GUEST ESSAY

Social Finance from an Investor's Perspective

By Leslie Christian

The first in a series of essays to be continued on the RSF blog

Social finance, impact investing, slow money, patient capital. These are all terms that are used to describe an approach to investing that places a priority on the "triple bottom line"— social, environmental, and financial results, or "people, planet and profits,"— in contrast to a more single-minded focus on short-term financial results, often at the expense of people and planet. Although impact investing is typically a small portion of most investment portfolios, it is my contention that, in the context of the world today and over the long term, impact investing will prove to be superior in all respects, including financial, and should be considered the core element of every investment portfolio.[1]

How do we move impact investing from margin to middle—from forming a small percentage of overall investments to taking a central position? We need to make a solid case based on critical thinking and analysis, that begins with the way investment management is currently practiced and identifies flaws and limitations. This is not about "feel good" investments, it's about forming an investment philosophy, guidelines, framework, and strategies that make the most sense in this new and challenging century.

The investment world is dominated by Modern Portfolio Theory (MPT), a 1950s dogma upon which the investment community has layered a set of principles and strategies for portfolio management. Even though MPT has detractors and critics, it still dominates our thinking. MPT was first applied to the stock market. It teaches that owning a diversified portfolio of stocks (20 or so) is less risky than holding just one stock because the ups and downs of one stock can offset that of another. This leaves the investor with a return that is representative of the overall stock market, not just of one stock that might be dramatically higher or lower. The concept of diversification has been applied not just to individual stocks but also to "asset classes"—groups of investment options that share certain structural characteristics such as stocks, bonds, cash, real estate or commodities. Today, the first step for nearly all investment advisors is to work with clients to decide upon an appropriate asset allocation, that is, to decide what percentage of the client's portfolio should be invested in each type of asset. After diversification among asset classes, holdings within each asset class are also diversified. This is all done with the expectation of achieving the highest return for a given amount of risk. And this is where it gets tricky! What do we mean by risk, and can we expect the same patterns to occur in the future as they have in the past?

During the past 50 years or so, modern portfolio theorists have established the case for diversification within asset classes as well as across asset classes. I am concerned, however, that in our efforts to quantify risk and return profiles, we have inadvertently closed our minds to the big picture. I'm not sure that our current categorization of asset classes with their associated risk/return profiles is sufficiently robust to deal with the complexities of the global economy as it relates to ecological limits and social inequity.

Cash is considered risk-free in that the value of the asset is stable, and the return on cash is usually quite low as a consequence. As we move along the risk/return spectrum, we encounter bonds of various types and then stocks—small cap, large cap, growth, value as well as domestic, non-US and emerging. Stocks are riskier than bonds but not as risky as private equity, which comes next on the spectrum. Then, there are commodities and real assets as well as a plethora of investment strategies in combinations of asset classes. Along with the ranking of assets with respect to risk, there are expected returns associated with asset classes—higher returns are expected from riskier assets.

Aside from the obvious problems witnessed during the past two years, there are some deeply embedded but questionable assumptions in this approach. These include assumptions about economic growth, globalization, and historical trends: growth as measured by GDP

[1] Subject to the risk/return analysis and investment discipline that will be developed in this and future essays.

will continue; global trade and capital flows will grow; and historical risk/return patterns will continue.

What if these assumptions are faulty? It's possible that the greatest risks lie in directions that are implicitly ignored in most asset allocation discussions. Rather than trying to measure the riskiness of a particular asset within the framework of a growth economy that looks a lot like the past century but with more players, perhaps we need to consider the riskiness of the global growth economy itself. When we frame the question this way, we open our thinking to great areas of uncertainty as well as risks that are not so obvious in our more constrained asset allocation models. And, we then find that the asset class spectrum that is so widely accepted is only a subset of what is possible. We can identify less conventional asset classes and specific opportunities that historically may have been considered very risky, but that, within a broader scope of risk, are not only less risky but may also serve to mitigate some of the new risks we have identified. This is how I think about "impact investing"—a deployment of investment dollars to mitigate a risk that threatens our collective future and, in so doing, provides an attractive risk/return opportunity.

Ecological constraints clearly have tremendous implications for us as humans. Within the constraints of ecology, there are societal issues with respect to wealth disparity, poverty, and unemployment. It is possible to perpetuate the trajectory of wealth disparity that is currently at work globally—the rich getting richer and more isolated from ecological devastation, and the poor getting poorer and even more marginalized. This is applicable not just to individuals but to communities as well. To the extent that community-based economies rely upon exogenous production and wealth creation, they are at risk of becoming part of the marginalized poor. At an aggregate level, this becomes a national problem with respect to the health of a country's economy, its ability to provide services to its citizens, and its influence in the world. Globally, it is difficult to imagine that perpetual poverty and wealth polarization will not continue to fuel resentment, social and economic disruption, and retaliation against the wealthy. Thus, wealth disparity presents a real risk to the global economy.

These risks are not specifically addressed in MPT, and they are not risks that can be mitigated using conventional portfolio management tools. The language of MPT is too sterile and linear to allow for the complexities of these multi-dimensional risks. It's necessary to develop a new framework for analyzing risk.

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MPT assumes that economic growth (as measured by GDP) will grow indefinitely. Yet, it is a physical fact that we cannot continue to deplete natural capital and exhaust ecological systems. We are already experiencing climate disruption, water shortages, and desertification that have direct impact on human health and welfare. Common sense tells us that we must change our practices. This is not a choice. Either we will change in time or we will be forced to change by nature. It stands to reason, then, that the economy must transform from a carbon-based, resource-devouring machine to a system based on renewal and resilience. It is quite possible that some companies' products and services will either be unnecessary or impossible to offer due to competition for natural resources. Our assumptions about a growth economy must be tempered by the reality of ecological limits.

With the emergence of globalization has come the belief that bigger is better and less risky. In fact, in an ecologically constrained world, it isn't size as much as form and efficiency that matter. A business model that considers location and logistics to be meaningful factors will tend to favor decentralization, co-location of raw materials and production, and efficient distribution systems rather than mass and magnitude.

Following are three suggestions for classifying investment opportunities based on risk. In a series of future essays on the RSF blog, I will continue to develop this analytical framework.

RISK FRAMEWORK FOR THE 21ST CENTURY

1. Rank investment opportunities according to the extent that the underlying businesses/governments are managing ecological risk through remediation and prevention as well as proactive development and expansion. Products and services must make sense in a resource constrained world.

2. Rank investment opportunities based on business models. Rather than depending upon huge, convoluted (and currently cheap) production and distribution systems, forward thinking companies will organize themselves using systems principles including decentralization, resilience and redundancy, and efficient logistics.

3. Rank investment opportunities according to their effectiveness at building and strengthening local economies as engines for social equity and environmental sustainability. > Continued on page 8

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to RSF. Rather than being driven by a particular social or environmental issue, this initiative is focused on demonstrating a more associative model for the field of philanthropy.

In his 1922 lectures on economics, Steiner described a troubling trend in the financial system of his time: "Everything was drawn into the stream of money, as it moved itself along. Pure money business, without any natural or personal subject – that is the end towards which, as the nineteenth century drew to a close, everything…was gravitating." We could easily substitute the word "twentieth" for "nineteenth" in that last sentence and, like Steiner, we have begun to see its unraveling in the subsequent century.

So where do we go from here? Steiner did not give us a blue print or instructions for creating economic associations. He only described their essential principles and stressed the importance of starting with our own individual economic activity and following it, observing it, and learning from it directly, rather than beginning from a theory or model. So, that is the journey that we are on at RSF. We will always strive to have a connection with the economic process that is as direct as possible.

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The risks identified and the analytical tools proposed lay the groundwork for a holistic approach to asset allocation. Step number one is categorizing investment opportunities according to whether and how they address fundamental risks of the 21st century. Only after this analysis and qualification is it prudent to move to structure, terms, and specifics of particular investment opportunities.

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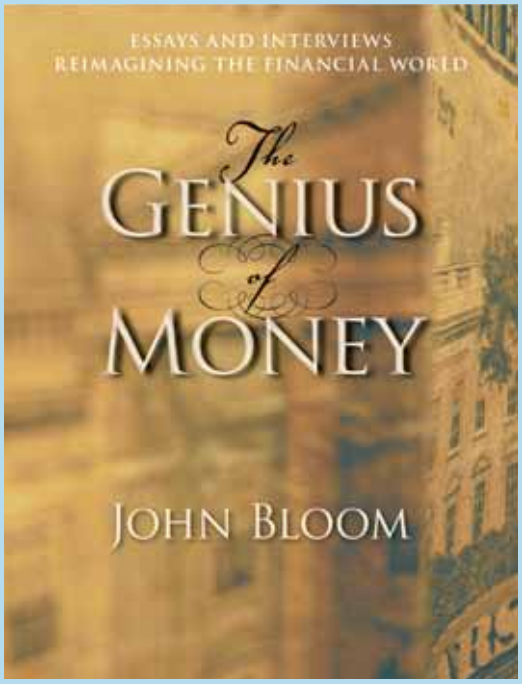

THE GENIUS OF MONEY
BY JOHN BLOOM

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