PART II

learn from peer experiences

wealth holders‘ approaches to impact investing

Part I covered the basic theory of impact investing. The objective of this Part is to show impact investing as a viable reality, by illustrating how wealth holders around the world have used it in practice. Chapter 3 will summarize the general approaches to impact investing used by wealth holders. The following chapters will examine in greater detail the strategies used by each of the subgroups of wealth holders — family offices and High Net Worth Individuals (Chapter 4), family foundations (Chapter 5), and family businesses (Chapter 6). These chapters will cover the relevance of impact investing to the investor group in question, motivations, practical application of core strategies, specific issues faced by investors, and will provide peer stories and examples. Chapter 7, the final one in this Part, will discuss impact investing as a career choice, as well as approaches of moderately wealthy individuals.

chapter 4. IMPACT INVESTING BY HNWIs AND FOs

4.1 RELEVANCE OF IMPACT INVESTING TO HNWIs AND FOs

Impact investing, in the context of an FO or individual wealth holder, **means integrating investment opportunities that generate societal impact into traditional investment portfolios, as well as setting up impact investment programs to address the specific objectives of the family or HNWI**. As this Guide is written from the perspective of the wealth holder, this section addresses single-family offices (SFOs) and HNWIs who have discretion over wealth-management decisions. Therefore, an FO here means an SFO owned by a family.

HOW A SINGLE-FAMILY OFFICE WORKS[5]

An FO is a professional organization, dedicated to managing the capital and private affairs of a wealthy family. Typically set up after the family experiences a significant liquidity event, its establishment is motivated by the desire to have a dedicated, but family-controlled, organization to deal with wealth management and the other needs of the family.

The services provided by FOs range from simple investment management to direct investing, accounting and reporting, tax and insurance planning, philanthropy, management of business interests, family governance, education of younger generations, succession planning, and 'concierge' services (travel arrangements, property and aircraft services, etc.). These activities may either be handled directly by the FO staff or be outsourced. While the size of FO teams varies, many are small, consisting of an investment specialist, a (tax) lawyer, an accountant, and an assistant. The family can be deeply involved in the operations of the FO, often with a family member acting as head of the FO, or the FO Board's being composed of family members.

As the cost of operating an FO often exceeds US$1m per year, the net worth of a family required for setting up an FO can be anywhere from US$100m to US$500m. In order to reduce the cost of running an FO, some families decide to offer the services of their FO to other families, thereby transforming it into a multi-family office (MFO). An alternative way of procuring FO services is through independent wealth-management companies or bank departments. In these cases, the family does not own the organization, but retains decision-making powers.

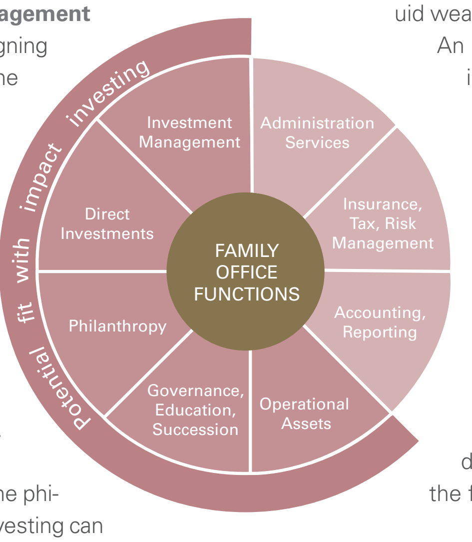
WHO TAKES THE LEAD? Impact investing is relevant to a range of activities and objectives of the FO, as described in Figure 4.1.

Figure 4.1: Fit of Impact Investing to FOs

Investment management: Impact investing is **primarily placed within the investment management activities of an FO**, as a way of aligning wealth with the values of the family. The benefit of this is that the existing investment resources and infrastructure can be used to source, analyze, and manage impact investments.

Direct investments: FOs often have a direct investment allocation, dedicated to private equity investments. An FO principal may place impact investments within this allocation, especially in the initial stage.

Philanthropy: The FO often manages the philanthropic giving of the family. Impact investing can be used alongside grants within this allocation, which can also be structured as a trust or a foundation.



Operational assets: Many families not only possess liquid wealth, but also control an operating business. An FO often provides a platform for discussing the strategy and governance of such a business. Discussion of the purpose of the family business and its legacy often results in the development of impact investment initiatives.

Family governance, education, and succession: a stand-alone impact investment program can be placed under this umbrella, managed with/by a group of family members, and structured in such a way as to address specific issues that are important to the family.

Note: To avoid overlap with the family foundation and family business sections, strategies falling under philanthropic allocation of FOs are covered in Chapter 5 and the use of impact investing as related to family businesses in Chapter 6.

4.2 KEY MOTIVATIONS

The common drivers for getting involved in impact investing, listed below, may be better understood in light of the key issues wealthy families have to deal with (see the box at the bottom of the page).

NEW FAMILY LEGACY AND HOLISTIC ALIGNMENT
Many HNWIs are increasingly concerned about social and environmental challenges, and feel compelled to help build a fairer society. Supporting market-based solutions as a method of addressing societal problems appeals to many wealth holders, especially entrepreneurial ones, looking to create a lasting change. Increasingly, wealthy people are also moving away from the tradition of separating personal values from investment principles. They would like all aspects of their lives — wealth management, family business, and their careers — to reflect their values and generate positive impact, seeing in this a new and powerful legacy. One wealth holder expressed it as follows: 'This disconnect between the values we apply to business decisions and in our personal life is not acceptable. We should live one life, guided by one strong set of beliefs, whatever they may be.'

AN EFFECTIVE WAY TO MANAGE WEALTH
The growing range of impact investment opportunities allows investors to construct diversified portfolios that reflect their risk and return expectations. Many wealth holders even saw their impact investments outperform traditional ones during the last crisis and subsequent economic slowdown, exhibiting lower volatility and lower correlation. 'While my brothers lost 40% of their portfolio during the last crisis, my microfinance and community-development investments kept producing 3–5% a year,' notes one impact investor. FOs also like the fact that many impact investments are linked to the real economy (agriculture, forestry, and SMEs), and consequently fit in with the long-term, multi-generational focus of FOs.

PERSONAL FULFILLMENT AND VALUES TRANSFER
Wealthy individuals often mention that involvement in impact investing has afforded them a lot of personal satisfaction, excitement, and fun. It helps inheritors to see wealth not as a burden, but as an instrument with which to make a difference and succeed in life. Wealth generators use impact investing as a tool to prepare the 'transfer of wealth with values' to the next generation. As one family representative put it: 'Being involved in these investments helps our children see the connection between investments and what they care about, and that, hopefully, will help them find their path.'

FAMILY UNITY AND INTER-GENERATIONAL CHANGE
Some families use impact investing to reconnect family members with one another, strengthening relationships through involvement in interesting and socially meaningful activity. An impact investing strategy, aligned with family values, can help to engage younger generations in the leadership and management of an FO[12]. Some multi-generational FOs consider the introduction of impact investing to be essential to the survival of the FO through wealth transfer to the next generation, which increasingly requires the alignment of their wealth with their values.

KEY ISSUES FACED BY WEALTHY FAMILIES

Multi-generational wealth preservation: While HNW families naturally want to preserve and grow their capital, it is estimated that, on average, 60% of that wealth is lost by the end of the second generation, and 90% by the end of the third[6]. This is attributed to the lack of motivation of subsequent generations to work for, invest, and grow their money[7], as well as the effect of fees and investment losses.

Wealth transfer: A great concern for wealthy families is raising children to be responsible adults, capable of stewarding the family's wealth[8], and, even more importantly, becoming happy, productive members of society. Around 75% of families worry that their children's lives will be adversely affected by wealth[9], and almost 80% feel their children are not prepared to handle wealth[10].

Family cohesion: Some multi-generational families, especially after the sale of the family business, struggle to preserve strong bonds and relationships. Unless proactive steps are taken to hold family members together, they tend to grow apart over time, thereby making the preservation of the family culture, standards, and legacy challenging. Enabling family harmony and arbitrating family conflicts is one of the key challenges that multi-generational families face[11].

chapter 5. IMPACT INVESTING BY FAMILY FOUNDATIONS

5.1 RELEVANCE OF IMPACT INVESTING TO FAMILY FOUNDATIONS

Impact investing is being adopted by a growing number of foundations globally, and is often referred to by them as 'mission investing.' Impact investments made by the foundation are divided into *Program-Related Investments* and *Mission-Related Investments*.

MISSION-RELATED INVESTMENTS (MRIs)

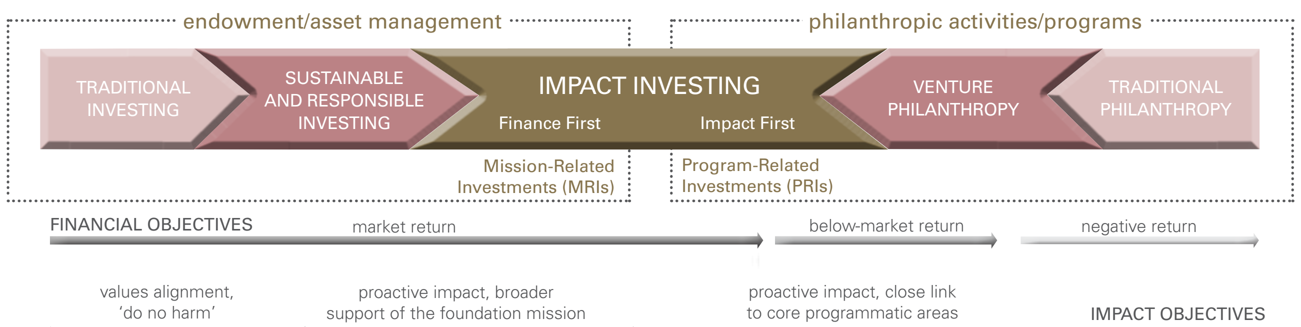
MRIs are impact investments that broadly support foundations' programmatic goals, but do not count toward a foundation's charitable distribution requirements. MRIs do not bear any thematic restrictions, but often are required to produce near-market rates of return in order to preserve the grant-making capacity of the foundation. **Made using endowment assets alongside traditional investments and SRI, they are typically Finance First investments.** A Mission-Related Investment made by a culture and arts foundation could be investing part of its endowment in a green bond or a microfinance debt fund with an extensive track record.

PROGRAM-RELATED INVESTMENTS (PRIs)

PRIs are made with the primary objective of furthering the foundation's mission. Made out of the charitable-expenditure budget, they are included in a foundation's annual payout requirement. PRIs often need to fulfill certain legal criteria, such as being closely linked to the core programmatic areas of the foundation, and may not be permitted in certain jurisdictions. **PRIs are typically Impact First investments, made alongside grants and venture philanthropy.** A PRI example would be a loan guarantee provided by the same foundation to a non-profit theater, enabling the theater to secure a lower interest rate for the purchase of a building.

This integration of various financing instruments and approaches can be seen as a new continuum, which provides foundations with an expanded set of tools to advance their missions. As Figure 5.1 shows, the impact objectives of the foundation can, therefore, be extended to include part of the endowment assets, while part of the programmatic budget can be used to achieve not only philanthropic, but also financial returns.

Figure 5.1: Expanded Toolbox of a Foundation



HOW A TRADITIONAL FAMILY FOUNDATION WORKS

The family foundation is the entity through which the family carries out its philanthropic activities in a tax-efficient manner. Its main activity is providing grants according to its mission. These core philanthropic activities of the foundations are called *programs* or *the programmatic side* of the foundation. These activities are typically handled in-house by the family and program offices, who are employed by the foundation. While some foundations are funded annually by the family, most are structured as *endowed* foundations. That means that a specific amount of capital, called an endowment, or the assets of the foundation, are segregated and used to fund the charitable activities of the foundation. The financial management of endowment assets is called the *investment* side of the foundation.

Investment management is often outsourced to traditional asset management firms. Even if investment management is undertaken in-house, there is a strict separation of the asset management team and the programmatic team, with little interaction between the two. With the assets of the foundation being critical to funding its programmatic activity, the endowment is typically managed in a conservative way, in order to yield an annual return of 3–8%, which is then used as a *spend-down budget* for the foundation. While the foundations benefit from their tax-exempt status, they are subject to specific regulations, such as a minimum annual spend down (5% in the US), restrictions on the type of organization that can be supported, permitted activities, etc. A family foundation is typically governed by a *Board of Trustees*, which oversees the programmatic and investment sides of the foundation. Typically, several family members serve on the Board, which may also include external members.

5.2 KEY MOTIVATIONS

Driven by the understanding that philanthropic resources and government spending are insufficient to resolve many of the societal challenges they choose to focus on, foundations are moving away from simply counting the philanthropic spend, and toward assessing what their capital has actually achieved. **This search for effectiveness is forcing foundations to examine a broader range of models that can advance their philanthropic mission, including impact-driven enterprises,** whose needs are different from those of charities. Effective philanthropy also means leveraging foundation resources, both human and financial, as fully as possible. Impact investing fits well with the above trend and appeals to philanthropists for the following reasons:

SCALE AND TYPE OF IMPACT

Foundations consider that impact investing allows them to reach the scale and type of impact that grants may not be able to provide on their own. Market-based solutions can provide sustainable business models and driven entrepreneurial teams that are accountable for their results, and can position impact-driven businesses to scale up rapidly, both directly and through replication. Through impact investing, foundations have the possibility to unlock endowment assets, as well as large pools of third-party capital, and to direct these toward achieving social outcomes. In the case of PRIs, investment returns are often reinvested alongside generated profits to support a greater number of organizations and, by allocating a portion of its endowment to impact investment, the foundation increases the amount of capital working toward the fulfillment of its mission, deepening its impact.

INDEPENDENCE FROM GRANTS

Many foundations feel trapped by the dependency of the grantees on their support and the operational inefficiencies of NGOs, caused by the need for continuous fundraising. Supporting self-sustaining models of impact delivery addresses this issue.

NEXTGEN ENGAGEMENT

Maintaining the interest of the younger generations in the foundation is often a challenging undertaking, as NextGen members may lack a sense of ownership of the foundation strategy, and may have a different attitude toward grant-based philanthropy. Impact investing may be used to trigger greater engagement of younger generations in foundation operations, creating an opportunity jointly to shape the philanthropic legacy of the family[14].

HOLISTIC VALUES ALIGNMENT

Families grow increasingly sensitive to the notion that their endowment may work against the mission of the foundation. It contradicts their desire for holistic impact and may present reputational risks. See more on that phenomenon, known as *philanthropic paradox*, in the box below.

Philanthropic paradox refers to a situation whereby foundations, created with a philanthropic purpose in mind, may end up generating negative impact due to their investment activities being managed without regard to societal impact. Awareness of the possibility of philanthropic paradox and the reputational risks associated with it grew with the appearance in 2007 of a series of articles in the *LA Times* on the Bill and Melinda Gates Foundation. *LA Times* reporters discovered that, while the foundation supported, through grants, the distribution of polio and measles vaccinations in the Niger Delta, its endowment invested in Eni, Shell, Chevron, and ExxonMobil, which owned the polluting oil companies in the same area, often blamed for contributing to the very same problems that the foundation was trying to address. The articles caused a lot of animated discussion in the boardrooms of foundations about the role that their endowment assets could and should play in the furthering of their respective missions, thereby questioning the wisdom of maintaining complete separation of the programmatic side and the investment side of the foundation's efforts.

RETURN AND RISK

As with the FOs, early adopters of impact investing saw that integration of impact investments not only provided an additional tool for reaching their mission, but reduced the overall risk profile of the endowment.

NOT A SILVER BULLET

Importantly, it is not being suggested here that impact investing represents a silver bullet that can solve all the social issues that foundations address. Rather, it is an additional tool available to foundations to advance their missions. Not only is grant-based philanthropy absolutely critical to the areas that are not amenable to market-based solutions, it also plays an important role in developing impact investing as an industry. See more on the use of grants to advance impact investing on p.116.

6.3 APPLICATION OF CORE APPROACHES

Impact investing through family businesses has its particularities, due to the link to the core operations of the business. Both internal and external strategies are employed, as shown in Figure 6.3 and summarized below.

INTERNAL STRATEGIES

A. Product/business-model innovation: Adaptation of products/services, distribution/payment models to generate greater impact.

B. Supply chain/production innovation: Integrating disadvantaged populations into the supply chain/workforce. Environmental-footprint reduction. Developing new raw-material inputs.

C. New business lines: Expansion of core business activities into new areas.

D. Total business realignment: Redesigning the family business around shared value objectives.

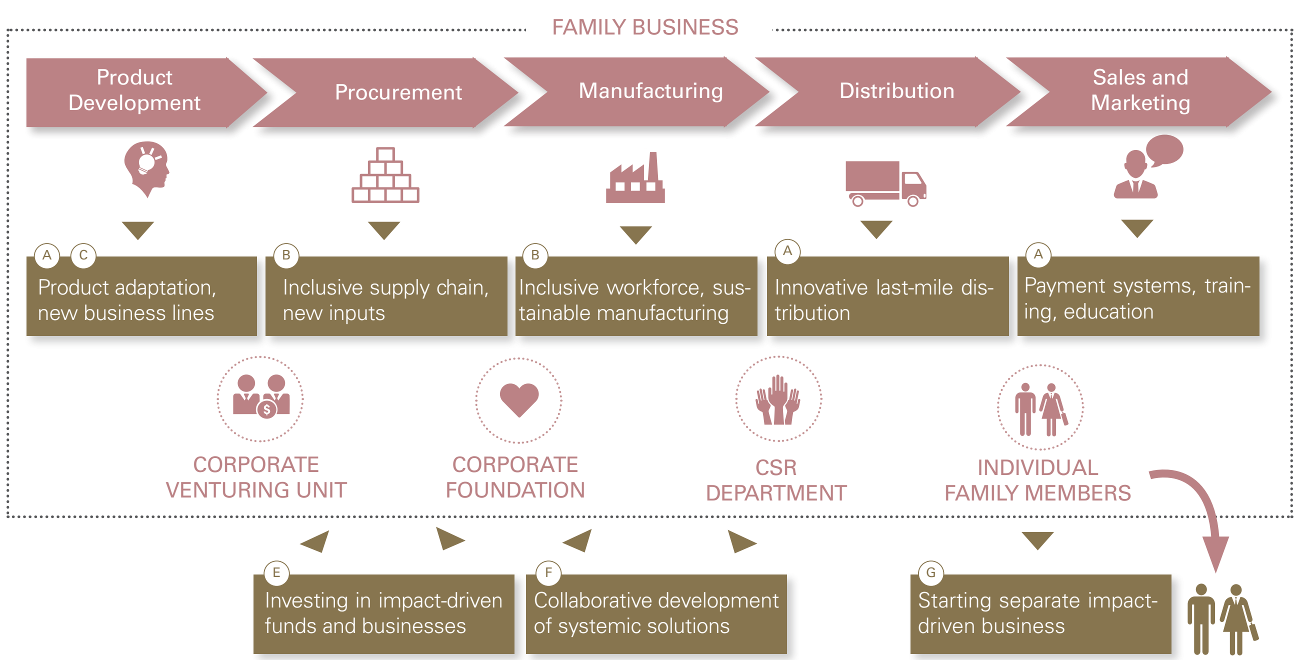
EXTERNAL STRATEGIES

E. Corporate impact venturing: Segregating a pool of capital to invest in a number of impact-driven businesses and funds.

F. Systemic innovation: Developing impact-driven business solutions collaboratively with the industry. Engaging in policy advocacy; developing inclusive business infrastructure.

G. Separate business: Starting a stand-alone impact-driven business outside of the core family business ecosystem.

Figure 6.3: Family Businesses' Approaches to Impact Investing



The above strategies can be linked to the core approaches in the following ways. Family businesses may *experiment* by investing in an impact-driven business through corporate venturing or a foundation, or innovating with internal operations in response to a specific business problem or an opportunity. Corporate impact venturing and development of new business lines can be considered *strategic approaches*. *Integration* can take the form of total business realignment or expansion of new, shared value business lines with the intention of transforming/phasing out traditional lines over time. Family businesses can *gain leverage* by engaging in systemic innovation, spinning out incubated businesses, and collaborating with other industry players in supporting the growth of impact-generating enterprises through venture investments. Developing a venture outside the family business can also be considered an example of a leveraged approach.

(A) PRODUCT/BUSINESS-MODEL INNOVATION

This approach means **an adaptation or customization of an existing product, service, or business model in a way that will lead to specific additional impact, while providing access to new markets and customer groups, and/or strengthening brand loyalty.**

Product innovation: Adaptation is often required in order to serve low-income consumers in emerging markets or other underserved populations. Products need to be affordable, need to meet the specific needs of these customers, and be adaptable to local conditions (for example, portability of solar lights due to outdoor sanitation facilities). Companies also innovate to offer more sustainable and healthier products to their traditional consumers. Business units typically initiate product innovation, but are assisted by R&D, CSR, and corporate foundations, which bring missing market insights, and, potentially, complementary funding for customer education.

Business-model innovation: Reaching emerging consumers, especially in isolated or rural communities, is difficult due to non-existent logistical infrastructure, resulting in the need for innovative last-mile distribution, payment and consumer-finance models. Some companies may use their existing distribution channels to deliver novel types of products incubated by the company. For example, Mahindra Group (see pp.70–71) uses its extensive vehicle-distribution network to sell insurance to rural populations; Godrej Group uses third-party commercial-distribution channels (post offices). An alternative is to invest in a community-based distribution model, which brings the additional benefit of greater employment and improved livelihoods (see the two examples below).

UNILEVER, GLOBAL/INDIA

In 2000, Unilever, a global consumer-goods company, pioneered an innovative distribution model called Shakti (which means 'strength' or 'empowerment' in Hindi) at one of its divisions, Hindustan Unilever (HUL). Aiming to provide sustainable-livelihood opportunities for underprivileged rural women, while expanding Unilever's presence in hard-to-reach areas of India, HUL invited such women to become HUL direct-to-consumer sales distributors in their villages, called Shaktiammas. HUL trained them to become micro-entrepreneurs and tapped into the microfinance market to enable the women to purchase stock, which HUL sold at a discount. Products were adapted (for example, a high-quality Pepsodent toothbrush was created, priced at only US$0.20, and other hygiene products were packed in small quantities to drive affordability). In 2010, the model was expanded to include the husbands or brothers of the Shaktiammas, who were employed as Shaktimaans to sell the products on bicycles (provided by the company) to surrounding villages. By 2012, the program included 112,000 Shaktiammas and Shaktimaans, doubling their monthly incomes. Collectively, they served over 4m people, affording them access to basic goods, such as nutritional food and hygiene products. Commercially, the program allowed HUL to expand its reach to over 165,000 villages not accessible through traditional retail models by the end of 2014. The success of the Shakti model in India has prompted Unilever to replicate it in Indonesia, Bangladesh, Sri Lanka, and Vietnam, and they are currently adapting it for Nigeria and Kenya[21].

CEMEX, MEXICO

In 2000, Cemex identified low-income families in Mexico as a large untapped market for its building materials. Identifying waste of raw materials and lack of financing as critical issues these families faced, it created Patrimonio Hoy to support affordable-housing development. It sells Cemex building materials at average market prices and offers micro-financing, technical advice, and logistical support. In partnership with community organizations, Cemex trains women to provide last-mile distribution. Following a basic, 'solidarity group' micro-lending model, customers apply in groups of three to the local Patrimonio Hoy cell and pay for building materials over 70 weeks. Cemex also provides an engineer and an architect to oversee participants' construction projects. The cost of materials is fixed over the course of the work, protecting customers from price fluctuations. Cemex also provides storage of and vouchers for materials if customers run into periods of inconsistent employment or wish to delay construction. The program has provided affordable home-improvement solutions to over 1m low-income people in Latin America and has enabled over 350,000 of them to build their own homes and increase their incomes, as a third of them use their homes for income-generating activities. Participants build houses three times faster than usual, and at a third of the national average cost. The market value of homes built through the program is 20% higher than comparable homes not built through it. Patrimonio Hoy creates jobs among local craftsmen and through its sales force, 95% of which are women, and half of whom had no prior work experience. The program has opened new markets and revenue streams for Cemex across Latin America[22].