

# Socially Responsible Investments (SRI)

## Introducing impact investing

- Impact investing is a relatively new term for investments that aim to generate both financial profits and positive social impact.
- It is suitable for investors who believe in the effectiveness of business as a means of improving social realities.
- Private equity-like impact investments are not suitable for everyone. They not only bear great opportunities but also significant risks.

At the beginning of this millennium, some well-known entrepreneurs of the dot.com era such as Jeff Skoll and Pierre Omidyar, the founders of the auction platform eBay, publicly announced that they would manage part of their own or their foundations' assets in a way that would further social good in addition to generating financial returns. A new investment style was born.

In this note we examine this new investment style, dubbed 'impact investing.' In particular, we look at the origins and nature of 'impact investing' and we set out challenges and opportunities for the investors.

### What is impact investing?

The term impact investing is relatively new. It was reportedly coined a few years ago by the Rockefeller Foundation – a philanthropic organization - which defines it as "(...) capital that is placed outside of public equities markets and generates social and environment value in addition to financial return." Its motivation stems from the fact that delivering social change at scale will require more capital than classical philanthropy and public resources can provide<sup>1</sup>. Furthermore, its motivation stems from the realization that private business has always been an unparalleled mechanism for meeting human needs, creating jobs, improving efficiency, and building new social realities.

Social investing goes back a long way. Early examples include provisions in the 18th and 19th century that prevented banks from offering financing to slave holders. Indeed for a long time, social investing and financing was about the exclusion of certain areas or players that did not align with delimiting criteria set by the investors, such as tobacco or the defense industry.

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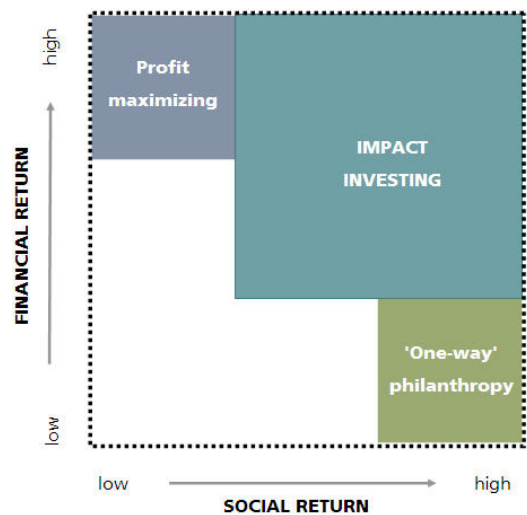
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### Alex Friedman, UBS Chief Investment Officer:

*"Impact investing is one of the most dynamic new asset classes to emerge in a generation and it offers the possibility to unite financial returns with social impact, in a market-driven and sustainable manner."*

### Impact investing aims for both financial and social return

Between philanthropy and profit



Source: UBS WMR

<sup>1</sup>According to UNDP Millennium goals progress report most of the goals are currently not on track or even deteriorating. There is an annual gap of USD 138bn only for these eight global issues that neither public resources nor philanthropic resources can fill. (United Nations 2007)

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Indeed, this is largely true also for Socially Responsible Investing (SRI), which burgeoned since the 1980s and today is a mature industry with USD 7 trillion globally under management<sup>2</sup>. Impact investing, and its close relatives such as 'mission-based investing'<sup>3</sup>, 'blended-value investing'<sup>4</sup> and 'program-related investing'<sup>5</sup> take a much more proactive route. Here investors actively seek to identify worthwhile projects that promise positive impact on society and/or the environment, besides adequate financial return. In the field of impact investing, terminologies and investment standards are still evolving, making it difficult to determine the current market size, especially given that most of the impact investing market is privately organized. But estimates suggest that the market offers the potential over the next 10 years for invested capital of USD 400 billion to USD 1 trillion<sup>6</sup>.

## Social investing and the profit motive

Noble Laureate Milton Friedman stated that the social responsibility of business is to increase its profits. While this sounds harsh at first glance, in economic theory this proposition is hard to challenge as long as markets are allowed to function properly. However, there are areas where institutional or societal factors prevent the proper functioning of free market exchange. In such instances, which are often misleadingly called 'market failures,' economic activity can generate undesirable results, ranging from environmental pollution to severe poverty. This is where social investing supplements the profit motive and the desire to achieve a certain good (access to health, food, education, finance or employment) can, in our view, offer real value.

This is important, because controversy exists regarding the profit motive in impact investing. Some authors state that social investors, including impact investors, must be prepared to forego some of the financial return available elsewhere in exchange for the desired social or environmental benefit. However, there are arguments why profit opportunities should be at least as attractive as elsewhere.

First of all, 'market failures' may represent neglected profit opportunities. For example, one prominent 'market failure' is called 'information asymmetries' – a situation in which a lack of information prevents efficient market-based allocation of resources to take place. By focusing on social or environmental deficiencies, impact investors may inadvertently seek out and overcome such information asymmetries that offer hitherto untapped profit opportunities. An example maybe so called base-of-the-pyramid<sup>7</sup> investing, where investment opportunities are aimed at providing important services to the 4 billion people at the base of the social hierarchy in developing countries.

A second argument pertains to sustainability itself. By emphasizing a positive social and/or environmental impact, social investing is by definition interested in long-run sustainability, which could give it an edge over comparable mainstream investment projects. Unfortunately, the empirical data to test this proposition sufficiently is not yet there, but the theoretical

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## Social impact objectives<sup>8</sup>

- Access to clean water
- Access to energy
- Access to financial services
- Access to education
- Affordable housing
- Agricultural productivity
- Capacity-building
- Community development
- Conflict resolution
- Disease-specific prevention and mitigation
- Employment generation
- Equality and empowerment
- Food security
- Generate funds for charitable giving
- Health improvement
- Income/productivity growth

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## Environmental impact objectives<sup>9</sup>

- Biodiversity conservation
- Energy and fuel efficiency
- Natural resources conservation
- Pollution prevention & waste management
- Sustainable energy
- Sustainable land use
- Water resources management

<sup>8</sup><http://iris.thegiin.org/indicator/social-impact-objectives>

<sup>9</sup><http://iris.thegiin.org/indicator/environmental-impact-objectives>

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<sup>2</sup>EUROSIF (2010)

<sup>3</sup> Refers to a foundation endowment investment strategy and means to invest in line with the foundations' mission on the expenditure side.

<sup>4</sup> Coined by Jed Emerson, blended value investing refers to the concept of blending both social and financial return objectives in ones' investment strategy.

<sup>5</sup> Program Related Investing is a legal term in the UK and the US. Program related investments qualify for tax exempt status.

<sup>6</sup> Monitor Institute (2009); JP Morgan (2010)

<sup>7</sup> Base-of-the-pyramid refers to the poor 45% of the planet. It is a broad term as it describes all people of poor income populations, from very poor to poor.

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argument appears to be valid. Overall, while investors engaging in this field may indeed be willing to accept lower returns in principle, it is by no means clear from a theoretical perspective that such activity should be expected to underperform mainstream investment activity.

## Criticisms of the profit motive

There has been a long-standing debate of whether philanthropic considerations can be blended with financial incentives. 'Making money on the back of the poor' has been a standard criticism of social investment. In our view, impact investing is a complement to philanthropy and there are good reasons for incorporating financial aspects that benefit not only the investor but importantly also the recipient of the funds and their environs.

1. The social capital market is far from efficient: Fund raising in traditional philanthropy is often time-consuming and extremely costly. According to a McKinsey & Company study<sup>10</sup> conducted in 2007 the cost of capital in philanthropy is 22-44% as opposed to 2-4% on the capital markets. By tapping into the conventional financial markets, impact investing may prove to be a more cost-efficient complement to channel capital to those in need.
2. Traditional philanthropy works by one-way grant giving, usually based on non-profit performance and aimed at relatively short-term results. Hence, better performers were not necessarily rewarded with additional resources. By incorporating financial considerations and increasingly raising money from financial markets, impact investing strives for value-driven allocation of capital, which should produce more sustainable long-term impact.

Indeed, in part impact investing was born out of the frustration among philanthropists with traditional fund raising and so called one-way grant-giving. However, investors may still choose how much weight they wish to put on social and/or environmental impact on the one hand and financial return on the other. So called 'impact first' investors target social or environmental good as their primary objective and prominent examples in this category include the Bill & Melinda Gates Foundation. On the other hand, 'financial first' investors prioritize financial return objectives over nonetheless desirable social and environmental objectives. However, given that impact investing tends to focus on small, private companies, in developing countries this can provide investors with an interesting diversification to their portfolio.

## Forms of investing

Impact investing can target a wide range of objectives, including for example productivity growth, food security, education, sanitation etc. Most impact investments would target a number of these objectives. Also, impact investing can take different forms: traditional equity, debt, loan guarantees or more innovative structures. A common form for impact investing is through the provision of private equity capital, whereby an investor takes a share in an unlisted company, typically small- and medium-sized enterprises (SMEs).

According to the IFC<sup>11</sup> private investments in SMEs are the best way to achieve the greatest social impact on local economies. They constitute the

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## Calvert Social Investment Foundation

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An example of a prominent impact investor is the Calvert Social Investment Foundation, a non-profit organization founded in 1988. It offers the Community Investment Note, which comprises a diversified mix of high-impact organizations whose missions cover a range of issues. "Our investors are looking for a way to have their investment portfolio impact the world they live in and strengthen their local communities," says Calvert Foundation's Art Stevens. "We direct their investment to over 250 organizations working in all 50 states (in the US.) and over 100 countries to provide that first critical loan for a small entrepreneur, or help build a day care center that allows a single parent to work. Since inception the note has helped us build or rehabilitate over 17,000 homes, create 430,000 jobs in the US. and in developing countries, and finance over 25,000 cooperatives, social enterprises, and community facilities, all while returning interest and principal. We believe it is a real 'win-win'".

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<sup>10</sup> McKinsey & Company (2004)

<sup>11</sup> International Finance Corporation (2010)

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backbone of most economies and are crucial drivers for entrepreneurship, economic growth and job creation. This is particularly true in frontier and developing markets, where SMEs and the informal sector contribute to a major portion to national income, and account for a significant portion of employment. Most of these newly created jobs are for low-skilled workers from the lower- and middle-classes, who enter a company at low and competitive salaries and get trained to do the job. In addition, investing in such SMEs indirectly creates business volume and employment for their suppliers, which typically benefits even less privileged social groups.

Therefore SME financing is a focus for impact investors and stakeholders interested in market-oriented solutions to poverty-reduction, income-creation, economic development, and long-term sustainable development.

There are basically three main investment vehicles to participate in social private equity impact investing.

1. direct equity investment in SMEs,
2. investment in a private equity fund
3. investment in a private equity fund of funds.

For the majority of private investors who want to engage in this field, the last two options are the most suitable, because direct investment in SMEs requires significant effort in identifying, evaluating and monitoring the investment. Naturally, fund managers need to be selected and vetted properly given the limited transparency in this business area. This also requires investors to show the necessary skills to select the managers. Furthermore, there is a relatively small universe of private equity fund of funds with an established track record in impact investing.

## Limitations and challenges

There are a number of drawbacks which every private equity investor needs to take into consideration. All forms of private equity investing are long-term, running 6 to 12 years or longer, meaning that assets can be illiquid for long periods of time. Furthermore, impact investing tends to focus on small companies at early stages in their development, and hence have higher risks. Also, management and due diligence costs are substantially higher than in traditional investment areas and since private equity markets are often lacking in transparency there are legal and reputational risks, especially in less developed countries where market regulation may be insufficient. Investors also need to consider that financial performance is dependent on a successful exit, such as the sale of a private company to a new owner, which can be more difficult in a less mature market.

A key advantage of social private equity, however, which sets it apart from conventional credit lending, is that social private equity investors can directly influence company decisions and contribute expertise. Thus, private equity investors often directly take power of decision in the management board, where they hold significant ownership shares. Thereby managers and investors can work together to achieve their financial and social goals and ensure an ongoing monitoring of financial and social indicators.

In general, it is important to keep in mind that private equity investments are not suitable for all investors due to the very specific risks mentioned earlier. Over time, impact investing is likely to become more widespread and more accessible. At the current juncture, impact investing appears to be an interesting field for investors with experience in private equity investing who seek to blend financial returns with philanthropic considerations.

## In principle there are three different strategies to social private equity investing<sup>12</sup>

1. Product-focused investments: early stage private equity companies develop and bring to market environmentally and socially beneficial products such as renewable energy or healthcare innovations.
2. Double-bottom-line investments: capital is made available to underserved business, for example to social entrepreneurs or companies managed by women or minorities.
3. Process-focused investments: established private companies are selected according to their track records in terms of social benefits and environmental benefits.

<sup>12</sup> D. Wood, B. Hoff (2007)

## Mario Marconi, UBS Head of Philanthropy and Values-based Investing:

*"The Impact Investing market has been gaining traction over the past few years and is in our view at an inflection point. Interest and demand is moving from a small number of philanthropically minded pioneers and charitable foundations to a larger number of investors. This is confirmed by numerous market studies, surveys and by feedback from our own client base. We believe Impact Investing could grow to become a significant market over the next five years and above all, we believe it can become a mainstream type of investment for philanthropists, foundations and a larger section of private clients."*

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## Interview with Amit Bouri

*Amit Bouri* serves as Director of Strategy and Development at Global Impact Investing Network (GIIN). After working on various impact investing projects, he began working in impact investing full time in 2008 when he was a strategy consultant with the Monitor Institute. At Monitor he was part of the team that produced the Investing for Social & Environmental Impact report (2009) and supported the business planning for the GIIN and several of its initiatives.

The GIIN was founded in 2009 with the aim to increase the scale and effectiveness of impact investing by developing the critical infrastructure, activities, education and research.

### Q1: What fascinates you about impact investing?

Traditionally, financial assets are used to fulfill two very distinct purposes: the bulk of assets are invested to maximize profit, and a very small portion is dedicated to charity. Impact investing challenges this way of thinking and enables investors to seek positive social and environmental impact with much more capital than is possible with charity alone. It is exciting to think about how impact investing can accelerate solutions to a number of global challenges, ranging from climate change to poverty.

### Q2: What has impact investing achieved so far?

The true results of impact investing will be realized over years and decades, but already impact investors are using for-profit investment capital to finance a broad range of social and environmental solutions, including low-income housing, affordable healthcare, education, access to financial services, clean energy alternatives and sustainable agriculture around the world. Despite this early momentum, impact investing is still relatively nascent, and these early investments represent only the tip of the iceberg.

### Q3: Who are the biggest players in the impact investing industry, and what distinguishes them?

Today's leading impact investors are varied and include diversified financial institutions, private banks, fund managers, institutional investors, family offices and private foundations. However this diversity is relatively new. The early impact investing market was pioneered by development-driven organizations like foundations and development finance institutions (DFIs), who saw the potential to increase their impact by addressing global challenges with for-profit capital that can complement traditional grants and government aid.

Most recently, high-net-worth investors have been increasingly attracted to impact investing because it enables more capital to finance sustainable global solutions while also returning a profit. Because they can invest with flexibility, wealthy individuals have pioneered new asset classes in the past, for example venture capital in the 1960s and 1970s, and we believe that they will be similarly instrumental in the growth of impact investing. As high-net-worth investors show increasing interest in impact investing, the financial institutions that serve them are working to develop products that will enable private individuals to enter the impact investing market more easily, and this type of product development is a critical step in the evolution of the industry.

### Q4: What are the risks?

Like any other type of investing, impact investing comes with its own risks. In particular, it's important that impact investors are clear about their objectives – financial as well as social and environmental – and apply equally rigorous standards to monitoring and evaluation of all aspects to their impact investments. Of course, there are well-established standards for reporting

Amit Bouri



Source: GIIN

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financial performance, and at the GIIN, through our Impact Reporting and Investment Standards (IRIS) initiative, we are developing standards to help impact investors measure and track the social and environmental performance of their investments. Our partners are leveraging the IRIS standards to create additional tools for investors, including a portfolio management technology platform and an impact investing ratings system.

### **Q5: What are the biggest challenges the impact investing industry faces?**

Despite significant positive momentum, the impact investing industry faces several hurdles. Most obviously, impact investing is still relatively new, and there is a need to increase awareness among investors about the opportunities to address social and environmental challenges with for-profit investment capital. The impact investing marketplace is also fragmented, which leads to high search costs both for investors and business and funds seeking impact investment capital. Once impact investments are made, there has been a lack of rigorous and credible standards to measure their social and environmental performance, which is just as critical to this asset class as financial performance. Lastly, because the earliest impact investors are so varied – including large-scale financial institutions, foundations, wealth managers and investment funds – there is a need for a leadership forum to identify and address additional industry challenges as they arise.

### **Q6: Could you describe in detail two successful impact investing projects? What were the initial objectives and how have they been met?**

One recent successful impact investment in sustainable forestry was coordinated through a fund called Lyme Northern Forest Fund Limited Partnership (LNFF). In 2002, the LNFF raised USD 65 million from a variety of investors, including high-net-worth individuals, university endowments, pension funds and institutional foundations. The fund then purchased woodlands in the United States. Before selling the forest property to return profits to investors, LNFF sold 'conservation easements' to the nonprofit conservation group "The Nature Conservancy" and the local government. Conservation easements permanently restrict development and require the future owners of the land to sustainably manage the property. In early 2009, LNFF sold the timberlands for a profit. An example of another impact investment is one managed by Root Capital, a fund that finances sustainable trade in developing countries. In 2007, Root Capital invested USD 200,000 in Savannah Fruits Company, a female-owned and operated company in Ghana that harvests shea nuts and processes them into shea butter, an ingredient used in cooking oils and in skin cosmetics and treatments. Root Capital, which invests assets from public institutions, corporations, individuals, religious institutions and philanthropic foundations, made loans that enabled Savannah Fruits to source their product in larger volumes, enabling the business to grow, ultimately enhancing livelihoods for rural women. In both of these investments, significant and measurable social or environmental benefits were produced in two very different parts of the world, while a diverse set of impact investors received profits in line with their expectations.

### **Q7: What is GIIN's role in meeting these challenges?**

As an industry-building organization, the GIIN follows industry trends and addresses barriers to effective industry growth. Through its outreach initiative, the GIIN participates in research, media outreach and speaking engagements to help increase awareness of impact investing and best practices. We have also launched an online directory of impact investment funds called ImpactBase, which is designed to help reduce search costs and bring order to the fragmented impact investing marketplace. To help impact investors and mission-driven businesses report their social and environmental performance in consistent, comparable terms, the GIIN oversees the devel-

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opment of IRIS, the Impact Reporting and Investment Standards, a library of commonly-used performance indicators. Thousands of organizations receiving impact investment capital are using IRIS to track their performance, and the standardized IRIS language is enabling the first-ever impact investing performance report which the GIIN will release later this year. Finally, the GIIN Investors' Council, a membership organization for large-scale impact investors, serves as a collaboration forum for industry leaders.

**Q8: What are your recommendations to private investors that are interested in investing for impact but have no experience in the field of impact investing so far?**

Impact investing holds incredible promise, but like other emerging investment sectors, it faces challenges. Fortunately for investors new to the field, experienced impact investors are paving the way, and many openly share best practices and lessons learned to help grow the industry successfully. Investors interested in impact investing should read research and case studies about impact investing (for a list of relevant resources, visit the GIIN website at [www.thegiin.org](http://www.thegiin.org)). Private investors looking to invest for social and environmental impact should identify areas of interest with their wealth advisor. Once capital has been placed into a mission-driven business or fund, the investment's performance should be monitored, and impact investors should periodically reflect upon their approach and revise to develop a refined impact investment strategy. We hope that they will soon recognize one immediate reward to impact investing: it is often more engaging and gratifying than traditional investing because investors and wealth advisors can track not only financial performance, but also the progress of important and innovative social and environmental solutions.

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## Appendix

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