From the Margins to the Mainstream

Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors

World Economic Forum Investors Industries, prepared in collaboration with Deloitte Touche Tohmatsu
WEF © 2013
2013
40 pages

Rating

8

8 Importance
8 Innovation
7 Style

Focus

Leadership & Management
Strategy
Sales & Marketing
Finance
Human Resources
IT, Production & Logistics
Career & Self-Development
Small Business
Economics & Politics
Industries
Global Business
Concepts & Trends

Take-Aways

- "Impact investing" – investing to earn returns and to create a measurable, positive social impact – now accounts for $40 billion in assets.
- High-net-worth individuals and family offices are impact-investing leaders.
- Mainstream institutional investors have been slower to climb aboard.
- Impact investing's relative newness, its lack of a social track record and the perception that such investments underperform the market deter mainstream investors.
- Impact investing is not an asset class; "it is a lens through which investment decisions are made."
- Impact investments can generate competitive and even superior market returns.
- More than three-quarters of impact investment funds expect to achieve market returns.
- Impact investing can offer various asset allocation benefits by providing geographic or sector diversification.
- About two-thirds of US pension funds surveyed plan to make impact investments in the future, but only 6% already have.
- To expand, impact investing will need advocacy and standardized social reporting.

Relevance

What You Will Learn
In this summary, you will learn: 1) What "impact investing" is, 2) What its benefits and limitations are, 3) Why it remains largely unknown among institutional investors, and 4) How impact investing can become more mainstream.

Review
Many investors believe that they must forego profits to advance social or environmental goals with their investments, but the World Economic Forum's Michael Drexler and Abigail Noble say otherwise – advancing good causes and earning good returns can go together. "Impact investing" is a relatively new investment approach that seeks to generate financial returns and to have measurable, positive social effects. This report presents a well-organized, balanced view of impact investing and addresses its obstacles and benefits. *getAbstract* recommends this intriguing study to foundation executives, family offices, private equity firms, asset managers, institutional investors and high-net-worth individuals considering impact investments for their portfolios.

Summary

"Impact investing...intentionally seeks to create both financial return and measurable positive social or environmental impact."

"The impact investment...ecosystem will need to progress from the margins and into the mainstream. Some mainstream investors are already making a play in impact investing."

Assessing the Landscape
"Impact investing" seeks to generate a financial return and to have a measurable, positive social impact. This investment niche accounted for an estimated $40 billion in assets under management worldwide in 2013. Family offices, pension funds and insurance companies find that attempting to drive social change can augment their philanthropic efforts, and affirmatively affect such issues as climate change and economic inequality.

The demand for investments that address social and environmental issues is likely to increase. Impact investing offers a unique niche with particular appeal to the wealthy. High-net-worth individuals and family offices currently lead the way in impact investing, since these investors are interested in shaping environmental and social issues as well as earning good returns.

Impact Investing Growth
A 2010 report from JPMorgan and the Rockefeller Foundation found that impact investing could expand to $1 trillion in assets by 2020. In order to gain popularity, impact investing must reach beyond the relatively small world of the wealthy and of family offices. It must also find acceptance among larger institutional asset managers such as banks, pension funds, insurance companies and foundations. Today, many wealth advisers are unclear about the nature of impact investing, how to measure this investment approach's success and what asset classes it encompasses.

A survey of US-based pension funds found that only 9% of respondents regarded impact investing as a "viable investment approach." Fully 81% assert that they know what impact investing is, but most are confused as to what it entails. Nonetheless, 64% say they plan to make impact investments in the future, and 6% already have. The common perception is that impact investments perform poorly – 32% of pension-fund respondents see it as "a noble way to lose money." In fact, 79% of impact investment funds expect to achieve market rates of return. Impact investments can generate results that are competitive with or even superior to market returns.

"There is limited consensus among mainstream investors and specialized niche players on what impact investing is, what asset classes are most relevant, how the ecosystem is structured and what constraints the sector faces."

"Although it is too early to determine the realized returns of many impact investments, there are numerous instances when market returns are targeted."

"Mainstream institutional investors face constraints when trying to make impact investments under the rules and norms of their existing investment decision-making process."

"Many constraints keep institutional investors from allocating capital towards impact investments...early-stage ecosystem, small average deal size, fit within asset allocation framework and double bottom line."

What Is Impact Investing?

Impact investing is an investment style and "a criterion by which investments are made across asset classes." It is not an asset class; "it is a lens through which investment decisions are made."

In impact investing, "intentionality matters." For example, if you buy shares in a pharmaceutical company just for its returns, you have not made an impact investment, even if some of the firm's projects have social or environmental value.

To avoid "definitional confusion," note the distinctions among these related investing terms: "Responsible investing" encompasses an overall category that includes impact investing, as well as "socially responsible investing" and "sustainable investing." Socially responsible investors use a "negative screen" to avoid placing funds with companies that follow objectionable environmental, social, and governance (ESG) policies. Sustainable investors use a "positive screen" to find companies that follow ESG criteria, but these investors emphasize economic returns over ESG returns. Socially responsible investing and sustainable investing "do not intentionally and explicitly set out to deliver the dual objective of social/environmental outcomes and financial returns," but impact investing does.

The Current Environment

The growth of "socially conscious" investment strategies bodes well for the expansion of impact investing. By one estimate, 11.3% of US assets under management in 2012 were in investments that followed responsible investing criteria. Providers of impact investment capital include:

- **"Development finance institutions" (DFIs)** – Like wealthy investors and family offices, these entities take a leading role in impact investing. DFIs mainly provide "anchor funding" for new projects, such as the African Development Bank's infusion of $100 million into Credit Suisse's agribusiness venture, the Agvance Africa Fund.
- **"Foundations"** – The social focus of foundations makes them a perfect match for impact investing, yet even strong advocates allocate only 5% to 10% of their endowments to impact investments. A lack of understanding among foundation leaders and communication gaps may account for this slow start.
- **"Pension funds, insurance companies and other liability-constrained investors"** – Concerns about below-market returns dampen these organizations' participation. If impact investing is to expand, more of these investors must follow in the footsteps of pension fund TIAA-CREF, Zurich Insurance and other notable trailblazers.
- **"University endowments"** – The mandate to increase their funds leads university endowments to resist impact investing. Harvard's appointment of a vice president assigned to oversee the ESG side of the university's endowment investments may help steer more funds to impact investing.
- **"Sovereign wealth funds"** – Despite exceptions such as Malaysia's and Abu Dhabi's national funds, few sovereign wealth funds explicitly target impact investments.
- **Impact investment funds** – These purpose-built funds, a common path for mainstream investors, often focus on different slices of the investment universe. The independent Bridges Ventures and Bamboo Finance firms, for example, deal in small and mid-cap growth opportunities. Prudential's $300 million impact investing fund emphasizes affordable housing, community development and education. According to a 2013 survey of these investment funds by JP Morgan and the Global Impact Investment Network, sub-Saharan Africa is the largest geographic area of focus, followed by Latin America, the Caribbean, the US and Canada. Food and agriculture is the most investment popular

sector, followed closely by health care, financial services and microfinance. Growth-stage and venture-stage companies garner the most attention, while mature public companies and start-ups draw relatively little interest.

"Impact investments focus on social challenges and issues – such as health care, education and poverty alleviation – that are typically addressed by governments."

A Road to Expansion

The pace of impact investing's growth will depend on several factors, including liquidity, risk control mechanisms and cost. A broad range of intermediaries will have to participate to build up those areas. The 2013 launch of London's Social Stock Exchange, which highlights companies traded on the London Stock Exchange, provides a blueprint for other exchanges and platforms.

To expand impact investing, specialized consultants can introduce traditional money managers to the practice and familiarize them with how it applies to a variety of asset classes. Rating organizations can provide certification of an impact enterprise's social and environmental policies, as well as its transparency. As an example, US-based B Lab uses "rigorous standards of social and environmental performance, accountability and transparency" to certify a business. "Accelerators," such as Echoing Green, provide financial and advisory support to qualifying social entrepreneurs and boost early-stage businesses. Wealth advisers can fulfill untapped demand for impact investing among high-net-worth individuals and families. Half of the respondents to a survey of more than 4,000 wealthy people in the US said their advisers had never mentioned impact investing to them; 48% indicated that they would be interested.

"Governments can play a critical role in mainstreaming impact investing."

To begin putting impact investing into wider practice, investors must get to know its broad variety of securities and investments. Institutions such as Triodos Bank in the Netherlands, which provides loans and investment capital exclusively to companies that meet its social and environmental criteria, offer cash and cash-equivalent investments to institutional and individual customers. On the fixed income side, governments and financial institutions offer bonds that fund businesses or projects dedicated to social or environmental causes. Private equity, the most common structure for impact investment funds, offers debt and equity capital to worthwhile companies. To a lesser extent, the public equity markets can also provide capital. Real estate and infrastructure investments in targeted areas round out the list of impact investment asset classes.

"Not all investing involves active measurement of nonfinancial metrics, thus posing a challenge for institutional investors approaching the impact investment sector."

Challenges Ahead

Institutional investors say that potential roadblocks and challenges deter them from impact investing. Some problems are unique to specific industries. For example, insurance companies, which allocate a substantial proportion of their investments to bonds, have trouble finding fixed-income securities that meet impact investment criteria. Many mainstream institutional investors regard the impact market as a narrow, immature investment niche. Competitive performance could help growth. Some impact investors hesitate to tout their returns because they fear being portrayed as greed-driven investors profiting from the less fortunate. Impact investment funds may have limited track records or offer too few products for mainstream institutional investors.

"Rating and certification organizations help verify the social and environmental performance of impact enterprises or impact funds."

Many institutional investors report that they have difficulty fitting impact investments into their asset allocation models – most of these investments lack sufficient track records to satisfy traditional metrics. Some investors, however, recognize that impact investing offers asset allocation benefits such as geographic or sector diversification. Small transaction size can be another problem for large institutional investors; their due diligence costs for a $10 million deal can be the same as for transactions 10 times that size.

Impact investing may not fit into an institutional environment where a different set of decision makers determines the investments made in each asset class. TIAA-CREF addressed this by forming a team to evaluate social and environmental criteria for a range of investments. Team members find investments that meet their criteria and present their findings to investment managers who handle each appropriate asset class. Fiduciary agents – such as consultants and attorneys – balk at investments they deem unfamiliar or risky. The "double bottom line" of impact investing – financial returns and measurable social or environmental benefit – dissuades some institutional investors, who can't gauge their success without a framework for measuring investments' social impact – or how they perform compared to each other or to traditional buys.

"Over the last few years, tremendous progress has been made in the emerging impact investment sector."

Measuring social outcomes can take years; accurate assessments can be complex and costly. To address these issues, some impact investment funds invest only in businesses with a quantifiable goal, such as, for instance, selling portable cook stoves to impoverished populations. Some organizations have introduced systems for measuring and reporting social and environmental progress, the most prominent being the Global Impact Investing Rating System (GIIRS) and the Impact Reporting and Investment Standards (IRIS).

Recommendations for the Future

Impact investment funds need to commission clear, concise financial reports from independent third parties so that institutional investors have a way to categorize and rank their results. Impact funds should state their social and financial missions and avoid promoting returns they may not be able to achieve. Standardized metrics assessing their social and environmental impact would offer clarity about their results. An industry association of impact investment funds could create such guidelines. Intermediaries and advisers can enhance due diligence by aggregating and publishing performance information. Those offering impact investments can seek agency ratings.

"In 2010, JP Morgan and the Rockefeller Foundation sized the bottom-of-the-pyramid market opportunity across five sectors and estimated that the impact investment sector could reach US $ 400 billion to US$1 trillion by 2020."

Philanthropists and foundations can encourage impact investing by providing anchor financing or guarantees for these investments. For example, Bloomberg Philanthropies partially guaranteed Goldman Sachs's $9.6 million Riker's Island Social Impact Bond. Funders can reduce their due diligence costs by tapping into information resources provided by impact industry networks. Governments can offer tax relief for early-stage enterprises that generate a public benefit, but that seem likely to produce below-market returns. Cautious revision of regulations restricting the flow of capital to impact investments might encourage pension funds and foundations. Creative government solutions include the UK's Big Society Capital. This brainchild of the Financial Services Authority "leverages unclaimed assets in dormant bank accounts...to provide access to capital to organizations that are building the impact investment market in the United Kingdom."

"Impact investing is currently growing linearly. In order for it to grow exponentially, we need to find a way to incorporate mainstream investors into the mix." (Randall Kempner, executive director, Aspen Institute)

Impact investing sector's "growing pains" may lessen in the future as its appeal to mainstream investors evolves more and more. Institutional investors that have achieved good returns in social and environmental investing have to become advocates and mentors for new impact investors.

About the Author

Michael Drexler is senior director and head of investors industries at the World Economic Forum USA, where associate director **Abigail Noble** heads impact investing initiatives.