Introduction

Faith-based investors generally seek to apply their resources to create positive change in the world, and impact investing is a powerful instrument to that end. Our goal in this paper is two-fold: 1) to provide clarity on what impact investing is; and 2) provide guidance on how faith investors can design and implement an impact investing program that meets their needs. Much has been written about impact investing, and we don’t want to be repetitive. Instead, we focus on those aspects that are most relevant to faith organisations, and those situations where providing further nuance will help investors make informed decisions. Our intent as an organization is ultimately to generate a variety of impact investments for the faiths, based on input from the faiths, including lower-risk projects with easier due-diligence requirements, all the way to grass roots investments with riskier profiles.

This paper will present three topics broadly, in an introductory manner. Each of the three topics will subsequently be explored further and in more depth in future publications.

1. Understanding alignment versus impact
2. Private markets for impact investing
3. The tradeoffs between impact and investment outcomes

1. Understanding alignment versus impact

A good starting point for organisations considering impact investments is understanding the distinction between alignment and impact, and why an organisation might choose one or the other, or a bit of both in proportions that are right for them. Note that both alignment and impact are considered elements of faith-consistent investing, and of ESG investing more broadly.

Alignment refers to the process of ensuring that an investment portfolio conforms to a faith organisation’s values, beliefs and preferences. This might entail screening out investments that are antithetical to key beliefs, and overweighting investments that generate selected environmental and social (E&S) benefits. Alignment does not necessarily introduce new E&S benefits to the wider world, but rather, supports or contributes to those that already exist, for example, a mutual fund that buys shares in a wind turbine manufacturer.

From an investment standpoint, alignment can affect the cost of capital favourably for companies being targeted, thus influencing their ability to raise future capital, ultimately with beneficial impact. Alignment can also inform negative screening and divestment.
Divestment, however, doesn’t make undesirable assets disappear; it merely reshuffles ownership. Responsible investors may also own shareholdings in companies whose goals they don’t entirely agree with, but through shareholder activism and proxy voting, hope to change in ways more closely aligned with their beliefs.

Impact investing is more ambitious in its goals. The objective of impact investing is to add to the sum total of ways that E&S benefits are currently being generated, for example, a private placement in a project to provide clean water to a village in a developing part of the world. This expands on the goal of alignment, which ultimately is limited to the reassignment of ownership in companies that already generate benefits or have undesirable effects.

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<th>Alignment</th>
<th>Impact</th>
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<td>Relatively faster implementation</td>
<td>Relatively slower implementation</td>
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<td>Indirect impact to targeted E&amp;S benefits</td>
<td>Direct impact to targeted E&amp;S benefits</td>
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<td>Less resource intensive</td>
<td>More resource intensive</td>
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<td>Plentiful supply of acceptable assets</td>
<td>Constrained supply of assets</td>
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<td>Assets are often liquid</td>
<td>Many assets are in less liquid private markets</td>
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<td>Index benchmarks are generally available</td>
<td>Fewer and less useful benchmarks exist</td>
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Impact investing is about generating new benefits, which generally requires fresh capital. Some of the most effective sources of capital for impact projects are listed below.

Private markets
- Private capital represents one of the most prominent and useful sources of funding for impact projects. This is because with private markets, the investments can be closely focused on a particular objective and directed very effectively in accordance with an organisation’s mission. Private markets are explored further in the next section of this paper.

Initial public offerings (IPOs)
- IPOs are effective sources of impact capital. However, care must be taken that such funding generates significant E&S benefits.

Secondary equity offerings and ‘green’ bonds
- Impact projects can also be funded with infusions of new capital to established companies. These may be in the form of equity or as fixed income, e.g., ‘green’ bonds.
2. Private markets for impact investing

In some cases, private markets may be the preferred, if not the only, way to fund certain impact projects. This is especially true of narrowly focused ‘grass roots’ projects that hold special meaning for faith-oriented groups. Appropriately structured, private markets can provide a high degree of control, which may be needed for certain types of projects. Also, niche projects may only appeal to a relatively small number of investors, which also favours private markets.

There are several ways to invest through private markets, including:

1. General partnerships/co-investors, which offer considerable control over an investment’s implementation but require the most specialised personnel and skills. While known for offering potentially higher returns than other methods, there are higher costs associated with this route.
2. Limited partnerships, which offer limited control, are particularly effective when close ties exist between the limited and general partners. Limited partners typically invest in funds with multiple investments, some of which may be closer to the investor’s mission than others.
3. Fund of funds, which can offer lower costs, but do not offer the level of design and control afforded by partnerships.

Each method described above requires a particular level of resourcing for successful implementation, and all entail tradeoffs between the level of control afforded and costs that can detract from the overall return of projects.

To varying degrees, successful private market investing requires the application of highly specialised skills, including but not limited to:

- Early-stage venture capital
- Small company investing
- Assessing unproven business models
- Emerging markets and emerging communities
- Investing in illiquid markets

Notably, impact investing in private markets requires an even greater assortment of specialised skills because it combines private markets with a form of ESG investing.

Currently, the highly specialised skills required for successful private market /impact ESG investing command a premium in the marketplace. This is due to high demand fueled by simultaneous booms in private markets investing, and by the rise in ESG investing broadly, of which impact investing is a part.
Faith-based institutional investors are often keen to expand their efforts in impact investing but must carefully assess the various tradeoffs involved to arrive at a framework or model that is best for them. One of the keys to successful impact investing is finding a sufficient number of meaningful projects. Backing a project that generates substantial E&S benefits should provide satisfaction, and although the choice of funding method will have an impact on the financial returns, the satisfaction of having positive impact remains, regardless of which funding method is employed.

3. Tradeoffs between 'impact' and investment outcomes

A central question in impact investing is: what are the tradeoffs between financial returns and E&S benefits? If an investor wants to generate E&S benefits, or specific types of E&S benefits, should they expect the same, lower or higher risk-adjusted financial returns compared to similar investments without E&S benefits? The answer to this question will affect the amount and type of impact investing a faith organisation undertakes, and the risk-return expectations for its investment portfolio.

If the investor believes that they can get market-level (or even higher) risk-adjusted financial returns in addition to E&S benefits, that would simplify some of the decision making. If, however, the investor believes that generating meaningful E&S benefits could only be achieved with below-market, or ‘concessionary’ risk-adjusted returns, then they would have to estimate how much financial return would be sacrificed to achieve the desired impact, and whether that is worthwhile. The latter is a step toward ‘pricing for impact,’ which is also something that grant-making organisations do.

While there are, we assert, tradeoffs between impact and investment outcomes, they are not straightforward. For example, there appears to be a reasonable number of market level risk-adjusted return opportunities in a field such as clean energy in rich countries, but it may be more difficult to generate market level returns by providing clean energy in poor countries. The latter would provide high levels of impact by relieving suffering, but there may be insufficient revenue in the community to generate a market return.

Another type of impact project might be setting up a manufacturing facility in a poor country. E&S benefits could include providing employment, raising incomes and building human capital in disadvantaged areas. Return potential may be high but financial risks may also be high if the country’s politics are volatile. A further concern would be the environmental impact of the facility. What if it pollutes? This highlights another kind of tradeoff – what is the project’s net E&S benefit? One needs a framework for assessing positive and negative impacts and making a determination of the net benefit. The net
benefit needs to be sufficiently positive for the project to be considered a solid impact investment.

A further consideration is the size or scale of a project: is it large enough to justify the effort needed to bring it to fruition? Institutional investors may have large amounts of money and but limited managerial resources. This constraint is especially binding for private market projects where the asset owner is the general partner or co-investor. The scale of a project may also have an impact on financial returns. For example, there may be a situation where providing a relatively low-cost tool or service dramatically improves the productivity of a laborer or craftsperson, and investing in this productivity-enhancing tool may generate a high risk-adjusted return and deliver a lot of impact, but it may be difficult to scale it up or continue for an extended period of time.

If the tradeoff between E&S benefits and financial returns depends, to some extent, on the type of the impact project, this could help provide a decision-making framework for a faith-based investor. The investor could select impact projects consistent with their mission and have an informed understanding of the financial implications. To further develop what we mean by ‘type’ of project, we would like to understand how the various dimensions of an impact project affect its expected risk and return: industry; ownership; location of employees; location of customers; size; nature and scale of E&S benefits, etc.

Above, we mentioned grantmaking, or philanthropy. From a financial perspective, there is a connection between concessionary impact projects and philanthropy. Both drain cash from an organisation. Even if a concessionary project generates a positive return, if the expected return is below-market, there is an opportunity cost to the investor, whose portfolio will lag others who avoid concessionary investments.

When organisations do have concessionary investments, special care must be taken to assess their financial results in a meaningful way. If their returns are included in the investment portfolio, the benchmark must be modified to reflect the lower expected return. Alternatively, concessionary investments might be removed from investment portfolio results and included with philanthropy.

Conclusion

The three topics of consideration for impact investors that we have discussed – understanding alignment versus impact, accessing private markets for impact investing, and tradeoffs between impact and investment outcomes – will all be explored further in subsequent pieces published by FaithInvest with input from and dialogue among faith-
based asset owners. These future publications will highlight research projects that seek to:

- Generate practical insights on how to initiate and implement impact projects.
- Develop frameworks for considering whether to pursue alignment or impact, and in what proportions.
- Provide techniques for measuring impact to determine net E&S benefits.

Developing and implementing an impact investment strategy is complex and demanding, but FaithInvest is here to help! Contact us to find out more about how we can support the development of your faith-value policies and guidelines.

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FaithInvest is an international, not-for-profit organisation for religious groups and faith-based institutional investors. Our aim is to grow the scale and impact of faith-consistent, values-driven investing worldwide.