How families can govern their way to successful impact investing

BY MARY PANG AND ERIN HARKLESS

Whether you're a newly minted tech billionaire in Silicon Valley or the owner of a family business in Asia experiencing exponential growth, you're likely to face challenges in coming to terms with financial success. First-generation wealth owners are often ill prepared for the changes that come with new levels of wealth and their corresponding responsibilities, including how they might spend and invest their newly earned fortunes.

Many business owners come to realize that their interests are best served when management of the family's wealth is handled separately from the business. Management of family wealth is often eclipsed by the needs of the company, or improperly delegated to business executives who are not equipped to manage personal assets (a comical yet important lesson learned in the CBC Television series *Schitt's Creek*). Many families establish a family office to address their unique wealth and investment needs. This article will discuss investment management through the lens of a family office, but the information can also be applied more generally to individuals or families who choose not to establish a formal structure.

As new wealth owners explore how to best manage their assets, they often face three key questions about effective investment planning: how best to invest to sustain future generations; how best to engage the next generation; and how best to ensure family unity endures. A good governance structure and the power of impact investing can help address these concerns.

The rise of impact investing

Impact investing, one of the fastest-growing areas of the investment business, is a form of values-driven finance in which capital is allocated to align with the world the investor wants to see. Not to be confused with philanthropy or charitable donations, impact investing aims to generate financial returns while also having a positive impact on key issues the investor cares most about. Examples of impact causes include providing access to education, combating climate change, creating more affordable housing and closing racial and gender gaps.

Family offices and foundations are among those leading the movement to integrate values and investment strategy through impact investing. Families pursue impact investing for a variety of reasons, such as alignment with personal values, risk mitigation and long-term outperformance or a desire to influence broader social and environmental challenges.

Impact investing can also be a means to engage younger family members, whether they're involved in the family business or not. By inviting younger generations to get involved with philanthropic and investment activities, the family can ensure continuity in the stewardship of assets across generations. We have seen increased interest in impact investing among NextGen and millennial investors, and previous generations are not turning a blind eye to impact efforts, either. A staggering 95% of millennials are interested in impact investing, according to a Morgan Stanley study.

Yet pursuing impact investments can and often does involve challenges. Expecting all members of a family to share the same values and goals is often unrealistic; some compromise may be needed to help the family unite behind a shared focus for its impact investments. Working through differences and having conversations about values and goals can help ensure the broadest possible buy-in, more unified decision making, and ultimately a more effective and satisfying investment experience. Once goals are agreed upon, family members should create a strong governance structure that ensures the management, decision making and execution of these ideas are carried out smoothly.

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Creating a governance structure

Governance provides families with a roadmap for effective decision making. This is imperative for new wealth owners to implement, because its absence can result in bad investments, poor due diligence or failure to move the needle on the impact goals you're hoping to achieve. While there is no one solution for all families, we have seen many different governance approaches implemented successfully.

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Thinking about governance broadly, families should start by asking themselves five key questions:

1. What are the purposes, priorities and principles that inform our family's impact goals?

2. Who are our stakeholders (e.g., impact constituents, multiple family generations, family office staff, external investment advisers)?

3. What are the appropriate roles, responsibilities and expertise needed of each stakeholder?

4. Does the current governance structure enable or inhibit the pursuit of impact investments?

5. Have we established an efficient communication process — meetings or otherwise — by which family members are informed of performance, impact or other considerations and have an opportunity to be heard?

From there, you can determine which governance approach might best serve your family's needs. For example, families can choose to designate and empower an individual decision maker, or to engage in a committee process where each family member has an equal vote. There are pros and cons to each approach and the many approaches that lie in between. To help guide your path, let's explore different governance models and some potential challenges and benefits of each. These models apply broadly to overall family investment portfolio governance and can support an impact investing program.

Your family may choose to have a governance model for your impact investing program that's separate from what is in place for the broader portfolio. For example, let's say your family governs its portfolio via a generational committee, yet because of your daughter's passion for combating climate change, you want to designate her as the single decision maker when it comes to the family's impact investments. While this may allow for timely decision making and accountability for specific impact investments, it can also lead to potential conflicts regarding the integration with the rest of the portfolio.

Another approach is to establish an impact "champion" or even a subcommittee or small group of family members who can integrate into the existing governance approach. Those designated for this type of role should care deeply about impact investments and be willing to liaise with other family members and stakeholders to ensure effective implementation of the family's impact portfolio. Often, this is a good role for NextGen family members who are increasing their involvement in the stewardship of the family's assets.

A challenge of the impact champion role can arise if other family members are not as aligned with the direction of the impact program and feel their perspectives are not being adequately represented. It is essential for those most engaged with the impact program to update other family members on objectives and metrics so everyone remains involved and supportive. Some families go so far as to have the impact champion act as the single decision maker, while others opt to have that person serve as the key advocate and voice for impact within one of the other structures. Regardless of the approach used, the role should be well defined and potentially be revisited as family circumstances evolve.

Overall, an effective governance structure helps a family develop consensus on a variety of issues, including an impact investing program. A clear decision-making process that is well aligned with the family's objectives and values improves the likelihood of long-term success.

Taking action

With a governance structure in place, you're now ready to take steps toward making your family's first impact investment. Regarding implementation, impact investors can choose from a variety of strategies. There is no "one size fits all" approach, but here are some key considerations.

• In **opportunistic deployment**, a family makes a case-by-case evaluation of impact investment opportunities. This more flexible execution allows for changing priorities but often lacks cohesion. This approach can work well with existing governance and decision-making structures in that each investment can be reviewed and approved under the current framework. A potential challenge of this approach, however, is how to assess each impact-oriented investment against non-impact investments, where the criteria for evaluating success may be very different.

• With **defined implementation**, a family determines a specific set of impact parameters, often executed within the traditional, non-impact portfolio of investments. For example, the family might establish a specific target, let's say 10%, to impact commitments, or use exclusionary screens to avoid objectionable exposures, such as fossil fuel investments. While this approach can be relatively easy to implement and offers flexibility, it may not optimize for broader investment objectives.

> Measuring the effectiveness of your impact investments can be a complex undertaking, and having a clearly defined governance structure to inform and support the measurement process is critical.

• With a **carve-out approach**, a family develops a distinct portfolio of impact investments. Under this approach, a separate impact governance structure might be preferred, because the investments are evaluated separately from the rest of the portfolio and can be held to their own separate decision-making structure. However, the dedicated impact portfolio may not fully integrate with other family investments.

• In **full integration**, impact investments are incorporated into the total portfolio, an approach that aspires to enable full alignment with environmental, social and governance (ESG) principles. A fully integrated implementation plan might be best within the existing governance structure, with few modifications, or it may require a complete overhaul of the governance structure given the different nature of impact investments. One potential challenge lies in sourcing investments across all asset classes. For example, there have historically been fewer ESG/impact-oriented hedge funds, making it difficult for investors to construct portfolios with that specific exposure. With full integration, a family must decide whether it's more important to be fully compliant with impact parameters or to have a broader range of investment options.

• With a **customized platform**, families have a range of capital solutions tailored to meet their entire spectrum of impact investing needs. For example, your family might seek to integrate a private family foundation with a limited liability company that invests in for-profit entities into one cohesive impact platform. This model offers the most flexibility and creativity in implementation but requires extensive costs to build a new business model. It also likely requires a more bespoke governance approach.

There is a measurement component to any impact investing approach. Measuring the effectiveness of your impact investments can be a complex undertaking, and having a clearly defined governance structure to inform and support the measurement process is critical in evaluating the long-term success of the impact program.

Families are at the vanguard of impact investing — challenging conventional philanthropic models, embracing flexible capital and increasing the integration of their values and investments. All families evolve, as do investment opportunities. Ensuring both continuity and new perspectives is important. We encourage you to periodically revisit your governance structure to ensure continued alignment with the values and realities of the family. Strong communication, clear decision making and a unified, long-term perspective will ensure that your family can effectively meet its impact objectives. FB

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