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Should investors consider impact investing?

What is impact investing?

Impact investing is an approach where investments are made with the intention to generate positive, measurable social and environmental impact alongside a financial return. It is built on the principle that the world's greatest challenges present some of the world's greatest investment opportunities and addressing the largest social and environmental challenges will require significant investment.

By "challenges", we are referring to things such as:

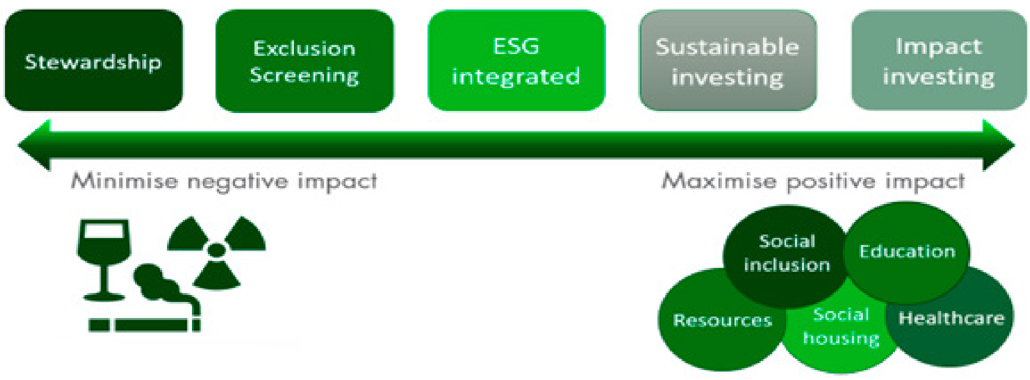
- Clean water and sanitation
- Financial inclusion (availability of opportunities to access financial services)
- Alternative/clean energy

Or any of those identified by the United Nations in the 17 Sustainable Development Goals ('SDGs'). These goals provide a blueprint for governments worldwide to achieve a better and more sustainable future. However, some asset managers now use them as a basis to assess how aligned investment opportunities are to these goals.

As examples, impact investing could include allocating to companies that:

- Provide water, waste and environmental management solutions
- Provide essential financial services to local businesses in underdeveloped regions
- Develop and produce renewable energy sources

The graphic below shows how impact investing sits alongside other "responsible investment" approaches:



As we can see, whilst other approaches seek to minimise negative impact, impact investing seeks to maximise positive impact, which is the key differentiator.

How can investors access these types of investments?

We listed above some examples of impact investing at a company-level. However, most asset owners (i.e. pension schemes, endowment funds and charities) do not invest directly into individual companies but use pooled fund arrangements instead. There is now a range of pooled fund solutions available to investors who wish to target impactful objectives.

Funds that invest in publicly traded assets (such as equity or debt) and invest in companies that align with certain impact themes are one example and there have been a range of new options launched over the past few years (particularly equity funds). Public markets have the benefit of being very transparent and reporting in this area is to a high-standard, which allows investors to hold their asset managers accountable and can help with their own reporting. These funds are usually liquid, which may be attractive to certain investors.

Private markets are another example how investors can access impact investing. Private markets include investments in private equity, private debt, real estate, infrastructure and natural resources. Private equity, for example, could include newer companies who apply innovative technologies and who create new products to address the big challenges. Infrastructure is another key area and can include investments in wind and solar farms, and other sustainable energy sources, which aim to help address the energy challenges we face. Private markets do have some barriers to entry relative to public markets, such as lower liquidity and size of assets committed. There have been efforts in the UK recently to ease such barriers, such as the launch of a "new" fund structure, Long-Term Asset Funds ("LTAFs"). A number of new LTAFs have been launched recently by various asset managers and they typically have objectives linked to sustainability/impact.

How do asset managers determine what makes an investment impactful?

The approach varies between asset class and asset manager. However, generally speaking, a company would only be considered as investable (i.e. impactful) if its core product or service (usually defined as a material portion of their revenue) aligns with certain impact themes. In some cases, asset managers will determine their own impact themes. In other cases, they will use the more widely known UN SDG's. There is often overlap between both approaches.

Asset managers will then undertake the usual due diligence on each investment to ensure it aligns with the specific strategy being targeted.

Benefits and drawbacks

Actively helping to address the world's greatest challenges aside, investors can benefit from impact investing in a number of other ways.

Some believe that investing in high-quality companies that address society's largest challenges will outperform and prosper over the long-term. A recent study[1] by Pensions for Purpose highlighted the performance of impact funds, across different asset classes. To the end of March 2023, listed equity impact funds outperformed the conventional equity market by 49% over the past 22 years and the report concluded that that there is no reason why impact funds should not achieve competitive risk-adjusted returns compared to conventional funds.

Other benefits include accountability (to various stakeholders), transparent and tangible reporting, mitigation of reputational risk and improving beneficiary engagement.

However, as the saying goes, there is no such thing as a free lunch. Investing in funds that target impact outcomes are typically more expensive than passively managed funds, which can create a drag on performance over the long-term. They are often associated with higher concentration risk, which can result in periods of underperformance and increased volatility. The funds are also typically actively managed and so investors rely heavily on manager skill. For these reasons, we think it is important that impact investing should be considered as part of a well-balanced, diversified portfolio.

What steps should investors take prior to integrating impact investments?

Step 1 : Training – An initial training session to ensure you understand what impact investing entails and how it could fit within your wider portfolio and ESG objectives. Importantly, it is good to have a focus on the area of most interest or passion, as no one investment fund can address all investors' belief sets.

Step 2 : Set objectives – Establish and incorporate impact objectives into your wider investment objectives.

Step 3 : Review existing arrangements – Determine if the existing asset managers and funds used meet your objectives and ensure they have the right capabilities to allow regular reporting and monitoring.

Step 4 : Engage – Progress your objectives by ensuring regular dialogue between all stakeholders.

Step 5 : Report – Consider reporting on impact objectives to help with accountability and beneficiary engagement.

Quantum Advisory's ESG research team provide guidance to investors on all of the above. If you would like to learn more about impact investing, please get in touch.

[1] https://www.pensionsforpurpose.com/assets/uploads/2023-11-27_ImpactLens-FINAL3.pdf. It should be noted that this data relied on the investment managers' own assessments of whether a fund was an impact fund or not and there was only one fund included in the data at the beginning (which later grew to nine funds).

Want to know more?

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A list of all members is available for inspection at our registered office.