Domestic Impact Investing

by | **Thalia Lankin** and **Lesylleé White**

Investing in domestic and local projects that rebuild infrastructure and create jobs and affordable housing may help Taft-Hartley and public pension plans improve returns while also serving the interests of their participants.

Socially responsible investing is likely here to stay. According to The Forum for Sustainable and Responsible Investment, the size of the sustainable, responsible, impact investing market has grown from $4.8 trillion in 2012 to $8.1 trillion as of the end of 2016.[1] This market now accounts for $1 out of every $5 invested by asset managers in the United States.[2]

As this sector has evolved, the names, categories and labels remain variable, overlapping and largely undefined. *ESG. Socially responsible investing. Community investing. Impact investing.* The host of ever-changing labels brings with them confusion and an uncertainty as to what managers are promising to deliver and what impacts investors are seeking to achieve. And there is little consensus as to how impacts are quantified and reported. In addition, there is still a measure of hesitation by pension plan consultants and trustees to recommend impact strategies due to concerns regarding fiduciary responsibility to the pension plan.

However, two recent developments stand to change this. First, the Department of Labor issued guidance in 2015 acknowledging that environmental, social and governance (ESG) "issues are not merely collateral considerations or tie-breakers, but rather can be proper components"[3] of investment choices, providing fiduciaries with new clarity. Second, there is increasing evidence that seeking social outputs does not necessarily require a sacrifice in financial return, thus aligning impact investing more directly with a fiduciary's traditional duty.

Institutional investors are gaining greater sophistication in this area, enabling the field to evolve from a focus on implementing a set of factors and exclusionary screens to a set of strategies that generate measurable social impacts together with competitive returns for pension plans. As part of this evolution, institutional investors also are increasingly interested in quantifying the impact of their investments along with the financial return.

Today, the number of product offerings is diverse and provides a wide array of potential benefits. While one strategy may focus on investments in clean energy power plants, another might focus on supporting companies that promote health and wellness. Still others might focus on international investments addressing the United Nations Sustainable Development Goals.

With so many investment options, some defined benefit pension plans are prioritizing investments that align with the needs and objectives of their plan participants. By investing in projects that rebuild the nation's infrastructure, create union jobs, and develop and preserve affordable housing, funds may serve the interests of many participants in Taft-Hartley and public pension plans. Such investments must be made in a way that protects plan beneficiaries and achieves the desired social outcomes.

Some pension plans have generated positive returns by targeting investments even closer to home—local real estate and community development projects. When a pension plan makes impact investments to address issues facing its local community, it can realize a competitive return while addressing some of the external factors that can influence the long-term health of the plan.

For example, Taft-Hartley pension plans might select investment managers that invest in real estate development projects in the plan's geographic area. In addition to the financial return generated by such investments, they also could be assessed for the number of work hours created for plan participants, the amount of additional employer contributions to the pension, the number of additional projects that resulted from the initial investment in the area and so on. Local impact investments that help improve the health of a pension plan can take on real meaning for the plan's present and future beneficiaries.

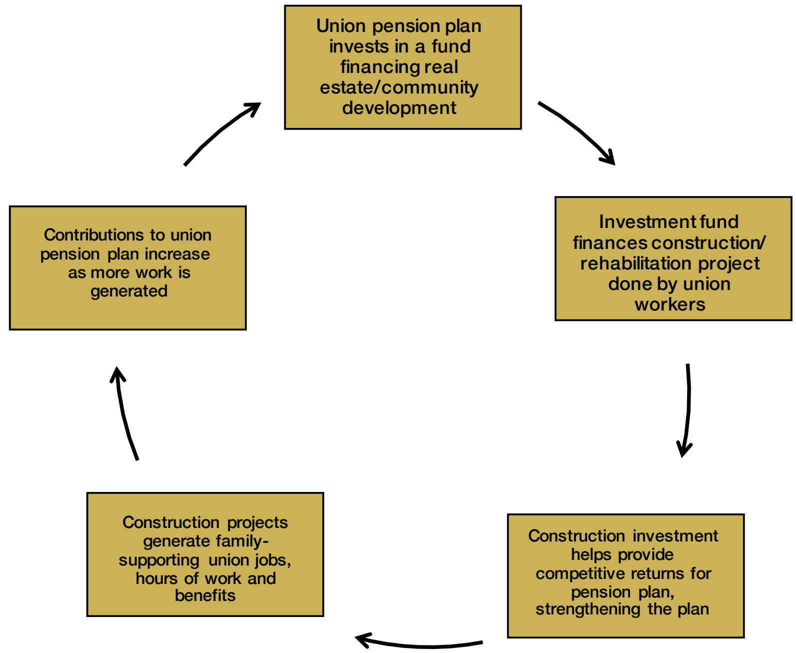
For public plans, effective impact investing might mean focusing on investments in the jurisdiction that add to the state or municipality's tax base, which in turn helps support the long-term health of their pensions. Cities and states are under increasing pressure as the percentage of their budget attributed to pension costs continues to increase. Investments in their locality can reshape the equation, adding to the tax base through prudent development that can further improve the health of the plan beyond returns, reducing the burden on local governments.

Early impact investing has been focused on small-scale investment, representing only a small percentage of a plan's total investment allocation. However, pension plans are seeking to allocate more of their assets to impact investments, and more products are emerging to allow larger scale investments.

This article focuses on domestic impact investing by Taft-Hartley and public pension plans.[4] It identifies three considerations when selecting an impact investment manager and highlights two pension fund domestic impact investment efforts.

FIGURE

Example of a Cycle of Sustainable Investment



Selecting Impact Investing Managers

Fiduciaries that decide to adopt an impact investing strategy might consider prioritizing domestic investment, putting their capital to work in places that can positively impact the long-term health of their pension plans. In that case, funds should evaluate impact investment managers for their ability to generate competitive returns and social impacts—job creation, infrastructure, affordable and workforce housing development and economic development—that have a direct relation to plan beneficiaries and their communities. Impact managers also should be expected to measure and track the impacts they generate, allowing fiduciaries to measure these benefits along with return.

In selecting an impact investment manager, pension funds should:

- **Look for managers whose returns are derived from the social benefit.** Sixty-eight percent of surveyed institutions have noted that integrating ESG criteria into their strategies has significantly improved returns.[5] Fiduciaries and consultants should look for strategies where the manager's ability to generate competitive returns is linked to the impact outcomes it generates. Managers who can capitalize on market inefficiencies or have superior knowledge in an industry with high barriers to entry could be strong potential candidates. For example, a manager focused on investing in affordable housing with expertise in structuring complex transactions can ensure a more consistent flow of investments in all market conditions, thereby positively influencing its returns while allowing them to continuously produce their collateral objectives.
- **Think beyond the return box—Many factors influence the health of a pension plan.** A recent survey of institutional investors by State Street Global Advisors showed that 80% of institutional portfolios include ESG factors as part of their investment strategies.[6] For Taft-Hartley and public pension plans, most of which are under increasing financial pressures, integrating impact investing into a portfolio that is subject to actuarial analysis can be complicated. The

TABLE I

Impact of an Investment in a Boston Rental Housing Project on the International Brotherhood of Electrical Workers Pension Funds (2010)

Total Investment in Development	$152 million
Hours of Electrical Work	228,000
Wages Generated by Electrical Work	$11 million
Pension Contributions Generated for Electrical Workers	$3.3 million

Source: IMPLAN, Pinnacle Economics and the AFL-CIO Housing Investment Trust.

financial return target set by the plan's actuaries is one key component to keeping a plan financially sound. However, other factors such as the number of work hours generated for active workers, the tax revenue generated to support municipal budget growth, the health of the local economy, the pace of economic development, the unemployment rate and other macroeconomic factors also have a material impact on the future of Taft-Hartley and public pension plans. Recognizing that investment decisions can positively influence these external factors can impact the long-term viability of pension plans and lead to outcomes that benefit the plan beyond the market return on the investment. Acknowledging these factors and finding ways to quantify the outcomes the pension plans seek to achieve are important steps to thinking three-dimensionally about a plan's investments. Increasingly impact investment managers and some third-party firms are assessing and measuring impact outcomes for pension plans. Increased demand from pension plans for this data should reinforce this trend.

- **Consider investing locally.** When pension plans invest locally, the impacts are more direct, more measurable and more immediate. Impact managers should be assessed for where they are investing. While supporting global development may be a noble cause, when pension plans seek to make impact investments they may want to consider keeping their capital close to home. Reinvesting in the pension plan's backyard can help improve some of the external factors that impact the plan's financial stability.

The figure illustrates how investing in a local housing project could have a positive impact on a pension fund.

takeaways

- *Impact investments* are investments made into companies, organizations and funds with the intention to generate social and environmental impact alongside a financial return.
- Some Taft-Hartley and public pension funds have generated positive returns with local impact investments in real estate and community development projects.
- Pension funds interested in local impact investing should select investment managers for their ability to generate competitive returns and social impacts that have a direct relation to plan beneficiaries and their communities.
- One of the challenges to impact investing is recognizing the material impact that the results of a local development project, such as increased work hours for active workers, can have on a pension plan's financial health.

Domestic Impact Investing in Action

International Brotherhood of Electrical Workers

The National Electrical Benefit Fund (NEBF) and the National Electrical Annuity Plan (NEAP), which are national pension funds sponsored by the International Brotherhood of Electrical Workers (IBEW), have often been at the forefront of innovation in the Taft-Hartley pension fund industry.

The funds' philosophy is that by investing in union-built real estate development they could put their pension capital to work, growing hours for current members while earning a return to pay retirees. Recently, NEBF and NEAP have begun working with their investment managers to measure the economic impacts associated with their investment program. NEBF and NEAP worked with an economics consulting firm to use the Impact Analysis for Planning (IMPLAN) model to assess the economic impacts associated with these investments.[7]

NEBF and NEAP worked with three of their investment managers to analyze the impact of their pension investments. They found that between 2012 and 2015, the managers collectively invested in 306 real estate projects in 24 states, resulting in $11.7 billion in total development, including an estimated $545 million in investment from the two IBEW pension plans. These investments resulted in 2.7 million hours of work being generated for union construction workers and 319,000 hours of work specifically for electrical workers. These investments represent only a fraction of NEBF and NEAP investments in real estate, and the effort continues to expand this analysis to include the full range of NEBF and NEAP investment activity.

Through this analytical exercise, NEBF and NEAP were able to quantify the work hours created for their members nationwide through these investments and understand the wage and tax benefits these investments generated in local communities. The authors understand that other pension plans are following suit in quantifying their impact outputs.

As the demand for such impact data grows and the industry becomes more sophisticated, the authors think that similar requests from a larger group of fund sponsors will lead to improved standardization, increase investor confidence in the outcomes and allow fiduciaries to better assess the impact of their overall portfolio.

Table I shows the impact an investment in a Boston rental housing project in 2010 had on electrical workers.

New York City Retirement Systems

In an effort to generate risk-adjusted market rates of return and to promote economic development in New York City, the New York City Retirement Systems (NYCRS) established its Economically Targeted Investments (ETI) program, which is designed to invest capital to address market inefficiencies by providing capital or liquidity to underserved communities and populations. The NYCRS trustees have allocated 2% of pension assets toward ETIs, totaling approximately $3.5 billion as of March 2017.

Historically, ETI program investments have been targeted toward affordable or workforce housing for low-, moderate- and middle-income neighborhoods and populations in the five boroughs and the six surrounding New York counties (Nassau, Orange, Putnam, Rockland, Suffolk and Westchester).

These ETIs have revitalized neighborhoods by returning distressed properties into habitable buildings, thereby returning them to city tax rolls. The program has also financed the development of new housing that is affordable to working people. Since the ETI program began, more than $2.7 billion has been invested in New York City's five boroughs.[8] To date the program has created or rehabilitated more than 99,000 units, providing affordable housing to New York City's working families, including city employees, so that they can continue to live in the city where they work.[9]

TABLE II

Impact of Investments in Affordable Rental Housing in New York City (2011)

Total Development Investment	$151 million
Affordable Units Preserved	2,820
Wages Generated in New York City	$131.5 million
Jobs Created in New York City	1,930
State and Local Tax Revenue Generated	$57.8 million

Source: IMPLAN, Pinnacle Economics and the AFL-CIO Housing Investment Trust.

Through its ETI program, NYCRS contributes to meeting the city's growing affordable housing needs and generates a market return to keep its pension plan solvent while adding to the very tax base that supports its future health.

Table II highlights the results of the NYCRS investment in affordable New York City rental housing in 2011.

In order to achieve these types of objectives, pension plans will need to review managers for their ability to provide competitive returns and their ability to produce and assess the impact outcomes the pension plans seeks to achieve locally. The number of investment managers able to achieve both of those objectives may be limited. Recognizing this and selecting managers with a solid track record on both accounts will ensure that pension plans can meet both objectives. As the impact investing industry has grown, the number of products available that are able to produce market returns, create local outcomes and report on these outcomes has grown, and this trend is expected to continue.

Conclusion

Taft-Hartley and public pension plans that focus their impact investing objectives on investing domestically, with particular focus on their local communities, have the potential to improve the long-term health of the pension system.

When evaluating impact investments, pension plan trustees and their consultants should apply a rigorous, fact-based analysis of the manager's strategy. Fiduciaries should prioritize investment strategies where the ability of the investment to outperform benchmarks and its competitive risk-adjusted returns are driven by the impact factors that the strategy focuses on.

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With respect to evaluating impacts, plan trustees and consultants should demand that managers produce metrics that quantify the benefits they are supporting. Plan participants and fiduciaries should be able to evaluate their managers on their impacts and their returns. With increased demand for these metrics, we expect that as the industry continues to mature, transparency and reporting will become the norm.

Endnotes

1. Report on US Sustainable, Responsible and Impact Investing Trends 2016, The Forum for Sustainable and Responsible Investment, page 12.
2. Ibid.
3. Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 CFR 65135.
4. Global Impact Investing Network defines *impact investing* as "investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets and target a range of returns, depending on investors' strategic goals. The growing impact investment market provides capital to address the world's most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education." https://thegiin.org/impact-investing/need-to-know/.
5. ESG Institutional Investor Survey, State Street Global Advisors, 2017, page 5.
6. Ibid, page 6.
7. IMPLAN is an input-output model. The IMPLAN model works by tracing how and where money spent on construction investments circulates through the economy. The data for IMPLAN is collected by the U.S. Department of Commerce, the U.S. Bureau of Labor Statistics, and other federal and state government agencies. Data are collected for 528 distinct producing industry sectors of the national economy corresponding to the Standard Industrial Categories (SICs). IMPLAN is utilized currently by a number of impact managers to quantify their outputs.
8. See https://comptroller.nyc.gov/services/financial-matters/pension/initiatives/economically-targeted-investments/.
9. Ibid.