MEASURING IMPACT – PART THREE: BEST PRACTICES FOR MEASURING AND MANAGING IMPACT

The Impact Investing Committee

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In this third and final installment of our series on Measuring Impact, we share best practices we recommend to clients on the implementation of impact measurement and management in portfolios.

In the earlier two pieces, we provide an overview of the common impact frameworks available in the market. We also discuss notable trends as the impact measurement and management industry continues to evolve.

NEPC IMPACT INVESTING BLUEPRINT

ESTABLISHMENT OF GOALS

At NEPC, we have established a process to implement, measure and manage an impact investing program aligned with a client's specific goals. Our aim is to ensure our clients have a rigorous understanding of not only their investment, but also the impact of their investment.

Successful measurement and management of your impact investing program starts by developing specific impact goals. When clients are interested in aligning portfolio investments with impact goals and developing an impact investing program, we frequently find that while their investment goals are well defined, their impact goals are not.

Additionally, points of view within the organization and its stakeholders may also be misaligned. Therefore, the first step in the process is to work closely with the client to assist them in establishing goals that are aligned to those of their organization and stakeholders. This is accomplished through a series of in-depth discussions, sometimes facilitated through customized surveys that allow stakeholders to share their views anonymously. Questions asked during this survey can include:

- Should the portfolio emphasize negative screening (exclusionary), environmental, social and governance (ESG) factors or thematic (proactive) investments?
- Should the portfolio consider an investment that has some but not all the desired characteristics?
- How should we evaluate the success of the portfolio?

The United Nations Sustainable Development goals (UN SDGs) (discussed in detail in Part One of this series) also serves as a foundation for these discussions.

During this process, we help our clients refine their goals to merge their impact aspirations with investable areas. For example, a family office may want to focus on alleviating poverty, reducing inequality, and increasing sustainability in cities and communities.

Taking this guidance, we can discuss potential areas of investment that align with these goals, such as private real estate investments focused on affordable housing or allocations to municipal investments within bond portfolios. The objective is not to finalize investment decisions, but rather to ensure that the impact goals under consideration are actionable within the investment portfolio, and that the impact and investment goals are aligned.

INVESTMENT POLICY STATEMENT INTEGRATION

Once impact and investment goals are determined, they are documented in the client's investment policy statement. (The impact industry refers to this as documenting your *Theory of Change*.) Documenting the investment policy statement guides portfolio construction and outlines key indicators of success and their measurement.

While every investment policy statement is customized, reflecting the client's unique goals, the following areas are typically addressed:

- **Impact goals and areas of focus**
- **Scope of the program and tools used:** The client can define specific targets for the program. For example, a client may adopt a goal of having a 100% mission-aligned portfolio or a target of 15% of the program invested with thematic managers aligned with the identified goals. They can also document which impact pillar(s) to utilize in their program (more on the pillars below).
- **Decision-making process:** Are decision makers willing to consider newer firms or funds with limited track records? Are they willing to take on illiquidity to pursue impact goals?
- **Identify success metrics:** What are the desired outcomes of the impact program? Ideally, this should include a description of how the program is monitored and measured (see more below).

One framework for managing the process of establishing, documenting, selecting, implementing and measuring investment strategies is Impact Management Project's Five Dimensions of Impact. The five dimensions can serve as a guide to ensure a potential investment will align with impact goals.

IMPACT MEASUREMENT AND MANAGEMENT (IMM)

As noted in the NEPC Impact Investing Blueprint, we view impact measurement and management (IMM) as an ongoing process of evaluating, learning and improving. We customize the IMM approach for each client, based on their goals, preferred frameworks, which pillar(s) they are utilizing, and what types of underlying investments are in the portfolio.

1	2	3	4	5
WHAT outcome(s) does the effect drive and how important are they to the people (or planet) experiencing it?	**WHO** experiences the outcome and how underserved are they in relation to the outcome?	**HOW MUCH** of the outcome occurs? Does it happen at scale and/or drive the outcome deeply? Does it last for a long time?	What is the **ENTERPRISE CONTRIBUTION** to what would likely happen anyway?	What is the **RISK** to people and planet that the impact does not occur as expected?

Source: Impact Management Project Analysis, https://impactfrontiers.org/norms/investment-classification/

For example, data from an investment manager who invests in U.S. public equity will differ significantly from data available from a private equity manager focused on sustainable energy. Below, we outline approaches that NEPC has used with clients at the individual investment level and the portfolio level.

IMM BY PILLAR

Today's impact landscape has four primary pillars clients can use to filter investment choices in their impact program. Depending on the type of strategy, we provide the following framework for clients pursuing an impact investing program:

	Screening	ESG Integration	Thematic Investing	Engagement
Strategy Focus	Screening in/out certain securities for non-financial reasons	ESG factors built-in as part of the investment process	Pro-actively seeking opportunities in targeted areas (e.g. Renewable Energy)	Actively engage in corporate voting process to push focus areas
Investment Universe	Varied across asset classes	Sizable and includes mainstream managers	Growing in size, but many funds are smaller and newer	Small but growing
Performance	May lag benchmarks due to restricted universe	Performance studies show neutral to positive impact	Varied and will have sizable tracking error due to sector focus	Values-oriented motivations, performance impacts tangential
Level of Impact	Low	Low/Medium	High	High
Most adoption	Religious organizations, Endowments, Foundations	All investors	Religious organizations, Endowments, Foundations	All investors, can be skewed to larger investors

Screening: For clients that have incorporated screening into their program, NEPC partners with the investment manager, typically a passive equity manager, to review the portfolio on at least an annual basis. During the review, we focus on ensuring none of the excluded areas of investment are in the portfolio holdings. We also compare key performance indicators of the client's portfolio to those of a relevant benchmark.

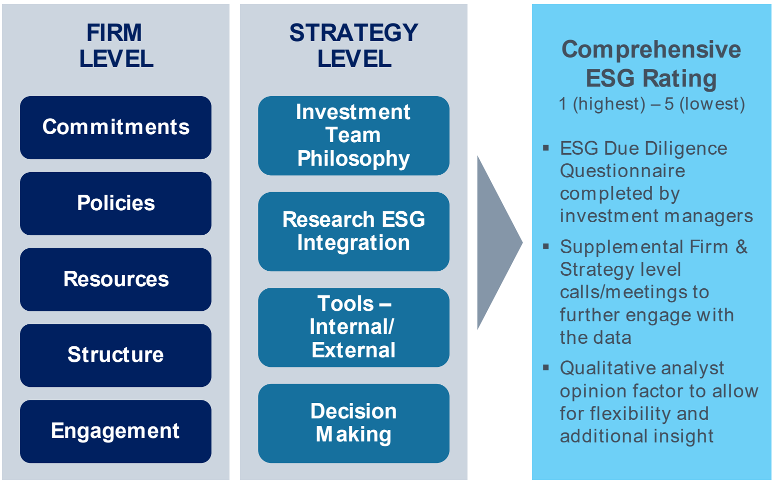
For example, the output below, provided by Parametric, offers metrics for a sample portfolio that has implemented a customized responsible investing screen. The sample metrics below illustrate how the client's portfolio compares to the MSCI ACWI ex U.S. Index with regards to several environmental issues. Within the report, an overall ESG score is also provided. The full sample report can be found in the Appendix.

	PORTFOLIO	MSCI ACWI EX US	IMPACT
Current Scope 1 and 2 GhG Emissions Tons of scope 1 and 2 Greenhouse Gas (GhG) emissions per million US dollars of sales reported by or estimated for companies in the portfolio or benchmark as of the most recent year	131 metric tons / $1M sales 215 companies	205 metric tons / $1M sales 2,272 companies	Your investment indirectly supported the equivalent of the carbon emissions of 898 less cars annually on the road than if you'd invested in the benchmark. *(Tax efficiency and/or portfolio optimization considerations might yield unexpected results)* With no reduction of emissions, the entire Greenland Ice Sheet will likely melt in a millennium, causing 17 to 23 feet of sea level rise. Source: NASA
Current Scope 3 GhG Emissions Tons of scope 3 Greenhouse Gas (GhG) emissions per million US dollars of sales reported by or estimated for companies in the portfolio or benchmark as of the most recent year	474 metric tons / $1M sales 214 companies	1,094 metric tons / $1M sales 2,225 companies	With no reduction of emissions, the entire Greenland Ice Sheet will likely melt in a millennium, causing 17 to 23 feet of sea level rise. Source: NASA
Environmental Controversies Weight of companies in the portfolio or benchmark involved in environmental controversies.	0.00% 0 companies	4.40% 35 companies	Over 2 billion people already lack access to safe drinking water at home, and by 2025 over half of the world's population will reside in water-stressed areas. Source: Pew Charitable Trust
Potential GhG Emissions Potential tons of Greenhouse Gas (GhG) emissions based upon the total coal; oil and gas reserves of companies in the portfolio or benchmark; per million dollars invested.	0 metric tons / $1M invested 0 companies	102,307 metric tons / $1M invested 97 companies	Even on a slower decarbonisation pathway limiting global heating to 1.65°C, the majority of energy companies would see more than half their project portfolio at risk of being stranded. Source: Carbon Tracker Initiative
Sustainalytics ESG Risk Rating The peer-relative ESG risk score of companies in the portfolio or benchmark on a scale from 0-100 with 0 representing a company with the best management of ESG risk in their industry (ideal); shown as a weighted average percentile.	15.70% 215 companies	21.14% 2,190 companies	The ESG Risk Rating is an overall company score based on Sustainalytic's assessment of its exposure to and management of material ESG risks. A high ESG Risk Rating means that material ESG risks are managed poorly versus other companies in the same sub-industry. Source: Sustainalytics

Source: 2023 Parametric Portfolio Associates LLC. Provided for illustrative purposes only. The data contained herein is fictional, does not reflect the performance of any client account, and should not be relied upon to make investment decisions. Is provided as an example and should not be considered an advertisement for or an offer of any Parametric investment strategy.

ESG integration: For clients who have implemented ESG integration, we use proprietary ESG ratings to evaluate the preferred investment managers in our program. These ratings are regularly updated as the investment managers' processes evolve. The process we employ to develop our ESG ratings is mapped below:

NEPC'S ESG RATING PROCESS



For clients who adopt ESG integration as a primary goal, we periodically review the ESG ratings of the managers in the portfolio and strive to improve the overall weighted average. This review follows a templated process and shows a quantitative look over time. The example below was designed to underscore a client's progress over time by count and average score (managers score from 1 to 5, with 1 being the highest level of ESG integration).

In addition to NEPC's proprietary ratings, we will often compile and consolidate ESG integration information provided by the investment managers in the portfolio. As the industry evolves, there is greater consistency in reporting by investment managers, with many managers using the UN SDGs and other commonly used frameworks. The example below from Wellington's Global Annual Impact Report highlights the money manager's approach to evaluating companies in its portfolios.

This approach incorporates the UN SDGs, outlines a theory of change, discusses the five dimensions of impact, and provides a qualitative performance assessment.

Thematic investing: Similar to the example provided by Wellington, for thematic investments held in an impact investing program, NEPC will partner with the investment manager to provide information on how the strategy is performing relative to its goals. Those can then be evaluated relative to the client's stated impact investment objectives.

UN SDG ALIGNMENT
Sustainable Cities and Communities

TARGET 11.1
By 2030, ensure access for all to adequate, safe and affordable housing and basic services and upgrade slums

NEGATIVE IMPACTS
Environmental impact of operations and supply chain

SCALE
Narrow

MITIGATION EFFORTS
Sufficient

WILLINGNESS TO ENGAGE
High

PORTFOLIO INVESTMENT SPOTLIGHT **EQUITY**

Vonovia

IMPACT THEORY OF CHANGE

(How will investment in company's issuer/products and services help solve this specific impact challenge? Why does our investment lead to progress?)

Investments in Vonovia provide affordable housing at a lower price point relative to standard local comparative rents in Germany, Austria, and Sweden. Vonovia reduces costs per residential unit through economies of scale. Affordable housing facilitates greater social and financial stability for its tenant base.

FIVE DIMENSIONS OF IMPACT

(Based on the framework formulated by the Impact Management Project)

WHAT	Lives and communities improved by access to affordable housing	Aspirational
WHO	Number of tenants housed	> 1 million
HOW MUCH	Affordable housing units under management	636,507
CONTRIBUTION	Reduction in monthly rent per square meter compared to market average (Germany)	12%
RISK	Execution: Potential deterioration in housing quality over time	Moderate significance/ low probability

QUALITATIVE ASSESSMENT

(How has company delivered relative to our expectations?)

Vonovia continues to provide high-quality affordable housing units, evidenced by high levels of customer satisfaction that increased over the pandemic. We are encouraged by its tenant outreach and consultation process as well as the discounted rates offered to social organizations.

Meets expectations

ENGAGEMENT PRIORITIES

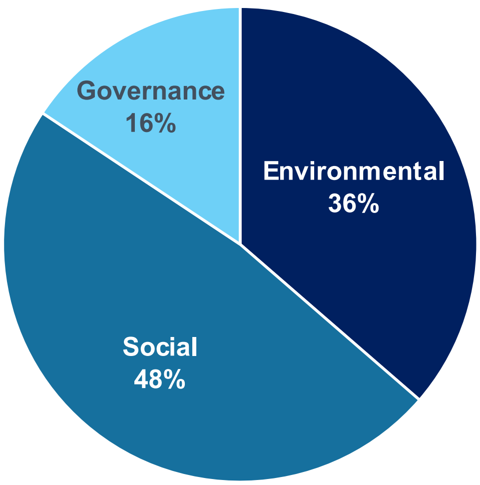
(Issues on which we are looking to engage/have engaged in the prior 12 months)

As Vonovia's balance-sheet leverage has increased, we have engaged on the company's strategic direction and potential modifications under new company leadership.

Source: Wellington Management, https://www.wellington.com/en-us/institutional/insights/global-impact-report-annual-2021

Total portfolio: NEPC provides a summary of the overall performance of funds within the impact investing portfolio. For example, the following summaries were prepared for a family foundation:

ENGAGEMENT SUMMARY BY INVESTED ASSETS



ENVIRONMENTAL

- Introduction of **KPIs** to regular reporting
- Identification of **material** indicators and relevant processes and disclosures
- Assistance with **carbon footprinting**
- Encouraging **transparency** and **management of climate-related risks**

SOCIAL

- Focus on building **sustainable workplace cultures** during and post-pandemic
- Human capital development including **pay equity**, **worker safety**, and **environmental justice**
- Raise awareness of benefits of **diversity** and push for positive diversity outcomes, targets, and policies
- Introduction of **paid sick leave**, improved **wellness programs**, and **flexible work options**

GOVERNANCE

- Facilitating searches for **diverse** board members and advisors
- Focus on tax practices and **transparency**, and governance structures
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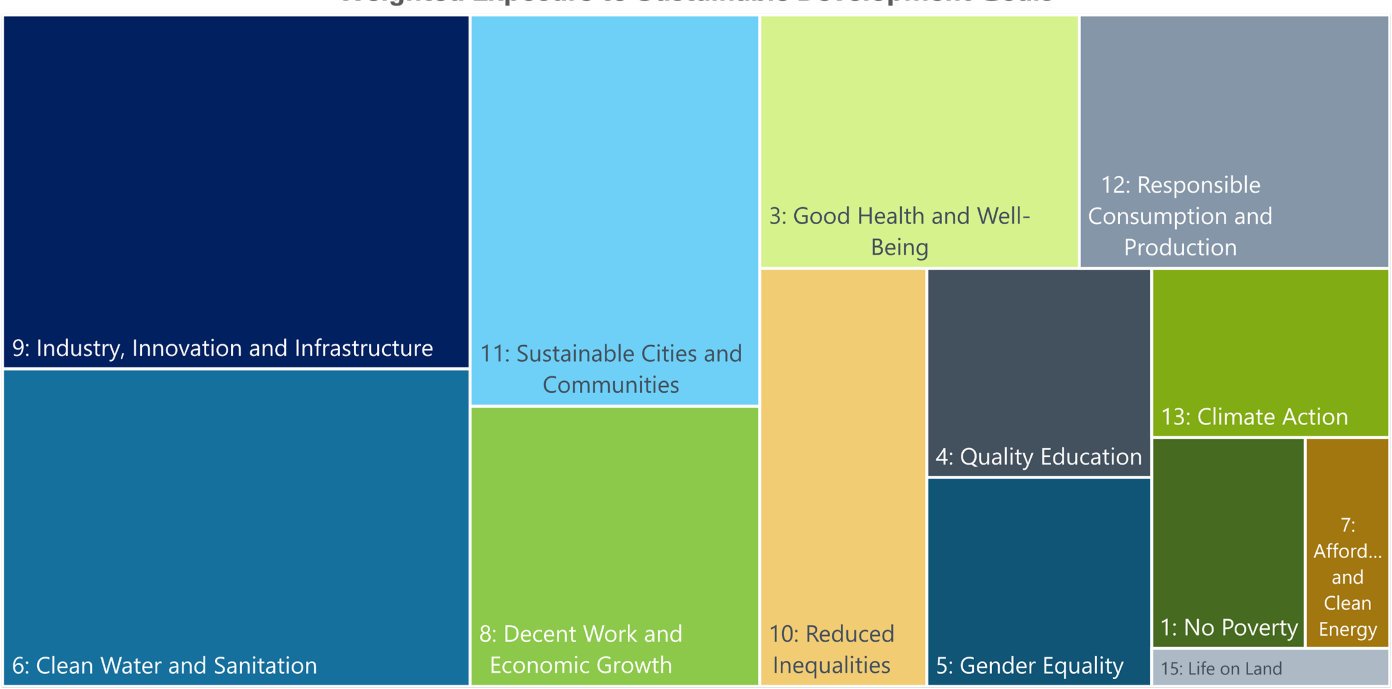
FOUNDATION SDG EXPOSURE

Weighted Exposure to Sustainable Development Goals



IMPACT PROGRAM EVALUATION AND MANAGEMENT

Implementing an impact investing program is not enough; it is also important to manage results over the long term. Once the measurement is complete, the final step of the process is to evaluate results and determine if any modifications should be made to the program. Some of the questions we discuss with clients during an impact program review are as follows:

- Did the program meet your stated goals?
- If goals unmet, what were the roadblocks?
- Do goals and expectations need adjustment, or should we add new targets and goals?
- Is an update to the Investment Policy Statement (IPS) needed?

At NEPC, we help clients implement and manage a successful impact investing program by defining goals, integrating an investment policy statement, measuring performance, and continuously evaluating program performance. For more information about partnering with us to manage your impact investing program, please reach out to your NEPC consultant or contact us here.

This piece was written by Stacey Flier, CFA, Principal, Senior Consultant, and Krissy Pelletier, Partner and Co-head of NEPC's Impact Investing Committee.

IMPORTANT DISCLOSURES

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