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SOCIAL IMPACT INVESTING

Many foundations are embracing impact investing as a way to leverage their capital.

Instead of being a charity with a fund management subsidiary they can do good and do well by providing appropriately priced finance.

Impact investing has many characteristics of private investing.

This requires both skilled risk assessment and specialized oversight.

Impact investing does not mean that philanthropy must turn a profit only that philanthropy can leave a bigger more positive imprint.

DOING GOOD & DOING WELL

Doing well by doing good is a strong organizing principle, and many charitable foundations have embraced the concept in impact investing. For philanthropists this squares a moral circle, and is reshaping the foundation asset management model. At the same time, we must guard against this organizing principle from implying that philanthropy is only worthwhile if it is profitable.

Foundations accumulate assets from donors, invest in public companies and acquire other assets to earn a return that funds charitable giving. However, the past fifty years of shareholder primacy has seen incremental growth in income captured by large corporations, which have channeled the gains disproportionately to shareholders, boosting the capital share of GDP. Real wages for most in the rich developed countries have stagnated since the early 1980s even as economic growth has continued. Growth has gone south, and debt has gone north. Offshoring sent jobs and production offshore, and brough want and need onshore.

The moral dilemma for the foundation arises because it invests in the very companies that are, through single-minded focus on building shareholder wealth and ignoring the impact of their decisions on the communities of which they are a part. Colin Mayer says that just as corporations are the source of much of what we need, they are also creating "inequality, depravation, and environmental degradation".

The rise of impact investing presents a new way for foundations to steer some of their investment assets towards investment in community businesses that provide the community with jobs and vibrancy, and make a good small business rate of return. The foundation does good for the community by investing in it, and does well for itself and its other grant recipients by sponsoring local and profitable businesses. And there is truth in this.

Social Impact Investing is More than Mantra

The logic behind impact investing is compelling, especially when you consider that the banking system in most countries is unwilling to finance small businesses because they are too small to “move the needle”. Banks will instead direct entrepreneurs to credit card financing at a staggeringly high interest rates. Credit card interest rates across Canada’s banks lie somewhere between 19% and as high as 30%, which borders on usury given that economic growth on average is barely 2% and inflation is just 2%. By offering to fund entrepreneurship this way, banks essentially capture all the potential returns to entrepreneurship, and as entrepreneurs tend to be intelligent and enterprising, they either find a way to self-fund or the idea can’t get off the ground. This is extraordinarily wasteful. Where there is opportunity there is incentive.

The pricing-out of small local enterprise by the banking system creates an opportunity in the market that charitable foundations can fill to both fund community enterprise, and benefit financially. Moreover, they align the desire to do good and do well so looked-at from an economic perspective there is reason to expect that done properly and with investment discipline foundations can both do good and do well.

Objectives and targets

Many community foundations have embraced social impact investing, so what do those portfolios look like, what returns are they targeting, and what risks are they taking? How is performance –both impact and financial -- defined, measured and managed, and how is investment risk defined?

Before entering the social impact space, it is worth asking what you are in this space to do? Diagram one below shows a matrix of impact opportunities and their expected return. We have also identified which asset class analogues map to each box.

The horizontal axis divides into three simple impact objectives: no impact, passive impact, and active impact. The vertical axis shows the range of expected returns, from outright granting to making returns in excess of the foundation’s hurdle rate.

To aid in investment intent, and to ensure the foundation is thinking clearly about what it both wants to do and what it wants to achieve, the impact decision would ideally fit in one of the identified boxes. This shows what return you can expect, what kind of impact investment proposition you are entertaining, and finally what the potential risk is.

The diagram captures the two objectives of impact investing: the rate of financial return, and the impact objective. Once you have

Diagram One

Expected Return & Desired Impact

Expected Return	No Impact Objective	Passive Impact Objective	Active Impact Objective
E(r) > Hurdle Rate	Private Equity Venture Capital Public Equity Alternatives	Preferred Equity High Yield Debt Emerging Market Debt Real Estate-Infrastructure	Venture Capital Private Equity Venture Debt Social Impact Bond
E(r) < Hurdle Rate	Sovereign Debt Cash	High Grade Debt	Mezzanine Debt Real Estate Financing Green Bonds Gender Lens Bonds
E(r) < 0 Partial Capital Recovery		Blended social impact investing and granting	"Pay-to-Play" Loss-given investment to "buy" outcomes
No Capital Recovery	Granting		
	Expected Impact		

decided what your combined objectives are, and you have determined your investment intent, then you need benchmarks to measure your impact ***and*** your financial performance.

The vertical axis divides into four expected return categories. From the top down there is the category of assets expected to yield investment returns that are above the foundation's hurdle rate, followed by expected returns that are less than the hurdle rate but greater than zero. Below this, expected returns are negative, with some intention to recover the value of some of the investment. Finally, there is a category that frames the decision as a complete loss of capital. This is not an investment objective.

No rational investor would intentionally "lose" money unless that investor had a "non-return" objective. In the impact context, you are prepared to lose ***some*** of your capital value because the impact has priority in your preference set, and this is necessary to achieve outcome leverage. If you are prepared to lose ***all*** of your capital, then this is essentially no different from making a grant. This is not impact investing, as there is no expected return. You are doing good, but you are not doing well.

Range of Investments & Risk

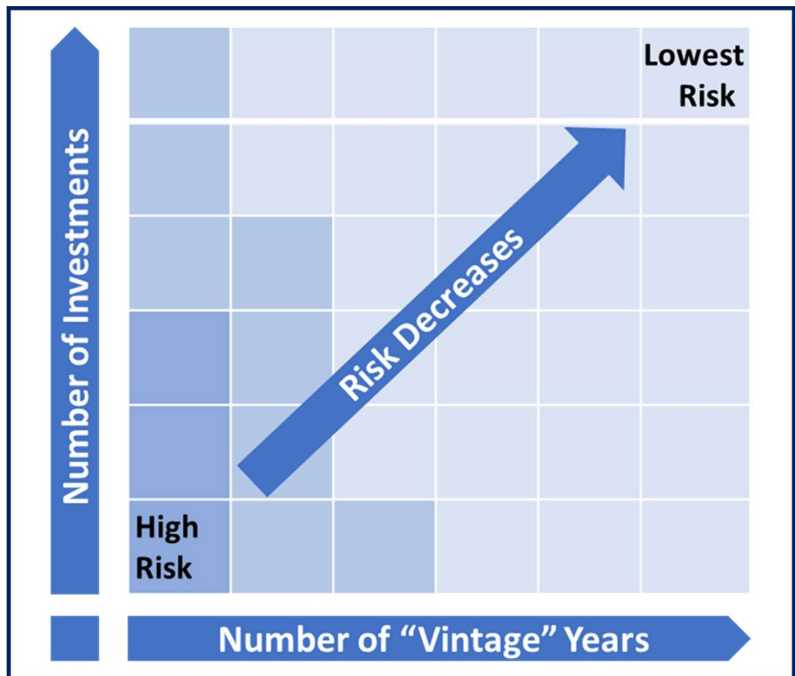
There are many innovative and creative social impact investment vehicles that deliver services the private market and public sector fail to deliver. One such concept is a social investment bond that is performance contingent. Consider an intervention program that aims to reduce recidivism, funded by a bond issue. If performance hurdles are met, the bond pays a return. The payer is a

government agency that back-stops the debt, and pays-out from expenditure saved from lower return to incarceration rates. Mortgages for housing for the relief of the homeless are another example, as is equity financing for local enterprise. But each has a different risk and return characteristic.

Risk is everywhere there is a return opportunity. As the foundation embraces social impact investing, like a child it must crawl, walk and then run. The Hamilton Foundation for example is already many miles into the marathon, with a significant allocation to direct impact, and its public market investments are aligned to sustainable investing principles.

To start, the foundation must size the impact portfolio expecting to make some losses, so those losses have to be scaled such that they have a minimal impact on the granting rate. The foundation must also undertake impact investing with the express intent that it does not cause the foundation's total expected return to fall short. Remember the private market is not funding many of the opportunities for a reason; they are too small to bother a bank, and they likely have a higher risk of loss.

Diagram Two: Diversification in Private Equity



Next the foundation must understand the risk of each individual opportunity, so that it can not only attach an expected loss estimate to the specific opportunity but also so it knows how to

manage the specific risk. In many cases, social impact investing looks a lot like private equity.

Calibrating the risk in private equity is difficult to do, as the value of a company in private hands has no observable market price until the day it transacts. Instead, the private equity manager must attach a valuation to the enterprise. This is not the same as a market value.

Risk must be estimated using statistical methods. Diller & Herger applied a Monte Carlo approach to estimating risk in private equity, and show that a significant diversification of risk, and expected loss reduction, can be achieved by maximizing the number of "vintage years" and the number of private equity holdings.

The lesson for the impact investor from this risk experiment is to build-up a portfolio of impact opportunities that are entered into over time so that losses when they come are not bundled together, and that the returns on the surviving opportunities are more than enough to both absorb the losses and deliver the overall expected return to sustain granting outside of the impact portfolio. Now, we should be clear what "loss" means in this context. It is not a loss in the normal investing sense, instead the investment becomes a grant to a project that might still have done well for the community for the time it lived. It didn't add to overall returns, and if risk is properly managed should not threaten the overall portfolio.

Private Equity -- As Far as it Goes

Any investor wants to know where the returns to their portfolio are coming from. This way you know the risks you are taking. We have asserted that management of a private equity portfolio is the best guidance we can apply to manage our impact investment portfolio.

In the private equity space, the manager builds a portfolio of exposures that she enters into through time. At the beginning there might be one exposure, and this is the time of greatest risk. As time proceeds, more exposures are added that are different from each other and are accumulated in different economic and financial market environments. This is known as the vintage year process, and provides diversification to the asset class. Just as private equity investors cannot time the market, the social impact investor cannot manage risk by timing the investment.

Most of the gains in private equity come from turning around under performing companies, leveraging the return drivers through the addition of debt, and realizing the value on sale. Private equity managers command high fees, and that meter starts

running from day one. For some time no revenue accrues to the fundholder, so the investment position “loses” money when it comes to its periodic valuation and fees are paid. This is called the J-Curve effect, you lose money before you make money as the returns early on are unlikely to more than cover costs. This is a dynamic that an impact investor will most certainly encounter.

Like the private equity investor, the social impact investor will be an active participant in the financial management of the impact opportunity. Some opportunities will proceed as planned, some will out-perform, and others will lag. The investor can expect to be involved in the business of the laggards especially if there is debt financing. Interest rate relief, interest holidays, and calls for interest or capital discharge will all be on the table. This is the most challenging time for the investor, so some skill in work-out management and some people with good negotiating skills are a must to navigating any distressed situation.

The final piece of the puzzle is liquidity. Like private equity, impact investing ties up liquidity. Its not quite Hotel California in that you can check out and eventually leave, its just that you can’t sell out of your positions at a moment’s notice. Given that a foundation is a charity with a financial subsidiary, it needs treasury and cash management acumen, a liquidity policy, and sufficient cash on hand to remain a going concern. Given the very low level of cash returns today, the more impact you do, the higher the expected returns need to be either from impact itself or other exposures in the portfolio to overcome the drag from a cash position that may now be bigger than it was prior to impact.

Governance

Managing an impact portfolio, like private equity, requires a deeper commitment and more intensive oversight of over the capital deployed. The foundation needs an oversight committee that has the skill, the experience, and the discipline to ensure that the impact portfolio meets objectives, delivers performance, and has a rational and skilled work-out process in the event of distress. Due diligence is the right place to start to minimize day-to-day management issues, and its best to have professionals do this.

We have advocated for the use of an OCIO to manage the assets releasing the oversight committee to focus on doing what it should be doing – exercising oversight! If you are in, or going into, the impact space, then it is best to ensure that you have the services

of professional management taking care of the day-to-day nitty-gritty of high involvement investing. From start to finish.

Conclusion

The logic for impact is compelling for any foundation, and offers the opportunity to do extraordinary good and earn the required investment returns. The social impact portfolio needs to be well managed, its needs frequent attention and intervention, and comes with a significant amount of risk. This is an illiquid venture, so one has to optimize the available cash on hand, and consider what the remaining portfolio of non impact assets is now required to do, if anything. Finally, size matters so the portfolio needs to be big enough to make a difference, but not big enough to cannibalize traditional granting. Happy impact investing!

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