Backgrounder: The rise of impact investing

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The history of impact investing is intertwined with that of The Rockefeller Foundation, a philanthropic organisation founded more than a century ago by renowned US oil industry tycoons, the Rockefeller family. Development of the "impact investing" term is widely credited to a group of investors which convened at the foundation's Bellagio Center – a residential facility on the shore of Lake Como, in northern Italy – in October 2007. According to former Rockefeller Foundation president Judith Rodin, the group discussed ways of channelling greater investment capital flows, into social and environmental initiatives which had traditionally relied on charitable or government funding[1].

As well as establishing a name for the sector, the Bellagio Center delegates conceived the Global Impact Investing Network (GIIN), which was formally constituted as an independent body, two years later in 2009.[2]

Then, in 2010, in collaboration with The Rockefeller Foundation and GIIN, investment bank JP Morgan sparked widespread interest with its study: "Impact investments: an emerging asset class".[3] Most eye-catching was the report's estimate that, by appealing to mainstream investors, impact investment in five segments – housing, rural water delivery, maternal health, primary education and financial services – could total between US$400bn and US$1trn, over the following decade.

In fact, investment flows during the past seven years suggest the sector will struggle to reach JP Morgan's 2020 target range. Rrespondents to the 2017 GIIN Annual Impact Investor Survey collectively managed less than US$120bn in impact assets.[4] However, several mainstream institutional investors are understood to be building internal impact investing capabilities, suggesting growth is on the cusp of acceleration. In addition, global initiatives – designed to foster greater urgency in meeting social and environmental, as well as economic, objectives – are raising the profile of the sector.

SECTOR DEFINITION AND OTHER CHALLENGES

The sluggish growth of impact investing is sometimes blamed on a failure by proponents to agree a common language, with which to describe the sector. For example, in its 2010 study, JP Morgan proposed that impact investments constituted a separate asset class, given that asset class definitions had shifted away from consideration of financial characteristics, and towards reflecting how mainstream investors organised themselves around those assets. To support its position, the report noted that hedge funds and emerging markets were commonly defined as asset classes, even though the underlying investments cut across debt and equity products.

Three years later, however, a World Economic Forum (WEF) report argued that impact investing was an "investment approach", and that asset classes should only be categorised on the basis of financial characteristics.[5] Even today, sector advocates say "the jury is still out" on whether impact assets are homogenous enough to be considered an asset class.[6]

In formulating its definition, WEF incorporated two important sector concepts: the notion that impact investments must, in part, be motivated by a desire to facilitate positive social or environmental change; and, the need for careful measurement of social and environmental outcomes. The WEF approach resonates with the most recent GIIN definition, that impact investments are "investments made into companies, organisations [sic], and funds with the intention to generate social and environmental impact alongside a financial return".

In an expansion of its definition, GIIN states that impact investments may be made in an array of asset classes, and that investments may target a range of returns – from below-market to market rate, depending on an investor's strategic goals. Below-market, or "concessionary", investments include grant support, equity and loans; while market-rate investments include those into fixed income, as well as public and private equity. Similar to the 2013 WEF definition, GIIN emphasises the importance of impact measurement and reporting, to promote transparency and accountability.

But despite the efforts of JP Morgan, WEF, GIIN, and others, in seeking a standard description for impact investing, further work is required. Almost half of respondents to the 2017 GIIN survey said that a lack of common understanding – in particular, regarding the definition and segmentation of impact investing – remained a significant hurdle to future growth. Other obstacles highlighted by the survey participants included a shortage of "appropriate capital" across the risk-return spectrum, lack of high quality investment opportunities, and a scarcity of suitable exit options.

IMPACT INVESTING IN PRACTICE

One way proponents have sought to foster greater understanding is through analysis of real-life impact investments. Several case studies may be found on the GIIN website, including investments by:

- US-based Root Capital in the debt of The Savannah Fruits Company – a Ghanaian company which produces shea butter for export, and improves livelihoods of rural women;
- The Rockefeller Foundation in the debt of The Disability Opportunity Fund – a US-based institution which finances the development of affordable housing and other services for people with disabilities;

- Gray Ghost DOEN Social Ventures Coöperatief in the equity of Beam – an Indian mobile payment services company enabling subscribers to make electronic payments without the need for a bank account, thereby increasing financial inclusion;
- Dutch development bank FMO in the equity and debt of Clean Energy – a vehicle created to fund the construction of Mongolia's first wind farm; and,
- SNS Impact Investing in the debt of Pro Mujer Bolivia – a microfinance institution providing credit services, education and healthcare to disadvantaged women in Bolivia.

The GIIN website additionally describes a partnership between Sydney-headquartered Leapfrog Investments and AllLife, a South African life insurer which offers products to individuals with HIV/Aids and diabetes. According to GIIN, a US$14m equity investment by Leapfrog enables AllLife to deliver affordable insurance to individuals previously excluded from the market. In his keynote address to last year's PortfolioConstruction Forum Conference, Leapfrog founder Andrew Kuper outlined a similar investment in BIMA – a low-cost insurer which reaches underserved consumers across the developing world, through collaborations with mobile technology and financial services providers.[7]

PERFORMANCE AND DIVERSIFICATION

As the impact sector matures, mainstream investors are able to consult a growing set of financial – as well as social and environmental – performance data. The 2017 GIIN survey suggests that investors are satisfied with returns so far. Indeed, about 90% of respondents reported that the financial performance of their impact investments was meeting or exceeding expectations.

Greater data availability also allows investment practitioners to better understand how impact strategies may be incorporated into portfolio construction. A recent study by Tim Macready and Simba Marekera, of Sydney-based Brightlight Impact Advisory, suggests that impact investing may offer valuable benefits within a broad multi-asset approach.[8] By analysing the performance of Christian Super – which invests 10% of its funds under management in impact strategies – Macready and Marekera show that impact assets produced an attractive blend of strong returns, low volatility, and low correlation, relative to other assets, over the six years ending December 2015.

Surveys suggest a growing awareness of the performance benefits that impact strategies may bring to investment portfolios. In its 2016 report, Impact Investing Australia found that institutions considered financial returns to be the third-biggest reason for investing in impact assets – behind "mission alignment" and "client, member or trustee demand".[9] Not-for-profit organisations, trusts and foundations similarly viewed mission alignment as the prime motivation for using impact strategies. However, this factor was closely followed, in second place, by "diversification benefits".

THE OUTLOOK FOR IMPACT INVESTING

Financial benefits strengthen the case for impact strategies among traditional institutional investors – many of which previously argued that ethical investment approaches conflict with their fiduciary duty to maximise returns for end clients – and Macready and Marekera note that JP Morgan, Deutsche Bank, AXA, Bain Capital, Russell, BlackRock, Wellington, Zurich and QBE are each developing internal impact investing capabilities.

However, other, more powerful, tailwinds seem likely to propel impact investing towards the mainstream profile envisaged in 2010, by JP Morgan.

In particular, global initiatives may play a significant role in driving participation in the sector. A report published by S&P Dow Jones Indices notes the importance of the United Nations (UN) Sustainable Development Goals (SDGs).[10] The SDGs – a set of 17 social, environmental and economic objectives, agreed by the international community in 2015 – are designed to foster progress in a range of areas, including access to clean water, decent work and affordable energy, by 2030. However, to achieve the goals, private investment will be required to plug a US$2.5 trillion annual funding gap.

To promote greater investor participation in reaching the SDGs, the UN Environment Programme Finance Initiative this year launched the Principles for Positive Impact Finance, as a means of "[guiding] financiers and investors in their efforts to increase their positive impact on the economy, society and the environment".[11] In addition, the S&P Dow Jones Indices study notes that investable indices are further stoking investor interest in the SDGs – the World Bank raised a bond linked to the goals in March, and other market participants are understood to be developing SDG-related benchmarks.

While GIIN survey participants warn that mainstream money risks creating "mission drift" for the sector – respondents note that, in some cases, firms are repackaging existing environment, social and governance (ESG) and socially responsible investing (SRI) strategies as "impact" – they were mostly positive on the scale and increased profile that well-known financial institutions will bring. About two-thirds of respondents said that large financial firms would help professionalise the market, while almost 60% expected the arrival of such players to improve the credibility of impact investing.

IMPACT INVESTING IN AUSTRALIA

Studies suggest a substantial and growing appetite for impact strategies, in Australia. According to Responsible Investment Association Australasia (RIAA), a body which represents ethical investors in Australia and New Zealand, assets under management in the core Australian impact investment fund category expanded by 10%, to A$4.1bn, between 2015 and 2016.[12] RIAA noted that a rising number of providers offer such funds, in areas including affordable housing and microfinance, and that bank and non-bank institutions are further boosting the sector through issuance of themed bonds.

RIAA's findings tally with the 2016 Impact Investing Australia report, which revealed that more than two-thirds of survey participants expected impact investing to become a more significant part of the broader investment landscape. Respondents who were not active in the sector forecast that their organisation would adopt social, environmental and cultural impact as a metric for investment decisions, during the next five years; while active impact investors said they would like to triple the size of their impact portfolios over the same timeframe. "There is growing momentum and interest in impact investing from Australian investors," the report concluded.

ENDNOTES

1."Impact investing: Judith Rodin takes on the naysayers", Knowledge@Wharton, June 2014

2. Global Impact Investing Network (GIIN) website

3. Available on The Rockefeller Foundation website

4. Available on the GIIN website

5. "From the margins to the mainstream: assessment of the impact investment sector and opportunities to engage mainstream investors", World Economic Forum, September 2013

6. Macready, T. and Marekera, S. "Impact investing in the context of a diversified portfolio", PortfolioConstruction Forum website, May 2017

7. "Purpose-driven portfolios perform better", Conference 2016 Resources Kit, PortfolioConstruction Forum website, August 2016

8. Macready, T. and Marekera, S. "Impact investing in the context of a diversified portfolio", PortfolioConstruction Forum website, May 2017

9. "2016 investor report", Impact Investing Australia

10. "Aligning sustainable development goals with investment objectives: the next ESG challenge", S&P Dow Jones Indices, May 2017

11. Available on the UN Environment Programme Finance Initiative website

12. "Responsible Investment Benchmark Report 2017: Australia", Responsible Investment Association Australasia

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