Impact Investing

from niche to mainstream

Standard Life Investments

November 2016

Introduction

Impact investing - once a niche corner of the market - has entered the mainstream. This has been driven by increasing awareness among investors of the important role they can play in order to help address the world's many environmental and social challenges. Impact investing allows them to meet this desire - while still seeking a financial return.

Historically, impact investing focused on private investments but there is an increasing recognition that publicly traded corporations have the ability to generate significant environmental and social benefits. Indeed, by channelling large amounts of mainstream capital into publicly listed companies whose primary business models address pressing environmental, social and economic challenges, investors have the ability to achieve positive impact at scale.

As such, this looks set to be the future of socially conscious investing. This also means there are huge opportunities for investment firms who embrace this growing market.

What is impact investing?

While the practice is decades old, the term ‘impact investing’ was coined by the Rockefeller Institute in 2007.

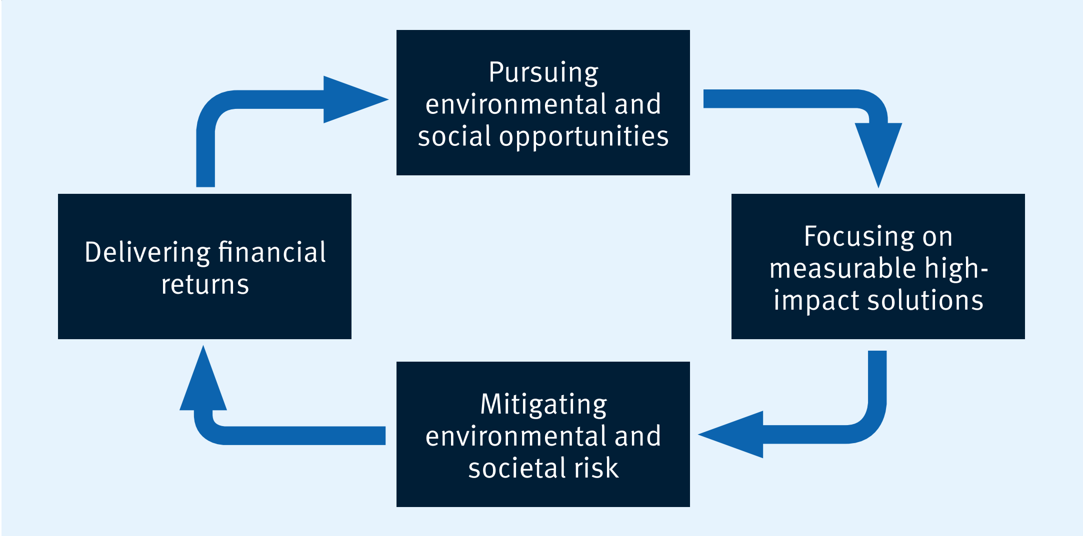
It involves investing in companies, organisations and funds with the intention to generate positive social and environmental impacts, alongside financial returns. It was developed, in part, as an acknowledgment that governments and philanthropy cannot solve all the world’s problems alone.

Two of the key facets of impact investing are that it must be intentional and measurable. A company that simply reduces its carbon foot-print or becomes more transparent about its activities would not be going beyond the norm in delivering impact. A company must actively seek to address a particular social or environmental concern in a quantifiable way. Despite the claims of some, a company with strong sustainable performance is not necessarily delivering impact.

A bright future

This is a rapidly growing industry: according to the Global Impact Investing Network, around $60 billion went into impact investing globally in 2015. This figure looks set to rise. Indeed, according to JP Morgan, impact investing will reach $1 trillion by 2020. This is likely to be driven by Millennials, (18-34 year olds) – a generation increasingly looking for investment vehicles that make a difference to the world. Indeed, a recent survey by Morgan Stanley found Millennials were twice as likely to invest in portfolios or individual companies that seek to have positive environmental or social impacts.

Chart 1: Impact investing



“For me, the benefits of impact investing are clear. Not only does it harness the creativity, expertise and discipline of the capital markets to address the numerous social and environmental challenges we face - but it also seeks to deliver competitive financial returns to investors. The very definition of win-win.”

Amanda Young
Head of Responsible Investment

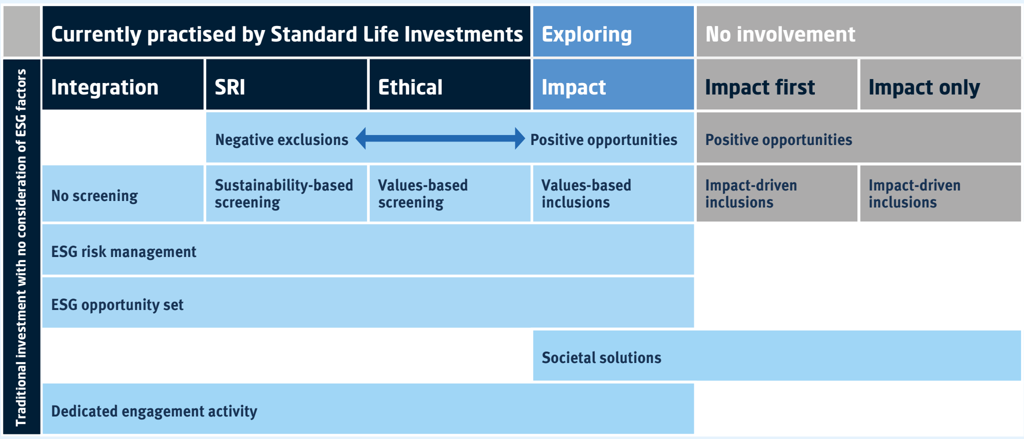
More than one way to make an impact

There are numerous different types of impact investing, from 'mainstream impact' to 'social impact'.

Philanthropic-based investing involves achieving a set environmental or social outcome, with little regard for financial returns. This could entail a charity or foundation building a health-centre or funding vaccination programmes in Africa. While noble, one drawback to this type of investment is that funding can be erratic, reliant on the financial stability and changeable attitudes of a few wealthy patrons.

Mainstream impact investing, by contrast, involves channelling capital into listed entities that are attractive from a financial position, but that also have a business strategy that can deliver measurable social and environmental returns. Such an investment could include investing in companies operating a closed loop business model, delivering renewable energy solutions, or buying bonds with a specific environmental or social purpose.

Chart 2: Evolution of responsible investing



Where does impact investing sit in the values-based investment universe?

As with everything in the financial world, values-based investment has evolved and grown over the years.

Ethical investment forms the foundation of the values-based investment universe. This type of investing excludes companies based on their activities, such as arms trading, tobacco, gambling, etc.

From this, sustainable responsible investment (SRI) developed. This type of investment may or may not apply sector exclusions. Its focus is primarily on measuring a company's approach to managing sustainability factors, e.g. avoiding companies that have polluted the environment or have poor health & safety standards.

SRI seeks to select companies that manage these risks effectively and identify those that are finding relevant opportunities. Through active engagement, SRI seeks to encourage laggards to improve their practices. It also promotes advocacy.

Environmental, social and governance (ESG) integration

More recently, investors have included ESG considerations in mainstream investment, recognising that environmental and social issues could be financially material to investment decisions. ESG integration is the understanding that environmental, social and governance aspects of a company's business can be material to its ability to deliver sustainable long-term financial returns. It is a management quality indicator, a risk assessment factor and an identifier for corporate stability.

Corporate governance is also part of this remit and involves voting at AGMs and assessing how companies are governed, including consideration of renumeration board independence and board structure.

While full ESG integration should be the goal for every investment house, this should not be mistaken for impact investing.

Impact investing

This is the process of investing in companies that specifically provide measurable solutions to long-term social and environmental challenges. Positive impact must be core to a company's business strategy and guide their technologies, products, services and business models. Mainstream impact investment is financially driven. These companies are selected for both their potential to deliver a financial return as well as their societal impact.

How is a positive impact measured?

While financial returns may be fairly straightforward to measure, the science of quantifying positive environmental or social impact is more difficult. Measurement in this area is still in its infancy.

Much of this also focuses on processes rather than results. However, accurate measurement will be necessary for impact investing to gain wider acceptance. There are already several frameworks in place.

One example is the UN Sustainable Development Goals (SDG) published in January 2016. This is a universal set of 17 principles that members of the UN are expected to use as the basis for all polices in the next 15 years (see Chart 3). Within these goals, there are 169 targets. These provide a framework against which to measure a company's impact criteria. So, for example, a company's commitment to sustainable energy can be measured against factors such as access to emerging markets, clean energy and efficiency.

The purpose of accurate measurement is to enable asset owners to understand how much (or little) positive impact their capital is having. It must be noted that impact measurement is still in its infancy. It will remain difficult to measure and define initially, but we believe it will evolve to become robust over time.

Chart 3: Proposed impact metrics

Impact investing in the real world

Mainstream impact investing can be achieved through various asset classes, including equities, bonds and real estate. Returns will likely vary depending on the asset class used.

Equities

As highlighted, we believe impact investing can involve buying shares in companies with meaningful business strategies that are designed to have a positive impact on society and the environment.

One place to find such companies is on global stock exchanges such as the London Social Stock Exchange. Its goal is to "create an efficient, universally accessible buyers' and sellers' public marketplace where investors and businesses of all sizes can aim to achieve greater impact either through capital allocation or capital raising."

This platform creates a more liquid market for dealing in companies identifed for investing. It also allows for strict regulation and oversight.

The companies listed cover a multitude of different businesses, from power generation in Vietnam to building affordable housing in the US. The goal is to have a positive influence while generating a meaningful return.

Bonds

Bonds may have both an environmental aim and a social aim. The former can be defined as a bond instrument (either government or corporate) that is exclusively applied to finance or re-finance new or existing projects that tackle environmental issues, such as promoting renewable energy.

This bond market has continued to grow at a rapid rate over recent years, which has created tensions between scale, quality and accepted standards. There are no universally accepted governance mechanisms in the market and current conventions to accredit such bonds are lagging behind the complexity, geographical make-up and range of the bonds being issued.

Real estate

An impact real estate fund may set its parameters to invest only in mainstream real estate that has a social purpose, e.g. schools, hospitals, green buildings and social housing.

How is Standard Life Investments involved?

We are a founding member of the Investment Leaders Group, a global network of pension funds, insurers, asset managers and academics that looked at ways to generate long-term investment returns within a sustainable economic, social and environmental framework.

As part of the group, we were actively involved in a live workstream that aimed to generate a framework with which to measure impact investing.

The framework has three characteristics.

1. It focuses on non-financial outcomes rather than intentions or policies.

2. It concentrates on the environment and society, not financial materiality.

3. The information derived from the framework is transparent and simple.

This framework should allow commonality across impact funds, including creating a recognised reporting standard. The pooling of expertise and resources also helps limit costs, which could otherwise make constructing funds prohibitively expensive.

Our impact proposition

At Standard Life Investments, we are considering how we can build our own range of impact investment funds, particularly in the equity space. This would consist of an actively managed portfolio, where companies are selected for their financial attractiveness as well as their ability to deliver measurable societal benefits as part of their business strategy.

Conclusion

The case for impact investing is strong. It represents a tangible way for social and environmentally aware investors to deploy their capital in a manner that supports solutions to the world's challenges.

As we move forward, we will no doubt see a wider range of investment vehicles, as well as more diverse impact targets. While still in its infancy, measurement will also become increasingly sophisticated and standardised.

As more capital enters this particular market, we will see innovation and scalable investment opportunities. Importantly, impact funds will slowly build track records, which will help demonstrate the benefits of this type of investment.

In general, we expect demand for impact investing will continue to grow, particularly among the Millennials. For asset managers that embrace impact investing and offer suitable products to cater for this market, the future looks bright.

The value of an investment can fall as well as rise and is not guaranteed –an investor may get back less than they put in.This material serves to provide general information. It should not be relied upon as a forecast, research or investment advice.

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