Making an in

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The Impact Investment market offers products that deliver financial returns alongside measurable social impact. Unlike some of their peers in the Netherlands, Scandinavia, Switzerland, and the USA, pension funds in the UK have been slow to consider Impact Investment in their portfolios. Social Finance and Finethic carried out a survey in 2012 to understand why.

We wanted to assess the level of Impact Investment undertaken today, the appetite for future Impact Investment, and the level of awareness of Impact Investment, as well as to raise awareness within UK pension funds of the Impact Investment 'asset class'.

We surveyed 47 organisations; together they hold 143 billion and serve 4 ½ million pension holders, making this the most comprehensive canvass (to date) of opinion leaders in the UK pension fund industry. [1]

Global pension assets in 2011 reached $27,509bn. The UK is the third largest market with $2,394bn under management.[2] The average asset allocation of the seven largest markets was 37.7% equities, 40.1% bonds, 3.7% cash, 18.5% other assets (including property and other alternatives). If pension funds in the UK chose to allocate just 1% of their members' assets, i.e. $24bn, the effect on the Impact Investment market would be staggering.

> Pension funds in the UK have been slow to consider Impact Investment in their portfolios

Genuine interest

We found that there is genuine interest in Impact Investment, and that a handful of pension funds are actively engaged in either investment and/or research. There is, however, a broad range of knowledge/ opinion on the subject; encouragingly most respondents are keen to learn more about this growing market.

Growing number of investors

23% of survey respondents include Impact Investments in their current portfolios and 48% of participants indicated that they would invest in Impact Investments within the next 12-24 months (see diagram 1).

Impact Investment: it's here and it's growing, but it has a way to go

Our survey demonstrates that the appetite for Impact Investment amongst UK pension funds is growing, and that a handful of funds show an openness and willingness to invest. We foresee these pension funds investing in high quality Impact Investments in clean energy, microfinance, social housing, sustainable forestry and land, and in their local communities. We expect them to be followed by other early adopters and then the 'early majority' as Impact Investing becomes mainstream (see diagram 2).

This pattern of market take-up is common when an innovation is presented. Everett Rogers' 1962 bell curve in the *Diffusion of Innovation*[3] shows there is a clear path as to how, why and at what rate new ideas and innovations spread. We expect Impact Investment to follow this well-trodden path.

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Is it pension funds' fiduciary duty to invest in Impact Investments?

We were encouraged that 20% of respondents thought that it was the role of pension funds to invest in Impact Investment. Even more surprisingly 47% of all respondents expected to have some form of Impact Investments in their portfolio within the next two years.

The biggest barrier to Impact investing is the discomfort that many investment managers feel in light of their fiduciary duty. Many interpret their fiduciary duty as maximising returns for their members. However a debate is being had about the nature of fiduciary duty. With a 40 year mandate, do pension funds have a responsibility to invest differently from those investing over a shorter term? Do pension funds, particularly those linked to location or profession, have a duty to invest in their community and their environment?

A FairPensions report[4], *Protecting our Best Interests*, suggests that there is a debate over the role of trustees in serving their clients' best interest.

> *… can fiduciaries act on environmental and social issues only when they are material to financial returns? Pension fund members who enquire about an ethical issue often encounter the seeming paradox of being told that their views must be ignored because of the trustees' fiduciary duty to act in their best interests. But are trustees legally restricted to interpreting this duty only in terms of financial best interests? […]*
>
> *… The effects of investment agents' behaviour on those whose money they manage go far beyond the size of their pension pot, yet 'fiduciary duty' is often treated as a straitjacket which allows investors to consider nothing else. For instance, fiduciary obligation is often still invoked as a barrier to investors taking full account of climate change in their decisions – despite its enormous implications for their beneficiaries' best interests, both financial and non-financial.*

Do pension funds have a mandate to invest?

If the fiduciary obligations allow trustees to invest in Impact Investments, do they have a mandate from their members to do so? Have they asked their clients what they would like to do?

In the US, a leading pension fund,TIAA-CREF, ($487bn as of March 2012), surveyed its members with some surprising results. 27% of participants strongly agree and a total of 83% agree with the statement "ensuring that my investment decisions reflect my personal values about social and environmental impacts" is most important when making investment decisions. TIAA-CREF's response is interesting:

> *Since 2007, several of TIAA-CREF's fixed-income strategies have maintained a visible commitment to including fixed-income investments with positive social and environmental outcomes … Investments are organized across four themes: affordable housing, community and economic development, renewable energy and climate change, and natural resources.*[5] ▸

1 To see the survey results in full please visit http://www.socialfinance.org.uk/resources/social-finance

2 http://www.towerswatson.com/assets/pdf/6267/Global-Pensions-Asset-Study-2012.pdf

3 Rogers, Everett M. (1962). Diffusion of Innovations. Free Press of Glencoe, Macmillan Company.

4 http://www.fairpensions.org.uk/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf

Diagram 1

Is your pension fund / institution invested in any Impact Investments today/in 12-24 months? (multiple answers)

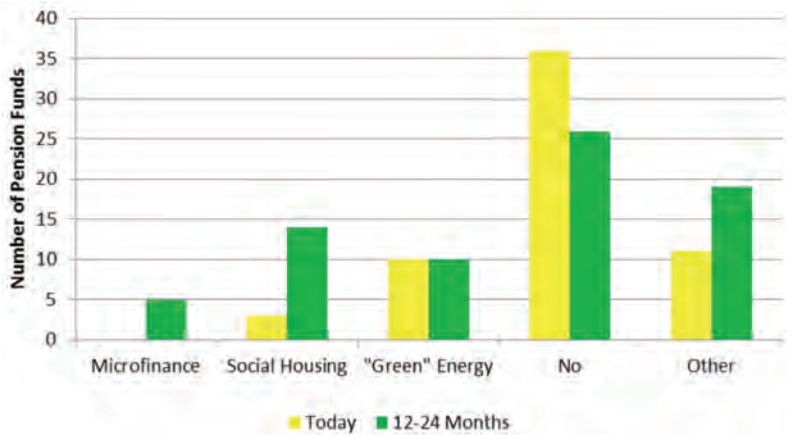
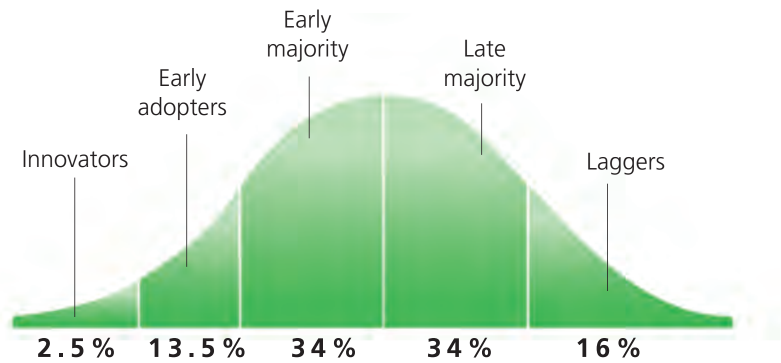


Diagram 2

Innovation adoption Lifecycle



5 https://www.tiaa-cref.org/public/pdf/sri_brochure.pdf

6 Ibid.

7 http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/investment-consultation-response,PDF.pdf

8 http://www.bcg.com/documents/file115598.pdf

During debates on the Pensions Bill 2008, Lord McKenzie, House of Lords government spokesman on Work and Pensions, said:

> *'There is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification. This applies to trustees of all pension funds.[6]'*

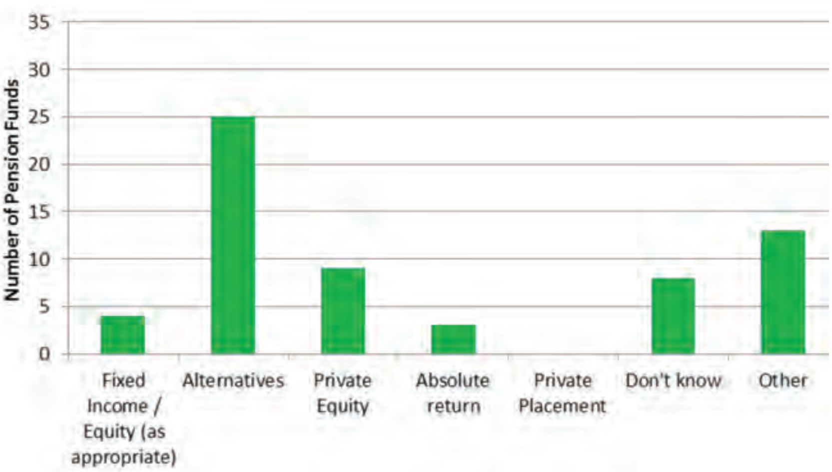
Interestingly, when setting up the UK government-backed pension scheme, NEST, the Government undertook a public consultation. It was clear from the consultation that "[…] respondents thought given environmental, social and governance considerations may improve investment returns, responsible ownership properly falls within the fiduciary duty of trustees.[7]"

How do Impact Investments fit into investment strategies?

It is a given that Impact Investments must provide a decent risk-adjusted return and conform to existing regulations, but where should Impact Investments sit within a pension fund investment portfolio? Some consider Impact Investment to be a separate asset class but there was a consensus among respondents that they should be considered Alternative Investments (see diagram 3).

Diagram 3

One of the challenges for pension fund / institutional investors is how to categorise Impact Investment. According to a JPMorgan report it is its own "asset class". Which "boxes" would you typically put Impact Investment into? (Multiple Answers)



Nearly 60% of respondents claimed to have heard of some form of Impact Investment, but over 50% said that they didn't know how to compare the risk or return of microfinance (the best known form of Impact Investment) with other investment opportunities.

Encouragingly, 69% of survey participants highlighted choosing assets that help diversify their portfolio was their first priority in deciding what makes an investment attractive. There is a growing consensus that many Impact Investments are de-correlated from many mainstream investments. If the Impact Investment industry can continue to demonstrate both good track record and low correlation, this should help pave the way for greater institutional investor participation.

Conclusion

A recent report by Boston Consulting Group forecasts that the demand for Impact Investment in the UK could reach £1bn by 2016[8]. Although Impact Investment is not well understood by UK pension funds, almost half of respondents expect to be invested within the next 12-24 months, showing an interest in this growing investment area.

Microfinance, the best known and most established Impact Investment has an impressive track record over the last 8+ years:

- it is decorelated with mainstream investment (the SMX microfinance debt fund index is negatively co-related with the S&P500 (-0.16)
- it has provided a decent return ($ >4% Vs. <3% for S&P 500)
- with very low volatility (<1% vs. >15% for S&P 500)
- it provides access to frontier markets (Cambodia, Kyrgyztan, El Salvador, Kenya etc) that is hard to find elsewhere

If pension funds are interested in diversifying their investment portfolio, capturing decent low-volatility returns, whilst giving a shine to their ESG credentials then Social Finance and Finethic believe that Impact Investments provide an interesting opportunity for pension funds.