Social investment: maintaining momentum and managing risk

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Social investment is nearing a critical juncture where its survivability – as a way of identifying new sources of financial return and an innovative method of contributing to society – depends on its ability to remain honest, effective and accessible. To do so, also requires that social investment and philanthropy continue to comply with the latest tax requirements and regulation – cue the informed and equipped wealth adviser!

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As a sector enjoying a great deal of attention, social investment is under increased scrutiny from a variety of stakeholders. This ranges from charities and social enterprises using private sector approaches to scale up their activities, to donors and investors seeking genuine impact and sustainable financial return as well as to tax authorities keen to ensure that tax advantages are given only when they are deserved.

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Remaining honest – learning from conventional investing

Impact investing must be viewed as an honest practice with good intentions for tackling the root causes of social problems, not one that takes ill-informed risks or one that is hijacked by the impact equivalent of 'green-washing'.

Honesty is not always a trait associated with conventional investing. The burgeoning market for detailed non-financial due diligence reporting on potential investments is, however, representative of a more ethical attitude to traditional investing, as well as the regulatory pressure applied on the financial sector in recent years. The long-awaited arrival of MiFID II (Markets in Financial Instruments Directive) on 3 January is testament to this and has particularly significant implications for investing in emerging markets and developing economies where transparency and the rule of law may be low.

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Detailed due diligence helps to ensure that an investment is not at undisclosed risk, and that funds will be used for the stated purpose in an economic and political context that is conducive to making the most of the investment. Within private equity, one very frequently hears that the most important information for an investor is a) about the key people involved – what is their track record? are they reliable? – and b) the context in which the investment is taking place – is the business making money based on a sustainable competitive advantage or just a potentially unsustainable set of personal and political connections? What are the underlying risks?

Within social investment and philanthropy, detailed non-financial due diligence can answer the same important questions but can also be used to analyse the 'impact case': are the intended outcomes of a project achievable and sustainable? Do the main players have a track record of success? Are there any contextual reasons which may prevent the investment from achieving its stated aims (e.g. incoming regulation or political shifts)?

To debunk a few myths about due diligence reporting: it may be done in-house or externally; it doesn't have to be expensive; it doesn't have to consist of long, dry reports; and, it isn't only about identifying 'red flags' and preventing investment. Due diligence can be used positively to help identify the right partners, projects and strategies to navigate the 'red flags' and reduce risk, even in challenging environments.

Robust due diligence practices are not only prudent for investors, but tax authorities are increasingly requiring evidence of proper management of funds that are claimed as charitable donations or impact investments. As tax incentives for philanthropy and for social investment grow (e.g. the Social Investment Tax Relief scheme in the UK), authorities are likely to harden on their assertion that 'relevant and proportionate' due diligence be conducted into the recipients of charitable donations or social investment, and the end use of funds.[1] This will only be exacerbated by recent scandals over the tax affairs of (U)HNWIs, criticism of donor-advised funds, and allegations that charitable giving has funded extremism in the UK and abroad.

Remaining effective – learning from international development

Social investment must prove that it is an effective philanthropic activity. It can do so by promoting and communicating accurate and clear impact measurement which helps align the ambitions of investors and investees.

It is now widely accepted that the measurement and analysis of impact is extremely important to charities and social enterprises wishing to encourage further investment/funding, promote their mission and maximise their impact. However, the recently published Growing a Culture of Impact Investing in the UK report highlights that 52% of people surveyed in the UK avoid impact investing because of the difficulty associated with measuring social impact.[2] Measuring and managing impact is often viewed as overly academic, jargon-loaded and expensive.

This does not have to be the case and the world of international development provides a great deal of experience in lean impact monitoring and evaluation ('M&E') practices. One of the principal impact management tools is the 'theory of change' – which aims to set out the visible effects of a social problem, then dig into the underlying causes. Understanding the underlying causes allows the design of genuinely effective interventions, and observing the resulting changes in the visible effects allows proper metrics to be designed. This provides verification that the underlying causes were correctly identified and are being tackled properly.

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A theory of change can sometimes require detailed research and analysis. But, even an hour spent brainstorming root causes can be invaluable in ensuring that all stakeholders understand the problem they are tackling and that they are not simply alleviating symptoms. Once complete, a theory of change tells the story of how the desired change is expected to occur, and should help satisfy all parties, including tax authorities, of the social intentions of an investment or grant.

Often used by purpose-driven organisations, but rarely explained to investors and philanthropists, a well-informed and logical theory of change can be a powerful process to engage a potential investor and ensure that their ambitions for impact are best met. For example, a wealth adviser recently reported that a client stated that they wanted to invest to help achieve the UN Sustainable Development Goals in Africa – a fairly tall order. After several emails and scattered conversations, it became clear that the potential investor had an interest in improving women's education in West Africa, where they had family. At this stage, using a theory of change framework to analyse where the need is and how a philanthropist or investor wants his or her money to be used will help identify suitable opportunities aligned to the client's principles.

Remaining accessible – learning from each other

Social investment must remain an accessible funding solution, available to a wide range of concerned citizens, whilst avoiding becoming a niche discipline, practised by an informed few.

Accessibility and awareness are major limitations within the field of social investment. It is common to hear charities and project leaders citing a lack of capital as a constraint to growth; but it is also common to hear that deal flow remains low and people struggle to find impact projects at an acceptable scale for investment. It was concerning to read in Growing a Culture of Impact Investing in the UK that a Centapse study revealed that people with financial advisers were less aware of social impact investment than those without.[3] Wealth advisers and other intermediaries can play a crucial role in helping both sides talk to each other, creating awareness of the broad spectrum of impact investments available and establishing partnerships to help charities and investors achieve their social and/or environmental goals.

Conclusion

Social investment can ensure its upward momentum and mitigate risks to its success by working towards what New Philanthropy Capital calls an 'evidence-led social sector'. A more rigorous approach to understanding and communicating impact, risk and sustainability should be embedded into the impact eco-system. Fortunately there is no need to reinvent the wheel, and proven approaches from conventional due diligence and international development can be adapted to suit the needs of investors and philanthropists for greater clarity on the true impact of their activities. In turn, these approaches have the dual benefit of helping social investors and philanthropists meet the requirements of the ever-shifting sands of tax and regulation.

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[1] *'Chapter 2: Due diligence, monitoring and verifying the end use of charitable funds', Compliance Toolkit, Charity Commission for England Wales, 2016*

[2] *Growing a Culture of Impact Investing in the UK, 2017*

[3] *Growing a Culture of Impact Investing in the UK, 2017*

[4] *New Philanthropy Capital, Towards an Evidence-Led Social Sector, 2017*