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Impact Investing - Going beyond SRI

New Form of Sustainable Investing is gaining in importance

Topic of the month November 2012

Impact investing has begun to come of age over the last ten years. Maybe not full maturity but certainly it is now a robust and thrusting teenager in the investment space. And yes, like all teenagers, it is starting to test the boundaries and to want to change the world.

Impact investing is no longer just a coming idea but is a growing body of proven practice. Impact investing is acquiring an investment track record. Its underlying investments have a business track record of entrepreneurship. There is a growing volume of specialised practitioners developing a body of impact investing practices and skills. Above all, impact investing is a global market, it is a growing market and it is a market that invests in enterprise and in sectors with growing demand.

That makes it very interesting. I want to argue that it is now an investment market that some ethically and SRI minded investors should definitely look at – particularly HNWIs and private wealth managers – and also that in its longer term potential impact investing should be seen as an addition to and more than just a sub-set of ethical investing – going beyond SRI...

What is Impact Investing?

Impact investing is investment which has the explicit expectation of achieving social and/or environmental gain as a "social return" alongside and in addition to an expected financial return. It is fundamental that the social return is not an incidental or even "nice-to-have" by-product of a financial investment but is a primary purpose and expectation of the investment.

In investment terms, and in capital market theory terms, this is therefore about incorporating social return (which includes environmental return) into the framework of investor expected returns and investor required returns. That in turn emphasises that the word "investing" is as important as the word "impact" in definitional terms. Impact investing is not only defined by the impact it seeks. Impact investing is investment.

'It is important that the social return is a primary purpose and expectation of the investment.'

This means that impact investing has two important boundaries. One boundary which distinguishes it from other investment which does not expect social return or looks at it as only a secondary goal (so defining impact investing by distinguishing it from most mainstream investment). And a second boundary which distinguishes impact investing from philanthropy, from charity, from grant giving, all of which are valuable activities but are just something quite different from impact investing.

Impact investing therefore occupies the space between philanthropic giving on the one hand and financial investment indifferent to impact on the other hand. Impact investing is an extension of investment and core to understanding impact investing is to see it as a set of "hard" investment processes and expectations which demands

investment disciplines of both investors and investees (those who are invested in) and which sets clear social and financial return.

Impact investing comprises equity, debt and bond, and quasi-equity or mezzanine forms of investment and indeed in practice currently is often more a fixed income and hybrid capital market than an equity market (though that will change over time) which reflects not just the limitations of legal form of social organisations (which often find it hard to issue simple equity) but reflects also the needs of packaging up the investment risks involved.

Much of the innovation in impact investing currently is in bonds and in more equity-like hybrid capital forms, such as social impact bonds.

Case Study: Social Impact Bonds

A social impact bond is a contract with central or local government in which the government body commits to pay for improvement in specified social outcomes for a specified beneficiary group in a specified geographic area. Investment for a social organisation targeting the social outcomes is raised from investors and returns are paid to the investors based on the actual level of social outcomes achieved. (Typically the payment of returns depends on that level of actual outcomes exceeding an agreed benchmark level). It is an innovative investment product designed to provide both a revenue model and a funding model for social organisations.

Although called a "bond", it is more equity- or quasi-equity-like, as investors' capital is at risk and returns are variable and depend on operating performance. The Social Impact Bond product was developed by UK impact investing pioneer Social Finance and the first social impact bond was issued in March 2010 to raise £5million to fund rehabilitation for short-sentence prisoners in Peterborough, England. Since then, Social Finance has announced at least a further four social impact bond programmes in the UK, addressing vulnerable young people in the Thames Valley, rough sleeping in London, and outcomes for children and young people in Manchester and has received funding from the Omidyar Network for social impact bond development in the US and internationally.

What are the return characteristics of Impact Investing?

Impact investing incorporates a range of expectations of the contribution that financial return should make to the total expected return. These range from a fully risk-priced financial return making up the whole of the required total return with social return being an expected premium return on top, to a positive financial return as one element of the total return with expected social return making up the difference, and to at least a 0% return (return of capital without loss) with significant social return meeting investor total return requirements.

This can be described as a spread of investment styles from “financial first” to “social first”. And one of the characteristics of impact investing is that both ends of that spread are legitimate forms of impact investing. That legitimate spread of impact investing is important for giving a range of options for developing marketable investment products for the wider groups of non-specialist investors that impact investing now needs to reach out to.

Much impact investing of course occupies the middle of that range of styles where both financial return and social return contribute to meeting the hurdle rate investor total required return. This is the area of “blended value” (a term devised by Jed Emerson, one of the leading analysts of impact investing) or “blended return”. (Michael Porter in the Harvard Business Review talked about “shared value”). This might mean for example an impact investment that pays “only” an expected 2% financial yield with the expected social return required to achieve the necessary risk-reflective expected total return.

Now of course in yield hungry markets currently, “only” a 2% yield, say, might start to look quite interesting anyway (allowing for risk of course but allowing also for the possibility of some real risk diversification).

Case Study: Charity Bonds

Investing for Good, an innovative UK social finance adviser has developed Charity Bonds as a way of using recognised investment and financing products for social finance and meeting both the financial and ethical objectives of impact investing. Essentially, a Charity Bond is a medium term bond operating in the same way as similar corporate bond products. The first to be marketed was issued by UK disability charity Scope, which issued the first tranche of a £20million bond programme in October 2011 backed by its income from charity shops and legacies/other donor income.

The Scope bond is listed on the EuroMTF market in Luxembourg, has the same regulatory and prospectus requirements as any corporate bond and will issue sterling bond tranches in varying nominal amounts, maturity dates and coupon rates. Typically, the aim of a Charity Bond is to be priced at a yield below yields for existing bonds of equivalent risk with investors being asked to accept social return in part-replacement. It is aimed at trusts, foundations, HNWIs and wealth managers.

This area of blended return is a rich and promising area of investment precisely because it integrates social impact – social return – into expected returns. And much useful work is being done on evaluating and measuring social impact – developing methodologies that seek a monetisable expression of impact (like the SROI - Social Return on Investment - metric) and others which acknowledge that a single, one-size-fits-all measure might not be appropriate and which instead embrace the range of outcomes of different impact activities by developing rigorous approaches to the articulation of “theories of change” or “social prospectuses”. (See also the IRIS metrics – the Impact Reporting and Investment Standards which are an initiative of GIIN – the Global Impact Investing Network in the US).

Who are Impact Investors and what is the size?

Existing impact investors are already a diverse group. The ImpactBase database which is another initiative of GIIN (see above) has a non-exhaustive list of just over 200 impact investors around the world. Many are relatively small funds at the moment. Existing impact investors include: specialist funds; individuals' and charitable foundations (the latter taking part in "mission related investing" as distinct from their grant giving activities); HNWIs, their advisers, family offices and private wealth managers; government backed funds; microfinance funds; international aid funds taking an investment approach; "mainstream" investors seeing impact investing as a next step in "thematic" sustainable and responsible investing; and a new class of "wholesale" investors which currently includes the brilliantly experimental and innovative Big Society Capital in the UK but which will grow to include a range of fund-of-funds and similar investor approaches.

'Impact Investing attracts a diverse group of investors, from foundations to specialist funds - but mainstream investors are pickung up the trend too.'

Deutsche Bank for example is beginning a fund of funds approach to impact investing. The European Investment Fund made its first wholesale investment in an impact investing fund at the end of 2011.

Size forecasts are exciting. Globally, J P Morgan has forecast that the impact investing universe could be $1 trillion in size by 2020. (See J P Morgan's seminal research paper *"Impact Investments: An Emerging Asset Class"*, also available in the database of yourSRI.com - direct link to the paper.) Some domestic markets are also exciting. For example, Adrian Brown of Boston Consulting Group (another leading commentator) forecasts the UK impact investing market at £1 billion by 2016. In investment markets in search of new investment products and value-added advice to clients a piece of this new investing market is worth thinking about even before taking account of social and ethical motivations and the realignment of finance with social purpose.

Going beyond SRI...

SRI has been one of the successes of the finance sector and the investment world in recent years, experiencing growth in investment – including inward funds-flow after 2008 and the credit crunch - and retaining a popular legitimacy. Organisations like the Europe-wide Eurosif network and in the UK the authoritative UKSIF have been leaders in promoting not only SRI as a necessary piece of the overall investment landscape but increasingly impact investing too.

SRI is the sector of the investment space which impact investing most naturally fits in and it would be easy, as some have argued, to see impact investing as a sub-set of SRI. There are of course overlaps. No longer confined to its roots in negative screening, modern SRI now embraces positive "thematic" investment, encourages engagement of investors with the companies they invest in on SRI issues, and promotes the integration of ESG sustainable investing criteria into mainstream investment criteria.

As impact investing begins to mature, though, there is more to impact investing than being an SRI theme (not that there would be anything wrong with that). Whereas SRI, even in its positive investment activities, is an approach for dealing with and evaluating existing investment opportunities, impact investing is an ongoing project to create

and build a new asset class of new investments, which though often individually small together are increasingly important (and which can also reach out to include some of the larger mutuals, cooperatives and housing associations in the business world – it is not a necessary claim for impact investing to be wholly new or "invented now").

By investing in social businesses and social enterprises, which use business models to address social and environmental needs, impact investing is seeing the development of a body of investment practices and skills (including asset class specific due diligence and analysis) that help to shape and define a new asset class, despite the fact that impact investing cuts across traditionally separate asset classes of equity, quasi-equity and fixed income (in the same way that hedge funds are regarded as an asset class because of a commonality of investment skills and absolute return objectives despite widely differing investment strategies).

This is an asset class, furthermore, which is about enterprise finance – investing in entrepreneurs and growth sectors (health and health care for example in many of the greying developed economies with unhealthy lifestyles) and growth enterprises.

One of the exciting things about impact investing is the way it is responding to and encouraging a new wave of entrepreneurs who are unashamed about creating new businesses and new business sectors in the cause of social purpose, often in sectors either not historically exposed to enterprise or not used to combining enterprise with the values of social impact. Impact investing can give exposure to growth sectors that mainstream investment cannot get exposure to.

As a new asset class investing in new growth enterprises and sometimes new sectors, impact investing is properly best understood as an Emerging Market, in capital market terms. This helps in two ways. First, it helps set expectations of impact investing at the right level. This is an early stage emerging market with more to do in terms of infrastructure and the ability to market its investment case. Secondly, it also helps identify the conditions and evolutionary path for impact investing to continue to develop: other emerging markets, each with their own individual characteristics have emerged before and there is nothing too unusual about the developmental stages that impact investing has to go through in its turn.

'Social Businesses address social and environmental needs.'

All emerging markets have to be able to define their average risk and return characteristics for general (non-specialist) investors to see what their asset allocation role in portfolio construction might be.

With its developing track record, impact investing will soon be able, like emerging markets before it, to define its risk levels and, I expect, to show that though still higher risk than mature markets, impact investing's risk is not as high as some might expect and is manageable. As for other emerging markets before it, clarity on risk and its manageability should be a tipping point in investibility for impact investing.

Impact Investing and Private Wealth Management

So, the future of impact investing offers something different from existing SRI, but which appeals to the same ethical investing motivations. With good momentum behind it, it is an asset class and an emerging market that justifies investors keeping a watching brief on it.

Now that means I don't want to claim that impact investing is a mature market that all investors should immediately plunge into. Rather it is a rapidly emerging market that should now be kept under review by professional investors who should consider dipping a toe into it to acquire some understanding of it - in view of its growth characteristics, its potential contribution to diversification and the underlying growth sectors it gives exposure to like health and healthcare - quite apart from the social benefits of investing finance in social purpose. Individual investment products like charity bonds are also being developed that mainstream investors can invest in as well as investing in diversified funds.

Just on size grounds, and in view of the tighter investment criteria set by investment mandates, institutional pension fund and insurance money is less likely to find much room for impact investing in the near term. And for risk reasons, impact investing is not yet suitable for mass retail investment products or probably even for the "mass affluent". Charitable foundations however (devoting a part of their investment portfolio to so-called "mission related investing" whereby a portion of their investment funds also look to achieve social outcomes in parallel with their grant activity – but with financial investment returns as well) are one source of institutional investment money that can more readily look at impact investing as an initially small part of their portfolio.

'Impact Investing can also be seen as bringing together investors' philanthropic acitivities with their investment activities.'

And private wealth management – or rather the VHNWIs, HNWIs and family offices that are their clients – are another type of institutional capital which has the flexibility and innovation to see how to integrate impact investing into their portfolios. Like private equity or hedge funds, impact investing could over time be say 0.7%-1% of portfolios. Eurosif's 2012 "HNWI and Sustainable Investment Study" showed that wealthy Europeans are deepening and expanding their commitment to sustainable investment and impact investing. Sustainable investment by European HNWIs increased by nearly 60% over the past two years (compared with an 18% increase in overall HNWI wealth). One in two HNWIs is participating or interested in impact investing as an alternative to philanthropy as much as an extension of SRI. Europe will not be the only market where this is the case.

Impact investments of course need to be able to demonstrate that they are "suitable" investments for private investors. One way in for achieving this is at the "finance first" end of impact investing. In place of a mainstream financial investment offering a particular return at a given risk level, the finance-first impact investing offer is to propose an investment which carries the same risk-return characteristics and which then also provides a social return on top.

Another way is to see impact investing as a bringing together in part or overlapping of private investors' philanthropic activities with their portfolio investment activities. A "blended value" impact investment *(see the Charity*

Bond case study above) might offer a less than fully risk priced financial yield – but it will offer a yield premium to 0% grant giving… and offers the potential for return of capital too, unlike grants. Viewed from the perspective of philanthropy, too, it offers the potential for recycling the same capital several times over, maximising the social gain compared with a one off capital grant. Viewed from the perspective of portfolio investment, blended value impact investing is at least setting out to maintain capital and pay some financial return… and keeps the capital concerned within the framework of the investment portfolio rather than giving it over to grants.

A preparatory step to either of these approaches is for private investors' attitudes and ambitions for their social giving (and appetite for translating some financial return into social return) to be part of the routine dialogue on target investment outcomes that already occur between clients and advisers and takes in their risk appetites and balance of capital growth and income. This does not seem too much of a stretch and incorporates an approach to impact investing into a disciplined framework of discussing and recording investment criteria that already exists.

Impact investing is still in its adolescence but has already come a long way. Like other emerging markets as they approach their tipping point of risk and return clarity and product availability, where they become genuinely investible if higher risk and alternative investments for a broader investor group, for mainstream investors impact investing is now worth putting on the watch list and beginning to experiment with.

'Impact investing is still in its adolescence but has already come a long way.'

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Engaged Investment is working on the creation and launch of an investment index for impact investing.

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