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Impact investing
A sustainable strategy for hedge funds

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Nearly a decade after its arrival on the social finance scene, impact investing is still growing in popularity. Hedge fund managers have been slow to adopt the strategy, although other types of investment managers are already gathering assets in this space. Yet as the hedge fund industry continues to face performance headwinds, it may be time to take a closer look at how this type of sustainable investing may support alpha generation.

Defined as “the intentional allocation of capital to generate a positive social or environmental impact that can be—and is—measured,”¹ impact investing blends the earlier concepts of investment screens and social selection criteria with the newer enhancements of intentionality and impact metrics.

Two developments have supported the growth of social finance. These include the business megatrend toward sustainability² and the emergence of social metric reporting. These developments indicate that the times appear to be changing, putting financial companies and investors right in the middle of the social evolution. And, they are responding positively to the idea.

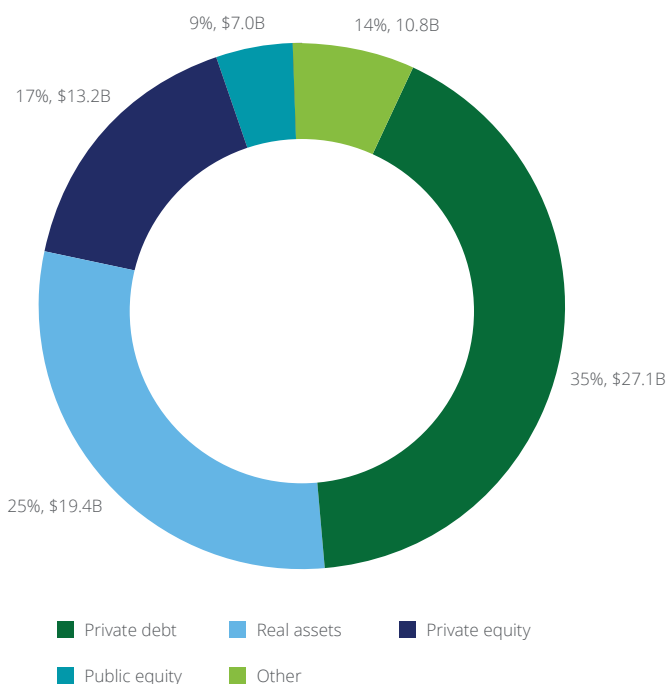


Social finance: An investment approach that blends social dividend and economic return objectives

Institutional investors are increasing capital commitments to impact investments on an annual basis, while investment by high-net-worth individuals has grown over the past two years.³ Investment managers continue to launch new and innovative strategies, even as regulators, the media, and universities show support for impact-oriented themes. Social influence appears to be evolving on a global scale, indicating that impact investing may have sustainable, long-term appeal.

As the newest entrant to social finance, impact investing is still an emerging area. As of 2014, it represented a relatively small portion of the \$6.6 trillion held in sustainable assets.⁴ While it is challenging to calculate the current market size of impact investing, a partial glimpse is offered by the respondents to the annual survey conducted by the Global Impact Investing Network (GIIN). It reveals that, by instrument, the largest percentage of assets is held in private debt, real assets, and private equity, as illustrated in Figure 1. Together, private equity and debt strategies comprise 52 percent of the assets identified as impact investments. Respondent assets under management (AUM) total \$77.4 billion across 156 entities, which include fund managers, foundations, banks, diversified financial institutions, family offices, and others (excluding retail investors).^{5,6}

Figure 1: Breakdown of \$77.4 billion in impact investing assets

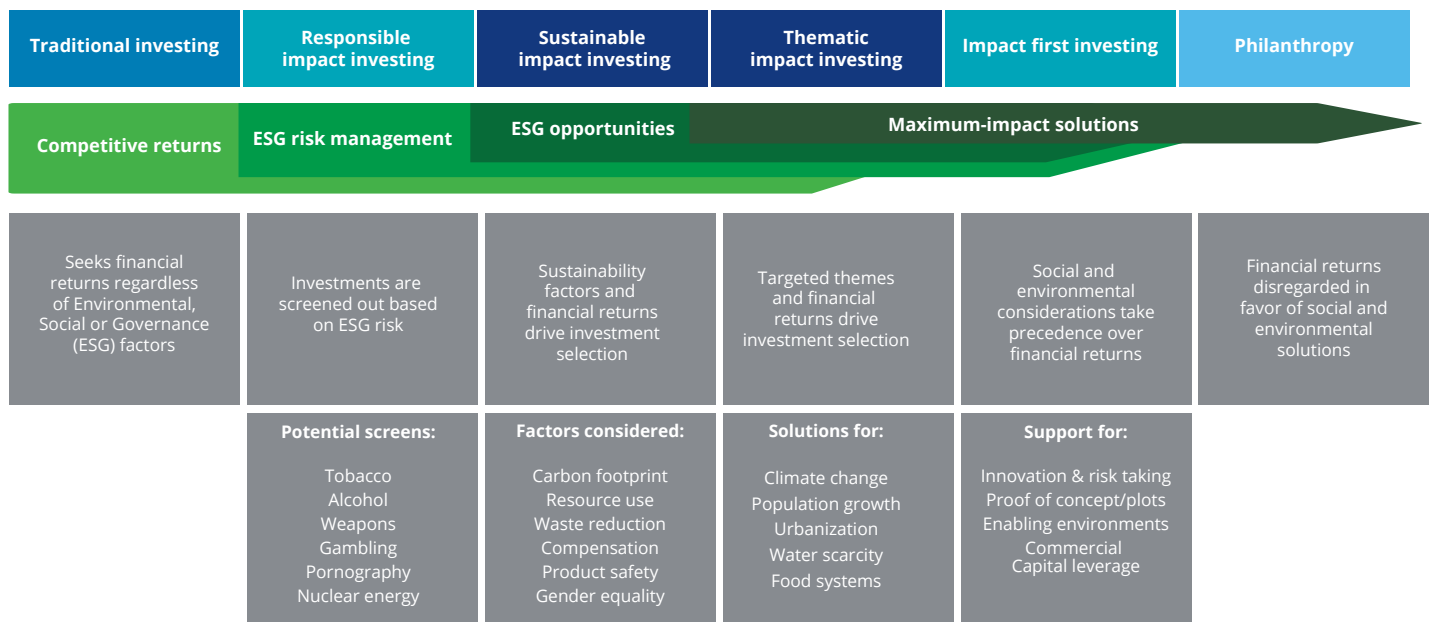


Source: Deloitte Center for Financial Services analysis of responses to the Annual Impact Investor Survey, 2016 by The Global Impact Investing Network: "Total AUM by Instrument (Full sample)." Numbers may not foot due to rounding.

As impact investing has grown, it has also gained definition as an investment style. Sonen Capital's Impact Investing Spectrum provides a useful conceptual tool, which investors and fund managers may, for example, use to analyze their approaches to impact investing. In this six-part spectrum, shown in Figure 2, the investing world that is shown between Traditional Investing and Philanthropy describes a range of impact approaches and opportunities. The Sustainable Impact Investing and Thematic Impact Investing categories—which may be the sweet spot for hedge fund managers—suggest selecting targeted companies (Sustainable Impact Investing) and social and environmental themes (Thematic Impact

Investing) while seeking competitive financial returns. The Impact First Investing category targets both social and environmental issues where the impact takes precedence over financial returns. For reference, the first category, Traditional Investing, is solely designed to achieve financial returns while disregarding any social or environmental impact. The last category, Philanthropy, is designed to achieve a specific social or environmental outcome, while disregarding any financial return.⁷

Figure 2: Impact investing spectrum by Sonen Capital



Source: Sonen Capital, www.sonencapital.com/impact/methodology, © 2016.



Hedge funds and social finance

Hedge fund managers have been active participants in social finance for a number of years. There are two funds with 2007 inception dates still in operation, with other more recent offerings available as well. Yet our research for this report uncovered no hedge funds that are currently self-identified as impact investments. Neither the ImpactBase managed by the GIIN nor

the fund data provider Preqin Ltd. lists an impact-oriented hedge fund or fund of funds.⁸ This illustrates that in the impact space, specifically, hedge fund managers have opted for using impact investments as part of an investment approach, rather than launching a dedicated impact fund.

This signals that hedge fund participation in impact investments is largely at the overlay-manager level, with SRI— and ESG—labeled funds being selected by overlay impact managers as part of the client portfolio. In this case, the hedge fund manager may not be aware of the selection of their fund as an impact investment. Yet the impact manager, through the selection process and by quantifying the social impact of the portfolio, creates a client-level impact investment designed to generate alpha and social good.

A second method of involvement may be through behind-the-scenes influence. One fund manager we researched has worked for a number of years with the companies it is directly investing in to increase their social impact. While their hedge fund is designated by Prequin as an ESG fund, the manager considers itself as being in the impact space as well, through the social influence it exerts on private investments.

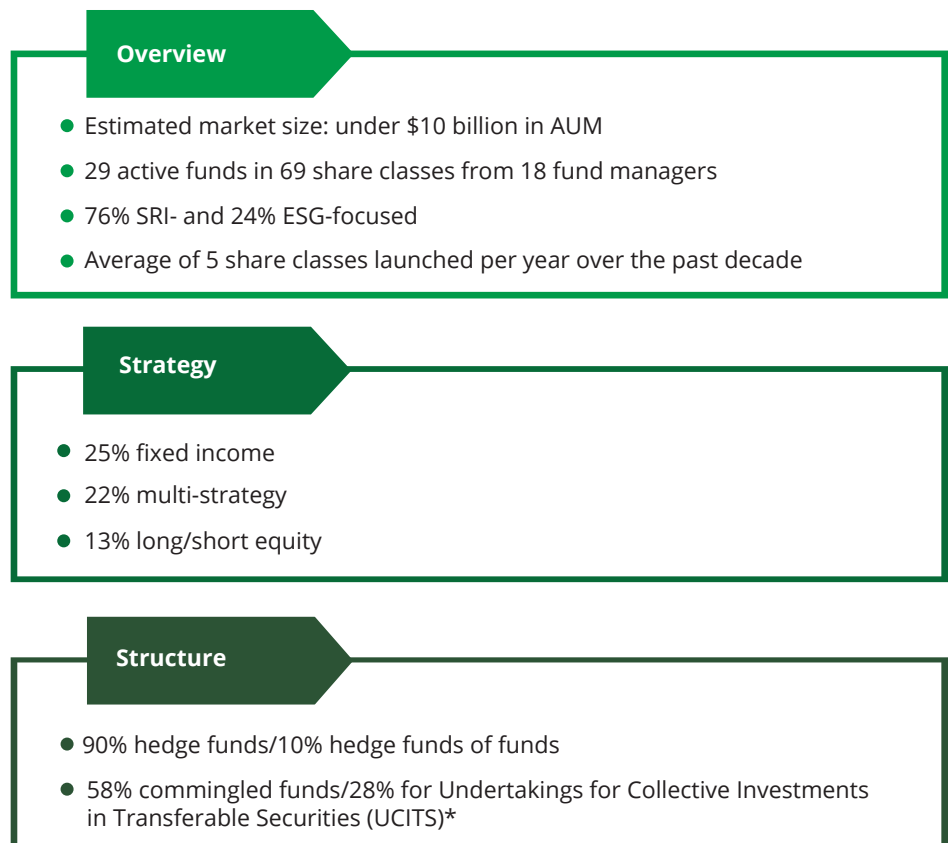
This may mean that visible and measurable social finance participation by hedge funds is currently through ESG and SRI strategies. Since managers self-report designations to data providers, market sizing for these areas of social finance is relatively transparent.

Prequin data summarized in Figure 3 shows that 18 hedge fund managers offered 29 ESG or SRI funds to investors at midyear 2016. An average of five share classes has been launched per year over the last decade. Three quarters of share classes are aligned to an SRI strategy, and the remainder are ESG-focused.⁹

This is still a niche market, however. Deloitte calculates under \$10 billion in assets is held in these strategies, based on analysis of Prequin data supplemented by our research into publicly disclosing funds—as compared to the \$3.1 trillion in hedge fund assets under management.¹⁰

<p>SRI—Socially responsible investing: Negative screens to exclude investments with adverse societal or environmental impact</p>	<p>ESG—Environmental, social & governance: Positive screens to include these three criteria that influence social impact</p>	<p>Overlay impact manager: Creates custom client portfolios using ESG and SRI investments and measures the financial and social results</p>
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Figure 3: ESG and SRI strategies in hedge funds



Source: Deloitte analysis of Prequin, Ltd. hedge fund data, / www.prequin.com. © 2016
*Of reporting funds.

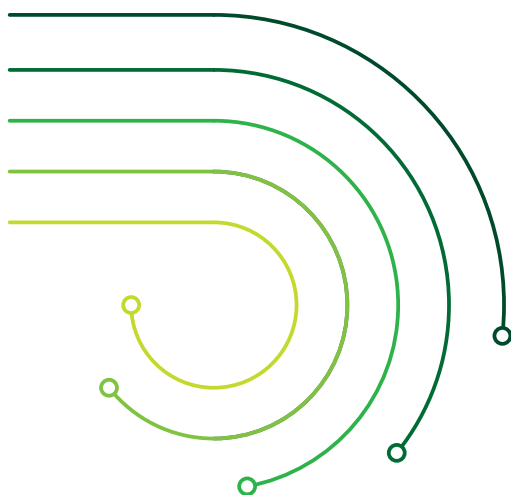
Key considerations for impact investing by hedge funds

The lack of a clear hedge fund leader in impact investing suggests there may be open space for early movers to gain a competitive advantage. The biggest value proposition for this strategy is that a growing class of investors wants to see these types of products within their suite of investment options. The value-add to managers is not only about interest in a specific fund, but also about how this creates opportunity to bring in new clients and deepen relationships with existing clients. Competition is fierce and any opportunity to show responsiveness to investor demands while being first in an untapped market is key. For managers taking a closer look at impact investing, and others already in the social space, we suggest the five following considerations.

1. Defining meaningful impact measures
2. Solving for intentionality, additionality and differentiation
3. Achieving comparable performance
4. Ensuring fiduciary compliance
5. Growing demand in a challenging marketplace

1. Defining meaningful impact measures.

The lack of standardization for impact performance measures is a key challenge for impact investment managers. While traditional metrics are measured in dollars of currency, social and environmental metrics vary in unit of measure according to the desired goal, such as energy consumption, carbon emissions, and employment generation.¹¹ The wide range of impact measurement practices and metrics makes it difficult for investment managers to efficiently integrate impact measures into investment decision making. As transparency around impact measurement and reporting increases, a growing evidence base of impact disclosure will better enable the market to evaluate impact investment as an investment strategy. Key questions managers may ask include: What is our impact objective? What are we measuring and why? And how should that inform what we're trying to accomplish from an investment perspective?



Source: Deloitte Center for Financial Services analysis

2. Solving for intentionality, additionality, and differentiation.

Hedge fund managers may have a few more hoops to jump through, conceptually, than other types of investment managers, before actively engaging in impact investing. While a full discussion of these is beyond the scope of this report, three elements are notable:

- **Intentionality.** This practice means that a portfolio manager's intention toward the positive, whether social or environmental, sets impact investing apart from other strategies that may measure performance only after the fact. It may be more difficult for hedge fund managers to embrace intentionality and an investment philosophy that includes social impact, as they are traditionally known for targeting short-term financial returns.

- **Additionality.** Another metric for success, viewed outside the category frameworks, is that an investment needs to create measurable social impact. But for this investment, as it were, there may not be any additional value-add or impact beyond what previously existed. There is ongoing debate about additionality as it pertains to impact investing and the public markets, yet it may be achieved in a couple ways by hedge fund managers. One is through influencing direct investments toward impact-oriented practices, and another approach is through investing in firms that are already socially focused.

The lack of a clear hedge fund leader in impact investing suggests there may be an open space for early movers to gain a competitive advantage.



• **Differentiation.** As the market matures, participating fund managers will want to create differentiation around their approaches. These include unique processes to inform effective decision making, and how a manager showcases the value of the algorithms and trading/investing philosophies that support impact investment. With less transparency in the hedge fund market in terms of disclosure of investment processes, this undertaking may also be more challenging than for other types of investment managers.

3. Achieving comparable performance.

Investors will want to measure the performance of impact investing versus established benchmarks, and weigh it against the opportunity cost of other investments not selected. In one solution, Cambridge Associates (CA) and the GIIN jointly launched an impact investing benchmark in 2015, which assesses the performance of 51 private investments. Initial results have been encouraging. Across all vintage years, funds in the Impact Investing Benchmark posted a 6.3 percent internal rate of return, versus the 8.6 percent returns of funds in the comparative universe.¹² These early findings illustrate that achieving comparable performance—or at least attaining returns which may be close enough to satisfy regulatory guidelines for institutional investing by foundations—may be a reasonable anticipation for impact investments. Hedge funds were not represented in the benchmark, yet managers considering entry into the market may find these results promising.

4. Ensuring fiduciary compliance.

Recent ERISA (Employee Retirement Income Security Act) guidance may help pave the way for greater adoption of social strategies, including impact investments. In essence, a 2015 Department of Labor bulletin clarified

that plan fiduciaries may invest in socially oriented funds so long as the investment is “economically equivalent—with respect to return and risk to beneficiaries in the appropriate time horizon—to investments without such collateral benefits.”¹³ As the market matures it will be vital for fund managers to ensure that their investment strategies and disclosures continue to keep pace with the evolution in regulatory oversight.

5. Growing demand in a challenging marketplace.

This may be the sticking point when it comes to hedge fund participation: Demand may not yet support launching a dedicated impact strategy. Complicating this further, the hedge fund industry has recently faced market challenges that may negatively influence current traction for impact investing approaches. But the broader long-term picture is that investor interest in ESG strategies is growing, which may translate into higher product demand in the future. As evidence, 24 percent of hedge fund investors surveyed by Preqin in late 2015 “always considered” a fund manager’s ESG policies when conducting due diligence; by mid-2016, 38 percent reported this practice.¹⁴ As social awareness is generally trending in the marketplace, and with millennials showing high interest in impact investments while their influence rises as their assets grow, it may be merely a matter of time before demand increases. If this happens concurrently with managers achieving comparable financial returns using impact styles, a new and welcome type of demand challenge may emerge: finding the opportunity to deploy capital effectively. Indeed, there may be rewards for hedge fund managers, on both the long and short side, who identify companies that will benefit from, or be punished for, ignoring these trends.

In a world where positive returns have been hard to come by, impact investment may represent an untapped source of alpha.



Positioning for growth

Perspectives on the potential of impact investing span a spectrum. On one hand are the skeptics, who doubt that financial returns and impact investing may be achieved together; on the other are those who believe impact investing is the philosophy of the future. At present we may be somewhere in the middle of those two viewpoints: the early awareness that financial returns may comfortably coexist with social impact, without sacrificing either benefit. Whatever form impact investing takes next, its contribution has already been significant.

Through the incorporation of new data and reporting methods, which are driving measurable metrics toward success, impact investing has taken social finance to the next level.

Social finance itself continues to grow as an investment philosophy. A number of wide-ranging developments, outlined below, point in this direction. While these developments may not apply explicitly to impact investing, any support for these social strategies will likewise encourage a wider use of this concept.

Escalating global support

The Principles for Responsible Investment, an organization supported by two United Nations agencies,¹⁵ has grown its signatory membership base from 100 to 1,500 globally over the past decade.¹⁶ To become a signatory, an organization is required to submit a declaration of intent to incorporate ESG practices into its analysis and decision-making processes. While responsible investing is not the same as impact investing, it also touches on the themes of environmental issues, social issues and sustainability. This high level of adoption for responsible investing portends greater interest in impact investing.

Regulatory attention

In addition to the recent ERISA interpretative bulletin, two other agencies have addressed social finance topics. The Internal Revenue Service issued guidance in 2016 related to investments made for charitable purposes by foundations.¹⁷ The guidance relieves the foundation of the requirement to select investments based only on the highest rate of return, as long as the manager exercises requisite due diligence. And as demands for company transparency have accelerated in recent years regarding sustainability matters or ESG disclosure, the the US Securities and Exchange Commission (US SEC) recently announced it is looking closer at the topic.¹⁸ Many believe the SEC will consider how ESG information might be included in SEC disclosure documents, as well as how the safeguards of the system could apply to such information, potentially including assurance on the reliability of such disclosures.

Greater use of social and environmental screens

Public pension funds are updating their sustainable investing screening methods. CalPERS, for example, voted in 2016 to adopt a five-year plan for governance and sustainability, which includes a sustainable investment research initiative, among other objectives.¹⁹ Similarly, there are reports of European pension plans withdrawing investments from hedge funds due to lack of sustainability focus.²⁰ As these developments intensify attention on broader social finance inclusion, impact investing may likewise benefit.

Stronger connections between investing for good and financial returns

There is a developing thesis that companies run with an intentional focus on managing environmental and social risk may have higher returns on the financial side as well.²¹ This may relate to the concept that better use of resources and environmental protection may lower risk while leading to better returns. The industry is still collecting data around this concept, with early studies favoring the possibility that in time, the connection between social impact and financial returns may be quantifiable, and impact investing may become a generally accepted investment style.



These developments illustrate that the global movement toward social finance and impact investing is becoming influential enough for hedge fund managers to thoughtfully consider their part in this next phase of evolution. If they do, they could be potentially setting themselves up to compete for the 52 percent of assets currently allocated to impact investments through private equity and debt funds. Though the focus for hedge funds needs to remain largely on financial returns, there may be steps that managers may take in the direction of impact investing that will position them higher on the social spectrum. Whether remaining behind the scenes and influencing companies through direct investment, or launching impact-oriented funds or funds of funds, any efforts move the concept forward.

The elevation of goodwill through impact philosophy may create a win-win for the broader financial markets as well. As investors and the capital markets more broadly gain access to data illustrating that impact investment strategies drive value, impact investing is poised to scale, making it a sustainable strategy for hedge funds.

The global movement toward social finance and impact investing is becoming influential enough for hedge fund managers to thoughtfully consider their part in this next phase of evolution.



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The Center wishes to thank the following Deloitte client service professionals for their insights and contributions to this report:

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Kristen Sullivan, partner, Deloitte & Touche LLP
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The center wishes to thank the following Deloitte professionals for their support and contributions to the report:

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Deloitte Services LP
Michelle Chodosh, manager, Deloitte Services LP
Sallie Doerfler, senior market research analyst,
Deloitte Center for Financial Services,
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Industry marketing leader, Deloitte Services LP
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