IMPACT INVESTING
What role for defined contribution plans?

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Impact investing is generating significant attention and press in a wide array of publications and increasingly, advisors and plan sponsors are curious to understand its implication for their business. Impact investments can be viewed as an offshoot of socially responsible investing (SRI) and have the stated intent of delivering measurable social impact, as opposed to the traditional SRI approach of avoiding and selling out of businesses that negatively impact the social good. And while positive and/or negative screening is still the most frequent approach to implementing SRI practices, impact investing is gaining ground, with 52% of investment consultants in a 2015 Cerulli Associates poll stating that they use it as a means of responsible investing.¹

The proactive approach impact investing takes is in line with the growing desire among millennials, experienced investors and the affluent to express their social values in their financial life.² But what about when it comes to ERISA defined contribution plans? What, if any, is the role of impact investing there?

The last few years have seen impact investing garner increasing attention from the investment community at large, and even among federal regulators, with the Department of Labor issuing Interpretive Bulletin 2015-01 in October 2015 relating to fiduciary standards under the Employee Retirement Income Security Act (ERISA). This ruling essentially reverts to 1994 guidelines that make it permissible for ERISA plan fiduciaries to consider the social impact of their investments, provided the investments do not compromise fiduciary obligations (explained more fully below).

Against this backdrop, and in line with our commitment to retirement innovation and best practices, Prudential decided to delve deeper, commissioning a research study on impact investing to gauge thoughts and attitudes on the concept as a whole, as well as within defined contribution plans.Nearly 1,000 people were surveyed, ranging in age from 21 to 55+, and all were participants in employer-sponsored defined contribution plans. The results indicated that while impact investing is a trend that deserves continued close monitoring—with some estimating the potential for it to be a trillion dollar market by 2020³—there are meaningful barriers that are limiting its role within ERISA defined contribution plans.

¹ Source: Cerulli Associates, in partnership with the US SIF Foundation. Ninety-two percent of respondents reported using screening, as opposed to 72% using shareholder advocacy, 52% using impact investing, 44% using community investing, and 20% reporting using other means.
THE FOUR CHARACTERISTICS OF IMPACT INVESTING

The not-for-profit Global Impact Investing Network (GIIN), of which Prudential is a member, has identified four core characteristics of impact investing:

**INTENTIONALITY.**
Investments are made with the specific intent of generating a positive social or environmental impact.

**INVESTMENT WITH RETURN EXPECTATIONS.**
Investments are expected to generate a financial return on capital or, at a minimum, a return of capital.

**RANGE OF RETURN EXPECTATIONS AND ASSET CLASSES.**
Impact investments deliver financial returns that can range anywhere from below-market to risk-adjusted market rates. Investments can take many different forms across many different asset classes, including cash equivalents, fixed income, venture capital and private equity.

**IMPACT MEASUREMENT.**
Impact investors are committed to measuring and reporting the social and environmental performance and progress of their investments.
A CASE STUDY IN IMPACT INVESTING

Impact investments are typically private investments made into companies, organizations and funds with the express intent to generate measurable social and/or environmental impact alongside a financial return. They are distinct from socially responsible investments, which are typically negatively screened subsets of investments that exist in the public markets. Impact investments can be made in both emerging and developed markets and target a range of returns from below market to market rate, depending on the circumstances. Prudential has been one of the earliest impact investments pioneers and its current portfolio is one of the largest in the world. Before we delve into the survey results, it may be helpful to look at some real-life examples from Prudential’s portfolio.

Prudential Impact Investing Unit (PII) invests in a range of investment types that include real estate, private equity, private debt and venture capital. Since its founding in 1976, PII has made nearly $2 billion in investments and the outstanding balance of the portfolio is currently $500 million. Prudential has committed to grow the outstanding balance to $1 billion by 2020. All investments are rigorously evaluated for both social and financial return and the portfolio has generated consistent social and financial returns.

The PII portfolio is split equally between investments in social purpose enterprises and real assets. Across both areas, PII strives to advance economic and social mobility for underserved populations.

SOCIAL PURPOSE ENTERPRISES

PII invests in a range of for-profit and nonprofit social purpose enterprises that endeavor to create affirmtive social good. Key segments of the portfolio include investments in companies promoting financial inclusion and protection (including microfinance institutions, community banks and financial services companies in emerging markets), educational advancement and greater access to quality jobs in underserved communities.

Example: Prudential helped launch The Disability Opportunity Fund, the first ever Community Development Financial Institution focused exclusively on housing and other social services for individuals with disabilities. Since its inception, Prudential remains its largest investor.

REAL ASSETS

Capitalizing on the company’s deep roots in urban communities such as Newark, NJ, PII continues to invest in real assets that improve the lives of both individuals and the communities where they live. Current investment focus areas include targeted real estate investments in affordable housing, revitalization of inner cities and investments in a variety of environmental sustainability strategies.

Example: Habitat for Humanity International developed the FlexCAP Program to provide liquidity to its local affiliates and generate more building activity. Since 1997, Habitat has raised approximately $156 million in FlexCAP financing for more than 280 affiliates. Among the first institutional investors in the FlexCAP program, Prudential has invested over $32 million to date and is the program’s largest investor.

PII believes that impact measurement is a critical tool to gauge the success of the investments and utilizes third party standards and measurement tools wherever available. As a GIIRS (Global Impact Investing Ratings System) Pioneer Investor, PII has an investment preference for GIIRS-rated companies and funds to measure social impact.

These are real world examples of the power of institutional impact investments. Next, we’ll examine how impact investing is viewed by participants, through the lens of our survey results.
To recap, Prudential Retirement® conducted a study asking participants in DC plans for their thoughts and attitudes toward impact investing, in general and as part of a DC plan. Our study revealed that only about one-third of DC plan participants were familiar with impact investing. The research found that general interest is higher among:

- Millennials 57%
- Those from affluent households 51%
- More risk tolerant investors 73%
- Experienced investors 71%

On the whole, older participants expressed relatively lower interest in impact investments than younger participants, with concerns related to risk, the potential for below market returns and uncertainty (related to lack of familiarity with the concept).

Our survey indicated that interest grows slightly as participants become more familiar with the concept. For example, among those surveyed, 36% said they were very likely to consider impact investing within their workplace retirement plan, but after viewing a short video on impact investing that figure edged up to 39%.

Overall, 43% of study participants expressed a strong likelihood to consider impact investments as an option. That number was slightly reduced, to 39%, when it came to interest in investing in impact investments within an employer retirement plan.

The study also found that, overall, investing in companies that undertake activities with a positive social impact and investing in companies that are socially responsible were at the bottom of the list of important factors when considering new investments among participants of all ages. Similar percentages of participants rated ability to help meet financial objectives, costs/fees, growth potential and historical performance as very important (69%, 69% and 68%, respectively). However, only 45% and 43%, respectively, ranked investing in companies that undertake activities with a positive social impact and investing in companies that are socially responsible as very important.

Even among the cohort that was “highly likely to consider” impact investments, these two factors ranked either at the bottom in terms of importance, or close to it.

Key obstacles to impact investing—the top concerns cited by participants less likely to consider it—revolve around risk and the potential to lose money, and concerns about the stability of the provider or organizations they would be supporting.

Participants’ concerns center on risk and losing money

Reasons for weak consideration of impact investing funds

<table>
<thead>
<tr>
<th>Reason</th>
<th>% of Selected Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concerned about risk, potential to lose money</td>
<td>42%</td>
</tr>
<tr>
<td>Concerned about stability of provider, organizations supported</td>
<td>33%</td>
</tr>
<tr>
<td>Too new a concept, would want more information or track record</td>
<td>31%</td>
</tr>
<tr>
<td>Focused more on returns whether or not investment has social impact</td>
<td>31%</td>
</tr>
</tbody>
</table>

In part, these concerns stem from the relatively limited (and often private) track record of most impact investments, mixed benchmarks and the limited number of institutional grade investors engaging in impact investing. These impediments are starting to be addressed, though, and a 2015 Cambridge Associates study of 51 funds found relative consistency among impact and mainstream strategies in terms of performance.4

Beyond the fiduciary concerns, however, our research also demonstrated that while interest among some segments of the participant population has certainly been piqued, interest has not yet reached critical mass and a lack of familiarity is impeding plan participants from creating a mandate for sponsors to change the investment offerings available on their platforms.

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IMPACT INVESTING AND DEFINED CONTRIBUTION PLANS

Supporters of impact investing have hailed DOL Interpretive Bulletin 2015-01 for opening the door to more impact investing within ERISA-regulated retirement plans. The bulletin specifies that plan fiduciaries can invest in impact investments—or what it calls economically targeted investments—based in part on their “collateral benefits.” It also acknowledges that “environmental, social and governance issues may have a direct relationship to the economic value of the plan’s investment.”

But the bulletin also explicitly reminds fiduciaries that they may not accept lower expected returns or take on greater risks in order to secure collateral benefits. Fiduciaries can invest based on collateral benefits only to the extent the underlying investment is “economically equivalent, with respect to return and risk,” to investments without such collateral benefits. In short, the bulletin does not cancel out the Labor Department’s consistently held position that an ERISA fiduciary may not, as the bulletin notes, “use plan assets to promote social, environmental or other public policy causes at the expense of the financial interests of the plan’s participants and beneficiaries.”

Beyond complying with this ERISA imperative, plan sponsors exploring the world of impact investing for DC plans face additional challenges. As most impact investment funds are private, often custom, they generally offer limited daily liquidity. (Conversely, SRI funds are usually public funds offering greater liquidity.) Other issues may include distinguishing between investments that had social and financial intent at the outset and those that did not; accurately measuring and documenting the social benefits delivered by impact investments; and even getting or calculating investment performance data on a timely basis. (Some financings and guarantees made by impact investment funds may be commercially priced, but can have long tenors and multi-year grace periods that can make it difficult to assess their performance until they come due.) The U.S. National Advisory Board on Impact Investing, whose mission is to support the growth of impact investing, acknowledges obstacles such as a lack of standardized performance measurement and reporting systems; lack of a standardized third-party rating system (although work is underway in that regard) and regulations; and lack of easily accessible, transparent data to support investors in making disciplined investment decisions.

Although this paper is primarily concerned with DC plans, it’s worth noting that defined benefit plans are currently in a position to take greater advantage of the benefits of impact investing, given their historical appetite for private equity and lower need for daily liquidity at the participant level.

CONCLUSION

We believe strongly that impact investing is a vital force in the investment industry and poised for continued growth. We also realize that ERISA fiduciaries face a number of challenges in adding impact investment opportunities to their DC platforms in the near term. Most notably, given the concerns expressed by participants in our study, plan participants must become better informed and see impact investments as a more responsible and compelling choice before there will be widespread demand for these offerings. In parallel, the impact investing industry must mature and address the very real hurdles that still exist in impact investment measurement and tracking. The industry is well on its way to successfully addressing many of the perceived challenges, and we expect to see continuing positive developments in the near future. In the meantime, plan sponsors and financial professionals with an interest in impact investing can reach out to us for more information on our findings and to continue the conversation.

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5 See, for example, Hazel Bradford, “Department of Labor opens the door for ESG considerations,” October 22, 2015, pionline.com.
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