Jonathan Steffanoni,
QMV Super Solutions

Jonathan Steffanoni is a lawyer, principal consultant - legal and risk at QMV and a fellow of ASFA. He advises and consults on a broad range of projects with Australia's most prominent superannuation funds.

Désirée Lucchese

Désirée Lucchese is a sustainability and ESG expert committed to the collaborative design and delivery of corporate responsibility and integrated investment strategies. In late 2015, she was appointed by Directorate-General for Environment (European Commission) as a peer reviewer

IMPACT INVESTING: AN EMERGING OPPORTUNITY TO ADD BROADER VALUE?

Jonathan Steffanoni and Désirée Lucchese

In a 1970 article in the New York Times Magazine, Nobel Laurette and late University of Chicago Professor Milton Friedman pronounced that *"the social responsibility of business is to increase its profits"*.

Essentially, Professor Friedman was suggesting that there should be no strategic or tactical prejudice to the financial imperative in making business decisions.

The law for superannuation trustees echoes Friedman in requiring that the social responsibility of fiduciaries is to provide the best financial interests of beneficiaries, being the best retirement income interests of members. Indeed, an adequate or comfortable income in retirement without depending on government or family for financial support is a social good in and to itself.

Yet, there are increasing voices that call for asset owning fiduciaries to integrate greater consideration for extra-financial information to address macro-economic risks such as natural resources scarcity, growing urbanisation, inequality and climate risk and thus bring about broader societal outcomes. This aligns with the concept of "universal ownership" whereby large asset owners such as pension and sovereign wealth funds are recognised to have broader responsibilities to their members and society at large.

Extra-financial information

Based on Universities Superannuation Scheme definition, as in Radley Yeldar's report "The Value of Extra Financial Disclosure", extra-financial information, also referred to as *non-financial information*, is information incorporating a wide range of issues which are likely to have a short, medium and long-term effect on business performance. These issues typically exist beyond the traditional financial variables that are considered as part of investment decision-making processes and include, but are not limited to, corporate governance, intellectual capital management, human rights, occupational health and safety and human capital practices, innovation, research and development (R&D), customer satisfaction, climate change and natural resource management, consumer and public health, reputation risk, and the broader environmental and social impacts of corporate activity such as biodiversity impacts and community impacts.

One of the most significant challenges in bridging the divide between financial and extra-financial outcomes has been the assumption that it is a zero-sum game, where financial and social or environmental outcomes are mutually exclusive.

That dichotomy is starting to dissolve, with the integration of broad ESG analyses into mainstream investment decision-making, the demonstrated correlation of ESG integration with company and portfolio performance, and the advent of impact investing. In this article, we will consider some of the challenges and opportunities for superannuation fund trustees in approaching impact investing.

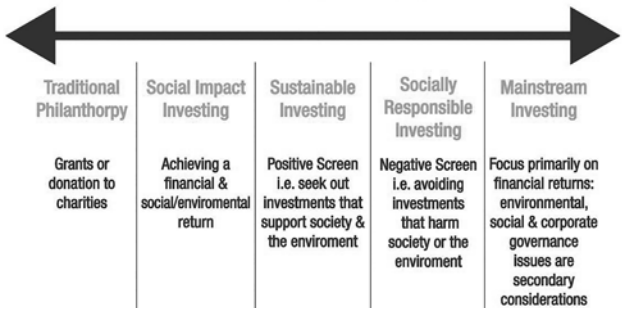
Impact investing in context

The lexicon of terminology related to the inclusion of extra-financial factors at a strategic and tactical decision-making level is complex and sometimes confused. It is therefore important to place impact investing in context of other approaches to investment.

Impact investments are those made into financial products, companies, organisations and funds with the intention of generating measurable social and/or environmental outcomes in addition to a financial return. Impact investing is an outcomes-based investment approach that brings together governments, service providers, investors and communities to tackle a range of policy (social and environmental) issues where the market has otherwise failed to deliver such extra-financial objectives.

To be more precise, impact investing is at the core of a broad "impact continuum", that runs from philanthropy to responsible and sustainably investment, which includes all those seeking to achieve a positive impact.

Figure 1. Spectrum of Investing



Source: Social Impact Investing Discussion Paper, Treasury, 2017

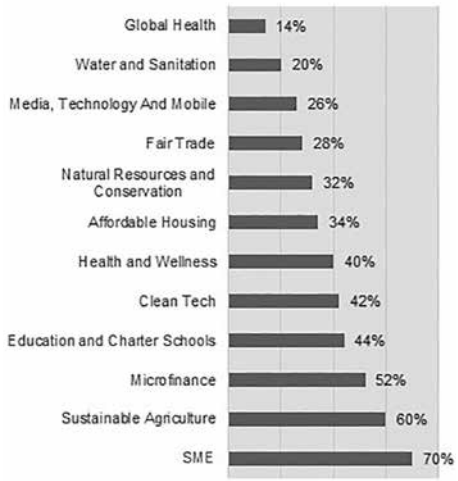
Impact investing and sustainable investing can be considered to have a close affinity in the realm of responsible investing. Both acknowledge the importance of the long-term health and stability of the market which, in turn, translates in the consideration of contextual factors and the evolving values and expectations of the societies in which investments are made without prejudice to the financial imperative at a micro or macro level.

What's in it for asset owners?

While the value based judgement about the merit of addressing social and environmental concerns may seem obvious or self-evident to many, there are also immediate and proximal benefits which fiduciaries might consider.

Employer sponsors and members of superannuation funds are often involved in working towards social or environmental outcomes. Education & research, sustainable energy, health, agriculture, affordable housing or physical infrastructure are tangible examples of themes where there may be an opportunity to align the extra-financial investment objectives of fiduciaries with the objectives of sponsors and members alike.

Figure 2. Preferred impact themes of Top worldwide 50 impact asset managers



Furthermore, member engagement and attention, as well as retention or loyalty, can be promoted by triggering the psychological response to positive social and environmental outcomes as rewards. This can assist fiduciaries in translating greater member attention towards behaviours that more appropriately reflect sound member-engagement and involvement.

Key Opportunities

- Alignment of investment mandates with super funds values and employer sponsors
- Member engagement, ability to reconnect with the shifting values of members and the enhancement of members loyalty
- Portfolio diversification and maximisation of risk-adjusted and efficient capital allocation
- Risk sharing with government – government paying for success

Impact investing and fiduciary duties?

Fiduciary duties and regulatory frameworks do not dictate what investments superannuation trustees should or should not make. This is a crucial characteristic which is important to retain.

However, one commonly perceived constraint to impact investing is that the fiduciary duties or prudential regulation which the trustee of a superannuation fund owes to beneficiaries are perceived as restrictive or unclear about whether extra-financial objectives can guide investment strategy and decisions without the consent of members.

Such concern is well founded, as these duties play a critical role in ensuring that fiduciaries are, firstly, loyal to their beneficiaries, act in good faith and avoid conflict of interest and, secondly, carry out their duties in a prudent manner, whereby acting with due care, skills and diligence.

To date, obligations of both loyalty and prudence seem to have focused on financial performance objectives over consideration of broader extra-financial themes in the investment decision-making process.

As Scott Donald et al. raised in their 2014 paper, the scale of the accumulation of assets within the system in Australia makes the efficient allocation of those assets across investment opportunities crucial. Furthermore, whilst individuals each need to earn an appropriate return from the financial resource dedicated to this intertemporal transfer, *'the long-term health of the economy as a whole depends on the efficient allocation of such a large pool of patient capital'*. Both the health of the economy and the stability of the society in which beneficiaries retire are, in the authors' view, relevant considerations for fiduciaries decision-making when allocating capital.

The prudential regulation of the superannuation industry is designed to protect both members and the broader financial system by ensuring that the processes of decision-making employed within funds are free from distraction and are directed towards relevant, rational and risk-adjusted criteria.

It is the above-mentioned combination of fiduciary and prudential regulatory environment that has led to a *'single-minded pursuit of long-term financial performance that appears, on its face, to constrain superannuation fund trustees in respect of impact investment'*.

The "sole purpose" test is of particular relevance. The statute reads to require that trustees maintain the fund solely for one or more of a set of identified "core" purposes. Taken literally, the sole purpose test can be read as a constraint on impact investing, however the provision exhaustively defines the "core" and "ancillary" purposes over all other matters to which a trustee might have given consideration.

Regulatory guidance may not carry the weight of law, yet APRA has provided persuasive guidance that a less exacting test of sole purpose than a literal reading of the section, and a more accommodating attitude to the presence of incidental advantages in the exercise of a trustee's powers. Donald et. al. captured this eloquently in summarising that:

"This principle does not prohibit trustees from making investments that may have a positive social impact, where the financial attributes of the investment are compelling".

In short, trustees can broaden a narrowly understood definition of fiduciary duty, and parallel prudential regulation in statute, to consider the investment credentials of specific impact investments without worry that the presence of 'incidental advantages' would fatally taint the proposition.

Impact investing offers the possibility of asset owning fiduciaries satisfying extra-financial objectives, such as social or environmental impacts, without prejudice to the financial imperative of the best financial interests.

Opportunities and performance

Impact Investment opportunities are varied in form, from green or social impact bonds, payment by results contracts, outcomes-focused grants, and debt and equity financing, to impact managed funds or social enterprise. The most common forms of Impact Investment opportunities include:

- **Social enterprises:** businesses which aim to achieve both financial and social or environmental outcomes through their work;
- **Social impact bonds:** contracts between the government, investors and service providers to trial innovative interventions — a form of payment-by-results contracts, wherein service providers are paid on the results they achieve; and
- **Social impact investment funds:** larger-scale funds that pool funds from investors to invest in several social or environmental impact investments.

Impact investing can provide a new form of investment product while, presenting an opportunity for fiduciaries to demonstrate universal ownership and help build a stronger culture of robust evaluation and evidence-based decision making in service delivery.

Yet, impact investing should be considered as an evolution of the thematic funds towards measurement rather than a new and separate asset class.

While impact investing in Australia remains in its infancy with an estimated total market value of $1-2 billion, the growth and performance of impact investments globally has been notable. The European impact investing market is the fastest growing of all the responsible investment strategies with +131.6% growth between end of 2011 and 2013. In particular, 70% of the top 50 worldwide "impact asset managers" are investing in SMEs.

Backing these findings, at a recent panel on 'Driving Green Growth', John McKinley, director of BlackRock Impact, revealed that by looking at the MSCI World index, working within 30 basis points of tracking error, impact investments achieved very similar risk-return ratios to mainstream investments while reducing carbon exposure by up to 75%. McKinley therefore asserted that "A sustainable company is fundamentally a stronger company and therefore a better investment opportunity."

Challenges and how fiduciaries can define appropriate social impact objectives?

Although there are good reasons for fiduciaries to consider impact investing, and no significant regulatory constraints, major challenges and obstacles remain.

Currently, impact investing takes place in imperfect markets where governments and industry alike have been

The quote

Large asset owners such as pension and sovereign wealth funds are recognised to have broader responsibilities to their members and society at large.

The quote

While impact investing in Australia remains in its infancy … the growth and performance of impact investments globally has been notable.

slow into enabling the market. In turn, this has translated in a lack of investment opportunities with market rates of return amenable to mainstream investors.

These market shortcomings include several challenges:

- Low supply in impact investing opportunities - usually these are small scale, bespoke and illiquid; limited capacity in the community sector to deliver projects, with many organisations mostly (and still) grant-focused and/or lacking the resources for complex contract negotiation and robust outcomes-measurement
- Shortage of qualified expertise - few mainstream advisers or wealth managers are experienced in providing advice on social impact investments; there is a need for involvement of specialist lawyers, finance professionals and intermediaries
- Management costs of impact investments are relatively high, up to 2% in some cases. While this may reduce if scale efficiencies are realised in the future, the possibility of higher costs of impact investments is a genuine consideration to which fiduciaries need to remain attentive
- Mistrust/concern about green washing – lack of general standardisation and accepted frameworks despite some emerging and widely adopted ones
- Risk concerns - high due diligence costs for investors and intermediaries alongside a lack of accessible, high quality data to measure outcomes to determine the level of success (and payment), and
- Performance concerns - lengthy process to identify opportunities, difficulty in articulating and agreeing to outcome measures and deriving returns. In particular, the costs and time to develop impact products may extend into the future and require longer timeframes.

As the market for impact investments in Australia develops further, many of these challenges might be addressed. The nascent impact investing market might be seen as too immature to warrant serious attention from large asset owning superannuation trustees, however the early stage in development presents an opportunity for these fiduciaries to play an active role in shaping an impact investing market which is well suited to the needs of superannuation asset investors.

The most significant opportunities may be the ability to shape the impact investing market by defining new products and arrangements, while diversifying portfolios and demonstrating a commitment to long-term value creation for beneficiaries. This may be achieved while demonstrating leadership in the alignment of financial outcomes with engaging social and environmental themes.

Superannuation fund trustees, in line with values of employer sponsors and members, can start to take a careful and more active stance, if they so wish. To act against growing macro-trends potentially affecting market volatility and be able to advance this new market through sharing and heralding success stories that engender a more stable, and indeed happier, society which is necessary for an adequate or comfortable retirement. **FS**