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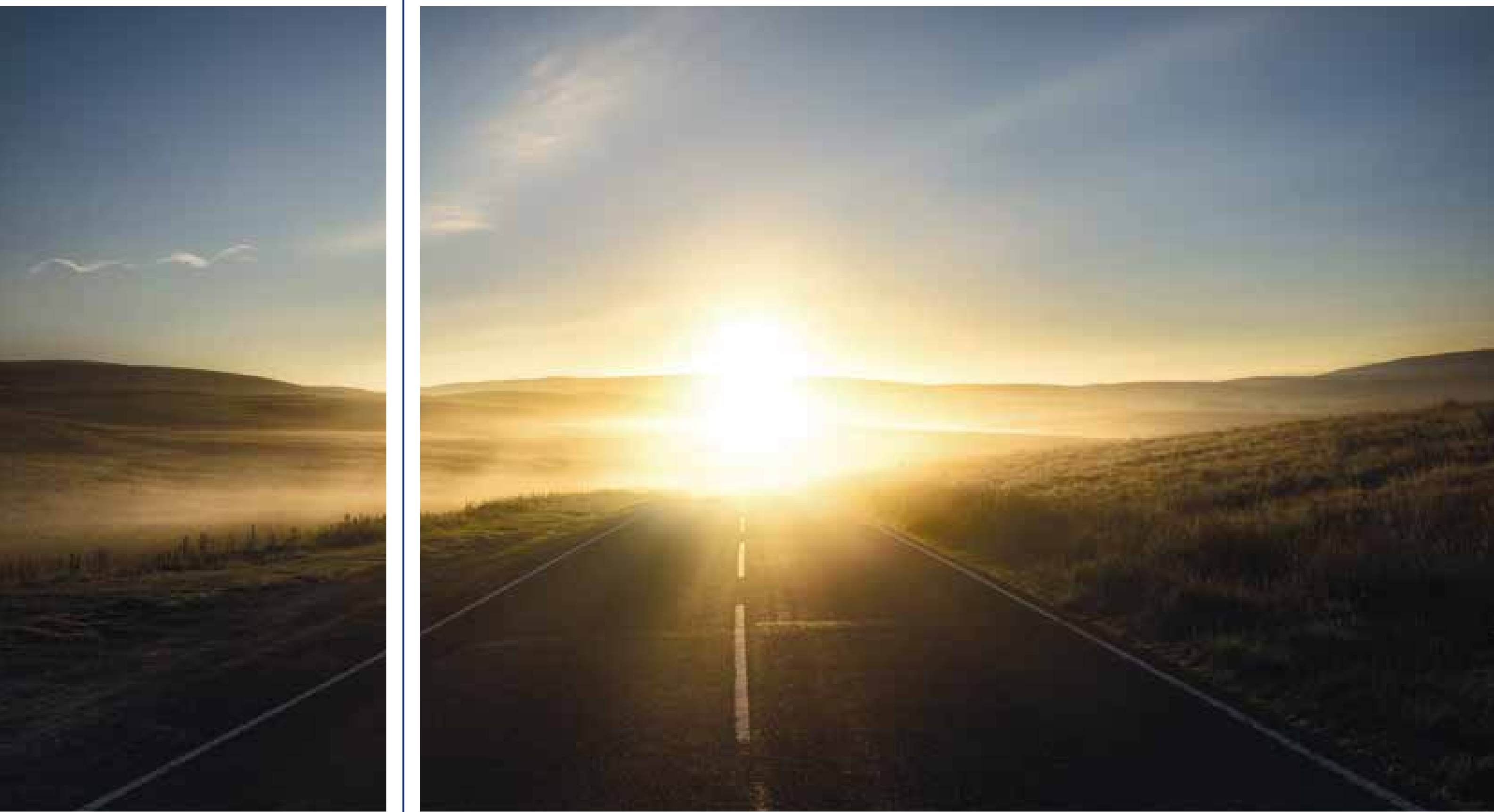

BIG SOCIETY CAPITAL & CAMBRIDGE ASSOCIATES

Unlocking the Investment Potential of the Treasury Portfolio for the Benefit of Society

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Big Society Capital, the UK-based Social Investment Institution, and Cambridge Associates, the global investment adviser, have pioneered a radical new approach for managing Treasury portfolios, in a move that could propel the UK's social investment market to a new level. If pension funds, foundations and other major institutional investors follow their lead, they could generate greater social value by shifting billions of pounds of untapped assets towards the development of innovations designed to transform society.

The two organisations have found a unique way to unite the apparently conflicting aims of the ultra-conservative Treasury function and the ultra-creative social impact function. Using the new approach, BSC's Treasury portfolio – which was previously managed according to conventional no-risk criteria – has been reshaped so that a greater proportion of the funds can be used proactively for social impact purposes without compromising either the generation of portfolio financial returns or the financial security of the company.

Also, they have identified an emerging group of innovative investment managers who are actively developing their capabilities in "impact investment". These managers will be among the drivers of the growing impact investment industry in the years to come. This was a key outcome for BSC in furthering its market-building mandate.

BSC & CA: Making Mission Impossible – Possible

In 2015, Big Society Capital ("BSC") approached Cambridge Associates ("CA") with a daring proposition: could it help find a way to better deploy the funds sitting in the Treasury portfolio towards social impact purposes and do so without compromising financial security?

> “ *The question posed by BSC was typical of a company with a clear mandate to think outside of the box and to test accepted norms.*

This was a big ask. In investment terms, the Treasury and social impact investment functions are generally regarded as polar opposites. Whereas the Treasury's golden rule is "don't lose money – ever", the social impact portfolios' mission is to be creative and to encourage new models of investment to meet society's needs. How could they be brought closer together?

But the question posed by BSC was typical of a company with a clear mandate to think outside of the box and to test accepted norms. It was co-founded in 2012 by Sir Ronald Cohen – who also founded Apax Partners, the venture capital firm – with a mission to develop social investment in the UK so that charities and social enterprises can increase their positive impact in society. It was set up as a wholesale social investor and capitalized with £600m to enable it to build the market. The funds are a combination of £400m that had languished untouched in dormant bank accounts and £200m of equity investment from the four major UK banks. Under UK legislation, money in dormant sterling bank accounts - often a forgotten £5 here or £10 there – can be collected by the government if it has been unclaimed for 15 years or more.

> “ *If institutional investors follow BSC and CA, they could shift billions of pounds of untapped assets towards the development of innovations designed to transform society.*

Already, BSC has signed 48 deals which, with matched investment, have made available almost £600m of additional social investments. Among the investee intermediaries are Social Finance's "Care and Well-being Fund" developed in partnership with Macmillan, Cheyne Capital's Social Property Fund, Salamanca's "Funding Affordable Homes" fund, Bridges Social Impact Bond Fund, Big Issue Invest's second Social Enterprise Investment Fund, LGT's Impact Venture Fund, Resonance's National Homeless Property Fund, and an equity investment in Charity Bank.

But, in late 2014, BSC started to rethink the role of its Treasury portfolio. Although payment of the money from the dormant accounts is staggered in tranches, it still adds up faster than BSC's long-term investments can draw it down. So, while it waits to be drawn down, it is held and invested through the Treasury portfolio. This prompted BSC to consider a series of questions: Could and should the Treasury Policy be changed to further align it to their mission? In particular, could it act as another tool, alongside the investment portfolio, in building the social investment market in the UK? Beyond this, BSC wondered whether the addition of an impact focus to its Treasury portfolio – and those of other investors – might encourage more issuance of Social Bonds to mirror the developments in the Green Bond market? Would it help to increase the level of listed retail bonds issued by Charities and other Social Sector Organisations through the RCB platform?

In essence, BSC wished to explore how a pool of money, within the restrictive financial considerations inherent in a Treasury portfolio, could be allocated for financial security and yet integrate an increased

social impact requirement. It viewed leadership in this endeavor as core to its mission. If it could design and follow a clear process, with due regard for fiduciary responsibilities, and share it with others, in keeping with the core principal of transparency, others might be empowered to ask themselves the same question.

CA was convinced this was possible. It advises some of the world's biggest institutional investors on the shape of their portfolios and the selection of their investment managers. In doing so, it has developed some pioneering asset liability models and a formidable knowledge of the world's best performing investment managers. It quickly realized that BSC's Treasury portfolio could be better utilized for the purpose of social impact investing. It also knew that a number of excellent investment managers would be delighted to have the opportunity to create new products for an influential investor such as BSC.

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After an initial consultation, CA proposed a two-step plan of action. BSC needed to:

1. Radically reshape its Treasury portfolio by mapping its cash flow requirements, introducing multiple layers of liquid reserve, and permitting the balance of the Treasury investment to be invested in SRI-friendly corporate bonds with a variety of maturity dates.

2. Discover a fixed income manager who could maximise the social impact of the portfolio within the right set of risk parameters.

BSC approved the plan, and over the next few months, CA implemented this strategy.

STEP 1
Reshaping The Treasury Portfolio

The first task was to map out BSC's future cash flow requirements. The fund makes capital commitments ranging from £100,000 to £15 million, with an investment period of 3-6 years. Combining BSC's knowledge of the social impact market and its own experience of implementing private investment portfolios, CA was well placed to model the expected cash needs from the Treasury portfolio.

The second task was to introduce multiple layers of liquid reserve in order to protect the portfolio against the risk of unknown future events. To do this, CA modeled six scenarios, conducting a series of increasingly extreme stress tests. Some of the less likely scenarios – for instance, if all of BSC's investments turned sour – were explicitly specified to test how BSC might be forced to draw down the whole of its Treasury assets to instantly fund its long-term social impact investments.

After this, CA developed three layers of liquid reserve. For the first layer, it chose a moderately stressed scenario as the base case – rather than what was considered to be the most likely scenario from a purely financial market perspective – and allocated a sum of money to the liquid reserve that would cover this eventuality. Next, it applied a series of standard asset valuation "haircuts" on the portfolio – using the European Insurance Solvency II framework for modeling Solvency Capital Requirements (SCR) – and transferred an equivalent amount from the bond portfolio to the liquid cash reserve. For a third layer, CA increased the absolute value of the available liquid cash by 100 per cent. This was designed to ensure that (even in increasingly challenging scenarios) it was highly unlikely that BSC would ever have to sell any of its Treasury assets at a capital loss.

Having completed this analysis, CA made three recommendations to the BSC Board:

1. The amount of cash to be held in the liquid reserve

2. The profile of future liabilities to be matched with bond maturities

3. The amount of Treasury assets to be made available for investing in longer maturity, mission-related securities.

As expected, CA's analysis demonstrated that a significant proportion of BSC's Treasury assets could be invested to meet its social impact objectives without undermining its financial objectives.

STEP 2
Selecting a Manager for the Treasury Portfolio

Having determined the shape of the Treasury Reserve portfolio, CA searched for an investment manager who demonstrated not only strong risk controls and a proven expertise in credit selection but also the capability to run a portfolio of high quality socially responsible fixed income securities using traditional negative and positive screening of the individual bonds as well as newer more innovative approaches.

CA's proprietary manager database tracks more than 900 socially responsible funds, across a broad range of asset classes. After an initial search, CA compiled a list of 14 investment managers who could provide customizable short-dated fixed income management while integrating social impact factors in their investment process.

The next task was to draw up a shortlist of three investment managers. To do this, CA devised a targeted questionnaire and together with BSC conducted a rigorous interview process. This was not the standard checklist RFP because CA already possessed a great deal of information on the managers. The questions fell into two categories:

1. On fixed income: did the managers have the ability to implement strong risk controls for customised portfolios of cash-flow-matching fixed income?

2. On social investment: how did they implement both the more traditional negative (exclusionary) and positive (best-in-class) impact seeking credit screening, and how did they actively engage with companies?

> *“ AXA Investment Managers... best addressed BSC’s twin goals of maintaining capital security and making a meaningful social impact without compromising financial returns.*

From a very strong field of candidates – all of whom could demonstrate risk controlled management of Treasury reserves and innovative socially responsible credentials – CA and BSC selected three managers for their exemplary SRI processes, appropriate fee structures, experienced and stable teams, ability to conduct positive and negative screening, evidence of thought leadership and existing activity in Social Impact Investing, and consistent record of outperformance.

After much deliberation, BSC chose AXA Investment Managers. AXA Investment Managers handles a total of £5bn of assets in core RI and Impact strategies, including an Impact Investing programme of about £152m. It has also integrated ESG factors into £263bn of assets under management or advice. As well as positive and negative screening, it looks for opportunities with social impact and green bonds. For these reasons – and ultimately because it had found a way to integrate the ESG and Impact function in the mainstream investment process – it was deemed to be the firm that best addressed BSC’s twin goals of maintaining capital security and making a meaningful social impact without compromising financial returns.

Conclusion

Big Society Capital now has a fully reshaped Treasury portfolio.

At the outset of the Treasury project BSC, tasked with building a diverse and sustainable social investment market in the UK, wanted to establish if its Treasury portfolio – that most conservatively-managed part of any investment organisation’s asset pool – could be deployed, alongside its investment portfolio, for its core mission. It believes that it has done so.

The approach adopted by BSC, Cambridge Associates and Axa Investment Managers has wider implications. BSC hopes that its bold decision to rethink its approach to its Treasury portfolio will encourage others to do the same. There are now a significant number of asset managers in the UK who are building their expertise and who are capable of working with asset owners to add an “impact” dimension to their portfolio goals.

Cambridge Associates is proud to advocate for the integration of ESG criteria into mainstream asset management. The firm is committed to helping clients find innovative ways to meet their socially responsible goals without compromising financial security or returns.

Investment Manager Universe		
	Aberdeen	Insight
	Alliance Trust	Kames Capital
	AXA IM	M&G
	Columbia Threadneedle	Newton
	Edentree	Rathbone
	BMO (formerly F&C)	Royal London
	HSBC	Sarasin

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