



# Development Finance Institutions' Effect on The Fund Manager's Investment Decisions

Balancing Financial Performance Goals and Development Impact  
Objectives

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## Abstract

*Development Finance Institutions* (DFIs) have played a crucial role in moving socially responsibility considerations up on the private equity industry's agenda. DFIs add a development impact criterion to traditional financial performance goals in the investment industry and play a catalytic role by mobilizing other investors. The gap in research regarding DFIs implications and significance in the investment community from a SRI perspective is evident. The development impact objective introduced by the DFIs is examined to understand its effects on fund managers' decision-making and if it exists a trade-off between this objective and financial performance. An understanding of how DFIs control fund managers to act in accordance to their objective as well as how they determine compensation schemes to incentivize them to pursue high return on investments, is discussed in relation to the agency theory. Furthermore, stakeholder/shareholder consideration is examined in relation to the subject.

The aim of this study is to examine how the behavior of fund managers is affected by the involvement of a DFI investor and try to add to the understanding of their significance as institutional investors in developing markets. Previous studies have been more focused on determining the financial performance of socially responsible investments by using very similar quantitative data collection methods. This thesis undertakes an in-depth approach with the purpose to understand the fund manager's drives as well as how a DFI involvement affects the behavior and decision-making process.

This thesis undertook a qualitative research strategy and semi-structured interviews were used as the tool to understand the fund managers' personal beliefs and perceptions of how the relationship with DFIs affect them. The selection criteria for the fund managers was that they needed to work in a fund in which a DFIs has invested. We also included DFI investors in order to understand their point of view. The interview was recorded, transcribed and later divided into themes in accordance with the thematic approach, following six steps.

Our findings show that Development Finance Institutions plays an important role in emerging markets and affect fund manager behavior to a certain extent. They did not perceive a trade-off between financial performance goals and development impact objectives. We conclude that DFIs increase fund manager focus on ESG/SEE elements in the investment process. DFIs requirements and reporting obligations is used as a tool to ensure that the fund manager act in accordance to DFI objective. The fund managers were neither willing to sacrifice commercial return in favor of development impact. Lastly, the interest among the DFIs and commercial investors is fairly similar, hence reducing the conflict of interest between investors.



## Acknowledgments

We would first and foremost like to begin to thank assistant professor and our supervisor Rickard Olsson for providing valuable input and constructive criticism during the process of writing this thesis. We would also like to extend our deepest gratitude to the DFI representatives that helped us get in touch with fund managers around the world. Of course we also thank the interviewees in this study. This research would not have seen the light of day without your participation. Lastly, we would like to praise ourselves and our ability to cooperate and support each other during these previous months.

Umeå  
20 May 2016

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## Abbreviation List

<b>AfDB</b>	African Development Bank
<b>CSR</b>	Corporate Social Responsibility
<b>DEG</b>	German Investment Corporation (Originally in German)
<b>DFI</b>	Development Finance Institution
<b>DVFA</b>	Committee on Extra-Financials by its Investment Professionals (Originally in German)
<b>EDFI</b>	European Development Finance Institution
<b>ESG</b>	Environmental, Social Governance
<b>FMO</b>	Netherlands Development Finance Company
<b>KPI</b>	Key Performance Indicator
<b>MDFI</b>	Multilateral Development Finance Institution
<b>NGO</b>	Non-Governmental Organization
<b>NPV</b>	Net Present Value
<b>ODA</b>	Official Development Aid
<b>SEE</b>	Social, Ethical, Environmental Criterion
<b>SIF</b>	The Forum for Sustainable and Responsible Investment
<b>SME</b>	Small/Medium-Sized Enterprises
<b>SR</b>	Socially Responsible
<b>SRI</b>	Socially Responsible Investment
<b>SIDA</b>	Swedish International Development Cooperation Agency



# 1. Introduction

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*The introductory chapter begins to present the rationale for research choices and then introduce the importance of development finance institutions in private equity market in developing countries. These institutional investors are later discussed in relation to socially responsible investments and how they include social, ethical and environmental criterion in their investment process. Their considerations of stakeholders as well as how they control their fund investments is later addressed. A gap in research, the main research question, the purpose of the study and intended contributions are lastly presented.*

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## 1.1 Choice of Research Area

Due to the increasing integration of economic, financial and environmental sustainability in business administration education the choice to contribute to research within the area felt natural. With an educational background in finance, management and CSR, we find it both interesting and important to study the phenomenon of long-term financial viability, sustainable development and the possible conflicts between them. Contributing to the discussions and trying to understand the controversies regarding the trade-off between traditional financial performance and societal improvement arguably add value to society. Likewise, due to the increasing role of governments and institutions, directing and allocating resources to developing regions of the world to eradicate poverty, the importance of their interferences is in need of more extensive examination. *Development Finance Institutions* (DFIs) are one actor that is committed to contribute to this changing landscape, but of course not without debate. These institutions have been subjected to public scrutiny as a result of their financial investments in the third world. This indicates a need to research the difficulties of balancing financial performance and societal development goals in a changing investment environment.

Furthermore, socially responsible and ethical investment has grown significantly during the last decade due to growing consumer demands, hence giving rise to the question if traditional fund manager behavior has followed suit and if the inclusion of societal and ethical and environmental aspects has affected their outlook. In fact, it would seem that there is a clear interplay between fund manager behavior and DFI investment in the funds in which they work. Namely, because DFI provision of capital into funds puts pressure on fund managers, not to only focus on traditional high return on investment, but also to live up to the other standards set by the DFI investors. Interestingly, this relationship has not been extensively examined from a qualitative point of view, arousing our interest in understanding new behavioral tendencies and the overall reflexivity.

## 1.2 Background

Over the past decades the private equity industry has grown significantly in emerging markets. One large type of actor that has contributed immensely to this increase in foreign investment opportunities are *Development Finance Institutions* or *DFIs* in short. These institutional investors for the most part resembles traditional commercial banks with the initial intent to mobilize private capital (Settel et al., 2008, p. 60). Settel although means that they have now gravitated towards a more growth focused equity model seeking to make investments that results in economic growth, job creation, innovation and business

opportunities. DFIs engage in what is called '*development finance*' when making investments, therefore calling for a clarification of its meaning. Development finance means to recognize private capital market imperfections and problems in the economic development process that results in ventures not receiving necessary capital (Leveré et al., 2006).

Even though the importance of these institutional investors seems to be increasing, the research community has not extensively examined their role nor their implications. The need to examine DFIs becomes more obvious when looking at *European Development Finance Institution* (EDFI) annual report, which reported that the collective investment of their 15 DFI-members increased with 15% between 2013 and 2014, reaching a total amount of €33 billion (EDFI Annual Report 2014, 2014, p. 5). In order for DFIs to promote SME growth and increase regional development they usually let private equity funds handle their capital investments, mainly because actual direct involvement in controlling investments is tactically difficult from a strategic and operational standpoint (Settel et al., 2008, p. 63).

The relevance of studying DFIs private equity investments in emerging markets is further emphasized when discussing their contribution to the mobilization of other investors. DFI involvement may intensify access to capital by attracting additional investors, and perhaps more importantly, provide risk litigation to private equity funds by provoking local governments to change policies and regulatory frameworks (Leeds & Sunderland, 2003, p. 118-119). Settel et al. (2008) also means that DFI investments in funds create a *multiplier effect* whereby credibility, prestige and good governance are assigned to the fund as well as indicate a high development significance (Settel et al., 2008 p. 63). How this multiplier effect is actually perceived by DFIs and fund managers in regards to private equity investments in emerging markets calls for further exploration. Furthermore, Leeds and Sunderland (2003) also found that DFIs are uniquely qualified to re-energize the industry in terms of practice and knowledge, and therefore play a catalytic role by combining three critical and essential capabilities spurring a turnaround in private equity; *credibility* that initiate local governments to make regulatory and policy reforms, since they are seen as honest brokers that promote public sector development; *powerful private sector influence* that encourage active private equity participation by undertaking a strong leadership role as incubators; and *financial resources* that can be used as leverage against funds and attract additional investors (Leeds & Sunderland, 2003, p. 118).

Furthermore, since DFIs are structured as private sector companies but are state-owned and financed with taxpayer money, they need to abide to strict public-sector norms, meaning that their investment need to result in high positive *development impact* - not only high return on investments (Settel et al., 2008). The term development impact is frequently mentioned in the discussion of DFIs, and according to (Bracking, 2012, p. 276) the term means the aggregation of economic, social, governance, financial and environmental components. The effect on how this additional objective increase the pressures on fund managers to align their strategic investment decisions with both criteria required by their DFI-investor, has not been subdued to much research.

The requirement on DFIs to make investments that are adhere to environmental, social and governance issues put pressure on funds' investment evaluation processes and their investee companies' operations, which should be further examined. It could be argued that there is an obvious trade-off between the conflicting and highly complex goals of

DFIs. The necessary compromises that needs to be made before an investment are currently not being explored and clearly defined, and DFIs sometimes seems to compromise too much of the development impact goals in favor of the financial gains. For example, as Einhorn (2013) reported in *Propublica*, the UK's DFI (CDC), has financed builders of shopping centers, luxury properties and gated communities in countries like Mauritius and Kenya, and the Swedish DFI (Swedfund) has also invested in high-end hotels in e.g. Addis Ababa. These investments are usually justified by emphasizing job creation, but have been questioned for their low level of development impact (Einhorn, 2013). Therefore, even though there are frameworks to weigh criteria against each other, there is an obvious difference between investment projects.

Without DFI investment, conventional IRR metrics usually dictates fund manager behavior when investing in projects in the private sector (Settel et al., 2009). Although, the DFI involvement introduce a development impact criterion, thereby requiring an assessment of a more multi-dimensional metric. The exceedingly difficult task of measuring development objectives due to their intangible nature, results in a more financial-return-oriented focus in fund management teams, since those goals are in fact measurable (Settel et al., 2009, p. 73-74). Hence, is would be interesting to further explore how the introduction of nonfinancial performance objectives affect fund manager behavior on a personal level as well as understand how their investment behavior change.

The increased awareness of socially responsible investment (SRI) and social, ethical and environmental (SEE) factors adds other dimensions to investment decision than previously. SRI is a vastly mentioned phenomenon in modern research aiming to study investors investment behavior and the trade-off they make when accepting suboptimal financial performance in favor of development impact goals (Renneboog et al., 2008, p. 1-2). Since, SRI apply SEE criteria in the investment screening process, traditional investment goals cannot be prioritized to the same extent as in conventional investing (Renneboog et al., 2008). Furthermore, Bollen (2007) emphasize that SRI investors use of a multi-attribute utility function that focus on risk-reward optimization, but also incorporate societal and personal values in the process. So with all this in mind, one can argue that the development impact objective introduced by DFIs mean that traditional fund manager incentive - to only invest in projects that generates high return on investments - is being challenged by SRI considerations. Also interesting, is the growth within the SRI area of study which is predicted to continue as a result of the increasing attention to issues such as global warming, the Kyoto protocol, emissions trading, corporate governance (Renneboog, 2008). Due to these facts it seems highly relevant to add more value to existing research in terms of how DFIs and fund managers manage the conflicting occurrences of maximizing both shareholder and stakeholder value, having to increase financial and societal value simultaneously.

To understand this confliction, it is important to grasp the general views on social and profit maximization. Contemporary theories within this area of research argues that the strain between social welfare maximization and profit-maximization is evident. Jensen (2001) means that the existing tension between social welfare maximization and shareholder goals is inevitable and that one comes at the expense of the other. Unavoidably, this tension requires the introduction of the *Stakeholder Theory* and the importance of business activities being beneficial for society as a whole. Stakeholder theory argues that managers within any organization need to account for the interest of shareholder and stakeholders, in the decision-making process (Laplume et al., 2008, p.

1153). Critics of this theory means that there are accountability and managerial incentive issues, since the value concept of shareholder states that the expectations of the manager is to invest until the marginal projects return is more than the cost of capital (Renneboog et al., 2008, p. 1730). Furthermore, the stakeholder theory lacks a definition of the trade-off between stakeholders, nor how promoting social welfare by accepting suboptimal financial performance can survive in a competitive market (Baumol, 1991).

It would seem that the problem of weighing in the interest of all involved agents is very complicated. Stakeholder inclusion and societal improvement increases the expectations on the fund manager when handling private equity funds for DFIs, and requires prioritization. Despite the conflict of interest there is clear evidence of successful integration between both interests. Ibikunle and Steffen (2015) conducted a comparative analysis of European *green*<sup>1</sup>, *black*<sup>2</sup> and conventional mutual funds to investigate financial performance contracts of dissimilar investment orientations. Their study concluded that the risk-adjusted return profile of the green funds progressively improved over time until there was no difference with conventional fund and the black funds was outperformed. The success of green investment funds could be seen as an indication of fund managers' succeeding in balancing the shareholder and stakeholder interests, or it could simply mean that ethical investments have become more financially viable. Due to the precarious relationship between DFI investment goals and fund manager traditional investment behavior, the contractual agreements between them is also in need of accentuation.

Even though the financial utility is vital for both the agent and the principal, the fund manager is required not only to consider DFI investor demands, but also other commercial investors. Hence, the first problem emerges when the fund manager is acquired to encompass the objectives of several investors who may not accept suboptimal financial performance in favor of development impact to the same extent as DFI investors. Agency theory described the ubiquitous agency relationships as a metaphor of a contract, whereby defined work from the principle in need of execution is delegated to the agent (Jensen & Meckling, 1976, p. 308). Jensen and Meckling (1976, p. 308) stated that if both parties are looking for maximizing their own utility it is very likely that the agent will act in its own interest rather than the principals. The application of this particular theoretical proposition is consistently used to describe how conflicts between the principal and agent arise, but also the increased risk that follows with the failure to control the agent. Verifying appropriate agent behavior is also difficult because this is highly dependent on which investor's preferences are prioritized, presumably the majority capital investor. More concrete; *who determines what is appropriate behavior?*

### 1.3 Research Gap

The background above has provided an existing conflict between the prioritization between financial performance and development impact of which seem to impinge on traditional fund manager behavior. DFI involvement in private equity funds clearly requires SEE considerations, and constitute the basis for the decision-making process.

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<sup>1</sup> A green mutual fund is defined as fund investments solely based on environmental engagements and principles, thus only select exceptional environmentally friendly companies with low environmental impact (Ibikunle & Steffen, 2015).

<sup>2</sup> A black mutual fund is defined as a fund investment based on the depletion and exploitation of natural capital and resources by selecting carbon-intensive equities of entities (Ibikunle & Steffen, 2015).



During the last decades the relevance of DFI in the private equity industry has dramatically increased, hence calling for further exploration. Fund manager behavior is in need of an in-depth review to understand of DFIs as institutional investors affect and control investment choices to include stakeholders and other SRI criteria.

While there is extensive research regarding private equity fund *performance*, objectives and behavior, the effect of DFI involvement in the SRI industry has not been extensively examined. It would seem that to date, most research has according to Capelle-Blancard and Monjon (2012, p. 246) examined SRI fund performance, which they concluded from a quantitative content analysis of SRI literature. Appendix 1 provide an overview of the most common topics, scholars and journalists address in the discussion of SRI. The authors used the number of citations in order to identify the most influential academic SRI papers and found that *performance* is one of the most mentioned terms as well as published in financial journals and in newspapers (Capelle-Blancard and Monjon, 2012, p. 245). The conceptual aspects of SRI are however examined in very few papers and they ask;

*‘This profusion of academic research on SRI financial performance raises at least two questions: (i) Why are there so many studies on financial performance of SRI? and (ii) Do not we pay too much attention to SRI financial performance?’* (Capelle-Blancard and Monjon, 2012, p. 245-246)

Our intention is to move beyond the commonly utilized quantitative research approach undertaken in current SRI literature aiming to determine financial performance of funds. Instead this thesis tries to fill this gap with an in-depth review SR investor/manager motives, what affects them and what role DFIs play as institutional investors. By examining the DFIs’ significance in the investment community and the implications they have on funds and fund manager’s behavior, the aim is to contribute more to the understanding of their relationship. Hence, this study intends to fill this gap by examining the importance of DFI influence on fund managers’ behavior, when having to take multi-dimensional metrics into their evaluation of an investment opportunity.

## 1.4 Research Question

*How does development finance institutions’ involvement in a private equity fund affect fund managers’ investment behavior and decision making?*

## 1.5 Purpose

The purpose of the study is to examine how the behavior of fund managers is affected by the involvement of a DFI investors and try to add to the understanding of their significance as institutional investors in developing markets. For this reason, our intention is to review how DFIs control fund manager’s behavior, in terms of requirements and incentives as well as if their involvement requires an actual prioritization between financial performance and development impact objectives. By conducting semi-structured interviews with fund managers and DFIs, we aim to provide an in-depth understanding of their motives as well as what drives their investment decisions, in order to get a sense of the SR investors drives and motives. Furthermore, we intend to provide insight regarding fund managers’ ability to take multiple investor preferences into consideration as well as other stakeholder preferences in their decision-making.

## 2. Methodology

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*The following chapter begins with introducing our preconceptions within the area of study and goes on to discuss our ontological and epistemological standpoints. Thereafter, we move on to explain our reasons for undertaking an inductive research approach and for conducting a qualitative study. In order to clarify our choices, we present a methodological overview (see table 2). Finally, we review the selected literature from a critical point of view.*

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### 2.1 Preconceptions - Theoretical and Practical Experience

Unavoidably, researchers are - *to some extent* - always influenced by personal values and practical experience, making a clarification of how these might impede this study's outcomes necessary. Bryman and Bell (2015, p. 40) argues that the materialization of values can occur at any point in the research process, and attitudes, knowledge and experience frequently influence *how* and *what* the researcher perceive. Due to that, an intrusion of personal values and practical experience inevitably occurs and it is of our opinion essential to emphasize our previous immersion within the examined subject.

At the outset of this thesis our pre-understanding within the area of study were relatively limited, and emerged from researching previous theories, scientific research papers as well as various news outlets. Implying that some of these previous studies did not strongly influence our view of DFIs, funds and fund managers would be negligible. For instance, some studies (Junkus and Berry, 2015; Renneboog et al., 2008; Settel et al., 2009) were particularly essential for our basic understanding of DFIs and their implications on development. By acknowledging this, we saw it as imperative to weigh in other views and opinions regarding DFI investments to avoid the risk of bias increasing.

Additionally, even though we can argue that we have previous academic knowledge within organizational studies, finance, management and CSR, we must underscore the lack of integration into the context of this specific research area. Our familiarity within agency theory, stakeholder theory and value maximization however, is very high since it have been present throughout our studies in business administration. Combining this knowledge with previous studies within environmental finance, CSR and public administration constitutes the underlying experiences forming our perception of the situational circumstance in which the fund managers operate. For this reason, our approach to the research question could be fairly described as business-oriented.

The unfamiliarity with institutional investment and fund manager behavior can also have had implications on the results, due to lack of experience within the SRI research area. In favor of preventing one view from overshadowing the other several alternative, opposing views and their respective implications were discussed, before proceeding in a specific direction. Furthermore, our knowledge within the fund investment industry is partially limited to our personal interest of placing money in ethical funds as well as the media coverage regarding their performance. In addition, Marie has some professional experience dealing with funds as a bank clerk, providing some insights regarding ethical choices when placing money into funds. Consequently, our favorability of placing money into socially responsible funds could have incused on our perception of fund managers within these funds by eliciting sympathy for their work. Bryman and Bell (2015, p. 40) emphasize this by stating that qualitative researchers can during intensive interviewing

develop a close affinity to whom they interview, which can conclusively result in difficulties disentangling subjects' perspectives from their own personal stance. In order to reduce the likeliness of this occurring, the objectivity of the interview questions was tested and validated through a pilot interview as well as by assigned supervisor. Although, this cannot fully disperse the occurrence of bias, it should have relieved the paper from effusive subjectivity.

Lastly, one of the authors (Alexander) has previous professional experience regarding trade-offs required in a leadership position from his work as an area operations manager. When having to make decisions that may have implications on two or more parties, whereas some needs to be prioritized over others, provides useful insights concerning how managers operate. It is important to note that this personal point of reference can have been transferred to the interviewed fund managers. However, since our professional backgrounds somewhat differ from each other we were able to question our own assumptions respectively.

## 2.2 Research Philosophy and Perspectives

Researching something as intricate and abstract as behavioral tendencies of specific individuals may be perceived as fairly convoluted and abstract. Even if this could to some extent be argued as truthful, it could also serve as a depiction of the true nature of people within social contexts, reaching far beyond what is considered objective, statistical and numerical evidence. The contestation of how the world should and should not be perceived will never reach homogeneous conclusions, although it can be useful to manufacture a researcher's suppositions and preconceptions of reality. Crossan (2003, p. 47-48) argues that the ongoing debate of qualitative/quantitative research is fogged by incoherent definitions and a focus on methods, rather than underlying philosophical assumptions. Moreover, Crossan means that a clarification of personal values and assumptions is very useful when planning research studies. Hence, the epistemological and ontological perspectives of researchers determine the legitimacy of their contribution to theory as well as what they consider as valid (Peter & Olson, 1983, p. 121-122). Saunders et al. (2012, p. 128) means that these assumptions underpin the choice of method and research strategy. Therefore, these main philosophical standpoints will be further discussed in order to accentuate our methodological choices.

### 2.2.1 Ontology

*Ontology* refers to the philosophical nature of social reality and if this reality is perceived as objective and external to the individual, or subjective and cognitively constructed from individual bias (Long et al., 2000, p. 190). Ontology is often divided into *objectivism* and *constructivism/subjectivism*. Objectivism refers to the view that the external world can be accessed objectively (Brannick & Coghlan, 2007, p. 62). Johnson and Duberley (2000, 155-156) further means that the ontological view of the *objectivist* assumes that natural and social reality exist independently from human cognition. A researcher that is adhere to an objectivistic reality argues that reality is independent and external (Brannick & Coghlan, 2007, p. 62). Contrastly, the ontological standpoint of *subjectivists* assumes that human cognitive processes constitute reality, and that no single external reality exist nor is objective (Johnson & Duberley, 2000, 155-156). Hence, the researcher cannot be separated from the research process but is instead an integral part of it (Brannick & Coghlan, 2007, p. 63).

Inevitably, the undertaken research question required subjective judgment of the individual views expressed by the fund managers. The decisions they make and the interaction they have with DFIs calls for interpretation, making it difficult to conceive this process as objective. Instead of assuming that a social reality exists objectively, themes and concepts describing the effect DFI investments have on fund manager behavior aided the conceptualization, that to some extent explained their decisions. Trying to objectively judge the implications institutional investments have on their personal decision-making process seem intricate. It is difficult to argue that reality is something objective that exists without being affected by people of different backgrounds and opinions, hence leading us to express our subjectivistic standpoint.

### 2.2.2 Epistemology

The *epistemological standpoint* assumes that the social world is a structure based on connections or networks created within constituent relationships (Long et al., 2000 p. 191), broadly referring to how to acquire knowledge and how it is transmitted to others. Epistemology is commonly divided into *positivism* and *interpretivism*. The basic assumption within positivism is that an objective reality exists independently from human behavior, therefore is not created by the human mind (Crossan, 2003, p. 50; Weber, 2004, p. 5). According to Crossan (2003, p. 49), the *positivist* means that the relationships between hard facts can be considered scientific laws.

In contrast, *interpretivists* believes that there is no separation between the individuals whom observe reality and the reality itself (Weber, 2004, p. 5). Essential to the interpretivistic paradigm is the understanding of subjective meanings of individuals; acknowledging, avoiding to distort, reconstructing and using them as the basis in theorizing (Goldkuhl, 2012, p. 137-138). Wainwright and Forbes (2000, p. 265) means that interpretivism is an antidote to superficial and atomistic survey methods within quantitative research, and instead provides an in-depth understanding of social phenomena more commonly embraced within qualitative research.

Since replicability, objectivity and causality was not this study's primary concern, our philosophical standpoint is not particularly positivistic. This thesis undertook a behavioral examination of specific individuals, working under specific circumstances and situations. It is of our opinion that the situation appearing when managers make new investments is very much intertwined with the fund managers and strongly affected by them, giving no reason to separate them. Hence, when studying the social reality in which our participants operate, our philosophical view of reality was more interpretivistic. Another reason for not taking a positivistic stance is that it has according to Brannick and Coghlan (2007, p. 62), been the dominant approach in previous management research. This presents an argument to further explore management behavior from an interpretivistic standpoint.

## 2.3 Research Approach

The research approach refers to whether the study incorporate an *inductive*, *deductive* or *abductive* approach for the conduction of data (Saunders et al., 2012, p. 144-145). *Inductive reasoning* applies to research where concepts and themes are derived from the gathered data through interpretations. (Thomas, 2006, p. 238). It involves a process of observing a phenomenon or examining a subject, from which theories will emerge (Hyde, 2000, p. 83). Deduction is usually denoted as the opposite of induction since it departs from already existing theoretical framework and seeks to generalize more specific conclusions (Ketovki & Mantere, 2010, p. 316). The *deductive approach* instead seeks to

explain and identify causal relationships between different variables and concepts by developing testable hypotheses or propositions (Saunders, 2012, p. 145). In addition to the inductive and deductive approach, an *abductive approach* can be undertaken, which combine the two involving a back-and-forth process between theory and data (Suddaby, 2006, p. 639). The abductive approach is more related to the inductive process of generating new concepts and models and does not seek to confirm already existing theories (Dubois & Gadde, 2002, p. 559). Abduction is different from induction in the sense that it is more concerned with refining theories than generating new ones (Dubois & Gadde, 2002, p. 559). The inductive approach is by tradition associated with qualitative research where concepts of interest is relatively unclear and not widely explored, while the quantitative researchers tends to instead subscribe to the deductive approach for interpreting the collected data (Hyde, 2000, p. 84-85). However, a large amount of studies demonstrates the use of both inductive and deductive procedures for their research (Hyde, 2000, p. 88-89).

Since this research aimed to use existing theories for analyzing data, the study undertook a deductive approach, by identifying themes that was relevant for the research question. The inductive approach was not considered suitable since this study's aim was not to develop new theories, but instead to examine whether e.g. SRI, agency, and stakeholder theories could be applied to situations fund manager's find themselves in when DFIs are involved. However, that does not mean that inductive elements were completely absent. After identifying themes during the interviews that was not highly applicable to the preselected theoretical framework we found it necessary to add additional theories and/or concepts to enrich the findings.

## 2.4 Research Strategy

A research strategy is according to Bryman and Bell (2015, p. 37) business research general orientation in reference to how it is conducted. Since the aim was to understand behavioral tendencies of the examined individuals, a qualitative approach was deemed as the most suitable approach. When having a subjectivistic view of reality it is very common to conduct qualitative research, and according to Williams (2004, p. 209) the terms are even used interchangeably. *Qualitative analysis* is highly descriptive, depicting how, why and when someone said what to whom as well as allows the examination of a process over a period of time as situational details unfold (Gephart, 2004, p. 455). The qualitative researcher aims to establish an intimate relationship with their peers, and perceives reality as a social construct in which they recognize situational constraints and how social experiences provides meaning (Denzin & Lincoln, 1994, p. 8). While *qualitative researchers* seek to reveal theories and concepts by explaining research observations in specific cases, the *quantitative researchers* instead aim to uncover relationships through general propositions and variable testing (Gephart, 2004, p. 455). Denzin and Lincoln (1994, p. 8) further emphasize that quantitative studies does not focus on processes but instead examine causality between variables through analysis and measurement. Hence, if the intention of the research is to provide a highly generalizable picture of a fund manager's behavior, a quantitative questionnaire-based survey would have been appropriate.

Robson (2002, p. 233-234) summarized the advantages with questionnaire-based surveys as follows; 1) takes a relatively straightforward approach when trying to examine values, attitudes, motives and beliefs; 2) have a high level of standardization in data; 3) can adapt the data collection enabling generalizable result to large populations. In contrast, Robson

(2002, p. 233) meant that some disadvantages are; 1) that respondent characteristics can affect the data (e.g. personality, experience and memory); and 2) that the disclosure of actual behavior and attitudes can be inaccurately depicted (e.g. the bias of being socially desirable depicting them as positive). Assuming a qualitative research approach (including interviewing) can provide enriching insights of socially responsible investment decisions. Robson (2002, p. 272-273) means that the advantages of the interview techniques are their adaptiveness, flexibility and ability to provide an in-depth understanding of the reasons for certain actions taken. Even though it can be very time-consuming for involved parties, it allows the identification of underlying motives, interesting responses and nonverbal cues, which questionnaires cannot (Robson, 2002, p. 272-273). Furthermore, Robson (2002, p. 272-273) also emphasizes that it inevitably increases the risk of reliability issues as a result of bias concerns and a lack of standardization. He also means that it can be very time-consuming for both parties because of the need to interview and later transform the recordings to written form (transcribe).

Large amounts of previous SRI literature have conducted quantitative analyses of SRI, and many (Barnett & Solomon 2006; Bauer et al., 2006; Goldreyer et al., 1999; Mallin et al., 1995) regarding mutual and conventional fund performance differences. However, even though quantitative studies can contribute with more general results of investor behavior from a statistical and mathematical point of view, the need for a more profound, humanistic and literary interpretation of how institutional investments (such as DFIs) can alter fund managers' behavior, still is needed. In order to understand attitudes regarding the acceptance of suboptimal performance in favor of development impact, we deemed it less important to probe the accuracy of a presumed reality in accordance with quantitative research. Instead, our aim was to provide well-substantiated conceptual insights of situational circumstances from a qualitative perspective. To the observant peer, trying to grasp behavioral aspects of specific individuals acting in different environments, in which decisions require personal and experienced judgment, can be very difficult. Hence, the argument to utilize qualitative techniques is further legitimized when trying to understand the effect DFI investments have on fund manager's behavior.

## 2.5 Overview of Method

In brief, this study seeks to provide an in-depth understanding of the relationship between DFIs and fund managers from an SRI perspective as well as explain how their involvement affect investment decisions. *Constructionism* mainly constitute the ontological view in this thesis, since reality was not perceived as objective and external but rather as a social construct by us. The epistemological standpoint is mainly *interpretivism*, aiming to explain the DFI-fund manager relationship without separating reality from them as actors and describe their experiences in a *subjective*, rather than objective way. Since the aim of the study was to test if already existing frameworks could be applied to the DFI-fund-fund manager relationship, it departed from a deductive approach (with some inductive elements). Lastly, with all the above in mind, the most suiting research strategy was decided to be the qualitative method, enabling us to gather insights and opinions of fund managers working in fund that DFIs have invested in and provide a *rigor* analysis. Table 1 below summarizes the research design.

Table 1. Research Methodology Application

Research Methodology	Application to this study
Ontological view	<i>Constructionism</i>
Epistemology standpoint	<i>Interpretivism</i>
Research Approach	<i>Deductive</i>
Research Strategy	<i>Qualitative</i>

## 2.6 Literature Search and Critical Review

In order to ensure high quality in accordance to scientific research standards, this thesis and a large part of its content has been based on carefully selected and peer-reviewed scientific articles. Due to its international nature, all utilized sources are written in English in order to facilitate the verification of sources and reducing translation distortions. The keywords used to identify relevant research is ranked in accordance to significance and use. Moreover, these keywords were combined for the reason of tapering the search results.

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*Development Finance institutions (DFI), Socially Responsible Investment (SRI), Agency Theory, Stakeholder Theory, Value Maximization, Principal-Agent Problem, optimal contracts, management behavior, SRI investment screens, suboptimal financial performance, SRI portfolio implications*

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Secondary sources are not utilized during the course of this work with the purpose to prevent information loss and contextual distortions. Important to note is however that one working paper were utilized to describe the European SRI market development written by Louche and Lydenberg (2006). While not yet been submitted to peer-review, is has been cited in many other scientific articles (Gond & Boxenbaum, 2013; Sandberg et al., 2009; Juravle & Lewis, 2008), somewhat ensuring a high level of credibility. The information obtained from the article only provided a background regarding the SRI market in Europe and had no significant implications on the scientific research review or method chapter as a whole. Another working paper was included as a source by (Stiglitz, 1991). Since it was only used to describe the very famous ‘Theory of the invisible hand’ that could easily be confirmed by other sources, we saw it as completely fine to use.

The primary online search tools used to obtain relevant material was; Umeå university library search tool, EBSCO, Emerald Insights, JSTOR, Google Scholar and Business Source Premier, containing several renowned scientific journals within e.g. social responsibility, finance and management (access provided by Umeå university). For the method chapter, several scientific articles (Braun & Clarke, 2006; Crossan, 2003; DiCicco-Bloom & Crabtree, 2006; Fenig et al., 1993) within the area of psychology and nursing has been used to describe our course of action in the method chapter. However, since this study falls within the area of business research these were only used as a means to describe our qualitative research process. These articles have also been used by other business researchers as a way to describe their method process, hence to some extent confirm their appropriateness.

Also, the reference lists of highly relevant research studies were utilized in order to find similar studies within the area. In addition to scientific articles, methodological and business literature were used, mainly in the methodology chapter. Since their primary aim

is usually to provide a broad understanding of concepts and terminology, they mainly constitute a basis for further discussion and substantiated arguments.

In order to critically review the included scientific literature Harris (1997) *CARS-framework* for source evaluation was utilized. CARS is an abbreviation for *credibility, accuracy, reasonableness* and *support* and can be used to critically review and evaluate information (mainly on the Internet), that is available in large quantities with different purposes and variations (Harris, 1997, p. 11).

Credibility emphasize the importance of the author's credentials, evidence of quality control, evidence of peer review and aims to evaluate authenticity, reliability and believableness in decisions (Harris, 1997, p. 4-5). Our main arguments for a high level of credibility of used sources was to only include peer-review articles as source material in the thesis, which is an ensured form of quality control. Evaluating the credentials of each author was deemed unrealistic due to the extensive reference list and because of time limitations. The referenced books in the thesis were also deemed as highly credible, since they are referenced in a large number of scientific articles.

Harris (1997, p. 5-6) refers to accuracy as to how timely, exact, factual, detailed and purpose completely reflects the intentions of the literature. In order to ensure high accuracy, the presented scientific literature was relatively new, thus depicting the contemporary development within the research area. Naturally, older articles and books were included (Demeski & Feltham, 1978; Guba, 1981; Holmström, 1979; Jensen & Meckling, 1976; Lincoln & Guba, 1985; Mulligan, 1986), mostly for the reason of explaining from where modern research originate. Moreover, there is always a risk of unintentionally leaving out important facts and alternatives (Harris, 1997, p. 6). Hence, we have been quite extensive in explaining and discussing rationales regarding methodological and theoretical choices in order to provide a more profound depiction of alternate directions and streams. As a reader of this paper you need to be aware that the primary data (information obtained from the participants during the interviews) has been exposed to some subjective interpretations increasing the risk of bias results.

Reasonableness is concerned with examining information related to objectivity, fairness, consistency and moderateness (Harris, 1997, p. 5-6). To ensure objectivity in examining the literature, the journals for publishing the articles were critically reviewed, ensuring that no financial motives of particular claims could have affected their results. In order to be fair in our judgment of authors, theories and methods, we tried to approach them without prejudice nor favoring one view over another. To avoid using scientific research presenting contradictory arguments, we made sure to extensively examine the consistency of their content. In regards to moderateness, one author specifically (Friedman, 1982) made controversial claims that seem to oppose the view of the established research community, regarding the ableness to act ethically in business situations. Since he is a renowned author we felt it necessary to include his opinions, although a clear discussion of more established views was weighed in. Apart from this exception there was no apparent claims out of the ordinary. Support refers to corroboration and source documentation (Harris 1997, p. 9-11). Several sources were used in order to corroborate the research articles results and conclusions. We found that none of the included articles made claims that were not substantiated with other appropriate sources, nor that any made claims that could not be retrieved from other studies.



### 3. Scientific Research Review

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*The following chapter review already existing literature in the areas of Socially Responsible Investment (SRI), Agency Theory and Stakeholder Theory. The different concepts and/or theories includes the development within in the respective research area and later goes into research specifically relevant to this study. Finally, we present our concluding model that provides an overview of how an involvement of a DFI can affect a fund manager's behavior and decision-making process from different aspects.*

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#### 3.1 Socially Responsible Investment (SRI)

Socially Responsible Investment or 'SRI' has received increased attention in the research community during the last decade due to its inclusion of goals of both social and financial nature. What is considered as 'social responsible' investment and what constitutes 'SR activities' is in many cases equivocal, especially since terms such as ethical-, sustainable, green- and impact investing, are being used interchangeably in research. Renneboog et al. (2008) means that SRI include exclusionary and selective investment screens based on the social, ethical, environmental (SEE) criteria. Bollen (2007, p. 685) argues that SRI investors engage in a multi-attribute utility function incorporating societal and personal values in addition to the usual risk-reward optimization. Brzeszczynski and McIntosh (2014, p. 335) defines SRI similarly as an investment strategy combining social and environmental benefits by linking investor concerns of social, ethical and ecological character. Another common definition of SRI is:

*'Socially Responsible Investing (SRI) is an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis. It is a process of identifying and investing in companies that meet certain standards of Corporate Social Responsibility (CSR)' (SIF, 2003, p. 3).*

The SRI growth is usually traced back to the US anti-military concerns and environmental issues in the 1960s and 1970s (Junkus & Berry, 2015, p. 1176-1177). In the 1960s, new legislation paved the way for corporate social responsibility, e.g. the Community Reinvestment Act and Environmental Protection Act, which linked corporate behavior, ethical, social and governance (ESG) criteria to public policy issues (Junkus & Berry, 2015, p. 1177). In 1970s SRI grew from being a subject of curiosity and a niche-market phenomenon to an embraced global force within the area of finance. The rapid industrial development has caused several environmental disasters, such as the Chernobyl nuclear power plant explosion and Exxon Valdez oil disaster in the late 1980s, further increasing the awareness of investment and environmental implications (Renneboog et al. 2008). The concept of SRI developed during this time stretches into today's time and portfolio investment decisions now go beyond personal values of individual investors, entering the realm of impact investing, social entrepreneurship and shareholder activism (Junkus & Berry, 2015, p. 1177). In the 1990s, the consequences of ethical consumerism as well as several corporate scandals has resulted in entirely new pressures on corporate governance and SR investors (Renneboog et al. 2008 p. 1725). Even if SRI has grown significantly, the social responsibility theorem in the context of business has been somewhat questioned within the research community.

Renowned Nobel Prize winner in Economic Sciences Milton Friedman (1982, p. 112-113) once argued that ethical obligations of public companies are limited to profit maximizing propositions and should function only as a means of avoiding fraud and deception by operating within defined ethical frames. Furthermore, he argued that businessmen declaiming concern for something other than profits, and having a 'social conscience' - eliminating discrimination, providing employment and avoiding pollution - are preaching for socialism and undermines the basis of a free society. The position of this influential American economist has however failed to attract adherents in the scholarly community, and instead many perceived great value in understanding the intersection between society and business as well as its practical ethical implementation. For example, Mulligan (1986, p. 269) argued Milton's paradigm to be inaccurate, arguing that even though social responsibility incurs company expenses when having to invest resources in consequence analysis, it does not mean that business people pursuing social goals inevitably acts without attention to return on investment, competitive pricing, budgetary limitations and employee remuneration.

Despite some evident controversy and SRIs seemingly young history, funds committed to socially responsible investment has been around since the Pioneer Fund (founded in 1928), which based investment screening on religious prohibitions (Renneboog et al., 2008 p. 1725; Junkus & Berry, 2015, p. 1177). The modern SR funds started to appear during the 1970s and include examples such as the PAX World Fund (1971) targeting militarism connected to the Vietnam war as well as the Dreyfus Third Century Fund (1972) (Renneboog et al., 2008 p. 1725). The interest for SRI arrived later in Europe compared to the US and is usually mentioned in relation to the adoption of ethical investment by the the UK Fund Friends Provident Stewardship Fund. European funds also adopted a more intensive green investment strategy in the 1980s e.g. the UK's Merlin Ecology Fund (1988) focusing more on environmental issues (Junkus & Berry, 2015. p. 1177). During the 1990s SR indexes and CSR analytic development rating systems were introduced by various companies such as Calvert Investments, Harvard Endowment and CalPERS, all incorporating ESG attributes in asset- and analysis decisions (Junkus & Berry, 2015, p. 1177).

Today new investment ecosystems of SRI analytics and vehicles has been developed in addition to SR mutual funds and impact bonds. For example, impact bonds base rate of return payments on social outcomes and can for example include partnerships between nonprofits and government agencies aiming to reduce prison recidivism by tying reduction goals to bond return (Junkus & Berry, 2015, p. 1177). Additionally, national and European level governmental involvement in SRI seem to have huge implications. For example, Louche and Lydenberg (2006) concluded that the European SRI market is on the verge of seeing a significant increase due to institutional investors' willingness to make environmental and social data available in financial markets. Moreover, SIFs biannual Report on *US Sustainable, Responsible and Impact Investing Trends* (2014, p. 12) shows that the growth of SRI has been substantial. From 2012 to 2014, management utilizing SRI strategies in US-domiciled assets grew from \$3.74 trillion to \$6.57 trillion, which is equivalent to a 76% increase. This means that out of every six dollars under professional management in the US, one dollar account for these assets.

Other examples of the SRI growth include the \$7 billion of issued green bonds by the World Bank, which is an AAA-rated bond that tries to meet fixed income investor demands by financing climate change initiative projects. Bloomberg's regular business

coverage now also includes ESG analytics as well as sustainability issues and in the Morningstar's portfolio screening tools, SR characteristics are now included. The MSCI Barra Aegis software also incorporates ESG analytics in their portfolio optimization process (Junkus & Berry, 2015, p. 1178).

All these examples show that SR considerations have achieved a strong foothold in financial markets the world over and increased the focus on the inclusion of social and environmental criteria into the investment process. The share sizes of this industry and its continued growth requires investors and fund managers' handling their capital to consider stakeholder implications in a more rigorous way than ever before. The discussion in the research community regarding its viability, effect on manager behavior and actual ability to alter the fund market, therefore needs further examination. The DFIs role in this trend is that they - as institutional investors - requiring funds and fund managers to include SEE criterion into the investment process. Leeds and Sunderland (2003) even means that these institutions especially evolve the private equity market in emerging economies and their involvement usually create a *multiplier effect*, which means that they attract new investors and provide increased credibility to investments. According to them, DFIs also plays a catalytic role, uniquely qualified to re-energize an industry in terms of practice and knowledge by combining three critical and essential capabilities spurring a turnaround in private equity; *credibility* to initiate local governments to make regulatory and policy reforms, since they are seen as honest brokers that promote public sector development; *powerful private sector influence* encouraging active private equity participation by undertaking a strong leadership role as incubators and; *financial resources* that can be used as leverage against (PI) funds and attract additional investors (Leeds & Sunderland, 2003, p. 118).

### 3.1.1 SR Investment Behavior

The expectations and objectives of SR investors are important to discuss in order to understand their investment decisions and what salient issues determines their investment choices. One way of truly understanding their investment rationale is to examine how these individuals differ from conventional investors. Rosen et al. (1991, p. 222) means that contributing with knowledge regarding their behavior is crucial for two reasons; 1) the investments subjected to social screening is rapidly growing, as is the need for corporations to adapt to challenges regarding key stakeholders whom are affected by firm action and; 2) this group has substantial financial power and has invested hundreds of millions of dollars into mutual funds.

Standard investor behavior theories presume that investors' investment choices are unequivocally determined by maximization of a financial risk-adjusted return objective over a specific time horizon (Williams, 2007, p. 43). Although, SRI provide evidence that a significant proportion of investors does not only consider financial returns but also include social and ethical criterion (Williams, 2007, p. 43). According to Renneboog et al. (2008, p. 1730) SR investors avoid firms that exploit employees and causes health hazards (negative screening), to instead choose environmentally and socially sound firms with a strong track-record and corporate governance. This means that value maximization in addition to social welfare is prioritized simultaneously. Furthermore, Bénabou and Tirole (2010, p. 16-17) came to the conclusion that investors' 'prosocial behavior' is driven by a complex set of motives (intrinsic altruism, self/social-esteem and material incentives), of which are all mutually dependent.

Nilsson (2008, p. 320) concluded that SR mutual fund investments are driven by both profit-oriented and *altruistic* motives. By including predictor variables of SR investors (such as subjective perceptions and profit rationality), he concluded that these investors incorporate their own social and environmental concerns in investment decisions. Investors that perceive themselves as having the ability to impact and are concerned with SEE criteria, invest more in SRI-profiled mutual funds than investors lacking those characteristics (Nilsson, 2008, p. 321). However, the study also concluded that SR investments are *not only* driven by prosocial motives and SEE criteria, but also the return on investment potential. If the SR investor believes that an investment into an SRI mutual fund will outperform its conventional counterpart in the long-run, they are more likely to choose that fund, than investors that have not identified the same potential (Nilsson, 2008, p. 321). The evident link between the amount invested in SR mutual funds and their perceived financial performance somewhat proves these investors' investment actions.

Rosen et al. (1991, p. 231) on the other hand found that the average SR investors represent a way-of-life and is a type of activist. Accordingly, their main rationale for investing socially responsibly is not to compensate for a hedonistic lifestyle, nor will they as a result of a social screen accept high social responsibility in exchange for low returns. Accordingly, investors operate on two scales; 1) their CSR expectations in terms of *avoidance* and *affirmative* behaviors; and 2) their return on investment preference. Affirmative behavior includes actively seeking out socially proactive SR investment opportunities, while avoidance behavior refers to avoiding activities considered to not be cutting edge in regards to social action (Rosen et al., 1991, p. 224). Conclusively, SR investors tends to perceive that affirmative behavior result in higher company cost than avoidance behavior and therefore engage in avoidance behavior to a larger extent. This would mean that the fund managers do not necessarily actively seek out SR investments that are '*best-in-class*', but rather comply with the defined standard requirement set by DFIs. Hence, by engaging in avoidance behavior might be enough to satisfy their DFI investor.

### 3.1.2 SRI Investment Screens, Selection and Implications

The selection process when deciding to invest in a portfolio is usually divided into two stages; 1) it begins with the beliefs regarding future performance of available securities as well as ends, experiences and observations and; 2) continues with *more relevant* beliefs regarding ends and future performance of portfolio choice (Markowitz, 1952, p. 77). According to Bollen (2007, p. 683-684), SR investors specifically integrates investment decisions through *social screens*, shareholder community investments and activism with societal concerns and personal values. Social screens subject companies to social and/or environmental qualitative criteria, often excluding companies with securities in specific industries (Bollen, 2007, p. 683-684).

Within SRI, *negative* and *positive screens* are commonly utilized as a way of deciding the added value of an investment. The negative SR investment strategy refers to the exclusion of specific stocks and industries that do not meet social and ethical criterion (Renneboog et al., 2008, p. 1728). This entails the exclusion of industries involved with tobacco, alcohol, weapon defense and gambling as well as companies having poor employee securities and environmental degradation issues. Positive screening on the other hand, focus on the identification of investments that are best-in-class and have superior CSR practices in regards to corporate governance, sustainability, labor relations, environmental standards and diversity (Renneboog et al., 2008, p. 1728). The investments

are thereafter ranked according to their fulfillment of CSR criteria in each industry and needs to pass through a minimum threshold. Both of these two screens are commonly referred to as the first and second generation of SRI and has given rise to a third generation of screening called '*the triple bottom line*' (also *People, Planet, Profit*). The triple bottom line integrates the positive and negative screening process by basing the investment selection on SEE criterion (Renneboog et al., 2008, p. 1726). Derwall et al. (2011, p. 2143) adds to this by stating that many SRI portfolios offers a mixture of positive and negative screens, hence cater to various types of investors.

Hence, since SRI does not utilize traditional investment assessments in the same way, it deviates from the *standard asset pricing model*. Renneboog et al. (2008, p. 1734) means that applying social screens to investment decisions can impede on the existing investment universe available to non-SRI investors. Consequently, this imposes diversification limitations and requires risk-return trade-offs when compared to conventional portfolios. According to Renneboog et al., (2008, p. 1734), if the market value investment opportunities correctly, the market will expect that SRI funds will underperform compared to conventional funds. This would mean that these funds underinvest in attractive investments with positive NPV as well as overinvest in projects with negative NPV, after passing through the social screening process (Renneboog et al., 2008, p. 1734). The SRI implications on the standard asset pricing model is therefore important to note since if investor preferences are not only to be risk avert when making investment decisions, but also to avoid unethical/asocial corporate behavior, SR investors do not require the optimal rate of return from ethical companies and deviates from the model. Hence, suboptimal financial performance seems to some extent be accepted in favor of development impact objectives, and if not completely, at least limit their accessibility to the whole financial market and impede diversification opportunities. This is however not as clear cut as it might seem.

The fact is that, Renneboog et al. (2008) conclude that current research does not unequivocally demonstrate that SRI investors accept suboptimal financial performance to pursue increased societal objectives. This argument is further strengthened by the aforementioned conclusions made by Nilsson (2008, p. 321) denoting that profit maximizing rationality does *not always* drive investor behavior in an investment decision-making process. The same goes for the claim that SRI investments are not necessarily exclusively 'prosocial based'. This would mean that identifying fund managers' investment intentions of socially responsible investing does not come without difficulty. Accepting suboptimal performance in favor of development impact objectives should presumably be dependent on various variables and situations. If the fund manager identifies a high financial performance potential in a SRI fund, and believe that it will outperform a conventional fund, their profit maximizing rationality and perceived impact ability can affect their decisions interchangeably. The questions of whether or not the fund manager's intention is to improve society or achieve high profitability on investment becomes less important than actually achieving DFI investment requirements and standards. This rationale is similar to the classic school of economics and Adam Smith's '*the theory of the invisible hand*', arguing that as individuals pursues their self-interest, they are also led by an invisible hand to pursue the nation's interest, which are not in conflict with each other (Stiglitz, 1991). In conclusion, pursuing one objective, such as financial return, might actually result in a favorable development impact outcome, even if not fully intentional.

Moreover, the share size of the SRI market increases the investor's capacity to enforce development impact goals into the investment-decision process. Derwall et al. (2011, p. 2146) mean that SR investors shape investments decisions collectively since the value-driven investors are large in numbers. These SR investors meet non-pecuniary needs because they form a large SRI movement with a subset of all SRI-practices. By shunning socially controversial stock trade that are consistent with personal and societal values, they can sometimes therefore accept lower financial performance. It would therefore seem that some SR-investors are not as susceptible to compromising societal impact in the screening process in order to achieve higher return on investment. Heinkel et al. (2001, p. 447) found that in order for social investment to impact market share pricing, the proportion of firms boycotting irresponsible social behavior needs to be large in number. According to Junkus and Berry (2015, p. 1195) “*The number of SR investors matters if the proportion of firms sequestered for unacceptable behavior is small relative to the total pool of available investments, which is generally the case for SR investment schemes.*”. This means that, in order for the effect on asset returns is to be statistically significant, the proportion of investors utilizing SR criteria in their investment decisions, needs to be high. Thus, the share number of SR investors collectively increases the likeliness of irresponsible behavior to decrease.

### 3.1.3 ESG Criteria

SRI seeks to integrate *Ethical, Social, Governance* (ESG) issues - considered to be of non-financial concerns - into the investment process which otherwise is driven by financial objectives (Sandberg et al., 2009, p. 519). ESG is naturally a part of the socially responsible research and Capelle-Blancard and Monjon (2012, p. 239-240) even define SRI as *the integration of ESG issues into the investment process*. Additionally, the significance of the inclusion of the issues is rapidly growing in regards to firm evaluations and also seem to be vital for the funds having DFIs investors, since excluding them would mean diverging from DFI development objectives.

According to Bassen and Kovács (2008, p. 184) ‘*The concept of ESG issues refers to extra-financial material information about the challenges and performance of a company on these matters*’. They argue that it enables investors to more extensively assess opportunities and risks, provides additional information and makes differentiated investment decisions possible. Furthermore, an important part of ESG is the *Key Performance Indicators* (KPIs) which constitutes a framework issued by the Committee on Extra-Financials by its Investment Professionals<sup>3</sup> (DVFA). The aim of KPIs is to provide a comprehensive as well as consistent ESG reporting framework and includes 12 general non-sector specific and 18 sector-specific KPIs within corporate financial analysis of performance (Bassen & Kovács, 2008, p. 188). Accordingly, KPIs adds to the ESG indicators and aid long-term viability and ability to produce profits without compromising resources, assets and skills in order to exploit short-term opportunities.

As DFIs co-invest, they valorize environmental impact in industry practices and assess development impact through the use of ESG criterion (Bracking, 2012, p. 276). Furthermore, Bracking means that ESG assessment of possible environmental harm and

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<sup>3</sup> The DVFA Committee on Extra-Financials is a professional body comprising investment professionals, financial analysts, corporates, auditing professionals and experts in the field of ESG issues. (Bassen and Kovács, 2008, p. 188)

consequential impacts is not the only calculative technology for doing that analysis, but it represents the development industry's contributions to frame and promote poverty reduction, environmental sustainability and private sector development. EDFI has created an *Exclusion List* (see Appendix 2) which specify activities and businesses that they cannot invest in and collaborated to harmonize comprehensive monitoring and assessment standards in regards to ESG criterion (Dalberg, 2009, p. 25). Bracking (2012, p. 277) however argues that the monitoring function of this includes few external audits and the fund managers almost exclusively self-certify their own performance. Accordingly, Bracking few projects are actually rejected by DFIs and/or funds based on ESG criterion, even if the environmental effects are deemed to have negative consequences. This would mean that even if ESG is seen as very important to include in the investment analysis, it is very difficult for DFIs to evaluate the fund managers' actual ESG performance. However, even if DFIs cannot accurately evaluate ESG performance, ESG do play an important role in their development impact criterion, making them important factors to include.

#### 3.1.4 SRI Investment Performance

In order to understand if a trade-off between financial performance and development impact actually exist, it is necessary to examine social investment (fund) performance. According to Bollen (2007, p. 684), it is necessary to examine if portfolio performance optimization is constrained by social screen investment vehicles and if they result in inferior risk-adjusted returns when compared to its conventional counterpart. Although, he also states that social screens can potentially generate superior risk-adjusted returns since they might serve as a filter for managers to invest in portfolios with high quality. The investment process and the incorporation of social concerns or values have canalized into two main views.

The first view argues that SR investors sacrifice investment performance – '*doing good, but not well*' - in their pursuit of their principles (Junkus & Berry, 2015, p. 1178). This view is supported by several arguments. Investments must result in less diversification and/or lower return per unit of risk if it is limited to assets that only are accepted based on SR criterion, compared to a portfolio that does not limit their investment universe by dismissing countries, stocks and/or industries (Hamilton et al., 1993). According to Junkus and Berry (2015, p. 1178) the weights assigned to investment opportunities also imply investment implications because SR is insufficient in calculating investment efficiency and instead calculate the potential SEE quality of investments. This under-exposure to high-performing sectors does not exist in fully diversified portfolios and result in SR investors suffering from inferior performance (Jones et al., 2008, p. 193). Ultimately, it could therefore be argued that efficient diversified portfolios can expect higher performance, compared to SR investors' suboptimal performance.

The discussion continues with a large body of research having tested the hypothesis that the asset price of mutual funds and/or stock return are driven by values and social norms. According to some researchers, risk-adjusted returns are higher in hypothetical socially controversial stock portfolios (Fabozzi et al., 2008; Hong & Kacperczyk, 2009; Salaber, 2013). For example, Hong and Kacperszyk (2009, p. 35) found that *sin stocks* expected returns are higher than comparable stocks, since social norms increase their litigation risk and are neglected by investors constrained to norms. Furthermore, they found that investors abstaining from funds promoting vice, particularly norm-constrained institutions, consequently increase financial costs and receives less analyst coverage.

The second view claim that implementing ethical principles in firm strategy can be expected to outperform the ordinary firm by ‘*doing well by doing good*’ (Junkus & Berry, 2015, p. 1178). Firms with ‘ethical principles’ might attract SR preferential investors that provides cheaper capital (Brzezczynski & McIntosh, 2014, p. 359) and/or more productive and enthusiastic employees (Becchetti et al., 2012 p. 1629). Porter and van der Linde (1995, p. 120) concluded that the adoption of SR-including corporate behavior increase the need for innovation to increase the value for the stakeholders. Positive CSR attributes may attract higher-value input but also give the investor additional risk indicators. This type of improved behavior and monitoring activities can serve as a way of decreasing corporate actions that result in costly litigations as well as reducing higher costs and variability in future earnings (Goldreyer et al., 1999, p. 23-24). Renneboog et al. (2008, p. 1731) means that ultimately the effect on the firm value depends on the ability to measure social welfare by maximizing stakeholder value in a comparable way to shareholder maximization.

There is even more extensive research concluding that SRI mutual funds that avoid sensitive stocks by utilizing social screens do not underperform compared to its regular fund counterpart (Bauer et al., 2005, 2006; Derwall et al., 2011; Leite & Cortez, 2014). For example, Bauer et al. (2005, p. 1765-1766) found no significant differences between conventional and ethical funds’ risk-adjusted returns between the years 1990-2001, when controlling investment styles. Although, they emphasize that the reasons for the ethical mutual funds not delivering similar financial returns compared to conventional mutual funds, is because they usually undergo a *catching-up-phase*. Bollen (2007, p. 683) also studied the relationship between SRI fund lagged performance and annual fund flows to matched conventional funds. He found that, between 1980 and 2002, SR investors significantly exhibited a smaller response to negative returns and a larger response to positive returns, when being compared to their conventional counterparts. The financial SR attribute serves as a dampening effect on the mutual fund trade rate of SR investors, resulting in a significantly lower volatility in monthly fund flow, than conventional funds. In addition, Barnett and Salomon (2006) identified a *curvilinear relationship*, meaning that when SRI funds increase their use of social screens, financial returns decline, to later rebound when the screens reach a maximum.

Despite some conflicting views in SR mutual fund studies regarding the significance of performance differences, it is reasonable to assume that social screening does not impede on financial returns. Even if some researchers have concluded that norm-constrained investors have diversification limitations, the significant growth rate within ethical and social investment is large enough to still retain vast investment options. The acceptance and growth of the SRI trend on financial markets indicate risk litigation, because an increase in numbers of SR investors implies that risk can be shared. The catching-up-face and curvilinear nature of the ethical mutual fund market should also serve as an indicator of why SRI mutual funds, as suggested by some, does not achieve the same financial performance as conventional and/or sin funds. Another fund manager tendency identified by Borgers et al. (2015, p. 125), was their reluctance to tilt heavily towards controversial stocks due to practical and social constraints. More importantly, they concluded that social dimensions are displayed in various conventional funds with core operations in sin industries, which is dependent on their targeted political preferences, clientele and local religiosity. All this should mean that the financial performance within the industry does not differ significantly over time and that the difference with conventional/controversial funds is small.



### 3.2 Agency Theory

Today it is common for investors to put their money in the hands of fund managers, consequently leaving them in charge of making decision regarding how the money should be invested. This result in a loss of control for investors and increase the likeliness of *conflict of interests* arising with management advisors (Starks, 1987, p. 17). The predicament can be discussed in relation to the *agency theory* which originate from the literature that describes the problem of risk-sharing that occurs when attitudes towards risk is inconsistent between two cooperating parties' (Eisenhardt, 1989, p. 58).

Ross (1973) is often seen as the forefather of the agency theory, describing the occurring dilemma in which both the agent and the principal have incentives to act in their own interest in order to maximize their own expected utility. However, the most cited authors within this renowned area of study are Jensen and Meckling, who used a *contract* as a metaphor to describe the relationship between the principal and the agent (Jensen & Meckling, 1976, p. 308). They meant that if both parties want to maximize their own utility, it is very likely that the agent will act in his or hers own interest rather than that of the principals. The relationship between the fund manager and the DFI strongly align with their theory of utility maximization. If the fund manager act as an agent for a DFI (the principal) and follow traditional fund manager incentives of financial viability, it may result in a conflict with the DFIs objective to promote development. This in term can lead to the fund manager focus more on trying to achieve the highest possible financial return and prioritize that over development impact objectives.

The agency theory is usually separated into two main streams, the *positivist agency theory* and the *principal-agent theory* (Eisenhardt, 1989, p. 59-60) and the common denominator for these are their focus on the contract between the principal and the agent, although deviate in their style and the mathematical attempts. Both perspectives provide meaningful insights regarding the possibility of conflict between the principal and the agent as well as how the agent is expected to act in the principal's interest (Cuevas-Rodriguez et al., 2012, p. 527). The positive agency theory seeks to identify situations in which conflicting goals arise, and aims to describe in what way the agent's behavior can be governed in order to limit the incentives to pursue their own interests (Eisenhardt, 1989, p. 59). This view has been broadly discussed in management literature related to the examination of contractual efficiency between managers and owners of large firms (Cuevas-Rodriguez et al., 2012, p. 527).

Additionally, the approach of the principal-agent theory is more mathematical and addresses the importance of determining whether the optimal contract involves a *behavior* or an *outcome* focus. (Eisenhardt, 1989, p. 59-60). On another note, these two perspectives are often said to complement each other since the positive agency perspective is based on theoretical guidance from the principal-agent theory (Cuevas-Rodriguez et al., 2012, p. 52). This specific branch of theory determines the most efficient contract under certain conditions, whilst the positive theory identifies the different alternatives of contract (Cuevas-Rodriguez et al., 2012, p. 52).

Moving forward, the principal-agent theory is highly appropriate to consider in this study since it aid in conceptualization of the contract between DFIs and the funds in which they invest as well as in the examination the fund manager behavior and/or outcome focus of made investment decisions. The positivist theory applicability is fitting to include since it can apply to potential situations where DFIs and fund manager find themselves having

conflicting goals and/or interests, e.g. the possible trade-off between the financial performance goal and the development impact objective. Since both of these models can be applied to the relationship between the DFI investor and the fund manager, they will both be considered in relation to the results.

In order to fully comprehend the aspects of the principal-agent relationship (fund managers and DFIs), in regards to these two streams within agency theory, we deem it necessary to present the two following models explaining their collaborative approaches. According to Settel et al. (2009, p. 70) MDFIs employ one of two predominant models to manage their private equity fund investments. The *direct-involvement model* entails MDFIs' and fund managers' establishing a close collaboration in which investment decisions and fund strategies are agreed upon jointly. One example of this is The Islamic Development Bank that oversee the investment policy through an autonomous management firm, specifically on their largest fund investment IDB Infrastructure fund. This is usually to provide essential operational mentorship in middle-income markets where local managers lack experience and the private equity industry is considered unknown or new. The second model is the *hands-off model*, which entails a more passive engagement from the MDFIs and their involvement are limited to the advisory board as well as heavily rely on the ability on the individual fund manager. Examples of institutions employing this model are the International Finance Corporation, The European Bank for Reconstruction and Development and the African Development Bank (AfDB). The AfDB deemed it unnecessary to be in engaged in fund investment committees to enhance fund deal flow. Despite the lack AfDB involvement the model has proven very serviceable in regards to connecting investment opportunities with fund managers and has worked well for investors entering new sectors as well as pension funds. Furthermore, the MDFIs' do not seem to think that taking a position on the investment committee is detrimental for the relationship. Instead the minimum requirement is usually to take a seat on the advisory board, since that provides sufficient MDFI-fund-interaction, political risk cover, fund deal flow and effectively leverage the relationship. (Settel et al., 2009, p. 71).

### 3.2.1 Agency Cost, Conflicts and Incentives

Agency cost can be defined as the sum of structuring, monitoring and bonding expenditures of a contract as well as the remaining residual losses incurred by the cost for establishing the contract (Jensen & Meckling, 1976). When the contractual relationship between the agent and the principal differ significantly, agency costs will most likely arise (Jensen & Meckling, 1976, p. 310). The reasons for this *agency conflict* is commonly denoted as; 1) the conflict of goals/desires between the principal and the agent as well as the verification of actual agent work that, jointly or individually, can result in difficulties to verify appropriate behavior; and 2) the divergence of attitudes towards risk where the risk preference between the principle and the agent are not aligned, causing them to recite in different actions (Eisenhardt, 1989). The principal-agent conflict assumes that the principal maximizes expected utility by choosing an incentive scheme to the agent to get desired outcomes, but if the agent pursues his/hers own interests instead of those of the principals, a conflicting situation appears and agency costs are imposed. This conflict can be similarly applied to the fund manager's (agent) desire to increase the fund's performance, resulting in an incurred cost for the DFIs (principal) other objective to increase development impact.

The separation of ownership and control results in agency costs for the principal, which requires investing in different kinds of control systems (Cuevas-Rodriguez et al., 2012, p. 526). Hence, the focus of agency theory is to design the most efficient contract with the purpose to reduce the agency cost (Cuevas-Rodriguez et al., 2012, p. 531). Eisenhardt (1989) meant that, in order to determine the *optimal contract*, it is necessary to resolve the problems that appear in the principal-agent relationship. According to Jensen and Meckling (1976), avoiding divergent interests between the agent and the principal, and efficient tool is agent incentives, but also limiting aberrant activities through *incurring monitoring costs*. By establishing compensations incentives based on the agent's ability to achieve the desired performance demanded by the principal, the interest of both parties can be aligned and the utility function maximized (Cuevas-Rodriguez et al., 2012, p. 536). However, the agent theorists' most prominent challenge is to determine the compensation package that maximize the agent's effort, since it is subjected to the risk of the agent self-interest rationales (Cuevas-Rodriguez et al., 2012, p. 537). This means that identifying the agents strive towards reaching his/hers own personal values is very challenging, therefore making the incentive structure even more difficult to derive. Subsequently, in order to understand how incentives motivates fund managers, it is vital to examine the underlying motives resulting in their actions as well as the effect financial compensation/intrinsic has on them. As previously mentioned, Benaco and Tirole (2005, p. 1663) concluded that prosocial actions are reflected in material self-interest, altruistic motivation and self-image concerns, but that this mix depends on the situation and the individual. They argue that the meaning of prosocial behavior change if any of these components are altered with, as for example by extrinsic incentives, and feed back into motivations of reputational incentives.

Starks (1987) argued that one of the major issues regarding the contract in the agency relationship is the principal's difficulty to devise an appropriate monitoring and incentive system that ensures that the agent will maximize the principal's desires. Accordingly, fund-manager-investor-relationship conflict often arise due to moral hazard, but also in the absences of complete/costless information, which in term make observing management resource expenditure in the management of portfolios very difficult. Starks (1987) goes on to state that even if the management compensation fees, to some extent are based on effort and expertise in the investment selection process, the investor cannot observe managers' risk-level preferences or distinguish if the outcome is a result of random factors or management actions. Since observing management risk preference comes with costs, investors cannot *ex ante* actual performance from risk and identify divergent risk behavior, hence increasing the risk of divergence between the investor and the managers. In order to minimize the principal-agent conflict, an incentive contract is usually utilized containing monetary rewards, performance-based compensations, measurements and a risk-sharing rule.

According to Renneboog et al. (2008, p. 1741), the incentive to pursue high-risk adjusted return may be low for SRI portfolio fund managers due to the multi-task nature of considering both social objectives and financial goals, conclusively increasing agency cost. The central concern for the principal is to hire agents with specialized knowledge and/or skills, but also to motivate them to perform in accordance to the principal's requests, accounting for the monitoring difficulties of agent activity (Sappington, 1991, p. 45). The fund manager's compensation usually comes in the form of carried interest, which is tied to the financial performance of their investment. Carried interest are the investment fund managers profit shares in exchange for their services (Cunningham &

Engler, 2008, p. 1). Conclusively, in the case of the relationship between DFIs, funds and fund managers, if the incentives **come** exclusively in form of carried interest they will be based on financial performance and not development impact. If the DFIs have formulated an incentive system for outperforming the development impact objective remains to be seen, as well as how the fund managers perceive how compensation/incentives motivates them. Personal objectives are not easily identified and the reason for management taking a specific action that leads to a certain outcome, is not either.

### 3.2.2 Determining Optimal Contracts

When determining the optimal contract, researchers discuss whether the contract between the principal and the agent should involve a *behavior-based* or *outcome-based* application. A behavior-based contract specifies the basis for evaluating and rewarding the agent based on the available information regarding the agent's behavior (Bergen et al., 1992, p. 4). Outcome-based contracts are used when the principal is not able to observe the behavior of the agent and therefore the agent is evaluated based on achieved outcomes (Bergen et al., 1992, p. 4).

Eisenhardt (1985, p. 136) argues that different situations need to be considered when discussing the application of the optimal contract. Several authors mean that the conflict that appears when the objectives of the principal and the agent are inconsistent, can be explained by applying different cases (Demski & Feltham, 1978, p. 338-339; Harris & Raviv, 1979, p. 232-233; Holmström, 1979, p. 74). *The first case* represents a situation where complete information exists and the principal is fully aware of the actions undertaken by the agent (Eisenhardt, 1989, p. 61). According to Eisenhardt (1985, p. 136) a behavior based contract is considered to be more efficient in a situation where complete information between the parties exist since then the behavior of the agent is a purchased commodity, meaning that both parties can distinguish what the agent has done. *The second case* illustrates a situation in which the principal is unaware of the agent's actions (Eisenhardt, 1989, p. 61). This inability to observe agent-behavior is described as the problem of information asymmetry, and causes the formulation of an optimal contract to be difficult, if not impossible (Holmström, 1979, p. 74).

Since the fund managers operate without the DFIs being aware of their exact actions, it gives rise to information asymmetry between them. Therefore, DFIs are in need of monitoring the behavior of fund managers and set up contractual agreements to avoid agency conflict and divergence from DFI objectives. Failing to attaining complete information in the agent-principal relationship often results in agency problems, such as *moral hazard* and adverse selection (Eisenhardt, 1989, p. 61). Moral hazard specifically, occur when the agent's actions is unspecified in the contractual agreement, subsequently affecting the outcomes and often result in less effort by the agent than expected (Demski & Feltham, 1978, p. 339; Harris & Raviv, 1979, p. 232) Another problem that might arise is the adverse selection problem, which occur when the principal misjudges the capabilities of the agent as a result of the principal failing to hire agents with the necessary skills. (Demski & Feltham, 1979, p. 340-341). In order to overcome the problems of information asymmetry, agency theorists emphasize the design of contracts between the principal and the agent. The principal can according to Eisenhardt (1985, p. 136) solve these problems by utilizing a behavior-based or an outcome-based contract.

Utilizing a behavior-based contract involves investing in different kinds of information systems with the purpose to track the behavior of the agent. In these situations, information asymmetry is reduced and motivates the use of a behavior-based contract (Eisenhardt, 1989, p. 61). Holmström (1979, p. 89) concluded that contracts can in general be improved by creating information systems, since it increases the amount of available information regarding the agent's behavior. Outcome-based contracts on the other hand is utilized for rewarding the agent, which is a way to measure agent behavior (Eisenhardt, 1985, p. 136). However, this option does not determine if the outcomes is a result of high or low effort by the agent, for the reason that the behavior itself is not measured. High outcomes is therefore not necessary a result of high effort since the behavior of the agent cannot be observed (Eisenhardt, 1985, p. 136). As previously described, the optimal contract varies depending on the situation and whether or not the behavior of the agent is observable. The principal-agent relationship between fund managers and the DFIs can be explained as a relationship, in which incomplete information exist. DFIs as investors cannot with precision monitor all actions undertaken by the agent. What they however can do, is to formulate a framework of requirements and demand funds to follow them, since they provide them with capital. Information systems should also relieve DFIs from the problem of information asymmetry, since more information regarding investment decisions can aid in the evaluation of investment effectiveness. This in regard to both development impact and financial performance.

### 3.3 Stakeholder Theory

The primary focus of the stakeholder theory is to define the purpose of organizations and the responsibilities managers have to their stakeholders (Freeman et al., 2004, p. 364). Stakeholder theory does not only seek to explain but also to guide corporate operations and structures (Donaldsson & Preston, 1995, p. 70). The emergence of the stakeholder theory has shed light on the importance of addressing the values and ethics in organizations (Harrison & Freeman, 1999, p. 479).

The founder of the stakeholder theory is often considered by many to be Freeman, who in 1984 was the first author to emphasize the organizations need to be cognizant of their stakeholders in order to achieve superior performance. He argued that the manager of the organization has to not only take shareholder interests into consideration in their decision-making, but all involved stakeholders (Freeman, 2010, p. 52). The five major stakeholder areas are according to Carrol (1991, p. 46) employees, customers, shareholders, local communities and the overall society.

The Stakeholder theorem is easily applied to the fund manager's role of having to consider multiple investors preferences when making investment decisions. One of the primary functions of DFIs is to promote economic and social development in the developing countries in which they operate. However, this may contradict conventional investor objectives of achieving the highest possible return on investment. The DFI funding derives from taxpayer money, which conclusively means that society as whole can be seen as stakeholders but also indirectly to the managers investing in funds with taxpayers' money. Both DFIs and fund managers thus needs to constantly consider stakeholders, not only in the developing countries in which they invest, but also to their home countries from which they receive capital from tax. This implies that fund manager needs to satisfy several stakeholders conflicting objectives. As a result of having multiple stakeholder preferences fund manager may face challenges of satisfying all the stakeholders.

Several authors have advanced the stakeholder theory and has developed new variations, now including a vast amount of different aspects. Some scholars view the stakeholder theory as a foundation of growth in research of social science, while others take a normative ethics based approach that has its ground in moral principles (Jones & Wicks, 1999, p. 206). Donaldsson and Preston (1995) distinguish between the *descriptive stakeholder theory*, depicting how a firm behave, the *normative*, arguing for how firms should behave and the *instrumental*, denoting how a firm's performance is affected by behavior. The separation between descriptive, normative and instrumental stakeholder can be further be divided into the *social science based* and the *normative ethics based* research. The social science based approach include the *descriptive* and *instrumental stakeholder view*, while the ethical approach focus more on the issues related to the normative view (Jones & Wicks, 1999, p. 207). Jones and Wicks (1999, p. 210) further argues for a hybrid form of stakeholder theory called *convergent stakeholder theory*. This hybrid incorporates both normative and instrumental elements to ensure the moral and practical applications of the theory. The normative perspective includes the moral aspects of fund managers' requirements to make investments considered to be ethical and socially responsible, meanwhile the instrumental view explains how the behavior of fund managers affect the actual performance of the firm. This thesis intended to examine the need for fund managers to take several stakeholders into consideration in their decision-making process, which required a focus on the moral perspective as well as the instrumental application of the theory, in order to determine how the behavior of fund manager affect the overall performance of the company. The normative approach can be seen as the behavior of fund manager when trying to satisfy several stakeholders, meanwhile the instrumental explain how the firm is affected by this behavior.

### 3.3.1 Stakeholder Vs. Shareholder

The stakeholder theory has over the past decades been under extensive research and is frequently discussed in comparison to shareholder theory as the opposite view (Kakabadse et al., 2005, p. 289). There is constant debate regarding the polarization in corporate governance between the stakeholder and the shareholder perspective (Letza et al., 2004, p. 242). These contrasting approaches differ in their attempts to understand and justify the fundamental purpose of the corporation in regards to its arrangements and structures of governance (Ayuso et al., 2014, p. 415). The shareholder approach is seen as the traditional perspective to corporate governance and assume that corporations primary function is to satisfy their shareholders by maximizing the return on investment (Letza et al., 2004, p. 243). In contrast, the stakeholder theory undertakes a broader perspective of the corporations and are concerned with affected stakeholders' interests (Letza et al., 2004, p. 243). Jensen (2001, p. 9) goes onto say that the maximization of shareholder value implies having to satisfy one-single objective, meanwhile the stakeholder theory argues that corporations needs to take all stakeholders in consideration, which requires fulfilling more than one goal.

The shareholder view is by tradition the conventional perspective of fund managers, and they strive to generate as much profits as possible for the shareholders they represent. However, the DFIs primary objective is not only to achieve high financial performance, but also to contribute with financial support that results in social and environmental improvements for the overall society (particularly in poor and developing countries). Settel et al. (2009, p. 72) found that investments generating high profits for DFIs give rise to internal conflict. They mean that this is a result of the latent perception of profits in the

public sector, where profits are seen as bad (especially high profits) and a result of a *zero-sum game*. In contrast, when funds however underperform they become anxious. This fact also emphasizes the acceptance of lowering shareholder wealth in favor of stakeholder wealth (Settel et al., 2009, p. 72). DFIs have the mandate to make investments, not to achieve the highest possible return on investment, but to increase development impact objectives. Due to them having this mandate, the internal conflict is mitigated and the DFIs avoid the negative repercussions stemming from the perception of high profits being bad. Since fund manager have both commercial as well as DFIs investors in the fund the interesting question becomes: is the stakeholder view of DFIs reflected in the actions of fund managers and whether or not there is a trade-off between satisfying both shareholders and stakeholders.

As a result of the increasing prominence of stakeholder theory in management literature, it has been subjected to criticism by several researchers because it questioned the traditional assumption of profit as the preeminent concerns of managers (Laplume et al., 2008). Jensen (2001) argued that companies that aim to serve more than one 'single value-objective' will experience conflicts in their pursuit of trying to satisfy all stakeholders. Having multiple objectives is equal to having no objective, since it results in confusion as well as difficulties in measuring the different goals. He meant that stakeholder theory opposes traditional views of economic theory, which argues that maximizing shareholder value leads to maximized social well-being (Jensen, 2001, p.11). Likewise, Sundaram and Inkpen (2004, p. 353) argues that maximizing shareholder value should be the preferred corporate objective, since having to fulfill more than one objective increases the difficulty to govern and is nearly impossible to achieve. They also meant that maximized shareholder value will lead to enhanced outcomes for other stakeholders as well.

As previously mentioned, Milton Friedman argued that a business only social responsibility is to operate and undertake actions that will increase the profits of the company and thereby the shareholder value (Friedman, 1982, p. 112-113). Whether or not simultaneous stakeholder and shareholder maximization is possible, the fund managers working in the funds, in which DFIs have invested, would be required to not only act in a profit maximizing manner to achieve high financial performance. These individuals must also be able to incorporate a stakeholder consequences analysis to ensure an accurate assessment of the development impact.

In practice, there is often conflicts between shareholder maximization and criterion related to social welfare, which is represented by all the stakeholders of the firm (Renneboog et al., 2008, p. 1730). Firms that emphasize the shareholder maximization view does not consider the interest of the remaining stakeholders (Renneboog et al., 2008, p. 1730). According to Jensen (2001, p. 14) the problem with stakeholder theory is that it does not contain specifications regarding how the trade-off between different stakeholders can and will be done. It simply lacks criterion for the decision-making processes in a company, in turn making it difficult (if not impossible) to compete with firms sticking with the value maximizing proposition. Furthermore, Jensen argues that the lack of performance criteria makes the evaluation of managers problematic, since it leaves them the option to pursue own self-interests over the firms without the ability to hold them accountable.

The stakeholder theory weakens the internal control systems within firms when managers' have the power to act in their own interest rather than what is best for the company (Jensen, 2001, p, 14). The fund managers in this study need to satisfy the interest of both commercial investors and DFIs. Although, DFIs are not a typical investor in the sense that they also consider societal improvement dictated by their development impact objective. Since the decision-making process is not measurable it is very likely that more tangible and measurable financial performance results are used as an indicator of the overall performance. This may cause fund managers to focus more on promoting high financial performance rather than on development impact, since these are criterions that by nature are more easily measured and used as proof of high performance. If development impact is poorly measured, it would be reasonable to assume that DFIs somewhat lose their ability to hold the managers accountable for failing to live up to development impact requirements. This demonstrates how fund managers may act in their own interests, instead of those of the DFIs.

Even though many have criticized the stakeholder theory for not providing a clear framework for how different stakeholders should be treated, nor how to prioritize between different objectives, the stakeholder approach and the insights that it provides has proven to create exceptional performance in many firms (Freeman et al., 2004, p. 366). Freeman et al. (2004, p. 366-367) argues that creating value for the stakeholders will also generate value for the shareholders since they are stakeholders as well. Furthermore, they state that the shareholder view is more likely to foster unethical behavior since there is no moral ground for maximizing profits for the shareholder.

By incorporating stakeholder theory in the governance system, it facilitates a larger degree of legitimacy and justice, since it then includes ethical and moral aspects not considered by shareholder theory (Simmons, 2004, p. 605-606). Jensen (2001, p. 16) criticize the stakeholder theory because of the *multiple objective function* and notes that to establish long-term value, corporations needs to take stakeholders interest into consideration. Since the examined fund managers operates in collaboration with DFIs, it calls for high ethical and moral standards in the fund organization. Thus, a stakeholder perspective should be the preferred approach in order to take social aspects into consideration in the investment decision-making process. Although, as previously mentioned there may exist a conflict between the different objectives of the commercial investors of the fund and the DFI investors. The commercial investors might be more interested in increasing the shareholder value than the stakeholder one. Whether or not the fund managers believe that it exists a conflict and/or trade-off when trying to satisfy the objectives of different shareholders/stakeholders continues to be somewhat unclear

### 3.3.2 Stakeholder Theory and Social Responsibility

Stakeholder theory is often discussed in relation to issues regarding social responsibilities of corporations, since it seeks to define proper corporate behavior towards stakeholders (Driver & Thompson, 2002, p. 117). The stakeholder theory is relevant for addressing problems related to unethical and non-social responsible behavior among organizations (Laplume et al., 2008, p. 1180). Stakeholder management implies that the social responsibilities a corporation have to specific groups, as a part of its business orientation, result in challenges for managers to prioritize between different stakeholders (Carrol, 1991, p. 43). Managers of companies must develop strategies that will generate high return on investment for their shareholders in order to be competitive in the market, as well as make sure that stakeholders will not find these actions offensive (Harrison &



Freeman, 1999, p. 479). A central concern in the debate regarding social responsibility is whether corporations are looking to satisfy their stakeholders interest to pursue intrinsic objectives or just for economic reasons (Donaldson & Preston, 1995, p. 83-84).

However, just because a firm engage with its stakeholder does not necessary means that they act in regards to their responsibility towards them (Greenwood, 2007, p. 316). Greenwood argues that stakeholder engagement can be an act of both moral and immoral practices depending on the underlying motives and should therefore be considered as morally neutral. He developed a model for exploring the relationship between stakeholder engagement and the treatment of stakeholder from a moral point of view. The model revealed many levels of responsibility depending on the number of stakeholder groups that the firm take into consideration as well as the level of stakeholder engagement. This indicates that just because the fund manager engages in favorable actions for various stakeholders they do not unequivocally act in accordance to their personal moral beliefs (Greenwood, 2007, p. 316). It merely suggests that by aiming to satisfy the objectives of DFIs, other benefits are revealed as a consequence.

Specifically, interesting when examining fund managers managing funds in which DFIs are involved, is the fund manager's reason for satisfying DFIs objectives. Is it to satisfy intrinsic needs and/or values to do good that they possess or merely to increase financial support for the fund by living up to investor expectations. According to Viviers and Eccles (2012, p. 9) SRI is usually considered as moral investing, whereas the moral option and implications are taken into account in investment activities. On another note, non-SRI is neither considered immoral nor moral, but instead amoral neglecting moral implications. Although at a broader societal level this all depends on if societal interests are aligned with the investors interests as well as their ethical foundation.

Carrol (1991, p. 45) discuss stakeholder management in relation to three different approaches to ethical management; 1) *immoral management* describes how managers decisions and behavior is guided by what is considered to be right by others but their major concern is to achieve success and profit for the company; 2) *amoral management* describes managers that do not believe that their actions and decisions implies any ethical dimensions and is not considered to be neither moral or immoral and; 3) *moral management* implies that managers are not only concerned about following norms of ethical behavior but also to operate above established laws by applying ethical principles in their decision making process.

The DFIs' role to ensure positive development impact could be strongly dependent on the manager's views on local communities and the society as a whole. If the examined fund managers should be considered moral to the extent that they apply high ethical standards, considered to be over and above already established laws, an involvement of a DFI should not have any particular effect of the fund manager's behavior and decision-making. If they are on the other hand immoral, DFI involvement might require more effort to align their investment decisions with DFI development impact requirements. Whether or not their ethical convictions are aligned or not they still cannot discard development impact in favor of financial return completely.

There are many studies arguing that stakeholder monitoring affects the likelihood of corporations to integrate SR behavior in their organizations (Driver & Thompson, 2002, p. 111-112; Mitchell et al., 1997, p. 856). Since institutional investors and other financial

intermediaries have become an increasingly important actor in financial markets, their importance of monitoring and pressure corporations to behave in a socially and environmentally responsible way has also been growing (Armour et al., 2003, p. 545-546). Campbell (2007, p. 958) argues that it is more likely for corporations to behave in a socially responsible way when private and independent organizations, such as NGOs and institutional investors, are monitoring the corporate behavior. These organizations and institutions can influence the corporations through actions that constrains them from acting irresponsible (Campbell, 2007, p. 958).

Hence, it can therefore be argued that a DFI involvement in a fund could pressures the fund manager to act in a more socially responsible way by monitoring their actions and have certain requirements that the fund manager has to fulfill. However, DFI rationale for investing in private equity funds somewhat lack safeguards, which has resulted in some cynically questioning the DFIs attraction to funds. Bracking (2012, p. 275) means that these cynics argue that DFI fund investments are used to avoid adhering to restrictive policies connected to direct investments, while they counterclaim by arguing that their involvement enables funds to be obtain to higher standards and increases their civilizing influence. Although, since they normally take a minority shareholder position, the DFI claims seems to lack support in research. Bracking (2012, p. 275) further argues that investors pool their funds and private equity funds conduct business from a distance which makes them *distal investors*. Their main purpose of this is to avoid liabilities and risks of reputational, pollution and regulatory nature as well as reduce escalation costs and community opposition regarding environmental and societal impacts.

### 3.4 Concluding Conceptual Framework

The theoretical research review provided above resulted in the following model that we mean help explain the DFI and fund manager relationship and how DFIs affect their behavior. It concludes how the DFIs (principle) control the fund managers (agent) as well as how an optimal contract may be used to determine a funds mandate. Moreover, their level of involvement in accordance with Settle's et al., (2008) *direct-involvement model* and *hand-off model* also provide an indication of their impact on fund manager decision-making. We also found it necessary to identify potential conflict of interest in order to see if there is any strain between the involved parties.

Also we find it important to include the DFI-imposed ESG considerations and how those plays into their relationships as well as if the fund managers perceive there to be a potential trade-off between financial performance and development impact. Moreover, in order to comprehend the relational aspects, it useful to include Junkus and Berrys' (2015, p. 1178) theorem of '*doing good but not well*' or '*doing well by doing good*' when ethical principles are imposed by the DFIs. The fund manager behavior is also more clearly determined by positive/negative screens or the '*triple bottom line*' when making investment choices. This, together with understanding if fund managers engage in *affirmative* or *avoidance* behavior, a fund manager profile start to take form. All his is tied up into the effect it has on stakeholders and shareholders and how these are taken into consideration by involved parties.

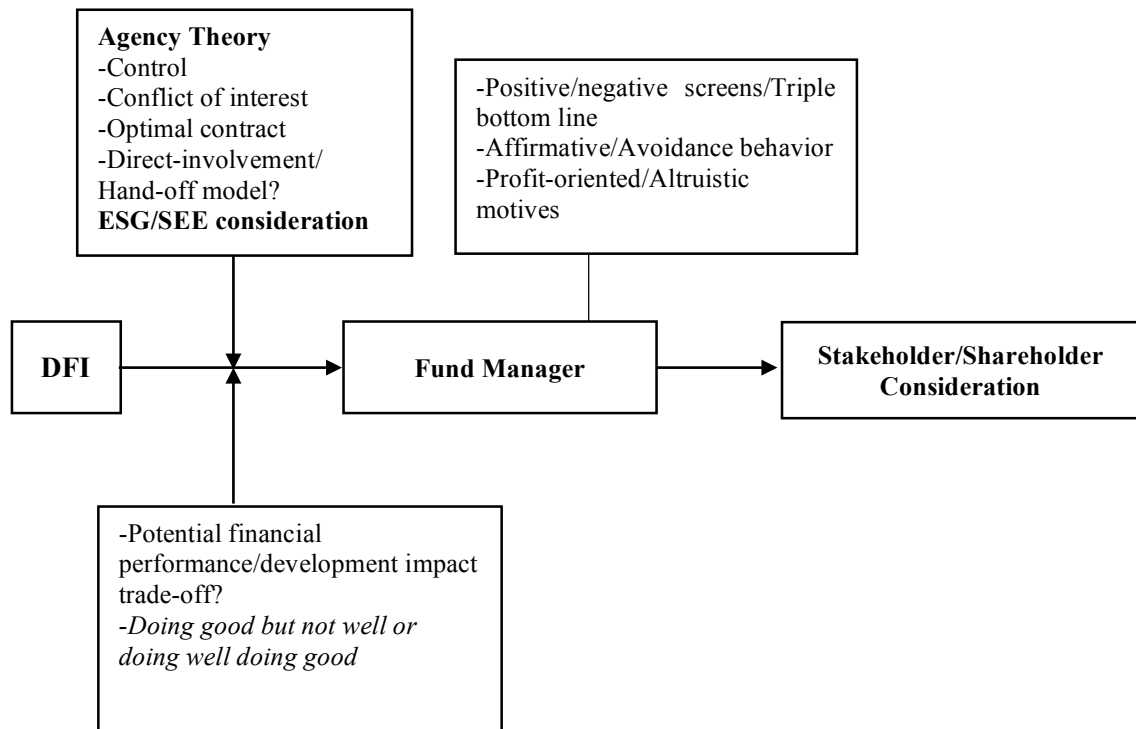


Figure 1. Concluding Conceptual Framework

## 4. Method

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*This chapter begins with addressing the research design and present arguments for choosing a cross-sectional design to answer the research question. Thereafter, we move on to discuss the reasons for conducting semi-structured interviews, utilizing a purposive sampling method as well as the design of interview guide. Lastly, we argue for the appropriateness of undertaking a thematic analysis and describe the different phases leading up to four different themes that constitutes the basis for our analysis.*

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### 4.1 Research Design

The research design refers to the general strategy selected to answer a particular research question and involves relevant elements for demonstrating the consistency in the research design (Saunders, 2012, p. 159-160). By establishing a coherent research objective and a distinct structure, misconceptions can be avoided as the study progresses. Consequently, the research design will provide the reader with a clear direction and predefined research question, which is; *How does development finance institutions' involvement in a private equity fund affect fund managers' investment behavior and decision making?*

There are several approaches and variations of the research design that are frequently mentioned in research literature (Bryman & Bell, 2015, p. 53). Bryman and Bell (2015, p. 53) discuss five different approaches to research design; *cross-sectional*, *experimental*, *case study*, *longitudinal* and *comparative design*. When the research design is determined before the main data collection method, the purpose is usually to quantify data of some sort, however this does not necessarily exclude the use of qualitative methods (Robson, 2002, p. 95). A cross-sectional design with a fixed approach was deemed as most appropriate for this study.

Even though a cross-sectional design is mainly used in quantitative research, there are several scholars that emphasizes the utility of cross-sectional design in qualitative research usually in connection to structured or semi-structured interviews (Saunders, 2012, p. 190; Bryman & Bell, 2015, p. 66). Levin (2006, p. 24) also underscore the usefulness of this design in descriptive studies when the goal is to determine prevalence. Utilizing a cross-sectional design commonly includes several cases where the data is collected at one point in time (Mann, 2003, p. 56). The major advantages of approaching a research question with a cross-sectional design is that it is relatively cheap and does not require a lot of time (Levin, 2006, p. 25; Mann, 2004, p. 57). What is important to note however, is that they do not make any causal inferences and can only provide a snapshot of the examined subject (Levin, 2006, p. 25)

Similar to most other studies, obvious resource and time constraints made more than one interview per participant unrealistic. An alternative approach to overcome these constraints could have been to conduct a case study, which can provide in-depth insights into the DFI investment implications on fund manager behavior and entailed decision-making processes from a SR perspective. The rationale for not conducting a case study was simply because of difficulties with getting in touch with the participants, financial constraints and maybe even more importantly due to geographical distance. Moreover, utilizing a comparative design was neither deemed appropriate since that would according to Bryman & Bell (2015, p. 68) entail contrasting two or more cases utilizing identical methods. Since we did not come across any studies utilizing a similar research design we

neglected this course of action. Moving forward with a longitudinal design would, according to Fraley and Hudson (2014, p.89), entail repeatedly following up with participants over a short period of time as well as involve sampling of individual behaviors, feelings and thoughts. As previously emphasized this study is constrained to a strict deadline, nor have the necessary resources for recurrent contact with involved fund managers, thus making this approach less serviceable to answer the research question.

## 4.2 Data Collection

Qualitative interviews were used as the main method for obtaining primary data in this study. According to Bryman and Bell (2015, p. 479) as well as DiCicco-Bloom and Crabtree (2006, p. 314) the qualitative interviews is the most widely used data collection strategy in qualitative studies, hence making our choice easy to motivate. This method provides the interviewer with an opportunity to collect rich data and investigate the answers of the participants in-depth (Saunders et al., 2012, p. 378). Moreover, the qualitative approach allows the interviewer to depart from the planned schedule and ask follow-up questions outside predefined schemes (Bryman & Bell, 2015, p. 480-481). In order to increase the understanding of the participants' perception of how a DFI involvement affect their behavior, a qualitative interview approach was deemed as necessary. Giving the interviewees the opportunity to elaborate and discuss the answers as well as ask follow up questions were important to achieve the wanted in-depth understanding. Even though a quantitative survey would contribute to more generalizable conclusions, it would most likely not result in an accurate probe of behavioral tendencies.

### 4.2.1 Semi-structured Interviews

The most widely used interview methods in qualitative research are *unstructured* and *semi-structured interviews* (Bryman & Bell, 2015, p. 479). Both techniques are considered to be flexible in nature and allows the researcher to interpret the collected data. Unstructured interviews do not follow a predefined script but instead have a tendency to resemble a normal, every-day conversation (Burgess, 2002, p. 84-85). DiCicco-Bloom and Crabtree (2006, p. 315) mean that unstructured interviewing originate from an ethnographic tradition of data gathering, whereby the ethnographer make observations from the sidelines, record occurrences in the field and observe and/or join the activities of the ones studied. Semi-structured interviews incorporate a type of schedule guided by different themes in need of covering, in order to ensure consistency (Qu & Dumay, 2011, p. 246). Moreover, the semi-structure interview method is most appropriate when the researcher has a clear focus and aims to compare different cases (Bryman & Bell, 2015, p. 483-484). DiCicco-Bloom and Crabtree (2006, p. 315-316) further argues, that semi-structured interviews constitute the sole data source, while unstructured interviews in a qualitative research project are conducted in conjunction with observational data. To clarify, the key features of a semi-structured interview are; 1) scheduled at a designated time in advance; 2) outlined around predetermined questions; 3) last at least 30 minutes; 4) located outside events occurring every day and; 5) emerging questions from dialogue (Whiting, 2008, p. 36).

The structured interview approach is on the other hand based on predetermined open-ended questions. However, this comes with difficulties in regards to adapting questions to studies of a flexible approach and is more appropriate for fixed designs whereby the data content analysis can be effectively transformed to quantitative form (Robson, 2002, p. 270). Structured interviews are often utilized in prior hypothesis testing, where the analysis and stimulus (questions) are standardized (DiCicco-Bloom & Crabtree 2006, p.

315-316). Moreover, Alvesson and Deetz (2000, p. 70-71) states that fully structured interviews are mainly used for surveys in quantitative research.

Since this study set out to examine occurrences that had not previously been extensively examined, a flexible design was deemed to be vital. However, conducting completely unstructured interviews did not seem as very fitting due to our limited prior knowledge regarding development finance and behavioral studies. Having no structure would have impeded on our ability to skillfully steer the conversation in the interview in the necessary direction. Additionally, due to the standardized characteristics of the structured interview design and the lack of previous formulated hypotheses regarding behavioral tendencies within the area of study, testing prior hypothesis as well as transforming the result to quantitative form was seen as unsuitable. Therefore, a semi-structured design was arguably the best option, because it provided both a value-adding flexibility, letting us as interviewers, to not be constrained by the interview guide, and a structure necessary to provide a basis of knowledge regarding the area of research.

#### 4.2.2 Telephone Interviews

The semi-structured interviews were conducted via telephone for convenience purposes, mainly due to geographical and logistical issues, but also due to resource limitation. Communicating with respondents over the phone comes with risk in need of clarification. Saunders et al. (2012, p. 404) underline that a failure to establish personal contact and mutual trust with participants can lead to reduced reliability in the sample, when questions of a sensitive nature is introduced. Furthermore, Robson (2002, p. 282) conclude that telephone interviews presents challenges due to visual cues elicited from the participants are not observable. In contrast, there are authors (Fenig et al., 1993, p. 896; Sweet 2001, p. 134) that mean that non face-to-face interviews is more effective when asking sensitive questions due to the anonymity that it offers. Fenig et al. (1993, p. 896) argues that telephone interview alleviates the difficulties of accessing respondents due to face-to-face interview reluctance, shifting work schedules and residency in dangerous locales. More importantly, it increases the validity of responses resulting from the granted anonymity, thereby reducing the involved embarrassment of socially and emotionally charged questions in face-to-face situations (Fenig et al., 1993, p. 896). Furthermore, Rohde et al. (1997, p. 1597) concluded that there is no qualified justification that face-to-face communication advantages override the logistic and economic advantages of interviews over the phone.

Conclusively, the time and costs associated with face-to-face interviews as well as distance impracticality reasons, telephone was considered to be the best tool to obtain relevant data for this study. Since the interviews were not conducted through video-calling due to technical issues, we could not identify visual cues. Although, this created a barrier that should have made the participants more comfortable to answer sensitive questions.

The choice of conducting phone interviews is further strengthened in the study '*Communicating Corporate Responsibilities to Investors: The Changing Role of the Investor Relations Function*' by Hockerts and Moir (2004). They examined the role of investor relations as well as the implications of investor communication of corporate responsibility. The authors assumed a semi-structured interview approach as their main data collection method, conducting twenty individual interviews of which eight were conducted face-to-face and the remaining 12 via telephone (Hockerts & Moir, 2004, p.

89). Throughout the study they noted that the investors in general preferred telephone interviews when approaching issues related to social responsibility (Hockerts & Moir, 2004, p. 91). Their conclusion, further diminishes the critic of the telephone interview method being limited when trying to understand respondents as well as emphasize its favorability in relations to the ones interviewed.

#### 4.3 Selection of Participants

It is important that the sample selection reflect the views of DFIs and fund managers regarding their relationship and how DFI involvement affect fund manager behavior, and therefore this study utilized a *purposive sampling method*. This method is a form of *non-probability sampling* aiming to gather participants in a strategic way to ensure their relevance to what is to be examined (Bryman & Bell, 2015, p. 429). The initial strategy for contacting relevant business professionals included identifying funds investing in Africa by looking at Nordic DFIs' websites. Thereafter, the identified funds were contacted through information provided on their respective websites, making it possible to reach fund managers managing funds in which Nordic DFIs invested. Since, the response rate of this initial contact was equal to zero, a change of strategy was required. The new approach was to contact responsible investment managers working for Swedfund, Norfund, Finnfund and IFU with the purpose to collect contact information of specific fund managers. This resulted in the acquiring of email addresses and phone numbers to relevant fund personnel, who in turn were contacted. Furthermore, some of the interviewees were contacted after been recommended by other participants. This endeavor resulted in eight people that were willing to participate.

The rationale for assuming this sampling method is its appropriateness for in-depth analysis of behavior, which would otherwise be difficult to obtain. The study does not seek to generalize to a specific population but instead to get a deeper understanding of the behavior of selected fund managers. In the purposive sampling method, the selection of participants is based in terms of relevant criteria enabling answering the research question (Guest et al., 2006, p. 61). This type of sampling is also commonly known as *judgmental sampling*, due to its judgmental approach in the process of participant selection (Saunders et al., 2012, p. 287). This study's main criterion for the selection process were the following; 1) the participants need to be a fund or DFI manager and; 2) the participant needs to manage funds investing in Africa in which a DFI has invested, or a DFI that has invested in a fund.

When deciding the sample size of participants many researchers emphasize the importance of *theoretical saturation*, which should be used as a criterion for justifying the sample size in the purposive sampling method (Guest et al., 2006, p. 59-60; Fossey et al., 2002, p. 726). However, few studies leave any guidelines for estimating and determining when the sample size have reach saturation (Guest et al., 2006, p. 60). Some study however does provide guidelines for determining the sample size. For example, Bernard (2011, p. 154) argues that a sample size between 10-20 participants is sufficient to understand the central categories in any cultural domain or life experience study. Moreover, Guest et al. (2006) investigated data of sixty in-depth interviews to determine the saturation of the sample in order to make recommendations about appropriate sampling size in qualitative interviews. They found that saturation was reached after twelve interviews and the main themes were identified after only six interviews, which conclusively means that *a sample of six is enough to make meaningful interpretations* (Guest et al., 2006, p. 78). Romney et al. (1986, p. 326) concluded that it is possible to

get sufficient information from only *four samples*, although the minimum sample depends on the competence of the participants. After the interviews we concluded that the participants had relatively high positions in the funds/DFIs, at least one university degree as well as a high level of knowledge/competence within their area of work. Being a DFI or an investment manager making investments into the socially responsible investment space does not only require high education, but also being acquainted with sustainability frameworks. In accordance with the conclusions made by Guest et al. (2006) as well as time and resource restrictions we therefore found that the sample of eight to be sufficient in order to reach saturation.

Morse (2000) argues that five factors need to be taken into consideration when determining saturation of the sampling; 1) the broader the scope is, the more participants as well as time is needed to reach saturation; 2) the more well-defined and clear topic the fewer participants are required, in comparison to a less graspable topic; 3) The higher the quality of the interview is, in terms of the participant's experience of the topic and willingness to provide the researchers with their knowledge as well as the length of the interviews, the less participants are needed; 4) the more interviews conducted per participants, the reason for a smaller number of participants is more easily motivated; and 5) the use of *shadow data* - participants discuss own and others' experiences, how they resemble each other and why - increase the speed of the analysis, but also enables moving beyond one single participant's personal experience and provides rational explanations of differences.

Since this study undertook a relatively narrow scope by examining specific funds in Africa that DFIs have invested in, enabled us to say that the saturation of the sample was reached. After having interviewed a few of the participants we realized that the answers to the questions were very similar among them, and by the eighth one we argue that saturation was reached in most parts of the interview guide. Even though there are several factors affecting human behavior and their decision-making, the study's narrowly defined topic should limit the need for a high number of participating fund managers to grasp their actions. As previously mentioned there should be limited risk in presuming that the fund managers level of experience is high due to the level of education required to carry out the work that is expected of them.

On another note, we find it important to underscore that the sample may have suffered from convenience sampling deficiency as the fund managers were selected in accordance to their availability. However, the effect on the results should be relatively insignificant since the main objective of the examination was to study the behavior of fund managers in-depth, and not achieve high generalizability. Since all the participants, except Jan Rixen, were anonymous in the thesis. Aliases/fictitious names were substituted for their real names and the names of the funds to protect their integrity. Jan Rixen gave his consent to use his real name instead of an alias, which is motivated by his position as the director of EDFI providing the results with credibility. The fictitious name as well as the length of the interviews is listed in Table 2 below.



Table 2. Overview of Interview Length

Name of Interviewee	Interview Length
Jan Rixen	55 minutes 2 seconds
Jessica	30 minutes 55 seconds
Lee	57 minutes 13 seconds
Luke	60 minutes 1 second
Milton	33 minutes 13 seconds
Mohamed	49 minutes 12 seconds
Richard	32 minutes 1 second
Walter	39 minutes 19 seconds

#### 4.4 Design of Interview Guide

Qualitative interviews in general contains some form of interview guide or predefined schedule containing a list of topics in need of covering during the interview as well as suggested probes used for the following-up questions to obtain more detailed information (King, 2004, p. 15). However, the level of detail and structure in the interview guide may vary between different researcher (King, 2004, p. 15). Due to the fact that our research involved semi-structured interviews, an interview guide was designed to help retain focus on the research question and to ensure that all relevant topics were covered.

Many researchers emphasize the importance of preparation before the actual interviews take part in order to alleviate and reduce the problems that may occur during interviews (Robson, 2002, p. 274; Saunders et al., 2012, p. 328; Turner, 2010, p. 757). According to Robson (2002, p. 274) the main structure of the interviews can be prepared in advance and should consist out of; 1) a selection of items or questions to ask the participants; 2) suggested probes or prompts that could be used to further investigate the answers; and 3) a pre-proposed sequence of the questions to guide the interviewer, even though it may change during the interviews. The interview guide can be seen as a working projects that can be modified and adjusted by adding new topics and probes that originally was not included in the interview guide but have emerged during the course of interviews (King, 2004, p. 15). Our interview guide consisted out of a list of 21 questions (see Appendix 4) that was based on the scientific research review, incorporating concepts within SRI/DFIs, agency theory and stakeholder theory. The questions in the guide was divided into groups in accordance to a specific topic, and the grouped questions accompanied by an explanation regarding their intention (see Appendix 4). The topics covered was; *background, general questions about the investment process and DFIs involvement, investment screens and personal motivations, control, the role of DFIs, stakeholder/shareholder considerations as well as compensation and financial incentives*. Some modifications were made to the guide after the first couple of interviews in order to obtain more elaborated answers from the participants.

##### 4.4.1 Designing the Questions

Qualitative interviews usually consist of questions that is open-ended in nature in order to allow the participants to contribute with their own perspectives and experience as well as encourage the participant to disclose more information (Chenail, 2011, p. 256). The interview questions were designed to encourage the participant to reveal as much information as possible, and therefore the questions were asked in a way which required

the participant to answer in detail and provide relevant examples of certain situations or experiences. The process of constructing effective research questions is essential in order to gain as much relevant information as possible and reduce the occurrence of misunderstandings (Turner, 2010, p. 757-758). Leading and long questions as well as multiple questions should be avoided to not confuse the participants or lead them in any direction (Robson, 2004, p. 275). In the beginning of the interviews it is important to gain confidence and establish trust with the participant (Saunders et al., 2012, p. 331). Therefore, it is preferable to start the interview with questions that is easy to answer and contributes to the participant feels confident and relaxed (King, 2004, p. 17).

Questions that are more difficult and/or sensitive should be saved for further in, into the interviews (King, 2004, p. 17). In the beginning of the interview we asked trivial background questions of a more general nature regarding the subject, to ensure participants' feeling comfortable. Thereafter, we went onto ask questions related to the different concepts defined in the scientific research review. Depending on the answers of the participant, follow-up questions were asked to get more details and further dig into the participant's personal view. Examples of these are the predefined probes (see Appendix 3). We avoided leading and too long questions, but of course sometimes this occurred inevitably. All the questions were not asked to all participants and some questions were refined to better fit the particular participant.

#### **4.4.2 Ensuring Quality of the Interview Guide**

To certify the quality of the interview, guide a pilot study can be performed to identify potential problems with the questions or sequence that otherwise would not have been detected before the actual interviews (Van Tejligen & Hundley, 2002, p. 33). A pilot study provides the researcher with an opportunity to make modifications and adjust the questions based on the performance of the pilot study (Chenail, 2011, p. 257). However, the pilot study is not always practical e.g. when there are few participants and the researchers do not want to lose valuable information by conducting a pilot study on some of the participants (Chenail, 2011, p. 258). Since this study only had eight participants available for interviewing, we did not want to perform a pilot study with any of them since that would mean a loss of valuable information and the risk of not reaching saturation. However, due to the obvious advantages of conducting a pilot study we considered other options. Chenail (2011, p. 258-259) presents an alternative approach to a pilot study, which involves interviewing the investigator to identify which questions seems to work well in the interview situation. When the first draft of the interview guide was finished we tested the questions on each other to identify needed adjustments. Further, we asked our supervisor and classmates for comments and feedback to verify that the quality of the interview guide was up to par. In hindsight, we recognize that some questions were a bit unnecessary and some could have been added to obtain more enriching answers as well as interesting information to analyze. Although, it is of our opinion that the interview guide was a helpful tool to ensure consistency in the different interviews as well as reducing the risk of failing to cover all topics in all interviews.

#### **4.5 Data Analysis**

According to Attride-Sterling (2001, p. 385), contrary to quantitative data, there are few accepted and well-established rules for analyzing qualitative data. The qualitative data analysis has neither developed the same level of analytical procedures of codification as quantitative methods (Bryman & Bell, 2015, p. 579; Robson, 2002, p. 456). Also, due to the fact that qualitative data are complex in nature, it needs to be grouped, restructured

and/or condensed before the analysis can take place in order for it to make sense (Saunders et al., 2012, p. 546-548). One of the most common methods utilized to analyze qualitative data is the thematic analysis (Attride-Sterling, 2001, p. 387; Bryman & Bell, 2015, p. 599).

Thematic analysis can be described as a method for discovering and recognizing common patterns or themes in the transcribed data (Braun & Clarke, 2006, p. 79, 84). The thematic approach to analysis provide the researcher with a tool for systematization and exploring the richness of the collected data (Attride-Sterling, 2001, p. 402). It also provides the researcher with a flexibility and can be used in both inductive and deductive analysis (Braun & Clarke, 2006, p. 79). Two of the most widely used approaches in qualitative analysis is *analytic induction* and *Grounded Theory*, which implies a back-and-forth process of the collection and analysis of the so far collected data (Bryman & Bell, p. 581). However, these methods incorporate an inductive approach where the collected data is used for building new theories that have emerged throughout the process of data gathering (Bryman & Bell, p. 581). Since the aim of this thesis is to makes sense of the collected data from a theoretical perspective by using a deductive approach, the thematic analysis was deemed to be appropriate for the study. It allows us to analyze data in a structured as well as flexible way, in order to gain as much rich information as possible.

#### 4.5.1 Thematic Analysis

As previously discussed a deductive approach was undertaken in this study and therefore the themes will be derived from already existing theoretical frameworks. Although, the thematic analysis is widely used in qualitative research, there are no clear framework for its application (Attride-Sterling, 2001, p. 386; Braun & Clarke, 2006, p. 77). However, Braun and Clarke (2006, p. 86) emphasize six phases for structuring and analyzing conducted data. The *first phase* involves taking notes and carefully reading through the transcribed data. This leads up to the *second phase*, which includes generating initial codes that emerged during the interviews (Braun & Clarke, 2006, p. 87-88). Once the interviews with a fund manager had been conducted, the data were transcribed into written form for simplicity reasons, but also to ensure accuracy. According to Bryman and Bell (2015, p. 493) this is vital in order to ensure the elimination of misinterpretations and mishearing that may have occurred.

Thereafter, the transcribed data were broken down into identified codes. The coding process is a way of organizing the data into meaningful segment to facilitate the searching for themes (Tuckett, 2005, p. 81). When data was initially analyzed and different codes had been identified, the searching for themes in *phase three* began. This phase involves organizing the codes into broader themes that emerged throughout the analysis (Braun & Clarke, 2006, p. 89). When the coding process were finished, mind-maps were used for analyzing the relationship between different codes and sort them into broader themes.

The *fourth phase* of reviewing the themes, referring to the process of refining the dividing of themes previously identified (Braun & Clarke, 2006, p. 91). The themes developed during the initial phases were refined by separating those that did not belong together and merge the ones that seemed to fit together. Some of the themes were removed, since the data lacked sufficient support. When the development of themes has reached a satisfactory level, the *fifth phase* of defining the overall scope of the themes were specified (Braun & Clarke, 2006, p. 92). We identified four themes where each was named after the aspects that each theme captured. The following themes identified was;

DFI investment into funds, the relationship between DFIs and funds, stakeholder management and lastly fund manager’s motives. The main themes will be further explained in the *Empirical Findings* of this thesis. Furthermore, sub-themes were derived from the main themes, to specify the content even more (see Figure 2). The *final phase* of the analysis involved constructing the report and demonstrating the validity of the analysis in relation to the research question (Braun & Clarke, 2006, p. 93). By connecting the empirical findings to the scientific research review we were able to find support for some of our assumptions as well as enable new insights.

### 4.6 Overview of Themes

The figure below visualizes the four main themes that was identified in the thematic analysis. Under each respective main themes there are sub-themes that provide an understanding of what each main theme includes.

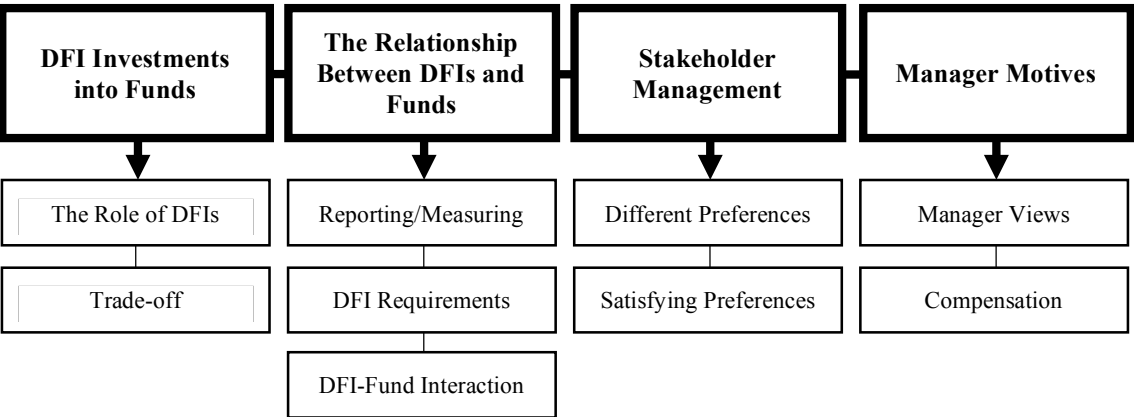


Figure 2. Overview of Themes

## 5. Empirical Findings

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*In the following chapter we begin to present the interviewee profiles and later moves on to the empirical findings obtained from the semi-structured interviews. The empirical findings are divided into the four identified main themes; DFI investments into funds, The relationship between DFIs and funds, Stakeholder management and Fund manager's motives. The themes capture different concepts related to the research question and is further divided into sub-themes in order to specify the content even more. Lastly, a thematic summary of conclusions is provided (see table 2).*

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### 5.1 Interviewee-Profiles

#### **Jan Rixen**

Jan Rixen is the director of the association of the European Development Finance Institutions (EDFI) in which 16 of European DFIs are members. He has a bachelor degree from Copenhagen Business School, with a major in tax and audit in order to become a chartered accountant. During the past 35 years he has been posted around the world in different positions in the private sector. He has experience in working with DFIs from running a Nordic (Denmark, Sweden, Norway and Finland) funded investment fund in sub-Saharan Africa over a period of ten years. Today his main task is to coordinate and engage in operational activities among the EDFI members as well as raise funding.

#### **Jessica**

Jessica has an educational background in engineering and a MBA at INSEAD University in France. She is currently working for **Fund 1** where she is, apart from being a fund manager, the CEO. Before joining Fund 1 in 2014 she gained experience in banking from working for a bank in Portugal, which included managing a business unit that made direct investment as well as through funds in emerging markets. Her role at Fund 1 is to encompass the investor relations by supporting fundraising and facilitate interactions with the investors of the fund.

#### **Lee**

Lee is an investment manager for **Fund 2** and have a major in mathematics and a minor in finance from Claflin College in South Carolina, US. After his studies he worked at an investment bank and later moved on to advisory services as a research associate for a capital fund. He began working for **Fund 2** in 2010 as an investment officer, from which he got promoted to a senior IEO, and is currently an investment manager. Prior to his career in **Fund 2**, he has been involved in financial services and other finance projects. All his investment and capital deployment experience is gained over the last six years.

#### **Luke**

Luke is an investment manager and has worked within M&A and leveraged finance for over ten years. Furthermore, he has experience in investment banking with leverage buy-outs and issuance of debts. He has worked in his current position in **Fund 3** since 2013 and they invest only in one specific African country, mainly in mid- to small size companies not limited to any specific types of industries.

### **Milton**

Milton is an associate partner in **DFI A** and manage their portfolios in China, India and other markets. He started working in the fund 2005 and has only been involved in socially responsible private equity. He has been working in the private equity fund space for nearly 10 years and has an MBA as well as LL.M (business law). His main responsibilities include sourcing fund investment opportunities, performing due diligence on those opportunities and managing the investment thereafter. In addition, he is also responsible for legal work and restructuring of funds.

### **Mohamed**

Mohamed is a program manager for **DFI B** and has a bachelor in business administration in management as well as in economics. He has a master's degree in international business and development with a focus on international trade and development and also a MBA. In his work as a program manager he goes through projects from the DFI-members, evaluate if it should be financed and provide DFI investment managers with project proposals to go through to approve or reject. He does not come from a straight, clear-cut oriented private equity background and then migrated into SRI private equity, but instead all his experience has been tied to SRI.

### **Richard**

Richard is the managing director for **Fund 4** in Zambia. He founded it together with his business partner in 2009 after finishing his MSc in economics and it was initially capitalized by himself, friends and family. The fund focus on corporate finance advisory, market entry and early stage investments in all types of sectors. In 2013 they also started a seed fund together with a local partner that invest in start-up businesses.

### **Walter**

Walter is the head of the African private equity at **Fund 5** and has been working for the fund since 2009. He has a bachelor of commerce with honors and a master's degree in philosophy and economics from Oxford. Altogether, he has worked in private equity for 14 years in different positions.

## **5.2 DFI Investments into Funds**

This theme discusses the participants' views regarding the DFIs role as an investor and how their involvement is seen to affect the market in which they invest. The interviews address the implications DFIs have had for their fund and their investments as well as their significance in affecting communities and society as a whole. They further discuss their perception on how development impact objectives imposed by the DFIs, affect their investments decisions, and if they deem it necessary to sacrifice some level of financial performance in favor of its progression. Commercial viability in relation to ESG criterion is also explained in the context of their work and how they take them into consideration.

### **5.2.1 The Role of DFIs**

Jan Rixen means that the DFIs role is to help develop local financial markets, specifically in middle and low income countries. Since the poorest countries in the world are concentrated in Africa, the governments providing funds to DFIs focus their efforts to this region. DFIs are engaged and involved in most projects in Africa and provide long-term financing with the purpose to help ventures take off. Without DFI investment there is little available funding for long-term investments outside of telecommunication and the oil industry. According to him, DFIs always take a minority shareholder position and let

sponsors operate as well as run the projects. He also points out that DFIs always require interest or/and profit on the equity investment and that they always stay in the projects as long as it is deemed necessary. When their involvement is no longer required for the project to be sustainable on its own, they pull out. Moreover, Jan Rixen underscored that DFIs have a strict additionality requirement, meaning that if project is commercially sustainable DFIs will not get involved. The only reason for their existence, is to gap the mismatches on the market and to provide long-term financing where there is none. He also said that if somebody else are willing to go in and finance a project long-term, DFIs step out.

Jessica believes that DFIs are more analytic and have very sophisticated ways of assessing market risks compared to fund managers and traditional finance providers, such as banks or other institutions. She means that these providers are usually more risk averse to emerging market risks compared to DFIs which have strong individuals and institutions behind them. She goes on to point out that DFIs also have the experience of emerging market investments having seen “...*the good, the bad and the ugly*...” meaning that they know how to reach out, asses risks and time opportunities. Furthermore, she does not believe that DFIs should influence fund management strategies, since that would be unfavorable from a liability standpoint. Instead it is better that DFIs choose where to invest their capital by utilizing a very detailed due diligence process. By doing so Jessica mean that they can understand the fund manager, how the fund is structured and define their mandate.

Lee means that DFIs plays a crucial role in terms of contributing to private sector development in Africa. They understand the continent, its existing potential and the risks. Furthermore, Lee underscores that the DFIs’ goes beyond commercial returns, to also focus on social fiber and intangible contributions. According to him DFIs have been actively involved in the African continent’s private equity fund industry development and have had huge implications on its proliferation. This has according to him, helped address the gap in private equity funding by making capital available to starving entrepreneurs and businesses that would otherwise not be able to realize their true potential. Lee thinks that the DFIs long track-record and experiences regarding investments in Africa is very useful when faced with issues on how to approach something. This is mainly due to the fact that they provide important advice and exchange helpful ideas. He also points out on the other hand, that for all intents and purposes the fund make the investment decision after submitting investment proposals to the investment committee for voting.

Luke finds DFIs essential for the development of the private sector in underdeveloped markets and means that without DFI investments his fund would not even exist, nor would it have capital for their portfolio companies to expand their businesses. Specifically, in regard to Fund 3, he means that there is currently no private sector agent except DFIs that are certified to take such high risks in the type of asset class his fund operates within. According to Luke, the DFIs affect the funds asset allocation and follow the principle of additionality, acting as first mover agents that finance early stage markets. Without the DFIs Luke means that the fund’s investment criterion would *not* be circumvented by the same levels of transparency, frameworks of governance, and the broad due diligence scope used in investment opportunity analysis. It also requires the fund to look at the private equity market in a value-added way where financial, tax and legal metrics must be complemented by ESG ones. Having DFIs as a shareholder also means more monitoring regarding ESG criteria. Luke means that DFIs has “...*set a parameter of*

*transparency to the development community at large.*”. He continues by stating that no single individual or private equity investor would be willing to take the same risks to invest in a frontier market. One example he brought up was one Nordic DFIs that invested in Fund 3’s fishing sector. They provided the fund with Norwegian experts in fishing that conducted in-depth research on the pelagic seas outside the coast of an African country, contributing with insights, technical expertise and analysis used to present the investment to the investment committee. This expanded the fund’s pool of resources which would otherwise have been outside of their reach.

Milton means that DFIs represent a positive and important role, although underscore that they will not necessarily change the macro economic framework of a country. DFIs tend to be more engaged and sensitive to where the money is being invested than other investors, because of potential reputational risk. He means that since they manage government funds and taxpayers’ money they have a fiduciary responsibility as well as need to be very conscious and sensitive when spending that money. He further points out that DFI investments has a strong demonstration effect and gives an example of an investment in a Vietnamese furniture manufacturer. The investment in question may have created and sustained one thousand jobs, and those jobs resulted in a *multiplier effect* that helped sustain another 10 000 jobs to shops and merchants, where those first employed people shop. DFI investments shows that a company can be financially sustainable while at the same time adhere to environmental, social and governance standards.

According to Mohamed, DFIs are crucial for supporting sustainable economic growth in all developing countries, not only countries in Africa. However, he means that DFIs should coordinate more with other actors, such as public sector actors, institutions and NGOs. He means that in the past, the public and private sector, the NGOs as well as other actors was playing in their own field. On the other hand, there seems to be an understanding that collaboration creates useful synergies. Moreover, Mohamed means that DFIs generates more commercial investments, since they act as *risk catalysts* for other investors. One example that he gave was the DFI investments in telecommunication in Africa. Before they entered the market the risks were deemed too high by private investors, although due to the DFIs’ willingness to support the sector, commercial investors pulled in. After proving the commercial viability DFIs began to pull out and leave the market to other investors.

According to Richard the DFIs have a “...*big balance sheet*...” to impact, referring to their financial power. He also points out that DFIs contribute to markets in which there is a shortage of capital, like for example in Zambia. However, he sometimes finds them to be rigid and bureaucratic, since it can take a lot of time to get financing. For example, a local loan in Zambia takes around two months, while a similar loan from a DFI can take a year due to the extensive processes and required paperwork. Richard therefore seem to find it easier to deal with local banks and financial institutions. On another note, those options become insufficient if the project enters the multi-million-dollar realm, hence increasing the role of DFIs. Moreover, Richard does not perceive that an DFI involvement affects his overall investment strategy, insisting that the fund already have similar objectives. Accordingly, DFIs are neither particularly active investors and does not contribute to a large extent. He said “*Once they're in, it's not like they are active, interested parties.*”. Furthermore, Richard does not believe that DFIs should engage more actively as investors since they are bureaucrats and public employees lacking passion and knowledge of the



real business in Africa on the ground. Conclusively, due to this mismatch he does not see any benefit of them increasing their involvement and becoming more active investors.

Walter thinks that DFIs play a massive role, not only in terms of economic and commercial returns, but also have development impact score cards and additionally objectives. He means that they are important in two different ways. Firstly, they are able to take risks and thereby get incentives, funds and strategies of the ground. Secondly, they almost act in a counter secular manner, meaning that when investors are fearful to invest in Africa because of currency volatility, DFIs step up and *keep the capital flowing* to the continent. Walter thinks that DFIs have been valuable in terms of input in their processes and helping them to launch strategies. Moreover, he does not feel limited in his investment options as a result of DFI involvement, because companies going through their investment pipeline need to live up to their ESG criteria. The fund that he is working for has an annual turnover of \$100 billion, hence is very concerned with their reputation. This aligns the interest with the DFIs, since they as well are very concerned with avoiding investments that can potentially harm their reputation. Walter means that their investor base *put ESG/SRI-issues very high on their investment agenda* and he is obliged to follow them, minimize risks and supporting ESG improvements of the investee companies.

### 5.2.2 Trade-off Between Development Impact and Financial Performance

According to Jan there is no trade-off between development impact and financial performance. He also means that DFI requirements regarding reporting on social and environmental issues can be somewhat time-consuming and could have been spent on applying and improving company performance. Jessica agrees and does not believe that a trade-off exists between social development impact and financial performance. She argues that without sustainability from a financial standpoint, societal impact is not possible. These social impact investments would not survive without sustainability in the long-run and DFIs accept as well as appreciate this fact.

Lee's view on the trade-off is that it is not an "*either-or-thing*"/mutually exclusive things, and both development impact objectives and financial return goals need to be prioritized. Their investors want return on investment on their capital by investing in companies with significant social and development impact, and not just in "*...a bunch of social enterprises*." He means that there are a lot of companies in the market that can have that kind of impact in two years just by increasing their operations. This means that jobs are created and profits generated, conclusively increasing the government's tax-income enabling them to educate locals and increase the country's capacity. First and foremost, however, he needs to be confident that the transaction will make money because if not, it would not be a sustainable business that can create added value. He also underscores the necessity to be careful when investing in risky social ventures, because it increases the probability of trading some of the commercial potential of the transaction. Even though Lee means that some funds positioning themselves as *purely* social and can grow into businesses that do a lot of social good, the commercial returns have not been as good as they have hoped for, ultimately affecting the company's sustainability and somewhat proving a trade-off.

Luke is of the opinion that one cannot weigh financial performance and development impact objectives against each other. The ESG criteria acts as a threshold deciding if the investment is compliant or not, and financial viability is evaluated if it passes through that threshold. He means that they only look for socially responsible investment that are ESG

compliant and can result in long-term return on investment. Luke therefore agree that the pool of investment opportunities is narrowed, which he means can be interpreted as a trade-off. In contrast, he also points out that the radical growth of ESG compliant investment opportunities is immense. Luke further underscores that he does not believe that one metric should be seen as a trade in favor of the other. Financial performance is a measure of sustainability and should not be less important than ESG. If there is no focus on financial returns the fund will lose their 'firepower' to make more impactful investments. Moreover, he underscores that it is important to not rely too heavily on ESG criteria and label financial aspects as bad. Instead, financial viability should be seen as component of sustainability that is *as* important as ESG and a tool that provides the investors with additional firepower and ability to allocate new money into new funds. Lastly, Luke said he is perfectly fine with the trade-off and means that it protects them from risks and makes them more connected to their present and future investors.

Milton generally disagree that a trade-off exists. He underscored that the DFI he is working for has invested in several funds that have given return in excess of 20% IRR, yet has not sacrificed the development impact objective. He continued with explaining that the funds and the underlying companies in which they in term have invested in are all adhere to ESG standards. This in term made them more attractive from an acquisition standpoint as well as an investment opportunity. Milton further underscored that all DFIs has one specific mandate given by their board of directors that answer to the shareholders, and that is to be commercially viable. He admitted however that DFI investments sometimes are more commercially focused than others, however emphasized that a high commercial focus does not mean that it lacks the development impact aspect. He argues that commercially oriented investments are necessary to receive high return on investment, in term enabling riskier development impact investments. Furthermore, he explained that their track-record showed that high risk, development impact project barely makes their money back when compared to financially focused projects. In conclusion, even though an investment is good from a development impact point of view, it can bad for the organization as a whole. All investments need to do both and needs to be balanced. He exemplified by describing a scale where each investment lean towards one side or the other. He argues that taking a portfolio approach is more important than evaluating every project individually. A balanced portfolio means that certain investment is high in risk and others low.

When asked if there is a possible trade-off between financial performance and development impact, Mohamed argued that it absolutely exists. He gave an example when he talked to an investment officer from FMO, the Dutch DFI. They invested in a cement company, which had a negative effect on the environment (CO<sub>2</sub>-emissions), although at the same time, cement is needed for construction as well as creates jobs, help the industry and the economy in the country. Mohamed finished by saying *"So it's always a trade-off and it's not easy to find a balance."* Moreover, Mohamed means that there is also a grey zone between development impact and something that they would usually not finance. He mentions how this is easily exemplified by the repercussions of the war in Mali. They are in desperate need for energy/electricity right now, although to fulfill their energy needs they need to burn heavy oils since renewables are not sufficient on their own, but DFIs would not finance that today. Therefore, he asks the question if this is an example of where some development impact should be traded.

Overall, Richard does not think that he as a fund manager needs to prioritize development impact over financial performance, due to DFI involvement in their fund. In contrast, he believes that a trade-off exists in terms of not being able to invest in for example gambling or weapons, even though those industries usually provide higher average returns on investments. However, he has no interest in doing so and does not feel limited when only being able to invest in the SRI investment space, arguing that there are enough opportunities.

Walter does not think that the trade-off between financial return and ESG considerations is real. He believes that in order to improve ESG elements, management time, focus and business resources are required. However, he points out that the time and resources spent on ESG will pay off in the end of the investment, especially when exiting the transaction, since the business is probably performing very good across all dimensions. This would accordingly lead to higher multiples as well as compensate for the incurred costs and time spent to address ESG issues during the holding period. Ultimately, Walter see no contradiction between the goals.

### **5.3 The Relationship between DFIs and Funds**

The second theme begins with the participants' knowledge and experience on how the more intangible development impact objective is reported to the DFIs. Different reporting methods, the frequency as well as the scale and magnitude of the reporting is broadly touched upon. Moreover, the DFIs requirements for investing in a fund as well as the funds requirements for investing in a company is addressed. Agreements between the DFIs and fund, and the level of involvement in the funds decision-making processes are brought up. The level of formal/informal DFI-fund interaction is also discussed, as is the role of DFIs in investment committees and advisory boards.

#### **5.3.1 DFI Requirements on Fund Managers**

According to Jan Rixen the DFIs spend a lot of time trying to find the best fund manager to invest in and it typically takes about one year before a DFI decide to invest in a fund. The fund manager needs to be experienced and have a track-record proving how successful they have been in the past. Furthermore, Jan Rixen means that there are very strict guidelines for reporting on development impact, and the members of EDFI are using a lot of resources to monitor their performance. Usually the DFIs have a very extensive client review to ensure that the companies in which they invest in are complying with the requirements in the agreement. They spend a lot of resources on technical assistance, trading programs and management systems with the purpose to improve the portfolio company's standards and quality. Furthermore, the EDFI members engage in medium to large size societal projects that comes with huge reputational risks, which in term requires a lot of focus on strong ESG performance. This requires that they strictly follow international standards and avoid governments/shareholders dissatisfaction.

Jessica means that DFI requirements are clearly defined and their mandate very detailed. Before a DFI decides to invest in a fund there is an extensive due diligence ensuring that no investments have been made into specific sectors that can for example create pollution or cause deforestation. Furthermore, Jessica means that they are not allowed to invest in companies that lack procedures in terms of compliance and money-laundering. The fund's way of disclosing information regarding their investment activities is presented in an annual report. So far she has found the feedback from the DFIs as extremely positive and she has not experienced any dissatisfaction regarding the information disclosure.

They try to align and tailor the reports to the DFI requirements from the start in order to avoid complaints of not having provided enough. When investing in sub-Saharan Africa, the fund's selection criteria includes that the average portfolio have to be on the \$30 million range as well as that the investee companies need to be in a growth stage. They also need to have *proof of concept*, meaning that they must have already generated revenues and have the ability to accelerate their growth by extension of product geographies across the value chain. The investment rationale is further built on a value creation plan which includes a ESG value creation plan focusing on metrics and measures that the investee company should implement. This requires raising awareness for sustainability in their business model as well as developing a comprehensive action plan showing how their ESG capabilities can be improved.

Lee describes that DFIs requirements as well as the funds mandate is specified in an agreement between the two parties. He points out that even though the DFIs have the ability to share opinions with the funds, they do not get involved in the decision-making process, hence leaving the funds to on their own accord make investment decisions. Lee means that the investor relationship is guided by their management agreement as well as by their investment patterns, which shows what types of companies they usually invest and not invest in. Moreover, his fund is not allowed to invest in certain types of companies, thus needs to ensure that predefined criterion is met in terms of strong track-records, operations, profitability, strong management as well as potential growth and expansion opportunities. Lee emphasized that certain *sin industries* are strictly forbidden to invest in (e.g. alcohol, gambling, guns and ammunition) that does not contribute to the social cohesion and development. He points out that they would not invest in these industries since it is not in the interest of the people. The fund does however invest in petroleum distribution and even though he recognizes a global trend towards green and renewable energy sources. Lee does not consider that industry to be a sin industry since most people are in need of fuel. Alcohol and gambling on the other hand has many negative social implications according to Lee, and even though some investors are a bit more liberal regarding these requirements, they have decided to not target those industries. He gives an example when they decided to not go ahead with an investment in a pharmaceutical company producing soaps and creams. Even though the company had high margins, strong financial performance and growth in revenue, a large part of their success came from a skin bleaching product, which can result in long-term negative health effects. Lastly, Lee explained that the fund has outsourced their due diligence process to external consultants in order to identify potential risks in a better way, and to ensure that the companies work with ESG issues. By taking this approach they can more easily formulate and implement action plans in investee companies when needed.

Luke also addresses the importance of due diligence required by DFIs when looking into an investment opportunity and that this process is performed by an external party. Apart from the typical legal, financial and tax due diligence they are also obliged to perform an ESG due diligence to all investment opportunities. This external party provides as previously mentioned the fund with a list of issues connected to a potential investee company and the fund is eligible to proceed with the investment from an ESG standpoint if there are no severe issues reported. However, before even looking into an investment the fund makes sure that the investment does not violate their mandate of prohibited sectors and activities. Issues related to criminal activity can be quite blurry and often not directly linked to criminals. For example, Luke means that gambling is by some perceived as criminal, and although not an illicit activity *per se*, they are prohibited from making

investments in that industry. Furthermore, the DFIs require additional monitoring of ESG criteria and every quarter the fund needs to provide the investors with specific information regarding the investee companies number of employment, female employees, potential ESG litigations etc. The fund structures their investments to avoid environmental harm or socially irregular conditions that does not comply to their standards. If the company is not compliant to the fullest extent at the time of the investment, they are given the opportunity to improve. As Luke himself put it *“...if it is not compliant in a given social criterion in the ESG report, but it can be compliant if we invest in certain safety equipment, material aspirations for instance, which can avoid working accidents in the future, then this can be done. And this in fact is a very value-added investment from the social perspective as well. If it’s a gambling investments, then it cannot be done regardless of whatever mitigation we can put there”*.

Furthermore, Milton explained that the funds they invest in are required to generate positive as well as measurable development impacts. Before making a fund investment it is required to go over extensive legal documentation that has to be agreed upon by both parties. Hence, the DFIs and the fund manager formulate a contract specifying the investment criteria, and what the manager are allowed to and not allowed to do, in detail. Once the DFI has subscribed to the fund they have a contractual obligation to align their investment decisions with the requirements of the DFIs. Because of this, the DFI are not worried *per se* that the fund will not abide to the criteria. The DFI that Milton is working for have *country based investment limitations*, meaning that the funds they invest in can only invest in countries that have a GNI per capita under a certain threshold. In addition to these requirements, they need to find funds that not only are commercially viable and will generate financial returns, but also generate development impact.

Mohamed means that funds are required to adhere to an exclusion list, which is harmonized among all DFIs and contains industries, sectors and other types of companies that they cannot finance. This is for industries dealing with for example weapons, tobacco, hard liquor, gambling, pornography and child-labor. Furthermore, he means that they sometimes make exceptions and invest in projects that are not completely adhere to their policies if they see potential to improve the conditions within a specific industry or company.

Richard means that DFIs have requirements in terms of ESG criteria that need to be fulfilled by the fund. He means that ESG criterion are included in the investment evaluation, although just as a formality and since it is required by the DFI investors. According to him they have a more holistic view on the issue by following a standard checklist and the DFI exclusion list, which require them to avoid for example gambling and liquor. They are allowed to invest in which sectors they want if it is not defined in the list, meaning that they could technically invest in petroleum. Furthermore, his fund has a very opportunistic investment strategy and he can invest in everything from real estate, building materials, goods and services etc. Another important factor according to Richard, is the company's ability to scale up as well as produce good margins and obtain a strong market position. Lastly, he also believes that companies with strong and specialized management is necessary since those companies usually provide higher margins.

Walter means that DFIs strong ESG obligations requiring funds in which they invest to be adhere to. These obligations are agreed upon from the start of engagement and if they

fail to adhere to the framework and principles agreed upon, the DFIs will most likely pull out. For this reason, the funds are incentivized to ensure that the requirements are lived up to. In addition to that, Walter also means that there is an exclusion list including sectors and companies that are off limits. Although, Walter goes on to explain that sometimes, the fund invests in companies that might have some ESG issues, with the purpose to improve their ESG performance. The fund he is working for is secular agnostic and have a broad sectorial focus, generally investing in the consumer space. They would definitely not invest in primary resource extraction (oil and gas), hard infrastructure or green field projects. The key focus is put on logistic-type companies that benefit from formalization of retail and increased trade. The selection process driving the investment decisions usually includes them looking for the broad theme that drive or determine the firm's performance. These include identifying how well the company is doing, how resilient they are and how it captures the benefit of the theme. The management, the founder and the owners are also important. As Walter said *"Are they just looking for capital or are they really looking for a partner? That partnership, that ability to create that partnership, is critical for us."* The management needs to have been with the business for at least three years and have a strong track-record.

### 5.3.2 Reporting, Measures and Development Impact

Jan Rixen describes the process of measuring and following up on development impact as a very dynamic process that are constantly improving. He explains that there are discussions among the different development agencies in both Europe and the rest of the world regarding what development impact is and how it should be measured. Most of the larger DFI members employ their own experts for this process and do the measuring themselves. EDFI are trying to harmonize all the different systems since many projects are co-financed by several DFIs. This would mean that instead of requiring the sponsors to report back to each individual DFI investor's reporting tools, one standardized template can be utilized. Although, he recognized that this is a difficult process since the philosophies and systems among their members are completely different. For instance, the German member DEG have developed an Excel-page system, which is used by some of the EDFI members. Other members have developed more sophisticated systems involving figures that are very difficult to understand. Jan Rixen believes that case studies denoting the results of various investments (e.g. giving people a salary to send their kids to school) is sufficient to judge the development impact of DFI investments.

Jessica explains that their fund utilizes a template, that is aligned with the DFI investor's interest, as a tool to report on development impact. At the end of every year they also send them their KPI metrics which show their ESG performance. According to Jessica, the DFIs have some KPIs that they track on an ongoing basis, requiring the fund to consciously report on their portfolio companies. They already tracked a few KPIs before the DFI decided to invest, although specific KPIs were introduced as a result of their involvement. She also gave some examples of such KPIs in connection to financial services and said that it can include for example how many people are served by a portfolio company, the total amount of achieved savings opportunities, how high the quality of service is etc. Additionally, they also track other metrics such as the number of employees and their level of skill.

According to Milton the process of measuring development impact needs to be improved since it is not as easily quantifiable as financial return and always involves a level of subjectivity. He means that even though it is hard to quantify these criteria, it

demonstrates to the market that treating employees correctly, respecting the environment and positively impacting people's lives can be done. Additionally, they created a development impact team for assessing the development impact on a regular basis. For example, they use questionnaires that they go through with the fund managers every two year, which includes more than forty questions related to job creation, women employment, women rights, environmental aspects and training etc. In addition to that, they sporadically perform case studies and field visits in order to ensure that the portfolio companies are generating development impact.

Mohamed explains that the DFI have a specific working group with one or two representatives from each member who meet twice a year to discuss environmental and social issues. The *Development Effectiveness Group* perform an analysis of the entire DFI portfolio to identify the collective development impact of the DFI. Furthermore, he underscores that gathering input from all members as well as harmonizing the indicators and portfolio information from each DFI member is a very challenging process. Usually, they come up with a conservative figure which they can prove with a high degree of certainty. Even if it in theory is most likely higher, they prefer to avoid overestimating the data which can very easily happen due to its complex nature. Indicators of development impact is e.g. the amount of job created and government tax-income in each country as a result of DFI investments.

Lee means that his fund is also provided with templates, which includes certain development impact metrics. The DFIs hence, require the funds to gather information regarding their portfolio companies with the purpose to assess their performance from a development impact standpoint. In addition, they also issue their own development impact report annually or biennially with the purpose to keep track on the development impact performance of their investee companies as well as to identify potential areas of adjustment. Lee means that fund activities are presented in quarterly/annual reports to their investors and also report on ESG issues on a continuous basis during the year. When reporting back on developing impact, Luke means that there are a predetermined set of KPIs defined by the DFI investors. Although, they all have their own specific report templates and there is no standardized approach. Furthermore, he means that the fund needs to ensure that they are compliant to the requirements set by the DFIs. Hence, they utilize a set of performance indicators such as employments, gender, age, working incidents, environmental litigations, tax etc. As Luke says “...it's a very comprehensive set of requirements that we fulfill for each investor individually...”.

In order to protect their minority investor position Luke means that a non-executive member is appointed to the fund board. That means that the fund prevents any strategic and new operational measures that impact the investee company to be harmful for their investment criteria, including the development impact objective. He explained that an external party provide the fund with a list of issues connected to a potential investee company, and if no severe issues are reported, the fund is eligible to proceed with the investment from an ESG standpoint. Usually when his fund makes investments they are responsible for certain areas in the investment contract i.e. the financial division (including auditing by an international reputable firm) within the investment period. Since the majority of the fund's investee companies are not yet audited, Luke means that they need to put pressure on the auditing e.g. the financing department, CFO, board level manager and/or manager director.

Richard's fund reports their development impact performance to the DFI through their annual report, and can include indicators such as the amounts of jobs created. Additionally, they have a separate reporting tool for ESG, which includes KPIs such as animal welfare, compliance and labor contracts. Richard however means that these KPIs are not *as* important to other investors as they are to DFIs. Unlike commercial investors they are more concerned with very detailed information.

Furthermore, Walter also mean that their fund discloses their progress on ESG issues through their annual report. These reports identify areas which require more focus in the upcoming year, if training is needed as well as what has happened in the company. They also provide the DFIs with more usual development impact metrics such as; how companies increase their number of employees, representation of women in the workforce, taxes paid etc. Some metrics are customized for specific portfolio companies since some ESG metrics are more relevant for a particular company.

### 5.3.3 DFI-Fund Interaction

Jan Rixen means that DFIs interactions with funds differ from member to member. The larger members specifically spend more time trying to identify the best funds to invest in and when they do, they do not interfere in their decision-making. Most of the EDFI members take a seat on the advisory committee as a measure of supervision and formulate social and environmental issues. However, most of them do not take a seat in the investment committee since they do not want to get too involved. Although, some of the smaller EDFI members that only make a few fund investments take a seat on the investment committee of the fund.

Jessica explains that the DFI have a seat in the advisory board, which meets twice a year or whenever issues appear. She means that they have a very open as well as continuous dialogue. If they are assessing an opportunity that they believe could be additive to the DFI, they interact more frequently. Personally she interacts with the DFI every month but her colleagues may interact on a more frequent basis if they are pursuing a transaction that could be interesting for the DFI. Despite this, she does not believe that the DFI influence their fund investment strategy since their mandate was clearly defined during the negotiation pre-investment. Once the DFI decided to invest in the fund they are not *as* aware of the funds' investments, until there is an investment decision.

Lee goes on to say that they are in touch with DFIs constantly, either through email or scheduled calls. In addition, they also meet twice a year for formal discussion regarding fund performance and future directions. DFIs as larger investors also takes a seat on the advisory committee. Lee further underscores that the experience of DFIs are very valuable and they do take their advice into consideration. However, in the end the fund managers are the ones that make the investment decision and the DFI investors cannot block a transaction.

When it comes to the practical interaction with DFIs, Luke explain that they interact with the DFIs through telephone and email, but they also take a seat in the investment committee and advisory committee. They interact with all DFI investors on a quarterly basis and through quarterly reports. In addition to the reports they have weekly contact with one of the DFIs to discuss issues, strategy and guidelines regarding a joint venture. He also means that these investors provide valuable insights as well as an extensive network of experts in a given sector. Milton also means that their primary way of



interacting with DFIs is via telephone and email. Furthermore, they arrange annual meetings twice a year and at least one of those meetings are in person, usually in the country of the fund. The DFI keep very close tabs on their fund managers through governance rules and monitoring. This includes taking a place on the advisory board and visiting funds and portfolio companies regularly.

According to Richard their DFI interaction is limited to the investment committee, in which the DFIs have a seat. Along with the commercial members they meet quarterly, although unlike the others participants Richard does not interact with the DFIs by telephone or email. He means that DFIs is just like any other financial investor and their seat on the investment committee is more of a formality. Sometimes they may have comments regarding a particular transaction or the fund's dealings and it happens that the investment committee members enforce decisions.

Lastly, Walter means that the primary DFI interaction is through the advisory board and other annual meetings as well as *ad hoc* advisory committee meetings. Walter also point out that they also meet with investors when they are in town and update them through telephone calls. ESG is also communicated frequently since most investors want to see development impact assessments across the portfolio. Walter believes that the more time spent with DFIs, the more comfortable the DFIs feel regarding the fund's way of deploying their capital.

## 5.4 Stakeholder Management

In this theme the participants briefly raise questions regarding shareholder/stakeholder prioritization and their perceptions of potential conflict of interests between different shareholders and stakeholders. Stakeholder inclusion into investments and potential conflicts between different stakeholder groups are discussed.

### 5.4.1 Different Shareholder/Stakeholder Preferences

Jan Rixen explained that the DFIs would never take a shareholder majority position in a project, which differ from the public sector where development banks can owe one hundred percent. Since DFIs want to attract private investors, they always encourage commercial banks to get involved in projects. He also points out the continuous debate with stakeholders regarding how social impact should be measured and how they sometimes disagree with each other. Jessica goes on to say that shareholder structure is roughly a 50/50 split between DFIs and other commercial investors investing in the fund. The non-DFIs investor include for example banks, financial institutions, insurance companies and some family offices.

Lee explains that the philosophy of their fund is to serve the community as a whole and to create value for the shareholders investing capital in the fund as well as all other stakeholders. Due to their aim to satisfy all investors they do not prioritize the DFI over any other investor. Instead he means that all investors deserve to know that their money is being managed in an appropriate manner. Although, he also pointed out that the majority of the total pool of investors are DFIs. They impose certain requirements which the fund use as a point of reference when creating their structure. Lee however underscores that the agreement between the fund and all of its investors guide the investor relationships. The fund manager is the one making the decisions and has always been approved and encouraged by their investors in the past.

Luke underscores that the only investors that can allocate money to the fund are institutional investors which all have agreed on the same investment strategy. Milton does not believe that different preferences of investors will affect the fund manager focus on development impacts, nor other DFI objectives. He means that the contract between them specify their investment criteria. If the fund manager does not abide to those conditions, it is a breach of contract and the fund manager can essentially be removed. For this reason, they monitor the fund in order to ensure that there are no deviations from intended goals.

According to Mohamed the DFIs investing in the funds may have different stakeholder preferences from geographical point of view. The Spanish DFI for instance, prefers to invest in Latin America for historical reasons, the France DFI invest heavily in ex-French colonies and the English DFI can only invest in sub-Saharan Africa and Southeast Africa. Moreover, he believes that the DFIs need to coordinate more with other actors such as the public sector and NGOs, because everyone plays important roles and complement each other. In the past the public sector and the NGOs played on their own individual field, but now people have started to understand that cooperation create useful synergies. Moreover, Richard believes that both preferences and requirements among DFIs as well as commercial investors are very well aligned since both aims to increase job creation, which is also the funds main focus in terms of development impact.

According to Walter the split between DFIs and commercial investors is about 40/60 percent. Apart from the exclusion list that specify which sectors and companies they cannot invest in, the funds objectives are clearly commercial. They do not differentiate their investors in terms of size and as he said: *“Whether you are a large DFI investor or a smaller one, they almost certainly gonna be singing from the same hymn sheet.”*

#### 5.4.2 Satisfying Multiple Objectives

Jan Rixen means that since there are many private investors involved in their projects conflict of interest often occur. If the DFIs are to invest in a project, a plan to overcome potential problems needs to be clarified and established prior to the investment. Moreover, he is also aware that SIDA, a shareholder of Swedfund, has over the last few years raised critical issues regarding that the Swedish DFI have made investments failing to live up to prosocial criteria. Although, he does not really agree with the criticism and explains that the DFIs are very often and almost regardless of what they are doing under constant attack from the NGOs. One reason for this is that the donors have decided that, over the last few years, development aid should be channeled through private sector instead of the public sector and NGOs. Conclusively, because the private sector arguably creates sustainable business, whereas the public sector and NGOs receive grants which eventually dry out and halting project development. The NGOs have had their allocation cut drastically the last couple of years, which is the reason why they try to explain to the donors that the DFIs are not doing the right things, and therefore more money should be channeled through NGOs.

Jessica goes on to say that the fund is given a clearly outlined mandate towards which the fund managers work to satisfy/obey. This means that the fund does not go back to the investors and seeks their approval when they explore investment opportunities. She means that the fund manager has responsibilities toward other investors as well, and needs to stay true to their given mandate.

Furthermore, Lee does not believe it is difficult to satisfy all investors' interests since they collaborate and work very closely with their investors. He however pointed out that some of the investee companies tends to be a bit slow to generate reports which require the fund to step in. Furthermore, Lee means that sometimes they do not see "...eye to eye on certain issues.". He means that as a private equity fund a typical investment horizon is typically five to six years after which you look to exit. However, Lee sometimes believes that if a company is doing very well by returning capital to investors, there is no need to exit just for the sake of exciting, which is a typical DFI rationale. Hence, the type of discussions that he tends to have with DFIs is whether or not it makes sense to continue to remain as an investor and grow the investment even bigger or just to exit. As Lee said: *"Do we always have to forward with the rulers, five, six years or sometimes depends on the nature of the company and how promising it is? Do you give yourself a bit more of a flexibility to exit later, at a much higher valuation?"*

Luke means that when a company's activities can cause stakeholder-harm from an ESG standpoint the investment committee body takes it very seriously. This could be a result of a lack in reporting of for example activities resulting in environmental harm (pollution), social, labor accidents, gender discrimination etc. If the potential investee companies cannot do business from an ESG perspective the investment will not go through.

Milton are very aware of the criticism many DFIs face from other stakeholders such as SIDA in Sweden, regarding the investments in projects/companies that do not have high enough development impact. Although, he means that the DFIs focus more on the private sector investments, while SIDA are more focused on traditional overseas development assistance (ODA). DFIs needs to make investments that will generate commercial returns as well as development impact. This means that some projects are more commercially oriented than others since it enables more future investments that can result in even higher development impact. Therefore, he believes that people need to look at the portfolio as a whole and not individual projects when assessing their financial and development impact performance. Mohamed goes on to say that sometimes situations occur where conflicts arise, although it is not particularly common. As soon as the conflict has been identified, it is just a matter of negotiation to find solutions for the different scenarios.

Richard means that the DFI requirements are not always aligned with the interest of the companies in which the fund invests in, since they do not really care about those principles. He argued that if they spend too much time and resources on CSR reporting it may take focus away from the corporations. Although, he does not believe that there is a big mismatch but as he said *"...there is not a big mismatch. It is just that it is a bit overkill, some of the requirements that DFIs have compared to what's pertaining on the ground"*. Moreover, Walter does not believe that there are any problems with considering all investor interests and has not experienced any conflict between different investors. He means that investors would only become dissatisfied in the occasion of development impact being traded for returns. Furthermore, he explained that a large part of the commercial investors are pension funds and therefore have a high level of ESG expectations from their managers as well.

## 5.5 Fund Manager Motives

The last theme identified is the fund manager's personal views, beliefs and perception of the concepts of being able to impact society as well as the importance of making profits.

An indication is given of the investor/fund manager profile, showing what drives their investment decisions and motivates them to work harder towards a certain goal. The participants' views on compensation/financial incentives is presented, as well how it is used to align the DFIs' interests with the funds in terms of both the financial performance goal and the development impact objective.

#### 5.5.1 Managers' views on investment

Jessica's explained that the funds she is working for was from the beginning set up to take into account the social impact. She believes that the financial services sector provides social benefits and impacts the whole population. Accordingly, it brings people that are underbanked and/or embanked to more formal financial services and benefits so therefore it has a clear impact from day one. For example, a business may only need one hundred dollars in working capital to produce something they can sell in the market, conclusively allowing them to kick-start their business.

Lee feels that even though touchable economic growth contributions are important, his motivations go beyond commercial returns and include intangible improvements in the social fiber in the countries in which they invest. One of the reasons they started the fund was because they saw a substantial gap in the private equity funding to the indigenous people. They wanted to fill that gap and help these people to realize their true potential. As Luke said *"So sometimes we just have to basically, we want to get ethical investors and we want to make investments that we will be proud of in many many years to come."* He means that their strong ethics and the social circumstances decide whether or not to invest. In contrast, Lee also explained that he as an investment officer tends to focus more on commercial elements of a transaction in order to ensure the financial viability, not only from a development impact standpoint but also from the financial perspective.

According to Luke, DFIs provide a safety network, a mind frontier and a psychological safety network. He means that he feels better when doing something according to the standards of the most demanding investor, not only from a financial perspective but also from a socially responsible criterion. Luke feels that he deeply believes in what he does as well as feels that he is doing something with a much broader requirement investment analysis than anyone else, essentially contributing to areas where other investors would overlook. Luke, thinks that DFIs are very important to involve and the decision to include or exclude them make huge difference.

Milton explained that for the last eleven years he has been working in the socially responsible space. Moreover, Mohamed believes it to be important to have a good balance between sustainability and financial performance. He means that it could be viewed on an axis where social issues and the financial point of view needs to be considered. The focus of the fund is commercial investment that emphasize job creation, so it does not directly focus on poverty interventions. He believes that the implementation of ESG criteria is more of formality since it's a requirement from the DFIs and his fund has a more holistic view on it. The DFI want the fund to implement certain requirements into their portfolio and the local companies. Although, accordingly they do not really care about these policies, hence as a fund manager he only does it because the DFI require it. Walter pointed out that SRI has always been important in terms of the funds processes and even more so over the last few years. He means that it has always been present in the integrity and mentality of the fund. He also means that the ESG criteria has a huge impact overall and as an investment house they also know that their investors put ESG/SRI-type

of issues very high on the agenda. Hence, the fund is obliged to help promote that objective as well as support the ESG improvement of their investee companies.

#### 5.5.2 Compensation structures and monetary incentives

According to Jan Rixen there is always what they call a “*carry*”, which is the share of the *upside* after the exit of the investment. There is often a 20-80 or 30-70 rule whereby the fund manager receives a carry of 20 or 30 percent that will remain with them, while the remaining part are paid back to the investors. Furthermore, he explained that the carry can also be connected to development impact, through environmental and social performance. It can also be part of an annual management fee based on certain indicators which have to be reported to the DFI. The management fee can also be performance related, which means that if the indicators for the portfolio the fund have invested in is very positive, there may be a higher management fee to the fund managers. Jessica also pointed out that the managers are remunerated based on the results, but since her fund just started to invest they are a few years away from reaching that phase.

Lee also means that the fund managers get financially compensated in terms of a carried interest, which is the money the fund makes if the investment performs. He believes that a carried interest helps to align the interest as well as make the fund managers feel that they are a part of it. If the investments that they are proposing does well, the fund manager and the DFI will both be rewarded. Lee explains that it is usually a 2-20 rule, which means that 2 percent of the total commitment is the management fee and the fund manager receive 20 percent of the upside. This means that the fund manager gets 20 percent of the financial return and the DFI the other 80 percent. When it comes to compensation for development impact Lee has not recognized a trend to compensate managers based on that. Although, he believes that they may get there in the future. Moreover, he means that the fund tries to make sure that all the interests are aligned. The fund is reviewed based on their performance in terms of managing the company and generating a certain return, but also on how they work to generate social impact. Hence, it is not only about the function of money they are able to return to the investor.

Luke explained that they have a threshold which is the preferred return given to their investors. If they only manage to get them up to that preferred return they do not receive any carried interest. If they however go above, the PE-managing fund team will also get rewarded. He described that this is a long-term commitment making this type of compensation structure a key to retain talents and incentivize the team to work on behalf of the investors. The fund does not have a any compensation or carried interest based on ESG, since this were already defined in the past. Luke believe that it could be dangerous to have such metrics because it could cause the PE-managing team to focus on employing more people, even if that may not be in the best interest of the sustainability of that business.

Milton explained that the fund manager is compensated based on the funds financial performance and *not* on development impact. They have tried to devise such an incentive in the past although came to the conclusion that it is very difficult to tie in financial incentives to development impact. However, there is a negative incentive in place saying that if the fund manager fails to adhere to the ESG principles imposed by the DFI and they feel that they are not investing in companies that will generate development impact, the DFI have the right to fire the manager at any time. He goes on to say that he does not believe that tying development impact performance to the compensation would have any

effect on the funds they invest in. Moreover, if financial incentives mainly based on development impact were to become a norm, a lot of new products would enter the market and financial return would as a result be more difficult to balance.

Richard means that they have a carry of 2,75 percent for the first fund, but so far the financial performance has not been strong enough to result in a carry. He also points out that they do not get compensated for development impact but he believes that a bonus could motivate some staff-member to focus more on the employment metric. Although, he further notes that it could mean that financial interest begins to misalign with other interests, hence making it less long-term sustainable. On the other hand, he said that it could be possible to devise a compensation structure based on ESG metrics similar to the financial compensation, since some of them are very tangible e.g. job creation. However, he does not believe that having financial incentives affect the performance of fund manager to a large extent since the fund is very small, but he does note that it can affect bigger fund where larger bonuses for financial performance exist. Walter described that the management fee and carried interest is explicitly linked to financial returns, and not development impact. Although, if they want to keep their investors happy they also need to satisfy the ESG criteria to avoid the DFIs stop supporting the fund.

## 5.6 Thematic Summary of Empirical Findings

Table 3 provides a brief description of the four main themes and an overview of the participants views.

Table 3. Thematic Summary of Empirical Findings

	<b>DFI Investments into Funds</b>	<b>The Relationship between DFIs &amp; Funds</b>	<b>Stakeholder Management</b>	<b>Manager Motives</b>
<b>Description of Theme</b>	The DFI implications and their significance on communities and funds. The trade-off between financial performance and development impact.	The way funds report development impact and investment performance. Agreements, ways of monitoring and level of DFI involvement in decision-making are addressed.	Stakeholder/shareholder prioritization and perceptions of potential conflict of interest.	Personal views and the perception of the concept of societal improvement and making profits. Fund managers' motives and drives are addressed.
<b>Participant View</b>	Provide risk mitigation, attract capital, increase development impact focus, catalytic role, add ESG/SEE dimension. Trade-off exist to some extent, and commercial returns is just as important as development impact.	Contracts specifies fund manager mandate. Extensive due diligence processes before investment. Engage in the triple bottom line. Utilize behavior-based contracts. Usually take a seat on advisory board.	No prioritization between shareholder/stakeholders. Similar commercial and DFI investor preferences.	Managers have altruistic and profit-oriented motives and engage in avoidance behavior. Fund managers receive compensation for high financial performance not for high development impact.

## 6. Analysis and Discussion

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*The following chapter analyze the four major themes and the sub-themes that was identified in the empirical findings and discuss it in connection to the scientific research review. The intention of the analysis is to find support for some of our claims as well as reveal new insights of how an involvement of a DFI affect a fund and the fund managers' behavior.*

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### 6.1 Main Theme: DFI Investments into Funds

One of the most distinct themes that we identified from interviewing fund managers and DFI representatives, was the effect that DFI investments have on funds and fund managers. As previously mentioned standard investor theories presume that investors make investment choices based on mainly financial risk-adjusted return neglecting social and ethical criterion (Williams, 2007, p. 43). Although, according to Williams SRI proves that a significant amount of investors includes social and ethical criterion, alongside with the standard financial return on investment goals. It is clear that DFIs plays an important role in the private equity market in developing countries. This theme reveals the opportunities with having an DFI investor in the fund as well as discussing the trade-off that comes from fund managers' having to focus on both development impact as well as the financial perspective in order to make sure that the fund is financially viable.

#### 6.1.1 Sub-Theme: The Role of DFIs

According to Settel et al., (2009, p. 71), the significance of DFI investments in sub-Saharan African is important in terms of attracting capital to the continent, new commercial investors and provide political risk coverage. All of the participants underscored how DFIs act as a catalyst for risk mitigation and that they are willing to invest in regions where other private investors would not. The interviewed fund managers seem to appreciate DFI-investors' ability to in a sophisticated way assess risk and add experience, conclusively increasing their confidence to invest in more high-risk projects that can result in high societal improvement as well as improved financial performance. Fund managers also seem to agree that the DFIs long track-record and experience provides valuable inputs into processes as well as offer important advice and helpful insights.

Most European DFIs have implemented ESG criterion in their investment process (Dalberg, 2009) and the interviewed fund managers also proclaim that they are required to include some form of ESG criteria in their investments decisions. As a consequence of the DFI investors' ESG focus, the fund managers are required to implement ESG criteria in their investee companies as well. Although, the majority of the participants seemed to believe that this focus is very valuable in terms of improving their investment risk analysis. Many seemed to agree that the development impact objective specifically, made them focus more on the effect of their investments in terms of social and environmental consequences. Thus, DFIs seem to somewhat alter traditional fund manager behavior of investing, not only to increase the value of the shareholders but also the value of the stakeholder. One exception however, was that one of the fund managers found ESG implementation as less rewarding and mostly cumbersome because it requires extensive reporting. The DFIs involvement can according to the fund managers help to increase the sustainability and development focus in several industries and help address the current

gaps in the private equity market. The participants all seem to agree with Bracking's (2012, p. 276) conclusion that the imposed ESG assessment by DFIs represents the development industry's contributions to frame and promote poverty reduction, environmental sustainability and private sector development.

The fund managers seem to all believe that having a DFI as an investor provides a safety network. One of them went as far as to say that his fund would not exist without DFI investments, and the same goes for the availability of capital for companies that seek to expand their businesses in the region. Furthermore, this fund manager meant that the DFIs also provide the fund with insights and technical expertise that expanded the fund's pool of resources, which otherwise would not have been possible. This demonstrates the importance of these institutional investors as providers of capital for the private sector expansion and improvement in terms of development impact in developing countries. In conclusion, when a DFI enters a market or invests in a fund/company they put ESG issues on the agenda and increase the focus on societal aspects on private equity investments. Even if one fund manager felt that their rigid and bureaucratic analysis of investment opportunities can cause a significant lag in receiving funding, the overall opinion of DFIs is that they provide valuable insights, knowledge and experience in emerging markets. This seems to be in line with Leeds and Sunderland (2003) conclusions that DFIs create a *multiplier effect* in terms of attracting new investors and increase investment credibility, as well as re-energize the industry by providing experience and knowledge as well as undertaking a *catalytic role*. They all seem to be in agreement that DFIs focus on long-term sustainable investments helps to proliferate and promote development objectives in the private equity industry in Africa.

#### 6.1.2 Sub-Theme: Trade-off Between Development Impact and Financial Performance

There seems to be a clear majority of the participants agreeing that the trade-off between development impact and financial performance is mainly *non-existent*. Many argued that both objectives are not mutually exclusive, thus requiring simultaneous prioritization. It would seem that strong financial sustainability and a high return on investment is perceived as necessary in order to achieve the DFIs development impact objectives. One fund manager for example, argued that financial performance and development impact objectives cannot be weighed against each other. ESG criteria instead act as a threshold and only when it has passed through it can the financial viability be assessed. The fund managers seem to find ESG criteria important since it is required by the DFI investors, however feel even more obliged to act on their mandate to achieve high return on investment.

As previously mentioned Bollen (2007, p. 684) means that portfolio performance optimization is constrained by social screen investment vehicles, that result in inferior risk-adjusted returns when compared to its conventional counterpart. Although, the fund managers do *not* seem to agree with each other that the required SEE criterion introduced by the DFI-investors, impedes the optimization of portfolio performance. For example, one participant meant that several of their funds actually achieved excess of 20% IRR without sacrificing on development impact. In contrast, he also meant that investments with a high development impact focus barely make their money back, while commercially focused projects do. This argument would instead support Bollen's conclusions that social investment vehicles result in inferior risk-adjusted returns. One of the fund managers pointed out that industries such as gambling and weapons provides a much higher rate of return than other assets, which means that an inability to invest in those



industries should result in a less than optimal financial performance. Moreover, some of the interviewed fund managers that argued that a trade-off does actually exist meant that sometimes an investment can be necessary from a societal point of view, in terms of creating jobs, producing energy and help the economy of a country. Although, this can require overlooking some negative environmental implications that might come from example burning oil in order to produce energy. This grey-zone seems very much real and difficult to balance. One of the participants gave a good example that visualize this balance, and described a scale showing how much of each investment lean towards one side or the other. Hence, some of the investment might have more development impact focus than financial performance, and vice versa. Investments can therefore be argued to require some level of prioritization of one goal in front of the other depending on the investment opportunity presented, although the main concept is that the portfolio should be balanced.

Junkus and Berry (2015, p. 1178) presented two views of shareholder/stakeholder maximization and looking back at the SR investment performance it would seem that fund managers believe that they can outperform the market by *doing well by doing good*. The participants seem to agree that social screening and implementing required ESG principles (development impact objectives) into their investment process, does not have negative side-effects on the financial performance. This could mean that Bollen (2007, p. 684) which meant that social screening can generate superior risk-adjusted returns, since they serve as a filter for managers to invest in portfolios with high quality. The interviewees seem to agree that focusing on development impact imposed by the DFIs takes time and effort, although will result in the investments performing better in the long-run, more attractive for acquisitions and positively affecting companies social, environmental and commercial sustainability.

Moreover, in accordance with Junkus and Berry (2015, p. 1178) *doing good not well*, some of the interviewees meant that some investment performance is sacrificed. Richard pointed out that sin industries (gambling and weapons) provide a higher rate of return than other assets and Luke found the pool of investment opportunities to be narrowed to the SR investment space. Hamilton (1993) therefore seems to have been right when proclaiming diversifications limitation for SR criterion focused investments. Despite only being able to invest inside the SRI investment space, it seems like most of the participants does not feel limited in their investment opportunities. Therefore, just because they cannot invest in all available industries *per se*, it does not mean that the fund managers feel limited. Most of them pointed out that the SR investment opportunities are plenty in numbers and sufficient in providing financial investment opportunities that generate great performance.

Conclusively it seems that the trade-off both exists and does not exist. The answer to that question is highly dependent on from which angle the question is approached as well as the context. It is reasonable to assume that the trade-off exists in terms of fund managers' not being able to invest in *sin industries* and other investments with negative or poor societal impact. If the fund manager in question aims to achieve the highest possible return on investment, he/she cannot pursue all options provided on the entire financial market. Hence, there is a trade-off in regards to not being able to make entirely free investment choices due to 'SR restrictions' imposed by the DFIs. On the other hand, fund managers that invest within the SR investment space does not perceive that their financial performance suffers because of a focus on development impact objectives since the SRI

investment space is perceived as large enough. In this sense the trade-off is perceived as non-existent. This could be the result of the interviewees not even considering, are interested in or do due diligence on investments that falls outside of the DFIs investment requirements. It can also be because the SR market actually provides the same financial return as the conventional alternatives, without compromising development impact by utilizing social screens, as concluded by many SRI researchers (Bauer et al., 2005; Derwall et al., 2011; Leite & Cortez, 2014).

The interviews also revealed that the presumed deviation from the standard asset pricing model is somewhat rational. According to Renneboog et al. (2008, p. 1734), if the market values investment opportunities correctly, the market will expect that SRI funds will underperform compared to conventional funds, but also that these funds underinvest in attractive investments as well as overinvest in projects with negative NPV after passing through the social screening process. Since the fund managers avoid unethical/asocial corporate behavior it could be argued that they do not require the optimal rate of return. If they would do so, they would maybe invest in sin industries and discard the development impact objective. Therefore, one can argue that due to these investment limitations imposed by the DFIs they accept suboptimal financial performance to some extent, in favor of development impact objectives. Although, this suboptimal performance is obviously preferable compared to not having DFIs investing in their funds at all, since it could mean that the fund would lack capital to even continue its operations. Conclusively, the development objective imposes a change to the market and to some extent, in these cases, confirm a deviation from the standard asset pricing model.

## **6.2 Main Theme: The Relationship between DFIs and Funds**

The second identified main theme includes how the relationship between DFIs and fund managers is guided by certain requirements from the DFIs as well as reporting obligations and the interaction between the two parties. As a result of the loss of control for investors when they put their money in the hands of fund managers it give rise to a potential conflict between the investors and management advisors (Starks, 1987, p. 17). This can be applied to the relationship between DFIs and funds. In order to ensure that the fund manager will act in accordance to the DFI objectives the DFIs seems to have implemented some sort of contract. This theme reveals the relationship between the DFIs and the fund managers and how DFIs use the contract to monitor and control the fund manager. Moreover, we connect the positive/negative screening processes as well as the triple bottom line to the fund managers decision-making process in accordance with what has been discussed by Renneboog et al. (2008).

### **6.2.1 Sub-Theme: DFI Requirements on Fund Managers**

Jensen & Meckling (1976, p. 308) used a contract as a metaphor for describing the relationship between the principal and the agent. They argued that if both the principal and the agent want to maximize their utility it is likely that the agent will act in his/her own interest rather than the principals. As previously mentioned, this can be applied to the relationship between the fund managers and the DFIs since the fund managers may have other interests than the DFI. If the contractual relationship between the fund managers and the DFIs differ significantly agency costs will occur, which is the sum of structuring, monitoring and bonding expenditures of a contract (Jensen & Meckling, 1976). From the interviews with the fund managers and DFIs, it is evident that the DFIs seems to utilize an extensive due diligence process before even deciding to invest in a fund in order to ensure the fund managers will act in accordance to their objectives. All

interviewees described a type of ‘contract’ between the DFI and the fund manager, which includes a specification of what they are allowed and not allowed to do. Thus, DFIs are keen on avoiding conflict of interests between the two parties by forming contractual agreements that establishes what is required in terms of development impact and financial performance. If the contract is in any way violated the DFIs seem to reserve their right to withdraw from the fund and/or take measures to ensure their compliance.

Moreover, both the fund managers and the DFI employees pointed out that before an investment into a fund or a company is made, they look at their track-record. DFIs can hence get an indication of the funds ability to be financially viable and achieve positive development impact. In a similar way a strong track-record proves for the funds that the companies they invest in can perform in those areas as well. This is similar to Sappington's (1991, p. 45) conclusion that the central concern for the principal is to find an agent with specialized knowledge and/or skills. Moreover, all interviewees described that they are required to be adhere to an exclusion list which contains prohibited sectors and activities that the fund managers are not allowed to invest in. Furthermore, most interviewees emphasize the importance to invest in firms with a strong track-record as well as strong management teams. This could be seen as a clear representation of a typical negative screening process, which according to Renneboog et al., (2008, p. 1728) refers to the strategy of excluding specific stocks and industries which are not compliant with the social and ethical criterion, as well as choosing firms with strong track-record and corporate governance. All of the participants mentioned that the fund managers are required to utilize this negative screen in their investment decision-making, which can for example mean avoiding sin industries.

Positive screens on the other hand focus on identifying investments that are superior in terms of CSR practices and are mainly focusing on corporate governance, sustainability, labor relations, environmental standards and diversity (Renneboog et al, 2008, p. 1728). From the interviews we found that many fund managers seemed to be required to perform a due diligence process when looking into a new investment opportunity. The main reason for this is to make sure that the portfolio companies utilize some sort of ESG criterias in their operations. If the companies are not ESG compliant the fund will not invest in those companies. Although, some of the fund managers described that there are examples of occurrences where they may invest in those companies anyway. Their rationale for doing so is that they aim to improve the conditions in that business by investing in for example certain safety equipment and material in order to avoid working accidents in the future. It seems like most fund manager also utilizes some sort of positive screening in their investment decisions since they are carefully examining companies that they are considering to invest in, to ensure that they fulfill predefined ESG criterias defined in the contract between the DFI and the fund manager. This would mean that if the fund managers utilize both positive and negative screening, which according to Renneboog et al., (2008, p. 1728) means that they engage in the *triple bottom line*. This is reasonable since the fund managers both needs to avoid everything on the exclusion list, but also need to actively seek out companies with superior management and labor relations as well as high ESG standards.

#### 6.2.2 Sub-Theme: Reporting, Measures and Development Impact

An important part of ESG is the KPI which have the aim to provide a comprehensive and consistent ESG reporting framework (Bassen and Kovács, 2008, p. 188). All fund managers explained that the DFIs track some KPI metrics, which in term requiring the

funds to report back on the portfolio companies' performance. The participants have similar ways of doing so but usually it includes annual, biannual or quarterly reports specifically presenting how they perform on specific KPI metrics. Evidently, the DFIs are requiring these reports as a way of continuously monitoring that the fund managers' investment decision is on par with their development impact expectations. Two of the interviewees mentioned that their fund hires external consultants for the due diligence process, although it seems like the monitoring function is mainly done completely by the fund themselves. According to Bracking (2012, p. 277) the monitoring of portfolio companies does not usually include many external audits, but is instead almost exclusively performed by the fund managers themselves who self-certify their behavior and performance. This can increase the possibility that the interviewed fund managers' report a higher performance on the portfolio companies, rather than being accurate since they want to avoid DFI repercussions. However, the DFIs' extensive due diligence processes as well as their detailed reporting mechanisms in place should hinder the fund managers from producing over-exaggerated and misleading reports. This study can however not conclude that they *accurately* self-certify their own behavior and performance, nor if it has negative or positive effects on fund manager-DFI relationship. What we on the other hand found out was that all participants seem to find the reporting mechanisms and the relationship to be generally satisfying and constructive.

As previously mentioned, the separation of ownership and control results in agency costs and therefore the principal needs to invest in different kinds of control systems to track the agent's behavior (Cuevas-Rodriguez et al., 2012, p. 526). When the DFIs are planning to invest in a fund, information asymmetry inevitable arise since all actions undertaken by the fund manager is not observable. According to Cuevas-Rodriguez et al., (2012, p. 531) it is therefore essential to design the most accurate contract possible in order to reduce agency costs. It seems like the DFIs have implemented a form of behavior-based contract with the purpose to track the behavior of the fund managers. All of them are required to report back on certain metrics and frequently interact with the DFIs. This type of behavior-based contract can according to Eisenhardt (1989, p. 61) be a way of reducing information asymmetry and to ensure that the agent act in favor of the principal's interest. When the agent's actions are not specified in the contractual agreement moral hazard is likely to arise. Therefore, it is important for the DFIs to clearly specify the requirements on reporting and measuring of development impact to ensure that the fund manager will act in an appropriate manner. From the interviews it seems that most of the DFIs require extensive reporting and follow up on fund performance, both from a financial and development impact standpoint. DFIs also appears to be more demanding in their reporting and have more detailed behavior-based contracts than other investors. Since DFIs are governmental institutions, financed by taxpayer money and constrained by public sector norms they need to ensure that they responsibly invest the taxpayer money into funds and projects that live up to certain ESG/SEE criteria. Conclusively, in order to decrease the possibility of fund managers acting in their own interest and misusing their capital they require more extensive insight in fund manager activity.

### 6.2.3 Sub-Theme: DFI-Fund Interaction

According to Settel et al. (2009, p. 70) there are two predominant models to manage private equity fund investments; 1) the *direct-involvement model*, which entails a close relationship between investor and fund manager where investment decisions are made in collaboration with each other, and 2) the *hands-off model* which entails a more passive

engagement from the investor where they rely heavily on the fund manager's ability and their involvement are limited to the advisory boards. The interviewed fund managers all confirmed that the DFIs take a seat on the funds advisory board to provide the fund with expertise and experience. As Settel (2009, p. 71) concluded this seems to be the minimum requirement from the MDFIs since it provides sufficient contact, political risk cover, fund deal flow and effectively leverage the relationship. Although, most of the fund managers pointed out that even if they appreciate and listen to the advice from DFIs, they are the one's making the investment decision in the end.

As the director of EDFI Jan Rixen also pointed out most of the organizations 16 members usually do not interfere in the decision-making of the funds or take a seat on the investment committee. All but one fund managers agreed with Jan Rixen in that, even though DFIs are usually on the advisory board, they do not get involved in specific investment opportunities. Two of the funds seemed to have DFIs represented on the investment committee, although only one seemed to be actually involved while the other one was more of a formality. According to Settel et al. (2009, p.71) MDFIs do not generally believe that taking a position on the investment committee is detrimental for the relationship. It seems that the funds receive a mandate to make investments decision within the defined DFI-requirements without too much DFI interference in neither the investment committee or advisory board. The majority of DFIs appears to be passively engaged in investment decision and does not interfere in the decision-making, hence indicate that the hands-off model is preferred by both fund managers and the DFIs.

In addition, to the advisory board and investment committee most of the fund managers implied that they frequently interact with DFIs by phone, emails and/or scheduled meetings during the year. Holmström (1979, p. 89) argued that contract can in general be improved by creating informations systems to track the behavior of the agent. This can be interpreted as a way for the DFIs to implement a form of information system with the purpose to increase the the flow of information regarding the agent's behavior, and ensuring that fund managers act in their interest.

### **6.3 Main Theme: Stakeholder Management**

The last theme was identified due to the fact that fund managers operate in an area where several stakeholders are affected by their actions. Carrol (1991, p. 43) argued that corporations' social responsibility to certain groups has resulted in challenges for managers to prioritize between different stakeholders. In this theme the potential conflict between different stakeholders is discussed as well as how managers feel that they need to prioritize between different stakeholders and shareholders. Furthermore, we discuss whether or not the fund manager seems to believe that it is difficult to fulfill multiple objectives, which Jensen (2001) argues that it is.

#### **6.3.1 Sub-Theme: Different Shareholder/Stakeholder Preferences**

Freeman (2010) argued that the manager of an organization need to take all stakeholders interest into consideration in their decision-making process. When making an investment, the fund managers are required to not only consider traditional shareholder return on investment preferences but also other affected stakeholders by focusing on development impact. Almost all of the fund manager explained that they have both institutional investors such as DFIs as well as commercial investors, which may have different preferences when investing in a fund. Since DFIs are financed by taxpayer-money they have to make investments that contributes to development and societal impact.

One problem with stakeholder theory is according to Jensen (2001, p. 14) that it does not contain any specification about how the trade-off between different investors are made. However, most fund managers did not seem to believe that prioritizing between different shareholders, such as commercial investors and DFIs, is necessary. They meant that the mandate to make investments is clearly outlined before DFIs invest in a fund. Thus, the expectations on the fund managers to consider both stakeholders and shareholder preferences are very clear and specified.

It seems like the fund managers does not differentiate between commercial and institutional investors, nor find taking their investment preference into consideration as problematic or contradictory. The reason why the conflict seems to be nearly nonexistent could be because DFIs invest in fund that are socially responsible already. The other commercial investors that the fund attracts should therefore have similar investment preferences as the DFI investors. Lastly, this conflict is also more easily avoided since the investment strategy is defined before the investment and the fund managers are therefore able to focus on identifying investment opportunities that are compliant to the mandate of the fund.

### 6.3.2 Sub-Theme: Satisfying Multiple Objectives

According to Carrol (1991, p. 43) Stakeholder management in SR firms can be challenging for managers when they have to prioritize between different multiple stakeholder objective. Furthermore, Jensen (2001) means that companies aiming to serve more than one objective will experience conflicts when trying to satisfy all stakeholders. Some of the interviewees were very well aware of the criticism that has been directed towards DFIs for not generating enough development impact, hence failing to live up to their development impact objective.

One of the participants explained that the DFIs are under constant attack by the public sector as well as several NGOs which could be seen as stakeholders to DFIs. Subsequently, this could be argued to negatively affect the funds since the stakeholders of DFIs indirectly become stakeholders to the fund and therefore increases the pressure on their performance. A reason for this criticism is according to one participant, that a larger part of the public sector official development aid has over the last year been redistributed to DFIs, having a negative effect on other public sector institutions and NGOs.

Furthermore, some interviewees have experienced *conflicts* between institutional and commercial investors, although the mismatches seem mostly insignificant and usually the interest are well aligned. One fund managers mentioned that a large part of their commercial investors are pension funds, and they usually also have high levels of ESG expectations from the fund managers. The fund managers appear to all agree that commercial investors involved in their funds emphasize ESG metrics. Since the funds already have a development impact focus from the start it could explain why the participants do not believe that it is very difficult to satisfy all their investors. This could be explained by Renneboog et al. (2008, p. 1730) conclusion that SR investors tend to choose SR firms with strong ESG and track-record as well as avoid firms exploiting employees and causing health hazards. In conclusion, the same types of investors tend to make the same type of socially responsible investments, which conclusively reduce the conflicts between them as shareholder. Hence, the commercial investors and the DFI investors should have similar expectations on development impact and financial returns

as well as how to take stakeholders into considerations, resulting in fund managers not perceiving a conflict to any larger extent. Lastly, it is important to underscore that they may have reason to conceal potential investor conflicts if they want to avoid anyone perceiving them as unprofessional and bad at handling diverging investors preferences.

## 6.4 Main Theme: Fund Manager Motives

The third main theme identified is derived from the fund managers' personal views on socially responsible investment and the compensation scheme that is used to motivate the funds to achieve certain outcomes. Bénabou and Tirole (2010, p. 16-17) concluded that an investor's *prosocial behavior* is driven by a complex set of motives including intrinsic altruism, self/social-esteem and material incentives. This theme discusses the fund manager behavior and beliefs in connection to what is considered to be moral behavior. Furthermore, the compensation structure is discussed in terms of both financial incentives as well as development impact incentives.

### 6.4.1 Sub-Theme: Managers' views on investment

The recurring themes in SRI research literature seems to describe the SR investor as an activist with high ethical standards, have environmental and social concerns as well as perceive themselves as having the ability to affect the market. Williams (2007, p. 43) meant that SR investors does not only consider financial return but also include societal and ethical criterion, which seem to be a correct assumption in this study as well. Most of the fund managers appears to not always be willing to give up potential profit in complete favor of other stakeholders. Even though most of the fund managers believes that what they are doing actually makes a difference, all of them underscored that financial viability is *very* important as well. One fund manager for example meant that his motivation goes beyond commercial returns and is more about social fiber. He want to be proud of his investments and argued that strong ethics as well as social circumstances dictates the funds decisions. However, he was also very keen to point out that he tend to focus on the more commercial elements of an transaction and that the financial standpoint is important because they are *not a charity*. The other participants also continuously underscored the importance of financial viability and that this is necessary for a business to become sustainable. This means that Nilsson's (2008, p. 320) conclusion that SR mutual fund investments are driven by both *profit-oriented* and *altruistic* motives, is somewhat true.

The interviewees appear to take a more nuanced approach when trying accommodate both financial performance goals and development impact objectives. According to Rosen et al. (1991, p. 231) the two scales investors operate on are; their CSR expectations (affirmative and avoidance behaviors) and their return on investment preference. Instead of taking affirmative action and actively enforce their beliefs, they seem to be more likely to avoid investments that they perceive as infringing and have negative implications for stakeholders. This conclusion is reasonable since limitations by the DFIs are often described by the fund managers and defined as an exclusion list. This exclusion list dictates what they are allowed and not allowed to invest in. Therefore, since they do not seem to be willing to sacrifice return on investment in favor of development impact they engage in avoidance behavior and only do what is defined as necessary in the exclusions list. Of course it is also reasonable to assume that some of the fund managers pursue their (C)SR-preferences in an affirmative manner, and demand very high standards from the portfolio companies in which they invest. For example, one investor argued that social fiber is an important variable in investment decisions. Encouraging fund managers to

actively seek out socially proactive SR investment opportunities (affirmative) may be more difficult for the DFIs, than handing out a list with activities they consider bad and should be avoided (avoidance). Even though we found indications that DFIs encourage affirmative behavior through control, they seem to mostly focus on imposing avoidance behavior on the fund manager by setting up ESG requirements and utilizing exclusion lists.

Furthermore, some of the participants seemed to express a genuine concern for ethical investments and SEE criteria, implying that they are moral managers. A moral manager is according to Carrol (1991, p. 45), managers that are not only concerned about following norms of ethical behavior, but also to operate above established laws by applying ethical principles. Even though this appears to be accurate to some extent the participants' also underscored the importance of not only development impact, but also for financial performance, hence pointing to them being immoral managers. This means according to Carrol (1991, p. 45) that their management decisions is dictated by what is considered to be right by others, but are first and foremost interested in achieving success and profit. All but one of the interviewees displayed a genuine passion for development impact objectives, SEE criteria, while also underscoring the importance of financial performance. Therefore, one can assume that they, in accordance with Greenwood (2007, p. 320-322), acts of both moral and immoral practices and should therefore be considered as *morally neutral*. While they do not unequivocally act in accordance to their personal moral beliefs, they do not seem to completely discard it in favor of a better financial performance. Hence, we did not find that SR investors are unequivocally moral. Although, as Viviers and Eccles (2011, p. 9) concluded, we found a tendency that moral options and implications are taken into account in investment activities, but mostly because DFIs require it.

#### 6.4.2 Sub-Theme: Compensation Structures and Monetary Incentives

As previously mentioned Cuevas-Rodriguez et al. (2012, p. 536) argues that the interest of both parties can be aligned and the utility function maximized by establishing compensation incentives based on the agent's ability. It seems as the DFIs compensations structure is based first and foremost on carried interest, hence receive profit shares tied to their financial performance. The most common ways for DFIs of devising the financial compensation by tying the compensation *only* to financial performance according to the participants. For example, according to one fund manager it help aligning fund-investor interests and make fund managers more involved. Another fund manager described a threshold of preferred return which, if exceeded, result in a carried interest and that the fund's private equity team get to take part of it. In long term this structure is important to retain talents and to incentivise the funds to work in the interest of the DFI investor. This could be seen as a way for the DFIs to remove the likeliness of agency conflict.

In order to ensure that both the development impact objective and the financial viability is achieved, they should therefore use financial incentives to achieve high performance. Although, the interviewed fund managers and the DFI employees (with the exception of Jan Rixen) all confessed that there was currently no form of financial compensation that is based on the development impact goals. Jan Rixen, mean that environmental and social performance can be part of the carry in form of an annual management fee and is based on performance related development indicators. However, the rest of the participants in this study did not utilize this type of carried interest. In conclusion, if financial incentives is a tool to align interest and ensuring agent working towards achieving both goals, DFIs



have only succeeded in establishing a way to extrinsically reward fund managers to achieve superior financial performance and not high development impact. Instead, it seems that the interviewees have no extrinsic rewards to incentivize them to go over and above the predefined ESG/SEE/development impact threshold.

Therefore, if one is to believe Benabou and Tiroles' (2005, p. 1663) conclusion that prosocial actions is reflected in material self-interest, altruistic motives and self-image concerns, and that if one of these are altered it feeds back into the individual's motivation. Thus, since there is a strong focus on financial compensation (material self-interest), the motivation of the fund managers should conclusively focus more on financial performance of their investments. Moreover, it should mean that the fund managers motivation is altered towards material self-interest and financial performance and away from altruistic motives and development impact. These assumptions seems reasonable to make in the case of these fund managers since they all agree that financial performance incentives is an effective tool to make them work harder towards ensuring the financial viability of the investments. Therefore, an incentive system for development impact should ensure the funds also work harder to perform higher in the development impact area. Although, Luke makes a good argument of why ESG should not be used as a metrics for financial incentives. He means that it could result in private equity management teams focusing more on for example employing more people to a portfolio company because they will get compensated, even if it is not good for the business.

## 7. Conclusions

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*In the chapter below we begin to state our general conclusions connected to the four different themes. The conclusions are intended to answer our research question and the purpose of the study. Furthermore, we discuss our theoretical and practical contribution as well as ethical and societal considerations. Lastly, we bring up our limitations and recommendations for future research in this area of study.*

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### 7.1 Conclusions: DFIs Investments into Funds

This study set out to understand what determines the relationship between DFIs and fund as well as how their involvement affect fund manager's behavior. We conclude that DFIs are perceived as very important in terms of providing risk mitigation and attracting capital to the African continent as well as act as a catalyst by focusing on development impact objectives and not only commercial returns. These fund managers also agree that these institutions support sustainable economic growth in developing countries and even though they do not alter the economic framework of a country they play an important role in attracting additional capital as well as aid in getting strategies of the ground.

Additionally, the fund managers generally believe that the involvement of a DFI considerably affect their investment decision-making process. This is especially true in terms of them requiring a focus on development impact objectives that goes further than just focusing on traditional financial performance goals. DFIs are also seen as more demanding investors since they add an ESG dimension that requires fund managers to invest more time and resources into the investment decision-making process. The introduced development impact dimension can cause fund managers to sometimes feel the need to *trade* some of the financial performance in favor of its progression, although mainly the trade-off is perceived as non-existent. The trade-off however does exist in terms of fund managers not being able to invest in all available industries on the financial market.

Due to these SR restrictions DFIs cause fund manager to trade some of the financial performance in favor of increasing development impact, when they are not allowed to invest in all projects that result in high financial return on investment. However, the financial performance is not perceived to suffer when limited to the SRI investment space, and therefore the trade-off can be either concluded to be non-existent or unimportant according to the fund managers. Moreover, these fund managers does not seem to believe that they need to accept suboptimal performance in favor of development impact objective. Even if making investments in for example sin industries which may result in a higher rate of return, it is deemed more important to include ESG/SRI/SEE criteria. Our findings show that investment opportunities that are not in line with the DFI investors, are not even considered as an option. Since these are not considered, fund manager does not compare sin industry funds with SR funds and the the assumption of a potential trade-off never perceived.

### 7.2 Conclusions: The Relationship between DFIs and Funds

The relationship between the fund and DFIs is according to the participants, guided by a contract that specifies what the fund manager are allowed and not allowed to do. In order to ensure that the investment into a fund will not violate DFI objective, they do an

extensive due diligence pre-investment. The DFIs are very keen on avoiding conflicts with the funds and do so by establishing contractual agreements that guides the relationship. They do so to ensure that the fund manager acts in accordance with their objectives and does not diverge from their mandate. If the contract is in any way violated the DFIs reserve their right to withdraw from the fund and/or take measures to ensure their compliance. The extensive due diligence indicates the importance of hiring fund managers with specialized skills and knowledge to increase the probability of fund managers being adhere to make sound investment choices in accordance to the DFI objective.

Furthermore, our findings show that the exclusion list provided by the DFIs cause these fund managers to engage in negative screening when deciding whether or not they make investments. Moreover, the DFIs also increase the focus on seeking out investments that are superior in the ESG/SEE investment space, thus positive screening. Our findings show that the participating fund managers utilized both positive and negative screening, in other words what is called 'the triple bottom line'. This is a reasonable conclusion since they both avoid making investments defined in the exclusions list as well as seek out companies with strong management and SEE standards.

Additionally, since the DFIs require extensive reporting and continuously follow up on ESG criteria, they utilize a behavior-based contracts. They require extensive disclosure from the funds in order to monitor their behavior and to ensure that the fund managers act in their interest. It can further be concluded that the DFIs engage in the hands-off model and give funds the mandate to make investment decisions within defined DFI requirements. Even though the DFIs and funds communicate on a regular basis, the DFIs are more of a passive investor in that sense that they do not get involved in individual investment decisions. The communication is more related to ensure that the fund adhere to the defined requirements. In order to further control funds' investments being adhere to their objectives and goals they take a seat in the funds advisory board and in some of the cases also in the investment committee. DFIs and fund managers interact regularly through meetings as well as phone calls. Hence, Holmström (1979, p. 89) was right in arguing that information systems can be used to track the behavior of the agent.

### **7.3 Conclusions: Stakeholder Management**

The interviewed fund managers do not differentiate between commercial and institutional investors, nor find taking their investment preference into consideration as problematic or contradictory. The commercial investors and the DFI investors' expectations can be concluded to be fairly similar in regards to development impact and financial return preference as well as how to take stakeholders into considerations, resulting in fund managers not perceiving much of a conflict. The expectations on the fund managers regarding taking stakeholder and shareholders interest considerations, is clearly outlined by the DFI investor. Some of the DFIs did mean that there can arise conflict of interest sometimes, however that did not appear to have insignificant repercussions. Hence, we cannot make claims that proves the existence of a conflict between fund managers and stakeholders. On the other hand, we can speculate that the reason for not identifying any tendencies of a conflict is because investors have similar investment preferences, or it could be that because fund managers conceal investors/stakeholder conflict to not seem unprofessional.

## 7.4 Conclusions: Manager Motives

The fund managers participating in this study were not willing to sacrifice financial performance in favor of development impact objective. Instead they take a nuanced approach and try to accommodate both objectives and are concerned with commercial returns, but also wants to be socially responsible. The extent to which fund managers believe that ESG/SEE should be taken into consideration varies between the participants. We would agree with Nilsson's (2008, p. 320) conclusions that SR investments are driven by both *profit-oriented* and *altruistic* motives. Moreover, the interviews mainly engage in avoidance rather than affirmative behavior, meaning that they avoid investments that they perceive as infringing on DFIs requirements and not actively seek out best-in-class investments to the same extent. We identified both a genuine concern for SEE criteria as well as an interests in achieving success and profit. Conclusively, it is reasonable to assume that they are, as Greenwood (2007, p. 320-322) described it; morally neutral.

In order to align the interest between the DFIs and the fund and maximize the utility function there is an established compensation package defined (carried interest). Interestingly, we can conclude that the compensation is tied only to financial performance and not development impact results. The extrinsic reward for achieving high return on investments motivate funds to perform better and exert more effort. Therefore, our conclusion is that if there were to be extrinsic rewards for high performance in regards to development impacts (e.g. ESG/KPIs) it would incentivize fund managers increase their focus on improving the development impact aspect on the investments.

## 7.5 Summary of Conclusions

To sum up the conclusions and more clearly connect them to the research question and the purpose of the study, we can conclude that DFIs affect the fund managers and their investment behavior to a certain extent. DFIs provide the fund with capital that is essential for many funds to operate in the private equity market in developing countries. Moreover, DFIs make the fund manager focus more on making SR investments by including the ESG/SEE elements as well as prohibit them from investing in certain industries. However, the fund manager did not perceive having to sacrifice investment opportunities by being socially responsible. The requirements and reporting obligations DFIs have on the fund manager, ensure that they will act in accordance to their interest. Although, all the fund manager was not willing to sacrifice commercial return in favor of development impact and therefore we conclude that the fund manager act in both *profit-oriented* and *altruistic* motives, which means that they could be described as *morally neutral*. The interest among the DFIs and commercial investors is fairly similar and therefore we cannot conclude that there exists any conflict of interest between different investors, which means that DFIs do not seem to affect the stakeholder orientation of the fund.

## 7.6 Theoretical Contribution

The intended contribution of this thesis set out to get a more in-depth understanding of how fund managers perceive the involvement of DFIs and their effect on their decision-making. We mean that we have managed to contribute with closing the gap within SRI research to some extent, which according to Capelle-Blancard and Monjon (2012, p. 245-246) has focused mostly on performance related to SRI funds by utilizing similar quantitative data methods. Our theoretical contribution provides a more *in-depth*, qualitative understanding of how fund managers behavior is affected by having to take SRI practices into consideration when making investment decisions as well as how they

utilize different investment screens. Additionally, we connect DFIs role as an institutional investor to previous SRI research, by providing new insights regarding their implications and significance on SR fund managers as well as how they impose an increased focus on social responsibility. Furthermore, we have somewhat closed the research gap regarding DFIs significance as investors in private equity funds in developing countries. We provide additional credibility to Leeds and Sunderland (2003) findings that DFIs play a catalytic role, offering credibility, financial resources and leadership to the private equity market. By discussing the development impact objectives and financial performance imposed by DFIs, we contribute to the theoretical understanding of how fund managers perceive the trade-off between the two goals often considered to be contradictory. Their general views on DFIs implications on investment choice and performance are also exhibited. Our contribution builds on Nilsson (2008, p. 320) regarding the profit-oriented as well as altruistic drives and motives within SR investment.

Furthermore, this thesis presents theoretical knowledge regarding how the relationship between DFIs and fund managers are perceived by both parties through the application of the agency theory. We provide useful insight on how DFIs (the principal) exert control over fund managers (agent), with the purpose to make them act in accordance to DFIs objectives. Moreover, we add insights to the discussion regarding financial compensation, and its ability to motivate fund managers' to pursue high financial performance, but also to the discussion of the implications not having such incentives connected to more intangible development impact objectives.

## 7.7 Practical Contribution

Our findings provide fund managers with insight of what it would mean to involve an DFI investor in their fund as well as how it can require them to change their investment choices to focus more on ESG/SEE criteria. The results indicate that financial incentive motivates fund managers to work harder towards achieving increased financial performance, hence giving DFIs reason to evaluate how a financial incentive structure would look like for development impact. We also demonstrated that the hands-off model seems to be the preferred way by the fund managers to interact with DFI-investors, which include less involvement in the fund's investment decisions. Therefore, if the amount of control is resulting in satisfactory investment results, there seem to be no practical reason to reevaluate its use and change their practices.

Regarding the fund managers view on how development impact and financial performance is taken into consideration - *and sometimes weighed against each other* - can aid DFIs in formulating requirements for funds. DFIs are hence able to examine how ESG/SEE criteria is perceived by the fund managers as well as how they consider them in their investment choices. By understanding how the development impact objective is perceived they can identify potential mismatches between them and the funds, conclusively closing the gap. The funds can also use the information provided in this thesis to align fund manager investment choices with DFIs investment preferences, thereby increasing the fund's performance and flow of capital.

## 7.8 Ethical Considerations

Ethical issues are of utmost importance when interviewing vulnerable people (professionals included) and provision of details regarding distribution of research findings should be provided to the ones involved (Whiting, 2008, p. 38). Since primary data was collected through qualitative interviewing, ethical praxis within the research community was applied throughout the research process and highly prioritized. Guides on ethical behavior in research are plenty in numbers (Beauchamp & Childress 2001; Hammick 1996), but according to UNESCOs (2016) '*Code of Conduct and Ethical Guidelines*', ISAs (2001) '*Code of Ethics*' and Whiting (2008) one of the primary concerns is *confidentiality*. Confidentiality is the participants' protection from being publicly divulged and that there is no linkage between provided information and participants (Polit & Beck, 2004, p. 714). For this reason, all participants were granted anonymity in the thesis and the recordings will be destroyed after final grading. The transcribed data are currently stored safely on an external drive, in order to conduct an audit trail later on, which is according to Whiting (2008, p. 38) is quite common within this type of research. Since the opinions of the fund managers in some cases were of intimate and sensitive nature, their privacy was respected and not disclosed in a way that might put them in a compromising position.

Furthermore, UNESCO (2016) states that the researcher should maintain the integrity of the research enterprise and be conducted in such a way that potential future research will not be diminished by negative after-effects. In order to fulfill this ethical requirement, scientifically accepted research journals, literature written by renowned authors within their respective area of research and respected newspapers, constitutes the basis for this thesis. In order to avoiding the risk of plagiarism sources were accurately referenced and cited.

## 7.9 Societal Consideration

The main goal of DFIs is to ensure a positive development in developing countries through socially responsible investment. Conclusively, they make investments that help weak actors in the society by providing capital (through private equity funds) to e.g. entrepreneurs in need of money. We see it as highly beneficial for these DFIs, fund managers and stakeholders, to be able to better understand the underlying dynamics of all involved parties. This could enable the identification of areas of improvement, hence enabling communities to benefit even more from DFI investments. Our future recommendations can also shed more light on the DFIs as institutions, conclusively increasing their mandate and budgets to make even more societal-improving investments. Moreover, our thesis contributes to fund managers not perceiving SR investments as impeding their ability to make great investments, subsequently increasing the proof that including ESG metrics in investment choice is just as good as not considering them. Therefore, by further adding proof that SR investments can result in great financial performance, the rationale for making investments that have a positive effect on stakeholders, should be strengthen. In conclusion, it would seem that this thesis contributes with added value to society and the area of study.

## 7.10 Limitations and Recommendations for Future Research

Due to time and resource limitations our study includes eight participants, which only provide an indication of how the dynamics between DFIs, funds and fund managers look like. Therefore, we suggest that more extensive qualitative research regarding this

relationship should be conducted and that more participants is included in the examination to increase the ability to draw even more valuable conclusions. Additionally, it would be interesting to see if there are any geographical differences determining fund manager behavior. Hence, we suggest that more research is done in other developing markets, such as in Asia or Latin America.

The study is also limited to fund managers that works in fund in which DFIs already invested. Therefore, it is necessary to widen scope of the research so that it also includes funds that does not have institutional investors. By doing so it enables the mapping of differences in investment behavior between fund managers that are subdued by DFI development impact pressures and those that are not. It is also important to continue taking a qualitative approach to the phenomenon of SRI, since it seems that the research community have been more focused on quantitative research methods and examines the differences in performance between conventional and SRI funds. Understanding how the fund manager behavior is important to fully grasp the financial market trend towards becoming more socially responsible. We also argue that qualitative research could connect institutional investments (e.g. DFIs) to SRI in a more concrete and nuanced way. This is especially important in terms of developing countries due to the high presence of these investors and since those markets are growing in an incredibly high rate, becoming more and more important.

Moreover, the increasing inclusion of ESG/SEE criterion is also vital to further examine in relations to fund managers, since traditional investment theorems, such as the standards asset price setting model, are being challenged. The demand for this type of investment options are pressuring fund managers to balance both shareholder and stakeholder needs in a more complex setting. We also mean that it is necessary to continue examining how multiple objectives in regards to traditional commercial investors and DFIs investors investment preferences put strain on the fund managers' ability to handle conflicting interests. Therefore, it would be interesting to further conduct both quantitative and qualitative research regarding this management of investors in relation to the stakeholder theory.

In order to complement our qualitative research results we suggest that future researchers undertake a quantitative method and/or a mixed-method with the purpose to achieve more generalizable results that can be applied to a wider population. For example, by using a survey-method, where fund managers can rate their perception of different factors affecting their investment choices, the implications of DFIs development objective can be further understood in a general sense. Additionally, it would be value-adding to conduct a study in which the selection of the funds is based on more criteria depending on for example, size, number of employees/investors, industries, return on investments etc. By increasing the number of selection criteria it enables the identification of how different variables affect fund manager's investment decision.

Lastly, due to the lack of previous research in the area of study regarding the relationship between DFIs, funds and fund managers, our included theoretical framework is quite extensive and very general. Therefore, we suggest that factors and parts presented in the scientific research review chapter should be individually examined more in-depth.

## 8. Quality Criteria

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*In the final chapter of this study we evaluate our quality criteria from a critical point of view. We discuss the credibility, transferability, dependability and confirmability in order to determine the quality of the study.*

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There has been a controversial debate since the 1980s regarding concerns of designated terminology of the measurement of quality in qualitative research. Initially, this development resulted in a spawn of new terms from qualitative methodologists, but more recently this generation of criteria aimed to measure quality has become even more contested (Seale, 1999, p. 465-466). Several authors (Kirk & Miller, 1986; Tracy, 2010) have argued that the scientific language from the quantitative tradition should be substituted, which has caused various new concepts to arise. Morse et al. (2002), however mean that quantitative measures are accurate concepts to achieve rigor. Other criterion's have also been discussed in the literature, such as *catalytic validity* (Lather, 1986), *tacit knowledge* (Altheide & Johnson, 1994), *transferability* (Lincoln & Guba, 1985) and *empathetic validity* (Dadds, 2008). LeCompte and Goetz (1982) discuss internal/external reliability and credibility, in the context of a particular research goal and problem. However, due to the controversy regarding combining concepts within qualitative and quantitative work, this thesis assume the quality criterion suggested by Guba (1981) and Lincoln and Guba (1985); *credibility, transferability, dependability and confirmability*.

### 8.1 Credibility

In order for the qualitative inquiry to attain high credibility and become acceptable in the eyes of others, the reality of what is examined needs to be described in several ways so that it reflects different aspects of reality (Lincoln & Guba, 1994, p. 301-315). According to Lincoln and Guba (1994, p. 301-302), the credibility will increase if the inquirer can provide '*evidence of persistent observation*' (identifying and assessing happenings and factors that are salient and atypical), demonstrate '*prolonged period of engagement*' (building trust, learn the context and minimize distortions) and to '*triangulate*' (using different methods, sources and multiple investigators).

To invigorate the credibility of the thesis, several aspects of fund manager behavior were embedded into the questions to reflect their reality, when faced with the question of accepting suboptimal performance in favor of societal impact. Theoretical frameworks previously presented in combination with other conducted studies within the area of SRI, constituted the basis for the interview questions. In order to avoid making assumptions regarding the nature of how situational aspects affects their actual work, questions establishing a various number of situations in which the trade-off could arise, were used. Even though this does not fully alleviate the thesis from the risk of failing to asses salient and atypical events, it should have increased the credibility. It is however important to underscore that time and resource limitations may have resulted in salient factors, that affect their behavior, to remain unidentified.

As the period of engagement were limited to circa four and a half months, a complete familiarization with all contextual factors were somewhat limited. Although, judging from the time frame, it is of our opinion that the examination of the theoretical framework combined with the relationships established with the fund managers, were sufficient in providing a credible exposition of contextual factors. Moreover, the use of open questions



contributed to an advantageous dialogue during the interviews, thus added to new and useful perspectives and angles. The semi-structured interview technique utilized gave the interviewed fund managers the opportunity to, from their own point of reference, elaborate their answers and explicate arguments. Consequently, this should have minimized the risk of distortion since the participants were encouraged to further develop answers outside of previously formulated questions. Furthermore, in order to build a sense of trust, the formulations used in emails as well as during the interviews, intentionally aimed to elicit trustworthiness, professionalism and commitment.

Moreover, because of time limitations, it is of our opinion that triangulation would be an obtrusive element when trying to achieve an in-depth understanding of fund manager behavior, thus seemed rational to not focus on. Although, an alternative approach to pilot study were conducted beforehand in order to increase the credibility of the research method. According to Crabtree and Miller (1999, p. 101), the interview guide should be reviewed by third parties and pilot-interviews should be conducted before the actual interviews to enable the identification of problematic aspects. To ensure that we have understood our respondents we have recorded and transcribed the interviews in order to avoid misinterpretations and other mistakes.

## 8.2 Transferability

The transferability of qualitative examination, is according to Lincoln and Guba (1994, p. 316) limited, since the naturalist is only able to formulate hypotheses describing a specific time and context. The degree of similarity between earlier and later context dictates if they are comparable and can only provide a thick description for others to judge if reached conclusions can be transferred to other situations or not (Lincoln and Guba, 1994, p. 316). Shenton (2004, p. 69) agrees with this and argues that it is impossible to apply findings and conclusions to other populations and situations in qualitative project, since it is specifically tied to a small number of individuals and environments. On another note, Williams (2000, p. 210) mean that generalizing claims exist in all interpretivist research to some extent. Stake (1994, p. 236) also suggests that the prospect of transferability not necessarily needs to be rejected immediately, since the findings can be an example of a broader group, even if it is unique. This should however, according to Shenton (2004, p. 70), be pursued with caution so that the influence of contextual factors impinging on the findings become belittled.

Because of this evident controversy regarding the level of transferability within qualitative research, we proceed with caution when discussing the possibility of transferring the conclusions to other contexts. We argue that the interviewed fund managers provide an in-depth picture of their behavior, within the limits of the specific situational circumstances they act within. With reservation, the transferability of the inferences could be argued as somewhat plausible. The experience of these fund managers cannot simply be discarded as mere fiction due to the lack of statistical generalizability, but should be accepted as indicators of industry behavior. Also, when analyzing the responses from the interviewed individuals, a certain level of homogeneity was identified. Even if they expressed themselves in a variety of ways, we interpreted the answers to several questions as very similar, conclusively indicating that managers working in different funds and DFIs share the same opinions. Subsequently, these observations should imply a possible transferability, if the study was replicated. Lastly, the narrow objective should provide a stepping stone for future research within the area

of behavioral finance and the implications institutional investments has on traditional investment behavior.

### **8.3 Dependability**

Shenton (2004, p. 71) argues that in order to reach high dependability, future researchers should be able to repeat the study and preferably achieve the same result, thus requiring detailed information of the study's methods. Readers should be able to evaluate the effectiveness of the method, develop an understanding and assess if the research practices have been followed (Shenton, 2004, p. 71).

In order to increase the dependability of the thesis, all included stages of the research were recorded. To facilitate a possible replication of the study theoretical frameworks, assumptions, and methodological approaches are clearly presented and argued for. The interview guide and interpretations as well as the method of analysis are available to the reader, thereby enabling the identification of potential flaws and improvements. Due to the detailed research approach as well as clearly presented rationales regarding decisions and choices, the ability to repeat this study is high - making the claim of high dependability more solid. However, it is important to underscore that even though the same method can be utilized, the same respondents is not going to be able to confirm their answers due to confidentiality reasons, hence lowering the dependability. Additionally, the thesis will be subjected to a grade assessment by the committee of grading at Umeå university, by assigned supervising assistant professor Rickard Olsson as well as critically reviewed by master students. These three parties should be viewed as sufficient peers to ensure that the research followed proper research procedures, reached plausible conclusions and that the theoretical inferences were somewhat justified.

### **8.4 Confirmability**

Confirmability refers to the comparable concern to objectivity of the investigator and how to ensure that the findings of the study reflect informant's ideas and experience, and not preferences and characteristics of the researcher (Shenton, 2004, p. 72). According to Shenton (2004, p. 72), the research should acknowledge methods adopted and decisions made as well as alternative approaches and rational arguments for and against chosen techniques.

Since our perception of reality have an inevitable effect on the outcome of the research, we consistently present rationales for choices made and directions taken. Due to the fact that our experience within the area of SRI and fund manager behavior, to a large extent stem from academia, it is deemed necessary to point out that the lack of professional experience can have had implications on our approach. In order to ensure that the result reflect the fund managers' experiences, the interview questions were based on accepted scientific concepts such as SRI, agency theory, stakeholder theory and value Maximization. To avoid the occurrence of bias we as author frequently and consistently questioned our interpretation of the answers in order to increase the level of objectivity in the interpretations. Finally, alternative methods of approaching the research question, including advantages and disadvantages, was presented in order to provide the reader with a more complete depiction of this study's choices. The level of confirmability should within previously presented facts, be considered as relatively high.

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## Appendix 1: SRI: what is it about?

Table 2: SRI: what is it about?

Newspapers	1982–1999		2000–2009		Difference in percentages
	#	%	#	%	
Altruism	12	0.3	52	0.2	–0.1
Sacrifice	129	3.1	372	1.6	–1.5***
Moral	467	11.1	1,367	5.9	–5.3***
Religion	82	2.0	296	1.3	–0.7***
Performance	1,359	32.4	8,289	35.6	3.2***
Diversification	87	2.1	973	4.2	2.1***
Best in class	10	0.2	255	1.1	0.9***
Filter or screen	497	11.9	1,537	6.6	–5.3***
Activism	134	3.2	1,017	4.4	1.2***
Stakeholder	74	1.8	948	4.1	2.3***
South Africa	710	16.9	864	3.7	–13.2***
Human rights	427	10.2	2,917	12.5	2.3***
Climate	100	2.4	2,817	12.1	9.7***
Sustainable	200	4.8	4,436	19.0	14.3***
Corporate governance	101	2.4	3,233	13.9	11.5***
Academic journals	1982–1999		2000–2009		Difference in percentages
	#	%	#	%	
Altruism	10	9.3	38	6.7	–2.6
Sacrifice	8	7.5	28	4.9	–2.5
Moral	33	30.8	241	42.5	11.7**
Religion	12	11.2	63	11.1	–0.1
Performance	58	54.2	411	72.5	18.3***
Diversification	5	4.7	53	9.3	4.7
Best in class	18	16.8	79	13.9	–2.9
Filter or screen	21	19.6	123	21.7	2.1
Activism	7	6.5	140	24.7	18.1***
Stakeholder	17	15.9	354	62.4	46.5***
South Africa	24	22.4	77	13.6	–8.8**
Human rights	18	16.8	188	33.2	16.3***
Climate	22	20.6	134	23.6	3.1
Sustainable	35	32.7	294	51.9	19.1***
Corporate governance	10	9.3	227	40.0	30.7***

The number of articles is obtained by running the following query: 'socially responsible investing' or 'socially responsible investment' or 'ethical investment' or 'ethical investing' for the period 1982–1999 and 2000–2009 successively. We provide, for each period, the total number (#) and the percentage (%) of articles (total number divided by the number of articles with the words 'investing' or 'investment'). Newspaper articles are collected from Factiva (Dow Jones). Academic articles are collected from ScienceDirect-Elsevier, Wiley Interscience, SpringerLink, and Jstor (only journal articles are considered). To test for differences between percentages, we use the standard Z-statistics. \*\* and \*\*\* denote significance at the 5% and 1% levels, respectively.

SRI, socially responsible investing.

(Capelle-Blancard and Monjon, 2012, p. 246).

## Appendix 2: EDFI Exclusion List

The European Development Finance Institutions (EDFI) have as a result of their harmonization process mutually agreed on the following Exclusion List for co-financed projects.

- 1) Production or activities involving forced labor<sup>4</sup> or child labor<sup>5</sup>
- 2) Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements.
- 3) Any business relating to pornography or prostitution.
- 4) Trade in wildlife or wildlife products regulated under CITES<sup>6</sup>
- 5) Production or use of or trade in hazardous materials such as radioactive materials<sup>7</sup>, unbounded asbestos fibers and products containing PCBs<sup>8</sup>.
- 6) Cross-border trade in waste and waste products unless compliant to the Basel Convention and the underlying regulations.
- 7) Drift net fishing in the marine environment using nets in excess of 2.5 km in length
- 8) Production, use of or trade in pharmaceuticals, pesticides/herbicides, chemicals, ozone depleting substances<sup>9</sup> and other hazardous substances subject to international phase-outs or bans.
- 9) Destruction<sup>10</sup> of Critical Habitat<sup>11</sup>
- 10) Production and distribution of racist, anti-democratic and/or neo-nazi media.

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<sup>4</sup> Forced labor means all work or service, not voluntarily performed, that is extracted from an individual under threat of force or penalty as defined by ILO conventions

<sup>5</sup> Employees may only be taken if they are at least 14 years old, as defined in the ILO Fundamental Human Rights Conventions (Minimum Age Convention C138, Art. 2), unless local legislation specifies compulsory school attendance or the minimum age for working. In such cases the higher age shall apply.

<sup>6</sup> CITES: Convention on International Trade in Endangered Species of Wild Fauna and Flora.

<sup>7</sup> This does not apply to the purchase of medical equipment, quality control (measurement) equipment and any other equipment where EFP considers the radioactive source to be trivial and/or adequately shielded.

<sup>8</sup> PCBs: Polychlorinated biphenyls, a group of highly toxic chemicals. PCBs are likely to be found in oilfilled electrical transformers, capacitors and switchgear dating from 1950-1985.

<sup>9</sup> Ozone Depleting Substances: Chemical compounds, which react with and delete stratospheric ozone, resulting in "holes in the ozone layer". The Montreal Protocol lists ODs and their target reduction and phase-out dates.

<sup>10</sup> Destruction means the (1) elimination or severe diminution of the integrity of a habitat caused by a major, long- term change in land or water use or (2) modification of a habitat in such a way that the habitat's ability to maintain its role (see footnote 10) is lost.

<sup>11</sup> Critical habitat is a subset of both natural and modified habitat that deserves particular attention. Critical habitat includes areas with high biodiversity value that meet the criteria of the World Conservation Union (IUCN) classification, including habitat required for the survival of critically endangered or endangered species as defined by the IUCN Red List of Threatened Species or as defined in any national legislation; areas having special significance for endemic or restricted-range species; sites that are critical for the survival of migratory species; areas supporting globally significant concentrations or numbers of individuals of congregatory species; areas with unique assemblages of species or which are associated with key evolutionary processes or provide key ecosystem services; and areas having biodiversity of significant social, economic or cultural importance to local communities. Primary Forest or forests of High Conservation Value shall be considered Critical Habitats.

In addition to the above, the financing of projects is excluded, when the following activities form a substantial<sup>12</sup> part of a project sponsor's primary operations or those of the project:

- 11) Production or trade in<sup>13</sup>
  - a) weapons and munitions
  - b) tobacco
  - c) hard liquor
- 12) Gambling, casinos and equivalent enterprise

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<sup>12</sup> A benchmark for substantial is 5 – 10 % of the balance sheet or the financed volume.

<sup>13</sup> In Financial Institutions this is calculated with regard to the portfolio volume financing such activities.

## Appendix 3: Interview Guide

### Interview guide

#### Short presentation of ourselves and our study

- **Thank you** so much for participating in our study, we're really **appreciate your help**.
- We are **examining** Development Finance Institutions and their **role** in reducing poverty, unemployment and improving the living standard in developing countries.
- What we specifically are interested in examining is how **DFIs affect funds and fund managers decision-making**.
- Since there are not a lot of scientific research regarding DFIs were looking to contribute to **new insights by discussing it in connection to socially responsible investments**.
- Of course you will be **completely anonymous** in this study.
- We would also like to ask you if it is okay to **mention the name of your fund** in our thesis? Your company will **not be put in a compromising position** since the study only aims to understand individuals' decision-making processes.
- **Before we begin the interview, do you have any questions** you would like to be answered to before we start?

### **Background**

1. What is your position in the company? Do you have a background in academia? If yes, what is your level of education and what was your area of study?
2. Which fund/s do you currently manage?
3. For how long have you been working as a fund manager? And for how long have you worked for this fund/s?
4. What is your previous experiences with socially responsible investment? How do you believe that this has affected your attitude towards investment decisions?

*(Question 1-4 aims to get a background of the participants, but also to understand their personal motives and values regarding socially responsible investments. This is important in order to understand how they perceive their investments having actual positive implications, or if they simply aim to avoid investing in projects that does not harm society).*

### **General Questions About the Investment Process and DFIs Involvement**

5. Which DFIs have invested in the funds of your company? (both Nordic DFIs and other). Do you only have institutional investors? Does the DFIs take majority or minority in the fund?
6. What role do you think DFIs plays in supporting economic and social development in Africa?

*(Question 5-6 aims to understand the significance of DFI investment has on fund operations, thus manager behavior. If several DFIs has invested in the fund it would presumably increase their influence of the funds and decisions made. Additionally, if the DFI(s) has a large percentage of the total investment their influence should increase)*

### **Investment Screens and Personal Motivations**

7. Which companies/industry/projects do you typically invest in? Please provide examples.
8. What are the selection criterias and investment strategies when deciding to invest in a company/project/industry?



9. Do you avoid different types of companies/projects/industries when investing?
  - a. Are there some projects that you would absolutely not invest in and if so, why?
  - b. Have you invested in companies/projects/industries that does not fulfill the established ESG criterions with the purpose to make them more sustainable and social responsible?
10. What do you personally believe is important important when investing in different projects? What do you think is most important?

*(Question 7-10 aims to identify what drives fund managers. Is it to avoid investing in non-pro-social projects (negative screening) or actively seek out best-in-class in regards to CSR practices? Do they perceive themselves as having the ability to impact or do they just invest in SRI-projects because they believe it will outperform the conventional counterpart in the long-run)*

#### **Control**

11. What kind of requirements does DFIs have on your fund and you as a fund manager?
  - a. Do you have any specific goals that you need to satisfy? And do you think they sometimes are difficult to satisfy? Please describe.
12. What is your primary way of interaction with a DFI? Telephone, video meetings, email, visits? And how often do you interact with DFIs?
  - a. Does the DFI take a seat in the advisory board and/or investment committee?
  - b. Do you think that DFI interaction affect your day to day work activities?
13. How does DFIs follow up on development impact results on your investments? Do you have any kind of information systems or other channels for reporting on financial performance to DFIs?
  - a. How do you report on societal impact results?

*(Question 11-13 aims to investigate if there exist information asymmetry between fund managers and DFIs and if DFIs utilize some sort of control system that affect fund manager behavior and decision making process. By asking these questions, it enables us to evaluate how DFIs control financial performance and development impact. They also help to understand their influence on fund manager activities)*

### **The Role of DFIs**

14. In what way does an DFI involvement influence your investment strategy? Do you think it affects you to a large extent?
  - a. And do you think it makes you as a fund manager focus more on investment that has high societal impact and maybe prioritize that over financial performance sometimes?
15. What is your view of the possible trade-off between social impact and financial performance? How may they contradict each other according to you? Do you have any example?
  - a. Would you say that you feel limited when not being able to invest in all types of projects when you have a socially responsible and sustainable focus?
16. How do you think that the size of the DFI investment affect your investment decisions?

*(Question 14-16 aims to understand the effect DFI have on the organization and how the fund managers perceive the role of DFIs to be. Additionally, the purpose of the questions is to understand DFI effect on investments and how they perceive the DFIs actual role in improving the conditions for people living in underdeveloped regions)*

### **Stakeholder/Shareholder Consideration**

17. How do you take all investors into account when making an investment decision? Do you think it is difficult to satisfy all your investors?
18. Do different investors have different investment preferences? Is there a difference between DFIs and commercial investors?
  - a. Do you feel that it sometimes can be a conflict of interest between investors? How would you go about that?

*(Question 17-18 aims to understand how different stakeholders affect the decision making of fund managers and if there exist any conflict between them. If there are other stakeholders that does not require the same level of development impact, these questions can provide an understanding of how the fund managers needs to account for various investor preferences)*

**Compensation and Financial Incentives**

19. How do you get compensated (bonuses) by your employer when investing in projects?
- a. Does your company receive compensation from DFIs for satisfying results?
  - b. Do you get compensated for investing in a project that result in high return on investment? How does this look?
  - c. How do you believe that financial incentives affect your performance?
20. Do you get compensated for investing in a project that result in high development impact? If yes, how does this look?
21. How do you think that your investment decisions are affected by the fact that you only get compensation for high return on investment, and not societal impact?

*(Question 19--21 aims to explain how the principal-agent problem can be applied to the relationship between fund managers and DFIs. If the fund manager's mostly have traditional incentives for financial viability it may result in a conflict with the DFIs objective of promoting development and sustainability. Therefore, we would like to examine how this could lead to the fund managers' acting in their own interests to maximize their utility)*

## Appendix 4: Interview Probes

### **1. Clarify their answers:**

- a. Can you please explain what you mean about (term or phrase)
- b. When you talk about (term or phrase), what do you actually mean that you are doing?
- c. Could this be summarized like...
- d. Do you mean that....

### **2. Ask for more details**

- a. Can you please exemplify
- b. How would you go about doing that?
- c. Can you please describe a little bit more?
- d. How would that look like?

### **3. Understand thoughts, feelings and rationales**

- a. In what way is this important for you?
- b. What was your feelings about that?
- c. Why do you feel that this is more important for you?

### **4. Identify variations**

- a. Have you always felt this way?
- b. In what way has your approach changed over time?



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