A Guide to Impact Investing

for Endowment & Foundation Fiduciaries

Overview

Fiduciaries of endowments and foundations across the US are considering whether and to what extent to integrate institutional values with the resources they oversee. That deliberative process involves evaluating the role of impact investing, divestment, and ESG investing in their investment programs. Unfortunately, this process is not straightforward; responsible investment practices date back to biblical times and yet new terminology and standards continue to cloud progress. By some estimates, as much as a third of all assets could be invested in "ESG" strategies by 2025[1] but there is no standard framework for qualifying an "ESG" investment. Across leading endowments and foundations that have adopted "impact investing," there is no singular approach or agreed-upon method to invest for and measure impact.

In this Guide to Impact Investing, we will summarize some of the common terminology, place some key terms and ideas in context, and present tools to fiduciaries who want to engage with these important issues.

In This Guide

Terminology

Impact Investing: A term that emerged in 2009, impact investing is a broad category encompassing investments that are made with the intention to generate positive, measurable social and environmental impact *alongside* a financial return. Impact investments can target a range of returns from "below market" to "market rate" (i.e., commensurate with a market expectation for a similar strategy or asset), depending on the investors' strategic goals.[2]

Spectrum of Capital: A term to describe a broad range of capital that extends from traditional investment capital, which seeks to maximize financial return, to philanthropic capital, which seeks to maximize positive outcomes with no financial return. Impact investors invest along a spectrum between these two ends in an effort to generate impact alongside returns. Not all impact investors adhere to the same spectrum, but most utilize a spectrum with traditional on the far left and philanthropic on the far right. We have provided a *Spectrum of Capital* graphic on page four that maps key terms and examples of investment strategies.

[1] Bloomberg Intelligence: https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/.
[2] Global Impact Investing Network (GIIN): https://thegiin.org/impact-investing/need-to-know/.

Socially Responsible Investing (SRI): The approach has its roots in early religious teachings that directed followers to invest in accordance with their values. In the US, it was popularized as part of social movements during the 1960s-1980s among university students and faith organizations focused on issues including the Vietnam War, Civil Rights, Nuclear Weapons, and Apartheid South Africa. According to Brian Trelstad in his whitepaper "Impact Investing: A Brief History," "[s]ocially responsible investment options allow an investor to take a moral stand consistent with his or her beliefs, and when a critical mass of investors targets one industry (e.g. coal) or business practice (e.g. labor conditions in sweatshops), they can, at a minimum, raise public consciousness about the problem, and potentially improve industry practices over time."[3] SRI is most often implemented through divestment strategies that seek to "do no harm" by divesting from regions, industries, and companies that have negative social and environmental impacts.

> **Socially Responsible Investing**, **Sustainable Investing**, **ESG Investing**, and **Responsible Investing** are listed in chronological order of when they became more popular in investment discourse, as we believe the timing and context in which the terms emerged helps explain their relationship to one another and their similarities and differences.

Sustainable Investing: This term became popular in the late 1990s and early 2000s to describe the practice of incorporating sustainability considerations in pursuit of competitive, long-term financial returns. Sustainable Investing has been championed by Al Gore and his investment firm, Generation Asset Management, which was launched in 2004, and regards "the integration of sustainability analysis into every investment decision we make as key to long-term performance."[4] Today, the US SIF defines Sustainable Investing as an investment discipline that considers environmental, social and corporate governance (ESG) criteria to generate long-term competitive financial returns and positive societal impact.[5]

ESG Investing: The term refers to the practice of considering environmental, social, and governance (ESG) factors as part of the investment decision-making process.[6] Coined in 2004, it was the first mainstream effort to tie environmental and social factors (previously considered "non-financial") to financial outcomes. In June 2004 a group of 20 financial institutions published a report entitled "Who Cares Wins: Connecting Financial Markets to a Changing World," which stated that "companies that perform better with regard to [environmental, social, and corporate governance] issues can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable development of the societies in which they operate. Moreover, these issues can have a strong impact on reputation and brands, an increasingly important part of company value."[7] Given its relationship to financial performance, ESG has been more quickly adopted by mainstream investment organizations, leading to the widespread use of ESG data providers and investment products. As stated above, the term is now commonly used to define Sustainable Investment, even though sustainable investment strategies emerged prior to the term ESG.

[3] Trelstad, Brian (2016) "Impact Investing: A Brief History," Capitalism and Society: Vol. 11: Iss. 2, Article 4.
[4] Generation Asset Management: https://www.generationim.com.
[5] The Forum for Sustainable and Responsible Investment ("US SIF"): https://www.ussif.org/sribasics.
[6] MSCI, "What is ESG?": https://www.msci.com/esg-101-what-is-esg.
[7] The Global Compact, "Who Cares Wins": https://www.scribd.com/fullscreen/16876740?access_key=key-16pe23pd759qalbnx2pv.

Responsible Investing: The term emerged globally in 2005, when then United Nations Secretary-General Kofi Annan brought together institutional investors to establish the Principles for Responsible Investment (commonly referred to as the UNPRI). Institutional investors can sign on to the six Principles to demonstrate their support of and intention to engage in Responsible Investment via ESG incorporation and reporting. The six Principles are as follows:

1. We will incorporate ESG issues into investment analysis and decision-making processes;
2. We will be active owners and incorporate ESG issues into our ownership policies and practices;
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest;
4. We will promote acceptance and implementation of the Principles within the investment industry;
5. We will work together to enhance our effectiveness in implementing the Principles;
6. We will each report on our activities and progress towards implementing the Principles.[8]

In recent years, Responsible Investment has been a popular term in place of SRI. Although many use the terms Responsible and Sustainable interchangeably, they did not start out as the same approach. Socially Responsible Investing strategies typically sought to avoid harm through divestment, while Sustainable Investing sought to incorporate sustainability considerations into investment analysis to generate returns. ESG Investing emerged as a tool for incorporating ESG analysis into the investment decision-making process, often as part of Responsible and Sustainable Investing strategies.

Mission-Related Investing (MRI): A term coined in 2007 to describe a spectrum of investment practices intended to generate social and/or environmental impact alongside financial return.[9] Mission-related investing is a term primarily used by US-based, mission-driven endowments and foundations who allocate their endowment capital to impact investments in alignment with their mission. Mission-related investments typically aim to achieve competitive, long-term returns in line with the foundation's traditional risk and return objectives. Also referred to as Mission-Driven and Mission-Aligned investing.

> Mission-Related, Values-Aligned, Program-Related Investing, and Catalytic Capital are often used in the context of US-based foundations; program-related investments have specific implications for non-taxable investors.

Values-Aligned Investing: A term to describe impact investments that align to an individual's or organization's *values* rather than *mission*, often because an organization's values offer a broader set of considerations than the organization's mission (i.e. values can extend beyond a specific geographical region or programmatic objective). Values-aligned investing can refer to investments across the full spectrum of capital, but sometimes refers to only investments intended to generate competitive, long-term returns.

Program-Related Investing (PRI): PRIs are typically concessionary investments made for programmatic purposes and have the potential to repay capital. Per IRS regulation for US foundations, PRIs that meet three criteria can count towards a foundation's annual distribution, and income received from PRIs can be reinvested or used towards distributions. The three criteria are: (1) the primary purpose is to accomplish one or more of the foundation's exempt purposes; (2) production of income

[8] UN Principles for Responsible Investment: https://www.unpri.org/pri/about-the-pri.
[9] Mission Investors Exchange: https://missioninvestors.org/resources/fundamental-terms-and-concepts-impact-investing.

or appreciation of property is not a significant purpose; and (3) influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose.[10]

Catalytic Capital: Catalytic Capital is a subset of PRIs that accepts disproportionate risk and/or concessionary returns relative to a conventional investment in order to generate positive impact and enable third-party investment that otherwise would not be possible.[11] For practical purposes, Catalytic investments are typically considered higher-risk PRIs with potential to generate market-rate returns at some point in the future.

Spectrum of Capital

<table>
<tr><td></td><td></td><td colspan="3">Impact investing or values-aligned investing</td><td></td></tr>
<tr><th>COMMON SPECTRUM OF CAPITAL</th><th>TRADITIONAL</th><th>RESPONSIBLE</th><th>SUSTAINABLE</th><th>IMPACT-FIRST</th><th>PHILANTHROPY</th></tr>
<tr><td>INVESTMENT EXPECTATIONS</td><td colspan="3">Competitive or "market rate" returns</td><td>Concessionary returns</td><td>No return</td></tr>
<tr><td rowspan="2">ESG TERMS</td><td></td><td colspan="2">ESG risk management</td><td></td><td></td></tr>
<tr><td></td><td></td><td>ESG opportunities</td><td></td><td></td></tr>
<tr><td rowspan="2">US FOUNDATION TERMS</td><td></td><td colspan="2" rowspan="2">Mission-related investing (MRI)</td><td>Program-related investing (PRI)</td><td></td></tr>
<tr><td></td><td>Catalytic</td><td></td></tr>
<tr><td rowspan="3">IMPACT MANAGEMENT PROJECT CLASSIFICATIONS</td><td></td><td>Act to avoid harm</td><td></td><td></td><td></td></tr>
<tr><td></td><td colspan="3">Benefit stakeholders</td><td></td></tr>
<tr><td></td><td></td><td colspan="2">Contribute to solutions</td><td></td></tr>
<tr><td>IRS CONSIDERATIONS</td><td colspan="3">Investment assets</td><td colspan="2">Can count towards 5% required annual spend for US foundations</td></tr>
</table>

[10] Adler & Colvin, "Legal Explanation of Program Related Investments ('PRI Primer')": https://www.adlercolvin.com/legal-explanation-of-program-related-investments-pri-primer/.
[11] MacArthur Foundation and Catalytic Capital Consortium: https://www.macfound.org/press/article/catalytic-capital-work#:~:text=Catalytic%20capital%20is%20defined%20as,otherwise%20would%20not%20be%20possible.

Recent Backlash to ESG Investing

ESG investing grew from initial references in "Who Cares Wins" in 2004 to an estimated $50 trillion in assets invested in ESG strategies by 2021.[12] In 2020 and 2021, ESG investing came under considerable backlash, from both insiders and skeptics.[13] At GEM, we believe this backlash stems from a fundamental misunderstanding of what ESG investing is intended to do, which can be best understood when considering the historical context from which it emerged.

As we said before, Socially Responsible Investment originated as a practice of avoiding investments that were inconsistent with moral or religious values, and was regularly tied to broader social movements outside of the investment industry. Over time, Socially Responsible Investment became commonly known as Responsible Investment, which is often understood as adherence to ESG investing as outlined in the UN Principles for Responsible Investment. However, SRI and ESG are not the same thing: SRI focuses on avoiding investments at odds with an investor's *moral or religious convictions*, while ESG investing incorporates ESG factors in an effort to *mitigate investment risk* (Responsible Investment) *or generate competitive, long-term financial returns* (Sustainable Investment). Many critics of ESG investing are disappointed that it has not gone further to advance positive social and environmental outcomes; and yet, that is not what ESG investing was created to do.

We believe that ESG investing plays an important role in investment portfolios: it can support investors in underwriting investment risks and opportunities related to environmental and social factors. However, we do not believe that this is the same as impact investing, which seeks to generate positive social and environmental outcomes alongside financial returns. This subject was addressed by Head of Impact Meredith Heimburger during GEM's 2021 Annual Meeting. A recording of this session is available upon request.

[12] Bloomberg Intelligence: https://www.bloomberg.com/company/press/esg-assets-rising-to-50-trillion-will-reshape-140-5-trillion-of-global-aum-by-2025-finds-bloomberg-intelligence/.
[13] The Economist: https://www.economist.com/finance-and-economics/2021/09/04/sustainable-investing-faces-the-beginnings-of-a-backlash.

The Journey to Impact: Key Steps for Fiduciaries

We believe there are a few key steps for fiduciaries on their journey to incorporating impact investments in their portfolios. These steps incorporate IEN's Intentionally Designed Endowment Roadmap, but also draw on GEM's experience working with endowments and foundations.

1. **Learn**: fiduciaries must start with a learning process that establishes shared terminology and supports an understanding of investment approaches and strategies within impact investing.
2. **Build Consensus**: fiduciaries can begin to build consensus around impact investing by addressing questions such as:
    a. What are the institution's risk tolerance, liquidity and spending needs, and long-term priorities?
    b. How do our mission and values relate to impact investing? Does the mission lend itself to a broad impact investment opportunity set? Or should we consider values-aligned investing to broaden the opportunity set?
    c. What are our primary objectives for incorporating impact investments? Do we want to better align our portfolio to the interests of a broad set of constituents? Do we want to identify impact investments that will support us in achieving our mission? Are we seeking new and innovative ways to deliver capital to our program areas?
    d. Where is our portfolio today? Can we map our investments against shared terminology? Can we identify where we want to go from here?
3. **Develop guideposts and benchmarks**: impact investing—like all investing—requires patience and a long-term view. In partnership with your investment team, determine ambitious but feasible impact investing objectives along a realistic timeline.
4. **Revisit governance**: impact investing often draws upon expertise across an institution, and may require input from constituents who haven't been involved previously in investment decisions. Reaffirm the process for making decisions. Incorporate voices and views where they can support the institution in achieving impact outcomes. For some institutions, steps 3 and 4 will require you to revisit your Investment Policy Statement and possibly other governing documents to ensure they reflect your objectives and governance model.
5. **Monitor the portfolio**: over time, fiduciaries will need to incorporate impact investment reporting into standard reporting to measure the institution's progress towards its impact investment objectives.

Impact Investing Networks and Organizations

Mission Investors Exchange: The leading impact investing network for foundations dedicated to deploying capital for social and environmental change.

Confluence Philanthropy: Confluence Philanthropy's mission is to transform the practice of investing by aligning capital with our community's values of sustainability, equity, and justice.

Intentional Endowments Network: The leading mission-aligned investing network for higher education and other endowed institutions.

Global Impact Investing Network (GIIN): The global champion of impact investing, dedicated to increasing its scale and effectiveness around the world.

Catalytic Capital Consortium: An investment, learning, and market development initiative bringing together leading impact investors to encourage greater impact and use of catalytic capital.

UN Principles for Responsible Investment: The world's leading proponent of responsible investing, the UNPRI works to understand the investment implications of environmental, social, and governance (ESG) factors, and to support its international network of investors in incorporating these factors into their investment and ownership decisions.

The Impact Management Project: A forum for building global consensus on how to measure, assess, and report impacts on people and the natural environment.

Further Reading

Trelstad, Brian (2016) "Impact Investing: A Brief History," Capitalism and Society: Vol. 11: Iss. 2, Article 4.

The Intentionally Designed Endowment Roadmap

Impact Measurement for Complex Portfolios

Endnotes

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