REBEL WITH A CAUSE

The Case for Impact Investing

By Randy Kaufman, JD

If you believe, as I do, that impact investing (investing for a social good as well as a financial return) makes sense, you already have started to embrace how a responsible and impactful approach is changing the way we invest without detracting from financial returns. For those of you who believe impact investing is a detraction (and even a distraction), and for those of you on the fence, I would like to share my perspective.

I believe that with their intense desire to make the world a better place, coupled with the largest intergenerational transfer of wealth the world has ever seen, millennials will be the group that solidifies the cultural shift toward impact investing.

Like many labels, this one can be polarizing. For almost a decade, people have argued about terminology. Is socially responsible investing (SRI) impact investing? Is environmental, social, and governance investing (ESG) impact investing? Is impact investing restricted to investing in private deals? Is it impact investing if the positive social or environmental impact is a by-product of the investments only? How much positive impact does a fund or manager need to show to be considered impact investing?

In this discussion, we will use the following definition from the Global Impact Investing Network (GIIN):

> *Impact investments are investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances.*
>
> *The growing impact investment market provides capital to support solutions to the world's most pressing challenges in sectors such as sustainable agriculture, affordable housing, affordable and accessible healthcare, clean technology, and financial services.*[1]

Impact investing, including SRI, ESG, mission-related, and purposeful investing, is not an asset class and is not limited to private deals. Impact investments are more prevalent in long-only equity and private equity, but they can be found across all asset classes. It is my position that:

1. Impact investing can no longer be ignored.
2. Many impact investing strategies achieve financial returns that are as good as traditional investments in the same asset class.
3. Choosing to invest your portfolio without a view to its impact (i.e., without reflecting the value system present in your grant-making) is a wasted opportunity.

THE FORCE IS WITH YOU

Impact investing has been around for hundreds of years, but it is finally approaching mainstream status. According to The Forum for Sustainable and Responsible Investment (US SIF), the total U.S.-domiciled assets using SRI strategies hit $8.78 trillion in 2016.[2] That is up a whopping 135 percent from the $3.74 trillion allocated to SRI strategies in 2012. Since 1995, when SIF first started tracking these trends, the SRI universe has grown ten-fold.

A 2016 survey of high-net-worth individuals by RBC Wealth Management and Capgemini found that 55 percent of U.S. respondents said they will increase their social impact investments over the next two years.[3] Studies have shown that particularly among highly affluent women, "helping others" and "environmental responsibility" are paramount in their investment decisions.[4]

According to Net Impact, 67 percent of millennials also believe that their investment decisions are a way to express their social, political, or environmental values.[5] This demographic is set to inherit $30 trillion over the next 30 years, making millennials the future of investing, impact or otherwise. I believe that with their intense desire to make the world a better place, coupled with the largest intergenerational transfer of

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wealth the world has ever seen, millennials will be the group that solidifies the cultural shift toward impact investing. But I digress.

As the demand has grown, so has the supply: The number of impact investment funds tracked by Cambridge Associates has tripled since 2008.[6] In addition, public efforts are underway to develop ways to measure impact, such as the formation of the Sustainability Accounting Standards Board, which determines materiality thresholds for ESG factors to qualify as an impact investment. Impact investing is becoming more common with institutional investors as well. For instance, the California Public Employees' Retirement System recently issued a statement saying it would evaluate all managers using ESG criteria.

Impact investors generally are motivated by the ability to leverage their asset ownership to influence behavior of enterprises, help catalyze solutions to key challenges, and align their investments with their values. In Europe, which has twice as many assets in sustainable investments than the United States, institutional investors have cited sustainable investing as part of their fiduciary responsibility.[7]

The proliferation of this practice bodes well for our respective futures. Hopefully, as a result of the dollars moving into the space, workplace best practices, environmental consciousness, and social causes will play a much larger role within the investment community and likely will benefit from the influx of funding.

MYTH BUSTERS: DEBUNKING THE ARGUMENT OF SUBPAR RETURNS

As professionals in this industry, one of our jobs is to find the best managers for our clients and to customize their portfolios based on their personal objectives. The number of managers that integrate impact themes that align with clients' social objectives is increasing. In the past few years, major institutional investment managers have entered this field, including BlackRock, Bain, Zurich, and AXA Group. Admittedly our due diligence team will say that finding top-quality managers is challenging to begin with, and identifying top-quality impact managers is even more complex. But the flood of talent entering the impact space puts the goal of doing well and doing good in closer reach.

Table 1

PERIODIC RETURNS OF S&P 500 TOTAL RETURN INDEX VS. S&P 500 ENVIRONMENTAL & SOCIALLY RESPONSIBLE INDEX

	1 year	3 year	5 year
S&P 500 Total Return Index	23.60%	10.74%	15.15%
S&P 500 Environmental & Socially Responsible Total Return Index	25.27%	11.14%	15.34%

Source: Bloomberg, as of October 31, 2017

As with any investment strategy, excellent performance is neither easy to find nor guaranteed. Not surprisingly, research results vary widely. But some research suggests that positive screening does not harm returns and actually can bolster them. The S&P 500 Environmental & Socially Responsible Total Return Index, for example, has outpaced the S&P 500 by 0.3 percent nearly since its inception in 2010 (see table 1).

TIAA-CREF compared five U.S. equity SRI indexes with performance histories of more than 10 years with the Russell 3000 and S&P 500 indexes. It concluded that in spite of short-term performance variability, over the long term there was "no statistical difference in returns compared to broad market benchmarks, suggesting the absence of any systematic performance penalty."[8] It is possible that allocation to impact will continue to trend now that more products with longer performance track records provide evidence that socially responsible funds and indexes can perform in line with, and sometimes beat, broad market benchmarks.

Some believe that the promising performance of impact-style investing may be due to the fact that impact data enhances positive screening of companies to find those with less risk and greater shareholder value. It makes sense that a well-managed company that considers environmental risks or embraces diversity could have a stronger bottom line in the long term than one that ignores those issues.

A recent study by Breckinridge Capital Advisors found that ESG integration enhances its efforts to mitigate and appropriately price risk and can help achieve goals of preserving capital, building sustainable sources of income, and seeking to opportunistically improve total return: "The advantages of ESG analysis also include its low positive correlation with credit agency ratings and alignment with the growing importance of ESG management and sustainability in corporate strategy."[9]

Regardless of which set of evidence you believe, SRI investing, like any customized investment program, carries a set of risks and rewards. SRI investing is not all about financial return and so should not be treated as such. Investors gain a positive intangible benefit by supporting causes that are important to them. It is important to remember this benefit when assessing the performance of SRI investments. Nonetheless, we strongly believe that both active and passive impact strategies of institutional quality are available that target market rates of return.

COGNITIVE DISSONANCE WITH GRANT-MAKING?

As a student of behavioral finance, I have identified a number of behaviors over the years (including an embarrassing number of my own), that make no

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sense in a modern world. But I have seen no behavior more irrational than people who willingly grant money away, accepting a guaranteed negative 100-percent (pre-tax) return, but who refuse to make impact investments because they are afraid of achieving below-market returns.

If a goal is important to you, then the left hand and the right hand (and the heart, too) should be aligned to make that goal a reality. A classic example is the foundation set up to foster a cleaner environment. Foundations are required to grant 5 percent of their assets a year. The remaining 95 percent stays invested in order to enable the foundation to operate and continue to make grants well into the future, often in perpetuity. It's ironic, even irrational, to be granting 5 percent to create a better environment while investing the foundation corpus (the 95 percent) in companies that actively pollute. It would be more prudent, more effective, and more in line with the organization's mission to invest in companies that might help solve environmental problems and create a market-based return, e.g., renewable infrastructure, clean transportation, smart energy management, energy efficiency in buildings, etc.

The Rockefeller Brothers Fund (RBF) is a prime example of a foundation that has granted large sums of money to environmental causes and embraced impact investing for the remaining 95 percent of assets, despite the fact that it was started using the funds of John D. Rockefeller's Standard Oil. In 2014, RBF agreed to four guiding principles for its investments, which include divesting from fossil fuels, investing with an ESG lens, engaging in active ownership, and investing for "significant, measurable impact."[10]

Lastly, it is important for advisors to remember that traditional advising styles may have to adapt as millennials come into their wealth and bring their financial aspirations to the table. Advisors who are slow to adopt impact investing do so at their own risk. This cultural shift is reminiscent of the Internet revolution, a connection that is well explained by Rod Schwartz, the chief executive officer of ClearlySo:

> *The 'Internet Sector' in the late 1990's … was viewed by many as a niche sector disconnected from traditional industries. This technology has become utterly integral to every corner of every sector, fast-tracked human development and changed the way we communicate, live, problem solve and conduct business. Impact is similarly becoming an integral consideration to every facet of our personal and professional lives.*[11]

So let's take the lessons learned from the Internet revolution and use them so as to not be left behind in the impact revolution.

FINAL THOUGHTS

If you care about social good or the environment, or are acting on behalf of clients who do, consider this question: If you care about certain causes, why not have your investment portfolio working toward that goal?

If you are concerned that such a move would jeopardize investment returns, do your own due diligence, perhaps starting by examining some of the research mentioned here, to determine whether your concern is supported by the facts or is really just a feeling or reaction.

This journey is not always easy, but it is a wonderful view from the top. You and your clients might be delighted to experience a kind of nirvana—growing wealth while helping to make the world a better place.

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ENDNOTES

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