alpha associates

innovest Advisory
Impact Through Innovation

# Positive impact and attractive returns – mutually exclusive?

*Achieving attractive risk-adjusted market returns while simultaneously benefitting society and the planet was once viewed as impossible. One would either be a philanthropic investor, prioritising positive impact over financial returns, or a "traditional" investor seeking risk-adjusted market returns (with or without ESG considerations). This noted, what if an investor can achieve both goals? This should be the ethos of impact investing: "doing well, whilst doing good".*

Over the past decade, impact investing has rapidly evolved from a niche segment of the financial landscape to a mainstream investment strategy. A growing awareness of climate change due to the negative impact of human activities on our planet has been a driver of this. As are the increasingly evident social inequalities and in particular income inequality among and within countries. These developments have created an urgency to act and have now pushed impact investing to the top of the institutional investor's agenda.

**Profit with a purpose**

A number of blue-chip institutional investors have already formally integrated impact strategies in their investment allocations. An example is Dutch pension fund PGGM, which has the goal of "providing good pensions in a liveable world" and contributes circa EUR 53b (or 18% of its AuM as of Q4 21) into assets that support several of the UN's Sustainable Development Goals (SDGs), another is Singapore-based Temasek, which in 2021 allocated USD 500m to a global impact investment platform.

While the list of blue-chip institutional investors in impact themes is growing and varied in type, a unifying characteristic is each investor's role as a fiduciary of their clients. Ultimately, investors answer to their clients' demand for environmental and social stewardship as well as risk-adjusted market returns. In other words, they cannot and should not trade financial returns for positive impact on society and planet. On the contrary, investing in solutions to meet the UN's SDGs allows institutional investors at the same time to diversify their assets into topical themes that are, for the most part, sheltered from economic downturns and are often more resilient to economic shocks. Furthermore, impact investing focuses on sectors that are fast growing and supported by macrotrends such as digitally enabled education and healthcare solutions, clean water and sanitation, social infrastructure, and climate action.

**Impact – no longer a vague promise**

Impact investing has come a long way from the days when it was hampered by confusion over basic principles and dubious practices that invited cynicism. Today, impact is defined by an ever-greater number of sophisticated organisations, standardised frameworks and principles, such as the Global Impact Investing Network (GIIN), IRIS+, IFC's Operating Principles on Impact Management, the UN's SDGs, the Impact Management Platform (IMP), and increased regulation from governing bodies such as the EU's Sustainable Finance Disclosure Regulation (SFDR). This has allowed investors and managers to establish a consensus on the definition of impact, whilst also continuously improving impact measurement and management methodologies, increasing impact reporting transparency, allowing for better industry comparison, and avoiding greenwashing. The market now also boasts an increasing number of impact fund managers with strong track records launching their second or third generation impact funds and improved levels of data and transparency that evidence the business case and financial viability of impact strategies. These advances have created market conditions enabling institutional investors to enter the impact investing market with confidence, which has led to significant growth of the market over the last few years.

According to GIIN an estimated total of USD 715b was managed in impact strategies as of 2020, up 42% from USD 502b in 2019. According to Holon IQ a record of USD 37b was invested in venture climate tech in 2021, up 60% from USD 23b in 2020 and USD 15b in 2019. H1 22 set a new record of USD 27b, and it is estimated that 2022 will exceed USD 40b in funding. In 2021, for the first time more than half a trillion of green bonds were issued. The International Finance Corporation (IFC) estimates that the appetite for impact investments is as high as USD 26t – USD 21t in publicly traded stocks and bonds, and USD 5t in private markets.

Yet, despite the growing impact investing market, much more capital is required to combat the impending climate crisis. Despite the urgent call to action by the UN's SDGs for financial market participants to provide solutions, there remains a USD 4.2t per annum gap in funding to meet these targets. Here, investors who choose to commit their capital to impact investments play a vital role in accelerating the pace and scale of capital flows into much-needed solutions to achieve the UN's SDGs.

**A rewarding set of opportunities**

While the required capital to address the funding gap appears overwhelming, one should put it in context of the enormous investment opportunities presented by investing in macro trends, such as healthy living, financial inclusion, better and lifelong education, and innovative solutions to mitigate climate change and reduce environmental harm.

The global decarbonisation required over the coming decades is expected to provide investment opportunities in the climate tech sector that compare to those at the beginning of the internet revolution. According to PwC's report "State of Climate Tech 2021", investment in climate tech is booming, totalling USD 87.5b over the report's 12 months observation period and now accounts for 14% of venture investments. That said, capital being deployed is currently disproportionately aligned towards climate tech areas with lower total emissions reduction potential (ERP) leaving more effective technologies underfunded. Light-duty battery EVs represents just 3% of the total ERP but has received more than 60% of the total funding, while micro mobility represents just 0.4% of ERP and has received 9% of the funding over the analysis period from 2013 to H1 21. In contrast, high-ERP technology areas such as solar power, wind power, green hydrogen production, food waste technology and alternative foods remain relatively underfunded. According to PwC, although these five technologies represent 81% of cumulative ERP by 2050, they have received just 25% of the total investment funding since 2013. Particularly green hydrogen production and food waste technology are lagging behind in terms of innovation in research and development. Here, institutional investors play a crucial role in furthering the adoption of these technologies by the mainstream, as evidenced in the field of renewable energy, which has resulted in a continuous cost decline of renewable energy, countries aiming for less dependency on imported energy and an increasing focus on sustainability by governments, corporates and consumers.

Impact investment opportunities in the healthcare space are also plentiful, with 2021 seeing record funding of more than USD 46b flowing into areas such as accessible and affordable healthcare, digital healthcare, and telemedicine devices. Additionally, impact investments in the education sector to enable and promote accessible education and life-long learning are attracting increased funding. In 2021, the educational technology (EdTech) sector, providing solutions such as virtual classrooms, learning apps and after-school tutoring recorded more than USD 20b of investments.

**The time is now**

The recent rapid growth of the impact market demonstrates the confidence and conviction held by investors today when allocating their capital into impact strategies. However, while the rapid growth of global impact assets under management is an encouraging signal for the future of impact investing, we are still only scratching the surface: More capital from institutional investors is required to mitigate the effects of climate change and address social inequalities. In return, growing institutional capital requires the continued expansion of specialist impact investment strategies that have been designed with institutional investors in mind. This will provide investors with continued access to high-quality investment opportunities in growth markets with a clearly defined and measurable impact enabling investors to fulfil the once distant promise of "doing well whilst doing good".