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"The purpose of life is not to be happy. It is to be useful, to be honorable, to be compassionate, to have it make some difference that you lived and lived well."
-Ralph Waldo Emerson

As Emerson eloquently alludes to in the above quote, for some investors maximizing financial return is not the only thing that matters. Investing profitably and in a manner that is useful, honorable, compassionate and ultimately makes a positive difference can express itself in the form of impact investing.

Most investors have heard of the increasingly popular term "impact investing" but they may not be fully familiar with its meaning. This paper will define impact investing and some related terms, explore the history of this type of investing, discuss why it is important now and explore how it can be implemented in portfolios for interested investors.

❖ What Is Impact Investing?

There are numerous definitions of impact investing, but a generally accepted description is "investing for both financial and social return".[1] Put another way, impact investing is "*making money while influencing positive change*".[2] Here are some other related terms that are helpful to define as we discuss the evolution of impact investing. This is by no means an exhaustive list, but these terms are commonly used today and are helpful to investors trying to navigate the choices available to them.

Socially responsible investing (SRI). This is one of the better known and more commonly used phrases in the investment world when referring to investments or portfolios with a social return aspect. Historically, SRI has dealt with more liquid investments and includes the use of portfolio screening, both positive and negative. For example, positive screening focuses on including companies in your investment portfolio that have a commitment to ethical business practices and help address social and environmental challenges. Negative screening involves "screening out" certain investments that fall into categories such as alcohol, gambling, adult entertainment, animal testing and weapons.

Sustainable investing. Sustainable investing includes environmental, social and governance factors (also known as ESG – see below) and other basic sustainability issues, and essentially incorporates these factors into the entire investment process.[3]

ESG. ESG or Environmental/Social/Governance refers to specific factors or criteria incorporated into impact investing when choosing investments. Examples of environmental factors include environmental policy and practices, sustainable transport and waste management; examples of social factors include health and safety, consumer rights, community relations and labor relationships;

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Kristi Combs, Director
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examples of governance factors include executive pay, business ethics and conflicts of interest.[4]

Social entrepreneurship. Social entrepreneurs are associated with revolutionary social enterprise projects that generate income as well as produce social and environmental benefits. Social enterprises can include both non-profits and for profit organizations. For example, Rockefeller Philanthropy Advisors' recent report on social entrepreneurs profiled TOMS shoes, a for profit company. TOMS has a program called "One for One". For every product that they sell, they help another person through their giving partners – either by providing shoes to children in need or by providing vision care in developing countries.[5]

❖ How Has Impact Investing Evolved?

Socially responsible investing has been around for centuries with the first form of ethical investing (essentially an investment process guided by moral or religious beliefs) beginning in the 1500s.[6] The term "SRI" entered the popular lexicon during the 1960s, and it has continued to grow in popularity since that time. Impact investing, on the other hand, is less understood and has really become more of a buzzword in the past five or six years.

Foundations have been practicing their own version of impact investing for years via mission related investing or MRI. MRI is a term associated with foundations and involves seeking out investments that offer market like returns and also provide for social, environmental or educational impact, thus allowing foundations to better align their investments with their stated mission. Foundations engaging in MRI are doing so above and beyond their program related investing, or PRI. PRI is also designed to further a foundation's mission and is included in a foundation's 5% payout requirement.[7]

European pension plans have been leaders in this space for several years. A good example is the Norwegian Government Pension Fund (NGPF), the largest sovereign wealth fund in the world. As cited in the Greycourt white paper "Yale vs. Norway", the NGPF excludes fifty large companies from its investment universe and it incorporates several ESG factors into its investing process including board responsibilities, children's rights, climate change and water management.[8]

The investment choices available to investors pursuing impact investing have greatly expanded over the past decade. With the understanding that impact investing has different meanings to different investors, impact investments are typically expressed in the form of targeted private equity or debt transactions although they can also include traditional stocks and bonds screened for SRI. As we will discuss later, impact investing can ultimately be implemented in a variety of ways in an investor's portfolio and can be customized to fit the specific interests of the investor.

❖ The Importance of Impact Investing

Whether you believe in the merits of impact investing or not, its growing popularity, especially among younger investors, cannot be denied. Investment advisors who have traditionally viewed their mission as simply maximizing financial return can no longer brush off interested investors by saying, "There is no need to invest for social return…just make as much money as you can and then give it to charity." The world has changed and many investors are interested in impact investing.[9]

Impact investing's growing significance in the investment world can be evidenced by the following:

- **Leading organizations and institutions have made substantial commitments to impact investing.** Besides the aforementioned Norway Government Pension Fund, CalPers – one of the top five pension funds in the world– launched a targeted investment programs unit focused on deploying capital in a way that produces both financial returns as well as positive social benefits.[10] Other significant impact investing commitments include the Bill & Melinda Gates Foundation, W.K. Kellogg Foundation, and the F.B. Heron Foundation. For example, the W.K. Kellogg Foundation's mission driven program focuses on improving the lives of vulnerable children and their families, while the Bill & Melinda Gates Foundation's mission is multifaceted and includes extreme poverty and poor health in developing countries and addressing issues within America's educational system.[11]
- **Currently a $36 billion industry, its assets are growing.** In a report issued by JP Morgan and The Global Impact Investing Network earlier this year, 99 impact investors were surveyed and responded that they planned to commit $9 billion to impact investments in 2013 (up from $8 billion in 2012).[12]
- **It's about more than just alpha.** Pure financial returns are not the only source of value to impact investors. Impact investments often represent what is truly significant to them.
- **Investment firms are catching on.** A report last year by The Forum for Sustainable and Responsible Investment found that 720 firms representing $1 trillion in assets incorporate ESG criteria. That is a 78% increase over assets tracked in 2010.[13]
- **Wealthy families continue to play an important role in impact investing.** As discussed in Gregory Curtis' book, *The Stewardship of Wealth*, private capital plays a critical part in the success of our economy, specifically by having members of society deploy that capital in a plentiful and diverse way – both for profit and non-profit.[14] The KL Felicitas Foundation is one of the most unique and progressive family foundation examples today. Created by Charly and Lisa Kleissner, former Silicon Valley executives, the foundation is focused on allocating its entire investment portfolio to holdings consistent with their values. The

foundation mission is built around helping struggling global social enterprises and entrepreneurs, especially in rural areas.[15]

- **Some recent research has shown that ESG focused firms may outperform their non-ESG focused peers.** George Serafeim, Assistant Professor of Business Management at Harvard Business School, has conducted research seeking to understand the relationship between ESG performance and financial performance. Along with Professor Robert G. Eccles of Harvard and Professor Ioannis Ioannou of the London Business School, they concluded that organizations incorporating a variety of sustainable practices outperform their competitors over the long-term.[16] A June 2012 paper by Deutsche Bank Climate Change Advisors on sustainable investing reached similar conclusions and cites multiple academic studies linking strong corporate social performance to financial outperformance.[17] While research in this area is still developing, at a minimum it helps dispel some critics' views on impact investing that introducing these additional constraints involves a "penalty" or negative drag for the investor.
- **Impact investing has been incorporated into the curriculum and programs of several of the top universities and is now a focus area for future investment professionals.** Examples include:
    - Dave Chen, principal of Equilibrium Capital, a sustainable investing firm, teaches a course at Northwestern's Kellogg School of Management called "Impact Investing," which explores impact investing while applying core financial principles and tools learned in the MBA program in order to achieve both a financial and social return.
    - Stanford's Graduate School of Business has established the Center for Social Innovation, which focuses on developing unique solutions to social problems and offers executive programs in non-profit leadership and social entrepreneurship.[18]
    - The Wharton Social Venture Fund is a student run impact investing fund that has a "triple bottom line" investment philosophy – people, planet and profits.[19]
    - Duke University's Fuqua School of Business has established CASE or the Center for the Advancement of Social Entrepreneurship. CASE encourages "the entrepreneurial pursuit of social impact through the thoughtful adaptation of business expertise."[20]
    - The focus on impact can also extend outside of the core curriculum. Harvard Business School's largest opt-in interest club in 2010 was the Social Enterprise Club.[21]
- **Impact investing is a meaningful way to engage the next generation of wealth owners.** The 2013 Nexus Global Youth Summit, with attendees representing $100 billion in wealth, included multiple sessions on combining the pursuit of profit and philanthropy and helping young people define their own family legacy.[22]

- **Large "mainstream" investment firms are involved.** Firms like UBS, Merrill Lynch, Deutsche Bank, JP Morgan and Morgan Stanley have developed platforms and products around sustainable and impact investing.[23]

❖ Challenges to Consider

While impact investing has come a long way, even its most ardent supporters acknowledge it has its challenges. The following issues are important for investors to keep in mind as they explore impact investing:

- **Lack of consistency and understanding**. Different firms are using the same terms in different ways (a good example is the term sustainable investing), and this lack of definitional uniformity has resulted in confusion among investors. Variations can also be observed in how investment managers implement their strategies, as execution methods can differ.[24] Similarly, a recent survey from Callan Associates found that a lack of understanding from investors and a lack of clarity from managers regarding ESG investments is a primary obstacle to this type of investing for many institutions.[25]
- **Measurement of the "impact" or social return aspect**. There are several resources available to help measure the impact of various investments (see *Investment Considerations* below), but it is still early in the evolution of the impact investing industry and there are transparency and credibility issues from fund to fund.
- **As referenced above, there tend to be trade-offs between liquidity and the magnitude of impact.** Direct private investments typically have more impact than simple negative screens.
- **The use of criteria such as ESG introduces constraints on a portfolio, limits the opportunity set and introduces potential risks for the investor.** In 2008's "The Cost of Socially Responsible Investing," authors Adler and Kritzman do not argue against SRI but do state that investors need to be aware of the associated costs.[26] Similarly, a 2012 white paper by Patrick Geddes, CIO of Aperio Group, discusses the increased risk that is present with SRI constraints.[27]
- **Defining the specific area of impact investing to focus on can be a challenge for a family.** Going from a specific mandate like, "I want to help poor rural communities gain access to clean water" to identifying specific investments that meet that mandate is not easy. Impact investing specialists can be helpful in these cases.
- **It can be difficult to get family members to agree on the appropriate impact mission and mandates.** This is especially true in larger families with multiple generations. What qualifies

as impact investing is to some extent, in the "eye of the beholder". There is a wide range of opinions, even among people who want to be socially responsible and make an impact, and like risk it is often defined by one's personal view.

❖ Investment Considerations for Impact Investors

As with any investment portfolio, investors that dedicate capital to impact investing need to have a plan. By developing an investment policy statement that is specific to their impact investing mission, investors can execute their strategy in a well thought out and programmatic manner that addresses several considerations including:

- What is the amount of capital dedicated to impact investing?
- What is the specific area or areas of focus (education, housing, climate change, etc.)?
- What are the measurement criteria and exactly how will the impact efficacy be measured?
- How important is liquidity?
- What are the risk and return parameters of the impact portfolio?
- How do existing non-impact oriented assets interact with impact assets?

Answering these questions can help an impact investor start to narrow in on what types of investments are appropriate for them to consider. There is a wide spectrum of choices from liquid to illiquid products - from an iShares ETF to a sustainable timber company to investing in an enterprise providing school meals to underprivileged children. Each investment has varying levels of impact (and liquidity and risk) associated with them. Those offering the most direct social impact tend to be private investments that are generally both illiquid and further out on the spectrum of risk.

Once possible investments that appear to be a fit for the impact investor are identified, the next step is to perform due diligence (above and beyond traditional investment due diligence). Although still a work in progress, there are resources available for investors who want to measure the effectiveness of an impact investment. Bloomberg offers an ESG data service on thousands of public and private companies. There is a B Corp certification (given by the non-profit B Lab) that applies to companies that have met rigorous standards of social and environmental performance, accountability and transparency.[28] There are organizations such as the Global Impact Investing Network (GIIN), which is a non-profit with a diverse global membership of firms that want to expand the resources and information associated with impact investing. ImpactBase is an online searchable database of impact investing vehicles, and it includes the ability to compare characteristics of funds and products along with their track records. There are established Impact Reporting and Investment Standards (IRIS), which are metrics that can be used to measure social, environmental and financial performance. The Global Impact Investing Rating System (GIIRS) utilizes IRIS metrics and provides a comprehensive rating of social and environmental performance.[29]

There are various non-profits that are focused on researching these potential impact investments. Givewell.org is one such organization that was started by two former hedge fund professionals and is dedicated to finding these opportunities and publishing their research to potential donors. Givewell actually focuses on measuring how much good each particular program has done, and they concentrate on a smaller number of charities in order to be as comprehensive as possible.[30]

Our approach at Greycourt for our clients interested in impact investing has evolved and continues to do so. We assist our clients by putting as much structure around the process as possible and by examining the aforementioned investment considerations (i.e. area of impact focus, measurement criteria to put in place, liquidity, effects on other portions of the portfolio etc.). Due diligence can be challenging with impact investments given the data available and shorter track records, but we can help our clients evaluate the information that is made available to them.

Investment advisors working with impact investors don't necessarily have to become impact investing experts. They do, however, need to become educated and be engaged with clients and make sure there is a process in place that includes establishing an investment policy, performing due diligence and practicing ongoing monitoring/measurement. For investors who are looking for dedicated impact investing consultants and resources, they do exist and generally work with both families and institutions.[31]

❖ Summary

Impact investing is a rising force in the investment marketplace. Although challenges remain for impact investors, it is important to remember that impact investing focuses on what really matters to the investor and the social return of an investment often gets to the heart of what is truly meaningful to them on a personal level. Through increased institutional investment, expanding academic research and strong interest from the next generation, the resources available to impact investors will continue to grow. Over time, those resources will translate into a more consistent framework for investors. In the meantime, there are still interesting opportunities for investors who want to generate a return and make a difference in the world.

This paper was written by Kristi Combs, Director, Greycourt & Co, Inc. The author can be reached by phone at 503.797.6411 or by email at kcombs@greycourt.com.

Please note that this presentation is intended to provide interested persons with an insight on the capital markets and is not intended to promote any manager or firm, nor does it intend to advertise their performance. All opinions expressed are those of Greycourt & Co., Inc. The information in this report is not intended to address the needs of any particular investor.

References

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