September 2022

Impact investing 2.0

Advancing into public markets

Passive Investing 2022

create | DWS

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Foreword

Impact investing is set to advance into public markets – and passive investing is an important driver for the democratisation of this long-standing preserve of private markets and philanthropy. This is the key finding of this report by DWS and CREATE-Research on passive investing.

The survey shows that the advance is being driven by two data points that indicate the scale of investment opportunities as today's capitalism undergoes a makeover. As much as $100 trillion of investment is likely to be required to attain the global net zero goal by 2050, alongside roughly $5–7 trillion in annual spending to achieve the UN's 17 Sustainable Development Goals (SDGs) by 2030. Private markets, with their limited scalability, cannot raise this amount of capital on their own, while public markets offer both scale and reach to leverage financial flows and drive investment in sustainable development.

As these two goals can be addressed through rule-based indices like the European Union's Paris-Aligned & Climate Transition benchmarks, thematic passive exposures through ETFs and mandates should provide impact investing with the necessary scalability and punch in public markets.

This view is supported by the findings of the report, which is based on interviews with senior decision makers at 50 large pension funds based in North America, Europe and Australasia, collectively managing €3.3 trillion of assets. 58% of participants believe that the rising interest in thematic funds will morph into impact investing over time, 64% think that the net zero goal will favour impact investing and 54% foresee that the SDGs are likely to bring new opportunities. 28% expect to use SDGs and Paris-Aligned & Climate Transition indices over the next three years.

This advance is likely to be more pronounced in bonds than in equities, because bonds – green, social or sustainability – are perhaps the most transparent vehicle, ensuring investments can potentially deliver a double bottom line: financial returns and social good.

In this context, active ownership is an important lever to encourage companies to make their business models more sustainable. When it comes to stewardship, engagement and proxy voting, DWS has a longstanding track record in both active and passive.

This report shows that impact investing is a pragmatic advance on a steep upward curve. I hope you find it as promising as I do.

Simon Klein
Global Head of Passive Sales, DWS

Acknowledgements

"Great feats are rarely the product of lowered ambition."

Amar Bhattacharya
Center for Sustainable Development

Yesterday's heresy could be tomorrow's orthodoxy. Is impact investing braced for such change?

This is the subject of the 2022 annual pension survey in a research programme first started by DWS and CREATE-Research in 2018 to highlight distinct foundational trends in both sustainable and passive investing.

Previous surveys in the programme have explored how pension plans worldwide are using passive funds to invest in the individual pillars of ESG as well as the net zero pledges made at COP26 in 2021 to meet the goals of the 2015 Paris Agreement.

This survey turns the spotlight on the remaining pillar of sustainability – impact investing. Its stringent design features have conspired to slow down its advance in the past, but the winds of change are evident.

This report provides a timely perspective on new drivers that will likely power the next wave of growth.

My foremost thanks go to 50 large pension plans in seven key fund jurisdictions for participating in this year's interview survey. Their regular participation in our surveys have provided an impartial research platform that is now widely used in the global investment landscape.

I am also grateful to DWS for sponsoring the publication of the report without influencing its findings in any way. Their arms-length support has enabled us to provide intelligent insights into how the global sustainability landscape is evolving and the role played by passive investing in the process.

Last but not least, I would like to thank four colleagues at CREATE-Research: Anna Godden for desk research, Lisa Terrett for project management, Naz Rajan for data analysis and Dr Elizabeth Goodhew for editorial support.

If, after all the help I have received, there are errors and omissions, I am solely responsible.

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Executive summary

Main takeaways

- Impact investing is not concessionary, even though it aims to solve the toughest challenges in our societies. It only targets companies that are seeking to provide solutions that have a high likelihood of delivering a double bottom line: doing well financially and doing good socially. Financial return is as important as impact because the two are seen as interdependent.
- So far, the advance of impact investing in public markets has been gradual due to three defining strictures: that there is an express intention to create positive societal outcomes; that such outcomes would not have occurred but for the investment; and that there is a robust framework in place to measure all outcomes. These have restricted the number of pure-play impact companies.
- A number of growth drivers are now emerging to hasten the advance. Principal among them are new regulatory requirements around ESG risks, rising interest in thematic investing and policy focus on the Sustainable Development Goals (SDGs) and net zero climate ambition, all of which are expected to give rise to new opportunities in public and private markets as the decade progresses.
- The advance will enhance the existing presence by increasing allocations to current portfolios and broaden them by venturing into areas previously unexplored. The advance will be evident in public as well as private markets and in passive as well as active funds. Private equity and bonds will drive the next wave of growth, as will the European Union's climate benchmarks.
- Impact investing is not a copy and paste exercise, but a pragmatic journey on a steep learning curve. In the absence of many pure-play impact companies, current emphasis is on various secular thematic funds that serve as a stepping stone to impact investing backed by by active ownership: stewardship, engagement and proxy voting. This reliance on learning by doing is based on the belief that perfection cannot be the enemy of progress.

Once-in-a-generation reimagining of global capitalism

Is impact investing finally set to go mass market?

For long the preserve of private markets, it is now advancing into public ones.

The upheavals caused by Covid-19 and net zero pledges at the UN's COP26 conference on climate change in 2021 are acting as catalysts that are ushering in a new era of accelerated action by policymakers, businesses and society alike. This is because the interests of business and wider society are now more intertwined than ever, as are concepts like shareholder value and stakeholder value.

Reimagining capitalism is a new imperative – one that puts as much emphasis on human, social and natural capital as it does on financial capital; however, while the direction of travel is clear, the exact path is fraught with challenges.

The energy crisis sparked by the Russian invasion of Ukraine has driven inflation to a 40-year high. This has roiled capital markets and triggered huge sell-offs, hitting the good, the bad and the ugly indiscriminately. Investments in ESG – or to give it its full designation, environmental, social and governance – were no exception. Policy attention has duly shifted to the immediate twin goals of lower inflation and energy security.

Yet, for pension plans, the concept of fiduciary duty continues to evolve in the face of new catalysts like changing regulations and social norms. It now rests on the belief that the future generation of retirees not only needs decent pensions in their golden years, they also need a viable planet fit to live on. The turbo-charged capitalism of the past 50 years has created mounting negative externalities, such as environmental degradation, loss of biodiversity and rising economic inequalities. These have inflicted heavy uncompensated costs on the economy and wider society while boosting the profits of the perpetrators.

New catalysts are set to hit their market valuations as these negative externalities are progressively priced in by capital markets as they evolve towards a new ecosystem.

Impact investing coming of age

As a result, interest in impact investing is gaining traction among pension plans. Currently, their sustainability investing follows a three-layer hierarchy. The bottom layer seeks to mitigate the portfolio and reputational risk by excluding companies who are deemed to engage in socially undesirable activities. The middle layer aims to include winners and exclude the laggards in the sustainability space in order to earn good risk-adjusted returns. The top layer goes a step further by having an overt goal to generate positive, measurable, social and environmental impacts alongside good financial returns. Thus, impact investing has four attributes that make it stand out:

- *Intentionality:* this refers to investors' express intention to create specific social and/or environmental outcomes.
- *Additionality:* this measures the extent to which desirable outcomes would not have occurred but for that investment.
- *Measurability:* this requires a process or framework to be in place to measure targeted impacts and report them regularly.
- *Financial outcomes:* these distinguish impact investing from philanthropy by seeking commercial returns.

Thus, impact investing is about targeting a quantifiable double bottom line: doing well financially and doing good socially. This has proven challenging in public markets owing to a lack of transparency: reliable data on quantifiable impacts have been notable by their absence. As such, impact investing has taken root in private markets where the above attributes are hard-wired in asset mandates.

However, as pension plans have progressed up the three-layer hierarchy since the 2015 Paris Agreement, they have begun to venture into impact investing via public markets – with constant improvements in their data infrastructure. The result is a set of actionable pathways that channel ever more capital into solutions that meet the environmental and social needs of business and society.

This advance is being powered by two data points that indicate the scale of investment opportunities as today's capitalism undergoes a makeover. As much as USD100 trillion[1] of investment would be required to attain the global net zero goal by 2050, and roughly USD5–7 trillion[2] in annual spending to achieve the UN's 17 SDGs by 2030. The SDGs are directed at governments, but capital markets are expected to play a significant partnership role.

Private markets, with their limited scalability, cannot raise this amount of capital on their own. In contrast, public markets have the necessary scale and reach to democratise access to a previously unattainable asset class, as prevailing barriers weaken gradually over time.

Research aims and method

Accordingly, this report presents a stocktake on where pension plans stand with respect to impact investing and their future expectations by pursuing three questions:

- Where are they currently in the adoption cycle of impact investing and which themes are most favoured?
- What are the barriers to their adoption so far and how are they likely to ease to propel the advance into public markets?
- Which asset classes and investment strategies will drive future growth and which criteria will influence manager selection?

These questions were pursued in an interview survey involving senior decision makers in 50 large pension plans based in North America, Europe and Australasia, collectively managing €3.3 trillion of assets. Their background details are given in Figure 1.0.

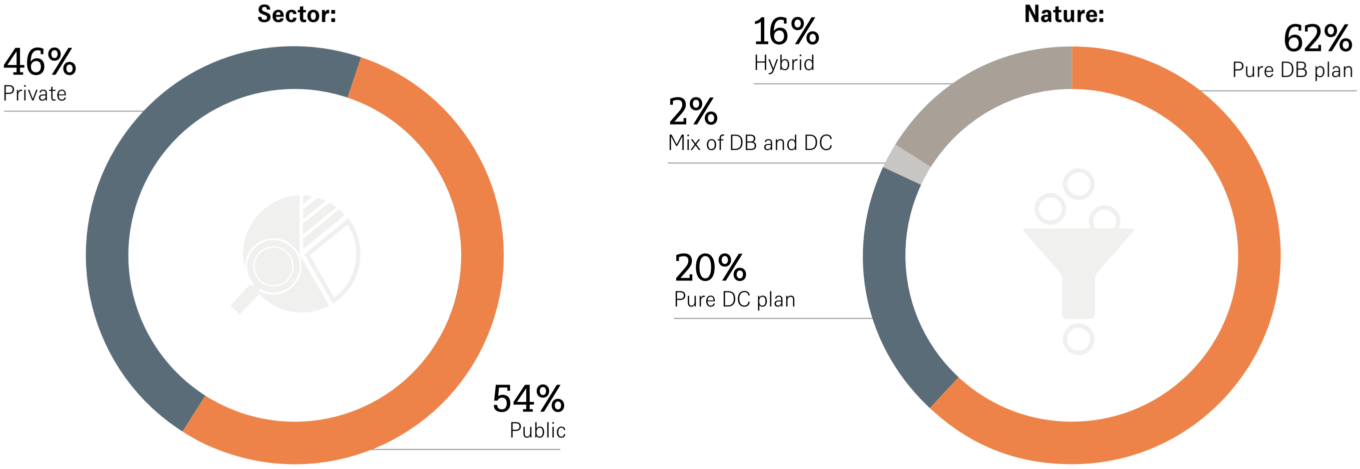
The rest of this section presents the survey highlights and our three key findings.

[1] For $100 trillion: 'Global finance pledge could mean $100 trillion for climate', CNN, November 3, 2021.
[2] For $5-7 trillion for SDG: 'SDGs can get back on track with more funding and targeted green investment', World Economic Forum, January 22, 2022.

Figure 1.0

Which sector does your pension plan cover and what is the nature of your plan?

% of respondents



Source: CREATE-Research Survey 2022

Survey highlights (% of respondents)

Impact investing is in the early innings of a new era

34% Have either fully embedded it in their active portfolio or are in the implementation stage

22% Have either fully embedded it in their passive portfolio or are in the implementation stage

34% Have focused on affordable and green energy as their chosen area of impact

Certain growth drivers are likely to hasten the advance into public markets

62% Believe that regulatory push towards mandatory reporting of ESG risks will ease data issues

58% Believe that improvements in the current suite of impact standards will reduce confusion

58% Believe that rising interest in thematic funds will morph into impact investing over time

Allocations to impact-oriented passive funds will rise in the next three years

48% Foresee proliferation of passive funds focused on impact themes

28% Expect to use indexes focused on thematic Sustainable Development Goals

28% Expect to use the climate benchmarks designed by the EU to implement the net zero goal

Key findings

1. Impact investing is in the early innings of a new era

a. Changing the market ecosystem

The growing interest in impact investing is based on the belief that the world is at an inflection point on how we solve society's toughest challenges. These have emerged as the unintended consequences of globalisation that has lifted over a billion people out of poverty in the developing world. To tackle them, impact investing seeks to harness the power of entrepreneurship, innovation and capital by overtly targeting social as well as financial goals (Case study 1a).

This emphasis on a measurable double bottom line also aims to send out a signal that impact matters and if ever more investors do the same, capital markets will duly price in environmental and social risks. Investors can also withhold investment in the expectation that they can influence the share price of a public company and signal that they do not endorse its practices. For too long, markets have ignored the fact that certain business behaviours are self-defeating and also undermine the wider economy and society. Financial information has been prioritised over non-financial information. Yet, under impact investing, both are treated with the same rigour, diligence and audit. As such, impact investing seeks to change the ecosystem of markets where capital has long chased the highest financial returns regardless of their impact on people and the planet. Thus, impact investing necessarily has longer time horizons, since changing corporate behaviours takes time, patience and persistence.

Impact investing has been around in various guises for the past 40 years. But it recently received fresh impetus and a sharper definition after the 2015

Case Study 1a

Today's capitalism needs a makeover if it is to survive and prosper

Over the past two decades, the twin rise of globalisation and technology has delivered benefits; but on the flip side, in the West, such benefits have accrued to many people in their role as consumers, not as workers or citizens.

If anything, as the centre of manufacturing moved to Asia, many Western nations experienced a hollowing out of middle-class jobs, rising income inequalities and growing market concentration, contributing to the rise of populism. The turbo-charged globalisation of the past 25 years is now giving way to a new age of beggar-thy-neighbour policies.

Capital markets rely on healthy economies which, in turn, rest on stable societies. The problems that our societies now face are immense. The UN's 17 SDGs require an annual spend of USD5–7 trillion by 2030, which governments alone cannot fund. Capital markets are likely to bridge the gap.

No wonder the Glasgow Finance Alliance for Net Zero has pledged to rewire the global financial system, with USD130 trillion at its disposal. The world is on the brink of a revolution in how we solve society's toughest problems.

Currently, around 2% of our assets are based on impact investing. This could double over the next five years. It's increasingly absurd to have to justify investing in our very survival – or having to prove that we should stop funding what's killing us. We only target opportunities for suitable long-term investors like us for whom doing well and doing good are not mutually exclusive.

A UK pension plan

"Our own record of success in delivering targeted impacts dispels the myth that impact investing is concessionary – sacrificing financial outcomes in pursuit of non-financial ones."

An interview quote

Paris Agreement on climate action. It has attracted USD715 billion, according to the latest 2020 market-sizing survey by the Global Impact Investment Network – a figure less than 1% of professionally managed assets worldwide. In contrast, sustainable investments in total have attracted USD35 trillion, according to the latest 2020 market-sizing survey from the Global Sustainable Investment Alliance. Philanthropists and multilateral institutions have been dominant players in the impact space, in view of their role as providers of 'patient' capital. Pension plans are relative newcomers.

b. Current allocations

That much is clear when we look at the current state of their adoption cycle with respect to their active and passive portfolios (Figure 1.1).

The advance has been relatively broad based in the active portfolio, where 34% have either fully embedded impact investing or are still in the implementation process. The corresponding figure for the passive portfolio is 22%.

Further details are provided in Section 2. It shows that, in terms of size of allocation, active portfolios have a higher share of impact investing: 24% of our survey participants have a share of up to 6% and a further 10% of participants have a share in excess of 6%. The corresponding figures for passive portfolios are 18% and 4% respectively.

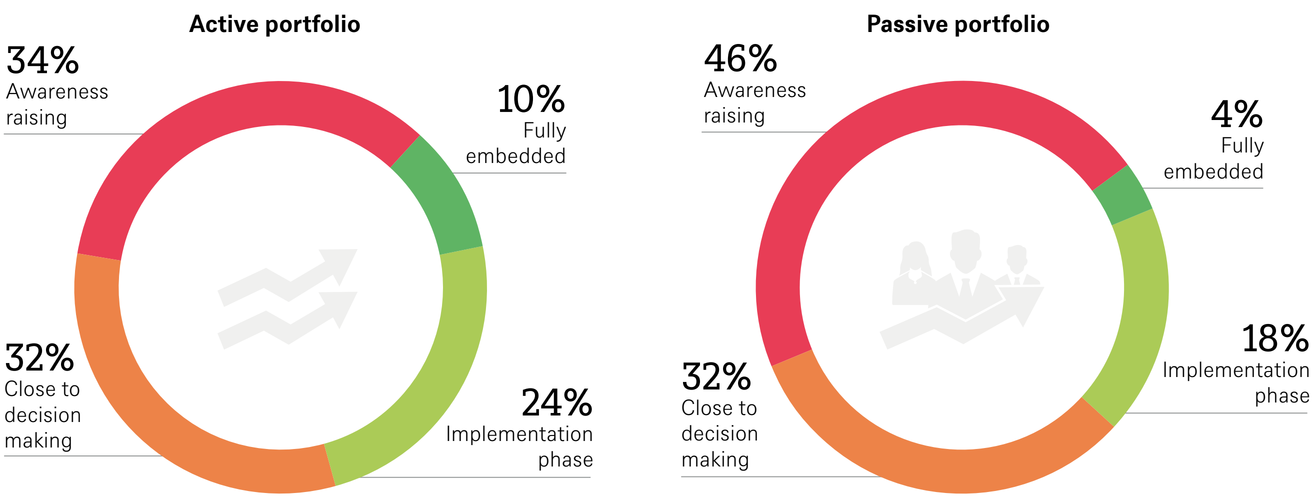
Five themes have been favoured in these allocations by at least one in every four participants: green energy (cited by 34%), biodiversity (32%), reduced social inequalities (30%), governance (28%,) social housing (28%) and quality education (26%).

Although the threat of global warming and loss of biodiversity may seem distant, their impact is already being felt. They are permanently weakening the capacity of the affected regions to recover.

Figure 1.1

In which stage is your pension plan currently with respect to impact investing in each portfolio?

% of respondents



Source: CREATE-Research Survey 2022

As such, they have attracted widespread media attention as well as a policy push from governments. In contrast, social themes rank marginally lower on the priority list: they are more difficult to define and measure, being behavioural in nature and varying between cultures.

As for the outcomes of their impact investing thus far, 44% report them as positive, 22% as negative and the remaining 34% indicate that it is too soon to say, as shown in Section 2.

This scorecard was compiled in June 2022, when global capital markets had already entered a bear stage, sparked by rate-hiking cycles in many major economies. How they will perform from here on is a matter of conjecture, especially if the global economy enters a long recession following the Russian invasion of Ukraine.

For now, however, given their status as part of buy-and-hold portfolios, interest in impact investing remains broadly intact. It is based on a pragmatic mix of two types of companies. The first covers pure-play best-in-class impact companies who are already recognised as leaders in environmental or social solutions in areas like climate transition, social housing and labour relations. The second targets promising companies in transition so as to help them reduce their cost of capital as they seek to become leaders in their field.

In sum, there is every indication that we are witnessing the birth of a new variant of public–private partnership under impact investing, with capital markets acting as conduit.

2. After a slow start, the winds of change are evident

a. Obstacles

As an investment strategy, impact investing is unlike any other. It implicitly requires companies to partner with governments in the delivery of a double bottom line. Hence, progress so far has been hampered by various barriers, as shown in Figure 2.3 in Section 2.

The first and most immediate is the Russian invasion of Ukraine. 70% of our survey participants believe that it will derail the world from its net zero path and disincentivise capital markets from pricing in climate risks. Greenhouse gas (GHG) emissions are set to rise if Western countries replace Russian gas with coal, forcing Russia to find alternative outlets. This means a faster rundown in the current carbon budget – the cumulative amount of CO_2 emissions permitted over a specific period of time to keep within a certain temperature threshold. This also means draconian cuts in emissions later on to compensate for the budget imbalance.

Second, data remain the Achilles heel of impact investing, as shown in Section 2. First, there is no widely accepted impact management and reporting framework, according to 68% of our respondents. Second, it is hard to find evidence that capital markets are pricing in ESG-type risks in earnest (66%). Third, there is no performance track record (52%). Implementing the three defining features of impact investing – intentionality, additionality and measurability – has proven difficult.

The third set of barriers centre on the fact that E, S and G are not mutually exclusive (64%). There are interdependencies as well as trade-offs between them, giving rise to complex feedback loops. For example, climate action requires abandoning large reserves of fossil fuels in the ground as stranded assets. But this could inflict huge social hardships on local communities.

b. Growth drivers

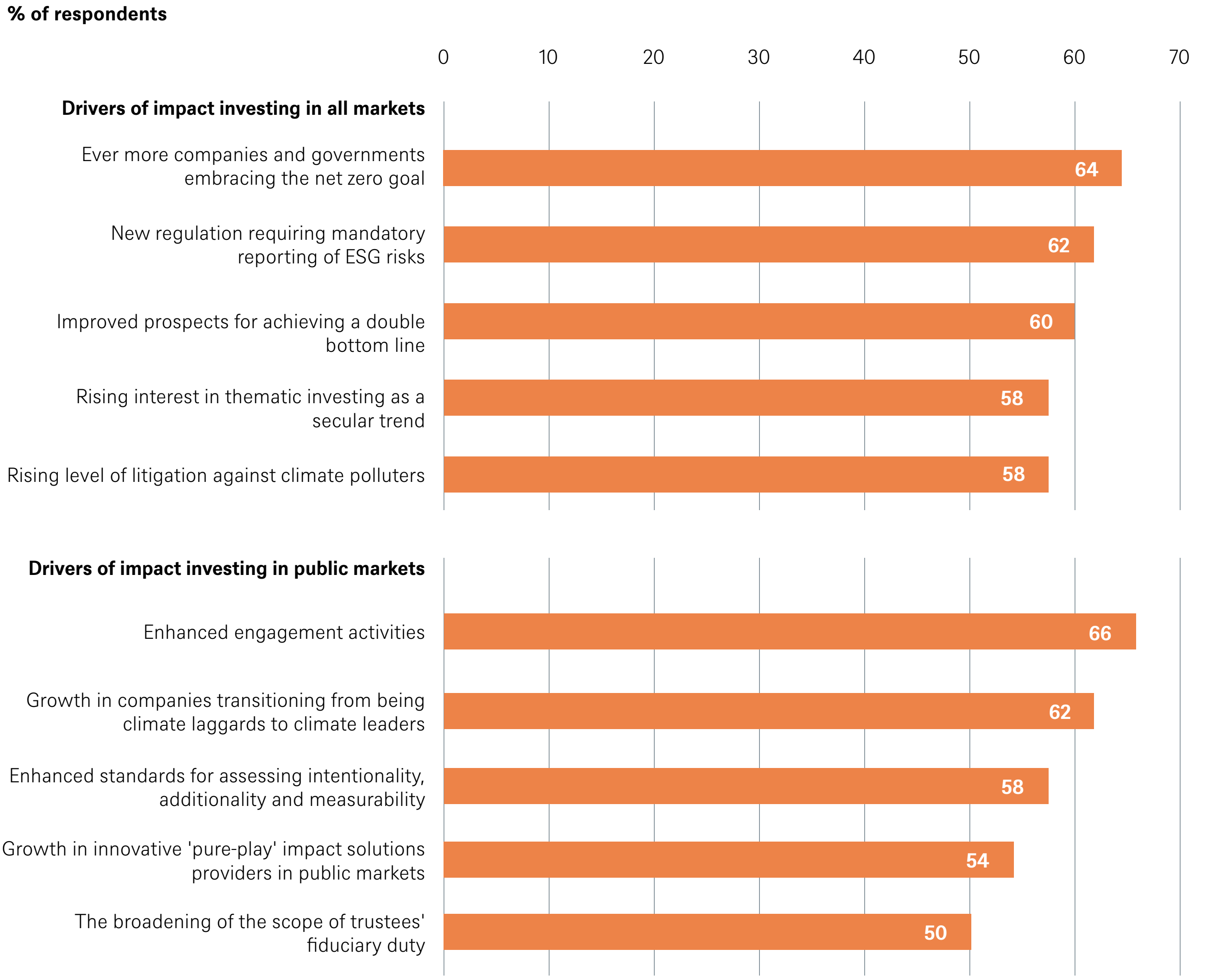
The stars, however, are realigning. A number of growth drivers have been asserting themselves lately: some across all markets and some in public markets.

Four growth drivers have the potential to deliver positive impacts in all markets (Figure 1.2, upper panel). The first is the adoption of the net zero goal by ever more companies and governments before and during COP26 (64%).

The second is new regulation inside and outside Europe requiring the mandatory reporting of ESG risks from listed companies (62%). Encouraging signs are also emerging in other nations. Four of them have already introduced mandatory carbon disclosure from their listed companies: Hong Kong (SAR), New Zealand, Switzerland and the UK. Similar rules are also to be finalised by the end of 2022 by the Securities and Exchange Commission, as part of the Form 10-K mandatory securities filings. They will be a game changer, as the US accounts for 62% of total global pension assets of over USD50 trillion. This will improve prospects for a double bottom line (60%).

The third driver is the rise of thematic investing as a secular trend (58%). This is seen as a stepping stone – or precursor – to impact investing. The final growth

Figure 1.2
What is now driving your pension plan's interest in impact investing?



Source: CREATE-Research Survey 2022

driver is the rising level of litigation against climate polluters (58%); for example, in a landmark court case in the Netherlands, the oil supermajor Shell was ordered to reduce the aggregate annual volume of all its CO_2 emissions by 45% net of 2019 levels by 2030.

Additionally, there are new drivers that especially favour the advance of impact investing in public markets (Figure 1.2, lower panel). The first is enhanced engagement activities (66%). These are widely accepted as vital in encouraging listed companies to move towards a more inclusive purposive model of capitalism. This is in the belief that those who are part of the problem can also be part of the solution (Case study 1b).

Second is the growth in the number of companies that are transitioning from climate laggard to climate leader (62%). As capital markets price in climate risks in earnest, such companies are set to deliver stellar returns.

Third is the availability of improving standards for assessing intentionality, additionality and measurability (58%). The launch of the International Sustainability Standards Board at COP26 is a big step in this direction.

Fourth is the rising number of pure-play impact solutions providers coming into public markets via IPOs, as governments step up their efforts to deliver the SDGs by 2030 (54%).

Case Study 1b

Thematic investing could potentially morph into impact investing in public markets

The additionality criterion has restricted the number of pure-play impact companies in public markets. The rest offer limited scope because public equities are usually traded in secondary markets such that investment capital is not directed to the selected companies. Over time, the role of equity markets has changed from a way of raising investment capital for growing companies to a vehicle for cash distribution and balance sheet management, as shown by massive share buybacks on both sides of the Atlantic since the 2008 crisis. Dealings in small blocks of shares neither influence their market prices nor the behaviours of the underlying enterprises.

On the flipside, however, new kinds of investing norms are evolving under recent regulatory developments, as investors seek to capitalise on mega initiatives like net zero and SDGs. Hence, rather than wait for norms to be established, which can only happen when businesses adapt their disclosures, we use an eclectic approach with two strands – both designed to send out the signal that impact matters to shareholders.

The first aims to address the additionality challenges through engagement with companies. Engagement is also about persuading investee companies to capitalise on the opportunities thrown up by the energy transition and SDGs.

The second strand is to invest in themes that connect with our own values and the chosen areas of impact. This is in the belief that, via engagement, we may be able to transition our theme-based investing to impact-based investing. Many thematic funds have the potential to morph into impact funds over time with active engagement.

A US pension plan

The fifth new driver is a broadening in the scope of the fiduciary duty of pension trustees (50%). On top of decent retirement pensions, they are also enjoined to deliver a viable planet on which their retirees can live.

3. Impact investing is set to broaden its footprint

a. Rising allocations in markets and portfolios

Because of the identified growth drivers, impact investing is expected to deepen and broaden its advance: deepen by raising the allocation to existing portfolios and broaden by advancing further into areas where it has, until now, had less presence (Figure 1.3, left chart).

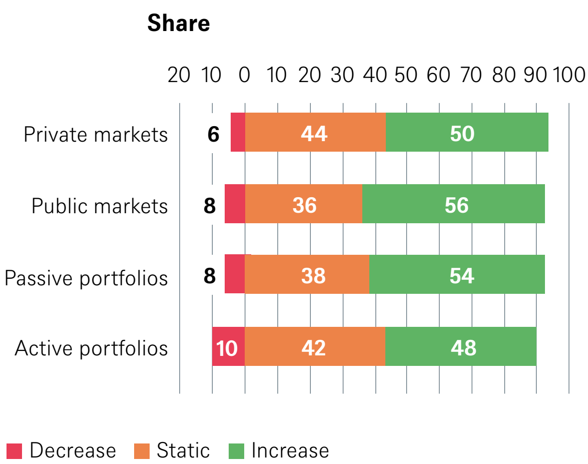
To start with, allocation is expected to continue in private markets: 50% of our survey participants expect an increase, whereas 6% expect a decrease. That private markets will remain a key channel for directing impact capital is not in doubt. Given the customised nature of their mandates and reporting requirements, they are better placed to accommodate design features such as intentionality, additionality and measurability.

This further incursion is unlikely to come at the expense of public markets. The latter are also likely to see an advance: 56% expect an increase in their allocations while only 8% expect a decrease. For reasons we shall cover later on, the advance is likely to be more pronounced in bonds than equities. Public markets are becoming attractive for four reasons. First, climate transition is turning many climate laggards into climate leaders; thus,

Figure 1.3

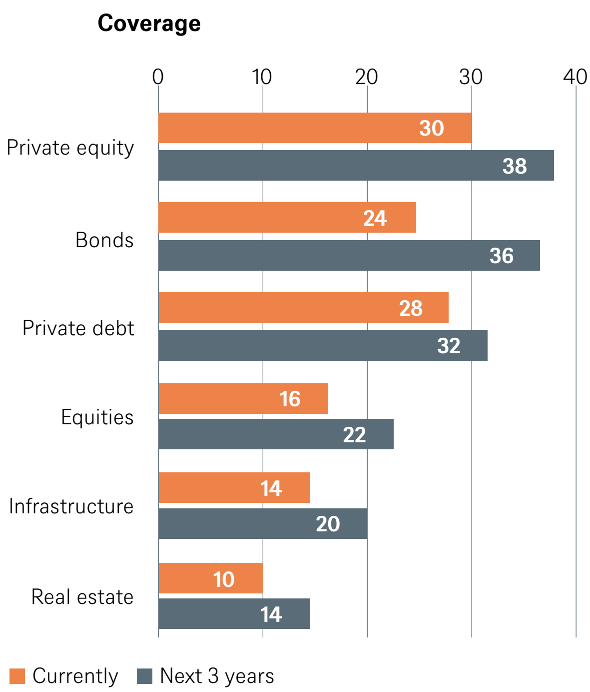
How are allocations to impact investing likely to change over the next three years?

% of respondents



Which asset classes are currently covered by your impact portfolios and which are likely to be covered over the next three years?

% of respondents



Source: CREATE-Research Survey 2022

they are reducing their cost of capital by satisfying some of the stringent criteria that come with impact investing. Second, the rise of impact solutions providers in public markets means that the cost of impact investing is a lot lower compared with private markets. Third, public markets offer the de-risking of the management team: it is much better analysed and understood than private company investing, which does not have a comparable track record in meeting goals and metrics. Finally, public companies have the scale and reach to create the intended impacts in multiple jurisdictions.

Another dimension of the expanding role of impact investing is also evident in two broad investment strategies (Figure 1.3, left chart). 54% of survey participants expect to increase allocations in their passive portfolios, while 8% expect to decrease them. This is not likely to be at the expense of active funds, where 48% expect to increase and 10% expect to decrease. Passives are now seen as a catalyst for changing the investment landscape. Their advance in impact investing is via a blend of core index funds, thematic funds and customised funds. The EU's climate benchmarks are likely to play a significant role (Case study 1c).

b. Rising allocations in asset classes

Impact investing is likely to advance in all asset classes, albeit at varying rates (Figure 1.3, right

Case Study 1c

The EU's climate benchmarks are designed to replace standard indexes

The EU's Sustainable Finance Disclosure Regulation, effective from March 2021, marks a milestone. It enables us to make the correct ESG choices by classifying fund products as 'light green' under Article 8 and 'dark green' under Article 9.

Additionally, the EU's Paris Aligned benchmark and the Climate Transition benchmark take a standard large or mid cap index and integrate climate action objectives. This is a significant innovation in the passive space, as is the SEC's recent stated intention to reclassify 'index providers' as 'investment advisers' in the US.

It is the first time that policymakers anywhere in the world have attempted to use index funds to channel capital towards companies that are implementing climate action.

Notably, whereas the previous generation of climate indexes simply aimed to reduce carbon emissions relative to their parent indexes – without targeting an explicit temperature scenario – the EU's two climate benchmarks are hardwired with the 1.5°C goal, in line with the Paris Agreement. The implication is that these benchmarks will stick to their decarbonisation path, even if the world goes off course with the net zero goal. Designed by regulators, the product integrity of these funds will be under heavy regulatory scrutiny.

Index providers have started to create science-based climate benchmarks in earnest. With headlong growth in passive funds since 2005, these benchmarks seek to allay fears that passives will become investors of last resort in fossil fuel companies and threaten climate transition, in view of their supposed stewardship 'inertia'.

Thus, not only do the EU climate benchmarks aim to tilt away from fossil fuels year on year on the decarbonisation trajectory, they also provide yardsticks against which entire climate portfolios can be benchmarked.

A French pension plan

"We believe that impact investing will move into the mainstream of equity and bond markets."

An interview quote

chart). Overall, the most widespread interest is in private equity and the least is in real estate. Three asset classes merit special mention.

First, private equity ranks highly because its customised mandates are conducive to impact investing. Just as importantly, its long duration mandates also enable PE houses to participate in blended finance projects, typically involving private–public partnership. It deploys public funds to de-risk and crowd in private capital to co-finance pioneering projects in new industries, markets and technologies. The main aim is to use scarce public resources in a catalytic manner to leverage much larger private financial flows to scale up investments in sustainable development.

Second, bonds – green, social or sustainability – have been dominant in impact investing. They are, perhaps, the most transparent vehicle for ensuring investments have clear real-world impact as well as netting financial returns. Issuances have hit record highs since the outbreak of Covid-19. Their impact credentials are usually certified by independent external reviewers. Their proceeds are solely committed to impact-type projects and offer a basis for engagement normally reserved for equity holders. In contrast, this requirement does not apply to general-purpose debt issued by a company, government or municipality.

Third, the advance of impact investing in equities is likely to continue, albeit at a gradual pace. The rising number of pure-play impact players offers significant opportunity. But they also carry concentration risk while this segment of equity markets is still in its infancy. Additionally, equity markets are no longer a source of raising fresh investment capital, driven as they are by the second order trading of existing financial assets, as we saw in Case study 1b.

Many publicly listed enterprises rarely issue further equity. Movements in their share price may not directly affect the cost of the capital that they may be raising elsewhere (e.g. bond issuances); hence, the advance of impact investing is more likely to evolve on the back of thematic funds.

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2

The rise of impact investing

What is the current state of play?

Impact investing stands out in two respects: first, by building global goals, like SDGs, into investment portfolios; and then by requiring companies to implicitly partner with governments in achieving those goals. Hitherto, both have been alien to capital markets, driven as they are by the financial metrics of business performance to the exclusion of everything else.

As such, advances in impact investing thus far have been modest in scale yet broad in scope. A range of SDGs are being targeted. The implied opportunity set is broad enough to indicate that impact investing can scale up quickly if various barriers are tackled. It is also deep enough to lend credence to the whole ethos of a double bottom line.

Progress to date has been modest because of the requirement to accurately measure and report on the impact. This has been hampered by the lack of a commonly agreed framework for impact measurement and reporting. Other barriers have been at work too. The key one is the tendency of capital markets to avoid pricing in ESG type risks until they are staring them in the face.

1. Putting progress above perfection

As we saw in Section 1, the majority of our survey participants are at an early stage of their impact investing journey: both in their active as well as passive portfolios. This is duly reflected in the lower share of impact funds in each portfolio (Figure 2.1).

In the active portfolio, 24% of participants have shares of between 1% and 6%; 10% have shares of 6% and above. The corresponding figures for the passive portfolio are 18% and 4%, respectively. In both portfolios, shares above 10% remain small. Their current approach can best be described as pragmatic.

On the one hand, survey participants target pure-play best-in-class impact companies that are already recognised as leaders in environmental and social solutions. These range from green energy to gender equality and social housing, as we shall see in the next subsection. On the other hand, they also target promising companies in transition so as to help them reduce their cost of capital, as they seek to become leaders in their field.

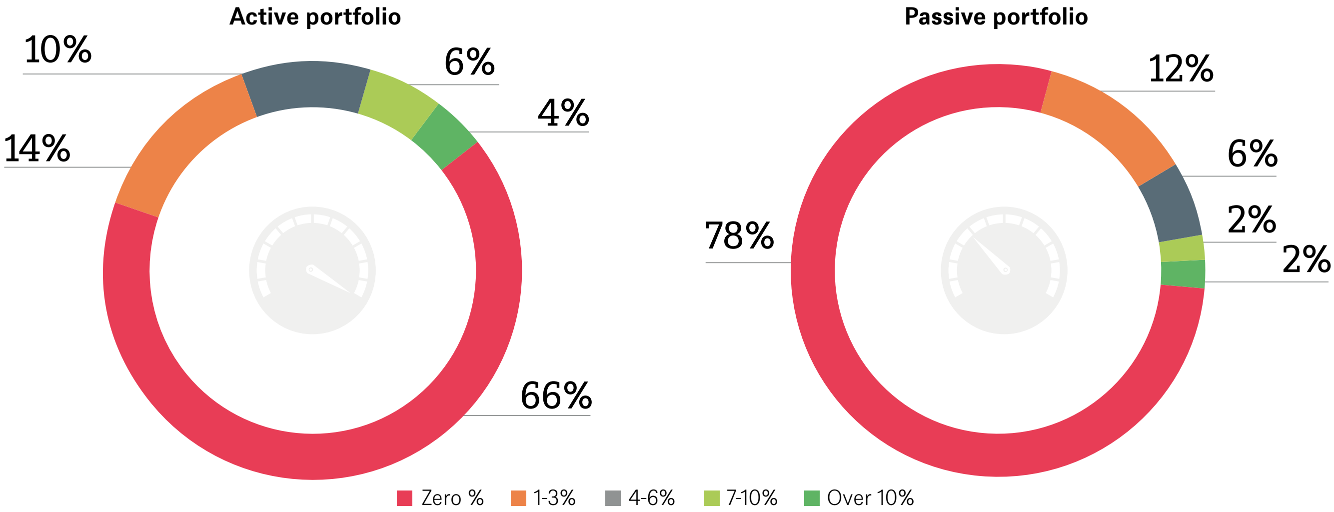
This pragmatism is dictated by the current lack of a universal definition and reporting frameworks on impact investing. Hence, investors are forced to use a multiplicity of standards and frameworks that have sprung up from various independent bodies: the Impact Management Project, IRIS+, the Task Force for Climate-related Financial Disclosure, the Task Force of Nature-related Financial Disclosure, the Carbon Disclosure Project and the Global Reporting Initiative.

Also, when it comes to classifying companies, impact is defined in terms of a threshold that is

Figure 2.1

What is the approximate share of all impact-related funds in your plan's two specific investment portfolios currently?

% of respondents



Source: CREATE-Research Survey 2022

based on the percentage of a company's revenues derived from products or services that provide a unique solution to environmental and social challenges today. But quantifying this revenue threshold remains a significant challenge, based as it is on a normative judgement. It varies a lot between funds. The result is a grey area between intended baseline outcomes and actual outcomes.

Pension plans seek to minimise the gap by relying on active engagement with their investee companies, as we shall see in Section 3. It involves proactive efforts to ensure that signals about intended impacts are converted into concrete actions and measurable outcomes (Case Study 2a).

The current data situation has parallels with the dawn of stock markets. The quality of corporate data then was sparse and weak. Many of the concepts that underpin today's investing – volatility, liquidity, risk factors – were alien back then. The institutionalisation of the fund industry over the past 60 years has created a new infrastructure of data, standards, expertise, linkage and metrics. Before then, however, investors had to climb a steep learning curve. A decade from now, many of today's impact data challenges may well be in the rear-view mirror.

2. A variety of SDG-based themes are being pursued

A key finding of our survey is that impact investing tends to follow the UN's Sustainable Development Goals far more than the conventional ESG categorisation. The former are deemed to be more comprehensive and granular. They provide a shared blueprint for peace, people, prosperity and the planet, placing humanity at the heart of sustainable development.

The ones that are targeted vary in their intent, with affordable and green energy topping the list (Figure 2.2, left chart). Indeed, it features in every portfolio, owing to the policy attention it has received in most pension markets – both before and after COP26 in November 2021. Other environmental themes, such as biodiversity, clean

"The stringent defining criteria of impact investing are essential for its integrity. But they also slow its advance."

An interview quote

water, sanitation and life below water, also appear on the list.

Although the threat of global warming and loss of biodiversity may seem distant, their impact is already being felt. Extreme natural disasters – floods, droughts, hurricanes, typhoons and wildfires – are no longer viewed as one-off events from which affected regions will go through a V-shaped recovery. They have become more frequent, more ferocious and more devastating in this century. They are permanently weakening the capacity of the affected regions to recover.

As such, they have attracted widespread media attention, as have instances of the loss of biodiversity, especially given its critical role in human health, economic wellbeing and a well-functioning earth system. The global economy relies entirely on abundance from the natural world – from the things we grow and dig up to harder-to-measure benefits, such as the provision of the sky as a free dumping ground for GHG emissions. This was duly highlighted at the UN Biodiversity Conference in October 2021, which agreed on an ambitious and measurable post-2020 framework to end biodiversity loss.

Hence, policy push in both these areas – global warming and biodiversity loss – has made them attractive to our survey participants for inclusion in their impact portfolios. The main thrust of their action is directed at one or more of three goals: managing risk and capturing opportunities, accelerating change towards a greener planet and funding the next generation of technologies. Other themes that are also now being targeted via impact investing fall mainly in the social sphere

Case Study 2a

It is hard to find a clear line of sight between a fund's label and what it can really deliver

Signalling intention and then engaging proactively defines impact investing. But that is easier said than done.

Hitherto, the whole ecosystem of capital markets has been dominated by financial metrics such as the P/E ratio or price-to-book value. Over the past 30 years, what has passed for active management has largely been the second order trading of existing assets, the main focus being trying to anticipate the behaviours of other investors. Holding periods for assets have declined too. These developments sit uncomfortably with impact investing, which is about using capital markets to tackle growing problems in our economy and society by taking a long-term view.

Currently, our efforts are held back by a lack of standardisation. Our asset managers tend to use multiple frameworks because no single framework has metrics for all the environmental or social impacts covered by their portfolios, or even by individual funds.

This forces us to compare and interpret various metrics that fund managers apply. For example, we are not able to compare several green impact funds. Some measure carbon footprint, some biodiversity and some water management.

Additionally, for key climate-based funds, the vast majority do not factor in scope 3 emissions. Hence, it is hard to establish a clear line of sight between a fund's label and the impacts it aims to deliver.

Most of all, when evaluating a company, it's not enough if it has one or two products that are aligned to one of the SDGs. We have to ensure that all their activities are holistically aligned.

A Swedish pension plan

(Figure 2.2, left chart). They cover education, health and wellbeing, gender equality and human rights. In each case, the percentages are lower because they are more difficult to define and measure, being behavioural in nature and varying between national cultures. That requires pragmatism (Case Study 2b).

Yet, they underscore an important point: investors are bringing the SDGs under the ambit of impact investing, even though they were originally designed for governments. After all, qualitative SDGs such as education, health, wellbeing and equality are seen as generating positive externalities that are observable, but not necessarily measurable. As such, they are 'public goods' that have long come under the realm of government responsibility.

Hence, we are witnessing the birth of a new variant of public–private partnership under impact investing, with capital markets acting as conduits. But it would be misrepresentative to say that there are no resulting tensions.

For example, achieving the net zero goal by 2050 could mean that between 50% and 80% of today's fossil fuel reserves have to be abandoned as stranded assets well before the end of their economic lives, causing undue hardship in local communities. We shall return to this and other trade-offs in the next subsection.

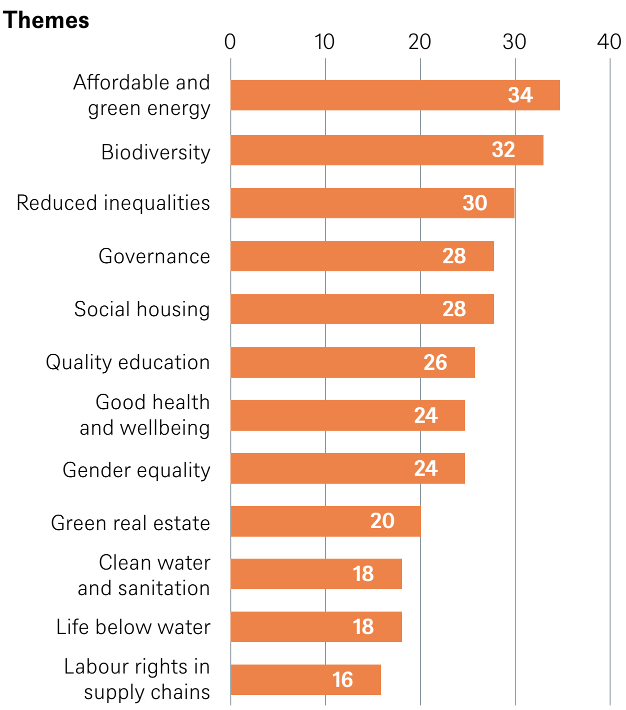
Having highlighted the themes that are being pursued by our survey participants, we now turn to the outcomes that have been experienced to date (Figure 2.2, right chart).

The results have been mixed: 44% report them as positive, 22% as negative and the remaining 34%

Figure 2.2

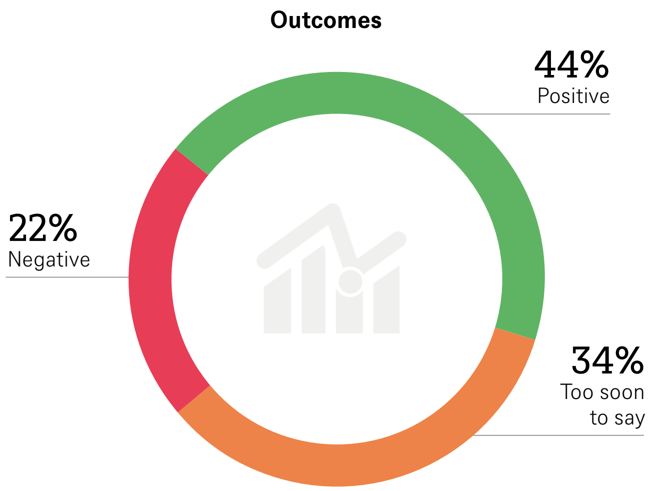
Which are the main themes being pursued by your pension plan's impact investing currently?

% of respondents



Which of the following best describes the outcomes of your pension plan's impact investments so far?

% of respondents



Source: CREATE-Research Survey 2022

> "The invasion of Ukraine will slow down energy transition but it will also cause a doubling down in the search for low cost energy with the lowest carbon intensity."

An interview quote

report that it is too soon to say. This scorecard was compiled in June 2022, when global capital markets had just entered a bear stage. How they will perform from here on is a matter of conjecture. But the implied resilience so far has intensified demand for improved impact reporting, which has traditionally been referred to as 'non-financial', creating the misperception that such information is not financially material. We return to this point in the next subsection.

3. Factors slowing progress

As we have seen previously in this section, current allocations to impact investing are relatively low. A number of factors have slowed progress. They fall into four clusters, as described below.

a. Impact of the Russian invasion of Ukraine on climate action progress

As Figure 2.3 shows, 70% of our participants believe that the invasion could potentially derail the world from its path towards net zero in the near term. It is dependent on two known unknowns.

First, there could be an increase in GHG emissions if Western countries replace Russian gas supplies with coal, leaving Russia to find new markets to compensate for the loss of existing ones.

Second, this means that the current carbon budget would be used up sooner than anticipated. The budget indicates the CO_2 emissions that can be emitted globally, beyond which point a given temperature outcome (e.g. above 1.5°C) is irreversibly locked in. A

Case Study 2b

Thematic strategies provide a stepping stone to impact investing

Historically, the purest form of impact investing has been the preserve of philanthropy, which was all about making an impact with no return requirement. As we adopted the spectrum of capital model, put forward by 'The Impact Management Project' in 2017, we moved up a step from ESG integration by initially investing in thematic funds, with the declared intent of making quantifiable impacts on top of decent financial results. We want to make a positive difference by supporting the transition to a more sustainable economic model.

This form of investing serves to consolidate impact and returns by ensuring that investee companies have products and services that tightly integrate the two. This way, it has become possible for us to invest in companies in public markets, where there is a proliferation of thematic funds. They are not pure-play impact funds, but they do have the potential to become so over time.

We choose them on the basis of how their business activities are geared towards mitigating climate change. We also ascertain the extent to which their CAPEX and sales are aimed at achieving a credible transition to a low-carbon future.

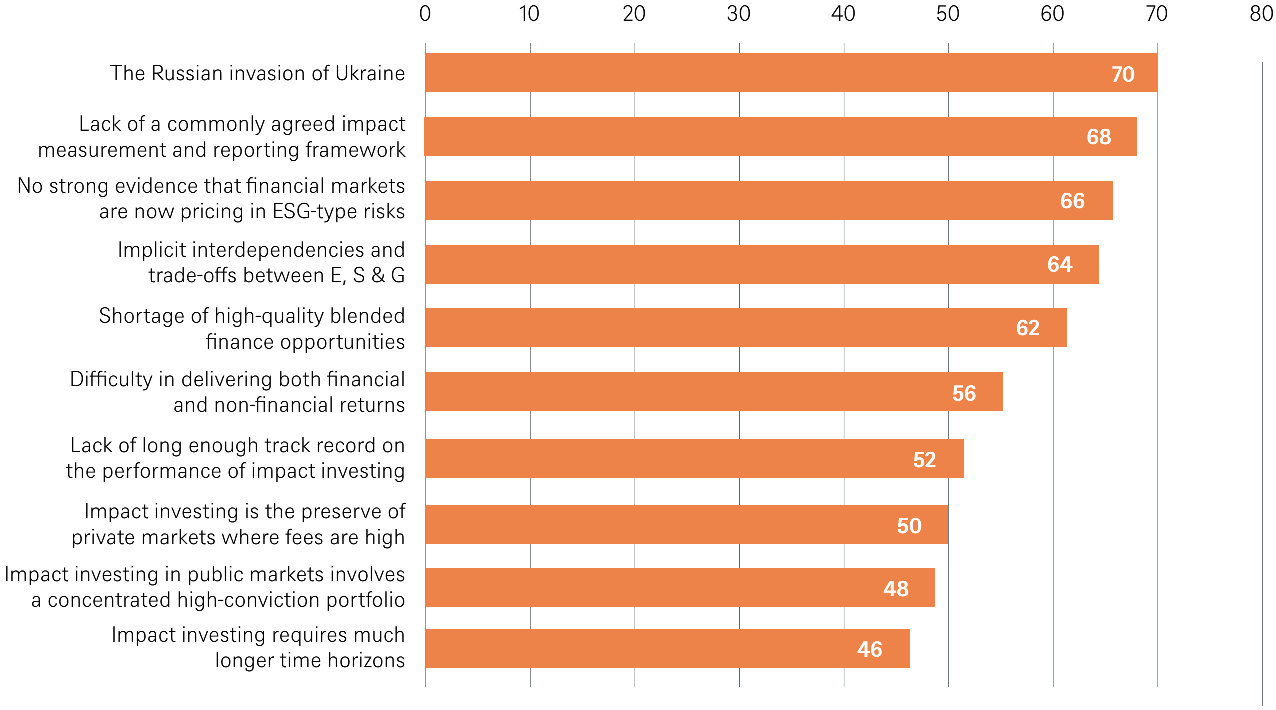
Our thematic funds encompass a broad spectrum of industry sectors such as green buildings, green infrastructure, green manufacturing, alternative energy, electrification and insulation materials. They account for 3% of our equity portfolio and 5% of our private market portfolio. In the former, getting data on double bottom line has proven difficult, as companies are not obliged to disclose them. But this has been less problematic in our private market portfolio, where mandates are customised. Either way, via active engagement, we expect to see more progress – as ever more thematic funds evolve into impact funds.

An Danish pension plan

Figure 2.3

Which factors have constrained, or are constraining, your pension plans from investing in impact-related funds?

% of respondents



Source: CREATE-Research Survey 2022

bump in emissions now will force more draconian reductions later on to stay within the budget. This would inflict higher costs on future generations as weather events become more extreme.

Of course, Western nations are also expected to double down on renewable energy. But the necessary projects have long planning horizons, require huge investments, have long payback periods and are exposed to political and technological risks. Additionally, the July ruling by the US Supreme Court to curb the regulatory power of the Environmental Protection Agency over fossil fuel fired power plants under the Clean Air Act is a significant setback as the US implements its net zero pledge.

b. Data remain the Achilles heel of impact investing

There remain a number of weaknesses in the current data infrastructure. First, there is no commonly agreed impact management and reporting framework, as cited by 68% of survey participants. Second, it is hard to find evidence that capital markets are pricing in ESG-type risks in earnest (66%). Third, impact investing performance does not have a long enough track record (52%). Worldwide, there are over 150 data vendors, each with their own proprietary definitions, research methodology and information sources. We are a long way from having real-time data that can enhance market depth and breadth for impact funds. Data challenges especially persist for three of the defining features: intentionality, additionality and measurability – as described in Section 1.

c. E, S and G are not mutually exclusive

There are interdependencies as well as trade-offs between E, S and G that force investors to make tough judgment calls (64%).

"There are no short cuts to any place worth going. Impact investing is no exception."

An interview quote

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The interdependency can perhaps best be exemplified by how eradicating hunger is closely linked with tackling the damage caused by the loss of biodiversity on agricultural productivity.

Similarly, the trade-off is exemplified by how the net zero goal requires between 50% and 80% of current fossil fuel reserves to be left in the ground as stranded assets, thus ensuring that the worst effects of global climate action will be disproportionately borne by the communities most directly affected.

Such positive and negative feedback loops add an extra layer of complexity to impact investing (Case Study 2c).

d. Impact markets are still evolving

Currently, impact investing is done through three channels, each with its own challenges.

The first, and the key one, is private markets. Customised mandates permit investors to target a double bottom line. However, fees are high and remain a drag on financial performance (50%).

The second channel is public markets. They offer opportunities to invest in pure-play impact companies, but they require high-conviction concentrated bets over long periods (48%).

The third channel is blended finance, typically involving private–public partnership. It aims to use public funds to de-risk and crowd in private capital to co-finance pioneering projects in new industries, markets and technologies. The main aim is to use scarce public resources in a catalytic manner to leverage much larger private financial flows to scale up investments in sustainable development, and to do so with minimum concession or subsidy. Currently, however, there is a shortage of high-quality blended finance opportunities (62%).

Case Study 2c

There are no taxonomies on social issues

The EU's taxonomy on green investing is a major advance in providing the appropriate definitions as to which economic activities can be considered environmentally friendly, so as to protect against greenwashing. Indeed, countries such as Canada and China are using that as a template for crafting their own taxonomy.

The EU taxonomy has six goals: climate change mitigation, climate change adaptation, protection of water and marine life, transition to a circular economy, pollution control and protection of ecosystems. However, the current version of the taxonomy covers only the first two – albeit very important – goals. So, it can best be described as work in progress.

On the social side, no taxonomy has yet been published, although a lot of work is going on behind the scenes.

The crux of the problem is this: for a large part of impact investing, there are no governmental guidelines for investors on whether their impact funds are on the right track – both definitionally and practically. A common taxonomy and standard measurement frameworks are vital. The same is true of alignment of expectations on time horizons over which measurable impacts – financial and non-financial – are likely to materialise.

It is not acceptable to simply have a label pasted on a multitude of investments, irrespective of what the underlying product can potentially deliver. Without a regulatory push, impact investing risks joining various everyday kitemarks or boilerplates when it was designed as anything but.

A Canadian pension plan

3

Drivers of future growth

Why is the impact portfolio set to grow?

Impact investing is expected to be propelled by a trifecta of accelerating secular trends, supportive public policies and new opportunity sets. Principal among them are new regulatory requirements around ESG risks, rising interest in thematic investing and the growing emphasis on SDGs as this decade progresses, giving rise to new opportunities in the blended finance space.

The winds of change are likely to drive impact investing into public markets with their greater breadth, depth and scalability. The newly evolving standards on intentionality, additionality and measurability are expected to improve the current infrastructure of data. This will also enable investors to access pure-play impact solutions providers and climate leaders via passive funds.

The next wave of passive funds in impact investing will be broad based and principally cover four categories: thematic SDG-related indexes, the EU's Climate Transition benchmark and Paris-Aligned benchmark, core ESG indexes, and green, social or sustainable bond indexes. The majority of them are expected to have a tracking error of less than 2%.

When it comes to selecting external asset managers, five criteria top the list: stewardship and proxy voting track record; expertise in tackling issues around intentionality, additionality and measurability with respect to impacts; reporting capabilities; a talent pool focused on delivering innovative impact solutions; and membership of international networks of like-minded peers.

1. Facing the winds of change

a. The emerging secular trends

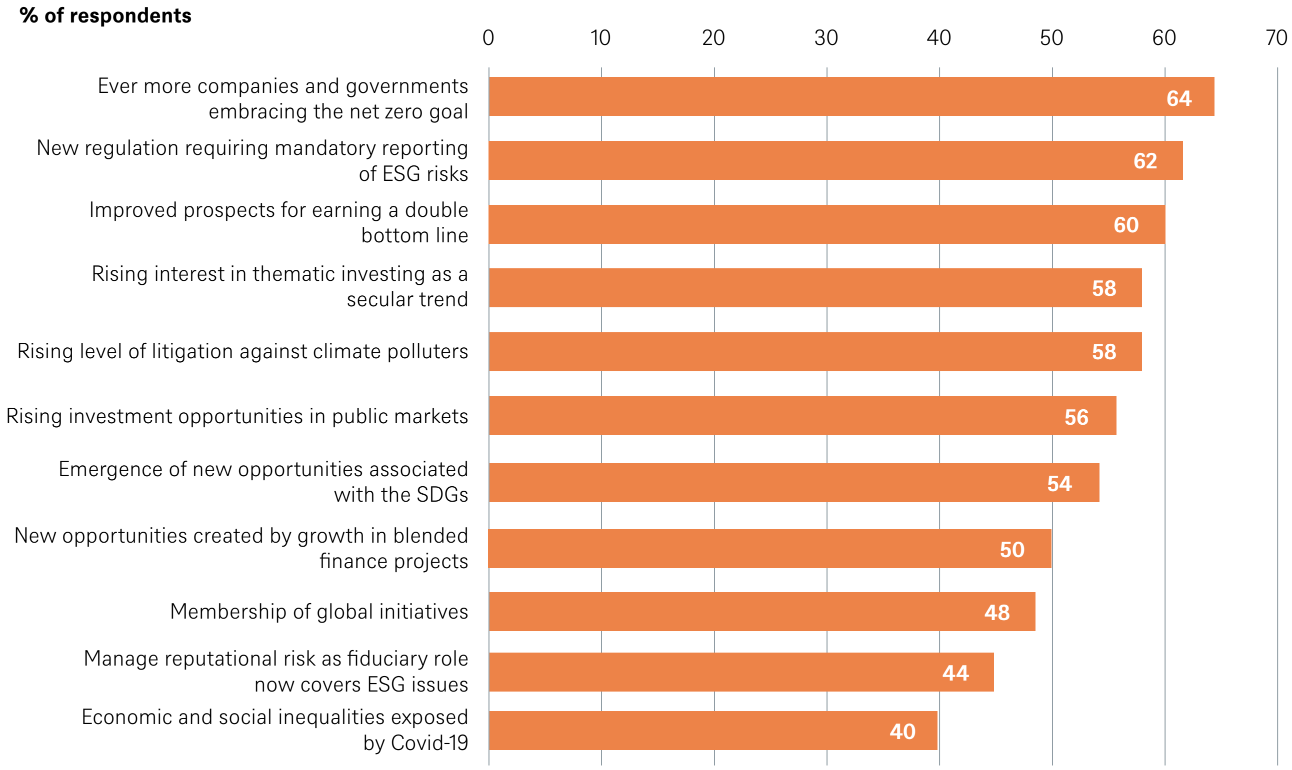
As Figure 3.1 shows, a range of drivers are expected to propel the next wave of impact investing, as the world seeks to meet the SDGs by 2030. Just as importantly, the UN-convened intergovernmental event in Glasgow in November 2021 strengthened the 2015 Paris Agreement by attracting new pledges, ensuring that 87% of the world's GHG emissions and 89% of its economy are now covered by net zero targets.

As a result, 54% of our survey participants think SDGs are likely to bring new opportunities. 64% believe that the net zero goal will benefit impact investing.

These and other developments are promoting the rise of thematic investing as a secular trend (58%). It matters to investors, as it disrupts industries and also gives rise to clear and predictable sources of value creation. It has a multi-year return profile and transcends typical market boundaries and categorisation by either the conventional sector or style factors.

Figure 3.1

What is or will be driving your pension plan's interest in impact investing in general?



Source: CREATE-Research Survey 2022

Over time, many thematic funds will likely morph into impact funds, as societies are expected to inch towards a more inclusive model of capitalism, and as investors and consumers become more vocal about businesses perceived as failing to take their social responsibility seriously. In this context, membership of international initiatives – like Climate Action 100+ and the Net Zero Asset Owner Alliance – is seen as vital in creating strong leverage in the stewardship process (48%).

b. The regulatory push

The UK and the EU have recently adopted the mandatory reporting of ESG risks by pension investors and listed corporates, using the template from the Task Force on Climate-related Financial Disclosure. The SEC in the US has finally issued its draft guidance for discussion with a view to implementing mandatory disclosure by the end of 2022. Such measures are likely to spread to other pension markets as well, according to 62% of our survey participants.

Worldwide, market regulators are stepping up their efforts to bring transparency and accountability to the financial sector on ESG investing as well as raising the bar on companies' disclosures of their performance on ESG criteria.

Tougher disclosure rules for financial firms are already improving transparency for investors; they are also adding more rigour to investment processes and stewardship activities. Their sole aim is to ensure that listed companies' business models are aligned with the SDGs and the Paris Agreement. Just as importantly, at the global level, the

"Under new regulation in the UK, we as trustees are now required to report on climate risks in our portfolio, using the TCFD framework, and report annually."

An interview quote

International Sustainability Standards Board was formed at COP26 to harmonise sustainability disclosure standards, increasing comparability across markets and facilitating greater investments. For now, the IRIS+ Thematic Taxonomy, covering generally accepted definitions of impact categories and impact themes, is already serving to create a shared language for describing, assessing, communicating, and ultimately comparing impact performance.

To cap it all, there is a rising level of litigation against carbon polluters in all regions (58%).

c. New opportunity sets

As a result, our survey participants expect improved investment opportunities in two spheres.

One is public markets (56%). The share of impact investing in them is set to grow, as we shall see in the next subsection.

The second sphere is blended finance (50%). SDGs will continue to require an annual investment of USD5–7 trillion and the net zero goal is likely to require USD100 trillion to enable the transition from fossil fuels to green energy.

Governments alone cannot fund sums of this magnitude. They remain keen to ensure that capital markets are offered the necessary rewards and sanctions to help bridge the gap.

2. Advancing into public markets by signalling that impacts matter

The impact investing universe held USD715 billion in 2020, according to the latest market-sizing study from the Global Impact Investment Network. This is a tiny proportion of total global capital market assets: managing USD123.5 trillion in bonds and USD105.8 trillion in equities, according to the 2021 Capital Markets Fact Book.

The 2020 GIIN survey also that found the majority of impact investments were in private equity or private debt, with public market investments the third largest, and fastest growing, part of this market at 14% of assets. Hitherto, in public markets, it's been rare to find pure-play companies in impact investing, without ending up with a highly concentrated portfolio. The higher the impact, the higher the concentration and the longer the holding periods.

In Section 2, we described the key barriers. These have confined impact investing to mainly private markets, thus holding back their advance into public markets.

However, the identified barriers are set to weaken in the light of growth drivers described in the preceding subsection. These will be reinforced by further drivers that are specific to public markets. Together, they serve to send out the signal that 'impacts matter' to shareholders. Their evolution will likely usher in a new era, impact investing 2.0, as listed companies reshape their businesses to create 'enterprise additionality' by shifting their CAPEX to address environmental and societal pressure points instead of tweaking their existing offerings. This means that business models and mission statements may well be restructured to make a deliberate and positive difference to global challenges.

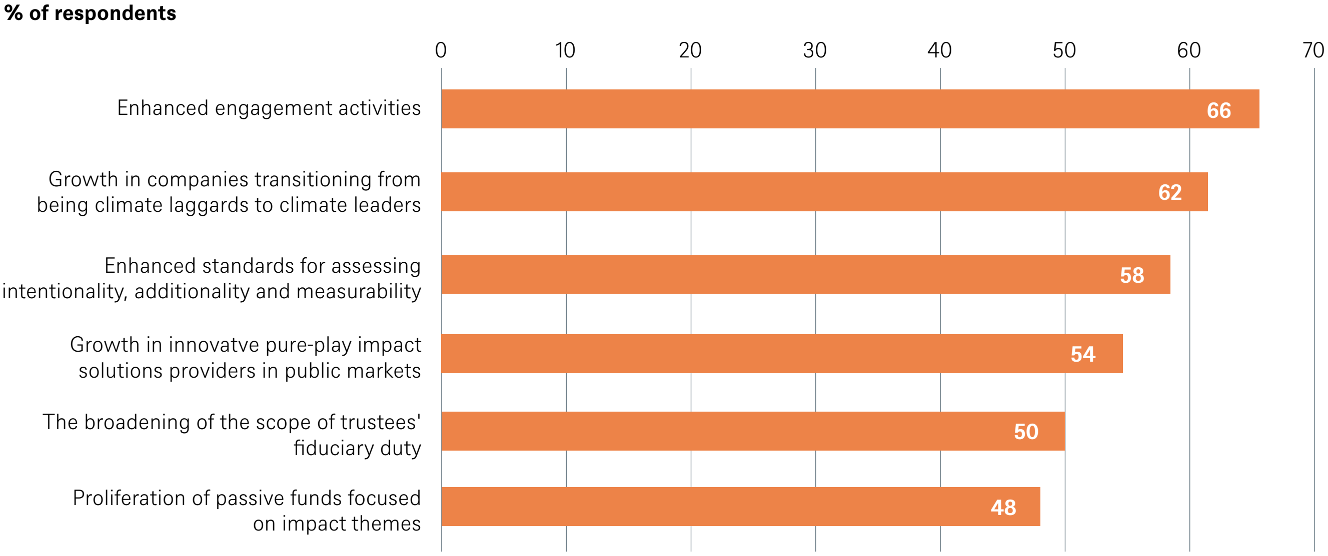
Two sets of mutually reinforcing growth drivers are expected to propel this process, as given in Figure 3.2 and described below.

a. The dynamics of energy transition

Greening the planet will be a multi-faceted project and will extend beyond carbon reduction, electrification, energy efficiency and renewable energy. It will also have profound social consequences; for example, there are an estimated 1.1 trillion tonnes of proven coal reserves worldwide, according to the World Coal Association. That means that there is enough

Figure 3.2

What is now driving your pension plan's interest in impact investing in public markets?



Source: CREATE-Research Survey 2022

coal to last around 150 years at current rates of production, according to the Association's estimates. Notably, proven oil and gas reserves are equivalent to around 50 years at current production levels. Both risk being stranded, exposed as they will be to a significant loss in value ahead of their anticipated economic life. The negative social impact on local communities could be significant. Accordingly, our survey participants anticipate investment opportunities emerging from three sources.

First, 62% expect growth in the number of companies who transition from being climate laggards to climate leaders, so as to attract investor interest, which puts climate impacts on equal footing with financial performance.

Second, 54% expect growth in the number of innovative pure-play impact solution providers across a range of SDGs to minimise the unintended social consequences of energy transition.

Third, 48% expect a proliferation of index funds focused on themes. The exponential growth in thematic ETFs is set to continue. We shall return to this point in the next section.

b. Enhancements in impact standards and data

The launch of the International Sustainability Standards Board at COP26 is expected to result in a unification of the existing plethora of standards. This is likely to enhance existing standards and the data that underpins them. As such, 58% expect improvements in the measurement and monitoring of four cardinal pillars of impact investing: intentionality, additionality, measurability and financial outcomes (Case study 3a).

The implied improvements will, in turn, boost progress in two areas. First, 66% expect that they will enhance the effectiveness of their stewardship activities. Second, 50% expect that they will also facilitate a broadening of their fiduciary role to encompass impact issues as much as the financial ones.

"The stars are aligning for impact investing to go mainstream into public markets."

An interview quote

Case Study 3a

Advance into public markets will be an evolutionary process based on learning by doing

The advance into public markets will be influenced by two contrasting sets of signals.

Positive signals are sent by markets when there are good investment opportunities that deliver a double bottom line. Negative signals are sent when we as investors withhold investment, in the expectation that we can influence price and thus send a signal to the public company that we do not endorse their practices.

Our signals are reinforced when we also require companies to report on their gender pay gaps and environmental impacts, in the belief that the market will adjust prices as a result of the consequent transparency. The same applies to public policy and market regulation. They also play a vital role in sending out the signal that 'impact matters'.

The advance of impact investing in public markets will be determined by how powerful these signals are. These are still early days for impact investing, especially as it relates to public markets. Scaling up this part of the investment universe depends upon how investors view impact investing.

The purist view states that impact investing is mainly about supplying capital to an entity that could not otherwise generate its intended positive outcomes. In other words, capital that is deployed makes a measurable incremental difference.

The pragmatic view states that it takes time for new investment strategies to evolve and acquire a distinctive identity, as markets gradually adapt to them over time, mostly via trial and error. Such adaptive behaviour occurs as both investors and markets climb a learning curve as the existing infrastructure of skills, data and technology improves.

Our foray into impact investing is based on the pragmatic view. Starting with theme funds, we are refining our approaches via learning by doing. It's a dynamic process that relies on continuous improvement over time. It also recognises that good corporate behaviour must be driven by law and enlightened self-interest, not investor altruism.

In contrast, critics of impact investing and ESG take a purist view and ignore how markets and public policies have historically evolved over time.

An Australian pension plan

3. Creating impact opportunities via a diversity of passive funds

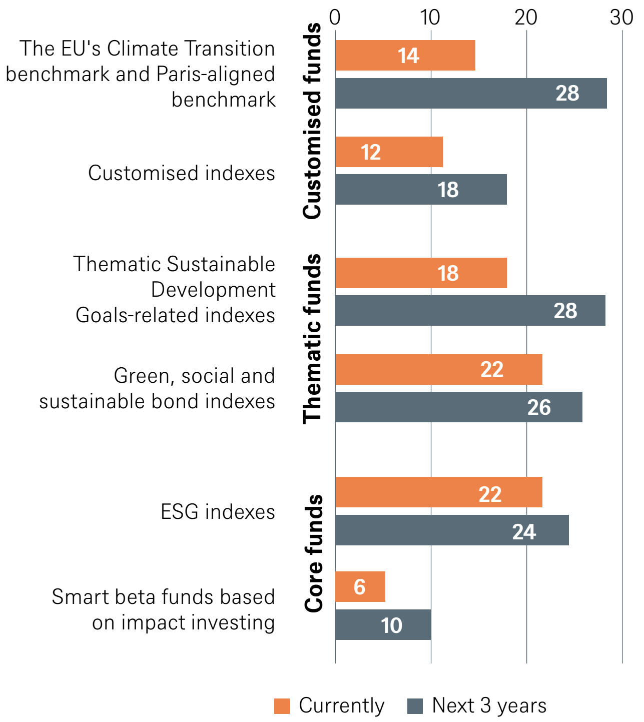
There is no one-size-fits-all methodology when it comes to constructing impact indexes, according to our survey (Figure 3.3, left chart). Three types are now being used.

The first centres on customisation. It covers specific opportunity sets and meets the objectives and priorities of different investors. It has developed several individual index series, focusing on areas as diverse as carbon price, healthcare, clean energy and gender equality. The most prominent among them are the EU's climate benchmarks. Currently, 14% of our survey participants use them, a figure that is likely to double over the next three years. Yet another category centres on customised indexes, which are growing in popularity in the index universe in general to target specific goals. Currently, 12% use it for impact indexing, a number likely to rise to 18%.

Figure 3.3

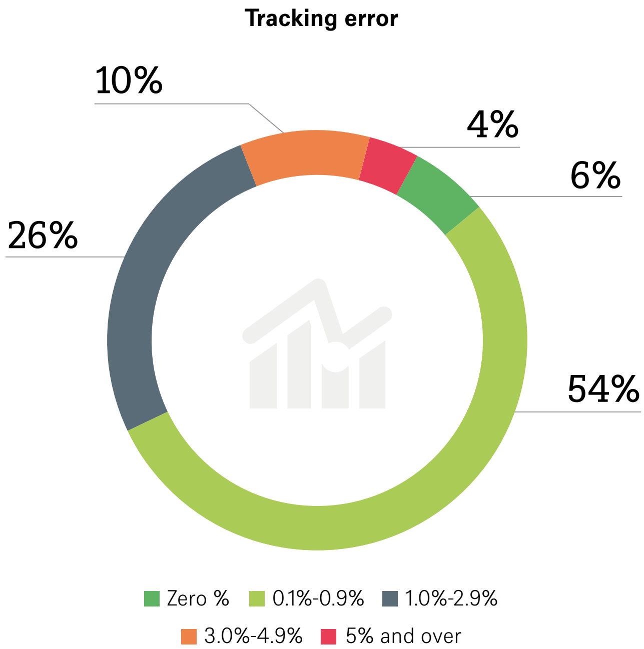
In the passive space, what are the main vehicles used in impact investing currently and which will be used over the next three years?

% of respondents



What is the extent of the tracking error that your pension plan is willing to accept in your impact-related passive funds?

% of respondents



Source: CREATE-Research Survey 2022

The second type of impact indexes centres on two varieties of thematic funds that focus on a particular area of the market, with a distinct impact objective. The first covers SDGs: 18% use them currently and 28% expect to use them over the next three years. The second variety covers green, social or sustainable bond indexes – with full transparency on the use of proceeds. Currently, 22% use them and this is likely to rise to 26% over the next three years.

The third and final type centres on two sets of core indexes. One covers broad indexes that embody ESG metrics with a low tracking error relative to the parent benchmark. Currently, 22% use them and the figure will likely rise to 24% in the next three years. The other variety centres on smart beta, which aims to deliver alpha returns at beta fees. Currently, 6% use them, a number that will likely rise to 10% over the next three years.

One recent development in the US could have far-reaching implications for the role of index providers. The SEC is now considering reclassifying them as 'investment advisers' instead of 'information providers'. The move would mean index providers would be treated the same way as asset managers under the historic Investment Advisers Act 1940. It means they will have a fiduciary responsibility to the clients and investors adopting their products. Potentially, this could cause a step improvement in the robustness of their indexes (Case study 3b).

"The EU climate benchmarks are are firmly locked into the net zero goal and bear no relation to their parent benchmark."

An interview quote

Case Study 3b

The index is not a fiduciary but its manager is

By its very nature, an index is not a fiduciary, but simply an opportunity set created by its providers, who are not obliged to recognise the interests and constraints of its end investors. A fiduciary, in contrast, is obliged to exercise a duty of care by putting clients' interests and needs above all else.

For a long time, passive index fund managers have been seen as lazy owners of companies, allowing unaccountable managers to put their own interests above those of their shareholders.

That stigma of ownerless companies, however, has been fading with the rise of ESG investing, which now enjoins index managers to be active stewards of capital, since they are also forced owners of shares they hold. Unlike active managers, they cannot dump their positions in poorly performing companies. With the price of index funds falling over the past three years, stewardship has become a key differentiator in the index world. Without it, passive funds risk losing their relevance in the sustainability landscape. It is unwise to think that an investment style such as impact investing can be encapsulated by an index in the same way that value indexes have become synonymous with value investing. Companies can and do fake good conduct in order to gain entry to an index.

A powerful factor helping index managers to be a fiduciary is the recent decision by the SEC to classify index providers as investment advisors. The consultation process has started. The end outcome is hard to anticipate. But it is clear that regulators are now turning the spotlight on index providers.

Under the current arrangement, there is an agency problem in the sustainability data market. The interests of data providers do not necessarily align with those of asset owners. There is not much consistency in the scores of individual providers, since they all have their proprietary methodologies on intentionality, additionality and measurability. When implemented, the SEC ruling will promote a better alignment of interest between data providers and their end users.

A German pension plan

Thus, impact investing is set to advance into the passive space. One notable feature of this advance is transparency, which is designed to counter the charge that passive investing means no opportunity to engage. Index providers have been progressively disclosing to constituent companies the specific factors that are driving their weights in the index, be that carbon emission, gender equality or board governance. This sends clear signals to companies about what really matters to investors. The resulting granularity is also used by index managers in their engagement activities. As we shall see in the next subsection, stewardship capabilities are now a key criterion in manager selection, for passive as well as active impact funds.

Given the variety of passive funds now used in the impact space, it is unsurprising that there is big variability in their tracking errors (Figure 3.3, right chart). Only a tiny minority of survey participants (6%) has an error of zero. A further 54% has an error of below 1%. Thus, a total of 60% aim to mimic their parent benchmarks.

Among the rest, 26% have an error in the range 1.0% to 2.9%; 10% are in the range 3.0% to 4.9%; and 4% have an error of 5% or above.

There is an apparent paradox here. Our survey participants see impact investing as a long-term endeavour, yet the majority of them have low tolerance for high tracking error. The reason is that they see low tracking error as only setting a baseline performance expectation in line with the chosen parent index. However, by reorienting their passive portfolio towards impacts, our participants expect to see some demonstrable upside without sacrificing baseline outcomes. In other words, they are seeking a free option, which gives an upside as markets start to price in impact risks and downside protection against capital loss if it doesn't.

The implication is that index constructors have to be pretty smart in their choice of constituent companies if they are to deliver added value on top of baseline benefits.

4. Recognising the centrality of stewardship

When asked what criteria are now being used in selecting external asset managers for their impact investing, our survey participants identified two clusters, as discussed below.

Past performance matters, as does the ability of managers to replicate that in the future. The two clusters below are seen as good proxies.

a. Recognising that active ownership is the alpha behind alpha

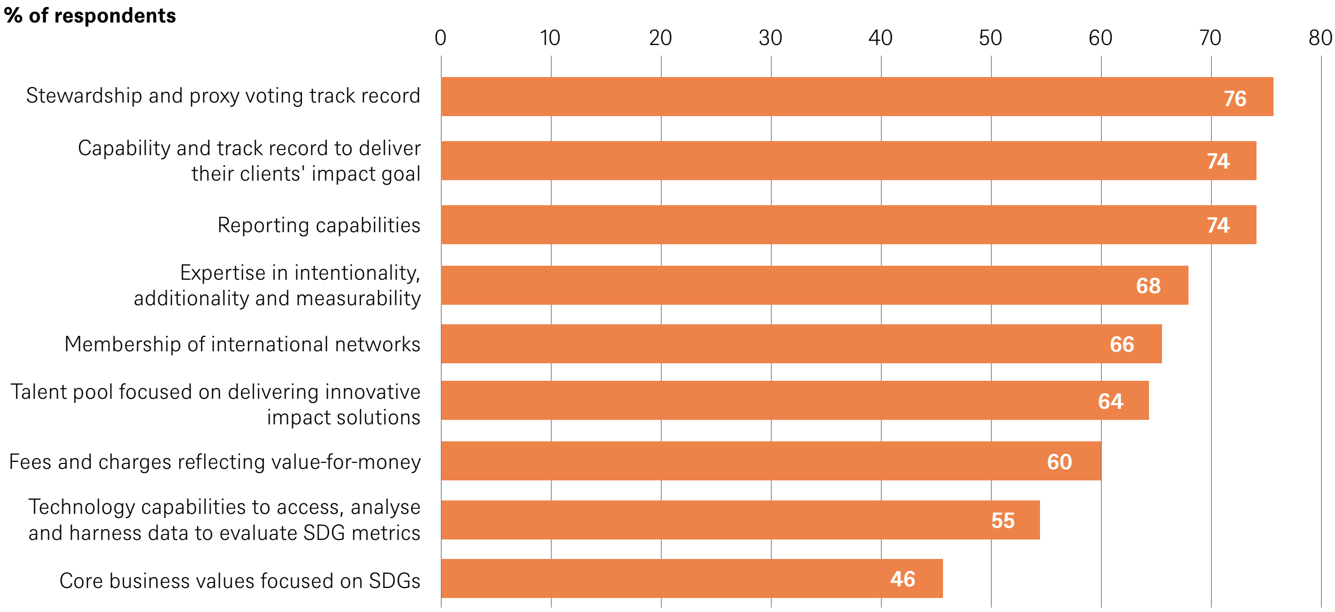
The key challenge that our survey participants have struggled with is how to realistically assess the impact of their investments while the current infrastructure of standards and data remains a halfway house.

Unsurprisingly, therefore, two criteria top their list: stewardship and proxy voting track record (cited by 76% in Figure 3.4).

In this context, stewardship is about the long-term mindset of ownership and advocacy, in line with the concept of 'universal owners', in which the majority of our survey participants include

Figure 3.4

When assessing/selecting external asset managers for impact investing, which criteria do you take into account?



Source: CREATE-Research Survey 2022

"A common language and mental models about impact investing are evolving gradually. That is why active stewardship is vital."

An interview quote

themselves. They believe that they 'own' the negative externalities caused by their portfolio companies due to the sheer depth and breadth of their holdings in all asset classes and regions. Such 'paper' holdings do not negate their fiduciary responsibility to wider society. They have to act as agents of change via their passive as much as their active portfolios (Case study 3c).

Typically, they use baseline company performance as a starting point to set goals, determine the engagement approach and measure progress towards outcomes (e.g. number of lives saved, CO_2 emissions reduced or improved labour practices).

In the energy transition, they also prefer stewardship over divestment because the exclusion of fossil fuel producers from pension portfolios does not starve them of capital: most producers carry large free cashflows anyway. For them, engagement and advocacy is the only effective approach for real change. This is in the belief that those who are part of the problem can also be part of the solution.

For that to work, it is essential to orient investors' goals around a framework that is both financially material and widely understood by corporate management teams. This especially applies

Case Study 3c

Stewardship is about being an effective agent of change

It is vital for us to understand the sustainability profile of our investee companies as a key measure of risk and opportunity. The reason is that the negative externalities they create are now being passed back on to them in the form of costs, social pressures and governmental intervention. Examples include sugar taxes, carbon prices and minimum wage legislation. These are spreading in Western economies, raising corporate costs to compensate for externalities.

The key instrument used in integrating impacts into our investment process is active company engagement that drives change on the ground. It is not a 'once and done' exercise but is, instead, for the long haul in weaning companies off a deeply ingrained addiction to quarterly financials.

We vote at AGMs and back that up with year-round conversations with top executives to deepen our relationships in the targeted companies. Last year, we engaged with over 900 companies via face-to-face meetings, zoom calls and emails. We vote against anti-ESG policies at AGMs and demand tangible outcomes and transparent reporting.

In the past, we relied on an exclusionary approach that screened out 'sin' stocks, only to find that it did not deliver change nor did it capitalise on opportunities as societies developed zero tolerance to negative externalities. At best, exclusion made our portfolio more defensive by reducing risk; however, when stewardship fails to deliver our goals, we divest.

Of course, divestment is not that easy in passives, unless passive managers are willing to overtly tilt their offerings. Overall, they are the ultimate long-term investors. As such, they have every incentive to exercise their stewardship role to boost the quality of beta via the sheer weight of their ever-rising share of equity and bond markets. They have even more ability and responsibility to promote sustainable investing practices via engagement so as to enhance investor returns.

A Dutch pension plan

to SDGs, which are essentially targeted at governments, not companies and their investors.

The main frameworks currently in use are the Impact Management Project's Five Dimensions of Impact and the IRIS+ impact themes.

In economic terms, however, stewardship is also a nonexcludable public good. This means that the benefits of engagement are enjoyed by all investors, irrespective of whether or not they behave as responsible long-term owners by investing in stewardship. The familiar 'free rider' problem is ever present.

In order to counter that, many of our survey respondents expect their managers to belong to networks of like-minded peers that work collaboratively when engaging with their target list of companies. Indeed, 66% of our survey respondents factor membership of international networks – like the UN Principles of Responsible Investment, Climate Action 100+ and the Net Zero Asset Managers Initiative – into their manager selection process.

b. Having best-in-class capabilities

To support the stewardship role, asset managers need a range of capabilities to deliver their clients' ultimate impact goals (74% in Figure 3.4). The criteria in question include: reporting capabilities (74%); expertise in foundational features like intentionality, additionality and measurability (68%); a talent pool focused on delivering innovative solutions (64%); and technology capabilities to access, analyse and harness data on net zero and SDGs (55%).

Given the weaknesses in the existing data infrastructure, it is essential to mine a vast amount of unstructured data in near-real time in order to identify both the risks and opportunities in today's investment landscape.

These weaknesses primarily arise from the lack of universal acceptance of what a good company is in practice. With rare exceptions, therefore, governments do not mandate companies to provide the data that matter most for impact investing. A common language and mental models about impact investing at statistical level are evolving gradually. That is why so much emphasis is put on data issues and stewardship in manager selection.

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