of sustainable impact measurement. One study concerned impact investing.

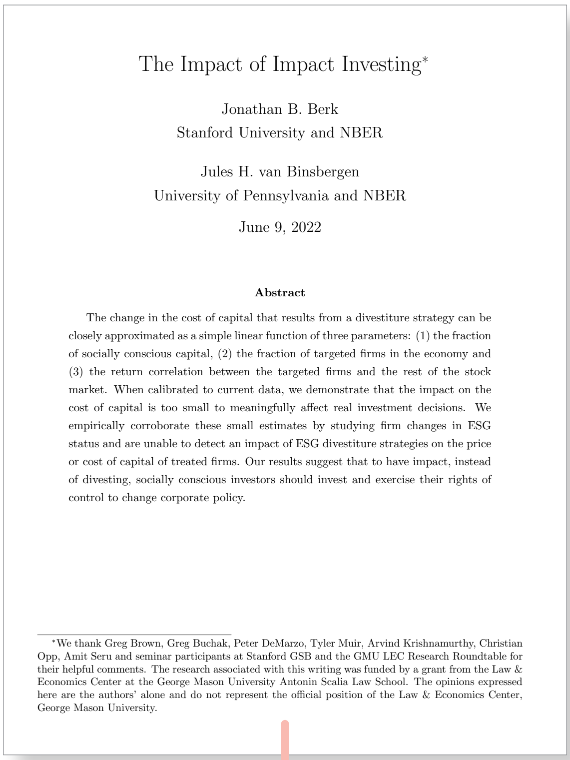
Impact of impact investments

The aim of impact investing is to attain environmental and social gains in society through various investment decisions. Divesting holdings in companies is often discussed as a possible way to increase the cost of capital, and thereby exert influence on companies to improve their sustainability work. However, opinions vary on how effective divestment is compared with other approaches, such as engagement and dialogue.

In the research article, *The Impact of Impact Investing* (see link below) Jonathan B. Berk and Jules H. van Binsbergen examine the effect of divestment on the cost of capital and how effective the method is for responsible investors. If divestment is to have the intended effect, it must impact the cost of capital for the company concerned.

Through their study of existing data, the authors draw the conclusion that the impact of divestment on the cost of capital, both now and in the future, is too small to result in meaningful changes to corporate strategies and actions. The transaction merely leads to shares changing hands, and does not impact the company's business activity – providing the new owners are not more inclined than the previous ones to exert their influence over the holding.

If divestment is to be a successful strategy, with impact on corporate policies and strategies, there must be a distinct increase in the proportion of "socially conscious capital" in the market. The authors therefore argue that investors have greater opportunities to engage with companies by buying rather than selling, and use their influence over the companies and their business activities through active ownership.



The Impact of Impact Investing*

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June 9, 2022

Abstract

The change in the cost of capital that results from a divestiture strategy can be closely approximated as a simple linear function of three parameters: (1) the fraction of socially conscious capital, (2) the fraction of targeted firms in the economy and (3) the return correlation between the targeted firms and the rest of the stock market. When calibrated to current data, we demonstrate that the impact on the cost of capital is too small to meaningfully affect real investment decisions. We empirically corroborate these small estimates by studying firm changes in ESG status and are unable to detect an impact of ESG divestiture strategies on the price or cost of capital of treated firms. Our results suggest that to have impact, instead of divesting, socially conscious investors should invest and exercise their rights of control to change corporate policy.

*We thank Greg Brown, Greg Buchak, Peter DeMarzo, Tyler Muir, Arvind Krishnamurthy, Christian Opp, Amit Seru and seminar participants at Stanford GSB and the GMU LEC Research Roundtable for their helpful comments. The research associated with this writing was funded by a grant from the Law & Economics Center at the George Mason University Antonin Scalia Law School. The opinions expressed here are the authors' alone and do not represent the official position of the Law & Economics Center, George Mason University.

Read the report here:

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3909166

Through their study of existing data, the authors draw the conclusion that the impact of divestment on the cost of capital, both now and in the future, is too small to result in meaningful changes to corporate strategies and actions.

Holistic approach gives best guidance for investors

How can the impact of investing in listed companies that develop solutions in the water field be measured? The asset managers KBI Global Investors and AP7 have together examined this issue, and published the results in the report *Improving measurement of impact in listed equity.*

The report focuses on the impact of investments in listed water equity and presents a method for measuring the companies' impact. The conclusions included that:

- A holistic measurement method that includes both positive and negative effects is most valuable
- The issue of greater transparency has moved higher up on corporate agendas
- Active investors have a role in guiding the companies on developing and standardising their reporting
- Dialogue and collaboration with management teams gives access to valuable and company-specific information

Read the report here: https://www.ap7.se/app/uploads/2022/04/kbigi-ap7-improving-measurement-of-impact-water-case.pdf

KBI Global Investors (KBIGI) invests in listed companies that develop solutions to various water problems. The problems include that water is a finite resource, at the same time as demand for and consumption of water is increasing, regulations are becoming more stringent, and there is a growing need for investments in infrastructure and technologies.

Over the years, there have been many good examples of the positive effect of portfolio companies on society and the environment. However, accepted standards and methods have been lacking for measuring the impact on the widespread problems the companies are trying to solve, such as increasing access to water, reducing water consumption and wastage, ensuring good water quality, and developing or repairing water infrastructure.

Measuring impact is complicated, because:

- relatively few companies report on their impact, and availability of information varies
- the lack of standardised metrics means that companies measure their impact in different ways, making comparisons difficult
- companies tend to focus more on the positive impact of their solutions, and less on the negative effects that can arise.

Consequently, KBIGI, together with AP7, have developed methods and metrics for measuring the impact of the investments in listed water companies. The conclusions were published in April 2022 in the report *Improving measurement of impact in listed equity.*

Building on the original KBIGI method

KBIGI realises the value of, and the challenges associated with, assessing and quantifying the listed companies' impact from an environmental and social perspective.

In an attempt to address the lack of accepted methods for reporting and measuring impact, KBIGI presented in 2017 a method it had developed itself – RASS (Revenue Alignment SDG Scores). The aim was to measure the proportion of listed companies' revenues that aligned with the UN Sustainable Development Goals, SDG.

However, the RASS method had limitations, such as that it could not quantify improvements. Also, it did not differentiate between, for example, revenues from a water plant in an industrialised country compared with one in a country where access to clear water is limited, where the improvement in quality of life brought by improved access to water is considerably higher.

Holistic approach to impact

In collaboration with AP7, KBIGI has built further on the RASS method, but has limited the work to four of the SDGs – those that AP7 prioritises connected to environmental sustainability. The analysis has been broadened to incorporate a more holistic approach. Instead of focusing on the companies' revenue-generating activities, the perspective has been widened to also include the companies' footprint, i.e. how they conduct themselves as organisations, and their handprint, i.e. the products and services they offer.

A scoring system was developed to measure the companies' impact. The system considers positive effects, while identifying company-specific indicators for measuring any negative effect of the business operation. Another step involved seeking to differentiate between companies in terms of their level of impact.

In-depth dialogue with ten companies

In the work to develop the method for impact measurement and to make it more comprehensive, KBIGI undertook enhanced engagement with ten companies in the portfolio. The aim was to supplement the information and to quantify and better ascertain the real-world impact where this was possible, both positive and negative. Another ambition was to develop company-specific impact indicators that could be monitored over time.

The ten companies comprised a differentiated sample representing utilities, infrastructure, and technology, and were diverse across end markets and geographies. The companies selected scored well on the first iteration, but more information was needed on the sustainability of their positive impact.

The information provided by the companies varied in terms of both quality and quantity. However, the in-depth dialogue (and the case studies in the report) showed that investors have an opportunity to push for greater transparency regarding corporate impact reporting.

In collaboration with AP7, KBIGI built further on the RASS method, but limited the work to four of the SDGs – those that AP7 prioritises relating to environmental sustainability.

Summary

KBIGI's and AP7's work shows that investments in global companies that offer solutions to critical water problems make an impact, and contribute to attainment of environmental and social goals.

Holistic approach preferable

Impact can be assessed both quantitatively and subjectively, and a holistic approach is the most appropriate. While many metrics focus on the positive effect of a company's products or solutions, KBIGI and AP7 looked to balance the positive effect of the solutions with any negative effect in achieving those outcomes.

Clear momentum for greater transparency

An increasing number of companies are realising the importance of greater transparency and of improving the information they provide to investors. Investor awareness has grown, and the issue has also been moved further up companies' agendas in response to developments in reporting regulations and the EU taxonomy. Companies that do not get on board with this may be left behind, and responsible and active investors have a role in guiding the companies on developing and standardising their reporting.

Dialogue and interaction improve access to information

Long-term active ownership and close dialogue with the companies' management teams enable access to detailed information that would otherwise have been unavailable. This information can form the basis of company-specific assessments and further monitoring and dialogue.

Many challenges remain

Much remains to be done before we can approach some form of standardised metrics. Complexity remains a challenge when comparing different companies with different products in different places. Quantifying the benefits is also a challenge, especially if the ambition is to sum up positive and negative impacts.

Key indicators of best practice

The project identified the following six indicators of best practice when it comes to measuring social and environmental impact:

1. High transparency and availability of information, for example, through sustainability reports, and collaboration with providers of ESG data, reporting to CDP (global not-for-profit organisation that runs the world's leading platform for environmental information).
2. Providing examples of real-world impact and quantifying these impacts.
3. Documented measures for addressing and limiting negative environmental impact, such as impact on biodiversity.
4. Internal monitoring systems aimed at avoiding or reducing negative impact.
5. Consistent messaging in company communications with the market-targeting impact as part of the company's DNA.
6. Targets regarding capital allocation prioritisation, expenses for product development, and link to incentive structures for company management.

KBI Global Investors and water

KBIGI manages approximately EUR 2.3 billion in water assets, on behalf of a global customer base comprising sovereign wealth funds, endowments, public pension systems, sub-advisory mandates, and wealth managers.

KBIGI's water strategy is to invest in companies that provide solutions to global water problems – increasing access to water, reducing water consumption and waste, improving and assuring quality, and building and repairing infrastructure. The strategy represents a valuable opportunity to invest in solutions that are helping to build a resilient, sustainable water value chain across the globe.

EUR
2.3
billion in water assets

"Measuring the total societal benefit of our investments is an attractive idea, but one that is difficult to attain in reality."

Over three years, AP7 has been examining the complex issue of how to measure the societal benefit of investments and active ownership. Here, AP7's Johan Florén and Flora Gaber sum up some of the conclusions from the work, and share their thoughts on how investors can contribute to a sustainable societal development.

When AP7 started the work on Sustainable Impact Measurement, the ambition was to investigate: *How do we measure the societal impact of our investments? And how do we generate positive societal impact of our investments and our active ownership?* Finding a simple solution proved difficult, and the field is full of challenges, but also offers opportunities.

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Why did you choose sustainable impact measurement as a theme for 2019–2021?

Johan: Knowledge is limited about the impact of investments on sustainable societal development, and we wanted to contribute to its development. Also, both stakeholders and investors want to report impact, but generally accepted metrics are lacking. The issue is becoming increasingly relevant, as legislators in the EU and other regions are tightening regulatory frameworks and external expectations are increasing.

What are your most important findings?

Johan: The idea that we could invest our way to a more sustainable society and measure impact is an attractive one. However, if the definition of impact is that the holistic picture of societal benefit is to be quantitatively measurable in a standardised way, this will not be possible in the near future.

Flora: We've examined the area together with our impact managers, KBIGI and Impax, and we've observed significant challenges about developing standardised and comparable data. However, this doesn't mean that the investments are not generating benefit or that they lack positive impact.

> **Finding a simple solution proved difficult, and the field is full of challenges, but also offers opportunities.**

> “... instead of putting resources into measuring things that can't be measured, we believe we generate most benefit through tangible measures, such as by working to get the companies with the biggest impact on climate to reduce their emissions.

Why is it so difficult to develop objective metrics for corporate impact?

Flora: If the aim is to really understand a company's impact, we would need a sophisticated analysis of and knowledge about the company, sector, and geography. There is often insufficient data about the geographical position of the companies and value chain to be able to measure the impact on the surrounding environment.

Johan: In our work with Impax, we examined global standards for measuring the impact on water provision, something that is strongly linked to local conditions. We found that, although there is geographical data regarding water-stressed areas, there is insufficient public data from the companies to enable a review of where in the value chain their impact on water provision is greatest.

Impact investors usually talk about net impact, where the objective is to invest in companies with a net positive impact. Even here, you encountered great challenges.

Johan: Yes, even this is difficult to attain, because we need to weigh up the companies' positive and negative impacts in different areas to produce a net figure. Together with KBIGI we examined corporate reporting regarding this impact. We could see that interest in reporting negative impacts was lower, for natural reasons, but the reporting of positive impact also needs to be standardised to enable some form of comparability.

Flora: There is also no given way to measure and weigh up the impacts when they are placed side by side, even if that would give us better information. Investors value different sustainability issues differently, and there is no model that shows who is right. How, for example, do you compare reduced hunger with availability of water or reduced biodiversity?

But there are ESG ratings, can't you use them?

Flora: ESG ratings really answer another question. They're a measure of a company's own sustainability work. There are examples of companies whose products have great societal benefit, such as manufacturers of electric vehicles, that at the same time have major shortcomings in their work on sustainability. Conversely, there are oil companies that are ranked highly in ESG ratings because they are good at managing their sustainability risks, but their actual product is a critical sustainability problem. So if the aim is to assess the companies' impact, you can't base the assessment on ESG ratings. ESG ratings say nothing about the extent to which the company impacts the environment and society positively or negatively.

What do these experiences mean for AP7, which is owner in 3,000 companies around the world?

Johan: Measuring impact for an aid project can be a great challenge in itself. Transferring the approach to a global equity portfolio without fundamental changes and trying to produce an aggregated figure is an impossible task. The complexity becomes many times greater, because every single asset would need a net figure, and the question is what could such a figure even be used for? If the aim is to seriously understand a company's impact, it's better to find a more immediate and more realistic level of ambition.

What would a more reasonable level of ambition be?

Johan: It could be to look at the concept of impact in another, more realistic way. In the absence of advanced, quantitative models for measuring societal benefit, it's already a major benefit if investors can clarify how to contribute real-economy sustainability impacts outside their own portfolio.

Flora: It doesn't need to be quantified or be in the form of a net figure, but an ambitious qualitative assessment and reporting of societal benefit is already a big step on the journey. We're trying to look at certain fundamental parameters, such as fresh water, climate, and biodiversity. For example, Impax has chosen to focus on water, and has proposed a limited number of indicators that can be monitored and assessed.

Many people advocate capital allocation as a way of engaging with companies. What are your conclusions on this?

Johan: The notion that investors could influence companies' capital expenses by buying and selling shares on the global equity market, exerting influence on them in that way, is very far-fetched. The strategy lacks credibility unless it is combined with considerably lower return requirements for these companies than for the market as a whole. If a sale or a lack of investment simply leads to another investor buying the company's shares, then nothing has been achieved.

What can you do as investors to generate real-world impact?

Flora: Engaging through directed investments can work if certain conditions are fulfilled, which is shown in the article, "Can sustainable investing save the world?" (see page 10). Here, investors can generate added value for smaller companies that find it difficult to raise financing and that need capital to grow and develop. But scalability is low, so it remains a niched business. For AP7, we've reached the conclusion that active ownership is undoubtedly the most important tool.

What can AP7 contribute in practical terms through its active ownership?

Flora: In larger, listed companies we can be active as owners and support them in developing business models that promote sustainable development. We can file shareholder resolutions and exert influence on the composition of boards, to get more members elected with expertise in sustainability. Another important task is to encourage portfolio companies to develop their reporting of risks and societal impact.

Johan: AP7 has been working on active ownership for many years, and the research done so far in the field supports the effectiveness of this approach. The results of the collaboration with Emma Sjöström at the Stockholm School of Economics also gave us a good basis for the theme Universal Active Ownership. Here, the aim is to develop our active ownership work to maximise positive effects in the real economy.

But you're continuing the work to increase transparency and improve reporting?

Johan: Yes, transparency is vital, but instead of putting resources into measuring things that can't be measured, we believe that we attain most benefit through tangible actions, such as working to get the companies with greatest impact on climate to reduce their emissions. Increased transparency and better reporting facilitates the dialogue with these companies and our monitoring of their adaptation to a world with net zero emissions.

Text: Seventh AP Fund (AP7) with the support of Helene Hellberg
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Project management: Mikael Lindh Hök, AP7
Graphic design & original: griller.se
Cover illustration: bottiger.se
Photos: Getty Images and Shutterstock

AP7

Theme Report

Sustainable Impact Measurement

Over three years, AP7 has been examining the complex issue of how to measure the societal benefit of investments and active ownership.