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/ ASSET MANAGEMENT

What to ask your asset manager: Developmental impact investing

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Overview

More access to unlisted and un-rated assets

Changes to Regulation 28 of the Pension Funds Act now afford investors higher allocations to alternative investments than before. Alternative investments are typically unlisted and without an official rating - which is no longer required under Regulation 28.

Infrastructure assets as building blocks

Although this is starting to happen more frequently, unlisted and infrastructure assets should not be seen as separate asset classes, as they need to fit within an already defined asset allocation strategy (which can involve debt, equity, or property) and commonly form the building blocks for developmental impact investment mandates. These assets are typically long term in nature and act as a natural asset/liability match for retirement funds – and they need to provide investors with sound, commercial risk/return attributes.

Project Bonds

The financing of infrastructure projects has become more difficult with stricter regulations on banks and their lending requirements since the global financial crisis. In addition, some retirement funds with fixed income mandates only allow investments in a listed form. To address these challenges, the JSE and The Association for Savings and Investment South Africa (ASISA) have been working together to create access to an alternative form of financing, namely, "Project Bonds". These will allow infrastructure-related projects to source funding from a new pool of capital via the listed debt portal of the JSE. Despite their "listed" nature, these project bonds carry the same level of risk as a typical "unlisted" project finance transaction.

By providing access to a sustainable vehicle to fund initiatives in the infrastructure and development space, pension funds invested in impact funds are able to gain exposure to sectors such as power, healthcare, transport, education, SMME development and housing, to name a few.

Impact washing

That said, there has been an increase in "impact washing", where investors are lured by clever marketing which is used to camouflage the underlying impact of their investments - or lack thereof. Pension funds need to critically assess their investments in developmental impact funds, to ensure that these are based on sound principles.

Clear, uncompromising mandates

As a first step, pension funds should define their social and developmental mandate before making an allocation into impact investments. This includes clarifying their objectives and the impact outcomes they want to achieve – without compromising on sustainable risk-adjusted returns for their underlying beneficiaries.

Questions to ask your manager

Here are some useful questions to ask your asset manager. These are collated from Futuregrowth's own experience in managing these complex unlisted alternative investments, and a range of frequently asked questions in client interactions over the past few years. These questions aim to assist pension funds when assessing alternative or developmental impact investment capabilities.

1. Impact mandates and sectors

Sectors that facilitate diverse impact include those that address South Africa's infrastructure backlog and those that historically had a lower deployment of capital. Most of these sectors are aligned with government's National Development Plan (NDP) goals and contribute to the economic and social development of South Africa, which, in turn, stimulates job creation.

The entire market has access to listed assets on an exchange – but these are limited to what is available on that exchange. The unlisted market, on the other hand, can provide investors access to a broader selection of assets, across a variety of infrastructure and developmental sectors not accessible to the listed market. These include transport, water, renewable energy, education, healthcare, affordable housing, agriculture and SMMEs. Some of these businesses can be in a niche market, where they may be difficult to replicate and have little competition.

Questions for your manager about the impact mandate and sectors:

- What is the impact investment approach of the fund?
- What social or developmental categories (or sectors) does the fund target?
- Is there sectoral diversity across the fund - or is the mandate limited to a single sector, e.g. is it a renewable energy fund, housing fund etc.?
- What is the geographical exposure of the fund?
- Do you consider all provinces and include rural areas when looking for deals for the fund? If not, why not?

2. Impact measurement

In addition to earning appropriate risk-adjusted returns, investors require compensation in the form of tangible social or developmental outcomes or impact.

Although measuring impact can be highly subjective, this aspect can be minimised by identifying tangible criteria to be used for measuring and reporting on impact. For example, metrics for an affordable housing investment could include the number of homes built, jobs created, and the extent of "green" building materials or technology used in the construction. It is possible to align impact and developmental objectives with concrete outcomes that are measurable and that do not compromise financial returns, when they are identified upfront.

Not all types of impact are created equal. Different investments have different degrees of on-the-ground impact. Providing low-income housing has a higher impact than, for example, holding a listed parastatal bond.

Questions for your manager about impact measurement:

- How is the social or developmental impact of the fund measured for the underlying investments and what criteria or indicators are used to measure the impact?
- How do you assess what is high impact vs low impact?
- Are the underlying investments linked to the Sustainable Development Goals (SDGs) and how is this reported?
- How many jobs have been created by the underlying issuers?
- How much local content is utilised in the design and development of the projects?
- What is the equity holding by BBBEE and/or the local community in the projects?

3. Manager track-record

In a low-return environment, impact investments can offer a good alternative to traditional investments in a diversified portfolio, but it is of utmost importance to choose an experienced investment manager who has the skills to both assess the risks and correctly price for them.

Investing in unlisted assets is complex, due to the additional layers of work that require highly specialised skills. We recommend that investors who choose alternative assets as part of their portfolio mix, always invest with partners who have a proven track record in managing investments in this asset class.

Questions for your manager about their track record:

- What is your demonstrable track record in managing complex alternative assets and impact mandates?
- What is the size of the investment team and what are the relevant skills of the various team members?

4. Risk and return on investment

The risk and return assessment on a listed asset versus an unlisted asset is almost the same. The only difference is that a higher liquidity premium would be added for an unlisted asset, which could result in a higher required rate of return over the life of the investment.

Questions for your manager about risk and return:

- What is the expected rate of return for the fund?
- Can the underlying investments be considered risky, e.g. for debt funding, what is the probability of default?

5. DFIs and subsidised finance

National government - through its departments, State-Owned Enterprises (SOEs) and Development Finance Institutions (DFIs) - has a substantial budget to facilitate national development. It is not the role of ordinary pensioners to be directly responsible for national development, except through the normal capital investment process.

One way pension funds can contribute to development is by partnering with DFIs, who receive funding from government to provide subsidised finance for infrastructure development. Here, institutional investors can choose how to deploy their money and the type of projects they wish to invest in - thereby responsibly targeting an appropriate risk-adjusted return to compensate for the related risk.

There is a role for subsidised financing to make some transactions bankable, and one way is through partnerships or co-investing with the DFIs.

Questions for your manager about DFIs and subsidised finance:

- Do you partner with government, and what percentage of the fund is allocated to DFIs and SOEs?

6. Liquidity

Investors often think that if an asset is more liquid it is less risky. If you were invested in African Bank shares or bonds before 2014, you would know that liquidity does not eliminate business risk and that liquidity is only beneficial when you can exit an investment before it sinks - and then probably at a deep discount.

Questions for your manager about liquidity:
- What are the minimum and maximum liquidity limits of the fund?
- How is fund liquidity managed, and how does this impact the deal pipeline?

7. Investment horizon
Investments in both unlisted and listed assets require a relatively long-term view, more so with unlisted assets due to the illiquid trading nature of these investments. There is no formal mechanism for trading unlisted assets and, due to their niche or developmental character, it may take longer to sell them. These investments may also need time to reach their optimal value.

Questions for your manager about the investment horizon:
- What is the investment horizon of the fund?
- Where in this cycle are the various deals in the fund currently sitting?

8. Ramp-up period
Depending on the cycle and deal flow within the fund, this could affect whether there is a waiting period or ramp-up phase before client monies are deployed.

Questions for your manager about the deployment of your money:
- Is there an investment (or ramp-up) period for a pension fund to access the fund?
- Historically, how quickly has client money been deployed in the fund, and what are the reasons for any anomalies?

Conclusion
The aim of these questions is to raise awareness and highlight some of the complex issues relating to alternative or developmental impact investments. They are also intended to assist pension funds to make informed decisions when assessing these investments. This includes assessing both financial and non-financial risks, and the developmental impact of these investments, as described above. It is part of our joint fiduciary duty to be an engaged, responsible investor when it comes to decisions that could materially affect the long-term sustainability of an investment.

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