

RACHEL F. WANG

A large silhouette of a wind turbine dominates the left side of the cover, extending from the bottom to the top. The background is a gradient of orange and yellow, suggesting a sunset or sunrise. Several smaller wind turbine silhouettes are visible on the horizon line. A solid teal vertical bar is on the far left edge.

IMPACT INVESTING FOR INSTITUTIONAL INVESTORS

JULY 2016

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Acknowledgments

The author would like to thank the various civil society organizations, academic institutions, financial institutions, and impact investing-related organizations whose innovations are featured in this paper. The impact investing market would not be the thriving hive of ideas that it is without the creativity and hard work of the people in this industry. The author would also like to thank the investors, academics, and experts whose comments and feedback were an integral part to completing this paper. Finally, the author would also like to thank New America and the Bretton Woods II Initiative for providing the space and resources for publishing this paper.

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Bretton Woods II is engaging sovereign wealth funds, pension funds, endowments, and family offices to build a new business model for social finance. The initiative is harnessing analytics, advocacy, and financial tools to channel part of the \$25 trillion controlled by long-term asset holders into strategic investments in social impact that address root causes of volatility. The effort aims to help close the gap in financing for the Sustainable Development Goals.

Bretton Woods II is reframing the value proposition around impact investing by demonstrating that properly targeted investments not only generate competitive risk-adjusted returns, but also reduce broader exposure to long-term risks and volatility.

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INTRODUCTION

As a group, institutional investors are among the largest and most influential actors in the investing community. It is, therefore, significant that a growing number of institutional investors are beginning to embrace the practice of impact investing.

Impact investments are designed to generate social and environmental benefits alongside financial returns. Since impact investing is still a relatively new industry, the academic literature as well as the metrics and tools used to assess impact are still nascent. This is not, however, due to lack of activity. Impact investing frameworks, measurements, and metrics are multiplying quickly through the work of academics and practitioners alike.

Institutional investors are among the most recent entrants into the impact sector, which was initially defined by foundations and family offices. Due to their scale and fiduciary obligations, the decision-making process for institutional actors is distinct from that of other investors. This paper is designed to serve as a guide for institutional investors interested in impact investing by compiling a toolkit of impact investing resources that align with the investment process. This paper will describe various financial vehicles that are sources for potential impact investments, as well as tools for understanding impact investing performance. It is our hope that this study will be a straightforward roadmap to this burgeoning market and a practical introduction to the variety of available impact investing techniques.

Impact investing frameworks, measurements, and metrics are multiplying quickly through the work of academics and practitioners alike.

OVERVIEW OF IMPACT INVESTING

Market Size and Growth

Opportunities for impact investment exist in emerging and developed markets and target a diverse set of objectives ranging from clean technology to poverty reduction. They also vary widely in size, composition, and structure. Because of this, impact investments can be difficult to track as an asset class.

While the industry is not completely new, its recent growth means that efforts to quantify the market size and number of investors are still ongoing. For example, the GIIN and J.P. Morgan estimated that \$60 billion were under management of 125 impact investors in their 2015 survey.¹ The survey also stated that these investors committed \$10.6 billion to impact investing in 2014, and planned to invest almost 16 percent more in 2015. To put this into context, the global market for general investments is sized at more than \$200 trillion, with around \$600 billion devoted to philanthropy. If half of the \$600 billion devoted to philanthropy went to impact investing, that would be five times the amount of current impact investments. And if even one percent of the general investment market went to impact investing, that would create a \$2 trillion market. The sector is expanding rapidly and has enormous growth potential.

Common Impact Investors

Currently, the most common impact investors include large foundations, large financial institutions such as investment banks, pension funds, and independent mission-driven funds. Of the GIIN's council of more than 50 major impact investors, more than 40 percent are foundations, 30 percent are funds whose main investing strategy is impact investing, and the rest are mostly financial institutions which offer other financial products and services as their main line of business.²

That is not to say that this will be the composition of major impact investors going forward. Already there is great variety in the impact investor landscape, with a plethora of varied impact investing financial tools. Mission Markets and Convergence are among a new crop of impact capital markets that facilitate impact capital activity around the world. The Impact Engine, for example, ran a Chicago-based venture capital accelerator program that targeted impact-driven and socially conscious enterprises.³ With frequent launches of new impact-driven venture capital firms, private equity shops, blended finance markets, and other investment funds, the sector is growing more diverse daily.

Common Types of Impact Investments

Although an impact investment is loosely defined as one that contributes to or produces positive social or environmental impact, the specifics of how to identify, categorize, and measure such an investment can be difficult to define. For the investor, it can be entirely subjective which traits qualify as an “impact” investment. Some investors choose their own definition of an impact investment; others follow guides and metrics. Regardless, impact investments most commonly fall under two categories: social and environmental.

Social investments are those that impact individuals or society as a whole. This includes investments that affect poverty, homelessness, education, crime, or unemployment. An example of a social investment is the \$27 million social impact bond Goldman Sachs and the state of Massachusetts organized and set in motion in 2014 to reduce recidivism of inmates in local prisons.⁴ Such investments are meant to positively affect the inmates as well as the society around them. Also included in social investments are investments aimed at addressing governance problems including corruption, financial transparency, and elections.

Environmental investments target challenges including climate change, natural resource management, bio-fuels, deforestation, and household or corporate sustainability practices. Environmental investments also vary widely by asset class or type of business. Depending on the investor’s objectives, an attractive investment may range from real estate holdings that are LEED-certified, to a water-based ETF, to seed capital in a small startup producing solar-powered handheld lamps. Several funds, such as Generation Investment Management, exclusively make investments that are related to such environmental causes.

Investors can choose to focus on a specific category or sub-category of impact investments (e.g. pollution solutions in Asia) or they can adopt a wider portfolio focus. Much like traditional

investment management, impact investment strategies often emerge from an investment manager’s interests and areas of expertise.

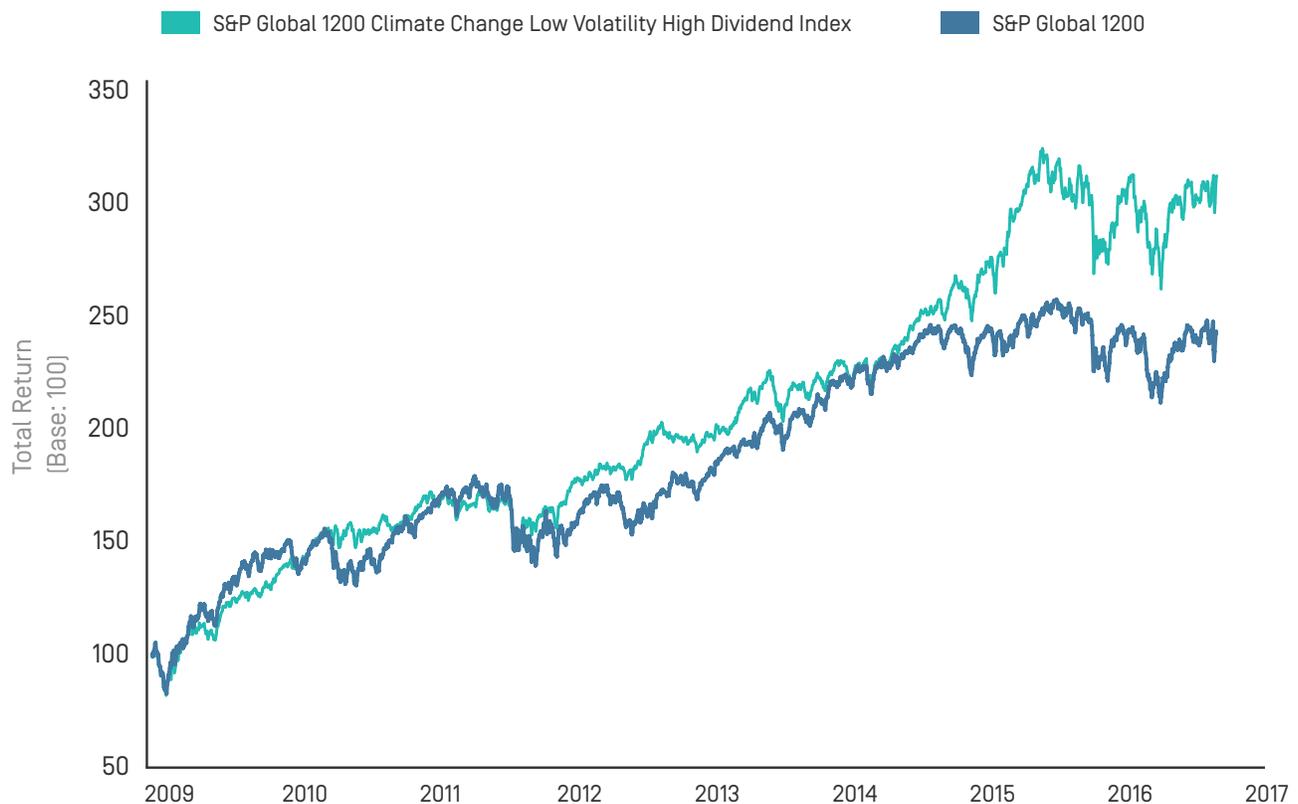
Impact Investing and Financial Returns

Increasingly, market trends and research reports show that impact investing can be as profitable as it is impactful. A 2011 Harvard Business School study published by Robert Eccles, Ioannis Ioannou, and George Serafeim followed the performance of a group of 180 companies over an 18-year period. The results showed that High Sustainability firms significantly outperformed Low Sustainability firms, especially over a long time period.⁵ Similarly, the 2015 Cambridge Associates/GIIN Impact Investing Benchmark showed that 51 private impact investment funds performed comparably to similar conventional funds from 1998 to 2004, despite the perception that impact investing generates sub-par returns. Furthermore, growing interest in green bonds in areas such as Europe, East Asia, and Australia has caused the market to reach almost \$40 billion in size.⁶

There is also increasing evidence that impact investments may provide favorable returns in addition to volatility reduction. In Figure 1, the S&P Global 1200 Climate Change Low Volatility and High Dividend Index (SPGCLDEP)—which groups low volatility and high yielding companies from the S&P Global 1200 with a low carbon footprint—shows a favorable total return over the conventional S&P Global 1200 in the last five years, especially after the financial crisis of 2009–2011.

Another example of financial success in impact investing is Generation Investment Management, a fund created by Al Gore and David Blood that employs an environmental sustainability lens towards its investment philosophy. According to a November 2015 article by James Fallows, Generation’s global equity fund generated a 12.1 percent return per year from 2005 to 2015, which is more than 500 basis points above the returns of MSCI World Index, the industry standard, during

Figure 1 | Total Return of S&P Global 1200 Low Volatility High Dividend Index, 2009–2016



Source: All data for both indices are gathered from S&P Dow Jones Indices and updated July 1, 2016. Data for the S&P Global 1200 Climate Change Low Volatility High Dividend Index prior to its launch date of March 28, 2016 is back-tested. Note that some of this data is subject to inherent limitations because it reflects application of methodology and selection of constituents in hindsight.

the same time period.⁷ Fallows also states that Generation’s 10-year average return ranked number two among more than 200 other global equity managers included in a survey by Mercer, a London-based analytics firm.

Although research is still nascent, evidence is growing that impact investing can produce strong financial returns, comparable to those of many traditional investment strategies. These results also show that impact investing’s returns are often particularly favorable over a long time period. This

is especially beneficial for institutional investors, who often employ long investment horizons and long-term investment objectives. New financial vehicles, such as ESG-themed indices and ETFs, also bolster impact investing’s effectiveness at producing financial returns and thus help establish it as a viable investment strategy. The subsequent sections will profile these financial vehicles and tools for institutional impact investors. The development of these innovations has made impact investing increasingly accessible.

IDENTIFYING IMPACT INVESTMENTS FOR INSTITUTIONAL INVESTORS

Institutional investors often have different characteristics than the family offices and foundations that have helped define the field of impact investing. It is therefore imperative that institutional investors find impact investments that suit their investment objectives. With their significant size and long investment horizons, institutional investors are among those best positioned to reap the returns of impact investing, which also favors stability and profitability over the long term.

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This section profiles several sources of potential impact investments suitable for institutional investors. Similar to conventional investment management, these sources include companies (private and public), indices, ETFs, and bonds (or other fixed income instruments). For investors who

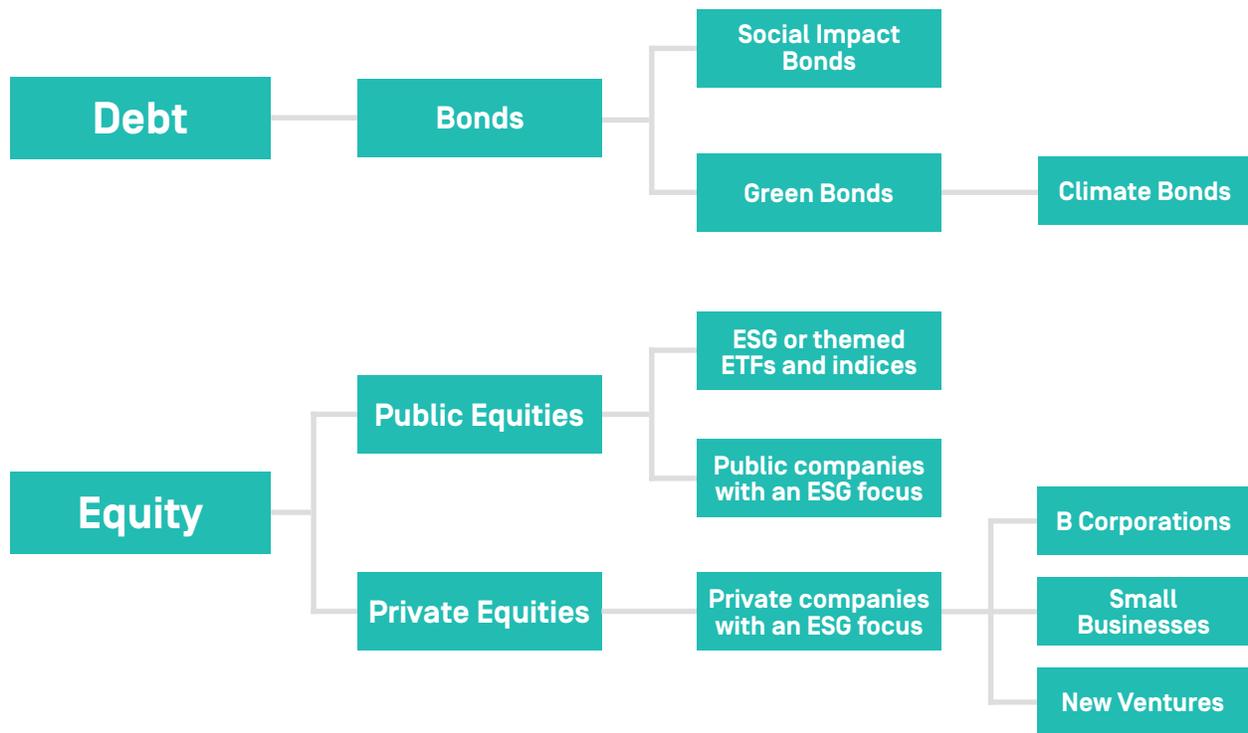
seek to define what makes an “impact investment,” refer to the Appendix for an explanation of IRIS, a series of metrics that encapsulates many environmental and social themes. It should be noted that the number of new impact investment vehicles continues to grow, and this is by no means an exhaustive catalogue. Whatever the objectives or preferences are, this guide can serve as an introduction to institutional investors who are interested in a broad overview of existing impact investment tools and vehicles.

Companies

Many funds choose to invest in companies individually based on their operations or mission. Some specialized venture capital firms, for example, choose to support only clean technologies. Although this is certainly possible for an institutional investor, investments in larger publicly traded companies may be preferred. Institutional investors can choose companies that value certain ethical guidelines in their business operations or products.

To determine whether a company qualifies as an “impact investment,” several frameworks can be used. One popular concept that many companies adopt is “corporate social responsibility,” which

Figure 2 | Overview of Common Impact Investing Instruments



is loosely defined as compliance with ethical standards in a business model. CSR frameworks can be used to identify companies or organizations that are ethical or impactful in their business operations. Another more active approach for companies is to make social or environmental impact the core of their mission. It is up to the institutional investor to select companies that best fit their appetite for impact (i.e. in operations or in mission) and preferences (e.g. investment horizon, company performance, and company size).

G4 Sustainability Reporting Guidelines

The G4 Sustainability Reporting Guidelines offer principles and standard disclosures for companies that wish to make their operations and products sustainable. Companies that follow the G4 Sustainability Reporting Guidelines—including many Fortune 500 companies—produce “Sustainability Reports” on an annual basis.

The G4 Guidelines include economic, environmental, and social categories that include a set of indicators for each category. Companies demonstrate their performance by marking whether they are “in accordance” with each indicator with the required documentation.⁸ A manual developed by the Global Reporting Initiative includes a comprehensive set of indicators, requirements for meeting each indicator, and reporting guidelines for any company looking to produce their own sustainability report. The G4 guidelines focus on not only a company’s direct activities but also its impacts throughout the entire value chain.⁹ Some examples of companies that have adopted the G4 Guidelines include Johnson & Johnson, GAP Inc., UPS, Lockheed Martin, Sony, and Microsoft.

B Corporation

Companies that want to incorporate impact as part of their main mission can file as B Corporations.

Certified B Corporations are businesses that are dedicated to social and environmental issues. It should be noted that most B Corporations are too small to be a viable investment for most large institutional investors. That being said, there are some larger companies that have attained B Corp status: Ben & Jerry's, Patagonia, Etsy, Warby Parker, and New Belgium Brewing. From 2006 to 2014, the number of certified B Corps has grown from zero to almost 1,200, across 60 industries and nearly 40 countries.¹⁰ In the United States, California has the most B Corps: more than 200 compared to less than 100 in Delaware and New York.¹¹

In order to earn the B Corp status, a business must start with scoring highly in a 150-question survey conducted by the B Lab.¹² Companies must have at least six months of revenue, pass interviews, and amend their bylaws to commit to their mission. Anecdotally, several businesses have stated that the B Corp status has helped them achieve both impact and financial success, attracting like-minded customers.¹³ Furthermore, because the B Corp community is still in its early stages, there is a camaraderie among B Corp companies that compels some to share beneficial business practices and values.¹⁴

In addition to the B Corporation status, an even more rigorous certification is also offered: the Benefit Corporation. The Benefit Corporation legal structure mandates that the company will consider its social or environmental mission on par with its financial viability. Benefit Corporations are also required to consider the impact of their decisions not only on shareholders, but on the rest of the value chain as well.¹⁵

Indices

Apart from selecting individual companies, investors can also track an impact-themed index. In this paper, we define an index as a group of companies treated as one single performance benchmark. It is important to note that this is different from ratings or other named "indices,"

which only provide ratings or scores based on a company or country's performance in a specific theme. Indices, according to the aforementioned definition, provide market performance information for their constituents as a whole and track performance over time. Because of this requirement, the indices featured in this section include only publicly traded companies or bonds.

Indices range from global to regional, industry-agnostic to industry-specific, as well as theme. The most prevalent theme in impact-oriented indices is

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the environmental, social, and governance (ESG) strategy. There are numerous ESG indices, varying in originating institution, regional focus, and size. Some other indices focus on a more specific theme, such as the exclusion of companies involved in controversial weapons or fossil fuels. With the variety of options available, it is up to investors to decide which indices fit their preferences. ESG indices have compared favorably to active ESG investment management, particularly over the medium term horizon (1-year, 3-years). In addition, passive investment strategies utilizing indices may offer lower costs than active management.¹⁶

Numerous companies and institutions now provide ESG indices. Thomson Reuters offers Corporate Responsibility Indices and Thomson Reuters/Future Super Australia Fossil Free Indices.¹⁷ FTSE Russell provides two ESG-focused index products: FTSE4Good Index Series and the FTSE4Good Global Minimum Variance Index, which aims to achieve reduced index volatility while maintaining a fully diversified allocation to the equity market.¹⁸ Vigeo,

an ESG ratings company focused on European companies, offers two index series: the Ethibel Sustainability Indices (ESI) and the Euronext Vigeo Indices. The Ethibel series is based on a best-in-class approach and ethical exclusion criteria, and the Euronext Vigeo series includes the highest-ranked companies in terms of corporate responsibility. Even the United Nations has created an index in partnership with Sustainalytics—the

Global Compact 100—an equity index composed of 100 companies selected based on implementation of UN Ten Principles (derived from Universal Declaration of Human Rights), leadership commitment, and consistent profitability. This is by no means an exhaustive section and new indices are continuously formed. To provide a more detailed overview of the indices available, two comprehensive ESG index providers are profiled:

Table 1 | MSCI ESG and ESG-related Equity Index Families

Index Family	Category	Description
MSCI Global ex Fossil Fuels	Values	Excludes companies involved with fossil fuels
MSCI SRI	Values	Excludes companies involved in tobacco, alcohol, gambling, civilian firearms, military weapons, adult entertainment, and GMOs. Includes companies with the highest ESG ratings in each sector of the parent MSCI index.
MSCI ex Controversial Weapons	Values	Excludes companies involved in land mines, cluster bombs, chemical and biological weapons, and depleted uranium weapons.
MSCI Global Low Carbon	Integration	Includes companies that produce low carbon emissions or companies that aim to reduce their carbon footprint by at least 50 percent.
MSCI Global Sustainability	Integration	Includes companies with the highest ESG ratings, making up 50 percent of the adjusted market capitalization in each sector of the underlying parent index.
MSCI Governance Quality	Integration	Includes companies that adhere to a high ethical and sustainable standard of governance.
MSCI Global Environment	Impact	An amalgamation of several environmental indices, including low carbon, exclusion of fossil fuels, and global climate.
MSCI Sustainable Impact	Impact	Includes only companies whose core business addresses at least one of the United Nations Sustainable Development Goals: nutritious food, treatment of major diseases, sanitary products, education, loans to small and medium size enterprises, affordable housing, alternative energy, energy efficiency, green building, clean water, and pollution prevention.

Source: MSCI ESG Indices

MSCI and S&P Dow Jones. These companies not only provide ESG indices but also offer more specialized products based on theme and region.

MSCI and Barclays

Morgan Stanley Capital International, or MSCI, provides several ESG and non-ESG related indices that pertain to a diverse set of themes. These “index families” are based off of two parent indices: for equity-based indices, it is the MSCI ACWI; for fixed income indices, it is the Barclays Global Aggregate.

The equity-based indices are organized by 1) valuing certain ESG factors (e.g. avoiding use of fossil fuels), 2) the integration of ESG factors into the company’s operations (e.g. governance quality), and 3) social or environmental impact.¹⁹ Equity-based indices are shown in Table 1. The fixed income indices—jointly named after its Barclays parent index—comprise more than 500 standard and customized ESG fixed income indices that represent a variety of strategies and objectives. Barclays MSCI fixed income indices include themes on social responsibility,

sustainability, and green bonds and are shown in Table 2.

S&P Dow Jones

S&P Dow Jones maintains at least 75 ESG-related indices, ranging in regional and thematic focus. Most of these indices are equity-based. However, there are also fixed income indices such as the S&P ESG Pan-Europe Developed Sovereign Bond Index, as well as variations on the S&P Global Clean Energy Index based on different risk controls. RobecoSAM, which provides environmental and social (E&S) scores from its global annual survey of over 2,000 publicly traded firms, is a partner on several S&P Dow Jones ESG indices.²⁰

A major category of S&P ESG Indices is environmental indices, which range from its global indices to country or region-specific indices (e.g. India, Egypt, North America, Europe). These environmental indices—similar to MSCI—focus on companies that are fossil fuel free, carbon efficient, or use clean technology or alternative energy.

Table 2 | Barclays MSCI ESG and ESG-related Fixed Income Families

Index Family	Description
Barclays MSCI SRI	Similar to the MSCI SRI index family, this includes bonds that exhibit socially responsible values and avoidance of factors such as alcohol, tobacco, gambling, etc.
Barclays MSCI Sustainability	Similar to the MSCI Sustainability index family, this includes bonds that have high ESG ratings.
Barclays MSCI ESG Weighted	This index weights based on ESG ratings performance and momentum rather than market capitalization. This is intended to reward consistently strong ESG fundamentals.
Barclays MSCI Green Bonds	Includes green bonds, or bonds that are linked with an environmentally beneficial outcome.

Source: MSCI ESG Indices, Upbin et al 2013

Other specialized indices include a S&P Global Water Index, which comprises of 50 companies involved with water related businesses, and the S&P Global Nuclear Energy index, which includes the largest publicly traded companies in nuclear energy that meet certain investment requirements. Some indices, such as the S&P Global 1200 Climate Change Low Volatility/High Dividend Index, show that there can be a favorable relationship between high dividends and low volatility when climate change is factored into the criteria.²¹

Social S&P indices include the S&P 500 Catholic Values Index, an index that takes religious norms into account by excluding from the traditional S&P 500 Index certain activities not aligned with the Responsible Investment Guidelines of the U.S. Conference of Catholic Bishops (USCCB). Another index, the S&P BSE PSU Index, focuses on the performance of several Indian public sector undertakings.

Over the past few years, the number of ETFs specializing in environmental and social themes has proliferated significantly.

ETFs

To track many of the indices profiled in the previous section, institutional investors can utilize exchange-traded funds (ETF). ETFs provide a low-cost way to track mid- to large-capitalization companies that exhibit environmental and social values. Over the past few years, the number of ETFs specializing in environmental and social themes has proliferated significantly. An example of this is Blackrock's announcement in 2015 that it would start an impact investing practice.²² Blackrock now offers numerous iShare ETFs focused on various sustainable practices. One recent example—iShares Sustainable MSCI Global ETF—was launched on April 22, 2016, or Earth Day.²³ Other environmental and social ETF

issuers include Vanguard, Barclays, Etho Capital, and State Street.

Table 3 provides a selection of several prominent ETFs with ESG themes. This is by no means an exhaustive list and only serves to act as an introduction to the types of ETFs currently available.

Bonds

Just like a traditional bond, specialty bonds raise capital from investors over a set period of time, repaying capital and interest when the bond matures. But unlike traditional bonds, these bonds expressly use capital to fund projects that will produce beneficial environmental or social impacts. These bonds are becoming an increasingly popular instrument for impact investors interested in fixed income strategies.

Green and Climate Bonds

Green bonds enable capital raising for new and existing projects with environmental benefits. According to the Climate Bonds Initiative, most green bonds are asset-linked or “use of proceeds” bonds; the proceeds are earmarked for projects but are backed by the issuer's balance sheet. Other types of green bonds include: “use of proceeds” revenue bond, which utilizes revenue streams as collateral; green project bonds, used for specific underlying green projects; and green securitized bonds, which uses a group of projects together for debt re-course.²⁴ A major subsector of green bonds is that of climate bonds, which are focused on climate projects and have developed a boisterous market sometimes separate from the general green bond market.

The first green bonds were the Climate Awareness Bond and the Green Bond, issued by the European Investment Bank and the World Bank respectively.²⁵ Since its origination in 2007, the green bond market has grown to at least \$37 billion in 2014. Although the EIB and World Bank were the only issuers of green bonds between 2007 and 2012, there has been

a sharp rise in corporate green bonds issued. In 2014, corporate green bonds accounted for one-third of the entire green bond market.²⁶

Some examples of recent and notable green bonds include that from the National Australia Bank, which raised AU\$300 million for wind and solar energy farms in December 2014. Another example is Unilever, the first corporation in the fast moving consumer goods sector to issue a green bond. Unilever’s GBP250 million bond was used for greenhouse gas (GHG), waste, and water reductions to support its sustainability plan.²⁷

Green bonds are becoming increasingly popular with large institutional investors. Swedish pension funds AP2 and AP4, APG of the Netherlands, AXA Investment Managers, Aegon, and Zurich Insurance Group are just some of the large institutional investors that have been known to invest in green bonds.²⁸ Long investment horizons and growing awareness of environmental factors in investment philosophies have made green bonds attractive to many institutional investors. Swedish pension fund AP4 has invested over 4 billion kronor across 13 bond issues from 2014 to 2015 and states that green bonds have contributed positively to their fixed

income portfolio returns.²⁹ Like any new financial innovation, green bonds and green bond markets invite some speculation as to whether it will be a legitimate and long-term financial instrument. While many sources are skeptical and consider it a fad, several others are highly optimistic.^{30 31}

Social Impact Bonds

The first U.S. social impact bond was launched in 2010 by Goldman Sachs, the City of New York, and Bloomberg Philanthropies. The bond—Adolescent Behavioral Learning Experience (ABLE) Program—invested \$10 million to reduce recidivism at Riker’s Island (New York City’s main jail complex).³² Goldman Sachs would receive the amount back only if the re-admission rate was reduced by 10 percent or more, and should the rate be reduced beyond that, Goldman Sachs received a financial return correlated with the reduction and related savings to the government. Since ABLE, social impact bonds have grown and diversified. One well-known financial incentive structure is the Pay for Success (PFS) contract, which has been the structure for two recent social impact bonds in early childhood education.

Table 3 | A Selection of Environmental and Social ETFs

Symbol	Name	Issuer	Parent Index	Price	Assets [USD Thousands]
VFTSX	Vanguard FTSE Social Index Fund	Vanguard Group	FTSE4Good Index, FTSE Social Index	\$13.22	~\$2,200,000
VIDI	Vident International Equity ETF	Exchange Traded Concepts	Vident Core International Equity Index with a governance filter	\$20.68	\$566,493
DSI	iShares MSCI KLD 400 Social ETF	Blackrock iShares	MSCI KLD 400 Social Index	\$77.60	\$535,413
KLD	iShares MSCI USA ESG Select ETF	Blackrock iShares	MSCI USA ESG Select Index	\$86.95	\$386,592

Table 3, continued | A Selection of Environmental and Social ETFs

Symbol	Name	Issuer	Parent Index	Price	Assets (USD Thousands)
SHE	SPDR SSGA Gender Diversity Index ETF	State Street SPDR	SSGA Gender Diversity Index	\$62.95	\$270,727
CRBN	iShares MSCI ACWI Low Carbon Target	Barclays iPath	MSCI ACWI Low Carbon Target Index	\$92.33	\$225,671
SPYX	SPDR S&P 500 Fossil Fuel Free ETF	State Street SPDR	S&P 500 Fossil Fuel Free Index	\$50.21	\$100,530
PBW	PowerShares WilderHill Clean Energy ETF	Invesco Powershares	WilderHill Clean Energy Index	\$3.81	\$89,982
WIL	Barclays Women in Leadership ETN	Barclays iPath	Barclays Women in Leadership Total Return Index	\$55.96	\$30,101
RODI	Barclays Return on Disability ETN	Blackrock iShares	Return on Disability US LargeCap ETN Total Return	\$54.37	\$27,288
EQLT	Workplace Equality Portfolio ETF	ALPS	Workplace Equality Index	\$27.27	\$10,901
HECO	EcoLogical Strategy ETF	Huntington	N/A	\$36.15	\$6,326
ETHO	Etho Climate Leadership US ETF	ETF Managers Group	Etho Climate Leadership Index	\$25.66	\$3,855
CATH	Global X S&P 500 Catholic Values ETF	Global X	S&P 500 Catholic Values Index	\$25.26	\$2,524
FIA	Falah Russell-IdealRatings US Large Cap ETF	Falah Capital	Russell-IdealRatings Islamic US Large Cap Index	\$25.50	\$1,302

Sources: All data updated on July 1, 2016. Price indicates closing price of trading day. Vanguard FTSE Social Index Fund data from Vanguard, Morningstar, and Semiannual Report February 2016. PBW data gathered from Invesco and Bloomberg. SPYX, andVIDI data from Morningstar. EQLT data from ALPS Funds. HECO data from Huntington. ETHO data from Etho Capital. CATH data from Global X Funds. FIA data from Falah Capital. All other sources include BlackRock, Barclays, and State Street.

Recently, social impact bonds have garnered increasingly mainstream acceptance. Notable investors such as Bill Ackman of Pershing Square Foundation and former U.S. Treasury Secretary Larry Summers invested in a 2013 social impact bond issued by Bank of America Merrill Lynch.³³ Family offices such as the J.B. & M.K. Pritzker Family Foundation have initiated active participation with early childhood education bonds in Utah and Chicago.³⁴ Social impact bond intermediaries who help oversee and manage the bond project have also proliferated, including Third Sector Capital Partners and the Harvard Social Impact Bond Technical Assistance Lab.³⁵ It is clear that social impact bond activity is growing in the United States as well as in some other developed markets.³⁶

Ratings

For institutional investors interested in a broader set of guidelines to finding impact investments, impact ratings may also be useful. Impact ratings differ from conventional credit ratings systems such as Moody's and S&P. In this paper, we define ratings as groups of companies, countries, or organizations that are given a score or rating based on their performance in specific themes. This includes any ratings system or index that scores and compares constituents based on criteria.³⁷ These impact ratings systems can range from countries ranked by environmental performance to companies rated based on ESG components. These ratings provide institutional investors with a general idea of where impact investments can be sourced. A few ratings systems are profiled below, which give an overview as to the broad applications of such systems when identifying investments. Note that this is not an exhaustive list and only meant to show the range of possible ratings systems available to institutional impact investors.

GIIRS

Whereas the Impact Reporting and Investment Standards (IRIS) is the common language that describes social and environmental performance metrics (see Appendix), GIIRS utilizes IRIS language to rate a fund's performance. Launched in 2011 by the Clinton Global Initiative and the B Lab, GIIRS now exists as part of the IRIS-aligned B Analytics platform.³⁸ The GIIRS (pronounced "gears") rating methodology includes aspects such as governance, worker conditions, environmental processes, and community. And from this methodology, data is gathered from an annual assessment.³⁹ Analogous to Morningstar and Capital IQ, GIIRS aims to be a comprehensive rating system for impact investment funds—a tool to help manage and benchmark impact investing portfolios. As of 2012, more than 60 funds and 300 companies have been rated.⁴⁰

CSRHub

While GIIRS rates funds, CSRHub rates companies on social and environmental standards. CSRHub currently includes ratings on more than 8,900 companies from more than 130 industries. Recently, a mobile application called Ethical Barcode utilizes CSRHub ratings to help inform the socially minded consumer on a company's ethics and business practices.⁴¹ CSRHub may also be useful for investors looking to evaluate companies' social and environmental performances.

Environmental Performance Index

Launched at the World Economic Forum and in its 15th year of inception, the Environmental Performance Index (EPI) provides a view of environmental performance by country to inform decision-making.⁴² The EPI ranks countries' performance on two high-priority environmental

issues: protection of human health and protection of ecosystems. Led by several academic institutions including the Yale Center for Environmental Law & Policy, the EPI provides online data on its country rankings as well as the country's ten-year-change. In 2016, Finland takes the top spot, followed by Iceland, Sweden, and Denmark. The United Kingdom ranks 12th, United States of America ranks 26th, Japan ranks 39th, Saudi Arabia ranks 95th, and China ranks 109th. The EPI also manages a scorecard of progress toward important environmental issues such as terrestrial habitat protection and access to drinking water.⁴³ For those concerned with climate change, the 2016 EPI Report compares countries by change in carbon emissions (increase or decrease), CO₂ emissions, and GDP-standardized trends in carbon intensity (level of achievement).

Social Impact Index (SII)

The Social Impact Index, managed by the Legatum Foundation, measures and ranks multiple factors of social development programs. Factors including breadth of impact, changing paradigms, wellbeing, empowerment, depth of impact, and quality of project implementation are rated and combined into an overall SII score.⁴⁴ Other descriptors such as grant size, number of lives changed, and cost per life are also provided. The SII provides a ratings system that focuses on recipients of grants or other forms of development finance, allowing the funding institution to better understand each program's impact in quantifiable terms.

UNDERSTANDING IMPACT INVESTING PERFORMANCE

Unlike conventional investment management, impact investors can benchmark their performance in social or environmental returns in addition to traditional financial returns. Investors in ESG-themed indices, ETFs, or equity can track financial returns using the same conventional benchmarking tools as other traditional investors. A discussion of financial benchmarking tools will not be included here as there is already a variety of literature on investment portfolio management.

Tracking social or environmental returns, however, is more difficult. Tools such as B Analytics (profiled in more detail in the Appendix) allow investors to manage their companies based on ratings derived from IRIS or GIIRS. Most of this information is only collected ex post facto and cannot be exhibited in real-time. Furthermore, most of the ratings are based on “scores” given to broader themes within environmental, social, and governance categories. This information is qualitative and therefore difficult to assimilate into economic returns, which are tracked in quantitative financial terms. Quantifying social and environmental returns remains a challenge for investors seeking more specific information on whether their “impact investments” are truly making a difference. One possible solution to this problem is the social return on investment (SROI) concept.

Social Return on Investment

Social return on investment (SROI) as a benchmarking tool is unique to impact investing. It can be compared to the price/earnings ratio in terms of its potential for evaluating performance. These metrics are used to measure value creation, and the SROI specifically measures the amount of social impact generated on a specific amount of investment in a particular subject.

SROI is not a new phenomenon in the world of impact investing—there have been discussions on SROI in the 1990s—however, measuring SROI remains tricky. Emerson, Wachowicz, and Chun of the Roberts Economics Development Fund (REDF) concluded that social enterprises create value in a continuum that ranges from economic, to socio-economic, to social value.⁴⁵ Economic value is the traditional motive for most enterprises; common measurements include return on investment, price/earnings ratio, and profit margin. Social value is created when processes and inputs are combined to create improvements in the lives of individuals or society as a whole. Emerson, Wachowicz, and Chun state that this is where most non-profits operate, and it is difficult to measure value in this space since most “products” are qualitative and not reducible to analytical terms.

Socio-economic value, on the other hand, includes economic and social value. An entity creates socio-economic value by generating economic value from its inputs, but also by creating social impact. For example, an initiative that provides job-training programs to unemployed people who currently receive public support would qualify as socio-economic value. This initiative develops professional abilities with the potential result of reducing unemployed workers dependent on government support.⁴⁶

Socio-economic value can be quantified and calculated as SROI, which in turn can help investors evaluate investments before and after they invest. A study conducted by SVA Consulting in Australia on the impact of SROI and SROI reporting showed that the SROI analysis gave organizations a deeper and more analytical insight into their value creation.⁴⁷ The study also found that the SROI report helped investors and organizations understand the true costs associated with delivering social impact, resulting in better strategic planning. However, SROI is not without its flaws. The study also noted that there were only two forms of SROI analysis: one that estimates social value creation in the past, and one that projects social value creation in the future. The study proposed a need for a third form – “baseline SROI” – that assesses SROI in the present.⁴⁸

Despite these considerations, calculating SROI can be a powerful way to track portfolio performance. Guidelines on calculating SROI and isolating social cash flows are available in Emerson, Wachowicz, and Chun’s paper. The SROI Network also offers assistance in calculating SROI, social net present value, and sensitivity analysis.⁴⁹

Market Performance

It can also be challenging for institutional investors looking to understand and benchmark their performance against the general impact investing market. At the time of this writing, there is still a significant lack of analytical research on the

impact investing market. Although there have been numerous developments in qualitative frameworks, there is still a dearth of research on market performance and other retrospective benchmarks. Some of the reasons that contribute to this could be 1) the market is still nascent and time horizons are too short to make significant conclusions, 2) many funds or organizations do not release data on their investing performance to the public, and 3) not all actors in the impact investing market are familiar with investment research or analysis. Despite these challenges, the literature on impact investing is constantly evolving to fill new informational gaps.

It can be challenging for institutional investors looking to understand and benchmark their performance against the general impact investing market.

Impact Investing Benchmark

The Impact Investing Benchmark (IIB) is the first comprehensive analysis of the financial performance of private equity and venture capital impact investing funds. Although it leaves out institutional investors such as sovereign wealth funds and pension funds, the IIB is still useful for any impact investor. To date, it is the only initiative that is produced similarly to analogous financial performance reports for traditional investment funds. In doing so, the IIB is paving the way for analysis of impact investments as an asset class.

Managed by Cambridge Associates and GIIN, the IIB is comprised of 51 private investment funds that were launched between 1998 and 2010. According to their 2015 inaugural report, the IIB found that these funds performed comparably well, despite the perception that impact investing may generate subpar returns.⁵⁰ From 1998 to 2004, the IIB funds outperformed similar conventional funds, and over the entire 1998 to 2010 time period, underperformed conventional funds by about 1.5 percent. IIB also showed that funds that raised under \$100 million

returned a net IRR of 9.5 percent to investors – outperforming similarly sized conventional funds (4.5 percent). As with any other investment strategy, manager selection, due diligence, and risk management are still important factors to achieving high returns.

The IIB provides much-needed information on impact investing as its own asset class. Its decision to focus on private investments shows that the impact investing strategy can be viable on a smaller basis as well. For institutional investors, this means that impact investing can be done without usurping many other fund resources.

Literature on Impact Investing Practices

While impact investing is not new, the recent exponential growth in the demand and diversity of this type of investing means that few widely established practices exist. An increasing number of organizations are producing both theoretical and practical advice for crafting a successful impact investment portfolio. For investors looking for qualitative information on how to manage an impact investment portfolio, several entities

conduct their own internal surveys of institutional investor practices.

J.P. Morgan and GIIN conduct an annual impact investor survey that includes information on asset allocation and performance, portfolio management, and general perspectives on the impact investing market. Their latest edition, published in 2016, featured answers from 158 impact investors that allocated capital to a wide range of asset classes and industries.⁵¹

The Sovereign Investor Institute has also conducted surveys on institutional investors – many of whom are impact investors as well. The Institute’s polling reports feature perspectives on macro risks as well as the percentage of participating institutional investors that promote good governance in their portfolios.⁵²

Other resources include the UK DFID, Rockefeller Foundation, and various academic institutions. For example, Rockefeller Foundation not only publishes articles on their investment performance, but also makes public their list of grantees and investments.

CONCLUSION

The impact investing market is increasingly active and innovative in its approaches to various forms of investment, corporate social responsibility, and research. With the flurry of activity from different perspectives—investor, organization, and academia among others—it can be difficult to keep track of all the developments and tools that are being offered.

The next few years will determine if impact investing will become a sustainable investing strategy. Institutional investors can play a major role in fortifying this market by pioneering precedents that will be adopted by future generations of impact investors. Many sovereign wealth funds, for example, are already known for including impact investments in their portfolios. These examples pave the way for other investors interested in doing the same. Furthermore, institutional impact investors are able to create more impact and influence due to

their scale and visibility, which can only bring more attention and resources to the impact investing industry.

One advantage of participating in impact investing at its current stage is that funds and organizations are able to define “impact investing” according to their views and act upon it without need for external qualification. At the same time, standardization and accreditation practices are needed to monitor the quality and activity of the impact investing market as it continues to develop. Frameworks are still being developed publicly and privately, and time will tell if a standardized approach will emerge. Nevertheless, the field is ripe for innovation and action and it is a pivotal time for existing and potential actors to become actively engaged.

APPENDIX: DEFINING “IMPACT” IN INVESTMENTS

One main question for the investor is to differentiate between a traditional investment and one that qualifies as an “impact investment.” Some impact investors choose not to base their investment decisions on external metrics or frameworks and instead develop internal definitions for what constitutes an impact investment. A set of impact investing metrics can help an institutional investor identify which investment qualifies as “impactful” depending on the investor’s preferences and values.

IRIS

The Impact Reporting and Investment Standards (IRIS) is perhaps the most comprehensive set of impact metrics currently available. It supports the taxonomy of impact investing by providing a set of metrics that measure the social, environmental, and financial performance of an investment.⁵³ Managed by the GIIN, IRIS features a widely adopted set of impact metrics and fits with several partner frameworks and platforms. IRIS does not provide any data on specific companies; rather, it is a catalog of benchmarks that investors can check off when determining whether an investment fits certain objectives and goals.

IRIS’ metrics are a compilation of several different impact measurement toolkits, not limited to the World Resources Institute (WRI), Global Reporting Initiative (GRI), Social Performance Task Force (SPTF), and the World Business Council for

Sustainable Development. These resources can be accessed separately, but they also exist synced into the IRIS system. Likewise, many other impact measurement tools and platforms that make use of IRIS metrics are considered “IRIS-aligned,” and can be used in conjunction with IRIS as well.⁵⁴

IRIS is continuously updated and is offered through a public online platform that allows the user to filter by sector, target beneficiaries, operations and financials, and strategic focus. Currently more than 180 impact investors use IRIS.⁵⁵ IRIS provides extensive starter manuals and other guidance materials on its website.

B Analytics

In addition to defining impact investments, the IRIS system also provides tools for comparing companies and funds based on their impact performance. B Analytics is an IRIS-aligned impact investing portfolio management platform managed by GIIN. In addition to offering the impact investment ratings database, GIIRS, it also includes PULSE, a comprehensive portfolio management tool. The B Analytics platform is optimized to allow investors to monitor and collect performance data using IRIS metrics and the B Impact Assessment tool. The platform is customizable for planning, developing frameworks, storing and analyzing data, and creating reports.

Notes

- ¹ GIIN
- ² GIIN
- ³ Gaughan 2015
- ⁴ Field 2014
- ⁵ Eccles, Ioannou, and Serafeim 2012
- ⁶ Climate Bond Initiative
- ⁷ Fallows 2015
- ⁸ Global Reporting Initiative 2015
- ⁹ Ghuliani 2013
- ¹⁰ McGregor 2015
- ¹¹ Sharp 2014
- ¹² Goodman 2013
- ¹³ Goodman 2013
- ¹⁴ Honeyman 2014
- ¹⁵ Honeyman 2014
- ¹⁶ Salemi et al 2015
- ¹⁷ Thomson Reuters Environmental, Social and Governance Indices
- ¹⁸ FTSE ESG Ratings
- ¹⁹ MSCI ESG Indices
- ²⁰ Salemi et al 2015
- ²¹ S&P Dow Jones ESG Indices
- ²² Rose-Smith 2015
- ²³ “BlackRock Introduces iShares Sustainable MSCI Global Impact ETF”
- ²⁴ Climate Bonds Initiative
- ²⁵ Bartels et al 2015
- ²⁶ Bartels et al 2015
- ²⁷ Bartels et al 2015
- ²⁸ Flood 2013
- ²⁹ Green Bonds, AP4 2014
- ³⁰ Scott 2014
- ³¹ “Green Grow the Markets, O” 2014
- ³² Hartley 2014
- ³³ Hartley 2014
- ³⁴ Rockefeller Foundation; J.B. & M.K. Pritzker Foundation
- ³⁵ Hartley 2014
- ³⁶ Azemati et al 2013
- ³⁷ Indices that track market performance of a group of publicly traded companies or bonds have already been discussed in a previous section (II.B).
- ³⁸ Calvert Foundation 2011
- ³⁹ GIIRS 2016
- ⁴⁰ GIIRS 2016
- ⁴¹ CSRHub 2014
- ⁴² Hsu et al 2016
- ⁴³ Hsu et al 2016
- ⁴⁴ Social Impact Index, Legatum Foundation
- ⁴⁵ Emerson, Wachowicz, and Chun 2000
- ⁴⁶ Further information is available in Emerson, Wachowicz, and Chun 2000. The paper includes examples of SROI calculations.
- ⁴⁷ Social Ventures Australia Consulting 2012
- ⁴⁸ A comprehensive list of observations are included in the SVA Consulting study, “Social Return on Investment: Lessons Learned in Australia.”
- ⁴⁹ The SROI Network 2012
- ⁵⁰ Matthews, Strenlicht, Bouri, Mudaliar, and Schiff 2015
- ⁵¹ Mudaliar, Schiff, and Bass 2016
- ⁵² Sovereign Investor Institute Polling Reports
- ⁵³ IRIS website
- ⁵⁴ For a table of IRIS-aligned platforms and tools, see Appendix 2 in Getting Started with IRIS, which is available on the IRIS website
- ⁵⁵ IRIS website

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