Article 3: Impact Manager Selection Framework

After our first article looked at 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 addressed the challenges institutional investors face when considering impact investing, as this requires the necessary investment care, knowledge, and tools to be successful. We discussed how an impact-focused SFDR Article 9 fund of funds can address these challenges in a cost- and time-effective manner. Our third article looks at the impact manager selection process that an impact fund of funds should deploy and the importance of a comprehensive selection framework – an essential tool to build a best-in-class portfolio that not only aligns with SFDR Article 9 requirements but also meets the impact goals set out in the investment strategy.

When conducting impact due diligence of short-listed funds, a fund of funds manager needs to ensure that the fund of funds both meets its impact goals and also achieves risk-adjusted market returns. For a fund of funds, impact due diligence has an added layer of complexity, as it requires an impact analysis of the investee fund manager in addition to the analysis of the investee fund's portfolio companies and investment pipeline. The fund of funds manager must therefore develop a robust impact due diligence framework and implement a standardised methodology for assessing the impact of each investee fund, while also allowing for viable comparison between funds.

A robust manager impact selection framework should cover the following aspects:

- Providing the fund of funds manager with information on the impact practices and capabilities of the target fund manager across the whole investment lifecycle,
- Ensuring the target fund manager's impact objectives are in alignment with the fund of fund's impact objectives,
- Helping to identify and refine investment pipeline opportunities across target investment themes and geographies, and
- Synthesising qualitative and quantitative impact data into transparent and actionable insights for both the fund of funds manager and target fund managers.

The Impact Manager Selection Framework at work

Given the specialist nature of developing and implementing a best-in-class impact manager selection framework, we at Alpha Associates decided to partner with impact advisory firm Innovest Advisory, which provided an impact screening and due diligence tool to assess, score, and select potential fund investments and direct co-investments. The framework has been modelled alongside Alpha's existing commercial and ESG due diligence processes to produce a comprehensive assessment of the impact risk and return profile of investment opportunities. The ultimate objective was to enable an informed investment decision-making process that incorporates both financial as well as ESG & impact considerations.

Having a bespoke Impact Manager Selection Framework in place allows the Alpha Impact Fund to be one of the first Sustainable Finance Disclosure Regulation (SFDR) Article 9 compliant funds of funds in the industry. All fund investments must meet the data collection and sustainability requirements for SFDR Art. 9 on a look-through basis.

For instance, having identified the newest SFDR Art. 9 classified fund of a leading impact fund manager focused on industrial decarbonisation and resource efficiency as a key investment opportunity for the Alpha Impact Fund, our due diligence focused on analysing the robustness of the manager's fundamental impact framework in line with the SFDR. Here, our Impact Manager Selection Framework allowed us to evaluate in detail the impact strategy, systems, policies and processes of the fund and underlying portfolio companies for alignment to SFDR Art. 9 requirements and the impact strategy of the Alpha Impact Fund. As such, the pre-contractual documents of the fund were discussed in depth with the manager in order to ensure compliance with the strict requirements of the regulator. The assessment also included the impact quantification methodology of the fund manager that is centred around GHG and waste reduction, with the fund manager requested to provide baseline and forecasted figures for key impact metrics across the portfolio including the usage of widely accepted market standards such as ISO 14040/14044 and the GHG Protocol. Furthermore, sustainability considerations across the entire investment decision process were assessed including GHG targets at fund manager level as well as the impact value creation plan across the portfolio. All information received through due diligence questionnaires and discussions was reviewed to develop the final impact screening and due diligence report, containing the scores for each question as per the screening and scoring criteria. The achieved scores showed the fund to be a good fit for the Alpha Impact Fund from an impact perspective, with the commercial due diligence still to be completed.

To be or not to be Article 9

Given the still-evolving nature of the regulatory landscape, we are observing a wide range of approaches and interpretations regarding the SFDR classification system. Some impact funds, despite following credible sustainability goals, are deciding for various reasons not to disclose in line with SFDR Art. 9 requirements. Other impact funds might self-classify as SFDR Art. 9-compliant but are presently unable to fully comply with the requirements of the regulator.

The Alpha Impact Fund will invest in funds that are SFDR Art. 9 compliant ("in-scope") but also in funds that can credibly demonstrate the sustainability objectives of their portfolio, on par with those required by SFDR Art. 9 ("out-of scope"). Regardless of the investee fund's classification an efficient data collection tool is necessary to enable the Alpha Impact Fund to fulfil its Art. 9 disclosure requirements. To better understand and categorise impact funds in the context of SFDR Art. 9, we have developed a two-step assessment framework that separates the in-scope and out-of-scope funds.

In-Scope: Funds that claim to disclose according to SFDR Art. 9. The focus is to assess whether the fund manager and fund can credibly demonstrate that they will be compliant with the SFDR requirements including demonstration of sustainability, Do No Significant Harm, good governance and required disclosures.

Out-of-Scope: Funds with a core strategy that is fully aligned with the fund of funds' impact strategy, but deliberately choose to not be classified as SFDR Art. 9. The focus is to assess whether the fund manager and fund can provide evidence that their investment objectives meet the definition of "sustainable investment" under SFDR Art. 9.

In both cases managers must demonstrate evidence of data collection and reporting on the mandatory Principal Adverse Impact indicators and sustainability goals. Areas to assess include KPI metrics and goals that measure attainment and track performance towards the stated sustainable investment objective.

From our discussions with out-of-scope fund managers, we have identified several reasons why a fund might prefer not to disclose according to SFDR Art. 9. So far, technical screening criteria has only been published for two of the EU Taxonomy's six environmental objectives. In addition, an absolute definition of social impact has still not arrived. Due to this lack of industry-wide clarity, some investors have chosen to opt out until the regulation has matured. Smaller managers have also cited the significant number of resources required to meet the SFDR Art. 9 requirements, while others point to their limited EU marketing and investor exposure, which reduces their need for European regulatory oversight. Finally, some managers wish to avoid falling victim to the common misunderstanding that an SFDR Art, 9-compliant fund prioritises impact objectives over financial objectives, an assumption that is frequently levied at impact-focused funds.

Why Alpha Decided to Qualify Under SFDR Article 9

Although the regulation remains technically incomplete, we believe that it is critical to align with the regulator early in the process, in order to better understand the core intentions and prepare for changes in the future. Therefore, Alpha's Theory of Change aims to embody the regulator's intentions to accelerate and move private capital towards sustainable investments, prevent greenwashing, increase standardised comparability by providing transparency, and help investors make greener choices. In general, a Theory of Change, should explain how activities are understood to produce a series of results that contribute to achieving the final intended goals.

In anticipation of further regulatory developments, we have also ensured that our impact due diligence goes beyond current SFDR Art. 9 requirements. Our scorecard-based fund manager selection tool, for example, evaluates the robustness and substance of the target funds' impact framework across three dimensions and more than 20 questions. The three dimensions (impact strategy, measurement & management, and transparency & governance) echo the framework already established by the SFDR and seek to determine whether a short-listed manager can demonstrate clear impact objectives, the integration of impact measurement and management practices, and sufficient disclosure of impact performance and good governance.

Going forward, we anticipate a growing adaptation of SFDR Art. 9 disclosure requirements as the impact landscape continues to evolve. Having a rigorous impact manager selection framework in place will be a critical component in ensuring that a manager can adhere to applicable and evolving regulation and meet the established impact goals.