<u>The Case for Defining Impact Investment More Broadly</u>

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Last month I attended a conference in Toronto called the *Foundation, Endowment and Not For Profit Investment Summit*. The conference had a somewhat predictable lineup with presentations generally fitting into four categories: 1) economic overviews; 2) foundation investment strategy case studies; 3) a few product pitches; and 4) finally, two impact investment case studies presented by Bruce Lourie of the Ivey Foundation and Stephen Huddart of the McConnell Foundation. To me these were the highlights of the two-day event.

However, there was one presentation though that really stuck with me: a recap of the financial performance of a very large hospital endowment. It started off with the usual introduction by a foundation Executive Director: "We were founded in the 1970s, we support certain health projects, our endowment is nearly $1 billion, we have a long standing investment policy statement, we don't forecast market movements, we have a very conservative blue chip investment committee led by our Chair who is a well-known financial executive," and so on.

But about half way through it started to sound very unconventional… "Our investment performance has been quite remarkable – up 14% annualized in the past 3 years. The foundation outperformed by making significant shifts from equities to cash and back again - look at this chart showing our asset allocation shifts over the last 5 years. Our investment committee Chair really makes all the calls." The presenter even mentioned a time last summer when the foundation sold over $200 million in equities *in one day*…. "This great performance is really helping us fundraise, all foundations should have a talented Chair like we have on their investment committee".

I don't know if the lauded Chair or any of the rest of foundation directors would have liked the presentation much, or if the case was even presented accurately. But I do think the story was generally representative of what we are seeing in the market: Investors are swinging wildly and frequently from a *Risk On* state of mind (equities – particularly luxury goods companies, commodities, precious metals) to *Risk Off* (U.S. treasuries and cash). This is not really investing – it's speculation.

My impression is that the financial world is becoming increasingly preoccupied with *price movement* – and have far less interest than ever before in *value creation*. Markets are becoming increasing volatile and investors are thinking in shorter and shorter time frames.

Investors also seem to be paying little or no attention to emerging risks like environmental degradation and resource scarcity. These were certainly *not* discussed at the Foundation conference. For example, energy price discussions were confined to what might happen if the straight of Hormuz is closed – not extended to the oil reserve issues or the increasing costs of energy production. There was no discussion about global warming, food and water shortages, even though these issues are all becoming increasingly linked *and* linked to investment outcomes.

There were no discussions about social risks either. Doug Porter, an economist from Bank of Montreal, talked about the continuation of low interest rate policy but only from the perspective that housing prices should hold. He did not mention the effect low rates have on housing affordability, what they are doing to pension plans or retirees. Low interest rates also discourage savings and investment and encourage debt and consumption.

One final observation relates to our preoccupation with yield: the idea that receiving a dividend makes investments less risky, or in the very least pays the investor while he waits for capital gains. It is a flawed assumption. Our obsession to find "rent" (i.e. income streams drawn from old or non-renewable assets) is contributing to mispriced securities and more importantly affects our ability to grow the economy.

We have noticed, for example, that the renewable power producers in Canada are priced differently based on their decision to pay dividends. The companies that offer a dividend like Brookfield Renewable Power, Northland Power, and Innergex are trading at a significant premium to companies like Boralex and Western Wind that don't : 17 x EBITDA for the dividend payers on average vs. 7 x for the non-dividend payers. The implications go beyond valuation though. These are *development* businesses with new power projects that need capital to build. The ones that pay out the dividends either have to raise further capital in the market, or develop fewer projects. So for investors like us that see building more renewable power infrastructure as a good way to maximize long term investment returns, the non-dividend payers are more attractive. Foundations that need some annual income might be better to sell a small percentage of holdings each year than pay the significant premium for the dividend payers.

In summary, we have too much focus on price movement, our investment horizons are too short, and we need to think about risk differently than we have in the past. This is leading capital, in my opinion, to the wrong places.

The solution may be found in the concept of impact investing?

If we simply thought more about where our investments were actually going, I think we might invest differently and actually produce better returns.

Unfortunately, one of the biggest challenges with the concept of impact investing is the narrow mental image we conjure up. Think about it: when I said I was going to discuss "impact investing" you likely thought of niche investment strategies like: social impact bonds, education investments, micro-finance, green building projects and environmental or social venture capital. But the investment opportunities are so much broader than people realize.

Our narrow definition of impact investing makes it challenging to build support for the concept. Even when there are proven track records and successful case studies to recite - traditional investors will be skeptical that they are somehow sacrificing returns, or taking on more risk as a trade-off for the "*social and/or environmental impact"* part of the equation*.*

I believe that broadening the definition of impact investing will help engage a larger audience in the discussion. I would suggest something like this:

Impact investing forces traditional financial investors to consider: 1) Value creation (vs. price appreciation); 2) Social and environmental impacts and risk; 3) and Longer-term investment horizons, all in service of maximizing investment returns.

The concepts of long-term investment horizons, thoughtful risk management, and value creation are historically attractive attributes of successful investors, yet these are the disciplines so many investors seem to have abandoned.

What do I mean by "Value Creation"?

Real economic growth comes from investing in real assets that will produce a stream of goods and services over an extended period of time: a factory, a railroad, a water treatment plant, a school, applied research, and so on. 'Financial' investment that merely shifts pools of notional assets does not create economic value.

Over the long term, companies that are contributing to building the world's efficient productive capacity should do better than those whose business models are based on squeezing more rent out of old assets or on catering to excess consumption that starves the world of a savings pool to fund new investments.

The value creators have business models that contribute to the sustainability of our society and, by implication, their own sustainability as well. They do not depend on a world content to "burn the furniture to heat the house" - rather they are the ones planting and harvesting trees for future fuel.

Why should we focus on the long-term?

Quite simply it takes time to create and realize value. As someone who has worked on too many start-ups in his life, I can tell you it never happens as quickly as you think, but the time and effort involved in building companies is an important part of creating value. It takes time to build customer support, develop products these customers want, and build the culture systems and organizational structure that can support growth.

History has shown that the most successful investors are able to identify growth and value that others don't. And then have the conviction and patience to realize a fair price. Sometimes we get lucky and get paid early, but there is no way to rush the process.

Why should investors consider social and environmental impact and risks?

Resource availability, healthy ecosystems, and a healthy and educated work force are the foundations of sustainable economies. Investors who ignore environmental and social risks or see them as externalities that cannot be priced into their financial analysis do so at their peril. Quite simply, businesses whose products and services address the challenges posed by demographic changes, resource scarcity and environmental degradation in time should outperform those that do not.

In closing, I would suggest that most current investment strategies are not working particularly well, and are not helping us build a sustainable economy for our children.

Bill Young, Tim Brodhead and a few others have recommended a number of impact investment initiatives that have started the ball rolling – momentum is building. Foundations are in a unique position to actually increase their impact through their investment practices.

My recommendation is that you support the ideas of Bill and Tim but also incorporate a broader definition of impact investing. I believe it could improve overall investment returns and help build wider support for the concept.