

# Social Metrics in Investing: The Future Depends on Financial Outperformance and Leadership

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## Introduction

In order to truly unlock the potential of the impact investing industry, social/environmental metrics must be directly connected to financial outperformance. When above-market rate—or premium—financial returns are present, large fiduciaries such as public pension plans (who globally hold a total of \$23 trillion in assets), are able to invest and the impact investing market will move beyond its current niche. Products and services that present solutions to the increasing constraints on natural resources and unmet basic human needs will be a major driving force for our economy. While there will be numerous investment opportunities that claim both premium financial returns and social/environmental benefit, non-financial metrics will enable us to distinguish the “pretenders” from the “real deal.”

The scale of the emerging opportunity in alternative energy alone is immense. As John Doerr of Kleiner Perkins Byer & Caulfield stated in September 2010, “The energy market is \$6 trillion, worldwide, with 4 billion users of electricity. It is the mother of all markets. Compare that to the internet economy, estimated at \$1 trillion worldwide with 1.5 billion users.” Many many more asset owners – including pension plans, foundations and families – express interest in the long-term sustainability of their investments.

In order to move forward and succeed in developing appropriate metrics and measurements, we need leadership from all parts of the investment ecosystem, but most specifically asset owners, intermediaries, and businesses. While the growing demand for impact investments presents an opportunity to leverage large capital for social and environmental good, it will never replace the critical role of governments, philanthropy, and community development to bridge the gap that addresses challenges that cannot be met by market mechanisms.

## Impact Investors: Growing Demand and Divergent Interests

Impact investments seek to generate financial returns while also creating social and environmental value across all asset classes. Attention on this emerging industry has grown over the last few years as asset owners have been searching for alternatives to the “traditional” financial markets, which collapsed in 2008-2009. In addition, asset owners are interested in exploring how impact investments can play a role in responding to current global crises – the floods in Pakistan, the Gulf oil spill, the earthquakes in Haiti – as well as ongoing chronic crises such as poverty and climate change. Impact investing has been featured in prominent news coverage during 2010, including the *New York Times*, the *Wall Street Journal*, and the

*Financial Times*. It has also been the subject of several recent notable publications, including *Investing for Social and Environmental Impact*, *Solutions for Impact Investors: From Strategy to Implementation*, and *Philanthropy's New Passing Gear: Mission-Related Investing*.

The potential size of the market is large: Global pension plans alone represent \$23 trillion in assets compared to US foundation assets of \$550 billion. The high net worth market (defined by Merrill Lynch and CapGemini as investors worth more than \$1 million) is valued at \$39 trillion. As a result, impact investing represents the single biggest opportunity for capital to unleash the power of the private sector and of entrepreneurial innovation to solve some of society's toughest challenges.

Impact investors, however, bring a wide range of divergent interests and priorities. Just as there is a continuum of expectations for financial returns (ranging from premium to sub-market rate), there are also degrees of expectation for social and/or environmental impact (ranging from a large degree of alignment to values and/or mission to very little). The market is in early stages and this continuum has no clearly accepted or delineated categories of "high" or "low." Thus, beauty is truly in the eye of the beholder. Given the many motivations and preferences, social and environmental metrics enable investors to understand if their expectations are being met on social and environmental criteria. Finding a way to measure social and environmental impact is essential for providing a mechanism through which investors can assess, compare and make investments as well as for tracking progress and making course corrections where needed. This is not unlike standard financial benchmarks, where it is clear whether or not one is above, at, or below expectations. If we can truly bring together the development of these metrics with above-market rate returning investments – and better yet show how these metrics create positive financial value – then impact investing will be poised to unlock large dollars and enter the mainstream.

### **The Importance of Defining the Relationship between Metrics and Premium Returns**

The development of metrics is important for beginning to explore how and whether social and environmental metrics are drivers of financial outperformance. If such a link can be established, then capital will undoubtedly begin to flow into the field, first from investors looking for returns and secondly as additional products begin to mimic the successful impact investments. As the cycle continues, investors will be able to compare strategies and products, and determine which ones are of the highest quality. The result is a higher bar and standard for practices in impact investing in particular, and for investing in general. It is at this point that the social and environmental measurements will play a crucial role in differentiating the products that are "pretenders" from those that are truly making a difference.

Today, there are a few products that can make investors money and create the desired social/environmental value in selected issue areas. Tomorrow, we envision products that make investors money because of their social and environmental benefits. There are at least three obstacles to this vision becoming reality: 1) the depth and breadth of investment products; 2) messaging and marketing these products; and 3) translation of externalities into meaningful financial measurements.

The most well-known impact investments tend to be either private equity funds that range from \$50-250 million in assets under management or public equity/fixed income investments that hold \$1.5 billion or less in assets. While many of these funds are doing groundbreaking work, their size naturally limits the amount of capital that they are able to invest. There are two paths to increasing the size of the investments: enable the current managers to grow their assets under management, or enable “traditional” fund managers who manage more than these amounts in capital to incorporate some of these criteria into their investments. Both operational excellence at the level of institutional asset management and on-the-ground know-how of these investments are critical to moving impact investing beyond its current niche.

Messaging and marketing these investment products continues to be a challenge for two reasons. First, the current dominant paradigm says that one invests money to earn the greatest return and then to give away the “excess” for philanthropic motivations. Until this understanding shifts to a new paradigm that recognizes that investments can create the highest returns and social and environmental benefits, investment managers need to choose their messaging carefully. If they do not address standard traditional financial language to which institutional investors are accustomed, then they run the risk of being perceived as products that are not “true investment grade.” If the products emphasize the social and environmental benefits or thesis without tying it to investment returns, then they may be miscategorized as philanthropic. Second, although the dominant paradigm is evolving, change is still slow and uneven. To be successful at raising new funds under the current paradigm while transitioning to this new paradigm, managers must know their audience. Angels, high net worth families, foundations, pension plans, corporations, and other investors have different structures, cultures, values, financial return criteria and asset allocation strategies which dictate their investment decisions. Thus, it is not surprising that there are currently no clear best practices for presenting investment solutions to impact investors. There is an emerging trend for some institutional investors to require transparency from investment managers to disclose externalities, including their reporting about the use of environmental, social, and governance (ESG) factors. Likewise, the Carbon Disclosure Project (CDP) is creating a platform for corporations, investors, and governments to transparently measure and report their greenhouse gas emissions and climate change strategies. According to their website at the time of this publication, the CDP is currently acting on behalf of 534 institutional investors holding \$64 trillion in assets under management, and some 60 purchasing organizations. However, reporting ESG factors and participating in the CDP and other initiatives is currently voluntary.

As local, state and national governments advance policies that require the efficient use of natural resources and implement limits on greenhouse emissions and other pollutants, standard financial reporting requirements will be expanded to include these sustainability factors, their associated business risks, and planned mitigations. Many companies will also be able to develop assets by integrating sustainability factors into their innovation processes, supply chain management, distribution channels, and brand management. The future disclo-

sure of these externalities - whether mandated by accounting standards or adopted by companies to create their competitive advantage - will enable investors to evaluate how companies and investment vehicles are balancing short-term profitability and long-term viability, all in pursuit of shareholder value.

### **How do we move forward?**

Leadership is critical to overcoming the obstacles we outline above and in furthering the link between social and environmental metrics and their contribution to premium returns. We need to start with leadership from three key and interrelated groups:

*Asset owners* play the critical role in demanding financial returns and social value measurement and transparency, given that it is their money that is being put to work. In addition, asset owners may lead the development of nonfinancial metrics in three ways: 1) voicing in clear terms their desire for them; 2) sharing openly their criteria for investment decisions; and 3) pushing for the integration of premium financial returns and social/environmental returns. Ultimately, asset owners lead by investing their capital when the investment product meets their criteria. Whether in small or large amounts, as a separate carve out or not from their traditional investment strategy, the most important thing is to start. Only by doing so will we be able to begin to compare investments, determine which ones meet standards on both financial and nonfinancial levels, share learnings, and advance the field.

*Businesses (potential portfolio companies)* working on the ground may have the clearest picture of current opportunities for social and environmental impact – and profit. In order for businesses to tap into potential investment from impact investors, these entrepreneurs must develop and articulate proof of premium financial returns, articulate a disciplined approach to unlocking value, and demonstrate their ability to create impact. To fulfill on the latter, a robust measurement methodology, a disciplined approach to gathering information related to social and environmental impacts, and excellent reports back to investors are required.

*Intermediaries* (consultants, advisors, and investment managers) play a crucial role in bringing the asset owners and businesses together. Whether funds or funds of funds, investment managers and financial advisors must work closely with portfolio companies in order to define a comprehensive investment thesis, including a clear articulation of what impact different investment levels will achieve and how this will be measured. They need to facilitate the conversation, and match the values, interests, and investing structures of asset owners with opportunities for impact. Finally, in order for the impact investing industry to grow and succeed, the entire field of intermediaries will also need to grow and evolve so that there is the breadth and depth of professionalism in the field to seek and measure both financial and nonfinancial returns.

## Conclusion

Currently, only a small set of asset owners, typically families and foundations but increasingly large pension plans as well, place their capital in impact investments. While additional funds from families and foundations may be brought in if there is a systematic way of understanding how much impact the investment generates, impact investing will remain a niche market until large pension plans and other institutional players adopt impact investing. In order for that to happen, premium financial returns must be coupled with social and environmental returns. In the best case, social and environmental performance is directly linked to the creation of outperformance.

An additional challenge is that investment managers do not have a financial incentive to gather the appropriate metrics. Tracking social and environmental metrics is more work, more costly, and is not straightforward. Additionally, the current incentive structure for investment managers and consultants is designed to reward only financial performance. In order for impact investing to succeed, social and environmental metrics must be demanded by asset owners, and the reward system needs to be adjusted so that managers and consultants are incentivized to collect and provide social and environmental metrics. The right policies may be one potential solution for setting the stage. For example, investors have an incentive to engage in impact investing if tax deductions for microfinance investments are enacted.

The impact investing industry is at an important juncture. There is an opportunity to attract major financial investments into the space by weaving financial and social/environmental gains together. What we need now is leadership – to develop the social and environmental metrics, report them transparently, link them to financial outperformance, and shift the fundamental rewards structure of the investing field.

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**Georgette Wong** is the CEO of the Take Action! Impact Investing Conference series and a leading speaker on trends in impact investing. Founded in 2007, Take Action! is the pre-eminent gathering of impact investors focused on premium returns. This by-invitation only community is composed primarily of asset owners from families, foundations, major pension plans and corporations. Together, these industry leaders exchange stories of success and failures, debate ideas and investments, and make the connections they need to move to their next level of success. The 2010 event brought together investors representing \$4.1 trillion.