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Impact Investing: Institutions Awaken to New Possibilities

GREENWICH ASSOCIATES

American Century Investments®

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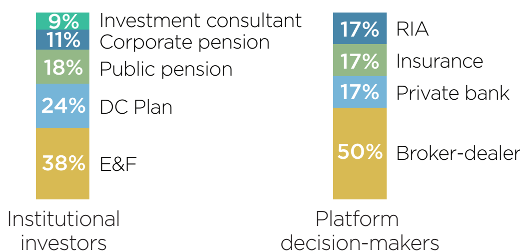
Managing Director Andrew McCollum advises on the investment management market globally.

METHODOLOGY

Between November 2015 and March 2016, Greenwich Associates conducted 74 in-depth telephone interviews with institutional investors and investment consultants and 52 intermediary platform decision-makers to test their knowledge of and receptivity to various approaches to impact investing across the asset management industry.

RESPONDENT PROFILE



Note: May not total 100% due to rounding.

DESPITE THE CATEGORY'S RAPID GROWTH, IMPACT INVESTING IN THE U.S. REMAINS IN ITS EARLY STAGES

57% OF INVESTMENT CONSULTANTS AND 40% OF PENSION PLANS EXPECT TO EXPAND ALLOCATIONS TO IMPACT INVESTMENTS

Executive Summary

Institutional allocations to impact investing are growing rapidly and are on track for further expansion in coming years. This growth is occurring despite a lack of consensus about how impact investing should be defined and treated within institutional portfolios.

To gain a better understanding of the fast-spreading phenomenon, Greenwich Associates and American Century Investments® interviewed approximately 75 U.S. institutional investors and more than 50 U.S. professional buyers at intermediary platforms about their views of impact investing.

- *Institutions participating in the study cite three main benefits of impact investing: 1) the ability to achieve positive social benefit, 2) the ability to align investments with personal or organizational values, and 3) the ability to send a positive message to stakeholders. Institutions are similarly aligned in their expectations of investment performance: Almost all expect a market rate of return, at a minimum.*
- *Institutional investors report lukewarm satisfaction with current impact investment efforts. Although 70% of respondents say they are at least "satisfied" with current programs, only about a quarter say they are "very satisfied." Public pension plans and defined contribution (DC) plans give particularly low satisfaction marks to existing impact investing programs. Institutions report tepid satisfaction levels with both the social contributions achieved by their impact investing programs and the investment performance of their impact investment managers.*
- *Study participants' preferred method of accessing impact investments is screened commingled funds (funds that screen in or screen out particular investments), followed by investments in screened separate accounts. Institutions also invest directly in socially responsible deals and companies, and with asset managers that financially support a designated cause.*

Despite the category's rapid growth, impact investing in the U.S. remains in its early stages. Impact investing definitions and best practices will take shape and solidify as the category continues to attract new participants and assets.

Impact Investing: Fast Growth in a Not-Yet-Defined Category

Over the past decade, growing numbers of both institutional and individual investors have started considering the social impact of their investments. Concepts like socially responsible investing (SRI); environmental, social, and governance (ESG); and "mission investing" first gained traction among investors in Europe, but these approaches now have taken hold among investors in North America. Many in the asset management industry refer to these approaches collectively as "impact investing."

The definition and best practices of impact investing will take shape and solidify as the category attracts new participants and assets.

In November 2015, Greenwich Associates and American Century Investments jointly set out to gain a better understanding of how impact investing is viewed by institutional investors in the U.S. To do so, the firms interviewed 74 public and corporate pension funds, endowments and foundations (E&F), DC plans, and institutional investment consultants.

The study yielded two immediate and important findings:

1. **Impact investing is growing.** One-third of study participants plan to increase portfolio allocations to impact investing in the coming three years. One-quarter of those institutions plan to boost allocations by more than 10%.

2. **Institutional investors do not agree on exactly what impact investing is.** To be more precise, the study results show a surprising lack of consensus among institutions about the specific definition of impact investing.

These findings show clearly that assets of pension funds and not-for-profit endowments and foundations are flowing into a category that is not yet defined. Despite rapid growth, impact investing in the U.S. remains in its early stages. The definition and best practices of impact investing will take shape and solidify as the category attracts new participants and assets. During this maturation phase, investors will benefit by working with asset managers willing to help educate them about impact investing and define the proper role for the category within an institutional portfolio.

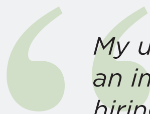
Defining Impact Investing

Institutional investors participating in the study express a general understanding of the concept of impact investing, which they identify as an investment approach whose results produce some benefit for society and link closely to terms like SRI and ESG. However, few investors could identify specific criteria that would qualify an investment strategy or firm-wide approach as "impact investing," and only 11% even know what proportion of their fund's assets are allocated to this category.

More than three-quarters of study participants agree that impact investing is not consistently defined in the marketplace. In fact, all of the public pension fund investment officers interviewed said the term lacks a clear and consistent definition.

Given this lack of consensus, Greenwich Associates uses the following definition provided by the Global Impact Investing Network (GIIN), the closest thing the field has to a trade association: "Impact investments are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return."

Study participants offered the following comments about their understanding of the definition of impact investing:



My understanding of impact investing is that you are thinking about your allocation of dollars from an impact standpoint first, such as creating jobs, preventing climate change, encouraging equitable hiring practices, those sort of things. Also, separate from philanthropy, you are expecting some sort of financial return on your investment … But the impact is first and the financial result is second.

—DC PLAN

We define impact investing as investment strategies that are capable of meeting our return expectation and at the same time are targeting ESG, or socially responsible criteria. On the environmental side, it could be helping support carbon credits, taxes or strategies around sustainable energy. Anything designed to encourage positive social change.

—INVESTMENT CONSULTANT

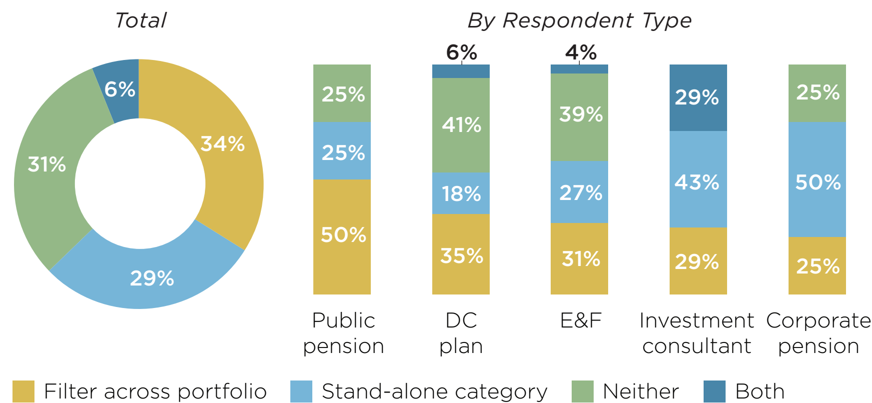
To me, it's socially responsible investing—you don't own anything in the 'sin' industry so to speak.

—PUBLIC PENSION

Multiple Approaches to Impact Investing

Perhaps complicating the effort to clearly define the category, institutions use a variety of approaches to integrating impact investing into their investment philosophies and portfolios. Thirty-four percent view impact investing as a concept, philosophy, or screen to be applied across the entire portfolio. Twenty-nine percent treat impact investments as a stand-alone investment category. Roughly 30% use impact investing as both a discrete category and a portfolio-wide application.

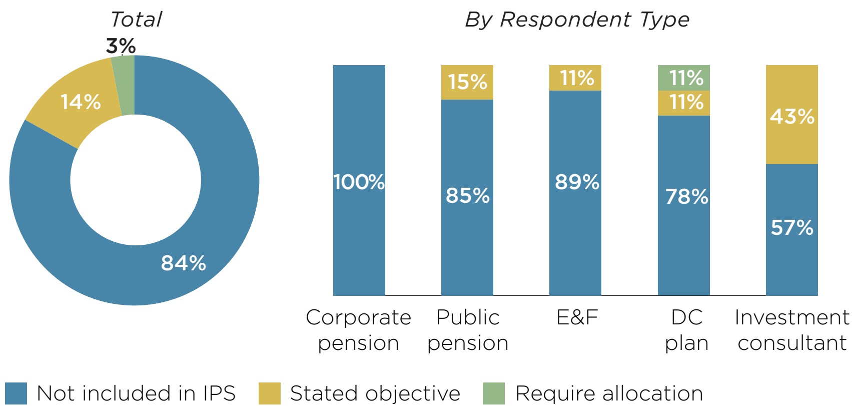
IMPACT INVESTMENTS: FILTER VS. STAND-ALONE CATEGORY



Note: May not total 100% due to rounding. Based on 70 total respondents: 8 corporate pensions, 12 public pensions, 26 endowments & foundations, 17 defined contribution plans, and 7 investment consultants.
Source: Greenwich Associates—American Century Investments 2016 Impact Investing Study

Most institutional investors do not include impact investments in their investment policy statements (IPS). Only 17% of study participants do so, with 14% including allocation objectives for impact investing and 3% requiring a specific allocation. The omission of impact investing from investment policy statements goes against the advice of many investment consultants, 43% of whom believe that impact investing should be a stated objective in the IPS. Considering that approximately 85% of institutional investors employ a consultant for advice and counsel, it's counterintuitive that respondents are essentially split down the middle as to whether advice from these advisors on impact investing is considered influential.

IMPACT INVESTMENTS IN INVESTMENT POLICY STATEMENTS



Note: May not total 100% due to rounding. Based on 74 total respondents: 8 corporate pensions, 13 public pensions, 28 endowments & foundations, 18 defined contribution plans, and 7 investment consultants.
Source: Greenwich Associates—American Century Investments 2016 Impact Investing Study

Perceived Benefits of Impact Investing

One key goal of the study was to answer the question of why institutional investors are adopting impact investing. Participants in the study are almost universally attracted by three main benefits:

1. **The ability to make a positive contribution to society**
2. **The ability to align investments with personal values**
3. **The ability to send the message to clients, board members, and all other stakeholders that the organization is socially responsible**

Conspicuously absent from the list above is superior investment performance. Respondents have mixed sentiments about the potential for impact investments to yield equivalent—or stronger—investment performance than traditional investment approaches. One consultant summarized, "If you want to feel good about what you're investing in and you are willing to give up some alpha, then that is great. But it's my job to find strategies to outperform benchmarks—sometimes those things are mutually exclusive, sometimes they are not."

VOICE OF THE INVESTOR: BENEFITS OF IMPACT INVESTING

Institutional investors spoke at length about what they perceive as the possible benefits of impact investing:

Offering a fund focused on impact investing/SRI/ESG sends a positive message to plan participants indicating that the firm endorses and supports the fund's mission and objectives.

—DC PLAN

You could look at it as a long-term PR type of benefit. In other words, how you look in the public eye. Your board members and politicians can say, 'Look at us, we don't support the gun industry.' It's a political statement, not a pension fund statement. For me, the benefit is that it keeps the board off my back ... [Also] you get to feel good about yourself. That's an intangible benefit.

—PUBLIC PENSION

When done right, I think it can have both a positive societal impact while generating a strong financial return. I think a lot of folks believe those two are mutually exclusive. That's not necessarily my thinking.

—ENDOWMENT/FOUNDATION

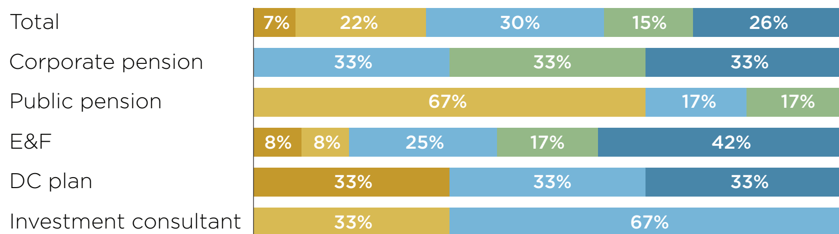
Lukewarm Satisfaction Levels with Impact Investing Efforts to Date

At a top-line level, roughly 70% of study participants say they are at least "satisfied" with their overall impact investing programs. However, a closer look at the results shows considerable room for improvement. Only about a quarter of respondents overall say they are "very satisfied," and across the board, views are divided sharply by type of institution.

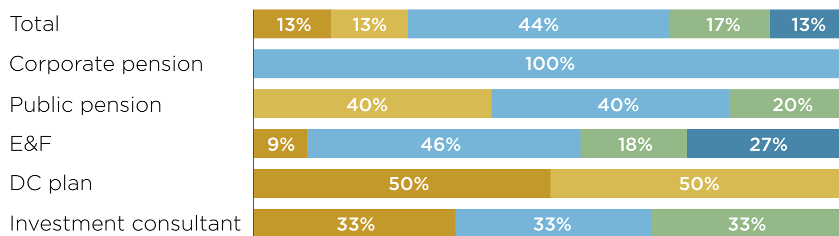
Public pension plans and DC plans give particularly low satisfaction marks to existing impact investing programs. Two-thirds of public pension plans say they are less than satisfied with current programs. Likewise, roughly 40% of DC plans participating in the study say they

SATISFACTION WITH IMPACT INVESTING

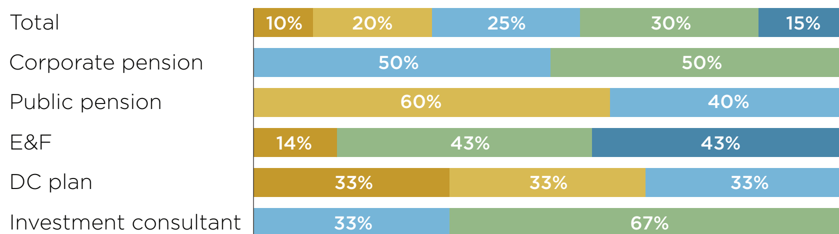
Overall Impact Investing Effort at Your Fund[1]



Achievement of Intended Social Impact[2]



Investment Performance of Impact Managers[3]



1—Not satisfied 2 3—Satisfied 4 5—Very satisfied

Note: May not total 100% due to rounding. [1]Based on 27 total respondents: 3 corporate pensions, 6 public pensions, 12 endowments & foundations, 3 defined contribution plans, and 3 investment consultants. [2]Based on 23 total respondents: 2 corporate pensions, 5 public pensions, 11 endowments & foundations, 2 defined contribution plans, and 3 investment consultants. [3]Based on 20 total respondents: 2 corporate pensions, 5 public pensions, 7 endowments & foundations, 3 defined contribution plans, and 3 investment consultants.
Source: Greenwich Associates—American Century Investments 2016 Impact Investing Study

are dissatisfied, with one-third of that group rating current satisfaction levels at the lowest possible 1 out of 5. At the other end of the spectrum, two-thirds of corporate pension plans report high levels of satisfaction with existing impact investment efforts.

Institutional investors also have tepid satisfaction levels with the social contributions achieved by their impact investing programs and the investment performance of their impact investment managers. Although three-quarters of respondents say they are satisfied with the social contributions they are making, only 13% are "very satisfied." Similarly, reinforcing potential concerns about the ability of impact investment managers to achieve strong investment performance, only 15% of institutional investors are "very satisfied" with the investment performance of their impact managers, while an additional 55% are satisfied.

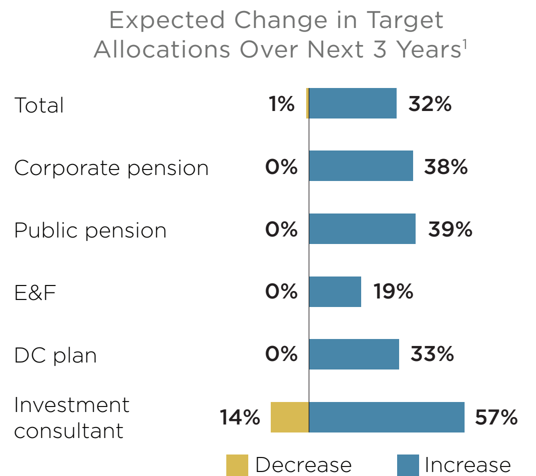
Significant Growth on the Horizon

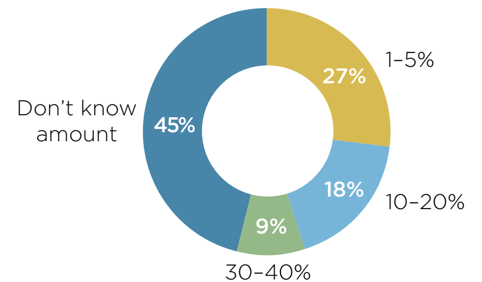
Despite these moderate satisfaction levels, institutional investors are extremely bullish about their focus on impact investing in the future. The results of the Greenwich Associates–American Century Investments study suggest much bigger growth could be just on the horizon.

One-third of the institutions in the study plan to increase allocations to impact investing in the next three years, while only 1% plan to reduce. Nearly 40% of pension plans in the study plan to expand allocations, and 57% of investment consultants say they will be recommending impact-investment allocation increases. Among study participants planning to increase allocations, approximately one-quarter expect to boost them by more than 10%. Nine percent of these institutions expect increases of 30%–40%.

With allocation increases of this magnitude, institutions are likely to raise their expectations for impact managers. Attributes that are considered most important when evaluating a manager offering impact investments—such as past investment performance, the ability to measure and communicate the impact of their investment, and a strong track record in the impact investing field—will become even more critical. Investment managers that are able to evidence success in these areas are likely to receive the most positive reception from the market.

TARGET ALLOCATIONS FOR IMPACT INVESTING

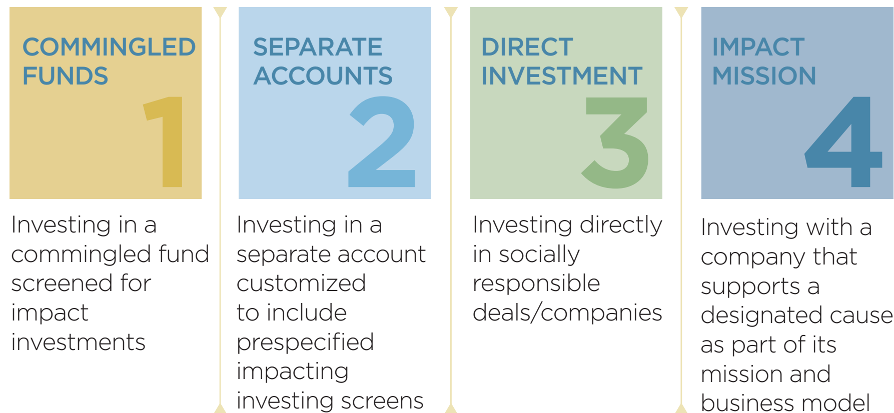




Note: May not total 100% due to rounding. [1]Based on 69 total respondents: 8 corporate pensions, 13 public pensions, 26 endowments & foundations, 15 defined contribution plans, and 7 investment consultants. [2]Based on 22 total respondents.
Source: Greenwich Associates—American Century Investments 2016 Impact Investing Study

Approaches to Impact Investing: Pros and Cons

One of the study's most important findings is that no one approach to impact investing appeals to every investor. In response to diverging views among investors, asset managers have developed a variety of ways to implement impact investments into an institutional portfolio. Among the most popular are:



Study participants rank investing in a commingled fund screened for impact investments as their preferred approach, followed by investing in a separate account customized to include prespecified impacting investing screens. These are indeed the most common and widely accepted approaches within the industry.

Both approaches allow investors to direct their assets to investments that align with desired societal benefits and their own values and beliefs. Separate accounts allow for a much higher degree of customization in terms of impact investing screens, but with the trade-off of higher fees. Of course, investors can tailor their entire portfolios according to impact investing goals by opting for approach No. 3, investing directly in socially responsible deals and companies.

Potential Drawbacks and Concerns

However, all four of these approaches include elements perceived by institutions as potential drawbacks. The first and most important of these: concerns about overall performance due to the limited universe of investment opportunities. The study results show clearly that strong investment performance is a prerequisite for virtually all institutions considering impact investing. Public pension plans and defined contribution plans in the study both see superior investment performance as a requirement for investment.

Overall, only 13% of participants would be willing to accept a lower financial return in order to make a positive social contribution. Another

39% say they are willing to accept market-rate returns from their social impact investments. Half the institutions in the study reject altogether the notion that an investor must sacrifice investment performance to achieve social benefit and say they pursue impact investments that will also drive superior returns.

At 40%, corporate pension funds are by far the most likely to say they would accept lower financial returns in return for social impact. The remaining 60% of corporate funds represented in the study say they expect market-rate returns from impact investments. Meanwhile, approximately 70% of DC plans in the study don't believe there must be a trade-off between investment performance and impact, and seek impact investments that can drive superior returns. Most investment consultants, 57% of study participants, take the middle ground and advise clients to expect market-rate returns from their impact investments.

INTERMEDIARY PROFESSIONAL BUYERS: ALIGNMENT WITH INSTITUTIONAL INVESTORS

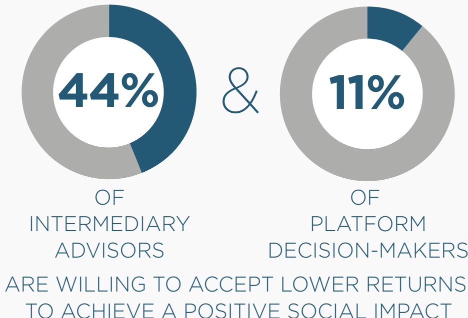
When it comes to impact investing views and behaviors, the professional buyers who select funds for intermediary distribution platforms are similar to institutional investors, but financial advisors working with high net worth clients sometimes hold starkly different views.

Alongside their research about impact investing in the institutional market, Greenwich Associates and American Century Investments conducted a study to assess how impacting investing is viewed in the intermediary-sold market through which many high net worth and individual investors access funds. To do so, the firms interviewed 52 platform decision-makers and 151 financial advisors across channels, including broker-dealers, private banks, insurance companies, and registered investment advisors (RIAs).

The results reveal some important differences among groups of study participants. Attitudes and perceptions about impact investments vary widely not only between the platform decision-makers and financial advisors, but also among different channels within the intermediary market. Those differences are clear even when it comes to defining the term "impact investing," and extend to critical measures of investors' levels of satisfaction with current impact investing efforts.

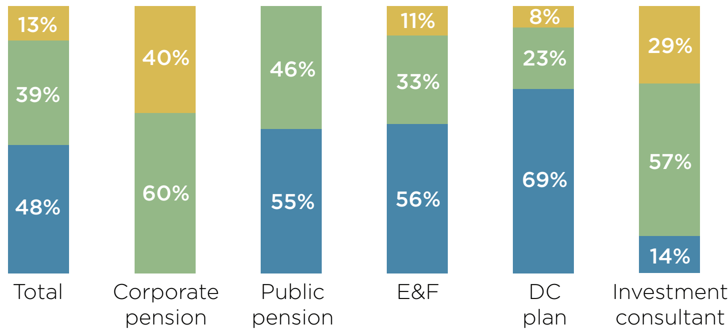
Perhaps the most striking divergence uncovered is that while intermediary decision-makers and institutional investors both largely reject any trade-off between positive social impact and investment returns, many intermediary advisors say they are willing to accept lower returns to achieve social benefits.

Despite these broad differences and an overall lack of consensus about the definition of impact investing, the study results show the category is growing and will continue to grow. Three-quarters of decision-makers for intermediary platforms and 80% of intermediary advisors believe client allocations to impact investments will increase in the next three years.



Such growth will make the intermediary market an appealing opportunity for asset managers able to deliver funds that allow individual investors to generate sufficient levels of investment returns while also meeting their increasingly important goal of achieving a positive social impact with their investment dollars.

TRADE-OFFS BETWEEN SOCIAL IMPACT AND INVESTMENT RETURNS



Willing to take lower financial return in order to have impact

Expect market rate return, but with filter for social impact

Reject trade-off between social impact and financial return and seek impact that will drive superior market returns

Note: Based on 54 total respondents: 5 corporate pensions, 11 public pensions, 18 endowments & foundations, 13 defined contribution plans, and 7 investment consultants.
Source: Greenwich Associates—American Century Investments 2016 Impact Investing Study

Given many institutions' requirements for market-rate or superior returns, the practice of excluding some potential investments from the portfolio through the use of screens or through direct investments limited to socially responsible companies could prove problematic over the long term—if this exclusion has a negative impact on performance. Managers that employ this approach to impact investing must use their impact screens to add alpha, rather than simply exclude selected categories.

For investors in the study, commingled funds and separate accounts that use screening as their primary means of implementing impact investing raises a second potential concern: difficulty measuring the true "impact" of the investment. While such screening can ensure that portfolio investments are aligned with institutions' values on important social issues, the diffuse nature of the approach makes it hard, if not impossible, to quantify the social impact the institutions' efforts achieve. Adding to institutions' concerns is the potential for conflicts of interest or even perceived conflicts of interest on the part of asset managers or consultants setting the parameters for the screen and choosing which specific industries and investments will be included and excluded.

The use of separate accounts and direct investments for impact investing raises another key concern for institutions: worries about added complexity and cost. Setting up a separate account imposes costs of resources and management attention, and often requires the use of an investment consultant. Making direct investments in socially responsible companies and deals brings with it obvious costs and demands in terms of deal sourcing, due diligence, and monitoring.

The fourth approach to impact investing—investing with an asset manager that financially supports a designated cause—alleviates several of these concerns. For starters, because the approach does not screen or exclude

investments for social impact, portfolio managers within the asset management organization have full discretion in working to maximize investment performance.

Because the investment process is not changed in any way by the impact investment commitment, the interests of investors and shareholders are fully aligned with the desired social benefit. In other words, higher returns not only benefit clients and shareholders, but also lead to bigger dividend payments to the designated cause.

For investors, there is no added cost, complexity, or due diligence requirements, and no potential for conflicts of interest in the exclusion of investments. Finally, the fact that the returns support a single cause concentrates the impact of allocated dollars and makes the process transparent, and thus, relatively easy for institutions to assess the actual social benefit generated by their investments.

However, that level of concentration can also be seen as a potential drawback. Using this approach, investors cannot set impact investing screens or otherwise direct their investment dollars. On the contrary, if the asset manager financially supports a single cause, investors with other impact investing goals might find the proposition limiting.

Investors will increasingly seek approaches that reject the trade-off between strong investment performance and meaningful and measurable societal benefit.

Conclusion

There is a clear—and growing—desire among institutional investors to use their investment pools to support both the financial and societal goals of participants, organizations, and stakeholders. This movement is still in its early stages, but as the category grows, the industry's definition of "impact investing" will solidify. While there is no one approach to impact investing that is right for all institutions, investors will increasingly seek approaches that reject the trade-off between strong investment performance and meaningful and measurable societal benefit.

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Commingled funds consist of assets from several accounts that are blended together. Separate accounts are owned by one investor, follow a defined strategy, and have their own cost basis. Alpha is defined as the excess returns relative to the return of a benchmark index. An Investment Policy Statement (IPS) is a document that outlines the general goals and objectives of a client and describes the strategies that the investment manager should employ to meet those objectives.

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