Robert Zevin's thoughts on Impact Investing

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Is impact investing really the new kid on the block or just the same old kid in new clothes with a new name? Amy Domini complained in a March Huffington Post blog that it is definitely only a new name for what she and others have been doing for 25 years or longer: 45 years in my case. At first glance Amy seems to have it right. The double or triple bottom line, doing well while doing good: these expressions predate the language of impact investing by many decades and they were and are focused on improving the economic well being of the disadvantaged, or supporting innovations that promise to ameliorate pollution or global warming. So community investing, green investing, alternative investing, Program Related Investing, mission related investing, things many of us have been doing for a long time, all look a lot like impact investing.

They all involve making investments with the expectation of sustaining themselves by earning positive returns. They all are private placements, or venture capital or other forms of non-publicly traded investments, with a few minor exceptions. However a closer look reveals important differences. Impact investing is basically an offspring of Silicon Valley. It incorporates the outlook and aspirations of a generation of dot.com entrepreneurs who made millions or billions of dollars before they were 30 years old, sometimes before they did or would have graduated from college. They believe, and I think they are probably more than half right, that their activities were also benign and usually had a beneficial effect on people and our planet.

From this experience and these beliefs it seems they have concluded that most environmental and social problems can be solved with the same entrepreneurial and technical skills they employed to make their fortunes along with capital infusions that they can supply. And they see no reason why they should not make more than normal profits on these investments as they certainly did with their original enterprises. In fact they apparently believe that unusually large profits are evidence of unusually large positive social impact, an idea that would certainly bewilder Adam Smith. When I Googled Impact Investing, the first 10 entries out of a stated 125 million contained abundant evidence of these beliefs. The invitation to the Impact Investing Summit in San Francisco this coming May begins by asserting that it would be a "conference of impact investors focused on premium or above market rate returns". And Invested Development, a Boston-based firm that makes start up venture capital investments in emerging markets says in its lead statement on "What We Believe": "The missing ingredient in impact investing is seed capital. Intrepid angels have led the way in Silicon Valley and they are destined to do the same in impact investing."

What is missing from all of this is the idea that green energy is an uphill struggle against the control of most countries' political systems by powerful vested interests in fossil fuels and nuclear power. And the idea that the poor are typically disadvantaged, often lacking critical aspects of the intellectual capital and social infrastructure that supports economic development not to mention the physical infrastructure. It is not so easy for solar and wind power to compete if hydrocarbon and nuclear fuels enjoy heavy government subsidies. And it is nearly impossible for poor communities to develop exclusively through the efforts of profit maximizing entrepreneurs.

In the early history of the American colonies, universal literacy -- a now well-known precursor to economic development, – was achieved, at least for the non-slave population, by public expenditure on public education. So too, with the help of public borrowing, the construction of roads, canals and railroads which were indispensable requirements for the tremendous economic growth of this country and this city in particular. Intellectual, social and physical infrastructure are stepping stones to economic development, <u>equal or greater in importance than private capital</u>. It is a stretch indeed to see how private entrepreneurs could achieve extraordinary risk-adjusted profits providing these necessities except by capturing the externalities of their investments. But, this would precisely kill the economic development the infrastructure was supposed to encourage.

For example, when the original South Shore Bank in Chicago undertook the revival of the South Chicago neighborhood in which it operated, it did not buy all of the property in the neighborhood so it could profit from the results of its multifaceted efforts to make more mortgage loans, rehabilitate deteriorated properties, organize a neighborhood grassroots economic development effort and so on. The increase in property values for family owned houses in the neighborhood was a critical part of its success in improving the economic well being, safety and sense of community in its area. The original investors in South Shore Bank and a long line of subsequent investors agreed to impose a limit of 5% on the total annual return they could earn. Similarly micro-lenders such as Grameen Bank and Accion accept low rates of return on their capital -- enough to ensure sustainability -- while still providing funds required to administer small loans, build new social networks and provide technical and business management assistance at an interest cost to the borrowers that leaves them enough money to save and grow.

You may have seen Elizabeth Warren's You Tube riff on why no "self-made" millionaire or billionaire really did it by his or her own self. All are dependent on our common heritage of knowledge created by others, schools, universities, libraries and social networks. Lewis Hyde's recent book, Common as Air, makes the same point as it carefully dissects the now feverishly flourishing philosophy that each of us is or ought to be completely self-reliant and therefore due all the credit for whatever fame and fortune we possess.

To have high social or environmental impact, an investor needs to consider where the major barriers to progress are located. Can they be overcome with the example or action of a business model or do they require efforts more explicitly focused on political and social change? As a general rule, if a business investment promises above normal returns, it is probably not high social or environmental impact for the simple reason that the social conditions already exist to make it successful and the high return would in all likelihood attract the necessary capital from investors concerned only with the single bottom line of financial returns. The primary question about an impact investment should not be "how profitable is it?" but "how well designed is it to achieve necessary changes in the social-economic context?" If investment in such an undertaking is preferable to the alternative of funding social-economic change philanthropically, the only requirement should be a positive return sufficient to make the business sustainable and replicable.

I will conclude with some illustrative examples of community development investing from my own experience. In the early 1970's the 21st Century Fund and several other clients were interested in supporting a new, small bicycle wheel factory in Mound Bayou Mississippi, an all black town, unique in Mississippi at the time I believe for its black municipal government. The organizers came out of the Civil Rights movement. We wanted to see a worker owned facility, to which they enthusiastically agreed. The investor capital required was about $100,000. There had already been some development grants. I was anxious to make it as easy as possible for the worker/owners to become true owners by paying back the investors. So the loan was at deferred interest for the first 18 months added to principal, an interest rate around 7%, interest only payments from year one and a half until year 8, when all the principal was due. Most important, there was no penalty for early prepayment of the loan. The factory did well thanks to a knowledgeable manager and orders from Sears Roebuck and other chains. It employed 25 people, making it the only manufacturer and the largest private sector employer in Mound Bayou. The loan was repaid in full at the end of 4 or 5 years. The factory continued to flourish and employ the same number of people until the recession of 1982, at which time it was purchased by the manager for a small sum. I do not know what became of it since then, but at some point it apparently went out of business along with many other US suppliers of bicycle parts. On the whole my investors were pleased to have created 25 jobs for ten years or more by lending$100,000 which was returned in full with interest after only a few years. This model of lending at interest, often with an equity kicker equal to a percentage of revenues over some baseline, is one I have used in numerous diverse circumstances as recently as this year in order to make it as easy as possible for communities, or entrepreneurs, to accumulate their own capital.

A second example is an effort that several of us involved with the anti-apartheid group Free South Africa or FREESA, made toward the end of apartheid to redirect outside capital back into South Africa in the most useful way possible. Shared Interest was the organization we developed to support the informal economy in the townships, which had sustained life itself for half a century of apartheid and was clearly about to be ignored by a soon to be elected African National Congress government. We also helped to create the Thembani International Guarantee Fund in South Africa. We wanted to support economic efforts that served local needs rather than export markets and had wide impact. We also wanted to make sure that the borrowers we served had liabilities only in rands not in dollars. Similar to Accion we raise money from US investors for various maturities at interest rates that are half or less the current rate on comparable maturity US Agencies. We invest the proceeds in those Agencies and use them as collateral to get US banks to issue letters of credit supporting loan guarantees issued by Thembani to cover portions of loans made by South African banks in Rands to CDFIs, MFIs or stand-alone organizations with wide reach. Thembani collects a guarantee fee from the borrower and we collect a fee from Thembani for the letter of credit. So far we have helped Thembani issue partial guarantees that facilitated loans well over $100 million or 1 billion rands. None of our investors has lost anything since we started in 1994. This is because of low default rates and reserve funds built up partly from our operating surplus but primarily from grants or interest free loans contributed for that purpose by foundations and churches. We calculate that we have made it possible for more than two million South Africans to obtain a job or a home. Still, I don't think of it as a great success since we have failed to redirect private capital or social attention to the still vital informal economy; although we certainly have helped the handful of banks that dominate the economy overcome their initial aversion to making any loans to township residents.

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Robert Zevin is the Chairman of Zevin Asset Management and has been a leader in socially responsible investing since he started the first investment advisory firm specializing in such work forty-four years ago.