Markets

Does This Investment Make Me Look Good?

Social impact investing tends to value style over substance.

By Tyler Cowen
February 24, 2020, 7:00 AM EST

Is this a “good” investment? Photographer: Craig Hartley/Bloomberg

One of the trendiest ideas in finance is something called “social impact investing,” which is the idea that people should put more money into socially beneficial companies and products, and less into socially harmful ones. That hardly sounds objectionable, but I am skeptical about how much good social impact investing can do.

The first risk is that social impact investing will be used to “whitewash” various harmful policies. By divesting from a particular set of companies, an investment fund loses at most a very small benefit from an additional degree of broader market diversification. The fund still is likely to earn the market rate of return on its other investments, and in the meantime it can claim virtuousness. At the same time, the funds can pursue socially harmful policies elsewhere: investing in companies that lobby for tariff protection, say, or emit less visible forms of pollution, or how about refined sugar?

A second risk is that social impact investing simply redistributes wealth from investments — maybe to less socially conscientious individuals. Imagine a socially conscious investment firm that declines to participate in the initial public offering of a company that pollutes the ocean. That might create downward pressure on the price of the IPO. But there is a problem: The value of the actual investment has not declined, so at a potentially lower IPO price other investors will step in to fill the demand. In fact, those investors may have the chance to buy at a discount and earn a higher return than otherwise.

The net result is that conscientious investors have missed out on a profitable opportunity, while less socially aware investors have earned more. Over time, the less socially aware investors will become richer, and their greater wealth may translate into greater political and economic influence.

Maybe this effect isn't large, but it is negative, and it will become correspondingly larger to the extent social impact investing becomes more popular (in 2018, the money pouring into sustainable investment funds quadrupled, rising to about $21 billion). That doesn't sound like an appealing trade-off.

But put that worry aside and assume that social impact investing simply makes it easier to get a solar power company off the ground with an IPO or an expansion. It's still not clear that much has been gained. At that late point in the process, the company will succeed or it won't, no matter what the socially conscious funds do.

If anything, it would be more useful to have socially conscious research and development at the very early stages of projects. To some extent there are such investments, and I am more sanguine about being conscientious then than when companies already exist and funds are making investment decisions.

It is also difficult to monitor the performance and social efficacy of the funds focused on doing good. In actively managed sustainable equity funds, for example, the most commonly held stocks are estimated to be Microsoft, Alphabet, Visa, Apple and Cisco. I have nothing against those companies, but you have to wonder exactly how much social improvement those investment funds are buying.

Norway's fossil fuel divestment is well-publicized. Less well known is that it exempted Shell and Exxon. There simply aren't clear benchmarks for which investments to avoid, and of course some critics will portray technology companies as the embodiment of evil.

Too many of the empirical arguments for social impact investing stem from a single example: South Africa under apartheid. In that case, a coordinated campaign of divestment and international economic and social pressure did hasten the end of apartheid, all for the better. But most sanctions are not very effective at achieving their stated political goals, or their effectiveness may be unclear. South Africa may have been a special case because it was relatively small and isolated, and because so many South Africans had ceased to believe in apartheid.

Investment in socially beneficial activities can be worthwhile. But it ignores the question of who decides what is "beneficial," and it is yet another example of how politics and media are becomingly increasingly performative. Everything is about looking good instead of substance. It is increasingly difficult for businesses and investment funds to perform their proper work under the glare of perpetual debate and periodic condemnation.

The notion of extending that same glare to economic investments is hardly reassuring. I've yet to see a conception of social impact investing that I find convincing.

To contact the author of this story:
Tyler Cowen at tcowen2@bloomberg.net

To contact the editor responsible for this story:
Michael Newman at mnewman43@bloomberg.net