

# THE IMPACTASSETS HANDBOOK FOR INVESTORS

GENERATING SOCIAL AND ENVIRONMENTAL  
VALUE THROUGH CAPITAL INVESTING

Edited by  
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# 1

## **Construction of an Impact Portfolio: Total Portfolio Management for Multiple Returns**

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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, volatile, high risk and a strategy available only 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 with the generation of social/environmental impacts, 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,” which is to say 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 chapter, 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 simultaneously asking,

*What is the best way to think about the nature of impact within this particular investment or asset class?*

When one takes 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 individual investors interested in taking a more holistic approach to their investment strategy as well as financial advisors who receive growing numbers of client requests to consider the social and environmental impacts of their portfolio as well as structure capital investments to advance positive impact.

Regardless of how much money you may have to invest, and while specific strategies may differ, it is increasingly possible to achieve positive impact across all one’s capital investments. And every month sees investment products being brought to market that make impact investments available at lower minimums to a broad cross-section of investors at different levels of wealth. While not yet an “off-the-shelf” approach, impact investing is a growing option for many investors. This chapter is offered as an introductory guide to help investors and advisors construct portfolios that integrate impact appropriately across asset classes. We refer to this practice as Total Portfolio Management.<sup>1</sup> Within such a Total Portfolio Management approach, all capital—philanthropic, near-market and market-rate—is managed to optimize financial performance across asset classes while maximizing the impact potential of each asset class you are invested within.

## 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 personal financial priorities

and objectives. And for individual investors operating without an advisor, the process of exploring and identifying what investment options are available in which asset classes can be one of discovery and real excitement. As your investment 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 Management, the fundamentals of traditional investment management still apply.<sup>2</sup>

As discussed below, it is 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 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 chapter offers an introductory overview of these ideas and suggests some initial steps investors may take 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 skilled investor knows, the first step in professionally managing assets is to define your core goals and objectives. These typically cover such issues as:

- date of future retirement,
- potential college or other education expenses, and
- 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 engaging in a traditional investment approach or crafting the asset allocation, investment policy statement (IPS) and investment portfolio in a more customized manner.

These factors are considered when developing a traditionally managed portfolio of investments and are equally important for effectively constructing an impact portfolio. However, in addition to standard “financial only” discussions that inform the creation of an investor’s profile, the process of creating an impact portfolio also includes simultaneous exploration of the investor’s expectations and objectives with regard to the generation of social and environmental impact.

It is important to understand the “right” answer as to what should constitute 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 investor may be spending her professional career focused on combating climate change or protecting the environment, and so will most likely not feel comfortable with financial returns generated largely from significant investments in fossil fuel production. And yet another investor may have a deep connection to his community or region and find tremendous value in identifying investment opportunities in regionally specific local food systems or area affordable housing.

Regardless of the ultimate goal and set of investment strategies, exploring your core values and expectations is critical to attaining a broader understanding of your definition of the purpose of your capital in order to create a strategy that best advances toward your goals.

## Step Two: The Investment Policy Statement

The Investment Policy Statement (IPS) is a document that outlines the overall vision and goals for the investment strategy. For those working with an investment advisor, the IPS outlines how the client’s investments will be managed over the course of a year

or more. The reader will find this topic referenced in the following two chapters as well, from the perspective of investment advisors. However, even if you are not working with an advisor, having a single memo outlining your vision, goals and objectives as well as detailing how you want to allocate your investment dollars across various strategies and asset classes is a good document to have. Either way, the IPS serves as a guide star for family members, advisors and, if you have one, your investment committee—even if it consists only of you and your partner or pooch!

While important for all types of investing, for clients seeking to intentionally integrate impact across their entire portfolio the IPS is critical. Ad hoc impact divestment or investment is not a sustainable strategy for impact. The IPS provides a framework for evaluating current holdings, exiting investments that are not consistent with the evolved investment strategy and assessing 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. Although there is substantial evidence to support the position that impact investments may deliver market-rate returns for any given asset class, many financial advisors and investment committees are resistant to change, mistakenly believing investing with an impact orientation might threaten the fulfillment of their financial fiduciary responsibilities. Since the IPS is the foundational agreement between an advisor 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 reaffirmed or modified based upon any number of factors. Such factors might include significant shifting of the overall market context or evolving investor intent—but should not be revised in efforts to try to “time the market.” At the same time, 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!

## The Portfolio Carve-Out

### A Possible “On Ramp” to Total Portfolio Management

While the focus of this chapter is on a holistic, Total Portfolio Management approach to investing, we acknowledge that some individuals 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 the 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. Such an approach may also be required in order to best manage 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.

Second, while in the past there may have been challenges in executing impact investing that helped justify taking a multiyear, incremental approach to deploying investment capital, more recently a significant increase in the availability of impact investing product—and the ever growing successful track record of managing that product—makes it possible for many 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, discovery and planning. 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.

It comes as no surprise that various investors will handle the specifics of this investment process differently, but it is in the IPS where investors outline what is referred to as an impact thesis. This will entail drafting of an investor-specific understanding of impact

and broadly defining how you 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 or sharply stated sentences. Either way, it is critical the IPS explore this question with enough definition to guide both the individual investor operating on her own, as well as an investment committee and/or wealth advisor who may be working with individuals with larger portfolios and assisting the asset owner in their decision-making process.

Setting a leading example, The F. B. Heron Foundation wrote their IPS 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.”\* You will find their full IPS on their website and other examples may be found in the web pages included in the resources section of this handbook.

### Step Three: Asset Allocation

With an understanding of your financial and impact performance objectives, as well as risk tolerance and time horizon, investors should now establish the initial structure of the portfolio; this is done through a process of 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 larger fixed-income allocation. There are sophisticated asset allocation strategies used to optimize the classic risk-return trade-off upon which traditional portfolio construction is based, and these strategies may be adapted to include consideration of impact across asset classes. An investor or advisor who

\* Across this volume, any quoted matter from organizations/companies have been taken from their website and readers can look up the sources for more information.



seeks to thoughtfully integrate impact within a portfolio will evaluate where impact is redundant, complementary, or catalytic in relation to the ultimate objectives of the investor as needs to be expressed through your portfolio.

When taken together, each of the specific investment allocations 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 microloan 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 you should seek to structure the total portfolio to best manage your capital in a manner that seeks to generate financial and impact returns in alignment with your specific goals.

## Manager Search, Due Diligence and Selection

After the asset allocation is established, the process of you and your advisor researching managers, conducting due diligence on those managers and selecting possible investments for consideration may begin. Chapter Seven of this handbook explores various aspects of due diligence in greater detail, but for now you should know a good starting place for your research are the socially responsible and impact investing communities that have compiled resources for identifying investment products with social and environmental criteria. Refer to our appendix sections for more on this information.

As with all other investment products, specific diligence requirements differ with asset class or deal structure. However, it is always important to take a close look at the background and experience of the people managing the investments, the philosophy behind their approach, the process they use for selecting investments and the total performance (meaning assessment of both impact and financial returns) they have achieved over time.

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 and reporting practices.

If you find you're 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, you may want to pursue an investment that takes on greater 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, shifting your own monitoring and engagement practices or by adjusting the overall asset allocation.

### Key Concept: Know Your Risk Tolerance

When considering your approach to *any* investment strategy, it is critical you be realistic when it comes to the risk you are willing to assume as an investor. If you have a significant amount of assets, a good number of years experience managing your investment process and an investment team to help you engage in deep due diligence then, depending upon your specific investment goals, you may be in a position to take on any number of higher risk direct or fund investments. However, if you are an individual investing on your own, with limited investment capital and managing your assets in order to fund your long-term retirement, it may well be inappropriate for you to take on various higher risk, direct or fund impact investments. Many people are attracted to impact investing because they want to draw as straight a line as possible between their investment dollars and community, family

or individual impact. While admirable, the reality is that the risk of such investments can be much greater and even though you may have access to such deals through crowdfunding and other platforms or via networks and word of mouth, if you are an investor of more limited means there may be a number of reasons why you should *not* engage in higher risk investing—whether or not they are intentional impact investments. Be cautious! Do not invest simply because you “like” an individual or a cause; do not invest simply because someone tells you they have done their homework and you can trust them! Remember: If you can’t afford to lose your money, don’t take on investment risk—regardless of whether it is an impact or traditional investment opportunity!—that might entail your having to lose your investment funds! There are various other ways you can invest with impact (by keeping your cash in a local, FDIC-insured community bank or regional credit union, for example) where you can feel you’re contributing to your local community without taking on greater risk.

### Step Four: Performance Monitoring

A best practice for any portfolio, and especially for a portfolio that is actively designed to generate positive impact, is regular monitoring and evaluation. Chapter Eight of this handbook goes into this topic in greater detail, but for now it’s important to understand that in alignment with your IPS, benchmarks and/or performance goals should be set for both financial and impact performance. Periodic review of portfolio performance against these benchmarks will indicate necessary revisions to the investment strategy as well as provide 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 over time in order to best meet your objectives. For those making use of investment advisors, this is a unique opportunity to create value within the investment relationship by engaging with a financial advisor and an opportunity

to strengthen the relationship between a client and advisor based on a more complete understanding of client values.

### The Bondage of Benchmarks and the Investor as “Market”

Comparing any given investment strategy with a complementary 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 equal 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<sup>†</sup> allocation that could increase their exposure to long-term, ill-liquid 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.

<sup>†</sup> Real Assets refers to such “hard” assets as real estate, forestry, ranch land and so on, but may also include “hard infrastructure” such as solar panels or wind turbines.

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 (and author of the following chapter on impact investing) has declared, “We should seek to liberate our clients from the tyranny of the benchmarks!”

## 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 15 years ago. While there are still some gaps in product and strategy offerings, today there are credible impact options across many asset classes and investors are being offered an increasing number of options every year. And there is also a growing body of case studies profiling leading impact investors who have demonstrated how Total Portfolio Management works in action generating various types of impact across various types of investment strategies. The resources section of this book offers several websites and networks that provide extensive examples of impact investments available in various asset classes. 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; furthermore, please note these examples are not offered 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 have made many of 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 green bonds that address carbon footprint reduction while advancing energy efficiency in emerging markets. One diversified 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. Also worth considering is a first-of-its-kind impact-rated bond portfolio, which provides investors with a quantified assessment of the impact realized by their investments. Finally, one well-known nonprofit focused on environmental preservation offers fixed-income options to impact investors interested in 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 “green,” “sustainable” or “impact.”

With a more social objective, nonprofit loan funds are additional options within a fixed-income allocation. Since nonprofits and cooperatives often 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.

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. One starting place for getting an overview of impact funds presently active across various thematic areas is the Impact Assets 50—known as the “I.A.50.” This is not an investible index or “top 10” list of the best funds, but rather offers you an introduction to the types of funds out there and the way they are structured to generate financial return with impact. Another database of impact funds will be found at ImpactBase and is worth exploring as well.

Product innovation plays a role as some private debt fund structures target greater liquidity, lower minimums and the ability to be held in brokerage accounts. As discussed in the closing chapter of this book, *Getting to Impact*, with some notes, investors may invest in a strategy for as little as \$2,000.

## Public Equity and Debt

Many investors deploy their capital 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. There are also 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 separately managed accounts. The screens available in mutual funds tend to be more general in part because they are based on popular interest.

There are three primary ways you, as an investor, may pursue impact through public equities, regardless of the vehicle. Divesting from stocks that have negative impact, such as 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 constrict the investible universe and thereby 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.<sup>‡</sup>

The second approach is by integrating environmental, social and governance (ESG) criteria into the selection and due diligence process. This can be a more proactive approach to promoting sustainable practices within corporations. Several fund families 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 larger capital market.

The negative screening practices of Responsible Investing are 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 share holders 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 previously mentioned ImpactAssets 50 and ImpactBase<sup>§</sup> are centralized resources for identifying and learning more about established

<sup>‡</sup> <http://www.ussif.org/performance>

<sup>§</sup> The Global Impact Investing Network (GIIN) published ImpactBase Snapshot in March 2015, a comprehensive analysis of the 300+ impact investment strategies on ImpactBase.



impact managers in private debt and equity. Because these impact fund managers are directly investing in ventures that advance social and/or environmental impact 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. 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. Networks 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, there are several leading mission-based, green real estate policy, development, project management and investment firms that have demonstrated an integrated approach to development can have 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. These funds tend to be long term (7–10 years or beyond), and may provide the potential for consistent returns, although as with any investment one should be cautious in predicting ultimate exit valuations.

## Program Related Investments

Asset owners interested in using their philanthropic portfolio to make impact investments may catalyze impact through the use of program related investments (PRIs). This means you would need

to have established a private or family foundation or have created a donor advised fund (DAF). Chapters Five and Six explore philanthropic impact investing in greater detail. For now, you should know PRIs come directly out of the investment pool of a charitable vehicle such as a DAF or foundation. These investments may take the form of private equity, but are more frequently structured as low-interest, yet higher risk, loans. Still widely underutilized, PRIs may count toward the 5 percent annual charitable distribution requirement and may be invested in both nonprofit and for-profit corporations.

The guidelines set by the IRS require these investments be made in alignment with the charitable purpose of the foundation or DAF and that its sole purpose cannot be to produce financial return. Since investors are accustomed to evaluating investments based upon their projected 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 PRIs 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 returns are ideal for PRIs and have impact potential beyond the specific individual investment. These catalytic investments may also be used as a tool to support development of an emerging market opportunity or attract traditional capital sources by being placed in a subordinate position in the “capital stack.” 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.

## Grants, Gifts and Related Philanthropic Investment Capital

Investors and advisors have traditionally managed their philanthropic grantmaking entirely separate from their financial

investments. Within a Total Portfolio Management approach, grants are an effective 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. Organizations such as The Eleos Foundation and The Grassroots Business Fund, among others, offer 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 might 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 that might arise when making both philanthropic and market-rate investments in proximity to each other.

## Risk, Return and Impact

Constructing an impact portfolio necessitates engaging in an integrated evaluation of risk, return and impact, a theme explored in Impact Assets Issue Brief #2, by that same name and released in 2010. The notion of “three degree performance” has now gone mainstream with a recent report on impact investing published by the G7 proclaiming,

This [impact investing] 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.<sup>3</sup>

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 impact options are

evaluated not in isolation but as complements to each other and as essential components of a larger whole.

## 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, but are not limited to:

- first fund risk,
- manager risk,
- specific aspects of market risk, and
- other traditional forms of risk consideration.

Again, it is important to remember that impact investing simply takes traditional investment practice and augments it with considerations of social and environmental value creation. When considering risk and return, impact investors may 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 in light of individual investor perspective and appetite. Specifically, in the past the perception of risk, whether real or imagined, has been a hurdle for the growth of impact investing. Various reports have attempted to explore 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 actually carry. For example, microfinance 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 microfinance may still carry the aura of a “nonconforming” investment opportunity and may be viewed as quite risky. As discussed further below, investors not familiar with that segment of the market may “misprice” the risk

of such investments and, in the process, miss out on viable investment opportunities impact investors seek to capture. 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 microcredit may wrongly view impact investing as carrying too great a risk in exchange for the financial returns one might project.

The Bridges Ventures report *Shifting the Lens: A De-risking Toolkit for Impact Investing*, released in 2014, includes an analysis of the five types of risk 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 may be more accessible than tools to boost financial returns. 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 seek to manage risk 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 business practices.

It is also interesting to note 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.<sup>4</sup> Furthermore, for many impact investors the risks of permanently destroying our environment; rising social and economic inequality and other looming social and environmental challenges pose far too great a risk to not address with the assets they have available. For those investors, engaging in impact

investing strategies of various types is in and of itself a type of risk management.

## 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 that 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 an investment category where some negatively screened funds might be placed—especially those that do not engage in any type of shareholder advocacy or proxy voting campaigns asking the company's managers to improve sustainability or worker rights practices.

Moving into general benefit, this category of investments may apply general 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 overall 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 versus 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 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, nonphilanthropic categories of investing. Therefore, as stated earlier, 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. 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 and is the focus of Chapter Eight of this handbook.

Within traditional investing, metrics have been largely refined for financial 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 IPS.

The most relevant metrics are those allowing 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 and portfolio management. In other cases, even if a particular investment offers lower financial returns, it may outperform 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 reassess 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 one's mix of investments over time.

## Conclusion

Investors are increasingly aware of both the positive and negative impacts that may be generated through the investment of financial capital. A growing community of investors, as well as a robust body of research, does not accept the notion that investors must accept a trade-off between financial return, risk management and social/environmental impact. The Toniic Network, a global network of impact investors, recently published a report documenting the strategies and experiences of some of their members in executing Total Portfolio Management approaches. Entitled *T100: Insights from the Frontiers of Impact Investing*, the report profiles over 50 impact investors with assets ranging from \$2 million



to over \$100 million and describes their experience in executing “100% Impact” investment strategies.<sup>5</sup> Review this report as well as the various profiles of impact investors one can find online to have a better understanding of how others are approaching the construction of their portfolios.

Total Portfolio Management provides a powerful set of tools for aligning investor assets with investment objectives through the development of smart and sophisticated impact investment strategies. At each step in the process—from creating the IPS 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 the era of portfolio construction that incorporates risk, return and impact may seem new, the impact products available in every asset class are growing rapidly and build upon a history of investors aligning their capital with their values and impact objectives. A total portfolio approach is far more accessible than it was even 10 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.

## Notes

This chapter was first published as ImpactAssets Issue Brief # 15 and was revised for this volume.

- 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 Total Portfolio Management here because, as described in this chapter, 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 The steps presented here reference “The Essentials of Portfolio Construction,” Consulting Group, Morgan Stanley Smith Barney, April 2010.
- 3 <http://www.socialimpactinvestment.org/about.php>, p. 43, Accessed March 26, 2017.
- 4 The same may not be said of public markets, so the reader is cautioned in that regard.
- 5 <http://www.toniic.com/t100/insights-from-the-frontier-of-impact-investing/>, Accessed March 27, 2017. Accessed March 27, 2017, <http://www.toniic.com/t100/insights-from-the-frontier-of-impact-investing/>.