CONSTRUCTION OF AN IMPACT PORTFOLIO:

Total Portfolio Management for Multiple Returns

An **ImpactAssets** issue brief exploring critical concepts in impact investing

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INTRODUCTION

Despite the growing media coverage of impact investing, and that coverage's increasingly sophisticated character, there continues to exist a widespread misperception that impact investing is a single type of investing and not a broad approach. It is easy for those considering impact investing to conclude it is similar to, say, venture capital investing—direct, high risk and only available to high net worth individuals. This perception was underscored when influential organizations initially made the mistake of labeling impact investing as an "emerging asset class," implying that impact cannot be achieved across all asset classes.

While understandable as a "way into" a discussion of how capital may be invested for financial return and the generation of social/ environmental impact, such an approach initially segregated impact investing within a single category of capital as opposed to laying the foundation for exploring how investors might manage *all* their assets for impact across an entire portfolio. In point of fact, impact investing is broad and nuanced. One may look at impact investing as both a "sleeve," as a discrete strategy within a larger portfolio of investments, or as a "lens" through which one looks at an entire portfolio. For the purposes of this Issue Brief, we will operate at a portfolio level and take the "lens" approach. When adopting such a total portfolio perspective, impact investors seek to achieve an appropriate financial return for any given investment instrument, fund or strategy under consideration within their portfolio while then asking, "What is the best way to think about the nature of impact within this particular investment or asset class?"

With this perspective, impact may be pursued across an entire portfolio with appropriate consideration of various risk, impact and financial return objectives for the allocation of philanthropic, near-market and market-rate capital. Developing this understanding of how best to incorporate impact within portfolio construction is especially timely for financial advisors who increasingly receive client requests to consider social and environmental impacts of their portfolio and structure capital investments to advance positive impact. Regardless of client asset size, while specific strategies may differ, it is possible to achieve positive impact throughout one's capital investments. And increasingly products are being brought to market that make high -impact investments available at lower minimums to be more broadly accessible to investors at all levels. This Issue Brief is presented as an introductory guide to help investors and advisors construct portfolios that integrate impact appropriately across asset classes. We refer to this as Total Portfolio Management.[1] This guide builds upon and summarizes the excellent work introduced by various thought leaders and investment experts whose efforts are driving the field of impact investment forward[2].

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EMERGING PRACTICES OF TOTAL PORTFOLIO MANAGEMENT

For financial advisors, engaging with a client in the process of portfolio construction offers an opportunity to understand and strategically respond to that investor's financial, personal priorities and objectives. As those objectives evolve to include social and environmental impact, the conversation between investors and advisors must weave considerations of impact throughout the portfolio construction process. Total Portfolio Management is an approach that seeks to optimize diversified financial returns while maximizing impact *as appropriate* for any given investment asset class. It is not reductive (asking, What do we remove from consideration from the investment universe?) but rather additive (asking, How do we take traditional investment practices and augment them with enhanced analytics and perspective to allow for consideration of both off-balance sheet risk *and* impact investment opportunities?). In this way, when engaging in Total Portfolio

[1] A word about words: While the terms Unified Investment and Total Foundation Asset Management were introduced in 2002 and Total Portfolio Activation in 2012, more recently family offices have begun using the term Total Portfolio Management to describe the allocation of all forms of family assets within a single approach to wealth management. This definition includes the allocation of all capital—philanthropic, near-market and market-rate. We prefer and use the term TPM here because, as described in this Brief, it best reflects the reality that all capital has "impact potential" and should be managed to optimize financial performance within a given asset class while maximizing the impact potential of that asset class.

[2] Please see Resources for a roster of papers exploring various aspects of the ideas presented herein as well as investment approaches being executed by impact investors.

Management, the fundamentals of traditional investment management still apply.[3]

Total Portfolio Management is not reductive—limiting the investment universe—but rather additive—bringing additional risk and opportunity factors into consideration.

As discussed below, it is also important to understand that Total Portfolio Management considers the full array of capital being deployed by asset owners: philanthropic, near-market and market rate. Such an approach acknowledges that charitable giving—by providing donors with tax benefits and other considerations—offers financial value while generating social and environmental returns. In this way, asset owners may bring a holistic approach to their consideration of how best to manage all their capital to pursue the full, blended value they seek to create as they manage and deploy their capital resources.

This Issue Brief offers an introductory overview of these ideas and suggests some initial steps asset owners may take together with their advisors to envision, create and execute an investment approach that integrates financial considerations with social and environmental concerns.

Step One: Establish Goals and Objectives

As every advisor knows, the first step in professionally managing assets is to define the core goals of the investor. These typically cover such issues as future retirement, college expenses, wealth preservation for future generations, and so on. The next step is to take stock of the unique cash flow needs, risk tolerance, and time horizon of the individual asset owner. All of this information is taken into account when making use of a traditional investment approach or crafting the asset allocation, investment policy statement and investment portfolio in a more customized manner.

This familiar advisory process is equally important for effectively building an impact portfolio. In addition to standard “financial only” discussions that inform an investor’s “profile,” the process of creating an impact portfolio also includes an exploration of client expectations and objectives with regard to the generation of social and environmental impact.

However, the “right” answer as to what constitutes the impact agenda of any given portfolio differs for each and every investor. For example, one family may be generally interested in making sure they are not invested in “bad” companies while having a broad interest in issues related to women and girls. Another client may be spending their professional career focused on combatting climate change or protecting the environment, and so will most likely not feel comfortable with financial returns generated largely from

[3] The steps presented here reference “The Essentials of Portfolio Construction”, Consulting Group, Morgan Stanley Smith Barney, April 2010

significant investments in fossil fuel production. And yet another client may have a deep connection to their community or region, and so will find tremendous value in an advisor able to introduce investment opportunities in regionally specific local food systems or affordable housing.

Regardless of the ultimate goal and set of investment strategies, incorporating discussion of a client's values enables closer alignment between an advisor and her client and is critical to attaining a broader understanding of the client's definition of the purpose for the capital under management in order to create a strategy that best advances toward her goal.

Step Two: The Investment Policy Statement

The Investment Policy Statement (IPS) is the agreement between an advisor and client that outlines how they will manage the client's investments. While it can take many forms—from simple to complex—the Investment Policy Statement serves as a guide star for the advisor and investment committee.

For clients seeking to intentionally integrate impact across their entire portfolio, the investment policy statement is critical. Ad hoc impact divestment or investment is not a sustainable strategy for impact. The IPS provides a framework for evaluating current holdings and new investment opportunities. It is the framework to be used in evaluating the total performance of a portfolio that seeks to generate financial returns with social and environmental impact.

Crafting an IPS with consideration of impact can be a challenge for advisors taking their first step into impact investing with a client. While there is substantial evidence to support the position that impact investments may deliver market rate returns for a given asset class, many financial advisors and investment committees are resistant to change, mistakenly believing investing with an impact orientation might threaten their fiduciary obligations. Since the IPS is the foundational agreement between an investor and client, explicit goals and practices outlined in the IPS should address investment committee concerns, detailing how any given asset owner defines their fundamental fiduciary obligations.

It should also be understood that the IPS is not a static document but rather a dynamic one that should be revisited annually, with its assumptions re-affirmed or modified based upon any number of factors. Such factors might include shifting market context or evolving investor intent. While any changes to the IPS should certainly not be undertaken lightly, the IPS offers "guard rails" to guide and direct investment practice, not "train tracks" to lock in an investment committee regardless of where the train appears to be headed!

A Possible "On Ramp" to Total Portfolio Management: The Portfolio "Carve Out"

While the focus of this Issue Brief is on a holistic, Total Portfolio Management approach to investing, some clients begin their impact journey by taking a portion of their investment portfolio and designating that allocation to be managed on an impact basis. Within this approach, the advisor and client agree to "carve out" a portion of their portfolio to be dedicated to specific impact investments, themes or strategies. Accordingly, this capital may be invested in a single asset class or distributed across asset classes with specific impact themes.

Such initially incremental approaches to impact investing may be necessary to help investment committees and fiduciaries become more comfortable with the idea and practices of aligning capital with ultimate investor intent. And for many asset owners new to the concepts of impact investing, taking a staged approach to exploring and deploying impact investment strategies may make the most sense. A staged approach may also be required due to existing investment lock-ups or tax considerations. With that understanding in mind, two points should be considered. First, all capital has impact of one form or another. For foundations or families concerned with advancing "the greater good" of society as well as fulfilling their fiduciary responsibilities, assuming one's investments do not have impacts upon the world (whether positive or negative) is increasingly being called into question. And, secondly, while in the past there may have been challenges in executing impact investing which helped justify taking a multi-year, incremental approach to deploying investment capital, more recently a significant increase in the availability of impact investing product makes it increasingly possible for impact investors to deploy capital across an array of conforming, competitive investment products, funds and managers. Regardless, identifying and then investing in new, impact investing approaches may take one to three years and all investors should recognize executing these ideas might take a certain amount of time and process. Even those investors seeking to go "all in" will find it is not a process that takes a quarter but rather a year or more.

Different investors will handle the specifics of this transition process differently, but it is in the IPS where investors outline their impact investing thesis. This will entail drafting of an investor-specific understanding of "impact" and broadly defining how they view the integration of impact and financial performance. Some investors will feel it important to include several pages of narrative on how they understand the nature of the impact they seek to create through their portfolio while others will simply address it in a few paragraphs. Either way, it is critical the IPS explore this question with enough definition to guide both the investment committee and wealth advisor in their work and decision-making.

Setting a leading example, The F.B. Heron Foundation wrote their Investment Policy Statement to reflect the "intent to balance the social and financial return on all assets, and to select opportunities for deploying capital, whether as grants or as investments, so as to maximize the combination of both kinds of return within each."

Step Three: Asset Allocation

With an understanding of a client's financial and impact performance objectives, as well as their risk tolerance and time horizon, advisors establish the initial structure of the portfolio through asset allocation. Since each asset class has its own risk, return, and impact profile, investors may customize a portfolio to fit their specific objectives by varying the level of investment in each asset class.

For example, additional risk taken on in private equity may be balanced by a large fixed income allocation. There are sophisticated asset allocation strategies used to optimize the classic risk return tradeoff upon which traditional portfolio construction is based, and these strategies can be adapted to include the consideration of impact across asset classes. An advisor who thoughtfully integrates impact will evaluate where impact is redundant, complementary, or catalytic in relation to the ultimate objectives of the investor's portfolio.

When considered together, each of the investments contributes to the Total Performance of the portfolio, generating financial and impact returns across various asset classes, including philanthropic. Accordingly, the impact goals sought through any given investment should be appropriate to that investment opportunity just as the financial returns expected of any strategy will differ based on the investment approach of that particular asset class. Said another way, one should not expect micro-loan impact from a socially responsible mutual fund, just as one does not expect private equity returns from a fixed income product. In this way, impact and financial returns may differ across individual asset classes within any given portfolio, but the total portfolio should be managed in a manner that seeks to generate financial and impact returns in alignment with the specific goals of any individual investor.

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Manager Search, Due Diligence and Selection

After the asset allocation is established, the process of the advisor researching managers, conducting due diligence on those managers and selecting possible investments for consideration by the client may begin. Socially responsible and impact investing communities have compiled many resources for identifying

investment products with social and environmental criteria.[4] As with all other investment products, specific diligence requirements differ with asset class and deal structure. However, it is always important to take a close look at the people managing the investments, the philosophy behind their approach, the process for selecting investments, and the total performance (meaning assessment of both impact and financial returns) they have achieved. The evaluation of performance for an investment in an impact portfolio includes measurable, demonstrated and reported impact that is aligned or complementary to the portfolio objectives. Therefore, it is critical those considering various managers analyze their impact reporting capacity and practices as well as their traditional financial management practices.

If a client is especially interested in an investment that doesn't quite fit the agreed upon criteria for that asset class, this can be thoughtfully accommodated by taking a Total Portfolio Management approach. For example, an investor may want to pursue an investment that takes on undue risk in relation to the expected financial return because it generates a particular type of demonstrated impact. Alternatively, an investor may choose to unconventionally risk-balance a portfolio to permit pursuit of high-innovation impact opportunities that offer an elevated probability of failure not due to their impact DNA but simply due to their innovative structure. And as discussed below, savvy portfolio construction may compensate for many different forms of risk—execution, liquidity, credit, innovation, start-up, and so forth—through complementary investments within each asset class or by adjusting the overall asset allocation.

Step Four: Performance Monitoring

A best practice for any portfolio, and especially for a portfolio that is actively designed to generate positive impact, is ongoing monitoring and evaluation. In alignment with the investment policy statement, benchmarks should be set for financial and impact performance. Regular review of portfolio performance against these benchmarks will indicate necessary revisions to the investment strategy as well as providing an opportunity to adjust investment strategy based upon new factors such as changing client circumstances or market conditions. By taking a formative approach to portfolio monitoring, the comparison of actual outcomes to expected outcomes highlights both the strengths and weaknesses of an investment strategy. These insights inform potential revisions that need to be made to the portfolio strategy to better meet client objectives. This is a unique opportunity to create value within the investment relationship by engaging a financial advisor and an opportunity to strengthen the relationship between a client and advisor based on a more complete understanding of client values.

[4] The reader is directed to our bibliography for references to a number of papers and support materials.

The Bondage of Benchmarks and the Investor as "Market"

Comparing any given investment strategy with a complimentary benchmark is the bread and butter of traditional investing. However, the use of benchmarks can be a limiting practice for both traditional and impact investors, having the effect of constricting one's expectations of return and limiting one's understanding of how any given strategy may be executed within a dynamic market. The portfolio profile of an investor may not conform to that of other investors in the market at a similar level of wealth—yet if the total performance objective of the investor is being attained, the financial performance of an underlying benchmark may be completely irrelevant. In this sense, the investor *is* the "market," defining what financial returns and impact are acceptable for the goals she is pursuing.

When choosing to make use of benchmarks to assess performance, the first question one must ask is whether the comparison benchmark is, in fact, truly comparable. Perhaps of greater importance is the fact that every investor should consider whether an outside benchmark would be effective for assessing performance—whether at the portfolio or individual investment level. For example, if an investor's objective is to use capital to sustain the planet, they may opt to invest in a Real Asset[5] allocation that could increase their exposure to long-term investments for which the "exit" is decades away. Or if an investor is committed to placing their capital within a specific geographic region, investing in global equities may not be relevant to or advance their ultimate, long-term investment goals. In either case, what "the market" does or does not deliver in terms of performance may be irrelevant to the goals of the individual investor. Regardless of the final decision investors and advisers may make with regard to how best to assess comparable performance, as Mathew Weatherly-White of The CapRock Group (a leading impact investing advisory firm) has declared, "We should seek to liberate our clients from the tyranny of the benchmarks!"

[5] Real Assets refers to such "hard" assets as real estate, forestry, ranch land and so on.

DEFINING IMPACT ACROSS ASSET CLASSES

Whereas the earliest examples of impact investing were easily classified into alternative investment strategies creating what could be thought of as "direct impact," the evolution of the field has enabled a Total Portfolio Management approach to impact that wasn't possible even ten years ago. There are now credible impact options across most asset classes, and an increasing number of options every year, as well as leading impact investors who have demonstrated how Total Portfolio Management works in action generating various types of impact across various types of investment strategies. Many publications that precede this Brief have provided extensive examples of impact investments available in various asset classes[6]. The examples listed here are only for illustration and are but a few options among many. Those looking to invest for impact should engage in their own process of due diligence and inquiry; please note that these examples are not meant to be taken as investment guidance or advice.

Cash and cash equivalents

Easily overlooked, moving cash to community institutions is low hanging fruit for providing impact alternatives to individuals at any asset level. By moving deposits from a multinational bank to a community development bank, regional bank or local credit union, investor assets are supporting small businesses, affordable housing, and other community banking activities that have positive social impact in low-income communities. Mobile and online banking has made these alternative banks as accessible as major financial institutions. Several networks within this asset class offer resources for investors to learn more about cash investment opportunities, including the National Federation of Community Development Credit Unions, and the Global Alliance for Banking on Values.

Private and Public Fixed Income

Making impact investments through fixed income products is also widely accessible and may be directed toward a range of social and environmental issues. One fixed income example is World Bank Green Bonds that are AAA rated and address carbon footprint reduction while advancing energy efficiency in emerging markets. The Calvert Green Bond Fund — a fixed income mutual fund — invests in corporate bonds in clean technology and sustainability, as well as project focused muni bonds, real estate, and international development that address environmental challenges. Advisors can also help clients to directly invest in municipal and corporate bonds that finance projects with social or environmental impacts. A first-of-its-kind impact-rated bond portfolio, managed by SNW Asset Management and scored by HIP Investor, provides investors with a quantified assessment of the impact realized by their investments. Finally, The Nature Conservancy's NatureVest offers fixed income options to impact investors interested in

[6] See Resources

financing critical habitats around the world—while receiving a financial return competitive with other offerings in the fixed income arena. As increasing numbers of bond products are introduced investors must continue to call for real transparency and objective analysis of the degree to which such products actually invest in sustainable impact as opposed to simply finance new, traditionally conceived development projects. Over years to come, many new offerings will claim impact and sustainability—and it will be up to the market to track their total performance relative to their claimed intent to be either "green" or "impact."

With a more social objective, nonprofit loan funds are additional options within a fixed income allocation. Since nonprofits and co-operatives cannot take equity capital, exploring ways to support these organizations with long-term debt financing, such as loans or loan guarantees, can provide necessary capital for program expansion. Calvert Foundation, RSF Social Finance and the Non-Profit Loan Fund have long-standing note offerings which finance work of non-profit and for-profit organizations on fixed terms and are broadly available to investors.

Fixed income investments in microfinance are primarily made through private debt funds available only to accredited investors. There are many private debt funds being deployed for issues beyond microfinance, including sustainable agriculture, community development, and clean energy. ImpactAssets has developed investment notes that increase access to these high-impact strategies. The IA Global Sustainable Agriculture Note and Microfinance Plus Note are five-year impact securities that will put capital to work through sub-advisor relationships with established impact fund managers. These notes will be distributed broadly and designed to democratize access to impact investing by lowering investment minimums. The TriLinc Global Impact Fund is another investment product that invests through private debt and is available to non-accredited investors. The Fund invests in small to medium size enterprises (SMEs) in emerging markets and investors can participate with as little as $2,000.

Public Equity and Debt

Most advisors invest in public equities through mutual funds or separately managed accounts. In separately managed accounts, the advisor has more control to develop customized screens based on a client's values. Aperio and Advisor Partners are two examples of firms that specialize in hyper-customized separately managed accounts and accommodate a wide variety of impact screens. This level of customization has high minimum investment levels, but wealth advisors may be able to pool client assets at their firm to provide access to public equity impact strategies through a separately managed accounts. The screens available in mutual funds tend to be more general because they are based on popular interest.

There are three primary ways investors may pursue impact through public equities, regardless of the vehicle. Divesting from stocks that have negative impact, such a fossil fuels or sin stocks (alcohol, tobacco, firearms) was one of the first efforts in the socially responsible investment arena and many managers have

been profitably investing with negative screens for many decades. While a traditional approach to investing would assume that any limit placed upon investments open for consideration would result in financial returns below those generated by investment strategies without such restrictions, many years of research indicate these strategies actually perform in line with—and may even exceed—traditional benchmarks.[7]

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The second approach is by integrating environmental, social, and governance (ESG) criteria into the selection and due diligence process and may be a more pro-active approach to promoting sustainable practices within corporations. Fund families such as Pax World and Calvert Investments have mutual funds across multiple investment styles that all apply ESG criteria in their selection of holdings. In many cases, applying ESG criteria has actually been shown to outperform the benchmark by capturing value that is not widely taken into account by the market.

The negative screens of Responsible Investing is often augmented with a third approach to creating impact through public equities: shareholder activism and engagement. Mission-aligned managers generally will vote proxies on behalf of clients to advance responsible governance and other practices. There are also organizations such as As You Sow and Sum of Us that organize and activate shareholders to hold corporations accountable for negative environmental or social practices, such as fair pay, diversity, or transparency. And investors may contract with organizations such as Proxy Impact to ensure their proxy votes are consistently exercised in accordance with their impact agenda.

Private Investing

The landscape of private equity impact investment managers is increasingly diverse, across geographies and issue areas. The ImpactAssets 50 and ImpactBase[8] are centralized resources for identifying and learning more about established impact managers in private debt and equity. Because these impact fund managers are directly investing in ventures that increase social and/or environmental issues as they grow, this is a very targeted approach to addressing impact challenges.

Impact investors comfortable with the risk, illiquidity, time and cost requirements of direct investment frequently identify individual deals to support social entrepreneurs directly advancing the issues they care most about.

[7] http://www.ussif.org/performance
[8] The GIIN published ImpactBase Snapshot in March 2015, a comprehensive analysis of the 300+ impact investment strategies on ImpactBase.

Direct investments in impact ventures can be made using private debt, equity, or convertible debt (a debt/equity hybrid). Transaction costs for direct investments may be high and require specialized expertise, but there is constant demand for early and expansion stage capital to scale organizations with demonstrated impact. Organizations such as Toniic and Investors' Circle facilitate direct investments by coordinating member efforts to source potential investments, perform due diligence, and gather best practices across transactions.

Real Assets

This category has tremendous opportunity for impact and appeals to many investors because of the tangible nature of the investment. Within the category of real estate development, Jonathan Rose Companies is but one example of a leading mission-based, green real estate policy, development, project management and investment firm. Their integrated approach to development has demonstrated significant social and environmental impact, alongside consistent financial returns. Sustainable real asset strategies have been used for decades in farmland, ranchland, and timber but some have not explicitly identified their funds as impact investments. Lyme Timber, Beartooth Capital and Farmland LP, among others, have each raised and deployed multiple funds to protect and promote sustainable natural resources. These funds tend to be long term (7-10 years or beyond), and may provide a bond-like return as well as long-term private equity upside, although as with any investment one should be cautious in predicting ultimate exit valuations.

Grants

Investors and advisors have traditionally managed their philanthropic grantmaking entirely separate from their financial investments. Within a Total Portfolio Management approach, grants are a powerful tool to achieve the overall objectives of a unified portfolio. Grant capital may be used to provide technical assistance to accelerate social ventures to investment readiness, can subsidize transaction costs for due diligence or deal structuring, and can fund high-impact programming to extend the work of an existing investment[9]. Organizations such as The Eleos Foundation and The Grassroots Business Fund are also good examples of this type of approach. These are just two examples of how grant capital and investment capital can work hand in hand to achieve greater impact than either one can achieve alone. It should also be noted that impact investors should exercise caution when executing these approaches, but syndication structures and other vehicles may be used to appropriately respect rules regarding self dealing which might arise when making both philanthropic and market-rate investments in proximity to each other.

Program Related Investments

Clients interested in using their philanthropic portfolio to make impact investments may catalyze impact through the use of program-related investments (PRIs). Still widely underutilized and misunderstood by many foundations, PRIs may count toward the 5% annual charitable distribution requirement.

[9] ImpactAssets Issue Brief #10 discusses a variety of ways that grants can unlock impact investments.

The guidelines set by the IRS require that the investment be made in alignment with the charitable purpose of the foundation and that its sole purpose cannot be to produce financial return.[10]

Because investors are accustomed to evaluating investments on market-rate return and evaluating their philanthropic options by social and environmental impact there is a wide middle ground of opportunity for investing in below market rate impact opportunities that has remained largely underexplored. However, the capital returned from program related investments may then be utilized to generate additional impact in the future. Mission Investors Exchange published a helpful primer on PRIs in 2012 and in 2013 the Rockefeller Foundation funded an independent evaluation, conducted by Arabella Advisors, of 12 years of PRIs made both domestically and internationally.

Impact investments that take on exceptional risk or are expected to produce concessionary return are ideal for PRIs and have impact potential beyond the individual investment. These catalytic investments may also be used as one tool to support develop of an emerging market opportunity or attract traditional capital sources by absorbing a disproportionate amount of risk. Importantly, an advisor who wishes to support a client's PRI desires should become reasonably well versed in the intricacies of PRI regulations before embracing this potentially powerful tool.

RISK, RETURN, AND IMPACT

Constructing an impact portfolio requires integrated evaluation of risk, return and impact[11]. As proclaimed in the recent G8 report on impact investing,

> ***"This requires a paradigm shift in capital market thinking, from two-dimensions to three. By bringing a third dimension, impact, to the 20th century capital market dimensions of risk and return, impact investing has the potential to transform our ability to build a better society for all."***

This is no small task as there may be additional kinds of risk to evaluate for an impact investment and multiple levels of impact to consider along the range of financial return. This makes a holistic, Total Portfolio Management approach especially valuable for those interested in impact investing. For an investor to achieve their overall objectives, the risk, return, and investment options are evaluated not in isolation but as complements to each other and as essential components of a larger whole.

[10] ImpactAssets' Issue Brief #12 provides additional detail on making Program Related Investments out of a foundation or donor-advised fund.

[11] ImpactAssets Issue Brief #2 explores multiple dimensions of risk and the "New Efficient Frontier"

Types of Risk

Understanding risk within impact investments, and subsequently designing a portfolio with appropriate risk for the investor, can position impact investors to see market opportunities overlooked or misunderstood by traditional investors. To begin with, impact investors consider all the same initial risk elements as traditional investors. These may include first fund risk, manager risk, specific aspects of market risk and so on. Again, it is important to remember that impact investing in many ways simply takes traditional investment practice and augments it with considerations of social and environmental value creation. And when considering risk and return, impact investors can allocate risk across a portfolio in the same way as traditional investors.

With that idea in mind, it is also important to understand that "impact risk" may take some effort to define and manage. Specifically, the perception of risk, whether real or imagined, has been a major hurdle for the growth of impact investing. Various reports have attempted to unpack and address the multiple dimensions of risk to unlock additional impact investments. For some traditional investors and advisors, the fact that something is new to them means they view it as having greater risk than it may in fact carry. For example, micro-finance debt has provided many impact investors with low volatility and uncorrelated, consistent returns for many years. While these investors are quite comfortable allocating a portion of their portfolio to such funds, to mainstream investors unfamiliar with this category micro-finance may still carry the aura of an "exotic" investment opportunity and view it as quite risky. As discussed further below, investors not familiar with that segment of the market may "mis-price" the risk of such investments and, in the process, miss out on viable investment opportunities. In this way, it is interesting to observe that within certain areas of traditional investing (venture capital, for example) the ability to take greater risk in favor of potential future returns is lauded, while those same traditional investors unfamiliar with how to assess risk within impact investments such as sustainable agriculture or micro-credit may wrongly view impact investing as carrying too great a risk in exchange for the financial returns one might project.

Bridges Ventures and Merrill Lynch produced *Shifting the Lens: A De-risking Toolkit for Impact Investing* in 2014, which includes an analysis of the five types of risk that are most relevant to impact investing, along with tools to mitigate or "de-risk" each type of risk. Of course, risk varies depending on investor expectations and the individual investment, but the tools to de-risk an investment are far more accessible than tools to boost financial returns. The types of risk identified in the report are Capital Risk (loss of principal capital), Exit Risk, Unidentifiable Risk, Impact Risk, and Transaction Cost Risk.

From the opposite angle, many investors have made the case that ESG and impact investing actually reduce or mitigate investment risk. For example, some ESG strategies do so by investing in sustainable management in companies that face less regulatory risk in the face of impending climate change regulations and less reputational risk due to corrupt or unjust practices.

It is also interesting to note that impact investments in emerging markets, especially in private debt and equity, may be largely uncorrelated to developed global markets and may therefore provide risk mitigation in times of a financial meltdown such as the crisis of 2008.[12] Furthermore, for many impact investors the risks of permanently destroying our environment, rising inequality, and other looming social and environmental challenges pose far too great a risk to not address with the assets they have available.

Types of Impact

Much of the foundational work for Total Portfolio Management has focused on the development of frameworks to consider multiple layers of potential impact. Often visualized as a bull's-eye or capital investment spectrum, these frameworks allow categorization of investment options by their expected impact. At one end, there are investments that are contrary to mission. When transitioning a traditional portfolio to an impact portfolio there may be existing assets that fall in this category which are important to identify and create a plan for reallocation. Next, there is a category of investments that produce no material benefit or harm in relation to investor objectives. This is generally the category that negatively screened funds would fall into. Moving into general benefit, this category of investments may apply ESG criteria or broadly promote economic development or environmental sustainability.

The category of relevant benefit begins to narrow the lens to the specific objectives of the individual investor but still takes a relatively broad view of the investment options that have a relevant impact. For example, an investor that has a specific objective of supporting women and girls may make investments into affordable housing and health that do not specifically target women, but clearly support the intended impact of the portfolio.

Moving to the direct impact categories, while it is not necessary to concede financial return for impact, and in fact the relationship between impact and financial return offers demonstrably low correlation, some impact investors intentionally choose to make investments that may be concessionary in some way to achieve elevated, broader or deeper impact. These are often categorized separately from direct impact investments that are expected to deliver attractive risk-adjusted financial returns. This distinction is made so that the expected vs. actual financial and impact returns may be appropriately evaluated for different types of direct impact investments.

Some believe asset owners may achieve the most direct and targeted impact through philanthropic investments. And, as previously

[12] The same may not be said of public markets, so the reader is cautioned in that regard.

mentioned, grantmaking is important to include on the capital spectrum of how we consider *all* the capital one may deploy since it can be a valuable tool for reducing risk, increasing impact and even increasing return within a holistic portfolio approach. That said, significant and direct impact may still be achieved in other, non-philanthropic categories of investing. Therefore, when considering "impact" across a variety of asset classes within a portfolio, many investors take a blended approach by asking, *What is the comparative financial return this investment category offers and what is the best way to think about the nature of the impact it creates?* Remember that, especially for impact investors in the United States, while philanthropic capital may not provide a direct financial return to the asset owner in the future, charitable gifts to a donor advised fund, family foundation or nonprofit entity *do* provide financial benefit to the donor and in that way offer financial "returns" to impact investors making use of one or more of those vehicles as part of an overall approach to investing capital for impact.

Metrics and Ongoing Evaluation

For many years, the general question of metrics and how best to apply them within an impact investing strategy has been the subject of much debate and deliberation.[13] Because of the additional complexity of constructing a portfolio that considers risk, return and impact, metrics and ongoing evaluation play an important role in achieving client objectives. Within traditional investing, metrics have been largely refined for risk and return but are still being developed for measuring impact, which is critical work for the integration of impact into investment performance evaluation. Impact expectations and criteria should be established within each asset class, along with the process and tools for collecting, organizing, evaluating and reporting specific, measurable metrics. If some investments do not report their impact, it is still important to identify criteria for evaluation that connects investments to the impact thesis and objectives laid out in the investment policy statement.

The most relevant metrics are those that allow the investor and advisor to evaluate whether the total performance of the portfolio is in line with the investor's objectives. Some standard financial and impact metrics will be appropriate, and in many cases the impact metrics will need to be customized in order to inform ongoing evaluation. In some cases, even if a particular investment offers lower financial returns, it may out perform with respect to its intended impact, and vice versa. Depending on the objective of the portfolio, the allocation to such an investment may need to be reweighted or reconsidered in relation to total performance of the portfolio.

Ongoing evaluation is an opportunity to re-evaluate risk, better understand the nature of returns, and course-correct for sustainable impact. So too is portfolio construction not a one-time exercise to set the course, but rather an iterative process of trying, evaluating, learning, and adjusting.

[13] For a reflection on the current state and challenges of impact metrics and reporting within impact investing, please see *The Metrics Myth: Why Quantitative Presentation of Qualitative Value Matters*.

CONCLUSION

Text

Investors are increasingly aware of both the positive and negative impacts that may be generated through the investment of financial capital. And a growing community of investors, as well as a robust body of research, does not accept the notion investors must accept a trade-off between financial return, risk management and social/environmental impact. Total Portfolio Management provides a powerful set of tools for aligning client assets with their objectives through smart and sophisticated strategy. At each step in the process, from creating the investment policy statement to setting asset allocation, selecting managers/investments, and creating processes for ongoing investment performance evaluation—there are opportunities to increase the impact of an investor portfolio while ensuring financial objectives are met. While this era of portfolio construction that incorporates risk, return and impact may seem new, the impact products available in every asset class are growing rapidly. A total portfolio approach is far more accessible than it was even ten years ago and leading investors are providing the proof points that impact investing is not an asset class, but rather an overall approach to maximizing the total performance of a portfolio in pursuit of generating sustained, blended value within the world we want to live in and pass along to generations to come.

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These Briefs are produced by various ImpactAssets staff as well as collaborators and should be considered working papers — your feedback on the ideas presented and topics addressed in IA Issue Briefs are critical to our development of effective information resources for the field. Please feel free to offer your thoughts on this Issue Brief, as well as suggestions for future topics, to Jed Emerson at JEmerson@impactassets.org. Additional information resources from the field of impact investing may be found at the IA website: www.ImpactAssets.org.

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RESOURCES

In recent years a growing number of investors and researchers have developed an interest in how to structure a portfolio of capital in alignment with values and in pursuit of impact. While we feel the following papers have been seminal in advancing thinking and practice in these areas, the field is growing rapidly and there may well be other documents of note. Naturally, readers should view this chronological list as a starting place for their own research and reading on the topic.

Readers should also note that a number of impact investors are in the process of documenting and publishing information on their experiences of Total Portfolio Management. For example, RS Group (a Hong Kong-based family office), Gary Community Investments (located in Denver, Colorado) and various members of the 100% Impact Network will soon be publishing reports and information on their experiences and lessons learned. The authors encourage readers to watch for many new case studies in the near future that will no doubt also be of interest.

A Capital Idea: Total Foundation Asset Management and the Unified Investment Strategy, Emerson, Jed, January 2002

The Investors Toolkit, Emerson, Jed, Freundlich, Tim and Berenbach, Shari, 2004.

The Prudent Trustee: Evolution of the Long Term Investor, Emerson, Jed, Little, Tim, Kron, Jonas, 2005

Solutions for Impact Investors: From Strategy to Implementation, Rockefeller Philanthropy Advisors, November 2009

Investing for Impact: Case Studies Across Asset Classes, The Parthenon Group, Bridges Ventures, March 2010

A New Foundation for Portfolio Management, Christian, Leslie, September 2011

Invest With Meaning: An Introduction to a Unified Investment Strategy for Impact, ImpactAssets, 2011

Total Portfolio Activation: A Framework for Creating Social and Environmental Impact Across Asset Classes, Tides Foundation, Trillium Asset Management and Tellus Institute, August 2012

A Portfolio Approach to Impact Investment, Yasemin Saltuk and Ali El Idrissi, Published by J.P. Morgan, Global Social Finance, 2012.

Evolution of an Impact Portfolio: From Implementation to Results, Sonen Capital and KL Felicitas Foundation, October 2013

Shifting the Lens: A De-risking Toolkit for Impact Investments, Bridges Ventures, Bank of America Merrill Lynch, January 2014

Impact Investing: A Primer for Family Offices, World Economic Forum, December 2014

Measuring Impact: Subject Paper of the Impact Measurement Working Group, produced by the G-8 in 2014.