SDG financing gap – The public market investment case

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Executive Summary

In September 2015, the United Nations (UN) adopted the 17 Sustainable Development Goals (SDGs), also known as the Global Goals, as part of the 2030 Agenda for Sustainable Development (UNDP, 2024). The agenda targets ending poverty, protecting the planet, and ensuring worldwide peace and prosperity. UN member states have committed to prioritizing progress for those in greatest need.

Since the enactment of the Global Goals, the annual financing gap, initially estimated to be around USD 2.5 trillion, has mounted to USD 4 trillion in 2023 (UNCTAD, 2023a, 7). The SDGs with the highest share of the gap, covering around 80%, are 6 (Clean Water and Sanitation), 7 (Affordable and Clean Energy), 9 (Industry, Innovation, and Infrastructure), and 13 (Climate Action).

During the same period, global investments labeled as sustainable have exhibited compound annual growth rates between a few percentage points and double-digit numbers depending on the region, reaching more than USD 30 trillion by the end of 2022 (Global Sustainable Investment Alliance, 2023, 10 - 11).

These two diverging developments of global capital flows form the basis of this study. Based on existing literature, the SDG financing gap and its underlying reasons are examined to determine the main impediments to global capital flowing into impactful investments. The empirical part is dedicated to constructing portfolios with a minor share of investments focusing on the SDGs most affected by the financing gap. Lastly, the impact characteristics of the chosen SDG-focused funds are evaluated.

Literature-Based Rationale for the SDG Financing Gap

Almost ten years after the SDGs were launched and their commonly agreed pursuit by the UN member states, the financial situation has deteriorated in recent years. The recent widening of the gap is said to have been caused by several global shocks in recent years, such as COVID-19 and the war in Ukraine. Subsequent rising prices and diverted developed market capital flows to address emergency measures had a detrimental effect on some developing countries. In addition, countries in the global south are disproportionally affected by climate change and have an enormous need for adaptation and mitigation measures. Furthermore, investment opportunities in developing countries often do not correspond to the requirements of developed market investors, and high-quality data is sometimes scarce. In particular, sustainable investors depend on comprehensive and reliable data (e.g., greenhouse gas emissions) to justify the inclusion of certain assets into their portfolios. Paired with a common perception of higher risk due to political instability, low credit ratings, and sometimes lack of a sound legal environment, capital flows often remain within established developed markets.

On top of that, numerous studies indicate that sustainable investments often do not live up to their promise. In many cases, capital flows and consideration of sustainable factors are not meaningfully different from those in conventional investment products. This holds especially true for investment decisions based on environmental, social, and governance (ESG) ratings with a single materiality focus, i.e., mere risk-return perception without consideration of an investee's impact on external social and environmental factors. Lastly, there is some indication that impact investors are surprisingly often satisfied with modest impact results and show a limited willingness to sacrifice more return to increase their impact significantly. As a recent study by Heeb et al. (2023) suggests, positive emotions experienced when investing with impact are not profoundly influenced by the level of generated impact. This has potential implications for fund providers as they might not see the need to design more impactful investments as long as there is limited client demand.

Empirical Analysis and Results

To address the illustrated challenges, this study evaluates whether investing in SDG financing gap-relevant investment funds yields improved risk-return ratios in diversified portfolios. The defining character of the investment funds chosen for this study has been their focus on the most underfinanced SDGs. The vast market of listed investments is analyzed alongside non-listed microfinance and SME-finance fund vehicles. Adding these investment vehicles to UCITS funds, accessible to retail clients, makes these available to a broad range of investors.

The two groups of impact investments are categorized along their impact mechanism based on the concept introduced by Busch et al. (2021). This concept suggests distinguishing impact-related investment opportunities as impact-aligned or impact-generating investments. In this thesis, the former category is represented by funds investing in listed securities with no capital allocation to investees. Whereas, the latter approach covers microfinance and SME-finance fund vehicles, providing additional capital to their investees.

Five impact funds were selected for each category and added separately to two different multi-asset UCITS funds constituting the base portfolios. These base portfolios are well-diversified, multi-asset funds investing in traditional and alternative asset classes such as equities, bonds, real assets, hedge funds, and insurance-linked securities. By adding a minor share of an impact fund, the effect on risk-return is determined based on the Sharpe ratios of the different portfolios. In total, 40 adjusted portfolios are constructed, each with a 5% allocation of an individual impact fund and two distinct approaches applied related to weighting the remaining assets in the portfolios.

The analysis period covers monthly return data from 2019 through 2023. Adding a 5% share of an impact fund increases the Sharpe ratio for 20 of the 40 constructed portfolios. With slightly lower returns, portfolios with impact-generating funds, i.e., microfinance and SME-finance vehicles, considerably reduce the standard deviation in most portfolios. This is remarkable because, as mentioned, both UCITS funds are already well diversified, with investments in traditional liquid- as well as alternative asset classes. Diversification benefits are most pronounced in portfolios where impact-generating funds replaced equities and bonds. The effect was less evident by replacing existing insurance-linked securities and hedge funds allocation. In impact-aligned fund portfolios (four equity and one bond fund), risk-return ratios could, on average, be improved when holdings of the same asset class were replaced.

The study further finds that Sharpe ratios can be maximized in a mean-variance analysis by allocating 4% to 6% of impact-generating funds. The defined optimized allocation is remarkably lower for impact-aligned funds, with an allocation of around 1% – 2% for most fund portfolios.

SDG Impact Consideration

As developing market companies in microfinance and SME-finance fund portfolios often have limited data-providing capabilities, these funds typically receive mediocre or no SDG ratings from standard ESG rating agencies. Consequently, investors should be aware that funds with high SDG ratings usually cover multinational corporations exhibiting a developed market focus and invest their capital in the secondary market. Such investments, however, might have negligible effects on addressing the capital needs of small-scale businesses at the lower end of the pyramid in the developing world effectively. Investors with the ambition to contribute to the SDGs therefore need to exercise a thorough due diligence and consider multiple factors when making investment decisions.

Abbreviations

ESG	Environmental, Social and Governance
SDG	Sustainable Development Goal
SME	Small and Medium Enterprises
UCITS	Undertakings for Collective Investment in Transferable Securities
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme

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