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The rise of impact investing

Rekha Unnithan, CFA, CIMA
Portfolio Manager
Impact Investing

Executive summary

Historically, investors looking to have a positive social impact have had a limited set of opportunities to do so while also earning a competitive return on their investment. In recent years, the emergence of impact investing has joined those twin ambitions by bringing market-based discipline to address some of society's most pressing problems.

Impact investing puts investor capital to work directly in organizations, companies or projects whose core mission is to generate financial return alongside a measurable social impact. This approach is a distinct category of Responsible Investment (RI), which also includes using environmental, social, and governance (ESG) criteria in investment decisions, ESG-focused funds, and active ownership (Figure 1). Individuals have been drawn to impact investing because it enables them to see how their money is having a direct and measurable impact through specific projects. By contrast, the effect of other RI categories tends to be indirect and, therefore, more difficult to measure. By harnessing market forces to meet social needs and generate returns, impact investing also addresses a key challenge of traditional philanthropy—the reliance on temporary or limited grants and donations. While philanthropy remains essential for funding non-investable projects, impact investing expands the resources available for addressing environmental and social needs.

Figure 1. Impact investing is one of four approaches to responsible investment (RI)

Impact investing	Investments made with a goal of financial return and measurable social or environmental outcomes.
ESG integration	Considering environmental, social and governance (ESG) factors in investment research and decisions.
ESG-focused funds	Portfolios that explicitly include ESG criteria in the investment decision-making approach.
Active ownership	Investors using their influence to improve issuers' ESG management, performance and disclosure.

The GIIN survey showed $15.2 billion in commitments to impact investments in 2015 and plans to increase this by 16% to $17.7 billion in 2016.

Capital committed to impact investments has been rising in recent years, with 2016 on track to outpace previous years' investments. According to the Global Impact Investing Network's (GIIN) annual survey of impact investors, respondents committed a total of $15.2 billion to impact investments in 2015 and plan to increase capital commitments by 16%, to $17.7 billion, in 2016.[1]

A deeper look at impact investing

Impact investments often aim to address some of the world's most pressing challenges, including sustainable agriculture, clean technology, affordable housing and access to healthcare. When concentrated in regions with the greatest need, this capital flow has the potential to improve the lives of millions.

Measurement

A hallmark of impact investing is the commitment on the part of investment managers to measure and report the social and environmental performance of underlying investments, ensuring transparency and accountability for stakeholders. Although approaches will vary based on investors' objectives and capacities, best practices for measuring impact include:

1. **Setting goals:** establishing and stating social and environmental objectives to relevant stakeholders
2. **Selecting metrics:** setting performance targets related to these objectives using standardized metrics wherever possible
3. **Collecting and analyzing data:** monitoring and managing the performance of investments against these targets
4. **Reporting:** communicating the social and environmental performance to relevant stakeholders

Of course, measuring the impact of social and environmental investments is much more complex in practice. It requires the integration of social and environmental considerations into investment management processes, and tight collaboration between multiple parties. For this reason, many impact investors choose to make their investments through asset managers and other partners with the infrastructure and capabilities to manage the process and monitor performance.

Most impact investors surveyed by GIIN expect competitive market-rate returns on a risk-adjusted basis.

Return expectations

Impact investing has a wide range of return expectations as the category includes financial assets across the risk spectrum in both emerging and developed markets. Notably, most investors surveyed by GIIN in 2015 pursue competitive, market-rate returns on a risk-adjusted basis (Figure 2).

Figure 2. Most impact investors expect risk-adjusted market rate returns

Target financial returns principally sought by number of respondents

Source: Global Impact Investing Network (GIIN), 2016 Annual Impact Investor Survey.

Opportunities to make an impact

Technological advances across the globe have made it easier for values-oriented investors to connect with innovative entrepreneurs who can provide solutions to societal problems while operating profitably. Three thematic areas in particular stand out for their potential social impact and opportunity to generate returns: inclusive finance, community and economic development, and affordable housing.

Inclusive finance

The United Nations defines financial inclusion as “universal access, at a reasonable cost, to a wide range of financial services, provided by a variety of sound and sustainable institutions.” As such, inclusive finance plays a crucial role in reducing poverty and supporting a healthy global economy. Despite recent strides in access to banking services across the globe, two billion adults remain without banking access of any kind,[2] and small- and medium-sized businesses continue to struggle to secure funding from traditional sources. The need is particularly great for low-income and rural populations, where access is further limited by socioeconomic or geographic barriers.

Impact investments in inclusive finance make high-quality, fair, transparent and affordable financial services widely available to underserved populations and enterprises across the globe. In the case of individuals, better access to financial products and services may help them accumulate assets and improve their livelihoods. Smaller enterprises can bring their ideas to market, create new jobs and fuel economic development when they gain access to non-traditional sources of financing. Companies in emerging and frontier markets, including

Carver Federal Savings Bank offers check cashing and other financial services at significant discounts in New York's underserved neighborhoods.

Africa, Asia and Latin America, may offer attractive returns on early-growth private equity impact investments in inclusive finance. But the opportunity also extends to certain sectors in developed and developing markets that suffer from market gaps in availability or quality, including microfinance, micro-insurance, mobile payments and education investments.

Carver Federal Savings Bank, the largest African-American-operated bank in the U.S., has deployed impact investing funds to make basic transaction services such as check cashing and money orders affordable for the chronically unbanked or underbanked in New York. The Carver Community Cash program offers significant discounts to the high fees charged by check-cashing agencies in neighborhoods such as East Harlem, saving customers as much as $40 a month and encouraging many of them to open a savings or checking account.[3] In addition, Carver is developing a series of new products—including secured loans, unsecured loans and lines of credit—that will provide an alternative to high-cost payday lenders.

Community and economic development

Investments in community and economic development focus on funding business models that provide enhanced access to essential services for low-income, economically distressed areas that are often ignored by mainstream financial institutions. Targeted services include child care, education, healthcare and environmental improvements that are necessary for individuals and businesses alike to succeed. These investments are designed to capitalize on alternatives to underserved markets, both in the U.S. and abroad.

In India, for example, Aavishkaar Venture Management[4]—a firm supporting development in underserved regions—invested in a company that helps rural farmers increase their incomes. AgroStar developed a direct-to-farmer, mobile-based platform that sells seeds, crop protection and hardware at discounts of 5% to 25%. Sourcing directly from manufacturers avoids distribution markups and provides access to genuine, better quality supplies. The company also has qualified agronomists who provide technical advice to help farmers improve crop yields.

Affordable housing

Preserving and recapitalizing affordable properties is essential to fostering vibrant, healthy and diverse communities. Yet the number of cost-burdened U.S. renters—those paying more than 30% of their income to housing—reached a record high of 21.3 million in 2014, with 83% of low-income households (those earning less than $15,000 annually) paying more than 50% of their income for housing.[5] As the number of cost-burdened renters continues to rise, access to affordable housing will become increasingly important, particularly for low-income and underserved populations in urban areas, where demand continues to outpace supply.

Impact investments in this area aim to maintain reasonable levels of housing affordability, improve housing assets' physical condition to ensure long-term stability, reduce the environmental footprint of the property through green retrofits and help to stimulate economic development in the surrounding community. The effort is focused largely on investment opportunities in the U.S., although international opportunities may also be considered.

In particular, markets with a high cost of living are prime candidates for impact investments because they directly address declines in the stock of affordable housing caused by gentrification. Private capital helps fund mixed-income projects, rent-stabilized, rent-controlled and Section 8 housing,[6] and Low Income Housing Tax Credit projects that enable property transformation and value creation. These investments may offer financial stability through their affordability component and potential upside through their market-rate component.

For example, a mixed-income property located in a rapidly gentrifying neighborhood of Washington, DC recently avoided conversion to market-rate housing thanks to funding from impact investors. The Jonathan Rose Companies and its partners, the National Housing Trust and Somerset Development, purchased the Channel Square apartment community, working closely with the tenant association to maintain rents at or below 50% of the area's median income (AMI) for a third of its units and below 80% of AMI for another third.[7] The organization is using additional impact funds to make green retrofits that will lower the building's operating costs, improving profitability and enhancing residents' overall comfort.

Understanding the risks and barriers

Although interest in impact investing is rising, the industry is still relatively new and, as a result, operates largely in uncharted territory. Very few investment managers offer established track records and experience that are essential to effective implementation of an impact investing strategy. As a result, impact investing has a unique set of risks that should be considered as part of investors' due diligence:

- **Capital risk:** The investment can be lost if a project fails or falls short of financial objectives.
- **Exit risk:** Investments are often relatively illiquid and difficult to sell if cash is needed.
- **Risk of the unknown:** Investors may be unable to determine the full range of potential risks before committing capital.
- **Impact risk:** The intended social impact might not be achieved.
- **Transaction cost risk:** The potential cost of due diligence, measurement and ongoing monitoring may be excessive relative to a project's size.

Although no investment is free from risk, selecting an impact investment manager with industry experience and a proven track record can help to manage potential risk exposure.

Conclusion

Impact investing has become a recognized approach for addressing some of society's most pressing problems, particularly in inclusive finance, community and economic development, and affordable housing. Increasingly, investors are attracted by impact investing's potential to produce measurable social benefits alongside financial returns. In addition, projects that are financially self-sustaining have strong potential for endurance, growth and expanding benefits. The search for solutions is likely to result in broader adoption of impact investing's twin goals for financial and nonfinancial returns.

To learn more about TIAA Global Asset Management, visit **TIAA.org/assetmanagement** or speak with your relationship manager.

1. Global Impact Investing Network (GIIN), "2016 Annual Impact Investor Survey."
2. The World Bank, "The Global Findex Database 2014: Measuring Financial Inclusion around the World."
3. Michael T. Pugh, CEO, Carver Federal Savings Bank, "Making Banking Accessible," Interagency MDI & CDFI Bank Conference, July 14, 2015.
4. Aavishkaar Impact Report 2015, Aavishkaar Venture Management Services.
5. Joint Center for Housing Studies of Harvard University, "The State of the Nation's Housing 2016."
6. A housing voucher program administered by the U.S. Department of Housing and Urban Development (HUD) to assist very low-income families, the elderly, and the disabled to afford housing in the private market. The program permits families or individual participants to find their own housing, including single-family homes, townhouses and apartments. Participants are free to choose any housing that meets the requirements of the program and is not limited to units located in subsidized housing projects.
7. Jonathan O'Connell, "Developers purchase Channel Square Apartments in SW, plan 'green' renovations," *The Washington Post,* December 11, 2013.

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