CHAPTER 12

Socially Motivated Investing[93]

To the extent that it does not sacrifice risk-adjusted financial returns, many readers of this *Guide* probably would prefer to place their investment assets in companies whose products and processes are aligned with their values. These are often called *socially responsible investments*. Indeed—though the jury is out—you may believe that investments in companies and funds that meet certain Environmental, Social, and Governance (ESG) criteria are likely to maximize financial returns in the long run.

There's nothing at all wrong with this. But if your only goals are value alignment plus good financial returns, you can skip this chapter. Your investment advisors know far more than we do about how to achieve those goals. However, if your goals include having *impact* by enabling an investee company to *do more* of whatever socially or environmentally (hereafter, simply "socially") beneficial thing it is doing, then read on.

To make the same point a little differently: All *businesses* have social impact, whether positive, negative, or both. They can, for example, deliver financial returns for investors, create jobs, and expand the provision of goods and services and also pollute the environment. The question for this chapter is when your *investments* can affect the behavior of those businesses for better or worse.

To anticipate the conclusion of this chapter, here's a spoiler:

- It is possible, though by *no means easy*, to achieve social impact through concessionary investments—investments that expect to have below-market returns. Some foundations do this through program related investments (PRIs).
- It is *impossible* to achieve social impact through investments in large cap, publicly traded companies.
- It is possible, but *very difficult*, to achieve social impact through non-concessionary (market-rate), private equity investments.

Even compared to **Chapter 6** on theories of change, this is the most complex and theoretical chapter in the *Guide*—because the ways in which investors can (and can't) achieve social impact comprise a complex subject that can only be understood in a theoretical framework.

This chapter is also a downer. How can it be that when there's so much excitement about *impact investing*, so little of it actually has impact? The answer is that much, if not most, of what falls under the name impact investing turns out to be value-aligned investing without impact. We're not interested in quibbling about definitions—about who is and who is not an impact investor. What we do care about, and hope you do too, is *when your investment can actually have impact*—when it results in the investee doing more things better.

We are not opponents of impact investing. Far from it: we have great aspirations for the field. But we have the same sort of concerns about false and misleading claims that those trying to advance medicine in the nineteenth century had with the patent medicine industry. And, as in the preceding chapters, we wish to help readers put their resources where they can actually improve society.

Value-Aligned Investing

To recapitulate, 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 foundations in pursuit of their charitable mission—and "socially responsible investing" (SRI).

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

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 meet high ESG standards and eschew companies with poor ESG ratings. Good ESG ratings sometimes predict good financial returns—perhaps because they signal that management is good at managing risks in general—but the evidence is mixed about whether ESG-oriented funds outperform or under-perform the market, net of management fees.

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.

Investing for Impact

Investors who seek impact begin by identifying enterprises that are aligned with their values and whose goods, services, or production processes create social impact. But impact investors then go on to ask whether their investments are likely to increase those enterprises' impact.

The fundamental distinction between value-aligned investing and impact investing lies in the term *impact*. While value-aligned investors need only learn whether a company's behavior is consistent with their personal values, impact investors must also predict whether their investment in a company will actually improve the company's performance.

Impact investors' goals can be as varied as those of philanthropists. They may include:

- Achieving the UN Sustainable Development Goals (SDGs), including reducing poverty and adapting to climate change. For example, the Gates Foundation made an impact investment in the company bKash to reduce poverty by providing financial services to the unbanked poor in Bangladesh.
- Improving outcomes for disadvantaged communities in developed countries. For example, the MacArthur Foundation's Benefit Chicago Program makes impact investments in job creation and job readiness programs; Bridges Fund Management makes impact investments to improve the lives of working people in the United Kingdom.

Impact investors typically achieve their goals through investments in for-profit companies rather than nonprofit organizations. Impact investments are transitory by nature. Their overarching goals are to create markets and opportunities that will eventually attract ordinary commercial investors as well as change companies' management practices in enduring ways.

Impact investments can achieve social impact by:

- increasing or improving a firm's *delivery of products or services*—for example, an investment in a firm that provides health services to underserved communities.
- improving 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.

The Two Requisites of Impact

There are two requisites for an investment to have "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 activities and outputs

ENTERPRISE IMPACT

Enterprise impact is the impact of the investee firm in achieving its beneficial outcomes. It is precisely the same for a for-profit investee as it is for a nonprofit grantee. Consider our earlier example of a program designed to reduce recidivism among young men released from prison. Suppose that before the program started, the recidivism rate in a particular city was 45%. And suppose that two years later, ex-offenders who participate in the program return to prison at a rate of 35%.

This sounds like a good outcome. But what if it turns out that, say, the program was cherry-picking participants who (perhaps because they had highly marketable skills) were unlikely to commit crimes again in any event? All things considered, the program does not have any impact because its outcome would have happened anyway.

If you are a philanthropist, you would think twice before making a grant to a nonprofit anti-recidivism program that didn't improve its

participants' outcomes. For the same reason, if you were an impact investor, you would be hesitant to invest money in a for-profit program whose apparent impact was based on its skewed selection criteria.

INVESTMENT IMPACT

Investment impact is the positive impact your investment has in enabling the investee company to increase its socially valuable products or processes. In this respect, impact investments in for-profit companies present a question about impact that doesn't occur when making philanthropic donations to nonprofit organizations.

Consider that philanthropic resources are almost always scarce. Very few, if any, effective nonprofit organizations get as much philanthropic support as they could productively use to increase or improve their outcomes. Thus every philanthropic dollar usually contributes incrementally to the nonprofit's outcome.

By contrast, for every impact investor in a for-profit company there are hundreds or thousands of ordinary commercial investors who care only about good financial returns. Having investment impact requires that your investment provides *additional* resources, beyond those supplied by commercial investors, that increase or improve a firm's socially valuable products or processes.

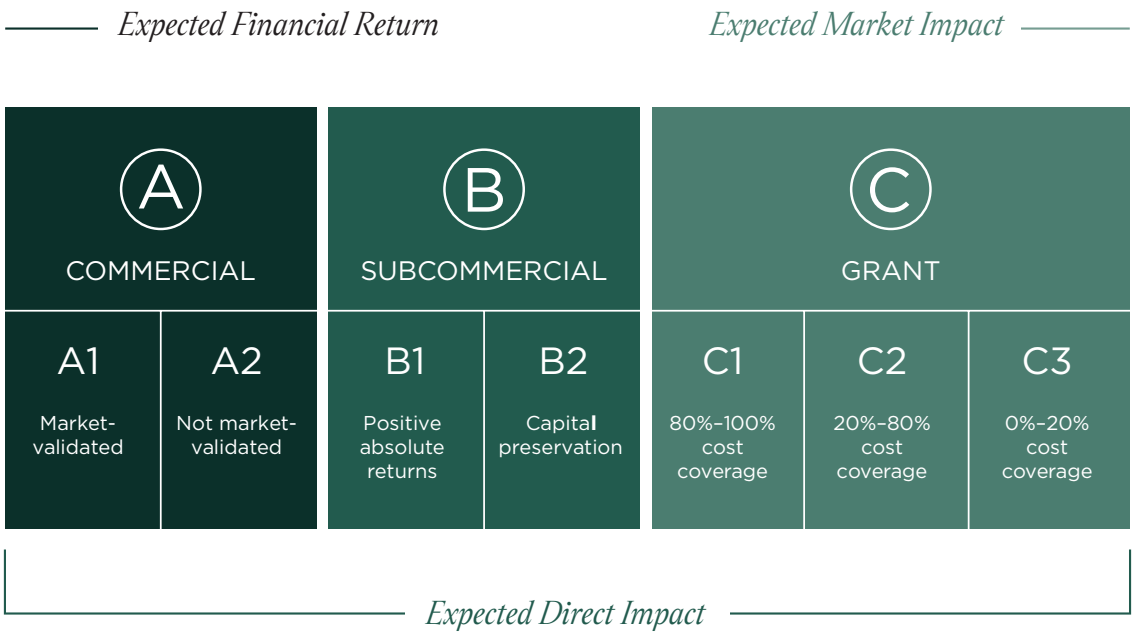
We will spend the remainder of the chapter discussing how an investor can create investment impact. There are essentially two ways: (1) through purely financial mechanisms just the money; and (2) through non-financial mechanisms, such as providing expertise and influence.

Purely Financial Mechanisms

The expected returns of impact investments range from at or above market (**non-concessionary**) to below market (**concessionary**)—with investors making a financial sacrifice to achieve their social goals. Impact

investments can fall into 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.

To help guide our exploration of the purely financial mechanisms that might create investment impact, we refer to the Omidyar Network's "continuum of returns," ranging from grants to commercial investments.*



GRANTS

Grants are not investments since they expect zero financial returns and a total loss of capital. Grants may nonetheless play an important role in the impact investing ecosystem. For example, the Global Investment Impact

* Omidyar Network was established by Pierre Omidyar, the founder of eBay, and his wife Pam to conduct both impact investing and philanthropy.

Network (GIIN) and the Impact Management Project (IMP), two major infrastructure organizations, are supported by grants.

CONCESSIONARY (SUBCOMMERCIAL) INVESTMENTS

A concessionary, or subcommercial, investment is one in which the investor expects to receive below risk-adjusted market returns. (Of course, many investments intended to receive market-rate returns don't succeed; but it's the expectation that matters.)

Why would an impact investor make a concessionary investment? Typically, to enable businesses 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 the poorest residents of Bangladesh, which several years later attracted non-concessionary private equity capital.

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 whose primary purpose is to further the foundation's charitable purposes rather than generate financial returns. For this reason, PRIs are almost always concessionary—though non-concessionary investments that are not market-validated also can qualify. Conceptually, you can consider the expected 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 complex than making a grant because of the need for financial due diligence and investment documents. The foundations with good reputations for PRIs tend to have dedicated PRI staff as well as legal expertise.

---

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

It's worth noting that although 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 PUBLIC MARKETS

Investors cannot have any social impact merely by trading securities in large cap secondary public markets.

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. For example, a publicly traded telecommunications company in a developing country may be of great value to smallholder farmers and poor urban residents, but no matter much of its stock you purchase, you will not lower the cost of service to your intended beneficiaries.

By the same token, investors may 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, however, impact investors have no advantage in moving the needle here.

In short, it's virtually impossible to have both investment impact and financial returns for investments in public markets.

NON-CONCESSIONARY INVESTMENTS IN PRIVATE MARKETS

Unlike in public markets, it's at least possible to have impact in *non-market-validated* investments—investments that have attracted few if any ordinary commercial investors, either because they regard the investment as too risky or because they haven't yet discovered the market.

The reason that it's possible for impact investors to have impact through non-market-validated investments is that private markets thrive on private information; impact investors' advantage lies in their expertise in assessing the financial potential of companies whose outputs fit their social values.

Just as a successful venture capitalist may possess expertise in, say, biotech, an impact investor may develop expertise in markets with the potential for socially valuable outcomes. For example, Omidyar Network (ON) argues that they are better able to assess the risks of 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."[94]

It's far more difficult to create social value through market-validated investments—investments that are already attracting commercial capital. When you're making market-validated investments, the critical question is whether you are providing capital on more favorable terms than the company can obtain from ordinary commercial investors. For example, you may hope that your investments in emerging markets in developing countries will have "additionality"—but they can't if their investee companies are already attracting ample commercial capital.

Investment Impact Through Non-Financial Mechanisms

The main non-financial mechanisms that can create investment impact are (1) providing the investee with knowledge and assistance that promote its social goals, and (2) influencing management decisions that affect the company's social goals through shareholder engagement and action.

PROVIDING INVESTEES WITH KNOWLEDGE AND ASSISTANCE

Venture capital and private equity firms provide their investees with various forms of knowledge and assistance—for networking

and fundraising as well as addressing internal management and organizational needs. Impact investors in private markets can provide similar assistance to their investees, increasing their social impact as well as their financial sustainability.

When financial returns and social impact are highly aligned, the investor need not make a financial sacrifice in providing assistance to achieve social goals. When the investee's financial returns are not necessarily correlated with its social impact, the fund manager must devote extra resources to assist with the latter.

Readers may wonder how they can know whether a self-identified impact fund manager offering commercial returns is providing its investees with knowledge and assistance that will promote their social goals. This requires that the fund manager be transparent and forthcoming about how it is adding such value. Ideally, although we haven't seen any examples to date, the fund manager would be compensated based on social impact as well as financial returns.

INFLUENCING MANAGEMENT DECISIONS

There is a long history of shareholder efforts to improve corporations' practices, particularly relating to ESG criteria. 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."[95]

There are some recent examples of major fund managers, including BlackRock, Inc., exercising shareholder power to influence its investees' environmental and social behavior. It remains to be seen whether this practice becomes more pervasive.

BENEFIT CORPORATIONS AND B CORPORATIONS

Almost all impact investments are made in traditional corporations. But philanthropist-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 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 chartered as benefit corporations, as "B Corporations" if they meet certain "standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose."[96]

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.
- It is possible to achieve impact through concessionary investments—investments that sacrifice risk-adjusted returns for social or environmental goals. It is also possible, but difficult, to achieve impact through non-concessionary investments in private markets. But it is not possible to achieve impact through investments in public markets.
- An "impact fund" that is serious about impact are is transparent about how and to what extent it is achieving both enterprise and investment impact.

THE STANFORD PACS

GUIDE

TO EFFECTIVE PHILANTHROPY

Published June 2020

Stanford PACS
Center on Philanthropy
and Civil Society
—
Effective Philanthropy Learning Initiative