The Rise of Impact Investing: Its Implications and Unanswered Questions

A workshop hosted by the Private Capital Project and the Impact Collaboratory at the Harvard Business School and the Private Capital Research Institute

Increasingly, people are making spending, philanthropic, and even career decisions to help make the world a better place. Investors are no exception. On **September 11, 2018**, a group of Limited Partners ("LPs"), Academics, and General Partners ("GPs") met to share their perspectives on impact investing and its implications. While some investors understand the basic concept, confusion about impact investing, its various approaches, and even the difference it can make, is widespread. Today, asset owners are stepping up allocations of much-needed capital in support of solutions to critical social and environmental challenges. They are also pressing their external managers to factor in the social implications of their investment decisions and demanding transparency about guidelines and metrics to measure the implications of their investment decisions. One of the most critical questions remains whether there is a tradeoff between investing in impact/ESG (environmental, social, and government) investments and maximizing returns. There does not seem to be a conclusive answer. The academic work to date has shown mixed results about the trade-offs between social impact and return. Some research provide evidence that impact investing does not sacrifice returns, while others show evidence that such investments underperform. Nevertheless, a highly diverse group of impact-investing funds have been created over the last decade which have billions of dollars to put to work across various sectors, levels of risk, and expected returns. And the wide range of standards for measuring social and environmental impact are anything but consistent and clear.

Limited Partnership Perspective

George Serafeim of the Harvard Business School led a panel discussion with a group of limited partners. The panelists included Peter Cornelius, Alpinvest; Christine Looney, Ford Foundation; and Christopher Walker, HarbourVest Partners.

Professor Serafeim opened the discussion by asking the panelists to share what their firms were doing about impact investing and their observations of the industry. The panelists explained that the relatively young industry is still evolving, and one solution does not fit all. One panelist described that while there is a lot of awareness, there seems to be two distinct approaches: an active approach driven by the younger generation of investors where LPs are very focused on making investments for positive change versus a passive approach where LPs basically just "check the box" and are satisfied if their investments merely "do no harm." In the former case, much of the capital that is currently going into impact investing was money previously earmarked for philanthropy.

Meanwhile, the organization of these efforts may differ. Some LPs create a separate fund for their best impact/ESG investments, while others include their impact investments within a more traditional fund. In general, the industry is seeing the emergence of separate teams to manage ESG/Impact investments. Furthermore, ESG and impact funds often have a long-term focus with less pressure to liquidate and a tendency to want to stay with winners. Thus, more of these funds are experimenting with longer horizons, say 20 years, and some have become evergreen funds.

The panelists noted that there are also geographic differences at work. While US foundations have been many of the pioneers in impact investing (through initiatives such as community development venture funds), today European institutional investors are much more advanced in applying ESG and impact investing principles. Yet even in the US, there is the feeling that GPs are going to lose funding if they do not have a good plan for ESG and impact investments. One panelist explained that innovations around financial structures could help spur more impact investing. For example, there is the possibility of partnering with the government, which is being done in Canada. Here, the idea is to use government-guarantee structures or subsidies to entice investors into the market. One such approach is using guarantee concessionary capital, whereby the government guarantees a minimum return on capital. But, as one panelist pointed out, these types of structures can be tricky, because once put in place, LPs may continue to demand it even when there is proven success. However, given that impact funds are so new, perhaps a public/private partnership is not a bad option.

Next, the panelist discussed the extremely important issue of whether, when investing in impact/ESG, there is a trade-off between the goal of maximizing returns and creating social impact. After all, as one panelist responded, there must always be some focus on returns; otherwise, these investments would just be philanthropy. One panelist stated that the real problem is that risk is not always properly accounted for when thinking about returns. Therefore, lower returns from ESG/Impact investments should not always be viewed as concessionary if there is lower risk. In addition to appropriately adjusting for risk, it was suggested that returns should also have a social-benefit adjustment factor. Some LPs simply just set a minimum return requirement for their impact investments, which could depend on the market conditions and past historical performance.

The panelists noted that investors often focus on internal rates of returns ("IRR"), when perhaps, public market equivalent ("PME") measures may be a better measure. However, PMEs can also be problematic when using the SP500 as a benchmark. In general, the panelists felt confident that ESG/impact investments were not a drag on returns, and that there was not a trade-off at work. If anything, one panelist believed that the most successful funds had both good financial performance and positive social impact. There was general consensus that when the impact-investing industry has matured, investors should be able to generate market-rate financial returns.

Lastly, the panelists discussed the challenge of figuring out metrics by which to measure social impact. LPs need to work closely with GPs to help evaluate ESG/impact, which is posing a huge burden on the GPs who are finding it difficult to report and respond to their many different measurement approaches. Thus, the panelists agreed that there needs to be established guidelines on how to measure impact for GPs to follow. GPs need to be able to articulate what impact means and how to measure and monitor, and LPs need to be able to track it. Currently, there are a few methodologies on how to quantify the impact. For instance, some GPs use surveys on how life is improving or how many people are being reached. Another approach is tracking consumer feedback over time and region. However, it is hard to assess these measures, in particular, in regards to what outcomes are considered "good enough."

Academic Perspective

Josh Lerner, from Harvard Business School, led a panel discussion with a group of academics, including Shawn Cole from Harvard Business School, Anna Kovner from Federal Reserve Bank of New York, and David Musto from University of Pennsylvania's Wharton School of Business.

To begin the discussion, Shawn Cole presented his ongoing research (with co-authors Michael Chu, Vikram Gandhi, and Caitlin Brumme at Harvard Business School) on measuring and evaluating impact investing. Professor Cole explained that many studies use a broad definition for impact funds, and thus pool all funds that describe themselves as "impact investing" together. However, impact funds are a diverse asset class, with some prioritizing their social goals over financial returns while others primarily focusing on returns.

Given such heterogeneity, Cole described some qualitative frameworks to categorize the funds, taking into account the motivation, return expectation, and the strategies employed by these funds. For example, a fund that is looking for the most efficient way to achieve impact without prioritizing returns would be classified as an "impact-driven" fund. Meanwhile, some funds that do not explicitly say that they are an impact fund, but are mindful to integrate environmental and social goals, would be categorized as "co-incident" funds, and thus fall on the other end of impact-fund classification.

Next, Cole went on to explain the challenges faced in evaluating the success of impact funds. One such challenge is that individuals value things differently, potentially making it difficult to know what to measure. But, if funds are able to create their own niche targeting groups, this may not be such a big problem. Another challenge is properly measuring the effectiveness of a project. But pioneering approaches like randomized control trials allow measuring the effectiveness of a project with very little bias, and frameworks like cost-benefit analysis can be used to evaluate very diverse sets of goals which may, at first, seem like an insurmountable task. Lastly, there still remains the challenge of how funds choose to present and report the evaluation of their impact funds. Tracking 38 impact funds, Cole and his co-authors find that while close to 40% of these funds explicitly report impact on their public website, only 13% have downloadable reports available to the public.

In the second presentation, Anna Kovner presented her research[1] (conducted with Josh Lerner) that examines investments made by community development venture capitals ("CDVCs") that are designed to benefit both entrepreneurs and communities. Kovner and her co-author used comprehensive venture capital financings by both traditional and CDVC venture funds from 1996 to 2009 to compare the effectiveness of CDVCs. The authors find substantial differences between CDVCs and traditional venture capital (VC) investments.

First, they find that CDVCs are more likely to invest in earlier financing rounds and that firms backed by CDVCs have fewer venture investors participating in each round. This finding suggests that CDVCs are typically more involved in investments where financial constraints are greater. The industries in which CDVCs invest also differ: CDVCs are less likely to invest in biotech and communications/electronics transactions—industries that typically have higher success rates for traditional venture firms. They also find that investments by CDVCs are far more likely to be in non-metropolitan regions and in regions with little prior venture capital activity. While San Francisco, Boston, and New York comprise close to 50% of all traditional VC investments, CDVC investments in these metropolitan areas were much lower at 25%. Given that CDVCs disproportionately invest in industries and regions associated with lower success rates, the authors use a comparable sample of traditional VC investments to compare returns. They find that CDVCs seem to substantially underperform financially: the companies they back are less likely to go public or to be acquired relative to comparable investments by traditional VCs. Moreover, they find that CDVC investments have limited impact on a region's GDP and unemployment. However, looking at success more broadly, the authors note that CDVC activity has other positive returns to the community. Not only do CDVCs invest in industries and regions that are less likely to receive traditional VC capital, they help attract other VC firms and VC investments to underserved regions in subsequent years.

1) Kovner, A., & Lerner, J. (2015). Doing Well by Doing Good? Community Development Venture Capital. Journal of Economics & Management Strategy, 24(3), 643-663..

In the final presentation, David Musto discussed his three research papers (conducted with his co-authors at the Wharton School). Musto began by explaining that, in general, institutional investors have a strict fiduciary duty that typically forbids sacrificing monetary returns for other goals. Thus, in their first paper[2], Musto and his co-authors look to understand whether institutional investors change their investing behavior when there is less pressure to maximize profits. To do this, the researchers explore changes in investment strategies after the passage of a constituency statute that gives directors of corporations the discretion to balance the interests of all stakeholders, rather than solely focusing on maximizing shareholder value. The authors find that institutional investors did not change their investment strategies, nor did they divest from firms incorporated in the states that had passed the law. If these institutions had perceived that their investments in states with the constituency statute were in conflict with their fiduciary duties, they would have decided to no longer invest in these companies. The authors conclude that this supports the idea that legislation that expand management discretion to consider non-shareholder interests are not in conflict with investment strategies employed under strict fiduciary responsibility.

In their second paper[3], the authors survey 53 private equity impact funds from around the world to evaluate whether GPs sacrifice their portfolio companies' missions in exchange for financial returns. To do this, the authors assess the financial performance of a subset of market-rate-seeking impact funds and find that these funds ultimately achieve their targeted returns, while also preserving their portfolio companies' missions. The researchers find that returns are nearly identical to the Russell Microcap market index returns.

Lastly, in their third paper[4], Musto and his co-authors analyze how GP-LP contracts and GP-portfolio company contracts differ between impact and non-impact funds. The researchers look at three different types of funds: non-impact funds, impact funds seeking market returns, and impact funds not seeking market returns. Analyzing the language used in the contracts, the authors find that the governance terminologies were very similar within each group. However, they find that other features of the contracts used by impact funds differ from traditional funds. For instance, impact funds use new terms that directly relate to impact, as well as adjusting provisions concerning governance and investor protection to help ensure compliance with the fund's impact goal.

2) Geczy, C., Jeffers, J. S., Musto, D. K., & Tucker, A. M. (2015). Institutional investing when shareholders are not supreme. Harv. Bus. L. Rev., 5, 73.
3) Gray, J., Ashburn, N., Douglas, H., Jeffers, J., Musto, D., & Geczy, C. (2015). Great expectations: Mission preservation and financial performance in impact investing, Unpublished working paper, University of Pennsylvania.
4) Geczy, C., Jeffers, J., Musto, D., & Tucker, A. (2018). Contracts with Benefits: The Implementation of Impact Investing. SSRN Electronic Journal, SSRN Electronic Journal, 2018.

General Partner Perspective

The GP discussion was led by Vikram Gandhi of the Harvard Business School. The panelists included Sir Ronald Cohen of Global Steering Group for Impact Investment and Social Finance, Lisa Hagerman of DBL Partners, and Greg Shell of Bain Double Impact.

Within the private markets industry, the panelists foresee outsized-growth in the mid-term mainly due to a tighter regulatory environment, increased cooperation on the political front, and a more socially and environmentally conscious millennial generation, set to inherit an estimated US$40 trillion in the next 40 years. However, they add that this mainstreaming of impact integration is not totally new. It is the culmination of over ten years of increasing LP focus on the area. Identifying, measuring, and reporting the positive impact of investments is a natural extension of long-established responsible investment practices that drive companies to systematically improve their ESG performance.

In this discussion, the panelists shared their opinions on the opportunities and impediments to impact and ESG investing. The group felt that as with many product innovations in PE, the recent trend of impact investing is driven by LP demand. A diverse set of investors, from sovereign wealth funds and public pensions to high-net-worth individuals and multi-family offices seek products that can deliver a dual financial and social return at scale. Whether investing through a fund dedicated entirely to impact or as part of a larger organization, the panelists stated that ESG/impact investing has brought a new set of opportunities to investors, just as the emergence of venture capital did 30 years ago. The new opportunities use the power of entrepreneurship to transform neighborhoods and build communities, improve health, wellness, and education, and promote environmental stewardship and, at the same time, provide good long-term investments with good growth potential.

While all of this seems fantastic, one panelist cautioned that it is still early to declare that impact investing is mainstream. While the amount of dollars going into impact is growing, it is still relatively limited. Big institutions have been slow to make major commitments of capital, but that is starting to change. Most of the capital is currently coming from family offices and high net worth investing platforms. This, as one panelist explained, is only natural, as institutions' responses typically lag what is happening in the world. For instance, it was not until consumers became more health conscientious that the big food companies started investing in more transparency from food labels and buying into smaller brands that were more focused on health. In addition, another major issue that is retarding the growth of impact investing is the question of how to measure impact.

In terms of financial returns of impact investments, the GP group acknowledged that there is likely a trade-off between short-term returns and social impact. But, they argued that the performance of a portfolio with social responsibility, in the long run, could exceed that of a traditional portfolio. Moreover, one GP felt that the extreme passion of individuals at impact investment firms helps produce better returns. Yet, the panelist recognized the challenge of how to achieve an optimal combination of social impact and financial returns, especially how to incorporate an impact perspective into the traditional buyout model.

To get further buy-in, the GPs felt that their LPs needed to stand up and make their attitudes clear on impact investing. Some pension funds are actively getting involved in creating new opportunities for impact investments. But others are more ambiguous. Although the risk of having larger impact funds is non-negligible (the phenomenon of "money chasing deals," etc.), the panelists had faith that impact considerations were beneficial for the long-term performance of investments. Fund managers, however, need to be careful about how allocations are made in the face of growth. Also, in order to be credible and build a good reputation, fund managers need to understand that it is better to have a good impact story with lower returns, than a bad story with higher returns.

Overall, the panelists agreed that even with all the challenges and risks, there seems to be a generational shift, with a more socially and environmentally conscious millennial generation. Investors should enter cautiously, but not let the perfect be the enemy of the good. Ultimately, only, those GPs who "know how to play the game" with a credible offering and are able to hit both social and financial targets will thrive.