Singapore Management University
Institutional Knowledge at Singapore Management University

Social Space
Lien Centre for Social Innovation

2012

The Promise of Impact Investing

Yvonne Li

Follow this and additional works at: https://ink.library.smu.edu.sg/lien_research

Part of the Social Welfare Commons

Citation
Li, Yvonne. The Promise of Impact Investing. (2012). *Social Space*. 48-53.
Available at: https://ink.library.smu.edu.sg/lien_research/91

This Magazine Article is brought to you for free and open access by the Lien Centre for Social Innovation at Institutional Knowledge at Singapore Management University. It has been accepted for inclusion in Social Space by an authorized administrator of Institutional Knowledge at Singapore Management University. For more information, please email cherylds@smu.edu.sg.

The Promise of Impact Investing

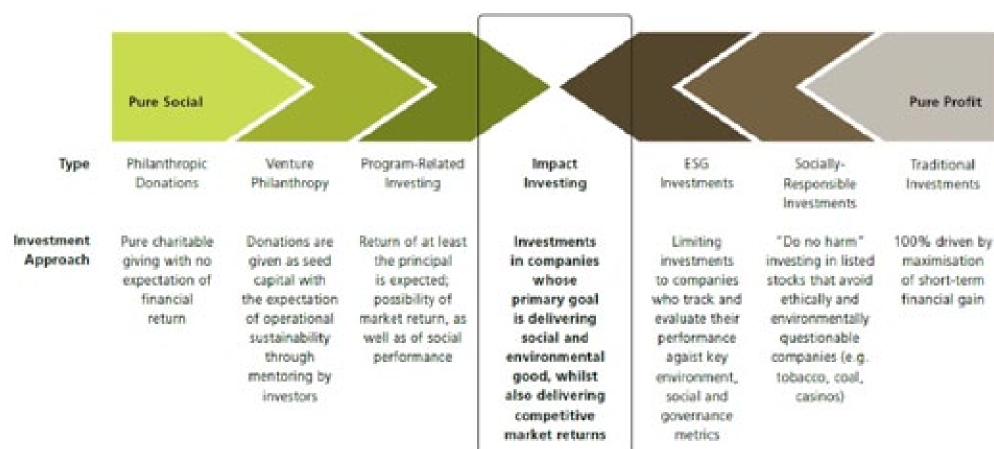
Yvonne Li is the founder and CEO of Avantage Ventures. Avantage bridges the information and funding gaps between social entrepreneurs and investors in Asia. She is a former Hong Kong finance executive who has worked in investment banking, hedge funds, and commercial banking. Her experience includes working at Lehman Brothers' capital markets division in equity structured derivatives and Hong Kong Shanghai Bank Corporation in commercial banking.

Charitable foundations have traditionally provided for the needy and marginalised where governments and markets have failed. In the face of increasing global challenges, **Yvonne Li** argues that, with the right approach—specifically impact investing—these bodies can do more, and for better and longer.

Though still a relatively young asset class, impact investments have caught the attention of philanthropists, socially-minded investors and companies around the world. Unfortunately, it is not getting the commitment and support it needs from charitable foundations.

Defined as investing in companies whose primary goal is delivering social and environmental good whilst also delivering financial return, impact investing is positioned as a tool that mobilises public and private capital towards pressing social and environmental needs (see Chart 1).

Chart 1: Investment Spectrum of Social and Financial Objectives



Source: Avantage Ventures, Beyond the Margin: Redirecting Asia's Capitalism, 2011.

A number of charitable foundations have been pioneering the use of impact investing as a tool to complement their programmes. The Rockefeller Foundation, for instance, is a leader in building impact investment-friendly ecosystems by supporting initiatives like Impact Reporting and Investment Standards and the Global Impact Investing Network.

In 2010, J.P. Morgan highlighted five global sectors that would benefit from impact investing, and projected that the potential market capital demand for critical products and services would reach US$400 billion to US$1 trillion.[1]

Impact Investing Opportunities in Asia

Asia is the most populous and fastest growing region in the world. Over the decades, its economic development has lifted hundreds of millions of people out of poverty and improved the lives of millions more. However, the same economic drive has also created many imbalances such as widening wealth gaps and social inequality, as well as environmental degradation from unfettered industrialisation and continuous urbanisation. These negative after-effects of unbridled economic growth have created immense social and environmental challenges that can no longer be ignored.

Against this background, Avantage Ventures' 2011 report, *Beyond the Margin: Redirecting Asia's Capitalism*[2] asserts that the potential invested capital for impact investing in Asia alone could represent US$44 billion to US$74 billion across the key sectors of affordable housing, water and sanitation, rural energy, rural and elderly healthcare, primary education and agri-business. (see Chart 2).

With strong social missions and the potential to effect positive social change, social enterprises are key to unlocking local economic growth and development. Like many other small and medium enterprises (SMEs) globally, social enterprises

Chart 2: Impact Investing Market Potential of Selected Sectors in Developing Asia

Sector	Market Demand Opportunity (USD billion per annum by 2020)		Expected Profit Margin		Expected Profit (USD billion per annum by 2020)		Invested Capital (USD billion)	
	Lower Limit	Upper Limit	Lower Limit	Upper Limit	Lower Limit	Upper Limit	Lower Limit	Upper Limit
Affordable Housing	11	33	15%	22%	2	7	15	21
Water and Sanitation	6	17	10%	10%	1	2	5	5
Rural Energy	1	4	10%	20%	0	1	1	2
Rural and Elderly Healthcare	16	50	5%	10%	1	5	7	15
Primary Education	17	50	10%	20%	2	10	15	30
Agri-business	1	4	5%	10%	0	0	1	1
Total	52	158			6	25	44	74

Source: Avantage Ventures, Beyond the Margin: Redirecting Asia's Capitalism, 2011.
www.avantageventures.com/publications

face difficulties in accessing funding as they fall into the "Missing Middle"[3] —a critical financing gap for enterprises needing between US$0.5 to US$3 million. These amounts are too large for philanthropic grants and angel investing; they are deemed too risky by local financial institutions; and they are too small for multilateral aid. One way to close this gap is through charitable foundations.

Conventional Approaches of Foundations

Given their risk and return profiles, foundations are uniquely positioned to provide angel financing to social enterprises via impact investments. In 2010, America's 76,000 charitable foundations made US$45.7 billion worth of grants, and held assets totalling US$618.1 billion. Private and tax-exempt, they are often required to allocate 5% of their endowment annually towards charitable purposes, with the balance assigned to income-driven investments. However, foundations tend to act like any other investor, looking solely to maximise financial return while ignoring the bigger impact their investments can achieve through impact investing.

In this respect, because foundations are typically fully engaged as an active investor in the global financial markets and behave like a typical commercial investor, they tend not to be impact efficient. Foundations, however, justify their bipolar behaviour on the grounds that they need to preserve their endowment and livelihoods.

In 2011, only 14% of American foundations employed mission-related investing (MRI)[4] or programme-related investing (PRI)[5] as one of their tools for impact. Both MRI and PRI are designed to further the impact missions of foundations and longevity of their endowments. MRI refers to impact investments generating market rate returns while PRI refers to impact investments generating sub-market rates of return, which is usually made by the grants committees.

Despite a growing interest amongst American foundations in MRI and PRI tools, many still keep a strict segregation between the investment staff who make endowment investment and the programme staff who undertake the impact-driven mission—the raison d'être of the foundation. This segregation does not, in my view, help foundations to better utilise their endowment for the mission they are created to achieve. Indeed, many fall short of assigning higher priority to impact investing and continue to ignore measures like breaking the barrier between the impact and investment departments and marrying mission investment with the foundation's strategic asset management policy, adopting a responsible investing mandate, and allocating a segment of the endowment specifically for MRI.

Humanitarian Imperative to Effectively Use Capital

Our world faces unprecedented humanitarian and environmental challenges, and it requires innovative and sustainable solutions. With the global population projected to reach eight billion by 2025, the issue of how to feed, accommodate, provide medical care, education and work opportunities for this growing population will become increasingly difficult.

Governments, multilaterals, the private sector and foundations need to come together to support the region's socio-economic development and to create a more equitable environment for its citizens.[6]

As an example, the ageing population is one of the most pressing issues. By 2050, the number of people aged 65 or over will have gone up from 7.6% to 16.2% of the world's total population. Standard & Poor's estimates that the cost of care of the nearly one billion elderly will rise from 16.7% of total GDP in 2010 to 27% in 2050 for advanced economies, from 10.9% to 17.1% for emerging economies, and from

Because foundations are typically fully engaged as an active investor in the global financial markets and behave like atypical commercial investor, they tend not to be impact efficient. Foundations, however, justify their bipolar behaviour on the grounds that they need to preserve their endowment and livelihoods.

> Modestly reducing grant-making in the short run and adopting impact investing will significantly boost the foundation's assets over time and magnify its long term financial ability to create further impact.

8.7% to 16.3% for BRIC economies.[7] Assistance from the philanthropic and private sectors are needed as government resources that tackle elderly issues have been channelled elsewhere as a result of the sovereign fiscal crisis of recent years.

Against this background, it is necessary for philanthropic foundations to explore alternative ways to better utilise their available resources. Allocating a higher percentage of endowment for grant-making seems the most straightforward way, as the Bill & Melinda Gates Foundation did—they increased giving from 5% of total asset to 7% in 2009 in anticipation of the surging funding demand caused by the economic crisis.[8] Merely increasing the grant percentage may, however, weaken the financial sustainability of some foundation endowments in the long run. In contrast, impact investing allows foundations to mobilise their assets without compromising their financial soundness. A survey of impact investors conducted by J.P. Morgan and the Global Impact Investing Network found that 60% believed impact investing does not necessarily compromise financial return. All the investors surveyed had earmarked US$3.8 billion for impact investments for the coming year.[9]

With impact investing, foundations can allocate a fraction, say 1% of the 5% allocated from their endowment, for impact investment programmes. By investing in social enterprises or programmes that meet the dual objectives of social and financial returns, this should, all things being equal, ultimately increase the foundation's future total funding.

A recent report funded by the Rockefeller Foundation concluded that institutional investors including foundations will be able to fulfil their fiduciary duty while undertaking social and environmental impact investment since this new asset class is actually earning a competitive level of financial return.[10] Another report[11] by an asset manager found that PRI in general can generate 2% net return (compared to negative 100% return for grants). The same report also found that a foundation can see its total assets grow by 12% after a 20-year period—with the assumption that the foundation allocates 4% of assets for grant-making and assigning the remaining 1% to PRI. The conclusion is that modestly reducing grant-making in the short run and adopting impact investing will significantly boost the foundation's assets over time and magnify its long term financial ability to create further impact.

Foundations' Issues with Impact Investing

Foundations have a number of reservations that inhibit the development and widespread adoption of impact investing. Top of that list are whether it genuinely creates impact and the possibility of mission drift.

For a foundation focused on poverty alleviation, the most direct way to create impact is to support organisations that hand out critical goods and materials such as food and other necessities to the poor. However, opponents to donor-development aid argue that the prolonged aid creates a never-ending cycle of poverty as it creates a culture of dependency.[12] Socio-economic development through investing in social enterprises, they argue, is a preferable approach because it spurs local economic development, generates revenue, provides employment and empowers its citizens to stand on their own feet while reducing reliance on donor funding.

Impact investing requires a unique blend of skills as each investment needs to be critically analysed for financial viability, where the skills of the investment manager of the endowment will be needed, while also measuring and monitoring the social and environmental impact of that

> An influential driving force for social progress and neutralising social imbalances, foundations must be encouraged to invest for impact.

particular enterprise. Few investment managers are aware of impact metrics, though they may have a basic knowledge of the work of the foundation's programme managers. Both teams therefore need to work very closely together and ensure that their interests are aligned before successful impact investments can be made. As not all ventures are suitable for impact investing, key conversations must be had to determine the foundation's focus and values, and how impact investing may better serve the population than the philanthropic and commercial sector.

Foundations may also be concerned about the risks of making direct investments in social enterprises. While such investments do have risks, they can be mitigated by due diligence and working with trusted, local partners, in the same way that foundations may work with local partners in monitoring programmes in remote places.

Similarly, the concern about mission drift can be mitigated by getting to know and understand the motivation of the entrepreneur leading the social enterprises and establishing and building a relationship with the organisation. A number of tools and frameworks have been developed by the industry such as IRIS[13], which measures the impact created by social enterprises and assists impact investors in assessing the impact potential of any specific investment project, as well as certification as B Corporations[14], or Community Interest Companies[15], or by GIIRS[16]. A growing number of professional intermediaries match impact investors with sound social enterprises looking for capital to create more impact together. With better market infrastructure, foundations, just like any other impact investors, will be empowered to make informed investment decisions that benefit the local community being served by the social enterprise.

Engaging Foundations for Impact

An influential driving force for social progress and neutralising social imbalances, foundations must be encouraged to invest for impact. For starters, they should allocate a fraction of their grants as well as an allocation of their endowment for this goal. Their grants should support early-stage social enterprises that are aligned with the principles and values of the foundation. Unlike other private investors with shorter investment horizons, philanthropic foundations are in a position to act like an angel investor, supporting high-potential social enterprises still in the start-up stage. Endowments should have a responsible investing mandate with a portion channelled into MRIs in the form of impact funds or into high-potential social businesses that have a proven and scalable business model.

If philanthropic foundations provide earlier stage capital and incubation support as a matter of course, the whole ecosystem of impact investing will become more vibrant, and attract awareness and further capital from commercial investors. These investments towards truly sustainable solutions to the greatest challenges of our times are critical as the current imbalance of philanthropy and social finance is massively outweighed by commercial dollars which are agnostic as to their impact and effect.

[1] Nick O'Donohoe et al., *Impact Investments: An emerging asset class* (JP Morgan Chase, the Rockefeller Foundation and Global Impact Investing Network, 2010). The report only focuses on sub-sectors including affordable urban housing, clean water for rural communities, maternal health, primary education and microfinance.

[2] This report focuses exclusively on Developing Asia and draws data from what is currently available on the market and the amount of investment required to bring service and product levels to basic levels (for example, based on targets set by the Millennium Development Goals) for the mass consumer. We follow the International Monetary Fund's 2009 definition of "Developing Asia" adopted in its World Economic Outlook analysis, comprising: Afghanistan, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, India, Indonesia, Kiribati, Laos, Malaysia, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Timor-Leste, Tonga, Vanuatu and Vietnam.

[3] "Missing Middle" was coined by the South African Chamber of Commerce in America. It was part of the Missing Middle Initiative, which was launched at the January 2010 World Economic Forum in Davos as part of the Young Global Leader's Global Redesign Initiative.

[4] MRI are market-rate financial investments that create not only financial returns but also social/environmental returns furthering the foundation's mission.

[5] PRI are sub-market-rate investments that are closely aligned with the foundation's mission and are often counted as part of the foundation's grant-making commitment.

[6] Department of Economics and Social Affairs, United Nations, *World Population Prospect, the 2010 Revision* (New York: United Nations, 2011), http://esa.un.org/wpp/Other-Information/faq.htm.

[7] *Global Aging 2010: An Irreversible Truth* (Standard & Poor's, 2010).

[8] Stephen Storm, "Gates Group Plans to Give More in 2009 despite Losses," New York Times, 27 January, 2009.

[9] Yasemin Saltuk, et al., *Insight into the Impact Investment Market* (J.P. Morgan and Global Impact Investing Network, 2011), www.thegiin.org/cgi-bin/iowa/download?row=334&field=gated_download_1.

[10] David Wood et al., *Impact at Scale: Policy Innovation for Institutional Investment with Social and Environmental Benefit* (Insight at Pacific Community Ventures, and the Initiative for Responsible Investment at Harvard University, 2012), www.pacificcommunityventures.org/insight/impactinvesting/.

[11] Trillium Asset Management, *Mission-Related Investing for Foundations and Non-Profit Organizations: Practical tools for mission/ investment integration* (Trillium Asset Management, 2007), www.nafoa.org/pdf/Mission-Related-Investing.pdf.

[12] Dambisa Moyo, *Dead Aid: Why aid is not working and how there is a better way for Africa* (New York: Farrar, Straus and Giroux, 2009).

[13] Impact Reporting and Investment Standards, www.iris.thegiin.org/about-iris.

[14] B Corp, www.bcorporation.net/.

[15] "Community Interest Companies," Department for Business Innovation & Skills, www.bis.gov.uk/policies/business-law/community-interest-companies.

[16] GIIRS, www.giirs.org/.