MACKENZIE
Investments

June 2025

Mackenzie Fixed Income Team

# Investing with impact

## The financial and social benefits of outcome bonds

## Executive summary

Outcome bonds represent a groundbreaking investment mechanism that aligns financial returns with measurable social and environmental impacts. These bonds involve a collaborative structure where investors, service providers, issuers and outcome funders work together to achieve predefined non-financial outcomes. Investors provide the initial capital; service providers execute the project; and outcome funders, typically governments or philanthropic organizations, monetize the project's success. If the project meets its objectives, investors receive enhanced returns; if it fails, the principal is returned.

Key risks associated with outcome bonds include issuer default and failure to meet project goals. These risks are mitigated by the high credit ratings of issuers and the inclusion of a "kill switch" mechanism that returns capital to investors if the project fails to scale.

The rewards for investors include enhanced financial returns linked to the achievement of non-financial outcomes, while service providers and outcome funders benefit from the scale and impact of the projects.

The market for outcome bonds is expected to grow as more investors recognize the benefits of this innovative approach, which combines financial returns with significant positive social and environmental impact.

## For decades, investors seeking to expand the influence of their capital beyond the generation of financial returns to enable non-financial impact, have been challenged by the perception of a zero-sum game: having to choose between doing well financially or doing good for society and the planet.

A range of investment approaches has been developed to resolve this dilemma. Some have proved more successful than others in meeting these twin objectives, but none have allowed investors to optimize both objectives equally and causally.

In some cases, falling short of meeting both goals — financial returns and direct, definable non-financial impacts — can be attributed to an oversimplification of the problem. For example, the concept that an investor could meaningfully mitigate climate change and achieve all-encompassing outperformance by buying transition technologies and selling high-emitting fossil fuel assets, has proved to be an inadequate approach. From an impact perspective, conventional investment vehicles that follow this script are transactional in nature and though they may marginally help to reduce the cost of capital for best-in-class issuers — either leading their peers in operational sustainability or the production of transition enabling products — they do not directly drive measurable positive social or environmental change. Likewise, while in a net-zero aligned future, these transition investments should outperform financially over a multi-decade horizon, in the short term, volatility will affect returns.

The bond market has developed dedicated instruments, such as green bonds to fund projects tied to the delivery of specific, measurable non-financial outcomes, and sustainability-linked bonds to provide accountability to sustainable KPIs. While green bonds effectively replicate the risk profile of non-green bonds from the same issuer, and sustainability-linked bonds provide financial insurance to investors in the event of missed targets, both structures are incomplete: green bonds fail to provide investors with financial incentive, while sustainability-linked bonds lack direct impact.

The limitations of these approaches do not mean sustainable investing is a structurally unsound proposition. While financially viable, the initial instruments fail to account for the delivery of impacts that are measurable and causal to the investment.

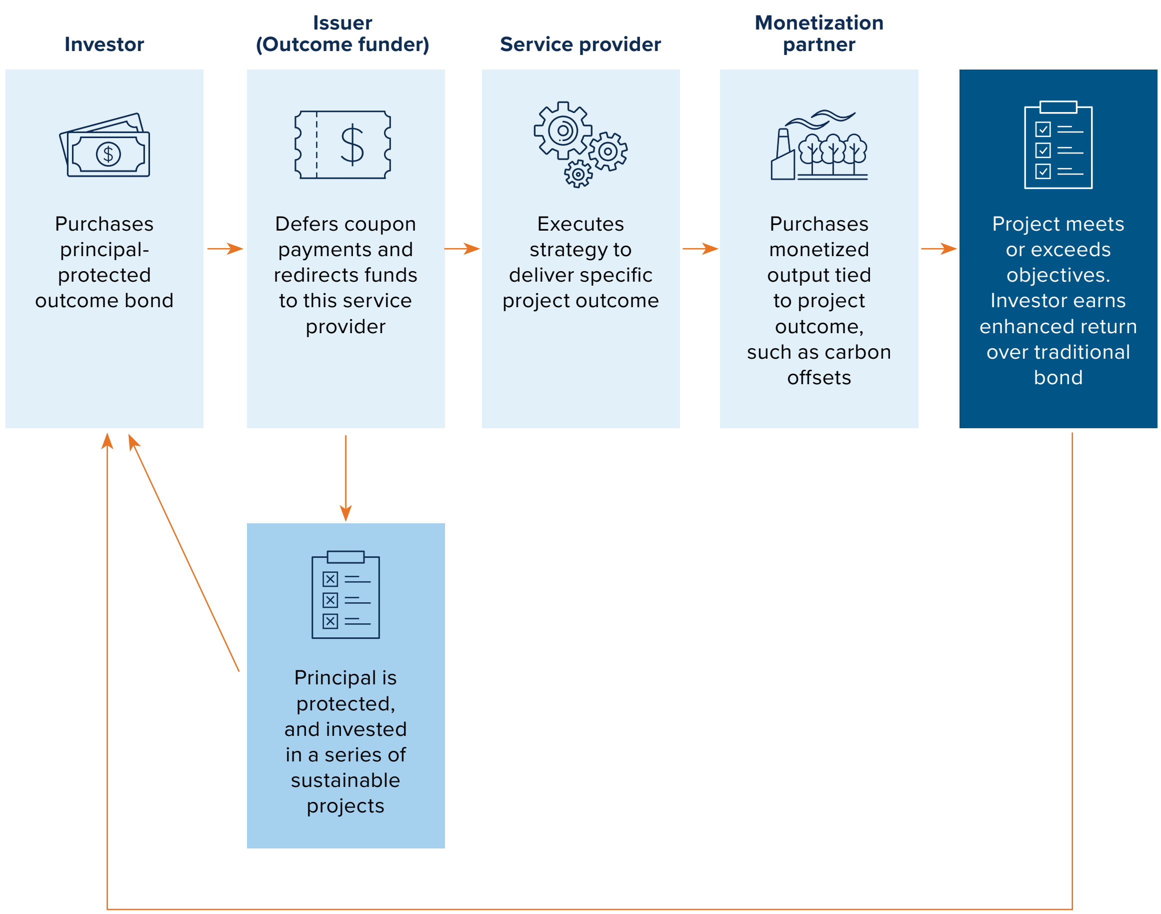
| Investment approach | Best-in-class issuers | Use of proceeds bonds | Sustainability-linked bonds | Outcome bonds |
|---|---|---|---|---|
| Measurable financial returns | ✓ | ✓ | ✓ | ✓ |
| Investment directly produces social or environmental outcomes | ✗ | ✓ | ✗ | ✓ |
| Linked non-financial outcomes are measurable | ✗ | ✓ | ✓ | ✓ |
| Financial returns directly connected to achievement of non-financial outcomes | ✗ | ✗ | ✓ | ✓ |

# Outcome bonds: establishing a direct and causal relationship between impact and financial returns

There is a different, lesser-known investment structure that addresses the essential challenge of delivering positive, measurable non-financial impacts and strong investment performance. This type of investment, known as an “outcome bond”, aligns the interests of all invested parties and incentivizes the optimal execution of development projects. As projects deliver increased output, service providers see enhanced performance, and investors see strengthened returns.

As seen in Figure 1, outcome bonds typically involve a contract between investors, service providers, issuers and outcome funders (often governments or philanthropic organizations). Investors provide the up-front capital required to initiate and sustain the project. Service providers are responsible for implementing the project and delivering the desired outcome, which is then monetized via the outcome funders. Issuers then distribute an incremental return stream to investors if the project meets predefined success criteria.

**FIGURE 1: Basic outcome bond structure**



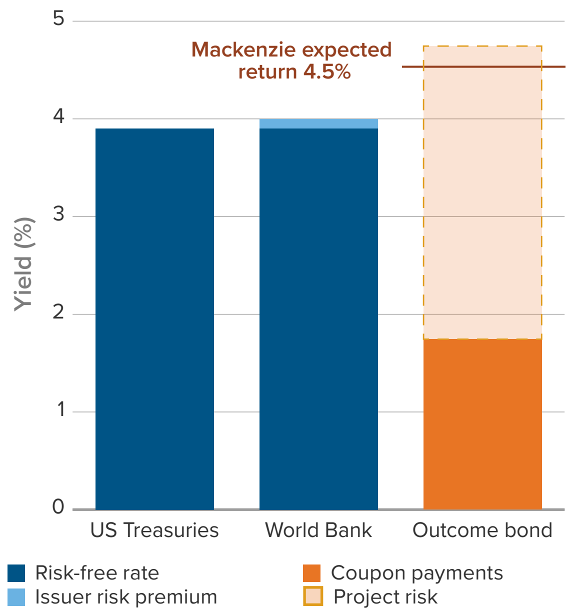
What fundamentally sets outcome bonds apart is the structure of investment risk. While most sustainable investment structures, such as green or social use of proceeds bonds, maintain the investment risk of the issuer, the success of the social or environmental outcome has no bearing on investment performance. As seen in Figure 2, with outcome bonds, a premium (or discount) is realized on the investment upon maturity, pending the successful completion of the project. This structure enables the transfer of non-financial risk — the risk that the expected social or environmental outcomes are not achieved — to the investor, creating a direct and causal relationship between impact and financial returns.

The result is a unique structure where every party has the potential to earn the results they desire at a risk level they deem attractively valued.

## Outcome bond example: Amazon Reforestation-Linked Bond

| | |
|---|---|
| **Issuer** | International Bank for Reconstruction and Development (World Bank) |
| **Size** | $225 million (USD) |
| **Tenor** | 9-year |
| **Rating** | AAAp (Principal protected) |
| **Service provider** | Mombak |
| **Monetization component** | Carbon removal units (“CRU”)[1] from the reforestation of degraded lands in the Amazon rainforest regions of Brazil. |
| **Outcome funder** | Microsoft (among others) |

**FIGURE 2: Return/impact structure**




Source: Bloomberg, World Bank. June 30, 2024.

### Outcome sample KPI’s

| | | |
|---|---|---|
| **Land restored** | Land restored from a degraded to functioning ecosystem and/or productive use. | 2,825 hectares |
| **Employment created/supported** | Number of jobs (direct employment, full time equivalent) created and/or supported by the project, during the reporting period. | 201 jobs |
| **Expected CRUs** | For each project, an estimate, as at the date of the Impact Report, of CRUs expected to be sold to Microsoft from such prior to the maturity date. | 480,000 |

Source: Mombak Amazon Reforestation Project

# Risks and rewards of outcome bonds

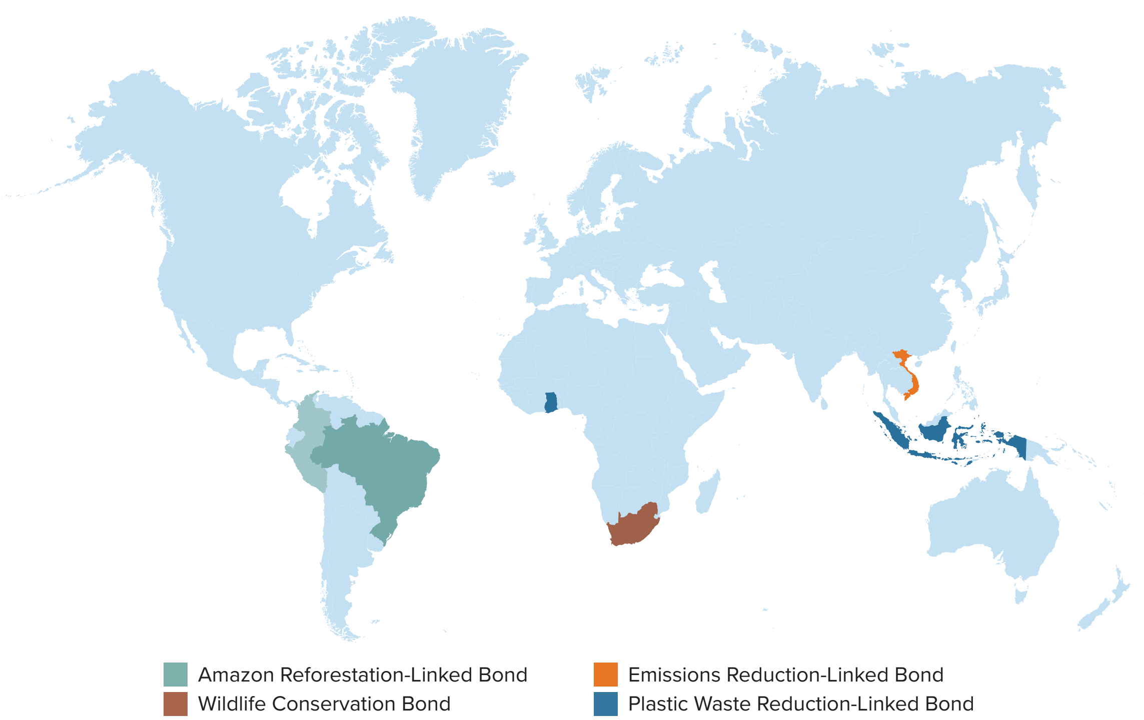
### Stakeholder rewards

| Stakeholder | Reward | Explanation |
|---|---|---|
| **Investor** | Enhanced financial returns | The more successful a project is in achieving defined non-financial outcomes, the greater the financial reward for the investor. |
| **Service provider** | Scale important projects | Attracts increased capital at a below market rate, ensuring sponsored projects have the necessary resources to achieve their goals. |
| **Outcome funders** | Expanded impact | Service provider achieves desired impacts that are measurable, incremental and causal to the investment, providing outcome funders with financially risk-free impact. |
| **Impact system** | Systemic enhancements | Contributes to the development of clear impact metrics, which benefits the broad ecosystem of impact-focused projects and initiatives, where measurement challenges persist. |

### Risks and mitigations

| Risk | Mitigation |
|---|---|
| Issuer default | Bonds are issued by highly rated entities with exceptionally low historic default rates. |
| Failure to meet project goals | Projects are well-vetted by issuers. Outcome bond structure attracts increased capital cost effectively, ensuring sponsored projects have the necessary resources to achieve their goals. |
| Project fails to scale | As investment is largely front-loaded, failure to scale is addressed through “kill switch” mechanism that returns capital to investors. |

### Outcome bond opportunities



# Mackenzie Fixed Income Team process

The Mackenzie Fixed Income Team is an innovative Canadian thought leader in the field of sustainability and is one of the world's original investors in outcome bonds. The team's leadership and continued support has helped to influence the evolution of these unique and impactful investment structures.

The team approaches every opportunity through the lens of managing risk — with respect to outcome bonds, these include risks related to the issuer in addition to the structure of the outcome bond itself. The rigour around the team's process is designed to ensure adequate compensation for any risk associated with the investment.

To achieve this goal, the team employs a rigorous process to evaluate investment opportunities for outcome bonds. This process encompasses thorough due diligence, strategic pre-investment activities, meticulous management during the investment period, and ongoing post-investment engagement. The team's approach aligns with the broad goals of outcome bonds to connect capital to projects with intentional social and environmental impacts and provide investors with the opportunity for enhanced and uncorrelated financial returns.

### Outcome bond due diligence and process

**Pre-investment**

- Cultivate strong relationship with issuers, dealers and implementing agents.
- Leverage the team's strong reputation and expertise to gain access to exclusive investment opportunities.
- Evaluating the alignment of projects with proprietary investment criteria designed to ensure that terms of the bond are favourable.

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**During investment**

- Maintain deep understanding of the project, its counterparties, stakeholders and monetization streams to immediately address any challenges that may arise.
- Engage directly with project funders to structure and, in some cases, negotiate the terms of the deal.
- Adopt an engaged, proactive approach that prepares the team to manage and respond to a range of possible outcomes and adapt the strategy if necessary.

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**Post-investment**

- Communication of project results with transparent, relevant and regular reporting.
- Development of internal documentation to track progress and assess performance.
- Conducting potential site visits to gain firsthand insights into the project's implementation and impact.
- Participation in key conferences to stay informed about industry trends and best practices, while continuing engagement with key stakeholders to monitor issues and ensure ongoing alignment with project goals.

## Conclusion

What began decades ago with the rise of sustainable funds and green bonds aimed to provide *comparable* returns, has evolved to the point that providing investors with *enhanced, impact-linked alpha* is a realistic goal. Outcome bonds have reconfigured the risk/reward equation such that doing good and doing well rest on the same side of the register: the greater the social or environmental impact realized, the greater the financial return. The more fully a project meets its non-financial objectives, the more an investor can earn financial rewards.

Because of the effectiveness of the outcome bond structure, the market for this investment type is poised to grow, as investors recognize the potential for generating both financial returns and social and environmental impacts. The ongoing development of new outcome bonds by institutions like the World Bank will likely expand the range of investment opportunities.

Ultimately, this innovative model has the potential to attract substantial capital to drive significant change in communities and ecosystems worldwide, while simultaneously rewarding investors seeking to achieve both financial returns and meaningful, non-financial impacts with their capital.

## Contributors

**Konstantin Boehmer, MBA**
SVP, Head of Fixed Income Team, Portfolio Manager

**Hadiza Djataou, MBA**
VP, Portfolio Manager

**Andrew Vasila, CFA**
Director, Investment Research

1 A carbon unit represents the reduction, removal or avoidance of a fixed amount of atmospheric carbon dioxide. Units purchased and used by companies to compensate for intractable carbon emissions from those same companies, help them reach their sustainability goals.



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