IMPACT INVESTING: QUESTIONS AND ANSWERS

Investing to earn a return while making a positive environmental or social impact is a growing market. Indeed, more than £500bn globally was working to make a difference in 2020. To find out how investors are approaching such strategies, we brought asset owners, consultants and analysts together to discuss the market.

***portfolio institutional:* Melanie, is impact investing universally popular across your schemes?**

Melanie Cusack: There is a mixed reaction, which might be a generational thing. There is still a fair bit of history around the argument that doing something good with your money means compromising the level of returns you get. We have to overcome that misnomer, as it has been proven not to be the case. There are still a lot of people who believe that and argue that sponsors will not want to give up returns, which is a lame argument.

It is a slow process. The compliance work we have to do helps because it makes people think about it sensibly, but the active impact has not happened, as yet, as much as it should have.

Naomi L'Estrange: Specific active impact investments are still perceived as quite difficult. We need more help from consultants to bring the right funds to boards. Nonetheless, across the board we are trying to monitor the impact of our investments and there are several changes going on across our portfolio but there is a lot more to do.

PI: In what ways can investors make an impact with their capital?

Aaron Pinnock: Impact investing is a continuation of our responsible investment process. It is not a carve out of funds to the side, but an approach to increase the general impact of our portfolios.

We are trying to make our direct holdings carbon neutral and increase the net biodiversity gain where we can. On the mandate side, we are always looking for impact or ESG-aligned investments. It is as much an advocacy or engagement approach with our companies and managers as much as it is trying to find new investments.

Oliver MacArthur: On manager selection, we help clients with potential strategies they can deploy, from ESG to impact within public equities.

From our own influence, in discussions with managers we share what we have seen from other managers that perhaps they might consider applying in their portfolios, such as using a particular framework.

Allowing clients to have the tools is one element, but then also using our position as a gatekeeper to share best practice where we see it and show how we are thinking about impact.

PI: Is there a lot of interest among Aon's clients for impact investing?

Tim Manuel: There is interest, but there is no one-size-fits-all conversation with trustees. I walk into trustee rooms and are faced with a whole spectrum of positions and counter arguments on this.

It is important to go through a process, which looks like what we went through a few years ago on responsible investment, where education is important at the outset. Then engaging with the right stakeholders – whether that is the trustees, the company and the other advisers – to make sure everyone is on the same page in terms of understanding. Then it is important to think about what trustees are trying to achieve and get that articulated, so good decisions can be made down the line.

PI: What trends are emerging in the impact market?

Bella Landymore: There is huge interest, but there is a lot of misunderstanding about impact investing and confusion around what action you can take.

We as an institute are set up to grow the market in whichever way we think is appropriate and helpful to our stakeholders, from trustees to consultants to fund managers.

The misunderstanding that impact investing involves sacrificing financial return is a myth that we have set out to bust, along with the idea that impact investing is not compatible with trustees' fiduciary duty.

We have looked at that in different stages. We have tackled the fiduciary duty issue through legal analysis with City law firms, ratified by the Association of Pension Lawyers, to demonstrate that impact investing is compatible with fiduciary duty.

Then how to put it into the context of the investment decisions trustees make. What does it mean to set impact objectives? What does it mean to measure, monitor and report on your impact and financial returns? What criteria are you going to use for your investment consultants and your fund managers? How can you take an impact lens to your standard governance procedures? We have published a set of principles which are written by and for the pensions industry.

PI: Aaron, we have heard that investing to make an impact does not necessarily mean lower returns. Is that right?

Pinnock: We see no difference between the performance of our impact or ESG investments and our regular investments.

One example is forestry. We see our forestry as impactful because they are sustainably certified and managed, and contribute to a more circular economy. Forestry assets have performed well for a number of years, and possibly the realisation of the future environmental benefits that forests can bring is helping this.

In private markets we have seen performance generally aligned with 'non-impact' funds. That is because we do thorough due diligence on all our funds, we do not go into impact blindly.

Cusack: You do not go after a fund because it says it is impact investing. It is part of the analysis you go through when selecting a manager to deliver your strategy. That process has not changed, it is just there are other factors to consider.

One might trump the other because they are more impactful. That is the only way of doing it because the past is not a good guide to the future. I have referred some trustee boards to various papers that have been written.

They also ask how they can make an impact if they are too small to do direct investments. That goes back to doing appropriate due diligence of the manager.

In this area, do not let perfection get in the way of progress. Just one small step can make an impact, rather than trying to make your whole portfolio, all at once, the most impactful that it can be. You will never get there, so just start somewhere.

L'Estrange: There are lots of trustees and investment consultants who are quite risk averse. We still see that box ticking approach, but I aim to flip it around and say: "You have this pool of assets, whatever size it is, how exciting is the opportunity to make a difference with whatever cash you have." Everything we do is trying to turn that around, trying to leverage as much as we can.

There has been a vicious circle around everyone being scared to move first. It is trying to flip that around to encourage everyone to see what a fantastic opportunity this is to do more and help secure the planet that all our members' children and grandchildren will live on.

Cusack: One of the problems is having the funds available to do this and not being one of the first investors. A lot of people do not want to be the one who takes a risk on the fund and finds that it flops. That is quite difficult. It is not an excuse, it is a recognition that this is the world we are operating in. It will get better.

Tim Manuel
Head of responsible investment
Aon

L'Estrange: This is why we are challenging consultants to challenge fund managers to look at the whole of their portfolio. Not just where they are advising us, but on everything they do to ask how they are monitoring their impact? Are they monitoring their carbon footprint? These questions will encourage them to push fund managers to put the right funds in front of their clients.

PI: Is making an impact limited to equities?

Anna Rudgard: Fixed income is an asset class that is benefitting from a multitude of innovative strategies coming to market. The most obvious in the impact space are green bonds, which is a growing part of the market. That is widening out with social bonds, blue bonds and, more recently, sustainability-linked bonds. These combined with the greater variety of issuer in bond markets, such as municipal or local government bonds, offer a huge opportunity for fixed income investors looking to make an impact.

PI: Are you challenging asset managers to make sure there is enough opportunity?

Rudgard: Absolutely, and within corporate credit there has been a growth of sustainable titled products coming to market, where I am also interested is beyond corporate credit in other fixed income sub-asset classes.

I saw a presentation recently that said asset-backed securities are the most ESG friendly asset class given the look through you get to the end borrower. If one believes this, then you can certainly construct your own impact portfolio from them. It is the idea that impact investing is a lens, a philosophy and once you have adopted that approach the investments that you can make from that point are varied.

PI: How is Aon helping its clients in this area?

Manuel: We work with several schemes which are quite well progressed in this space. There is one client in particular that has influenced me in the way I think about this. They are the longest-term investor we work with. All their equity mandates have absolute benchmarks and 10-year investment cycles. They believe that the way they will deliver their return objectives is by investing in impactful investments. Those are the investments that will be most successful over the long term. For them, the conversation has completely flipped.

There is some complexity and fragmentation in the way that impact investing is defined, we currently have different groups working on different things, and we don't have a consensus. This client has put that noise to one side and they just work from an assumption that impact can be achieved everywhere. They know they do not have all the answers, but that is not their job. Their job is to ask the challenging questions.

They have built impact objectives into their public equity mandates, their private market mandates and even, this might sound slightly ridiculous, where they have some synthetic exposures. They have challenged their managers to try and achieve it.

I am not saying that they have done this, the point is they believe in it, they are trying, they are ask the challenging questions and leave it to others to come up with the answers. I like how they approach it.

A core foundation to their mindset is that they are, as most pension schemes should be, a proper long-term investor.

PI: Is Bella right that this is part of the fiduciary duty?

Pinnock: Impact investments are addressing the systemic issues we face, not just as investors but globally. Climate change is probably the easiest one for people to get their heads around and to point to. This is where the TCFD is useful. If you do scenario analysis of your portfolio across varying global temperatures, we have found the most frequent result is that 3-degrees-plus is poor for everyone from a returns perspective.

By investing into climate solutions, you are not just investing into assets that could potentially do well as a result of the climate transition, but they are also reducing the systemic risk of your portfolio, as these assets are contributing to a lower temperature world. If you are investing into that lower temperature world, you are reducing the risk bucket of the entire portfolio if you are taking that long-term horizon.

That is probably the best way to look at impact investments, in that you are addressing the systemic risk your portfolio is prone to over the long term.

Landymore: When we worked to demonstrate the compatibility of impact investing and fiduciary duty, it was for this point. It is about delivering long-term benefits to your members; it is not about wanting to do good in the world. That is not a pension scheme's job. A pension scheme is there to deliver benefits to members.

This idea of a transitional mindset: that if we are looking at long-term investments, if we are looking at the outcomes for members who are going to retire in 40 years' time, what will the world look like? What investments will have stood that test of time?

It is not just about doing good. It is about taking a lens to your investments over the long term and seeing what is going to perform best.

Cusack: What is the point of having a pension if you cannot spend it because the world has gone. It has taken it right down to the member level.

There is no argument against doing this, whichever way you look at it. It is taking time. And pandemics do not help in terms of keeping the focus.

PI: Interesting point. How has the pandemic changed attitudes towards making social impacts?

Landymore: The pressures on pension schemes are immense, with rafts of new regulation, but we have seen record inflows into ESG, and impact has taken centre stage.

It has not just been the climate crisis on people's agendas. The health crisis, mental health and social factors have come to the fore, as have the links between the E and the S in ESG. This idea that to an extent climate change has caused biodiversity loss, which is one of the factors that causes pandemics; recognising the interrelation between those two and that we cannot address one without taking account of the other.

That has been, for want of a better word, a positive trend in terms of raising awareness and getting a focus amongst regulators and investors on the range of issues that need to be addressed.

PI: Has the pandemic hardened your resolve for investing to make social and environmental impacts, Aaron?

Pinnock: Being a faith-based investor, we have always focused on the social side, nevertheless, the environment has been our number one engagement and ESG topic.

On the social side, the outsized negative effect that the pandemic has had on ethnic minorities and other groups of people, as well as the Black Lives Matter movement, has brought diversity and inclusion to the front of our minds. We are doing a lot of work on that.

The key workers debate has been interesting. We are looking at ways in which we, as investors into big tech and other companies that directly and indirectly impact key workers, can influence that dynamic.

Oliver MacArthur
Senior consultant,
Impact Research Lead
Aon

These are two interesting social areas that we are trying to use our voice for.

MacArthur: There has been a greater acceleration on the environmental side where companies are clamouring to commit to a net zero target. Last year, partly due to the pandemic, we saw a better environmental outcomes with carbon emissions down by around 7%. But to hit the net-zero targets by 2030 is going to need a substantially greater reduction, which is scary considering how the world changed last year.

On the social side, we saw Covid exacerbating inequalities in society. People who can work from home maybe did better than key workers who were regularly exposed to risk of the virus.

Internationally, we are seeing the difference between the countries that have the

vaccines and those who do not, so there is a need for impact investing to increase.
From my own experience at Aon, clients are making more of an effort in this area. In the past year, a lot of that discussion has been translated into making such a move. There is still divergence across the client base, but pockets of action and acceleration are happening.
Cusack: If it wasn't for the pandemic, would we have made more progress? Business has carried on throughout and there are compliance issues, but I wonder if we would have been further ahead because people were able to focus on this rather than all the other issues.

PI: What are the barriers to making impact investments?

Pinnock: Even though we are a faith-based investor, we have a fiduciary mandate. We are searching for 'win-win' investments: those that have a positive impact and risk/return profile broadly in line with our other investments.
There is a high bar in which we choose our managers, and the nature of impact investing in being a new and nascent area, the investments that come to us often do not have a track record and the areas they are investing in are often unproven.
It is trying to get comfortable around the strategy and the team that are involved in an impact investment compared to our regular investments. Sometimes we can get comfort from that.
We expect the market for these types of investments to continue to expand over time.
Landymore: The lack of track record and the perceived lack of product are issues for pension schemes because of fiduciary duty, size and other constraints. No one wants to be the first mover. It is about finding a track record for that strategy, manager or asset class.
We have researched the UK's social housing market. What does it look like in terms of its risk/return characteristics? This is the first time it has been done and demonstrates that, as an asset class, it is a viable investment for institutional investors with fiduciary duties.

Anna Rudgard
ESG fixed income fund research
Aon

We then have to find examples of where pension schemes have gone before, so people do not feel like they are the first mover.
In the UK, unfortunately, it is hard to find those examples, so we had to look globally. We have found some good examples of large institutional investors who have made pioneering and successful impact investments, which we take to pension schemes to demonstrate what is possible.
Manuel: Pensions for Purpose published a collection of polls around impact investing about two years ago. What came top in that poll, in terms of barriers to impact investing, was a lack of understanding and lack of consultant recommendations. We re-ran that poll and it was a lack of opportunities and concerns about sacrificing return that came top this time.
For me, the market has moved on. That means the education strategy needs to change and highlighting schemes that have done it successfully is critical.
But some schemes who have done it successfully do not want publicity. In some ways, that has enabled them to go about it without worrying about what might come back to them when they put their head above the parapet.
It would be great if we could encourage those schemes to help others realise that the concept of first mover is a myth that needs busting. There is no such thing as being a first mover in a market that is worth $700bn.
L'Estrange: Absolutely. There are lots of trustees who do not want to do this because they are subject to the myths around returns.

PI: Is it possible to make an impact in short-term strategies?

Rudgard: It is possible. We have seen green bonds issued with a one-year duration.
Coronavirus is another example of where there have been opportunities for impact investors. You need to have a nimble investment strategy to address those short-term needs. Perhaps where there might be a struggle is that there are not as many pooled investment vehicle options coming to market, such as short-term impact bond funds.
L'Estrange: It would be interesting to talk about defined contribution. I have been disappointed in the government's approach to support for the pandemic – there was an opportunity to attach requirements to government support which could have made a huge impact, but that opportunity has been lost.
However, the consultation on infrastructure is a huge opportunity. Infrastructure is an area where you can have a fantastic impact, deliver great returns and is an

Naomi L'Estrange
Managing director
20-20 Trustees

engagement tool. Because younger members tend to be more interested in this and master trusts are rapidly gaining funds, there is an opportunity to tie all these pieces together to get some of these case story wins. Then you can expand the fund range at less risk for defined contribution schemes. There are huge opportunities here and we need to lobby in every direction to support each other.

PI: Is impact investing a lost opportunity for DC?

Cusack: There is a risk of trustees focusing on their strategy for DB without recognising the importance of DC. If a DC scheme member wants a fund that does X, why can't the trustees set it up. Usually, it is not that difficult, it can be self-select and makes members feel good because they have been listened to. That is something we should be doing as matter of course.

DB engagement is more challenging, although I heard a case study of someone using recycled plastic to make affordable furniture. An organisation put one of these chairs in the foyer of their building and said this is what your pension scheme is doing. It is tangible evidence of doing something worthwhile and being responsible with an investment.

Landymore: Aon is doing great stuff in this space, but when you speak to the different parts of the chain – trustees, consultants or fund managers – there is a lot of finger pointing. It is always someone else's fault. We have put a lot of pressure on trustees, who are under pressure already, and so this is a call to action to investment consultants.

There is an onus on them to search out that product, to bring the idea to the trustees, to educate them that this is a strategy worth pursuing. We are not getting that level of proactiveness from consultants.

Cusack: I did a webinar for professional trustees talking about, not so much impact investing, but SRI. Everyone was complaining about not having the tools to do it, but no one was asking how to get them. It was disappointing because it was that finger pointing Bella talked about.

Manuel: I want trustees to challenge us. The more we are asked the question, the more I can corral resources and expertise to try and find those answers. I want those challenging questions to keep coming.

L'Estrange: That is exactly what we are trying to do. We are about to issue a document to all the consultants advising us, saying that each year we are going to ask you certain questions. We are going to keep asking them to achieve continuous improvement.

PI: What returns do you expect to make from impact strategies?

Pinnock: We expect to make the same returns as our non-impact strategies.

The issue with this question is that impact investing covers a very wide spectrum of returns and means different things to different people. To say that an impact strategy is likely to return X%, is similar to asking how much will a technology investment return? It can make nothing, or it could make an awful lot.

Manuel: Getting back to DC, we thought we should sort our own house out first. Aon's DC plan has an element of impact investing. It was put in first as a self-select option and was one of the most actively selected. It now features in the default strategy.

It focuses on public equities and it now has more than £70m invested.

When we communicated this, the general reaction was a sense of pride in what their money was doing. Not one person said, "I wish we had not done this."


Melanie Cusack
Client director
PTL

PI: How do approaches to public and private assets vary in impact investing?

Rudgard: There is an argument that you get more influence and control through a direct approach, but to make it an opportunity for all sizes and investment levels, there needs to be pooled fund options. Not everyone has the ability to invest directly.

The overall approach is the same. The ideas that underpin how you are making the investment are the same, the difference comes in terms of the closeness and the control that you get within the actual investment when investing privately.

MacArthur: Private assets have a greater potential to make a deeper impact. You could, perhaps, see more clearly how your money is explicitly influencing an outcome. In the public markets, that is increasingly becoming part of the conversation. Some might say it could be democratising impact investing from its endowment-led background to a more mainstream offering.

From a broad public equity context, we think about delivering impact in two ways: using equity financing to support companies offering better environmental and social outcomes, like clean energy companies, vaccine suppliers or providers of meat alternatives.

Then there is using the tools of active ownership to encourage change, whether that makes a business more sustainable or aligning them with stakeholder interests, say with natural capital accounting, for example.

Public markets increasingly have a role to play. Previously, impact investors have looked down upon public equities, which has changed in the past couple of years. Hopefully, that continues because all asset classes have a role to play in the broader conversation.

PI: How do you measure the impact of such strategies?

Pinnock: A common approach from our managers focusing on impact is to target just a few KPIs that are directly relevant to the business, baseline them and then see how extra capital and active ownership improves the performance of these over the course of that investment. This is not perfect, but it is one of the easiest ways for fund managers or portfolio companies to collect that information. It is easily digestible by the asset owner, so it is probably the best way at the moment to look at your impact at this level.

It becomes more difficult if you are taking an impact lens in addition to your responsible investment approach, for example across your entire portfolio. We try to look at our alignment to impact through revenue or investment in certain themes and that is where the EU taxonomy can help.

Landymore: There is no one-size-fits-all way to measure an impact investment. There is no best example. There is no standardisation. It is a rapidly evolving area.

Just do what you can. There are many options out there and every fund manager is going to do it differently.

The issue for the consultants and the end investors is translating that information into something that is comparable and understandable. The problem is the onus often lies with the end investor to make sense of that.

The only caution in picking one impact KPI is the risk of ignoring some of the negative impacts a portfolio might be having. Again, it is asking difficult questions about potential negative impacts, asking about the frameworks the fund manager is using and how they are improving the information they are providing you.

There is a huge range of options and until there is a standardisation, the advice would just be: pick one.

Manuel: What is the point of measurement? One is to support decision making. There is no shortcut to due diligence. Measurement frameworks bring more information and new lenses into the mosaic of information that goes into the due diligence process.

The other reason is engagement and communication. That is where some of the measurement frameworks can only solve part of the problem. We have found that the way members get engaged through those communications is more from the stories than the stats. Stats are a bit abstract, while case studies bring the situation more to life.

Obviously, in those stories there is a challenge around cherry picking. It is important for trustees to choose the case studies they want to show rather than let them be dropped on them by managers where it is easy to find a good story in any portfolio.

Pinnock: People hiding behind measurement being the major issue is a stalling tactic. The likelihood is that an impact fund is probably going to deliver a better positive impact, if not the same, as a standard fund. So, take the plunge.

MacArthur: In the lack of standardisation and regional frameworks, I can see parallels with the ESG data debate from five years ago. We are seeing good incremental efforts coming out of mainstream data providers on impacts. There is lots of innovation from the start-ups, so maybe we will see a shakeout with more mainstream providers coming forward in the ESG data space in the next two or three years. To pick up on Tim's point, there is a trade-off between complexity and accessibility, so professionals can get lost in a zoo of acronyms.

I like the efforts some participants have made to bring in impact calculators, which could help make the connection between your money and how it is changing in the world. That is the skill for consultants to navigate this zoo of acronyms but also translate it into actionable ideas that people can take forward.

Bella Landymore
Policy director
Impact Investing Institute

PI: Are trustee attitudes towards this market improving?

L'Estrange: They are, particularly over the past 18 months. Some of that has been driven by compliance and some by changes in the world.

A couple of years ago I was already passionate about it, but I was concerned about having the answers before I was vocal and then I realised it was my job to ask the difficult questions. I have been doing that on my boards and a year on from giving them a grilling, they are coming back with thoughts and ideas. Just starting these conversations is powerful.

Occasionally, you get disappointing responses from consultants, but if we all jump on board, there is momentum here that could make a difference.

Cusack: There is still some convincing to be done, but it is heading in the right direction. People are not averse to having the conversation, whereas a few years ago they would have been. They recognise this is the direction of travel that they need to get familiar and comfortable with. There is still work to be done, but I am optimistic that it will move quickly and appropriately.

Aaron Pinnock
Impact investment analyst,
The Church Commissioners for England

PI: How else is impact investing evolving?

Manuel: Part of the challenge is getting the message out: that by doing this, you are not putting yourself out on a limb, it is fundamental to the delivery of fiduciary duty.

To help the market evolve, trustees need to make it clear what they want and that it is a non-negotiable, absolute need to have. It is for all the participants in the market to come together to try and resolve it.

The more we can demonstrate the strength and solidarity of that view from the decision makers or beneficiaries, the more hope we have to make that happen.

MacArthur: We will see more sophisticated data come in overtime as well as more consolidation in the frameworks.

L'Estrange: I love the enthusiasm and pro-activity amongst the people in this discussion.

It shows that the information is there, that the activity is there. We come up against a lot of excuses and we have highlighted those myths today. So do not be afraid to seek out the people doing this and the information, which is available. The precedent is there. The business opportunity is the key.