Impact Investing

SUMMARY

Increasingly, investors want their financial holdings to reflect their personal values and have a positive impact on the world around them. At the same time, most investors still want to earn a reasonable return on their portfolio. "Impact investing" seeks to reconcile these two objectives by helping investors create diversified portfolios that strive to deliver competitive performance while generating measurable social and environmental impact. With appropriate investment planning and knowledge, investors can incorporate impact investing into their investment strategies without compromising their long-term goals.

INTEREST IN IMPACT INVESTING CONTINUES TO RISE

Early in 2013, Morgan Stanley Wealth Management commissioned a team of students from the Columbia University School of International and Public Affairs to conduct an evaluation of impact investing. This is a summary of their findings, which was first published as a three-part series in the *Custom Investment Outsourcing Strategy Committee Monthly* newsletter produced by Morgan Stanley's Consulting Group. The following sections focus on how the impact investing space is evolving; five sectors that are attracting particular investor attention; and some thoughts about important considerations and future prospects for this type of investment.

History and Evolution

The ancestor to impact investing is private philanthropy, which traces its origins to Andrew Carnegie in the 19th century. Carnegie was not the first to donate portions of his wealth to charity, but he was the first man of significant wealth in America to champion prominently the practice of private giving. Spurred by Carnegie, private wealth in the 20th century would flow to universities, libraries, hospitals, and any place that the public and non-profit sectors left a void. Philanthropists accepted these social investments as sunk costs that they would not retrieve. While this traditional form of philanthropy continues to grow, new types of social investments that leverage markets and innovation for impact are sprouting around it.

Business and social investment broadly converge in a couple of ways. The first is through the now-ubiquitous concept of "Social Enterprise," generally defined as "businesses whose primary purpose is the common good."[1] The distinguishing feature about social enterprises is their utilization of business disciplines and market forces to advance their social and/or environmental agendas. Invariably, social enterprises never abandon their primary mission, which is in some way social (or environmental). While they often aim to be financially self-sustaining, they are

– by definition – not driven foremost by a financial bottom line.

"Corporate social responsibility" (CSR) represents the second major convergence of business and social investing. As consumers become better informed and more selective based on ethical issues tied to corporate activities, CSR has become more the rule than the exception for businesses. Corporations have found that "doing good" can translate directly to "doing well" – or, at the very least, "doing bad" can directly decrease share value given the investor community's rising attention to the responsibility (or irresponsibility) of corporations' business activities and externalities.

Beyond CSR as an investment consideration, some investors are committed to "Socially Responsible Investing" (SRI), where investment funds exclude certain businesses or types of business through negative screening. These typically include companies associated with more "impure" products, like tobacco or firearms.

This brings us to impact investing. In the evolution of social investing, from its origins in the "Carnegie model" of philanthropy, impact investing is the latest and most ambitious form. A range of actors today fashion themselves as impact investors, from foundations to for-profit firms. One such influential organization is the Rockefeller Foundation, which has collaborated with leaders in finance, philanthropy and development to build the platform for "impact investing" – a term originally coined by the Rockefeller Foundation itself.

Another pioneer in the space is the Acumen Fund, a non-profit that channels donations and grants to social enterprises in the form of debt or equity. The Acumen Fund's primary concern is not with generating market-rate returns on their investments, an approach it shares with many impact investors. Increasingly, however, firms and funds are entering the space with expectations of truly competitive returns. The total value of capital deployed for impact investments rose to $4.4 billion in 2011, which was channeled to approximately 2,200 projects.[2]

What Exactly is Impact Investing?

There is no generally accepted definition of impact investing. While most definitions of impact investing include references to both financial and social returns, the lack of uniformity hinges on a particular aspect: financial returns.

What sorts of financial returns can be expected from an impact investment? In short, the answer varies by sector, geography, risk profile, and stage of investment. The influential Global Impact Investing Network (GIIN) does not confront this question directly in its commonly used definition of impact investing, as "investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return."[3] The type of financial return is tellingly unclear.

Impact investments span both emerging and developed markets, involving companies in various phases of their growth, with investors pursuing a wide range of returns - from below-market to market-rate. Many impact investors actively seek to place capital in businesses that are high-risk and would not therefore receive funding from traditional sources. As with philanthropists, these investors are seeking to fill a basic societal void, but through a slightly different approach. Often they expect full repayment of their equity investments or loans, though not for a number of years, and many times companies return for second or third rounds of funding. Offering this "patient capital" mitigates enterprises' early pressure to generate financial returns, and instead redirects focus to "social" returns.

The impact investing described so far reflects more of an advanced form of philanthropy, in which financial returns are expected but not paramount in an investment decision. Put differently, this type of impact investing prioritizes nonfinancial (social) returns over financial returns. This particular notion of impact investing, however, is far from universally accepted. A GIIN survey found that 65 percent of impact investors expect market-rate financial returns.[4] Indeed, look no further than Morgan Stanley's own definition: "Impact Investing characterizes an investment approach that aims to generate risk-adjusted financial returns while supporting positive environmental and/or social impact."[5]

What Constitutes Successful and Unsuccessful Investments?

Impact investors often are one of two types: "financial first" or "impact first." The former seeks to optimize financial return while requiring some measure of social and environmental impact (usually by targeting risk-adjusted returns), while the latter seeks to optimize social and environmental impact with a financial floor, willing to accept a higher risk or below market returns in order to create some social good. However, impact investors increasingly reject these types of distinctions, as reflected in an investor survey in 2011. Sixty percent of investor respondents did not believe that a tradeoff between impact and financial returns is necessary.[6]

Social Impact Indicators

The term "social impact" tends to encompass a broad range of nonfinancial information. Thus, any further reference to "social impact" will include this wider bucket of issues, often referred to as environmental, social, and governance (ESG) issues. The notion of "social returns" can seem nebulous. Terms like "student transition rate" or "number of people served" are not common features in financial vocabulary, and can be more difficult to ascertain. Furthermore, these metrics are relatively new and untested, and while they are rapidly evolving, at present they are underdeveloped next to their financial equivalents. To define a successful investment in terms of social impact is complex and often case-specific. Furthermore, it is difficult to determine what an "adequate" social impact looks like. While it is not easy to delineate adequacy thresholds, three major tools are emerging in the impact investing space to measure social impact: IRIS, PULSE, and GIIRS. These three impact metrics complement one another and shape what constitutes a successful impact investment.

IRIS (Impact Reporting and Investment Standards) is a set of metrics that governs the way companies report their social and environmental performance. Operated by the Global Impact Investing Network, IRIS metrics span an array of performance objectives, such as operational and product impact, and include sector-specific standards. It shows, in one snapshot, everything from "operating profit margin" to "communities served."

PULSE, jointly created by Google and the Acumen Fund, is a software platform that makes it easier for companies to aggregate and benchmark their own ESG metrics, allowing for clearer and more simplified reporting. In turn, it enables fund managers to take the "pulse" of their investments through real-time, accessible, and actionable metrics that allow managers to identify their portfolio's high and low performers quickly.[7]

GIIRS (Global Impact Investing Rating System), a product of the independent, non-profit, B Lab, is an impact ratings and analytics platform that assesses companies and funds on the basis of their social and environmental performance. Using IRIS definitions, GIIRS helps investors – and other stakeholders – assess the ESG performance of companies and funds relative to their respective peers.

All three tools serve to assist impact investors in wading through the complexity of measuring social impact. In effect, these services help investors distinguish between traditional investments and those that are truly for impact.

KEY SECTORS

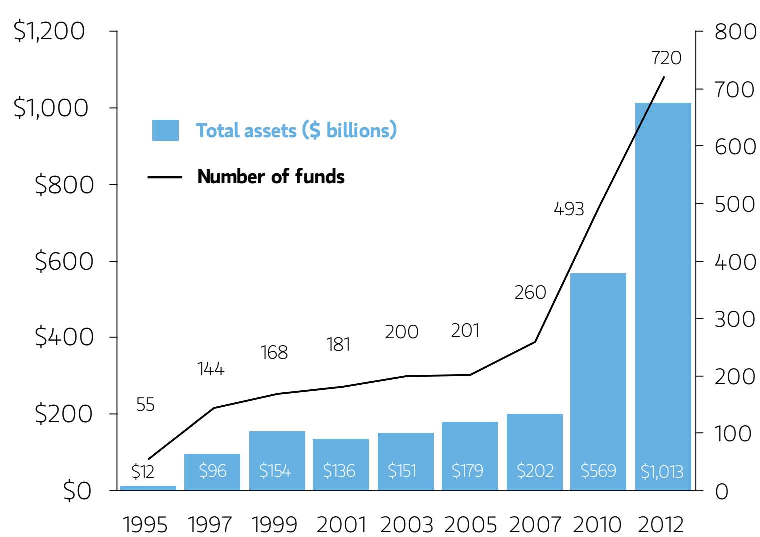
Among impact investors, there are five sectors that have been attracting particular attention: healthcare; consumer products; social finance; energy and environment; and community development.

Healthcare

Impact investments in this sector typically support companies that expand access to healthcare through lowering costs or increasing access to services and drugs. Historically, investments in the pharmaceutical industry have gone towards major multinational companies. Impact investments generally favor generic-drug producers with the potential to provide social benefits for communities from increased prescription-drug access. Developing countries with large populations, limited access to basic drugs, and rapid population growth present a large target market. The health services subsector encompasses insurance companies and private

Increased Interest in Socially Screened Funds

According to information from the Social Investment Forum, both the number of, and assets in, socially screened funds have continued to rise.



Funds in this composite include mutual funds, annuity funds, closed-end funds, exchange-traded funds (ETFs), alternative investment funds and other pooled products, but exclude separate account vehicles.

Source: *2012 Report on Sustainable and Responsible Investing Trends in the United States*, Social Investment Forum Foundation.

healthcare institutions. The demand for health services differs dramatically by countries' stage of development. In developing countries, the private sector has stepped in to provide services typically undertaken by the public sector, since the limited resources of governments render them incapable of meeting the overwhelming need. In developed countries, opportunities tend to be primarily in preventative care.

In a 2013 survey of impact investors, the Global Impact Investing Network found that while 84 percent of respondents invested across multiple sectors, among investors focused on developed markets, 52 percent prioritized healthcare, and among investors focused on emerging markets, 51 percent prioritized healthcare. These numbers have jumped dramatically in a short period of time – only 3 percent of respondents prioritized healthcare in the 2011 survey. Three attributes of healthcare seem to explain its appeal to many impact investors: 1) the ability to deliver sizable and measurable social impact, 2) the large and growing size of the market, and, 3) a track record of delivering competitive investment results.

Consumer Products

Although the consumer products sector encompasses a wide array of product categories, distributional channels and services, impact investments in this sector tend to cluster in the food and beverage industry. Consumer demand is shifting towards sustainably and equitably produced products. Consumers are demanding higher health and wellness standards in their food and beverage purchases. They are also questioning the ethical aspects of the production process for those goods.

Major investments in this area are going towards improvements in both product and process quality, such as shipping, packaging, and energy use.[8] In comparison to other areas, impact investments in the consumer products sector are in their infancy. Still, there are numerous funds focused on investments in sustainable food and other products. Some of these funds qualify for New Market Tax Credits, increasing their appeal for investors.

A considerable amount of capital and technical support is flowing to agricultural enterprises in emerging markets – largely from foundations and development agencies. These investments typically focus on increasing local food supply to meet the demand of a growing population or aim to link small producers to developing-market consumers. The latter initiatives typically involve investment guarantees and stringent safety and quality standards to appeal to developed-country investors. One example is the $25 million African Agricultural Capital Fund established by the U.S. Agency for International Development in partnership with J.P. Morgan, the Bill and Melinda Gates Foundation, the Gatsby Charitable Foundation, and the Rockefeller Foundation.

Social Finance

Impact investments in this sector generally provide financial services to unbanked or under-banked populations in the following categories: 1) financial inclusion, 2) small business lending, and, 3) microfinance. Several government agencies facilitate investments in this sector. Impact investors frequently offer early-stage equity or quasi-equity financing to help small businesses build their capital base and/or increase their financial leverage.

Financial inclusion: In addition to providing access to capital and banking services, certain impact investments focus on improving financial literacy and savings behavior. For example, the Corporation for Enterprise Development (CFED), a nonprofit "think and do tank" in Washington, DC, seeks to expand automatic enrollment in retirement savings accounts. By automatically enrolling new employees into a retirement savings account, CFED cites a dramatic increase in participation among communities of color. Impact investors also partner with Community Development Financial Institutions as intermediaries for investing in domestic community development projects.

Small business lending: Community banks, non-profits, credit unions, Community Development Financial Institutions, and Certified Development Companies all extend long-term capital to small businesses. Many impact investors utilize federal government revolving loan funds, such as the SBA 504 program for commercial real estate investments or the Small Business Investment Company designation when extending access to capital.

Microfinance: Microfinance aims to stimulate economic growth and improve living conditions through the provision of financial services to low-income and unbanked individuals, as well as start-up entrepreneurs lacking assets or access to debt financing. Microfinance institutions provide small loans, insurance, remittances, and saving products.

According to a Treetops Capital study, the number of microcredit borrowers has grown annually at a rate of 25 percent in recent years. Yet, microfinance institutions serve only a small fraction of potential borrowers eligible for this type of financial service.[9] Financing transactions include debt, equity, or payment guarantees, with debt deals being the most common.[10] Most microfinance investment vehicles seek a diversity of borrowers across regions and sectors in order to reduce portfolio risk.

Energy and Environment

Impact investments in alternative energy and the environment occur across numerous industries, primarily among three categories: 1) energy efficiency, 2) sustainable forestry, and 3) water.

Energy efficiency: McKinsey projects that by 2020, investors will commit $170 billion each year to energy efficiency, cutting global energy demand in half and yielding approximately $900 billion in annual energy savings; roughly two-thirds of the capital would go to developing economies.

Sustainable Forestry: Sustainable forestry applies an Ecosystem Forest Management approach aiming to reduce the ecological difference between the managed forest and the natural forest. Sustainable forestry investments typically benefit from conservation tax credits, carbon credits, and New Market Tax Credits.

Water: As with energy, factors like world population growth, rapid urbanization, and quickly developing economies translate to increasing demand for water, the supply of which is finite and without substitute. Less than 1 percent of the earth's water is immediately drinkable. Global Water Intelligence estimates that roughly 300 venture funds are now active in the space.

Community Development

Community development impact investments aim to expand social and economic opportunity through community-based assets. Community development funds provide capital and technical expertise in order to yield long-lasting, community-built assets, such as affordable housing, schools, infrastructure, and cultural facilities.

Investors frequently seek community development investments in order to finance 'bricks and mortar' projects with tangible impacts in their local communities. The Community Reinvestment Act of 1977, enacted to spur financial institutions to invest in underserved communities, has long been a driver of community development investment. However, due to industry consolidation following the 2008 financial crisis, fewer financial institutions exist to provide this type of financing. The public sector has also been a significant source of community impact investment, reflected in the U.S. Treasury's direct financial support to Community Development Financial Institutions whose primary mission is to provide traditional capital in less active markets. Even so, the supply of public-sponsored capital cannot meet the demand in underserved communities, creating opportunities for impact investors to fill the void.

GENERAL CONSIDERATIONS

Investors should not adopt a one-size-fits-all approach to evaluating impact investment opportunities. Each sector has unique dynamics that investors should consider. However, an awareness of the following general considerations can help investors navigate their search for investments that provide financial returns with measurable impact.

MACROECONOMIC TRENDS AND PUBLIC SECTOR ENGAGEMENT. The macroeconomic environment will affect consumer demand for products across all sectors. The number of households in emerging markets with disposable income over $10,000 will surpass that of the US and Europe within the next 3-4 years. The growing working population and rising middle class in emerging markets translates to greater impact investing opportunities.

- Population growth will stimulate demand for impact products. The United Nations predicts world population to peak at 9.22 billion in 2075, with populations in Africa and Asia growing the fastest, where median income is generally lower.[1] This suggests ample opportunities for impact investments in social finance, health care, and energy and water.
- Government policy can positively sway demand for impact products. Tax breaks and subsidies are often integral components of financing for impact products, especially in affordable housing and community development. This can increase institutions' appetite to provide financing for projects that target underserved communities.

TECHNOLOGY AND INNOVATION. The proliferation of technology in the developing world presents opportunities for private-sector investments, particularly in large, under-banked communities. Technology that enables individuals to use mobile phones to make direct payments, circumventing the need for strong local financial institutions, mitigates repayment risk. Product and service innovation will prove especially important. Given that many impact investments occur in the developing world, innovation is necessary to overcome hurdles, such as lack of infrastructure, to provide goods and services to the population.

RISK MITIGATION. Innovative products mitigate risk. Grouping of loans implies collective responsibility; providing technical assistance builds the capacity of organizations receiving loans. Both of these practices tend to increase repayment rates.

NATURAL SYNERGY BETWEEN SOCIAL IMPACT AND FINANCIAL RETURNS. Financial and social returns can have a positive correlation. For example, investments that increase energy efficiency often increase productivity, reduce costs and conserve energy. Therefore, the investment not only reduces carbon emission, which benefits the environment, but can also generate higher profit, which typically benefits investors. Sustainable forestry not only protects the ecosystem and prolongs the life cycle of the forest, but can also enhance its inherent value and generates additional return potential by way of tax credits, carbon credits, and conservation sales.

COUNTRY RISK. Impact investments typically have greater country-related risks, as a sizable proportion are made in developing countries with weaker and more unpredictable political and financial institutions. Marginalized communities, traditionally under banked, are often recipients of loans. Lack of information on these communities, particularly on repayment rates, increases credit risk.

MANAGEMENT AND LEADERSHIP RISK. Funds focusing on impact investments generally are unable to offer leadership teams the same compensation as competing entities operating outside of impact investing. This may change as impact investing gains traction. Investors should scrutinize the goals of leadership teams. Do leaders emphasize financial returns or social impact, and how does this align with the investor's objectives?

MEASUREMENT RISK. Social metrics are still evolving. There is no unquestioned industry standard for measuring social and environmental impact, and relevant metrics for different sectors can vary substantially. Many of the current frameworks rely on self-reporting, which raises concerns related to accuracy and consistency.

FINANCIAL AND CURRENCY RISK. Many investments are capital intensive with long time horizons, particularly in the sustainable energy and health care sectors. Inflation, particularly in developing countries, is always a risk – particularly where governments and monetary policy is historically unstable.

POLITICAL RISK. Governments, particularly in developed countries, provide loan guarantees for under served and under banked communities, reducing investment risk. However, this type of intervention raises other considerations. For example, government policy can be fickle, and policies can change. For many capital expenditure projects requiring significant up-front costs, government subsidies are often necessary to render projects cost-competitive. This is particularly relevant for renewable energy products, where the creation of institutions like the carbon market attempt to price externalities into the cost structure of nonrenewable projects.

Diversification

Given the inherent risks associated with many impact investments, a diversified investment approach seems prudent. Impact investments can involve a diverse set of companies in different stages of development and various types of projects. A diversified investment strategy increases investors' chances of realizing competitive, risk-adjusted returns. Each sector exhibits different levels of correlation with their policy environment and the international market. The healthcare industry, for instance, is largely policy-driven, while the consumer products industry is more dependent on company innovation. International resources largely drive the energy market, whereas local officials typically shape community development. An external impact on one sector may have no significant effect on another.

Looking Forward

Many investors have employed a wait-and-see approach when it comes to impact investing, questioning whether this is a fleeting fad or has staying power. As the space continues to evolve and as success stories continue to surface, the risks associated with investing in marginalized communities or "sustainable" products will diminish in turn. Indeed, there is mounting evidence that not only are financial and social returns not fundamentally in conflict, but also that they can align to simultaneously generate competitive returns for investors and a positive impact for society.

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