Impact Investing

Impact investing has gained popularity in recent years, but how is impact defined? Can impact be achieved in public markets? And how does one measure impact? This RI Expert Briefing seeks to answer these questions.

What is ‘Impact Investing’ and what is its role?

It is generally said that all investments have an impact, whether positive or negative, but not every investment is an Impact investment. Impact investing is defined by the Global Impact Investing Network (GIIN) as ‘investments made with the intention to generate positive, measurable, social and environmental impact alongside a financial return’.[1]

The core elements of Impact investing are therefore:

- Intentionally contributing to positive social and environmental impact.
- Determining the contribution of the investment, i.e. and how material and how significant is the Impact. This is also known as the additionality aspect of Impact investing.
- Monitoring and measuring the impact that is occurring.
- Reporting on the impact.

Thus, a hallmark of ‘Impact investing’ is the ability to measure and report the stated impact.

What is the need for Impact Investing?

Whilst originally it related to philanthropic investors willing to sacrifice an element of market return in order to deliver a measurable element of social impact, investors are no longer expected to sacrifice return under the modern definition of ‘Impact investing’. This makes the appeal of Impact investing very compelling, as it can be a powerful tool in which to navigate capital to support some of the most needed projects in the world and so close the funding gap required to reach the UN’s 17 Sustainable Development Goals (SDGs) by 2030.

Meeting five of the key SDG areas (education, health, roads, electricity, water and sanitation) will require additional annual spending of $0.5- $2.1 trillion in low-income countries and emerging markets.[2] Tax revenues alone will not be enough to finance this investment, and governments therefore need the private sector to fill the gap. Impact investing argues that systemic change, both in developing and developed markets, can now be achieved through investors, and not only through policy makers and/or philanthropists.

1 https://thegiin.org/assets/Core%20Characteristics_webfile.pdf

2 Fiscal Policy and Development in: Staff Discussion Notes Volume 2019 Issue 003 (2019) (imf.org)

Frameworks to measure impact

One of the most popular frameworks to evaluate impact is the 'Impact Management Project's (IMP) Five Dimensions of Impact and the Theory of Change'.

The IMP first begins by defining the ABC of Impact Investing. It illustrates how investors may contribute to impact through their investments as part of a portfolio. This is outlined as;

A. Acting to avoid harm,

B. Benefiting stakeholders, and

C. Contributing to solutions.

Building on the ABC's are IMP's Five Dimensions of Impact, recognising that all investments have effects on people and the planet, whether intended or unintended. Using the five dimensions of impact, investors and investees can identify which effects matter and assess the performance of those effects.

The Five Dimensions are:

1. **What:** what outcome the investment is contributing to, whether it is positive or negative, and how important the outcome is to stakeholders.
2. **Who:** which stakeholders are experiencing the outcome and how underserved they are in relation to the outcome.
3. **How much:** how many stakeholders experienced the outcome, what degree of change they experienced, and how long they experienced the outcome.
4. **Contribution:** has the investor's efforts resulted in outcomes that were likely better than what would have occurred otherwise.
5. **Risk:** the likelihood that impact will be different than expected.

One of the core elements of Impact investing that can be overlooked sometimes is the theory of change. Theory of change looks at to what extent do Impact investments really make a difference in the lives of the people and the planet. This is the core question for any evaluation of Impact investing, and where the theory of change should be tested in greatest detail.[3]

Journal of Sustainable Finance and Investment

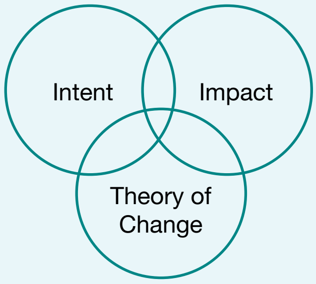

Figure 1. Core components of the definition of an Impact Investment. As per the Journal of Sustainable Finance and Investment.

Building up on all those frameworks, GIIN launched the IRIS+ tool, which identifies performance indicators by impact theme or category, aligning to the SDGs, the IMP's five dimensions, and more than fifty other conventions. The IRIS+ tool is currently viewed as best practice for impact reporting.

Challenges in measuring impact

Whilst there are several popular frameworks for measuring impact, there are still challenges in its measurement. As opposed to financial return, the assessment of impact has not yet evolved to the point of standardised metrics, and impact measurement does not yet have a mandatory reporting framework in the same way that standardised accounting frameworks exist, making it difficult to compare between different projects. This in turn poses challenges to investors who are trying to allocate capital to Impact investments.

Impact Investing in private markets

As mentioned above, measuring impact is a two-fold process. Firstly, there is the impact made by the investee entity on society, and secondly there is the impact made by the investor investing the money.

Therefore, it is often argued that the original and true form of Impact investing can only be achieved through private market investments, such as private equity, or venture capital firms where the investors hold over 50% ownership of the company.

Due to this ownership structure, these investors can drive change in the company more quickly. They are also able to calculate the investment impact more easily, as without this investment it is likely that the investee company's cost of capital would have been higher.

[3] https://www.tandfonline.com/doi/full/10.1080/20430795.2013.776257

Impact Investing in bond markets

Impact is possible to measure in Fixed Interest markets, through the issuance of labelled bonds. These instruments often link the proceeds directly to environmental or social outcomes that are measurable.

Labelled bonds are intended to promote sustainability practices in companies. Having increased in popularity over recent years (figure 2), they highlight the role debt markets can play in funding and inspiring companies to contribute to sustainability, and thus they form a key part of financial markets.

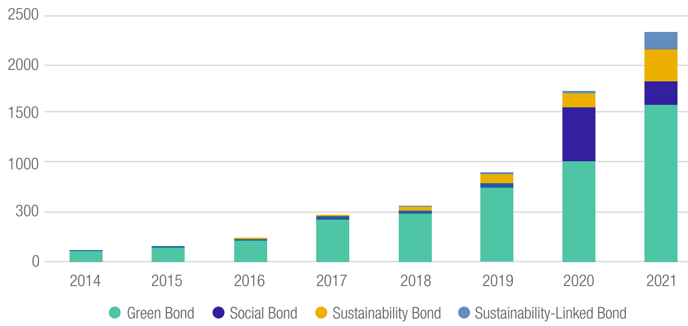

Figure 2. Issuance of labelled bonds from 2014-2021.
https://www.msci.com/esg-101-what-is=esg/navigating-complexities-of-esg-bonds

The different types of labelled bonds as defined by the International Capital Market Association (ICMA) are:[4]

- **Green Bond:** Use of Proceeds bonds which enable capital-raising and investment for new and existing projects with environmental benefits.
- **Social Bond:** Use of Proceeds bonds where the proceeds must finance or refinance social projects or activities that address or mitigate a specific social issue and/or seek to achieve positive social outcomes.
- **Sustainability Bond:** Use of Proceeds bonds where the proceeds will be exclusively applied to finance or re-finance a combination of both green and social projects.
- **Sustainability-linked Bond**: Aim to further develop the key role that debt markets can play in funding and encouraging companies that contribute to sustainability.

For all the above labelled bonds, ICMA has issued a set of voluntary guidelines designed to promote more transparent, unified reporting on the bonds' environmental and social objectives and estimated impact. Although not mandatory, reporting in line with the ICMA principles is viewed as a best-in-class approach.

However, even labelled bonds are not without challenges. In an attempt to tackle greenwashing, the European Council and European Parliament have recently passed an agreement to introduce new regulations on green bonds, by which, to be labelled "green", 85% of the funds raised by the issuance must be allocated to activities that align with the EU's taxonomy. This move has faced some criticism given the current taxonomy usability issues will result in very few bonds qualifying for the new label.

Example: sustainability bond – Co-operative Group

The Co-op is one of the world's largest consumer co-operatives, with over 4.6 million members and 64,000 colleagues. Since its formation over 150 years ago, Co-op has always had a clear social commitment.

In 2018, Co-op issued a sustainability bond with the aim of using the proceeds for Eligible Sustainability Projects, focusing on Fairtrade products, water and sanitation projects, responsible sourcing and energy efficiency technologies.

Co-op intends to allocate the net proceeds of the Sustainability Bond issuance to the costs of bringing Fairtrade products to customers, marketing and promoting Fairtrade products and the wider Fairtrade movement.

The five-year Sustainability bond pays investors an annual interest of 5.125% and was 2x oversubscribed when issued. Raising funds through a Sustainability Bond allows the Co-op to access long-term funding at an attractive rate and enables global investors to increase their focus on investments that meet the UN's Sustainable Development Goals and key environmental and sustainability targets.

[4] https://www.icmagroup.org/sustainable-finance/

[5] Brussels clamps down on 'greenwashing' in bond market | Financial Times (ft.com)

Impact Investing in public equity markets

We think that whilst the impact model may lend itself to Fixed Income instruments and private markets, it is more difficult to measure impact in secondary listed equity markets. This is due to the way capital markets operate, making it particularly challenging for listed equity to deliver an additional element of quantified impact.

In listed equity markets, investors who value the company's social or environmental characteristics will purchase company shares in the hope that their purchase and engagement with a company will result in the company share price increasing, thus causing the cost of capital to decrease, and allowing the company to produce more socially and/or environmentally valuable goods. However, attributing impact to one specific investor in the listed equity market, is extremely challenging, if not impossible, as a company does not directly receive cash as a result of an increased share price.

With regards to listed equities, we view that increased channelling of investor money into industries and companies which generate valuable solutions to environmental or social problems, for example through Thematic Funds, is key as it could generate a form of impact on aggregate.

Furthermore, as a House, we believe that investor stewardship, such as voting and engagement, is a key aspect of driving positive change in a company and a way in which all investors can generate a form of Impact in their investee companies.

Conclusion

It is notable that of 'Impact' Funds currently in the market, the majority are in fixed interest, private equity or venture capital, with publicly quoted or mainstream equity representing the minority of products.

As a House, we believe that for public markets, impact can be achieved in its truest form through fixed income investment. Therefore, in January 2022, EdenTree launched its first Global Impact Bond Fund. We believe that within public markets, the Fund is best positioned to achieve real life outcomes. The fund aims to invest in fixed income instruments with demonstrable positive environmental and social impact and is aligned with the GIIN definition of Impact Investing. The holdings in the Fund are designed to contribute to EdenTree's themes of Education, Health & Wellbeing, Social Infrastructure and Sustainable Solutions.

Examples of holdings in the Fund include the Severn Trent Sustainability Bond and Motability Social Bond. The Fund is expected to publish its first Impact report in 2023, which will allow clients to see the impact their investments have.

Additionally, whilst not pure 'Impact' instruments, we believe our two Thematic Funds (Green Future Fund and Green Infrastructure Fund), do lend themselves to having a positive impact by investing in companies that support vital industries, which are required to meet global challenges, such as renewable energy production, circular economy models and water supply & sanitation.

Performance with principles®

Our Responsible Investment Team

We have a specialist in-house Responsible Investment (RI) team who carry out thematic and stock-specific research to identify ethically responsible investment ideas for our range of screened Funds. Headed up by Neville White, Head of RI Policy & Research, and supported by Senior Responsible Investment Analysts Carlota Esguevillas and Rita Wyshelesky and Responsible Investment Analysts Amelia Gaston and Cordelia Dower-Tylee, the team is also responsible for creating an on-going dialogue with companies, allowing us to engage on a wide variety of ethical and socially responsible investment concerns. For investors, it's an added layer of assurance that our client's money is being invested in companies that are operating in a responsible and sustainable way. Our ethical and responsible investment process is overseen by an independent Advisory Panel that meets three times a year, and comprises industry and business experts, appointed for their specialist knowledge.

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We hope you enjoy this RI Expert Brief and find it useful and informative.
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