

Industry Agenda

From Ideas to Practice, Pilots to Strategy Practical Solutions and Actionable Insights on How to Do Impact Investing

A report by the World Economic Forum Investors Industries

December 2013



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REF161213

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1. Preface



Michael Drexler
Senior Director,
Head of Investors
Industries
World Economic
Forum USA



Abigail Noble
Associate Director,
Head of Impact
Investing Initiatives
World Economic
Forum USA

From Ideas to Practice, Pilots to Strategy is both an attempt – and an opportunity – to disseminate the best practices and lessons learned from the first movers, early adopters and bold innovators in the field of impact investing, with the goal of further advancing the sector.

When we published *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors* in September 2013, we sought to add clarity to the field through a realistic, current assessment. With over 10,000 people accessing the report in the first two weeks, it became evident that we touched on a strong need. However, given the relatively small scale of impact investing, we realized that more than clarification was needed. For active investors in the field, to shift impact investing from a small part of their portfolios to a full-fledged strategy requires operational and practical knowledge. New players in the impact investing space, looking to take it from a compelling idea to a real investment approach, need to know how to get started in this nascent and potentially rewarding sector. This codified know-how and repository of best practice is currently as embryonic as the sector itself.

Readers of the Margins to Mainstream report reached out from far and wide to ask for advice on how to start (or do even more) with impact investing. While we could hypothesize and make suggestions, it is only experienced impact investors who can speak with authority about what does and doesn’t work, and why. With that in mind, we curated this collection of short, action-oriented and insightful thought pieces on how to put impact investing to work.

Because the sector is in a nascent stage and engages diverse individuals, organizations and societies, no one solution will apply to every situation. Rather, this publication can serve as a trailhead and as a semi-trodden path for new practitioners; but much more trail-blazing will be necessary before the sector can call itself mature.

We advocate learning by doing, failing fast, synthesizing feedback and quickly re-engineering shortcomings into a more informed approach. Above all, we believe that intentions (and certainly good ones) matter with every action and step towards building a new sector. With these principles in mind, we can collaboratively and proactively ensure that the impact investing sector is on the best path forward.

For the many key players whose wisdom and expertise could not be represented here, we look forward to hearing from you and, where possible, including your perspective in future efforts to help bring the impact investing sector to maturity.

Contact us at impactinvesting@weforum.org

2. Introduction to the Mainstreaming Impact Investing Initiative

Nearly two years ago, at its Annual Meeting in Davos in January 2012, the World Economic Forum convened a discussion among mainstream investors and social entrepreneurs on how to harness the hype of Impact Investing. While the list of reasons why impact investing would remain niche seemed overwhelming, bringing it into the mainstream was too important an opportunity not to pursue.

With this in mind, the Forum launched the Mainstreaming Impact Investing Initiative. The first milestone – *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors* – was released in September 2013 and provided an overview of the sector, identified challenges constraining the flow of capital, and laid the groundwork for mainstream investors to begin a meaningful discussion on impact investment. Most of the constraints identified fit into one of four broad, overarching challenges: an early-stage ecosystem; small average deal size; the fit within an asset allocation framework; and double bottom line.

From Ideas to Practice, Pilots to Strategy is the second publication in the Forum's Mainstreaming Impact Investing Initiative. The report takes a deeper look at why and how asset owners began to include impact investing in their portfolios and continue to do so today, and how they overcame operational and cultural constraints affecting capital flow. Given that impact investing expertise is spread among dozens if not hundreds of practitioners and academics, the report is a curation of some –but certainly not all –of those leading voices. The 15 articles are meant to provide investors, intermediaries and policy-makers with actionable insights on how to incorporate impact investing into their work.

Target Audience for *Ideas to Practice, Pilots to Strategy*

This publication's target audience includes three key groups: (1) investors looking to start impact investing; 2) active impact investors looking to expand impact investing from a limited part of their work to a full-fledged strategy; and (3) intermediaries, policy-makers and development finance institutions whose support is vital for the sector's growth. Since large investors often have a proportionally large influence on a sector, a key focus is on highlighting best practices or frameworks from large asset owners and asset managers.

Motivation and Scope of *Ideas to Practice, Pilots to Strategy*

The report's goals are to show how mainstream investors and intermediaries have overcome the challenges in the impact investment sector, and to democratize the insights and expertise for anyone and everyone interested in the field. Divided into four main sections, the report contains lessons learned from practitioner's experience, and showcases best practices, organizational structures and innovative instruments that asset owners, asset managers, financial institutions and impact investors have successfully implemented.

The strategic case for impact investing from the mainstream investor's perspective is the focus of "More than an Idea: Creating the Case for Impact Investing". This section includes the following key messages:

- Reflecting environmental, social and governance (ESG) standards in the investment process, across asset classes and alongside traditional financial metrics and competent risk management practices, can generate superior risk-adjusted, long-term investment returns. Moreover, inadequate ESG capability can lead to poor financial performance.
- Institutional investors can shape markets and encourage managers to design products with social impact. Recent data indicates that many institutional investors look to incorporate ESG standards into their investment decision-making. However, so that impact investment strategy becomes an institutional priority, decisions

must come from top leadership. Institutions that have a commitment from top leadership for impact investing (or a similar mission) find it easier to implement the strategy as well as collaborate for shared successes.

- Reviewing past successes, those intended or not, can help investors evaluate potential strategy within their institutions. Large investors can conduct a rigorous review and retroactively tag their investments as “impactful” (i.e. those with a measurable social and financial return, but without clear intent). By sharing this knowledge, such investors help to set a reassuring climate for future impact investment strategy that would include explicit intention to generate measurable social and financial returns.
- Traditional investors are seeing the benefits of diversifying portfolios by working with socially minded investment managers who generate reasonable returns that are somewhat uncorrelated.
- Conventional interpretations of fiduciary duty can lead to herding, which while providing safety of numbers, can produce investment decisions that are not in investors’ long-term interests. For impact investing to engage pension funds, there must be a clear account of how impact investing is congruent with fiduciary duty, and active engagement with asset owners on why impact investments may require funds to reassess their own attitudes towards what constitutes “conventional” investment.

The section on “Building a Strategy” provides examples of organizational structures, processes and strategies employed by large asset owners and asset managers to implement impact investing, while generating risk-adjusted financial returns and meeting the fiduciary responsibilities of institutional investors. Depending on the organizational structure, the frameworks may include impact investing as an investment approach across various asset classes; or, focusing and developing expertise in a particular sector. This section’s key messages include the following:

- Impact Investing can be done within a large institution through a variety of operational approaches: a stand-alone team, a hub-and-spoke structure, an outsourced adviser or an institution-wide commitment and strategy. Whatever the approach, the impact investment thesis and criteria for selecting and evaluating impact should be clear from the outset. In addition to diversifying across asset classes, impact investors can increasingly diversify across impact sectors as markets deepen
- Investors need to ensure that impact investing is well-integrated into an organization’s decision-making processes and has buy-in from major internal stakeholders. If impact investing has received support from top leadership, integration of it throughout the organization is a matter of communication and coordination. In other circumstances, it is up to the teams to open communication channels laterally and collaborate across teams for shared objectives such

as diversified portfolios and reduced costs of entering new markets. Impact investors can diversify not only across asset classes, but also and increasingly across impact sectors, as markets deepen and the choice of investment opportunities grows.

- Given impact investing is a nascent sector, focusing due diligence on fund managers’ track records may hold the industry back. Investors should rather seek to understand the factors determining a fund manager’s decision-making process.
- Partnership is critical for success. Successful impact investing fund managers share four qualities: partnering effectively with the public sector, using catalytic capital, providing “multilingual” (i.e. cross-sector) leadership, and placing financial and social objectives on equal standing. Moreover, treating investors (LPs) as partners from the outset on governance structures, financial and development goals, as well as including impact objectives early in the investment process, is important to ensuring mission alignment among key players.
- Impact investing does not have to be “finance-first” or “impact-first”, but can be “professional-first”. Asset managers can apply the same degree of professionalism to investment decision-making as to traditional investing, and so comply with the fiduciary responsibility of institutional investors. Investors can use a methodical approach to building an impact investment portfolio based on the risk, return and impact profile of individual investments and the portfolio as a whole.

“Innovations for Unlocking Mainstream Capital” looks at innovative impact investing solutions that can meet the needs of multiple stakeholders, including commercial investors, philanthropic organizations, governments and retail investors. The section’s key messages include the following:

- Commingling funds serve as innovative forms of partnership among previously isolated capital providers. Set up correctly, they can multiply the impact of capital while preserving their contributors’ interests.
- The Social Stock Exchange is a mechanism for opening up impact investing to retail investors, as well as making it more attractive to mainstream investment. A conducive environment for issuers and investors, along with an ecosystem within which they can interact, are important requirements for creating a vibrant public impact investing market.
- Social impact bonds (SIBs) are a novel way of finding economic solutions to social problems and, as such, have tremendous potential for channelling resources to programmes that work. Development of a mature, well-organized SIB market based on solid infrastructure is still very much a work in progress; a robust pipeline of SIB-ready projects, an ecosystem and a blended-value investor pool are and will be key factors for success

Definitional Alignment

Realizing that a definitional discussion of impact investing can lead to more questions than answers, this section is devoted to clarifying common areas of confusion.

Impact investing as an investment approach that intentionally seeks to create both financial return and positive social or environmental impact that is actively measured.

First, it is an investment approach and not an asset class. Impact investing is an investment approach across asset classes, or a lens through which investment decisions are made, and not a stand-alone asset class. Certain impact investments (e.g. public equity security of an impact enterprise) may behave similarly to certain asset classes (e.g. public equities), while other impact investments (e.g. social impact bond) may not behave similarly to other asset classes (e.g. corporate bond).

Second, intentionality matters. Investments that are motivated by the intention to create a social or environmental good are impact investments. However, if the intention is solely financial gain, even if the investment unintentionally creates social or environmental value, the designation of the investment being an impact investment is less certain. For example, an investment made into a pharmaceutical company that manufactures life-saving medications solely for the purpose of generating financial returns without the intention for social impact is not an impact investment. That said, the investment may certainly be impactful, but not an “impact investment” by definition.

Third, the outcomes of impact investing, including both the financial return and the social and environmental impact, are actively measured. The degree of financial return may vary widely from recovery of principal to above-market rates of return. In addition to financial return, the investment’s social or environmental value must be measured in order for the investment to be considered an impact investment.



3. More than an Idea: Creating the Case for Impact Investing

3.1 Enhancing Financial Returns by Targeting Social Impact

By Gavin E.R. Wilson, Chief Executive Officer, IFC Asset Management Company

Key Insights

- Based on IFC's investment track record, a convincing correlation exists between those investments that do well on a financial yardstick and those that show strong development results; moreover, integrating ESG criteria into the investment process appears to enhance financial performance.
- Incorporating non-financial factors into the investment process requires additional skills and expense, but it is self-reinforcing rather than counter-productive in terms of investment performance.
- The growth in impact investing will serve to develop common standards, language and measurement yardsticks and thereby reduce transaction costs for investors looking to combine social impact with financial returns.

The International Finance Corporation (IFC) invests in private enterprise in developing countries. We do so to promote economic development as well as to make a profit. When we make investments, our aim is that all of them should do well on both dimensions. Of course, they don't always do so, so we invest a lot of time to understand the link between our investments and their development results. By measuring our development results and financial performance, we have seen a convincing correlation between those investments that do well on a financial yardstick and those that show strong development results. This has positive implications for the ongoing debate on social impact investing.

An independent study by the World Bank Group's Independent Evaluation Group¹ looked at 176 IFC debt and equity investments totalling US\$ 3.1 billion that reached early maturity in the three-year period of 2006-2008. The study looked at each project's development and investment outcomes, scoring each outcome "high" or "low". Projects scoring high on both outcomes or low on both outcomes represented 83% of all projects. This rose to 89% when the

analysis focused on equity investments only (64 investments totalling about US\$ 800 million).

In our experience, superior financial performance seems to go hand in hand with strong development results. This is not completely surprising, since an investment in a company that grows fast, employs more people, pays more taxes, invests more in research and development, responds well to environmental and social issues and increases exports, is likely to yield good returns and support local economic growth.

This correlation also emerges when we look at an investee company's financial returns and its ESG performance. The preliminary results from two internal analyses we conducted on our equity portfolio suggest that companies with good environmental and social performance achieve financial returns dramatically better than those with low environmental and social performance. This result holds for non-listed as well as listed companies; leaders in ESG also displayed lower return volatility. These correlations reflect the instinctive belief that well-managed companies will score well on many dimensions; but, what does it say about causation?

Traditional investment theory holds that financial returns (or, more precisely, risk-adjusted returns) will be negatively affected if an investor introduces a non-financial objective. The argument is simple: adding a new constraint necessarily limits the attainment of the original objective. A double bottom line is not a free lunch. If this is true, it has challenging implications for the mainstreaming of impact investing. Can financial returns and social impact be mutually reinforcing, or are they bound to restrict each other?

This is where it gets interesting. We have integrated our ESG analysis into our investment decision process. Essentially, when evaluating a potential investment, we are assessing a company's current ESG performance (including its capacity to improve). While it is just one of many criteria examined, we have come to the conclusion that strong ESG capability today is a predictor of future financial performance; in other words, to predict a company's financial performance, pay attention to its current ESG capability. So, including an additional objective of promoting environmental and social sustainability actually supports attaining the financial objective. The additional objective has helped not hindered the achievement of the first.

While superior ESG capability may be a leading indicator of strong financial results, this does not mean that the former actually causes the latter. Nevertheless, we have good anecdotal evidence from our portfolio that inadequate ESG capability can certainly cause poor financial performance by negatively affecting business operations. For example, a mining company that loses its licence due to environmental infringements or social issues is not doing much good for the local economy or for its investors. Viewed from the portfolio level, the risk-return ratio is improved if these types of poor performers are excluded, thus enhancing overall returns as well as reducing risk.

Of course, IFC's experience is focused entirely on investments in developing countries; it is possible that the relationships we perceive between financial returns, ESG capability and social impact are peculiar to developing countries with their less-developed capital markets. These relationships may also be driven by our particular style of minority growth equity investing. Still, the alignment is remarkably consistent across region, sector and vintage year when viewed from the perspective of both our direct investing and fund investing businesses.

One caveat is worth mentioning: it takes time and effort to incorporate non-financial factors into investment decision-making. It may lead to better decisions, but it does require resources. IFC's Development Impact Department comprises about 25 staff, with 25 more specialists in investment departments who measure development impact. In addition, 16 corporate governance and 60 environmental and social sustainability specialists work on over 600 investments made each year (and many that we decide not to make), as well as on a portfolio of nearly 2,000 existing investee companies. We use our IFC Performance Standards on Environmental and Social Sustainability to govern our investment activities, covering both the due diligence conducted prior to investment and the subsequent performance of our portfolio companies on a range of environmental and social issues.

These standards are designed to help clients avoid, mitigate and manage risk as a way of doing business in a sustainable way. Launched in 2006 and updated in 2012, IFC's Performance Standards define thresholds of behaviour that we expect our portfolio companies to reach across a number of areas, including assessment and management of environmental and social risks and impacts; labour and working conditions; resource efficiency and pollution prevention; community health, safety and security; land acquisition and involuntary resettlement; biodiversity conservation and sustainable management of living natural resources; indigenous peoples; and cultural heritage. We view this not only as a compliance activity but also as one where we advise and assist our clients to improve performance on dimensions relevant to their businesses. Our internal team includes specialists in all these areas, some with technical backgrounds and others with legal or investment expertise.

Similarly, IFC has established its Corporate Governance Methodology, a system for helping investee companies and other clients to address corporate governance risks and opportunities.

While we firmly believe that attention to ESG criteria adds to our track record on financial performance, this is not a free good that can be replicated by every investor. As a development finance institution, IFC's strategic drivers include both financial sustainability and development impact. The double bottom line approach requires more resources, but in our experience this is self-reinforcing rather than counter-productive.

Recommendations

Common standards are vital. As impact investing evolves, many debates on how to define and measure social impact, and various types of social objectives, will arise. However, if we can develop a common language, as exists on the financial side of the equation, it will become much easier to compare different investors, investees, investment styles and strategies and thus understand where the alignment is strongest (and where not). This will differ by industry and region and will evolve over time.

In 2002, we convened a group of 12 commercial banks, leaders in project finance, to discuss environmental and social issues in their field. In the following year, these banks used IFC's environmental and social standards, then referred to as IFC's safeguard policies, as the basis for a voluntary risk-management framework known as the Equator Principles. This framework has been adopted by 78 financial institutions from 35 countries, covering an estimated 70% of international project finance debt in developing countries.²

Similarly, in 2005, the United Nations helped initiate the creation of the Principles for Responsible Investment (PRI), a set of six core principles for institutional investors looking to incorporate ESG criteria into their long-term investment decision-making. Currently, about 1,200 investors representing US\$ 35 trillion in assets under management have signed on to the principles.³

These examples illustrate how like-minded early adopters can create a template for a set of minimum standards. For impact investing, these standards could cover how social impact is defined and measured prior to investing, and how it is subsequently evaluated as investments mature. The objective would not be to cajole investors into becoming impact investors, but to allow those looking to invest with impact to speak a common language and develop a shared set of investment approaches and evaluation tools.

Conclusion

Where will social impact investing go from here? Traditional investment theory might suggest that greater capital deployed in a specific area tends to reduce returns, including social returns; however, this is the same traditional thinking that suggested financial returns could not be aligned with social impact. Far from reducing social and financial returns, the growth in impact investing will actually help to develop common standards, language and measurement yardsticks; these in turn will reduce transaction costs associated with a double bottom line, thereby benefitting investors, investees, social entrepreneurs and their clients.

3.2 Making Impact Investing an Institutional Priority for Achieving Superior Investment Performance

By Manuel Lewin, Head of Responsible Investment, Zurich Global Investment Management

Key Insights

- Traditional financial institutions can get comfortable with impact investing, given the right framing and the right champions within the companies. Reflecting ESG standards in the investment process – across asset classes and alongside traditional financial metrics and competent risk management practices – generates superior risk-adjusted long-term financial returns.
- Green bonds are a practical example of how impact investing can work in an institutional portfolio.
- The rewards of integrating responsible investment are worth the effort; it can help attract talent, engage existing employees, enhance a company's brand among customers, and signal to shareholders a company's commitment to a long-term vision.

Zurich Insurance Group offers a variety of general and life insurance products to clients in over 170 countries, and currently manages over US\$ 200 billion of own assets.

As a global insurance company with a growing presence in emerging markets, Zurich is exposed to many of the risks associated with climate change, competition for scarce natural resources and extreme poverty. We believe that impact investments, which can have a targeted, positive and measurable effect on society and the environment, while generating a financial return commensurate with the risks they entail, are one way to help mitigate and address the exposure to such risks; this is also why Zurich has direct interest in sustainable economic growth and in developing resilient communities.

While some investors may accept a trade-off between returns and impact, Zurich focuses on opportunities where the return fully compensates for the risk. Both types play an important role. The former can provide higher-risk capital to fund, for example, early-stage social ventures and small entrepreneurs. The latter can make capital available in greater quantities that can be 'scaled up' to fund sustainable growth.

We are convinced that such profitable investment opportunities exist across various asset classes. Our approach is to develop a strategy for impact investing within each of the major asset classes in which we invest. This process begins by analysing the universe of potential impact investments in a particular asset class, and making sure the impact is in line with the intended outcome. The underlying assets' risk and return are then analysed to determine which fit best within the overall portfolio. At the same time,

other potentially limiting factors are considered, including regulatory requirements and balance-sheet capacity. The final step is to determine the best structure for investing in those assets. The same process is used to assess any new type of investment and it requires close collaboration among people throughout the organization. For Zurich, the natural place to start impact investing is to look at simple, low-risk investments.

Leadership and Vision Are Required to Establish a Responsible Investment Culture

As impact investing is a strategy across asset classes, and definitions of responsible investment can vary, an investment institution must develop a clear and coherent set of vision, mission, principles and rationale for its approach.

At Zurich, this process of defining what we consider to be responsible investment was initiated at a senior level by the Group Chief Investment Officer (CIO), and took well over a year to complete. The CIO, intrigued by the notion of "impact investing", held discussions with peers, other asset owners, industry practitioners and leading asset managers. The insights from that process, along with those obtained through internal discussions, provided the outlines of a vision and strategy for responsible investment: to create long-term value for all our stakeholders while remaining true to our mission of achieving superior risk-adjusted returns relative to liabilities.

Zurich's Investment Management (IM) business strategy team assessed the PRI, a global investor initiative that promotes responsible investment, to learn from best practices while developing our approach. As a consequence, Zurich became a signatory to the PRI in July 2012. Within Zurich, IM is the driver for including responsible investment in the overall investment management approach. This philosophy is also aligned with the Group's overall Corporate Responsibility (CR) strategy to fully embed the respective CR-focused topics within the topic-owning departments.

Zurich's responsible investment strategy was finalized with the IM executive team as well as its external advisory council. The strategy articulates three pillars: ESG integration, impact investing, and collaboration and thought leadership. This approach was endorsed by the Group's Executive Committee and the Board of Directors.

Pillar One: Investing for ESG integration and generating superior risk-adjusted, long-term financial returns

The first pillar of Zurich's responsible investment strategy is based on our conviction that ESG factors do matter. Reflecting these factors in the investment process – across asset classes and alongside traditional financial metrics and competent risk management practices – will support us in generating superior risk-adjusted, long-term financial returns. While our investment approach is primarily based on economic considerations, integrating ESG factors and taking an active approach to ownership are a critical part

of a sound investment process. We are convinced that markets in which all relevant ESG risks and opportunities are correctly priced offer powerful incentives. Companies that effectively manage their impact on the environment and society, while adhering to high standards of governance and integrity, should also enjoy a premium. However, the positive impact of integrating ESG factors in an investment strategy is likely to be indirect and difficult to quantify and measure.

Pillar Two: Investing for targeted and measurable impact without comprising financial returns

It follows that the second pillar of our responsible investment strategy is to look for investment opportunities that allow us to generate a much more targeted, direct and potentially measurable outcome, but without compromising financial success: this is our definition of impact investing. We acknowledge that our approach will only have a true impact if responsible investment becomes mainstream.

Pillar Three: Collaborating to build the sector while becoming a leader in responsible investing

With that in mind, our strategy's third pillar is focused on thought leadership and industry initiatives to provide insights and raise wider awareness about topics related to responsible investing.

Responsible investment must be led by a person highly familiar with the organization and the existing investment approach. Specialist know-how in the field is also required. For this, Zurich recruited an analyst with experience in responsible investment. However, the ultimate goal is to have everyone in IM thinking as a single responsible investment team.

Resources Need to Be Allocated and Incentives Aligned

A strategic approach to responsible investment, based on a clear vision and supported by strong leadership, will ensure that an organization devotes the resources necessary to accomplishing the task. Effectively managing change, driving engagement, and ensuring that responsible investment goals are expressed in general investment management concepts and vice versa, require both strong leadership from the top and diffused ownership and empowerment of the objectives throughout the institution.

Responsible investment brings with it a new language, concepts and market participants. This is particularly true where impact investments are concerned. However, Zurich has consciously rejected creating a designated responsible investment department on the side, which would introduce parallel structures to IM. In accordance with Zurich's overall CR approach to fully embed the respective focus topics within the topic-owning departments, responsible investment will be fully integrated into IM's culture.

Zurich embarked on this journey by embedding CR targets into individual goals as part of the overall objective-setting process. Within IM, the CIO's targets, as well as those of the

CIO's leadership team, already reflect the goal of responsible investment. Targets to support responsible investment are also included in the individual objectives of most senior IM staff, and of all those directly involved in responsible investment initiatives.

Selecting and Working with Investment Products: Green Bonds and Beyond

Roughly 30%— or US\$ 65 billion— of Zurich's investment portfolio is held in government, government-guaranteed or supranational bonds. Within this "minimum risk" asset class, green bonds have emerged as a potential opportunity for impact investing and have been predominantly issued by supranational institutions such as the World Bank, IFC, European Investment Bank and others. Green bond proceeds are ring-fenced, meaning they can be used only to fund projects that either mitigate climate change or help communities to adapt to its consequences. Currently no standardized approaches for project selection frameworks and measuring impact exist. However, all major issuers apply well-developed internal methods to set targets and track progress of the environmental impact of underlying projects. Green bonds are of the highest credit quality, and while returns are modest, so are the risks.

The green bond market is still relatively small, with total outstanding issuance at around US\$ 10 billion, depending on the exact definition. The market attracts many buy-and-hold investors, and individual issues have tended to be relatively small compared to standard bond issues in the supranational space. While the impact of underlying projects is impressive, most of these would also have received funding through the supranationals' regular bond-issuance programmes. After a number of conversations with the issuers, Zurich realized that the true impact would lie in its ability to invest in size, and to make a significant contribution to the market's development by actively and regularly participating in it.

Zurich conducted an in-depth analysis of green bonds that confirmed they would complement the existing portfolio well, and allow for a minimal increase in yield with an equally minimal increase in risk. Zurich also weighed various restrictions and limitations, and determined that up to US\$ 1 billion would be a prudent allocation for one of its largest balance sheets. Most of Zurich's investments in North America are managed by external asset managers, so the same approach was chosen for green bonds and the process supported by the manager selection team. At the outset, a dedicated mandate was established to tie the potential allocation to the anticipated level of green bond issuance in the market. Eventually, green bonds may become part of Zurich's broader fixed-income portfolio benchmarks.

Once the allocation parameters were established, portfolio guidelines were drafted and the search for an external asset manager began. Standard processes and the established investment committee governance were followed throughout. With regard to the manager selection criteria, a collaborative approach to support development of the green bond market, including an active dialogue

with issuers and other market participants, was deemed vital. Despite the relatively simple nature of a green bond, it took many months to complete the process. The very notion of “green” meant that educating people about the bonds and addressing their perceived concerns formed a substantial part of this effort. Joint responsibility, shared by the head of responsible investment together with the regional investment management team, helped to accelerate the process in some cases, but slowed it down in others. Carefully planning joint efforts and defining responsibilities is important. To date, Zurich has invested over US\$ 200 million in various green bonds. Next steps will include following a similar process for green bonds issued in other currencies.

Recently Zurich began two other projects to determine impact investing strategies for private equity and debt instruments. These projects will follow a similar overall process, but they will take more time than the one related to green bonds, as the risks and the return opportunities are considerably more complex. These types of investments tend to be more fragmented and less liquid, and are often not geared to institutional investors of a certain size. Some of the challenges include finding people with the right skills and finding the right partners to engage with. More complicated structures also face more regulatory restrictions; while mandates need to be narrow enough to effectively control risks, they should be sufficiently broad to allow for necessary scale. They also need to take into account any limitations when it comes time to measure impact. As a global team, and with the ability to tap into the know-how of some of the leading asset managers, Zurich is confident that these challenges can be overcome.

The Journey towards Responsible Investment Is Long and Cannot Be Completed Alone

Insurance is a long-term business, as policy-holders expect us to provide security for 10, 20 or many more years in the future. Responsible investment can generate the superior investment performance our shareholders and policy-holders expect from us in a sustainable and fair way, but to do so requires the right processes and incentives, and gets to the heart of investment philosophy and organizational culture.

It will require many years to establish a culture in which responsible investment practices are fully integrated into Zurich’s overall investment philosophy and approach. The rewards of achieving this in terms of investment returns and positive impact will, however, be well worth the effort. A commitment to responsible investing engages our existing employees and helps in recruiting new talent. It will enhance the Zurich brand not just with today’s customers, but also with those in growth markets who will form tomorrow’s middle classes. It also sends a signal to our shareholders that Zurich truly takes a long-term view. Most importantly, it is consistent with our long-term company strategy and vision for a more secure world.

3.3 Evaluating Past “Impactful” Investments to Create a Future Impact Investing Strategy

By Elizabeth Littlefield, President and Chief Executive Officer, Overseas Private Investment Corporation (OPIC); Mitchell Strauss, Special Advisor, Socially Responsible Finance, OPIC; and Astri Kimball, Senior Advisor for Policy and Operations, OPIC

Key Insights

- Most impact investments need different types of capital at different stages of the investment life cycle. Development finance institutions (DFIs) are a powerful bridge; they can provide financing, align different sources of capital, and provide risk mitigants that remove the barriers to allocating capital to impact investments.
- By tagging investments retroactively as “impactful investments”; institutions can demonstrate a track record across investment products with a full spectrum of financial, social and environmental returns; this can help reinforce strategic case for impact investing.
- It is difficult to draw a line between those investments that had social and financial intent at the outset, and those that did not have this dual intentionality. A strict definition and a clear methodology are critical.

The Overseas Private Investment Corporation (OPIC) is the US Government’s development finance institution. Working exclusively with the private sector for over 40 years, OPIC mobilizes private capital to help solve critical development challenges in emerging markets. With a portfolio of US\$ 18 billion and operating in over 100 countries, OPIC achieves its mission by providing investors with debt financing, guarantees, political risk insurance and support for private equity funds.

OPIC’s Portfolio Review

In recent years, OPIC has made it a priority to support impact investing through requests for impact investing fund proposals; new product development to address specific market gaps and needs; and identifying and highlighting impact investments in its portfolio.

In 2012, we set out to determine how much of OPIC’s business met the strictest definition of impact investing: *investments with partners whose very business models aim to address social or environmental problems while generating sustainable financial returns*. We conducted a full review and “tagging” process of our portfolio to apply this test to each of our investments, and found that determining intent was often subjective and not always clear-cut. Knowing this, we first identified OPIC commitments in sectors whose investors tend to be socially motivated, such as agriculture, health, education, renewable energy, finance, housing for the poor, and water and sanitation.

From there, each individual investment was examined against the intentionality test to identify those investments that were specifically intended to bring positive social impact alongside financial sustainability. The review revealed that of OPIC's US\$ 3.6 billion in financing and insurance committed in 2012, US\$ 333 million qualified as impact investments. This same methodology was applied to OPIC's commitments going back to 2008, ultimately identifying 129 impact investment projects over the five-year period totalling US\$ 2.4 billion in commitments.

OPIC's Impact Investing*

2008-2012

Number of impact projects: 129

Value of impact projects: US\$ 2.4 billion

Host country jobs: 10,657

** Numbers represent impact investing with intent. They exclude transactions generating social or environmental returns that were not the main intent of the project.*

Impact Investments vs Investments with Impact

All OPIC transactions aim to have development impact, but not all are tagged as impact investments. Two examples illustrate the distinction:



Tagged as an OPIC impact investment: MicroEnergy Credits (MEC)

OPIC committed a US\$ 10 million loan to MEC for the development of carbon credit programmes. Low-income populations' access to clean energy products, such as clean stoves for cooking and heating, water purifiers and solar lighting, will be made easier and more affordable through this loan that directly links the purchase of those products to the generation of carbon credits. MEC is an environment-and-social-first investor that qualified as an impact investor through OPIC's tagging process.

Not tagged as an OPIC impact investment, despite being an excellent venture: Sante GMT (Sante)

OPIC provided a US\$ 10 million loan to Sante, the largest dairy and juice production facility in Georgia. The loan enabled the company to improve milk production and distribution, with 20 new milk collection centres throughout the country and strong local job creation. Sante has had a powerful development impact; however, according to our definition, it did not qualify as an impact investment because it was undertaken strictly as an economic venture.

Lessons learned from OPIC's portfolio review

1. Identify and adhere to the industry's standard definition for impact investing (investments with intent to address social or environmental problems while generating sustainable financial returns)
2. Create a process to assess and document the intent behind each investment
3. Do not underestimate how difficult it will be to draw a line between those investments that had social and financial intent at the outset, and those that did not have this dual intentionality
4. Value quality over quantity
To truly understand this sector and its role in a portfolio, it is better to have an inventory of truly impact investments than a large number of investments that fall in a grey area.
5. Develop a methodology that tracks the performance of each financial instrument
6. Do not expect financial return data right away
We sought to determine if our impact investing portfolio performed differently than the rest of our portfolio; however, we were unable to draw clear conclusions as most of OPIC's financing and guarantees, while commercially priced, have long tenors, often with multi-year grace periods. Since few of these investments have come due, it is not yet possible to determine if this portfolio is performing differently relative to OPIC's wider portfolio of assets.

OPIC Impact Investment Tools

In response to the needs of the impact investment sector, and to address the gaps in the sector, OPIC tailors its range of financial and insurance products to support impact investing.

- **Impact investing equity funds:** In 2011, OPIC issued a request for proposals for impact- investing funds. In response, 88 groups – including 63 funds, 7 “funds-of-funds” and 18 debt and microfinance vehicles – submitted proposals. The result was a historic commitment to impact investing, as OPIC approved US\$ 285 million in funding for six impact investing funds, which are expected to catalyse US\$ 875 million in investments.

Example: Sarona Frontier Markets Fund 2, LP (Sarona). Sarona, a fund-of-funds, is targeting funds that invest in frontier countries with per capita GDP of less than US\$ 12,000, and in sectors such as water, healthcare, education, access to finance and sustainable agriculture.

- **Fixed-income notes for impact investors:** OPIC issues fixed- and floating-rate notes to eligible investors and portfolio managers seeking to fill socially responsible investing or impact investing portfolio allocations that meet the impact investing test. These notes carry the full faith and credit of the United States, have maturities of 1 to 20 years and are priced at the relevant US Treasury note plus a small spread.
- **Working capital:** In many cases, we found that OPIC’s standard project finance is not well suited to the impact investment sector. Many innovative impact investing businesses are distributing retail products for low-income households, such as single-home power sources, LED lights or cookstoves. These businesses primarily need working capital to finance the growth in inventories, but working capital finance is new to many OPIC origination and credit teams. We have since been developing guidelines to enable the institution to offer working capital finance.

Market Gaps in the Impact Investment Sector

1. Lack of information about financial return, by instrument

- > Tag portfolios to help the impact field reinforce and clarify definitions
- > Share information with investors and managers

2. Limited range of investment products

- > See OPIC investment funds and fixed income notes

3. Pioneer gap; dearth of investment-ready, scalable enterprises

- > See OPIC working capital, early-stage capital and the Pi platform.

- **Financial intermediary facilities:** OPIC provides financing and political risk insurance to financial intermediaries that lend to the impact investment sector. OPIC can leverage the outreach and track record of proven performers, which increases access to capital in various impact sectors through a portfolio approach.

Example: Grassroots Business Fund (GBF). GBF provides financing and business advice to for-profit companies that have a strong commitment to bringing measurable and sustainable social and economic impact. GBF uses a US\$ 20 million OPIC loan to invest in high-impact businesses in Latin America, Africa and Asia. With its two complementary vehicles, a private investment fund and a non-profit organization, GBF expects to invest in 40 to 50 businesses over the next five years, providing economic opportunity for millions of people.

Example: Global Partnerships. OPIC is investing up to US\$ 15 million in the Global Partnerships Social Investment Fund 5.0, which works to expand opportunity for people living in poverty in the Latin America and Caribbean region. Global Partnerships provides loans to social enterprises, as well as microfinance investment vehicles that combine financial support with other non-financial services such as healthcare, education or training.

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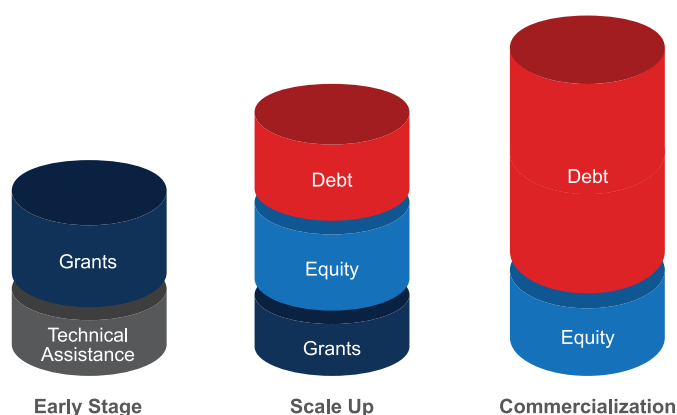
- Early-stage equity capital and co-investment opportunities – aligned capital: Most investments need different types of capital at different stages of the investment life cycle (see Figure 1). Many impact investments that OPIC has reviewed have required early-stage grant or equity capital to cover operating losses or to establish proof-of-concept and make the project financeable. On the other hand, an early-stage risk capital provider may need access to larger amounts of capital to scale up its successful project. Philanthropic capital is a solution here; it can be invested in a way that catalyses DFIs, which in turn catalyse commercial capital, creating a powerful leverage effect. As OPIC has neither an equity nor a grant instrument, we have partnered with grant and equity investors who wanted to benefit from OPIC's origination and due-diligence capabilities by investing alongside us.

Example: Portfolio for Impact (Pi). Pi is a new initiative to increase OPIC support for smaller, highly developmental and innovative early-stage companies in the impact investment space. This platform represents a response to the growing demand for OPIC to provide financing that supports the scaling-up of socially-oriented enterprises. OPIC will underwrite deals of up to US\$ 5 million and create a portfolio of up to US\$ 50 million over two years. Consistent with OPIC's interest in aligning different types of capital, Pi will present co-investment opportunities for other socially-minded investors in a more efficient manner, and serve as an important bridge between philanthropic and private capital.

Example: Rockefeller Foundation partnership. In a collaboration supported by the World Economic Forum's Global Agenda Council on Social Innovation, OPIC is entering into a partnership with the Rockefeller Foundation to co-invest in impact investments globally, combining the Foundation's programme-related investment capability with OPIC's origination, due-diligence and debt-financing capabilities. The partnership aims to create an innovation in process, whereby the two parties – and more parties in the future – can collaborate on and co-invest in impact investments that each institution would otherwise not have been able to consider on its own.

Figure 1: Different Stages Require Different Capital Mixes

Source: OPIC



- Political risk insurance for impact investors: OPIC offers insurance products that significantly mitigate specific risks posed to impact investors in developing countries. Political risk insurance offers protection against losses to tangible assets, investment value and earnings that result from political perils in 150 developing countries. Without this insurance, potentially impactful investment may not take place.

Example: MicroVest Capital Management LLC (MicroVest). OPIC provides political risk insurance on loans made by investment funds managed by MicroVest to microfinance institutions throughout the developing world. OPIC can also provide insurance against changes in government regulations (e.g. changes in interest rate caps for microfinance institutions).

Next Steps for the Impact Investment Sector

1. **Clarify the definition of success.** The impact investing field urgently needs common definitions and clarity about expectations, by investment instrument, of both social and financial return. This sector should strive to compile good information to demonstrate a track record across the range of investment products with a full spectrum of financial, social and environmental returns. This data gathering can more clearly situate impact investing in relation to corporate social responsibility and socially responsible investing (SRI).
2. **Align different types of capital to grow and support investment-ready enterprises.**
3. **Work with development finance institutions.** They are powerful bridges, providing the financing and risk mitigants that remove barriers to allocating capital for impact investments.
4. **Beware of overpromising.** While the impact investment sector has the potential to be truly transformational, it is in its early stages and will take many years of slow, hard work to deliver on its promise. We must be careful not to let expectations get ahead of reality and need to be both optimistic and realistic, pushing hard and aiming high, but also nurturing the sector with patience.

3.4 The Current Limits and Potential Role of Institutional Investment Culture and Fiduciary Responsibility

By David Wood, Director, Initiative for Responsible Investment (IRI) at the Hauser Institute for Civil Society, Harvard Kennedy School

Key Insights

- (Correctly) understanding fiduciary duty, as well as the complex decision-making chain of institutional investors, is key for mainstreaming impact investing. Conventional interpretations of fiduciary duty can lead to herding, because what looks like a reasonable and therefore fiducially sound decision to one investor tends to be the decision that others are also making.
- Reorienting institutional investment culture towards long-term wealth creation will support incorporation of ESG values into the institutional decision-making process. Impact investors need to link long-term performance to social and environmental considerations.
- Education around the long-term implications of ESG analysis is needed across stakeholders in the asset management supply chain (large asset owners, their trustees and investment consultants).

Investment decisions for institutional investors are ultimately made through the interaction of multiple stakeholders – a network including boards of trustees, staff at funds, investment consultants, managers, and end users of capital – and are filtered through a variety of beliefs at every level about how markets work, what sorts of investments are appropriate, and what sorts of incentives are attached to individuals acting within that network.

Unless consideration is given to how impact investing interacts with the culture of mainstream investing, product and policy design to encourage institutional participation in impact investing is likely to fall short of its potential. Moreover, even well-performing impact investments of scale, and with track records, may not receive the attention they deserve.

What types of challenges does the culture of mainstream institutional investment present to the broader adoption of impact investing? Three of them are highlighted here:

Fiduciary Duty and the Incentive to Herd among Pension Funds

The potential role of pension funds in impact investing bears consideration. Pension fund trustees have a fiduciary obligation to their members; fund investment decisions must serve the interests of all their beneficiaries. Fiduciary duty, in theory, is the governance tool that aligns the interests of investors with beneficiaries, and ensures sound decision-making.

These large asset owners have the wherewithal to shape markets, and to carry the scale and credibility for encouraging managers to design products with social impact. As evidenced by the ranks of the world's largest pension funds that have signed onto the PRI – with tens of trillions of US dollars under management – many institutional investors have an expressed interest in incorporating ESG information into their investment decision-making. According to the World Economic Forum report *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*, around 6% of US pension funds have made an impact investment, and nearly 64% say they expect to in the future.

Yet, for pension funds to engage in impact investing, products must meet the long-term needs of the fund and must be reliably assessed for their long-term effects on fund portfolios. The recent financial crisis demonstrates how hard this ideal is to achieve in practice, just as it has reinforced the crucial role these funds play in retirement security.

Fiduciary duty is the lens through which these decisions are made; it is the standard of care that, for example, fund trustees must exercise in the interests of their fund's ultimate beneficiaries. But in practice, conventional interpretations of fiduciary duty can lead to herding, because what looks like a reasonable and therefore fiducially sound decision to one investor tends to be the decision that others are also making. Shared portfolio theories that funds adopt in the name of fiduciary duty – which may encourage the evaluation of investments along a limited set of factors related to past returns and volatility, and the benchmarking of performance against those (often short-term) factors – may also contribute to herding.

In turn, herding raises concerns that fiduciary duty in conventional practice can become an excuse for pension funds not adopting the unconventional, because performance measures make it difficult to spot opportunity. While providing the safety of numbers, this behaviour may end up producing investment decisions that are not in investors' long-term interests.

For impact investing to engage pension funds, advocates must deal directly with the theory and practice of fiduciary duty. This requires both a clear account of how impact investing is congruent with fiduciary duty, and active engagement with asset owners on why impact investments may require funds to reassess their own attitudes towards what constitutes "conventional" investment. Without addressing how pension funds approach impact investment through their governance and portfolio structures, the impact investing field will be less likely to build mainstream support. Prudence, in terms of fiduciary duty, is process. Impact investors need to work with large asset owners to develop systems that evaluate promising new sectors for impact investment, to link long-term performance to social and environmental considerations, and to identify performance measurement systems which do not favour short-term herding.

Integrating Environmental and Social Goals into Investment Practice

There have been a number of efforts to integrate environmental and social information into investment decision-making in recent years, as advocates have (correctly) identified the lack of systems for processing this information as a fundamental barrier to impact investment. These efforts are often explicitly counterposed to conventional, mainstream investment analysis, which has no standard method for integrating environmental and social information.

The institutional investment culture likely disfavours incorporating new types of information, as unconventional approaches such as environmental and social analyses can be labelled as dilettantish or motivated by “nonfinancial” considerations. Interviews with mainstream investors about responsible investment reveal language that marginalizes impact or responsible investment strategies, such as “soft” as opposed to “quantitative” or “rigorous” analysis, and this even in a post-financial-crisis period when the supremacy of financialized mathematics and the rigor of conventional analysis has come into question. As a result, mainstream investors often begin with a bias against impact investments.

For impact investing to gain mainstream acceptance, advocates will need to forthrightly challenge the idea that a concern for environmental and social outcomes necessarily means “taking your eye off the ball” with regard to investment returns.

Advocates may need to directly challenge conventions for measuring short-term performance; to advocate for investment analysis that focuses as much on the fundamental value of assets as on their price movements; and to resist a rhetoric of “rigour” used more to police conventional boundaries than to identify sound investment strategies. Merely claiming that using ESG standards makes for a more effective analysis is unlikely to do the trick.

The primacy of short-term performance standards has not served institutional investors well over the past 15 years; many critics feel that those standards have contributed to the financial crises and poor economic performance that have so affected the beneficiaries. Trustees and staff should directly engage consultants and managers on the long-term value propositions of investment strategies. They should ask hard questions on how investment propositions are linked to generating real economic value. Reorienting institutional investment culture towards long-term wealth creation will likely support the integration of environmental and social analysis into investment decision-making.

Agency Issues and the Challenge of Intermediation

Investment decisions by asset owners typically involve input from a series of internal and external stakeholders. Theoretically, members delegate authority to board members, who direct staff and help choose consultants, who in turn select managers; however, this decision chain is not so linear in practice. The agency issues inherent in this

network of decision-makers – such as alignment of interests and variance in time horizons for performance assessment and rewards – are often implicated in critiques of market short-termism, bubbles and fraud. More generally, the interaction of agents with different institutional and personal agendas necessarily shapes the availability of investments in the marketplace and how these options are presented to various decision-makers along the chain.

Impact investing faces a particular challenge when considering agency issues, as it takes more multiple sets of decision-makers for impact investing to explore and adopt something new and different. For example, a staff managing a large university endowment decides that an impact investing strategy would benefit long-term portfolio performance and better achieve the university’s mission. The Board of Trustees must sign off on any newly proposed strategy. In turn, its investment consultants must have the ability and willingness to identify investment options that fit into this strategy. Fund managers must meet social goals as well as the consultants’ other criteria for investability. Those managers will need a sufficiently robust pipeline of opportunities with social impact to merit investing at a scale large enough to attract investment not only from this one endowment, but also from enough investors so that the endowment’s position will not be too large for the fund staff’s comfort.

Of course, any investment faces these challenges. But the nature and newness of impact investing means that the field may lack products that fit neatly into existing asset allocation schemes. If impact investing is seen by agents in the chain as a marginal or niche activity, they may dismiss it as unappealing. Further, for the strategy to be successful, agents in the chain must develop their own capacity to manage impact investments, and those without this capacity may resist the perceived (and real) costs of developing it.

How can advocates for the field address this issue? No easy path for navigating agency issues exists. Perhaps it is best to say that impact investors need to regularly review whether they are taking multiple stakeholders into account as they develop their strategies and tactics. They may also seek to concentrate efforts on key actors in the chain – asset owner trustees and investment consultants are frequently mentioned in this regard – who have particular influence on how decisions are made.

One obvious path forward is for large asset owners themselves to signal demand for different kinds of products, and to engage the market through requests for proposals that call for ESG-themed investments. Alternatively, they can engage investment consultants to introduce ESG-related issues into the management selection and evaluation process. But it is too easy to claim that these forms of asset owner interest alone will move the market. More general education across stakeholders in the asset management supply chain on the long-term implications of ESG analysis will be necessary for institutional investors to become players at scale in the impact investment marketplace.

Conclusion

To say that existing institutional investment culture throws up barriers to impact investing is not to say that impact investing cannot grow to scale in the mainstream investment community. We have seen an openness across a variety of channels in the institutional investment community, a history of engagement on environmental and social issues among many investors, and important and recent movements that have expanded interest in the field. These developments suggest that impact investing on a much larger scale than is currently practised is very possible.

The intent here was to highlight some of the well-known ways in which conventional investment-decision-making culture may disfavour impact investment. Efforts to engage the “mainstream” in impact investing will be best served if this culture is taken into account. The challenges of changing how investments are made, and how success is measured, are necessarily part of bringing impact investing to scale – and those challenges are unlikely to be met by financial innovation and incentives alone.



4. Building a Strategy: Integrating Impact Investing in the Mainstream Investor's Portfolio

4.1 A Portfolio Approach to Impact Investment: A Framework for Balancing Impact, Return and Risk

By Yasemin Saltuk, Director of Research, J.P. Morgan Social Finance

Key Insights

- This research presents a tool for the analysis of impact investment portfolios across the three dimensions that determine their performance: impact, return and risk.
- Key considerations that investors face when building a portfolio include choosing an organizational structure to manage the portfolio, and defining impact and financial targets with which the portfolio will be built.
- These targets can be translated into a graphical representation of the three dimensions to show the profile of individual investments and of the entire portfolio.

This is an extract from A Portfolio Approach to Impact Investment (Y. Saltuk, J.P. Morgan Social Finance, October 2012), a report written as a practical guide to building, analysing and managing portfolios of impact investments for professional investors. Since completing this work, we have been using the framework for managing our own portfolio and representing the profile of our targets and investments. For the full report, visit: www.jpmorganchase.com/socialfinance.

In traditional financial analysis, investment management tools allow investors to evaluate the return and risk of individual investments and portfolios. This research presents a tool to analyse impact investments across the three dimensions that determine the performance of these assets: impact, return and risk. Throughout, we reference the experiences of impact investors with case studies of how they approach each step of the portfolio construction and management process. The content for this research was informed by our own investment experience as well as that of 23 institutional investors that we interviewed. Figure 2 gives an overview of the report structure, and we provide a summary of the key findings.

Throughout, the term “social” is used to include both social and environmental concerns.

Also, the term “institutional investor” refers to non-individual investors, including foundations, financial institutions and funds.

Figure 2: A Portfolio Approach to Impact Investment

Source: J.P. Morgan



Building an Impact Investment Portfolio

Find a home for the portfolio

To successfully build a portfolio of impact investments, investors need to assign an individual or a team to source, commit to and manage this set of investments, and institutions are setting up their organizations in different ways to address this need.

Some institutions establish a separate portfolio with its own management team, while others employ a “hub-spoke” strategy where a centralized impact team partners with various portfolio managers across instrument types (such as fixed income and equity) to manage the portfolio’s multiple dimensions. Still others bring the total institution in line with the impact mission. Table 2 shows some examples of investors including foundations, pension funds, financial institutions and fund managers, and their organizational structures.

Table 2: Organizational Structures across Institutional Investors

Source: J.P. Morgan

Investor Type	Example	Portfolio Management
Foundation	The Rockefeller Foundation	Separate team
	The F.B. Heron Foundation	Whole institution
Pension fund	TIAA-CREF	“Hub-spoke” partnership
	PGGM	“Hub-spoke” partnership
Financial institution	Storebrand	Separate team
	J.P. Morgan Social Finance	Separate team
Fund manager	MicroVest	Whole institution
	Sarona Asset Management	Whole institution

Define an impact thesis

Once the organizational structure is in place, the portfolio management team will need to articulate the impact mission of the portfolio to set the scope of their investable universe. For many impact investors, the impact thesis is usually driven by the value set of an individual or organization and can reference a theory of change, often with reference to specific impact objectives such as access to clean water or affordable housing. An impact thesis can reference a target population, business model or set of outcomes through which the investor intends to deliver the impact (see Table 3 for examples).



Table 3: Illustrative Components of an Impact Thesis

Source: J.P. Morgan

Target Population	Target Business Model	Target Impact
Income level	Product/service provider to target population	Number of target population reached
Degree of inclusion	Utilizing target population retail distribution	Percent of business reaching target population
Region of inhabitation	Utilizing target population suppliers	Scale of outputs
	Implementing energy and natural resource efficiency	Quality of outputs

Define financial parameters

Alongside the impact thesis, the investment team will determine the investment scope with respect to the parameters that can drive financial performance. These parameters include the instruments that will be eligible for investments; the geographies and sectors of focus; the growth stage and scalability of the businesses that will be targeted; and the risk appetite of the investor.

Abandon the trade-off debate for economic analysis
In setting the investment scope and return expectations, we encourage investors to abandon broad debates about whether they need to trade-off financial return in exchange for impact. We rather propose that investors rely on economic analysis on a deal-by-deal basis of the revenue potential and cost profile of the intervention they are looking to fund, and set risk-adjusted return expectations accordingly.

A Framework for Impact, Return & Risk

Once the target characteristics of the portfolio are defined, investors can map the following across the three dimensions of impact, return and risk: a target profile for the portfolio, the expected profile of the individual opportunities and the profile of the aggregate portfolio, which can then be assessed against the target.

Map the target profile

To illustrate how different investors might map their portfolio targets, we present the graph of our own J.P. Morgan Social Finance target portfolio – the shaded grey area in Figure 3 – alongside the profile that might be targeted by an investor with a higher risk appetite and a lower return threshold (Figure 4), and the graph that might represent the target for an investor pursuing only non-negative impact with a low risk appetite (Figure 5).⁴

Figure 3: J.P. Morgan Social Finance Target Portfolio Graph

Source: J.P. Morgan

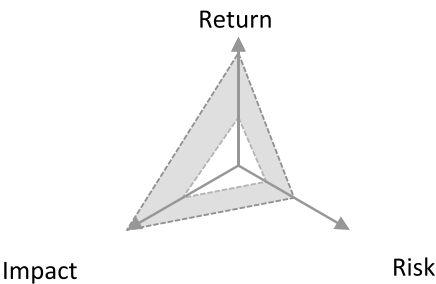


Figure 4: High Risk Investor's Target Portfolio Graph

Source: J.P. Morgan

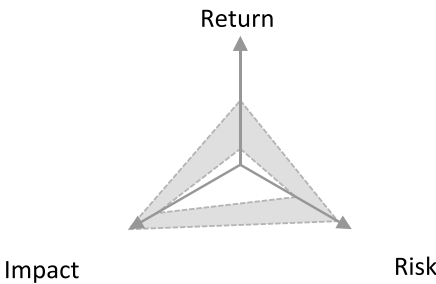


Figure 5: "Non-negative Impact" Investor's Target Portfolio Graph

Source: J.P. Morgan

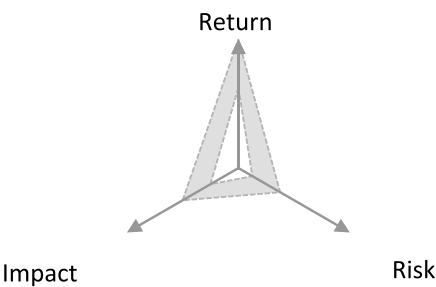
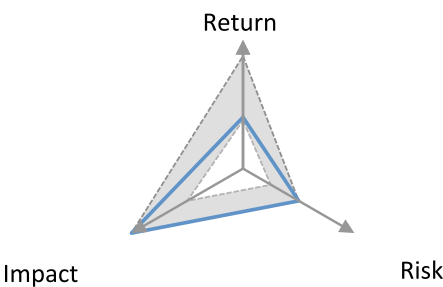


Figure 6: One Investment in the Context of Portfolio Targets

Source: J.P. Morgan



Map the individual investments

Next, we map out expectations for an individual investment based on assessments of the impact, return and risk. Once that investment is mapped, we can then compare it to the portfolio target as shown in Figure 6. Although we show an example in which the individual investment profile does fit within the portfolio targets, in general investors may not require that each investment necessarily fits within the target range, so long as the aggregate does.

Map the aggregate portfolio and compare to target

Once the portfolio begins to grow, we can consolidate the individual investment graphs into one graph representing the characterization of the portfolio as a whole, aggregating the individual graphs by either overlaying them or averaging them (simply, or on a notional-weighted basis). Then, this aggregate can be compared to the target profile for the portfolio to ensure alignment.

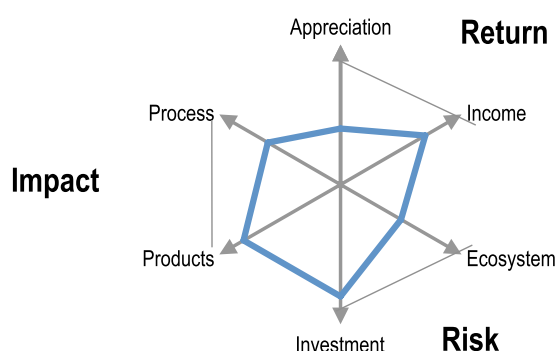
Expand the dimensions of the graph, if desired

Investors should consider the three-dimensional graph as a template. For some, the simplicity of this approach might be appropriate for aggregating across large portfolios at a high level. Others might prefer to use a more nuanced framework that better reflects the different contributing factors of the parameters represented on each axis – impact, return and risk.⁵ As an example, we could consider an investment graph across six dimensions, splitting each of the three into two components, as shown using a hypothetical investment in Figure 7. Alternatively, an investor might choose to show four dimensions, where risk is split by financial risk and impact risk.

Figure 7: Illustrative Graph in Six Dimensions

The bold blue hexagon illustrates the profile of a hypothetical debt investment.

Source: J.P. Morgan



Once the targets have been set and the portfolio begins to grow, investors are then faced with managing the investments to ensure that the portfolio delivers both impact and financial returns in line with the targets.

Financial and Impact Risk Management

Identify the risks in the impact portfolio

On an individual investment basis, the risks that arise for impact investments are often the same risks that would arise for a traditional investment in the same sector, region or instrument. Just as we abandon the trade-off debate on return across the asset class and encourage deal-by-deal analysis, we encourage investors to assess the risk profile that results from their particular impact thesis and motivation.

There are also some cross-market risks to consider, including the early stage of the market and its supporting ecosystem; mission drift; the responsible combination of different types of capital (including grants); and the moral hazard of recognizing impact failure or financial loss. The development of the market over time should erode some of the risks associated with its early stage and ecosystem. While some of these risks will remain in place, investors will likely develop better processes for recognizing and dealing with them.

Manage risk through structural features

Once the risk profile of the investment is determined, investors manage it using structural features such as seniority in the capital structure, fund intermediaries and compensation-related or covenant-based incentives. With respect to the currency risk that arises for investors allocating capital internationally, some investors referenced diversification across countries as the preferred means of management.

Manage friction between impact and return

Many investors cite that they pursue opportunities where the impact mission is synergetic with the financial return pursuit. Several organizations also acknowledged that, at times, friction can arise between these two pursuits. Some of the challenges referenced include the investee's growth coinciding with a reduction in jobs; the investee maintaining mission; or ensuring impact measurement. Some investors manage these challenges by building covenants referencing the mission into the deal.

Portfolio diversification

Investors often find a softer approach to diversification to be more suitable to the private nature of this market. Rather than setting exposure limits as can more easily be done for public equity portfolios, impact investors tend to start with a more opportunistic approach. They assess the merits of investments mostly on a stand-alone basis, while monitoring the broader concentrations in any sector, geography, instrument or impact pursuit. Once the portfolio reaches a critical mass, many of them become more strategic about diversification, considering an investment's individual merits alongside those in the context of the broader portfolio.

Looking Forward

Challenges should ease over time

To be successful today, investors need to be realistic about the stage of the market, employing patient capital, bringing a dynamic approach and taking an active management role to the investment. Whether investing directly or indirectly, they need to navigate a broad ecosystem to ensure success. Investors today share a collaborative spirit in meeting these challenges with the broader goal of catalysing capital towards impact investments. This research has been a first step towards sharing the experiences of these field builders to help investors establish a strategic approach to portfolio management for impact investments.

About J.P. Morgan Social Finance

J.P. Morgan Social Finance was launched in 2007 to catalyse the growing market for impact investments and accelerate the delivery of market-based solutions to social, economic and environmental challenges. Our business is dedicated to growing this market through client advisory services, principal investments and research.

Disclosures

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4.2 Leveraging Expertise across Asset Classes for An Institutional Impact Investment Mandate

By Amy M. O'Brien, Managing Director, Global Social & Community Investing, Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF)

Key Insights

- As impact investing efforts within an organization grow, organizing and coalescing around important themes and/or organizational strengths is key.
- Institutional structures and outreach efforts need to ensure that even if the impact investing team is separate from other teams, it is well integrated into an organization's decision-making processes and has buy-in from major internal stakeholders.
- As it moves into its next phase, the impact investment sector is shifting from an approach based on a single-asset-class into a cross-asset-class strategy, as evidenced by the TIAA-CREF example.

For TIAA-CREF, a full-service financial services company specializing in the distinctive needs of those working in the academic, research, medical and cultural fields, social impact investing is deeply ingrained in who we are. Impact investing is part of our company-wide commitment to direct capital towards high-quality investment opportunities consistent with our overall investment strategy, and to create measurable social outcomes. This commitment stems from TIAA-CREF's legacy of community investing and our mandate to engage in responsible investing on behalf of our investors. As of 31 December 2012, TIAA-CREF's social impact investing portfolio consisted of US\$ 663 million in assets under management; by year-end 2013, TIAA-CREF will have committed an additional US\$ 100 million to the portfolio.

As impact investing has matured, TIAA-CREF has updated its approach to ensure it can access quality opportunities across select themes, asset classes and geographic regions. As a result, TIAA-CREF has been able to diversify its holdings and set the stage to include more of these types of investments in its portfolio.

Why Impact Investing Makes Sense for TIAA-CREF

TIAA-CREF's Social Impact Investment Program traces its roots to the mid-1980s, when the firm joined six insurers to create and fund New York's Housing Partnership Mortgage Corporation. The purpose of that initiative was to provide mortgage financing for the rehabilitation and production of housing in low-, moderate- and middle-income neighbourhoods. That investment signalled to the market that we were open to this sort of investment opportunity and paved the way for many other impact investments. Since

our initial impact investment three decades ago, the firm has demonstrated its responsible investment commitment in a number of ways. These include offering investment options subject to explicit ESG guidelines, community investment and shareholder advocacy.

Responsible investments are important to TIAA-CREF for three main reasons. One reason is that our clients typically work in the non-profit arena, with many in higher education. They are highly educated, aware and knowledgeable about the social and environmental impact of their investments, and feel favourably about our focus on the “double bottom line”. Another reason is that our proactive efforts have a positive effect on our relationships with state-level insurance regulators, some of whom prioritize meaningful, voluntary community investing. For example, we are subject to statutory requirements in some states that are related to publicly disclosing our community development investment policy and reporting on specific investments. To do this, we work via collaborative efforts such as the California Organized Investment Network to bring together multiple stakeholders, including regulators, insurance companies and community development organizations, to enhance shared learning. The third reason is that impact investments can provide exposure to new markets and emerging sectors, both in the US and abroad.

Over the years, we learned how to develop an impact investing strategy consistent with the investment objectives of our General Account, a portfolio of over US\$ 200 billion that supports the claims-paying ability of our annuity and insurance products. The General Account is a conservatively managed portfolio, with 87% of its assets invested in fixed income. In seeking greater diversification and risk-adjusted returns, this account has increasingly sought opportunities for direct private investments across several asset classes including real assets, private equity and private fixed income.

Strategy Evolution: Updating Our Approach to Be Portfolio-Wide

In the summer of 2012, TIAA-CREF initiated a review of its social impact investing strategy. Over the previous decades, TIAA-CREF had launched a series of varied social investment programmes, some closely linked to a specific asset class (such as deposits in leading community development banks, and private equity in microfinance), and others that covered more than one asset class, such as our corporate social real estate portfolio. A specific group was in charge of executing these investments (i.e. sourcing, evaluating and monitoring them), effectively controlling the entire investment process and creating a distinct sub-portfolio of responsible investments. This process was similar to the organization of other investors that were incorporating responsible investments into their portfolio.

The Global Social & Community Investing (GSCI) team, created in 2006, was tasked with the 2012 strategy review. The review process was designed so it would aggregate diverse and balanced input from critical internal and external stakeholders. First, the process included more than a dozen meetings with key internal stakeholders to clarify the internal rationale, appetite, enterprise-level commitment

and resources available to support the strategy for the General Account’s Social Investment Program. The GSCI met with groups that included the Board of Trustees, Senior Investment Management leadership, the Product Management and Business Development areas within Asset Management, and Government Relations.

The review process also included significant external benchmarking – gathered from sources such as meetings with insurance company peers, as well as investment banks, foundations and faith-based retirement plans – to better understand the various investment approaches, programme types, programme size and return expectations of those active in this space. We spoke to these groups about their programme history, asset-class expertise and how they define social investments. We explored how they allot resources to their social investment initiatives, their source of funding and the staff placement that governs these programmes. We asked in detail about their deal sourcing, size, risk and return trade-offs relative to traditional investment valuation criteria. Finally, the team engaged with industry thought leaders and practitioners who provided insight into market trends, opportunities and ideas for new investment structures, as well as information on policy efforts underway to facilitate the growth of the social impact investment space.

When the strategy review process was complete, the overarching mandate remained the same: to achieve competitive risk-adjusted returns and generate specific social and environmental outcomes. But compared to the legacy approach, the new strategy included some important distinctions.

First, the new starting point placed a greater emphasis on asset allocation and the appropriate mix of investments across multiple asset classes. Second, the return expectations for all investments needed to be commensurate with the appropriate asset class target returns for the General Account. Third, we needed a more coherent investment-strategy communication plan. Within our institution, it was critical to communicate and demonstrate throughout the firm that impact investment was not a philanthropic endeavour, similar to portioning out grants. Rather, it was an investment opportunity that had potential to provide diversification and boost more than the balance sheet’s bottom line. To accomplish these goals, TIAA-CREF set a thematic framework for impact investing, delineating three areas for investment focused on low- to moderate-income communities globally:

- Affordable housing
- Inclusive finance
- Community and economic development

TIAA-CREF decided to focus on these areas because, following the review process, each of them met the criteria, which were:

- Facing ‘capital gaps’ which had not yet been adopted by mainstream investors
- Having a market-based solution for addressing select social needs
- Having quality deal flow that reflected the balance between financial and social return potential
- Offering significant potential for TIAA-CREF to play a market leadership role given our in-house expertise

By focusing on the three areas, TIAA-CREF not only introduced impact investing as an investment strategy to additional investment teams internally, but it also developed expertise in these areas through the use of high-quality sourcing opportunities.

TIAA-CREF's portfolio seeks to invest both directly and through funds, depending on asset class, sector expertise, size of investment and geography. When appropriate, investing in funds can mitigate risk, given the complex nature of rapidly evolving regulatory frameworks in emerging countries and sectors as well as the need for local presence and operational expertise in the relevant business models. It can also offer greater diversification and provide valuable co-investment opportunities.

Investments we have made in this area include the following examples:

TIAA-CREF Investments

Developing World Markets Microfinance Equity Fund I:
A private equity fund focusing on financial inclusion serving underserved communities

Urban Partnership Bank:
Investment in FDIC-insured certificates of deposit (CoDs) at community development banks that provide financial services to underserved US neighbourhoods in Chicago, Illinois; Cleveland, Ohio; and Detroit, Michigan

ProCredit Holdings:
A private-equity investment in a bank that provides global microfinance and financing solutions to small and medium-sized enterprises (SMEs) and to low- and middle-income individuals

Impact Community Capital:
A Community Development Financial Institutions (CDFI) initiative of eight insurance companies (including TIAA-CREF) to facilitate investments benefiting low-income families and underserved communities

Avanath Affordable Housing:
A real estate equity fund that invests in affordable multifamily US housing properties

Executing the Investment Programme

A common institutional investor model organizes teams by asset class. Our experience and belief is that a partnership model is central to the execution of the social investment programme. Otherwise, some potential transactions might get overlooked because their relatively small size might not merit a fund manager's attention. A partnership model should be built upon a coordinated approach that taps into internal expertise and pulls together a small team, one that can identify potential transactions and evaluate social and environmental returns with investment management colleagues.

How does it specifically work? First, a firm-wide mandate hinges on the support of senior leadership, including both executives at the firm and the board of trustees. Its backing of the programme signals that social impact investing is a priority, and it intentionally allocates resources for the initiative. This is not a static, one-time decision; rather, it is a continuous process involving periodic reviews, assessing financial, social and environmental results. On an annual basis, the GSCI team reviews the strategy with Asset Management senior leadership using our proprietary template for analysing transactions, and proactively identifies possible modifications, opportunities and challenges.

To facilitate the integration of impact investing with investment expertise across several different areas of the firm, senior leadership has assigned ownership of the strategy to the GSCI team. Under the enhanced strategy, the team could look at all the investments from a portfolio-wide perspective, ensuring they fit within asset-allocation parameters in terms of themes and geographic reach.

The GSCI team engages select investment teams to analyse investment opportunities in specific asset classes that may have a tangible social impact. The team is charged with building partnerships (as described below) with other teams, originating high-quality investment opportunities, tapping into investment expertise and working with asset-class-specific teams to do due diligence and invest in impact investment deals. The GSCI team is involved to some degree in each of the five steps required to execute the annual investment programme:

1. *Sourcing potential investments:* Impact investing opportunities, unlike a bond or equity trade or even a real estate transaction facilitated by a broker or an intermediary, typically do not cross an investment manager's desk. As a result, the GSCI team plays a pivotal role in proactively originating deals and creating relationships to learn about such opportunities. Today's impact investing market lacks a formal marketplace to fundraise (although emerging platforms like the Global Impact Investing Network's ImpactBase exist), which means that deal flow origination requires overcoming information asymmetry. The team considers each deal to determine whether it fits within one of the three approved themes and is eligible for financial evaluation.
2. *Financial evaluation:* Once a potential deal is identified, it must go through enhanced due diligence, which brings together the deep asset-class expertise of both the investment management and GSCI teams. Investment management partners aligned with particular asset classes bring their experience in structuring and analysis-specific expertise to the due-diligence process. For example, the team that manages private investments would lead the underwriting process for a private equity fund or private debt impact investment opportunity.
3. *Social impact & sector evaluation:* The GSCI team simultaneously determines whether the transaction meets the firm's social-impact criteria in addition to providing best-in-class sector exposure. This step

is run in conjunction with the financial evaluation, but it falls largely to the GSCI team, which has the sector knowledge to determine whether the deal has the potential for measurable impact. This step includes reference checks and marketplace analysis to determine, for example, whether a community and economic development investment can enhance access to essential services, such as credit or healthcare for low- or moderate-income families. Meetings with the sponsors and potential investees in the countries or communities in which they operate are a very important part of the analysis. One example of evaluating an impact thesis would be leveraging the Principles for Investors in Inclusive Finance framework (which is backed by the UN and to which TIAA-CREF is a signatory). The framework offers guidance on specific aspects including client protection, transparency of product, range of services and affordability.

4. *Investment decision:* This step entails presenting the investment committee (comprised of senior leadership from the respective asset class teams and the head of the GSCI team) with a formal investment proposal for review and approval. The committee meets every time a deal is proposed, and the approval process is an important step in the overall portfolio management.
5. *Portfolio management and reporting:* Once the investment committee approves the deal, the portfolio-management team for the relevant asset class has ongoing operational and supervisory responsibilities. The GSCI team is involved in monitoring the investment to ensure it maintains its social mission and delivers on its promise to improve the environment or community. These types of investments can have a multi-year investment horizon, mandating consistent review to ensure they stay on target to deliver on their impact investment potential. By maintaining an active oversight role, the GSCI team is also in a position to learn of potential co-investment and secondary financing opportunities that it might otherwise not be offered.

Keys to Success: Integrating Impact Investing across a Platform

Looking ahead, we believe an increasing number of financial institutions will seek impact investment opportunities as they strive to meet financial and social goals—whether from their own mandates, from regulators or shareholders, or from a combination of these drivers. As the demand for impact investing increases, investment firms can prepare by ensuring their organizations are structured to maximize future opportunities. That process needs to begin by first securing and sustaining top-level support for impact investing.

A focused approach helps to provide clarity for the roles and responsibilities of each part of the organization with regard to impact investing. It will also, of course, include setting annual and overall portfolio allocations.

In our experience, having a dedicated impact investing team that sits alongside investment managers has proven

to be a successful model. The team handles a variety of activities such as identifying, tracking and measuring investment opportunities across a range of asset classes, and ensuring that the programme delivers on its promise to achieve competitive social and financial results. The team serves as a catalyst, engaging managers of specific asset classes to use their expertise in evaluating transactions. It also plays a pivotal role in communicating the benefits of the programme and dispelling common myths, including the perceived elusiveness of finding investments that can deliver both social and financial returns. These investments not only exist, but also are likely to proliferate. The investment firms that prepare themselves opportunistically today will be well-positioned to succeed in this space.

The market for impact investing opportunities is in its formative stages; however, as it matures, investors will have additional opportunities to put money to work – in areas that can provide benefits to their portfolios’ bottom lines and create societal change.

Disclosures

The TIAA General Account is an insurance company general operating account. It is not available to investors and does not present investment returns to participants.

The material is for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which this information may relate. Certain products and services may not be available to all entities or persons. Past performance does not guarantee future results.

Diversification is a technique to help reduce risk. There is no guarantee that diversification will protect against a loss of income.

TIAA-CREF Asset Management provides investment advice and portfolio management services to the TIAA-CREF group of companies through the following entities: Teachers Advisors, Inc., TIAA-CREF Investment Management, LLC, and Teachers Insurance and Annuity Association® (TIAA®). Teachers Advisors, Inc., is a registered investment advisor and wholly owned subsidiary of Teachers Insurance and Annuity Association (TIAA).



4.3 Incorporating Impact Criteria in Portfolio Construction: From Policy to Implementation

By Justina Lai, Associate Director, Sonen Capital LLC; Will Morgan, Director of Impact, Sonen Capital LLC; Joshua Newman, Investment Analyst, Sonen Capital LLC; Raúl Pomares, Senior Managing Director, Sonen Capital LLC

Key Insights

- An impact investing policy is the critical link to translating an impact investing strategy into tangible implementation steps.
- Impact investors can benefit from an additional layer of due diligence by using specific impact lenses to identify investments that fit clients’ financial and impact requirements.
- In addition to diversifying across asset classes, impact investors can increasingly diversify across impact sectors as markets deepen.

Introduction

The following was adapted from *Evolution of an Impact Portfolio: From Implementation to Results*, a landmark report released in October 2013 by Sonen Capital in collaboration with the KL Felicitas Foundation (KLF, or the Foundation). The report demonstrates to investors that impact investments can compete with, and at times outperform, traditional asset class strategies while pursuing meaningful and measurable social and environmental results.⁶

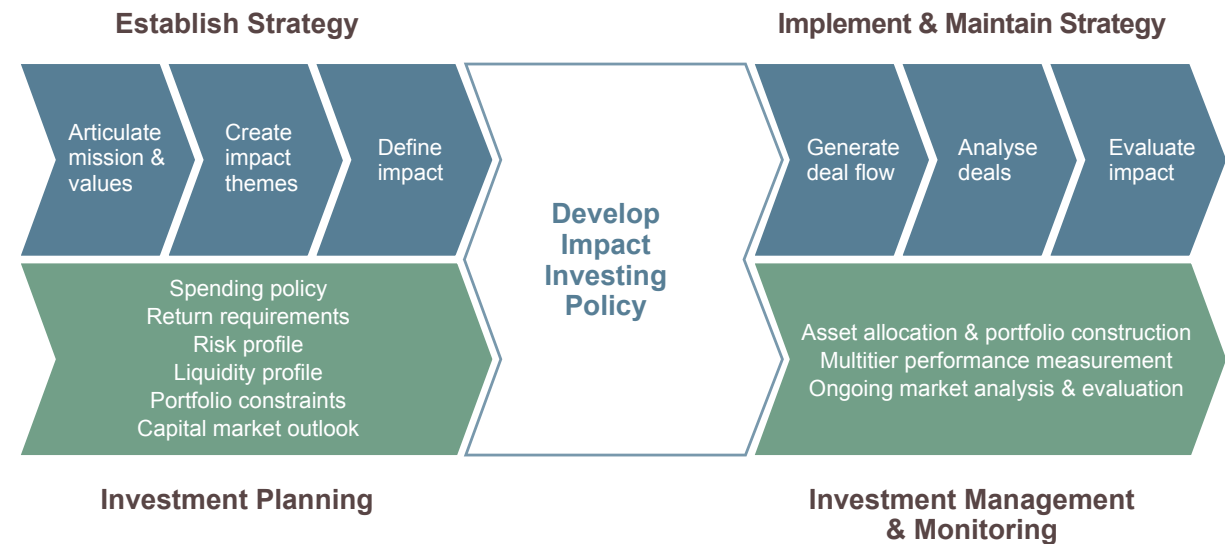
In 2004, to meaningfully address the world’s most pressing social and environmental issues, KLF began a process that would eventually allocate 100% of the Foundation’s capital to impact investments. Over the seven-year period of 2006-2012, the Foundation moved from 2% of assets allocated to impact to over 85%, while generating index-competitive, risk-adjusted returns. This article highlights Sonen Capital’s strategy for building impact investment portfolios, utilizing our experience in investing KLF’s assets as a case study to concretely illustrate this approach.⁷

Creating an Impact Investment Policy

Constructing KLF’s impact investment portfolio required following a framework through which investors could move towards action – from establishing to executing and maintaining an impact investing strategy. This cycle, depicted in Figure 8 and described in greater detail in *Solutions for Impact Investors: From Strategy to Implementation*⁸, provides a roadmap for other investors to build impact investment portfolios. A central component of this process is developing a comprehensive Impact Investing Policy, the critical link to translating a strategy into a tangible implementation plan.

Figure 8: Impact Investing Cycle

Source: *Solutions for Impact Investors: From Strategy to Implementation*. Rockefeller Philanthropy Advisors, 2009.

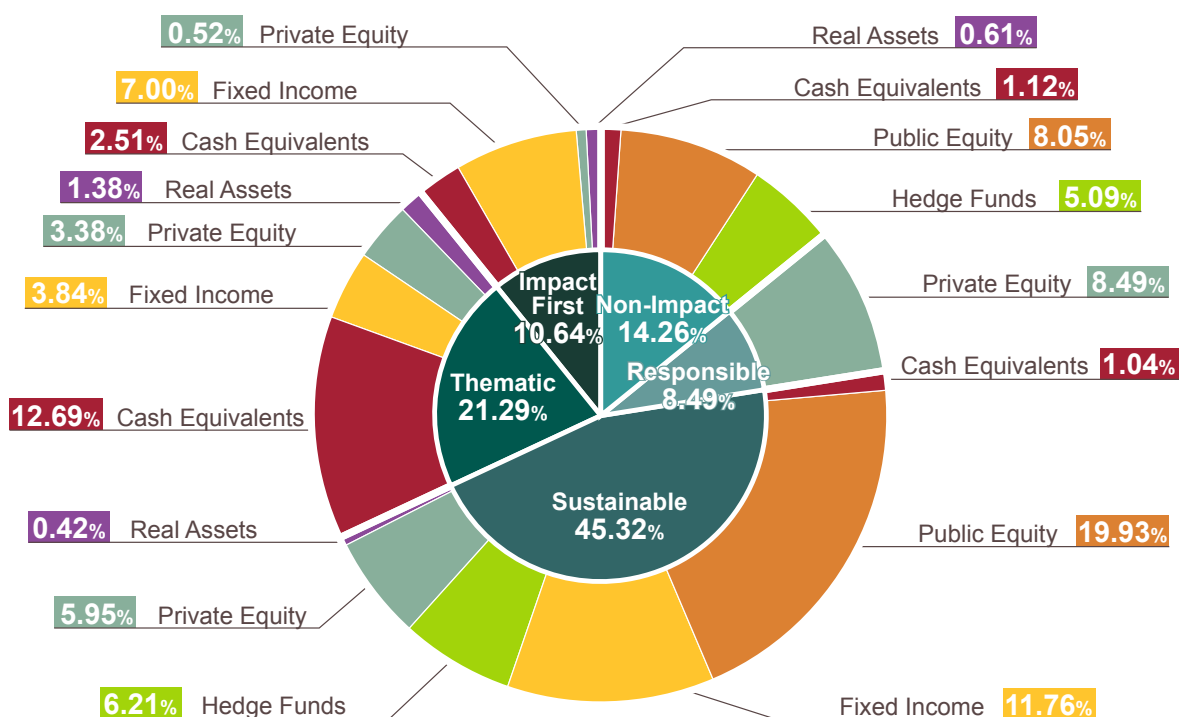


KLF's Impact Investing Policy was designed to incorporate impact criteria into the portfolio construction process and, to the extent possible, select impact investments that satisfied the Foundation's Investment Policy Guidelines.⁹ The selected policy targets reframed KLF's Investment Policy with respect to asset allocation to achieve both financial and impact objectives.

Anchored by rigorous financial analysis and ongoing assessments of factors affecting macroeconomic conditions, these asset allocation targets are also still designed to diversify KLF's investments across and within asset classes, while achieving lower volatility and risk over time to protect portfolio capital and achieve competitive returns across market cycles (see Figure 9 for KLF's impact investments).

Figure 9: KLF Impact Investments by Impact Strategy and Asset Class

Source: Sonan Capital, LLC



Portfolio Construction

As the Foundation's assets were moved into impact, a balance was sought between financial and impact considerations. An effort was also made to reconcile KLF's mission with the realities of a growing industry and to maintain adequate diversification across risk exposures. As an early mover in the implementation of impact investing strategies, KLF's Return-Based Impact Portfolio evolved as the industry itself matured. At the outset of portfolio construction, there were not enough accessible and/or suitable impact investments to achieve desired asset allocation targets. Due to these constraints, the portfolio, at times, was heavily over-allocated to fixed income or cash products, and a positive by-product of this was exposure to mission-aligned impact themes. In these instances, KLF's mission overrode portfolio optimization goals. As the impact investment universe expanded, so did the opportunity-set through which KLF could express preferences based on impact themes and investment views according to asset class targets.

Despite the potential challenges of such early adoption, KLF's Return-Based Impact Portfolio remained competitive with widely accepted financial benchmarks based on the portfolio's stated asset and risk exposures, with no indications of a so-called "pioneer penalty". On a weighted total portfolio basis, KLF's Return-Based Impact investments performed in line with their asset-class exposures while providing for diversification benefits.

Importantly, the impact industry has since matured enough to offer a more complete set of investment options, and it has become increasingly possible to find financially compelling investments across asset classes that achieve the required impact criteria.

Adding "Impact" to Investment Due Diligence

In addition to the fundamental financial analysis and discipline that goes into investment decision-making, KLF used a specific impact lens based on the Foundation's charitable mission and its founders' values to further

refine the investment selection process. This included an assessment of a potential investee's impact strategy, impact reporting capabilities and fit with the Foundation's mission. To this end, meetings were set up with portfolio managers and analysts, and each team's investment process was studied to understand how investment decisions were made, all in an effort to understand how ESG or impact factors are integrated to add value.

KLF's impact investments were allocated across all asset classes, making it possible to identify specific social or environmental impacts for each. As a greater number and wider spectrum of impact investment opportunities continue to become available to investors, all asset classes are expected to be capable of delivering risk-adjusted, financially competitive and mission-aligned impact returns to investors.

Due diligence for public strategies

To construct a diversified impact investment portfolio, we classify investment opportunities principally according to three categories, listed in order of lowest to highest impact:

- *Negative screening (Responsible)*: When high-impact opportunities are unavailable as a result of portfolio construction necessities, investors may opt to screen out issue areas such as tobacco, firearms or alcohol. Investors should note that the use of sometimes arbitrary negative screens can reduce the efficiency of portfolios and may entail certain risk/return trade-offs.
- *Positive screening (Sustainable)*: Investors can add value to the investment process by incorporating ESG criteria or sustainability considerations into manager or security selection. Positive screening allows managers to express themes and investment ideas through best-in-class approaches or through careful selection of companies that manage their ESG risks and opportunities in a proactive manner.
- *Social or environmental themes (Thematic)*: Thematic strategies look to focus on a particular social or environmental trend by expressing investment ideas that are best positioned to benefit from exposure to the theme. Typically, managers identify and invest in the most progressive companies (or other issuers) with strong ESG performance within a theme.

After categorizing strategies, quantitative screens for financial track records are applied. Impact investors should analyse not only the returns of a strategy, but also attempt to understand the underlying drivers of returns and risk, including the factors to which each strategy is exposed. After promising candidates have been isolated in each asset class, investors must thoroughly analyse managers' impact strategies. As investors become more comfortable with the options in the impact marketplace, they can begin to think about "impact allocations" – allocating their investments optimally across various impact approaches and target themes – in addition to asset and risk allocations.

Due diligence for private strategies

For investors able to access private market investments, alternative strategies are critical components of an investor's diversified asset allocation strategies.

Private investments offer both compelling economic exposures and the potential to capture unique impact opportunities through highly thematic exposures. For example, private strategies can provide exposure to direct impact in themes important to investors, such as clean energy and technology, community development, sustainable forestry, sustainable ranchland and financial services for base-of-the-pyramid (BoP) communities.¹⁰

Just as in the public markets, private investments require extensive financial, impact and operational due diligence. Investors should be aware that the due-diligence process is iterative and non-linear; new quantitative and qualitative data points, enhancing the quality of due diligence and ongoing monitoring, can surface by integrating impact criteria into the investment process.

Investors will need to balance the desire to invest directly in companies or projects with the need to remain diversified (i.e. invest in funds). For example, KLF's private equity allocations were generally made to funds, but occasionally, when an investment's impact attributes seemed particularly compelling, KLF made direct investments. Not all investors will be able to achieve adequate diversification through private investments by investing in deals individually or with individual managers. For such investors, multimanager vehicles can provide options for broader exposure.

Asset Allocation

In the context of a complete portfolio approach to impact investing, every potential investment should be evaluated for its contribution to the total portfolio. Position levels should be monitored relative to the investment policy, but to the extent possible, investors should remain flexible and nimble in light of new impact information and when faced with changing conditions. Investors will need to balance the impact desired with the impact available. In many cases and across asset classes, it is possible to achieve a satisfactory balance.

For KLF, once appropriate investments were identified, each investment was matched to the Foundation's overall asset allocation targets. An effort was made to avoid overexposure to any particular theme, sector, manager or company – sometimes even allocating to cash, cash equivalents or short-term debt when the desired exposures could not be matched with acceptable impact investments. This type of occurrence continues to decrease in frequency as the impact marketplace matures across asset classes.

Next Steps for Investors

For investors seeking to integrate impact across their investment portfolios, the impact investing cycle roadmap can serve as a useful guide for moving from strategy to implementation to results.

- Ask for impact: Asset owners should no longer accept the premise that sacrificing financial performance is necessary to achieve measurable and meaningful impact. Evolution of an Impact Portfolio: From Implementation to Results can serve as a reference.
- Reclaim ownership of assets: If the service provider is not willing and/or not able to deploy assets to impact, another service provider should be found who is.
- Become more educated: Growing industry networks and an abundant set of topical resources are available to those interested in learning more.
- Widen options: The industry continues to evolve, and investors today have an increasing number of choices to implement their impact strategies. More high-quality, turnkey solutions are available in the marketplace than ever before.



4.4 How to Evaluate Impact Investing Fund Managers¹¹

By Christoph Birkholz, Co-Founder and Managing Director, Impact Hub Zürich, Switzerland

Key Insights

- Given the early stage of the impact investing sector, due diligence focused on the fund manager's track record may hold the industry back; alternatively, understanding the fund manager's decision-making process may be the second-best approach.
- Asset owners should evaluate the following key areas of a fund manager's organization: the backgrounds of those involved in decision-making, mission alignment between asset owner and fund manager, and sources of revenue and practised governance. A set of recommended key questions in each area can help to understand the inner workings of a fund.
- As the sector is still prototyping new approaches, impact investment fund managers should share how decisions are made flexibly, and not overemphasize a strict fund strategy that leads to predefined outcomes. Asset owners should appreciate this flexibility instead of viewing it as a lack of focus.

Institutional impact investing¹² in start-up and growth companies was inspired by the venture capital (VC) model, in which two criteria are key for fundraising: first, a risk-adjusted target return based on a distinct investment strategy; and second, the track record of the fund manager's team. To successfully raise capital, the management teams develop fund strategies based on assumptions about distinct venture developments, their risk profiles and exit opportunities.

Not surprisingly, impact investment fund managers focus their fundraising efforts on articulating a strategy that leads to an expected return, both financially and socially; and, on emphasizing fund management's experience in relevant areas of social impact and/or fund management's financial performance.

However, given the early stage of the impact investing sector, such focus on the fund's target returns and the management team's track record may hold the industry back. First, it is difficult to know whether sustainable positive social or environmental impact has been achieved due to the longer time horizon needed to effect social change, and the lack of standards for measuring and benchmarking non-financial impact. Second, past experience of most impact investing professionals lies either in the traditional investing or philanthropic sector and, therefore, is a poor indicator of a fund's future both impact and financial performance.

While it ultimately matters whether a fund reaches its impact and financial targets, until this can be properly evaluated,

asset owners and investment advisers should focus on understanding the internal workings of an impact investment fund when conducting due diligence. In particular, the following key factors that determine impact investment fund managers' decision-making could be analysed:

1. People: How are decisions made and by whom?
2. Mission: How does the fund manager combine impact and finance?
3. Business model: How does the fund finance its operations?
4. Practised governance: How is the fund organization actually governed?

1. People: How Are Decisions Made and by Whom?

As with other investment funds, impact investors are involved in three major types of activities and decisions: forming a fund investment strategy, raising capital and investing. To complete these activities, fund management organizations typically include an investment committee (IC) or board, managing partners, investment managers and other personnel such as sector experts, associates and assistants.

Being in a nascent sector, few people can claim to be long-term, experienced impact investing experts. Board members, managing partners and investment managers may come from investment banking, venture capital, asset management, strategy consulting, development organizations, philanthropy or development work. These professionals make decisions based on how they were educated and socialized. If not managed carefully, such diversity in backgrounds can lead to unintended outcomes based on unconsciously diverging beliefs. Ideally, assumptions should be openly addressed to use diversity as a source of innovation rather than as an internal lack of clarity.

For those funds that separate the final investment decision from the preparation of the decision, potential investment opportunities undergo a due-diligence process and are then presented to the IC in a written document distributed in advance, as a presentation at the IC meeting or on a conference call, with a subsequent follow-up discussion. While intended to be an objective decision process in which the final decision-makers have no ties to the entrepreneurial ventures, the relationship and reputation between the deal's presenter and those evaluating it have an impact on the decision. To understand past decisions or to assume future ones, asset holders might consider the following:

- What are the experience profiles of those presenting deals and of the IC?
- How many deals are declined, and at which stage of the investment process does this happen?
- Which investment managers have been more or less successful in convincing the IC?

As the sector is still prototyping new approaches, impact investors should share how decisions are made flexibly,

rather than overemphasizing a strategy that leads to predefined outcomes. Likewise, asset owners and advisers should appreciate, as a sign of agility and transparency, when a fund manager answers their questions honestly, as in “we will decide depending on how the sector develops”, rather than perceiving such answers as a lack of experience and focus.

2. Mission: How Does the Fund Manager Combine Impact and Finance?

Impact investors may need to make decisions that trade off greater impact against financial returns. For example, an impact enterprise can reinvest its profits into scaling its impact, or cross-subsidize lower profit areas and forgo offering its investors an early or higher pay-out in the short term.

Asset owners should evaluate impact investment fund management organizations based on their ability to foster productive debate between the two (or three) camps of managing for double or triple bottom lines. Here it is useful to ask the following questions:

- Does the fund organization equally employ champions for financial performance and for societal impact?
- Do the fund managers maintain dialogue between financial and social impact experts?
- Does the fund organization encourage team members to contribute to shaping the fund's focus while preventing mission drift?

Decision-making is likely to be a collective process in which the individual managers and the key (financial) stakeholders influence not only the outcome, but also the organization's shared intent as codified in the mission statement and as realized in the organization's core practices. Here, Jed Emerson and Sarah Williams of ImpactAssets offer useful guidance by calling for analysis of the impact investment fund's intent and practices¹³. How fund managers understand and translate the mission statement into practice is important. The following questions can help ensure a consistent, coherent and meaningful decision-making process:

- Are the fund's impact targets as clear as the intended rate of financial return?
- Do the managers investigate impact performance as regularly and rigorously as they check the financial performance of their portfolio companies? Do they take into account that impact performance needs to be contextualized as opposed to evaluated using quantitative metrics only?
- Are portfolio metrics (other than individual company metrics) in place?
- Is the investment process an iteration between financial and impact due diligence, or are both dimensions evaluated simultaneously?
- Does the fund hire separate specialists for finance and impact, or are they expected to master both?

3. Business Model: How Does the Fund Finance its Operations?

Asset owners should analyse the nature of a fund's investor base to understand the manager's decision-making process behind the investing style and outcomes. For example, Acumen Fund, the impact investing pioneer, targets foundations and philanthropists as primary limited partners (LPs), whereas the specialist fund manager, Bridges Ventures, raises capital from institutional investors that require a financial return. Similarly, if one wealthy individual is the main investor in a fund and also covers most of the operational expenditures, that individual's opinion about a potential portfolio company's social impact may be more relevant than other decision points along the well-structured investment process.

Another critical factor affecting a fund's investing style is the strength of investor influence, which is determined by the ratio of operational budget to funds invested, and may also be a proxy for the fund's efficiency. As a rule of thumb, the more that revenue comes from the actual investment activity, the stronger the pressure will be on efficient decision-making, larger deal sizes and lower risk profiles. By contrast, donation-based impact investors may not reach a comparable financial sustainability and scale to those applying a stand-alone business model. However, impact investors financed by donations and corporate and public sponsorships may have more space for innovative approaches, trial and error, sector development activities, pre-seed deals, highly contextualized impact analyses and investments in regions where purely commercial funds would not be able to get involved.

Therefore, understanding the source of revenue for the manager's operating budget is essential. The revenue source for a mainstream VC fund is the management fee (usually 2% of committed capital) and carried interest (usually 20%). In impact investing, "carry", which is the exception rather than the norm (e.g. Bridges Ventures), and the management fee are not the only sources of income. Some fund managers' operational expenditures are primarily covered by grants (e.g. Acumen Fund), some are linked to a corporate or institutional parent (e.g. LGT Venture Philanthropy), and some may be initiated as an investment into a new business line (e.g., responsAbility). Some fund managers generate revenues from private wealth advisory mandates; others accept grants from public funders for technical assistance, advisory and coaching of ventures; and some pursue revenues from investment activity alone, i.e. management fee and potential upside in case of exits (e.g. Bamboo Finance, Social Venture Fund). While they bring the mainstreaming of impact investing ever closer, few regions and sectors today allow for purely commercial impact investments in start-up and growth companies. A large number of impactful ventures fall through their due diligence processes.

4. Practised Governance: How Is the Fund Organization Actually Governed?

Understanding fund governance must go beyond the fund's mere ownership structure; it needs to include analysis of factors such as the performance incentives for fund managers, distribution of expertise within the fund manager, and the fund's organizational structure.

Larger impact investment fund managers may have teams distributed across the globe, with regional offices responsible for deal screening, negotiations and post-investment support of portfolio companies. Some impact investment funds have strongly independent regional teams, whereas other funds tend to centralize main decision-making at the fund manager's headquarters. The degree of decision-making distribution across the globe affects a fund's activities. Strong regional-team independence is conducive to adapting a fund's strategy to the local context. While this may help fund managers to align with local realities, it is harder to adhere to one coherent, global fund strategy that can be communicated to asset owners looking to invest in a fund.

Incentives can translate intended governance into behaviour. In mainstream VC, a carried interest financially aligns fund managers' goals to investors' goals. A carried interest in impact investing must be well designed to avert prioritizing financial over social impact goals. For mission-oriented talent that tends to gravitate towards impact rather than mainstream investing, non-financial incentives such as a sense of ownership, independence in decision-making and clear understanding of a fund's social purpose may become more relevant than financial incentive structures.

Asset holders and entrepreneurs should ask about the governance practices in place; how people are incentivized; and how governance has actually worked in past strategy and operational changes. Key questions may be:

- How much independence do local investment teams enjoy?
- How do local investment teams and individuals respond to strategic changes?
- Does the fund have a carried interest? If so, does it include impact targets?

Conclusion

Asset owners and stakeholders of impact investing funds should know the backgrounds of people involved in a fund management organization, how revenues are generated, the organization's purpose and how governance is actually practised. By presenting some new perspectives and emphasizing intuitive thoughts, this article is meant to contribute to mitigating a few pitfalls of the emerging impact investing sector. Fund managers should be allowed to prototype and pilot their approaches, stay humble with expectations for returns, and reach out to mainstream investors, rather than emphasizing novelty.

4.5 Best Practices of High Performing Impact Investing Fund Managers

By Catherine H. Clark, Director of CASE i3 Initiative on Impact Investing and Adjunct Associate Professor at Duke University’s Fuqua School of Business; Jed Emerson, Chief Impact Strategist, ImpactAssets; and Ben Thornley, Director of InSight, Pacific Community Ventures

Key Insights

- The four qualities common to successful impact investing fund managers are effective partnership with the public sector, use of catalytic capital, “multilingual” (i.e. cross-sector) leadership, and integrating financial and social objectives on an equal footing.

This article explores what works and does not work in impact investing, based on the experience of 12 high-performing impact investing funds. Two years ago, we embarked on a research effort to closely examine their practices, having culled them from an initial list of around

350 funds. This small group of 12 pioneering intermediaries has successfully raised capital for some time from prominent commercial investors, among others. The funds prove the case that concurrently delivering significant social impacts and financial returns that meet or exceed investor expectations is both possible and being done at significant scale. The purpose of the research was to gain and share knowledge of what does and does not work in impact investing, based on the experience of these outstanding organizations.

The 12 funds are characterized by practices common to all high-performing asset managers: they nurture their brands, leverage relationships, are often headed or backed by uniquely reputable individuals/institutions, and demonstrate exceptional financial discipline and operational transparency. However, four attributes above and beyond these practices were found to be distinctive for effective impact investing. The sooner that funds internalize these attributes, the sooner a “small group” of pioneering funds will become a “universe” of investment possibilities.

Practices and Recommendations

These four attributes are presented in Table 4, together with diagnostic questions and recommendations for fund managers.

Table 4: Attributes and Recommendations

Attribute	Description	Diagnostic Questions	Recommendations
Policy Symbiosis	Impact investing intersects with all levels of government, consistent with the promise that impact investing can deliver social and environmental benefits at scale.	Are there public sector funds, tax credits, regulations, certifications or procurement policies that might be beneficial? Do you have relationships with policy-makers interested in your market sector? Do you include policy-makers at all stages of your thinking on market and field development?	Be aware of policies that apply to you Cultivate relationships and be part of the conversation Invite policy-makers to the table
Catalytic Capital	The grants, guarantees, letters of credit, collateralization, subordinated loans, concessionary or cornerstone investments that trigger additional capital not otherwise available – all can be instrumental to a fund, from providing early funding to driving reputational benefits.	Have you looked beyond philanthropy for catalytic capital? Do you know the strategic reason why LPs invest, and is it in alignment with your priorities? Do you consider others you want to invest alongside and the strategic value of having them in the deal? Do you share ideas with others who have expertise in structuring products and blending catalytic and commercial capital?	Think broadly about the motivations of investors Target and partner with investors who are aligned on both mission and strategy Be a catalyst in your own right Create peer groups of structural innovators

Multilingual Leadership	<p>Successful fund leadership is about more than simply effective financial management; it requires experience and fluency in the private, public and non-profit sectors.</p>	<p>Do you have the right mix of perspectives to tackle a multitude of issues and range of relationships?</p> <p>If your original backers and leaders have unmatched reputations and relationships, are they sustainable?</p> <p>Are there gaps in your cross-sector expertise that need to be filled?</p> <p>Do you encourage aspiring practitioners to diversify their education?</p>	<p>Recognize that you will need different kinds of expertise</p> <p>Leverage strong foundations into strong teams</p> <p>Be open to growth and transformation</p> <p>Train the next generation of leaders to be multilingual</p>
Mission First and Last	<p>Successful funds integrate financial and social objectives by establishing a clearly embedded strategy and structure for achieving mission prior to investment, enabling a predominantly financial focus throughout the life of the investment.</p>	<p>Do you embed mission in your structure or strategy early, explicitly and unequivocally?</p> <p>Do you devote time and resources to demonstrating impact that is proportional to the fund's accountabilities?</p> <p>Are the metrics you track well targeted to your mission, and do they help harmonize LP objectives?</p> <p>Do you use the same financial processes, analytical methods and deal terms of any mainstream investor?</p>	<p>Lock in mission</p> <p>Align accountability with mission</p> <p>Track mission-direct metrics and strengthen feedback loops</p> <p>Ensure financial discipline in investment</p>

Each of the 12 funds provides insight into the responses of leading practitioners to the four attributes. Together, they offer a taxonomy of common approaches within each category.



Policy Symbiosis

The funds studied utilized public policy and benefited from it, but the relationship between the funds and government entities was not just that of “recipients” and “benefactors”; it was treated as an ongoing partnership, influencing the development of public policy at the investee, market and field levels. The practice of policy symbiosis typically falls under the following, non-exclusive categories:

Foundational: The origins of the firm were rooted in a partnership with government, beyond the provision of any type of assistance (e.g. Business Partners Limited (BPL) was created as a partnership between the South African government, a leading philanthropist and some of South Africa’s largest corporations).

Financial: Government entities were direct investors in the fund. For example, the UK government provided a 1:1 investment in Bridges Ventures for every pound raised in the £40 million Sustainable Growth Fund I.

Regulatory: Government regulations influence structure, operations and investments. Huntington Capital’s first fund was registered with the US Small Business Administration. Investors in its second fund were motivated in part by the US Community Reinvestment Act and California state-level regulations.

Advocacy-driven: Funds may work directly with government to influence broader/systemic policy environments. Aavishkaar was a key player in the formation of the Indian Impact Investor Council, which creates voluntary guidelines to avoid potential crises (e.g. the Indian microfinance sector in 2010).

Opportunistic: The fund makes an effort to identify and leverage discrete, non-systemic opportunities for government to support the success of portfolio companies. Managers of SEAF’s Sichuan SME Investment Fund in the People’s Republic of China (China) worked closely with local public officials to leverage their knowledge of, and influence over, government processes.

Catalytic Capital

In the field of impact investing, catalytic investments encourage the flow of capital for strategic reasons, beyond the pursuit of financial return alone. All 12 funds studied benefitted from or deployed catalytic capital for one of four distinct purposes:

Sustaining: Some segments of impact investing require ongoing grants or concessionary investments, particularly where market failure is endemic. Accion Texas receives half of its US\$ 14 million operating budget for making high-impact microloans from grants—a proportion that is shrinking but will likely never reach zero.

Seeding: Making first investments in a fund enables operations to commence, and helps to develop a track record needed to attract other capital. Deutsche Bank’s Microfinance Consortium I was made possible by a grant

from the UK Department for International Development (DFID), which provided the operating budget during fund creation.

Risk-reducing: Financial risk for investors can be managed by tiered capital structures. RSF Social Finance (RSF) uses an “integrated” lending approach, tapping philanthropic capital to make more borrowers eligible for RSF financing.

Signalling: Large, reputable investors often elevate the recipient’s perceived credibility and visibility. Elevar Equity’s first fund received an early programme-related investment from the Omidyar Network, which introduced Elevar Equity to other investors and provided added comfort to potential capital providers.

Multilingual Leadership

Broadly, three approaches exist for achieving multilingual leadership in an organization: individual (principals with deep/broad experience); institutional (defined governance structures); and acquired (recruiting necessary talent). Founders and leaders of the 12 funds studied often had experience across multiple, essential areas (e.g. finance/business, policy and impact/philanthropy), providing them with essential multilingual perspectives. Diverse skillsets were especially important in influencing four stages of fund development:

Creation: Enabling fund managers to think outside traditional investment models/approaches and create innovative solutions

Capital development: Facilitating engagement with a wide range of stakeholders

Pre-deployment: Understanding dynamics of various enterprises and a range of financial and non-financial tools needed for businesses to flourish

Accountability: Communication and rigorous tracking of financial and impact results

Mission First and Last

Successful funds seamlessly integrate financial and social objectives, establishing a clear mission that embeds the delivery of impact through structure and investment strategy. Knowing early and explicitly that impact is in a fund’s DNA, all parties (investors, investees, and the fund itself) are able to move forward with the investment disciplines akin to any other financial transaction, confident that mission drift is unlikely. The four categories below emphasize important differences in the key elements of mission first and last: intention, or how mission is embedded in the structure/strategy of a fund; and accountability, or the way that a mission is revisited, evaluated and reported throughout and at the back-end of the investment cycle.

Structure: Mission is locked into the DNA of the fund through an external designation, registration or special-purpose corporate form. A fund’s performance is assumed to be consistent with this structure, and accountability is

often limited to the form's requirements. Calvert Foundation manages a Community Investment Note, registered in nearly all 50 US states, that is accessible to non-accredited investors. The impact thesis and constraints of the fund are built into the registered security.

Strategic: Mission is embedded in an investment strategy that explicitly targets certain enterprises or populations, often with defined attributes that are generally understood to be inherently impactful. BPL targets SME growth broadly in South Africa, but takes care to identify viable companies located in urban and rural areas and/or run by women and/or indigenous entrepreneurs. These businesses have been plainly underserved by mainstream capital markets, particularly for the provision of risk capital/finance, in which BPL specializes.

Investor-driven: These funds are created in close collaboration with investors for whom the fund is meeting a very specific mission objective. Demonstrating impact against this objective is an important element of accountability. SEAF's Sichuan SME Investment Fund answered a clear need for two key investor groups: a US insurance company eager to demonstrate its support for Chinese enterprise, and DFIs committed to capitalizing small business development in China.

Thematic: These funds embed mission in an investment strategy targeted towards sectors that have potential for social/environmental impact, although the sector may include many other non-impact investments. Accountability relates to demonstrating that investments within these sectors have been impactful. The Bridges [Ventures] Sustainable Growth Funds I and II focus on a cluster of issue areas including health, education and the environment, where social or environmental need creates a commercial growth opportunity for market-rate or market-beating returns.

Conclusion

To be sure, neither a "small group" of successful intermediaries nor the relatively limited number of investors who have supported these funds is enough to mainstream impact investing – an indication instead that insight into best practices has remained in relatively closed circles. We call this initial growth period the "1.0 era" of impact investing. Anecdotal "observation" rather than broad "evidence" has been the main organizing principle during this time, and few investors have had the benefit of observation.

The key to mainstreaming – to entering the "2.0 era" – is to shift emphasis from the "why" of impact investing to the "how"; to ground our thinking in the experiences of funds with veritable track records of successful financial and social performance across geographies, investment strategies and impact objectives. Judging by the 12 outstanding funds we have had the privilege to study, we believe the 2.0 era has arrived.

In sum, in an effort to generate multifaceted financial and social returns, impact investing fund managers should dedicate resources to the following practices:

- Becoming familiar with policy issues and cultivating mutually beneficial relationships with philanthropists and government actors
- Ensuring both "soft skills" to collaborate effectively and "hard skills" needed for financial structuring are in place in order to leverage catalytic capital
- Building teams with multi-sector experiences, approaches and skill sets
- Establishing clear mission accountabilities that help align the strategic priorities of investors (and the interests of others including investees and beneficiaries), and that can be managed with unrelenting financial discipline.



4.6 Achieving Portfolio Diversification and Double Bottom Line through Investing in Underserved Markets

By Mildred Callear, Executive Vice President of Small Enterprise Assistance Funds (SEAF) and member of the SEAF Board of Directors

Key Insights

- Partner closely at the outset– to seek alignment
 - with investors regarding governance structures, developmental goals and expected financial returns; traditional investors see the benefits of diversifying portfolios by investing with socially-minded investment managers, with the objective of generating reasonable financial returns that are somewhat uncorrelated.
- Impact objectives and metrics should be integrated into the investment process as early as possible; in this way, investment opportunities are framed within the impact objectives, and the fund manager can then seek and select those opportunities most likely to achieve financial targets.
- Corporate governance structure should be conducive to double bottom line investing.

The mission of Small Enterprise Assistance Funds (SEAF) is to invest in and support SMEs as a means of economic growth and development in underserved markets.¹⁵ SEAF, a registered 501(c)3 non-profit global fund management group, has carried out its economic development mission by deploying private sector tools, i.e. launching private, for-profit equity funds in Central and Eastern Europe, Latin America and Asia.

By the end of December 2012, SEAF's historical cumulative committed capital reached US\$ 655 million, with more than US\$ 470 million in debt and equity investments in nearly 400 companies and 214 completed exits. These businesses have created and/or maintained more than 34,000 jobs, developed the skills and increased the wages of their employees, and raised their revenues year-on-year to become stable economic forces in their local economies. We estimate that every US dollar invested in one of our SMEs has generated US\$ 13 for the larger community (see "SEAF – The Economic Rate of Return" for more information on the calculation methodology). SEAF's investors, a combination of development institutions and private sources, have been able to satisfy both their financial and developmental objectives.

While a non-profit group, SEAF is also an investment adviser registered with the US Securities and Exchange Commission (SEC). This unique structure (described in more detail under "Design and Manage Governance to Make It Easier to Achieve a Fund's Objectives") allows

SEAF to align its mission of achieving developmental impact with generating financial return to its investors through its network of for-profit funds and their underlying investments in SMEs.

Now on its 32nd SME investment fund, SEAF has had many successes and learned crucial lessons about how to align financial return and social impact. We share four of them below.

Work with Investors Aligned to Your Vision for Change and with Investment Parameters

To meet investors' expectations, it is critical to work with those that share the same goal of achieving both financial and social returns, as well as the same focus of a particular sector, geography or theory of change.

Our investors rarely work with us for the sole objective of maximizing financial returns, but rather for a variety of fund attributes. On a high level, investors must be aligned with our vision that SMEs can be engines of prosperity and forces for change in challenging environments; they sense undiscovered value in the less mainstream corners of the global economy. On a more tactical level, investors must be comfortable with smaller transaction sizes, since our funds, most of which make investments of between US\$ 1 million and US\$ 5 million, are off the spectrum for traditional private equity funds. Moreover, given that we invest in less mature companies and markets, investors need to be at ease with the uncertainty inherent in frontier and underserved markets, as well as in working with earlier-stage companies.

Historically, only DFIs, existing for the explicit purpose of leveraging finance to achieve economic development, shared our social impact mission. Over time, local investors who want to participate in the growth of their economies through high-potential, home-grown companies have increasingly invested in our funds. These investors include local pension funds and insurance companies, as seen in our Colombian and Peruvian funds.

Recently, family offices, foundations, forward-looking corporations and individuals have seen benefits in focusing on an otherwise hard-to-reach sector, population or geography. These investors often do not identify themselves as "impact investors"; rather, they seek reasonable and somewhat uncorrelated returns. They also recognize that aligned investing provides some protection against the potential financial risk that less socially-minded investment managers can unwittingly create, as when they pursue profit maximization without regard for social, environmental and other standards.

Integrate Social Impact Metrics into the Investment Screening, Selection and Monitoring Process as Early as Possible

The impact objectives should drive the fund thesis, pipeline generation, investments made and, importantly, incentives of the investment team. The fund management team should be aware of investors' dual motivations. To demonstrate

success, the manager must be able to collect, track and evaluate the data from investments made. Alignment from the beginning makes it much easier to integrate the metrics into the investment process; however, the more specific the targets become, the more difficult it can be to balance the developmental objectives with the financial ones. For example, narrowing the universe of acceptable investments too much may mean that the available investments cannot meet financial objectives. Instead of strengthening the impact, a plethora of very specific and potentially competing metrics can hamper the investment team’s ability to find good investments that meet the criteria. This results in the funding of financially unsustainable investments that meet neither social nor financial objectives.

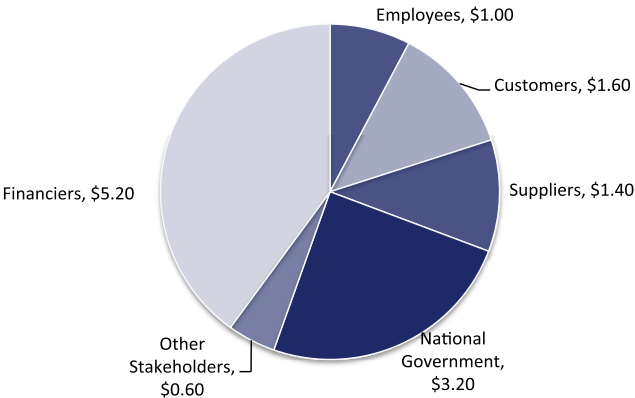
These caveats are particularly important with investments made in smaller and often less mature markets. In the end, the team must seek opportunities that are sound and sustainable, yet conducive to the social impact that investors desire.

Ideally, the investment professionals should see that achieving the developmental objectives also factors into their compensation. Unfortunately, this is all too rare for two reasons: first, it is not easy to devise the right balance of incentives; and second, even aligned investors are frequently most comfortable remaining with traditional incentive structures based on financial return. No basis exists to create incentives geared to anything other than financial performance if the fund manager does not develop and deploy metrics for evaluating agreed social and developmental outcomes (e.g. job creation, wage growth or sector-specific metrics related to providing basic services or health outcomes).

In the end, rigorous impact measurement and evaluation methods can play a significant role in successfully balancing financial and social returns, so long as both are measured and the incentives do not tip the scale too far in one direction. One example is a scale of financial incentives that increases as long as sufficient progress is made in achieving both social and financial returns.

Figure 10: SEAF Economic Rate of Return

Source: SEAF



We have also adapted and implemented a stakeholder-benefit methodology that quantifies the net benefit to the local economy of investments made in emerging-market SMEs. We calculate the multiplier effect of investments through in-depth case studies of representative portfolio companies. Using a cash-flow model, the multiplier effect considers the financial return of an investment plus additional external social returns (see Figure 10 and “SEAF – The Economic Rate of Return”).

By gathering more than just deal-specific financial data, we are able to tell the story of the investments and make the case to an increasing number of stakeholders about the positive role that SME investment can play.



SEAF – The Economic Rate of Return

Since 2004, SEAF has conducted 20 in-depth case studies to assess and report on impacts beyond the scope of the indicators included in the portfolio-wide data survey. The case studies allow us to conduct an overall quantitative analysis similar to an assessment of an investment's financial performance. The detailed information collected from site visits and interviews is quantified in dollar terms and incorporated into a cash-flow model of the company that is used to calculate two impact measures: an investment multiplier and an economic rate of return (ERR).

By adding the social impacts to the cash-flow model for the company in each case study, SEAF is able to calculate the multiplier effect of investment for each company. To calculate a net economic benefit/cost ratio, SEAF considers the value of financial and social cash flows and the value of the total amount invested into the company. This figure includes returns to financiers (the owners, SEAF and other financiers) and the impacts on other stakeholders, and is net of the amount invested.

For the 20 cases conducted to date, every dollar invested into frontier-market SMEs has generated, on average, an additional US\$ 13 in the local economy. The calculation is based on a 0% cost of capital (i.e. discount rate). With a 10% discount rate, the figure is US\$ 6. Use of various discount rates (a valuation methodology used in finance) allows investment managers to consider potential impact results in line with how they assess expected financial performance.

Case study methodology

SEAF quantifies the development impact of each portfolio company using a development impact model adapted from the economic department of the International Finance Corporation (IFC) ("Assessing Development Impact", by Frank J. Lysy, International Finance Corporation, 20 October 1999). This model measures the economic impact on each group of stakeholders affected, either directly or indirectly, by the investments in the company. SEAF calculates the present value of net cash flows generated for all stakeholders and divides it by the present value of the dollars invested over the life of the company; this provides the additional dollars generated in the local economy per dollar invested.

The model is based on the recognition that not all of the impact or value of a market transaction is reflected in price paid. Such effects beyond the price paid are variously referred to as externalities, public goods or consumer surplus. In the case of the impact of or value derived from investing in SMEs, some impacts, whether positive or negative, are not captured in the returns to financiers. These excess values – the aggregated value to all members of the economy – must be added to the SME financiers' net profits for assessing the investments' value to the economy as a whole. The overall value represents the total development impact resulting from the investments. The stakeholders potentially impacted by investments are broken down into the following categories: financiers, employees, suppliers,

customers, competitors & new entrants, producers of complementary goods & services, local community, national governments.

The model is built using data from the company, including financial statements and market statistics, and makes extensive use of information gained through stakeholder interviews. The model is based on 10 years of cash flows (usually from inception of the company and projected cash flows) and a terminal value. Results from the model are expressed as internal rates of return (IRRs) and present-value net benefit/cost ratios calculated at various discount rates. Both are in real terms, as the cash flows used in calculations are in constant US dollars. The benefit of calculating figures in real terms is that the reader may select the discount rate thought to be the most appropriate for risk without having to consider inflation (also making it easier to compare case studies).

The impact on financiers is measured, with a cash-flow model, as the traditional financial returns that they receive from the company. Using the net financial cash flow, SEAF calculates the IRR to all the financiers of the company, which per the IFC model is called financial rate of return (FRR). We measure the return to all the financiers, including both the investments from the Fund and those from other parties, over the entire life of the company. Next, we evaluate the impact on the other stakeholders (see stakeholder category list) over the life of the company. As with the net financial cash flow, we count the social benefits from inception onwards, including projected years. The net social cash flow is calculated as the premium over the benefit that the stakeholders would receive elsewhere, or would receive if the portfolio company did not exist. For example, the benefit to suppliers is calculated as the net income resulting from the portfolio company minus the estimated net income they would receive elsewhere if the portfolio company did not exist.

SEAF then adds the net social cash flow to the net financial cash flow to calculate an IRR representing the total development impact of the company, or return to all stakeholders, which is the ERR as per the IFC model. Again, the ERR does not represent the economic return from the Fund's investment alone, but the economic return generated by all of the debt and equity investments in the company, and over its life. Finally, we calculate the net economic benefit/cost ratio, which represents the additional dollars generated in the economy from one US dollar invested. The net economic benefit is the present value of the net financial cash flow and the net social cash flow, and the cost is the present value of all the debt and equity investments in the company and over its life (financing cash flow).

Select Financially Sound Investment Opportunities and Provide Support to Keep Them on Track

Central to SEAF's investment philosophy is the belief that high developmental impact can only be achieved through financial success of the portfolio company.¹⁶ Given that our vehicle for achieving impact is a private-sector company, the SME must be financially healthy to continue delivering on impact objectives (e.g. creating jobs, increasing wages and skills, paying taxes, procuring supplies of inputs, giving customers better value and more choices, and contributing to the fabric of the local community by a variety of philanthropic activities).¹⁷

We provide technical assistance to portfolio companies' management teams to improve their financial and cost controls, source new customers and markets, adhere to relevant quality standards, and access industry experts to advise on operations and expansion strategies.

That said, we monitor and evaluate the portfolio companies to ensure that even the most financially successful investments continue to meet the development priorities of the Fund and provide the social benefits sought through the original investment thesis. This is critical for managing investor expectations given that our investors stipulate ESG norms and development impact in their investment parameters.

Design and Manage Governance to Make It Easier to Achieve a Fund's Objectives

As impact investing funds move from the donor world to the investment world, they need to seek appropriate business models and develop strict investment discipline and strong financial controls. Several aspects of governance are critical to achieving double-bottom-line performance. At a high level, the legal structure and governance should protect the mission of the organization. On a day-to-day basis, sound governance practices should ensure clear investment policies and processes. Finally, the importance of full accountability and transparency could not be overestimated in giving confidence to investors.

SEAF is structured as a non-profit with a mission-focused charter and binding investment policies that stipulate the scope and target of investments. SEAF's board of directors ensures the mission is central to charting the organization's direction. Besides SEAF's own board, each individual fund's board and shareholders provide additional oversight and governance necessary to keep the fund manager on track and aligned – both through financial incentives for risk-adjusted investment returns, and from an investment policy standpoint whereby approval is given only to investments meeting the developmental parameters.

We make it a priority to meet all fiduciary obligations to our investors and have developed strong financial controls and reporting. We perform regular valuation of fund investments and provide investors with quarterly reports on their investment status.

Strong focus on its development mission, strict investment discipline and commitment to transparency has enabled SEAF to attract diverse investor base and grow assets under management. SEAF is a SEC-registered investment adviser, which further signals to investors its commitment to prudently manage capital, and with full understanding of fiduciary obligations.

As assets under management in impact investments grow, more fund managers will become registered and regulated by governmental or industry bodies. Meeting regulatory requirements will in turn lead to the further professionalization of the impact investing sector. It is a virtuous circle that starts with the fund manager ensuring appropriate fund governance practices. This eventually will lead to more capital flowing into impact investing.

Conclusion

While the desire to produce both financial returns and development impact can create occasional tension, the challenges of achieving a healthy balance can indeed be reduced by consciously developing an approach and structure that allows an organization to pursue both goals effectively. First, the importance of working with investors who are aligned with the dual mission and take each aspect of it seriously cannot be understated. Second, the investment team must be able to define, measure and incentivize non-financial success. Third, it should be understood that social and development impact flows from financial success when the impact delivery vehicle is a private sector company. And finally, creating a corporate governance structure conducive to double-bottom-line investing can help tie all activities together.



4.7 Impact Investing through Advisers and Managers who Understand Institutional Client Needs

By Harry Hummels, Managing Director, SNS Impact Investing

Key Insights

- Impact investing does not have to be “finance first” or “impact first”; it should be “professional first” and require the same degree of professionalism in investment decision-making as traditional investing does. This “professional first” approach allows asset managers to meet the fiduciary responsibility of institutional investors.
- A structure with clear governance and division of tasks between the fund manager and the investment adviser can serve as an effective business model for asset managers of institutional capital.
- Availability of adequate investment opportunities and lack of liquidity of impact investments are major concerns for institutional investors – but they can be mitigated.
- Defining impact in a way that is appealing to institutional investors is key to successful marketing of impact investments.

Introduction

With a net asset value of nearly €400 million as of 2012, SNS Impact Investing¹⁸ is the world’s third largest foreign-private-capital provider of microfinance after responsAbility Investments AG (Switzerland) and Oikocredit¹⁹ (Netherlands). SNS Impact Investing invests in microfinance institutions (MFIs) across the globe through the SNS Institutional Microfinance Fund I (Fund I) and the SNS Institutional Microfinance Fund II (Fund II). The investments are made on behalf of institutional investors aiming for attractive financial returns while adding social value.

Since its inception in 2007, Fund I has provided more than 256 loans to 123 MFIs totalling approximately €850 million²⁰. Fund II has provided 184 loans to 99 MFIs totalling €260 million since its launch in November 2008. In addition, the Funds have equity stakes in six MFIs.

SNS Impact Investing is responsible for structuring funds, fund governance, investment decision-making, monitoring the investment advisers, and constant communication and reporting vis-à-vis its participants. Once an investment decision is made, SNS Impact Investing works closely with investment advisers who source the investment deals, perform the due diligence on the investments, write investment proposals and monitor MFIs.

Fiduciary Responsibility: “Professional First”, not “Impact First” or “Finance First”

Investing on behalf of institutional investors requires taking into account their fiduciary responsibility towards their beneficiaries. In continental Europe, and particularly in the Netherlands, pension funds and insurance companies include a focus on their investees’ ESG performance. After all, institutional investors on the Continent increasingly want to invest in a world worth living in – now and in the future. Using the PRI as their framework, most European pension funds and insurance companies have integrated social and environmental aspects into their investment processes.

While open to foreign investors, Fund I and Fund II, both non-listed, closed-end mutual funds, are funded almost exclusively from Dutch institutional investors²¹. As these investors have fiduciary responsibility to invest the capital in the best interests of their beneficiaries, SNS Impact Investing is responsible for upholding that fiduciary responsibility. Satisfying fiduciary responsibility usually (but not always) means looking for a market-rate, risk-adjusted financial return. In 2009, the Monitor Institute qualified these investors as “finance first”, as opposed to foundations, family offices and high-net-worth individuals (HNWIs) who are seen as “impact first” investors. However, SNS Impact Investing’s institutional investors are likely to remark that they are “professional first”, not “finance first” or “impact first” investors.

“Professional first” investors seek investments that satisfy several aspects, in addition to achieving market-rate financial returns. First, these investors seek impact investing fund managers that demonstrate a convincing track record in the investment area. This means that the investors will be unlikely to invest in first-time offerings or in funds with a previously below-market-rate performance. In addition, these investors put much emphasis on cost-efficiency. In an environment where returns are under pressure, driving fees down becomes an important consideration for investors. Generating net annual returns of approximately 6%, adding value to microfinance institutions and clients, and charging the lowest fees in the market have helped SNS Impact Investing to convince investors that microfinance investments can make sense – even for institutional investors²².

Second, “professional first” investors seek the fund managers whose impact investment pipeline needs to meet the requirements of pension funds, insurance companies or mainstream asset managers. Most often, the constraining requirement is the size of the deal. Depending on the size of their investment portfolio, institutional investors will want to invest at least US\$ 40 million to US\$ 70 million per investment. To complicate things further, institutional investors often want to mitigate their risks by taking no more than a 20% to 30% share in the fund. As a result, impact investing funds targeting the institutional investment market must be able to accommodate at least US\$ 200 million to US\$ 250 million in investments. Apart from infrastructure, microfinance, responsible agriculture, renewable energy and clean tech investments, there are few categories that can absorb the size of capital disbursement brought by

institutional investors. However, the number of potential investments and investment funds that can accommodate the amounts required by institutional investors will grow rather fast in future years. In addition, new areas will emerge like large-scale water projects, or refertilization of deserts making them productive for sustainable agriculture. While such infrastructure projects focusing on societal impact are currently in their infancy, they will come to market quite rapidly.

Third, “professional first” investors seek fund managers who demonstrate their (potential) impact on the economy or community in which the investments will be made. Thus, in addition to information on the direct social or environmental outputs, investors increasingly require the fund manager to report on the outcomes of the fund’s investments. For microfinance, this means that apart from knowing how many microfinance loans have been provided to the poor and how many poor families have been given access to finance, investors also like to receive information on the effect of the loan provision on the well-being of microfinance clients.

The expectations of fiduciary responsibility have also evolved with the recent financial crisis. Influenced by the European Commission, the European Central Bank, national banks and other supervisory authorities, the focus on managing financial and non-financial investment risk has increased tremendously in the crisis’s aftermath. Basel III and Solvency II have had a clear impact on the risk perception of institutional investors and the conditions under which risks are deemed acceptable or not. Institutional investors need to demonstrate an understanding of and management control over their investments. Since impact investments are often made into illiquid, long-term investment funds, the question is what does it mean to be in control? At present, investors and fund managers are still working on new tools for managing risks in illiquid investments and for reporting on these risks to boards and supervisory authorities.²³

In short, the financial crisis significantly reduced the appetite among asset owners for high-risk, long-term and illiquid investments. As a result, institutional investors have changed their policies and introduced tighter risk management procedures. For SNS Impact Investing, this development has resulted in the fund manager introducing quarterly investor meetings and reinforcing its risk reporting. Issues like market development, local currency policy, operational risks or social risks are now discussed with investors on a regular basis.

Responsible Management: Working with Impact Investment Advisers

To select and monitor investments, SNS hired an independent investment adviser. SNS uses investment advisers to:

- Source investment deals
- Perform due diligence
- Write investment proposals
- Monitor MFIs once SNS Impact Investing’s Investment Committee has made the investment decision.

A structure with clear governance and division of tasks between manager and adviser can provide asset managers with an effective business model for impact investing. First, this structure prevents ‘deal blindness’, a common characteristic among investment managers performing both sets of tasks. Second, it ensures that the right expertise and oversight capabilities are working to provide maximum results in each step of the process. The fund manager employs portfolio and relationship managers with adequate understanding of the institutional investment and microfinance markets. The investment adviser employs specialists with expertise in sourcing, analysing and monitoring deals on the ground.

The process for selecting an investment adviser is similar to the process used by pension funds, insurance companies or professional asset managers. The evaluation of advisers focuses on their track record of returns, their capacity to deploy sufficient capital, a solid financial position and the quality of management. Once the adviser has been selected, fund manager and adviser operate on the basis of an “investment advisory agreement”, which stipulates the conditions the adviser has to meet before and during the contract period. These conditions usually refer to issues such as retaining key personnel and guidelines for selection, due diligence, and monitoring investments for financial, operational and social performance. Table 1 shows the division of roles between the SNS Impact Investing fund manager and the investment adviser.



Table 1: Division of Responsibilities between Fund Manager and Investment Adviser

Activities	Role of SNS Impact Investing Fund Manager	Role of Investment Adviser
Structuring & Marketing	<ul style="list-style-type: none"> – Provide legal and fiscal fund structure – Market and sell the fund 	
Investments	<ul style="list-style-type: none"> – Design investment policy – Evaluate investment proposals – Take investment decision – Design impact and responsibility policy – Monitor the fund – Monitor the investment adviser – Safeguard interest of participants against bias of investment manager – Maintain focus on investment targets 	<ul style="list-style-type: none"> – Identify investment opportunities – Investment due diligence – Investment and divestment proposals – Structure investments legally and fiscally – Add value to investments – Monitor the investments
Fund Management	<ul style="list-style-type: none"> – Governance – Treasury – Risk management – Impact and performance measurement 	
Administration & Reporting	<ul style="list-style-type: none"> – Day-to-day administration – Prepare interim and annual report – Value the fund 	<ul style="list-style-type: none"> – Administer and report performance – Value individual investments
Relationship Management	<ul style="list-style-type: none"> – Communicate with investors – Organize investor meetings – Provide additional services to investors 	

Active investment monitoring is essential to ensure the fund manager is ultimately in control throughout the investment lifecycle. SNS Impact Investing monitors and oversees the investment advisers in several ways. First, the team visits the investment adviser annually for two days of meetings with key personnel. Separate meetings are scheduled with the adviser's management board. Second, the team members will accompany the investment adviser on a site visit to perform due diligence on (prospective) investees. All relevant financial, social and operational matters are discussed in-depth during these visits, sometimes leading to adaptations of processes and activities. If the investment adviser does not meet key performance indicators of the investment advisory agreement, the fund manager can terminate the contract.

Conclusion

For SNS Impact Investing, to work in the best interests of institutional clients means to focus on realizing market-rate returns, while creating added value to microfinance institutions and microfinance clients. As we have seen with predatory lending, prioritizing high financial returns may result in undesirable social outcomes – not only for investees, but also for investors.

We understand that institutional investor behaviour is not guided by poverty alleviation, but by enabling the poor to manage their own financial affairs. By financing MFIs that are best situated to become commercially viable, we can serve the broader fiduciary interests of sophisticated and enlightened institutional investors while simultaneously serving the needs of microfinance clients. However,

commercial investors cannot – and will not – completely replace the role of public financiers who are best positioned to serve the needs of the poorest of the poor. Both public and private investors have their own responsibility to stimulate access to finance, and sometimes they can help each other in producing outcomes beneficial to all – to private investors, the general public and the clients of microfinance institutions.

By being focused on our investors' financial and social interests as well as their risk concerns, and having extensive discussions with them over the years, we have been able to develop a stable yet dynamic business model. In 2007, what it meant to be “professional” was clearly different from the meaning of the word today. Currently, asset managers and other service providers to institutional investors need to be constantly and fully aware of challenges their clients face. Moreover, they have to act on this knowledge. The model we have provided here aims to create and maintain a “professional first” approach to investing. This approach is relevant to fund or asset managers working with independent advisers, and to those performing both the fund management and investment management functions themselves.

5. Innovations for Unlocking Mainstream Capital



5.1 Social Stock Exchanges: Democratizing Impact Investing

By Durreen Shahnaz, Founder and Chairwoman, Impact Investment Exchange Asia (IIX)

Key Insights

- Social stock exchanges, which provide liquidity, transparency and efficiency, are mechanisms that can open up impact investment to retail investors, and make it more attractive to mainstream investors.
- Strict entry and reporting requirements for listing will help standardize impact measurement and highlight social investments as legitimate investment opportunities.
- Much work needs to be done to build a vibrant public impact investing market; the article provides a roadmap on how to develop enabling environment which includes issuers, investors, and an ecosystem within which they can interact.

Today, impact investing is still the field of a few; to participate directly often requires a “sophisticated investor”²⁴, given the potential illiquidity of the investments²⁵. There are few retail investment opportunities available on a broader basis²⁶ for several reasons.

First, too few social enterprises (SEs) are truly investment-ready. Major impact investing funds invest in only 1% of the thousands of socially conscious companies that they evaluate.²⁷ The low volume of deals results in high transaction and operational costs for all stakeholders, curbing the sustainability of trading platforms, impact investors and investees.

Second, measuring impact is more of an art than a science, as it is still the early days of creating quantifiable and comparable metrics. Tools such as the Global Impact Investing Rating System (GIIRS) and Impact Reporting and Investment Standards (IRIS) are steadily advancing standardized measurement and reporting.²⁸

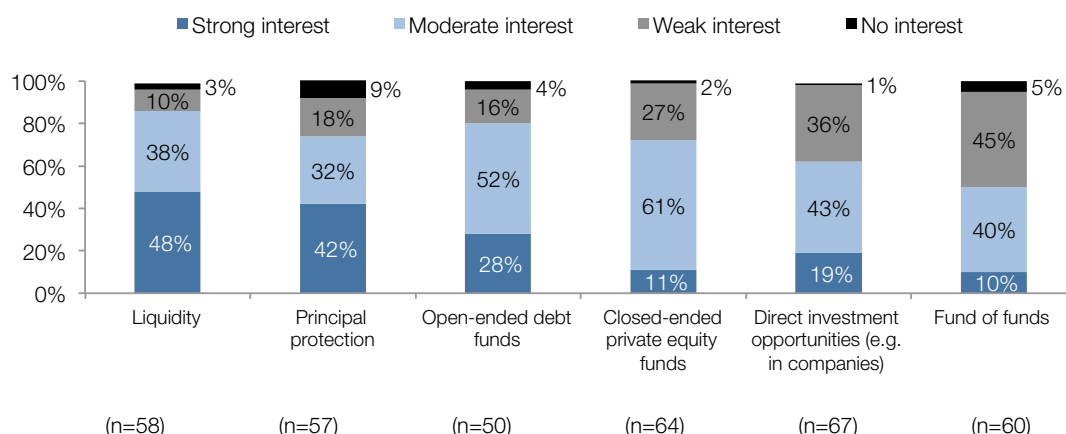
Third, legal concerns related to tax structures and uncertainties around exit strategies prevent impact investors from making investment decisions.²⁹ Tax issues become considerations in investment decisions because impact investments can be made into both for-profit and not-for-profit entities. As not-for-profit entities can benefit from special tax treatment in their local jurisdictions, such as 501(c)3 status in the US, tax implications of impact investments will need to be considered. On the flip side, if a 501(c)3 is investing in a for-profit SE, it will still have to pay capital gains tax. And, to retain its status, the organization will need to ensure that investments fit under its bylaw requirements and tax-exempt status.

While impact investing is still far from being an accessible opportunity for the general population, investor demand for greater liquidity (see Figure 12) and platforms such as Kiva and Kickstarter make it clear that the potential for involving retail investors in the sector is immense.

A social stock exchange, which can create a liquid market for private investments that generate social and environmental value, is one approach to unlocking a greater supply of impact investment capital.³⁰ From a demand side, social stock exchanges can enable SEs to access global mission-aligned investment from diverse investors. Moreover, a social stock exchange platform can accelerate the transition towards consistent and widely accepted social and environmental impact reporting.

Figure 12: Degree of Interest for Impact Investment Structures and Structural Features: Investor Demand for Liquidity in Impact Investments

Source: Global Impact Investing Network (GIIN), J.P. Morgan



Democratizing Capital Markets

Similar to regular stock exchanges, social stock exchanges operate by facilitating the listing, trading and settlements of shares, bonds and other financial instruments. However, alongside traditional financial reporting, impact issuers must comply with social and environmental impact criteria. Listing on a social stock exchange enables financially sustainable entities that address social and environmental issues, including SEs, non-governmental organizations, impact funds and inclusive businesses, to raise capital and expand their operations.

Social stock exchanges provide a mechanism for listed companies to raise capital through primary placements of securities, and liquidity to investors through secondary trading of securities. Moreover, for all those looking to make a difference, they provide the opportunity to purchase a security. Thus, these exchanges open up impact investment to retail investors, and make the field more attractive to institutional investors.

Evolution of Social Stock Exchanges

The notion of a social stock exchange has been developing for some time. In Brazil, the Bolsa de Valores de Sao Paulo (BOVESPA) was the first philanthropic donation arm of the Brazilian stock exchange. The South African Social Investment Exchange (SASIX) was a similar philanthropic initiative with the Johannesburg Stock Exchange.

A more recent initiative is London's Social Stock Exchange (SSE). Launched in June 2013, SSE exhibits information on socially responsible companies already listed on regulated stock exchanges. While shares cannot be bought or sold on SSE, impact information is available on the currently listed 11 companies.

In North America, Social Venture Connection (SVX), a Canadian platform endorsed by the Government of Ontario in 2008 and approved by the Ontario Securities Commission

in June 2013, recently had a public launch at the Toronto Stock Exchange and is now gearing up for issuances for small- and medium-sized social enterprises in Toronto. However, shares cannot be traded on SVX. It is a direct investment platform into not-for-profit entities.³¹

Launched in July 2013, Impact Exchange, a collaboration between Impact Investment Exchange (IIX) and the Stock Exchange of Mauritius (SEM), is the only full-scale social stock exchange with an ability to issue and trade shares and bonds of social enterprises from across the globe. Impact Exchange is the third market of the SEM and the only dedicated exchange board in the world for social impact investments.

The Mechanics of Impact Exchange

Impact Exchange works as a public trading platform, providing liquidity, transparency and efficiency while also ensuring that the social and environmental mission of the issuers is safeguarded and showcased.³²

Impact Exchange is operated by the SEM and regulated by the Financial Services Commission, Mauritius. The SEM provides infrastructure and regulatory oversight while IIX prescreens potential issuers on the impact eligibility criteria and provides recommendations based on this assessment to the SEM. IIX also monitors ongoing social and environmental listing obligations of issuers listed on Impact Exchange. All issuers must demonstrate positive social and environmental impact to be listed on Impact Exchange.

Impact Exchange will allow trading in securities (including shares and bonds) issued by social enterprises and by funds that invest in social enterprises. Social enterprises will be required to meet strict standards for disclosing information about their businesses (see Figures 13 and 14), their financial results and their social and environmental performance in accordance with the standards laid out in the listing rules for the Impact Exchange Board. The rules set out the minimum standards of behaviour to protect investors and ensure the market is fair, orderly and transparent.

Each entity intending to list on Impact Exchange will be required to appoint an authorized impact representative (AIR). AIR is an accredited social adviser who will provide support through the listing process and ensure that the issuer complies with impact requirements. The assistance of the AIRs will boost investor confidence through independent verification of the social and environmental impact of the issuer, and increased transparency. Figure 15 shows the issuer's steps to listing on the exchange.

AIRs include nominated impact advisers (NIA) and impact verification agents (IVA). Entities are required to appoint an accredited NIA for providing assistance and verifying the

impact nature of the applicant prior to listing. NIAs assist prospective issuers in preparing for listing, meeting the market transparency requirements and fulfilling other listing obligations. An accredited IVA must also be appointed to verify impact reports at the end of each financial year. Only organizations accredited by and recorded on the SEM Register may act as NIAs and IVAs for the Impact Exchange Board.

Impact Exchange-listed companies have a general obligation to disclose material information on a continuous basis and to release specific information periodically.

Figure 13: Overview of Impact Exchange Entry Requirements as per the Listing Rules³³

Source: IIX

Impact Requirements

<p>Primacy of social/ environmental purpose and intent</p> <p>Specific and clearly stated positive social or environmental impact as the primary reason for its existence</p>	<p>Clear purpose and theory of change</p> <p>Purpose and intent must be clearly articulated in a theory of change that forms the basis for performance assessment to demonstrate output, outcomes and social performance</p>	<p>Impact performance measurement and monitoring systems</p> <p>Commitment to the ongoing monitoring and evaluation of impact performance using clearly defined indicators of impact for performance assessment and reporting</p>	<p>Sustainable business model and market orientation</p> <p>Demonstrating a market-based approach to achieve its purpose and therefore able to provide returns on financial capital to meet the financial return obligations of its investors</p>
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Financial Requirements

<p>Published financial statements</p> <p>Published financial statements for at least one year before listing thereby meeting internationally accepted standards</p>	<p>Minimum market capitalization of US \$ 700,000</p> <p>Minimum market capitalization of US\$ 700,000 (or foreign currency equivalent)</p>
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Shareholder Requirements

<p>Minimum of 100 shareholders (for equity or funds)</p> <p>Minimum of 100 shareholders and 10% in public hands for a class of equity securities (or commit to achieving these targets within 36 months)</p>	<p>Minimum of 25 shareholders (for debt)</p> <p>Minimum of 25 shareholders for a class of debt securities (or commit to achieving these targets within 36 months)</p>
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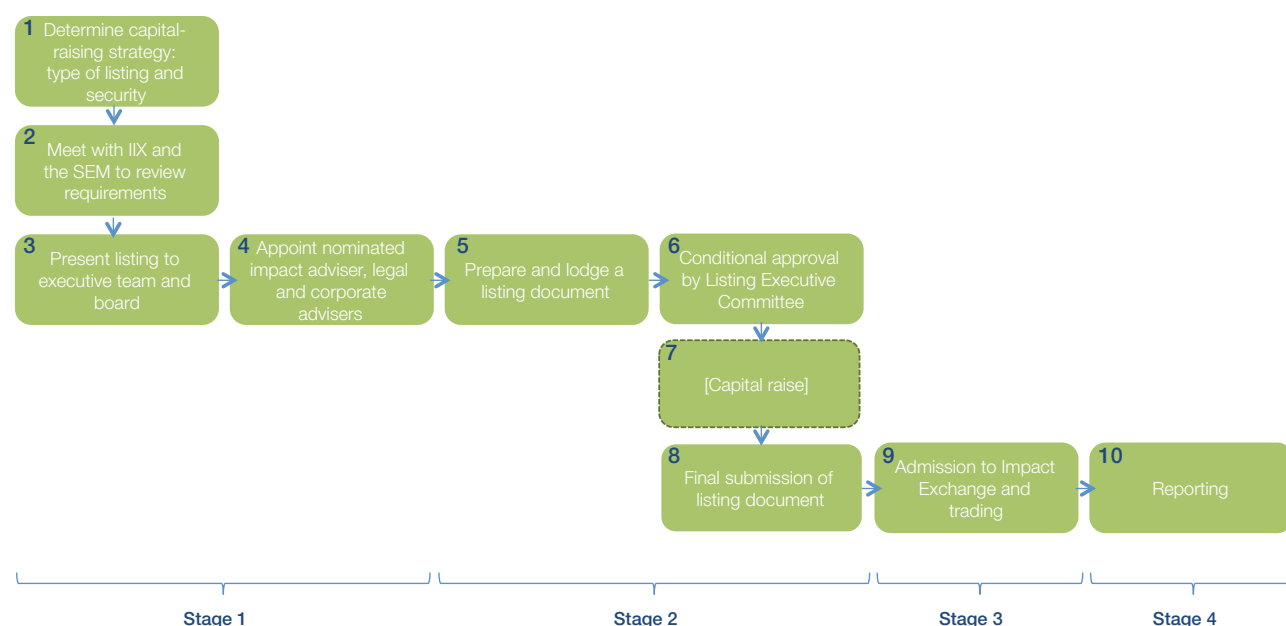
Figure 14: Ongoing Listing Obligations

Source: IIX

<p>Continuous Disclosure</p> <ul style="list-style-type: none"> Listed entities should immediately release to the market any information which could reasonably be expected to have a material effect on the price or value of their shares 	<p>Periodic Disclosure</p> <p>Entities listed on the Impact Exchange Board are required to submit certain reports at regular intervals:</p> <ul style="list-style-type: none"> Interim (quarterly) financial reports Half-yearly impact reports Annual financial reports Annual impact performance report verified by an accredited impact verification agent
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Figure 15: Issuer's Steps to Listing on Impact Exchange³⁴

Source: IIX



Impact Exchange Ecosystem

As with any regular listing process, professional advisers assist in legal matters, accounting, valuation and due diligence. While a vibrant impact investing ecosystem has started to emerge on a global and regional level, this ecosystem will need to be developed, and advisers will need to build expertise for (public) social capital markets.

AIRs are key players in this ecosystem; they work directly with the issuers to meet entry requirements and verify impact once an issuer is listed. As the market develops, more traditional capital market players will enter.³⁵

Investment banks, brokers and financial advisers will be key to moving capital to scale, providing the market information to attract and connect institutional and retail investors to SEs listed on the social stock exchange. Only with these market linkages in place can capital markets democratize, and individuals as well as institutional investors use their investment funds to contribute to larger social impact.

The Path to Developing a Vibrant Public Impact Investing Market

The development of the public impact investing market is poised for a quick take-off if concerted effort is made among intermediaries (investment bankers, advisers and investment platform operators), the ecosystem (lawyers, accountants and AIRs), policy-makers, issuers and investors. These stakeholders should use the road map of the following actions:

Develop strong investment opportunities

- Intermediaries need to work with potential issuers as well as investment and social advisers to develop a strong pipeline of investment opportunities.
- Advisers may also look to create innovative financial instruments that pool together the financial needs of a group of SEs in a certain sector, and structure a bond around that, such as the Water Bond or Health Bond.
- Policy-makers and foundations may seek to coordinate support for the first issuers and develop the templates for further issuances.

Develop an enabling environment for impact investing

An enabling environment encompasses a fluid ecosystem, a ready and able issuer, and willing and informed investors. For this to happen, much advocacy and education is needed as well as alignment of incentives among all the players. The list of priorities to initiate this virtuous cycle would be as follows:

- Educate the ecosystem on the specific characteristics of the public impact investment market and its potential to build early engagement
- Provide incentives for the ecosystem to engage with first listings
These incentives can be driven by DFIs, policy-makers or foundations that would like this space to get off the ground to help relieve their burden of developmental support over time.
- Educate and provide incentives (e.g. tax incentives) to retail and institutional investors to build awareness and steer investor behaviour

- Enable ease of access to impact investment opportunities for retail investors by engaging a broad range of global brokers
- Provide easier regulatory hurdles for issuances to be marketed in large retail and institutional markets such as the US and Europe
- Encourage institutional investors to play a role in moving the market for the issuances on the exchange
- Encourage consistent social and financial reporting based on listing requirements
- Work with information providers to establish information flows on investment opportunities and trading information between the market, ecosystem and investors
- Create the next generation of Impact Exchange participants by exposing them to simulation of the exchange academic institutions

Develop best practices and path to scale

- Evaluate and develop best-in-class reporting standards based on ecosystem, issuer and investor feedback
- Collaborate with intermediaries, ecosystem, service providers and policy-makers to share best practices
- Set up a task force, after demonstration effect of the first issuers, to develop and implement the roadmap to scale social stock exchanges – focused on replication of the Impact Exchange model
- Document the trials and successes in creating fully-functional social markets, and disseminate them to the public via media and academic institutions
- Encourage similar exchanges to be set up at the local level across the globe

Conclusion: Unlocking Mainstream Capital

Social stock exchanges ensure alignment of a company's social mission with the interest of its board and investors, making mission sacrifices that give way to higher profit margins a concept of the past. The first potential issuers – from mature SEs to international non-governmental organizations – are currently preparing issuances ranging from US\$ 10 million to US\$ 30 million for listing. These securities will unlock mainstream capital sources and give everyone a chance to invest in social good.

When floated on Impact Exchange in the next few months, the first issue will not only unlock mainstream capital for social investment, but also set the stage for democratizing capital markets – a much needed task for creating sources of equitable growth in the world.

5.2 Commingling Funds: Scaling Impact while Protecting the Interests of Diverse Capital Providers

By John Cox, Policy Adviser, Social Investment and Finance Team, UK Cabinet Office

Key Insights

- Commingling funds are an innovative form of partnership designed to achieve a financial return alongside a clear social impact, and to use their governance structure to define and protect the fund's social mission. For this reason, they can appeal to both philanthropic and more commercially sensitive investors.
- While establishing new structures in a nascent market can be costly and time-consuming, when set up correctly, commingling funds can multiply the impact of capital while preserving the interests of all contributors; this article provides strategic guidance.

Introduction

Commingling funds combine philanthropic with commercial capital. While they vary in terms of the target social outcomes and the way they are structured, they share several attributes: all commingling funds are designed to achieve a financial return alongside a clear social impact, and to use their governance structure to define and protect the fund's social mission. For this reason, they can appeal to both philanthropic and more commercially sensitive investors.

Philanthropic investors like trusts and foundations are using commingling funds to explore their distinctive role as investors. These funds enable foundations to leverage commercial capital that might not otherwise be invested for a social purpose by providing cornerstone investments and taking different risk positions. This allows the funds to achieve social outcomes at scale and address entrenched social problems that require large investment.

Commingling funds are typically structured in one of three ways, differentiated by the way in which philanthropic capital helps leverage commercial investment into the fund:

- **Pari passu** (literally “on equal footing”): In these funds, all parties invest on the same terms, taking the same risk in expectation of the same financial return. Philanthropic investors can act as principal investors in a fund, sometimes providing a cornerstone investment. In so doing, they give confidence to others to invest and so leverage investment from more commercial investors.
- **Risk-reward**: Investors take on different risk according to their motivation. Those with a focus on achieving social impact take a higher risk position in the fund but receive

a greater proportion of any financial returns. This reduces the investment risk for more commercially focused investors who receive a lower proportion of any financial returns.

- **But-for** (the commercial investors would not follow “but-for” foundations): Like risk-reward funds, investors also enter but-for funds on differential terms according to their motivations. Foundations and other impact-focused investors take a subordinate position in the fund, which means they accept a higher level of risk for a smaller proportion of any financial returns. They do this to attract commercially focused capital that otherwise would not be invested, and so create a fund to tackle an issue at a scale that otherwise could not be achieved.

In addition, commingling funds are a platform to share knowledge and skills. For example, the Gatsby Foundation invested directly into the African Agricultural Capital Fund and used its networks, knowledge and experience of investing in East Africa to attract major partners to the project, including J.P. Morgan and the Bill & Melinda Gates Foundation. In this case, the commercial investors are not only a co-investor of funds, but also a “knowledge partner” in investing in a new field.

Setting Up a Commingling Fund

By convening both capital and expertise, commingling funds play an important role in building social investment marketplaces. However, establishing a commingling fund can be costly and time-consuming due to the complications of establishing new structures in a nascent market, and the professional and legal costs which inevitably accrue. Commingling funds are often bespoke structures, being developed without the possibility of using templates as reference points. This can add an additional layer of time and cost to the development process.

For organizations thinking about setting up a commingling fund, the following four guidance points could be useful:

Guidance point 1: Build an economic case for the fund

Any investment fund needs to develop an economic case, whereby an assessment is made of the types of investments the fund will make and the expected returns. This analysis will ultimately determine how the fund is designed, in terms of whether a fund has a *pari passu*, risk-reward or but-for terms structure. Structuring a fund that has different investor “layers” is only necessary if one group of investors would not otherwise invest in the structure. Where a layered structure is chosen, however, it is essential to consider the fiduciary responsibilities of any charitable investors in the fund. In the UK, for example, any private benefits accrued as a result of charitable activity can only be “necessary and incidental” to furthering the charity’s objectives. Trusts and foundations must be able to justify the necessity of taking higher risk or subordinate positions in funds to leverage capital that otherwise would not be invested in the space.

Guidance point 2: Develop an investee pipeline

A key consideration for any organization looking to establish a commingling fund is the capacity of its potential investees to take on investment capital. Even in sectors with a robust investee pipeline, some investees may require business support and guidance to become investment-ready. For this reason, some funds have technical assistance facilities for the kind of activity that the UK Cabinet Office’s Investment and Contract Readiness Fund³⁶ carries out. These facilities, built alongside the fund, can help ensure that the fund has a strong pipeline of opportunities for investment. The facility attached to the African Agricultural Capital Fund (and funded by the United States Agency for International Development) is a good example of this in action. This facility provides investees with agricultural expertise and business and finance training to help sustain and improve their operation and commercial viability.

Guidance point 3: Create a governance structure that hardwires the social outcomes

A key draw for social investors is ensuring that the social outcomes they seek are hardwired into the design of the fund to avoid mission drift. Based on our research, this is usually achieved through a fund’s investment policy and governance structure. For example, the investment policy of the Bridges Social Entrepreneurs Fund³⁷ states that the fund can only invest in social enterprises with a clear social mission protected in their legal structures. The fund’s investment committee is therefore obligated to consider only investees that meet this criterion.

Measuring impact is equally important and can be done in different ways. The New York City Acquisition Fund,³⁸ for example, is able to measure its impact through the number of affordable housing units it creates or preserves, while the Big Issue Invest Social Enterprise Investment Fund³⁹ assesses social impact by using a performance measurement system developed in cooperation with Investing for Good, an impact investment advisory firm.

Guidance point 4: Choose a legal structure that can accommodate different classes of investors

Determining which legal structure is appropriate for a fund is an essential part of the fund-structuring process. In the UK, a number of commingling funds use an English limited partnership. While this is not the only legal form that UK funds can adopt (commingling funds could use a limited liability partnership structure, for instance), a limited partnership is attractive because it is a versatile entity well understood and recognized by a wide range of investors. It can also have flexible profit-sharing arrangements and could therefore be well suited to accommodate the different economic entitlements of different investor classes.

Where Next?

The cost of setting up a commingling structure can, in some instances, make it difficult to justify the economic case for a fund. Governments, however, can play a role in making it cheaper and easier to establish commingling funds.

The UK government has been working to establish a pilot commingling fund to test the barriers to creating these structures and establish what levers government has to break them down. It recognizes the value of commingling as a tool to generate social outcomes and hopes the guidance points set out above, and the lessons learned from the pilot process, will encourage others to follow its lead.



The UK Cabinet Office report *Achieving Social Impact at Scale* provides case studies on various commingling funds. Figure 11 is the case study of a fund launched after the report was published.

Figure 11: Impact Ventures UK

Overview:

- Impact Ventures UK is a commingling fund specifically created to provide growth capital for enterprises that benefit less advantaged people and communities in the UK, while targeting a 7% net financial return.

Social impact:

- The fund will focus on achieving positive social outcomes across eight sectors: education, jobs and skills, health and social care, housing and shelter, young people/children, community regeneration, social expulsion, and financial inclusion and access to finance/infrastructure.

Underlying investments:

- The fund will provide a mixture of equity/quasi-equity and debt to enterprises generating a positive social impact.
- Investment amounts will range from £0.5 million to £5 million.
- LGT Venture Philanthropy and Berenberg Bank will provide business mentoring for investees, in addition to growth capital, to help their business models scale successfully.

Structure:

- The fund is guided by an investment committee with experience in private equity, social entrepreneurship, philanthropy and building businesses.
- All investors have invested on a pari passu basis.
- Big Society Capital, the world's first social investment wholesaler, has committed initial seed capital of £10 million subject to the fund raising match investment on a 1:1 basis. LGT Venture Philanthropy has committed a further £2 million.

Key facts:

- Fund size: target a minimum of £30 million; first close minimum of £20 million
- Investor eligibility: the fund is open to well-informed private or institutional investors investing a minimum of £250,000
- Fund constitution: closed-ended SICAV-SIF vehicle domiciled in Luxembourg
- Fund manager: LGT Venture Philanthropy
- Term: 10 years, with two possible one-year extensions

5.3 The Social Impact Bond Market: Three Scenarios for the Future

By Tracy Palandjian, Chief Executive Officer and Co-Founder, Social Finance US; and Jane Hughes, Director of Knowledge Management, Social Finance US

Key Insights

- Social impact bonds (SIBs) are a novel way of finding economic solutions to social problems and, as such, have tremendous potential for channelling resources to programmes that work.
- Development of a mature, well-organized SIB market based on a solid infrastructure is still very much a work in progress.
- A roadmap outlines the steps needed to build a successful SIB market, where success is defined by a robust pipeline of SIB-ready projects, an ecosystem and a blended-value investor pool.

Social impact bonds (SIBs) are among the newest and most promising innovations within the impact investing space. As financial instruments that mobilize investment capital to tackle social challenges, they have the potential to create shared value – financial returns for investors, social benefits for underserved communities and individuals, and enhanced efficiency for governments and social service providers. Until their promise is demonstrated, however, the future of SIBs is far from certain.

How Do Social Impact Bonds Work?

- *A SIB begins with a social challenge.* Take, for example, the issue of prison recidivism in the US. Over the past 40 years, the country's total incarcerated population has grown by more than 700% to 2.24 million mostly minority and poorly educated men. After their release, 50% of former prisoners are unemployed and more than 50% will return to prison within three years.
- Based on a desire to ameliorate this problem, a *partnership forms* to include an intermediary, best-in-class service providers, government and investors.
- Partners agree on an *investment structure*, including desired programme outcomes. In the recidivism example, targeted outcomes could include the number of prisoners staying out of jail and finding gainful employment over a period of time.
- *Private investors provide upfront working capital to service providers.* The funds can be used, for instance, to scale up prisoner re-entry services, including workforce skills coaching, stable housing and employment services.
- Independent validators conduct a *rigorous programme assessment* to determine whether the target outcomes have been achieved.

- *Government pays back principal and provides a rate of return to investors* based on the programme's successful delivery of pre-agreed outcomes; if these outcomes are not achieved, investors risk losing their capital.

Social Finance UK launched the world's first SIB in 2010 to fund interventions aimed at reducing the rate of recidivism among ex-offenders leaving Peterborough prison.⁴⁰ In 2013, New York City launched the first US SIB in partnership with Bloomberg Philanthropies and Goldman Sachs.⁴¹ While many SIBs are in the pipeline, this is still the only SIB on the ground in the US today. In contrast, there are now 16 operational SIBs in the UK, and more are planned.

The reality is that the US SIB market is untested, with plenty of potential pitfalls and much work to be done before a stable and efficient market is in place. Demonstration and early-stage projects are getting underway, but the fundamental market ecosystem and infrastructure are in the process of being established. Participants still quibble over terminology (is a SIB the same as pay-for-success financing? Is a SIB really a bond?), while each SIB requires high levels of start-up and development costs. Serious doubts remain about the ultimate efficacy of SIBs and their potential to fund social interventions at scale.

At Social Finance, we recognize these challenges; indeed, we live them every day, but remain optimistic about the market's ability to learn and adapt so that it can reach its full potential. Nonetheless, we have identified three possible scenarios ("doors") for the US SIB market over the next decade, as well as a roadmap to market success.

Door Number One: Boom-Bubble-Bust

SIBs are the latest craze, but the heightened attention stands in sharp contrast to the modest number of transactions on the ground. In fact, in a recent survey of US market participants, we found that deep concern exists over the level of hype surrounding the SIB market.⁴³ Overblown expectations and deep pockets of misunderstanding are prevalent and threaten to derail the market's evolution if left unchecked.

Under this scenario, enthusiasm for the concept could lead to an influx of players over a fairly short period of time. Combined with a lack of education and the eagerness to get deals on the ground, poor-quality transactions could result. For the next few years, SIBs could look like the impact investing industry's version of "beanie babies" or "pet rocks" – a fad with lots of hype, high costs and little value. Poorly designed transactions, in turn, could taint the entire industry. For example, one SIB could result in a loss of capital for investors because of impossible-to-achieve outcomes or targets, or sloppy execution, while another could result in negative, unintended consequences.

The World Economic Forum report *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors* (September 2013) notes this danger within the impact investing sector as a whole: "A risk in attempting to

accelerate the supply of capital into impact investments is the potential for good capital to chase bad deals and potentially create a bubble.”⁴⁴ Overexcitement around SIBs, underestimation of risks and overestimation of returns could create just such a bubble in the SIB market, as too much money chases too few good deals. In the end, the bubble would end just as all of them do – with a painful pop. Investors would walk away, and the SIB concept would be relegated to the same historical attic as the telex machine.

Door Number Two: SIBs Are the Wave of the Future – and They Always Will Be

Under this scenario, the SIB market continues to limp along; it always appears promising but never comes close to realizing its potential. A small number of deals would be launched in the next few years, but each deal would be highly individualized, entailing high transaction costs. Heavy philanthropic support would be needed to subsidize these deals, which would never appeal to mainstream impact investors without substantial credit enhancements from charitable foundations.

This scenario mirrors to some extent the decades-long challenges of developing a large-scale market for social entrepreneurs. Hype and inflated expectations have characterized this market at times, especially when contrasted to the scarcity of viable, investable projects. It is often said that you can’t push on a string in financial markets; in other words, you can’t create impact investments unless investment-worthy entrepreneurs and business-builders are already on the ground.

In the SIB market, this would translate into a dearth of service providers with the capacity to scale up evidence-based work, and/or a dearth of government officials with the will or ability to engage in such work.

Door Number Three: A Successful Market for Social Outcomes

This scenario would feature a number of well-structured, well-managed projects that will prove the SIB concept in the next few years. These deals would lay the foundation for a much broader-scaled market, with appeal to blended-value investors beyond the philanthropic community. Within 5 to 10 years, SIBs would be a well-established, widely-accepted option for funding effective social interventions at scale.

Which Door?

What factors will determine which door to go through? There are two intertwined facets to this question: deal flow and investor demand.

Deal flow: The supply of high-quality, SIB-ready projects – or deal flow – is currently limited, and could remain limited due to a number of constraints:

- A lack of knowledge of SIBs exists among many government decision-makers, compounded by silos

across government levels and agencies, which hinder market growth.

- A lack of capacity among service providers is similarly constraining, especially in their ability to provide an evidence base of solid, measurable outcomes.
- Ideological objections about the role of private investors in funding social services can create caution and even negativism around the concept.
- Early-stage transactions have been defined by fairly narrow criteria, such as a five- to eight-year time span to measurable outcomes, and a relatively narrow focus on results that can be easily quantified.

Investor demand: Investor demand for well-designed SIB projects, while also not assured, may be less challenging than deal flow. A growing consciousness of social and environmental goals exists among the investor community, fuelling greater demand for blended-value investments. Examples illustrating this point include the following:

- According to its 2013 *Insights on Wealth and Worth*, U.S. Trust found that 6 in 10 wealthy individuals feel that they can have some influence on society by how they invest, and 45% agree that how they invest is a way to express their social, political and environmental values. Nearly half (46%) feel so strongly about the impact of their investment decisions that they would be willing to accept a lower return from investments in companies that have a greater positive impact. Moreover, the U.S. Trust study found that 44% would be willing to take on higher risk.⁴⁵
- SIBs are also a viable investment vehicle for foundations that engage in programme-related investments.⁴⁶ Such investments are an alternative way for charitable organizations to use their grant dollars or mobilize “the other 95%” of their funds to serve their mission, as well as earn financial returns.
- Investors, of course, are usually concerned with preservation of capital. As the SIB market learns and grows, better risk assessment and management techniques should bring perceived risk into line with actual risk around the preservation of capital. And, in the early stages of the market, philanthropic foundations may be willing to offer a guarantee of some portion of investors’ principal to attract private capital into the sector.

The Roadmap to Door Number Three

At Social Finance, we believe that the vision behind “door number three” can be realized. We also believe, however, that this future is by no means assured; to set it on this path, the market will need a steady supply of experience and learning from projects on the ground over the next few years. In particular, developments in three areas – a robust pipeline of SIB-ready projects, a market ecosystem and the blended-value investor pool – will be critical for setting the market on the path to success.

Importantly, this proposed action plan requires coordinated work among all market stakeholders. Market research and education, as well as the development of widely-accepted standards, will only be effective if intermediaries, financial institutions, government representatives and leading service providers pool their efforts. In all likelihood, this coordination will only occur if spearheaded by an industry network leader – suggesting that cohesion around an industry-wide network is the all-important first step in any action plan.

Build a robust pipeline of SIB-ready projects

- Educate and drive service providers to incorporate rigorous data collection practices and assessment of outcomes into their work
- Broaden the scope of potential SIB applications to encompass longer-term and more widely varying areas such as early childhood education, health and family services
- Support the growth and development of strong market intermediaries with the ability to launch and manage well-designed SIB programmes

Action points

- Launch demonstration projects to prove the concept of prevention-based interventions in early childhood, health and family services
- Design projects that incorporate both payments for long-term social value and payments based on savings within the investment horizon, to accommodate longer-term interventions with high social value
- Conduct educational outreach to service providers, investors and government, including publication of research and analysis, webinars, training sessions on pay-for-success principles, data collection and analysis

Build a market ecosystem

- Commit to high standards of transparency and information-sharing among market participants
- Ensure that foundations remain engaged in the market to provide leadership and expertise
- Develop a new regulatory framework for impact investing and SIBs

Action points

- Create, at the federal level, new divisions at the Internal Revenue Service (to develop tax policy) and SEC (to define the role for non-profit intermediaries as separate and distinct from that of broker-dealers)
- Help to build the pool of impact investment capital by providing guidance on fiduciary duty for institutional investors, and incentivizing foundations to increase their use of programme-related investments

- Create a federal insurance fund to backstop state governments in the event of a failure to appropriate
- Enact “full faith and credit” legislation at the state level to address appropriations risk
- Create a legal working group, at the level of the American Bar Association, to develop a legal and legislative framework and standard contracts for SIB transactions

Build the blended-value investor pool

- Engage leading financial institutions in the design and distribution of SIBs to mainstream impact investors
- Reduce transaction costs, through scaling up and standardization, to provide higher returns for investors and government
- Explore risk-sharing models to distribute risks among stakeholders, align incentives and enhance efficiency

Action points

- Research and develop models for management and pricing of SIB risks associated with performance, data, sovereign immunity, financial markets, demographic shifts, reputation, force majeure and legal contracts
- Create templates for contracts, private-placement memoranda and other legal documents to reduce transactions costs and perceived risk for SIB investors

SIBs: A Work in Progress

The field of impact investing is far more established than the narrower subset of SIBs; microfinance and community investing, for example, are decades-old. The development of a mature, well-organized SIB market based on a solid infrastructure is still very much a work in progress. We have learned valuable lessons from impact investing pioneers, and continue to learn and evolve with every demonstration project and every deal. These lessons, properly applied, should guide us on the path to “door number three” – a successful financial market for social outcomes.



6. Road Map: Next Steps for Mainstreaming Impact Investing

By Jed Emerson, Chief Impact Strategist, ImpactAssets

In many ways, more is “known” about the successful execution of an impact investing strategy today than in years past. Clearly, diverse practices and actors are coming together under a banner of impact – and now, each stakeholder community has work to do. The path to success is not guaranteed, however. Table 5 offers a road

map of the actions that should be considered by various actors with the potential to influence the development of impact investing and traditional finance in the next years. While these are currently discrete stakeholder groups and strategies, they will combine in the future to advance a single, integrated approach to investing capital for financial returns and impact.

Table 5: Road Map for Mainstreaming Impact Investing

Stakeholder	Recommendations
Policy-makers	<ul style="list-style-type: none"> – Engage market stakeholders – Develop government capacity for action – Build market infrastructure and capacity – Prepare impact funds for growth – Create enabling environment to support movement to private capital – Review and refine impact investing policy experience
Institutional Investors	<ul style="list-style-type: none"> – Explore ways that definitions/regulations of fiduciary responsibility may be revised and/or redefined to capture greater value – Promote the variety of ways that consideration of “impact” may be executed within traditional portfolio management – Promote practices for effective due diligence of impact investing funds
Impact Investment Fund Managers	<ul style="list-style-type: none"> – Adopt common reporting practices, such as IRIS/GIIRS – Engage asset owners as anchors for new investment strategies – Collaborate with investees to promote better performance measurement practices
Intermediaries	<ul style="list-style-type: none"> – Work to “connect the dots” between related investment areas – Promote total portfolio investment strategies with asset owners – Advance collaborative public-policy strategies with impact investors – Engage institutional investors in creating new investment platforms
Development Finance Institutions	<ul style="list-style-type: none"> – Develop more effective communications strategies to share best practices pioneered by DFIs over past decades – Engage more directly with foundations, family offices and institutional investors to explore strategic co-investment opportunities – Work to more effectively link DFI capital with public and foundation capacity-building capital
Foundations	<ul style="list-style-type: none"> – Commit to total portfolio management to make use of every investment asset class for creating impact – Fund field-building, sector-based and general infrastructure development within impact investing – Work to structure philanthropic capital investments as catalytic capital assets
Asset Owners and Family Offices	<ul style="list-style-type: none"> – Manage capital for total performance that integrates social and environmental factors in pursuit of financial returns – Seek out innovative financing opportunities in partnership with impact investment fund managers – Report on performance and investment experience – Demand that mainstream investment advisers and banks offer impact products/strategies on their platforms – or transfer assets to those that do
Retail Investors	<ul style="list-style-type: none"> – Purchase products such as community investment notes to demonstrate market demand for impact investment options at the retail level – Engage with crowdfunding platforms to move money to impact – Advocate for retirement plans to offer impact/SRI options to investors

These steps forward are all elements for advancing impact investing over the years to come.

Impact investing gathers together many aspects of traditional financial practices combined with a variety of community, development and environmental finance strategies. The numerous impact investing practices of the past are becoming the common, integrated investing practice of the future.

Diverse financial strategies may be applied to advance social and environmental value creation, while at the same time, social and environmental factors may be seen to impact the ability of traditional investment strategies to generate financial returns.

Traditional investors are recognizing that unrealized, “off-balance-sheet” liabilities represent a real threat to their ability to make a simple financial return. By not considering such factors as global climate change, pandemics and educational levels of national workforces, investors are placing their portfolios at risk. However, by engaging with stakeholders in addressing those factors, they are advancing their own interests and those of society.

The awareness of the power of managing portfolios for total performance – for financial returns woven with social and environmental impacts – is bringing not only new capital to market, but advancing a new vision of investing to generate sustained and blended value.



7. Acknowledgments and About the Authors

World Economic Forum Project Team

Michael Drexler, Senior Director, Head of Investors Industries
Abigail Noble, Associate Director, Head of Impact Investing Initiatives
Marina Leytes, Project Manager

Editors

Abigail Noble, Associate Director, Head of Impact Investing Initiatives, World Economic Forum
Marina Leytes, Project Manager, World Economic Forum
Ann Brady, Head of Editing, World Economic Forum

The project team would like to offer special gratitude to members of the Reviewing Committee:

Reviewing Committee Members

Joel Bryce, Manager, Monitor Deloitte
Elizabeth Coston, Manager, Impact Investing Initiative, Kellogg School of Management
Patrick Elmer, Head of Responsible Investment and Philanthropy Services, Credit Suisse
Jacob Gray, Senior Director, Wharton Social Impact Initiative
Saurabh Lall, Research Director, Aspen Network of Development Entrepreneurs (ANDE)
Jenna Nicholas, Executive Assistant to Chairman, Calvert Foundation
Wayne Silby, Chairman, Calvert Foundation
Betsy Zeidman, Adjunct Fellow, Milken Institute

World Economic Forum

Jean-Pierre Rosso, Chairman, World Economic Forum USA
Hilde Schwab, Chairperson and Co-Founder, Schwab Foundation for Social Entrepreneurship
David Aikman, Managing Director, Head of the New Champions
Robert Greenhill, Managing Director and Chief Business Officer
Sarita Nayyar, Managing Director and Member of the Managing Board
Richard Samans, Managing Director and Member of the Managing Board
Michael Drexler, Senior Director, Head of Investors Industries

Special thanks to the Investors Industries team for their support throughout the project: Erik Classon, Maha Eltobgy, Peter Gratzke, Alice Heathcote, Tik Keung, Marina Leytes, Irwin Mendelssohn, Abigail Noble, Megan O'Neill, Jason Rico and Dena Stivella

With gratitude to our collaborators across the World Economic Forum: Jennifer Blanke, David Bustamante, Tiffany Chan, John Cunningham, Manju George, Cynthia Hansen, Lucy Jay-Kennedy, Kamal Kimaoui, Marjo Koivisto, Katherine Milligan, Michele Mischler, Paul Smyke, Jonathan Quigley, Mark Schulman, Terri Toyota, Dominic Waughray and Andrea Wong

About the Authors

This publication synthesizes contributions from the following individuals whom the project team would like to thank for generously contributing their time, energy and insights:

Christoph Birkholz, Co-Founder and Managing Director, Impact Hub Zürich, Switzerland Christoph Birkholz is Co-Founder and Managing Director of Impact Hub Zurich and founding Chairman of the global Impact Hub Fellowship Association. Alongside his entrepreneurial career, he researches impact investing and entrepreneurship at the University of St Gallen and INSEAD. Birkholz received a Master's degree from Witten/Herdecke University, Germany. He is an alumni of the INSEAD Social Entrepreneurship Program, member of the Sandbox Network and the Young Global Shapers Community of the World Economic Forum.

Mildred Callear, Executive Vice President of Small Enterprise Assistance Funds (SEAF) and member of the SEAF Board of Directors

Mildred Callear has over 25 years' experience in the emerging market investment arena. She is involved in investment and corporate policies, fund establishment and implementation, and participates in investment committees and boards of SEAF funds. Callear serves on the Executive Committee, and SEAF is a founding member of the Aspen Network of Development Entrepreneurs (ANDE). Prior to joining SEAF, she served for almost 20 years with the Overseas Private Investment Corporation.

Catherine H. Clark, Director of CASE i3 Initiative on Impact Investing and Adjunct Associate Professor at Duke University's Fuqua School of Business
Catherine Clark created an impact investment fund in 2001 with Fred Wilson and Jerry Colonna of Flatiron Partners, taught and directed a research programme at Columbia Business School for 10 years, and helped develop the standards for B Corporations. She also serves as chair of Investors' Circle, and supports global health entrepreneurs as part of Duke University's Social Entrepreneurship Accelerator, a collaboration with the United States Agency for International Development.

John Cox, Policy Adviser, Social Investment and Finance Team, UK Cabinet Office

At the UK Cabinet Office, John Cox leads on commingling funds and the Office for Civil Society's £10 million Social Incubator Fund. He joined the UK Cabinet Office in 2012 after spending four years in Deloitte's Investment and Pension Consulting division. Cox has an MSc degree in Development Studies from the University of London's School of Oriental and African Studies.

Jed Emerson, Chief Impact Strategist, ImpactAssets

Jed Emerson is strategic adviser to high-net-worth families regarding development and execution of impact investing. He also acts as Chief Impact Strategist for ImpactAssets where he oversees intellectual property development and field-building efforts as an impact investment adviser, author and public speaker. He is chair of the ImpactAssets 50, an annual presentation of leading impact investment funds. Emerson has also held appointments at Harvard, Stanford and Oxford business schools and, among a large body of writing, has co-authored the book *Impact Investing: Transforming How We Make Money While Making A Difference*.

Jane Hughes, Director of Knowledge Management, Social Finance US

Jane Hughes has authored and co-authored numerous books and articles on international finance, including a leading international banking textbook and the forthcoming second edition of *Separating Fools From Their Money: A History of American Financial Scandals*. A former international corporate banker, she currently also teaches in the MBA programmes of Simmons College and Boston College (both Massachusetts, USA).

Harry Hummels, Managing Director, SNS Impact Investing

In addition to heading SNS Impact Investing, Harry Hummels is also European Liaison of the Global Impact Investing Network (GIIN), and Professor of Ethics, Organisations and Society at Maastricht University. He is a fellow of the university's European Centre for Corporate Engagement (ECCE) and the Caux Round Table. Before joining SNS REAAL in 2006, he was responsible for setting up and leading ING Bank Sustainable Investments for six years.

Astri Kimball, Senior Advisor for Policy and Operations, Overseas Private Investment Corporation (OPIC)

Astri Kimball came to OPIC after serving four years in the US White House, first as Deputy Director of the Office of Cabinet Affairs and, most recently, as Deputy Counsel to Vice-President Joseph Biden, where she provided guidance on the legal parameters around a number of international and domestic policy issues. She previously worked in the International Dispute Resolution and Strategic Counseling practice groups at O'Melveny and Myers, LLP and at Goldman Sachs.

Justina Lai, Associate Director, Sonen Capital LLC

Justina Lai serves as a member of the investment team, where she is responsible for developing portfolio strategies and for managing the full investment process for Sonen's private markets strategies. Lai has over 10 years of capital

markets, private equity and impact investing experience. She is co-author of *Evolution of an Impact Portfolio: From Implementation to Results*.

Manuel Lewin, Head of Responsible Investment, Zurich Global Investment Management

Manuel Lewin is the Head of Responsible Investment at Zurich Insurance Company, where he oversees the implementation of Zurich's Responsible Investment strategy. He joined Zurich Insurance Company in Zurich, Switzerland, in 2007 as an analyst in the Market Strategy and Macroeconomics team before becoming the Strategic Assistant to the Chief Investment Officer of the Zurich Group and Communications Manager for the Investment Management department.

Elizabeth Littlefield, President and Chief Executive Officer, Overseas Private Investment Corporation (OPIC)

Operating in over 100 countries, OPIC manages a US\$ 18 billion portfolio of financing and insurance to support private investment in sustainable economic development, especially in the world's poorest countries. From 2000 to 2010, prior to her appointment at OPIC, Elizabeth Littlefield was Director of the Private and Finance Sector at the World Bank and Chief Executive Officer of the Consultative Group to Assist the Poor (CGAP), a multi-door organization housed at the World Bank and created to help build a professional, global microfinance industry. Prior to CGAP, she was J.P. Morgan's Managing Director in charge of capital markets and financing in emerging Europe, Middle East and Africa, as well as J.P. Morgan's Head Debt Trader in Africa, Eastern Europe and Asia.

Will Morgan, Director of Impact, Sonen Capital LLC

Will Morgan leads the effort of portfolio impact measurement and evaluation for portfolio strategies and client accounts. He has over 12 years of impact measurement and evaluation experience, and focuses on the integration of Impact Reporting and Investment Standards (IRIS) throughout the investment process. Morgan applies IRIS evaluation rubrics for individual grant portfolios and international programme-related investment portfolios for some of the largest private foundations in the US and Europe. He is co-author of *Evolution of an Impact Portfolio: From Implementation to Results*.

Joshua Newman, Investment Analyst, Sonen Capital LLC

An investment analyst, Joshua Newman conducts manager research and due diligence, performs portfolio analysis and assists with portfolio management duties. Newman has written on the topic of municipal finance for climate change mitigation and adaptation. He is co-author of *Evolution of an Impact Portfolio: From Implementation to Results*.

Amy M. O'Brien, Managing Director, Global Social & Community Investing, Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF)

Amy O'Brien is managing director and head of Global Social and Community Investing (GS&CI) for TIAA-CREF Asset Management. She is responsible for the environmental, social and governance (ESG) criteria utilized in TIAA-CREF's Social Choice investment products and the firm's community and impact investing programmes. O'Brien has

17 years of professional experience in the field of socially responsible investing and the incorporation of ESG factors into investment decision-making.

Tracy Palandjian, Chief Executive Officer and Co-Founder, Social Finance US

Prior to co-founding Social Finance US in January 2011, Tracy Palandjian was a managing director of the Parthenon Group, where she established and led the Nonprofit Practice. She also worked at McKinsey & Co. and Wellington Management Co., and is a frequent speaker and writer on impact investing and social innovation. Palandjian co-chairs the US National Advisory Board of the G8 Social Impact Investment Task Force, and serves on the Board of Overseers of Harvard University and the Board of Affiliated Managers Group.

Raúl Pomares, Senior Managing Director, Sonen Capital LLC

Raúl Pomares is Co-Founder of Sonen Capital, where he leads the firm's overall investment and business activities, and maintains portfolio management responsibilities for select strategies. Pomares has over 20 years of portfolio management and investment advisory experience. He is an internationally recognized speaker, and has authored and contributed to numerous publications, most notably as co-author of *Evolution of an Impact Portfolio: From Implementation to Results and Solutions for Impact Investors: From Strategy to Implementation*, and supporting author to *Promoting Sustainable Food Systems through Impact Investing*.

Yasemin Saltuk, Director of Research, J.P. Morgan Social Finance

Yasemin Saltuk is Director of Research for J.P. Morgan's Social Finance unit, based in London. Her publications deliver analysis and data for institutional investors making or exploring impact investments. Prior to joining Social Finance, she covered alternative investments and then credit derivatives as a research analyst at the firm, where she and the team were ranked No.1 by Institutional Investor and awarded Risk magazine's Derivatives Research House of the Year.

Durreen Shahnaz, Founder and Chairwoman, Impact Investment Exchange Asia (IIX)

In addition to founding IIX, Durreen Shahnaz also founded Impact Investment Shujog, the capacity and awareness-building affiliate of IIX. Until recently, she was also an Adjunct Associate Professor at the Lee Kuan Yew School of Public Policy at the National University of Singapore, where she headed up the Programme on Social Innovation and Change. Shahnaz is a TED 2010 Fellow, a member of the World Economic Forum's Global Agenda Council on Social Innovation in 2011, and is on the advisory board for the CASE i3 Initiative on Impact Investing at Duke University's Fuqua School of Business.

Mitchell Strauss, Special Advisor, Socially Responsible Finance, Overseas Private Investment Corporation (OPIC)

Mitchell Strauss is Special Advisor for Socially Responsible Finance at OPIC. She is responsible for policy matters and origination of innovative financing structures designed to leverage socially responsible investment to achieve

sustainable projects in emerging markets. She collaborates with other US government agencies to assist in coordinating public funding to support socially responsible projects. Formerly, she was the Director of Credit Policy for the corporation at OPIC and held various positions in finance and banking.

Ben Thornley, Director of InSight, Pacific Community Ventures (PCV)

Ben Thornley directs InSight, the research and consulting practice at PCV. He leads a number of seminal projects and partnerships, including on fund best practices with the CASE i3 Initiative on Impact Investing at Duke University's Fuqua School of Business and with ImpactAssets, and on the role of policy with the Initiative for Responsible Investment at Hauser Institute for Civil Society, Harvard Kennedy School. He created the Impact Investing Policy Collaborative together with the IRI, and is collaborating with the World Economic Forum on the development of the Global Learning Exchange. He also advises clients including CalPERS, Citi, Annie E. Casey Foundation, and The California Endowment through PCV InSight's work.

Gavin E.R. Wilson, Chief Executive Officer (CEO), IFC Asset Management Company

Gavin Wilson has been CEO of IFC Asset Management Company since its founding in 2009. Previously, he was a managing director in the Investment Banking Division at Goldman Sachs, which he joined in 1996. IFC Asset Management Company, a wholly-owned subsidiary of the International Finance Corporation (IFC), manages third-party funds on behalf of institutional investors looking to invest alongside IFC in emerging markets.

David Wood, Director, Initiative for Responsible Investment (IRI) at the Hauser Institute for Civil Society, Harvard Kennedy School

David Wood directs the IRI's research and field-building work on responsible investment across asset classes, and currently manages projects on responsible investment strategy with pension fund trustees; mission investing by foundations; the changing landscape of community investing in the US; and impact investing and public policy. Prior to joining the IRI, he taught History of Ethics, including History of Economic Thought and Human Rights, at Boston University.

Endnotes

¹ *Independent Evaluation of IFC's Development Results 2009*, February 2009. Independent Evaluation Group (IFC), World Bank Group.

² See: www.equator-principles.com.

³ See: www.unpri.org.

⁴ The term “non-negative” is used to indicate, for example, a socially responsible investor that might employ some negative screening to exclude negative impact from a portfolio, but does not actively pursue positive impact. Readers should note that no particular correlation or relationship between impact, return and risk is implied.

⁵ To ensure the investment profile is not oversimplified, the use of this framework is advocated – whether in three dimensions or more – in conjunction with a more detailed understanding of the investments, and never on a stand-alone basis.

⁶ For a complete understanding of the strategies, principles and performance results, please see *Evolution of an Impact Portfolio: From Implementation to Results*, October 2013. San Francisco, CA: Sonen Capital, <http://www.sonencapital.com/evolution-of-impact.php>.

⁷ Sonen Capital was founded in September 2011, and therefore much of the performance commentary relates to investments made under the supervision of Raúl Pomares (with significant input from KLF) before the existence of Sonen Capital, and by an investment team that is different from that of Sonen Capital. There can be no assurances that Sonen Capital would have achieved similar performance, or that investments made by Sonen Capital in the future will achieve their stated objectives or avoid losses.

⁸ Godeke, S, Pomares, R. *Solutions for Impact Investors: From Strategy to Implementation*. Rockefeller Philanthropy Advisors, 2009.

⁹ The complete investment policy is available at <http://www.klfelicitasfoundation.org/> and depicted in *Evolution of an Impact Portfolio: From Implementation to Results*.

¹⁰ Base of the pyramid refers to the 4 billion people with annual income under US\$ 3,000 in local purchasing power. Hammond, A, Kramer, W, Tran, J, Katz, R and Walker, C. “The Next Four Billion: Market Size and Business Strategy at the Base of the Pyramid”. World Resources Institute, 2007.

¹¹ This article draws on the author's experience in venture capital; an 18-month, in-depth research projects in impact investing; and numerous conversations and observations in the industry over the past five years. The first draft circulated among impact investing professionals from leading funds for feedback. Admittedly, the methodology lacks scientific rigour, but the author hopes that it provides relevant new ideas and intuitive arguments that tend to get ignored elsewhere. The article should allow asset holders, advisers, entrepreneurs and policy-makers to develop a better understanding of the current state of impact investment fund managers' decision-making process.

¹² Throughout the article, the author refers to institutional impact investing fund managers as a) fund managers that raise and deploy capital from other asset holders, as opposed to, for example, business angels; and b) fund managers that intend to preserve or grow financial assets for their funds' investors while generating positive social and/or environmental impact. Grant making and purely commercial investors that may also generate positive impact as a residual effect, rather than as an intended ex-ante effect, are excluded. While impact investing is one approach among many, if not all, asset classes, the author's experiences that led to this article stem from impact investments in start-up and growth companies.

¹³ See: ImpactAssets Issue Brief. http://www.impactassets.org/files/downloads/ImpactAssets_IssueBriefs_4.pdf.

¹⁴ Detailed case studies on the 12 funds, and a complete synthesis of findings and recommendations, are available at: www.pacificcommunityventures.org/impinv2.

¹⁵ By investing in SMEs and catalysing their growth, revenues and productivity would increase and more employees would be added to local payrolls. Employee skills and experience would rise and wages would follow suit as employees become more valuable. This ever-widening and virtuous circle would help to meet humanitarian needs and reduce poverty.

¹⁶ This approach differs from a grant-based approach to achieving development outcomes, in which incremental grant funding may be possible even if initial efforts are not successful.

¹⁷ SEAF considers it an extra bonus if the nature of the business in which a SEAF fund directly invests also fulfils a social need such as affordable health care, clean energy, education and productive agribusiness – as so many of SEAF’s investments already do. Importantly, however, neither SEAF’s investment teams on the ground nor the entrepreneurs it invests in consider SEAF as engaged in “social” investment.

¹⁸ SNS Impact Investing is the impact investing arm of SNS Asset Management, the in-house asset manager of Dutch bank assurance company SNS REAAL.

¹⁹ Ranking is based on publicly disclosed information by the world’s largest microfinance investment vehicles (MIVs): responsAbility, Oikocredit, Blue Orchard, ASN Bank, Triodos IM, Incofin IM, and Symbiotics. DFIs such as the International Finance Corporation (IFC), UK Department for International Development (DFID), KfW Bankengruppe and FMO Entrepreneurial Development Bank may have larger stakes in microfinance than private MIVs. They are, however, working mainly with public money.

²⁰ This includes rollovers. In total, the SNS Institutional Microfinance Funds (SIMFs) have provided more than €1 billion in debt to MFIs, an indication of the long-term focus of both funds. With a seven-year investment horizon, the committed capital of €360 million has been made productive for, on average, 2.5 to 3 years per loan. Given that many loans were rollovers, SNS Impact Investing was able to establish a long-term relationship with its MFIs.

²¹ SNS Impact Investing deliberately decided not to focus on the retail market for several reasons. First, the fiduciary duty that SNS Impact Investing has vis-à-vis institutional investors is significantly different from that for retail investors. Second, institutional investors have patience and large buffers; unlike most retail investors, they are able to move risk across the investment portfolio. In light of the fact that both SIMFs do not have an option to liquidate the investment before the end of the fund life, this lack of liquidity may pose a problem to retail investors. Third, offering the funds to retail clients requires a marketing and sales organization that SNS Impact Investing – or SNS Asset Management – simply does not have.

²² SNS Impact Investing has been able to keep costs down precisely because of the clear division of work between itself and the investment advisers; this means that it works with a small team of professionals. In addition, it believes in scaling up with regard to both the number of investors and the number of investments. The total number of investors, which does not exceed 20, is easy to handle for a small team. Finally, SNS Impact Investing aims at providing somewhat bigger loans, thereby reducing transaction costs.

²³ The notion of liquidity is often discussed before an institutional investor decides on an investment. Many investors have a preference for liquidity, although it is not a requirement. In case the fund does not allow investors to liquidate an investment before the end of the fund’s life, the investors want to be compensated adequately in terms of an “illiquidity premium”.

²⁴ Sophisticated investors are eligible to participate in private placements under the relevant laws of their jurisdiction of residence. In Singapore, an accredited investor is an individual whose net personal assets exceed SGD 2 million or whose income was at least SGD 300,000 in the preceding 12 months, or a corporation with net assets in excess of SGD 10 million as per its most recently audited balance sheet.

²⁵ *Perspectives on Progress: The Impact Investor Survey*, 2013. J.P. Morgan and the Global Impact Investing Network (GIIN).

²⁶ Several mutual funds exist, such as Calvert Funds (US), responsAbility (Switzerland) or Ethex (UK).

²⁷ Triolo, P. “Are Social Stock Exchanges the Great Equalizer to Democratize Development Finance?” Devex, 15 July 2013.

²⁸ Ibid.

²⁹ Lee, A. “Impact Exchange: How It Will Change Investing”. *International Financial Law Review*, June 27, 2013.

³⁰ Triolo, P. “Are Social Stock Exchanges the Great Equalizer to Democratize Development Finance?” Devex, 15 July 2013.

³¹ Anwar, T. “Social Stock Exchanges: A Global Perspective”. *Social Enterprise Buzz*, 10 September 2013.

³² See: <http://impactexchange.asiaix.com/>.

³³ Impact Exchange Board Listing Guide.

³⁴ Step 7 applies only to companies seeking to raise capital through listing.

³⁵ There have been early movers, such as Daiwa Securities Group, which has raised over US\$ 5 billion to date for SRI funds and social bonds.

³⁶ The Investment and Contract Readiness Fund supports social ventures to build their capacity to receive investment and bid for public service contracts. Grants from £50,000 to £150,000 are available on a rolling basis to ambitious social ventures that will go on to raise at least £500,000 in investment, or that want to bid for contracts of over £1 million.

³⁷ *Achieving Social Impact at Scale: Case Studies of Seven Pioneering Co-mingling Social Investment Funds*, May 2013. London, UK: UK Cabinet Office. <https://www.gov.uk/government/publications/achieving-social-impact-at-scale>.

³⁸ Ibid.

³⁹ Ibid.

⁴⁰ See: http://www.socialfinance.org.uk/sites/default/files/SF_Peterborough_SIB.pdf.

⁴¹ See: <http://www.frbsf.org/community-development/publications/community-development-investment-review/2013/april/rikers-island-social-impact-bond/>.

⁴² For more information about SIBs and how they work, see the Social Finance US website at www.socialfinanceus.org. The Nonprofit Finance Fund and Center for American Progress also have excellent online resources for those who wish to learn more about SIBs, at www.payforsuccess.org and <http://www.americanprogress.org/series/social-impact-bonds/view/>, respectively.

⁴³ “Foundations for SIBs: How and Why Philanthropy Is Catalyzing the Development of a New Market”. Social Finance US, to be published in January 2014.

⁴⁴ *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*, September 2013. p. 6. Geneva, Switzerland: World Economic Forum.

⁴⁵ *U.S. Trust 2013 Insights on Wealth and Worth*, available at <http://www.ustrust.com/ust/Pages/Insights-on-Wealth-and-Worth-2013.aspx>.

⁴⁶ Programme-related investments are loans and equity investments that foundations provide at favourable rates to support activities having a direct charitable purpose.



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World Economic Forum
91–93 route de la Capite
CH-1223 Cologny/Geneva
Switzerland

Tel.: +41 (0) 22 869 1212
Fax: +41 (0) 22 786 2744

contact@weforum.org
www.weforum.org