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The Verified Value of Impact Investing

AlphaMundi Group (AMG) presents its perspective on the merits of comparing the performance of impact investments to more traditional market returns, based on historical data aggregated by the GIIN and TAMEO for impact investments, and MSCI and Cambridge Associates for market returns. This article is a follow up to the Africa Impact Summit convened in July 2024 in Nairobi, Kenya. At that conference, a plenary panel sought to address whether impact investing can achieve risk-adjusted market rates of return.

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The prospect of achieving the United Nations' sustainable development goals or SDGs by 2030 looks increasingly bleak. The good news is that mobilizing traditional assets for SDG targets and converting environmental, social and governance allocations to impact strategies can help avert critical thresholds of suffering for humanity and our biosphere. The shift can also unlock hidden financial value that's not currently monetized in many impact portfolios.

At the mid-way mark since launch of the SDGs in 2015, only 17% of the 169 targets are on track or have been met. Another 18% are stagnating while 17% have regressed below their 2015 baseline levels. These statistics may seem abstract, so here are some illustrations of their implications:

- **Poverty:** by 2030, 590 million people representing 6.9% of the world population will remain in extreme poverty.
- **Hunger:** by 2030, 20% of children under the age of 5 will be affected by stunting due to malnutrition, while more than 5% of children will be overweight.
- **Climate**: by 2030, governments have announced plans to produce 110% more fossil fuels than what the world can afford if we aim to keep the average temperature increase to +1.5°C.
- **Gender Equality**: at current rates, women worldwide will need to wait another 176 years to achieve economic parity and receive fair value for their work.

Developing countries alone face an SDG funding shortfall of USD 4 trillion, a financing gap that's 60% higher than in 2019.

Just 1% of the USD 98 trillion held by the global asset management industry in 2022 were invested with a measurable and positive impact. Another 31% were invested with an ESG lens, mostly through negative screening and engagement - approaches often criticized as greenwashing.

If the impact investing industry can demonstrate to asset owners that it can match or exceed their expectation of market returns, we may be able to marshal traditional assets for the SDGs or shift ESG allocations to impact strategies.

Market Returns

Most asset owners, including institutional investors, would likely agree that a good set of benchmarks for market returns include equity and bond performance, at a global level as well as for emerging markets, given that the allocation of impact investing assets is broadly split between the two.

The bulk of impact assets are invested through alternative investment strategies, mostly via private equity and private debt vehicles. It therefore also makes sense to look at the performance of traditional private equity for a comprehensive comparison of market and impact returns.

- **Global equity focus:** From 2013 to 2023, global equity delivered an average annual return of 7.8% in USD terms, while emerging markets equity returned an annual average of 2.4% in USD. In both cases, those returns came assorted with significant volatility, as MSCI indices show.

- **Global debt focus:** From 2013 to 2023, global corporate bond markets delivered an average annual return of 2.6% in USD, according to MSCI indices. Sovereign bonds in emerging markets returned 3.3%.

- **Private equity focus**: Based on Cambridge Associate's review of the quarterly and audited statements of 797 private equity funds investing in emerging markets, PE vehicles delivered an average annual USD return of 9.8% over the last decade.

Impact investing performance

In its 2023 survey, the Global Impact Investing Network (GIIN) found that 74% of impact investors pursue market returns. It noted that 79% expected their investments to match or outperform their financial targets and 88% expected to achieve or outperform their impact targets.

In terms of actual performance, from 2020 to 2022, the GIIN determined that private equity impact investments delivered gross realized financial returns of 25% - 4% above target. Private debt impact investments returned 7%.

TAMEO reports that from 2019 to 2022, impact private equity funds focused on emerging markets posted a net annual average gain of 9.1% in USD. Private debt funds in emerging markets delivered an annual average of 2.7% in USD and showed relatively low volatility when compared to the returns of emerging market bonds and equity.

Changing the notion of equity value

Most equity or corporate bond prices don't factor in the true value of negative externalities, or costs imposed on third parties due to harmful activities that companies are responsible for.

For example, if Nestlé paid to offset its own carbon dioxide emissions for 2023 alone, at the offset cost of EUR 85 per ton in Europe, the EUR 7.9 billion (USD 8.5 billion) price tag for 93.3 million tons would wipe out 66% of the company's net profits of CHF 11.2 billion (nearly USD 13 billion) for 2023.

How much would it cost a multinational to clean up the plastic contamination it's been responsible for over decades? What about the deforestation driven by the production of commodities? Or the obesity caused by the distribution of unhealthy food products? By going on websites like www.impaakt.com, you will find legions of documented examples to that effect.

The International Foundation for Valuing Impacts, or IFVI, was launched in July 2022 to help implement the 2021 recommendation of the G7 Impact Taskforce, which stated: "Investment decisions are being taken today with incomplete information. We should be working towards a world in which such decisions are thoroughly informed by risk, return, and impact."

Foundation Chair Sir Ronald Cohen explained the nonprofit's purpose: "IFVI will drive the global establishment of standardized monetary valuation of impacts created by businesses and investors. We are ushering in the era of impact and profit, where both drive resource allocation and the valuation of companies."

In other words, the G7 aims to change the notion of equity value and make it a global accounting standard to integrate the true negative or positive value of externalities in share prices.

Monetizing impact

By the same token, most impact portfolios have not yet monetized the financial value of the positive impact their investments are fostering.

The tradeoffs between market returns and impact investing should therefore be redefined, ideally with the support of regulators.

The EU is already taking steps in that direction with the Corporate Sustainability Reporting Directive (CSRD), which will require all companies with more than 500 employees to disclose their impacts and conduct double-materiality (financial and impact) assessments. The CSRD entered into force in January 2023 and encompasses non-EU companies earning more than EUR 150 million (USD 162 million) in the EU market.

Growth Prospects of Impact Investing

Judging by the European Union's Sustainable Finance Disclosure Regulation (SFDR) data and GIIN, TAMEO and Phenix Capital reports, impact investing has been growing steadily at every level for years.

The number of impact debt funds has grown annually by 13% from 2014 to 2023, while the industry's assets under management have increased annually by 18% from 2017 to 2022. The product range has also been expanding across asset classes, like public debt and real assets, and into sectors like energy and healthcare.

Pension funds and family offices now represent the main source of impact capital, ahead of development finance institutions, which reveals the progressive mainstreaming of impact investing.

While northern countries can certainly use more impact capital and financial innovation as they pursue a transition to environmentally sustainable and socially inclusive economies, the global south needs impact capital even more.

Emerging Markets are the growth story of our generation, and their percentage of global GDP, population and market capitalization is growing rapidly. Institutional portfolios cannot afford to miss the opportunities they present, but asset owners are justifiably leery of the risks these markets are associated with.

Historical data shows that the best risk-adjusted return exposure to Emerging Markets is offered by traditional private equity as well as impact private equity and private debt. By 2023, TAMEO determined there were more than 750 impact funds investing in Emerging Markets, with USD 95 billion in aggregate assets held by 385 managers.

Impact investing in Emerging Markets has been tried and tested, and it seems to offer one of the best paths to SDG funding for developing countries and asset owners alike.

De-risking assets

Besides risk-adjusted returns, what are the other critical factors that will help mainstream impact investing from an asset owner perspective?

Blended finance was hailed as a catalyst, but it's fallen short of expectations. From 2018 to 2023, while the impact investing industry grew, blended finance assets shrank by 1.2% and amounted to USD 9.8 billion at last count, according to Convergence.

The declassification of numerous ESG-labelled funds and the rapid growth of Article 8 and 9 funds under the SFDR regime might serve as an early demonstration that sharper regulations may help the financial industry reduce its green washing practices and increase its commitment to impact strategies.

Promoting the true narrative of impact investing performance and market return tradeoffs will help asset owners change mindsets; regulatory support will help them change policies; product labels will help them change portfolio allocations, even if they don't have impact experts in-house.

Providing tax incentives to invest in impact products could unlock new commitments at scale, and help governments and society save money and lives by mitigating future damages resulting from negative impacts. De-risking impact products through guarantees, concessionary

tranches or liquidity facilities and democratizing retail investor access to them would be a major step forward.

Matching fossil fuel subsidies with impact investing subsidies could be a good start as well, to help impact asset managers or impact ventures grow more easily, as most of them are still sub-scale, challenging their viability and excluding them from mainstream institutional investor consideration.

In any market, these measures will be most effective when used simultaneously, and the world's financial hubs should lead the charge in creating a new paradigm for the asset management industry.

The Greek philosopher Archimedes once said: "give me a firm place to stand and a lever and I can move the Earth." Finance is the greatest lever of change of our age, and there is no firmer place to stand on than the measured and verified value of impact investing.

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