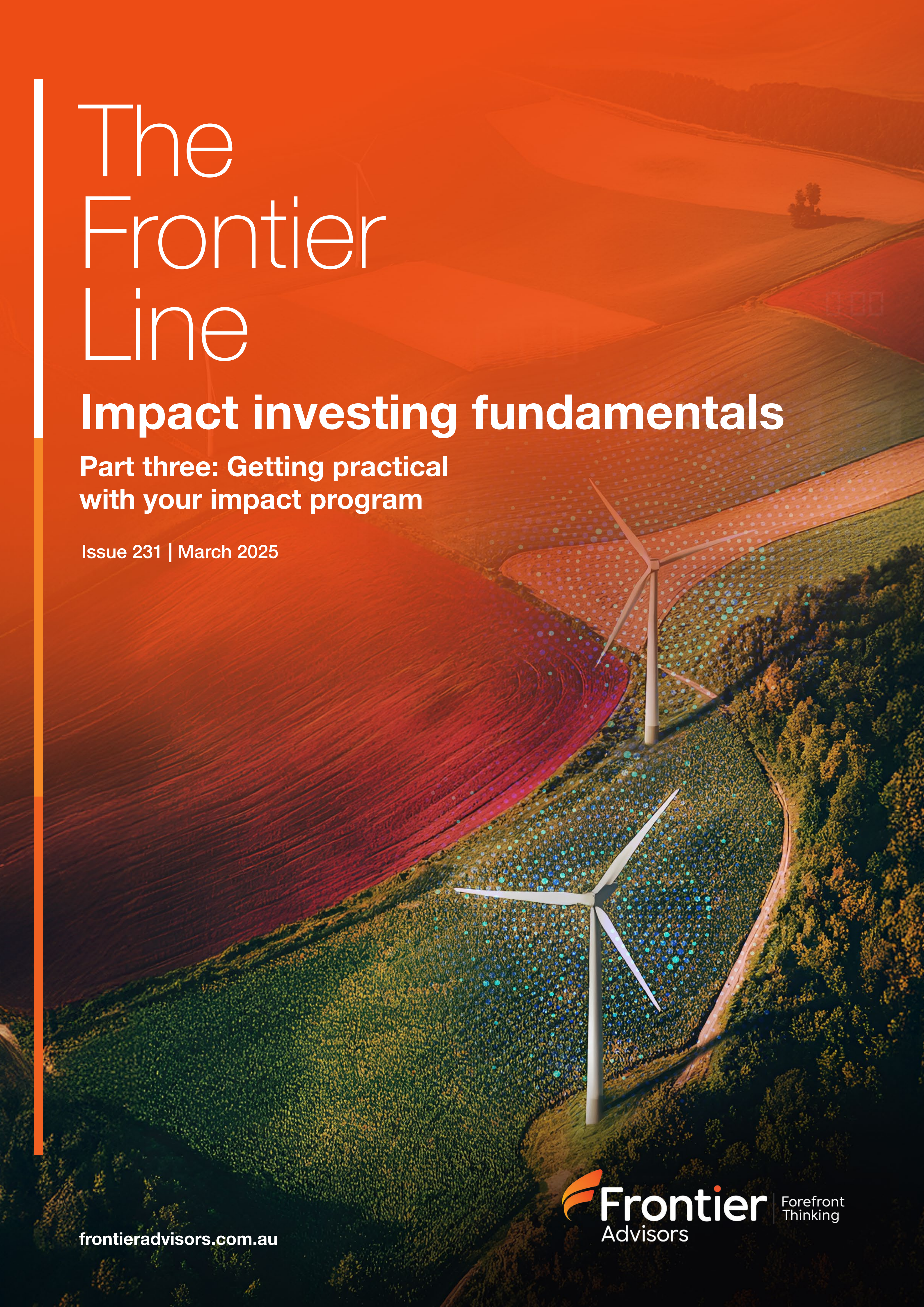

The Frontier Line

Impact investing fundamentals

Part three: Getting practical with your impact program

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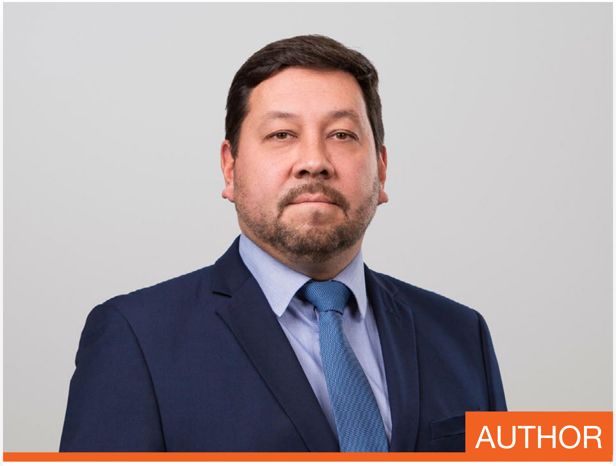
About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for thirty years and provides advice on around $800 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 through knowledge sharing; customisation; technology; and an alignment and focus that is unconstrained by any product conflicts.



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Introduction

Impact investing, which targets both financial returns and positive social or environmental goals, is reshaping the way some investors make their portfolio decisions. But both the growth in assets invested, and the impact that investors want to achieve through their impact investments, have arguably yet to reach their true potential.

Impact investing remains a relatively small proportion of total invested capital globally, but more notably, well below most estimates of the investment required to address major sustainability needs like renewable energy, clean water, and sustainable cities (among others). Closing this funding gap will be essential to meeting these goals, and we believe this creates an interesting opportunity for investors who are willing to commit to an impact investing program.

Part One of our series introduced the concept of impact investing and highlighted why an organisation must clearly define the measurable impacts it intends to target. In Part Two we explored the terminology of impact investing, the role of the UN Sustainable Development Goals, and considered some of the opportunities in the space.

In Part Three, we delve deeper into the practical considerations of impact investing such as how investors can address scale issues while also contributing to the bigger sustainability picture. We then highlight the importance of managing ESG risks in impact investing.

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Impact alignment versus breadth of opportunities

At the heart of impact investing lies intentionality: the specific and measurable impact goal an investor wants to achieve.

This intentionality is unique to each investor and therefore should be defined by them after going through a process of introspection and often consultation with external advisers to guide their ambitions.

However, we have seen some investors sharply refine intentionality without sufficient consideration of investment practicalities, resulting in an approach which can limit opportunities by establishing overly tight impact parameters, which then limits the size of the investable universe. By severely constraining what is deemed investable, this can limit the flow of productive capital to where it is needed from a sustainability perspective.

For example, a specific impact investor may decide to only target opportunities which support underprivileged teens, with poor literacy, who live in a particular low socio-economic region. Such objectives are highly meaningful and valid for that individual impact investor, but they can also limit the potential investment universe and ability to implement.

Realistically, few fund managers will build products (i.e. pooled investment vehicles) that are very tightly focussed on a highly-specific impact outcome, as they risk not attracting sufficient breadth and scale of investors to be economically viable. This makes identifying products that align sufficiently with an investor's impact objectives more difficult.

A related challenge is that even when impact investment products are available, investors still need to evaluate their suitability and quality. Asset consultants like Frontier conduct product ratings to assist clients with this, though challenges can arise with pooled vehicles. Typically, consultants recommend highly rated products to multiple clients, scaling the resource-intensive rating process. However, if each client seeks products tailored to specific, niche impact objectives, individual ratings may not be broadly applicable. If a client is not willing to commission and pay for an upfront rating, it may not be economically feasible for the asset consultant to invest the several months required to assess and rate a product for just one client. This limits the asset consultant's ability to build a robust 'bench' of impact investing ratings, as seen in the traditional investment manager space.

Put simply, the greater the specificity, the less scalable the impact investing program.

Less specific impacts

Pros:

- ✓ Larger opportunity set and scale
- ✓ Better diversification
- ✓ Larger contribution to global impact

Cons:

- ✕ Moderates alignment with investor values
- ✕ Harder to measure impacts

More specific impacts

Pros:

- ✓ Clear alignment with investor values
- ✓ Readily measurable impact

Cons:

- ✕ Constrained opportunity set
- ✕ Difficult to scale invested capital

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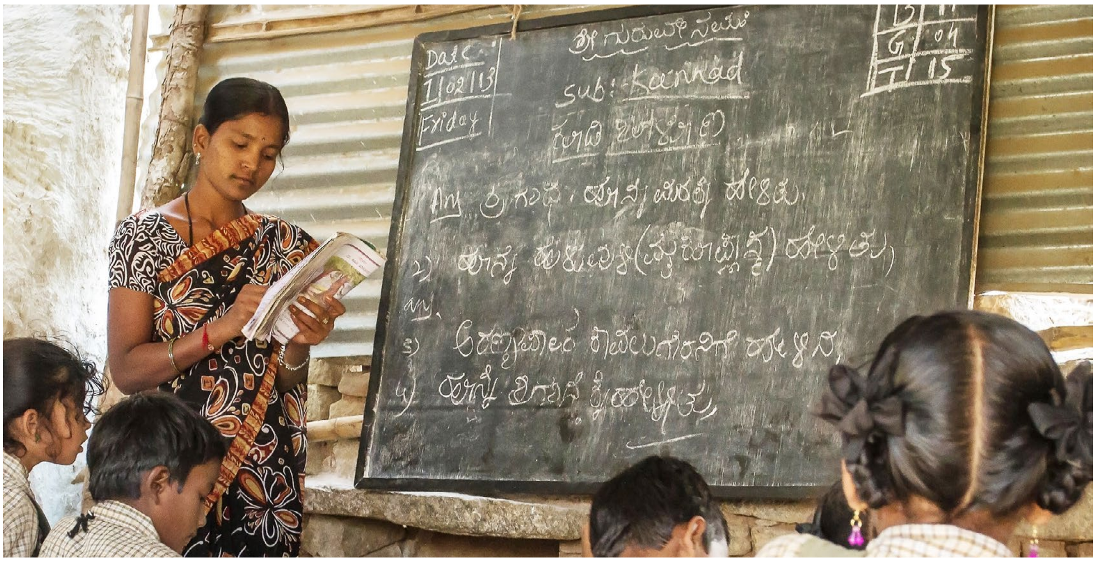
Impact beyond my own backyard – a virtuous (and profitable!) circle

Impact investors can instead, take an approach which affords them greater scale and access to opportunities – they can take a wider lens to the intentionality behind their impact investing program to include a larger geographic area and/or investment strategies which target a diverse set of impacts.

For example, the investor mentioned earlier who wants to help underprivileged teens with poor literacy levels in a specific, low socio-economic suburb, could instead invest in a product that targets this impact 'thematically' across a range of international developing markets. Similarly, another impact investor who may want to invest in a social impact bond with a focus on improving the health outcomes of a specific community, could consider strategies that invest in larger, related areas such as medical research or healthcare technology.

Both approaches retain a thematic alignment to the impact a particular investor intends to make but expand the universe of opportunities they can choose. The investment is likely to benefit from greater diversification and scalability with a more stable return stream.



As a knock-on 'bigger picture' effect, if more investors take this approach, it will likely increase demand for a broader array of impact investing products, which will attract more fund managers to the market. This rising number of products can, in turn, then attract more impact investors to the market, and so on.

Such a 'virtuous circle' could turbocharge the growth many estimate the broader impact investing industry needs to achieve in coming years.

Even very large institutional investors may benefit from broadening their impact investment objectives. While building a program of highly specialised impact investment exposures does allow the entity to show demonstrable alignment with its values, such programs can take significant internal resources and time to set up, especially for small capital allocations. If the returns generated are inconsequential or immaterial in the context of a large overall portfolio (i.e. 'does not move the needle'), the payoff for committing those substantial resources may be questioned. Regulators could seek an explanation as to why beneficiaries' funds are being used to undertake investments that have minimal impact on overall financial outcomes.

Addressing the challenge of achieving this growth is crucial given the amount of investment needed to address the world's existing social and environmental issues. The Global Impact Investing Network (GIIN) recently emphasised the role of institutional asset owners in bridging the estimated $US4.2 trillion annual shortfall needed to achieve the UN Sustainable Development Goals (which form a common basis for impact investing objectives – see Part Two of this series).

When defining their intentionality, Frontier believes investors should take these bigger picture dynamics into account.

A look at some new impact investing products on offer

There are an increasing number of scalable impact investing products that offer investors a broader exposure to different types of impact outcomes.

In response to growing interest in impact investments, while also balancing the need to scale our research efforts, we recently rated two products: LGT Capital Partners' Crown Impact Trust II and HarbourVest's Stewardship Fund. In this section, we provide a brief introduction to these strategies. If you have further questions or are simply curious to know more about them, please get in touch with your Frontier client team.

The Crown Impact Trust II is a direct co-investment fund which focusses on buyouts and late-stage growth investments predominately in Europe and the US. The Fund's impact investments must measurably and directly contribute to one or more of the United Nations' Sustainable Development Goals across three core impact sectors: climate action, healthcare and inclusive growth.

Investment opportunities undergo the same investment due diligence and underwriting as other LGT Capital Partners' private equity investments, which have generated an attractive performance track record over the long term. Given this product will have the added dimension of impact, investors receive comprehensive impact reporting information in addition to standard performance reports.

Similarly, HarbourVest's Stewardship Fund is a private equity co-investment strategy that invests alongside GPs into buyout and growth strategy investments aligned with a set of pre-defined positive stewardship themes including health; inclusive finance; education; environment and sustainability; and community.

The manager's stewardship screen allows HarbourVest to find appropriate investments from private equity managers beyond only specific impact-focussed private equity firms, significantly increasing the investable universe.

Both of these funds can invest scalable amounts of capital while maintaining the scope to achieve significant and authentic impact. These products, and products like them, may enable investors to grow the proportion of impact investment across their wider portfolio more effectively than highly specific investments. Even so, an investment in either fund still requires the impact investor to carefully assess their suitability given the nature of their desired impact investing programs.

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Do impact investment funds automatically tick the ESG box?

While impact investing has social or environmental goals intrinsically entwined with its investment targets, it does not mean impact investment products are inherently strong on managing material ESG (environmental, social and governance) risks and opportunities.

It may seem counterintuitive, but just because an investment focusses on initiatives like producing solar panels, building schools for underprivileged children, or providing access to credit for those living in poverty, it does not necessarily mean these activities are being carried out in a responsible or sustainable way. Investors must recognise the need for an explicit assessment of ESG capability applies equally to impact managers as it does to any other investment manager type.

For the impact investment strategies which we have rated to date, all the managers have demonstrably strong capabilities in managing ESG factors. Unfortunately, we are also aware there have been examples of greenwashing in projects which, while ostensibly aligned to positive social or environmental outcomes, have been implemented poorly with respect to ESG, in some circumstances with highly damaging financial results.

Microfinance is one area of impact investing where ESG risks have been recognised over time. This sector involves providing small business loans to people who are typically unable to access bank finance. These loans may help someone acquire a productive asset (e.g. a sewing machine) that they can use to achieve financial independence and potentially lift themselves out of poverty. The positive social outcome from investments in microfinance can therefore be significant. Nonetheless, there have been some instances where local microfinance intermediaries have charged egregious rates of interest and even threatened borrowers who are behind on their payments. Sadly, some borrowers in these circumstances have suffered extreme stress, even to the point of suicide. Clearly, these behaviours are contradictory to the objective of positive social change, but can also be detrimental to investment outcomes. It is critical for investment managers to have suitable processes in place to ensure such agency risks are identified and managed.

Another example relates to recent revelations some solar farm operators in Australia were using unqualified labour to undertake electrical work, representing a significant health and safety risk.

These examples highlight that even the ESG credentials of impact investing products need to be assessed to ensure they are managing material ESG risks arising from the impact activity.

The final word

As the market for impact investment continues to evolve, opportunities for investors and service providers grow. However, to address the world's most pressing social and environmental issues, further scale in impact investing is required.

Investors, fund managers, and consultants can and should work together to create a more sustainable and meaningful impact investing ecosystem. This may involve investors applying a wider lens to their impact goals, even as they define, and own, their intentionality. Frontier believes there are a range of positive benefits for investors and the wider market to be gained from participants looking beyond their immediate circumstances. These include a larger investment universe and a more economically scalable impact program. The examples we have highlighted in this paper are attractive options in this regard.

Learn more

Understanding and assessing this area requires significant effort and expertise. As an asset consulting firm advising many asset owners, we have been able to deploy time and resources to complete that work, and we continue our efforts. Frontier can support you in establishing an impact investing program, including by creating a robust governance framework and identifying suitable investment opportunities. Our dedicated teams in governance, responsible investment, and research are ready to assist and help you leverage our expertise and experience. For more details, please reach out to you consultant or contact Frontier's Responsible Investment Team.

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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.

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