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OVERVIEW IN 7 SLIDES

(The Original note, all 105 pages, is available at https://zhengpartners.co)

PRICING IMPACT

Extending impact investing to price externalities and lower the cost of capital to impactful investments

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What is the Issue Being Addressed?

- Large & growing bottom-up demand for the inclusion of impact in portfolio construction

But

- Institutional Investors experiencing difficulty incorporating impact operationally

As a result

- Impact is applied to a modest carve-out of capital, not total AUM

Leading to

- A missed opportunity to cause the pricing of impact, positive and negative, across the capital markets
- A missed opportunity to reduce the cost of capital to more impactful investments

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What is Causing Institutional Investors Difficulty in Incorporating Impact?

1) Fragmented, unclear definition – SRI, ESG, impact

2) Institutional investors focus on allocating capital among asset classes.
- Current approaches to impact focus on *individual assets* and cannot be generalized to asset classes
- Impact cannot be incorporated into the first and major step in portfolio construction

- Institutional investors (mostly) out-source the selection of individual assets.
- Institutional investors are (mostly) not staffed to deal with individual assets

3) Impact ratings blend factors which help to predict the quantity of impact with factors which keep investors within mandate guard rails.
- Has the effect of imposing mandate restrictions on all investors regardless of mandate
- Limits investable opportunity set

4) Current approaches to impact, generally, focus on the 'optimal' data at the individual asset level.
- This data is not readily available.
- Creating this data is resource intensive and requires skills institutional investors do not have.
- For the purposes of portfolio optimization, this level of data is 'nice to have' not 'must have'.

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Approach Taken to Address the Issue

1) Focus solely on ex-ante estimation of the *quantity* of primary impact
- Consistent with portfolio optimization.
- Remove asset-specific variables Qualitative aspects and ESG are asset-specific and do not generalize to asset classe
- Total impact is goal-specific not asset-specific and so cannot be used to predict primary impact.

2) Strict separation between factors which predict the quantity of primary impact and mandate-relevant factors which keep investors actions consistent with their mandates.
- Consistent with investment management practice.
- Enables rank-order of ratings to match rank-order of impact quantity.
- Enables investors to tailor portfolios that are relevant to their mandates.

3) Develop a General Theory of Impact which can be applied to asset classes
- Highly simplified.
- Conceptually similar to development of CAPM from the multitude of specific theories used in commercial evaluation of individual assets

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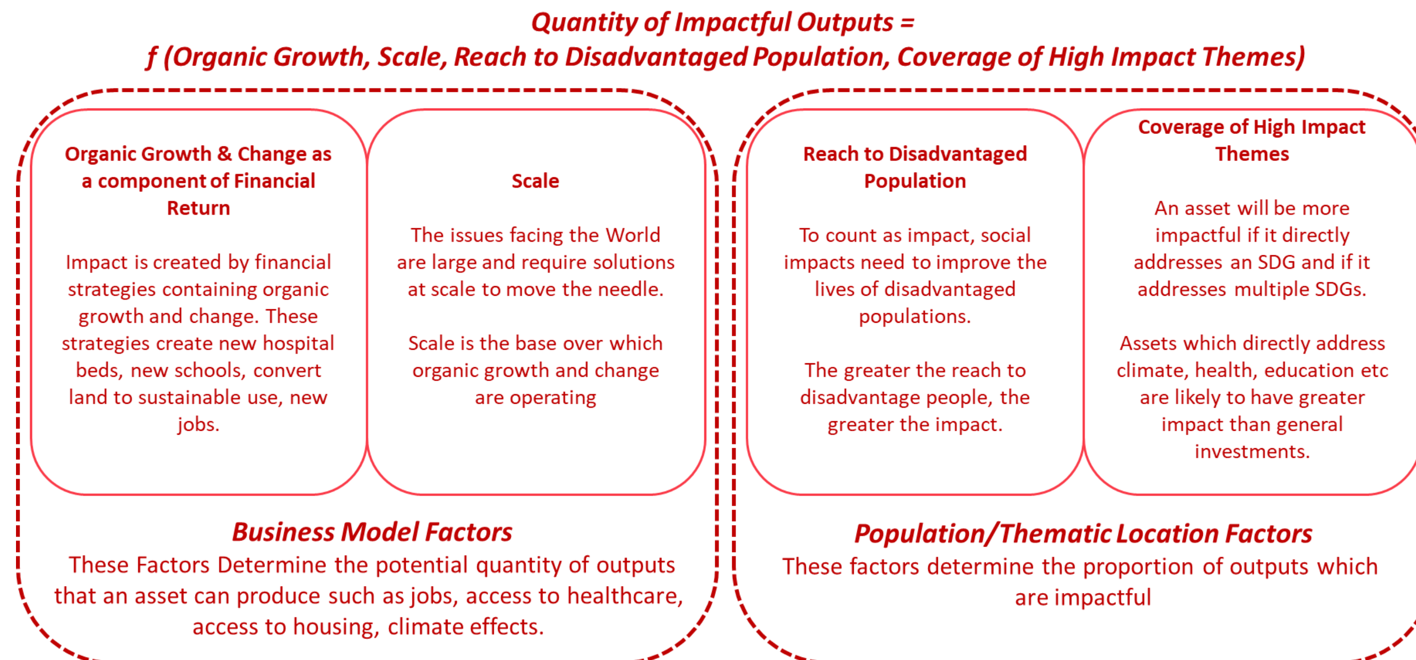
Basis for Developing the General Theory

1) Based on personal experience managing the IFC portfolio to a double-bottom-line

2) Limited data from IFC and Morgan Stanley: Tables 2,3,6   Charts 19,31

3) Some operational proof of concept

- IFC portfolio meeting return and impact targets at time left: 19.3% net IRR, job growth 15.5% CAGR, good ESG compliance.
- Integro 18.8% gross IRR after 3 years and job growth 12.2% CAGR plus growing portfolio of measured impacts such as access to finance, health care, education.



What this Approach to Impact IS and IS NOT

IS

- Very simplified data requirements
  - Easier to operationalize
- Can be applied to asset classes and so integrated into standard portfolio optimization
  - Can be applied to all asset classes
  - Allows portfolio modeling in three dimensions of risk/return/impact
- High-level way to bring large amounts of capital under impact management and
  - *Generally* direct capital toward more impactful assets and away from less impactful assets
  - Cause impact to be priced, lowering the cost of capital for more impactful assets

IS NOT

- A way to link assets to goals. This requires Theories of Change and total impact.
- The most informative way to identify the most impactful individual assets or to rank-order individual assets.
  - As with the commercial evaluation of assets, assessment of the qualities of individual assets requires much deeper data and analysis.
  - For individual assets the General Theory is the minimum standard not the preferred standard.
- While it can be applied to all asset classes, it is weakest for those assets for which the ratio of total impact to primary impact is well above average, for example infrastructure and policy actions.

High potential to mobilize capital for Impact. Low potential to identify the most impactful individual assets

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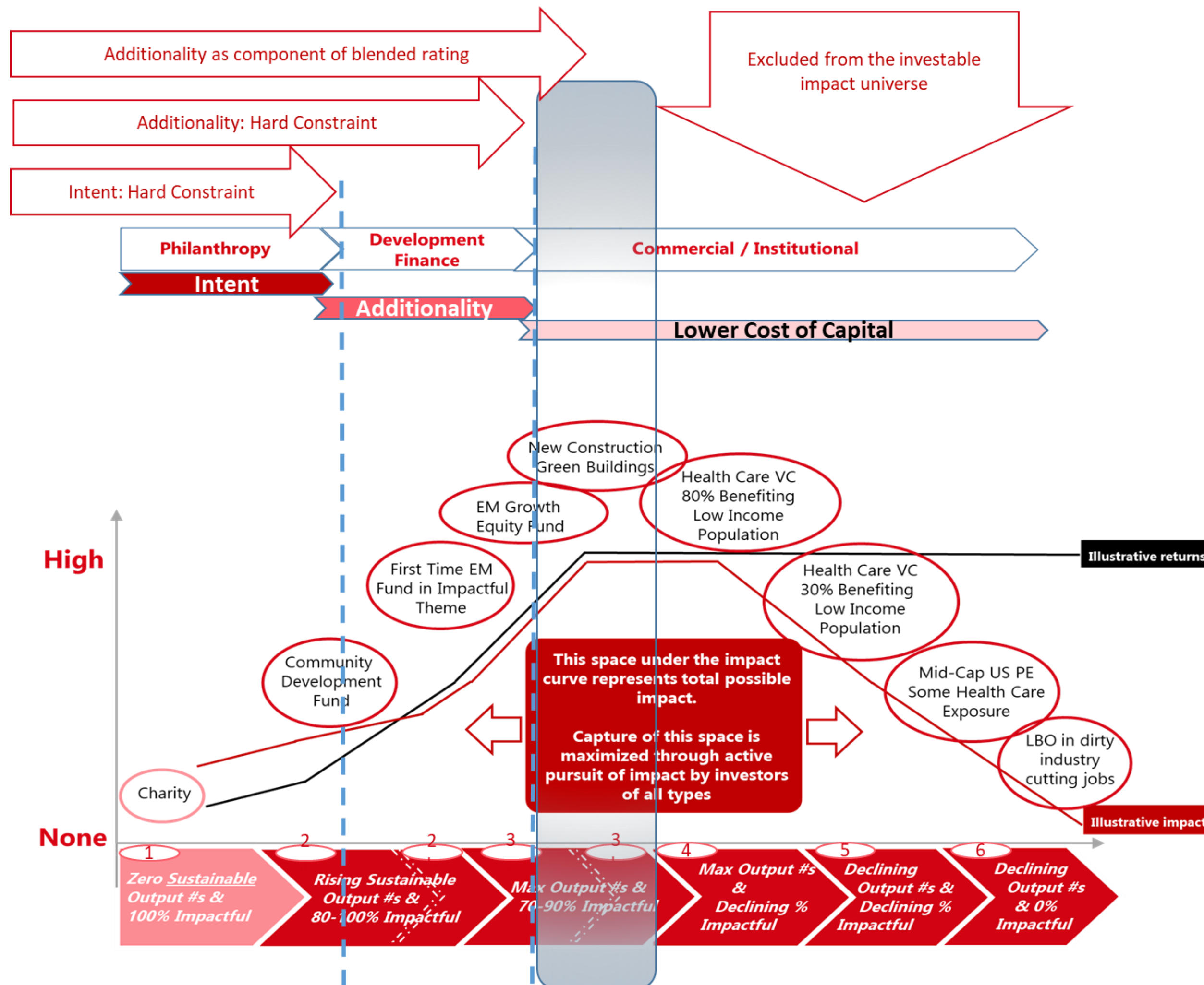
Additionally, the General Theory Provides Insights

- The General Theory enables the Impact Opportunity Space to be mapped.
- This provides further insight into why current approaches to impact are problematic for institutional investors.
- It also provides insights for policy makers.



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Next Steps?

Annex 1

Ideas for Further Investigation

1) The methodology for operationalizing the general theory needs to be developed. Initially this is likely to require a scoring methodology, which as yet does not exist. As improved disclosure increases access to relevant data, a modeling approach will need to be developed.

2) This note speculates that there is, at some point, a trade-off between declining organic growth and increasing scale in terms of an assets' ability to create a quantity of impactful outputs. However, the exact nature of the relationship between organic growth, scale and quantity of outputs across all sizes and types of assets still needs to be established.

3) This note speculates that, for most assets, primary impact will be a reasonable indicator of the relative potential of an asset to create a quantity of impactful outputs. The note further speculates that primary impact will not be such a good indicator for a subset of assets such as infrastructure and VC where the difference between primary impact and total impact may be much larger than average. Analysis to establish the nature of the relationship between primary impact and total impact across a wide range of asset types is yet to be undertaken.

4) This note emphasizes the role of disclosure in making available the information required to operationalize the general theory and measure externalities. What this data set is and how it compares to data already disclosed is yet to be established.

5) This note combines business strategies in which financial returns are driven by organic growth and strategies in which returns are driven by converting a stock of assets to a higher impact state under the general heading of 'organic growth'. Operationalizing the general theory would benefit from a clear understanding of how the financial returns on conversion strategies are usually classified.

6) This note suggests that execution risk is a good candidate for inclusion in the general theory as a measure of impact risk. The note further suggests that, until better data are available, financial risk may be an acceptable proxy for execution risk in the general theory due to the common underlying effect of execution risk on both returns and impact. The relationship between impact risk, execution risk and financial risk deserves further investigation.

7) This note suggests that the acceptable depth of impact data that an investor should be expected to use is relative to the cost/ benefit calculus of the investors mandate and is presently undetermined. Establishing the increase in impact achieved through the use of information of increasing depth would help to both focus activity on creating the information which enables the greatest increase in impact and create demand for this information.

8) This note sketches out potential policy options that arise from investors' interest in impact. It also notes the potential to calibrate policy responses to the nature of the underlying problem by using the area of the impact opportunity space in which an asset is located as a guide to the likely nature of the problem. There is considerable scope to further develop these themes.

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