M&G INSTITUTIONAL

Investment Insight

Impact investing: Taking sustainable investing to the next level

February 2018

In this *Investment Insight*, Richard Sherry, Director of Alternative Credit, discusses the ways in which evolving investor preferences have helped to bring impact investing firmly into focus over recent years, and how impact investing can offer a diverse opportunity for institutional investors looking to take sustainable investing to the next level.

Understanding the terminology

Being a responsible investor can mean different things to different people, so clarifying what is exactly meant by terminology, such as sustainable investment, socially responsible investing (SRI), green bonds and impact investing, is important to ensuring investors fully understand what approach is most effective for their long-term objectives.

Responsible investment, in its broadest sense, is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.[1]

As responsible investment has gathered momentum, it has led to conflation of related terms, including sustainable investment, socially responsible investing, green bonds and impact investing.

According to the Global Sustainable Investment Alliance (GSIA) – which uses an inclusive definition of sustainable investment – sustainable investment encompasses the following broad range of activities and strategies:

- **Negative / exclusions-based screening:** the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria;
- **Positive / best-in-class screening:** investment in sectors, companies or projects selected for positive ESG performance relative to industry peers;
- **Norms-based screening:** screening of investments against minimum standards of business practice based on international norms (e.g. the UN Global Compact);
- **ESG integration:** the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis and investment decisions;
- **Sustainability-themed investing:** investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture);
- **Impact investing:** targeted investments, typically made in private markets, aimed at solving social or environmental problems, as well as financing that is provided to businesses with a clear social or environmental purpose; and
- **Corporate engagement and shareholder action:** the use of shareholder power to influence corporate behaviour, including through direct corporate engagement, filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

Nevertheless, we believe care should be taken not to confuse the various approaches to responsible or sustainable investing, as the aims of these strategies can vary greatly. For example, impact investing directly targets environmental or social benefits, while strategies such as ESG integration and negative screening do not. However, it is important to note that the common theme underlying all the above strategies is an emphasis on environmental, social, and / or governance issues.

Impact and SRI funds comprise a small segment of the fixed income universe, but can take a variety of approaches to investment, including using an ESG scoring system; negative / exclusions-based screening; green bonds and private debt impact investing.

[1] Source: The UN-supported Principles for Responsible Investment (PRI).

The first two approaches do not explicitly target a direct positive impact. ESG scoring strategies rank companies in a given investment universe using an ESG scoring system based on their environmental, social and / or governance credentials, while negative screening excludes from an investment universe all companies involved in certain activities, such as fossil fuels, alcohol, tobacco or weapons.

The latter two approaches – green bonds and impact investing – both target investments in projects or activities that seek a direct positive impact.

Green bond market sees sustained momentum

Green bonds are bonds where the company commits to using the proceeds to finance new and existing projects with environmental benefits – whether that is building renewable energy solutions in order to take action on climate change or develop processes to improve energy efficiency of their plants. From a credit risk perspective, the credit risk of the green bond will be exactly the same as the conventional bonds from the same issuer.

A large proportion of green bonds continue to be issued by supranational and government agencies, such as the European Investment Bank (EIB), the World Bank and KfW – the German government-owned development bank – and are rated 'AAA'.

The first green bond was issued by the EIB in 2007 and the green bond market is still a relatively small market. Although global demand for green bonds is high and rising, supply is still playing catch-up and the market is dwarfed by outstanding volumes of similarly-rated government and corporate bonds.

The green bond market, nevertheless, has experienced rapid growth particularly since 2013. US$155.5 billion of green bonds were issued globally in 2017 compared to a mere $3 billion in issuance in 2012. The current global green bond universe is estimated at around $221 billion, based on September 2017 figures from the Climate Bonds Initiative, with the not-for-profit organisation forecasting the green bond market to top $1 trillion by the end of 2020.

The breadth and depth of the market does not easily allow the construction of a well-diversified, institutional-scale portfolio. There is also a lack of global green bond standards which issuers must adhere to, leading to some concerns about 'greenwashing'. Bodies such as the Climate Bonds Initiative and the International Capital Market Association that developed the Green Bond Principles in 2014, have helped set some principles and standards for green bond issuers to aid transparency. However, the market is still awaiting a complete set of widely accepted 'green' standards to provide consistency for green bond investors.

Impact investing moves firmly into focus

Investors that have wanted to take sustainable or ESG investing to the next level have turned to impact investing. Impact investing describes investments made in companies, projects or organisations that intentionally seek a measurable social or environmental benefit alongside a financial return. It is this dual objective that sets impact investing apart from philanthropy and charities, that don't seek a financial return, and other sustainable or ESG investment approaches, that don't generally target direct social or environmental benefits.

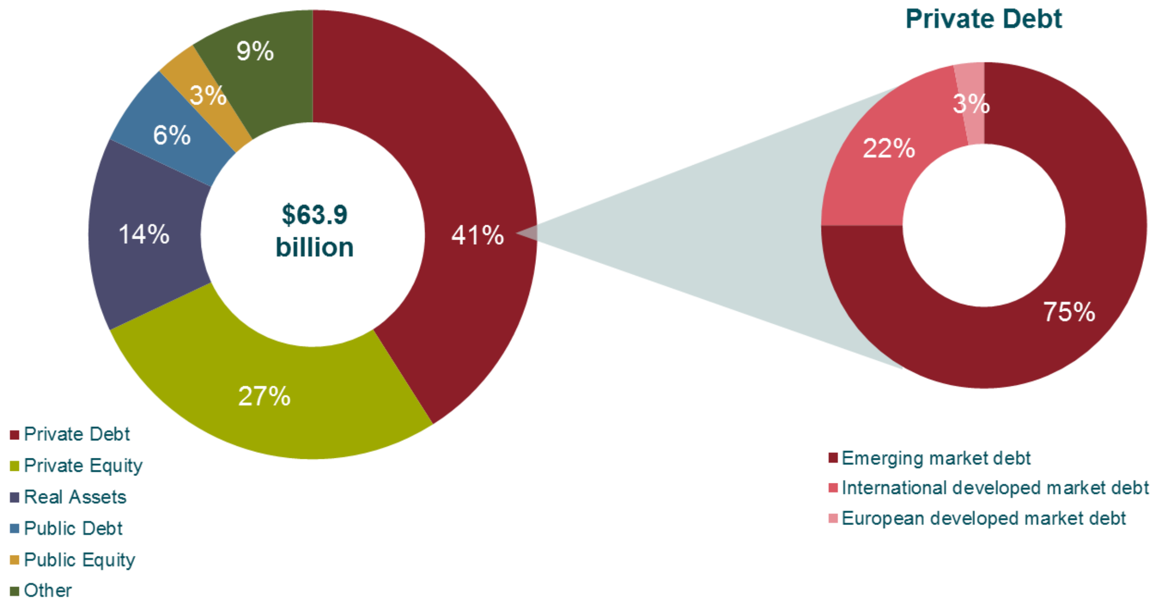
Impact funds are often small, concentrated products such as microfinance, and in many cases they focus primarily on the impact of the investments with financial returns a secondary consideration i.e. 'impact first'. However, the emergence of institutional-size private debt funds offering more attractive return levels while maintaining the positive impact has seen impact investing really come into its own in recent years.

The main driver of activity is investor demand. This reflects a growing ambition among global institutional asset owners to invest not only for financial return but also to benefit society and the environment. Unsurprisingly against this backdrop, the size of the impact investing industry has grown – the GIIN's 2017 Survey[2] suggests there were $114 billion of impact investing assets under management, although the GIIN notes this figure serves as a best-available 'floor' for the size of the impact investing market.

As the impact investing industry has evolved, investment opportunities across asset classes and impact themes have proliferated. As shown in Figure 1, private debt represents 41% of the impact investing universe – it is worth noting that most of these private debt impact assets are in emerging markets (approx. 75%) – however, the focus of our private debt impact strategies is developed markets.

[2] Source: "Annual Impact Investor Survey 2017". The Global Impact Investing Network (GIIN), published 17 May 2017. Total reported AUM based on collective data from 208 survey respondents.

Figure 1. Private assets represent the largest share of the impact investing universe



Source: "Annual Impact Investor Survey 2017". The GIIN. Total AUM by instrument excluding outliers.

For the first time, impact investors targeting both environmental and social impacts (50%) now outnumber impact investors targeting social impacts only (41%) according to survey findings[2]. We advocate a multi-focus approach when it comes to applying a private debt impact strategy that includes both a broad range of environmental and social impacts to ensure diversification and a wide and diverse opportunity set to select investments to maximise returns for investors.

Together with confusion surrounding the many forms of sustainable investing, there has been ambiguity among investors on impact investing more specifically. Whether impact investors prioritise financial return or impact ('financial first' or 'impact first'), what they define as impact and how their investments achieve this, tends to vary greatly according to their impact investment strategy. We target both clear positive environmental and social impact in tandem with strong financial returns.

Many in the industry believe that a lack of common understanding of definition and market segmentation represents a significant challenge to the growth of the impact investing industry[3]. However, private-sector momentum behind the adoption of the UN Sustainable Development Goals (SDGs) continues to grow, helping to channel capital towards investments and projects with positive real world impact aligned with global development and sustainability priorities. This increased focus has added further weight to impact investing as a diverse and viable opportunity for investors to actively address key social and environmental challenges faced globally.

[3] Source: "Annual Impact Investor Survey 2017". The GIIN. Total reported AUM based on collective data from 208 survey respondents.

Contact

UK

Andrew Swan
+44 (0)20 7548 2375
andrew.swan@mandg.co.uk

Henry Barstow
+44 (0)20 7548 3469
henry.barstow@mandg.co.uk

John Atkin
+44 (0)20 7548 3466
john.atkin@mandg.co.uk

Sunita Dey
+44 (0)20 7548 3393
sunita.dey@mandg.co.uk

www.mandg.co.uk/institutions
institutional.investors@mandg.co.uk