Impact investing: Social enterprises with a healthy return

Funding projects with a positive social or environmental impact and a healthy profit is the goal of impact investing, with BlackRock among its fans.

October 21, 2015

Halfway between traditional investing — focused solely on financial profits — and acts of philanthropy — focused solely on positive social and/or environmental impact — is where a novel investment concept can be found. It's called impact investing.

IESE's **Joan Fontrodona** and Pablo Sanz, together with DiverInvest's David Levy and Miguel Casas, analyze this growing phenomenon in a 2015 study and report, published by IESE's **Center for Business in Society** in collaboration with DiverInvest, an independent financial advisory firm based in Barcelona.

The impact investing space

According to the authors of the report, impact investing is finding its place alongside socially responsible investing and pure philanthropy, although it differs from each of the two.

Like both traditional and socially responsible investing, impact investing seeks profits (with returns comparable to traditional investing's returns). But while socially responsible investing focuses on harm reduction by excluding investments in companies with negative aspects, impact investing seeks to actively create a positive impact on society.

This approach, according to the report, means that impact investing is notable for its more efficient management of resources and activities, for its greater commitment to stakeholders and for its lower risk profile compared to traditional investments — even those considered socially responsible choices.

Advantages for the investor's portfolio

From a strictly financial point of view, there are several objective reasons to include impact-investing assets in one's portfolio.

Although impact investments in debt products tend to have lower expected return rates than the broader market, three characteristics give them high financial value: 1) low default and bankruptcy rates among social enterprises and communities receiving the loans; 2) low price volatility; and 3) a low correlation between their prices and those of other assets in the traditional debt market, which makes them valuable as safe havens in times of turbulence.

In the case of bond- or debt-fund investments, it is worth noting that these products can also offer high liquidity to investors.

In terms of capital investments, such as private equity, the advantages are innovative business models and new locations in emerging countries. In these cases, expected returns may be higher or lower depending on the particular business model proposed, with the innovation factor making it difficult to generalize.

What to invest in?

Impact investing funds are used to finance business models and social initiatives that are both sustainable and scalable. Ideally, their earning capacity makes them profitable and allows them to grow, while serving as an inspiration to other entrepreneurs who may replicate winning models elsewhere.

Target companies should efficiently generate a positive impact on society, either by directly improving people's lives or helping to protect the environment for the long term.

Impact investments are usually made through intermediary agents specializing in fundraising to finance social initiatives with the characteristics outlined above.

The types of investment assets can be divided into three basic groups: loans, equity investments and hybrid products. These products are already in the portfolios of not only development finance institutions (DFIs), but also foundations, individual investors, family offices, sovereign and pension funds, insurance companies and businesses.

Profitability, risk and liquidity profiles — which are analyzed and compared to traditional assets in the study — make these products attractive alternatives for investors seeking to diversify their portfolios and explore new sectors and geographical areas.

In fact, the report provides recent data showing that investments in alternative assets, including impact investing, is gaining traction in the portfolios of private banks and family offices globally, ranging from 12 to 18 percent the total capital invested, as analyzed by region.

Risks under control

The data and experience both show that investment portfolios generally benefited from the inclusion of these alternative assets, as they help reduce volatility while offering an attractive combination of risk and return.

However, the authors warn that the selection process for impact investing is complex, rarely standardized and presents its own specific risks. For this reason, the report concludes with a series of recommendations to help analyze and select the best impact investments.

www.iese.edu/insight