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SOCAP11: Impact Investing Special Edition

ENTREPRENEURIAL SOLUTIONS TO GLOBAL CHALLENGES

Philip Auerswald

The Myth of the Market

Editor's Introduction

In the beginning, there was usury.

In the deflationary, no-growth world of the early Middle Ages, lending was frequently predatory. More often than not, the predators were priests. The poor were not the only victims. Nobles also forfeited property—even entire estates—to rapacious moneylenders.

The Church was powerful, but ultimately it could not resist pressure to curb abusive practices within its ranks. In 1049, Pope Leo IX outlawed interest-bearing loans, declaring at the Council of Reims that "No cleric or layman should be a usurer."[1]

At that point, a surprising thing happened: the trade in interest-bearing loans—officially outlawed by the Church—took off. With the usurious energies of the clergy becalmed, if not entirely dissipated, a new market space opened up in which the medieval "private sector" could provide loans. At the center of this transformation was a financial innovation known as the bill of exchange, predecessor to today's garden variety bank check. Bills of exchange were important not only because they enabled commerce to occur over long distances, which facilitated trade, but also—and importantly—because they created a loophole in the papal ban on interest-bearing loans. By carefully designing their terms, the earliest merchant bankers could employ bills of exchange as a way to extend short-term loans.

As financial institutions developed around bills of exchange and other innovations, they changed the social function of banking. "What made the new banking different from the old," says Robert Lopez, a pioneering scholar of early financial institutions, "was its shift from an agrarian to a commercial orientation and from an antagonistic to a collaborative attitude of borrowers and lenders."[2] Where the old banking was fundamentally extractive, the new banking had the potential to be

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creative. Alongside lending, a new and deeply disruptive financial form took shape: private investment.

This special edition of *Innovations* journal, collaboratively produced for the 2011 Social Capital Markets conference at Fort Mason, is a report from the evolutionary frontier of capital, and of capitalism. The authors of the essays, case narratives, and analytic papers published in these pages are a veritable Who's Who in the linked domains of blended value and impact investing.

In this brief essay I will reinforce a simple point also made by Antony Bugg-Levine and Jed Emerson in their contribution to this issue: The nascent world of "impact investing" is not entirely new and unprecedented, nor is it simply an incremental tweak to a now nearly perfected "market system." Instead, the development of impact investing and of new approaches to assessing value represents the latest stage in the invention, and reinvention, of the concept of economic self-interest and the reality of market-based capitalism over the period of centuries.

In other words, the movement described in the pages that follow is not a fad. It is the next step in a historical progression that dates back to the 11th century. Consequently, there is good reason to think that the transformations suggested by contributors to this special edition are just getting started.

BEFORE ADAM SMITH

You've probably heard the one about the old fish who calls out to the young fish swimming by: "How's the water?" The young fish replies, "What's water?"

So it is with prosperity in market-based democracies. Old fish: "How's the capitalism?" Young fish: "What's capitalism?"

The "market," in all of its various extensions, was not discovered by people. It was created by people. It is a social artifact. It is what we want it to be. Nothing more, nothing less.

Markets existed in the Middle Ages, but they were no closer to being mechanisms for the determination of social value than medieval lending was to being a mechanism for what we would today call investment. The value, and values, of society were situated outside of human interactions and aspiration: the virtuous pursuit of glory in the service of God.

The foremost spokesman for this chivalric, aristocratic ideal was the French philosopher Montesquieu. It was Montesquieu who first formulated the idea of the "Invisible Hand"—a phrase later famously adopted by Adam Smith to describe the beneficial consequence of market exchange—to describe how individual pursuit of glory constitutes "a force that makes men pursuing their private passions conspire unknowingly toward the public good."[3]

Indeed, a fundamental difference between the era of the Renaissance (literally, "rebirth") in Western history and Europe's medieval era is reflected in Renaissance thinkers' focus on redirecting rather than repressing the passions. A common theme of political philosophy of this era—most clearly exemplified in the works of Niccolò Machiavelli, Thomas Hobbes, and Benedict Spinoza, but evident elsewhere—was an insistence on considering human beings as they really are and not as we would have them be. (The anti-idealistic rhetoric of this bygone era reminds one rather strikingly of modern-day critiques of aid-based approaches to development.)

Where medieval thinkers generally endorsed the state taking coercive action to rein in the worst abuses by humans, Montesquieu and other Renaissance thinkers took the continued existence and potency of human passions as a given; they focused on social arrangements that successfully redirected those passions to yield lasting prosperity. Giambattista Vico's *Scienza Nuova* (New Science) contains a wonderful articulation of this principle:

> Out of ferocity, avarice, and ambition, the three vices which lead man astray, [society] makes national defense, commerce, and politics, and therefore causes the strength, the wealth, and the wisdom of the republics; out of these three great vices which would certainly destroy man on earth, society thus causes the civil happiness to emerge. This principle proves the existence of divine providence: through its intelligent laws the passions of men who are entirely occupied by the pursuit of their private utility are transformed into a civil order which permits men to live in human society.[4]

In a book whose title *The Fable of Bees* suggests interesting and mostly accurate parallels with the concept of swarm intelligence, Bernard Mandeville would similarly discuss how "the Skillful Management of the Dextrous Politician" was required to convert "private vices" into "public benefits." In focusing on one particular vice—avarice—Mandeville set the stage for Adam Smith, whose single-minded focus on economic interest as the rationalizing principle for society was to become synonymous with the Invisible Hand.[5]

Not long after the Spanish Conquistadors were famously sailing for "God, glory, and gold," European philosophers took up the question of how to limit the excess of monarchs driven by the three lusts (money, power, sex). History amply illustrated that reason was a feeble weapon with which to oppose the lusts. However, early social theorists conjectured, reason in the service of these three lusts—in the form of self-interest—might serve to stabilize rulers' behavior, and thus improve outcomes for the ruled.

Adam Smith's great innovation was to collapse the "interests," representing the fundamental passions of humans, into the single dimension of economic interest. Notably, "glory," which for centuries was exalted as the most elevated form of human ambition, was replaced with "profit." The double meaning of the word "interest"—both self-interest and income from an investment—underscored this shift. From the 18th century onward, the pecuniary motivations were imagined by political philosophers (and, later, economists), as holding a place of primacy over other motivations. In the Middle Ages the accumulation of money was viewed as a base occupation, or at best a means to the end of glory, but by the 19th century it was accepted by social theorists as an end in itself. The mercantilist worldview follows directly from the elevation of economic interest. Trade is exalted because it advances the interests of both parties involved—in contrast with banditry, which advances the interests only of the bandit, to the detriment of the victim.

By the 18th century, the central puzzle of political philosophy had shifted fully from that of controlling passions to that of assessing value. Of greatest concern was the difference between inherent value and market value. For example, why does water, which is essential for life, cost nothing, while diamonds, which are mere ornaments, are highly valued?[6] The resolution to this problem turned out to be in the effects of scarcity: goods whose supply is low relative to demand will command a higher price than goods whose supply is abundant relative to demand.

That the "market" could be a neutral determinant of value was a myth to start with. The nuanced and multidimensional approach to the assessment of value creation that Jed Emerson has dubbed "blended value" is, in fact, not a peripheral phenomenon. It happens in markets every day.

Today the question of value is back—with a vengeance. The rampant mispricing of assets that was central to the global financial crisis of 2008 served as a stark reminder that the market is fundamentally limited as a mechanism for determining value. But even the most casual student of microeconomics should require such a reminder: all are aware of the fundamental dimension of "market failure" that creates a systematic wedge between social value and market value. That the "market" could be a neutral determinant of value was a myth to start with. The nuanced and multidimensional approach to the assessment of value creation that Jed Emerson has dubbed "blended value" is, in fact, not a peripheral phenomenon. It happens in markets every day.

To make this point, and to tie back to the notion of investment with which I began here, think about the idea of a market return. Does a market return include investment in an entrepreneur who aims to launch a human trafficking venture in South Asia? No, it does not, because the venture is criminal. But, as we know—sadly, but nonetheless truly—there is a market for the sale of human beings. Why do those prices not count when we determine a "market return" on investment?

To respond simply by appealing to the legality, or not, of the market is to avoid the question. Are legislatures the determinants of market authority? Such a view strays very far from the notion of objective market value that lies at the heart of the myth of the market.

I would contend that we (and here I include many beyond the community gathered at Fort Mason and its global affiliates) don't use investments in human trafficking as an investment benchmark because we understand that the data on such returns is fundamentally corrupt. Whatever the accounting profit from a morally bankrupt practice, it does not constitute a legitimate return on investment.

Once we accept the limiting case argument for the inherent limitations of market pricing, if we would like to maintain even a semblance of logical coherence, we must also admit that a range of other investments are similarly subject to a metric of value assessment independent to the market's. The production and sale of cigarettes, the extraction and sale of carbon-based fuels, and trade in hardwoods harvested from rainforests—these are just a few activities on the legitimate side of the "market return" line that similarly reflect not just the mispricing but the lack of pricing of underlying assets.

What "blended value" represents is an approach to "value investing" that connects Warren Buffet's Nebraska common sense with Amartya Sen's Bengali courage to be both moral and uncompromisingly analytical. The combination is a powerful one, as the essays in this special issue of *Innovations* evidence.

ABOUT THIS SPECIAL EDITION

One word of warning: you will not be able to make it through the very rich content in this publication in a single sitting. The insights encapsulated here derive from years, in some cases decades, of work and experience.

Consider first the lead essays. Two of them—that by Bugg-Levine and Emerson, to which I have already referred, and that by Mario Morino, founder of Venture Philanthropy Partners—summarize the core arguments these authors have developed fully in recently published books. Another, authored by Wayne Silby, offers a rare opportunity to hear from one of the real pioneers of the field of impact investing—a person whose full observations and experiences could certainly fill volumes.

In these essays and others, you as the reader of this collection will also be challenged to think creatively about the future. The lead essay by Elizabeth Littlefield, for example, presents a vision for the role of government in investing for global impact that—while it has clear historical precedents—is of a different scale and nature than anything previously tried. Ultimately, it is a vision that challenges us to rethink the way that government carries out not only its development assistance but its core functions, both at home and abroad.

Brian Trelstad and Rob Katz (about whom I'll say more in a moment) also have set forth a challenge to readers. In their case, the motivating aspiration is not only to create social value through investment but to do so at a scale that is comparable to global challenges. Martin Fisher, in "Real Good, Not Feel Good," offers a succinctly presented and clearly argued set of principles to guide impact investors, derived from his decade and a half of experience as the founder and CEO of KickStart.

Finally, Ann-Kristin Achleitner, Andreas Heinecke, Abigail Noble, Mirjam Schöning and Wolfgang Spiess-Knafl have provided a wonderful service to the community interested in impact investing by putting together a primer on the topic that clearly describes the terminology and logic of this new domain. It is fittingly titled "Unlocking the Mystery." For anyone—particularly an entrepreneur—seeking a practical orientation on this topic, their essay is a great place to start.

The four case narratives make evident how investment can lead to high-leverage impact. Fighting energy poverty while achieving carbon offset at any meaningful level requires going to scale, but not necessarily through one firm or product line. E+Co is rapidly on the road to achieving this scale by investing services and capital in a global portfolio of clean-energy enterprises in developing countries. So far, E+Co has garnered or leveraged $280 million dollars to provide eight million people access to clean energy while offsetting five million tons of carbon emissions.

Husk Power Systems in India provides off-grid power to villagers using technology that converts biomass waste (rice and mustard husks, corn cobs, and certain grasses) into electricity. As described in the case narrative authored by Manoj Sinha, the company has successfully installed 80 mini-power plants in over 325 villages and is now growing at the remarkable rate of two to three power plants per week, with plans to nearly double that rate next year. In addition to classic entrepreneurial boldness, the company employed a flexible and effective financing strategy, tapping what they call the full spectrum" of financing appropriate to each business development stage—from early stage, to scale-up, to mature company capital sources.

Where Husk Power is seeking to make electric power accessible to millions, Envirofit is tackling another obstacle faced by rural areas worldwide: the adverse health consequences of open indoor cookstoves. To date Envirofit has sold more than a quarter million clean cookstoves in over 30 countries. Within five years, the company expects to scale to sales of five million increasingly efficient and safe stoves. The evolution in their financing, linked to their trajectory of growth, follows a pattern seen in the other cases: using a "mission-to-scale" strategy. It started as a not-for-profit, supported by foundation and government support, and it is now spinning off for-profit enterprises as it attracts commercial capital.

The Husk Power Systems and Envirofit cases are followed by insightful commentaries authored, respectively, by Simon Desjardins and Pradeep Pursnani.

In the last of the four case narratives, Jaime Ramirez illustrates, through the experience of Swaziland's Gone Rural, the quandary faced by new and growing businesses that seek to serve the global majority. These businesses are high leverage, in the sense that they have the potential to generate a substantial social return on each dollar invested, but they have a hard time making the transition to being "high impact" because they do not have the organizational capacity to absorb large investments without substantial support. This is a common phenomenon: organizations that have successfully utilized philanthropic capital, but struggle to make the leap to commercial capital to fund further growth. For these enterprises to scale, they need a blended approach of subsidy, support, and capital.

Finally, three strong analytic papers provide a deeper dive into different aspects of impact investing. Amit Bouri, director of strategy and development at the Global Impact Investing Network, chronicles the progress of an initiative aimed at establishing common standards for impact assessment, opening his piece with the fascinating question, "Can a common reporting framework be credibly developed and accepted over a few decades, rather than over millennia?" Katherine Milligan and Mirjam Schöning of the Schwab Foundation for Social Entrepreneurship offer a rich and engaging summary of the insights on impact investing offered by the World Economic Forum's Global Agenda Council on Social Innovation. And, finally, Ross Baird describes a method of peer-evaluating entrepreneurial ventures that holds real promise in disrupting conventional methods for the performance of due diligence.

A NOTE OF THANKS

More than any issue that we at *Innovations* have published in the six years since we launched, this one is the result of an editorial collaboration.

Paul Hudnut, a cofounder of Envirofit, was the original instigator of the idea of putting together a special edition of *Innovations* on the topic of impact investing for release at SOCAP11. Rob Katz of the Acumen Fund and Patrick Maloney soon signed on to form a core team of guest editors. This group then brought the idea to Kevin Doyle Jones and his SOCAP team.

Kevin not only gave the green light but also, over the coming weeks, shared generously his tremendous energy and understanding of the impact investing landscape. The guest editors and the SOCAP team, with input from the *Innovations* staff, then collaborated on a list of potential authors.

At that point, our superlative list of authors created time where it didn't exist to meet deadlines that extended over weeks, not months, from first query to final draft. As initial drafts came in, the outstanding *Innovations* editorial team comprised of Winthrop Carty, Adam Hasler, Dody Riggs, and Helen Snively got involved, to the usual excellent effect. When the Acumen Fund, Bohemian Capital LLC, the Schwab Foundation for Social Entrepreneurship, and Paul Hudnut (personally) offered funding to support the printing and distribution of the special edition at SOCAP11, the deal was done.

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Our sincere thanks to all.

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Winthrop Carty contributed to the summary of contributions to the issue. Helen Snively offered able editorial assistance—as usual, on a short timeframe. Conversations with Marc Ventresca were helpful developing the ideas presented in the first part of the essay, and arriving at its title.

1. Robert S. Lopez, *The Dawn of Modern Banking* (New Haven, CT: Yale University Press, 1979), 3-4. Only non-Christians were exempted, creating a social stigma around lending that carried forward to Elizabethan England, when the persona of the money-lending Jew was immortalized by Shakespeare in the character of Shylock.
2. *Ibid,* p. 4.
3. Albert O. Hirschman (1977), *The Passions and the Interests: Political Arguments for Capitalism before Its Triumph*, Princeton, NJ: Princeton University Press, p. 10.
4. *Ibid,* p. 17.
5. *Ibid,* p. 17.
6. Michel Foucault (1970), *The Order of Things: An Archaeology of the Human Sciences,* New York: Vantage Press, chapter 6.

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About *Innovations*

Innovations is about entrepreneurial soultions to global challenges.

The journal features cases authored by exceptional innovators; commentary and research from leading academics; and essays from globally recognized executives and political leaders. The journal is jointly hosted at George Mason University's School of Public Policy, Harvard's Kennedy School of Government, and MIT's Legatum Center for Development and Entrepreneurship.

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