Guidelines for Impact Investing – Part Two: Maximizing Impact per Dollar

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Rate of return still matters, even if the return doesn't go to the investor.

When we last left off in our discussion about impact investing (Guidelines for Impact Investing – Part One: Separating Financial & Social Returns, June 2024), we made the argument that an endowment is better off splitting its investment functions into two: one exclusively pursuing the growth of the endowment's capital base ("growth"), and one exclusively pursuing the mission of the endowment ("impact"). The implication is that pursuing both types of investments out of the same pool of capital, or even within the same investment opportunity, weakens the ability of the endowment to achieve either goal.

But let's say an endowment has now adopted our suggested strategy. The impact investing team is sitting around the table, weighing multiple investment opportunities. All of them have positive effects for the endowment's stakeholders, but in different ways and to different degrees. How can that team compare these disparate opportunities? Similarly, once completed, how can the team measure the ongoing success of an impact investment?

In this Part Two of our Guidelines for Impact Investing series, we'll endeavor to answer those questions and leave you with a framework for evaluating investments for the benefit of a stakeholder base.

First, this wouldn't be a Zachary Scott article without a caveat or two. In our last article, we pointed out that there are financial investments to create an economic return for someone else (that we termed an "impact" investment), and there are also financial investments to create a non-financial return for someone else (that we termed a "community" investment). The naming convention is somewhat arbitrary, but the distinction is not. On the latter, there exists an enormous body of work supporting methodologies for capturing the value of "quality of life," and we won't even pretend to scratch the surface of those here. The scope of this discussion is simply to present some ideas for evaluating financial investments generating economic returns for stakeholders.

To better understand how impact investments can differ, it can help to categorize these investments along a few dimensions: (a) how direct is the effect of the investment on a stakeholder; (b) how uniform is the benefit realized across all stakeholders, and (c) how much economic benefit is created per dollar invested. Each of these dimensions deserves some explanation, so let's walk through each with some examples.

Characteristic #1: Directness

A "direct" impact investment just means that it is easy to plot the connection between a dollar invested and a dollar of benefit realized by a stakeholder. A good example is a distribution: a dollar distributed to a beneficiary, for instance, creates exactly one dollar of benefit. The linkage is clear and very straightforward to measure. An "indirect" investment, conversely, is one where the measurable benefit can be much more difficult to track. An example might be an infrastructure investment in a region, like a road linking two towns.

That's an investment that will have a definite economic impact on the region—travel time shortens, shipping costs decrease, a business owner in one town can now service both towns, essential services have a larger radius of coverage, and so on—but because the actual realized benefit to the constituents happens through a series of mechanisms

over an undefined period of time, it can be very difficult to measure with any precision.

It is important to note that the directness of an impact investment is neither good nor bad; it is simply a characteristic that helps describe the challenge of measuring the outcome (or range of outcomes). As we will see later, many of the impact investments that produce the most impact per dollar invested—the most "bang for the buck"—can be far on the "indirect" end of the spectrum.

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Characteristic #2: Uniformity

A "uniform" impact investment is one in which every stakeholder sees the same amount of economic benefit. A good example is a rebate or other direct subsidy, offered to and used by every stakeholder; everyone sees the same monetary benefit from the investment. On the opposite end of the spectrum, economic benefit may be distributed unevenly throughout the population of stakeholders. An example is a college scholarship program, as stakeholders within a narrow demographic segment will receive the entirety of the economic value distributed, while those ineligible for the program will not.

Again, an ongoing theme: uniformity is not a positive or negative characteristic, just a way to determine the type of impact a particular investment might have on a community. Need is very rarely distributed equally among the members of a community, so it stands to reason that the highest-impact investments may also be designed to target a particular population segment.

Characteristic #3: Multiplier Effect

Similar to other measures of investment return, this is a way to think about the efficacy of an impact investment. In short, it's the ratio of dollars returned to stakeholders to dollars invested, over the life of a program or investment.

In the example of direct distributions, this is easy: one dollar invested returns one dollar realized by stakeholders, for a multiplier of 1.0x. A community grant program gets a little more complicated: one dollar invested has to pay for both administrative costs and the actual grant funds, so maybe eighty-five or ninety cents of the dollar make it to the stakeholder, for a multiplier of 0.85-0.9x. A subsidized loan program for local businesses might have similar administrative costs but earns interest from its loans that pays a little more than its costs, so it may have a multiplier of 1.1-1.2x.

Symmetry would dictate that here is where I claim that a multiplier is not in and of itself good or bad, just a way to characterize an investment. Not so fast, my friends: all else equal, a higher multiplier is always preferable.

A multiplier may seem like an obvious metric, but the world of social programs (and nonprofits, and—dare I say—government) constantly fights an uphill battle against the inherent cost of delivering the value it is designed to deliver in the first place.

If an organization has a choice to spend a dollar that could either put twenty cents or three dollars back to work for its stakeholders, then it should pick the one that returns three dollars. The complexity, of course, arises from the fact that all else is rarely, if ever, equal.

A multiplier may seem like an obvious metric, but the world of social programs (and nonprofits, and—dare I say—government) constantly fights an uphill battle against the inherent cost of delivering the value it is designed to deliver in the first place. It is not unheard of to find charities that deliver less than a quarter of donations to the intended recipients, the remainder spent on marketing, advertising, and overhead. There are investment types that are self-perpetuating and deliver more value to stakeholders than the initial contribution, and these investment types stand out when this metric is applied.

Using Characteristics to Make Choices

The reason for introducing some ways to characterize impact investments is to provide a few examples by which an organization can align potential impact investments with its mission.

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A critical note: it is not for us to decide in this article if a low-measurability, high-multiplier, uniformly distributed impact investment is preferable to a high-measurability, moderate-multiplier, targeted impact investment. Certainly, that choice cannot be made without the context of a specific organization, the needs of its stakeholders, and its stated mission. Our aim is simply that by incorporating this type of methodology in investment evaluation, and the use of these (or many other) characteristics, organizations have a higher likelihood of success in making the types of investments it wants.

That said, we have observed some trends. One such trend is that organizations with successful impact investing arms have figured out how to fund those opportunities with (a) measurable outcomes and (b) high multipliers. The preference for high multipliers is somewhat self-evident—why deliver less value when you could deliver more value—but a preference for measurable outcomes is not as apparent. Just because an impact investment can be tracked and measured doesn't make it good or bad, but it does open the door for a future feedback loop.

Too many times, we see an impact investment made with a very nebulous definition of success (this will have a "positive impact on the community"), which doesn't allow for any analytical perspective to determine if the investment accomplished what it set out to. We often find that these activities correlate: if an organization has a penchant for applying measurement to investments, then using those measurements to continually examine the effectiveness of its portfolio follows.

Some of you are reading this with furrowed brows, imagining an investment that is difficult to measure but that features a very high multiplier. There are countless examples of this, to which we point back to the beginning of this section: these are general observations, not specific to a single investment opportunity, subject to the specific goals of the organization.

Exploring Impact Investment Mechanisms

Now that we have a few ways to characterize impact investments, we can use these dimensions to describe some different types of impact investment mechanisms. This is by no means a canonical list but should help to illustrate where some familiar schemes live on the spectra.

1. **Cash distributions.** Perhaps the simplest form of impact investment, this is a check written to a beneficiary. Along with the three dimensions previously described, it is very direct, its uniformity can range from very targeted to very broad, and its multiplier is at or very near to 1.0x. A good example of this kind of program is the Alaska Permanent Fund, which issues an annual dividend to every qualifying Alaskan.

2. **Targeted subsidies.** These are a lot like a cash distribution, except the value is distributed as a credit rather than a check. Very direct and can also be very broad (fuel subsidies for an entire community) or very targeted (scholarships).

3. **Grants.** Just like a cash distribution, except not typically to an individual, but to a larger organization like a business or a community. Because it's not directly targeted to an individual, grants are not usually as flexible on uniformity, but they are very direct. Multiplier is often a touch lower than a distribution because there is some administrative cost of the grant.

A loan can be subsidized in several ways, as it can be at a lower interest rate or a recipient-friendly structure that otherwise wouldn't be attainable from a commercial bank.

4. **Subsidized loans.** Now is where the complexity begins! A loan can be subsidized in several ways, as it can be at a lower interest rate or a recipient-friendly structure that otherwise wouldn't be attainable from a commercial bank. Maybe the subsidy is that the loan can be made at all. This type of impact investment is still quite direct, and much more targeted than the previous methods, and the multiplier can be really challenging to calculate.

5. **Community programs.** This is a large catch-all for activities staffed by the organization that create some benefit for stakeholders, and very often include a non-financial quality of life component. Think of programs with a social work element, community support, education, healthcare, and similar community development programs. Typically, these have a low multiplier, as they're not creating much in the way of economic value, but often are very closely aligned with the mission of the organization.

6. **Job creation.** Last time, we proposed a scenario where an organization buys a business. The business is break-even but employs many of the organization's stakeholders. These can be really interesting impact investment opportunities, as they have both direct (payroll and benefits) and indirect (employee spending in a community, economic impact of the business) economic benefits, the broadness of its impact can be both narrow (to the employed) and broad (to the entire community, depending on the business), and the multiplier effect can be well in excess of or much lower than 1. Most economic impact studies just tally up the employees and their payroll dollars to measure dollars returned to the community; the trick is to measure the marginal increase in total wage and benefit impact to stakeholders with and without the existence of the business. In other words, a processing facility in Dutch Harbor (where there are few alternative employment opportunities) is going to have a higher impact than a bakery in Juneau (where the job pool is much more liquid).

7. **Infrastructure development.** Like in the road-creation example referenced earlier, infrastructure projects are the perfect very-indirect, high-multiplier, difficult-to-measure impact investment. When applied creatively, these kinds of impact investments can pay for themselves many times over and create real economic value for communities; but many countries worldwide have a "Road to Nowhere," expensive monuments to value creation that never came to pass.

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Implications for Successful Impact Investments

Let's go back to our impact investing committee, who we abandoned at the end of our introduction. We've thrown an awful lot of ideas at them, but they would benefit from some digestible takeaways that they can put into practice. We're here to help! Here are a few rules of thumb that a team can start using immediately:

1. **The mission defines the priorities.** Should an impact investment benefit a few? Benefit many? Benefit a little, or a lot? The answer comes from the mission. Every impact investor serves a group of stakeholders, and those stakeholders have specific needs and vulnerabilities. Those

needs and vulnerabilities inform the mission; the mission informs the investment priorities.

2. **Avoid multipliers under 1.** Put simply: if an organization is spending money to accomplish a goal in a community, and more benefit would be created by liquidating the organization and simply distributing the money, then distributing the money is likely a better choice.

3. **An investment can be hard to measure, or have a low multiplier, but not both.** Distributions are easy to measure and have a relatively low multiplier. We've gone through many examples with a much higher multiplier, that are very challenging to measure. Both types can make sense for an organization. The messy middle is where impact investors end up with low-performing investments that trap capital from more productive uses.

As a wrap-up to this two-part series, we hope we've illustrated just how challenging making successful impact investments can be. While this topic is on the outskirts of our regularly scheduled programming, many of our clients wrestle with these challenges daily and we appreciate what these investments can represent to the daily lives of the people that these organizations are designed to support. We hope we've been constructive in furthering the efforts and missions of these organizations and opened a window into the topic for others.

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