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Impact Investing:

History & Opportunity

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***Innovation in the financial services industry has not always been a force for good.** Americans are by now familiar with the story of the sub-prime mortgage industry and the novel securitization strategies that contributed to the financial crisis of 2008. Yet alongside the scandals, a more positive form of financial innovation has emerged. Variously referred to as sustainable, ethical, responsible or impact investing, an increasing number of investors are employing strategies that look beyond the quarterly, or even annual financial results of their portfolios. Their interests extend to the long-term economic, social, and environmental impact of the companies they help to finance.*

One barometer of this activity is the United Nations (UN) Principles for Responsible Investment (PRI), an association of institutional signatories that have committed to consider environmental, social, and governance issues in their investment processes. As of April 2016, the UN PRI had 1,500 signatories with $62 trillion of assets under management (AUM), up from just 100 signatories and $6.5 trillion of AUM at the organization's founding in 2006.[1]

As interest in this new approach to investing has grown, asset managers have responded with an increasing number and variety of strategies designed to meet the demand. Investors can today deploy capital across a spectrum of investment products, in nearly every asset class, and build diversified portfolios that align with their values, if not promote them. The challenge is to sort through all the opportunities, many of which are new and have limited experience.

***Impact Investing: History and Opportunity** reviews the sometimes confusing terminology that proponents and practitioners of this new investment approach use and then introduces various strategies that are available across asset classes. It is most relevant for institutional-scale investors with comprehensive, multi-asset class portfolios. A companion piece to this paper, to be published separately, will focus on the investment process – how investors can draw from the opportunity set described here and successfully navigate the challenge of building diversified portfolios that balance the sometimes competing objectives of maximizing risk-adjusted financial return and generating social or environmental impact.*

A Brief History

Many of the early ideas about the moral responsibilities of commercial enterprises in the United States came from Christian ministers preaching in the 1700s against participation in the slave trade and other industries deemed immoral, such as alcohol and tobacco.[2] In an oft-quoted sermon titled "The Use of Money" delivered in the mid-1700s, John Wesley, the founder of Methodism, advised his followers that evil could not be found in money itself, but rather in how it was used. "Gain all you can," he wrote, "without hurting either yourself or your neighbor, in soul or body…"[3] Eventually, these ideas made their way into finance with the launch in 1928 of what is now called the Pioneer Fund, the first mutual fund to avoid certain types of investments on the basis of religious criteria.[4]

Later in the 1960s, politically-motivated investors joined faith-based investors in using their investments to draw attention to social and environmental issues. Opposition to the Vietnam War and growing awareness of the social and environmental consequences of the country's economic activities spurred the launch of the first "Socially Responsible Investment" funds. These funds not only excluded investments in alcohol and tobacco, but avoided investments in weapons manufacturers.[5]

In the 1970s and 1980s, the growing movement of socially-motivated investors turned its attention to apartheid South Africa. Student activists pressured their universities to divest from companies that conducted business in South Africa while others rallied around the so-called Sullivan Principles, which called on U.S. corporations to divest.[6] The debate over the ultimate impact of the divestment movement continues, but the campaign did spark a discussion about the role personal, community, and national values should play in shaping business behavior.

Through the 1990s up to the present day, the field has grown substantially and has begun to coalesce around industry standards and best practices. The U.S. Forum for Sustainable and Responsible Investment estimated in 2016 that "sustainable, responsible and impact investments" had reached over $8.7 trillion, up from roughly $3 trillion in 2010 and $500 billion in 1995.[7] Other industry organizations, such as the Global Impact Investing Network, the Global Reporting Initiative, and the Sustainable Accounting Standards Board, have all emerged to bring structure to the still-nascent field.

The Landscape Today

Until the late 1990s and early 2000s, investors typically drew a clear distinction between their investment activities and their philanthropic giving. To the extent personal values, social concerns or environmental considerations were used to inform investment decisions, they typically led to binary outcomes. Investors simply avoided companies with attributes they considered undesirable.

Today, the investment landscape is far more diverse. Investors can now access strategies that make varied use of social and environmental data to guide investment decisions, and the line between finance and philanthropy is no longer as sharp. As with any new and emerging field, practitioners continue to debate the appropriate use of terminology. While "impact investing" is often used as a short-hand reference to the entire field of practice, it constitutes one of three distinct approaches to the incorporation of non-financial factors into investment decision-making, as shown in the graphic below.

Socially-Responsible Investing (SRI)	Environmental, Social and Governance Investing (ESG)	Impact Investing

Socially-Responsible Investing (SRI)[8]: The practice of avoiding investments in companies with characteristics that conflict with an investor's values or worldview.

Environmental, Social & Governance (ESG) Investing: Investing on the basis of an integrated assessment of financial, environmental, social, and governance factors.

SRI is the oldest investment approach depicted in the graphic. The practice is often referred to as "negative screening" because of its focus on screening out "bad" companies from the investment opportunity set. Typical screens include avoiding investments in companies that derive more than a threshold level of revenue from the sale of alcohol, tobacco, firearms or military-grade weaponry. In response to the fossil fuel divestment movement, some fund managers offer products that screen-out companies with any ownership of fossil fuel reserves. Screening criteria have also been developed for a variety of religious faiths, including Catholicism, Judaism, and Islam.

ESG investment strategies emerged as investors increasingly sought ways to go beyond the "do-no-harm" approach of SRI in favor of a more proactive, strategic approach. For some, this has meant implementing both positive and negative screens when constructing an investment portfolio. Rather than avoiding fossil fuel companies altogether, for instance, some ESG mutual fund managers remain invested in the energy sector but only select companies that employ state-of-the-art environmental and safety practices.

A second group of ESG strategies has been developed purely from a financial return perspective. These are based on the thesis that companies with positive ESG characteristics, such as strong corporate governance, a motivated workforce, and resource-light operations, will be better positioned than their peers to ride positive economic trends, weather downturns, and ultimately generate superior long-term returns.

Recent studies have demonstrated this effect empirically, though only when companies perform well on ESG metrics that are material to their industry.[9] For instance, the stock price of an airline working assiduously to minimize its water use is unlikely to see a boost. In fact, the stock may suffer as management wastes time and energy on an issue with little operational relevance. By contrast, investors may reward an airline that focuses on reducing its carbon footprint. Improved fuel management reduces greenhouse gas emissions, but it also generates cost savings and reduces the airline's sensitivity to the volatility of fuel prices.

ESG analysis can also be the basis of broader, thematic strategies. A number of investment managers pursue strategies designed to capitalize on what they see as the inevitable global transition away from fossil fuels and towards renewable energy. Others have built strategies around gender equity, investing in companies with strong anti-discrimination policies, a diverse workforce or above-average female representation in positions of leadership.

Impact Investing: Investing with the intention to generate positive social or environmental impact alongside a financial return.

Of the three approaches, impact investing resides closest to the line that separates finance from philanthropy. Underlying every impact investment is a theory of change that describes a cause-and-effect relationship between the capital deployed and some set of targeted social or environmental outcomes. These theories of change can be straightforward. For instance, the well-researched link between water quality and health outcomes might motivate impact investors to finance the construction of a water treatment facility. They can also emerge out of the rigorous analysis of interrelated issues, as is the case in the field of microfinance, one of the most mature sub-sectors of the impact investment market. Microfinance institutions operate on the basis of complex theories of change that link access to capital with economic development, women's empowerment, and access to education, among other development objectives.

As with philanthropic grants, the priority that impact investments place on achieving specific outcomes is most evident in performance assessment. Just as donors expect their grantees to report back on the outcomes they achieve, impact investors measure the social and environmental outcomes associated with their investments and use that data to evaluate success. In this regard, impact investments differ from ESG and SRI investments. The typical ESG or SRI investment is assessed on the basis of its exposure to certain sectors or business practices, not on the outcomes achieved per dollar invested.

The similarities between impact investing and philanthropy should not overshadow the key difference between them: the expectation of financial return. Unlike grants, impact investments are always made with the expectation of earning some financial return, whether a simple recovery of capital or a several fold increase in the initial investment. The opportunity to reinvest proceeds into new investments is a major component of impact investing's appeal.

What About Returns?

Investors often assume that SRI, ESG, and impact investments invariably deliver lower financial returns than traditional investments. Indeed, some impact investments are designed with lower rates of return in order to enhance their social impact. Community Development Financial Institutions, for example, often provide low-interest loans to help spur economic development in their local communities.[10] But research has shown that SRI, ESG, and impact investment strategies that target market-rate returns are capable of achieving them. In *From Stockholder to Stakeholder*, a team from Oxford University and Arabesque Asset Management examined over 200 academic studies on the relationship between sustainability and financial performance. The team found that 80% of the studies showed that the "stock price performance of companies is positively influenced by good sustainability practices."[11]

In March 2015, Morgan Stanley examined performance data for 10,228 open-end mutual funds and 2,874 separately managed accounts based in the U.S. They report that "investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments…on both an absolute and risk-adjusted basis, across asset classes and over time…"[12]

Finally, the Global Impact Investing Network, in partnership with Cambridge Associates, published the first-ever impact investing benchmark in 2015 based on a review of the performance of 51 private equity funds launched from 1998 to 2010. The results were mixed. While the full sample of impact funds underperformed the comparative universe of traditional funds over the period analyzed, various subsets of impact funds outperformed their peers. These included impact funds launched between 1998 and 2004, those that raised less than $100 million in AUM, and those focused on emerging markets.[13]

In all of these cases, researchers emphasized the importance of manager selection. Just as in traditional investing, investor due diligence is critical in identifying and assessing quality SRI, ESG, and impact investment opportunities.

Across the Asset Classes

Some early work on impact investing characterized the field as an asset class unto itself, arguing that just like publicly-traded equity or private real estate, impact investments share a common set of distinguishing characteristics.[14] As the preceding section has hopefully made clear, SRI, ESG, and impact investing are better described as investment approaches, rather than as asset classes. Today's investors sort through these types of investments using a cross-sectional grid, assigning each opportunity to one of the traditional asset classes as well as to one of the three approaches.

Nonetheless, the reality of today's market is that these approaches are better aligned with some asset classes more than others. SRI and ESG strategies are typically found in the public markets, such as listed equities and fixed income, while impact investments are concentrated in the private markets, such as private equity, debt, and real assets.

THE SRI, ESG, AND IMPACT INVESTING LANDSCAPE

	Public Markets	Private & Alternative Assets
SRI & ESG Strategies	Public Equity Fixed Income	Hedge Funds
Impact Investing	Public Equity with Shareholder Engagement	Private Equity Private Debt Real Assets

The Public Markets

Public Equity

In the years that followed the launch of the Pioneer Fund in 1928, SRI strategies gradually grew in number and became more widely available. SRI strategies are accessible through "off-the-shelf" mutual funds and Exchange-Traded Funds (ETFs), as well as through separately managed accounts (SMAs). High net worth and institutional investors dissatisfied with the screening packages used in widely-marketed products may prefer to access SRI strategies using the SMA format, which often allows for the use of customized screening criteria. Common screening packages include:

Alcohol, Tobacco, Gambling, Firearms, and Weapons

Many SRI funds screen out so-called "sin" stocks, which include companies in the tobacco, alcohol, gambling, firearms or military weaponry industries. Given that large conglomerates can often have operations in a variety of industries, screening criteria are usually based on an exposure test. For instance, a fund might restrict itself to companies earning no more than 10% of their revenue from screened activities.

Fossil Fuel-Free

In response to growing concerns about climate change, several mutual fund providers offer portfolios that exclude the securities of companies that have significant ownership of fossil fuel reserves, such as coal, oil or natural gas. The Carbon Underground 200 is a popular resource for fossil-free investors. It lists the top 100 public coal companies and top 100 public oil and gas companies, ranked according to the potential carbon emissions of their reserves.[15]

Religious Values

Given the field's roots in the religious community, it is no surprise that a variety of strategies are available that screen companies based on their compatibility with the tenets of several major religions. The United States Conference of Catholic Bishops (USCCB), for instance, has developed a set of socially-responsible investment criteria outlining how portfolios should be constructed to comply with Church teachings.[16] Muslim and Jewish investors can also purchase investment products that are managed in compliance with their faiths.

Implementing an SRI strategy typically begins with the selection of a popular asset class benchmark, such as the S&P 500 Index, the Russell 3000 Index or the MSCI All Country World Index. After excluding from consideration any securities that violate the selected social or environmental screening criteria, the manager then rebalances the portfolio to approximate the risk and return profile of the underlying index. The goal of the process is to minimize tracking error, which is the performance differential between the portfolio and the index, while maintaining strict adherence to the screen.

SRI strategies remain an important part of the opportunity set in public equity markets but, over the past decade, the industry has largely shifted its focus towards ESG investing. Investment managers today employ proprietary analytical methods to process both ESG and financial data and identify which securities to include in their portfolios. Negative screens may be used to limit the investable universe, but it is increasingly rare that they are used as the sole basis of security selection.

Case Study: Pax World

The experience of Pax World ("Pax") exemplifies the shift from SRI to ESG that has occurred among asset managers in the public markets. The first Pax World fund was launched in 1971 in response to the antiwar movement in the United States. The SEC maintains an archive of Pax World's fund prospectuses going back as far as the late 1990s. From the earliest available document through 2006, Pax included a section titled "Social Screening" that emphasized its funds' avoidance of investments in military-related businesses. The language in this section offers a good example of how SRI strategies were typically structured:

Consistent with their ethical investment criteria, [The Pax World Funds] seek investments in companies that produce goods and services that improve the quality of life and that are not, to any degree, engaged in manufacturing defense or weapons related products or companies that derive revenue from the manufacture of liquor, tobacco and/or gambling products…

The ethical investment policy of each Fund is to exclude from its portfolio securities of (i) companies engaged in military activities, (ii) companies appearing on the United States Department of Defense list of 100 largest contractors (a copy of which may be obtained from the Office of the Secretary, Department of Defense, Washington, D.C. 20301) if five percent (5%) or more of the gross sales of such companies are derived from contracts with the United States Department of Defense, (iii) other companies contracting with the United States Department of Defense if five percent (5%) or more of the gross sales of such companies are derived from contracts with the United States Department of Defense, and (iv) companies that derive revenue from the manufacture of liquor, tobacco and/or gambling products.[17]

In 2007, as the investment community began to recognize the limitations of the SRI approach, Pax shifted to ESG investing. The Pax prospectus filed in 2007 dropped the language quoted above in favor of a "Sustainable Investing" section that read as follows:

[The Pax World Funds] pursue a sustainable investing approach – investing in forward-thinking companies with more sustainable business models. We identify those companies by combining rigorous financial analysis with equally rigorous environmental, social and governance analysis. The result, we believe, is an increased level of scrutiny that helps us identify better-managed companies that are leaders in their industries; that meet positive standards of corporate responsibility; and that focus on the long term. By investing in those companies, we intend for our shareholders to benefit from their vision and their success. Investors should understand that "sustainable investing" refers to the full integration of environmental, social and governance criteria into our investment approach; it does not mean that our funds will necessarily perform in the future as they have in the past.

We avoid investing in companies that we determine are significantly involved in the manufacture of weapons or weapons-related products, that manufacture tobacco products, that are involved in gambling as a main line of business or that engage in unethical business practices.[18]

Unlike SRI strategies, which involve simple, binary decisions about whether a security passes or fails a screen, ESG strategies require investment managers to make subjective assessments of dynamic information. As the industry has shifted towards an ESG approach, access to timely, detailed, and accurate ESG data has become increasingly important. Managers often do their own research, but they also purchase ESG data and ratings from third-parties. Some of the major providers include the following:

MSCI ESG Research

MSCI is one of the leading providers of ESG ratings to the asset management industry. The firm's flagship ratings product is based on a methodology that ranks companies within sub-industries based on their exposure to and management of ESG risks and opportunities. Only those factors considered material to the financial performance of companies within each sub-industry are considered.[19]

Sustainalytics

Sustainalytics has roots in Canada and Europe, but has emerged as a major source of ESG data in the United States. In 2016, Morningstar announced that the firm would serve as the data provider for its own mutual fund sustainability ratings system. The Sustainalytics ratings methodology is very similar to MSCI's in that they score companies relative to their industry peers on those issues that are most material to financial performance.[20]

Bloomberg

Bloomberg is well-known as one of Wall Street's main sources for news and information about financial markets. Keen on maintaining that position, the company has added ESG functionality to its data services in response to increasing investor demand. Bloomberg Terminal subscribers can access social, environmental, and governance data on individual companies, sourced from company reports, publicly-available research, and through Bloomberg's partnerships with third-party data providers.[21]

Other Providers

ESG data is available from several other major providers, including TruCost, RepRisk, RobecoSAM, Carbon Disclosure, and Vigeo Eiris.

Index providers, such as MSCI, have produced a wide range of ESG indices covering various asset classes, but very few mutual fund companies or ETF providers have designed passive products to track them. Thematic indices are an exception to this rule. There are a selection of mutual funds and ETFs that track indices designed to provide exposure to specific issue areas, such as women's leadership, climate change solutions, and water management.

Investors have far more actively-managed options from which to choose. Many are offerings from firms that have long-specialized in SRI and ESG investing, going as far back as the 1970s when the field first emerged. They include Domini Social Investments, Trillium Asset Management, Calvert Investments, PAX World, and Parnassus. Since the late 1990s, more mainstream asset management firms have entered the market, offering a selection of ESG products to complement a more robust offering of traditional strategies. TIAA launched its Social Choice Equity Fund in 1999, while BlackRock, the largest asset manager in the world, began offering an actively-managed Impact US Equity Fund in 2015.

Since the late 1990s, more mainstream asset management firms have entered the market, offering a selection of ESG products

The Forum for Sustainable and Responsible Investing (USSIF; www.ussif.org) maintains a useful directory of mutual funds that implement SRI and ESG strategies, most of which are focused on public equity markets.

Fixed Income

SRI and ESG strategies have not made as much headway in the bond markets as they have in the public equity markets. In an effort to provide comprehensive solutions to investors, many of the firms that offer active SRI or ESG equity funds also offer fixed income strategies. However, whereas they may have products covering various market segments and geographies on the equity side, they often have just one fixed-income offering.

There are effectively two-approaches to the analysis of social and environmental factors in fixed income markets. The first involves assessing fixed income securities based on the ESG characteristics of the issuers. This approach is most applicable to corporate and sovereign debt markets, where funds are typically raised for general corporate or budgetary purposes. To assess corporate debt, fixed income managers employ the same company-specific ESG ratings used to build equity portfolios, such as those available from MSCI and Sustainalytics. ESG factors fit naturally into the analysis of sovereign debt as well. The strength of a country's economic and political institutions, the environmental threats it faces, and risks related to social welfare all influence a country's willingness and ability to pay its debt.[22]

The second strategy focuses on the large number of debt offerings tied to specific projects, programs or assets, particularly in the municipal bond and asset-backed security markets. As a result, investors are not only able to use these instruments to construct ESG portfolios, but they can evaluate these types of offerings as impact investments. So-called "green bonds" are the latest innovation in this category. Though they lack an official definition, green bonds are generally issued to finance projects expected to have some positive environmental impact. In 2014, for instance, the District of Columbia Water and Sewer Authority issued $350 million in "green bonds," the proceeds of which are being used to finance a waste water tunnel project designed to reduce sewage overflows in regional waterways.[23]

Shareholder Engagement

Though SRI, ESG, and impact investments are theoretically untethered to specific asset classes, the reality is that impact investments are primarily found in the private markets. In fact, some argue that the size of the public markets make them inhospitable to impact investing. There are so many buyers of publicly-issued stocks and bonds that the actions of any individual impact investor are typically too small to affect the market equilibrium.[24] Investors make millions of trades each day on the New York Stock Exchange alone and the vast majority of these trades are made among investors, rather than with the companies whose behavior they seek to influence.

What these arguments miss is that the same characteristics that make the public markets unresponsive to individual action make them an ideal venue for collective action. Coordinated action among like-minded public equity investors can create influence and stimulate change. For this reason, most impact investing in the public markets tends to be focused on shareholder engagement.

The simplest approach investors can take to shareholder engagement is to track and vote shareholder proxies issued by the companies in their portfolios. These proxies often contain statements related to ESG issues, such as animal testing, board diversity, climate change, and corporate governance. Investors with large portfolios that find the volume of proxy votes overwhelming can engage companies that offer proxy voting management services, such as ISS, ProxyVote, and Glass Lewis.

Investors interested in a more active approach can lend their support to the broader corporate engagement efforts that are often behind shareholder resolutions. Asset management firms specializing in SRI and ESG investing often employ staff dedicated to leading corporate engagement activities. These specialists use the shareholdings of the firm's various accounts as the basis for meeting with corporate leadership on ESG issues. The threat of a shareholder resolution can be a useful tool in these negotiations. Subject to certain other criteria, Securities and Exchange Commission regulations permit any shareholder that has held at least $2,000 or 1% of a company's shares for a year to file a resolution.[25] The negative publicity associated with these filings can sometimes be enough to pressure otherwise reluctant corporations to change their behavior. In fact, ESG-focused asset managers often maintain toe-hold $2,000 positions in the worst ESG performers solely to maintain the right to file shareholder resolutions.

Finally, investors can work with non-profit organizations, industry groups and campaigns dedicated to influencing corporate behavior. As You Sow is one of the better known groups in this category. The organization "promotes environmental and social responsibility through shareholder advocacy, coalition building and innovative legal strategies."[26] As You Sow builds networks of supportive investors around issues like climate change, corporate disclosure, and gender diversity and uses their shareholdings as the basis of corporate engagements.[27]

Unfortunately, outside the realm of shareholder engagement, the opportunity set of true impact investments in the public markets is limited. Despite their appeal, in the absence of engagement, sector-based investment strategies, such as those focused on renewable energy, are better categorized as ESG.

The Private Markets & Alternative Assets

Hedge Funds

Given that most hedge fund trading activity occurs in the public markets, all of the screening, ESG integrations, and engagement strategies that have been discussed can be carried over into hedge fund strategies. While the adoption of these practices by hedge fund managers has been slow and underwhelming, there are signs that the pace is accelerating. In 2011 and again in 2014, Swiss asset manager and UN PRI signatory Unigestion surveyed its portfolio of hedge fund and private asset managers to assess the extent to which they considered ESG factors in their investment processes. The results showed that while 60% of the hedge fund managers in 2014 were "reluctant to adopt ESG" analysis, the percentage that did adopt ESG analysis had risen from 25% in 2011 to 40% in 2014.[28]

Despite the momentum behind ESG, the hedge fund market is underpenetrated relative to long-only markets. Data on the number of SRI, ESG or impact-focused hedge funds is difficult to come by, but the industry is notably absent from many of the major surveys and databases covering the investment landscape. For instance, the Global Impact Investing Network's (GIIN) ImpactBase, a database of impact investments for accredited investors, does not yet have any entries listed in the hedge fund asset class. GIIN's 2016 survey of impact investors does not mention hedge funds and the asset class represents only a small portion of the UN PRI's directory of signatories.[29]

One challenge to expanding the opportunity set is that many hedge funds strategies, such as global macro or merger arbitrage, do not lend themselves to ESG integration. The ESG hedge funds that do exist are largely, if not exclusively, found in the sub-category of equity long/short funds. In a typical long/short ESG strategy, the manager might match long positions in companies with strong ESG profiles, with short positions in companies that have weak ESG profiles. For instance, San Francisco-based Etho Capital is launching a hedge fund that will construct a zero-carbon portfolio by going long "climate leaders" while shorting "climate laggards."[30]

Investors dissatisfied with the limited selection of ESG hedge funds may be able to find traditional hedge fund managers willing to implement an SRI screen as part of an SMA. For example, some managers have begun marketing screened strategies in order to attract the assets of religious institutions.[31] These types of partnerships may fall short of a true ESG solution, but they offer investors a method of maintaining an allocation to an asset class that might otherwise be inaccessible.

However, investors should take care to understand the terms of these special arrangements. In some cases, hedge fund managers will only offer to implement SRI screens on a profit-and-loss basis. When taking this approach, the manager does not change the fund's strategy, but rather only distributes to the SRI investors those profits and losses associated with screen-compliant trades. For example, a public health-conscious SRI investor would not benefit or suffer from the outcome of a trade involving tobacco stocks, but would participate in the results of trades in the information technology sector. Some investors may not be comfortable with this arrangement because despite the SRI screen, their capital is still being invested in the same underlying portfolio as other, non-SRI investors. In fact, because they do not share in the profits or losses from non-compliant trades, SRI investors in these scenarios are effectively providing an interest free loan to the fund.

Private Debt & Equity

The largest number and greatest variety of impact investment opportunities are available in the private debt and equity markets. Unlike the public markets, which function on the basis of standardization and aggregation, private markets afford investors and investees the ability to customize transactions to suit their particular needs. In these markets, impact investors have the opportunity to generate impact across a range of issue areas and geographies while earning varied risk-adjusted returns.

features its pledge to send "all profits to charity" on each food and beverage item it sells. Many firms have robust corporate philanthropy efforts, but these companies differentiate themselves by making impact an inextricable component of their corporate identities, their brands, and their consumer appeal.

The second approach is to invest in companies offering products or services that themselves address a particular social or environmental challenge. The amount of impact these firms generate is tightly linked with their financial success. For example, a solar developer's impact grows with each megawatt of electricity it sells into the grid. The strong connection between impact and profit makes these types of companies particularly attractive to impact investors looking for market-rate returns.

The final approach impact investors take is to generate social or environmental impact through the sacrifice of financial return. Community Development Financial Institutions, for instance, focus on generating economic development in low-income, low-wealth communities.

Profit + Impact	Profit = Impact	Low Profit = Impact
Tom's Shoes Warby Parker Newman's Own	Renewable Energy Project Microfinance Institutions Tesla	Below-Market Loans to CDFIs Acumen Fund

Impact investors generally take one of three approaches in the private equity and debt markets. The first involves investments in companies that seek to generate impact through what might be considered an enhanced form of corporate philanthropy.

Companies like Tom's Shoes, Warby Parker, Ethos Water, and Newman's Own were all founded with impact at the core of their mission yet the products they sell have little to no impact on their own. Rather, these companies all employ some form of the "one-for-one" model. Tom's Shoes, for instance, drew attention from many consumers for its pledge to donate a pair of shoes to children in need for every pair it sold. Newman's Own prominently

In pursuit of that mission, they often provide financing to small businesses, affordable housing developers, and non-profit organizations at lower rates or on more flexible terms than are available from conventional lenders.

Some impact investors make direct private equity and debt investments, negotiating the terms of their investment directly with each company. However, most invest through private equity and private debt funds. These funds are often structured as limited partnerships, have limited lives of 7 to 10 years and typically expose investors to greater liquidity risk than most public market investments.

Private Debt: Microfinance and Community Development

According to the latest investor survey conducted by the Global Impact Investing Network (GIIN), the largest asset class in the impact investing market is private debt. Though private debt can be used to support a range of impact objectives, the size of the asset class reflects the large portion of the impact market dedicated to microfinance. The GIIN reports that microfinance received the largest allocation of capital from impact investors in 2015, representing 21% of total assets under management after excluding three outliers from the sample. Of the capital deployed through private debt investments, nearly 40% went to microfinance.[32]

The outsized role of microfinance in the private debt segment of the impact market is not surprising. Microfinance is one of the largest and most mature industries in the impact investing landscape, and many microfinance institutions (MFIs) finance themselves with debt sourced from foreign investors. The World Bank's International Finance Corporation, for instance, describes itself as "one of the leading global investors [of microfinance] in terms of volume," noting that in fiscal year 2014 it committed $519 million to 47 projects with MFIs and had outstanding commitments of $1.68 billion.[33]

Individuals interested in contributing to these capital flows have a range of investment options. Several non-profit organizations and foundations raise capital for microfinance and community development finance through the issuance of private investment notes. The oldest of these instruments is the Calvert Foundation's Community Investment Note, which is offered under a securities registration exemption for charitable organizations in amounts as low as $20. The Calvert Note, and others like it, gives investors the flexibility to select the maturity and corresponding interest rate of the note they purchase or to enhance their social impact by accepting only a simple return of capital at maturity.[34]

Alternatives to private investment notes include private debt funds called Microfinance Investment Vehicles (MIVs) and peer-to-peer lending platforms, such as Kiva.org.

Private Debt: Social Impact Bonds

Among the most cutting-edge offerings within the private debt category are social impact bonds (SIBs), also known as "Pay for Success Financings." SIBs were developed to help risk-averse government agencies experiment with new, cost-effective solutions to social challenges. A simple SIB structure involves a contract among several actors: a social service provider, a government agency, private investors, and an independent impact evaluation firm.

The SIB transaction begins with a capital investment from the private investors, which is used to finance the social service provider and its programming. As the programming is implemented, the independent impact evaluation firm collects data on both the cost and effectiveness of the intervention. If the program is meeting its impact targets and is doing so at a lower cost than existing government programs, then the government agency pays the private investors the amount of their initial investment plus a rate of return. If the program fails to deliver the promised impact or costs more than standard government programs, then the government agency has no obligation to pay, and the private investors may suffer a loss of capital.

The key innovation of SIBs is that they shift the risk of implementing new programming from government agencies to private investors. However, to-date, many SIBs have simply been too risky and too costly to attract private capital without the addition of credit enhancements, such as guarantees from philanthropic foundations. They require extensive preparation and coordination among the various parties involved, which makes them highly customized transactions best suited for those investors focused more on social impact than financial return.[35]

Private Equity: Venture Capital

Perhaps the best known type of private equity investing is venture capital, the industry that launched Google, Facebook, and Tesla. Venture capital is also one of the most prolific areas for impact investing. Of the 398 funds listed on the Global Impact Investing Network's directory of impact investment funds, 102 are classified as "venture capital."[36] These funds target innovative business models and technologies in a wide range of sectors, from clean technology to education technology.

Venture capital funds bet on innovation, which makes them among the most exciting asset classes for those interested in affecting transformative change. However, for all of its potential, investors must approach the asset class with a substantial degree of caution. There are a number of risks associated with venture funds, and impact venture funds in particular, that need to be analyzed and understood before moving forward with an investment.

First, venture capital is a low probability business. An early stage venture capital fund may make initial investments in 15-30 companies with the expectation that a third of the companies will fail and another third will manage to just break-even. The fund's success depends on the remaining third turning into "home runs." These companies must perform well enough to not only overcome the losses incurred in the rest of the portfolio, but also to ensure the fund hits the typical return target of 20-30%, after fees.

The basic math of the venture capital model means that investors face a difficult task in selecting managers that can tell the difference between a passing fad and a transformative business model or technology. The first step investors often take is to review the manager's investment track record. It is on the basis of track record that venture capital firms tend to grow in size, attracting more and more capital from investors. However, the nascence of the impact investing market means that many funds are often led by first-time investment teams with limited investment history. As a result, impact investors may have little to go on when deciding whether or not to invest with a manager.

Selecting a good manager at the outset is critical because venture capital is among the least liquid asset classes. Investors cannot rely on the secondary market to exit a venture capital fund they no longer wish to hold. The legal documents governing venture capital fund sometimes place restrictions on how and to whom a sale can be made and buyers often impose a steep discount to fair value.

The asset class' liquidity profile is made worse by the fact that many venture funds invest in companies that have yet to generate revenue, let alone a profit. Whereas large private equity and debt funds may periodically distribute income to their investors, venture investors may wait years before that first company sale allows for a return of capital.

Real Assets

In contrast to stock, bonds, private equity, and other financial assets, the real assets category includes investments involving physical property. Real estate is the best known type of real asset, but there are others in the category, such as timberland, farmland, infrastructure, and energy projects. Traditional investors often gain exposure to real assets in the public markets through vehicles such as Real Estate Investment Trusts (REITs). While investors can take a best-in-class approach to REIT investing using ESG scores from data providers, they generally look to the private markets for most opportunities. Fortunately, there are a number of opportunities available across a range of social and environmental themes.

Real Assets: Real Estate

The real estate market includes residential properties, such as single family homes and multi-family apartment buildings, as well as commercial properties, such as office buildings and industrial parks. Investors can gain exposure to a number of themes, but two of the more common impact strategies in real estate focus on affordable housing finance and "green" buildings.

The vast majority of the private capital available for affordable housing comes from large financial institutions, which are subject to regulatory mandates on community investments and benefit from federal tax incentives. However, the properties they help build and renovate through these federal programs are only required to remain affordable for a limited time. Individual investors play an important role in providing capital to help preserve the affordability of these properties once the regulatory requirements expire. Affordable housing preservation funds purchase affordable, multi-family housing properties that are at risk of converting to market-rate apartment buildings serving higher income individuals and families. During the hold period, the funds typically make small capital investments designed to enhance the efficiency of the buildings and generate cost savings. By the time the property is ready for sale, the manager may have negotiated special tax incentives with local and state housing agencies in order to keep the property affordable after it is sold.

Green real estate strategies focus on improving the resource efficiency of the built environment. The U.S. Green Building Council's Leadership in Energy and Environmental Design (LEED) standards have emerged as one of the more common tools managers use to integrate sustainability into their strategy. Buildings can obtain one of four LEED certifications: Certified, Silver, Gold or Platinum. Certifications are awarded based on a comprehensive sustainability assessment tailored to the type of building under review. Factors such as the location of the building and its proximity to public transportation, the types of materials used in construction, energy efficiency, and water use are all taken into account. According to the U.S. Green Building Council, LEED-certified buildings are more resource efficient, have better indoor environments, and are often less costly than their peers.[37]

Real Assets: Timberland and Farmland

Both timberland and farmland investments involve the purchase and management of productive land. Traditional timberland funds, managed by Timberland Investment Management Organizations, purchase large swaths of forests, conduct logging operations, and sell the felled trees to local saw mills for processing. Farmland funds take a similar approach to agricultural land. Once purchased, they work to maximize crop yields and ultimately sell their harvests into various intermediate and end markets.

Impact investors active in these two sub-asset classes take fundamentally the same approach as traditional investors, but with a focus on sustainability. Sustainable timberland funds take care to log timberland in line with standards such as those set by the Forest Stewardship Council, a sustainable forestry organization.[38] Others go further and implement strategies designed to generate a profit from conservation measures. One example involves the sale of conservation easements, which are voluntary legal agreements that restrict, in perpetuity, the development or exploitation of land.[39] Fund managers will target forests that have significant conservation value with the intention of ultimately selling easements to non-profit conservation organizations, land trusts or government agencies. Conservation easement sales can often improve the cash flow profile of a timberland investment because they generate proceeds that can be distributed to investors early in the life of the investment.

Sustainable agriculture investors are as focused as traditional investors on maximizing the productivity of their farmland, but their management approach is rooted in a philosophy of stewardship that places special emphasis on the role farms plays in local environmental and social systems. There is no single framework for sustainable agriculture, but farmland managers will often focus on ensuring workers are treated fairly and on maintaining, if not improving, the quality of the natural resources on which their farms depend, such as water and soil.[40] Blackdirt Capital, for instance, is a new fund that purchases undervalued farmland in the Eastern United States and converts it to grass-fed and organic production systems.[41]

Real Assets: Energy Infrastructure

The most common financing mechanism used in infrastructure is known as "project finance." Whereas most other investments involve the capitalization of a business entity with growth potential, but uncertain future cash flows, project finance is often used to capitalize individual assets with predictable cash flows. Power plants are a common example. The plant's development and operating costs, as well as its production capacity, can all be assessed with a significant degree of confidence prior to investment. Investors can then model the return on their investment based entirely on the expected income stream over the useful life of the asset.

The project finance model works just as well for clean energy assets as it does for more traditional types of power generation. One common approach investment fund managers take is to act as an intermediary between individual clean energy project developers and large-scale institutional investors eager for stable, yield-generating assets. These managers partner with trusted solar and wind farm developers and provide capital at a relatively early stage in the project's development cycle. Once the projects are stabilized, the fund bundles its holdings into a portfolio and sells it to pension funds or publicly-traded clean energy investment vehicles known as "YieldCos."

Conclusion

Though SRI, ESG, and impact investing have their roots in the earliest days of modern finance, their adoption has grown most rapidly over the past two decades. Nearly every year, industry groups publish survey data showing that total assets invested in these strategies have reached record highs. Nonetheless, the sector remains small in size relative to broader capital markets and faces obstacles to becoming part of mainstream investment practice.

Among the leading challenges is the need for greater standardization. Best practices are emerging, but investors have yet to reach consensus on many important questions, such as, "how best to measure and report on impact?", "how to construct useful ESG ratings?", and "which approaches to ESG integration yield the best results?" For portfolio managers, one of the more difficult challenges is the task of blending various SRI, ESG, and impact investing strategies into a diversified, multi-asset class portfolio that meets an investor's risk, return, and liquidity requirements.

A companion paper to follow will address these questions, with a particular emphasis on portfolio management. Building on the tenets of Modern Portfolio Theory, the paper will offer portfolio managers a practical approach to integrating an investor's social or environmental objectives into each component of the investment process.

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