The Frontier Line

Impact investing fundamentals

Part two: Building your impact investing vocabulary

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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for thirty years and provides advice on more than $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.

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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.

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Introduction

Impact investing has the power to help drive positive change in the world while also delivering financial returns to investors. But it is a path that is best undertaken after significant planning to achieve what, at first glance, may appear to be disparate goals.

Part one of this series introduced the foundational concept of impact investing, before emphasising the importance of how an organisation must first understand its own motivations and values in order to define the measurable impact it wants to achieve.

In Part two, we break down the underlying characteristics of impact investing, look at why the UN Sustainable Development Goals are commonly associated, and explore the market for impact investing opportunities.

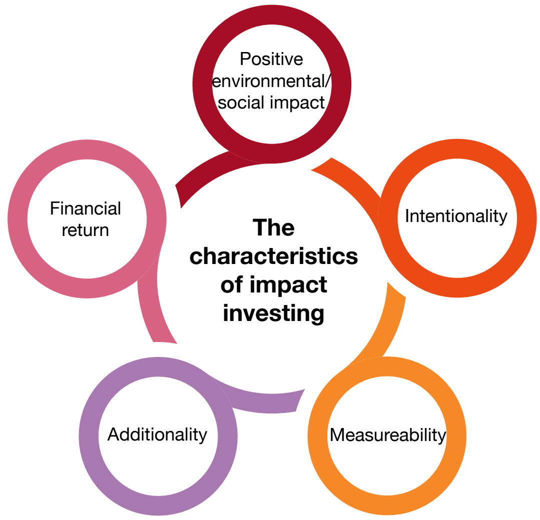
These are big questions that invariably involve multiple stakeholders across an organisation. But investors can make use of various building blocks that can provide a starting point. This includes a checklist which we are including in each part of this series.

The characteristics of impact investing

It is important for potential impact investors to first know and understand the relevant terminology and characteristics specific to impact investing. This enables them to engage with organisations like fund managers in a constructive way and thereby make effective decisions. Here, we briefly introduce these terms and how they ultimately lead to the creation of a 'positive environmental/social impact' – see Figure 1.

We begin with the concept of 'intentionality', which requires the impact investor to pursue impact with deliberate and conscious intent. An investor's intentionality cannot be defined by anyone else but that investor because it is based on their values. The impact that an organisation targets – whatever that may be – must be achieved on purpose and not just a byproduct of investing more generally.

Figure 1: Characteristics of impact investing



Intentionality sits within a broader concept of ‘theory of change’, which describes how an organisation’s capital investment will lead to specifically targeted positive changes. This requires an analysis of available evidence which shows why deploying capital in this way will work.

Impact investing is a broad area that encompasses many different strategies so ‘measurability’ is crucial to assess whether it is working. A ‘financial return’ is easily measured, but while it is reasonable for an investor to expect that they can also track progress being made on their impact objective, this can be a challenging area to measure accurately. This is especially the case if investing in a fund vehicle that its allocating capital across multiple different projects.

For example, an impact investor might aim to build 20 hospitals in developing areas to improve healthcare. Measuring success here is relatively straightforward: if the strategy achieves the expected financial return but only delivers 15 hospitals, it falls short of its impact objective despite meeting financial goals. However, if investing in a fund with multiple exposures to different opportunities, it becomes more challenging to determine whether the fund as a whole has met its impact expectations.

‘Additionality*’* is another area related to impact investing, although there is some debate as to how it manifests across investment types. It describes how an impact investor should add something new to drive the impact that wasn’t there before and without which, the impact would not have been possible.

It may be financial additionality, such as committing new capital to a closed-end private market impact fund. However, it could be non-financial, such as engaging with listed company’s executives to drive change (which subsequently shifts capex decisions to higher impact areas). This area is still evolving and not all impact investors endorse or agree on additionality as being a required characteristic of impact investing.

We encourage investors to become familiar with these concepts as they form the language of impact investing used by practitioners and investors alike.

How the UN Sustainable Development Goals interact with impact investing

The UN Sustainable Development Goals (SDGs) were launched in 2015 to address the environmental, political and economic challenges facing the world in a globally coordinated way. It recognised that organisations, companies and investors have key roles to play in solving these urgent issues in the way they allocate capital. Frontier’s short fact sheet on the SDGs can be found here.

While investors must ultimately select and own definitions and criteria for success in impact investing, we observe that many have used the SDGs as a starting point to guide their impact investing strategy and measure how their portfolio is tracking against those goals.

Because one of the objectives of impact investing is to generate positive social and/or environmental change, referencing the SDGs makes intuitive sense given these areas require vast sums of private capital to become sustainable.

We find organisations often select a focussed subset list of the 17 SDGs to 'target', usually on the basis the selected SDGs are aligned to their objectives, values or beneficiaries. Frontier encourages investors to ensure their reasons for selecting certain SDGs are clearly articulated.

A common pitfall is for organisations to adopt relevant SDGs and their associated targets without consideration for their own definitions for impact and goals. While SDGs are a great starting point to establish impact objectives, we urge investors to also incorporate their unique values and mission into their impact objectives. For example, SDG 7, which aims to increase access to affordable, reliable, sustainable and modern energy, is a popular SDG for investors to select because climate change is strategically important to the majority of investors. From a portfolio perspective, it aligns well with common impact investments that address climate change in some way, including investments in green buildings, energy efficiency and renewable energy.

Each SDG includes clear targets, which are tied to the intended outcomes by 2030, as well as indicators to measure progress. A tracking report on SDG 7 can be found here. Another popular impact investing area is gender equality (SDG 5) – a progress snapshot can be found here.

The SDGs therefore provide helpful context for organisations that want to make a measurable impact in areas of global need, and a high-level framework to guide the allocation of capital which will generate a specific environmental or social impact, even as the ways to measure impact are constantly evolving.

The market for impact investing opportunities

We emphasise that impact investing describes an investment approach rather than a specific asset class.

In fact, it can be argued that impact investing crosses most of the asset classes in which institutional investors are active including an array of investment opportunities in private equity, public equity, real assets, private debt and public debt. Some alternatives (especially short-term trading or derivative-based) seem to have limited scope to drive positive impact although the future may reveal opportunities here too.

Because impact investing is an approach across asset classes, the size of the market is difficult to determine. A quick internet search shows a wide range of estimates between $US66 billion (Grand View) and $US3 trillion (Yahoo Finance), with climate change solutions comprising the largest area. What is clear however, is that impact investing opportunities are attracting growing sums of private capital as the world makes the transition to net zero by 2050 and opportunities become more apparent.

Some large asset owners are now allocating a defined percentage of their portfolios specifically to impact themes such as climate solutions. Investments in these allocations might include renewable technologies and climate adaptation strategies.

With the impact investing universe being so large, it can feel overwhelming to investors starting out in the area. It can also be opaque. The nature of impact investments can differ widely, which makes marketing them challenging, and the sector includes a number of closed-end funds, where capital is raised through a one-time offering. We encourage investors to start their journey with the expectation their investments will grow and evolve over time with learning. It is certainly not required that everything is done at once.

There are also industry practitioners who are working to drive greater understanding and transparency for investors. Wealth of Nations for example, is one group attempting to make the process easier. It has created a fintech smartphone-based platform that allows investors to select criteria such as the area they want to generate impact, the range of capital they want to invest, and the return they want to generate. The platform then displays a range of open impact investing funds that meet those requirements. Think of speed dating for impact investors!

The final word

Ultimately, introducing impact investing to your investment strategy involves a few additional steps compared to traditional investment.

But anything new usually does ask a little more. A strong governance process to systematically assess market opportunities that align with your strategy is essential. Additionally, understanding the language of impact investing and leveraging resources like the SDGs can help you stay focussed and make consistent progress.

In the next part of our impact investing series, we will look at some case studies that encapsulate the challenges of being an impact investor. Stay tuned for this paper in the new year.

Learn more

Frontier can help you facilitate an impact investing program including building a governance framework and identifying appropriate investment opportunities. We can also assist with:

- Determining which of the SDGs best link to your organisation's values, mission and definition of impact.
- Forming the foundations of an impact investing program including navigating the concepts of 'intentionality', 'measurability' and 'additionality'.
- Discussing potential investments that may match your impact investing needs.

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.

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?

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