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A Capital Idea: Total Foundation Asset Management and The Unified Investment Strategy

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A Capital Idea:
Total Foundation Asset Management
and
The Unified Investment Strategy

A Discussion Document

By

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Abstract:

This paper presents the perspective that the purpose of foundations is not simply to engage in grant making, but rather to invest in the creation of social value. The idea is also presented that available foundation assets for supporting this process of social value creation should be viewed as not simply its grant making ability, but its overall investment strategy for both core assets <u>*and*</u> *philanthropic investments. A strategy for achieving maximum social impact—The Unified Investment Strategy—is presented, and the implications of that strategy are discussed. The paper's appendix includes an extended discussion by two foundation trustees regarding the question of fiduciary responsibility.*

The Purpose of this Paper

While this paper is the product of significant thought and reflection on the part of a number of people, it is not offered simply in the spirit of objective analysis and foundation strategy. This paper is offered in the spirit of a passion for change.

The practices and values of the past are not to be disregarded. History, however, is known; what lies ahead is unknown. While the practices of the past should be honored, they must also be built upon and improved. Significant achievements are attained when the vision driven by history's actors is combined with our ambition to achieve the absolute best within us all. It is this passion to push, to achieve, and to improve upon what we create that will constitute the true measure of our lives' work.

This paper is offered in the belief that we are called upon not simply to manage our financial and intellectual assets, but to apply ourselves in continual improvement of our communities and world. The tools at hand—companies, non-governmental organizations, foundations, and public sector entities—are dynamic. The capital sources of talent, nature, and finance stand ready. What remains to be addressed is our own willingness to innovate and embrace emerging visions of what evolved institutions can become.

This paper is intended as a jumping-off point for discussions regarding the effectiveness of leveraging various investment strategies which, when taken together, hold the promise of leaving our children and their children the same thing that was promised to us:

That we might excel and achieve our best, while in the process
contributing to the creation of thriving, sustainable communities
and a world in which we may each take pride.

Acknowledgements:

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While the author is solely responsible for what follows, the critiques, observations, and thoughts offered by each of these individuals have helped strengthen and shape the concepts presented in this document.

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Introduction

Beginning with the Potlatches held by the Indians of the Pacific Northwest and continued by settlers of the New Frontier through the practice of community barn raisings, Americans have always engaged in giving of themselves. We have done this in the belief that it is the right thing to do—in the name of community, in the name of personal integrity, and in the name of God. Yet our relationship with the concept and practice of philanthropy has been a complex one, with the values of selfless giving and charity at play next to notions of "the deserving poor" and the general perception of a separation between the interests of commerce and community.

Take, for example, the creator of the modern foundation, John D. Rockefeller. He was a constant and conscientious practitioner of charitable acts at the same time that representatives of his own corporation were firing weapons at the families of miners on strike in Colorado. We cannot really understand the specifics of how Mr. Rockefeller managed this seeming contradiction. What *is* clear, however, is that while committed to charity and justice, Americans have always struggled with how best to balance social interests with those of business.

Historically, Americans have handled this tension by creating a dividing wall between "doing good" and "doing well." People have generally assumed that while in the process of "doing business" during the week, they should not take into serious account the interests of community or the environment. Rather, such concerns should be addressed naturally through "the market" or during one's personal time. Or, better yet, such concerns should be left to the efforts of others who are drawn to "the cause," however defined.

One could write a strong historical defense of this arrangement. And in many ways, this philanthropic equivalent of the "separation of church and state" has served the nation well. The United States is arguably the most successful experiment in democracy and individual initiative the world has ever seen. One may, quite literally, start a company in the garage behind one's house that ultimately sparks revolutions in both business and technology that profoundly alter people's lives. For many individuals, this drive to create and contribute is a central reason for living. Many of this nation's finest companies and small businesses have been lead by those who provided for the needs of their customers at the same time they sought to provide for the needs and interests of their employees and larger community.

But as a general rule, our society has sought to separate the interests of the company from those of community—to place a dividing line between the worlds of the nonprofit and for-profit corporation. And this line has clearly been drawn within the foundations of this country. Of the 48,000 foundations active in the United States, fewer than 15% take social, environmental, or other non-financial factors into account when managing their greatest resource—their financial assets.[1]

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[1] As recently reported in the New York Times, "…(F)oundations, especially larger ones, have not been in the forefront of the social investing movement. When it last surveyed its membership in 1997, the Council

Within many foundations, staff members who develop and execute strategies for the investment of social capital (in this case, grants) have little interaction with those individuals who invest the institution's financial capital (what has historically been referred to as the "corpus", although this term is somewhat dated). This separation exists despite the fact that both sets of investors work for the same institution, presumably pursuing the same social mission. Foundation leadership expects to invest in the creation of economic value through financial instruments, and to engage in charity through grants and related gifts. While acts of charity are certainly worthy, an evolving philanthropic perspective views grants as a form of capital investment in the creation of social value. At present, there is an investment gap between the financial capital that foundations invest in economic worth, and the social capital with which, through grants, foundations pursue investments in social value.[2] This paper attempts to bridge this "capital chasm" between financial and social capital by leveraging the two sides in pursuit of a more effective realization of their shared goal: *Value Maximization*.

The following pages explore capital investment and the variety of returns it may generate: financial, social, and environmental. We make the following points:

- the "best" way to create total value may not be first through wealth accumulation, and secondly, through wealth distribution;
- a broader framework—the *Unified Investment Strategy*—that combines capital allocations that seek to protect investor assets with investments that support greater social and other value should be considered by investors;
- such a strategy should not be limited to the obvious areas of community economic development and related activities, but should be considered in areas as diverse as education, the environment, and cultural arts;
- foundations can explore new strategies for achieving the *maximum* value possible in the allocation of their philanthropic <u>and</u> market-rate dollars; and,
- there are a growing number of foundations presently applying various aspects of a Unified Investment Strategy to their overall approach to foundation asset management.

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on Foundations found that slightly less than 15 percent screened for any social or ethical consideration. Small foundations, those with assets of less than $10 million, were almost twice as likely to do so as large ones, those with assets of $100 million or more, according to the survey."

[2] The distinction between these two approaches to philanthropy is referred to as transactive philanthropy versus investment philanthropy. This distinction is explored at greater length in *The Nature of Returns*, available at: http://www.redf.org/download/other/emerson1.pdf.

Because this paper raises a number of questions that beg further discussion, we have included a series of discussion points and initial commentary.

Finally, since the issues presented in this paper center largely upon one's understanding of fiduciary responsibility and the purpose of foundation assets, an expanded appendix presents an excerpt addressing the question of an evolved definition of fiduciary responsibility.

Our intent for this paper is less to provide definitive answers than to offer foundation boards, staff, and interested stakeholders the opportunity to discuss what remains the central challenge of philanthropy:

> *How do we achieve the greatest social, environmental, and financial value from our precious philanthropic resources as we strive to contribute to the creation of a better world?*

It is to an exploration of this challenge that we now turn.

Traditional Perspectives on Capital Formation and Allocation

The traditional approach to financial and social capital[3] formation and allocation is quite straightforward:

> An individual, through talent, effort, and chance, generates an increasingly significant amount of personal wealth. These funds are managed with the specific goal of building the asset base, while protecting existing capital. To that end, the individual pursues a range of investment strategies, investing funds in various equity and debt instruments. As the individual's wealth increases, he or she may shift from personally managing the assets to assigning the assets to professionals trained in the effective pursuit of financial asset development and protection.
>
> In time, the individual is approached by two sets of players: charities in search of resources, and fund managers attempting to responsibly oversee the ever-increasing financial base. Many high-net-worth individuals would like to return some portion of their success to the community and society that helped make that success possible. Hence, they would like to positively respond to requests for charitable support. Naturally, they would also like to have those funds effectively managed. In short order, the decision is made to create a family foundation through which the individual may direct his or her financial resources while at the same time protecting his or her own financial interests through various tax advantages.

And it is at this point that the divide begins:

One set of players is charged with protecting and growing the foundation's financial assets, while another is charged with giving away what has been allocated for charity. Foundation board members and program staff are told what surplus funds are available for grant-making, while financial managers sweat to nurture and grow the source that generates surplus funds, which may then be given away.

For the vast majority of foundations the amount of funds allocated for annual giving is the 5% annual disbursement level set by federal regulation. That amount (including foundation administrative expenses) is established as the minimum, but many foundations operate as if it were the maximum amount available for support of charitable purposes. This is in large part due to the traditional assumption that the primary fiduciary responsibility of foundation trustees is to wisely manage the foundation's financial assets

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[3] In this paper, the term "social capital" is used to refer to both civic and financial capital, which, together with other capital elements, constitute the Integrated Social Capital Marketplace. For an extended discussion of these concepts, their connection to traditional definitions of social capital and how they relate to concepts of the Blended Value Proposition and Blended Return on Investment referred to elsewhere in this paper, please see "*The Nature of Returns: Elements of Investment and the Blended Value Proposition,"* a Harvard Business School Working Paper available at http://www.redf.org/download/other/emerson1.pdf. For now, it should be noted that this paper focuses upon the investment of financial capital to generate multiple forms of return and that future papers will explore how multiple types of investment (of financial, social and natural capital) may also be considered.

so that there will always be additional (and, hopefully, an ever-increasing pool of) assets generating 5% returns which may be given away.

Many people who aren't directly involved in asset management of major foundations assume that a foundation's assets consist of a single pot of investments (the "corpus") from which the annual 5% is taken to support grant making programs. In truth, the process of foundation asset management is often much more fluid than that. Indeed, a good deal of a foundation's assets need to be invested in liquid investments (such as bonds) in order to provide the cash flow necessary to fund grants and expenses. Additionally, many people think these grants and expenses are funded solely from the interest and income generated by a foundation's asset base. While this was once true, it is no longer the case. Most large foundations today focus on total return, and are less concerned with whether those returns are generated by dividends, interest, or capital gains. Therefore, there really isn't a corpus anymore, as it has been traditionally understood.[4] As will be argued in this paper, it is the author's position that this understanding of "total return" should be expanded to include not simply financial returns, but social and environmental returns as well.

The entire process as described above is driven in fulfillment of what the board defines as its fiduciary responsibility. This central question of fiduciary responsibility is addressed at great length below (page 35), but for now let's accept the definition as presented above: as the responsibility to manage a foundation's financial assets so as to ensure the ability to generate 5% annual returns which may then be given away.

This process of capital allocation and management produces two results:

1. Many individuals continue to manage their <u>personal</u> assets with the primary goal of providing for their own long-term <u>financial</u> well-being.

2. An additional pool of funds is established with the stated goal of achieving some <u>charitable</u> purpose or intent. Yet those funds are *also* managed with the primary measure of successful management defined on <u>financial</u>—and not charitable, social, or environmental—terms.

It is worth stating again:

The *raison d'etre* for the creation of foundations is to create social value—to provide a public good not generated by the market. This is precisely the reason why foundations are established as tax-exempt entities. And yet 85% of foundations invest their core assets with no reference to social value creation. These foundations measure the success of their investments on a strictly financial basis. Of this 85%, most dedicate only 5% of their asset income (the minimum allowed by law) to the pursuit of social value through the grants they award. These grants become the sole vehicle by which the foundation pursues its social mission. Therefore, the remaining 95% of the foundation's assets are

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[4] The author would like to thank Diana Lieberman of the William and Flora Hewlett Foundation for her input regarding this specific point and related sections of this paper.

committed to the goal of creating ever-greater *economic* value and *financial* returns, since the dominant perspective is that foundations should not spend any of their endowment, but only spend those financial returns it generates.

Under this formula, 5% of capital returns is assigned in pursuit of 100% of the institution's larger social mission, while 95% of capital assets is assigned in pursuit of increasing financial value, with 0% consideration of the social mission[5].

Toward a New Perspective on Social Capital Formation and Allocation

If the foundation's intent is simply to perpetuate its own existence while annually allocating 5% of its wealth to charity, then this scenario is fine. And such a strategy may, in fact, be precisely what a donor and board of directors intend. The following question, however, must at least be broached:

If a donor receives a charitable tax deduction for the creation of a foundation, and has separate investments providing for his or her own long-term <u>financial</u> well-being, then shouldn't a foundation's mission (and the self-defined understanding of fiduciary responsibility for its Board) demand greater consideration than the mere protection and development of financial value as a means to fulfilling its mission? Put more simply:

> *Shouldn't a foundation's investment strategy seek to maximize not only financial value, but social, environmental, and other value as well?*

The emphasis on managing funds in order to have additional funds to give away is based largely upon our understanding of the role of foundations as charitable *gift* entities as opposed to institutions charged with *investing* in the creation of social and other value. In order for a foundation to maximize its value, the general understanding of philanthropy must shift from one that is transactive (i.e. a form of wealth re-distribution) to one that is investment-oriented (i.e. focused upon long-term value created through the application of available resources).

At the same time that we need to shift our perspective away from purely financial capital and toward other types of capital investment, the opposite extreme doesn't work, either. In the same way that individuals of modest means cannot spend their way to wealth, foundations interested in maximizing the total return and overall value of their grant making cannot only make more and larger grants. A balance must be struck: foundations must complement their philanthropic investment strategies with financial investment strategies that leverage the aggregate power of the resources being brought to bear. The goal of combining these two strategies should be to create the largest set of overall returns possible—both social and financial—to maximize the total value of and total returns on the foundation's investments.

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[5] This point was the subject of an extensive conversation between the author and Allen Grossman of Harvard Business School. The author would like to acknowledge Allen's contributions to these ideas.

In other words, a comprehensive investment strategy is required – a strategy that views grant making, asset investment, and institutional debt issuance as three integral parts of a holistic approach to applying, and maximizing the impact of, the foundation's available resources. If an investing institution seeks to create financial, social, and environmental value, it should consider pursuing a *Unified Investment Strategy* focused upon this Blended Value Proposition, and should develop metrics capable of tracking its Blended Return on Investment. Other documents explore this concept of a BVP and BROI,[6] however a brief explanation may be helpful.

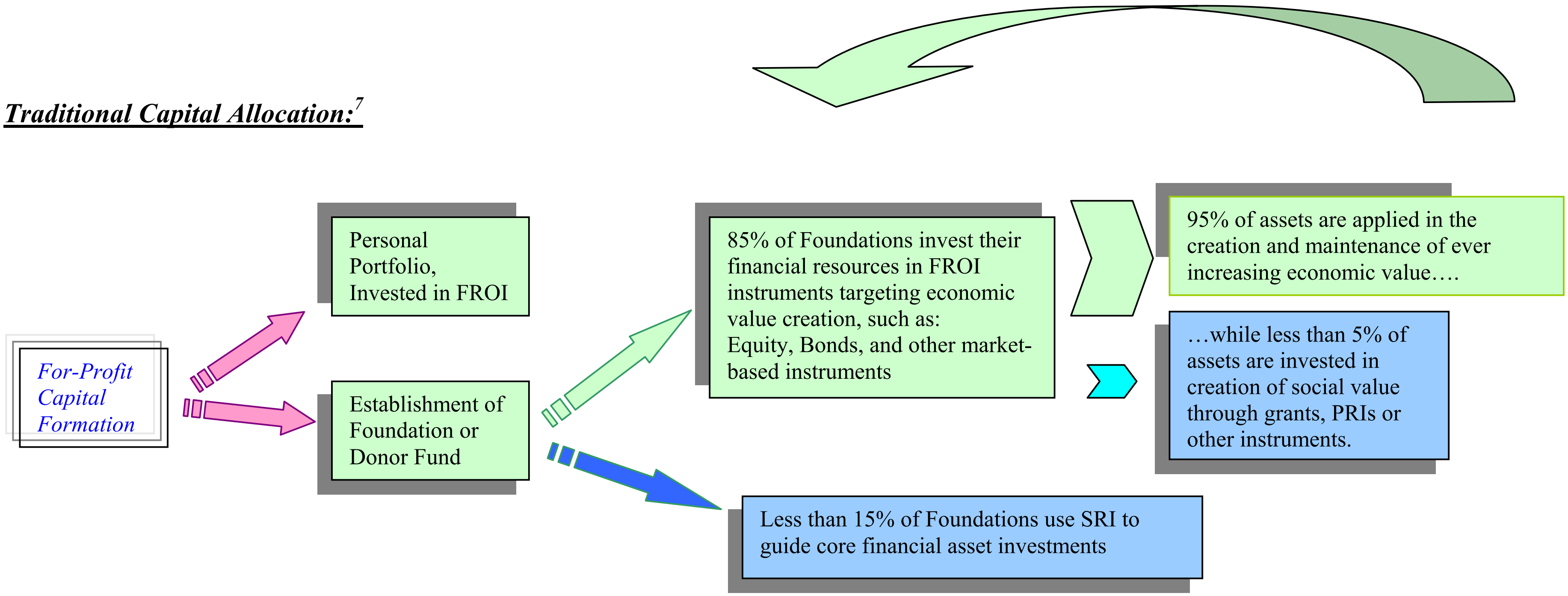
A core concept in traditional business management is one's "value proposition" — namely, in any given business undertaking, what value are you creating for your customers and shareholders? In practice, the performance of any company in pursuing this value proposition is tracked by numerous metrics, but is most frequently assessed on the basis of corporate profit and shareholder return on investment—which are both assessed in strictly financial terms.

Increasingly, however, both nonprofit and for-profit organizations are recognizing that their value far exceeds simple financial efficiency and shareholder returns. Organizations create value in a wide variety of forms—economic, environmental, social, etc.—and therefore are best thought of as encompassing a Blended Value Proposition that generates (and may destroy) a Blended Return on Investment. While an important concept for all organizations, the idea of a BVP/BROI is central to tax-exempt financial institutions, like foundations, that are charged with the pursuit of social value.

And it is to the Blended Return on Investment framework that we now turn.

[6] While this paper touches on the concept of both a Blended Value Proposition and Blended Return on Investment, a complete discussion of the investment continuum and these ideas is beyond the scope of this document. A complete discussion is presented in *The Nature of Returns,* a Harvard Business School Working Paper available at http://www.redf.org/download/other/emerson1.pdf.

<u>Traditional Capital Allocation:</u> [7]



[7] FROI: Financial Return on Investment; SRI: Socially Responsible Investing; PRI: Program Related Investment.

Economic Investment and Social Returns:
A Blended Return on Investment Framework

The Problems with Traditional Definitions of Investment and Returns

The goal of applying any resource to any opportunity is always value maximization. If the composite value of an investment is not increased, then the rationale for surrendering that capital is eliminated. If we know that a grant's stated social goal will not be attained, then why award the grant to begin with? If we think a business venture will fail to return the financial rewards we seek, then why make the investment? The end goal is always to do more and better with the resources available to us. This fact is not usually up for discussion.

The problem is that our measure of value creation—the return on investment—has traditionally been defined strictly on financial terms. But in fact, <u>the value created by financial capital also resides at social and environmental levels</u>. As a result of financial investment in a small company, for example, jobs may be created; social capital within a community may be cultivated by virtue of the presence of the company in the neighborhood; and the manner in which the company pursues its business model may generate environmental returns that are either positive or negative. And yet, within a traditional approach, the focus is solely upon financial performance.

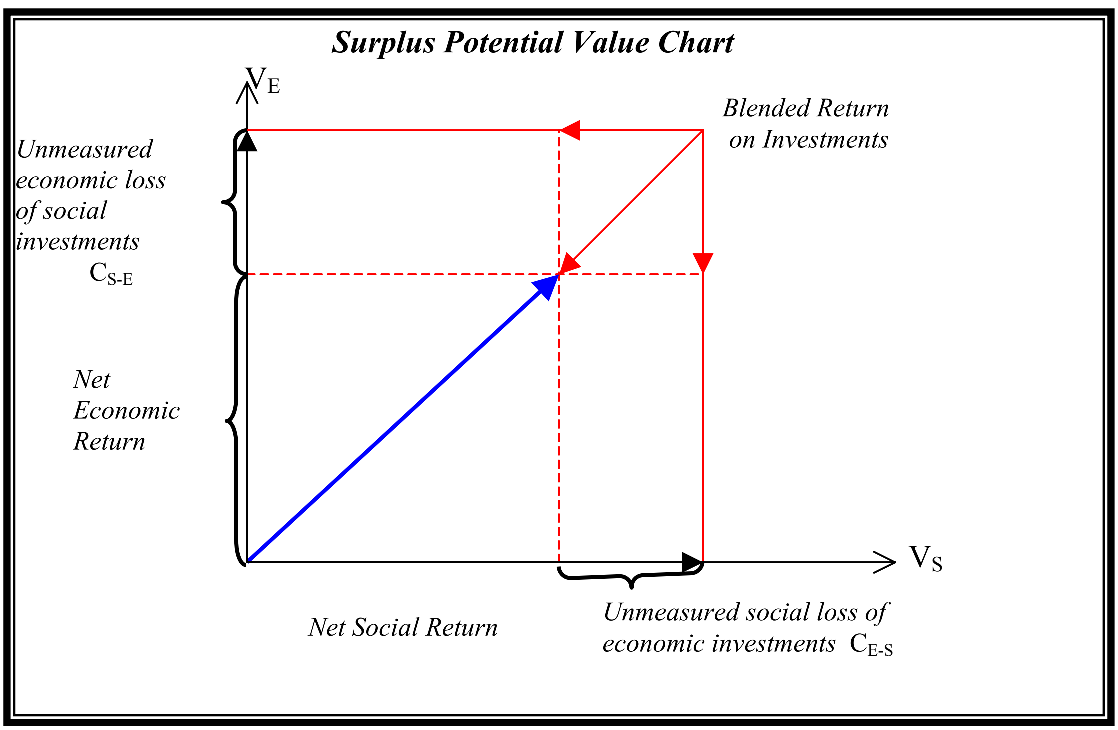
Let's take a different example. Foundations generally award grants to nonprofit organizations on the basis of perceived social impact and value. For example, a grant may be awarded to a community job training program in order to provide transitional support and training to displaced workers. A certain number of individuals receive training in exchange for the receipt of a program grant of a given amount. Although the challenge of program evaluation is not insignificant, let us assume the program is achieving its stated social goals. While achieving these social goals, the organization is also creating a host of economic effects seldom taken into consideration by the philanthropic investor. These may include specific cost savings for governmental programs that no longer provide general assistance to individuals now enrolled in the training program. There may be a decrease in emergency hospitalization visits as a result of improved health care coverage. There may be a decrease in the number of individuals placed in the criminal justice system because of diversion from the street to a job – thereby decreasing the overall cost of the criminal justice system. These are all real and measurable cost savings—economic value—created by virtue of a philanthropic investment. But such value is frequently ignored by many due to the notion that "this is only a grant."

In sum, grants and other capital support provided to nonprofit organizations have economic worth and the potential for financial return; and investments made in for-profit corporations generate social and environmental impacts—both those of value and not. By limiting our attention to only one form of return (financial), we fail to address an entire set of value components that might also be leveraged by our financial investments.

A New Approach: The Blended Return on Investment Framework

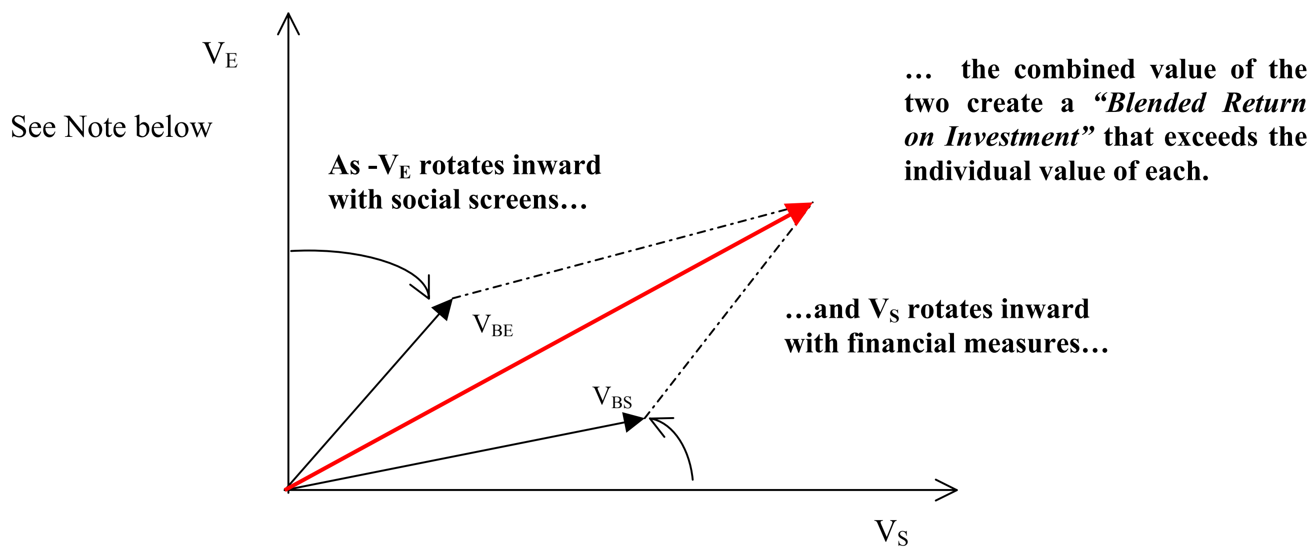
The *Surplus Potential Value Chart* (presented below) illustrates that within the traditional definition of investment and return, financial investors are content with the value created in the area defined as *Net Economic Return*. And philanthropic investors look only to the social value created by their support, the area defined as *Net Social Return*. As a result, through the use of screens that are predominantly financial or social in nature, a degree of unmeasured loss on both social and economic investment is created. If investors operate with a limited focus on either financial or social investment, they "leave surplus value on the table," as it were, and do not leverage the full potential of their investment. Each of these areas is comprised of unmeasured, and often unconsidered, aspects of value creation—in the one case, economic value, and in the other, social value.

In truth, however, both market-rate and philanthropic investors have the potential to capture an additional area of value creation. This area is that of *Blended Return on Investments,* and represents the potential combined value of both social and economic worth that exists beyond the boundaries of the traditional definition of investment and return.



When the axes of both economic value (V_E) and social value (Vs) are considered in concert (when the screens of both social and financial value consideration are viewed together),the total value of an investment is maximized, and the returns generated to both shareholders and stakeholders become blended—including components of economic and social value.[8] This process of value maximization is depicted in the chart below (*Value Maximization with a Blended Return on Investment).*

Value Maximization with a Blended Return on Investment



By approaching this "value equation" with a commitment to leveraging the greatest possible combination of both financial and social value, the returns of all investments—philanthropic, market-rate, and below market-rate[9]—are extended. This combined level of return may be thought of as a Blended Return on Investment (BROI) consisting of the economic, social, environmental, and other value components that result from the investment of capital and other resources.

For example, a regional lumber processing plant has a given economic value based on such things as its balance sheet, core assets, sales, and profit. That same company, however, might convert to sustainable forestry practices (thereby cultivating natural

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[8] One should also acknowledge that the two axes may be assigned differing weights or valuations based on a variety of factors. For the purpose of illustration, we will assume an equal weighting in this example, but the question of how to assign accurate weighting to various components of the value proposition remains an interesting area for future inquiry.

[9] A philanthropic investment is a grant invested in a nonprofit organization with no expectation of return of principal, but expectation of social return on investment. Below market-rate investments are defined as any investment made on a concessionary basis. For example, if a standard market rate of return is 8% and a loan is extended to an organization at 3%, this is a concessionary rate loan. Grants, when understood as investments in the creation of social value, may also be thought of as concessionary rate capital investments that provide 0% financial return to the investor in exchange for the creation of social returns.

capital), sponsor a job-training program (developing human capital), or help sponsor a local "Festival in the Woods," (nurturing cultural capital). This same firm might historically have only accessed traditional financial capital in the form of market-rate debt and equity. Such capital would allow it to pursue financial returns, and to have its performance measured against the single bottom-line of profit performance. But with access to other forms of financial capital (concessionary rate debt and alternative asset class equity[10]), the firm could actually pursue and maximize other components of its value proposition well beyond simple economic value. By the same token, investors also have the option of pursuing simple economic value, or of pursuing blended value that goes well beyond traditionally defined profit and loss as a measure of return.

Implications of the BROI Approach for Social Capital Market Players: The Unified Investment Strategy

The concept of multiple levels of value creation is not altogether new. In recent years, corporate social responsibility, social investing, and social entrepreneurship have all gained increasing currency. And each of these notions blends financial value with other components of a value proposition. Whether CEO of a Royal Dutch Shell, executive director of a Rubicon Programs[11], or head of a community bank, today's leaders must—and are—reassessing their understanding of the interplay between the application of financial resources and the returns/value generated.[12] Furthermore, the general public is increasingly taking interest in these discussions as well. Whether via public statements at town meetings regarding the placement of factories, participation in community sustainability indicator projects, or participation as individual social investors, a growing cross-section of individuals is taking interest in looking "beyond the single bottom-line." Because this paper focuses on the implications of these ideas within the context of foundation strategies, however, we now turn our attention to the implications of a Blended Return on Investment for philanthropic investors.

For foundations, the concepts of a Blended Value Proposition and Blended Return on Investment are put into action through:

- ✓ the overall foundation investment strategy,
- ✓ the specific type and form of investment instruments used, and
- ✓ the metrics by which the foundation tracks the performance of its investments and overall portfolio.

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[10] An alternative asset class investment instrument is an asset class that intentionally combines financial and social returns as a part of its structure. For example, the Calvert Foundation offers investors the Community Investment Note, a fixed rate debt instrument with principal return, but an interest rate of 0 to 4 percent. The actual rate is determined by the investor herself depending upon what level of return and social impact she seeks. Shorebank, the community development bank based in Chicago, offers investors certificates of deposit that are slightly below market rate, with the balance being used to support community economic development. In this way such investments represent an alternative to traditional, strictly financial return investment instruments.

[11] A social purpose enterprise employing formerly homeless individuals.

[12] The citations regarding socially responsible investing, business practice, and entrepreneurship are vast and beyond our ability to include in this paper. They are available to the reader at any library and through a number of web searches.

Taken together, these elements comprise the building blocks of a Unified Investment Strategy. A UIS is discussed at length later in this document, but for now may be simply defined as an investment strategy that seeks to directly leverage philanthropic investments against equity and other market-rate investments in an effort to maximize the total value of the portfolio being managed by the foundation. For a graphic presentation of this strategy, please see the chart on page 20.

Below, we consider each of the above three points in turn.

1. Investment Strategy

With regard to investment strategy, the most fundamental implication of the BVP/BROI for foundations is that *investors come to view their overall investment portfolio as a single body of investments—not simply as financial investments on the one hand and charitable gifts on the other.*

In addition, a foundation board must discuss whether the investment goal of the board is to maintain the assets of the foundation in perpetuity, or to apply those resources in the most effective and direct manner to leverage the greatest possible *total* return. Even for boards that feel their fiduciary responsibility is to act as a long-term steward of foundation assets, with no decline in financial value if such declines are felt to come as a cost of pursuing greater social value, there are still approaches by which the board can pursue aspects of a UIS.

Instead of grappling with these complex issues, a board might respond to the questions of investment strategy by simply making larger and longer-term grant commitments to organizations in which it is already invested. While this action would certainly drive additional resources directly into nonprofit organizations, such an approach would bypass an important opportunity. The foundation, by making larger and longer-term grants, will still fail to use core assets as an additional and leveraged investment vehicle applied in concert with its grant making activities in order to fulfill the foundation's corporate mission of maximizing social impact and value.

In addition to viewing one's investment portfolio as a single portfolio consisting of both financial, market-rate investments and philanthropic, non-market-rate investments, a UIS perspective also allows investors to move beyond short-term, "profit/loss" measures of success to long-term, *transformative investing*. This investment approach has the potential to generate increased overall returns for both a specific foundation investor as well as other investors in the marketplace who also maintain investments in the firm or fund. A common refrain heard in the funding community is a commitment to "leveraging" one's grants against other funds, ("Matching Grants" being the classic example of this approach). Building upon this idea of leverage, foundations might also pursue a strategy for increasing overall portfolio performance and return on investment by managing their total capital resources on terms that allow them to assist in transforming the corporations in which such funds are invested. They might, for example, make equity investments in health related industry firms that promise to create products of great social value, a la The Provenex Fund recently launched by The Rockefeller Foundation. The net result of such a strategy is to break down the notion of zero sum trade-offs between financial and social interests in favor of a more comprehensive vision of maximizing *both* total overall value and total returns for the investor/stakeholder community.

2. Specific Type and Form of Investment Instruments

The application of this new investment strategy may be best executed through a Unified Investment Strategy (UIS). A Unified Investment Strategy is defined as an investment strategy that makes use of both philanthropic and core asset investments to maximize the blended value of those investments. As described at length in the balance of this paper, a Unified Investment Strategy views grants, below market-rate loans, and market-rate equity investing as various tools to be used in the pursuit of a single value proposition—one that seeks to maximize economic, social and environmental value.

In its purest sense, a Unified Investment Strategy consists of the following strategic investment components:

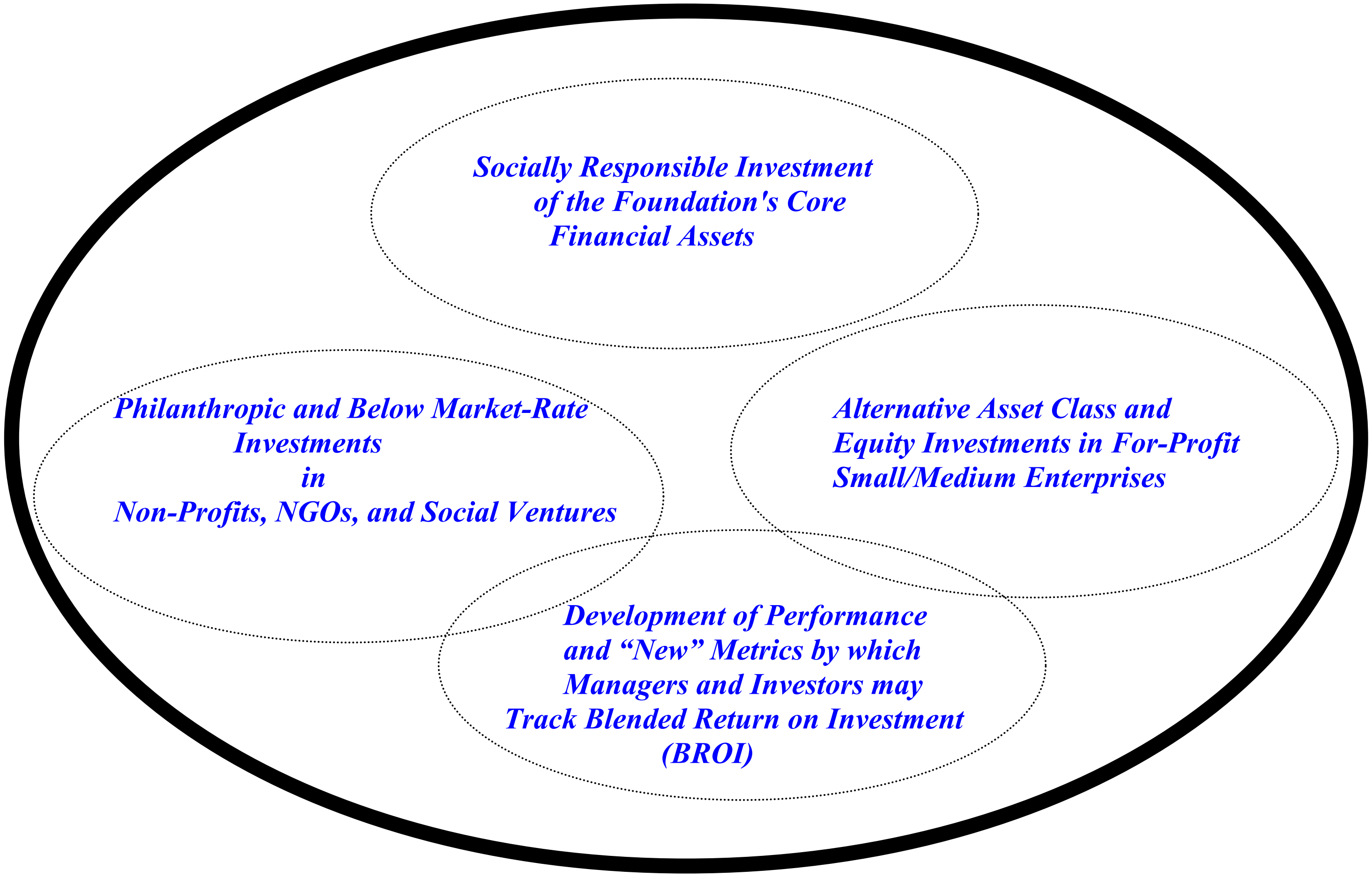
- *Socially Responsible Investment of Core Assets:* Rather than investing assets under investment strategies that solely track financial performance, a UIS calls for a significant portion of foundation's assets to be invested in accordance with Socially Responsible Investing principles. Socially Responsible Investing principles do not mean such assets are expected to perform at significant financial deficit to market-rate investments. They simply imply that such funds are invested with due consideration of financial, social, environmental, and other criteria.

- *Alternative Asset Classes and Equity Investments in For-Profit Small and Medium Enterprises:* The main drivers of job creation and market innovation are found in the world's Small and Medium Enterprises (SMEs). A foundation concerned with the total health of society might identify and invest in SMEs that promise to create economic, environmental and social value. Such firms often require capital on terms that the mainstream capital market does not provide. For example, mainstream investors are hesitant to see funds expended for the creation of management information systems capable of tracking social impact, whereas alternative asset class investors may require such systems be in place in order to accurately assess the firm's creation of social value over time. Foundations should therefore participate with other socially responsible investor funds in the creation and offering of Alternative Asset Classes (AAC) of investment instruments for these types of firms. Such AACs are not structured for quarterly or annual profit, but instead are offered based on long-term value investing principles.[13]

[13]In the case of both SRI investment of the corpus and AAC and Equity Investments for SMEs, foundations may choose to manage these investments internally or through intermediary investment vehicles (such as a

- *Philanthropic and Below Market-Rate Investments in Non-Profits, NGOs, and Social Ventures:* As a complement to its market-rate financial investments in for-profit SMEs, a foundation pursuing a UIS views its grant making and below-market rate capital activities with non-profit firms, nongovernmental organizations, and for-profit social ventures as an integral component of its overall investment portfolio. The practice of foundation grant making is well known, and is the primary activity of most foundations. While program-related investments and other types of below market-rate investments have been with us for decades, the total number of foundations engaging in this type of investing is still relatively modest in light of the total number of foundations active in the United States. Such investments may be directed toward both non-profit and for-profit corporations as part of an overall UIS.

"Fund of Funds"). While this is certainly a broad application of the strategy, such breadth allows the foundation to diversify market risk by leveraging some investments against others.



A Unified Investment Strategy

3. Development of "New Metrics" to Track Blended Return on Investment

The traditional approach to evaluating philanthropic investment usually includes an assessment of whether or not funds were expended according to plan—but involves minimal emphasis on the actual value generated from those funds. This is because for many, though not all, foundations, the nature of the relationship is fundamentally transactive (Did you do what you said you would do?) and not investment-oriented (What value did you create as a result of actions supported by our capital?).

Furthermore, "you can't eat social returns on investment"—in other words, if the only definition of successful asset management is the degree to which a fund manager generates or exceeds his or her 5% financial return on investment, any effort to alter this definition of success poses problems. It poses problems because many professional financial managers are solely responsible for generating additional financial resources through effective fund management. Including other components of value beyond financial measures may be viewed as detracting from this mission. Therefore, in order to successfully implement a UIS, an evolved understanding of value is necessary—and new tools by which to track that value creation process must be created. Over the past decade the philanthropic community has witnessed an emerging interest in "outcome funding," and a renewed focus on evaluation. These may be the first small steps toward creating a more holistic framework by which to assess the total impact of one's resources. These steps, however, fall short of the larger opportunity before us.

Many for-profit corporations are currently grappling with the challenge of understanding those aspects of the firm that stand beyond traditional financial metrics of valuation. These lessons can be brought into the philanthropic investment community to help inform our processes as well. Development of these metrics may involve such historic practices as social auditing and cost-benefit analysis, as well as sustainable development indicators (at both the firm and community levels) and evolving social return on investment frameworks. At this point there are promising approaches, but additional work remains to be done. The absence of an "off the shelf" application is no excuse for avoiding the challenge of maximizing the value proposition of foundation assets and investment strategies.

If such metrics are to be effectively applied, foundation investment committees will have to adopt "the long view". Committees will have to keep their eyes on the ten-year outlook for generating real, blended value as opposed to focusing on quarterly financial performance and a "how many grants can we make" approach to both fiduciary responsibility and philanthropic practice. This change will also require the development of new capital allocation practices that reflect a more complex strategy of foundation asset management. Such capital allocation practices will require simultaneous consideration of both philanthropic and market-rate investments as well as development of alternative terms of capital investment.

Because of the significant changes implied by a UIS, this final section regarding "New Metrics" is worth special attention. As more philanthropic investors depart from traditional, charitable grant-making and instead create new, investment-based approaches to their work, there is increasing emphasis not only on how best to assess the performance and impact of one's resources, but also on how best to assess the *value* of that performance relative to the specific investment being made.

Initially, individual funders will meet this challenge by grappling with each of these questions in turn. But as these investors explore the creation of better metrics by which to assess both organizational and capital performance, these non-profit investors will encounter (coming from the other direction!) data and accounting frameworks being developed by for-profit investors and managers in the business community who are in pursuit of this same Holy Grail—namely, the ability to adequately assess, track, and monitor social performance. One of the most exciting developments of recent years, has been the emergence of these two schools of inquiry driving toward a common answer to the same question:

How do we best assess, track, and value intangibles of the firm—whether for-profit or nonprofit; whether the result of capital provided by philanthropic or market-rate investors?

As each set of actors explores the answers to this question, there is ample opportunity for the creation of independent, third-party "ratings firms" that can document and assess the relative performance of activities within various organizations. These ratings firms can assign performance rankings to organizations based on the effectiveness with which capital is applied in pursuit of the creation of full, blended value—combining economic, social, environmental, and a host of other considerations heretofore considered "unmeasurable" and intangible for the purpose of accounting or valuation measurement.

As presented in the chart titled *"A Unified Investment Portfolio,"* (pp. 32) a foundation's financial assets are merely one part of a total strategy of value creation. In part, the value sought is financial and in part it is social/environmental. The key is that invested capital is not positioned purely as an individual effort to pursue returns, but rather as an approach to applying resources that will ultimately maximize returns for the portfolio as a whole.

A Philanthropic Theory of Change and Total Foundation Asset Management

The Basic Elements of the UIS Theory of Change

Any investment strategy is predicated upon the belief that an investment of resources at one level and point in time will result in an increase in the value of that investment at some future point in time. One invests $5 today in the belief that such an investment will result in a return of $7 in the future. Philanthropic investors also invest in the hope of capturing greater returns tomorrow—but for them, the return sought is not simply a financial return, but a blended return consisting of increased assets *and* changed communities, organizations, and society. Since a UIS is focused on maximizing the potential of investments to initiate change in communities, companies, NGOs, and public policy, it is important to understand the philanthropic theory of change that influences this investment strategy.

The UIS theory of change entails three elements: Pressure, Purpose, and Performance.[14]

- *Pressure* consists of compliance with regulatory codes, reporting requirements, the specific terms of invested capital, etc. In this case, individuals receive certain tax considerations in exchange for the creation of a foundation. Most foundations disperse their assets on the basis of compliance with the "5% payout rule" imposed by the federal government. The goal of a UIS is to complement this compliance with a broader, mission-driven pressure, that of…

- *Purpose.* In the corporate context, purpose consists of incentive mechanisms that corporations and their managers pursue in order to perform in accordance with a larger vision of the firm's value proposition, culture, and market position. As previously stated, the traditional purpose pursued by managers has been financial returns. In this context, however, the incentive of operating within a BVP/BROI framework encourages key players in the firm to be market leaders of a different sort. In recent years, increasing numbers of corporations and corporate leaders have begun to support corporate practices viewed as "socially responsible". In this sense, they are evolving a broader definition of purpose than that of simple financial return to shareholder. The purpose of a foundation's UIS is to support this evolving shift in perspective with regard to...

- *Performance*. When combined, external pressure and an internalized sense of purpose result in changes in performance. Performance occurs on internal and external levels as the organization and its individual players operate within the dynamic context of the firm, market, and society. This new understanding of performance is what drives the need for creating the new metrics previously described—metrics capable of documenting and tracking the complexities of

[14] The author wishes to acknowledge that these three general components are taken from notes made at a collective discussion session regarding corporate social responsibility hosted by the Hewlett Foundation in May 2001.

> performance sought by investors in pursuit of a blended return on their investments. Without these new metrics, shifts and improvements in performance of investments cannot be accurately assessed or valued. This assessment is fundamental to one's ability to determine whether the leverage of one's investment has contributed to the creation of appropriate pressure that helps affirm new understandings of purpose—which are then manifest in changed performance of managers and the firms they lead.

Within this theory of change, organizational and social transformation occur as part of a process whereby individual, NGO, for-profit, and larger, market-based investments are all leveraged for the greatest possible effect. A UIS allows for the simultaneous building, affirmation, incenting, and disciplining of financial investments at individual, firm, and societal/market-based levels—all in pursuit of the larger vision sought by investing the foundation's total assets. An organizational counter-part to the UIS is a *Total Foundation Asset Management* strategy. This strategy requires the complete alignment of both financial and non-financial assets of the foundation in pursuit of its mission. All the resources that can be mustered under total foundation asset management—capital investments (both philanthropic and market-rate), intellectual capital, program and organizational resources, and all other aspects of the foundations possible activities—are positioned to create maximum value for both the foundation and larger society.

While the strategic philanthropy notion of mission alignment is for the most part well understood, most foundations view only their grant making activities as their "tool box" used to pursue organizational mission. In truth, the actual grants a foundation makes are only a part of the total assets that may be applied to the task. Equity investment, staff expertise, and the foundation's convening power are all additional assets the foundation may use in pursuit of its goals. These are all brought together under TFAM.

The strategic positioning of a Total Foundation Asset Management approach allows investors to maximize the leverage and impact of all institutional assets—while enabling other actors in the market place to "play off" those investments in order to create yet greater overall value for individual investors and society as a whole. This leverage may take place in the form of other foundations making philanthropic investments in a given venture or "second round" investors participating in a progressive for-profit firm's next round of equity fund raising. The foundation engages in not only grant making and market-rate financial investments, but also in *transformative investing* whereby the foundation's *total* assets (both financial and *organizational*) are positioned in full pursuit of value maximization.

Returning to consideration of how financial investments are structured, it is a central tenet of a UIS that all philanthropic investments are leveraged against a foundation's market-rate investments. For example, a foundation might invest in a community finance institution that makes loans to corporations pursuing sustainable development technologies. At the same time, that foundation also makes grants to NGOs engaged in policy and program development to help increase the number of companies engaging in sustainable development practices and strategy. As a result, the foundation's assets are being applied toward value maximization from several investment angles—both equity and grant investments being made in an array of for-profit and nonprofit firms in order for the foundation to achieve its *total* goal for maximizing the total value of its assets. The foundation is thereby leveraging its assets to "triangulate" toward a position where its assets achieve maximum impact.

While a UIS may most easily be applied in the context of certain program areas—for example, sustainable development or community economic development—the general concept also applies to education, health-care, and virtually every other area of investment application. This is because the fundamental concept of a UIS is that foundations should attempt to leverage ***all*** their investments in support of their primary mission—that mission being the pursuit of both financial and charitable intent; the creation of both financial and social value. A given foundation may choose to apply such an approach either across the board, or within given program areas where it can potentially leverage the greatest impact. Let's take, for example, the program area of sustainable development. Foundation program officers can manage grants and program-related investments made to nonprofit organizations seeking new program and policy initiatives that are more sustainable for society, while at the same time the foundation can make market-rate, equity investments in privately held companies working to bring new, sustainable technologies to the marketplace.

Investment Instruments within a Unified Portfolio

A UIS is advanced through the use of a variety of investment instruments. The specific type and constellation of investments within the portfolio will change depending upon the particular investment goals of the foundation in question. What is presented below is only one example of how such a portfolio might be constructed. The main idea is that each instrument has a different level of risk, potential for various types of financial return and capacity for creating a variety of social returns. A sample of these possible instruments is illustrated in the chart entitled *"A Unified Portfolio*." As demonstrated in the chart, each of these instruments carries various levels of social risk in the same way that financial investments carry different levels of financial risk.[15]

We will begin by considering three basic types of philanthropic investments (grants):

- Program,
- Infrastructure, and
- R&D.

[15] It should be noted that there are limits to this risk analogy. For example, while one could conceive of a "low risk, high return" social investment, it is harder to advance a financial investment that would also be low risk and high return. By its very definition of risk and reward, financial markets demand that the greater the level of risk exposure, the more significant the level of potential financial return demanded by investors.

Program Grants

Program grants are low-risk investments made in areas that are relatively well understood and of which the social impact is clear. An example of this level of social risk is providing grant support to a local soup kitchen. The intent is to feed a certain number of individuals with a certain amount of resources—and the actual number of people fed is easy to count. A philanthropic investment at this level is nearly "risk free," in that $10,000 is guaranteed to buy food for 5000 clients. These types of philanthropic investments have little social risk because they are used to cover a specific expense (providing a specific service or activity, such as support services to employees with mental illness). There is little risk involved because it is relatively easy to track units of service, and whether or not those services were provided.

Infrastructure Investments

Infrastructure investments are less direct, but may be structured to assist an organization in increasing effectiveness of service delivery or execution of a certain strategy. One example of an infrastructure investment is making a grant to improve the professionalism of a community loan fund by providing better staff training, thereby decreasing the number of "bad" loans made by the fund. This kind of grant is used to improve the ability of a nonprofit to provide its services more effectively and to better manage its business. The risk of failure here is higher because infrastructure development is often process-oriented (it takes a few years to build and manage the infrastructure), so the impact of that investment may occur over the long-term.

R&D Grants

R&D grants represent the greatest social risk. Why? Because they are experimental, and returns are derived over an extended period of time. Sometimes those returns are even provided indirectly to the investee or investor. Consequently, the possibility for failure is increased, and it may be very difficult to establish a causal relationship between the investment and the return. The ability to value that return as a part of this portfolio of investments may therefore be more challenging as well. R&D grants might include, for example, a "proof of concept" grant to an organization exploring a new intervention strategy with high-risk youth—or a grant to an organization engaging in long-term policy development thought to be potentially beneficial to a particular community of interest. These grants carry higher social risk—but often provide greater social returns in the long run, as well.

Financial Value Provided by Each of These Three Grant Types

Each of the grants presented in "*A Unified Portfolio*" has a component of social value and possible return—and each has an aspect of economic value as well. In the case of Program grants, a program grant awarded to an organization focused on providing individuals with opportunities to move from welfare to work represents a cost savings to the public sector that may be tracked over time and assessed in relation to the total cost of providing the funded intervention.[16] Infrastructure grants also carry financial benefits, such as greater operating and other efficiencies; but these benefits are of greatest value to the organization itself and are more difficult to tie directly to a particular investment. Having said that, from the investor perspective, an investee that improves efficiency of its operations can gain greater impact for each dollar spent, thereby making for a more attractive investment opportunity. While R&D grants may generate real value in the long run, in the short-term they have the lowest level of immediate financial value for an investor.

While it may be self-evident to some, it should be noted that in the same way each level of grant investment moves into greater areas of SROI Risk, each level of investment may also be viewed as moving further away from a Risk Free Rate of financial value and returns. The more "experimental" a given social investment is, the less sure one may be of its potential benefits and value.

Specific non-grant financial investments also move progressively along a financial and social risk continuum from Program Related Investments, Recoverable Grants and other concessionary or below market-rate investments, to T-Bills, to Social Value Notes (Equity Linked Zero Coupons with an SRI Index Option or such investments as the Community Investment Notes offered by The Calvert Foundation[17]), to Equity and Venture Capital investments. Each of these investments has an increasing level of assumed financial risk, and an historically decreasing level of defined social value.

It should be noted that both Social Value Notes and Socially Responsible Investing are two forms of investing that connect financial and social value creation as defined components of a single investment. Traditional Private Equity Investing and Venture Capital Funds, both of which pursue pure financial returns with no enunciated or strategic social/environmental return consideration, exist at the extreme of the financial return on investment risk boundary, and also stand furthest away from the deliberate pursuit of social value. Note that, while this is historically true, there are a number of emerging investment funds that seek to hold themselves accountable for more than just financial performance. These funds include Commons Capital, UrbanAmerica, ICV Partners, and Genesis LA, among others. And there are also growing numbers of experienced investment advisors, such as Innovest, providing institutional investors with guidance on how to maximize the blended value of one's portfolio.

[15] This is the form of SROI analysis known as a cost/benefit analysis. The Roberts Enterprise Development Fund has based its SROI Reporting on this type of analysis. And the International Financial Corporation (IFC) makes use of a similar method, External Rate of Return, to evaluate investment opportunities.
[16] Please see HBS Working Paper: http://www.redf.org/download/other/social_value_note.pdf

The Unified Investment Strategy in Action

Perhaps the best way to understand the possible implications of a UIS for philanthropic investors is via the following two hypothetical examples.

Foundation X has been making grants in community development for a number of years, and is currently exploring ways to move beyond its traditional grant-making practices. The Foundation decides to shift its focus to a UIS. Under this new strategy, the Board designates $100 million to be invested over a period of five years, and budgets another $50 million to be awarded in grants. The financial investments are allocated among several socially responsible investment funds targeting resources to inner-city business development and the creation of affordable housing. These investments are placed in both equity and fixed-rate debt notes. Concurrent with its capital structured finance strategy[18]*, the foundation identifies its "highest value" grantees working in community economic development and provides a number of related Program, Infrastructure, and R&D grants to those groups. Foundation finance personnel work directly with program staff to "connect" the financial investments with the program investments through a shared capital allocation process in order to achieve maximum fund leverage. Finally, over this same 5-year time frame, the Foundation works directly with a team of academic, business, and nonprofit organizations to develop and apply metrics appropriate to its investments and the assessment of the blended value being created. At the close of the investment period, BROI Reports assess capital performance at financial, social, and environmental levels.*

Foundation Y is interested in sustainable development. The foundation pursues this commitment by approving $100 million in investments and $50 million in grant support. In addition, the foundation identifies five bioregions within which it would like to target these investments. $50 million of the foundation's investment dollars are placed in a nationally active Socially Responsible Investment fund that targets financial and business development to ventures creating sustainable development technologies. The other half of the investment is placed in five regional business development equity pools that make investments in SME companies engaging in sustainable business practices. The $50 million in grant support is targeted to nonprofit organizations operating within each bioregion to assist social, public policy, and other activities necessary to support the creation of community health indicators, laws, regulations, and policies needed to support the expansion of the field of sustainable development. At the end of the five-year period, the Foundation's investments are assessed on the basis of BROI performance metrics.

In both of these cases, the specific details could be fleshed out in a variety of ways. But the important facts are that, first, the investments of the foundation are being applied in mutual support of financial and social/environmental value creation in order to achieve maximum leverage. Second, "blended" metrics are being created that seek to capture,

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[17] A capital structured finance strategy refers to the overall strategy an investor or investee pursues that makes use of various types of capital (debt, equity) in various forms (fixed rate/concessionary, high risk/low risk, etc.) in order to provide the appropriate mix of capital to achieve the returns one seeks.

track, and define this value-creation process. Over time, as more metrics are developed and historical performance is assessed, investors will have greater ability to evaluate, invest, and track the returns of their portfolios. For the time being, though, making investments on a blended portfolio basis with a commitment to creating "new metrics" capable of tracking non-financial returns is a crucial first step. Finally, one must also consider whether a foundation's size may affect its ability to operate within a UIS basis. Smaller, family operated foundations may find it difficult to execute such an approach without partnering with other funds or working through intermediaries. Such difficulties do not mean smaller foundations cannot use this approach, but rather that they must seek out alternative ways to structure their investments in blended value creation.

"Real World" Examples of a UIS in Action

It is important to note that while a complete UIS may be the goal, foundations do not have to execute a UIS in its entirety to capture at least some of the benefits of such an approach. Indeed, a growing number of foundations engage in mission-related investing that seeks alignment between a foundation's market-rate investments and its grantmaking. A UIS seeks to move one step further by viewing the foundation's assets as a single portfolio as opposed to separate elements to be aligned, however there are certainly similarities in the two strategies. Foundations may combine various components of traditional and alternative investing in order to maximize value from their market-rate, below-market-rate, and philanthropic investments. In the future, it will be important to present detailed case analyses of those foundations engaging in a UIS. These cases should explore lessons learned, details on strategy, performance/return analyses, information about issues related to sustainability, and comparisons of how the various investment instruments function together to create a Blended Return on Investment for the portfolio as a whole.

Although there is currently a lack of such detailed analyses, there are several examples of foundations working to apply these types of strategies. While many in the philanthropic community are aware of the historic work of the Rockefeller Foundation and the John D. and Catherine T. MacArthur Foundation, for example, other foundation innovators should also be acknowledged. The following three foundations are of particular note:

- ✓ ***F.B. Heron Foundation***: Founded in 1992 with the mission of helping people and communities to help themselves, the New York-based F.B. Heron Foundation has embraced the vision of becoming a "private community investment trust." As conceived by its Board, such a trust would eventually deploy most of the Foundation's assets of $265 million in investments that support its mission. The resulting endowment would be a mix of market-rate and below-market rate assets, fixed-income, and equity. To this end, the Foundation has initiated a multi-year process of transitioning toward the creation of a portfolio consistent with this strategy. By the end of 2001, the Foundation anticipates that 10% of its total assets will consist of such investments.[19]

[19] Information provided by foundation staff.

- ✓ ***Abell Foundation***: In addition to making grants to a variety of organizations in the greater Baltimore area, the Abell Foundation earmarks a portion of its core financial assets for investment in corporations located in or committed to doing business within the Foundation's target area. In this way, the Foundation's market-rate investment policies reinforce its philanthropic investment practices in the region. The Foundation makes direct investments in local firms ranging from alternative energy companies, to high-tech firms, to pharmaceutical companies. The Foundation also executes part of its strategy through the Abell Venture Fund—a separate, professionally managed fund that makes investments both in local firms and in those willing to re-locate to the Baltimore area. Investments range from a few hundred thousand to three million dollars. The Fund presently has over $25 million under management.[20]

- ✓ ***Jessie Smith Noyes Foundation*:** The Jessie Smith Noyes Foundation launched its strategy for mission-related investing in 1993. While not a UIS per se, the staff and board of the Noyes Foundation have been leaders in the area of seeking alignment between foundation assets and asset allocation. As such, it was an early leader among those seeking consistency between its investment of philanthropic and market-rate capital. The JSN Foundation embraces an investment philosophy that leverages its core assets and venture fund investing in direct pursuit of its mission. As stated in the Foundation's Investment Policy, "We recognize that our fiduciary responsibility does not end with maximizing return and minimizing risk. We also recognize that economic growth can come at considerable cost to communities and the environment. We believe that efforts to mitigate environmental degradation, address issues of social justice and promote healthy communities should be incorporated as part of business and investment decision making. We believe that management, directors, employees, and investors should consider these social issues in the pursuit of financial objectives. We believe that in light of the social, environmental, and economic challenges of our time, fiduciary responsibility in the coming decades will dictate the integration of prudent financial management practices with principles of environmental stewardship, concern for community, and corporate accountability to shareholders and stakeholders alike." To fulfill this vision, the Foundation seeks "to invest our endowment assets in companies that provide commercial solutions to major social and environmental problems; and/or include concerns for environmental impact, equity and community."[21]

As these and other foundations continue to execute their strategies, they will provide unique opportunities for others to learn from those experiences and for others to apply this new knowledge to their own foundation investment practices.

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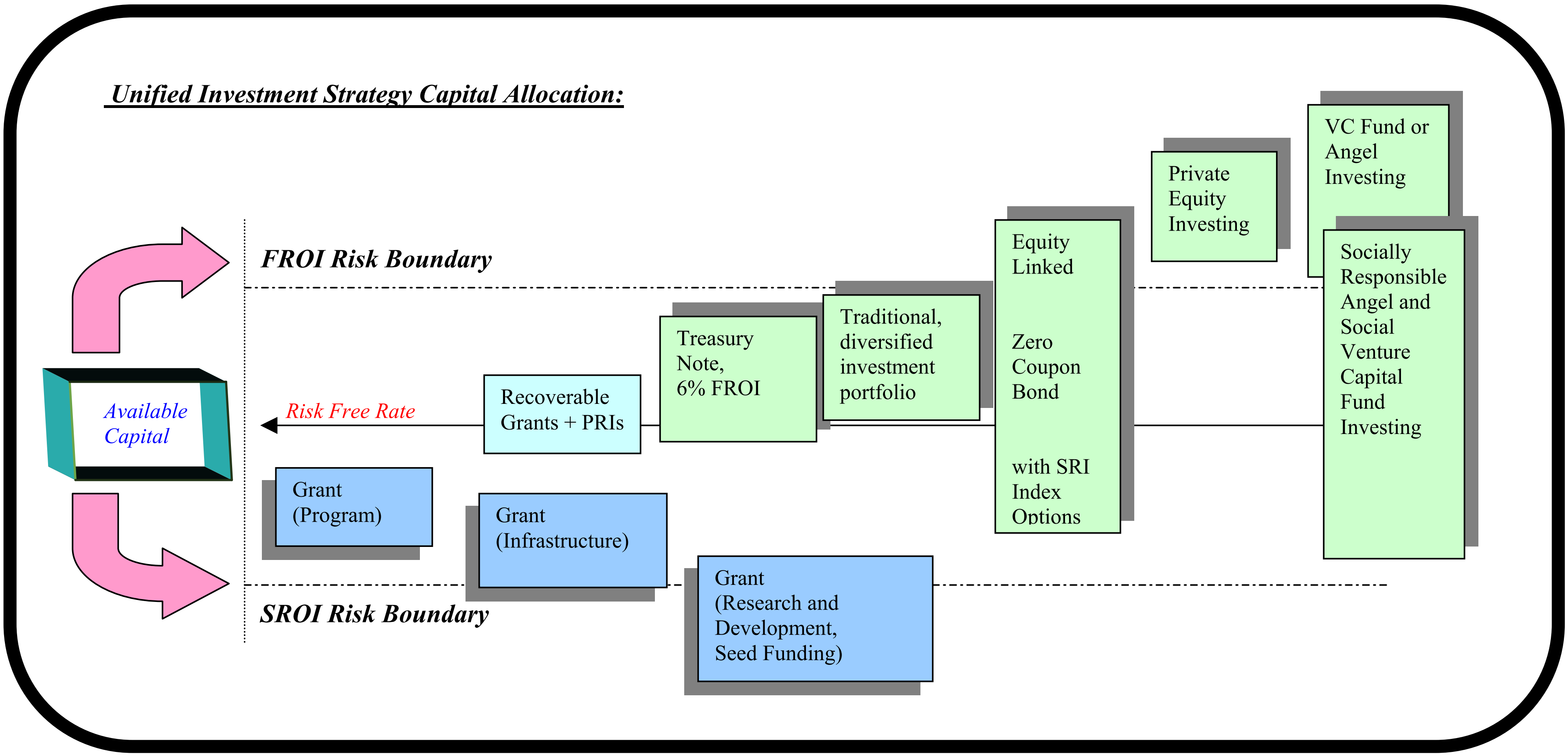
[18] Information taken from the Abell Foundation's web site: www.abell.org.

[21] Text taken from foundation web site.



A Unified Investment Portfolio

<u>Questions for Discussion:</u>
Implications of a Unified Investment Strategy
For Social Investors

The preceding pages present a framework for investing in the creation of blended value. They also raise a number of questions, including:

1. What is the true nature of a foundation's fiduciary responsibility?

The appendix to this paper includes an excerpt that addresses the concept and issue of fiduciary responsibility in some detail. Readers are encouraged to peruse this excerpt and to reflect on the larger issues raised: What constitutes fiduciary responsibility in the context of a foundation trustee? Is the pursuit of financial return and asset protection adequate? Does fiduciary responsibility include the responsibility to maximize the pursuit of social value? How is that best done and is there the opportunity to increase that value by leveraging <u>both</u> the foundation's financial and program investments?

2. While adequate metrics exist to quantify and measure financial value, social value remains largely unaddressed. Is it possible or prudent to invest in the absence of defined metrics by which SROI may be assessed and tracked?

How are investors to track the creation of social value? Where does traditional program evaluation leave off and "new metrics" begin? Do organizations (both investor and investee) have adequate operating MIS in place to track agreed-upon new metrics? What is the process by which a portfolio can assess its performance on a blended basis? Must all metrics lend themselves to some level of monetization in order for them to be compared with traditional financial performance metrics?

3. If a fund is committed to investing on a blended basis, how are capital allocation decisions made?

What are the allocation rules or decision criteria used to maximize blended returns on investments that involve diversified financial and social instruments? What are the appropriate levels of diversification in order for a fund to maximize its blended value while simultaneously protecting assets and minimizing risk? Should investment decisions be made by a committee consensus, or by the application of strict, numeric scoring?

4. What are the organizational requirements necessary to pursue a Unified Investment Strategy?

Such a major shift in the terms of engagement may require more sophisticated operating MIS, more engaged and active fund management, and the development of appropriate risk measures. How is this best achieved? How much would the foundation itself require? How much could be outsourced and at what point would the foundation know the appropriate infrastructure was in place?

The implication of a Unified Investment Strategy will entail a shift in thinking on the part of foundation trustees regarding the concept of fiduciary responsibility. Traditionally, many have viewed the fiduciary responsibility of board members as being primarily a question of financial responsibility and oversight—not a definition of fiduciary responsibility that includes social, environmental and other elements of portfolio performance. Therefore, the following excerpt is included to address the concept of fiduciary responsibility and foundation boards. The author would like to thank United Nations University for permission to reproduce the following material.

New Concepts of Fiduciary Responsibility[22]
By
Edward Tasch
and Stephen Viederman

Rate of return, liquidity, diversification, emerging markets, hedging, derivatives, asset allocation: the business of today's institutional asset manager seems as remote from global warming and ozone holes as mahjongg is from gene mapping.

The notion that financial institutions might play a role in steering business toward sustainability is, to be sure, quixotic. To most financiers, it is downright wrongheaded. Consider, for example, the remarks of two contemporary financiers, whose views are more the norm than the exception. The first, a noted Wall Street investment banker who is also widely known for his environmental interests, gave a 1990 commencement address about lessons learned from the Exxon Valdez spill, after which he took questions from the audience:

> Q. You have spoken eloquently about corporate responsibility and the need for better federal regulation, but you have said nothing about the role of Wall Street. Don't investment banks and financial institutions have a role to play in shaping corporate policy, in transmitting investors' concerns regarding the environmental impact of corporate activity?
>
> A. Absolutely not. One of the cornerstones of free markets is efficient capital markets. It would be inappropriate, inefficient, or worse to attempt to layer concerns about environmental impact onto financial intermediaries, who are singularly focused on the task of providing corporate access to capital on the best possible terms and upon whom the efficient functioning of capital markets depends.

The second institutional investment manager, responsible for many hundreds of millions of dollars of institutional venture capital portfolios, made the following remarks during a conversation:

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[19]Reprinted with permission from: *Steering Business Toward Sustainability*, Fritjof Capra and Gunter Pauli, eds., Copyright 1995 by the United Nations University. All rights reserved.

> *As a fiduciary, I have a moral obligation to my investors to maximize return and minimize risk. I simply cannot take into account exogenous factors like social or environmental impact, or I will reduce the opportunity set and thereby reduce the rate of return.*

Such constructs of the roles and obligations of financial intermediaries and fiduciaries have arisen with a certain inevitability over the past two hundred years, ever since Adam Smith originally formulated the concept of an "invisible hand" through which each man striving only to better himself would, through a thriving free market economy, improve standards of living for all. After tracing how these views have developed and their context in contemporary financial markets, we will describe how one small financial institution, the Jessie Smith Noyes Foundation, is trying to construct for itself a new definition of fiduciary responsibility.

The Prudent Man

In 1830, a Massachusetts court offered a definition of prudence that has, through decades of subsequent re-examination and re-definition, survived in the canon of fiduciary responsibility as "the prudent man rule":

All that can be required of a trustee to invest is, that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering probable income, as well as the probable safety of the capital to be invested.1

This describes a narrow form of "sustainability," which persists among fiduciaries today: sustainability as maintenance and growth of financial capital, sustainability as growth of assets sufficient to keep pace with inflation and preserve or even augment purchasing power. The concept of prudence, built around risk aversion, predictability of income and preservation of capital, came to define a whole culture of managing "other people's money." In the mid-nineteenth century, such a definition of sustainability was understandably devoid of a whole range of concerns that had yet to be articulated. But in the late twentieth century, our knowledge regarding environmental degradation and the social problems which persist in the wake of economic growth and rising standards of living should impel us to ask the following questions:

- Can there be fiduciary responsibility without incorporating questions about the social and environmental impacts of economic growth?
- How do concepts of fiduciary responsibility affect corporate culture?
- What is the relationship between fiduciary responsibility and institutional or corporate responsibility?
- Can institutional investment management be an effective agent for change?

Sustainability, as maintenance or restoration of ecological integrity, provision of economic security, and protection of popular participation in the life of a community, takes on a new meaning.

The Question of Scale

The contemporary fiduciary cannot easily factor such issues into his/ her decision-making, due in part to the very scale of modern financial institutions and their role in global capital markets. Consider the following items, which evidence the staggering growth of financial institutions and capital markets:

• Private pension fund assets in the United States grew from about $250 billion in 1975 to $2.5 trillion in 1994.
• The State of California's public employee pension fund grew from $13.3 billion in 1979 to $80 billion in 1994.
• In 1990, nearly a hundred portfolio management organizations managed more than $10 billion, and the ten largest managed $800 billion of financial assets of the roughly $5 trillion in stocks, bonds and real estate owned by institutions.
• Volume on the New York Stock Exchange increased from 767 million shares in 1960 to almost 36 billion shares in 1986 and to the 70 billion range in 1993. From 1982 to 1992, trading increased tenfold in Tokyo, twelvefold in Frankfurt and thirty fold in London.
• In 1960, annual turnover (shares traded as a percentage of total tradable shares outstanding) on the New York Stock Exchange was 12 percent. Turnover rose to 64 percent in 1986, but when the activity which now occurs on regional exchanges, in the over-the-counter market and in foreign markets is taken into account, the consolidated trading in Exchange-listed stocks in the U.S. and abroad produced a turnover of 87 percent.
• Derivatives and synthetics - futures, warrants, swaps and scores of newly engineered financial products - have created multi-trillion dollar markets, many of which have doubled in a single year. In 1992, the value of swap contracts equaled the combined worth of the New York and Tokyo stock markets. Annual international volume of equity index derivatives in 1992 exceeded $10 trillion.
• Pre-tax profits of U.S. brokers and investment banks reached a record $8.9 billion in 1993.

As financial markets explode, intermediaries and transaction-based incentives increasingly influence corporate decision-making and the flow of capital. Increasing complexity of financial instruments and global markets drives increasing specialization of financial managers. Fiduciaries seem more removed than ever from the social and environment consequences of their decisions. "Most of the time," writes leading investment banker Felix Rohatyn, "the product being bought or sold only exists on a computer screen or as an electronic impulse on a magnetic tape.... The movements of capital and the paper economy related to it used to be the result of industrial and commercial activity; now they are the cause."2

When transactions come first, the consequences on individuals and community can be devastating. Commentator Adam Smith describes how most financiers never see the effects of their decision-making:

A worker may work for the same company for twenty years. A manager may live in the community, support its schools, and work to integrate the company and the community. But the owner reigns supreme; it is up to him whether the plant is shut down, the worker laid off, the manager sent somewhere else. Yet the owner these days is seldom the founder with the big house up on the hill. Technically, the owner (or at least one of the owners) is probably a pension fund or mutual fund, represented by a young portfolio manager who shares neither history nor loyalty with the company and who will sell out in five minutes if that will improve his track record. Or the owner may even be a group of arbitrageurs seeking the fastest return possible on a very swift turnover - measured in hours, not in months or years.3

The implications for those concerned with the social and environmental impact of business are daunting. Whither, amidst the torrent of financial activity and the divorce of portfolio managers from people and places affected by their decisions, the concept of sustainability?

Asset Management and the Behavior of Business

So long as assets are viewed as passive pools of income-generating securities, fiduciary responsibility ends with a diversified asset allocation plan and the selection and monitoring of money managers. Yet some institutional investors have taken in recent years a first step towards a more proactive definition of fiduciary responsibility, one which recognizes that their investment expectations can and do impact corporate behavior.

The Council of Institutional Investors, whose membership includes roughly eighty of the nation's largest public employee and union pension funds, focuses attention on corporate governance and the problem of boards of directors failing to adequately represent the financial interests of shareholders. In particular, the Council has vigorously attacked distorted compensation packages for senior management of many corporations: "High pay is not the same as pay for performance and may not, in fact, improve performance," noted the Council's April, 1994 newsletter. "Compensation can be tied to performance without giving away the store. And giving away the store pursuant to a formula still leaves one without a store."

The California Public Employees Retirement System (CALPERS), one of the nation's largest institutional investors and an active Council member, has been a leader on issues of corporate governance. Most recently CALPERS has included issues of workplace conditions and employment practices in their annual governance reviews as "one of many other considerations ... in our investment decisions."4

Such initiatives mark the beginning of a process of integrating into investment decision-making factors that have previously been considered beyond the purview of financial analysis. How does a $10 million CEO compensation package affect employee morale? How does a CEO's "independent wealth" affect his/her attitude toward and loyalty to the corporation? Will directors who are paid $40,000 per annum in fees act with sufficient independence to effectively oversee senior management? Will corporations with broader employee participation in ownership or decision-making enjoy a competitive advantage? These are questions about compensation and governance, specifically, and, more generally, about corporate culture.

Assistant Secretary of Labor Olena Berg, the former Chief Deputy Treasurer of California who currently oversees the regulation of the U.S. pension industry, believes that a broader view of investor responsibility is inevitable for pension funds. "We will be asking pension funds to change their thinking," Berg says. "Instead of thinking only about beating the market by another increment, we want them to think about how their investments are contributing to the long-run health of the economy ... Given the size of the funds, it doesn't make sense to try to beat the market for a quarter. When you are the market, as the funds are, you can't beat it. The goal should be an overall lifting of the economic boats by investing in ways that are economically productive and create more and better jobs." (New York Times, August 10, 1993.)

The role of financial institutions in steering business toward sustainability begins with such steps. Concerns about corporate governance and the creations of long-term benefits to the economy as a whole mark evolving concepts of "prudence" towards broader investor responsibility and the inclusion in investment decision-making of factors previously beyond the purview of financial analysis.

Nevertheless, the connection between the long-term health of the economy and the social and environmental costs of economic growth remains problematic for fiduciaries. Institutional investors have been very slow to embrace "social investing," or strategies, which explicitly seek to address this connection.

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Economically Targeted Investing

While most financial institutions have been reluctant to pursue social investing through stock and fixed-income portfolios, some have, however, pursued "economically targeted investments" (ETIs) in their private or alternative investments. While lacking a single, standardized definition, ETIs have been defined by the Center for Policy Alternatives as "any prudent investment that fills a capital gap in an under financed area of the economy and earns a risk-adjusted market rate of return." Aiming to produce competitive returns and targeted social benefits, ETIs have included small business loans, venture funds dedicated to minority-owned businesses, and mortgage pools for low-cost housing.5

The Colorado Public Employees' Retirement Association (PERA) targets more than $850 million, or about six percent of its total assets, to economic development investments in Colorado. PERA invests $75 million through Colorado Housing and Finance Agency bonds to finance fixed-rate, long-term small business loans in Colorado. Since 1992, the California Public Employee Retirement System has committed $375 million for single-family housing construction when traditional financing sources withdrew from the market. By the end of FY 1992, CALPERS had invested $5.6 billion, or over seven percent of total assets of $77 billion, in investments classified as ETIs.

As of September 1993, the twenty largest U.S. public pension funds had invested more than $23 billion in ETIs, with roughly 85 percent going to mortgage-related investments and the remainder in venture capital, private placements, or other direct investments.

Despite these initiatives, however, nine out of ten pension funds responding to a 1994 survey conducted by Institutional Investor magazine indicated that they felt ETIs were not consistent with their fiduciary responsibility to secure the greatest financial returns for their beneficiaries. Nearly three-quarters of survey respondents were corporate pension funds.

For those who have pursued ETIs, various financial and social measurements have been used to evaluate performance. Massachusetts measures its small-business-loan securities against 90-day Treasuries. The GE pension fund expects an economically targeted mezzanine fund to beat the S&P 500 by 300 basis points. As for social benefits, yardsticks include number of new homes under a certain price level or jobs created within a defined geographical area or within a particular population.

But questions regarding rate of return, performance benchmarks, measurement of social benefits, and possible trade-offs between financial and social returns continue to prevent many institutional investors from pursuing either ETIs or from choosing money managers who pursue social investment strategies.

http://www.noyes.org/admin/concepts.html