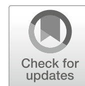
Positive Impact Investing: A New Paradigm for Future Oriented Leadership and Innovative Corporate Culture



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How to Connect Strategy, Culture, Impact and Investment

Why an anthology on Positive Impact Investing and Corporate Culture?—you may ask. The short answer is—because the topics are intertwined.

In the face of humanity's unsustainable journey, the current geo-political crises, and climate challenges, the implementation of both the 17 Sustainable Development Goals (SDG) of the United Nations and the Paris climate accord (COP21), have become an unavoidable obligation for the business and investment community as well. Yet, scientists, investors, entrepreneurs, business people, politicians, economists, the civil society, and political leaders are daunted by the task at hand.

While handling change is now part of everyday life for many companies, the question to be resolved is how make transition as smooth as possible while keeping up profitability. Companies expect their executives to be successful in day-to-day operations while at the same time aligning responsibility and profit with solving global challenges- moving to doing good while doing well. Our society can no longer be brought forward with the old means. Neither competition nor marketing nor allocation of power lead to any meaningful results. Moores's Law is no longer valid. In the meantime, global knowledge is doubling in less than a year, while industry 4.0, digitization and the Internet are transforming our world, the interdependence of processes and global networking are constantly increasing. However, the change of order patterns always means a transition from a stable macroscopic order pattern to another order pattern, which ultimately has to be better suited to ensure the survival of the company and maintain its ability to act and its ability to innovate. In this regard we can learn from biological systems. When an

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entrepreneur sends his company into an unstable phase, the search horizon should be the market, the value added of the future clearly identified, the ability to resonate with the world tested and the pain of transition to attractive market opportunities transformable. How to do this smoothly is an interesting and relevant question. Dr. Sonntag and Mr. Wynne show us all how we can learn from nature in creating functional and nourishing organizations and networks and moving from transition to transformation.

Integrating impact and impact measurement into investment decision making leveraging on management systems, multi-criteria decision analysis and applying systems approaches is the challenge requiring thought leadership and post heroic approaches. Positive impact investing is a nascent field of research. At the moment, it is mostly practitioners that are driving the impact assessment process and its integration into investment and finance. This has various reasons from managing risks effectively to protecting reputation and addressing stakeholder requirements. The process is most obvious on the lending side where collaborations between the World Bank, International Finance Corporations, other multilaterals and the private banking sector have contributed to the development of relatively consistent ESG standards which are often referred to as "Global Administrative Law" (McIntyre 2015). It has become increasingly the norm for international development banking institutions, including multilateral development banks (MDBs), and many private sector lenders, to adopt comprehensive environmental, social and governance (ESG) safeguard policies and standards to circumscribe the projects and activities they finance. This is particularly the case in the financing of major infrastructure projects in developing countries or economies in transition (McIntyre 2015). For Internationals Banks it is today good practice to integrate environmental, social and governance considerations into the lending process. For project and structure finance, the Equator Principles offer a financial industry benchmark for determining, assessing and managing environmental and social risk in international finance activities (see www.equator-principles.com). For lenders such as the EBRD or IFC that focus on private sector lending, the performance standards of environmental and social governance (see www.ifc.org and www.ebrd.org) are imposed upon private corporate entities, against which most requirements of international law could never be formally applied (McIntyre 2015). The Equator Principles Association website recognises growing 'convergence around common environmental and social standards', as well as the 'development of other responsible environmental and social management practices in the financial sector and banking industry', such as the Carbon Principles or the Cross-Sector Biodiversity Initiative (see www.equator-principles.com). Also the export credit agencies, through the 2012 OECD Common Approaches, are increasingly drawing on the same standards as the EPs' (see www.equator-principles.com).

On the investment, wealth management and asset management side the process of integrating ESG has been fostered by a number of players, in particular the United Nations Environmental Programme. While it has been commonly argued for long that trustees may be acting unlawfully if they take any account of "non-financial" factors in their decision- making more recently legal research from Freshfields shows

the contrary. Berry and Scanlan (2014) quotes the following response from a pension fund to an enquiry from a member about the fund's management of an environmental risk:

The Trustees have a legal duty to not only invest, but to actively seek the best possible financial return . . . even if it is contrary to the personal, moral, political or social views of the trustees or beneficiaries. This was demonstrated in the Cowan and Scargill (1985)[1] court case (Berry 2015). The first major challenge to the conventional interpretation of Cowan v. Scargill came from the "Freshfields report", commissioned by the United Nations Environment Programme Finance Initiative (UNEP-FI 2005). This report argued that there was good evidence that environmental, social and governance (ESG) issues could have an impact on financial returns and therefore, that taking them into account clearly fell within the ambit of fiduciary obligations. Indeed, taking such issues into account was "clearly permitted, and arguably required" in all jurisdictions analysed. Specifically in relation to Cowan v. Scargill, the report concluded that "no court today would treat Cowan v. Scargill as good authority for a binding rule that trustees must seek the maximum rate of return possible with every individual investment and ignore other considerations that may be of relevance, such as ESG considerations" (UNEP-FI 2005). In 2005, a group of institutional investors met at the invitation of the then UN Secretary General Kofi Annan to formulate the principles for sustainable investment. The PRI were presented to the public in April 2006 at the New York Stock Exchange. The total of 68 initial signatories included the BT Pension Scheme, CalPERS, the Government Pension Fund of Thailand, Munich Reinsurance, the New York City Employees Retirement System and the powerful Norwegian Government Pension Fund. More than 1200 institutional investors, asset managers and financial institutions have committed themselves by recognising the Principles for Responsible Investment (PRI) to integrate sustainability criteria into their investment. Together they manage more than US$30 trillion, representing a share of around 45% of global investments by end of 2014 (Hässler and Jung 2015).

There are a number of reasons for practitioners to consider integrating ESG into lending and investment decisions ranging from reputation, fiduciary duties, risk

[1]Cowan v Scargill [1985] Ch 270 is an English trusts law case, concerning the scope of discretion of trustees to make investments for the benefit of their members. It held that trustees cannot ignore the financial interests of the beneficiaries. The trustees of the National Coal Board pension fund had £3,000 million in assets.[4] Five of the ten trustees were appointed by the NCB and the other five were appointed by the National Union of Mineworkers. The board of trustees set the general strategy, while day to day investment was managed by a specialist investment committee. Under a new "Investment Strategy and Business Plan 1982" the NUM wanted the pension fund to (1) cease new overseas investment (2) gradually withdraw existing overseas investments and (3) withdraw investments in industries competing with coal. This was all intended to enhance the mines' business prospects. The five NCB nominated trustees made a claim in court over the appropriate exercise of the pension fund's powers.Mr JR Cowan was the deputy-chairman of the board. Arthur Scargill led the NUM and was one of the five member nominated trustees, and represented the other four in person. See [1985] Ch 270, 276, per Megarry VC "with both courtesy and competence".

management considerations and last but not least the emergence of global administrative law which can be described as a mixture of voluntary and regulatory initiatives, that create global norms together. They normally include according to Kingsbury 'intergovernmental institutions, informal intergovernmental networks, national governmental agencies acting pursuant to global norms, hybrid public-private bodies engaged in transnational administration, and purely private bodies performing public roles in transnational administration' (Kingsbury et al. 2005, p. 5). An example are the OECD Guidelines for Multi-National Enterprises (OECD MNE Guidelines) for the financial industry that require the sector to respect human rights, international labour law and other international conventions on environmental and social issues (https://mneguidelines.oecd.org/rbc-financial-sector.htm).

Academic research has been done so far on the consequences of consistent implementation of ESG standards and their value in de-risking assets, managing reputation and preventing damage to communities and environment, which should finally show up in a better rating, lower operational risk or a higher good will (Reverte 2012; Simpson and Kohers 2002; Saltuk 2012; Saltuk et al. 2014; Richardson 2011). An open question as of today is whether components like lower risk, better rating, higher good will translate into a higher share price (Ammann et al. 2011; Barby and Gan 2014; Beiner et al. 2006; Benson and Davison 2010; Beurden and Gossling 2008; Bevan and Winkelmann 1998; Brammer et al. 2006; Busch and Hoffmann 2011; Cheung 2011; Clark et al. 2013, 2014; Darnall et al. 2008; Deng et al. 2013; Eccles et al. 2013; El Ghoul et al. 2014; Filbeck and Preece 2003; Fisher-Vanden and Thorburn 2011; Flammer 2013a, b; Fogler and Nutt 1975; Fulton et al. 2012; Garcia-Castro et al. 2010; Godfrey et al. 2009; Gompers et al. 2003; Hart and Ahuja 1996; Jensen 2002; Jiao 2010; Johnson et al. 2009; Simpson and Kohers 2002). Very few researchers look into the quality of data when applying ESG. An analysis how consistent the underlying ESG data set is, is missing. For some ESG is just a short exclusion list of one or two sectors for other ESG is a multi faced concepts including exclusion lists, best in class approaches and institutional credibility. Positive Impact investing shares the triple bottom line concept with ESG, but it makes the creation of a triple bottom line core of the business strategy applying a theory of change, creating additional assets and extending rather than reducing the investment universe. It is based on the concept of blended values and on the concept of long term investment approach (Harji and Hebb 2010; Harji and Jackson 2012; Harji et al. 2014; J.P. Morgan Social Finance 2013; Jackson and Harji 2012; Krlev et al. 2013; Lai et al. 2013; Laing et al. 2012; Lyons and Kickul 2013; Moore et al. 2012; Nicholls 2010; Nicklin 2012; O'Donoho et al. 2010; Porter and Kramer 2011; PWC 2010; PRI-UN Global Compact 2013; Rodin and Brandenburg 2014; Salamon 2014; Saltuk et al. 2014; Shiller 2013; Social Investment Research Council 2014; Wilson 2014). As always sustainability can be proven only in a long term horizon.

The upside view one can take on—ESG is its inherent potential to create innovation in the financial field based on political environmental, social technological and organizational analysis (PESTO analysis). The concepts of impact investing and ESG are sometimes confounded, but may merge in a future business cycle phase (Shiller 2013; Porter and Kramer 2011; McIntyre 2015; Moore et al. 2012; Loew

et al. 2009; Krlew et al. 2013; Harji 2008a, b; Harji and Hebb 2010; EMPEA 2015; Desjardins 2011; Bishop and Green 2010).

Positive Impact Investing is in its nascent stage. The number of purely academic and theory- building publications is still quite limited and a short overview of the so far existing literature is given in this document further down in section "What Vehicles for Impact Investments Are Available and What Asset Classes Are Preferred?". Considering environmental and social impact while in first place emerging in order to deal with the enormous risk in foreign direct investment and in project finance stemming from PESTO context factors in order to de-risk assets and portfolios has turned into a more pro-active and forward looking process. While the notion that all investments are impactful has led to a growing body of expertise and the development of a community of practice among financial practitioners on the international lending side including in Export Credit Agencies and structured export and project financing dealing with such risks and negative impacts, it has not entirely captured the upside potential of looking into positive impacts beyond the creation of jobs or new consumption possibilities for customers. Since the economic crisis triggered in 2008 impact investing further stretched into the sphere of positive impact creation, "because governments, charities, philanthropists alone are no longer capable of dealing with the twenty-first century's social and environmental challenges. Focussing on the act of charitable giving rather than on achieving social outcomes and a dependence on unpredictable funding hindered many charitable organizations from realizing their full potential concerning innovations, effectiveness and scale." (Brandstetter and Lehner 2015). The World Economic Forum recently acknowledged the role the investment and finance sector can play in creating solutions to social problems and stated: "Given the nature of how resources are distributed in the world, private investors may have a special role and responsibility in addressing social challenges." (World Economic Forum 2013). Yet apart from a small number of specialized forms of impact investing like social impact bonds, green bonds and mission related philanthropic investments little is known about the complex interplay between entrepreneurs or organizations, intermediaries, investor regulations and the successful use of instruments in the field. One important aspect often alluded to in impact investing is the approach seeking to generate both an eco-social and financial return at the same time. The dominant paradigm in financial markets today is the creation of financial returns solely and taking into consideration eco-social return is seen as sacrificing a certain amount of financial return, which misaligns impact investing with the principal—agent theory that posits that shareholder value is the indicator on how well the agent has managed the capital and ownership rights of the principal. Thus the logical constructs of mainstream investing and finance and impact investing appear to be incompatible with each other. Compatibility however is a prerequisite for the inclusion of impact considerations and therefore impact investment into the portfolios of traditional investors (Brandstetter and Lehner 2015).

The World Economic Forum in its 2013 Report states: "Despite the buzz, there is limited consensus among mainstream investors and specialized niche players on what impact investing is, what asset classes are most relevant, how the ecosystem is

structured and what constraints the sector faces. As a result, there is widespread confusion regarding what impact investing promises and ultimately delivers." (World Economic Forum 2013). The development of a clear definition, clear measurement methodologies for describing and measuring impact and a credible value theory often referred to as theory of change have to be established in order to open the field for more traditional investors.

How to Implement Impact Investing: Challenges and Solutions

How can impact investing be defined? How can it be evaluated? How should it be evaluated? In such a metrics-rich and increasingly data-driven industry, it could be argued that all stakeholders in the emerging field of impact investing are concerned with these questions (Jackson 2005). The most renown definition is that of the Rockefeller Foundation: Impact investments are investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return (2007). They can be made in both emerging and developed markets, and across asset classes, including bonds, listed shares, and private equity. With this original definition impact investing is no different from Triple Bottom Line Investing, a term coined by John Elkington in 1994. In recent years the definition therefore has evolved and the elements of additionality, profitability as a prerequisite (to distinguish it from philanthropy) and theory of change (ToC) have been added. However, an important element is often underdeveloped in the discourse and practice on performance assessment in the sector. That element is theory of change (Jackson 2013). A construct and tool originating in the field of program evaluation, theory of change can, and should be a core element in the evaluation of impact investing (Jackson 2013). Fortunately, theory of change is already a part of the Global Impact Investors Network (GiIN)—definition. Nevertheless, there are two problems. First, in some areas of the field's practice, theory of change is still invisible, not explicit or missing altogether (Jackson 2013). And second, there has not yet been an assessment of the overall state of play of this pivotal element in the field as a whole and how it can be applied to the maximum effect (2013). Currently ToC is currently more of a framework than a tool and not sufficient to understand the multiple levels and dimensions of the emergent field of impact investing and the success factors of interventions. Jackson refers this problem as a **leadership decision making problem** arguing, "Open-ended qualitative interviews with leaders, as well as closed-ended surveys can be deployed (Laing et al. 2012; Jackson and Harji 2012; Jackson 2013)."

In order to de-risk assets a theory of change that builds on organizational assessment tools like PESTO analysis that can be applied on individual, policy and universal level are important. Sets of tools able to build an overall integral assessment of organizational performance on the basis of three pillars (1) first the

external environment (legal and administrative, political, cultural and economic) (2) second, of its organizational 'motivation' (history, mission, rewards and incentives); and (3) third, of its organizational capacity (strategic leadership, human resources, program management, financial management, inter-organizational linkages may provide a good starting point for developing qualitative research when combining these three analyses to generate an overall assessment of the organization's effectiveness, efficiency and financial viability (Canadian International Development Agency 2012; IDRC/Universalia, n.d.). This approach can be applied to organizations operating at any level across the industry's spectrum.

Let us look at more traditional definitions on impact investing. Impact Investing has four distinct categories in the view of NPC and Cambridge Associates. It encompasses Responsible Investment or Socially Responsible Investments (SRI), Sustainable Investment, Thematic Investment and Impact First Investments (Cambridge Associates 2015). Note that this definition concentrates on the journey element leaving out the Theory of change element altogether. Many researchers in the literature recognize this journey undertaken by investors from responsible investment (applying some exclusion lists and criteria together with a best in class selection process for the remaining assets) to sustainable investment, which is understood by a majority of industry players as implementing sustainable management practices with regard to environmental, social and governance issues (ESG) to then turning ESG into an innovation driver and catalysing process while keeping the core of the ESG—value creation process leading to a thematic investment strategy and finally an impact first driven investment strategy (Cambridge Associates 2015, New Philantrophic Capital 2015). The following figure reflects this journey (Fig. 1).

Impact investing is also a process by which investment managers screen, evaluate and monitor investments using Environmental and Social Governance. Whereas Responsible Investment or Socially Responsible Investment" (SRI) screens to avoid portfolio exposure to socially or environmentally harmful investments, impact investing actively and intentionally seeks to create a positive, measurable impact through profitable businesses and at the same time applying systematically ESG practice to re-risk assets. Impact Investors achieve this by including into their due diligence and gap analysis process environmental, social and governance issues (ESG issues) as well as leadership and culture. They will normally start with a comprehensive gap report including ESG, leadership and culture gaps and actively address the gaps and influence the leadership of a company prior to investing into it, thus exerting influence as active owners over the full life-cycle of their investments. A good example for this is the integrated investment approach of AQAL Capital (see Bodzesan 2015).

Fig. 1 The impact investment journey. Source: Cambridge Associates and New Philantrophic Capital NPC (2015)

Impact investing is a lens through which investors consider investment options across asset classes, such as bonds, listed equities, and private equity (EMPEA 2015). Patricia Dinnen and Abigail Beach from EMPEA evolve on their former publication in this anthology. Impact investors aim to generate a financial return for themselves and measurable benefits to society and/or the environment (EMPEA 2015). Positive Impact Investing is looking to creating a triple bottom line performance, i.e. an environmental and social performance alongside with financial performance with the pro-active intention to create positive environmental and social outcomes. In many cases, Impact Investors do so by deploying capital to companies which sell products or services that improve the lives of low-income or vulnerable populations in a way that conserves and/or protects the environment (EMPEA 2015). Extending the traditional investment model, impact investing deliberately and fully integrates intentionality, measurement and accountability for social and environmental benefits into the investment process, in addition to and in equal measure to the emphasis placed on financial returns. As a result, private equity impact funds, unlike standard private equity funds, tend to invest primarily in businesses that sell essential products or services to low-income people. They seek to create compelling business propositions in markets where low-income consumers are willing and able to pay for certain products/services that are affordable, accessible, good quality, and competitive with those offered by other suppliers, including the government and foreign companies. Such businesses may operate in sectors that include sustainable agriculture, healthcare, education, housing, communication technology, and financial services. The positive impacts are created by expanding access to a wide range of critical goods and services for the low-income populations that can improve their health, education, and employment prospects. Another form of impact investing is addressing global challenges like climate change, water scarcity, waste reduction, resource efficiency, address climate adaptation risk, health care and nutrition problems, demographic change or education through product innovation. A good indicator of how E&S risk are becoming more material is the fact that five of the "10 Global Risks of Highest Concern in 2014" collated in the World Economic Forum's "Global Risks 2014" report are related to E&S issues: water crises (ranked third); the failure of climate change mitigation and adaptation (fifth); the greater incidence of extreme weather events such as floods, storms, and wildfires (sixth); food crises (eighth); and profound political and social instability (tenth). The report was produced by the World Economic Forum in collaboration with a leading advisory firm, insurance and reinsurance companies, and academic institutions (Marsh and McLennan Companies, Swiss Re, Zurich Insurance Group, National University of Singapore, the University of Oxford, and the Wharton School of the University of Pennsylvania).

As can be seen from the most relevant ESG Risk Factors in the meta-analysis provided by Arabesque and the University of Oxford (Clark et al. 2014), the same ESG criteria can be used for creation of positive impacts and fostering innovation which is the aim of impact investors.

Other Impact Investing Funds target investments in small and medium size enterprises (SMEs) in view of their inherently impactful role in driving job creation,

GDP growth, and social stability. According to the International Finance Corporation, the private sector arm of the World Bank, formal SMEs contribute up to 45% of formal employment in developing economies. One such SME-focused fund is the TriLinc Global Impact Fund, a US$14.3 million debt fund that has invested in South America and Indonesia (IFC 2010; The SME Banking Knowledge Guide). The Fund's strategy is driven by the belief that impact objectives such as better trained staff and energy efficiency can be intrinsic to the portfolio company's success as well as investor returns, in addition to creating societal benefits (EMPEA ibid).

What Vehicles for Impact Investments Are Available and What Asset Classes Are Preferred?

Impact Investors use the following vehicles for activating impact investments. They set up Private Equity or Venture Capital Fund, use Direct Investment Strategies and to a lesser extent, they have been experimenting with Social Bonds and Green Bonds. However the analysis from J.P. Morgan Social Finance and the global Impact Investing Network (GIIN) shows that private equity is by far the most commonly used tool for impact investment (O'Donohoe et al. 2010; Saltuk et al. 2014).

J.P. Morgan Social Finance and the global Impact Investing Network (GIIN) further examine and explore Impact Investment dynamics in several publications, such as in "Perspectives on Progress: the Impact Investor Survey" (see: https://www.missioninvestors.org/tools).

The report reveals the experiences, expectations, and perceptions of 99 impact investors in 2012, and their plans for 2013. Investors surveyed for the report include fund managers, development finance institutions, foundations, diversified financial institutions, and other investors with at least USD10 million committed to impact investment. Respondents also reported the instruments that they use to make impact investments. Unsurprisingly, most of the respondents state using private equity and private debt instruments—83% use private equity and 66% use private debt. Interestingly, 44% of respondents use equity-like debt structures and 18% of respondents reported using guarantees, higher numbers than we expected.

In 2013 ACCENTURE conducted a survey of 1000 CEOs in 103 countries and 27 industries. They found that 80% of CEO view sustainability as a means to gain competitive advantage relative to their peers (Accenture 2013, p. 36), but only 33% of all those surveyed CEOs believe "that business is making sufficient efforts to address global sustainability challenges." (Accenture 2013, p. 15). One reason for this imbalance acknowledging the importance of sustainability and acting on it is pressure from the financial markets' short termism applicable for publicly listed stock companies (Accenture 2013; Barton and Wiseman 2014). Unilever under the leadership of its CEO Paul Polman has stopped giving earnings guidance and has moved away from quarterly profit reporting in order to transform the company's culture and shift management's thinking away from short term results (CBI 2012; Ignatius 2012). It seems that private equity and venture capital is able to look at

longer time horizons and therefore can embrace longer-term patient money and is less dependent on short term results. Private equity impact funds often invest in early or growth-stage businesses that are immature and have not been able to reach critical scale. These businesses can include start-ups and occasionally may involve supporting entrepreneurs in creating businesses; for example, Brazil-based private equity firm FIR Capital has been working to perfect business models for several pipeline companies in parallel with raising a new fund that will focus on healthcare, education, housing, and financial services. Preparing these companies and investing in their re-structured businesses requires discipline and patience (with long enough duration to yield returns), and risk tolerance (EMPEA, ibid).

Private equity is one investment approach within impact investing. It employs the traditional private equity model that intends to generate an attractive financial return for fund managers and their investors. The private equity process is one in which investors structure an investment vehicle (private equity fund) to raise capital from major institutional and individual investors (such as pension funds, endowments and high net worth individuals), committing the commingled capital into private businesses to expand and improve their operations, and ultimately, and usually after several years, to sell their stake in these businesses or to take them public on a stock exchange in many cases as an IPO.

An important attribute of private equity is that it can enable access to vast pools of financing through global capital markets. By comparison, funding sources such as government aid and philanthropic finance are often limited (and unpredictable) in low-income countries, and represent only a fraction of what is potentially available from the capital markets. Funding from Development Finance Institutions (DFI) may be significant in scale and can play a catalytic role, but is usually only available on the condition that additional private equity is put in at a certain quota and therefore private equity may in combination with DFI capital raise much more money than in isolation. On the other hand DFI funds will impose much more restrictions on impact investors' assets and normally is bound to a proven track record, which may not exist in the infancy stage in which many impact investment businesses find themselves.

For example, equity investment can be a more favourable capital base than debt for the many businesses with potential impact that are testing new business models to deliver products or services to consumers who have inconsistent and low incomes. "Some new business models require significant customer education, which can be capital intensive and can take some time to translate into revenues, which can make it challenging to service a debt investment", explained Yasemin Saltuk of J.P. Morgan Social Finance. In certain situations, particularly in frontier markets or early stage businesses, portfolio companies can face volatile cash flows, unpredictable supply chains, poor infrastructure, or inefficient regulation. This can translate into volatile cash flows for the businesses, making debt payments a burden, especially at high interest rates (EMPEA 2015).

Impact Investment Criteria for Impact Investors

Impact Investors use a number of criteria which distinguish them form conventional investors: They proactively define and measure impact: Although many private equity funds in emerging markets generate a positive economic impact through their investments, this is not sufficient to qualify them as impact investors. These funds must define, analyse, integrate and manage impact through the whole life-cycle of an investment. They must also demonstrate that they have integrated impact considerations throughout their investment process from initial screening, through due diligence (including ESG), closing, and post-investment monitoring with measurable results. They are therefore differentiated from purely financially-driven private equity funds because of intentionality, measurement and accountability.

They display active ownership: Once a private equity impact fund makes an investment, it monitors impact closely. Funds typically interact with their portfolio companies on a quarterly basis, tracking metrics that vary across sectors and apply active ownership behaviour. Although multiple organizations are attempting to develop standardized metrics, such as Impact Reporting and Investment Standards (IRIS) and Global Impact Investing Ratings System (GIIRS), there is still no universally accepted approach. What is important is that the fund specifies to its investors the relevant metrics to track and is held accountable to this end (ibid).

They create a value statement and a theory of change, which they measure their investment against: To increase effectiveness, many impact investing PE funds embed this social mission in their investment thesis. According to TriLinc Global, integrating impact intent alongside financial goals allows funds to (1) integrate data gathering monitoring and analysis on both finance and impact performance; (2) formalize accountability to investors on impact, and; (3) mitigate the potential trade-off between return and impact.

They come in with the intention of Cleaning Up the House: Another way to improve business, according to FIR Capital's Marcus Regueira, is to "clean up the house" by improving management capacity, corporate governance, and legal compliance, so as to create a competitive advantage for the business. Arun Gore, President and CEO of Atlanta-based Gray Ghost Ventures, agrees that private equity funds inculcate discipline and execution—the hallmarks of private equity—in fast-growing businesses. The role of educating firms about private equity can be remarkably effective particularly in environments where informality is the norm. The educating role can, in Gore's words, "trigger a systemic change on how to develop an enterprise." (EMPEA ibid).

They improve the way firms do business by Changing the Business Model by Instilling Innovation and Additionality: Impact Investors offer more than capital to businesses; they seek to improve the way firms do business (Porter and Kramer 2011; Moore et al. 2012; Loew et al. 2009; Krlew et al. 2013; Harji 2008a, b; Harji and Hebb 2010; EMPEA 2015; Desjardins 2011; Bishop and Green 2010). Any growth private equity fund—not just in the impact or emerging market space—seeks to transfer management and operational expertise to its portfolio companies. Impact

Investors in addition transform the business model. African- focused impact investing firm Vital Capital, for example, believes the operational expertise it brought to bear in financing Kora Housing, a 40,000 unit project in Angola, significantly enhanced the project's financial and impact performance. The fund understood the structural limitations of the Angolan housing market, and developed a unique approach involving a lease-to purchase mechanism, which increased the perceived value of housing to customers and therefore can be considered as a sustainable branding approach. It enabled local families to acquire housing units gradually, thereby making it possible for a larger percentage of the Angolan middle class to own a home, which ultimately has the effect of contributing to economic growth (Vital Cap. 2014). This form of additional growth would not have happened without transforming the business model.

What Do Impact Investors Do Differently from Conventional Investors?

One pattern in studying positive impact investors and there approach appears to be the employment of active ownership strategies (voting, shareholders resolutions and management dialogue). They have an extended due diligence approach including ESG, leadership and culture and also apply a sound stakeholder analysis (Benson and Davidson 2010; Borgers et al. 2013; Clark et al. 2014; Deng et al. 2013; Freeman 1984; Global Reporting Initiative 2013; Hillman and Keim 2001; Jensen 2002; Jiao 2010). The involvement of the investors in setting the agenda for the strategy of the target seems to be an important difference to a conventional investor.

Impact Investors normally apply a theory of change: Their mission is to influence the financial markets by creating new sustainable assets by growing the eco-system of sustainable entrepreneurs, by growing the eco-system of financial intermediaries active in the field and by growing the investment community investing in positive impact. They normally choose an educate, innovate and incubate approach.

Another consistent pattern is focus on thematic issues. The quest is to find responses to the growing global challenges of the universe like water scarcity, climate change, increasing pollution, finding answers to the growing state failures to address social issues. While some social issues may be a consequential damage of the global financial crisis impact investors see it as part of their strategy helping to provide the necessary social aid in order to overcome the state budgetary limits existing under current austerity schemes. Foundations in particular desire to finance and invest into the creation of products and services for those at the bottom of the pyramid. They want to create wealth for others and themselves and do good while doing well.

Another commonly observed pattern is the application of CQ—cultural intelligence in investment decision through analysing and actively influencing Leadership and Culture of their investments.

They employ a systematic and consistent ESG driven investment strategy, investment policy and ensure the implementation of ESG systems policies and KPIs at the level of the investee as part of their active ownership strategy. While most ESG schemes used by companies differ in practice, impact investors employ and implement a rigorous ESG approach based on their value statement and theory of change and connect and exchange about the metrics used in order to create commons.

With its rigorous focus on building commercial, scalable and profitable businesses, the thematic approach impact investment uses though deployment of private equity, creating new customer value, it is well positioned to generate positive and sustainable impacts in such critical sectors as affordable housing, healthcare, and local food production. It is especially poised to do so compared to other funding sources that are not driven by profitability, including government, foreign assistance, and philanthropic capital. The Emerging Markets Private Equity Association writes that "combining profitability with impact objectives can lead to mutually beneficial outcomes if there is intentionality, measurement, and accountability" (EMPEA ibid).

A systematic analysis and further in depth analysis on the various forms of impact investing (financial first, impact first and layered structures) as well as on the role of philanthropy and ethical banks in nourishing the impact investing market and its reach can be found at Bridges Ventures at http://bridgesventures.com/wp-content/uploads/2014/07/Investing-for-Impact-Report.pdf.

What Are the Main Challenges Facing Private Equity Impact Investing?

Attracting institutional capital remains a significant constraint to the development of impact investing. Although increasing in size and prominence in the past several years, private equity-style impact investing remains a "niche" investment strategy according to Bridges Ventures that mainstream institutional investors do not typically include in their portfolios. Attracting institutional investors will require evidence that it is possible to achieve both impact and financial returns, and education of investors about appropriate opportunities in which to invest. For instance, FIR Capital has raised awareness locally in Brazil by convening private wealth managers, the Brazilian private equity association, universities, pension funds and journalists, with the support of the Brazilian private equity association ABVCAP (EMPEA, ibid).

Another necessary milestone is the delivery of evidence that it is possible to achieve impact alongside risk-adjusted financial returns. Developing a comprehensive financial performance database would help enormously to identify critical success factors and to develop customized benchmarks. Many impact investments are first-generation and therefore early in their respective investment cycles. Impact Investors are working together and with partners to collect and analyse data on exits

in an attempt to quantify financial returns and key impact metrics (New Philanthropic Capital, KLF, Cambridge Associates, Aqal, PINEO, EMPEA).

Furthermore relevant and robust metrics are needed that demonstrate success in achieving social and environmental impact. The idiosyncratic nature of impact investing presents some specific challenges with respect to the development of metrics, including:

- Time Scale. Whereas financial returns to investors end once the fund has exited the investment, the social impact continues after a project has been completed. Some projects create impact throughout the life of the investment such as an insurance company, whereas others such as housing or infrastructure deliver impact over the longer term but in many cases only beginning in the final stage of the investment. Vital Capital thus suggests differentiating immediate and long-term impact projects and measuring them differently.
- Differentiated value of outcomes versus outputs. Outcomes, such as poverty reduction, reflect the ultimate impact objective of impact investments while output measure metrics such as units of housing constructed. Yet outcomes are more difficult to measure; to the extent that it is possible to determine a causal link between a firm's operations and the outcome, it is expensive to do so. Attributing the outcome to a particular investment in the firm is a further challenge.
- Each company and product creates impact in its own idiosyncratic way so generic indicators make it impossible to capture the complexity of the true impact. For example, one operational metric for insurance companies is the speed at which a claim is paid, which is not relevant for education where graduation rates would be a more appropriate measure. Even for metrics that appear on the surface to be comparable, variability in the methodology can create challenges. For example, a simple count of the number of jobs created obscures whether those were local workers or child labor or jobs offered at competitive wages and therefore need to be topped with rigorous ESG analysis criteria. Further, cross-comparisons are extremely difficult for certain units of value that have an inherently subjective component such as valuing the life of one patient or the value of reducing one unit of fuel consumption. To accommodate the wide range of metrics, IRIS has developed a repository of over 400 metrics, recognizing that no single combination will be right for all organizations.
- Tracking Social and Environmental Portfolio Performance across a number of Standards (Organization, Product; Financial Performance) is done by the Impact Reporting and Investment Standards (IRIS) managed by the Global Impact Investing Network GIIN, a network founded by impact investors back in 2008, namely the Acumen Fund, B Lab and the Rockefeller Foundation. This effort by IRIS (as well as GIIRS) is helpful, but one aspiration among the growing field of private equity impact investors is to simplify the process and make it more practical by focusing on the key "metrics that matter." (EMPEA ibid). FIR Capital's Marcus Regueira recommends 4–5 indicators per industry to provide a balance between comparability and overload of indicators.

- Finally, scale in impact investing is hindered by a mismatch between investors' preferences and realistic investment opportunities. J.P. Morgan Social Finance conducted a survey of leading institutional impact investors and found that absorptive capacity is a critical bottleneck. It is not unusual for mainstream pension funds, insurance companies, and asset managers to consider investing in only those funds that are of significant size (e.g. minimum of US$500 million). Furthermore, many investors have minimum commitment sizes (e.g. they want to commit more than US$100 million) and maximum ownership limits (e.g. they cannot represent more than 20% of the fund's interests). By way of comparison, the average impact investing private equity fund is US$7 million, and the average underlying investment is US$2 million (J.P. Morgan Social Finance 2013).
- Another gap lies between investor preferences for the stage of the business in which they would like to invest and where the majority of impact investees are in the growth cycle. The J.P. Morgan survey "Perspectives on Progress" revealed an overwhelming focus on growth stage businesses (78%), while only 51% indicated a focus on venture capital. Eighteen per cent of respondents indicated an appetite in seed or start-up capital.

What Does Science and Academic Research Tell Us About Impact Investing?

There is little research on impact investing at least when it comes to impact first and thematic impact investing, theories of change or embedding impact into the strategy of traditional companies. There is a more to find on responsible and sustainable investment (see Meta-analysis provided by Clark et al. 2014). Responsible and Sustainable Investment is included in the impact investing definition in academia, but impact investors do differentiate between the two concepts clearly (Brandstetter and Lehner 2015).

Impact investments do not yet match the logic of traditional finance tools (Brandstetter and Lehner 2015). Measuring the potential social and environmental impact of investments in a generally accepted manner will thus be a key component of research to be undertaken since impact investing explicitly seeks to intentionally generate quantifiable social and financial returns. The World Economic Forum states in its report: "Although many exceptions exist, the leading asset owners that are allocating capital to impact investments today include development finance institutions, family offices and high-net-worth individuals. However, relative to other sources of capital, these investors hold only a small share of the global capital pool." (World Economic Forum 2013). Addressing the factors that constrain other types of asset owners from allocating capital to impact investments therefore is an important topic for investigation.

The few researches undertaken in the field provides early evidence that overall performance of mixed portfolios might profit because the experienced low correlation of impact investments to traditional markets reduces portfolio risk and increases sustainability (Hertrich and Schäfer 2015). In addition, more and more investors demand ESG (environmental, social and governance) criteria to be considered, in a consistent manner and so implemented mainly based on pressure from stakeholders and regulators. Those demands have fostered voluntary frameworks on a global scale, creating global level playing fields for eco-social criteria and standards and are considered by some authors to constitute "Global Administrative Law" (McIntyre 2015). Impact investments differ significantly from traditional investments through their hybrid goals (Doherty et al. 2014; Lehner 2012).

The rare authors from the academic field dealing with Impact Assessment will normally use the definition provided by the World Economic Forum "Impact Investing is generally understood in science as the proactive intention of an investor to create a measurable positive social and/or environmental impact (in the following referred to as eco-social impact) through investment or finance and to achieve (eco-) social returns alongside with financial returns. Impact Investing is an investment approach that intentionally seeks to create both financial return and positive social or environmental impact that is actively measured" (World Economic Forum 2013). However practitioners have provided a lot more disclosure on their "hybrid goals" and began to include Theory of change as an additional tool for creating impact.

It is important to stress, that impact investment is an investment approach and not an asset class. It is a criterion by which investments are made across asset classes. Second, intentionality matters. Investments that are motivated by the intention to create a social or environmental good are impact investments. Third, the outcomes of impact investing, including both the financial return and the social and environmental impact, are actively measured (World Economic Forum 2013).

A new way of categorizing various forms of impact investments has been developed by Bridges Ventures, Lehner and Brandstetter.

The following figure shows the scale up of impact from responsible to philanthropic and presents a different scheme of categorizing the various forms of impact investing. Whereas practitioners in Impact Investing have described Impact Investing as journey from Responsible Investment to Impact first Investment concentrating on thematic issues creating additional customer value (which can be compared to new products (see Fig. 1), the few sources in academia describe the journey leading through the responsible and sustainable investment process pillars to visionary and philanthropic, which appears to be a different definition than the one used by practitioners (focussing on thematic social issues and impact first structures). The journey described by Brandstetter and Lehner (2015) adopting and adjusting the model provided by Bridges Ventures leads from conventional risk/return driven investment through responsible and sustainable investment to visionary and philanthropic investment (see Fig. 2).

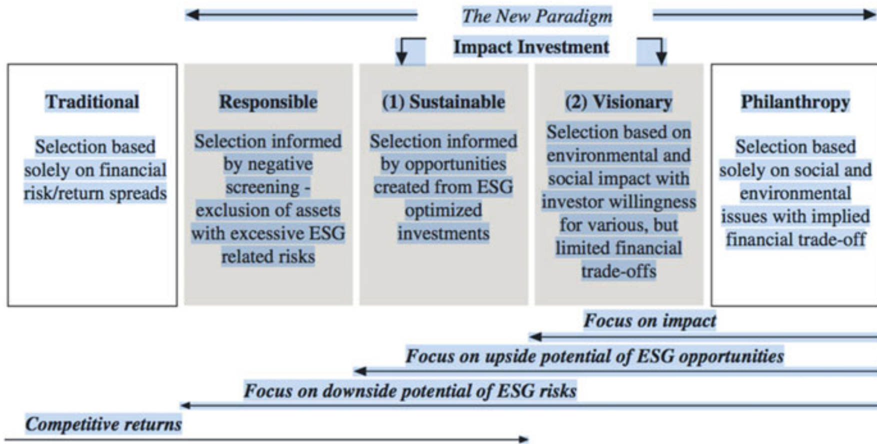

Fig. 2 The spectrum of capital. Source: Own description based on Nicklin (2012), and Clara Barby, Bridges Ventures

Comparing Science and Practice in Impact Investing

Difference in Focus

There is agreement between practice and science though that Impact Investment is a journey that is starting with responsible investment, then adding ESG, leadership and culture (L&C) analysis and assessment for potential portfolio assets, providing ESG/L&C Gap Reports and ensuring systematic ESG implementation, leadership and culture management throughout the assessment, investment and management process.

There seem to be differing views about the way going forward. Whereas science represented by Lehner and Brandstetter describes the future path as visionary and philanthropic, impact investors themselves see impact investment as thematic and impact driven, based on clear measurement criteria they lend from international networks occupied with impact measurement like GIIRS, EIRIS, IRIS B Lab, GIIN. This distinction about the way forward may be relevant as ESG, leadership, culture and gap analysis are all elements that have to be defined in the investment approach and investment policies of the impact investor. The criteria visionary and philanthropic appear to be less clear and could in practice just mean that the investment complies with the internal investment house policy without any external stakeholder driven “assurance”, endorsement or license.

Relevant Criteria and KPIs for Capital Allocation

According to Brandstetter and Lehner (2015) investors struggle to allocate capital towards the social sector, because the above proposed performance measurement metrics do neither fully assess risks associated with the generation of impact nor consider relationships and interdependencies between parameters of risks and return. This becomes an aggravated problem when looking at a portfolio level, due to inevitable co-variances that remain unaccounted for (Brandstetter and Lehner 2015). Portfolio models can only be applied in situations where risk and return metrics are accurately measurable and comparable. According to the academic research undertaken so far, some researchers find that "Unfortunately, such consistent metrics are largely absent within the emergent field of social finance" (Geobey et al. 2012). According to Brandstetter and Lehner (2015) "Therefore—since an optimized asset allocation is an indispensable necessity for institutional investors—the expected market growth of impact investing will be dampened as long as impact investments' characteristics do not match conventional portfolio tools." One question is how impact investment characteristics meet conventional portfolio tools.

Business seems to be searching for a how to implement impact investing into mainstream business be it from an ESG driven, good-will and branding driven or an investment philosophy standpoint. Some hope that an answer may come from the future fit business benchmark, which is developing for the true values network a benchmark to measure future fitness based on a branding approach. The tool is meant to be open source and it is organized through the true values network, a collaborative open source initiative led by The Natural Step Canada and 3D Investment Foundation. On the bases of a system of principles that are designed to describe future-fitness, the network will develop key performance indicators (KPIs) that can be used to tell how far away any company is from reaching the future-fit goals. In essence the goals are addressing the global challenges from resource scarcity, climate change, and ocean acidification to trust into business organizations. It includes the commitment to consistent ESG implementation and wants to show the relevance of ESG implementation. With this approach the future fit benchmark picks up the thematic issues approach that impact investors use and which has some similarities with good will branding.

At the same time scientific researchers acknowledge that "Across sectors, there are already a number of measurement systems in use, endorsed by various impact investing actors. Among them are the Impact Reporting and Investment Standards (IRIS), the Global Impact Investing Rating System (GIIRS) and the B Impact Assessment powered by B Lab" (Antadze and Westley 2012; Jackson 2013).

Social Responsible Investing (SRI) in distinction to Positive Impact Investing presents itself as a broad category in literature, consisting of a range of different investment activities based on negative screening of existing assets in various asset classes and negative selection of those assets that have been screened out. This approach is usually complemented by a Best in Class benchmarking approach for assets that have passed the negative screen and therefore are eligible for investment.

Best in Class approaches are meant to provide further support and guidance to the investor. SRI approaches are not designed to intentionally create assets with measurable positive environmental or social outcomes. Rather it is a negative screening and selection process reducing the investment universe of investors instead of intentionally increasing it by adding more sustainable positive impact driven assets driving the market in a desired direction. For a detailed elaboration on the issue of SRI, see, for example, Renneboog et al. (2008), Sandberg et al. (2008), Lee et al. (2010), and Harji and Hebb (2010).

Increased Research Interest in the Field of ESG, But No Final Consensus in the Conclusions About Its Effectiveness

A new meta-analysis on ESG taping into the practitioners as well as the academic field has been established by Arabesque fund management in collaboration together with well reputed pioneers in the field of ESG, Global Administrative Law, Triple Bottom Line Creators and Global Compact Senior staff. The main results of this meta-analysis and mapping exercise on the ESG landscape will be summarized below.

The meta-analysis conducted by Arabeques Partners together with the University of Oxford finds a strong business case for companies implementing sustainable management practices and systematically integrate ESG, in other words doing well while doing good. In "From the Stockholder to the Stakeholder. Clark et al. (2014) base their meta-analysis on more than 190 academic studies, industry reports, articles and books. The meta-study concludes that "case studies and academic literature are clear that environmental and social externalities impose particular risks on corporations (reputational, financial and litigation related) which can have direct implications for the costs of financing- in particular debt" (ibid: 18). According to the study companies with good sustainability standards enjoy significantly lower cost of capital and have better access to capital. This applies to both equity and debt. Good corporate governance structures such as small and efficient boards, good disclosure policies, good environmental management practices, such as the installation of pollution abatement measures and the avoidance of toxic releases, as well as environmental and social company policies lower the cost of capital (both equity and debt). They likewise conclude that Meta-studies generally show a positive correlation between sustainability and operational performance one of the factors being implementation of ESG Management Systems.

The findings seem to be supported by academic research for instance by Chen et al. (2011). They show that the governance index of Gompers et al. (2003) is significantly and positively related with a firm's cost of equity. This implies that relatively better governed firms can benefit from lower cost of equity, relative to poorly-governed firms. This is not surprising, as good corporate governance translates into lower risk for corporations, reduces information asymmetries through

better disclosure (Barth et al. 2013) and limits the likelihood of managerial entrenchment (Derwall and Verwijmeren 2007). International evidence on Brazil and emerging market countries also supports the view that superior corporate governance reduces a firm's cost of equity significantly (Lima and Sanvicente 2013) for evidence from Brazil and emerging markets). Attig et al. (2013) studied firms from 1991 to 2010 and used MSCI ESG STATS as their source for CSR information. Additional evidence is provided by Jiraporn et al. (2013): after correcting for endogeneity, the authors conclude that firms with a better ESG quality tend to have better credit ratings, pointing towards a risk- mitigating effect of ESG. Likewise, the adoption of proper environmental management systems increases firm performance (Darnall et al. 2008). Also it has recently been demonstrated that more eco-efficient firms have significantly better operational performance as measured by return on assets (ROA), see Guenster et al. (2011). It is further argued that corporate environmental performance is the driving force behind the positive relationship between stakeholder welfare and corporate financial performance measured by Tobin's Q (Jiao 2010).

The Arabesque/University of Oxford Meta-study concludes: "Given the evidence, it is clear that the social dimension of sustainability, if well managed, generally has a positive influence on corporate financial performance. What is missing in this strand of research is direct evidence of other types of corporate social behaviour, for example, corporations' worker- safety standards in emerging markets, respect for human rights, or socially responsible advertising campaigns." (Clark et al. 2014).

It has to be added that the meta-analysis while interesting and valuable in mapping the existing research and findings and well written, nevertheless it uses different studies with different criteria to come to the conclusions drawn. The question is whether it is really possible to compare such different criteria when drawing conclusions and cluster them into four different categories. It therefore remains under question whether the study is comparing like with like.

The following meta-analysis study results are stunning:

1. Despite the relationship between ESG on one hand and a better operational performance and lower costs of equity on the other hand, it is quite surprising that the relations between ESG implementation and stock prices appears to be less clear.
2. The same applies to research on Responsible Investment. Depending on the study and research question the results appear to be mixed. For instance Galema et al. (2008) argue that the reason some studies find no significant alpha after risk adjusting using the Fama-French risk factors is that corporate environmental performance significantly lowers book-to-market ratios, implying that the return differences between high CSR and low CSR stocks are created through the book-to-market channel because 'SRI results in lower book-to-market ratios, and as a result, the alphas do not capture SRI effects', p. 2653.
3. Flammer (2013a) investigates stock price reactions around news related to the environmental performance of corporations. Investigating environmentally

related news over the time period 1980–2009, the author concludes that on the 2 days around the news event (i.e. 1 day before the announcement of the environmentally related news and the announcement day itself), stocks with "eco-friendly events" experience a stock price increase of on average 0.84% while firms with "eco-harmful events" exhibit a stock price drop of 0.65%, which is regarded only weak evidence for sustained ESG benefit.

4. Eccles et al. (2013) classify the sustainability quality of firms based on a sustainability index, which evaluates whether corporations adopt several different kinds of CSR policies (e.g., human rights, environmental issues, waste reduction, product safety, etc.). The authors primarily investigate the stock market performance of both groups of firms and therefore circumvent any reverse causality issues. Their empirical analysis reveals that a portfolio consisting of low-sustainability firms shows significantly positive returns. Further, the high-sustainability portfolio displays positive and significant returns over the sample period. Importantly, the performance differential is significant in economic and statistical terms. The authors also find that the high-sustainability portfolio outperforms the low- sustainability portfolio in 11 of the 18 years of the sample period.
5. Outside the meta-analysis study Gasser, Kremser, Rammerstorfer and Weinmayer in Markowitz Revisited: Social Portfolio Engineering (2014) find that that investors opting to maximize the social impact of their investments do indeed face a statistically significant decrease in expected return. In their paper they revisit Markowitz' Portfolio Selection Theory and propose a modification allowing to incorporate not only asset-specific return and risk but also a social responsibility measure into the investment decision making process. Together with a risk-free asset, this results in a three-dimensional capital allocation plane that allows investors to custom-tailor their asset allocations and incorporate all personal preferences regarding return, risk and social responsibility. We apply the model to a set of over 6231 international stocks and find that investors opting to maximize the social impact of their investments do indeed face a statistically significant decrease in expected returns. However, the social responsibility/risk-optimal portfolio yields a statistically significant higher social responsibility rating than the return/risk-optimal portfolio.

Therefore there seems to be need for on-going research to identify which sustainability parameters are the most relevant for operational performance, investment returns and to deliver competitive risk- adjusted performance over the short-, medium to longer term, appropriately de-risk assets through systematic implementation of ESG and—for Investment and pension funds to fulfil their fiduciary duty towards their investors.

With regard to the stock market: it is relevant to research which ESG components will provide sustained alphas and better sharp ratios.

We all hope very much that you will enjoy the diverse views and converging concepts presented in this anthology on the way to a sustainable society.

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