Impact Investing in the Context of a Diversified Portfolio

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It has been almost six years since J.P. Morgan, supported by the Rockefeller Foundation, published a landmark report arguing that impact investment is an "emerging asset class." Despite a number of persisting challenges, including a limited (but growing) deal pipeline and a narrow universe of intermediaries with the capability of connecting capital with opportunities, the impact-investing market has developed significantly. The momentum gained from philanthropic and foundation investors and development finance institutions over the past few years has begun to attract the attention of global institutional investors. A number of institutional investors already have begun to construct portfolios or have announced intentions to allocate capital to impact investments.

For all the potential social and environmental good to be achieved through impact investing, feel-good factors are not enough because institutional investors bring a particular fiduciary mindset. Many foundations approach their impact portfolios through the lens of program-related investments, which can accept a lower level of financial return. Fiduciary institutional investors, however, are focused on allocating capital first and foremost to assets that offer an appropriate risk-return profile in the context of a diversified portfolio that aims to deliver on investment performance objectives. The idea that nonfinancial factors are perhaps financially relevant overall, and the subsequent growth in responsible and environmental, social, and governance (ESG) investing, have followed evidence that such approaches, at worst, don't detract from returns.

However, few such studies exist for impact investing, given its relative youth as a field. For most institutional investors, therefore, the question of whether impact investing has any place in a diversified portfolio remains unresolved. This article begins to lay out a framework for an evidence-based conclusion to that question, using data from Christian Super, an Australian pension fund with an eight-year track record of investment in impact assets and a portfolio that represents just less than 10 percent of its total assets under management.

**Definition**

The Global Impact Investing Network (GIIN) definition of impact investing is useful. For GIIN, impact investments are investments "made into companies, organizations, and funds with the intention to generate a measurable, beneficial social or environmental impact alongside a financial return." This definition picks up the key aspect of intentionality (i.e., a particular range of positive social or environmental outcomes is targeted). Many impact investors also use the lens of additionality (i.e., catalyzing a change that otherwise would not have occurred but for the intervention of impact-investment capital).

This definition embraces a wide range of sectors and potential impacts. Impact investing includes sectors that traditionally have been underserved by commercial investors such as community development, affordable housing, child care, welfare, and mental health. It also encompasses aspects of more-traditional sectors in the investment space—sectors such as education, health care, energy, and financial services—but with a particular focus on low-income or otherwise disadvantaged or excluded populations.

Leapfrog, an emerging-markets private equity manager, makes investments in companies that provide insurance and related products to low-income demographics in Asia and Africa, and it presents a good example of taking a traditional sector (i.e., financial services) and making it available to a nontraditional client base. Abraaj, another manager with a background in emerging-markets private equity, is taking a similar approach with its Global Health Fund. Outside of emerging and frontier markets, organizations such as TIAA-CREF (through its $20-million affordable housing partnership with the Community Development Trust in California, for example) and Cheyne Capital (through its U.K. Social Property Impact Fund) are taking sectors traditionally funded by government and making them commercially investible.

**The Impact-Investing Market**

According to the 6th annual GIIN Impact Investor Survey, investors continue to have strong interest in the impact-investment space, with increasing levels of activity. Although the total size of the impact-investing market is hard to ascertain, the 157 respondents to the GIIN survey report $116.2 billion of impact assets under management. GIIN reports more than $15 billion in new investments in 2015, with 50 percent of that capital flowing to emerging markets. The most common impact sectors are housing, clean energy, and microfinance or other financial inclusion services, with increasing interest in food and agriculture.
Most current investors in the space are development finance institutions, family offices, and high-net-worth individuals. The World Economic Forum argues that mainstreaming of impact investing will require participation from mainstream private institutional investors. This is now happening. Major financial institutions are creating internal resources in the sector, including J.P. Morgan's Social Finance Unit and Deutsche Bank's Community Development Finance Group. AXA, Bain Capital, Russell, BlackRock, Wellington, Zurich, QBE, and numerous others have announced that they are looking to allocate capital or participate in some way in the space.

The impact industry would argue that this is part of an inevitable move from being a niche movement to becoming an increasingly legitimate component of mainstream asset allocating, and the industry expects institutional participation to continue to grow. This would be driven by a number of factors including the need to source uncorrelated return in a low-interest-rate environment, demand from stakeholders (particularly younger generations) to demonstrate social value added through the investment chain, and increased demand from the public sector for alternate sources of funding for social programs (including pay-for-success models). This has been coupled in recent years with a number of regulatory clarifications about responsible-investment approaches.

Impact Investing as an Asset Class

However, for an investor the “impact” side of impact investing is not the only relevant component. Any positive potential social or environmental impact must be understood in the context of risk and return, because there is often a complex but crucial relationship between impact outcomes and financial outcomes, particularly for instruments such as social-impact bonds. And not every impact investment offers an appropriate risk-return trade-off, just as not every mainstream investment opportunity is attractive. We therefore return to our question of whether impact investment, as a concept and as a group of investments, offers attractive characteristics.

The high-level definition of an asset class is a group of securities that exhibit similar characteristics (i.e., return drivers) and behave similarly in the marketplace (in other words, it behaves differently from all other asset classes, i.e., diversification). The CFA Institute and others provide a more-nuanced definition by adding characteristics such as homogeneity of assets and ability to construct a sufficiently sized diversified portfolio (i.e., scale). The question is therefore whether impact investing meets these definitions.

Return Drivers

On the question of whether return drivers for impact investments are similar across the field, there are arguments on both sides. On the one hand, impact investments often share similar characteristics, such as participation by government (or another body whose interests are not wholly financial), exposure to disadvantaged or low-income populations, and the application of capital to solve social and environmental problems that philanthropic capital alone cannot solve. Most impact investments also create exposure to a shared set of risks, including illiquidity risk, exit risk, geopolitical risk, and social/environmental outcome risk. Most require a particular skill set to evaluate and research—requiring a strong understanding of the business case as well as the likely social or environmental outcomes and the extent to which those things interrelate.

Impact investing also carries a high degree of idiosyncratic risk. One major challenge is the lack of consistency in deal structure, deal pipeline, and exit opportunities. The jury is still out on the question of whether this disparate set of assets is homogenous enough to be called an asset class.

Diversification

On the question of diversification, there is more evidence. Analysis of Christian Super's portfolio (below) shows a very low correlation with all other asset classes in the portfolio. This makes intuitive sense. Most impact investments take one set of risks (market risk, etc.) and replace it with another set (geopolitical, idiosyncratic, currency, illiquidity, exit).

Scale

The field has certainly suffered from a lack of scale. Few deals have been of a size that would attract institutional investors. But this has been changing. In the past 18 months, a number of funds have closed with more than $1 billion in capital. This may not be enough to accommodate the largest institutional investors, but it certainly allows for allocations in the hundreds of millions to be made.

Performance

Even if impact investing may legitimately be considered an asset class, two key questions remain for fiduciary institutional investors:

- Do the performance characteristics of an impact portfolio have a legitimate place in a diversified portfolio?
- If so, is it possible to construct a portfolio of impact investments that delivers these desirable performance characteristics?

The rest of this article explores answers to these questions using data from Christian Super's impact-investment portfolio for the six years ending December 2015. The six years selected allowed us to use a full set of performance data that is available for both the impact portfolio and other asset classes to facilitate appropriate comparison.

Review of Sample Impact Portfolio

Using Christian Super’s portfolio as a case study, we have been able to explore whether an impact-investing portfolio is able to meet risk-return hurdles of institutional investors and enhance diversified portfolio outcomes. Christian Super’s portfolio consists primarily of investments in various unlisted unit trust structures, with some direct investments included. All returns presented below are after fees.

Return Performance

Against a performance benchmark of Australian inflation +4 percent per
annum (pa), the impact portfolio returned 6.7 percent pa after fees over the six years ending December 31, 2015, outperforming its benchmark by 0.4 percent pa (see figure 1). Growth assets in the portfolio have been built largely in the past three years and consist primarily of private equity investments, meaning that the j-curve effect is material in the performance. The more defensive assets, however, which consist of investments with some form of explicit or implicit capital protection, more than offset the j-curve impact, allowing the portfolio to exceed its target return.

Our preliminary conclusions in this respect are that the implicit and explicit forms of capital protection contained in the more defensive assets in the portfolio have contributed toward driving performance in excess of the target. It appears possible to construct an impact portfolio that contributes meaningfully to portfolio performance objectives, but it seems substantially easier to do so in those parts of the impact market where there is capital protection, often provided by governments, development banks, or other catalytic investors.

Risk Performance
Christian Super’s explicit risk objective is for the impact portfolio as a whole to exhibit monthly volatility of less than the MSCI World Accumulation Index over rolling three-year periods. Most impact investments carry some form of illiquidity, with less-frequent pricing, hence the use of a monthly measurement frequency.

The portfolio has achieved that objective, demonstrating monthly volatility of 1.49 percent over the six years against MSCI World volatility (in Australian dollars) of 4.06 percent. Figure 2 shows the risk-return profile of the impact portfolio compared with other asset classes during the six years to December 2015.

Correlation
We have undertaken correlation analysis of the portfolio’s performance for the six years to December 2015 against Christian Super’s other asset classes, which consist primarily of more-mainstream asset classes.

Results are encouraging, with the portfolio showing a correlation of 0.1 with public equities and 0.19 with cash. All other asset classes showed a correlation of less than 0.2, in an environment where other asset classes showed higher-than-expected correlations.

Diversification
Finally, we examined whether Christian Super’s impact portfolio is internally diversified by geography and impact sector. Volatility and correlation are not the only measures of risk. Like any asset class, to be successful an impact portfolio must offer sufficient internal diversification so as to minimize idiosyncratic risk. This is particularly important in a portfolio that is less exposed to more-traditional risks (market risk, basis risk) and more exposed to niche risks (geopolitical risk, climate risk, liquidity risk).

Christian Super’s portfolio has exposure to seven industry sectors, five of which have been added since 2011 (see figure 3). This is, in part, a testament to the growth of the market over the years. It includes 14 separate investments—mostly in pooled unit trusts—comprising 179 underlying portfolio investments. The largest manager represents 21.8 percent of the portfolio, and the largest individual portfolio company (or instrument) represents just 8.7 percent.

The impact portfolio has a substantial bias toward Australian investments given Christian Super’s domicile and stakeholder base, but the rest of the portfolio is well-diversified by region (see figure 4). There is minimal exposure to developed markets, giving the overall portfolio a distinct bias toward emerging and frontier markets.
Three sectors make up 73 percent of the portfolio—energy, infrastructure, and financial services—indicating room for more impact-sector diversification; more recent investments have focused on emerging impact sectors including education and community services (see figure 5).

**Considerations for Asset Allocators**

The evidence presented is not conclusive, but we hope it goes some way to begin to provide an evidence base for decisions around impact investing. There is enough to suggest that an allocation to impact investments can contribute as part of a diversified portfolio, with potential portfolio benefits from the risk-return profile of the field (particularly in defensive assets) and low correlation with other asset classes.

The existence of a particular investment opportunity does not, however, imply that it is able to be exploited. There are a number of considerations for asset allocators who are considering approaching the impact-investment space, most of which were highlighted by investors in the 2016 GIIN Survey:

**Asset allocation and portfolio construction expertise.** Understanding how an impact-investing portfolio will interact with the rest of a diversified portfolio is crucial in constructing an impact-investing portfolio that enhances overall performance. As noted, there is a great deal of variance within the impact-investment space such that the impact-investing portfolio’s composition needs to be investor-specific.

**Access to pipeline.** As with other private markets, access to a pipeline of high-quality deals that meet a set criteria and objective is a strong determinant of portfolio outperformance. Although the volume and quality of deals is improving, sources of high-quality deals are still limited and the bulk of opportunity does not meet institutional-level standards.

**Investment selection and management.** Once the asset allocation of an impact-investing portfolio is complete and there is access to a pipeline of deals, the selection and ongoing management of those investments would require specialized resourcing, especially if there is an explicit link between impact objectives and financial returns. This is also pertinent if investors have certain impact objectives, which most impact investors do.

**Market intelligence.** On an ongoing basis, investors need to ensure they have a reliable source of market intelligence to guarantee that they can make adjustments to their investment strategy in a timely manner. With impact-investing market data and research still sparse, missing key market trends and developments may lead to underperformance of the portfolio in the long term.

**Conclusion**

Although impact investing still has a number of growing pains ahead, the empirical evidence presented here and seen globally...
indicates it is beginning to warrant further consideration by institutional investors.  

Tim Macready, CIMA®, is managing director of Brightlight Impact Advisory in Sydney, Australia; he designed and implemented the investment strategy for Christian Super’s $1.1-billion investment portfolio, including its impact-investment capability. He earned a BComm in actuarial studies from Macquarie University and an MDiv from Australian College of Theology. Contact him at tmacready@brightlightia.com.

Simba Marekera is head of research for Brightlight Impact Advisory in Sydney, Australia. For the past five years he has managed Christian Super’s alternatives, fixed income, and impact-investment portfolios. He earned a BS in engineering sciences (electrical) from Yale University and a Masters of Applied Finance from Sydney Graduate School of Management. Contact him at smarekera@brightlightia.com.

Endnotes
2. These include AXA, Bain Capital, Russell, BlackRock, Wellington, Zurich, QBE, and others; see endnotes 9–14 for details.
5. Definition found at https://thegien.org/impact-investing/.
19. See endnote 1.
21. The j-curve effect in private equity is defined as the tendency of private equity funds to deliver negative returns in the early years as companies are investing in growth and positive returns in the later years as the portfolios of companies mature and start to reap the benefits of the investments.