ALTERNATIVES

An Introduction to Impact Investing

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Interest in impact investing is growing within the asset management industry, but there is still some confusion about it. We view impact investing's defining feature as the explicit intention to generate positive, measurable social and environmental outcomes alongside a financial return. In the first of a three-part series, our Franklin Real Asset Advisors team, in collaboration with consulting firm Tideline, provide an overview of what impact investing is—and isn't.

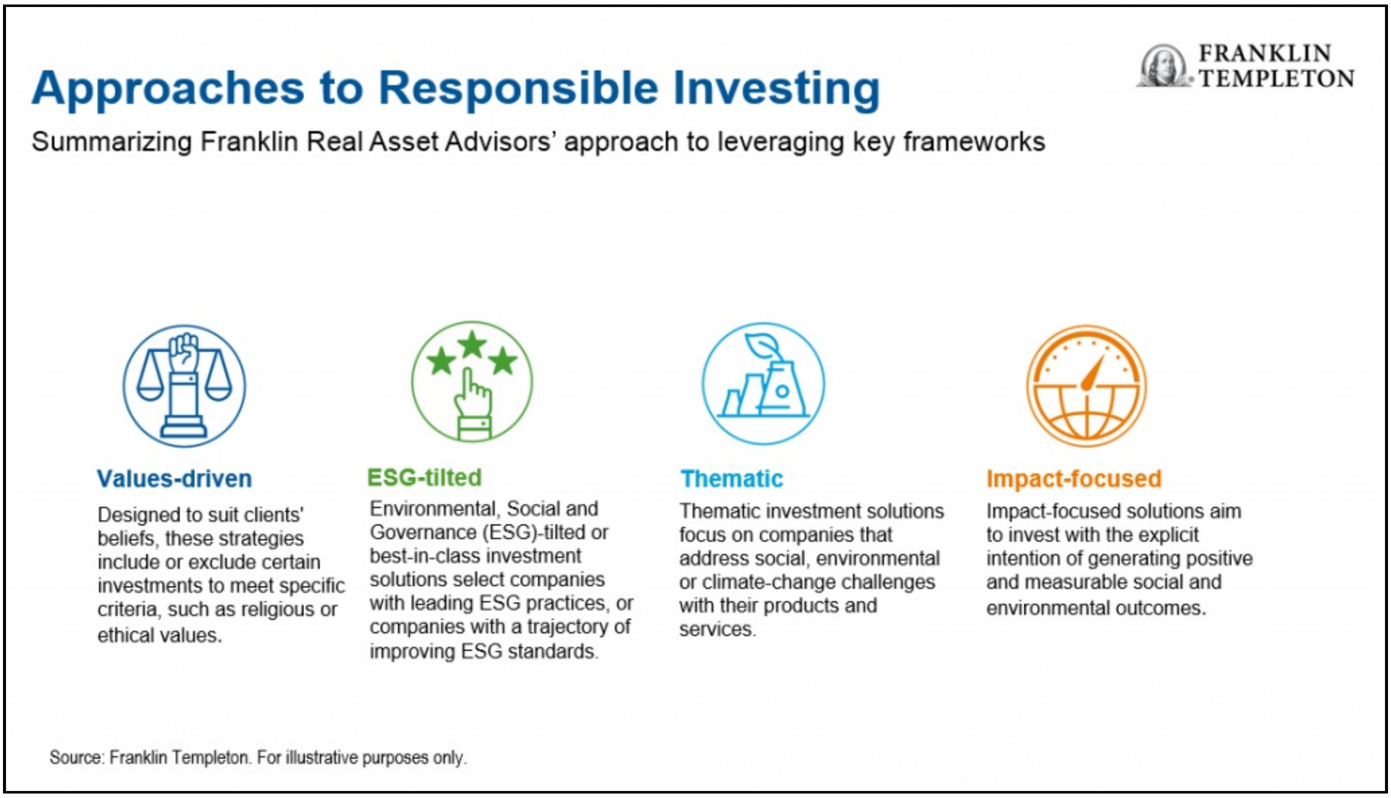
Impact investing is a form of responsible investing with the explicit intention to generate positive, measurable social and environmental outcomes alongside a financial return.

It is distinct from other sustainable and responsible investing strategies, including the exclusion of certain investments based on an investor's ethical or religious values; thematic investing, which focuses on sectors or trends that affect society, but does not intentionally seek impact outcomes; and environmental, social and governance (ESG)-tilted strategies, which focus on selecting companies based on their ESG practices and potential.

Each of these strategies may also incorporate material ESG factors (ESG integration) into fundamental research to provide a comprehensive view of an investment's value, risk and return potential.

The impact investing market is growing in both size and diversity. According to Global Impact Investing Network (GIIN) estimates, more than 1,340 organizations currently manage US$502 billion in impact investing assets worldwide.[1]

Impact investors have identified “win-win” opportunities where impact and financial returns align with and often reinforce one another, across a diverse range of sectors and asset classes. The latest survey from GIIN, for example, identified financial services, energy, microfinance, and food and agriculture as major sectors of focus and listed private debt, private equity, public equity and real assets as the most popular instruments for making impact investments.[2]



Source: Franklin Templeton. For illustrative purposes only.

Integrating Impact into the Investment Process

Impact investors are committed to understanding and improving the social and environmental benefits of their investments, and impact management has increasingly become the standard approach for doing so. A few years ago, impact investors were primarily concerned with quantifying and validating the impact of their investments, advocating for the practice of *measuring impact* ex post. As the practice has matured, the focus has evolved to managing impact over the lifetime of an asset.

Put simply, impact management is the process of determining which of an investment’s effects on people and the planet are relevant and trying to prevent the negative effects and increase the positive ones. In practice, impact management goes beyond impact measurement to integrate impact considerations into each stage of the investment process: from setting investment goals and conducting due diligence, to portfolio management and reporting.

The sheer number of initiatives and organizations involved in developing and systematizing impact management is indicative of the growing size and importance of this market. It also speaks to the impact industry’s complexity and need for multiple approaches.

Examples of these initiatives include the International Finance Corporation’s Operating Principles for Impact Management, the United Nations’ Sustainable Development Goals, the GIIN’s catalog of metrics and the Impact Management Project, to name a few.

As impact investing grows, the clarity and efficiency of impact management practices will likely continue to increase with the introduction of new frameworks and the refinement of best practices. Keeping pace with this constant evolution will require commitment from investors and managers. After all, continued improvement on impact management lies at the heart of achieving social and environmental outcomes through investment, with authenticity and rigor.

As part of the evolution of impact investing, many frameworks and tools have been developed to categorize and guide investments seeking positive social and environmental outcomes. There is no single, unified best practice or approach.

Most commonly, multiple frameworks are used in combination, along with some customized elements to fit an investor's strategy. According to a 2019 GIIN survey, respondents use a variety of metric sets and standard frameworks, among other methods.[3] The survey found most investors use a blend of these tools to understand and manage their impact.

To understand these frameworks and their roles in impact management, it is useful to classify them in five broad categories: objectives, standards, certifications, methodologies and metrics.

In our next post in this series, the team will dive into these "five building blocks" in more detail.

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1. Source: Global Impact Investment Network (GIIN): Sizing the Impact Investing Market, April 2019.

2. Ibid.