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IMPACT: Dual-Purpose Investing

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CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

The Impact Investment Team

Maïa Ferrand

As Co-Head of External Multimanagement, Maïa has been absorbing Candriam's responsible investing ethos since 2001 and applying it to Fund selection and multimanagement since 2004. Holder of a masters in econometrics from the University of Paris Panthéon-Assas and a degree in Fine Arts, she has worked in financial markets in New York, London and Paris, including currency option trading.

Mohadeseh Abdullahi

An Investment Analyst, Mohadeseh has joined Candriam since 2018. She has experience in ESG investing, High Yield credit, and Renewable Energies. Holding an MSc in Environmental Technology from Imperial College London and in Economic Geography from LSE, she has published academic research on Impact Investing.

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As Co-Head of External Multimanagement, Jean-Gabriel has been managing alternative portfolios and multimanagement products with Candriam since 1998. Holder of an engineering degree from the "École Nationale Supérieure des Techniques Avancées" in Paris, he also has a background in fixed income trading.

Samuel de Bousquet

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He has also been a deputy head of risk management for a fund of hedge funds.

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Impact *and* Return… not Impact *versus* Return

Once, creating a better world was called charity, and generating return was termed investing.

Our goal is to make them the same thing.

Investing for a better world.

Why should responsible investing mean sacrificing return? At Candriam, as for many academics and for the UN PRI, responsible investing means enhancing returns. If words mean something, let's introduce another nuance. We like to invest for impact, as does an ever-growing proportion of investors.

We welcome the investment world's next step. In Impact Investing, the underlying business model is the impact — goods or services designed to meet a societal need, either social or environmental. These companies economic and financial performance are linked to their social or environmental missions. We believe that pursuing environmental and/or social returns simultaneously with financial returns yields a more efficient outcome than treating this goals separately.

The Nascent Impact Business Model

Impact Investing: What is it?

An Impact Investment is "made with the intention to generate positive, measurable social and environmental impact alongside a financial return".

So says the Global Impact Investing Network[1]. Across Candriam, for all investments, we hold the conviction that those companies which embrace sustainability-related opportunities and challenges, along with their financial opportunities and challenges, are the most likely to generate shareholder value. So for Impact Investing, we would begin with the GIIN definition, but we would add:

- **Market returns** – Rather than simply a positive financial return, at Candriam, we believe that Impact Investments should target market returns.
- **Impact and financial returns are interlinked** – We believe Impact Investments should be holistic businesses in which the impacts generated and the growth in financial returns are entwined.

This is not a mere rebranding of the 'sustainable' label. The difference is that Impact is the intent. Impact is a business model in which the impact creates the financial returns.

Covid sharpens the focus

If anyone doubted the investment needs for public health, food security, the environment, and the creation of secure jobs and a living wage, then the Covid-19 pandemic should have caught their attention by now. Throughout the academic thesis on which this document rests*, as well as in Candriam's own investment approach, Impact Investing refers to both social AND environmental investments.

The damage from Covid continues to be most severe for the must vulnerable, across all nations. News headlines are demonstrating that social impact business models are in demand across the globe. After the governmental or charitable responses in the teeth of the crisis, infrastructure will need to be maintained, restored, or newly built.

Remote teaching, tele-health, and increased use of remote access to courts and other citizen services are examples of social needs with rising demand and unequal access. Impact investing can play an important role in these areas, in all countries.

Over the last fifty years, there has been a transformation in thought about the purpose of the firm, and the role of shareholders versus other stakeholders – see the appendix, *Nuances and Nomenclature*, for some thoughts. Covid is an extra push to an evolution already underway.

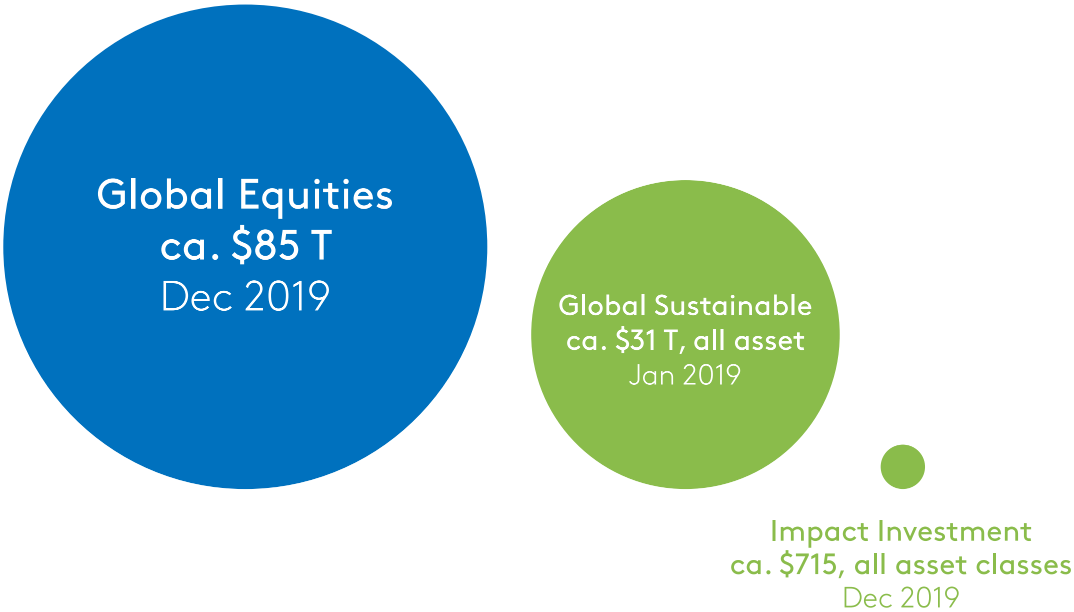
Impact Investment growth potential

There is plentiful scope for Impact Investments. The UN Trade and Development conference estimated a $2.5 trillion need[2] for initiatives to avert threats of food insecurity, pandemics, energy supply, climate change, etc. If certain externalities such as emissions are priced, taxed, or fined – for example, wide adoption of carbon pricing – products and services which were once left to governments or controlled through regulation could become profitable impact business opportunities.

Additionally, because of these needs, some businesses may be eligible for government or other grants, offering a cushion to seed investors.

Figure 1: Market Size Perspective

Global equities, Global sustainable all asset classes, Global Impact all asset classes



Sources: FactSet, GSIA[3] bienniel, GIIN

The GIIN estimated the Impact Investment sector at $502 billion in December 2018, and $715 billion in December, 2019. That is, a leap of 42% in just twelve months.

* The foundations of this Candriam White Paper rest on the findings of the Imperial College thesis *Impact Investing – Is there a case for European institutional investors to pursue Impact Investing in Europe*[4]. The thesis methodology was based on in-depth interviews with leading impact investors and industry stakeholders throughout Europe, conducted in collaboration with Candriam. The thesis author has subsequently joined Candriam's Impact Investing Team.

Impacts and Returns

Societal Impact: Social or Environmental?

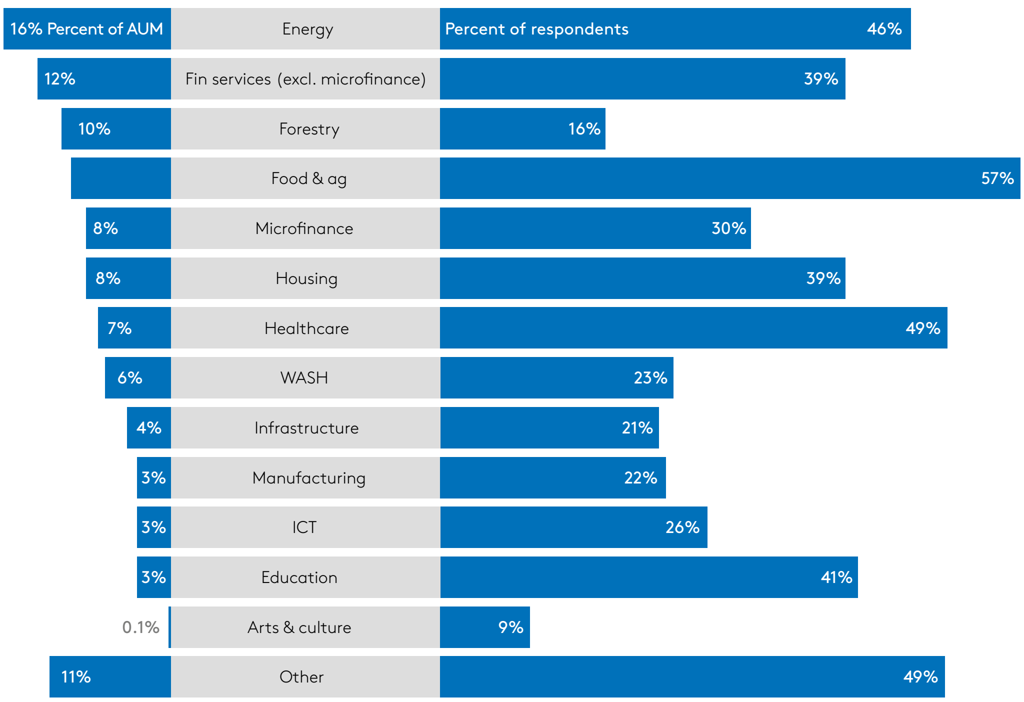
A surprising number of Impact Investments pursue Social goals. Indeed, the quintessential image of an Impact Investment, micro-lending[5], is a social goal-driven business. Many Impact Investments address both types of societal goals, social and environmental – clean water, for example. Environmental impact[6] still leads in total dollars of Impact Investments, but Social investments are growing rapidly and lead in the number of investments. One might expect Covid to highlight not just the need, but the opportunities for businesses which target social needs, and attract investment.

The financial press and others have been examining the extent to which the broadly-defined sustainable investing world actually puts much emphasis on the 'S', or 'Social', in Environment, Social, and Governance factors. The conversation has become louder since the outbreak of the Covid-19 pandemic.

One note. Impact is not ESG investing (Environmental, Social, and Governance factors). For some investors, ESG has a reputation as a negative screen. Candriam applies ESG as a positive screen, to help investors identify sustainable growth (in both the 'green' and 'enduring' sense of the word sustainable). Impact Investing is neither an analysis nor a 'screen'; it is a *founding intent*.

Figure 2: Societal Investment areas – Social, Environmental, or both?

Left side - Percent of AUM.
Right side - Percent of respondents with any allocation to each sector.



Notes:
'Other' includes investments that did not align to these sector categories such as real estate, tourism, community development, retail, and sector agnostic investments.
WASH = Water, Sanitation and Hygiene; ICT = Information Communications and Technology

Source: GIIN, 2020 Annual Impact Investor Survey

Impact goals – a taxonomy

Despite the size and popularity of sustainable investing (Figure 1), ESG analysis suffers from an under-developed taxonomy and measurement system. Impact Investors, as a younger and smaller segment facing the same hurdles, have watched and learned. While more is needed, Impact Investing has made important progress in taxonomy and measurement over the last three years.

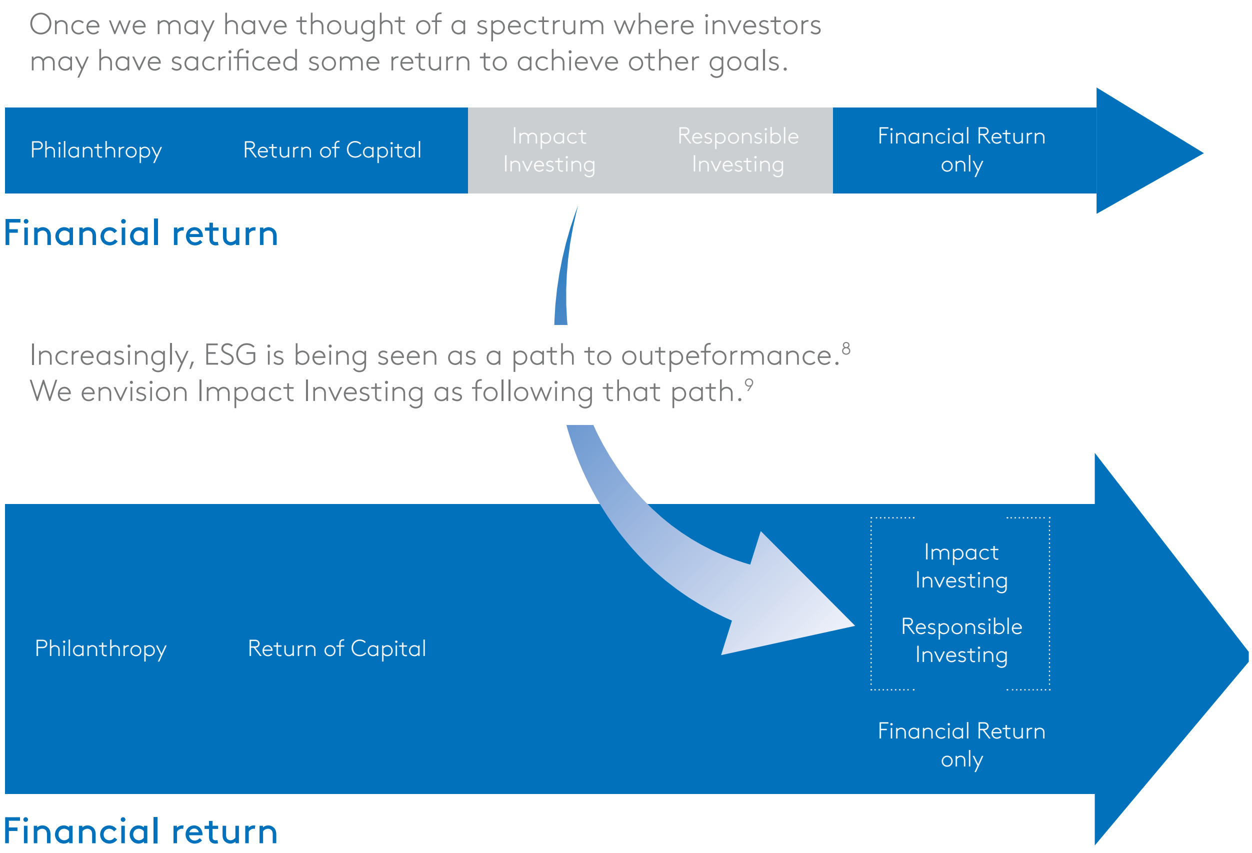
The United Nations SDGs, the seventeen Sustainable Development Goals formalized in 2015 to provide a "blueprint to achieve a better and more sustainable future for all" by 2030, is increasingly being used in finance as a common language and taxonomy. This includes Impact Investors, who are increasingly employing the SDGs to describe qualitative goals, enhancing comparability. At the end of 2019, it was reported that 73% of Impact Investors used the SDGs for at least one measurement purpose, up from 60% over just the previous twelve months.[7]

Figure 3: The United Nation Sustainable Development Goals

A spectrum of returns

'Impact Investing' was once thought of as sacrificing some financial return in exchange for a social or environmental goal. To some, 'Impact Investing' could denote anything from a return of capital – that is, a zero return — to a near-market return. (Perhaps some Bund buyers these days would actually consider a zero return to be above market?) After all, compared to donation, return of capital to recycle for additional projects is very attractive to philanthropists.

Figure 4: Investment goals spectrum



Impact with market returns – the holistic approach

The GIIN's broad and sophisticated 2020 survey shows that **67% of Impact Investors target market returns or better**[10]. The GIIN noted previously that, ***"Fully one third of our respondents are motivated to make Impact Investments because of – not in spite of – their financial return potential."***[11] We say... *Right on.* We do not accept a compromise in either Impact or financial returns.

The GIIN's carefully constructed survey included only current Impact Investors. Candriam conducted a simple survey in the May 2020 edition of our *Convictions* newsletter, with a single question: *What return do you expect from Impact Investments?* Of our 165 respondents, including a wide array of investor types, 38% expect Impact returns of market rates or better. A pretty good start for a broad audience! We hope that we, and the rest of the Impact Investing universe, will provide results which convince the 62% remaining investors.

Asset classes

Impact Investments are made across a wide range of asset classes (Figure 5). In a survey conducted by the GIIN[12], Impact Investors accounting for $404 billion of the estimated $715 billion market responded, showing that debt comprised more than half of their Impact Investments.

Fixed Income

Green bonds are typically tied to specific climate and environmental projects, so are backed by Impact assets. While private and public debt instruments are the largest category in Impact Investing at this time, green bonds are less than 1% of the overall bond market. With socially and environmentally-aware investing on the rise, and debt backed both by the project assets and often also by the credit of the parent company, investor demand for green bonds is outstripping supply. At one time, green bonds were viewed as offering higher risk-adjusted returns; the strong demand may have eroded that advantage by last year. The constraint on green bonds is the number of projects, and not the capital supply.

Private Equity, Start-ups, Real Assets

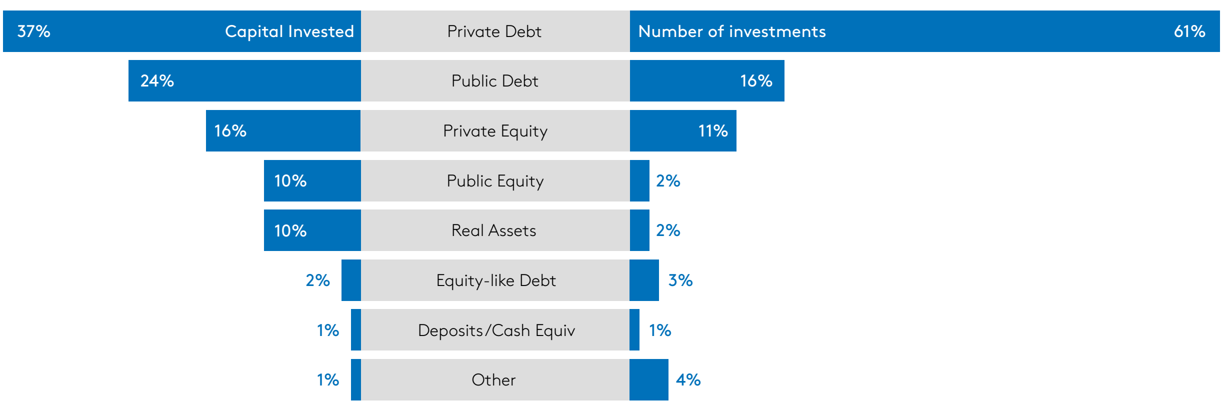
Roughly a fourth of the Impact category, these are currently our focus. At this stage in the development of Impact Investing, we feel that growing societal impact and financial returns together is most efficiently accomplished through participating in the equity of this new type of business model. We hope these companies grow big and strong and supply our colleagues with more green bonds. And eventually many large Impact public equities for our more traditional investment funds.

Public Equity?

The relative size of the self-reported public equity 'Impact' category demonstrates the data difficulty in analyzing Impact Investments. The survey communicates on self-reported data. Put less diplomatically — beware of 'greenwashing' in publicly-traded equity until the definition of 'Impact' becomes fully standardized.

Figure 5: "Impact" Investments by Asset Class

Self-defined, self-reported



Source: GIIN

Nuts and Bolts

Scalability

Our requirement that Impact and returns should interlink is not just an investment philosophy, it is a practical check to help evaluate the scalability and success of an Impact business model. As for any private equity investment and many other areas, scalability of the business model is critical to the return on the investment.

In today's market where green bonds focus on individual projects and much Impact equity is still in the venture capital and private equity stages, larger institutional investors may find the investments too small[13] to build a meaningful position, or the number of investments available too few to provide portfolio diversification. At the moment, this rapidly-growing area has the happy problem of more investor interest than supply of investments.

Scalability is constrained by the limit of skilled managerial, entrepreneurial, and investment professionals, particularly for social projects. Impact Investments may begin by addressing unmet needs in a local community. When these businesses expand, investors and on-the-ground teams may need to adapt training to local areas or local culture or regulatory environments, and adapt to individual situations, all while expanding the business. It may be necessary to tailor the concept – potentially rendering scale less profitable. The skills, time, and resources required could be a great barrier to entry.

Impact Investing does not have to be only about infant-sized companies destined to growth into huge publicly-traded companies. SMEs are an under-financed sector of the global economy, and in many nations, they are the companies creating the job growth. Impact Investing has a big role to play here; yet again, it is constrained by the availability of skilled and experienced professionals.

Measurement and Reporting

More than half of Impact Investors believe that reporting is improving, and share their best practices. Standardizing measurement will help develop the Impact ecosystem.

Five years ago, there were more than 150 methods to measure the impact of an investment[14]. Not to panic; most investors now focus on a narrower range of quantitative and qualitative systems. IRIS[15], the GIIN's investor-led system, is developing a measurement system with metrics and definitions, which gaining in usage. Reporting for Impact Investments will be most useful in expanding investment in the area when it becomes comparable, or at least parallel, to that which investors already know and use.

The most widely-used standard is the United Nations SDGs, a qualitative measure (Figure 3). At present, most investors use a combination of qualitative information, proprietary metrics, and the IRIS standards. Qualitative measures are easier to communicate, and can be less expensive to measure. If qualitative reporting is included, 98% of surveyed Impact Investors measure social and environmental performance in some form. Costs of measuring and reporting Impact are high; more so for Social Impact than for Environmental Impact. The clearer definitions for renewable energy, for example, reduce the cost of measuring their impact. This provides support for the expectation that improving measurement comparability can also reduce measurement costs.

Many current Impact Investors are finding that they are able to clearly define their impact strategy. However, industry participants are finding it more difficult to collect 'quality' data, and particularly challenging to compare impact results with a 'market performance' measure. Ten years ago, 85% of surveyed Impact Investment managers used proprietary measurement systems. This has reversed, and now 89% use external tools and systems[16]. A 'market' measure may not have been established yet, but progress is ongoing. For the moment, potential investors must pay particular attention to the goals laid out, to ensure that they will be satisfied with the ultimate measurement and reporting.

Risks to manage

Because it is a nascent category, Impact Investing shares many of the risks of any other alternative investments. For investors who prefer at this point, as we do, to grow their impact through private equity, most of the risks are similar, although some loom a bit larger. Scalability is critical, as for other early-stage investments. Impact reporting is expensive, and lacking in agreed standards. Comparable measurement and management data is not yet fully developed. Indeed, measurement is considered the second-greatest risk in Impact Investing, for the moment. Skill sets are in short supply both for Impact Investment management, and, in common with some venture capital areas, skills are also in short supply for operational management of impact business models.

In Impact Investing, skills of the on-the-ground team are both the biggest limitation to growth in supply of investments, and the greatest risk to success of investments. Across the first fifty of the one hundred studies and interviews conducted by Candriam[17], *all* "institutions place an enormous importance on the additional value from investors beyond the deployment of capital".

Moreover, "the dearth of knowledge means that Impact Investing is [currently] synonymous with 'higher risks' in investing… [however] The skills needed for Impact Investment will not be in short supply indefinitely as the market ages." Also consistent among all the case studies and interviews was that "institutions place an enormous importance on the additional value from investors beyond the deployment of capital. Impact Investors are required to support the governance and management structures of SMEs and offer their expertise in sectors where the demand is lacking infrastructure."

Exit Strategy: maintaining the impact

Every issue seems to lead back to how one defines Impact Investing. Public equities are typically liquid, the easiest exit. While some bonds may trade infrequently, at least they mature. Figure 5 implies that 60% of Impact Investments are illiquid – private debt, private equity, or real assets. Exit strategy is an investor consideration in all private equity. Fortunately, private equity and venture capital is an established asset class with an exit path, often trade sales or IPOs (or occasionally, write-offs). Obviously, the success of the exit strategy is inextricably bound with the accuracy in forecasting the business model scalability. It also underscores the importance of skills on the ground in Impact Investing.

And now for something completely different. To our view, **a successful exit from an Impact Investment demands that under the new owner, the business model continues to interlink societal impact and financial returns**. Phrased differently, there must be a responsible exit, and/or the buyer must be an impact investor.

At this early stage in the Impact business model, where so many of the pure Impact Investments are still private equity, asset managers with additional skill sets are required. Private equity managers must evaluate the business model and monitor operations with a constant eye on a profitable exit, presumably as the business passes from startup to growth. If Impact private equity managers define a successful exit as one which both pays out at the time of exit, and continues the societal impact beyond the exit, they must have the experience to anticipate the future business stages, such as growth, maturity, and renewal.

In the first set of fifty interviews of European institutional investors conducted jointly by Candriam in 2016 and 2017, 80% reported some difficulties in their exit strategy with at least one Impact Investment. In the 2020 GIIN survey, a significant 48% of respondents reported that suitable exit options were a concern, although a huge 76% reported that progress is being made in Impact Investment exit strategies[18].

A Framework for Impact Investing

Private Equity: Funds and direct co-investment

The Impact Investing paradigm is nascent and fragmented, and must be viewed through a niche lens[19]. Our own direct studies, along with industry data, lead us to conclude that most of the pure impact business models are still in the private equity stage.

Direct investment, and venture capital funds, require intensive due diligence and that analysis demanding very specific skills and resources.[20] We believe that for the next several years, the best structure for investor participation in Impact business models is through a fund of funds. To best address this early stage, we would propose a portfolio of Impact private equity funds, direct company co-investments, and Impact bonds.

We have developed a holistic philosophy to structure our internal analyses (Figure 6). To put this into practice, we have spent three years studying the market and building Impact skills into our long-standing multi-management team.

Figure 6: Candriam Impact philosophy

Step	Rationale
Impact Measurement	Intentionality: Impact purpose of the investment
Financial Return	Financial and extra-financial objectives interlinked
Alignment of Interests	Performance Fees mechanically linked to the social plan
Sustainable Development Goals	Alignment with UN SDGs

Source: Candriam

How would a Fund of Funds address the challenges?

This structure helps address some of the practical challenges such as the relative youth of the business model. These challenges include the need to identify *scalable impact*, our search for pure impact *business models*, the small size and typically non-public nature of the existing equities, the *skills* challenge of evaluating private companies, the evaluation of *entrepreneurial skills* on the ground, *diversification*, and *measurement and reporting*.

The *skills* challenge of Impact Investing includes entrepreneurial and financial skills, as well as business-specific operational skills. Venture capitalists involved in Impact business models therefore tend to include partners with these operational skills, to the benefit of the investments, and tend to invest in businesses in related areas according to their expertise. This specialization naturally leads to a lack of diversification within any single well-staffed Impact VC fund. This related *diversification* challenge of can also be addressed by a fund of funds approach.

Other *investment management skills* can also be brought to bear if the fund of funds is managed by a broadly-staffed investment firm. At the current stage of development, Impact Investors are a diverse range. They may be specialised departments within large insurance companies with, for example, full risk departments at their disposal. Frequently, Impact Investment managers are venture capitalists with terrific on-the-ground skills, but lacking in the sophisticated risk monitoring departments and other infrastructure of a larger financial firm. Indeed, roughly two-thirds of the Impact Investors responding to the GIIN's made only Impact Investments.[21] The need for skills such as legal and financial structure evaluation, operational checks, reporting, compliance verification, can all more reliably met in this early stage using a fund of funds structure.

At Candriam, we have colleagues managing traditional, sustainable, indexed, and absolute return investments and funds across the spectrum of liquid and less-liquid assets, including a full and independent risk management team. We can call on an in-house team of Environmental, Social, and Governance researchers with almost 25 years of experience. Supported by this investment infrastructure, Candriam's solution was to build a four-member Impact Investing team within our existing multi-management team. The Candriam Impact Investing Team has also brought on board the author of our collaborative Impact Investing research study.

FoF managers can help clients with monitoring and measurement, described as the second-greatest specific challenge in Impact Investing after the need for specific skills. The *data*, *performance measurement,* and *performance reporting* challenges – including *measurement costs* — also benefit from a fund-of-funds approach. The increasing standardization of reporting within the Impact community brings some comparability to qualitative impact measurement; 75% of surveyed Impact Investors incorporate one of two systems, the UN SDGs or the IRIS Catalog of Metrics.[22] Almost 90% of Impact Investors report increasing the rigor of their impact measurement and reporting standards.[23] With the goal of a market standard not yet fully realized, investors in a fund of funds can benefit from a manager who screens those underlying funds not only for impact performance, but for clarity and comparability in their impact reporting.

> *We can call on an in-house team of Environmental, Social, and Governance researchers with almost 25 years of experience.*

The structure can help investors overcome the lack of historical data. The measurement and reporting of impact is both difficult and expensive because of the complexity of social objectives. Not only is historical data lacking, but data is not yet easily comparable across funds. For this reason, choosing the manager for an Impact fund of funds may be even more critical than for most funds of funds. At Candriam, we spent three years prior to launch interviewing investors, and creating a 25-factor scoring system based on our practical and academic research. Our database is internally consistent, and continues to grow both as we conduct more research on existing private Impact companies and funds, and as we make more investments. In the near term, this helps improve information and follow-up questions and conversations to monitor investments using our own internal criteria.

Impact and financial results should be positively related. A fund of funds allows for *alignment of interests*. By our definition, the Impact performance and the financial return for an Impact Investment should be positively correlated. One way to enforce this in a fund of funds is to align the incentive or performance fees with both impact targets and financial return targets. That is, the manager does not receive performance fees unless both hurdles are exceeded. It is amazing how much a well-designed fee structure can both inform, and benefit, clients.

Conclusion: Investment equals Impact *PLUS* Return

At Candriam, it is our conviction that an Impact Investment should *interlink* the societal impact and the financial return of the investment. This is an important addition to the definition, and one which is very personal to us as responsible investors.

Investing Evolves

The United Nations PRI has over 2,000 signatories, representing invstments of $90 trillion. Investing responsibly, and identifying sustainable companies through analysis of Environmental, Social, and Governance factors, or ESG, is a very visible and growing method of investment selection. The next step for financial markets to improve the deployment of capital resources is Impact Investing. That is, investing in companies whose actual business models are dedicated to measurable societal impact, and whose social or environmental results generate their financial returns.

We believe that pursuing environmental and/or social returns simultaneously with financial returns yields a more efficient outcome than treating these goals separately.

Candriam's Conviction

As responsible investors, it is our mission to help financial markets meet societal challenges. Around the world, in developed and emerging markets alike, Covid has merely made our existing social and environmental issues more visible.

We pledge to bring our collective experience to Impact Investing. A fledgling investment category, we believe that for the moment, it is best incubated as private equity funds of funds. We have a long-established multi-management business, established risk systems, and a history of innovation in responsble investing. We launched our first ethical fund in 1996 and first sustainable fund in 1998, established in-house ESG research in 2005, and were a founding signatory of the UN PRI in 2006. We look forward to this new chapter.

Today and Tomorrow

For *today*, our goal at Candriam to make it easier for our clients to become involved in the nascent area of Impact Investing. As a responsible investor for almost 25 years we hope that actively sharing our best practices in Impact Investing will help make extend the adoption and success of this new business model.

For *tomorrow*, we hope to make Impact Investments accessible for all.

Impact. We can measure it. We can manage it.

Case Study: Investment

Social Impact Ventures NL, a Dutch impact venture capital manager

Intentionality/Impact Measurement

Market-based solutions in three key social and environmental impact challenges in the Netherlands – Circular Economy, Healthy Living, and People Power.

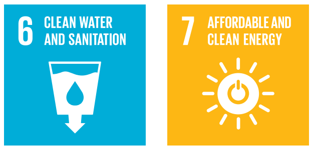
Return/Interlinkage

Target significant minority stakes with particular rights — such as board seats, strategy, management appointments — and budget approval, in scalable enterprises, sharing of experience and learning alongside team, investors, entrepreneur, other stakeholders. Target 100% impact goals and net financial returns of double digits.

Alignment

Investments typically between €1 million and €8 million, responsible exits in 5 to 7 years through trade/strategic sales to buyers aligned with the mission, or IPOs.

Circular Solutions



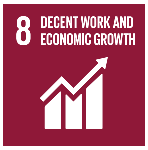
Healthy Living

People Power

Case Study: Investment

Samasource, an investment of Social Impact Ventures

Intentionality/Impact Measurement



Move people out of poverty in some of the poorest parts of the world by training low-income young people for jobs in artificial intelligence. *#aiforall*

Says one employee, "Real empowerment is not in books, it's in work". Quantifiable targets are set entirely in terms of number of jobs created.

Return/Interlinkage

Provider of training data to technology teams through a workforce 90% sourced from low-income backgrounds in countries such as Kenya and Uganda. Revenue, or turnover, growth is linked to number of persons moved out of poverty through developing their technology skills and ensuring their ongoing relevance in the digital economy.

Alignment

Substantial scale available through satisfaction of large international customers and high demand growth for product. Exit multiple tied to revenues and/or EBITDA, aligned as long as workforce continues to be majority from disadvantaged backgrounds.
Initial investment February, 2019 and targetting an exit to a responsible strategic buyer/investor in 5-7 years.

Case Study: Investment

Olio,
an investment of Social Impact Ventures

Intentionality/Impact Measurement

Reduce food waste and increasing social cohesion through a hyper-local mobile peer-to-peer consumer app primarily for food sharing, which prevents good food from being discarded. This business creates impact in all three of SIVs main themes – Circular Economy, Healthy Living, and People Power. Three-year quantifiable targets set based on CO_2 emissions avoided, liters of water saved, and with a lesser weighting, number of interactions confirmed through the app.

Return/Interlinkage

Local and personal interactions can be replicated across regions and countries by leveraging the app, interlinking growth of impact and revenues. Still in early stage; 2 million people have the app and have saved and redistributed 648 tonnes of food.

Alignment

Exit potential to large international multi-use (social) marketplaces/platforms such as Amazon or eBay; comparable young companies raising funds, providing a benchmark for revenue and suscriber muliples.
Initial investment December, 2019 and targetting an exit to a responsible strategic buyer/investor in 5-7 years.

Nuances in Nomenclature

Candriam's long history of sustainable investing, particularly of ESG analysis and managing ESG portfolios demonstrates that ***value and values can be aligned and grow together***.[24] Candriam believes strongly that companies which embrace sustainability-related opportunities *and* challenges in concert with their financial opportunities and challenges are the most likely to generate shareholder value; indeed, our ESG analysis of publicly-traded companies is based on this conviction.
The UN PRI, of which Candriam was a founding signatory, specifies that responsible investment "should be pursued even by the investor whose sole purpose is financial return." Perhaps there is an expectations bias, or perhaps managers and investors faced a learning curve. In the twentieth century, most investors expected that ESG strategies would necessarily sacrifice returns. Most contemporary studies show that companies which follow good ESG practices can reduce their cost of capital.

What Impact Investing is not: Impact *versus* ESG

Environmental, Social, and Governance factors can be integrated into the investment process to build portfolios of sustainable investments, usually listed equity securities or debt instruments. These issuers can be evaluated for their impact on climate change, societal well-being, or resource efficiency. ESG investments can be measured through impact indicators such as greenhouse gas emissions, water usage, or gender diversity. Investors may use voting rights and engage in dialogues to influence and accompany company managements to adopt more sustainable practices; in our view, sustainable practices are more shareholder-friendly practices in the long term.

Investors in publicly-traded shares do not exert direct control over management The majority of public companies were not originally founded with the intention to generate these positive impacts. The best-managed companies are incorporating these impacts into their business models as they evolve; or in some exceptional cases, even changing their business models to an Impact Intent.

Impact Investing at Candriam takes the next step beyond ESG analysis, by investing in private equities whose business models have clear and measurable societal targets, either environmental or social. This is a more direct result, in that the impact is the business model, and the impact is a prerequisite in our decision to make an Impact Investment in the firm.

Investing for impact — or Impact Investing?

One might easily say that when applying ESG criteria to publicly-traded equities, one is investing both for financial returns, and investing for impact. Because we believe that companies which meet social and environmental challenges are more likely to achieve financial objectives, at Candriam, investing for impact aligns with many of our corporate goals about responsible investing.

The argument that financial markets can allocate capital for the benefit of society is widely accepted. For example, several years ago the CFA Institute updated its mission statement by adding that the investment profession should work for 'the ultimate benefit of society'

Impact Investing, as the GIIN defines it, is a long way from a mutual fund category as designated by, say, Morningstar or Lipper. Impact Investing is not a methodology, like ESG investing; it is not a style, like income or growth; it is not an asset class like European equities, or emerging market bonds. Indeed, Impact Investing crosses asset classes, including bonds, private equity, and others.

Is this greenwashing, a limitation of the language, or just the sign of a young investment concept? Probably all. Although the GIIN defines an Impact Investment as one "made with the intention to generate positive, measurable social and environmental impact", — that is, intent — some of the GIIN's own self-reported survey data includes a 10%-plus tranche of publicly-traded equities.

While to us, the term Impact Investment describes only projects established with the intent to create an impact, original intent is not the only way to make an impact with our investments. Investors just need to remember to read the ingredients before deciding which investment box holds the product which best satisfies their goals. This definitional ambiguity is one of the reasons we define the Impact strategy by seeking a correlation between impact and financial return.

How investors can invest with impact

The options available for Impact Investments, or profit with a purpose, depend on the goals, size, and experience of the investor, as is the case for all investing.

The most obvious Impact Investment options, such as direct investment in seed stage or early growth companies founded with the intent to produce a specific impact, and direct investment in green bonds, are most suitable for institutional investors or high net worth individuals.

Funds of Impact companies, like most venture capital funds, usually have a minimum investment and a minimum multi-year holding period beyond the range of most individuals.

Green bonds can be a bit more accessible, although they are a tiny 1% of the debt market and lack a universal certification. Retail investors are likely to find the normal considerations as for any corporate bond – large face value of individual bonds, and low liquidity. The small but increasing number of green bond mutual funds may provide easier options for individuals.

All is not lost for retail equity investors. Individuals can still invest for impact, especially environmental impact. Even direct investment is a possibility – some countries offer tax incentives and maintenance services for individuals to invest in low-income housing. There is project finance; there are green bond funds, and traditional bond funds which hold green bonds. An increasing number of mutual funds invest broadly in climate change topics, including low-carbon or green energy funds, but also less obvious areas such as non-traditional agriculture. And while we wait for these new little Impact companies to grow up and become big public Impact companies, there are many sustainable investment options. Just like breakfast cereal, read the label first.

What's my goal?

Carbon footprint?	Social?	Environmental?
	5% **E** 80% **S** 15% **G**	80% **E** 5% **S** 15% **G**

A highly selective history of the purpose of the firm

OK Boomers, here come the Millennials !

It's not quite as black-and-white as Boomers versus Millennials, but there has been a transformation in academic thought, and perhaps popular thought, about the responsibilities of publicly-traded companies.

> *Boomers see doing good as separate from investing; whereas Millennials don't see how you could possibly separate the two.*[28]

Boomers: Shareholders only?

Milton Friedman, 1976 Nobel Laureate in Economics and father of monetary theory, might also be called the unintentional father of the shareholder society. The so-called 'Friedman Doctrine' holds that a firm's main, perhaps only, responsibility is to shareholders and to maximizing shareholder value. First published as an editorial in 1970, Friedman and generations of subsequent financial scholars declared that firms which spend money for social initiatives are stealing profits from the real owners, the shareholders. Those owners who want to see company profits used for society should take their dividends or capital gains and allocate these funds as they choose – reinvest, make a charitable contribution, or spend. Professor Friedman, it must be remembered, was an advisor to both US President Ronald Reagan and British Prime Minister Margaret Thatcher. One might conclude that Wall Street took this doctrine much further than Friedman intended, moving beyond the shareholder firm to the 'greed is good' shareholder society.

Millennials: the Stakeholder Society

A stakeholder approach expands the responsibilities of a corporation to more stakeholders, including investors and shareholders, employees, customers, suppliers, society, and the environment.

Financial market clout will be devolving to the Millennials. Within ten years, this generation will be the largest share of workers and leaders. Importantly for both the corporate world and the investment markets, this cohort is expected to inherit $30 trillion in assets from their parents by 2025[29].

To be fair to the Baby Boom[30] generation, many investors in this age cohort care deeply about whether the companies in which they invest are good corporate citizens. Roughly half of the Baby Boom generation lists ESG considerations as central to investment decisions[31]. A few of these Baby Boomers were the university-age protestors of the 1960s and 1970s, and are back out on the streets in June, 2020.

A highly selective history of Impact Investing

Impact Investing: Old or New?

We prefer to think of Impact as a nascent business model. For an historian, we would probably date the Impact strategy from 2007, when the Rockefeller Foundation's Lake Como Summit took mission-related investing a further step, to realize the financial and extra-financial objectives in parallel.

Growing

As an investible market, Impact Investing is growing rapidly off a 'small' base, with an estimated market size of \$500 bn at the end of 2018[32] and \$715 bn at the end of 2019. Well, according to the late US Senator Everett Dirksen "a billion here, a billion there; and pretty soon you're talking real money." For perspective, in a world where several public companies already boast individual equity market caps in excess of \$1 trillion each, the entire Impact investment market is likely to reach that level this year.

As private equity has become more popular, it has suffered from more demand for investments than good ideas from entrepreneurs. Impact has a surplus of business needs and addressable markets; the problem is businesses — scalable Impact business models, and managers to implement them. The UN Trade and Development conference estimated a \$2.5 trillion need[33] for initiatives to avert threats of food insecurity, pandemics, energy supply, climate change, etc. So the addressable Impact Investment market is large. The profitable addressable market is likely to grow as we correctly price emissions, water pollution, waste, and social consequences.

Figure 7: Genesis of Impact Investing

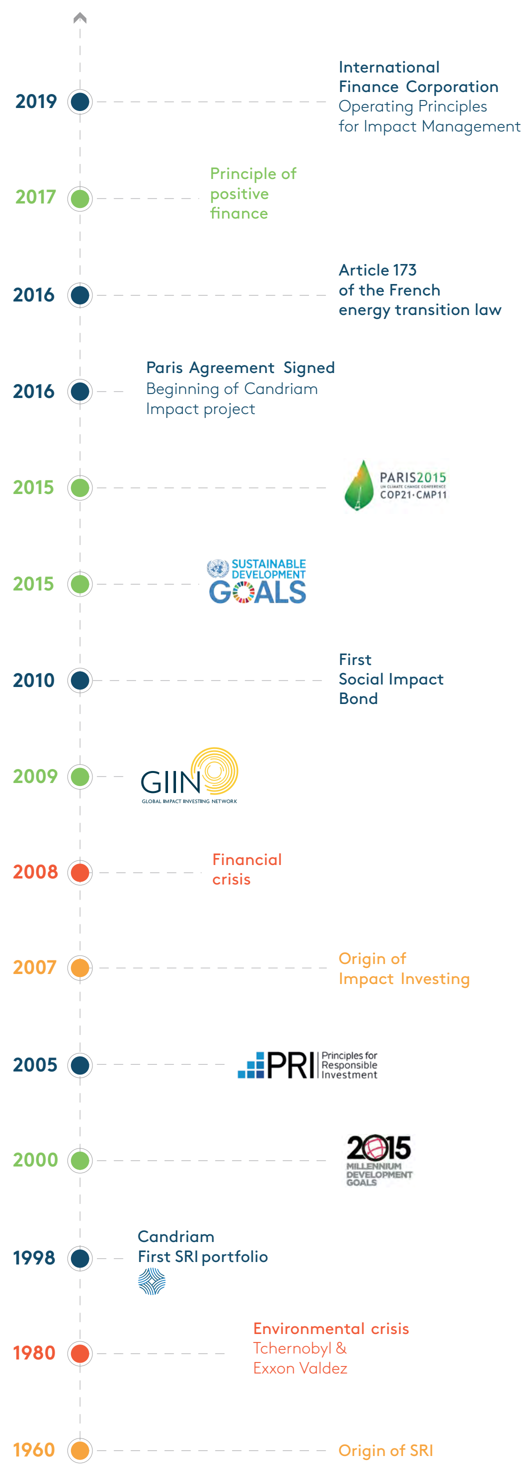
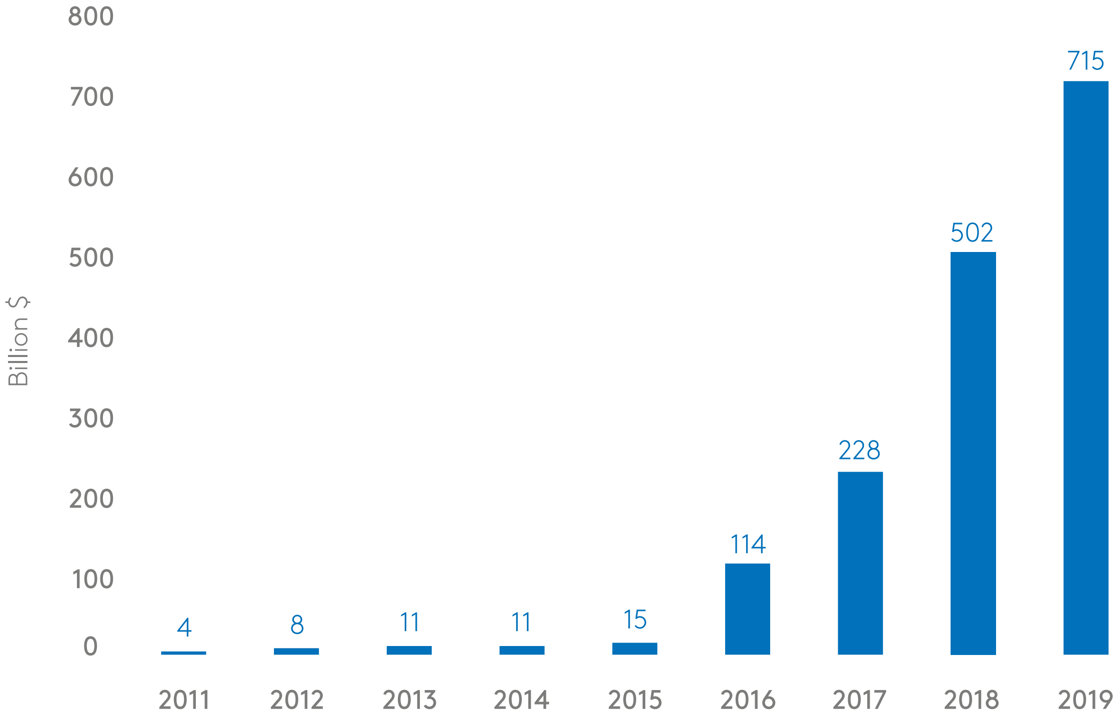


Figure 8: Growth of Impact Investing



Source: GIIN

Not quite ready for prime time

Demand for investing in Impact businesses is outstripping supply, in part because of the need for experienced and entrepreneurial business managers, as well as the need for experienced entrepreneurs and investment managers. Thanks to the growth in investor interest, the growth of the available investments, and the efforts of Impact Investors as an industry, the definition of Impact Investing is beginning to coalesce around the GIIN's definition – an investment "*made with the intention to generate a positive, measurable social and environmental impact alongside a financial return.*"

Amazing progress has been made in turning the concept into a recognized strategy in just the most recent three years.[34] Academic interest in studying the concept is blossoming. Once thought of as emerging markets and frontier markets (perhaps because of the fame of microlending), more than a third of Impact assets under management are in developed markets as of the end of 2018.[35]

Statistics remain both minimal, and lacking in comparability. As a young corporate structure, Impact *companies* remain predominantly structured as private equity. Of course Impact *projects* within non-Impact companies may be financed with 'green bonds' or other instruments. This small size of Impact companies leads to some of the same issues as any other alternative investment. Results are self-reported, and lacking in widely-adopted reporting standards such as GIPS[36]. The survivorship bias, valuation time lags and valuations incorporating estimates rather than public market prices make Impact equity similar to other private equity. However 'flawed' an alternative index might be, it offers a starting point; as a newcomer to alternatives, Impact Investing does not yet benefit from an index or benchmark.

Returning to the opportunities, Impact private equity presumably offers *diversification* benefits when combined with other asset classes, as other private equity investments do. It should not be too long before we have reasonable data to analyse. At the moment, the rapidly-growing Impact market has the happy problem of more investor interest than supply of investments.

The early life of an asset class

So, how do you study it? If Impact is not an asset class, not a category, perhaps not really an investment strategy, then what is it? Perhaps, a new business model or profit paradigm? And if it is none of these, and has few statistics how does one study it?

The Impact paradigm has been around long enough to develop a group of keenly interested investors. some quite large. Candriam's Multi-Management Team has studied the the investment potential for three years, interviewing more than one hundred institutional investors in Impact Investing, fifty of them in collaboration with an academic study.

We hope you have enjoyed Candriam's qualitative review of the industry helpful. For more information, do not hesitate to contact your Candriam sales representative. Suggested industry data sources include GIIN and the IFC.

Notes

[1] The GIIN, Global Impact Investing Network. https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing, accessed 27 November, 2019

[2] United Nations Conference on Trade and Development, 24 June 2014, https://unctad.org/en/pages/PressRelease.aspx?OriginalVersionID=194, accessed 9 June, 2020.

[3] Global Sustainable Investment Alliance, GSIA. "Global Sustainable Investment Review 2018". http://www.gsi-alliance.org/#, accessed 9 July, 2020.

[4] Abdullahi, Mohadeseh. "Is there a case for institutional investors to pursue Impact Investing in Europe?" London: Imperial College Faculty of Arts and Sciences, 17 September, 2017.

[5] *Mouhammad Yunus, pioneer of the concepts of microcredit and microfinance, was awarded The Nobel Peace Prize in 2006 jointly with the Grameen Bank, which he founded, "for their efforts through microcredit to create economic and social development from below".*

[6] The GIIN, "Annual Impact Investor Survey 2020", tenth edition. New York: 11 June, 2020. https://thegiin.org/research/publication/impinv-survey-2020 page 33; and The GIIN, "Annual Impact Investor Survey 2020", ninth edition. New York: 19 June, 2019. https://thegiin.org/research/publication/impinv-survey-2019

[7] GIIN 2020, page 45; and GIIN 2019, page 30 (40% + 20%).

[8] University of Oxford and Arabesque Partners. "From the Stockholder to the Stakeholder." March 2015.

[9] For a more complete taxonomy, see also Seitz, Tasha. The Spectrum of Impact Investing. "The Spectrum of Impact Investing." Impact Engine, 9 January, 2018. https://medium.com/impact-engine/the-spectrum-of-impact-investing-e34b0e4dc164

[10] GIIN 2020, page 4.

[11] GIIN 2020, page III.

[12] GIIN 2020, page 10.

[13] van Vugt, Bertil and Mirko Zuerker. "The Next Challenge for Impact Investing: Scaling up Support to Early Stage Social Enterprises." August 2015. https://www.inclusivebusiness.net/ib-voices/next-challenge-impact-investing-scaling-support-early-stage-social-enterprises

[14] Lim, as referenced in Abdullahi, page 34 section 4.2.

[15] Global Impact Investing Network. "ABOUT IRIS+". https://s3.amazonaws.com/giin-web-assets/iris/assets/files/IRIS_2-Pager.pdf, accessed 15 June, 2020.

[16] GIIN 2020, page XVII.

[17] Abdullahi, page 31.

[18] GIIN 2020, page 8.

[19] Abdullahi, page 75.

[20] Abdullahi, page 30.

[21] GIIN 2020, page 3 (61%) and GIIN 2020, page 3 (66%).

[22] GIIN 2020, page 46.

[23] GIIN 2020, page 47.

[24] Candriam. "The Impact of ESG Investing in Emerging Market Equities." November 2019. https://www.candriam.com/en/professional/market-insights/topics/sri/the-impact-of-esg-investing-in-emerging-market-equities/

[25] UN PRI. "PRI Brochure." https://www.unpri.org/download?ac=6303, accessed 8 June 2020.

[26] University of Oxford and Arabesque Partners. "From the Stockholder to the Stakeholder." March 2015. *In a review of more than 200 academic studies, more than 90% of the academic work showed that sound sustainability standards lower the cost of capital, while 88% of the research showed that solid ESG practices resulted in better operational performance.*

[27] CFA Institute Mission Statement: "To lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society." https://www.cfainstitute.org/en/about/vision, accessed 5 June, 2020.

[28] Julia Balandina Jaquier, family advisor and impact investor. Quoted in *The Economist*, 25 November 2017.

[29] JPMorgan Private Bank. Quoted in "How green are your investments?", *Financial Times*, 23 May 2019.

[30] *One popular definition of Boomers are those born between 1946 and 1964 – or, those beginning their working years between the late 1960s and the late 1980s.*

[31] Allianz. Quoted in Business Wire, 12 August 2019. https://www.businesswire.com/news/home/20190812005374/en/Socially-Responsible-Investing-ESG-It%E2%80%99s-Millennial-Tren, accessed 25 June, 2020.

[32] The GIIN, Global Impact Investing Network. "Sizing the Impact Investing Market" New York: 1 April 2019. https://thegiin.org/research/publication/impinv-market-size. Also, The GIIN, "Annual Impact Investor Survey 2020", [below], page 40.

[33] United Nations Conference on Trade and Development, 24 June, 2014, https://unctad.org/en/pages/PressRelease.aspx?OriginalVersionID=194 , accessed 9 June, 2020.

[34] GIIN, 2020. "The vast majority also noted at least some progress in the sophistication of the impact measurement and practice (89%) and the availability of professional with relevant skill sets (87%)."

[35] GIIN 2019, pages XII and 16. Survey shows 38% of survey respondents' AUM invested in US, Canada, and western, northern, and southern Europe.

[36] GIPS = *Global Investment Performance Standards.*

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