

Impact investing – breaking down barriers to unlocking institutional capital

By David Brown

This blog reflects on the practical experiences shared at a recent roundtable on the challenges to unlocking institutional capital to invest for impact. The event was attended by a range of industry stakeholders and hosted by **Charlotte O'Leary** and international law firm, **Pinsent Masons**.



Trustees have an ever-growing investment governance agenda whether it is TCFD, recent liquidity concerns or rising inflation. In addition, a growing part of the 'in-tray' relates to sustainable investing. Or is it responsible investing, ESG (Environmental, Social and Governance), impact or something else? That is the initial conundrum, the array of terminology we use as an industry is at best confusing and at worst unnecessary and hinders progress.

Where to start? We can think about ESG as the risk the world poses to a company, and therefore the ratings and scoring relate to that risk and how well it is being managed. Impact is about the risk and return opportunity the company poses to the world. Investors cannot adequately equip themselves with the information about what risks and opportunities their investments may face without understanding both.

This means a holistic approach to ESG and impact is required across the portfolio. However, where and how you may be able to have impact differs depending on asset classes and geographies. It is worth noting impact is not the preserve of illiquid assets such as private markets and infrastructure. Impact is just as relevant in public markets. We see many examples of this across larger pension funds that have set net-zero objectives and are aligning investment strategy in equity and debt markets to deliver against this impact objective.

Risk, return and impact

Then there is the question of fiduciary duty. Can impact be considered alongside risk and return? As the Spectrum of Capital, by *Bridges Fund Management* and *Impact Management Project*, visually illustrates, investing for impact can provide acceptable risk-adjusted returns. In fact, regenerative farming and carbon reduction

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were examples shared by attendees at the roundtable, indicating there is a lot of evidence to support this. Additionally, survey results from the Global Impact Investing Network (GIIN) reveal strong risk and return outcomes from impact investors. A broader perspective on asset classes, including impact opportunities, also supports diversification. Among those pension funds that hold impact investments some have focused on 'intentionality' while others are by default. Either way, the risk and return outcomes have nearly always been positive.

Governance and strategy

From a pension fund and Trustee perspective it is important to distinguish between 'impact governance and strategy', for want of a better term, and physically 'implementing impact investments' with the help of an asset manager. It is critical to understand this difference.

In summary, impact governance is about ensuring environmental and social impacts are being considered in relation to and by the different stakeholders to the pension fund (sponsor, members, trustees, advisers, asset managers and companies) as well as in the negotiated agreements (covenant), governance structures, decision-making, policy setting etc.

The session explored what is meant by impact strategy among the large pension funds and impact managers present. The consensus view indicated it is about understanding where the pension fund is having 'negative', 'positive' and the 'potential to have positive' impacts. There are different governance tools available to help pension funds with this. A mapping exercise could be considered against the United Nations 17 Sustainable Development Goals (SDGs) or the PRI Market Map, which can be easier as the SDGs are assessed against 10 investment themes. Whichever tool is used, this can help inform policy on how to mitigate negative impact risks and pursue or increase positive impact opportunities. This is in relation to its own operational activities and its investment.

Green/impact washing

In completing and monitoring the mapping, care is needed to avoid green/impact washing. The session highlighted notable examples of reporting from impact managers, but consistency of approach across the asset manager community would help. For example, is Tesla a good or poor example of ESG/impact investing?

Using the GIIN definition, impact investments are those, which intend to pursue positive environmental and/or social impact investments alongside a financial return. Impact manager reporting should align with this definition.

Overarching this, it is important to understand the leadership and culture of an asset manager. Positive impact needs to be a core belief of the asset management company and there are different ways this can be measured. For example, B Corp status can be a strong indicator of positive impact.

In relation to investments, this can mean tying impact objectives to stewardship and engagement activities in public markets, including collaborating with other investors to affect positive change. Positive outcomes from this engagement, combined with technology innovation (such as split voting enabling pension funds

Blog

to use their voice directly), will help further.

What does this mean in the context of DB schemes?

Many private sector defined benefit (DB) pension schemes are mature and close to buy-out with less than 5-10 years of life. They may go through several buy-ins to reduce sponsor risk and require liquidity. The composition of these portfolios is largely comprised of gilts and liability-driven investments (LDI) with potentially some legacy private assets. The recent LDI crisis highlighted the issue for some DB schemes of having illiquid assets where the asset allocation grew as the pension fund sold off liquid assets to meet collateral calls. Therefore, some DB schemes will be reducing their private markets exposure to meet liquidity requirements. For some larger DB schemes, they may decide to run on/off, in which case they can consider illiquid assets to a certain extent.

The buy-out insurers must be the long-term target for stewarding capital from DB schemes to private markets and pure impact investments. Yet how are the insurers thinking about climate action when considering bulk annuities? There is also the potential for the DB consolidators to play an interesting role in part of the market in helping to shepherd assets between the sponsor/pension fund and the insurer. Despite this, many are having to and are setting net-zero targets, making them impact investors. This raises the question about what can be done from a governance and strategy perspective.? Engagement and investor collaboration is needed to change the behaviour of, and solutions provided by, public market companies.

What does this mean in the context of DC Master Trusts?

Defined contribution (DC) is the future for pensions and will see further consolidation as well as the ramping up of assets, with contributions increasing through auto enrolment and likely to increase significantly (if the Australian model is anything to go by) in order to

meet pension member needs. Cost has historically been an issue for investment in private markets but there is an increasing focus on value that needs to be carried through. There is also the need for innovative solutions, such as the Long-Term Asset Fund (LTAF), to provide a mechanism for DC schemes getting access to private market opportunities. Understanding the engagement and stewardship activities of passive investment providers is important because passive investments are often used to drive down cost.

What does this mean for the LGPS and for pools?

The Local Government Pension Scheme (LGPS) sector appears far further forward on the impact journey, with many setting net-zero targets and embedding the UN SDGs. The introduction of pooling has helped significantly and further potential remains. The experiences of LGPS need to be nurtured, including the ability to transfer knowledge, share best practice and work in collaboration with corporate schemes and Master Trusts to better collectively achieve their environmental and social impact goals.

Knowledge collaboration

Throughout the roundtable, the attendees shared notable examples of capital being deployed for measurable positive impact, although this represents only a small proportion of the £2 trillion plus of assets under management. Why is this? The most frequent reason given by pension funds is insufficient knowledge of how to embed impact investment from a governance perspective and then how to implement. This knowledge gap can be addressed. If we can empower pension funds with the tools they need to work with their consultants and asset managers we can really start to move the positive impact dial going forward. This will be a focus for Pensions for Purpose during 2023.

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