A Market Emerges:
The Six Dynamics of Impact Investing

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PCV InSight (www.pacificcommunityventures.org/insight/) is the thought leadership and advisory practice at Pacific Community Ventures, a U.S. Community Development Financial Institution and nonprofit organization. PCV InSight provides research on community finance and impact investing to clients including The Rockefeller Foundation, The Annie E. Casey Foundation, and Omidyar Network, and is a founder and co-convener, along with the Initiative for Responsible Investment at Harvard University, of the Impact Investing Policy Collaborative (www.iipcollaborative.org). InSight also evaluates the social and economic performance of over $19 billion invested in California by the $235 billion California Public Employees Retirement System.

CASE at Duke University’s Fuqua School of Business

The Center for the Advancement of Social Entrepreneurship (CASE, www.caseatduke.org) at Duke University’s Fuqua School of Business promotes the entrepreneurial pursuit of social impact through the thoughtful adaptation of business expertise. The CASE Initiative on Impact Investing (CASE i3) is focused on establishing a rich set of resources and activities for students, entrepreneurs, investors, funders and academics to explore and support the development of the field of impact investing. CASE i3 serves as the global research coordinator for B Lab and the Global Impact Investing Rating System and also develops strategy and knowledge for funds, financial institutions, foundations and investor networks, including the Rockefeller Foundation, Credit Suisse, Investors’ Circle and Toniic.

ImpactAssets

ImpactAssets (www.impactassets.org) is a nonprofit financial services group offering investors access to information and knowledge regarding the Impact Opportunity as well as participation in impact investment vehicles. IA manages one of the nation’s leading Donor Advised Funds, allowing philanthropists at all levels access to impact investments supporting community development finance, affordable housing and other areas of interest to investors. The IA-50 provides individuals new to the field a general overview of leading impact investment firms across various thematic areas. In 2011, IA first introduced Impact Investing Issue Briefs which explore various questions of interest to high net worth individuals and their advisors.
## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXECUTIVE SUMMARY</td>
<td>04</td>
</tr>
<tr>
<td>1. ABOUT THE RESEARCH</td>
<td>06</td>
</tr>
<tr>
<td>2. INTRODUCTION</td>
<td>08</td>
</tr>
<tr>
<td>3. THE SIX DYNAMICS</td>
<td>11</td>
</tr>
<tr>
<td>Dynamic One</td>
<td>12</td>
</tr>
<tr>
<td>Dynamic Two</td>
<td>16</td>
</tr>
<tr>
<td>Dynamic Three</td>
<td>20</td>
</tr>
<tr>
<td>Dynamic Four</td>
<td>24</td>
</tr>
<tr>
<td>Dynamic Five</td>
<td>27</td>
</tr>
<tr>
<td>Dynamic Six</td>
<td>32</td>
</tr>
<tr>
<td>4. CONCLUSION</td>
<td>36</td>
</tr>
<tr>
<td>APPENDIX ONE: BEST PRACTICE QUESTIONS</td>
<td>37</td>
</tr>
<tr>
<td>APPENDIX TWO: ORGANIZATIONS INTERVIEWED</td>
<td>39</td>
</tr>
</tbody>
</table>
EXECUTIVE SUMMARY

Impact investing is taking shape as a distinct activity, with its own unique stakeholder relationships and operational strategies. As dozens of new funds are created explicitly to tackle the world’s most intractable social and environmental problems, including over 60 globally in 2011, the diverse practices of impact investing are coming into sharper focus.

We have defined evolving tensions in the field of practice as Six Dynamics, each of which describes a unique set of relationships, challenges and questions. Further investigation of the Six Dynamics will underpin a deeper understanding of the best practices required to deliver blended financial and social returns successfully, particularly for funds and their managers.

The Six Dynamics build off a simple ecosystem model of impact investing. Funds link the providers of capital (investors) to the recipients of capital (investees). Platform and financial innovation enable investors and funds to provide and deploy capital more efficiently.

Investors in funds – typically known as Limited Partners (LPs) in the private markets in which most impact investors operate – are playing an especially and increasingly active role in impact investing. This role as an Active Investor distinguishes impact investing from conventional investing, where a clearly articulated financial return, and a known strategy for achieving it, is typically presented to LPs as a fait accompli.

Impact investing and the funds created to deploy capital for impact are often seen by LPs as a means for achieving a more nuanced, blended return objective, rather than an end in itself. This has significant ramifications for fund performance, which can be influenced as much by the work and role of LPs as by the decisions of the management team that ultimately vet and make investments.

In the nascent, shifting market of impact investing, there is a consistent gap between reality on the ground and the best-laid plans. The manner in which funds respond creatively and resiliently to uncertainty is core to their DNA.

The role of the impact investing fund manager is complex. Like a mainstream investor, she must find ways to define market offerings that can attract capital, invest it, and harvest financial returns in a reasonable timeframe. Like a foundation officer, he must understand the drivers of change within the ecosystems in which he chooses to work and nurture the relationships that allow the desired impacts to flourish, creating new supply chains and institutions to get the work done.
Impact investing is the use of capital in pursuit not only of financial returns, but social and environmental impact. By definition, the traditional approach to capital structure and finance is simply a jumping off point for capturing the full value potential of capital investing.

On the one hand, impact investment funds are experimenting with new financial tools, structures and enhanced instruments for capitalizing impact. On the other, these same funds are taking traditional approaches to venture and private equity investing and executing “work arounds” in order to overcome the limitations of these established approaches.

The growth in the universe of funds available to impact investors has been paralleled, and in some cases driven by, growth in the number of distribution platforms making these opportunities more readily accessible.

Intermediaries are exploring how best to “mix and match” individual impact investments with a growing range of investor types and risk profiles – all with significant implications for the manner in which funds are created, capitalized, and deployed.

Conventional track records of performance are hard to come by in impact investing. In their absence, the definition of success in impact investing remains enigmatic, and ultimately challenging for the growth of the impact investing market.

Some norms have been emerging around how fund managers can communicate their achievements. However with a large portion of the marketplace dependent on equity-style returns, and still waiting for cash to come back from deals, there is a great deal of uncertainty about the best way to track and report financial and social returns.

Mission-driven objectives and priorities are imbedded in every decision asset owners make to invest in funds, fund managers make when they choose one deal over another, and investees make when readying for capital. At the most elementary level, the structure of a fund reflects a coordinated effort to put these shared or complementary purposes to work.

Reconciling or, better still, leveraging the disparate priorities of capital providers is an essential element in impact investing. The drivers of alignment include transparency, whereby institutions more intentionally determine and describe their purposes, and segmentation, which provides a foundation for quickly identifying key actors and developing effective partnerships.

These Six Dynamics are neither exhaustive nor conclusive. However they do show the way toward greater clarity in a market subject to relatively uncoordinated growth and ambiguous investor preferences. The Impact Investor project will use the Six Dynamics as the foundation for detailed interviews with leading funds in coming months, with the objective of isolating and disseminating best practices in impact investing.

Impact investing can be extraordinarily difficult, with funds swimming upstream against the current of conventional financial tools, wisdom and infrastructure. The Six Dynamics continue the effort to provide guidance to those making the journey, and a ballast of consolidated ideas and experiences.
I. ABOUT THE RESEARCH

The Impact Investor, a research collaboration between InSight at Pacific Community Ventures, CASE i3 at Duke University, and ImpactAssets, was launched at the Skoll World Forum on Social Entrepreneurship in March of 2012. It follows and benefits from a body of recent work describing and advancing the field of impact investing, defined in the broadest terms as investments made with the intent to create measurable social or environmental benefit in addition to financial return.

By focusing on funds as a unit of analysis, The Impact Investor research project explores the sets of individual skills and experiences, intermediary practices and structures, investment strategies, deal terms and disciplines correlated with success across the broad diversity of impact investors. It aims to clarify universal guideposts, choices, and decision tress built around practices common to the highest performing impact investors, while also aggregating lessons from failure.

Interim Report Objectives
The Six Dynamics of Impact Investing is the second in a series of Project-related publications. Our first report, The Need for Evidence and Engagement, highlighted key Project questions and market challenges.1 The objective of this report is to contribute and continue conversations advancing the field of impact investing.1

While our work is in progress and it is too early for best practices, we have designed this interim report to share findings pertaining to the market landscape and provide deeper analysis into the sector’s remarkable recent growth. Our present report highlights six key research themes that appear to disproportionately impact the development of impact investing funds surfaced from over 35 early conversations with leading impact practitioners (listed in the Appendices), and frames these recurring “Dynamics” by presenting a picture of the ecosystem influencing funds.

Project Update
Since its launch at the Skoll World Forum, The Impact Investor project has taken a systematic approach to mapping potential impact investment funds to study. The process has cast a wide international net to identify over 380 funds managed by 240 different intermediaries, including through dozens of practitioner interviews, particularly with limited partners, in Europe, Africa, South America, North America, Australia, and Asia.

1 Available at www.pacifccommunityventures.org/insight/reports/The_Impact_Investor_201203.pdf
Next steps include a range of activities connected to the SOCAP12 conference in San Francisco and focused case study interviewing and data collection with a group of successful, representative funds, with a view to surfacing the field’s first evidence-based set of best practices.

As a collaborative project, we firmly believe this is an ongoing discussion. We welcome insights from all impact investing stakeholders.

Project Scope and Limitations
While funds do not have a monopoly on knowledge by any means, they provide an excellent locus for the purposes of this research, with their on-the-ground experience of interacting with hundreds of companies and their ultimate responsibility for delivering the blended financial and social performance upon which the case for impact investing rests. Indeed, when funds succeed, many important results follow that can positively impact the development of the field: limited partners increase their investments over time, replicable financial structures emerge for new pools of fund capital, entrepreneurs have clear guideposts of what to expect of investment, and secondary markets will more naturally emerge.

Definition of Impact Investing Funds
This interim report focuses on the ecosystem surrounding funds, defined as the intermediaries channeling capital directly to impact investing opportunities. Our research focuses on for-profit or non-profit, privately-owned funds investing in operating enterprises or development projects and not fund-of-funds. Impact investing funds should have a demonstrated core objective to create measurable social or environmental impact in addition to financial return, whether as a primary or ancillary benefit. Intent for impact and intent to measure are key attributes.

In seeking out existing funds, we benefited greatly from excellent existing resources such as Global Impact Investing Network’s ImpactBase, ImpactAssets 50, and the current GIIRS Pioneer Funds. In addition, we were able to examine Development Finance Institution awardees and various international investing associations and networks. Rounding out the list of funds were recommendations from impact investors. With thousands of community finance organizations internationally, including over 1,000 Community Development Finance Institutions (CDFIs) in the United States alone, and over 100 microfinance investment intermediaries globally, priority of focus was given to those firms within these categories that were most recommended by investors.
2. INTRODUCTION

The global impact investing market is taking shape as we speak. It has passed initial proof of concept, and is well into early adoption, making headway towards the mainstream. Time will reveal the successes and failures as we look back on the flurry of activity in the past few years.

Helping drive this train, roughly 60 new impact focused funds were created in 2011. This immense class, up from 44 in 2010 and 20 in 2009, enters a difficult fundraising environment with confidence and optimism. Most funds are targeting over $50 million in capital, with others seeking well over $100 million. As market makers, these funds will help write the fate of impact investing as they connect the supply of capital to the demand of social and environmental entrepreneurs.

CHART 1: New Funds Per Year
Overall, our research cast a wide net resulting in a cumulative list of 380 international funds and 240 different firms with impact investing experience. While the sample is not exhaustive, it aligns well with overall trends and is illustrative of the breadth of the field. The above diagrams show the industry growth over time, highlighting the 346 funds whose start dates could be confirmed. The total volume of capital managed by these funds exceeds $40 billion.

Geographically the funds span the globe. Roughly 30 percent of the sample included North America in their focus, followed by Africa (23 percent), Asia (18 percent), Latin America (17 percent), Europe (13 percent) and, lastly, global funds (12 percent).

Size of assets under management can vary dramatically. While the majority of funds have been below $50 million, there are firms managing several funds totaling well over a billion dollars.

When segmenting the market by impact focus, the predominate impact themes tend to be financial inclusion or small-and-medium enterprise investing. Comparatively, a smaller number of firms focus on investment opportunities in areas such as education, water and sanitation.

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2 The list was compiled with the benefit of resources including GIIN’s ImpactBase, ImpactAssets 50, GIIRS Pioneer Funds, qualified Development Finance Institution awardees, international investing associations and networks, and impact investor recommendations.
3 This cumulative number would not account for a fund closing over the time period.
4 Funds target multiple geographies.
THE ECOSYSTEM OF FUND GROWTH

This report builds on a simple ecosystem model of fund growth that explores the critical relationships among **three primary stakeholders, two related and conjoined areas of activity** influencing the efforts of funds, and an **ultimate success indicator**.

**THREE STAKEHOLDERS:**

- **Funds** are the focus of our analysis. Funds are the intermediaries that receive capital from those that own it and distribute that capital to the social enterprises and other impact investing recipients that require it.

- **Investors** provide capital to funds, whatever their blended financial and social motivations. These investors include individuals, development institutions, philanthropic foundations, governments, banks and other deposit takers, institutional fiduciaries, and other wealth and investment advisors.

- **Investees** are the recipients of capital from funds. They include social-purpose and other small businesses, enterprising non-profits, and housing and other development or infrastructure projects.

**TWO INFLUENCES:**

- **Platform innovation** is the tool that, from the perspective of funds, enables investors to effectively and efficiently provide them with capital.

- **Financial innovation** is the tool that, from the perspective of funds, enables them to effectively and efficiently provide capital to investees – although the benefits and influence of financial innovation clearly extend to investors also.

Last, we add our **ULTIMATE SUCCESS INDICATOR**.

- **Fund performance and growth** is the essential outcome to which all effort is directed in this ecosystem, leading to the realization of financial and social returns.
3. THE SIX DYNAMICS

The Six Dynamics are critical trends, research themes and questions at the core of developing and defining impact investing practice. They highlight key relationships and challenges present in the ecosystem of fund growth.

**DYNAMIC ONE: THE ACTIVE INVESTOR**
Exploring the integral role of investors in fund creation and development and the closeness of the relationship between limited partners and fund managers in impact investing.

**DYNAMIC TWO: THE PIONEERING FUND**
Highlighting the resilience and creativity that characterizes fund deal-making and investing. The manner in which funds respond to uncertainty is core to the DNA of impact investing.

**DYNAMIC THREE: FINANCIAL INGENUITY**
New financial tools, and the innovative use of existing mechanisms, is providing funds with the opportunity to deploy more capital to a greater variety of investee.

**DYNAMIC FOUR: PLATFORM INFLUENCE**
The emergence of impact investing distribution infrastructure is influencing the creation and structure of funds in its own right.

**DYNAMIC FIVE: THE PERFORMANCE PROBLEM**
Demonstrated success is essential for the growth of funds. But conventional track records are hard to come by. What are other indicators of performance, and what does success even look like?

**DYNAMIC SIX: ALIGNING PURPOSES**
Bringing all three stakeholders together – and doing so successfully and sustainability – is largely a challenge of aligning the very different and complex objectives and priorities that LPs, GPs, and investees bring to the table.

The Six Dynamics are intended to push the field’s thinking and to synthesize practitioner experiences. The Six Dynamics are questions, not solutions, findings or best practices. Nor are they intended to be exhaustive or conclusive.

The Six Dynamics are presented in the sections that follow as areas for further inquiry, including through “best practice questions” focused on the way funds are addressing related challenges. By building on the Six Dynamics as the project progresses, we expect to more readily surface the actions and strategies that distinguish funds and intermediaries that have excelled at impact investing.
**DYNAMIC ONE: THE ACTIVE INVESTOR**

*The Emerging Relationship between Limited Partners and Fund Managers*

Investors in funds – typically known as Limited Partners (LPs) in the private markets in which most impact investors operate – are playing an especially and increasingly active role in impact investing.

This distinguishes impact investing from conventional investing, where a clearly articulated financial return, and a known strategy for achieving it, is typically presented to LPs as a fait accompli.

When impact investing is perceived by LPs as a tool for achieving a more nuanced return objective – combining elements of financial and social/environmental performance – it is usually the case that the articulation of this objective precedes any investment, let alone the creation of a fund in which LPs are playing an especially active role.

In other words, impact investing and the funds created to deploy capital are often seen by LPs as a means to an end, rather than an end in itself.

This has significant ramifications for fund performance, which can be influenced as much by the work and role of LPs as by the decisions of the management team that ultimately vet and make investments. And the collaboration between the two entities, and the nature of this relationship, provides a unique insight into a fund’s DNA.

**Structuring Investments**

There are numerous examples of LPs playing a central role in the creation of impact investing funds before delegating management to a General Partner.

The Baltimore Fund is prototypical, a $15 million double bottom line equity fund with the objective of creating employment opportunities for low-income workers in and around Baltimore, USA. The Baltimore Fund was first conceived of by the Open Society Institute (OSI) in 2000. Only after partnering with The Annie E. Casey Foundation as a co-lead investor, attracting ten other institutional LPs, and raising over $1.5 million in grant funding for a new workforce development agency, did OSI seek a sub-advisor for the Fund.

There are also examples of impact investment funds created out of that most formal of solicitation processes – the public sector RFP, with governments clearly identifying a broad set of public objectives to be achieved by sub-advisors, albeit with some discretion.

In Australia, the Federal Department of Education, Employment, and Workplace Relations (DEEWR) provided $20 million in grant funding to create the Social Enterprise Development and Investment Fund and selected three fund managers from the more than two dozen that responded to an RFP. The fund managers were required to match the Government’s funding on a 1:1 basis and have attracted additional capital from a range of private and institutional investors including a bank and pension fund.
LP influence extends much further in impact investing, including to the investment policies and practices utilized to accomplish a very explicit set of financial and non-financial objectives.

In the US, the Overseas Private Investment Corporation (OPIC) provided $285 million in funding to six funds with the goal of catalyzing a total of $875 million for impact investing in emerging markets. Eighty-eight groups responded to OPIC’s RFP, including 63 funds, 18 debt and microfinance vehicles, and seven funds-of-funds.

To be sure, the RFP is a common practice, even in mainstream markets. Large institutions like pension funds often conceive of a high-level strategy to be executed by third-party sub-advisors. However, in most cases that strategy focuses on investment style or stage, leaving funds with whatever discretion they require to maximize financial returns.

LP influence extends much further in impact investing, including to the investment policies and practices utilized to accomplish a very explicit set of financial and non-financial objectives.

This creates added complexities. LPs report that they are almost never provided with a fully completed and functioning fund structure in which to invest. Rather, they are called upon to support the management team from the beginning to create a viable fund.

There is also the question of the significant costs associated with establishing a fund; costs that are often borne by LPs, most notably out of foundation grant budgets. And because some funds are designed specifically to qualify for grants or “Program-Related Investments” — very particular and restricted kinds of capital — the role of legal advisors is more pronounced. The willingness of some LPs to shoulder these costs is clearly a distinguishing feature of impact investing. As Brinda Ganguly, Associate Director at The Rockefeller Foundation, explains:

“Where we can play a differentiating role is in our tolerance for risk, and creativity for structuring and willingness to do something different”

First Dollars Down
The peculiarities of private markets also point to a unique role for LPs with an appetite for the risks associated with the start-up phase of a fund — most notably that the fund will not succeed in being created at all, or will not be fully invested.

These risks diminish as more LPs commit, but for those that invest early, there is a real probability the exercise will result in significant time and opportunity costs, with little to show for it. And because impact investing funds are newer, smaller, and relatively unconventional, the risk a fund will be unable to attract sufficient capital to begin or extend operations is more pronounced.

As a particularly active LP, the Chicago-based John D. and Catherine T. MacArthur Foundation has often committed capital early. Says Debra Schwartz, Director of Program-Related Investments:

“In orchestrating a deal, Macarthur has had to be willing to commit to the money before we knew what the deal was going to be.”
Similarly, there are concerns that the most innovative anchor investors might be too small to attract others. The Esmee Fairbairn Foundation in the UK has seeded some highly impactful investments, succeeding in bringing peers to the table, but has also made commitments to funds that were returned without ever being invested, in part because Esmee’s investments were not large enough to play the “cornerstone” role, according to Danyal Sattar, Finance Fund Manager, Social Investment, at the Foundation.

Collaborating and Coordinating

What emerges from the picture of the Active Investor deeply engaged in fund creation is an urgent need for collaboration and coordination. LPs are the providers of ideas, infrastructure, and capital, first and foremost, but also of advocacy, extensive networks, and even market demand.

LPs sometimes assume responsibility for attracting co-investors, as happened with the Baltimore Fund, where OSI sought out the partnership of The Annie E Casey Foundation. And LPs may become the buyers of the very companies they have helped to incubate, providing a built-in exit strategy. This is the case with Physic Ventures, a San Francisco-based investor in health and sustainability, which counts Unilever and PepsiCo among its LPs.

Moreover, many LPs are focused on any and all efforts to reduce relatively high transaction costs in impact investing, including by sharing due diligence and coordinating impact metrics and reporting standards.

“Sharing due diligence is really important at multiple levels. You cannot make diligence less work or less effort; you can only have it be of greater benefit. And it is a nice peer review process, which is a constructive dynamic.” - John Goldstein, Imprint Capital

“It’s important to think about sharing due diligence and research. Impact investing looks more like philanthropy than typical investing in this way. Program officers often actively partner around grantees. Keeping that practice would be fantastic as this field develops as a way to deal with transaction costs.” - Laura Callanan, McKinsey & Co.

The importance of collaboration as a device for learning was emphasized by a number of interview subjects, among them Tony Berkley, Director of Mission Driven Investments at the W.K. Kellogg Foundation:

“The potential for a learning return in addition to financial and social returns makes us more willing to place capital with a GP and take a chance on a first time fund. Specialist GPs are real experts in their sector. We value their sector expertise and that helps strengthen the activist LP/GP relationship. GPs like the fact that we have the potential to invest alongside them on specific deals that meet our criteria.”
To be sure, there will always be a larger number of passive LPs, grateful for their more engaged and better resourced peers. However it is the Active Investor that is pushing the market forward, ensuring that funds are created to solve challenges they and others care deeply about, and ultimately influencing the trajectory of the market’s development as much as the fund management teams they partner with to deploy the capital.

**Best Practice Questions**

1. How can funds best engage, coordinate with, and leverage the willingness of LPs to play an active role, the skills they have developed in doing so, and the networks of which they are a part?

2. How can funds partner with LPs in a manner that enables (and does not constrain) the investment and other practices necessary for delivering great returns and ensuring operational sustainability?

3. How can impact investors learn from the active role that LPs have already played – and the innovative fund structures they have created – and develop funds that offer LPs a wider array of “off-the-shelf” opportunities for which their active involvement is either unnecessary or, at the very least, more optional?

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**The New York Acquisition Fund**

In 2004 the New York City Housing and Preservation Department (HPD) proposed the $200 million New York Acquisition Fund to address the city’s affordable housing crisis. A similar, preceding fund had failed to address a gap in predevelopment financing largely because it did not involve all stakeholders to accurately diagnose the scope of the problem.

With collaboration as a guiding principle, The Rockefeller Foundation quickly emerged as a critical partner, advocating for the project and providing over $1 million in start-up administrative costs during a laborious negotiation and incubation phase. Four other foundations provided $806,000 in start-up grants.

Foundations were also identified as anchor LPs, investing alongside the city in a $40 million guarantee pool designed to leverage commercial bank funding in a ‘layered risk’ approach.

It took over two years to reach a final agreement that involved the city government, 10 foundations, 16 commercial banks, five community lenders, and two national housing organizations. Disagreements spanned everything from project eligibility, to risk allocation, underwriting criteria, and loan terms. However all parties ultimately agreed on a final structure and the fund was launched in late 2006.

Since its launch, the Acquisition Fund has proven the value of coordination, investing over $150 million in New York City and creating or preserving 4,384 units of housing.5 As of 2009, nine initial loans representing $50.4 million have been fully repaid.6 Due to its success, the Fund has been used as model for other cities; governments in New Orleans, Atlanta, Chicago, and Los Angeles have looked to develop similar solutions with local foundations and financial institutions.7

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1 http://www.nycacquisitionfund.com/
2 Kennedy School of Government Case Program, Buying Property in a Hot Market: NYC Creates a Fund to Keep Affordable Housing Developers in Play, 2012.
3 http://www.innovations.harvard.edu/awards.html?id=122261
DYNAMIC TWO: THE PIONEERING FUND
Resilience and Creativity in the Face of Uncertainty

The role of the impact investing fund manager is complex. Like a mainstream investor, she must find ways to define market offerings that can attract capital, invest it, and harvest financial returns in a reasonable timeframe. Like a foundation officer, he must understand the drivers of change within the ecosystems in which he chooses to work and nurture the relationships that allow the desired impacts to flourish, creating new institutions or interactions if needed to get the work done.

The most salient tension for fund managers with whom we spoke was the additional work they take on to nurture markets and support ecosystems. Successful fund managers are extraordinarily creative, nimble, and resilient. To survive as an impact investor requires attention to market development, from fund inception through investment and portfolio management.

Attracting Capital is Iterative and Entrepreneurial

The fund manager’s job starts before the first dollar is raised, in understanding a market and defining an offering attractive to LP investors. Many investors spoke about the ingenuity of various fund managers in navigating capital sources during this phase. Fund managers, in turn, talked about the fundraising process as an entrepreneurial exercise. Responsiveness to market conditions has pointed funds to different pools of capital, which have, in turn, shaped the development of funds. This is as true for funds working in emerging markets as it is for funds stepping into more established markets in the U.S. and Europe. According to Ron Phillips, CEO of Coastal Enterprises, in Maine, U.S.:

“Every time we submitted a proposal to a private or public funding source we tried to be innovative and show impact. In other words, on the leading edge of that particular topic, not as a reaction to the market, but analyzing and identifying market opportunities in which to invest to meet a need, whether in small business, affordable housing, or social services like child care facilities. Looking back, this has been much more of an entrepreneurial exercise than I thought. And in terms of working with federal government programs to support community and rural economic development, we actually joined with others nationally to create the field of resources to fuel our work, whether funds for microenterprises, revolving loan business funds, venture capital, or tax credits along the way, for ourselves and for others.”

Other funds have been offshoots of larger organizations and their capital negotiations involved blending those organization’s interests. As fund managers develop track records, they have more sway in terms of aligning diverse interests, though often those interests evolve as well.
Making Markets

Once the fund is in place, finding the right opportunities to respond to a particular social or environmental priority, and ensuring investees succeed, requires continuous innovation. According to Nancy Pfund, Managing Partner at DBL Investors in San Francisco, “Our deal development efforts are certainly more advanced and organized in fund two [compared to fund one] - but there still is an element of creative chaos to it. You just don’t know what’s going to work ahead of time.”

In discussing the Omidyar Network’s approach, Bill Barmeier, Partner and Head of Investments, explained that the organization’s investment approach “is continually evolving as we learn more, though several themes remain constant, including our aim to act catalytically and to back strong entrepreneurs who pursue innovative and sustainable solutions.”

Many fund managers alluded to working to expand their focus areas after closing the fund to respond to opportunities on the ground. According to Phillips, “We have a diverse operation - so we have eggs in multiple baskets and can be responsive to the diversity of opportunity in rural regions. An example of that would be natural resources industries, which continue to be part of our sweet spot, but also, we have diversified to focus on overall manufacturing and even services.”

Sometimes what funds learn on the ground significantly changes their strategy. Keely Stevenson, Chief Executive Officer of Bamboo Finance US, says she and her colleagues saw a lack of pipeline to get companies to the growth stage where they could invest in them. The solution: Bamboo developed a new fund for earlier stage investments for local investors in Colombia.

Lack of appropriate dealflow has inspired innovation outside of fund creation as well. According to Wiebe Boer of the Tony Elumelu Foundation (TEF), an Africa-based and African-funded not-for-profit dedicated to the promotion of excellence in business leadership and entrepreneurship, “the actual making of investments is a lot more difficult than I had anticipated because there just aren’t that many good deals in the pipeline, or at least that have become apparent.”

In the last year, TEF has closed on just one and turned down over 50 deals. In response, the Foundation is becoming more active in business development and deal generation. For example, TEF is investing in a commodity exchange in Rwanda in partnership with a consortium of other investors. Traditionally someone else would have put the deal in place, Boer explained, and then the Foundation would have invested. But in this case the Foundation has been active, along with its sister company Heirs Holdings, in structuring the deal and hiring the CEO. “We are more proactive to start, rather than waiting for the entrepreneur.” TEF is collaborating on similar business development efforts for an impact sourcing company as well as a technical and vocational education solution provider company, both in Nigeria. The Foundation continues to source deals from more traditional pipelines, with current opportunities in Ethiopian agriculture and Ghanaian healthcare going through due diligence.
In explaining the challenges of building new markets, Robert Kraybill, Managing Director of Impact Investment Exchange Asia, reminds us to step back and see the difficulties even in traditional investing. Outside of India, he explains, “some of these markets are just very small. So when you go beyond [traditional investment] to the niche of impact investing, the opportunity is just going to be very limited”.

Accion Texas is another fund bringing significant entrepreneurialism to its work, in part by developing proprietary underwriting software that has 12 paying, third-party licensees, helping the organization remain financially sustainable.

According to Christa Velasquez, former Director Social Investments at the Annie E. Casey Foundation, there is a balance to be struck. Some high-performing funds have strong personalities leading the charge but they also have real discipline in their approach. Other funds, she fears, don’t have a coherent strategy or are trying to do too much to appeal to the broadest range of investors possible.

Portfolio Management: From Survival to Success
The blending of mission and management is still more of an art than a science. Challenges persist in generating dealflow, creating demand for product, closing deals, and working with companies and managing exits.

Boer talked about the difficulty of finding suitable deals in the countries within which he works:

“The reasons the Foundation hasn’t been able to close more deals: 1) Deals are repackaged to look like impact on the surface, but there is limited social impact built into the business model; 2) There are plenty of offers that have social impact, but the business model is not viable; and 3) There are deals with the right balance of social and financial return, but then many impact investors converge on those and crowd each other out. It turns out the investor is the one begging and the investee sets the terms.”

And according to Álvaro Rodríguez Arregui, Managing Partner at IGNIA, there are inherent inconsistencies at the fund level. You need a very large fund to build out missing ecosystems, especially in some emerging economies like Mexico, where he works. Simply making an investment in a company is usually not enough (see case study). You need to work shoulder to shoulder with the entrepreneur building the industry ecosystem that will allow the business to flourish and thrive.

Keely Stevenson’s biggest fear is that impact investing will not work out, not because of poor company business models, but because funds are unable to reach sufficient scale to provide the appropriate level of support. For example, she says, many impact funds are so small they have limited ability to pay their staff. This means staff is not adding value, especially if they don’t have enough industry experience.

John Goldstein, Managing Director at Imprint Capital, reflected on the three general characteristics that a fund manager can bring to the table, and asks if there is a right mix of these attributes to have. His list includes: 1) Investment savvy; 2) Industry connections; and 3) Mission focus.
Best Practice Questions

1. What are the most important non-investment functions that fund managers find themselves taking on and how do they carry them out?

2. What are the essential elements of a successful capital attraction strategy in impact investing?

3. What kinds of engagement with portfolio companies are different for an impact investor and does engagement correlate with impact focus or other variables?

IGNIA and MeXvi

IGNIA is a $100 million venture impact investing fund based in Monterrey, Mexico, that invests in companies that provide effective responses to the enormously underserved needs of low income populations — both as consumers and as productive agents in value-added supply chains. One of IGNIA’s investments is MeXvi, a company that builds affordable houses on a customer’s own land in rural and semi-urban areas in Mexico and has improved the lives of over 25,000 individuals.

According to Álvaro Rodríguez Arregui, Managing Partner, IGNIA’s investment in MeXvi provides a great example of the kind of proactive, on-the-ground work that fund managers need to do every day to help their investments succeed. One of MeXvi’s biggest challenges was to figure out how to get its customers financing for their home construction. MeXvi houses cost on average $7,000, much less than any informal alternative, yet customers could not access the necessary upfront cash. To overcome this hurdle, MeXvi worked with microfinance institutions (MFIs) to provide loans for people so they could afford a MeXvi home.

MFIs were forthcoming with the idea but, given their funding structure, only offered short-term, one-year loans. IGNIA therefore stepped in to make the case to government that moving people from slum housing to clean, affordable, efficient and safe housing, would require long-term MFI funding and support. It took over 18 months for the government to provide the appropriate help and allow MFIs to extend long-term loans – a task made more difficult because public loans to microfinance companies are not morgagable by land title. Today, MeXvi has a successful partnership with 14 MFIs to facilitate access to long-term credit for the payment of its homes.

Thanks to IGNIA’s advocacy and credibility, MFIs are part of a commercial ecosystem that has enabled the construction of 1,400 homes in rural and semi-urban areas in states of Mexico in 2012 alone.

“When an entrepreneur goes to authorities and other players with the backing of a $100 million institutional investor, authorities are generally receptive. Opening these doors is where we spend a lot of our time and where our value-add shines through,” explains Rodriguez Arregui.

According to Rodriguez Arregui, assisting portfolio companies is more than just providing ad-hoc “technical assistance,” from a distance. “Adding value to portfolio companies means being there day-to-day, 24 hours on call, putting your reputation on the line, providing advice when it is needed, and actively being a sounding board.”
Dynamic Three: Financial Ingenuity
Creative Ways for Funds to Deploy Capital Differently

At the core of impact investing is an ability to use capital in pursuit of not only financial returns but social and environmental impacts. By definition, this means the traditional approach to capital structure and finance is simply a jumping off point for the creation of new financial tools, new structures and enhanced instruments capable of achieving this type of total, integrated performance. Many are experimenting with new creative approaches to capitalizing impact, and the goal of impact investing is to fit the best tools to the new integrated purposes of these investments.

But this creativity can also be in tension with the growth of the market. As Debra Schwartz of the MacArthur Foundation observed, impact investors should seek to make their financial innovations with as few “aberrations” as possible so that, as mainstream investors consider moving capital, they do not find them too complex or risky. If we truly seek to move large amounts of mainstream capital into the impact investing arena we need to facilitate the process as opposed to making it more challenging or difficult to understand.

In response, we see investors taking traditional approaches to venture and private equity investing and executing what can be referred to as “work arounds” in order to overcome the limitations of those approaches in the pursuit of impact. These strategies are all variations on the generally accepted principles of investing that impact investors are playing with in order to create total returns.

Limitations and Their Work Arousds

- **Expanding Fund Time Horizons.** Many private equity funds are structured with a life of seven years, with the option of one or possibly two three-year extensions. This timeframe places an artificial limit on the period within which a company can grow, address impact challenges and generate performance for investors. Yet, many investments—especially those involving a defined impact goal—may take 10 or 20 years to fully mature and generate that impact. Placing an artificial limit on the life of a fund simply because that is how traditional private equity is managed forces what may be a premature exit that may detract from realizing potential social benefits.

- **Changing Return Expectations.** While a key aspect of the definition of an impact-investment is the pursuit of financial returns together with social and environmental impacts, defining what returns are realistic can be a challenge—especially in those cases where multiple limited partners (LPs) are in the same fund but may have different understandings of what “success” means for that fund. This issue of returns plays out at several levels but fundamentally has to do with expectations regarding levels of projected financial return as well as degrees or levels of impact.
While many investors have moved beyond the early notion of measured trade-offs between financial and social returns (i.e., the idea that if one includes consideration of social/environmental value, this will necessitate a decrease in financial returns) there are still very real challenges involved in managing multiple levels of return within any given fund. And this can cut a number of ways. For example, Tracy Kartye of The Annie E. Casey Foundation reflects:

“Where we’ve run into trouble on the social return side is that the capital hasn’t been deployed based on the original expectations. It happens quite a lot that you feel like you have the right product, and then something changes, and the investment doesn’t pan out the way you thought it would. It doesn’t mean the investment is at risk from a financial perspective, but it means we didn’t achieve our social goals.”

Overcoming Limited Manager Expertise. While the field of impact investing is populated with a growing pool of promising fund managers, the reality is that many of the investment teams managing individual funds have limited experience working together or in a given area of targeted impact investment.

The Power of Diversity: Capital Stacks
Impact investors with a broad perspective of their markets see the real power in capital diversity; namely, that various types of capital may be “stacked” in order to enable certain types of investments to be realized which would not otherwise be possible. GPs are in a unique position to not only see how various types of capital, seeking various forms of return, might be stacked along various tranches—but also to coordinate different parties to participate in bringing such investment opportunities forward.

Furthermore, by accessing concessionary Program-Related Investments (PRIs) from foundations, low interest/high risk debt can be structured to play an “equity-like” role in a deal structure, thereby leveraging additional debt or equity from private market investors or in some cases development finance institutions. Capital stacking is one way actors have come together in the impact investing arena to ensure not only that impact seeking capital can find appropriate deals but that those deals are able to secure the appropriate forms of capital necessary to finance the next stage of development, growth and, ultimately, sustainability.

As Ron Phillips, of Coastal Enterprises, observed:

“With respect to impact investing, what I’ve been hearing more about in our field is understanding the continuum of the risk-return spectrum. This spectrum covers high-risk projects to the more risk-averse collateral or guarantee requirements. For impact investing to be effective, it will need to embrace and understand that whole continuum of risk, the need for philanthropy – a kind of “blended investment” – and the recognition that market return projects are only a portion of the spectrum of social investing.”

Various authors have explored this from different perspectives. Most recently, Impact Assets’ Issue Brief #9: Capital Stacking in Impact Investing, A Living Cities Case Study (2012), looks at the topic from a U.S. perspective. Equity with a Twist (2001) explored the idea of mixing philanthropic and debt capital in the form of PRIs from foundations. From Blueprint to Scale: The Case for Philanthropy in Impact Investing (2012), explores the topic from more of an international perspective; and Grants, Debt and Equity: The Nonprofit Capital Market and Its Malcontents (1996) originally explored capital stacking from a markets perspective.
The capital stack brings investors together. In other cases, access to diverse types of capital is present under the one roof. Bill Barmeier, from Omidyar Network, says: “We are highly flexible in how we deploy capital. In making an investment, we determine first the purpose of our investment and the right organization to support, and then select the appropriate form of capital – equity, debt, grant, PRI or MRI. We have developed significant expertise across all of these capital types.”

**Integrating Debt and Guarantees to Reduce Risk**

As becomes clear, the real issue here is the ability to access risk-tolerant capital. Many investors want debt and lower levels of risk; however, what many investees really need is first-loss equity or other capital capable of taking on greater levels of risk.

For example, as Mitchell Strauss, Special Advisor for Socially Responsible Finance at the U.S. Government’s Overseas Private Investment Corporation, commented:

“The reason you see a combo debt-equity fund is to be able to reward investors on the journey, because the delay to equity exit can be unattractive to some investors. That’s why there are debt instruments in some hybrid vehicles, to give some return with a greater probability than a highly variable equity return in a world where equity exits are more challenging.”

While not a form of capital, securing and structuring government loan guarantees may also be used as a risk reduction technique. The presence of such guarantees can help assuage private market investor concerns with regard to risk while at the same time opening access to new sources of equity investment.

**Best Practice Questions**

1. How do funds manage multiple types of capital, and is it possible to create standard financial templates to minimize the costs of structuring inherently complex deals?

2. Do intermediaries prefer to “hold” diverse investors within a single pool, or are they working to create investment products that can accommodate different investor types beyond their individual funds?

3. How can funds best engage with philanthropic and public sector capital to bring deals to market that would otherwise not be viable, as well as compensate that capital for the higher, earlier-stage risk it may carry?
Three prominent examples of capital stacking have emerged to promote conservation, support healthy food in underserved communities, and invest in smallholder farms in Africa.

Case Study

The Capital Stack at Work

Three prominent examples of capital stacking have emerged in the past 18 months to promote conservation, support healthy food in underserved communities, and invest in smallholder farms in Africa.

At Lyme Timber, a for-profit timberland investment firm based in New Hampshire, U.S., a forest was purchased with two separate types of capital. The St. Croix Forest – 78,000 acres of land in Wisconsin – was purchased from a paper company in 2011 with $21 million from the firm’s equity fund and $16 million of low-cost financing from The Conservation Fund, which then held an option to purchase a conservation easement on the property. In the case of the St. Croix Forest, the stacking of capital from a nonprofit partner with the firm’s equity made it possible to protect the forest and work toward the easement.

In California, low-interest debt from PRIs has been stacked with grant funds to create the California Freshworks Fund at The California Endowment. The California Fresh Works Fund is a public-private partnership loan fund created to: 1) Increase access to healthy food in underserved communities; 2) Spur economic development that supports healthy communities; and 3) Inspire innovation in healthy food retailing. With different investment term options, and associated return rates, the California Freshworks Fund has raised $264 million to invest in bringing grocery stores and other forms of healthy food retailers to underserved communities.

The African Agricultural Capital Fund – managed by Pearl Capital Partners – has blended a wide range of private capital, PRI dollars, grants and public debt guarantees to invest in smallholder farmers in East Africa. In September 2011, four members of the Global Impact Investing Network’s Investors’ Council—the Bill & Melinda Gates Foundation, the Gatsby Charitable Foundation, J.P. Morgan, and The Rockefeller Foundation—closed a $25 million impact investment into the fund. The United States Agency for International Development provided a 50 percent debt guarantee to J.P. Morgan’s investment, as well as a grant-funded technical assistance facility for the fund’s investees. With all of these pieces in place, the Fund can make loans and offers equity and quasi-equity to African farmers looking to grow their ventures.
DYNAMIC FOUR: PLATFORM INFLUENCE

Evolution in Investor Access Affecting Fund Structure

There was a time when, to paraphrase Henry Ford, you could have any color impact investment you wanted—as long as it was black! But today, as documented by our own research as well as confirmed by the introduction of the ImpactAssets-50, ImpactBase and other on-line rosters of impact funds, it is clear that over recent years the universe of investable opportunities available to impact investors has grown significantly. Indeed, the total identified, cumulative number of funds created in the last 10 years has swelled to over 250.

Democratizing Investing: A Retail Imperative?

It is no wonder various intermediaries are exploring how best to mix and match individual impact investment opportunities with a growing range of investor types, profiles and risk tolerances. And it is no wonder funds are themselves responding to these new, potential sources of capital, laying the foundation for a groundswell of new impact investment offerings to hit the market in coming years. Finally, this innovation in the size, form and function of various investment platforms promises to democratize impact investing itself—bringing opportunities for smaller, retail investors; all of which means a multi-billion dollar investment market could potentially move into the realm of trillions.

As observed by Laura Callanan of McKinsey & Co:

“Retail is a unique segment but there are different challenges to it. Clearly a lot more money is out there but there are different transaction costs, different channels of information sharing, a new layer of people needing to be educated. Conscious of distortions of a market that is new—how do you make it healthy and grow sustainably?”

Much of this dynamic shift in how impact investing products are offered brings us to reflect upon the possibilities of a “retail imperative,” wherein changing structures and strategies are put in place to respond to what could be growing demand by new investors for new products.

While there is great promise here, there may also be new responsibilities and calls for accountability. How “deep” can investment products be that are sold on a mass platform? What obligations do institutions promoting such products have to drill down and assess performance true—on both financial and social/environmental levels? How much of the introduction of new impact investing products will be a function of “pull” (namely, client demand for such products) versus “push” (demand driven by broker/dealers promoting products which may offer financial compensation for sale)?
There are various ways institutional investors are managing this process of developing and then introducing impact investing platforms to the investing public. Hilary Irby of Morgan Stanley explains the firm’s framework as follows:

“Our Investing with Impact framework includes a range of strategies offered through four different approaches – the first three are all public equity/public debt: 1) Values Alignment, which is screening by interests and values and excludes things clients don’t feel comfortable investing in; 2) Environmental, Social, and Governance Integration, which identifies managers who evaluate companies’ ESG approaches for value differentiation, using both active and passive strategies; and 3) Sector Exposure, which focuses on themes or sectors targeting specific environmental or social changes. The fourth category, Impact Investing, focuses on private equity and private debt.”

Platforms: Equalizer or Creator of Further Differentiation

The introduction of distribution platforms dedicated to impact investing products is intriguing to funds for a very simple reason. If structured properly, impact investing distribution platforms will help lower high transaction and other costs, while potentially standardizing offerings which, in turn, will make it cheaper to move money from traditional investments into impact investing offerings. Due diligence expenses could be shared, marketing expenses managed more efficiently, and monitoring costs allocated across a wider set of actors.

However, this also raises additional concerns and issues about the great diversity within impact investing. Paul Bernstein, Chief Executive Officer of The Pershing Square Foundation, made the following comment at the launch of The Impact Investor project in Oxford:

“If the conversation remains at the level that Jed (Emerson) and Antony (Bugg-Levine) laid out in the book [Impact Investing: Transforming How We Make Money While Making a Difference, Jossey-Bass 2011], which is incredibly broad and can encompass a number of things, I wonder if it makes the conversation about how we expand, how we discuss and measure impact, and how the financials are laid out more difficult. Do we need to get to a point of somehow segmenting this market, based on different investors or based on different investor needs? My guess is there is a lot of diversity in this room. Can we look at different folks who are focused on impact at the base of the pyramid and what that means, as distinct from the group that just cares about GDP growing in countries, because that’s their version of impact. How much do we need to do that in order to get the conversation moving forward?”

The Role of New Gatekeepers

One key element in moving the conversation forward is likely to be engaging those gatekeepers who control the relationship between investor and investment opportunity; the broker dealer representatives, wealth advisors and asset managers representing clients who are or could become interested in impact investing. It is a tricky process since many distribution platforms have high hurdles for inclusion, at least at this stage. All offered impact products must naturally be approved by the firm before they may be placed for distribution to clients.
Many advisors do not feel comfortable discussing impact investment options

To make the process even more complex, many advisors do not feel comfortable discussing impact investing options either due to perceived lack of client interest or because many advisors are not themselves well versed in the opportunities offered by impact investing products and funds. In order to help address these issues, together with various impact fund managers and field experts, ImpactAssets has produced a set of Issue Briefs—long form essays targeting wealth advisors and high net worth clients. These Briefs address everything from how to think about total portfolio management to considerations of risk and return. In addition, organizations such as the Global Impact Investing Network, Social Finance and others have assembled resources online that should be promoted to gatekeepers to assist in developing both their knowledge and comfort with the impact investing field.

**Best Practice Questions**

1. How should funds support the development of distribution platforms as a strategy for expanding their own footprint and impact investing more broadly?

2. How do funds best maintain a focus on their mission, and not dilute their blended performance, even as they seek to maintain compliance with the requirements for participating on platforms?

3. How is the “retail imperative” changing the way funds are conceived, created, and positioned?

**Calvert Foundation Community Investment Note**

The Calvert Foundation, headquartered in Maryland, U.S., works to maximize the flow of capital to disadvantaged communities in order to create a more equitable and sustainable society. They do this with innovative financial products, and are a leader in platform innovation. The Community Investment Note is just one example of the work taking place at the Foundation which currently has nearly $200 million invested in 250 community organizations in all 50 U.S. states and over 100 countries.

Community Investment Notes can be purchased by individuals and are also offered by brokers – providing a platform that can reach investors of all types. When an investor purchases a Calvert Community Investment Note, the full value of the principal is placed in a revolving loan fund that supports nonprofit partners working to end poverty and inequality. For the Calvert Foundation President and CEO Lisa Hall, this is one step toward creating a world where people think about their investment profile differently, and put some percentage toward impact investing.

In creating a platform that is not only available to individuals, but can be offered through brokers, the Community Investment Note provides an opportunity to educate advisors and wealth managers while providing a simple investment option that may be many individuals’ first foray into impact investing. As of 2011, the Community Investment Note had over 7,000 investors, all of whom receive a return on their investment, but also an annual report on the social impact of the program.
Dynamic Five: The Performance Problem

Demonstrating Success Through Diverse Performance Indicators

“An ounce of performance is worth pounds of promises.”

—Mae West

A critical issue for impact investing funds is to prove their success. As noted above, when funds have a clear track record of success in both social and financial scales, a number of positive things happen in the overall marketplace and growth becomes more organic. The difficulty with the field of impact investing, however, is that for the most part, evidence of success does not always look like that of conventional investing. Some common practices have been emerging around how fund managers can communicate their achievements, but with a large portion of the marketplace dependent on equity-style returns, and still waiting for cash to come back from deals, there is significant uncertainty about the best way to assess track records and evaluate success.

The New Metrics

The very first issue that emerges when talking to impact investors about their performance is not the metrics they use, nor their performance relative to peers, but the nuances of how they differentiate the relative priority of financial and social goals and how this shapes how they and we should perceive their success. Some examples:

“Personally I am of the opinion that you don’t have that many scenarios in the impact investing space where you can have social impact without financial performance. So to me, financial performance is a key criterion of success. It doesn’t have to be a 25 percent IRR but it does mean that, if a fund targets a 15 percent IRR and they have not hit those numbers, that is not a success. If it’s a loan where the projected return is 5 percent, and they pay 5 percent, then that is good. I think every investment is different. I think hitting the targeted financial performance is part of the success criteria for me.”

—Brinda Ganguly, The Rockefeller Foundation

“For me, personally, [success] is about giving 100 percent and it is about making our best effort in that moment. Translated to the microfinance world, it’s all about the intentions of people, and what they are trying to achieve. It is very complex to see your social impact. Once an investor has communicated their philosophy, only then do they turn to performance metrics. We note a few common threads by theme. That’s what I personally care about, and why I talk with many people in the field in Laos or Cambodia – to capture the social impact in those personal stories.”

—Femke Bos, Triodos Bank

Once an investor has communicated their philosophy, only then do they turn to performance metrics.
Financial Metrics: Islands of High Performance in a Sea of Uncertainty

There is general agreement that the ultimate objective for financial performance is to get to internal rate of return data for the investor that can be benchmarked and compared with the equivalent, most relevant other impact and non-impact investments. However while some debt funds have very good financial data and strong performance, most equity funds do not have significant exits, and thus do not have actual performance to report.

To be sure, examples emerged from our interviews of extremely good performance by funds with track records of over five years that matches promised targets across asset classes, industries and geographies. But this is not the norm. Rather, the norm is determined by a great many funds that are young and uncertain about their ultimate financial performance. This has left potential LPs even more confused.

Cambridge Associates, an investment consulting firm, is working with foundations and other types of clients to invest portions of their portfolios in impact investments. According to Noelle Laing, who leads Mission-Related Investing (MRI) manager research:

“Due diligence on private impact investing funds is difficult because most impact managers are raising their first or second fund. Even if the managers are on fund three, their track records are usually largely unrealized. You can point to other facts about the team and their abilities, such as their experience, their connections, and their passion, but without realized returns, there’s no proof that they can successfully execute the strategy. I’m hopeful that in 10 years, we’ll be able to point to many funds that have been successful in the space. For now, I think performance and the lack of realized track records are the biggest due diligence hurdles.”

Intermediary Success Points: A Few Good Exits

Several interviewees talked about the need to evaluate other metrics as substitutes for the full-blown exit and return data people want. And fund managers are raising multiple funds using these metrics, even with track records that are unrealized. According to Keely Stevenson, Bamboo Finance uses the amount of capital that has come into their deals after them in order to tell the story of their performance in the absence of portfolio-wide exit data. And if that capital comes from non-impact sources, they are also pleased.

Noelle Laing has a set of questions she asks each fund manager about their LP base, as she wants to ensure that this includes institutional investors. It is also helpful to know if the funds meet the Community Reinvestment Act regulatory requirements for U.S. banks, as that provides validation that the funds are meeting certain standards for community investment.

Nancy Pfund, from DBL Investors, says that during fundraising for the firm’s last DBL Equity Fund, she and her team recounted the stories of a handful of successes in their last fund, over and over. “I think we calmed people down, because we had some returns. There is a whole faction that says you are going to diminish your returns if you pay attention to all this social stuff. We were able to show that we did this and we are making money at the deal level.”
These intermediary metrics may help a small group of funds raise multiple funds, but the lack of tangible data has left the field in an ambiguous state more broadly. There is still a lot of concern about whether and why impact investment can meet their targets, or whether there is a trade-off between social and financial returns and what the right portfolio strategy is for these kinds of investments. For example, Doug Miller, past Chairman of the European Venture Capital Association, believes “the start-up stage requires that 50-plus percent of the investments will fail. And the way we make money in private equity, you have winners that pay for losers - so if you don’t have winners that carry 5x your money, then you can’t sustain the losers and get your capital back.”

Some foundation officers, like Debra Schwartz of MacArthur, are eager to call a spade a spade. “The cost of intermediation alone for the kind of active investing we do means you will not get a market rate of return, if you are honest about the cost of that intermediation. The time, the paths you go down that don’t work, the amount of wrangling of partners and subsidies and dealing with illiquid assets – there is no way it’s market rate if you take all that into account.”

Until there are deeper track records and some useful segmentation about where and when these trade-offs actually have historically existed, by stage, industry or investment approach, we agree the field is lacking essential credibility and coherence.

Impact Metrics: Evolving

On the impact metrics side, practice remains extraordinarily diverse. Some funds talk about their goals in the most general of terms and point to their industries as inherently pro-social. Others work within regulatory or other frames (such as CRA requirements in the U.S.) to track and report very detailed impact data from their portfolio companies.

According to Noelle Laing, this diversity exists at the LP level as well. “Since our clients have a variety of missions and values, they tend to have varying definitions of impact and different standards to measure that impact,” she says.

Many fund managers are starting to adopt and use new standards and tools, including metrics from IRIS (Impact Reporting and Investment Standards) and ratings from GIIRS (Global Impact Investing Rating System). And many of the people we talked to spoke about keeping or adding their own internal impact system alongside the standard systems:

“Whenever we go into a transaction we try to select metrics beforehand. During the negotiation process we ask the fund manager to set targets against those metrics. That provides a basis for discussing any programmatic changes, and it provides a basis for discussing social impact performance overall. Setting realistic targets and achieving or outperforming those targets is a sign of success.”
— Brinda Ganguly, Rockefeller Foundation
**Fund managers are being asked to move from tracking outputs, to outcomes and sometimes even impacts**

“Huntington’s mission is to provide our limited partners with excellent returns while having a positive impact on the communities in which we invest. As part of our mission, we have agreed that up to 60 percent of our invested capital in our current Fund Two will have a measurable impact on the communities in which we invest. Currently, we are exceeding that goal with more than 80 percent of our capital deployed into businesses that qualify as underserved” — Tim Bubnack, Huntington Capital

For the managers who are intensive about tracking social performance, there is a general trend line emerging, especially for impact-focused investors. Here, fund managers are being asked to move from tracking outputs, to outcomes and sometimes even impacts.9 This evolution was articulated by Janie Barrera, President and Chief Executive Officer at Accion Texas:

“Our impact assessment has evolved quite a bit. What used to satisfy our investors were operational outputs of our lending: numbers of loans, dollars disbursed, delinquencies and defaults. Over time everybody has become excited about new ways of doing things, so that doesn’t work anymore. Then it became focus on outcomes: how many jobs have you created? How has the credit score moved for a customer? The more recent trend is to track the person post-loan, which we are trying to figure out but don’t have the capacity for right now. For example, how many of your customers become millionaires three years later? We are trying to figure out a way of capturing that with typical T.A. [technical assistance] capacity.”

Some funds are developing robust internal systems to track and report on financial and social performance (see case study). We believe there is still ample room in the marketplace for improvement in how financial and social performance is tracked, compared, rated and acted on. It is a huge and important challenge for the field.

**The Larger Lens: A Portfolio Approach**

As a compliment to this, it will be interesting to follow the growing number of investors that are pursuing a unified approach to managing their capital; an approach which seeks an integrated investment strategy across a continuum of financial, social/environmental returns and total performance.10 Such investors will find a growing set of options for managing their investments across philanthropic, near-market and market-rate investments.

Yasemin Saltuk of JP Morgan has been exploring impact investment portfolio management by asking investors and fund managers how they assess their portfolios in terms of return, risk and impact. She finds that many market participants are target-oriented by sector, geography or impact objective and maintain flexibility in their approach to take advantage of the opportunistic nature of the market at this stage. And the team behind the Global Impact Investing Rating System (GIIRS) is hoping that their new subscription-based tool, GIIRS Analytics, which allows investors to customize portfolio-level reports of financial and social performance, will be a useful equalizer in this regard.

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9 For a detailed discussion of these terms, see “A New World of Metrics: Trends in Monitoring Social Return,” Clark and Emerson, in “Investing For Impact,” Credit Suisse Research Institute, 2012, pp. 31-35.

Best Practice Questions

1. How can and should funds define success?

2. In the absence of typical performance data, what are the interim data points managers are using? Which are most convincing and important?

3. What are the most essential high-return practices of social impact assessment and communication for fund managers?

The Annie E. Casey Foundation

The Annie E. Casey Foundation is a private charitable organization dedicated to helping build better futures for disadvantaged children in the United States. The Foundation’s impact investments include debt, equity, Program-Related and Mission-Related Investments (PRIs and MRIs). Most of the Foundation’s investments have been PRIs in the form of loans to community development financial institutions (CDFIs) working in “Casey Places” – geographical target areas around the U.S. where the Foundation’s other grant-related services are concentrated. The Foundation has investments in five areas: housing and community development, economic development (small business financing), education, child welfare, and access to capital. All its investments were made through intermediaries. The Foundation has invested in 22 funds, averaging around $10 million per year in debt allocations. Its active impact investment portfolio totals $102 million in 2012.

A sophisticated impact-focused LP, the Foundation’s approach reveals a number of performance tracking and measurement practices others in the field could learn from:

1. Setting clear goals at the time of investment Tracy Kartye, Associate Director of Social Investments, and her colleagues work to establish metrics at time of investment. This way they know what they are looking to see and can track progress against those targets. According to Kartye, on the financial side, the equity target is what the fund manager sets and, for debt, they might start at 3 percent and adjust from there. On the social side, they look to fund managers to help define the metrics. They might ask if other targets can be added, but they don’t set the numerical goal – that is up to the manager.

2. Quarterly tracking of percentage of achievement The Foundation produces quarterly tracking reports, which they call their “impact dashboard,” on both financial and social performance. On the social side, the dashboard includes the aggregated portfolio targets in each output area, what’s been achieved to date, and the percentage of total achieved. Collecting this information, Kartye notes, depends on funds being good at both deployment and reporting, which is a combination of skills many still lack, in her opinion.

3. Thorough exit interviews The Foundation conducts in-depth exit interviews with investees. This overall analysis of what happened over the time of investment explores obstacles, and quantifies ancillary benefits that may have accrued.

4. Enough flexibility to adjust social parameters based on lessons learned According to Kartye, the Foundation has had some difficulty finding fund managers that align with their mission, especially due to their geographic focus. The Foundation has done some deals where there was a “carve out” for the funds to invest a percentage in Casey Places. They have discovered, however, that too narrowly defining geography can be constraining and are currently underwriting a new equity fund where they dropped a more targeted requirement.
DYNAMIC SIX: ALIGNING PURPOSES

Bringing Stakeholders Together in Common Cause

A New Zealand proverb – “A house full of people is a house full of different points of view” – applies well to impact investing, where each investor, fund, and investee brings their own discrete values-driven financial, social and environmental objectives to the table.

The idea of aligning these objectives may seem trite, and the impact of doing so inconsequential. Yet when we dig a little deeper, it quickly becomes apparent that the values of key stakeholders underpin the entire activity of impact investing.

Simply put, purpose is imbedded in every decision asset owners make to invest in funds, fund managers make when they choose one deal over another, and investees make when readying for capital.

The challenge is to clarify and communicate these purposes, both individually and collectively. If disparate perspectives are not reconciled across LPs, funds, and investees – or better still coordinated and leveraged – success in impact investing is likely to be more elusive.

It Starts With Transparency

Alignment requires transparency above all else. Such is the myriad of preferences for return in impact investing that a clear understanding of the blended performance each stakeholder desires and the different roles they can play is essential.

And while transparency seems like a theoretically simple undertaking, the reality is very different, with interview subjects reporting that ambiguity prevails in impact investing.

As Beyond Capital Fund’s Eva Helene Yazhari explained at the launch of The Impact Investor project at the Skoll World Forum:

“In some cases I’m not sure investors know exactly what they want. At the very least they are looking for social return, and at the most they are looking for everything under the sun, including what some refer to as market rates of return – although I don’t think people know what that is either. At BCF we aim to set professional standards in our work and set the bar high so our supporters are able to engage with our investment process and learn how we do our work.”

Interview subjects shared stories of companies poorly positioning themselves in the market, funds struggling to remain focused in order to showcase competitive advantages, and LP impact investing programs that miss the mark and have failed to attract either the support of internal stakeholders, or the co-investment of other institutions; all because of insufficient clarity.
Says Jessica Matthews, Manager of the MRI Group at Cambridge Associates in the U.S.:

“We observe clients having a harder time initiating their impact investing programs if they have not clearly articulated the goal or purpose of the program. There can be several actors involved in making these decisions, so it is helpful to have a statement or policy regarding impact investing goals and objectives.”

Clarity was on the mind of Rosemary Addis, Social Innovation Strategist at the Australian Government Department of Education, Employment and Workplace Relations, when she approached the market in December 2010 to invite applications for seed funding to establish at least two new Social Enterprise and Development Funds. “If we couldn’t explain our intentions and objectives and set out clearly what we expected fund managers to address, how could we expect others to come forward with robust ideas?” Addis asks.

It would be a mistake not to recognize that transparency has its risks. With different investor groups still relatively siloed — focused either on financial returns or social and environmental impacts — funds tend to tailor their disclosures accordingly. It will be important to understand what this means in practice and how this more selective representation by funds is changing over time.

**The Importance of Segmentation**

If transparency establishes a clear and critical path to alignment, the next step is segmentation. Impact investing opportunities often include multiple parties with varying demands for blended returns. Segmenting these different actors based on revealed preferences is the backbone of negotiating and developing effective partnerships.

At the most elementary level, the structure of a fund reflects a coordinated effort to put shared or complementary priorities to work. Does the fund promise an investment return (and by extension an exit in some cases)? If so, how will that return be generated? Is this consistent with an institution or individual’s purpose?

The sooner prospective collaborators get specific in discussing values and priorities, the sooner an informed process of segmentation can ensure that the right people are talking about the right issues.

To be sure, funds are often a tool for segmenting the market in their own right. Numerous LPs report that one of the benefits of investing through intermediaries is that it focuses their decision-making. Investors are either aligned with the fund manager or not; a clarity which benefits both parties, as Janie Barrera from Accion Texas explains:

“When an investor doesn’t see 3 percent as a decent return, and they walk away, then they just don’t get it at all.”
Of course funds must be created to begin with. This too – and the related, laborious process of deliberation and negotiation— has itself become a significant determinant of priorities, driving some investors towards a more direct mode of engagement.

**On the Ground**

It is difficult to overestimate the importance of alignment, which concretely impacts so many of the day-to-day operational and investment activities of funds.

Good alignment ensures that investing is in sync with their investors, becoming willing partners in the effort to deliver blended returns. “Companies need to share our deep interest in the second bottom line”, Nancy Pfund, DBL Investors, argues. And at Huntington Capital, Managing Partner Tim Bubnack explains that a socially conscious culture pollinates all the firm’s portfolio companies. “I’d recommend talking to our CEOs. I expect that they will say we are a good partner. They know we are tough and expect performance, but we are socially conscious, and that comes with who we are.”

Alignment also ensures that investors are in sync with investees. At Triodos Bank, experience shows that microfinance institutions are only successful when like-minded investors understand their business and share the same principals. “It is our purpose to work and build relationships with these MFIs. We are not a funding factory. We are not shoving money at MFIs. We want to add value by sharing our knowledge of sustainable banking,” says Femke Bos.

The notion of alignment points to a more nuanced understanding of the role of investors, according to Doug Miller, formerly of the European Venture Philanthropy Association, with capital that is more “sticky” being recycled, redirected, or repurposed to ensure an investee’s needs are more fully met, including by supporting the markets, communities, or infrastructure in which they operate.

For John Goldstein, Imprint Capital, good alignment leads directly to good investment:

“For us, if a fund is doing impact but scattered or with a disparate thesis, then it’s hard in two ways. How do we explain it to the client? How do we think about it as your edge as an investor? What do you bring to the table?”

And finally, alignment is a big draw for individuals in impact investing, as described by Bos:

“If the social mission is really clear to everybody, people are attracted to it. That’s why I shifted from working for a big commercial bank to Triodos Bank.”
**Best Practice Questions**

1. How can funds best align and coordinate stakeholder purposes during start-up, as expeditiously as possible, in order to maximize efficiency and the probability of success?

2. What does good alignment look like in practice once a fund is created? What policies, practices, and disclosures are associated with alignment excellence?

3. What are the practical outcomes of good alignment? What difference does it make to the achievement of social and financial performance, if any?

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**Accion Texas**

Accion Texas, the largest nonprofit micro lender in the United States, enjoys the support of a diverse group of over 60 investors that provide loans at an interest rate typically under 4 percent in order to provide credit to small businesses unable to borrow from commercial sources.

Usury laws cap interest rates at 18 percent in the U.S., with the practical effect of ensuring no microlenders are self-sufficient without government or philanthropic subsidy. This means that alignment of purpose is essential for Accion Texas.

As a U.S. Community Development Financial Institution, Accion Texas’ mandate to operate in low-income communities aligns with the mission of its philanthropic, religious, and public sector investors. Commercial lenders fulfill a regulatory requirement by investing with Accion Texas and also see a pipeline of future customers. And for staff, purpose is palpable. When the U.S. economy turned sharply downwards in 2008 and delinquencies started to rise, every Accion Texas employee volunteered to make phone calls to all 2,000 of Accion Texas’s customers after work hours, inquiring as to their financial health.

Strong alignment is a big financial deal for Accion Texas, essentially converting debt into patient, equity-like capital by developing a pool of investors that choose to turn over loans rather than demand repayment.

Accion Texas is also a model of transparency, publishing its audited financial statements and other organizational disclosures online.
3. CONCLUSION

The Six Dynamics are an attempt to clarify some of the key relationships and activities that make impact investing unique. The fact that these themes have emerged from the whirlwind of growth and experimentation in impact investing is testament to the field’s developing maturity and viability.

This is not to say that impact investing is any less complex than ever. On the contrary, the Six Dynamics reveal a practice characterized by multifarious institutional relationships, ambiguous investor preferences, obscure financial and social performance, and bespoke, high-cost transactions.

And yet there are hundreds of investors and funds globally that have been successfully navigating the terrain of impact investing for many years, providing the field with a rich vein of insights with which to build a more consistent and coherent practice.

The Six Dynamics lay the groundwork for exploring the performance of funds in more detail. While it is too early to speculate about best practices, it is clear the field has a number of urgent needs, including for greater transparency—of the objectives and priorities of investors and the returns of funds—and for additional standardization—of deal structures, reporting, and networking.

However with ever more experience, impact investing is poised to become an established part of mainstream capital markets, not in decades, but in years.

The Impact Investor project will continue its work in the next year by diving deeper into the Six Dynamics with leading practitioners. By understanding how funds are addressing the unique challenges associated with impact investing, the project will identify a set of best practices supporting the realization of exceptional financial and social returns.
APPENDIX ONE: BEST PRACTICE QUESTIONS

The following compendium of best practice questions from each of the Six Dynamics provides a useful summary of key challenges in impact investing, from the perspective of funds. These questions will anchor future project convenings and fund interviews and, for investors, may assist in setting strategy and undertaking due diligence in their own right.

DYNAMIC ONE: THE ACTIVE INVESTOR
1. How can funds best engage, coordinate with, and leverage the willingness of LPs to play an active role, the skills they have developed in doing so, and the networks of which they are a part?
2. How can funds partner with LPs in a manner that enables (and does not constrain) the investment and other practices necessary for delivering great returns and ensuring operational sustainability?
3. How can impact investors learn from the active role that LPs have already played—and the innovative fund structures they have created—and develop funds that offer LPs a wider array of “off-the-shelf” opportunities for which their active involvement is either unnecessary or, at the very least, more optional?

DYNAMIC TWO: THE PIONEERING FUND
1. What are the most important non-investment functions that fund managers find themselves taking on and how do they carry them out?
2. What are the essential elements of a successful capital attraction strategy in impacting investing?
3. What kinds of engagement with portfolio companies are appropriate for different impact investors and how does engagement support impact achieved or other variables?

DYNAMIC THREE: FINANCIAL INGENUITY
1. How do funds manage multiple types of capital, and is it possible to create standard financial templates to minimize the costs of structuring inherently complex deals?
2. Do intermediaries prefer to “hold” diverse investors within a single pool, or are they working to create investment products that can accommodate different investor types beyond their individual funds?
3. How can funds best engage with philanthropic and public sector capital to bring deals to market that would otherwise not be viable, as well as compensate that capital for the higher, earlier stage risk it may carry?
DYNAMIC FOUR: PLATFORM INFLUENCE
1. How should funds support the development of distribution platforms as a strategy for expanding their own footprint and impact investing more broadly?
2. How do funds best maintain a focus on their mission, and not dilute their blended performance, even as they seek to maintain compliance with the requirements for participating on platforms?
3. How is the “retail imperative” changing the way funds are conceived, created, and positioned?

DYNAMIC FIVE: THE PERFORMANCE PROBLEM
1. How can and should funds define success?
2. In the absence of typical performance data, what are the interim data points managers are using? Which are most convincing and important?
3. What are the most essential high-return practices of social impact assessment and communication for fund managers?

DYNAMIC SIX: ALIGNING PURPOSES
1. How can funds best align and coordinate stakeholder purposes during start-up, as expeditiously as possible, in order to maximize efficiency and the probability of success?
2. What does good alignment look like in practice once a fund is created? What policies, practices, and disclosures are associated with alignment excellence?
3. What are the most essential high-return practices of social impact assessment and communication for fund managers?
APPENDIX TWO: ORGANIZATIONS INTERVIEWED

Accion Texas
Aga Khan Foundation
Bamboo Finance
Beyond Capital Fund
Bridges Ventures
Calvert Foundation
Cambridge Associates
CDC Group
Coastal Enterprises
DBL Investors
Deutsche Bank
EcoEnterprises Funds
Esmee Fairbairn Foundation
European Venture Philanthropy Association
Gray Ghost Ventures
GroFin
Huntington Capital
IGNIA
Impact Investment Exchange Asia
Imprint Capital
Initiative for Responsible Investment
JP Morgan
Latin Idea Ventures
Lyme Timber
John D. and Catherine T. MacArthur Foundation
McKinsey & Co
Morgan Stanley
Omidyar Network
Overseas Private Investment Corporation
RSF Social Finance
Social Investment Business
The Annie E. Casey Foundation
The Tony Elumelu Foundation
The Pershing Square Foundation
The Rockefeller Foundation
Total Impact Advisors
Triodos Bank