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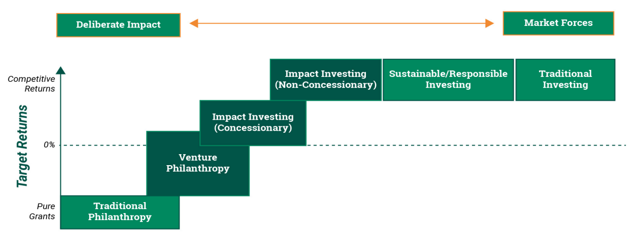
Maximising Outcomes in Impact Investing

Debates on whether investing for impact should involve financial compromises are moot. Here's the more relevant question: How can different kinds of investors optimise their societal impact?

There is an emerging consensus that relying on the invisible hand of markets to create societal value is not good enough. Evolving societal norms and regulatory pressures have rendered deliberate consideration of societal impact a necessity for business. In addition, many investors' genuine desire to do good is another factor increasingly leading them to carefully manage the impact of their investment choices.



Adapted from:EVPA; LGT Impact Ventures;Julia Jaquier.2016.Catalyzing Wealth for Change: Guide to Impact Investing.

The investment spectrum

Yet different investors incorporate impact into their strategies in different ways. When considering the range of such blended investment approaches, I find it useful to distinguish among three generic models that lie along a spectrum between traditional investing and traditional philanthropy: sustainable/responsible investing, impact investing and venture philanthropy (analogous to a similar spectrum of different kinds of businesses that I discuss in a recent **podcast** and **article**).

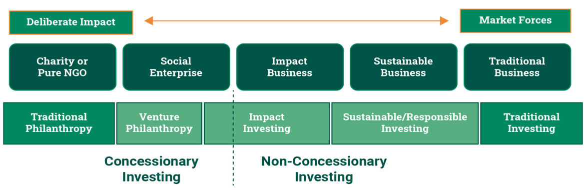
Unlike traditional investing, which focuses only on financial data, **sustainable investing** also considers and manages environmental, social and governance (ESG) metrics in order to generate long-term value and reduce risk. It has rapidly grown to become the most prominent segment within "responsible investing" (which includes other approaches like positive or negative screening at the sector level). However, as financial returns continue to be investors' dominant focus, even sustainable investing is often not well-suited to support cutting-edge solutions for society's most neglected issues and segments. This is the gap impact investing and venture philanthropy try to fill. They go much further in terms of defining, measuring and managing the precise societal impact investors seek while, in the case of impact investing, striving to preserve and generate some financial returns.

However, **ideological differences remain** in terms of whether and how much financial compromise might be acceptable. For example, pioneering impact investor **Acumen** accepts significant trade-offs in supporting high-potential social enterprises. But **Credit Suisse** focuses its impact investing efforts only on "win-win" opportunities that it expects to generate competitive returns.

Venture philanthropists go even further than impact investors in prioritising impact, accepting negative expected financial returns for the right impact. Examples include the **Bill & Melinda Gates Foundation investing in financial inclusion venture bKash** at an early stage, and online lending platform **Kiva's initiative to invest in impactful social enterprises** that other investors view as too risky. Investments thus chiefly serve as a means of making philanthropy more effective than for making money; investing in social enterprises with an earned revenue model can achieve **greater impact per dollar** than giving the equivalent amount as a grant.

Concessionary vs. non-concessionary investing

Together, venture philanthropy and impact investing comprise a broader category called "**concessionary investing**". Given the inherent financial compromise, this approach is only practical for impact-first investors, often high-net-worth individuals, foundations or development agencies. Bono, the celebrity-turned-activist, went as far as to dub concessionary investing as "**bad deals done by good people**".



Note: The boundaries between organisational forms and the investee-investor mapping are not meant to be precise.

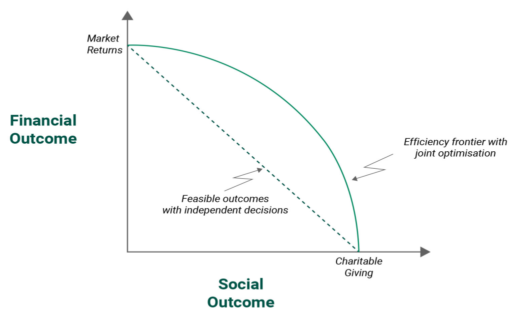
In contrast, "non-concessionary investing" is the preferred approach for mainstream investors like banks and pension funds that need to also deliver strong returns. Non-concessionary investing promises attractive financial returns, and therefore has a broader appeal. However, the approach has been criticised for devoting far more attention to financial performance than **ensuring real impact**, and for baulking at the sometimes inevitable **financial compromise** that results from providing capital to social enterprises working on innovative market-based solutions in difficult contexts.

Cognitive biases and inefficient choices

A unique challenge facing concessionary investing is that the trade-off between financial and social goals makes it hard to evaluate whether an investing decision is optimal. I examine this issue in my recent article, **"Categorical Cognition and Outcome Efficiency in Impact Investing Decisions"**, co-authored with Matthew Lee of NYU Stern School of Business and INSEAD PhD candidate Arzi Adbi. The paper examines whether people are able to make effective decisions in straightforward scenarios where they are given relevant information regarding financial and social outcomes (a rarity in the real world). This issue is important given the buzz around impact measurement being the bottleneck preventing impact investing from going mainstream.

We conducted four experiments involving more than 1,600 participants. Each participant was given real cash (between US$2 and US$20, depending on the experiment) to allocate across three options with clearly specified financial and social outcomes: a "for-profit" (financial returns only), a "charity" (social benefits only) and a "social enterprise" (generating both financial returns and social benefits, but with a trade-off). Participants were not told that they were in an experiment. The promised financial paybacks and social benefits (operationalised as reduction of critical iodine deficiency in poor communities) were truthfully executed.

The key idea is that having a social enterprise option during portfolio allocation can improve financial-social outcomes over those achievable with just a combination of investing in a for-profit and giving to a charity. As long as the social enterprise generates sufficient impact per dollar of returns given up, the "efficient frontier" of outcomes achieved would be an improvement over the outcomes feasible by allocating money only to the pure for-profit and charity options.



We define an "outcome-efficient" allocation as a decision that lies on the efficient frontier, i.e. realises one of the best possible combinations of financial payback and social benefits feasible for the

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given amount of money. In our experiments, a large fraction of individuals – between 33 and 62 percent, including many participants who were well educated and financially savvy – systematically failed to make optimal allocation decisions.

Our last two experiments explored whether the observed failure to achieve efficiency could be attributed at least in part to "categorical cognition", a tendency to make decisions using heuristics based on known categories rather than full analysis of relevant data. We found that removing labels – "social enterprise", "charity" or "for-profit" – from investment options led participants to make better decisions; outcome-efficiency was higher in all the "no labels" groups compared to their respective control groups. For example, in the final experiment that involved MBA students as participants and an endowment of US$20, only 9 percent of people in the no-labels group chose inefficient options, compared to 31 percent in the with-labels group.

Our paper, published in *Strategic Management Journal*, is one of the first academic studies to document the cognitive challenges inherent in impact investing decisions. The paper builds on related research showing that the choices **individual donors** as well as **retail investors** make might often be inefficient due to cognitive biases, like the "warm glow" one gets from altruistic actions (regardless of actual outcomes). We show that such human tendencies to use heuristics, including thinking in terms of categories, can also get in the way of making effective decisions in impact investing and venture philanthropy.

Making better impact investing decisions

Ensuring that impact investing and venture philanthropy realise their full potential certainly requires continued improvement in how we measure impact in the first place. Promising efforts in this direction are already under way – both at the organisational level (such as **Root Capital** employing a version of the efficient impact frontier framework) and at the ecosystem level (through initiatives like **B Impact Assessment** and the **Impact Management Project**).

But making progress on impact measurement alone would not be sufficient. Investors need more support in making effective decisions. This will involve getting them to both care about and understand the real impact their portfolios could achieve. Reaching this goal requires a combination of investor education and behavioural nudges to help overcome decision-making biases.

More broadly, rather than considering concessionary vs. non-concessionary investing as competing ideologies, we should think of them as **complements**. Which one is the better option depends on the particular context and venture stage. And sometimes bringing them together as a "**blended finance**" arrangement can realise overall impact greater than the sum of the parts.

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