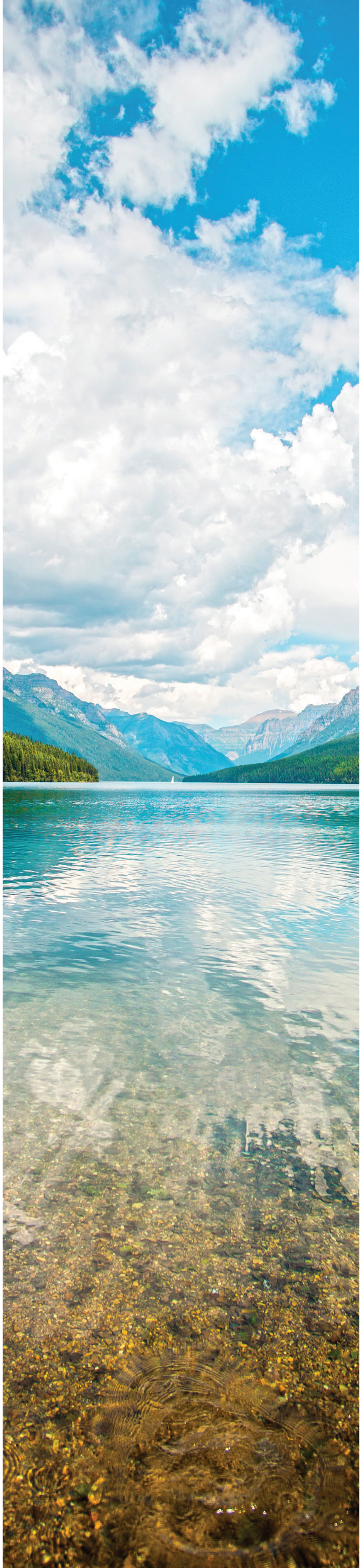
IMPACTFUL INVESTMENT

CAPITAL AS A FORCE FOR GOOD: MOVING FROM THEORY TO PRACTICE

TABLE of Contents

Acknowledgements:
Written and edited by Jason Anthony Dudek, MSc



1. FOREWORD From the Board Chair

Facing injustice against Indigenous peoples, the environment, the impoverished, and uprooted peoples who arrive here, Canadians need extraordinary solutions. Given our mission to promote positive change, the Catherine Donnelly Foundation (CDF) joins a growing momentum of Impact Investing. This report shares our experience and encourages colleague foundations or organizations who may be pondering such investments. We honour the beating heart of impacts we seek: the passionate, inspired work of groups, communities and organizations. The CDF gives warm thanks to CDF's Investment Committee, especially *Jason Dudek*, author of this report, and *Desmond Wilson*, Chief Financial Officer, for their leadership.

Mary Corkery

Mary Corkery
Chair, Catherine Donnelly Foundation

2. INTRODUCTION From the Investment Committee Chair

Engaging with our capital, and fully understanding its power, is a matter of ethical integrity for foundations and endowments. For the Catherine Donnelly Foundation (CDF) there is an inherent contradiction if our granting towards a healthier environment is funded by the proceeds of "dirty" investments. As the financial legacy of an exceptional group of women religious who acted boldly in the face of great need, the CDF began engaging with our capital to ensure our investments reflected our values. We needed to know our overall financial footprint was advancing our organization's mission and was congruent with our granting.

Initially, the CDF set out to "do no harm" and became an early adopter of one of Canada's most rigorous Socially Responsible Investing (SRI) screens while engaging in shareholder activism. This was a positive experience and built confidence amongst our staff and board. Building on this confidence, the CDF began to explore the possibility of investing for impact. This was a challenging process as it required new decision-making capabilities, networks and expertise. Now, at this current stage in our Foundation's evolution, we have come to understand value-based engagement with our capital as a path to stronger, more stable financial performance. Better managed companies who have a positive impact on their communities can be more profitable; taking an investment's strategic value and risks (e.g. cleantech vs. fossil fuels) into account can also yield better results than simply following the status quo. The financial performance of our Foundation's investments has clearly demonstrated this: Since the CDF began deploying our capital in alignment with our values and mission, our portfolio has done significantly better than market benchmarks year after year.

The purpose of this report is to share our findings, learnings, successes and failures. It is also a call to action. In a century which will be defined by global inequality, climate change and related market volatility, we can no longer afford to be passive beneficiaries of our investments. Now is the time to reclaim our capital through impact investing and converge upon right relations, a renewed economy and a healthy, sustainable environment. We humbly submit this report in furtherance of this exciting potential.

Jason Anthony Dudek, MSc
Past Chair/Investment Committee Chair

3. WHO WE ARE

Established in 2003, the CDF is the financial legacy of a remarkable group of women religious, The Sisters of Service. The Foundation is a living testament to the Sisters' tradition of response to the greatest needs in communities across Canada.

The Foundation honours and builds upon the spirit of service and dedication that inspired Catherine Donnelly, the Foundress of the community. It affirms the inherent dignity of every person and the sacredness of creation. It seeks to extend the radical commitment to social change, and to empowering the marginalized that characterized the Sisters' every action.

In reaching out to the marginalized and excluded, the Foundation collaborates with, and provides funding to groups and organizations engaged in housing the homeless, protecting the environment and to activities intended to mobilize, educate and equip those working for positive social change across Canada.

The Foundation does not see itself as a passive philanthropic actor in the process of social change. It seeks active collaboration and engagement with those groups and institutions it chooses to support. Its strategy is one of partnership, which sees it prepared to make a contribution beyond financial resources to the work of social change groups and organizations. It actively seeks to promote linkages and synergies across and within the groups with which it collaborates.

The same bold spirit of active engagement and collaboration that guides our granting process informs our investment strategy. Not only do we provide grants that serve our mission, we also make investments that support our mission. Our internal management of investments (through SRI screens and impact investment) reflects the external positive impacts we want to see in the world, and is reflective of our philosophy as an organization – we want our work to be a net positive impact, including the use of our invested funds.

4. IMPACT INVESTMENT: Our Experience

The Global Impact Investing Network (GIIN) defines impact investment as follows:

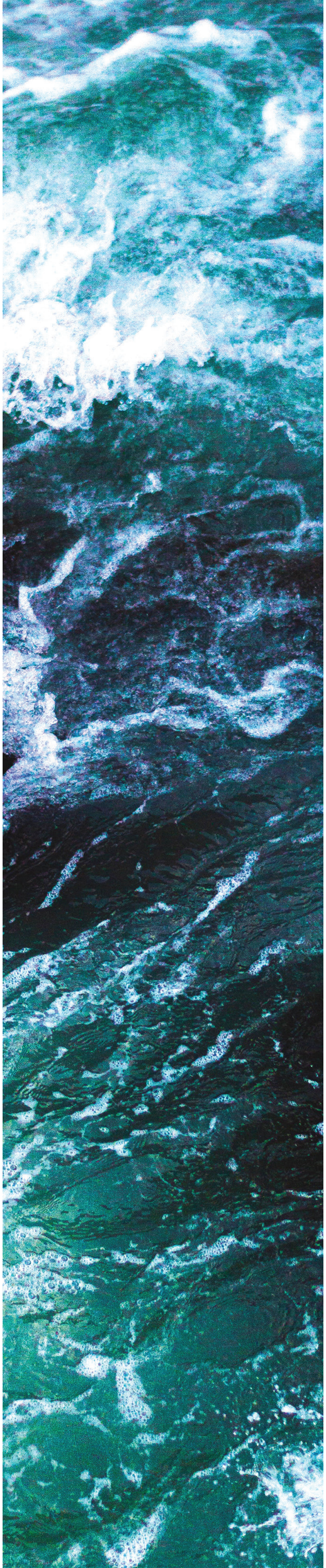
> "Impact investments are investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return."[1]

Impact investing is a subset of responsible investing (RI) and socially responsible investing (SRI). The Catherine Donnelly Foundation embraces all three strategies. RI and SRI take environmental, social and governance (ESG) factors into account in investment selection. SRI often uses positive or negative screens on investments in what can be seen as a 'do no harm' proposition. Impact investing goes a step further, as investors actively seek out the positive social and or environmental objectives they wish to see delivered together with a financial return.

For the CDF, our impact investing has materialized as the purposeful advancement of investor-defined social and/or environmental objectives through *direct investing*. Embracing impact investment as direct investment has been an important aspect of the CDF's evolution. In a practical sense, this is the major operational shift impact investing requires of foundations or endowments. While traditionally most foundation investments are managed through an investment broker or other intermediary, impact investment often requires "hands-on" deal analysis and decision making. Though daunting at first, developing the capacity for extra analysis and rigour has in the CDF's case led to better overall performance and portfolio management. Acknowledging our limitations, we carefully built up expertise, processes, policies and networks with other foundations that have made our organization stronger overall. We also worked together with other foundations to share due diligence and brought in new resources to fill the gaps in our capacity. We are proof that a young foundation can rapidly develop expertise in this area and invite other foundations to embrace the challenges, and benefits, of being more "hands-on" with their portfolio.

Impact itself should be simple and not laden down with complexity, vagueness or defined externally by "experts." Impact must be measurable but more importantly *it should be fundamentally linked to an investment's core revenue generating activities*. Specifically, the CDF seeks what we call an "Integrity of Return" from its impact investments wherein the investment's core business is directly linked to the desired social/environmental impact. For example, if our desired impact is to enable the low-carbon economy, an investment in Solar Energy has a clear integrity of return since every kilowatt hour of revenue is also a kilowatt hour of clean energy that can be used as an impact metric. This is entirely different from, for example, an oil producer seeking an investment into a new facility that is more fuel efficient. Both arguably reduce carbon emissions but in only one case is the core business built on this reduction. As the (solar energy) business grows so too will the impact, so an Integrity of Return also ensures impact reporting is cost-effective and simple. This principle also helps the Foundation avoid impact "greenwashing."

1. https://thegiin.org/impact-investing/need-to-know/



4. IMPACT INVESTMENT: Our Experience

The CDF also expects impact investments to perform well financially, since the Foundation believes businesses which benefit the community and/or the environment have laid the groundwork for their own lasting success. We are constantly looking for win-win investments that are both financially sound and impactful, and believe that capitalism and businesses are at their best when they are solving important problems. This has been reflected in our portfolio's improved post-SRI and impact investment performance, where we have avoided an unwanted trade-off between program impact (driven by the return from our investments) and investment impact.

The above learnings were enabled through the lengthy and careful development of our impact investment policy but also over several years of encountering and working through practical challenges. The following section chronicles how the CDF worked through specific problems and what we learned from those experiences.

CHALLENGE: Measurement and Metrics

Initially, the CDF placed much of our focus on measuring impact rather than defining it. We employed a number of 3rd party consultants and "experts" to assist with this work at significant cost to the Foundation. However, we found the metrics of measurement were always highly subjective, and at times were so dependent upon our own input they became meaningless. In some cases impact quantification was a matter of consultants asking us what we wanted to hear. Moreover, the added costs significantly impacted the overall financial performance of the related impact investments. Eventually, we understood it would not be possible for 3rd parties to tell us what our impact should be: it was our responsibility as an impact investor to define this.

LESSON LEARNED: It Is Bad When One Thing Becomes Two

Profit or Impact - which one is more important? We can find some insight for this difficult question from an ancient Japanese book of practical wisdom, the Hagakure, written by Yamamoto Tsunetomo (1659-1719):

> *"It is bad when one thing becomes two."*[2]

The interplay between profit and impact can become confusing and unnecessarily complex if profit and impact are pitted against one another as separate aspects of the investment. At the CDF we learned that an ancillary connection between impact and profit solves this dilemma. If the revenue-generating activities of an investment are also its impact generating activities, there should be no conflict. Investments where the revenue generating activity and impact generating activity are the same provide a clear sense of performance and a guarantee of impact – our Integrity of Return.

2. Tsunetomo, Yamamoto. *Hagakure*, Shambhala Classics, 2014.

LESSON LEARNED: Impact Can Lead To Better Financial Performance

There have been many studies and data sets demonstrating clearly what the CDF has seen firsthand, that SRI Screens do not reduce performance and can in fact improve portfolio profitability[3]. Companies that are making a positive impact in their communities, solving important problems and/or governing themselves better (or at least more rigorously) can potentially be more profitable. A vision of impact also tends to involve strategic considerations, such as understanding the change in sectors and looking ahead in anticipation of social/environmental problems, which can also be beneficial. When the CDF divested from fossil fuels, for instance, this was done while keeping a keen eye on the low-carbon economy which we believe can be an innovative source of growth and employment for Canadians – as well as a profitable investment.

CHALLENGE: Fear of The Unknown

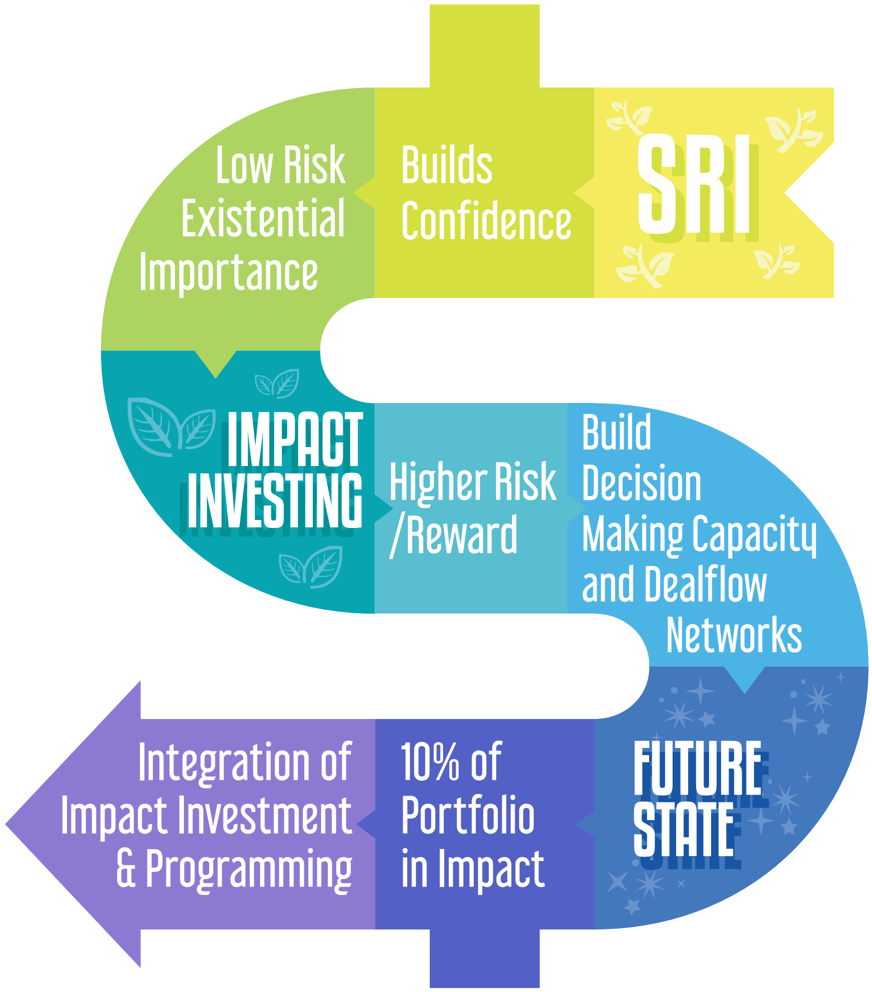
There is a significant amount of hesitation all foundations must feel about engaging more directly with their investments. Investing – even through managers, exchanges and indexes – is fraught with uncertainty at the best of times. The CDF was no different, with a significant amount of board and committee uncertainty present throughout the process. Our best ally in this fight against hesitation and uncertainty was the inspiration we draw from our namesake to be bold and earnest in our decisions. Time was also an ally – we allowed the process to evolve at a pace our board and staff were comfortable with, and have acted incrementally understanding our own great need for learning and confidence building. The results (detailed in the next section) have been exciting and substantive, while the perceived risks and lack of capacity were not what we initially feared. In fact, as described above, embracing a more rigorous and involved approach to wielding our investments has improved our overall performance and has greatly enhanced our overall impact as a foundation.

LESSON LEARNED: Building Confidence

A foundation or endowment's journey can begin in steps, and we suggest the first step before impact investment should be getting a board and staff behind the "do-no-harm approach" of SRI screens. While not as significant or impactful as impact investment, this initial first step was vital for our foundation to get comfortable with the idea that engaging with our capital is possible, and can be profitable as well as impactful. No amount of external consulting or reports can replace the confidence that comes with seeing firsthand the positive results of a decision or strategy. Starting small with a basic SRI screen, which we then over time enhanced, eventually gave us the confidence to proceed further down the path of wielding our capital. The growing strength of our impact investment processes and portfolio is now emboldening us to envision a future state where our impact investments directly integrate with our granting. We recommend the same staged process to other foundations.

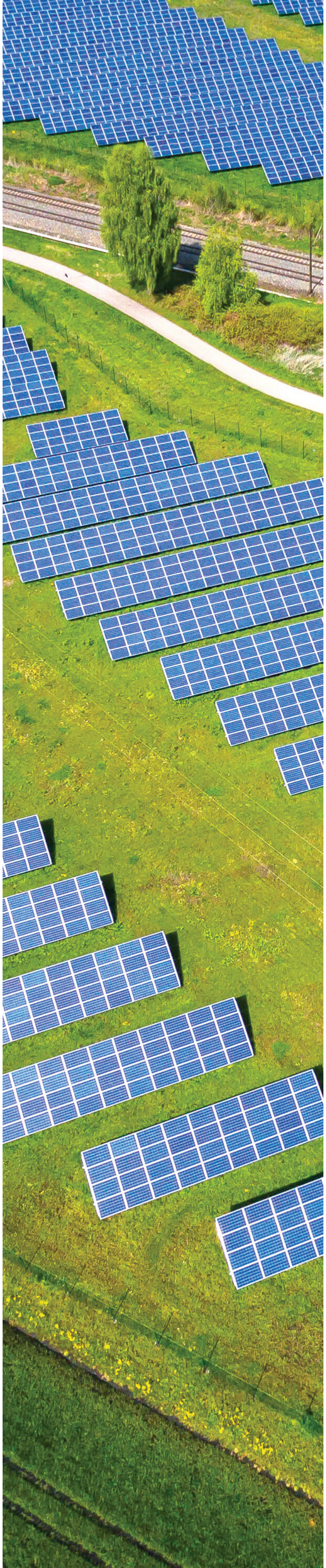
3. http://accounting.uwaterloo.ca/seminars/09-10papers/04%20Weber.pdf

4. IMPACT INVESTMENT: Our Experience



LESSON LEARNED: The Importance Of Board Ownership

The CDF has come to view impact investment as an ongoing process of educating ourselves as the field is rapidly developing and changing. Moreover, when board members understand the broader concepts and context of impact investment it makes individual financial decisions more tractable. It has also been vital to demonstrate the additionality of our investment dollars to board members: what is it we are bringing an impact investee that they cannot get through a more typical lender or financing arrangement? Since the CDF does not sacrifice financial returns for impact, this answer has often been a matter of time and risk. In other words, the value we bring as an impact investor is that we are willing to be more patient and accept a higher degree of risk. A good example of this is an investment CDF is currently exploring where an exciting housing project for low-income families needs an additional $500,000 beyond what traditional lenders would provide. In this instance, the CDF would be looking to fill the gap and take on the extra risk that traditional lenders would not. Assessing such additionality has been important for our Board and Committee in their decision making around impact investments. Decisions are made not just by assessing the impact and financial potential of an opportunity, but through a clear understanding of the additional value we are bringing (if any) as a lender to the opportunity.



5. HISTORY, TOOLS AND RESULTS

Investment Pace and Focus

The CDF made its first impact investment in 2014 and as of June 2017 it has made or committed to a total of seven. This takes the Foundation one-third of the way towards its objective of deploying ten percent of its assets in this arena. New prospects are presenting themselves all the time. As our intent becomes more widely known, some proposals emerge from direct approaches to the CDF from potential investees. Others materialize from the networks we participate in and others from introductions by our Investment Manager, who has continued to encourage and support the foundation in its endeavours.

Three of the investments have been in alternative energy initiatives, two are in social impact bonds and one is in a new social purpose, non-profit, real estate development company in the making that aims to enhance affordable housing in key Canadian cities. With the environment and housing being two of the CDF's three grant areas, complementary investments in these sectors also have an obvious alignment for the foundation. The social impact bonds are innovative, pay-for-success models, representing the potential expansion of the social finance sector in Canada[4]. The pioneering nature of these investments is attractive to the Foundation and our belief that we can imagine wielding the power of our capital as a force for good.

Building Expertise

Naturally we have found that the more commitments we make, the more we learn about this task. From time to time it has been beneficial to engage third party expertise for more assurance on an investment, and to add further independent credibility to the due diligence process. The engagement with an external evaluator strengthens our understanding of good decision-making practices and adds to the confidence of the CDF's Investment Committee and Board. We have also worked bilaterally with other foundations to share due diligence costs and learnings when both organizations were considering the same investment. All the above activities are key components of ongoing improvements to the Foundation's Impact Investing Policy.

4. The MaRS Cente for Impact Investing provides an excellent overview of the new Pay for success (PFS) model. CDF is one of the investors in the MaRS Heart and Stroke hypertension PFS.

5. HISTORY, TOOLS AND RESULTS

Deal Analysis

When considering an impact investment proposal we prepare, review or comment on the following:

1. The investment's impact
2. Alignment with the CDF
3. A summary of the investment - purpose, instrument, key individuals, fees, etc.
4. Financial return and liquidity
5. Reputation of issuer
6. Investment structure and portfolio implications
7. Financial assessment
8. Risk and risk mitigation
9. Third party independent review
10. Legal implications
11. SRI screening
12. Compliance with Foundations Impact Investing Policy.

In the eagerness to deploy further capital in this unique sector, it is important not to lose sight of fundamental socially responsible investing principles. Thus we incorporate appropriate consideration of pertinent environmental, social and governance factors impacting the investee. Are there any operations, product or services-related controversies or incidents? Does the investment offer an Integrity of Return? What about business ethics or governance related concerns, such as the experience, diversity and independence of the Board of Directors? Particularly when investing in a fund, is there any potential for the fund's investment in a company or region that could bring reputational risk to the Foundation? These are some of the questions addressed. Our process has been streamlined to efficiently use Board and staff expertise as mapped out on the following page.

The CDF's growing impact investment portfolio is generating steady and predictable returns in the five to seven percent range. More importantly these revenues are emanating from real and purposeful enterprises, delivering demonstrably important socially and environmentally beneficial products and services. The stable returns also offer some inoculation from the seemingly inevitable volatility associated with the traditional investment markets.

IMPACT INVESTMENT DEAL ANALYSIS FLOWCHART

1 BASIC ANALYSIS

Tasked to: Chief Financial Officer

Review Opportunity for basic compatibility with CDF Impact Investment Criteria:

- Cannot be a Start-Up
- Within \$50-400,000 for direct; Within \$50-1,000,000 for intermediary
- Cannot be a permanent operating line of credit or loan
- Liquidity window must be 7 years or less
- Must demonstrate strong potential for impact and profitability through a sound financial model

2 COMMITTEE INITIAL REVIEW

Tasked to: CDF Investment Committee

Taking into consideration CDF Values and the opportunity's Impact and Financials, is it worth pursuing?

- Does it add value to CDF granting and programs?
- Attractiveness of Impact and Profitability
- Organization's Track Record
- Integrity of Return (does investment work directly towards its impact, or is it indirect as in CSR, etc)

3 DUE DILIGENCE

Tasked to: CDF Investment Committee Advisor and Chief Financial Officer

Perform a thorough analysis using CDF due diligence template

- CDF Committee to support and participate in Due Diligence
- External Due Diligence/opinions can be sought as committee deems appropriate, but costs should be as low as possible

4 COMMITTEE APPROVAL

Tasked to: CDF Investment Committee

Committee to review stages 2 and 3, then:

- ⓐ Approve - Send to Board
- ⓑ Not approve
- ⓒ Require more information (return to stage 3)

5 BOARD APPROVAL

- Investment Committee Chair to pitch investment to the Board, including both the pros & cons of the investment
- Board will make a decision on the investment or can send back to the Committee for further review

6. DIVESTMENT

When speaking of impact investment and SRI, there are many studies demonstrating SRI screened portfolios can do as well if not better than standard unrestricted portfolios. At the CDF, we have also considered investing deliberately as advantageous in terms of risk. Simply put, there is a risk-side advantage to investing in strategic sectors and in being more aware of our investment agency. With political crisis and international consensus mounting on climate risk, we felt confident in divesting from fossil fuels and pursuing greener opportunities. Not only did this fit with our values, there was a certain strategic advantage to taking international and domestic political trends, regulation and production into account. At the highest level, divestment makes sense because we agree that, one way or another,

> *"if the free market is going to survive it must recognize its greater responsibility to the environment and the whole community."* [5]

Going forward the CDF prefers to stress not so much what we have divested from, but what we have redeployed our resources to. This is happening through our impact investing strategy as described in this paper, but also through the traditional public markets. Our Investment Manager has purchased positions, amounting to about eight percent of total equity holdings, in a number of companies and industries that herald, or will be important components of, the new low carbon economy, in the belief that the trend towards a clean energy economy is inevitable.

7. LOOKING TOWARDS THE FUTURE

The CDF has made considerable progress to date to reaching our own internal goals and has been an active, important contributor to the overall impact investment discourse in Canada. We have brought to it the same earnestness and boldness which defines our Foundation and the legacy we preserve. The results have been beyond our expectations, and we are proud to have helped co-create new investment instruments and play a leading role in the Canadian divestment campaign. But we also feel this is just the beginning. Impact investment has the potential to transform capitalism and turn one of our greatest resources into a force for solving problems rather than creating them. We intend to pursue this potential by learning and sharing with other groups (especially foundations) interested in wielding their capital for impact. Collaboration with other actors and engagement with important networks like *Philanthropic Foundations Canada*[6] and *Community Foundations Canada*[7] are a priority for us as we seek to both deepen and expand the scope of our impact investment. Ultimately, we would like to see all foundations in Canada set and reach the goal of investing at least 10% of their capital in impact-related investments by 2020, as recommended by the Canadian Task Force on Social Finance.

We are relentlessly seeking to enhance our impact investment capabilities by bringing on new talent, developing new tools, participating in training and conferences and in general structuring this as an ongoing need rather than a static goal. The future state we are driving towards internally is to have 10% of our assets deployed in impact investments by 2020, and to seamlessly integrate impact investments with our granting and program-related goals. The CDF believes the integration of investment and granting/programming has enormous potential but it is to a large extent unexplored territory. If both granting and investment could be coordinated around a single opportunity or effort, the potential exists to simultaneously strengthen the investment's performance while also providing projects or programs with additional capital resources. The CDF will be exploring this complex potential over the next several years and hopes to lead by example with substance and sincerity.

5. Rt. Hon. Paul Martin, SIO Conference June 20th 2012

6. http://pfc.ca

7. http://communityfoundations.ca

8. CONCLUSION

We live during a period of unprecedented opportunity and progress, as well as unprecedented conflict, poverty and inequality. For those seeking to make positive change through the proceeds of capital, it is vital we cultivate a deep understanding of how it is actively shaping our increasingly globalized and financialized world. In a time when eight men have acquired as much wealth as the 3.6 billion people who make up the poorest half of humanity,[8] capital looms large over our world as a profound, active force which unless wielded deliberately has the potential to drive humanity apart. This is the conclusion of French economist Thomas Piketty's acclaimed work *Capital in the Twenty-First Century:*

> The overall conclusion of this study *[Capital in the Twenty-First Century]* is that a market economy based on private property, if left to itself, contains powerful forces of convergence, associated with the diffusion of knowledge and skills; but it also contains powerful forces of divergence, which are potentially threatening to democratic societies and to the values of social justice on which they are based. The principal destabilizing force has to do with the fact that the private rate of return on capital can be significantly higher for long periods of time than the rate of growth of income and output... The consequences for the long-term dynamics of the wealth distribution are potentially terrifying.[9]

Piketty's conclusion is reinforced by other studies and data such as Oxford University's Institute for New Economic Thinking's 2017 Chartbook of Economic Inequality.[10] Inherently "overpowered," as capital outgrows production and wages it creates inequality and exerts more and more influence over our economic, social and political systems.

What exactly will this influence be? We who can answer have a responsibility to do so, and to wield our capital as a force for good. The CDF ultimately envisions a future where capital is engaged as an instrument of liberation rather than oppression, contributing to a more effective economy for all Canadians. We call on all foundations in Canada to join us in impact investing as the vanguard of this transformation.

8. https://www.oxfam.org/en/pressroom/pressreleases/2017-01-16/just-8-men-own-same-wealth-half-world
9. Thomas Piketty. Le Capital au XXIe siècle, Éditions du Seuil, Belknap Press, Cambridge MA 2013.ing "deal analysis"
10. Tony Atkinson, Joe Hasell, Salvatore Morelli, Max Roser. *Chartbook of Economic Inequality. May 2017 INET Oxford Working Paper no. 2017-10*

9. THANKS

With immense gratitude to those who have supported and/or contributed to the development of our impact investment strategy:

- Philanthropic Foundations of Canada - Impact Investing Affinity Group
- Terry Cooke, President & CEO, Hamilton Community Foundation
- Community Foundations of Canada
- Alan Harman, Director, Portfolio Manager, Scotia McLeod
- Dr. Tessa Hebb, Distinguished Fellow, Carleton Centre for Community Innovation, Carleton University
- Catherine Donnelly Foundation Board of Directors