Debunking ESG myths for more sustainable investing

Under growing pressure to behave more sustainably and with greater social responsibility, organisations everywhere are increasingly adopting environmental, social, and governance (ESG) standards around the way they operate.

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In recent years, the financial sector has been paying closer attention to these standards, with many investors now applying ESG-related criteria when considering the risks and growth opportunities of their portfolios.

At the same time, many firms are making impact investments which, like ESG-related investments, are intended to generate a positive and measurable social and environmental impact. It's perhaps unsurprising that the two are often confused. But, while there is certainly an overlap, there is one significant difference between them - unlike ESG investments, impact investments are also linked to *enhancing* societal value, not just *protecting* it. Both focus on delivering financial value, but only when speaking about Venture Capital (VC) Impact funds. There are some Impact funds that are not VC funds and that address societal challenges where returns are still unproven, or that require below market-financial return for investors. These include funds that provide quasi-equity or unsecured debt to social enterprises or charities, for example.

Discerning the difference between ESG and impact investing isn't the only area of confusion, however. A number of misconceptions exist around just what ESG is, and what it's for. Given that how a company meets ESG standards has now become a deciding factor for many investors, it's

important that these misconceptions are put right.

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Categories and frameworks

When it comes to ESG, venture capital firms will typically fall into one of four "*Spectrum of Capital*" categories, with an increasing focus on societal impact going down this list:

- Financial – with no ESG policy or tracking in place, these VCs are concerned only with maximising financial returns. This has become an increasingly unpopular approach, with many funds viewing responsible investing as the baseline;
- Responsible investing – while most investors are focused on delivering financial returns and remaining competitive, they're careful to avoid

certain verticals, such as gambling, to *minimise* ESG risks, and *protect* rather than enhance value;
- Sustainable investing – with a desire from LPs for every investment to be sustainable, this is now high on every VC's agenda; adopting progressive ESG practices to *enhance*
- Impact – this group of investors actively seek out those companies that deliver both a quantifiable societal and environmental impact, as well as competitive financial returns. To measure this impact, investors will set and track KPIs relating to their portfolio. In addition, there is a sub-group of impact investors which don't seek above market financial returns - this doesn't include VCs.

Of course, whichever category a VC falls into, it's essential that any company they're looking to invest in or onboard meets their necessary ESG criteria. Several ESG frameworks are available, with a wide range of questions allowing VCs to carry out due diligence around a company's potential social and environmental impact, and how this could be mitigated. Asking questions on a company's environmental footprint – and that of its supply chain, or its responsible and ethical tech policy will help VCs understand whether they're at least investing responsibly.

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Dispelling common myths

Growing awareness – and concerns – around issues such as climate change, and diversity and inclusion mean responsible and sustainable investing is becoming increasingly important, not least to LPs, who are driving the movement for investors to a large extent. But, as VCs work toward more formal, measurable principles and guidelines, it's important to dispel some of the common myths that exist around ESG and impact investing.

1 - ESG comes at the cost of financial performance

There's a long-held perception of ESG and impact investment as a form of

charity. Concerned that their financial performance could be negatively affected, investors would often veer away from it entirely. Indeed, given their negative connotations regarding financial reward, the terms ESG and impact were often avoided.

This is no longer the case. As mentioned, although some impact investors focus only on impact, a growing number now look at the financial performance of their portfolio companies as well as the impact they have. In fact, ESG-focused companies now *demonstrate better performance* in terms of growth and returns, with women-led ventures *delivering twice the revenue* for every dollar invested.

2 - KPI tracking is for impact funds

Impact investors work with their portfolio companies to set the KPIs they want to track. Non-impact investors, on the other hand – even those looking at ESG - don’t have to do this. But that doesn’t mean they shouldn’t.

Whether they’ve been formally established or not, a company will send investors its KPIs throughout their relationship. It’s therefore worth establishing those KPIs from the start. Trying to do so later down the line can be challenging, especially when they need to be backdated. There’s no real reason for investors not to set and track KPIs with their portfolio. After all, ESG risks can jeopardise a company’s financial performance, and this is something that matters a lot to LPs.

3 - ESG is a PR strategy

ESG is often seen as greenwashing, the act of promoting a company and its products as more environmentally friendly than they are. Indeed, greenwashing was *recently revealed* to be the number one concern for investors when it came to responsible investing, with *one industry insider* describing ESG investments described as “marketing hype”.

But, while there have been issues with greenwashing in ESG investing, international bodies are taking steps to ensure greater transparency and legitimacy when making claims around sustainability. As part of its Principles for Responsible Investment (UN PRI), for example, the UN has a commitment to fostering accountability in ESG investing and addressing the issue of greenwashing. B Corp Certification, too, is an increasingly popular means of proving that a company meets the highest standards of verified social and environmental performance, growing from 19 Certifed B Corporations in 2017 to *over 3,500 today*.

4 - ESG reporting is tedious and time-consuming

Adhering to *ESG commitments* does involve certain reporting obligations. But if this reporting is included in a portfolio company's standard KPI reports from the moment of investment, there's no reason it should be any harder or more time-consuming to collect than any other metrics.

5 - ESG investing is all about a VC's portfolio

It's true that a portfolio's impact will reflect well on a VC, but it works both ways. A VC should lead by example. There's a degree of hypocrisy in expecting high levels of diversity among portfolio companies when diversity in the VC space is traditionally far from optimal.

So, while portfolio and metrics are important, VCs should also hold up a mirror to themselves, and consider the make-up of their own teams, their working environments and compensation structures, and, indeed, the fund's environmental impact.

6 - ESG doesn't matter at the early stage

Many people still believe that ESG is only for big corporations. The fact is that, even in its infancy, a *company can be ESG-compliant*. As mentioned earlier, a company's sustainability matters more than ever, whatever its

size. It matters to customers – for younger consumers, in particular, a company's sustainability credentials can be a point of competitive difference. And it matters to investors – more and more early-stage VCs are building out ESG mandates, while angels increasingly want to work with companies making a positive impact.

As environmental, social, and corporate governance factors have become more important on the financial landscape, VCs have applied ESG and impact principles to their investing practices. Longstanding misconceptions may be preventing some VCs from fully embracing these principles, though. So, whether these investments are largely for impact or for additional competitive financial returns, it's essential that we, as VCs, LPs, executives and founders clear up these outdated ideas, for the benefit of society as a whole. It is only with the private sector's support that we will deliver the *funding needed to meet the Sustainable Development Goals (SDGs) by 2030* and provide solutions to some of the world's most pressing problems which have so far evaded us.

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