Rise of the impact investor

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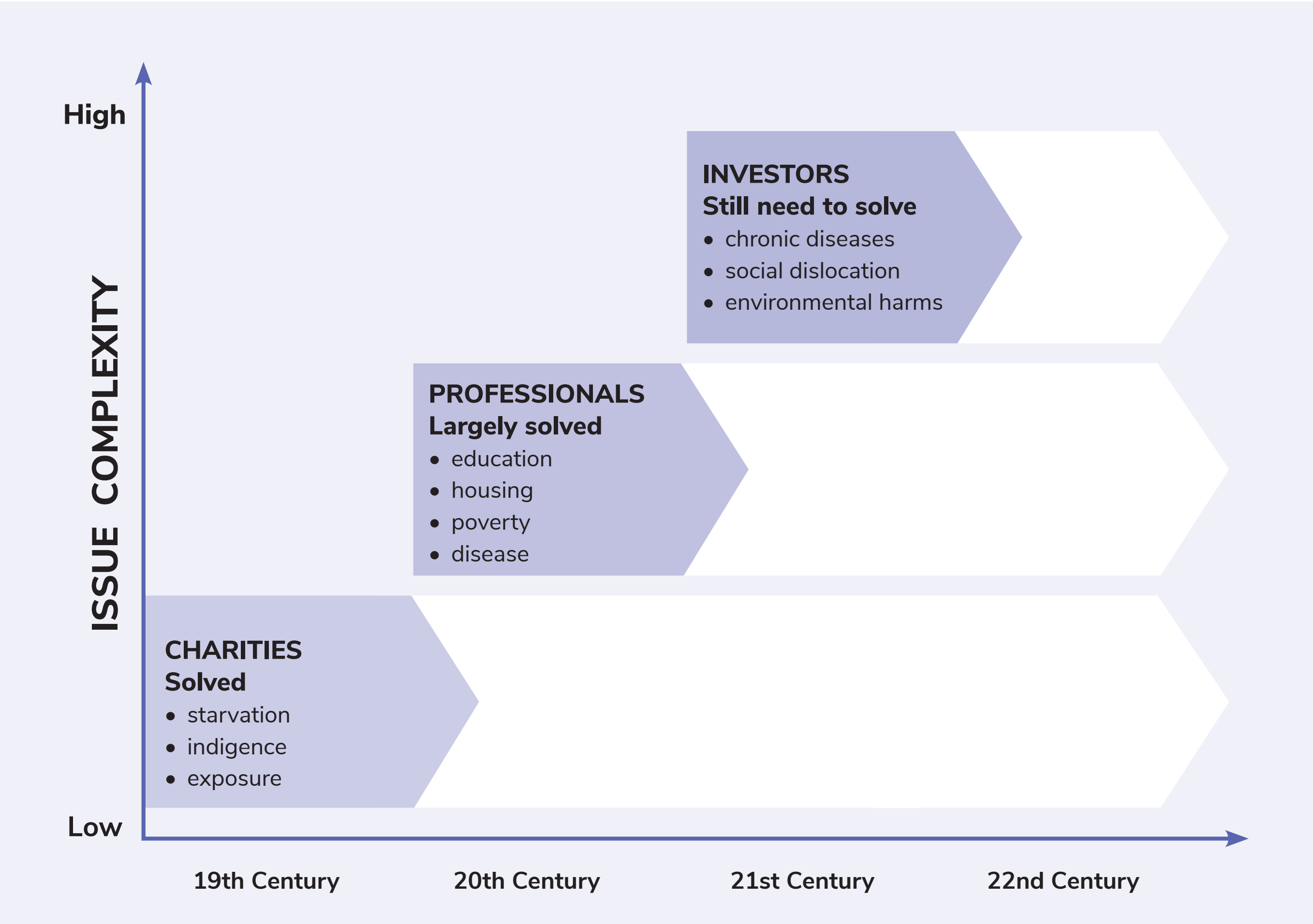
Up to the turn of the twentieth century, a charity model almost entirely solved three seemingly impossible problems, in Western countries at least: Death, hunger and exposure. Hospices were set up to look after those about to die who didn't have a family to care for them at home. Workhouses existed for those who couldn't feed themselves. And a wide array of hostels, from the comfortable to the dismal, existed for those who couldn't put a roof over their heads, including children.

What all of these services had in common was that they provided only the most essential safety nets for the most needy. Those who did this work acted as missionaries, or even crusaders, under obligation to a higher power, even when they acted voluntarily and altruistically. The descendants of these organisations are still present and some are powerful still, with large armies of staff, substantial balance sheets, and favourable tax status in many Western countries.



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Around the middle of the twentieth century, this charity model was rapidly overtaken by professional bureaucracies under the guise of the welfare state. Governments, non-governmental organisations (NGOs) and non-profits rapidly expanded their scope, and set about tackling some very diverse problems that were considered impossible to solve in the nineteenth century. In Western countries, between World War Two and the end of the century, these successes included: Almost completely eradicating communicable diseases, eliminating extreme poverty, assuring minimum quality standards for housing, and creating universal literacy.

During this period, these professional bureaucratic models took over vast swathes of various systems, including public healthcare, most forms of welfare and aged care. In Australia alone, public spending in each of these areas now exceeds $10 billion a year. What used to be the entitlement of the rich (a well-heated house, education for each child, protection from fire and theft, and care provided at home for the aged) is now considered a necessity for the vast majority of Westerners. Over the last 100 years, we've seen what was a privilege evolve into a right. This expanded professional model did not displace the charity model, but operates alongside it, or even has subsumed it, as many charities are no longer run by their originators (such as religious orders) but by professional managers, officers, therapists, clinicians, educators and support workers. This has been necessary as society's expectations of the delivery of public value have expanded from just the needy to everyone.

So, where to from here? Charities still exist, but their historical base (missionaries doing good works) carries limited resonance in a world of Facebook and Netflix. The professional model has become bloated, a victim of its own success, where finding untrodden ground is difficult, and most organisations operating under this model (regardless of the sector) are concerned with operational and cost efficiencies rather than true impact. To replace these, I believe an impact investment model of public value is emerging and will rapidly subsume both. The impact investor model is now accelerating to a tipping point where both the charity and professional models will become irrelevant if they do not address their future sustainability - and supportability.

What is an impact investor?

An impact investor functions within a market system, not the donor system of charities, nor the taxation system of the professional model. The most successful are led by entrepreneurs, rather than by social workers or missionaries. They don't operate from a premise of obligation (a higher power compelling them), nor necessity (a basic human right dictating that it's essential). Rather, they believe in competition, and that the privilege of meeting need goes to the most capable organisations. The mindset and structures are demand-driven (they offer what's needed), which is in contrast to the supply-driven approach of the charity and professional models (which encourage people to consume what's offered).

The entrepreneurs leading the best impact investment organisations are nearly always systems thinkers. They acknowledge that 'simpler' problems (like communicable diseases, housing quality and basic education) are mostly solved in Western countries, except for a minority who are severely disadvantaged or vulnerable. Their perspective is most similar to that of the founder of a start-up – they search out addressable needs in "the market" that can be filled by an innovative product or service. In the case of public value business leaders, they find gaps created by economic and social systems that are unable to be filled by entities with solely commercial motives. For instance, problem gambling is a phenomenon with physiological, social and economic components. It only affects one per cent of regular gamblers, but those it affects suffer catastrophic losses. And, there is no real commercial incentive for the gambling industry to do much about it. Consequently, we need impact investment thinkers who can find ways to fund combinations of industry regulation, gambling education, industry research and support services.

Who are these investors?

They are sometimes government departments and agencies, but are increasingly likely to take other forms, such as venture funds (for example, Social Ventures Australia, and Social Enterprise Development and Investment Funds) or other innovative financial channels (like Kiva or Thankyou), various types of enabling entities and intermediaries (like Primary Health Networks in Australia), or even insurers (like Australia's National Disability Insurance Scheme or Transport Accident Commission, both of which are government enterprises). Even the historical distinction between non-profit and for-profit starts to dissolve when we look at impact investors. We see non-profits behaving with the commercial acumen of for-profits (like the community health business EACH), and we see for-profits delivering benefits to customers that truly provide remarkable social, health and wellbeing changes (like the Bendigo Bank). We see hybrid forms of organisations too – commercial entities with shared value subsidiaries, and non-profit corporations with profit-making subsidiaries whose profits are reinvested in unfunded public value activity. And, of course, we also see a strong trend towards mission-driven, profit-motivated companies such as Facebook ('connect the world'), John Deere ('feed the world') and pharmaceutical company Merck ('make the world a better place'), which blend highly adept business acumen with a higher, even noble, purpose. None of these organisations are above reproach, but what they have in common is that they are using social and market forces to solve complex, universal, systemic and large-scale behavioural issues.

What really differentiates impact investors from charity-motivated and professional-driven organisations is in the way they create value. The charity model is largely dependent on philanthropic or donor support, and value is defined by its mission or its good works. My first job in the late 1980s was with a charitable organisation that operated factories with the goal of employing people with significant disabilities. Those people made wooden clothes pegs, re-labelled incorrectly labelled cans of dog food, and packaged census survey forms. The driving force was to provide a pleasant workplace and a 'realistic' worksite for people who otherwise couldn't work. No thought was given to effectiveness or efficiency. People came to work, day after day, year after year, and that was that.

This is quite different from the professional public value organisation whose revenue source is very often a taxpayer-funded block grant, with its value defined by its products. Compare my first job to my second job, a few years later. This was with an employment service for people with a wide variety of disabilities, where efficiency was important (we all had caseloads of clients), as were results (our placements were counted). However, these were measured against the work performed, not the experience of the customers. My manager told me that what mattered was the number of clients I worked with, the number of clients I placed in work, and the number of on-the-job support hours I provided. What was not mentioned was the value I provided to our customers – first the worker (who ultimately wanted income security and job satisfaction, which contributed to their overall quality of life) and second the state (which wanted to convert welfare recipients into taxpayers).

How do impact investors create value?

Impact investors are much more adept at understanding the real reasons they're in business. They are not defined by how they generate revenue, which can include a mix of taxation, insurance premiums, sale of services and investor support. They are defined instead by how they create value. Among my clients, I see seven value creation approaches, listed in the diagram on the next page, clockwise from most to least common, and also from least to most effective!

Ways that Public Value is created

1 ACTIVITY PERFORMED

In Australia, public hospitals' value is premised on the occasions of service they provide. These are paid at a market-competitive, activity-based rate. Similar models are bundled payments where packages of care are priced and paid for together.

2 RISK MITIGATED

Transport accident and disability insurers' value is based on their ability to pay out claims in order to avoid or reduce downstream social and financial risk after a catastrophic event.

3 POPULATIONS SERVED

Value is created by providing packages of service for defined populations. Most often used in primary healthcare, where it's called capitation, a set amount is paid for each enrolled person over a certain time period, whether or not that person seeks care.

4 EFFORT TRANSFERRED

Value is created where a more effective (and often cheaper) vehicle provides the public value than the traditional provider. For example, local governments transferring dog pound operations to community dog lovers' organisations, which adhere to 'no kill' policies, or psychologists augmenting traditional treatments for young people with mental illness with online social media support.

5 CONSUMER OUTCOMES ACHIEVED

Employment services' value is based on outcomes such as job obtained and retained, with higher rates based on complexity of client and other weighted factors, such as rural locations and disability. Value resides in the outcome achieved for the consumer.

6 SOCIAL RETURN CREATED

Traditional housing developers calculate financial returns, but social housing providers try to measure their value by adding factors such as social services avoided by housed tenants, or employment outcomes achieved by tenants. Social return calculates extra financial value, such as environmental and social value not currently reflected in conventional financial accounts, relative to resources invested.

7 SOCIAL COST PREVENTED

Some fifty per cent of the annual burden of deaths is preventable, yet few effective investment models exist, with ninety-five per cent of healthcare dollars still directed towards treatment and curative medicine. In this model, value is created by preventing burden of cost and negative impact.

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The first three of these value creation approaches are well established, and commonly used in fields such as education, health, disability and employment services. The fourth is controversial as it challenges entrenched professional interests. The fifth and sixth are complex, as intangible outcomes are often as important as the tangible ones. The seventh is a holy grail of public value – once this nut is cracked, a huge wave of potential financing will open up. One area ripe for this approach is the large burden of preventable deaths. While efforts to improve lives and reduce medical care costs are taking aim, no direct hit has been achieved as yet.

So now more than ever, government agencies and non-profits need to adopt an impact investment model in order to turn the impossible into the possible. What are some of the problems that impact investors can help solve?

- **Income inequality.** Some occupational groups, such as information technology, have dramatically increased their incomes over the past twenty years, while others – like manufacturing and service jobs – have had their earnings remain largely stagnant. And, what about those who are incomeless or earn very low incomes?
- **Mental health and chronic disease epidemics.** In 2017, the World Health Organization identified depression as the leading cause of ill health and disability worldwide. In a given year, one in five Australians experience symptoms of a mental disorder, with anxiety, mood disorders (like depression) and substance use accounting for a quarter of this.
- **Ageing at home and choosing a place (and a way) of dying.** Less than 15% of people die at home, and more than 70% say they'd like to. And, nearly everyone says they want to stay living independently as long as possible and stay out of hospitals and nursing homes.

These are all areas that the charity and professional systems have tried to solve, but haven't. But are they impossibilities for an impact investor? I predict not. Also, I see impact investors solely able to address those 'impossibilities' that have past and possibly irreversible causes, which the charity and professional sectors can't put a dent in, like reversing the decline of young people participating in employment, remediating land that has become too polluted for safe use, and keeping older people in the workforce for longer. And what about 'impossibilities' that have multiple causes, or even intangible causes, like gender-based violence and climate change? And finally, what about those 'impossibilities' that are the black swans that we can't even predict, such as fixing the displacement of humans from work by artificial intelligence, and retaining identity and privacy in a world driven by social media?

Who will solve these seemingly intractable impossibilities? I look forward to hearing about – and working with – the growing and flourishing impact investment sector into the 2020s and beyond.