Fundamentals and Trends in Impact Investing

Impact Investing as a growing Asset Class

The Global Impact Investing Network estimated the impact investing market to be USD 1.16 trillion in assets under management (GIIN, 2021). Southeast Asia may only account for 3% of the capital allocated globally, but it is one of the fastest growing regions for impact investing, at a rate of 23% per year between 2015 and 2020 (IFC, 2021). This growth is expected to continue in the next five years, driven by growing interest from pension funds, high net-worth investors, and corporate impact investing and development finance institutions (DFIs).

> Southeast Asia is seeing a stark rise in impact investing: capital allocation grew 23% per year between 2015 and 2020

The ability of fund managers to effectively manage impact must grow in tandem with available capital for this new asset class. Impact washing remains a key concern to many impact investors (GIIN, 2022). This has contributed to increasingly stringent expectations from LPs on how their GPs should integrate impact measurement and management practices throughout their investment cycle.

Though ESG and impact are often used interchangeably, this is not quite the case. Any investor can integrate ESG risk management into their processes to mitigate the negative effects of their portfolio. Impact investors, however, are expected to invest with an eye towards maximising the positive effects of their investments, while managing risks. In simple terms, ESG investing is a risk management exercise, while impact investing is an investment strategy. Impact investors are led by an explicit mandate to generate positive and measurable social and environmental impact alongside a financial return.

Though the impact investing space evolves rapidly, three evergreen principles fundamentally guide an impact fund's approach:

1. **Intentionality:** Impact investors purposefully choose the impact they want to make. They start with defining the issues that should be addressed through investments and then identify which company to best invest in to address those issues.

2. **Measurability:** Impact investors define metrics that measure what they consider a success of their intervention. In the case that outcomes do not meet the ambition of their goals, strategies are further adjusted.

3. **Additionality:** Impact investors contribute to achieving a specific social or environmental outcome beyond what would have been achieved by other investors or market forces alone.

Figure 1 offers an overview of how LPs can integrate the three evergreen principles of impact investing across their investment cycle.

Figure 1: How LPs can integrate the impact principles requirements throughout the investment cycle

DFIs' high expectation for IMM practices

Impact investors possess a unique ability to prioritise positive social and environmental impacts on the back of financial returns. This has put them under the spotlight of Development Financial Institutions (DFIs). DFIs provide long-term financing and technical assistance to support private sector investment in developing economies. Impact funds offer them a platform to do so. To uphold the integrity of their investments, DFIs have established minimum requirements in terms of impact measurement and management (IMM) practices for impact funds to align themselves with. GPs are expected to embed these practices in core decision making.

Integrating IMM practices across different DFIs may prove challenging as different investors might prioritise different impact themes. The Development Finance Institute of Canada (FinDev Canada), for example, focuses on gender equality and climate impact, while British International Investment (BII) focuses on driving innovation and market development. These varied agendas will translate to differing expectations from DFIs on their GPs' impact strategies, frameworks, data collection and reporting.

There exists no single gold standard for how to integrate IMM into core decision making. Instead, impact investors may refer to a range of existing forums and platforms on how to integrate these practices throughout their investment cycle. Some examples include the *Impact Management Project*, a methodology to assess the impact of investments; *IRIS+*, a catalogue of metrics to harmonise definitions of impact indicators; the *Sustainable Development Goals (SDGs)*, which is a universal set of goals to end poverty, protect the planet; and the *Operating Principles for Impact Management (OPIM)*, which is a practical guide to impact measurement and management. While these frameworks are relevant, they offer different perspectives on the meaning and implementation of impact management, potentially leading to more confusion than clarity for GPs that want to navigate the impact investing space.

Given this lack of cohesion, GPs are best advised to go about IMM by building a tailormade impact strategy, narrative, results measurement framework, and review mechanism. Bringing existing resources together, contextualised to geography and impact focus will be key to a robust and feasible IMM framework.

Building tailored impact frameworks

To implement these lessons in practice, GPs should first look inwards. Instead of targeting to meet LP requirements as a starting point, GPs should first evaluate the purpose of their capital, what they consider their potential impact, and how they want to define the success of their investments. Only once these objectives and parameters have been established, GPs should take inspiration, and bring together elements from the various impact frameworks to align their unique approach to their LPs expectations. When done well, an IMM framework provides fund managers with clear guidance to take informed decisions and drive maximum impact.

> The best standards are timeless and universal, focusing on *how* to measure and manage instead of *what* to measure and manage.

The framework will be critical to four phases of a fund's lifetime:

1. **Fund raising:** How can GPs build a strong impact narrative which supports the investment strategy and contributes to the mandate's focus?
2. **Investment decision making:** How can GPs build an impact framework that helps collect the data required to take informed investment decisions?
3. **Portfolio monitoring:** How can GPs keep track of the portfolio impact progress over time in a meaningful and comparable way?
4. **Evaluation:** How can GPs learn from historic results and improve performance in the future?

On the next page, we dive into four case studies of how we have supported different funds in their impact journey across these four steps.

1 Fund raising: Defining an impact strategy and narrative

Fund managers require a clear impact strategy supported by a compelling impact narrative to effectively meet their goals.

Steward Redqueen enabled this by supporting an impact fund in formalising their impact strategy. Although this fund manager had already developed individual impact strategies and frameworks for its funds under management, it lacked an overarching, firm-wide strategy. As a result, each fund followed its own impact strategies, diluting the overarching impact narrative.

Steward Redqueen developed a firm-level Theory of Change (ToC) for the firm to build its overarching impact strategy. The ToC explains the pathways through which a fund's investments contribute to achieving its impact vision, substantiated by impact metrics. To develop a strong strategy, we needed to manage the conflicting perspectives of the fund's internal stakeholders. The CEO held an ambitious vision that would drive fundraising, the impact manager prioritised establishing measurable targets, while the investment officer emphasized a requirement for non-restrictive market opportunities.

To solve this trilemma, we facilitated open discussions with senior leadership, aligning on broader strategic questions such as: *What do we aim to achieve as a fund? What do we bring as a partner that is unique? How do we achieve impact?* This discussion allowed us to acknowledge conflicts of interest and realise internal synergies.

This led to increased understanding and cohesion within the fund and paved the way to an overarching and clear impact strategy and narrative.

2 Investment decision making: Measuring impact performance

A natural second step is to develop an impact measurement framework to measure and track the impact of the fund's investments.

We were approached by an impact investor with a mandate focused on equality to integrate a measurement framework to support their gender lens investment strategy.

We designed questionnaires that assessed clients' eligibility for the 2X criteria, a global standard for the measurement of gender impact of investments. This assessment gave clarity over their contribution to career development opportunities and products and services for women.

It might be tempting to set up a long list of indicators to measure contribution, but it is important to focus the data collection efforts of investee companies and avoid unnecessary data collection. We prioritised indicators by assessing and screening each indicator on its ability to reflect results and feasibility of data collection. To understand framework feasibility, we interviewed different internal teams during development, and conducted a pilot with a sample of clients.

Staff and client engagement offered feedback that the data was feasible to obtain, and that the framework was client centric. This meant that it provided minimal burdens in reporting and maximum insights. The final measurement framework was embedded into operations, as part of a 5-year implementation roadmap developed by Steward Redqueen.

3 Portfolio monitoring: Aligning objectives with global standards

Monitoring performance and aligning impact reporting with global sustainability standards will allow a fund manager to communicate impact results to a global audience in a recognisable manner.

The SDGs provide an important framework for sustainable development, but it is difficult for GPs to report on their intentional and measurable contribution. It may be more practical for GPs to focus on specific SDG indicators and targets.

A sustainable agriculture fund manager sought to improve their monitoring efforts and define its actual contribution to the SDGs. Steward Redqueen facilitated this by breaking down the fund's core-impacts into strategic impact (such as SDG indicator 6.4.1: Change in water-use efficiency over time; or 15.3.1: Proportion of land that is degraded over total land area), from its co-benefits or operational impact that is achieved unintentionally (such as SDG indicator 8.3.1: Proportion of informal employment in total employment, by sector and sex). This analysis provided structure and supported the fund manager in identifying underlying metrics of the SDGs that it intentionally contributes to.

4 Evaluation: Improving future achievements through learnings

GPs will be able to improve their performance continually and consistently, through a structured review and evaluation of their fund's impact achievements.

These evaluations help narrow in on challenges, identify points for improvement, and learn which strategies have worked best to drive positive impact. One way to do this is by assessing a fund's alignment with the OPIM. For example, we supported a tech-focused GP with an independent review of its IMM practices.

This started with thorough research into the fund's portfolio and existing IMM approach. We then systematically assessed all aspects these practices by scoring them against each of the nine OPIM principles. The evaluation highlighted how the fund benefits from ex-ante impact estimation and revealed practical points for improvement.

Based on our analysis we recommended a clarification of impact objectives, by adopting a logic framework or ToC. This could be built upon by a more targeted and practical impact measurement framework. This gave the fund a clear assessment on the progress of its impact management practices and ideas for next steps.

About Steward Redqueen

Steward Redqueen is a boutique consultancy that works across the globe helping its clients address today's sustainability challenges. As specialists since 2000, Steward Redqueen focuses on integrating sustainability, quantifying impact, and facilitating change. We work for leading commercial banks, private equity funds and impact investors, development finance institutions, industry associations, multinationals, and government donors in developed and emerging markets.

We understand the sustainability ambitions of the international investor community, just as the operational reality of the funds and companies they invest in. We create value by bridging that gap. Clients appreciate us for our pragmatic approach to impact management strategies that work in practice. In Singapore, we support our clients to develop these into efficient and effective frameworks. Further, we offer workshops on ESG and impact measurement and management, to drive capacity building and adoption of frameworks into operational processes. Clients appreciate our rigorous analysis, flexibility, and ability to implement.