Morgan Lewis

# IMPACT INVESTING
## DESKBOOK SERIES

### Differences Between Impact Investing and ESG Investing

Impact investing and ESG are often used synonymously, but in practice, particularly in the United States, each of these terms conveys a different concept and has evolved into a distinct idea, and a comparison of the two may end up feeling like comparing apples to oranges. The Global Impact Investing Network (GIIN), a nonprofit membership organization dedicated to building industry infrastructure and reducing barriers to impact investment, defines impact investing as investing "with the intention to generate positive, measurable social and/or environmental impact alongside a financial return." In contrast, ESG, an acronym for environmental, social, and governance, is a framework for stakeholders to assess how an organization manages the risks and opportunities around sustainability issues. ESG is often referenced in the context of an organization's operations. However, in the context of investing specifically, ESG is a factor for investors to consider alongside traditional metrics (e.g., financial return) and so "ESG investing" does not, as a primary goal, seek to measure the actual impact of the investment itself on sustainability issues. However, it may refer to investing with a negative screen such as excluding companies that do not incorporate ESG principles in their own operations, or to an investment strategy that considers nonfinancial metrics based on ESG reporting or third-party ratings.

Variations of the concepts underlying ESG and impact investing have been part of the private sector landscape for many decades, but the specific terms "ESG" and "impact investing" were not popularized in private sector industry circles until the 2000s. The term "ESG" hails from the public sector and originates from a report produced by the United Nations Global Compact, the International Finance Corporation, and the Swiss Federal Department of Foreign Affairs in 2004, which recommended that the financial industry consider ESG issues. Three years later, "impact investing" was coined at a meeting of investors, entrepreneurs, and philanthropists organized by the Rockefeller Foundation. This group would evolve into, and later form, GIIN.

ESG has become a polarizing term in the United States following pushback from political conservatives, incidents of greenwashing, and perceived underperformance of ESG funds (notwithstanding data suggesting otherwise[1]). This has not been the case for impact investing, however, which has stayed out of US political and regulatory battlefields as it involves intentionality by the investor in producing an environmental or social benefit and primarily exists in private markets. Impact investing remains attractive to those investors that seek it out. For this reason, the distinction between ESG and impact investing is starker in the United States than it is in Europe, where the incorporation of ESG metrics in mainstream investing and the progress in sustainability-focused investing has been driven by governments, although European ESG funds still face the problem of greenwashing and smaller returns.

The following illustrates further differences between impact investing and ESG investing.

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[1] https://impactalpha.com/pension-funds-in-pro-esg-blue-states-outperform-those-in-anti-esg-red-ones-to-the-tune-of-159-billion/.

| Aspect | ESG Investing | Impact Investing |
|---|---|---|
| **Definition** | Integrates environmental, social and governance factors into investment analysis | Actively seeks to generate measurable social and environmental impact alongside financial returns |
| **Primary Goal** | Risk management and long-term financial performance | Positive, measurable impact with financial return |
| **Investor Motivation** | Align investments with values and reduce risk | Drive change and solve social/environmental challenges |
| **Approach** | Screening and scoring companies based on ESG criteria | Direct investment in projects or companies with intentional impact goals |
| **Examples** | Investing in companies with high ESG scores | Investing in clean energy startups or affordable housing projects |
| **Financial Return** | Financial return is the priority, with ESG as a risk/ethics filter | Dual focus on financial return and social/environmental outcomes |
| **Measurement** | ESG ratings and risk metrics | Quantifiable impact metrics (e.g., lives improved, emissions reduced) |

### Impact as a Deliberate and Pursued Strategy

Impact investing is an intentional investment strategy that seeks to invest in projects or companies whose mission is to produce a measurable environmental or social benefit alongside a financial return. Impact investors often target specific and defined environmental or social goals and develop, or seek targets that have developed, performance metrics measuring the same. An investor seeking to reduce poverty, for example, and may make impact investments in companies that work to improve access to proper nutrition or create jobs in disadvantaged communities.

ESG investing, by contrast, is not itself a strategy but refers to the incorporation of ESG factors into the investment decision-making process. This could be applied by an investor as avoiding investments in companies that do not adhere to a set of ESG principles based on the rationale that companies that do not consider ESG issues expose investors to additional risk, or that it is the investor's moral responsibility to avoid investment in controversial industries (e.g., fossil fuels). For example, a company that does not seek to limit its carbon footprint or engages in risky employment practices may be more susceptible to regulatory fines or suffer reputational damage.

### The Exercise of Discretion

Pursuing an impact strategy is, in some ways, straightforward. As an impact investor, your stakeholders, whether they are beneficial owners, a board of trustees, or another party, are aware of and aligned with the pursued goals of the investor. There is no argument over the pursuit of the defined environmental, social, or other benefit, and the role of the impact investor is then to seek the best projects and companies to achieve such goals. It may even modify the fiduciary duty an investment manager owes to its fiduciaries, as such fiduciaries accept and agree that their interests in receiving a financial return may be weighed against the interests of other stakeholders, such as the beneficiaries of a portfolio company. It would be prudent for such an investment manager to clearly define its investment strategy and goals to ensure its clients are in alignment.

ESG investing, on the other hand, requires an investor to balance ESG factors holistically against other investment considerations. A fund manager, for example, may be pressured by certain clients, such as public pension plans, to invest with an ESG lens while also being pressured to maximize financial returns at all costs by other clients (or to disregard companies that prioritize ESG factors at all). In acting as a fiduciary to all clients, the fund manager must make investment decisions that are in the best interests of its client base as a whole. Do the short-term gains of a company justify certain suspicious hiring practices? And what if those hiring practices later undergo scrutiny by a regulator resulting in an exposé? And what if such exposé results in shareholders protest-selling shares and lowering the value of the company? The exercise of discretion becomes even more fraught if a fund manager is seen as pursuing investment decisions based on their own sense of ethics, or accommodating the pressures of certain big-ticket clients over others. From a US regulatory perspective, ESG has also evolved into an area of scrutiny for the SEC.

**Maximizing Returns vs. Environmental and Social Good**

A primary objective of the ESG framework is to enhance the lens through which an investment is evaluated, providing a better understanding of the anticipated risks and financial returns, which may result in environmental and social benefit by incentivizing companies to address ESG issues. However, it is only one of many factors in an investor's decision-making process.

On the other hand, a primary objective of impact investing is for the investment to have a measurable environmental and/or social benefit, although investors may still expect reasonable or market returns. Impact investors may, but do not necessarily have to, accept more modest returns for the sake of generating environmental or social benefit. Impact investing weighs the financial, and environmental or social, benefits based on investors' goals.

**Measurement of Past Behavior vs. Future Results**

ESG investing will look at organizations' past behavior as part of the investment making decisions, but does not require organizations to change their behavior. For example, when constructing a portfolio, one may look at a company's greenhouse gas emissions in the past year or whether or not the company has maintained a diverse board of directors to date. However, impact investing looks at what an organization proposes to accomplish in the future. How many students will an educational program reach? By how much will a product increase farmers' crop yields? It would behoove an investor seeking to have a more direct impact to pursue an impact investing strategy over the application of an ESG lens to an existing strategy.

The difference between ESG investing and impact investing can be confusing, and there is some overlap. ESG investing and impact investing both evaluate risk and return, and environmental and social benefit. Both also often require investors to obtain data from investee organizations. However, they have different primary objectives and are fundamentally different concepts. Using the terms interchangeably obfuscates the broader role of impact investing as its own investment strategy and the fact that ESG investing is only one facet of the ESG movement. As the demand for impact investing increases, it becomes more important to understand these differences.

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For more information on the issues discussed here, please contact your Morgan Lewis Impact Investing attorney.

**About Morgan Lewis's Impact Investing Practice**
Morgan Lewis has one of the nation's leading Impact Investing practices and, in June 2024, was ranked as one of two firms in Band 1 by *Chambers* in its inaugural rankings for Impact Investing in the United States.

**About Morgan, Lewis & Bockius LLP**
Morgan Lewis is recognized for exceptional client service, legal innovation, and commitment to its communities. Our global depth reaches across North America, Asia, Europe, and the Middle East with the collaboration of more than 2,200 lawyers and specialists who provide elite legal services across industry sectors for multinational corporations to startups around the world. For more information about us, please visit www.morganlewis.com and connect with us on LinkedIn, X, Facebook, Instagram, and WeChat.

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