SYSTEMS CHANGE: AN EMERGING PRACTICE IN IMPACT INVESTING

EXECUTIVE SUMMARY

Enclude
A PALLADIUM COMPANY

Preface

It has been a rewarding journey to produce 'Systems Change: An Emerging Practice in Impact Investing' that captures collective experience by investors and investees. Enclude authored this research report to more broadly introduce systems practice to impact investing by showcasing how investors are implementing this practice to address root problems to social and environmental issues globally. We deeply appreciate the increasing urgency to direct financial and human capital towards social inclusion and justice and environmental regeneration.

The aim of the Executive Summary is to provide a concise overview that entices readers to explore the full Report. Deploying capital with the aspiration of chipping away at global urgent threats requires open exchange of information and deep collaboration among partners. By sharing the Executive Summary and the full Report we hope to stimulate thought and encourage action.

The Report was commissioned by the Economic Justice Program of the Open Society Foundations. As part of this engagement, Enclude facilitated roundtables in London and New York, and interviewed various experts and leading practitioners. Additionally, Enclude gained valuable insights and support from the Economic Justice Program team at Open Society Foundations, with great support from Daan Besamusca. We want to thank all contributors for their generous and thoughtful input.

About Enclude

Enclude is a leading impact investment bank creating solutions and mobilising capital to address the world's most pressing challenges. We strive to co-design innovative ways towards achieving positive systems change alongside our partners. Enclude is part of Palladium, a global impact firm working at the intersection of social progress and commercial growth. With a global network operating in over 90 countries, Palladium has spent the past 50 years helping its clients to see the world as interconnected – by formulating strategies, building partnerships, and implementing programs that have a lasting social and financial impact.

Enclude Project Team:

- Laurie Spengler, CEO
- Alexandra Korijn, Associate Director
- Radek Halamka, Associate
- Alexander Rowlett, Associate

About the Open Society Foundations

The Open Society Foundations, founded by George Soros, are the world's largest private funder of independent groups working for justice, democratic governance, and human rights. Today, Open Society supports a vast array of projects in more than 120 countries, providing hundreds of grants every year through a network of national and regional foundations and offices. It pursues social impact investments through the Soros Economic Development Fund, part of its Economic Justice Program.

Executive Summary

Putting money to work across the globe in the singular pursuit of making more money is old-fashioned and dangerous. Capital is a powerful tool, but it is in service of something beyond money: 'Money is in service of [__________]'. Each of us must fill in the blank – of people, of community, of society, of entrepreneurs, of the environment, or other priorities. Our individual and collective answers to this statement demonstrate that investment is inexorably linked to purpose.

The notion of money in service of something beyond itself is not new. What is new and significant, is the growing realisation that we cannot afford – in terms of social and environmental costs – to ignore the need to redirect money to be put to work for the benefit of people and the planet.

Within this developing awareness we are challenged to consider whether we are putting money to work in response to problems and challenges we can readily see; or whether we are addressing the root cause of issues.

Asking the tough questions

As vanguards of the growing field of impact practitioners – investors, intermediaries, policy makers, entrepreneurs and more – we must be willing to stretch ourselves and ask the tough questions: *Are investors with positive social and environmental impact goals fundamentally improving the very systems that produced the problems in the first place, or merely treating symptoms? How can these investors identify solutions that are likely to catalyse significant, long-term positive change, without triggering negative unintended consequences elsewhere in the targeted system?*

Fuelled by such questions, investors are increasingly engaging in systems practice to better understand the underlying causes to social and environmental problems and to identify high leverage solutions to advance positive systems change.[1]

The purpose of this Report is to highlight how investors are engaging in this emerging practice, to arouse interest among investors to reflect on their own investment practices, and to galvanise investors towards more thoughtful coordinated action. While not solo actors in pursuing systems level impact, we focus on the role of investors and the deployment of impact capital to stimulate dialogue and action within the growing impact investing community. This Report is the first of what we anticipate will be several resources for practitioners interested in systems thinking as a foundational input to achieve positive long-term change.

A new lens on risk and return

With urgent issues threatening a sustainable future for people and planet, there is a pressing need to remodel the traditional finance paradigm of risk and return.

Impact investing focuses on both developed and developing economies, each with its unique set of challenges. But we are facing collective challenges that cut across geography and unite us in confronting global threats. The world's leading climate scientists have warned that we have 12 years to limit the climate change catastrophe, and that urgent changes are needed to cut the risk of extreme heat, drought, floods, and poverty.[2] At the same time, we live in a world of extreme social inequality, with the eight wealthiest individuals in the world owning as much as half the world's population.[3] Climate change and inequality are highly interdependent and locked in a vicious cycle. Existing inequalities result in disadvantaged people facing disproportionate exposure to the adverse effects of climate change; the consequences of climate change on poor and vulnerable communities in turn reinforces greater inequality.[4]

These challenges are accelerated (and often caused) by a failed economic system and a flawed 'traditional finance' paradigm.[5] Social and environmental costs and benefits – 'externalities' in current economic theory – are not adequately priced in the economy's market of products and services, leading to flawed 'optimal pricing'. Similarly, traditional finance, which allocates financial resources to households and businesses in the current economic system, distributes capital based on financial risk and return, without consideration of related social and environmental costs and benefits. The result is capital allocations to businesses that maximise financial return based on a certain level of risk, at material cost to people and planet. The environmental cost of doing business is estimated at USD 4.7 trillion a year.[6] A response calls for meaningful, long-lasting solutions.

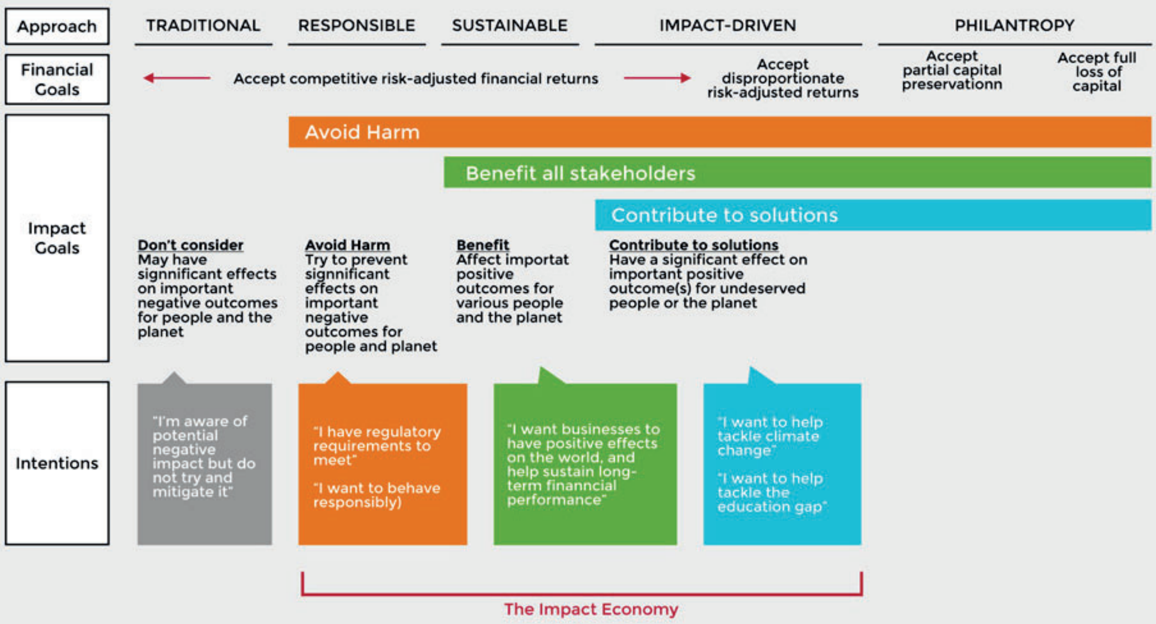
A growing number of investors are updating the traditional finance paradigm to include three factors – risk, return, and impact – to screen out negative impacts and to contribute to positive solutions.

The good news is that a growing number of investors across the globe recognise that all investments have positive and negative social and environmental impact; the relevant inquiry is whether that impact is 'net positive', i.e. the positive impact outweighs the negative impact. These investors believe that they can lower risk, and create more long-term value, by integrating social and environmental factors in their investment decisions. Through these combined efforts, more and more investors are updating the traditional finance paradigm of risk and return to explicitly include impact.

These investors are taking different approaches to integrating impact into their investment decisions. As highlighted in 'the spectrum of impact' figure below, some investors are seeking to avoid harm by screening out negative impacts (i.e. 'responsible investing'), some are seeking to benefit all stakeholders by investing in positive social and environmental impacts (i.e. 'sustainable investing') and others are aiming to actively contribute to solutions (i.e. 'impact investing').[7] These three investment approaches are gaining real momentum. In 2018, global assets under management (AUM) with responsible, sustainable, and impact

Figure 2: The Spectrum of Impact

Intentions and goals of organisations in the impact economy



The Rise of Impact. Report of the UK National Advisory Board on Impact Investing. October 2017.

investing approaches reached USD 30.7 trillion. This represents a significant increase (34%) from USD 23 trillion in 2016 and a dramatic increase (71%) from USD 18 trillion in 2014.[8]

Investors and other stakeholders around the world expect this trend to further increase in the years and decades to come. Together, these three investment approaches are financing the 'impact economy': an economy where institutions, investors, enterprises, households, and individuals optimise for total risk (i.e. financial and impact risk) and total return (i.e. financial and impact return) when making decisions about how to allocate resources.[9]

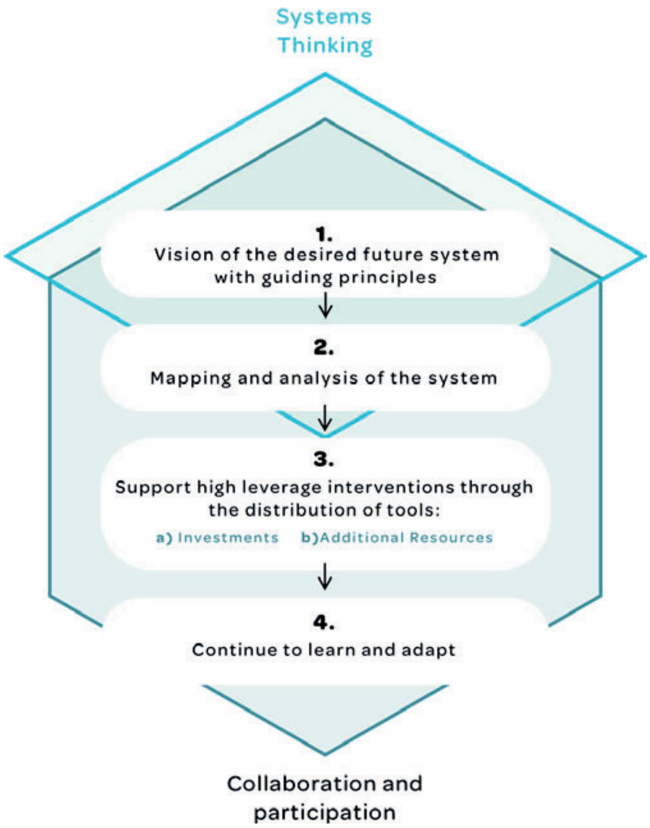
Going deeper: Finding and treating root causes

While these new approaches to finance are delivering positive impact, an emerging group of investors is questioning whether these approaches are addressing root causes of social and environmental issues, or treating their symptoms. This group is increasingly adopting 'systems practice'.

While the impact economy has achieved material growth and captivated the imagination and interest of many, it is still enabling only a fraction of the positive impact required to address urgent global challenges facing people and planet.[10] For example, using the United Nation's Sustainable Development Goals (SDGs) as a guide, experts estimate a USD 2.5 trillion gap between current funding levels and what it will take to accomplish the SDGs; this estimate is already considered conservative, under-representing the actual funding needed. Within this context, there is a small but increasing number of investors questioning whether these three investment approaches – responsible, sustainable and impact investing – are ultimately addressing root causes of social and environmental issues, or merely treating their symptoms. This emerging group of investors is increasingly adopting what we refer to as 'systems practice' – a practice with processes and tools that incorporates systems thinking.[11] These investors seek to understand the whole system in which the social and environmental issues are occurring, identify causes and effects within the system, find high leverage points to catalyse significant, long-lasting, positive change, and invest capital to yield positive results within the mapped system.

A framework for systems practice

In this Report, we present a framework for systems practice – building on existing frameworks such as those introduced by The Omidyar Group, FSG, and New Philanthropy Capital – and highlight how such practice is applied by investors that aim to create positive environmental and social impact.[12]



Systems practice involves (i) a holistic mindset or way of thinking, along with distinct (ii) processes and (iii) tools. When such a practice is applied by investors to support positive social and environmental impact, we found that they tend to share some common characteristics across these three areas, as highlighted briefly below.

Systems Thinking

First and foremost, these investors use systems thinking – a holistic approach to analysis that looks at how and why systems behave the way that they do by examining their parts, relationships, and resulting behaviours, and how those elements change over time.

Processes

1. Vision of the desired future system with guiding principles:
These investors often start by defining a 'guiding star', which is a vision that is framed as the desired future system towards which the investor is working.[13] Appreciating that systems have many interdependent and dynamic elements, investors may define guiding principles – fundamental norms, rules, or values that represent what is desirable – to help them navigate their way through the current system towards the desired future system. Guiding principles tend to take the shape of fundamental behavioural concepts such as (re)building trust in local and/or global communities, ensuring equity and justice, seeking participation of all stakeholders, exercising empathy and humility, listening and learning, ensuring accountability and transparency, exercising courage and risk-taking, and questioning the status quo.

2. Mapping and analysis of the system:
Before deciding on the specific interventions to support in alignment with the identified vision, many investors that have adopted systems practice will map and analyse their target system – through engagement with relevant stakeholders. The purpose of this mapping and analysis is to better understand the various parts at play, with an inventory of causes and effects that form feedback loops. Understanding feedback loops at play supports the investor to identify the highest leverage points for intervention, and to align their organisations' unique skills, knowledge, and networks to mo bilise for constructive intervention and influence. This exercise can help investors define their theory of change – a description of how their desired change is expected to happen in a particular context or system and what their contribution may be.

3. Support high leverage interventions through the distribution of tools:
Once high-leverage points have been identified, these investors will support targeted solutions through the use of one or more tools that they are capable of deploying, such as investment capital, grants, policy engagement, and/or human capital capacity building.

a) Investments: Investors following systems level considerations typically seek to structure an investment in a way that benefits all stakeholders, including entrepreneurs, employees, and local communities. They do so through active engagement with those relevant stakeholders throughout the investment process. When setting their target total returns for the investment, these investors are guided by the solution that they are targeting to support, rather than adhering to an external benchmark such as 'market rate of return'; they believe that commonly used benchmarks have been derived without relevance to the problem being solved. These investors define their investment activity by asking 'what problem are we solving with this capital?'. Similarly, the expected timeframe of their investments is typically solution-driven, and thereby flexible, depending on the particular context and intervention.

b) Additional resources: These investors believe that investments alone are not going to change the target system. Additional resources need to be deployed, either simultaneously or sequentially, to bring about the desired change. Some investors may have a flexible structure with multiple available resources, such as grants, policy engagement, and human capital support, while others may only have investment capital available and will need to collaborate with others to provide additional resources. Regardless of whether they have additional resources available under their direction, systems practice investors tend to have a 'multi-resource mindset' when evaluating solutions.

4. Continue to learn and adapt:
Investors that have adopted systems practice realise that complex systems are difficult to fully understand and highly dynamic, and will continue to evolve. As a result, investors need to learn and adapt their underlying assumptions, mapping and analysis, high leverage points, best tools to support interventions, and best partnerships to influence the desired change. While measurement of systems change is not easy, practicing investors typically seek to develop a few key performance indicators to assess whether they are on track to moving towards

the desired future system. Even these indictors may need to be adapted over time.

For investors that have adopted systems practice, collaboration with – and meaningful participation by – key stakeholders in the targeted system is essential during each part of the process, from setting the vision and mapping the system to the distribution of tools and extrapolation of learnings. As systems are highly complex and dynamic, systems practice investors believe that such collaboration and participation will drive towards better outcomes for all, not just the individual investor.

Walking the walk: Systems practice in action

The Report highlights practical examples of how various investors have implemented such practice across a range of issue domains.

For instance, Aqua-Spark is an investment collaborative dedicated to sustainable aquaculture. In their initial search for investment solutions that would make meaningful, long-lasting change, they realised you can't change the way we farm fish without also looking at the inputs and all other parts of the supply chain. Their strategy evolved into what it is today: an open-ended, innovative fund that identifies leverage points within the aquaculture industry to make a meaningful, catalytic change – from solutions in genetics and feed ingredients, to farm management technologies and farming operations, to traceability, consumer products, and distribution – while generating a high economic return. The portfolio works as an ecosystem, with the companies agreeing to collaborate on optimal solutions, share knowledge and networks, and work together toward a shared vision of a healthy, sustainable, accessible global aquaculture industry. Their portfolio sits inside a much larger ecosystem of partners, co-investors, strategic actors, NGOs, universities, and groups working toward a shared vision of a healthier, more sustainable, and accessible global aquaculture industry. Systems practice recognises that industry-wide change requires organised solutions that bring together disparate components of the aquaculture value chain in a coordinated and synergistic way.[14]

Through this practice of mapping and analysing the system – its parts, relationships, and resulting behaviours – investors also seek to avoid unintended negative consequences. For instance, Open Society Foundations was interested in investing in a sustainable fish farm in Kenya in an effort to contribute to more sustainable and inclusive food systems in Africa. As part of its systems practice, Open Society Foundations' Economic Justice Program analysed and mapped the food system in the target region, including relevant stakeholders and relationships between them. What became clear through this analysis is that all fisheries in that region were owned by men, and all traders were women. More importantly, the way in which these stakeholders interacted was that the men would only sell the fish to the women in exchange for sex. In this current system construct, if the Economic Justice Program would use its financial resources to grow the sustainable fish farm with investment capital, it would unintentionally also help grow the sex trade in that region. In response, the Economic Justice Program did not exit the situation and seek a new opportunity. Rather, it is currently working to develop partnerships to support a more complete set of changes across the fishing industry, trading market, and civic rights protection in that region.

Systems practice is gaining traction, but there are still some big questions that need to be further explored.

Recognising the complexity of issues facing our world today, this emerging practice of applying systems thinking to investing for positive change is gaining traction within the impact economy. Investors want to make sure – to the extent that they are able – that their efforts are not limited to addressing the symptoms of problems in the system, but rather to chipping away at the root causes within the system. That being said, leading practitioners highlighted in this Report acknowledge that their efforts are modest and they are merely contributing to an on-going practice that will evolve over time. There is no clear or simple way to change a system, through investment and/or other means. Practitioners described in this Report are humbly attempting to achieve a very ambitious goal without quantitative data (yet) that such a practice is working to change the system.

The way ahead

Putting money to work for more than making money is gaining interest and traction. It is also inviting temptation to celebrate individual transactions. We must remain cautious not to overclaim the results arising from 'good deals'. We must engage with one another and with stakeholders affected by individual deals in order to achieve more with our money - more impact, more tangible and lasting results, more positive outcomes for more people and the planet. We will only achieve material impact on a scale that moves the dial on issues of inequality, environmental degradation, social dislocation, community prosperity, and more if we expand our perspective beyond the execution of individual deals and at least ask ourselves questions that touch upon the dynamics of the system in which the individual deal lives.

No investor alone can achieve positive impact on a 'system'; however, every investor can move from doing good individual deals to achieving significant positive impact results by 'stretching' her aperture of commitment and putting her decisions about capital into a systems perspective. What we are discovering, and what this Report will share, is that this process of 'stretching' comes with support from others. It is a more powerful, more meaningful, and, ultimately, more effective process for making decisions about how to invest our capital.

This is the first of what we anticipate will be several resources for practitioners interested in systems thinking and contributing to positive systems change.

Only through collaboration amongst a broad set of stakeholders – investors, civil society, policy makers, and more – will we be able to have any chance at making lasting progress in tackling these problems.

We appreciate the move from pursuing positive impact at a transactional level to considering systems level questions may seem like a daunting undertaking. Each of us tends to doubt our ability to make this transition. What this Report will demonstrate is that we are all learning by doing, that we can tap resources and expertise around us, and that we cannot afford to refuse to ask questions about what is really happening as a result of our invested capital.

Looking forward, there are critical considerations that demand immediate and collective action:

Create a vision of the desired future system with guiding principles:

- How can we set a vision that is truly reflective of all relevant stakeholders?
- How can we inspire others to adopt and adapt the vision to spark individualised and collective change?

Map and analyse the system we are seeking to improve:

- How can we build dynamic and complex system maps that can be regularly and reliably updated to reflect changing realities?

Support high leverage interventions through the distribution of tools:

- How do we structure deals that would lead to participation of system actors both on design of a solution and on its impact and financial returns?
- Can we find new ways to build and train teams that can use multiple resources, either simultaneously or consecutively? How can we incentivise teams if the success can only be achieved in the long-term?

Continue to learn and adapt:

- How do we measure progress and contribution towards systems change?
- How can we balance 'learning by doing' and 'being deliberative from the outset' when it comes to systems change?
- How do we monitor and identify unintended consequences transpiring within the system following one or more interventions?

We hope that you will join us in this further exploration – whether or not you are new to systems practice. Our global urgent threats confronting people and planet demand purposeful consideration. Let's endeavour to align visions, coordinate actions, and create a future for all life on this planet that is positive and resilient.

Please be in touch with us with any feedback you may have on the framework and findings presented in this Report, and any examples you may have of investments in support of systems change.

We hope you will join us as we host convenings and roundtables to spur more thoughtful, coordinated action as we continue this this conversation into 2020 and beyond.

References

1. Adapted from Systems Practice Workbook. The Omidyar Group.
2. Special Report: Global Warming of 1.5C. IPCC. October 2018.
3. An Economy for the 99%. Oxfam. January 2017.
4. World Economic and Social Survey: Reflecting on 70 Years of Development Policy and Analysis. United Nations Department of Economic and Social Affairs.
5. Finance for a Regenerative World. Act 1: Context. John Fullerton. Capital Institute.
6. Environmental Cost of Business Estimated at $4.7T Annually. Avery Fellow. Bloomberg. 17 April 2018.
7. The Rise of Impact. Report of the UK National Advisory Board on Impact Investing. October 2017.
8. 2018 Global Sustainable Investment Review. Global Sustainable Investment Alliance.
9. Adapted from the definition of the Aspen Institute (article: White House and Aspen Institute Co-Convene Meeting on Impact Economy. June 21, 2011. Jonathan Greenblatt), Impak (website), and McKinsey (article: Catalyzing the Growth of the Impact Economy. December 2018.)
10. Roadmap for the Future of Impact Investing; Reshaping Financial Markets. Global Impact Investing Network. March 2018.
11. Adapted from Systems Practice Workbook. The Omidyar Group.
12. Systems Practice Workbook. The Omidyar Group. The Water of Systems Change. FSG. John Kania, Mark Kramer, Peter Senge. June 2018. Systems Change: A Guide to What it is and How to do it. NPC. Rob Abercrombie, Ellen Harries and Rachel Wharton. June 2015.
13. Adapted from Systems Practice Workbook. The Omidyar Group.
14. Aqua-Spark Impact Report. 2018.