Dollars and Change Podcast: How do impact investors measure impact? With Michael Brown, Head of Research at Wharton Social Impact Initiative

Michael Brown, Head of Research at Wharton Social Impact Initiative, joins host and Vice Dean Katherine Klein to discuss the complexities around impact measurement. Most impact investors report meeting or exceeding their impact performance metrics. But is this truly the case? Brown collaborated with Wharton PhD candidate Lauren Kaufmann on research that uncovers how it is common practice for impact investors to report impact metrics primarily to market, or publicize, their success – rather than to evaluate and understand where their impact may fall short. While the reality of impact measurement may not meet the rhetoric, Brown believes this is due to the challenges of measuring impact rigorously while simultaneously running an investment fund. He offers recommendations for measuring impact, and also explains why the field needs to get more comfortable with impact underperformance in order to learn and grow.

Transcript:

Katherine Klein: Welcome to Dollars and Change. This is Katherine Klein. I am the Vice Dean for Social Impact at Wharton, also on the faculty at Wharton as a Management Professor, and today I'm really excited about talking with my Wharton Social Impact Initiative colleague, Michael Brown. Michael is our Head of Research and has been really leading on a lot of our work on impact investing and has just wrapped up a fascinating interview-based study looking at impact measurement. It's a crucial part of impact investing. So Michael, welcome to the program. Great to have you with me. Thank you for joining us.

Michael Brown: Thanks for having me.

Klein: Great. So, Michael, I'm going to start by reading a few definitions of impact investing, because one of the things that I think is really striking about these definitions is how much measuring impact is part of the very definition that people in the field use to describe impact investing.

So for example, the GIIN -- and we'll refer to the "GIIN" sometimes in this conversation. The GIIN is the Global Impact Investing Network, and the GIIN defines impact investments as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return." Measurable social and environmental impact.

The International Finance Corporation has a very similar definition. They define impact investing as "an approach that aims to contribute to the achievement of measured, positive, social, and environment impacts.

And we'll give one more definition. They all say very much the same thing. This is the Impact Investing Hub. They say, "Intentionality and measurable impact are the fundamental concepts that differentiate impact investing from traditional forms of investment."

So as we dig into this and explore how much measurement is actually happening in this space, I should say that you and I are both trained researchers. We both have our PhDs in research -- you in sociology; me actually in psychology. We spend a lot of time thinking about how you measure things, and so this commitment to measurement in impact investing is really interesting. What is it that made you want to dig into this topic more and learn more about impact investing and how measurement actually gets done?

Michael Brown: There really are, I would say, two reasons that I wanted to get into this with my colleague, Lauren Kaufmann, who's a Ph.D. candidate at Wharton. It's really two puzzles. One is sort of a higher-level puzzle, and one is a more specific puzzle. But the higher-level puzzle is what you described, that impact measurement is such a critical component of impact investing as it's defined by all of these advocacy organizations and trade associations. But impact measurement done rigorously is quite difficult. It's difficult for all sorts of reasons, but we'll just leave it at that for now. It's difficult. So the question is, how do impact investors go about threading that needle, measuring and documenting their impact and doing so in a way that's compelling but not draining off all of their resources on impact evaluation? That was the first big puzzle.

And the more specific puzzle is this finding that has surfaced in all of the annual impact investor surveys that the GIIN has done, which is that impact investors pretty consistently report that their portfolios have performed on impact, either in line with their expectations or even above their expectations. Underperformance is extremely rare, on the order of 1 to 3% of the respondents to these surveys. And that was interesting because our initial thought was impact -- meaningful impact, we should say -- should be pretty hard to achieve. At least that was our assumption. So how is it that underperformance is so uncommon? So those two reasons, I would say, are what were really the impetus for getting into this research.

Klein: I want to underscore what you described with the GIIN survey. So going back to that, this annual survey of hundreds of impact investors asks respondents, "How well are your portfolios doing with regard to impact? And are they meeting your expectations for impact, exceeding your expectations for impact, or are you underperforming? Is there a problem with impact?"

And again, as you said, 20% or so of them were saying, "We're doing better than we expected with regard to impact." About 80% say, "We're in line." And that leaves, well, zero -- or nearly zero -- in this case probably more like 1 or 2 or 3% saying, "Yeah, we're not quite meeting expectations," which is kind of a remarkable statistic, as you say. And there's that song: "Things that Make You Go Hmm." So this was something that made you go "Hmm."

I guess it's fair to say you were skeptical. I look at these numbers. I'm skeptical. You and I know impact is difficult to measure. It's difficult to achieve. So what did you try to do to get below the surface and dig a little bit more into what's actually going on with regard to impact measurement?

Brown: So there were two steps here. I think the initial reaction that -- well, certainly the reaction that I initially had, and I think that most Ph.D.-trained researchers would have is, "Well, that's just a guess," right? These respondents are just BS-ing. They're trying to paint a rosy picture. And I think that even though that's an understandable initial reaction, it's not necessarily the most constructive reaction.

So the first step was we decided to hear out impact investors. We wanted to assume that they're being forthright and truthful, and just again, hear them out and give them the benefit of the doubt -- even while maintaining some degree of skepticism. And then to follow up on that point of just hearing them out, literally we wanted to hear them out, which is to say we wanted to talk to a whole lot of them.

Surveys are really powerful research tools, but Lauren and I decided that to really get under the hood of this topic, we needed to talk to these professionals. And so we went about interviewing, in the end, staff at 135 impact investing organizations -- mostly fund managers, but also their own investors, so limited partners and so on who invest into these funds. And also about a dozen or so consultancies that are also part of the impact investment process and supply chain.

Klein: Right, so most of these folks you were speaking with were at impact investing funds. These are folks practicing impact venture capital and private equity. They are financially-trained, perhaps also impact-trained financial investors. And I love what you did to start to unpack what was going on, and I think a key question that you asked is, you asked these people you were interviewing to describe to you two deals that they had done-- to describe two deals. In one case, one that they regarded as really an impact success story, where they were delighted with the impact they had achieved. And the second story should be a story about when there was some disappointment. The deal did not achieve the impact that they had hoped.

It sounds like people were able to come up with these stories, but you saw some striking things when you started to reflect on the kinds of stories people were telling you. So tell us more about what you learned from these stories.

Brown: Yes, that was a really important part of the interview protocol that we used. We planned the line-up of the questions. We really wanted to get concrete examples or stories of specific deals. I'll go into our findings in just a moment, but I just want to give a bit of the rationale for using this approach. And as I said, we really wanted to get into specifics, and there is a temptation sometimes, or a tendency in impact measurement to escape into abstraction, to say, "Oh, I use this framework," or "I collect these metrics," or "I use a logic model," or something like that, which is useful to some extent, but it doesn't really give you the full color of what's going on. So that's why we asked for these specific examples.

And as we got these stories, after the interview was concluded, Lauren and I listened to those stories again and classified the kinds of evidence that our interviewees used to explain why a given deal was deemed a success from an impact perspective or deemed a case of underperformance from an impact perspective. We wanted to pay attention to whether this evidence was quantitative or qualitative in nature. Was it focused on the business or more focused on the impact? And what we found, after we went through that classification process, was a pretty striking inconsistency, especially in the use of impact metrics. So impact-focused, quantitative data -- those kinds of data were cited far more often in cases of impact success than they were in cases of impact underperformance. And specifically, the numbers are 82% of the examples of impact success involved citing quantitative impact data, while only 24% of the underperformance examples involved quantitative impact focus data.

Klein: So that's really curious, you know? It sounds like folks are being much more specific with regard to quantitative indicators when they are telling you about a success story. Now, listening to that story, I've got to imagine that they probably had quantitative indicators for their low-performance stories, as well, but they weren't sharing them with you. What was your interpretation? I'm not sure that my interpretation is correct, but what do you make of this disparity in the kinds of evidence that people bring to bear, that they offer in their stories when they are describing successful deals with regard to impact, versus unsuccessful deals with regard to impact? Why do they use numbers differently?

Brown: Yes, and specifically in this case, it's the impact numbers. So the initial interpretation was, "Well, this is just more top-of-mind to our interviewees when it comes to the success stories." Impact metrics, essentially, are for some reason more top-of-mind than in cases of impact underperformance. But we've really, really wanted to see if impact metrics factor into cases of impact underperformance, and so Lauren and I made a point of following up, especially with cases of impact underperformance, to ask: What kind of data are used?

So just to be more concrete, if they described impact underperformance in terms of business underperformance, you know, just lack of scale or lack of market penetration or just poor financial performance, we actually followed up to ask about any more impact-focused data. And still, we tend to not really meet with that kind of answer, which led us to conclude that in many cases -- not all the time, but most of the time, it seems, at least based on our data -- impact metrics are not really used to measure performance or to evaluate performance. They are really used to convey accomplishments and to describe what portfolio companies are doing.

And the big assumption here, admittedly, is that a meaningful system of performance evaluation would be more sensitive to cases of underperformance because performance evaluation is not just about showing business success.

So that was the conclusion that we drew from the interviews, and we also actually got direct supporting statements of that interpretation. We had a number of interviewees admit that, "Yeah, impact metrics are really more for describing success to stakeholders than they are for evaluating, engaging underperformance.

Klein: Yes, so measurement more as marketing than in-depth inquiry and evaluation, it sounds like. So really a provocative statement in this space that cares so much about measurement, so let's continue. And I may have summarized this more boldly than you would have, but let's continue to dig into this.

Another thing you found when you went looking at some of the surveys that have been done -- and again, there's a GIIN survey that asks impact investors, "Do you set impact targets, and is this an important part of your measurement and evaluation and an important part of our practice to actually have targets for impact?" And something like 78% of these folks say, "Yes, we have these."

Have you found in talking to people that that didn't really seem to be the case, that these impact targets, if they had them, were not very rigorous, not very rigid standards? What did you find?

Brown: That's right. And just to clarify, we were interested in targets because again, they're relevant to this question of impact underperformance. To set a target is explicitly or implicitly to set a threshold for success, and therefore also to set a guideline for potential underperformance. And so for the same reason that we asked about examples of success and underperformance, we also asked about target-setting, as you noted. And we found exactly what you described, that target-setting appears to be pretty rare on the impact side, at least. And when it is used, it seems to be used quite loosely.

And I'll just draw up some of the data points that we came across. Actually, this comes not just from the interviews but also from an analysis of about a hundred impact reports that we reviewed, both public-facing impact reports and also private performance reports. And in the public impact reports, we carefully read these documents. We found that only about 14% of these public impact reports even cited a quantitative impact target, and all of them conveyed success.

And this is important because this was not a random sample of impact funds. The way we went about sampling and reaching out to these funds -- the way it was set up, we reached out to funds that were more likely to be more sophisticated on impact measurement. And I can get into more details, if that would be helpful, but if 65% of impact investors are using quantitative impact targets, as the latest GIIN report suggests, then that should be evident in the reports produced by this sample of funds that we've collected. But it was only 14%, as far as we could tell, from the reports.

And then yes, when we spoke about this topic with our interviewees, we got statements like "Yeah, it's more of like kind of just a general gut check. It's more of an impression. You know, we're just making sure that the portfolio companies are kind of doing what they said they would. We don't really monitor these targets carefully. It's just kind of to set an expectation." It doesn't seem to be analogous, in short, to a commercial performance benchmark, like an IRR or a multiple.

Klein: So let me ask one more question about this and about your findings in this space, and then I want to turn to what you make of this. So you're finding that these -- number 1, the fund managers are describing impact success and impact underperformance differently in their use of metrics. You're finding that this idea of impact targets doesn't quite measure up to what people are saying in surveys, that these targets are not as explicit, not as common, they're looser, there's more of a gut check. What about investors, because I want to come back to this idea that the field is saying impact measurement is a really important part of practice. You know, I think impact investors, fund managers probably feel a lot of social pressure. There's a norm here that we need to say that we measure impact seriously. I'm wondering if investors hold this to them? You know, the investors who are putting up a million, 10 million, 50 million -- hundreds of millions of dollars into these impact investing funds. Are they saying not only, "Show me the money," but "Show me the impact"?

Brown: Based on what we heard, the investors into funds do want to see that impact is being measured, but in terms of the technical specifics and the rigor of that impact measurement, our interviewees told us that the expectations are pretty low, frankly. We were told that investors into funds don't really ask questions about the impact reports. They seem to be pretty content with what's reported out, and they're just really happy to know about the kinds of companies that are being capitalized, rather than all of the quantitative details of the specific social and environmental impact that these companies are producing.

So an investor wants to know that solar companies are being invested into, but they don't necessarily have lots of questions about the specific tonnage of greenhouse gas emissions being reduced and whether that's aligned with standards and expectations or falling short.

There are some exceptions here. We were told that certain kinds of investors tend to be more attentive to the impact measurement specifics, specifically development finance institutions and philanthropic foundations tend to be more "invested," so to speak, in impact measurement, presumably because these institutions tend to be more likely to accept below-market rate returns and are therefore more likely to differentiate impact performance from financial performance. We were actually told that and were given that explanation by a couple of our interviewees. But overall, our interviewees were not getting a whole lot of pressure from their investors to do rigorous impact measurement, it's safe to say.

Klein: So this is a really interesting set of findings, and not much of what you're describing surprises me. This is what I would have expected. When I look at a lot of the rhetoric around impact measurement, and I think about how difficult it is to achieve some of these standards, to quantify how much impact you're having. Or some of these standards that we have for how to do impact measurement focus on contribution. Would this change have happened anyway? Is the impact you're having possible, even without the investment? Well, that is really difficult to establish quantitatively and in a way that meets scientific standards.

So part of me is not surprised by what you're finding, which I think I would summarize as saying that the reality of impact measurement, as practiced by most impact investors, does not meet the rhetoric in the field. So I think that's a fair conclusion. That's what your findings suggest.

I think my question for you is, assuming that that's a reasonable summary of your findings, what do you think is going on here? How do we make sense of the fact that, as I put it, the reality of impact measurement doesn't measure up. That's maybe too many "measures." It doesn't live up to the rhetoric of impact investing.

Brown: Yes, and I'm glad that we're getting into this part of the conversation because at this point, listeners may be wondering if this is just one long indictment of impact measurement and impact investing. And that's really not the takeaway that Lauren and I had. And this goes back to what I said at the beginning of the conversation, that we came across this weird survey finding, and the initial reaction was, "Well, that's just BS. These impact investors are just lying," or something like that.

Klein: Exaggerating.

Brown: Yes, or exaggerating -- right. And that was not the attitude that we wanted to take. We really wanted to understand the pressures and the constraints and the challenges that these professionals are working under. And in that spirit, the way we interpret these findings is not that impact investors are cutting corners or that they're lazy or that they're just trying to suppress unpalatable information. Because as you noted, it's not that surprising. This is really hard to do, even for scientists with all the credentials and budget and staff and time to do impact evaluation, this is hard work. So it's understandable that impact investors need to make certain compromises and think about impact measurement in a way that maybe doesn't jibe with how we think about rigorous impact evaluation.

I think what's happening here is that impact investing is a relatively new field, and field-builders have understandably used really ambitious language to grow the field and to advocate for the work that they're doing. And investors hear that, but they also have businesses to run and deal pipelines to manage. And they're basically going a good deal what they can, which means that in many cases they're screening potential investments carefully and thoughtfully, and really trying to be clear on how they interpret impact. But they're not trying to do randomized control trials, and they're not trying to approach impact assessment in a way that would resonate with a more academic approach.

A lot of this seems to be more pre-deal when it comes to the impact side. And then once companies or potential investees are deemed impactful, then a lot of the performance evaluation is actually business performance evaluation. A lot of it is based on financial performance. And impact metrics remain relevant as a way of describing what these companies are doing for stakeholders.

I mean, it is marketing in a sense. That's the word that you used before. So I'm not necessarily pushing back on that. I just want to acknowledge that marketing sometimes has a negative connotation, but it doesn't necessarily need to have that connotation. Marketing is a really important part of any business endeavor, and so it makes sense that impact measurement would be relevant to marketing.

Klein: And where does this leave you in terms of recommendations? In the face of the information that you've collected, do you think that investors should demand more rigorous data, that we should have more rigorous impact data, that investors should hire more PhD researchers to conduct these studies? Is that what you would advocate or hope for? Faced with this, as I'm putting it, this discrepancy between the rhetoric of impact investing and the reality, what do you think the field should do? What would you encourage impact investors to do, given the challenges of rigorous impact measurement?

Brown: Yes, I do think that more resources need to be allocated to impact measurement. I don't know if that necessarily means having a team of PhDs in every impact investment fund. I actually have selfish reasons for advocating for that, but I'm not sure if it's realistic. But yes, we heard very consistently from our interviewees that they face this expectation to do impact measurement, but they just don't have the resourcing and the funding to do it.

When we did hear that they had resourcing and funding, it tended to be from, again, those DFIs and foundations who are giving grants for building out impact evaluation teams. But that seems to be pretty uncommon, and I think that there needs to be more of that for impact measurement to mature and really reach its potential.

So yes, people need to put their money where their mouths are, for sure. There are some really interesting tools that are coming online for doing more robust, post-deal impact measurement and monitoring, and 60 Decibels is one example that I've cited before as a really exciting development in the field. So I would be thrilled to see more adoption of those kinds of tools. But I do think that there is a limit to this. Even with the power of a tool like 60 Decibels, it remains really, really difficult to do impact measurement and evaluation in a way that's truly rigorous.

And so while I do think that there needs to be more of an emphasis on post-capital deployment impact measurement, I still think that a lot of the most substantive impact assessment will happen before that capital is deployed, that is in the screening process and the deal selection process and due diligence, having those initial site visits, talking to company management and leadership, and really making sure that the case for designating a particular company as impactful is a solid case and a compelling case.

Klein: I think that's a really important point to underscore, and it's one that makes a lot of sense to me, that investors can draw on academic research. What do we know about the impact of affordable housing? What do we know about solar lighting? What do we know about employment opportunities for people who have had a hard time getting jobs?

You know, we have a lot of research evidence in the academy that can speak to some of these impact areas. And in evaluating different deals, different companies working in these different areas, before an investment, I think it is possible to learn an awful lot. So I think that's a really important practical implication.

I know you've also talked about learning from failure and that perhaps the rhetoric that we have around impact measurement and the push for documenting that you're measuring impact and that you're achieving it has gotten in the way of a real learning orientation in this space. So I'd like for you to say more about that.

Brown: Yes, I think that the field needs to get more comfortable with underperformance and how underperformance is relevant to impact measurement and management. I mean, if impact measurement is going to be relevant to more than just marketing, if it's going to be relevant for impact management, as well, then underperformance has to be an important part of that equation, right? Because the acid test of impact management is underperformance.

So how do you detect it? How do you manage it? How do you improve? I think if we get to a point where impact reports more consistently and more frequently acknowledge cases of impact underperformance and explain how the fund is responding to that, I think that that will be a major win for the field. I think that means that the stakeholders, specifically the investors into funds -- limited partners, for example -- need to make it very clear to fund managers that as long as there is sufficient explanation for the underperformance and sufficient reason to believe that it's being managed, this information will not be penalized. I think that basically fund managers need that psychological safety to disclose this information and to bake it more thoroughly into their investment management process.

Klein: That makes total sense to me, and I have to say listening to you, various metaphors and analogies have been coming to mind at different times. I will date myself, and some listeners will remember -- gosh, I forget. *A Prairie Home Companion*, I think it was, where describing a town, Lake Wobegone, where all children are above average. It's where all investments have above-average impact. And we need to be comfortable with, as you say, saying that some of these investments do not have above-average impact by definition.

I also think of the analogy of teaching, as I get ready to teach next semester. Not all students pass with flying colors. Some students underperform, and this is part of the challenge and opportunity of grading.

So this has been a really important conversation about impact measurement, Michael, and I'm just really so glad that you and Lauren have done this research. I think it's really provocative. It's really important, and it's just very valuable that you have looked behind the scenes, that you have actually talked with impact investors, and I hope it moves the field to reckon with what's possible around measurement. You know, what's possible, what's feasible, what's smart, as the field continues to grow. I think all of us who are interested in impact investing really want to see real impact, and that's going to be continuing to figure out how we do measurement and when, and as you say, getting comfortable with the possibility that we're not always going to achieve it.

So thank you so much for joining me.

Brown: Thanks for having me.

END OF TRANSCRIPT # #