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Impact Investing: What Family Offices Must Consider

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John D. Rockefeller retired in 1897, at 56 years old, having accumulated more private wealth than anyone in the history of capitalism. His retirement from for-profit enterprise made way for an equally vigorous career as a philanthropist. As a devout Baptist, he believed that it was his duty to continue working, but now instead of trying to make profit, he sought enterprises that would allow him to give his money away. What we might refer to as “The Rockefeller Model,” divides one’s career into two distinct halves: a career of wealth accumulation and a career of charitable activity. More contemporary philanthropic standards, like The Giving Pledge, and the rise of large foundations sponsored by family wealth, exist within, and expand upon the Rockefeller model.

While that model will continues to this day, with Bill Gates as the obvious modern day analog to John D Rockefeller, a new paradigm is emerging, with a set of practices that are reconfiguring how people think about business, capitalism, wealth accumulation, philanthropy, ethics, investments, returns, and value. Terms like “conscious capitalism,” “double bottom line,” “impact investing,” “environmental, social, & governance investing (ESG),” “sustainability,” “mutual aid,” “shareholder vs stakeholder outcomes” are introducing a new lexicon into the world of philanthropy and investing. The result is that the bright line between for-profit business and mission-driven philanthropy is becoming murkier and murkier every day.

In a generous reading of the situation, entrepreneurs and analysts are asking good-faith questions about the relative efficiency of capital. They ask, is it possible to structure a for-profit business in a way that would relieve the pressure for philanthropic activity altogether? Would that not be a more efficient use of traditional corporate capitalism? In a less generous reading, these activities greenwash (sometimes dubious) investments with marketing designed to pull at the heartstrings and make it appear a little more tolerable to allocate good money into questionable deals[1].

While it’s useful to keep the good faith and bad faith renditions of these arguments in mind, the primary purpose of this whitepaper is focused on understanding the landscape of impact investments, and defining what is often a vague and ill-defined nomenclature, in order to help family office investment teams navigate these murky waters. In the face of a rapidly changing environment, it’s all the more important to understand the ground you’re standing on. In the context of impact investing, that means being able to make distinctions between the major trends in impact investing in order to develop your own methodology for incorporating these ideas into your diligence process. It’s also important to maintain a bright line distinction between for-profit and not-for-profit activity. While the landscape around for-profit business is evolving, that is no excuse to simply collapse mission driven goals together with for-profit activity. At

[1] One might also note that adding a subjective element to investment selection may help the ‘active’ management crowd, who are long suffering when it comes to their performance relative to low cost passive investing strategies.

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their root, these designations are important tools in your total balance-sheet, especially as you're looking to optimize tax efficiency.

Defining Terms

The four most common terms used to describe these emerging strategies are Impact Investing, ESG (Environment, Sustainability, & Governance), Sustainability, and Conscious Capitalism. These terms overlap in many ways and differ in others. In casual conversation they're often used confusingly and interchangeably. What these terms share is a commitment to a profitable outcome, measured financially, as well as a commitment to another set of values, measured according to a different set of metrics. Additionally, there is a shared belief across these philosophies that the consideration of non-financial factors should not come at an expense of the ultimate bottom line. To the contrary, the position that these investment philosophies uphold is that a more complete understanding of impact and investment outcomes will ultimately increase the value of the investment.

Impact Investing

The term "impact investing" is, in our opinion, the broadest, most all-encompassing, and least meaningful. Looked at from one angle, almost anything can be construed as an "impact investment." This very article has used the term "impact" because of its capaciousness, not because it carries with it a special meaning. "Impact Investing" is a placeholder term. It shows that the organization using the word is either making a space for further definition or is trying to reframe (or greenwash) an existing investment or strategy in order to make it seem more impactful than it might otherwise be.

The problem with the term is that there are no standards or considerations as to what would make an investment an "impact" investment. As a family office investment analyst, you should engage with the term "impact" with care. If you're evaluating an "impact investment," be sure to drill down into the specific ways the sponsor understands and defines the term. In the best-case outcome, pressing this line of questions will reveal a more comprehensive strategy; in the worst case, the term will be revealed as a largely meaningless designator, like the word "unique." In either case, it

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falls to you to evaluate of the true investment impact and the extent to which it aligns with your family office goals and values. Be aware that the term impact may not carry the weight you want it to. Expect that an engaged audience will ask you to further define what you mean by impact.

Sustainability

Although "sustainability" is a popular concept, in the realm of impact investing it is not much more meaningful than "impact." A sustainable investment could be focused on a set of environmental outcomes, as in a company that is not degrading or damaging the local community or environment; or it could refer to a capital strategy that is "sustainable" in that the business has a low turnover, efficient with capital, and requires little from outside managers.

Whereas "Impact" is ambivalent and omnidirectional in its provenance, sustainability adds a sense of efficiency. A business might qualify as sustainable if it has a high employee retention rate, efficient capital management, or a low energy or environmental impact. In contrast to "impact," "sustainability" also imparts a notion of maintaining the status quo. To sustain is not necessarily to change, and this might be the most important difference between it and impact.

One way that "sustainability" becomes more meaningful is through an organization like US SIF, The Forum for Sustainable and Responsible Investment. US SIF takes "sustainability" as their watchword, and underneath that term they build an understanding of environmental, social, and governmental metrics (ESG). The mission statement of US SIF is to "rapidly shift investment practices towards sustainability, focusing on long-term investments and the generation of positive social and environmental impacts." US SIF expands this mission through its declaration of values; "environmental, social and governance impacts are meaningfully assessed in all investment decisions resulting in a more sustainable and equitable society."[2] US SIF connects with international advocacy groups; offers education for asset managers, retail investment professionals, financial advisors, and community-based investment

[2] US SIF Mission and Values, from their 2019 Annual Report.

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platforms; develops policy proposals for investments via the SEC; and acts as a central hub to build a network of investment professionals that are committed to a shared set of standards for sustainable investments.

While the US SIF is a major player in the space, it is not all things to all people. They work with some large family office foundations, however the major focus of their education and advocacy is directed toward retail investors and investment managers. Family offices often have more institutional needs and capabilities, as such these retail-focused offerings should be read through the lens of your particular family office needs, wants, and capabilities. If "sustainability" is the key word that is driving your family offices' efforts in impact, be sure to carefully define the term according to your target outcomes.

Environment, Social, and Governance (ESG)

ESG Investing was one of the first technical approaches to frame this kind of thinking within the context of more traditional securities analysis. The CFA Institute uses ESG in order to mark a set of risk-mitigating protocols and considerations that any securities analyst or marketing firm should utilize in an effort to market or analyze a security.[3] The terms themselves are meant to be somewhat open to interpretation, because the ultimate outcome that the CFA wants to cultivate is one focused on a more comprehensive risk matrix. As such environmental may refer to specific environmental risks associated with an energy plant or with the health and safety concerns within an oil refinery; social risk might refer to strained relationships between management and the labor force; and governance might refer to potential regulatory changes or shareholder activism.

[3] "Environmental, Social, & Governance Issues in Investing: Guide for Investment Professionals" CFA Institute, 2015

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In the rather dry landscape of risk-mitigation, it's no wonder why an organization like US SIF is compelled to overlay ESG with their concept of sustainability. ESG on its own does not necessarily lead to an "impact" or "sustainable" outcome. While ESG is the most robust framework for analyzing and measuring various forms of risk analysis, it's also the easiest to "greenwash" investments, because the metrics themselves do not require any special lens in order to qualify as a sound "ESG" measured investment. On their own, ESG considerations are helpful in producing sound analysis, but they are insufficient in underwriting an impact outcome on their own. When evaluating ESG opportunities, pay special attention to the values that are motivating these metrics. Is it coming from a well-grounded theory of sustainability or mission-driven objective, or is it merely a more comprehensive way to risk-mitigate the security or investment? Or something worse, an attempt to greenwash an investment by ticking the boxes on an ESG checklist?

Conscious Capitalism

In comparison to the three terms above, conscious capitalism simply introduces a new lexicon to what is an old conception of how capitalism, when done right, should be practiced. The term as its commonly used, refers to a set of practices that aim at achieving a broader and deeper understanding of capitalism as an economic endeavor. The intended result of these practices is twofold: First, the shift of focus moves from strictly maximizing (short-term) shareholder value to include optimizing outcomes for a broader set of stakeholders. These stakeholders may include anyone who is affected by the business's activity. When decisions are made in light of stakeholder outcomes, then stronger (long-term) alignment emerges between the business, its owners, operators, customers, and the community. Second, the time-horizon expands to consider longer-term outcomes. Consciousness in this sense not only refers to an awareness of how decisions you make today have an impact today, but also how the decisions you make today will impact your stakeholders further out into the future. These two insights are intertwined, but distinctly refer to two different sets of analytical and operational practices.

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Organizations such as Conscious Capitalism Inc., a non-profit organization, supports business leaders that want to incorporate these kinds of practices into their business culture. Other such organizations – like Good Business or Certified B Corporation – are similarly aligned non-profit organizations that hope to cultivate a new understanding of business. Their credo is as follows: "*We believe that business is good because it creates value, it is ethical because it is based on voluntary exchange, it is noble because it can elevate our existence, and it is heroic because it lifts people out of poverty and creates prosperity. Free enterprise capitalism is the most powerful system for social cooperation and human progress ever conceived. It is one of the most compelling ideas we humans have ever had. But we can aspire to even more*."[4]

From this credo four core themes emerge: Higher purpose, stakeholder orientation, conscious leadership, and conscious culture. Unlike ESG risk analysis, or even the educational tools offered by an organization like US SIF, implementing conscious capitalism in your investing strategy requires a more holistic and philosophical approach. To put it bluntly, it requires that you take seriously the "conscious" part of the equation. The ultimate purpose of conscious capitalism is the development of a prosperous ecosystem, one that encompasses all of the terms discussed above. In some ways this is the highest bar to achieve as a portfolio manager, but it is also the most rewarding.

Conscious capital practitioners believe that private enterprise has an important role as a force for good in the world. If your family office is looking to develop a more sophisticated approach to 'impact' investing, we recommend this approach as one worth exploring further. Of course, as with all investment-related endeavors, the more you know about your desired outcomes, the more you can navigate these waters.

[4] https://www.consciouscapitalism.org/credo

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Final Thoughts

Impact advocates insist that there is moral and financial premium that is earned through impact investing. According to this view, impacting investing is not only good, but it is also more profitable in the long run. In some cases this may be the case, and over time that may be easier to achieve, but more often than not there will be trade-offs and sacrifices that a Chief Investment Officer will have to make in order to achieve a desired impact target. Given the potential trade-offs, it is especially important to define what objectives and concepts are most important to your family office investment plan and to organize your portfolio according to how your current holdings line up with that plan. With that initial knowledge you can start to implement an allocation strategy that slowly incorporates more opportunities that achieve your desired impact outcomes while maintaining overall fund performance.

The world of capital is a lot more complicated than it was for John D. Rockefeller. While there is a temptation to think that the abundance of new terms related to investing with ‘impact’ is merely the clever proliferation of greenwashing tactics, the truth is that these terms point to a vigorous and ongoing secular shift, raising fundamental questions about best practice for a family office’s investment capital. This whitepaper only scratches the surface of a topic that is on the mind of every investment professional and institution today. The sheer breadth of the terms we discussed speaks to the many challenges that will likely cause this subject to remain ongoing and undecided for the foreseeable future. Looking ahead, we hope to see the emergence of more concrete standards and metrics. In the meantime, there is an opportunity for family offices to lead by example by simply initiating these conversations and beginning to implement specific strategies.

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