IMPACT
MANAGEMENT
PROJECT

## An illustration of how we can build portfolios that match impact and financial goals with intentions and constraints

UBS

impactmanagementproject.com

# INTRODUCTION

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The Impact Management Project is a collaborative effort by over 700 organizations, from different contexts and countries, to agree on shared fundamentals for how we talk about, measure and manage impact – and therefore our goals and performance.

Shared fundamentals for describing the effects that different underlying businesses – or portfolios of businesses – have on people and planet help investors to understand the different options available to them within each asset class. Investors can then build a portfolio that matches their intentions, constraints, financial and impact goals.

Over the last six months, UBS has been working with the Impact Management Project on a series of model portfolios that illustrate different combinations of impact and financial goals. Those, along with insights we gained along the way, are showcased in this paper, in the hope that we can contribute to the ongoing discussion about how best to integrate impact considerations into asset allocation.

This report is the product of a series of discussions among a wide range of practitioners as part of the Impact Management Project. The report has been co-authored by UBS and the Impact Managment Project Team. Please direct any feedback or further enquiries about this report to:

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## Acknowledgements

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# CONTEXT SETTING

## What is our shared understanding of impact?

In finance, we use shared fundamentals about performance - such as return, volatility and liquidity - to describe and manage against our respective financial goals. We also use asset classes, which group investments with similar financial performance, to facilitate alignment with investor expectations. Financial capital flows, and the investment management ecosystem have grown, not just because we have common accounting standards but because we have evolved these shared fundamentals for communicating and aligning our expectations. It would be impossible to uphold any notion of "fiduciary duty" if we didn't.

For impact, we now have a shared understanding that all businesses – and therefore all investments – have effects on people and planet, both positive and negative. Our impact is the combination of our **material effects on people and planet**. Effects are material when they:

**1. Relate to important positive or negative outcomes (WHAT)**.

**2. Are significant (HOW MUCH)**, based on**:**

- how deep the effect is, based on data about whether the effect is a deep or marginal driver of the outcome
- how many people the effect occurs for, based on data about the number of people experiencing the effect
- how long the effect lasts for, based on the time from beginning of the effect to end of the effect
- how quickly the effect occurs, based on data about the time it takes for an business to generate its effect

**3. Occur for underserved people or the planet (WHO)**, where 'underserved' is defined as a population, species or the planet that does not currently experience – or have the opportunity to experience – the important positive outcome that the effect relates to, or is experiencing an important negative outcome as a result of the effect.

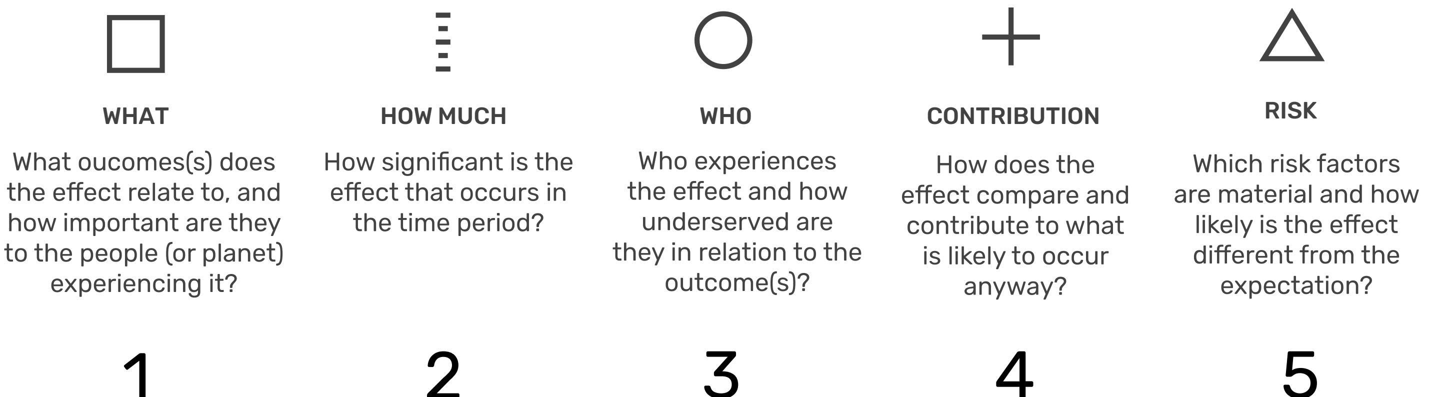
When deciding if and how to manage the material effects we are having, we also consider:

**4. Whether our role makes the effect better or worse than is likely to occur anyway (CONTRIBUTION)**, by benchmarking whether the effect:

- leads to more important positive or negative outcomes than are currently occuring for people or planet, and/or
- is more or less significant than the effect that people (or the planet) are currently experiencing, in terms of depth or the number of people it occurs for or how long it lasts for or how long it takes to occur, and/or
- occurs for people (or the planet) who are more or less underserved than those currently experiencing it

**5. The likelihood that the effect is different from our expectation (RISK).**

**Figure 1: Five dimensions of impact**




*For examples on each dimension please follow this link.*

# CONTEXT SETTING cont'd

## How can investors match their impact goals to relevant investments?

These five dimensions help us all to understand a business' material effects on people and planet - and therefore help investors to select investments that have the best likelihood of meeting their impact goals.

In reality, most business models generate a range of good and bad effects. For example, businesses with harmful products or sourcing practices might support high quality jobs in an economically distressed community. Conversely, business models that provide life-saving services might cause significant environmental emissions, nonbiodegradable waste, or require animal testing. Since positive and negative effects do not cancel each other out (except in cases such as carbon emissions), impact management involves investors having to decide that achieving a certain material positive effect is worth, at a point in time, generating a possible negative effect. But impact management still means setting goals to try to mitigate that negative effect over time.

The extent to which businesses set goals to prevent negative impact and increase positive impact depends on their intentions.

These intentions tend to fall into three broad archetypes:

- Those who try to avoid harm to people and planet, either because they care about being responsible citizens or because they want to mitigate risk, or both
- Those who do not just try to avoid harm but also want to generate benefits for people and planet, either because they believe that businesses that have positive effects on the world will sustain long-term financial performance or because they believe that businesses should serve society, or both
- Those who try to avoid harm and generate benefits for people and planet but also want to go further and contribute significantly to solutions to specific social or environmental challenges.

These intentions inform impact goals across the five dimensions, as shown in Figure 2 below. Taken together, the five dimensions therefore provide a lens for an investor to understand the impact goals of different businesses and the extent to which investment in those businesses fits with the investor's own intentions.

For example, if an investor wants to use some of their capital to help everyone in the world have the opportunity to achieve good health (Sustainable Development Goal number 3 - "WHAT") she or he cannot assume any investment in healthcare is relevant. The investor will want to support business models that not only set goals to prevent material negative effects but also set goals to have a significant effect ("HOW MUCH") on the health of underserved people ("WHO"), resulting in an improvement of the situation relative to what would otherwise happen ("CONTRIBUTION"), with any risk of impact failure ("RISK") justified by the level of positive impact if things go as planned.

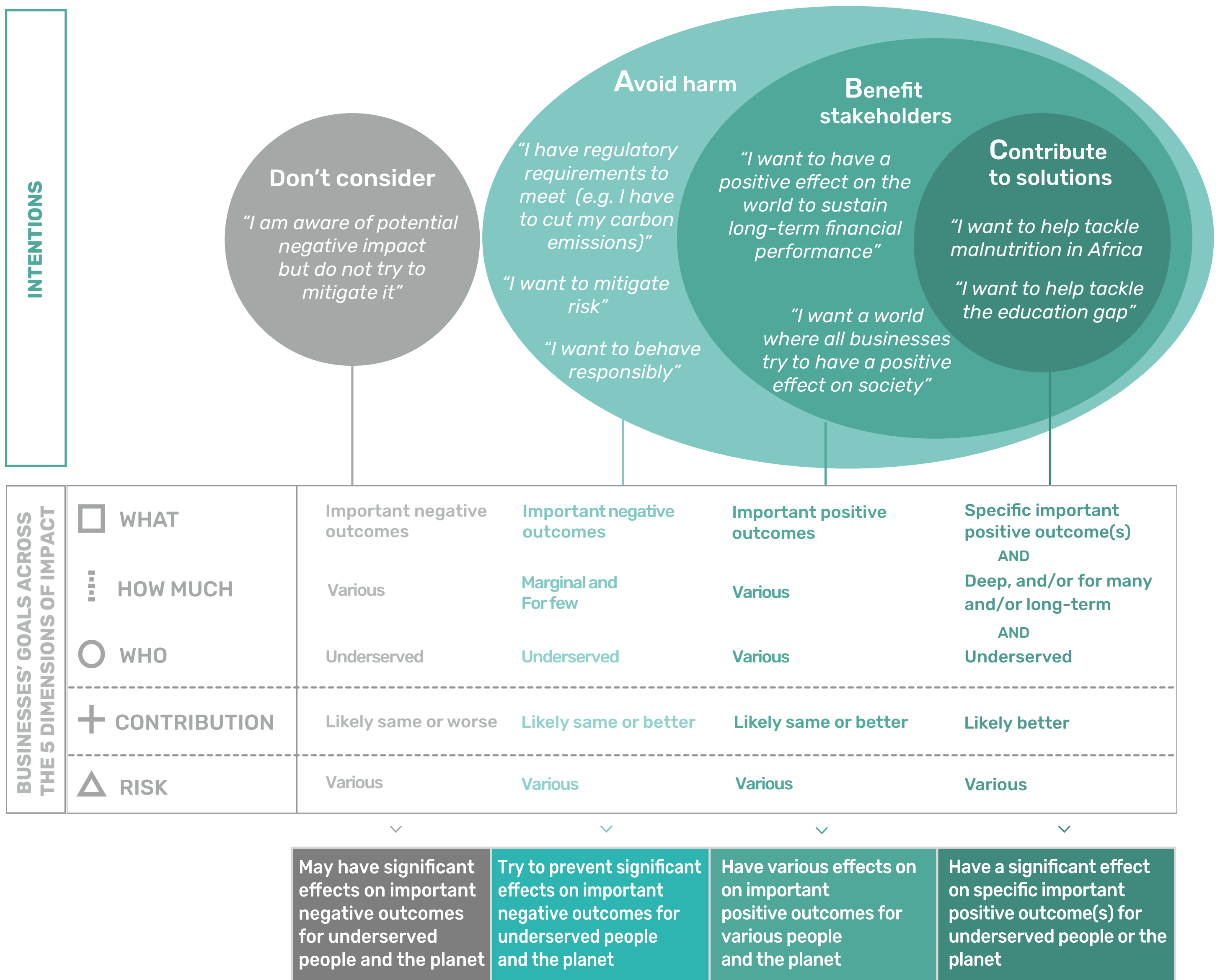
By focusing on an outcome (such as good health) rather than a sector (such as healthcare), the dimensions also widen the array of business models that investors might consider. For example, education and clean energy (e.g. solar that replaces kerosene) are both significant drivers of good health for some underserved populations.

The dimensions are equally useful for investors whose impact intention is driven by risk mitigation. For example, investors in large consumer goods corporations, who want to reduce the risk that their raw commodities are not sufficiently available, will want to know whether they are having a significant effect on important negative outcomes for farmers (WHAT and HOW MUCH), who their farmers are and how underserved they feel (WHO), whether the corporation is in a position to make the situation better than it would likely be otherwise (CONTRIBUTION) and how confident they are about these effects (RISK).

# CONTEXT SETTING cont'd

**Figure 2: Impact goals of businesses**

The five dimensions provide a lens for an investor to understand the impact goals of different businesses and therefore the extent to which investment in those businesses fits with the investor's own intentions.



# CONTEXT SETTING cont'd

The impact goals of an investment are a function of the impact goals of the underlying business, or portfolio of businesses, that the investment supports (as shown on the previous page), plus the ***contribution*** that the investor makes to enable the business(es) to achieve those impact goals.

Investors use a variety of strategies to contribute to businesses' ability to generate impact. They can:

- **Signal that impact matters**: choose not to invest in or to favour certain investments that, if all investors did the same, would ultimately lead to a 'pricing in' of effects on people and planet by the capital markets more broadly. Some people think of this as 'values alignment'.
- **Engage actively**: use expertise and networks to improve the environmental/societal performance of businesses. Engagement can include a wide spectrum of approaches - from dialogue with companies to investors taking board seats and using their own team or consultants to provide hands-on management support (as often seen in private equity). While a significant dialogue with companies, including about environmental, social and governance factors, is a normal part of the fund management process, the phrase 'engage *actively*' reflects a strategy that involves, at a minimum, significant proactive efforts to improve businesses' effects on people and the planet.
- **Grow new or undersupplied capital markets**: anchor or participate in new or previously overlooked opportunities that offer an attractive impact and financial opportunity. This may involve taking on additional complexity, illiquidity or *perception* of disproportionate risk. In public equities, bonds or infrastructure, an investor might move from holding mainly well-subscribed issuances (which is just a signalling strategy) to participating in a higher proportion of undersubscribed issuances.
- **Provide flexible capital**: recognise that certain types of businesses will require acceptance of disproportionate risk-adjusted return in order to generate certain kinds of impact. For example, creating a new market for previously marginalised populations can require very patient capital that cannot offer a commercial return.

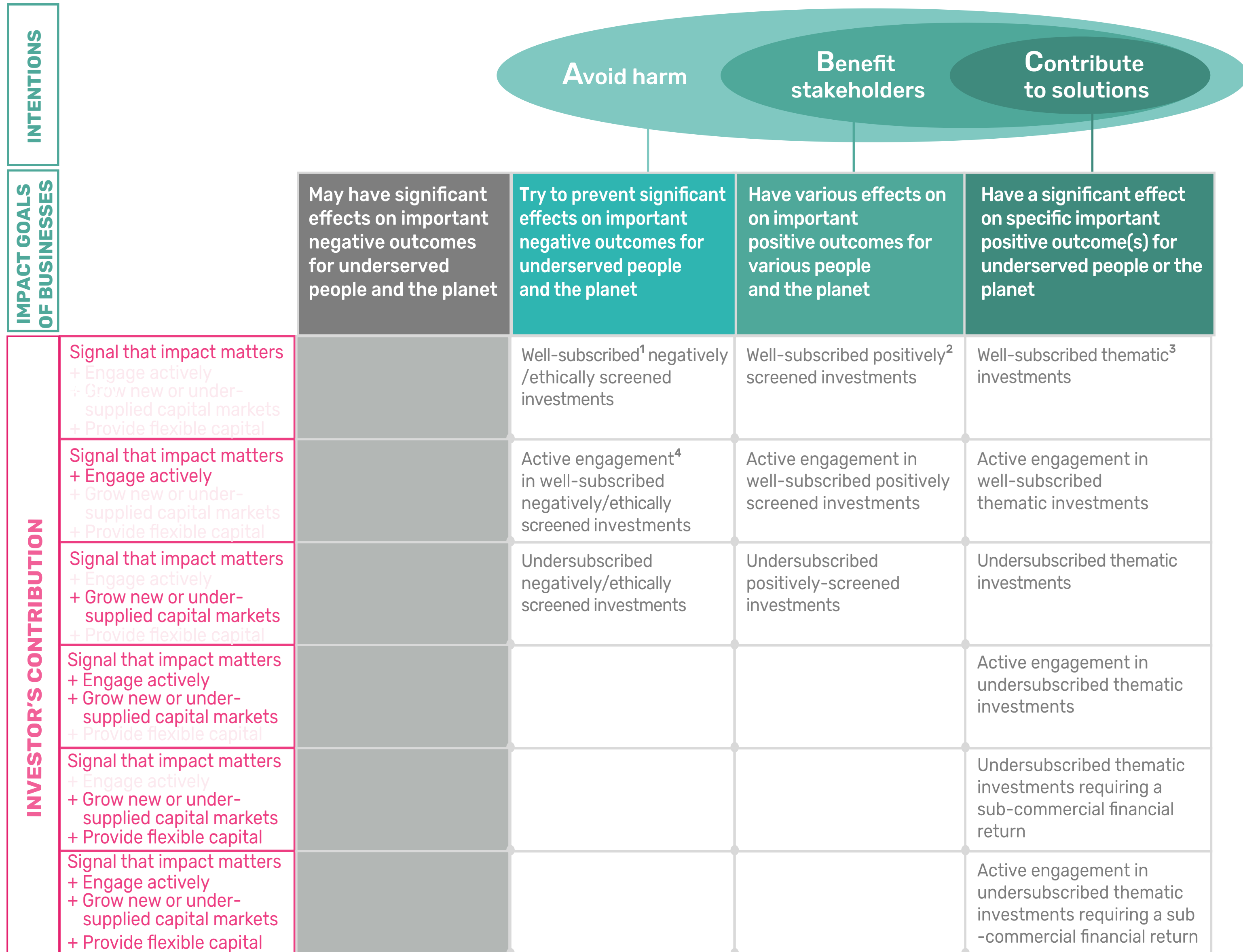
The types of contribution that we make are driven by our constraints as much as our intentions. For example, a smaller retail investor, who does not have the expertise to engage directly with businesses and who needs significant liquidity may be satisfied with making a different type of contribution than the one that a foundation or an ultra-high net worth individual might want to make.

The resulting table (see Figure 3) brings together the impact goals of the businesses being invested in and the strategies that investors themselves use to contribute to impact. This allows us to plot the landscape of relevant investment options currently available to investors. An investor can plot their existing portfolio and then transition that portfolio over time to be impactful in the way that they wish, given their intentions and constraints.

# CONTEXT SETTING cont'd

**Figure 3: The landscape of investment opportunities**

The impact goals of an investment are a function of the impact goals of the underlying business, or portfolio of businesses, that the investment supports (x-axis), plus the investor's ***contribution*** to enable the business(es) to achieve those impact goals (y-axis). The table below therefore plots the landscape of relevant investment options currently available to investors.




| Investor's contribution | May have significant effects on important negative outcomes for underserved people and the planet | Try to prevent significant effects on important negative outcomes for underserved people and the planet | Have various effects on on important positive outcomes for various people and the planet | Have a significant effect on specific important positive outcome(s) for underserved people or the planet |
|---|---|---|---|---|
| Signal that impact matters | | Well-subscribed[1] negatively /ethically screened investments | Well-subscribed positively[2] screened investments | Well-subscribed thematic[3] investments |
| Signal that impact matters + Engage actively | | Active engagement[4] in well-subscribed negatively/ethically screened investments | Active engagement in well-subscribed positively screened investments | Active engagement in well-subscribed thematic investments |
| Signal that impact matters + Grow new or under-supplied capital markets | | Undersubscribed negatively/ethically screened investments | Undersubscribed positively-screened investments | Undersubscribed thematic investments |
| Signal that impact matters + Engage actively + Grow new or under-supplied capital markets | | | | Active engagement in undersubscribed thematic investments |
| Signal that impact matters + Grow new or under-supplied capital markets + Provide flexible capital | | | | Undersubscribed thematic investments requiring a sub-commercial financial return |
| Signal that impact matters + Engage actively + Grow new or under-supplied capital markets + Provide flexible capital | | | | Active engagement in undersubscribed thematic investments requiring a sub -commercial financial return |

**Notes to Figure 3**

[1] **Well-subscribed** refers to any investment for which there is high competition from investors and which would therefore likely be funded anyway (versus undersubscribed investments that grow new or under-supplied capital markets)

[2] **Positively-screened** investments include the use of deep 'ESG integration' as an approach to investment selection and management

[3] **Thematic** investments refer to any investment that targets a specific important positive outcome, or set of outcomes, for underserved populations

[4] **Active engagement** refers to a strategy that involves, at a minimum, significant proactive efforts to improve businesses' effects on people and the planet

# CONTEXT SETTING cont'd

## How do such investments relate to asset classes?

Investments that have impact goals are not a separate asset class; they are a strategy that can be applied across asset classes whose financial characteristics they reflect. Table 1 maps the kinds of investment shown in Figure 2 to the traditional asset class in which they might fall.

**Table 1: Mapping investment products with impact goals to their relevant asset class**

| Asset class | Equivalent investment products with impact goals | Examples |
|---|---|---|
| **High grade bonds Government bonds** | Thematic* bonds issued by Multilateral Development Banks/Development Finance Institutions/Governments | DFI- and Supranational bonds to finance economic development that benefits underserved people; Sovereign-backed social bonds (e.g. those enabling vaccine delivery to underserved people); Green bonds issued by Multilateral Development Banks; |
| **Corporate bonds** | Ethically and/or negatively screened corporate bonds | Bonds issued by businesses avoiding products/practices that have a significant effect on important negative outcomes (e.g. gender inequality) |
| | Positively screened corporate bonds | Bonds issued by businesses that demonstrate positive effects on important outcomes for people and planet |
| | Thematic corporate bonds | Corporate green bonds issued by businesses where proceeds are earmarked for projects that have a significant effect on specific important positive outcomes for the planet; Development Finance Institution-Syndicated loans providing participation in DFI-originated loans to private sector borrowers who have a significant effect on specific important positive outcomes for underserved people/the planet |
| **Global equities** | Ethical and/or negative screening in public equities | A public equities fund selecting businesses that screen out or try to avoid/reduce products and practices that have a significant effect on important negative outcomes for people and planet |
| | Positively screened public equities | A public equities fund selecting businesses that have positive effects on important outcomes for people and planet (without engagement) |
| | Active engagement in negatively and/or positively screened public equities | A public equities fund actively engaging to prevent businesses having significant effects on important negative outcomes for people and planet and/or engaging with businesses that already demonstrate positive effects to improve performance further |
| | Thematic public equities | A public equities fund screening for businesses that have a significant effect on specific important positive outcomes for underserved people/the planet (e.g. businesses making a material contribution to one or more SDGs) |
| | Active engagement in thematic public equities | A public equities fund screening for businesses that have a significant effect on specific important positive outcomes for underserved people/the planet and engaging with them to improve performance further |
| **Other alternatives** | Thematic structured debt product with medium liquidity | A structured debt fund for businesses that have a significant effect on specific important positive outcomes for underserved people/the planet (e.g. a microfinance fund) |
| **Private market investments** | Ethically and/or negatively screened private debt | A private debt fund that ethically and/or negatively screens businesses that have a significant effect on important negative outcomes (e.g. illness due to tobacco) |
| | Positively screened infrastructure | An infrastructure fund screening for investments with positive ESG performance |
| | Positively screened real estate | A real estate fund screening for investments with positive ESG performance |
| | Thematic private equity/ venture capital investments | A private equity fund for businesses that have a significant effect on specific important positive outcomes for underserved people/the planet (e.g. a PE fund growing new models that improve educational outcomes for underserved people). |
| | Thematic real estate | A real estate fund for businesses that have a significant effect on specific important positive outcomes for underserved people/the planet (e.g. an affordable housing fund) |
| | Thematic private debt | A private debt fund for businesses that have a significant effect on specific important positive outcomes for underserved people/the planet (e.g. an debt fund focused on improving income for smallholder farmers) |
| | Thematic infrastructure | An infrastructure fund for investments that have a significant effect on specific important positive outcomes for underserved people/the planet (e.g. a social infrastructure fund) |

Bonds Equities Alternatives

* This category includes both general issuances by MDBs to finance a wide range of positive outcomes that these institutions consider important for achieving sustainable development that is inclusive of underserved people, as well as bonds that have a specific pre-determined use of proceeds (e.g. immunization for underserved children).

# MODEL PORTFOLIOS

## Introduction

As shown above, investments that have impact goals can often be categorised according to standard financial drivers. The following pages describe how we have modelled a series of portfolios to show how traditional asset allocation principles can be used to build a realistic portfolio that satisfies both the need for investment efficiency (i.e. offering the highest expected investment return for a given level of risk) and the desire of an increasing population of investors to incorporate impact goals into their investment decisions.

During this process, we confronted a variety of questions and challenges. By elaborating some of these hurdles, as well as the insights gained along the way, we hope to contribute to the ongoing discussion about how to integrate impact goals into asset allocation and inspire other market participants to take up some of the related challenges.

## Recapping strategic asset allocation

By categorising investments with impact goals according to standard financial drivers, the traditional framework for portfolio construction can be used to guide our allocation to investments with impact goals. We re-cap this framework below.

A multi-asset class portfolio approach is based on the principle of diversification of risks and returns. The aim is to achieve investment goals with the lowest possible amount of risk and uncertainty over a longer period of time (typically five years or more). We believe that the only free lunch in finance is diversification. Thanks to the fact that different asset classes behave differently at different stages of the business cycle, combining them into a well-diversified portfolio helps to reduce volatility of returns meaningfully. In particular, in times of market stress, different asset classes typically move in different directions. The challenge is to find optimal combinations of asset classes to achieve the best possible return for any given level of volatility.

The building blocks of such a portfolio include the traditional asset classes of government bonds, investment grade corporate bonds, high yield bonds and public equities, and can be complemented by private equity and private debt instruments.  In investment language, the Strategic Asset Allocation (SAA), which defines the long-term allocation of the portfolio across asset classes, determines most of the risk and return of the portfolio. Tactical short-term shifts or instrument selection are additional drivers of risk and return.

The SAA structures a portfolio at the asset class level to match the specific investment objectives and risk tolerance of investors. Constructing an SAA is both an art and a science; good practice requires a robust quantitative framework and seasoned judgment. The combination of the quantitative and qualitative inputs results in a set of capital market assumptions (CMAs), representing volatility, correlations, and return expectations for each asset class.

Constructing portfolios or SAAs based on optimal risk and return trade-off includes testing portfolios across historical and possible future market stress scenarios. SAAs and CMAs should be reviewed regularly, to assure that portfolios and expected returns are anchored on long-term views and account for structural market adjustments over time. Given the variation among investments that have impact goals, as well as the limited evidence base to-date, our approach assumes that investors carefully assess both top-down (macroeconomic, market-specific characteristics and asset class proxy modelling) and bottom-up (security or deal-specific) considerations when creating CMAs.

# MODEL PORTFOLIOS cont'd

## Our approach

Incorporating impact goals into the asset allocation thought process adds another dimension to portfolio construction. As mentioned, there are multiple ways of including impact goals in an investment portfolio or a set of SAAs. Different investors have different impact goals (see Figure 3 above). Importantly, investors also differ in the degree to which they want to focus their portfolio on impact. Based on conversations with asset owners and investment managers, we have opted to show the evolution of a traditional portfolio rather than building an impactful portfolio from scratch, because this reflects the experience of a large proportion of investors to date. We hope that this will help investors to recognize their particular stage of engagement compared to their envisioned stage. At the end of this process is an aspirational portfolio – not suitable or possible for everyone but helpful for understanding what is available to fiduciary investors looking to combine impact with their financial goals.

## Model portfolios

The model portfolios we developed should therefore be seen as illustrative examples of how a traditional portfolio, without impact goals, could evolve into one with impact goals. See Portfolios A-D below for potential stages of this evolution.

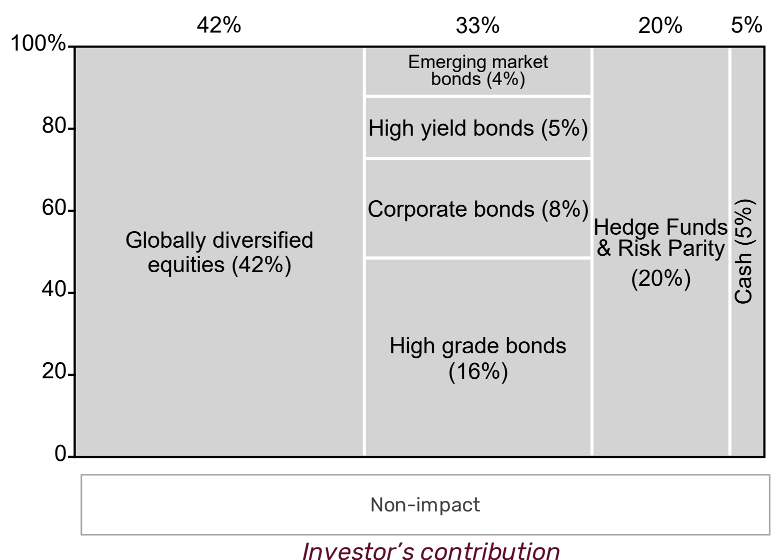
These model portfolios are built for a medium/balanced risk profile targeting an annual volatility of 7–8%. Our aim was to keep volatility roughly stable as we move from a traditional portfolio without impact goals (portfolio A) to a more aspirational portfolio (portfolio D).

To make the incorporation of impact goals an appealing choice for a wider audience, we considered that the portfolio should aim for expected returns close to, or in line with, market returns. While this assumption again does not hold true for every investor seeking impact, we think it is crucial to attract a considerable portion of both private, as well as institutional investors, for whom market returns often are a regulatory requirement[1].

**Portfolio A** is a traditional portfolio with a medium/balanced risk profile.

[1] *The Impact Management Project will be releasing a companion piece to this paper with Root Capital, demonstrating how investors who can be more flexible about their financial goals might maximize, within a single asset class, for a joint function of financial risk, return and impact (based on the five dimensions).*

**PORTFOLIO A**
Exp. 7yr return 5.4%
Exp. Volatility 7.9%



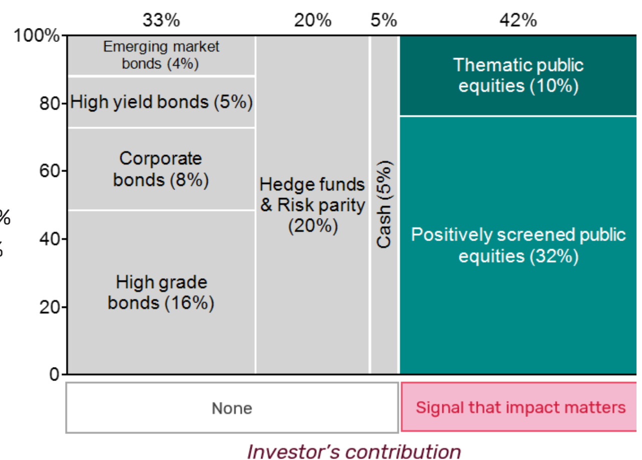
# MODEL PORTFOLIOS cont'd

To move to **Portfolio B**, we suggest positively screening the public equities allocation and adding some thematic equity exposure, such as public equities that have a significant positive effect on climate change or health for underserved people. According to our estimates, this does not meaningfully change the risk/return profile of the portfolio.

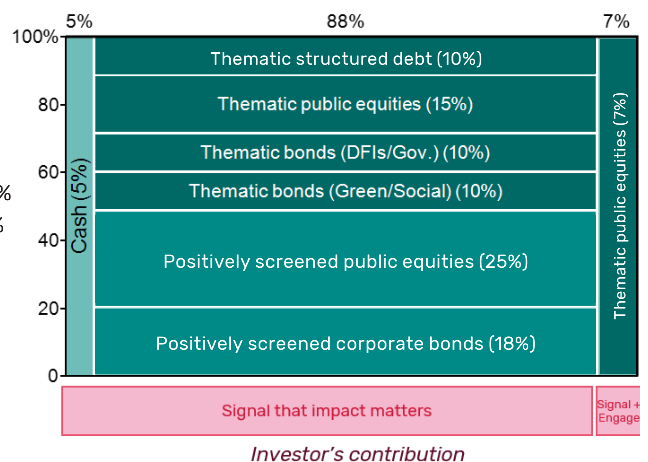
**Portfolio C** replaces the remaining investments in portfolio B with substitute investments that have impact goals. The fixed income allocation is moved into positively-screened corporate bonds and some thematic bonds (e.g. green bonds). In public equities, thematic products are incorporated, including some where active engagement is used to influence impact. As strategies that have impact goals are not available within Hedge Funds at the moment, we have looked for a partial alternative within structured debt. Again, we do not expect such a shift to alter the financial risk/return profile meaningfully.

While the Sharpe ratios of portfolios A-C are very similar (~0.4), you can see that the aspirational **Portfolio D** has a significantly higher expected return. This is due to the increased allocation to less liquid asset classes in portfolio D, which in the medium term offers a better risk-adjusted return outlook (also see Key Insight #3 below). Portfolio D also shows how an investor can shift their contribution to impact by deliberately favouring investments (across a range of asset classes) that are under-subscribed and therefore grow new markets.

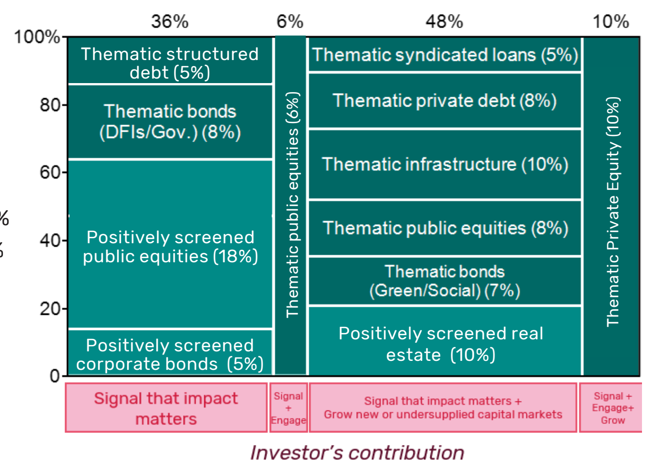
**PORTFOLIO B**
Exp. 7yr return 5.4%
Exp. Volatility 7.9%




**PORTFOLIO C**
Exp. 7yr return 5.3%
Exp. Volatility 7.5%




**PORTFOLIO D**
Exp. 7yr return 7.3%
Exp. Volatility 7.3%




Legend

| Try to prevent significant effects on important negative outcomes for underserved people and the planet | Have various effects on on important positive outcomes for various people and the planet | Have a significant effect on specific important positive outcome(s) for underserved people or the planet |
|---|---|---|

## How to read the portfolio charts

We are using a Marimekko chart to express three dimensions of the portfolio: the investor's contribution strategy (expressed on the x-axis), the different investment types deployed within each contribution strategy (expressed on the y-axis) and the impact goals of the underlying businesses in the portfolio (expressed through different shades of green). For example portfolio B contains 58% of products that do not have impact goals, whilst investors 'signal that impact matters' with 42% of their allocation (indicated on the x-axis). Looking at the y-axis, we can then see that 'thematic public equities' constitute c.24% of all public equities. To calculate the total allocation to thematic equities across the whole portfolio, we multiply the x-axis percentage (42%) and the x-axis percentage (24%) which results in 10% of the total portfolio being allocated to thematic public equities. Lastly, the green shading indicates the impact goals of businesses that these investments support. For example, in portfolio B the impact goals of the allocation to thematic equities are to have a significant effect on specific important positive outcomes for underserved people or the planet.

# INSIGHTS

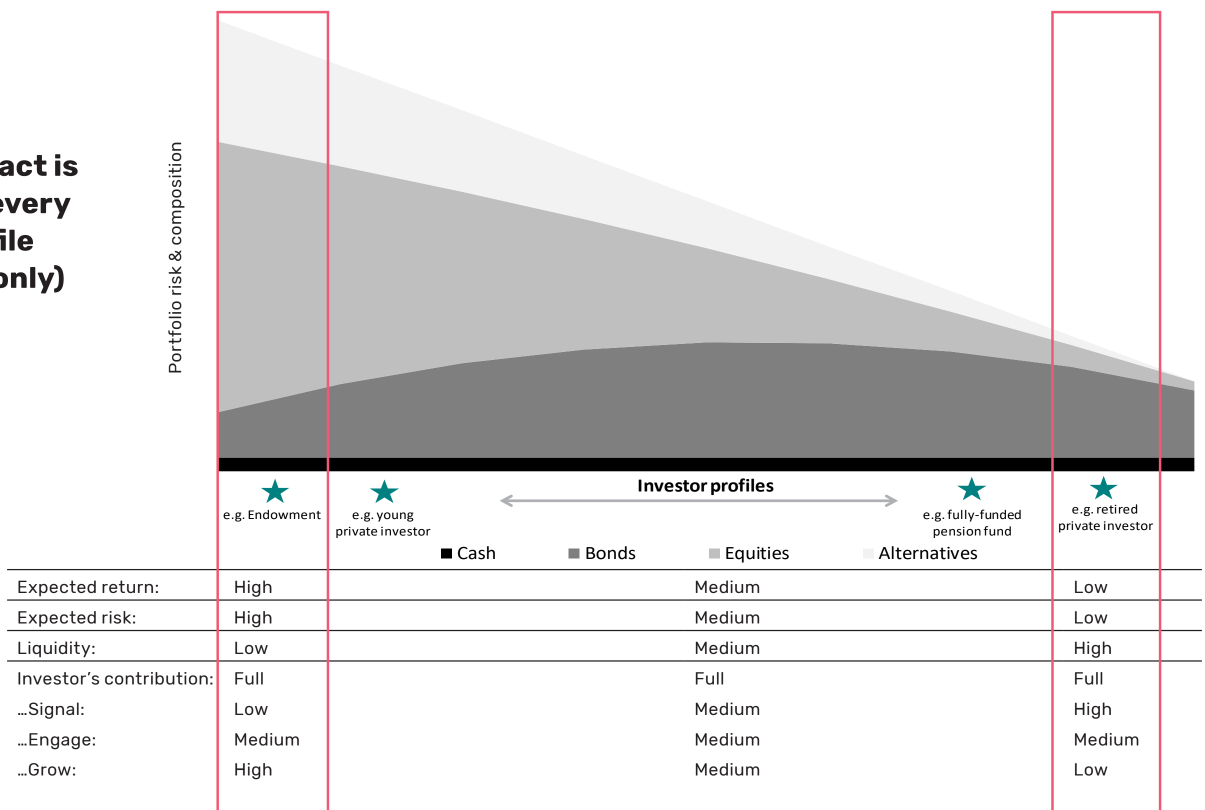
## #1: Anyone can invest for impact

Given the relatively wide range of investments that incorporate impact goals available by now, we believe that portfolios that incorporate impact considerations can be set up for any risk profile. There is a suitable portfolio that incorporates businesses with impact goals for any combination of investor preferences (in terms of financial return, volatility and liquidity), since we think traditional asset classes can be substituted by investments in businesses with impact goals (as illustrated in Table 1 above).

Figure 5 below shows that it is the nature of the investor's contribution to impact that may shift over time. From left to right the portfolio risk declines as the allocation to equities and (mostly illiquid) alternative investments is reduced in favor of bonds. As equities and alternatives are reduced, there will be a natural re-allocation across different strategies of investor contribution (and likely impact themes), based on the availability of investments in the various asset classes.

## #2 Product availability today limits the specific type of impact goals that investors can satisfy

Individual investor preferences to engage in certain well-defined areas (e.g. climate change or gender equality) could to some degree be considered by adapting exposure within the equity themes allocation, for example, but is generally beyond the scope of our modelling for now. Looking at the currently available product shelf of investments that have impact goals, we find that "climate change" in particular is over-represented as an available investment theme (e.g. through thematic bonds or equity funds focused on the reduction of carbon emissions), while other areas (e.g. food or gender equality) would deserve more attention in the future.




| | | | |
|---|---|---|---|
| Expected return: | High | Medium | Low |
| Expected risk: | High | Medium | Low |
| Liquidity: | Low | Medium | High |
| Investor's contribution: | Full | Full | Full |
| ...Signal: | Low | Medium | High |
| ...Engage: | Medium | Medium | Medium |
| ...Grow: | High | Medium | Low |

**Figure 5: Impact is possible for every investor profile (illustration only)**

## #3 The trade-off may be with liquidity, rather than competitive financial returns – but the illiquidity premium is attractive

As many of the asset classes in the impact universe are relatively young, track records and widely accepted benchmarks still have to be developed for most of them. To estimate capital market assumptions (CMAs), we therefore decided to rely on market expertise. Expected risks and total returns were estimated by our asset class experts working closely together with dedicated experts in the field of impact and sustainability. Their estimates rely on a mix of historical market data, comparisons with traditional asset classes (where more data is available), public research studies, discussions with external experts and product providers.

Based on the work above, we found that there's not necessarily a trade-off between expected impact and expected financial return, but rather between expected impact and liquidity. Many opportunities that are attractive from an impact perspective are found in less liquid asset classes, such as private equity or real estate. Investors must solve this trade-off in line with their personal intentions and constraints. In our aspirational portfolio (Portfolio D), we accept a higher degree of illiquidity in order to shift the impact goals of the portfolio. This "Endowment approach" to investing has the positive side effect of increasing expected risk-adjusted financial returns, as the illiquidity premium adds to the return outlook. It also helps to align the investment time horizon with that of many impactful projects, which can require a longer-term timeframe.

## #4 To date there may be higher cost to implementation

While we focused mostly on constructing a top-down portfolio with impact goals, implementation questions have to be considered before deciding on any concrete portfolio. We proceeded under the assumption that implementation and transaction costs of investments that have impact goals are similar to those for traditional investments. Time will tell if this assumption holds true. It is likely that in early stages of an asset class's lifecycle, implementation costs are somewhat higher, since buyers and sellers are still rare, but costs should diminish as more investors are attracted and the asset class grows.

## #5 There are currently limits to tactical asset allocation (TAA)

The relatively smaller and potentially less liquid universe of investments that have impact goals put some limitations on tactical asset allocation as well as instrument selection. This likely reduces the potential for alpha generation (additional to expected SAA returns), compared to traditional portfolios. We will need to collect more information to establish evidence and test whether this assumption holds.

## #6 Many asset classes are available but there are product gaps, which also means opportunities

While we wanted to present a realistic portfolio that could be implemented more or less immediately with instruments available in the market today, we also wanted to identify gaps in the current asset class universe to facilitate a discussion between investors and product providers about the future advancement of products. Below we discuss the different asset classes in more detail, and also identify some gaps we discovered in the current universe of investments that have impact goals.

- **Fixed Income (FI)**: Opportunities for corporate bond investors to influence companies actively are more limited than for shareholders, but there is a growing awareness about ESG on the FI side. Thematic bonds issued by Multilateral

Development Banks (MDB) and Development Finance Institutions (DFI) offer a relatively liquid high-grade bond alternative. Thematic bonds such as green bonds issued either by companies or institutions are an interesting and growing asset class with similar characteristics to traditional high grade/investment grade bonds. Direct exposure to public high yield or emerging market bond issuers seems difficult to get at this point. Social Impact Bonds (SIBs) and Development Impact Bonds (DIBs) are an interesting asset class offering diversification potential (because returns are directly linked to delivery of social outcomes rather than the economic cycle) but the asset class is very small and very diverse, so we do not consider it explicitly here. Additionally, SIBs and DIBs are still a relatively new investment product and returns are as yet unproven. At the moment, investors interested in SIBs/DIBs could treat it as part of their private debt/private equity exposure.

- **Equities:** Different approaches can be included here to support businesses with different impact goals and enable different types of investor contribution. A thematic equity allocation can be introduced to contribute to solutions to specific social or environmental challenges (e.g. climate change or poor health) and investors can shift their contribution from just signalling to active engagement to improve big businesses' effects on people and planet. Exposure to clearly defined regions / countries is more difficult to get than with traditional equities, so we decided to go for globally diversified equities including developed and emerging markets. Also, we have assumed a tracking error in line with what is currently observed in the traditional global equity market. This area deserves further research as we accumulate more transaction data over time.
- **Hedge Funds:** The universe of dedicated impact hedge funds seems small to non-existent for now, but would be an asset class that could contribute to portfolio diversification, if more products were developed. In particular long/short fund structures could be well suited to send strong messages and influence company behavior in a positive way.
- **Private Markets:** Thematic impact can best be achieved when illiquid investments (private equity, private debt, real estate, infrastructure) are included in the portfolio. We generally think the illiquidity premium is attractive and to-date underappreciated by many private investors.
- **Regions:** We were surprised to find that within the wider universe of investments with impact goals, emerging market investments seem to be relatively scarce compared to investments in developed regions, in particular in the US, while there certainly are thematic investments focusing on emerging markets, we particularly see a lack of EM-focused products within the more liquid space of investments that have impact goals. This is despite our belief that the largest amount of impact should be expected in under-developed regions. After all, developing nations are facing an annual investment gap of USD 2.5 trillion to fund just the basic Sustainable Development Goals (SDGs), according to UNCTAD estimates. We therefore see scope for product development focusing particularly on emerging markets, which would also add to diversification opportunities for asset allocators.

## #7: Behavior under stress

The relatively short history of many asset class offerings to target impact makes it difficult to perform meaningful stress tests for impact-oriented portfolios. Looking ahead, it remains to be seen how investments that have impact goals perform relative to traditional ones. For instance, there is some tentative evidence that growing asset classes, such as microfinance, have offered lower draw-downs and fewer "fat tail events" in recent years, as investors targeting impact tend to be stickier and thus demand for impact-oriented investments does not fluctuate as heavily as for traditional asset classes.

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