Impact investing

The investment case for doing good

In conversation:
William Nicoll | Amandeep Shihn | Adam Matthews | Chris Panteli

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The investment case for doing good

Investors generally choose funds based on their desire for either growth or income. In recent years however, another significant driver has emerged as a growing number of individuals and institutions seek to align their investments with their values and principles.

There has been an increasing realisation that, along with philanthropy and government aid, private enterprise can contribute to solving social and environmental problems. At the same time, a growing number of investors are expressing a desire to "do good while doing well".

These 'impact investments' are made into companies, organisations, and funds with the intention to generate measurable social and environmental impact alongside a financial return. They can be made in both emerging and developed markets, and target a range of returns from below market to market rate.

Impact investing is a relatively new term, used to describe investments made across many asset classes, sectors, and regions. As a result, the market size has not yet been fully quantified.

A survey conducted earlier this year by the Global Impact Investing Network however, suggests impact investors committed $15.2bn to 7,551 deals in 2015, with a median amount of $12m of capital committed to a median of nine impact investment deals. These respondents planned to increase their capital committed in 2016 by 16% to $17.7bn and plan to increase their deal volume by 55% to 11,722 deals.

The rapid growth of impact investing has been accompanied by questions about how to assess impact and concerns about potentially unrealistic expectations of simultaneously achieving social impact and market-rate returns.

We brought together an asset owner, consultant and asset manager to discuss the nascent market and share their views on selecting and measuring the success of investments.

Chris Panteli
editor, *portfolio institutional*

The green bond revolution

Green bonds are likely to play a key role in how investors switch to clean energy, but is the asset class right for everyone? *Emma Cusworth* investigates.

Green bonds look set to revolutionise not just the speed at which the world transitions to clean energy, but also how broader bond markets work. The rapid growth of the asset class, which is well supported for continued acceleration, underlines asset owners' increasing interest in accounting for climate change risk in their portfolios.

According to the Climate Bond Initiative (CBI), there are now $694bn in outstanding climate-aligned bonds, an increase of $96bn (or 16%) since the same analysis was conducted the previous year. Within that total, $118bn are "labelled" green bonds – those that have been certified by the CBI to say the funds raised from their issue will be used to finance new and existing projects with environmental benefits. Green bonds saw record issuance during 2015 with $42bn issued, meaning this sub-section of bonds now account for 17% of the broader climate bond market, an increase from 11% the previous year.

INSTITUTIONS DRIVE DEMAND

"Most of the demand is coming from institutions who by nature have a long-term time horizon and are exposed to the consequences of climate change," says Bram Bos, lead portfolio manager for NN IP's Euro Green Bond fund. He points to the risk of exposure to stranded assets (such as oil reserves that will no longer be exploitable as regulations tighten) or higher insurance claims resulting from flooding. Institutions have started taking climate change much more seriously over the last two years as the dialogue around the issue changed in focus away from ethics towards risk management with high-profile commentators, including the Bank of England governor, Mark Carney, suggesting asset owners were in breach of their fiduciary duty if they failed to account for the risks associated with climate change. Peer pressure has also mounted as more institutional investors have signed up to initiatives such as the Portfolio Decarbonisation Coalition. Meanwhile, regulators are also increasing the pressure through agreements such as COP21 and are

becoming increasingly aware of the powerful force asset owners can play in financing and policing the the corporate sector.

Financial innovations, including green bonds and low-carbon indices, have also made the historically challenging task of green investment considerably easier. Some of the world's heavy-weight institutions have already allocated significant assets to these innovations, including CalSTRS, the New York State Common Retirement Fund, Sweden's AP2, France's Fonds de Réserve pour les Retraites (FRR) and the United Nations Joint Staff Pension Fund.

Lombard Odier's Bertrand Gacon, head of impact investing and SRI, says green bonds should be a "no brainer" for institutions. "Green bonds allow institutions to invest in green projects without compromising on their fiduciary duty to provide long-term returns and risk management processes," he says.

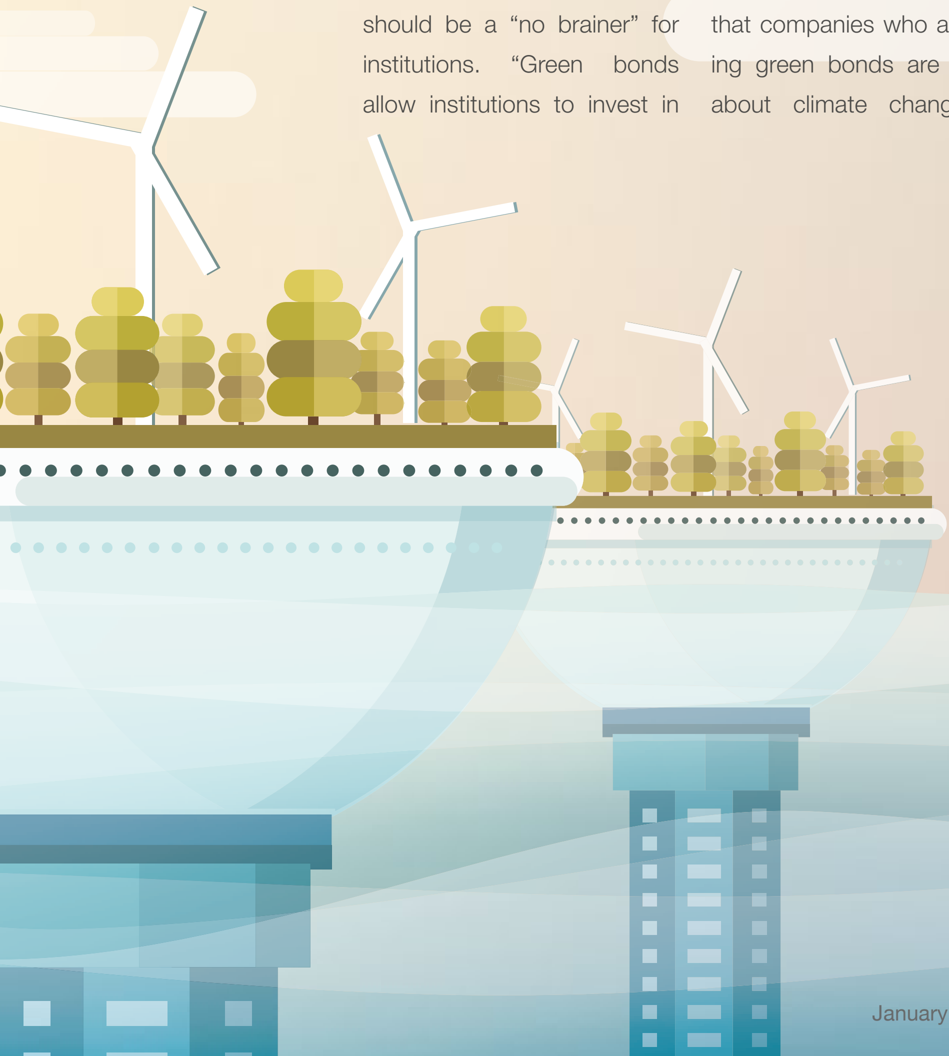
NO COMPROMISE

Green bonds offer the same risk and reward profile as traditional bonds from the same issuer because the default risk associated with these bonds relates not to the specific environmental project being financed, but to the issuing entity. It is therefore the company, not the investor, that carries the risks associated with the specific project.

In terms of yield or spread, there is currently "no difference compared to non-green bonds from the same issuer", according to NN IP's Bos. "In the long-run you could argue that companies who are issuing green bonds are serious about climate change and have lower risks of, for example, having stranded assets on their balance sheets. "We think that the risk of this type of company running into difficulties is smaller and would argue they have a more attractive risk-return profile in the long-run," Bos continues.

So do investors have to compromise on returns to fund environmental projects? "Quite the opposite," says Frédéric Samama, Amundi Asset Management's deputy global head of institutional & sovereign clients. "Low carbon indexes have outperformed the market over the last five years."

The MSCI Europe Low Carbon Leaders index returned 8.75% in the period between November 2010 and May 2016 compared to 7.93% for the MSCI Europe. Between November 2014 and June 2016, the excess return of the MSCI Europe Low Carbon Leaders



> **"Green bonds allow institutions to invest in green projects without compromising on their fiduciary duty to provide long-term returns and risk management processes."**
>
> Bertrand Gacon, Lombard Odier

index was 120 basis points versus the MSCI Europe with an information ratio of 1.25.

Another area where the compromise of green investing has been overcome is that of liquidity. Traditionally, investors would have to choose between either investing in highly targeted projects through private finance, or by going down the less-targeted ESG route.

"Green bonds enable us to design high-impact strategies within a liquid asset class for the first time," Lombard Odier's Gacon says. "Liquidity levels are very similar to conventional bonds, but with slightly less volatility," he continues.

There does, however appear to be some degree of compromise as their positive marketing value is priced into issuances.

Mark Mansley, CIO at the Environment Agency Pension Fund, which invests in green bonds in a "modest way", says: "Currently green bonds trade very close to their non-green alternatives – if they were significantly more expensive then we would be less keen. There is some evidence that new issues of green bonds require less of a yield premium than conventional bonds to get them away at issue, indicating they provide a marketing advantage and making them attractive for issuers and slightly less attractive for investors able to access and keen to find value in the primary market."

NOT ENOUGH SUPPLY

Mansley also points to lack of supply as an issue for institutional investors. "As primarily sterling investors interested in relatively longer maturity bonds and seeking a reasonable amount of credit risk exposure (to get some yield pick up), there are not many suitable offerings," he says. "This is the biggest limitation for us – sterling green bond issuance is only a fraction of the total."

For the market to become more attractive, Mansley says there would need to be more bonds issued, lower maturities and more issuance by corporates and projects offering reasonable spreads (i.e. issuance by A/BBB credits). "We would also like green bonds made more accessible to smaller entities (borrowers) where there is little doubt about their green credentials (e.g. renewable energy projects, social housing etc)," Mansley says.

"We currently have quite a bit of bond exposure in uncertified bonds which we are satisfied are essentially green – issued by typically smaller borrowers reluctant to spend large sums on certification," he continues. "To some extent our bond strategy is about finding value/quality/sustainability in the unrated/smaller/less recognised parts of the market, which is somewhat at odds with the high profile and transparent nature of green bonds."

SUPPORT FOR CONTINUED GROWTH

As the green bond market continues to grow and more entities issue bonds in the market, concerns about the ability of the green bond market to absorb institutional-level flows diminishes and the range of available bonds with varying characteristics should begin to increase.

The last 12 months have seen some notable issues of green bonds. Apple's $1.5bn green bond issuance in February this year was hailed by many as a landmark for the asset class, which according to Gacon is becoming "the single most important instrument in the fight against climate change".

The Chinese authorities certainly appear to share this view. China has been one of the main engines of growth for green bonds over the last year and their support is unlikely to wane any time soon. China will host the G20 this year and is already promoting the idea of mobilising financial markets to tackle climate change and

sees green bonds as a key vehicle to do so.

In a report entitled "Establishing China's Green Financial System", China's central bank, the People's Bank of China (PBoC), paves the way for official guidelines on green bonds, an evaluation system to check the correct allocation of funds and assess environmental impact, creates incentives for green bond issuance such as preferential taxation and interest rates, and streamlines the approval process.

"The Chinese market for green bonds is exploding," says Amundi's Samama. "The Chinese government is pushing very hard and green bonds are the product they want to promote. That means it will become harder for companies to cheat. Furthermore, the introduction of national pollution taxation in 2017 will see the creation of the world's biggest taxation system on polluting companies."

China's role in promoting green bonds could be game changing in terms of the availability of finance for the transition to a low-carbon economy at a faster pace. China already accounts for around 20% of global issuance of climate bonds.

One lingering concern, however, is that China has not signed up to the CBI's certification standards. Instead, it has created its own system, which, although it is inspired by the CBI standards, takes into account idiosyncrasies of the local economy. (As such Chinese green bonds are, strictly speaking, considered to be climate bonds.)

"Transparency standards are largely the same," Samama says, "but there are differences in the definitions of what is green. In China clean coal is considered green, for example. But the differences are minor compared to the overall alignment of standards."

Axa Investment Managers responsible investment analyst Vincent Compiegne believes establishing credible standards for green bonds is important not just in China, but for all emerging markets. "China's standards are good," he says, "but they are not the same as the CBI's certification, which is the best in the market. To accelerate the growth of green bonds in emerging markets, it is important to quickly establish a set of standards, especially in China and India."

REVOLUTIONARY IMPACT?

The impact of green bonds is unlikely to be limited just to the fight against climate change. In an environment of increased investor scrutiny and thirst for transparency, green bonds have the potential to force an evolution in how conventional bond markets work.

Green bonds have a very significant transparency advantage over traditional bonds. The assets raised by certified green bonds are ring-fenced to finance specific environmental projects, which gives investors superior transparency not just in how their assets will be put to use, but also what the environmental impact of their investment will be.

This ring-fencing of assets is something that could spread to wider bond markets. "It offers investors much more transparency and should give them more comfort," NN IP's Bos says.

Lombard Odier's Gacon says because of green bonds' ring-fencing characteristics, the financial community is learning it can take a closer look at what exactly issuers are using the funds raised by bonds to finance. "This allows them to make a more informed decision," he says. "I would bet that in 20 years this will have become normal practice for the whole bond market."

Amundi's Samama is less convinced given the additional costs associated with acquiring a certification regarding how funds will be spent. "Companies are willing to pay a little extra to send a signal to the market they are investing in green initiatives because investors favour companies that do so," he explains.

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Chris Panteli
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Adam Matthews

"For us there is a clear link between our ethical policies and our values."

Adam Matthews

How would you describe impact investing?

William Nicoll: An investment where you have a measurable, positive environmental or social impact, and where you are able to monitor and maintain that investment throughout the life of it.

Amandeep Shihn: Intentionally creating a measurable societal and/or environmental impact over the long term alongside a financial return.

Adam Matthews: A model that serves the general need of society, as well as generating returns. ESG is clearly important, a key stepping stone. We should be encouraging companies that have demonstrated clear evidence of their overall contribution.

Nicoll: What has changed is there is more specialist knowledge in the sector that allows you to make a proper, considered view of what is impact and what isn't impact investing.

Shihn: There's not one technical definition which everyone uses or agrees with. That makes discussions more interesting, more fluid and more dynamic. For clients it's how you integrate that within your framework as an investor and an owner. So there's no one-size-fits-all. There are a number of dynamics which feature in an asset owner's discussions and views, but everyone should have a belief which they put into writing and then into practice and then hold themselves to account by that. We're having more and more discussions with clients in this regard.

Nicoll: If we are funding a solar park, on the surface that looks like an environmentally good thing, but we need to have more detail, more understanding of what the governance of that particular project is. You need to look at all the possibilities for controversy that are there in an ownership structure.

How are these being used or positioned in portfolios?

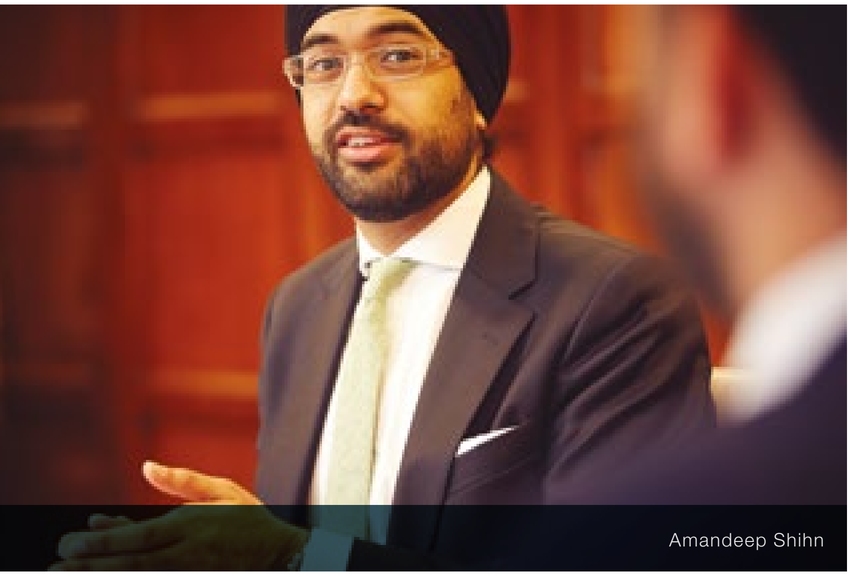
Matthews: We recognise that the church, as an investor, is in a different space to others. For us there is a clear link between our ethical policies and our values. Climate change is one example where we are proactively looking for opportunities. These opportunities include infrastructure, renewable energy and green investments.

The Church Commissioners, for example, are the largest holder of forestry, and that makes a very significant return. Much more emphasis has been placed on it as a result of having a policy on climate change that really sought to focus us much more in looking for those opportunities. It's done within the expectation that it's also got to make the return we seek as well. Having clarity on the values of the organisation and allowing that to drive and to find those opportunities is quite important.

You don't see that being a problem with fiduciary responsibilities?

Matthews: Our Ethical Investment Advisory Group is staffed with experts on ethics, theology and investment theory. They produce independent advice that then goes to our trustees, who balance that against their fiduciary responsibilities. It enables us to very clearly look at these opportunities in line with the returns that we need to make to be able to fund the cathedrals, the pensions and the activities of the church.

Shihn: There is often a perception, it may be a misperception, among asset owners that doing something ethical or doing something ESG-related or sustainability-related might have a negative impact on your financial returns. Infrastructure, renewable energy are all examples of investments which have impacts and can have strong returns in their own rights.



Amandeep Shihn

When making decisions and taking actions concerning sustainability, asset owners need to ensure that these are consistent with their mission and beliefs. Actions also need to take into consideration the materiality of any changes made to their investment portfolios and end objectives, while also fulfilling their fiduciary duty.

Matthews: Is it easy to find information about the underlying assets so that you are comfortable with the price?

Shihn: Data quality and availability is improving. But there is still a long way to go. Schemes like Global Impact Investing Network's (GIIN) IRIS Metrics, have key performance indicators (KPIs) for different asset classes and different asset types that look at the financial and non-financial aspects of an investment. These are meant to be measurable KPIs that you can look at and try to measure portfolios against.

Matthews: Bespoke analysis can play a key role. In relation to climate change, we've initiated a major initiative with the London School of Economics. It allows us to plot where individual companies sit in the transition to a low carbon economy against the 2° target and against the current regulations in each of those sectors. We're doing this with a group of other high-profile asset owners, and will be offering it to the whole market to use and adapt as they see fit. The tool will identify the leaders and potential future investment opportunities.

There remains a knowledge gap regarding what a company's future projected environmental performance looks like. We will be pushing to fill that gap by asking companies for further disclosure.

Nicoll: Do you find there are lots of impact-type investments out there that are easily accessible? Because of all those difficulties.

Shihn: From our client base, the rate of take up or understanding of the investments based in impact is markedly different from a global perspective. We have some very large asset owners, say, in Australia or Canada, which are very much at the forefront of this. They say: "Well, we definitely want to have an impact from our investing so we will go out and look for particular investments. Maybe do our own on-the-ground research and partner up with asset managers and companies."

Whereas some other asset owners are not all as fully up to speed on the topic, or maybe don't have the governance and so are trying to explore what they could do within their constraints. We're also in an environment where pension schemes, in general, have been de-risking. So their proportion of return-seeking assets has been coming down.

Because of that where is the marginal effort in their limited time and trustee meetings? Is it spent on matching assets which are the bulk of the portfolio? Or do they look at the smaller equity part of the portfolio? Looking at our delegated client business, roughly speaking the equity exposure is fairly small, maybe in the region of around 10%. So in terms of time spent and where they've put their mental capacity to work, it's maybe not as high a priority. The discussions with clients looking to explore sustainability for the first time is more in the public equity space.

Nicoll: If you want to put direct money to work, then [primary] debt is one of the obvious ways to do it. That also should link with the de-risking agenda. You can lend to solar companies or building student accommodation or funding hospitals or social housing. The problem that we've seen in the debt market, certainly in terms of impact assets, is that a lot of the assets tend to be very small. So we look to use primary debt, where we try to get sufficient returns to satisfy fiduciary duties, and also know that the information on possible impact should be very good.

Adam Matthews

Shihn: For a number of years now, we have been doing a lot in terms of debt, real estate and infrastructure investing which may also have a social impact. This is something which has continued to grow in recent years and continues to do so.

Matthews: What more could the government do to encourage pension funds in this space?

Shihn: The Department for Work and Pensions changed the wording of their legislation earlier this year. It got rid of E, S and G, which is great, because it goes beyond that. But financial and non-financial are also perhaps not great definitions. Non-financial can very easily turn financial.

Nicoll: The consistent refrain from asset managers to government is consistency and clarity on regulatory regimes. Many of these assets are going to be inside some sort of regulatory regime, whether it's in the UK or elsewhere.

Shihn: If you look at something like solar energy where it's still a very heavily subsidised market, and now that it's becoming cost effective, cost competitive, those subsidies seem to be reducing and that in itself changes the investment and the risk profile for investment. So regulatory regimes are going to have a

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William Nicoll

massive impact in certain parts of the market.

Matthews: The signals from government on renewables in the UK are very mixed. In areas such as renewables key measures and initiatives are being changed very rapidly and one begins to ask the question, "What's the overall policy direction of the government?"

And just being able to signal to asset owners that, "These are priorities. There's going to be a long-term commitment here that we can then seriously look at it in that context." Obviously, we're looking over a much longer horizon, we need to get as much security as we can.

Do you think there is a growing awareness among larger institutions that they have a role to play in society and that they can do something beyond just a membership of their scheme?

Matthews: We believe the market is there to serve a number of societal needs. Clearly you want to receive a pension, but you also want to continue to have an environment that is clean, where you can breathe, with goods that aren't being produced on the back of slave labour, for example. Making every effort you can in your context, and working collaboratively with other asset owners and articulating expectations beyond those is important and consistent with any fund that has a long-term objective.

Nicoll: One of the discussions that we had for many years was the discussion about how can you, in the various different markets, show impact? In the equity market, you're really looking at IPOs to some extent

in order to get the money to work in that way. In the secondary and public debt markets normally you don't have any levers to pull, so you're not usually influencing what the company is doing.

It's clear that there are specialist areas of the market where you can quite happily say, "Yes, I am having impact,"

If you have an IPO, or companies trying to borrow money directly from an investor, you can say no. Or you can say, "Yes I would invest, but we need to change some things." That's a really strong effect, and stronger than saying, "I'm not going to buy your bond." "I'm not going to buy your equity," is slightly stronger than that, but impact investing should be a slightly different way of looking at it.

What kind of time horizon are we looking at here? I take it there's no secondary market for this kind of investment. You're in it for the long haul, right?

Nicoll: The most effective long-term investments that give true environmental or social impact tend to be 10, 15, 20 years long. You don't want a hospital to last two years. There can be exceptions - you might give a mortgage on a new-build building, because it is really driving environmental standards, and that might only be five to seven years in maturity. But you're generally talking quite long term. It is a question again of, if there's more understanding about what an impact asset could be, then gradually over time, the store of assets should increase. Over the next decade you could have a really significant impact on

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William Nicoll

how the environment looks.

Shihn: There's always going to be a secondary market to a certain extent, and there will be people willing to buy out other stakeholders of a project, whether it's impact or other private equity or any sort of private market investment.

Nicoll: Liquidity will follow the client interest as well. If we were all able to build these markets correctly, then liquidity would follow because everybody would know what they look like.

Shihn: But liquidity isn't always necessary. You may want capital to be locked up to ensure that everything is put to work. So lack of liquidity, perhaps, is a benefit at an earlier stage in the development of a newer industry or asset class or development project.

So given the length of these terms and the fact that they're defined by their targets almost, how important is dialogue with the projects you're investing in?


Amandeep Shihn

"Everyone should have a belief which they put into writing and then into practice and hold themselves to account." Amandeep Shihn

Nicoll: Vital. None of this works without it. That's the point. You can only truly talk about impact investing if you are having a very close dialogue with the borrower or with the people raising equity. You have to be close enough to be able to decide very clearly what you want and what might need to change in order to satisfy your particular definition of impact investing.

As the market and as the banking sector retreats from various different sectors, then we do have the opportunity to invest in more areas and to have those sorts of dialogues where long-term capital is talking to long-term borrowers in a way that's not intermediated.

This has to be a very open discussion about what companies may want and what investors need so that, in the end, the driver should come more from the clients about where they think sensible impact is.

Matthews: Do you think that there's a need for higher-level of dialogue from asset owners on this?

Nicoll: Part of the reason we spent so long forming these criteria is to be able to say, "Here are some criteria. Now we have something to discuss." So a pension fund can say, "Well, that's great but I don't like that." Or, "You're wrong," and that's fine.

We need to have that sort of conversation going because at the moment we are still in a slight information vacuum. We all need to be very clear about what we're trying to do.

And you do have to do quite a lot of work to get to strict, standard criteria. And this involves a lot of knowledge transfer which requires more discussion between client and asset manager. Until you really start talking to people, you don't really know whether you have found a perfect asset or not.

Matthews: Has the asset owner community articulated their views in this area?

Shihn: Asset owners also need to be a little bit more proactive. They will always help drive a particular view. Asset managers serve at the pleasure of asset owners, so when we talk about products being created, it's not typically the asset managers.

Matthews: Where would you say the noise level is?

Shihn: In the DC space, it's a little bit more evident when you have individual numbers sending in letters to the trustee boards saying, "Hi, I've read about this. What is our exposure and what are we doing about this sort of topic in general?"

Then the DC pension scheme trustee board has to say, "Well, we already have a response for that. This is what we're doing. Let's be a little bit more proactive, maybe we need to be a little bit more vocal to our members if we're being asked these questions." Maybe they do a lot of this already, so it's just about telling people a little bit better.

Nicoll: You're right, a lot of things are done and a lot of decent investing is done but it's not something where the information exchange has been particularly good because it's not been something that clients have particularly been focused on.

There's a lot of ESG-type work done that I don't think is particularly shouted about. Until you're doing that, it's very hard to then go onto the impact and say, "Now, let's develop it further, from, 'Let's do no harm, to, 'Let's do something positive.'"

Is there a typical type of scheme looking to do this?

Chris Panteli

Shihn: No, I don't think so. It comes down to beliefs and ambitions. What is the scheme trying to achieve and do they have the mandate to do it? Do they have the belief that it is the right thing to do? Not only on behalf of them but on behalf of their members and their contributors.

I take it this is something that's very hard to replicate in DC given the active nature of most of it?

Shihn: We've been thinking about how we do longer-term private markets type investing in DC for quite a while. I'm not sure we've found a solution yet, but that is mainly a function of requiring daily liquidity. It is going to be tough, but where there is a will and where there is capital, there is going to be a way. But so far, the interest in DC has largely been on the listed equity side because of liquidity issues.

Nicoll: Measurability is the important thing otherwise you can't show you've done something. If you're looking at an investment saying, "That is so many tonnes of CO2 equivalent," or, "I've just built a 400-bed hospital," the equivalence between these things is clearly impossible to measure, but how do you try to report those things and show those things to people?

Matthews: We examine very carefully individual investments. This has happened with climate change, where our policy challenges the national investing bodies (the three funds of the church) to proactively manage our fossil fuel investments. In doing so you have to take trustees along with you in that process. That's been quite an engaging process in terms of getting assurance from their side that this actually does deliver what they're expecting.

Nicoll: Do they demand data? On forestry, are there discussions about how many trees have been planted?

Matthews: Understanding where there are opportunities in terms of land management goes beyond just simply holding the trees. It's how you manage it proactively, the whole estate in a sense. It's a much

William Nicoll

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Adam Matthews

broader responsibility there.

Nicoll: Biodiversity is very difficult to measure.

Matthews: Yes, there is an increased range of indicators in terms of managing biodiversity. For each indicator you need to have the expertise.

Nicoll: Clearly, as asset managers, we can offer things that we think are what people want from our discussions with them. When you look at the various different sub-asset classes, they're really quite small which is why you end up with little ability to say, "I will do a CO2 reduction fund." You need to have choice to invest wisely and sensibly because these are long-term illiquid assets.

So you end up with a very broad discussion, which I hope gradually over time separates into various different asset classes saying, "Does this asset do something good? Can I measure each asset for the good that it does?" But it does mean that the reporting is therefore a mixture of effects such as, "We've done some CO2 reduction." You've built some hospitals, you've removed some coal-fired power station capacity". They're all slightly separate.

Again, when we talk about the level of information exchange needed, that's quite high. It would be very easy to go to investors saying, "Here is a fund. You've reduced that much carbon dioxide." Every investor would understand that but you just can't do that on an institutional scale yet because at the moment the markets aren't developed enough.

“We’ve seen pension funds going from ESG to more interest in impact as people become more aware that you don’t necessarily have a financial penalty for doing impact investing.” William Nicoll

Shihn: Do you think that there is a need for a more consistent measurement for CO2 emissions and carbon footprint? You can take a rating for a particular fund or a particular asset and get three different people to measure the carbon footprint and give you four or five different measures and metrics, none of which will be any way similar to each other. That is an issue.

Matthews: Of course, if you have four different answers to the same question then that’s concerning. That is an evolving area that’s rapidly improving and refining. Over a relatively short period of time, hopefully we’ll see that kind of clarity.

The initiative that we’re working on at the moment allows us to plot performance of companies against the 2° goal. We need a lot more disclosure, and governments need to step in with increased disclosure requirements. Things like the task force on climate change are going to be critical, and hopefully ensuring some of those standards and that reporting is codified or more clearly required. But at the same time, there’s a gap in knowledge. A group of asset owners are working together at the moment internationally to define for each sector what transition looks like, and to put that information out there and offer it up to whomever.

We’re working with The Environment Agency, a pension fund and a range of other major partners as well.

Nicoll: It’s going the right way. If you look at green bond verifiers, you need to have more than one. You have rating agencies who have slightly different views but don't tend to have dramatically different views, I'm sure as the market evolves and the number of third parties who are willing to certify the amount of CO2 equivalent that's saved will converge. In some ways, I'm quite positive about the fact that there are so many people involved already. You can look at it the other way and say, "Actually, the level of interest compared with the amount of investment is quite high."

Shihn: It's harder when you have different providers providing thoughts to asset managers. We've got three different metrics for the same thing from three different providers. One is the asset manager, one is the custodian, which is more correct and who should I be paying attention to?

Nicoll: The more people who are comparing these things, the more consistency comes through. It feels to us, from the asset management side, that there is more interest. We've seen pension funds going from ESG through to more interest in impact as people become more aware that you don't necessarily have a financial penalty for doing impact investing. Part of that is down to the fact that the very first impact investments tended to be much more socially driven rather than financially driven. As that awareness develops, then I don't see why this market doesn't grow significantly.

Matthews: Equally, the question back to asset owners is, how do you put into practice your values and beliefs as a fund, and see that taken through in your investments?

As disclosures and information flow increases, there's opportunity for much greater clarity in how companies and asset owners can support markets to grow. As that information flow comes forward, I can see companies going much further on climate change.

Shihn: Again, measurements and performance, everything is moving in the right direction so impact investing will become a bigger topic until no one talks about it anymore. You can make investments which have great financial returns, and also have the benefit of creating a social impact on the end of it.

Amandeep Shihn

Impact investing: a growing market for institutional investors

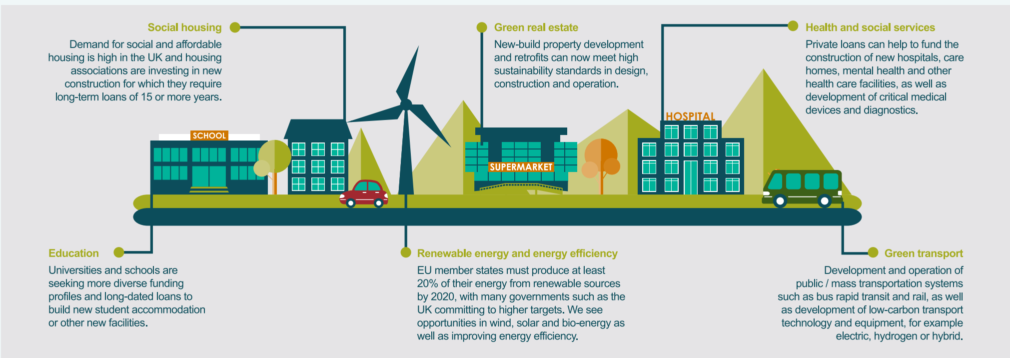
By William Nicoll, co-head of Alternative Credit, M&G Investments

The world requires investment on a huge scale to address environmental and social challenges, such as carbon emissions, disease and poverty. As such, impact investing (investing to achieve social/environmental benefits in addition to attractive returns) is a growing area and, given increasing constraints on public resources, mobilising private investment is imperative. Impact investing is therefore increasingly becoming of interest to institutional investors. While impact investing first became established in equity markets, lending in all its forms accounts for far greater flows of finance to corporates and organisations, leading to opportunities in debt investment that are commensurately larger than for equity.

Understanding the approaches to sustainable and impact investing

Although sustainable and impact bond funds comprise a small segment of the fixed income fund universe, they take a variety of approaches to investment:

- **Using an ESG scoring system**, which ranks companies in a given investment universe based on their environmental and social credentials. Investors can target companies with high ESG scores relatively straightforwardly; however, ESG scoring typically covers companies with liquid fixed income securities only, with little information available on private assets.
- **Negative screening** excludes from an investment universe all companies involved in certain activities e.g. tobacco, weapons. While simple to implement, this does not target a direct positive impact.
- **Green bonds** lend to projects seeking a direct positive environmental impact, e.g. reducing carbon emissions, generating renewable energy. Though demand for green bonds is rising, the market is still relatively small, with a total outstanding value of 94 billion[1]. The first green bond was issued only in 2007 by the European Investment Bank, and issuance is still concentrated in supranational and government agencies such as the EIB, World Bank and Transport for London. In our view, supply is arguably not yet sufficient to construct well diversified portfolios of green bonds..
- **Private debt impact funds** lend to projects that seek a direct positive social or environmental impact. They source, create or acquire assets that target demonstrable environmental or social benefits, alongside financial returns, and report the impact each investment generates. Impact funds have (historically) been predominantly small, concentrated products such as microfinance and, in many cases, financial returns have been a secondary consideration. However, this is changing with the emergence of institutional sized private debt funds offering more attractive return levels whilst maintaining the positive impact.



The appeal of private debt impact investing for institutional investors

Private debt includes a wide range of assets that offer sustainable outcomes and many more “pure play” impact investing opportunities than liquid bond markets, often because they are financing discrete projects or smaller companies, rather than broad corporate loans. Many of these assets are suitable for institutional investors because they are long-term investments that require the investor to give up a degree of liquidity, in exchange fora higher premium. Since short-term liquidity is generally of less importance to institutional investors, this is exactly the type of investment that can be beneficial. Additionally, it creates scope to diversify portfolios.

Selecting an appropriate investment manager

As this market is still developing, it is essential for institutional investors to select an investment manager with proven strength in this area, e.g. breadth and depth of private debt experience to source and analyse assets, an ability to be flexible with deployment to avoid being a forced buyer of assets, and a rigorous understanding of both the opportunities and limitations of the various approaches to impact investing. With £20 billion[2] of fixed income impact assets under management, M&G is a large player in the market and understands that a good impact investing strategy should target three objectives:

- A clear positive social or environmental impact
- A competitive financial return
- A high degree of flexibility to invest in a diversified manner

In M&G's view, private lending offers the greatest breadth of attractive opportunities to achieve these goals. In our view, a multi-focus approach is best, to ensure a broad range of environmental and social benefits, sufficient diversification, and a wide opportunity set to maximise returns. Returns are generally comparable to other private debt strategies and usually pay a premium over public bonds to compensate for their lack of secondary trading opportunities. In addition, the ability to negotiate directly with the borrowers allows higher protections.

Emphasising all the advantages of active management, impact investing requires skilled and experienced managers with well-established networks of borrowers, banks and intermediaries, as well as expertise in credit analysis, structuring and covenant negotiation. Also important is an excellent knowledge of ESG and impact standards.

A robust process to measure and report the social and environmental outcomes of each investment is essential for any impact investment strategy. Examples of impact measurements include the number of social homes built, , or the reduction in CO_2 emissions from renewable energy projects. At M&G, external partners provide specialist ESG research, and sustainability and impact assessment criteria appropriate to the private and illiquid assets that we source.

When managing investments, engagement is vital. Maintaining open lines of communication with borrowers allows us to advise and support management should any risks emerge to either credit or the quality of the anticipated social/environmental benefits. Engagement is often much more effective in private debt compared to public debt, because of the closer relationship between borrower and lender. As the lender is often a key funding source for the borrower, it can have more influence.

Case study: Lightsource Renewable Energy

In October 2015, M&G agreed a £247 million bilateral refinancing of 33 solar parks with Lightsource Renewable Energy. This was a 22-year inflation-linked senior financing, secured against fully operational solar parks mainly in the South and East of England and was the world's largest Sterling-denominated renewables bond. M&G's role was central to the transaction – our team solely arranged, structured and negotiated the transaction, creating different payment streams for differing client funds. The debt was tranched in order to achieve differing risks and returns for differing client funds. A CO_2 saving of approximately 43,430 tonnes per annum is expected. The transaction has been recognised with the "Environmental Bond of the Year" in 2015 from Environmental Finance and "Best European Solar deal of 2015" by Infrastructure Journal Global.

[1] MSCI Global Green Bond Index, as at 19 October 2016
[2] As at 30 September, 2016

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