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Paul Brest
Stanford Law School, pbrest@stanford.edu

Ronald J. Gilson
Columbia Law School, rgilson@law.columbia.edu

Mark A. Wolfson
Stanford Graduate School of Business

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ESSAY

How Investors Can (and Can't) Create Social Value

Paul Brest,* Ronald J. Gilson** & Mark A. Wolfson***

I. INTRODUCTION

Most investors throughout the world have a single goal: to earn the highest risk-

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* Paul Brest is former president of the William and Flora Hewlett Foundation and professor emeritus (active) at Stanford Law School.
** Ronald J. Gilson is the Stern Professor of Law and Business at Columbia Law School and the Meyers Professor of Law and Business emeritus at Stanford Law School.
*** Mark Wolfson is a founder and Managing Partner of Jasper Ridge Partners, President of Jasper Ridge Charitable Fund, and Adjunct Professor in Accounting and Finance at the Stanford Graduate School of Business.
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adjusted financial returns. They would not accept a lower financial return from an investment that also produced social benefits.

More recently, an increasing number of *socially-motivated* investors have goals beyond maximizing returns.[1] They also seek to align their investments with their social values (value alignment), and some also seek to cause the companies in which they invest to create more social value as a result of their investment (social value creation). We show in this essay that while it is relatively easy to achieve value alignment, creating social value is far more difficult.

Socially-motivated investors who seek value alignment prefer to own stocks only in companies whose business and practices accord with their moral or social values. Independent of whether their investment affects the company's behavior, these investors wish to conform their investment behavior with their social values by owning the stock of companies that share them or refusing to own the stock of companies that do not.

Value-aligned investors may be concerned with a firm's *outputs*—its products and services. For example, they might want to own shares in an energy company that relies on renewable resources and avoid owning shares in an energy company that relies on fossil

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1. The most common reference for the amount of assets under management that take socially-related issues into account in their investment strategies is that offered by the US SIF. US SIF & US SIF FOUND., REPORT ON U.S. SUSTAINED, RESPONSIBLE AND IMPACT INVESTORS TRENDS 12–13 (11th ed. 2016), https://www.ussif.org/files/SIF_Trends_16_Executive_Summary.pdf. It reports that assets under management within three categories—sustainable, responsible and impact investing—increased from $6.57 trillion as of January 1, 2014 to $8.72 trillion on January 1, 2016, representing some 20% of U.S. assets under management. *See, e.g.*, MORGAN STANLEY & CO., INVESTING WITH IMPACT, CREATING ECONOMIC, SOCIAL AND ENVIRONMENTAL VALUE (2017), https://www.morganstanley.com/assets/pdfs/articles/investing-with-impact.pdf (adopting SIF calculation). This quantification establishes that an expansive construction of the environmental, social and governance categories (ESG) results in a substantial amount of assets that fall into this very broad bucket. Fund Directions, a mutual fund trade publication, brings part of the calculation current by reporting that ESG-focused public mutual funds had $2.9 billion in positive net investment inflows during 2017, compared to $4.8 billion during 2016, in both cases during periods when actively managed general equity mutual funds lost large amounts of assets. Yun Li, *Morningstar: Demand for Sustainable Investing Soars*, FUND INVS. (July 10, 2017, 12:30 PM), http://fundintelligence.global./fundaction/news/morningstar-demand-for-sustainable-investments-soars. (Subscription req.) Calendar year 2017 also saw five new ESG funds launched that offer investors more choices focusing on sustainable portfolios. Hank Boerner, *Morningstar Now Informs Investors About ESG/Sustainable Mutual Funds – And The Good News is That ESG Funds' AUM Continues to Grow*, GOVERNANCE & ACCOUNTABILITY INST.: SUSTAINABILITY UPDATE (Oct. 24, 2017), https://ga-institute.com/Sustainability-Update/2017/10/24/morningstar-now-informs-investors-about-esgsustainable-mutual-funds-and-the-good-news-is-that-esg-funds-aum-continues-to-grow. A related but one-off measure of investor interest in more than financial return is the growth in the number of financial terminal clients who access ESG data for their analysis. For example, Bloomberg reports that the number of its global clients who seek such information reached 12,242 in 2016, having grown from 3010 in 2010. The 2017 number represents approximately 3.7% of the total number of Bloomberg's subscribers. *See* BLOOMBERG, 2016 IMPACT REPORT (2016), https://data.bloomberglp.com/company/sites/28/2017/05/17_0516_Impact-Book_Final.pdf. However, as we discuss in more detail in the remainder of this essay, ESG, broadly defined, lumps together very different activities; for example, traditional fundamental analysis in the oil and gas industries necessarily involves assessment of the impact of climate change on future fossil fuel demand. Including as ESG-managed assets, the funds managed by investors who engage in fundamental oil and gas research and who care only about financial returns is something of a stretch. This distinction is important, however, in assessing the recent proxy voting of very large mutual funds. *See generally infra* note 45–47. ESG managed funds are better understood as facilitating value-aligned investors to identify appropriate investments regardless of the impact of those values on risk-adjusted expected financial returns.

fuel.[2] Other value-aligned investors might avoid owning shares in companies that manufacture firearms or tobacco products. Or the investors may be concerned with a firm's *practices*—the way it produces its outputs. They might want to own shares in companies with high environmental, social and governance (ESG) standards, and eschew companies with poor ESG ratings.[3] Value-aligned investors must only examine their personal values and then learn whether a company's practices promote or conflict with those values. They then would assess the cost of value alignment by comparing the return on a portfolio affected by these value-aligned weighting considerations compared to an otherwise comparable unconstrained portfolio.[4]

Investors who wish to *create* social value begin with the same questions value-aligned

2. Of course, individuals have diverse views on what is socially valuable and on the appropriate tradeoff among different values. For example, those concerned with protecting coal mining jobs in West Virginia to address income inequality may value supporting low income communities through support for clean coal more highly than concern over greenhouse gas emissions. Thus, when we refer to social value throughout this article, we mean the particular investor's values rather than any universal principles.

3. For example, B Analytics Ltd. publishes ESG ratings, *see GIIRS Funds*, B ANALYTICS, http://b-analytics.net/giirs-ratings (last visited Mar. 3, 2018), and Morningstar publishes sustainability ratings, *see Special Report: Morningstar Sustainability Rating*, MORNINGSTAR, https://www.morningstar.com/articles/745467/morningstar-sustainability-rating.html (last updated Aug. 24, 2016). *See also* CASEY O'CONNOR & SARAH LABOWITZ, N.Y.U. CTR. FOR BUS. & HUM. RTS., PUTTING THE "S" IN ESG: MEASURING HUMAN RIGHTS PERFORMANCE FOR INVESTORS (2017), https://static1.squarespace.com/static/547df270e4b0ba184dfc490e/t/58cad912e58c6274180b58b6/1489688854754/Metrics-Report-final-1.pdf (demonstrating the difficulty in identifying a rating system, focusing on the social component of ESG, and assessing 12 existing measurement techniques). Given the range of factors necessary to construct a rating structure, and the fact that different investors will weight various ESG factors differently, it is not surprising that there are many ratings systems. A recent Department of Labor study addressed to pension funds reviews the literature. *See* OGECHUKWU EZEOKOLI ET AL., SUMMIT CONSULTING, ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) INVESTMENT TOOLS: A REVIEW OF THE CURRENT FIELD (2017), http://www.dol.gov/asp/evaluation/completed-studies/ESG-Investment-Tools-Review-of-the-Current-Field.pdf.

4. Mutual funds that limit their investment options in this fashion typically will disclose the extent to which their fund's performance diverges from a benchmark that is comparable but is unconstrained. As an extreme example, the Norwegian sovereign wealth fund, with a portfolio of $11 trillion, has over the last decade gradually excluded from its portfolio the stock of companies that produce tobacco, nuclear arms, and cluster weapons. They also exclude companies that engage in coal mining and coal-fired generation. Over this period, the constrained portfolio has underperformed the unconstrained benchmark on an annual basis by six basis points (0.06%). NORGES BANK INV. MGMT., RETURN AND RISK: GOVERNMENT PENSION FUND GLOBAL (2017), http://www.nbim.no/en/transparency/reports/2017/return-and-risk-2017/ (follow the "Download the publication (PDF)" hyperlink). In a fossil fuel industry funded paper, DANIEL R. FISCHEL ET AL., FOSSIL FUEL DIVESTMENT AND PUBLIC PENSION FUNDS (2017), http://divestmentfacts.com/wp-content/uploads/2017/06/Divestment-and-Public-Pension-Funds_FINAL.pdf, have estimated that 11 large public pension funds' annual returns would have been reduced by 15 basis points (0.15%) over the previous 50 years were fossil fuel companies excluded from their portfolios. *Id.* at 3–5. Mats Andersson et al., *Hedging Climate Risk*, 72 FIN. ANALYSIS J. 13 (2016), provide a more sophisticated analysis, defining the socially-motivated investor's goal not as divestiture, but instead reducing the total carbon footprint of companies in its portfolio. Using financial engineering techniques, they show that, based on back testing, the carbon footprint of an engineered portfolio can be reduced by 40% with no tracking error compared to an unconstrained benchmark. The large empirical literature reports mixed results with respect to how much, if at all, the performance of constrained funds falls short of that of an unconstrained index. *See, e.g.*, Luc Renneboog et al., *The Price of Ethics and Stakeholder Governance: The Performance of Socially Responsible Mutual Funds*, 14 J. CORP. FIN. 302 (2008); Allen Ferrell et al., *Socially Responsible Firms*, 122 J. FIN. ECON. 585 (2016); Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. SUS. FIN. & INV. 210 (2016); Michael S. Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims underlying Socially Responsible Investment*, 57 BUS. LAW. 681 (2002).

investors do, but then must move on to the more challenging task of deploying their capital to increase an investee company's socially valuable outputs—for example, by enabling the company to provide additional health care or education to poor people in developing countries. Appropriately called "impact investments," these investments must lower the cost of capital to the investee firm compared to the cost available to the company in ordinary commercial markets, or otherwise cause it to produce more socially valuable outputs or to engage in more socially valuable practices—the criteria for creating social value.

Both investors seeking value alignment and those seeking to create social value face the initial question of what financial sacrifice, if any, they must accept to achieve their social goals. When can investors achieve these goals—value alignment or value creation—through *non-concessionary* investments, from which they expect a full risk-adjusted market-rate financial return?[5] When must the investments be *concessionary*, sacrificing some financial return to achieve social goals?

The literature published by asset managers, charitable foundations, and related trade associations manifests considerable optimism that socially-motivated investors can ensure value alignment and, indeed, create social value through non-concessionary investments. Some asset managers claim to provide their investors (at least) value alignment with no financial concession,[6] while others hold out the prospect of "excess financial return" or "alpha"—value alignment with better than risk-adjusted market returns.[7] And some asset managers promise their investors the gold ring: social value creation without sacrificing financial return.[8] Similarly, some foundations imply that they can create social value through non-concessionary investments of their endowment assets and urge their peers to follow suit.[9]

We are skeptical about many of these claims. Precisely because the socially-motivated market sector is growing so rapidly, participants on both the sell-side and the buy-side of the market label their activities in a loose fashion that reflects either their aspirations or their marketing strategies rather than measurable results.

The need for clarity and precision in defining a socially-motivated asset management strategy is highlighted by the term *impact investing*. The attractions of impact investing are obvious. Socially-motivated investors seek change, and having an impact on the direction and pace of change through one's investments resonates powerfully with that aspiration. Yet this resonance has led to a grab bag of investment strategies that all claim the same

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5. The judgments of different investors also may differ about what financial returns a particular investment is likely to produce. For our purposes, it is the particular investor's judgment that is relevant.

6. *See, e.g.*, CALVERT INVS., INC., http://www.calvert.com/ (last visited Mar. 3, 2018); *see* Andersson et al., *supra* note 4 (discussing the financial engineering necessary to construct a portfolio that significantly reduces the portfolio's carbon footprint relative to a benchmark index without meaningful tracking error; that is, without an offsetting increase in risk or reduction in return).

7. *E.g.*, GENERATION INV. MGMT., https://www.generationim.com/ (last visited Mar. 3, 2018).

8. *E.g.*, SCHULZE GLOB. INVS., http://schulzeglobal.com/ (last visited Oct. 8, 2017); EQUILIBRIUM CAP. GRP., http://www.eq-cap.com/ (last visited Mar. 3, 2018) (stating that Equilibrium Capital focuses on "sustainability-driven real assets investment strategies" and "drives economic value, portfolio advantage and . . . alpha returns through scale and effective management").

9. *E.g.*, HERON FOUND., http://heron.org/ (last visited Mar. 3, 2018). *See generally* CLARA MILLER, HERON FOUND., THE WORLD HAS CHANGED AND SO MUST WE (2012), https://www.heron.org/sites/default/files/The%20World%20Has%20Changed.pdf (explaining the purpose of the F.B. Heron Foundation).

mantle but with more or less precision and evidence of impact. The core of asset management is evaluation and benchmark comparison. Absent a clear framework for the strategy and, hence, a well-defined benchmark against which portfolio returns should be measured, neither evaluation nor comparison is possible. Without both, the socially-motivated investment market segment will suffer.

We do not doubt that with care and skill, it is possible to achieve value alignment with limited financial concessions over time.[10] But while we disagree with those who define impact investing to include only concessionary investments, it is in our view very difficult to create social value through one's investments while nonetheless earning full (socially-neutral) risk-adjusted and illiquidity-adjusted financial returns. In any event, we believe that the term "impact investor," as its name implies, should be reserved for investors who seek social value creation rather than simply value alignment. The social investing field can grow responsibly only if individual investors, impact investing trade associations, and asset managers are candid with themselves and others about the conditions necessary for real impact.[11]

In this Article, we first address the problem of imprecise terminology that presents a barrier to important issues actually being joined. In particular, we address a range of terms that are commonly and confusedly used in the social investing community. We then present a straight forward taxonomy of socially-motivated investments that identifies what should count as impact investing and how that framing relates to concessionary and non-concessionary investments.

Such a taxonomy allows investors to articulate their goals and allows asset managers to articulate clearly what they offer and how their performance should be measured. Putting forward a clear taxonomy is not, as a commentator on an earlier version of this Article put it, "prescriptive."[12] There are many ways to make important contributions, but the field badly needs a benchmark against which claims of social value creation can be measured. Specifying that benchmark allows the actual debate to begin.

We next address three big questions in that debate. First, can investments in public companies achieve value alignment or create social value, whether or not with concessions on return? Second, can investments in private companies create social value, again whether or not with return concessions? Third, can socially-motivated investors working with other stakeholders cause public companies to create social value?

Our conclusions are as follows:

- *Impact investments in public markets.* It is virtually impossible for investors to affect the outputs or behavior of firms whose securities trade in public

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10. *See generally* Andersson et. al., *supra* note 4 (presenting an investment strategy designed to allow "long-term passive investors to hedge climate risk without sacrificing financial returns").

11. *See* Brian Trelstad, *Impact Investing: A Brief History*, 11 CAPITALISM & SOC'Y 1, 3 (2016), http://capitalism.columbia.edu/journal/11/2-0 (click on article title link) (noting that standard definitions of impact investing are so broad "that it is hard to identify what is an impact investment and what is not").

12. *See* Nancy E. Pfund & Lisa Alexander, *Response to "How Investors Can (and Can't) Create Social Value*," STAN. SOC. INNOVATION REV. (Dec. 8, 2016), https://ssir.org/up_for_debate/how_investors_can_and_cant_create_social_value/pfund_hagerman ("[T]here does not have to be a sacrifice between achieving top-tier financial return and possible positive social and environmental impacts.").

markets through buying and selling securities in the secondary market. Socially-motivated investors who seek to improve ESG performance or otherwise increase the social value produced by a public company must join forces with consumers, employees, corporative activists, and regulators to affect portfolio company behavior. The recent success of climate change-related proxy proposals at major oil companies illustrate the point:[13] portfolio strategy alone will not work. Finally, secondary investments in public markets are inevitably non-concessionary save through the loss of portfolio diversification.

- *Concessionary investments in private markets.* It *is* possible, however, for impact investors to affect the outputs of firms in private market transactions by accepting financial returns below those required by socially-neutral investors. Foundations' program-related investments are paradigmatic of such subsidies.
- *Non-concessionary investments in private markets.* It is also possible for impact investors to affect the outputs of private firms through non-concessionary investments by taking advantage of private knowledge that they or their asset managers possess. However, non-concessionary investors' claims to have private information should be taken with a grain of salt. These investors are playing in a highly competitive game against the universe of private equity investors whose success depends on developing value-relevant private information regardless of the strategy.

II. THE TERMINOLOGY OF FOUNDATIONS AND OTHER PROFESSIONAL SOCIALLY-MOTIVATED INVESTORS[14]

The first step in our analysis addresses the imprecise and confusing terminology used by foundations and other professional socially-motivated investors, as well as asset managers who seek their patronage. This imprecision creates a barrier to debate and, more important, to assessment. Readers will note that elements of this common terminology often overlap. Next, in Part II we focus on the term impact investment and specify what investments can and cannot create social value. Part III addresses concessionary and non-concessionary investments. This precision permits investors to articulate their goals clearly, and allows asset managers to articulate what they offer clearly and, most important, how their performance should be measured.

A. Unpacking Common Terminology

Impact Investments are socially-motivated investments made for the purpose of increasing or improving the socially-valuable outputs and practices of investee enterprises: for example, manufacturing anti-malaria bed netting or reducing greenhouse gas emissions. In our terms, these investments seek to create social value. Impact investments can be made by all types of investors: foundations, family offices, endowments, funds, and individuals. As we discuss in Part II, social value is created *only* by increasing the amount of an investee company's socially beneficial outputs or their quality rather than just aligning the

13. *See infra* pp. 120–21.
14. *See* MISSION INV'RS. EXCH., INC., https://www.missioninvestors.org/ (last visited Mar. 3, 2018).

investors' portfolio decisions with their social values. This necessary causal link between the investment and an increase in socially-desirable outputs is commonly blurred in the social investment community.[15]

Impact investments may be concessionary or non-concessionary. Some investment funds, such as Equilibrium Capital, claim to create social value and also claim to be non-concessionary, targeting market returns.[16] Others, such as Acumen Fund,[17] expect to earn less than market returns as the price of creating social value. And some, such as Bridges Ventures UK and Omidyar Network,[18] consider both types of investments, thereby holding out the potential of non-concessionary returns. The significance of this distinction is discussed in Part III.

Mission, or *mission-related*, *investments* refer to investments made by a foundation in pursuit of its charitable mission. They fall into two categories:

- *Non-concessionary mission investments* have the primary purpose of generating financial returns to fund the socially-motivated investor's programmatic efforts but are limited to companies whose outputs or practices are consistent with the foundation's mission.[19] Non-concessionary mission

15. The confusion over what is included in the impact investment category may reflect the apparent absence of attention in the academic community. Robert Robb and Martine Sattell report that based on all issues of six "top" economics and finance journals (AM. ECON. REV., ECONOMETRICA, J. FIN., J. ECON. LIT., J. POL. ECON., Q. J. ECON.) available on JSTOR, not a single article uses the term "impact investing." Robert Robb & Martine Satell, *Socially Responsible/Impact Investing: Theoretical and Empirical Issues*, CAPITALISM & SOC'Y (2016). Morgan Stanley & Co., for example, provides a good example of why precision is needed. Its overall ESG platform is titled *Investing with Impact: Creating Economic, Social and Environmental Value*. When one reads further, the prospective investor is advised that only private market investments are held out as having the potential to create value. This casual usage of the term impact investment can at best confuse investors and at worst mislead them. *See* MORGAN STANLEY & CO., *supra* note 1.

16. *See* EQUILIBRIUM CAPITAL GROUP, *supra* note 8 (fund claims to create social value and be non-concessionary).

17. *See* ACUMEN FUND INC., http://www.acumen.org/ (last visited Mar. 3, 2018) (fund claims to earn less than market returns in order to create social value).

18. *See* BRIDGES FUND MGMT., LTD., http://www.bridgesfundmanagement.com/us/ (last visited Oct. 8, 2017) (making both claims); OMIDYAR NETWORK, http://www.omidyar.com (last visited Mar. 3, 2018) (making both claims).

19. Under a 2015 interpretation of I.R.C. § 4944, Investments Made for Charitable Purposes, the IRS advised that "[u]nder the regulations, an investment made by a private foundation will not be considered to be a jeopardizing investment [and so subject to excise tax] if, in making the investment, the foundation managers exercise ordinary business care and prudence (under the circumstances prevailing at the time the investment is made) in providing for the long-term and short-term financial needs of the foundation to carry out its charitable purposes." I.R.S. Notice 2015-62, 2015-39 I.R.B. 411, https://www.irs.gov/pub/irs-drop/n-15-62.pdf.

Outside the tax area, the Delaware Uniform Prudent Management of Institutional Funds Act, DEL. CODE ANN. tit. 12, §§ 4701–4710 (2007), from which most U.S. nonprofits derive their guidance, takes much the same position as the IRS. Delaware explicitly requires that persons making investment decisions on behalf of an institution consider the institution's charitable purpose, characterizing this as a "fundamental duty." Under standard features of Delaware corporate law, this would require the board to consider whether the foundation's purpose warranted accepting a lower financial return to achieve a charitable purpose (and vice versa). That decision would be protected by the business judgment rule. To our knowledge, the Delaware Attorney General has never made an allegation of imprudence with respect to Delaware nonprofits' social impact investments.

In contrast, the Labor Department, which administers the Employee Retirement and Security Act (ERISA), is significantly more restrictive than either the IRS or Delaware. Plan fiduciaries that are subject to ERISA may take ESG considerations into account in making portfolio decisions *only* if doing so does not negatively impact investment returns. Thus, such pension funds may not make concessionary investments: "Under ERISA, the plan trustee or other investing fiduciary may not use plan assets to promote social, environmental, or other public investments seek at least value alignment but with market-rate risk-adjusted returns.

- *Concessionary mission investments* are typically made as *program-related investments (PRIs)*. This category is a construct of the U.S. Internal Revenue Code, which requires that PRIs' primary purpose be to further the foundation's charitable purposes rather than only to secure financial returns even if the returns will be used to further the charitable purpose. For example, it is highly unlikely that a foundation would invest in the public bond market though it might well use a PRI to finance a social impact bond that addressed one of the foundation's charitable purposes, or more generally make concessionary investments in debt instruments for the same purpose.[20] Like grants, PRIs count toward a foundation's required annual mission-related payout of five percent of its endowment. And like grants, PRIs seek to create social value, that is, to increase or improve the investee's socially-valuable outputs.

Socially-responsible investments are investments whose primary purpose is to generate financial returns that are consistent with certain values—what we have called value alignment investing. These include, for example, investments in companies that engage in good ESG practices that may be independent of a foundation's particular mission. For example, a foundation whose charitable purpose does not include environmental improvement, or a university, may still prefer not to hold stock in fossil fuel companies; hence, the familiar targeting of universities in divestiture campaigns. Thus, socially responsible investing also includes divesting from, or not investing in, companies whose outputs (e.g., alcohol, tobacco, firearms, or gambling) or business practices (poor treatment of employees or environmental degradation) conflict with the investor's values.

Most socially responsible investments take place in public markets, for example,

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policy causes at the expense of the financial interests of the plan's participants and beneficiaries. Fiduciaries may not accept lower expected returns or take on greater risks in order to secure collateral benefits." 29 C.F.R. § 2059.95-1 (2015). Under the 2015 Interpretive Bulletin, one would expect, however, that a good faith belief by the trustees based on reasonable diligence as to the non-concessionary character of an investment would protect them from liability, thus narrowing somewhat the difference between the standards. Ning Chiu et al., *The Impact of DOL Guidance on ESG-Focused Plans*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May. 8, 2018), https://corpgov.law.harvard.edu/2018/05/08/the-impact-of-dol-guidance-on-esg-focused-plans/. The risk, of course, is that the ambiguity may suggest a more intrusive regulatory review and a higher likelihood of trustee liability. One might wonder whether the game is worth the candle. Max M. Schanzenbach & Robert H. Sitkoff, *The Law and Economics of Environmental, Social, and Governance Investing by a Fiduciary* (Harv. L. Sch. John M. Olin Ctr. for Law, Econ., & Bus. Discussion Paper Series, Discussion Paper No. 971, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244665 (click "Download This Paper"), (reviewing the legal standards applicable to trustees under trust law and ERISA, and review the empirical literature concerning whether taking ESG considerations into account reduces portfolio returns).

20. A social impact bond is a form of pay for performance contract in which a government contracts with an expert organization to plan and execute a social project in which the expert is paid based on achieving milestones specified in the contract, for example, reducing recidivism among released prisoners. The expert's efforts are funded through bonds under which payments are made only if the project meets its contractually specified milestones. Foundations do invest in funding such bonds. *See generally* JEFFREY LIEBMAN & ALINA SELLMAN, HARVARD KENNEDY SCH. SOC. IMPACT BOND TECH. ASSISTANCE LAB, SOCIAL IMPACT BONDS: A GUIDE FOR STATE AND LOCAL GOVERNMENTS 1, 8 (2013), https://govlab.hks.harvard.edu/files/siblab/files/social-impact-bonds-a-guide-for-state-and-local-governments.pdf.

through public mutual funds that impose a screen on their portfolios to exclude companies whose activities are antithetical to the values of many socially-motivated investors. These funds hold themselves out to investors as being capable of earning non-concessionary returns—they are expected to earn at least risk-adjusted market returns.

III. IMPACT AS A REQUISITE OF SOCIAL VALUE CREATION

To say that a socially-motivated investment *creates* social value is to say that the investment produces a *social impact*—that is, an outcome that would not occur *but for* the investment. In the language of evaluation, what would happen without the investment is called the counterfactual. For an investment to actually have social impact, it must meet two conditions:

- *Enterprise impact*. The investee company must produce the investor's intended social outcomes; and
- *Investment impact*, *additionality*, or *social value-added*. The investment must increase the production of those outcomes.[21]

To illustrate enterprise impact, suppose that a socially-motivated investor invested in a company that provides health care for the poor in a developing country. Enterprise impact requires that firm-related health care professionals are in fact serving the poor (or will when its strategy is implemented) and, as a result, that their clients have (or will have) better health outcomes. As with any investment, the outcome can only be predicted when the investment is made. Here the measure is *ex post*: were the expectations met?[22]

The matter of investment impact, or as we'll call it henceforth, *social value added*, is unique to impact investing. For an investment to meet the condition of social value added, it must increase the amount or quality of the investee company's socially valuable outputs or practices compared to what they would be with only socially-neutral investments. As we will explain below, an investor who believes that mobile telephony has tremendous social and economic benefits might have social impact by investing in a risky mobile telephone startup in a developing country or in the rural U.S., but cannot have impact by buying AT&T or Verizon stock on the New York Stock Exchange. In the former case, the investor may provide essential capital that the start-up cannot get elsewhere or on the same favorable terms; in the latter case, the investment will not result in additional mobile phone access for even a single customer.

An investment can affect a business's operations in two fundamental ways: through (1) financial impact, or (2) signaling mechanisms.

Financial Impact: Assume the investor believes that the company has opportunities to increase its production of social value. An investment results in financial impact if it

21. In some cases, for example, greenhouse gas production, the desired output change is negative. While the problem can be solved rhetorically, say by framing the goal as increasing the production of carbon neutral product, in the interests of presentation we will ignore the distinction except when it has substantive consequences.

22. The challenges of assessing the social impact of for-profit enterprises are not conceptually different from assessing the impact of nonprofit organizations generally—the subject of much writing and good work in recent years. *See, e.g.*, PAUL J. GERTLER ET AL., WORLD BANK, IMPACT EVALUATION IN PRACTICE (2011) (eBook), https://siteresources.worldbank.org/EXTHDOFFICE/Resources/5485726-1295455628620/Impact_Evaluation_in_Practice.pdf; ABHIJIT V. BANERJEE & ESTHER DUFLO, POOR ECONOMICS: A RADICAL RETHINKING OF THE WAY TO FIGHT GLOBAL POVERTY (2011). There is less consensus on how those outcomes should (or can) be measured. We will not address this problem here other than to note the necessity that disciplined measurement be undertaken.

provides more capital, or capital at lower cost, than the enterprise could otherwise secure from socially-neutral investors.[23] Under these circumstances, the investment meets the criterion for creating social value.[24] Conversely, an investor's divesting of its holdings in a company would have financial impact only if it deprived a wicked enterprise (that is, one that generates negative welfare consequences to the public at large) of needed capital that it cannot replace at an equivalent cost. If the capital can be replaced at the same cost, then the divestment may create value alignment but does not create social value other than possibly through signaling impact. As we will see, divesting stock in a publicly traded company will not directly increase a wicked enterprise's cost of capital. Just as socially-neutral private equity and venture capital firms also provide non-monetary assistance, so may social impact investors, for example, by improving management and governance, fundraising, and networking. Because such assistance is almost always ancillary to providing financial impact, we will include it in this category rather than create a new one.[25]

Signaling Impact: A socially-motivated investment decision may indirectly affect an enterprise's cost of capital by signaling approval or disapproval of the enterprise's strategy and actions to consumers, employees, regulators, or other stakeholders, thereby affecting stakeholders' direct interaction with the enterprise through their purchasing, employment or regulatory decisions. The investor may also engage in "shareholder activism" by initiating or voting proxy resolutions with the goal of affecting the corporation's behavior.

IV. CONCESSIONARY VS. NON-CONCESSIONARY INVESTMENTS

As previously defined, a concessionary investment is one with a below-market risk-adjusted expected financial return. The concession is the economic equivalent of a donation or grant intended to create social value. Whether an investment by a foundation is non-concessionary or concessionary is a question of its expected risk-adjusted return, and not whether the funds come from the endowment or program budget, which is a matter of internal governance and accounting.[26]

Socially-motivated concessionary investments have the potential to reduce an enterprise's cost of capital. By definition, socially-neutral investors will not invest at below-market rates while socially-motivated concessionary investors may do exactly that.

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23. Paul Brest & Kelly Born, *When Can Impact Investing Create Real Impact?*, STAN. SOC. INNOVATION REV. 22, 22 (2013).

24. *See, e.g.*, BRIDGES FUND MGMT, BRIDGES IMPACT REPORT: A SPOTLIGHT ON OUR METHODOLOGY (2013), http://www.bridgesfundmanagement.com/publications/bridges-impact-report-2013-spotlight-methodology/; SOC. IMPACT INV. TASKFORCE, MEASURING IMPACT (2014), http://gsgii.org/reports/measuring-impact/ (click on "Download Report" link).

25. Investments are occasionally designed to improve an entire sector. This is the rationale for some of Omidyar Network's investments. *See* MATT BANNICK & PAULA GOLDMAN, OMIDYAR NETWORK, PRIMING THE PUMP: THE CASE FOR A SECTOR BASED APPROACH TO IMPACT INVESTING (2012), https://www.omidyar.com/sites/default/files/file_archive/insights/Priming%20the%20Pump_Omidyar%20Network_Sept_2012.pdf. Similarly, the Bill & Melinda Gates Foundation invested in M-KOPA, which sells solar panels to consumers on credit, to demonstrate a new financial asset class safe enough to qualify for commercial bank financing. *See* Paul Brest, *Investing for Impact with Program-Related Investments*, STAN. SOC. INNOVATION REV. 1 (2016), https://ssir.org/articles/entry/investing_for_impact_with_program_related_investments (last visited Mar. 3, 2018).

26. If one were to characterize a grant as an "investment," as is often done metaphorically, it would be an investment with a 100% financial return, since a grant entails a total loss of capital.

The potential upside of a concessionary investment is that, by providing capital at below-market rates, it will have an impact: the investee firm can produce more socially valuable outputs. The potential downside is failure—that the subsidy will not create social value—but failure is possible with respect to any investment whether socially-motivated or not. As well, the investment may merely redound to the benefit of other investors; or worse, the subsidy may distort the markets in which the company operates to the ultimate detriment of the investors' intended beneficiaries.[27]

Although we have characterized a concessionary investment as one that sacrifices risk-adjusted market returns, there are two ways in which even a seemingly non-concessionary investment may compromise the investor's financial interests. The first focuses on the phrase risk-adjusted returns: a socially-motivated investment may sacrifice portfolio diversification, thereby causing the investor to bear risk for which he will not be compensated. We would expect this effect to be most prominent when a socially-motivated investor divests from an entire sector (e.g., fossil fuels) or overweights a particular sector because of the potential for social gain (e.g., renewable energy).[28]

If certain stocks (or industries) are perceived to be "mispriced" in that they offer greater than risk-adjusted returns, risk-averse investors will rationally choose to sacrifice an element of diversification to secure the higher returns. They will overweight (hold more of that security than appropriate to diversify efficiently) the undervalued security (or industry) in their portfolio to the point where the greater expected return is offset by the perceived cost of greater portfolio risk due to reduced diversification. The less risk-averse an investor, the more they are willing to sacrifice diversification to achieve higher expected return.

Similarly, if investment in (or divestment from) certain stocks or industries are believed to give rise to increased socially desirable outcomes, then socially-motivated investors will rationally choose to sacrifice an element of diversification by overweighting (or underweighting) such securities or industries in their portfolios. They will do so up to the point where the value they attach to the socially desirable outcomes produced at the margin are offset by the cost of greater portfolio risk from lost diversification. The greater the value investors place on the social benefits their investments produce, the more they

27. *See* Matt Bannick & Paula Goldman, *Do No Harm: Subsidies and Impact Investing*, STAN. SOC. INNOVATION REV. (Sept. 28, 2012), https://ssir.org/articles/entry/do_no_harm_subsidies_and_impact_investing; Michael Kubzansky, *Why Business Models Matter*, *in* GETTING TO SCALE: HOW TO BRING DEVELOPMENT SOLUTIONS TO MILLIONS OF POOR PEOPLE 33 (Laurence Chandy et al. eds., 2013).

28. To see this, keep in mind that most equity investments yield returns that are positively correlated with one another because of common macroeconomic factors affecting nearly all investments. However, these macroeconomic factors typically explain only 40% of the total variation in equity returns. Of the remaining 60% variation, about one third, or 20% of total volatility, is explained by factors common to the stock's industry (the industry is typically described by its Standard Industrial Classification (SIC)). The final 40% of total volatility is, on average, idiosyncratic to specific stocks. These statistics imply that if stocks are correctly priced to reflect their risks, well-diversified portfolios can eliminate as much as 60% of the risk of holding a single security without sacrificing expected returns. If investors concentrated their bets in a single industry with a portfolio of, say, 25 equally weighted positions, they could eliminate approximately 30% of the risk; that is, none of the common industry risk factors would be eliminated, and 80% (*1–1/(25^.5)*) of the 40% of risk that is idiosyncratic would be eliminated. There are interesting efforts to create portfolios that, for example, significantly reduce a portfolio's exposure to a socially-negative characteristic like the portfolio's carbon footprint, but without significantly deviating from the performance of an unconstrained benchmark portfolio. *See generally* Andersson et al., *supra* note 4.

should be willing to sacrifice diversification to achieve it.[29]

The second way in which financial returns can be compromised by socially-motivated investments is through incremental asset management costs incurred in pursuing this category of investments. The due diligence efforts of socially-neutral fund managers or investment staff is designed solely to enhance financial returns. By contrast, socially motivated fund managers must conduct due diligence and post-investment interventions to enhance social as well as financial performance—resulting in higher aggregate evaluation and monitoring costs.[30] Such costs may be partially outsourced to fund managers and consultants who charge incremental fees for assembling socially-screened investment portfolios and incremental fees for manufacturing benchmarks against which such portfolios can be evaluated for investment performance. Nonetheless, the fees paid to fund managers and consultants is still an increase in costs over those associated with a socially neutral investment strategy. In addition, the absence of clear measures of social impact causes this second category of due diligence information to be comparatively more expensive—and less informative—than due diligence concerning financial returns. Market demand and regulatory mandates have reduced the cost of acquiring financial information and have produced clear standards for determining what information is necessary. Information concerning social value creation remains far behind in both the cost of information and in developing shared standards of what to measure and how the measurement should be made and audited.[31]

To the extent that these additional costs are not compensated by incremental returns, the net financial returns to socially motivated investors will suffer. Such sacrifices in net financial returns may be mitigated by a subsidy provided by individuals working for socially motivated investors who accept lower compensation than they could get elsewhere because of their social commitment.[32] Such hidden subsidies effectively make such

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29. *See generally id.* The authors argue that a properly constructed low carbon index can allow investors to better align their portfolio with their social values with little or no sacrifice in diversification benefits. They also argue that if a sufficient number of investors favor such hedged portfolios, the cost of capital of high carbon footprint companies will increase. While an investment in a decarbonized index of stocks may represent an effective strategy for hedging climate risk, we are skeptical that such an index can meaningfully affect high carbon footprint companies' cost of capital, as we discuss in the next section.

30. In a study commissioned by the fossil fuel industry, Hendrik Bessembinder examines the additional transaction costs associated with creating and maintaining a constrained portfolio—one that excludes companies or industries based on ESG criteria. HENDRIK BESSEMBINDER, INDEP. PETROLEUM ASS'N OF AM., FRICTIONAL COSTS OF FOSSIL FUEL DIVESTMENT 8–16 (2016), http://ssrn.com/abstract=2789878 (Click on "Download This Paper").

31. *See* Michael T. Cappucci, *The ESG Integration Paradox*, 30 J. OF APPLIED CORP. FIN. 22, 26–27 (2018) (Cappucci, Senior Vice President of the Harvard Management Company, stresses the costs associated with integrating ESG characteristics in portfolio selection). The Sustainability Accounting Standards Board (SSAB), founded in 2011, is a private sector standards setting board that seeks to set environmentally-related disclosure standards for a variety of industries. The goal is to accomplish for sustainability accounting the same reduction in disclosure costs accomplished for financial accounting by the Financial Accounting Standards Board (the FASB). It is important to recognize the FASB has the far easier job because its goal is to provide disclosure that allows assessment of a single goal: maximizing firm value. As we stated in O'CONNOR & LABOWITZ, *supra* note 3, at 25–30, ESG assessment requires tradeoffs among multiple goals, about which investors will often disagree. Gianni Betti, Costanza Consolandi, and Robert G. Eccles present a sophisticated (and complicated) approach to linking reporting and development goals in *The Relationship between Investor Materiality and Sustainable Development Goals: A Methodological Framework*, 10 SUSTAINABILITY 1 (2018).

32. *See*, e.g., ROBERT FRANK, WHAT PRICE THE MORAL HIGH GROUND? HOW TO SUCCEED WITHOUT SELLING YOUR SOUL 76–86 (discussing the reasons socially-motivated individuals work in non-profit sector);

investments even more concessionary.

V. The First Big Question: Can Investments in Public Markets Create Social Value?

When can investments or divestments in public capital markets have an impact by affecting the behavior of portfolio companies directly through purchasing company securities? *The answer is virtually never*. Because this issue has generated so much discussion within the socially-motivated investment community, we have set out in detail the analysis that gives rise to our skepticism that non-concessionary public market investments can create social value.

The paradigmatic public market involves the active trading of securities by many buyers and sellers in corporations that produce multi-billion-dollar capitalizations on organized stock exchanges. Now suppose that a publicly-traded company produces outputs that are valued by a socially-motived investor. These might include, for example, clean energy or drugs to cure diseases whose development would not be supported by the markets to be served. Impact investors who value these social goods would buy shares of the company if they believed that the purchase would cause the company's share price to increase, thus causing its cost of capital to fall. As a result, (1) the company would be able to finance more projects that produced the valued social benefits, (2) the company would need to sell fewer shares to raise any given amount of capital, (3) or more capital could be raised for any given number of shares issued. All three cases financing an increased volume of desirable projects.

But most investors in public markets are socially-neutral—hence, indifferent to a firm's social value in the context of their investment decision. Therefore, in public markets, any premium in the valuation of shares that results from socially-motivated investors clamoring to own them presents an opportunity for socially-neutral bargain-hunters to profit from selling shares that are overpriced (from a purely financial perspective). For example, if two companies are alike in all respects except that one produces socially-valuable goods and the other does not, any increase in the share price of the former will prompt socially-neutral investors to sell their shares and buy shares of the latter. This arbitrage process would continue until the stock prices of the two companies were identical, thereby eliminating any share price impact based on the socially-motivated trading, and therefore neutralizing any social value added. Indeed, the socially-neutral investors need not own the overpriced shares to accomplish this arbitrage. They could borrow the shares owned by others and sell the borrowed shares—the common practice called short-selling.[33]

Karine Nyborg & Tao Zhang, *Is Corporate Social Responsibility Associated with Lower Wages*, 55 Envtl. & Resource Econ. 107, 107–16 (2013) (discussing the motivation for socially driven work and outcomes).

33. Of course, there are frictional costs associated with socially-neutral bargain hunters engaging in such behavior, so it is possible that if there were enough social-motivated investors in the world, they would, in fact, reduce the cost of capital to producers to whom the investors were attracted by social issues. But we do not believe that such investors come remotely close to comprising a sufficient fraction of the market today to make much, if any, difference in the public markets. Recent estimates of the value of investment assets of impact investors as a fraction of overall public equity market capitalization is less than one-tenth of one percent. *See* Lisette Cooper et al., *Social Finance and the Postmodern Portfolio: Theory and Practice*, 18 J. Wealth Mgmt. 9 (2016). Note the estimate in *supra* note 1, that socially-motivated investments comprise 20% of assets under management includes all forms of such investment rather than only impact investment. Because sophisticated investors understand that impact investing is possible only in private markets, it is fair to assume that the great bulk of socially-motivated

In any event, purchasing existing shares of stock in a public company that produces socially-desirable outcomes is not equivalent to purchasing new shares issued by that company.[34] One person's purchase of shares is another person's sale. Unless the company raises fresh capital in the primary markets, the scale of its activities is largely unaffected by secondary market transactions.

Of course, public companies sometimes do return to the primary markets to raise capital. In principle, public firms could advertise for subsidized capital in the primary markets to finance socially-desirable activities. For example, an electric power company whose stock trades at $100 per share could announce that it is seeking investors to purchase newly-issued shares at $120 each so that the firm could afford to convert coal-fired plants to cleaner-burning gas-fired plants without causing existing investors to suffer a decline in share price below $100. If investors deemed the social value of improving the environment in this way to be worth at least $20 per share and could lock in the company's environmental commitment, they would find such an investment attractive even knowing that the share price would fall to $100 in the secondary market. In effect, socially-motivated investors would be making a $20 per share grant to the investee company conditioned on the company using the grant, in combination with raising non-concessionary capital, to convert its plants.[35]

We do not recall ever having seen an offering by a public company that has this characteristic, but in principle a socially-motivated investor could have social impact by investing in a public company's primary issuance of shares on subsidized or "concessionary" terms.[36] This example provides a natural segue to the more plausible claim that opportunities for impact investing—creating social value—are available in private markets.

VI. THE SECOND BIG QUESTION: CAN INVESTMENTS IN PRIVATE MARKETS CREATE SOCIAL VALUE?

If purchases of publicly traded stock cannot create social value, what about investments in private companies? For our purposes, the critical difference is that in private markets value-relevant information about a company is significantly less widely shared, ownership interests do not trade freely, and short-selling of overpriced stock is virtually non-existent. These features of private markets prevent socially-neutral investors from eliminating through arbitrage the subsidy from socially-motivated investors in the same way they can in public markets. In short, the market for investments in privately held companies is likely to be informationally inefficient; that is, more investors are likely to have value-relevant private knowledge about the company that is not reflected in the

investment in public markets is value alignment rather than impact investing. In the end, whether the combination of these types of socially-motivated investors is sufficient to affect returns is an empirical matter.

34. Even some published research makes this mistake. *See, e.g.*, Cooper et al., *supra* note 33 (wrongly suggests that purchasing existing shares within a company is the same as buying shares upon original offerings).

35. It may be more straightforward to structure this form of transaction through the provision of project finance, which can be cast, in effect, as a commercial version of social impact bonds. *See supra* note 20.

36. In several instances, the Bill & Melinda Gates Foundation has made PRIs of this sort to induce a small-cap biotech company to develop products for neglected diseases in developing countries. *See, e.g.*, David Bank & Dennis Price, *Returns on Investment: How a Broad Bet on a Biotech Company Paid Off in Promising Drugs For Neglected Diseases*, STAN. SOC. INNOVATION REV. 1 (2016), https://ssir.org/articles/entry/returns_on_investment.

trading price at which private interests change hands than is true in public markets. This creates an opportunity for socially-motivated investors to create social value.

A. Concessionary Investments in Private Markets

An impact investor who is willing to sacrifice risk-adjusted returns can sometimes can increase the socially-valuable outputs of an enterprise operating in non-public markets because socially-neutral investors would not provide capital on the same favorable terms. Thus, the impact investor would make a concessionary investment on such terms if she believed that the subsidy (equivalent to the difference between a risk-adjusted market return and the expected return from the concessionary investment) to the investee company would create social value in an amount the investor values by an amount at least as great as the return concession. Just as with *risk clienteles* (where more risk-tolerant investors hold larger fractions of their portfolios in risky stocks and less risk-tolerant investors hold larger fractions of their portfolios in less risky bonds), and *tax clienteles* (where investors facing high tax rates invest larger fractions of their portfolios in tax-favored assets and investors facing low tax rates invest a larger fraction of their portfolios in tax-disfavored assets), the presence of impact investors and impact investment opportunities will give rise to *impact investment clienteles*.

The dynamic of tax clienteles illustrates how the portfolio selection mechanics operate. Investors must assemble a portfolio of investments designed to maximize *after-tax* risk-adjusted returns. Suppose there are two types of riskless assets: taxable bonds issued by companies and the federal government, and tax-exempt bonds issued by state and local governments. If these two types of bonds offered equal pre-tax returns, taxable investors would prefer to hold the tax-exempt bonds. Their demand for tax-exempt bonds would bid up the price of those bonds, causing their yield to fall. The reduced yield on tax-exempt bonds allows state and local governments to borrow more cheaply than other borrowers. In effect, they are able to collect taxes implicitly through subsidized borrowing rates.

Taxpayers who face a 30% tax on returns from the taxable bond would be indifferent between investing in a taxable bond that yields a 5% return and a tax-exempt bond that yields 5% x (1 – 30%) or 3.5%. Tax-exempt investors (like foundations) would prefer to own the 5% taxable bond and none of the tax-exempt bond. In turn, taxpayers facing tax rates above 30% would prefer to own the 3.5% tax-exempt bond and none of the taxable bond. Taxpayers facing different tax rates thus sort themselves naturally into tax clienteles.[37]

Now consider social impact investment clienteles. Investors who value creating social value most highly will invest in companies where their investment will increase the social output of the investee company, and will feel appropriately compensated for doing so. The marginal socially-motivated investor will be indifferent between a concessionary investment in the social value-producing company at a discounted expected risk-adjusted financial return that comes bundled with a social impact "bonus," and investing in a

37. It is useful to note that unless restrictions are placed on the ability to borrow (short-sell) one type of bond or the other, a taxpayer facing a tax rate different from 30% could create arbitrage profits. For example, a 40% taxpayer could "print wealth" by borrowing at 5% pretax and 5% x (1 – 40%) or 3% after tax and investing the proceeds from the loan in tax-exempt bonds yielding 3.5%. To prevent this possibility, the interest from borrowing to purchase tax-exempt bond is not deductible.

socially-neutral investment at a higher risk-adjusted return but no social impact bonus. And just as with tax clienteles, there will be infra-marginal investors on both sides of indifference. The most socially-minded investors who place the largest value on creating social value will get a bargain. They will receive more financial return than they would have required to invest. And the least socially-minded investors will simply not include the social impact investment in their portfolio.[38]

B. Non-Concessionary Investments in Private Markets

The opportunity to create social value through non-concessionary investments also is greater in private than in public markets. As noted above, private markets are less informationally efficient than public markets. An investment officer for a foundation, or the general partner of an impact investing private fund, that specializes in a particular sector may possess the same kind of special knowledge about, say, enterprises delivering health or education services to underserved populations that venture capitalists and private equity investors have about the technology, social media, and biotech industries. In both cases, their knowledge and expertise, not widely held by others, may enable the fund managers to make savvy investments that either are not noticed or mistakenly thought to be too risky by other investors. Just as the conventional venture capitalist or private equity investor may have special information about an investee company's financial prospects, the non-concessionary impact investor seeks special information about both an investee's potential social impact and its financial prospects.

However, the non-concessionary impact investor faces difficulties, and perhaps even conflicts, not faced by her concessionary cousin. Both investors seek to create social value, which, as we have seen, requires meeting two criteria: (1) the investee firm itself produces socially valuable outputs and (2) the investment reduces the cost of capital to the investee firm (compared to investments from socially-neutral investors) and thereby, can be expected to increase the firm's socially valuable outputs. But while the concessionary investor is willing to sacrifice financial return to meet these criteria, the non-concessionary investor is not. Thus, a third criterion also must be satisfied: (3) the investment must be expected to earn a risk-adjusted market-rate return.[39] A Venn diagram of the choices shows that a non-concessionary impact investor limits itself to the area of overlap between market-rate financial returns and increased social outputs.

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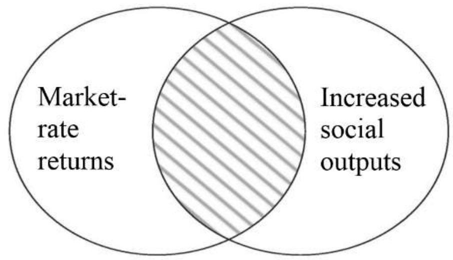
38. Of course, measuring social value creation is a nontrivial task, and each investor may place a different value on social outcomes. But this heterogeneity is also present when investors trade off risk and return or pretax and after-tax returns when different investors face different tax rates. In any event, Harrison Hong & Marcin Kacperczyk, *The Price of Sin: The Effects of Social Norms on Markets*, 93 J. FIN. ECON. 15 (2009), make a useful effort to measure empirically the effects of a socially-motivated clientele on shareholder returns, showing that investors in "sin" stocks earn more than risk-adjusted returns. The outcome was then contested. David Blitz & Frank J. Fabozzi, *Sin Stocks Revisited: Resolving the Sin Stock Anomaly*, 44 J. PORTFOLIO MGMT. 1 (2017), report that the greater than risk-adjusted returns disappear when additional factors are added to the asset pricing model.

39. Note that impact funds that are able to generate risk-adjusted financial outperformance (so-called investment "alpha") but that set market returns as their goal, create capacity to produce social impact by investing on both a concessionary and non-concessionary basis. If they are able to identify opportunities that produce social impact and market returns or greater, whereas other investors anticipate financial returns that fall below the level that socially-neutral investors would demand, then their investment can create social value without sacrificing financial return. Moreover, they have room to make a financial concession equal to some or all of the excess financial return above the market return they would otherwise earn, thereby further reducing the investee's cost of capital and magnifying the social impact while still earning market returns or better.



To understand the non-concessionary investor's difficulties in seeking to operate in the overlap space, imagine that she is the general partner of a fund that promises its limited partners both social impact and market-rate returns. If there are many opportunities that present this overlap in the fund's particular domain, everyone is happy. But if such opportunities are scarce, the general partner will have to compromise one or the other goal. Especially because she and her limited partners will find it much easier to measure financial success than the social value created, the latter is likely to be sacrificed, intentionally or not.[40]

Another difficulty arises with non-concessionary private market impact investments. Assume that the investee firm has the capacity to scale its outputs: the more that is invested, the more the enterprise will be able to produce socially-valuable outputs and still provide socially-motivated investors a market return. The asset manager's general partner who discovered the opportunity can direct investments to the firm in two ways: by attracting more investors to her fund, thereby increasing her investable funds; or by spreading the

40. Bengt Holmström was awarded the 2016 Nobel Prize in economics in part for the insight that the optimal incentive contract for managers depends on the extent to which the manager's principal is able to observe the manager's effort. *Bengt Holmström—Facts*, NOBEL PRIZE, https://www.nobelprize.org/prizes/economics/2016/holmstrom/facts/ (last visited Oct. 8, 2017). In particular, Holmström (with Paul Milgrom) showed that when a manager is asked to accomplish two goals but his performance can be measured only with respect to one, the second goal, in retrospect not surprisingly, will receive less attention. Bengt Holmström & Paul Milgrom, *Multitask Principal–Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24, 35 (1991). Holmström and Milgrom's insight correctly predicts the matter of concern here: that asset managers with a fund that seeks investments from socially-motivated investors will choose to be compensated based only on financial returns, presumably unwilling to bear the risk of poorly specified, and so relatively unobservable, social outcomes. A recent announcement of a new socially-motivated fund by TPG, a large private equity firm, in conjunction with Bono, a socially-committed recording star, illustrates the point. While the parties are committed to non-concessionary financial returns, the motivation for the $2 billion fund is to create social value. The fund claims to have its own metrics for measuring the social value it creates; however, the asset managers' compensation will be based only on financial performance. Andrew Ross Sorkin, *New Fund Seeks Both Financial and Social Returns*, N.Y. TIMES: DEALBOOK (Dec. 19, 2016), https://www.nytimes.com/2016/12/19/business/dealbook/a-new-fund-seeks-both-financial-and-social-returns.html. Following Holmström and Milgrom, compensation based only on financial measures can be expected to further bias such managers toward financial returns and away from creating social value. We also note that the potential for a conflict between a general partner's financial incentives and the fund's investors desire to create social value can also arise as the fund needs to secure liquidity as it approaches the end of its term (typically ten years). Here the concern would be that the general partner would then influence portfolio companies to sacrifice social value creation secure liquidity. *See* JACOB GRAY ET AL., WHARTON U. PA. SOC. IMPACT INITIATIVE, GREAT EXPECTATIONS: MISSION PRESERVATION AND FINANCIAL PERFORMANCE IN IMPACT INVESTING 3 (2015), https://socialimpact.wharton.upenn.edu/wp-content/uploads/2016/09/Great-Expectations-Mission-Preservation-and-Financial-Performance-in-Impact-Investing.pdf.

word about the investment to other investors, including competing funds. Foundations making (inevitably concessionary) PRIs are often happy to get the word out with the hope of sharing the burden. But unless our general partner needs co-founders beyond her budget to make the investment viable, she will typically reserve the opportunities for her own limited partners, thereby restricting social value creation.

VII. THE THIRD BIG QUESTION: CAN THE POWER OF CONSUMERS, EMPLOYEES, CORPORATE ACTIVISTS, AND REGULATORS FACILITATE SOCIAL VALUE CREATION?

This Article focuses on the power of investors to achieve social impact through the financial leverage created by their investments. Other stakeholders, however, can also exert leverage, and sometimes more effectively. When one investor sells her stock in a publicly-traded company, tautologically another investor takes his place. In contrast, each consumer who refuses to purchase apparel made under poor labor conditions detracts incrementally from the seller's bottom line. A company that treats its workers poorly may not be able to recruit valuable employees. And a company that despoils the environment may be scrutinized by regulators who have immense power over its practices. Such considerations make it clear that even socially-neutral investors may be very interested in assessing the ESG performance of potential investee companies.

Consumers are particularly influential when they act in concert as part of an organized movement intended to affect a firm economically or to influence regulators. Investors can contribute to such a movement both symbolically and, perhaps, by instilling in corporate managers a degree of fear of unanticipated consequences. Although divestment seldom has direct economic consequences to the portfolio company, the signaling effect of divestment by a high-profile investor may provide publicity and support for more effective stakeholder efforts, including ESG-type proxy proposals.

The potential for an investment decision to contribute to an effort to influence firm behavior is highly dependent on the specific context. At one extreme, a silent investment/divestment decision not noticed by other stakeholders will have no influence, since investment decisions can have signaling power only if they are known. At the other extreme is a highly-publicized decision made as part of a concerted boycott movement by a respected investor, for example, the Rockefeller Family Charity's recent decision to divest fossil fuel investments, including those initiated by John D. Rockefeller.[41]

The 1990s movement to divest from companies doing business with South Africa and the current movement to divest from companies extracting fossil fuels or that manufacture firearms are examples of divestment playing a role in broad social movements to influence the behavior of its targets. The strategies are essentially political; the more stakeholders who express disapproval of the behavior, the more effective the effort.

41. Rupert Neate, *Rockefeller Family Charity to Withdraw All Investments in Fossil Fuel Companies*, GUARDIAN (Mar. 23, 2016), https://www.theguardian.com/environment/2016/mar/23/rockefeller-fund-divestment-fossil-fuel-companies-oil-coal-climate-change.

An empirical study of the South Africa divestment movement suggests that divestment had little if any effect on the capital markets, though it may have contributed to publicizing the moral issues.[42] It is too early to assess the effects of the current movement targeting fossil fuels or firearm companies. As of this writing in early 2018, the coal industry is economically distressed and the oil industry's experience has been subject to significant variance. But other factors, such as the advent of plentiful natural gas through fracking, improvements in solar and wind energy in part through government subsidies, and government regulations, such as renewable energy portfolio standards, may fully account for the situation. Few doubt that changes in consumer behavior, such as increased use of public transportation and electric and energy-efficient automobiles, as well as regulatory changes, such as a carbon tax, could significantly reduce CO2 emissions. Similarly, the growing public response to firearms production following the Parkland school shooting may influence legislators and regulators to impose more effective limits on their manufacture or sale.[43] Divestment may serve as a rallying point for such other actions, but as we have argued in this essay, the sale of publicly traded stock alone will have little direct economic consequences.

In one critical respect, however, socially-motivated investors may have the ability to influence portfolio company decisions by facilitating consumer boycotts. There is evidence that consumer boycotts can influence company behavior, and that an important part of the success results from company-perceived reputational damage rather than only from the boycott's immediate financial impact.[44] A high-profile impact investor with a stake in a boycotted company may be able to leverage the combination of its image and its financial investment to facilitate consumers' effort to influence the targeted company through withholding patronage.

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42. Siew Hong Teoh et al., *The Effect of Socially Activist Investments Policies on Financial Markets: Evidence from the South African Boycott*, 72 J. BUS. 35, 83 (1999) concludes:

> In all, the evidence from both individual and legislative actions, taken together, suggests that the South African boycott had little valuation effect on the financial sector. Despite the prominence and publicity of the boycott and the multitude of divesting companies, the financial markets' valuations of targeted companies or even the South African financial markets themselves were not easily visibly affected. The sanctions may have been effective in raising the public moral standards or public awareness of South African repression, but it appears that financial markets managed to avoid the brunt of the sanctions.

Id. This may be an important point . . . for future activists who are considering using the tools of the boycott for other causes." *Cf.*, Bernard Feigenbaum & Anton Lowenberg, *South African Disinvestment: Causes and Effects*, 6 CONTEMP. POL'Y ISSUES 105 (1988).

43. *See*, *e.g.*, Michael Scherer, *Florida Gov. Rick Scott Breaks with NRA to Sign New Gun Regulations*, WASH. POST (Mar. 9, 2018), https://www.washingtonpost.com/powerpost/florida-gov-rick-scott-breaks-with-nra-to-sign-new-gun-regulation/2018/03/09/e5d1f02e-23b2-11e8-86f6-54bfff693d2b_story.html?utm_term=.1efe1b65f2df (explaining Florida governor and legislature's support of gun regulations).

44. For example, Mary-Hunter McDonnell and Brayden King report that a significant number of large companies that were the subject of a consumer boycott made changes in response, even when the boycott did not significantly reduce company revenues. *See generally* Mary-Hunter McDonnell & Brayden King, *Keeping up Appearances: Reputational Threat and Impression Management after Social Movement Boycotts*, 58 ADMIN. SCI. Q. 387 (2013). Of course, in consumer markets, reputation is tied closely to financial results. McDonnell and King argue that their data shows a company response in excess of what the observed immediate financial results of the boycott would explain.

A. ESG Criteria as Proxies for Financial Value

Concern over ESG criteria may influence companies through a channel different than actions taken by socially-motivated investors. With respect to fossil fuel production, large institutional investors and especially large mutual funds (including index funds) recently have become much more likely to vote in favor of shareholder environmental proxy proposals that would require fossil fuel companies to become more transparent concerning the relationship between climate change and their business strategy. These explicitly socially-neutral investors now seem more willing to support proxy proposals that are based on a link between ESG factors and portfolio firm profitability.

A proxy proposal made to Occidental Petroleum in May 2017 is a useful example. The non-binding proposal asked that Occidental issue an annual report assessing the impact of long-term climate change on its business, including environmentally-based scenario planning. This was the first shareholder proposal of this type that commanded a majority vote at a major U.S. oil company. Equally telling, it was the first time that BlackRock, the world's largest asset manager, voted for a shareholder environmental proposal that management opposed.[45] The Occidental proxy contest then was followed by shareholder approval of a similar proposal at Exxon Mobil.[46]

Critical to this approach, for both environmental activists and asset managers, is that the Occidental and Exxon Mobil proposals and asset managers' voting principles,[47] are keyed to improving the targeted companies' financial performance. As discussed earlier,[48] recent Labor Department statements concerning ERISA compliance allows a pension plan fiduciary to take into account environmental concerns in its asset management as long as the decisions, whether with respect to an investment decision or in voting pension fund securities, are not concessionary—that is, they do not reduce the expected risk-adjusted return to the fund. Thus, proposals are framed in terms of the positive effect on a company's financial performance of greater attention to the business consequences of climate change.

A different group of shareholders—large index-based mutual funds—followed an alternative approach to influence portfolio company behavior. Because investors have shifted very large amounts of assets from actively managed equity mutual funds to equity

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45. Erin Ailworth, *Occidental Shareholders Vote for Climate Proposal*, WALL ST. J. (May 12, 2017), https://www.wsj.com/articles/occidental-shareholders-vote-for-climate-proposal-1494616669. BlackRock's explanation for its Exxon Mobil vote is contained in its announcement that it had voted in favor of the shareholder proposal; Press Release, BlackRock, Supporting a Shareholder Proposal Following Extensive Management Engagement, https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-exxon-may-2017.pdf (May 31, 2017).

46. *See* Lyuba Goltser & Kaitlin Descovich, *Investor Support Heating Up For Climate Change Proposals*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (July 3, 2017), https://corpgov.law.harvard.edu/2017/07/03/investor-support-heating-up-for-climate-change-proposals/. Prior to this vote, BlackRock, as well as Vanguard and Fidelity, routinely voted against environmental proposals of any character that were opposed by management. *Id.*

47. For example, BlackRock's proxy voting guidelines voting principles can be found at BlackRock, PROXY VOTING GUIDELINES FOR U.S. SECURITIES (2018), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf. Vanguard's (another very large mutual fund company) voting guidelines are available at https://about.vanguard.com/investment-stewardship/policies-and-guidelines/; STATE STREET GLOBAL ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES (2018), https://www.ssga.com/investment-topics/environmental-social-governance/2018/03/Proxy-Voting-and-Engagement-Guidelines-NA-20180301.pdf.

48. *See supra* note 19.

index funds, and because of the concentration of index funds with the three largest funds—BlackRock, Vanguard, and State Street making up some 90% of total index fund investment—these funds are quantitatively important shareholders.[49] Taken together, these three institutional investors are the largest shareholders in 88% of S&P 500 companies.[50] In January 2017, Blackstone's CEO, Larry Fink, sent a letter to the CEOs of its portfolio companies stating BlackRock's basis for assessing company management: "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."[51] Because BlackRock cannot sell shares in index funds if they believe portfolio company strategies are ill-advised, the company intends to have continual "engagement" with their management to influence company decisions.

This strategy took concrete form following the 2018 Parkland, Florida school shooting. BlackRock, the largest shareholder in the three largest U.S. firearms manufacturers, urged firearms manufacturers to assess their business strategies concerning distribution of their products and noting that it might vote against directors of companies who did not respond appropriately. It also announced that it intended to offer an index product that excluded firearms manufacturers.[52]

Outside the proxy proposal context, proponents of ESG factors as a measure of investment desirability extend the argument that socially responsible behavior leads to better company performance one step further. Rather than seeking to improve the quality and availability of information assessing the impact of environmental factors on a company's long term performance, proponents argue that high ESG ratings have a direct

49. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COL. L. REV. 863, 883 (2013) (tracing the growing intermediation of equity).

50. Jan Fichtner et al., *Hidden Power of the Big Three: Passive Index Funds, the Re-concentration of Corporate Ownership and the New Financial Risk*, 19 BUS. & POL. 298 (2017). Large index tracking funds recent reduction of management fees to zero can be expected to further solidify the dominance of the largest index fund providers. Not surprisingly, inflows of capital into index funds go overwhelmingly to funds with fees in the lowest quartile. *See* Chris Flood, *Price Quake Heralds the Glorious Era of Zero-Cost Index Funds*, FIN. TIMES, (Aug. 5, 2018), https://www.cambridge.org/core/services/aop-cambridge-core/content/view/30AD689509AAD62F5B677E916C28C4B6/S1469356917000064a.pdf/div-class-title-hidden-power-of-the-big-three-passive-index-funds-re-concentration-of-corporate-ownership-and-new-financial-risk-a-href-fns01-ref-type-fn-a-div.pdf.

51. Larry Fink, *Larry Fink's Annual Letter to CEOs: A Sense of Purpose*, BLACKROCK, https://www.blackrock.com/corporate/en-gb/investor-relations/larry-fink-ceo-letter (last visited Sept. 17, 2018).

52. Press Release, BlackRock, BlackRock's Approach to Companies that Manufacture and Distribute Civilian Firearms (Mar. 2, 2018), https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-approach-to-companies-manufacturing-distributing-firearms. In its release, BlackRock was careful to stress the potential cost to companies from the public response to misuse of their products, as with the oil company proxy contests voicing a business rather than a social concern. The gun manufacturers' response highlighted the awkward application of fiduciary duties in these circumstances. American Outdoor Brands, which manufactured the weapon used in the Florida attack, responded to BlackRock's March 2nd letter by staying closely to its existing strategy: "We believe that our stockholders are well aware of the products we manufacture and fully understand the risks associated with investing in a firearms manufacturer." Sheeraz Raza, American Outdoor Brands Corporation Issues Detailed Rebuttal to BlackRock (Mar. 6, 2018), https://www.valuewalk.com/2018/03/american-outdoor-brands-corporation-issues-detailed-rebuttal-to-blackrock/.

impact on profitability.[53] As discussed above, proponents of fossil fuel divestiture argue that current stock prices do not reflect the impact of future environmental regulation on the ownership value of "stranded assets"—coal, oil, or gas.[54]

The argument, while superficially attractive, is implausible. Information concerning stranded assets is publicly available, and proponents offer no explanation for why this risk is not already reflected in existing stock prices through the actions of socially-neutral analysts and investors. From this perspective, ESG factors and reliance on fossil fuels reflect a familiar part of standard fundamental analysis. Absent a better argument, there is no reason to believe that equity analysts are systematically less able to assess the valuation implications of these factors, such as stranded assets, than of non-ESG factors.[55]

Other studies have posed similar hypotheses. Suppose a company's social capital, including the trust stakeholders have in the company, allow the company to contract more effectively with its stakeholders, including labor and capital market participants, over items that are not otherwise observable or verifiable. In that situation, a company's ESG ratings may provide a credible signal of the company's less observable social capital.[56] It would follow that better ESG ratings could lead to a company having greater social capital and so higher productivity.[57]

Again, however, the same problem appears. If ESG ratings and investments in ESG affect productivity, then they should already be reflected in companies' stock prices; companies then will have selected and invested in achieving the efficient level of ESG rating. The Sustainability Accounting Standards Board presses for standardized disclosure of ESG factors that are material to investment decisions.[58] We strongly support

53. *See, e.g.*, FirstCarbon Solutions, *Sustainability Metrics: ESG Actions Make for Profitable Business*, ADEC INNOVATIONS (May 28, 2013, 5:50 AM), https://info.esg.adec-innovations.com/blog/bid/293787/Sustainability-Metrics-ESG-Actions-Make-for-Profitable-Business.

54. *See, e.g.*, Karel Beckman, *An Investor Speaks: The Oil Party is Almost Over*, ENERGY POST (Feb. 21, 2014), http://www.energypost.eu/investor-speaks-oil-party-almost/.

55. Henri Sevaes & Ane Tamayo, *The Role of Social Capital: A Review*, OXF. REV. ECON. POL'Y, (forthcoming) (manuscript at 22), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2933393 (Click "Download This Paper" link) ("[W]e believe that if prices do not fully reflect the fundamentals of a company and if this information is readily available, there is sufficient arbitrage capital available to correct any mispricing.").

56. Steven Blader et al., *The Real Effects of Relational Contracts*, 105 AM. ECON. REV. 452, 452 (2015) (developing the importance of social capital or trust in contracting with stakeholders).

57. *Id.* In this vein, Amiraslani et al. recently sought to test empirically the link between a company's trustworthiness and its access to the bond market, where bond market access was measured by secondary market bond spreads and trustworthiness was measured by ESG activities. Over the period 2005 through 2013, the authors find that, on average, there is no relation between corporate bond spreads and ESG investment. Trust, as measured by ESG, does not signal that an issuer is less likely to take advantage of its bondholders. The results are strikingly different between August 2008 and March 2009, when the literature finds that the financial crisis caused a shock to information concerning companies' trustworthiness. The authors report that their "results are unambiguous: during the [financial] crisis of trust, secondary market credit spreads of high-CSR [ESG] firms did not rise as much as the spreads of low-CSR [ESG] firms." They "conclude that corporate social capital [as measured by ESG] affects bond contracting and pricing when it matters most: when there is a crisis of trust and bondholders seek reassurance that they will not be expropriated." Hani Amiraslani et al., *The Bond Market Benefits of Corporate Social Capital* 6 (ECGI Fin., Working Paper No. 535/2017, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2978794 (click "Download This Paper" link).

58. *See, e.g.*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD (SASB) http://www.sasb.org/ (last visited Mar. 3, 2018) (stating that the organization is committed to disclosure of material information). Materiality also lies at the core of the investment strategies of Generation Investment Management LLP, an investment fund founded by David Blood and Al Gore. *See, e.g.*, GENERATION INV. MGMT., https://www.generationim.com/ (last

encouraging companies to disclose ESG practices and other characteristics that will assist investors in assessing the value of companies' investments more accurately, as well as provide information to stakeholders who wish to pursue consumer or politically directed strategies. If done well, it will reduce the cost of acquiring that information by centralizing its production through requiring disclosure by the party that has the least expensive access to the information.[59] However, it seems highly unlikely that socially-motivated, or even socially-neutral, investors can systematically profit from identifying mispriced securities based on such information.

VIII. CONCLUSION—AND ADVICE TO INVESTORS

The thrust of this essay is as follows:

- *Value alignment*. Socially-motivated investors who only wish to align their portfolios with their values must determine whether a potential investee company's outputs and practices are so aligned; and whether concentrated holdings in or divestment from a particular sector will increase investors' portfolio risk by reducing diversification. If portfolio risk is increased, then the socially-motivated investor must decide whether they wish to pay the price of value alignment. We do not denigrate value alignment. But we think it is extremely important not to confuse it with social value creation.
- *Social value creation*. As the term "impact" suggests, impact investors are the subset of socially-motivated investors who wish to go beyond value alignment to create social value by using their investment decisions to influence a portfolio company's performance. For an affirmative investment, this requires that:

  The investee company's outputs or practices must have social value beyond the private value created between firms and the parties with whom they contract directly.

  The investment either must (1) lower the cost of capital to the company compared to ordinary commercial markets, thereby allowing it to produce more socially valuable outputs or to engage in more socially valuable practices—the criteria for creating social value; or (2) allow the investor to provide expertise that the portfolio company does not have, with the same effect.
- *Public markets*. It is virtually impossible for a socially-motivated investor to affect the outputs or behavior of companies whose securities trade in public markets through buying and selling their shares in the secondary market. Socially-motivated investors who seek to affect public companies' ESG practices must join forces with consumers, employees, corporative activists, and regulators. As we have seen, ESG-based proposals are gaining institutional investor support where the proposals are explicitly tied to company financial performance.

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visited Oct. 8, 2017).

59. *See* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 597–609 (1984) (discussing information costs and market efficiency).

- *Concessionary investments in private markets*. However, it *is* possible for concessionary impact investors to affect the outputs of portfolio firms through private market transactions by providing subsidies in the form of accepting financial returns below the level that socially-neutral investors would require. Foundations' program-related investments are paradigmatic of such subsidies. The difficulties of concessionary impact investments lie in targeting the subsidy so as to benefit one's intended beneficiaries rather than other investors, or the company's asset managers, through the absence of accountability for whether and how much social value was created, and in not adversely distorting the markets in which the firm operates.
- *Non-concessionary investments in private markets*. It is also possible for non-concessionary impact investors to affect the outputs of firms while still earning a risk-adjusted market return through private market transactions by taking advantage of private knowledge or special expertise that they or their fund managers possess. However, non-concessionary investors' claims to have value-relevant private information should be viewed with healthy skepticism. These investors are playing in a highly competitive game with the universe of private equity investors whose success depends on developing such private information. The ultimate test of a non-concessionary impact investment is whether (1) the risk-adjusted financial returns match the market, a familiar assessment for which there are accepted measurement techniques, and (2) how much social value is created, for which there is still little consensus on the difficult question of how value creation should be measured. The differential measurability of financial value created and social value created has resulted in asset managers running impact investing funds being paid based (almost) exclusively on financial measures of performance. If the managers' success in creating social value cannot be measured, neither can that of the investors providing the capital.

We disagree with those who define impact investing to include only concessionary, or only non-concessionary investments. Under the right circumstances, both kinds of investments can create social value. But the field can only grow responsibly if individual investors, impact investing trade associations, foundation officers, and asset managers are candid with themselves and others about the conditions necessary for social value to be created and rigorous with respect to how it, and hence their performance, should be measured.

And this leads us to offer some advice for the large majority of individual impact investors who do not make direct investments but place their confidence in the general partners of so-called impact funds.

- First, it is difficult, though not impossible, for a fund to create social value—as opposed to achieve value alignment—while also promising to deliver market-rate financial returns or better. Funds that promise both deserve special scrutiny and a clear understanding of how both elements of fund performance will be measured.
- Second, if the fund is serious about impact, it should report on social value created as well as financial returns, including an estimate of that value creation and a clear description of how it was calculated. A strong signal that

the general partner is committed to social impact as well as to financial returns would be that her compensation is based at least in part on the social value created as well as on financial returns. We note that doing so is difficult because vague measurement standards impose risk on the general partner that affects incentives and so exacerbates the problem.[60] In turn, that difficulty helps explain the limited occasions on which impact investment funds have sought to link general partner compensation and social value created.

- Third, make sure that the fund manager is using appropriate benchmarks for the fund's performance. The appropriate benchmark against which to evaluate private investments is other private investments, including the significant illiquidity premium associated with such investments.
- Fourth, treat the presence of any public equities in a self-styled impact fund as the thirteenth strike of the clock, which calls the others into question.[61]
- Finally, the socially-screened ESG mutual fund industry should be regarded as offering investors a value alignment strategy, not an impact investment

60. Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 74 (1979). There is little literature concerning the difficulties of constructing a compensation contract that links the general partner's compensation directly to the amount of social value created. Christopher Geczy et. al., Contracts with Benefits: The Implementation of Impact Investing (revised July 2, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3159731 (clikc "Download This Paper" link), report that only 10% of their sample in any fashion formally link general partner compensation to social value created. Consistent in order of magnitude, Transform Finance Investor Network in 2016 reported only four small impact investment funds that did so. TRASNFORM FIN. INV. NETWORK, TYING FUND MANAGER COMPENSATION TO IMPACT OUTCOMES (2016), https://static1.squarespace.com/static/54cfca5be4b06d2d0d7c0f1d/t/57e285d1bebafb329d4a71fa/1474463185846/TFIN+Issue+Brief+-+Tying+Carry+to+Impact+2016-09-12+v3.pdf. If social value is difficult to observe or to measure with precision, one approach would be to distinguish between using contractual tools to make the assessment of success more observable even if not verifiable with precision, such as advisory boards and disclosure, as a substitute. This approach uses formal contracting to facilitate the development of trust between the general partner and investors, in the contracting literature, a form of braiding formal and informal contracting in which the formal elements of the contract focus on a process that endogenizes trust, between the parties and so supports continued dealing based on reputation. *See* Ronald J. Gilson et. al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377 (2010). A similar analysis applies to the structure of venture capital limited partnerships. *See* Ronald J. Gilson, *Engineering Venture Capital Markets: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003). A second informal approach would be to make impact investments in products and markets where the products and market themselves make it easier to measure social value created. For example, the number of mosquito nets provided is subject to familiar auditing techniques. Consistent with this intuition, the charities to which GiveWell, an organization that facilitates donor gifts based on evidence of impact, transfers funds on behalf of donors, appear to share the characteristic that the nature of the projects selected make the social value created more observable and so more measurable. *See GiveWell's Impact*, GIVEWELL (June 2018), https://www.givewell.org/about/impact. Bhagwan Chowdhry, et. al., *Investing for Impact*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (2018), https://corpgov.law.harvard.edu/2018/07/12/investing-for-impact/, thoughtfully explore the contracting implications when the general partner cannot commit to a level of social value created because of observability problems. Much work remains to be done in understanding how the standard private equity/venture capital contracting models translate into the much more difficult tasks associated with the multi-task setting of impact investing.

61. This is not to say that an investor should shun a portfolio that includes socially-neutral as well as socially-motivated investments, as well as investments aimed at value alignment and value creation. The most straightforward way to do this is through investments in separate funds, each of which describes its purpose, expected financial return, and (in the case of an impact fund) how its impact will be measured.

strategy. Prospective investors in such funds should take care to understand the premium expense ratios charged by the sponsors of such funds, the sacrifice in diversification these funds may impose on investors, and the financial engineering employed to offset the diminished diversification. Investors should also be skeptical of claims of impact that may appear in the marketing materials for such funds.