Achieving a critical mass

CATHERINE CHEN, AVANTFAIRE INVESTMENT MANAGEMENT'S FOUNDER AND MANAGING PARTNER, EXAMINES THE RATIONALE BEHIND IMPACT INVESTMENT AND ITS POTENTIAL BENEFITS, BOTH SOCIAL AND FINANCIAL.

IMPACT INVESTMENT HAS THREE salient aspects. First, it is objective-oriented. Second, it looks at the positive side of disruption and uses creativity to uncover investment opportunities. Third, it requires investment managers to use their antifragile skill sets to handle risks associated with randomness, complexities and unknowns.

When making an impact investment, we do not consider it with the trade-off debate in mind.

For a long-time-horizon investment, we target value creation instead of profit. An enterprise has long-term value if it makes itself useful and valuable to its customers or provides a solution to their pain points. Impact investment is about building an enterprise to last with positive social impact, but not making short-term transactional profits.

An objective-oriented approach

The objective of impact investment should have three components: a plausible business thesis, a concise implementation plan and sufficient resultant impact.

Take "quality education", one of the 17 Sustainable Development Goals (SDGs) of the United Nations, as an example. When investing in an education provider, it is not good enough to solely have an objective to educate the poor. We will assess what impact it brings, such as the quality of educational materials and the environment of the education and the sustainability of the business model, which should be able to earn a meaningful profit over the investment period.

The education provider should be providing implementable steps with specific goals in order to measure the effects such as the improvement of quality that leads to enhancement in the abilities, skills and income of individuals. Lastly, the impact must be big enough to justify the input and be able to achieve a critical mass effect. All these components are essential when we evaluate impact investment opportunities and assess the possibility of success.

We consider various aspects of impact for investment. The SDGs can be one, but also any other social or environmental initiation, such as the Paris Agreement for climate change and Belt and Road Initiatives for sustainability technology transfer.

Opportunity creation in disruption

Impact investment often happens in a disruptive situation or business environment, which is not necessarily bad. We look at the opportunistic side of it and seek positive results. The opportunities have both financial and social aspects. In private markets, an impact investor seeks the bottom of the J curve, which coincides with the disruptive changes. For example, global oil shortage has accelerated the development of the alternative energy market, which leads to large profits being generated in related industries and the supply chain in this paradigm shift. We invest in companies and managers who are bright and practical enough to seize the opportunity and ride on the changing trends.

Many industries are facing negative environmental and social impacts, often with many externalities unsettled. A typical example is the food industry, where producers tend to produce more, sell cheap and generate large carbon footprints. An increasing number of green-minded customers are not buying this model. More companies in this market are focusing on the positive side of the business and vowing for the idea of "less is better" while improving product quality and carbon footprints. We understand that global business and environment cannot be changed in one day, nevertheless we appreciate large companies making small steps with big impact and small companies making big laps to create incremental influences.

More companies have been changing unfavorable conditions into valuable and investable products. In order to create such positive change, we rely a lot on the left brain and creativity. Impact investment managers must have a strong design thinking skill set to make it happen. Design thinking is a method to discover real customer pain points, using prototyping and other techniques to remodel a business and create a win-win structure of an existing trade-off. Impact investment managers often need to be creative in managing invested projects with different culture, geographical and industrial specifics.

> **"IMPACT INVESTMENT IS ABOUT BUILDING AN ENTERPRISE TO LAST WITH POSITIVE SOCIAL IMPACT, BUT NOT MAKING SHORT-TERM TRANSACTIONAL PROFITS."**

Managing risk on impact assets

In the above example, companies are able to manage its operational and compliance risks. Impact assets also have particular risks to be managed. In comparison to other traditional investments, impact investment requires higher levels of risk control. If managed appropriately, impact investment could provide better risk-adjusted returns.

Impact investments are linked with ESG and sustainability measures. The underlying risks may not appear as salient and obvious as the traditional array of risks such as the macro and business-specific risks. Disruptive business and unsettled environments are less predictable. The theory about antifragility is very much applicable in impact investment, where having the ability to understand and make use of the risks are more effective than controlling the unknown parameters.

Asia is where the action is

We are entering an era where the world has become more transparent. It is easier for investors around the world to get information about their investments in Asia. We are also seeing more Asian investors realise the importance of diversifying their portfolios across the globe. Along with the growing popularity of impact investment globally, when we disclose to our investors project details and the sustainability, or ESG factors, associated with their investments, investors become interested. Education and transparency are the key to better communication with investors on the benefits.

It is advantageous for impact asset managers to be located in Asia, which has the highest growing demand in impact investment. Hong Kong, for example, is an excellent nexus between ASEAN countries, the Greater China region and other Asian countries, along with its connection to global financial markets and the Western technology centres. Impact investment managers in Hong Kong are therefore in a good position to connect impact investment opportunities to the rest of the world. We have a strong belief that Asia will spearhead the impact investment action in the next five to ten years. There are ample impact investment opportunities yet to be created or uncovered in this region.

› THREE-PRONGED STRATEGY - Impact investors must assess a business thesis, an implementation plan and the resultant impact, says Catherine Chen.