



It's not personal, it's business

We believe that non-financial and financial goals can co-exist. However, implementing such an approach takes time, professional expertise, innovative thinking and deep access to potential investment opportunities that align with investors' desired objectives.

In this paper, we describe our approach and experiences with implementing an impact investment mandate (focused on private asset classes) for an institutional client.

*A case study on
institutional investing to
generate social impact
and financial return.*

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Introduction

Institutional investors have long been active in impact investing, including in private markets asset classes. According to the Global Impact Investing Network ("GIIN"), a leading industry organisation, impact investing is defined as, "investments made into companies, organisations and funds with the intention to generate social and environmental impact alongside a financial return."

Despite the growing momentum in impact investing over the past decade, there is often skepticism and a general concern among investors about whether impact investing necessarily entails a compromise between high-conviction investment opportunities, appropriate risk-adjusted returns and fiduciary obligations relative to investing in traditional investment management. This skepticism seems to have, at bottom, a view that impact investing is driven by "personal" convictions rather than business or economic convictions. The following case study illustrates how these convictions need not be mutually exclusive.

Client objectives

Our client (the Client) engaged with Russell Investments to design and implement a discretionary impact investment sleeve "impact portfolio". They wanted to allocate 1% of plan assets to dip their toe in the water; the idea was to get experience in the social-impact investing area and to see what kind of challenges they would face. If the financial and social results of this portfolio prove satisfactory to them, they plan to increase the size of the allocation towards the more typical asset class minimum of 5%. As an organisation focused on financial services and healthcare, the Client wished to focus the impact investing portfolio along these sectors. The initial expectation was to focus on the private markets space through fund-of-funds.

Furthermore, the Client was seeking the same rigour in portfolio design, construction, operational due-diligence, portfolio management and reporting to the impact portfolio as we provide for other asset class portfolios that we manage on the Client's behalf. Critically, they desired the target net return for the impact portfolio to be aligned with that for the overall plan.

Investment process and solution

Russell Investments has been an adviser and investment manager to the Client for a number of years. With this historical perspective and the understanding of the Client's goals, the Russell Investments' client team worked closely with the Client to create an alignment between their investment objectives and to refine the impact goals to help measure the outcome. An integral part of this process was designing, constructing and managing the impact investing mandate in the context of the Client's overall goals.

Design

We wanted to design the framework at a sufficiently high level and applicability so that the impact themes would be appropriate regardless of whether they were applied to the Healthcare or Financial Inclusion sectors (see chart on page 3). The expectation was that the underlying data markers (impact metrics) would vary depending on the sector. The Client desired a 50/50 strategic allocation between the Healthcare and Financial Inclusion sectors, but left discretion with Russell Investments to determine tactical percentage allocations based on our ongoing evaluation of the opportunity set, the risk-reward profiles and alignment with the investment objectives of the portfolio. We committed to impact portfolio outcomes and agreed to develop a reporting framework based on best practices identified by industry groups as well as on discussions with fund managers to confirm the practical realities of the proposed reporting scope. It is worth noting that, broadly speaking, measurement of impact is a challenging and evolving concept in the institutional impact investing industry. There is significant skepticism within the industry regarding whether impact investing can offer competitive risk-adjusted returns with traditional investment options, and on how real and durable the impact can be.

As part of the design phase, Russell Investments' private markets team worked closely with the Client to further define their impact goals and to build an impact measurement framework. We drew heavily from industry tools like the GIIN's IRIS (Impact Reporting and Investment Standards) catalogue for selecting performance metrics as well as best practices identified through active engagement with industry players in impact investing. The catalogue was created by the Center for Health Market Innovations (CHMI)¹ and GIIN. The goal was to:

- a. align the metrics and objectives to ensure availability and relevance of data to be reported to the Client,
- b. not impose an undue burden on the underlying stakeholders for reporting purposes, and
- c. have practical use for monitoring progress over time.

The result of this process was an agreement with the Client to embed the following themes in the impact evaluation framework:

Affordability, Empowerment & Transparency, Access and Outcomes.

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1. <http://healthmarketinnovations.org/>

We have included an excerpt of this impact framework, including themes and objectives, below:

Impact Themes	Sectors and Guiding Principles	
	Healthcare	Financial Inclusion
Access	› Improving access to and use of services that prevent and treat disease and support wellness	› Creating and supporting opportunities for underserved populations to access financial services products that promote economic stability and upward mobility
Affordability	› Generally lowering the cost of healthcare and healthcare services for patients, including those that suffer from rare and/or chronic diseases or are otherwise vulnerable or underserved	› Generally lowering the costs of financial services for underserved populations, with a focus on scalability
Empowerment & Transparency	› Improving transparency to position the medical and patient community to make informed decisions and improve healthcare delivery, including reporting patient outcome statistics (i.e., medical/clinical errors, hospital infection/complication rates, etc.)	› Improving transparency to position underserved populations to make informed financial decisions; support gender equity in accessing financial services and products, including ancillary services such as education and training
Outcomes	› Improving standards of healthcare and healthcare services at the community level and at scale for underserved populations › Improving patient outcomes for healthcare delivery, valuing extension and quality of life	› Improving socio-economic stability as well as upward mobility at the individual level and at scale for underserved populations › Improving employment growth and access to goods and services for underserved populations, including women

Improving transparency to position the medical and patient community to make informed decisions and improve healthcare delivery, including reporting patient outcome statistics.

Construct

The range of investment opportunities in private markets, more so in impact investing, can be broad and dynamic due to market changes, regulatory regimes, social dynamics and competitive trends influencing the profile and depth of the investment universe at any given time.

For the Financial Inclusion sub-portfolio, the Client initially anticipated that it would primarily consist of institutionally-managed microfinance funds. However, market dynamics had significantly altered the risk profile of institutional microfinance investments. Aligning the construction of the impact portfolio with the investment guidelines required ongoing responsiveness to changes in the market environment including turning points for deciding the build-out of the texture of the portfolio.

DYNAMIC INVESTMENT LANDSCAPE

As part of our research on the microfinance opportunity set, we noticed shifts such as forays into equity investments (away from fixed income-only), expansion into Sub-Saharan Africa (and away from an historical emphasis on Latin America and Central Europe, which are more mature microfinance markets) and transitions from larger-scale microfinance institutions (MFIs) with greater market share in their target regions and longer operating histories towards smaller MFIs whose target markets may have a higher risk profile.

We also noticed that regulatory changes were disrupting organisational dynamics (i.e., roll-out of Alternative Investment Fund Managers Directive's (AIFMD) application to microfinance). Further, new publications of studies of the efficacy of microfinance for social impact were released that demonstrated some of the flaws in the traditional microcredit model for supporting poverty reduction and alleviation. These flaws included, but are not limited to, issues related to:

- a. how far down the household income scale microfinance products actually go,
- b. the efficacy of micro-loans in the absence of being offered with other supporting services (e.g., training, peer support, healthcare) in alleviating poverty,
- c. transparency from and burden to the borrower of the actual costs associated with the loans, and
- d. the potential diversion of loan funds towards consumption versus business-enterprise investment and the associated implications for alleviating poverty.

These dynamics appeared to elevate the tension between the profile of available investment options, the strength of the social impact thesis, and the required risk-adjusted return for the impact portfolio.

For the Healthcare sub-portfolio, the Client established a preference for managers that have headquarters or that principally do business in the Client's region, and an ongoing evaluation was conducted to avoid any potential overlap of funds or products with the Client's traditional private equity and venture capital portfolios. This significantly narrowed the opportunity set for the Healthcare sub-portfolio, particularly when considering timing windows for closed-end funds (i.e., private-equity style funds that tend to have five-to-10 year liquidity lock-up periods) and the desire for vintage year diversification.

As a result of the above, we had notable 'pivots' during the initial construction phase of the portfolio (which is ongoing), highlights of which are included below:

› Combining bottom-up with top-down.

We engaged with academic specialists to identify microfinance institutions (as opposed to fund managers) that were considered leading-edge in their responsiveness to addressing the perceived flaws in the traditional microfinance model; we used this insight to match-up with the credible institutional portfolios in the space. Further, we refined our manager-selection process to take into account the new academic research to tease out which of the managers had the ability to demonstrate stronger awareness of, and the ability to address, the flaws highlighted in the academic studies.

› Doubling down on active engagement with the Client.

We held a series of meetings with the Client to keep them informed on our observations of the changing dynamics in the financial services and healthcare markets, and on their implications for the portfolio. Specifically for the Healthcare sub-portfolio, Russell Investments held a series of in-depth discussions with the Client and, in order to support the manager diversification and risk profile intended for the impact portfolio per the investment guidelines, the Client decided to expand the geographical focus of their Healthcare sub-portfolio investments to reduce manager concentration risks

As part of our research on the microfinance opportunity set, we noticed shifts such as forays into equity investments (away from fixed income-only), expansion into Sub-Saharan Africa and transitions from larger-scale microfinance institutions (MFIs) towards smaller MFIs whose target markets may have a higher risk profile.

and broaden the pool of high-conviction products. Further, we engaged in ongoing discussions regarding strategic, diversifying and impactful sectors to add to the mandate, thereby augmenting the potential pool of high-conviction managers and investment opportunities that met the target return and risk profile for the portfolio.

› **Watch for opportunities hidden in plain sight.**

By taking a page or two from the development finance institution (DFI) playbook, we were able to identify alternative investment opportunities that offered the potential for stronger risk-adjusted returns and higher impact. For instance, for the Financial Inclusion sub-portfolio, we considered investing as part of the General Partner (GP) equity component (which may be subordinated to traditional limited partner equity interests). Further, we considered niche financial inclusion products that can offer a compelling risk-return profile as well as a demonstrable and scalable impact proposition, but may be more narrowly focused.

Manage

A critical component of the impact portfolio is how we measure the social impact. As stated earlier, the measurement of social impact, particularly within an institutional private investing context, is still evolving. In addition to our traditional active engagement tools that we use during the “manage” phase of the lifecycle of a private investment, we have also found that the social impact measurement aspect of the impact portfolio appears even more high touch.

Developing and sharing ideas about how to approach social-impact measurement with private equity managers so that the data pulled is relevant and useful while not overly burdensome (and, preferably, helpful) to the underlying portfolio companies has been an ongoing, iterative process thus far. Nevertheless, we developed an impact performance measurement framework that aligned with the Client’s goals and is based on industry guidelines and direct discussions with managers. As stated previously, we leveraged the IRIS catalogue² and other tools referenced by the GIIN; the catalogue assists stakeholders in their efforts to quantify how well they deliver impact. Additionally, our real-time discussions with managers during the due-diligence phase provided a reality check on the practical viability of the metrics.

For instance, based on an in-depth discussion with a healthcare private equity manager, we recognised that the metrics reporting for new technologies might be more qualitatively based until the portfolio company had progressed sufficiently to provide robust quantitative data. In contrast, the microfinance open-ended funds (which typically offer quarterly or periodic liquidity relative to the lock-up periods associated with closed-end funds) tended to be further along in providing impact-reporting metrics relative to private equity funds. We have included an excerpt of our social-impact objectives and indicators below. As stated above, the impact metrics are intended to be aligned with the objectives and sectors established in the impact portfolio design.

As noted below, we endeavored to test our impact metrics model with managers during the due-diligence process. For example, as part of our historical track record analysis for healthcare private equity funds, we went through each portfolio company transaction and discussed which ones were aligned to impact goals, what quantitative and qualitative data related to impact investing were systematically captured and what set of metrics could be applied to track progress over time. We also discussed applying academic-based theses where relevant to address the portfolio company lifecycle issue (e.g., potential paucity of quantitative data early on in the life of a company, particularly with new technologies).

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2. <http://iris.thegiin.org/>

Sector	Impact Metrics			
	Access	Affordability	Empowerment	Outcomes
Financial services	› Number of loans › Percentage of loans to women › Percentage of loans to very poor	› Loan structure › Effective interest rate › Grace period (+2 months) › Frequency of debt installments (monthly or biweekly vs. weekly) › Joint vs. individual liability › Insurance structure › Deductible cost › Co-insurance cost	› Jobs created in financed enterprises › Percentage of women-led enterprises	› Number of enterprises financed › Use of loans (production, consumption, other) › Percentage of savings accounts: commitment accounts vs. flexible accounts › Percentage of the newly insured › Use of insurance (i.e., Mother & Child Wellness, chronic diseases) and scope of coverage
Healthcare	› Number of households provided new access to healthcare service › Number, percentage of women › Number, percentage of very poor, underserved	› Number of patients served, comparative cost savings › Number of patients receiving free products/ services	› Quality assurance mechanism and reporting made available to patients, public at large	› Reduction in negative outcomes (i.e., medical errors, infections) associated with delivery of healthcare service › Health intervention completion rate › Disease/condition addressed

The design and construction of the impact portfolio combined with the reality of market conditions and dynamics had a meaningful impact on the pacing of its build-out. Our experience has been that the build-out of the impact portfolio has significantly lagged the pace that we originally anticipated. We actively managed our Client's expectations in this regard.

Progress and client experience

The Client has been pleased with the profile and the pacing of the build-out of the portfolio, preferring objective alignment and high-conviction execution to accelerated pacing. In response, the Client repeatedly emphasised their patience for establishing the impact portfolio. Further, while the structure of the mandate is a discretionary segregated account, the Client's Investment Committee members have been keenly interested in its progress. Indeed, the Client's own goals and objectives with regard to the impact portfolio have been continually refined and honed as we have progressed with the processes associated with its design, construction and management.

Thus far, we have committed roughly 20% of the portfolio, solely in the Healthcare sub-portfolio, with two funds in active due-diligence targeted for 2016 commitments for the Healthcare and Financial Inclusion sub-portfolios. Thus far, the pipeline of funds committed to or that are in active due-diligence for the impact portfolio offer financial-return and risk-profile expectations in line with those set forth in the Investment Guidelines. Further, it is our view that these funds "stand on their own" as high-conviction investment opportunities irrespective of the impact investing synergies that they happen to offer. With that being said, the commitment pacing has taken longer than originally anticipated although not out of step with the Client's desired outcome for the portfolio.

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ENABLING THE CLIENT TO MEET GOALS

Working closely with the Client's Investment Committee, Russell Investments has served as a strategic investment partner enabling the Client to:

- › Design a robust impact investing framework that aligns with the Client's impact goals
- › Conduct a comprehensive manager research and due-diligence process to find impact investment opportunities that align with the agreed-upon financial and non-financial goals
- › Draw on a broad and deep access to investment strategies, investment managers and academic expertise
- › Allow the Investment Committee to focus on long-term strategic goals and to be involved as much or as little in implementing the impact investing portfolio

The resulting solution, to date, not only meets the Client's impact outcomes but also aligns with their total portfolio risk and return targets; all of this implemented with the same level of research rigour, robust investment process and professional expertise as with the rest of their investment program.

Conclusion

Private markets responsible investing is a dynamic space with nuances to portfolio construction and reporting, and is somewhat nascent in the development of a collective narrative and shared best practices for what impact investing means for institutional investors. Despite this, our experience of developing client solutions to navigate and access impact investment opportunities, as part of a broader continuum of activities in the sustainable/responsible investing spectrum, has been very compelling. Institutions pursuing impact investing in private markets need not compromise in terms of governance, fiduciary duty or financial returns.

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RELATED READING

Global Impact Investing Network: <https://thegiin.org/>

IRIS Catalogue: <https://iris.thegiin.org/>

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ABOUT RUSSELL INVESTMENTS

Russell Investments provides strategic advice, world-class implementation, state-of-the-art performance benchmarks and a range of institutional-quality investment products, serving clients in more than 35 countries. Russell provides access to some of the world's best money managers. It helps investors put this access to work in defined benefit, defined contribution, public retirement plans, endowments and foundations and in the life savings of individual investors.

For more information please contact your financial adviser.

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