Impact Investing: An Introduction

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Introduction

Impact investing has become an emerging buzzword in the investment industry over the past decade. Investors ranging from philanthropic foundations to commercial banks and everywhere in between have ramped up their interest in the concept. What is it? Impact investing is the practice of investing capital into a company or strategy that seeks to generate positive social and environmental impact while at the same time generating a financial return. Many consider impact investing to fall within a broader category of responsible investing which also includes the commonly heard socially-responsible (SRI) and environmental, social and governance (ESG) focused investment styles.

Impact investing goes beyond the typical negative screening methodologies found in other responsible investing disciplines (i.e. no alcohol or tobacco industries) and focuses on making proactive investments to benefit society. Advocates of impact investments suggest the concept goes well beyond alternatives to fossil fuels and can influence all aspects of society.

Profound growth in this niche industry has also brought confusion for market participants and investors alike. Surveys taken of investment managers often combined the data between the several forms of responsible investing and some would argue there remains disagreement in definitions themselves! The purpose of this paper is provide a high level overview of the concept serving as a starting point for interested investors. We will explore the history of impact investing, current strategies and market participants, its integration with traditional portfolio management, and finally difficulties and opportunities for the industry going forward.

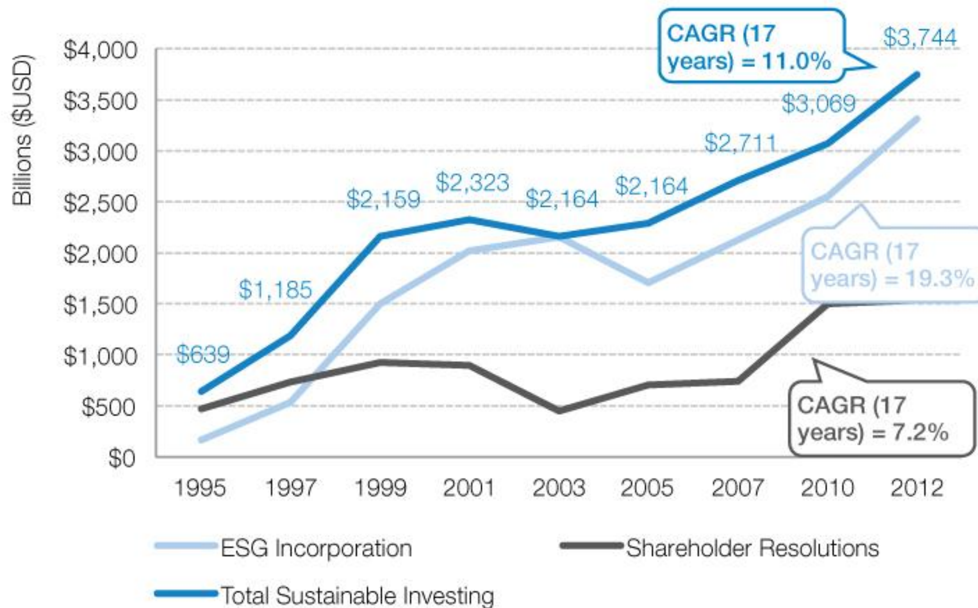
History and current landscape

While impact investing may be a new terminology for many investors, the practice of investing in companies or initiatives addressing social and environmental challenges is centuries old. Some argue it grew out of the Quakers in 17th century England to incorporate their religious values into day to day commercial activities. Other examples highlight anti-apartheid divestment campaigns starting in South Africa in the 1960s, investments targeting environmental initiatives to improve clean air and water across the US in the 1970s or growth in microfinance and development loans in developing nations through the 1990s[1]

Statistics for assets in impact investment focused strategies are hard to pinpoint. Most of the data sets rely on inputs from surveys that may not capture the full market or may be subject to manager discretion in how the strategy assets are reported. That said, the responsible investing universe as a whole has shown

[1] Bugg-Levine, Antony and Emerson, Jed, “Impact Investing: Transforming How we Make Money while Making a Difference,” *Innovations: Technology, Governance, Globalization,* Summer 2011, Vol. 6, No. 3, Pages 9-18

considerable growth since the mid-1990s as shown in the figure below.



Source: US SIF Foundation's 2012 Report on Sustainable and Responsible Investing Trends

Today, within the United States there is an estimated $3.74 trillion allocated to socially responsible investment strategies and only $25-30 billion within the impact investment sector alone[2].

Current strategies and market participants

As the industry has evolved, so has the number of participants. Recent survey data published by the World Economic Forum indicates the distribution of impact asset ownership to be heavily concentrated among institutional investors[3]:

- 48% Pension Funds
- 39% Insurance Companies
- 9% Sovereign Wealth Funds
- 2% Family Offices/High Net Worth Individuals/Development Finance Institutions
- 1% Foundations
- 1% Endowments

These participants range in size from small investment funds and grants to large scale billion dollar initiatives across the globe. These participants have operational differences worth noting as well. Some actively make impact investments while others allocate capital to those making the investments. For example, sovereign wealth funds have the size and capability to originate microfinance loans or make

[2] World Economic Forum, "*From the Margins to the Mainstream – Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*," http://www3.weforum.org/docs/WEF_II_FromMarginsMainstream_Report_2013.pdf (September 2013).

[3] Ibid

infrastructure investments while other participants like mutual funds can only invest in companies with impact initiatives or products.

These investment managers and strategies focus on improving basic human needs and services by focusing on microfinance, clean technology, carbon offset, water purification, smart-grid technology, sustainable commerce, sanitation and health improvement, education initiatives, food security, sustainable land use, and other items.

Impact investments are made via the same investment structures as other opportunities in financial markets including equity and debt offerings. Institutional investors typically have access to these strategies via boutique investment funds and private equity while retail investors have access via mutual funds, common equity investments and exchange traded funds.

Large institutional investors are declaring plans to launch huge initiatives in the impact investing realm. In 2012, Bloomberg Philanthropies and Goldman Sachs announced a 5-year, $9.6 Million Social Impact Bond (SIB) to reduce recidivism in incarcerated youth. This SIB will fund initiatives to keep re-incarceration rates down, while attempting to deliver a financial return to Bloomberg and Goldman. Since the U.S. Government does not have the money up front to invest in an SIB themselves without seeing the outcomes first, institutional investors can provide the financing. Hopefully, after seeing the results, the U.S. Government will be able to finance the appropriate returns to the investors, creating an optimal investment structure. In 2012, President Obama authorized $100 million of these SIBs, otherwise known as "Pay-for Success" financings. The alignment of institutional investors and Government agencies in the SIB initiatives seeks to give it the push necessary to withstand the pressure from those unfamiliar with the strategy[4].

Impact investments are diversified globally yet are predictably guided by the level of economic development in a particular region. Investors will find a higher focus on health and human service investments in developing nations while smart grid and other high tech investments are focused in developed nations with sufficient infrastructure.

Integration with Portfolio Management

Most investors use modern portfolio theory as their primary portfolio management tool because it provides a relatively easy way to calculate and measure risk vs. return for a set of investments. Impact investments add a third dimension, representing the social and environmental impact generated by the investment. This third dimension has been difficult for most investors to quantify. For starters, one fundamental issue is the lack of available data. Financial markets digest news and information instantaneously which is reflected in the stock or bond price of a specific company. It is much harder to measure the effectiveness of an impact investment as data points are not generated on a minute by minute basis. Impact investments take time to measure effectiveness. There is also an issue with data collection all together. For example, studies commissioned on carbon emissions in North America may be larger in number with more accurate results as compared to developing nations. It is hard to reject or accept a hypothesis when the data set doesn't exist for a large part of your sample.

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[4] The Rockefeller Foundation, "*Building a Healthy and Sustainable Social Impact Bond Market: The Investor Landscape,"* http://www.rockefellerfoundation.org/blog/building-healthy-sustainable-social (Dec. 2012)

Another example could be microfinance initiatives. Surveying individuals can be difficult due to privacy issues and lack of participation. An organization created in 2009, the Global Impact Investing Network (GIIN), was established with funding from the Rockefeller Foundation, JP Morgan and the United States Agency for International Development to solve some of these issues in the impact investing industry by establishing standardized metrics and building an online global directory for participants.

Additionally, asset allocators and investment managers are trying to determine where impact investments fit into a diversified portfolio. In a common core/satellite approach, would impact investments fit in the core as a long term investing, or as a satellite strategy complementing other core equity and bond holdings? To answer this, one must take a step back. Impact investments are often not considered an asset class by themselves. They are considered an investment approach utilizing specific criteria. For example, shares of a public company that builds smart grid technology may exhibit the same characteristics (volatility, interest rate sensitivity, etc.) as other non-impact public companies of similar size.

Impact investing advocates will suggest that companies leading the way towards making a positive social and environment impact in addition to profits, will be rewarded in the long term. For example, companies creating solutions in the green economy like solar energy or carbon offset solutions, will be the ones who capture larger market share as the economics of traditional natural resource industries begin to shift. The argument continues that these companies will develop a competitive advantage, absorb market share from traditional industries, motivate employees and emphasize to shareholders their focus on long-term sustainable value creation. Should this investment thesis be correct, market capitalization and share price will increase with profits and deliver gains to shareholders. In this example an asset allocator may consider this type of impact investing as a growth strategy and fit into the portfolio accordingly. On the fixed income side, impact investments can be made via microfinance loans, social impact bonds or simply loans to companies engaged in industries deemed suitable by an impact investor's criteria. A portfolio manager would follow the same due diligence process used for other fixed income analysis to determine the risk/return profile of the strategy and place in the portfolio accordingly. Depending on the portfolio manager or client's preference, an emphasis may be placed on social impact over financial returns which would ordinarily skew the results.

Impact investors can still rely on traditional modern portfolio theory as the issues mentioned above are addressed. Traditional MPT analysis would indicate that these asset classes are not without risk. Several impact strategies with a green energy focus lost more than 60% during the credit crisis. Despite an investor's social inclination, a 60% loss is always hard to swallow.

To further complicate the matter, some impact investors will identify companies owned by traditional asset managers as well. Household names like Google, Apple and Microsoft are often found in impact focused publically traded portfolios as well as traditional market capitalization weighted strategies due to their commitment to sustainability, corporate responsibility, green energy and overall emission reduction. This can result in a higher than expected concentration and correlation for the portfolio manager.

<u>Difficulties facing impact investing</u>

It is hard to measure the tradeoff between financial and social returns. Would you feel better about earning X% on your investment portfolio, or improving the quality of life for future generations by some intangible amount? What about for an investment committee of a major pension plan? They have

fiduciary responsibilities which require them to be accountable to the plan beneficiaries. If the committee makes an impact investment that earns sub-par returns compared to an identical non-impact investment, should they be accountable for missed returns?

A slightly more nuanced difficulty comes when trying to apply a common performance-evaluation tool, attribution analysis, to impact investments. This analysis attempts to identify the sources of an investment manager's performance. The analysis looks at individual stock selection, allocating to high returning asset classes or timing their investment decisions accurately among other items. Currently, there is no way to incorporate social and environmental benefits to society in this type of analysis. The infrastructure for widespread access to these data sets are not as robust as compared to traditional finance metrics.

Furthermore, the time horizon for measuring social and environmental trends is often much longer than we are used to in the investing world. It may take decades to measure the effectiveness of a microfinance program in raising economic standards in a particular region. Also there is an issue with standardization and interpretation of data. Investment professionals can very quickly and easily calculate Alpha, the measurement for excess return relative to a benchmark, for an investment manager's strategy and the results are to be interpreted identically for all analysts. The same can't be said for measuring impact investments as there is often bias in interpretation in addition to the data collection issues mentioned above.

Lastly, external factors play a bigger role in these areas of investments. Suppose you were able to quantify a trend indicating a sustainable farming initiative had a positive environmental benefit. Would you be able to isolate the long term environmental benefit as a direct result of the farming initiative or would some exogenous factor like climate change have skewed the results?

These are just a few of many questions often raised to impact investing advocates and highlights the need for the financial services industry to develop a more robust analysis standards.

Opportunities going forward

Fortunately for the impact investment industry, serious initiatives are underway to improve these measurement difficulties. Organizations like the Global Impact Investing Network, large pension plans like CALpers, private foundations such as the Rockefeller Foundation, and SRI focused investment companies like Calvert are attempting to improve understanding, measurement and acceptance of impact investing as the industry evolves.

Investment capital is abundant and growing. In a study recently conducted by JP Morgan, between $400 billion to $1 trillion will be available over the next ten years to address problems facing individuals at the 'bottom of the pyramid.'[5] Interest in this type of investing is growing rapidly as well. A recent study by Deloitte uncovered that while a small percentage (6%) of US based pension funds have made an impact investment, 64% expect to make an impact investment in the near future.[6] Large scale pension managers

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[5] JP Morgan Chase, *Impact Investments: An emerging asset class*, https://www.jpmorgan.com/cm/BlobServer/impact_investments_nov2010.pdf?blobkey=id&blobwhere=1158611333228&blobheader=application%2Fpdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs (Jan 15, 2014).

[6] http://www3.weforum.org/docs/WEF_II_FromMarginsMainstream_Report_2013.pdf

and investment companies like CALpers and JP Morgan have developed divisions focusing exclusively on responsible and impact investing strategies.

Studies are already being created on the resulting returns of impact investing, and they appear promising. Of the primary focuses for impact investing, reducing the recidivism rates amongst the incarcerated youth is at the forefront of the U.S. Government and many investor's initiatives. A pro-forma analysis by McKinsey showed that 25% of SIB returns go back to tax-payers, while the balance went to the rest of the participants of this particular juvenile justice program[7]. Returns such as these provide a hope for sustainability in impact investing, both socially and financially.

Additionally, impact investing is going more mainstream and attracting a more diverse investor base. Deal sizes are getting smaller and being a qualified purchaser or accredited investor is no longer mandatory in all cases. Mutual funds and exchange traded funds are being organized to focus exclusively on impact investments.

Conclusions

We have provided an introduction to impact investing and recommend further reading if you are interested in learning more. If history is any guide, we can tell by the sheer number of market participants and the investable capital they represent, that impact investing is here to stay. As the industry matures surely some of these difficulties will be addressed and opportunities capitalized upon.

We also realize that financial gain and societal benefit need not be mutually exclusive. Our current research has lead us to an investment manager identifying publically traded companies that are leaders in managing environmental risks and opportunities with above average growth potential and reasonable valuations. We view the fund as a strategic investment, held outside our core allocation to equities and fixed income, as we expect a longer investment hold period with a higher than average risk/reward profile. As we expand our impact investing capabilities, we encourage you to contact us if you would like to know more.

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[7] The Rockefeller Foundation, "*Building a Healthy and Sustainable Social Impact Bond Market: The Investor Landscape,*" http://www.rockefellerfoundation.org/blog/building-healthy-sustainable-social (Dec. 2012)