CONSTRUCTION OF AN IMPACT PORTFOLIO

Total Portfolio Management for Multiple Returns

By Jed Emerson

Despite the growing sophistication of the media’s coverage of impact investing, a widespread misperception that impact investing is a single type of investing rather than a broad approach continues to exist. It is easy for those considering impact investing to conclude it is similar to, say, venture capital investing—direct, high risk, and only available to high-net-worth individuals. This perception was underscored when influential organizations initially made the mistake of labeling impact investing as an “emerging asset class,” implying that impact cannot be achieved across all asset classes.

This misperception has segregated impact investing within a single category of capital when it is ideally suited to laying the foundation for investors to manage all their assets for impact across an entire portfolio.

Impact investing is broad and nuanced. It is both a “sleeve,” a discrete strategy within a larger portfolio of investments; and a “lens” through which one looks at an entire portfolio. Here we operate at a portfolio level and take the lens approach. With the total portfolio perspective, impact investors seek an appropriate financial return for any given investment instrument, fund, or strategy as they ask, “What is the best way to think about the nature of impact within this particular investment or asset class?”

With this perspective, impact may be pursued across an entire portfolio with appropriate consideration of various risk, impact, and financial return objectives for the allocation of philanthropic, near-market, and market-rate capital. Developing this understanding of how best to incorporate impact within portfolio construction is especially timely for financial advisors who increasingly receive client requests to consider social and environmental impacts of their portfolio and structure capital investments to advance positive impact.

Regardless of client asset size, and although specific strategies may differ, it is possible to achieve positive impact through all one’s capital investments. Increasingly products are being brought to market that make high-impact investments available at lower minimums to be more broadly accessible to investors at all levels. This article is presented as an introductory guide to help investors and advisors construct portfolios that integrate impact appropriately across asset classes. We refer to this as total portfolio management (TPM).1 Within this approach, all capital—philanthropic, near-market, and market-rate—is managed to optimize financial performance within a given asset class while maximizing the impact potential of that asset class.

EMERGING PRACTICES OF TOTAL PORTFOLIO MANAGEMENT

For financial advisors, engaging with a client in the process of portfolio construction offers an opportunity to understand and strategically respond to that investor’s personal financial priorities and objectives. As those objectives evolve to include social and environmental impact, the conversation between investors and advisors must weave considerations of impact throughout the portfolio construction process. TPM is an approach that seeks to optimize diversified financial returns while managing impact as appropriate for any given investment asset class. It is not reductive (it doesn’t ask, “What do we remove from consideration from the investment universe?”) but rather additive (it asks, “How do we take traditional investment practices and augment them with enhanced analytics and perspective to allow for consideration of both off-balance-sheet risk and impact investment opportunities?”). In this way, when engaging in TPM, the fundamentals of traditional investment management still apply (see figure 1).2

TPM considers the full array of capital being deployed by asset owners: philanthropic, near-market, and market rate. Such an approach acknowledges that charitable giving—by providing donors with tax benefits and other considerations—offers financial value and generates social and environmental returns. In this way, asset owners may bring a holistic approach to their consideration of how best to manage all their capital to pursue the full, blended value they seek.

This article offers an introductory overview of these ideas and suggests some initial steps asset owners may take with their advisors to envision, create, and
execute an investment approach that integrates financial considerations with social and environmental concerns.

**STEP ONE: ESTABLISH GOALS AND OBJECTIVES**

As every advisor knows, the first step in professionally managing assets is to define the investor’s core goals. These typically cover retirement, college expenses, wealth preservation for future generations, and so on. The next step is to take stock of the unique cash flow needs, risk tolerance, and time horizon of the individual asset owner. All this information is taken into account when engaging in a traditional investment approach or crafting the asset allocation, investment policy statement, and investment portfolio in a more customized manner.

This familiar advisory process is equally important for effectively building an impact portfolio. In addition to standard financial discussions that inform the creation of an investor’s profile, the process of creating an impact portfolio also includes an exploration of client expectations and objectives with regard to the generation of social and environmental impact.

However, the “right” answer as to what constitutes the impact agenda of any given portfolio differs for each and every investor. For example, one family may have a broad interest in issues related to women and girls and be generally interested in making sure they are not invested in "bad" companies. Another client may be professionally focused on combatting climate change or protecting the environment and most likely will not feel comfortable with financial returns generated from significant investments in fossil fuel production. Yet another client may have a deep connection to a community or region and will find tremendous value in an advisor able to introduce investment opportunities in regionally specific local food systems or affordable housing.

Regardless of the ultimate goal and set of investment strategies, discussion of a client’s values enables closer alignment between an advisor and client and understanding of the client’s purpose for the capital under management in order to create a beneficial strategy.

**STEP TWO: THE INVESTMENT POLICY STATEMENT**

The investment policy statement (IPS) is the agreement between an advisor and client that outlines how the client’s investments will be managed. The IPS can take many forms—from simple to complex—and it serves as a guiding light for advisor, client, and investment committee.

For clients seeking to intentionally integrate impact across an entire portfolio, the IPS is critical. Ad hoc impact divestment or investment is not a sustainable strategy for impact. The IPS provides a framework for evaluating current holdings, exiting investments that are not consistent with the evolved investment strategy, and assessing new investment opportunities. The IPS is the framework to be used in evaluating the total performance of a portfolio that is designed to generate financial returns with social and environmental impact.

Crafting an IPS with consideration of impact can be a challenge for advisors taking their first steps into impact investing with a client. Substantial evidence supports the position that impact investments may deliver market-rate returns for a given asset class, but many financial advisors and investment committees mistakenly believe investing with an impact orientation might threaten their fiduciary obligations. Because the IPS is the foundational agreement between an investor and client, explicit goals and practices outlined in the IPS should address such investment committee concerns, detailing how any given asset owner defines its fundamental fiduciary obligations.

In the IPS, investors outline an “impact thesis,” which details an investor-specific understanding of “impact” and broadly defines how the client views the integration of impact and financial performance. Some investors will feel it important to include several pages of narrative about how they understand the nature of the impact they seek, and others will address it in a few paragraphs. Either way, the IPS impact thesis must explore this question with enough definition to guide both the investment committee and wealth advisor in their work and decision-making. For example, The F. B. Heron Foundation wrote its IPS to reflect the “intent to balance the social and financial return on all assets, and to select opportunities for deploying capital, whether as grants or
as investments, so as to maximize the combination of both kinds of return within each.”

Note also that the IPS is a dynamic document that should be revisited annually, with its assumptions re-affirmed or modified based upon any number of factors. Such factors might include shifting market context or evolving investor intent. Changes to the IPS should certainly not be undertaken lightly, however; an IPS offers guard rails that guide and direct investment practice, not train tracks that lock in investment committee regardless of where the train appears to be headed.

An on-ramp to TPM: The portfolio carve out

TPM is a holistic approach to investing, but some clients begin impact investing by designating a portion of their portfolios to be managed on an impact basis. The advisor and client agree to “carve out” a portion of the portfolio to be dedicated to specific impact investments, themes, or strategies. Accordingly, this capital may be invested in a single asset class or distributed across asset classes with specific impact themes.

Such incremental approaches to impact investing may be necessary to help investment committees and fiduciaries become more comfortable with the idea and practices of aligning capital with ultimate investor intent. For many asset owners new to the concepts of impact investing, taking a staged approach to exploring and deploying impact investment strategies may make the most sense. Such an approach also may be required in order to best manage investment lock-ups or tax considerations. With that understanding in mind, two points should be considered.

First, all capital has impact of one form or another. For foundations or families concerned with advancing the greater good of society as well as fulfilling fiduciary responsibilities, assuming that one’s investments do not have impacts upon the world (positive or negative) is increasingly being called into question. Second, a recent significant increase in the availability of impact investing products makes it possible for impact investors to deploy capital across an array of conforming, competitive funds and managers. Identifying and then investing in new, impact investing approaches may take one to three years. All investors, even those ready to go all in, should recognize that executing these changes will take time.

For many asset owners new to the concepts of impact investing, taking a staged approach to exploring and deploying impact investment strategies may make the most sense.

STEP THREE: ASSET ALLOCATION

With an understanding of a client’s financial and impact performance objectives, as well as their risk tolerance and time horizon, advisors establish the initial structure of the portfolio through asset allocation. Because each asset class has its own risk, return, and impact profile, investors may customize portfolios to fit specific objectives by varying the levels of investment in each asset class.

For example, additional risk taken on in private equity may be balanced by a large fixed income allocation. Sophisticated asset allocation strategies are used to optimize the classic risk–return trade-off upon which traditional portfolio construction is based, and these strategies may be adapted to include consideration of impact across asset classes. An advisor who thoughtfully integrates impact will evaluate where impact is redundant, complementary, or catalytic in relation to the ultimate objectives of the investor’s portfolio.

When considered together, each of the investments contributes to the total performance of the portfolio, generating financial and impact returns across various asset classes, including philanthropic capital. Accordingly, the impact goals sought through any given investment should be appropriate to that investment opportunity just as the financial returns expected of any strategy will differ based on the investment approach of that particular asset class. Said another way, one should not expect micro-loan impact from a socially responsible mutual fund, just as one does not expect private equity returns from a fixed income product. In this way, impact and financial returns may differ across individual asset classes within any given portfolio, but the total portfolio should be managed to generate financial and impact returns in alignment with the investor’s specific goals.

Manager search, due diligence, and selection

After the asset allocation is established, the advisor begins researching managers, conducting due diligence on those managers, and selecting possible investments for the client’s consideration. Socially responsible and impact investing communities have compiled many resources for identifying investment products. As with all other investment products, specific diligence requirements differ with asset class or deal structure. However, it is always important to look closely at the people managing the investments, the philosophy behind their approach, the process for selecting investments, and total performance (both impact and financial returns). The evaluation of performance for an investment in an impact portfolio includes measurable, demonstrated, and reported impact that is aligned or complementary to the portfolio objectives. Therefore, it is critical to analyze impact reporting capacity and practices as well as traditional financial management practices.

A client that is especially interested in an investment that does not quite fit the agreed-upon criteria for that asset class...
can be thoughtfully accommodated with a TPM approach. For example, an investor may want to pursue an investment that takes on undue risk in relation to the expected financial return because it generates a particular type of demonstrated impact. Alternatively, an investor may choose to unconventionally risk-balance a portfolio to permit pursuit of high-innovation impact opportunities that offer an elevated probability of failure. And as discussed below, savvy portfolio construction may compensate for many forms of risk—execution, liquidity, credit, innovation, start-up, and so forth—through complementary investments within each asset class or by adjusting the overall asset allocation.

**STEP FOUR: PERFORMANCE MONITORING**

A best practice for any portfolio, and especially for a portfolio designed to generate positive impact, is ongoing monitoring and evaluation. In alignment with the IPS, benchmarks should be set for financial and impact performance. Regular review of portfolio performance against these benchmarks will indicate necessary revisions to the investment strategy and allow adjustments based on changing client circumstances or market conditions. By taking a formative approach to portfolio monitoring, the comparison of actual outcomes to expected outcomes highlights the strengths and weaknesses of an investment strategy. These insights inform revisions to the portfolio strategy to better meet client objectives. Monitoring is a unique opportunity to strengthen the relationship between client and advisor through a better understanding of client values.

*The bondage of benchmarks, the investor as market*

Comparing any given investment strategy with a complementary benchmark is the bread and butter of traditional investing. However, the use of benchmarks can be a limiting practice for both traditional and impact investors. Benchmarks may constrict expectations of return and limit understanding of how any given strategy may be executed within a dynamic market. The portfolio profile of an investor may not conform to that of other investors in the market at a similar level of wealth—yet if the total performance objective of the investor is being attained, the financial performance of an underlying benchmark may be completely irrelevant. In this sense, the investor is the market, defining the financial returns and impact that are acceptable.

When choosing to use benchmarks to assess performance, the first question one must ask is whether the comparison benchmark is, in fact, truly comparable. Perhaps of equal importance is the fact that every investor should consider whether an outside benchmark would be effective for assessing performance—whether at the portfolio or individual investment level. For example, if an investor’s objective is to use capital to sustain the planet, that investor may opt to invest in a real asset allocation that could increase exposure to long-term investments for which the exit is decades away.

For an investor committed to placing capital within a specific geographic region, investing in global equities may not be relevant to or advance the ultimate, long-term investment goals. In either case, what the market does or does not deliver in terms of performance may be irrelevant to the goals of the individual investor.

Regardless of the final decision investors and advisors may make about how best

**TABLE 1: ILLUSTRATIVE LANDSCAPE OF IMPACT THEMES WITH ASSET CLASS EXPOSURES**

<table>
<thead>
<tr>
<th>Social, Environmental, or Blended Impact Themes</th>
<th>Philanthropy</th>
<th>Liquidity</th>
<th>Income and Wealth Preservation</th>
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<tbody>
<tr>
<td>Education</td>
<td>Patient Venture Philanthropy for Education in Emerging Markets</td>
<td>Cash/Cash Alternatives</td>
<td>Catalytic Capital</td>
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<td></td>
<td>Private Debt</td>
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<td>Bonds</td>
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<td>Energy and Climate Change</td>
<td>Solar Debt Fund Catalytic Tranche</td>
<td>Banks Screened for Sustainability</td>
<td>Off-Grid Solar Finance</td>
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<td>Financial Inclusion</td>
<td>Financial Inclusion Venture Capital</td>
<td>Microfinance Funds</td>
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<td>Financial Inclusion</td>
<td>Balance Sheet Support for Agricultural Finance Fund</td>
<td>Smallholder Agricultural Finance</td>
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<td>Health and Wellness</td>
<td>Technical Assistance for Healthcare Debt Fund</td>
<td>Private Healthcare Business Loans</td>
<td>Hospital Tax-Exempt Bonds</td>
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<tr>
<td>Housing and Community Development</td>
<td>Nonprofit Low-Income Community Lenders</td>
<td>Community Development Banks</td>
<td>Affordable Housing Bonds</td>
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<tr>
<td>Resource Efficiency</td>
<td>Seed Funding Innovative Technologies</td>
<td>Conservation Notes</td>
<td>Green Bonds</td>
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<tr>
<td>Water, Sanitation and Hygiene (WASH)</td>
<td>Credit Enhancement for Water Infrastructure Projects</td>
<td>Water Development Finance</td>
<td>Water and Waste Utilities Tax-Exempt Bonds</td>
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Source: Rockefeller Philanthropy Advisors, Solutions for Impact Investors, 2009

Updated: Align Impact, 2017
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<tr>
<td>Philanthropy Liquidity Income and Wealth Preservation</td>
<td>Venture Capital</td>
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<tr>
<td>(WASH) Water, Sanitation Development Housing and Wellness Health and Agriculture Food and Financial Inclusion Change Education</td>
<td>Sustainable Impact Tilt</td>
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<td>Water ETFs</td>
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<td>Waste-to-Energy Technology</td>
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<td>Recycling</td>
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<td>Green REITs Sustainable Timber</td>
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<td>Affordable Housing Preservation Healthcare REITs</td>
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<td>Healthcare Delivery and Devices Biotechnology Sustainable Impact Tilt</td>
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<td>Built Environment Technology</td>
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<td>Workforce Development</td>
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<td>Distributed Generation and Storage Clean Energy Technology Digital Financial Services</td>
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<td>Microfinance and Insurance Firms</td>
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<td>Lab-grown and Plant-based Meat Alternatives Negative Screening and Shareholder Engagement</td>
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<td>Sustainably Sourced Food</td>
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<td>Organic Farmland</td>
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<td>Retrofit Real Estate Strategies</td>
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<td>Solar and Wind Projects</td>
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<td>Charter School Facilities Finance</td>
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<td>Retirement Real Estate</td>
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<td>Distributed Generation</td>
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<td>Renewable Energy</td>
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<td>Distributed Generation</td>
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**CASH AND CASH EQUIVALENTS**

Moving cash to community institutions is easily overlooked low-hanging fruit that provides an impact alternative to individuals at any asset level. By moving deposits from a multinational bank to a community development bank, regional bank, or local credit union, investor assets are supporting small businesses, affordable housing, and other community banking activities that have positive social impact in low-income communities. Mobile and online banking has made these alternative banks accessible as major financial institutions.

Several networks within this asset class offer resources for investors to learn more about cash investment opportunities, including the National Federation of Community Development Credit Unions and the Global Alliance for Banking on Values.

**PRIVATE AND PUBLIC FIXED INCOME**

Impact investments through fixed income products are also widely accessible and may be directed toward a range of social and environmental issues. For example, green bonds address carbon footprint reduction and advance energy efficiency in emerging markets. One diversified fixed income mutual fund invests in corporate bonds in clean technology and sustainability, as well as project-focused municipal bonds, real estate, and international development that address environmental challenges. Advisors also can help clients to directly invest in municipal and corporate bonds that finance projects with social or environmental impacts. Another example is a first-of-its-kind impact-rated bond portfolio that provides investors with a quantified assessment of the impact realized by their investments. Finally, one well-known nonprofit focused on environmental preservation offers fixed income options to impact investors interested in financing critical habitats around the world—and receiving a financial return competitive with other offerings in the fixed income arena. As more bond products are introduced, investors must continue to call for real transparency and objective analysis of the degree to which such products actually invest in sustainable impact as opposed to simply finance new, traditionally conceived development projects. Over years to come, many new offerings will claim impact and sustainability—and it will be up to the market to track their total performance relative to their claimed intent.
With a more social objective, nonprofit loan funds are additional options within a fixed income allocation. Nonprofits and cooperatives cannot take equity capital, so long-term debt financing, such as loans or loan guarantees, can provide necessary capital for program expansion. Two note offerings that finance work of nonprofit and for-profit organizations on fixed terms are broadly available to investors.

Fixed income investments in microfinance are primarily made through private debt funds available only to accredited investors. Many private debt funds are being deployed for issues beyond microfinance, including sustainable agriculture, community development, and clean energy.

Product innovation plays a role as some private debt fund structures target greater liquidity, lower minimums, and the ability to be held in brokerage accounts. With some notes, investors may invest in a strategy for as little as $2,000.

PUBLIC EQUITY AND DEBT
Most advisors invest in public equities through mutual funds or separately managed accounts (SMAs). With SMAs, the advisor has more control to develop customized screens based on a client’s values. Some firms specialize in hyper-customized SMAs and accommodate a wide variety of impact screens. This level of customization has high minimum investment levels, but wealth advisors may be able to pool client assets to provide access to public equity impact strategies through SMAs. The screens available in mutual funds tend to be more general because they are based on popular interest.

There are three primary ways investors may pursue impact through public equities, regardless of the vehicle. Divesting from stocks that have negative impact, such as fossil fuels or sin stocks (alcohol, tobacco, firearms) was one of the first efforts in the socially responsible investment arena and many managers have been profitably investing with negative screens for many decades. Although a traditional approach to investing would assume that any limit placed upon investments open for consideration would result in financial returns below those generated by investment strategies without such restrictions, many years of research indicate these strategies actually perform in line with—and may even exceed—traditional benchmarks.4

The second approach is by integrating environmental, social, and governance (ESG) criteria into the selection and due diligence process and may be a more pro-active approach to promoting sustainable practices within corporations. Several fund families have mutual funds across multiple investment styles that all apply ESG criteria in their selection of holdings. In many cases, applying ESG criteria has been shown to outperform the benchmark by capturing value that is not widely taken into account by the market.

The negative screens of responsible investing often are augmented with a third approach to creating impact through public equities: shareholder activism and engagement. Mission-aligned managers generally will vote proxies on behalf of clients to advance responsible governance and other practices. Organizations such as As You Sow and Sum of Us organize and activate shareholders to hold corporations accountable for negative environmental or social practices such as fair pay, diversity, or transparency. Investors also may contract with organizations such as Proxy Impact to ensure their proxy votes are consistently exercised in accordance with their impact agenda.

PRIVATE INVESTING
The landscape of private equity impact investment managers is increasingly diverse, across geographies and issue areas. The ImpactAssets 50 and ImpactBase5 are centralized resources for identifying and learning more about established impact managers in private debt and equity. Because these impact fund managers are directly investing in ventures that increase awareness of social and/or environmental issues as they grow, this is a very targeted approach to addressing impact challenges.

Impact investors comfortable with the risk, illiquidity, time, and cost requirements of direct investment frequently identify individual deals to support social entrepreneurs directly advancing the issues they care about. Direct investments in impact ventures can be made using private debt, equity, or convertible debt (a debt-equity hybrid). Transaction costs for direct investments may be high and require specialized expertise, but there is constant demand for early and expansion-stage capital to scale organizations with demonstrated impact. Organizations such as Toniic and Investors’ Circle facilitate direct investments by coordinating member efforts to source potential investments, perform due diligence, and gather best practices across transactions.

REAL ASSETS
This category has tremendous opportunity for impact and appeals to many investors because of the tangible nature of the investment. Within the category of real estate development, several leading mission-based, green real estate policy, development, project management, and investment firms have demonstrated that an integrated approach to development can have significant social and environmental impact alongside consistent financial returns. Sustainable real asset strategies have been used for decades in farmland, ranchland, and timber, but some have not explicitly identified their funds as impact investments. These funds tend to be long-term (7–10 years or beyond) and may provide a bond-like return as well as a long-term private equity upside, although as with any investment one should be cautious in predicting exit valuations.
PROGRAM-RELATED INVESTMENTS

Clients interested in using their philanthropic portfolios to make impact investments may catalyze impact through program-related investments (PRIs). These investments may take the form of private equity, but more frequently they are structured as low-interest, yet higher-risk, loans. Still widely underutilized and misunderstood by many foundations, PRIs may count toward the 5 percent annual charitable distribution requirement.

Internal Revenue Service guidelines require that the investment be made in alignment with the charitable purpose of the foundation and that its sole purpose cannot be to produce financial return. Because investors are accustomed to evaluating investments on market-rate return and evaluating their philanthropic options by social and environmental impact, there is a wide middle ground of opportunity for investing in below market-rate impact opportunities that has remained largely underexplored. However, the capital returned from PRIs may then be utilized to generate additional impact in the future.

In 2012 Mission Investors Exchange published a helpful primer on PRIs and in 2013 the Rockefeller Foundation funded an independent evaluation, conducted by Arabella Advisors, of 12 years of PRIs made both domestically and internationally. Impact investments that take on exceptional risk or are expected to produce concessionary return are ideal for PRIs and have impact potential beyond the individual investment. These catalytic investments also may be used as one tool to support an emerging market opportunity or attract traditional capital sources by absorbing a disproportionate amount of risk. Importantly, an advisor who wishes to support a client’s PRI desires should become reasonably well versed in the intricacies of PRI regulations before embracing this potentially powerful tool.

GRANTS

Investors and advisors traditionally have managed their philanthropic grant-making entirely separate from their financial investments. Within a TPM approach, grants are a powerful tool to achieve the overall objectives of a unified portfolio. Grant capital may be used to provide technical assistance to accelerate social ventures to investment readiness, can subsidize transaction costs for due diligence or deal structuring, and can fund high-impact programming to extend the work of an existing investment. Organizations such as The Eleos Foundation and The Grassroots Business Fund, among others, offer good examples of this type of approach. These are just two examples of how grant capital and investment capital can work hand in hand to achieve greater impact than either one can achieve alone. Impact investors should exercise caution when executing these approaches to appropriately respect rules regarding self-dealing when making philanthropic and market-rate investments in proximity to each other. The investor may use philanthropic capital to support a field of work or practice, but one cannot make a grant directly to an individual for-profit in which one has placed an equity or debt investment. To do so would be viewed as using charitable dollars to enable private, financial gain.

For an investor to achieve overall objectives, the risk, return, and investment options are evaluated as complements to each other and essential components of a larger whole.

RISK, RETURN, IMPACT

Constructing an impact portfolio necessitates engaging in an integrated evaluation of risk, return, and impact. As proclaimed in the recent G8 report on impact investing:

This requires a paradigm shift in capital market thinking, from two dimensions to three. By bringing a third dimension, impact, to the century capital market dimensions of risk and return, impact investing has the potential to transform our ability to build a better society for all.

This is no small task because there may be additional kinds of risk to evaluate for an impact investment and multiple levels of impact to consider along the range of financial return. This makes a holistic, TPM approach especially valuable for those interested in impact investing. For an investor to achieve overall objectives, the risk, return, and investment options are evaluated as complements to each other and essential components of a larger whole.

TYPES OF RISK

Understanding risk within impact investments, and subsequently designing a portfolio with appropriate risk for the investor, can position impact investors to see market opportunities overlooked or misunderstood by traditional investors. To begin with, impact investors consider all the same initial risk elements as traditional investors. These may include:

- first fund risk
- manager risk
- specific aspects of market risk
- other traditional forms of risk consideration

Again, it is important to remember that impact investing in many ways simply takes traditional investment practice and augments it with considerations of social and environmental value creation. When considering risk and return, impact investors may allocate risk across a portfolio in the same way as traditional investors.

With that idea in mind, it is also important to understand that “impact risk” may take some effort to define and manage in
light of individual investor perspective and appetite. Specifically, the perception of risk, whether real or imagined, has been a hurdle for the growth of impact investing.

Various reports have attempted to unpack and address the multiple dimensions of risk to unlock additional impact investments. For some traditional investors and advisors, the fact that something is new to them means they view it as having greater risk than it may in fact carry. For example, microfinance debt has provided many impact investors with low volatility and uncorrelated, consistent returns for many years. Although these investors are comfortable allocating a portion of their portfolios to such funds, mainstream investors unfamiliar with microfinance still may view this investment opportunity as exotic and quite risky. These unfamiliar investors misprice the risk of such investments and, in the process, miss out. Ironically, within certain areas of traditional investing (venture capital, for example) the ability to take greater risk in favor of potential future returns is lauded. But those same traditional investors may be unfamiliar with assessing risk for investments in sustainable agriculture or micro-credit and may wrongly view impact investing as carrying too great a risk.

In 2014, the report “Shifting the Lens: A De-risking Toolkit for Impact Investing” included an analysis of the five types of risk most relevant to impact investing, along with tools to mitigate or “de-risk” each type. Of course, risk varies depending on investor expectations and the individual investment, but the tools to de-risk an investment are far more accessible than tools to boost financial returns. The types of risk identified in the report are capital risk (loss of principal capital), exit risk, unidentifiable risk, impact risk, and transaction cost risk.

From the opposite angle, many investors have made the case that ESG and impact investing actually reduce or mitigate investment risk. For example, some ESG strategies do so by investing in sustainable management in companies that face less regulatory risk in the face of impending climate change regulations and less reputational risk due to corrupt or unjust practices.

The category of relevant benefit begins to narrow the lens to the specific objectives of the individual investor but still takes a relatively broad view of the investment options that have a relevant impact.

Impact investments in emerging markets, especially in private debt and equity, may be largely uncorrelated to developed global markets and may therefore provide risk mitigation in times of a financial meltdown such as the crisis of 2008. Furthermore, for many impact investors the risks of permanently destroying our environment, rising inequality, and other looming social and environmental challenges pose far too great a risk to not address with the assets they have available.

Types of Impact

Much of the foundational work for TPM has focused on the development of frameworks to consider multiple layers of potential impact. Often visualized as a bull’s-eye or capital investment spectrum, these frameworks allow categorization of investment options by their expected impact. At one end, there are investments that are contrary to mission. When transitioning a traditional portfolio to an impact portfolio there may be existing assets that fall in this category that are important to identify and create a plan for reallocation. Next, there is a category of investments that produce no material benefit or harm in relation to investor objectives. This is generally the category that negatively screened funds would fall into.

Moving into general benefit, this category of investments may apply ESG criteria or broadly promote economic development or environmental sustainability.

The category of relevant benefit begins to narrow the lens to the specific objectives of the individual investor but still takes a relatively broad view of the investment options that have a relevant impact. For example, an investor that has a specific objective of supporting women and girls may make investments into affordable housing and health that do not specifically target women but clearly support the intended impact of the portfolio.

Moving to the direct impact categories, although it is not necessary to concede financial return for impact, and in fact the relationship between impact and financial return offers demonstrably low correlation, some impact investors intentionally choose to make investments that may be concessionary in some way to achieve elevated, broader, or deeper impact. These often are categorized separately from direct impact investments that are expected to deliver attractive risk-adjusted financial returns. This distinction is made so that the expected vs. actual financial and impact returns may be appropriately evaluated for different types of direct impact investments.

Some believe asset owners may achieve the most direct and targeted impact through philanthropic investments. As previously mentioned, grant-making is important to include on the capital spectrum of how we consider all the capital one may deploy because it can be a valuable tool for reducing risk, increasing impact, and even increasing return within a holistic portfolio approach. That said, significant and direct impact still may be achieved in other, non-philanthropic categories of investing. Therefore, when considering
impact across a variety of asset classes within a portfolio, many investors take a blended approach by asking: “What is the comparative financial return this investment category offers and what is the best way to think about the nature of the impact it creates?” Remember that, especially for impact investors in the United States, although philanthropic capital may not provide a direct financial return to the asset owner in the future, charitable gifts to a donor-advised fund, family foundation, or nonprofit entity do provide financial benefit to the donor, so they do offer financial returns.

METRICS AND ONGOING EVALUATION

The general question of metrics and how best to apply them within an impact investing strategy has been the subject of much debate and deliberation. Because of the additional complexity of constructing a portfolio that considers risk, return, and impact, metrics and ongoing evaluation play an important role in achieving client objectives.

Metrics have been largely refined for risk and return but are still being developed for impact, which is critical work for the integration of impact into investment performance evaluation. Impact expectations and criteria should be established within each asset class, along with the process and tools for collecting, organizing, evaluating, and reporting specific, measurable metrics. If some investments do not report their impact, it is still important to identify criteria for evaluating that connect investments to the impact thesis and objectives laid out in the IPS.

The most relevant metrics are those that allow the investor and advisor to evaluate whether the total performance of the portfolio is in line with the investor’s objectives. Some standard financial and impact metrics will be appropriate, and in many cases the impact metrics will need to be customized in order to inform ongoing evaluation. In some cases, even if a particular investment offers lower financial returns, it may outperform with respect to its intended impact, and vice versa. Depending on the objective of the portfolio, the allocation to such an investment may need to be re-weighted or reconsidered in relation to total performance of the portfolio.

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Ongoing evaluation is an opportunity to re-evaluate risk, better understand the nature of returns, and course-correct for sustainable impact. So, too, portfolio construction is not a one-time exercise to set the course but rather an iterative process of trying, evaluating, learning, and adjusting.

CONCLUSION

Investors increasingly are aware of the positive and negative impacts that may be generated through the investment of financial capital. A growing community of investors, as well as a robust body of research, does not accept the notion that investors must accept a trade-off between financial return, risk management, and social or environmental impact. TPM provides a powerful set of tools for aligning client assets with their objectives through a smart and sophisticated strategy. At each step in the process, from creating the IPS to setting asset allocation, selecting managers and investments, and creating processes for ongoing investment performance evaluation, there are opportunities to increase the impact of an investor portfolio and ensure financial objectives are met. The approach to portfolio construction presented in this article builds upon the traditional approach to investing that is based upon a two-tier frame of risk and return by adding the third dimension of impact. This approach builds on the work of recent years, and investors may find a growing number of impact investment products across an array of asset classes from which to choose. A total portfolio approach is far more accessible than it was even 10 years ago. Indeed, investors are providing proof that impact investing is not an asset class but an overall approach to maximizing total portfolio performance in pursuit of sustained, blended value within the world we want to live in and pass along to generations to come.

Jed Emerson has led, cofounded, and served on the board of directors of a variety of impact funds, social enterprises, and family office investment committees. He is lead author and editor of The Impact Assets Handbook for Investors: Generating Social and Environmental Value through Capital Investing (Anthem Press 2017). Contact him on LinkedIn.

APPENDIX

KL FELICITAS FOUNDATION PORTFOLIO

The KL Felicitas Foundation portfolio illustrates the potential of aligning a financially competitive investment strategy with specific social and environmental goals.

In 2004, in order to meaningfully address the world’s most pressing social and environmental issues, the KL Felicitas Foundation (KLF) made the decision to begin a process to eventually allocate 100 percent of its capital to impact investments—that is, investing with the intent to generate both financial returns and purposeful, measurable, positive social or environmental impact.

By the end of 2014, evolution in the impact space allowed the KLF portfolio to be composed of 99.5-percent impact investments. This composition reflects a diversified, multi-asset-class portfolio that has provided both traditional index-competitive, risk-adjusted returns with meaningful and measurable social and environmental impact. An investment portfolio dedicated to 100-percent impact, without compromising financial outcomes, is far less of a challenge today than it was just a few years ago.

Figure A1 illustrates how impact is implemented across the KLF portfolio by impact strategy (i.e., responsible, sustainable, thematic, and impact first) and corresponding asset classes within each impact strategy.
Figure A2 illustrates how impact is implemented across the portfolio by asset class and corresponding impact theme.

ENDNOTES
1. The terms unified investment and total foundation asset management were introduced in 2002 and total portfolio activation in 2012. More recently, family offices have begun using the term total portfolio management (TPM) to describe the allocation of all forms of family assets within a single approach to wealth management. This definition includes the allocation of all capital—philanthropic, near-market, and market-rate. We prefer and use the term TPM here because, as described in this article, it best reflects the reality that all capital has “impact potential” and should be managed to optimize financial performance within a given asset class while maximizing the impact potential of that asset class.
3. The term “real assets” refers to hard assets such as real estate, forestry, ranch land, etc.
7. The same may not be said of public markets, so the reader is cautioned in that regard.