

Impact Investing **An Overlay, not an Asset Class**

Definition: Impact Investing

Incorporates social and environmental risk/return analysis into the overall investment decision because these factors materially affect the financial returns.

Impact investing is a growing theme among investors due to their desire to see private investment strategies make a difference for the benefit of our environment and communities. Some finance professional classify this strategy as a separate, discrete asset class. In my opinion, this will cause the impact to be limited and potentially negate positive environmental and social benefits. I believe instead that Impact Investing should be considered an overlay across all asset classes (as defined in the text box above). Specifically:

If you view Impact Investing as a single asset class then:

- It causes all type of financial investments to blended into one asset class (private equity, public equity, fixed income, etc.),
- This in turns makes it impossible to compare potential investments to the average since there is no average,
- The required return gravitates to highest returns with highest risks,
- Reduces the universe of potential investments to the highest return financial asset class (private equity).

If you view Impact Investing as an overlay then:

- All types of investments can be considered as Impact Investments,
- Lets the risk and return benefits of each investment be compared to the appropriate financial asset class,
- Uses the most efficient capital to solve the specific need.

In this way, the scope and scale of Impact Investing can be expanded and risk/return benefits appropriately measured.

Example: Impact Investing & Ecosystem Markets

One of the recognized areas of significant potential for positive environmental and social impact is the use of Ecosystem Markets. These markets assign a financial value to environmental benefits that come from enhanced land and water usage through use of transferable credits (carbon, water, species, etc.). The markets also provide a means for smaller landowners and communities to receive new income by selling credits to large scale emitters (power companies, water utilities, etc.). However, how we define Impact Investing (separate asset class vs. overlay) has a direct effect on how much environmental and social benefit these markets will provide.

The main investment strategy within the Ecosystem Markets if Impact Investing is considered a separate asset class will be the aggregating model. In this strategy, funds purchase credits at low prices directly from landowners, and sells at a higher price to entities needing offset credits. This model is effective for new markets as they mature from volunteer to pre-compliance for it helps start a demand for credits.

The issue with this model is that once a market matures to a more robust regulated market where demand driven by laws and regulation (much as our stock markets are the required place to buy and sell public securities), then the aggregating model will begin to inhibit the supply of credit because of the pressure to maintain high return for investors. In a more efficient mature market and using a more traditional economic development model investors would start use debt to finance projects.

Loans allow landowners to finance land and water usage that will generate credits being sold into a broad market more cost effectively. Now landowners can share in the profit of the credit sale and improve their profit. Investors, the landowners and their community are now partners trying to expand the scale of the land and water usage practices which drives improvement in the environment, decreases risk, increases total amount of capital invested and spreads more income to more people.

Only seeing Impact Investing as an overlay will the markets properly develop.

Summary: Why Impact Investing must be seen as an Overlay

As shown in the example above how we view Impact Investing in the finance community will impact how beneficial our investments are for investors, the environment and the community. By limiting Impact Investing to its own asset class and the corresponding demand for high return, then the benefits accruing to the communities and the environment will be limited. By considering it an overlay, the appropriate type of investment capital can be used and the benefits measured against the appropriate financial asset class. In the Ecosystem Markets, using an overlay definition allows the larger pool of lower cost debt capital to be used to finance the majority of the work, and lets communities and individual landowners realize greater income with incentive to do more environmental practices.

This logic can be expanded to other financial asset classes. For example, public equity investment would be limited to high growth stocks vs. dividend paying value stocks, or within fixed income high yield “junk” bonds vs. municipal/government bonds. This pressure to push returns up and the corresponding reduction in environmental and social benefits is directly based on the financial community viewing Impact Investing as its own asset class.

Therefore, we need to think more of Impact Investing as an overlay. This will allow all types of capital to be used, create more benefit to the environment and communities, and still provide the appropriate market returns for investors.