Making an Impact:

A Guide for Private Market Investors

In 2015, the UN set forth 17 interlinked Sustainable Development Goals (SDGs) to serve as "a blueprint to achieve a better and more sustainable future for all." Four years after all member countries agreed to the SDGs, leaders met to evaluate their progress toward the 2030 targets. The group acknowledged that despite the good work that had been done, the initiative was behind schedule. UN Deputy Secretary-General Amina Mohammed called 2020 "the year we must change course."

Needless to say, 2020 brought more challenges than any of us could have imagined. From the coronavirus pandemic and tragedies that highlighted social injustice to increasing political polarization and climate disasters, these ongoing issues surged into the spotlight.

- Concerns over the economic effects of Covid-19 turned to how the pandemic was exacerbating existing social inequities. One report estimated women accounted for more than half of job losses despite making up less than 40% of the global labor force.[1] Another study found the mortality rate among African Americans was more than double that of whites.[2]
- The deaths of Black Americans including George Floyd and Breonna Taylor sparked an international movement to end systemic racism and to reform the institutions that enable it.
- Wildfires in Australia and the western US and other extreme and unusual weather events made the realities of climate change impossible to ignore.

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[1] McKinsey Global Institute. 2020. "COVID-19 and gender equality: Countering the regressive effects."

[2] Reyes, Maritza Vasquez. 2020. "The Disproportional Impact of COVID-19 on African Americans." *Health and Human Rights Journal* 299–307.

June 2021

Many around the world gained new perspective on these issues. Critically, many came to realize the effects of Covid-19 and climate change were both correlated with socioeconomic inequity. The effects of years of poor policies and weak institutions, coupled with unequal housing, health and education, brought these inequities into sharp focus.

We also witnessed a range of government and civic responses to these issues, all of which led individuals and institutions alike to reconsider their responsibilities in contributing to a more just and equitable world. Many investors turned to look more closely at the rapidly evolving impact investment opportunity set and to ponder how they might deploy capital differently.

Changes in Investor Appetite

Over the last decade, investors of all types have taken to thinking more critically about their fiduciary responsibility and their ability to help solve environmental, social and governance (ESG) challenges. The rapid growth in the number of signatories to the Principles for Responsible Investment (PRI) is a testament to this evolution. Since its founding in 2006, more than 3,000 organizations representing over $100 trillion in assets under management (AUM) have adopted the PRI. More than 500 signatories are asset owners **(Figure 1)**.

A 2015 PRI report underscored the link between fiduciary responsibility and ESG considerations.[3] The private investment space is littered with cautionary tales of investors who did not sufficiently incorporate ESG risks into their investment considerations, from outright fraud to unfair labor practices and pollution. Today, institutional investors have come to appreciate that fulfilling their long-term fiduciary obligations requires a deep understanding of ESG issues and their implications for financial performance.

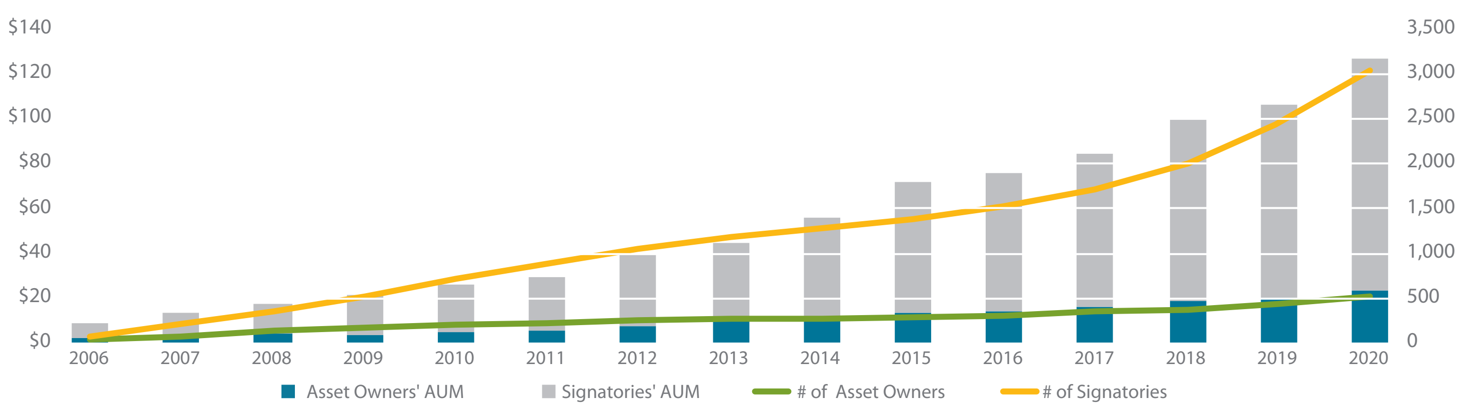
Groups like the PRI have shifted that discussion from divestment to engagement, from negative screening to proactive ESG-related value creation. As ESG integration has become the rule, investors are looking for opportunities to generate targeted social and environmental outcomes, with a view toward having more intentional impact with their investment dollars.

Several additional secular changes are contributing to this shift in perspective.

First, investor profiles are changing. As investment options become more numerous and sophisticated, more stakeholders are investing their capital in a way that matches their worldview. For example, the $30 trillion millennials stand to inherit is creating a generation of investors who believe they can fulfill their financial goals without making concessions.

Second, the financial, regulatory and reputational costs of ESG factors are becoming clearer and easier to measure. The push toward greater disclosure on these topics is underway.

FIGURE 1 | PRI SIGNATORY GROWTH



Source: PRI, March 2020.

[3] Principles for Responsible Investment. 2015. "Fiduciary Duty in the 21st Century."

DISCLOSURE DRIVE

Earlier this year, the EU promulgated the Sustainable Financial Disclosure Regulation (SFDR), and British pension funds adopted the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

The move toward greater transparency highlights the inextricable link between these issues and fiduciary duty. While European investors and regulators push ahead, other jurisdictions could benefit from their own regulatory frameworks to align fiduciary duty and sustainability outcomes. Law firm Freshfields Bruckhaus Deringer is working on a report for the PRI to address this issue and offer suggestions for working across jurisdictions.[4]

2020 was also a record year for the number of net-zero commitments made by corporations, including Amazon, BP, Nestlé and Facebook, to name a few.[5] Companies that have yet to embark on the path toward carbon neutrality will face greater pressure to do so, as evidenced by initiatives such as Climate Action 100+.

Governments are also making net-zero commitments. Last year, China, Japan and South Korea joined the list of countries that are formalizing their carbon neutrality goals. The EU unveiled its ambitious taxonomy, which defines activities aligned with sustainable outcomes. We expect other countries will follow suit. Such commitments will drive focus and investment dollars toward climate change solutions. Achieving these targets by 2050 or earlier will require national policy, operational initiatives and significant investment in accordance with these objectives.

THE INVESTMENT CASE

There has always been the nagging concern that driving intentional impact through an investment program would come at the cost of competitive financial returns. Like climate change, diversity and inclusion (D&I) have found a place at the top of investors' agendas, shining a spotlight on how focusing on intentional D&I impact does not come at a cost. We have seen investors large and small seek out asset managers with diverse teams, and funds that focus on minority-owned businesses or provide goods or services to underserved communities.

FIGURE 2 | LIKELIHOOD OF FINANCIAL OUTPERFORMANCE

Source: McKinsey, 2020.

There is a growing body of evidence that expanding one's investment calculus to include ESG considerations can be a source of alpha. In both public and private markets, data corroborate the strong performance of diverse investment and management teams. On the public side, a 2020 McKinsey study found that diverse teams outperform their more homogeneous peers.[6] As seen in **Figure 2**, companies with executive teams in the first quartile of gender or ethnic diversity are more likely to generate above-average profits than their less diverse peers. A more recent study by Goldman Sachs that looked at 496 large-cap US equity funds found that those with at least one-third of manager positions held by women outperformed those with no women by one percentage point in 2020.[7]

Similarly, in the private markets, studies have demonstrated outperformance by diverse managers and management teams. For example, a study by the National Association of

[4] To learn more, visit https://www.unpri.org/policy/a-legal-framework-for-impact.

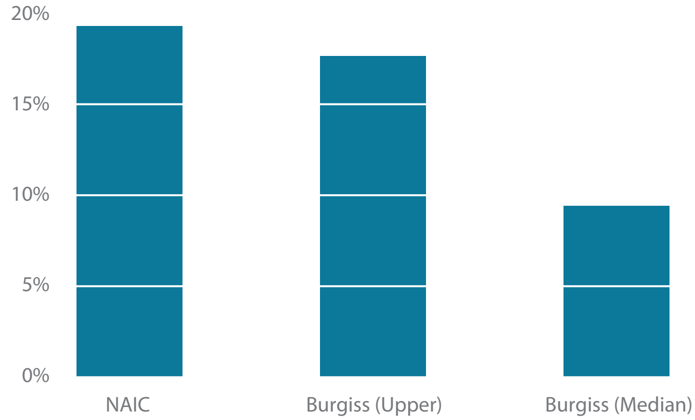
[5] As a firm, StepStone Group purchased enough carbon offsets to negate its carbon output for 2019 and 2020, and is committed to remaining carbon neutral going forward.

[6] McKinsey & Company. 2020. "Diversity wins: How inclusion matters."

[7] Goldman Sachs. 2020.

Investment Companies found that between 1994 and 2018, diverse private equity managers outperformed the broader private equity universe (**Figure 3**).

FIGURE 3 | IRR OF NAIC PRIVATE EQUITY INDEX VS BURGISS BENCHMARK



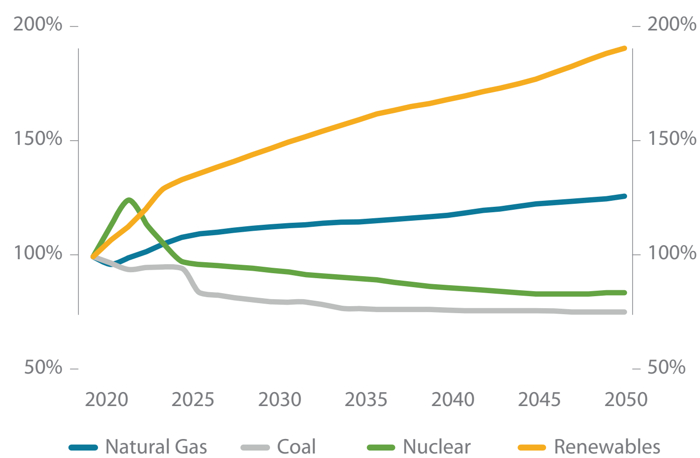
Source: NAIC, 2019.

THE CLIMATE TECH EVOLUTION

As green technologies move down the cost curve, business models that had not been viable are increasingly so. These developments are creating new climate investment opportunities across asset classes. A 2020 Bloomberg analysis found solar power and onshore wind are now the cheapest sources of new-build electricity generation for at least two-thirds of the global population.[8] With renewables projected to constitute the majority of new power construction going forward (**Figure 4**), infrastructure opportunities are emerging in renewable development, energy storage and grid management. Lower battery costs, brought on by the growth of consumer electronics, have made electric vehicles more cost competitive. Real estate investors are also seeing the benefits of owning green or LEED-certified assets. These benefits come in the form of lower costs, higher valuations and lower discount rates.

Although the first wave of venture and growth investing in clean tech (Clean Tech 1.0) still haunts some investors, technological evolution and supportive regulations have led many to reconsider the opportunity set in Clean Tech 2.0 (Climate Tech). In contrast to Clean Tech 1.0, in which venture and growth managers took on substantial technology risk, Climate Tech spans the risk spectrum, including a range of enabling technologies that support the inevitable transition to a greener economy, and some potentially game-changing technologies like green hydrogen and carbon capture, utilization and storage. Notably, this also includes asset-light businesses that seek to improve the emissions profiles of sectors that are the biggest emissions contributors. According to a PwC report, Climate Tech venture capital grew at nearly five times the rate of the overall global venture capital market between 2013 and 2019, increasing from $418 million in 2013 to $16.3 billion in 2019.[9] StepStone sees this reflected in the growing number and size of funds focused on Climate Tech. Most have fallen under infrastructure, followed by growth equity and venture capital. Climate Tech-focused buyouts are still emerging as a strategy.

FIGURE 4 | US TOTAL ENERGY PRODUCTION



Source: US Energy Information Administration, February 2021.

Defining Impact Investing

While investing with dual impact and financial goals stretches as far back as the 1960s, the coining of the phrase "impact investing" by the Rockefeller Foundation in 2006 marked a defining moment. Undoubtedly, the rapid growth in ESG adoption cannot be ignored when discussing the evolution

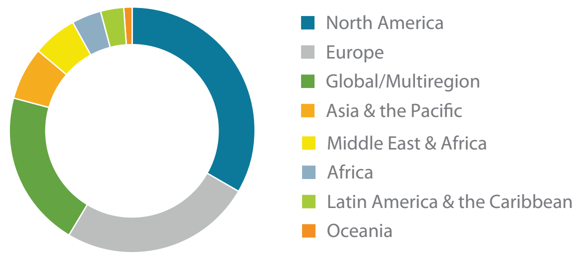
[8] Eckhouse, Brian. 2020. "Solar and Wind Cheapest Sources of Power in Most of the World." Bloomberg Green, April 28.
[9] PricewaterhouseCoopers. 2020. "The State of Climate Tech 2020: The next frontier for venture capital."

of the impact sector over the last 15 years. Today there is a well-recognized spectrum along which investors can add nonfinancial dimensions to their portfolios, from negative screening to ESG integration, to impact investing (**Figure 5**).[10] Along this spectrum, the Impact Management Project's ABC framework illustrates how impact investors are seeking to not only avoid harm and benefit stakeholders but also contribute to solutions. Contributing to solutions may be one of the most critical aspects of impact investing; however, it is an area where rigor varies considerably. Though many managers have impact engagement or asset management plans, these plans can only go so far. GPs are already exacting in their measurement and monitoring of financial outcomes. Extending this same level of precision to nonfinancial outcomes will help the private markets community solve the problems facing society and the planet, earning an attractive return in the process.

Evolution of Impact Investing

The private impact investing universe has grown larger and more sophisticated over the last decade, eclipsing $500 billion in AUM by some estimates.[11] The space has also expanded geographically. Since taking root in the emerging markets, more than half of the impact AUM now targets developed markets (**Figure 6**). Moreover, two-thirds of investors are seeking investments that target the same risk-adjusted returns they would expect from a comparable investment in the same asset class.[12]

FIGURE 6 | REGIONAL FOCUS OF IMPACT FUNDS

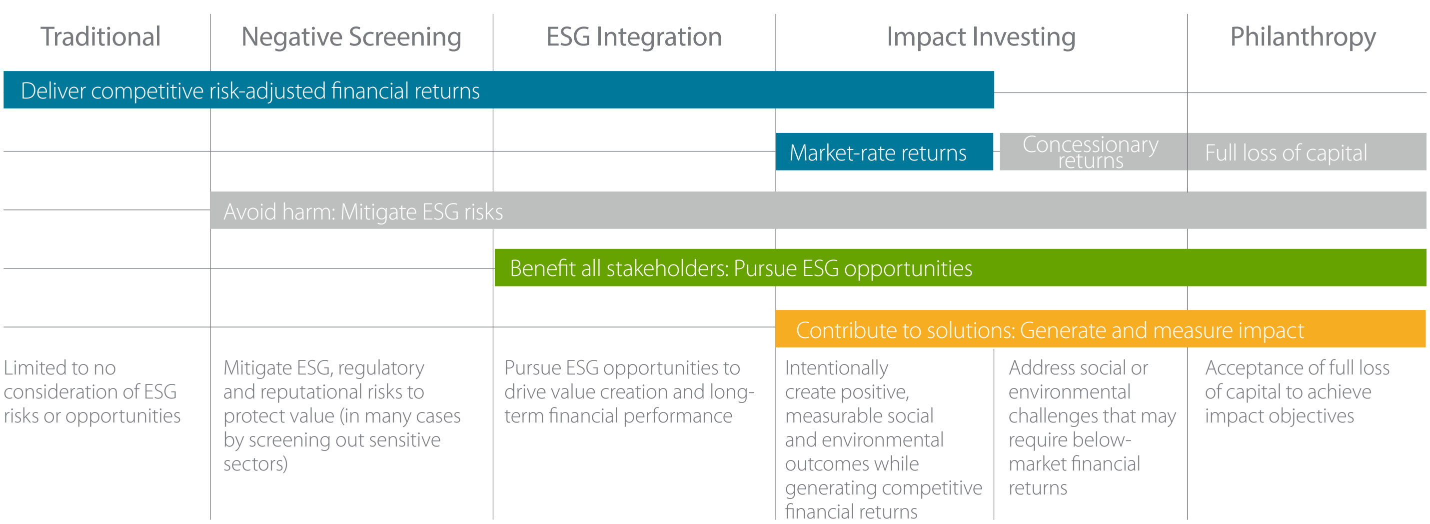


Source: International Finance Corporation, 2020.

This changing face of the investable impact universe reflects the changing profile of LPs and GPs engaged in this space. Stepping back, this underscores the need for a large-scale funding solution to meet the ever-growing needs in emerging markets. Current impact funding models are unable to effectively address this need since the majority of LPs are unable to digest emerging market risk and concessionary returns.

The long holding periods and active ownership structure that characterize private markets suit impact investing. Within the impact universe, there is also a high degree of sector

FIGURE 5 | SPECTRUM OF RESPONSIBLE INVESTMENT



Source: Bridges Fund Management (2019), G8 Social Impact Investment Taskforce, Asset Allocation Working Group (2014), StepStone Group.

[10] Concerned that "impact" carries a heavy development angle, some investors still prefer to use the terms "outcomes" or "sustainability." In doing so, however, they fail to recognize how much the sector has evolved.
[11] International Finance Corporation. 2020. "Growing Impact: New Insights into the Practice of Impact Investing."
[12] Global Impact Investing Network. 2020. "Annual Impact Investor Survey."

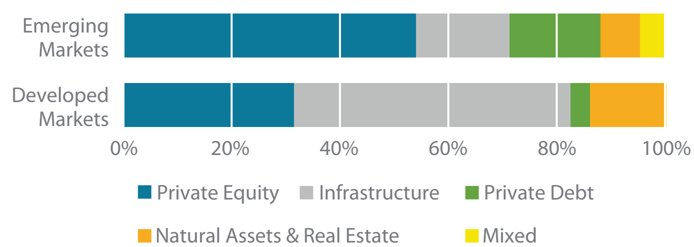
specialization, generating similar benefits to what we see from sector-focused managers in private markets generally. **Figure 7** illustrates the growth in impact investment opportunities across private market asset classes. This growth should enable capital allocators to tailor their portfolios to their investment objectives.

Our proprietary private market research library, SPI, tracks over 700 private impact investment funds and more than 400 managers. Owing to this breadth of coverage, we have observed similar trends. Developed market funds make up 85% of our mapped universe (by number), with the greatest focus on private equity and infrastructure.[13] The funds are split roughly equally between those that focus on environmental outcomes and those that focus on social outcomes, including multi-theme funds that target both. We have found that clients can access many themes by investing across asset classes. For example, we have found compelling climate investment opportunities among our private equity, infrastructure and real estate managers.

We have also observed that the composition of the impact-investing universe is similar to that of the broader private markets. More than half of the impact funds we track are smaller than $250 million, and more than three-quarters are smaller than $500 million—splits that are representative of our broader private market coverage. As impact investment options become more numerous and sophisticated, we expect a similar dispersion among funds in overall performance.

The increase in investor interest for impact solutions has led many traditional alternative investors (e.g., Bain Capital, KKR and TPG) to create new multibillion-dollar impact products. Some of these larger funds focus on a single theme. Brookfield's new climate fund is one such example. Other GPs are providing

FIGURE 7 | TARGET ASSET CLASS BY PRIVATE IMPACT FUNDS



Source: International Finance Corporation, 2020.

multi-theme solutions. Similarly, oil and gas managers are looking to capitalize on the changing winds, repositioning themselves and launching energy transition strategies. When vetting impact managers, LPs should customize their due diligence to each GP type: Focus on the capabilities and track records of emerging managers; for established firms looking to make inroads in the impact space, it is important to root out "impact washers." Determining a firm's authenticity is easier said than done, but the extent to which they have integrated ESG considerations into their operations and investment processes can be a good indicator.

ESG & IMPACT FRAMEWORKS

Another major development is the proliferation of organizations that have emerged as leading standard setters. In addition to the PRI and TCFD, the Sustainability Accounting Standards Board (SASB) and the Global Real Estate Sustainability Benchmark (GRESB) are among the leaders in this endeavor as far as ESG is concerned (**Figure 8**). We

FIGURE 8 | SELECT ESG FRAMEWORKS

	Framework	Description
PRI Principles for Responsible Investment	PRI	The PRI is the world's leading proponent of responsible investment. It works to understand the investment implications of ESG factors, and to support its international network of signatories in incorporating these factors into their investment and ownership decisions.
SASB	SASB	Founded in 2011, SASB develops sustainability accounting standards to account for the impact of ESG factors on the financial performance of companies.
GRESB	GRESB	Established in 2009, GRESB has become the world's leading ESG benchmark for real estate and infrastructure investments. The real estate benchmark covers 1,200+ property companies, REITs, funds, and developers; its infrastructure benchmark covers more than 540 funds and assets.
TCFD Task Force on Climate-Related Financial Disclosures	TCFD	Created by the Financial Stability Board to develop recommendations for more effective climate-related financial disclosures, the TCFD consists of 31 members from across the G20. In February 2020, the number of TCFD supporters surpassed 1,000.

[13] StepStone Private Markets Intelligence. 2021. SPI data are updated continually; values are subject to change.

evaluate ESG practices and material ESG risks across all our direct and indirect investments, leveraging guidance from the SASB Materiality Map, which maps the key risks for each SASB industry. We continue to see evolution in the space toward greater integration as well as stronger commitment to monitoring and transparency. In our experience, the best impact investors build upon sound ESG foundations, align with these standards and disseminate best practices.

On the impact side, the SDGs provide a framework for investors to align their impact objectives with critical global problems. The Impact Management Project (IMP) and the IFC's Operating Principles for Impact Management (OPIM) have created frameworks for evaluating and benchmarking impact management processes, thereby building on the decades of impact experience and codifying it for broader adoption (**Figure 9**). A critical additional dimension for impact investments over ESG is the need to track and measure outcomes. As the universe matures, investors are seeking greater standardization of metrics. The IRIS+ catalog of impact metrics was developed to address this issue. On climate, the TCFD encourages asset owners to disclose a variety of metrics, including the effect of hypothetical climate change scenarios on their portfolios. StepStone has intentionally aligned its approach with these frameworks: We believe standardization reduces compliance costs and enables us to collect more usable data. As such, we urge other asset allocators to align with peak bodies, rather than reinvent the wheel.

EXIT MARKETS

With more companies and countries making climate commitments, and technological advancements making several business models more sustainable, corporate buyers, alternative investment funds and public investment vehicles have become increasingly interested in these sectors. One sign of investors' growing appetite for green ventures is the flurry of special purpose acquisition companies that went public last year, many of which are looking for the "next big thing" in clean energy. According to one report, last year more than a dozen such firms raised more than $5 billion. Many were backed by traditional oil and gas investors who are keen to be at the forefront of the energy evolution.[14] Beyond Meat's 2019 IPO and Oatly's 2021 IPO also underscore the appetite for plant-based food companies, drawing the interest of a number of traditional venture and growth equity investors. This trend highlights some important shifts.

1. Consumer demand is rising for sectors that may have previously been considered niche.
2. Increasingly, funds focused on sectors like food or climate change are recognizing the merit of rigorously measuring nonfinancial impacts and setting targets—particularly when doing so can contribute to higher exit multiples.
3. This increase in demand for such assets is helping to reduce the amount of risk startups face, thus driving more asset supply into the impact realm.

FIGURE 9 | SELECT IMPACT FRAMEWORKS

	Framework	Description
SUSTAINABLE DEVELOPMENT GOALS	UN SDGs	The SDGs are a collection of 17 global goals and targets established by the United Nations General Assembly in 2015 for delivery by 2030.
IRIS+	IRIS Catalog of Metrics	IRIS+ is a catalog of impact metrics aligned with industry standards and best practices that investors can use to measure and report the impact of their investments.
IMPACT MANAGEMENT PROJECT	IMP	The IMP is a forum for building global consensus on how to measure, report, compare and improve impact performance.
	OPIM	The OPIM provides a framework for investors to ensure that impact considerations are purposefully integrated throughout the investment life cycle.

Source: Bridges Fund Management, 2019; G8 Social Impact Investment Taskforce, Asset Allocation Working Group, 2014; StepStone Group.

[14] Elliott, Rebecca. 2020. "Investors Turn to SPACs for Clean-Energy Bets." *The Wall Street Journal*, December 11.

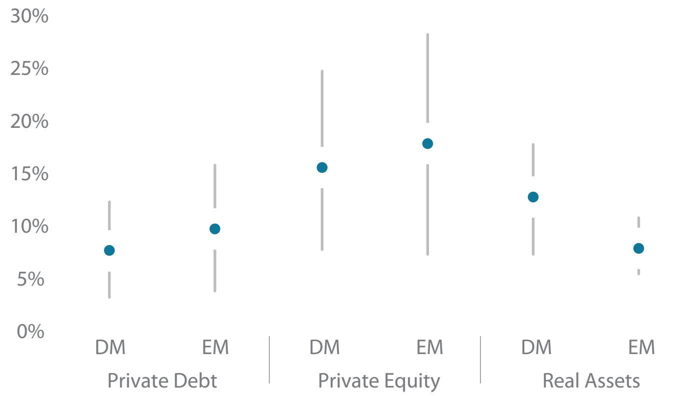
Formulating and Deploying an Impact Strategy

Impact investing is at an inflection point. We believe it is mature enough to be included in any private market portfolios. Impact's performance across asset classes has been in line with the expected risk-adjusted performance for a given asset class (**Figure 10**). There is a similar level of performance dispersion, necessitating a continued focus on rigorous asset and manager due diligence and selection.

StepStone has created an impact taxonomy (**Figure 11**) that we use to help our clients align their objectives to specific investable opportunities in private markets.

Although the impact-investing landscape is sufficiently robust to allow impact programs to remain focused on a single asset class, many clients are seeking multi-asset class exposure as they progressively allocate a greater portion of their portfolios to align with their impact objectives. StepStone's broad private market coverage across asset classes enables us to draw insights from across the risk and return spectrum to bring forth the opportunities most aligned with our clients' financial and nonfinancial objectives.

FIGURE 10 | AVERAGE REALIZED GROSS RETURNS FOR PRIVATE MARKETS SINCE INCEPTION



Source: Global Impact Investing Network, 2020.
Note: Vertical bars represent one standard deviation from the mean. DM denotes developed markets; EM denotes emerging markets.

Based on what we've seen so far, our impact clients have been most interested in energy transition, sustainable agriculture and food, and D&I. Public pension funds have generally been more focused on the developed markets, while foundations

FIGURE 11 | STEPSTONE IMPACT TAXONOMY

and family offices have been willing to entertain emerging markets. The universe of credible managers is only getting bigger, and larger investors still have the potential to tailor their exposure through separately managed accounts.

As standardization in monitoring and reporting ESG and impact KPIs is still developing, StepStone has developed a proprietary metrics catalog, aligned with the IRIS+ framework to allow for consistent impact reporting across our clients' portfolios.

As with any evolving space, some challenges remain for investors looking to deploy impact portfolios (**Figure 12**). We believe these challenges are best addressed through broad market coverage, thoughtful portfolio construction, thorough but tailored due diligence, and active GP engagement pre- and post-investment by investors.

FIGURE 12 | COMMON CHALLENGES TO IMPACT INVESTING

Source: Global Impact Investing Network, 2020; StepStone Group analysis.

Conclusion

As challenging as the last one and a half years have been, we remain optimistic. If there are any silver linings, the heightened focus on inequality in all its forms would be a good candidate. It took a pandemic for us to realize just how similar and interconnected we are. That the effects of Covid-19 and the climate crisis were correlated with socioeconomic inequity has brought social and environmental issues into sharper focus. The investment community has a better grasp of what it can do to fix these problems, and it understands that it needn't forgo attractive returns to do so.

In its earlier incarnations, impact investing was focused on emerging markets, capital preservation or concessionary returns. Today, the impact opportunity for private market investors has never been larger or more robust. Still, formulating a cogent impact strategy, rooting out impact washers and monitoring investments even after the investment period has ended are hurdles that investors need to surmount. Notwithstanding these challenges, the message is clear: The investment community has a critical role to play in enabling the flow of capital to investments with clear and authentic impact. As we look to the future, we expect that these opportunities will be the cornerstones of private asset portfolios, bringing multiple dimensions of value to asset managers and their LPs.

StepStone Group is a global private markets firm overseeing US$333 billion of private capital allocations, including US$80 billion of assets under management.

We create customized portfolios for many of the world's most sophisticated investors using a highly disciplined, research-focused approach that prudently integrates fund investments, secondaries and co-investments.

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