Serving Client Demand for Impact Investing:

A Hands-on Guide for Financial Advisors and Senior Management

Overview of Findings

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Impact Economy
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What's Happening?

Interest in impact investing—the practice of investing with the intention to generate measurable social and environmental impact alongside a financial return—has hit a fever pitch. Throughout 2013, some of the biggest names in the financial services industry—Morgan Stanley, UBS and Goldman Sachs—announced plans to establish or otherwise augment their individual activities around the theme of impact investing.

In its most rigorous form, impact investing involves specifying, measuring and reporting social and environmental impacts throughout the investment process, from fund design through sourcing, diligence, selection and monitoring and verification of individual investments—which is different from other forms of impact-related investing, such as Socially Responsible Investment (SRI).

Various factors are contributing to growing awareness, with the prospect of servicing latent client demand (i.e., future business growth) being chief among them. A subset of financial institutions are utilizing parts of their institutional platforms as a result, but less observable has been a push towards aligning these programs with various organizational functions, including: advising, originating, trading, managing, and distributing capital. The fragmentation of practice is raising questions over how to approach these activities and optimally integrate them within a leading global financial institution.

The hands-on guide ("Serving Client Demand for Impact Investing") on which this overview of findings is based unpacks the motivations, dimensions, issues, and opportunities that investors and firms encounter when creating impact investment programs, helping the financial services industry to harness impact investing in ways that are commercially viable and socially transformative.

Evidence increasingly suggests that investors need not sacrifice risk-adjusted financial returns by simultaneously pursuing social or environmental objectives, and that awareness of these opportunities continues to grow, alongside demographic trends that reflect a cultural inclination to "do well and do good" simultaneously. As individuals and institutions look to the financial services industry to supply financial products and strategies consistent with these broader goals, firms will increasingly need to rely on diverse competencies and a variety of organizational structures to service client demand.

Dimensions of the Market

Due to inconsistencies in terminology, clarity around the contours and significance of the impact investing market has proven challenging for financial services providers to determine—the points where impact investing begins and other forms of impact-related investing end have remained elusive. This is true in the overall global financial system, but is compounded in the context of major financial institutions. As a result, the following section attempts to stack

Spotlight: Motivations

A number of factors are contributing to the growing interest in impact investment, but the main driving force for financial institutions is servicing latent client demand; over 62 percent of respondents to the Impact Economy and Money Management Institute (MMI) survey that MMI distributed to over 400 senior executives in the financial services industry in March 2014 echoed this point. Demand for impact investment opportunities will only grow in significance as emergent trends—including a projected generational inheritance between Baby Boomers and their beneficiaries—begin to influence future decision-making. This transfer has been estimated to be upwards of USD 41 trillion in total value. A 2013 study found that these younger recipients consistently ranked impact performance as their primary investment criteria, ahead of profit. Moreover, a majority of impact investment fund managers have noted the importance of using impact performance to raise capital.

impact investing in the context of the financial industry, individual firms, their programs, funds, and investments.

Scale 1: The Financial Industry

There was an estimated USD 600 trillion in total global assets in 2013, with approximately USD 36 billion in impact investments (equating to .006 percent of total global assets).

Scale 2: A Single Global Financial Institution/ Big Bank

Overall Assets under Management (AUM) of the major financial firms covered in this research (e.g., Citigroup, Deutsche Bank, Goldman Sachs JPMorgan Chase, Morgan Stanley, and UBS) range from USD 500 billion to USD 2 trillion, in comparison to USD 100 million to USD 10 billion in impact investments.

Scale 3: A Bank's Impact (and Impact-Related) Investment Program

Impact (and impact-related) investment programs within major banks range from USD 100 million to USD 10 billion in impact investments, with USD 2 million to USD 10 million in individual investments in impact funds (variety of instruments).

Scale 4: An Impact Investment Fund

The number of newly formed impact investment funds averaged less than 10 per year between 1970 and 2000. However, the market rapidly expanded from 2006 to the present as 20 to 60 new funds were formed annually, with most of these funds raising between USD 50 and USD 100 million in capital.

Scale 5: Individual Impact Investments

An average impact investing equity transaction is estimated at USD 2 million, 20 times smaller than a standard private equity transaction size. Portfolio deal sizes in microfinance-based impact funds are typically much smaller, and range from USD 25,000 to USD 100,000, or USD 250,000.

Issues

While a number of financial institutions are beginning to embrace impact investing, investors, funds and advisors are struggling with different elements of impact investing strategies—including the sourcing of investments and building fund portfolios, as well as obtaining adequate financial and impact related data. Evidence also suggests that global financial institutions are succeeding (to varying degrees) with aligning impact investment (or impact-related investment) programs with their responsibility motivations but, on the whole, have not succeeded in aligning these programs with their financial motivations.

In addition, building a robust fund requires extensive due diligence, particularly given the small transaction sizes for individual impact investing portfolio components. Because many impact investments are made in frontier or emerging markets, sourcing and pricing investments without detailed in-market financial information or asset class performance benchmarks can be particularly daunting. The severity of this dynamic cannot be underappreciated, particularly when the investment pipeline is limited by inadequate financial data and a dearth of suitable investments that align with a firm's vision and motivations. These problems can cause contract volumes to decrease, while transaction costs increase.

Client demand stands to continue to outstrip the supply of investments, and financial diversification of impact investing has yet to extend significantly into institutional and client holdings. The resulting picture that emerges is one of a nascent but growing field of practice that is broadly aligned with the philanthropic arms of large financial institutions, but not the investment side. This overall pattern belies the hype of impact investing as a distinct practice area for mainstream investors, at least to date with most institutions.

A Way Forward – Harnessing the Institutional Platform

The issues limiting the growth of impact investing overall and within the financial services industry in particular are, in turn, creating a number of conditions for pushing it forward.

What is now needed is for financial services firms to seize the opportunity, take a more systemic approach and actually leverage the full spectrum of their resources, expertise, and infrastructure to match client demand and build a viable pipeline of investible products and deals. A number of firms are essentially pursuing components of this approach—using philanthropy, CRA-motivated lending, ESG and SRI, and wealth management to service client demand on a bespoke basis or meet narrow compliance requirements. But they, and others, could go further and optimize both the impact and financial proposition of these kinds of investments by venturing to align them.

Available evidence raises important implications about the integration of impact investment with other parts of a financial institution. Alignment with compliance and philanthropy might be a logical short-term solution; particularly since in-house expertise regarding social impact resides here, while other skillsets are dispersed throughout the organization.

Firms can also begin to broaden where their CRA-motivated capital actually flows, moving beyond real estate transactions to include greater diversification into health care, education, social services, and the arts—sectors of great interest to the very clients now fueling demand for impact investing opportunities. But strategically, using an approach that aligns impact investing and wealth management provides a more promising long-term solution. It prepares the firm to respond to increasing client demand for the integration of impact investments within client portfolios, and it provides a better opportunity for the institution to respond to the financial motivation for impact investing. While none of the banks covered in the research that corresponds to this overview have implemented impact investing at scale, some are beginning to create organizational structures to do so in the future, as investment opportunities arise to meet increasing investor demand.

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