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Impact Investing: A Framework for Decision Making

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Impact investing, through which investors allocate capital to market-based (i.e., profit-oriented) solutions to social and environmental challenges—in contrast to philanthropic or political solutions—has garnered increasing attention over the last decade. Emblematic of this interest was the More for Mission Campaign, launched in 2007 to encourage foundations and other institutions to commit more of their portfolios to mission-driven investments.[1] A key attraction of impact investing is its potential scalability: solving a social or environmental problem through an investment in a profitable enterprise generates profits that both provide and attract more resources to address the challenge than solving it through spending alone.

As we have noted in the past,[2] investors' pools of capital have always been means to ultimately social (and/or environmental) ends[3]—however those ends are defined by a particular institution or private investor—and we believe that investors should consider impact investing as another tool to achieve mission objectives. Impact investing enables investment assets to *directly* achieve an organization's[4] social return goals while *also* facilitating spending, the traditional means through which pools of capital have contributed to an organization's mission.

However, maximizing desired social returns through an optimal blend of spending and impact investments can be challenging for two reasons. First, incorporating impact investments within the context of a long-term investment pool's (LTIP's) risk allocations requires careful thought given the often limited size and idiosyncratic nature of the impact investment opportunity set available to a given investor. Second, building an impact investment allocation within an LTIP is a multi-disciplinary exercise, requiring an oversight team with both investment and social return expertise and performance evaluation tools.

Accordingly, this paper provides a decision-making framework to help investors successfully build impact investing portfolios within the context of their LTIPs. We begin with a deeper exploration of the nature of impact investments, to highlight both what they are and why they may be attractive, as well as some of the central challenges that will need to be considered in the selection of these assets. Then, building on the investment decision-making stages in Cambridge Associates' Risk Allocation Framework, we explore the key questions that impact investors need to resolve as part of their Enterprise Review, Policy Setting, Implementation, and Monitoring processes.[5] Our central thesis is that impact investors should strive to be as specific as possible in articulating their impact investment social return objectives, while at the same time taking a more opportunistic, "bottom-up" approach to impact investment selection and allocation. Indeed, as investors seek to do "more" of "it" (i.e., impact investing), a key first step is for them to be clear about precisely what "it" means to them so they can better, and continually, assess how much "more" of it they can or should do.

[1] In May 2012, the More for Mission Campaign merged with the PRI Makers Network to form a broader organization called Mission Investors Exchange. For more background on Mission Investors Exchange and the history of its two predecessor organizations please see www.missioninvestors.org.

[2] Please see our 2007 report, *Social Investing*, p. 5.

[3] Going forward, the terms "social" and "social return" will be used as umbrella terms intended to encompass all social and/or environmental issues and outcomes that may be of interest to an investor.

[4] In this paper we use the term "organization" in a very broad sense, referring both to institutions as well as to private investors (families, individuals, etc.).

[5] For a more detailed description of Cambridge Associates' Risk Allocation Framework, please see our 2013 report *From Asset Allocation to Risk Allocation: The Risk Allocation Framework*.

Impact Investments: Definition, Promise, and Challenges

What Is an Impact Investment?

Impact investing is a tricky term to define, particularly when taken at face value. First, as we have argued in the past, *all* investments have social and environmental impacts,[6] so whatever definition is used for the term must help clarify what differentiates "impact investments" from any other investment. Second, although institutions have been engaged in impact investing for some time,[7] the term "impact investment" has come into prominence only over the last decade or so.[8] Without an "official" dictionary definition, the term is used in different ways in practice. (See "Are Impact Investing and Socially Responsible Investing the Same Thing?" at the right.)

For the purposes of this paper, we define an impact investment as an investment made in an enterprise (whether a corporation, a non-profit, a government, or some other entity) because that enterprise offers a market-based solution to a social or environmental challenge *that the investor wishes to address*. The central point of emphasis in this definition is the *investor's intent*. In other words, an impact investment is one chosen by an investor precisely because of its ability to generate the particular social and/or environmental returns of interest *to that investor*.

[6] Please see our 2007 report *Social Investing*, p. 6, or our 2010 report *Environmental, Social, and Governance (ESG) Integration: For Performance, For Ethics, or For Both?*, pp. 5-6.
[7] The Ford Foundation made its first program-related investment, a type of "impact investment," in 1968. See www.fordfoundation.org.
[8] In our 2007 report *Social Investing*, we originally referred to these investments as "Proactive Investments." Our language (as well as our thinking) has evolved over time!

Are Impact Investing and Socially Responsible Investing the Same Thing?

The terms "socially responsible investing" and "impact investing" both refer to selecting investments in part because of their consistency with an investor's social and/or environmental objectives. However, in practice the terms have different nuances in meaning. Specifically, "socially responsible investing" generally refers to an investment process that reflects an investor's *ethical commitments*. In contrast, "impact investing" tends to refer to the decision to invest in enterprises that offer *market-based solutions to a particular social or environmental challenge of interest to the investor:*

Some have tried to draw a distinction between the two by claiming that socially responsible investing focuses primarily on "negative" screening while "impact" investments are more "positive" and actually have, well, "impact." In our experience, socially responsible investing can include both "positive" and "negative" screening and can have an impact, so this simple distinction between the two does not work well in practice.

Our focus on investor intent as a defining characteristic of an "impact investment" has several important implications.

- Impact investments do not correspond to any particular asset class, and can theoretically be made across all asset classes.
- Impact investments are not constrained to any particular social return objective. The spectrum of social return objectives that impact investments *might* address is as broad as the social return objectives of the investors that seek to address them.[9]
- Just as social return objectives can vary, so, too, can financial return objectives. Some investors may be comfortable accepting "below-market-rate" returns from their impact investments if they believe the

[9] Whether there actually are impact investments that *can* address a particular social return issue is another question.

investment's *social* returns will adequately compensate them for any expected shortfall in the investment's *financial* returns relative to other investments of comparable risk. Other investors fully expect their impact investments to generate "market-rate" returns, i.e., returns that are competitive with investments of a similar risk profile made without regard to their social impact.[10]

- Our focus on investor intent as a defining characteristic of an "impact investment" also implies that the intent of the money manager chosen by the investor is *not* a defining characteristic. In other words, a portfolio investment could be considered an "impact investment" even if the money manager to which investment decision making is delegated is indifferent to the social returns.[11]

To bring the concept of "impact investing" to life we provide several examples of impact investments made by a variety of organizations in "Impact Investing Examples" on the following two pages.

Why Impact Investing?

Investors are drawn to impact investments in large part because the resources that can be brought to bear to address the investor's social return goals could be larger if investments are used to this end rather than relying on charitable spending alone. There are two reasons why this might occur.

First, assuming the investments are indeed profitable, the profits thus generated would help expand the financial resources available to the investor to address the social issue of interest. In contrast, if the investor simply spent an equivalent amount to address the issue in question its financial resources would be reduced.

Second, if an investment's returns are competitive with those of other investments with a similar risk profile, the investment may attract other investors that are indifferent to the social returns and are instead focused solely on its monetary return potential. As a result, the funds directed to addressing this particular social or environmental issue could be larger than those that could be marshaled solely through appealing to others' charitable motives.

Thus, these investments could potentially provide profitable, and thus sustainable and scalable, approaches to solving social and environmental problems.

What Are Common Challenges?

While the promise of impact investing is clear, investors pursuing this space also frequently face a common set of challenges.

Narrow Opportunity Set. *In theory*, given our definitional focus on investor intent, what *could* constitute an impact investment is not constrained by any asset class, social return issue, monetary return expectation, or the intent of a given investment manager. *However, in practice, what actually will constitute an impact investment for a given investor may very well be quite constrained.*

As many organizations tend to have fairly focused missions, the range of potential investments that specifically address those missions is likely to be similarly narrow. The constraints

[10] For a helpful schematic that reflects a holistic view of social and financial risk/return trade-offs, please see our 2012 report *The U.K. Social Investment Market: The Current Landscape and a Framework for Investor Decision Making*, pp. 15-17.

[11] Because impact investors often require their money managers to measure investments' social and monetary returns, these managers often share, or at least acknowledge, the investors' social missions. Otherwise the manager would be unlikely to devote the resources necessary to prepare the *social and environmental performance* reports often requested by impact investors.

Impact Investing Examples

Below we offer several brief descriptions of investors and representative impact investments they have made. The examples encompass a range of organization types, social and environmental return objectives, asset classes, and monetary return expectations. Our descriptions couple the investor with the investment, rather than describe the investments in isolation, to emphasize that the investor's intent, rather than any intrinsic property of the investment itself, is what justifies the investment's "impact" descriptor.

Accion's Investment in Compartamos Banco. Accion is a private non-profit organization whose mission is to give people the financial tools they need to work their way out of poverty. Accion relies on several funding sources, including its own foundation assets as well as public and private donations. According to its 2012 financial statement, Accion had $310 million in net assets.

In 2000, Accion made a $1 million investment in Compartamos Banco, a Mexican microfinance institution. Since its inception, Compartamos Banco has served mostly female entrepreneurs by providing microloans for a variety of economic activities, including food trade, handicraft production, and farming. Accion made investments through assets in its Gateway Fund, a pool that stands separately from its foundation and was funded through donations from the U.S. Agency for International Development (USAID)[1] and the Consultative Group to Assist the Poor (CGAP)[2] to provide equity capital to microfinance institutions. Accion's $1 million investment enabled it to acquire an 18% stake in Compartamos Banco.

In 2007, Compartamos Banco offered roughly 30% of its equity in an initial public offering, through which Accion sold half of its 18% stake, resulting in net proceeds of $135 million.

Annie E. Casey Foundation's Investment in the Corporation for Supportive Housing. The Annie E. Casey Foundation (AECF) is a private foundation "dedicated to helping build better futures for disadvantaged children in the United States."

In October 2011, AECF made a $2 million below-market-rate loan to the Corporation for Supportive Housing (CSH). CSH helps communities create permanent affordable housing with services to prevent and end homelessness. According to AECF, among the overall homeless population, certain subsets—at-risk youth, formerly incarcerated individuals, and vulnerable families—face multiple unique barriers to housing stability, putting them at greater risk for long-term homelessness. Permanent supportive housing (PSH) that includes case management, assistance with education and job training, and avenues for self-improvement can help these groups. CSH will re-lend AECF's loan to nonprofit affordable housing developers for acquisition and predevelopment costs associated with permanent supportive housing projects. In AECF's view, providing safe housing for vulnerable families can enable the children in those families to have better outcomes in behavior, school, and life.

The AECF loan carries a 3% interest rate and a ten-year term.[3] Largely because the investment was made primarily to advance AECF's mission rather than to generate income and capital appreciation, it meets the Internal Revenue Code's definition of a "Program Related Investment" or PRI. As such it could be counted toward the Foundation's 5% annual distribution in the year it was made. Further, the principal that remains outstanding in subsequent years will not be included in the pool of assets upon which the Foundation's 5% distribution requirement is calculated going forward. Thus, the PRI is effectively "carved out" of the portfolio's overall asset pool.[4]

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[1] USAID is the U.S. government's development institution. Its stated mission is to carry out U.S. foreign policy by promoting broad-scale human progress at the same time it expands stable, free societies, creates markets and trade partners for the United States, and fosters good will abroad. For more information, see www.usaid.gov.

[2] CGAP is an independent policy and research center dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions, and offers advisory services to governments, financial service providers, donors, and investors.

[3] The terms and background of AECF's loan were provided to Cambridge Associates directly from AECF.

[4] For an in-depth primer on PRIs, see "Strategies to Maximize Your Philanthropic Capital: A Guide to Program Related Investments", Linklaters and TrustLaw, April 2012. The document is available on the Mission Investors Exchange website at www.missioninvestors.org.

F. B. Heron Foundation's Investment in Huntington Capital III. The F.B. Heron Foundation (Heron) is a private philanthropic institution dedicated to helping people and communities at the bottom of the economic and social scale in the United States to help themselves. Recently, Heron has placed the creation of jobs for lower income communities as a mission priority. Heron is one of the most well-known advocates for mission-related investing and is striving to put 100% of its endowment assets in mission-related investments.

In 2012, Heron committed to Huntington Capital III, a mezzanine debt fund. The fund will invest a substantial portion of its capital in businesses with several of the following characteristics: limited historical access to traditional capital sources, located in low- and moderate-income areas, employ ethnic minorities and women, and operated or owned by ethnic minorities or women. The fund is targeting a mid-teens net internal rate of return (IRR).

Mercy Investment Services' Investment in Fonkoze. Mercy Investment Services (MIS) provides the asset management program for the Sisters of Mercy and its ministries. The Sisters of Mercy is "an international community of Roman Catholic women religious vowed to serve people who suffer from poverty, sickness and lack of education with a special concern for women and children."

MIS continues the work of the Mercy Partnership Fund, which was formed in 1995 to make investments that benefit the economically poor, especially women and children. The portfolio is diversified across geography, organization type, and investment type, though it primarily consists of low-interest debt instruments. For instance, for ten years the Mercy Partnership Fund has supported Fonkoze, Haiti's largest microfinance organization. Fonkoze offers financial services to Haiti's rural poor. Mercy's loans to Fonkoze support a fund that makes capital available to very poor women to enable them to build small businesses. Mercy's loans to Fonkoze typically do not charge interest.

OPIC and Sarona. The Overseas Private Investment Corporation (OPIC) is the U.S. government's development finance institution. OPIC's goal is to mobilize private capital to help solve critical world challenges and, in doing so, advance U.S. foreign policy. OPIC achieves its mission by providing investors with financing, guarantees, political risk insurance, and support for private equity investment funds.

In March 2011, OPIC issued an "Impact Investment" call for proposals, through which it solicited proposals from private equity funds whose investments could deliver "social and environmental benefits to emerging markets while at the same time generating profits." In October 2011, OPIC approved $285 million in financing to six funds, including the Sarona Frontier Markets Fund 2.

As noted on OPIC's website, Sarona is a fund-of-funds that targets funds that invest in frontier countries with per capita GDP of less than $12,000. These underlying funds will invest in sectors such as water, health care, education, access to finance, and sustainable agriculture.

Private Investor's Investment in Lyme Forest Fund III. A high-net-worth family with a keen interest in investments that offer solutions to environmental challenges committed capital to Lyme Forest Fund III (LFF III), a private equity timber fund managed by The Lyme Timber Company. LFF III invests in timberland and rural real estate with conservation attributes. The Fund hopes to simultaneously preserve and monetize these conservation attributes. In addition, the fund will allocate a portion of its capital to ecosystem projects, such as wetland and endangered species mitigation banks, the credits from which can be sold. LFF III is targeting a net IRR of 8% to 10%, and the manager's investor-base includes both impact investors and traditional investors.

that mission objectives place on an investor's universe of impact investment opportunities could play out in a variety of ways. For example, for some investors, suitable impact investments—if they are available at all—may only be available in certain asset classes (e.g., debt or private equity) while for others they may be limited to a particular geographic region or economic sector. As a consequence, the narrowness of the impact investment opportunity set, which is a function of a given investor's social return objectives, will be an important consideration when determining the size of the portfolio's allocation to these investments. We will discuss this issue in more detail later.

Unproven Strategies. Quite often, the challenges investors seek to address through impact investments have no "easy" solutions—otherwise they would not still be challenges! There are at least two reasons why these challenges remain unresolved.

First, potential market-based solutions continue to remain experimental and have therefore not yet been proven to be viable. Second, if viable solutions are available, they may not yet have achieved sufficient scale to adequately address the problem.

In our experience, many (but certainly not all) impact investments fall into the first category. As a result, they are relatively unproven, either with respect to the strategy's overall track record, the management team's experience in implementing it, or both.

Small and Illiquid Investments. Consistent with the nascent nature of the "sectors" impact investors often target, many (but again, certainly not all) impact investments are relatively small in scale and illiquid (i.e., privately, rather than publicly traded) in nature.

Added Level of Diligence. By definition, impact investments have combined financial and social return objectives. As a result, the team responsible for selecting and monitoring these investments will need to have an interdisciplinary skillset to help ensure that both financial and social objectives are met.

How Can the Promise of Impact Investing Be Realized?

Clearly, impact investing offers great promise, but is not without considerable challenges. The promise, of course, is the potential to achieve an investor's social return objectives *directly* through portfolio investments themselves, while also generating a financial return and (thereby) potentially providing and attracting additional capital to address the social issues of interest. But the challenges are also formidable, since the impact investment opportunity set for any given social return objective is often narrow, and the actual investments are frequently unproven, illiquid, and require interdisciplinary talent to diligence. So what is an investor to do?

The remainder of this paper highlights key questions investors will need to resolve as they move through the various stages of the investment decision-making process, from the enterprise review and policy setting stages to implementation and monitoring.

Impact Investing and the Enterprise Review

As we discuss in our Risk Allocation Framework report, an important element, and often a key first step, in developing any investment strategy is the Enterprise Review.[12] The Enterprise Review seeks to fully understand the organizational context in which the long-term investment pool, or LTIP, is embedded through a comprehensive examination of the organization's financial circumstances, risk attitudes, and governance issues. An important goal of the Enterprise Review is to better comprehend the relationship between the LTIP and the organization it supports and, relatedly, to uncover any constraints to which the LTIP should be subject. For instance, the Review should help clarify such issues as the organization's spending policy[13] and its dependence on LTIP distributions for its operating budget, tolerance for illiquidity in stressful economic environments, debt covenants, risk tolerance (broadly defined) of the organization's key stakeholders, and the relationship of its governance structure to the investment decision-making process, among many other factors.

Impact investing adds an interesting twist to analysis of the relationship between the LTIP and the organization. The key link between the two is typically the spending the LTIP facilitates. However, with impact investing, the investments themselves are intended to directly contribute to achieving the organization's objectives via the social returns generated by the enterprises that underlie those investments, while *also* supporting the organization through their financial returns and the spending distributions those returns help to facilitate. As a result, the imaginary wall that often seems to exist between an organization's investment operations and its mission activities becomes even more porous when impact investments are introduced.

Two questions in particular require further exploration when conducting an Enterprise Review for organizations contemplating impact investing:

- To what degree are the social returns that could be generated via impact investing interchangeable with those generated from spending?
- To what degree does the structure of the organization's investment oversight team facilitate selection and monitoring of the impact investment portfolio's financial and social returns?

We will explore each of these questions in turn.

Social Return Interchangeability?

Investors will need to determine what optimal blend of spending and impact investing will help them maximize their organization's overall social returns. Many may simply decide that spending will be their sole means of social return generation, either because no impact investments exist that adequately address the organization's social return objectives or because the organization does not have the resources or inclination to build out an impact investment program. As a result, these investors will focus their efforts on ensuring that the portfolio can support a spending stream that is as high, sustainable, and predictable as possible.

[12] For more background on the questions raised by an Enterprise Review, please see our 2013 report *From Asset Allocation to Risk Allocation: The Risk Allocation Framework*, pp. 10-11.

[13] An organization's spending policy provides guidelines for how much it can withdraw from its LTIP in a given year for grants, operating expenses, and other expenditures in support of its mission.

However, for those who do pursue impact investing, one key consideration is whether the social returns these investments generate are interchangeable with those generated by spending, or whether they are merely complementary. The more "interchangeable" they are, the more an investor may theoretically be willing to compromise spending targets—and by extension, the LTIP's financial return targets—if the impact investment–generated social returns could be expected to more than compensate for any reduction in spending these investments may cause. Clearly, such interchangeability could have important implications for portfolio construction, since it would lessen the imperative to build portfolios for the sole purpose of maximizing sustainable and predictable spending and potentially increase the organization's willingness and ability to pursue and experiment with impact investments. (See "Social Return Interchangeability: A Hypothetical Example" to the right.)

Of course, what may be defensible in theory may be difficult to implement in practice. Thus, an important issue to tease out during the Enterprise Review process is whether or not the organization actually has the legal or cultural flexibility to relax its spending requirements if it believes that the social returns its impact investments generate would compensate for any reduction in sustainable spending. In our experience, organizations differ greatly with respect to this issue.

For instance, U.S.-based private foundations, which are quite natural candidates for exploring impact investing, have relatively inflexible spending requirements as they are mandated by law to spend 5% of their endowment assets annually. Thus, assuming the impact investment does not qualify as a program-related investment (PRI) (and therefore cannot be

Social Return Interchangeability: A Hypothetical Example

A key part of the "interchangeability" calculus will depend on a factor largely out of the investor's control—the characteristics of the impact investment opportunity set available to that investor. Are the social returns these investments can generate truly similar in nature to those that otherwise would have been generated by spending—which would suggest doing one (spending) or the other (impact investing) and achieving very similar outcomes? Or will these two social return generation tools have different but complementary impacts, suggesting that both are needed to optimize results?

To provide a hypothetical example of an impact investment whose social returns truly are interchangeable with those that could be generated through spending, imagine an organization that spends 5% of its LTIP's corpus on charitable programs designed to build per capita wealth in a given community. Given these spending goals, the organization's leadership has sought to construct an LTIP that generates an 8% expected return—3% of which enables the portfolio's purchasing power to keep pace with inflation while the rest of the return (5%) is used for spending—4% on grants and 1% on the organization's operating costs.

Suppose, however, the organization learns of a compelling community development loan fund expected to generate a 4% return per annum. After thorough due diligence on the opportunity, the organization concludes that investing its entire LTIP in that fund would achieve higher per capita wealth in the targeted community than simply spending 5% of the portfolio annually. In this case, given both the complete interchangeability of the social returns generated by either spending or this impact investment opportunity, and the greater efficacy of the latter, the optimal course of action would be to invest 100% of the LTIP in the community development loan fund and cut spending from a rate of 5% per year to 1%. In so doing, the organization would achieve greater per capita wealth in the targeted community than through its original spending program, while also ensuring maintenance of the LTIP's purchasing power (and the organization's stability) into perpetuity.

removed from the asset base upon which the 5% spending requirement is calculated), a foundation will need to give very careful thought to how that investment will contribute to its ability to achieve its required spending rate while preserving the purchasing power of its assets over time.[14,15]

Contrast the regulatory mandate of U.S. private foundations with that of, say, the Overseas Private Investment Corporation (OPIC), the U.S. government's development finance institution (DFI). Like many DFIs, OPIC is specifically mandated to make investments that further the U.S. government's policy objectives. In other words, *its mandate is to achieve social return through its investments*, while (hopefully) ensuring that its operating costs are also covered by financial returns on those investments (rather than by U.S. taxpayers). Such a mandate clearly gives an institution like OPIC more flexibility to allocate capital to "impact investments."

Similarly, high-net-worth families also may have more flexibility with respect to their desired spending levels, and therefore may be able to build in greater scope for experimentation with below-market-rate or unproven strategies into portfolio design.

Thus, during the Enterprise Review, an organization should seek to determine where it fits along this spectrum of organizational spending flexibility. To what degree can the organization relax spending needs, if necessary, to make room for compelling impact investment opportunities whose social returns are interchangeable with those that spending could generate? The organization's degree of flexibility on this issue will be an important factor in the decision-making process for portfolio construction.

How Should the Investment Oversight Team Be Structured?

Another issue to explore during the Enterprise Review process is the skillset and depth of the team—including both in-house staff and external advisors—that will oversee the LTIP's impact investments.

Typically, those charged with overseeing the organization's investments (e.g., investment committees, staff, investment advisors) are distinct from those who oversee its programmatic efforts, creating a separation between those who strive to generate the institution's financial returns and those charged with generating its social returns. Impact investing, by its nature, requires oversight from both of these disciplines to assess whether a given investment opportunity meets the organization's social and financial return expectations. Thus, an organization that moves forward with impact investing will need to make sure that the team it puts together to implement these investments collectively has the multidisciplinary skillset to execute the allocation successfully.

Further, not only is this broader-based skillset a necessary prerequisite for impact investment success, it might also constitute a competitive advantage from an investment standpoint. Indeed, a multi-disciplinary impact investment team can leverage the organization's intellectual capital and networks to assist the investee, while also giving the team an informational edge relative to "conventional" investors who do not have the same degree of specialized domain knowledge.

[14] We presume here that the Foundation plans to exist into perpetuity.

[15] Further, even if the asset did qualify as a PRI, the foundation would still need to determine whether the social return of the PRI exceeded the social return that otherwise would have been generated had the capital invested in the PRI been used for charitable spending instead.

In addition to the breadth of the team's skillset, it is also important to look closely at the depth of due diligence resources at the organization's disposal. Depending on the uniqueness and specificity of what would constitute an "impact investment" for a particular organization, such investments may need to be direct investments in specific enterprises (such as an individual company), rather than, say, investments in funds (or funds-of-funds).[16] Even if the investments are made via investment funds, these funds, as noted previously, often have more limited track records and may be illiquid in nature. These relatively common attributes of impact investments suggest a need for impact investment oversight teams to have heightened due diligence capabilities in addition to a multidisciplinary skillset.

Setting Investment Policy for Impact Investments

Informed by the information gleaned through the Enterprise Review about the LTIP's relationship to the organization in which it is embedded, the next step in the Risk Allocation Framework process is setting investment policy. An LTIP's investment policy codifies the most evergreen aspects of the LTIP's objectives, constraints, and "role-in-portfolio" allocations. (For example, an endowment might choose to define those roles as "diversified growth," "deflation-hedging," and "inflation-hedging.") In our view, the investment policy is also an appropriate venue to clearly articulate the organization's objectives for its impact investments. However, as we discuss in more detail below, while we strongly argue for specifying the organization's social return goals for its impact investments, we would be cautious about being proscriptive with respect to allocation sizes and return expectations.

What Specific Social Return Goals Does the Organization Hope to Achieve through Impact Investing?

Investors should be as specific as possible about their social return goals for their impact investments. Impact investment policies that simply articulate a desire to include investments that have "positive social and environmental impacts" are challenging to implement satisfactorily, largely (and ironically) because *so many* investments fit this description, including a great deal that are likely to be in the "non-impact" assets in the portfolio.[17] Investment committees with very broad impact investing mandates

[16] For instance, one of the more well-known "impact investments," made famous in part by its greater than 100x return, was the $1 million direct investment by Accion, a private non-profit organization, in Compartamos Banco, a Mexican microfinance bank. See "Impact Investing Examples" on pp. 4–5 for more details.

[17] Many, if not most, investments produce at least *some* socially or environmentally beneficial outcomes (e.g., employment, higher quality and lower cost goods such as clothing, food, heat, transportation, medicines) from *someone's* perspective.

are likely to be mired in indecision due to the overwhelming number of options—from microfinance opportunities in Bangladesh, to U.S. mortgage-backed securities composed of mortgages to lower income borrowers, to renewable energy investments, to a start-up firm with a promising cancer-fighting drug, and so on.

Consistent with our emphasis on investor intent, investors should strive to clarify precisely what outcomes they hope to achieve through their impact investments—preventing the spread of malaria in tropical regions, for example, or helping reduce the amount of carbon in the atmosphere. There are, of course, as many possible objectives as there are organizational missions.

Investors may wish to articulate additional goals that speak more to *how* they hope to achieve these social and/or environmental outcomes. Some impact investors seek to play a catalytic role by demonstrating the financial viability of a particular impact investing strategy to attract more traditional sources of capital in the future and thereby create systemic change (see "Impact Investors as Catalysts" below). Others may hope to attract traditional sources of capital to impact investing deals *right now* through creative deal structuring, perhaps

Impact Investors as Catalysts

Accion's decision to sell Compartamos Banco illustrates the inclination among some impact investors to lean toward more experimental investment opportunities in order to serve as potential catalysts for attracting traditional capital. In its June 2007 newsletter, Accion explains:

> It was strongly argued inside ACCIÓN that since Compartamos was now very attractive to a range of investors, ACCIÓN should sell some of its shares, allowing more commercial investors to come in, and at the same time freeing capital that could be invested in riskier, earlier stage microfinance projects. Such a move would serve the dual objective of moving microfinance into the mainstream capital markets and allowing ACCIÓN to stay at the riskier edge where as a non-profit its mission lies. Hopefully, ACCIÓN could use the funds to help develop Compartamos-caliber institutions in other locations.

OPIC shares a similar view of its role. In describing its rationale for investing in emerging markets private equity funds, OPIC notes that it is trying to address a shortfall of private equity capital in developing countries. OPIC goes on to note that it is "typically one of the first fund sponsors to enter an unproven market."

Arguably, impact investor capital can have the most incremental social impact when applied to investments in potentially market-rate opportunities currently underappreciated by conventional investors, since these investments could not otherwise attract conventional capital.[1] However, once certain "impact investments" attract conventional capital, demand from impact investors could start to elevate the investment's price to "overvalued" levels (because such investors may not be purely financially motivated, and may thus be less price sensitive), ultimately repelling conventional investors and limiting the investment's scalability.

This comment is not meant to discourage impact investors from investing in market-rate investment opportunities, which would be a strange recommendation indeed from an investment consultant! Rather, the more conventional investors find certain opportunities attractive, the less impact investor capital is needed to fund them. In such cases, impact investors should allocate no more capital to these investments than they otherwise would if they were indifferent to the investment's social return. The impact investor's "risk budget" might be better spent elsewhere.

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[1] See Paul Brest and Kelly Born, "Unpacking the Impact in Impact Investing," *Stanford Social Innovation* (Fall 2013). The authors similarly argue that impact investors who seek "non-concessionary" investments (i.e., investments generating market rate returns) are most likely to actually have an "impact" when making investments in inefficient markets in which the inefficiencies (or "market frictions") are apt to deter "conventional" investors.

by providing "concessionary capital"[18] to help make the deal's traditional investors more likely to achieve their desired market-rate return targets.

Regardless of the investment policy's specific impact-investing outcomes, the key is to ensure that they provide a clear definition of what constitutes impact investing "success." Doing so will better enable the organization to evaluate possible strategies and investment opportunities, and to monitor whether the impact investment portfolio is behaving as intended.

Impact Investment Allocation Size and Return Expectations?

Given that investment policies also often specify asset allocation targets (or, in the case of the Risk Allocation Framework, "role-in-portfolio" allocations) and, relatedly, portfolio return expectations, a natural question is whether the policy should also address targets and return expectations for the impact investing allocation. We lean against doing so, and would instead suggest reserving these decisions for the Implementation process rather than for the Policy Setting exercise.

Allocation Sizes Are Generally Best Left to Opportunistic, Bottom-Up Decisions. While investors may aspire to allocate "more" of their portfolios to impact investments, the degree to which they should do so will ultimately be a function of a variety of factors including:

- The availability of investments that truly meet the organization's impact investment objectives;
- The nature of the impact investment opportunity set;
- The impact of these investments on the portfolio's risk allocation structure and, by extension, its ability to meet its spending objectives; and
- The likelihood that these investments will enhance the overall social returns of the organization, even if they might negatively impact the LTIP's ability to meet its objectives for sustainable spending.

In our view, these factors should be evaluated on a bottom-up, investment-by-investment basis, with the investor keeping a careful eye on the continued unfolding of the opportunity set of impact investments that are truly applicable to the organization. Attempting to set hard, top-down impact investment allocation targets as a matter of policy—particularly without a solid grasp of the nature of the truly applicable impact investment opportunity set—could cause investors to sacrifice impact investment quality for the sake of quantity, potentially jeopardizing their ability to maximize their organization's overall social returns.

Setting Impact Investment Return Expectations at the Policy Level May Be Premature. The argument against specifying impact investment return expectations within the investment policy is less clear cut. Those investors seeking to attract traditional investors to impact investments to scale the *social* returns those investments are able to achieve may need to focus on opportunities that offer competitive market-rate returns. In this case, the ability of an impact investment to generate market-rate *financial* returns *is an intrinsic part of its social return proposition* and for this reason should be formally specified as an objective within the investor's evergreen investment policy.

However, in other instances, allowing more flexibility with respect to the type of strategy

[18] By "concessionary capital" we mean capital provided with the explicit understanding that expected returns are not commensurate with the risks incurred—in other words, "below-market-rate" capital.

and, by extension, return expectation might be better. Consider an investor with two options to increase the number of acres of sustainably managed timber property in a given region, each requiring an equal amount of investment. The first offers a higher rate of return and the potential for sustainable timber harvesting practices on 1 million acres of property. The second has below-market-rate return expectations and the potential to apply such practices on 3 million acres. Which is the better investment? The answer depends on a number of factors that are likely to be hard to foresee. For instance, the investor might be comfortable investing in the lower-returning opportunity if the financial opportunity cost could be offset in other parts of the portfolio by increasing the LTIP's allocation to higher-returning assets and decreasing its allocation to other, lower-returning assets.

Further, without an exhaustive sense of what the impact investment opportunity set looks like ahead of time—do sustainable timber investment opportunities tend to be high- or low-returning opportunities?—foreordaining return expectations may be premature. Again, bottom up, case-by-case analysis during the implementation process, rather than a predetermined "top-down" mandate articulated in the investment policy, may be the better approach.

GIIN and ImpactBase

The Global Impact Investing Network's (GIIN's) ImpactBase is a free online global directory of impact investment vehicles. The database allows investors to search on asset classes, impact themes geographic targets, target returns, and other parameters. GIIN, the organization behind ImpactBase, is a non-profit sponsored by Rockefeller Philanthropy Advisors that is dedicated to increasing the scale and effectiveness of impact investing. To learn more about ImpactBase, visit www.impactbase.org. To learn more about GIIN, visit www.thegiin.org.

Implementation and Monitoring

After the Enterprise Review is complete and the impact investing–related dimensions of the investment policy are established, it is time (at last!) to build an impact investment portfolio within the context of the LTIP's overall portfolio structure, and to monitor the results. As with any prospective investment, impact investors will need to source and conduct thorough due diligence on each opportunity's strategy and supporting team—with an eye toward assessing the investment's competitive advantages and performance expectations—and monitor performance going forward.[19] (For information on one of the more established resources for sourcing impact investments, see "GIIN and ImpactBase" to the left.)

The remainder of this section focuses on aspects of implementation and monitoring that are particularly relevant to impact investing, including:

- A framework for thinking about how to implement impact investment allocations within the LTIP;
- Determining which type of investment vehicle (e.g., direct investments, funds, and/or funds-of-funds) makes the most sense in light of the organization's investment objectives and governance structure; and
- Our reflections on holistic performance measurement.

[19] With respect to impact investment due diligence, Cambridge Associates generally focuses its efforts on funds and funds-of-funds (not direct investments) with reasonable scale and that target market rates of return.

Impact Investing and Portfolio Construction

As noted earlier, we believe impact investment allocations should generally be made through an opportunistic, "bottom-up" investment selection process, rather than predetermined from the top-down at the policy-setting level, given the difficulty of knowing in advance the nature of the impact investment opportunity set. As potential impact investments are identified, their position sizing should be a function of three things:

- The degree to which the characteristics of the impact investments overlap with the types of risk exposures the portfolio would otherwise have had if supporting spending was the LTIP's sole purpose. For instance, if an investor had a 10% allocation to core U.S. bonds, and the impact investment opportunity set had similar risk/return/liquidity characteristics to core U.S. bonds, the investor could reasonably allocate a substantial amount (i.e., up to 10%) of the LTIP to these types of investments without changing the character of the portfolio.
- The degree to which the opportunities are, indeed, narrow, small, unproven, illiquid, and/or below market rate in nature. If so, when viewed solely from the perspective of achieving a high and sustainable spending stream, such strategies would typically merit smaller portfolio allocations to any one opportunity, and, if possible, diversification across a basket of such strategies, rather than larger, and thus more concentrated, positions.
- As noted in our Enterprise Review discussion, the extent to which the organization feels impact investments' social returns are interchangeable with those generated by spending. The more interchangeable they are, the more flexible the organization can be with regard to its spending requirements. This flexibility assumes, of course, that the social returns generated by a prospective impact investment would offset any negative impact that investment might have on the LTIP's ability to facilitate spending.

Again, each investment should be analyzed in light of these factors on a case-by-case basis, always ultimately keeping in mind the degree to which the investment is likely to help the organization maximize its overall *social* returns.

A related question investors struggle with is whether to integrate their impact investments into their portfolio's target risk exposures or dedicate a "carved-out" portion of the portfolio for impact investments. The carve-out approach suggests that one portion of the portfolio—the "non-impact" portion—will have more well defined risk/return expectations while the carved-out portion will not, and can thus serve as a holding place for a range of impact investments whose outcomes may be less certain, are below market rate, are concentrated in one specific area, and/or are otherwise difficult to find a home for within the rest of the asset allocation.[20]

A carve-out approach fosters a more experimental spirit on the part of the investor. The apparent "constraints" of target risk exposures are thrown aside to enable the investor to more readily exploit impact investment opportunities. However, if investors still need to rely on the assets in the carve-out for spending purposes, *they must make an effort to understand how those assets will interact with the rest of the portfolio to achieve their spending goals.* The larger the "carve-out," the more important such analysis becomes. In these

[20] The IRS's Program Related Investment designation is a perfect example of a "carve-out" approach.

cases, the assets are not truly "carved out" but continue, in practice, to be part of the investors' overall risk exposures for spending purposes—and should therefore explicitly be viewed as such.

Impact Investing Vehicles

As with traditional investments, impact investors can use three types of vehicles: (1) direct investments in underlying enterprises; (2) investments in commingled funds, which pool the capital of multiple investors and delegate the selection of direct investments to the fund's portfolio manager; and (3) investments in funds-of-funds, which also pool investor capital but, rather than have the portfolio manager select individual securities, invests in funds that, in turn, make direct investments.

The impact investor's choice of vehicle is largely a function of two factors: (1) the degree to which the investor requires the investment to closely match its impact investment objectives; and (2) the degree to which the investor needs to outsource the investment selection process, which is, itself, a function of the internal due diligence resources the investor can bring to bear. As we illustrate below, these two factors are often in tension with one another.

Building a direct impact investment program would likely enable impact investors to adhere the most closely to their impact investing social return objectives. However, this approach requires tremendous resource commitment on the part of the investor to source, execute, and monitor each investment. In contrast, investing through a fund enables an investor to outsource most aspects of investment selection, execution, and monitoring to the fund manager. Of course, the fact that the fund pools capital from multiple investors increases the probability that the fund's objectives do not perfectly overlap with that of any given underlying investor. Thus, investors in an impact investment fund likely need to be comfortable with some degree of imprecise mission alignment. Investments through funds-of-funds offer greater diversification and resources for portfolio construction, fund selection, and performance measurement. However, these aggregated vehicles create potentially even more diffused mission alignment.

In our view, the less a particular impact investment vehicle is aligned with an investor's mission objectives, the more weight should be given to that investment's ability to contribute to the investor's spending objectives. For instance, an investor should be particularly cautious about committing to a fund-of-funds manager with a limited track record and relatively high fees that is investing in nascent sectors if the social returns thus generated are only tangentially aligned with the investor's social return goals. However, if a fund-of-funds does match up well with an investor's social return interests, it may offer an efficient means of obtaining diversified impact investment exposure while also outsourcing much of the due diligence effort.

Impact Investment Performance Measurement—Start Simple

As with any investment, impact investment performance must be measured and monitored over time. However, unlike most investments, impact investment performance requires measuring *both* financial and social returns. While the methodologies for measuring an investment's financial performance are already fairly well established, the approaches for measuring an investment's social return continue to evolve.

Among the more prominent efforts to introduce a consistent framework of social impact metrics in recent years is the Global Impact

Investing Ratings System, or "GIIRS." GIIRS seeks to provide a means for assessing the social impacts of both individual companies and investment funds with ratings and analytics analogous to those of traditional financial rating systems. One of GIIRS's chief goals is to enable impact investors to have a standardized system to compare and contrast the impact characteristics of different investment opportunities. As of July 2013, 52 investment funds representing $2.7 billion in assets under management had GIIRS ratings.[21]

Just how much impact measurement is necessary for any given investment continues to be debated, given the time and expense for both individual companies and funds to submit to ratings regimes. As investors often have focused impact investment objectives, each individual investor will need to decide whether a universal ratings system (e.g., GIIRS) or a more customized solution will best fit its needs.[22] We suggest investors start with the approach that is *simplest* for them (whether using an off-the-shelf framework like GIIRS or a straightforward set of social return metrics developed in-house) to avoid implementation paralysis, with the understanding that initially simple approaches to measuring social returns can be expanded upon over time as the investor gains more experience.

Finally, for many impact investors, an investment's success will ultimately be a function of the aggregation of, and interaction between, the investment's financial and social returns.

[21] To learn more about GIIRS, visit www.giirs.org.
[22] For a thoughtful research paper that, among other things, argues for why a customized approach to impact measurement may be preferable, see Uli Grabenwarter and Heinrich Liechtenstein, "In Search of Gamma: An Unconventional Perspective on Impact Investing," IESE Business School, University of Navarra, 2011, available at www.iese.edu.

An impact investment might be said to have generated a successful "holistic" return if any shortfall between the investment's expected and actual financial return is more-than-compensated for by a social return that vastly exceeded expectations—and *vice versa*.[23] Of course, the hope is always that both types of returns will exceed expectations![24]

Conclusion

If a social or environmental problem can be tackled through a profitable means, rather than through (or as a complement to) a charitable or governmental intervention, we are hard pressed to see why an investor would not want to explore doing so given the likely sustainability and scalability of such a solution. Impact investors clearly play a key role in facilitating these types of solutions by providing capital to market-based enterprises with the potential to address social or environmental challenges.

However, as we have discussed, building allocations to these types of investments within the context of an investor's LTIP is often not straightforward given (1) the qualities (relatively unproven, illiquid, narrow opportunity set, etc.) that often characterize the types of investments that a given investor might deem "impactful" and (2) the multidisciplinary skillset and often

[23] Please see our 2012 report *The U.K. Social Investment Market: The Current Landscape and a Framework for Investor Decision Making* (particularly pp. 12-17), for an extended discussion of a "combined return" framework that incorporates both financial and social risk/return considerations. We also addressed this topic in our 2007 report Social Investing, pp. 5, 6, 16-19, referring to this concept as "holistic total return."
[24] For an interesting and in-depth framework for assessing the "impact" of one's impact investments, see Paul Brest and Kelly Born, "Unpacking the Impact in Impact Investing," *Stanford Social Innovation* (Fall 2013), available at www.ssireview.org.

heightened resources required to select and monitor these investments.

For investors considering an impact investment, our central recommendations are as follows:

- Assess the degree to which the social returns generated from impact investments are interchangeable with those generated through spending. If they are *not* relatively interchangeable—i.e., the social return from one cannot serve as a substitute for the social return from the other—than the impact investments will need to be carefully incorporated into the LTIP in a manner consistent with the LTIP's spending objectives.
- Work to ensure that the team brought to bear on this effort, whether composed of in-house or external talent, has both the necessary resource capacity and multidisciplinary skillset to select and monitor impact investment opportunities effectively.
- Be specific when articulating impact investing social return objectives, both to avoid decision-making paralysis given the dizzyingly wide array of investments that *could* be considered "impactful" by *somebody* and to ensure that what will constitute impact investment "success" is well understood ahead of time.
- The *less* a particular impact investment is aligned with an investor's mission objectives, the *more* investors should focus on the investment's ability to contribute to the investor's spending objectives. If an investment has only an indirect relationship to the investor's social return objectives, *and* is unlikely to contribute satisfactorily to the investor's spending goals, it is probably best to move on.
- Be wary of setting hard, predetermined LTIP target allocations to impact investments. For any given investor, the impact investing opportunity set is often narrow, relatively small, and continually evolving, making it premature to assume the feasibility of filling an allocation bucket without a thorough knowledge of the nature of that opportunity set. Emphasize careful bottom-up selection instead.

Ultimately, these recommendations are designed to ensure that any impact investments are truly additive to the organization's ability to maximize the overall social returns it hopes to achieve, which, as we have said many times before, is the ultimate end toward which the LTIP is but a means. ■