Why active?

Preparing for impact

27/11/2019

Summary

Impact investing's recent growth looks set to continue, coupling social and environmental benefits with financial returns to help meet investors' evolving demands.

Key takeaways

- With investors increasingly wanting their capital to have a positive real-world influence, the topic of impact investing is moving into the mainstream
- Impact investing is defined by its intention to generate a positive, measurable social or environmental impact through investment, and the ongoing measurement of the impact alongside a financial return
- Impact strategies exist across a broad range of industries and geographies

Impact investing has two primary goals – to generate financial returns, and help tackle social and environmental issues. In other words, impact investing seeks to support a social good while at the same time offering attractive risk-return profiles, and while monitoring the impact it is achieving.

Private markets have led the charge, incorporating a plethora of investment opportunities in areas such as energy efficiency, financial services, health and education, food and agriculture, and sustainable forestry. The private market can be accessed through both equity and debt; while equity, being lower down the capital structure, is riskier, it gives the investor more control over the asset.

A growing market

The market for impact investments is growing. In 2018, impact strategies held EUR500 billion under management worldwide, up from EUR120 billion two years previously[1]. To give a sense of the scale of the potential opportunity, these numbers are dwarfed by the capital that the United Nations anticipates is required to fulfil sustainable development requirements.

According to the OECD (Organisation for Economic Co-operation and Development), the cumulative size of infrastructure investments alone required to achieve UN Sustainable Development Goals (SDGs) – initiatives focused around climate change or hunger prevention for example – will total more than USD 70 trillion by 2030, about 3.5% of predicted global GDP[2]. More than 60% of impact investors, driven by a desire to integrate into a "global development paradigm", track performance to one or more of the UN's 17 SDGs, according to the Global Impact Investing Network[3]. The most commonly referenced are decent work and economic growth, no poverty, reduced inequalities, good health and well-being, climate action, and affordable and clean energy.

In other words, impact investing is more than an investment fad. The potential market growth is mirrored by investors' shifting priorities, as a younger demographic is more likely to prioritise sustainability concerns when investing.[4] This trend should continue to push impact investing further towards the mainstream.

Development goals

Major international initiatives such as the UN's SDGs, or the Paris Agreement on climate change, have catalysed and shaped this growth.

The growing significance of SDGs to portfolio managers was underlined by our recent survey of institutional investors, which saw 59% of respondents state that they were familiar with the UN targets.

Nevertheless, SDGs are not an investment template; they exist primarily to steer society rather than individual transactions. They can, however, help frame the impact thesis for an asset: what can it contribute to which goals, and how can this be done? The ability to source transactions where the social and environmental impact is directly correlated to the financial performance is therefore vital.

To identify these transactions, at Allianz Global Investors our impact portfolio managers analyse the specific impact of any project, identifying its ability to contribute positively, along with any challenges to such outcomes. Key performance indicators (KPIs) then need to be developed to align the asset with defined outcomes.

Tracking impact investment

While the financial performance is measured in the same way as any other real asset – through the internal rate of return – there are currently no benchmarks specifically pertaining to impact strategies.

At the beginning of every transaction, the KPIs should be embedded in the procedures and processes. These can be financial or impact-based.

Whether return or impact-focused, KPIs need to be specified from the start and written into the contract, with targets agreed between investors and the organisation responsible for driving the impact project (the vendor). These KPIs will establish specific performance targets and enable investor intervention in extreme cases. Determining the detail around KPIs at the outset is where the skills of the investment team are vital. They must ensure that the counterparty's management team is able to provide all necessary information and fulfil all impact due-diligence criteria. Such an approach creates a feedback loop between investors and management around strategic goals and the measurement of desired impacts. As this level of communication becomes commonplace, investors are noting "substantial progress [in the] sophistication of impact measurement and management practice".[5]

Identifying and managing the process requires an experienced investment team, which will take into account many other factors, including investor demand and any regulatory drivers that would affect asset value.

Impact's growth so far is just the beginning

While typically private markets investments are less liquid – and therefore generally the preserve of institutional investors – impact strategies may offer potential protection; most are backed by real assets, and carry the potential for lower volatility, as mitigation of social and environmental risk is "hard-coded" into the investment process.

As the environmental issues underpinning them become more important – to investors and society as a whole – the impact investing market will likely continue to grow, positioned to meet more environmental and social needs while still seeking attractive financial returns. The range of needs which impact strategies can help meet is vast, and changing priorities of investors will mean demand continues to rise in line; we have already seen dramatic growth, but we believe the impact story has only just begun.

1) Global Impact Investing Network: https://thegiin.org/assets/GIIN_AnnualImpactInvestorSurvey_2017_Web_Final.pdf
2) Page 116, CFA Institute Research Foundation Handbook on Sustainable Investments (https://www.cfainstitute.org/en/research/foundation/2017/handbook-on-sustainable-investments)
3) https://thegiin.org/assets/GIIN_2019%20Annual%20Impact%20Investor%20Survey_ExecSumm_webfile.pdf
4) https://www.visualcapitalist.com/millennials-sustainable-investing-mainstream/
5) https://thegiin.org/assets/GIIN_2019%20Annual%20Impact%20Investor%20Survey_ExecSumm_webfile.pdf

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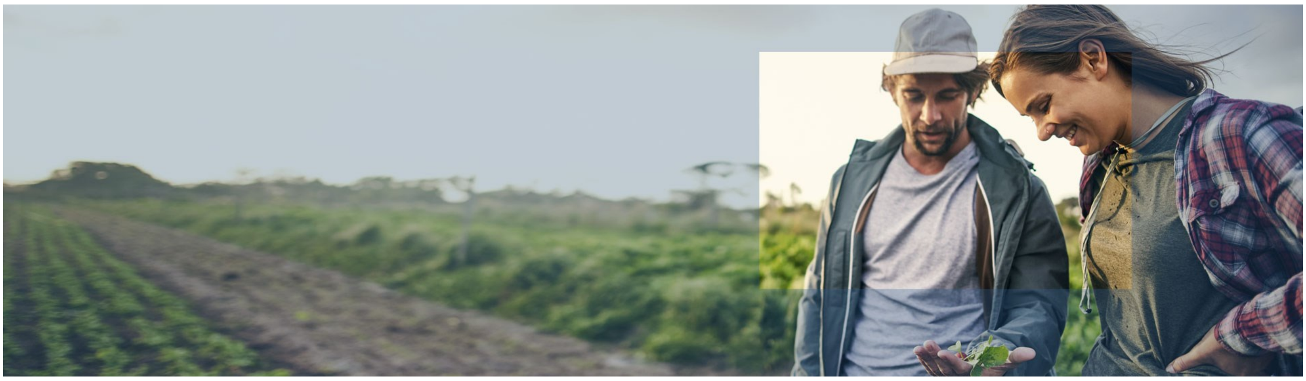

Summary

ESG factors have historically been more commonly associated with equity investments, but the past year has seen a significant change with fixed-income investors pushing for ESG factors to be appropriately and demonstrably integrated into investment analysis and risk decisions.

Key takeaways

- Integrated ESG means the inclusion of environmental, social and governance factors in all investment process and risk decisions
- The ESG focus relating to fixed-income investments has mostly concentrated on downside mitigation, but there is an opportunity to generate positive alpha from companies with improving and transitioning ESG profiles
- A fully integrated ESG process draws on individual and collaborative expertise from diverse research teams covering ESG, equity and fixed income

- The market has yet to adopt a common approach, with a debate around the merits of exclusion strategies compared with integrated ESG's ability to invest and engage with issuers on a transitional path