Why Impact Investing Needs a SFDR Art. 9 Fund of Funds Approach

While our first article discussed the recent growth of the impact market and how impact investing can achieve attractive risk-adjusted market returns while simultaneously benefitting society and the planet, our second article looks at how a fund of funds approach enables institutional investors to access a diversified range of specialist impact fund managers whilst embedding enhanced impact practices across the underlying portfolio. We also look at how to avoid the pitfalls of sustainable investing such as greenwashing, and how the product classification of the Sustainable Finance Disclosure Regulation (SFDR) leads to increased transparency of funds and comparability between financial products and enables investors to more easily identify investment products that align with their sustainable preferences.

The diversity of the impact funds market mirrors that of the broad spectrum of global challenges covered by United Nations 17 Sustainable Development Goals (SDGs) and is therefore characterised by an increasingly diverse range of impact focussed enterprises and specialist fund managers. They target a wide range of environmental themes, including food and agricultural technology, sustainable cities, clean and efficient energy solutions, industrial decarbonisation technologies as well as circular economy concepts, alongside social inclusion themes such as healthy living, education and skills, and financial inclusion. Divergent geographical scopes are also seen, with impact funds active in developed markets, emerging markets, global markets or specific countries and/or regions. Whilst there are many capable and dedicated specialist impact fund managers operating in the market, many are still at their early evolution phase.

Is the impact market already investible, and how to approach it?

At this phase of the industry's evolution, bridging capital flows between institutional investors and specialist managers is crucial. However, the key obstacles for any institutional investor seeking exposure to a range of themes and geographies is typically limited available capital allocation in combination with minimum fund commitment sizes. A lack of in-house expert knowledge required to select viable strategies and managers is also a challenge. The sourcing, due diligence and monitoring costs of investing in multiple funds including specialist managers, if tackled in-house, are significant and eat into aggregate net returns achievable. Here, impact fund of funds of established fund managers have the ability to scale investment and expand the reach that is required to give institutional investors the necessary comfort to start investing in the impact industry. Joining a larger pool of capital provided by a fund of funds manager enables diversification across specialist managers, themes and geographies, selection of best-in-class managers following a rigorous due diligence and benchmarking process, and a balanced portfolio construction and vintage diversification, leading to smoothed and less volatile investment and divestment cashflows. Furthermore, by evaluating the robustness of the underlying managers' impact measurement, management and reporting framework, impact funds of funds provide greater integrity to the impact investing market by identifying and circumventing the risk of greenwashing, including impact-, SDG- and SFDR- washing.

Impact fund of funds due diligence process: getting it right

A fund of funds offers an additional layer of impact due diligence considering impact at both the portfolio and manager level. Firstly, at the portfolio level, the actual and potential impact of a fund's underlying investments and their alignment to the proposed impact objectives, investment themes and SDGs need to be evaluated. Secondly, manager-level impact needs to be assessed, specifically how a manager embeds impact into their investment decision making and active management processes. This includes a review and assessment of the manager's impact strategy and impact related policies, processes, and staff functions relating to measurement and management throughout the lifecycle of a fund.

For fund of funds seeking to classify as SFDR Article 9, this added layer of impact due diligence is essential for understanding whether an underlying fund meets the rigorous requirements to be Article 9. Meeting these conditions requires extensive data collection, demonstration and disclosure activities from both the underlying fund manager and the fund of funds. As such, fund of funds managers have to be committed to sharing the impact due diligence results from their fund selection process with each fund manager, enabling them to reflect on their specific strengths, weaknesses and areas for improvement. At Alpha Associates, we believe that investments that can credibly demonstrate real, durable and deep impact at scale will be the most valuable for achieving both superior financial returns and positive impact on people and the planet.

The power of funds of funds

Successful impact fund investing requires an active and collaborative approach. Many impact fund managers have relatively nascent operations, and industry standards, although maturing, still require ongoing refinement.

The power of pooling capital from multiple investors and being able to invest larger amounts compared to a single investor, provides a fund of funds with a powerful voice from a governance standpoint. A fund of funds manager can share best practices observed and experienced from the market. We believe that an entrepreneurial and supportive approach should be used to enhance the success of underlying fund managers including active advisory board participation and governance oversight, as well as serving as a long-term partner to fund managers through activities such as knowledge and best-practice sharing, advice on technology and innovation transfer, and connections to the fund of funds manager's broader partner ecosystem. Enhanced practices can be adopted and implemented across the underlying fund portfolio, especially those related to measurement, transparency, disclosure and reporting.

Maximising impact and returns

When Alpha Associates began screening the market in 2019, impact investing had only started to enter the mainstream consciousness. Consequently, the opportunity set and investable universe were relatively small. Three years later, the investable universe has grown significantly, with numerous high-quality teams now operating on the ground. The majority of large established private equity houses such as KKR (KKR Global Impact Fund II), Apollo (Apollo Impact Mission Fund), Bain (Bain Double Impact), EQT (EQT Future Fund) and TPG (TPG Rise III) have raised, and are continuing to raise, multi-billion dollar impact funds. We anticipate that the market will continue to experience significant levels of growth, as increasing numbers of traditional private capital firms and spin-off teams launch impact strategies, and more established impact managers raise even larger pools of capital. Furthermore, industry standards, frameworks, and principles will continue to evolve and solidify.

To fully capitalise upon these rapidly developing dynamics, institutional investors seeking to establish impact exposure will require a host of dedicated resources. Impact investing is an important investment theme and needs to be addressed with the necessary care, knowledge and tools to be successful. An impact-focused SFDR Article 9 fund of funds can address this challenge in a cost-and time-effective manner and with optimal results.