ADOPTING IMPACT INVESTMENT STRATEGIES: LESSONS LEARNED FROM PIONEERING LEADERS

January 1 2014

A growing number of progressive organizations and individuals are exploring the adoption of an impact investment strategies. These organizations are pioneers in this new and promising form of social capitalism. We thought now was a good time to reflect on their experiences, lessons learned, and how to best align decision makers within organizations.

IMPACT INVESTMENT IS INVESTING IN COMPANIES, ORGANIZATIONS, AND FUNDS WITH THE INTENTION OF GENERATING MEASURABLE SOCIAL AND ENVIRONMENTAL IMPACT ALONGSIDE A FINANCIAL RETURN.

The following is a compilation of our thoughts and those of four Canadian impact investment leaders: Edmund Piro of the JW McConnell Foundation (JWMF); Annette Aquin of the Hamilton Community Foundation (HCF); Martin Garber-Conrad of the Edmonton Community Foundation (ECF); and Julia Langer of Toronto Atmospheric Fund (TAF).

In the spring of 2013, Greenchip Financial encouraged Ann Jackson and Denis Ho of Jackson/Martin/ImpactLink to conduct a series of interviews with impact investing pioneers. Greenchip believes that understanding the experiences of these pioneers might help others adopt impact investment programs. Based on their experience, we also believe Ann and Denis were the right people to find and compile these stories.

STEP 1 – DEVELOPING A PATH TO IMPLEMENTATION

One of the common threads we picked up early on was that each organization had found their own path to implementation. That said, they shared several common challenges such as mission alignment, board engagement, establishing goals and strategies, ensuring that appropriate governance structures and policies are in place, identifying advisors, and building the internal and external infrastructure to facilitate their programs.

The organizations often cited the influence of early impact investment advocates like Tim Brodhead, Bill Young and Betsy Martin and the release of the Task Force on Social Finance (TFSF). Their report in 2010 made a number of important recommendations including that all foundations aim to have 10% of their assets invested in impact investments by 2020. While most of the organizations we interviewed had entered the arena of impact investment prior to the release of the TFSF, it served as a pivotal event.

New entrants should recognize that these organizations carried out preparatory work — such as board development and board augmentation — often several years prior to their first investment.

Ann and Denis: “Describe the journey your organization went through to make an Impact Investment.”

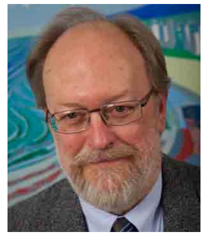
Annette (HCF):

For us, the road to impact investing started in 2008, spurred on by Bill Young, Jr, a pioneer in social finance and the donor advisor for our largest donor-advised fund. Our learning started by joining Community Foundations Canada (CFC) Responsible Investing Pilot project, followed by attending a series of MaRS events to develop champions in the incoming board leadership. The commitment was solidified at a Spring 2010 retreat at which Betsy Martin helped introduce the concept to HCF’s board. As a result, the board committed $5.0 million to start the Hamilton Community Investment Fund (HCIF), which made its first loan in June 2011.

To continue to increase the support for broader impact investing Betsy then arranged for Jed Emerson, a well-regarded, international thought leader and expert on impact investing, to speak both at a Fall 2010 retreat and to a broader audience of HCF stakeholders. This resulted in the board committing to impact investment more broadly, and to using The Young Fund as a pilot impact investment portfolio. Our first direct impact investment outside of the Hamilton Community Investment Fund (HCIF) was approved in spring 2013.

Edmund (JWMF):

The idea of impact investments was spearheaded by Tim Brodhead, former President of the McConnell Foundation and a member of the TFSF. Despite Tim’s leadership, our journey has been a lengthy and complex process. For example, our first impact investment, a program related investment (PRI), was made several years ago. The PRI was a loan offered to a large institution at below-market interest rates. At the time, the rules for foundations investing in PRIs were not clear, a number of lawyers were brought in and there was a lot of back and forth with CRA. In the end, the loan was fully repaid before maturity, along with all interest owing. All told, it was a successful first impact investment.



Martin: (ECF):

Our journey towards impact investing began when the City of Edmonton approached ECF, not long after I joined the organization, looking for assistance in implementing a community-based loans program for social enterprises. Initially, the ECF Board was not particularly interested, but when they understood that the City would put up substantial seed capital they agreed to try it out. To make the conceptual case for this type of activity, we hired Betsy Martin, who was already working with Community Foundations of Canada, to take us through the background. After we had started the Social Enterprise Fund, the 2010 report of the Canadian Task Force on Social Finance encouraged us to think bigger and take on their suggested goal of 10% of our assets in some form of social finance. Our Board’s interest in SRI is primarily the “community” aspect rather than a particular theme, like “green.” They are excited about investing a portion of our assets right here in our own community. The Board recently committed another $5 million to our social finance efforts, bringing the total available through the Social Enterprise Fund to about $12 million. The original $4 million that we have been working with for the past five years has already been loaned out more than once.

Julia (TAF):

TAF was formed in 1991 with a mandate (established in the TAF Act) to advance local solutions to climate change and air pollution. TAF was endowed with $23 million by the City of Toronto from sale of a surplus property, and made its first investment that year — $8 million came to TAF as cash and $15 million was loaned to the City (as a debenture) to replace all the street and laneway lights to a more efficient technology. That original loan generated financial returns for TAF, financial savings for the City, and greenhouse gas emission reductions for the planet.

TAF’s journey as an impact investor continues to evolve. The TAF Act was amended in 2005 to make TAF subject to the Trustee Act which allowed us to invest in a balanced mandate, including sustainability-focused equities. Our Investment Policy was recently revised to reflect the belief that attention to carbon risk is key to long-term performance and allows up to 60% of our portfolio to be invested directly to generate both financial and mandate-related returns.

STEP 2 – ADAPTING THE INVESTMENT POLICIES AND PROCEDURES

We spent some time discussing the importance of amending investment policy statements and the changes necessary to implement decision-making processes. There were a number of common themes. For example, boards were expanded or augmented to include the relevant experience and skills and new investment committees were created to provide the appropriate governance structures to handle new types of investments. It is interesting to note that, in all cases, the first investment made was structured as a loan.

Ongoing commitment from the CEO and staff was clearly required to keep the boards and investment committees moving forward. Early investments proved universally difficult, often as 'one offs' and as a result they consumed a lot of staff time and legal fees. In addition, complex rules facing charities and foundations necessitated the creation of investment holding structures such as trusts.

Ann and Denis: "What changes were made to your investment decision-making processes to accommodate the impact investment strategy? For example, what changes did you make to your investment policy?"

Annette (HCF):

We established a new committee to vet, approve and recommend the investments, making sure its members had an appropriate mix of skills to evaluate the new investments. In addition to existing board members, we reached out to our community for volunteers with the newly required expertise. We developed a schematic of concentric circles to help describe our strategy. This framework looks at our expenditures and assets and how they relate to our mission. Our mission is in the centre, surrounded first by our granting and community leadership. The $5.0 million HCIF accounts for the second concentric band as a result of its geographic focus, followed by our commitment to $7.0 million in direct impact investments both nationally and internationally. A $25 million public market ESG portfolio in the third band is followed, lastly, by our traditional equities and fixed income asset allocations.The farther away a band is from the mission, the lesser the impact of those holdings. This schematic acts as a guide for our board to continue to monitor our process and consider our next steps.

Martin (ECF):

In the beginning, in common with most foundations, granting and investing were viewed very differently. Blended value investing was a new concept. The concrete experience of making actual loans to charities in our community—and having those loans repaid—has helped increase the Board's comfort with the concept.

Because we have the City of Edmonton as our partner in this work, the governance structure as well as the investment holding vehicles had to be established in a complex way. Some loans are reviewed, approved and monitored by an independent board. Loans made directly from ECF resources are then brought to the ECF Board for approval. It's a bit complicated but it does work!

Julia (TAF):

We place a priority on having people on the Investment Committee who understand the philosophy and process of prudent investing and who have the expertise to evaluate direct investments.

Initially, our standing investment committee (traditional) was not involved in direct investments, especially since this new way of investing was ad hoc and possibly viewed as another granting mechanism. The few direct investments were separate from the traditional investments and not even monitored by TAF's independent investment advisor.

We used to have two managers for our marketable securities, both with balanced mandates. However to address our new investment policy and take carbon risk into account, a more fundamental change was needed, which led to a search and hiring two sustainability-focused equities managers (including Greenchip).

Our current task is to integrate the tracking and reporting of all our investments, to ensure the same level of rigour regarding performance and impact is applied to the direct and publicly-traded investments.

STEP 3 – BUILDING THE REQUIRED RESOURCES

The resources needed to implement an impact strategy are greater than traditional endowment asset management. Aside from the amount of staff time required for the moment, we found two primary areas where extra resources were needed. The first area related to the due diligence teams. Unique skills were required to analyze the financial potential of direct investments, private equity funds, and unusual loan structures. At the same time, the abilities to select and oversee traditional investment managers also had to be maintained. Second, additional legal and tax expertise was required. The rules around foundations holding limited partnerships and direct investments were often unclear. And new deals needed to be structured with appropriate downside protection negotiated.

These are unique skills not traditionally found inside foundations where public equities and bonds are the norm. These skills can be expensive to acquire. Traditional private equity investors can spend up to one year on the due diligence on a single deal. The analysis they perform is detailed and painstaking. All stakeholders are typically interviewed, including fellow investees and those who declined to invest. On one deal alone, HCF's advisor spent more than 90 hours performing the 'deep dive' due diligence. As with traditional investments, due diligence is required post investment to monitor portfolio holdings.

Ann and Denis: "Describe the due diligence processes your organization went through."

Julia (TAF):

If impact investing — with all of the one-off structuring, due diligence, and negotiating involved — were easy to do, the banks would be doing it themselves. On the direct investing side, it is much more intensive even relative to the research and monitoring required to invest in traditional private equities. We have been structuring private deals since 1991 so we were familiar with those resources, and have dedicated staff and a very expert committee. On the equities side, when we decided in 2011 that our listed investments could and should be achieving impact, it was also challenging. After an extensive review of ESG and environmental managers in the industry, we were hard pressed to find even six we wanted to interview with a credible approach on sustainability and demonstrated performance.

Annette (HCF):

We run potential investments by our impact investment committee and if they are interested in proceeding, we then go to external experts to help with due diligence. The whole process requires significant staff and governance time and money.

Edmund (JWMF):

In the beginning, we tried to ensure we had the right processes in place but it is still evolving. We have come a long way but it continues to take us a lot of time to analyze investments. For example, when we made our investment in Renewal Partners (a private equity fund focused on social change), the whole diligence process took over a year. To be fair, we were developing our processes and building board support in real time. There was a lot of to-ing and fro-ing between the Board, the CRA and the investment committee. Incidentally, an external member of our investment committee performed the due diligence. We have a traditional investment committee, so the board had to give very specific and strong directions to the committee in order to keep the process moving forward.

We have now arrived at a position at McConnell where the Board of Directors, the investment committee and the staff, have clearly defined roles relating to our impact investment program.

Step 4 – MEASURING AND MONITORING FINANCIAL PERFORMANCE AND IMPACT

The organizations we interviewed universally had mature protocols for monitoring traditional investment performance, and while they were certainly able to measure the financial performance of their impact investments, it was generally too early to comment on relative performance to traditional assets. As well, most would agree that existing tools for measuring social and or environmental impact are inadequate. It is still unclear whether it will ever be possible to fully quantify the social impact of these programs. The challenges in developing a system that is intellectually honest, simple and effective were acknowledged by all. It seems the approach taken most often is to get started with investing and then laterally develop policies around impact measurement.

Ann and Denis: "How are you assessing or planning to assess your investments for their social impact?"

Edmund (JWMF):

We are in the midst of developing the measurement of impact beyond outputs. We have a dedicated staff person working on this.

Julia (TAF):

TAF has a long-term investment horizon and we use the endowment's returns for all our operating expenses – there is no draw on the tax base. The value of our direct investment portfolio was highlighted in the downturn – it provides stable returns that can mitigate market volatility – and can generate a healthy risk-adjusted return along with environmental ROI. We moved into global ESG equities at a good time with top quartile financial and low-carbon performance. The third and most important objective of our impact investing is to demonstrate and de-risk financing strategies and structures and mobilize significantly more than our limited $23 million for low-carbon investment solutions.

Annette (HCF):

Our plan to measure impact is still very much a work in progress. We implicitly know that our investments will benefit our community and the communities they are in. We will continue to work on the measurement as we move further into the process.

Martin (ECF):

We believe that our assessment of impact will stay as narratives for a while. We can tell stories about how our work is impacting people's lives. At Edmonton Community Foundation, social impact is always top of mind—whether it's via a grant or a loan. A quantitative process for measuring social return on investment is still pending. For it to work, the system must be transparent and easy to use. There are such a variety of social issues out there. A methodology that is broad enough to capture all of them will be a challenge.

FINAL NOTE – THE FUTURE OF IMPACT INVESTING

We believe that investing strategies will remain as unique as the missions of the organizations that initiate them. We expect approaches to range from to illiquid, high-risk, high-impact investments in direct deals to strategies that mirror those of the traditional markets. We greatly appreciate these pioneers for sharing their experiences to-date and believe they should be lauded for their efforts to expand the mission of their own organizations, as well as their ability to draw together new sources of capital in search of effective solutions to our greatest social and environmental challenges.

ABOUT THE INTERVIEWERS

Having already provided impact investment advice to a number of Canadian foundations and organizations, Ann Jackson, CFA, MBA, co-founded Jackson/Martin with the impressive and unforgettable Betsy Martin in 2011, to help others develop impact programs. Ann brings a full career of professional investment management experience from her years at PH&N and others.

Denis Ho, is the founder of ImpactLink Capital — an impact investment advisory firm that is helping a number of foundations with their direct private investment portfolios. Previously, Denis spent over 30 years in the venture capital industry at both Business Development Bank of Canada and MDS Capital and he has served on the boards of more than 20 early-stage life sciences companies.