actiam
PERSPECTIVE

Impact investing:
from underdog to mainstream

Today, more than ever before, the private sector has a critical role to play in safeguarding a sustainable future for upcoming generations. This is one of the premises of the United Nations Sustainable Development Goals (SDGs). One of the investment strategies that can bridge private sector with sustainable developments goals is impact investing. With the fiduciary duty in mind, institutional investors are expected to generate a financial return. An investor's intention to have a positive social or environmental impact through investments is nevertheless essential to impact investing. Even though overall allocation to impact investing has been relatively limited, the impact investing industry is growing.

GROWING IMPACT INVESTING INDUSTRY

A positive growth trend of the impact industry has been observed over the past decade. The Global Impact Investing Network (GIIN) 2018 survey shows growth of impact investing AUM of more than 10% per annum, portraying that current impact investing AUM are about USD 228bln. While the investments are allocated across different asset classes in both public and private markets, private debt and private equity still dominate the market. In this contribution we focus on private debt, in particular on financial inclusion investments, as this is one of the impact investing segments with relative longer track record.

CHALLENGES A PROFESSIONAL INVESTOR FACES WHEN ENGAGED IN IMPACT INVESTING

Although an impact investing assets growth trend is observed, still large number of institutional investors struggle with some hurdles when deciding on impact investing allocation. The first question that arises concerning impact investments is whether this investment sector is capable to meet the risk-return hurdles of institutional investors. Given that it is a relatively young investment category, questions on evidence of its success are pronounced, as well as on clear evidence of impact contribution. Moreover, some institutional investors are struggling with scalability, size of investments and costs structure, but also capacity and size of specialized impact asset managers or just finding the right bucket for ALM purposes.

An increasing number of professional impact investing asset managers aim to tackle these hurdles as to make impact investing themes more accessible for institutional investors. The GIIN lists more than 120 impact investing asset managers currently active, amongst them several specialised firms with longstanding track records and since recently also quite a few big names from traditional asset management industry.

ADDING IMPACT INVESTING TO A PORTFOLIO

In allocation decisions, an asset manager can weigh the amount of impact (potential) of the investment made as an important factor, next to market based returns. Furthermore, expected return and level of risk should in line with the standards of investments for an institutional investor, and potential reputational risk for institutional investor should be minimized. Another key aspect an investor can consider, is the level of additionality of its investments, which further substantiates the impact of an investment from traditional asset classes. The level of additionality is driven by the extend the investment brings necessary means to places it otherwise would not reach (in size) or by helping the projects meet higher standards. However, compared to the mainstream market, the number of impact investing opportunities is still relatively limited.

This is a publication of our Impact Investing team, consisting of 8 professionals with an average experience of 15 years in the industry.

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One of the most visible impact investment strategies, microfinance/financial inclusion, has a size of just USD 20bln, currently managed in more than 90 investment vehicles[1]. Microfinance/financial inclusion is therefore a decent example of an impact investment strategy that fairly well address institutional investor main impact investing constraints: risk and return, impact measurement and reporting, size and costs.

THE ADDED VALUE OF MICROFINANCE/FINANCIAL INCLUSION IN INVESTMENT PORTFOLIO'S

Microfinance is one of the impact investment themes with a relatively long track record. Given that microfinance activities have a distinct bias towards emerging and frontier markets, and as such the emerging markets risk is evident. The common view of investments in emerging markets is that those are volatile and unpredictable, caused by political risk, corruption and the like. Traditional investments in emerging markets typically also exhibit significant correlation to other asset classes and global market developments. However, microfinance private debt, which offer less liquidity and thereby less possibilities for repatriation, tend to capture the underlying value of emerging economies better. Typically, microfinance debt investments are of buy and hold nature, have a low duration and are structured as untraded (illiquid), private loans, with strong covenant packages in place. If the underlying currency exposure is hedged, volatility is driven mainly by credit risk. We see that well-managed portfolios tend to experience relatively low losses. This has also been achieved by the fact that these strategies on average cover more than 40 countries and have more than 100 of the underlying financial/microfinance institutions.

A recent study[2] from the GIIN has put in perspective the performance of private debt microfinance funds versus other asset classes. While the composite microfinance debt funds 5-year return of 2.7% was below emerging markets bonds and other assets classes, the volatility of the microfinance funds was less pronounced. To a significant extent such stabile returns are contributable to the relatively low default rates. Overall, provisioning levels for the microfinance funds were 2.6% p.a. while the net write-offs were 0.7% p.a. demonstrating high recovery rates. These loss rates are significantly lower than annual loss rates of “B” emerging market high yield corporate debt, which is between 1.5% and 3.1%. Such performance of microfinance investment strategies is attributable, to a significant extent, to enhanced financial and regulatory infrastructure and professionalization that the industry has undergone in the past decade.

Returns, volatility and correlation by asset class (2012-2016)

	Private Debt Impact Funds (MR Funds only)	Microfinance Private Debt	Developed Markets Bonds	Emerging Markets Bonds	Cash	World Stocks	US Stocks	Alternatives
Compound Annual Net Return (5 years)	2.6%	2.7%	3.4%	5.4%	0.4%	8.2%	12.2%	1.6%
Annualized Volatility (5 years)	0.9%	0.5%	3.1%	7.2%	0.1%	11.2%	10.4%	3.6%
Correlation Table								
Private Debt Impact Funds (MR Funds only)	1.00	0.91	0.81	0.45	-0.43	-0.01	0.07	0.10
Microfinance Private Debt		1.00	0.09	-0.00	-0.30	-0.08	-0.11	-0.19
Developed Markets Bonds			1.00	0.37	-0.12	-0.17	-0.18	-0.13
Emerging Markets Bonds				1.00	0.05	0.57	0.44	0.42
Cash					1.00	-0.03	-0.03	0.04
World Stocks						1.00	0.95	0.85
US Stocks							1.00	0.83
Alternatives								1.00
Sharpe ratio	0.77	1.77	0.48	0.49	-25.45	0.56	1.00	-0.08

Source: GIIN; the financial performance of impact investing through private debt, April 2018

The study shows that microfinance private debt produced on average returns of 2.7% at notably low volatility 0.5% with attractive risk adjusted return profile judged by the Sharpe ratio. To put the return into perspective an eye on a cost structure is relevant as well. Fund managers of microfinance/financial inclusion strategies tend to have relatively high total expense ratio of 2.7% (TER) as reported in the 2018 MIV survey,[3]. This can be explained by labour intensiveness of the private debt structure , but we also see that costs are coming down.

With regard to the impact measurement and reporting, microfinance/financial inclusion strategies, when compared to the other investable SDGs, are probably most cited. An array of non-financial performance indicators are regularly followed. This has been done by universally accepted initiatives amongst others IRIS, the UN PRI Principles for Investors in Financial Inclusion and the Universal Standards for Social Performance Management. Availability of such non-financial performance indicators and regular reporting may help institutional investor to understand the impact potential and performance of an investment.

[1] 2018 SYMBIOTICS MIV SURVEY Market Data & Peer Group Analysis, September 2018

[2] The financial performance of impact investing through private debt. GIIN, April 2018

[3] 2018 SYMBIOTICS MIV SURVEY Market Data & Peer Group Analysis, September 2018

WHERE FROM HERE?

The above example may suggest that adding a microfinance/financial inclusion private debt strategy is of added value in a typical Emerging Market Debt allocation as well as in SDG/Impact Investing allocation (if such exists at an institutional investor level) However, for many institutional investors impact investing is still seen as underdog in investment portfolios because of risk perception, market size and costs remain major challenges. One of ways to overcome those hurdles may be to pull additional impact investing themes, think about energy, water, agriculture, together with financial inclusion that should help in creating more sizeable, diverse impact portfolio while it should improve cost effectiveness of such broader impact themes.

The GIIN annual impact survey 2018 shows obvious growth trend. Just in 2017 the investors planned some USD 11bln of impact related investments while ended up with more than USD35bln invested. This demonstrates a strong and growing commitment. However, those investments are still mainly done by Impact biased investors. In order to bring this industry to next level, where it should be as to safeguard a sustainable future for upcoming generations, impact investing should turn from underdog to 'mainstream.'

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