

Up For Debate

When Can Impact Investing Create Real Impact?

By Paul Brest & Kelly Born

With Responses From

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When Can Impact Investing Create Real Impact?

Although it is possible for impact investors to achieve social impact along with market rate returns, it's not easy to do and doesn't happen nearly as often as many boosters would have you believe.

BY PAUL BREST & KELLY BORN

ILLUSTRATION BY BEN WISEMAN

There has been an increasing realization that, along with philanthropy and government aid, private enterprise can contribute to solving social and environmental problems. At the same time, a growing number of investors are expressing a desire to “do good while doing well.” These are impact investors, who seek opportunities for financial investments that produce social or environmental benefits. However, the rapid growth of the field of impact investing has been accompanied by questions about how to assess impact, and concerns about potentially unrealistic expectations of simultaneously achieving social impact and market-rate returns.

This article is addressed to impact investors who wish to know whether their investments will actually contribute to achieving their social or environmental (hereafter, simply “social”) objectives. We introduce three basic parameters of impact: *enterprise impact*, *investment impact*, and *nonmonetary impact*. Enterprise impact is the social value of the goods, services, or other benefits provided by the investee enterprise. Investment impact is a particular investor’s financial contribution to the social value created by an enterprise. Nonmonetary impact reflects the various contributions, besides dollars, that investors, fund managers, and others may make to the enterprise’s social value.

The most novel and intriguing question we consider is whether and when investors can expect both to receive risk-adjusted market-rate

returns on their investments and to have real social impact: that is, can investors both make money and make a difference? That is the claim made by many impact investment funds. One recent study asserts that most of what it estimates to be a \$4 billion impact investing market involves investments producing market rate returns.¹

We posit that a particular investment has impact only if it increases the quantity or quality of the enterprise’s social outcomes beyond what would otherwise have occurred. Under this definition, it is readily apparent that grants or concessionary investments (investments that sacrifice some financial gain to achieve a social benefit) can have impact: By hypothesis, an ordinary market investor, who seeks market-rate returns, would not provide the capital on as favorable terms, if at all.

But if an impact investor is not willing to make a financial sacrifice, what can he contribute that the market wouldn’t do anyway? We believe that in publicly traded large cap markets, the answer is nothing: Even quite large individual investments will not affect the equilibrium of these essentially perfect markets. The frictions or imperfections inherent in some smaller, private markets, however, may offer the possibility of achieving both market returns and social impact. For example, someone with distinctive knowledge about the risk and potential returns of a particular opportunity may make an investment that others would pass up.

The question of investment impact is of obvious importance to investors who want to make a difference. Although we do not reject the possibility of earning market-rate financial returns while achieving social impact, we are skeptical about how much of the impact investing market actually fits this description.

Impact Investing Defined

An impact investor seeks to produce beneficial social outcomes that would not occur but for his investment in a social enterprise. In international development and carbon markets, this is called

WITH RESPONSES FROM

Audrey Choi | 27

Sterling K. Speirn | 28

Alvaro Rodriguez
Arregui &
Michael Chu | 29

Nancy E. Pfund | 30

Nick O'Donohoe | 31

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- Responses from 10 other thought leaders
- Authors' comments on responses
- Lively discussion with your peers
- Longer version of Paul Brest and Kelly Born's article



additionality. With this core concept in mind, we define the practice of impact investing capaciously, as *actively placing capital in enterprises that generate social or environmental goods, services, or ancillary benefits such as creating good jobs, with expected financial returns ranging from the highly concessionary to above market*.²

The adverb “actively” excludes negative investment screens. This is not a judgment about their value, but rather reflects the general understanding that impact investing encompasses only affirmative investments. Within the field of impact investing, we include concessionary investments, which sacrifice some financial returns to achieve social benefits, and non-concessionary investments, which expect risk-adjusted market returns or better.

Like philanthropists, impact investors invariably intend to achieve social goals. They are, by definition, socially motivated. Their goals may be as specific as providing anti-malaria bed nets to residents of a region in Africa or as general as doing environmental good. In contrast, socially neutral investors are indifferent to the social consequences of their investments. Many endowments invest in a socially neutral manner, as do individuals who invest through money managers or funds whose only mandate is to maximize financial returns.

Whatever an investor’s intention, the fundamental question is whether an investment actually has social impact. For example, socially neutral investors, motivated only by profit, have contributed to the social impact of telecommunications companies in both the developed and developing world. Yet while social impact can be achieved unintentionally, this does not mean that intention is unimportant. In business, as in philanthropy and all other spheres of life, people are more likely to achieve results that they intentionally seek.

Having impact implies causation, and therefore depends on the idea of the counterfactual—on what would have happened if a particular investment or activity had not occurred. The enterprise itself has impact only if it produces social outcomes that would not otherwise have occurred. And for an investment or nonmonetary activity to have impact, it must increase the quantity or quality of the enterprise’s social outcomes beyond what would otherwise have occurred.

Enterprise Impact

In this article, we explore the three parameters of impact: the impact of the enterprise, investors’ contribution to the enterprise’s impact, and the contribution of nonmonetary activities to an enterprise’s impact. Without successful outcomes from the social enterprise, no investment can have social impact. Therefore, the social impact of investors and other actors ultimately depends on that of the enterprises they support.



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An enterprise can have impact in several ways, two of which are fundamental: *product impact* is the impact of the goods and services produced by the enterprise (such as providing anti-malaria bed nets or clean water); *operational impact* is the impact of the enterprise’s management practices on its employees’ health and economic security, its effect on jobs or other aspects of the well-being of the community in which it operates, or the environmental effects of its supply chain and operations.

The theoretical framework that underlies the assessment of enterprise impact makes a distinction between outputs and outcomes. An output is the product or service produced by an enterprise; the (ultimate) outcome is the effect of the output in improving people’s lives. So the impact investor must answer two questions: First, to what extent will the intended output occur? Second, to what extent will the output contribute to the intended outcome (where the counterfactual is that the outcome would have occurred in any event)?

Consider an investor supporting an organization that manufactures and distributes bed nets with the goal of reducing morbidity and mortality from malaria. The focus of the first question is whether the bed nets were manufactured and distributed. It is answered by looking at the quantity and quality of the organization’s outputs.

The second question is concerned with whether the bed nets actually reduced malaria in the target population. For example, even if bed nets are often effective, and even if the ultimate outcome occurred in the target population, can the reduction in malaria be attributed to the enterprise? Perhaps the reduction was due to a simultaneous vaccination or mosquito eradication program. The question of outcomes, or social impact, is typically answered by using the same social science methods used in assessing outcomes in public policy and philanthropy—for example, randomized controlled studies or econometric analysis.

The Impact Reporting and Investment Standards (IRIS) and Global Impact Investment Rating System (GIIRS) provide standardized metrics for assessing some common output criteria. But these focus more on an enterprise’s operations than on its products. With rare exceptions—most notably, the field of microfinance—there have been few efforts to evaluate the actual outcomes of market-based social enterprises. The absence of data and analysis makes it difficult for impact investors to assess the social impact of the enterprises they invest in.

Investment Impact

As we noted above, to have investment impact requires that an investment increase the quantity or quality of the enterprise’s social output beyond what would otherwise have occurred. Assuming that, at the time of an investment, the enterprise can productively absorb more capital, then an investment has impact if it provides more capital, or capital at lower cost, than the enterprise would otherwise get.

Debra Schwartz, director of program-related investments at the MacArthur Foundation, has alliteratively summarized the kinds of capital benefits that impact investors can provide in terms of five P’s, to which we add a sixth, perspicacity:

- *Price.* Below-market investments
- *Pledge.* Loan guarantees
- *Position.* Subordinated debt or equity positions
- *Patience.* Longer terms before exit
- *Purpose.* Flexibility in adapting capital investments to the enterprise's needs
- *Perspicacity.* Discerning opportunities that ordinary investors don't see

These capital benefits enable the enterprise to experiment, scale up, or pursue social objectives to an extent that it otherwise could not. The first five are particularly relevant to investments that expect below-market returns. The sixth, perspicacity, may hold the key to achieving both market returns and social impact.

Socially motivated investors fall into two categories: concessionary investors who are willing to make some financial sacrifice—by taking greater risks or accepting lower returns—to achieve their social goals; and non-concessionary investors who are not willing to make any financial sacrifice to achieve their social goals. Most so-called “double-bottom-line” impact investors are non-concessionary. In the context of philanthropy, non-concessionary socially motivated investments are often called mission-related investments, and are distinguished from program-related investments, which are generally concessionary.

Concessionary Investments | The return sacrificed by a concessionary investment is, in effect, a charitable donation or grant. Assuming that the enterprise can productively deploy additional capital, a concessionary investment has investment impact virtually by definition, because it makes available capital to which an enterprise would not otherwise have access. Consider three general situations in which impact investors have made concessionary investments.

Supporting nascent enterprises. The early stages of many social enterprises that aspire to become financially sustainable depend on philanthropy and highly concessionary investments that involve higher risks than ordinary market investors would take. This was true of microfinance and of other social enterprises that serve base-of-pyramid (BOP) populations, which often depend on innovations in technology and marketing and require significant investments before yielding any financial returns.

Subsidizing ongoing enterprises. Some mature social enterprises require the ongoing support of investors who are willing to forgo a degree of financial return for social benefits. For example, in 1994 the US Department of the Treasury created Community Development Financial Institutions (CDFIs) to “provide economically depressed communities access to credit, equity, capital, and basic banking products.” Subsequently, the Calvert Foundation began offering below-market Calvert Community Notes, which in turn are invested in CDFI-accredited community organizations that provide below-market loans to nonprofit organizations and small businesses in underserved communities.

Simultaneous layering of concessionary and non-concessionary investments, with the former intended to encourage the latter. For example, the New York City Acquisition Fund is designed to promote the development of affordable housing by providing flexible capital for developers. The city was joined by the MacArthur,

Rockefeller, F. B. Heron, Robin Hood, Starr, and Ford foundations in providing subordinate debt and loan guarantees. More or less non-concessionary investors include Bank of America, JP Morgan Chase, and HSBC.

These are examples of the beneficial effects of subsidies. But the fact that an investment is concessionary is no guarantee that it will create net positive social impact. Subsidies can also mask an enterprise's inefficiencies and crowd out healthy competition. Subsidizing microfinance and community development institutions has been both positive and harmful in different circumstances.

In any event, the ideal outcome for most enterprises that initially rely on concessionary capital is that they eventually yield market returns and attract socially neutral investors. Here, impact investors have played their part in bringing the enterprise to market, the impact investing story is over, and the enterprise is now supported by customers and ordinary market investors.

The modern history of microfinance provides examples of this. The story begins with grants to the Grameen Bank and other microfinance institutions (MFIs) to develop and prove the concept, followed by concessionary loans and equity investments to begin implementing it. Although even today many MFIs depend on subsidized investments, an increasing number now attract market investors. For example, in 2007 the initial public offering of the highly profitable Compartamos Banco was vastly oversubscribed, and some mainstream banks, such as Citigroup, now have a microfinance business. This generally positive story has a dark side, however. As MFIs become more financially attractive, they may adopt practices that compromise their social missions.

Non-Concessionary Investments | It's easy to see how below-market investors can provide capital benefits to an enterprise, but it is less clear how and when investors expecting market returns (or better) have investment impact. Yet much of the impact investment space is occupied by funds that promise their investors both socially valuable outputs and at least market returns. For example, Elevar Equity generates “outstanding investment returns by delivering essential services to disconnected communities underserved by global networks.”

We don't question these fund managers' assertions that their investments have strong financial returns. The immediate question is how their investments might have investment impact. Under our criterion of additionality, the investment must increase the quantity or quality of the social or environmental outcome beyond what would otherwise have occurred. The counterfactual is that ordinary, socially neutral investors would have provided the same capital in any event. Under the additionality criterion, how can an impact investor expect market returns and still provide capital benefits to the enterprise? After all, if it's a good investment, one would expect socially neutral investors to be in it as well.

Most economists agree that it is virtually impossible for a socially motivated investor to increase the beneficial outputs of a publicly traded corporation by purchasing its stock. Especially if—as is generally the case—stock is purchased from existing shareholders, any benefit to the company is highly attenuated if it exists at all. Impact investing typically does not take place in large cap public markets, however, but rather in domains subject to market frictions. While some of these frictions impose barriers

to socially neutral investors, socially motivated impact investors may exploit them to reap both social benefits and market-rate financial returns. These frictions include:

- *Imperfect information.* Investors at large may not know about particular opportunities—especially enterprises in developing nations or in low-income areas in developed nations—let alone have reliable information about their risks and expected returns.
- *Skepticism about achieving both financial returns and social impact.* Investors at large may be unjustifiably skeptical that enterprises that are promoted as producing social or environmental value are likely to yield market-rate returns.
- *Inflexible institutional practices.* Institutional investors may use heuristics that simplify decision making but that exclude potential impact investments, which, for example, may require more flexibility than the fund's practices permit.
- *Small deal size.* The typical impact investment is often smaller than similar private equity or venture capital investments, but the minimum threshold of due diligence and other transaction costs can render the investment financially unattractive regardless of its social merits.
- *Limited exit strategies.* In many developing economies, markets are insufficiently developed to provide reliable options for investors to exit their investment in a reasonable time.
- *Governance problems.* Developing nations may have inadequate governance and legal regimes, creating uncertainties about property rights, contract enforcement, and bribery. Navigating such regimes may require on-the-ground expertise or personal connections that are not readily available to investors at large.

We believe that non-concessionary impact investors are especially likely to have investment impact in conditions of imperfect information—for example, in social or environmental niche markets where impact investment fund managers or other intermediaries have special expertise or intelligence on the ground.

Perfect markets are functionally omniscient, but the impact fund manager says (in the words of David Chen of Equilibrium Capital), “I see something that you don’t see.” Socially motivated investors may be particularly interested in identifying these opportunities and thus may be able to have impact even at non-concessionary rates. This is the most likely explanation for the asserted double-bottom-line success of firms like Elevar Equity. Even here, one might ask whether investments that seem non-concessionary on their face incorporate hidden concessions in the form of risk or extra and costly due diligence that ordinary investors would not undertake.

Nonmonetary Impact

Beyond just providing capital, fund managers as well as other actors can improve an enterprise’s social outputs by providing a range of nonmonetary benefits:

Improving the enabling environment for social enterprises and investors. Governments and foundations can provide funding to improve the social, political, and regulatory environments in which social enterprises and their investors operate. For example,

the Boulder Institute has developed scoring and rating models for MFIs, established benchmarking, introduced an open source management information system, and trained thousands of MFI practitioners. In addition to providing public goods of these sorts, a well-designed set of investments in a sector has the potential to catalyze markets to a greater extent than the sum of random investments in the individual investee enterprises.

Finding and promoting impact investment opportunities. Impact investment intermediaries are critically important in discovering investment opportunities and bringing them to the attention of investors, thus helping to overcome the information failures previously noted. For example, Agora Partnerships identifies early-stage impact investment opportunities in Central American communities, focusing on small and growing businesses that are too large for microcredit and too small for traditional financing. Its clients, such as the Draper Richards Kaplan Foundation, engage Agora to pursue impact investment opportunities in the region.

Aggregating capital and providing other investment services. Fund managers and other intermediaries reduce transaction costs by creating economies of scale, and they may also provide technical assistance to impact investors. For example, Imprint Capital Advisors helps foundations and family offices identify domestic and global opportunities for impact investment. Imprint guided several foundations to invest in Southern Bancorp, a US development bank that provides banking and nonprofit services aimed at reducing poverty and unemployment in distressed rural communities.

Providing technical and governance assistance to enterprises, and helping them build strategic relationships. Fund managers and other third parties provide nonmonetary benefits, ranging from technical assistance for nascent enterprises to helping more mature enterprises develop relationships with customers, suppliers, and other partners. For example, Root Capital’s Financial Advisory Services are designed to strengthen the business processes of social enterprises with high growth potential in Africa and Latin America. Training modules focus on business and administrative management, financial planning, risk management, accounting, and loan applications.

Gaining socially neutral investors. One of the unfortunate characteristics of imperfect impact investing markets is their inability to attract the large majority of socially neutral investors who demand market returns. Where such returns seem plausible, a respected institution can signal to other investors that a particular investment or an entire sector that others may have thought dubious is actually worthy of consideration. For example, the David & Lucile Packard Foundation made an initial \$1 million equity investment, followed by a low-interest \$10 million loan, in EcoTrust, a sustainable forest management firm. The foundation’s general counsel noted: “Our main reason for investing in EcoTrust Forest in this way is to demonstrate that sustainable forest practices can generate a profit so that mainstream investors will become more interested in it.”³

Securing and protecting the enterprise’s social mission. Over time an enterprise’s management and directors may discover opportunities to increase financial returns at the expense of social impact. For example, the manufacturer of products or services designed for BoP clientele may find it more profitable to market to wealthier

customers. The dangers are especially acute as the enterprise scales up and takes on new, socially neutral investors. There are a number of possible protections against such mission drift, including contractual arrangements; B Corps, and other corporate forms that require, or at least welcome, producing social benefits that may compromise market returns; and the continual influence of socially motivated investors.

The Demand for Information About Impact

Having addressed this article to impact investors who wish to know whether their investments will actually contribute to social or environmental impact, we conclude with a reality check on investors' making this inquiry and learning from it.

A 2010 survey of philanthropists and impact investors suggests that the vast majority are not willing to make any effort to gain information about the actual social or environmental impact of their investments.⁴ Social impact is notoriously difficult to measure, and it could well be that many investors are satisfied with the good public relations and warm glow of doing a beneficent act. But we are optimistic that there are impact investors with significant resources who actually care whether their investments are making a difference.

For those who do care, efforts to assess impact come at a cost—greater or lesser depending on the degree of evaluative rigor. Estimating the expected financial return from an investment is a difficult but familiar exercise. Estimating social return is intrinsically much harder because of the complexities of placing values on social and environmental outcomes and predicting what outcomes an organization is likely to achieve. Estimating the value of nonmonetary contributions that directly benefit an enterprise is a commonplace task that an organization engages in whenever it hires consultants. Estimating the value of nonmonetary contributions to an entire sector is a far more speculative task.

In contrast to enterprise and nonmonetary impact, assessing a particular investment's additionality in order to determine its investment impact is a novel task that, so far as we know, has not previously been undertaken. In this article, we propose the questions that underlie this analysis. An investor who expects market returns must ask whether his non-concessionary investment is likely to have investment impact, and if so, how much. An investor who is prepared to sacrifice market returns should ask how much concession it's worth making for the social value produced by the organization. Although we have no a priori commitment to any particular depth of analysis, we believe that realizing the promise of impact investing depends on all three measures becoming central to the marketplace. ■

This article is based on a longer article by Brest and Born, "Unpacking the Impact in Impact Investing," available at SSIR Online.

Notes

- 1 <http://www.pacificcommunityventures.org/reports-and-publications/market-for-social-impact-investing-by-private-equity-funds-stands-at-4-billion-in-the-united-states/>
- 2 Our definition borrows liberally from the definition used in the report *Investing for Impact: Case Studies Across Asset Classes*, Bridges Ventures, The Parthenon Group, and Global Impact Investing Network, p. 3.
- 3 Stephanie Strom, "To Advance Their Cause, Foundations Buy Stocks," *The New York Times*, Nov. 24, 2011.
- 4 <http://hopeconsulting.us/money-for-good/>



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Audrey Choi

Paul Brest and Kelly Born's article provides useful rigor in helping a self-identified "impact investor" answer the question, "How can I be certain that my impact investment is creating an impact that otherwise would not have occurred?" This consideration is particularly relevant for philanthropic individuals or institutions who may be contemplating impact investing as an alternative use for the precious resource of dollars that would otherwise go to grants or concessionary program-related investments. Many of us in the impact investing field, however, find more compelling a different question, "How can we drive positive change to address the world's problems as broadly, as rapidly, and as effectively as possible?"

If that is the outcome we seek, then it matters much less whether a particular investment counts as an "actual" impact investment. It also matters less whether the positive impact created was the central intent or an outcome or by-product of the investment. What matters more is whether change happens and whether it reaches transformational scale. If those positive changes happen to benefit from the tailwinds of market forces, and if the investments were made in the company of non-impact-minded investors who are primarily interested in financial returns, then so be it. If it is good to fuel the growth of a company that creates critically needed jobs, reduces carbon emissions, or improves community resilience, then isn't it better if we can harness more capital to help that company grow faster and replicate more broadly?

Grants, PRIs, and concessionary investments play a critical role in fueling social innovation. The goal of impact investing isn't to substitute for those vital grants or PRIs but rather to tap into the much larger pools of pensions, endowments, and other fiduciary and commercial capital that can complement and augment the grants and concessionary capital. Our role as field-builders in impact investing, then, should be to create as many broad and inclusive on-ramps as possible for investors with many different appetites in order to attract as much capital as possible for investment in opportunities that drive, support, and accelerate positive change.

For the growing number of mainstream investors beginning to contemplate impact investing as an additional tool in their portfolios, the first question should perhaps be "How can my investment dollars be directed in ways that provide positive social impact as well as satisfy my economic requirements?" To be sure, a decision to invest with impact may not have as dramatic a social-impact multiplier effect as a highly intentional, impact-first investment.

But one cannot say that no positive benefits accrue from decisions by mainstream investors to direct their funds away from investments that have negative or neutral social impact and toward ones that have positive impact.

Brest and Born suggest that in market-rate opportunities impact investors don't actually have much impact, because those businesses already have access to more than enough commercial capital. But economically sensible investments do not necessarily get ample funding automatically. If they did, there would be no need for the venture capital industry, which specializes in identifying and funding businesses that it believes have the capability to deliver outsized returns but that have been overlooked by traditional capital. By seeking out and seeding investments that have the ability to achieve both market-rate returns *and* high social impact, impact investors can introduce those enterprises to conventional capital and thereby broaden the scope of possible impact.

As proponents of impact investing, we are best served when investors—impact or otherwise—are clear about their goals, expectations, risk tolerances, return requirements, and desired impact outcomes. In assessing how well a particular investment fits an investor's needs, “actual impact” as outlined by Brest and Born is an important analytic tool—as is the recognition that appropriate risk-adjusted market-rate returns aren't necessarily at odds with impact, especially if they help deliver impact more quickly and more broadly. ■



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Sterling K. Speirn

Paul Brest and Kelly Born's article brings clear and rigorous analysis to a field that is desperate to have the practice catch up with the rhetoric, and that until now has surrounded a provocative idea with too much wishful and fuzzy thinking. In addition to developing a very helpful taxonomy and terminology, Brest and Born raise a critical question: What is the nature of the impact created by the investment itself, separate from the outputs or outcomes produced by the social enterprise that received the investment?

They argue that *investment impact*—as distinguished from the *enterprise impact*—exists only if the quantity or quality of the enterprise or investee's output is increased “beyond what would otherwise have occurred.” From the perspective of an experienced impact investor—the W.K. Kellogg Foundation's \$100 million Mission Driven Investing Portfolio (MDI) now has a five-year track record across multiple asset classes and sectors—I find this framework

illustrative but in need of expansion if we are to fully describe all the returns and impacts that are generated in the relationships between impact investors and their investees.

To begin, it's important to differentiate among investors, as I will argue that there is an *investor impact* that adds yet another dimension of *additionality* in any transaction, depending on the unique interests of the investor. Brest and Born define foundations or other investors who start with a philanthropic perspective to promote and stimulate positive social change as *socially motivated* investors, as distinct from *socially neutral* investors. And indeed, at the Kellogg Foundation we have found ourselves often in deals side by side with socially neutral investors, realizing or hoping to achieve market-rate returns.

The authors are right to be skeptical that much impact investing strictly defined can achieve both market-rate financial returns and social impact returns, but the likelihood of this happening increases if we take into account another potential return: what we at the Kellogg Foundation call the *learning return*. (There is also a corresponding learning return for socially neutral investors, who by specializing in an industry gain increasing expertise to optimize future financial returns.) For foundations, which for the most part have made only charitable grants, becoming impact investors in commercial enterprises brings new and different information and insights into social problem solving that would not otherwise be available to them through charitable grantmaking alone.

Brest and Born appreciate that value is added from the relationship between investor and investee (called *nonmonetary impact*), but they see this as occurring in only one direction, from the investor to the investee. There is, however, the potential for a “more than money” return from the investee to the investor that can make socially motivated investors smarter and more effective in their core philanthropic endeavors, increasing social impact in both conventional charitable grantmaking and impact investing.

Here are some examples from the Kellogg Foundation. With decades of work and experience in food systems and with long-term field-building efforts in farm-to-school, community food, and school food transformations, the foundation saw an opportunity to invest in a young company, Revolution Foods, that was dedicated to selling healthy, affordable, delicious food for schoolchildren. It has brought us wholly new perspectives on issues of public policy, school and community food systems, and family and child behaviors that we can use to inform our grantmaking and institutional efforts on the very same issues. Investing in a bank, Southern Bancorp, that does business in the Mississippi Delta region, one of the foundation's priority places, creates a partnership and provides a unique perspective on the challenges of economic and workforce development with which our program staff continually grapple. With our investment in Wireless Generation, our intense learning return on how to bring technology and big data to real-time assessments, coupled with customized instruction for K-3 early grade literacy, was matched by our 26 percent return with an early buyout. And today, as more funders seek to promote and invest in prevention and wellness as opposed to disease treatment, our investment in SeeChange Health tells the same story in the health arena.

Traditionally, foundations have supported pilot and model programs in the hope that they will be replicated and then funded

more broadly by government. Now we see that when our field-building efforts are successful, they can create new demands and ultimately new markets for entrepreneurs to take advantage of. In this way, foundations can enlist private sector forces in scaling up what works.

Impact investments are not stand-alone transactions, but pivot points on the continuum of grants to commercial investments that enable socially motivated investors to continue learning and to stimulate continued advancement of their missions across sectors. For any given transaction, there might not be investment impact additionality as strictly defined by Brest and Born, but there can be substantial investor impacts that will increase mission efficacy over the long term. ■



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Alvaro Rodriguez Arregui & Michael Chu

The article by Paul Brest and Kelly Born perpetuates the idea that financial returns and social impact are a zero-sum game and that you cannot maximize both. This perspective has done a tremendous disservice to the impact investing field. If the world had adopted it two decades ago, poverty would not have been reduced by 50 percent.

Not all human and environmental challenges can be tackled with commercial approaches, and many terms denote the noncommercial initiatives that address these challenges, including *philanthropy*, *nonprofit*, *public sector*, and *corporate social responsibility*. A new term is justified only if it is not old wine in a new bottle. That is why at IGNIA we believe that impact investing should be reserved for a commercial approach, lest we confuse more than we clarify.

The authors ask, When can investors expect both to receive risk-adjusted market-rate returns on their investments *and* have real social impact? The answer is, When an intervention of high social value is mounted on a sturdy business platform. We proved that this was possible with commercial microfinance. At IGNIA, we seek to extend this approach to affordable housing, digital access for the daily needs of people at the base of the pyramid (BOP), access to health care, high-nutrition products, and other basic needs.

If we succeed and achieve extraordinary financial returns, this will attract a flock of market entrants. With their entry we will create

an industry, and only then can we guarantee achieving a lasting and large enough impact to move the needle. In this way financial returns can be the main driver for social impact. Accordingly, there is no question that intentionality is a key element of impact investing and the intention should create an industry. How else can we stand a chance of tackling the enormous challenges we face?

Brest and Born's perspective—that in order to achieve impact you need capital willing to accept concessionary returns—is based on the view that reaching clients depends on a single dimension: price. But the value proposition to a client is much more complex than price. For example, Mexico provides free public health care, but after factoring in travel time, waiting time, multiple visits to the doctor, and quality of care, people at the BOP would consider that the total transaction cost is actually large. Seeking a better value, people at the BOP are often willing to dig deep into their shallow pockets to opt for a commercial health-care alternative. The market economy has taught us this lesson, but in the social-impact world we refuse to accept it.

Brest and Born's view that “an ordinary market investor, who seeks market-rate returns, would not provide the capital on as favorable terms” perpetuates two false views: first, that investments with impact cannot achieve extraordinary returns, and second, that the impact world sets the bar too low and continues to fund mediocre business plans for which no source other than concessionary funding is possible. If the first view were accurate, few of the great innovations that have improved the quality of life of humankind over the past 100 years would have flourished. The second leads to the view that impact investing is an industry devoted to funding the well-intentioned “walking dead” (to use the venture capital industry's term).

By focusing on financial returns, Brest and Born miss the point that what distinguishes impact investors from traditional investors is that they have a higher tolerance for risk.

Brest and Born also call for more attention to measuring outcomes. But we have spent too much time and too many resources discussing impact measurement and trying to measure outcomes. Is an individual who needs eyeglasses better off if she has access to them? If you are wearing a pair while reading this article, you know the answer. There are myriad basic products and services such as eyeglasses to which the majority of the world's population does not have access and which, if they did, would allow them to live significantly improved lives. So let's move on and not overburden those initiatives focused on underserved communities with academic questions. They already face plenty of challenges trying to deliver what they promise.

There is no question that there is a role for philanthropic capital in impact investing. Philanthropy, as in the biotech and the cleantech industries, can provide the very early stage R&D capital that carries such high risk that it would never attract any return-seeking investor. In this well-worn model, philanthropy, often through universities, helps give birth to new ideas and enables their development into working concepts, at which point the risk level is in the range where venture capital can enter and bet on building an effective business model. Instead of playing this role in impact investing and supporting disruptive business concepts on their hard road to viability (or not),

philanthropy too often funds no risk and therefore no innovation, as when it gives free houses to the homeless or waits in line to provide growth capital to already-proven social enterprises.

One last thought. Venture capitalists understand that their industry is based on the portfolio approach to returns. In impact investing we seem to have missed this lesson. With a “concessionary returns” approach, the end result is a portfolio characterized by very low risk/low returns projects that, by definition, are neither transformative nor very innovative. Instead we should adopt the portfolio approach, knowing that most projects that swing for the bleachers will fail but those that succeed will achieve such high impact and financial returns that they will more than compensate for the failures. ■



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Nancy E. Pfund

Lately, it seems, just about everybody is becoming an impact investor. “All good,” one might say, for who wouldn’t want to rally behind those who strive to make a difference in the world while implementing a compelling investment strategy? The tricky part, as Paul Brest and Kelly Born argue in their thoughtful article, is determining what exactly that impact looks like and whether its existence bears any connection to the investment process attached to it.

After almost 10 years of building our practice of double-bottom-line venture capital at DBL Investors, we find many aspects of the authors’ conceptual framework resonant, including the notion of perspicacity, the presence or absence of *additionality*, and the importance of metrics and nonmonetary benefits.

By its nature, venture capital as an asset class relies on a certain level of perspicacity, as referenced in the article—discerning opportunities that ordinary investors don’t see. Routinely investing in often unproven entrepreneurs who take on difficult product development challenges in markets that can be hostile does not happen successfully without some sixth sense that the innovation will prevail and that the odds are not as bad as they appear. What impact investing lends to the venture capital model is another level of purpose, one that reaches into a social or environmental domain by splicing itself into the DNA of a young company whose culture is still in the making.

For example, in the early days of Tesla Motors (one of our investees), when we were looking for a site to build a manufacturing plant, DBL helped the company explore regions of the San Francisco Bay

Area that might be suitable and where economic development incentives could help to level the playing field compared to other countries and states that had lower costs. This effort stemmed from aspects of our mission at that time, which included reducing the carbon footprint of transportation and creating high-quality jobs in Bay Area neighborhoods that needed them. Through a process that broke apart the conventional wisdom about whether California was an appropriate place to manufacture, the Tesla team’s perspicacity helped it grab a plant (the former NUMMI plant in Fremont) that many thought was out of its reach, creating a strategic win for both the company and the community. Whether this would have happened without a robust and purposeful early collaboration with DBL Investors we will never know. We do know that to infuse impact into decision making, one needs first to get a seat at the decision-making table.

While the Tesla example shows how mission can lead to nonmonetary assistance to a company that can create very strategic benefits, the fact that DBL Investors invested alongside traditional venture capital firms makes the question of additionality harder to answer. In other cases, it is much clearer. When evaluating a prospective investment with both a social lens and a financial returns lens, we have found that we can connect the dots a little sooner as to why a particular company idea might work. This is because we are keyed into certain societal trends, problems, and policies that have been hard to solve and may even be getting worse. In these situations, it may well be time to turn to an entrepreneurial company to build on previous research and programmatic development from public and nonprofit organizations and to work to solve the problem at a scale unachievable by grants and social-welfare programs alone. Revolution Foods is the clearest example of this in our portfolio. DBL seeded this company at a time when it was very difficult for the founders to attract investment because the company’s purpose was “off-spec” from traditional venture business models. For us, by contrast, the company represented an exciting opportunity to address the epidemic of obesity and diabetes in our schools, particularly those in lower-income demographics. We also believed that cracking the code on K-12 healthy meal preparation would be of interest and value to existing players in the food service industry, creating potential for significant value creation. Today, Revolution Foods is serving more than 200,000 meals a day to children in K-12 schools and has attracted investment from an array of traditional and impact investors. In this as well as many other cases, the impact investor who sees the potential early and so invests early acts as a catalyst to help the entrepreneur gain access to traditional investors later on.

Finally, the appeal by Brest and Born at the end of the article for investors to start measuring and analyzing aspects of their work rings very true to DBL Investors. As the examples I have presented here demonstrate, if you don’t track the efforts, count the jobs, detail the carbon saved, or whatever your social-mission priorities happen to be, it is very hard to show how or whether your investment approach has made a difference. At DBL, twice a year since the inception of both our funds we have been writing quantitative and qualitative impact reports that detail successes, failures, and works in process across a wide range of industries and locales, and through these reports we have been able to help our investors and ourselves assess the nature and scope of our impact.

We believe that some aspects of double-bottom-line venture capital investing, such as working with broader constituencies, paying attention to place, and engaging in policy issues, will become mainstream. In the startup world, using perspicacity with purpose to build businesses and address social problems is a way to refresh the venture capital model to address 21st-century needs and opportunities. ■



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For practitioners in the world of social-impact investing, a number of questions come up time and again: How do we define a social investment? How do we define social enterprise? and How big is the market and should we define it as an asset class? The question that comes up most of all is Do we believe that making an investment with the intent of creating *impact* necessarily leads to a risk-adjusted return that is lower than a purely financial investor would expect? Or in other words, Does impact investing require investors to “trade off” social return against financial return, or is it in fact a “free lunch” that allows investors to optimize risk-adjusted returns at the same time as they generate positive social value?

The article by Paul Brest and Kelly Born is by some margin the most coherent attempt yet to consider this question. In the January 2013 survey of impact investors by J. P. Morgan and the Global Impact Investing Network, *Perspectives on Progress*, 65 percent of respondents indicated that they were seeking market-rate returns. If Brest and Born are right in saying that they are “skeptical about how much of the impact investing market actually fits this description,” then at best these investors are going to find it very difficult to find suitable investments, and at worst they are facing disappointing financial returns.

So is the authors’ skepticism justified? Broadly speaking, I believe it is. In my view the vast majority of impact investors projecting market-rate returns fall into one of four categories.

- They are in fact earning a market-rate return but only because there is subsidy in the capital structure. For example, large US banks are increasingly describing their lending to Community Development Financial Institutions (CDFIs) as impact investing. Without wanting in any way to discourage this activity, I would point out that the CDFIs receive significant subsidy through government grants and tax credits, and the banks that lend to them rely on that subsidy to earn their return.

- They are confusing absolute return with risk-adjusted return. Projecting a 15 percent return for a microfinance equity fund may seem like a reasonable absolute return, but it is not close to what an appropriate risk-adjusted return would be for early-stage investments in some of the least developed markets in the world.
- They focus on returns from individual investments rather than returns on the entire portfolio. The extraordinary returns to the original shareholders in Compartamos do not prove that a portfolio of microfinance equity generates commercial risk-adjusted returns.
- They confuse projected returns with actual returns. Risk and return data are scarce in the impact investing world, and the projected returns of an investment manager rarely match actual returns.

I particularly find Brest and Born’s notion of investment impact helpful. They are correct in suggesting that for impact investment to have impact it has to be “additive,” and although it is easy to argue that concessionary investments are additive, it is much more difficult to do that with non-concessionary investments.

Is it ever possible for the impact investor to earn a market return? Are there ways in which being an impact investor gives a competitive advantage over mainstream investors that allow the impact investor to optimize financial and social return?

The authors identify a number of frictions that may impose barriers to what they describe as socially neutral investors but may provide some competitive advantage to socially motivated investors. Some of these frictions—such as small deal size, limited exit, and governance issues—are true of any investment portfolio that focuses on smaller companies, particularly in emerging markets.

The authors also describe a skepticism and inflexibility that can create an unintended bias among mainstream investors. The following is a gross generalization, but I am going to make it in any case. If you go into any mainstream bank, investment manager, or private equity firm in Europe or the United States you find the same people: hordes of MBAs from the same schools investing with people they know and like, in places they visit and in businesses they can relate to. This homogeneity among investors has unintended consequences.

New business models that create social value through the people they employ, the products they produce, or the areas in which they locate tend to find it difficult to attract capital. Because impact investors start from a different point of view, they go places, meet people, and see opportunities that the mainstream investment community misses. It may be possible, as David Chen notes, for them to “see something that you don’t see.”

I share the conclusion that it is critical for impact investors who are providing concessionary capital to provide clear measurable metrics that demonstrate and support the impact they are creating. Those, however, who seek to provide non-concessionary capital also need to demonstrate evidence of impact, but they must in addition be able to articulate their investment impact, and that means a clear articulation of why normal commercial investors are missing the opportunities that they are pursuing. ■