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Impact investing: solutions for people and planet through alternatives

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Rekha Unnithan, CFA, CIMA
Impact Investing Portfolio Manager

Executive summary

- Impact investing is growing rapidly, with rising demand for strategies that go beyond traditional risk reduction approaches to produce direct benefits for people and the planet.
- Institutional investors are among the largest sources of impact capital as the market's evolution has increased opportunities to earn market-rate returns in scalable investments.
- The diversity of opportunities in alternative investments across sectors and asset classes in developed and emerging markets provides a range of risk-return profiles to meet the needs of mainstream investors.
- Potential risks — including exposure to less mature businesses, illiquidity and the wide variation of returns noted in recent studies— place a premium on due diligence in manager selection.
- Investments in affordable housing, inclusive growth and resource efficiency demonstrate the potential for direct social and environmental impact with financial returns.

Impact investments are intended to generate direct social and environmental benefits alongside a financial return.

The growing impact investment market provides capital to address the world's most pressing challenges, and many investors are adopting the U.N. Sustainable Development Goals.

Impact investing is growing rapidly from specialty niche toward the mainstream. Responsible investment programs are expanding to embrace impact strategies that produce direct benefits for people and the planet. Leading the way are institutional investors who have become one of the largest sources of impact investment capital. Pension plans, insurance companies, banks and other financial institutions account for 40% of the capital managed by impact funds in 2017, according to industry research.[1] Institutions are pursuing investments that directly influence social and environmental outcomes, going beyond their traditional emphasis on rating companies for social responsibility — in response to three key trends. First, there is growing client demand for investments that produce measurable results in advancing the U.N. Sustainable Development Goals. Second, various studies provide evidence that impact investments can achieve market-rate returns for fiduciaries. Finally, institutional investors are finding opportunities to put larger amounts of capital to work in scalable businesses, such as affordable housing, microfinance and environmental technology.

Investors seek direct social and environmental outcomes beyond traditional ESG

Impact investing is a distinct approach allowing investors to see tangible results. More traditional responsible investing approaches emphasize investments in securities with higher ratings and fewer risks on a range of environmental, social and governance (ESG) factors. Some may exclude investments in certain sectors, such as alcohol, gambling and firearms. Securities with higher ESG ratings may provide better investment returns in the long run and *indirect* benefits through better corporate behavior. In contrast, impact investing offers investors the opportunity to produce *direct* and measurable benefits in improving social and environmental outcomes.

Comparing two examples helps to clarify the distinction. An ESG integration strategy, for example, may identify companies in a particular sector that perform better than peers in conserving energy, reducing costs and potential risks. An impact investing strategy may fund the commercial rollout of new environmental technology as a more effective way to combat global warming. Both strategies aim to improve environmental outcomes, but impact investing allows investors to make more direct and measurable contributions.

Impact investing grows rapidly and becomes more mainstream

The impact investing market is growing rapidly. Reported assets under management increased from $46 billion in 2013 to $228 billion in 2017, while the number of organizations reporting increased from 125 to 229 (Exhibit 1), according to annual surveys by the Global Impact Investing Network (GIIN).[2] Annual funding commitments more than tripled to $35.5 billion, and the number of investments more than doubled to 11,000 during the past five years. Although the GIIN survey is not comprehensive and AUM partly reflect the increase in organizations reporting, the market's expansion is clearly accelerating.

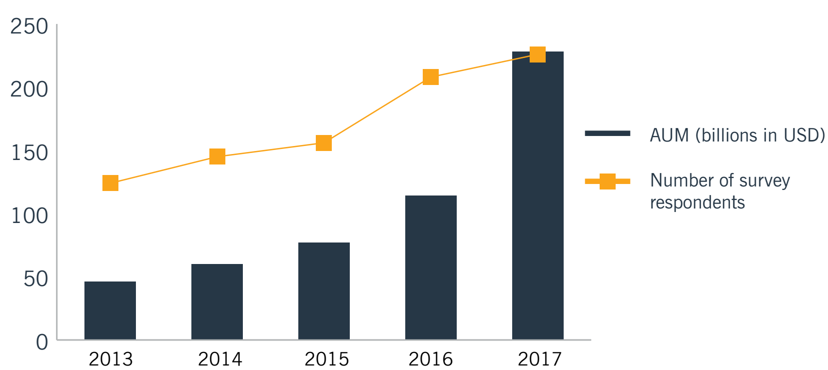
There is growing interest from a variety of investors. The share of institutions already invested or starting to develop an impact strategy ranges from nearly 40% for pension funds and insurance companies, to almost 60% of banks and nearly 90% of foundations (Exhibit 2).[3] An additional 40% of pension funds and insurance companies are considering impact investments. The growth partly reflects the more recent influx of more traditional, for-profit financial institutions. In 2017, nearly half, or 46%, of the organizations surveyed were for-profit managers, compared with 13% not-for-profit managers and 13% foundations. Reflecting the growth among mainstream investors, a third of respondents use both conventional and impact investments.

Despite the recent growth, impact investments represent a relatively small portion of responsible investments overall. The Forum for Sustainable and Responsible Investment (US SIF) estimates that responsible investments represent $8.7 trillion, or about 22%, of professionally managed assets in the U.S.[4] The $228 billion of impact assets reported in the GIIN survey represent only 3% of the total subject to ESG evaluation or exclusions. Still, nearly as many money managers and institutional investors reported using impact investments as those using ESG integration or exclusions, according to US SIF, supporting the potential for continuing growth.

Impact investments are diverse

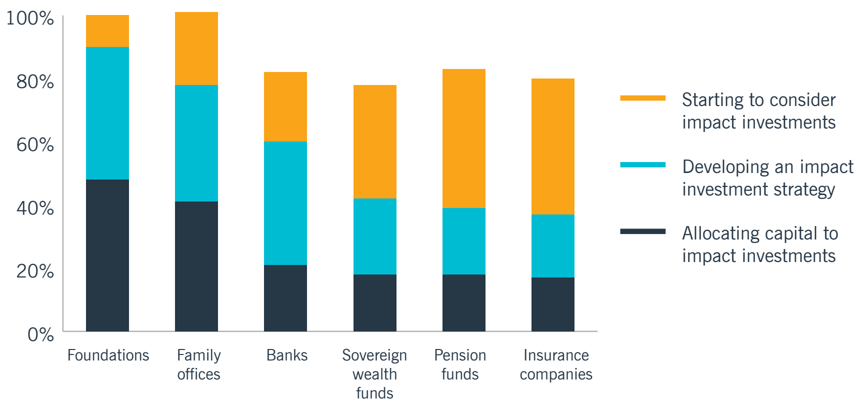
The diversity of impact investments offers institutional investors the opportunity to match a desired risk and return profile — and the specific goals of their responsible investment program (Exhibit 3). For example, private real estate investments in the U.S. offer the opportunity for steady income with less risk, compared to the potential for higher risk and higher returns with private equity strategies in emerging markets.

Exhibit 1: Impact investing is growing rapidly



Note: Reported AUM reflect an increasing number of survey respondents.
Source: 2018 GIIN Annual Impact Investor Survey.

Exhibit 2: Growing interest from a range of investors



Source: 2017 GIIN Annual Impact Investor Survey.

Impact market evolves to meet the needs of institutional investors

The market's evolution has increased the range of opportunities meeting institutional investor needs in terms of asset size and desired risk-return profile. Assumptions that impact investments are necessarily small, not scalable, sacrifice returns and are better suited to nonprofit organizations are no longer valid. Research shows that profit-oriented investors are finding attractive opportunities for institutional mandates. Pension funds and insurance companies, for example, represent the largest sources of capital for impact funds at 22%, followed by banks and diversified financial institutions at 18%, according to the GIIN survey.[5]

Institutional investors are responding to strong demand from clients and traditional financial incentives. Nearly two-thirds of impact investors, or 64%, target risk-adjusted, market-rate returns, with the balance targeting below-market returns for philanthropic mandates (Exhibit 4). More than 90% report that impact investment results — financial and social — matched or exceeded expectations.[6] Nearly three-quarters of investors found impact investments financially attractive compared to other opportunities, and more than half cited diversification benefits for the broader portfolio. Deal sizes are gradually increasing, although the industry average of $3.2 million in 2017 is a fraction of those available to more experienced investors with established pipelines.

Untapped markets provide financial opportunity

Impact investing's financial opportunity often lies in vast untapped markets where traditional businesses fail to meet the demand from lower-income groups. Underserved customers often are willing to pay for better services if those services can be made affordable and tailored to their needs. Impact investments often use innovative technology and business models to dramatically reduce costs and increase flexibility. For example, impact investments in affordable housing in the U.S. address an acute shortage affecting low and moderate income families and the elderly. Better management to reduce vacancy rates and "green" retrofits to reduce utility costs help to reduce rents and improve cash flow for investors. Similarly, banking services on mobile phones in emerging markets are tapping a market of nearly two billion adults without access to financial services. Loans and other services are offered at affordable rates, for example, to help individuals start businesses and emerge from poverty. Impact investments can also serve as venture capital supporting investments in disruptive new technology designed to improve efficiency throughout global supply chains.

Exhibit 3: Impact investments vary by global regions, industry sectors and asset classes — supporting a range of risk and return objectives.

Top five global regions

	Percentage of reported impact AUM
1 U.S. and Canada	20%
2 Latin America and Caribbean	16%
3 Sub-Saharan Africa	12%
4 Europe (excluding Eastern Europe)	11%
5 Eastern Europe, Russia and Central Asia	10%

Top five sector allocations

	Percentage of reported impact AUM
1 Financial services (excluding microfinance)	19%
2 Energy	14%
3 Microfinance	9%
4 Housing	8%
5 Food and agriculture	6%

Top five asset classes

	Percentage of reported impact AUM
1 Private debt	41%
2 Private equity	18%
3 Public equity	14%
4 Real assets	9%
5 Public debt	6%

Source: 2017 GIIN Annual Impact Investor Survey.

Standards for measuring social and environmental benefits are improving

The ability to effectively measure and manage desired outcomes is critical to ensuring that impact investments fulfill their stated objectives. Reliable metrics are also needed to avoid the potential risk of "impact washing," or using the label primarily for marketing and asset gathering purposes. Ideally, impact measurement and management should be embedded in all phases of the investment process, from initial due diligence and project selection, to business management and reporting. More than three-quarters of GIIN survey respondents set impact performance targets for all or some impact investments using internal or external standards, such as IRIS, a metrics catalog managed by GIIN. More than half also track their performance against the U.N. Sustainable Development Goals (SDGs), such as eliminating poverty and preventing climate change. Clearly, more progress is needed, with 35% of survey respondents citing the limited sophistication of impact measurement as a "significant challenge."[7] Shortcomings can include unclear objectives, poor data collection and analysis, inconsistent reporting and a lack of clear standards for what qualifies as an impact investment.

Potential risks highlight the importance of due diligence

The risks of impact investing can be more severe than other private investments. They may include exposure to less mature businesses, relatively illiquid investments, new technology and countries with political or currency risks. Investors may not be able to predict when they will be able to exit a business and recoup their capital. In addition, the wide dispersion of investment returns noted in recent studies highlights the importance of selecting the right asset manager. While there is no definitive list of desirable qualifications, the following represent broad capabilities that investors should consider:

- **Effective impact measurement and management.** A process for measuring and managing outcomes should be integral to every stage of the investment lifecycle. Investors should have a clear understanding of impact goals, measurement standards and results reporting.
- **Impact investing experience**. This includes a track record of building successful businesses with measurable impact. Experience in private asset classes — equity, debt and real assets — and in emerging markets can be important for accessing better opportunities. Past experience is often critical in evaluating opportunities and risks in particular sectors, countries and asset classes.
- **Dedicated investment team**. Does the investment team specialize in impact investing or does it handle a mix of conventional and impact investments? A dedicated team may have more time to perform deep due diligence in the field. The manager should be committed for the long term, given that private impact investments may continue for five to 10 years before making distributions.
- **Access to proprietary deal flow.** The most promising opportunities often come through informal industry contacts that may depend on a manager's experience, reputation and scale.
- **Broad diversification.** Does the fund provide exposure across asset classes, sectors and regions to help manage risk and provide a balance of income and capital appreciation?

Exhibit 4: Most organizations target market-rate returns

Source: 2017 GIIN Annual Impact Investor Survey.

Conclusions

- Impact investing is growing rapidly in response to rising demand for strategies that go beyond traditional ESG risk reduction to produce measurable benefits for people and the planet.
- The market's global diversity is increasing opportunities for institutional investors to earn market-rate returns in scalable investments with a desired risk and return profile.
- The potential for increased risk exposure in less liquid alternative investments and the wide dispersion of investment returns require rigorous due diligence in manager selection.

Nuveen: A pioneer in impact investing for more than 20 years

Nuveen is among the largest impact investors with more than $1 billion in active capital commitments to private market investments and more than 20 years of experience. Our impact investing experience is broadly diversified in developed and emerging markets, by social and environmental themes, and across asset classes. As a pioneer in responsible investing, Nuveen refined its approach by investing for parent company TIAA's insurance general account, which included $1.2 billion in total impact capital commitments, as of 30 Jun 2018.[8]

Nuveen's diversified capabilities

Nuveen's approach to impact investing is diversified across three broad themes that align with the U.N. Sustainable Development Goals:

Inclusive growth provides financial services, healthcare and education to reduce poverty among underserved populations, particularly in emerging markets. By providing higher-quality services at lower cost, these investments help the poor contribute to and benefit from broader economic growth. Providing financial services, such as small business loans, to the 1.7 billion people lacking access to banking could become a $380 billion revenue opportunity by 2020.[9]

Affordable housing preserves and expands the U.S. supply of lower-rent housing to improve the health, safety and living standards of poor and elderly populations. An estimated 38 million households spend more than 30% of their income on rent.[10] By purchasing and improving subsidized housing, these investments reduce the rent burden that often leads to underspending on food, healthcare and other necessities. Real estate investments, such as affordable housing, offer the potential for steady income to help diversify portfolios and reduce risk.

Resource efficiency addresses food supply, waste and energy challenges caused by population growth estimated at 9.8 billion by 2050.[11] Agriculture is among the largest contributors to global warming, emitting more greenhouse gases than cars, trucks and airplanes. The combination of natural resource scarcity, regulations against emissions and changing consumer preferences create attractive opportunities. For example, farm crops and waste streams can be recycled as low-cost, alternative feedstocks for the forest product and chemical industries. Resource efficiency initiatives offer the potential for high-growth businesses with inherent cost advantages.

Nuveen aligns with U.N. SDGs

Nuveen's diversified approach to impact investing aligns with five U.N. Sustainable Development Goals (SDGs) targeting poverty and inequality, sustainable communities, resource conservation and climate change. In a rapidly growing market, the SDGs help to forge agreement among a broad group of stakeholders and mobilize capital to address the highest-priority needs determined by the U.N.

Impact investing themes

Inclusive growth: Lending to small and medium-sized businesses in emerging markets.

The lack of financing for small and medium-sized businesses in India, for example, is a major barrier to raising living standards. Smaller enterprises account for 45% of India's industrial output, but generally don't qualify for traditional bank loans.[12] Next-generation finance companies are using mobile phone-based technology to make better underwriting decisions and deliver affordable loans for e-commerce sellers, restaurant owners, manufacturers and other businesses. For example, individuals seeking to increase their earnings by owning rather than renting a taxi often can't afford traditional bank loans. Innovative microfinance companies are serving this market with web-based loans featuring no collateral requirements, flexible repayment options and disbursement within 72 hours for loans in the $10,000 to $40,000 range. The market offers tremendous growth potential with the ability to acquire thousands of customer using a scalable business model that reduces service costs.

Affordable housing: Preserving rent subsidies for lower-income and elderly tenants

Housing affordability is worsening in the U.S. as rent increases exceed income growth and government subsidies fall short of demand. This has created opportunities for impact investments that preserve rent subsidies and reduce rents through better management. Although 2.5 million housing units have federal tax credit subsidies, more than one million have subsidies that will expire over the next decade.[13] Impact investments are purchasing multifamily housing to preserve rent subsidies that can average as much as 40% — savings that help low-income and elderly tenants pay for food, healthcare and other essentials. In cases that don't involve tax credits, rents can be reduced by cutting management fees, saving utility costs with green retrofits and increasing occupancy rates. Impact investments in real estate offer the potential for steady, long-term income backed by strong market demand and high barriers to entry.

Resource efficiency: Technology innovation to conserve energy and natural resources

Population growth and rising consumption are likely to outstrip dwindling natural resources in the foreseeable future. Resource efficiency investments are designed to save energy and reduce waste in production and consumption. The investment opportunity can involve capturing cost savings from more efficient production and recycling consumer waste as cheaper raw material. One example is new technology designed to improve the treatment of fresh produce, reducing food-borne illnesses and the 40% of fresh fruits and vegetables wasted due to spoilage. A new process currently in operational testing offers the potential to dramatically improve shelf life and food safety by eliminating 99% of insects and pathogens. Impact investments are funding the commercial rollout of this new technology offering the potential for rapid expansion in the global fresh produce supply chain.

For more information, please visit nuveen.com.

Endnotes

1 Global Impact Investing Network (GIIN), Annual Impact Investor Survey 2018, June 2018. Data reflect sources of capital reported by impact fund managers.

2 GIIN, annual impact investor surveys published in 2014 and 2018. Note: The increase in reported AUM for the five-year period 2013 – 2017 partly reflects the increase in the number of survey respondents.

3 GIIN, Annual Impact Investor Survey 2017. Note: Data reflect impact fund managers' perceptions of investor interest.

4 The Forum for Sustainable and Responsible Investment, Report on Sustainable, Responsible and Impact Investing Trends 2016.

5 GIIN, Annual Impact Investor Survey 2018 Survey 2018.

6 Ibid.

7 Ibid.

8 Data reflect total impact capital commitments in the TIAA General Account, including assets under management and committed capital not yet invested, as of 30 Jun 2018.

9 Accenture, Billion Reasons to Bank Inclusively, 2015.

10 Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2018*.

11 United Nations, World Population Prospects, 2017 Revision.

12 Capital Float blog, Working Capital Financing, March 2017.

13 Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2018*.

Past performance is no guarantee of future results.

Risks and other important considerations

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy or sell securities, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with advisors.

There can be no assurance that the returns presented herein will be achieved. Actual returns may vary significantly. There is no GIPS composite for the impact investment strategy. Committed capital figures represent internal investments made with TIAA's insurance general account capital.

The historical returns achieved by private investment vehicles is not a prediction of future performance or a guarantee of future results, and there can be no assurance that comparable returns will be achieved by the strategy. Investors should be aware that alternative investments are speculative, subject to substantial risks including the risks associated with limited liquidity, the use of leverage, short sales and concentrated investments and may involve complex tax structures and investment strategies. Alternative investments may be illiquid, there may be no liquid secondary market or ready purchasers for such securities, they may not be required to provide periodic pricing or valuation information to investors, there may be delays in distributing tax information to investors, they are not subject to the same regulatory requirements as other types of pooled investment vehicles, and they may be subject to high fees and expenses, which will reduce profits. Alternative investments are not suitable for all investors and should not constitute an entire investment program. Investors may lose all or substantially all of the capital invested.

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