Ensuring Your Impact Investments Deliver Impact

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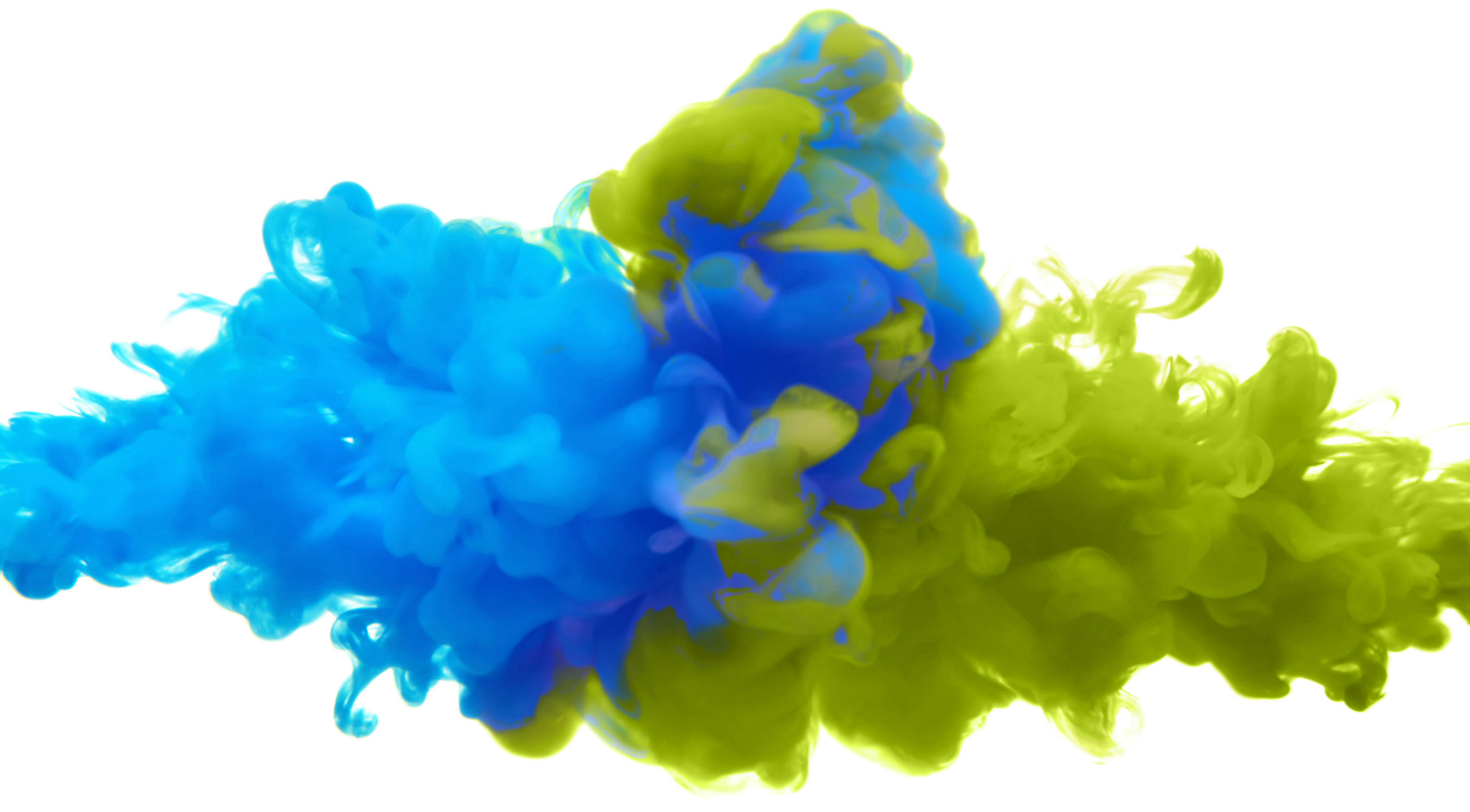

The fundamental premise of impact investing is that it can deliver a double bottom line: a positive social and/or environmental change and a market-rate financial return. Yet it can be difficult to parse through a sea of information (and frequently marketing spin) to select funds that actively deliver on these twin goals.

Environmental, social, and governance (ESG) frameworks are laudable and have had a positive influence for those concerned about investing with ESG goals in mind. ESG-compliant funds, however, are not required to make a measurable impact. True impact investing, on the other hand, should intrinsically meet ESG criteria.

The reputational risk of failing to meet impact goals or ESG requirements has become an increasingly significant concern for companies.[1] Regulations, such as the Sustainable Finance Disclosure Regulation (SFDR) in Europe, go some way toward ensuring transparency and accountability for public market sustainable investments, but there is no precise legal equivalent for private markets. This is a challenge for investors because effectively assessing the processes implemented by funds to guarantee that their underlying holdings will meet impact goals is crucial to achieving the sought-after double bottom line.

THE FIRST BOTTOM LINE: HAVING A POSITIVE SOCIAL AND/OR ENVIRONMENTAL IMPACT

How should investors approach identifying funds that are likely to provide genuine impact? In short, we think they should seek out funds that:

- Demonstrate intentionality around their impact
- Employ a robust framework for measuring effectiveness
- Actively track and regularly report on impact-related key performance indicators (KPIs)

Intentionality

While some strategies are inherently impactful—for example, a renewable energy fund that invests in solar and wind energy—it is more important to seek out fund managers who clearly state their intention to contribute to positive social and/or environmental change. While this may seem obvious, fund managers that place this goal front and center—rather than as a marketing-led afterthought—are more likely to have thoughtfully constructed a robust approach to generating and measuring impact.[2]

Measuring impact

When selecting a fund, the primary goal for investors looking for impact should be ensuring that the fund applies a robust framework to its portfolio companies. For example, some firms map their portfolio companies to the United Nations Sustainable Development Goals (SDGs) (See "UN Sustainable Development Goals: Mapping Impact" in the Appendix). These SDGs are, however, relatively high-level, abstract concepts. It is therefore preferable to seek out funds that go a step further by explicitly analyzing how those SDGs (or other impact goals) are being met.

There are frameworks that help fund managers do this. One such common framework is the five dimensions of impact laid out by the Impact Management Project—namely what, who, how much, contribution, and risk.[3] As our hypothetical case study in Exhibit 1 shows, this framework breaks down the expected impact of a portfolio company into practical, easy-to-digest factors that help funds understand the expected depth and breadth of an impact outcome, and parse who and what it would directly affect (See Exhibit 1).

Monitoring and reporting impact

It is vital to determine whether an investment is likely to have a positive impact, but it is not sufficient. It is equally important that a fund manager has a robust system by which to track impact throughout its ownership of a portfolio company.

One common and useful approach involves selecting one or more KPIs for each holding, alongside typical financial measurements, such as net profit margin and interest coverage. There are several sources—including the Global Impact Investing Network (GIIN) IRIS+ catalog—that offer metric sets that aim to foster consistency across investments, although in many cases impact KPIs should be tailored to the specific company and/or sector. Examples include greenhouse gas emissions avoided or reduced and number of children developmentally on track.

These results must be included in regular reports to investors, whether quarterly (alongside financial performance) or annually. In recent years, a few pioneering managers have even held themselves accountable by tying a portion of their own carried interest (profits) to reaching certain impact-oriented goals.[4]

This clearly signals a firm commitment to impact, as well as aligning managers' interest with investors.

Exhibit 1: IMP's five dimensions of impact

Case study—a hypothetical EdTech company serving underprivileged students

IMP Dimension of Impact	Applied to EdTech Company
What	
What outcome is occurring in the period?	Improving educational achievement, as measured by attained outcomes compared with baseline metrics of underprivileged students
Is the outcome positive or negative?	Positive impact likely
How important is the outcome to the people experiencing them?	Educational outcomes are key determinant of future wealth and a social good
Who	
Who experiences the outcome?	Students from lower-income families receive a direct benefit from the service provided
How underserved are the affected stakeholders in relation to the outcome?	Students may be very underserved depending upon the community
How Much	
How much of the outcome is occurring across scale, depth, and duration?	High degree of positive change likely over a long duration, though scale could initially be relatively limited until tech solution is developed further
Contribution	
Would the change likely have happened anyway?	Unlikely to have happened considering the program targets underserved communities and is intended to complement existing services
Risk	
What is the risk to people and planet if the impact does not occur as expected?	Limited risk—largely execution risk—in implementing service, leading to missed opportunity to promote a social good

Source: IMP. For illustrative purposes only.

THE SECOND BOTTOM LINE: DELIVERING A MARKET-RATE RETURN

Impact investments may generate a strong or top-quartile return, but there is insufficient data available to ensure an apples-to-apples comparison with other investments, due, in part, to the difficulty in separating out the historical performance of impact and non-impact investments in funds that may have featured both. Further, we are likely still several years from the emergence of a high-quality equivalent impact fund benchmark, unlike more established private market asset classes in which there are multiple major data providers that allow investors to benchmark funds against their peers.

Performance analysis must, therefore, focus on absolute or market-rate returns. In other words, each investor should use their own asset class return expectations to determine what appropriate performance would be for their impact investments. For example, investors may target a mid-teens return within their equity bucket, or a high single-digit yield within their credit allocation. They can then apply these benchmarks to impact investments they are considering. In other words, rather than seeking top-quartile outperformance, investors should target the double bottom line we mentioned at the start of this paper: a positive social or environmental impact and a market-rate return as determined by their own investment goals.

In our view, a market-rate return is more than adequate compensation, given the ability to also do good and drive positive change.

APPENDIX: UNITED NATIONS SUSTAINABLE DEVELOPMENT GOALS–MAPPING IMPACT

The 17 Sustainable Development Goals were adopted by the United Nations in 2015 and are commonly known as the UN SDGs. The goals are a shared global blueprint to help governments, corporations, and capital providers coalesce around solving society's most significant challenges, with the aim of making substantial progress by 2030. These goals recognize that, "ending poverty and other deprivations must go hand-in-hand with strategies that improve health and education, reduce inequality, and spur economic growth – all while tackling climate change and working to preserve our oceans and forests."[5]

Companies in the impact space are likely to meet multiple SDGs simultaneously, for example:

Company A: Industrial-scale water purification tech solution

Company B: Solar energy platform

Company C: Vertical farming solution

Company D: Innovative biodegradable packaging producer

Company E: Education technology start-up

Source: United Nations. For illustrative purposes only.

END NOTES

1. Source: PwC, "The economic realities of ESG," October 28, 2021.
2. Source: GIIN, "Core Characteristics of Impact Investing," April 2019.
3. Source: Impact Management Project, "Impact management norms."
4. Source: New Private Markets, "Linking carried interest to impact: The 'who?' and the 'why?'," September 27, 2021.
5. Source: United Nations.

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