IMPACT INVESTMENTS: PERSPECTIVES FOR AUSTRALIAN CHARITABLE TRUSTS AND FOUNDATIONS

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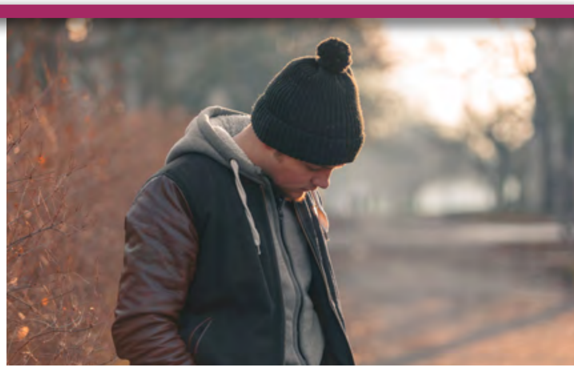

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OVERVIEW

IMPACT INVESTMENT GAINING INCREASING RECOGNITION AND MOMENTUM

Australia, like many jurisdictions around the world, has witnessed increasing interest and activity in impact investment over recent years as businesses, governments and communities seek new solutions to enable an inclusive and sustainable society.

On the global stage, impact investment took a major step forward when the Social Impact Investment Forum was convened by the G8 in June 2013. UK Prime Minister David Cameron heralded impact investment as a "*great force for social change*". Subsequently, a Social Impact Investment Taskforce was established by the G8 governments to foster the impact investment market. The Taskforce includes an observer representative from Australia.

Philanthropists, foundations and charities as well as institutional investors have implemented impact investment strategies. These strategies aim to yield financial returns, as well as positive and measureable social and environmental impacts. While some investors pursue commercial financial returns, others consciously elect to accept reduced financial returns in the interests of pursuing greater impact.

A POWERFUL ADDITION TO THE IMPACT TOOLKIT OF FOUNDATIONS AND TRUSTS

For charitable trusts and foundations, impact investment represents a powerful addition to their impact toolkit beyond traditional grants. Investing all or part of the corpus of charitable trusts and foundations in impact investments that can generate social and financial returns makes intuitive sense.

Done well, impact investment provides the opportunity for charitable trusts and foundations to deploy a greater proportion of capital resources in support of their mission, engage with a broader range of solutions for addressing social and environmental challenges, and sustain and grow assets for future use. Charitable trusts and foundations may also use their resources in a manner that catalyses and attracts additional capital to social and environmental needs.

MARKET POTENTIAL REQUIRES INVESTOR ENGAGEMENT BEYOND EARLY ADOPTERS

In Australia, the market potential for impact investment is estimated to be $32 billion over the next decade. Global commentators estimate a market potential in the range of US$400 billion to US$1 trillion. However, the number of active investors and level of capital committed so far is small relative to the pool from which engagement is necessary if such market potential is to be realised. Active take-up from charitable trusts and foundations for which impact investment has a natural appeal, together with take-up by institutional investors is essential to the success of a long-term impact investment market.

Despite the natural appeal of impact investment to charitable trusts and foundations, only a relatively small number have embraced the practice. Many are challenged by the misperception that investing for impact necessitates an appetite for high risk or a financial trade-off. Many also grapple with how to assess and position impact investment within mainstream investment portfolios. Extensive track records that indicate sound financial returns over extended periods for impact investments, together with measurable social and environmental impacts, are yet to be produced. Impact investment products are scarce and most are of limited scale, which makes it difficult for even positively disposed charitable trusts and foundations to identify investable products unless they commit specific resources to research or explore new opportunities. At a more fundamental level, charitable trusts and foundations seek comfort that impact investment, with its 'soft' and 'non-financial' benefits, will not compromise the investment duties with which they must comply under statute and general law.

CHARITABLE TRUSTS AND FOUNDATIONS CAN LEGITIMATELY EXTEND THEIR INVESTMENT UNIVERSE TO INCLUDE IMPACT INVESTMENT

The initial reaction of many trustees of Australian charitable trusts and foundations to impact investment is one of cautious enthusiasm. They are enthusiastic about the opportunity impact investment provides to expand the tools they have available to drive social change, but are cautious about how to navigate the statutory and general law duties with which they must comply. While caution is appropriate, in many cases the duties imposed on trustees can with care be navigated in a way that permits the trustees of charitable trusts and foundations to implement impact investment strategies.

Anecdotal evidence would indicate that a well-executed impact investment strategy provides trustees the opportunity to build income generating investment portfolios aligned with the mission and values of their charitable foundation or trust, which can offer unique exposure and uncorrelated diversification to a wide range of geographies and sectors.

EARLY ADOPTERS HAVE SUCCESSFULLY EMBRACED IMPACT INVESTMENT

First-mover charitable trusts and foundations, together with institutional investors, have successfully established and implemented impact investment strategies. Impact investments have been made across a range of sectors including: agriculture, microfinance, renewable energy, small and medium enterprises, healthcare, affordable housing and community development. Impact investments have also been made across a range of asset classes including: private equity, venture capital, private debt, real estate and international listed equity.

Between investors, the proportion of the investment portfolio allocated to impact investment varies significantly. Some charitable trusts and foundations have elected to adopt a total portfolio approach, targeting a transition towards one hundred per cent of their portfolio in impact investments as suitable investment opportunities present themselves. Others have opted to allocate a small to moderate proportion of their total portfolio to impact investment to amplify impact and diversify their portfolio, while limiting the change in the existing composition of the portfolio. It can be anticipated that more may move towards greater engagement, and potentially a total portfolio approach as the track record of impact investment builds, and charitable trusts and foundations gain access to the resources necessary to design, implement and manage impact investments.

Assessing impact investments on the basis of financial merits using the same professional processes and techniques as have been used for traditional investments is an appropriate pathway for charitable trusts and foundations. If impact investments meet traditional investment criteria, charitable trusts and foundations can justify pursuing the inclusion of impact investments in their investment portfolios. Once an investment case showing an expected rate of return commensurate with risk can be established, investors can consider social impact. Ideally trust deeds would be written or amended for the investment provisions to specifically reference that social impact factors can be considered as relevant to evaluation of any investment decision.

FOCUSED EFFORT REQUIRED TO REALISE OPPORTUNITY

It will take the collective and focused effort of diverse stakeholders to realise the opportunities presented by impact investment. All stakeholders – investors, intermediaries, government and impact enterprises – must work together to build a pipeline of opportunities that can be translated into investable product. It is essential to develop product that moves beyond the bespoke investment opportunities that have dominated the market to date, that will offer ease of engagement by a diverse set of investors and will recognise investors' differing requirements in regards to size, risk, and liquidity as well as targeted social or environmental impact.

Charitable trusts and foundations must secure the commitment of trustees and senior management to include impact investment in their impact toolkit. Resources required to design, implement and manage an impact investment strategy must be identified to successfully action this commitment. A well designed, implemented and managed impact investment strategy holds the potential to substantially amplify the impact charitable trusts and foundation have on their stated mission.

WHAT ARE IMPACT INVESTMENTS?

The Global Impact investing Network (GIIN) defines impact investments as:

> *… investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.*

This definition can be broken into three underlying components: intentionality, measurable social and environmental impact, and financial return. These three components serve to distinguish impact investments from mainstream financial investments, responsible or ethical investments, corporate social responsibility initiatives and philanthropic grants. Varying levels of financial return, market-rate, below-market or market-beating, can be found across the spectrum of impact investment which reflects the reality that different investors require different levels of financial return. Such variation reflects both individual appetite for risk and each investor's motives for entering the market.

The GIIN definition is increasingly finding acceptance amongst peak financial industry and professional member groups, such as the Global Sustainable Investment Alliance, Principles for Responsible Investing and the Responsible Investment Association Australasia.

Impact investments have been made in a wide variety of sectors including: agriculture, microfinance, renewable energy, small and medium enterprises, healthcare, affordable housing and community development. Recurring asset classes include private equity, venture capital, private debt, and real estate. The impacts commonly sought are:[1]

SOCIAL IMPACTS		ENVIRONMENTAL IMPACTS
Access to clean water	Conflict resolution	Biodiversity and conservation
Access to energy	Disease-specific prevention and mitigation	Energy and fuel efficiency
Access to financial services	Employment generation	Natural resources conservation
Access to education	Equality and empowerment	Pollution prevention and waste management
Access to information	Food security	Sustainable energy
Affordable housing	Health improvement	Sustainable land use
Agricultural productivity	Human rights protection	Water resources management
Community development	Income/productivity growth	

GLOBAL

New investors, focused intermediaries and policy developments in impact investment have emerged in all corners of the globe over the last decade. The market has moved from a stage of 'uncoordinated innovation' to 'market building' as various centres of activity and early stage infrastructure have emerged to catalyse increased activity and reduce transaction costs.[2]

Global networks are emerging with a specific focus on market building, such as the Global Impact Investing Network (GIIN) and the Impact Investing Policy Collaborative (IIPC). Initiatives to establish common standards for impact measurement and benchmarking are developing through the work of the Impact Reporting and Investment Standards (IRIS) and the emergence of the Global Impact Investing Rating System (GIIRS).[3] The task of unravelling the landscape of impact investment funds and products is being eased by databases such as ImpactBase[4] and ImpactAssets 50.[5]

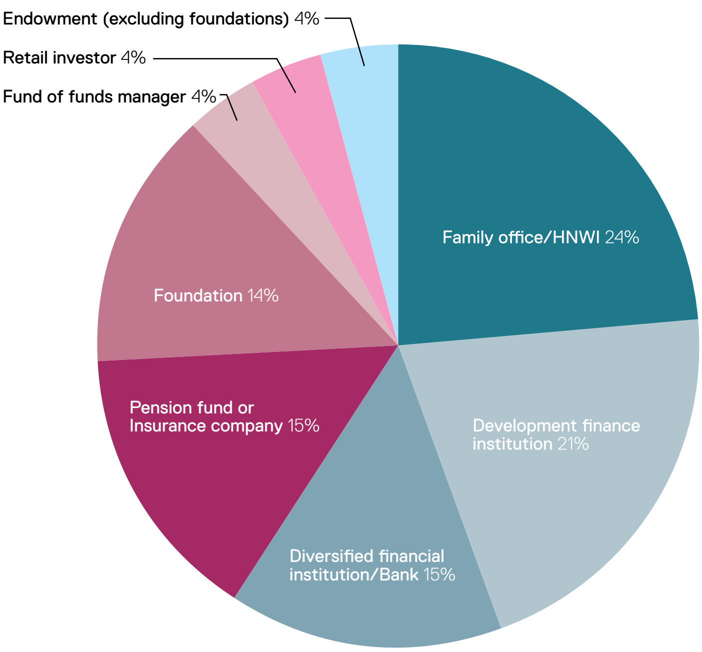
Influential powers are also looking to contribute to development of the market. A Social Impact Investment Taskforce has been formed by the G8 governments to report on three fronts:

- the policy framework to take impact investing to its tipping point;
- a common approach for measuring outcomes; and
- ways to introduce a market standard allocation towards impact investments by foundations, institutions and private investors.

The World Economic Forum has also launched the Mainstreaming Impact Investing initiative, which aims to move impact investment from the margin and into the mainstream.[6]

The majority of capital for impact investment originates in the United States and Canada, the United Kingdom and Europe, and Oceania.[7] Private individuals, charitable foundations and family offices together with international development banks have predominantly championed impact investment. Institutional investors are gradually becoming more interested as the track record of successful impact investments becomes available, and investment product to place and manage capital at scale is developed.

Figure 1: Source of Funds for Impact Investment Fund Managers, 2012

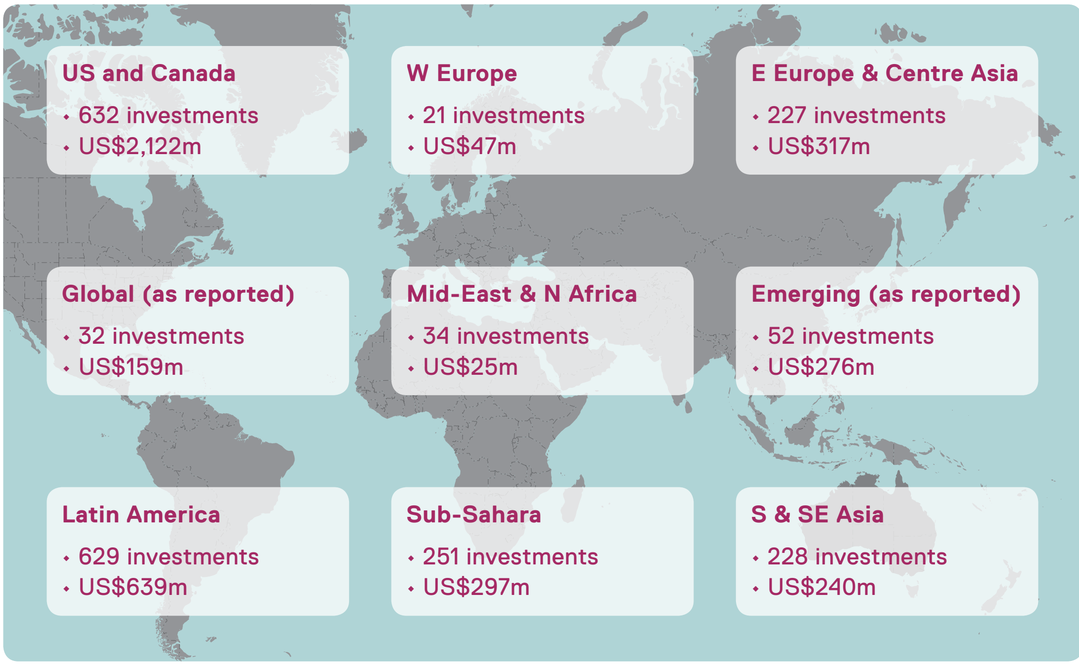


Source: GIIN, J.P.Morgan

Percentages are derived from rankings of relative capital contributions from each group of investor rather than absolute capital contributed

The demand for impact investment spans both developed and developing countries; with investments being made into for-profit, not-for-profit and hybrid entities with a diverse range of social and environmental impacts.[8]

Figure 2: Impact investing funds invested by destination during 2011



Source: R. Addis, J. McLeod and A. Raine, *IMPACT – Australia: Investment for social and economic benefit*, 2013

MARKET SIZE AND POTENTIAL

It is difficult to get an accurate indication of the size of the global market for impact investment, as little information on transactions is made publicly available, and there are various views as to what is or is not impact investment.[9] Estimates of the current market size vary significantly between commentators:

- Global Sustainable Investment Review 2012 reports US$89 billion in impact investment representing 0.14 per cent of total managed assets of professionally managed funds actively applying ESG strategies.[10]
- J.P. Morgan's third annual survey on the impact investment market reports that the 99 organisations that participated in the survey committed US$8 billion to impact investment in 2012 by, and plan to commit US$9 billion in 2013. Survey respondents reported cumulative allocations of US$36 billion since inception to impact investment.[11]
- The Impact Investor, which maps 380 different impact investment funds, reports that that total volume of capital managed by these funds in 2012 exceeds US$40 billion.[12]

Similarly, a range of views in regard to the market potential can be found:

- A J.P. Morgan survey of 52 investors highlighted that impact investments have the potential to constitute 5-10 per cent of high net worth individuals (HNWI) and institutional investor total portfolios by 2020.[13] In another survey, J.P. Morgan presented the opportunity for invested capital into businesses within five sectors – housing, rural water delivery, maternal health, primary education and financial services – serving the global population earning less than US$3,000 per year as ranging from US$400 billion to US$1 trillion.[14]
- The Monitor institute suggested in 2009 that impact investment could grow to US$500 billion or up to US$1 trillion in the next 5-10 years.[15]
- The Calvert Foundation estimates the market could potentially reach US$650 billion.[16]

Opportunities for impact investment are enormous if one considers projected demand-side needs. It will require $1.3 trillion to halve greenhouse emissions from the energy sector by 2050, $41 trillion to modernize global infrastructure and $5 trillion to reach 4 billion people in the global consumer market.[17]

RETURN EXPECTATIONS

Investors' expectations regarding risk, return and impact vary according to their intentions. This has given rise to the classification of investments as 'financial-first' or 'impact-first'. 'Financial-first' investors include banks, pension funds, sovereign wealth funds and development finance institutions that seek to achieve market-competitive financial returns from investments that offer the prospect of positive social and environmental impact. In contrast, some foundations and family offices are positioning themselves as 'impact-first' investors; seeking to maximise social or environmental returns while having a floor for financial return.[18] It is for the investor to determine how much return to pursue, and there are opportunities available across a full spectrum of returns from market-rate, below-market to market-beating.[19]

Independent realised return data for impact investment is not readily available. Commentary on returns is currently based largely on self-reported expected or target financial returns. What data is available indicates that the expected financial returns across impact investments range from 0-25%. The variation in return expectations reflects the differing prioritisation of financial return between 'financial-first' and 'impact-first' investors. It also reflects the range of instruments used for impact investment, and extrapolation from the available data is complicated by diversity in currency, region and sector. Impact investment funds do however predominantly target market rate returns.[20]

J.P. Morgan reports that the majority of respondents (65%) to its 2012 annual impact investment survey principally sought 'market rate financial returns' with the balance targeting financial returns that are 'below market rate'. Regardless of financial return expectation, 68% reported financial performance in-line with what they had expected, with 21% outperforming and 11% underperforming expectations. Many pursuing impact investment through equity (64%) report they have had at least one, if not many investments significantly outperform their expectations in financial terms, while delivering the predicted impact. Benchmarks used to assess performance against the market include: Cambridge Associates venture capital vintage year benchmarks, Cambridge Private Equity Index, LIBOR, MCSI Emerging Markets Indices, Consumer Price Index and Barclays U.S. Aggregate Bond Index.

2010 and 2011 surveys by J.P. Morgan also explored the question of return expectations with survey respondents. While the sample sizes were small, respondents reported that return expectations for impact investment in the emerging markets – debt or equity – largely compete with traditional benchmarks. Average return expectations in developed markets would, on the other hand, appear in many instances to be concessionary to market benchmarks, a phenomenon perhaps part explained by regulation and, in some instances, tax incentives.[21]

Microfinance is the one sector within impact investment where indices tracking actual return data have emerged reflecting the increasing scale and accessibility of investment opportunities. There is also good data available on financial returns from funds having, in some instances, experience of over 10 years. For example, the Swiss based responsAbility Investments AG reported an average return in US dollars of 3.9% for its debt investments in microfinance in 2012, which was consistent with its long-term target corridor of 3 to 5% despite very low interest rates worldwide.[22] Triodos Microfinance Fund managed by Triodos Investment Management, a subsidiary of Netherlands based Triodos Bank, reported annual returns in Euro of 7.8 to 8.7% in 2012 with returns since inception in 2009 of 4.9 – 5.4% per annum.[23] Similarly, the BlueOrchard Microfinance Fund targets an annual return of 6M LIBOR +100 to 200 basis points and SNS Impact Investing targets net returns in Euro of 6 to 11% on its two microfinance funds and targets net returns in Euro of 6 to 9%.[24]

Historical returns for investors with ESG strategies provide another insight into the potential of impact investment. Portfolios with high ESG ratings have been shown to outperform benchmarks in a majority of industries and these portfolios exhibit significantly less downside risk.[25]

While realised return data is currently limited, it is clear from what data is available that the opportunity exists to pursue impact investment without compromising market competitive financial returns. This information debunks a commonly held misperception that impact investment necessarily means accepting a concessionary financial return.

Moreover return streams from impact investments are in many instances uncorrelated to mainstream investments. This has led to a growing recognition that they may provide the benefit of diversification in a traditional investment portfolio. Sir Ronald Cohen and William A. Sahlman believe impact investments can deliver a financial return of 7 per cent, uncorrelated with equity markets while maintaining a consistently high social return.[26]

AUSTRALIA

IMPACT Australia: Investment for social and economic benefit provides a detailed analysis of the current state of impact investment in Australia; its growth potential and possible challenges.[27] The following touches only briefly on the rich data contained in that report. Readers wishing to build a more in-depth understanding of the Australian market are encouraged to refer directly to the *IMPACT Australia* report.

CURRENT STATE OF PLAY

In Australia, impact investment is increasingly finding its way into conversation. Social economy organisations are seeking to maximise social and environmental benefits.[28] Such organisations seek a greater choice of capital and a broader range of funding products to provide opportunities for secure, sustainable, predictable and appropriate funding. Landmark transactions such as Goodstart Early Learning, Hepburn Community Wind Farm, Chris O'Brien's Lifehouse at RPA and StrEAT have provided investors opportunities across varying asset classes, including fixed income, property and private equity, while generating impact in the areas of education, health, renewable energy and employment generation. Impact investments are also funding innovative businesses like TOM Organic and Barefoot Power as well as commercial and residential properties that all intentionally generate diverse social and environmental impacts.

Consistent with global trends, Australian federal and state governments have begun to explore and enable impact investments as they seek to balance constrained fiscal environments and leverage government spending with private sector investment to achieve improved social outcomes.

Through the Social Enterprise Development and Investment Fund (SEDIF) the Australian government has provided one-off grants totalling $20 million which together with matching private sector investment have seeded the establishment of three impact investment funds:

- Foresters Community Finance (Foresters);
- Social Enterprise Finance Australia (SEFA); and
- Social Ventures Australia Impact Fund,

to finance the start-up and expansion of social enterprises in Australia. The private sector investment into these funds was provided by a combination of diverse investors including Christian Super, Triodos Bank, Community Sector Bank, Macquarie Group, NSW Aboriginal Land Council and private investors.

Two social benefit bond pilots to facilitate out-of-home care have been initiated by the NSW government.[29] The Newpin Social Benefit Bond launched in March 2013 successfully raised $7 million one month before its scheduled close to support UnitingCare Burnside's Newpin program, an intensive support program that works with families to improve parenting so children can live safely with their families.[30] The Newpin Social Benefit Bond is aiming for a financial return of 10 to 12% per annum over seven years, based on the program's success in restoring children to their families. The second social benefit bond launched in June 2013 successfully raised $10 million to support The Benevolent Society's Intensive Family Support Service to help at-risk families deal with issues, keep children out of the child protection system and keep families safely together. The bond has two tranches – a $7.5 million principal protected component with returns of up to 10% and a $2.5 million capital performance based component with returns of up to 30%. In both instances, interest paid to investors is dependent on the program's success in keeping families together.[31] A third social benefit bond pilot in the area of recidivism is still in development.[32]

The Victorian, Queensland, South Australian, West Australian and Tasmanian state governments are all at various stages in actively considering how best to mobilise impact investment initiatives. Some are already rolling out initiatives to stimulate the development of the impact investment market.

This government activity follows on the heels of the Productivity Commission report released in early 2010 on *Contribution of the Not-for-Profit Sector* and the November 2011 report *Investing for good: the development of a capital market for the not-for-profit sector in Australia* of the Senate Economics References Committee. Both reports recommended the development of a market to increase access to capital for the not-for profit sector in Australia. To develop such a market requires a general acknowledgement that social and environmental impact is not the sole purvey of the not-for-profit sector. Business guru Michael Porter pointed out, "*Separating business and competition from social progress and social issues was a big mistake. Some of the biggest opportunities for business are in tackling social issues and social challenges*."[33]

MARKET SIZE AND POTENTIAL

Analysis in *IMPACT Australia* details annual impact investments of A$300 million and total capital managed of A$2 billion in 2012, projecting growth to around A$32 billion over 10 years.[34] These numbers assume market development in Australia will mirror the progress of similar investments in the United Kingdom and United States, and that we will enjoy the same growth rates as have been forecast for those markets.

RETURN EXPECTATIONS

Impact investments in Australia span instrument types, sectors and funding recipients: from equity to debt, employment generation to education, for-profit companies to non-profits. As such, it is not surprising to find a range of return expectations reflecting not only different underlying investment characteristics but also varying philosophical approaches to impact investment from both investees and investors.

Table 1 details the return expectations for a number of impact investments across the Australian landscape. As the sample size is limited, and there is a lack of historical data across asset classes for comparison, it is not possible to draw firm conclusions from this data. The table does however highlight that opportunities exist for investors to pursue competitive financial returns through impact investment, though currently such opportunities are limited in number and scale.

Table 1: Actual or expected returns for Australian impact investments

	GOODSTART SOCIAL CAPITAL NOTES	SEDIF	NEWPIN SOCIAL BENEFIT BOND	BENEVOLENT SOCIETY SOCIAL BENEFIT BOND		BAREFOOT POWER		STREAT
Year	2009	2012- 2013	2013	2013		2008-2011	2012	2012
Total Investment Amount	$22.5 million	$20.6 million[35]	$7 million	$7.5 million principal protected tranche	$2.5 million performance base tranche	$3 million	$5.8 million	$0.3 million
Asset Class	Fixed Income	Fixed Income and Equity	Fixed Income	Fixed Income	Equity	Fixed Income	Equity	Equity
Actual or Expected Annual Financial Return	12.0%	6.0%-13.0%	10.0-12.0%	Up to 10.0%	Up to 30%	3.0-15.0%	Up to 15.0%	7.0-12.0%

A POWERFUL TOOL TO AMPLIFY IMPACT

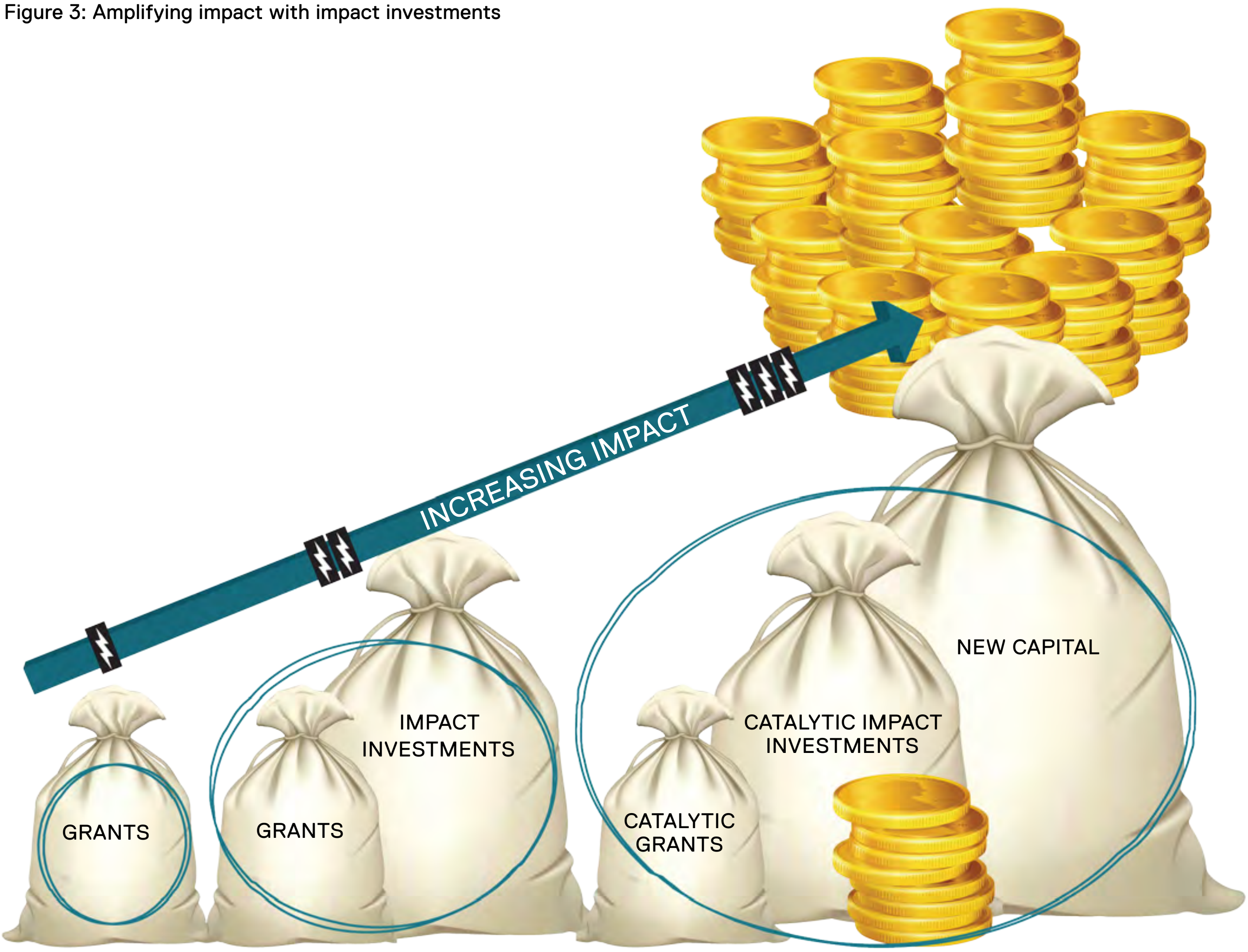
Grant capital from traditional philanthropic and government sources is insufficient in volume and inadequate in form to fuel the diverse array of solutions emerging to address persistent social and environmental challenges. Solutions are no longer constrained by traditional sectoral boundaries but are leveraging cross-sector experience, practice and resources. Charitable trusts and foundations looking to actively engage with these new solutions must review their options for applying available capital to the achievement of their mission.

Impact investment represents a powerful addition to the impact toolkit allowing charitable trusts and foundations to deploy a greater proportion of their capital resources in support of their mission. It makes intuitive sense for, part or all, the corpus of charitable trusts and foundations to be invested in impact investments that generate both social and financial returns. Enabling flows of capital beyond traditional grants allows charitable trusts and foundations to engage with the expanding solution set for social and environmental challenges. Support can include letters of credit, guarantees or first-loss capital, collateralisation, loans, insurance, reserve accounts and equity. A flexible approach to applying foundation assets to impact investments in diverse ways can substantially amplify a foundation's social mission.[36]

> *We do not see any point in investing in investments that are causing some of the problems we are trying to solve with our granting. It is important to us to have coherence in managing our funds by moving as much as we possibly can to investments doing social good. Why not have your money working for you twice, it seems a waste otherwise.*
>
> JOHN MCKINNON *MCKINNON FAMILY FOUNDATION*

Perhaps the most compelling argument for charitable trusts and foundations to engage with impact investment is that it may catalyse impact. Catalytic impact investments by charitable trusts and foundations trigger additional flows of capital by other investors to a desired company, fund, asset class, sector or geography. Investments from respected charitable trusts and foundations can build credibility, demonstrate viability or improve the risk-return profile of an investment opportunity for other investors. For example, a large, reputable charitable foundation may provide a cornerstone investment into an impact fund to improve the recipient fund manager's credibility with other investors who, in turn, invest in the impact fund thereby increasing the fund assets available to apply to the investment thesis.[37] Alternatively, they may use letters of credit, first-loss capital, over-collateralization, insurance or reserve accounts to credit enhance an investment opportunity thereby improving its risk-return profile and catalysing more risk-averse sources of capital.[38]

Figure 3: Amplifying impact with impact investments



While an expanded toolkit is critical for charitable trusts and foundations to engage with additional opportunities to achieve their missions, traditional grants also serve an important role in development of the market for impact investment. The impact investment market is, as detailed in the previous section, still in a relatively early stage of development. Much of the infrastructure to support investors and investees that is seen in mainstream investing markets is not yet in place. Grants have and will continue to serve an important role in developing the missing infrastructure including membership groups, rating frameworks, systems and agencies, think tanks, investing platforms, and investee mentoring and coaching. The value of grants in developing the market has been illustrated by Rockefeller Foundation, Omidyar Network, Deloitte and others in supporting the establishment and operation of the Global Impact Investing Network (GIIN), Impact Reporting Investment Standards (IRIS), Global Impact Investment Rating System (GIIRS) and TONIIC. In Australia, grants have likewise played an important role in enabling market research, education workshops, conferences and business incubators.

Impact investment, like any investment activity, has risks and rewards that need to be appropriately considered and managed. Done well however, impact investment provides charitable trusts and foundations with the opportunity to:

– Deploy a greater proportion of capital resources in support of their mission;
– Direct and attract additional capital to social and environmental needs; and
– Sustain and grow assets for future use.[39]

A well-designed implementation strategy and a strong accountability framework together with full commitment of trustees, board members, senior management, staff and other stakeholders is key to successful impact investment. It is not the intention of this report to provide instruction on how to establish such a strategy and framework but to highlight the common myths and challenges charitable trusts and foundations experience in regard to impact investment and to share practical insights from some that have embarked on their impact investment journey.

DISPELLING COMMON MYTHS AND ADDRESSING PERCEIVED CHALLENGES

Charitable trusts and foundations often raise common concerns as they begin to explore impact investment. These concerns fall into five categories:

- concern by trustees as to whether impact investment is permissible under the applicable legal framework in which they operate;
- uncertainty as to where impact investment is included within modern investment portfolios;
- a narrow set of bespoke investment opportunities;
- limited human capital to design, implement and manage an impact investment strategy; and
- a lack of enabling industry infrastructure such as standardized frameworks for measurement of social return.

Early adopters of impact investment have demonstrated that none of these issues are insurmountable. With a firm commitment to expanding their impact toolkit, charitable trusts and foundations are well able to embrace impact investment.

NAVIGATING INVESTMENT DUTIES OF CHARITABLE TRUSTEES[40]

The initial reaction of charitable trustees to the prospect of impact investments is typically one of enthusiasm tempered with caution. The enthusiasm is for the opportunity impact investment provides to expand the tools they have available to drive social change; the caution arises from uncertainty regarding how to navigate statutory and general law duties. While such caution is appropriate, with care, the requirements imposed on trustees can be navigated in a way that permits the trustees of charitable foundations to provide capital to enterprises and funds pursuing a social impact agenda.

There is a fundamental distinction at the heart of charity law. This distinction separates the investment of the assets of the charity on one hand, and the distribution of monies in the form of grants on the other. The law clearly establishes that assets earmarked for investment must be applied in the pursuit of income that can be used to fund the grants made by the charity. Those assets cannot be applied directly in pursuit of the charity's aims.

This general principle is qualified in four ways:

1. The trust deed may specifically empower the trustee to have regard for certain criteria, including social impact, when making investment decisions.
2. A trustee of a charitable trust may refuse investments inimical to the aims of the charity. For example, charities devoted to cancer research might properly eschew investment in tobacco companies and those devoted to temperance or the treatment of substance abuse might eschew investment in brewers and distillers.
3. The investment power must be exercised for a proper purpose. An investment that is however capable of being justified on purely financial grounds will not be rendered improper merely because, for instance, it provides capital to an entity engaged in activities consistent with the charity's aims.
4. The trustees of Private Ancillary Funds (PAFs) and Public Ancillary Funds (PuAFs) are able to include in the calculation of their respective minimum 5% and 4% distribution each year any discount to the return received from a deductible gift recipient that is attributable to the delivery of a social benefit (for example, subsidised rental). This important concession does not however empower the trustees of PAFs and PuAFs to invest in non-financial-first investments where such power does not exist (for example, under the trust deed) but it does reduce one of the constraints faced by PAFs and PuAFs.

The foremost duty of any trustee is to give effect to the terms of the trust as enshrined in its trust deed. Most deeds will include rules, often broad, governing the investment strategy of the fund. Trustees are also subject to the rules specified by the Trustee Act of the State or Territory in which they reside.[41] The power granted by the *Trustee Act 1925 (NSW)* provides a trustee with flexibility to pursue a range of investment instruments unless expressly prohibited by its trust deed:

> *A trustee may, unless expressly forbidden by the instrument (if any) creating the trust:*
>
> *(a) invest trust funds in any form of investment, and*
> *(b) at any time vary any investment.*

Trustees of most modern trusts enjoy powers of investment that encompass a wide range of investment types. Impact investments that conform to these legal types (shares, loans and the like) are likely therefore to fall within the range of authorised investments for a charitable trust.

The breadth of this power must be seen in conjunction with the general law applying to trustees. Trustees owe a general law duty to act carefully in the administration of the trust and to ensure that the investment power is exercised for the purpose of investment and not some collateral purpose. Specifically, they must in making any investment decision give regard to such things as risk, return, cashflow, diversification, liquidity, valuation data, tax, costs and the liabilities of the charitable foundation. These criteria emphasise the importance of trustees having regard for the financial grounds of any investment decision.

So, what does a charitable trustee need to consider when investigating impact investments? As a starting point, a trustee must ensure that:

1. any investment has an expected rate of return commensurate with the risk that it carries. One of the most important developments in recent years is that impact investment opportunities are increasingly being designed to offer market rates of return and, in some circumstances, their financial position is 'de-risked' by government commitments, enabling would-be investors to apply traditional modes of credit analysis;
2. the investment must also have diversification and liquidity characteristics that fit with its role in the overall portfolio of investments. There can be no 'trade-off' between these criteria and other, ancillary purposes, even if those purposes align with the objectives of the charity;
3. any personal connections that the trustees have with any of the potential target investments are dealt with in a way that is consistent with the charity's conflicts policy; and
4. the trustee has the resources and processes in place to undertake due diligence on any investment. Investment propositions that require intensive, bespoke analysis on a case-by-case basis by the trustee necessarily compete for attention with the myriad of other issues requiring trustee attention. This suggests that intermediated solutions, or carefully framed delegations, may be required to ensure that potential investments are given the attention required in order for the trustee to be in a position to demonstrate that they have acted prudently in the exercise of their investment power. That said, impact investments increasingly have governance and reporting practices similar to those an investor would expect to see in respect of more traditional targets for investment.

As discussed above, express reference to the consideration of social impact factors in the investment provisions of the trust deed will ease the path for a trustee to make impact investments.

Not all impact investments will be winning investments. But that is true of all investments. Impact investment is no different. With a little care and due attention, the trustees of many charitable trusts and foundations can pursue impact investments, incorporating them where appropriate in the investment portfolio they craft in satisfaction of their statutory and general law duties.

RECOGNISING IMPACT INVESTMENT AS AN ESG STRATEGY ACROSS MAINSTREAM ASSET CLASSES

Commentators on impact investment fall generally into two schools of thinking. The first school argues that impact investment is an emerging asset class. They consider that investors require a unique combination of complementary financial, social and environmental skill sets, together with ability to navigate a diverse range of complex capital structures. Investors should also understand social and political dynamics that might influence investment outcomes, and be well versed in distinct organisational structures or stand-alone specialist initiatives to be able to properly engage with the impact investment space.[42]

> *We view impact investment as a strategy across existing asset classes not as an asset class of its own.*
> **JOHN MCKINNON** MCKINNON FAMILY FOUNDATION

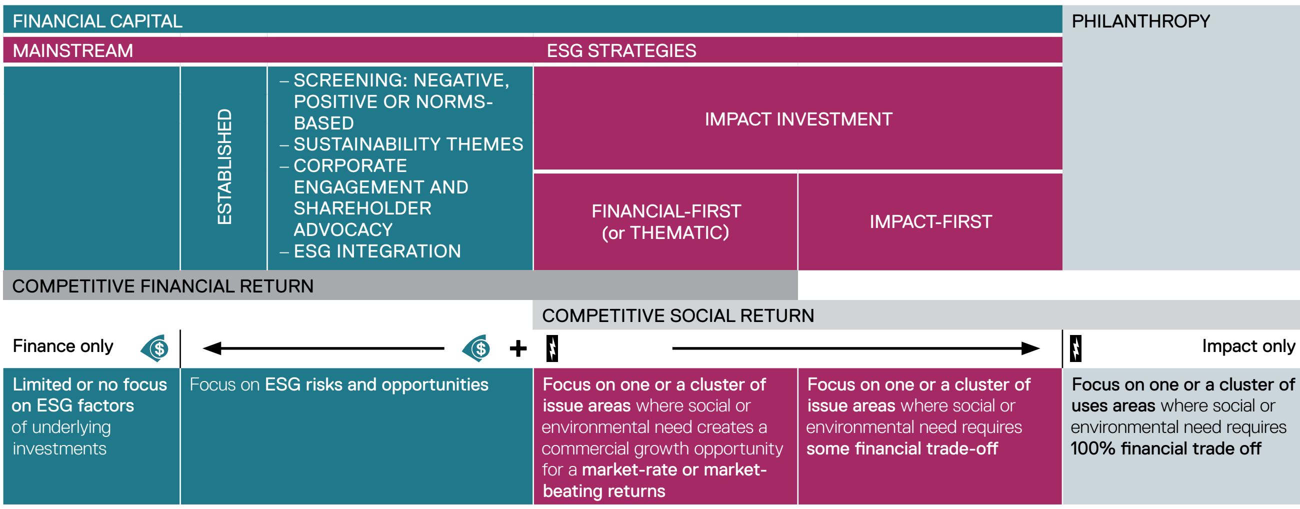
The second school holds the alternate and increasingly popular view recently endorsed by the Global Impact Investing Network that impact investment should be recognised as an investment approach that can be undertaken across the suite of established asset classes.[43] This school of thought characterises impact investment as spanning all asset classes, impact areas and geographies. For example, an investor may hold cash in a community bank, bonds enabling vaccination programs in developing countries, public equities of a listed microfinance institution, or units in an environmentally sustainable property fund. As the market for impact investment matures increasing opportunities will exist for investors across all asset classes (See Figure 4).

Figure 4: Impact investment – an investment approach across asset classes

Source: Adapted from *World Economic Forum*

Investors taking this *integrated approach* may choose to apply an impact investment strategy to a proportion of their investment portfolio across all or selected asset classes or to 100 per cent of their investment portfolio. The decision as to how much of the investment portfolio to which to apply an impact investment strategy will be influenced by the expected impact on the risk and reward characteristics of the overall portfolio. In this way, impact investment becomes an alternate or complementary ESG strategy alongside longer established strategies such as negative screening, best-in-class screening, or corporate engagement and shareholder action (See Figure 5).

Figure 5: An emerging impact investment spectrum



Source: Adapted from *Bridges Fellowship Report, June 2012*

ADAPTING MAINSTREAM INVESTMENT DECISION FRAMEWORKS

Recognising impact as a lens that can be applied across all asset classes enables established investment decision making frameworks, due diligence processes and portfolio construction models to be applied to an investment portfolio encompassing impact investments. Adaptations of mainstream investment decision frameworks are beginning to emerge to provide guidance to investors seeking to incorporate impact investment into diversified investment portfolios. These frameworks recognise assessment of financial risk and reward is paramount to an investment decision, yet acknowledge that social risk and reward – impact – is also an essential part of the decision process for impact investments. The frameworks also adopt mainstream portfolio construction best practices, such as diversification and liquidity.

These emerging frameworks provide a basis for developing and implementing a strategy to incorporate impact investment into an overall investment portfolio. As detailed in Appendix 2, these frameworks guide investors to establish portfolio parameters, define investment strategy and asset allocation targets, determine an impact thesis, assess investment opportunities for risk, return and impact, and manage financial and impact risk.[44]

The frameworks provide complete flexibility to investors to elect the proportion of assets to be allocated to impact investment within a portfolio. Investors may elect a strategy where a minimal proportion of assets are allocation to impact investment through to 100 per cent of assets being placed into impact investment.

The target allocations for impact investment by charitable trusts and foundations vary greatly from a small proportion of the investment portfolio to 100 per cent depending on legal and cultural flexibility regarding non-traditional investment. Those focused on meeting mandatory (for example, 5% of net assets for PAFs and PUAFs) or voluntary distribution requirements without any erosion of capital tend to allocate a small proportion of their investment portfolio to impact investment. A small allocation to impact investment will have only marginal effect on overall returns and may usefully diversify the portfolio. In contrast, foundations with more flexibility and a commitment to achieve full value alignment of their investments with their mission are actively seeking to move towards allocations of 100 per cent (that is, a total portfolio approach) as impact investment opportunities become available.

we want to make a significant enough investment but, at the same time, if lost or the returns were not that great, then it would not have a huge impact on our capacity to do other activities.

ELENA MOGILEVSKI THE MYER FOUNDATION AND SIDNEY MYER FUND

We currently have approximately 10% of our corpus in impact investments...in the long term we would really like to have one hundred per cent.

JOHN MCKINNON MCKINNON FAMILY FOUNDATION

The extent to which impact investment diversifies the portfolio will be governed by the correlation of returns. To date, anecdotal evidence suggests that the underlying economic drivers thus return correlations for impact investments are different to those for mainstream investments.

ACCELERATING DESIGN OF SUITABLE INVESTMENT OPPORTUNITIES

While Australia has seen a growth in impact investment over the past five years, growth has been driven and dominated by bespoke individual investment opportunities that present limited scale, liquidity and diversification. Structured investment funds and products that have emerged are few in number, limited in scale and have yet to establish a proven track record. None are yet included in the approved lists of mainstream wealth advisers, who may be knowledgeable about impact investment, but cannot without adequate reputable data recommend any investments to their clients. The small number of charitable trusts and foundations that have participated in these investments have typically worked outside mainstream wealth advisers drawing on in-house or specialist expertise to assess the investment opportunity.

The Social Enterprise and Development Investment Funds (SEDIF) and the NSW Social Benefit Bonds have demonstrated that careful design and early collaboration with potential investors can ease the process of securing investment commitments. They also highlight that vehicles and structures providing 'de-risked' tiers can be designed to attract a range of investors including charitable foundations together with superannuation funds and other institutional investors in the early stage of market development.

Early engagement and input by potential investors on the terms and conditions for proposed investment opportunities will accelerate the development of suitable investment opportunities and facilitate commitment by anchor investors. The terms and conditions of a proposed investment will need to be sufficiently comprehensive to ensure investors are able to discharge their various investment duties, as discussed above.

ACCESSING EXPERTISE TO DESIGN, IMPLEMENT AND MANAGE IMPACT INVESTMENTS

Accessing expert resources to successfully engage in impact investment is critical and is often listed as one of the first challenges to exploring impact investment encountered by charitable trusts and foundations. Building expertise is essential throughout the entire impact investment process, from initial knowledge of the field, through to the design, implementation and management of an investment portfolio incorporating impact investments. The nature of impact investment demands financial expertise together with programmatic expertise in the targeted social or environmental areas, as well as the ability to understand and work with diverse sets of stakeholders across the social, public and private sectors.

An honest assessment of both in-house expertise and the competencies of existing investment and philanthropic consultants is the first step in understanding the adequacy of current resources. The skills needed to source, analyse and manage impact investments are not necessarily those currently held by existing finance or program staff, executive management, board members or external consultants. It is essential for charitable trusts and foundations to be open to supplementing current resources through education, future hiring or board appointments and engagement with new consultants or intermediary organisations. In some instances, this openness may need to extend as far as a complete transformation of resources.[45]

As the market for impact investment in Australia has emerged over the past number of years the pool of expertise has expanded to include specialist consultants and intermediaries. A number of mainstream financial intermediaries, wealth advisers and consultants have also begun to build knowledge and understanding of the field. For example, Foresters Community Finance, Social Enterprise Finance Australia and Social Ventures Australia are all specialist intermediaries offering investment opportunities, while Ethinvest, Evans & Partners, Impact Investment Group, JB Were and Myer Family Office are actively supporting clients to identify opportunities and build impact investment strategies. Upon assessing their resource needs, charitable trusts and foundations must determine if they should look to such intermediaries for help, build in-house expertise or adopt some combination of the two.

DEVELOPING SUPPORT INFRASTRUCTURE

The traditional support infrastructure used by asset owners, fund managers and advisers to originate, analyse and manage mainstream investments is largely unavailable for impact investments.

Intermediaries to facilitate impact investments in Australia are only beginning to emerge. For these intermediaries to have broad appeal, they will need to scale and build a track record of sound and consistent returns over time. Mainstream intermediaries are yet to build a credible depth of knowledge and expertise in impact investment.

Standards for pricing risk and reward or measuring social impact are beginning to emerge, however more time must pass before such standards garner widespread acceptance and adoption. The Impact Reporting and Investment Standards (IRIS) provide a set of standardised metrics to describe an organisation's social, environmental and financial performance. The Global Impact Investing Rating System (GIIRS) provides a rating to funds and companies to allow investors to benchmark and compare social and environmental performance. The issue of finding a common approach to measure non-financial outcomes is a focus area of the Social Impact Investment Taskforce of the G8.

Databases aggregating information about impact investment opportunities are in the early stages of roll out. ImpactBase is a searchable online database of more than 250 impact investment funds. ImpactAssets 50 is an annual showcase of experienced private debt and equity impact investment fund managers. Currently however there is very little data specific to Australian impact investment opportunities. This reflects the nascent nature of impact investment in Australia together with the fact that much activity to date has been through bespoke single transactions rather than funds.

The task of developing support infrastructure, while not insurmountable, will take time. Those interested in cultivating impact investment as a market will need to exert a concentrated effort to customise international infrastructure or to build bespoke solutions for the Australian market. The absence of clear and specific infrastructure necessitates investors individually adapt familiar investment decision processes to impact investment or adopt carefully selected intermediated solutions.

SOME PRACTICAL INSIGHTS

We conducted interviews with a small selection of charitable trusts and foundations in Australia, the United Kingdom and the United States: donkey wheel Foundation, Esmee Fairbairn Foundation, McKinnon Family Foundation, Myer Foundation and Sidney Myer Fund, and Omidyar Network. We also interviewed Small Giants who are holistically adopting impact investment into the investing activity of their family office. While the form, nature and mission of these organisations vary widely, all have navigated the challenges and successfully incorporated impact investment into their impact toolkit.

These interviews provided practical insights into the rationale and processes involved in establishing and implementing an impact investment strategy.

BE COMMITTED TO AMPLIFYING IMPACT

Impact investment is recognised as a tool that can be used to align the income generating activities of the corpus of a charitable foundation and trust with its mission and values. Successful impact investment requires a commitment by the organisation to utilise all resources available to directly amplify impact.

… thinking about investment strategies, we always felt we would like to undertake investments that would advance our mission… I'm excited because [impact investment] is a new way (at least in Australia, it is a reasonably new way) of thinking about how we utilise our dollars to achieve greater impact.

ELENA MOGILEVSKI THE MYER FOUNDATION AND SIDNEY MYER FUND

What excites me most about the future is we have 800 million pounds in our endowment and that's a lot of money. We are giving away 30 to 35 million pounds a year in grants and five million on impact investment. What if we could put all of that money or a greater proportion of that money to work for social benefit? That would be quite exciting. In some ways we're sitting here in a position of saying we have all the resources we need to solve problems, can we convince ourselves to deploy the funds to solve them? I don't know whether it would be right to deploy it all to impact investment or not but I think that is the exciting prospect.

DANYAL SATTAR ESMEE FAIRBAIRN FOUNDATION

Instead of setting up a foundation, we just said 'why don't we change the entire way we invest?'. So for us it was strategic… I would challenge anyone who believes in impact investment why they would not invest their entire corpus in impact… Why would you not put all your money through that lens?

DANNY ALMAGOR SMALL GIANTS

We are committed to having 100 percent of our corpus invested in mission-aligned investments. What we want to see is a well-structured deal that demonstrates the organisation we are investing in is capable of delivering both a positive social impact and a good financial return. If that is present we will invest in a whole range of ways including debt, equity, bridging finance, etc. We don't want to eat away at the capital available in our corpus so for that reason we need to make a financial return on those investments. For us impact investment simply allows us to see all of our money contributing to creating the world we want to see rather than only our granting contributing. It's about leverage.

BESSI GRAHAM DONKEY WHEEL FOUNDATION

ESTABLISH A COMPREHENSIVE TOOL KIT TO OPTIMISE USE OF AVAILABLE RESOURCES

While impact investment expands the tools available to charitable trusts and foundations to drive impact, flexibility to draw on a comprehensive toolkit is essential to ensure all available resources can be optimally applied.

… what [Pierre and Pam Omidyar] realised was that in order to be consistent with how they believe impact can be achieved at scale, it would be necessary to unleash market-led tools and the power of the individual entrepreneur. With our dual legal structures (non-profit (501(c)(3)) and limited liability company), we have the flexibility of focusing on the problem first and tool second. That is a part of our theory of change, 'problem first, tool second'… [It's] all about being able to focus on meeting the entrepreneur and his or her venture in its evolution.

ROSITA NAJMI OMIDYAR NETWORK

We are building the market for impact investment with grants from The Sidney Myer Fund and doing impact investments from the corpus of The Myer Foundation.

ELENA MOGILEVSKI THE MYER FOUNDATION AND SIDNEY MYER FUND

UNDERSTAND HOW AND BE PREPARED TO BE A CATALYST FOR OTHER INVESTORS

Early adopters highlighted that decisive actions by those with experience and track record can build credibility, demonstrate viability or improve the risk-return profile of an investment opportunity for other investors.

Catalytic has a number of definitions in our approach and in the impact that we seek. One is coming in at the right time. For example, coming in early to help de-risk, and thereby engage other funders with lower risk tolerances. Catalytic could also be about size. Often we make large investments because that is the necessary intervention. Catalytic can also involve leveraging our reputation to 'crowd in' other types of capital or tap into our network capital to experiment with a partnership. Omidyar Network believes not only in interventions that encourage co-investors but also in opportunities to leverage a spectrum of capital – financial, human, intellectual, and network.

ROSITA NAJMI OMIDYAR NETWORK

We do a bunch of things that are market building because we knew when we came into the [impact investment] space that we would want to make direct investments and to support intermediaries who as specialist entities… could attract other investors into the sector alongside us so our money is pooled with others and the risks are shared.

DANYAL SATTAR ESMEE FAIRBAIRN FOUNDATION

We are doing a combination of both stand-alone investments and investing alongside partners… what we see as exciting however is the potential to offer more syndicated style investments.

DANNY ALMAGOR SMALL GIANTS

ACTIVELY LEARN FROM AND SHARE EXPERIENCE WITH OTHERS

Early adopters of impact investment stressed the importance of learning from others throughout their impact investment journey. All highlighted that a critical first step in commencing impact investment was building knowledge and understanding of the field from early adopters, practitioners, researchers and commentators in order to educate organisational stakeholders about the possibilities and challenges of impact investment. Gaining an early understanding of how impact investment fits or can be fitted within organisational and legal structures was also stressed.

I think the key to us adopting an impact investment strategy was understanding the [impact investment] space conceptually… My suggestion would be, get yourself educated. Build an understanding of what impact investment is in a non-threatening environment, and then find people to help you conceptualise how it applies to your particular circumstances and understand your legal framework.

ELENA MOGILEVSKI THE MYER FOUNDATION AND SIDNEY MYER FUND

All our investments – impact or otherwise – are bona fide and prudent and made on an arms-length basis thus ensuring we are compliant with our fiduciary duties.

JOHN MCKINNON MCKINNON FAMILY FOUNDATION

… structurally, we were set up in 1961 as an unincorporated trust and have a very flexible trust deed… Charity law is complex, but the guts of it around investment seems to be behave as a prudent person would do.

DANYAL SATTAR ESMEE FAIRBAIRN FOUNDATION

Early adopters have also emphasised a collegiate spirit of learning, sharing and collaboration amongst those actively seeking and making impact investments and market building organisations as crucial to fostering investment opportunities, optimising capital flows and developing the market to maximise impact and mitigate risk.

With our other trust and foundation colleagues, we participate in a group of about 30 institutions that are usefully networked into something that we call the social impact investors group. We have regular quarterly meetings and quarterly to bi-monthly pitching days where people come and pitch to foundation investors as a group… a bit of mutual moral support. We are also members of the Investors' Council of the Global Impact Investing Network and the European Venture Philanthropy Association. We are networked with our local Community Development Finance Institutions through the Community Development Finance Association. We are affiliate members of the UK Sustainable Investment Forum. Essentially we consciously put our name up there, go along, hang out, listen in, try and learn.

DANYAL SATTAR, ESMEE FAIRBAIRN FOUNDATION

We seek to be active contributors to ecosystems, at the sector, geographic, or industry levels… sponsoring conferences, investing in industry infrastructure, advancing policy, and producing and commissioning knowledge products. We invest directly and via funds… if we get introduced to an investment opportunity that does not align well strategically, we will forward it on to others. Similarly, others will forward potential fits to us.

ROSITA NAJMI OMIDYAR NETWORK

We have a strong network. We do get to see a lot. My staff and I have travelled around the world. We've been to the Skoll World Forum, SOCAP, and the B Corporation Retreat… We really are out there consistently. This means we get to see opportunities that others don't see. We're also active; we have people scouring the country for deals.

DANNY ALMAGOR SMALL GIANTS

With the field of impact investment being relatively new, learning is and must be a constant.

We are committed to a spirit of learning and an iterative approach. Our team is constantly challenged by our management and Board. They often ask us – what are we learning, how are we contributing to the field and what are we sharing? If we don't approach our work with the spirit of learning and an iterative model, the impact of our direct engagement with entrepreneurs will be limited

ROSITA NAJMI OMIDYAR NETWORK

BUILD RESOURCES TO CONDUCT PROFESSIONAL DUE DILIGENCE

Charitable trusts and foundations use the same professional processes and techniques for due diligence on impact investments as they do for mainstream investments. The consideration of social impact is an additional element in this process. The resources used to undertake this additional due diligence, as well as to originate, pipeline and manage the resulting investment portfolio, varies between organisations. Some organisations have chosen to build internal capability, while others have elected to outsource to intermediaries and external advisors or to collaborate with co-investors to access and share expertise as well as spread transaction costs.

… [our due diligence] includes everything you would expect a typical venture capital firm to consider; in addition, we look at social or environmental indicators and sector impact

ROSITA NAJMI OMIDYAR NETWORK

Make sure the financials stack up… take a careful focused look at the management and team…

JOHN MCKINNON MCKINNON FAMILY FOUNDATION

In terms of assessment, the first hurdle has to be our social hurdle, is this investment achieving something we want to achieve?… [If] we can say yes… we will look at the finances… we will take these things to a monthly meeting where somebody from the grant making team and the finance director will be… We also use a business advisor for anything that looks like a small business so a social enterprise or small charity we could unleash him on them to do some real assessment due diligence work and, from time to time, other providers… Sometimes we get specialist advice because you need a technical expert to give you a view on a project.

DANYAL SATTAR ESMEE FAIRBAIRN FOUNDATION

Most of our investment staff bring backgrounds in commercial or development finance, consulting, venture capital and private equity, technology, entrepreneurship, and beyond. We also have team members who bring experience from organisations like the World Bank, or who have deep experience in direct service delivery in the field via international NGOs or in policy… Our staffing composition is actually a point of differentiation. And, that could be among one of the barriers to the development of the impact investing industry: the necessary talent is either expensive or not proficient in social and environmental impact, business at the base of the pyramid, or emerging markets…

ROSITA NAJMI OMIDYAR NETWORK

We realised very quickly that we were never going to be in a position to be able to evaluate deals. We are not equipped to make a reasonable assessment whether any particular social enterprise is a viable investment proposition or not. Consequently we turned our mind to who would be able to do this for us, provide a level of diligence and expertise.

ELENA MOGILEVSKI THE MYER FOUNDATION AND SIDNEY MYER FUND

It's very straightforward for us to determine whether an organisation is investible, we look at the same things that a financial institution would look at. The organisation needs to have some track record and be able to demonstrate a commercially viable business model. One of the nuances I would add is that for us when we talk about investable social enterprises we also want to see a willingness to be held accountable for both the social and financial returns generated.

BESSI GRAHAM DONKEY WHEEL FOUNDATION

ACTIVELY DECIDE YOUR APPROACH TO PORTFOLIO MANAGEMENT

After making impact investment decisions, charitable trusts and foundations vary in the level of engagement they will have with investees. Some charitable trust and foundations favour a more engaged approach, whilst others maintain an arm's length involvement. The financial instrument the investor has used will influence the level of involvement.

We frequently apply a suite of technical advisory services to help the entrepreneur and senior management team succeed. For example, Omidyar Network might help you hire not only key, C-suite level senior managers, but also might help identify strategic hires for particular skill sets or functions. We have an in-house 'ninja' team of HR recruiters at Omidyar Network who are directly engaged in the hiring for and coaching of our investees. In addition to hiring and on-boarding, we also help them with strategic planning. We might even link their legal and finance teams with our legal and finance teams to sophisticate their systems and make them more resilient.

ROSITA NAJMI OMIDYAR NETWORK

The term we use is 'being invested in them', rather than just considering the financial transaction at the end, we want to be invested in [these social enterprises] to help them along a process to produce the type of investment we want our corpus funds to be invested in.

BESSI GRAHAM DONKEY WHEEL FOUNDATION

[Our level of engagement] varies greatly investment by investment. On some of them, the limited partnerships, we can't exercise control over the management or investment otherwise we lose our limited liability. Typically we're on things like advisory boards. Sometimes we have the option to observe board meetings or we're observers on investment committees. Sometimes it's general quarterly meetings or six monthly meetings. Other ones it's just attending annual general meetings or saying any time you're passing through London drop by, have a talk to us. The frequency of interactions vary if things get into trouble. I think that's when having the right to observe board meetings comes in.

DANYAL SATTAR ESMEE FAIRBAIRN FOUNDATION

We knew that we didn't want to be a passive investor; we wanted to be in there. We have more to give than just money... you get more out of it if you put more in... With some investments we are incredibly close... intimately involved. Others where we take a small share, we take a back seat, sitting as advisors.

DANNY ALMAGOR SMALL GIANTS

A parting word of advice for charitable trusts and foundations considering impact investing comes from Danyal Sattar of the Esmee Fairbairn foundation... Take the first step.

What should be the first steps for an organisation contemplating impact investing?... Start. I think that is the number one thing. A young journalist was interviewing an extremely renowned elderly pioneer of the feminist movement in the States and she said what's your advice? She said 'just start, take the first step. If you don't do that you don't go anywhere'

DANYAL SATTAR ESMEE FAIRBAIRN FOUNDATION

SELECTED IMPACT INVESTMENTS

Table 2: Selected impact investments of institutional investors

DONKEY WHEEL FOUNDATION	JOHN MCKINNON FAMILY FOUNDATION	SMALL GIANTS[46]	ESMEE FAIRBURN FOUNDATION[47]	OMIDYAR NETWORK[48]
Australia	Australia	Australia	United Kingdom	United States
donkey wheel House: Property investment through the purchase of 'donkey wheel House', a physical space for social organisations seeking to address social challenges in innovative, entrepreneurial, financially sustainable and collaborative ways.	**AU$50K – Streat:** Equity investment a Melbourne-based foodservice social enterprise providing a pathway to long-term employment for at-risk young people.	**Streat:** Investment in a Melbourne-based foodservice social enterprise providing a pathway to long-term employment for at-risk young people.	**£875K – Charities Aid Foundation:** An investment in developing affordable community owned rural housing. The fund is managed by Venturesome.	**US$15M – Change.org:** Equity investment in Change.org, the world's largest online social action platform enabling individuals anywhere to start, join and win campaigns for social change.
Streat: Equity Investment in a Melbourne-based foodservice social enterprise providing a pathway to long-term employment for at-risk young people.	**AU$300K – Lismore Soup Kitchen:** A secured property loan to social enterprise providing meals and accommodation to marginalised individuals.	**Tom Organic:** Investment in Melbourne-based enterprise producing Certified Organic tampons.	**£825K – Herefordshire Nature Trust:** An investment in the purchase of Birches Farm, conserving rare, unimproved grassland.	**US$25MM – Elevar Equity:** Investment in two private equity growth funds managed by Elevar Equity – Unitus Equity Fund (UEF) and Elevar Equity II. UEF invests in high growth microfinance companies, while Elevar Equity II invests in entrepreneurial companies offering products and services to the poor as well as microfinance companies.
SVA Social Impact Fund: Investment into the SVA Social Impact Fund, an AUS$8.8MM fund established to provide loans and equity investments to social enterprises in Australia.	**AU$10K – Barefoot Power:** An unsecured loan to an entrepreneurial Australian company designing, manufacturing and distributing affordable lighting and charging solutions for households without reliable access to electricity.	**The Commons:** Investment in the development of an Australian sustainable apartment building showcasing renewable energy and urban community design.	**£750K – Social Finance Ltd:** An investment in the first Social Impact Bond focused on reducing reoffending of short-sentence male prisoners discharged from Peterborough prison.	**Bridge International Academies:** Investment in Series A, Series B and Series C equity rounds for expansion of Bridge International Academies, the world's largest chain of primary schools offering education at an affordable price to families living on less than $2 a day per person.
Team Wild Enterprises: Equity investment in a Queensland social enterprise working with disadvantaged and disengaged youths to reduce recidivism.	**AU$220K – Women's Legal Service Queensland:** A secured property loan to a specialist community legal centre facilitated by Foresters Community Finance	**Livelihood Investment Fund:** Investment in US$30MM Unitus Impact's Livelihood Impact Fund established to invest in companies that improve the livelihoods of the working poor across Southeast Asia and India and achieve strong financial returns.	**£750K – Bridges Community Ventures Ltd:** An investment in the Bridges Social Entrepreneurs Fund, aimed at growing social enterprises to scale.	**d.light design:** Investment in two equity funding rounds to support growth of d.light design, an entrepreneurial company developing solar-powered consumer products for families without access to reliable electricity.
Ethical Property Australia: Equity investment to launch the newest member of the international Ethical Property family. Ethical Property creates spaces where organisations can come together to make a difference.	**AU$50K – REBBL:** A combined equity and convertible debt investment into a social enterprise operating in Peru, India and Thailand.	**Hub Australia:** Investment in the Australian 'Hub' professional member community focused on innovation and collaboration.	**£550K – Commonweal Housing Ltd:** An investment in housing for formerly homeless people in transition to private rented accommodation.	**MicroEnsure:** Equity investment in MicroEnsure, a leading provider of a range of insurance products to low-and-middle income consumers in Africa and Asia.
Newpin Social Benefit Bond: Debt investment to support UnitingCare Burnside's Newpin program, an intensive program that works with families to improve parenting so children can live safely with their families.	**AU$250K – Team Wild Enterprises:** Equity (AU$100K) and debt (AU$150K) investment in a Queensland social enterprise working with disadvantaged and disengaged youths to reduce recidivism.			**US$10M – IGNIA:** Anchor investment in IGNIA, a venture capital investment firm supporting promising, scalable enterprises serving the needs of low-income populations in Latin America.

Australian charitable trusts and foundations are able to pursue and benefit from the opportunity presented by impact investment. Opportunity to build investment offerings aligned with their mission and values and to gain unique exposure and uncorrelated diversification to a wide range of investments across geographies and sectors. While ready impact investment product is currently scarce and uncovering investable opportunities takes focused effort, as market momentum builds and collaborative effort is made to develop product to accommodate the needs of a wide range of investors, the pathway to pursuing impact investment will be eased. Those willing to engage early will make a valuable contribution to the building and development of the market and, most importantly, driving social change.

APPENDIX ONE: INVESTMENT DUTIES OF CHARITABLE TRUSTEES

INTRODUCTION

There are a variety of forms that charitable foundations can take. Most are constituted as trusts. As such they are subject to the Trustee Act of the relevant State and to the general law applying to trusts and trustees.[49] Within this group some are constituted and administered to comply with the *Private Ancillary Fund Guidelines 2009* (Cth) ('PAFs') or the *Public Ancillary Fund Guidelines 2009* (Cth) ('PuAFs'). This status entitle contributors to claim certain tax advantages but also subjects the trustee to a range of special rules pertinent to the exercise of their investment power. A small number of charitable entities operate as corporations rather than trusts and will, as a result, be subject to the *Corporations Act 2001* (Cth). Fewer constraints on investment are likely to apply in that context and the analysis below will for that reason focus on the rules applying to trustees of charitable trusts.

The multiple layers of rules imposed on charitable foundations can be daunting. However the various requirements can often be navigated in a way that enables the trustee to provide capital as part of its investment activities to enterprises pursuing a social impact agenda.

THE DISTINCTION BETWEEN INVESTMENT AND GRANT-MAKING

It is important at the outset to recognise a fundamental distinction at the heart of charity law. The distinction is that between the investment of the assets of the charity on the one hand, and the distribution of monies in the form of grants on the other.

This is relevant in the context of charitable trusts specifically because the duties owed by trustees in the two situations are quite different. As Sir Donald Nicholls V-C noted in *Harries v Church Commissioners:*[50]

> [By] their very nature, and by definition, investments are held by trustees to aid the work of the charity in a particular way: by generating money. That is the purpose for which they are held. That is their raison d'etre. Trustees cannot properly use assets held as an investment for other, viz., non-investment, purposes.

His Honour also noted that:[51]

> Where property is so held, prima facie the purposes of the trust will be best served by the trustees seeking to obtain therefrom the maximum return, whether by way of income or capital growth, which is consistent with commercial prudence. That is the starting point for all charity trustees when considering the exercise of their investment powers. Most charities need money; and the more of it there is available, the more the trustees can seek to accomplish.

That is to say, assets that are earmarked for investment cannot be applied directly in pursuit of the charity's aims. Rather, those assets must be applied in pursuit of income that can be used to fund the grants made by the charity. This principle is crucial in understanding the obligations of trustees of PAFs, PuAFs and charitable trusts generally.

This general principle is qualified in four ways:

1. The trust deed may specifically empower the trustee to have regard for certain criteria, including social impact, when making investment decisions. The process of decision-making will still need to demonstrate the other qualities (such as care and skill) expected of trustees, as detailed below.
2. The courts have recognised that there may be certain types of investments that are so inimical to the aims of the charity that trustees of a charitable trust could properly refuse to consider them.[52] So for instance charities devoted to cancer research might properly eschew investment in tobacco companies and those devoted to temperance or the treatment of substance abuse might eschew investment in brewers and distillers.
3. The investment power must be exercised for a proper purpose.[53] That said, the fact that an otherwise proper course of action brings about collateral advantage to another will not of itself render that course of action improper.[54] So an investment that is justifiable on purely financial grounds will not be rendered improper merely because, for instance, it provides capital to an entity engaged in activities consistent with the charity's aims.
4. Both PAFs and PuAFs are required to distribute a minimum portion (currently 5% and 4% respectively) of their fund each year to retain their preferential taxation status. Unusually, though, the trustees of PAFs and PuAFs are able to include in that calculation any discount to the return received from a deductible gift recipient that is attributable to the delivery of a social benefit (eg through subsidised rental). This is an important concession. However it is also important to recognise that it does not actually empower the trustees of PAFs and PuAFs to invest in non-financial-first investments where such power does not exist (eg under the trust deed). It does mean that the trustees who have such powers may have a preparedness to invest in arrangements where some, at least, of the return is delivered directly to the charitable objects, so long as those arrangements can satisfy their other obligations under the trust deed.

THE INVESTMENT DUTIES OF THE TRUSTEE OF A CHARITABLE TRUST

The foremost duty of any trustee is to give effect to the terms of the trust.[55] The trust deed is therefore the starting point for understanding the rules governing the investment of the assets of a charitable trust. Moreover, trustees must be very attentive to the specific provisions governing administration of their trust because subtle differences in the drafting of the governing rules can have a material impact on what they can and cannot do.

The trustees of charitable trusts are also subject to the rules specified by the Trustee Act in which they reside.[56] Most pertinently in the current context, the Trustee Act in each State contains a provision equivalent to s14 of the Trustee Act 1925 (NSW). That section provides:

> A trustee may, unless expressly forbidden by the instrument (if any) creating the trust:
> (a) invest trust funds in any form of investment, and
> (b) at any time vary any investment.

The power granted by s14 (and equivalent provisions in other states) is notably broad. It is an effective response to older case law that held certain types of investments to be unsuitable for trust investment *per se*. However it does make clear that the terms of the trust instrument remain paramount in defining the investments[57] in which a trustee may invest. Fortunately, the trustees of most modern trusts enjoy powers of investment that encompass a wide range of investment types. Social impact investments that conform to these legal types (shares, loans and the like) are likely therefore to fall within the range of authorised investments for a charitable trust.

There is however another way in which the investment decisions of trustees are regulated. The legislation in each State regulates how investment decisions are to be made.[58] So for instance s14C of the *Trustee Act 1925* (NSW) provides:

> (1) Without limiting the matters that a trustee may take into account when exercising a power of investment, a trustee must, so far as they are appropriate to the circumstances of the trust, if any, have regard to the following matters:
>
> (a) the purposes of the trust and the needs and circumstances of the beneficiaries,
> (b) the desirability of diversifying trust investments,
> (c) the nature of, and the risk associated with, existing trust investments and other trust property,
> (d) the need to maintain the real value of the capital or income of the trust,
> (e) the risk of capital or income loss or depreciation,
> (f) the potential for capital appreciation,
> (g) the likely income return and the timing of income return,
> (h) the length of the term of the proposed investment,
> (i) the probable duration of the trust,
> (j) the liquidity and marketability of the proposed investment during, and on the determination of, the term of the proposed investment,
> (k) the aggregate value of the trust estate,
> (l) the effect of the proposed investment in relation to the tax liability of the trust,
> (m) the likelihood of inflation affecting the value of the proposed investment or other trust property,
> (n) the costs (including commissions, fees, charges and duties payable) of making the proposed investment,
> (o) the results of a review of existing trust investments in accordance with section 14A (4).

This provision has to be seen in conjunction with the general law applying to trustees. Trustees owe a general law duty to act carefully in the administration of the trust[59] and, as was noted above, to ensure that the investment power is exercised for the purpose of investment and not some collateral purpose. Those duties will apply to all of the acts performed by the trustee but are specifically relevant here.

The criteria in section 14C clarify some of what it takes for a trustee to satisfy that duty specifically in respect of investing. On the whole the criteria emphasise the importance of trustees having regard for the financial grounds of any investment decision. Importantly also, however, paragraph (a) talks about the ‘purposes of the trust’ which suggests that accommodating particular sensitivities such as those mentioned above (tobacco, alcohol, and so on) may be acceptable in appropriate circumstances. Whether it might accommodate consideration of social impact benefits (absent some express reference in the trust instrument) is much less certain.

GOVERNANCE AND DELEGATION

The general law is wary of permitting trustees to escape accountability for the key decisions relating to the administration of a trust. Generally a trustee is permitted to appoint agents to perform 'ministerial' tasks, so long as such a delegation would be prudent and consistent with ordinary business practice.[60] Trustees cannot however escape accountability for decisions containing a 'discretionary' element simply by passing responsibility for such decisions to another person.

This is relevant in the charity context because it powerfully conditions the way that trustees need to approach the governance of charitable trusts, especially in relation to investment of the trust's assets. The trustees of a charity may not be expert investors, in fact that will be the case more often than not. It is important to recognise therefore that trustees can accept advice and appoint specialist firms to implement investment mandates, but the trustees remain ultimately accountable for the administration of the funds under their trusteeship. They may have rights against the agent (the investment manager or adviser), if that agent has not performed its duties appropriately, but they must demonstrate that as trustee they have acted with care and diligence, and that there is a consonance between the needs and objectives of the fund and the investment strategy they have implemented. The appointment of an agent does not detract from that fundamental obligation. So the trustees of a charitable trust must ensure that they seek expert advice in areas where they lack relevant expertise, and then must consider that advice and monitor any agents carefully. They cannot simply defer to the expertise of others.

Trustees of charities also need to be careful to manage situations in which their duties to the trust come into conflict with their other interests, or more commonly, their duties to other parties. This could for instance arise in an impact investing context if a trustee also served as director on the board of an entity seeking investment from the charity. In such a situation the trustee must be very careful to comply with the charity's conflicts policy to avoid any suggestion of legal impropriety.

In addition to these general considerations, charities must comply with the governance standards prescribed by the Australian Charities and Not-for-profits Commission ('ACNC') if they wish to stay registered.[61] The standards require that the entity (the charity) work towards its charitable purpose (Standard 1), take reasonable steps to be accountable to their members (Standard 2), comply with Australian laws (Standard 3), ensure their board and committee members are not disqualified from undertaking such a role (Standard 4) and take reasonable steps to ensure that all responsible persons (including board and committee members) comply with their common law and legislative duties (Standard 5). In effect these standards use the threat of de-registration to motivate the entity to give effect to governance processes that limit the likelihood of legal transgressions by the entity or its officers.

THE IMPLICATIONS FOR SOCIAL IMPACT INVESTING

The first implication of this multi-level regulatory regime is that the trustees of charitable trusts cannot simply apply the assets entrusted to them directly in support of the charity, say by lending funds at favourable interest rates to organisations pursuing the charity's aims, unless provision has been made for this in the terms of the trust deed. Rather, any investment made by the trustee of a charitable foundation must have an expected rate of return commensurate with the risk that it carries. The investment must also have diversification and liquidity characteristics that fit with its role in the overall portfolio of investments. There can be no 'trade-off' between these criteria and other, ancillary purposes, even if those purposes align with the objectives of the charity.

The second implication is that express reference to consideration of social impact factors in the investment provisions of the trust deed will make it easier for a trustee to make such investments. This of course will depend on the precise circumstances of the trust. There are a variety of legal issues that may make it harder for such a reference to be included after the trust is established.

The third implication is that the legal form of the 'investment' can have a material impact on the extent and nature of the due diligence required of a trustee. Investments packaged in familiar legal forms carry fewer due diligence risks for trustees, risks that are not, on average, compensated by higher expected returns.[62] The trustee must therefore ensure that it has the resources and processes in place to undertake this due diligence. This suggests that intermediated solutions, or carefully framed delegations, may be required to ensure that potential investments are given the attention required in order for the trustee to be in a position to demonstrate that they have acted prudently in the exercise of their investment power.

APPENDIX TWO: DEVELOPING AND IMPLEMENTING AN IMPACT INVESTMENT STRATEGY

Both Cambridge Associates and J.P.Morgan have adapted mainstream investment decision frameworks for developing and implementing an impact investment strategy within the context of an existing or new investment portfolio[63]. The key elements of these frameworks are to:

- Establish portfolio parameters: The composition of any investment portfolio and, in turn, the decision to include or exclude impact investments in a portfolio must account for the relationship between the investment portfolio and the organisation it supports. For charitable foundations it is essential that the relationship between the investment portfolio and such issues as the organisation's distribution policy, operating budget, risk tolerances (for example, illiquidity and financial covenants in stressful times) and governance structure around investment decision-making are well understood and parameters reflecting these relationships are established to guide the construction of an investment portfolio.
- Define investment strategy and asset allocation targets: Taking account of the portfolio parameters an investment strategy is to be defined and portfolio asset allocation targets established. The strategy will determine the investment scope, with regard to the drivers of financial performance of the overall portfolio, as well as at the level of individual investments. These parameters include: geographies and sectors of focus; life-cycle of targeted investee companies (for example, start-up or growth); eligible investment instruments; risk appetite; and risk-adjusted return expectations.

After the investment strategy has been defined, the asset allocation for impact investments must also be determined. Impact investments may comprise a small percentage of a portfolio or a portfolio may be actively constructed comprising fully of impact investments. The degree to which a portfolio is comprised of impact investments will be influenced by both the portfolio parameters and investment strategy. Flexibility is required around allocations, as it may take time to identify and/or develop suitable investment opportunities. Taking an opportunistic approach in the early stage of market development may be most effective.

- Determine impact thesis: Once the investment strategy guiding the construction of the investment portfolio is defined, an investor will articulate the desired impact of the portfolio. The impact thesis will represent the values of the investor and may be articulated with reference to a set of specific impact objectives. For example, if an impact thesis is defined as 'social', examples of activities within the portfolio could include increasing access to affordable housing or generating employment opportunities for a target population.

Together the portfolio parameters, investment strategy, asset allocation targets and impact thesis define the set of impact investment opportunities an investor can consider.

- Assess investment opportunities for risk, return and impact: As with any investment opportunity, assessment of impact investments must start with analysis of the financial risk and return. This analysis is conducted at the individual investment level as well as for the portfolio as a whole with the results being compared to the adjusted risk-return target of the investment strategy. It is not necessary that each and every impact investment perfectly fits within the target range, provided that the portfolio does so in aggregate.
- Manage financial and impact risk: All investments carry risks that must be appropriately managed. The risk profile of many impact investments will often mirror those carried by mainstream investments in the same geographies or sectors. Impact investments do however carry some specific risks that need to be considered on a deal-by-deal basis and factored into calculation of the aggregate risk of the overall portfolio. Risks specific to impact investments can include: reputational risk or moral hazard of impact failure; early stage of market development limiting track record, investment choice and liquidity; blended capital structures bringing together financial capital with philanthropic grant capital; and financial returns dependent on social outcomes.

Once risks are identified they can then be managed by a range of risk management strategies including: choice of investment instrument; structural features with the capital structure; fund intermediaries; or linking compensation structures to financial return and/or impact.

FOOTNOTES

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40. Appendix 1 provides the complete analysis of the investment duties of charitable trustees in the context of impact investment as prepared by Herbert Smith Freehills
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57. Earlier quibbles about whether certain transactions undertaken by a trustee (such as lending money without security) were properly characterised as 'investment' appear now to have been overtaken by accepted practice and by the self-evident legislative intent of the section: JD Heydon and M J Leeming, *Jacobs' Law of Trusts in Australia* (7th Edn, LexisNexis Butterworths, 2006), [1807].
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