Seven Key Impact Investment Questions Every Investor Should Ask
Aligning Financial Return and Investment Impact

Written By: Michael Cosack and Jeremy Bach

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While a growing number of investors have expressed interest in impact and ESG investing, many still are unsure how to implement a program of such investments. This paper provides a series of questions designed to help investors navigate the sustainable investment space in the context of their overall investment program.

Due to the frequent confusion regarding the proper use of sustainable investment terms, we feel it is important for our readers to have a solid understanding of these terms, before proceeding to the discussion of the Seven Key Impact Investment Questions contained in this paper.

Sustainable investing is an umbrella term that encapsulates not only ethical investing, socially responsible investing and responsible investing but also various other strategies or approaches that come with their own set of risks and benefits.

While there is no universally accepted definitions or framework yet, today sustainable investing refers to the following range of overarching investment approaches or strategies that may be employed individually or in combination:

- **Values-based Investing –** is a strategy based on the guiding principle of investments that are based on a set of beliefs that contain a view toward achieving a positive societal outcome. Typically, this approach is executed via negative screening, divestiture or divestment.
- **Negative Screening Strategies -** involve the exclusions of companies or certain sectors from portfolios based on specific ethical, religious, social or environmental guidelines. Traditional examples of exclusionary strategies cover the avoidance of any investments in companies that are fully or partially engaged in gambling, sex related activities, the production of alcohol, tobacco, firearms, fossil fuels or even atomic energy. These

exclusionary categories have been extended, in recent years, to incorporate serious labor-related actions or penalties, compulsory or child labor, human rights violations and genocide.

- **Impact Investing –** is still a relatively small but growing slice of the sustainable investing segment. Impact investments are investments directed to companies, organizations, and funds with the intention to achieve measurable social and environmental impacts alongside a financial return. The direct capital in this strategy addresses challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, affordable and accessible basic services, including housing, healthcare, and education.
- **Thematic Investing –** is an investment approach with a focus on a particular idea or unifying concept. Clean energy, clean tech and gender diversity are a few of the leading sustainable investing fund themes. Investing in green bonds or low carbon emitting stocks, bonds and funds also fall into the thematic investing category.
- **ESG Integration -** is the investment strategy by which environmental, social and governance factors and risks are systematically analyzed and, when deemed relevant and material to an entity's long-term performance, influence the buy, hold and sell decision of a security. For these reasons, ESG integration is referred to as a value-based investing approach.
- **Shareholder Advocacy -** leverages the power of stock ownership in publicly listed companies using action-oriented approaches that rely on influencing corporate behavior through direct corporate engagement, filing shareholder proposals and proxy voting.

The following Seven Key Impact Investment Questions present a framework that is applicable for investing in all sustainable investments and can help both professional and nonprofessional investors navigate the sustainable investment decisions.

KEY IMPACT QUESTION 1: What are the areas that you want to make an impact?

This is a much more complex question than it initially appears, as impact investing, like charitable giving, is based on personal values. It is much easier to choose a particular investment strategy than it is to understand what potential social and/or environmental impact an individual investment may have.

To address this issue, several organizations, both for-profit and not-for-profit, have created various ranking and filtering systems that analyze investments and companies based on various environmental, social and governance (ESG) criteria. Each of these organization's approach can be used to create an investment thesis aligned with an investor's values to help the investor identify appropriate investments or exclude investments that do not meet said criteria.

The three sustainable investment ranking and filtering organizations that we focus on, The United Nations Sustainable Development Goals (UN SDGs), The Principles for Responsible Investment

(PRI) and Morgan Stanley Capital International (MSCI) ESG Research, all provide useful metrics to align a portfolio's investments with an investor's values.

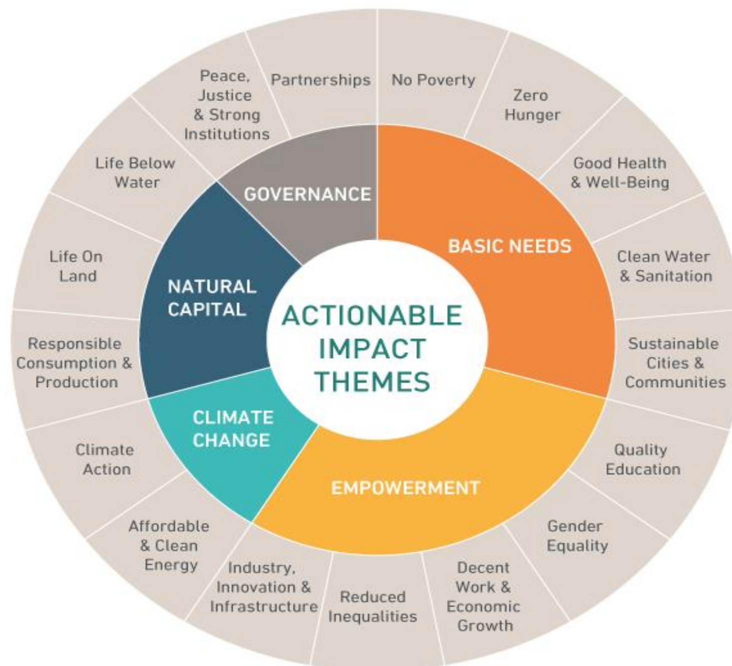
- **The United Nations Sustainable Development Goals (UN SDGs) -** was adopted by the United Nations' member states in 2015, consist of seventeen (17) high-level global goals that many consider the blueprint to achieve a better and more sustainable future for all. Each of these goals, except SDG 17 "Partnerships for the Goals", are actionable through investments.

Source: United Nations Brussels 2019

- **The Principles for Responsible Investment (PRI) -** took the SDGs to the next level, by creating the Impact Investing Market Map, and brought additional clarity to the process of identifying mainstream medium and large impact investing companies (privately-owned or listed equity firms) in the real economy. The PRI used two basic frameworks, the UN Sustainable Development Goals (SDGs) and their own PRI Reporting Framework, to identify ten (10) investment themes so that investors can better assess opportunities. The Market Map provides a common definition of a thematic investment and a list of Key Performance Indicators (KPIs) used by the impact investing community to track and assess the environmental and social performance of a specific theme.

Source: Principles of Responsible Investments 2019

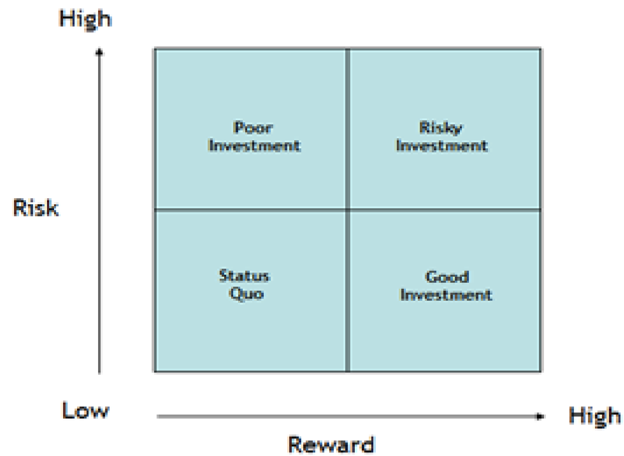
- **Morgan Stanley Capital International (MSCI) ESG Research -** created a framework to allow investors to group the SDGs into five (5) actionable impact themes. While the categorizations shown below are not meant to be all inclusive, they can be used as a framework to identify common social themes when building a sustainable investment portfolio.



Source: MSCI ESG Research

KEY IMPACT QUESTION 2: What is your financial risk tolerance and return goals for a new investment?

Sustainable investing is an investment approach that intentionally seeks to create both financial return and positive social or environmental impact. It is not philanthropy and needs to fill a financial role in a portfolio. The process of assessing the financial risk of an impact investment is no different than for any other investment and should be done separately from the impact evaluation.



Source: "Risks, Returns and Diversification" Abi Tyas Tunggal 15 March 2018

Normal due diligence, risk assessments and portfolio construction techniques should be applied. The principles of Modern Portfolio Theory that state that higher levels of return have higher levels of risk generally applies to impact investments. It is important for investors to understand the financial implications of a particular investment regardless of its impact.

KEY IMPACT QUESTION 3: Should you invest the entire portfolio with a social/environmental purpose or just a portion of it?

The question of how much of a portfolio's total assets to invest in impactful investments is a key question that reverberates through both the financial and impact side of the investment decision. On the financial side of this question, the decision can affect an investor's potential risk, return and available investment options. On the impact side, the decision can affect the number of social and environmental issues that an investor can address, the level of impact achievable and the risks to the investment making the impact.

Impact investors will generally incorporate one of the following three investment strategies when implementing an ESG/Impact investment program:

A. **Strategy I: Portfolio Overlay (Holistic)**
    - This approach invests 100% of the portfolio with an impact investing lens. Portfolio design, construction and reporting is completed by using a multi-dimensional approach that incorporates both the financial and social objectives of the portfolio.

The Nathan Cummings Foundation is an example of an organization using this holistic investment strategy.

B. Strategy II: Balanced Sleeve (Carve-Out)

- This approach carves out a portion of the total portfolio and constructs a balanced impact sleeve with the same principles utilized in Strategy I. The remainder of the investment portfolio is invested in a traditional investment format. An example of an organization using this carve out strategy is The Ford Foundation.

C. Strategy III: Theme Specific Sleeve (Carve-Out)

- This approach is similar to the balanced theme described above, but the sleeve is invested using a specific theme. The theme is generally aligned with the mission and values of the investing organization or party (e.g. Climate Change, Ex-Fossil Fuels, Sustainable Forestry, etc.). The remainder of the total portfolio is invested using a more traditional investment methodology. An example of an organization that has used this carve out strategy is The Russell Family Foundation.

While Strategy I (Portfolio Overlay-holistic) is probably the most effective way for an investor to generate social/environmental impact from their portfolio, investors often have constraints that drive them towards Strategies II (Portfolio Sleeve-carve out) and III (Theme Specific Sleeve-carve out). All three of these investment strategies are being effectively used by investors throughout the world to generate positive financial and socially/environmentally impactful results.

KEY IMPACT QUESTION 4: Is it possible to identify specific investments that meet the desired risk/return parameters and are socially/environmentally impactful in the areas in which you want to make an impact?

While there has been a proliferation of new investment products, finding investments that are both impactful and meet an investor's financial parameters is still a challenge. There are now many service providers who rate and rank investments both on financial risk/return and impact criteria. However, investors' needs and preferences, both on the financial and impact side, are often unique thus making it difficult for an investor to find the appropriate mix.

In dealing with publicly traded securities, there are generally two approaches that investors use to find the right balance between their financial needs and desire to be impactful. The first is to only purchase companies that meet a set of impact criteria. This can be accomplished by either negative screening (avoiding companies that are not "good corporate citizens") or positive selection (choosing companies that exhibit positive behavior). Either way, the result is that companies that behave well get rewarded with capital. The other approach is to invest in companies that are not "good corporate citizens" and engage with management to alter their

behavior. This can be achieved through voting proxies, joining boards and raising corporate resolutions.

Investing in private securities can often allow investors to be more focused on a single issue or social problem. As the companies are often smaller and have more specific missions, investing in private offerings can be an effective way for investors to match their social or environmental goals. However, private securities are generally less liquid and therefore carry greater risk. Finding a comfortable balance is important from both the financial and impact perspective.

KEY IMPACT QUESTION 5: Will the investment's impact be significant?

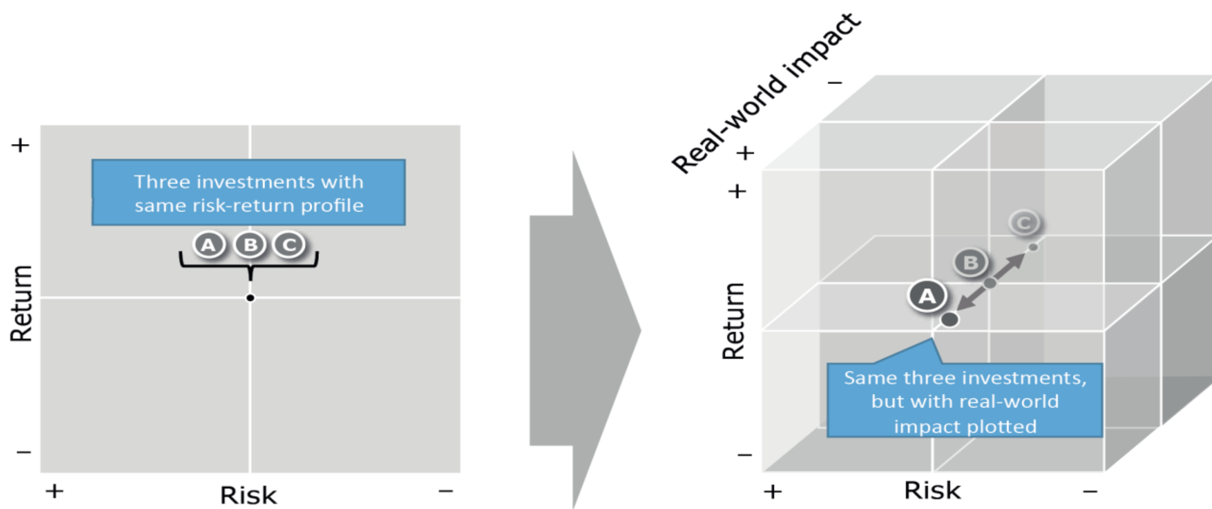
This key question is whether the selected investment will materially help the social or environmental issue as intended. To return to the public company example from the prior question, one could argue that more impact can be created by reforming a company that is a "bad actor" versus the marginal impact gain from providing capital to a company that is doing almost everything right. That said, one would have to ask if an investment in a "bad acting" company would be large enough to truly affect change in the company and if such an investment is, in effect, penalizing the "good corporate citizen". On the private placement side, the question is whether the company's social contribution is going to meaningfully affect an existing social or environmental issue.

In both cases, there is room to have investment dollars move the social/environmental needle, but investors need to be careful about "feel good" investments that will not truly address the problem that they are most concerned about.

KEY IMPACT QUESTION 6: What are the risks to the potential impact?

Impact Risk is the risk that an investment will not provide its targeted social impact. Impact Risk is difficult to quantify because it involves two elements. The first and more obvious is the risk that a particular investment will not reach its stated impact goal. Whether an investment's impact goal is environmental, job creation or diversity, there is always the risk that a particular investment does not have a large enough social/environmental impact to justify the investment. The other Impact Risk is a bit more subtle. It is the risk that an investment will meet its impact goal, but also deliver negative unintended consequences. For example, the microfinance model that is currently being used in impoverished communities throughout the world, has positively affected women, by giving them the ability to start their own small businesses. The investor impact goal of women being able to lift themselves and their families out of poverty and gain financial independence has, in many cases, been achieved. However, through the empowerment of these women business owners, there has also been an unexpected rise in domestic violence in some of the male dominated societies where these loans are provided that has been directly

tied to these microfinance programs.[1] This is, of course, an unintended consequence that when measuring the overall social good of the program, provides a negative contribution.



Source: United Nations Principles for Responsible Investing (UNPRI)

KEY IMPACT QUESTION 7: What is the relationship between the financial return and impact return?

While the traditional framework, which maintains that there is a financial cost to achieve social/environmental impact, may hold true for some investments, it should not be the pervasive assumption when contemplating an impact investment. In fact, in some cases, the financial return of an investment may be directly linked to the amount of impact provided by that investment. For example, an activist investor might invest in a poorly performing company with a less than stellar governance record with the purpose of driving change that will improve its internal controls, diversify the Board's composition thus making the company more attractive to current and future clients and investors. Arguably, the investor's ability to bring about such change will directly affect the financial returns of the company while also providing social good.

The relationship between financial and impact returns may have been further clouded by the recently adopted Statement of Purpose of a Corporation. The Statement was signed by one hundred and eighty-one (181) of our nation's largest corporate CEOs embracing the notion that a corporation has a broad responsibility to society and should consider all stakeholders in making future business decisions. The Statement essentially rejects the assumption that seeking profits for shareholders is a corporation's sole purpose and promotes the idea that corporations will prosper over the long run by broadly serving society. While the effect of the Statement is not yet known, it supports the notion that there is not an inverse relationship between profits and impact.

[1] S. R. Schuler, S. M. HASHEMI and S. H. BADAL, 2010, Men's violence against women in rural Bangladesh: Undermined or exacerbated by microcredit programmes? Development in Practice, 8, 148-157.

Conclusion

The Seven Key Impact Investment Questions presented in this paper allow investors to focus their investments on the social and environmental issues that most align with their values, while putting those investments in the context of their overall financial needs and objectives. It provides a framework for incorporating impact investments into an overall risk/return framework with a particular focus on the sustainable risk side of the equation.

While the questions provided in this paper are just a portion of the analysis required to implement a full sustainable investment program, they do provide guidance on how to approach such investments. For those wishing help diving in further, they should seek the assistance of those service providers and consultants who specialize in helping investors create portfolios based on their combined financial and social goals.

Source: Net Impact blog "What is the Difference between Socially Responsible Investing and Impact Investing?"

About Our Authors

Michael Cosack
Principal
ImpactWise LLC
cosackm@impactwise.us

Michael Cosack is a principal at ImpactWise and brings more than twenty years of business leadership experience, including the qualitative and quantitative analytical skills needed to implement programs and people in a meaningful, measurable and impactful way. Michael has spent most of his professional career advising the trustees on the investment and fiduciary responsibilities regarding their institutional funds. As an entrepreneur, he has built several organizations, including one of the largest independent investment consulting firms in the Greater Philadelphia region. His role at ImpactWise is to help institutional money managers, consultants and trustees explore, create and implement innovative impact investment strategies and solutions.

Jeremy Bach, CFA
Founder
Bach Capital Advisors LLC
jbach@bachcapitaladvisors.com

Jeremy Bach has been working in the Financial Services Field for over 25 years. Mr. Bach founded Bach Capital Advisors, LLC immediately after the financial crisis of 2008. The firm was established to identify and analyze investment managers and the firm provides both diligence services to investors and distribution services to managers. Mr. Bach has gained steady interest in the Impact Investment space and some of his projects have included affordable housing, neighborhood stabilization and agriculture investments. Prior to founding the firm, Mr. Bach's experience includes roles at Miller Anderson & Sherrerd (now Morgan Stanley), Markov Processes International and Financial Software Systems. Mr. Bach is a graduate of Hofstra University and holds the CFA designation and is a CPA. He is a past president of the CFA Society of Philadelphia, treasure of the Veterans' Monument Foundation of Whitemarsh and on the asset management committee of the Triskeles Foundation and Donor Advised Funds.