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Determining strategies and accessing alternative assets in a highly competitive market

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NATIXIS INVESTMENT MANAGERS

mirova Responsible Investing

What comes first alternative or ESG strategies: what is impact investing and what drives it?

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POINTS OF DISCUSSION

- *There is no standardised answer as to exactly what qualifies as impact investing, but in the narrow sense of the term it depends on having a predetermined bottom-line with social and economic goals and objectives*
- *Impact investing can be measured against positive impact on certain targets such as the Sustainable Development Goals by the UN*
- *Impact investments are put through both an impact lens and a financial return on investments lens*
- *Getting the right definition for impact investing in your investment policy as well as putting targets to ensure that there is attention to possible impact investments will help to make it more robust in your own organisation*

Zoi Fletcher: How would you define impact investing and how wide does the definition go?

Rasmus Juhl Pedersen: For an investment to qualify as impact investing it has, in the narrow sense of the term, to have a predetermined social and economic bottom line. There must be a reflection of how the investment is meant to reach both its return on investments as well as its social impact. This means that the investment needs to qualify both in respect to the returns in social and financial aspects.

Jos Gijsbers: We are still finding new ways to describe impact investing although there is a very general definition. We feel that we do a lot of impact investing already, especially within the alternatives space, but we would like to have a broader definition to ensure that we can have impact investing within all of our portfolios. We feel that asset classes such as listed equities, corporate and governments bonds should also contribute to this bottom-line approach and that it could create a positive impact.

Christian del Valle: It is very telling that this is the question we are starting with, because when we set up the Althelia Climate Fund 5-6 years ago, we became one of the founding members of the Global Impact Investors Network ("GIIN"). At most of the GIIN events in those days, one of the questions that we were all trying to answer was what exactly impact investing is, and what goes first, the pursuit of returns of the pursuit of impact. The truth is that I am not sure that there is a canon answer for this question, even today.

Now, we have arrived at a place where the notion of impact investing is beginning to take the shape of a combination of interesting and additional social and environmental outcomes paired with a return-driven strategy. This is getting more attention and focus from investors.

The fact that we don't have a standardised answer and it is not driven by any sort of regulatory based matrix, in the same way that corporate governance and AML are, means that this is still warming up and there is a lot of room for standards to be agreed and applied. But it is still very much a work in progress.

Zoi: Do you agree investors can have a positive impact when investing in bonds, and are they also part of your definition?

Rasmus: In the broader sense of the word yes. Although every investment potentially has both positive and negative impacts so of course all types of investing have an impact. In the past, we have been satisfied by the income, employment and export generation from investments being about impact in the broader sense. But, in terms of the SDGs it does call for a narrower perspective.

Christian: We are not formally active on the fixed income side. We manage a series of fund structures that are akin to private equity in some important ways. In our recent tie up with Mirova and Natixis at the end of 2017, we have since been working with the bank to broaden the investor reach (e.g. products targeting retail and high net worth clients) through some bond type structures.

The preliminary feedback we have received from the market has been very positive and we feel that there is a lot of interest there for impact investing strategies. But again, this fixed income sector is even farther behind our space in coming up with a definition for what they are actually seeking.

Without diving too deeply into our own strategy, what we seek to do is to create a parity between fair and transparent market-based returns and absolutely cutting edge, leading ESG and impact delivery, primarily on the natural capital side as well as the social side.

Some of our funds do lend themselves very well to using a bond wrapper to broaden the reach of investment euros and dollars that could be flowing into this space which is very important right now.

Zoi: Would you measure impact by how much it achieves your ESG goals?

Jos: As the definition of impact investing is already difficult, metrics to measure the impact is even more difficult. It is not just the ESG impact because the ESG policies are applied to all of our investments, which includes exclusions, ESG integration or best in class investments. Impact investments go a little bit further where the intention is important for making the investment in order to have a positive impact.

This is typically driven by a theory of change to tackle problems or to have a positive impact on certain targets such as the Sustainable Development Goals by the UN. There you also have many indicators on how you could measure the impact. When we try to define our impact investments, we also try to have a number of relevant metrics for each investment. We cannot tackle all of the SDGs, but typically you can have a major impact on 5 to 7 of the SDGs as an institutional investor. And we have a number of simple metrics available, but there isn't one standard model that measures it all.

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Rasmus: It is a combination the SDGs which is something that is relatively new for us in terms of investment approaches. We have used them in the past, trying to designate how our investment stewardship dialogues with companies relate to the SDGs but in terms of investments it is relatively new for us. We can see that this is an approach taken by more and more funds.

Zoi: Are you really investing for impact or are you investing for a good return then looking at it through an impact lens?

Rasmus: If we are looking at our entire portfolio it wouldn't not live up to the definition that I previously gave. We do have particular investments that we term impact investments where we put the investment through both an impact lens and a financial return on investments lens. For instance, we are invested in a micro finance fund and are currently looking into another micro finance fund. And when the external manager is selecting or identifying which fund to work with, they want to have assurances that it can meet its social objectives before they start looking at whether their economic objectives can be fulfilled as well.

This is a good way to distinguish between different approaches to impact investing and whether you are taking it seriously.

Jos: Firstly, we are an institutional investor and an insurance company with several stakeholders. Thus, we primarily invest to safeguard the payments that we have to make to our clients, now and in the (long-term) future. So financial returns are always a very important part of the decision process.

We are seeking to mainstream environmental and social integrity into operating models, primarily in developing countries where you have potential for conservation and agricultural production objectives to run in opposition to one another. This means that definitionally we have to deliver impact along with fair investment returns. And they are sitting at parity with each other in terms of our decision making on where to invest, how to invest and what expectations to strive for.

Zoi: Assuming you can generate more quantitative impact per Euro in alternative assets, do you start with good investments in alternatives and then see where they are the most impactful?

Jos: The impact per euro is typically higher in the private equity or private debt space. It can be efficient for us to also invest within alternative assets which are different from our standard investment approach, to build a more diversified portfolio. Like Althelia funds, as head of manager selection I also know them and was recently pitched for a co-investment by FMO for the Althelia climate fund. It's an interesting opportunity but slightly out of our comfort zone. We also prefer investments in alternatives or impact investments in more developed markets that are better accessible or less risky for investors. It may be that the impact per euro is more within the emerging markets space but the impact per euro multiplied by your investment is what makes the total impact. So, I could commit 10 million for an Althelia fund to invest in emerging markets or 100 million in a renewable energy fund in the euro zone.

"This isn't just cosmetics, as we target investments that will be successfully driven in a complimentary way both by the impact elements and the profit-based elements"

Nonetheless, we have allocated a budget for impact investing of 300 million euros per year for the next three years. So, we do pay special attention to possible impact investments. But these should also tick all the other boxes.

Christian: It isn't a matter of one or the other for us: quite simply our founding mission is to generate fair market returns as well as key impacts that are both quantifiably and qualitatively demonstrable.

We target the so-called bottom of the pyramid, and we see the UN's Social Development Goals (SDGs) as a layer cake of sorts. We have identified climate, life on land and life in the water as underpinning the natural resource base upon which the rest of human economy and society rests. Our investors across three funds have invested on the basis that we are going to invest profitably as well as continue to deliver the impact reporting that they expect.

This isn't just cosmetics, as we target investments that will be successfully driven in a complimentary way both by the impact elements and the profit-based elements.

The most impactful is a combination of the impact per euro times the number of euros that are invested. Because of the a.s.r. investment guidelines, we have most assets in developed markets, including impact investments. Like climate change for example, which is a global problem and is also caused by developed markets. So, the energy transition in developed markets is also a great opportunity to have a meaningful positive impact.

Rasmus: In terms of renewable energy, we have several investments made to renewable energy through fund investments. These investments are made primarily from return on investments and a diversification perspective. It isn't as if we have looked at which particular renewable energy investments we can make the biggest impact with and we have not been choosing between different renewable energy investments based on their impact.

In the more conscious way that we are looking at impact investments is that there needs to be both a social, environmental as well as a return bottom line which is positive and lives up to our requirements.

> IT MAY BE THAT THE IMPACT PER EURO IS MORE WITHIN THE EMERGING MARKETS SPACE BUT THE IMPACT PER EURO MULTIPLIED BY YOUR INVESTMENT IS WHAT MAKES THE TOTAL IMPACT

It is more difficult to determine which social or environmental impact is appropriate or satisfactory as this is an area where we need to have a more experienced based view which we don't currently have.

Christian: We have double-barrelled selection criteria and neither is senior to the other. Both are must-haves. We work typically with a growth strategy, less so with green field activities. We work with sponsors who have a track record and who may have been working on a model that has been primarily driven by donor or philanthropic funding in the past but are now trying to march to scale by creating a more investor friendly approach. This is where impact investing can be very useful.

Thus, when we select a pipeline and try to assemble the portfolio, we are already looking at both. At times, we start with something that at its core, is a productive activity, say livestock farming in the Brazilian Amazon. In these cases, we need to layer on investment such that you can ensure that this livestock farming maintains productivity and profitability, but where we can remove deforestation in a quantifiable way from the outcome, so that people who wish to purchase beef from these ranches know that it is deforestation-free beef and production is maintained to high animal welfare standards etc.

This is an example of where you can start with something that at its core is just a commercial enterprise but through impact investing you can layer on the social and environmental positives.

Equally, sometimes we see activities that were previously led by NGOs or donor-based initiatives that have been very powerful at delivering conservation in a finite or local area. But we feel that by incorporating elements of sustainable production with buffer zones of national parks etc., we can drive to scale and build a wider landscape level model that delivers conservation alongside economic benefits, as well as investor returns.

Issues such as climate change are global problems and in order to be a meaningful actor in delivering solutions you need to always keep scale foremost in your mind. A good impact manager can excel at doing both, bringing green to financially sound initiatives and bringing financial soundness to strong green initiatives and choosing which tactic to work with as appropriate.

Zoi: How can the industry make impact investing more robust, where it really drives investment decisions, rather than being an add on story?

Rasmus: This approach that one particular external manager takes in terms of making sure that the social and environmental impact is satisfactory before they start looking at whether they can also secure a positive financial return. This is a good way to separate and compare different investments. It makes it more explicit that it is an impact investment. When you try to portray a relatively traditional management approach and then try to align it with the UN development goals, that has the taste of an add on story. That's not an investment where you started by looking at where you could make a difference in terms of impact such as, for instance, by concentrating our micro finance on rural areas and focusing on women.

Generally, the industry needs to develop their experience as making impact investments is relatively new and there are as yet relatively few examples to learn from. There seems to be a new set of managers who offer themselves and don't have the traditional investment management background and track records. They come out of development impact with strong records in this area.

These different elements must come together and within the industry. When we are talking about impact investing, we need to know exactly what we are talking about. Are we talking about the narrow definition that I gave with the predetermined expectations on both sides? Or are we looking at impact in a much broader sense where investments have both positive and negative impacts? Ultimately, it is about reducing the negative impacts and improving the positive ones.

This covers a large stretch of different approaches so using impact investing as an umbrella term for responsible investing is one way. But a narrower and better-defined approach is to separate impact investing where you have a top and bottom line with predetermined goals and objectives.

system services each year due to the loss of biodiversity, or the fact that natural capital actually makes up around 36% of total wealth within developing countries, you very quickly get to a point where you see that if you are doing business in a way that does not take this into account, then there is a problem with the business model.

Mainstreaming ESG and impact investing is very key and, not to sound too alarmists, but we are told every year by the UN that we have about 4-5 years left at today's CO2 emissions levels before we surpass the carbon budget that keeps us to within one and a half degree of historical temperatures. So, we know that the clock is working against us. Swiftness as well as ambition are required to address this issue as quickly as possible.

> “A good impact manager can excel at doing both, bringing green to financially sound initiatives and bringing financial soundness to strong green initiatives and choosing which tactic to work with as appropriate”

Jos: Getting the right definition for impact investing in your investment policy as well as putting targets on the definitions to ensure that there is attention to possible impact investments will help to make it more robust in your own organisation.

We will often partner with other financial sector specialists to source impact investments. Typically, the impact is driven by a theory of change by small innovative companies who are starting up very impactful business models, which are less accessible for us. In these cases, we will typically use private equity managers, like Althelia or others, with the expertise and network to help us find the right portfolio companies. Still, these companies are in the early stages and not always very scalable. So comingled funds from professional financial organisations make impact investing more robust for our portfolios, to invest in sufficiently diversified portfolios with limited budgets.

When you move further away from the developed markets, then you also encounter political, legal, currency and other risks, which can make it difficult to make a robust investment proposition. And here it would be helpful if there were a facility for blended financing i.e. when development banks or super-nationals help us to invest in these markets and can put certain guarantees on them as well. In this case, it can become a market-consistent impact strategy, that can also compete with other private equity or private debt investments.

Christian: We feel that we need to look at both impact and sound ESG management as two sides of the same coin. Internally, we see them as key to our business and also sustainability in the wider sense. When you look at something like the 20 trillion dollars lost in eco

Jos: That is right, but it should be said that there is a lot of tailwind for these kinds of strategies. And this helps us to generate good returns so it is helpful that there is a transition going on and that you can position yourself accordingly.

Christian: Absolutely and it is not easy, and I have a lot of respect for those inside of mainstream financial services or innovations because it is difficult. I spent a lot of time working at a large bank, and to take mainstream, tailwind or not, I understand is a difficult climb, so you do have to give yourself a pat on the back because it is still going across the broader grain sometimes.

Jos: Yes, and every small step counts, so it is about continuing to take these steps in the right direction.

Zoi: Thank you all for sharing your thoughts on this topic.

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