

Investing for real people

**Three ways to improve
your returns**

IMPACT INVESTING

Introduction

Conventional ‘wisdom’ tells us that investing is all about getting the best risk-adjusted returns: aiming for the best possible returns for the level of risk we’re willing and able to take. Succeed at this and we’ve done all we need to find the right portfolio.

This isn’t a bad starting point. And taking on more risk without expecting anything in return is not a recipe for investment success. However, as a description of what your best portfolio looks like, it is woefully incomplete. There are three broad reasons for this that we will examine in turn:



Each of these three offers compelling reasons why, for most investors, incorporating social and environmental impact is the intelligent way to approach *any* investing.

ABOUT THIS PAPER

This paper was written by Greg Davies PhD in conjunction with Tribe. Greg is the owner of Centapse and worked with Tribe to build their **ImpactDNA**™ assessment.

Greg is a specialist in applied decision science and behavioural finance, turning academic insight into practical applications. With a prior background in academia and consulting, in 2006 Greg started, and for a decade led, the banking world’s first behavioural finance team as Head of Behavioural-Quant Finance at Barclays. He holds a PhD in Behavioural Decision Theory from Cambridge; is an Associate Fellow at Oxford’s Saïd Business School; a lecturer at Imperial College London; and author of *Behavioral Investment Management*.

TOTAL RETURNS ARE

Financial and emotional

All investment delivers two distinct types of return. There are the more obvious and mundane financial returns: delivering us money with which to satisfy our wants and needs. But there are also emotional returns: the value we get from the very act of owning something. These emotional returns may come from a sense of satisfaction, or enjoyment, or purpose, often from the impact of what we have has on the world.

Investing in collectables is a common example. These may not always make good investment sense from a narrow risk-return perspective, but are nonetheless a popular form of investment. One reason for this is that art investors are also usually art lovers. They *may* get financial return from their art portfolio, but they *will* get guaranteed emotional return from owning beautiful things they enjoy, or which have cultural or heritage value. In addition, collectors may revel in the social recognition that comes from building a collection¹. These are all forms of emotional return, and they are all worth something to the investor.

But emotional returns can come from many sources. For some this may be from a sense that they are doing good in the world. It is simply more intrinsically valuable to own something that delivers financial returns and makes the world a better place, than one which delivers only financial returns.

This purpose brings satisfaction, and hence emotional returns, in much the same way as philanthropic activity makes us feel good². But with investing the emotional return can be in addition to, rather than instead of, financial returns.

A truly rational investment process should seek to maximise the combination of both financial returns and emotional returns, and not merely ignore the latter. Of course, we all have our own idea of purpose - for some passing a beautiful object on to the next generation is purpose enough; for some any investment that provides capital for others to put to productive use represents sufficient purpose to feel good about it; and for others purpose comes only from a very specific cause that we feel strongly about. Emotional returns may come from quietly knowing we're doing good, or from the social recognition that comes along with it. Whilst gaining social stature from doing good through our investing is perhaps less purely altruistic than doing it anonymously, it's no less valuable.

That is why building the most suitable portfolio for an investor cannot simply rely on the traditional approach of assigning the investor a risk profile. A suitable portfolio also needs to understand what investments will generate emotional returns for each investor. How do you understand what drives your emotional returns? What is your unique purpose?

Tribe's **ImpactDNA**[®] helps to do just this: to understand not just how strongly you feel about doing good with your portfolio and what financial characteristics will be most suitable for you, but also where your unique purpose lies, and therefore what portfolio would be most effective in delivering you the best total package of financial and emotional returns.



In the same way philanthropic activity can make us feel good, a sense of purpose gives us emotional returns



MEIR STATMAN

¹ See *Profit or Pleasure? Exploring the Motivations Behind Treasure Trends*. Barclays Wealth Insights, Vol. 15.

² See Ch. 13, *What Investors Really Want*, Meir Statman (2011).

MONEY IS A

Means not an end

Implicit in the narrow assumption that we should maximise risk-adjusted returns is that more money is always better. And if we ignore the possibility of emotional returns this may appear to be true: the more money we have, the more we're able to satisfy our desires and aspirations.

Even if we ignore emotional returns, it is important to recognise that money is a means to an end, not the end itself. More money is valuable only because we believe it helps us get more of what we want.

But what if some of what we want can already be acquired through the process of investing, rather than just from its proceeds? For those who care about doing social or environmental good, money is one of the means to support the causes we believe in: donations to charities and spending money on things that accord with our world view.

So here is one great upside of impact investing: even if only a small part of what you want to spend your money on is doing some good, then impact investing enables you to combine acquiring the means with accomplishing the end.

When one of your desires is to make a positive mark on the world, what better way to invest than to double up such that acquiring the means to do so itself becomes a mechanism to do even more. So we can achieve our goals, even while we're building the wealth to achieve more goals.

Of course how much you want to do this depends on how strongly your impact is an end for you, and what you might be giving up to do so. But by investing thoughtfully you can often invest for impact without stepping

far from the risk-return balance of even the most focussed financially 'optimal' portfolio..

There is a myth that impact investing requires there to be a sacrifice of financial efficiency. It is important to debunk this myth. A wide range of socially valuable investments seems to involve little or no reduction of returns at all. Indeed, for the long-term investor (and any other type is an oxymoron) there is a strong argument that sustainable investments are likely to do better over time precisely because they are sustainable³.

It is also important to challenge an equally widely propounded counter-myth: that no impact investing need ever involve a sacrifice. A large swathe of the most effective social or environmental investments may well require an investor to accept somewhat lower returns. Or lower liquidity. Or higher risk⁴. However, sensibly mixing some of these deeper impact investments, with a range of very low sacrifice impact investments within the context of the broader portfolio, means that substantial impact can be achieved with little deviation from the narrow theoretically 'optimal' return maximising investment choices.

If doing good is something your investing will help you do in the future, impact investing means you can achieve some of this goal now - even while growing your wealth to do more of everything you want to do in the future. Tribe's **ImpactDNA**[™] helps investors to understand, more deeply and personally, how much doing good in the world is an end in itself. And from this, how to build a portfolio to get the most out of the act of investing.



Sustainable investments are likely to do better over time precisely because they are sustainable



OXFORD UNIVERSITY
SMITH SCHOOL

³ See, for example, *From Stockholder to Stakeholder*, Oxford University Smith School (2014).

⁴ See *The Value of Being Human*, Barclays (2015).

GOOD INVESTING REQUIRES

Emotional comfort

The third major reason why the traditional approach is wrong is rooted in behavioural finance, a field which combines finance theory with psychology to understand and improve how people really do make financial decisions. The financially 'optimal' portfolio may be right for an emotionless robot, but is seldom the best solution for a real person.

Humans have emotions, they are influenced by context and environment, and their best portfolio isn't just financially efficient, it also needs to be one that feels emotionally comfortable. A portfolio based purely on technocratic financial reasons is unlikely to offer much comfort.

Incorporating our human need for emotional comfort isn't about pandering to human frailty and making people feel happy for the sake of it. It is about getting better returns. If we don't feel comfortable with our suggested portfolio prescription we're going to fail to follow it fully⁵. When we feel uncomfortable with an 'optimal' portfolio the natural, and strong, human response is avoidance. This means we might invest less, delay decisions, deviate from the 'right' answer, and make mistakes along the journey.

Abundant evidence from behavioural finance shows that uncomfortable investors make a myriad of poor decisions along the investment journey, and achieve substantially worse returns as a result. Two of the most systematic behavioural costs are Reluctance and the Behaviour Gap.

1. RELUCTANCE: the simplest way of avoiding the discomfort of investing is to avoid investing. If the 'optimal' portfolio feels uncomfortable the natural inclination is to invest less, leaving wealth safely in cash. This pleasantly comfortable situation is nonetheless extremely expensive. Over time a moderate risk profile investor should expect to reap returns in the range of 4-5% above cash rates⁶. Leaving portions of your wealth doing nothing for long periods of time may be comfortable, but giving up 4-5% per year is a very expensive way of getting to sleep at night.

2. BEHAVIOUR GAP: it is invariably more comfortable taking risk when times feel good, and less comfortable when markets are under stress. Despite the obvious insight that investors should 'buy low, sell high', our innate human psychology inclines us to do exactly the opposite. Investors tend, sometimes in disastrously large ways, to put more money into markets when they're high than when they're low. This means that because of their need to feel comfortable with their portfolio and decisions along the investment journey, investors underperform the returns they would get from simply putting money to work and leaving it alone⁷. This is known as the Behaviour Gap - and evidence suggests that this quest for emotional comfort costs the average investor around 1.5% per year relative to just leaving it alone.

So, using a theoretically perfect approach may well end up with you getting worse returns than if you had a portfolio that was just good enough, but was also sufficiently comfortable.

How do we acquire the emotional comfort we need? It isn't about risk and return estimates. As much as we'd like to believe in the numbers, real people rarely gain comfort from them. Instead, we decide based on stories. Vitally important is that what you invest in reflects stories that resonate with you and that you identify with. A portfolio that reflects your beliefs is what makes your investment portfolio comfortable for you, and so enables you to avoid some of the costly behavioural responses to investing.

A portfolio which expresses your values will be one you're far more likely to invest in, reducing the costs of reluctance: you are likely to invest sooner, reducing the drag of delay; and you are likely to invest more fully, leaving less of your wealth doing nothing over time. But it will also be a portfolio you are more likely to stick with even as markets turn down, reducing the behaviour gap: knowing your portfolio is producing impact will make you less likely to sell in panic in stressed times.

Finally, impact investing also provides a natural emotional hedge to the stress of bad markets. You keep reaping emotional returns even through periods when financial returns are lacking.

⁵ For example through the *disposition effect* (clinging to losing assets and selling winning assets), through costly switching to chase funds with good recent performance or through over-trading. A recent book documenting up to date knowledge on many such behavioural costs is *Financial Behavior: Players, Services, Products, and Markets*, Baker, Filbeck, and Ricciardi (eds.), 2017.

⁶ Davies, G.B., 2014. *Behavioral Finance: Overcoming the Cost of Being Human*. Investments and Wealth Monitor.

⁷ See, for example, Clare and Motson (2010), *Comparing the performance of retail unit trusts and capital guaranteed notes*, working paper, Cass Business School, London.

THE MISSING INGREDIENT:

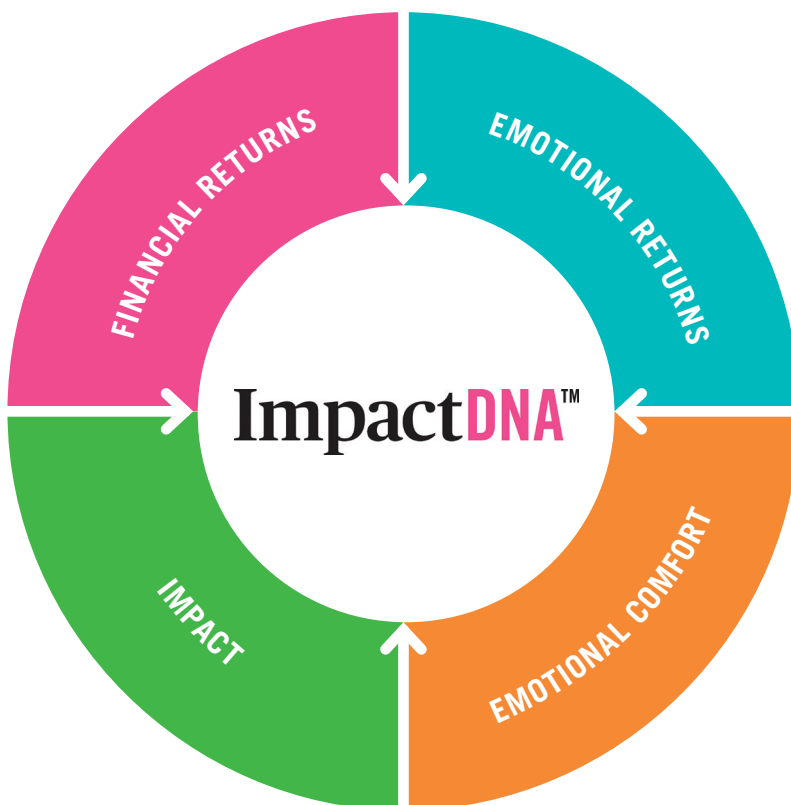
Discovering your values

Doing the above effectively requires your portfolio to be tailored to your financial personality, and to your social attitudes and beliefs. However, understanding your values well enough to guide portfolio construction is no easy task. Such attitudes can be complex, and often reflect aspects of ourselves that we haven't thought extensively about, and may struggle to articulate⁸. It is even more difficult for wealth managers to second-guess your personal values accurately without a robust framework to guide them.

Establishing your values sufficiently to inform the building of your portfolio, one that delivers you the comfort needed to be

a better investor, requires a thoughtful process of exploration and discussion.

This emphasises the importance of a thorough, behaviourally-designed, client profiling process. Tribe's **ImpactDNA™** is designed specifically to help investors to explore, unearth and even construct their own unique set of social and environmental values, alongside a full range of the more traditional financial preferences that are needed to establish a suitable portfolio. These can then be used to build portfolios to ensure that you, as an investor, get the most out of all aspects of your investing:



⁸ See *The Construction of Preference*, Slovic (ed.), 2006.

ABOUT TRIBE IMPACT CAPITAL

Tribe is the UK's first dedicated impact wealth manager.

In providing advisory and discretionary investment management, we help our clients to align their wealth with their financial requirements, their personal values, and the impact they want to create. To find out more, please visit www.tribeimpactcapital.com.

REFERENCES

¹ See *Profit or Pleasure? Exploring the Motivations Behind Treasure Trends*, Barclays Wealth Insights, Vol. 15.

² See Ch. 13, *What Investors Really Want*, Meir Statman (2011).

³ See, for example, *From Stockholder to Stakeholder*, Oxford University Smith School (2014).

⁴ See *The Value of Being Human*, Barclays (2015).

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⁶ Davies, G.B., 2014. *Behavioral Finance: Overcoming the Cost of Being Human*. Investments and Wealth Monitor.

⁷ See, for example, Clare and Motson (2010), *Comparing the performance of retail unit trusts and capital guaranteed notes*, working paper, Cass Business School, London.

⁸ See *The Construction of Preference*, Slovic (ed.), 2006.



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