

Stanford SOCIAL INNOVATION^{Review}

Viewpoint
Marginalized Returns
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VIEWPOINT

INSIGHTS FROM THE FRONT LINES

Marginalized Returns

Impact investing has been seduced by a false narrative of combining social impact with financial gains.

BY MARA BOLIS & CHRIS WEST

Impact investing appears to have been seduced by a convenient narrative. According to the prevailing view, the achievement of both social impact and market-rate financial returns is the norm—not the exception. Those who question the financial returns aspect of this assumption are portrayed as lacking business savvy. “If we want to change things and we want to make an impact, we can’t be hippy-ish about this,” pop singer and philanthropist Bono said at the Skoll World Forum in April. “Impact investing has really been an excuse for good people to do bad deals.”

Impact investing was originally created to improve the lives of others; that impact investing could also deliver financial returns to investors was a means to that end. But nowadays, achieving predefined financial returns has become the primary goal, with the needs of investors taking priority over the interests of the communities their funding seeks to benefit. This trend has fueled a growing mismatch between the supply of impact investment and the demand for funding from enterprises working to improve conditions for marginalized communities.

Here is the reality: The most impactful and successful of social enterprises in emerging economies—even in developed countries—are likely to generate only low-single-digit financial returns. This is hardly surprising. They bear not only the same risks faced by all startup enterprises but also the challenge of testing, adapting, and refining business models appropriate to marginalized communities—who typically have previously either lacked access to the new product or service, or had it provided for free. Furthermore, such enterprises make business

decisions—on prices, wages, and hiring—in a way that maximizes long-term social benefit against short-term financial gain.

This reality is not reflected in industry research describing the financial terms and expectations of most impact investors. For example, the Global Impact Investing Network (GIIN) reports that 84 percent of the organizations they canvassed declared that they targeted risk-adjusted market-rate returns or close to market-rate returns. For any fund manager to generate a net 10 to 15 percent portfolio return, while assuming typical costs and losses, they must seek returns from individual transactions of at least 20 percent.

We know hardly any impactful social enterprises in emerging economies that are capable of achieving this result. Meanwhile, social enterprises face massive information asymmetries vis-à-vis their potential

investors. Money is scarce, their networks are weak, and their negotiating power is limited. As a result, social entrepreneurs often accept financial terms and conditions that pressure them to drift from their social mission. The downside risk of a failed social enterprise is borne not just by the entrepreneur, but also by the community it was set up to serve.

KNOW YOUR HISTORY

For decades, the only financial instrument used to improve the lives of people living in poverty was the 100 percent loss-making grant to nonprofit organizations. Then, in the 1960s, the Ford Foundation and the MacArthur Foundation started offering below-market-rate loans instead of grants to support low-income housing. This led to the emergence of program-related investments as an additional way of achieving public benefit. Following the pioneering Grameen Bank research project by Muhammad Yunus in 1976, the microfinance movement dramatically expanded access to credit for people living in poverty. Both cases demonstrated how new financial instruments coupled with innovative business models could benefit marginalized communities.

In the past decade, a more heterogeneous mix of nonprofits and for-profits have pursued a wide range of activities to deliver social benefit alongside financial return. As these new businesses emerged, the first impact investors began deploying debt and equity in ways more sustainable than the provision of grant funding. Several enterprises are now using business-based approaches that are both impactful and financially viable. Examples include Root Capital, which connects small farmers in emerging economies with global markets; Divine Chocolate, a Fairtrade chocolatier that shares ownership with the cocoa farmers; and M-KOPA, which introduced new pay-as-you-go



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financing for solar power. Underpinning their success, however, has been the provision of significant subsidy over long periods of time—often seven years or more. Without such subsidy, impact investors would have obtained no investment opportunity or faced the prospect of far lower financial returns with higher risk.

Most articles about impact investing fail to take this history into account. The literature ignores the preconditions and support that have enabled these successes, as well as the perspectives and needs of enterprises themselves. Instead, the field is evolving with an almost exclusive focus on the investor side of the equation.

The 2015 report “Introducing the Impact Investment Benchmark,” by Cambridge Associates and GIIN, is arguably the most comprehensive assessment of returns on impact investing funds. It states: “In aggregate, impact investment funds launched between 1998 and 2004—those that are largely realized—have outperformed funds in a comparative universe of conventional private investment funds.” The report concludes that “market rate returns are attainable in impact investing.” In short, no trade-off exists between social impact and financial returns.

But is this report really about impact investing? Or is it about emerging-markets private investing in sectors that are seen as broadly socially positive? It is not possible to know, because the report includes *no data or commentary* on the associated impacts achieved. Instead, the report uses a self-reported intention to generate social impact as the only impact-related criterion for inclusion in the benchmark. In addition, it draws on a small sample of funds targeting net 15 percent or greater financial returns, weighted toward those investment vehicles supporting financial inclusion and microfinance. But these sectors became investment-ready only after receiving an estimated \$20 billion in subsidies over 20 or more years, according to the Monitor Group report “From Blueprint to Scale.”

However, some independent studies are now reporting different results. The 2015

EngagedX study, at the time the largest aggregate study of historic social investment performance on closed deals in the UK market, found total returns over a 12-year period of negative 0.77 percent annualized. Boston Consulting Group studied the UK's FutureBuilder Funds and found similar results. The Monitor Group report states that Acumen—an early pioneer of impact investing that has an explicit social purpose—reported that its portfolio had an average after-tax profit of negative 20 percent, with the highest performers earning 6 percent.

It would be a huge mistake to conclude from these financial returns that their outcomes are disappointing; in fact, they are revolutionary. Enterprises with business models that produce social benefits such as job creation, affordable housing, and proper sanitation in a financially sustainable manner should be celebrated. But the prevailing narrative about impact investing paints a darker portrait. Such results are perceived as disappointing because they are measured against a very narrowly defined and unrepresentative benchmark.

WAY FORWARD

Unlike commercial investment, with its exclusive focus on risk and return, impact investing has changed finance by establishing social benefit as a goal. To be sure, impact investing offers a spectrum of financial and social returns. The problem is that too many impact investors have predefined expectations of financial return that are both too high and too short term.

There is therefore a need for greater transparency in reporting the social return as well as the actual financial returns (gross and net) achieved by impact investors. This, in turn, requires more independent research, starting with an understanding of the concrete realities, needs, and challenges of social enterprises. “The Report of the Alternative Commission on Social Investment” (2015) achieved this for the UK market by focusing on what social enterprises want and whether social investment, as currently

conceived, meets the needs expressed, all in an effort to make social investment better.

A similar effort is needed for emerging-market entrepreneurs, so that impact investors develop more realistic projections of financial return. It would be tragic if impact investors were judged to have failed despite having supported tremendous creation of social value, simply because they set overly ambitious financial targets from the outset that did not correspond with enterprise-level realities.

Most promising enterprises do not meet the risk-return criteria of today's impact investors, which gets reported as “lack of pipeline.” We suspect the addressable market would be considerably broader if more realistic standards were applied. To solve this gap, we need to shift from the false binary of grants with no financial-return expectations, on the one hand, and investments seeking net-15-percent-or-greater return, on the other. This requires philanthropists and donors to deploy more long-term funding in the form of program-related investments—which have a primary objective to maximize impact while accepting some associated level of return of capital—to build a robust and diverse new generation of social enterprises. Only in this way will such enterprises meet the risk-return objectives of most impact investors.

We also need more impact investments that are structured in ways that match the needs of enterprises seeking to benefit marginalized communities. One example is for more impact investors to shift to evergreen funds (also known as “permanent capital vehicles”) that are not constrained by the fixed term period of most other funds. This structure better reflects the low and slow growth profile of most social enterprises.

Finally, impact investing needs to return to its original guiding purpose: to achieve social and environmental impact. We call on impact investors to agree to a voluntary code of practice that enshrines how the field should evolve—based on the intention to make decisions in ways that prioritize impact; to appreciate the challenges at the enterprise level; and to measure, verify, and report impact achieved. ■