PART ONE

KEY PRACTICES AND DRIVERS UNDERLYING IMPACT INVESTING

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1

Inside Collaborative Capitalism

Collaborative Capitalism is the realization of a community's highest economic and social aspirations through the enterprising deployment of ideas, capital, and shared resources in pursuit of common impact.

COLLABORATIVE CAPITALISM IS MANIFEST AT MANY LEVELS and in many ways, within and between companies, investors, and the markets and communities in which they operate. It has evolved out of the creative adaptation of business norms, practices, and relationships to address the ultimate effect of capitalist activities on broader social and environmental purposes. At the organization or company level, it is driven by what we often refer to as "mission"; at the fund or investor level, it is usually in the details of the transaction, in the price premium, in the metrics of accountability, or in the ways that risks are mitigated to allow more stakeholders to achieve their goals.

But let's get down to brass tacks. Collaborative capitalism is not a theoretical construct. It is made real in myriad markets through a wide range of business approaches and financial innovations.

Consider Fair Trade, a prototypical impulse of Collaborative Capitalism applied to global value chains. A key concept of Fair Trade is to recognize the supplier as a constituent of the business, who is affected by lowered commodity pricing, such as for coffee or

This chapter draws on the e-book *Collaborative Capitalism and the Rise of Impact Investing,* which was published as a prelude to this book by the three authors in April 2014, available at www.bit.ly/collabcapital.

3GC01 08/05/2014 9:4:4 Page 20

bananas. Fair Trade advocates have applied diverse sets of strategies to align the tools of capitalism with working to ensure a fair wage is offered to the supplier in local communities.

In essence, Fair Trade labels aim to make transparent the effect that a fair, living wage has on this constituent, and ask the customer to agree to pay for those benefits up front. Advocates of Fair Trade then use a host of accountability practices to ensure this price premium is protected all the way down the value chain.

The outcome at the end of this process—the targeted impact Fair Trade seeks—is a supplier farm, cooperative, or worker with a higher quality of life due to a higher income. This seemingly small innovation in the supplier-to-consumer relationship has become a practice hundreds of companies may now build on and extend to other areas of corporate practice. Collaborative Capitalism–based movements and industries are born of effective innovations like this.

Peer-group-based microfinance is another example of Collaborative Capitalism at work. In this case, the transparency of peer pressure within a borrower group replaces the need for hard collateral assets, transforming local peers into stakeholders who are highly motivated to ensure regular payments, and obviating the need for layers of risk protection by the lender.

In our introduction, we presented this idea of Collaborative Capitalism as a larger field of practice encompassing everything from corporate social responsibility (CSR) to operational and supply chain sustainability, public private partnerships, and socially responsible investment. Indeed, it is a broad term we use to describe many different impulses with various terms and names. In this chapter, we explore the roots of Collaborative Capitalism, define its subfields more concretely through the Collaborative Capitalism pyramid, and parse three essential elements of Collaborative Capitalism: transparency, attention to constituency, and an outcomes orientation.

The Roots of Collaborative Capitalism

There are three major trends that, taken together, have fused into the widespread practice of Collaborative Capitalism. They include the acceptance of a social role and responsibility for business as a

core aspect *of* business, the development of a new feeling of "agency" among the Millennial generation and entrepreneurs, and the realization that risk mitigation by investors can be aligned with achieving better outcomes—both financial and extrafinancial.[1]

The Social Role and Responsibility of Business

Since the time of Andrew Carnegie and John Rockefeller, charitable organizations—alongside or as a complement to government programs, and fueled by the profits of business success—have been counted on to fill gaps in the fabric of society left by the failures of markets to meet human needs and potentials.

Some would say the historic vision of the role of charity as the sole agent advancing a private sector social agenda is very much in the past. Today, business itself is viewed as one of many stakeholders in a system that perpetuates inequity.

"I truly believe that capitalism was created to help people live better lives, but sadly over the years it has lost its way a bit," said Virgin's Richard Branson in 2011. "The short-term focus on profit has driven most businesses to forget about the important long-term role they have in taking care of people and the planet."[2]

Writing in *Atlantic* in November 2013, Chrystia Freeland described the concerns of a number of other high-profile critics:

> "Capitalism, even 150 years ago, was more inclusive; there was more of a sense of social responsibility," Dominic Barton, [the global managing director at McKinsey] told me. Today, trust in business is declining. "The system doesn't seem to be as fair or as inclusive. It doesn't seem to be helping broader society."
>
> Barton's concern is shared by David Blood, former head of Goldman Sachs Asset Management, who cofounded Generation Investment Management with former vice president Al Gore a decade ago. "Some people say income inequality doesn't matter. I disagree," Blood said. "We are creating a situation in which only the elite of the elite can be successful—and that is not sustainable." Both men worry that if capitalism doesn't deliver for the middle class, then the middle class will eventually opt for something else. Barton says that business needs what he calls "a license to operate," and without a new approach, he fears, it risks losing that license.[3]

Attempts to understand the business community as a morally legitimate and important actor in the resolution of these problems have followed naturally, because of what are perceived to be at least four key assets.

First, businesses have important sets of **relationships**, such as with suppliers and value chains, entities they may nudge, negotiate with, or block. They also have influence over their workforces and often the communities in which they work, and they can set hiring policies, implement broad training programs, or encourage healthy and positive environmental behavior among employees and their families through internal rewards and programs. Large companies may choose with whom they do business in every community, from the local bank to the food vendor. They wield an influence rivaling that of local governments.

Second, businesses have **operational capacity**, which means they can have direct impact on all sorts of outcomes and ideas. Large manufacturers can, for example, experiment with efforts to reduce harmful environmental effluents coming from their factories and, when they discover what works, serve as conduits for that knowledge. Companies of all sizes in all industries, from Stonyfield Farm (organic yogurt) to Interface (sustainable carpets), have spent a great deal of time and energy experimenting with new ways to be environmentally sustainable and in the process spreading the word with more credibility and authority than a nonprofit in the same field might have. Small private companies have the power to be R&D labs for new ways of doing business (as Ben & Jerry's was from its inception) and, when they get large, to efficiently operationalize global implementation of those innovations (as Ben & Jerry's can do now, as a subsidiary of Unilever). As philanthropy and government working in lockstep may have done fifty years ago, so business today represents the potential of a whole value chain in the production of social and environmental outcomes and influence at the same time that business generates financial returns for shareholders.

Third, businesses have the **power to create markets** that allow others to emulate and follow their formulas for success. Very few industries are made up of a single business—successful value chains, customer bases, and innovations tend to create clusters, and many businesses flourish in them, sometimes for decades,

3GC01 08/05/2014 9:4:4 Page 23

before a new disruptive innovation comes forth and a new industry takes over.

Fourth, businesses have **access to capital** at levels that dwarf philanthropic resources—and sometimes governmental will and capacity—to scale solutions. The kind of investment capital that Coca-Cola can access to ensure the availability of clean water for its own global supply chains almost certainly supersedes what the most dedicated philanthropically supported nonprofits or separate government agencies can do to develop clean water systems and try to maintain them. And a start-up company may access more capital for social good than nonprofits that are many decades old, if it has a scalable business model. For a social change maker, this ability to scale what works and sustain it over time is the impact equivalent of pixie dust—magical stuff that dreams are made of. Although there are plenty of problems that cannot be addressed by business and for which government and nonprofit attention is essential, smart change makers look for the most effective solution agents, and increasingly they are turning to business as a key partner in their efforts.

With power comes heightened responsibility. Many believe it is in businesses' interest to wield their influence to provide social good alongside financial return. As Rockefeller Foundation president Judith Rodin argues, "This new way of doing business extends beyond just the mainstreaming of 'impact investing.' The needs of business blend the lines even further, as businesses look to philanthropic models to keep their value chains sustainable and their customers and employees healthy and secure. As companies expand globally—especially into the developing world—it will no longer be profitable to exist without taking the community and the work force in which they work into consideration."[4]

The profound role for business in society may seem obvious and has been a fact well understood for decades by titans of industry, such as Henry Ford. But we must remember efforts to include business in discussions about explicitly improving society and the world have been relatively recent. For example, the United Nations Global Compact, an initiative to encourage businesses worldwide to adopt sustainability policies and to report on their implementation, was not created until 2000. Financing for Development, a UN conference held in Monterrey, Mexico, in 2002, was

the first meeting of its kind to include the private sector as a formal "interlocutor," alongside the public sector (UN member states) and nongovernmental organizations.[5]

The New Fiduciaries: Millennials and Entrepreneurs in the Lead

Large companies are increasingly being held to account for the risks of *not* behaving sustainably, including in public markets through investment strategies that make use of negative and positive screening for environmental, social, and governance (ESG) factors. However, the strongest impulse to execute business strategies with impact and attract capital aligned with that purpose has been in the realm of smaller, private business creation and in educational programs grooming new leaders, where the recent growth and appeal of social entrepreneurship are undeniable. As Katie Smith Milway and Christine Driscoll Goulay report in a recent article, "MBA programs today are minting not just captains of industry, but also crusaders for social good. Any program teaching business skills needs to train their graduates to serve both companies and society. This means equipping would-be entrepreneurs with an understanding of multiple bottom lines and equipping would-be corporate professionals with intrapreneurial vision to connect business interests to social value. Steeped in both social and business principles, this new breed of MBAs will be able to navigate complexity and create opportunities to sustain the world we live and work in."[6]

For example, Net Impact, a membership organization of students interested in the intersection of impact and business, has grown from seventeen members in six chapters in one country in 1993, to more than forty thousand members in 315 chapters in over ninety countries in 2013.

This trend in education at the graduate level is based not on hope but on a major demographic and capital transition that is under way. The baby boom generation, recognized for its interest in how its actions affected society, is passing the torch to its children, who now express interest in affecting society even more than their parents did.

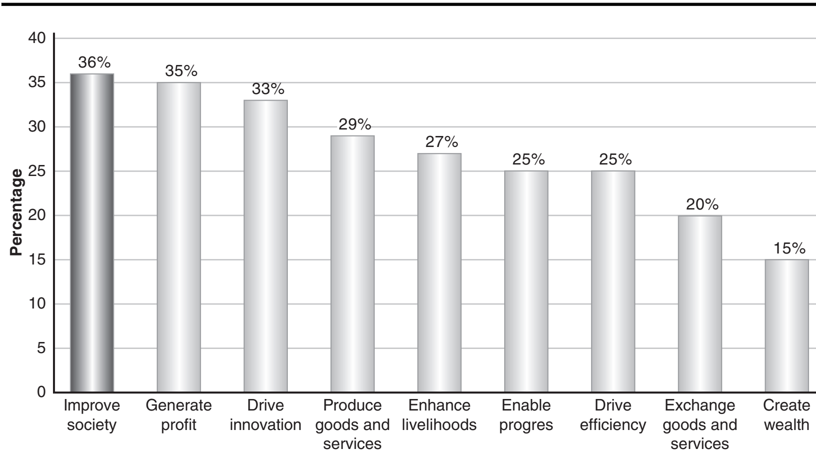
Although generalities have their limits, on the whole the culture of the so-called Greatest Generation, coming from the

era of the Depression and World War II, was one where folks believed in hard work during the week and volunteering and recreation on weekends; their idea was that you spent a life gathering assets to retire on and, if you were lucky, to give to your children and community as you got older. The baby boomers' generation was about social change and revolution as a path to enlightenment and personal fulfillment. Granted, only a minority of boomers dropped out of society for good—indeed, their greatest impact lay in changing society's mores and values from within—but on the whole, the legacy of this generation was a rejection of traditional thinking and beliefs, moving us from a 1950s/Cold War mind-set to a 1960s/1970s counterculture mind-set. The Millennials—today's current crop of future leaders in their twenties and thirties—are pursuing a path between, a middle road of "profit with purpose." To many Millennials, the idea that you would spend a life working for a single company and then retire to do what you always wanted to do is as much anathema as the prospect of living in a commune and making a living selling handcrafts.

In addition to a sense of purpose, there is also a new sense of agency, empowering these young people to bring their talents and energy to bear, not simply as activists, but as agents of change. They are willing to work not just to knock down established systems as their parents' generation sought to do but to use their creativity and insight to build new solutions. The Ashoka U slogan "Everyone a changemaker" has swept over college campuses, blending with the hot trends of design thinking and rapid, lean, start-up prototyping. The energy of Silicon Valley has met the purpose impulse, and the result is a new fascination with social innovation.[7]

Many have studied this new generation, puzzled at the seeming contradiction: coming out of the recent Great Recession, young people are willing to earn less to ensure that their work addresses social and environmental issues. A 2011 report commissioned by the Career Advisory Board and conducted by Harris Interactive found that the number-one factor young adults ages twenty-one to thirty-one wanted in a successful career was a sense of meaning.[8] Deloitte's 2011 Millennial survey showed the same results; over 50 percent of Millennials believe the purpose of business is primarily innovation and societal development (see Figure 1.1).

Figure 1.1 Primary Purpose of Business According to the Millennial Generation



Note: All figures are the percentage of 4,982 survey respondents in eighteen countries, all of whom had college degrees, were employed full-time, and were born after January 1982, answering the question, "Which of the following words and phrases match your own belief as to what business is for?"

Source: Deloitte Global Services Limited. (2013, January). *Millennial Innovation Survey*. http://www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/dttl-crs-millennial-innovation-survey-2013.pdf.

Almost 50 percent of Millennial respondents believe business leaders today think too much about the short term and are entirely focused on profit. And around a third of Millennials believe today's business leaders lack awareness of the wider society.[9] Similar results have been found as Deloitte has repeated this survey over the last three years; in 2014 Deloitte noted, "Millennials believe the success of a business should be measured in terms of more than just its financial performance, with a focus on improving society among the most important things it should seek to achieve."[10]

The younger generation is not alone. The field of philanthropy as a whole was bitten—hard—by the business bug in the late 1990s, as Seattle and Silicon Valley entrepreneurs started to cash out and contemplate what to do with their newfound time and money.

In fact, the growth of "social entrepreneurship" as a field of study in graduate business programs in the early 2000s coincided with the emergence of these new philanthropists, attempting to blend what they knew of successful business practices, such as venture capital investing, with philanthropic objectives.

The "venture philanthropy" and "philanthrocapitalism" movements were born, and it is no accident that investors such as George Roberts of KKR and John Doerr of Kleiner Perkins, together with social entrepreneurs they funded, jumped into the emerging space and began to define it in the early 1990s.

In fact, the two largest philanthropies in the United States dedicated to the pursuit of social objectives through entrepreneurial activity and investment were later created by the two founders of eBay, Jeff Skoll and Pierre Omidyar. Now, more than fifteen years after they emerged from their company as paper billionaires, each of them has put hundreds of millions of dollars to work supporting mission-driven entrepreneurs and the systems that support them.

The two are heralding and celebrating the type of ingenuity that gave them their wealth, and are working hard to apply those skills to address the globe's most pressing problems. Skoll, Omidyar, and other successful entrepreneurs, such as Steve and Jean Case, who have been pioneers in bringing entrepreneurial practices to philanthropy, are also working to contribute to the discussion among the Giving Pledge billionaires—ultra-high-net-worth individuals who have pledged at least 50 percent of their assets to charity.

This group, consisting of some of the world's wealthiest individuals and families, is following the example of Bill and Melinda Gates's and Warren Buffett's bold attempts to understand and share the lessons and rewards of their philanthropic pursuits. These discussions are not about philanthropy alone, but also include explorations of impact investing practices. As these efforts continue to create successful track records, in twenty years we may have, not a handful of significant entrepreneur philanthropists using investment as a tool to achieve social outcomes, but hundreds if not thousands.

Although the exact definition of *social entrepreneurship* has been elusive to some, for business leaders the term resonates powerfully.

3GC01 08/05/2014 9:4:4 Page 28

In the early 1990s, a small set of pioneering entrepreneurs—such as Anita Roddick of the Body Shop, Gary Hirshberg of Stonyfield Farm, and Will Rosenzweig of the Republic of Tea—started spreading their ideas and meeting regularly to explore the potentials and limitations of managing business for social good. Together, through organizations they and others founded—such as Social Venture Network, Business for Social Responsibility, and Net Impact—they created clubs of like-minded businesspeople, all striving to create what have been called "social ventures" or "mission-driven companies": businesses with social objectives. These entrepreneurs came together to support each other's work and share best practices.

Investing in Impact Enterprises

Mainstream capital markets have only recently started to catch up with social entrepreneurs. Back in 1992, a few of those CEOs realized that you cannot be a successful impact entrepreneur without the alignment of your key stakeholders, especially funders and investors. Without alignment over the mission-driven activities of the business, many entrepreneurs found that their best plans were waylaid in the pursuit of profits by those investors. The group Investors' Circle was created to identify investors who had interests in the mission side of the business; it would invest in their growth, patiently and creatively nurturing both the teams and the field to help develop successful social capitalists. The group, now more than twenty years old, has invested $175 million in more than 275 companies and funds, and it has invested in some of the brands and companies that are now household names. Zipcar (sustainable car sharing), Honest Tea (iced tea with an ethical supply chain), and many others received capital from investors who recognized an enterprise model blending social impact and financial return.

The CEOs of many other ventures who did not seek out mission-aligned capital found out the hard way what can happen: investors may turn your business away from its commitments to paying employees a living wage, from fair trade suppliers, or from customer segments that are not imminently profitable, such as low-income people in developing countries. Today mission-focused and other investors are collaborating intensively to help successful ventures scale, but recent

3GC01 08/05/2014 9:4:4 Page 29

research shows that many entrepreneurs still report looking for mission-aligned capital in the early stages of their company's development.[a]

[a]Clark, C., Allen, M., Moellenbrock, B., and Onyeagoro, C. (2013, May). *Accelerating Impact Enterprises: How to Lock, Stock, and Anchor Impact Enterprises for Maximum Impact.* https://dl.dropboxusercontent.com/u/7845889/AcceleratingImpactEnterprises.pdf.

Fast-forward a decade, and we see the notion emerging of a new form of capitalism to recognize and protect the for-profit mission-driven impetus, realized in the idea of the B Corporation (which was developed by members of Investors' Circle, described in "Investing in Impact Enterprises").

The B Corporation certification was designed to affirm and clearly signal a business's commitment to "solving social and environmental problems." Going beyond the many *product* certifications, such as LEED for buildings or ISO standards for labor, which audit the footprint of a specific product, the founders of B Lab, the nonprofit that manages the B Corporation certifications, wanted to provide a *company* certification as a transparent and comparable holistic record of an entire company's social and environmental impact. The goal was to create a trustworthy signal to employees and investors that a company was not just greenwashing its intentions. B Lab also insisted on the need for legal protections for these companies dedicated to stakeholder interests, to protect them from the strict interpretations of fiduciary duty that have become the norm for the last few decades.

Soon thereafter, new corporate forms arrived, such as "benefit corporations" and "flexible purpose corporations," building on the legacy of more narrowly designed special-purpose vehicles, such as low-profit limited liability companies (L3Cs) in the United States and community interest companies (CICs) in the United Kingdom. Some of these new corporate forms require companies to declare their mission intentions from the outset and to regularly report back on them in annual reports, ensuring transparency and accountability.

The fact that the number of new, emerging socially oriented businesses remains relatively small—certified B Corporations,

benefit corps, flexible purpose corps, and L3Cs together constitute probably less than 1 percent of the businesses created in the United States today—is beside the point. They are a community of practice and a beacon, with hundreds of examples, of what is possible; interest and attention in emulating the model are surging. In the United States, for example, according to B Lab, as of December 2013, more than twenty states had passed legislation allowing companies to incorporate as benefit corporations within their state, including New York, California, and, significantly, Delaware, which holds the largest share of all new business incorporations. Also in December 2013, there were more than 894 certified B Corporations in over twenty-nine countries. Governments around the globe are exploring similar programs with the goal of stimulating businesses that are good social citizens.

As the norms and practices for socially oriented businesses develop, it has also become easier to identify companies whose impacts match their objectives. And within the many organizations emerging to support investment in businesses with social objectives—including the expanding SOCAP conferences; the Global Impact Investing Network; and even mainstream groups like the World Economic Forum—we see activities focused on how to blend the pursuit of outcomes with new forms of metrics, transparency, accountability, and attention to stakeholders.

The agency of business as a force for social good is quickly becoming established.

Aligning Risk Mitigation and the Delivery of Better Outcomes

The development of new notions of business practice has been paralleled by an evolving understanding of what constitutes a sound investment strategy.

That the definition of "sound" investment strategy evolves should be no surprise to anyone familiar with the history of capital market development. For example, there was a time in the State of New York when fiduciaries were not allowed to invest in anything other than bonds issued by the State of New York.[11] Most today would see this as severely limiting; clearly, the definition of what constitutes responsible action on the part of fiduciaries has shifted significantly since those days. It continues to mature as fiduciaries

explore various strategies for fulfilling what they understand to be their obligations as overseers of capital. Others have addressed this question of the emerging definition of fiduciary duty and responsible investing; as it continues to evolve, many have documented movement in a direction that allows—indeed, increasingly requires—fiduciaries to consider more than simple financial performance alone in the allocation of capital.

It would be a mistake to think sustainable or impact investing is a completely new way to invest or in some way detracts from how fiduciaries previously approached good investment practice, though this is an easy trap to fall into. In this worldview, negative screens remove investments from consideration, limiting the potential investment universe and possibly decreasing potential future returns; in other discussions, impact investing is thought to require investors accept a lower rate of financial return in exchange for potential future social or environmental returns.

In truth, sustainable and impact investing are not about limiting investor options or returns. Rather, effective impact and sustainable investing *augment* traditional investment discipline with enhanced perspectives and additional information, for the purpose of allowing asset owners or fiduciaries to make better decisions regarding their investment strategies and risk-and-return expectations. After events including the Enron scandal, the BP oil spill, and self-dealing among various actors on Wall Street, which contributed to the 2008 financial crisis, prudent investors increasingly recognize the importance of this kind of thinking.

One of the most significant investors to tackle these issues has been CalPERS, America's largest public pension fund, in the state of California, with over $278 billion in assets as of December 2013. CalPERS is charged with management of retirement assets for current and former employees of California public schools, local agencies, and state employers. As can be imagined, it is not in the business of either taking unreasonable risks or losing money on behalf of its pensioners. That said, it is for precisely this reason that the fund is moving to integrate more aspects of sustainability into its investment approach.

Janine Guillot, former chief operating investment officer at CalPERS, led the adoption by the CalPERS Board of Administration of a set of investment beliefs that have set a new standard

for institutional investors.[12] They include statements such as these:

- **A longtime investment horizon is a responsibility and an advantage.** This requires CalPERS to encourage investee companies and external managers to consider the long-term impacts of their actions and favor investment strategies that create long-term, sustainable value.
- **CalPERS investment decisions may reflect wider stakeholder views**, provided they are consistent with its fiduciary duty to members and beneficiaries. CalPERS names its primary stakeholders as members/beneficiaries, employers, and California taxpayers.
- **Long-term value creation requires effective management of three forms of capital: financial, physical, and human.** Governance is identified as the primary tool for aligning the interests of CalPERS and the managers of its capital.
- **Risk to CalPERS is multifaceted and not fully captured through measures such as volatility and tracking error.** This belief states that, as a long-term investor, CalPERS must consider risk factors that emerge slowly over long time periods but that could have a material impact on company or portfolio returns, such as climate change and natural resource availability.

Each of these notions draws on ideas fundamental to sustainable investment practices and in keeping with the goals of many impact investors. CalPERS invests for secondary social benefits in addition to financial returns in a relatively narrow and targeted fashion. However, in establishing heightened principles of transparency and accountability in capital markets, CalPERS plays a broader catalytic role in driving Collaborative Capitalism.[13]

In effect, by making it plain that many core concepts of sustainable investing are simply a function of good investment practice, CalPERS is effectively saying all long-term asset owners should take these factors into account. As Guillot explains: "As a general rule, sustainable investing should just be about good investment practice. That's thinking about your time horizon and what risks and returns are relevant to a particular investment over your time horizon. If you're a long-term investor, thinking

about some of the risks that get labeled as 'sustainability-related risks' is essential—environmental risks, human capital risks, governance risks, including whether a potential investment (whether it's a public company or private vehicle) is governed in a way that will enable it to succeed over the long term. Thinking about those kinds of issues is just good practice."

This is the same notion that led David Blood, together with Al Gore, to create Generation Investment Management. Blood argues that the integration of sustainability (or ESG issues) into traditional financial analyses is not a screening process but a research process: "As long-term investors, we fundamentally believe that sustainability issues can materially impact a company's ability to sustain both earnings and a long-term competitive advantage. ESG analysis gives us a more complete picture of business performance."

Other investors are following suit. In its excellent report *Climate Change Scenarios: Implications for Strategic Asset Allocation* and its follow-up report, *Through the Looking Glass: How Investors Are Applying the Results of the Climate Change Scenarios Study,* Mercer, a global consulting firm, documented the experiences and practices of a leading group of institutional investors augmenting traditional financial analysis with consideration of ESG factors. In *Through the Looking Glass,* the authors note how "within the group of project partners, a large proportion of funds had well-established, active engagement policies and practices in place prior to this study. It was in this area we found the most commitment from investors to take action: a large majority of partners reported the findings of the study strengthened their conviction for the need to engage with companies and policymakers to tackle climate risk management."[14]

Jane Ambachtsheer, a partner at Mercer and adjunct professor at the University of Toronto, makes the observation that there are a host of risk factors sustainable investors can explore with greater confidence: "What is your governance framework around the time horizon over which you're investing? Think about quarterly capitalism; are you part of that problem? Are you part of the solution? Do you believe it's a solution? Is it hitting your bottom line? If the answer is yes, what are you going to do about it? . . . [and] on the ESG risk management side, are your fund managers playing with a full deck of cards? Are they using ESG analysis to help them in their corporate valuation, in their risk assessment, how they engage with companies?"

All of this matters, however, only if we can show the practices of sustainable and impact investing actually deliver the returns of financial and social value creation that investors seek. On that front, the jury is in. Deutsche Bank Group's 2012 benchmark metastudy titled *Sustainable Investing: Establishing Long-Term Value and Performance* is unequivocal on the point of materiality:[15]

- 100 percent of the academic studies agree that companies with high ratings for CSR and ESG factors have a lower cost of capital in terms of debt (loans and bonds) and equity. In effect, the market recognizes that these companies are lower risk than other companies and rewards them accordingly. This finding alone should earn the issue of sustainability a prominent place in the office of the chief financial officer, if not the boardroom, of every company.
- 89 percent of the studies we examined show that companies with high ratings for ESG factors exhibit market-based outperformance, while 85 percent of the studies show these types of companies exhibit accounting-based outperformance. Here again, the market is showing correlation between financial performance of companies and what it perceives as advantageous ESG strategies, at least over the medium (three to five years) to long term (five to ten years).

The Collaborative Capitalism Pyramid

It is interesting to note that with the introduction of the term "impact investing" in 2007, many in the existing community of sustainable and socially responsible investing argued that impact had always been an aspect of their work.

We agree and would add that socially responsible investing has not only been a precursor to impact investing but also operates alongside impact investing as part of the same, larger body of activity we call Collaborative Capitalism. Put another way, Collaborative Capitalism brings together the two core practices that underpin socially responsible investing and impact investing, namely, risk mitigation and investing for outcomes.

The first practice of investing for *risk mitigation* in mainstream financial markets, especially in publicly owned securities, has

expanded significantly in recent decades to include consideration of how extrafinancial factors affect an investor's ability to generate profits. Climate change, education, water, pandemics, and a host of other issues traditionally viewed as the purview of government and the nonprofit sector are increasingly understood to be legitimate objects of effective business management and investor interest. ESG factors are commonly included in the valuation of equity, real estate, corporations, and fixed-income investments. And many major global exchanges now require aspects of ESG reporting for listed securities.[16]

In the discussion led by Mercer on tackling climate risk, for example, we see how impact is present—though manifest differently—across asset classes and investment strategies. In addition to the effect of a firm's core operating practices, impact takes the form of corporate engagement and policy initiatives within a public equity strategy. This is not the direct outcomes-oriented impact of investing in, say, a microfinance fund; however, these are aspects of impact critical to asset allocation if an investor aims to generate social value across a total portfolio of capital investments.

The second practice is investing for *outcomes*. For decades, hundreds of individual asset owners, foundations, governmental actors, and others have been exploring how capital can be used to create positive social and environmental benefits. Government institutions have been doing this with grants and contracts; more recently, they also do it through investing.

The US government's Overseas Private Investment Corporation (OPIC), for example, is authorized to operate in 150 developing nations around the world, and it invests in projects across a range of industries, including energy, housing, agriculture, and financial services. OPIC focuses its work on "regions where the need is greatest and in sectors that can have the greatest developmental impact."[17] Individuals and institutions wielding purpose-driven capital of this kind have invested billions of dollars in the form of private, philanthropic, and public capital to drive social and environmental value creation in below-market-rate, near-market-rate, and market-rate return strategies. This explicit focus on outcomes is one of the key defining elements of an impact investment. You can inadvertently have impact (all investments have outcomes, both positive and negative), but when you are explicit

about managing to achieve the specific positive outcomes you've articulated, *that's* impact investing—it is the intention to create and manage for optimizing impact that matters.

It should be noted these two approaches are often the primary entry points for investors into the realm of impact investing. Impact investors often start either with an orientation toward the outcomes they are trying to achieve, such as an interest in health or education, or by wanting to look across their portfolio to see whether they can align that portfolio with those interests in ways that mitigate risks. The two notions, of outcomes and risk mitigation, have very different histories, theories of practice, and practical steps in terms of how one realizes them through a set of investments.

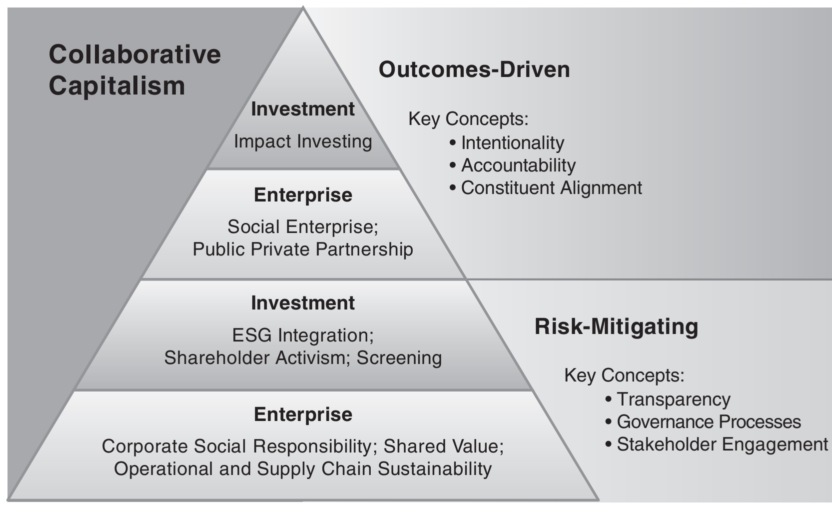
But, and this is a critical step forward, the distinction between the results from these two practices—investing for risk mitigation and investing for outcomes—is becoming theoretical at best. They are really two sides of the same coin, as investors consider how to align more of their assets with the things they care about, and as the recipients of capital find themselves speaking to investors coming from both perspectives. The combination of the two practices is ushering in a new form of capitalism that integrates diverse stakeholder interests; recognizes the complex range of strategic, values-driven, and financial motivations that have always influenced why we invest in the first place; and generates blended value. The key elements of Collaborative Capitalism are shown in Figure 1.2.

The Collaborative Capital pyramid in Figure 1.2 is intended to be indicative, and certainly not exhaustive. It includes a range of business and investment approaches consistent with risk mitigation on the one hand, and an outcomes orientation on the other.

Starting at the bottom of the pyramid, we feature business practices with the primary objective of risk mitigation—namely, CSR, shared value, and operational and supply chain sustainability.

CSR has been developing quickly in recent years, pushing corporations into new territory consistent with the ideas of Collaborative Capitalism. For example, John Elkington, a leading advisor to companies integrating sustainability with CSR, has outlined a vision of the future of CSR and sustainability that moves toward new understandings of capitalism.[18] In this same vein, Professor Edward Freeman's vision of the future of capitalism has as its centerpiece a new understanding of corporations' engagement with stakeholders.[19]

Figure 1.2 The Collaborative Capitalism Pyramid



Shared value (introduced by Michael Porter of Harvard in 2006) builds on the concept of blended value introduced in 2000 and explores a similar theme in how companies can view their potential for creating value as being more than simply a function of pursuing shareholder returns. And operational and supply chain sustainability has been elevated as a core priority in recent years, as reflected in the work of Deloitte and others.[20]

The next tier in the Collaborative Capital pyramid consists of the investment strategies associated with risk mitigation, which we discussed previously in this chapter: ESG integration, shareholder activism, and positive and negative screening.

For all the diversity in risk-mitigating corporate and investment strategies, they share a number of key focal points: transparency, governance processes, and stakeholder engagement. In each case, a number of significant initiatives have arisen to advance these ideas.

On the issue of transparency, for example, there have been rapid developments in the effort to have companies report on their ESG practices and performance alongside financial data, led by

groups including the Global Reporting Initiative and the Sustainability Accounting Standards Board, which explicitly promote the use of "integrated" sustainability reporting.

On the issue of governance processes, numerous networks have been developed, such as the Council on Institutional Investors, to bring the collective strength of investors to the table in an effort to influence the behavior of the largest public companies. And investors in their own right are being held accountable on their sustainability practices and governance through their participation in the UN Principles for Responsible Investment and its mandated disclosures.

On the question of stakeholder engagement, we see dozens of large advocacy organizations confronting companies with respect to specific social or environmental issues, sometimes combatively, sometimes in partnership with industry. Ceres is a community of investors interested in addressing climate change, for example. And companies are responding by developing platforms for engaging investors and other key constituencies on social and environmental issues. For example, the Sustainable Apparel Coalition is a trade organization comprising manufacturers, retailers, government, and nongovernmental organizations working to reduce the environmental and social impacts of apparel and footwear products around the world, representing about one-third of the global market.

The first layer of outcomes-driven activities in the Collaborative Capitalism pyramid is reserved for business approaches, specifically social enterprise and public-private partnership.

We have discussed social enterprise, which is broad in scope but has been aptly described by many leaders in Collaborative Capitalism, including Nick O'Donohoe, CEO of Big Society Capital in the United Kingdom:

> Do we really just have binary choices—between public or private provision of education, health and other social services; between charities and aid agencies focused only on dire needs or corporations focused only on maximizing profits; between investors who can choose only to maximize their returns or make philanthropic donations? Is there a middle way? Is there a model that embraces the financial disciplines of market capitalism but also

> provides opportunity and support for the vulnerable, the dispossessed and the downright unfortunate? There is. Social enterprises balance a social mission with financial viability and sustainability, existing between the public sector and private markets in both the developed and developing world.[21]

Public-private partnerships are collaborative by definition. The term (and structure) spans everything from public service delivery by private enterprise through to sustainable infrastructure development.[22]

For its part, impact investing sits at the apex of the Collaborative Capitalism pyramid—as an investment strategy defined by (and illustrative of) the key concepts of outcomes-driven Collaborative Capitalism, including intentionality, accountability, and constituent alignment, each of which we discuss in some detail forthwith.

Before we leave the Collaborative Capitalism pyramid, it is important to note again that these different categories are by no means mutually exclusive, or exhaustive. On the contrary, many of the ideas and concepts may be seen as "rolling up" to a new understanding of the nature of value itself and the role of organizations (whether nonprofit or for-profit) and capital (whether philanthropic, near-market-rate or market-rate) managed with the intent of generating multiple returns and blended value, the previously referenced "meta" concept introduced at the turn of the century.

Similarly, impact investors are learning how to build on risk mitigation strategies, as we have discussed, and risk mitigators are learning to take external stakeholders' needs into consideration and to account for outcomes. And things change quickly. In the 1990s, the sustainability movement and ESG reporting were viewed by many in the mainstream business community as either irrelevant to fundamental business management or some type of neoliberal babble. They are now seen as a fundamental way to reduce long-term risks.

Three Core Elements of Collaborative Capitalism

Recognizing the distinction between the six key concepts in our pyramid is relatively nuanced, we have integrated and reworked the

list into a more manageable number that can be readily translated and applied to business and finance writ large. The result is three core elements of Collaborative Capitalism: transparency, outcomes orientation, and attention to constituency.

Transparency

One of the requirements of Collaborative Capitalism is that people supplying capital and those receiving it know enough about each other to understand mutual strategic motivations. Disinterested and anonymous financial transactions executed globally through spreadsheets and wire transfers do not allow for this level of transparency. However, fund managers are exploring new structures to allow for increased transparency and for alignment of the strategic objectives of both parties. Many funds and transactions in the space, especially those that benefit from concessionary capital as part of the deal, include layered capital stacks in which different parties agree to certain kinds of risk and return in order to create an overall investment or fund. A good example of this is in our study: the Deutsche Bank Global Commercial Microfinance Consortium I contained five different capital "layers" (three debt layers and two equity layers), and each vehicle had a tranche of first loss or guarantee capital provided by a government agency.[23]

In a sense, all investments that have layered stacks of capital involve transparency to some degree. What is new in Collaborative Capitalism is that the trade-offs among different parties' interests involve more variables: they include impact, return, and risk.[24]

There is a tension in the notion of transparency as well; transactions that come with high-touch, customized, or idiosyncratic information are difficult to achieve at scale without friction and at low transaction costs. Many of the most successful impact investing deals require more effort in understanding and integrating the diverse objectives of both parties before transactions can be completed. A new field of intermediaries, including advisory firms such as CapRock Group, Enclude Solutions, and Imprint Capital, has arisen to coordinate the extra layers of critical information in such deals.

Outcomes Orientation

The second precept of Collaborative Capitalism is increased attention to outcomes. Social and environmental outcomes are important in different ways to various stakeholders, and the increased attention and accountability related to producing measurable, understandable, attributable outcomes are core concepts.

All sorts of strategic goals become possible when there are measurement methods to determine whether and when one is succeeding. For example, a government agency such as OPIC can and does use its capital for multiple catalytic and risk mitigation purposes. Still, there are many challenges in this work. Efforts to standardize metrics across geographies, thematic areas, and industries are making progress, but as yet the results are imperfect.[25] The field has concentrated primarily on outputs (quick measures of direct activities of a business or project, such as how many solar lanterns were sold) in the absence of rigor, energy, and capacity to track true outcomes (such as how much the purchaser's income increased due to the extra working hours that the solar lantern allows). We found in our study a combination of well-articulated "intentionality" (to achieve a particular social outcome) and carefully operationalized "accountability" to those intentions. We call this "Mission First and Last."

Attention to Constituency

Constituency is an important aspect of nonprofit mission-related activity that is often overlooked. All US nonprofits, in order to remain designated as 501(c)(3) charitable organizations in the eyes of the IRS, must prove that they have a diverse set of donors and thus a diverse set of financial stakeholders. This is to prove that their purpose is public, not private. The translation of nonprofit activity to Collaborative Capitalism requires a similar sensibility, even if the implementation is different. Constituents are parties that have an interest in the organization's outcomes, not just those with a fiduciary relationship. The elements of constituent relationships, constituent feedback, constituent buy-in, and constituent accountability are all increasingly essential to the new model of Collaborative Capitalism.

In short, impact investing is about the convergence of interests and ideas that were previously viewed as distinct. This evolution in the understanding of our relative interests presents a historic opportunity—but also a multitude of challenges. Constituents are highly diverse and may include investors, governments, employees, community members, nonprofits, customers, suppliers, and others. Many of these groups may not communicate their desires effectively or efficiently. Thus key questions become challenging, such as: In an impact investment with multiple stakeholders, are the interests of investors more important than the interests of other stakeholders, such as beneficiaries or customers? If not, how can these interests be effectively balanced?

No norms exist to guide the answers yet, and mistakes are often clearer to discern than successes. The need to consider constituent accountability and alignment explains why a university can't toss out its president without consulting its key stakeholders, such as when the University of Virginia ousted President Teresa Sullivan in 2012, only to reinstate her several weeks later when key constituents protested their lack of involvement in the decision. It's why Mohammed Yunus, founder of Grameen Bank, argues that microfinance without ownership by its borrowers is prone to exploitation. (And, in at least one instance, he was proven right in India in the province of Andhra Pradesh in 2010; in other cases, his predictions have not come to pass.) And it's why B Lab, the nonprofit organization that certifies B Corporations, decided to pursue the legal strategy of creating a new corporate form that incorporates the needs of stakeholders into corporate charters. Once you posit the notion that an impact business is responsive to the needs of stakeholders, you set the expectation that these needs will be considered. A fundamental question for those engaged in Collaborative Capitalism is how to create the relationships and feedback loops that make the constituency engagement process feasible, actionable, and, of increasing importance, binding.

We also know there are potential downsides to Collaborative Capitalism. If, for example, there are not identifiable stakeholders who wish to purchase outcomes for a particular population or issue, it may be more difficult to attract *both* private capital and the public resources that may have been more readily available in the past.

Transparency is costly and can never be total in any market that depends on information asymmetry. Constituent feedback is often messy and expensive; sometimes you won't like what you hear. And decision making can be painfully slow, as we know from the political realm. Interpretation of constituent wishes may also be subjective, and political forces can seize power if relationships are not formalized. There is not yet a clear sense of the limitations and choices being made by and for stakeholders; however, we are certain that these limitations will make themselves more clear in the future and that we are now in a period of exploration, figuring out the potentials and limits of Collaborative Capitalism.

Examples of Collaborative Capitalism at the Enterprise Level

Transparency

Seventh Generation is a leading brand of green household and personal care products. The company remains an independent, privately held company distributing products to natural food stores, supermarkets, mass merchants, and online retailers across the United States and Canada.

Company highlights: More than 25 percent of managers are evaluated on the accomplishment of social and environmental targets. Seventh Generation publishes a transparent annual external report detailing mission-related activities, targets, and consistent measurements to allow for year-over-year comparisons.

Outcomes Orientation

IceStone is the world's "safest, most sustainable durable surface." Made from three core ingredients—100 percent recycled glass, Portland cement, and pigment—IceStone surfaces are used for everything from kitchen countertops to conference room tables to art installations. Since 2003, IceStone LLC has diverted over ten million pounds of glass from landfills.

Company highlights: 100 percent of products are certified "Gold level Cradle to Cradle"; IceStone uses 100 percent recycled glass in production; 100 percent of facilities are powered by renewable energy credits; 100 percent of water used in production is reused in the manufacturing process.

Attention to Constituency

Indigenous Designs is a leader in organic and fair trade clothing. Its clothing supports thousands of artisans in the most remote and impoverished regions of the world, and uses the finest organic materials and traditional skills passed down over thousands of years.

Company highlights: Supplier price controls are entirely democratically governed; more than 40 percent of suppliers are majority owned by women or minorities; Indigenous Designs builds direct and long-term relationships with artisans; and more than 5 percent of the company is owned by nonprofit organizations.

Note: These examples of award-winning certified B Corporations were accessed from B Corp. (2014). *Impact Reports.* http://www.bcorporation.net/.

Putting It All Together: Collaborative Capitalism in Action

Collaborative Capitalism is a relatively new idea—at least to the extent that it has been *intentionally* implemented—which makes any insight into the strategic approach that organizations are taking to address impact investing and Collaborative Capitalism invaluable. The following six real-world examples offer insight into the activities and approaches that Collaborative Capitalism encompasses, both within and beyond the twelve funds we studied.

1. Integrating an outcomes orientation into The California Endowment
2. Constituent alignment at Citi
3. Creating an investing platform for outcome-driven investors at Morgan Stanley
4. Aligning "outcome buyers" through social impact bonds
5. Transparency through RSF Prime
6. Stakeholders as investors at Calvert Foundation

Integrating an Outcomes Orientation into The California Endowment

Just as some philanthropic foundations have played a leading role in elevating and supporting business as a force for good, they also have the flexibility and strong incentive to turn principles into action. Endowed private foundations generally invest 95 percent of their capital purely for financial returns, enabling grantmakers to give away the remaining 5 percent for social impact. In effect, 100 percent of the charitable mission of a foundation is driven by just 5 percent of its capital (its grant making), while 95 percent of its assets are managed with no regard whatsoever for the purpose that the institution was created to pursue.[26] Although a small percentage of foundations use program-related investments (PRIs) to drive investment capital to "charitable" investments in social outcomes, these usually constitute a very small portion of the limited grant segment of their budgets.

With this situation in mind, on the urging of several thoughtful provocateurs (one of us [Jed] among them), over a decade ago foundations began considering whether it really made sense to invest most of their assets in a manner that was at best neutral and at worst undermining of their institutional mission.[27] A handful of pioneering foundations began to slowly change investment practice, even while acknowledging that strong financial performance was essential to sustain grant making. Among those leading the charge was Luther Ragin, now CEO of the Global Impact Investing Network and former vice president at the F. B. Heron Foundation, who asked: "Should a private foundation be more than a private investment company that uses some of its excess cash flow for charitable purposes?"[28]

The most explicit manner in which foundations responded was to create dedicated "mission-related investment" strategies, usually setting aside a small portion of their endowments for proactively advancing philanthropic goals through carefully selected investments earning competitive rates of financial return.

One of these is The California Endowment (TCE), a $3.5 billion foundation committed to supporting access to quality health care for underserved individuals in California. Since 2008, TCE has committed $101 million to investments in affordable housing, health clinics, community lending, and, most notably, the California FreshWorks

Fund, a $272 million initiative created by TCE (and launched in 2011 by Michelle Obama at the White House) for supporting healthy food retailing in low-income communities.

Like its peers, TCE had questioned how to broaden the set of tools available for achieving its mission. The foundation understood the necessity of adopting a systemic approach encompassing public policy, deep bottom-up perspectives from the communities in which TCE works, and a frontal assault on many of the upstream causes of health outcomes, including through the investment portfolio. The financial crisis of 2008 was also a clarifying moment. As Wall Street's supposedly clear understanding of risk and complex financial instruments unraveled, space was created in the boardroom to "hear and actually consider an alternative to the status quo," says Tina Castro, who was until late 2013 TCE's director of impact investing.

What's most interesting at TCE, however, is the way in which the conversation has moved beyond the financial crisis and evolved to complement the impact investing program—essentially socializing internally what had been a niche initiative. TCE is discussing divesting from companies that undermine its mission, such as weapons manufacturers and heavy polluters, and Castro envisions a future in which the foundation is a more active shareholder, pushing companies to change their behavior, adding additional screens to the portfolio, deploying more dollars in structured funds like FreshWorks, and spending more time being a catalyst and advocate for impact investing—strategies that are consistent with the notion of sustainable investing discussed earlier. As recently as a few years ago, this might have sent the board of trustees and investment staff running for the hills, but the debate is now less hyperbolic. Explains Castro, "The Great Recession enabled a conversation, but there was also this increased fear and skepticism, and a sort of recoiling, retrenching and protecting of assets. Now it feels to me like a more rational conversation. We have a new set of board members with a different skillset. They are more multilingual. You have folks who are very investment savvy and sophisticated, but also who understand issues of public health, social justice, and these other things that are so core to our mission."

It helps that TCE has been doing impact investing for five years. Rather than wondering how to do something, TCE is looking at

3GC01 08/05/2014 9:4:4 Page 47

what has already been achieved and figuring out how to do it better. Although it is neither advisable nor possible for TCE to invest $3.4 billion in highly distressed communities in California, Castro believes there is a balance between investing in a manner consistent with fiduciary responsibility, with an eye to managing risk and targeting appropriate return, and dedicating resources to supporting California communities. This is not necessarily by investing in the communities directly, but in ways that support the work TCE is trying to do in those communities—an impact investing "wraparound" to their philanthropic investment strategy, as it were.

Constituent Alignment at Citi

The experience of foundation investors speaks to the idea of aligning investments with an explicitly social mission. And although the sector as a whole has been criticized for only recently taking baby steps to align their total capital with their institutional missions, it is clear why foundations would (or at least should) lead the charge in investing for impact.

For commercial financial institutions—including banks, insurers, and wealth and asset managers—it is a different question. Mission alignment is not the goal; rather, the goal is also responding to the changing political and regulatory environment in which they operate as key stakeholders.

In the United States, regulation has been the single most important driver of impact investing by the largest financial institutions. For example, the Federal Reserve System's supervisory mandate includes promoting development in low-income communities as an element of fair and impartial access to credit. And the most notable effort of this kind—the Community Reinvestment Act (CRA), which requires that depository banks make loans and investments in underserved places where they have branches—has created a $60 billion market for community finance, capitalizing some of the largest and most sophisticated impact investing intermediaries in the world.

In other words, all banks (certainly those in the United States) have at least some capacity for integrating elements of financial and social return through investment. But, as was the case for The

3GC01 08/05/2014 9:4:4 Page 48

California Endowment, with its evolving embrace of investment strategies extending beyond the niche of mission-related investment, the developments that provide most insight are those that push beyond this more limited, mandated effort.

Citi is an interesting case in point. In recent years, the bank has reinvigorated its community development efforts in the United States, not just by building locally on the CRA's distinctively American and "nontransferable" platform, says Bob Annibale, global director of Citi community development and microfinance, but also by importing and adapting lessons from ten years of experience working in microfinance.

In fact, impact investing owes much to microfinance, which provides the best illustration of an investment market that has evolved from small and primarily philanthropic origins to being large and relatively commercial. In the years prior to Citi's foray, the microfinance sector grew about 12 percent annually, serving ninety-four million customers.[29] New intermediaries were launched, improving the availability and flow of information between microfinance institutions (MFIs) and other industry stakeholders. And as commercial funding became more abundant and grant funding scarcer, a greater number of MFIs became for-profits in order to access more capital. Roughly 50 percent of MFIs were nonprofits in 1997; by 2004, this was reduced to 24 percent.

Citi had been making grants in microfinance since 1982, consistent with its global footprint. And Annibale sees an important, ongoing role for a dynamic philanthropy in the sector, including through the Citi Foundation and Citi Microfinance, investing in research, innovation, new models for deepening financial education in the sector, and important microfinance networks like CGAP, SEEP, Women's World Banking, and Pro Mujer.

However, like many financial institutions, Citi thought it could add tremendous value by being much more a "part of the process" and treating MFIs like clients rather than beneficiaries, explains Annibale. "You could see in the work and what was happening in the market that there really were some impressive models coming out, some of which themselves had the potential to scale."

For Citi, that meant it was time *not* to create a separate fund or a separate "goodie bag" of proprietary assets to invest, but rather

to fully integrate the idea of financial inclusion into existing business lines—extending a client service proposition to more far-flung locations. When he started the group in 2004, Annibale says that all of his colleagues came out of Citi's businesses and could bring relevant skills to the table. "We had worked with clients on solutions, on products, on risk management, on technology. We wanted to bring things of value to [microfinance] institutions, so much so that they think of us as a partner and banker."

Interestingly, even as Citi's total lending bottomed out in 2009 during the financial crisis, the microfinance business was growing—not by maximizing profit, which was never the objective, Annibale says, but by delivering sustainable rates of return through a portfolio that was stable and growing. Citi's work is well illustrated by an award-winning payment solution the bank created in the Dominican Republic, which allowed typically unbanked small grocery stores and other businesses to replace cash payments to their providers with mobile transactions. The service has now expanded to India, China, and South Korea.

Citi now works with 150 clients in the microfinance sector in nearly fifty countries, on financing, capital markets issues, foreign exchange hedging, fund administration, and transaction services. This includes a partnership with the US government's OPIC, which has provided $360 million directly to forty MFIs in the local currency, local language, and under the local law of twenty-two countries, reaching 975,000 borrowers, of which approximately 91 percent are women.

Annibale was handed responsibility for Citi's community development division in 2010, essentially representing the bank's CRA-driven work in the United States. Asked to approach that sector in the same way he had tackled international microfinance, Annibale transformed the community relations team into bankers, with "partners, clients, and goals," and soon made a mark when Citibank agreed in late 2010 to set up free bank accounts for all public school students and parents in San Francisco as part of a taxpayer-funded college savings plan.

The strategy at Citi goes so far as to include considerations of financial inclusion in any decision to close a bank branch. Annibale's role in the process is to ensure that the business is

not thrown "out of balance" by eliminating a physical location that might be essential for reasons beyond just profit. "Some of that can go back to regulation and other stakeholder interests," he says. "But it's more than that. It's about how and where decisions are made, and their implications. If you're too far from the implications, you just can't be that effective. Others have to be the arbiters of whether we are impactful or not."

From the perspective of Collaborative Capitalism, Citi is in fact experimenting with new forms of constituent alignment and stakeholder-oriented governance.

Creating an Investing Platform for Outcome-Driven Investors at Morgan Stanley

Another institution pushing the boundaries is Morgan Stanley, the world's largest wealth manager, with over sixteen thousand financial advisors. But whereas Annibale's work at Citi focuses very intentionally on corporate and institutional partners, Morgan Stanley is laying foundations for impact investing primarily as a response to strong demand from a broad range of institutional, retail, and high-net-worth clients, including the new fiduciaries discussed earlier.

Morgan Stanley created an Investing with Impact platform in 2012 and, late in 2013, a new Institute for Sustainable Investment focused on product development, thought leadership, and capacity building. Announcing the Institute, together with a goal of managing $10 billion in client capital on the Investing with Impact platform, Morgan Stanley's chairman and CEO, James Gorman, said: "Our clients are increasingly turning their attention to what it takes to secure the lasting and safe supplies of food, energy, water, and shelter necessary for sustainable prosperity."[30]

Morgan Stanley sees the enthusiasm from younger investors that we discussed earlier, and the company believes that its efforts are enabling financial advisors to have more conversations with multigenerational clients. "The younger generation is clearly signaling that when they take over the reins to family offices and their own inheritances, they will not invest the same way," says Audrey Choi, CEO of the Institute and head of Morgan Stanley's Global Sustainable Finance group.

3GC01 08/05/2014 9:4:5 Page 51

Choi's observation is also true in the institutional space, where young people are stoking interest in impact investing. It was Harvard students who unsuccessfully demanded that the university sell its stake in fossil fuel companies, through a divestment campaign that has been likened to earlier efforts to limit investment in South Africa during apartheid and in Sudan as fighting continued in Darfur.

In parallel with new client needs, however, Morgan Stanley has also been testing its own understanding of the changing social and economic landscape and seeing the business case for sustainability more clearly than ever. According to Choi, the challenge of resource scarcity demands not only that governments play a role through policy and public investment and that philanthropy provide catalytic financial support, but also that the power of capital markets is fully harnessed. "As a financial institution, we believe that private capital can and must play a role in driving innovation and investment to meet those challenges in the future," says Choi. "More than that, however, those challenges will represent a very powerful business opportunity."

Morgan Stanley is also focused on the full integration of this new perspective, as with Citi, culminating with the launch of the Institute, which provides a firmwide mandate for collaborating with core business units. Says Choi, "At the Institute, we really want to do something that is consistent with the quality and scale of opportunities that lie in the sweet spot for Morgan Stanley. Whether it's with our wealth management or investment management colleagues, we are increasingly turning our core skills to developing and distributing products with a focus on impact."

Morgan Stanley's Institute for Sustainable Investing aims to provide greater clarity and easier access to products that offer a risk-adjusted market rate of financial return, such that the core investment portfolios of clients can be mobilized. To this end, Morgan Stanley has structured the Investing with Impact platform to predominantly focus on a broad range of sustainable investing opportunities, from public markets to private equity. The implications for attracting talent are also clear to Morgan Stanley. Choi says that the best and brightest recruits, as well as the future leaders at the firm, care deeply about impact. "There is an increased desire and commitment to integrate what people do

in their professional life with the values that they care most about," she affirms.

Aligning "Outcome Buyers" Through Social Impact Bonds

Using capital as a tool for social good means finding new ways to harness the power of transparency, outcomes orientation, and constituency to recalibrate the impact that finance has on society. If capital from impact investing is the fuel, building a strong, resilient society with it may depend on getting this right. According to the late J. Gregory Dees of Duke University, the value of social innovation and entrepreneurship is ambiguous at best, unless we as a society set out to use the power of continuous innovation properly. He called for using social enterprises as learning labs to help society more quickly identify solutions that work, reject those that don't, and create more resilient and effective social systems.[31]

This is the mind-set—which is appealing to even the casual observer—that is driving significant interest (and media attention) in new financial innovations like social impact bonds (SIBs), also called pay-for-success contracts. SIBs provide a new tool to help governments finance social outcomes through private investment in efforts to address homelessness, adult recidivism, juvenile delinquency, preschool readiness, environmental sustainability, and other issues.[32]

The mainstreaming of that idea received a significant boost when Goldman Sachs emerged as the sole investor in the first SIB in the United States as part of its strategic commitment, through its Urban Investment Group (UIG), to "invest the firm's capital through strategic partnerships with developers, nonprofits, and other local stakeholders to bring economic and social benefits to underserved urban areas."[33] In August 2012, UIG announced that its $9.6 million loan would support the delivery of therapeutic services to sixteen- to eighteen-year-olds incarcerated on Rikers Island, New York City's largest correctional facility, with the support of a guarantee provided by Bloomberg Philanthropies.

SIBs are on the march, particularly in the United Kingdom, where there are more than fourteen SIBs completed or in development, but also in at least nine other countries around the

globe.[34] We think this is happening in part because SIBs embody Collaborative Capitalism, spreading risk for cash-strapped governments and allowing investors, especially those who care about social outcomes, to step into a new and formalized stakeholder relationship so as to achieve those outcomes.

Transparency Through RSF Prime

RSF Social Finance (RSF), a fund in our study, is an innovative public benefit financial service organization dedicated to transforming the way the world works with money. RSF offers investing, lending, and giving services to individuals and enterprises committed to improving society and the environment. Since 1984, RSF has made over $285 million in loans and over $100 million in grants.

RSF is both philosophically and functionally unique in the investment marketplace. Philosophically, RSF acts not just as a financial service organization but as a thought leader and field builder, inspired by the work of the famed economist and scientist Rudolf Steiner. Today RSF is dedicated to exploring how money can connect people and their values and strengthen the bonds of community. Functionally, RSF is also quite innovative. Through its mix of eight legal entities comprising both investment and grant vehicles, RSF offers its fifteen hundred investors, lenders, and donors the possibility to leverage investments, loans, and grants in order to create significant positive impact by working to align their money with their values.

The RSF Social Enterprise Lending Program is RSF's core investment product. The program, with $70 million in assets under management in January 2014, employs a disciplined risk management process, resulting in an extremely low default rate and leverage ratio. The team also employs a unique high-touch, transparent approach that allows borrowers and investors to interact with one another throughout the investment process.

In its lending activity, RSF funds its operating costs on the spread between the interest rate the borrower pays and the interest rate the investor receives. It calls the borrower rate "RSF Prime." Unlike other funds, it holds quarterly community pricing meetings for its borrowers and investors to discuss and have input into what

RSF Prime interest rates, investor interest rates, and RSF's operational cost rate should be.

The quarterly meetings began in 2009 after RSF decided to decouple its interest rates from LIBOR (the London Interbank Offered Rate, the interest rate charged by banks lending capital to each other), which is used as the basis for most short-term bank loan interest rates around the world. This was an important but challenging decision, and what made it possible was a study, conducted by RSF staff, of Rudolf Steiner's economics lectures, in which he speaks about setting price by bringing together all parties involved—producer, consumer, and distributor. According to John Bloom, RSF's senior director of organizational culture, "This struck a deep chord for [RSF staff,] as it is an essential part of our mission to build community through finance." At the pricing meetings, RSF asks each participant to discuss his or her interests, so as to bring all sides into alignment—investors talk about their motivations, borrowers talk about their use of the loan proceeds, and RSF staff discuss the resources needed for them to work in their unique way as an intermediary. Further, RSF asks participants to respond to how a change in interest rate would affect them. During this round of conversation, the group participants gain insight into one another's financial needs, priorities, and plans.

For example, at the December 2013 meeting, two borrowers indicated they had set their budgets for 2014 and that any upward change in interest rate would require reducing important program expenditures and potentially compromising business activities. As the intermediary, RSF brought to the table the fact that it had not changed the 4.0 percent margin it earns since 1991. It was clear from the meeting that because of the weak economy and historically low bank rates, everyone was operating on thin margins. Despite the initial tension, as a result of the discussions, there was a general desire to maintain the status quo for the first quarter of 2014. As John Bloom described in a recent blog post:

> A week following the pricing meeting, the RSF Pricing Committee met to set the interest rate for the quarter. After reflecting on what was shared at the pricing meeting, it was clear that a raise in rate for the borrowers would cause some financial hardship, and might potentially discourage other new borrowers from applying for loans,

> as banks have a significantly lower cost of capital and more flexibility to negotiate rates. While none of the investors was enthusiastic about a lower interest rate, it seemed they were overall affected less by a change. Even a slightly reduced rate is still competitive with rates on bank savings accounts or CDs. The Pricing Committee needed to adjust somewhat for RSF's needs, at least for the near term. The result was a reduction of return to the investors by 25 basis points from the current rate of .50% to .25%, with RSF Prime (the rate for borrowers) remaining the same at 4.5%, [increasing RSF's margin to 4.25%].
>
> This last gathering marked an important change in the nature of the pricing meetings. The associative [economics] picture that Rudolf Steiner gave was fully present as all parties outlined their needs and engaged in heart-felt learning. Though the resulting recommendation for status quo was not followed, the Pricing Committee believes the outcome respected the needs that were voiced at the meeting. RSF's purpose to transform the way the world works with money is exemplified in pricing meetings. We cannot imagine a more direct, transparent, and personal way to work with interest rates. Though the system may not be perfect for everyone, the participants in the meetings can assure you it is very real.[35]

Stakeholders as Investors at Calvert Foundation

Another financial innovation highlighting the core principles underpinning impact investing is the effort to integrate community lending more fully with local stakeholder communities. For example, Calvert Foundation, a longtime community development financial institution (CDFI) in the United States, launched in June 2014 an "Iconic Places Initiative" with support from the Kresge Foundation. The goal of the initiative is to connect local residents with investment opportunities that support redevelopment in their own backyards. Residents are able to invest with as little as $1,000 through a paper application or brokerage account, and in June 2014, Calvert Foundation also launched vested.org, an online platform to offer the investment in the underlying product, called a Community Investment Note, at a minimum of only $20.

The initiative set Calvert Foundation down the path of an entirely different theory of change, focused on the role of local investors in contributing to their own communities becoming more

economically vibrant and sustainable—or what Calvert calls *place-making*. According to Jennifer Pryce, CEO of Calvert Foundation, the Iconic Places Initiative focuses not just on how money is deployed but also on how it can be raised. "We have an opportunity to engage local stakeholders in this work. We began to talk to nodes of connection within a city like Detroit—community foundations, other funds, initiatives—and all were passionate about finding a way for the local community to participate in the revitalization of the city. Our Community Investment Note fits that need without being philanthropy, but rather investment, so it can live on in the community," Pryce explains.

Calvert Foundation is not going into cities like Detroit with an economic development agenda. It is going in with the ability to raise capital and connect people to a conversation and movement about "the value of owning your community and owning the opportunity to invest in your community." "It's about civic pride and grassroots engagement," says Pryce.

Calvert Foundation is also doing similar work internationally and recently signed a partnership with the US Department of State and USAID to be a managing partner of the agencies' "IdEA" platform, which aims to create connections and opportunities for US investors to invest in their countries of origin or heritage, as part of the diaspora work initiated in 2011 by then secretary of state Hillary Clinton. Calvert Foundation is turning into a product development shop that specializes in Collaborative Capitalism—helping turn stakeholders into investors so they may invest in outcomes they care about.

Looking Ahead

Although many in the field of practice are talking about the growth of impact investing in the context of how to mainstream it—debating precisely where on the iceberg the waterline can be found—the transformation at hand is far more significant. We are witnessing both an opening up of investing itself—wherein financial markets are progressively internalizing new perspectives on value creation and asset management—and an expanded understanding of stakeholder relationships and the other factors that provide investors with what they really want:

3GC01 08/05/2014 9:4:5 Page 57

fuller, more complete levels of accountability in that value creation process.

Put simply, impact investing and Collaborative Capitalism are a response to a changing world and shifting beneficiary preferences, in an era of unprecedented global growth, connectedness, and openness. In truth, investors have never cared only about financial performance. That was the means, but the end we all have in mind is the deep generation of true stakeholder and community value—blended value—through a capital system that truly "enriches" us all to live humanely and with dignity. And although we may differ on what we want or believe the path to that state to be, impact investing, by helping us clarify the essential elements of Collaborative Capitalism, may hold the key to its realization.

In chapter 2, we put the spotlight on impact investing; in chapters 3 through 6, we look at the specific practices of leadership and strategy that have underpinned the success of our twelve funds.