THE Frontier Line

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A Beginners Guide to Social Impact Investing

FRONTIER ADVISORS

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $235B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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A beginners guide to social impact investing

"Impact investing is a powerful movement driven by investors of all types who are effectively putting their capital towards solutions to issues in areas like conservation, education, and affordable housing."

Amit Bouri, GIIN co-founder and CEO.[1]

Social impact investing defined

Social impact investing is not a new concept but has grown in significance in recent years. But what exactly is it? Some people bundle it into their environmental, social and governance (ESG) bucket while others package it into socially responsible investing and philanthropy.

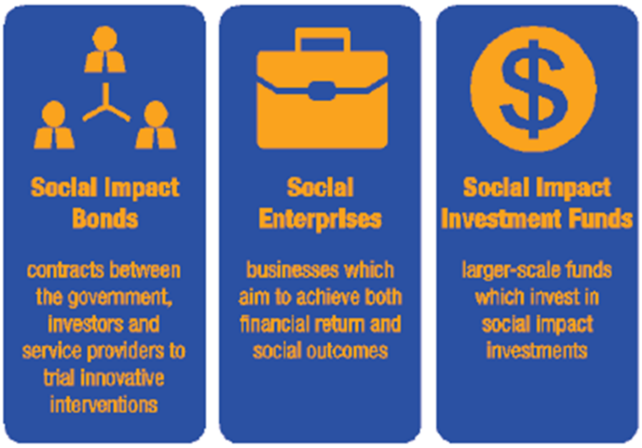
It is easy to understand why there is a lack of clarity around social impact investing, as it is such a broad concept which covers investments from a range of asset classes (such as fixed interest, private equity and property), across multiple sectors and regions. For example, a social impact investment might focus on delivering healthcare to low-income communities, housing for the disadvantaged or provide jobs to the long-term unemployed. This makes it harder to define but probably the most widely used definition comes from the Global Impact Investing Network (GIIN), a not-for-profit organisation focussed on increasing the scale and effectiveness of impact investing around the world. It defines impact investments as:

"investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return."[2]

The defining part of social impact investing is that it is an investment, not a grant, and there is an expectation of a capital return (to some degree).

While this is a broad definition, a Discussion Paper by the Australian Government in 2017 grouped social impact investing into three main forms which are shown following.

Forms of social impact investing



Source: Social Impact Investing Discussion Paper – January 2017

Social Impact Bonds are contracts between the government and investors which operate under a payment by results method. An example of this is the first social impact bond for the NSW Government, the Newpin bond, which was established to help vulnerable families. Social Enterprises are organisations where the objective is to achieve a financial and a social/environmental gain. Social Impact Investment Funds are larger scale pooled vehicles and issuers have included Social Ventures Australia and Indigenous Business Australia. These groupings illustrate the vast and diverse range of investments which fall under the umbrella of social impact investing.

Newpin Bond in focus

The Newpin Social Benefit Bond (SBB) is a $7 million bond, issued in 2013 via a joint partnership with the NSW Government, Social Ventures Australia and the Uniting Church. The Newpin SBB aims to expand on the Newpin program set up in 2009, which focusses on creating a safe environment such that children who have been living in care can be reinstated with their families as well as trying to avoid children entering the system at all.

The Newpin program includes a 12 to 18 month course for families with children aged six and younger and operates separate centres for mothers and fathers. The Newpin SBB aims to fund six new Newpin centres and investors receive a return based on the success of the Newpin program. This is measured using a "Restoration Rate" which measures the proportion of children attending a Newpin centre who have been successfully reinstated with their family (all family restorations are independently approved by the NSW Children's Court). There is also a financial benefit to the NSW Government by reducing the number of children in care which it estimates to cost annually on average $30,000 to $45,000 per child.[3]

The Newpin SBB is targeting a financial return of 10% to 12% per annum. The NSW Government provided a minimum 5% interest rate for the first three annual payments and a guarantee that a minimum of 50% of the principal will be repaid at the end of the bond.[4] Table 1 shows the Restoration Rate and return for the Newpin SBB since its inception to 30 June 2016.

Table 1: Restoration rate and return for the Newpin SBB as at 30 June 2016

	FY 2016 (%)	FY 2015 (%)	FY 2014 (%)
Restoration Rate	65.2	61.6	60.0
Return	12.2	8.9	7.5

Source: Impact Investing Australia

From a social perspective, as at 30 June 2016, 67 children have been returned to their families. Superannuation investors include Christian Super and not for profit organisation, The Benevolent Society.[4] The Newpin Queensland SBB was issued in April 2017, focussing on families in Queensland.

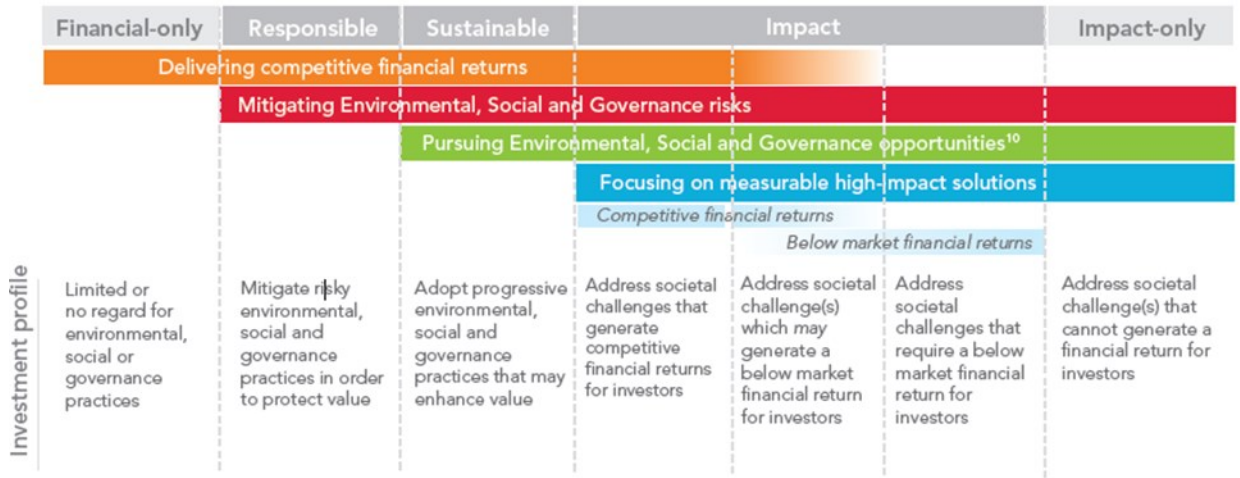
Range of social impact investments

Investors are faced with a wide range of options when it comes to social impact investing.

The Social Impact Investment Taskforce (2014) developed a diagram to outline the choices available to investors. Dotted lines have been used to separate the different types of investing, recognising that many investors may transition across categories, or build a portfolio across the spectrum.[5]

Impact Investing Australia found that among active investors, mission alignment was the primary motivating factor for allocating funds to impact investments. Other factors include client demand, financial returns, diversification benefits and corporate social responsibility.[6]

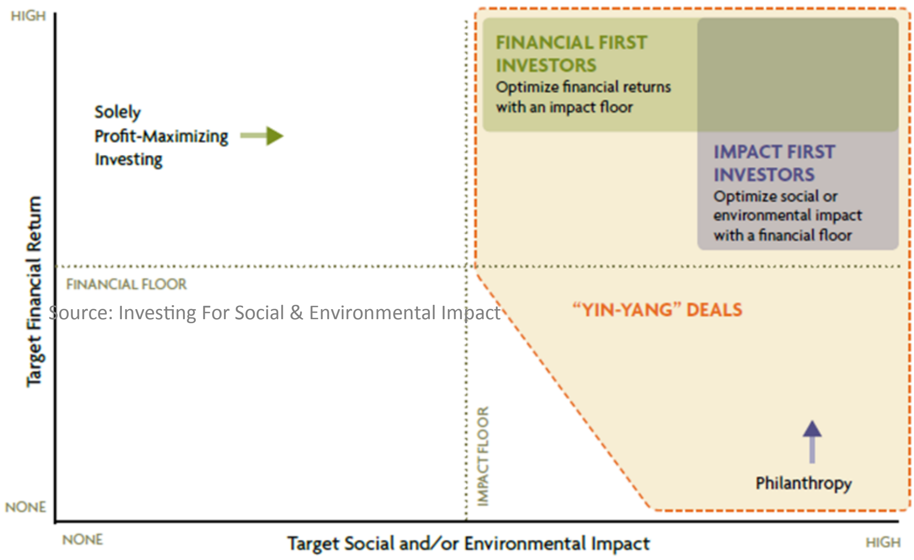
Spectrum of investing



Source: The Social Impact Investment Taskforce (2014)

Segments of impact investors

In general, social impact investing can be categorised into two broad groups, those who seek to optimise social/ environmental impacts with less regard for the financial outcome and those who seek to optimise the financial outcome as a priority. This is shown diagrammatically by The Monitor Institute 2009, which highlights that, in some cases, the two groups align in what it describes as "yin-yang" deals.



Source: Investing For Social & Environmental Impact

Evolution of impact investing

It is difficult to accurately measure the size of the social impact market given its broad definition, the range of investments and the limited data available in this space.

Having said that, a study by Eurosif, 2016, found that impact investing was the fastest growing strategy in Europe since 2015 with a Compound Annual Growth Rate of 120%.[7] The GIIN Annual Impact Survey (a survey of 58 organisations based across the globe) found that respondents committed more than US$15 billion to impact investments in 2015 and planned to increase capital committed to impact investing by 16% to US$17.7 billion in 2016.[8]

In Australia, The Responsible Investment Benchmark Report 2016 found that impact investing in Australia (depending on how it is defined) grew 74% from 2014 to 2015, from A$2.1 billion to A$3.7 billion.[9] A survey of Australian investors by Impact Investing Australia 2016 found that more than two thirds of all investors surveyed in Australia expect impact investing to become a more significant part of the investment landscape in the coming years. Those not yet active in the field strongly expect to consider impact as a metric in decision making in the future.[10] These figures show that interest in social impact investing is growing, however it still only makes up a tiny part of the global market.

The biggest growth area has been in social bonds and green bonds. The last two years have seen a steady increase in green bonds, and in coming years it is anticipated that the Australian green bond market will align with international growth trends as Australian investors seek opportunities to invest in low carbon assets.[11] Until recently, the NSW Government had been the pioneer when it came to the issuance of social bonds. In July 2016, Victoria was the first state to issue Green Bonds, raising $300 million which was fully subscribed in 24 hours. Projects expected to be undertaken include the roll-out of LED traffic lights, the construction of mini-hydroelectric power stations, low-carbon buildings, parts of the Melbourne Metro Tunnel, new trains, the Mernda Rail extension and the development of a large-scale renewable energy power station.[12] More recently, the Queensland and South Australian Governments have also announced programs.

An example of a social impact investment

LeapFrog Investments invests in companies providing financial services in emerging markets (predominantly Africa and Asia). In March 2017, LeapFrog announced that it had acquired a stake in Fincare, a microfinance platform in India, currently providing financial services to emerging consumers, the majority being women in rural areas (two of the most underserved segments of the market).

Fincare is one of only ten institutions in India set to become a Small Finance Bank, at the heart of the government's financial inclusion agenda. LeapFrog's stake is part of an overall $75 million transaction by investors including Tata Opportunities Fund, Kotak Mahindra Old Mutual Life Insurance Ltd, and TA Associates.[13]

Considerations for institutional investors

Measuring the social impact

Impact Investing Australia found that active impact investors expect well-documented evidence of social impact; many also indicated they seek third-party verification of impact and/or reporting that aligns with global standards. Active impact investors require more investable deals, proven financial track record and evidence of social impact to increase their allocations to impact investment.[14]

Measuring the impact of the social and/or environmental investment is challenging but is at the heart of impact investing and a key part of its growth in the market going forward. Measurement legitimises the practice and *"ultimately, measurement provides boards of directors and chief executives with a toolbox that helps them to meet growth, profitability and impact objectives."* [15]
Recognising this, The Social Impact Investment Taskforce in 2014 (set up under the UK's presidency of the G8) outlined seven best practice guidelines to measure impact which include (among others) setting goals, developing a framework and analysing data.[16] More recently, in January 2016, the UN published the UN Sustainable Development Goals, a set of seventeen aspirational "Global Goals" with 169 targets among them. Members of the UN are expected to base their policies on these goals which should form the foundation to measure a company's impact.[17]

Return expectations

Given the broad definition of social impact investing, return expectations can vary widely from one investment to another. As discussed earlier in this paper, investors also have differing motivations for investing in social impact investing, which can result in different return expectations. Most investors expect competitive market returns from their social impact investments, however some investors are more willing to consider below market returns. For example, investors surveyed by GIIN largely said that they expected impact investments to achieve risk-adjusted returns equivalent to the market rate, however some 21% were satisfied with returns in line with capital preservation.[18]

The need to identify more "yin yang" deals becomes more important when it comes to superannuation funds. That is, under section 52 of the Superannuation Industry Act 1993, superannuation fund trustees have a fiduciary duty to make decisions in the best interest of their members.
The SIS Act requires an RSE licensee, when formulating an investment strategy, to give regard to the risk and the likely return from the investments, diversification, liquidity, valuation and other relevant factors.[19]

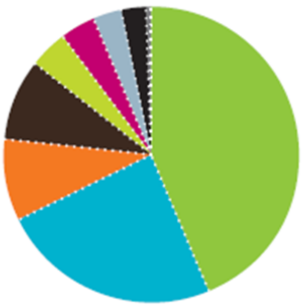
Some trustees have questioned whether social impact investing is consistent with their fiduciary duties and this will depend on the social impact investment which is being invested in. The Financial System Inquiry has recommended that the Australian Prudential Regulation Authority (APRA) provide guidance to trustees on the appropriateness of impact investment for superannuation trustees.[20] From a global perspective, in 2015, the US Department of Labour updated its guidance to trustees of pension plans to confirm that fiduciaries may invest in "Economically Targeted Investments" (defined as socially responsible investments, ESG investments and impact investments) so long as this is appropriate for the plan and economically and financially equivalent with respect to the plan's investment objectives, return, risk and other financial attributes.[21] In 2014, the UK Law Commission undertook a review of the fiduciary duties of investment intermediaries and concluded that trustees should take into consideration factors which are financially material to the performance of an investment and this should include ethical and ESG factors which trustees deem to be material.[22]

While this is helpful, it also raises the question of what constitutes "material" and clearly shows that there remains a lot of work to be done in this area. Recognising the diversity of investments in the social impact investment space, it would be difficult to give specific guidance and as a starting point trustees need to think about these investments on a case by case basis.

Structuring social impact investments

One common structure of social impact investments to date has been through venture capital or private equity funds. A paper by RobecoSam in 2016 found that private equity accounted for around 24% of global impact assets. This paper found that around 70% of the identified private equity impact funds that are open for investment focus on companies that provide (improved) access to basic services in emerging markets.[23] Additionally, the survey by Impact Investing Australia 2016 found that active impact investors who were surveyed prefer real assets, pay for performance instruments and private equity or venture capital, while investors not yet active in impact investing have no consistent preference for investment types.[24]

Total global impact investment asset under management by investment



Private debt	44%
Private equity	24%
Public debt	9%
Equity-like debt	9%
Real assets	4%
Other	4%
Deposits & cash equivalents	3%
Public equity	3%
Social impact bonds	0.3%

Source: RobecoSam 2016

Another common approach has been through partnerships including but not limited to Governments and not for profit organisations. The most common sectors which investors have concentrated on have been in microfinance, energy, affordable housing, healthcare and agriculture.

Scale

To date, some roadblocks for institutional investors wanting to invest in social impact investments have been the size of investments (or the scale) as well as a lack of supply (to meet the demand). Most investments in this space to date have been too small for institutional investors to invest. However, this is starting to change, evidenced by the $200 million commitment made by the Overseas Private Investment Corporation to LeapFrog Investments in 2015 which was the largest commitment to an impact fund manager.[25] In addition, private equity firm, The Abraaj Group, set up the Growth Markets Health Fund, with a $1 billion target which focusses on building hospitals in India, Pakistan, Ethiopia and Kenya. As at September 2016, the Fund had raised around half its $1 billion target.[26] While these levels may still be too small for the larger institutional investors, smaller institutional investors will be able to access investments and shows that the space is constantly evolving.

Other considerations

Before an investor delves into social impact investing, other questions to ask are:

- Where does it fit in a Portfolio?
- What should be the size of the allocation?
- Should the allocation be a strategic allocation or a dynamic allocation?
- What benchmark should be used?

All these considerations really depend on the investor, their goals and beliefs and their regulatory environment as well as the specific investment being considered. Should green bonds be allocated to Fixed Interest and a social investment in housing be allocated to Real Assets or should investors set up a separate asset class for social impact investment opportunities. If so, what should its target performance be, given the diverse range of investments? While these questions are important, ultimately investors thinking about investing in social impact investing need to address the following three key questions:

- What are the return expectations?
- How much of a social impact are you looking for?
- How much risk will you take on with this investment?
- What is the balance between expected return and social impact?

The final words….

Interest in social impact investing has grown in recent years although the amount invested remains comparatively small. It is such a broad concept that it is difficult to define and can encompass several asset classes, across multiple sectors and geographies. Investors also have differing motivations and investment environments, including regulations, which can result in differing return requirements and expectations and measuring the social impact can be very difficult. Evidence of the social value may also take some years to present.

While Frontier believes in the concept of social impact investing, we recognise that fundamentally investments need to be of an institutional quality and fit for purpose. Ultimately, a decision to invest in social impact investments needs to start with an investor's investment beliefs. It must be considered on a case by case basis and take into account the current portfolio and where it fits in that portfolio. At the core of all this, the key focus for any investor should be on what the financial return expectations are, what social impact is being pursued and what level of risk is willing to be taken.

Frontier continues to place a high importance on ESG and believes that ESG issues and the management of them can have an impact on investment risk and return for our clients. Frontier is a signatory of the Principles for Responsible Investing (PRI) and to The Paris Pledge. As such, ESG integration is a major project for Frontier in 2017 as we continue to embed the assessment of key ESG risks and opportunities into our investment and manager research and actively engage with the funds management industry on these issues.

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