The potential for superannuation funds to make investments with a social impact

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The potential for superannuation funds to make investments with a social impact

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Abstract

The trustees of Australia's superannuation funds oversee the administration of pools of investible monies of unprecedented size. They are required both by statute and by the general law to exercise their powers in pursuit of the best interests of their members. At the same time, there is a strong demand for capital from what have come to be called 'social impact' projects. These are projects which expressly seek to address social or environmental issues while providing competitive financial return to investors. This paper examines the challenges faced by superannuation trustees in providing investment capital to these types of enterprises. It finds that superannuation fund trustees may be able to participate in such ventures if 1) they are careful in their attention to the specific issues arising from these types of investment and 2) they remain focussed on how the drivers of expected returns and risk contribute positively to the investment strategy they have designed for their funds.

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Introduction

The trustees of Australia’s superannuation funds have to find over $30bn of new investment opportunities each year. Much of this will flow into traditional equity and fixed income markets. Some will flow into property markets and some into investment vehicles designed to facilitate investment into infrastructure projects. Moreover the inflow is unrelenting. Not for many decades will payments out of the system to retirees start to exceed member contributions.

At the same time, there is a strong demand for capital in what have come to be called ‘social impact’ projects. These include projects directed towards alleviating poverty, providing access to education, clean water, affordable housing and other resources and protecting human rights, as well projects directed towards improvements in the physical environment. Traditionally financing for such projects came from government and charitable sources. However in a recent report the Department of Education, Employment and Workplace Relations cited Sir Ronald Cohen and Professor William A. Sahlman to the effect that:

During the past century, governments and charitable organizations have mounted massive efforts to address social problems such as poverty, lack of education, and disease. Governments around the world are straining to fund their commitments to solve these problems and are limited by old ways of doing things. Social entrepreneurs are stultified by traditional forms of financing. Donations and grants don’t allow them to innovate and grow. They have virtually no access to capital markets and little flexibility to experiment at various stages of growth. The biggest obstacle to scale for the social sector is this lack of effective funding models.

The question many in the social impact domain are asking is whether there is any way to apply some of the $30bn (or indeed the $1.8tr already in the superannuation system) to projects in these areas. In other words, might it be possible to persuade the trustees of superannuation funds that they could properly make so-called ‘impact investments’; that is, investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.

To answer that question, it is important first to be clear why the superannuation system exists in the form that it does. Then analysis can turn to the legal and regulatory environment in which the trustees of superannuation funds operate. That in turn provides the framework for evaluating in detail how the current regulatory environment constrains impact investing by the trustees of superannuation funds.

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5 APRA, Quarterly Superannuation Performance (interim edition) (December 2013), 6.
7 APRA, above n 5, 6.
The purpose of the superannuation system and the regulatory scheme applied to it

Australia’s superannuation system exists to facilitate the accumulation of financial assets by individuals that can meet some portion of their expenditure in retirement. The scale of the accumulation of assets within the system makes the efficient allocation of those assets across investment opportunities absolutely essential. Not only do individuals need to earn an appropriate return from the financial resource dedicated to this inter-temporal transfer, but the long term health of the economy as a whole depends on the efficient allocation of such a large pool of patient capital.

The trustees of the superannuation funds are central to the capital allocation process. As the Commonwealth Treasurer of the day noted when introducing the legislation that forms the backbone of the regulatory scheme:

‘prime responsibility for the viability and prudent operation of the superannuation industry rests with trustees (and through them investment managers)’

The significance of this de-centralisation of decision-making cannot be over-estimated. Around two-thirds of the system is currently administered by trustees on behalf of others. Those trustees are, as the 1993 Law Reform Commission Report described it, responsible for ‘other people’s money’. The superannuation system relies on these trustees (or more accurately their boards as most are constituted as corporations) distributed across the system to make decisions that are locally optimal, given the perceived needs of their funds and the investment opportunities that present themselves. It should come as no surprise, therefore, that the regulatory scheme applied to the superannuation system focuses its attention on the decision-making process of those trustees.

Importantly, the regulatory scheme does not dictate what investments super funds should or should not make. Rather, the regulatory scheme is designed to ensure that the processes of decision-making employed within funds are free from distraction (such as a conflict of interest or duty) and are directed towards relevant, rational criteria. It is this single-minded pursuit of long term financial performance that appears, on its face, to constrain superannuation fund trustees in respect of impact investment. However, as we shall, see, close attention to the regulatory requirements and to recent market developments elicits grounds for optimism. Opportunities suitable for investment by superannuation funds are

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11 APRA, above n 5. The other one third is administered within Self-Managed Super Funds (SMSFs) in which the members have a direct involvement in all decision-making.
emerging and funds are starting to engage in ways that are similar to the movement seen over the past decade towards incorporation of Environmental, Social and Governance (‘ESG’) factors into investment decision processes.¹⁵

The regulation of superannuation fund investment

Successive federal governments have resisted pressure to regulate the investment decisions of superannuation fund trustees directly.¹⁶ Instead the regulatory scheme is designed to ensure that the key decision-makers are competent, diligent, focused on the needs of members and undistracted by competing interests or duties. The regulatory scheme therefore focuses on the processes by which investment decisions are made not on the actual investments made. As a corollary of this it does not, in a primary sense¹⁷ at least, focus on the actual profitability of the decisions made.

The investment decisions of superannuation fund trustees are governed by rules derived primarily from three sources. The first, although in practice the least important, is the trust instrument. The second is the statutory scheme centred on the *Superannuation Industry (Supervision) Act 1993* (Cth) (‘SIS Act’) that now includes a buttressing set of Regulations, Prudential Standards and licensing requirements. Finally there is a backdrop of general law principles expressly preserved by section 350 of the *SIS Act* that provide default rules and interpretive guidance where required. The trustee of a superannuation fund would need to be confident it could comply with all these rules before entering into an impact investment.¹⁸

The rules from these different juridical sources co-exist in a quite complex and often subtle tapestry.¹⁹ There are however two main areas relevant to the present discussion. The first is the collection of statutory and general law rules relating to the proper exercise of the investment power. The other is the collection of statutory and general law rules related to the standard of care that the trustee of a superannuation fund must demonstrate when making investment decisions. Importantly, although these rules apply to all investment decisions taken by the trustee of a superannuation fund, their application in the context of impact investing raises some issues that require specific attention.

¹⁵ For an account of the development of ESG in a number of major markets globally see Benjamin J Richardson, ‘Fiduciary and Other Legal Duties,’ in H. Kent Baker and John R. Nofsinger eds., *Socially Responsible Finance and Investing: Financial Institutions, Corporations, Investors and Activists* (John Wiley & Sons, 2013).


¹⁷ In practice there is of course an inherent asymmetry that predisposes litigation or prosecution when a loss has actually occurred.

¹⁸ For a discussion of the rules applicable in New Zealand (and Australia prior to the recent reforms), see Doug Tennent, ‘Ethical Investment in Superannuation Funds; Can it Occur without Breaching Traditional Trust Principles?’ (2009) 17 *Waikato Law Review* 98. For the situation prior to recent Australian reforms see also Koo, above n 14.

¹⁹ For a discussion of this ‘multi-valent’ regulatory tapestry see M Scott Donald, ‘Regulating for Fiduciary Qualities of Conduct’ (2013) 7 *Journal of Equity* 142
The proper exercise of the investment power

There are three overlapping sets of rules related to the proper exercise of the investment power by superannuation fund trustees that deserve attention: the sole purpose test in section 62 of the *SIS Act*, the requirement deriving from the covenant articulated by section 52(2)(c) of the *SIS Act* that a trustee act in the best interests of members, and the general law doctrine of powers. A fourth, the presence of constraints imposed in the trust instrument, is no more than a theoretical possibility only because in practice modern superannuation trust deeds do not contain such constraints.

The sole purpose test

The starting point of many discussions about what is required of the trustees of superannuation funds in respect of investment is the ‘sole purpose’ test imposed by section 62 of the *SIS Act*. In essence that prolix section requires trustees to maintain the superannuation fund solely for one or more of a set of identified ‘core’ purposes (the provision of benefits upon a member’s retirement, attainment of the official retirement age or death) or a combination of core purposes and one of a short list of ‘ancillary’ purposes.

Section 62 is self-evidently designed to orientate the trustee towards pursuit of the primary objective of the superannuation system, namely the provision of a means by which individuals will save during their working lives to accumulate assets to fund their expenditure in retirement. The problem for impact investing is that, taken literally, the provision exhaustively defines the ‘core’ and ‘ancillary’ purposes and thereby entrenches the all-eclipsing sovereignty of those purposes over all other matters which a trustee might have otherwise considered. In so doing it inspires the impression that investments that are made not purely for financial gain, such as impact investments, may be off-limits for superannuation funds.

Surprisingly, section 62 has yet to be the subject of any sustained curial analysis. The section is frequently applied in the self-managed superannuation fund (‘SMSF’) context but only occasionally in the context of large-scale superannuation funds. In both contexts it is most frequently invoked to stop members from personally deriving benefits from the superannuation fund prior to retirement. It has for instance been applied to restrain trustees from using the monies in the fund to purchase assets used for personal recreational purposes, or using the money to prop up a family business, or, most famously, to provide access to members to shareholder discount cards from a prominent retailer. In each of

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20 *Sutherland v Woods* [2011] NSWSC 13, [115].
22 A self-managed superannuation fund is a superannuation fund in which the (up to 4) members act as trustees or as directors of the corporation acting as trustee.
23 *Sutherland*, above n 251, discussed further below.
24 See for instance *Amp Superannuation Ltd As Trustee of the Amp Superannuation Savings Trust* [2011] NSWSC 1439, [14].
these examples the benefit flowed to members and their families rather than to a party unrelated to the trust, as would typically be the case in an impact investment.

In the absence of detailed analysis by the courts, APRA has documented its interpretation of section 62 in *Superannuation Circular No.III.A.4 The Sole Purpose Test.*28 The Circular is not authoritative but it suggests that the key regulator for the superannuation industry envisages a less exacting test of ‘sole purpose’ than a literal reading of the section would impose. Of particular relevance in respect of impact investing, the Circular displays a benign attitude to the presence of ‘incidental advantages’ in the exercise of a trustee’s power. Such advantages will not taint a decision of a trustee if:

the provision of retirement benefits for members is the **overriding** consideration behind the investment decision29 (emphasis added)

This interpretation, if accepted by the courts, is more accommodating of impact investment than is a purely literal interpretation of section 62. It would permit trustees to consider the investment credentials of specific impact investments without being concerned that the presence of incidental advantages would fatally taint the proposition.

**A trustee’s duty to act in the beneficiaries’ best interests**

The second rule relevant to the proper exercise of the investment power is the covenant expressly inserted into all trust instruments by section 52(2)(c) of the *SIS Act*. Section 52 provides:

(1) If the governing rules of a superannuation entity do not contain covenants to the effect of the covenants set out in subsection (2), those governing rules are taken to contain covenants to that effect …

(2) The covenants referred to in subsection (1) are the following covenants by each trustee of the entity: …

(c) to ensure that the trustee’s duties and powers are performed and exercised in the best interests of the beneficiaries

The precise scope and effect of this covenant has been subject to both curial30 and academic31 scrutiny over the past eight years. It suffices here to note that it clearly echoes the general law principle, articulated most famously in *Cowan v Scargill*,32 that trustees must act in the best interests of members. Importantly, Megarry V-C in that case went on to define the best interests of members in the context of a pension (superannuation) fund as the financial best interests of the members.33 The result is that trustees are repeatedly told

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29 APRA, above n 28, [34].
33 *Cowan*, above n 32. This attention to the financial interests is further heightened in the case of trustees of MySuper products by section 29VN(a) of the *SIS Act* which requires those trustees to:
they must eschew any non-financial considerations in the pursuit of the best interests of members.\(^\text{34}\)

This focus on the financial interests of members, narrowly defined to be those arising \textit{qua} member, is clearly relevant in the context of impact investment. It suggests that trustees of superannuation funds cannot be motivated in making investment decisions by the potential for that investment to promote specific social objectives. Equally, this principle does not prohibit trustees from making investments that may have a positive social impact, where the financial attributes of the investment are compelling. The position would seem to be that, from the perspectives of the best interest duty at least, trustees can make investments that are attended with the potential for social benefit, so long as they can demonstrate that there is no prejudice to the financial interests of members.

\textit{The doctrine of powers}

The final set of rules relevant here derives from the general law principles governing a donee’s exercise of a power. Although there are harmonic resonances in the powers doctrine with both section 62 and the best interests covenant, it would be a mistake to assume it could be subsumed within them. The most important of the rules deriving from the doctrine of powers for present purposes is that the trustee of a superannuation fund must exercise its powers for a ‘proper’ purpose.\(^\text{35}\) The ‘proper’ purpose is defined narrowly in the general law as being the purpose for which the power was granted.\(^\text{36}\) An exercise of a power for a purpose other than a ‘proper’ purpose is voidable as a ‘fraud’ on the power.\(^\text{37}\)

As with the definition of best interests, the ‘proper’ purpose underpinning the investment power in the superannuation fund context is narrowly defined; namely to achieve the financial objectives of the fund.\(^\text{38}\) The question then arises whether the investment power can be exercised properly where there is an additional or subsidiary purpose relevant to the decision, such as the potential for social impact. The courts have held that the presence of potential incidental or collateral benefits will not necessarily taint the exercise of a power. As Parker LJ noted in \textit{Vatcher v Paul}:

\begin{quote}
It is not enough that an appointer or some person not an object of power may conceivably derive some benefit.\(^\text{39}\)
\end{quote}

This approach was applied to the superannuation context in \textit{Invensys v Austrac Investments}\(^\text{40}\) where Byrne J was not prepared to impugn the trustee’s division of surplus

\begin{footnotesize}
\begin{enumerate}
\item \textit{Re Courage Group’s Pension Schemes} [1987] 1 WLR 495. The classic modern description of the doctrine of powers can be found in Geraint Thomas, \textit{Thomas on Powers} (OUP, 2\textsuperscript{nd} ed, 2012).
\item \textit{Vatcher v Paul} [1915] AC 372, 378; \textit{Re Courage}, above n 35.
\item \textit{Duke of Portland v Topham} (1864) XI HLC 59; 11 ER 1253
\item \textit{Cowan}, above n 32, 287.
\item [1915] AC 372, 379. Also \textit{Fuller v Evans} [2000] 1 All ER 636.
\item [2006] 198 FLR 302, [111].
\end{enumerate}
\end{footnotesize}
simply because it conferred a benefit on the employer, so long as other relevant requirements (such as bona fides on the part of the trustee) were met. But under what circumstances might an incidental purpose that is improper taint the decision? It is clear from the general law authorities that an intention to secure collateral benefits need not be the ‘sole’ or ‘dominant’ purpose behind the exercise of the power for the court to intervene. Where the power exercised is a dispositive power, the court has on occasion severed the polluting purpose (for instance by voiding the appointment of a non-object) where to do so does no injury to the rest of the decision. Even if such an approach were to be extended to an administrative power such as the investment power, it would not assist here as the social impact inheres to the investment made and thus it would not be possible to sub-divide the consequences of the decision into parts consistent with a proper purpose (which would be valid) and those tainted by an improper purpose (which would be invalid). Another approach is required.

Logic would seem to suggest that in respect of decisions like the decision to invest, the polluting purpose must at least be capable of influencing the decision taken by the trustee. There is some authority for this, but it is by no means unequivocal. In Hooke v Robson, Jacobs J talks of an ‘actuating purpose’ that he distinguishes from secondary or incidental purposes. In a similar vein, the court in Re Greaves, applied a materiality test; only improper purposes of sufficient materiality would sufficiently taint the exercise of the power to render it void. Likewise Ranero, in reviewing the doctrine of powers in respect of the analogous area of managed investment schemes, identifies a preference for a ‘dominant’ purpose test within corporate law that he believes reflects an appreciation of the commercial realities in which directors, such as those responsible for making decisions within a corporation acting as trustee of an investment trust, operate. Against this, MacLean is clearly uncomfortable with a materiality test. Thomas also reports that a materiality test is inconsistent with the weight of authority he has reviewed. In its stead Thomas discerns amongst the early cases a preference for a ‘but for’ test, albeit noting an absence of support for this approach more recently.

It is a matter for speculation as to which of these views will ultimately prevail. For present purposes it is perhaps sufficient to note the apparent consensus that, whatever the criterion applied, in practice the court will not intervene unless it believes the decision was in fact influenced by the alternative purpose or purposes to the detriment of the beneficiary. This encourages the conclusion that a decision made by a trustee using strict investment criteria will not be rendered ‘improper’ from the perspective of trust law simply because other benefits accrue incidentally.

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41 D M Maclean, Trusts and Powers (Law Book Co, 1989), 120.
42 Maclean, above n 41, 121 – 122.
44 Re Greaves [1954] Ch 434, 447
46 MacLean, above 41, 119.
The duty of care

The second broad set of rules for which the trustee of a superannuation fund must have regard are the rules that regulate the standard of care required in decision making. The general law rule articulated in *re Whiteley* was that trustees must:

‘take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.’\(^{48}\)

This formulation has now effectively been eclipsed in the superannuation context by the bespoke statutory requirement contained in the covenant in s52(2)(b) of the *SIS Act* to:

‘exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity of which it is trustee and on behalf of the beneficiaries of which it makes investments’

The question then arises, what is meant by ‘care’ in the context of investment by superannuation fund trustees? The terms of the covenant do not precisely replicate the general law but they are similar enough to suggest that the general law jurisprudence in the area can inform construction of the statutory covenant. Relevantly in that regard, the general law identifies two distinct strands of the touchstone notion of prudence: one related to investment risk and one related to what might be termed ‘due diligence’.\(^{49}\) Each is dealt with below.

Prudence and the assumption of investment risk

The traditional view of investment by trustees emphasised caution and the preservation of capital.\(^{50}\) That sensibility is understandable when the trust is concerned with the enjoyment and distribution of assets between different classes of beneficiaries over time. Self-evidently, it is less well suited to trusts in which the underlying objective is to accumulate wealth, such as superannuation funds.

It is interesting therefore to note that the terms of section 52(2)(b) of the *SIS Act* were recently amended to remove the reference, borrowed from the general law, to a moral claim possessed by the beneficiaries to expect care on the part of the trustee.\(^{51}\) As can be seen from the text of the provision reproduced above, the amended provision is now more focused on the context of its application, expressly referring both to a prudent superannuation trustee and to the making of investments. This brings the covenant in s52(2)(b) into line with the covenant in section 52(6) (previously section 52(2)(f)) of the *SIS Act* that requires trustees to:

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\(^{48}\) (1886) 33 ChD 347, 355.

\(^{49}\) This distinction, although discussed briefly below, is more fully outlined in Donald above n13.

\(^{50}\) See for instance *ASC v AS Nominees* (1995) 133 ALR 1,12

\(^{51}\) The terms of this covenant were amended by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth). The pre-amendment covenant required a superannuation fund trustee to:

‘exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide’

formulate and give effect to an investment strategy that has regard to the whole of the
circumstances of the entity including, but not limited to, the following:

(i) the risk involved in making, holding and realising, and the likely return from, the
entity's investments having regard to its objectives and its expected cash flow
requirements …

It is therefore now unambiguous that the trustee of a superannuation fund will be expected to
have regard for the needs of the fund in setting its investment strategy, which in many cases
will require the trustee to assume some investment risk in pursuit of investment returns.\(^\text{52}\)

**Prudence and the elimination of due diligence risk**

The covenant articulated in section 52(6) now also starts to address the second dimension
of the trustee's duty of care with respect to investment: due diligence. This requirement was
arguably always present in the general law.\(^\text{53}\) Cases such as *Smethurst v Hastings*,\(^\text{54}\)
*Fouche v Superannuation Board*,\(^\text{55}\) *Re Lucking's Will Trusts*,\(^\text{56}\) and *Re Preuss and APRA*\(^\text{57}\)
are good examples of circumstances in which the trustee's breach of duty arose not from the
acquisition by the trustee of an asset that was of a type inappropriate for the trust (as was
the case in *re Whiteley*)\(^\text{58}\) but rather arose from deficiencies in the conduct of the trustee.

Reproduced more fully, section 52(6)(a) provides that a trustee must:

formulate, review regularly and give effect to an investment strategy for the whole of the
entity … having regard to:

'(i) the risk involved in making, holding and realising, and the likely return from,
the investments covered by the strategy, having regard to the trustee's objectives
in relation to the strategy and to the expected cash flow requirements in relation to
the entity; and

(ii) the composition of the investments covered by the strategy, including the
extent to which the investments are diverse or involve the entity in being exposed
to risks from inadequate diversification; and

(iii) the liquidity of the investments covered by the strategy, having regard to the
expected cash flow requirements in relation to the entity; and

(iv) whether reliable valuation information is available in relation to the
investments covered by the strategy; and

(v) the ability of the entity to discharge its existing and prospective liabilities; and

(vi) the expected tax consequences for the entity in relation to the investments
covered by the strategy; and

(vii) the costs that might be incurred by the entity in relation to the investments
covered by the strategy; and

(viii) any other relevant matters. (emphasis added)

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\(^{52}\) Donald, above n 13. Also Finn and Zeigler, above n 34, 337.

\(^{53}\) Donald, above n 13.

\(^{54}\) (1885) 30 Ch D 490 – a general failure to enquire, where enquiry would have identified the deficiencies
of the investment proposed.

\(^{55}\) (1952) 88 CLR 609- failure to secure adequate security for a loan made from trust monies.

\(^{56}\) [1967] 3 All ER 726 - failure to supervise adequately the affairs of a privately held business.

\(^{57}\) [2005] AATA 748 - failure to employ adequate operational safeguards in the handling of trust cashflows
and assets.

\(^{58}\) (1887) 12 App Cas 727.
The requirement (in (iii)) to have regard to the liquidity of the investment under consideration and (in (iv)) to whether reliable valuation information in respect of that investment is available are to some extent common sense. It is hard to see how a prudent trustee could ignore such things. They are also paradigmatic examples of due diligence considerations. Other examples not listed, but potentially incorporated under (vii), include the legality of the structure under relevant regulatory regimes, the availability of mechanisms within the structure to protect investors’ rights and the types of other investors participating in the scheme.

**Why impact investments?**

There is no doubt that there is considerable demand for funds by organisations pursuing social and environmental agendas. This is hardly new, nor is it unique to Australia. Nor is it any surprise that the accumulation of assets in the superannuation system is seen as a possible source of funding. Similar calls have been seen in respect of finding funding for infrastructure projects, small business financing and any number of other potential applications.

Estimates of the size and potential growth of the impact investing ‘market’ extend from its current US$40bn to over US$1,000bn in the coming decade. However it is not necessary to form a view on the potential size of the ‘opportunity’ for impact investing to answer the question of whether trustees should consider including impact investments for their portfolios. As we have seen, trustees must focus on the circumstances specific to their fund in formulating their investment strategy. The claim, then, for impact investments, must rest on what they can bring to the investment portfolio of the superannuation fund as investments.

It is first necessary to discount one possible approach. Despite some apparent similarities, the case for impact investing cannot rely on the success of the push for sustainable investing seen over the past decade. Ultimately the push for consideration of ESG factors by superannuation fund trustees was successful because the factors could be re-cast as risk factors. Consideration of risk has always been a core part of a trustee’s role. That opportunity does not exist for social impact investing. Social inequality certainly has economic ramifications but the connection of those ramifications to the financial best interests of the members of superannuation funds is altogether too tenuous.

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61 World Economic Forum, above n 8.


Impact investing must rely on its own credentials. It turns out that the key is the potential for impact investments to provide diversification to institutional portfolios. The projects underlying impact investment span a wide variety of activities and jurisdictions. That diversity suggests the potential for impact investment to provide a naïve form of diversification to investment portfolios; ‘naïve’ because it does not rely on any information about what those investment portfolios already hold.

There is however a much more powerful argument in support of the ability of impact investments to add diversification to the portfolios of superannuation funds. Whatever points of difference may distinguish impact investments one from the other, they all share one important, unifying characteristic: they all relate to activities where traditional markets have failed. This is not only a unifying characteristic. It is also the basis of a much more compelling argument for the diversification potential of impact investing. Put simply, there is almost no overlap between the social activities that underlie the financial performance of all investments created by capital markets and those funded by impact investment. The demand for impact investing arises from the absence of private market institutions (coupled with the presence of societal norms that identify the ‘need’). This is the essence of true diversification, the ability to harness different return ‘drivers’.65

What is the source of those returns? In some cases governments provide financial rewards to the entity for achieving specified goals. So for instance, the returns provided by the UK government to investors in the Peterborough Social Impact Bond66 depends on the success of a specially-constituted partnership of social sector organisations in achieving or beating a measured reduction in the rate of recidivism amongst a specific offender demographic. The NSW State government has recently introduced two analogous programmes (the Newpin Social Benefit Bond and the Benevolent Society Social Benefit Bond).67 In other cases governments have provided risk capital to seed investment opportunities that might otherwise appear inappropriate for institutional investment.

In each case the impact investor is left bearing risk. No investment return is absolutely guaranteed. However the entity-specific factors that determine the level of investment return have a strong claim to be uncorrelated with the factors driving the performance of more traditional investments such as the securities traded on mainstream financial markets. There may be broad sources of correlation between financial returns in the mainstream and impact sectors, such as economic growth and changes in wealth and income distribution, but the entity-specific drivers will be distinctive.

An important difference today is that organisations concerned to address specific social issues have recognised that they can package the financial ‘opportunity’ in ways that render these social activities amenable to institutional investment. The Goodstart Early Learning programme, for instance, was a public company limited by guarantee that issued a range of different tranches of debt, the Australian Chamber Orchestra Instrument Fund was structured as a fixed unit trust and Barefoot Power was a proprietary company funded using convertible debt and equity. Alternately, the Federal government has used its the Social

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64 This does not include investments, such as bonds, issued by governments at all levels as these also might be said to arise as a response to failures in private markets.

65 Zvi Bodie, Alex Kane and Alan J Marcus, *Investments* (Irwin, 1993), 197.


Enterprise Development and Investment Fund (SEDIF) to seed the establishment of three social enterprise investment funds – Foresters Community Finance (Foresters), Social Enterprise Finance Australia (SEFA) and Social Ventures Australia Impact Fund to finance the start-up and expansion of social enterprises in Australia. Private sector investment into these funds was provided by a combination of diverse investors including Christian Super, Triodos Bank, Community Sector Bank, Macquarie Group and the NSW Aboriginal Land Council. Similar programmes are well developed overseas, including both developed and developing markets.  

The availability of such investment opportunities does not mean that they will all be appropriate for investment by superannuation funds, nor that they will all be successful in delivering adequate investment returns. The size of some of the opportunities is too small to warrant the research effort required to ascertain their relevance to a multi-billion dollar superannuation fund. Moreover some impact investments will inevitably fail. Others will provide lower returns than expected. But that is true of any investment. As Judge Putnam famously noted in respect of the Harvard endowment almost one hundred and eighty five years ago, ‘do what you will, your capital is at hazard.’

What must trustees do?

The regulatory regime governing the superannuation system does not require that the trustees of superannuation funds consider social impact investing. The social impact sector is unlikely ever to amount to such a large portion of the investible universe that trustees would be held to be in breach for not considering it. On the other hand, the analysis presented above suggests that it may be possible for trustees of superannuation funds wanting to engage in social impact investing to consider specific proposals for investment without contravening the legal and regulatory requirements imposed upon them.

It will be crucial for trustees wishing to go down that path to ensure that all potential impact investments are subjected to the same processes that are employed in respect of other investments in their portfolio. The economic drivers of return must provide confidence about the potential role of the investment in the portfolio. That may require the trustee to source expert assessments about the viability and risks associated with social programmes not ordinarily within the expertise of institutional investors. More prosaically, there must be protocols in place to provide accurate, independent valuations and audit reports and there must be sufficient transparency and reporting from the entity receiving the funds that the trustee can monitor the success or otherwise of its investment, and form judgments about its continued relevance for the fund. Finally, the trustee will also have to consider carefully how it reports its participation in impact investments to members. Section 1013D(I) of the

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69 Harvard College and Massachusetts General Hospital v Amory 26 Mass (9 Pick) 446 (1830).
Corporations Act requires trustees to report the extent to which environmental, governance and social factors are considered in its investment strategy.

Concluding Comments

The privatisation of social security in Australia has resulted in the accumulation of a large number of discrete pools of patient capital; the superannuation funds at the heart of the superannuation system. The size of these pools is unprecedented in Australia, such financial consequence hitherto having been wholly the domain of a handful of banks and insurance companies. The fiduciary overseers of these pools, the trustees of the superannuation funds, therefore have a crucial role in seeing that these monies are invested efficiently and effectively.

At the same time, there is a burgeoning demand for finance in areas not currently well served by modern markets, areas where the social benefits from the activity are not ordinarily accompanied by financial reward. Impact investing attempts to address this disconnect. These innovative programmes are specifically packaged to facilitate institutional investment and the presence of engaged investors can be expected to promote further development. Importantly, though, it turns out that neither trust law nor the statutory scheme applied to superannuation funds specifically, are as restrictive as some believe. Trustees must simply proceed with care and due attention to the unique features of impact investments, apply financial criteria to the assessment of any investment proposition and remain steadfastly focused on the best interests of their members. There is nothing new in that.