As one ponders the title, the way forward may seem straightforward enough. After all, the range of vehicles that provide investment capital to micro-entrepreneurs, broadly defined, has expanded beyond traditional micro-lending to include other, in fact, equity forms, including impact-driven private equity. Certainly two investment trends among institutional managers appear to have converged with this development. Over the last 15 years institutional managers have progressively increased their exposures to alternative assets, particularly private equity. In addition, asset owners have become considerably more socially aware and some have purposely extended investment mandates to extra-financial criteria, including, for example, resource sustainability and other socially responsible objectives. Also some investment programs – among them sovereign investment programs – have established philanthropic counterparts to fund projects completely beyond the scope of more narrow investment mandates. Thus, while, on the surface, it might appear that institutional investors with deep pools of assets and long investment horizons would make probable candidates to fund inclusive or dual return projects or invest in impact-driven vehicles\(^2\), the reality is starkly different. What barriers prevent this intermediation? Can these be surmounted?

Institutional investors operate within a governance context or with liability structures that can place hard constraints on their investment activities. At the same time, they also establish baselines for return requirements. In addition to these constraints institutional investors also face significant operating hurdles to the investment in dual or social return projects. Principal among these are investment size/scale and analytical capacity relative to institutional size. In fact, it is somewhat paradoxical that larger funds with more operating flexibility and greater analytical capacity frequently are unable to achieve scale economies from investing in smaller scale projects traditionally associated with social finance, micro-finance, or impact investing. As David Wood and his colleagues note well, asset owners face statutory constraints and operate in an investment culture that at the outset preclude investing in dual return structures.\(^3\) Following conventions of fiduciary duty and portfolio management – “diversified portfolios, standardized forms of investment that exist at scale, benchmarks that determine how the broader market

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2 Because investments in inclusive projects generally have lower financial return components and include additionally social return features, we use the term “dual return” interchangeably here with “inclusive” to describe such investments.

evaluates products, and, especially in recent years, relatively short time horizons for evaluating investment performance” – institutional investors must first justify dual return investments on conventional grounds, i.e. financially, and only then can turn to their ancillary benefits.4

How then to bridge this apparent institution/inclusion gap? From a portfolio perspective, there are several dimensions to this challenge that must be considered from the outset. For example, will investments with dual return structures be “permitted investments” under an investment mandate? Certainly, elements of what is traditionally SRI (e.g. excluded investments) are made expressly part of investment mandates between asset owners and institutional investors. Similarly, should we think of such investments as more formally a discrete dimension of an institution’s investment strategy, such as a microfinance fund as part of a university endowment? Would these not be considered in the broader context of strategic asset allocation decisions, especially as they may impact risk-adjusted returns? Finally, in the latter context, some have suggested that dual return investments should in fact be considered an asset class (e.g. impact investing) or perhaps a sub-asset class - somewhat akin to alternatives. In this respect, it is not only returns that must be analyzed, but also the risk contribution in a broader portfolio context. Thus, while dual return structures generally result in financial returns lower than those of market-based investments, do they offer diversification compiling benefits, i.e. are their returns less correlated with those of the investor’s portfolio as a whole?

Moving beyond the constraints of the investor per se, perhaps it is that financial product engineering or innovative investment design can help bridge the gap. Here the challenges are no less complex if well-designed structures are to facilitate intermediation. Without prejudice to a solution, critical factors minimally to address include risk and return structures, periodization and contingency of cash flows, liquidity and pricing, and of course the ability to contextualize non-financial returns through some form of monitoring and measurement.

The risk/return profile of inclusive or dual return vehicles will form the baseline of the investment decision for institutional investors when considering dual such projects. Market risks remain as with conventional investment products. These include credit, interest rate, equity, inflation, and other related market risks. Also, to the extent that investments in dual return or social return structures disproportionately involve projects in emerging or frontier markets, political, legal, and capital market risks become more acute. Furthermore, the dual return structure of such products itself presents inherent risks, including the ability to monitor and measure social impacts. Thus, at minimum, inclusive investments must not only define a clear basis for financial return – i.e. monetary return via discrete cash flows, but also provide a transparent means to monitor and measure the social impacts created by the investment decision.

The timing and contingency of cash flows will also be important components in the structural design of dual return product and vehicles. For example, periodization will impact investor ability to match investment flows with liabilities and so manage liquidity risk. Contingency features – for example funding triggers as in the case of social impact bonds - can influence pricing models, but also the co-variability of returns with market-traded or conventional products. Because such impacts may be influenced less by economic and more by social outcomes, returns based on these outcomes should be less correlated with those based on

4 Ibid.
economic or financial factors and so offer the tangible opportunities for risk reduction noted above.

Existing experience suggests that the liquidity of dual return products/vehicles - debt swaps, local currency bonds, livestock insurance indemnity pools, weather derivatives - is generally low or non-existent, largely as a function of the underdeveloped nature of the markets for such products.\(^5\) Secondarily, pricing for these products is directly impacted by liquidity, as lower levels of liquidity result in inefficient pricing. Thus, among the basic challenges to overcome sequentially will be those of related to size and scale in the development of markets for such products, the development of both primary and secondary markets, and ultimately price discovery and efficiency.

The road ahead appears rocky, though not without direction…or hope. Examples, though few, point a way forward. Initiatives will necessarily require both creativity and courage…to move beyond traditional institutional practices in search of returns that meet both the financial and increasing expanding social agendas of asset owners.