Aegon Asset Management

Responsible Investing
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AEGON **INSIGHTS**

Additionality: The Secret Sauce or the Snake Oil of Impact Investing?

Brunno Maradei
Global Head of Responsible Investment

Much has been written and discussed recently on impact investment, and an increasing number of investors have become interested in the idea of 'putting their money to good use'. The Global Impact Investor Network (GIIN) estimated the global impact investing market to stand at USD 1.164 trillion in 2022[1]. When discussing impact investments and what defines them, a certain common mantra tends to be repeated: intentionality, additionality and measurability.

What is impact investing?

Every economic activity will generate positive and negative social and environmental impacts. A textile manufacturer will likely be providing several workers with their livelihoods (hopefully through living wages), be paying local and national taxes thereby contributing to public goods and perhaps also investing in local communities. At the same time, they will be consuming a lot of freshwater, potentially polluting the environment through the use of dyes and other chemicals and generating other negative environmental impacts that can vary depending on how they source their raw materials, the recyclability of their products and so on.

Impact investing is anchored on the concept of intentionally trying to maximize the net positive social or environmental impacts of investment decisions. In its most widely accepted definition, from the GIIN, 'Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return'.

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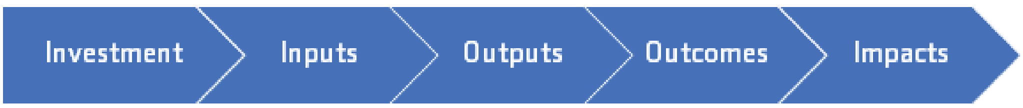
How do we evidence an intention?

The consensus is that, at a minimum, an investor should be transparent about their impact objective prior to making the investment. To be credible, such a documented intention should include the assumptions being made about how the investment will lead to the intended impact. This is usually called a 'theory of change'.



1 https://thegiin.org/research/publication/impact-investing-market-size-2022/

What is additionality?

Assumptions are made at each step of this process, the first of which is that an investment enables the economic activity in question. The term 'additionality' is usually referenced with regards to this assumption, or in other words, it questions whether the activity would have taken place without the investment proposed.

As a test based on a counterfactual scenario, additionality can never be proved beyond reasonable doubt: there may always be an investor somewhere willing to have made the investment if you had not. Intuitively many impact investors use liquidity as a proxy for additionality under the assumption that the more liquid an investment, the larger the number of investors willing to make that investment and therefore the lower the additionality of their investment. But this assumption may not hold true in every scenario and may be difficult to test. For example, there may be more investors willing to invest in venture capital funds in the US than those willing to purchase green bonds issued by a small emerging market financial institution, even if at first glance most would categorize venture capital funds as some of the most illiquid and therefore 'additional' investments.

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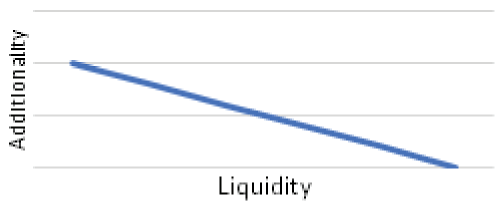
Potential additionality assumed to decrease with increasing liquidity



Furthermore, it is difficult to test whether all investors would be willing to invest on the same terms, further hampering the additionality test. This is an additionality measurement problem often encountered in development finance. While at face value you may find many investors that would respond positively to a potential investment opportunity, their perception of risk and demanded return to compensate for that risk can vary significantly, especially in developing countries and more illiquid asset classes where market pricing signals are harder to obtain, and risks are harder to assess.

Using liquidity as a proxy for additionality without careful consideration of the impact objective and the means proposed to achieve such impact may also inadvertently penalize investments with high potential impact. Consider the common impact objective of mitigating climate change. At one end of the spectrum, liquidity as a proxy for additionality would lead us to conclude that a venture capital investment in new carbon reduction technologies has the highest additionality. At the other end of the spectrum, an investor claiming impact by investing in large cap stocks such as Tesla would be classified as having low additionality, given capital is just changing hands in secondary markets without being directed towards new projects. However, an activist investor taking targeted positions in the oil majors with the objective of transforming those companies and getting them to set Scope 3[2] emission targets might have a much larger real-world impact on climate change mitigation than the venture capitalist and her investment in unproven, potentially unscalable technologies.

2 Scope 3 emissions are indirect greenhouse gas emissions that are not captured by Scope 1 and 2 reporting. They occur in the value chain of the reporting company, including both upstream and downstream activities, and in the case of oil majors, capture the majority of the company's emissions, i.e., those resulting from use of their products.

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Do we really need to prove additionality to be credible impact investors?

These challenges do not necessarily mean additionality is a useless concept. Many impact investors are keen to demonstrate or be assured that their capital is transformative, and additionality presents the ultimate test as to whether the world changed as a result of the investment made. However, when addressing additionality, claims are hard to verify, and investment liquidity remains an imperfect proxy. It is reassuring that the impact investment definitions proposed by regulatory and legislative bodies so far do not refer to additionality directly, as enforcement would be problematic otherwise. Instead of focusing too much attention on arguing and proving additionality, impact investors are better served by thorough descriptions of the theory of change, including the assumptions made at each stage and the risks to those assumptions playing out, as well as increased efforts to measure outcomes and evaluate long-term impacts.