Socially Motivated Investing[93]

THIS CHAPTER CONSIDERS two related but nonetheless different purposes that socially motivated investments may serve. The first is to *align* your investments with your social and environmental values regardless of whether your investment decisions affect the investee companies' behaviors. The second, which builds on value alignment but goes much further, is to *cause* improvements in the social and environmental behaviors of your investee companies.

The chapter begins with value-aligned investing and then turns to what the Global Impact Investing Network (GIIN)—the sector's major infrastructure organization—defines as impact investing: "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Socially motivated investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending on investors' strategic goals."[94] Impact investments can encompass virtually every asset class, including equity stakes in conventional and benefit corporations; corporate, municipal, green, and social bonds and other forms of debt; mutual funds; hedge funds; and real estate.

After discussing impact investments in depth, the chapter turns to social movements or campaigns that involve divestment and shareholder activism. It concludes with a note about benefit corporations and B Corps.

Value-Aligned Investing

All businesses have social impact, whether positive, negative, or both. They can, for example, deliver financial returns for investors, create living wage jobs for low-income workers, and expand the provision of goods and services—and also exacerbate gender inequality and pollute the environment.

Investors who seek value alignment would prefer to own stocks only in companies that act in accordance with their moral or social values. The term *value-aligned investing* encompasses both *mission-related investing* (MRI)—investments that are made by a foundation in pursuit of its charitable mission—and *socially responsible investing* (SRI)—which focuses on a company's environmental, social, or governance (ESG) criteria.

Independent of having any effect on the company's behavior, value-aligned investors wish to own stock in what they deem to be "good" companies, or to avoid "dirty hands" or complicity by refusing to own stock in what they deem to be "bad" ones.

Value-aligned investors may be concerned with a firm's outputs—its products and services. They might want to own stock in a solar power company or avoid owning shares in a cigarette company. Or they may be concerned with a firm's practices—the way it produces those products and services. They might want to own stock in companies that have high ESG ratings and eschew companies with poor ratings.

Each of the ESG components contains many different factors. For example, as summarized by Investopedia[95]:

- *Environmental* criteria may include a company's energy use, waste, pollution, natural resource conservation, and treatment of animals.
- *Social* criteria look at the company's business relationships. Does it work with suppliers that hold the same values as it claims to hold? Does the company donate a percentage of its profits to the local community or encourage employees to perform volunteer work there? Do the company's working conditions show high regard for its employees' health and safety? Are other stakeholders' interests taken into account?
- With regard to *governance*, investors may want to know that a company uses accurate and transparent accounting methods and that stockholders are given an opportunity to vote on important issues. They may also want assurances that companies avoid conflicts

DONOR STORY

Aligning Values with Investing—*Janine Firpo*

Research from Morgan Stanley suggests that 86% of women and 95% of millennials want to invest all their money with their values. All of it—regardless of whether it has impact. Whenever we talk about women and their money, we should be talking about investing their money in a way that matters to them and that is aligned with their values. I was talking to a friend of mine the other day. She said, you know Janine, it's like fashion. In her view, we get up every day, we get dressed. In that moment, we can choose to just put on completely functional clothes—we don't! As women, most of us love clothes; we love to shop for them; we love to think about them; we think about what colors go together, what styles, we think about the jewelry we wear. For us, clothes are fun. They give many of us joy and they are really an expression of who we are.

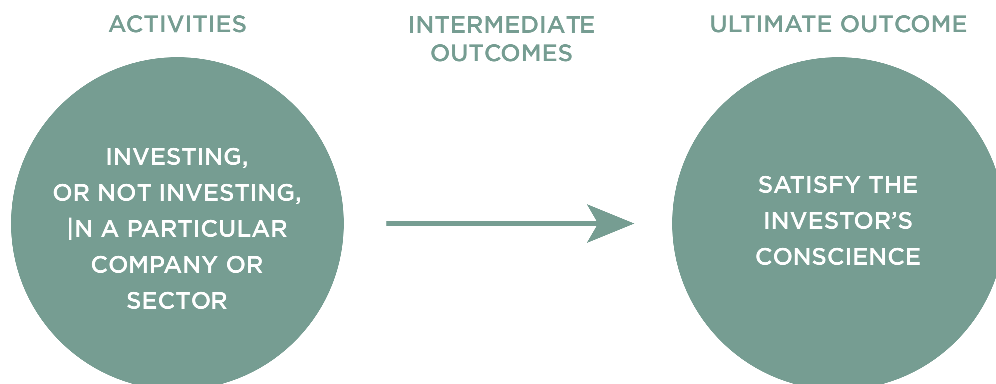
What I call values-aligned investing is like that. Traditional investing equates to just putting on a utilitarian outfit and walking out the door. But if you really want to feel good about your money, you invest it in a way that shows who you are. Getting dressed is fun. Why can't our money be fun? Philanthropy shouldn't be the only place we have fun and feel good about our money—particularly if so many of us want more.

of interest in their choice of board members, don't use political contributions to obtain unduly favorable treatment and, of course, don't engage in illegal practices.

Just as philanthropists have varied goals, value-aligned investors may be concerned with varied ESG criteria and may make investments in companies working toward different types of impact—for example:

- Contributing to the UN Sustainable Development Goals (SDGs) by reducing poverty in developing countries.
- Improving outcomes for disadvantaged communities in the United States.
- Reducing greenhouse gas emissions.
- Ensuring the fair treatment of workers in their supply chains.

The theory of change for value-aligned investment is unusually straightforward because it does not require an intermediate outcome. As shown in the chart below, investing—or not investing—in a particular company or sector directly produces the ultimate outcome of satisfying the investor's conscience. Also, the investor can assess whether he or she has achieved the ultimate outcome simply through self-reflection.



To the extent that it does not sacrifice risk-adjusted financial returns—and especially if it increases returns—most readers of this *Guide* probably would prefer to place their investment assets in companies whose products and processes are aligned with their values. As mentioned above, these are often called *socially responsible investments*.

One might think that good ESG ratings predict good financial returns—perhaps because they indicate that management is effective at managing environmental and social risks in general. Unfortunately, the evidence of the financial performance of ESG funds (net of management fees) is ambiguous. This shouldn't be surprising: ESG values—especially those of the "S," or social, components—are highly subjective, and there is little agreement among the ratings provided by different agencies. Hopefully, the evidence will become clearer in the coming years and, indeed, will show that ESG investments are good for the pocketbook as well as the soul. In any event, though, investors who care about value alignment may be willing to accept somewhat lower returns, as well as some loss of portfolio diversification, to invest based on their values.

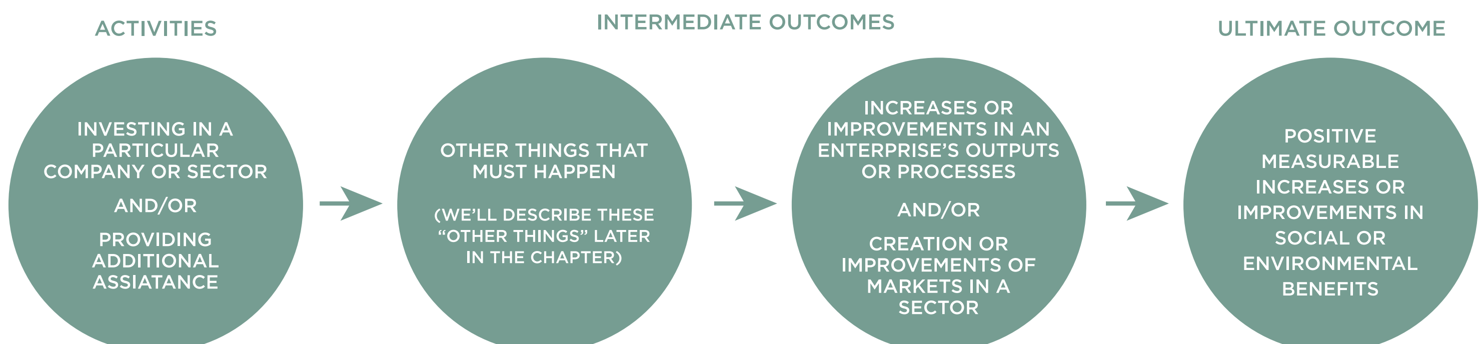
Investing for Impact

Investors who seek impact begin by identifying enterprises that are aligned with their values. But they then go on to make investment decisions that they predict will improve those enterprises' social or environmental impact. (Notice that we say "predict"—because, as with financial returns, an investor can at best make an informed prediction about the effect of an investment decision on the company's behavior.)

The fundamental distinction between value-aligned investing and investing for impact lies in the term *impact*, which means that the investment *causes* the desired outcome. While value-aligned investors need only learn whether a company's behavior is consistent with their personal values, impact investors seek to improve a company's performance with respect to values they care about. They may seek to:

- Increase or improve a firm's *products or services*—for example, an investment in a firm that provides health services to underserved communities, or
- Improve the *processes or practices* by which the firm produces those products or services—for example, an investment, perhaps coupled with technical assistance, to reduce a firm's environmental pollution or ensure the fair treatment of workers in its supply chain.

Because it calls for changes in a company's behavior, the theory of change for an impact investment is more complicated than for a value-aligned investment. The chart below shows a generalized theory of change for an impact investment:



- Like the charitable gifts and grants considered in the preceding chapters, socially motivated investments can have a variety of aims—to improve health in rural African villages or in U.S. urban areas, to reduce global warming, to protect the welfare of animals… the list could go on forever. The *ultimate outcome* is the particular social or environmental gain that the particular investor intends to achieve. Put another way, the impact is the increase or improvement in the intended outcome over what would have happened without the investment.

- The investor seeks to achieve the ultimate outcome through *activities* of two sorts: (1) providing equity or debt funding and (2) providing additional assistance designed to improve a company's social as well as financial outcomes. Such assistance can include networking, fundraising, addressing internal management and organizational needs, and helping keep a company focused on its social mission.

- These activities cause *intermediate outcomes* that are necessary to cause the ultimate outcome. The "other things that must happen" bucket (which we'll discuss below) cause the further intermediate outcome of improving a particular enterprise's or sector's outputs or processes. Impact investors typically focus on one company at a time, while multilateral investment organizations, such as the International Monetary Fund, often focus on entire industries or sectors.

DONOR STORY

Impact Investing in Action: From Catalytic Capital to Commercial Returns While Solving the World's Water Crisis— ***Tony Stayner, Excelsior Impact Fund***

It is an embarrassing disconnect that most of us in the US walk around with a supercomputer in our pocket while 2.5 billion people globally do not have access to the basic services of clean water and/or sanitation. Besides the human suffering, the annual cost to the global economy is at least $323 billion.

Global nonprofits Water.org and WaterEquity together are tackling this challenge through innovative financial solutions. Driving their transformative impact is the

insight that those living in poverty already pay significant sums for access to water and a toilet and that a large segment of those in need could gain access through affordable finance.

Water.org uses philanthropy as a catalyst to unleash commercial capital. By offering small grants and technical assistance to microfinance institutions (MFIs), they spark commercial lending for water and sanitation. Nearly 90% of the 6.6 million loans to date are to women, and the repayment rate has been a remarkable 99.6%.

Water.org established WaterEquity in response to requests from MFI partners for more affordable capital to lend for Water and Sanitation Supply (WSS). The first-of-its-kind asset manager exclusively focused on solving the global water crisis.

WaterEquity's first two funds, both concessionary to investors, have deployed $68 million through 30 debt investments in financial institutions and water and sanitation enterprises across India, Indonesia, and Cambodia. They have successfully reached 1.6 million emerging consumers with access to safe water or sanitation, while exceeding the return expectations they set with investors.

It took Water.org 20 years of drilling wells to reach its first million people. Now by making affordable loans available, Water.org reaches more than 2 million a quarter—30 million people to date. By showing that it is profitable for MFIs to make WSS loans, they draw commercial capital to the sector. As of June 2020, Water.org has helped mobilize $2.4B to the sector. Commercial capital would not have found this opportunity without the work of Water.org and WaterEquity, and it is a big part of their impact.

Water.org's next exciting innovation is to use philanthropic guarantees to entice private banks to enter the WSS loan market either directly or by purchasing assets from MFIs, freeing them up to make additional loans.

My wife and I have been philanthropic donors to Water.org since 2005, have invested in each of WaterEquity's funds, and plan to be a guarantor. Operating at scale to improve public health, enhance gender equality, protect the environment, and ensure vulnerable communities around the world are more resilient to the impacts of climate change, we consider this our most impactful investment. With the pandemic showing how central water, sanitation, and hygiene are to our health, this work is more important than ever.

The Ultimate Outcome: Enterprise Impact and Investment Impact

Let's dig deeper into how an investor can have impact in achieving their desired ultimate outcome. An impact investor is concerned with two types of impact:

- *enterprise impact*—the impact of the investee firm itself
- *investment impact* (sometimes called *additionality* or *social value added*)—the impact the investment has on the firm's (and sometimes a sector's) activities and outputs

Enterprise Impact

Enterprise impact means that the investee firm is achieving the social outcomes sought by the investor and that those outcomes are making a positive difference in the lives of its intended beneficiaries. This is the same meaning of *impact* as for a nonprofit organization's activities, as described in **Chapter 6**.

Imagine a new company, Beyond Fish, that uses algae to make food that tastes like fish.* You have invested in the company with the goal of reducing overfishing.

- In the happy scenario, consumers of Beyond Fish eat less actual fish.
- In the unhappy scenario, the product's almost-fish taste increases its consumers' demand for actual fish. Under these circumstances, the company did not have enterprise impact because it did not meet your social goals.

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* There actually are companies producing vegetable-based fish substitutes.

Investment Impact

Now assume that Beyond Fish is meeting your social goals as an investor. The question remains whether your investment is having impact. That would happen if your investment is enabling the company to provide more, or better, or cheaper artificial fish than investments by ordinary commercial investors who are just out for a buck. Why does this matter? Because if your investment is not making a difference, you are squandering the funds when you could invest them where they could make a difference.

Consider these three scenarios:

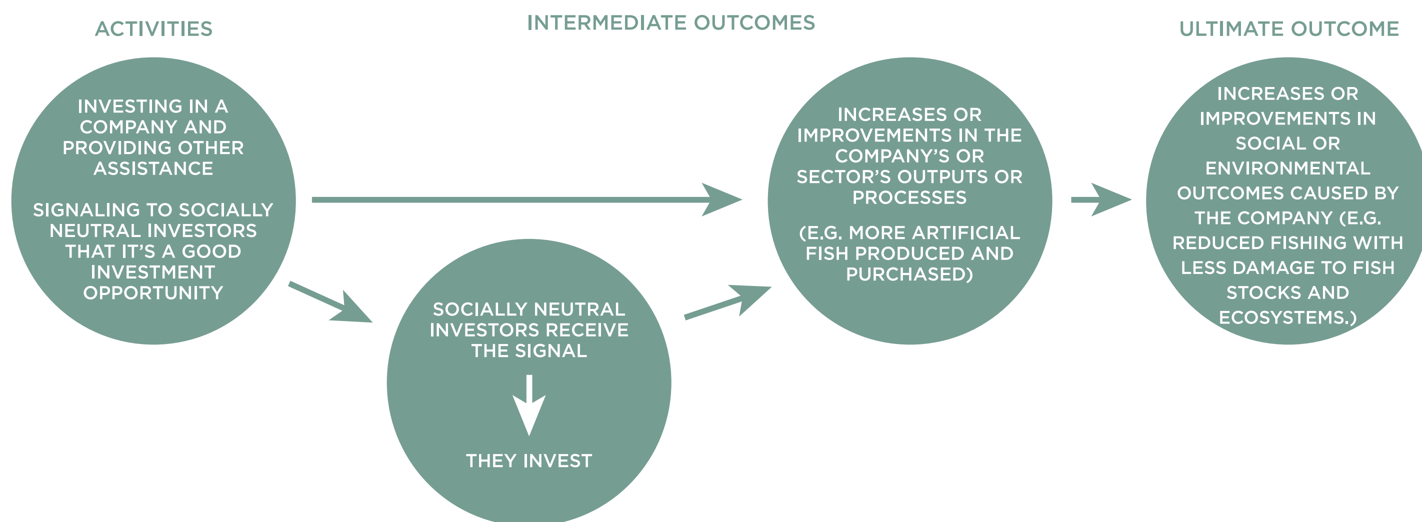
1. Because of the success of artificial meat companies, ordinary commercial investors who care only about strong financial returns are flocking to Beyond Fish.
2. Beyond Fish's product is so novel that it's uncertain whether consumers will buy it, and the company is not attracting commercial investors. You are by no means certain yourself, but you believe that if the product is successful it will have such great social impact that you are willing to risk a substantial loss, not compensated by the possible return, in order to test the concept.
3. The same scenario as #2: Beyond Fish's product is so novel that it's uncertain whether consumers will buy it, and the company is not attracting commercial investors. Based on your expertise in the food sector, however, you believe that the market is missing a great opportunity, and you make a substantial investment expecting to receive good risk-adjusted returns.

In the first scenario, the impact investor has no investment impact because their investment is not providing additional resources, beyond those supplied by commercial investors, that increase or improve the firm's socially valuable products. Simply put, even though your investment may be aligned with your values, your funds are not making a difference. By contrast, the other two scenarios describe opportunities for investment

impact. The second investment is *concessionary* because you are taking a greater risk than you would if your goals were purely financial. The third investment is *non-concessionary* because you believe it's a good deal and are not sacrificing financial returns in order to achieve social impact.

The Intermediate Outcome of Attracting Socially Neutral Investors

In the second and third scenarios it is possible that your investment, together with those of other socially motivated investors, will have some investment impact. But you will create a sustainable company with much greater impact by attracting socially neutral investors to join you or follow on your investment. In other words, the theory of change calls for your investment activities to be *catalytic* by signaling to socially neutral investors that Beyond Fish is a good financial investment.



Concessionary Investments

Why would an impact investor make a concessionary investment—one that expects to receive below risk-adjusted market returns? Typically, to enable a business to test products or services in unknown markets, where the likelihood of commercial success is too low to attract ordinary

investors until and unless the business succeeds. This was the Gates Foundation's rationale for its concessionary investment in bKash, the mobile money company aimed at benefitting the poorest residents of Bangladesh, which several years later attracted non-concessionary private equity capital. It was only because the Gates Foundation paved the way with concessionary capital that bKash was able to attract private equity investors.

The Gates Foundation's investment in bKash was what the Internal Revenue Code characterizes as a *program related investment*, or PRI. The Code defines a PRI as an investment by a private foundation whose primary purpose is to further the foundation's charitable purposes rather than generate financial returns. For this reason, PRIs are almost always concessionary. Conceptually, you can consider the concession as the functional equivalent of a grant. Indeed, the US Internal Revenue Code treats PRIs like grants in some (but not all) respects, including counting toward a private foundation's required 5 percent annual payout.* Making a PRI is far more complicated than making a grant because of the need for financial due diligence and investment documents. Foundations with reputations for making effective PRIs tend to have dedicated PRI staffing and legal expertise in this arena.

While only foundations can treat investments as PRIs, an increasing number of individuals and families are making concessionary investments, mainly through family offices. Some donor advised funds are getting into the game as well.

Non-Concessionary Investments in Private Markets

It is also possible to have impact through non-concessionary investments in private markets—in companies that have attracted few if any ordinary commercial investors, either because commercial investors regard the

* Capital returned to the foundation must, however, be granted out or reinvested as a PRI.

investment as too risky or because they haven't yet discovered the market. Private markets thrive on private information. Impact investors' advantage lies in their expertise in assessing the financial potential of companies whose products fit their social values. Just as a successful venture capitalist may possess expertise in, say, biotech, an impact investor may develop expertise in particular markets with the potential for socially valuable outcomes. For example, Omidyar Network (ON) argues that they are better able to assess the risks in some of these markets than are ordinary commercial investors because ON "may have greater familiarity with a given geography (such as Africa) or sector (such as financial inclusion) or more confidence in a particular entrepreneur."[96]

ON made an early stage investment in Ruma, an Indonesian financial and information services provider, with the goal of making financial transactions affordable for very low-income consumers. Although ON believed that Ruma had the potential for good financial performance as well as social impact, commercial investors were not attracted to the company because they believed that it was too risky. ON's investment turned out to be a success both socially and financially. Ruma has provided financial services to millions of low-income people in Indonesia and given ON solid returns; it has also attracted commercial capital for subsequent rounds of financing.

Another impact investing group, Bridges Fund Management, focuses on underserved markets in the United Kingdom. Bridges is a non-concessionary investor whose impact metrics are "fully aligned with commercial success." Bridges invested in the Babington Group, a training and apprenticeship provider, with the aim of providing education and employment to marginalized, working-class people. On exit, the fund reported positive social outcomes and, financially, a 33 percent annual rate of return.

It's worth emphasizing that these non-concessionary impact investments are in companies or sectors that are not attracting adequate commercial capital—as they have the goals of providing early stage funding and

signaling to commercial investors that these are good investments. It can be more difficult to have investment impact in firms or markets that are *already* attracting commercial capital. Yet given the noisy and imperfect information in private markets, a startup, though not widely known, may nonetheless be known to a few commercial investors. For example, ON invested alongside some socially neutral, commercial investors in Dailyhunt, an Indian news service aimed at low-income, non-English-speaking populations. ON had investment impact to the extent that it provided capital that Dailyhunt could not get elsewhere or that it alerted commercial investors to the startup's financial value.

In sum, it is often difficult to predict whether a non-concessionary private equity investment has investment impact. Socially motivated investors can only do their best to predict whether their investment is likely to provide capital in addition to that provided by socially neutral investors (or on more favorable terms) or is likely to inform those investors about the investee's commercial viability.

Non-Concessionary Investments in Public Markets

To be blunt, and postponing the strategy of shareholder engagement to a later section: Investors cannot have any social impact merely by trading securities in large cap secondary public markets. (Purchasing stock at an initial public offering or a refinancing may be more akin to acquiring ownership of private equities.)

For better or worse, the vast majority of investors in public markets care only about financial returns and are indifferent to a firm's social value. If impact investors buy stock in a publicly traded company because it provides socially valuable products, these myriad socially neutral shareholders will happily sell their shares and the stock price won't change one iota. No finance expert believes otherwise.

What if you care about a company's environmental and employment practices and therefore invest in a publicly traded company with good

ESG ratings, believing that they may also increase the company's long-term shareholder value? Because socially neutral investors have the same information, impact investors have no advantage in moving the needle here.

The most frequently voiced impact investing thesis for these circumstances is that non-concessionary ESG investors will signal to socially neutral investors that ESG investments are financially beneficial. But for the same reason, it seems likely that socially neutral investors will examine those correlations directly without the intermediation of ESG investors. The Impact Management Project (IMP), a widely respected effort to measure, assess, and report impacts on environmental and social issues, addresses the value of signaling in this context, noting that "if all investors did the same—it would lead to a 'pricing in' of social and environmental effects by the capital markets. … But alone, it is not likely to advance progress on societal issues when compared to other forms of contribution."[97] The IMP appropriately characterizes the strategy as one of value alignment rather than impact.

Advisors and Fund Managers

As just discussed, the two most promising areas for making investments likely to have impact are concessionary investments and non-concessionary investments that have not yet attracted commercial investors. Both of these lie in the traditional domains of venture capital and private equity—with the added complexity that an investor must perform due diligence with respect to social impact as well as financial matters. How can socially motivated investors who are not themselves experts in a particular sector, nonetheless make savvy investments?

The past decade has seen a tremendous growth in "impact funds" in virtually every area of interest to a socially motivated investor—domestic and global poverty, clean water, health, education, you name it. And it has also seen the growth of firms offering to advise investors about opportunities to have impact in these areas.

The evolution of these advisors and funds is so fluid, that any list we provided would quickly become out of date. But we do have some suggestions about how you can ensure that you are getting sound advice and that your funds are being managed for impact. Ask:

- Do the advisors and fund managers understand the concepts of enterprise and investment impact and use them as guides for their decisions?
- Are they transparent about how particular investments are achieving impact?
- Do a fund's portfolio include large cap publicly traded equities? If so, unless the fund systematically seeks impact through shareholder engagement, treat this as the proverbial 13th strike of the clock that calls all the others into question. And if the fund does employ a shareholder engagement strategy, ask for specifics about the strategy and its results.
- Is a fund manager compensated based on social impact as well as financial returns? This can't realistically be a gating matter because there are few if any actual examples of the practice. But a good faith effort to do this would show that the fund is true to the observation that one manages what one measures.

Participation in Campaigns to Change Corporate Behavior: Divestment and Shareholder Engagement

Thus far we have focused on conventional impact investing as defined by the GIIN: providing funding and assistance to companies whose products and processes investors believe to be socially valuable. But there is a long history of efforts by investors, consumers, and other stakeholders to influence companies' various social and environmental practices through boycotts, divestment, and shareholder activism. A campaign directed against Nike to improve the treatment of workers in its supply chain

led to changes by major segments of the apparel industry. A campaign directed against U.S. companies doing business with the South African government added to the pressures for that government to abandon apartheid. More recently, a campaign against coal likely contributed to the reduction in its use as a source of fuel in the U.S. There are also some recent examples of major fund managers, including BlackRock, Inc., exercising shareholder power to influence their investees' environmental and social behavior.

Investors have contributed to such campaigns by divesting or refusing to invest and through shareholder engagement. With respect to the last of these, the Impact Management Project describes how impact investors can "engage actively," using their "expertise, networks, and influence to improve the environmental/societal performance of businesses. Engagement can include a wide spectrum of approaches—from dialogue with companies to creation of industry standards to investors' taking board seats and using their own team or consultants to provide hands-on management support (as often seen in private equity). This strategy should involve, at a minimum, significant proactive efforts to improve impact."[98] Besides occasional signal successes, such as a resolution requiring ExxonMobil to disclose the impact[99] of climate change on its business, shareholder engagement may cause companies to improve their ESG behaviors even in the absence of successful resolutions.[100] Some organizations, like Ceres,[101] and asset managers, like Trillium,[102] systematically engage in shareholder engagement.

Like advocacy pursued by philanthropists and nonprofits, successful efforts to change corporate behavior require coordination among investors and other stakeholders as well as a willingness to stick with the project for the long term. Like all strategies for social change, the efforts must be supported by a strong, evidence-based theory of change. While the likelihood of success is often low, the impact of a successful campaign is potentially huge, and little wins can add up.

Benefit Corporations and B Corporations

Almost all impact investments are made in traditional corporations. But investors who wish to promote a company's social mission can also invest in benefit corporations or certified B Corporations.

The charters of benefit corporations obligate management to consider interests beyond those of shareholders, including those of other stakeholders who may be materially affected by the business: workers, customers, suppliers, the communities in which the firm operates, and the environment.

Along similar lines, the nonprofit organization B Lab certifies companies, whether or not they are chartered as benefit corporations, as "B Corps" if they meet certain "standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose."[103]

Until recently, the constellation of B Corps consisted mainly of smaller companies, such as Patagonia and New Belgium Brewing. But in recent years Danone North America, Natura (Brazil's top manufacturer of cosmetics and personal-hygiene products), and other large corporations have received B Corp certification, with more to come.[104]

Conclusion

We have great aspirations for the field of impact investing. But we have the same sort of concerns about ignorant and misleading claims that those trying to advance medicine in the nineteenth century had with the patent medicine industry. The promise of impact investing can only be realized if investors, fund managers, and advisors understand what impact means and when it can plausibly be achieved. Our goal here, as in the preceding chapters, is to help readers put their resources where they can actually improve society.

Socially Motivated Investing Takeaways

- Value-aligned investing refers to owning shares only in companies—whether publicly or privately traded—whose products and activities comport with the investors' moral or social values or their foundations' missions.
- Having impact goes beyond value alignment by enabling an investee company to do *more* of whatever socially beneficial thing it is doing or to do it *better*.
- Impact investments are intended to be catalytic. Their overarching goal is to create markets and opportunities that will eventually attract ordinary commercial investors as well as change companies' management practices in enduring ways.
- One can achieve impact through concessionary investments—investments that sacrifice risk-adjusted returns for social or environmental goals.
- One can also achieve impact through non-concessionary investments in private markets, when the investee company or sector has not attracted sufficient commercial capital.
- But one cannot achieve impact in public markets through investments alone, as distinguished from strategically designed campaigns of shareholder engagement.
- An "impact fund" that is serious about impact is transparent about how and to what extent it is achieving both enterprise and investment impact.

THE STANFORD PACS

GUIDE

TO EFFECTIVE PHILANTHROPY

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