The Frontier Line

Impact investing fundamentals

Part one: How to start a successful impact investing program

Issue 223 | October 2024

Frontier Advisors
Forefront Thinking

frontieradvisors.com.au

About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for thirty years and provides advice on around $700 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

AUTHOR

Joey Alcock

Head of Responsible Investment

Joey Alcock is a Principal Consultant and Head of Responsible Investment at Frontier Advisors. Joey joined Frontier in 2005 and has worked across client consulting, investment research and manager due diligence. Following a stint with UK consultant bfinance working with clients in Europe and North America, Joey returned to Frontier in 2018 where he currently leads the firm's responsible investment efforts and chairs its Responsible Investment Group. He holds a Master of Applied Finance from the University of Melbourne.

AUTHOR

James Damicoucas

Senior Consultant

James is a Senior Consultant servicing charities, foundations, higher education, community trusts, family office and private wealth clients. James joined Frontier in 2024. Before joining Frontier, he worked at Zenith Investment Partners as a Consultant for various private wealth firms and conducted sector research. He also has experience as an Associate Adviser at Perpetual Private where he specialised in servicing clients in the Not-For-Profit segment. He holds a Bachelor of Commerce (Finance) and a Bachelor of Engineering (Chemical) (Honours) from Monash University.

*Additional research input by Nathan Gelb, Associate

Introduction

This is part one of a series of quick-reads by Frontier Advisors on the topic of impact investing. Investors are increasingly interested in how they can invest with purpose, and we see impact investing as one of the pieces of that puzzle, albeit an important one.

In this series, we look to introduce the fundamentals of impact investing, identify some of the current opportunities, and even challenge some of the preconceptions about this space.

In part one, we explore what is driving interest in impact investing from investors, how it differs from traditional investment approaches, and why success must begin with good investment governance.

What is impact investing?

Impact investing is providing a genuine avenue for investors to reach their unique, non-financial goals.

Yet this relatively new, but nonetheless established concept, is sometimes challenged by misconceptions and scepticism. It is an investment approach that sits on the spectrum between traditional investing, which is entirely focussed on returns, and philanthropy, which seeks to address social or environmental needs but has no financial return objective.

Chart 4: RIAA's Responsible and Ethical Investment Spectrum

Traditional investment	**Responsible and ethical investment**					**Philanthropy**
	ESG integration	Screening	Thematic investing	Stewardship	Impact investing	

RIAA's detailed version of the Responsible and Ethical Investment Spectrum can be found here.

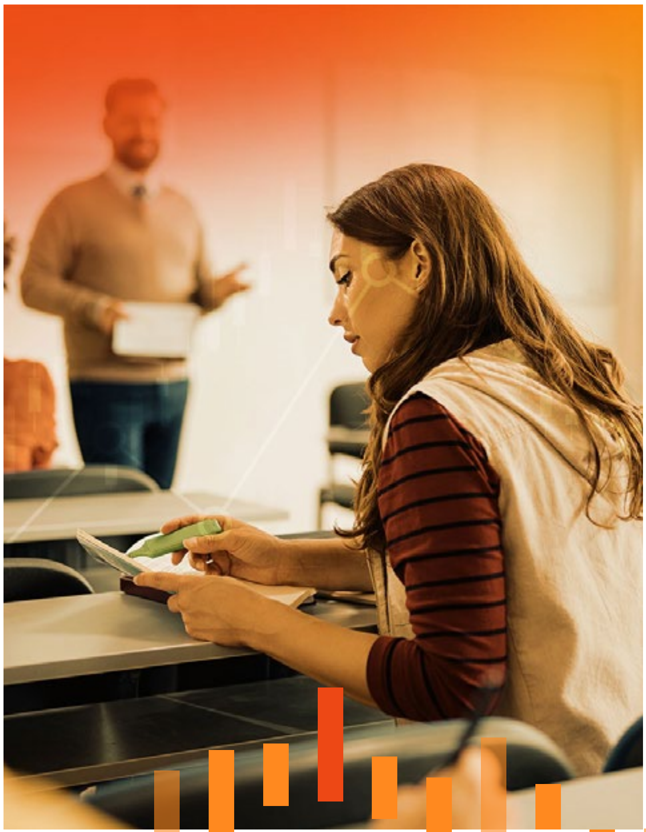
Frontier Advisors

Impact investing aims to achieve both of these goals simultaneously, that is, to generate a positive and measurable social or environmental impact at the same time as a suitable financial return.

The impact being targeted varies according to the investor's values, and often also reflects those of its beneficiaries/members. It is recognised now that impact investors can and do contribute to tangible solutions, system stability, economic sustainability and positive outcomes in the real economy.

For example, one of Frontier's philanthropic clients, the Helen Macpherson Smith Trust, chose to invest in Melbourne City Mission's Living Learning Social Impact Bond. It generates a financial return for the philanthropic organisation and supports a group of young Victorians aged 15-21 to improve their attendance, engagement and learning within an innovative educational environment.

It is helpful to clearly distinguish these examples from investing that integrates environmental, social and governance (ESG) processes to better manage financial risks (what is typically termed 'responsible investment'). While there may be some indirect social or environmental benefits to this approach, these are more by-products of the investor's primary objective to manage ESG risks, rather than intentionally targeting such impact goals.



Understanding your motivation and goals before starting a program

Many types of investors including not-for-profits, endowments, family offices and universities want to align their core activities to generate positive changes in their broader community or other sectors.

Increasingly, we also see these investors seeking the same alignment from their investment portfolios.

Impact investing is a fundamental way to achieve this.

But before embarking on a program, an organisation must first identify, understand and document their own motivations for pursuing impact investments. This is directly tied to the organisation's values and not always as easy a process as it may sound. A common challenge is ensuring all stakeholders within the organisation not only endorse these values collectively, but agree on how to express them.

Each organisation must ultimately own their 'intentionality' – the intent and reasons driving the specified social or environmental impact they want to achieve.

Impact investing may not suit everyone as it involves some additional steps and complexity. Positively though, there are a range of alternative investment approaches across the responsible investment (RI) spectrum, such as thematic sustainability or positive investment screens. These tilt portfolios to particular sectors and can also drive positive social and environmental change. Investors can therefore identify which approach suits them depending on balancing their specific objectives, preferences and constraints.

Want to get your impact investing journey started?

Why not try our handy checklist on page 6. Which questions can you answer and which ones still need answers?

Frontier Advisors

Good investment governance is crucial to success (always!)

Impact investing is ultimately defined by the investor's intention to have a positive effect.

While impact investing also aims to generate a financial return, investors only undertake impact investing because they also have impact objectives in addition to their financial goals.

Frontier believes that better practice involves the investor's impact objective being front-of-mind and the first thing to be determined. We recommend clients give thoughtful consideration to developing their impact objectives, and seek assistance where required. This is because the agreed-upon impact objective will have implications for the opportunity set of investments, as well as how the investor communicates the intention behind those investments. In fact, some organisations' primary goal is to 'maximise impact' while generating an appropriate investment return.

These goals, including how they are measured, need to sit within a suitable governance framework. Many organisations' existing governance arrangements have not been set up to address the nuances of impact investments, such as any fiduciary duties the organisation may have.

A clear and robust impact investing governance structure supports effective implementation, monitoring and reporting. This framework is fundamental to ensure a program avoids common pitfalls and has the best chance of succeeding. Some examples of pitfalls include losing track of accountability and internal disagreements due to mismatches in expectations.

While it ultimately falls to an organisation to define its own values and the impact it wants to achieve, an external expert such as Frontier can provide this crucial and independent governance advice which underpins a functional impact investing program. Because Frontier has decades of experience tailoring investment advice according to each client's specific requirements, we are well positioned to deliver solutions that are value-for-money and fit-for-purpose.

While the size of the impact investing market is challenging to measure (with estimates ranging from $US66 billion to $US3 trillion), what we do know is that the opportunity set is growing, and quickly. The impact investment ecosystem now encompasses a wide range of asset classes and opportunities for organisations to make a positive, measurable social or environmental impact.

In part two of our series on impact investing, we take a deeper look at the opportunities currently available; build up our impact investment vocabulary; explore how the United Nations' Sustainable Development Goals fit in; and flag some of the main challenges facing asset owners and fund managers in this space.

Want to learn more?

Frontier can support you in establishing an impact investing program by creating a robust governance framework and identifying suitable investment opportunities. Our dedicated teams in governance, responsible investment, and research are ready to assist. For more details, please reach out to your consultant or contact Frontier's Responsible Investment Team.

Frontier Advisors

Checklist: Before launching an impact investing program

- What or who has motivated your organisation to pursue impact investing?
- What type of impact does your organisation want to generate?
- How will the success of this impact be reported to stakeholders and what defines a successful impact investment?
- What type of asset class exposure is sought?
- Where will impact investments sit in your portfolio?
  For example, will it be a standalone percentage allocation or a strategy embedded across asset classes?
- What risk-adjusted return are you seeking?
- How will you identify suitable impact investments?
- How often are impact objectives expected to be revised or reviewed?

Appendix

Impact investing key terms

Additionality: The contribution an impact investor makes, without which the positive impact would not occur. For example, a non-financial additionality may be engaging with a listed company's executives in a way that the company's strategy changes sustainably for the better.

Externality: A positive or negative outcome of a given economic activity that affects a third party that is not directly related to that activity. An impact investor assesses the positive social and/or environmental externalities (impacts) resulting from an investee company's products, services or the way it behaves.

Intentionality: To allocate capital with deliberate and conscious intent to generate a specified social/environmental impact.

Impact investing: Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.

Measurability: Determining whether an impact investment is successful requires measuring performance against both financial and impact objectives. Measuring whether an investment has met its impact objective can be more complex than assessing its financial performance.

Theory of change (or impact thesis): An explanation about how an investment will lead to specific development change, drawing on a causal analysis based on available evidence. A theory of change allows an investor to plan and measure how its investment will generate positive impact with intentionality.

Frontier Advisors

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266

Frontier Advisors