Impact investing: Misunderstood opportunity?

November 7, 2011

Across the financial spectrum, there's a growing belief that investments should be judged on their ability not only to generate profit but also to make a positive social impact.

When Norwegian entrepreneur Jan Sundt set up a chain of ski resorts in Oslo, he helped transform one of the city's most run-down zones into a resort area with the fourth highest turnover in the country. He also helped make skiing more accessible to a wider section of the population.

Sundt is the perfect example of a new breed of investor called 'impact investors,' who invest in businesses not only for financial gain, but also to generate a positive social impact.

Unfortunately, impact investing suffers from a common misconception, namely that it must involve a trade-off between financial gain and social impact.

In their report 'In Search of Gamma: An Unconventional Perspective on Impact Investing,' produced with support from the Family Office Circle Foundation, IESE's Uli Grabenwarter and Heinrich Liechtenstein debunk this myth and suggest that it is merely based on a fundamental misunderstanding about what impact investing actually is.

Based on interviews with more than 60 dedicated impact investors, the authors present an innovative approach for clarifying the fundamentals of impact investing and addressing the challenges of impact and performance measurement.

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What is impact investing?

Impact investing can only be called impact investing if there is a positive relationship between the financial return and the social impact.

True impact investing has five defining characteristics.

- Profit is a key objective.
- The investment must have a predetermined and intended social impact objective.
- The impact must be measurable.
- There must be a positive correlation between the intended social impact and the financial return of the investment.
- The business must be seen to produce a net positive change to society.

Only if these five criteria are consistently met can the boundaries of impact investing with respect to charity and philanthropic activities be clearly defined.

Core success factors

Impact investors vary greatly, both in terms of approach and the amount of profit they choose to retain or reinvest in the business.

But what is it that makes some impact investors more successful than others?

There is actually little difference between impact investing and other alternative investment classes, such as the relatively more established venture capital and private equity investment areas.

Indeed, the only major difference is that impact investing must take into account the social and/or environmental impact throughout the investment process.

Just like venture capital and private equity, successful impact investing requires a strategic approach, intelligent deal sourcing, a strong, competent management team, and a well-defined exit strategy.

A clear, strategic vision

Impact investors need to have a careful strategic approach and be able to anticipate big trends and cater to the changing needs of consumers and society as a whole.

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However, unlike traditional asset classes, impact investors typically assess longer-term trends as well as social and sustainability challenges in their investment decisions.

Successful impact investors take a holistic approach to accurately anticipate the costs (including externalities) and returns (including nonfinancial benefits) of their investment.

The biggest challenge in achieving this is getting the timing of the trends right, which is why laying the groundwork ahead of an investment is vital.

Besides a clear strategy, a structured approach is also vital for success. Unlike traditional asset classes, impact investors need to be able to assess the impact achieved, not just at the end, but at every stage of the investment process.

The tricky business of measurement

Measuring the performance of one's investment is often easier said than done. On the financial side, the lack of cost transparency and the prevalence of cross-subsidizing or understating mean that real costs are often not reflected accurately.

When it comes to measuring the nonfinancial part of investment performance, one of the greatest obstacles to impact investing is the inadequacy of the measurement tools currently in use.

For example, in the clean-tech area, broad-brush CO2 statistics are so generalized for the sake of uniformity as to be meaningless in an investment decision process. These difficulties are further exacerbated by the absence of a generally accepted industry standard to measure impact performance.

The main challenge, therefore, is to find a suitable measurement tool that is widely accepted by the various stakeholders in the investment process.

The gamma factor

To address this challenge, the authors propose the gamma factor to measure impact investment performance. They suggest using the gamma factor as a multiplier for deriving the return of an investment, and they call the outcome the 'impact-adjusted return.'

Just as alpha and beta in the Capital Asset Pricing Model (CAPM) can help to determine the financial return of an investment, taking into consideration the assets risk profile, the gamma

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factor integrates an investment?s social or environmental impact into the performance assessment.

The appeal of the gamma factor is in its ability to measure investment performance without sacrificing transparency: as a relative performance measure, gamma uses predefined impact indicators that are carefully tailored to the business model of the targeted investment.

As such, a company's social business performance can be monitored in a meaningful way. At the same time, impact investors have a valuable decision tool for assessing investment performance.

Looking to the future

Many societal needs today depend on philanthropy and will continue to do so in the future.

However, given the scale and scope of the social and environmental issues facing our society, impact investing should prove to be an indispensable tool.

At the very least, a smart use of impact funding might help preserve the scarce resource of philanthropic funding for areas that cannot be addressed with a market-based investment approach.

The authors help to clarify some of the misconceptions that have held back impact investing from entering mainstream markets, and they propose solutions to bridge the current standardization gap.

Most importantly, their report should help inform investors on ways of capitalizing on the full potential of this emerging asset class.

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