Summary

- An important first step for pension funds to consider when developing an impact investment strategy is to define exactly what is meant by 'impact.'
- Measuring impact against the United Nations Sustainable Development Goals is one potential way in which investors can gain a clear and transparent view of the impact of their investments on a group of ESG objectives.
- Another useful way of viewing ESG is to see it as a set of components, each of which potentially carries additional sources of investment risk and return.

A noticeable difference

Andrew Williams considers how best to measure the impact of ESG investment strategies

In recent years, impact investing has emerged as a useful tool for pension fund investors to discover how much of an impact their ESG and responsible investment strategies are having. So, how best can pension funds measure the impact of their ESG and responsible investment strategies? How can they use the results of such exercises to avoid the risk of 'green washing'? And what are likely to be the key innovations and trends in how pension funds measure the impact of their ESG and responsible investment strategies over the next few years?

Definitions

According to Insight Investment's ESG analyst, Joshua Kendall, the most important first step for pension funds to consider when developing an impact investing strategy is to define exactly what is meant by 'impact.' For example, does it refer to an environment, social or other objective – or relate to achieving a positive impact or avoiding a negative one? In his view, the establishment of such goals can help frame the required impact strategy and appropriate measurements.

"Unfortunately, the data to help measure and manage impact is extremely sparse. Within fixed income you can use bonds labelled as impact, but even then, relying on labels is not the best measurement of impact because there is no universally agreed definition of what qualifies as an impact bond," he says.

Insead's Global Private Equity Initiative's academic director, Professor Claudia Zeisberger, agrees that the key for institutional investors is to be clear about their mandate and recognise that language is crucial in that context.

"Are we talking about ESG compliance – or a broader responsible investment mandate – or do we care about a specific impact, for example improving schooling in a community?" she says.

Kames Capital's head of ESG research, Ryan Smith, also believes that measuring the impact of investments can be difficult, with quantification of the impact of some companies or sectors easier to achieve than others. In this light, he suggests that, before trying to measure outcomes, it is equally important for clients to understand the investment philosophy and process of any fund.

"What's the fund and fund provider's track record of responsible investment? I'm not just talking about investment performance here either – there seems to be a certain amount of re-branding of existing funds in this area," he says.

Metrics

Meanwhile, HSBC Global Asset Management's responsible investment specialist, Stephanie Maier, points out that pension funds are increasingly seeking to align their financial objectives with real economic impact. As part of this exercise, she observes that metrics can be used "both to better understand the risks and opportunities institutional investors are exposed to and the extent to which their investments are delivering against the sustainable development goal (SDG) agenda, and in particular tackling climate change".

In terms of what she describes as 'pure' impact investing, she explains that the sustainability outcomes and associated metrics are part of the investment proposition. Yet increasingly, impact metrics are "being designed to understand the impact of other responsible investment styles across a variety of asset classes", she says.

"The Taskforce for Climate-related Financial Disclosures is playing a key role in catalysing development of carbon risk metrics. Measuring carbon, for example carbon intensity or tonnes of carbon avoided, is increasingly common," Maier explains.

"Beyond carbon, we are part of the Cambridge Programme for Sustainability Leadership – Investor Leaders Programme, seeking to develop a broader set of SDG sustainability metrics," she adds.

Elsewhere, KBI Global Investors' head of responsible investing, Eoin Fahy, believes the main challenge facing pension funds considering how best to measure the impact of their investments is to find a methodology that allows a comprehensive analysis of all stocks in the portfolio, at a very detailed granular level.

"Looking at the contribution of each and every business activity carried out by each company is the best way this can be done, in our view, and using the framework of the United Nations Sustainable Development Goals allows investors to have a very clear and transparent view of the impact of their investments on a group of ESG objectives with the needs of developing nations to the fore," he says.

Green washing

When it comes to avoiding 'green washing,' Zeisberger urges institutional investors to hold their agents to the promised mandate. In terms of responsible investing, she also points out that investors should have a clear definition of the desired outcome, know where on the spectrum they are playing and have a measure in place that can clearly communicate whether the set targets have been achieved within their desired risk appetite.

"It is the measuring where more work needs to be done: No industry standard exists to date," she says.

"Until such a standard is achieved it is everyone for himself and certainly caveat emptor when looking to invest in responsible investment vehicles. Rigorous due diligence, a clear set of questions based on a carefully developed responsible investment mandate are only the start; they need to be followed by a regular audit of the actual investments made to ask if the results live up to expectations and are within the mandate," she adds.

For Kendall, the 'uncomfortable truth' is that no investment portfolio is free from negative environmental impacts – and that every company included in mainstream portfolios has a carbon footprint and is very likely to be a net carbon contributor.

"Pension funds should emphasise the strategy they have in place to manage these risks, as well as being fully transparent with the performance of the portfolio," he says.

Robust governance

Looking ahead, Redington's associate manager – research, Honor Fell, hopes to see a number of trends gain pace in the next few years, including the continuing improvement and standardisation of ESG reporting metrics, continued and increased scrutiny of consultants and asset managers by pension funds, portfolio level ESG reporting as standard on the rise from asset managers, as well as new tools to visualise and interpret data becoming more and more applicable.

"I think one of the key innovations will be the level of data available to end members, particularly in DC schemes. We know that younger members are increasingly interested in the impact of their investments – the investment industry has an opportunity here to offer transparency to the end-consumer and, in doing so, to potentially build trust and saver engagement," she says.

In the near future, Kendall also predicts that the EC Sustainable Finance Action Plan, announced earlier this year – and which aims to introduce guidance for investors on sustainable investing, including a taxonomy on the definition of impact, reporting and disclosure, and fiduciary rules – will be a very important development.

"These changes will likely grow the market awareness and tools for impact strategies," he says.

Meanwhile, Smith does not see the demand for more impact reporting going away – particularly since end investors are expecting more transparency of all sorts from fund providers.

"Hopefully, we can all appreciate that not every impact is quantifiable, which would reduce the risk of green washing," he says.

Ultimately, Maier stresses that pension funds, by their very nature, invest for the long term and so, it can be argued, need to look to risks that aren't necessarily directly in front of them. In doing so, she believes that a useful way of viewing ESG is to see it as a set of components, each of which potentially carries additional sources of investment risk and return. By ignoring ESG, she warns there is a risk that pension funds would be missing the full picture, and could potentially be adopting a short-term view on investments and risk.

"This is one of the reasons why pension funds not only embrace the concepts fundamental to sustainable investment strategies but, increasingly, seek to measure the impact of the policies they adopt," she says.

"Companies need the support of long-term ESG-aware investors to help them adapt their business models to succeed in a 'two degree world'. Pension funds have a real opportunity to allocate capital to funds that value a company's long-term resilient business models and robust governance structures. There is no point just thinking about quarterly results and short-term earnings," she adds.

Written by Andrew Williams, a freelance journalist