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The year 2019 starts with great expectations of the financial sector. Whilst the IMF warns of a downturn[i] and continuing Brexit chaos poses serious uncertainties to the market, there are still high hopes that asset owners and asset managers will make significant steps towards achieving the Sustainable Development Goals (SDGs), which is believed to require investment of somewhere between US$5 and $7 trillion by 2030[ii].

In this context, 'impact investing' – here understood, according to the Global Impact Investing Network's (GIIN) definition, as 'investments made with the intention to generate positive, measurable, social and environmental impact'[iii] – sits in a privileged position. While it addresses some of the most pressing issues of our times, it also guarantees competitive financial returns to investors.

However, currently, impact investing represents only a tiny fraction of the total Assets Under Management (AUM). Therefore, two fundamental questions arise: If impact investing is a competitive form of investment and addresses the big problems of our generation, why is it not the new business norm? And how do businesses unlock the power of impact investing?

What are the main challenges?

A pipeline of investment

A common challenge reported by impact investors is finding a quality pipeline. This means an adequate supply of investments that meet certain thematic, liquidity and managerial capability criteria, as well as risk and asset size constraints set by investors.

Any potential investor must develop a robust pipeline by establishing a clear investment strategy. The strategy should firstly articulate target geographies, sectors and industries, as well as the type of companies the investor is looking for. Secondly, investors must develop a strong network of companies, peers, partners and intermediaries. Thirdly, keep track of potential companies in which to invest. Organisations involved with impact tend to be very dynamic and if one is not suitable for

investment today, it may well become suitable in the future. Many impact investors have struggled to achieve these steps, compromising their pipelines.

Another key aspect influencing the quality of the pipeline is the skillset required to succeed. It is not unusual to find organisations that embody a strong impact orientation, but then fall short on the necessary business skills. Conversely, a strong business orientation with less of an understanding of how to create and manage impact is also a regular occurrence.

Track record and building trust

Despite the quantity of AUM increasing over the past few years, the reality is that impact investing is still relatively niche and has fewer success stories when compared to more traditional investment. According to the International Finance Corporation (IFC), global AUM in 2016 amounted to close to $100 trillion, whilst the market for impact investing was estimated at only $228 billion, despite growing fivefold between 2013 and 2017[iv]. This shows us that, despite significant growth, there is still a long way to go.

One possible explanation for the slow shift of traditional to impact investing is the lack of track record. According to a GIIN survey[v], 57% of impact investors made their first investment in the past 10 years. Assuming median holding periods after which investors exit has been about five years[vi] and that often impact investors need a few rounds to adjust their models and refine their investment strategy, the relatively small number of success stories is not surprising.

Acknowledging that numerous investors, such as pension funds or insurance companies, might have less appetite for risk, the impact investment space has a long way to go in building trust in their strategies and debunking myths about performance. Of course, this process requires time. However, robust reporting is fundamental to speed it up and build the business case for impact investing.

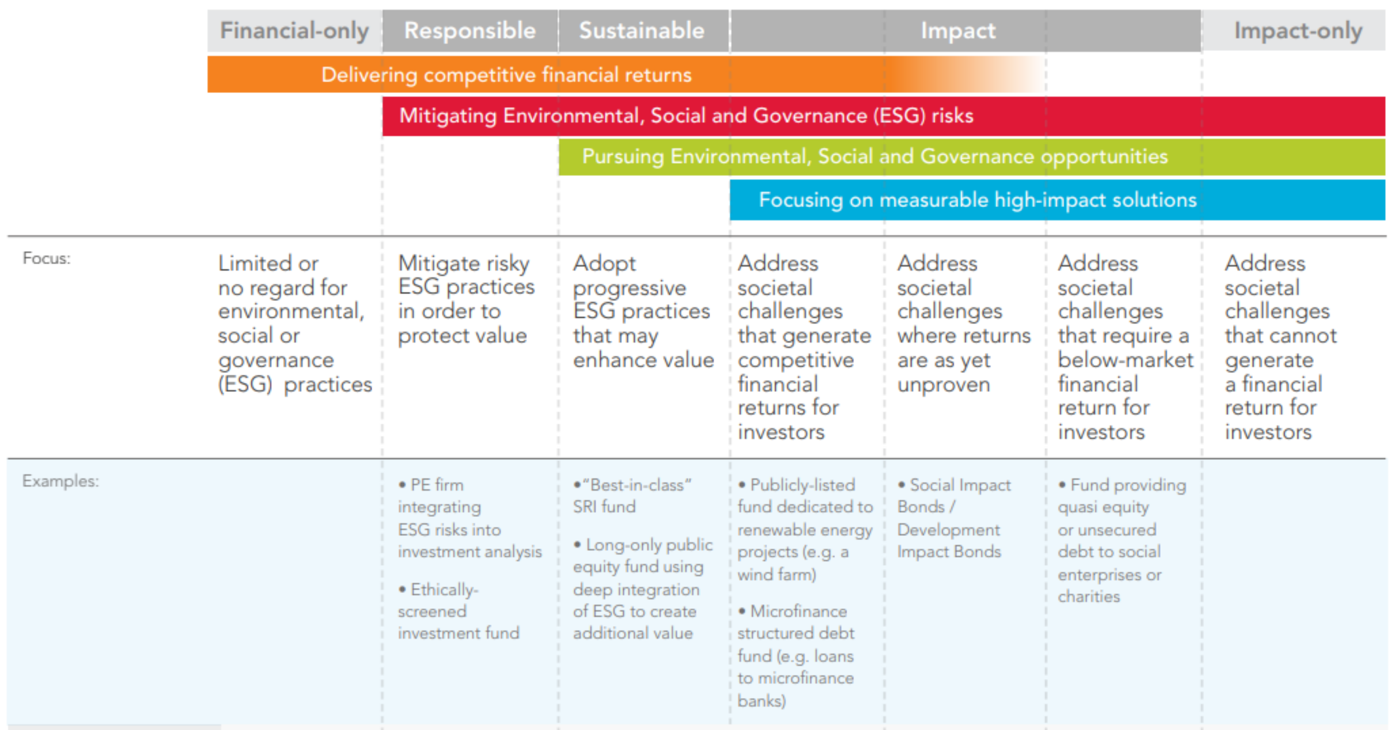
A common language and frameworks

While the lexicon of the financial world is highly developed and translated across countries, ‘impact investing’ is not understood on the same level. Although the practice of investing to generate positive impact beyond financial return is not a novelty, the term ‘impact investing’ was only coined by The Rockefeller Foundation in 2007[vii] . A multitude of concepts are often used interchangeably, such as ’sustainable investment’, ’impact investment’, ’socially responsible investing’, ‘ethical investment’, causing some confusion.

Defining a common ground seems to be a key foundation for scaling up impact investment. Developing shared terminology will enable the articulation of goals and metrics that can be understood by multiple stakeholders internationally.

Although there is no clear consensus, the following diagram developed by Bridges Fund Management is a widely-accepted exercise which helps map and clarify a vast range of investment strategies:

Spectrum of Capital



Source: The Bridges Spectrum of Capital (November, 2015)

Frameworks such as the 'Spectrum of Capital' can be helpful to pave the way towards a common lexicon. It does not, however, address another key challenge: measuring impact and assuring it.

Impact measurement and assurance

While reporting financial data tends not to be a problem, as it largely replicates traditional financial reporting, the measurement and reporting of 'impact' is an issue that has yet to be solved.

Although investors expect impacts to be managed, measured and reported, little guidance or expectations are provided. Therefore, organisations measure what they can, without necessarily planning or employing a rigorous methodology. The origin of this issue probably relies on the fact that

attributing positive social and/or environmental impact to a specific investment is a complex and expensive task, leading many organisations to poorly measure their impact.

There are several attempts to address this issue. For example, the Impact Management Project (IMP) aims to facilitate consensus about the definition of impact (how we talk about, measure and manage it). By defining impact as 'material effects experienced by people and planet, both positive and negative across five dimensions', they aim to bridge this challenge. However, there is still little practical use of this framework.

On top of polemical discussions around measurement, another key issue is assurance. Whilst there have been multiple attempts to measure and report the impacts generated by investments, other questions remain unanswered: is self-assessment and reporting enough? Is third-party verification required? If so, what are the most-accepted credible schemes? These are questions that are not easy to answer, but as this arena changes fast, we may have solutions in the future. Watch (and engage with) this space.

How to bridge the gaps?

Although I am not arguing for an immediate and complete shift from traditional finance to impact investing, boosting the portfolio of impact investing will help to address some of the most pressing issues of our time, such as climate change and extreme poverty. Some pathways are outlined below:

Development of metrics

A key step for success in impact investing is defining and communicating a clear investment strategy, and financial and impact objectives. In order to manage investments and track if outputs and outcomes are aligned with strategy and objectives, metrics are fundamentally important.

The general consensus is that metrics and key performance indicators (KPIs) are a must-have tool to make informed decisions, communicate value, and balance returns. However, there is less agreement on the practicality of this process. There are numerous frameworks and methodologies, such as IRIS or the CISL, that can be used. Interestingly, and to a growing extent, such methodologies are linked to the UN SDGs. But with a plethora of potential emerging metrics to utilise, what is the most suitable for each business?

Business partners can help impact investors to navigate this environment. As experts, partners can support investors to first define their strategy and objectives. Secondly, they can help to estimate the potential impacts, always reflecting upon the strategy and objectives. Then, the most suitable frameworks can be identified, and a structure set up to include adopted metrics, and the logic behind them, to oversee how they are applied throughout the portfolio.

Reporting

As mentioned above, reporting helps investors to manage the portfolio and understand where they should allocate more engagement and effort. On the investment side, the exercise on reporting impact can be a powerful management tool.

From an external perspective, reporting plays a relevant role for the industry itself. Bearing in mind that it is an incipient and niche type of investment, good communication helps to increase awareness, debunk myths and encourage further investment.

Reporting can also improve the quality of pipeline. A clear communication strategy enables investors to market themselves and communicate their interests and strategies. This raises awareness about the investor and builds their reputation.

Capabilities and competencies: having the right skillset in place

Compared with traditional businesses, the impact investment universe requires additional skills and organisational capabilities to help manage, measure and report impact. Finding teams and organisations that have both the 'business as usual' and impact capabilities can be challenging[viii]. In fact, investors report that there is a talent gap in this sector. For example, on the investor side, it is not easy to find professionals with solid financial knowledge who have also a background in impact work.

Perhaps the key to solving this problem is to move away from looking for the 'dream team' and instead invest more resources in training and development. For both investors and investees, having organisational capabilities and the right skillsets in place is fundamental to success.

Investors can again count on business partners to build such skills internally. Analysts and asset managers must have a clear understanding of how to integrate the 'impact' into the investment process, which might require adjustments to existing frameworks and processes. On the other side, it is not unusual to find organisations that have a strong impact orientation, but a weaker business orientation. For these companies, accelerators, for example, can provide great contributions. They will help companies to build strategic capabilities and expand their network.

Conclusion

Despite the variety of challenges, the impact investing sector faces, there are practical and relevant solutions that should prove powerful and even transformational, if investors are wise to the opportunities and ready to act. This is a fast-paced arena where innovation is constant. Stay tuned to hear more about it.

Sancroft's Chairman, Lord Deben, will be discussing how investors can take a direct approach to social and environmental issues, and be a part of the solution, at the SuperReturn International conference in Berlin on the 28th of February. If you would like to discuss impact investing or sustainability issues with him or any of our experts, please get in touch.

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[i] IMF warns storm clouds are gathering for next financial crisis, *The Guardian*
[ii] Financing for SDGs Breaking the Bottlenecks of Investment from Policy to Impact, *U.N.*
[iii] Global Impact Investing Network (GIIN)
[iv] What is impact investing? *IFC*
[v] Annual Impact Investor Survey 2017, GIIN
[vi] A closer look at impact investing, *McKinsey & Company*
[vii] Bringing Scale to the Impact Investing Industry, *The Rockefeller Foundation*
[viii] Battle to recruit ESG specialists intensifies, *Financial Times*