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Generations Winter 2021 - Impact Investing: Finding Profit Through Purpose

This is the second in a series of articles about impact investing, which is generally understood to represent investments made with the intention of generating positive, measurable social and environmental impact and a financial return. For a general overview of impact investing and a discussion of how to develop an impact investing strategy and measure the social impact of investments, please refer to the first article in this series, "Impact Investing: How to Define Your Goals and Measure Your Impact."

Measuring the financial return of an investment is a familiar concept. Less clear to investors is whether impact investing sacrifices profitability. As with mainstream investments, the profitability of impact investments depends on the objectives and the approach employed by each individual investor. Unlike traditional investing strategies, impact investing has the potential for double returns—achieving financial returns consistent with expectations while funding a social or environmental cause of significance to the investor.

This article addresses the assumption that investors will make lower returns on impact investments and discusses strategies to maximize the financial returns of impact investments.

The Myth of the Trade-off

Market-rate financial return is possible with impact investing. The assumption that impact investments are less profitable than traditional investments may be related to early market research.

The first well-known impact investing benchmark study was developed in 2015 by Cambridge Associates and the Global Impact Investing Network (GIIN), a nonprofit advocacy group that has grown to become a key authority on impact investing. The GIIN study found that top-quartile returns (net of fees and expenses) of impact investments reached 9.7 percent or higher, in line with the average return of the top 10 percent of the S&P 500, but that overall average returns since inception reached only 5.8 percent. The GIIN study's findings have been compared with the findings of a 2015 study of 32 impact investing funds by the Wharton Business School and a 2017 McKinsey & Company study of 48 private equity impact investing exits, which found average gross internal rates of return of 9.2 percent and 11 percent, respectively. When taken together, these three studies demonstrate that over time, impact investing funds can perform at their benchmarks.

It is important to note that the GIIN and Wharton studies, both early indicators of the impact investing market, focused exclusively on market-rate-seeking private equity impact investing funds, because not all impact investors seek market-rate returns. As discussed in our prior article, impact investing is inherently tailored to the investor's particular goals, and the first step in formulating an impact strategy is to choose between pursuing an "impact first" investing approach (which prioritizes the achievement of a specific social or environmental goal over financial return) and a "financial first" investing approach (which prioritizes a high return on investment). The second step is to determine the social causes or issues to address through investing.

Since the 2015 impact investing benchmark study, the GIIN has conducted and published an *Annual Impact Investor Survey*, its flagship report, which provides the most comprehensive overview of the impact investing market. The 2020 report captured data from 294 of the world's leading impact investors—the most respondents ever—who collectively manage $404 billion of impact investing assets. Those respondents represent a meaningful subset of the $715 billion global impact investing market and demonstrate the growing diversity of the current market and the amount of growth experienced in only five years.

The 2020 respondents indicated that their target financial returns ranged from capital preservation to market rate, with most respondents (67 percent) targeting risk-adjusted, market-rate returns from their impact investments. Target returns vary by organization, size and type, reflecting the investors' organizational structures, investment strategies and impact objectives. That said, 88 percent of all respondents reported meeting (68 percent) or exceeding (20 percent) their financial expectations, and 99 percent of respondents reported meeting (78 percent) or exceeding (21 percent) their impact expectations. What is more, only 8 percent of market-rate investors reported underperforming their financial performance expectations—meaning that 92 percent of impact investors targeting market-rate returns reported that their investments were performing in accordance with market expectations; this represents a sharp increase in performance from the average return of 5.8 percent in 2015.

Most recently, investors have flocked to impact funds amid the social and economic disruptions resulting from the COVID-19 pandemic. Those funds have largely outperformed expectations. As reported in "Investing in Social Good Is Finally Becoming Profitable" in *The New York Times*, "64 percent of actively managed E.S.G. funds beat their benchmarks versus 49 percent of traditional funds through the first week in August [2020]."

Maximizing Returns From Impact Investments

Impact investments span numerous sectors, asset classes and geographies, and they can be made in nonprofit organizations or investment funds. However, returns (as well as risk) vary by asset class, and impact investors have developed different return expectations accordingly.

For example, equity investments have been shown to generate higher returns on average than investments through debt or real assets, and market-rate investments tend to perform better than their below-market-rate counterparts. Private equity impact investments have outperformed the S&P 500 index by as much as 15 percent but are subject to the greatest variances in performance and tend to be the riskiest, which is consistent with traditional private equity investments.

The data has shown less variance among investments in different geographies. Investments in emerging markets perform similarly to developed market investments with comparable ranges of return. However, the respondents to the GIIN's 2020 *Annual Investor Impact Survey* reported a significantly greater rate of investments in emerging markets underperforming financially compared with investments in developed markets. Although the majority of respondents reported that most of their impact investments were in the United States and Canada, they also reported meeting or exceeding their financial expectations.

In addition to adopting a financial-first strategy, the impact investor seeking higher returns can take a portfolio approach to satisfy his or her risk and return parameters by balancing investments across asset classes and geographies.

Case Study

One of the respondents to the GIIN's 2020 *Annual Investor Impact Survey* was Farmland LP, a U.S. real estate fund that generates competitive risk-adjusted returns by acquiring conventional farmland and converting it into organic, sustainably managed farmland, creating value by enhancing soil fertility and productivity through science-based livestock and crop rotation. Founded in 2009, Farmland LP currently owns and manages more than 15,000 acres and more than $175 million in assets.

In June 2015, Farmland LP purchased Willamette Valley farmland in Oregon. Since that time, Farmland LP has employed its unique model to convert over half of the land to producing certified organic products and increased revenue per acre by 18 percent in 2018 and 34 percent in 2019. This was achieved by reducing the use of synthetic pesticides and fertilizers, rebuilding the soil with organic matter (which in turn reduced carbon dioxide levels), improving irrigation systems, upgrading to state-of-the art farming equipment, and using aerial imagery to inform decision-making.

Farmland LP's approach to owning and managing farmland investments benefits farmers, investors, the environment and consumers. In particular, investors benefit from the security of owning farmland while participating in the growth and profitability of local, organic food markets.

The Potential of Double Returns—Performance Relative to Expectations

If the investor's goal is to target market-rate returns, the investor would adopt a financial-first strategy for impact investing. After determining the social causes or issues to address, the next step is to identify investment opportunities aligned with such causes or issues and with a financial-first objective. This can be done by strategically selecting asset classes and building a diversified portfolio of impact investments.

In the relatively new field of impact investing, while uncertainties and unique risks remain, the mounting body of research on the performance of impact investments across asset classes provides meaningful insight about the achievable levels of financial return on which investors can base realistic expectations and formulate strategies aligned with their goals. The available data should give investors confidence that a thoughtful and deliberate impact investing strategy that is closely tailored to the investor's particular goals should perform in accordance with the investor's financial expectations.

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