OMIDYAR NETWORK

BEYOND TRADE-OFFS

Investor perspectives from across the continuum of impact investing

INTRODUCTION

In impact investing, is there a necessary trade-off between financial return and impact? *Beyond Trade-offs* - an Omidyar Network series published on The Economist digital hub - features leading impact investors who have moved beyond the polarized trade-off debate to invest across the returns continuum.

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Voices Across the Returns Continuum: How impact investing can unlock new capital for even greater impact

OMIDYAR NETWORK

By **Matt Bannick**, Former Managing Partner, **Mike Kubzansky**, Managing Partner & **Robynn Steffen**, Director, Impact Investing

In South Africa, a venture capital-backed network of low-cost independent schools uses a blended learning model with technology to deliver a world-class education to low- and middle-income students. They do this at a cost per student equal to that spent in often poorer-quality, government-funded schools, proving a new model for education. Meanwhile, a small island nation recently restructured its national debt, allowing a portion of debt payments to be repurposed for the protection of precious marine environments. And CEOs are increasingly responding to shareholder petitions to report on and improve diversity in leadership. Each of these is an example of the way markets can be leveraged as a force for good—the unifying idea behind the impact investing movement.

Building on this idea, the impact investing industry has grown from a nascent concept into a sizable and sophisticated sector with more than $228 billion invested, representing a fourfold increase since 2014. More generally, the Global Sustainable Investing Alliance reports nearly $23 trillion in assets using socially responsible investment strategies. Whether you consider impact investing alone or the broader umbrella of socially responsible investing, the trend is clear: high net worth (HNW) families, foundations, and institutional investors like pension funds, insurance companies, and even sovereign wealth funds are increasingly seeking to align their investments to their values or those of their stakeholders. Likewise, a new generation of entrepreneurs are building businesses that address challenges previously overlooked by existing models. They have a growing need for investors who value them not only for their financial potential but also for their ability to generate positive social or environmental benefits. In response, asset managers are expanding their product offering to a wide range of impact focus areas and asset classes. Indeed, impact investing has the potential to attract hundreds of billions—if not trillions—of dollars to address the world's greatest challenges, from poverty to climate change, and the market continues to gain momentum.

However, the industry's potential is hindered by an increasingly polarized debate about whether impact investing requires a trade-off between financial return and social or environmental impact. One perspective claims that there is always a trade-off between financial return and impact, and that all true impact investing therefore involves concessionary, or subcommercial, returns. The opposing perspective is that there is no trade-off between return and impact, and thus that all smart impact investments should achieve fully commercial, market-rate returns. Combined with the rapid growth in size and diversity of impact investors, these competing claims fuel confusion that threatens to leave critical capital on the sidelines. While the first perspective may scare off commercial capital that is essential to scaling promising solutions, the second risks dismissing as "bad deals" rigorous subcommercial investments generating types of impact that are only possible with more flexible capital.

We believe that both positions fail to acknowledge the far more nuanced reality reflected in the portfolios of experienced impact investors. While some impact investments can and do deliver impact alongside risk-adjusted, market-rate financial returns, it is also clear that not all types of impact can be achieved with market-rate returns.

Impact investing has the potential to attract hundreds of billions—if not trillions—of dollars to address the world's greatest challenges, from poverty to climate change, and the market continues to gain momentum.

We need to move beyond the trade-off debate and embrace all types of capital along a continuum of financial returns. By understanding the full range of investment options, investors can more easily navigate the growing market to achieve their goals. In this series, you'll learn how diverse impact investors—from family offices to foundations and institutional investors—balance risk, return, and impact in their own investing.

Authors in this series target different asset classes, social issues, geographies, and levels of expected financial return, but their experiences begin to highlight common approaches in different parts of the market. Together, they demonstrate the power and subtlety with which impact investing portfolios combine investments from different segments of the market to deliver many combinations of social and financial results. To be sure, there is no single 'right' way to do impact investing, but matching capital to clear-eyed expectations for specific market segments in this way can help us fund lasting social and environmental change more efficiently while ensuring that impact investing lives up to its promise—on both impact and financial returns.

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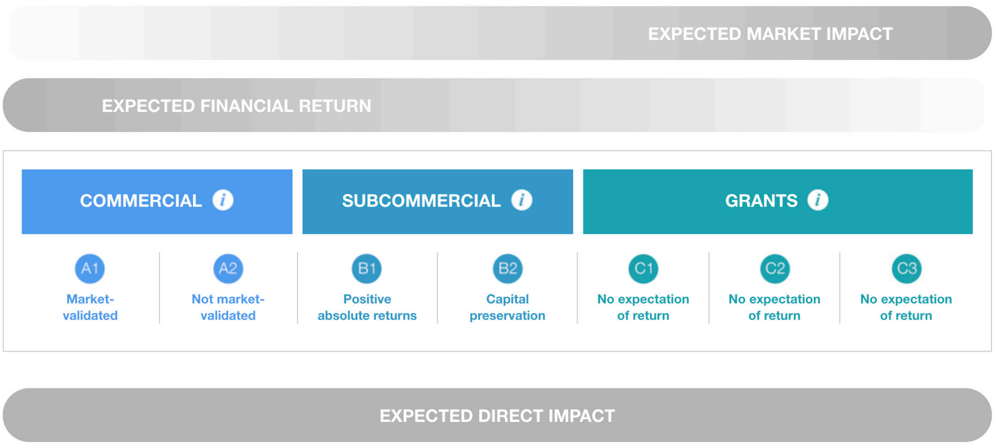
Omidyar Network's experience investing across a continuum

We first introduced our investment approach in *Across the Returns Continuum*, which provides our firm's rationale for seeking investments across all levels of financial return. Building on more than a decade of experience, we've learned that an investment can have both a *direct impact* on the customers or beneficiaries of a company, and a *market-level impact* that often drives sector-level change. Understanding these different types of impact led us to differential expectations for financial return and risk. When investing in companies pioneering new models, providing industry infrastructure, or influencing policy discussions, we've found that achieving these types of market-level impact often requires flexibility on financial returns or risk, and sometimes both. As such, while we seek to drive strong direct impact with every investment along the continuum, market-level impact is at the core of our decision-making in those cases where we decide to accept subcommercial returns or make grants.



This is summarized in our three-part framework of investment options: Category A includes investments with the expectation of fully commercial returns; Category B focuses on subcommercial returns; and Category C consists of grants with no expectation of a return. We prioritize impact investments that deliver market-rate returns wherever possible, as this is where the trillions of dollars in commercial capital can be most readily deployed to scale market-based solutions. At the same time, while subcommercial capital and grant dollars are much scarcer, they have a crucial role to play, and it is critical to deploy those types of capital to investments where they can be uniquely catalytic.

Since we published *Across the Returns Continuum*, we have heard from many investors that found our framework helpful in moving beyond the trade-off debate. Some even used it to articulate more clearly their own role in the market, revealing a desire for a more coherent way to categorize diverse approaches within impact investing. Others saw our framework as uniquely applicable to Omidyar Network, given our focus on early-stage investments, flexibility in deploying capital, willingness to accept risk, and market-building strategies. Regardless of how relevant our framework was for them, many leading impact investors across the market shared the fundamental beliefs that underpin our work—namely, that there is a broad range of viable investment profiles, some of which involve a choice between impact or financial return and some of which do not, and that it is essential for impact investors to bring clarity to decisions on the conditions under which one should accept below-market returns.

With this in mind, and to help readers to navigate the series, many authors have plotted their portfolio on our returns continuum. While this is a helpful tool, we readily acknowledge that our continuum may not reflect the experiences of investors across all asset classes or stages of investing. Building on the insights of authors in this series, we hope to spur new learnings and collaboration to develop a more holistic framework that clearly distinguishes the different permutations of risk, return, and type of impact possible across capital markets.

A continuum to meet diverse needs

If we learn one thing from this series, it is that many investors have already moved beyond the trade-off debate to develop sophisticated approaches that deploy capital at multiple points along the continuum. Across the series, authors of all types describe how different parts of their portfolios achieve different types of impact with varying degrees of risk and return. As an asset owner, Prudential Financial leverages three different pools of capital with different return expectations to pursue the widest array of impact investment opportunities possible. This approach also has economic benefits—Prudential finds that transactions in its subcommercial "catalytic portfolio" routinely become future sources of alpha in its main impact portfolio.

Meanwhile, the Ford Foundation uses its $1 billion endowment commitment to mission-related investing to increase the supply of affordable housing in the US and support global financial inclusion while targeting competitive rates of return. This activation of "the other 95%" of their assets complements their well-developed program-related investment strategy, which uses risk-absorbing catalytic capital to activate nascent markets and business models.

Yet another example comes from Indian investment firm Lok Capital, whose early funds focused on microfinance and financial inclusion in India. In Lok's experience, it is possible to achieve competitive returns in those sectors. Yet as it has expanded its investment focus, Lok has had to be more selective when considering opportunities in sectors like healthcare, education, and agriculture exclusively for the underserved, where immature market infrastructure makes it difficult to justify market-rate return expectations. With their forthcoming High Impact Platform, Lok hopes to leverage a mix of more patient, subcommercial capital to achieve impact in sectors that do not yet offer commercial returns but may well do so in the future as the market matures.

Several authors in this series pursue purely market-rate returns, demonstrating that under certain circumstances it is possible to achieve risk-adjusted, market-rate returns with substantial social impact. As defined by the Impact Management Project, investors can contribute to the impact of an investment via four strategies: signal that impact matters, engage actively, grow new or undersupplied capital markets, and provide flexible capital. Multiple authors leverage a combination of the first three strategies to enhance the impact of a company without sacrificing financial returns. For example, Elevar Equity has played an active role supporting companies in an undersupplied capital market while still achieving competitive rates of return. Its early success scaling businesses serving low-income customers in India and Latin America has led to follow-on funds managed by both Elevar and others with similar investment theses.

Other investors engage actively to maximize the impact of an investment. In addition to bringing a new degree of scale to impact markets via growth-stage private equity, The Rise Fund has developed a rigorous impact underwriting process and works with portfolio companies to ensure impact scales alongside financial returns. Meanwhile, Goldman Sachs has helped several clients to identify creative ways to increase the impact that they are able to achieve across an asset allocation, even in public markets.

Investors constrained to market-rate investing will nevertheless find that opportunities which meet their needs will have some limits. For example, their return constraints may limit their geographic focus for private equities to regions that are sufficiently developed to facilitate an exit, or they may focus on just a few sectors or parts of a value chain where business models are more conducive to commercial returns. Nevertheless, even within these constraints, investors are proving new methods of contributing real impact from market-rate portfolios.

Finally, authors also identify some types of impact that are not conducive to market-rate returns, and their experience underscores the importance of rigor in making decisions about when and how to deploy subcommercial capital. We repeatedly see savvy investors who could achieve market-rate returns forgo them in pursuit of additional types of impact. The most common rationale for subcommercial returns is to target high-risk, high-impact opportunities where a lack of track record or comparable models makes it difficult—if not impossible—to estimate expected financial outcomes in the short term. For example, Blue Haven Initiative participated in a blended finance facility to help PowerGen Renewable Energy increase access to electricity via mini-grids. If successful, the investment could unlock commercial capital for mini-grids at scale by helping to prove the economic viability of mini-grid models. Similarly, Big Society Capital has helped de-risk and develop the market for bonds issued by UK charities. Their flexible capital helped issuers and investors overcome initial uncertainty about the feasibility of such investments, which are now an increasingly accepted part of market-rate institutional bond portfolios.

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In other situations, impact investors have unique insight that helps them more accurately assess the risk of investment opportunities, which they use to lower perceived risk for commercial actors. A prime example is the Bill & Melinda Gates Foundation's use of volume guarantees. By guaranteeing demand for drugs and vaccines, they have helped to "make a market," such that manufacturers can now pursue viable high-volume/low-margin manufacturing strategies that are crucial to enable affordable access to medicine in emerging economies.

Another role for subcommercial capital is to offer an attractive, more sustainable alternative to grants to achieve types of impact that require more permanent flexibility on returns. In the UK, early-stage charities and social enterprises face challenges accessing small-ticket, unsecured loans, as the economics of underwriting such loans are often not attractive. However, blending investments from Big Society Capital with grants from the Big Lottery Fund and the UK government, Access – The Foundation for Social Investment is able to meet this demand and reach regions and sectors that Big Society Capital alone is unable to serve.

Taken together, each of these rationales demonstrates that, when coupled with a disciplined investment strategy, subcommercial capital can play a unique role in bridging the wide gap between purely market-rate finance and grants.

Towards a deeper understanding of the impact investing continuum

Despite the power of these examples, all of the authors, along with our team at Omidyar Network, would agree that even the most sophisticated impact investors are still on a learning journey. Only with a deeper understanding of the complex relationship between risk, return, and impact at various points along the continuum can we match each type of capital with the investment opportunity that it is best suited to fund.

To build that understanding, one area where we have particular room to grow is developing new methods to measure and manage impact. Impact happens in many ways, and some types—such as market-level change—can be very hard both to predict ex-ante and to assess ex-post. However, if we are to understand its interaction with risk and return, we need to manage impact with a similar level of rigor and precision. At the industry level, the Impact Management Project has released a guide to map the impact goals of investments across a portfolio or the industry as a whole. After setting impact goals, however, investors also need to develop a more reliable understanding of whether they have realized those goals; efforts like Acumen's Lean Data offer new ways to ensure that assessments of impact are grounded in the views of the actual people we aim to empower. While recent progress is promising, there is much work ahead to develop and drive adoption of best practices in impact measurement and management.

In the meantime, we hope that this series sheds light on what combinations of risk, return, and impact we see in our portfolios, and which ones might be less likely. We encourage others to share their own learnings and to consider opportunities along the continuum beyond those where they traditionally play. Together, we can move the industry beyond the simplistic trade-off debate and drive increased clarity about the many different approaches along the continuum of impact investing. Leveraging our diverse strategies, we can increase the types and volume of capital available to address the complex social and environmental challenges that we face today.

About Omidyar Network

Omidyar Network is a philanthropic investment firm that harnesses the power of markets to create opportunity for people to improve their lives. Established in 2004 by eBay founder Pierre Omidyar and his wife Pam, the organization invests in innovative organizations to catalyze economic and social change. Omidyar Network has committed more than $1 billion to for-profit companies and nonprofit organizations that foster economic advancement and encourage individual participation.

About the series

This series was curated by Omidyar Network, with invaluable support from FSG. Special thanks to McKenzie Smith, for her extensive contributions to this series, as well as Christopher Keefe, Libby Smiley, and Chris Jurgens from Omidyar Network, and Mark Kramer, Harvey Koh, Nikhil Bumb, Chinyere Amanze, and Mark Russell from FSG.

COMMERCIAL | SUBCOMMERCIAL | GRANTS

Investing Together for Impact: The need for different types of capital when investing *for* impact

ACCESS – THE FOUNDATION FOR SOCIAL INVESTMENT AND BIG SOCIETY CAPITAL

By **Seb Elsworth**, Chief Executive, Access – The Foundation for Social Investment & **Evita Zanuso**, Senior Director, Financial Sector & Investor Engagement, Big Society Capital

Big Society Capital (BSC) was set up in 2012 to improve the lives of people in the UK through the use of social investment. BSC was set up to help grow the social impact investment market by investing through funds that deliver impact alongside return and have the potential to catalyse the market by "crowding in" other impact investors. It also raises awareness of how to invest for impact amongst investors and helps signpost social impact funds that social entrepreneurs can go to for investment.

Big Society Capital's portfolio

BSC's investments are extremely diversified across asset class, return profile, size and issue. BSC's portfolio target return is 4-6%. Investments are made based on their social impact, market development potential and financial return.

As the world's first independent wholesale social investment financial institution, BSC has assumed a leadership role in the impact investment ecosystem. It has helped build the UK market by iterating its investing and engagement activities based on what it has learned from fund managers, asset owners and social entrepreneurs.

Together with co-investors, BSC has made £1.25bn available across 74 investments—these are banks or funds that go on to invest or lend to social entrepreneurs as well as direct investments into social investment infrastructure organisations such as arrangers and advisers. From this experience, we've learned that to be able to drive a wide spectrum of impact across many different sectors—that is, to invest for impact—understanding and leveraging the unique role that each type of capital can play are vital.

Demonstrating a market for social impact investment

BSC's investments and efforts to support the charity bond market, such as a £30m investment in the Charity Bond Support Fund in 2014, are examples of how investing can demonstrate a market for further investment. Managed by Rathbones, the fund mandate was specifically designed to support the issuance of new bonds by charities by investing in up to one-third of each new issue.

This was an important step for both potential issuers, giving them greater confidence in their ability to raise investment through a bond issue, and for other investors, by supporting early deals to successfully launch and helping to develop the track record of the emerging market.

Critically, because of BSC's market-building mandate and desire to have as many co-investors as possible, it embedded an incentive mechanism into the fund such that should wider investor interest emerge, then the fund itself would be scaled back ahead of others (to a target investment size of 15%).

This work and other initiatives, including the Retail Charity Bond plc platform and Triodos Bank's respective crowdfunding platform, helped open up the bond markets for charities—with the total amount issued by small and medium-sized charities in the UK increasing from £24m at the time of the fund's launch to more than £230m issued to date.

Resonance Homelessness Funds (BSC invested £58m total)

Provides housing for people at risk of homelessness. The funds acquire properties and receive rental income by letting the properties to Real Lettings (part of St Mungo's charity).

Bridges Social Impact Bond Fund (BSC invested £10m)

Invested in 27 social impact bonds (SIBs) benefiting 18,000 individuals, generated £70m+ outcomes payments worth £130m+ to government in children's services, school support, homelessness and health and social care.

Big Issue Invest SEIF 2 (BSC invested £15m)

Provides growth capital through unsecured loans for UK social enterprises across a range of social outcomes areas such as employment, mental health, health and social care, financial inclusion, community development and community-led development.

Using blended finance to meet the need for smaller scale lending

After BSC's work progressed, it became clear that there was significant unmet demand from mission-led organisations such as charities and social enterprises for smaller amounts of unsecured lending for early-stage growth of enterprise activities and working capital. From BSC's perspective, meeting this gap in the supply of capital from the sector in the UK was a strategic priority but would be difficult to achieve given BSC's risk appetite and return expectations. This type of lending was very likely to be loss-making and not compatible with the other market-building imperative of assuring a sustainable social investment market. Therefore, in early 2015, BSC, together with Big Lottery Fund and the UK Government, set up **Access – The Foundation for Social Investment (Access)** to address this challenge through providing an appropriate blend of capital to this segment of the market.

Blended approaches can help to build a bridge between the differing requirements of investors, in terms of return expectations, risk appetite and impact goals, and the capital needs and risk profile of different beneficiary organisations.

Therefore, in early 2015, BSC, together with Big Lottery Fund and the UK Government, set up **Access – The Foundation for Social Investment (Access)** to address this challenge through providing an appropriate blend of capital to this segment of the market.

Bond markets for small and medium-sized charities in the UK increased from £24m at the time of the fund's launch to more than £230m issued to date.

Access – The Foundation for Social Investment

Access was set up to make charities and social enterprises in England more financially resilient and self-reliant so they can sustain or increase their impact. It does this by:

- Providing support for enterprise development
- Managing and promoting blended finance
- Sharing learning from their programmes and listening to the changing investment needs of the charities and social enterprises

The grant plays three specific roles which are intended to overcome the barriers which had prevented this sort of finance from being more commonly available. First, it provides loss protection in each fund, giving BSC a buffer of between 15% and 35% before any capital might be eroded. Second, it provides a small subsidy to the fund manager, thus tackling the relatively high transaction costs of making many small loans. Third, it allows the fund manager to deploy some non-repayable capital to the charity (always the minority of an investment), either in the form of a grant or, in some cases, an equity-like instrument. The Growth Fund has invested in 12 funds so far and will be fully committed by mid-2018. Funds vary in size from around £1.5m to £5.5m. BSC's return is capped at 5%; if there are fewer defaults than anticipated, then the fund manager may be able to retain the balance for future loss protection.

Both the Big Lottery Fund and BSC share the impact objective of increasing the supply of smaller scale unsecured finance to the sector to help develop enterprising activity with the goal of boosting resilience in the sector. Access's grant structure has allowed BSC's capital to contribute to providing these loans and still realistically aim to make a positive return. While the impact objective here is a broad one, principally focused on market building, the blended approach can be used to target more-specific goals—such as proving out new models which might or might not turn out to be commercially viable or targeting underserved UK regions—which are otherwise not compatible with the risk and return profile of an investor.

To date, 166 loans have been made to charities and social enterprises of an average size of just over £60k. Many of the recipient organisations are small, with an average turnover of less than £250k.

The provision of grant subsidy at the fund level has also increased the range of organisations seeking to manage these loan funds. Fund managers of the Growth Fund include three community foundations; several membership bodies such as Homeless Link, the national membership organisation for charities tacking homelessness; GMCVO, the sector network body in Greater Manchester; and existing social investment fund managers like Resonance, Big Issue Invest and Key Fund.

Building demand-side capacity and pipeline through grant funding

In addition to the Growth Fund, Access also provides grant support to charities and social enterprises which are at an earlier stage of developing enterprise models; funding comes from a £60m expendable endowment given to Access by the UK Government in 2015. These grants are used in a variety of ways—from feasibility studies to explore the potential for new earned income to investment readiness grants which help organisations overcome particular challenges at the final stages of raising investment. All of this is aimed at achieving Access's goal of enabling charities and social enterprises in England to be more financially resilient and self-reliant so that they can sustain or increase their impact.

There are other ways for investors to explore making deep-impact investments and still enjoy good financial returns. In the UK, individual investors can make social investment in qualifying entities using Social Investment Tax Relief (SITR). Guarantees in social impact investing are also used on a large scale by the European Union.

Helping impact-motivated capital get access to deep-impact opportunities

Asset owners and investors say that it's getting easier to invest with impact, particularly in listed markets and in private equity. Most of these impact products offer breadth of impact. However, if you want to invest for impact and help contribute to solutions, starting from the problem first, you will often have to engage with public and social sectors as well as the private sector. Many of these fund opportunities cause investors pain: long due diligence processes, infrequent timing of fund-raising, long ramp-up periods, size of investments, unproven managers, concentration risk and impact measurement and report, not to mention the ongoing monitoring of these investments.

Deep-impact opportunities that 'contribute to solutions' will only be a small allocation in most investors' overall portfolios. BSC wants to help lower the barriers to entry for investors wishing to have this type of impact in the UK. After a six-year track record running its own proprietary capital, BSC will now turn to helping investors get access to an investment product that delivers deep and lasting positive social impact in the UK and that can provide positive and sustainable financial returns. BSC is also engaging with a number of leading managers in responsible investment to realise its ambition of a UK version of the French solidarity fund—a mix of socially responsible and high-impact social investment funds—so investors can access values-based investment opportunities.

BSC and Access are sister organisations working together to develop the social investment sector and infrastructure in the UK. Recognising it's a diverse market we're trying to build, we've evolved multiple vehicles and structures to be able to play in and build out different market segments—and it continues to evolve.

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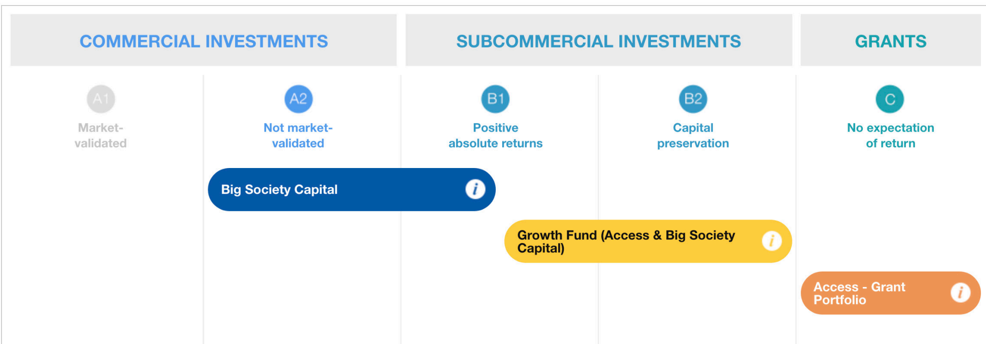
About Access – The Foundation for Social Investment

Access – The Foundation for Social Investment works to make charities and social enterprises in England more financially resilient and self-reliant so they can sustain or increase their impact. Access does this by supporting the development of enterprise activity to grow and diversify income and improving access to social investment that can help stimulate that enterprise activity. As a 10-year spend-down foundation, Access seeks to deliver its work with and through partners in order to build a legacy.

About Big Society Capital

Big Society Capital improves people's lives in the UK by connecting social investment to charities and social enterprises. We focus on: providing homes for disadvantaged people; supporting communities; and early action to prevent problems. We engage with investors, fund managers, charities and social enterprises to make it easier to use social investment. With our co-investors, we have made over £1.3bn of new capital available to organisations with a social mission.



Creative Capital: Improving lives through innovative investments

BILL & MELINDA GATES FOUNDATION

By **Andrew Farnum**, Director of Strategic Investment Fund, Bill & Melinda Gates Foundation

Over the last several decades, the world has made remarkable progress in improving health, especially for the most vulnerable. Since 1990, child mortality has been cut in half, HIV is no longer a death sentence, and we are on the verge of eradicating polio.

The Bill & Melinda Gates Foundation has worked with a wide range of government partners, NGOs, multilateral institutions, and the private sector to help drive such progress.

As Bill and Melinda saw the transformative impact that the foundation's investments and partnerships could have on helping more people lead healthy, productive lives, they began to ask an important question: could we further leverage the knowledge, capacity, and resources of the private sector to accelerate progress even more?

In particular, could the foundation help change the risk-reward calculations of for-profit companies to serve the world's poorest, scale lifesaving interventions to reach more people in need, and unlock significant amounts of capital, technology, and expertise that have not typically been available to support global health?

In 2009, Bill and Melinda established the Gates Foundation's Strategic Investment Fund (SIF) (formerly the Program-Related Investments team), seeded it with an initial $400 million of pilot money, and created a team of experts that I manage. Our mission is to discover and harness private sector innovation to help the foundation achieve its ambitious charitable goals. Over the last decade, we have made 70 investments and now have a $2 billion mandate to leverage the foundation's technical and investment expertise to stimulate innovation and make markets work for the poor.

Our toolbox

Working with the foundation's program strategy teams, each of whom focus on distinct challenges in global health, global development, and education, we identify, evaluate, and execute deals with the goal of de-risking markets and incentivizing private sector initiatives to help the poor. Unlike traditional investors who typically seek out competitive rates of return, the primary purpose of our investments is to accelerate and increase the impact of our other philanthropic initiatives.

Unlike traditional investors who typically seek out competitive rates of return, the primary purpose of our investments is to accelerate and increase the impact of our other philanthropic initiatives.

We take into account the following factors when we look at investment opportunities:

- *Impact:* Are we helping advance the foundation's strategic goals? We invest in organizations and projects that benefit the world's poorest and that are often overlooked by traditional investors.
- *Additionality:* Would this happen without us? Our aim is to support projects that would not happen or would have lower social impact without our involvement.
- *Sustainability/scalability:* Are we promoting rational market solutions? We always look for products and market solutions that can scale widely and sustainably ensure availability well into the future.
- *Risk:* How much risk/subsidy are we providing? Any cost to the foundation of making the investment must be justified by the expected social impact.
- *Leverage:* Are we drawing in external capital? Our goal is to serve as a catalyst for great ideas that can expand opportunity. We aim to have investments matched by other investors.

Just as there isn't a one-size-fits-all approach to our other philanthropic initiatives, we also try to be creative when approaching potential investments in for-profit companies. We spend a lot of time on the front end understanding the constraints that exist in the target market and then create investment tools that provide the right incentive(s) to companies to sustainably serve the poor. SIF has tremendous flexibility, so we can use a variety of tools, including equity investments, loans, guarantees, royalty investments, and support for investment funds.

The following sections describe how we've used two of these tools—volume guarantees and equity investments—to leverage our deep technical expertise to build on our grants and use private sector approaches to expand our impact and make markets work for the poor.

Taking risks where others can't or won't

One of the most innovative approaches we have used to accelerate progress in global health is **volume guarantees**. As an example, an important foundation priority is increasing the number of modern contraceptive options available to women in the developing world so they can choose a method that best meets their needs. The data showed there was high demand for long-lasting, reversible contraception options, particularly implants, which can provide protection for 3-5 years.

Historically, implant suppliers have been reluctant to make their products available in the developing world at an affordable price. This is not uncommon for companies that are unfamiliar with a high-volume/low-margin strategy, and it means that people in low-income countries often don't have access to products at a price they can afford.

We realized we could tackle this market failure by structuring and executing agreements with implant suppliers that guaranteed significant demand for their products in select low-income country markets if they were willing to provide them at an affordable price. If these companies don't sell an agreed-upon number of units each year, the foundation will provide financial support for the purchase of the shortfall amount by third-party donors for distribution in low-income country markets or make cash payments—backstopped by the foundation's balance sheet—to make them whole.

These guarantees help address two crucial challenges. First, for businesses that involve significant upfront capital investment—such as drug and vaccine manufacturing—uncertain volume is one of the key barriers to reducing prices and encouraging additional capacity. Second, the demand and funding uncertainty in low-income markets has resulted in suppliers building risk premiums into their pricing to compensate for the potential higher costs of operating in these markets. Sharing the risk through volume guarantees helps to reduce or eliminate the need for these premiums.

In the case of the contraceptives mentioned above, our foundation—in partnership with the governments of Norway and Sweden, as well as the Children's Investment Fund Foundation—negotiated a series of guarantees with Merck & Co. Inc. and Bayer AG to make contraceptive implants more widely available and affordable in 70 priority countries. By the time these agreements wind down at the end of this year, we estimate total savings of more than $500 million.

As our forecast of huge demand for these products was realized, our guarantees were never called, so these deals didn't cost the foundation a penny, but they created an important measure of certainty for our private sector partners. More important, they catalyzed the creation of what is now a large, sustainable market for implants in the developing world, so the impact will continue for years to come.

> **We are on track to help make available an anticipated total of 55 million modern contraceptives to women in the developing world and save our philanthropic partners money.**

By de-risking new market entry for these companies, we are on track to help make available an anticipated total of 55 million modern contraceptives to women in the developing world and save our philanthropic partners money by the time this 6-year guarantee concludes.

Our team has also leveraged different types of guarantee investments to benefit the world's most vulnerable populations. For instance, we supported UNICEF's Vaccine Independence Initiative (VII), a financial mechanism that provides loans to ensure a sustainable vaccine supply for the world's poorest countries and that helps build the infrastructure and budgeting processes needed for these countries to self-fund going forward.

VII's bridge financing has accelerated the delivery of vaccines and prevented temporary shortages of essential supplies for children in low-income countries. But, as more countries became aware of the program, UNICEF was unable to meet most of the pre-financing requests due to a limited pool of funding relative to demand.

In 2017, the SIF team arranged a $15 million financial guarantee to VII through 2021, doubling the mechanism's total funding availability and building on recent contributions from Gavi and the U.S. Fund for UNICEF. This funding guarantee will allow VII to provide stopgap funding to select low-income countries to ensure that there is no interruption in crucial vaccines reaching the most vulnerable populations.

Our team's 12 volume guarantee-type investments have saved more than a billion dollars to date in similar deals that have made new vaccines, HIV diagnostics, drugs, and contraceptives available at affordable prices in the developing world.

> **For investors with the level of flexibility and risk tolerance required, guarantee investments offer a way to change the risk-reward calculus to encourage companies to serve people or markets they otherwise wouldn't—or couldn't—consider.**

De-risking research for global health and development

Many of our other investments resemble the traditional equity investments that for-profit venture capitalists make on a regular basis. But they are evaluated through the lens of our work in global health and development. These investments, often in early-stage biotech companies, help ensure that new advances in science and technology are applied not only to diseases afflicting wealthier countries but also to health conditions that disproportionately affect the poorest. To accomplish this, our team negotiates "global access" rights that ensure the products and tools developed by the companies we support will be provided at an affordable cost to people in the poorest countries. We have made 40 such investments to date totaling about $700 million.

One example is Lodo Therapeutics, a company spun out of work being done by one of the foundation's grantees, Dr. Sean Brady, the Evnin Professor of the Laboratory of Genetically Encoded Small Molecules at Rockefeller University. Lodo focuses on identifying novel compounds from soil microbes that could significantly increase the number and diversity of natural products available to test as therapeutic agents against cancer and infectious diseases. Our partnership with Lodo resulted in the discovery of a vast trove of overlooked compounds that we believe could be the key to finding effective treatments for TB and other diseases that disproportionately affect people in low-income countries.

Another promising example is our investment in Vir Biotechnology. In December 2016, the foundation teamed up with several renowned venture capitalists, including Arch Venture's Bob Nelsen and Alta's Bob More. Vir raised more than $500 million to discover and develop treatments for serious infectious diseases, including prophylactic vaccines for HIV and TB. Through an equity investment, the foundation secured global access rights and unlocked significant capital from co-investors that have traditionally not been sources of funding to support global health. This investment from private sector partners enables us to pursue bigger and more ambitious goals than we could otherwise.

Equity investments have allowed us to achieve success in global development as well. In January 2015, the foundation invested $7 million in AgBiome, an agriculture biotech working to identify microbes that can help crops resist pests and diseases. This investment—and three subsequent grants—have helped develop AgBiome's discovery platform and harnessed it to identify products that can protect specific crops in low-income countries.

A successful and expanding endeavor

While most of the foundation's investments will continue to comprise grants to nonprofit institutions, our private-sector initiatives will continue to serve as a valuable tool to advance the foundation's strategic goals and make markets work for the poor.

Here are a few lessons learned from our work that may be helpful to others as they consider similar approaches:

First, technical expertise is important. In our program teams, we have access to world-class experts in drug and vaccine development and delivery of products in various world markets and other relevant sectors. This helps us source opportunities and gives nuance to our assessment process that others may miss. Similarly, collaboration with our program teams and partners around the world allows us to have unique insight into markets that we would not have working alone from Seattle. Understanding local markets and political and social dynamics is essential for successful investment and helps fundamentally change our partners' risk calculations. In impact investing, like in all investing, hiring and working with people with the right expertise are paramount.

Second, aligning incentives is critical. To form a successful partnership, you must understand the needs of your partner and use the right tools to give them an incentive to focus on the needs of the poor. There is no substitute for sitting down with the management team and Board of Directors to understand what drives their decision making and using that to inform the development of a win-win partnership that allows them to focus on projects that benefit the poor while generating a financial return for their investors.

Third, don't be afraid to take risks and try new approaches. The markets we serve are challenging, with technical hurdles to overcome as well as customers who are difficult to reach and may have limited ability to pay once you do reach them. To make a difference, you need to think creatively, be comfortable taking risks, and not shy away from trying new things—constantly pushing the boundaries of what is possible in the pursuit of improved lives for all.

About the Bill & Melinda Gates Foundation

Guided by the belief that every life has equal value, the **Bill & Melinda Gates Foundation** works to help all people lead healthy, productive lives. In developing countries, it focuses on improving people's health and giving them the chance to lift themselves out of hunger and extreme poverty. In the United States, it seeks to ensure that all people—especially those with the fewest resources—have access to the opportunities they need to succeed in school and in life.

Direct Equity Investments | Loans and Credit Enhancements | Fund Investments | Volume Guarantees

Impact Goals Across All Investments

- Further the charitable goals of the foundation's program teams
- Ensure that the capital structure of the business is healthy
- Avoid distorting the financial market for goods or services in the sector in which the investment is made
- Exert an appropriate amount of influence over the recipient enterprise's management as necessary to ensure good governance

COMMERCIAL | SUBCOMMERCIAL | GRANTS

Impact Across All Investments: The role of family offices in building the impact investing ecosystem across the continuum

BLUE HAVEN INITIATIVE

By **Liesel Pritzker Simmons**, Co-Founder and Principal, Blue Haven Initiative

Back in 2012 my husband, Ian Simmons, and I created Blue Haven Initiative (BHI) as a single-family office with market-rate impact investing as its focus. We set out to build a portfolio that incorporated social and environmental factors into every investment decision we made. We wanted to do this not just because we thought it was the *right* thing to do, but also because we thought it was the *smart* thing to do. To us, impact investing is more informed investing.

This meant acknowledging a simple, but powerful axiom: *All* investments have an impact—social, environmental and financial. Using this as a guiding principle, we systematically rebuilt our investment portfolio to try to maximize our positive impact across all asset classes. Although the vast majority of our investments did seek and are seeking market-rate financial returns, we quickly realized that how we used our philanthropic assets (both grants and concessionary investments) would be crucial to our overall impact. Over the past several years, we have experimented with and refined our rationale for *when* it makes sense to deploy *what* type of capital. While still a work in progress, we believe that playing across the returns continuum expands our opportunities to have scalable impact.

Family offices like ours have a unique role to play in building the impact investing ecosystem. With an estimated $1.7 trillion of assets under management in the U.S. alone[1], family offices are well positioned to help scale the impact sector and promote a sense of accountability across generations. Mobilizing that additional investment capital into impact investing is an exciting prospect, but family offices can also bring an even more important dimension to the table: *flexibility*.

Like us, many family offices already have dedicated investment teams (or outsourced CIOs) and are active in some type of philanthropy, perhaps through a foundation or donor-advised fund. Family offices possess the vehicles to invest across the returns continuum—most other institutional investors do not. They also tend to have more lean and nimble decision-making structures, which is helpful when evaluating some of the creative financing structures that are being developed. But too often family offices adhere to a bifurcated approach to impact—paying attention only to the financial impact of their investment portfolio and only to the social and environmental impact of their grant portfolio. We think this can lead to missed opportunities across all three dimensions of impact.

We believe that playing across the returns continuum expands our opportunities to have scalable impact.

[1] https://www.ussif.org/files/Publications/Family_Offices.pdf

Market-rate portfolio

At BHI, we have tried to take a holistic approach to building our portfolio. We worked with our outsourced CIO (Goldman Sachs Asset Management, GSAM—Imprint) to create an asset allocation that made sense for our family given our risk tolerance, cash flow and liquidity needs, philanthropic goals and time horizon. We are looking for risk-adjusted, market-rate returns for all of the investments not designated for philanthropy. The resulting asset allocation is not unlike that of an institutional investor or a typical endowment, except for one important difference: we have populated each asset class and sub-asset class with managers and strategies that we think are best-in-class in terms of financial, social and environmental criteria.

In-house at BHI, we manage a $50m evergreen portfolio of direct investments. Overseen by our MD of Ventures, Lauren Cochran, this portfolio funds early-stage, innovative businesses that improve standards of living, create economic opportunity and deliver products and services cleanly and efficiently to underserved communities. More specifically, we are looking for tech-enabled businesses in financial services, renewable energy and logistics in sub-Saharan Africa.

We have populated each asset class and sub-asset class with managers and strategies that we think are best-in-class in terms of financial, social and environmental criteria.

From a financial returns standpoint, the Ventures portfolio is also seeking market-rate (as in early-stage venture capital) returns. For the kinds of businesses in this portfolio, we think for-profit venture capital funding is the right tool to facilitate the growth and scale that these innovations need to serve the market.

When building a market-rate portfolio, regardless of the asset class, the goal is to find investments that would actually have *more* impact because of the sustainability, growth and scale associated with for-profit investing. This means that we want to see social/environmental impact imbedded in how the fund or business plans to make money. Some sub-asset classes are harder to fill than others, but, overall, we have been pleased with the deal flow we have seen and are encouraged to see new products and strategies that view social and environmental impact as an opportunity to deliver commercial financial returns and/or reduce risk.

The asset classes in which we seek risk-adjusted, market-rate returns are: Public Equity Funds, Fixed Income, Private Equity Funds, Alternative Investments, Real Assets and our Direct Investment (Early-Stage Venture Capital) portfolio.

Although our market-rate strategy is largely agnostic to impact theme or sector, we have noticed that some industries provide a more robust pipeline than others. Currently, our portfolio has heavy exposure to financial inclusion and climate change solutions.

Although our market-rate strategy is largely agnostic to impact theme or sector, we have noticed that some industries provide a more robust pipeline than others.

Philanthropic portfolio

To complement the impact of our market-rate portfolio, we also allocate a substantial amount to philanthropy. We believe that while markets can scale many kinds of solutions, they cannot (and *should* not) do everything. We use our philanthropic portfolio to support ideas and interventions that are systemically undervalued by markets. This portfolio is divided into two sub-asset classes: **Grants** and **Catalytic Investments**.

When we give a **Grant**, we are expecting no return (100% financial loss).
Among the themes we fund in this portfolio are:

- Strengthening US democracy, NextGen leadership and civic engagement innovation
- Research and networks that support impact investors
- Supporting talent and human capital initiatives in sub-Saharan Africa

The **Catalytic Investment** pool was designed to fund innovative ideas that don't quite fit into either our for-profit or grant portfolios. This can mean a lot of different types of investments, but currently includes:

- Blended finance facilities
- Pay-for-success notes
- High-risk/proof-of-concept investments

When we make a Catalytic Investment, it could be said that we expect below-market returns, but often that isn't the best description. Some of these investments don't exist in a comparable market, so we cannot genuinely compare the opportunity cost.

Every Catalytic Investment is made from our philanthropic capital (a donor-advised fund at Impact Assets). Even though these investments may have a return expectation, we find that keeping these investments under the "philanthropic" heading helps us keep risk, innovation and impact at the forefront of our decision-making.

Deciding when and why to make a Catalytic Investment is tricky, with many potential pitfalls. Our Grants team and Ventures team work collaboratively to source and conduct due diligence on these opportunities. We have developed a very simple screen. We ask ourselves is this investment:

- Too risky or low return for the Ventures portfolio?
- Piloting a significant innovation over the status quo?
- Catalytic for follow-on funding?

If the answers are yes, it comes into the pipeline.

Playing across the continuum—distributed renewable energy access in sub-Saharan Africa

To illustrate how BHI has played across the returns continuum, let's look at a series of investments that target renewable energy access in sub-Saharan Africa[2]. We have made five investments/grants in this sector, in addition to being active members of the Power Africa initiative of USAID.

[2] World Bank, 2017, Rural Electrification Concessions in Africa, What Does Experience Tell Us?

A 2017 World Bank report estimated that 630 million people lack access to electricity across sub-Saharan Africa. This is a complex problem and involves several kinds of actors, including ministries of energy, multilateral donor agencies, development finance institutions, foundations and private investors. Their efforts run the gamut, providing support for large, centralized electricity grids, commercial- and industrial-scale distributed solutions, small-scale minigrids that work at the community level and solar home systems for individual households.

BHI has participated in the energy access story in a few different ways. In our Ventures portfolio, we have made three market-rate investments. We have invested in M-KOPA Solar, the leading pay-as-you-go (PAYG) solar home system company operating in East Africa. We have invested in PEG Africa, another PAYG solar home system company that focuses on sales and distribution in West Africa. Additionally, we have invested in Cross Boundary Energy, a platform that finances commercial and industrial solar projects across the continent.

We also evaluated several opportunities in the minigrid space, but we concluded that seeking market-rate returns wasn't appropriate at this time because minigrid projects still need substantial subsidy to prove the economics of their models. However, we acknowledge the potential that minigrids have to bring high energy capacity at lower costs to rural communities if scale can be demonstrated. We participated in a blended finance facility that aims to add 3,200 new connections in rural Tanzania operated by PowerGen Renewable Energy, a leading minigrid developer. Our grant, in addition to subsidy provided by the Rural Electrification Agency of Tanzania, will help unlock $1.35m in investment capital from private investors and help PowerGen achieve lower connection costs at scale. Although technically a grant (100% loss), we consider it a Catalytic Investment because of its unique position in a blended finance facility.

We have also made a grant to the Global Off-Grid Lighting Association, the industry association serving many different distributed solar companies and service providers. Specifically, our grant was to help them hire a government relations professional in West Africa. We consider it an investment to help create an enabling and fair policy environment for private off-grid operators.

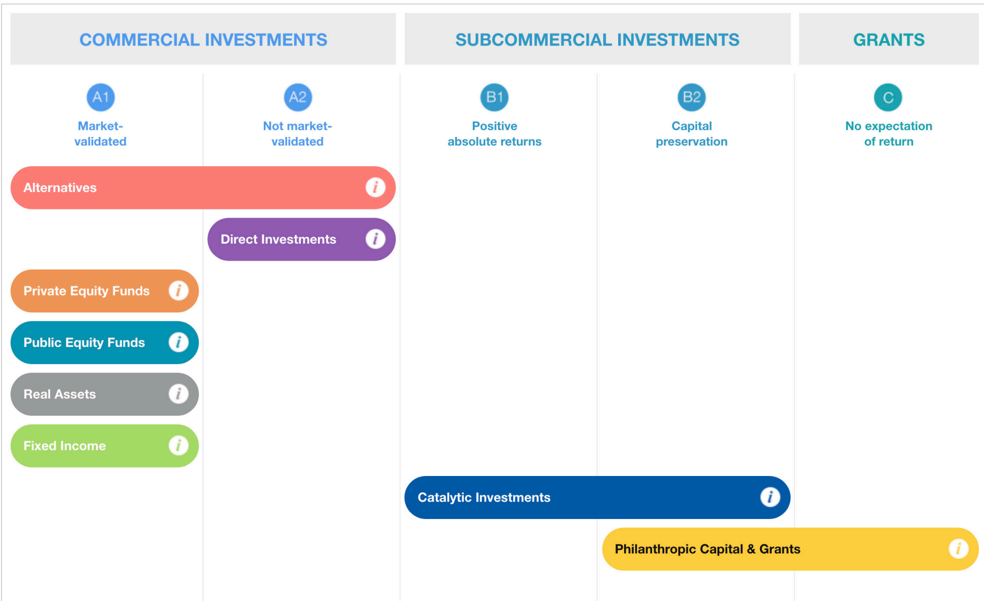
Investments and grants in distributed renewable energy in sub-Saharan Africa

Organization	Description	Investment Type	Return Expectation
M-KOPA Solar	PAYG Solar Home System Company	Preferred Equity, Debt	Market-rate
PEG Africa	PAYG Solar Home System Company	Preferred Equity	Market-rate
Cross Boundary Energy	Commercial and Industrial Solar Financing Platform	Investment to GP, LP	Market-rate
PowerGen SPV	Blended Finance Facility for Minigrid Project in Tanzania	Catalytic Investment (Grant)	100% Loss
Global Off-Grid Lighting Association (GOGLA)	Global Nonprofit Off-grid Solar Industry Association	Grant	100% Loss

The renewable energy access story in sub-Saharan Africa is complicated and requires participation across capital type. As a relatively small and lean family office, we feel these are meaningful ways we can use our flexibility and expertise to contribute to broader effort. We hope other family offices will join us in impact investing—leveraging our collective wealth and flexibility, we can drive meaningful impact for generations to come.

About Blue Haven Initiative

Blue Haven Initiative is an innovative family office dedicated to putting wealth to work for competitive returns and positive social and environmental change. Investing with high standards to maximize financial performance and public benefit, it manages a diversified investment portfolio across asset classes from public equities and fixed income holdings to private equity and direct investments.



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Distinct Commercial Approaches for Scalable Impact: The Elevar Method and The Rise Fund's journey

ELEVAR EQUITY & THE RISE FUND

By **Sandeep Farias**, Co-Founder & MD, Elevar Equity and
Maya Chorengel, Senior Partner, Impact, The Rise Fund

Impact capital has long been referred to as "patient capital" or assumed to have subsidized returns and, thus, institutional-minded investors have shied away from entering the space, depriving it of needed capital. This is changing with many more investors, including commercially minded investors, realizing the potential of the impact landscape. Partnerships such as those between Elevar Equity, an early-stage investor, and The Rise Fund, a growth-stage investor, were created to leverage their commercial approaches and highlight attractive investment opportunities with impact measurably embedded in their respective strategies. The two investment strategies, while different in stage and focus, are complementary in backing companies that highlight the potential of an aligned financial- and impact-focused strategy.

Evolution of Elevar Equity and The Rise Fund

Elevar Equity, a human-centered capital firm, is managed by three partners: Sandeep Farias, Johanna Posada and Jyotsna Krishnan. The Elevar Method has democratized 18+ essential services for more than 20 million underserved customers from low-income communities and has catalyzed billions of dollars of equity and debt from other investors with its early-stage investments. These investments, in more than 30 companies across India and Latin America, focus on providing financial services, agriculture, education, healthcare, and housing. Elevar is the first institutional capital in 28 and the founding investor in 13 of these companies. Elevar focuses on large sections of low-income communities where there is entrepreneurial vibrancy, an ability and willingness to pay for affordable products and services, a discerning customer who demands quality, and an opportunity for massive scale at profitable margins. The crux is that impact without scale is ineffective. Scale requires commercial capital that comprehends the opportunity and can address the demand in the world's largest customer base. Moreover, generating returns that are attractive to capital markets is a prerequisite for truly large-scale impact. The how and why of "impact" is Elevar's commercial thesis.

An internal exercise linking the primary business of Elevar's investments and existing metrics to specific United Nations Sustainable Development Goals (SDGs) targets found that Elevar's active portfolio collectively delivers on 10 of the 17 SDGs.

Launched in 2017 with $2.1 billion in committed capital, The Rise Fund brings institutional investors (such as pension funds, university endowments and sovereign wealth funds) and high-net-worth investors together to allocate capital proactively to impact-oriented strategies. Rise was co-founded by Bill McGlashan (Managing Partner of TPG Growth), Jeff Skoll (internet entrepreneur, film producer, and philanthropist), and Bono (U2 lead singer, social activist, and investor). TPG Growth is the investing engine behind Rise, which was founded with the belief that institutional investors needed a vehicle to enter the impact space at scale to address the problems and goals articulated in the United Nations SDGs. Rise focuses on making equity investments globally in growth companies across seven sectors—agriculture and food, education, energy, financial services, healthcare, growth infrastructure, and technology. These sectors translate to Rise pursuing impact outcomes addressing 12 of the 17 SDGs.

While TPG brings best-in-class investment underwriting and hands-on operational support, Rise needed to incorporate depth-in-impact investing. This is the cornerstone on which the co-investment partnership between Rise and Elevar was established. Maya Chorengel, one of Elevar's Founding Partners, joined Rise's leadership team as the Senior Partner for Impact and leads the fund's investing in financial services. Elevar's track record coupled with its ability to develop pipeline opportunities in some geographies and sectors of interest to Rise presented an optimal partnership platform. Elevar, constitutionally, continues to make independent investment decisions and remains a dedicated early-stage investor with access to the business-building resource teams at TPG and potential access to capital for its companies over time. Rise focuses its investing efforts on larger, growth-stage opportunities while maintaining visibility within the early-stage through its partnership with Elevar.

Two distinct approaches, both with no trade-offs

In its 10+ years of investing, Elevar's investment thesis has evolved based on time spent in the field and understanding the needs and aspirations of underserved customers in low-income communities. The commercial success of the Elevar Method depends on identifying the nuances of self-evident, demonstrated demand and in timing an investment to match customer readiness. In 2009, as some customers prospered and outgrew microfinance loans, a need for more complex financing solutions for growing MSME (micro, small, and medium enterprises) businesses emerged. MSME customers continue to be highly underserved despite their growth potential. Apart from finance, MSMEs are seeking other products and services that can help them generate sales and revenue. Elevar's first MSME-focused investment was in Vistaar (early 2010) and was based on field interactions with microfinance customers. Vistaar delivers customized loan products that address the individual needs of MSMEs in India. Over the last few years, Vistaar has financed more than 190,000 MSMEs. Several MSME-focused investments have followed, including Varthana, which provides education infrastructure loans to grow affordable private schools in India; Samunnati, which provides trade credit, working capital and market linkages to Indian agriculture value chains; Credijusto, which provides affordable financing to underserved Mexican enterprises that are too large for local MFIs yet remain unattractive to traditional banks; and Tienda Nube, which provides an end-to-end solution for Latin American MSMEs to access e-commerce channels to increase sales.

While the products and services themselves are simple, the innovation and discipline needed to build effective distribution channels customized for underserved markets have not existed historically. Identifying how affordable margin structures can result in robust distribution economics has been key to the development of the Elevar Method over the years. For example, while it is understood that technology can be leveraged to build non-linear scale, to most it is not obvious that you can also integrate long-standing community networks with dynamics or creatively combine online and offline strategies to achieve similar non-linear scale. It should be noted that Elevar primarily invests in and works with certain segments within low-income communities and the success of the Elevar Method rests in the shared expertise developed from learning across the business models of those investments. However, a different set of models are required to serve those at the "base of the pyramid" who are unable to pay.

> **Micro, small, and medium enterprise (MSME) customers continue to be highly underserved despite their growth potential.**

Elevar's initial capital goes into proving distribution channels and building a strong moat to demonstrate the long-term sustainability of a business model—in effect, focusing on white spaces and not zero-sum competitive investments. Since the market size is large, with millions of customers that can be reached, Elevar backs entrepreneurs who have years of operating experience building businesses and, most important, have a strong hand on the pulse of the customer segment. Early capital invested in these businesses combined with the entrepreneur quality has helped establish their credibility with mainstream capital markets.

In essence, the Elevar Method is based on following: the CUSTOMER, backing the right ENTREPRENEUR, who can build a BUSINESS MODEL premised on distribution economics and affordability, which, in turn, SCALEs and reaches a large number of underserved customers in low-income communities. Similarly, Elevar's impact framework is deeply rooted in the Elevar Method. Business metrics demonstrate the progress of portfolio companies on three dimensions—Community, Business Model, and Scale—consistent with Elevar's belief that metrics that indicate impact and business performance are best suited to achieve lasting impact and financial returns.

At Rise, the interplay between risk, return and impact follows two sets of criteria that every investment must meet. First, the investment case underwriting criteria, germane to every private equity fund, focuses on financial and operating performance and is ultimately expressed in potential financial return from the investment in internal rate of return and money on money/return on investment terms. Second, the impact underwriting criteria for Rise focuses on the potential social or environmental impact that a company's products and services will have. Rise seeks "collinear" business models—those in which the drivers of business and financial success also deliver impact success. Furthermore, Rise expresses its impact analysis with the "impact multiple of money" (IMM) metric—a measure of the value of the social or environmental benefit created by a company per equity dollar invested—developed in collaboration with the Bridgespan Group. Calculation of the IMM is a multistep process articulated alongside the investment process that incorporates the most rigorous academic studies available to estimate the expected impact of a company's output. The IMM framework, its evidence base, and its methodologies will be further developed over time and eventually shared more widely.

In all cases, each investment by Rise must meet the same underwriting standards of any investment from TPG Growth and also meet the IMM threshold required by Rise. TPG's confidence that market-rate-return-oriented private equity funds have a role to play stems from its historical experience of making successful investments in companies that the impact world would have considered impact investments. TPG, through its extensive history of working with private sector companies, recognized the ability of some successful, growing companies to produce collinear social and environmental impact alongside market-rate returns. This realization, combined with the fundamental reality that meeting the SDGs will require trillions in private capital, led to the creation of The Rise Fund.

Both Rise and Elevar are making investments where both impact and financial returns are achieved without trade-offs.

Both Rise and Elevar are making investments where both impact and financial returns are achieved without trade-offs. This is an important but nuanced perspective. It is imperative to note that impact investing is not a one-size-fits-all approach. On the contrary, impact investing is characterized by a spectrum of objectives involving both financial return and depth of impact—just as there are business models that may require a subsidy or require a trade-off between impact and commercial returns. For example, because of their fiduciary responsibilities, some classes of institutional investors cannot engage in a trade-off; these investors are required to pursue competitive financial returns. Unlocking the ability of many institutional investors to direct capital to impact, given their fiduciary responsibilities, requires a commercial approach similar to that of Elevar or Rise.

> **It is imperative to note that impact investing is not a one-size-fits-all approach.**

These considerations have driven Rise to meet its investment objectives, for example, by focusing on countries with the characteristics and financial infrastructure to facilitate market exits (e.g., out of 54 countries in Africa, TPG focuses on 4-7 countries or pan-African opportunities). Rise has been deliberate about sectors of focus (e.g., healthcare or technology) and the features of companies that lend themselves to commercial returns. Rise's portfolio of companies includes Everfi, a SaaS-based company providing educational institutions and corporates with courses in financial education, health and wellness, diversity and inclusion (to name a few), Cellulant, a pan-African digital payments service provider with significant reach in agriculture and among the unbanked, and Fourth Partner Energy, India's leading renewable energy services company. These are all examples of collinear business models.

Sectors and companies in which Elevar invests lend themselves to commercial return expectations, albeit with early-stage characteristics. A driving component of measured risk stems from the ability to identify models that are fundamentally profitable at a unit level while focusing on affordable margins and scale. This ensures that the focus on serving these communities is not compromised at later stages of business, maintains alignment with the entrepreneur regarding the company's vision, and avoids mission drift. Innovation may occur at the level of product distribution or organizational design, but the target customer segment must remain the main focus. In all cases, because of Elevar's investment approach and alignment between business and impact metrics, investment decision-making does not discern between the two.

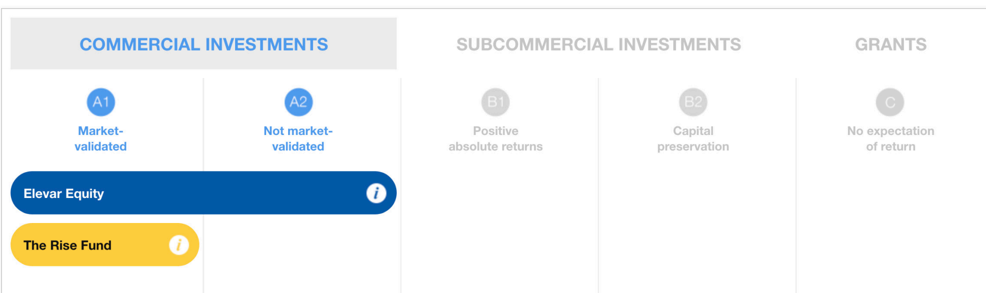
The emergence of multiple sizable impact funds that have attracted commercial capital is a strong testament to the commercial and competitive success of businesses that deliver positive social and environmental benefit and cater to underserved customers that have been largely ignored because of a perceived inability to generate benchmark returns. Core to the DNA of both Elevar and Rise is an understanding that disciplined investing, thematic focus, and rigor in impact assessment are key precursors for success. We have a long way to go to perfect impact investing, but, ultimately, success is defined by performance in terms of both financial return and impact, with the absence of friction around "trade-offs."

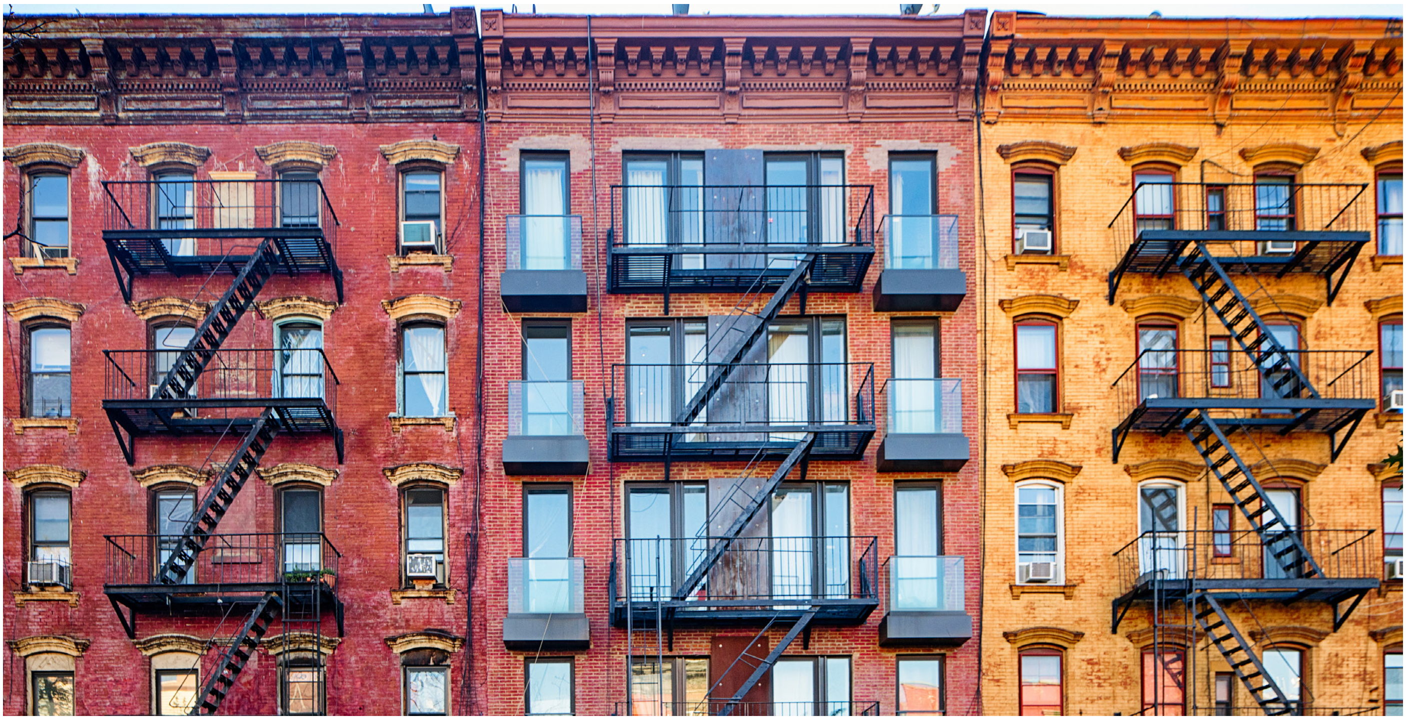
About Elevar Equity

Elevar Equity, a human-centered capital firm, invests in transformative and scalable entrepreneurial ventures focused on underserved customers in low-income communities. The Elevar Method of investing has democratized essential services for more than 20 million underserved customers and catalyzed billions of dollars of capital into 30+ companies in India and across Latin America focused on financial services, agriculture, education, healthcare, and housing.

About The Rise Fund

The Rise Fund is a global impact investing fund committed to achieving "complete returns"—measurable, positive social and environmental outcomes alongside competitive financial returns. It is managed by TPG Growth, the global growth equity and middle market buyout platform of alternative asset firm TPG. Led by a group of influential thought leaders, The Rise Fund invests in education, energy, food and agriculture, financial services, growth infrastructure, healthcare, and technology, media, and telecommunications companies that deliver complete returns.





COMMERCIAL SUBCOMMERCIAL GRANTS

Scaling Capital for Good: How the Ford Foundation is leveraging its endowment to finance more social good than ever before

FORD FOUNDATION

By **Roy Swan**, Director, Mission Investments,
Christine Looney, Deputy Director, Mission Investments, and
Darren Walker, President Ford Foundation

Last year, the Ford Foundation committed to allocating up to $1 billion of our endowment to mission-related investments (**MRIs**) over the next decade. We did so because we believe that if the last fifty years of philanthropy were defined by grantmaking budgets (or private foundations' required 5% annual contribution to charitable activities), the next fifty must be about directing the other 95% of our assets toward justice. Our challenge is to finance more social good than ever before.

We also are clear-eyed about the challenges of today's world. While capital has a role to play in addressing those challenges, our own investment is a modest one relative to the size and scale of global inequality in all its forms. That is why, to maximize positive social impact, capital must collaborate with other players, including civil society (employees, consumers, voters), responsible investors, and government.

To maximize positive social impact, capital must collaborate with other players, including civil society (employees, consumers, voters), responsible investors, and government.

With $40 million in MRIs already committed as of July 30, 2018, in a portfolio that seeks competitive, risk-adjusted market rates of return and positive social impact—and with a core priority to embed principles of diversity, equity, and inclusion as part of our strategy—we've tested our approach through practical application and already learned a great deal. While we likely have more questions than answers after the first year, we are intent on sharing the lessons learned to assist others coming into this space.

For starters, what we've observed has reaffirmed our sense that the current debate about trade-offs, and the tension between a return-driven strategy and a concessionary strategy, is stuck in a quagmire of disputed definitions and a murky sense of objectives. There is also a risk that pursuing a perfect impact investment opportunity could slow progress.

In these early days, we have repeatedly heard that an investor who does not seek the highest promised financial return in a specific sector is taking a concessionary approach. But we see a few factors at play that we think are worth exploring further.

First, we must consider the language of the debate. In our minds, the term "concessionary" means that an investor is intentionally accepting a lower risk premium than is appropriate for a particular investment. Our observations indicate that some investors simply conclude that the highest promised return is "market-rate" and anything lower is deemed "concessionary." That is a semantics problem.

Second, investors may not be aware of or well-informed about the risk of an investment. If that's the case, the investor's perceived view of risk may differ substantially from the actual risk. As a result, the mismatch between perceived and actual risk could lead to the logical but incorrect conclusion that an impact investment opportunity is automatically concessionary.

Third, slapping the "concessionary" label on an impact investment opportunity that has a lower target return than competing opportunities, even when it is properly priced for risk, may be a shorthand way to dismiss an impact investment opportunity. In fact, that reflexive disregard may stem from stereotypes associated with the terms "impact investing" and "mission-related investing." Such dismissals may overlook the investor's big picture objectives.

For example, because pension funds and insurance companies seek to meet long-term obligations to their retirees and beneficiaries, they consider liquidity and relative certainty of returns and do not simply chase the highest advertised promised returns. It is no secret that investors who single-mindedly seek the highest advertised promised returns often fall far short of their objectives as the risk tide turns against them and the efficient market hypothesis flaunts its mysterious and mercurial temperament.

It is no secret that investors who single-mindedly seek the highest advertised returns often fall far short of their objectives as the risk tide turns against them and the efficient market hypothesis flaunts its mysterious and mercurial temperament.

Some investors pursue opportunities with lower-targeted absolute returns that generate more reliable cash flows, forgoing what appear to be more attractive opportunities that promise higher returns but require greater risk-taking with all or part of their portfolios.

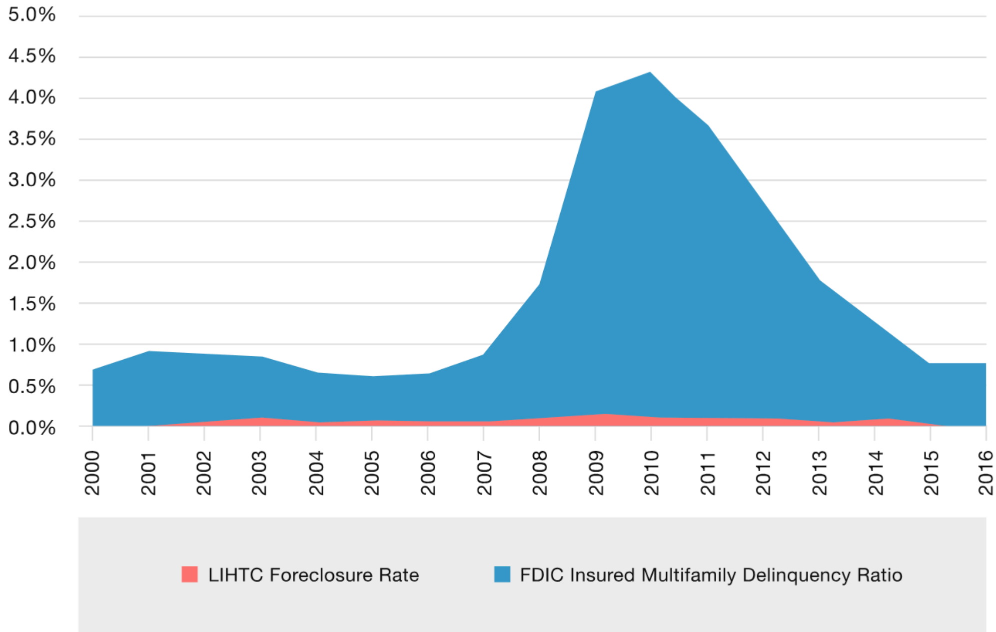
Real estate provides a useful illustration of how this might work. Consider two investments: one in market-rate apartments, perhaps in upper Manhattan, where you might expect to draw $5,000 a month in rent per unit, with an expected return of 20 percent; another involves affordable units, with an expected return of 10 percent.

Some might look at this set of facts and say that investing in the latter means accepting a concessionary return because, in the words of some dismissive skeptics, affordable housing should surely promise a higher return given what they believe to be the inherent riskiness of low-income renters.

We say: not so fast. In fact, upscale rental housing (particularly in an environment where a recession might be on the horizon) can be a far riskier investment. Those investing in affordable housing can be far more confident that, rain or shine, they will be able to find renters, keep their tenancy high, and their vacancies low. For example, during the recession, conventional multifamily rental properties suffered much higher rates of foreclosure than low-income housing tax credit (LIHTC) or multifamily affordable rental properties.[1]

[1] Cohn Reznick, "Housing Tax Credit Investments: Investment and Operational Performance." LIHTC properties are home to individuals and families whose incomes do not exceed 60% of Area Median Income.

**Annual LIHTC Foreclosure Rate vs.
Conventional Multifamily Delinquency Rate**



The graph above shows the performance of affordable compared with conventional rental housing

At the Ford Foundation, our mission investments team seeks to drive both financial and social returns. While we do not take a formulaic approach to returns in either case, we understand that our financial returns must be sufficient to allow our efforts to continue and grow. Therefore, we evaluate what a reasonable target return might be given the specific risks taken. What's more, our many decades of grantmaking experience in the affordable housing space—and the learning we've accrued as a result—have given us an additional leg up in implementing our real estate MRI strategy. We know from experience, for example, that managers who pay close attention to on-site social services and resident engagement deliver even higher occupancy rates, higher yields, and better investment outcomes. Moreover, affordable housing managers who implement social services and encourage resident engagement may help reduce costs borne by government because residents of quality affordable housing, especially children, have a higher chance of life success and are less likely to require government assistance. Thus, the manager delivers reliable returns to investors and significant benefits to society. When applied, this knowledge further improves the return outlook and gives us a deeper understanding of the risks.

We recently spoke with one manager of an affordable housing project with a novel strategy, one that fuses a real desire to do good with practical savvy. With the promise of free or reduced rents, the manager aimed to attract skilled residents from a variety of social services backgrounds. In exchange, those individuals would give something back to the broader community. A teacher, for example, would offer after-school programs on the property. Healthcare workers might offer essential preventive health services and make sure that residents connect to the broader healthcare system. A police officer might park her car out front to improve safety, become part of the social fabric of the community, and build new connections between the police and the people they serve.

All this serves the broader point: when it comes to this investment strategy for the foundation's MRIs, an unconventional approach doesn't mean the risk-adjusted return has to be "concessionary." Those seeking to avoid "concessionary" investments should take care to ensure that they aren't automatically ruling out opportunities simply because they have lower returns than competing products might advertise, as those lower return opportunities may be well-priced for risk taken and help investors achieve their overall portfolio return objectives. Doing so would leave viable investments on the table that yield very real and tangible social benefits and strong, risk-adjusted rates of return. In sharing our experience, we hope that other long-term asset owners will begin to see opportunity in impact investments they might otherwise avoid.

Of course, that's not to say that concessionary investments are inherently bad or that we don't make them. Rather, they are distinct from our MRI portfolio and ought to be distinctly defined. In fact, we strongly believe that social investors should be in the business of providing early, risk-tolerant money to help new, exciting, and socially beneficial ideas build capacity and track records—even when such investment might be deemed "concessionary."

For example, the Ford Foundation has long made **program-related investments (PRIs)** where income or value appreciation is not the primary aim. Through our PRI portfolio, we seek to provide a catalytic source of capital to bear the risks of early-stage innovation. Our current strategy seeks to advance impact investing fund managers on their first or second funds, with a priority of supporting diverse fund management teams. And we aim to serve as a catalyst for the private sector in an effort to leverage private sector financing at scale and reduce perceived or real risk in impact sectors aligned with Ford's programmatic goals. Often, the team or investment strategy is untested, presenting higher risk with no real "market comparables" for what a correlated financial return should be. In these instances, we find ourselves filling a role that the private sector, given regulatory constraints or perceived risk, is unable to fill without concessionary capital in the form of credit enhancement or first-loss protection.

For example, in 2006, the Ford Foundation, along with four other foundations and the City of New York, provided a $40 million guarantee to leverage more than $200 million of financing from financial institutions to create the New York City Acquisition Fund. The Fund was innovative at the time in its use of structured finance to combine mission-oriented capital with public and private sector financing to achieve a social impact, with a goal to create and preserve affordable housing in New York City. The guarantee capital provided was intentionally concessionary in an effort to reduce the banks' perceived risk in investing in affordable housing and to overcome certain regulatory constraints faced by the banks. By 2016, the Fund had demonstrated the success of the model by supporting the development of more than 10,000 homes in NYC; it then served as a model for many other structured impact real estate funds throughout the United States. Importantly, it demonstrated financial success by fully repaying the Foundation's $4 million PRI, plus interest.

Another example: social enterprises operating in emerging markets provide products and services in areas like clean energy, education, healthcare, and housing to low-income households. While these companies are critically important, traditional financial institutions are reluctant to provide them financing given the perceived higher risk, unconventional business models, and areas of operations of these social enterprises. In response, the Ford Foundation provided the bank a guarantee in the form of a PRI to reduce perceived risk and overcome regulatory constraints. We did so in the hope that, over time, these social enterprises will build a credit history with the bank and become viewed as less risky, thus reducing the need for a guarantee and graduating these companies to the level of "bankable" institutions. The capital provided here was intentionally concessionary, covering the risk of loss to the financial institution and with a concessionary guarantee fee return, but with the goal to build the capacity and track records of vital social enterprises.

Capital alone is not enough, but it can help drive collaborations with other partners including civil society, responsible investors, and government.

We hope the Ford Foundation's effort will stand as an example of what impact investing can look like at scale. With a mixture of concessionary and return-minded investments, a fusion of experimentation and time-tested experience—and always with due consideration of risk—we have started to learn what's possible in this space. But there is still so much more we can accomplish.

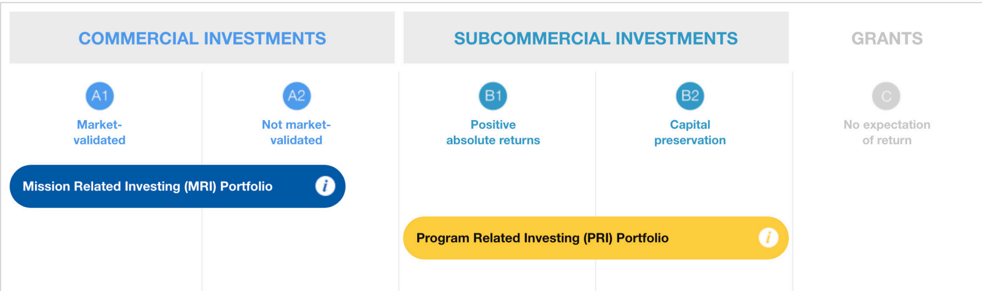
Today, there are roughly $865 billion in philanthropic assets housed in America's grantmaking institutions alone—and we are thrilled and inspired by the potential of leveraging more of those assets more immediately for social good. We are also encouraged to see that large asset owners such as family offices, public pension funds, and sovereign wealth funds are increasingly exploring ways to align their investment activities with their values. We owe much to the philanthropic organizations that have taken this path before us and look forward to sharing the lessons we learn along the way.

The need is profound, and we hope more will join us in this journey and invest for the common good. Together, with the help of other innovative and inspiring philanthropists, asset owners and managers, we can create the pools of "good" capital the world needs to address some of society's most pressing challenges, now and in the years to come.

At a moment when social ills can feel insurmountable—and when trillions of dollars are needed to address humanity's problems—our society needs active, interested, thoughtful, and empathetic capital to finance change.

About the Ford Foundation

The **Ford Foundation** is an independent, nonprofit grant-making organization. For more than 80 years it has worked with courageous people on the front lines of social change worldwide, guided by its mission to strengthen democratic values, reduce poverty and injustice, promote international cooperation, and advance human achievement. With headquarters in New York, the Foundation has offices in Latin America, Africa, the Middle East, and Asia.



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Engaging Across the Portfolio: ESG and impact investing at Goldman Sachs

GOLDMAN SACHS

By **John Goldstein**, Managing Director and **Megan Starr**, Vice President
Goldman Sachs, ESG and Impact Investing Strategy Team

One of the core challenges in the ESG and impact investing field is how to move past ideological debates and into thoughtful portfolio implementation. As we evolve from simplistic binaries—for example, that approaches are either poorly implemented negative screens in public markets or high-risk, illiquid, potentially concessionary direct investments—we open up a spectrum of tools and asset classes to use across a market-rate investment portfolio. These tools incorporate a more nuanced understanding of how environmental, social, and governance issues can augment our traditional ways of thinking about risk and return. Where can these issues help address and potentially mitigate risks? Where can they be a component of alpha generation? How do you think about the role of public markets and the "sweat equity" of your investment teams as agents for impact?

At Goldman Sachs, the 30 dedicated ESG and impact professionals in our Investment Management Division help supervise more than $15 billion in targeted ESG and impact investing assets (and an additional $70 billion in assets with ESG screens) for clients ranging from family offices to public pension plans. Here we highlight two of the approaches we have seen – embodied by market leading investors – that have transcended simplistic debates and driven constructive implementation:

1. *Rethink the risk-return-impact framework* – Get out of a zero sum mind-set and take a more holistic view of how ESG and impact can add material value to portfolios.
1. *Rethink the approach to public markets as an opportunity for impact* – End the debate over whether public equities "count" and move to how creative engagement and sweat equity drive more value in this large portion of the portfolio.

We believe that these two developments are helping drive the field forward to get beyond simplistic arguments– "does it work? does it not?"–into thoughtful, practical applications of these ideas.

Rethinking the risk-return-impact framework

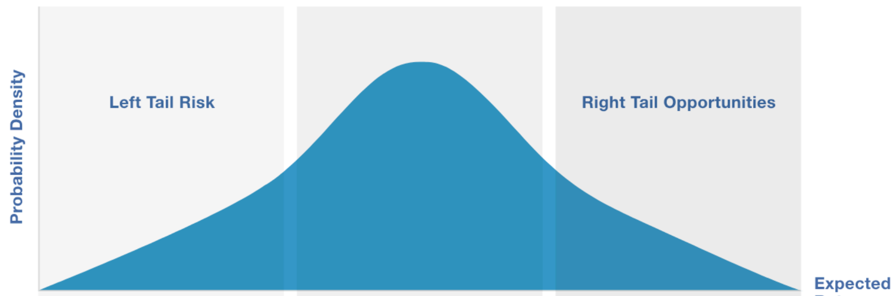
One of the most overdone tropes in the ESG and impact investing space is that to maximize one node of the risk-return-impact triangle, another has to give. In other words, if you want to have maximum impact, returns must always suffer. We are now seeing investors challenging this simplistic conception by asking how ESG data, analyses, and insights help us take a more nuanced view of risk and return opportunities across a portfolio. Namely, how can ESG factors help us to:

1. Address, and potentially manage, left tail downside risks
2. Integrate ESG to drive material value in active processes
3. Capitalize on potential right tail upside from environmental and social themes aligned with market forces and potentially overlooked by other investors

> **We are now seeing investors ask how ESG data, analyses, and insights help us take a more nuanced view of risk and return opportunities across a portfolio.**

This framework illuminates where various ESG themes, from water to gender diversity, can potentially add investment insights and value. Take climate change, for example. We believe that the climate transition will result in significant physical, market and policy changes. While scenario projections demonstrate the wide array of potential results, it will be difficult to identify the timing, magnitude and precise outcomes. Hence these scenarios may provide limited information in which to ground investment decisions made today. Against this backdrop, simply doing nothing may seem inappropriate, but taking large directional bets based on rapidly changing variables may also seem unsuitable.

We see thoughtful investors—from endowments and foundations to public pension plans—seeking to manage climate risk and reward across the distribution of investable assets through multiple approaches:



	Left Tail Risk		Right Tail Opportunities
Approach	Identify corporations that are poorly positioned for a low carbon economy by industry	Enhance company practices around energy efficiency of operations and in the supply chain	Directly invest in clean energy and energy-efficient technologies
Examples	Coal-dependent utilities, auto companies that are not investing in electric vehicles, worst prepared fossil fuel companies	Invest in energy-efficient retrofits for real estate properties	Commercial and industrial solar investments
Potential Implication	**As renewables accelerate the move towards clean energy, fossil fuel-dependant practices pose increased financial risk**	**Energy efficiency may enable cost savings**	**Impact investing may provide direct tactical opportunities tied to more efficient and cleaner energy**

[1]

1 GSAM as of July 2018. For illustrative purposes only and should not be construed as research, investment advice, or a recommendation. Expected returns do not represent a guarantee that any amount of future realized returns can be achieved.

2 Interview with Thomas DiNapoli, New York State Comptroller, Environmental Finance, June 2017

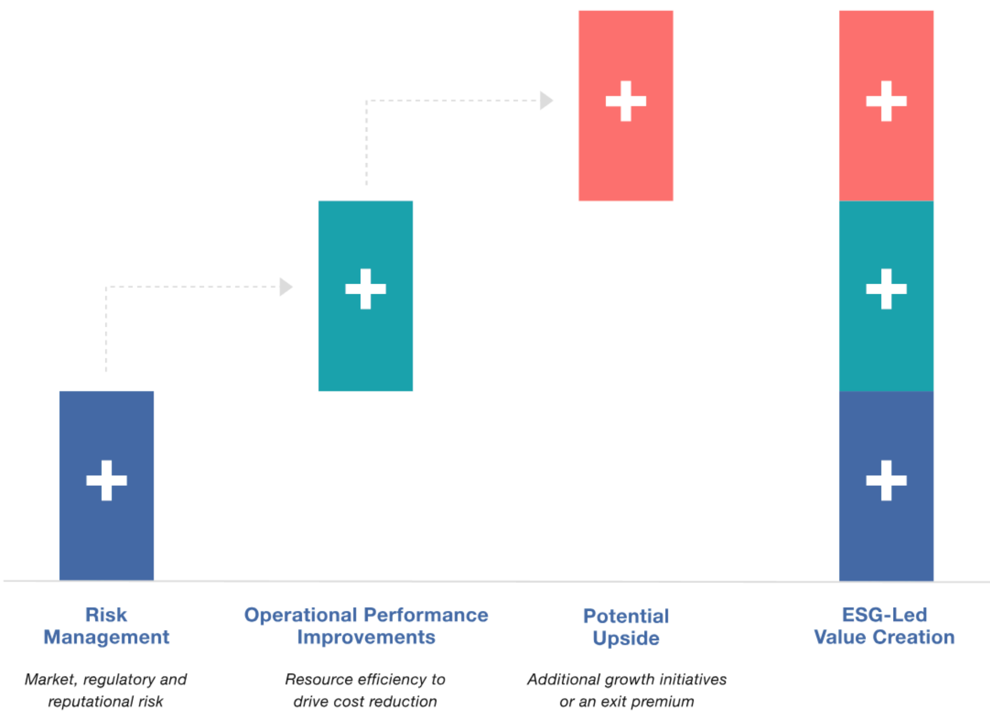
One investor example of this first component — addressing risk — is the **New York State Common Retirement Fund (NYSCRF)**. As Thomas DiNapoli, Comptroller of the State of New York, noted: "addressing climate risk is my fiduciary duty as trustee of the NYSCRF … Our large size and diversified holdings means that the Fund has direct and indirect exposure to systemic risks that climate change may cause..." [2]

In 2014, we worked with NYSCRF to develop a customized risk-aware, low emissions strategy to reduce investments in companies that are large contributors to carbon emissions relative to their peer group in a manner that targets similar return and risk characteristics (e.g., sector weights, factor exposures) to the NYSCRF's policy benchmark for US large cap equities. The initial equity program sought to lower the portfolio's carbon emissions intensity by approximately 70% relative to benchmark. We believe that this approach was an efficient way to add risk management to the portfolio while pairing with their advocacy and engagement efforts, from promoting emissions disclosure with CDP (formerly the Carbon Disclosure Project), supporting policy change (the initial announcement was made at the Paris climate talks), to their own direct engagement with companies.

An example of an investor that is proactively managing for sustainability risks and rewards using three approaches described above is the **World Resources Institute (WRI)**, an environmental non-profit based in Washington, DC. In addition to the programmatic ESG and impact work they conduct through their Sustainable Investing Initiative, WRI also applies their insights across their own portfolio.

To manage potential downside risks from sustainability issues, WRI's portfolio includes passive managers that under-weight companies with relatively poor environmental records and over-weight companies that are helping to solve the

We believe an ESG integrated approach to *sourcing, due diligence and portfolio management* can drive value creation[3]



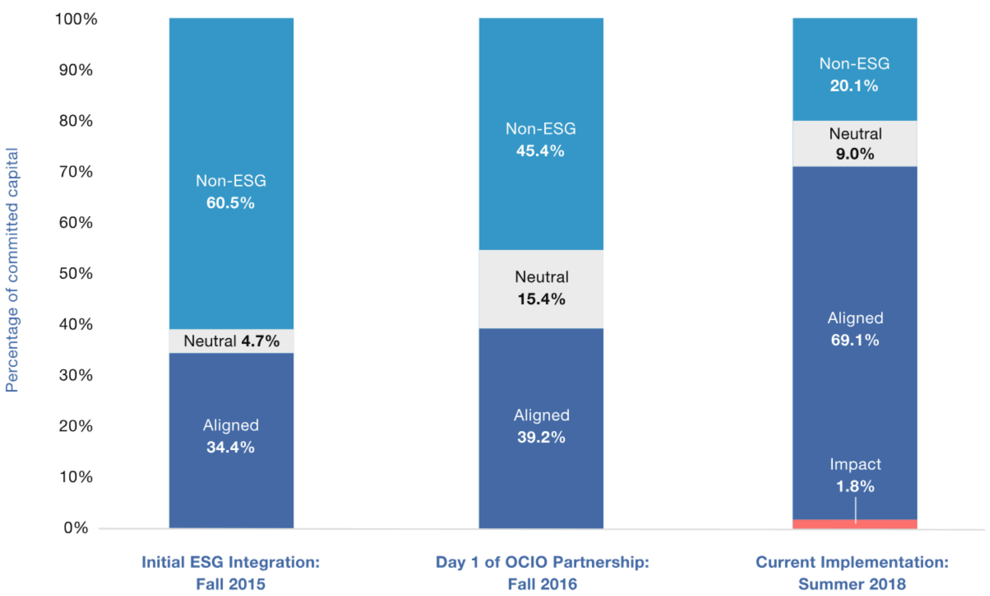
world's environmental problems. On top of this risk mitigation strategy, WRI focuses on the latter two components of the risk-return-impact framework. In selecting active managers across asset classes, WRI has sought best-in-class "ESG integrated" managers — or managers, who are cognizant of how material ESG factors can add value across investment processes, as illustrated below.

3 AIMS Imprint, March 2018. For discussion purposes. The portfolio risk management process includes an effort to monitor and manage risk, but does not imply low risk.

WRI also has made targeted private impact investments seeking to capture growth opportunities in environmental markets that have more direct, measurable impacts aligned with their mission, such as distributed commercial and industrial solar installations in the US.

After several years of adding ESG and impact investments across asset classes, more than 70% of WRI's overall portfolio is now invested in this way.

WRI's Portfolio Progress Over Time [4]



4 Goldman Sachs, adapted by WRI as of July 2018. For illustrative purposes only and should not be construed as investment advice. "Aligned" refers to products for which the manager is actively integrating ESG considerations, as determined by Goldman Sachs' five factor approach. "Non-ESG" describes products for which the manager is not proactively integrating ESG considerations, even though feasible for that type of product (e.g., fixed income, hedge funds). "Neutral" represents products that, by nature of the asset class, do not lend themselves to ESG integration (e.g., US Treasury inflation-protected securities). "Impact" refers to private equity investments that provide solutions to environmental and social challenges. WRI is making a concerted effort to build out a thoughtful and consistent approach to the impact portion of the portfolio to achieve its 15 percent target allocation for that asset class.

Working thoughtfully across their portfolio over multiple asset classes has allowed WRI to add financial value through these three levers – risk management, operational enhancement, and growth opportunities – and extend their impact and mission alignment.

Rethinking the role of public markets as an opportunity for impact

Like many others, we define impact investments as private market investments in which primary capital is directly capitalizing an enterprise whose core business model is intended to produce measurable positive environmental and social impacts, alongside sustained alpha. We primarily target market rates of return – i.e., a rate of return commensurate with a "conventional" investment for a given asset class. However, public equities are a large part of investment portfolios, and we believe that some impact investors are leaving value on the table by dismissing or ignoring the potential to do more with this portion of their portfolio.

Other investors, however, are finding creative and nuanced ways to expand the type and level of impact they are able to drive from public market allocations. We find limited utility to debating whether impact from private vs. public markets is inherently "better" or "worse". Leading investors increasingly acknowledge that there are ways to leverage components of a diversified portfolio to achieve distinct types of impact or influence while balancing constraints on risk, return, and liquidity within and across asset classes.

The $2.3 billion Minneapolis-based **McKnight Foundation** has dedicated $200 million of its endowment to mission-aligned investments, and is finding other opportunities to leverage its broader endowment in support of its mission. For example, in 2014 McKnight seeded a carbon-efficient public equity strategy with $100 million that it designed with Mellon Capital Management and Imprint Capital[5]. But that wasn't all

> **Public equities are a large part of investment portfolios, and we believe that some impact investors are leaving value on the table by dismissing or ignoring the potential to do more with this portion of their portfolio.**

[5] This fund launch was prior to Goldman Sachs Asset Management's 2015 acquisition of the assets of Imprint Capital Advisors.

— in 2016, McKnight then wrote to over 170 companies in energy-intensive sectors in the fund that did not report emissions. Rockefeller Brothers Fund and the Nathan Cummings Foundation joined them in that request, to underscore investor interest in data and disclosure. Since that letter, at least 12 additional companies have begun reporting emissions data.

When the United States withdrew from the Paris Agreement in 2017, the McKnight Foundation emailed all its fund managers asking them to sign an investor letter on climate mitigation ahead of an upcoming G20 meeting, which encouraged governments to implement the Paris Agreement and facilitate low-carbon investments (a project McKnight estimated took them three hours of staff time). This outreach in turn mobilized more than $1.5 trillion in signatory assets, and started important dialogues between McKnight and influential financial institutions, an outcome which Elizabeth McGeveran, Director of Impact Investing for the foundation called "a pretty spectacular return on a small investment."

This investment example illustrates the concept that part of what you get out of investments is a factor of what you put in. McKnight has further extended this principle of "sweat equity" in a more holistic ways across other parts of their portfolio. McKnight notes that they play four distinct roles in the investment world as a result of their portfolio. They are an:

- Asset owner and deploy millions of dollars in public/private markets;
- Consumer of financial services, so can promote integrated thinking on ESG issues across the asset managers they hire;
- Shareholder of corporations that votes proxies and raises questions about ESG practices, strategy, and risk management; and
- Market participant that works in conjunction with others to source deals, change markets, and share the challenges and success of their investments.

These roles all take time, work, and manpower to maximize but in conjunction have driven significant impact across the broader market – both public and private. These investments don't require a concessionary return, but they do imply a higher

Leading investors increasingly acknowledge that there are ways to leverage components of a diversified portfolio to achieve distinct types of impact or influence while balancing constraints on risk, return, and liquidity within and across asset classes.

investment in people, staffing, time, and resources to achieve the desired level of impact.

McKnight represents just one example of how public market strategies have been leveraged to drive broader impact and influence across a range of environmental and social issues.

Other institutions have extended this “sweat equity” concept in order to participate in markets they find attractive but difficult to access. Blue Haven Initiative built a direct investment team that combines local experience with global resources in order to access attractive early-stage investment opportunities aligned with its mission.

Conclusion

Getting beyond the simplistic paradigms of ESG and impact investing helps uncover a more nuanced landscape of how investors are thinking though risk, return, and impact across their portfolios, and drawing upon a range of thoughtful tools – from integrating ESG factors into traditional risk-return frameworks, to leveraging public markets as a tool for change, to drawing upon additional sources of capital such as “sweat equity” to enhance the overall impact of their investing – as a way to drive value across portfolios.

About Goldman Sachs

The ESG and Impact Investing Strategy team works within the **Goldman Sachs** Investment Management Division to deepen ESG knowledge and learning throughout Goldman Sachs Asset Management strategies and services, work to develop ESG and impact investing strategies across the platform, and partner with clients and prospects to implement custom ESG and impact investing strategies across asset allocations. The team has over 30 dedicated ESG and impact professionals and supervises $14.8bn in capital as of June 2018.

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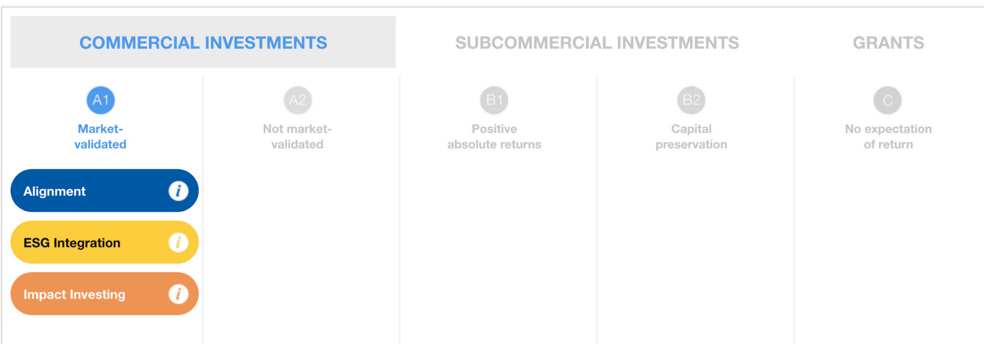

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Shades of Gray: Exploring the diversity of impact investing practices through Lok Capital's evolution

LOK CAPITAL

By **Vishal Mehta**, Co-Founder and Managing Director, Lok Capital

The impact investing sector has grown dramatically in recent years. Many different institutions and individuals are coming into this area to help make the world a better place. This means there is an increasing diversity of practices within "impact investing," yet there is a tendency for many people to see things in a binary, black or white way. What really *is* or *is not* impact investing? Is impact investing always marketrate or always concessionary? What is "impact"?

These questions all have answers that are arrayed along a wide continuum: instead of black or white, they come in many different shades of gray. This should not be surprising when you imagine all the ways in which capital could be invested for positive social and environmental impact, but it is something that many continue to struggle to accept. As a sector, we must get comfortable moving beyond black or white and, instead, try to understand and promote the different shades of gray across the continuum of impact investing.

"As a sector, we must get comfortable moving beyond black or white and, instead, try to understand and promote the different shades of gray across the continuum of impact investing.

Lok Capital was started in 2002-03 with a view of supporting the nascent Indian microfinance institution (MFI) sector. Shortly after starting Lok, we quickly got into these shades of gray. After reviewing a significant number of investment opportunities, we realized that venture funding by itself was unlikely to be sufficient to scale these businesses. In particular, these businesses lacked an adequate pool of skilled managers they could draw on as they grew. The development of such a pool was a public good that Lok as a venture investor could not readily achieve.

There was a clear need for a parallel capacity-building effort—funded by grants—that could deliver long-term technical assistance and training support to those MFIs that we invested in. As a result, we set up a hybrid structure for Lok Capital Group. On the one hand, we established a venture fund to raise capital from institutional and individual investors and to make equity investments in Indian MFIs. On the other, we set up Lok Foundation, a not-for-profit registered public charity, to manage the fund and provide grant funding for technical assistance to those MFIs that had received, or were likely to receive, an equity investment.

In effect, the Foundation provided a "smart subsidy" to absorb a portion of the cost of capacity building at both the MFI and community levels. This enabled the MFIs to meet their skills needs and grow effectively, while keeping on-lending rates affordable (i.e., below 30%), maintaining access to market-rate commercial bank financing, and allowing providers of equity capital to reap a reasonable return on their investment. This also reduced the time and losses to breakeven, improving the economics of the fund's investments.

This was early in this century, when impact fund managers like us were beginning to establish ourselves in India. The international development finance institutions (DFIs) that backed us in the early days were comfortable betting on us with many unknowns in both financial and social return expectations, and how these two would be balanced, if at all. Some of them accepted our hybrid structure of investing and grant-funding entities as an enabler of such balance, but many other LPs struggled to accept our innovative and untested structure; they were not comfortable navigating these gray areas with us.

Having gone through two further fund investment cycles, we can easily say our first fund was the least complex in terms of balancing social impact along with commercial risk and reward objectives for two main reasons: (1) the MFI model was inherently impactful, and (2) Lok I came in during the early MFI days and was able to play a key role in transforming the sector. Many of these companies achieved successful IPOs and even became mainstream banks. From a financial return as well as social impact perspective—including the field-building impact of the Foundation's work—we were able to achieve most of our objectives. The desire to be successful in building new markets for transformative impact will require funders to be open to unconventional structures and approaches. We've seen how this innovation can lead to the birth of a sector and significant impact at scale.

It is sometimes overlooked that much of the track record of impact investing has really been that of financial inclusion models. A recent McKinsey report found that of the 48 exits in India between 2010 and 2015, 31 were in financial inclusion; the same report found that even in recent years (2014-16), just over half of all new deals done by value were in financial inclusion. By the time we were raising Lok II in 2009, the success of the MFI sector was clear to both GPs and LPs. We were all keen to extend that success into new areas. New LPs beyond DFIs came on board, including large institutional investors such as Responsibility Fund and TIAA. Most of these new LPs came with the firm view that returns did not have to be sacrificed for impact, largely driven by what they had witnessed from the near-universal success of microfinance models around the world.

The desire to be successful in building new markets for transformative impact will require funders to be open to unconventional structures and approaches.

From an impact perspective, it was obvious to us that financial exclusion was just one of multiple exclusions that low-income households in India faced, and we wanted to see how market-based solutions could help in other areas. We sought to diversify into other sectors to replicate some of the learnings from our initial success with MFIs. We chose education and health because they are basic and beneficial services with high impact potential when delivered to low-income populations. We saw similarities with respect to last-mile delivery to rural and semi-rural geographies at an affordable price point, providing an opportunity to leverage our operational expertise gained from microfinance.

The reality was much more challenging. Unlike the target MFI customer group that was fairly uniform and exclusively low-income, we faced non-uniform, mixed target segments. In an environment where even the middle-income segments (with higher incomes than the MFI segments) had not had ready access to quality health and education services, it was not easy to set up a business exclusively focused on low-income groups.

The structural weaknesses in education and health were also far more complex than we had encountered in financial services, and the investment needs in public infrastructure and other parts of the ecosystem were far greater. In financial services, we have had the benefit of several pathbreaking policy reforms and infrastructure investments—such as banking correspondent regulations, credit bureaus, interbanking infrastructure with the National Payments Corporation of India, support for digital payments, and the issuance of new banking licenses oriented toward financial inclusion—all within the last 5-7 years.

In comparison, we have seen hardly any productive reforms in health and education. In fact, policy changes have actually hindered the progress of innovative models. For example, the Right To Education (RTE) Act set out demanding school infrastructure requirements but only for private schools, causing thousands of affordable private schools to shut down because they could not make such investments while maintaining an affordable price point for low-income families. Meanwhile, the RTE Act made no mention of learning outcomes, an area where there the vast majority of schools severely underperform.

This has a direct effect on innovative impact enterprises, such as Hippocampus, one of our Lok II investments. While Hippocampus works in the preschool space and, therefore, is not currently covered by the RTE Act, the concern that the RTE Act might be extended to preschool has caused challenges when the company tries to raise private capital.

Ecosystem challenges such as these have led us to focus on specific sub-themes within these sectors (such as dairy and single-specialty affordable healthcare) where we are having more success at balancing financial return and social impact. For instance, given the fragmented nature of Indian dairy farming, we have focused on small farmers and, therefore, low-income households. As long as you can solve the last-mile raw milk collection issue and do it in a responsible manner so that the farmer receives payment in a transparent and timely manner, the social impact is very achievable. For most small famers this becomes a steady second source of household income. On the financial side, the demand for milk and milk-based products (cheese, yogurt, etc.) has risen steadily over the past few decades. Accordingly, the Indian dairy model helps balance the social and commercial aspects.

Even so, we are realizing that we cannot match the financial return benchmarks established by the MFI experience. Specifically, we need to moderate return expectations to 15-20% IRR (rather than 25% IRR), investment horizons need to be longer (6-8 years instead of 3-5 years), and exit options have to be thought about completely differently from how we have achieved exits in financial services. For instance, returns might have come via coupons or dividends over 7-8 years and not via M&A or secondary sale over a 5-year horizon.

Stepping back, we can see that many impact sectors have a large element of "public good." Businesses left to market forces alone will not supply these public goods *and* most impact funds chasing market-rate returns will not back businesses focused on public goods. Some examples in the Indian context are clean drinking water, sanitation, electricity mini-grids, and education and healthcare focused exclusively on the underserved. Most enterprises in these sectors, though highly impactful in their intentionality, have not reached significant scale, which is directly related to the lack of the patient capital needed for such businesses. These businesses cannot be sustained by the typical venture approach with which most impact investors are familiar.

Businesses left to market forces alone will not supply these public goods and most impact funds chasing market-rate returns will not back businesses focused on public goods.

This is why our next step at Lok will be to travel further into new shades of gray in search of greater impact. Specifically, we are setting up a new High Impact Platform to focus on businesses such as those we have just described, where the impact is indisputable and business risk is low but returns are likely to be muted compared with investments made by our earlier funds. We will have a stronger focus on the public good sectors described above, have different investment structures (i.e., more mezzanine and debt), and continue to strengthen our capacity to have high engagement with our investee companies.

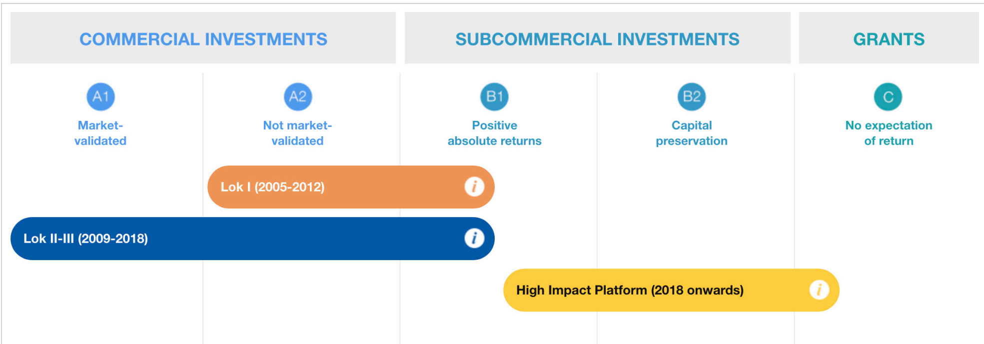
We will seed the new fund through our Foundation, so that we can build a 3-4 company portfolio, learn, and demonstrate our approach before we try to raise external money. While financial returns from the new fund are of course unclear, it is unlikely that we would be able to promise LPs the IRRs achieved by our early funds for the reasons described above. It may be that IRRs will only be in the single digits, but we will be able to have a strong impact on otherwise unaddressed social problems.

Ultimately, that desire to solve deep social problems must be our guiding light as the sector develops. We should embrace the shades of gray that we inevitably encounter as we search for the right investment tools to address each problem and each situation. We should not be distracted by arguments about which investors, approaches, or instruments are truly worthy of the label of "impact investing," rather continue to focus on how capital can be mobilized to solve problems. If we manage to put the "right" label on everything, but do not make progress in solving the pressing challenges facing our world today, we will still have failed.

This is why we at Lok will continue to challenge ourselves and evolve our approach through the shades of gray. Of course, not all capital and not every investor will be able to play in this way, but we would encourage investors with the most flexible capital to wade into these gray zones alongside—or indeed beyond—us, while those with less flexibility strive for impact within the asset classes and opportunities available to them.

About Lok Capital

Lok Capital (which means People Capital) was founded in 2004 with the motivation to build a unique platform to foster inclusive growth in India. Lok has done this by following the venture capital approach with a strong on-the-ground presence and operational experience that allows us to make long-term equity investments and provide management support to our partner investees.



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Active Capital: Implementing a billion dollar mandate

PRUDENTIAL FINANCIAL

By **Ommeed Sathe**, Vice President,
Impact Investments, Prudential Financial

Prudential Financial, Inc. manages one of the largest impact investment portfolios in the world and has been a long-time pioneer in the field. Since the unit was formally established in 1976, we have invested more than $2.5 billion across a broad range of impact assets (with over $1 billion in the last five years). Our commitment to impact investments is rooted in our own founding in 1875 as the *Widows and Orphans Friendly Society*, a social-purpose enterprise dedicated to bringing an affordable form of burial insurance to the working poor. This was a controversial idea at the time, but our success with that product launched a purpose-driven company dedicated to promoting financial well-being for all.

Prudential's experience is proof that it is possible to incorporate impact strategies within the norms and constraints faced by institutional investors. At the same time, as we bring ever larger sums of capital to the impact market, we urge our large, institutional peers to avoid the trap of mistaking scale for impact. Ultimately, we believe that the best solutions to the challenges we face today will come from investors who can engage across a spectrum of strategies ranging from concessionary to market-rate and have the commitment to focus on "Impact Value Add," not just counting impact assets under management (AUM).

We believe that the best solutions will come from investors who can engage across a spectrum of strategies ranging from concessionary to market-rate and have the commitment to focus on Impact Value Add.

What makes something an impact investment?

As we have rapidly grown our impact investing portfolio—currently $800 million in AUM—an important internal debate has focused on what constitutes an impact investment versus a traditional investment. This question became more pressing as the portfolio grew and began to generate risk-adjusted returns equal to, or better than, traditional investment portfolios. At the same time, as we analyzed the general account investments of the company, we found sizable allocations to traditional impact sectors like renewable energy facilities, municipal bonds to support schools and hospitals, support for development finance institutions (DFIs) and low-income housing tax credits.

Could we describe a meaningful difference between these two portfolios? Is there was some higher standard to which we should hold Impact Investments or should we categorize all investments with any social impact as impact investments. In many ways, this struggle harkens back to a seminal article by Paul Brest and Kelly Born about "additionality."[1] In the article, the authors make the case that in the absence of some form of financial concession there is no additionality to impact investing (and therefore no impact since the investments would have occurred anyway).

Directionally, we absolutely agree that additionality is a crucial distinction between impact and traditional investments. However, while financial concessions can be one form of additionality (as we describe further below), we disagree that it is the only form. There are a range of impact management practices that can distinguish impact investments *without requiring flexibility on financial returns*. The graphic below outlines some of the core practices that characterize how we manage for impact.

[1] Paul Brest and Kelly Born, "When Can Impact Investing Create Real Impact?" Stanford Social Innovation Review, Fall 2013

What is managing for impact?

Intentional impact sourcing	Impact diligence	Impact value-add	Mission safeguard	Impact reporting
Strong, research driven thesis on how a certain sector or approach generates social impact. Investments are selected for their positive impact attributes.	Formal analysis that the company is creating impact and that products and services are appropriately designed, particularly for underserved communities. Diligence process examines co-investors, sponsors, and board to ensure there are individuals with mission-oriented backgrounds and genuine focus on impact embedded in the organization.	During investment period, active managers will work with company or sponsor to improve level of impact. Investors seek to identify relationships, partners and systems that can boost impact of underlying investment.	Safeguards on exit, capital raising and other corporate processes to preserve and enhance mission orientation. Sensitive mission preserving practices during workouts and restructuring.	Measuring and reporting impact using both external benchmarks and customized measures that related to core KPIs. Ensure impact assessment and improvement is built into practices of investee.

Ultimately, we believe managing for impact provides important domain knowledge, preferential sourcing relationships, and risk awareness that drives positive financial returns.

Impact value-add is active

As the graphic above depicts, these practices are largely about "how" investments are made rather than "which" investments are made. This broad suite of "Impact Value-Add" practices are fundamentally active management strategies and have analogues among typical financial value-add strategies. As such, we have had to build a senior team with deep experience and an ability to constructively engage with investees. We also inevitably self-select for counter-parties willing to engage around impact and eschew channels in which we have limited ability to influence the underlying investee or project. Implicitly, this means we will rarely find attractive transactions in the public markets.

Many of these impact strategies can reinforce profitability, but, crucially, we also engage in these practices even when the impact may be independent of the financial drivers.[2] As we describe further below, we also see great potential in layering impact management practices with concessionary capital.

[2] It is certainly possible that certain impact practices may come at the expense of long-term financial performance. However, our experience is that most investments have ample room to improve impact without confronting that tension. For those impact practices that may be in tension with long-term financial performance, we recognize that scalable for-profit businesses may not be the right vector to derive those impacts.

Asset class flexibility

Another critical aspect of our approach to impact investing is to target an extremely broad and flexible allocation among different asset classes and impact sectors. Presently, the portfolio includes both direct and indirect investments, debt and equity, real assets and operating businesses, mortgages, securitizations, private placements and various other types of alternatives. This freedom gives us the ability to move up and down the capital stack and find opportunities that provide a sensible combination of risk, return and impact. For example, we see strong opportunities in affordable housing equity (but less so in debt), whereas we generally prefer lending opportunities around education and workforce development investments. This asset class flexibility is paralleled by a broad array of impact outcomes that we target, including financial inclusion, affordable housing preservation, educational excellence, workforce development and sustainable agriculture, among others. While not suitable for all investors, this breadth has allowed us to ensure a steady and diversified pipeline even as regulatory, social or investment conditions change.

Asset class flexibility has allowed us to ensure a steady and diversified pipeline even as regulatory, social or investment conditions change.

Three separate portfolios

So, just how *do* we operationalize these beliefs? Internally, we have divided our work into three portfolios each of which uses different assets of the firm. Each portfolio has clear and distinct expectations for its risk appetite, return targets, and impact goals.

All three portfolios are managed for impact and the largest portfolio, which represents 80% of our impact holdings, seeks market-rate, or better, returns. The other two portfolios have the flexibility to take on additional risk and, in certain cases, make concessionary investments. Notably, we differentiate between a catalytic portfolio—in which the overall portfolio takes on additional risk but individual investments are profit maximizing—from our truly concessionary portfolio in which investments are deliberately below-market and used only for nonprofits. In aggregate, steady outperformance on the 80% of assets in the main portfolio has largely offset the total concessions on the remaining 20%. For different investors, other ratios are possible, but we think having flexible capital sources is crucial to addressing the widest range of impact opportunities. Further details on the three portfolios are provided below.

1. **Impact Managed Portfolio** – This is our largest category, comprising approximately 80% of our assets. This portfolio contains a range of asset classes and has generated market or better levels of financial return. It is typically comprised of larger investments (typically \$5-\$25 million, depending on asset class) with more established partners. These investments are used to support the liabilities we take on as an insurance company and receive the same regulatory treatment and scrutiny as all of our traditional assets. A prime example of this portfolio is our charter school lending activity. These loans have produced strong and stable yields and have helped a number of best-in-breed operators rapidly expand to serve more children. When we entered the market, there were limited borrowing options for charter schools and no established framework for evaluating these borrowers. However, we recognized that strong academic operators could also be strong credits since loan repayments were directly driven by student enrollment. Today, charter schools routinely access the public bond market with oversubscribed offerings that are now at rates much lower than our legacy loans. As these assets have migrated to traditional channels we have shifted our new authorizations into more emerging sectors.

2. **Catalytic Portfolio** – This portfolio is comprised of smaller investments (typically $1-$5 million) in for-profit entities, projects or financial structures that generally lack the data or track record to be included in the prior group. Typically, we are one of the only institutional financial investors supporting these projects, and this portfolio is more heavily weighted toward equity investments. These assets are not used as part of our typical asset-liability matching process, which allows us to take additional risk. Individual investments in this portfolio can perform extremely well, but, over time, we expect the overall portfolio to have a greater volatility of returns, increased risk and, on average, trail the returns of the Impact Managed Portfolio. We also see tremendous R&D value in these investments and when successful they will typically lead to larger future opportunities that can be included in the Impact Managed Portfolio. One prime example was working with Naturevest to initiate a local cap-and-trade marketplace to address stormwater runoff in Washington D.C. Our initial investment was high risk since there was not yet an established market price for stormwater credits. After using our capital to initiate the first major stormwater runoff mitigation project, the market for credits has become far more predictable and subsequent investments will be made through our Impact Managed Portfolio.

   The performance of the Catalytic Portfolio trends around 150 to 250 basis points lower than that of similar assets in the Impact Managed Portfolio Too often investors hear the term "concessionary" and think a loss of principal—in reality, a "concession" could be anything from strong, slightly lower returns to a total loss of capital, with many points in between those extremes. In this case, we are talking about basis points, despite taking on exclusively investments that would not meet the underwriting standards for our impact managed portfolio. In exchange for this concession, we have received some of the most dramatic examples of social impact and created pipelines for future investments.

3. **Philantropic Portfolio** – Our final portfolio is managed on behalf of The Prudential Foundation and is used to provide explicitly concessionary capital to nonprofits. Unlike the Catalytic Portfolio, which targets for-profits and has lower average returns on a portfolio basis due to outsized risk, this portfolio is comprised entirely of investments that are below-market from inception. In this portfolio, we largely use low-interest loans to support organizations in which the underlying principal is relatively safe, but where cheaper capital can be directly connected to an end user or beneficiary. For example, many community development finance institutions (CDFIs) like ROC USA or the Disability Opportunity Fund provide specialized loans to vulnerable populations where the rate on those loans is a direct function of their own cost of capital. These borrowers are also often grantees of the Prudential Foundation and there is significant value in blending grant and investment support for the same non-profits.

Conclusion

By any measure, impact assets are rapidly growing alongside a new array of investment approaches. While Prudential's 80/20 portfolio approach may not be the right ratio for all investors, we see a hybrid approach as crucial to addressing the widest array of impact opportunities. A hybrid approach also explicitly acknowledges that there is continuum of returns and that catalytic investments often set the stage for future market-rate portfolios.

Within our market-facing investments, we also think it is vital to insist on impact management practices and not simply count all of the assets in our portfolio that have social impact or, worse still, engage in a race-to-bottom with ever-more strained definitions of impact in the pursuit of larger "Impact AUM."

At Prudential, we firmly believe that the key purpose of impact investing is to solve the social and environmental problems that aren't already being effectively addressed by government, philanthropy or traditional investors. In certain transactions, it is possible to do this while achieving strong, market-rate or better returns. In others, investors with flexible capital will be a necessary and vital part of the ecosystem. As we have grown our portfolio, we have strived to keep these different approaches balanced and unified and see substantial value in that approach for other institutional actors.

We firmly believe that the key purpose of impact investing is to solve the social and environmental problems that aren't already being effectively addressed and in certain transactions, it is possible to do this while achieving strong, market-rate or better returns.

About Prudential Financial

Prudential Financial, Inc., a financial services leader, helps customers grow and protect their wealth through life insurance, annuities, retirement-related services, mutual funds and investment management. Founded on the belief that financial security should be within everyone's reach, Prudential has been a pioneer in impact investing and is building a $1 billion portfolio of investments that combines both social and financial return.