

# Is impact the new black?



Performance with purpose: Impact investing rises to prominence



**Samantha Steele**, Head of Private Market Strategies, Private Markets

**Leigh Hazelton**, Research Analyst, Private Markets

**Adam Rizvi**, Intern, Private Markets

Impact investing is an investment strategy that has grown dramatically since its infancy. In essence, its objective is to make a positive difference and target progress on environmental, social, and governance (ESG) matters. Whilst still in the initial stages of development, impact investing continues to grow and mature. In this regard, it should be front and centre in investors' minds that this industry is at a turning point. An increasing awareness of critical global issues such as climate change, food production, and healthcare has made it clear that investors — both institutional and retail — should start considering how to integrate ESG practices actively into their investment portfolio.

As a concept, socially responsible investing at the institutional level took off in the 1970s, led by social pressure on university endowments. The growth rate of the impact industry has ratcheted up following the publication of the United Nations' 17 Sustainable Development Goals (SDGs) in 2016, which aim to address a collection of global societal challenges to be met by 2030. Shortly following the release of the SDGs, a small group of investors took the initiative to review their existing portfolio and their investment allocation approach, to determine how they could do more to achieve the SDGs. This socially conscious approach to investing — also known as impact investing — is rapidly becoming an established part of the asset management industry. Nowhere is this more evident than when considering that the total assets under management (AUM) of signatories to the United Nations-backed Principles for Responsible Investment is now USD\$82 trillion (according to the Annual Impact Investor Survey, 2018).

The inclusion of an impact mandate to a wider portfolio can add several new and useful risks. These risks can be useful both from a performance and diversification perspective. Therefore, they can make the impact strategy a useful building block when constructing and maintaining a private markets mandate. Having said that, as the industry evolves there are challenges. Take, for instance, the lack of harmonisation around reporting and measurement as well as the shallow market of experienced managers. Both challenges highlight the need for dedicated expertise in order to harness the investment strategy's true potential.

## The evolution of impact investing

There are several ways for investors to incorporate ESG concepts and methods into active investment portfolios that offer the potential to enhance diversification and access new return drivers over the long term. Many investors prefer the incorporation of ESG into their portfolio via the exclusion of certain securities or industries. However, now there is a growing contingent of global investors who are seeking to make a direct impact on the world by means of impact investing — a strategy employed by those who are determined to generate both a positive societal and environment impact whilst generating financial returns.

From an evolutionary perspective, impact investing represents the third generation of ESG. The first focussed

on exclusionary screening, while the second saw investors employ a thematic approach to gain access to ESG themes. The natural evolution from these two preceding approaches was for investors to seek greater influence over their ESG portfolio. Then, impact as an investment strategy was born.

As a strategy, impact investing is growing rapidly. The Global Impact Investing Network's most recent estimate is that the impact market doubled in size to USD\$228 billion in AUM from USD\$114 billion between 2016 and 2017.<sup>1</sup> Investors ranging from public pensions to private equity firms are increasingly including impact investments as part of their asset mix. Some of these impact investors are '*impact first*' and are willing to accept a lower financial return (compared to a conventional financial product) in lieu of a greater impact. The other group of impact investors are '*finance first*' and believe that return on investment is the

higher priority. Neither strategy is better than the other, and we believe that for the sector to function properly both *impact first* and *finance first* investors are required.

Whilst the opportunity set is broad (and loosely based on the 17 SDGs), some common asset classes utilised to design an impact strategy are renewable energy, healthcare, and education-oriented private equity. From an unlisted investment perspective, these strategies are commonly accessed via a commingled, closed-end fund in the private equity, private real estate, private debt, and infrastructure sectors. Out of the four main strategies, the level of impact and explicit link with impact contribution can vary. For example, private debt can be viewed as an attractive investment strategy for investors seeking to capture a yield premium. However, we believe the limited management influence may dilute the true 'impact' of this type of investment. As a result, we believe the use of private debt in an impact portfolio may best be limited to opportunities directly linked to the SDGs. Furthermore, the aforementioned linkage should be tangible and be clearly underwritten by the end investor.

Previously, impact investing was largely concentrated in private foundations (e.g. the Gates Foundation), government bodies (e.g. the European Investment Bank) and the largest, most sophisticated institutional investors. This is changing as impact investing is now becoming more recognised as a credible investment strategy by the broader investment market. The industry is also receiving significant attention from sub-national governments at the regional and local level, who are stepping in to fill some of the void left behind by sovereign governments. Take for instance, the Overseas Private Investment Corporation (OPIC), which is a US government agency that helps businesses invest abroad and is a well-known financial participant in many segments of the industry. In fact, certain sovereign governments are increasingly targeting tax incentives towards investments with a clear impact potential.

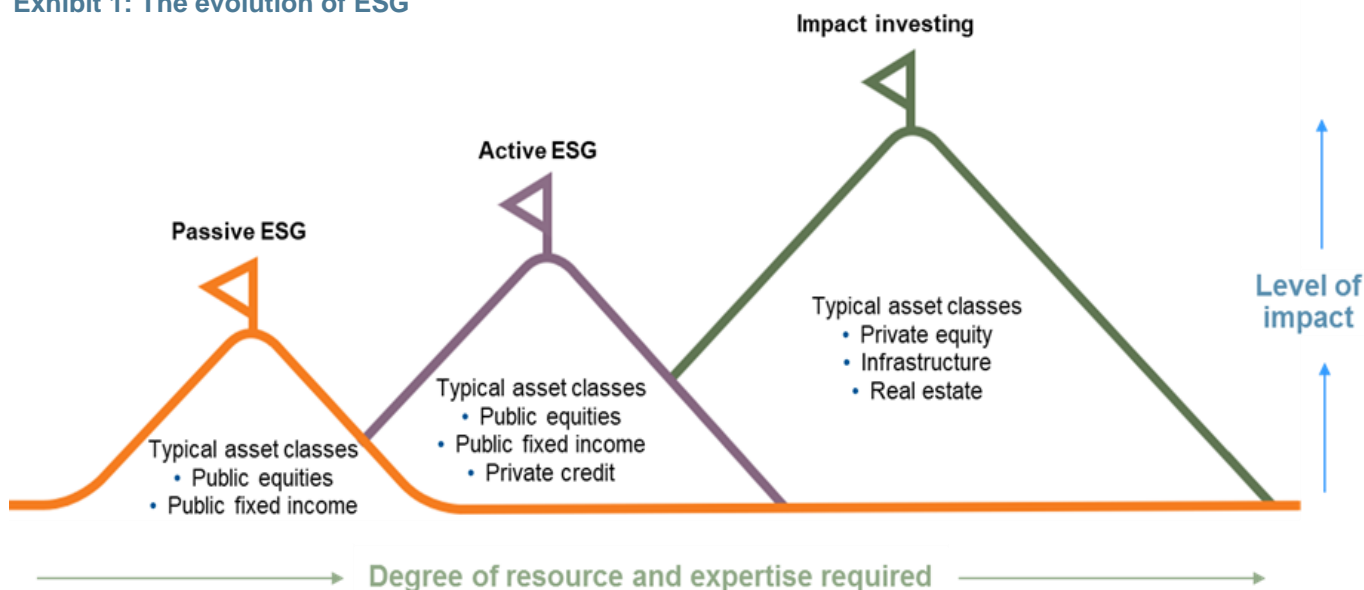
## Can impact investing add value to a diversified private markets portfolio?

Interest in impact investing has grown significantly as the strategy has challenged the preconceived notion that social and environmental benefits could only be achieved through philanthropic donations. Instead, impact investing provides an opportunity for investors to commit their capital with an eye towards advancing social and environmental solutions, whilst generating financial returns.

An argument can be made that returns from impact strategies should match those produced in the traditional alternative asset classes, in light of the complexity and technical knowledge often required to create value. Complexity is generally due to the esoteric nature of the underlying assets, for example: financial inclusion private equity, charitable social enterprises providing early years education, or anaerobic digestion power plants.

Prior to, and during, the ownership period of an asset, a deep understanding of how the asset is affected by factors such as current and future legislation and technological developments is necessary to achieve consistent risk-adjusted success. This additional layer of complexity along with the knowledge barrier has helped maintain lower pricing. In contrast, more traditional private market strategies which sit outside the impact sphere have experienced a dramatic increase in valuations over the past ten years, driven up across the spectrum by the huge amount of cash inflows. This concept is becoming more accepted by global investors as showcased in the 2018 GIIN Annual Survey, where 82% of respondents indicated that their impact investments have met their expectations both from an impact and performance perspective.<sup>2</sup>

**Exhibit 1: The evolution of ESG**



Source: Russell Investments, for illustrative purposes only

The impact sector should also benefit as the private market industry continues to expand and raise new capital, which should provide greater stability and certainty to performance via the solidification of a robust and consistent exit market. Take for instance, the core infrastructure fund market, which has already raised roughly USD\$60 billion year-to-date in 2018, a figure which already surpasses the entirety of 2017.<sup>3</sup> For the renewable energy segment of the impact strategy, this is bolstering the creation of a healthy exit market which fund managers can profitably tap into once the operational and technical complexity has been worked through for their assets. This phenomenon is not limited solely to renewable energy and is therefore likely to benefit the entire impact strategy in the form of greater exit potential in the future.

## What do investors need to consider prior to making an allocation to impact?

The potential for additional risk-adjusted return has not gone unnoticed by the institutional investment market. As the asset cycle ages, a surge of new investor capital into the general private markets industry has begun to slowly drip into the impact space. Yet it is important to note that the impact sector is still a small part of the overall market. Amounting to only USD\$228 billion<sup>4</sup> out of USD\$7.8 trillion,<sup>5</sup> the relatively small size of the market is helping to maintain a perceived yield premium for investors with the right level of sophistication to access the opportunity.

This increase in investor appetite is expected to be beneficial for the strategy as it provides vital feedstock for it to grow. However, as with private markets more generally (and any new industry) there are clear considerations that investors must factor into the decision-making process.

## Risks

Impact investing is not without risk; however, we believe that impact investing is a useful building block when constructing a private markets portfolio. The introduction of new risks — such as country risk due to the potential inclusion of new countries, asset risk (a combination of first-mover risk and technical knowledge risk), and new macro risks which may be more demographic in nature than market-linked — can help further diversify an existing mandate.

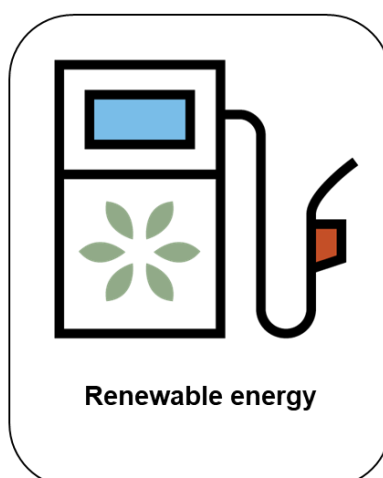
By no means are any of these risks insurmountable or unrewarded. Instead, their addition to an existing portfolio places an even greater value on due diligence. Investors with the capability to underwrite new asset classes in new markets, or who are able to achieve this via the support of their adviser, should be able to understand the risks to ensure that a suitable return is being earned.

## Reporting

Institutional investors and managers alike increasingly want to assess the impact of their investments on society. However, measuring a firm's societal impacts is not easy. Accounting standards for measuring impact do not yet exist and the measures in use are still evolving. Greater clarity on measurement is slowly emerging with academic researchers studying impact assessment, and organisations such as the [Global Impact Investing Network](#), [GIIRs](#), and [Principles for Responsible Investment](#) seeking to develop standards for the industry.

The growing involvement of large-scale and mainstream firms also presents a surmountable risk, namely the risk of 'impact washing' — i.e. when actors adopt the label without meaningful loyalty to investors' societal goals. Encouragingly, impact investors are aware of this risk and are beginning to emphasise the importance of greater transparency around impact investing when underwriting a commitment.

### Exhibit 2: Examples of impact investing



Source: Russell Investments, for illustrative purposes only

---

Other emerging ideas include third-party certification and the development of shared principles. Indeed, the GIIN has committed to developing a set of principles (to be launched later this year) to strengthen the identity of impact investing in order to drive growth and protect the integrity of the market.

Whilst this evolution of the reporting process is positive, multiple frameworks and definitions — even when thoughtfully developed — can create confusion. Therefore, this remains an area to monitor closely in the future. There are several players in the impact industry who are taking the bull by the horns, with the objective of pushing the industry up the maturation curve at a quicker pace. As the industry grows and institutionalises, this feature is expected to improve, and the anticipation is that it will advance to a similar level as the rest of the private markets.

## Investment opportunities

Even considering the entrance of the large diversified fund managers, the credible manager pool can be quite shallow within the impact sector. The pool gets incrementally shallower as investors delve into more esoteric investment strategies where often even the most experienced and talented managers are fundraising. Unlike more common private markets (where there can be a dozen managers available at any point in time) this shallow pool puts even greater emphasis on the ability to underwrite a manager, as well as the investment opportunity. To achieve long-term success, experienced hands will be vital to navigating the selection process.

An important consideration for institutional investors looking at including impact investing into their wider portfolio is that the strategy may be client-focused — rather than product-oriented. This is because the areas of impact tend to vary based on the client's wants and preferences. For example, investors could be focussing on specific SDGs, or might have select locations in mind. Therefore, the 'one size fits all' approach may not be the best access point for many investors.

As the market matures and investor demand strengthens, the universe of product offerings continues to expand. In 2017, fund managers collectively raised USD\$18.7 billion with a median capital raise in 2017 of USD\$32.5 million.<sup>6</sup> Overall, fund managers in this space are expecting to raise USD\$22.5 billion in 2018,<sup>7</sup> a 20% year-on-year increase, highlighting the extent to which impact investing is gaining momentum.

## Looking to the future

Out of all the key private market investment strategies, impact is the most likely to gain from multi-generational

appetite. This is because the underlying investment opportunities often benefit from direct links to long-term demographic factors. Impact is an area of focus for younger generations who are more likely to have made or considered an impact investment. This comes as no surprise given that these generations are more likely to be more socially and environmentally conscious. For example, the Millennial generation is four times more likely than Baby Boomers to invest their money for positive social and environmental impact.<sup>8</sup> Therefore, for the industry to maintain growth, it is important for managers to continue to develop impact products and services that meet the wants and needs of multiple generations of investors.

## Where do we go from here?

We believe strongly that as the impact industry expands and matures with more capital allocated to this strategy, it will eventually evolve to become a familiar slice of a private markets portfolio — similarly to the gradual inclusion of private debt. However, it is important to consider that the sector is currently in its adolescence, growing and maturing at the same time, which lends it several rough edges and potential pitfalls. Given the clear and growing number of investors seeking to take an active approach to achieve their ESG and impact goals, we are fully confident that impact investing is not a passing fad.

From a risk and return perspective, the inclusion of an impact strategy in an existing private markets mandate will potentially have a positive effect on the overall risk/return characteristics. Impact investments are not by definition riskier than traditional investments, but specific risks can be identified, especially because of the dual objective at play. These risks, however, will be highly dependent on the type of investment. Therefore, it is important for investors to conduct thorough due diligence prior to making an initial impact investment, as well as throughout the lifecycle of the mandate (and where possible, with the assistance of those who have specific expertise). This review ensures that the new risks being incorporated into the portfolio are better understood, underwritten, and are being adequately rewarded.

As an industry that is growing and maturing at the same time, impact investing understandably has some rough edges to be polished, and we expect they will be in time. These rough edges point to the necessity for an experienced manager who can guide investors on their journey in the impact industry.

---

<sup>1</sup> Global Impact Investing Network, Annual Impact Investor Survey 2018.

<sup>2</sup> Global Impact Investing Network, Annual Impact Investor Survey 2018.

<sup>3</sup> Infrastructure Investor, 'Welcome to the golden age of infrastructure fundraising', 18 October 2018.

<sup>4</sup> Global Impact Investing Network, Annual Impact Investor Survey 2018.

<sup>5</sup> Preqin, 'Alternative Assets Performance Monitor' —2016 figure.

<sup>6</sup> Global Impact Investing Network, Annual Impact Investor Survey 2018.

<sup>7</sup> Global Impact Investing Network, Annual Impact Investor Survey 2018.

<sup>8</sup> Barclays, 'Investor motivations for impact: A behavioural examination?', 18 July 2018.



---

## Impact investing and private equity: The perfect marriage?

Based on its history, private equity would seem an unlikely partner for impact investing. However, with a greater emphasis now on 'profit with purpose', many private equity firms are embracing impact investment as a new opportunity to raise capital. The private equity sector's early impact investing approach has been led by the traditional, financially motivated investors. However, it is now evolving to encompass a broad suite of operational and strategic capabilities. Part of that operational expertise necessarily involves setting goals for portfolio companies and actively monitoring performance against these goals — whether they are sales growth, gross margin enhancement, or customer satisfaction.

Many private equity managers across asset classes now recognise that a strong focus on ESG and impact (as part of the business decision-making process) can add value at the bottom line of the underlying portfolio companies, and thus does not necessarily need to be viewed as a trade-off. Some managers go even further to use their impact programs to unlock new investment opportunity sets. For them, impact is a lens that can help them:

1. Spot under-served markets where other investors are not looking;
2. Work with mission-driven management teams, who would otherwise be wary of private equity; and
3. Build economic value by thinking deeply about, and measuring clearly, the social or environmental returns that move in lockstep with earnings growth.

In light of this, several major private equity firms are now building out their capabilities in impact investment as it is no longer simply viewed as the latest investment fad. We believe this changing approach reflects a market realisation that impact investment themes have permanence and may be less susceptible to cyclical factors than once thought — in both operations and liquidity.

Despite the growing interest of private market fund managers there remains a potential misalignment between the fee structures of the private equity industry, which rely on the '2 and 20' model and the underlying impact investment ethos. As more capital flows into the sector, the expectation is that greater competitive pressure during the fundraising process will adjust fee structures to a level that is more palatable to investors, and encourage different business models where the fee structure allows for efficient resource allocation.

A transition to lower fees will present challenges, as the operation of an impact strategy tends to be asset management intensive. Impact investing may require a broader geographical market and due to the specialist skills required, may require a pay premium to attract the best talent. Investors must therefore evaluate whether fees are justified by the manager's strategy and the non-financial goals of the fund, whilst also appreciating that unprofitable management fees could act as a constraint on performance and business focus.

## About Russell Investments

Russell Investments is a global asset manager with a unique set of capabilities that we believe is essential to managing your total portfolio and to meeting your desired outcome. At Russell Investments, we stand with you, whether you're an institutional investor, a financial adviser, or an individual guided by an adviser's personalised advice. We believe the best way to reach your desired outcomes is with a multi-asset approach that combines: asset allocation, capital markets insights, factor exposures, manager research and portfolio implementation.

## For more information

Call Russell Investments at **44 (0)20 7024 6000** or visit [russellinvestments.com](https://www.russellinvestments.com)

## Important information

For professional clients only

Unless otherwise specified, Russell Investments is the source of all data. All information contained in this material is current at the time of issue and, to the best of our knowledge, accurate. Any opinion expressed is that of Russell Investments, is not a statement of fact, is subject to change and does not constitute investment advice.

The value of investments and the income from them can fall as well as rise and is not guaranteed. You may not get back the amount originally invested. Any past performance is not necessarily a guide to future performance. Indexes are unmanaged and cannot be invested in directly.

Issued by Russell Investments Limited. Company No. 02086230. Registered in England and Wales with registered office at: Rex House, 10 Regent Street, London SW1Y 4PE. Telephone 020 7024 6000. Authorised and regulated by the Financial Conduct Authority, 12 Endeavour Square, London E20 1JN.

Russell Investments Ireland Limited. Company No. 213659. Registered in Ireland with registered office at: 78 Sir John Rogerson's Quay, Dublin 2, Ireland. Authorized and regulated by the Central Bank of Ireland.

Russell Investments Limited (DIFC Representative Office) is regulated in the United Arab Emirates by the Dubai Financial Services Authority at: Office 4, Level 1, Gate Village Building 3, DIFC, PO Box 506591, Dubai UAE. Telephone 971 4 359 0322

KvK number 67296386

©1995-2018 Russell Investments Group, LLC. All rights reserved.

MCR-00464/01-11-2020 EMEA-1718 [russellinvestments.com](https://www.russellinvestments.com)