Future proof investments: impact investing
Impact investing is trending. The International Finance Corporation (IFC) estimates that investor appetite could grow to USD 26 trillion, with as much as USD 5 trillion of that in private markets involving private debt and equity, real assets, infrastructure, and natural assets. Looking at the market size of impact investing, the Global Impact Investing Network (GIIN) currently estimates that it was USD 715 billion at the end of 2019, with private debt attracting the highest capital allocation (34%). The huge gap between potential demand and the current market size shows that there is great potential for the impact investing market to grow.

Impact investing is expected to play a pivotal role in channelling private capital into projects and companies that could help to address key social and environmental challenges. Within this area, we believe that private debt, in particular, is well-suited to impact investing and could offer investors access to a diverse array of assets with the potential to generate intentional and measurable impact alongside a financial return. Additionally, as we begin to emerge from the COVID-19 pandemic, investors are also looking for a measure of certainty. With low interest rates not expected to rise any time soon, and continued stock market volatility, it comes as no surprise that alternative investment options are at the forefront of many minds.

CHALLENGES IDENTIFIED

Despite the huge appetite for it and the pivotal role it could play, it seems that investors are facing great challenges preventing them from allocating to impact investing. Let’s explore what is holding them back.

One cornerstone of impact investing is the ability to translate intention into impact results. However, despite the maturation of impact measurement and management tools and strategies, both investors and managers still see opportunities for optimisation, especially with respect to the comparison and verification of impact results. At the moment the market is still lacking sustainable benchmarks and standardised data (collection and measurement), resulting in some of the highest-ranked greatest challenges the impact market faces over the next five years, according the GIIN 2020 survey.

Greatest challenges facing the market over the next five years

Note: Each respondent selected three challenges. Indicators are ranked in order of the number of respondents that selected each as a challenge.
Source: GIIN, 2020 Annual Impact Investor Survey

However, when turning to pension funds and institutional investors, what is really stopping them from allocating to impact investing? After obtaining soundings from Dutch institutional investors, the main challenges they seem to face are:

1. lack of scale;
2. lack of knowledge/capacity;
3. no place in the allocation policy;
4. high costs;
5. illiquidity (high capital charge); and
6. mismatch with the risk-return characteristics of mainstream assets by leaving sustainability risks/measurable impact out of the equation.

What is interesting to note is that we believe that there has been a shift in the definition of fiduciary duty, following societal pressure and EU legislation. For that reason it could be an enabler rather than a challenge to impact investing. It is becoming increasingly apparent that the wider social and environmental impacts of investments may be financially material to the investments over time. Thus, acting in the beneficiaries’ best interests means having a long-term approach to business and fully factoring in ESG issues in investment decisions.

1 IFC, Creating Impact—The Promise of Impact Investing, April 2019. Based on the assessment of the current preferences of investors to take criteria other than financial returns into account in the investment process.
3 https://unctad.org/
4 The “prudent person principle” in investment, known as “fiduciary duty” in some jurisdictions, is the moral obligation of investors to act in the best interests of beneficiaries.
5 In 2015, in the Capital Markets Union Action Plan, Eurosif called for a clear definition of the concept of fiduciary duty, too often interpreted by investors and investment advisors as a duty to maximise short-term financial return. As climate and wider ESG risks are material to business, it is believed that acting in the beneficiaries’ best interest means having a long-term approach to business and fully factoring in ESG issues in investment decisions.
CHALLENGE 1: LACK OF SCALE

COVID-19, EU legislation (Sustainable Finance Disclosure Regulation (SFDR)/Regulatory Technical Standards (RTS)) and the new Dutch pension agreement are expected to help create an enabling environment for the impact investing landscape and allow institutional investors to scale-up their impact-related capital.

The UN (2020) has projected that COVID-19 will negatively affect almost all the SDGs, and the highly uneven response to the pandemic has widened the (already great) disparities and inequities within and between countries and peoples, moving social needs into the spotlight following COVID-19. Furthermore, it underlines the interconnectedness of all SDGs. For example, it is forecast that for the first time in nearly two decades there will be a rise in global extreme poverty as a result of the loss of income and suspended economic activities. Severe long-term effects of the COVID-19 pandemic could push an additional 207 million people into extreme poverty on top of the current pandemic trajectory, bringing the total to over 1 billion by 2030.

Investors can play a key role, alongside policymakers and philanthropists, in contributing to achieving the SDGs by 2030.

Proportion of people living below $1.90 a day, 2010-2015, 2019 nowcast, and forecast before and after COVID-19 (%)


CHALLENGE 2: LACK OF KNOWLEDGE

The top four greatest challenges indicated in the GIIN 2020 survey, risk of impact washing, inability to compare impact, lack of transparency and lack of uniform impact language, are at the heart of EU legislation.

The Level I requirements of the SFDR (which entered into force on 10 March 2021), set out sustainability disclosure requirements for a broad range of financial market participants, financial advisers and financial products. It was enacted to address the twin objectives of i) increasing the transparency of sustainability-related disclosures, and ii) increasing comparability for end investors. In Level II, the Regulatory Technical Standard (RTS), this is taken to the next level, with the aim of reducing the information asymmetry in principal-agent relationships with regard to the integration of sustainability risks, the consideration of adverse impact and the promotion of social or environmental characteristics by means of obligatory pre-contractual and ongoing disclosures according to pre-set templates. It comprises a whole list of disclosure requirements, but we would like to highlight two requirements which contribute to increased transparency and comparability: i) sustainable investments in article 9 products with (an) environmental objective(s) should be sustainable according to the EU taxonomy, and this should be substantiated and disclosed; ii) financial market participants should disclose a minimum set of standardised and comparable relevant quantitative and qualitative indicators to show how each financial product meets the environmental or social characteristics that it promotes or the sustainable investment objective.

ACTIAM Financial Inclusion Fund:
Investment opportunity SDG1 and 5

Global access to financial services by 2030, including all men and women and in particular the vulnerable

Access to finance | expand access to finance | MSME growth

- Over 7 million clients reached by the financial inclusion institutions in 2020
- Reached 49 FIIs in 24 countries in 2020 and 69 FIIs in 31 countries since Fund inception

Serving the poor | serving the vulnerable | equal access to finance | developing countries

- Exposure 83% of exposure to women, 17% to men
- Individuals below the poverty line: 29% of the client
- 73.3% of clients that are microenterprises
- 46.3% of FIIs that provided insurance
- 71% of exposure is to rural clients

8 https://www.elopa.europa.eu/content/final-report-draft-regulatory-technical-standards_en
Additionally, the EU Commission announced that it is going to issue guidance on how asset managers should apply article 8 and 9 product categorisations, which either promote environmental or social characteristics or have a sustainable investment objective, respectively. This additional measure has been taken to address concerns about potential greenwashing by asset managers using the SFDR classifications as a marketing tool.

**Connecting sustainable agenda & investor agenda**

The SFDR and RTS are expected to contribute strongly to the new paradigm of the triple helix of risk-return-impact, moving away from the current concept of risk-adjusted return. By making the integration of sustainability risks and their impacts on the financial return, the adverse impact and the (net) positive impact mandatory throughout the investment process, this is expected to lead to other investment decisions going forward, whilst at the same time taking the first steps to increase transparency, comparability and combating so-called ‘impact washing’.

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**CHALLENGES 3, 4 AND 5: NO PLACE IN ALLOCATION POLICY, HIGH COSTS AND ILLIQUIDITY**

The new Dutch pension agreement will have consequences for the allocation policy of pension funds. The Dutch pension system will become more personal and transparent, moving from a defined benefit (DB) to a defined contribution system (DC). It will become increasingly important for pension funds to seek more alignment with their beneficiaries. By targeting certain impact themes and SDGs, reflecting the interests of beneficiaries, this alignment can be increased and can act as a catalyst, to become future proof. For example, employees of ASML and NXP recently sent a statement to PME (the pension fund of and for people in the metal and technological industry) requesting greater efforts towards the energy transition.

In a nutshell, there seem to be three main drivers in the new pension agreement which could contribute to overcoming the hurdles of no place in the allocation policy, high costs associated with impact investments and illiquidity (high capital charge).

- The biggest game changer is that there will be no capital charge (equity) requirements anymore. We believe that this will create significantly more room for alternative illiquid private debt investments. Removing this capital charge tackles an important hurdle, allowing illiquid investments to take a place in the allocation policy. Illiquid investments also have a natural fit with the collective and long-term horizon characteristics.

- Pension funds will be required to measure their members’ risk tolerance and adjust their investment mix accordingly. This is expected to pave the way for an investment mix that could contain pockets with higher risk.

- Diversification remains a cornerstone. Illiquid private debt impact investments may offer long term diversification benefits while meeting sustainability criteria.

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FROM INTENTIONALITY TO ALLOCATION

Looking at appetite and the developments which are creating an enabling environment for the impact investing landscape, it would be good to outline a roadmap for institutional investors to get them to move from intentionality to allocation.

The most appropriate impact strategy to be pursued will be highly dependent upon size, the experience and skills already gained and whether impact investments have already been pursued. We believe that staying true to your core values, aligned with the values of your beneficiaries, is key to strengthening your position in the evolving pension landscape and being future proof.

✓ Express intention and commitment: what additional steps can you take to realise the SDGs?
✓ Gain insights into the preferred impact themes and SDGs of the ultimate beneficiaries.
✓ From policy to allocation: implementation into the strategic asset allocation.
✓ Allocation to implementation: once starting points have been defined, the impact themes, impact goals and associated theory of change can be determined per category.

IMPACT INVESTING: NO BRAINER AND FUTURE-PROOF PORTFOLIO MAKER!

Impact investing is here to stay and it is expected to experience a demand and supply boost in the following decade. The most recent developments should contribute to overcoming the greatest challenges faced and creating a sense of urgency to increase capital flows to address the global challenges we are facing. By integrating the paradigm of the triple helix of risk-return-impact into the investment decision process, we believe that impact investing can contribute positively to asset diversification, lower overall volatility and reduce the effect of negative externalities. This could also increase future fitness, resilience and the prospects for long-term capital growth and the overall performance of pension funds and other forms of institutional assets.
ACTIAM stands for: active and passive management, sustainable investment strategies and impact investing. We aim for financial results, social returns and risk management. With our focus on sustainability, we structurally lower the risks and increase the opportunities in our investment portfolios. We serve clients through both funds and mandates; we supply a variety of tailor-made solutions.

ACTIAM is a trendsetter when it comes to impact investing, with our first institutional funds in microfinancing in 2007 & 2008. We make investment opportunities scalable in high-impact themes like financial inclusion and energy transition. With a track record of over 14 years in impact investing, our team demonstrates a sound performance.

ACTIAM offers capital and knowledge and develops small initiatives into scalable investments. We monitor the progress, measure the impact, prepare reports and safeguard the robustness of the process. We are also active in the professional development of the sector. In 2018, ACTIAM was the co-author of the PRI Impact Investing Marketing Map of the Principles for Responsible Investments (PRI).

Find out more about our impact investing strategies or go directly to our funds.