BALLENTINE PARTNERS

Debunking the Myths of Impact Investing

March 2014

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The path of development and globalization we have accelerated on for the last 300 years has brought profound advancements in health, technology, comfort, and prosperity, but today we face an ever growing array of challenges both socially and environmentally. Corporate growth and strong capital markets (i.e. stock market, banking system) have been our engines of progress, but we are to a point where those engines have created, or at least contributed to the critical issues we face today like income inequality and environmental sustainability.

It should not be unfathomable that businesses look beyond quarterly profits and act in the interests of society. Profit-maximizing behavior inconsistent with the public good puts too much onus on our bureaucratic system of oversight, taxation, and redistribution. The idea of returning values, accountability, and transparency to corporations and capital markets has the ability to address many of our challenges at their root, and impact investing is pushing us there.

Impact investing comes in a wide variety of flavors, but at its core it's two things: helping a social or environmental cause (Impact) and making money (Investing). As simple as this seems, the concept still eludes many. Imagine that investors could make money by paying for job training for prison parolees, by conserving lands that are key habitats, or by making a business case and force a company to provide more benefits to workers. These are all real examples of impact investing in action today.

Myth 1: I don't mind holding tobacco stocks and I'd rather support philanthropic causes than sacrifice returns, so <u>impact investing is not for me</u>.

There are plenty who hear "impact" or "doing good" and immediately associate impact investing with philanthropy. Impact investing is not philanthropy. There is an important place for philanthropy in the solutions to our social challenges, but until people are willing to give away infinite amounts of money, non-profits will continue to face issues scaling. That impact investments can earn returns to match or exceed traditional investments means they can and will scale to tackle problems on a global scale; there is an infinite amount of capital available for things that make real money.

Impact investing's older sibling, socially responsible investing (SRI), has been around for decades, and has yet to make good on its promises to reform corporate behavior. Champions of SRI will point to the amount that was divested from South Africa during Apartheid, or the campaign against Dow chemical in the wake of the famous Vietnam War photograph of the young girl exposed to napalm. Adoption of the Sullivan Principles in divesting from South Africa was successful, but took from 1977 until 1989 to make significant progress and was helped considerably by political pressures and US legislation limiting trade and increasing taxation for activities in South Africa. The divestment "victory" against Dow chemical was a drop in their shareholder base from 95,000 to 90,000; not exactly a watershed moment. Dow chemical is still in business today, as are the tobacco and alcohol companies that more recent divestment campaigns have targeted. The SRI approach of avoiding bad companies can help investors clear their consciences and serve as a platform to voice an opinion, but it is not pragmatic enough to effect change on its own. A responsible person doesn't litter; an impactful person adopts a highway. Investors who assume impact investing is all about avoidance are selling it wildly short.

Myth 2: Impact investing won't have much effect.

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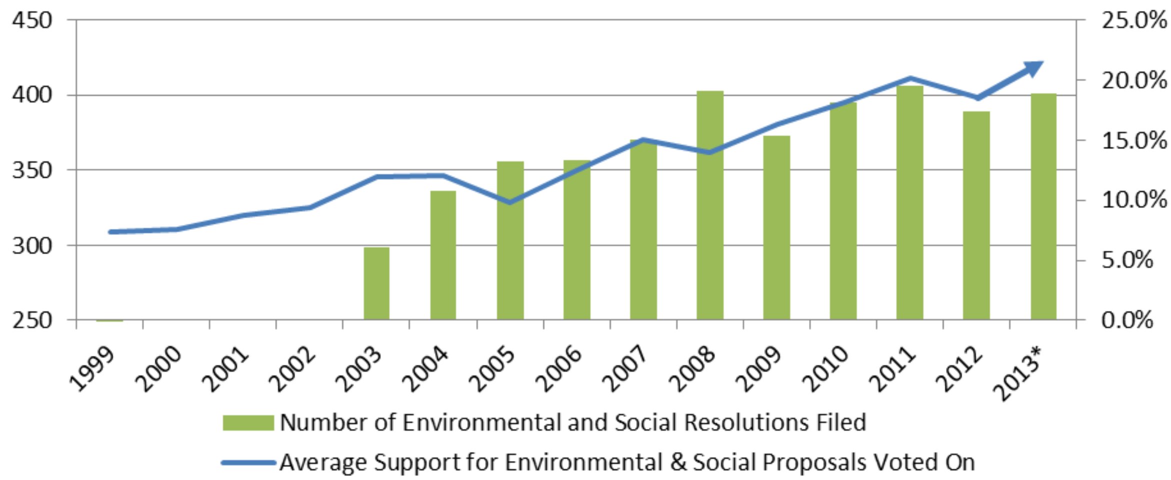
Impact investing comes in many flavors, from small to large and from local to global. At the large and global ends of the spectrum we have the challenge of bringing transparency and accountability to how large companies are managed. For many public companies there exists a disconnect between quarterly results (to which senior management compensation is often tied) and the interests of the rest of the stakeholders like communities, employees, the environment, and even long-term shareholders.

If your grandparents had a store 75 years ago, they had a profit motive to support their family, but they also had a motive to treat employees, customers, and their community with respect. Accountability for how they ran their business was ever-present. They saw their employees, and their customers every day at the grocery store and their kids went to the same schools as their employees'. Safe to say that most Fortune 500 CEO's children don't attend school alongside their employees'. Impact investors are in a unique position to restore this accountability and transparency to how businesses are run because unlike other activists, environmentalists, or ideologues, impact investors are part owners of the company. They have a profit motive just like management does, and they have a legal standing to push for change. Management cannot dismiss an investor's request as easily as they can dismiss protestors rallying outside a corporate headquarters.

Impact investment firms will typically push companies to do one of two things: release information or change one of their practices, and they typically will do this by dialoguing with the company (if management is receptive), or by filing a shareholder resolution. The latter is a more forceful way of bringing attention to their request, and it is essentially a call to all shareholders to vote on a proposal. Like any democratic process it needs enough support to have any credibility, and here is a good example of how impact investing has turned a corner. Ten years ago it was hard to find other shareholders to support a resolution or participate in a discussion. As a result, it was much easier for management to ignore the issue at hand. Today the field has established organizations like CERES, As You Sow, and US SIF to coordinate like-minded, long-term investors to reach the critical mass needed to effect change where it has the biggest impact – in the boardrooms of leading, multi-national companies.

The US SIF's 2012 Report on Sustainable and Responsible Investing Trends in the United States estimated that $1.5 Trillion of assets were held by managers or institutions that filed or co-filed shareholder resolutions on Environmental, Social, and Governance (ESG) issues. This amounts to a three-fold increase since 1995; $1.5 Trillion is not a drop in the bucket! Not surprisingly, the growth in assets behind shareholder advocacy has led to an increase in credibility for impact investors' shareholder resolutions, which you can see in the chart below.

Environmental and Social Resolutions Filed and Average Support



* Note: 2013 data is through September 10, 2013

Sources: 2013 U.S. Proxy Season Review: E&S Issues; Institutional Shareholder Services; 2013 Proxy Preview, As You Sow Foundation.

Impact investors need the information to evaluate the company, and to factor long term risks from mistreatment of employees, environmental litigation, or resource scarcity into their investment process.

Investor networks and infrastructure have also advanced corporate transparency and environmental reporting. The Global Reporting Initiative (GRI) is a framework for businesses to report their sustainability metrics, and its adoption has been growing rapidly over the past ten years. Not only has the adoption been growing, but the reasons that companies are reporting are in large part driven by the engagement of impact investors who play an important role pushing companies to disclose information. Impact investors need the information to evaluate the company, and to factor long term risks from mistreatment of employees, environmental litigation, or resource scarcity into their investment process. An activist off the street is not going to prompt Pepsi to evaluate how water scarcity impacts their business model in the Middle East and Africa, but activist investors have had meaningful discussions on that very topic.

Myth 3: <u>Impact Investing can't provide real opportunities for me</u> to invest given the magnitude of the problems involved.

Impact investing opens the door to be creative. And here creativity is a good thing. Creativity means developing new investment structures and partnering with government agencies and non-profits.

It means seeing a wave of impending foreclosures and knowing that the results will be devastating: displaced families, boarded up homes, depressed real estate values, and urban blight. Launched in 2009, Boston Community Capital's Stabilize Urban Neighborhoods initiative identified this challenge, and developed a process and structure to reissue mortgages for those facing foreclosure, funded with capital from investors. Ben Bernake was impressed: "Boston Community Capital is pursuing an innovative strategy to prevent occupied homes from becoming vacant and creating a strain on the community." The 459 Massachusetts households who avoided eviction through the program from 2009-2013 were pleased as well. Boston Community Capital expects investors in the first initiative to earn 4.25% per annum.

Creativity means seeing ranchlands with important ecological value turning into housing developments and figuring out a way to try to make money by protecting habitats. Beartooth Capital, based in Bozeman, MT has purchased ~25,000 acres of ranchlands on behalf of investors and over half of that is now under conservation easement. They have restored 37 miles of river and creek habitat as illustrated in the image below, all while maintaining an objective of generating 15% returns for investors.

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Creativity is identifying the extraordinary costs to government and society of prison recidivism and structuring an investment to reduce it. Social Finance US identified that parolees committing new crimes upon release was inordinately expensive: the cost to investigate, prosecute, and incarcerate alone is huge, and that doesn't take into account the social costs of the crime or the impacts to the victim. They put together a structure where impact investors buy a "bond" which pays to administer transitional employment training program to inmates up for parole. If this program, run by the Center for Employment Opportunities, is successful in lowering recidivism and increasing employment rates for participants upon release from prison, the investors can earn up to 12.5% annually. While this is still a new and somewhat unproven concept, it definitely represents financial creativity in an exciting, impactful way.

Creativity can be used to tackle very specific problems like those above, or can come in the form of a partnership with government or philanthropic organizations. We have seen impact investment funds coordinate with agencies like Overseas Private Investment Corporation (OPIC), the Small Business Administration (SBA), or even the US Treasury's New Market Tax Credit (NMTC) program to increase the scale of their operation. Here, the creativity came in structuring an investment to suit the agency's impact-first mandate and the return-first mandate of private investment capital. The result usually involves something we call a concessionary investment from the agency/ organization. For example, the impact-first investor might accept losses before regular investors, or they might be willing to give profits back to investors. The impact-first investor might also be willing to lend money very cheaply to an investment fund or underlying deal. All of these creative structures have the same result of improving the characteristics of the investment for the regular investors who want to make a market-rate return. Organizations making these concessionary investments have a primary goal of increasing impact (economic development, conservation, etc.), so they don't mind giving up some profit if by doing so they act as a catalyst to attract more private money into the area. Impact investment firms are in a unique position to forge these partnerships, because they share the values and mission alignment with foundations, NGOs, and governmental organizations that are willing to make concessionary investments. Considering most associate impact investing with giving up returns, here is an example of how an impact investment might offer investors better returns.

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Myth 4: Impact investing sounds complicated and confusing, <u>I don't know anything about investing</u>.

Impact investing can reconnect investors with their investments. You wouldn't lend money if you didn't know what it would be used for, but few people know how the investment funds in their accounts really work. The complexity of financial markets, hidden fees, and conflicts of interest make it nearly impossible for the average investor to understand exactly where their money goes. The impenetrable jargon of the finance industry like sharpe ratios, overlays, volatility reduction, and arbitrage certainly doesn't help.

Paul Volcker, former Chairman of the Fed and head of the Obama Administration's economic recovery task force, said in a February 6, 2014 speech to the Boston Security Analysts Society that investor education is regulation. Interesting that the man for whom the Volker Rule is named thinks that consumer education is just as important as regulation. (The Volker Rule is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act and it limits banks' proprietary trading activities.) Would we have had a subprime lending crisis if people truly understood what those AAA mortgages they bought were? Would people be complaining about offshore manufacturing if they realized they pushed production there by buying the lowest cost item on the shelf? It makes sense that education is important, but how does this relate to impact investing?

Impact investing won't turn you into an investment professional (you can be thankful!), but bringing values to a discussion of investments can help investors learn more about investments by making the conversation more engaging. It becomes a dialogue about things that matter, not sharpe ratios and downside semi-variance. Not everybody is an investment professional, but everybody has a profession or a passion, and discussing how your interests apply to your investment portfolio will help you understand your investments better. If you are in the legal profession and have an expertise in labor rights, you might want to talk with an investment manager about what types of labor practices they want to see when evaluating a company for investment. This can help you understand their investment process to evaluate a company, and it will probably help them learn more about what labor practices are best.

Myth 5: Impact investing <u>sounds complicated to implement</u>.

As the networks and infrastructure in the field have developed, the task of implementing an impact investment strategy has gotten easier in some ways and harder in others. It used to be easy to identify the ~25 SRI funds available, but it was nearly impossible to create a multi-asset class portfolio with impact. Now it is possible to create a truly diversified portfolio of equities, bonds, real estate, timberland, and farmland with real impact and few, if any, trade-offs in return. However, staying current on the rapidly growing array of opportunities and how they fit together to achieve investors' mission and financial goals is more challenging than ever.

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This challenges individuals and advisors to think about investing on a deeper level than risk and return. Investors need to ask their advisors about the space, and demand that their advisors address it meaningfully. Ultimately impact investing's potential is limited if the end consumers of investments don't ask for it.

Advisors need to listen to clients: ask them what level of impact they want, who they want to impact, what are the social trends that trouble them? Why do they want to invest for more than financial return? How do they want to measure success? Are they willing to concede returns? Are they willing to invest in new managers or strategies? Are they interested in global or local issues, public or private investments, pragmatic low-hanging fruit approaches or revolutionary idealistic approaches? We see too many advisors tell their clients what impact investing is rather than listen to what their clients actually want. Many advisors simply find a fund with the word "sustainable" or "ESG" in the name that fits into their existing framework, and offer that to clients. That approach is neither impactful nor meaningful; there is no one-size fits all approach to impact investing.

We see the advisor's role as more than putting together a portfolio of investments. The advisor must be a liaison into the networks and eco-systems of the impact investing field. Advisors must be attending conferences, comparing notes with other practitioners, and canvassing the field for opportunities for clients. Advisors must first truly understand their client's goals and interests, and then help to educate them on what might be possible and what the risks or tradeoffs might be. Clients need to be engaged in the process, advisors need feedback on opportunities from clients and clients need to bring ideas and areas of interest to their advisors.

Some of the most meaningful work we have done on this front at Ballentine Partners has been helping clients pursue very specific non-financial goals through their investment portfolio – from investing in local year-round businesses in a summer resort community to advocating for less promotion to consumers of "miracle" drugs by pharmaceutical companies.

Conclusion

We face ever growing challenges around resources, education, equality, and healthcare; yet solutions are not developing fast enough. Non-profits are important, but there will always be a finite amount of philanthropic capital; the footprint of faith-based organizations can be limited by ideology; the effectiveness of government is thwarted by politics and bureaucracy. To address the social challenges we face on a scale that matches their size we need a more effective solution. Impact investing has scale (if money can be made doing this, there will be no shortage of money put to work), efficiency (corporate behavior is the root of many problems; impact investing strikes the root), and meaning (reconnecting people with the how their money is invested).

Ask your advisor about what matters to you, and discuss whether it makes sense to incorporate those ideas into your portfolio. It may be the start of a fun, profitable, and rewarding journey.

To address the social challenges we face on a scale that matches their size we need a more effective solution.

[i] http://sustainability.thomsonreuters.com/2013/08/09/history-of-socially-responsible-investing-in-the-u-s/

[ii] http://www.bostoncommunitycapital.org/what/sun-initiative

[iii] http://dealbook.nytimes.com/2013/12/26/restoring-ranch-land-for-a-profit-and-a-trout-dividend/

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