THE IMPACTASSETS HANDBOOK FOR INVESTORS

GENERATING SOCIAL AND ENVIRONMENTAL VALUE THROUGH CAPITAL INVESTING

Edited by
JED EMERSON

2

Total Portfolio Management: One Practitioner's Approach

Matthew Weatherly-White

Elsewhere in this book, the reader will discover any number of threads that, when woven together, reveal the tapestry that is Total Portfolio Management (TPM). Better Investing. Better philanthropy. The future of capital markets. Metrics and reporting. How to work with advisors. An inevitable evolution of the way we deploy capital. More responsible stewardship of the environment. Less exploitative markets. And all based on the braided notions that:

1. At some point, it will simply be unacceptable to invest while disregarding the environmental or social consequences of doing so, and
2. Most people, at least subconsciously, want a better world.

This chapter is but one of those threads. And while it has the benefit of a great deal of thought and capital behind it, it should be taken as neither gospel, nor as light-hearted advice, nor as yet another idealistic vision of how the world "should" be. Rather, think of it as a set of reflections on how one might deploy an impact-integrated portfolio along the lines of TPM; guardrails rather than a railroad. For, just as in conventional investing, there are any number of ways to invest well, in impact investing there are any number of ways to create durable, measurable value. In other words, I write not tell you how *you* should pursue impact. I am

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

here to share how *we* pursue impact. And, hopefully, this process of sharing will illuminate your path and provide some amount of encouragement, inspiration or simply permission to get started.

More specifically, this chapter examines one practitioner's application of TPM through the narrower lens of so-called finance first impact investing. Although I have never liked the term *finance first* (we reject the implied impact/finance trade-off), it does capture the essence of how we think about impact investing: solving first for our client's financial requirements, and then pursuing impact to the maximum extent possible within a given asset allocation and a defined thematic orientation. Said differently, we think of investing as deploying capital through various types of investment strategies and instruments to achieve the multiple returns our clients seek—financial performance with integrated consideration of social and environmental impacts. While some of the material in this chapter may occasionally come off as a pitch for my company, I'll ask the reader to understand that this is due to the self-referential nature of this chapter: What I share here is what we do. Other firms—professional fellow impact travelers I hold in high regard—do it differently.

What Exactly Were We Thinking?

Our primary thesis when we began committing firm resources toward building our impact capability in 2007 was simple: we believed that, to invest for impact well, we needed to be able to deploy impact capital with the same rigor, similar risk profile and liquidity characteristics, and wide range of potential financial return objectives as we do on behalf of our conventional clients. In other words, the financial characteristics of an impact portfolio had to reflect similar financial characteristics as those experienced by *all* of our clients … or we wouldn't do it. We felt at the time—and we believe it now with even more conviction—that if we were to both build credibility in the market and meet our fiduciary obligations, we had to approach impact investing as *investors* rather than activists.

What did this distinction mean? After all, if we accept that impact investing is somehow different, that at its core it is about changing global capital markets as we know them, doesn't that imply some form of activism? And if so, how did we square that with the notion we are investors?

It meant, first, we had to build rational, coherent portfolios. Far too often we have seen portfolios—both impact and conventional—composed of ideas that, when disaggregated, can be individually quite compelling. But those same ideas when viewed within the context of an integrated portfolio may make no sense. Surprising correlations and redundancies. Unexpected illiquidity profiles. Risk characteristics that failed to reflect the client's tolerances for volatility or illiquidity. To be excellent impact investors meant we had to nail the allocation work with the same rigor and authority with which we underpinned our conventional portfolios.

This conclusion, paired with the above observations, inexorably led to the realization there was insufficient capital absorption capacity in the impact markets. Investors, to pursue impact, seemed required to accept irrational portfolios simply because there was not enough investable breadth (or depth) in the impact ecosystem. Put simply: When we began our journey into impact we discovered there were not enough investment products and strategies to build the diversified portfolios we needed. And while this wasn't true in the public markets (more on this later), it was absolutely true in the more arcane asset classes on which we depend to generate steady, attractive risk-adjusted returns through complete business cycles … and which so many impact-oriented investors define as "impact."

So we had to roll up our sleeves and join others in the gritty, motivation-busting business of field building: evangelizing, networking, structuring, funding, speaking, helping conventional asset managers understand the space and launch products into it and so on. If we didn't join this collective effort, we would have no path to impact portfolios with the same risk, liquidity and financial performance characteristics as our conventional portfolios. And if we couldn't do that, we didn't see how we could offer impact as a viable solution to our clients.

A Valuable (or at Least Informative) Tangent

I reference the above concept of asset classes and then imply many impact investors believe impact can be defined only within

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

the context of certain asset classes (I offer our thoughts on this dynamic below). But …what exactly *is* an "asset class"? We hear the phrase daily, and its use is just as ambiguous as it is ubiquitous. To level-set this chapter, we'll use the definition offered by Investopedia:

> An asset class is a group of securities [or other investments] that exhibits similar characteristics, behaves similarly in the marketplace and is subject to the same laws and regulations.

Let's accept this definition and use it to highlight an enduring fallacy: that impact investing is somehow an "asset class." It isn't. Period. This notion emerged in the early days of impact investing to create the conditions for an easier commitment. "If people thought they only needed to incorporate impact within their asset allocation," the logic seemed to argue, "then it would be a lot easier to make the commitment." And Wall Street joined in, happily productizing the idea so as to more easily sell it.

But impact investing isn't a discrete asset class. It is a mindset, an investing discipline, applicable across all asset classes. To argue, for example, investing in a municipal bond providing development capital for water treatment infrastructure in Los Angeles is the same thing as making an equity investment in a distributed solar power company in Uganda … well, just reading that should convince anyone that impact isn't an asset class. Yet, the myth continues to linger. Just recently, I was invited to speak at a family wealth conference in Switzerland that proposed to introduce "the emerging new asset class of impact investing." I declined.

Investopedia then continues by listing three asset classes: stocks, bonds and cash. But just the first page of Google results for a search on asset classes reveals that there are actually four asset classes. Or maybe five. And I've seen a pitch deck from a highly regarded investment advisor that detailed no fewer than a dozen … all in the public markets!

And the confusion can get even more bewildering in sub asset classes. For example, if you invest in real estate in the public markets via a Real Estate Investment Trust, is that a "real estate investment" or an investment in a share of a publicly traded company? Or if you buy fixed income in a mutual fund, are you actually investing in fixed income, or are you buying a derivative—a share in a pool of capital, the value of which is derived from the underlying value of the bonds? And do such fine distinctions even matter?

We believe the distinctions matter because without them it becomes quite difficult to develop a sense of a portfolio's future behavior … for all the reasons referenced above. As such, we have settled on six primary asset classes, with any number of sub-asset classes organized beneath them. These asset classes apply to both conventional and impact investments, as they define the *financial* characteristics of the investment (please recall my previous comments on Finance First Impact Investing): liquidity, duration, anticipated financial performance, correlation to other assets and so on. With all of this in mind, The CAPROCK Group's asset class framework is as follows:

- Cash: liquid assets, time deposits, money funds and so on. Held in banks, Community Development Financial Institutions Funds (CDFIs), brokerages and the like. Anticipated returns: 0 percent to 2 percent, depending on the prevailing interest rate environment (in some cases, given global interest rates, returns from some sovereign bonds can be *negative*). Daily liquidity.
- Public Fixed Income: corporate and government debt, traded on a public market (marketable securities). Held by a custodian or (rarely) in certificate form. Anticipated returns: 2 percent to 7 percent, depending on the risk reflected in the instrument and the prevailing interest rate environment. Liquid.
- Public Equity: corporate equity, traded on a public market (marketable securities). Held by a custodian or (rarely) in certificate form. Anticipated returns, over a complete business cycle: 6 percent to 10 percent. Liquid.
- Alternative Investments: typically, either marketable securities or similar instruments, held directly in an unconventional structure like a Limited Partnership (hedge funds are the most common example of this asset class). Anticipated returns: anything from 8 percent to 20 percent, depending on strategy, leverage, securities focus and so on. Semi-liquid.

- Private Investments: illiquid (nonmarketable) debt and/or equity of an operating entity (corporate, nonprofit, sovereign, etc.), typically held directly with the issuing entity or via one of many different fund structures. Anticipated returns: ranging from 8 percent to 25 percent, depending on a wide array of factors. Illiquid.
- Real Assets: illiquid (nonmarketable) investments in tangible property(timber, agricultural, commodities, land, real estate, etc). Anticipated returns: ranging from 5 percent to 30 percent, depending on a wide array of factors. Illiquid.

As you can see, each asset class reflects different liquidity, risk and return characteristics. And each asset tends to perform well (or poorly) in different market conditions. The intended result when blended together is a portfolio that strives to generate attractive risk-adjusted returns through a complete business cycle, while minimizing volatility. Importantly, the point of asset allocation and diversification is never to make a directional or sector bet on the market. And, as such, it is rarely the objective of a diversified portfolio to sharply outperform market benchmarks, particularly over a relatively short time period. For that, asset concentration is required.

So, while the portfolios we build tend to underperform during periods of rapidly rising public equity prices, they also tend to outperform during periods of heightened asset volatility or times of crisis. This performance is entirely by design, and is the objective of many—but not all—market participants. After all, as my first market mentor once told me, “It isn’t how much you make that matters, it is how little you give back!”

Asset Classes: A Bit More Detail

It should be noted that entire books have been written on this subject. It is not our hope to deliver a master class on asset allocation, much less a definitive sense of how one might go about performing security analysis and selection. Instead, in the following section we hope to convey the essence of how an investor would take the steps necessary to building a viable impact portfolio.

The fundamental idea behind risk control through diversification is that the future is impossible to predict. Thus, while

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

most investors believe they can make educated guesses based on a rational assessment of prevailing conditions, and can thus impute some sort of "reasonable valuation" thesis to each opportunity, the truth is … none of us knows. To reference a recent example, who would have built a portfolio based on a Trump presidency, much less on the policies that his administration put into motion in their first 100 days?

More to the point, and more simply, we like diversification. Companies, like investment strategies, face idiosyncratic risks. More diversification should produce more predictable results by commingling these risks. All else being equal, more diversification is better than less diversification. The issue arises in the "all else being equal" bit. And here's where it gets interesting … the most fascinating aspect of impact investing is that it is – in theory at least - both a risk mitigation strategy (climate change exposure, governance transparency, headline damage avoidance, etc.) and an opportunity screen (industrial disruption, new technology, consumer demand, etc.). If you believe, as we do, that risk control and commitment decisions are the only two levers that are entirely within the control of every investor, the conclusion must be that, when pursued with financial rigor, impact investing may be both a material volatility dampener and, potentially, a performance enhancer.

However, I don't want to create the impression that impact represents a free lunch simply because it is "doing good." Investing is hard. Impact investing, in part because it is a relatively new discipline and in part because it adds dimensions to an already complex process, is harder. Good ideas are rare. There are plenty of ways to lose money, and far fewer ways to earn an attractive return. Given this, why not just concentrate all of one's capital in one's very best idea, forgoing entirely the idea of diversification? On the face of it, this is a sensible enough suggestion. It is hard enough to invest in a few ideas well. Why try to invest in many? Furthermore, assuming an investment were to unfold as expected, it would very likely maximize both financial compounding and impact outcomes over time. Unfortunately, such an approach makes no allowance for fallibility.

The reality is we are dealing with sprawling, complex, dynamic financial and social systems. Outcomes can be surprising. The most rigorous diligence can fail to eliminate "confirmation bias." No matter how much research we do or how much we think we know, there is always some chance that, either for reasons previously unforeseen or just plain bad luck, we lose most (or all!) of our capital in a single investment. If 100 percent of one's wealth is invested in a particular company and that company, for whatever reason, loses all its value, there is no way to recover. The loss would be devastating. If, by contrast, that company represented only 10 percent of one's investment portfolio, a bankruptcy would be a meaningful setback, but is not unrecoverable. Clearly, some amount of diversification is necessary to account for the possibility of a total loss. Yet it is axiomatic that the key to both wealth creation and maximizing impact is through asset concentration, not diversification. This tension is not always easily resolved.

And thus we find ourselves torn between two competing objectives. On the one hand, we want to concentrate as much capital as possible into our best impact ideas to maximize the scope of the solution. On the other hand, we want to ensure sufficient diversification to survive negative financial outcomes. With all of this in mind, I feel obliged to point out that there is no "correct" answer to what constitutes optimal diversification. Academic careers have been made or broken by the turning of the publishing wheel on this subject, and we'll not solve it here.

To help think about how one may begin to resolve this issue, I offer the following:

> While it is impossible for us to know the specific investment environment in which we will find ourselves in the future, we do know the future will fall into two of four basic scenarios, with the depth of that orientation hanging from any number of interlocking factors:
>
> - rising economic growth,
> - falling economic growth,
> - rising inflation, and
> - falling inflation.

That's it. Despite the millions of words harnessed by the world's financial media to convince us otherwise, *these are the only four driving scenarios that we, as investors can expect to encounter when making an investment.*

To reference my previous section, different asset classes are expected to perform well (or poorly) in each of these four scenarios. The challenge comes not necessarily in identifying current conditions, as they tend to be fairly obvious. Rather, the challenge lies in building a portfolio that will perform well in whatever future an investor imagines will unfold. No matter how short-term an investor's time frame may be, every investment requires a set of assumptions regarding what the future will hold. And the extent to which one is willing to bet on one's ability to predict the future will drive how one allocates capital.

To use Ray Dalio's (founder of Bridgewater, the iconic hedge fund) expression—"The All Weather Portfolio"—an impact advisor might contemplate allocating a quarter of a portfolio's risk budget to each of these four scenarios. In this way, the investor would be protected from their own inevitable ignorance, their possible hubris … and the potential for an overly cautious allocation. (For a deeper understanding of risk budgeting and its application, I encourage the reader to turn to Google. In this, as in so many things, it is an indispensable resource.)

A Few Thoughts on Pan-Asset Impact Opportunities

It would be absurd to try to list here all of the different strategies that sit under each asset class. However, it would be helpful to at least reference a few to give readers a sense of how the market is evolving, and a feel for the breadth of opportunities now available.

Before proceeding, I should disclose that The CAPROCK Group clients have capital in every single fund referenced below, and in some cases our clients have capital in the management company as well. And please also keep in mind, these are not investment recommendations, but simply examples of products, firms and investment strategies I'm sharing to offer specific examples of how we approach our work. How you approach *your* work will differ based upon your own impact investment goals and objectives. That said, following are the asset class categories we use to create impact portfolios

- **Cash**
  Cash is the most overlooked and underestimated impact asset class. Why? Because some of the most important impact work is

being done in the field of community development, providing start-up, scale and operating capital to small businesses … yet the vast majority of cash is held in banks and brokerage firms that have zero-interest in unlocking the potential social impact of these deposits. If investors even moved 10 percent of their cash balance to dedicated community banks (for example), the amount of capital focused on providing loans to previously underserved communities would be transformative. Firms such as Beneficial State Bank, New Resources Bank, Southern Bancorp and any number of committed community banks and community-oriented pools of capital are doing extraordinary work. But they are constrained because of capital ratio requirements, which are in part solved over time by building larger depositor bases. Thus, if an investor wants to pick the lowest hanging fruit on the impact tree … move your money to a community bank. Do your homework first, of course. But if you leave your cash at a money center bank or your brokerage firm, it is possible your capital is funding companies operating contrary to your values.

- **Public Fixed Income**
  Although a great deal of attention has been paid over the past several decades to the discipline of environmental, social and governance (ESG) factors as applied to public equity portfolios, the world of public fixed income has seen less focus. This is surprising on many levels, not the least of which being that, in general, the list of approved (or condemned) equity issuers maps closely to the roster of debt issuers. Even more surprising is the ease with which one might construct a socially responsible portfolio of municipal securities, as they typically fund services so essential to economic and opportunity equality. Over the past few years, firms such as SNW Asset Management, Breckenridge Capital and Wasmer Schroeder (all three of which are Certified B Corps[1]) have launched thoughtful, professional impact-facing fixed-income strategies.
- **Public Equity**
  It is not hyperbole to say the public markets offer the most developed asset class relative to mission/values/impact. The options are nearly endless. Pioneers in responsible investing such as Trillium, Walden and Boston Common introduced

professionalism and credibility to the discipline many years ago. Huge Wall Street firms such as Blackrock, Goldman, JP Morgan, Morgan Stanley, UBS and others have recently launched (or rebranded SRI (socially responsible investing)) impact strategies. A wide range of other asset managers have begun to offer screened versions of their conventional portfolios and newly minted asset managers are branding themselves as responsible/sustainable firms offering products that reflect their values. In addition, technology is now playing a role, with computer-driven customization platforms beginning to appear in the market as well as a bewildering array of Exchange Traded Funds with an SRI/ESG/Impact orientation now available to any investor. In short, public equity investing is likely the easiest way, outside of cash, for an investor to begin her impact journey. (Note: not only is this the most developed asset class in which to pursue impact, it is also the most controversial, with many leaders arguing that investing in the public markets creates no impact whatsoever.)

- **Alternative Investments**

  One of the most interesting perspectives to emerge from the impact investing community is that hedge funds are by definition not a legitimate impact option for the simple reason that hedge fund managers hope to profit from the decline of stock prices. To which I reply: soft thinking. After all, if a hedge fund were to do nothing beyond "shorting" coal companies and were to generate impressive financial returns by doing so, how would that differ from another fund that chooses to avoid coal entirely? We believe hedge funds have a role to play in portfolio construction, as during periods of adverse market performance they can dampen portfolio volatility while producing acceptable returns. And if they have the same ESG rigor as a long-only equity fund, they may be in a position to profit from the collapse of a poor ESG-rated company.

  Recognizing that "hedge fund" applies to a wide variety of fund strategies, one example of a clearly impact-oriented hedge fund structure is Brevet Capital, a specialty lender and structured finance expert. Most interesting for us is that Brevet's "Impact Sleeve," which is composed of a subset of the all the loans underwritten by the firm, outperforms their conventional portfolio. Note that Brevet is not a conventional long/short equity hedge fund.

- **Private Investments**

  Outside of public equity options, private investing is arguably the most developed impact asset class, particularly in the early growth equity phase.

  A. Seed and angel capital is being deployed steadily, if in a highly fragmented way, with groups such as Investor's Circle, Toniic, CREO, Seattle Venture Partners and a handful of crowdfunding sites (see comments on crowdfunding below) working to unlock early stage impact capital.
  B. There are also several effective early stage venture funds working in the impact space: Village Capital, Unitus Frontier, Golden Seeds and a growing list of others would be on that list.
  C. More typical, growth venture funding is healthy and attracting both capital and deal flow. This category is also continuing to experience positive exits, with firms such as SJF, EIF, Uprising, City Light, Elevar, DBL and many others all contributing leadership to the sector.
  D. At this point, there is surprisingly little late-stage (Private Equity) capital being organized, with Cranemere, TPG's recently announced Rise Fund, and Bain Capital's impact initiatives being the three notable exceptions. We are paying particularly close attention to TPG's acquisition of Elevar Equity and their creation of the Rise Fund which is seeking to raise two billion dollars with the support of the likes of Bono, Richard Branson and other luminaries, as this fund could be the belweather the discipline needs to scale.

- **Real Assets**

  Although Real Assets is not the most richly developed impact asset class, in some ways it offers the most direct and durable link between capital allocation strategy and the creation of extrafinancial value. Mixed-use developers, affordable housing developers, community development lenders and large philanthropic players have all been circling the question of community resiliency for decades. Similarly, sustainable timber harvesting funds such as Lyme Timber and EcoTrust Forest

Management have been reinventing how we utilize a renewable resource like timber in a truly sustainable manner. Lastly, wide-scale conversion of conventional agriculture to sustainable, organic food production at firms such as Iroquois Valley Farms, Farmland LP and Agricultural Capital Management all point to an exciting future for agriculture as a key player in the impact ecosystem.

A Nod to Innovation

In addition to these asset classes that, while perhaps not embraced with unanimity, are at least understood by all capital market participants, there are a handful of impact-specific innovations. The list below is by no means complete, but touches on some of the major developments we've seen over the past few years.

Revenue-based Lending

The premise behind revenue-based lending (RBL) is that startups rarely have the cash flow to support debt and entrepreneurs may fail to appreciate that selling equity early in a company's life can be the most expensive capital they ever raise. Investors have tapped into RBL as a way to align deal structure with the reality of early stage business cash flow, the desire to create and hold wealth at the company level (rather than the investment fund level) and to de-risk the investment by triggering a rapid return-of-capital flow to the investor. The downside of RBL (to the investor) is that if you happen to invest in one of the magical, transformative companies that is eventually worth hundreds of millions, you won't capture any of that upside. But, to many impact investors, this is a fair trade-off.

The last point about RBL, which is unfortunately frequently overlooked, is that the structure does not force a transaction. One of the legitimate complaints about conventional venture fund structures for impact investments is that the fund must exit the company to comply with fund life terms or to generate financial returns so the venture firm can successfully raise subsequent funds. This places the entrepreneur in the uncomfortable position of being forced to consider a sale of her company, perhaps

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

to a larger enterprise that is not mission-aligned. RBL sidesteps that concern by beginning to return invested capital quite early in the company's life and by relieving the entrepreneur of the need to sell the company at a high valuation to justify the early sale of equity.

Social Impact Bonds/Pay For Success

So-called Social Impact Bonds (SIB), or as many prefer to refer to them Pay For Success (PfS) Contracts (or more recently, Outcomes-Based Financing), may be the most hyped innovation in the impact world. In a nutshell, they offer:

- the promise of more efficient public funding of social services,
- the potential to unlock billions of market-oriented impact capital, and
- the possibility of an entirely new sub-asset class focused primarily on impact.

They seek to do this by using private capital to front-load costs for proven interventions, relying on the government to redirect future savings to pay the investors a reasonable risk-adjusted rate of return. A rare win-win-win, right? And yet …

To date, transactions have been expensive, bespoke and time consuming. Proving causation has been fiendishly elusive, despite best intentions and careful modeling. And there remains more than a little confusion in the marketplace as to what exactly these structures are, what problem they are designed to solve and who will be the ultimate beneficiary.

I personally have direct experience with the structure, having launched a PfS initiative in Idaho four years ago. We were able to quickly secure champions in the Statehouse (a mild surprise given the profound rightward tilt in the state's political environment), passing PfS legislation in our first attempt … only to run into a recalcitrant Department of Education. After overcoming that hurdle, we then encountered resistance from the budgeting office, inconveniently learning there was no line-item appropriation for redirected

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

payments upon which a PfS depends. Successfully negotiating new language in a modified version of the bill, we then bumped into resistance from the teacher's unions, as unrelated concerns of job losses surfaced. Suffice it to say that the learning and structuring curve was depressingly shallow. The irony of this is that, with few exceptions, every person involved actually *wanted* this to happen.

This tortuous experience does not for a moment diminish my careful enthusiasm for the structure, as I believe it can encourage government to embrace risk, can bring commercial capital to bear on otherwise underfunded social enterprises, and can unlock potentially massive amounts of financing for proven, evidence-based social interventions. And of course, there are also organizations now established (Social Finance, Third Sector Capital, The Sorenson Institute and others) on a dedicated basis to manage the process of bringing these types of investments to market. Time will tell, but if it can survive the hype factory that surrounds it, I predict that SIB/PfS financing will within a few years be an important sub-asset class in the impact ecosystem.

Crowdfunding

Though not a prima facie impact instrument, crowdfunding has the potential to transform the way social enterprises raise capital, just as it has changed the face of investing in more than one industry. Real estate crowdfunding sites such as RealtyShares and RealtyMogul have brought increased transparency into a sector that had been notoriously opaque and difficult to access. Equity crowdfunding platforms such as IndieGoGo and KickStarter have brought visibility and capital opportunities to enterprises that would have been all but invisible only a few short years ago. And so-called peer-to-peer lending platforms such as Lending Club and SoFi are disrupting everything from small business loans to student loan refinancing to specialty lending. Even corporations are beginning to crowdfund R&D and prototyping activities. Suffice it to say crowdfunding, made possible by the JOBS Act passed by the Obama administration and the subsequent ruling by the Securities and Exchange Commission (SEC) to remove the crowdfunding equity prohibition, is here to stay.

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

At the same time, warning signs are flashing. There have been increasingly strident calls for greater disclosure, more transparency, more imputed liability and more evidence regarding how valuations are determined. AIG has begun to sell crowdfunding insurance. And the roster of scams grows at an accelerating rate. All of this leads some investors to shy away and leaves some regulators with the itch to shut it down. To me, these responses, though understandable, are misguided. Crowdfunding is a form of capital raising that is innovative, disruptive and incredibly compelling. It has the ability to transform the way capital is aggregated, as well as the people from whom it is drawn. And it is incredibly difficult to determine if a failed crowdfunded enterprise was a scam … or just a dud.

Of course crowdfunding will experience growing pains, just as it will surely become the target of Wall Street's army of lobbyists if it begins to carve market share away from the large investment banks. But this is not a reason to torpedo the method. Instead, it is a reason to become informed; to embrace the dictum "caveat emptor." The trick is to be aware enough of the potential for a scam to avoid them, while still being enthusiastic enough by the inspiring stories to remain engaged. And if you are a social entrepreneur trying to crack the capital markets, crowdfunding might be your best solution.

Impact Term Sheets

Of all the solutions the impact community has devised to address the challenges that swirl through the discipline—mission drift, misaligned interests, communicating intention, and so on—none I've seen has the potential that impact-oriented terms sheets offer. Why? Because a term sheet is the only legal document that spells out—in enforceable language—the expectations and intentions entrepreneurs and investors hold when entering a transaction. A well-structured term sheet can:

- link compensation to impact performance, thus ensuring impact fidelity as an investment unfolds;
- lock the mission of an enterprise through a transaction by embedding incentives in the operating agreement (which can be addended to a term sheet);

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

- articulate the mission of the enterprise seeking funding, so that there are no surprises later in the lifecycle of the business;
- formalize and harmonize the legal landscape around impact investing;
- and more …

I would encourage any impact-oriented entrepreneur, asset manager, advisor or investor to spend time exploring The Impact Terms Project's website.[2] Brainchild of pioneering impact investor Diana Proppert de Callejon and legal mind Bruce Campbell, The Impact Terms Project has been a multi-year, multistakeholder effort to capture the best legal thinking around impact deals. The library of sample terms sheets alone is priceless.

More Color on Risk Control, Diversification and Asset Classes

We have touched on the notion of risk control, particularly relative to asset allocation, and observed that it is a multi-faceted topic, far too nuanced for an overview like this. But it is important to note we do *not* subscribe to fixed risk statistics. Every investment can be either more or less risky, depending on a range of factors, the most critical being valuation. How much one pays for an asset, either debt or equity, when one invests is the primary determination of future returns. As an extreme example, stocks of technology companies were extremely risky in 1999, and much less risky in 2009. Subsequent financial returns reflect this risk variability for one simple reason: the lower the valuation when one is making an investment, the higher potential return on invested capital … a rule that many investors neglect during periods of rising valuation.

This reality leads to our rejection of so-called model portfolios. Since most models usually depend upon static risk calculations, they tend not to reflect shifting market dynamics, and thus may undermine both market-responsive allocation decisions, as well as the discounted cash flow method that undergirds our approach to portfolio construction. Perhaps even more problematically, static risk assessment may distort asset class correlation matrices and capital

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

market return assumptions, leading to hidden risks in the portfolio and a possible mismatch between expected return and what an investor needs. But those conversations are for another book!

We then begin to map investable impact themes and opportunities to each asset class. Below are two graphics that illustrate how we think about the intersection of conventional asset classes (as we define them) and impact. Note that there are other ways to think about this intersection and there are any number of ways to categorize investable opportunities.

The first table is an illustration of the way high-level impact strategies map to different asset classes:

**ASSET CLASSES &
IMPACT CONSIDERATIONS**

CASH	FIXED INCOME	PUBLIC EQUITY
Community Bank CDs Community Bank TIme Deposits CDFIs	Impact Overlay Impact Scoring Green Bonds International Aid Bonds *Liquid: 0–45 days*	Positive/Negative Screens Impact Mandates Proxy Voting Shareholder Engagement *Liquid: 0–45 days*
ALTERNATIVES	**REAL ASSETS**	**PRIVATE INVESTMENTS**
Microfinance Long/Short Hedge Funds (Mandate) Structured Finance Small Business Lending Social Impact Bonds *Semi-Liquid: 46–365 days*	Sustainable Timber/Forestry Land Conservation/Rehabilitation Mitigation Banking Affordable Housing Renewable Energy Infrastructure Project Finance *Illiquid: 1–12 years*	Venture Capital Private Equity Direct Investments (Seed, Early, Growth) Private Debt Platform Building *Illiquid: 1–12 years*

THE CAPROCK GROUP

The second is a more detailed way to reflect some of the opportunities, and the impact and financial characteristic of those opportunities, that map to the Real Assets asset class (an investor might construct a similar table for each asset and sub-asset class, to begin identifying the combination of financial and impact characteristics that are available within their impact focus and to help guide her own portfolio construction process):

Real Assets Overview

Real Estate	Land Management	Renewable Energy	Agriculture
Green (Re) Development	Timber/Forestry	Project Finance - Development Phase - Construction Phase - Operational Phase	Supply Chain
Single Family	Rehabilitation		Acquisition & Conversion
Multifamily	Replanting		Crop Management
Affordable Housing	Conservation Easements	Infrastructure	Project Finance
Mixed Use/T.O.D.	Mitigation Banking	Residential Installation	Carbon Credits
Impact	**Impact**	**Impact**	**Impact**
Energy Efficiency	Ecosystem Restoration	Climate Change Mitigation	Sustainable/Organic Practices
Sustainable Materials	Forest Regeneration/Conservation	CO2/GHG Reduction	Increased Productive Capacity
Health Improvements	Sustainable Timber Harvesting	Air Quality Improvement	Decreased Land Toxins
Community Resiliency	Watershed Protection	Job Creation	Ecosystem Integration
Urban Renewal	Biodiversity	Fossil Fuel Independence	Healthier Diets
Financial	**Financial**	**Financial**	**Financial**
Leverage	Harvesting Philosophy	Technology Risk	Valuation Approach
Style (e.g., Core, Value Add)	Income Sources	Monetize Credits	Acquisition Strategy
Components of Return	Valuation Approach	Project Finance Risks	Components of Return
Tax Efficiency	Acquisition Strategy	Regulation Risk	Harvests/Current Yield
Exit Strategy	Exit Strategy	Exit Strategy	Exit Strategy

THE CAPROCK GROUP

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

A Practical Suggestion

It may need not be said, but I'll say it anyway: the "All Weather Portfolio" allocation referenced below in no way implies a specific recommendation, for anyone, at any time. It should be read as nothing more than a hypothetical approach to portfolio construction, a way to think about bringing impact to bear across an entire portfolio, specifically for someone who is not an accredited investor. Any investor who deploys capital along these lines is doing so on their own volition, and accepts full responsibility for the results, including 100 percent loss of capital. Got it? In other words: "hot coffee is hot," Consider this appropriately disclaimed.

Continuing the theme of Ray Dalio's All Weather Portfolio, and framing it through the lens of a typical non-accredited investor, the range of investments would apply to the following four economic scenarios:

- Rising Growth Expectations: Stocks, Commodities, Corporate Bonds, Emerging Market Bonds, Treasury Inflation Protected Securities (or other inflation-linked bonds)
- Falling Growth Expectations: Certificates of Deposit, US Government Bonds (specifically treasuries)
- Rising Inflation Expectations: Treasury Inflation Protected Securities (or other inflation-linked bonds), Commodities, Emerging Market Bonds
- Falling Inflation Expectations: Stocks, US Government Bonds (specifically longer-dated securities)

As mentioned above, one would want to try to quantify the risk profile associated with each of these scenarios, assign a weighting to that risk profile and then allocate – for illustrative purposes only - 25 percent of one's total risk budget to each asset class. Understand that this overview does not take into account any of the nuance associated with risk budgeting, as doing so would consume the remainder of this book. The trick, of course, comes with one's assessment of risk. There is no rulebook for doing so. And while machine learning and artificial intelligence have come a long way, computers aren't even close (yet) to being able to assess the risk embedded in a given asset, at a given time, at a given valuation.

Finally, once one has identified with some degree of confidence one's asset allocation, one gets to indulge in the

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

profound satisfaction of beginning to integrate impact into that allocation. Which is where the rubber finally meets the road. . . .

Yet Another Red Herring: Financial Performance

The discussion/debate/argument over financial performance and impact has flowed for years, and it shows no sign of ebbing. As the editor of this book observed in his introduction, this debate seems to rotate more on bias than on fact, a point with which we, as investors, are all too familiar. Rather than point to the ever-expanding body of evidence proving that there are market-rate opportunities in impact (some studies indicate that there may actually be alpha associated with an impact strategy), I'll simply state that our impact portfolios perform in line with both our conventional portfolio and the expectations we set when building them.

I will, however, point to the exercise that sits at the heart of this fact and that relates back to my earlier comments on "finance first" impact investing: working with our clients to build a rigorous, thoughtful, assumption-heavy Lifetime Discounted Cash Flow (LDCF) model.

What is an LDCF? In short, it is a framework designed to capture all known and anticipated future financial events, both assets and liabilities. Some examples might include:

- Assets:
  - Current and anticipated earned income
  - Current invested assets, taxable and tax-deferred
  - Potential inheritance
  - Life insurance proceeds
  - Lottery winnings
- Liabilities
  - Educational costs for children or grandchildren
  - Purchase of a second home
  - Debt associated with real estate or student loans
  - Future car/boat/plane purchase
  - Down-payment on a first home for your children
  - Investing in your children's business
  - And so on . . .

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

Once as many of these financial events that we can identify have been captured, organized and time-stamped we then apply a discount rate to the liabilities and perform a basic asset/liability present-value calculation. Doing so allows us to answer two absolutely critical questions.

First, given the assumptions in the model, do we have enough *right now* to do everything that we want to accomplish in our life? And second, if not, what rate of return must we achieve from our invested assets to be able to do so (we call this the Target After Tax and Inflation Rate of Return—ATI ROR)? In other words, an LDCF answers the existentially paired questions: "How much is enough … and do I have it?" The reason this is so important is that answering these questions allows any investor to build portfolios composed of investments that fill specific financial objectives …thereby permitting a range of target impact outcomes so long as they meet, in aggregate, the required financial characteristics.

I realize this is an oddly circular form of logic, but given impact investors are pursuing two, linked objectives—financial and impact returns—it makes sense. Why? Because, while it is not mandatory that investors sacrifice impact for financial return, doing so is certainly an option. And in some sectors, markets and enterprises, subsidies are required: tax breaks, direct government support, credit enhancements, first loss equity cushions, or even higher asset management fees. Yet if one can understand an investor's capacity to absorb these subsidized costs via concessionary returns, thereby revealing the ability to build a portfolio that supports the development of impact markets … then why not? After all, impact investors are interested in using market mechanisms to drive capital toward social and environmental challenges. If high transaction costs (for example) can be borne and justified by an investor's ATI ROR, that implies a multifaceted, highly leveragable application of impact.

Which is a long way of saying that once an investor is liberated from the tyranny of an arbitrary market performance benchmark (like the S&P 500), instead anchoring return objectives in clearly defined personal financial needs, the option set for impact is immediately visible.

Rubber? Meet the Road. Integrating Impact

As I've said above, there are many different ways to begin integrating impact into one's investment strategy. After a fair amount of trial and error, we believe the process on which we have settled—identify the financial characteristics of the portfolio and then pursue impact within that framework—works well for us. Why? Because, while it may not be an inspiring way to begin one's journey (it can be far more immediately gratifying to invest in a local artisanal bakery sourcing grains from fields ploughed by rescued oxen), nailing down the financial aspects of a portfolio allows one to think both creatively *and* pragmatically about pursuing impact … to the extent permitted by the asset classes and sub-asset classes identified by the allocation work. The essence of Total Portfolio Management. Boring, yes. But powerful and potentially liberating.

We have discussed, at length, the process of defining an optimal asset allocation. The next step is drafting an investment policy statement (IPS). The IPS can take any number of forms, can reflect aspirational desires just as much as it can reflect concrete guidelines, can be designed as a communication tool, can be used to inform future generations … In short, an IPS can be just about anything, so long as it articulates your relationship to impact, and how that relationship influences the selection of investments.

However, at a minimum, the IPS should:

- include language that captures and reflects your values and why that is driving you to pursue impact: the "why";
- present clearly articulated financial goals, liquidity requirements, return expectation, asset allocation ranges and values-based screens: the "how";
- include a description of your timeline—how long you expect it to take for your to either invest cash, pivot an existing portfolio, reallocate an inheritance, move toward philanthropy: the "when";
- provide some insight into the geography on which you would like to focus your attention—local, regional, global: the "where"; and

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

- perhaps most importantly, detail the various parties involved in this process—family, advisors, board members, beneficiaries: the "who."

We've seen effective IPSs that range from concise three pages all the way to massive tomes. Some have been philosophical. Others entirely pragmatic. Some offer specific investment guidelines. Others give only the vaguest sense of investment direction, leaving the details to be defined, and to evolve, in the future. Some are highly descriptive, with long written passages. Others are a field of bullet points. Some focus entirely internally, on family members and close advisors. Others function as an external communication tool, intended to inform a broad array of stakeholders as to what you intend to accomplish. Some are operational; others inspirational. If you'd like to see a range of great IPSs, visit the Mission Investors Exchange website, where their members share many such documents. I would particularly encourage a close reading of the F. B. Heron Foundation IPS.

The point is that *how* an IPS is composed and what information it includes is less important than the fact that one exists. Once it has been crafted, it becomes a forcing function for action, a set of guidelines to reference as your strategy is implemented, a reminder of why you wanted to pursue impact in the first place, and a communication tool for current and future stakeholders. In short, a well-conceived and dynamic IPS is the armature upon which the impact orientation—through thematic focus and perhaps even a well-articulated Theory of Change—is built.

Elsewhere in this book, a detailed chapter on due diligence and investing methodology is presented. The only element of this process I'd like to add is to highlight the distinction between "values alignment" and "value creation." While this may seem like a distinction in search of a difference (a logical fallacy that regretfully sits at the heart of many poorly conceived impact and other investing strategies), we have found it to be central to effective capital deployment. Why? Because one could make a clearly values-aligned investment that offers precious little in the way of value creation (ESG-screened investing in the public equity markets is a fantastic example), and one could create a great deal of value without that value necessarily being values-aligned (e.g., if one's values incorporates indigenous population education and you were to make an investment in a renewable energy project). Put even more starkly, one could build a theoretical values-aligned portfolio that specifically erodes extrafinancial value by, for example, investing in environmentally destructive companies … presuming that environmental destruction happens to sit at the core of your values!

I have written extensively on this subject on my blog (www.i3impact.com), so will refrain from both treading well-worn ground and consuming unnecessary space in this book. Suffice it to say that when you begin your journey to impact, I encourage you to be intellectually honest and emotionally passionate about where your values lie and how those values may (or may not) shape the specifics of your impact investing strategy.

A Final Word on Investing in the Public Markets

An ocean of ink has been spilled on investing in the public markets, in particular the public equity markets. In particular, the argument on impact availability in the stock markets is a topic of heated debate. As a result, there is very little that I can add to the broad, primarily academic discussion.

I can, however, share our stance:

To coin a phrase, we believe that it isn't "what you own" so much as "what you do with what you own" that matters. In other words, if you sell your shares in Exxon because you believe they misled the world about their role in exacerbating the challenges associated with climate change, the C-suite at Exxon simply doesn't care. There is no functional mechanism to transmit your disapproval through transactions in the secondary market. Yes, if every person who owned Exxon decided to sell their shares, the price would fall enough to get management's attention. But it wouldn't change their essential business. Witness the collapse of Peabody Energy: despite the stock being driven to near zero, they continued to be the largest producer of coal in the United States.

We do believe, however, that here *is* a path to impact in the secondary markets: shareholder activism, engagement and proxy voting. And, fortunately, there are an increasing

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

number of options for impact investors who wish to pursue these options. From activist-inclusive asset management firms to impact-dedicated proxy voting services to shareholder engagement service firms, the avenues to communicate your values to management are robust and accessible. As a result, we believe that an impact investor who is *not* engaging in this way with their public security exposure—either directly or through a third party service provider—needs to take a long, hard look at themselves in the mirror.

The Last Step—Measurement

Sara Olsen, in her chapter on impact measurement, outlines the many issues that simultaneously bedevil and inspire measurement professionals. As advisors, we are not immune to a similar set of challenges and frustrations, nor to the sense of pioneering accomplishment that accrues to those of us who choose to tackle the matter. But, as advisors, we face a specific and surprisingly narrow challenge. It is our responsibility to communicate to our clients, in some fashion, the impact that their capital is having in the world. In other words, we must generate a consolidated impact performance report for each of our clients. And the issues that Sara and her peers face—lack of common standards, a hugely diverse lexicon, informative yet cacophonous reports from our impact investees, a wide array of thematic priorities, and so on—contribute to the difficulty we face. Yet we cannot escape the responsibility. Just as it would be unacceptable to deliver disaggregated financial performance information ("You want to know how your portfolio performed? But why? Isn't it enough that we provide a mountain of performance data related to your portfolio?"), we believe that it will be unacceptable to deliver disaggregated impact performance reports.

The trouble is that there is no off-the-shelf solution for this challenge. So we built it. And, had we known how difficult it would be—seven years of work, an enormous investment in hard and soft costs, and a distressing amount of anxiety, distraction and stress—I don't think we would have done it. But we did, and we believe the solution is powerful. So powerful, in fact, that we were convinced by asset managers, advisors and family offices to spin the platform out into a stand-alone, impact-facing financial technology company: iPAR (www.iparimpact.com).

And while we know that there is a high-value service at the heart of what iPAR does, we don't yet know if there is a business at the heart of what iPAR does. We are nonetheless confident that a company dedicated to bringing transparency and accountability to the impact ecosystem, even if that is only in the form of communicating and reporting (as opposed to measuring or assessing), that company will fill an important gap in the idea-to-execution chain.

Conclusion: It Ain't What You Don't Know That Gets You in Trouble . . .

There you have it. Soup to nuts from one leading practitioner. Some basic advice and guidance. A handful of specific examples. The path we use to debunk, demystify, familiarize and structure our approach to impact.

The one thing that we haven't emphasized yet is the temperament necessary to be a good impact investor. Yes, one must know how to invest—the technical aspects of debt versus equity, of private versus public investments. One must be smart enough to understand how to wrap a set of portfolio decisions around a discounted cash flow model. And one must be patient, disciplined and far-sighted. But these characteristics are just table stakes for committing capital. To be a good *impact* investor, one must also be capable of independent thought, of pursuing a core belief in the power of the capital markets and in the power of justice and stewardship: a blend of Warren Buffett, MacGyver and Mother Theresa.

But, perhaps most importantly, one must remain humble. For, although the discipline is now well into its third-plus decade, and the evidence that impact is a legitimate, market-facing approach to investing is accumulating rapidly, we are only now moving from proof to scale. And as every businesswoman knows, scaling a business requires a different type of thinking.

Just as nobody really knows how the most important fiscal experiment in history will end—post financial crisis central bank intervention—nobody really knows how the notion of impact investing *at scale* will unfurl. Will Wall Street co-opt the discipline, lowering standards in order to bring institutional capital to bear? Will political events stall the momentum that the discipline has built over the last decade? Will hype lead to unrealistic expectations? And until we do know—*and recall that I believe without reservation that impact is the future of capitalism*—we must continue to ask ourselves hard questions. After all, as Mark Twain may or may not have said: "It isn't what you don't know that will get you in trouble … it is what you know for certain that just ain't so!"

Notes

1 Certified B Corps have successfully completed a rigorous vetting and evaluation process—the B Survey—designed to reflect best practices in sustainable, responsible business management. The B Survey provides a framework and certification for companies wishing to benefit society as well as their shareholders. More can be found on B Laboratory's website, the certifying entity: www.bcorporation.net.

2 www.impactterms.org.

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)