SCALING UP INSTITUTIONAL INVESTMENT FOR PLACE-BASED IMPACT

White Paper

MAY 2021

EXECUTIVE SUMMARY

The UK is a country of entrenched place-based inequalities which have persisted for generations and are more extreme in the UK than most OECD countries. The Covid-19 pandemic and Brexit have combined to move these place-based inequalities to centre stage in public debate – alongside a search for effective and sustainable ways of tackling them. The need for more public investment is undeniable and the political will appears to be in place. There is now a golden opportunity for responsible, patient private capital to step in, match public investment and deliver positive environmental and social impact in places and communities across the country.

Currently only a small fraction of UK pension money is invested directly in the UK in ways that could drive more inclusive and sustainable development, in sectors like affordable housing, small and medium-enterprise (SME) finance, clean energy, infrastructure and regeneration. This white paper offers a place-based approach to scaling up institutional capital, including pension fund investment, into opportunities that enhance local economic resilience and contribute to sustainable development, creating tangible benefits for people, communities and businesses across the UK.

If we manage to accomplish this, the UK will be creating bridges between London and the rest of the country, and bridges between financial capital and the real economy.

Place-based approaches to tackling deep-seated social and spatial inequalities are now the norm internationally and they are relatively advanced in the UK. The current UK Government's levelling up policies are consistent with a place-based approach. With the costs to the nation of levelling up expected to exceed £1 trillion over the next 10 years, it is clear public investment will need to be matched by private investment. This is the rationale for our study, which explores how a place-based approach, already favoured by public and social investors, can be extended to institutional investors.

To establish an empirical basis for understanding place-based investing, we chose to focus on the Local Government Pension Scheme (LGPS). These pension funds are locally managed by 98 sub-regional administering authorities and have assets with a combined market value of £326 billion as of March 2020 (see footnote 6). The LGPS has a place-based administrative and membership geography.

Environmental, social and governance (ESG) integration and alignment with the Sustainable Development Goals (SDGs) are becoming increasingly important to investment strategies, and there is a legacy and current interest in local investing. If all LGPS funds were to allocate 5% to local investing, this would unlock £16 billion for local investing, more than matching public investment in the £4.8bn Levelling Up Fund and associated government initiatives.

The levelling up agenda goes hand-in-hand with the climate change agenda where pension funds already have a strong focus, including how to build net zero portfolios. Delivering these two goals together would support a 'just transition' to a net zero economy that supports green job creation and simultaneously delivers environmental, economic and social benefits across the UK.

We should emphasise, however, that we see place-based impact investment (PBII) as a new paradigm and lens for investors more generally. We envision PBII as a confluence of capital from commercial, social and public investors that results in equitable distribution of investment across all regions of the UK for the benefit of local places and people. This confluence of capital flows, with institutional investors playing a key role, must happen if we are to make the levelling up aspiration a reality. As such, we hope this report acts as a template for change, and will be read and acted upon by all institutional investors and financial institutions.

The project has been led by The Good Economy working in partnership with the Impact Investing Institute and Pensions for Purpose. The research project has been supported by the Department for Digital, Culture, Media & Sport, City of London Corporation, and Big Society Capital.

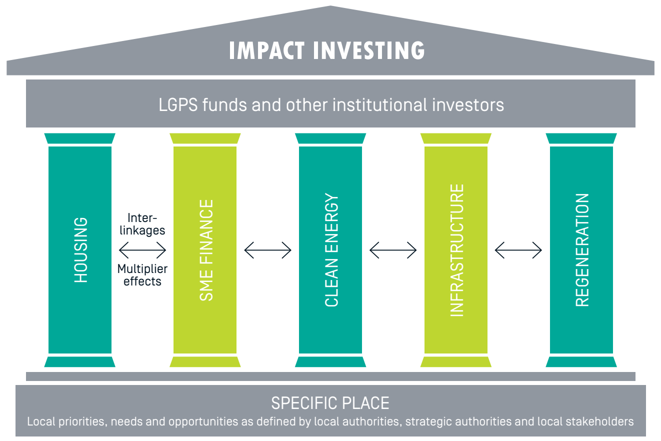
A PLACE-BASED APPROACH TO IMPACT INVESTING

We define place-based impact investment as:

Investments made with the intention to yield appropriate risk-adjusted financial returns as well as positive local impact, with a focus on addressing the needs of specific places to enhance local economic resilience, prosperity and sustainable development.

We present an original conceptual model of PBII that brings together places and investors around five 'pillars', underpinned by a solid social and financial rationale for investing (see Section 2). The five pillars are dual structures. On the one hand, they represent policy objectives and priority areas in local and regional development strategies. On the other hand, the pillars are real economy sectors and investment opportunity areas that fall within institutional investment strategies and asset classes.

PBII Conceptual model



Central to PBII is creating an alignment of interest and action among all stakeholders in shared impact creation for the benefit of local people and places. Stakeholder consultation and engagement is indeed fundamental to PBII. This type of investing is about 'boots on the ground rather than eyes on screens'.

The white paper also defines five traits that define and distinguish PBII as an investment approach:

1. Impact intentionality
2. Definition of place
3. Stakeholder engagement
4. Impact measurement, management and reporting
5. Collaboration.

THE FINANCIAL CASE FOR PBII

For institutional investment to flow to PBII, it needs to meet the commercial investment requirements of LGPS funds and other institutional investors. We carried out original analysis of market data which demonstrates that investments within the sectors that are key to PBII - affordable housing, SME finance, clean energy, infrastructure and regeneration – can deliver risk-adjusted financial returns in line with institutional investor requirements. Specifically:

- → Investments in these key sectors provide stable, high, long-term returns and low volatility versus other mainstream asset classes.
- → Investments in most of these sectors are generally in real assets, such as housing and infrastructure, so can also provide income streams.
- → These assets are generally illiquid which often command higher returns, hence, are attractive from a portfolio diversification and financial return perspective.

The universe of assets is, however, comparatively small and often in the private markets, suggesting a need for manager selection and a deeper understanding of the risks by interested institutional investors.

THE OPPORTUNITY FOR LGPS FUNDS

Currently the scale of PBII is very limited. Our baseline analysis of investment activity by LGPS funds in sectors that are key for PBII found that:

- → **Few pension funds demonstrate intentionality to invest with a local place-based lens.** We were only able to identify six LGPS funds out of a representative sample of 50 that have a stated intention to make place-based investments: Cambridgeshire, Clwyd, Greater Manchester, Strathclyde, Tyne and Wear and West Midlands. Of these, only Greater Manchester has an approved allocation to invest up to 5% of its capital locally.
- → **There is a very low level of investing into key PBII sectors.** Only 2.4% of the total value of LGPS funds holdings are in these key sectors, of which only 1% of total assets (£3.2 billion) is clearly identifiable as directly invested in these sectors within the UK. Infrastructure dominates in terms of the scale of investment. SME finance provides the most opportunities for direct local and regional investment through specialist fund managers.
- → **Key sector allocations are generally relatively small size, averaging £10 million** and busting the myth that pension funds can only make large allocations in the £50 million to £100 million range.

- **Investment in these sectors is growing due to an increasing number of funds** managed by specialist fund managers. From 2017 to 2020, the number of private market funds investing in these sectors increased by 16% from 106 to 123 funds, and the number of public funds increased by 62% from 21 to 34 (see Annex 2 for a list of funds). The largest growth is seen in investments in residential housing, including social and affordable housing.

STAKEHOLDER PERSPECTIVES AND CURRENT PRACTICE

There are challenges to PBII but none of these are hard barriers. The three main challenges are:

- **Traditional mindsets** whereby institutional investors allocate capital to the global capital markets without giving full consideration to whether allocations closer to home could deliver comparable returns and diversification while benefiting the development needs of local communities.
- **Fears of conflicts of interest** make LGPS managers wary of being accused of succumbing to political pressures that undermine their fiduciary responsibility.
- **Capacity constraints** and having the time, expertise and skills to source and carry out due diligence on PBII opportunities are the most limiting factors to scaling up these types of investments.

It appears that the universal requirement to scaling up PBII is an increase in operational resource across the ecosystem to prepare, identify and do due diligence on PBII investments, including building expertise within local authority teams, LGPS investment teams and consultants. In order to meet this capacity challenge, we observed approaches we broadly classify as 'building' capabilities, 'buying' in the skills or 'borrowing' resources. Section 4.4 provides examples of how different LGPS funds have used these strategies to make local investments.

Many UK fund managers expressed frustration that it is easier to raise capital from foreign pension funds than it is from UK pension funds. This is in part because these foreign pension funds are larger with teams that are more experienced in private market investing who proactively seek out UK opportunities.

In the UK, individual LGPS funds have made PBII-aligned investments in three ways: direct investments, co-investment strategies and via third-party managed funds. The vast majority of capital is invested via third-party funds, hence, fund manager selection and experience is critical to scaling up PBII. Pension funds review their managers closely and are often guided by advisors and consultants.

Many of the fund managers in this space are relatively small, specialist firms. Those LGPS funds that have a commitment to PBII have the appetite and resources to engage with and do due diligence on smaller fund managers. However, the majority of LGPS funds rely on consultant advice for strategic asset allocation and fund manager selection and the smaller funds do not get considered. This pattern tends to lead to bifurcation in the market. Large fund management firms which are more able to raise capital are successful but with more traditional strategies. This contrasts with specialised niche firms which often have a more impactful strategy or place-led approach but find it challenging to raise capital.

Consultants perform a gatekeeper role. Hence, getting consultant buy-in and support is key to scaling up institutional investment in PBII.

Pension pools are building their capacity and skills in private markets investing and could potentially also play an important role in scaling up PBII. There are eight pension pools in England and Wales which were established as a means for individual LGPS funds to invest collectively so leveraging scale to improve investment opportunities and reduce costs.

IMPACT REPORTING FRAMEWORK

Evidencing the achievement of place-based impact is fundamental to PBII. TGE convened a working group of LGPS funds, local authorities and fund managers to develop a common approach to impact measurement, management and reporting.

We used the PBII pillars to provide a set of common impact objectives that are relevant from both a local government policy and investment perspective. We also co-created a reporting approach that provides a core metrics set to report back on PBII activity. A key aim was to develop a right-sized and practical approach to impact reporting that would enable LGPS funds to communicate with their members in a clear and straightforward manner about their place-based investment activity.

CALL TO ACTION

We have presented PBII as a new paradigm for institutional investment using the LGPS to explore its implications for thinking and doing things differently. We see this paradigm as potentially having a much bigger reach: the aim should be for PBII to become a main investment theme in the next decade for the UK's leading pension funds.

Successful adoption of PBII through projects that are appropriately planned, designed and financed would help reduce place-based inequalities. However, this also requires deploying the PBII model within existing national strategies that aim to tackle regional inequalities, such as the Devolution and Growth Deals, the National Infrastructure Strategy, the Industrial Strategy, the Climate Change Adaptation Strategy and the levelling up programmes. PBII can also provide an umbrella framework for local investment partnerships between commercial impact investors, local and central government, social investors (including foundations) and local anchor institutions, such as housing associations and universities.

Levelling up is about creating this landscape of investment activity with hundreds of PBII projects underway right across the country, and with inequality within and between places diminishing over the next decade. This is what success looks like.

We recommend five areas for action to scale up PBII. We want to change the traditional investment paradigm and scale up investment in PBII for the benefit of communities across the UK. Hence, we need to raise awareness and strengthen the identity of PBII as an investment approach that could contribute to inclusive and sustainable development across the UK, whilst achieving the risk-adjusted, long-term financial returns required by institutional investors. This requires actions that raise awareness, increase capacity and competency, promote place-based impact reporting, connect investors and PBII opportunities and scale up institutional grade investment products. Section 6 provides details of these priority areas and a call for action to all market actors to engage in the PBII agenda.

FINAL REFLECTION

Behind all of the discussion in this white paper is the idea that if we can get PBII right and launched across the country – as a top national priority within the build back better and levelling up agendas – then it is not unrealistic to expect the UK to approach 2030 as a landscape where place-based inequalities are becoming a thing of the past. Much of this report is about 'getting there'.

If we manage to accomplish this, the UK will be creating bridges between London and the rest of the country, and bridges between financial capital and the real economy. Bridge-building calls for collaboration and a sharing of money and method, with impact investors of all kinds working closely with place-based stakeholders from business, government and community to get things done. There is a need for mutual learning and understanding, as we have emphasised throughout this report.

“Behind all of the discussion in this white paper is the idea that if we can get PBII right and launched across the country – as a top national priority within the build back better and levelling up agendas – then it is not unrealistic to expect the UK to approach 2030 as a landscape where place-based inequalities are becoming a thing of the past.

ABOUT THE PROJECT

The Good Economy, Impact Investing Institute and Pensions for Purpose have joined forces to produce a white paper on place-based impact investing (PBII) that can mobilise institutional capital to help build back better and level up the UK. Based on extensive consultations with market actors and stakeholders, this white paper offers a clear set of directions, models and practical guidance for investors to engage in PBII and report their impact across sectors and geographies. The Local Government Pension Scheme (LGPS), the empirical focus of this project, could itself become a pioneer of PBII in the UK, showing the way forward for the multi-trillion pound pensions industry.

This research project has been supported by the Department for Digital, Culture, Media & Sport, the City of London Corporation and Big Society Capital. Our approach to the project has been collaborative and consultative throughout, with LGPS funds, local authorities, fund managers and other stakeholders contributing advice, guidance and practical support throughout the project work.

ABOUT THE PARTNERS

THE GOOD ECONOMY

The Good Economy (TGE) is a leading social advisory firm dedicated to enhancing the contribution of finance and business to inclusive and sustainable development. Formed in 2015, TGE has rapidly established itself as a trusted advisor working with public, private and social sector clients. TGE provides impact strategy, measurement and management services and also runs collaborative projects bringing together market participants to build shared thinking and new approaches to mobilising capital for positive impact. TGE currently provides impact advisory services for over £3.4 billion assets under administration.

IMPACT INVESTING INSTITUTE

The Impact Investing Institute is an independent, non-profit organisation which aims to accelerate the growth and improve the effectiveness of the impact investing market. It does this by raising awareness of, addressing barriers to, and increasing confidence in investing with impact.

PENSIONS FOR PURPOSE

Pensions for Purpose exists as a bridge between asset managers, pension funds and their professional advisors, to encourage the flow of capital towards impact investment. Its aim is to empower pension funds to seek positive impact opportunities and mitigate negative impact risks. It does this by sharing thought leadership and running events and workshops on ESG, sustainable and impact investment.

ACKNOWLEDGEMENTS

We would like to thank the UK Department of Digital, Culture, Media & Sport, City of London Corporation and Big Society Capital for their funding and support for this research. We would also like to thank all the individuals and organisations who have supported this project by participating in interviews, roundtables and providing case studies and data. A special thanks to Edward Jones and Nicole Pihan for sharing the LGPS holdings data that they accessed through Freedom of Information requests.

TGE CO-AUTHORS AND PROJECT TEAM

Sarah Forster, CEO and Co-Founder
Mark Hepworth, Co-Founder and Director of Research and Policy
Paul Stanworth, Principal Associate, TGE and CIO of 777 Asset Management

Sam Waples, Head of Data Analytics
Andy Smith, Head of Impact Services, Housing and Real Estate
Toby Black, Research Assistant

ABOUT THE CO-AUTHORS

SARAH FORSTER

CEO AND CO-FOUNDER, THE GOOD ECONOMY

Sarah Forster is CEO and Co-Founder of The Good Economy. She has worked at the forefront of finance for positive impact for more than 25 years, working in the fields of sustainable economic development, development finance and impact measurement and management.

Sarah co-founded The Good Economy in 2015 to enhance the role of business and finance in inclusive and sustainable development. She acts as a trusted advisor to clients across the private, public and social sectors.

Other recent work includes directing the development of the Sustainability Reporting Standard for Social Housing and co-authoring an influential roadmap for the Urban Land Institute to help global real estate capture and enhance its social value.

Previously, Sarah held senior positions at Big Issue Invest, the New Economics Foundation and the World Bank.

MARK HEPWORTH

RESEARCH AND POLICY DIRECTOR AND CO-FOUNDER, THE GOOD ECONOMY

Mark Hepworth is The Good Economy's research and policy director, leading its work on inclusive and sustainable development. Mark is a multidisciplinary economist whose international career spans academia, public policy and business consultancy.

His focus at The Good Economy is on business-led inclusive growth, Place-Based Impact Investing and the UN Sustainable Development Goals as future drivers of business model innovation and transformative policy.

Mark has deep knowledge of the UK economic development landscape through his research at the Universities of Newcastle and London and policy consultancy at the Local Futures Group, which he co-founded in 1997 (now part of Grant Thornton).

PAUL STANWORTH

PRINCIPAL ADVISOR, THE GOOD ECONOMY

Paul Stanworth is currently CIO of 777 Asset Management and a former CEO of Legal & General Capital, which he set up to pioneer the drive for socially useful investments by large institutions.

Prior to this, he was Managing Director with Merrill Lynch and Deutsche Bank providing derivative and structured solutions for insurers and also previously held executive positions at Royal Bank of Scotland and Prudential (UK). He has held positions across asset management, finance and insurance.

As a principal associate at The Good Economy, Paul has co-led the PBII research programme alongside Sarah Forster and Mark Hepworth.

THE GOOD ECONOMY

4 Miles's Buildings
Bath BA1 2QS
T: 01225 331 382
thegoodeconomy.co.uk

impact investing institute

6th Floor, 2 London Wall Place
Barbican, London EC2Y 5AU
T: 07749 741 793
www.impactinvest.org.uk

PENSIONS FOR PURPOSE

1 Townview House, Hales Field
Haslemere, Surrey GU27 2JS
T: 07894 290 449
www.pensionsforpurpose.com