The Foundation Review

Volume 14
Issue 4 *Impact Investing*

12-2022

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doi: 10.9707/1944-5660.1630

Using Foundation Capital for Good: Opportunities in the Balance Sheet

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Keywords: *Impact investing, ESG, PRIs, MRIs, social bonds, guarantees, catalytic capital, balance sheet, finance, sustainability, policy, advocacy*

Key Points

- Foundations increasingly use their full balance sheets to unlock more of their capital for good. They look beyond conventional grantmaking to pursue their charitable purposes in many ways that exemplify innovative, full-balance sheet approaches: investing in nonprofit and for-profit companies that offer clear social and financial returns; investing their corpus in companies whose products and services align with their missions; using social bonds to inject new resources into their programs; offering guarantees to help grantees manage risk; and avoiding companies whose practices run counter to their grantees' efforts.
- This article looks at the structures, pathways, and tools for foundations wanting to use all their assets and strategies to enhance their positive impact, describes the context in which these efforts are occurring, and provides the landscape of actors and leaders. It also notes countervailing arguments to foundations using their balance sheet or grant dollars for anything but awarding grants mainly focused on opportunity costs and net social impact. In addressing some legitimate concerns, this article offers considerations and suggestions that may help foundations identify and evaluate their investment options.

(continued on next page)

Introduction

Money. Philanthropic funders have a lot of it — over $1 trillion in assets as of June 2022 (Foundation Mark, 2023). Nonprofits want to access it, and investment houses want to manage it. At the 30,000-foot level, how foundations meet those demands is clear — every year, in keeping with the U.S. tax code, 5% of those assets on average is deployed for charitable purposes and the remaining 95% is managed by firms that invest it in for-profit companies. Closer to the ground, how that 95% is invested — on what, for what, for whom — is changing.

Just as they want their grants to have an impact, many foundations — like other investors — want their investments to better serve society; to do well and do good. They seek investments that at best have dual social and financial impact (i.e., impact investing), and at the worst do no harm — investing in companies with superior environment, social, and governance (ESG)[1] ratings, for example. Wanting to utilize more of their capital for good, some also aspire to reduce the countervailing effects their investments may have on the social impacts sought by their grantees. Many belong to funder-focused impact investing groups such as Mission Investors Exchange, the U.S. Impact Investing Alliance, and Confluence Philanthropy, three foundation-oriented groups that focus on informing the field and advancing the policies and practices of

[1] ESG is a set of criteria used by investors to assess a company's operations in terms of its environmental performance; management and quality of its social relations with its employees, suppliers, customers, and the communities where it operates; and its internal governance, including company leadership, executive pay, audits and internal controls, and shareholder rights. Third-party ESG ratings firms use these criteria (individually and collectively) to assign ESG ratings to businesses. Investors may include these ratings in assessing the level of financial and social risk of a company prior to investing in it or in monitoring a current investment.

Key Points (continued)

- Amid the rapid evolution of impact investing, much remains to be done; there are gaps to fill and value to be created. This article concludes with a discussion of key opportunities and challenges for philanthropic foundations and all investors wanting to ensure a sustainable planet and the well-being of all people.

impact and do-no-harm investing within philanthropy and beyond.

Groundwork laid over the past 15 years offers structures, pathways, and tools for foundations wanting to use all their assets and financial tools to enhance their positive impact on people and planet. For example:

- The Global Impact Investing Network (GIIN), established in 2008, provides an organizational structure for defining, tracking, and informing the impact investing field.
- The GIIN-sponsored IRIS+ system provides a set of tools for impact investors to measure and manage their impacts by sector and for cross-cutting themes such as racial and gender equity.
- The Impact Management Platform (formerly called the Impact Management Project), managed by Impact Frontier (n.d.), offers standard ways to consider impacts, including its widely adopted five dimensions of impact.
- The United Nations (2022) Sustainable Development Goals Impact Standards provide businesses and investors detailed internal management standards to help them integrate sustainability and the SDGs into their management systems and decision-making practices.
- The International Finance Corp. (2019), a global development institution affiliated with the World Bank, developed a set of impact management operating principles that identify essential features of managing impact investments.[2]

Context

Definitions of impact investing vary, though the "spectrum of capital" model offered by Bridges Fund Management Ltd. (2015) is a frequent reference. (See Figure 1.) Note that impact investing ranges from requisite competitive returns to requisite below-market returns.

ESG-sustainable investing is frequently included in conversations about impact investing. Public and government investment is excluded. Critically important, it focuses on risk mitigation, while impact investing intentionally seeks to have positive environmental and social impacts. From a "why does it matter" perspective, the ESG market dwarfs the impact investing and philanthropic foundation markets. Bloomberg (Kishan, 2022) placed the ESG market in 2021 at $35 trillion, 30 times larger than the $1.164 trillion impact investing market (Hand et al., 2022) and the $90.88 billion granted by U.S. foundations in the same period (National Philanthropic Trust, 2022). Scale matters.

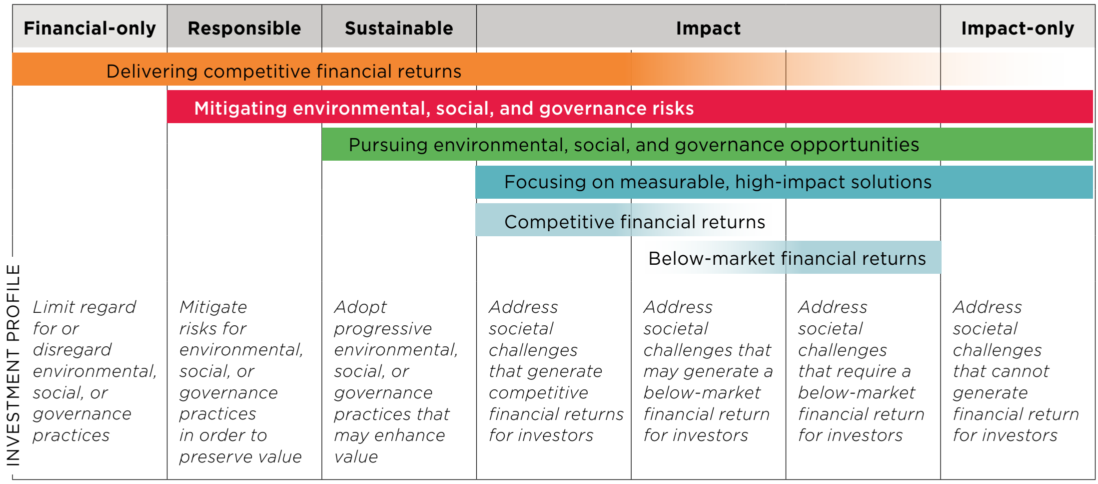
Foundations' Position In the Investment Space

Foundations clearly occupy a unique position within the spectrum of capital. As investors, as opposed to grantmakers, they can make impact investments and they can invest in companies with high ESG scores. Moreover, as investors and shareholders they can use their influence to seek improvements in how companies identify, assess, report, and manage ESG "impacts." They can also inform and educate policymakers and regulators (e.g., the U.S. Securities Exchange Commission) on ways to ensure investors have access to comparable impact risk information on companies before investing in them.

Foundations already do a lot in the nontraditional investment space. Many support

[2] In 2022, the GIIN took over as Impact Principles Secretariat from the IFC.

FIGURE 1 Spectrum of Capital



Source: Bridges Fund Management Ltd. (2015)

program-related investing (PRI),[3] many position some or all their investments to align with mission (mission-related investing, or MRI),[4] some support pay-for-performance, and others support undercapitalized, higher-risk markets through catalytic capital and direct investments. In response to the need for an immediate tranche of funds at the onset of the COVID-19 pandemic, several funders issued social bonds collectively providing over $2 billion to fund crisis-created needs and support building the long-term resiliency to such crises (Beaty, 2022). A handful of funders also provide guarantees to nonprofits so they may extend their loans and investments to higher-risk, capital-starved communities; some of these have created pooled guarantee funds (e.g., the Community Investment Guarantee Pool) in the hopes of reducing transaction costs, demonstrating utility to other funders, and spurring innovation within the nonprofit lending community and conventional lenders.

And even more could be done, noted Hilary Pennington, a Ford Foundation executive vice president. Commenting on the foundation's social bond issue, she said: "It just kind of shows you how much value we leave off the table that people don't actually imagine how much more we could do if we just thought a little bit more creatively" (Beaty, para. 27).

Perhaps the biggest impact investing role to date for foundations is as grantmakers to support infrastructure development and conveners for field building. They led establishment of and provide ongoing support for the GIIN and IRIS+ and were critical early supporters of the Impact Management Platform. Nonprofit engagement in the SDG Impact Standards and the IFC efforts made them more robust because of foundation support. All these efforts continue to evolve; the field would benefit if foundations continued their support for and engagement with them.

An underserved role of foundations is to support the many ways grantees can educate and inform investment-related public policy (i.e., strengthening of laws and regulations). Whether through the SEC, Community Reinvestment Act, Opportunity Zone policies, Community

[3] PRI refers to foundation investments whose primary purpose is to accomplish one or more of the foundation's exempt purposes — its programs — and for which earning income or appreciation of property is not the significant purpose. They often are loans and loan guarantees to, and may be equity investments in, charitable organizations or in commercial ventures for charitable purposes.

[4] MRI refers to investments made by foundations that align with their charitable missions with the primary purpose of earning income.

Development Banking and Financial Institutions Act, or the myriad policies supporting investments in underserved communities and businesses, foundations can support their grantees' policy advocacy efforts. Individual funders are doing this, and some, like the Tipping Point Fund,[5] are doing it together. All are important, and still more needs to be done.

Opportunity Costs and Net Social Impact

Countervailing arguments to foundations using their balance sheet or grant dollars for anything but awarding grants mainly focus on opportunity costs and net social impact. What opportunities to advance social good are missed if some of those dollars are removed from the corpus, thus reducing the amount of grant dollars available and invested in other socially impactful ways?

While legitimate concerns, if you are a foundation, then we offer some considerations and suggestions that may help.

Consider that risks to the corpus, the mission, and social impact accompany all investments — including grants. Grants awarded that fail to or only partially achieve their desired social impacts means that there was missed opportunity to invest those dollars in another nonprofit or perhaps for-profit organization. While not affecting or threatening the corpus, such grants certainly affect fulfillment of the foundation's mission. And, while such underperformance may be considered a problem only for the program side of the foundation, it diminishes the foundation's raison d'etre. Similarly, as mentioned above, the foundation's mission is also threatened by investments whose practices or products run counter to it as reflected in the foundation's programs. Unlike programmatic underperformance, investment underperformance vis-à-vis the foundation's mission is fully controlled by the investment side of foundations.

To manage risks to the balance sheet, we suggest the following:

- Start with lower-risk investments that have less financial impact on the balance sheet. PRIs, while intended to provide a return at market or below-market (i.e., concessionary) rates also are issued from grant dollars and thus have no impact on the balance sheet. If the principal and interest are fully paid, there is zero financial risk; if the PRI defaults, then it can be charged off as a grant. Or perhaps join a guarantee pool. Unfunded guarantees may only affect the balance sheet if the underlying loan defaults, and then the terms of the guarantee (e.g., percentage of loan covered, the position of the guarantee relative to other guarantors) can be written to further limit exposure to the balance sheet. And if a guarantee is called, then it can be paid out of grant dollars and not the balance sheet; the choice from which bucket — balance sheet or grant dollars — the guarantee is covered is the foundation's decision.

- Another low-risk impact investing strategy is to align investments of the corpus with the mission and values of the foundation. Like PRIs, several foundations employ this strategy. The Mission Investors Exchange provides case studies of MRI-using foundations that demonstrate the strategy's low-financial risk, high-mission benefits.[6]

- Providing loans or making equity investments in individual companies is considered the riskiest impact investment strategy. However, just as chief financial and investment officers seek a balanced investment portfolio, so too can a foundation have a balanced impact investment portfolio, both across different "asset classes" (i.e., PRIs, MRIs, direct loans or investments in companies) and within an asset class. Impact Frontiers developed and leads this portfolio approach, offering principles, practices, and trainings for foundations and other impact investors.

[5] See https://tpfii.org/

[6] See https://missioninvestors.org/resources/examples-how-foundations-are-using-mission-related-investments

Filling the Gaps

The breadth, depth, and rapid evolution of impact investing, even as applied just to foundations, is beyond the scope of one journal and its several articles. Much remains to be done; there are gaps to fill and value to be created. Five gaps — thus opportunities — we see that foundations could help fill and continue to build the field are:

1. *The SDG funding.* Impact investing alone will not fill the annual $2.5 trillion SDG funding gap (United Nations, 2014) or bend the curve on our global social and environmental challenges. Capital from public sources and a lot more from private sources via ESG investing and public-private partnerships is necessary. Foundations possess an abundance of useful tools to assist in bridging the funding gaps. They can use their traditional tools of convening, educating, and informing through their own influence and their interested grantees to help mobilize more private and public funds. They can use the more innovative financial tools, such as guarantees and social bonds, or other ways to leverage the markets to help lower the financial risks and accelerate funding. They can also, as the John D. and Catherine T. MacArthur Foundation is doing through its Catalytic Capital Consortium,[7] provide the risk capital to support high-risk, undercapitalized emerging markets that address some of the world's most pressing challenges.

2. *Sustainability.* The health of our planet needs to be elevated into the way in which markets assess risk and consider investment policies. Much of impact and ESG work focuses on single investments and single companies, not on cumulative and systemic impacts or opportunities. Lack of systems thinking, combined with the limited impacts of single investments and the absence of enforceable validation markers to ensure sustainability, beg for resourced attention. Foundations can support intentional, focused support to elevate assessment, management, and verification of individual and collective issues of sustainability into the market and policy discussions.

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3. *Materiality.* Fundamental to financial risk is the "materiality" of the risk being assessed. Existential risks to the planet and people may rise to financial review of a single investment, but not necessarily. Such risks may be cumulative and systemic. Like sustainability, the issue of what constitutes "nonfinancial materiality" remains outside consideration in current markets and most public policies. Foundations can play the same role here as they do in sustainability.

4. *Stakeholder engagement.* One of the knottiest issues with which foundations could play a role is community engagement. From the SDG Impact Standards[8] to the IMP[9] and the World Economic Forum,[10] stakeholder engagement receives hallowed attention. However, the ways in which communities

[7] See https://www.macfound.org/programs/catalytic-capital-consortium

[8] See https://sdgimpact.undp.org/practice-standards.html

[9] See https://sptf.info/images/SIWG-WEF-AG3-Engaging-all-affected-stakeholders-December-2017.pdf

[10] See https://www.weforum.org/reports/measuring-stakeholder-capitalism-towards-common-metrics-and-consistent-reporting-of-sustainable-value-creation

can and should be engaged when issues of their communities' sustainability or non-financial risks are considered (and measured, reported, and managed) remain maddeningly sparse. Foundations can play a role in supporting their grantees and communities along with investors, trade associations, and financial market regulators in finding common ground on acceptable, effective community engagement principles and practices.

5. *Infrastructure.* This article highlights the foundation community's leading role in building the impact investing field. The dynamism of the field and of the changing financial and social context requires ongoing field-level infrastructure investments. The roles of organizations like the Impact Frontiers, IMP, GIIN, the SDG Impact Standards, and the New Capital Project are critical to the continued evolution of the field and to utility of impact investing. These and other nonprofit groups are shaping the necessary impact investing practices, policies, and trainings.

Conclusion

Foundations occupy a critical and unique perch in the investment landscape. As investors they can influence and inform investment practices. As grantmakers they support the field building and enhancement of sustainable investing practices and principles, while also supporting advocates to shape finance and market-oriented public policies. Fully using this powerful dual ability to harness their money for market-scale change with social purpose intent remains the opportunity and challenge for foundations.

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