

## **Attracting Traditional Investors to Impact Investing**

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April 19, 2013



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## ACKNOWLEDGEMENTS

I wish to express my appreciation to all who have helped me throughout my research process. I am particularly grateful to my advisor, Dr. Fritz Mayer, for his wise counsel, invaluable insight, and patience with me throughout the academic year. I would also like to thank Dr. Joel Fleishman and Professor Tony Brown for their contributions of time, expertise, strategic thinking, and participation in my review committee.

To Cathy Clark, Tom Darden, Jonathan Greenblatt, Lee Roberts, Mike Schneider, and Adrian Talbott, I offer special thanks for their first-hand knowledge and experience in the fields of traditional and impact investing.

I owe a profound debt of gratitude to Mark Newberg, Rob Lalka, Scott Kleiman, Meghan Whealan, and Navid Samadani-McQuirk for their willingness to review, revise, and serve as sounding boards for innumerable iterations of this final product.

Lastly, I wish to thank 5 Stone Green Capital for providing me with the valuable opportunity to learn more about the field of impact investing through the lens of your important work.

## EXECUTIVE SUMMARY

### *Research Question*

5 Stone Green Capital (“5 Stone”) seeks to fund green real estate investments by attracting capital from both traditional and “impact” investors. The impact investing space is relatively new to capital markets, and traditional investors are skeptical of the risks on investments accounting for anything other than financial returns. 5 Stone wishes to explore how to draw traditional investors into the impact investing space.

Given its emphasis on generating optimal sustainability in energy, housing, food and employment markets, while generating consistent economic returns, and the constraints of an evolving impact investment market, how can 5 Stone draw traditional investors into the impact investing space?

### *Recommendation*

With the underlying goal of bringing traditional investors into the impact space to fund its green real estate investments, 5 Stone should pursue Generation Investment Management’s model of “sustainable capitalism” that incorporates profitability and sustainability into its long term strategic planning. 5 Stone’s target investors from traditional financial markets will accept few tradeoffs for maximum financial returns. While both the patient and sustainable capital models provide examples of profitability and long term visions for impact, only Generation seeks above-market-rate risk returns on investment.

### *Defining of Impact Investing*

Impact investing is broadly defined as a set of investment strategies that generate financial return while intentionally improving social and environmental conditions within a defined context. Many view impact investing as a response to the shortcomings of existing efforts – i.e. government, philanthropy, and private markets – to effect positive, large-scale social change. Governments have fallen short due to inefficient use of resources and, in some cases, corruption. Traditional philanthropy has failed to establish scalable means of addressing many global issues. Private markets are structured for strictly financial returns, without a historically accepted method for considering non-financial returns.

### *Sources of Capital for Impact Investors*

For impact investing to grow beyond its current state, it must attract and incorporate new sources of capital into the market. The Acumen Fund has outlined seven sources of capital for impact investors, noting that commercial capital is virtually absent from the sector due to a perceived risk return tradeoff. These sources of capital, from most commercial to most philanthropic, include financial institutions, pension funds, high net worth individuals, single limited partnerships, governments, foundations, and individual philanthropists.

### *What Is Not Working*

The financial industry has developed a vast infrastructure for managing investments that traditionally “puts profits ahead of people” – or emphasizes risk-adjusted financial returns over social and environmental outcomes. To sustain any capital market, a certain threshold of investment is required to allow an enterprise to scale its initiative and overcome transactional costs. Underinvestment in social capital markets, signaling a lack of recognition among financial managers, hampers the growth of impact investing. This underinvestment is shaped by multiple factors, among them: the failure of the current model to account for social returns on investment (SROIs), a lack of industry-wide performance metrics, uncertainty related to impact investments’ ability to achieve sustainable returns on both social and financial ROIs, and conflicting regulations within the financial market.

### *What Is Working*

Jonathan Greenblatt, Director of the White House Office of Social Innovation and Civic Participation, views the success of impact investing as a gradual process that “doesn’t happen over night.” To date, the impact investing sector has four factors working in its favor as it moves toward broader recognition and acceptance as a viable investment strategy: above-market-rate returns during the recent financial crisis, the emergence of a common language and infrastructure for impact investors, influential market actors affirming the space, and a growing body of evidence linking financial success and commitment to impact.

### *Key Considerations*

Any proposed solution to attract traditional investors into 5 Stone’s impact-oriented projects must be weighed according to its ability to:

- Maximize risk-adjusted financial returns
- Align short term financial targets with long term impact goals
- Appeal to traditional investors within their comfort zone
- Contribute social and environmental impact to target markets

### *Two Models of Success*

Acumen Fund and Generation Investment Management present two divergent models for raising capital for impact investing. Acumen, funded predominantly by smaller investments from individual philanthropists, employs a model they refer to as “patient capital,” targeting disciplined investments – loans or equity in lieu of grants. Generation, on the other hand, focuses its model on more traditional investments, under the principle that an investment’s measurements of sustainability will drive the company’s returns. Both models emphasize an investment approach that prioritizes long term returns over short term performance measures.

## INTRODUCTION

Impact investing is a response to the shortcomings of existing efforts – i.e., government, philanthropy, and private markets – to effect positive, large-scale social change.<sup>1</sup> Governments around the world have fallen short in their efforts to create and sustain positive social and environmental outcomes due to inefficient use of resources and, in some cases, corruption. Traditional philanthropy has failed to establish scalable means of addressing many global issues. Private markets are historically structured, and in some cases required by regulation, to consider financial returns to the exclusion of social, environmental, or other non-financial returns.

Impact investing, a “new breed” of social enterprise, steps outside of existing models to dispense “financial and intellectual capital directly to entrepreneurs motivated to address societal problems.”<sup>2</sup> It can complement government aid and philanthropic capital. As grants have become increasingly scarce following the global financial crisis, impact investments present a new pool of money available to entrepreneurs seeking to right social imbalances.<sup>3</sup> Comparably, private markets alone do not fully address social problems. Impact investments should be evaluated on their ability to achieve explicit social returns alongside financial ones.<sup>4</sup>

### I. WHERE 5 STONE FITS IN

5 Stone Green Capital (“5 Stone”) seeks to fund green real estate<sup>5</sup> investments by attracting capital from both traditional and “impact” investors. The impact investing space is relatively new to capital markets, and traditional investors are skeptical of any investment that accounts for social or environmental externalities beyond immediate financial returns. Given its emphasis on generating optimal sustainability in energy, housing, food and employment markets, while generating consistent economic returns, and the constraints of an evolving impact investment market, how can 5 Stone draw traditional investors into the impact investing space?

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<sup>1</sup> For the purposes of this paper, social change is defined as an alteration, over time, of cultural norms, values, and patterns of behavior.

<sup>2</sup> Cordes, Impact Investing 2010

<sup>3</sup> Edwards, et al. 2011

<sup>4</sup> Grace, Wood and Haszhia 2011

<sup>5</sup> “Green” real estate implies business-related efforts targeting environmentally beneficial outcomes. These initiatives include, but are not limited to the use of renewable resources, energy-efficient products, and low-emission construction and maintenance targets.

## II. DEFINING IMPACT INVESTING

Impact investing is broadly defined as “investment strategies that generate financial return while intentionally improving social and environmental conditions.”<sup>6</sup> Impact investments are designed to deliver a financial return and address key social or economic problems through investments in social enterprises.<sup>7</sup> Over the course of more than twenty years, impact investing has evolved into a system that “integrates social, environmental and economic considerations into the decision-making structures and processes of business.”<sup>8</sup>

Although the concept of socially responsible investing (SRI) has been around for decades, impact investing has emerged as an offshoot of SRI. Whereas many foundations hold SRI assets in public equities, the primary tools of impact investing revolve around private equity and debt transactions.<sup>9</sup> If the *raison d’être* of SRIs can be defined as “do no harm,” impact investing can be identified by its intentionality to generate new social and environmental impact.

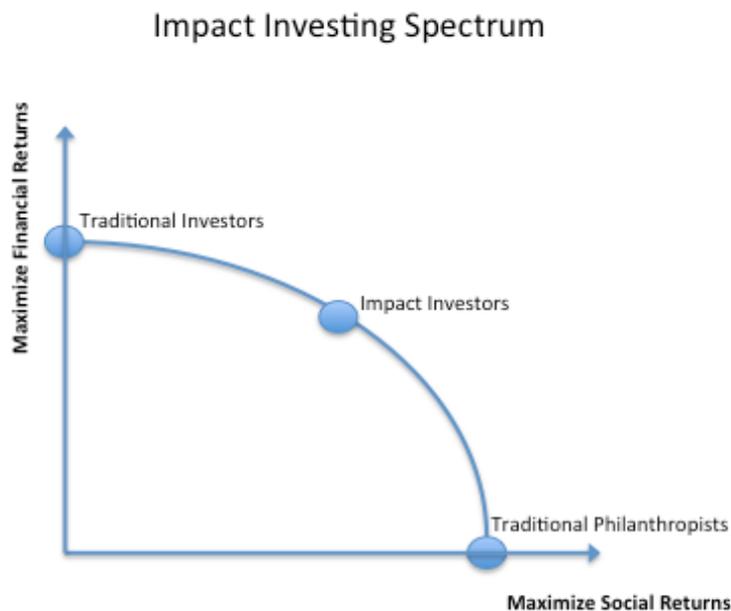


Figure 1: Impact Investing Spectrum<sup>10</sup>

<sup>6</sup> Bugg-Levine and Emerson, *Impact Investing* 2011

<sup>7</sup> Cordes, *Impact Investing* 2010

<sup>8</sup> Bendell, Miller and Wortmann 2011

<sup>9</sup> *Ibid.*

<sup>10</sup> Trelstad 2009

As Figure 1 shows, the primary actors across the spectrum of impact investing include traditional investors, traditional philanthropists, and impact investors<sup>11</sup>. Where traditional investors forgo maximizing social returns in favor of financial returns, traditional philanthropists tend toward the polar opposite: maximizing social returns over financial ones.<sup>12</sup> Impact investors, while not made up of any one identity or profile, embody the space between traditional investment and philanthropy.

The social enterprise movement that impact investing strives to bolster encompasses an evolving range of organizations with diverse areas of focus.<sup>13</sup> The ultimate goal of the impact investing space is to bring new capital and ideas to issue areas that have hindered the traditionally distinct fields of philanthropy and finance. What initially started as an interest in supporting philanthropy has transformed into an “industry in its own right.”<sup>14</sup>

Notwithstanding the sector’s philanthropic roots, impact investors pay close attention to financial returns. Typical impact-oriented returns range from simple returns on principle to market rate for the class of capital deployed. As noted by Antony Bugg-Levine, an enterprise’s social mission “should not result in lower standards in creditworthiness or it misses the point.”<sup>15</sup>

### III. SOURCES OF CAPITAL for IMPACT INVESTORS

Under the current system, existing impact investments are generally structured as private debt or equity funds. In 2011, private foundations in the U.S. held approximately \$700 billion in assets, and gave away a minimum of \$35 billion (5%) annually. Many private investors – both asset owners and managers – appear prepared to devote more money toward social impact, but are stymied by the complexity of creating their own private foundations. When we consider the more than \$100 trillion the investment management industry holds in assets, the potential for impact rises exponentially.<sup>16</sup>

Growth in the impact investing space can be attributed to several key factors. Among them, a shift in demographics combined with easier access to information has resulted in an increased awareness of social issues. Additionally, a large portion of the world’s wealthiest individuals (i.e. U.S. “baby boomers”) have reached an age where there is “an increasing sense

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<sup>11</sup> Impact investors can be divided into two primary camps: limited partners (LPs – or asset owners) and general partners (GPs – or asset managers).

<sup>12</sup> The terms “social” and “impact” are often used interchangeably. However, “social entrepreneurship” and “impact investing” are distinct.

<sup>13</sup> Cordes, Making an Impact 2010

<sup>14</sup> Grace, Wood and Haszhia 2011

<sup>15</sup> Avery, Impact investing: Making money make an impact 2012

<sup>16</sup> Friedman and Stonesifer 2012

of urgency [to leave] a legacy.”<sup>17</sup> As philanthropic dollars are combined with private capital and government investment, the potential to scale impact investing becomes increasingly probable.<sup>18</sup>

For impact investing to grow beyond its current state, it must attract and incorporate new sources of capital into the market. J.P. Morgan Global Research and the Rockefeller Foundation estimate that, over the next ten years, the impact investing market will grow from approximately \$400 billion to more than \$1 trillion.<sup>19</sup> The field is attracting new investors and increasing amounts of money, but impact investors are “a heterogeneous group with a range of expectations about appropriate financial and social returns.”<sup>20</sup>

Acumen Fund’s 2009 *The Nature and Type of “Social Investors”* outlines seven sources of capital for impact investors, noting that commercial capital is virtually absent from the space due to a risk return tradeoff that “just doesn’t compute.” In their view, the more commercial the source of capital, the more likely a fund manager will focus on traditional, commercial investment outcomes rather than impact. Comparably, the more philanthropic the source of capital, the less predictably the fund will work with traditional investors.

From most commercial to most philanthropic, the following entities have provided sources of capital to impact investors:

- *Financial Institutions* – Many financial institutions in the U.S. have been prompted to invest in distressed communities by the Community Reinvestment Act.<sup>21</sup> Bank of America’s Capital Access Fund investment in Pacific Community Ventures is an example of a traditional fund that invests in “impact” in the state of California, specifically targeting job creation.
- *Pension Funds* – Many pension funds approach impact investing as a means of diversifying their risk and fulfilling clients’ social mandates. Fund managers will often turn to community housing or clean tech to counterbalance their other, riskier investments.
- *High Net Worth Individuals* – To date, few multimillion-dollar funds raised from high-net-worth investors have sought market-rate returns. Most have sought sub-market-rate returns comparable to the microfinance sector.
- *Single Limited Partnerships (LPs)* – High net worth individuals often provide primary sources of capital to impact investment funds. Funds like the Omidyar Network and Gray Matters have been funded and capitalized by a single high net worth funder. In such instances, investment teams are often focused on maximizing financial returns while also

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<sup>17</sup> Avery, Impact investing: Making money make an impact 2012; Cordes, Making an Impact 2010

<sup>18</sup> Meehan and Jonker 2012

<sup>19</sup> Biotech MaRS Award 2011; Brody and Andre 2011

<sup>20</sup> Mair and Milligan 2012

<sup>21</sup> The Community Reinvestment Act is a federal law encouraging regulated financial institutions to address the needs of borrowers from all segments of the community – specifically low-income areas. Federal regulators evaluate financial institutions’ compliance with the law before approving applications for new bank branches, mergers, acquisitions, etc.

having the flexibility to take on greater risk in unpredictable markets.

- *Governments* – Many governments around the globe host some form of “development finance institutions.” In the US, Community Development Financial Institutions invest federal resources to incentivize and promote economic revitalization in low-income communities. Globally, the International Finance Corporation and its regional and national equivalents (i.e. The Inter-American Development Bank, German Development Bank, etc.) hold a range of investments – largely in private equity – with an emphasis on economic development.
- *Foundations* – Increasingly, foundations provide capital to impact investors through Program Related Investments (PRIs)<sup>22</sup> and recyclable grants, generally tied to a charitable project or activity. A PRI from the Rockefeller Foundation, for example, helped launch E+Co, an energy investment fund, in 1994.
- *Individual Philanthropists* – while not a common source of large amounts of capital, some individual philanthropists have provided significant sources of capital for impact investors. Acumen Fund provides a prime example of source capital raised from donors contributing between \$10,000 and \$5 million over a three year period. In Acumen’s case, unlike traditional LPs, individual donors focus on capitalizing social change over financial returns.

#### IV. WHAT IS NOT WORKING

The maturation of the impact investing space is dependent on financial investment in social capital markets.<sup>23</sup> To sustain any capital market, a certain threshold of investment is required to allow an enterprise to scale its initiative and overcome transactional costs. Underinvestment in social capital markets, while signaling a lack of recognition among financial managers, ultimately hampers the growth of impact investing. This underinvestment is shaped by multiple factors, among them: the failure of the current model to account for social returns on investment (SROIs), a lack of industry-wide performance metrics, uncertainty related to impact investments’ ability to achieve sustainable returns on both social and financial ROIs, and conflicting regulations within the financial market.

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<sup>22</sup> Mission Investors Exchange defines PRIs as a type of social investment foundations can make to support another organization’s charitable activities to achieve the foundation’s own programmatic objectives. Unlike grants, PRIs are typically expected to be repaid, often with sub-market rates of return.

<sup>23</sup> The term “social capital markets” refers to a form of capitalism that recognizes market actors’ ability to “direct the power and efficiency of market systems toward social impact.” (Social Capital Markets, 2013)

## *SROIs not factored into traditional capital markets*

The financial industry has developed a vast infrastructure for managing investments.<sup>24</sup> The current model of investing does not factor social or impact returns on investment into traditional capital equations. The financial industry is bifurcated between investing money and giving money away. A new model that incorporates impact into financial returns could require an overhaul of traditional capital markets, and would demand change from all existing stakeholders.<sup>25</sup>

The traditional role of finance “puts profits ahead of people” – or emphasizes risk-adjusted financial returns over social and environmental outcomes. As those in the finance world have begun to tackle social problems along side government and philanthropists, investors’ motivations for impact are changing.<sup>26</sup> The private sector has turned to impact investing to fulfill its increasing desire to “do good” while making money, but maintains its focus on capital markets to drive its growth.<sup>27</sup>

For impact investing to grow beyond its current state, somewhere vaguely between philanthropy and traditional finance, traditional investors need to begin seeing impact investing as a “private sector-based solution” instead of simply a charity- or government-based activity. Only after impact investments are seen as viable, non-philanthropic solutions with clear financial benefits will more traditional capital flow into the impact sector.

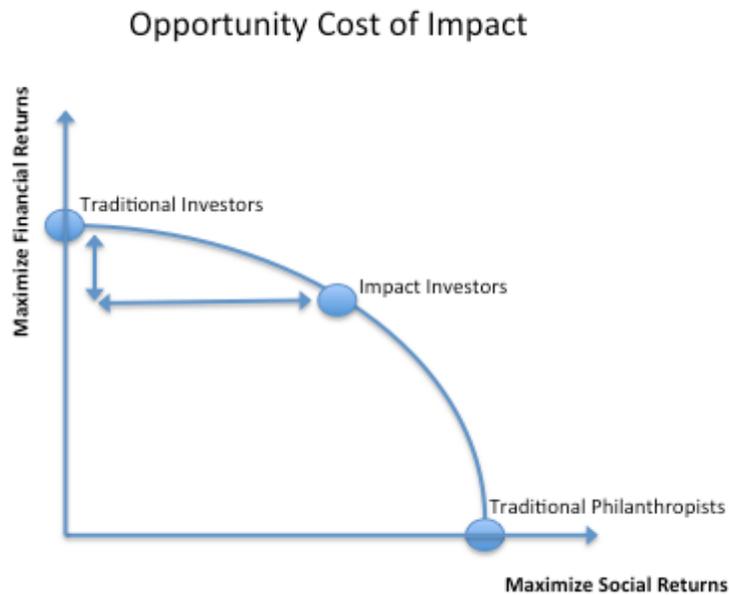


Figure 2: Opportunity Cost of Impact

<sup>24</sup> Friedman and Stonesifer 2012

<sup>25</sup> Avery, Impact investing: Making money make an impact 2012

<sup>26</sup> Friedman and Stonesifer 2012

<sup>27</sup> Cordes, Impact Investing 2010

Many traditional investors reflexively believe in zero-sum tradeoffs between impact and financial returns despite a lack of empirical evidence to back the assumption that impact implies financial loss.<sup>28</sup> While tradeoffs inherently exist between any two options, the choice between traditional and impact investing is not a zero-sum game. As can be inferred from Figure 2, relatively small financial gains or losses can be exchanged for significant social payoffs. Additionally, in some cases, greater financial returns are correlated with greater emphasis on impact returns.<sup>29</sup> What some may view as a unilateral tradeoff between one set of financial forecasts and another is simply the opportunity cost of business.

When investors approach the space differently, politicians, beneficiaries, and other key stakeholders will follow their lead.<sup>30</sup> Market-based approaches offer a more effective model for targeting specific products to populations in-need than traditional philanthropy, and the traditional investment community has begun to recognize the potential for “making financial returns while improving society.”<sup>31</sup>

### *Conflicting performance metrics*

Impact investors – a diverse cohort ranging from individuals to financial institutions, private foundations, retirement fund managers, and wealth advisors – do not have a common set of standards or metrics for impact. The lack of universal standards makes it difficult for traditional investors to evaluate empirically social enterprise projects and impact investments.<sup>32</sup> For any investment, the imbalance of information between the entrepreneur and investor often discourages investors from making transactions that would benefit the overall market; for impact investors, social returns present an additional layer of information asymmetry.<sup>33</sup> Ultimately, investors and fund managers hold the primary responsibility for demanding the evidence and metrics they need to justify to their investment in social enterprises.<sup>34</sup>

In light of the impact sector’s novelty, many argue that asset managers must establish common measures to track the social performance of their impact-oriented portfolios with the same rigor used to monitor traditional financial returns. As common standards and metrics are adopted, investors’ risk of the unknown will dissipate. Uniform impact metrics will allow asset managers to establish more cost-efficient processes with lower transaction costs, facilitate “robust information flows” with data on value and risk, foster value-driven allocation of money to align investments and performance, and create flexible outlets for easily buying and selling assets.<sup>35</sup>

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<sup>28</sup> Darden 2013; Greenblat 2013

<sup>29</sup> Clark, 2013

<sup>30</sup> Mair and Milligan 2012

<sup>31</sup> Aspen network of development entrepreneurs releases second annual impact report 2011

<sup>32</sup> Avery, Impact investing: Making money make an impact 2012; Cordes, Making an Impact 2010

<sup>33</sup> Meehan and Jonker 2012

<sup>34</sup> Morduch and Agrawal 2011

<sup>35</sup> Edwards, et al. 2011; Morduch and Agrawal 2011

Cathy Clark, Director of Duke University's Fuqua School of Business CASE i3: Initiative on Impact Investing,<sup>36</sup> believes that the struggle to find a uniform language of impact investing is counterproductive to the actual work of integrating social and financial returns. Despite continued efforts to define which impact label best fits a business model, social entrepreneurs across the spectrum describe their own measures of impact with minimal reference to a common set of standards or metrics. Traditional financiers anchored on risk/return profiles conceptually reject any returns (social or otherwise) not directly tied to existing standardized metrics.

As impact-oriented markets evolve and diversify, both information and funding intermediaries will play a larger role in the space. Information intermediaries include non-profit advocates, investor networks, and evaluation entities. Funding intermediaries like Acumen Fund and the Nonprofit Finance Fund will continue to shape how the sector defines its performance and addresses investor risk.<sup>37</sup>

### *Uncertain financial sustainability*

The ability of an enterprise to scale its return on investment is a decisive factor for private banks in assessing the enterprise's financial sustainability. Scalable impact investments provide capital to organizations with viable revenue models and help direct public and private dollars to worthy ventures.<sup>38</sup> Jacqueline Elias, co-head of philanthropy at JPMorgan Private Bank, notes that scaling impact deals is one of JPMorgan's primary challenges as they are often "somewhat limited and sometimes quite small" compared to the philanthropy's more typical capital targets.<sup>39</sup>

In 2011, Johanna Mair and Katherine Milligan estimated 200 impact-oriented investment funds, and a growing number of foundations, networks (i.e. GIIN<sup>40</sup> and ANDE<sup>41</sup>), and mainstream financial institutions have entered the impact investing field. Amidst the excitement over the sector's growth, some question the impact investors' expectations to be able to sustain consistent and simultaneous financial and social returns (Mair and Milligan 2012).<sup>42</sup> Others view the impact investment field as comparable to the nascent tech industry of the late 1980s, before common standards were widely accepted. As such standards are adopted and cross-sector information is shared within the impact investing field, significant growth is possible.<sup>43</sup>

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<sup>36</sup> CASE i3 is an initiative of Duke University's Fuqua School of Business. Its stated mission is to "establish... resources and activities for students, entrepreneurs, investors, funders, academics, and policymakers" related to the field of impact investing. ([www.casei3.org](http://www.casei3.org))

<sup>37</sup> Meehan and Jonker 2012

<sup>38</sup> Edwards, et al. 2011

<sup>39</sup> Avery, Impact investing: Making money make an impact 2012

<sup>40</sup> Global Impact Investing Network

<sup>41</sup> Aspen network of Development Entrepreneurs

<sup>42</sup> As Director of the White House Office of Social Innovation and Civic Participation Jonathan Greenblatt noted, when many investors hear "impact," they think "tradeoff."

<sup>43</sup> Cordes, Making an Impact 2010

## *Conflicting regulations*

The current systems regulating philanthropy and investment are increasingly anachronistic. While many within the traditional systems of philanthropy and investment combat inefficiencies within the sectors, government regulation by tax exemption is inefficient. Impact investing has evolved as a more holistic “patchwork quilt of innovation” – ranging from predominantly mission-oriented investments willing to forgo profits for social impact, to predominantly finance-oriented investments that target market rates while aiming to “do no harm.” It should be regulated by a system that fully covers how investors address social problems today and in the future.<sup>44</sup>

Policies that fail to support sustainable markets threaten the flow of private capital over time. Assessing regulatory and policy risk is critical to investors concerned about the risk of policy change. An investor specifically worried about tax subsidies, for example, would likely abstain from investing in a market of heavily supported tax credits nearing uncertain reauthorization.<sup>45</sup>

## V. WHAT IS WORKING

Jonathan Greenblatt, Director of the White House Office of Social Innovation and Civic Participation, views the success of impact investing as a gradual process that “doesn’t happen over night.” Just as Limited Liability Companies (LLCs) took ten to fifteen years to become fully integrated into the corporate environment and parlance, Greenblatt believes the nascent impact investing sector will take time to become fully integrated into capital markets.<sup>46</sup> To date, the impact investing sector has four factors working in its favor as it moves toward broader recognition and acceptance as a viable investment strategy: above-market-rate returns during the recent financial crisis, the emergence of a common language and infrastructure for impact investors, influential market actors affirming the sector, and a growing body of evidence linking financial success and commitment to impact.

### *Financial crisis a turning point for impact investing*

Impact investing has been on the rise for nearly a decade, but the recent financial crisis has proven a turning point for the sector. The economic downturn caused both public and private institutions to reevaluate their budgets and agendas, emphasizing the need to find and leverage alternative sources of capital.<sup>47</sup> For philanthropists, the financial crisis brought a distinct awareness of the sustainability of charities to which they were donating. For others, the simple

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<sup>44</sup> Bugg-Levine, Emerson and Hayman, Hype or Promise? 2011

<sup>45</sup> Grace, Wood and Haszhia 2011

<sup>46</sup> Greenblat 2013

<sup>47</sup> Grace, Wood and Haszhia 2011

fact that returns on investment for microfinance were up 5% while global equities were down as much as 30% proved that impact investing could “do good”<sup>48</sup> while making a profit.<sup>49</sup>

With the positive financial returns amidst the economic downturn as proof, impact investors can challenge naysayers who associate impact with inherent tradeoff. Individual investors, wary of the outcome the recession would have on their long term financial planning, showed increased interest in how their money is invested. This personal interest in financial outcomes “provides a perfect springboard” for incorporating impact investing into investors’ financial decision-making.<sup>50</sup> As the market has begun to rebound from the nadir of the crisis, impact investing has proven itself a financially viable, market-oriented solution alongside traditional financing and investment options.

### *Emergence of common language and infrastructure*

Metrics help investors discern good investments from good marketing, both in terms of performance and profitability. A 2008 meeting of investors and philanthropists focused on aligning social and financial returns to “unlock trillions of dollars” for impact investments led to the creation of standardized definitions, rating systems and performance management tools for assessing impact investments.<sup>51</sup> Since that time, three complementary tools have emerged to proffer common metrics and infrastructures for impact investors:

- *Impact Reporting and Investment Standards (IRIS)*<sup>52</sup> – a lexicon of impact industry terminology by which companies, investors, and other stakeholders can define, measure, and govern their social performance. Similar to International Financial Reporting Standards or the Generally Accepted Accounting Principles, IRIS is designed to be integrated into most approaches to impact reporting and data management.<sup>53</sup>
- *Global Impact Investing Rating System (GIIRS)*<sup>54</sup> – an impact ratings tool and analytics platform for assessing social and environmental performance of developed and emerging market companies and funds. GIIRS aims to provide impact investors with mechanisms to benchmark and change investor behavior through verified social and environmental performance data, comparable to Morningstar investment rankings and Capital IQ financial analytic.<sup>55</sup>

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<sup>48</sup> A common criticism of impact investment, and specifically of microfinance loans to the developing world is that the financial risk outweighed the reward (Cordes, Impact Investing 2010).

<sup>49</sup> Avery, Impact investing: Making money make an impact 2012; Cordes, Impact Investing 2010

<sup>50</sup> Fleetwood 2010

<sup>51</sup> Brandenburg 2012

<sup>52</sup> in conjunction with the Global Impact Investing Network (GIIN)

<sup>53</sup> Brandenburg 2012; Gelfand 2012

<sup>54</sup> in conjunction with B Lab

<sup>55</sup> Brandenburg 2012; Richardson 2012

- *Pulse*<sup>56</sup> – a data management tool, pre-loaded with IRIS metrics, to collect, manage and report on impact portfolio data. Pulse is a cloud-based database built on the Salesforce.com platform, targeting user flexibility in how data is collected, managed and reported.<sup>57</sup>

While the impact investing field has yet to universally adopt IRIS, GIIRS, and Pulse as the gold standards in measuring and reporting impact data, their congruent evolution has positioned them as strong contenders to streamline impact data industrywide. If the three continue to grow together, and are more universally adopted, both impact investors and entrepreneurs can benefit from reliable, reportable, and unified data.<sup>58</sup>

### *Influential actors affirming the sector*

The vanguard of impact investing plays a pivotal role in the development and institutionalization of the sector. While impact investors seek more than a simple financial return on capital, the differences in their respective approaches to the sector span the full spectrum of impact investing. As these leaders collectively find ways to navigate new and riskier investments, they pave the way for others to follow, and create a robust infrastructure for impact investing.<sup>59</sup>

At the global level, organizations like the Aspen Network of Development Entrepreneurs (ANDE), the European Venture Philanthropy Network, and the Global Impact Investing Network (GIIN) help create global and regional standards for the impact investing industry. Tangentially, respected foundations with substantial assets – including the Rockefeller, Gates, and Skoll foundations – have drawn the attention of traditional and impact investors while funding and promoting innovative impact investments.<sup>60</sup>

Beyond the non-profit and foundation world, governments and intergovernmental development organizations have helped to institutionalize impact investing. Among the most prominent and influential institutions are the World Bank’s development marketplace, the UK Department for International Development, and the US Agency for International Development.

In the banking sector, JP Morgan, Morgan Stanley, and Citibank, among others, have devoted significant time and resources to developing their own impact portfolios. As these traditional financial institutions allocate capital, publish thought leadership, and provide advisory services to their own investors and issuers, they set precedent for other traditional asset owners and managers to follow their lead.

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<sup>56</sup> in conjunction with Acumen Fund

<sup>57</sup> Brandenburg 2012; Busenhart 2012

<sup>58</sup> Busenhart 2012

<sup>59</sup> Bannick and Goldman 2012; Trelstad 2009

<sup>60</sup> Bannick and Goldman 2012

### *Financial success tied to commitment to impact*

In a forthcoming analysis<sup>61</sup> of empirical data received from for-profit social entrepreneurs, Duke Professor Cathy Clark has found that businesses most highly committed to achieving impact<sup>62</sup> are growing the fastest.<sup>63</sup> From these findings, she deduces that entrepreneurs who are actively thinking of how to align their businesses with their mission may better position themselves for growth due to the multi-faceted attention they give their business model in meeting the standards of certifying impact organizations like B Lab. Effectively, while the impact label may scare off some investors, incorporating key mission-focused metrics into financial returns can aid in profitability.

## VI. KEY CONSIDERATIONS

To draw traditional investors to into the impact investing field, 5 Stone seeks to develop client-oriented solutions that mitigate the uncertainties of social capital markets for its investors. Creating such solutions presents a complex challenge. The impact investing sector has evolved in reaction to inefficiency between the public and private sectors. Impact investing attempts to step outside the existing model<sup>64</sup> to achieve its dual goals of financial and social gain. Any proposed solution to attract traditional investors to 5 Stone's impact-oriented projects must be weighed according to its ability to:

- Maximize risk-adjusted financial returns
- Align short term financial targets with long term impact goals
- Appeal to traditional investors within their comfort zone
- Contribute social and environmental impact to target market

### *Maximize risk-adjusted financial returns*

5 Stone is a for-profit enterprise that seeks social and environmental sustainability in addition to market-rate financial returns. While it may be willing to assume different risk/return ratios than most traditional funds, its business model is built around profit maximization. Prospective investors from traditional financial markets will accept few tradeoffs for maximum financial returns.

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<sup>61</sup> The working title for Clark's forthcoming research is "Accelerating Impact Enterprises." Duke University and SJF Ventures will publish it later this year.

<sup>62</sup> as defined in their mission or statement of purpose

<sup>63</sup> Clark 2013

<sup>64</sup> In this instance, the "existing model" refers to the traditional actors in financial markets: government, philanthropy, and private markets.

*Align short term financial targets with long term impact goals*

5 Stone's mission to generate optimal sustainability in energy, housing, food, and employment markets is integral to its identity and its financial prosperity. It seeks long term social impact alongside more immediate financial successes. Although failure to maximize profit is not an acceptable tradeoff for social gain, 5 Stone seeks to bolster its long term mission through its investments.

*Appeal to traditional investors within their comfort zone*

For 5 Stone to deploy capital to its green real estate ventures, it must attract capital from both traditional and impact investors. Many traditional investors and financial institutions shy away from "impact" considerations because they are not permitted<sup>65</sup> to stray from the established criteria for evaluating financial performance.<sup>66</sup> 5 Stone strives to bring traditional investors into the impact investing sector in a way that appeases their apprehensions and emphasizes the risk-adjusted returns 5 Stone can offer.

*Contribute social and environmental impact to target market*

To differentiate itself from traditional commercial competitors, 5 Stone must add social and environmental value to its target market. The company's desired "green" impact defines its role in the greater (traditional) real estate sector and delineates its competitive advantage among market rivals.

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<sup>65</sup> by their own investors or fiduciary responsibilities

<sup>66</sup> Darden 2013

## VII. TWO MODELS OF SUCCESS: PATIENT v. SUSTAINABLE CAPITAL

Acumen Fund (“Acumen”) and Generation Investment Management (“Generation”) present two divergent models for raising capital for impact investing. Acumen, funded predominantly by smaller investments from individual philanthropists, employs a model they refer to as “patient capital,” targeting disciplined investments – loans or equity in lieu of grants. Generation, on the other hand, focuses on more traditional investments, under the principle that an investment’s measurements of sustainability will drive the company’s returns. Both models emphasize an investment approach that prioritizes long term returns over short term performance measures.

	<b>Acumen Model</b>	<b>Generation Model</b>
<i>Goal</i>	Bring market-based solutions to traditional philanthropy	Embed sustainability into market calculations
<i>Philosophy</i>	Patient Capital	Sustainable Capital
<i>Market Orientation</i>	Emphasis on social returns	Emphasis on financial returns
<i>Expected Returns</i>	Below-market rate	Market-rate
<i>Impact Target</i>	Multi-Issue	
<i>Outlook</i>	Long term view, shorter-term benchmarks	
<i>Investors</i>	Aware of double-bottom line from outset	

Table 1: Acumen-Generation cross-comparison

### **Acumen Fund: Patient Capital Model**

#### *History*

With seed capital from the Rockefeller Foundation, Cisco Systems Foundation and three individual philanthropists, Acumen was incorporated in April 2001. Over the past twelve years, Acumen’s investors and advisors have funded social entrepreneurs’ efforts to find solutions to poverty – specifically those related to water, health, housing and energy for people earning less than four dollars per day.

## *Mission*

Under the philosophy that traditional charities may meet the immediate needs of “very low-income” populations but fail to enable people to solve their own problems, Acumen contends that market-based solutions have a greater potential to grow, in the long term, than traditional charities whose sources of funding can abruptly dry up. It defines its core mission as creating a “world beyond poverty” through investment in social enterprises, emerging leaders, and breakthrough ideas.

## *Vision*

The overarching vision for Acumen’s work is grounded in the idea that poor people seek dignity rather than dependence. Thus, it seeks to create a world in which everyone has access to the “critical goods and services they need” to make their own decisions and “unleash their full human potential.”

## *Investment Approach*

Acumen’s investment approach is built around the idea that new models of investment require “patient capital” to provide critical services at affordable prices. Supported by “investors”<sup>67</sup> willing to take on a risk/return profile considered unacceptable to traditional investors, Acumen views its approach as a third way, seeking “to bridge the gap between the efficiency and scale of market-based approaches, and the social impact of pure philanthropy.” According to its website, patient capital is debt or equity investment in an early-stage enterprise with a long term horizon for the investment, risk-tolerance. Acumen prioritizes social over financial returns, manages support to entrepreneurs, and maintains the flexibility to seek partnerships with government or corporations through subsidy and co-investment when beneficial to low-income customers.<sup>68</sup>

## *Model of Success*

In 2004, Acumen invested \$600,000 in a company focused on bringing safe drinking water to rural India. A year after the initial investment, the company, WaterHealth International (WHI), had broken ground on two new water systems. Two years after the initial investment, after working with Acumen to adjust the water facility design, WHI was operating ten systems and had begun to attract additional investors. By year three, WHI had raised \$11 million in private capital and was engaged with banks to finance an additional twenty water systems.

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<sup>67</sup> Although Acumen refers to fund contributors as “investors,” the individuals play the role of donor more than traditional investor as there is no risk/return from dollars “invested” with Acumen Fund.

<sup>68</sup> Acumen Fund 2013

Today, WHI has more than 275 water systems, \$30 million in capital, and continues to develop its efforts to address India’s water challenges.

*Meeting 5 Stone’s Criteria*

Acumen’s model fails to fully meet 5 Stone’s key criteria for consideration. On a technical level, the model can be defined as profitable, but fails to maximize risk-adjusted financial returns. The goal of bringing market-based solutions to traditional philanthropy partially relates to 5 Stone’s desire to align its financial and mission-focused goals, but the underlying focus on philanthropy would undermine 5 Stone’s effort to appeal to investors within their comfort zone.<sup>69</sup> However, the model would allow 5 Stone to contribute impact to its target market.

While patient capital can arguably qualify as profitable in the long term, the traditional investors 5 Stone seeks to attract have little patience for tradeoffs. The Acumen model provides for no market-rate financial returns despite strong adherence to its long term vision and impact. The underlying sub-market rate of return for Acumen investors would likely repel the traditional investors 5 Stone seeks to attract.

	Profitability	Alignment	Appeal	Impact
<b>Patient Capital</b>	X	✓	X	✓

Table 2: Patient Capital Model and 5 Stone Criteria<sup>70</sup>

**Generation Investment Management: Sustainable Capital Model**

*History*

Generation, founded in 2004 by former Vice President Al Gore and former Goldman Sachs Asset Management CEO, David Blood, is a private, owner-managed partnership based in London and New York. Its Advisory Board, chaired by Gore, crafts its long term thematic research agenda into targeted global sustainability issues. Generation focuses on what it considers to be the “key drivers of global change,” including issues of environmental degradation, poverty, natural resource scarcity, healthcare, migration, and urbanization.

<sup>69</sup> The emphasis on philanthropy would likely trigger traditional investors connotations of imbalanced tradeoffs between social and financial returns.

<sup>70</sup> A “check” represents the model meeting the key consideration; an “x” represents a failure to meet the consideration.

## *Mission*

Generation divides its mission into three tiers. The first aim is to “deliver superior investment performance by taking a long term investment view” and incorporating sustainability research within a framework of “equity analysis.” The second element focuses on establishing long term client partnerships through “unique investment insights and exceptional client service.” The final component looks internally to attracting, retaining, and developing a “passionate investment culture.”

## *Vision*

Generation describes its institutional vision as “[embedding] sustainability into mainstream capital markets.” Among its core values, the organization highlights its commitment to clients, excellence and innovation, sustainable research, and responsible citizenship.<sup>71</sup>

## *Investment Approach*

Generation believes in replacing existing short term economic thinking with something they call “sustainable capitalism,” a framework that attributes sustainability factors’ direct affect on long term business profitability. They incorporate economic, environmental, social and governance criteria to evaluate a company’s sustainability over the long term. In their view, shareholders’ interests will be best served by companies that maximize financial returns in tandem with strategic management of economic, social, and environmental performance. While Generation strives to “deliver superior investment performance” – presumably, market rate returns on investment – it discreetly calls prospective investors’ attention to the fact that such superior performance is an aspiration with no guarantee that such performance goals will be realized.<sup>72</sup>

## *Model of Success*

Recognizing that businesses cannot be asked to assume the role of governments, Generation believes companies and investors will inevitably be the ones to mobilize the capital needed to overcome global challenges like climate change, water scarcity, and poverty. Combining Generation’s research and investing arms, in a 2011 *Wall Street Journal* editorial, Gore and Blood identify five key actions for companies and investors to adopt to “accelerate the current incremental pace of change to one that matches the urgency of the situation.”

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<sup>71</sup> Generation’s full list of values, as outlined on their website, is commitment to clients, integrity, excellence and innovation, teamwork, diversity, sustainability research, independence, and responsible citizenship (Generation Investment Management 2012).

<sup>72</sup> Generation Investment Management 2012

Gore and Blood’s five recommendations are:

- *Identify and incorporate risk from stranded assets*, or assets whose value would change dramatically when significant externalities (i.e. carbon or water pricing) are taken into account. As long as stranded assets’ true value is ignored, their long term potential to negatively disrupt markets grows.
- *Mandate integrated reporting* for more comprehensive insight into companies’ financials and performance metrics. Such information would allow both companies and investors to make better resource-allocation decisions for long term planning.
- *End the default practice of issuing quarterly earnings guidance* as the quarterly calendar incentivizes short term management of funds by managers and overemphasizes the significance of certain (short term) performance measures to investors.
- *Align compensation structures with long term sustainable performance* that hold asset managers and corporate executives accountable for their decisions beyond a yearly or quarterly basis.
- *Incentivize long term investing with loyalty-driven securities* to replace the “dominance of short termism” that fosters market instability and undermines the efforts of those seeking longer-term value creation.<sup>73</sup>

### Meeting 5 Stone’s Criteria

Across the board, Generation’s sustainable capitalism model meets each of 5 Stone’s criteria for consideration. Generation’s goal of embedding sustainability into its market calculations offers 5 Stone a strong example of translating valuation of social and environmental impact into the existing language, metrics and “comfort zone” of traditional investors. Like any asset management fund, Generation cannot guarantee short term, market-rates of return on investments, but it provides a clearly-defined business model targeting maximum risk-adjusted returns. Generation’s application of the sustainable capital model supports 5 Stone’s alignment of its long term mission with more immediate financial returns, as well as its desire to maximize profits and effect social and environmental impact.

	Profitability	Alignment	Appeal	Impact
<b>Sustainable Capital</b>	✓	✓	✓	✓

Table 3: Sustainable Capital Model and 5 Stone Criteria

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<sup>73</sup> Gore and Blood 2011

## VIII. RECOMMENDATION

With the underlying goal of bringing traditional investors into the impact sector to fund its green real estate investments, 5 Stone should pursue Generation’s model of “sustainable capitalism,” incorporating profitability and sustainability into its long term strategic planning. Despite the fact that the impact investing field is relatively new to capital markets and traditional investors are skeptical of its potential risks and perceived tradeoffs, the sustainable capital model presents investors with a growing source of information for socially, environmentally, and politically responsible investing that, importantly, meets traditional investors in their comfort zone.

5 Stone’s target investors from traditional financial markets will accept few tradeoffs for maximum financial returns. While both the patient and sustainable capital models provide examples of profitability and long term visions for impact, only Generation seeks above-market-rate risk returns on investment. Given its emphasis on generating optimal sustainability in energy, housing, food and employment markets, and the constraints of an evolving impact investment market, 5 Stone can draw its targeted traditional investors into the impact investing sector through the Generation model.

To incorporate the sustainable capital model into 5 Stone’s existing business model, the company’s management team should pursue the following actions:

1. *Address perceived tradeoffs head on.*

Tradeoffs exist in every transaction, and investors who will accept only short term strategies and returns are unlikely to be a good fit for 5 Stone. However, for investors with some flexibility – seeking strong financial returns, but open to impact returns – 5 Stone must lay out how it will justify risk-adjusted financial returns within the context of its social impact over time. If, like Generation, 5 Stone can convince its investors to look beyond short term economic frameworks, misconceptions of tradeoffs may dissipate, and draw in new investors.

2. *Clarify impact targets as value-added to risk-adjusted financial returns.*

5 Stone’s impact targets are straightforward and speak to a broad audience of impact-oriented investors, but they must be contextualized to meet traditional investors where they are. Without having to ask, prospective investors should be able to answer for themselves how the creation of sustainable energy, housing, food, and employment markets benefit their bottom line – immediately and in the long term.

3. *Provide prospective investors with tangible models of success that respond to what’s not working elsewhere in the field of impact investing.*

5 Stone’s models of success should differentiate the company from others in the impact investing field. Specifically, to show traditional investors how targeted impacts can add value to their investment, 5 Stone should factor SROIs into its financial models, clarifying what and how performance will be measured. SROIs will not always lead to financial gains, but are crucial to 5 Stone’s competitive advantage.

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