

Industry Agenda

From Ideas to Practice, Pilots to Strategy Practical Solutions and Actionable Insights on How to Do Impact Investing

A report by the World Economic Forum Investors Industries

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1. Preface



Michael Drexler
Senior Director,
Head of Investors
Industries
World Economic
Forum USA



Abigail Noble
Associate Director,
Head of Impact
Investing Initiatives
World Economic
Forum USA

From Ideas to Practice, Pilots to Strategy is both an attempt – and an opportunity – to disseminate the best practices and lessons learned from the first movers, early adopters and bold innovators in the field of impact investing, with the goal of further advancing the sector.

When we published *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors* in September 2013, we sought to add clarity to the field through a realistic, current assessment. With over 10,000 people accessing the report in the first two weeks, it became evident that we touched on a strong need. However, given the relatively small scale of impact investing, we realized that more than clarification was needed. For active investors in the field, to shift impact investing from a small part of their portfolios to a full-fledged strategy requires operational and practical knowledge. New players in the impact investing space, looking to take it from a compelling idea to a real investment approach, need to know how to get started in this nascent and potentially rewarding sector. This codified know-how and repository of best practice is currently as embryonic as the sector itself.

Readers of the Margins to Mainstream report reached out from far and wide to ask for advice on how to start (or do even more) with impact investing. While we could hypothesize and make suggestions, it is only experienced impact investors who can speak with authority about what does and doesn’t work, and why. With that in mind, we curated this collection of short, action-oriented and insightful thought pieces on how to put impact investing to work.

Because the sector is in a nascent stage and engages diverse individuals, organizations and societies, no one solution will apply to every situation. Rather, this publication can serve as a trailhead and as a semi-trodden path for new practitioners; but much more trail-blazing will be necessary before the sector can call itself mature.

We advocate learning by doing, failing fast, synthesizing feedback and quickly re-engineering shortcomings into a more informed approach. Above all, we believe that intentions (and certainly good ones) matter with every action and step towards building a new sector. With these principles in mind, we can collaboratively and proactively ensure that the impact investing sector is on the best path forward.

For the many key players whose wisdom and expertise could not be represented here, we look forward to hearing from you and, where possible, including your perspective in future efforts to help bring the impact investing sector to maturity.

Contact us at impactinvesting@weforum.org

2. Introduction to the Mainstreaming Impact Investing Initiative

Nearly two years ago, at its Annual Meeting in Davos in January 2012, the World Economic Forum convened a discussion among mainstream investors and social entrepreneurs on how to harness the hype of Impact Investing. While the list of reasons why impact investing would remain niche seemed overwhelming, bringing it into the mainstream was too important an opportunity not to pursue.

With this in mind, the Forum launched the Mainstreaming Impact Investing Initiative. The first milestone – *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors* – was released in September 2013 and provided an overview of the sector, identified challenges constraining the flow of capital, and laid the groundwork for mainstream investors to begin a meaningful discussion on impact investment. Most of the constraints identified fit into one of four broad, overarching challenges: an early-stage ecosystem; small average deal size; the fit within an asset allocation framework; and double bottom line.

From Ideas to Practice, Pilots to Strategy is the second publication in the Forum's Mainstreaming Impact Investing Initiative. The report takes a deeper look at why and how asset owners began to include impact investing in their portfolios and continue to do so today, and how they overcame operational and cultural constraints affecting capital flow. Given that impact investing expertise is spread among dozens if not hundreds of practitioners and academics, the report is a curation of some –but certainly not all –of those leading voices. The 15 articles are meant to provide investors, intermediaries and policy-makers with actionable insights on how to incorporate impact investing into their work.

Target Audience for *Ideas to Practice, Pilots to Strategy*

This publication's target audience includes three key groups: (1) investors looking to start impact investing; 2) active impact investors looking to expand impact investing from a limited part of their work to a full-fledged strategy; and (3) intermediaries, policy-makers and development finance institutions whose support is vital for the sector's growth. Since large investors often have a proportionally large influence on a sector, a key focus is on highlighting best practices or frameworks from large asset owners and asset managers.

Motivation and Scope of *Ideas to Practice, Pilots to Strategy*

The report's goals are to show how mainstream investors and intermediaries have overcome the challenges in the impact investment sector, and to democratize the insights and expertise for anyone and everyone interested in the field. Divided into four main sections, the report contains lessons learned from practitioner's experience, and showcases best practices, organizational structures and innovative instruments that asset owners, asset managers, financial institutions and impact investors have successfully implemented.

The strategic case for impact investing from the mainstream investor's perspective is the focus of "More than an Idea: Creating the Case for Impact Investing". This section includes the following key messages:

- Reflecting environmental, social and governance (ESG) standards in the investment process, across asset classes and alongside traditional financial metrics and competent risk management practices, can generate superior risk-adjusted, long-term investment returns. Moreover, inadequate ESG capability can lead to poor financial performance.
- Institutional investors can shape markets and encourage managers to design products with social impact. Recent data indicates that many institutional investors look to incorporate ESG standards into their investment decision-making. However, so that impact investment strategy becomes an institutional priority, decisions

must come from top leadership. Institutions that have a commitment from top leadership for impact investing (or a similar mission) find it easier to implement the strategy as well as collaborate for shared successes.

- Reviewing past successes, those intended or not, can help investors evaluate potential strategy within their institutions. Large investors can conduct a rigorous review and retroactively tag their investments as “impactful” (i.e. those with a measurable social and financial return, but without clear intent). By sharing this knowledge, such investors help to set a reassuring climate for future impact investment strategy that would include explicit intention to generate measurable social and financial returns.
- Traditional investors are seeing the benefits of diversifying portfolios by working with socially minded investment managers who generate reasonable returns that are somewhat uncorrelated.
- Conventional interpretations of fiduciary duty can lead to herding, which while providing safety of numbers, can produce investment decisions that are not in investors’ long-term interests. For impact investing to engage pension funds, there must be a clear account of how impact investing is congruent with fiduciary duty, and active engagement with asset owners on why impact investments may require funds to reassess their own attitudes towards what constitutes “conventional” investment.

The section on “Building a Strategy” provides examples of organizational structures, processes and strategies employed by large asset owners and asset managers to implement impact investing, while generating risk-adjusted financial returns and meeting the fiduciary responsibilities of institutional investors. Depending on the organizational structure, the frameworks may include impact investing as an investment approach across various asset classes; or, focusing and developing expertise in a particular sector. This section’s key messages include the following:

- Impact Investing can be done within a large institution through a variety of operational approaches: a stand-alone team, a hub-and-spoke structure, an outsourced adviser or an institution-wide commitment and strategy. Whatever the approach, the impact investment thesis and criteria for selecting and evaluating impact should be clear from the outset. In addition to diversifying across asset classes, impact investors can increasingly diversify across impact sectors as markets deepen
- Investors need to ensure that impact investing is well-integrated into an organization’s decision-making processes and has buy-in from major internal stakeholders. If impact investing has received support from top leadership, integration of it throughout the organization is a matter of communication and coordination. In other circumstances, it is up to the teams to open communication channels laterally and collaborate across teams for shared objectives such

as diversified portfolios and reduced costs of entering new markets. Impact investors can diversify not only across asset classes, but also and increasingly across impact sectors, as markets deepen and the choice of investment opportunities grows.

- Given impact investing is a nascent sector, focusing due diligence on fund managers’ track records may hold the industry back. Investors should rather seek to understand the factors determining a fund manager’s decision-making process.
- Partnership is critical for success. Successful impact investing fund managers share four qualities: partnering effectively with the public sector, using catalytic capital, providing “multilingual” (i.e. cross-sector) leadership, and placing financial and social objectives on equal standing. Moreover, treating investors (LPs) as partners from the outset on governance structures, financial and development goals, as well as including impact objectives early in the investment process, is important to ensuring mission alignment among key players.
- Impact investing does not have to be “finance-first” or “impact-first”, but can be “professional-first”. Asset managers can apply the same degree of professionalism to investment decision-making as to traditional investing, and so comply with the fiduciary responsibility of institutional investors. Investors can use a methodical approach to building an impact investment portfolio based on the risk, return and impact profile of individual investments and the portfolio as a whole.

“Innovations for Unlocking Mainstream Capital” looks at innovative impact investing solutions that can meet the needs of multiple stakeholders, including commercial investors, philanthropic organizations, governments and retail investors. The section’s key messages include the following:

- Commingling funds serve as innovative forms of partnership among previously isolated capital providers. Set up correctly, they can multiply the impact of capital while preserving their contributors’ interests.
- The Social Stock Exchange is a mechanism for opening up impact investing to retail investors, as well as making it more attractive to mainstream investment. A conducive environment for issuers and investors, along with an ecosystem within which they can interact, are important requirements for creating a vibrant public impact investing market.
- Social impact bonds (SIBs) are a novel way of finding economic solutions to social problems and, as such, have tremendous potential for channelling resources to programmes that work. Development of a mature, well-organized SIB market based on solid infrastructure is still very much a work in progress; a robust pipeline of SIB-ready projects, an ecosystem and a blended-value investor pool are and will be key factors for success

Definitional Alignment

Realizing that a definitional discussion of impact investing can lead to more questions than answers, this section is devoted to clarifying common areas of confusion.

Impact investing as an investment approach that intentionally seeks to create both financial return and positive social or environmental impact that is actively measured.

First, it is an investment approach and not an asset class. Impact investing is an investment approach across asset classes, or a lens through which investment decisions are made, and not a stand-alone asset class. Certain impact investments (e.g. public equity security of an impact enterprise) may behave similarly to certain asset classes (e.g. public equities), while other impact investments (e.g. social impact bond) may not behave similarly to other asset classes (e.g. corporate bond).

Second, intentionality matters. Investments that are motivated by the intention to create a social or environmental good are impact investments. However, if the intention is solely financial gain, even if the investment unintentionally creates social or environmental value, the designation of the investment being an impact investment is less certain. For example, an investment made into a pharmaceutical company that manufactures life-saving medications solely for the purpose of generating financial returns without the intention for social impact is not an impact investment. That said, the investment may certainly be impactful, but not an “impact investment” by definition.

Third, the outcomes of impact investing, including both the financial return and the social and environmental impact, are actively measured. The degree of financial return may vary widely from recovery of principal to above-market rates of return. In addition to financial return, the investment’s social or environmental value must be measured in order for the investment to be considered an impact investment.



3.2 Making Impact Investing an Institutional Priority for Achieving Superior Investment Performance

By Manuel Lewin, Head of Responsible Investment, Zurich Global Investment Management

Key Insights

- Traditional financial institutions can get comfortable with impact investing, given the right framing and the right champions within the companies. Reflecting ESG standards in the investment process – across asset classes and alongside traditional financial metrics and competent risk management practices – generates superior risk-adjusted long-term financial returns.
- Green bonds are a practical example of how impact investing can work in an institutional portfolio.
- The rewards of integrating responsible investment are worth the effort; it can help attract talent, engage existing employees, enhance a company's brand among customers, and signal to shareholders a company's commitment to a long-term vision.

Zurich Insurance Group offers a variety of general and life insurance products to clients in over 170 countries, and currently manages over US\$ 200 billion of own assets.

As a global insurance company with a growing presence in emerging markets, Zurich is exposed to many of the risks associated with climate change, competition for scarce natural resources and extreme poverty. We believe that impact investments, which can have a targeted, positive and measurable effect on society and the environment, while generating a financial return commensurate with the risks they entail, are one way to help mitigate and address the exposure to such risks; this is also why Zurich has direct interest in sustainable economic growth and in developing resilient communities.

While some investors may accept a trade-off between returns and impact, Zurich focuses on opportunities where the return fully compensates for the risk. Both types play an important role. The former can provide higher-risk capital to fund, for example, early-stage social ventures and small entrepreneurs. The latter can make capital available in greater quantities that can be 'scaled up' to fund sustainable growth.

We are convinced that such profitable investment opportunities exist across various asset classes. Our approach is to develop a strategy for impact investing within each of the major asset classes in which we invest. This process begins by analysing the universe of potential impact investments in a particular asset class, and making sure the impact is in line with the intended outcome. The underlying assets' risk and return are then analysed to determine which fit best within the overall portfolio. At the same time,

other potentially limiting factors are considered, including regulatory requirements and balance-sheet capacity. The final step is to determine the best structure for investing in those assets. The same process is used to assess any new type of investment and it requires close collaboration among people throughout the organization. For Zurich, the natural place to start impact investing is to look at simple, low-risk investments.

Leadership and Vision Are Required to Establish a Responsible Investment Culture

As impact investing is a strategy across asset classes, and definitions of responsible investment can vary, an investment institution must develop a clear and coherent set of vision, mission, principles and rationale for its approach.

At Zurich, this process of defining what we consider to be responsible investment was initiated at a senior level by the Group Chief Investment Officer (CIO), and took well over a year to complete. The CIO, intrigued by the notion of "impact investing", held discussions with peers, other asset owners, industry practitioners and leading asset managers. The insights from that process, along with those obtained through internal discussions, provided the outlines of a vision and strategy for responsible investment: to create long-term value for all our stakeholders while remaining true to our mission of achieving superior risk-adjusted returns relative to liabilities.

Zurich's Investment Management (IM) business strategy team assessed the PRI, a global investor initiative that promotes responsible investment, to learn from best practices while developing our approach. As a consequence, Zurich became a signatory to the PRI in July 2012. Within Zurich, IM is the driver for including responsible investment in the overall investment management approach. This philosophy is also aligned with the Group's overall Corporate Responsibility (CR) strategy to fully embed the respective CR-focused topics within the topic-owning departments.

Zurich's responsible investment strategy was finalized with the IM executive team as well as its external advisory council. The strategy articulates three pillars: ESG integration, impact investing, and collaboration and thought leadership. This approach was endorsed by the Group's Executive Committee and the Board of Directors.

Pillar One: Investing for ESG integration and generating superior risk-adjusted, long-term financial returns

The first pillar of Zurich's responsible investment strategy is based on our conviction that ESG factors do matter. Reflecting these factors in the investment process – across asset classes and alongside traditional financial metrics and competent risk management practices – will support us in generating superior risk-adjusted, long-term financial returns. While our investment approach is primarily based on economic considerations, integrating ESG factors and taking an active approach to ownership are a critical part

of a sound investment process. We are convinced that markets in which all relevant ESG risks and opportunities are correctly priced offer powerful incentives. Companies that effectively manage their impact on the environment and society, while adhering to high standards of governance and integrity, should also enjoy a premium. However, the positive impact of integrating ESG factors in an investment strategy is likely to be indirect and difficult to quantify and measure.

Pillar Two: Investing for targeted and measurable impact without comprising financial returns

It follows that the second pillar of our responsible investment strategy is to look for investment opportunities that allow us to generate a much more targeted, direct and potentially measurable outcome, but without compromising financial success: this is our definition of impact investing. We acknowledge that our approach will only have a true impact if responsible investment becomes mainstream.

Pillar Three: Collaborating to build the sector while becoming a leader in responsible investing

With that in mind, our strategy's third pillar is focused on thought leadership and industry initiatives to provide insights and raise wider awareness about topics related to responsible investing.

Responsible investment must be led by a person highly familiar with the organization and the existing investment approach. Specialist know-how in the field is also required. For this, Zurich recruited an analyst with experience in responsible investment. However, the ultimate goal is to have everyone in IM thinking as a single responsible investment team.

Resources Need to Be Allocated and Incentives Aligned

A strategic approach to responsible investment, based on a clear vision and supported by strong leadership, will ensure that an organization devotes the resources necessary to accomplishing the task. Effectively managing change, driving engagement, and ensuring that responsible investment goals are expressed in general investment management concepts and vice versa, require both strong leadership from the top and diffused ownership and empowerment of the objectives throughout the institution.

Responsible investment brings with it a new language, concepts and market participants. This is particularly true where impact investments are concerned. However, Zurich has consciously rejected creating a designated responsible investment department on the side, which would introduce parallel structures to IM. In accordance with Zurich's overall CR approach to fully embed the respective focus topics within the topic-owning departments, responsible investment will be fully integrated into IM's culture.

Zurich embarked on this journey by embedding CR targets into individual goals as part of the overall objective-setting process. Within IM, the CIO's targets, as well as those of the

CIO's leadership team, already reflect the goal of responsible investment. Targets to support responsible investment are also included in the individual objectives of most senior IM staff, and of all those directly involved in responsible investment initiatives.

Selecting and Working with Investment Products: Green Bonds and Beyond

Roughly 30%— or US\$ 65 billion— of Zurich's investment portfolio is held in government, government-guaranteed or supranational bonds. Within this "minimum risk" asset class, green bonds have emerged as a potential opportunity for impact investing and have been predominantly issued by supranational institutions such as the World Bank, IFC, European Investment Bank and others. Green bond proceeds are ring-fenced, meaning they can be used only to fund projects that either mitigate climate change or help communities to adapt to its consequences. Currently no standardized approaches for project selection frameworks and measuring impact exist. However, all major issuers apply well-developed internal methods to set targets and track progress of the environmental impact of underlying projects. Green bonds are of the highest credit quality, and while returns are modest, so are the risks.

The green bond market is still relatively small, with total outstanding issuance at around US\$ 10 billion, depending on the exact definition. The market attracts many buy-and-hold investors, and individual issues have tended to be relatively small compared to standard bond issues in the supranational space. While the impact of underlying projects is impressive, most of these would also have received funding through the supranationals' regular bond-issuance programmes. After a number of conversations with the issuers, Zurich realized that the true impact would lie in its ability to invest in size, and to make a significant contribution to the market's development by actively and regularly participating in it.

Zurich conducted an in-depth analysis of green bonds that confirmed they would complement the existing portfolio well, and allow for a minimal increase in yield with an equally minimal increase in risk. Zurich also weighed various restrictions and limitations, and determined that up to US\$ 1 billion would be a prudent allocation for one of its largest balance sheets. Most of Zurich's investments in North America are managed by external asset managers, so the same approach was chosen for green bonds and the process supported by the manager selection team. At the outset, a dedicated mandate was established to tie the potential allocation to the anticipated level of green bond issuance in the market. Eventually, green bonds may become part of Zurich's broader fixed-income portfolio benchmarks.

Once the allocation parameters were established, portfolio guidelines were drafted and the search for an external asset manager began. Standard processes and the established investment committee governance were followed throughout. With regard to the manager selection criteria, a collaborative approach to support development of the green bond market, including an active dialogue

with issuers and other market participants, was deemed vital. Despite the relatively simple nature of a green bond, it took many months to complete the process. The very notion of “green” meant that educating people about the bonds and addressing their perceived concerns formed a substantial part of this effort. Joint responsibility, shared by the head of responsible investment together with the regional investment management team, helped to accelerate the process in some cases, but slowed it down in others. Carefully planning joint efforts and defining responsibilities is important. To date, Zurich has invested over US\$ 200 million in various green bonds. Next steps will include following a similar process for green bonds issued in other currencies.

Recently Zurich began two other projects to determine impact investing strategies for private equity and debt instruments. These projects will follow a similar overall process, but they will take more time than the one related to green bonds, as the risks and the return opportunities are considerably more complex. These types of investments tend to be more fragmented and less liquid, and are often not geared to institutional investors of a certain size. Some of the challenges include finding people with the right skills and finding the right partners to engage with. More complicated structures also face more regulatory restrictions; while mandates need to be narrow enough to effectively control risks, they should be sufficiently broad to allow for necessary scale. They also need to take into account any limitations when it comes time to measure impact. As a global team, and with the ability to tap into the know-how of some of the leading asset managers, Zurich is confident that these challenges can be overcome.

The Journey towards Responsible Investment Is Long and Cannot Be Completed Alone

Insurance is a long-term business, as policy-holders expect us to provide security for 10, 20 or many more years in the future. Responsible investment can generate the superior investment performance our shareholders and policy-holders expect from us in a sustainable and fair way, but to do so requires the right processes and incentives, and gets to the heart of investment philosophy and organizational culture.

It will require many years to establish a culture in which responsible investment practices are fully integrated into Zurich’s overall investment philosophy and approach. The rewards of achieving this in terms of investment returns and positive impact will, however, be well worth the effort. A commitment to responsible investing engages our existing employees and helps in recruiting new talent. It will enhance the Zurich brand not just with today’s customers, but also with those in growth markets who will form tomorrow’s middle classes. It also sends a signal to our shareholders that Zurich truly takes a long-term view. Most importantly, it is consistent with our long-term company strategy and vision for a more secure world.



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World Economic Forum
91–93 route de la Capite
CH-1223 Cologny/Geneva
Switzerland

Tel.: +41 (0) 22 869 1212
Fax: +41 (0) 22 786 2744

contact@weforum.org
www.weforum.org