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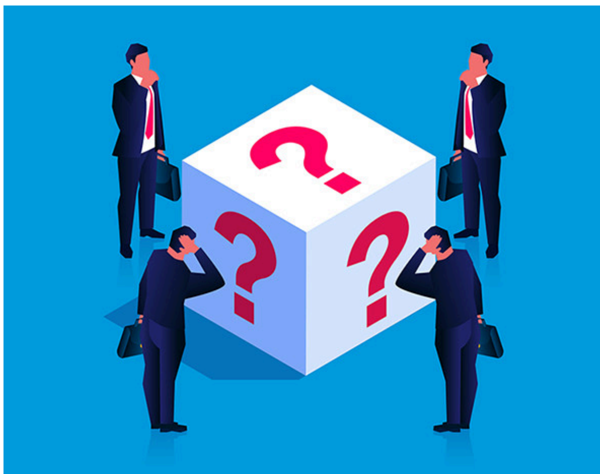
Impact Investing

Why Investment Funds Don’t Have Enough High-Quality Impact Data

Despite widespread acceptance in impact investing of the need for reliable impact data, funding for producing it lags behind.

By Sasha Dichter & Aaron Bourke | May 15, 2024



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The past few years have seen major strides in how investors measure social and environmental performance. Frameworks like the Impact Management Project (IMP) and the International Sustainability Standards Board (ISSB) have given investors a more structured approach to impact reporting, while regulatory changes like the EU’s Sustainable Finance Disclosure Regulation (SFDR) hold investors to higher levels of disclosure. This is progress.

However, cost is a meaningful barrier to the widespread implementation of robust impact measurement and reporting. Because investment funds have not historically been structured to incorporate rigorous impact measurement, such activities don’t have a natural “home” in budgets. This not only limits the resources available to undertake these increasingly important activities, but each general partner must therefore engage—both internally and with their limited partners—in one-off discussions about how their fund will solve this problem in piecemeal fashion. The result has been to produce a significant mismatch between current fund practices and the rising expectations for high-quality social and environmental impact data. Because most funds were created in an environment of lower expectations, the ground has shifted beneath the feet of fund managers, who—often in the middle of a 10-year fund life—find themselves saddled with a fund LP agreement that did not anticipate today’s reality.

Without a clear path forward, investors raising new funds have no playbook to follow around how to tackle this problem.

How Do Investors Pay for Impact Measurement Today?

Current approaches typically fall within two broad categories, with funding coming either out of the fund's Management Fees, or from a separately financed Technical Assistance fund set up outside the main fund structure to pay for impact measurement. Neither is wholly satisfactory.

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For the former, private investment funds have a fund management fee that is typically 2 percent per annum of committed capital during the investment period, and 2 percent per annum of invested capital thereafter. Fund managers must cover all the general operating overhead of running their businesses from these management fees. But having worked with hundreds of investment funds as a service provider, 60 Decibels' experience has been, in nearly all cases (and regardless of fund size), that this 2 percent management fee always seems scarce. Because most self-described impact investment funds are relatively small—$250 million or less—there is not a lot of wiggle room when it comes to using this capital; for most funds, the amount that can be drawn for impact measurement activities often tops out at around $100,000 per year. If a typical GP has 30, 40, or even 50 investments in their portfolio, this won't be enough to get actionable impact data for each company. Instead, more likely, they'll get no more than basic metrics that are easy to gather, but which don't offer the insights that investors and companies seek or provide a meaningful basis on which to confirm that the fund is having the impact that it seeks to achieve.

The second avenue for funding impact measurement, Technical Assistance (TA) funds are typically grant funded, with specific requirements for how these funds can be used in support of portfolio companies. The upside is that TA funds can often be used to fund impact measurement expenses, because they tend to be highly flexible. However, TA funds are an unpredictable undertaking with a low success rate, and they require a significant investment of time and resources to raise and structure. As a result, only a very small minority of impact-first funds (and a much smaller percentage of all funds with an environmental or social mandate) have any TA funds at all.

New Approaches

As the adage goes, "you get what you pay for." In the case of high-quality social and environmental data, structural constraints to allocating adequate resources within funds have the predictable effect. The good news is that frameworks already exist within fund structures and commercial diligence practices to address this issue.

1. Fund Expenses in the LP Agreement

We have seen a growing number of funds treating impact measurement as an allowable fund expense, codified in their LP agreement. The rationale is simple: funds need to engage in a certain set of activities to operate. Traditionally these activities have been things like legal fees or completing an annual audit, but a growing number of impact funds are now saying they need good impact data to run their fund, and, therefore, gathering this data should be an allowable fund expense.

Take, for example, Social Finance's pioneering "Impact First" Fund. Central to the Fund's strategy is a rigorous Impact Measurement and Management (IMM) process that ensures that the Fund not only targets but also achieves meaningful social and environmental impact. Due to its importance, IMM is an explicit allowable expense within the LP agreement, specifically covering "costs incurred in connection with the assessment, measurement, and monitoring of impact within the portfolio (which may include associated travel costs)." This approach enables the Fund to leverage both in-house and external expertise when needed in its impact measurement processes. LPs have been supportive of the inclusion of measurement costs and the opportunity for enhanced data and reporting on their investments' financial, social, and environmental impacts.

An added rationale for treating these expenses as fund expenses under the LP agreement is based on a theory of how expenses are categorized. It is generally accepted in the industry that fund expenses cover all expenses specific to that fund, whereas GP expenses covered by the management fee are expenses that are inherent in running the fund management business. By that logic, it would be odd for impact measurement expenses specific to a fund's investments to be covered out of the management fee, and far more logical for these to be classified as fund expenses. Classifying these expenses as fund expenses under the LP agreement also acknowledges that the industry-standard 2 percent management fee developed as a proxy for how much money a GP needs in order to "keep the lights on" without taking into account a substantial expense for impact measurement.

What does the math on impact measurement expenses look like? Imagine a fund aiming to get best-in-class social impact data, and the cost of doing so at the fund level is between 25 and 50 basis points per year (0.25 percent to 0.5 percent of committed capital). If this cost is thought of as part of a 200-basis point annual management fee, it is between 12 percent and 25 percent of all available resources, which is impractical in most cases.

Conversely, if the expense is charged to a financially successful fund—imagine an equity fund that has a 20 percent IRR—then in the context of this outsized financial success, the impact management cost feels appropriately small, both to LPs and GPs. In addition, on a more technical note, the waterfall of the fund could be adjusted to have some sort of adjusted cost share between the GP and the LPs of the fund (for example, by providing LPs with a preferred return).

We've spoken to numerous legal and fund advisors about this practice, and there is broad agreement that it makes sense. "There is clear precedent to pass through expenses of third-party service providers when skills outside the scope of a fund manager's expertise are needed," as Leslie Cornell (Vice-President and Deputy General Counsel at Social Finance) notes; "This fundamentally improves investment decision-making, and integrating the costs of these high-yield activities into the fund's mechanics demonstrates forward-thinking in impact investing."

The decision of how to allocate a fund's impact measurement expenses does not need to be a zero-sum game or an adversarial exercise. The best GP/LP relationships are built on a foundation of trust and shared purpose. To that end, we think the heightened expectations around impact measurement provide an opportunity for GPs and LPs to discuss and align expectations before the initial closing. In other words, GPs and LPs should have a robust discussion about the scope of impact measurement, what they are trying to achieve, how it will be implemented (such as what language to use in the LPA, how budgets will be set, and what activities will be included), and how much it will cost to do so. As noted, cost-sharing mechanics can be built into the fund's distribution waterfall.

Having this robust discussion—instead of simply adding a new line item to the laundry list of fund expenses—will also help ensure alignment at the outset and avoid challenging discussions if the cost of impact measurement exceeds expectations.

2. Due Diligence Costs

Including company-level impact assessment as part of due diligence is another way that funds have been getting higher-quality data.

The logic is relatively simple: a company's social and environmental impact is one of the core drivers of the investment thesis, so it makes sense to put appropriate diligence resources behind these activities, either with a mindset of value creation or risk mitigation. Furthermore, for any investment with a thesis around customer-level impact, understanding those customers' experience with a product or service will be similar to traditional market research, a very common activity in any investment diligence process. Indeed, paying for customer research in diligence is an expected activity for consumer-facing private equity deals, so it's surprising that this isn't a more common practice for assessing social performance of impact-oriented deals.

At a practical level, this is very appealing to investors: a private equity investor typically hires multiple third-party vendors to conduct due diligence. These typically include commercial diligence providers, HR experts, legal counsel, accountants, risk advisory firms, management consultants, and insurance providers. And, in both B2B and B2C companies, it is typical to hire firms that speak to a representative sample of customers to understand their perspective on the company.

Similarly, some of most innovative work in social impact measurement, including the work done by 60 Decibels, centers on speaking directly to customers or supply chain actors about their experience of a company and its products and services. Incorporating these activities as part of due diligence gives investors insight they need at the most important moment: at the time when they are making the decision whether to deploy capital and enter into what could be a 10-year relationship with the potential investee. Best of all, these sorts of activities create direct value for the investee: insight into customers' experience is immediately actionable by the company.

In addition, while these costs are paid for upfront by the investor, they are typically capitalized as part of the deal, meaning that some or all of the cost is ultimately borne by the investee in the form of equity to the investors. Given that this is standard practice for other diligence costs, it seems logical that customer and impact diligence would be part of this mix for all deals for which social or environmental impact are an important part of the core investment thesis.

Changing Terms

Broader socialization of these approaches starts with an honest conversation between Limited Partners and General Partners about the purpose of the fund and what data are needed to see if a fund is on track or not. Beyond that, we propose a structural change in how the LP agreements for "impact" funds, broadly defined, are written. The default should be to name gathering and reporting data on social and environmental performance as an allowed and expected fund expense so that we can begin to trust these data from funds as much as we trust the financial data shared by their auditors.

Beyond this, we should ask what funds mean by "underwriting for impact" and free investors to allocate resources during the diligence process to meaningfully understand the impact thesis—whether that is impact on the environment, if that is the core of a deal, or impact on people, which requires listening to them directly to hear their perspective.

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Read more stories by Sasha Dichter & Aaron Bourke.

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