Considering risk and return for social investments

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The conventional approach to investment would typically consider three things. Firstly, your needs and attitudes. How much risk are you willing and able to take? Are you looking for regular, predictable income or for capital growth? Of course, the answers to questions like these may be different for different parts of your investment portfolio and may change over time. Secondly, what risk is involved in any particular investment? Not only risk of capital loss but also the risk of not getting the returns expected when expected, or the risk of not being able to exit early should you need to. Finally there's the question of return – what's the promised or forecast return, and is this sufficient in light of the risks, given your alternative investment options?

When looking at social investments, however, a whole new dimension of social impact is introduced. So how does this affect the investment decision-making process?

Determining your needs and attitudes

The first step is again to consider what you need and what you want to achieve. It may be that for certain parts of your portfolio you want to maintain your expectations for financial return – for example, with your pension funds – but you would rather the capital was invested for social benefit than social harm. And it is certainly possible to allocate investment for positive impact and achieve returns that are comparable to (and some would even argue better than) the rest of the market.

However, there are also many opportunities to create impact that may involve higher risks, lower returns or a more long-term, patient approach. This is what I would describe as true 'social investing', where investors are willing to take a potentially less advantageous financial position because of the anticipated social outcomes. If you want to build a social investment portfolio that is more philanthropically motivated like this, you may want to set new financial parameters that aren't orientated for maximum return but still set boundaries for the risk/return profile that's acceptable to you.

Finally, you need to decide your approach to impact. You might simply look for highest impact potential, or you might want to focus on a particular geography or social issue. But be aware that you can't simply put impact, risk and return into a formula and pick those investments which come out with the biggest number. Organisations working on one particular social issue may be able to offer higher returns than those working on another, but that doesn't mean the former are necessarily better social investments. So it's important, before you begin, to know what you want to achieve.

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Ignore the impact

It may sound strange to suggest you ignore the impact when talking about social investment, but of course it is still an investment and needs to be treated as such. It would be easy to get so caught up by the opportunity to make a difference and get involved in the social mission of the organisation that we skip over the financial details and don't properly consider whether this is an appropriate investment. But like any other commercial company, impact-driven organisations are not immune to going bust.

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So once you've set the parameters of your social investment portfolio and are considering your first social investment, you need to look at the financial risk and return in a cold light, deciding whether they fit within those parameters and then whether any concession is worth taking in light of the anticipated social outcomes.

There's an important point here for investees too. Every social organisation wants to make a big deal about its impact, and the fundraiser will naturally want to tug at the donor's emotions. But when it comes to investment we must take care not to emotionally manipulate. Make your financial promotion clear and factual, allowing investors to come to a carefully considered decision.

Social risk and return

When turning to consider the social impact, we again need to think about both risk and return. Typically, we'll give most attention to the forecast 'social return' – the benefit to be generated by the investment. And there are essentially two types of return.

In some cases the primary intended outcome of a social investment may be the strengthening or continued sustainability of the investee. Take, for example, a community share offer to save and take over the ownership of your local pub. It plays a key role in the life of the community, fostering social cohesion as well as giving job opportunities for people who have found it hard to get employment elsewhere. In this scenario what matters isn't the anticipated number of pints served or any other outcomes to be counted and reported, but the ongoing existence of a community facility.

In many cases though the investment is being sought to enable the delivery of specific activities that are anticipated to create particular outcomes. Sometimes it may be enough to make an investment decision on the basis of how valuable you feel those activities to be. But where possible you should look for details of the expected scale of the impact and how those outcomes are going to be monitored and reported.

However, just as with financial factors, it's also important to consider how realistic the social forecast is and what the risks are that it won't be delivered. Are the expected outcomes really achievable? What evidence is given to justify the forecast and what assumptions have been made? Has the investee clearly articulated the factors that might affect the level of outcomes delivered and shown how they will be mitigated? If you're making an investment decision on the basis of projected outcomes, you need to be confident that the projections are sound.

Again, investees must also take note. The rules on financial promotions state that communications must be fair, clear and not misleading so that investors can properly judge for themselves whether it is an appropriate investment for them. If you're inviting someone to make an investment decision based on the creation of social outcomes, then you need to make sure your social forecasts are robust, justifiable and fully explained.

***Phil Caroe** leads Allia's social finance programme, developing retail products to raise finance for social ventures. Since joining in 2009 he has managed the issue of numerous bonds by Allia to individual, corporate and public sector investors. Phil is behind the creation of Retail Charity Bonds, a ground-breaking platform to raise unsecured loan finance for charities through bonds listed on the London Stock Exchange. He manages a major investment programme for Scottish Government in affordable housing, and always has a few different development projects on the go.*