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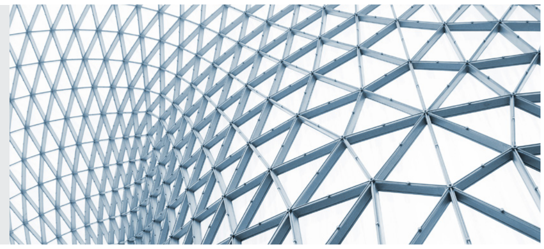

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Why has making an impact been made so hard?

As if the regulatory burden that has emerged since the 2008 Global Financial Crisis wasn't enough, today's trustees of the UK's pension schemes are also expected to assess the financial impact of climate change. Yet, without an accepted definition of how ESG can make a difference, it all seems just a tad unfair but could be made a lot simpler.

Key Takeaways:

- Despite an inordinate amount of words written by sustainability advisers over the last 10 years, Trustees are still none the wiser about how to account for climate change in their scheme's SIPs
- Now regulations have been expanded to include Impact Investing, a simple philosophy that offers Trustees the ability to influence social good, but where purists insist on a conflict between intentionality and the priority for investment returns
- This threatens the added burden of another raft of definitions and measurements that risk disenfranchising LGPS (in particular) from benefiting their local communities. On the other hand, a strategy such as AEW's UK real-estate strategy can have a significant social impact while meeting fiduciary investment objectives, without the need to be labelled as a 'social impact fund'. AEW believes that enabling and not labelling should be the defining force for good.

When the concept of ESG (Environmental, Social and Governance) arrived on the investment scene, it seemed like such a wonderful phrase. It perfectly encapsulated such a broad agenda of risks and opportunities in a succinct statement that:

- **started a long-overdue debate on social good and corporate responsibility**
- **recognised that good governance was the ideal way to safeguard investor assets**
- **seemed to allow investors to take into account the effects of climate change as well as many other extra-financial issues**

ESG also underpinned the UN-backed Principles for Responsible Investment, from which many asset managers' and asset owners' Responsible Investment Policies have been written since its inception over two decades ago.

Finally, the emergence of ESG seemed to ease some of the historical tensions associated with the ideology of 'ethical investing' – namely whose ethics were the most laudable, yet did the least damage to investment returns?

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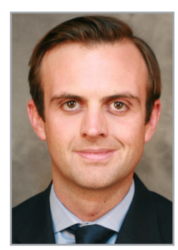

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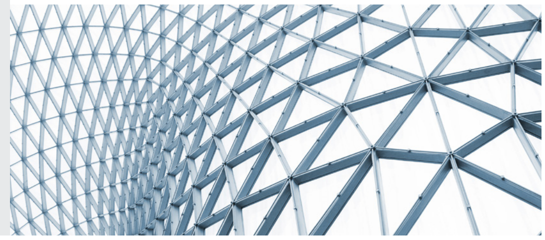
Making a better world

Of course, experience teaches us that as soon as an investment band wagon starts to roll in the financial services community, a new set of measurement standards, performance benchmarks, detailed reporting and regulations will inevitably follow. So too will a raft of consultants, advisers and technocrats, each of them embracing the opportunity of articulating and promoting this new paradigm to the masses. Why? Because as an industry we are somewhat obsessed with SMART[1] objectives.

Some of the leading industry actors have been quick to capitalise on this trend. So-called 'Heads of Sustainability' wax lyrically about 'making a better world', reassuring us that sustainability goals can be achieved without compromising investment returns. How can they ever

[1]Specific. Measurable. Achievable. Relevant. Time-bound



know that without understanding the specific objectives of the investor or the investment fund? This feels naïve at best.

Still, in no time at all, ESG has evolved from the conceptual to the literary. It has become almost a word in and of itself. It has now made its way into the Department of Work and Pensions regulations and The Pensions Regulator Codes of Practice as a mandatory consideration in all investment strategies.

Emerging risks

ESG – as a paradigm, a concept, and as a word – is pervasive within the UK investment community. Yet at the same time, this has all happened without a generally accepted definition or common understanding of what ESG really means and how it makes a difference.

Therefore, trustees of the UK's pension schemes, already overburdened by a raft of regulatory requirements that have emerged since the financial crisis, have an additional responsibility bestowed upon them. And, whilst no one should deny that climate change is a risk that spreads across the whole of society, one could question if it is fair to expect Trustees of pension funds to be forced to shoulder such a responsibility when Government climate change policy allows the rest of us to carry on consuming exponentially without bearing the cost of the damage we are doing to the planet.

Given these issues, it should come as little surprise that trustees have begun to look towards the concept of 'impact investing'. It's seen as a way of escaping both the vagaries of ESG and the onus of constant negative screening. If trustees are forced to own the responsibility, impact investing seems, on the face of it, a much more explicit method for their investment powers to make a positive impact on the community.

GINN tonic

But impact investment also does not come without its challenges. The Global Impact Investing Network (GIIN), the non-profit organisation dedicated to increasing the scale and effectiveness of impact investing, requires clear intentionality and impact measurement.

'Intentionality' means that, for a given investment, the investors' purpose is to create social or environmental impact. 'Measurement' requires investors to measure and report the social and environmental performance of underlying investments. One can only presume that if these two criteria are not met, in the eyes of GIIN, it doesn't count but one of the attractions of social impact investing (SII) is that it is currently less defined, less restrictive and more philosophical in its approach.

However, it might not stay that way for long. Cue calls for another set of guidelines – this time from the Society of Pension Professionals. Their July 2019 white paper prescribes the need for a new 'universally agreed' set of standards for measurement, reporting and monitoring to "help boost growth in the £91 billion market for SII globally". They proffer that this will subsequently give more funds sufficient scale, and ultimately provide trustees greater choice.

Social need

Ethical investing, responsible investing, ESG, impact investing – and now social impact. Call it what you like, we can only think that if we were a UK pension fund trustee, we'd be wondering why the burden of governance around something so simple has made it all so hard.

As the manager of a UK real-estate strategy, the investment objective of AEW, an affiliate of Natixis Investment Managers, is to achieve an inflation-linked, absolute return by investing in traditional and alternative property sectors. This includes funding investments in care homes, NHS accommodation, supported living and nursery education – all of these are sectors of the economy where occupier demand is driven by social need.

The strategy has a combined exposure to social sectors of almost 40%. By their very definition, these investments must be having a social impact. Still, it is not a 'social impact fund', nor does it pretend to be. Yet, AEW has demonstrated **that the strategy can deliver meaningful social outcomes while meeting the fiduciary investment objectives**.

Purists would argue that such a strategy is unworthy of being considered as a form of social impact investment if it is not branded a social impact fund, and if there is no clear demonstration of 'intentionality', nor any impact reporting. They would also likely baulk at the fact that the investments in social sectors sit alongside investments in – horror of horrors - "unethical" properties, namely pubs. This logic would, however, negate comments from investors who have genuinely suggested that our pubs, so often at the heart of a community should also form part of our social impact allocation – if nothing else, this illustrates the need for freedom to allow trustees to form their own definitions of where and how they seek to make a social impact.

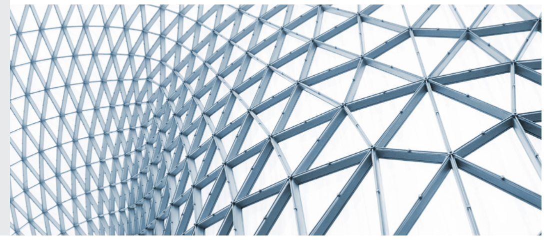
AEW's proposition is simply to say that if Trustees want to choose part, all or more of RRF's social allocation as part of their scheme's own definition of Social Impact Investing, they should have the freedom to do so. But if the pressure on trustees pushes this nascent world of SII into tighter and tighter definitions, the economics of supply and demand would suggest that returns might suffer as a result. This could create a paradoxical situation where the intention to 'do good' ends up undermining the duty to 'invest in the beneficiaries best financial interest'.

Enabling change

It feels to us like the fascination with SMART objectives has caused us to put the proverbial horse before the cart. We seem to have become more concerned with 'labelling' than we have with 'enabling'.

One of the great attributes of the financial services industry is its ability to innovate and develop new products and services to meet the needs of an evolving world. But our worry is that, more recently, we are now so hung-up on the labelling of activities that we're unable to move forward.

Indeed, we are starting to wonder whether it might be easier for schemes to shape their own social investment choices, based on the causes that are most relevant to the scheme's members, such as homelessness, poverty or health.



Doing so would allow them to focus on enabling, ie working with governments, authorities and NGOs to put more investable programs in place.

We would suggest that if scheme SIPs (Statement of Investment Principles) must now include Impact Investing (where this did not compromise the Trustees' duty to invest for the beneficiaries best financial interests), Trustees might welcome such a qualitative approach to "positive screening" which can be applied across all asset classes and where manager selection might develop a bias to themes of social impact, but not to compromise returns, as a way of demonstrating implementation of a policy with objectives that can be bespoke to each scheme. If this defines the Impact, is there really the need for a huge debate about whether it was the intention or the consequence of a sound, "responsible" approach to investment? After all, we all know it was the chicken that came first.....or was it the egg?

What should come first is the process of making a difference through investment, rather than a product label that loosely interprets a set unnecessary rules.

If SII evolves down the path outlined in the SPP White Paper, we fear that what is currently a philosophical approach to sound investing, risks becoming an investment allocation decision – equities, bonds, alternatives or SII; if it evolves as a sector it has to evolve its own return characteristics and skew the returns achievable from a portfolio that otherwise would be ex-SII. This is something our colleagues at Natixis have already observed with "green" products which have had some popularity, but resistance has grown to the idea of "token" allocations because the implication is that the rest of the portfolio has to be "brown".

A sector regulated by "standards" will inevitably end up disenfranchising Trustees from choice – it might be easier for a corporate pension scheme to shape their own positive SI choices than screen out ethical risk but, depending on how LGPS Pools choose to offer or prescribe an SII allocation to their members, Local Authorities seeking to launch community focused investment initiatives with pension funding (similar to Lancashire CC and South Yorkshire) might find themselves on the wrong side of the definition of SII.

One glimmer of hope from the Society of Pension Professionals' white paper is the recommendation that, even with a SMART framework in place, investment consultant buy-in is essential. We would not disagree, but now is the time for advisers to suggest, as we have tried to do here, that the emphasis should be on enabling and not labelling and that for once, the KISS[2] principle might be a far better and simpler solution.

Written in March 2020

[2] Keep It Simple, Stupid

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A simplified joint-stock company with capital of € 828,510, register under the RCS number Paris 329 255 046.
Registered office: 22 rue du Docteur Lancereaux 75008 PARIS
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INT176EN-0420