Rahul Kapur is a student member of the IFoA working for E&Y in Delhi, India. He believes that Impact Investing provides a win-win for investors and society. In this article, the second of a 3-part series, Rahul sets out the rationale for impact investment for pension funds, gives real-life examples and explains how pension funds can enter this space. See the first part of this article on the IFoA Blog site.

Impact Investing by Pension Funds – Towards a better future

By Rahul Kapur, India

COVID-19 and Inequality

The COVID-19 pandemic has highlighted pre-existing inequalities. Emerging data suggests that it is also responsible for widening some inequalities. According to research carried out by the International Monetary Fund (IMF), countries with higher relative poverty had higher rates of both cases and deaths. Furthermore, countries with worse access to health care have experienced higher COVID-19 mortality rates. It also estimates that education losses in 2020 amount to one-quarter of the year for advanced economies compared with twice as much for emerging market and developing economies.[1]

It is becoming patently clear that we urgently need to stem the tide of ever increasing inequality in our societies and worldwide. Impact investing is gaining momentum as people realise its potential to target social issues and environmental challenges.

What is Impact Investing?

Impact investing means having the intention of generating positive, measurable social and environmental impact alongside a financial return. These investments have an ***intention*** to generate positive outcomes, rather than simply avoiding harm, and are ***accountable*** for the measurement of their impact.

Impact investing is not a new concept, but it is often confused with other elements of Environmental, Social and Governance (ESG) investing. The difference comes down to intention; impact investing specifically targets enterprises that intentionally create a positive social benefit, either as a primary or secondary purpose.

In my first article on this topic "Impact Investing – Can We Make Returns and Reduce Inequality?"[2] I outlined in more detail what this growing investment approach is.

Why should Pension Funds engage in Impact Investing?

All money has impact

As consumers we are becoming increasingly aware of the positive (or negative) consequences resulting from our choices about where we spend our money. We should be mindful of the power of our investments too. Millennials (and indeed other generations) across the world have voiced their desire for their money to be used to drive positive social and environmental change. Millennials will make up the largest portion of the pension savers over the next two decades as they move into middle age.

Attractive returns

With more focus and emphasis on sustainability and equality, these investments have the potential to yield strong returns, ensuring stability of income in the future for pensioners. According to Jackie VanderBrug, head of Sustainable and Impact Investment Strategy in the Chief Investment Office of Merrill and Bank of America Private Bank[3], sustainable investing is proving its strength and durability more than ever before. She states that "there is growing data showing that impact investing may potentially produce long-term returns that are as good as, or even better than, traditional investing". More generally for ESG, BofA Global Research found that a strategy of buying stocks that rank well on ESG metrics would have outperformed the broader market by up to 3 percentage points per year over the last five years.[3] Specifically for the impact investment segment, the Impact Investing Institute is in the process of compiling data on past performance for publication. It seems plausible to suggest that future returns are likely to be positively impacted by the changing regulatory environment. For example the commitments made by governments around the world to keep pace with the Paris Climate Agreement, which have been bolstered recently by the U.S. re-joining the agreement, will increase the pressure on companies worldwide to develop greener solutions and act more responsibly.

Duty of Care

Pension scheme trustees have a legal obligation to act in the best interests of their schemes' members. What does this mean in the context of the need to manage the world's environmental and social challenges? It could be argued that trustees should view it as a part of their fiduciary duty to consider generating positive impact through their investments. The role of a pension trustee is not only to maximise returns but to efficiently manage risks and safeguard the assets of the fund, ensure its solvency to ultimately ensure that pensioners receive their benefits. Thus, a trustee should also look at other benefits that impact investing may be able to provide to their members such as diversification, provision of income and reduced volatility. The question for trustees needs to be "for our risk budget, can we find assets that will generate the sustainable returns we need to meet our return objectives?"

Diversification

Impact investing can be a useful tool for pension funds to diversify their portfolios. According to impact investment managers BlueOrchard, although impact investing can be carried out across a wide array of asset classes and sectors, currently the main focus is on asset classes that are conventionally not available through public markets, namely private debt, private equity and sustainable infrastructure. The low correlation between private markets and the traditional asset classes could make impact investing an attractive diversification option.[4]

Disclosure

Increasingly, new regulations are coming into force requiring the disclosure of ESG credentials.

In October 2019, the UK government introduced the requirement for trustees of occupational pension schemes to explain how they considered climate risk, as well as other ESG factors in their investments.[5] The Pension Schemes Act 2021 passed in February took things further – requiring schemes report on the climate risk associated with their investments from this autumn, starting with the largest schemes.[6]

In the EU, as a further step in the roll-out of its green agenda, the European Commission is shortly expected to finalise ESG-related changes to MiFID II. These amendments will make it mandatory for advisers to introduce ESG considerations into their suitability assessments. The new rules go beyond simply asking clients if they have any ethical considerations. Under the current proposals, advisers will have to determine clients' ESG preferences and recommend investment products and services that are suitable on that basis.[7]

A sizable impact

The impact investing industry has grown enormously over the last five years. According to Global Impact Investing Network (GIIN), as of 2020, the size of Impact Investment worldwide was USD 715 billion.[8] It is estimated that only 3% of this is held by pension funds and insurance companies. The pension industry worldwide is worth over $50 trillion dollars.[9] If the pension industry embraced impact investing the effect on people and the planet could be transformational.

Pension Funds practicing Impact Investing

MN is a fiduciary asset manager responsible for pension administration for almost two million people in the Netherlands. It started practicing impact investing in the year 2016. As at the end of 2018, its impact investments totalled 1.9 billion euro. For the pension funds it serves, it focuses on energy transition, circular economy, access to finance and affordable housing. If MN is not able to find existing funds or projects that match its impact themes, it is willing to construct investment products with external partners. For instance, it invests directly in residential projects in the Netherlands. Like many institutional investors, MN integrated ESG considerations across its investment portfolio. Over time they decided that they wanted to do more. The integration of ESG-criteria tends to be focused on excluding or improving the *negative* aspects of investments. With the impact investments, it was seeking to actively channel capital to *positive* environmental and social solutions with that investment. It believes that one of the keys to success is to have thorough and rigorous discussion with the boards of the pension fund clients in order the establish objectives and expectations.[10]

Merseyside Pension Fund is responsible for providing pension for local authority employees in the Merseyside Region, United Kingdom. As of March 2017, it had invested £50m in the impact investment sector.[11] Further investments were also made. For example, in July 2020, it was confirmed that it had made investment into COLIV - the world's first fund offering institutions an opportunity to invest in the London co-living sector, helping to address the capital's housing shortage by increasing the supply of an innovative residential asset class.[12]

How can Pension Funds engage in Impact Investing?

The Impact Investing Institute has designed a set of Impact Investing Principles for Pensions[13] to help pension schemes navigate and respond to the significant shift in understanding of ESG risks and opportunities. The IFoA is one of the early adopters of these principles.

Sarah Gordon, CEO of the Impact Investing Institute presented a live webinar to the IFoA on the 24th February explaining why pension funds should be looking to invest sustainably and with impact. She recommended "not letting the perfect get in the way of good" and to take baby steps by initially allocating a small proportion of the portfolio to impact investing and see how it goes.

The Principles are for trustees, local government pension scheme (LGPS) committee members, advisers and in-house investment teams across the full spectrum of pension schemes.

Principle 1 - <u>*Set impactful objectives*</u>: establish and incorporate 'impact objectives' as part of your pension scheme's statement of investment principles (SIPs) or policies, which can be explained to your members and are designed to serve the scheme's purpose.

Principle 2 - *Appoint investment consultants and managers with impact integrity*: identify and appoint investment consultants who are aligned with your investment beliefs and objectives, and fiduciary and/or investment managers who can achieve your scheme's impact objectives through their investment and stewardship activities. The GIIN is an excellent resource for identifying experts in the impact space.

Principle 3 - *Use your voice to make change*: progress your impact objectives by formulating stewardship guidelines for your, or your investment manager's, voting and engagement activities.

Principle 4 - *Manage and review your impact*: monitor progress against your impact objectives by identifying relevant indicators and benchmarks, assisted by your investment managers.

Conclusion

The Impact Investing Institute is an incredibly useful resource for further information. The Global Impact Investing Network (GIIN) is another rich source of material. Actuaries need to start by educating ourselves about impact investing.

I believe that we, as actuaries can play a critical role in bringing this investment approach into mainstream pension investments for both defined benefit and defined contribution pensions. The financial and non-financial benefits have the potential to be immense.

References

1. IMFBlog. Giving Everyone a Fair Shot. *IMF Blog* https://blogs.imf.org/2021/04/01/giving-everyone-a-fair-shot/.
2. Impact Investing – Can We Make Returns and Reduce Inequality? *Institute and Faculty of Actuaries Blog* http://blog.actuaries.org.uk/blog/impact-investing-can-we-make-returns-and-reduce-inequality.
3. What is Impact Investing? The Benefits of ESG Sustainability. *Merrill Lynch* https://www.ml.com/articles/market-decode-is-impact-investing-right-for-you.html.
4. Why pension funds should consider impact investing. *BlueOrchard* https://www.blueorchard.com/why-pension-funds-should-consider-impact-investing/ (2020).
5. Investment DC pension schemes. *The Pensions Regulator* https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes-.
6. Pension Schemes Act 2021. https://www.legislation.gov.uk/ukpga/2021/1/contents/enacted.
7. New ESG changes to MiFID II, AIFMD and the UCITS Directive - what fund and asset managers need to know - Allen & Overy. *Allen Overy* https://www.allenovery.com/en-gb/global/news-and-insights/publications/new-esg-changes-to-mifid-ii-aifmd-and-the-ucits-directive-what-fund-and-asset-managers-need-to-know (2021).
8. 2020 Annual Impact Investor Survey. *The GIIN* https://thegiin.org/research/publication/impinv-survey-2020.
9. Assets of pension funds globally 2009-2019. *Statista* https://www.statista.com/statistics/421220/global-pension-funds-assets/.
10. MN | The GIIN. https://thegiin.org/mn.
11. Merseyside Pension Fund. *Pensions For Purpose* http://www.pensionsforpurpose.com/knowledge-centre/case-studies/2017/10/12/merseyside-pension-fund/.
12. July 2020, I. S. Merseyside Pension Fund invests in London co-living fund. *IPE* https://www.ipe.com/merseyside-pension-fund-invests-in-london-co-living-fund/10046705.article.
13. The power of pensions – how pension funds can invest with impact. *Impact Investing Institute* https://www.impactinvest.org.uk/the-power-of-pensions-how-pension-funds-can-invest-with-impact/ (2020).