Money Management Institute

Special Report

June 2015

Bringing Impact Investing Down to Earth: Insights for Making Sense, Managing Outcomes, and Meeting Client Demand

By William Burckart
Burckart Consulting

With an introduction by Erika Karp and John Wilson
and essays by Jamie Butterworth, Mark Sloss and Anna Snider

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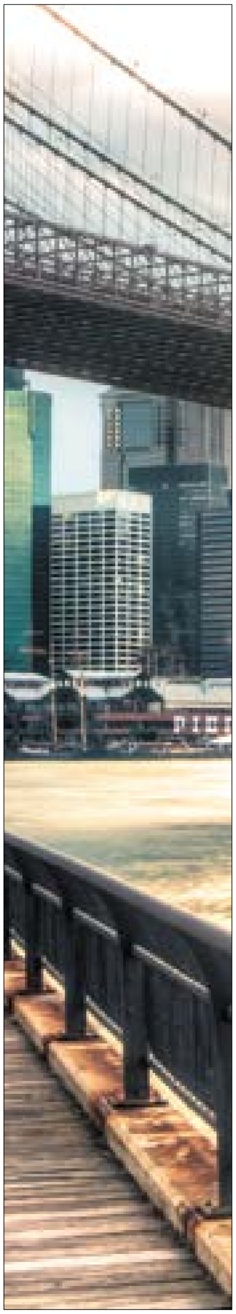
June 2015

This special report continues a multi-year discussion between the Money Management Institute (MMI) and William Burckart, the Founder and CEO of Burckart Consulting, about the emergence of impact investing and the particular challenges and opportunities it represents for the financial services industry. This collaboration began in October 2012 with a showcase Burckart conducted on impact investing for attendees at MMI's Fall Solutions Conference in New York. Subsequent activities included:

- The launch of an ongoing Impact Investing Blog on MMI's website in July 2013;
- A panel at the MMI Annual Convention in April 2014 (New York, NY), during which Burckart was joined by Amy Bell, the Executive Director and Head of Principal Investments for JPMorgan's Social Finance unit; Joel Hornstein, the Managing Director of DreamFund; and Mark Sloss, the Senior Portfolio Manager and Head of Premier Portfolio Services for UBS Wealth Management Americas;
- MMI's publication of the special report "Serving Client Demand for Impact Investing: A Hands-on Guide for Financial Advisors and Senior Management" in May 2014;
- An MMI webinar in May 2014 that revisited the well-received impact investing panel discussion from MMI's Annual Convention; and
- A panel at the MMI Annual Convention in April 2015 (Charlotte, NC), during which Burckart was joined by Anna Snider, the Managing Director and Head of Global Equity Due Diligence for Merrill Lynch Wealth Management; John Streur, the President and Chief Executive Officer of Calvert Investments; and Gil Crawford, Chief Executive Officer of MicroVest.

The report also draws from Burckart's advisory work and industry knowledge, reviews of client engagements, data analysis and desk research, and targeted interviews with leading financial institutions and advisors.



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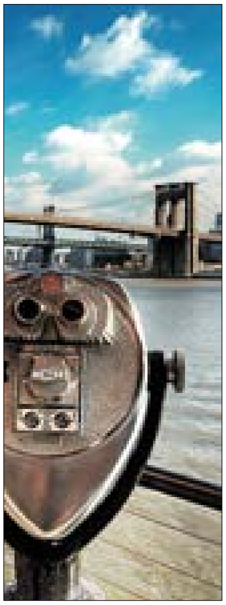
This Special Report is part of the MMI Reports Series (2015).



Introduction by Erika Karp and John Wilson

Today, the sophistication of the financial markets far exceeds what could have been imagined only a few decades ago, offering products and services tailored for every investor's needs. Yet, they may miss the real risks to investors' well-being, which are systemic and long-term: climate change, financial instability, and inequality are significant *investment* risks, not just *societal* risks.

By contrast, financial market incentives are primarily short-term, often punishing those who forgo immediate excess returns in favor of a long-term, sustainable approach. Long-term investors may unknowingly exacerbate this problem, and act against their own interests, when they abandon managers for one or a few quarters of underperformance. Investment managers, understandably, focus on "beating the market" even at the expense of rewarding companies for boosting immediate profits at the expense of the long-term health of the organization or of society at large.

For this reason, long-term investors need to think both in terms of financial results and systemic risk and opportunity. In the long term, growth of portfolios will not happen because of financial engineering but becomes possible only in the context of a real economy characterized by innovation and inclusion.

This shift in perspective cannot happen without contributions from all market players, but too often communication fails among these groups because they do not speak a common language. At Cornerstone Capital, we seek to provide these linkages: wealth management that truly integrates impact into investing practices; institutional research that uses impact to inform investment analysis; and consulting to corporations to help them articulate their sustainability case in a manner that is meaningful, consistent, and useful to investors.

It is against this backdrop that we welcome William Burckart's series of thoughtful and practical insights for translating the major trends reshaping our planet and converting the intentional pursuit of positive impact into an actual investment process. In bringing impact investing down to earth, Burckart and the outstanding team of colleagues he assembled from Merrill Lynch, UBS, and Circularity Capital have unpacked years of pioneering work and provided a powerful analysis of the opportunities, challenges, and breakthroughs emerging on the road towards meeting increasing client demand for impact investing.

"Sustainability," "ESG," "Social Responsibility." These terms have become buzzwords that may be inspiring to some and make others' eyes glaze over. Burckart's contribution is a needed resource for those who want to get beyond the hype to understand how their investments can have real, positive impact.

About the contributors: Erika Karp, Founder & Chief Executive Officer, Cornerstone Capital Group and John Wilson, Head of Corporate Governance, Engagement & Research, Cornerstone Capital Group

Executive Summary

Executive Summary

Client demand for impact investing, the practice of investing with the intention of generating measurable social and environmental impact alongside appropriate financial returns, is growing. This demand mirrors a broader reshaping of global macroeconomic priorities, several trends changing the economy, and increasing interest from Generation X and Millennial investors. The financial services industry has recognized that it must serve client demand for impact in order to stay competitive. And while impact accounting systems and complicated frameworks exist, well-defined and basic steps on how to actually harness impact data are absent. Because there is no clear and industry-wide way to see which investments are doing the social and environmental good they promise, those who are not yet engaged in impact investing fail to act. Transparency is key and impact investing needs more of it.

Translating these impact measurement breakthroughs into an actual investment process could offer the opportunity to similarly advance the practice of impact investing—serving to better fortify investments.

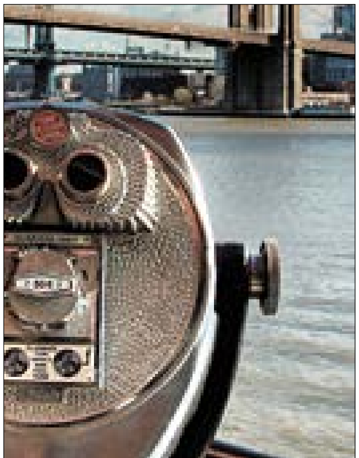
Many of the leading venture philanthropists who entered the nonprofit sector in the late 1990s and early 2000s understood the limitations of existing systems that only measure hard output data, like simple numbers of houses built, and instead focused on the real social outcome they were hoping for, like the ability of low-income people to stay long term in those houses and reach financial stability. Translating these impact measurement breakthroughs into an actual investment process could offer the opportunity to similarly advance the practice of impact investing—serving to better fortify investments.

At a practical level, the industry can go beyond the utilization of mainstream providers of Environmental, Social and Governance (ESG) data—MSCI, Thomson Reuters, and Bloomberg—and adopt leading impact investing tools for accounting for ESG outputs—the Global Reporting Initiative (GRI), Impact Reporting and Investment Standards (IRIS), Global Impact Investing Rating System (GIIRS) and Sustainability Accounting Standards Board (SASB) in particular. Investors, advisors, and firms can reach further and engage the providers of social outcome software and monitoring solutions such as Social Solutions and Community TechKnowledge (CTK), which are providers of performance management software for health and human services organizations. The industry can go deeper still and partner with firms that specialize in improving the quality, objectivity, and excellence of impact including Mathematica, MDRC, and Urban Institute. An approach like this would enable a specific portfolio *and* broader systems perspective on impact created.

Education programs directed at achieving the level of ESG integration associated with impact investing are now becoming available. Major financial institutions are strengthening their proprietary ESG training programs for their advisors and fund managers to include the rigor associated with impact investing. But wholesale training programs directed at impact investing instruction are also becoming available by the Global Impact Investing Network (GIIN), the Aspen Institute, as well as Oxford University. In addition, various indices and resources—such as ImpactAssets50 (IA50), ImpactBase, and the U.S. Social Investment Forum (USSIF)—are now demonstrating a wide range of impact investing activities across geographies, sectors, and asset classes. Embracing these new utilities would help fund managers to expand engagements with firms like Morgan Stanley, UBS, Merrill Lynch, and Envestnet that are drawing on separately managed accounts and mutual funds to build impact investing product offerings.

Developments like these offer a springboard for greater clarity for how investors, advisors, and firms can integrate impact information in a way that would be strategically material, as well as socially and environmentally effective. What is needed now is more dynamic collaboration between the worlds of philanthropy, government, and finance. Doing so would help move the impact investment concept from being a largely academic exercise to one that is deeply rooted in the systems of mainstream finance.

Bringing Impact Investing Down to Earth



Human beings are complicated, messy, and unpredictable. Metrics and systems that are supposed to measure and manage impact are often not dynamic enough to keep up with all that human complexity.

Bringing Impact Investing Down to Earth

The Pursuit of Social and Environmental Impact Is Messy and Complicated

"I heard Egypt was doing really well according to all the metrics that we pay attention to at the World Bank and the IFC," said Aleem Walji of the World Bank Institute. "Investment was up, returns were good, we were investing in all the right sectors, or so we thought."[1] Then the Arab Spring happened. Clearly, the World Bank's metrics had not captured the deep frustration of Egyptian youth, who were cut out of the supposedly expanding economy there.

In the field of social services, teaching that domestic violence is an acceptable expression of love is a major problem. Accidently doing so as a nonprofit organization focused on helping youth to become responsible adults is an out-and-out disaster. But this is precisely what happened in 2007 when the Latin American Youth Center (LAYC), a nonprofit based in Washington, DC, added a few sessions on domestic violence issues to its existing parenting programs. The addition was meant to teach parents that domestic violence is not appropriate in any culture but ended up having the exact opposite effect.[2]

By many measures the LAYC runs successful programs, serving over 4,000 individuals each year. But it wasn't until the specific addition to the organization's parenting program was completed that Isaac Castillo, LAYC's then-director of learning and evaluation, realized something had gone very wrong. According to tests that the LAYC administered before and after the parenting programming, participants' attitudes toward domestic violence changed in the wrong direction with the additional lessons included.[3]

The numbers in both of these very different cases simply weren't telling the whole story.

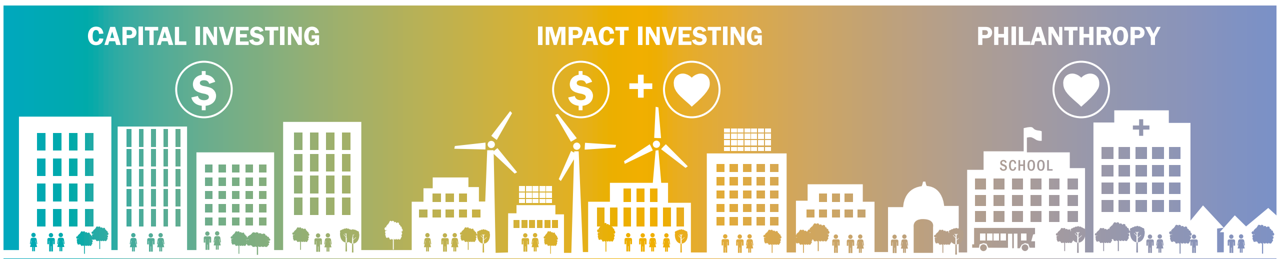
Human beings are complicated, messy, and unpredictable. Metrics and systems that are supposed to measure and manage impact are often not dynamic enough to keep up with all that human complexity. Still, investors, funders, organizations, businesses and governments need some way to assess, manage and communicate their impact. This is true when accounting for the non-financial performance of transactions like the World Bank's investments in Egypt or social interventions like the LAYC's courses on domestic violence prevention, but is absolutely critical when the two worlds of investing and philanthropy get mixed together as impact investing.

Client Interest in Doing Well and Doing Good Simultaneously Is Intensifying

Impact investing is different from grants or donations where dollars are simply given away to nonprofit organizations without the intention of a financial return. Embedded within the concept of impact investing is the idea of "doing well and doing good" simultaneously. This is notably different from the old model of "making money and giving back," personified by Warren Buffett.[4] Impact investment dollars can capitalize a wide range of sectors from, for example, providers of affordable homes designed for low-income families in rural settings in Brazil to companies that set up water purification plants in villages throughout India.[5]

Per the figure below, this concept is different from Socially Responsible Investing (SRI), which traditionally aims to avoid social or environmental harm while still pursuing a single bottom line of profit, or Program-Related Investing (PRI) and Mission-Related Investing (MRI) that share similar qualities to impact investing but are used almost exclusively to describe this approach in the context of endowment and foundation investing and have specific rules governing their use.[6] It is important to note the variation in terminology and how "impact" is often defined, and whether or not particular products are actually impact investments or if they are simply Environmental, Social and Governance (ESG)-aligned investments. [For more on the different pathways investors are taking towards impact, please see Mark Sloss's essay on "Calibrating Expectations for Impact."]

THERE IS A SPECTRUM OF INVESTORS, CAPITAL AND ENTERPRISES

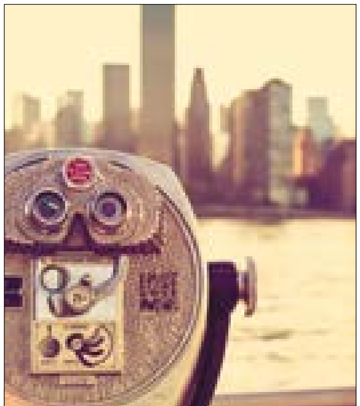


Capital Investing			Impact Investing		Philanthropy	
Investing that deploys capital with the anticipation of generating financial returns to the investor but *no expectation* of generating positive social and/or environmental impact.			**Socially motivated investing that deploys capital with the anticipation of generating financial returns to the investor *alongside* positive social and/or environmental impact.**		**Socially motivated funding that deploys capital with the anticipation of generating positive social and/or environmental impact for society but no financial returns to the funder.**	
	SOCIALLY NEUTRAL INVESTING					
Mainstream Investing	**Socially Responsible Investing (SRI)**	**Sustainable Investing (ESG)**	**Non-Concessionary Impact Investing**	**Concessionary Impact Investing**	**Venture Philanthropy**	**Charitable Giving**
Investing in companies without consideration of social or environmental impact	Using a negative investing screen to exclude companies considered ethically problematic	Using a positive investing screen to include the environmental, social and governance (ESG) considerations of companies	Investing that seeks measurable social impact alongside risk-adjusted financial returns	Investing that is willing to make some financial sacrifice—either taking greater risks or accepting lower returns—to achieve social goals	Funding non-profit social enterprises that generate some or all of their revenues from business activities	Funding non-profit social enterprises that rely completely on charitable donations

*Adapted from the [Impact Space], a project of Impact IQ, Inc., accessed on February 11, 2015, URL: http://impactspace.com/category/impact-investing-101

In its most rigorous form, impact investing involves specifying, measuring and reporting social and environmental impacts throughout the investment process, from fund design through sourcing, diligence, selection and monitoring of individual investments.[7] Simply put, this kind of investing is meant to make a difference and a return, and it is on a winning streak in many ways. Consider a few recent milestones that illustrate its growing momentum:[8]

- In early September 2014, nearly a dozen wealthy families in the CREO Network announced their commitment to invest a combined $300 million over five years in commercial ventures in the areas of climate, energy, health, food and sustainability.[9]



[Giant companies] are responding to the newest group of investors—including Generation X and the Millennial Generation—who, according to a 2013 World Economic Forum study, consistently rank "impact performance" (the social good that may come from an investment) as more important than return.

- Merrill Lynch advisors got in on the action in late 2014 when the firm became the first U.S. underwriter to offer the World Bank's new green bonds to retail investors in $1,000 denominations—helping to further democratize impact investing.[10]
- An analysis of over 300 impact investing funds published in March 2015 indicated that more than 40 percent of examined funds have a track record of more than three years, more than 75 percent of the funds target returns comparable to traditional investments, and the average committed capital of funds is $53 million while the average target assets under management (AUM) is $110 million.[11]

The Embrace of Impact Investing Reflects a Broader Reshaping of Global Priorities

The world's deepening embrace of impact investing reflects a broader reshaping of global macroeconomic priorities.[12] The urgency of climate change, rising inequalities in income within and among developed and developing countries, and the scarcity of water, energy and other resources are just some of the global problems weighing on investors' minds as they decide where to put their money. More than ever before, they are looking for ways to limit risk and make investments that can be part of the solutions to these problems.

At the same time, investors and consumers are responding to several trends changing the economy. There is growing consumer demand in poor countries for fuel, cell phones, clothing and all kinds of goods as incomes rise. Wealthier nations are seeing the emergence of the "virtuous" consumer—people who only buy fair-trade coffee or sustainably sourced peanuts. A modernization of the welfare state is underway in developed countries, which is driving belt-tightening measures in the USA, UK and Europe.[13] The need for efficiency in water and energy consumption, and minimizing the creation of waste by business is intensifying as well.[14] [For more on how the increasingly complex and fast moving global economy is changing the nature of investment and business, please see Jamie Butterworth's essay on "A New Industrial Revolution Poses New Opportunities for Investors."]

The economy—from investors and businesses to NGOs and governments—is reacting to these developments. Examples are everywhere. D.Light Design, a for-profit business developing goods that fill social needs, is manufacturing inexpensive solar lamps and selling them at a cost competitive to lower quality candles in communities that do not have access to reliable, safe and renewable energy.[15]

CO2Nexus, Inc., a company that has developed a sustainable method of processing (cleaning, disinfecting and coating) textiles and garments, recently secured an investment from a venture fund called $20 Million & Change. $20 Million & Change is a venture fund launched in 2013 to help innovative startups that use business to develop solutions to the environmental crisis; this fund is operated by Patagonia, the privately held clothing company.[16]

The financial services industry is settling into impact investing, too. Morgan Stanley recently showed that sustainable bonds can move beyond traditional issuers such as development banks (think the Inter-American Development Bank) and utility groups (think the European Investment Bank) to include major companies when it helped Unilever, the world's second largest food producer, issue a $416 million "green bond." The proceeds of this green bond will be invested into projects like new and retrofitted factories that will result in reductions of 50 percent in CO_2 emissions from energy and water used, and waste generation.[17]

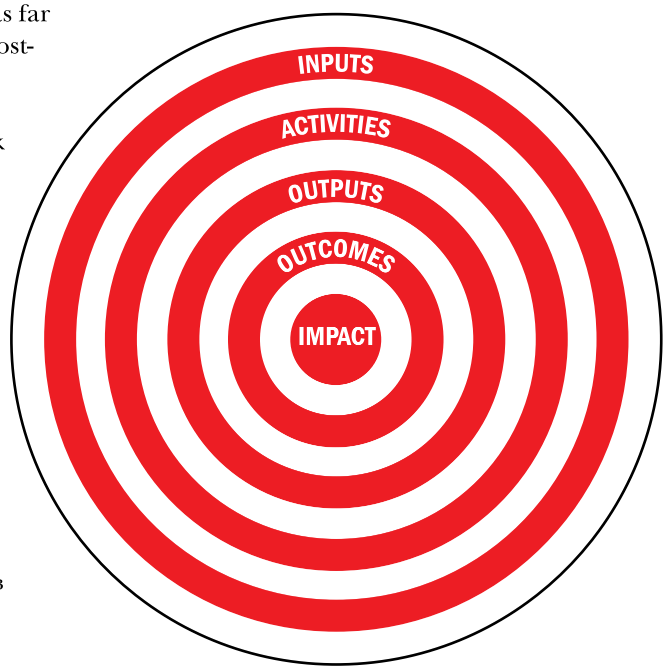
Following a number of years of formally integrating ESG research into stock analysis for select investment strategies, American Century Investments (ACI)—the major investment management firm with $150 billion in AUM—is in the process of developing an integrated impact investment strategy. The firm's "Profits with Purpose" directs a portion of annual profits—$1 billion since 2000—in the form of dividends to support cancer research.[18] While Merrill Lynch identified ACI as an example of a values-based investment opportunity, ACI seeks to go further and examine and establish the linkages between the firm's unique ownership structure that directs 40 percent of profits to a research center and the intentional and measurable outcomes that it generates for clients—aiming to achieve the rigor required of an impact investment.[19]

Morgan Stanley, Patagonia and other giant companies aren't doing these things out of the kindness of their corporate hearts. They are responding to the newest group of investors—including Generation X and the Millennial Generation—who, according to a 2013 World Economic Forum study, consistently rank "impact performance" (the social good that may come from an investment) as more important than return.[20] A 2014 survey of high net worth individuals by RBC Wealth Management and Capgemini mirrored these findings and indicated that achieving social impact is important to 92 percent of respondents—with investment ranked as the leading mechanism for meeting these goals.[21]

Even so, investors struggle to credibly and comparably evaluate the social and environmental consequences of their activities, and investors who are not yet engaged fail to act because the field of opportunity is obscured by a lack of clarity on how to actually do it. Transparency is key and impact investing needs more of it.

Progress with Non-financial Performance Monitoring Accelerated Over the Past Few Decades

Accounting for the non-financial performance of programs and interventions has a long history, going as far back as the 1930s with the introduction of cost-benefit analysis (CBA) as a way to calculate and compare the benefits of a program or portfolio.[22] An impact evaluation framework was added to the mix in the 1960s. Per the figure to the right, this framework has five key dimensions, including: the inputs made (investments into a microfinance institution); the activities undertaken (programs conducted by the microfinance organization to attract clients); the outputs generated (loans extended); the outcomes (the changes in the clients' lives such as the doubling of household income among the clients of the microfinance institution); and impact (the changes in the clients' lives directly attributable to the microfinance activities).[23]



These two techniques—the CBA and classical impact evaluation framework—largely served as the standards for evaluating government and nonprofit programs over the following decades. Progress with the measurement of non-financial performance accelerated during the late 1990s and early 2000s with advancements in information technology, the entrance of venture philanthropists and philanthrocapitalists, and emergence of social entrepreneurs who saw opportunity in the blurring of sector boundaries—harnessing market forces for social and environmental gains.[24] A whole host of measurement tools emerged along with them.

Some provide screens, which rate investments based on specific criteria such as the now-commonplace "Fair Trade" certification that signals to consumers their purchases meet specific social standards. A few summarize results, which periodically assess an investment's progress, like the "One Dollar a Day" movement, where organizations have begun to track progress out of poverty based on how many people are living on one U.S. dollar a day in regions across the country.[25] Still others provide ongoing tracking based on performance management and learning such as New Profit's "Balanced Scorecard," which is used to track New Profit's individual philanthropic grants over time to ensure the grantee organizations are on track to meet specific social metrics.[26]

The leading systems don't take into account things like place (back to the problem of investing in Egypt, pre-Arab Spring), organizational performance or type and timing of capital deployed (say, sub-prime mortgages in 2007). Instead, they still focus on numbers, devoid of context.

Impact investors have recently added more resources for linking impact to investing, notably including sustainability reporting guidelines like the Global Reporting Initiative (GRI), impact and sustainability metrics like the Impact Reporting and Investment Standards (IRIS) and Sustainability Accounting Standards Board (SASB), and ratings and analytical tools like Global Impact Investing Rating System (GIIRS), B Impact Assessments, B Analytics, and B Corporation certification.[27] These tools are helping investors measure the non-financial performance of their investments and even compare investments by the social good they achieve.[28]

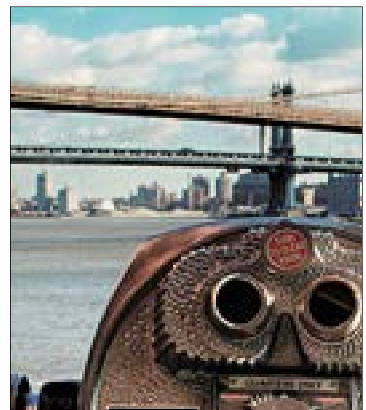
But Accounting for Impact Still Relies too Much on Simple Numbers, Devoid of Context

But there is still no perfect way to measure those messy, complicated human and environmental problems. The leading systems don't take into account things like place (back to the problem of investing in Egypt, pre-Arab Spring), organizational performance or type and timing of capital deployed (say, sub-prime mortgages in 2007). Instead, they still focus on numbers, devoid of context. This is true of the resources mentioned above, but also of mainstream financial data providers like MSCI, Thomson Reuters, and Bloomberg, which are increasingly offering environmental, social, and governance (ESG) data services.[29] A BSR report commented that while the shift among leading data providers has made data on ESG performance more accessible to mainstream investors, companies are concerned that the data lacks the context necessary for accurate interpretation.[30]

This overreliance on metrics raises the risk of counting jobs when the goal is really empowerment or counting houses when the objective is building a community. The point: "Too many metrics can lead to grade inflation, where every intervention gets a pass, or even an A, by having some measures on which to score highly."[31] Too many metrics can also jeopardize how social and environmental impact is ultimately integrated in order to fortify investments. This caveat is important when making comparisons across investment options, but also for determining the significance of impact achieved. In drawing a contrast between ventures that provide education to a child versus those that provide a clean cookstove to a family or access to health diagnostics, leaders at the Unreasonable Institute observed that each has an impact on a human life, but perhaps not to the same degree.[32] Failing to capture the full context of these kinds of investments threatens missing the forest for the trees.

Neglecting this context also leaves the door open for fund managers and product developers to slap a few vague metrics on an investment fund just to market it as an impact investment.[33] For example, TriLinc Global, an impact fund manager, made a deal in 2014 to finance a South African textile importer. Despite a respected management team with a strong track record of success, the transaction was nonetheless met with public criticism about whether the investment would actually have any significant positive impact locally.[34] A South African investment advisor raised various concerns around the potentially negative effect the investment could have on the local textile industry; how most households in South Africa purchase clothing on debt; and the environmental impact of importing cheap goods from Asia when there is a ready supply of labor that can produce them locally and with a smaller carbon footprint.[35]

Similar concerns have been raised for impact investments that are based on gaming regulatory policies or subsidies, or are focused solely on outputs rather than outcomes. Ian Galloway of the Federal Reserve Bank of San Francisco captured this tension when discussing an investment in Walmart, the largest retailer in the world.[36] The company has been installing solar panels on store roofs, generating two times more renewable energy than its closest commercial solar power competitor (Kohl's). This is particularly significant from an impact perspective because Walmart's solar power generation is more than that of 35 states and the District of Columbia combined.[37] But this only tells part of the story. While an investment in Walmart might decrease carbon emissions, it may also create an increase in low-wage jobs, which is a negative impact many investors with social impact preferences would prefer to avoid.[38] The overriding implication is that impact investing requires a higher level of scrutiny than has been typical in investment or philanthropy alone.



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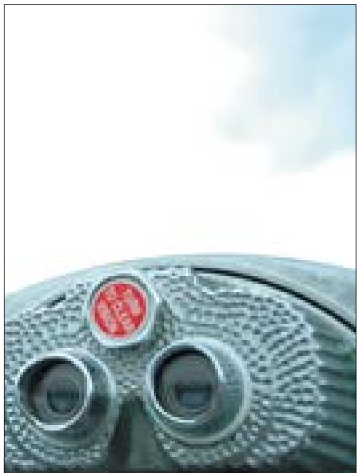
Though a broad spectrum of investors and policy makers have jumped on the bandwagon, the investments themselves—which are happening across sectors—are still occurring largely in silos, and without the benefit of commonly accepted standards or systems. Enthusiasm notwithstanding, making and managing investments that aim to build communities, enable empowerment, preserve the environment, or achieve any number of other impact goals while still generating an appropriate financial return presents a complicated proposition for the financial services industry, and progress has been slow. If impact investing is the "crazy uncle in the attic," to quote Sloss, the broader industry is still struggling to find a way to set him free. The measurement of impact continues to be disjointed as a result and major financial institutions are struggling with the prospect of developing proprietary frameworks or forcing funds to adopt a particular standard in order to get on various platforms.

Impact Investing Is Arriving During a Sea Change in Wealth Management

Impact investing is entering the arena at the same time when deeper upheavals are occurring within the broader financial services industry, particularly in wealth management. Len Reinhart, Jim Tracy and Chuck Widger—three former chairmen of the Money Management Institute—recently wrote in *InvestmentNews*, "A sea change is under way in the financial services sector, one with two dominant currents. The first swirls around demographics and the evolving needs of different generations of investors. The second is what we consider the inevitable movement toward a holistic, goals-based approach to wealth management that will meet those changing needs."[39]



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Saving, investing and spending behaviors, risk capacity and risk tolerance, investment costs and taxes are all changing. As covered in Anna Snider's essay on "Market Forces and Demand Drive Impact Investing From Niche to Mainstream," there is a growing need to efficiently align all of these dimensions as investors increasingly look to advisors for help in achieving familiar commercial and personal objectives associated with wealth management and financial planning—from eliminating debt and preparing for a comfortable retirement, to saving for a child's college tuition and inheritance—while also attaining some social good with their investments along the way. Morgan Stanley, UBS and Merrill Lynch have seen this and have taken confident steps to introduce impact investing via their goals-based wealth management platforms by beginning to include concrete impact objectives and products.

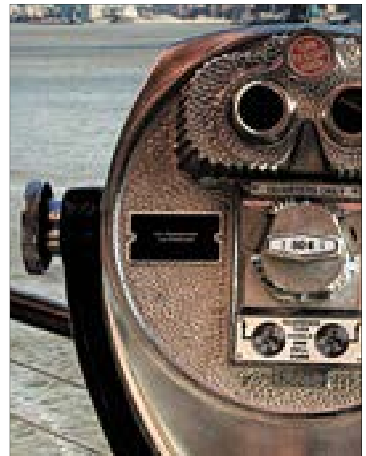
But the situations with Walmart and TriLinc illustrate a broader challenge that these wealth management platforms and others will ultimately encounter. As one observer argued, "It seems that any fund manager can now publicly declare himself or herself as an impact investor, apply to become a GIIN member and utilize a few standardized IRIS metrics, which the fund manager can apply subjectively,…[thus] we run the risk of placing capital with marginal impact."[40] A number of financial institutions echoed this sentiment during interviews for this report, and expressed that trying to translate hundreds of metrics to communicate to a client the type and quality of impact they are having is overwhelming—ultimately diminishing what firms can practically offer to clients.

Opportunity for Harnessing Impact Resides in Moving Beyond Just the Metrics

Many leading venture philanthropists who entered the nonprofit sector in the late 1990s and early 2000s understood the limitations of hard output data, like simple numbers of houses built, and instead focused on the real social outcome they were hoping for, like the ability of low-income people to stay long term in those houses and reach financial stability. They wanted every social program to have a way to measure whether it was meeting the real, on-the-ground, long-term goals they were created to address.

Case in point: the LAYC benefited from the investment of Venture Philanthropy Partners (VPP), which puts a lot of effort into improving the way that its grantees measure and manage their impact performance.[41] If the LAYC had only counted the number of participants in its programs, rather than also measuring the quality of the program before and after it was administered, it would have missed that one of its programs was sending young people out into the world with the misguided idea that violence can mean passion or love. As Castillo thoughtfully wrote in *Leap of Reason*, “In a very real sense, our program caused harm to our participants, despite the best of intentions.”[42]

Castillo would not have caught this disconnect if he had stopped at measuring just outputs. And this insight was only possible because the LAYC had a performance tracking system in place, and organizational buy-in from the board of directors down to the direct service providers who were collecting and inputting data about the programs and participants on a weekly basis. The LAYC was able to implement needed changes—including splitting the classes into separate classrooms for men and women so that each could feel more comfortable expressing their feelings—bringing about positive changes in attitude in every single cohort.[43]



The frameworks emerging for measuring impact are countless, with more seemingly coming to life everyday. But few have managed to connect all the pieces that contribute to social and environmental progress, let alone market competitiveness.

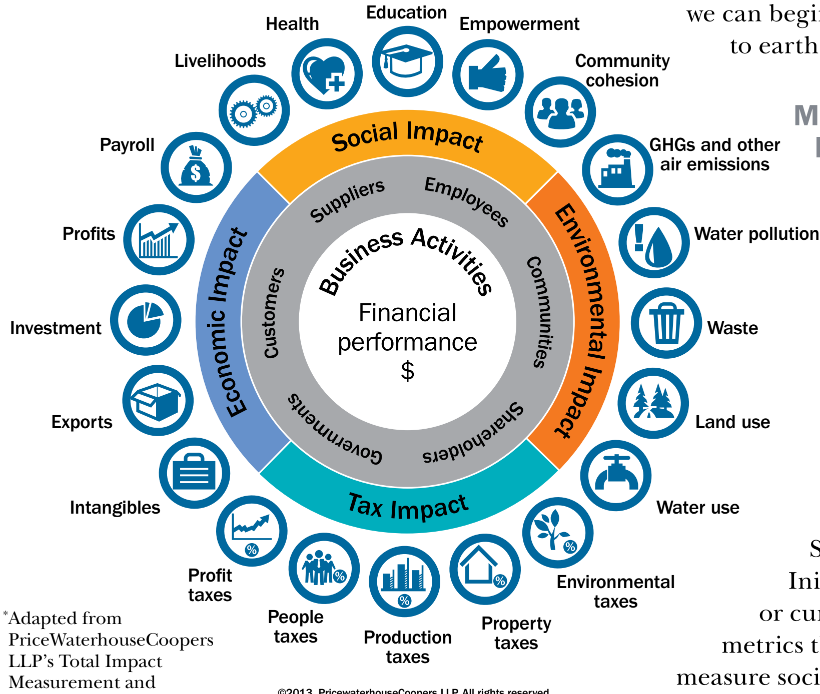
The frameworks emerging for measuring impact are countless, with more seemingly coming to life everyday. But few have managed to connect all the pieces that contribute to social and environmental progress, let alone market competitiveness. For example, Patagonia’s $20 Million & Change program, which funds start-up businesses, is the company’s big-picture way to build up its supply chain so that it aligns with the company’s mission to bring about positive benefit to the environment. Yet Patagonia seems to have no way to communicate to its shareholders the material value of the social and environmental impact being created by, for instance, the investees of $20 Million & Change like CO2Nexus, Inc.

While efforts at the global policy level are attempting to deepen the conversation around the measurement of impact investing, the question of “to what end?” that VPP posed to grantees like the LAYC is rarely asked in the context of impact investing.[44] This may be because of the relative newness of impact investing’s premises, the divide between advisors who are comfortable with the language and pursuit of social and environmental impact and those who are not, and basic capacity limitations. But it may be possible to bridge this gap by translating the best impact measurement and management practices of philanthropy and public policy for the world of investing—better fortifying investments with social and environmental considerations in the process.

Impact Creates a Dynamic Value Proposition for Boomers and the Next Gen

Investors, advisors, and firms already realize that they must serve their clients’ demand for impact to stay competitive. This is particularly true with the Generation X and Millennial Generation investors who stand to inherit more than $30 trillion in baby boomer wealth over the next few decades.[45] Of course, this shift in wealth will be gradual, and the opportunity for immediate action resides with the current holders of the wealth (the Boomers) as much as it does with the future recipients (the Millennials). Thus money managers need to both retain the loyalty and the assets of the Boomers and develop a value proposition that is relevant to the next generation of inheritors.[46] As the following figure conveys, these investors want to know that their retirements and family legacies will be secure. They also want to know that an impact investment such as solar light producer D.Light can generate improvements in health and safety, better performance in school, and increased productivity and income—all of which are details that go far beyond how many lamps the company sells to low-income individuals.

Impact accounting systems and complicated frameworks exist, yet clear and basic steps on how to actually measure, manage, and market the impact data are absent. The resulting challenge is twofold: determining how to link social and environmental impact with existing investment activities, and figuring out how to integrate this information in a way that it becomes strategically material for clients and society. "We've been building [impact investing capabilities] in the air," said Kirstin Hill, Managing Director at Merrill Lynch.[47] But enough progress has now been made that we can begin to bring this type of investing down to earth.



*Adapted from PriceWaterhouseCoopers LLP's Total Impact Measurement and Management Framework (TIMM), accessed on February 11, 2015, URL: http://www.pwc.com/gx/en/sustainability/publications/total-impact-measurement-management/total.jhtml

Measure Your Portfolio *and* Systems Impact by Focusing on Outcomes

At a practical level, the financial services industry can go beyond mainstream providers of Environmental, Social and Governance (ESG) data—MSCI, Thomson Reuters, and Bloomberg—and begin adopting leading metrics and tools used by impact investors for accounting for ESG outputs. These include the Impact Reporting Investment Standards (IRIS), the Global Impact Investment Reporting Standards (GIIRS), and Global Reporting Initiative (GRI). These resources are creating or curating generally accepted performance metrics that leading impact investors use to measure social, environmental, and financial success, evaluate deals, and grow the credibility of the impact investing industry.[48] They are also providing systems for assessing the social and environmental impact of developed and emerging market companies and funds with a ratings and analytics approach analogous to Morningstar investment rankings and Capital IQ financial analytics.[49]

But investors, advisors, and firms can go further and borrow strategies and tools from the worlds of public policy and philanthropy and engage the leading providers of social outcome software and monitoring. Social Solutions provides performance management software and helps human service organizations measure the progress that they make with participants and families.[50] The firm's Efforts to Outcomes (ETO®) software has been widely adopted by thousands of nonprofits and government agencies around the world and has made it easier to increase the effectiveness and efficiency of monitoring and managing impact.[51] Community TechKnowledge (CTK) offers another option. The firm's Apricot software features best practices in design, implementation and technology support for outcomes-based services delivery.[52]

Investors can go deeper and partner with firms that actually specialize in improving the quality, objectivity and excellence of impact including Mathematica, MDRC, and Urban Institute. These organizations, as well as many others like them, have long track records of offering credible research and data services to government and nonprofit programs. They help evaluate and make sense of social, environmental and economic impact—and provide recommendations for how to improve such interventions. Even McKinsey & Company, a leading management consulting firm, has gotten in on the action with its Social Impact Assessment portal.[53] The goal of this tool is to help organizations to plan better, implement more effectively, and successfully bring initiatives to scale, as well as to facilitate accountability, support stakeholder communication, and guide the allocation of resources.[54] These considerations are not solely impact plays; rather they each contain major implications for the "investibility" of impact investments as well.

Are we there yet? Not quite. But embracing impact investing measurement systems as well as deepening and broadening the engagement of the financial services industry with policy research and evaluation solutions providers offers a huge potential breakthrough in making impact measurable.[55]

Market, Attract, and Locate Impact Investment Opportunities with New Indexes and Resources

A number of indexes and resources have been developed to showcase impact investment opportunities to investors. To varying degrees these indexes illustrate the breadth of impact investment fund managers operating today, with featured firms selected to demonstrate a wide range of impact investing activities across geographies, sectors and asset classes.[56] For instance, ImpactAssets50 (IA50) is an annually updated list for investors and their financial advisors that offers a way to identify experienced impact investment firms and explore the landscape of potential investment options.[57] Examples of funds listed on the IA50 include Bamboo Finance, a commercial private equity firm specializing in investing in business models that benefit low-income communities in emerging markets and has over $250 million in assets under management (AUM); and DBL Investors, a venture capital firm in the Bay Area that manages $225 million and invests in companies that can deliver top-tier venture capital returns while working with the companies' management to promote social, environmental and economic impact in the regions in which they operate.[58]

Another resource is an effort of the Global Impact Investing Network (GIIN) called ImpactBase, which is a global platform for investors to explore impact investing opportunities and investigate the market landscape across asset classes, impact themes, geographic targets, fundraising status, AUM and other parameters.[59] Examples of funds listed on ImpactBase include the Alliance Fund II, which is investing $350 million in the construction stage of U.S.-based small and mid-sized energy projects focused on clean energy infrastructure; and the Flexible Capital Access Program (FlexCAP), a Habitat for Humanity International (HFHI) program which enables affiliates to borrow against selected mortgages in their portfolios.[60]

These platforms are also meant to enable institutional asset owners, family offices and high net worth individuals and their advisors to find separate account managers and fund managers with expertise in sustainable and responsible investment strategies. Investors can search for managers by asset class and benchmark, and review descriptions of each strategy and account minimum requirements—refining the ability for investors to be able to search for funds that may fit with their impact investment interests and objectives. For example, the USSIF hosts a "Mutual Fund Performance Chart" that displays all sustainable and responsible mutual funds offered by USSIF's institutional member firms.[61] This tool offers individual investors a way to compare cost, financial performance, screens and voting records of competing funds, with all listed funds being open to new investors. The USSIF also hosts a chart that displays information about the sustainable and responsible investment (SRI) strategies available to separate account clients from USSIF's institutional member firms.[62]

There are, of course, limitations to these resources. Many of the funds featured on the IA50 and ImpactBase ultimately rely on the very impact accounting tools and systems discussed earlier (which still have some maturing to do), and the USSIF's resources are largely focused on SRI or ESG-aligned investment opportunities (passively considering social and environmental elements as opposed to measuring and reporting them throughout the entire investment process). But these resources are each uniquely situated to go deeper and broader in their embrace of rigor and impact investing.

Manage the Integration of Impact in Order to Build the Pipeline (and Flow Within It)

…the investment management methodology exists most readily within the managed account universe to envelop impact investments, more so than any other investment structure.

An Impact Investing brief that the Money Management Institute (MMI) released in 2012 argued that the investment management methodology exists most readily within the managed account universe to envelop impact investments, more so than any other investment structure.[63] The promise that was hinted at in 2012 has proven out, with firms like Morgan Stanley, UBS, Merrill Lynch, and Envestnet now drawing on separately managed accounts and mutual funds to build impact investing product offerings.[64] In September 2014, Morgan Stanley announced the creation of two sustainable investing portfolios for its Select Unified Managed Account (UMA) Platform. These new portfolios—Investing with Impact Balanced and Investing with Impact Equity—will provide Morgan Stanley clients the opportunity to effectively align their financial goals with their personal values.[65] Available on the firm's UMA platform, the portfolios leverage firm-wide portfolio construction resources including asset allocation advice, manager research, risk management and ongoing portfolio monitoring to provide clients with a diversified multi-asset class portfolio.[66]

Not to be outdone, UBS has developed a managed portfolio of ESG investments, which serves as a sustainable take on an existing managed portfolio series, drawing on mutual funds and ETFs as underlying investments.[67] Merrill Lynch, for its part, has an open architecture ESG platform that includes a wide variety of mutual funds, ETFs and separately managed accounts that its advisors can use to build portfolios for clients. One of its newest offerings is the ALPS Workplace Equality ETF (EQLT), which tracks an index of 140 publicly traded global stocks chosen because the issuing firms support equality for lesbian, gay, bisexual and transgender employees. Another new offering is the recently introduced Calvert-Osmosis MORE World Strategy, an SMA that selects best-of-breed stocks based on how efficiently the firms use resources versus their revenues.[68]

As noted earlier, while the focus and majority of products showcased on these platforms are more compatible with ESG-alignment or SRI, these platforms are uniquely structured to incorporate impact investment products and will grow increasingly important to advisors and product developers looking to engage investors in this way.

Getting on these platforms is another question, though. Major financial institutions are deepening their proprietary ESG training programs for their advisors and fund managers in order to include the rigor associated with impact investing. But wholesale utilities for fund managers to better integrate and manage impact are emerging, too. The Global Impact Investing Network (GIIN) launched a fund manager training program in November 2014 that offers practical coursework to help fund managers build applied skills to successfully attract, deploy, and manage capital.[69] Included in this program are courses designed and delivered by experienced practitioners and specialists; instruction that builds on real market data, case studies, and feedback from leading LPs, experienced GPs, and advisors; a flexible format; and subsidized costs.[70]

The Aspen Institute also offers an impact investing manager training course (via its Aspen Network of Development Entrepreneurs unit, or "ANDE" for short) that is designed both for investment managers who are actively making investments in small and growing businesses (SGBs) and capacity development providers who are working to support entrepreneurs through the investment process. The five-day course covers the entire investment process—from deal sourcing and due diligence to term sheets, ongoing business support, and exit strategies.[71] The Oxford Impact Investing Program made available by Oxford University provides yet another example of opportunities for developing the practical skills necessary to implement effective investments that will yield maximum social, environmental, and financial results.[72]

…wholesale utilities for fund managers to better integrate and manage impact are emerging, too.

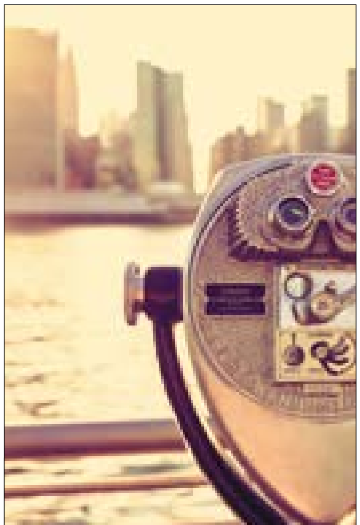
Training programs like these will also help with funds that aim to be showcased on the indexes and resources mentioned earlier. While ImpactBase requires disclosure of a fund's impact objectives, impact measurement, and impact targets, the IA50 relies on a more rigorous qualification process. Fund managers must have more than three years of experience as a firm in the impact investing field; have at least $10 million in AUM; operate in more than one country, in a country with significant population, and/or in a sizable region of the United States; manage assets that are recoverable; have demonstrated financial capacity/oversight; and demonstrate significant commitment to social impact and track clear measures of social and/or environmental impact (GIIRS rating, use IRIS metrics, or other indicators).[73]

Ask "To What End?" Today

The measurement of impact is a trail littered with good intentions, inadvertent outcomes, and not a small amount of "impact imposters." Yet the need to optimize "impact" is a shared struggle and is critical to all actors in this market—from the international financial institution making investments in Egypt to the nonprofit organization focused on youth development in Washington, DC and the investment advisor seeking to offer relevant and real impact investing products to his or her clients.

The above tension was notably captured in 2007 in a *Los Angeles Times* expose on the Bill & Melinda Gates Foundation, the largest private philanthropy in the world.[74] The foundation came under fire when the *Times* exposed that some of the investments the foundation was making on behalf of its endowment were actually causing the very afflictions the foundation was combating as part of its grant-making.[75] The foundation was funding, for example, innoculations to protect public health in the Niger Delta while its endowment was invested in companies like Royal Dutch Shell and Exxon Mobil, which were largely responsible for the pollution that was covering the delta and causing poor health in the first place.[76] The foundation has since made moves to align its programmatic mission with its endowment investing. But the lesson remains for major investors who, like Gates, can end up in the press when social and environmental outcomes of investments are not accounted for. It is also a lesson that will increasingly play out with the clients of investment advisors who will be demanding this type of alignment in their portfolios.

With investor interest in achieving social and environmental impact on the rise, the actions of major financial players reflect an ambition to serve the growing demand they see emerging. And there has clearly been no shortage of effort or ingenuity to address the issue of impact measurement (as evident in the many frameworks and tools currently available). Yet key limitations persist, despite all the progress thus far achieved.



…key liabilities persist, despite all the progress thus far achieved. But addressing these limitations represents both a sustainable and viable proposition for all stakeholders.

But addressing these limitations represents both a sustainable and viable proposition for all stakeholders. SASB perhaps best articulated the added value of making impact more measurable, manageable and marketable when it recently announced a series of provisional sustainability accounting standards. The group maintains that impact measurement enables companies to better measure and manage the sustainability risks and opportunities most likely to impact value; investors to better identify risks and opportunities in their portfolio, and benchmark companies in a given industry; analysts to better benchmark, rank, and rate companies at the industry level; and auditors to help clients recognize risk factors that may affect their businesses.[77] And there are a number of concrete next steps that all investors, advisors, and firms can take now. These include:

- Going beyond utilizing mainstream providers of ESG data (MSCI, Thomson Reuters, and Bloomberg) and adopting leading impact investing metrics and tools (the GRI, IRIS, GIIRS, and SASB) for accounting for ESG outputs, but also going further and engaging the leading providers of social outcome software and monitoring solutions such as Social Solutions and Community TechKnowledge (CTK), thereby enabling a specific portfolio *and* broader systems perspective on impact created;
- Partnering with firms that actually specialize in improving the quality, objectivity, and excellence of impact including Mathematica, MDRC, and Urban Institute to understand and improve impact performance across a range of sectors;
- Deepening proprietary ESG training programs for financial advisors and fund managers to include the new level of rigor associated with impact investing and making use of (and replicating) wholesale education programs that are becoming available by the Global Impact Investing Network (GIIN), the Aspen Institute, as well as Oxford University;

- Utilizing various indices and resources—such as ImpactAssets50 (IA50), ImpactBase, and the U.S. Social Investment Forum (USSIF)—that are demonstrating a wide range of impact investing activities across geographies, sectors and asset classes; and
- Intensifying engagements with firms like Morgan Stanley, UBS, Merrill Lynch, and Envestnet that are now drawing on separately managed accounts and mutual funds to build impact investing product offerings—helping to inform how these firms consider impact.

Investing that makes a difference sits on the cusp of mainstream wealth management and, much like solutions that came before, impact investing has an opportunity to shift the paradigm. It can become one of many answers to the problems posed by skyrocketing deficits, uncertain financial markets, and staggering need. But for us to realize this potential we need to translate impact measurement and management tools from public policy and philanthropy into an actual investment process, as well as embrace and replicate new indexes and resources for showcasing and attracting the pipeline of opportunities. Only then will investors, advisors, and firms be able to integrate information in a way that would be strategically material. And only then will the impact investing concept move from being a largely academic exercise to one that becomes deeply rooted into the systems of mainstream finance.

In answer to the question of "to what end?" the "end" of impact investing is not a conclusion or finale at all. Rather, it speaks to the consequence, quality and ultimate goals of this high potential concept. All well and good as promises go, but now we need to prove it.

…we need to translate impact measurement and management tools from public policy and philanthropy into an actual investment process, as well as embrace and replicate new indexes and resources for showcasing and attracting the pipeline of opportunities.

Essays by Practitioners Who Are Learning by Doing

Essays by Practitioners Who Are Learning by Doing

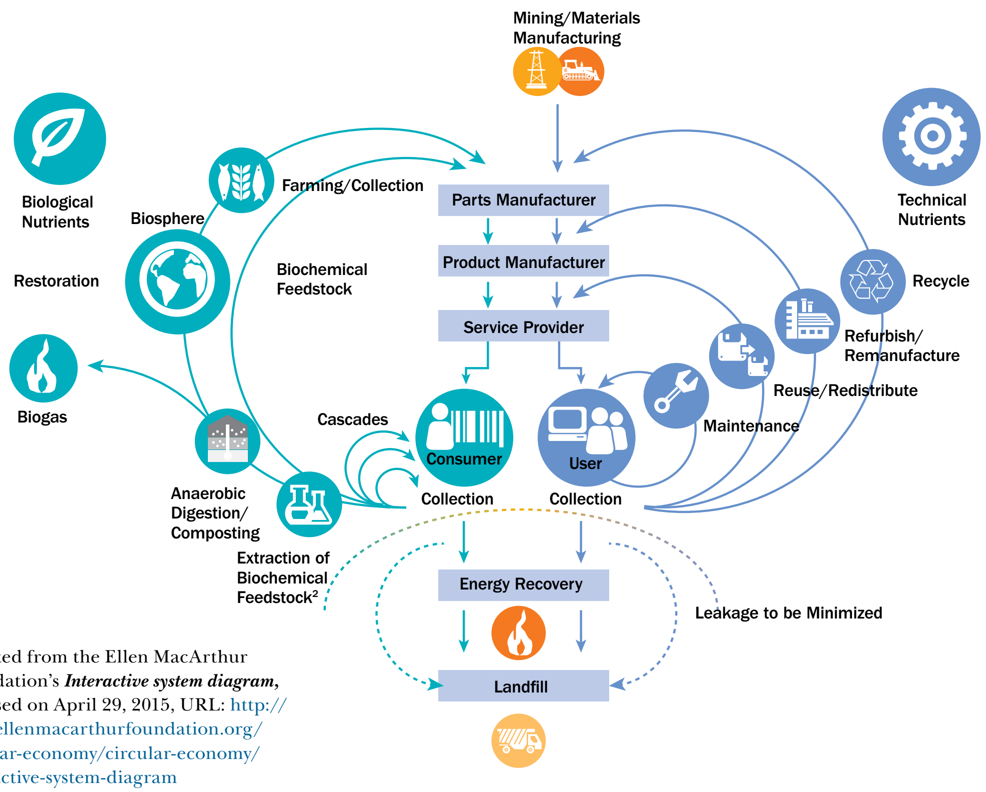
"A New Industrial Revolution Presents New Opportunities for Investors" by Jamie Butterworth

In an industrial suburb to the southeast of Paris on the banks of the River Seine, a new industrial revolution is quietly taking place. Choisy-le-Roi is one of Renault's (the multinational vehicle manufacturer) automotive plants, however it is subtly different from many other similar facilities around the world. Choisy-le-Roi is a "re-manufacturing" plant and receives pre-used components from end-of-use vehicles and transforms these into "as new" or better than new condition, before re-deploying them into the economy. The plant is, in the word's of its former COO, "the most profitable of all Renault's operations." Furthermore, it does this using 20 percent of the energy and 30 percent of the materials required by a "virgin" automotive plant. Renault is one of a new wave of businesses looking to capitalize on the model of the circular economy to decouple growth from resource constraints.

Circular economy strategies are a reaction to today's economic growth, which is to a large extent dependent on a linear "take-make-dispose" model of extraction, production, consumption and disposal. For example, 80 percent of the $3.2 trillion of commodities used by the Fast Moving Consumer Goods (FMCG) industry each year are "lost" to the economy as waste. A linear approach to economic growth has already begun to have an impact on the price and volatility of global commodities, including metals, phosphates and agricultural goods.

Looking ahead, the world's middle classes are expected to grow from 2 billion to almost 5 billion by 2030. This shift in demographics and purchasing power—what the U.S. National

THE CIRCULAR ECONOMY—AN INDUSTRIAL SYSTEM THAT IS RESTORATIVE BY DESIGN



Adapted from the Ellen MacArthur Foundation's ***Interactive system diagram***, accessed on April 29, 2015, URL: http://www.ellenmacarthurfoundation.org/circular-economy/circular-economy/interactive-system-diagram

Intelligence Council calls a "tectonic shift"—represents one of the most important trends over the next several decades.[78]

With this in mind, the circular economy is attracting increased attention from businesses and investors as a model for decoupling growth from resource constraints through the conscious re-designing of business models, products and services.[79] A culmination of increasingly volatile commodity prices and advances in technology has led to an increasingly large number of global brands adopting this model to increase their competitiveness and resilience.

Materials and components within a circular economy are designed for cycling through the economy many times, creating both new value opportunities and an eradication of waste (or system losses). The material or product cycling provides for a quantum increase in resource productivity. Partnering this with the adoption of renewable energy generation reduces the price exposure of virgin material and produces a more robust and resilient operating model.

Remanufacturing and refurbishment are in themselves not new concepts, but they have the potential to be game changing when deployed in conjunction with new business models, often enabled by information technologies. For instance, Sprint (the U.S. mobile operator) is offering customers the opportunity to buy into an "'iPhone for Life." This is one of the first smartphone contracts whereby consumers effectively become users who never own their devices but buy into a pre-defined technology refresh cycle. Customers hand in their iPhone for a new model every two years. Since they are renting the phone and not buying it, iPhone for Life subscribers also avoid paying any sales tax.

The increasingly short refresh cycles of many consumer products have led to a number of companies changing their business models to capitalize on this trend, though some are advancing beyond even this. Philips, the Dutch based electronics and healthcare giant, has gone one step further in deploying a new range of service models that includes the sale of light (Pay Per Lux) and healthcare (Philips Healthcare) as a service. "In Philips Healthcare we establish leasing relationships with customers to take back equipment and upgrade it, then refurbish it and send it on to another customer. In the process, we might upgrade the first customer to a more state-of-the art technology, and in doing so we make both customers happy. This is already a €200 million business for us," commented Philips CEO Frans Van Houten in the McKinsey Quarterly. Philips, now as a service provider, is beginning to optimize the design of its products to fit this new business model and enable optimization, repair, upgrading and redeployment.

The shift towards selling the performance of a product, rather than the product itself, is of course widespread, but the recent IT-enabled explosion of the sharing (or collaborative) economy has accelerated the transition to a more circular economy. From Zip-Car to IBM's Global Asset Recovery Program (recovering and redeploying 1 million products per annum and netting over $1 billion of sales in the process), businesses are evolving from box shifters to asset managers.

A growing number of SMEs (Small and Medium Enterprises) are positioning themselves to capture opportunities associated with the circular economy, particularly as materials and component flows create new sources of value. The breadth of opportunities is evident through the numbers and diversity of SMEs making up the different return "loops" of the circular economy. These businesses are acting as key players in the reverse supply chain of bigger players or are disrupting the linear economy by capitalizing on the transition to a circular one.

New York-based Ecovative Design has developed a material for transit packaging and insulation to replace Styrofoam. Unlike its linear, oil-based counterpart, Ecovative manufactures its packaging using agricultural waste and avoids the environmental costs of Styrofoam disposal. Ecovative packaging can be consumed at the end of its life quite literally by nature in the form of soil nutrients. Ecovative packaging is fully price competitive with petrochemical based alternatives and major customers (such as Dell, Steelcase and Electrolux) are adopting it for their packaging needs.

Many believe that a shift towards a circular economy will prove inevitable as a trend toward increased competition for resources builds momentum. The opportunity to invest in those businesses that play a key role in enabling the transition will emerge alongside this shift. Analysis by McKinsey, on behalf of the Ellen MacArthur Foundation, suggests a relatively small increase in circularity could net European manufacturers $630 billion in net material costs savings (p.a.) by 2020. The broader value creation opportunity is expected to be greater still.

It is no coincidence that the potential presented by the circular economy is of increasing interest to government, businesses, pension funds, investment banks, and private investors—and now represents a priority focus area for the World Economic Forum. The circular economy's ability to generate economic growth while having a positive impact on the use of natural resources and employment and innovation will also provide an opportunity for the growing number of private and institutional investors looking to invest in the future economy.

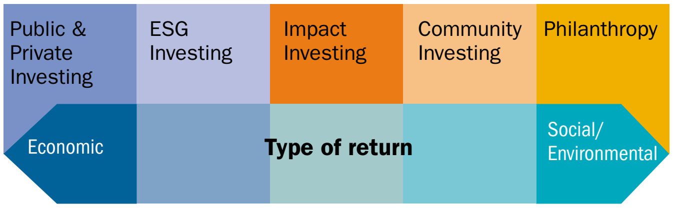
With an increasing number of investors looking to achieve both competitive financial returns and social/environmental impact, the circular economy offers a massive opportunity to invest in what can only be regarded as the next industrial revolution.

About the contributor: Jamie Butterworth, Partner, Circularity Capital

“Calibrating Expectations for Impact” by Mark Sloss

The challenges to fulfilling expectations of a client’s impact investing mandate are those of definition, context and measurement. It can be argued that every allocation of capital has an impact. The question properly framed for the client should be what the nature of the impact desired is and how it is most simply achieved. Allocating capital through investment in a public or private business may have the impact of making more capital available to grow inventory, add facilities and jobs, fuel research and development, or pay for marketing and distribution. Allocating that same capital philanthropically through gifts and grants can fund operations, acquire resources, pay for research, support communications, or directly mitigate a problem.

EXPECTED IMPACT RETURNS OF CAPITAL ALLOCATION



Allocating capital always has impact

Positive: price appreciation to righting social injustice

Negative: predatory lending to governmental oppression

It is just a question of what type(s) of impact and in what proportions

These may be perceived as polar opposites, but they exist on the same continuum of impact, and therefore we can locate mixes that lay between the two that make the most efficient use of capital to achieve some combination of those two impacts. An optimal impact investment will be one that fully and efficiently exploits the opportunity set presented by the available capital to deliver a blended return of economic and social/environmental impacts.

Clients arrive at an interest in impact investment outcomes through a variety of conduits that often correlate with the opposing ends of the impact spectrum. For some clients, the gateway to impact is principally altruistic and found through their philanthropy. They have identified a mission or purpose for giving, and are either seeking to imbue their investments with that same purposefulness, or are looking for a way to make their philanthropy more regenerative or self-perpetuating. For others, the goal is more capital-markets based with the emphasis on portfolio alignment or activation. Investors intend to create commercial outcomes with an attendant social or environmental benefit, but the traditional financial return is the paramount requirement—“doing well while doing good.” Either reconcile the portfolio with the investor’s world view and eliminate dissonance, or look for points of leverage where the investments can reinforce and amplify the mission.

In the public markets, in particular, the location and measurement of impact is more elusive, but it is also where the overwhelming majority of investor capital flows. The most common and most widely used approach to seeking impact is also the most traditional in the classic “socially responsible investing” sphere: divestiture. Exclusion of certain investments has the immediate benefit of isolating the client's wealth from areas and issues of concern, the notion of not wanting to profit from businesses and activities to which the client objects.

Impact is a second derivative of this approach insofar as portfolio exclusion uses market mechanisms to deprive investment targets of needed capital to pursue controversial activities. While this is a comforting notion on its face, the reality is that markets are awash in capital seeking any fundamental investment opportunity and increasingly flowing through index vehicles like Exchange Traded Funds (ETFs). Unless investors globally divest on a massive scale, at best a security price might be slightly depressed or quality execution might be more difficult to find in a less liquid market. Divesture movements around controversial activities will certainly draw attention to issues and may set the stage for other actions, but material impact from the investor's perspective is very difficult to locate and quantify.

The next, more meaningful, but conceptually more elusive, impact approach is engagement. The investor has the power of the owner or lender franchise as an equity shareholder or as a bondholder to challenge how the capital is being utilized. It is necessary to resolve for the investor the discomfort with holding an investment that on its surface is at odds with a mission, purpose or belief system by understanding the potential to improve the investment through the tools of engagement and activism. There is a time-honored tradition of activism for the benefit of shareholders and lenders from both famous and infamous investors to improve operations, unlock value, change boards, or force mergers or divestitures and much can be taken from these franchise tools. The same pressures can be brought to bear to address controversial activities from the supply chain to the factory floor to the store shelf by engaging with C-suite executives, voting proxies, or sponsoring shareholder resolutions. These actions are visible and measurable and have the potential to be material.

To date though, the results have been mixed when it is only a vocal minority that engages, or when proposals appear at odds with creating fundamental investor value. There also remains a regulatory gap that has not fully empowered public market investors to the extent necessary to truly drive change from the market inward.

Lastly, and perhaps most consistent with the private investment space, public market investors can employ a more selective and affirmative approach to allocating capital to investments that hold positive impact attributes. A municipal bond offering backing a water, school, hospital, or energy project has measurable and material impact that directly connects the investment with the outcome. Investments in companies innovating in areas like sustainable energy, clean water, fair trade organic food, or drugs for global pandemics have obvious environmental and societal benefits that can be understood and measured. However, pure-play companies are the exception rather than the rule.

Most of the investment opportunities in the public markets are in diversified enterprises where the impact value proposition may not be so clear, and therefore the investor must make an assessment of whether, on balance, the company does more good than harm. The worrisome issue with this approach is, much like in the private space, investments can be re-labeled as "green" or "impact" to take advantage of investor sentiment without truly embracing the principles behind those terms. Fundamental analysis is critical to parse material impact from window dressing.

There are numerous sub-markets that have emerged to tackle the challenge of connecting investors with investment opportunities consistent with extrafinancial considerations—Socially Responsible Investing (SRI), Environmental, Social and Governance (ESG) investing, Values Based Investing (VBI), and impact investing among many. Organizations such as the Global Impact Investing Network (GIIN), the United Nations Environment Programme, the Sustainability Accounting Standards Board (SASB) and others have undertaken the challenge of defining what is sustainable and material in these sub-markets and from which we can understand and measure impact outcomes with the same systematic rigor as we do financial performance and risk. In order to elevate impact from a "feel good" exercise to a fundamental investment discipline, a comprehensive measurement framework needs to be adopted that expresses outcomes in coherent financial and non-financial terms for clients. There is a necessary role for business, academia and the marketplace in bringing these discrete efforts together to create a single investable framework allowing allocators of capital to communicate impact objectives, drive decisionmaking, and measure outcomes systematically.

About the contributor: Mark Sloss, Senior Portfolio Manager, UBS Investment Management

"Market Forces and Demand Drive Impact Investing From Niche to Mainstream" by Anna Snider

The financial services industry is at the beginning of a transformational change in the way investors allocate their capital and in how companies create and measure value. In the U.S., socially responsible investing grew 76 percent from 2012 to 2014 according to a recent study by the U.S. Sustainable Investing Forum. For purposes of this paper, we will call this type of investing "impact investing" as an umbrella term that includes ESG (environmental, social, governance), socially responsible, and values based investing and extends across both the public and private markets.

As is often the case with innovation, impact investing evolved through a period of slow, gradual growth before its recent rise, and the conditions for the market to reach mainstream maturity, scale and sustainability are only now converging. The result of this evolution has been a maturation of both the breadth and depth of quality investment offerings that we believe provides a compelling opportunity with the potential for maintaining market-rate returns.

In many ways, the incubation of impact investing began in the 80's with what Nelson Mandela referenced as one of his greatest tools in the fight against apartheid, when shareholders divested of South African assets. Divestment developed into an investing niche that sought to advance positive social policies by avoiding or screening out companies, often referred to as "sin stocks." For many years, impact investing options remained limited, and the technique of negative screening often created portfolio gaps that led to many socially responsible investors never seeing the returns they needed, or expected. Unfortunately, that poor performance created lasting negative perceptions that impede mainstream adoption even today.

The market environment has changed dramatically in the decades since negative screening developed. Investors now have the data, tools and market context that allow them to achieve social or environmental impact without sacrificing financial returns. Investors' impressions of low-returning impact investments have been made obsolete by market changes and financial innovations.

Specifically, there are four developments that have come together to produce this opportunity: (1) the proliferation and availability of ESG data; (2) advancements in portfolio construction techniques; (3) the shift in the underlying drivers of public market valuations and risks, and (4) the rise of social entrepreneurism, as a generation of wealth creators and inheritors look to take on societal issues through private capital.

Impact Investing Market Comes of Age: Innovation Drives Structural Capacity

Technological change and the era of big data have transformed the impact investing community's ability to analyze risk, identify potential sources of alpha, and construct risk and return balanced portfolios. An industry has developed to provide research and data on a diverse range of ESG factors, allowing investors to better understand and measure risks as well as identify investment opportunities in the public markets. Major data providers such as MSCI and Thompson Reuters, along with traditional asset managers, have been acquiring or building out ESG research teams, and many are now creating ESG ratings for both public fixed income and equity securities. For example, MSCI now uses 1,000 data points to rate the constituents of the MSCI World Index on both positive and negative ESG factors. As in any market, the availability of new information and comparable data points creates a new pool of potential investors. Portfolio managers, institutional and high net worth investors can now better construct and manage their portfolios using this data, thus creating a positive cycle of more users and more and better data.

Of course there remains room to improve. As industry adoption grows, there are ongoing initiatives to standardize public market metrics and data for the impact industry, for example, at the Sustainability Accounting Standards Board (SASB). Similar efforts are underway in the private equity, private debt and real assets space to help investors identify social businesses and ventures that operate with a "double bottom line," which refers to financial results of the vehicle but also focuses on societal benefits. For these private investments, traditional investors struggle with relatively limited track records and exit data, fund size and how to compare impact metrics across different vehicles. Nonetheless, the pool of private impact capital is growing quickly, and we applaud the efforts of organizations such as the Global Impact Investors Network (GIIN) and B Analytics to create standardized frameworks for private impact data across asset classes.

The big data revolution has also enabled and paralleled the development of more sophisticated portfolio construction techniques across the financial industry. Critically for impact-focused managers, it is now possible to build portfolios that integrate ESG factors across a range of sectors, with balanced weightings that reduce risks over various cycles and market conditions. Using substitution methods based on improvements in factor-based analysis as well as portfolio optimization techniques, portfolio managers that are screening out "sin stocks" from values-based portfolios can now use positive ESG factors to find best practitioners in those sectors. Access to new and better data, partnered with more sophisticated portfolio construction techniques, allows a portfolio manager to exclude a large polluter but include a company that manages waste more effectively, without impacting the sector allocation or portfolio characteristics. This has led to a strengthening and proliferation of offerings in the public equity space and a growing number of fixed income offerings.

While the proliferation of investment options in the market is positive and will lead to a better overall investment quality for investors, it has also increased the importance of due diligence. There are a large number of funds that now identify themselves as values-based or impact investments. But all of them are not equal in investment quality and not all deliver reasonable investment return for the risk.

New Definitions of Value and Risk

Over the last quarter century, a seismic change has occurred in the valuations of companies listed on the S&P 500. In 1975, tangible assets comprised more than 80 percent of the value of the S&P 500, with intangible assets representing less than 20 percent of market capitalization. Today, that ratio has *flipped*. 80 percent of corporate value now resides in intangible assets.

This means that traditional balance sheet and credit analysis doesn't capture the largest aspects of risk or potential reward in companies. The value drivers of many businesses now lie not in physical and financial assets but instead in intellectual property, market share, brand awareness and perception of the company's impact (good and bad) on society and the environment. Corporations have responded. In 2011, only 20 percent of S&P 500 companies were reporting on their corporate social responsibility (CSR) activities, while in 2013, the proportion is *reversed*, with 80 percent publishing CSR reports.[80]

Competitive Returns and the Perception Gap

The transformation of data accessibility, financial technology and market valuation has made competitive financial performance for impact-oriented investments a reality. In fact, a 2010 Harvard University report found that high-sustainability companies' returns topped their low-sustainability equivalents by 47 percent over a 17-year period. Furthermore, the MSCI KLD index, which is the oldest socially responsible index, has outperformed the S&P 500 since its inception in 1990 (Bloomberg).[81] However, a perception gap persists. According to our research, two-thirds of investors are unsure whether impact-oriented investments can offer competitive performance. Half said they would likely increase their allocation to these investments if they believed performance was competitive.

Investors Drive Market Change

The forces that will continue to push impact investing further into the mainstream are not a mysterious phenomenon. In this era of innovation, the world around us is changing rapidly, and many of the forces driving shifts in the economy are also reshaping global and personal priorities. The advance of science and technology has heightened awareness of our interconnectedness, the cause and effect of our actions and decisions not only on our own wellbeing but also on our families, society and the environment, now and for future generations. We continue to see demographic and economic shifts—globalization, the economic empowerment of women, the retirement of the baby boomers and the potential $56 trillion in wealth transfer to the millennial generation—that are driving this change. Our clients are demanding that we consider another dimension of investing, that results be measured on impact as well as financial return.

Institutional investors have led the way. Recognizing that environmental, social and governance factors are critical to evaluating not only investment risk but also investment opportunity, institutions have, for example, almost doubled investments with environmental criteria in the past two years, to $1.24 trillion at the end of 2014. At the same time, public pensions have invested $513 billion in climate change and carbon emission-focused assets. This increase in activity signals an important shift in impact investing. For many institutional investors, it is now a stated fiduciary obligation to ensure that environmental and social risks are taken into account in their investment approach.

The next generation of investors is also pushing the investment world to expand its boundaries. Millennials will be the beneficiaries of a tremendous wealth transfer, with more than $56 trillion dollars in intergenerational family wealth expected to change hands between now and 2020. As a group, this generation feels compelled to address issues that government resources alone can't solve. They are highly entrepreneurial and motivated by a strong and passionate desire to change the world. Business schools are creating institutes and programs to meet the demand of students who want to create socially oriented businesses, where the goals of positive social and environmental impact and financial return are equal in importance. The generation that has moved the world into social networking is now incubating the next set of corporations that will help form the new economy.

Our research shows that our clients, and women and Millennials in particular, want to match their investments with social issues that matter most to them, an interest that has grown over the past five years. In a 2014 U.S. Trust survey, nearly three quarters of Millennials surveyed believed that it is possible to achieve market rate returns when investing for environmental and social impact and eight out of ten thought that the use of private capital is a way to hold governments and companies accountable for their actions.

New Approach to Wealth Management

Astute financial advisors and institutional investors have awakened to the fact that our primary business is not simply dispensing financial advice and meticulously constructing investment portfolios to be measured against benchmarks. It's about making financial lives better and transforming clients' financial and emotional wellbeing into financial and non-financial goals.

While market risk and fundamentals are supremely important and carefully architected portfolios might outperform the S&P, the greatest risk for investors is that they don't meet their goals and the value created by their investments comes at the expense of what matters to them most.

There is a profound connection between personal wealth, desire for social and economic impact, and meeting investor demand to align their wealth and values. However, we also recognize that impact investing is not only a question of values, but also a tool to identify structural investment opportunities such as energy alternatives, financing gaps both in the U.S. and developing world, or new education and healthcare based technologies.

Meeting Demand; Building the Platform

As a firm, we share with our clients the notion that private capital can be used, alongside government and philanthropic resources, to solve complex social and environmental issues, and that impact investing can financially reward both investors and corporations. The investments we have made in our impact platform, the focus of our due diligence and manager selection, and our work with policy makers, non-profit organizations and industry partners reflect this belief and commitment.

We recently signed on to the United Nation's Principles of Responsible Investing and are integrating these important principles into our discretionary asset management businesses. We are aligning with industry partners to explore new and ever more innovative investment structures with the hope of expanding the impact investment landscape for all investors. Recent examples include: our offering of the first social impact bond offered to private investors, the proceeds of which are employed in an effort to reduce prisoner re-incarceration rates; the first offering of a green bond to individual investors; and funding of new research that demonstrates the feasibility of social impact bonds for funding expanded services needed by U.S. military veterans.

These trends and market developments have created a path that supports a large, sustainable market for impact investing among mainstream investors. Our focus as an industry and a firm must now be on delivering on clients' expectations for measurable social and financial impact, and communicating it in a way that changes the question from "Why would I?" to "Why wouldn't I?"

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Acknowledgments and Endnotes

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