AdIn Ventures Paper 3:
Investing with Impact

How we think of Impact

Simply put, we view impact as the third pillar in investment decision making and capital allocation, the other two being return and risk. Impact captures the social and environmental benefit (or harm) of an investment. Social benefit refers to the improvement in the well-being of individuals and communities (e.g. education, healthcare, employment, social mobility, security, etc.) and environmental impact refers to the consequences of economic activity on our planet.

Prevailing investment models focus mainly on return and risk. All else being equal, a rational investor selects an investment that delivers a higher return for the same risk. For a portfolio of investments, add the effects of diversification across asset classes and you can further optimise risk-return. As an extension of this model, the investee or asset and their agents seeks to maximise returns to the investor for the risk taken. This is now the bedrock of modern capital allocation.

While this approach has created significant progress and prosperity in the last 100 years or so, the limitations are now becoming apparent. Not only do we have high income/wealth gaps and unequal access to opportunities in many countries, technology risks leaving many workers behind. At the same time, relentless consumption of natural resources is causing irreversible damage to the planet. If we do not fix these problems, the consequences can be catastrophic.

Faced with these challenges, there is a need to adjust our approach to allocating capital, the fuel that drives the economy and society. Investing with impact requires considering the social and environmental consequences in addition to risk and return. We believe that this approach will lead to more sustainable outcomes for all of us.

Doing good and Doing well

For an investor, the logical question is what does incorporating impact into investment decision making do for the returns. For the risk-return equation, conventional wisdom is that an investor should be compensated with higher returns for taking more risk. Startups have high failure rates and for that reason investors expect astronomical

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returns from each investment. Admittedly, we are in the early stages of impact investing and there is insufficient data to clearly establish a relationship between impact and returns.

Our belief is that it is possible to do good and do well or in other words, there is not an explicit trade off between impact and returns (for a given risk). In fact the two can be self-reinforcing. There are instances of companies like Patagonia and Toms that integrate social factors in their business and have been able to achieve high levels of customer loyalty, which in turn drives value. Increasingly, customers are aligning their spend with their values and the kind of world they want to see. There are many silicon valley companies that are purpose driven which has enabled them to attract better talent and solve real pain points for their customers. At the same time, there are polluting companies that are being subject to penalties and regulations and consumers are rejecting sugary and processed foods that cause health problems in the long run.

This is also borne out of my personal experience. Recognizing that traditional college education was not equipping most students with the skills to land a job and loans for short-term courses were not readily available, I backed a startup that partnered with training institutions to create a frictionless financing solution whereby admitted students could pay back the loan in installments once they found a job. We initially focused on courses with high placement rates and found that training schools were also willing to bear some of the risk to increase enrollment. It was a win-win for all and we were able to build a profitable business with risk adjusted returns better than most unsecured lenders while creating positive social impact via education and employment.

There is one caveat which is that for impact investing to be relevant, it requires that we are able to measure impact dependably and avoid "impact washing". There is a lot of meaningful work underway in this area and it is a matter of time that standardised approaches will emerge and companies will be rated on the quality and integrity of impact accounting. There are two things to note here: first that while humans have understood the concept of risk since the dawn of time, incorporation and measurement of risk in investment decisions is a fairly recent phenomenon, and second, measurement of returns itself can be fairly subjective depending not the least on complex accounting, tax and regulatory rules that are being constantly redrawn and vary by jurisdiction. So we are still in the early days of impact measurement and though healthy skepticism is warranted, the wheels are already spinning.

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Investing with Impact framework

At a very high level, this is how we consider applying the return-risk-impact model in investment decision making. Green represents the investment profile that is acceptable, while Red is not. For the Yellow profile investments, we consider what levers are available across the three parameters to move to the Green profile.

RETURN	RISK	IMPACT
HIGH	HIGH	POSITIVE
HIGH	HIGH	NEUTRAL
HIGH	LOW	POSITIVE
HIGH	LOW	NEUTRAL
HIGH	HIGH	NEGATIVE
HIGH	LOW	NEGATIVE
LOW	HIGH	POSITIVE
LOW	LOW	POSITIVE
LOW	HIGH	NEUTRAL
LOW	HIGH	NEGATIVE
LOW	LOW	NEUTRAL
LOW	LOW	NEGATIVE

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