

# IMPACT INVESTMENTS: PERSPECTIVES FOR AUSTRALIAN SUPERANNUATION FUNDS

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### IMPACT INVESTMENT GAINING INCREASING RECOGNITION AND MOMENTUM

Australia, like many jurisdictions around the world, has witnessed increasing interest and activity in impact investment over recent years as businesses, governments and communities seek new solutions to enable an inclusive and sustainable society in the face of social and environmental challenges.

On the global stage, impact investment took a major step forward when the Social Impact Investment Forum was convened by the G8 in June 2013. UK Prime Minister David Cameron heralded impact investment as a “great force for social change”. A Social Impact Investment Taskforce has since been established by G8 governments to foster the impact investment market and will include an observer from Australia.

Philanthropists, foundations and charities as well as institutional investors have implemented impact investment strategies. These strategies aim to yield financial returns, as well as positive and measurable social and environmental impacts. Commercial financial returns are pursued by some, others consciously elect to accept reduced financial returns in the interest of impact.

### MARKET POTENTIAL REQUIRES INVESTOR ENGAGEMENT BEYOND EARLY ADOPTERS

In Australia the market potential for impact investment is estimated to be \$32 billion over the next decade. Global commentators estimate a market potential in the range of US\$400 billion to US\$1 trillion. However, the number of active investors and level of capital committed so far is small relative to the pool from which engagement is necessary if such market potential is to be realised. In particular, active take-up by institutional investors will be crucial to the success of a long-term impact investment market.

Institutional investors, while indicating a willingness to consider impact investment, are hesitant to move forward. Many are challenged by the misperception that investing for impact necessitates a financial trade-off. They also grapple with how to assess and position impact investment within mainstream investment portfolios. Reliable track records that indicate sound financial returns over extended periods, together with measurable social and environmental impacts, are yet to be produced. Investment product is scarce and typically illiquid, while the limited scale of much of the currently available investment product makes it difficult for investors to identify and commit the necessary resources to research or explore new opportunities. At a more fundamental level, institutional investors seek comfort that impact investment, with its ‘soft’ and ‘non-financial’ benefits will not compromise the investment duties with which they must comply under statute and general law.

### SUPERANNUATION TRUSTEES CAN LEGITIMATELY EXTEND THEIR INVESTMENT UNIVERSE TO INCLUDE IMPACT INVESTMENT

The initial reaction of many trustees of Australian superannuation funds to impact investment is one of pessimism. A pessimism triggered by the morass of investment obligations enshrined in statute – *Superannuation Industry (Supervision) Act 1993 (Cth)* – and general law with which they must comply. A limited understanding of impact investment also drives trustees to err on the side of caution. A review of these obligations indicates that trustees can consider impact investments within their investment strategies.

Anecdotal evidence would indicate that a well-executed impact investment strategy provides trustees the opportunity to build investment portfolios aligned to member’s values and with unique exposure and uncorrelated diversification to a wide range of geographies and sectors. All factors that support impact investment having a legitimate role within superannuation fund portfolios.



*Investors have made impact investments across a range of sectors*

### **EARLY ADOPTERS HAVE SUCCESSFULLY EMBRACED IMPACT INVESTMENT**

First-mover institutional investors have successfully established and implemented impact investment strategies. Assessing impact investments on the basis of financial merits using the same professional processes and techniques as for traditional investments has been and will continue to be essential to the engagement of institutional investors. Once an investment case showing an expected rate of return commensurate with risk can be established, investors can consider social impact.

On this basis, investors have made impact investments across a range of sectors including: agriculture, microfinance, renewable energy, small and medium enterprises, healthcare, affordable housing and community development. Impact investments have also been made across a range of asset classes including: private equity, venture capital, private debt, real estate and international listed equity. Allocations across each sector and asset class have been a relatively small proportion of the total portfolio of institutional investors, thereby having only a marginal effect on overall returns but providing the opportunity to usefully diversify the portfolio.

### **FOCUSED EFFORT REQUIRED TO REALISE OPPORTUNITY**

Realising the opportunities of impact investment will take focused effort and commitment of significant resources from superannuation funds and market makers. As the market currently stands, investable products in the impact investment space are unlikely to flow across the desks of managers at any significant pace or volume. It is necessary for superannuation funds to collaborate with all stakeholders – other investors, intermediaries, government and impact enterprises – to build a pipeline of opportunities that can be translated into investable product. Product that meets the needs of superannuation funds and simultaneously delivers improved wellbeing for communities and the environment. Institutional investors willing to actively engage in conversations with market makers and take action to catalyse and shape the market will develop expertise and long-term competitive advantage.



# WHAT ARE IMPACT INVESTMENTS?

The Global Impact investing Network (GIIN) defines impact investments as:

*...investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.*

This definition can be broken into three underlying components: intentionality, measurable social and environmental impact, and financial return. These three components serve to distinguish impact investments from mainstream financial investments, responsible or ethical investments, corporate social responsibility initiatives and philanthropic grants. Varying levels of financial return - market-rate, below-market or market-beating – can be found across the spectrum of impact investment, reflecting that the required level of financial return differs between investors, depending on each investor's motives for entering the market.

“Our definition is that our [impact investments] have to meet regular financial criteria, but at the same time they have to have the intent of societal impact...that is measurable so we can account for the impact to the pension funds whose money we manage and their beneficiaries...Our process is that we don't label afterwards, if it is [impact investment] it needs to be taken into account in the due diligence, because it means we want to measure the societal impact of that investment.

TIM VAN DER WEIDE PGGM

The GIIN definition is increasingly finding acceptance amongst peak industry and professional member groups, especially those championing the inclusion of environmental, social and governance (ESG) factors into investment decisions, such as Global Sustainable Investment Alliance, Principles for Responsible Investing and Responsible Investment Association Australasia. Impact investments that deliver risk commensurate market rates of return are considered an additional option for institutional investors committed to ESG strategies.

Impact investments have been made in a wide variety of sectors including: agriculture, microfinance, renewable energy, small and medium enterprises, healthcare, affordable housing and community development. Recurring asset classes include private equity, venture capital, private debt, and real estate. The impacts commonly sought are:<sup>1</sup>

SOCIAL IMPACTS		ENVIRONMENTAL IMPACTS
Access to clean water	Conflict resolution	Biodiversity and conservation
Access to energy	Disease-specific prevention and mitigation	Energy and fuel efficiency
Access to financial services	Employment generation	Natural resources conservation
Access to education	Equality and empowerment	Pollution prevention and waste management
Access to information	Food security	Sustainable energy
Affordable housing	Health improvement	Sustainable land use
Agricultural productivity	Human rights protection	Water resources management
Community development	Income/productivity growth	

## GLOBAL

Impact investment is an international phenomenon. New investors, focused intermediaries and policy developments have emerged in all corners of the globe over the last decade. The market has moved from a stage of 'uncoordinated innovation' to 'market building' as various centres of activity and early stage infrastructure have emerged to catalyse increased activity and reduce transaction costs<sup>2</sup>.

Global networks are emerging with a focus on market building, such as the Global Impact Investing Network (GIIN) and the Impact Investing Policy Collaborative (IIPC). Initiatives to establish common standards for impact measurement and benchmarking are developing through the work of the Impact Reporting and Investment Standards (IRIS)<sup>3</sup> and the Global Impact Investing Rating System (GIIRS)<sup>4</sup>. The task of unravelling the landscape of impact investment funds and products is being eased by databases such as ImpactBase<sup>5</sup> and ImpactAssets 50<sup>6</sup>.

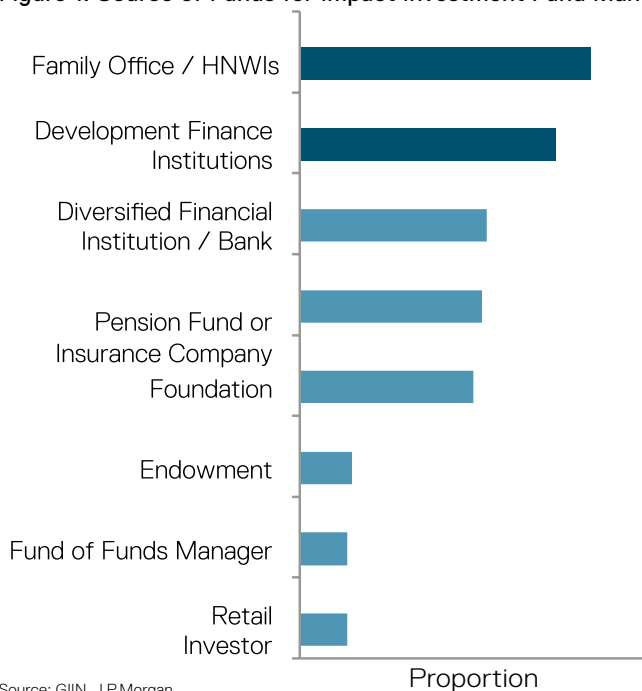
Influential powers are also looking to contribute to development of the market. A Social Impact Investment Taskforce has been formed by G8 governments to report on three fronts:

- the policy framework to take impact investing to its tipping point;
- a common approach for measuring outcomes; and
- ways to introduce a market standard allocation towards impact investments by foundations, institutions and private investors.

The World Economic Forum has also launched the Mainstreaming Impact Investing initiative aimed at moving impact investment from the margin and into the mainstream<sup>7</sup>.

The majority of capital for impact investment originates in the United States and Canada, the United Kingdom and Europe, and Oceania<sup>8</sup>. Private individuals, charitable foundations and family offices together with international development banks have predominantly championed impact investment. Interest from institutional investors is gradually emerging as a track record of successful impact investments becomes available, and investment product to place and manage capital at scale is developed. Figure 1 below illustrates the main source of funds for impact investment

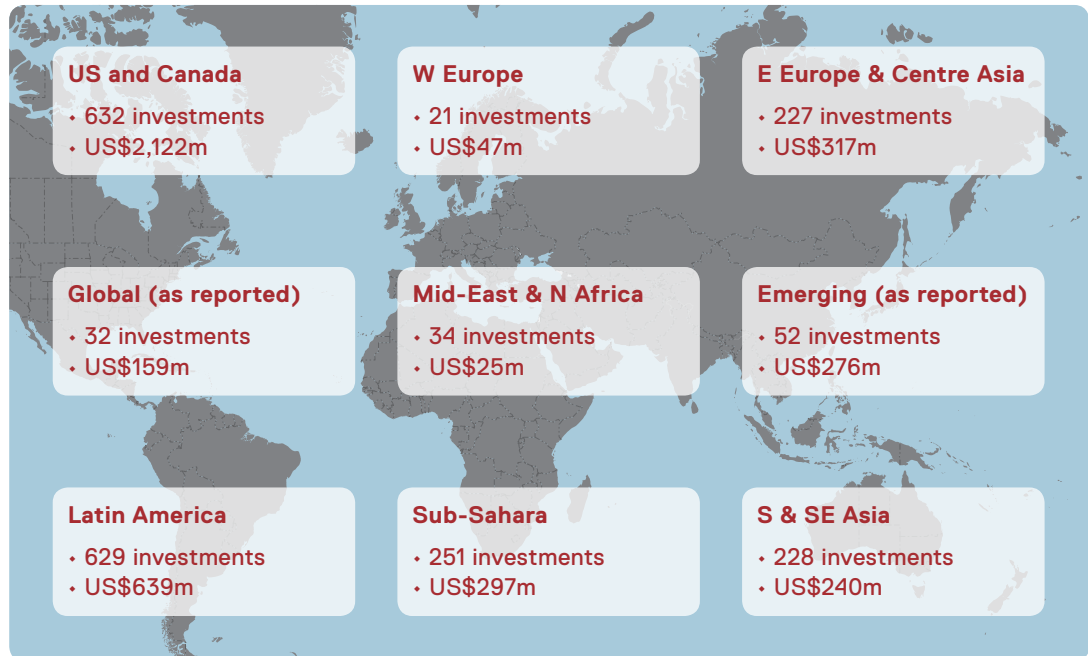
**Figure 1: Source of Funds for Impact Investment Fund Managers, 2012**



Source: GIIN, J.P.Morgan

The demand for impact investment spans both developed and developing countries; with investments being made into for-profit, not-for-profit and hybrid entities with a diverse range of social and environmental impacts<sup>9</sup>.

Figure 2: Impact investing funds invested by destination during 2011



Source: R. Addis, J. McLeod and A. Raine, *IMPACT - Australia: Investment for social and economic benefit*, 2013

### MARKET SIZE AND POTENTIAL

Gaining an accurate indication of the size of the global market for impact investment is challenging, as there is little publicly available information on transactions, and there are various views as to what is or is not impact investment<sup>10</sup>. Estimates of the current market size vary significantly between commentators:

- Global Sustainable Investment Review 2012 reports US\$89 billion in impact investment representing 0.14 per cent of total managed assets of professionally managed funds actively applying ESG strategies<sup>11</sup>.
- J.P. Morgan's third annual survey on the impact investment market reports that the 99 organisations that participated in the survey committed US\$8 billion to impact investment in 2012 by, and plan to commit US\$9 billion in 2013. Survey respondents reported cumulative allocations of US\$36 billion since inception to impact investment<sup>12</sup>.
- The Impact Investor, which maps 380 different impact investment funds, reports that that total volume of capital managed by these funds in 2012 exceeds US\$40 billion<sup>13</sup>.

Similarly, a range of views in regard to the market potential can be found:

- A J.P. Morgan survey of 52 investors highlighted that impact investments have the potential to constitute 5-10 per cent of high net worth individuals (HNWI) and institutional investor total portfolios by 2020<sup>14</sup>. In another survey, J.P. Morgan presented the opportunity for invested capital into businesses within five sectors – housing, rural water delivery, maternal health, primary education and financial services – serving the global population earning less than US\$3,000 per year as ranging from US\$400 billion to US\$1 trillion<sup>15</sup>.
- The Monitor institute suggested in 2009 that impact investment could grow to US\$500 billion – US\$1 trillion in the next 5-10 years<sup>16</sup>.
- The Calvert Foundation estimates the market could reach a potential of US\$650 billion<sup>17</sup>.

Opportunities for impact investment are enormous if one considers projected demand side needs - \$1.3 trillion to halve greenhouse emissions from the energy sector by 2050, \$41 trillion to modernize global infrastructure and \$5 trillion to reach 4 billion people in the global consumer market<sup>18</sup>.



## RETURN EXPECTATIONS

Investors' expectations regarding risk, return and impact vary according to their intentions. This has given rise to the classifications of 'financial-first' or 'impact-first' investments. 'Financial-first' investors include banks, pension funds, sovereign wealth funds and development finance institutions that seek to maximise financial return with a floor for minimum expected social and environmental impact. In contrast, some foundations and family offices are positioning themselves as 'impact-first' investors; seeking to maximise social or environmental returns while having a floor for financial return<sup>19</sup>. It is for the investor to determine how much return to pursue, and there are opportunities available across a full spectrum of returns from market-rate, below-market to market-beating.

Independent realized return data for impact investment is not readily available. Commentary on returns is currently based largely on self-reported expected or target financial returns. What data is available indicates that the expected financial returns across impact investments range from 0-25%<sup>20</sup>. The variation in return expectations reflects the differing prioritisation of financial return between 'financial-first' and 'impact-first' investors, as noted above. The variation in reported financial returns also reflects the range of instruments used for impact investment and is complicated by diversity in currency, region and sector. Impact investment funds do however predominantly target market rate returns<sup>21</sup>.

J.P. Morgan reports that the majority of respondents (65%) to its 2012 annual impact investing survey principally sought 'market rate financial returns' with the balance targeting financial returns that are 'below market rate'. Regardless of financial return expectation, 68% reported financial performance in-line with what they had expected, with 21% outperforming and 11% underperforming expectations. Many pursuing impact investment through equity (64%) report they have had at least one, if not many investments significantly outperform their expectations in financial terms, while delivering the predicted impact. Benchmarks used to assess performance against the market include Cambridge Associates venture capital vintage year benchmarks, Cambridge Private Equity Index, LIBOR, MCSI Emerging Markets Indices, Consumer Price Index and Barclays U.S. Aggregate Bond Index.

2010 and 2011 surveys by J.P. Morgan also explored the question of return expectations with survey respondents. While the sample sizes were small, respondents reported that return expectations for impact investment in the emerging markets - debt or equity – largely compete with traditional benchmarks. Average return expectations in developed markets would, on the other hand, appear in many instances to be concessionary to market benchmarks, a phenomenon perhaps part explained by regulation and, in some instances, tax incentives<sup>22</sup>.

Microfinance is the one sector within impact investment where indices tracking actual return data have emerged reflecting the increasing scale and accessibility of investment opportunities. There is also good data available on financial returns from funds having, in some instances, experience of over 10 years. For example, the Swiss based responsAbility Investments AG reported an average return in US dollars of 3.9% for its debt investments in microfinance in 2012 consistent with its long-term target corridor of 3 to 5% despite very low interest rates worldwide.<sup>23</sup> Triodos Microfinance Fund managed by Triodos Investment Management, a subsidiary of Netherlands based Triodos Bank, reported annual returns in Euro of 7.8 to 8.7% in 2012 with returns since inception in 2009 of 4.9 – 5.4%<sup>24</sup>. Similarly, the BlueOrchard Microfinance Fund targets an annual return of 6M LIBOR +100 to 200 basis points and SNS Impact Investing targets net returns in Euro of 6 to 11% on its two microfinance funds and targets net returns in Euro of 6 to 9%<sup>25</sup>.

Historical returns for investors with ESG strategies provide another insight into the potential of impact investment. Portfolios with high ESG ratings have been shown to outperform benchmarks in a majority of industries and these portfolios exhibit significantly less downside risk<sup>26</sup>.

While realized return data is currently limited, it is clear from what data is available that the opportunity exists to pursue impact investment without compromising market competitive financial returns. This information debunks a commonly held misperception that impact investment necessarily means accepting a concessionary financial return.

Moreover return streams from impact investments are in many instances uncorrelated to mainstream investments. This has led to a growing recognition that they may provide the benefit of diversification in a traditional investment portfolio. Sir Ronald Cohen and William A. Sahlman believe impact investments can deliver a financial return of 7 per cent return, uncorrelated with equity markets without compromising a consistently high social return<sup>27</sup>.

## AUSTRALIA

The recently released *IMPACT Australia: Investment for social and economic benefit* provides a detailed analysis of the current state of impact investment in Australia; its growth potential and possible challenges.<sup>28</sup> The following touches only briefly on the rich data contained in that report. Readers wishing to build a more in-depth understanding of the Australian market are encouraged to refer directly to *IMPACT Australia*.

In Australia, impact investment is increasingly finding its way into conversation. Social economy organisations<sup>29</sup> are seeking to maximise social and environmental benefits. Such organisations are, looking for a greater choice of capital and a broader range of funding products in the impact space to provide opportunities for secure, sustainable, predictable and appropriate funding. Landmark transactions such as Goodstart Early Learning, Hepburn Community Wind Farm, Chris O'Brien's Lifehouse at RPA and StrEAT have provided investors opportunities across varying asset classes, – fixed income, property and private equity - while generating impact in the areas of education, health, renewable energy and employment generation. Impact investments are also funding innovative businesses like TOM Organic and Barefoot Power and commercial and residential properties that all intentionally generate diverse social and environmental impacts.

Consistent with global trends, Australian federal and state governments have begun to explore and enable impact investments as they seek to balance constrained fiscal environments and leverage government spending with private sector investment to achieve improved social outcomes.

Through the Social Enterprise Development and Investment Fund (SEDIF) the Australian government has provided one-off grants totalling \$20 million which together with matching private sector investment have seeded the establishment of three impact investment funds – Foresters Community Finance (Foresters), Social Enterprise Finance Australia (SEFA) and Social Ventures Australia Impact Fund – to finance the start-up and expansion of social enterprises in Australia. The private sector investment into these funds was provided by a combination of diverse investors including Christian Super, Triodos Bank, Community Sector Bank, Macquarie Group, NSW Aboriginal Land Council and private investors.

Other major initiatives by the Australian government include the National Rental Affordability Scheme (NRAS), providing \$1 billion in incentives for investment into affordable rental housing, and the Southern Cross Renewable Energy Fund, that will provide \$200 million in venture capital for Australian renewable energy companies<sup>30</sup>.

The NSW government is pursuing three social benefit bond<sup>31</sup> pilots in the areas of out-of-home care and recidivism. The Newpin Social Benefit Bond launched in March 2013 successfully raised \$7 million one month before its scheduled close to support UnitingCare Burnsides Newpin program, an intensive support program that works with families to improve parenting so children can live safely with their families. The Newpin Social Benefit Bond is aiming for a financial return of 10 to 12% per annum over seven years, based on the program's success of restoring children to their families.<sup>32</sup> The second social benefit bond launched in June 2013 successfully raised \$10 million to support The Benevolent Society's Intensive Family Support Service to help at-risk families deal with issues and keep children out of the child protection system and families safely together. The bond has two tranches – a \$7.5 million principal protected component with returns of up to 10% and a \$2.5 million capital performance based component with returns of up to 30%. In both instances, interest paid to investors is dependent on the program's success in keeping families together.<sup>33</sup> The final of the three pilot social benefit bonds is anticipated to be launched by Mission Australia before the end of 2013.

The Victorian, South Australian, West Australian and Tasmanian state governments are all at various stages in actively considering how impact investment may be mobilised or are already rolling out initiatives to stimulate market development.

This government activity follows on the heels of the Productivity Commission report released in early 2010 on Contribution of the Not-for-Profit Sector and the November 2011 report Investing for good: the development of a capital market for the not-for-profit sector in Australia of the Senate Economics References Committee. Both reports recommended the development of a market to increase access to capital for the not-for-profit sector in Australia. Development of such a market, in the context of impact investment requires a general acknowledgement that social and environmental impact is not the sole purvey of the not-for-profit sector. Business guru Michael Porter pointed out, “Separating business and competition from social progress and social issues was a big mistake. Some of the biggest opportunities for business are in tackling social issues and social challenges.”<sup>34</sup>

### MARKET SIZE AND POTENTIAL

Analysis in the *IMPACT Australia* publication details annual impact investments of A\$300 million and total capital managed of A\$2 billion in 2012, projecting growth to around A\$32 billion over 10 years.<sup>35</sup> These numbers assume market development in Australia will mirror the progress of similar investments in the United Kingdom and United States, and that we will enjoy the same growth rates as have been forecast for those markets.

### RETURN EXPECTATIONS

Impact investments in Australia span instrument types, sectors and funding recipients: from equity to debt, employment generation to education, for-profit companies to non-profits. As such, it is not surprising to find a range of return expectations reflecting not only different underlying investment characteristics but also varying philosophical approaches to impact investment from both investees and investors.

Table 1 details the return expectations for a number of recent impact investments across the Australian landscape. Drawing conclusions from this data is not possible given the limited sample size together with the lack of historical financial data across various asset classes. The table does however highlight that opportunities, albeit currently limited in number and scale, exist for investors to pursue competitive financial returns through impact investment.

**Table 1: Actual or expected returns for Australian impact investments**

	GOODSTART SOCIAL CAPITAL NOTES	SEDIF	NEWPIN SOCIAL BENEFIT BOND	BENEVOLENT SOCIETY SOCIAL BENEFIT BOND		BAREFOOT POWER		STREAT
Year	2009	2012- 2013	2013	2013		2008-2011	2012	2012
<b>Total Investment Amount</b>	\$22.5 million	\$20.6 million <sup>36</sup>	\$7 million	\$7.5 million principal protected tranche	\$2.5 million performance base tranche	\$3 million	\$5.8 million	\$0.3 million
<b>Asset Class</b>	Fixed Income	Fixed Income and Equity	Fixed Income	Fixed Income	Equity	Fixed Income	Equity	Equity
<b>Actual or Expected Annual Financial Return</b>	12.0%	6.0%-13.0%	10.0-12.0%	Up to 10.0%	Up to 30%	3.0-15.0%	Up to 15.0%	7.0-12.0%

## DISPELLING COMMON MYTHS AND ADDRESSING PERCEIVED CHALLENGES

Impact investment is attractive to Australian superannuation funds from a number of perspectives. Superannuation funds face an investment environment in which differentiated or uncorrelated return streams are hard to find. They also face an industry environment in which they are regarded as being out of touch with the communities in which their members live. Many such communities face entrenched disadvantage and disenfranchisement. Impact investment, properly and carefully managed, has a contribution to make in respect of each of these dimensions.

Several issues appear to discourage superannuation funds from pursuing impact investments. These issues – perceived or real – fall into four categories:

- concern by superannuation fund trustees as to whether impact investment is permissible under applicable regulatory regime;
- absence of a commonly accepted framework for inclusion of impact investment within modern investment portfolios;
- limited availability of appropriately designed investment opportunities; and
- relative immaturity of supporting infrastructure typically used by investors for the origination, analysis and portfolio management of investments.<sup>37</sup>

### NAVIGATING INVESTMENT DUTIES OF SUPERANNUATION FUND TRUSTEES<sup>38</sup>

The initial reaction of superannuation fund trustees to a suggestion that they could make impact investments is typically one of pessimism. Many cite the sole purpose test and investment covenants of the *Superannuation Industry (Supervision) Act 1993 (Cth)* ('SIS Act') and the proper purpose doctrine enshrined in general law to justify such pessimism. While caution is appropriate, with care, the requirements imposed on trustees can be navigated in a way that permits the trustees of superannuation funds to provide capital to enterprises and funds pursuing a social impact agenda in certain circumstances.

Superannuation funds exist solely to assist individuals to accumulate monies on which those individuals can draw in retirement. While government has resisted the impulse to tell trustees what to invest in, they must invest the funds entrusted to them carefully and with an eye to the circumstances of the fund. Specifically, they must comply with covenants to make and give effect to an investment strategy that has regard to such things as risk, return, cashflow, diversification, liquidity, valuation data, tax, costs and the liabilities of the fund. They also have to exercise due care and act in the best interests of the members as a whole. In addition the trustees of funds offering MySuper products have a specific duty to promote the financial interests of MySuper members. Further details of these statutory duties are provided in Appendix 1.

Taken together, then, these statutory duties are specifically designed to ensure that trustees turn their minds to how best to employ the assets under their stewardship in pursuit of the objective of accumulating sufficient funds to enable members to secure a dignified retirement.

In addition to these formal duties, the statutory duties of trustees extend also to the communication that trustees have with members and with prospective members. Trustees are required to make a variety of disclosures to prospective and current members. For instance the financial product disclosure regime specifically requires trustees of superannuation funds to disclose:

*the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment*<sup>39</sup>.

More generally, that regime also requires the periodic disclosure (usually in an Annual Report) of:

*all information that the trustee reasonably believes the member would reasonably need to understand the management and financial condition of the fund and of the relevant sub plan (if any)*<sup>40</sup>.

A swathe of revised reporting obligations have also recently been announced<sup>41</sup>.

Understandably superannuation fund trustees having so many hoops to jump through in respect of their investment activities may be tempted to place impact investments in the 'too hard' basket. There is however a way through the morass.

Impact investment opportunities are increasingly being packaged in forms that are familiar or appealing to superannuation funds. They are being designed to offer market rates of return and, in some circumstances, their financial position is 'de-risked' by government commitments, enabling would-be investors to apply traditional modes of credit analysis. They have governance and reporting practices similar to those an investor would expect to see in respect of more traditional targets for investment.

So, what does a superannuation fund trustee need to consider when investigating impact investments? As a starting point, a trustee must ensure that:

1. any investment has an expected rate of return commensurate with the risk that it carries. The investment must also have diversification and liquidity characteristics that fit with its role in the overall portfolio of investments. There can be no 'trade-off' between these criteria and other, ancillary purposes. This is particularly the case where the ancillary benefits are enjoyed by parties other than the members;
2. the entity into which the investment is being made has information disclosure and valuation protocols sufficient to enable the trustee to discharge its duty of care both at the time of the investment and thereafter and to comply with its disclosure requirements. Timeliness, detail and independence are important in this regard; and
3. the trustee has the resources and processes in place to give effect to its investment strategy. Investment propositions that require intensive, bespoke analysis on a case-by-case basis by the trustee necessarily compete for attention with the myriad of other issues requiring trustee attention. This suggests that intermediated solutions, or carefully framed delegations, may be required to ensure that potential investments are given the attention required in order for the trustee to be in a position to demonstrate that they have acted prudently in the exercise of their investment power.

Not all impact investments may turn out to be winning investments. But that is true of all investments made by a trustee. Impact investing is no different. With a little care and due attention the trustees of superannuation funds can extend their investment universe to include impact investments, incorporating them where appropriate in the investment strategies they craft in satisfaction of their statutory and general law duties.

“You can classify impact investments in a number of ways from infrastructure to equity to debt to property... you should be able to find a place for it in your current asset allocation strategy.

BRIAN BAILEY INVESTING4GROWTH

”

### RECOGNISING IMPACT INVESTMENT AS AN ESG STRATEGY ACROSS MAINSTREAM ASSET CLASSES

Commentators on impact investment fall generally into two schools of thinking. Some argue that impact investment is an emerging asset class. They consider investors require a unique combination of complementary financial, social and environmental skill sets, together with ability to navigate a diverse range of complex capital structures. Investors should also understand social and political dynamics that might influence investment outcomes, and be well versed in distinct organisational structures or stand-alone specialist initiatives to be able to properly engage with the impact investment space<sup>42</sup>.

The alternate and increasingly popular view recognises impact investment as an investment approach that can be undertaken across the suite of established asset classes.<sup>43</sup> This recognises that impact investment spans all asset classes, impact areas and geographies. For example, an investor may hold cash in a community bank, bonds enabling vaccination programs in developing countries, public equities of a listed microfinance institution, or units in an environmentally sustainable property fund. This enables relative ease of adaptation of established investment decision making frameworks, due diligence processes and portfolio construction models.

Under such an integrated approach, investors may choose to apply an impact investing strategy to some proportion of their investment portfolio across all or selected asset classes or exclusively to 100 % of their investment portfolio. In this way, impact investment becomes an alternate or complementary ESG strategy alongside longer established strategies such as negative screening, best-in-class screening, or corporate engagement and shareholder action. The decision as to how much of the investment portfolio to which to apply an impact investment strategy will be influenced by the expected impact on the risk and reward characteristics of the overall portfolio.

Figure 3: Impact investment - an investment approach across asset classes



Source: Adapted from World Economic Forum

Figure 4: An emerging capital continuum



Source: Adapted from *Bridges Fellowship Report*, June 2012

**ADAPTING MAINSTREAM INVESTMENT DECISION FRAMEWORKS**

Adaptations of mainstream investment decision frameworks are emerging to provide guidance to investors seeking to incorporate impact investment into diversified investment portfolios. These frameworks recognise assessment of financial risk and reward is paramount to an investment decision, yet acknowledge that social risk and reward – impact – is also an essential part of the decision process for impact investments. The frameworks also adopt mainstream portfolio construction best practices, such as diversification and liquidity.

For Australian superannuation funds, these emerging frameworks provide a basis for developing and implementing a strategy to incorporate impact investment into an overall investment portfolio in a manner that gives regard to trustee duties under the SIS Act and at general law. As detailed in Appendix 2, these frameworks guide investors to: define investment strategy and asset allocation targets; determine an impact thesis; assess investment opportunities for risk, return and impact; and manage financial and impact risk<sup>44</sup>.

The frameworks provide complete flexibility to investors to elect the proportion of assets to be allocated to impact investment within a portfolio. Investors may elect a strategy where a minimal proportion of assets are allocation to impact investment through to 100 per cent of assets being placed into impact investment.

Investors interviewed for this report have all made small allocations to impact investment. This approach is consistent with the approach of superannuation fund managers to hold well diversified portfolios that would usually incorporate a minimum of four or five asset classes. With portfolios such as these, small allocations to impact investment will have only marginal effect on overall returns and may usefully diversify the portfolio. The extent to which it diversifies the portfolio will be governed by the correlation of returns. To date, anecdotal evidence suggests that the underlying economic drivers thus return correlations for impact investments are different to those for mainstream investments.



## ACCELERATING DESIGN OF SUITABLE INVESTMENT OPPORTUNITIES

While Australia has seen a growth in impact investment over the past five years, that growth has been driven predominantly by bespoke individual investment opportunities that present limited scale, liquidity and diversification. Investment vehicles that have emerged domestically are few in number, limited in scale and yet to prove their value over a period of time. Superannuation funds and other institutional investors remain wary.

The Social Enterprise and Development Investment Funds (SEDIF) and the NSW Social Benefit Bonds have demonstrated that careful design and early collaboration with potential investors can significantly drive investment commitments. They also highlight that vehicles and structures providing 'de-risked' tiers are most attractive to superannuation funds and other institutional investors in the early stage of market development. For example, it was critical for Foresters Community Finance to use the grant capital provided by the Commonwealth Government under SEDIF as first loss capital to attract investment by Christian Super. Similarly, the capital guaranteed tranche of the Benevolent Society Social Benefit Bond was fundamental to attracting Australian Ethical Investments and NRMA Motoring & Services.

Early engagement and input by superannuation funds and other institutional investors on the terms and conditions for proposed investment opportunities will accelerate the development of suitable investment opportunities and ease commitment by anchor investors. Terms and conditions will need to be sufficiently comprehensive to ensure superannuation fund trustees are able to discharge their stringent legal duties, as discussed above.

Collective action and commitments by superannuation funds and other institutional investors may also accelerate the design of suitable investment opportunities. Five local government pension funds in the UK have invited asset managers to put forward investment opportunities under the Investing4Growth initiative. Ideally such opportunities will display market correlative risk and return characteristics together with a targeted positive economic impact on UK communities. To encourage asset managers the five pension funds have collectively committed £250 million, subject to suitable investment opportunities<sup>45</sup>.

“Many investors are ring-fencing a relatively small portion of capital to go towards impact investment thereby limiting financial exposure.

AMY BELL J.P.MORGAN

”

## DEVELOPING SUPPORT INFRASTRUCTURE

The support infrastructure used by asset owners and fund managers to originate, analyse and manage mainstream investments is largely unavailable for impact investments.

Intermediaries to facilitate impact investments in Australia are only beginning to emerge. For these intermediaries to have broad appeal to superannuation funds, they will need to scale and build a track record of sound and consistent returns over time. Mainstream intermediaries are yet to build a credible depth of knowledge and expertise in impact investment.

Standards for pricing risk and reward or measuring social impact are beginning to emerge, however more time must pass before such standards garner widespread acceptance and adoption. The Impact Reporting and Investment Standards (IRIS) provide a set of standardised metrics to describe an organisation's social, environmental and financial performance. The Global Impact Investing Rating System (GIIRS) provides a rating to funds and companies to allow investors to benchmark and compare social and environmental performance. The issue of finding a common approach for the measurement of outcomes is a focus area of the Social Impact Investment Taskforce of the G8.

Databases aggregating information about impact investment opportunities are in the early stages of roll out. ImpactBase is a searchable online database of more than 250 impact investment funds. ImpactAssets 50 is an annual showcase of experienced private debt and equity impact investment fund managers.

The task of developing support infrastructure, while not insurmountable, will take time. In the meantime, its absence necessitates that superannuation funds adapt familiar investment decision processes to impact investment or adopt carefully selected intermediated solutions.

## SOME PRACTICAL INSIGHTS

We conducted interviews with a select handful of institutional investors – Christian Super, J.P. Morgan, PGGM and TIAA-CREF – that have navigated the challenges and successfully undertaken impact investment as principals or on behalf of their beneficiaries or members. These interviews provided practical insights into the why and how to establish and implement an impact investment strategy.

Why do institutional investors engage with impact investment? Impact investment offers a competitive edge to satisfy client demand for value-aligned investment and enhance business value. When it is implemented across asset classes, impact investment also offers an opportunity to broaden portfolio diversification.

Institutional investors pursue impact investment that are unequivocally ‘financial-first’ investments and assessed using the same due diligence processes as for any other investment. No concession is made in regard to risk-reward, an essential characteristic for any impact investment under consideration of a trustee of an Australian superannuation fund. Given the early stage of market development investor flexibility is often needed on factors such as deal size, investment horizons and liquidity. Uncovering opportunities requires concentrated effort.

### SATISFY CLIENT DEMAND AND ENHANCE BUSINESS VALUE

Impact investment allows asset managers to meet a growing demand from individual and institutional clients that investments should align with social and environmental values. Knowing client values and preferences is important to optimizing the appeal of an impact investment strategy to clients.

*One first step in designing an impact investment strategy is to look at what client preferences are and start investing in a theme that's very close to the fund. You need an alignment with clients, that is financial alignment and also impact alignment, what the clients want. I think what your clients think are important issues is important. In the Netherlands many pension funds are sector related, so impact may start with coming from that sector. For example, we work for the health care sector among others so we're also looking at impact investment in health care sector.*

**TIM VAN DER WEIDE** PGGM

*Large asset owners are very favourable towards ESG and responsible investment and are looking for asset management partners who have a demonstrated commitment to this space. We see our [impact investment] activities and our broader commitment to responsible investment as positively contributing to future growth objectives for the company.*

**AMY O'BRIEN** TIAA- CREF

*Our largest client surveys their beneficiaries every quarter on what they think about responsible investing and whether we should do more. There are an overwhelming proportion of beneficiaries that respond positively. The beneficiaries themselves are a driving force in ultimately driving PGGM to invest in impact investments for our clients.*

**TIM VAN DER WEIDE** PGGM

*We have seen an evolution of thought as to how to apply values to the investment process. This evolved from negative screening to ESG, to the next frontier of impact investment. This has been the logical next step to secure good returns for members and align the fund more deeply with member's values.*

**SIMBA MAREKERA**  
**CHRISTIAN SUPER**

*Our investor base tends to be highly aware of social and environmental impacts of investments and demanding of us in terms of having these types of investment programs ...we have a strong client demand and favourable client base towards this kind of investing and see it as a way to differentiate ourselves in the market place.*

**AMY O'BRIEN** TIAA-CREF

## EMBRACE THE OPPORTUNITY FOR PORTFOLIO DIVERSIFICATION

Impact investment fits across existing asset classes, thereby presenting another dimension of diversification in each asset class.

*Our impact investment portfolio is currently and continues to be built in a diversified manner. All of it is in private markets, but we have everything ranging from private equity, private debt, real estate equity, real estate debt and deposits... We use modern portfolio theory for our portfolio construction with respect to taking into account how these asset classes correlate to each other.*

**REKHA UNNITHAN** TIAA-CREF

*We support investment teams on how impact investment could be incorporated into their investment decisions. We are organised in a way that every investment team should be looking for these types of investments. So we don't have a separate team that solely does impact investment.*

**TIM VAN DER WEIDE** PGGM

## BUILD AND SECURE SENIOR COMMITMENT

The business case for impact investment should be embraced at the firm level. Impact investment should not be adopted as part of a firm's corporate social responsibility or philanthropy efforts, but be implemented as a value creation strategy.

*We spent two years building the business case for impact investment including demonstrating that it would deliver real value to the business and was indeed something that would bring tangible and intangible benefits to our client relationships.*

**AMY BELL** J.P. MORGAN

*Achieving top level commitment is key...requires education of senior executives to provide them with knowledge of what the market really looks like and how institutional investors can participate.*

**AMY O'BRIEN** TIAA-CREF

## ESTABLISH THE INVESTMENT CASE

Institutional investors stressed that impact investment decisions be made on a financial first basis, as risk adjusted commercial rates of return are critical to meeting fiduciary obligations. While institutional investors make no concession for the risk-reward element of impact investments, the current early stage of market development requires an investor to be more flexible than usual on deal size, investment horizons, liquidity and other factors.

*We target an overall aggregate return on the portfolio that allows us to be financially viable as business.*

**AMY BELL** J.P. MORGAN

*We do not accept a low return just because it is an investment that is having a social impact. We look for social and financial sustainability.*

**REKHA UNNITHAN** TIAA-CREF

*The overall philosophy is that we are striving for equivalent financial returns as investment...we believe we can find and make quality investments that satisfy the investment objectives of the general account... there may be things that are different about the nature, size and other structure issues that make these look a little different to their 'mainstream' counterparts.*

**AMY O'BRIEN** TIAA-CREF

*We look for opportunities where there is no trade-off between financial and social return but where the two are complementary and we are able to get a market rate return... We have to be comfortable with the financial investment case first of all.*

**SIMBA MAREKERA**  
CHRISTIAN SUPER

### UTILISE PROFESSIONAL PROCESSES AND TECHNIQUES FOR DUE DILIGENCE

The same professional processes and techniques for due diligence on mainstream investments are used by institutional investors for impact investments.

*There is no difference in terms of due diligence in how we assess our impact investments compared to other investments. The only thing is that we are more stringent on labelling them as [impact investments] because they have to meet certain criteria to be labelled as such. Due diligence is the same but there is added due diligence to determine whether they are truly sustainable*

**TIM VAN DER WEIDE** PGGM

*The due diligence process is quite standard for what a fund of funds manager would do...looks and feels similar to other investment businesses at JP Morgan and, in fact, the processes are largely borrowed from our own institutional processes elsewhere. There is nothing dramatically different... the one component of our process that is unique relative to more traditional investment activities is whether or not the impact objective is being achieved.*

**AMY BELL** J.P. MORGAN

*We are leveraging the same underwriting process and capital market assumptions. So, if we are doing private equity in emerging markets, we are really using the private equity emerging market framework to underwrite these; but, we recognise the deals look and feel different because they are going after an untapped market. Same for debt and other asset classes...*

**REKHA UNNITHAN** TIAA-CREF

*We treat all impact investments as 'normal'. The financial analysis rigour that goes into impact investments is exactly the same as other investments...*

**SIMBA MAREKERA**  
CHRISTIAN SUPER

*All investors emphasise how important it is to assess the impact investment fund manager when making indirect investments and understanding reputational risk.*

*We go through a very intensive due diligence process where we spend probably a disproportionate amount of time on understanding and evaluating the team because that is who we are ultimately banking on. (Amy Bell, J.P. Morgan) We take time to understand whether [the fund managers] are the right people to run the fund from both a financial and impact perspective.*

**SIMBA MAREKERA**  
CHRISTIAN SUPER

*A lot of the focus within our due diligence as well as within our portfolio management activities is mitigating reputational risk.*

**AMY BELL** J.P. MORGAN

*Use of external resources to assist in due diligence may be necessary if an investor does not have the necessary in-house expertise.*

*We sometimes have external advisors to assess the sustainability, but that is normally done on an ad-hoc basis depending on the nature of the investment.*

**TIM VAN DER WEIDE** PGGM

*We recognise that we need more than financial skills to assess some of the deals. We are not the experts in understanding impact – we need to step back and consult with players in the ecosystem to understand unique impact risk and look outside the financial sector to understand these risks.*

**SIMBA MAREKERA**  
CHRISTIAN SUPER

## BUILD NETWORKS AND RELATIONSHIPS

Early adopters of impact investment consistently highlight that to understand the market, they must have both focused effort and time. Developing strong relationships with other impact investors and market building organisations can add significant value to these efforts.

*We use a number of ways to originate our impact investments. We deliberately decided a number of years ago to be plugged into the impact investment network. We are members of GIIN and RIAA and reach out to different players. From being a member of the Investor Council of GIIN we have been able to be plugged into a number of fund managers that work in this area as well as other investors that play in this area. We have also been proactive in reaching out to other players such as development banks...*

*The timeline is getting shorter as we are getting higher quality deals coming through and it can take anywhere from three months to a year with an average of six to nine months from engaging a fund manager going through to investment.*

**SIMBA MAREKERA**  
CHRISTIAN SUPER

*The way these deals originate is still a little unstructured... right now they can originate through our responsible investment department, through meeting somebody who has a great fund or great opportunity. They also come through the more ordinary processes that we have – for instance through our private real estate portfolio or infrastructure deals, deals may pop up that also have a societal impact... We set targets on the total amount of impact investments to make sure there is a focus on seriously looking at them.*

**TIM VAN DER WEIDE** PGGM

*Deal origination is largely through our network and relationships that we have in the field. We have been very transparent in conversations with people about what we are trying to achieve from an investment standpoint and as a result we tend to get high quality references from other investors.*

**AMY BELL** J.P. MORGAN

*Deals do not typically come across the desk of mainstream asset managers... we spend a lot of time building pipeline and originating opportunities.*

**REKHA UNNITHAN** TIAA- CREF



Table 5: Selected impact investments of institutional investors

CHRISTIAN SUPER	J.P. MORGAN	PGGM	TIAA-CREF
Australia	United States	The Netherlands	United States
<b>AU\$15MM – MicroVest and Triodos Bank:</b> Private debt and equity investments to support microfinance activities.	<b>US\$25MM - African Agricultural Capital Fund:</b> A private equity fund managed by Pearl Capital Partners that invests in agribusiness to support the development of small holder farmers and rural economies in East Africa.	<b>BNP Clean Energy:</b> An infrastructure investment fund focused on sustainable energy projects in Europe.	<b>US\$40 million – Developing World Markets (DWM) Microfinance Equity Fund I:</b> A private equity fund focusing on financial inclusion investing majority stakes in influential financial institutions serving underserved communities
<b>AU\$750K - NewPin Social Benefit Bond:</b> Investment into Social Benefit Bond focused on providing mentoring, counselling and education to families that have been separated through their children being placed in foster care.	<b>£2.75MM - Bridges Social Entrepreneurs Fund:</b> An equity-like capital fund from Bridges Ventures, a leader in the impact investment market. The fund provides growth capital to support high-impact, scalable and financially sustainable social enterprises in the UK.	<b>Alpinvest Clean Tech PE:</b> Worldwide investments into private equity funds that focus on activities and technologies which improve the sustainable and efficient use of natural resources and reduce the ecological impact.	<b>US\$13MM - Urban Partnership Bank:</b> Investment in FDIC-insured certificates of deposit at community development banks that provides financial services to underserved neighbourhoods in Chicago, Cleveland and Detroit.
<b>AU\$6MM - Community Finance Fund:</b> Co-investment alongside grant from Australian government into Social Enterprise and Development Investment Fund managed by Foresters Community Finance.	<b>US\$5MM - IGNIA:</b> A venture capital fund supporting the founding and expansion of high growth social enterprises serving low-income populations in Mexico.	<b>IFC African, Latin American and Caribbean Fund:</b> A private equity investment fund that co-invests with the IFC in a range of sectors in Sub-Saharan Africa, Latin America and the Caribbean.	<b>US\$58 MM – ProCredit Holdings:</b> A private-equity investment in ProCredit Holdings, a bank providing global microfinance and financing solutions to small- and mid-sized enterprises, and to low- and middle-income individuals.
<b>LeapFrog Financial Inclusion Fund II:</b> A microinsurance fund that provides insurance and related financial services to low-income and financially excluded people in Africa and Asia.	<b>US\$10MM - LeapFrog Financial Inclusion Fund:</b> A microinsurance fund that provides insurance and related financial services to low-income and financially excluded people in Africa and Asia.	<b>Climate Change Capital:</b> Investments into real clean technology assets in developing countries to earn carbon credits. These carbon credits are then sold forward on CO2 exchanges.	<b>US\$142 MM – Impact Community Capital:</b> TIAA is an investor in IMPACT Community Capital LLC, an independent CDFI initiative created, owned and funded by eight insurance companies (including TIAA) to facilitate, on their behalf, quality investments benefiting low-income families and underserved communities
<b>AU\$18MM - AMP Community Infrastructure Fund:</b> An infrastructure fund that focuses on water treatment, schools, TAFE, convention centre, prison, hospital car park. Impact comes from provision of essential community services.	<b>US\$10MM - MicroVest II:</b> A private equity fund managed by MicroVest, which seeks sustainable solutions to poverty by facilitating the flow of capital to pro-poor finance institutions serving low-income individuals in emerging markets such as Latin America, Asia, and Eastern Europe.	<b>Adecoagro:</b> Equity investment into Adecoagro, one of the leading producers of food and renewable energy in South America. Activities include the production of grain, rice, oilseeds, dairy products, sugar, ethanol, coffee and cotton.	<b>US\$25MM - Avanath Affordable Housing, LLC:</b> A Real Estate Equity Fund that invests in US affordable multifamily housing properties with a focus on preservation of affordability while generating current income and capital appreciation



Australian superannuation funds are, with care, able to pursue and benefit from the opportunity presented by impact investment. It is an opportunity to build investment offerings aligned to members' values that actively contribute to strengthening communities in which their members live. Impact investment also provides superannuation funds unique exposure and uncorrelated diversification to a wide range of investments across geographies and sectors. While ready impact investment product is currently scarce and uncovering investable opportunities takes focused effort, as market momentum builds and collaborative effort is made to develop product to accommodate the needs of superannuation funds, the pathway to pursuing impact investment will be eased. Those willing to engage early and contribute to the building of the market can build an enviable competitive advantage.



# APPENDIX ONE: INVESTMENT DUTIES OF SUPERANNUATION TRUSTEES

The regulatory regime applied to the trustees of superannuation funds in Australia neither expressly promotes nor expressly prohibits impact investment. It does however impose obligations that together hold the trustee accountable for making decisions that are in the best interests of the fund's members.

With care, these requirements can be navigated in a way that permits the trustees of superannuation funds to provide capital to enterprises pursuing a social impact agenda.

The trustee of a superannuation fund owes a range of duties relating to the investment of fund assets. Some are expressed in statute; some derive from the general law.

## THE STATUTORY DUTIES OF TRUSTEES OF SUPERANNUATION FUNDS

The Government has resisted the impulse to tell the trustees of superannuation funds what to invest in. *The Superannuation Industry (Supervision) Act 1993 (Cth)* ('SIS Act') does however require that trustees invest the assets of the fund for the purpose of gaining interest, income, profit or gain<sup>46</sup> pursuant to an investment strategy that has regard for<sup>47</sup>:

- '(i) the risk involved in making, holding and realising, and the likely return from, the investments covered by the strategy, having regard to the trustee's objectives in relation to the strategy and to the expected cash flow requirements in relation to the entity; and
- (ii) the composition of the investments covered by the strategy, including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification; and
- (iii) the liquidity of the investments covered by the strategy, having regard to the expected cash flow requirements in relation to the entity; and
- (iv) whether reliable valuation information is available in relation to the investments covered by the strategy; and
- (v) the ability of the entity to discharge its existing and prospective liabilities; and
- (vi) the expected tax consequences for the entity in relation to the investments covered by the strategy; and
- (vii) the costs that might be incurred by the entity in relation to the investments covered by the strategy; and
- (viii) any other relevant matters'.

In addition, there are more general duties that impose qualities of decision-making that have relevance in the investment context. These include covenants by the trustee that it will:<sup>48</sup>

*'exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity of which it is trustee and on behalf of the beneficiaries of which it makes investments;*

*perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries'.*

It is also the case that trustees responsible for a MySuper (default) product specifically are required to:<sup>49</sup>

*'promote the financial interests of the beneficiaries of the fund who hold the MySuper product, in particular returns to those beneficiaries (after the deduction of fees, costs and taxes)'*

Finally there is an overarching duty to ensure that the fund is maintained for the sole purpose of providing retirement benefits to members.<sup>50</sup> Although this provision has typically been used as a means to restrain trustees from permitting members to enjoy benefits from their superannuation fund prior to retirement,<sup>51</sup> it is also commonly understood more generally to restrain trustees from employing the assets of the fund in pursuit of benefits not directly linked to retirement.

Taken together, then, these statutory duties are specifically designed to ensure that trustees turn their minds to how best to employ the assets under their stewardship in pursuit of the objective of accumulating sufficient funds to enable members to secure a dignified retirement.

The statutory duties of trustees with respect to investment go beyond this. They extend also to the communication that trustees have with members and with prospective members. Trustees are required to make a variety of disclosures to prospective and current members. For instance the financial product disclosure regime specifically requires trustees of superannuation funds to disclose:

*'the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment.'*<sup>52</sup>

More generally, that regime also requires the periodic disclosure (usually in an Annual Report) of:<sup>53</sup>

*'all information that the trustee reasonably believes the member would reasonably need to understand the management and financial condition of the fund and of the relevant sub plan (if any).'*

## THE 'PROPER' PURPOSE DOCTRINE AT GENERAL LAW

Section 350 of the SIS Act provides that a law of a State or a Territory continues to apply, to the extent that it is capable of operating concurrently with the provisions of the SIS Act. This means that the rules and principles present in the case law on trusts, and the rules present in State legislation such as the Trustee Acts of each State, continue to be relevant to trustees of superannuation funds.

The most important consideration arising from the general law is the requirement that the trustee of a superannuation fund exercise its investment power for a 'proper' purpose.<sup>54</sup> The 'proper' purpose is defined narrowly in the general law as being the purpose for which the power was granted.<sup>55</sup> The exercise of a power for a purpose other than a 'proper' purpose is voidable and attracts the colourful (but potentially slightly misleading) description of being a 'fraud' on the power.

The 'proper' purpose underpinning the investment power in the superannuation fund context is narrowly defined. The proper purpose of the investment power in that context is to achieve the financial objectives of the fund.<sup>56</sup> It thus dovetails with the requirement in section 62 of the SIS Act that the fund be administered to provide retirement benefits to members.

The question then arises as to whether the investment power can be exercised properly where there is an additional or subsidiary purpose relevant to the decision. The key here would seem to be that the additional purpose (sometimes called an ancillary or collateral purpose) cannot compromise the pursuit of the proper purpose.<sup>57</sup> So a decision made using strict investment criteria will not be rendered 'improper' from the perspective of trust law simply because other benefits accrue as a result. It will however be improper if those other benefits entail a compromise in respect of the investment criteria, including expected return, risk, diversification and liquidity.

### GOVERNANCE AND DELEGATION

The general law is wary of permitting trustees to escape accountability for key decisions relating to the administration of a trust. Generally a trustee is permitted to appoint agents to perform 'ministerial' tasks, so long as such a delegation would be prudent and consistent with ordinary business practice.<sup>58</sup> However, trustees cannot escape accountability for decisions containing a 'discretionary' element simply by passing responsibility for such decisions to another person.

Section 59 of the *SIS Act* achieves a similar result specifically for superannuation funds.<sup>59</sup> This is important, because it powerfully conditions the way that trustees need to approach the governance of those funds, especially in relation to investment of the fund's assets. Thus trustees can accept advice and appoint specialist firms<sup>60</sup> to implement investment mandates, but they remain ultimately accountable for the administration of the funds under their trusteeship. They may have rights against the agent, if that agent has not performed its duties appropriately, but they must demonstrate that as trustee they have acted with care and diligence, and that there is a consonance between the needs and objectives of the fund and the investment strategy they have implemented. The appointment of an agent does not detract from that fundamental obligation.<sup>61</sup>

### THE IMPLICATIONS FOR IMPACT INVESTMENT

The first implication is that any investment made by the trustee of a superannuation fund must have an expected rate of return commensurate with the risk that it carries. The investment must also have diversification and liquidity characteristics that fit with its role in the overall portfolio of investments. There can be no 'trade-off' between these criteria and other, ancillary purposes. This is particularly the case where the ancillary benefits are enjoyed by parties other than the members.

The second implication is that the use to which capital invested is put by the entity in which the investment is made (or to whom the loan is made) is relevant in so far as it underpins the expectation of return, and the risks surrounding that expectation, but not necessarily beyond that. Trustees are not, for instance, required to have regard for the use made by governments of the capital raised through bond issues, except to the extent that it bears on the credit-worthiness of the issuer. Nor are they required, with one exception, to have regard for the use (laudable or not) of capital by the companies in which they are equity holders. (The exception is where the trust is the predominant shareholder and is, *de facto*, in control of the business)<sup>62</sup>. By extension, therefore, how an impact-seeking entity uses the money ought to be irrelevant from a legal perspective except insofar as it underpins the financial returns it seeks to deliver.

The third implication is that the entity in which the investment is made must have information disclosure and valuation protocols sufficient to permit the trustee to discharge its duty of care both at the time of the investment and thereafter and to comply with its disclosure requirements. Timeliness, detail and independence are important in this regard.

The fourth implication is that the legal form of the 'investment' can have a material impact on the extent and nature of the due diligence required of a trustee. Investments packaged in familiar legal forms carry fewer due diligence risks for trustees; risks that are not, on average, compensated by higher expected returns<sup>63</sup>.

Finally, the trustee must ensure that it has the resources and processes in place to give effect to its investment strategy. Investment propositions that require intensive, bespoke analysis on a case-by-case basis by the trustee must compete for attention with the myriad of other issues requiring trustee attention.<sup>64</sup> This suggests that intermediated solutions, or carefully framed delegations, may be required to ensure that potential investments are given the attention required in order for the trustee to be in a position to demonstrate that they have acted prudently in the exercise of their investment power.

## APPENDIX TWO: DEVELOPING AND IMPLEMENTING AN IMPACT INVESTMENT STRATEGY

Both Cambridge Associates and J.P.Morgan have adapted mainstream investment decision frameworks for developing and implementing an impact investment strategy<sup>65</sup>. The key elements of these frameworks are to:

### DEFINE INVESTMENT STRATEGY AND ASSET ALLOCATION TARGETS

The starting point for the construction of any investment portfolio, with or without impact investments, is to define the investment strategy and portfolio asset allocation targets. The strategy will determine the investment scope, with regard to the parameters that drive and influence financial performance of the overall portfolio, as well as at the level of individual investments. These parameters include: geographies and sectors of focus; life-cycle of targeted investee companies (for example, start-up or growth); eligible investment instruments; risk appetite; and risk-adjusted return expectations. After the investment strategy has been defined, the asset allocation for impact investments must also be determined. Impact investments may comprise a small percentage of a portfolio or a portfolio may be actively constructed comprising fully of impact investments. The degree to which a portfolio is comprised of impact investments will be influenced not only by the investment strategy but also by the cash flow and liquidity requirements of the fund. Flexibility is required around allocations, as it may take time to identify and/or develop suitable investment opportunities. Taking an opportunistic approach in the early stage of market development may be most effective.

### DETERMINE IMPACT THESIS

Once the investment strategy guiding the construction of the investment portfolio is defined, an investor will articulate the desired impact of the portfolio. The impact thesis will represent the values of the investor and may be articulated with reference to a set of specific impact objectives. For example, if an impact thesis is defined as 'social', examples of activities within the portfolio could include increasing access to affordable housing or generating employment opportunities for a target population. Together the investment strategy, asset allocation targets and impact thesis define the set of impact investment opportunities an investor can consider.

### ASSESS INVESTMENT OPPORTUNITIES FOR RISK, RETURN AND IMPACT

As with any investment opportunity, assessment of impact investments must start with analysis of the financial risk and return. This analysis is conducted at the individual investment level as well as for the portfolio as a whole with the results being compared to the adjusted risk-return target of the investment strategy. It is not necessary that each and every impact investment perfectly fits within the target range, provided that the portfolio does so in aggregate.

### MANAGE FINANCIAL AND IMPACT RISK

All investments carry risks that must be appropriately managed. The risk profile of many impact investments will often mirror those carried by mainstream investments in the same geographies or sectors. Impact investments do however carry some specific risks that need to be considered on a deal-by-deal basis and factored into calculation of the aggregate risk of the overall portfolio. Risks specific to impact investments can include: reputational risk or moral hazard of impact failure; early stage of market development limiting track record, investment choice and liquidity; blended capital structures bringing together financial capital with philanthropic grant capital; and financial returns dependent on social outcomes. Once risks are identified they can then be managed by a range of risk management strategies including: choice of investment instrument; structural features with the capital structure; fund intermediaries; or linking compensation structures to financial return and/or impact.



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39. Section 1013D(1), *Corporations Act 2001* (Cth).
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48. This list reflects the duties in section 52(2), *SIS Act* that will be required when legislation already passed by Parliament comes into force on 1 July 2013.
49. Section 29VN(a), *SIS Act*, which comes into force on 1 July 2013.
50. Section 62, *SIS Act*.

51. See for instance Case 43/95 (1995) 31 ATR 1067 (purchasing membership in a golf club and a Swiss chalet); APRA v Derstepanian [2005] FCA 1121 (purchase of assets at an inflated price from an employer-sponsor); Re Montgomery Wools Pty Limited as trustee for Montgomery Wools Pty Limited Super Fund v Commissioner of Taxation [2012] AATA 61 (supporting a family-owned business).
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54. Vatcher v Paul [1915] AC 372, 378.
55. Ibid.
56. Cowan v Scargill [1985] Ch 270, 287.
57. Invensys v Austrac [2006] 198 FLR 302, [111].
58. Speight v Gaunt (1883) 9 App Cas 1.
59. There is a limited exception granted in respect of employer contributions in the context of decisions to terminate a fund – section 59(1)(b), SIS Act.
60. Section 125, *SIS Act* requires that an investment manager appointed by a superannuation fund must be an incorporated entity.
61. It is worth noting that although indemnity and relief from liability clauses can effectively modify this position at general law, section 56, SIS Act voids such provisions in the superannuation context if they would have the effect of indemnifying or exempting from liability, where the trustee has acted dishonestly or has intentionally or recklessly failed to exercise the requisite degree of care and diligence.
62. *Re Lucking's Will Trusts* [1967] 3 All ER 726.
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Kylie is Managing Director and Co-founder of Unitus Capital, a financial services company dedicated to working with entrepreneurial businesses serving low-income communities. Working at the intersection of mainstream capital markets, social impact investing and philanthropy since 2004 internationally and domestically, Kylie has arranged capital for microfinance institutions and social businesses, structured specialised impact investment funds, advised banks, investment funds and governments, and written and spoken widely on the topic of impact investment. She has been an active contributor to the emergence of impact investing in Australia authoring submissions and participating in roundtables for commissioned studies of the Australian Government Productivity Commission and Senate Economics References Committee in regard to the development of a social capital market in Australia, consulting to and serving as an ex-officio committee member for the Department of Education, Employment and Workplace Relations in regard to Social Enterprise Development and Investment Fund (SEDIF), co-authoring reports for the Centre for Social Impact (CSI) on the NSW Government Social Impact Bond Pilot and Understanding Social Impact Partnership in Western Australia, and co-designing and delivering the post graduate unit of 'Philanthropy and Social Impact Investment' offered as part of the Graduate Certificate of Social Impact by the University of New South Wales and University of Western Australia. Kylie is actively committed to developing the market for impact investing and mobilising capital to enable innovative solutions to local and global challenges.

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Scott is an External Consultant to Herbert Smith Freehills and a member of the Faculty of Law at the University of New South Wales. He teaches and researches in the area of corporate and trust law and the regulation of superannuation. He was a consultant to the Federal Government's Super System Review (the 'Cooper Review') in 2010 and a member of the Federal Government's Stronger Super Governance Consultative Working Group in 2011. Earlier in his career, Scott worked for Russell Investment Group in Sydney and London, in roles spanning investment consulting, investment and governance research and new product development. Prior to that he was an investment analyst at Ipac Securities. During his time in those roles, Scott advised public and private sector organisations both in Australia and overseas on issues associated with regulation, governance and the investment of superannuation funds.

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