LOHAS ADVISORS

Impact Investing

FOR FAMILY OFFICES, FOUNDATIONS, AND THE SOCIAL-MINDED:

A Primer on the Dramatic Evolution of the Social and Environmental Impact Investment Market

Contents

FAMILY OFFICES

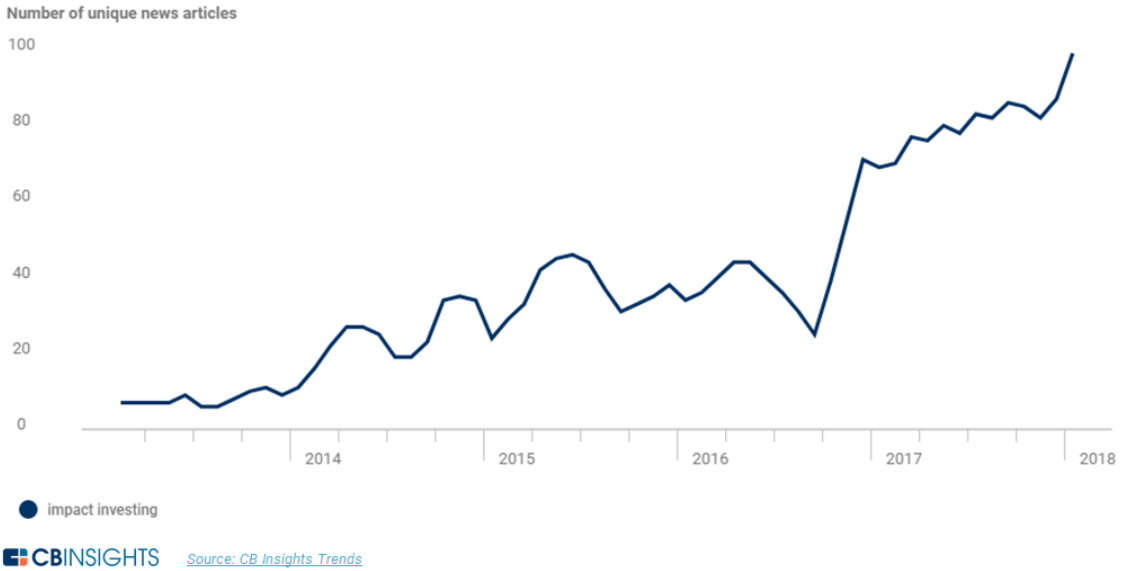
It would be a grand understatement to suggest that social impact investing is garnering greater attention in the media and investment community. The interest from investors as witnessed in media coverage and throughout investment literature clearly demonstrates the global zeitgeist.

Perhaps most shocking has been the pace of the shift in mindset among investors. Sofia Merlo, Co-Chief Executive of BNP Paribas Wealth Management, which has more than $10 billion invested in responsible investments, points to her firm's market research: "Two years ago, 10% considered mission to be important, now that's almost 40%."

Mark Haefele, Global Chief Investment Officer at UBS Wealth Management, now says, "40% of family offices are already expected to align their portfolios more closely with social and environmental values." So why the rush to social impact investing, who is involved, what are the options, and how should investors address the challenges that come with doing good while doing well?

INVESTORS WANT RETURNS THAT ALIGN WITH THEIR PRINCIPLES

Social concerns are impacting investing decisions



FAMILY OFFICES

The modern notion of a family office, charged with the stewardship of a specific family's wealth for current and future generations, emerged in the 19th century, when the family of financier and art collector JP Morgan founded the House of Morgan in 1838 to manage the Morgan family's wealth. Since then family offices have primarily focused on wealth preservation and expansion, but in recent years increasingly more family offices and other wealth and asset managers of high net worth

individuals (HNWI's) have begun to look beyond the accumulation of wealth to investments that may also be socially or environmentally impactful.

These socially and sustainably-minded investments are not philanthropy but rather intended to generate financial returns as well as societal benefits, and the numbers supporting this quickly evolving shift in investment approach are overwhelming. According to the UBS/Campden Wealth 2018 Global Family Office Report (GFOR), about a third (32%) of family offices are currently engaged in impact investing. Over half of these are engaged via direct private equity (67%) while some of the most popular sectors to invest in are education (51%), housing and community development (49%), women's empowerment (43%), environmental conservation (28%), and energy/resource efficiency (30%). The family offices that impact invest are often active in more than one sector.

Family offices in North America and Emerging Markets were the most enthusiastic impact investors, with a third of respondents in these regions saying they now held investments which are "impact-oriented". Most notably, over half of GFOR respondents (54%) reported that they plan to increase their allocation to impact investing over the next twelve months.

According to familyoffice.com, there are over 10,000 HNWI's in the U.S., with an estimated 6,000 family offices. The GFOR suggests that over 60% of family offices are active or likely to become active in impact investing, which would indicate interest or action by over 3,600 family offices in the U.S. alone.

IMPACT INVESTING

The term "impact investing" was first coined in 2007 at a meeting convened by the Rockefeller Foundation to describe investments made with the intention of generating financial return plus positive social and/or environmental consequences. Amit Bouri, CEO of the Global Impact Investing Network (GIIN) says, "Investors have been thinking for decades on how to get harmful things out of their portfolios, but [impact investing] is about proactively investing in solutions. It is that much more intentional step about investing in things like climate change directly."

The GIIN 2018 Annual Impact Investor Survey indicates there is about $228 billion in impact assets globally. The survey is based on analysis of the activities of 226 impact organizations, including funds, foundations, banks, development finance institutions, family offices, and pension funds. Family offices made up just 4% of the GIIN sample.

Despite the small percentage of the overall survey, Bouri suggests that family offices have played a leading role in the sector: "In family offices there is a very small distance between the owners and the asset... [so] in many cases family offices are blazing the trail. That said, the opportunity for family offices is largely untapped—there are many that are only now getting involved."

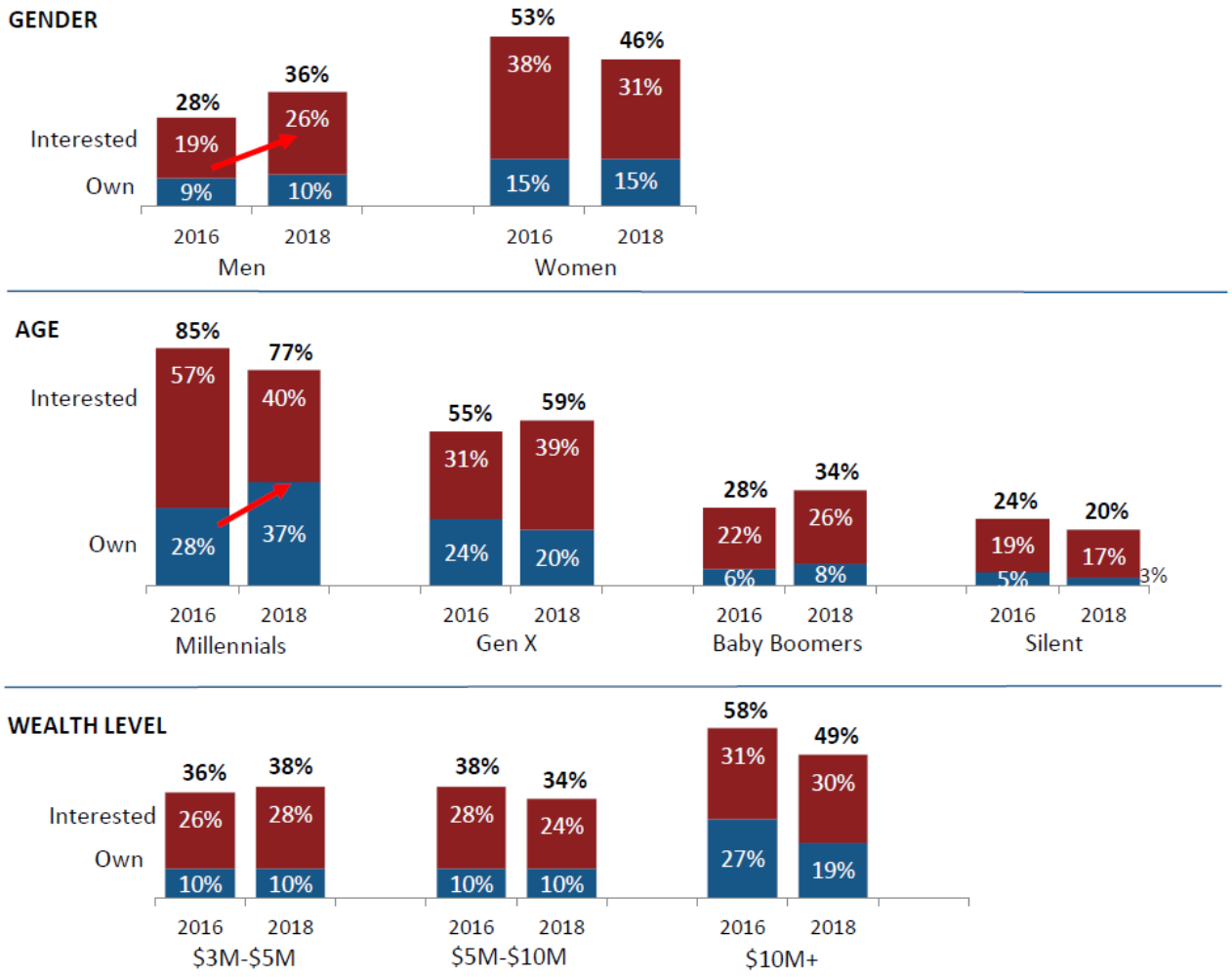
Another piece of GIIN research, Evidence on the Financial Performance of Impact Investments, demonstrates that market-rate returns (or better) can be achieved through impact investments. However, the report also showed many impact investors are willing to accept a financial trade-off: 18% of private equity impact investors and 61% of impact-motivated debt-issuers were willing to accept below market returns.

According to Bouri, "Some newcomers entering the [impact investing] market may be bold in their pursuit of impact, and others may be more incremental and cautious; for those who choose to start more incrementally, we wish to embed the mindset that this is the first step in their journey, not the final destination."

Despite that perspective, a majority of GIIN survey respondents over the years have indicated that their investments have met or exceeded their expectations for impact (97%) and financial (91%) performance. Also, 82 respondents who filled out the survey five years ago said their impact investments have experienced a 13% compound annual growth rate. In addition, 86% of GIIN survey respondents noted some or significant progress in the availability of "high quality investment opportunities". According to Bouri, that indicates investors are finding that the pool of investment-worthy companies is increasing.

Notably, of all the respondents to the 2018 GIIN study, 50% made their first impact investment in the last decade (indicating the ongoing entry of new participants to the sector), and survey respondents planned to increase the amount of capital they invest by 8% and the number of deals by 5% during 2018.

CHANGE IN PERCENT OF THOSE WHO OWN OR ARE INTERESTED IN IMPACT INVESTMENTS
2016 – 2018



U.S. Trust – Insights on Wealth and Worth, 2018

MILLENNIAL INVESTORS

The rising influence of socially-conscious millennials in wealthy families suggests that impact investing is only going to increase. According to Deloitte's 2016 Millennial Survey, almost 87% of millennials believe that "the success of business should be measured in terms of more than just its financial performance".

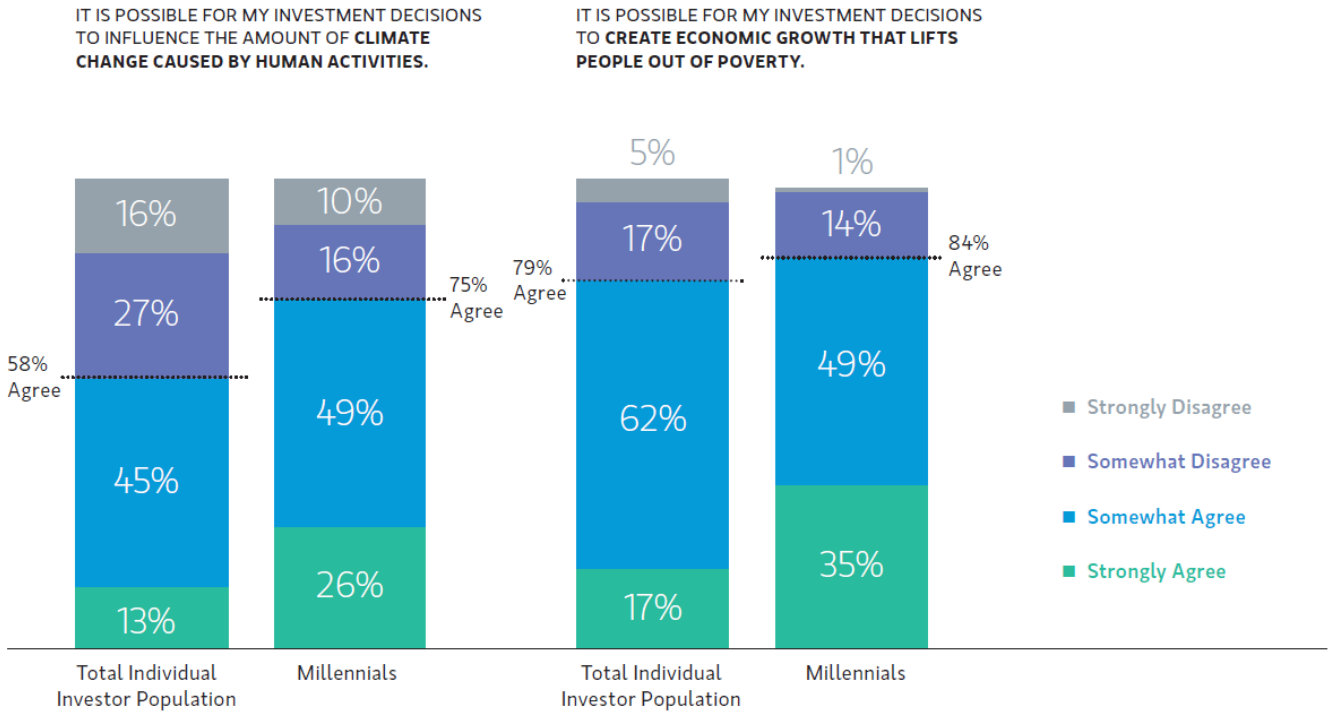
Similarly, a study by HSBC Private Banking showed a noticeable difference in priorities and goals between clients in their 20's and 50's: 24% of the former cited "having positive effect in the community" as their priority versus just 13% of the latter; and while 45% of the group in their 50's listed "increasing personal wealth" as their goal, that was just 38% among those in their 20's.

According to data from the Shullman Research Centre, 23% of the world's millionaires are millennials. Per Accenture, this age group of 20 to 37-year-olds is also going to receive a $30 trillion transfer of wealth from their baby-boomer heirs. In U.S. Trust's 2017 annual survey of high-net-worth and ultra-high-net-worth Americans, 52% of

millennial survey respondents indicated that they are interested in impact investments, the highest among all generations polled.

These trends are not limited to the United States. With Asia's share of the world's ultra-wealthy population growing nearly 10 percent over the last 10 years, there are now more billionaires in Asia than in the United States, and Asia is now positioned to have the world's largest concentration of wealth; and given that 35 percent of Asia's wealth is expected to be in the hands of millennials in the next five to seven years and that demographic shows the same social impact inclinations as their peers in the West, it is expected that social and environmental concerns will factor more and more into investing decisions in Asia as well.

Notably, according to 2017 polls by the Morgan Stanley Institute for Sustainable Investing, millennials are not merely advocating socially or environmentally impactful investments to appeal to their contemporaries. On the contrary, Morgan Stanley's survey clearly shows that millennials pursue social impact investing because they largely believe that they can make a difference with their investment decisions.



Morgan Stanley Institute for Sustainable Investing, 2017

And this is not only "talk" in responding to survey questions. According to Fidelity's 2018 Charitable survey, a majority of affluent Millennial (77%) and Generation X (72%) donors indicated that they had already made some form of impact investment. Per the 2018 GFOR, as millennials become more involved in their family offices, they are pushing those groups more towards impact investing, with 39% of family offices saying that as the next generation takes on control of their families' wealth, they will increase their allocation in this investment class.

RELATIONSHIP TO PHILANTHROPHY

Traditionally, many family offices thought that profit-making and philanthropy should be kept separate. While a family office's first generation may have deployed capital through the private wealth teams of large banks and conventional philanthropy, the second generation appears to be focusing on social impact investing.

The average family office surveyed in the GFOR gave $5 million to philanthropic causes last year, with one survey respondent commenting: "Let us do the best job we can at making money. Then that gives us more money and resources to give." Though he then conceded: "But that may be old thinking. And I suspect that we may look at [impact investing] a little more over the next few years. The next generation cares more and more about social impact investing and how we invest."

While noting that millennials are the driving force towards impact investment, Susan Ward, head of UK global family offices at UBS, says, "90% of our clients tell us they are actively involved in philanthropy, though one of the key things in encouraging people to transition from philanthropy to impact is that impact has the ability to be sustainable over the long term. It has the ability to make a real long-term difference, where people invest and reinvest, and family money continues to grow; but what is really important is impact investing does not detract from what you can achieve using philanthropy."

ROLE OF FOUNDATIONS

In 2017, the Ford Foundation committed one billion dollars from its endowment to mission-related investments, opening up a substantial line of potential investment for impact-driven enterprises. However, while large foundations may garner the press coverage, private family foundations of all sizes, including small and mid-size foundations, are adopting impact investing for their programs. Per the GFOR, 69% of family offices have set up their own foundations to support the causes they care about most.

According to data from the Foundation Center, more than 98% of all foundations have assets less than $100 million, but these foundations account for over half of all grants made in the United States. But beyond grant-making, according to research by the Foundation Center, one

in three foundations made a program or mission-related investment in 2016, and that number is growing.

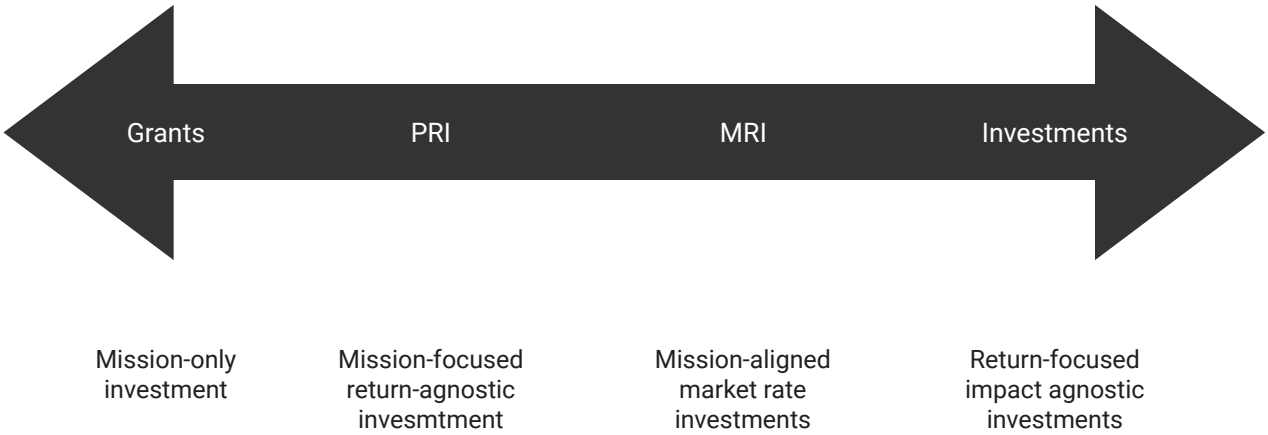
Before pursuing a social impact investment, foundations must understand the difference between mission-related investments (MRIs) and program-related investments (PRIs). While both forms of impact investing can be used to increase a foundation's impact, program-related investments (PRIs) are a particularly useful (albeit underutilized) tool for small and mid-sized family foundations. Both PRIs and MRIs can provide financial returns from the social enterprises in which they invest, but PRIs and MRIs are characterized and treated differently by the Internal Revenue Service.

While a PRI is a "mission first" investment, as long as the investment is consistent with the foundation's mission statement, a PRI can be counted towards the 5% minimum payout required for private foundations annually. The returns on the investment, in the year they materialize, are added to the 5% minimum payout requirement for that year, which serves to recycle the philanthropic capital. In addition, there is no limit on the actual return on a particular investment, as long as charitable purpose is the primary consideration when making the investment.

There are no limits on the size of the investment, the type of investment vehicle (e.g., equity), or the type of enterprise receiving the investment (i.e., for-profit). A PRI also protects foundation trustees from violating their fiduciary duties in investing in potentially risky ventures because (per IRS rulings) PRIs do not run counter to the "prudent-person rule" to which trustees are required to adhere.

PRIs can be particularly useful in helping scale a solution, kick-start a project, or sustain a social enterprise with new capital. Foundations can also use PRIs to help lower the risk for other investors, helping for-profit social enterprises attract additional capital or unlock needed credit. PRIs are often compared with investments, but in actuality they are a tool on the spectrum between grants and traditional investments.

Compared to a grant where the foundation is conceding all of the capital in exchange for impact, a below market-interest PRI that helps the foundation accomplish its mission can be highly effective. In fact, according to the Ford Foundation, $1 million



invested in a PRI is the equivalent of $5 million in grant expenditures.

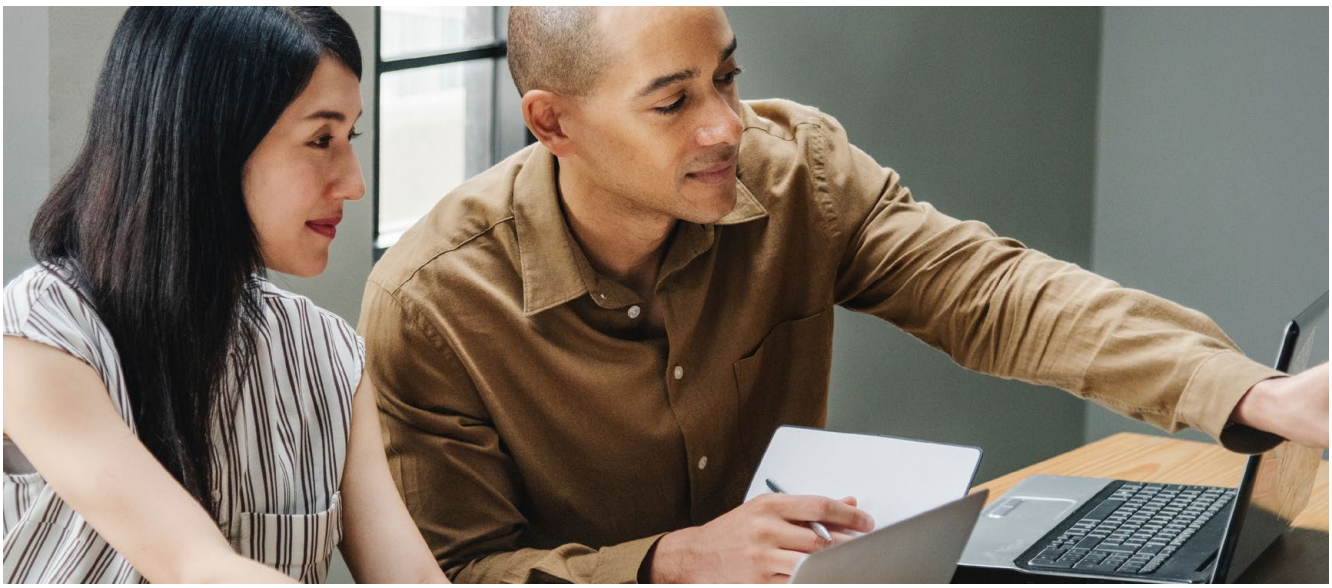
While an MRI can also be made in any asset class, because MRIs are not designed to meet the IRS requirements for charitable distribution, an MRI does not count towards a foundation's annual 5% payout requirement. MRIs are also subject to violation of "jeopardizing investment" laws, which require foundation managers and directors to avoid investments "that show a lack of reasonable business care and prudence in providing for the long- and short-term financial needs of the foundation."

In this respect, MRIs are used to make investments in social enterprises in which market-rate returns are expected, while PRIs may be the better social impact investment structure for small and mid-sized foundations looking to diversify beyond just grant-making to investing directly in (mission-aligned) for-profit social enterprises if the foundation wants to have more hands-on control and provide funds that endure and enable future capital allocations but in which returns on investment are understood to be below market-rate.

According to data from Mission Investors Exchange, median PRI and MRI outlays are $250,000 to just over $1 million. From 2010 – 2015, Mission Investors Exchange reported PRIs and MRIs of approximately $1.3 billion across 14 different impact sectors and using 8 different investment vehicles. For example, of the $152 million in education investments, $102 million was in private equity while $38 million was in private debt. As these numbers continue to grow, it is expected that the flexibility offered by these social impact investment structures will encourage foundations to invest in more sectors using even more diverse investment vehicles.

DONOR ADVISED FUNDS

Donor Advised Funds (DAFs) are philanthropic and social impact investment tools that allow donors (which could be individuals, families, corporations, etc.) to fund special accounts through DAF "sponsor" organizations. Donors receive immediate U.S. income tax deductions and maintain allocation privileges over the funds' ultimate distribution. While adoption of DAFs started slowly, they have become a leading tool for capital aggregation and,



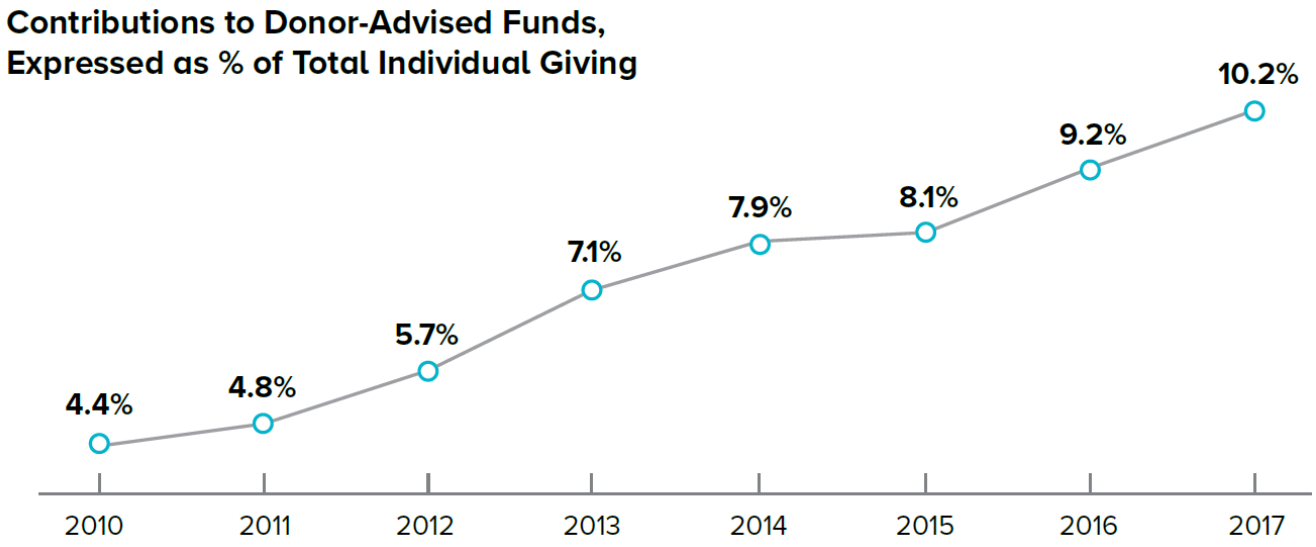
ultimately, donation and investment in the social and environmental impact sectors.

According to the 2018 Donor-Advised Fund Report of the National Philanthropic Trust (NPT), assets in DAFs now total $110 billion, with over $29 billion in new DAF contributions made just in 2017. Notably, there are now over 463,000 individual DAFs across the U.S., and the number of DAFs grew an astonishing 60% from 2016 to 2017. Contributions to DAFs have also continued to increase as a percent of total giving over the last decade.

While DAFs have typically been used for charitable donations and philanthropic grant making, astute DAF sponsor organizations have started to help parties with DAFs recognize that investing DAF assets for impact can dramatically magnify the effect of traditional charitable giving. By directly investing DAF capital, DAFs can become extraordinary vehicles for achieving meaningful social and environmental impact.

There are a variety of ways in which the capital held in DAFs can be invested to further one's impact goals. For example, DAF assets can be invested directly into for-profit social enterprises, typically with a specific social or environmental focus. This can be ideal capital to use for early stage or higher risk investments, and all principle and interest gets returned to the DAF.

Similarly, corporate DAFs can provide businesses with a simple mechanism for making strategic investments in mission-aligned companies that complement the corporation's business model. Notably, DAF funds can even be used to pay advisors to help analyze investment opportunities and deploy DAF capital as effectively as possible (while supporting the causes of most interest to the party that created the DAF).



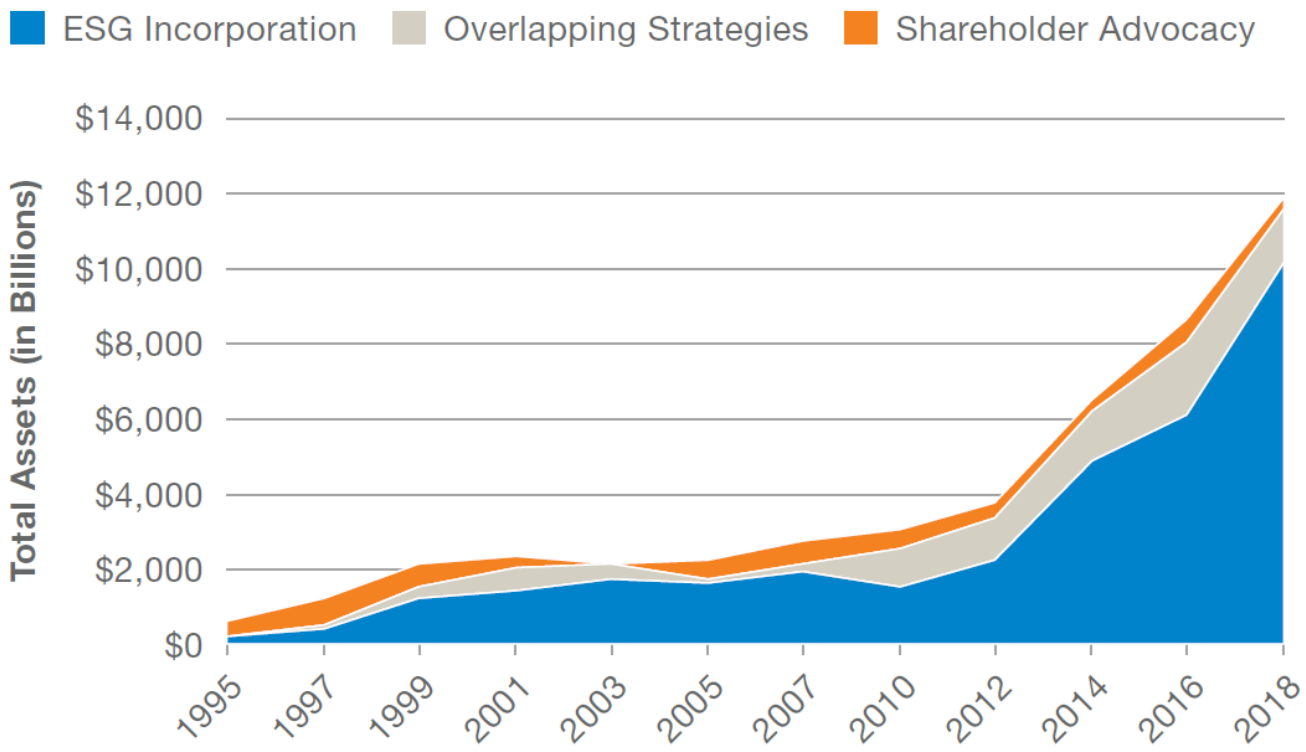
2018 Donor-Advised Fund Report of the National Philanthropic Trust

DIFFERENCE BETWEEN ESG, SRI, AND DIRECT SOCIAL IMPACT INVESTMENT

When discussing social impact investing, it is important to understand the various terms and categories, such as environmental, social, and governance (ESG) investing, which refers to three central factors in measuring the sustainability and ethical impact of an investment in a company and is primarily tied to investing in the public markets. To add to the confusion, ESG investing is sometimes used synonymously with, or described as a component of, sustainable, responsible, impact (SRI) investing.

According to the US SIF Foundation's biennial Report on US Sustainable, Responsible and Impact Investing Trends released in November 2018, SRI investing assets (which SIF shows as being primarily made up of public ESG investments) now account for $12 trillion or one in four dollars invested under professional management in the United States. That represents a 38% increase since 2016.

Sustainable and Responsible Investing in the United States 1995–2018



SOURCE: US SIF Foundation

Notably, there is clearly a strong degree of correlation between the growing trend of direct investments by family offices and the increase in capital being allocated by family offices to public companies that operate with ESG considerations in mind.

The goal of the impact investment community is to move some of the trillions of dollars being invested in somewhat less toxic and better behaving public companies under ESG or SRI umbrellas and redirect those funds directly into businesses and organizations delivering actual, proven solutions to the health, environmental, and other social problems facing society.

As Don Shaffer, former CEO of RSF Social Finance, states in his Interconnectedness article, this investment shift is the key to making a material change in the social impact marketplace. He notes that the questions that concerned investors should be (and are) asking involve what's actually in their ESG portfolios and whether there are more suitable direct investments instead, and he poignantly adds:

> ***"Let's get real – individual investors have no sway in the public markets. The place where individual investors can have the most impact – by far – is in providing direct growth capital to private companies and social enterprises. Instead [we are] giving investors an (arguably) false sense of doing good through ESG funds…"***

Advisors in the family-office sector are already observing a clear trend towards more capital being allocated to private equity, with a greater focus on direct social impact deals and co-investments. This trend is being encouraged by the emergence of a new cohort of global entrepreneurs with strong social and ecological consciences and loud social media-enabled voices which further support the momentum of a new generation who want to put their money to work in a socially productive and beneficial way, while still generating acceptable investment returns.

In Fidelity's 2018 Charitable study, 48% of the HNWI's surveyed indicated a strong interest in investing in small businesses or start-ups with strong social or environmental practices. Likewise, in the GIIN survey, the greatest share of impact assets under management were invested in mature, private companies (39%) and growth-stage companies (35%), but a sizable portion of investments was also going to seed and venture-stage companies.

In short, direct investments offer a significantly more "hands-on" approach to impact investing than ESG investments, by removing intermediaries and often giving investors a role in the operation or governance of a business, enabling them to make a real "impact." Reputational benefits by association may also accrue to families and organizations that are seen to be actively involved with these types of direct social and environmental impact investments, which adds to the appeal for many family offices, foundations, corporations, and HNWI's.

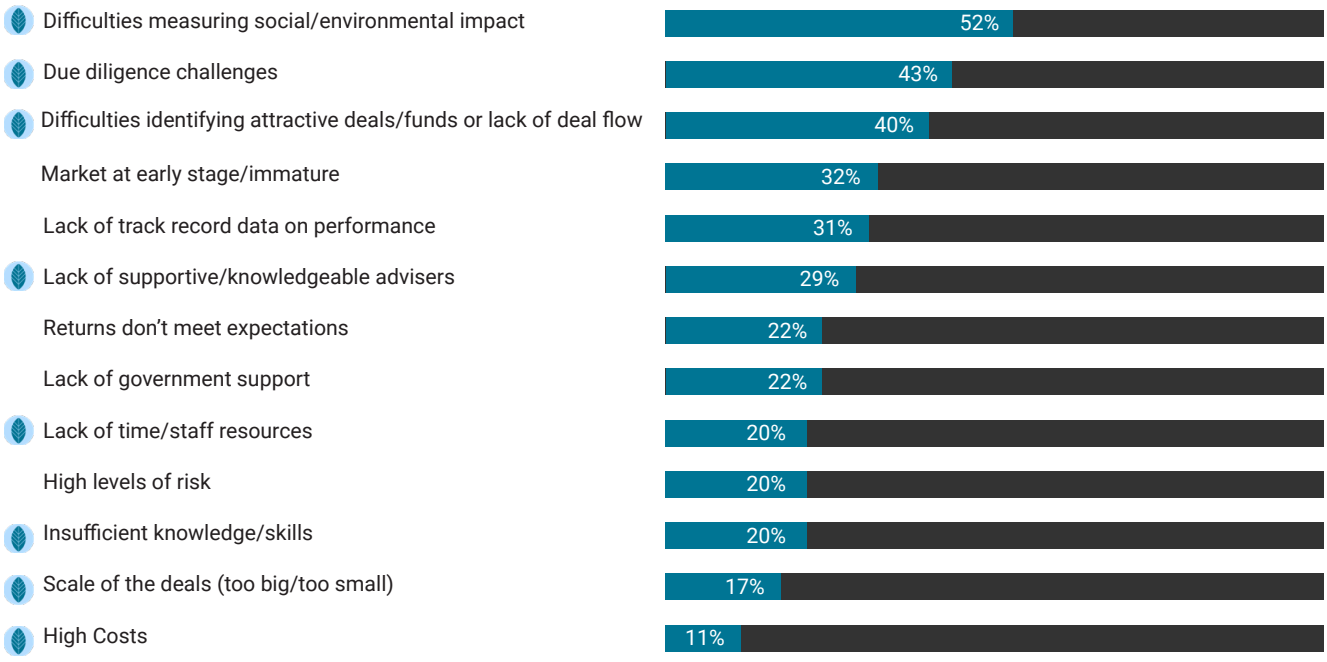
CHALLENGES FOR THE WOULD-BE IMPACT INVESTOR

With the change in the global perspective on impact investing occurring so rapidly and with resources to support that evolution relatively scarce, family offices, foundations, and HNWI's (and the wealth/asset managers and investment advisors that support them) may struggle with executing on their desire to increase their level of direct impact investment. 60% of respondents to Fidelity's 2018 Charitable survey of HNWI's (and 77% of millennials in the study) indicated that they had made an impact investment once presented with ways to make such an investment.

However, according to the GFOR, many family offices have trouble understanding how to source and implement impact investments, including addressing due diligence needs with staffs historically focused purely on financial returns.

Traditional institutions are often not offering solutions to this challenge. Family offices trying to manage their wealth in alignment with their family's values by investing in projects or companies that have a positive social or environmental impact may find that even the leading private banks have limited insight into true impact investing. While most banks promote their commitment to sustainable investing, few are impressing clients with their offerings just yet, and those that do provide guidance do so

Most Common Challenges in Impact Investing



SOURCE: THE UBS/CAMPDEN WEALTH GLOBAL FAMILY OFFICE REPORT 2018
NOTE: RESPONDENTS WERE ABLE TO SELECT MULTIPLE OPTIONS

AREAS ADDRESSED BY LOHAS ADVISORS

primarily in the areas of public ESG investing and not direct impact investment.

The challenge for private banks to do more than simply say they are committed to impact is complex because bankers may not be comfortable with the topics of social impact or sustainability and, thinking that they do not fully understand it or that their banks cannot provide full solutions, opt not to bring it up or disregard it.

Similarly, according to a survey by Calvert Foundation of 1,065 investment advisors in the U.S., advisors cited the lack of sufficient knowledge to speak comfortably with clients about impact investing as one of the top barriers to making impact investments. Financial advisers may also be apprehensive about delving into more sensitive topics with their clients. For example, "What are your views about the world and your role in it?" is a more challenging line of questioning than "What is your expected return on investment or when do you want to retire?".

Ultimately, however, having a discussion about "How do you want to be remembered?" and "What causes are most important to you?" is central to making those first steps down the path of social impact investing, and family offices in particular may struggle with aligning their vision, goals, and execution strategy within the family itself even before they learn that, in the case of direct investments, identifying and gaining access to the right investment opportunities and then executing them will present real challenges.

Notably, these obstacles are similar for foundations, which must determine, for example, how they will manage the relationship between PRI's and grants and how sometimes to think more like an investor and less like a donor. Beyond these types of culture questions, foundations also must evaluate their capacity and determine whether program staff have the expertise to source and vet investment opportunities, including how to communicate interest in making PRI's to social entrepreneurs in order to increase the flow of investable projects that fit the mission.

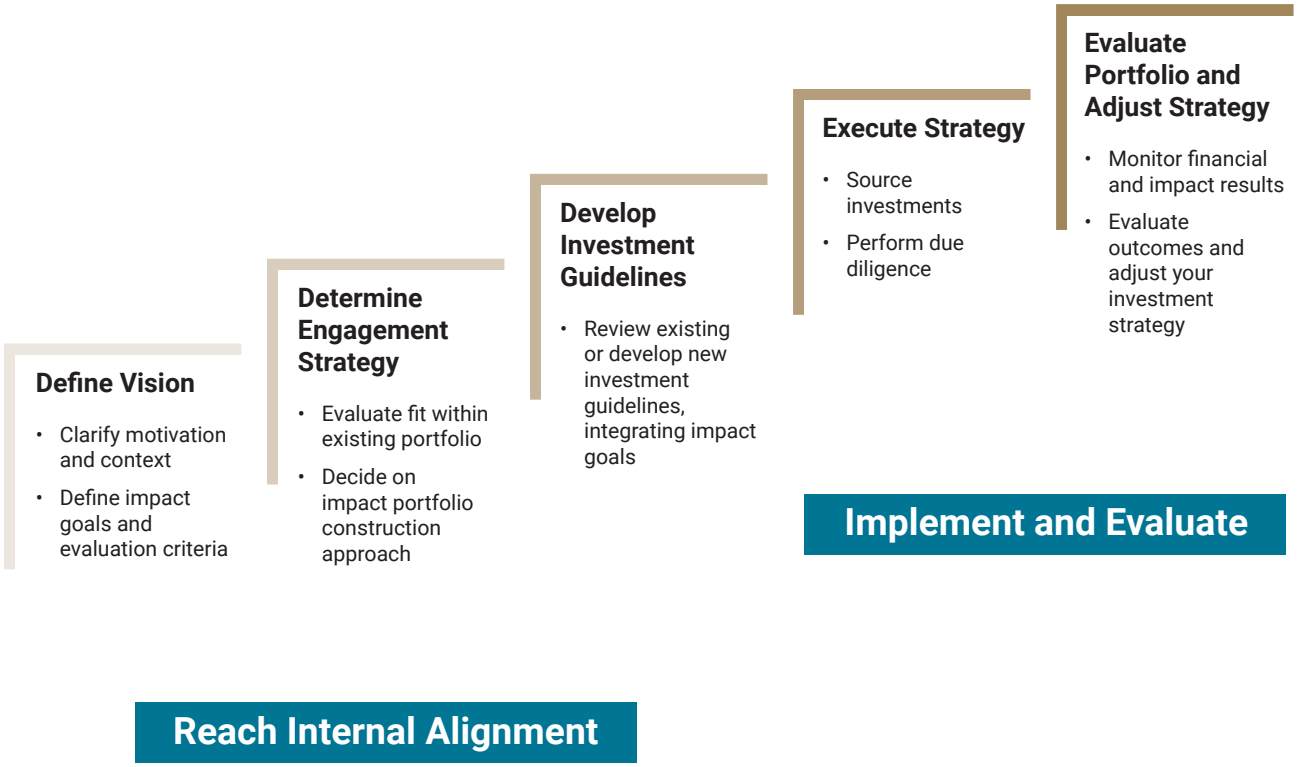
Similarly, the ability to conduct due diligence and structure an investment vehicle that is right for both the foundation investor and entrepreneur is essential, and foundations often must build the capacity to do that work – by either developing skills internally or outsourcing to other experts.

LOHAS ADVISORS ADVANTAGE

LOHAS provides advisory services to support HWNI's, families, foundations, family office managers, wealth and asset managers, investment advisors, and DAF sponsors in satisfying direct impact investment demands. LOHAS is uniquely positioned to be that resource due to the firm's time spent exclusively focused on supporting the health, sustainability, and social impact sectors as well as the technology and relationships in place to source deal flow and perform due diligence. LOHAS' support even extends to funds, corporations, real estate developers, and other investors seeking socially or environmentally impactful investment opportunities.

However, because the motivations and expectations of every client are different, before engaging in a deal sourcing initiative, LOHAS typically walks clients through an internationally accepted process to ensure alignment within the family/organization and agreement on the steps to be taken in the execution of the initiative.

Notably, there are a variety of areas under the social impact umbrella about which individuals may be passionate. As Advisors, LOHAS does not guide its clients to come up with solutions for all of the world's challenges. Everyone has a different perception of and sensitivity to those issues, and LOHAS' role is to open up that discussion and determine the best direction for clients and then empower them to execute on that vision.



One way to help clients think about and ultimately determine the areas that are of most interest to them is to look to the United Nations Global Goals for Sustainable Development (SDG's) which are a complete, internationally accepted collection of social and environmental objectives that can serve as both a guidepost for activity and a framework against which accomplishments can be tracked and measured.

Although relatively new, the SDG's have quickly become the standard within the social and environmental impact community for categorizing and tracking efforts, with investments often impacting more than one SDG. Notably, while the SDG's can be helpful in thinking about the broad challenges that face the world, LOHAS clients frequently already have a clear understanding of the type of areas that they would like to influence based on their own past experiences or preferences.

For example, families who have been impacted by autism may want to identify social entrepreneurs developing solutions for improving the quality of life for autistic children; while families who have traditionally invested in real estate and feel they understand that space may want to explore ways to bring more sustainable practices to that sector; and others who have experienced the challenges of community poverty may look to invest in education, health, or housing solutions.

Source: United Nations Sustainable Development Goals

There is no one right path. LOHAS helps those that are interested in making a direct social or environmental impact but are unsure how best to proceed. LOHAS may help clients explore:

- Market trends (to educate and determine optimal areas of focus)
- Investment portfolio strategy (to set the direction for the initiative)
- Investment types (to establish parameters for deal identification)

But ultimately, LOHAS serves as a hands-on advisor to identify optimal investment opportunities and provide due diligence services. LOHAS is particularly well suited for these activities due not only to the firm's market insight but also its corollary practice of supporting health, sustainability, and other social impact ventures in raising capital and growing their businesses and the volume of and access to investment opportunities LOHAS manages as part of that practice.

This unique advantage allows LOHAS to provides its advisory clients with a better source of social impact investment opportunities while improving the likelihood of future success. In fact, LOHAS' campaign technologies and techniques used to raise awareness for social entrepreneurs (and funds, accelerators, developers, etc.) can also be used to support the deal sourcing needs of family offices and other investors that wish to run their own campaigns to identify optimal, targeted investment opportunities.

To learn more about how LOHAS can support your social impact investment initiative, visit LOHASadvisors.com