Re-thinking Risk / Return / Impact to Drive Impact Investing Innovation

Accelerating innovation in impact investing requires stronger integration between financial returns and impact outcomes - in the identification of investment opportunities, formulation of strategies that yield superlative results, rigorous data-driven analysis, sound resource allocation decision-making, and communicating among disparate silos of the ecosystem.

While the markets understand financial risk-return, the addition of impact outcomes needs closer alignment with these frameworks. Some of these challenges relate to legacy assumptions of risk, return, outcomes, and governance from public, private, and philanthropic sector marketplaces that have been adapted to date. While much critical work has gone into impact measurement, new investment funds, and pioneering organizations, leaders still struggle with formulating clear objectives and making choices across the broad blended return spectrum.

Re-thinking foundational risk / return / impact for effective resource allocation can help overcome these challenges. Focusing the discussion on practitioner applications that synthesize and push all the good work to date can further accelerate innovation in impact investing.

Hypothesis: If we create more sophisticated frameworks of blended returns, the market can strengthen communication among its actors and become more efficient in matching asset owners, investment opportunities, and service providers – regardless of where they sit on the risk-return-impact spectrum.

Three illustrative cases highlight current practitioner challenges

1. Resource Allocation – two financial officers cannot effectively articulate investment options to their leadership teams and boards:
   - A corporate CFO cannot compare a $10 million investment on an initiative to align organizational governance with corporate strategy with an investment of a similar amount in a capital project that will reduce operating costs by 10% over 3 years.
   - A healthcare foundation Treasurer cannot articulate clearly whether the organization should stay with its current approach of investing in a broadly-diversified portfolio to meet its 5% spend rate for grants or concentrate more heavily in venture capital fund investments focused on innovative healthcare treatments that are aligned with its mission.

2. Investment Fund Strategy – a private equity fund cannot communicate its strategy to potential investors effectively. The fund blends public, private, and philanthropic capital to pursue unique opportunities, minimize risks, and generate specified sustainability impact outcomes. Traditional metrics cannot fully capture how the fund generates superior risk-adjusted financial and outcome returns. GPs describe the opportunity simultaneously as a "market rate fund" to an alpha-seeking fund-of-funds, and an "impact fund" to a mission-seeking foundation endowment.

3. Data Analytics - an investment data technology provider cannot generate analytics for custom blended-return strategies in a way that enable clients to make decisions, including the following types of tools:
   - Roll up a portfolio to understand collective risks, outcomes, and financial returns.
   - Create benchmarks to understand relative performance against baseline results, portfolio objectives, and broader market performance.
   - Generate attribution metrics to understand which investments are contributing to and which ones are detracting from portfolio objectives.

Sample questions to stimulate discussion

1) Strategy: How do we integrate drivers of financial returns and impact more powerfully, particularly around risk concepts and time horizons? This question assumes blended return strategies have insufficient detail to shape breakthrough quantitative analyses and resource allocation decisions.

2) Data: How can we accelerate the synthesis of blended-return data to create meaningful market performance benchmarks that can be integrated into existing investment frameworks? This question assumes customized blended return investment opportunities hinder aggregation of broader market data needed for meaningful comparative analyses.

Accelerating Innovation in Impact Investing

Impact investing is a rapidly-developing field that requires urgent continued innovation to amplify superior blended returns to meet a range of investor objectives and address the critical issues of our times. Accelerating innovation requires a multi-disciplinary understanding of the complex markets and capital flows that drive superior results. Many early leaders in the field tapped into personal experiences gained over many years across the disparate silos of the ecosystem, but this path is inefficient for current and future generations of leaders to contribute to ongoing innovation. By understanding current impacting investing opportunities and challenges more holistically, practitioners can accelerate their knowledge of the field and speed the scale and effectiveness of these investment strategies.

Holden Lee | October 2024