STATE OF THE MARKET

EVERCORE | Private Funds Group

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STATE OF THE MARKET 2024

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Designing and building private market impact portfolios

BY GEORDIE COX, SENIOR INVESTMENT MANAGER AT CARDANO

Private impact strategies raised c.€72 billion across 2022 and 2023[1] in what was a record two years for impact fundraising globally. In 2022, TPG Rise Climate raised over €7 billion from more than 500 investors.[2] Impact investing in private markets is now statistically relevant within private markets; yet for most allocators, it remains niche and (relatively) unconsidered.

If we adopt terms from the Everett Rogers innovation adoption curve,[3] over the last five years, impact investing has moved beyond the realm of the "Innovators" – smaller, impact native investment firms along with charity and development finance institutions – and is now being considered by "Early Adopters", namely first-moving General Partner ("GP") platform extensions and more sophisticated institutional Limited Partners ("LPs").

If the current adoption rate continues, which we believe it will, the question then becomes whether asset owners and institutional investors can afford not to consider it. Our clients are already asking about how to integrate an impact approach into their portfolios at scale and more asset owners are likely to follow suit.

Within the context of impact investing, we would count ourselves amongst Rogers' Innovators. At Cardano, several teams have been incubating, seeding and investing in private impact for more than 15 years. We have tried different strategies and learnt several lessons. Drawing from that experience, we are now helping our "Early Adopter" pension and endowment clients to design and build impact investment portfolios from first principles. We have made some key observations along the way, so here is an allocator's perspective on how to design and build impact portfolios.

To those who wonder whether impact investing at scale is a challenge, it certainly is! There are only modest amounts of quality institutional product today, track records are limited and there is a high degree of regulatory scrutiny that is only growing. Nevertheless, we firmly believe that, when applied through a deliberate design approach, impact investing has a place in an institutional portfolio. The right approach will not only deliver against risk-return objectives, it can also act as a meaningful and positive change-driver to some of the biggest challenges being faced by society and the global economy.

What is Impact Investing?

Cardano's definition of impact investing is investing with the intent to contribute to measurable social or environmental impact alongside a financial return.

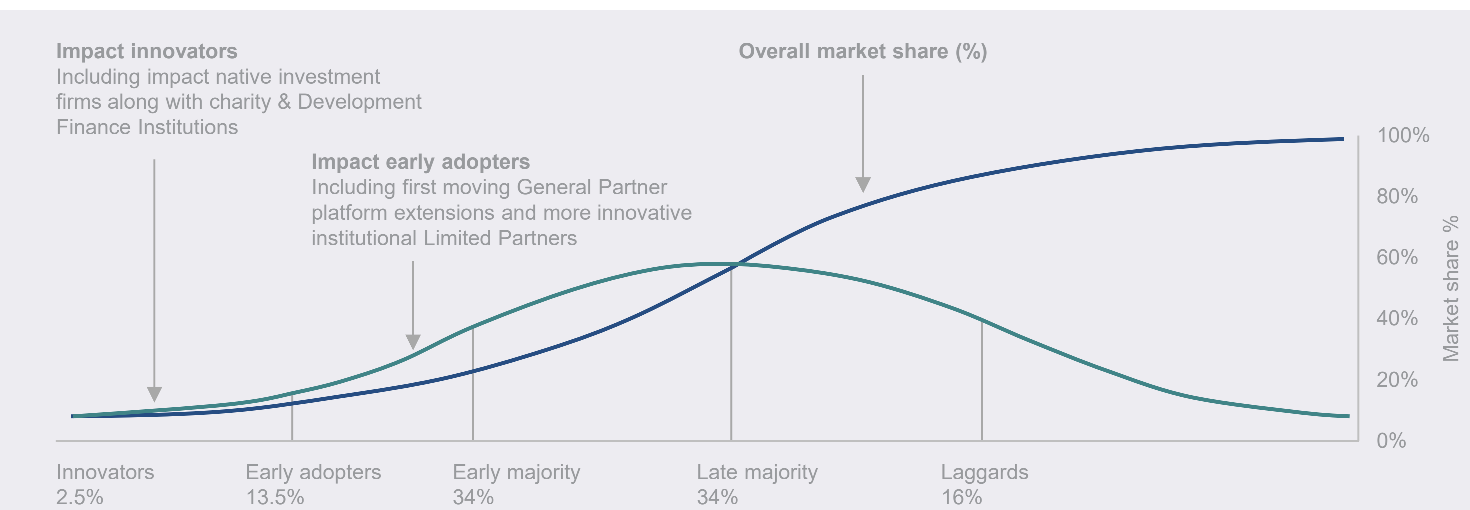
Applying this at a portfolio level means explicitly having dual asset allocation objectives: financial and real-world impact. Increasingly, institutional investors and asset owners are considering this approach for a portion of their portfolio and it's something we've been helping clients implement.

What do we mean by impact by deliberate design?

The traditional approach

As many managers will likely have observed, although every LP claims to have

Figure 1 – Diffusion of innovation, applied to private impact investing



Source: Cardano, applying Rogers, Everett (2003). Diffusion of Innovators, 5th Edition, Simon and Schuster their own "unique" approach to building a portfolio of private market investments, most will largely follow a three-stage process:

1. Portfolio design: Scoping investment objectives, risk tolerances and building a strategic asset allocation framework;

2. Portfolio building: Selecting investments by following a structured underwriting and portfolio construction process; and

3. Portfolio management: Monitoring, reporting against performance objectives and adjusting/optimising that portfolio once scaled.

This approach is deliberate and has proved to be an effective method for an investor to target specific investments that, at a total portfolio level, can deliver the desired investment risk-return objectives. It provides for clear measurement and relative performance assessment against those objectives, allowing investors to learn and fine-tune their strategy accordingly, to ultimately perform over the long term.

An integrated approach to impact investing

At Cardano, we don't see "impact" as being meaningfully different from "risk". Furthermore, we don't see impact investing as being a particular strategy. In fact, much like risk management, impact is an investment approach applicable to any asset class. Investors commonly optimise for risk and return. We believe that the same should be true for non-financial objectives – investors should optimise for impact outcomes.

An effective impact investing approach holistically encompasses the whole investment process from portfolio design, through to portfolio building and then portfolio management. We believe the best way of doing this is by using our five-stage Impact Management and Measurement ("IMM") framework, as detailed in Figure 2.

Figure 2 – Example impact management & measurement model

Source: Cardano

You may already be familiar with it in the context of a traditional investment programme. But, what do these five stages look like from an impact perspective?

(1) Setting a clear impact strategy

An impact strategy is an approach that seeks to achieve positive, social or environmental change through specific investment choices. It is fully integrated into traditional investment objectives. An impact strategy starts with setting specific goals for the portfolio. Impact frameworks are useful in this regard, as they provide clear and simple models for investors to set objectives and then track progress. The United Nation's 17 Sustainable Development Goals is one such framework that is commonly used. Similarly, IRIS+[4] (see Figure 3) is a generally accepted system for impact investors to measure, manage and optimise for impact.

Although impact measurement is not as objectively verifiable as financial returns, striving for that level of scrutiny must be the goal.

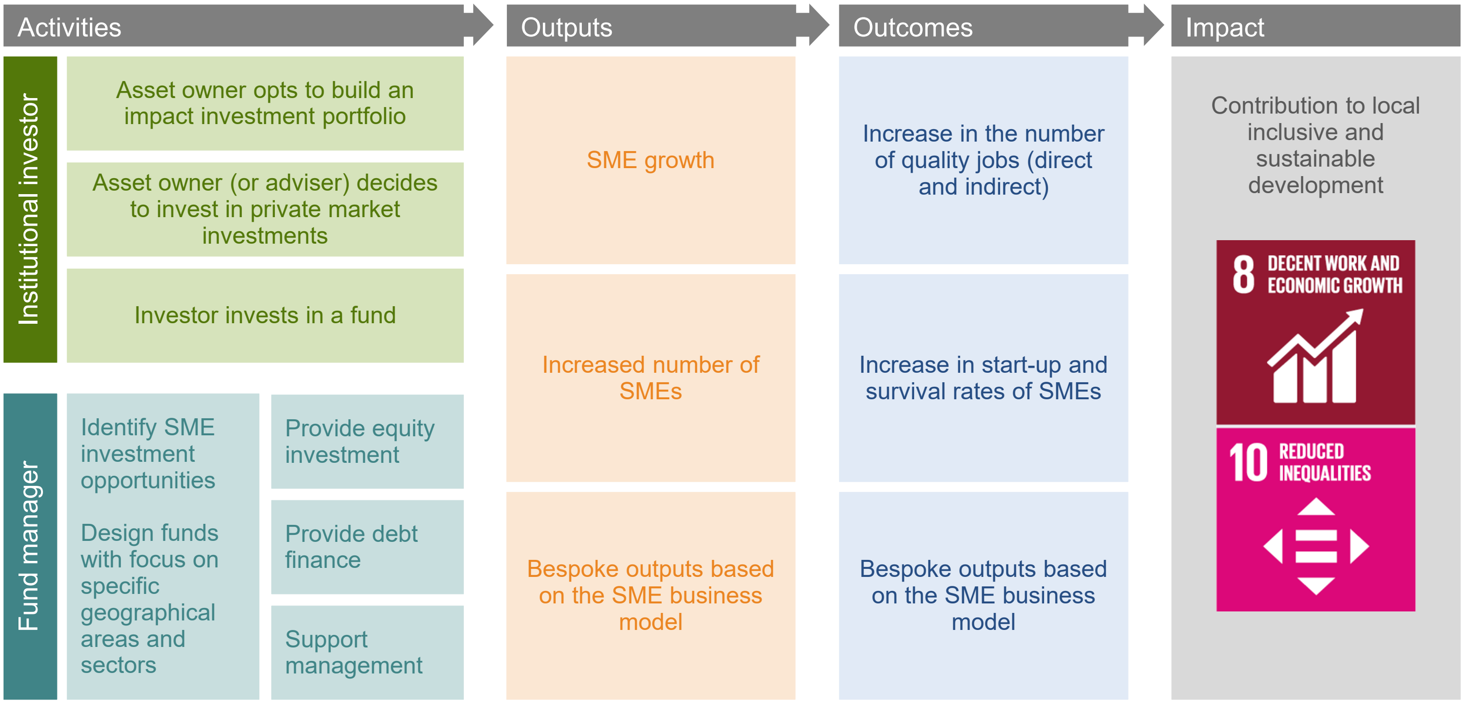
(2) Tying investments to positive change

Once overall objectives are set, it is important for an investor to establish which investments have the highest potential to deliver the chosen objectives, whilst offering sufficiently robust fundamentals that deliver attractive risk-adjusted returns. It is no longer sufficient to merely intend to invest for positive change; the change or positive impact must be evidenced.

Typically, there are multiple pathways that can deliver the same impact objectives. A portfolio designed to reduce greenhouse gas ("GHG") emissions might incorporate a wide variety of investment strategies, for example sustainable food & agriculture systems, clean infrastructure, or energy efficient real estate. Each would contribute to the objective, but in different ways. A well-thought-out "theory of change" will help to identify – and evidence, where possible – exactly how investment actions lead to specific outcomes and, eventually, positive real-world impact (Figure 4).

Figure 3 – IRIS+ Thematic Taxonomy [4]

Figure 4 – An example of the Theory of Change for SME finance



Source: Impact Investing Institute's 2021 white paper, "Scaling Up Institutional Investment For Place-Based Impact, 2021"

It will also help to establish answers to other key portfolio design questions related to how to optimise impact outcomes:

- **Asset class selection**: Is equity or credit a better delivery tool for the impact desired?
- **Business maturity**: What business stage is best for achieving the intended impact - venture, growth, mature, corporate or infrastructure?
- **Geographical selection**: What regions should be prioritised, emerging markets or developed markets?

Each decision will have an effect on risk-return, as much as on impact outcomes. Hence, we believe that it is key to consider both throughout, to help balance and optimise both financial and non-financial objectives.

Clear objectives and a set of clear pathways will provide the investor with confidence about the investments' potential to lead to positive change. For example, equity investments in private companies operating within the mid-stream food & agriculture industry are likely to lead to:

1. Specific outputs (e.g. natural produce to be sold cheaper)

2. Positive outcomes (e.g. less unsustainable food produced, thereby reducing GHG emissions)

3. Positive impact (e.g. a reduction in climate degradation)

(3) Investment sourcing and selection

Let us now move on to selecting the right partners and strategies. In our view, this is best achieved, not by outsourcing impact due diligence to a specialist team, but by fully integrating impact assessment alongside investment appraisal, ESG assessment – which, incidentally, we view as fully distinct from impact assessment – operational due diligence and legal due diligence.

Ideally, a good impact manager should clearly demonstrate all the behaviours of a high-performing investment manager and simultaneously, should:

- At the total fund level: evidence how they invest and manage assets in order to maximise impact outcomes using a set of clear policies, systems and processes; and
- At the underlying portfolio company level: showcase how this process translates into investments in underlying business models that generate positive real-world impact.

This cannot be a "tick-box" due diligence process. For instance, let us consider an investment fund's SFDR status. While Article 9 might be a helpful signal, it should never be the sole indicator. Investors should go beyond what is in the marketing documents and get to know the people involved, understand their motivations, culture, investment processes and impact operating model.

Conforming to existing best practice frameworks can help, for example:[5,6]

- The nine Operating Principles for Impact Management help to assess integrated impact management; while,
- The Impact Frontiers'[7] Five Dimensions of Impact can help assess the quantum, quality and scale of the impact produced by a business model.

Both frameworks are detailed in Figure 5.

Figure 5 – Overview of the Operating Principles for Impact Management and Impact Frontiers' Five Dimensions of Impact

	Operating Principles for Impact Management	Impact Frontier's Five Dimensions of Impact
Origins	Launched in 2019 by the International Finance Corporation	Launched in 2018 out of the Impact Management Project - a practitioner community of 3,000 impact enterprises and investors - convened to build consensus around impact measurement
What is it?	A set of nine principles intended to help managers and investors design and implement an impact management system throughout an investment process	A set of five dimensions, providing a framework for the high-level categories under which an impact investor can measure their impact
What does it help with?	Tool to assess a manager's impact process, often known as impact management framework	Tool to assess the impact generated by an underlying enterprise or business, as well as the actions of an investor

(4) Portfolio management and monitoring

Here, we believe that there are two key issues to address:

1. Impact engagement: In the same way that investors should challenge managers on ESG analysis, it is critical that they challenge managers on impact too; and

2. Measurement: To assess the effectiveness of any impact investment strategy, the real-world impact performance of investments must be measured.

Much has been written on the lack of consistent, high-quality data for private impact investments. We have two observations on this:

1. Data availability is improving rapidly. The control-orientated governance structure of private investments allows for faster innovation. Effectively, the information is nearly always there, but in order to access and utilise it, there needs to be a systemised approach to data capture; and

2. The pursuit of perfection should not prevent progress. Models or narratives that describe impact outcomes, where data is incomplete, are better and preferable to having nothing at all. Measurability is a delicate balance between the ability to collect high-quality data and being pragmatic about the data available.

(5) Evaluation and reporting

In any traditional portfolio, investors customarily track key performance indicators ("KPIs"). If there is underperformance, an investor will consider a variety of actions: engagement, position trimming or exit (together with subsequent portfolio re-balancing) are all common tools.

Again, we believe that these processes should be no different when considering impact objectives. Thus, developing impact KPIs and a robust reporting framework up-front – prior to making a commitment – to ensure that progress can be tracked throughout the lifecycle of an investment. KPIs should also be specific to each investment: a food & agriculture impact strategy will fundamentally differ from an energy efficiency infrastructure strategy, albeit both may seek to reduce GHG emissions.

A coherent suite of individual KPIs should enable progress to be measured versus the objectives and KPIs for the overall portfolio, allowing actions to be taken as required and for lessons to be learnt. They can also be used to further develop alignment, such as impact-linked performance fees which will doubtlessly become more prevalent. This is a concept not without its complexities… but that is a topic for another article!

Concluding remarks

What has become clear to us on our journey with impact investing is that private capital is not a "nice-to-have" – it is a necessity. Public spending cannot solve today's challenges in isolation; private capital must be mobilised. What is equally clear is that to mobilise institutional capital toward impact at scale, investment strategies must do so without trading risk-return for impact. All three must come together in one approach.

Reflecting on the innovation curve for impact investing, the goal must be to move adoption further still, beyond Early Adopters and towards the mainstream majority. That is certainly our intention. By sharing our perspectives about looking beyond the specific product of investment and taking a holistic and deliberate impact approach, we hope that these will help allocators think through how to deliver private impact portfolios at scale, such that they too might join us and many of our clients on this crusade.

1. PEI New Private Markets, "Biting headwinds hit impact fundraising figures" (24 July 2024)
2. TPG press release, "TPG closes Rise Climate Fund at $7.3 billion" (27 April 2022)
3. Everett Rogers, Diffusion of Innovations, 5th Edition, Simon and Schuster (2003)
4. IRIS+ is the generally accepted system for impact investors to measure, manage and optimise their impact. It does so by increasing data clarity and comparability, and provides streamlined, practical, how-to guidance that impact investors need, all in one easy-to-navigate system. The IRIS+ system is managed by the Global Impact Investing Network
5. Operating Principles for Impact Management
6. Impact Frontier's Five Dimensions of Impact
7. Formerly known as the Impact Management Project

Geordie is a Senior Investment Manager at Cardano *where he leads the private equity fund and impact investment research programmes. He sits on both the private market portfolio construction committee, as well as oversees Cardano's ESG ratings process across all external managers, representing €24 billion of invested capital (as at September 2023). Geordie has worked in private market investing for more than a decade. Before Cardano, he qualified as an investment funds lawyer, structuring alternative funds with Macfarlanes.*

Founded in 2000, Cardano is a privately-owned investment management and advisory business with a focus on risk and sustainability*. Widely recognised as a market leader, our c. 550 professionals support pension schemes and other long-term savings organisations in the United Kingdom and the Netherlands to secure better, resilient and more sustainable financial outcomes for savers, employers and wider society. Cardano is a purpose-built investment management and fiduciary management provider, with a leading-edge sustainability offering, serving long-term savings clients and pension schemes, with risk management requirements. Cardano has over £40 billion of assets under management and £32 billion of assets under advice as at 31 December 2022.*

St. Paul's Cathedral, London - Lukas Blaskevicius