How can pension funds overcome barriers to impact investment?

EMMA POWELL IDENTIFIES THE REASONS FOR THE RELUCTANCE OF SOME PENSION FUNDS TO INTEGRATE IMPACT INVESTMENT INTO THEIR INVESTMENT STRATEGIES AND OFFERS TIPS ON HOW TO COMBAT IT

Emma Powell
LAPF Investments

Impact investment has risen up the agenda for asset owners as they increasingly question the difference their investments make to society and the environment and how they can integrate impact into their strategies. Yet products that fit this approach represent a relatively small slice of the portfolios of institutional asset owners.

The top concern cited by pension funds in implementing impact investment is the ability to achieve sufficient scale, predominantly due to a lack of products in the marketplace. That is partly due to the fact the schemes have a large proportion of their assets allocated to liquid investments, where few products have a proven approach or a proven understanding of impact, aside from fixed income.

Sean Gilbert, director of member engagement at the Global Impact Investment Network notes that many private market impact funds are relatively small in size in comparison to public markets or the larger private equity funds. "Large institutional asset owners typically have internal rules limiting the percentage of a fund that they can hold and, given their typical ticket size in comparison to the size of many impact funds, they often have difficulty finding funds large enough for them to invest," he says. "A separate problem is that many funds are relatively new and may not have the duration of track record that institutional asset owners require as a prerequisite to investing," he comments.

However, some argue that there are, in fact, a sufficient number of products out there, and that investors, who have become used to sifting through an excess of potential opportunities, need to change the way that they approach selecting funds in which to invest.

"So you can find impact investments, but you can't find a hundred of them that you then get to winnow down," says James Broderick, board director of the Impact Investing Institute. "They're not presented to you on a silver platter in a beauty contest."

For some schemes, the concern is that if they were to make an allocation, they would account for a disproportionately large amount of assets within the fund, particularly as some of those products are early-stage and niche in their underlying investments.

"The top concern cited by pension funds in implementing impact investment is the ability to achieve sufficient scale, predominantly due to a lack of products in the marketplace."

"So part of the issue that we have had is we're a bit uncomfortable as well about going into a fund where we will be the first [pension scheme] in there and where we'll account for the majority of the capital unless there are clear plans for further raises going forward," says Tim Mpofu, pension fund manager at Hammersmith & Fulham Pension Fund.

For smaller schemes, working with pools to incorporate impact investment strategies into their asset allocations could not only help tackle concerns around achieving sufficient scale, but also address those relating to their ability to perform adequate due diligence. That does not just relate to the upfront investment, but also the resource to manage those investments going forward, says Dawn Turner, former chief executive at Brunel Pension Partnership.

"Often the thing that's holding people back is that risk management and that oversight afterwards and pooling actually reduces that risk and creates greater opportunity," Turner said.

For individual schemes there is a considerable need for further education on the topic of impact. Training has not generally been provided to investment committees, which has resulted in them not feeling comfortable with opportunities. However, formulating a clear definition of what impact is can also be problematic. That can prevent schemes from integrating impact into their investment strategies. "So each fund will have a different idea of impact," says Debbie Fielder, deputy head at Clwyd Pension Fund. "And I think that's the other thing. It's a minefield out there, there's no one definition of it."

Some investment managers themselves have difficulty in identifying whether or not their product fits into the impact investment category. That is partly because they do not know whether they map any of the UN Sustainable Development Goals, which is often the first starting point. In addition, some managers do not know how to monitor their performance against those goals or how to report on how they are achieving them.

Working towards attaining carbon neutrality is well documented, but it is more difficult to measure and monitor other forms of impact reliably. Nevertheless, many investors are looking at a variety of environmental indicators beyond the simplistic gauge of a "carbon footprint".

Looking at the portfolio across all asset classes in a holistic way can be a more helpful approach to accessing a wide range of opportunities, rather than thinking about impact as a carve-out within the portfolio. With that in mind, many funds are creating new responsible investment strategies to cover specific areas that provide a link between ensuring members get the best returns and having a local impact of some sort, and they are endeavouring to define the balance in terms of the desired outcome.

"There is a lingering perception that there is some sort of a trade-off to be made between impact and financial return, but I think that's more a confusion about being able to differentiate the purpose of particular offerings, some of which may be designed to accept a lower return for a specific impact objective, than it is about something inherent in impact," Gilbert commented. "It's important to set goals before making allocations to assets," he adds. "Then you start working down saying, 'where do I find different kinds of opportunities across the asset classes available to me?'"

Some pension schemes are looking at impact investment as a continuation of a responsible investment approach. That means adding on an impact lens to the minimum criteria for responsible investment that is expected of all managers.

Admittedly, some investment managers will score zero in terms of achieving a measurable, positive impact. However, others may already fit the bill as impact investment managers without knowing. In fact, some asset owners have discovered that 75% of their managers were, in some way, invested in companies or projects with various degrees of positive impact.

Therefore, a typical pension fund could discover that a number of their traditional investments, with which the investment committee is already comfortable, do actually have a collateral impact benefit, in sectors such as housing or energy.

That has led some schemes to engage further with their investment managers, questioning them about their investment into positive impact companies or projects and seeing if they can increase the proportion they account for within their portfolios, as well as how they may be able to broaden the scope of those impact investments across their funds.

Covid-19 has given added impetus for institutional investors to consider their positive impact. Although lip service has always been given to the danger of "Black Swans", the pandemic has led to the investment community being faced with the reality of such an unforeseen disaster. So while Covid-19 has had devastating impact, there is also a positive outcome in that individuals have started to look at themselves and to consider the need to be more aware of neighbours, and the wider impact on society.

It has also highlighted that being prepared is key. That could include modelling scenarios for multiple stresses at once, such as a pandemic, a cybersecurity attack and a natural disaster and judging how you would react. Within the last year or two, the Task Force on Climate-related Financial Disclosures have become increasingly used to assess risk, but taking a forward-looking approach is also important in scenario planning.

"So in terms of how that relates to impact investment, I really believe that although we don't have the perfect solution at the moment and we're never going to have faultless data straight away, it is really important to collect what is possible in a forward-looking way and try to think about future scenarios instead of just last year's impact," says Jacqueline Jackson, head of responsible investment at the London Collective Investment Vehicle.

But it is also important for investors to appreciate that some investments that are aligned to some sustainable development goals may also have negative consequences. For example, the balance between vertical farming, which helps to reduce water waste and pesticide use but also has a massive increase in consumption of electricity, and in the toxic waste that results from lithium batteries. Yet balancing the positive outcomes against the negative is not solely a measurement problem – it is arguably an issue of priorities. Brian Svendahl, Managing Director, Co-Head, US Fixed Income, RBC Asset Management said: "A common theme we've experienced is really around how impact can become isolated. It's a very small bucket for most asset owners, and in general investors seem to want to ignore the social or environmental footprint of the rest of their assets. So you can be invested 1% in renewables, but many will often ignore the fact that you may be 90% invested in transport or extraction, and so on. So, simply focusing on the positive impact is one thing, but what if you took those others into the negative impact as well? In doing so, you measure the overall picture so you can see what the net impact of your overall portfolio really is."

This reinforces the idea that asset owners should assess their entire portfolio when considering how to integrate impact into their strategies, rather than attempting to align investments with individual sustainable development goals. It is essential to focus on what the desired outcomes are for the scheme.