Outcomes aligned incentive structures for investment managers and their employees:

Is the accurate measurement of outcomes a pre-requisite for impact investing or does too much focus on the precision of measurement act as a barrier to progressing the wider impact story?

Acre

Foreword

MARK THOMPSON
Roundtable Chair

The narrative for institutional asset management is changing. Investing for outcomes is moving beyond the domain of dedicated impact funds and into the broader church of mainstream investment. Asset owners and their beneficiaries are increasingly wanting to understand the impact of the investments made on their behalf by asset managers.

In this evolving market nobody has a monopoly on good ideas. Can we learn from the progress fund management companies have already made regarding imbedding impact into rewards structures? Can we learn from the successes and can we learn more from the failures in this area?

Against this changing market, this paper considers how the incentive structures for asset management companies and their employees should be evolving in regard to impact outcomes, whether it be for dedicated impact managers or indeed the wider investment market.

THE PAPER EXPLORES THIS DEVELOPING ISSUE BY DELVING INTO THREE SPECIFIC AREAS OF INTEREST:

1. **Is the increased interest in impact outcomes manifesting itself in actual demand?**
2. **Is there more talk than action?**
3. **If there is demand, does this involve new products or the evolution of existing products?**

This paper may not give all of the answers, but, I believe, it is an important step in developing the dialogue in this area that the investment industry needs.

IAN POVEY-HALL
Head of Sustainable & Impact Investing
Acre

We are experiencing a transition to an era where total social benefit is becoming an increasingly important metric for the perceived value of products and services. Consequently, the investment industry is risking its enduring relevance and credibility by assessing and subsequently rewarding success through solely financial metrics.

For this roundtable discussion we assembled representatives from asset owners, investment managers, family offices, foundations, private equity groups and a responsible remuneration specialist to discuss the potential for outcomes-based investment products to offer an opportunity for investment managers to deliver greater value for their clients.

We are very conscious that different types of sustainable/responsible/impact investment products have different goals about what a 'successful' outcome represents for their respective clients. Hence, we have done our best to curate a diverse group of participants reflecting the need to consider not just outcomes-based products themselves, but also the capacity for the principles that underpin them to be useful for individuals and companies providing traditional investment products.

We feel this is a topic worthy of focus due to our experiences working with clients to build teams that are incentivised to create and manage products that allow them to invest in companies with profitable business models which deliver scalable, net positive, impact as a function of their growing business models.

While there are some fantastic pioneers delivering incredible work in this space, there is an undeniable opportunity for the wider investment management community to incorporate these principles into their personal and professional development plans and subsequently create greater long term value for both themselves and their clients. I hope you enjoy reading about the discussion and thanks again to all of those who took the time to participate.

Please also do look into the recommended reading section at the end of the paper which includes some fantastic research for anyone keen to investigate the themes covered in the conversation in greater detail.

1

Demand from investors for investment managers to demonstrate additional value beyond traditional risk & return considerations

EXPERT VIEWS FROM:

THOMAS L. FERRE
Private Equity Mandates
European Investment Fund

SIMON FINCH
Investment Consultant
Enhance Group

> From our perspective demand is increasing, however still a long way to go. If I would look at our portfolio which includes 800 GP's, less than 4% of them have strategies are required to have KPI's that create some sort of value beyond risk/return financial metrics and less than 30% of our portfolio includes outcomes ba sed targets.
>
> If you consider yourself an impact fund, and aim to have EIF as an LP - and as a reminder we have 800 GPs in Europe, you are required to have your carry aligned with non financial impact KPI performance.

— THOMAS L. FERRE

> We see four categories of client demand: Firstly, a client with existing mechanisms to make good investment decisions which have positive outcomes, secondly a generational transfer of wealth and responsibility acting as a catalyst for seeking to allocate to investment strategies which have a positive impact on society, third category is family offices who are starting to get interested in allocating to more outcomes focused products but being frustrated with the lack of clarity of how to measure and then select managers. Finally, the fourth that is engaged only in capturing financial returns, with little regard for their positive or negative outcomes.

— SIMON FINCH

Discussion points

European governments and central banks are already setting up standards and measurement requirements for the financial industry. In fact, they are the driving force behind this, with taxonomy and reporting requirements targeting the financial industry to deliver against non-financial KPIs.

As well as the inter-generational transfer of wealth there is also the inter-gender transfer of capital which will have a significant effect on the evolution of demand for investment products. Female investors have a much higher propensity to consider net positive impact when making investment decisions vs their male counterparts. By 2025, 60% of household income will be in female control so this will likely create a further increase in demand.

A key question raised was how best to engage with the increasing appetite for this type of product, considering that the day when there is crystal clear data and standards are universally agreed on the non-financial outcomes of investment products is still a long way away. Emphasis was put on the opportunity this represents for the investment industry to shift from being a delivery mechanism for financial instruments, to a values-based service provider managing capital for individuals seeking to align their own personal values with the companies they are invested in.

Appetite to deploy capital into innovative, outcomes-based products is coming from private investors more so than institutional at this point. It was also noted that there are a growing number of specialist advisory groups focused on delivering access to outcomes-based investment products for UHNW's and family offices, which is adding momentum to this trend.

It was suggested that it will be crucial for clients and their advisors to differentiate between investment managers seeking to transition as a reaction to client demand and policy change as opposed to those with the core belief in delivering positive outcomes with the capital they invest.

This growth in demand for impact investment products was compared to the early stages of the green bond market, rapidly growing from £100m to circa £300bn invested annually over the last decade, where growth in demand was driven by the incremental involvement of a much wider range of participants.

The growth of the green bond market could be seen as a signal for the opportunity for investment managers to deliver a more outcomes-based product suite. Evolution of the green bond market has shifted from a basket of credit products to a correlation between the product and the overall business model and corporate strategy of a company.

It was suggested that now that there is a more diverse pool of participants, it is perhaps time for investment managers to consider producing a range of investment products that deliver for that range of demand by positioning various products across the impact vs returns range, and across a mix of environmentally and socially-driven themes. There would then be the opportunity to create a 'glidepath' of transition to outcomes-driven investment structures by working with clients as they move along a transition curve of various degrees of outcomes.

Reference was made to the significant effect that increasing regulatory demand for corporates to show their business models 'do no harm' would have on the investment industry and the resulting need for investment firms to be able to report on the outcomes of their products and services in order to prove that. Investment managers need to work to maintain their social legitimacy as society's expectations evolve. This will be further enhanced by forthcoming requirements for increased disclosure of adverse impacts of investment decisions on sustainability factors under MiFID II.

It was noted that despite in many cases that social factors can be easier to measure, for example; gender diversity at board level, regulatory driven demand for environmentally linked products/services risks crowding out broader, socially-driven investment strategies. While this is the case from a European perspective there tends to be a more socially-driven appetite for outcomes-based products from investors in the US and Asia.

There is a danger of oversimplification when broaching these topics with clients, making it a zero-sum debate as opposed to allocating capital across a spectrum of outcomes as a function of their individual perspectives. It was argued that it is possible to go further to understand the true drivers of demand from clients and then seek to transparently map that to the expected outcomes of their portfolios. Discussing values and outcomes as part of the advisory process can create the opportunity to connect with a client's 'higher order purpose' as opposed to conforming to the stereotypical view that the role of investment managers is to simply generate returns.

Previously, capital invested into impact funds came from specialised pots of capital, mainly from DFI's, allocating to impact funds that had obvious direct impact in the purest form, or from private investors and charities who would allocate a small percentage of their capital into specialist impact products with the majority of their portfolio in traditional products only covered by negatively screening from an ethical standpoint. Clients across the board are now seeking to understand the impact of the entirety of their portfolio as a function of the business models of their underlying investments.

The point was made that there is a need for larger asset managers to focus on sowing impact aligned principals through the fundamentals of their approach. This can be a multifaceted approach with top down, active engagement with companies as well as an ongoing evolution in the way that their investment teams assess the value of individual companies. A good example quoted was the oil industry; "If the world is going towards EVs and green hydrogen vehicles, even a "traditional" manager that has no explicit impact/ sustainability goals should very much be looking at analysing the potential outcomes in the future, as it will determine what the assets owned by these business will be worth and whether they can indeed sustain themselves as going concerns."

A shift from discussions with clients centred on purely risk and returns to broader outcomes-based elements of their portfolios was noted from the institutional side, with more openness from clients for a wider tracking error vs a lower negative impact in a portfolio with greater focus on the environmental than social side thus far. Engagement was referenced as one of the key tools to align investment outcomes with clients' tolerance of these factors and their beneficiaries for the longer term.

Reference was made to the issues for larger asset managers to use the word 'impact' explicitly vs the more traditional impact investing industry. The response from some of the specialist investment managers around the table was that it's a wide term and if you feel you are having a positive impact you should be confident to use the term as long as you can measure and explain the rationale behind your view that you are delivering a net positive impact.

From a private equity lens, over the last 10 years there has been a huge increase in demand and consequently capital being committed. Issues continue to be raised regarding the lack of 'institutional ready' products however that is slowly reducing as specialist groups become more mature and more established managers enter the market. Institutional investors are becoming more comfortable with the look and feel of specialist impact investment managers from a track record and scalability perspective, currently the reservations are around ensuring authenticity of impact from an intentionality perspective versus more opportunistically labelling products as impact when in fact the positive outcomes are a side effect of thematic investing.

How can pre-agreed outcomes be accurately measured

2

EXPERT VIEWS FROM:

KEVIN BOURNE
Managing Director, Sustainable Finance
IHS Markit

AMY CLARKE
Co-Founder & Chief Impact Officer
Tribe Impact Capital

"One of the greatest challenges we face is the industry norm over the last 18 years of collecting information in written vs numerical form which has acted effectively as a parachute, slowing down the debate on where investing by incorporating nonfinancial factors is really going. Considering the policy drivers creating ever increasing levels of disclosure from companies, we must change the way we collect information by reformatting the nature of the questions such that they have been answered numerically. Investment managers can't manage what they can't measure."

— KEVIN BOURNE

"We have reviewed more than 100 funds over the last three years to assess the true impact of investment vehicles seeking to deliver positive outcomes. It has been difficult to see clear demonstrations from many of the fund managers of what impact they are trying to achieve. There have been some managers, however, with clear theories of change at play who are moving towards outcomes-based measurement, rather than relying on outputs. This is usually because they know the challenges they are trying to solve and understand how they should be reporting against that hypothesis.

Where performance is concerned, incentives (like carry linked to impact) is one accountability tool for investors; behaviour is another. The behaviours of an investment manager and their team is a key factor for investors to consider. Behaviours provide a good insight into levels of engagement and authenticity."

— AMY CLARKE

Discussion points

Better data is required across the investment spectrum to drive an analyst's approach whether that manifests itself either in quantitative or fundamental strategy. Without clear data points engagement with companies can be ineffective. In order to prove an authentic approach to offering products that deliver value beyond financial returns, investment managers must invest in developing the analytical capability to demonstrate it if they cannot already.

There needs to be a flexible blend of approaches delivered with consistency of transparency, accountability, purpose and objectives with clarity of focus that people can understand and are appropriate. There's no KPI for everything, so we need to work through that discussion with clients, but we need transparency. There is a danger of using a focus on specific quantitative metrics which can create rigid, narrow boxes leading to artificial distortions in the capital markets on the back of incorrectly identified environmental or social factors.

It was suggested that there is a need for institutional investors to think beyond their traditional scope, for example widen their classic risk parameters to allow allocation to innovative product run by high quality investment professionals that can catalyse change. The long term risk of not taking this approach could therefore far exceed decimal deviation from VAR models.

There is a scope to see the data issue as an opportunity to link the previously conflicting world of quantitative vs fundamental to create a blended solution of outcomes-based products reflective of the various requirements of clients.

It was speculated that at some point in the future there will be standardisation of data required for outcomes-based products with an impact P&L for companies and it will most likely be regulated.

Up until that point there is a need to work together as an industry to deliver commonality of language and consistency of methodologies.

It was suggested that to work at scale, rather than attempting to package this in homogenised buckets of specifically labelled products, perhaps having a specific focus, purpose and objective underpinned by different tools to achieve them can deliver mechanisms that can be applied across the full suite of products used by asset managers. Delivering this approach in a transparent way that clarifies the core elements of the product/strategy could significantly increase understanding for clients rather than seeking to repackage traditional products with new labels and slowing down the innovation curve.

In listed equities, outcomes can be measured through investing in companies where their core business model produces a net positive impact which the company itself reports. This represents one way that financial markets can be used to connect clients with companies that have a measurable positive impact in society through the nature of their investment choices.

Without being able to deliver the evidence to suggest this is a better way to invest on behalf of clients, it will remain hard to increase allocations at a scale where they can have a meaningful impact. It could be argued that the responsibility rests on investment managers to deliver the numbers that move the question from belief to reality.

It was also noted that investors must consider the burden being placed on companies by a lack of consistency on the data they are required to report on by different investment managers. Reference was made to the need for simple, clear outcomes as a starting point rather than perfection being the enemy of innovation. ■

3

Practical applications from existing fund managers

EXPERT VIEWS FROM:

VISHESH SRIVASTAVA
Partner and Head of Investments
Future Business Partnership

MEG BROWN
Executive Director
Impax Asset Management

"Our focus is on delivering positive impact by backing environmentally friendly and socially responsible consumer brands and suppliers of inputs to those brands which are enabling a shift to a more sustainable model of consumption. We are seeking to measure our impact not only through the companies we select for our portfolio but also what we do with them during our holding period. In order to deliver authentic transparency, intentionality is important but must be built into the incentives through measurement. We have chosen to use the B Corp methodology as a metric to ensure that we are genuinely backing brands that are more sustainable than their competition. Additionally, we need to be able to report that the B Corp rating of a company has risen during our holding period otherwise the investment team will not be paid their carried interest on that transaction. It's transparent, comprehensive, externally designed and verified, perfect for benchmarking and shows quantifiable progress over time. Plus, it's a driver of commercial and financial value, a real win-win."

— VISHESH SRIVASTAVA

"Impax was founded on an investment belief in the opportunity to invest in fast growing areas of the market delivering environmental products and services; for example, reducing pollution or supporting the more efficient use of natural resources. The environmental benefits delivered by the companies we invest in started out as an assumption by investors, considering our analysis of a company's core business model when selecting them as an investment. 6 years ago, we started to quantify that using operational metrics for a company as the foundation of our reports. For us the reporting is the extra assurance that we are staying authentic to our investment beliefs for our clients."

— MEG BROWN

Discussion points

The alignment of net positive outcomes with the scalability of the business was highlighted as key metric for the more experienced asset owners seeking to allocate to outcomes-based products. One example was given of an investment made into a global health fund focused on neglected diseases, buying into a theory of change model that investing in the fund would result in more people being cured from neglected diseases. As an LP they asked what the GP framework could build in to deliver that? The fund manager then agreed that they will not invest unless an investee has signed up to the global access to medicine commitments.

It was suggested that investment firms seeking to deliver outcomes beyond performance must invest in developing and articulating their own theory of change, developing analytical teams to measure it and then incorporating that capability into the investment process by giving it a vote in the investment committee.

One firm described how they link the discretionary pay for their investment team to the calibre of company analysis in regard to both their financial and non-financial factors, as well as how they engage with investments on an ongoing basis as opposed to previously; where bonuses for the investment team was solely based on the financial performance of their investments.

Outcome linked carry in private markets remains difficult but not impossible; examples exist where the structure dictates that a proportion of the 20% carry, generally 25-50%, is awarded on the delivery of pre agreed impact outcomes regardless of financial performance. Another example given where a hurdle rate of a pre agreed % return plus outcomes must be proved by the GP to then unlock the carry.

One investment manager described how the level of the assessment of environmental and social factors when assessing companies is part of their individual performance objectives, which determine their variable compensation.

Behaviours of investment managers as corporates (net zero carbon commitments) can be a tool to incentivise outcomes. Non-financial tools are also being used to incentivise behaviours; an example given was additional holiday allowance if an employee chooses to travel by train as opposed to plane.

It was noted that more practical examples are seen in private vs public investing however there are also clearly ways that one can complement the other. Investment signals are often about momentum, change, process and commitment to the process. The same principles can be applied to both public and private investing, but the methods of delivery will be different. The case was made that, as financial performance and attribution analysis is engrained in the investment industry, the challenge is now about changing the culture of how best to service clients so that non-financial outcomes can be delivered on the same footing as financial returns.

There is an opportunity to use basic common measurements as foundations for outcomes-based products; net zero carbon, top to bottom pay ratio, gender pay gap to name a few, rather than giving up due to complexity or purely relying on a sense of aligned mission which can slide if not held to account through measurement. This is not about creating overnight black and white change; it is about catalysing change and transition using quantifiable metrics to drive that journey and increase momentum. ▪

Incentive structures for employees

> "Responsible reward is a growing remuneration trend for investment managers to link part of their incentives to ESG metrics. It demonstrates their integrity and their authenticity in the way that they serve their clients' long-term needs. Responsible reward is about aligning investment managers' remuneration expectations of their portfolio companies with their own pay practices and applies to both compensation and employment benefits."
>
> — CORINNE CARR

Discussion points

Looking across the lifecycle of investment products, having the right incentives depends on the internal incentives of a manager to review the delivery of the strategy in line with the commitments, objective and purpose that the product is meant to have on an ongoing basis.

Financial incentives based on outcomes can be a very useful tool in transitioning existing investment teams and individuals towards a more engrained understanding purpose in their work that facilitates a shift from focusing purely on financial drivers as a key metric of satisfaction for employees to broader holistic goals for both themselves and society as a whole. 'Success' could then be redefined as than building a business driven by a sense of purpose aligned to an investment philosophy, delivered by the entire firm.

If investment managers continue to define success of both themselves and their employees in purely financial terms rather than providing employees with a sense of contributing to a wider social purpose, it may make it difficult to hire and retain the best talent.

It was suggested that values alignment with clients is about transparency on what are you trying to achieve, how and why. There needs to be a refocus on outcomes; how investment managers are doing business and how each employee is being incentivised in correspondence to their behaviours and the outcomes they generate as a result of delivering their role function.

Concluding comments

There are clearly strong demand signals for investment managers to align their incentive structures with both the financial and non-financial outcomes created by the investment products they provide. However, the lack of the available data and consensus around impact measurement frameworks will make this a challenging and costly exercise. That said there are an increasing array of signals that point to a significant dividend for those managers able to authentically grapple with these complexities and go the extra mile to deliver meaningful results for clients.

One of the recurring trends of the discussion was that the often thematic nature of these non-financial outcomes have highlighted that perhaps it is a lack of 'systems thinking' that is reducing the capability of investment managers to find ways to effectively deliver scalable, outcomes-based solutions for clients

The intentionality of the managers approach to search for companies whose core business model delivers a net positive value to society could be considered as more important than a purely outcomes-based approach. There may be situations where net positive outcomes are created as a biproduct of a thematic strategy rather than by design.

The discussion around additionality does create some difficulties as per the definition used by some incumbents in the impact investing space when looking at how to scale this approach to a meaningful degree and influence capital markets in a meaningful way. Considering that it was originally used to refer to the additional impact created by the capital provided for the investment being made, it could be argued that additionality would be negatively correlated to increasing amounts of capital flowing into impact investing strategies.

It was good to see that generally this discussion had more of a focus on incorporating intentionality and measurability into products and strategies designed to deliver outcomes beyond performance for clients

In an environment where investment management has lost trust from clients, incentive structures aligned to ESG integration and outcomes-based products represent a huge opportunity to regain that trust through the transparency and authenticity required in their delivery. However, while this is undoubtedly a significant opportunity, if done incorrectly and without industry cohesion about measuring and reporting on the outcomes and the extent to which they were achieved, there stands the risk of further alienating clients with false promises

Perhaps the key takeaway from the event was for all individuals seeking to manage capital on behalf of others to consider the following questions:

What are the outcomes that matter to me as an investment manager?

Do I use them as the key driving principles behind my investment process?

How do I communicate that to clients in the simplest way possible?

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RECOMMENDED READING LINKS

THE FUTURE OF RESPONSIBLE INVESTMENT NEW FRONTIERS

SOCIAL IMPACT INVESTING:
European Investment Fund

IMPACT INVESTING INSTITUTE

INVESTING FOR IMPACT:
The Evidence

PROJECT SYNDICATE:
Making Impact Investing Work

SUSTAINEX:
Quantifying the hidden costs of companies' social impacts.

RESPONSIBLE REWARD:
How to fulfil your ESG promises through performance and pay.

EMBRACING THE NEW AGE OF MATERIALITY

INVESTING IN A BETTER WORLD:
Understanding the UK public's demand for opportunities to invest in the Sustainable Development Goals.

A GUIDE TO CLASSIFYING THE IMPACT OF AN INVESTMENT

A RANKING OF 75 OF THE WORLD'S ASSET MANAGERS APPROACHES TO RESPONSIBLE INVESTMENT

CREATING IMPACT:
The Promise of Impact Investing

TEG FINAL REPORT ON THE EU TAXONOMY

Acre provides global financial institutions and investors access to the most established network of talent to build teams that not only outperform the markets, but also support the transition to a sustainable economy. Acre's pioneering work in responsible investment, sustainable finance and impact investing has created the largest global recruitment network of its kind.

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