Guidelines for Impact Investing– Part One: Separating Financial & Social Returns

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A single investment should have a financial goal or a social goal, but not both.

We've had the great pleasure of working with many types of investing organizations—Alaskan Native Corporations, Community Development Quota Groups, and Federally Recognized Tribes, among others—that are all, functionally speaking, endowments.

Bear with me for a moment: while many readers may associate endowments with public pensions or private academia, each of these named entities has a common structure and mission. Each exists for the improvement of the quality of life of its beneficiaries (or shareholders, or members), supported by a cash-flowing asset base, which can be used to either (a) further grow the asset base over time, or (b) deploy for immediate use by beneficiaries (which can take many forms; more on that later).

Unfortunately, the unavoidable tension between the two aims of the asset base—financial and social, growing and spending, saving and using—often drives organizations to try to find investment opportunities that accomplish both at once. Perhaps counterintuitively, our experience with multiple organizations over many investment life cycles has been that the most successful strategy does the opposite: it draws a bright line between these two aims, and investments are made that prioritize one or the other aim, *but not both*. Our experience base is deepest with the types of organizations named at the beginning of the article, but we hope that any similarly-structured permanent capital vehicle, especially family offices, can learn from our conclusions.

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In this two-part series, we'll first provide a framework for how to separate the different aims of investing, and follow up with a discussion of optimizing strategies for capital deployment for beneficiaries.

Background: Endowments & Their Purpose

For our purposes, an "endowment" can be any pool of resources, stewarded for the perpetual benefit of some set of beneficiaries. In the case of CDQs, the "endowment" began as fishing rights in the Bering Sea, and the beneficiaries are coastal communities in Western Alaska; in the case of ANCs, the "endowment" began as primarily land and resource rights, and the beneficiaries are shareholders; in the case of many tribes, the "endowment" is a right based in the tribe's sovereignty, like gaming rights or mineral rights, and the beneficiaries are members. In all cases, these original kernels of value have produced cash flows that have since been reinvested into a widely diversified basket of assets.

Regardless of the makeup, any endowment has two aims, always in balance:

a) Grow the endowment, because without growth, the purchasing power of the endowment diminishes over time, so at

the very least the endowment has to grow to match inflation; and

b) Spend the endowment, because its whole point is to be used to benefit the quality of life of its beneficiaries, present and future.

The first aim is straightforward, if not easy. Buy assets that will generate future cash flows (land, quota, real estate, private businesses, public securities, etc.), at prices that produce attractive rates of return. This is true for every investor on the planet, and endowments are no different. The second aim is much, much more complex, as there are lots of ways to return value to beneficiaries. More on this in a bit.

Categorizing Types of Investments: Growth, Impact, & Community

To more clearly discuss how an endowment might think about segmenting activities between its two aims, a discussion about different types of investments is in order. This is by no means a globally-accepted slate of terminology, but hopefully it clarifies the discussion.

First, an **investment** implies a return: a trade, exchanging value today for (if all goes well) more value tomorrow. Nothing controversial here. But investments can take many forms, depending on the type of value exchanged, and to whom the future value accrues.

The most straightforward example is a one-party financial investment. The trade exchanges value (dollars) today for a future cash flow stream (dollars). The asset exchanged and the asset returned is the same, and the party both committing and collecting the dollars is the same (the investor). For the purposes of this discussion, we'll call this kind of investment **"growth,"** generating a "**growth return,"** as it is employed simply to grow the base of assets of the endowment.

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A more complicated example of an investment is a grant or low-interest loan. It's still a financial investment; dollars spent now, in exchange for value created later. But in this case, there's more than one party involved. Imagine a grant provided to a small business owner that enables the purchase of raw materials for the first time. The grantor spends the dollars, and the grantee starts up a business that otherwise could not have existed, and then receives the benefit in the form of future dollars generated from the now-successful business. The grant is still an investment—a return has been generated—but the return has accrued to the grantee, not the grantor. For the purposes of this discussion, we'll call this kind of investment **"impact,"** generating an **"impact return."**

A very complicated example of an investment is a service or program. Let's say an organization pays for the setup and operation of a healthcare clinic in a rural town. In this case, one party spends dollars, and then a second party (the citizenry of the town) receives a quality of life improvement by being seen by a doctor. This is still a kind of investment, but it's very difficult to measure return, as the value contributed (dollars) is of a different form than the value generated (health, quality of life). For the purposes of this discussion, we'll call this kind of investment a **"community"** investment, generating a **"community return."**

We're self-aware enough to admit that there are scores of non-profit and foundation investors well-trained in evaluating community return, or any value creation in a form other than financial, and we are not. As such, the scope of this series is really to consider the financial-only growth vs. impact investments described above.

Clarifying the Investment Aim

The reason that these different types of investments matter is that endowments, in the pursuit of the two aims, often consider all of them within the scope of opportunities. We have found that likelihood of success decreases when attempting to accomplish more than one type of investment within a single project. For those wondering how this could be the case, tell me if this sounds familiar: "*We're going to buy this business, and while it doesn't have a very compelling financial return profile, it has many secondary benefits to a community or region in the*

forms of job creation and essential services, and all of those benefits are in support of our mission."

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On the surface, this looks like an excellent investment for the organization, as it touches multiple realms of benefit simultaneously. However, as counterintuitive as it sounds, we have observed that it is unfortunately likely that this accomplishes the least of both worlds: it will tie up investable capital without earning an acceptable growth return, while also delivering less impact to beneficiaries than an equivalently-sized but more efficient impact investment.

The opportunity cost problem is a big one. If capital were infinite, then an endowment might say that an investment opportunity that provides a blended growth and impact return that is attractive in aggregate, if not individually, is worthwhile. And we would agree! Unfortunately, capital is never infinite, and if some capital in the endowment earns a financial return lower than the hurdle rate for its asset class, then the rest of the endowment must achieve even greater growth to compensate for the underperforming financial profile of this particular investment.

While it would be fantastic to find investment opportunities that simultaneously achieve a rate of return acceptable to the growth of the endowment, and also deliver impact return to beneficiaries, our experience is that those opportunities are incredibly rare, and cannot reliably used as a cornerstone of an endowment's investment strategy *for the purposes of growing the asset base.*

Instead, we suggest a very clear dividing line: an investment must reach a minimum financial rate of return to be considered as a growth investment, otherwise it warrants consideration as an impact investment, alongside other spending programs out of the endowment's budget. Very plainly, from the endowment's perspective, the former is a source of cash and the latter is a use of cash. This is not to say that financial metrics are unimportant in impact investing; in part two of our series, we will look at how best to fold financial metrics into an impact investment assessment. The key is to first delineate if an opportunity belongs in the "growth" or "impact" bucket, and then diligently stay within those bounds.

Caveats & Conclusions

It may seem like we're negative on impact investing. Not in the slightest! In fact, part two of this short series will be a discussion of impact investing, and some suggestions for how to get most value to beneficiaries out of the limited time and monetary resources of the organization (in fact, the investment profile described in this article as a poor growth investment might be an excellent fit as an impact investment). But in connecting back to the basic endowment principles: impact investing out of an endowment is a bad idea, but impact investing out of the *distributions* of the endowment is a great idea. What may seem like a semantic difference can in practice have enormous implications not just on the structure and function of the endowment and its organization, but ultimately on the ability of the endowment to provide its beneficiaries with continuing support.

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