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Impact Investing: What Exactly Is New?

By Roger Frank

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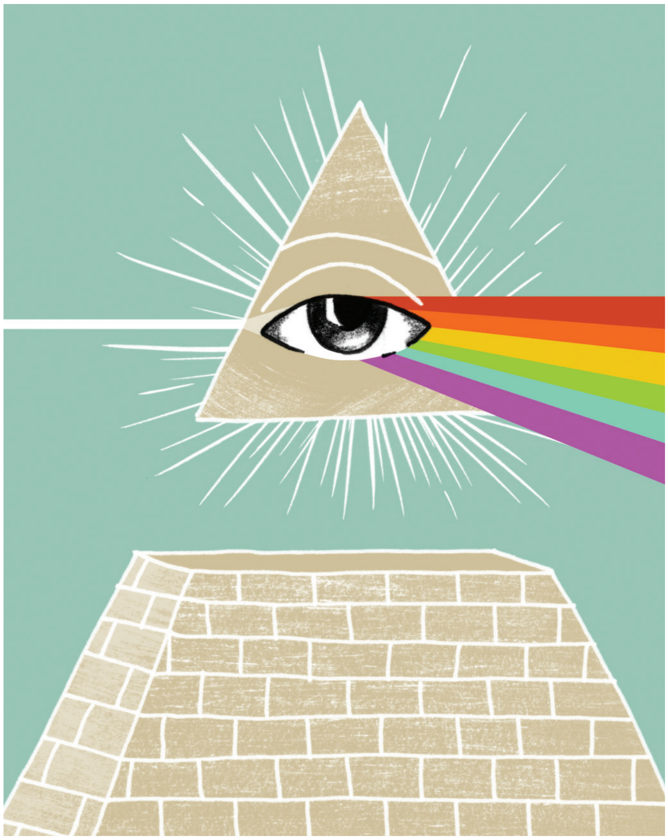
Impact Investing: What Exactly Is New?

A veteran of the microfinance industry looks at impact investing through the lenses of history, language, and psychology BY ROGER FRANK



As I walked out of the conference room with a handful of annual reports from some of the largest Latin American-based microfinance institutions, I muttered to my partners in disbelief, "These numbers can't be real." It was the fall of 2004. I had spent 20 years traveling the globe with investors, had sat in hundreds of meetings with management from leading international banks, and was pretty sure that there was no such thing as a financial institution with these types of ratios.

I was wrong. These financial institutions, which lent to poor women in emerging markets to start their own businesses, were a damn good investment. Period.

I first became aware of microfinance in the early 1990s while in discussions with several South African banks, which following apartheid were doing a strategic review of potential new customers, including microfinance borrowers. I had left a two-decade career on Wall Street to join Developing World Markets, a boutique investment firm that was in the process of structuring what would become the first cross-border capital markets transaction for microfinance. Eventually, the transaction would serve as the model that brought billions of dollars into the field.

Although I knew the basics of microfinance, back in 2004 it was time for a graduate-level course. I locked myself in a conference room with a stack of annual reports from microfinance institutions and enough food and water to last a week. Fifteen minutes later, and one inch into the stack of annual reports, I had my microfinance epiphany. Although the positive social benefits of microfinance were well known, there was very little information, and significantly less market understanding, about the pure investment features of these financial institutions and their unique customer base.

There were two parts to completing the first microfinance bond offering. First, creating it. Second, selling it. Sadly, despite what we thought was some very exciting financial innovation, the phone was not ringing off the hook with investors looking for "a market-rate, emerging market fixed income investment with low volatility that also had a positive impact on people's lives." The same now seems to be true with impact investing, a newer financial strategy also devoted to triple bottom line results that is the subject of increasing buzz. This has made me wonder: Why is impact investing growing so slowly? And is impact investing really something new or just the new packaging of an old idea?

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"Kumbaya" without a sale

Let's start with a definition. According to the Monitor Group, impact investing is "placing capital in business and funds that can provide solutions at a scale that purely philanthropic interventions usually cannot reach." Other definitions are broader and include crowdsourced donations, foundation grants, venture philanthropy, and for-profit and nonprofit funding that spans "mission first" impact investors and "return first" impact investors.

But what does this mean in practice? Let's return to the first microfinance bond for a partial answer. After structuring that bond, we asked a question to find buyers: "Who cares?" It didn't take long to realize that foundations would be natural targets. I began to contact several foundations with a stated interest in global economic

ILLUSTRATION BY SHANNON MAY

development or poverty alleviation, and I was able to arrange several appointments.

I'll never forget my first meeting. By the time it was over, we had pushed the desks away and were sitting cross-legged on the floor, singing "Kumbaya." I knew I had made the sale, or so I thought until I heard the next words: "I love what you're doing, but we don't invest. We give money away. You need to meet with Charlie, our chief investment officer. Let me introduce you."

I picked up my briefcase, straightened my tie, and walked down the hall to meet Charlie. Before I even sat down, I knew I had lost the sale. It was the pictures of the women lining his walls—vegetable growers, bakers, soup sellers, and seamstresses—that did it. I knew investment in these women did not fit his definition of "fiduciary responsibility." Charlie cleared his throat while he found his words: "We have a fiduciary responsibility to maximize returns and could never consider investing in something like this." Little did it matter that the only reason Charlie had this job was that the foundation was committed to poverty alleviation.

As I prepared for my next foundation meeting, I knew I had to rework my pitch. I still started out on the program side, and once again we pushed the desks away, sat cross-legged on the floor, and sang "Kumbaya" as we discussed global poverty alleviation. It was not a surprise to hear the same refrain: "We don't invest, we give money away." But this time I was prepared.

As I walked down the hall to meet Charlie II, I ripped out the first five slides of my presentation and stuffed them into my briefcase. After the introductory chitchat, I shifted into institutional investor sales mode.

"Do you invest in emerging markets?" I asked Charlie.

"Of course we do. We're trying to run a well-diversified investment portfolio, and exposure in emerging markets is part of our strategy," he answered in a patronizing tone.

"Do you have exposure to any banks or financial institutions in your portfolio?"

This time, the tone was almost hostile: "Yes. Of course!"

"Well," I said, pausing for effect, "would you be interested in investing in an emerging market financial institution that is growing at 50 percent and has a return on equity of 30 percent, a return on assets of 5 percent, and a default rate of less than 1 percent?"

"Yes. Of course," I heard again. But this time, I sensed that he was hooked.

Although I still didn't make the sale, I slowly have been able to make the idea of investing in a microfinance institution safer and sexier. It took several years for the phone to start ringing, which didn't happen with any frequency until after Muhammad Yunus won the Nobel Peace Prize in 2006. It's amazing how much smarter I became in the eyes of investors that day.

"Hey, Roger, what was that 'micro stuff' you were telling me about?" asked several people who previously had led me to their office door.

MONEY, NOT SOCIAL CAUSE, TALKS

So why are Charlie and Charlie II, my would-be investors in microfinance, important to an understanding of impact investing? They show that the language of finance is a one-way street. The vocabulary of impact investing, with its emphasis on helping people rather than earning money, tends to make commercial investors skittish.

Although understanding the issue of language is a start, what's philosophically new about impact investing? Does it significantly differ from many examples of commercial finance? To answer this question, let me provide some examples.

I started on Wall Street in 1986, when the number of international investors based in the United States could be counted on one hand with a few extra fingers to spare. One of our analysts at Moseley Securities started to cover a then obscure Mexican phone company called Telmex that was selling for 6 cents a share. We could never tell what earnings per share were going to be, because Telmex had a policy of giving away shares with each new telephone. We still had enough information, however, to make a palpable investment case. We sold the stock on the basis of growth, opportunity, market potential, and, yes, limited financial information. Through the rearview mirror of impact investing, I've often wondered how much stock I would have sold if my pitch had been: "We're trying to create economic opportunities and enhanced social networks by providing an improved telecommunications network."

My experience in the fall of 1998 provides another example. The Russian markets had blown up that summer and the capital markets were virtually shut. We had a problem. The Polish government was trying to raise a billion dollars by privatizing its phone company, and my firm, Wertheim Schroder, was the leading broker selected for this herculean task. I'll never forget the month I spent traveling the continent in a private jet with the management of TPSA, the Polish telecommunications monopoly, including the day I had each meal in a different time zone. We were able to complete the transaction for more than $700 million and reopened the Eastern European capital markets in the process. I wonder how much stock I would have sold if my pitch had been: "We're trying to support a young democracy and foster a free and civil society through an improved telecommunications network."

Although these commercial examples had strong social benefits, there is a confluence of trends that bodes well for impact investing, notably the growth of socially responsible investing, corporate social responsibility, and environmental, social, and governance reporting. Impact investing has brought attention to the fact that addressing a basic need through a commercial enterprise is fundamentally a good idea. What has complicated the more widespread acceptance of impact investing is not the concept—it's the introduction of "new" investment vocabulary, "new" nonfinancial objectives, and "new" legal structures, which are all obstacles to attracting capital from traditional, risk-averse investors.

I think I got my answer to the question about whether impact investing is emperor's new clothing the day I started helping my 12-year-old son prepare for his Bar Mitzvah. We were reading Leviticus 23:2. A farmer, in planting his field—a very commercial enterprise—was instructed by a Greater Authority: "And when ye reap the harvest of your land, thou shalt not make clean riddance of the corners of thy field when thou reapest, neither shalt thou gather any gleaning of thy harvest: Thou shalt leave them unto the poor and to the stranger."

Sounds like impact investing to me. ■