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The Role of Community Partners in Urban Investments

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The Role of Community Partners in Urban Investments

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ABSTRACT:
Institutional investors seeking to deploy capital to underserved areas do not have either the time or the expertise to actively manage these specialized investments. Investment vehicles intervene by using their financial expertise to pool assets and lower transaction costs. Community partners, in turn, link the investment vehicle to the neighborhood. This paper develops a typology of community partners and their unique characteristics that enable them to overcome information asymmetries in certain markets. The paper also discusses the business models that establish the relationship between the investment vehicle and community partner to highlight strengths of the different models for delivering community transformation.

Keywords.
Urban investments, community partners, institutional investors, financial intermediaries, economic development.

JEL Codes.
N90, O00, RO0, R50

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Introduction

Large institutional investors are increasingly placing capital in urban investments.[1] These investors seek opportunities to earn high financial returns while spurring economic growth in underserved areas. They aim to invest large amounts of capital into easily replicable financial instruments that generate risk-adjusted market-rate returns. In contrast, investments in underserved communities are generally small, illiquid, and highly specialized to meet the needs of the community. The challenge has been to find ways to funnel large amounts of institutional capital to urban investments that have both high financial returns and meaningful benefits for communities.[2]

Hagerman, Clark, and Hebb (2007a) set forth the role of intermediaries in community-based investing, noting that investment intermediaries, or "investment vehicles," and community intermediaries, or "community partners," are needed to link the institutional investor to the economic development area. Investment vehicles intervene between the investor and the community by pooling investments, spreading risk across investors, and pricing the transaction in line with the associated risk. They also link with community partners, who draw on their specialized knowledge of the local area to help structure deals that ensure social benefits for low- and moderate-income residents, often utilizing a variety of subsidies necessary to bring these deals to market rates of return. As such, the partnership between the investment vehicle and the community partner acts to unlock value for institutional investors and communities alike.

In this paper, we argue for the necessity of the partnership between the investment vehicle and the community partner in order to help promote the revitalization of the community and prevent harmful gentrification. First, we draw on the academic literature of financial intermediaries to identify how investment and community intermediaries help mitigate the

[1] These are investments targeting geographic areas and businesses that have traditionally had difficulty attracting private sector capital. Most of these investments are in lower-income urban areas, but some are targeted to rural areas as well. Other terms to describe these investments include *emerging domestic markets*, *community investments*, and *investments in underserved areas*.
[2] Community benefits are composed of the economic, social, and environmental returns to the local area. Economic returns include the creation of jobs, affordable housing, and other real estate developments. Social returns include the creation of community facilities, open spaces, and services for local residents. Environmental returns include promoting mixed-use, transit-oriented, and "green" developments as well as sustainable practices in local industries. In this paper we use the convention of referring to these three types of returns collectively as *social returns*.

associated risks of urban investments. Second, we use evidence from literature and interviews with principals of investment vehicles and community partners to develop a typology of community partners and the unique characteristics they bring to urban investments. Finally, we discuss the business models, building on the work of Daniels (2004), that establish the relationship between the investment vehicle and community partners for the purpose of understanding the relative strengths of the different models for delivering community transformation. We find two scenarios that are particularly successful at yielding tangible benefits for the community. In the first scenario, a not-for-profit community partner owns or contracts with the for-profit investment vehicle. In the second, a for-profit investment vehicle affiliates with a not-for profit community partner. We argue that investments made in partnership with a community development corporation (CDC) or community development financial institution (CDFI) provide some of the strongest community benefits.[3]

Investments made in partnership with a community development corporation or a community development financial institution provide some of the strongest community benefits.

Public pension funds in California, New York, and Massachusetts were early adopters of economic development policies that place capital with an investment vehicle. Lessons learned from these cases demonstrate that these investments yield both high financial returns and social returns (Hagerman et al. 2005, 2006 and Hebb 2005, 2006). To date, public pension funds have committed $11 billion of their capital to targeted underserved capital markets (Hagerman 2007a).[4] Targeted investments from other types of institutional investors, such as foundations, are beginning to grow as well. Cooch and Kramer (2007) note that in 2005, market-rate investments by foundations “accounted for 11% of all mission investments, having grown at a 19.5% compound annual rate since 2000. In contrast, below market-rate mission investments grew by only 7% annually during this period.”

[3] A community development corporation (CDC) is a resident-owned and -controlled organization engaged in affordable housing, business and commercial development, and community services for low- and moderate-income areas. Most are not-for-profit, tax-exempt 501(c) 3 organizations. A community development financial institution (CDFI) is a financial institution whose primary mission is to promote community development in low- and moderate-income areas. CDFIs provide comprehensive credit, investment, banking, and development services. Some are chartered banks, others are credit unions, and many operate as self-regulating, not-for-profit institutions that gather private capital from a range of investors for community development or lending.

[4] The figure includes programs intended to stimulate economic activity in the underserved markets but does not include broad in-state targeted investments, which are significant across the United States.

While it is still too early to report on the financial returns of many of these investments, we find evidence of the market case for these investments in the returns of several large U.S. pension funds that have adopted this approach (see particularly Hagerman et al. 2005, 2006, 2007 and Hebb 2005, 2006 on this point). In the case of the California Public Employees Retirement System (CalPERS), their targeted urban real estate portfolio returned 22 percent from inception through March 2005 (Hebb 2005), with their targeted private equity portfolio returning 16.3 percent from inception through September 2005 (Hebb 2006).

In addition to market rates of return, targeted investments are already yielding tangible social returns to communities. Opportunities exist to increase the flow of institutional capital into underserved communities. This paper illustrates how the investment vehicle and community partner work together to create investments that meet the needs of both investors and communities.

Financial Intermediation in Urban Investments

In his work on the structure and organization of pension fund capitalism, Clark (2000) identifies a growing interest by public pension funds in alternative investment products (AIPs) as a way of gaining higher returns. Such alternative investment products include both real estate and private equity (venture capital), two asset classes that lend themselves to targeted investment strategies.[5] Pension funds, particularly public sector pension funds, seek to outperform the market through a strategic investment decision-making process and rigorous investment philosophy, as shown in Hagerman's (2006) work on the Massachusetts state retirement system. Hagerman and Hebb (forthcoming) highlight that central to any institutional investor's investment philosophy is the investor's strategic asset allocation policy. The policy governs the investor's ability to minimize its investment risk and maximize return. Institutional investors are increasingly looking for ways to achieve higher returns and are guided by the principles of modern portfolio theory and the notion that investors can maximize return by increasing variance (Markowitz 1952).

[5] AIPs also include hedge funds that do not lend themselves to long term investment time horizons and targeted investment opportunities.

Investors seek to optimize their portfolio by minimizing risk through portfolio diversification and aiming for the highest possible return. Investors are drawn to AIPs as they provide an opportunity for superior returns, albeit with greater risk involved. Clark (2000) cites that the most important problem investors (public pension funds, in this case) must overcome to adopt AIPs is the cost of imperfect information and the management of the agent (investor)-agent (investment manager) relationship, given the potential for misrepresentation and corruption. Financial intermediaries are essential for designing and managing "customized products" (Merton and Bodie 1995).

Member choice is also a factor affecting pension funds' investment options, and increasingly plan members are expressing a desire to align their investment choices with their personal values (Santos-Wuest 2008). Some insurance companies are required by state legislation to invest in underserved markets (Massachusetts, for example), while others have initiated a strategy of pooling funds for the purpose of investing in underserved areas as a way of preempting state legislation (California, for example). Additionally, several foundations align their investments in their programmatic and endowment funds to the core mission of the organization. While Hagerman et al. (2007) indicate that there is an increased supply of capital to targeted investing, the appropriate deployment of such capital is dependent on the financial intermediary that places the investment in the community. On the supply side, product innovation in the financial services industry is adding credibility to these types of unconventional products (Clark 2000).

Types of Intermediation

Clark (2000) describes four types of financial intermediaries that design AIPs for public pension funds and describes how each model works to solve the information and veracity problems associated with these types of investments. Given that information asymmetry is at the heart of the market failure that creates the barrier to capital in these investments, it is critical that the financial intermediary be able to overcome the information asymmetries in order to generate the appropriate returns to the investors (for a more detailed discussion of information asymmetry and market failure, see particularly the Nobel prize winning work of

George Akerlof, Michael Spence, and Joseph E. Stiglitz; for a detailed examination of information asymmetries as they apply to targeted investment, see Larry Litvak 1981). Clark (2001) identifies specialized investment companies are the most common source of AIPs because of the expertise and knowledge necessary to design these products.

Modified Mutual Fund: Modification of an existing product is a common strategy of product innovation in the investment management industry. The costs of such as strategy are marginal when compared with the costs of setting up a completely new product (Clark 1994). The value of the security selection depends on two factors: that the cost is comparable to that of a standardized product and that the investment manager has firm-level expertise. The latter is essential to the development of any tailored product (Black 1985)—otherwise the returns may be much lower than the accepted benchmark. Clark cites the Massachusetts Financial Services (MFS) Union Standard Trust (the "Trust") as an example of this type of intermediary. The Trust was designed to take advantage of the company's expertise associated with its mutual fund business. The product allows pension funds to invest in companies and institutions that are sensitive to organized labor's interests. MFS contracts with another financial services company to evaluate the performance of the Trust and relies on an Advisory Board of union officials and academics to ensure investments are consistent with the goals of investors. Given these characteristics, the Trust offers a formal solution to the twin problems of costly information and veracity. It also offers investors the opportunity to share risk and pool capital.

Secured Investment Trust: In this model, investment managers choose a strategy of commitment over one of diversification. These trusts, exemplified by the AFL-CIO Housing and Building Investment Trusts, are highly specialized (in a segment of the market such as low- and moderate-income housing or a geographic region), are normally traded in the open market, and are backed by mortgages or properties held by the trust or include some form of government insurance. Pension funds likely prefer secured investment trusts over other kinds of property and investment trusts because pension fund trustees are conservative and any risk that can be covered will enhance the value of the potential trust investment.[6] It is very difficult to obtain reliable third-party information on the internal operations of particular trusts, but the stability, expertise, and performance record of trusts can be verified by consultants. Investment trusts can spread investors' risk by providing a variety of projects with different risk profiles, and investors can spread risk by investing in a variety of trusts.

Pension Fund Investment Innovation: These intermediaries are more deliberately innovative in design and intention. They tend to be multi-purpose institutions that use the administrative and technical infrastructure of their organizations to develop investment products at the margin of their core activities. Clark (2000) highlights that these intermediaries also tend to take advantage of economies of scale and aim to hold AIPs over the long term. In some cases, they are large individual pension plans. In other cases, these organizations are fund managers for a set of public funds, such as the New York City Bureau of Asset Management (BAM), which acts as an investment services firm for five of the largest New York City pension plans. These organizations can draw on their broad-based expertise of the industry and become brokers for public and private agencies seeking innovative ways of engaging in large-scale urban investments. BAM is willing to make project specific commitments because of the enormous assets of the five funds; risk-sharing is not done among projects but among asset classes. The costs of imperfect information and concern over veracity are minimized by the organization's ability to internalize market relationships.

Fund Management

Investment opportunities in underserved markets take advantage of demographic changes—ethnic minority population growth with increased consumers, purchasing power, and entrepreneurs (Hagerman and Hebb forthcoming). In the United States, research specific to investing in underserved markets has taken hold under the rubric of investing in U.S. emerging domestic markets (EDM). Investment opportunities in EDM can take advantage of U.S. demographic changes and overlooked economic opportunities in low- and moderate-income areas that include growth

[6] On issues of pension fund trustee decision making see Gordon L. Clark, Emiko Caerlewy-Smith, and John C. Marshall's Pension fund trustee competence: decision-making in problems relevant to investment practice. (2006).

areas for women and ethnic minority entrepreneurs and mixed-use, mixed-income real estate opportunities.

Harvard Business School Professor Michael Porter (1995) highlighted the “competitive advantages” of the inner city and untapped economic opportunity in terms of strategic location, unmet local demand, integration with regional clusters, and available human resources. Various stakeholders (institutional investors, investment fund managers, community-based organizations) have different levels of criteria for what defines an underserved market. Generally the criteria include three key elements: a region (urban or rural) with limited access to investment capital, a diversified community and management composition (female or minority ownership), and that the firm in which investment is made employs labor from a low- to moderate-income area (CalPERS and Pacific Community Ventures 2007). EDM investments generally reach people and places overlooked by mainstream markets and take advantage of economic opportunities missed by conventional investors.

Daniels (2005) further identifies market barriers that help explain why capital does not easily flow to emerging domestic markets. The market barriers that he sites include the following:

1 Insufficient risk pricing, pooling, and spreading mechanisms: Traditional fund managers do not adequately manage, price, pool, and spread risk for a range of institutional investors.
2 High information and transaction costs: Few fund managers are capable of looking at the highly specialized deals found in the EDMs, and few have the business models to absorb the associated costs.
3 Market prejudice: Conventional fund managers are inclined to prejudgment about particular EDMs and unlikely to adequately investigate information.
4 Insufficient market competition: Scarce competition among providers of equity capital to EDMs can result in developers’ paying a monopoly price for the capital or choosing not to pursue an otherwise profitable development.

5 Market-distorting government policies: Inadvertent tax and regulatory policies, and transportation and infrastructure policies can have the unintended consequence of lowering the cost of greenfield development to developers, placing a hidden cost on older low to moderate income (LMI) neighborhoods.

Investment vehicles and community partners can overcome these barriers by linking the institutional investor to the economic development area (see Hagerman et al. 2007 on this point). Investment vehicles intervene between the investor and the community by pooling investments, spreading risk across investors, and pricing the transaction in line with the associated risk. By creating scale, the investment vehicle produces the high financial return and large-size investment required by institutional investors. These investors allocate capital to economic revitalization through three asset classes: fixed income, equity real estate, and private equity (Hagerman et al. 2007a).[7]

Linking Institutional Investors to Communities

Institutional investors seeking to deploy capital to underserved areas have neither the time nor expertise to actively manage these specialized investments. Investment vehicles and community partners are needed to link the institutional investor to the economic development area. Investment vehicles intervene between the investor and the community. The investor supplies the large amount of capital needed by the investment vehicle to undertake the development project, while the investment vehicle produces the high financial return and large-size investments required by institutional investors.

The community partner establishes a relationship of trust between the investment vehicle and the affected community.

Investment vehicles link with community partners, who identify local needs and enlist the participation of local partners and resources from the broader society, as well as helps assemble support to get the deal approved. Most critically the community partner establishes a relationship of trust between the investment vehicle and the affected community (Babcock-Lumish 2006 highlights the importance of trust

[7] Hagerman et al. (2007) describe three asset classes of investments made by public pension funds: fixed income, equity real estate, and private equity (early and later-stage venture capital). Fixed income is a debt-based real estate and small business development finance product investing in affordable housing. Equity real estate is a real estate finance product investing in the potential growth in market value of the investment property. Private equity is the business finance product investing in mission-oriented companies at the early and expansion stages of the company's development.

between all partners in private investment deals). The community partner also works to ensure that the investment benefits for the local neighborhood and does not lead to the displacement of lower-income residents—an outcome when revitalization raises property prices to the point that local residents can no longer afford to live or work in the community (Booza et al. 2006). The investment vehicle helps create the scale necessary to bring about community revitalization (Hagerman et al. 2007b). Many community partners have experience promoting economic development through assembling smaller-scale investments in affordable housing, mixed-use real estate, community facilities, and small businesses. However, they do not have the capacity or expertise for large urban investments. Many urban investments are multi-use real estate developments projects, which are seen by investors as inherently more difficult to evaluate and implement. Investors consequently favor larger, more experienced fund managers and developers for these types of projects (Gyourko and Rybczynski 2000). The multiple stakeholders in the investor/investment vehicle/community partner relationship act to unlock value for institutional investors and communities alike.

Hebb argues that the responsibility for achieving social outcomes is best left to the community partner and not to the fund manager or the investors.

Hebb (2005, 2006) argues that the responsibility for achieving social outcomes is best left to the community partner and not to the fund manager or the investors. This is because the fund manager needs to focus on meeting the fund's fiduciary responsibility to achieve the targeted risk-adjusted rate of return. Hebb suggests that another best practice is the use of broad geographic rather than social targeting. This allows the fund to focus on diversification and return, allowing for some flexibility in how it meets social goals. Then, the social goals are best achieved by partnering with a local not-for-profit whose purpose is to create and deliver social outcomes. Research from the community development and sociology fields describes how community-based organizations contribute to community economic development by filling funding gaps, participating as developers, addressing systemic inequalities, and building social capital (Rubin 2007, Lamore et al. 2006, Robison et al. 2002).

The Role of the Investment Vehicle

The investment vehicle uses a variety of operating models to link the institutional investor to the area needing revitalization. Daniels (2004) identifies four approaches to the oversight of an investment fund. Steiger et al. (2007) suggest that two models, the Contractual Model and the Ownership Model, hold the greatest promise for unlocking value for institutional investors and communities alike. In the Contractual Model, a not-for-profit community partner organization or “sponsor,” such as a business civic organization organized as a 501(c) 3, designs and builds an urban investment fund and contracts with a well-established for-profit investment fund manager. In the Ownership Model, a not-for-profit sponsor—often a well-established CDC or a CDFI—owns the for-profit fund manager. The third model, the Legislative Model, has been effective in the state of Massachusetts, but it is dependent on supportive legislatures. The fourth model, the Fund Manager Model, is effective in aggregating investment for institutional investors but can lack grounding in the community unless it affiliates with a community partner. We find that most funds currently operating in this investment space fall into the Fund Manager Model and may or may not affiliate with a community partner.

The role of the investment vehicle is to engage in three primary activities. First, the investment vehicle is responsible for working with the community partner to source deals (Flynn et al. 2007). Second, the investment vehicle is responsible for undertaking the financial engineering of the deal. The capital structure of an investment fund is developed through complex financial engineering. The structure can involve a debt component that helps bring the deal to scale (Hagerman et al. 2007b). This is an important factor in understanding how the investment vehicle provides large investments that lead to the transformation of neighborhoods and significant investment in growth companies. The role of subsidies is another component in the capital structure of private debt and equity funds. While the second and third generations of funds have moved away from a reliance on public subsidies, public subsidies can still play a role (Flynn et al. 2007). Finally, the investment vehicle engages in promoting the growth of the urban investments industry. The investment vehicle works to increase demand for and supply of urban investments by educating potential investors, community partners, and other stakeholders about how these investments work and about the typical financial returns and social outcomes.

Each of the four businesses models described above calls for the participation of a proven for-profit fund manager to undertake the complex financial engineering needed to deliver strong financial returns and garner the confidence of investors. All of these models have the potential for delivering strong social outcomes where the community partner takes a lead role in helping design and build investments.

The Role of the Community Partner

Flynn et al. (2007) identifies community partners as not-for-profit organizations chartered as 501 (c) 3s such as CDCs, CDFIs, and business civic organizations, specifying that they act either as fund sponsors or as fund affiliates. We broaden this list to include not-for-profit, for-profit, and public-mission-driven lending intermediaries such as state housing finance agencies; municipal governments, and public officials; and underserved businesses. Underserved businesses include minority- and women-owned businesses, and local, small, and disadvantaged business enterprises (LSDBEs) as certified by certain state economic development agencies. This typology is detailed in Table 1.

Table 1: Typology of Community Partners

Type	Key Roles/ Tools	Strengths	Weaknesses	Examples
Not-for-profit fund sponsors such as business civic organizations that are 501 (c) 3s	Create a fund and select a fund manager Help identify and structure deals *Tools* Social and Political: Ties to community stakeholders Financial: Philanthropic funding/NMTC/ LIHTC	Robust community benefits that are often tied to regional priorities	Few existing examples; difficult to start	Bay Area Council sponsorship of the Bay Area Smart Growth Fund (of the Bay Area Family of Funds); Genesis LA sponsorship of the Genesis LA Family of Funds
Not-for-profit affiliates (such as CDCs and CDFIs)	Help identify and structure deals *Tools* Social and Political: Ties to community stakeholders Financial: Philanthropic funding/NMTC/ LIHTC	Robust community benefits—well established CDCs and CDFIs have been successful in partnering with for-profit investment vehicles	Varying organizational capacity	Coastal Enterprises, Inc.; Lena Park CDC; Asian CDC
Mission-driven lending	Help identify and structure deals Provide housing finance: loans,	Strong institutional capacity	Narrow mission (i.e. housing finance)	Illinois Housing Authority (with the AFL-CIO HIT)

intermediaries (such as state housing finance agencies)	guarantees, tax credits *Tools* Financial: Loan guarantees, LIHTC and other tax credits			senior housing project in Chicago; Mass Housing Investment Corporation's (with Access Capital) Holyoke Housing Center
Municipal governments and public officials (such as mayors)	Use zoning/ permitting authority for community benefits *Tools* Social and Political: Ties to community stakeholders Financial: Zoning/ permitting authority	Ability to recruit public and private resources to deal	May or may not focus benefits for low-income or other underserved individuals	Canyon Johnson and Mayor of Miami (arranged for down-payment assistance for city workers in 2006)
Minority or women-owned businesses or businesses in underserved areas such as LSDBEs[8]	Entrepreneurial activity *Tools* Financial: Some states offer incentives to investors such as loan guarantees	Public incentives tied to LSDBE investment opportunities	Limited set of tools	LSDBE program in Washington, D.C.

We argue that not-for-profit fund sponsors and affiliates, in particular CDCs and CDFIs, are the strongest community partners for the following three reasons: First because their mission is most closely aligned with the needs of underserved areas; second because they have access to the broadest set of *social and political*, *material*, and *financial* tools described below; third, both of these attributes contribute to the ability of the community partner to obtain the trust of the affected community and to broker deals that lead to genuine revitalization for the existing community. Mission-driven lending intermediaries can act as the community partner in some deals and as the investment vehicle in others. However, many lending intermediaries usually have a narrow mission and scope of activities, restrictions that may limit their ability to deliver a robust and diverse array of community benefits. Municipal governments and public officials such as mayors and city councilors can also play an important role in attracting resources for investments, but these entities and individuals may not necessarily focus on securing benefits for lower-income and other underserved groups. Finally, underserved businesses are the investment opportunity as well as the community partner. These businesses may be linked to public incentives intended to attract investors to underserved markets. In addition, they are the actor that delivers the economic benefits to the community, such as economic growth or wealth building opportunities for employees. But most businesses have a limited set of tools with which to create community impact.

[8] *LSDBEs* refer to "local, small, and disadvantaged business enterprises" as certified by certain state economic development agencies.

Community-based organizations that participate either as a fund sponsor or as a fund affiliate with a lead position, such as a joint venture developer, play two important roles in a partnership with an investment vehicle. We develop our typology of community partners by examining their roles in Table 2.

Table 2: Structures of Investment Vehicle and Community Partner Relationships

Legal Model	Structure	Role of Community Partner	Strengths	Weaknesses	Examples
Contractual Model	Not-for-profit fund sponsor contracts with a proven fund manager. The project can be structured either as an LLC or Limited Partnership.	Not-for-profit fund sponsor, such as a business civic council, helps source deal flow, connect fund manager to community resources, and ensure that the investments deliver community benefits.	Proven outside fund manager	Fund Manager may lack accountability to the not-for-profit sponsor and may run off with the idea if ongoing funds are not built into the contract.	Genesis LA Funds, Bay Area Family of Funds, San Diego Capital Collaborative, Nehemiah Sacramento Valley Fund
Ownership Model	Not-for-profit fund sponsor owns for- profit fund manager.	Not-for-profit affiliate, such as a CDC or CDFI, helps source deal flow, connect fund manager to community resources, and ensure that the investments deliver community benefits.	Not-for-profit community fund sponsor has control over fund manager.	Institutional investors may not have confidence in the not-for-profit manager.	Community Preservation Corporation (owns CPC Resources), Coastal Enterprises, Inc. (owns CEI Ventures), MA Hou sing Investment (owns MHIC Equity LLC)
Legislative Model	Fund criteria and tax deal codified in state legislation; fund may operate with or without a not-for-profit affiliate.	Not-for-profit partner, such as a CDC or CDFI, helps source deal flow, works with fund manager to create economic development securities, or sells securities to the fund manager.	Good option with a sympathetic legislature	Not an option with an unsympathetic legislature	MA Life Initiative, MA Property and Casualty Initiative
Fund Manager Model	For-profit fund manager operates without a not-for-profit fund sponsor and may operate with or without a not-for-profit affiliate.	Not-for-profit partner, such as a CDC or CDFI, helps source deal flow, connect fund manager to community resources, and ensure that the investments deliver community benefits.	Investors like returns, fund managers, and double bottom line concept.	Who is monitoring second bottom line?	American Ventures, CA Urban Investment, Urban Strategy America Fund, New Boston USA Fund, Urban America, Canyon Johnson Urban Fund

Note: This table builds on Daniels's (2004) four models of investment vehicles.

First, the community partner ensures that the urban investment delivers benefits that are in line with community interests. This responsibility can be understood in light of the mission of community-based organizations and the activities they engage in to promote community economic development. In the 1960's and 1970's CDCs were created to promote economic development as a way to alleviate poverty (Parachini 1980). Early organizations engaged in business and economic development, labor-training activities, and housing and community development (NCEA 1981). The industry has since grown, and CDCs have expanded their services to include a wide array of activities ranging from health and human services, to early childhood education, and to community organizing and advocacy. Two public policy initiatives in the 1990's spurred the growth of CDFIs as an industry focused on redressing the financial exclusion of lower-income communities (Rubin 2007). In 1994, the U.S. Department of Treasury created the CDFI Fund to finance CDFIs and banks that invest in CDFIs. Second, revisions to the Community Reinvestment Act (CRA) in 1995 recognized CDFIs as qualified investments, giving commercial banks incentive to finance CDFIs. Today, CDFIs provide capital, technical assistance, and financial education to businesses, housing and real estate developers, not-for-profit community groups that need facility or operating loans, and consumers.

As such, the organizational mission of CDCs, CDFIs, and other community partners such as business civic organizations directs them to engage in activities that promote the welfare of local residents and businesses. These organizations are also held accountable to the local community by their boards of directors and leaders, who are generally local residents, by the funding sources whose continued support is contingent upon the social outcomes produced by the community partner, and by their internal drive to maintain their good standing with the local community.

Second, the community partner also leverages its resources to maximize the financial returns and social outcomes of an investment. The community partner is able to combine its in-depth knowledge of the local area and experience in economic development activities to identify investment opportunities and work with investment, development, and other community partners to structure the investment to meet community needs (Leiderman et al. 2003). The community partner also takes into consideration systemic inequalities that need to be overcome if community welfare is to be improved (Lamore et al. 2006), works to address these inequalities (Daniels et al. 1981), and ultimately contributes to social capital (Robison et al. 2002).

Community partners have access to a broad range of social and political, material, and financial tools.

The community partner makes use of several tools to promote social outcomes, as well as strengthen financial returns. In addition to drawing on its local knowledge to identify community needs and potential investments, the community partner utilizes the social networks of the community to mobilize local (and outside) resources and expertise, such as small investors and real-estate developers, and to assemble the support of civic leaders, government officials, and residents necessary to get the project approved. The above resources qualify as the community partner's *social and political tools*. The community partner may also own a parcel of land or a community facility that underpins the investment, which are the *material tools* available to a community partner.

Finally, community partners also leverage *financial tools*. These are public and private incentives used to overcome market inefficiencies that are often contingent upon the participation of a community-based organization. Examples include land zoning and encumbrances, Low Income Housing Tax Credits (LIHTCs), grant and equity investments from the CDFI Fund, New Markets Tax Credits (NMTCs), philanthropic grants provided by foundations and private donors, and other types of public and private subsidies.[9] Not all urban investments require these types of subsidies, but in some cases these tools help to create investments that might not otherwise have been possible, or to create more robust extra-financial outcomes than would otherwise have been possible. Utilizing these instruments enables investment vehicles and by extension investors to achieve market rates of return. Simultaneously

[9] Subsidies for economic development come in a variety of forms, including grants, loans, loan guarantees, the provision of in-kind products and services, regulation, and tax credits. Land zoning includes land use regulation; easements are land preservation agreement between a landowner and a municipality or a qualified land protection organization on conservation lands; the Low Income Housing Tax Credit program is run by the IRS and allows companies to invest in low-income housing, while receiving 10 years of tax credits; the CDFI fund provides grants and below-market rate equity to CDFIs; and the New Markets Tax Credit program is run by the CDFI Fund and permits taxpayers to receive a credit against federal income taxes over a seven-year period for making qualified equity investments in low-income businesses.

they help ensure that local residents and communities experience true revitalization rather than harmful gentrification in order to achieve financial returns.

All of these characteristics of community partners allow them to acquire the trust of investors and communities interested in securing strong community outcomes. Babcock-Lumish (2006 and 2008) highlights the need for trust among all parties in private investment deals and how imperfect and asymmetric information impacts the decision-making process in venture capital and other types of investment fields. Information barriers can pose challenges for institutional investors and communities looking to choose fund managers that will promote strong community benefits. Investors and communities have sought to deal with this trust issue in various ways. Many cities, towns, and states have established a community investment review process that requires the fund manager to persuade the local community of their intent and ability to deliver on community benefits, often requiring an explicit agreement from the fund manager to work with local community partners. Investors usually track social metrics, requiring that fund mangers meet predetermined social outcome targets. The explicit participation of a community partner in designing and setting up the investment fund and/or an investment can build on these approaches and, more importantly, serve as a proxy for trustworthiness of the fund manager when these and other approaches are not available or do not provide adequate assurance to stakeholders.

Strengthening Community Outcomes

Researchers argue that systemic issues of discrimination of underserved individuals need to be addressed if they are to benefit from the opportunities afforded by urban investments. The barriers to development transcend the availability of capital, and race, class, and gender have contributed to unequal levels of capital and wealth that influence individuals' ability to take advantage of opportunities provided by urban investments (Seidman 2007). Studies of minority-owned business formation and success have concluded that class resources, educational attainment, and wealth are the most important determinants of business formation and success (Bates 1998) and that the lower rate of business ownership among blacks is due to lower levels of net worth and start-up capital as well as higher loan rejection rates (Yago et al. 2007). Educational disparities also impact the labor market outcomes of minority and low-income workers, while limited wealth, education, and savings create barriers to home ownership (Seidman 2007). To contribute to the transformation of local areas, urban investments can include benefits that strategically address systemic inequalities and allow individuals to take advantage of opportunities created by the investments.

Urban investments can include benefits that address systemic inequalities and allow individuals to take advantage of opportunities created by the investments.

This argument raises the issue of the role of subsidy in these investments. Concern about future reductions in public subsidy has prompted the CDFI industry to consider how to strengthen the sustainability of institutions by reducing their reliance on subsidy. Yet some researchers question whether there is a case for ongoing subsidy for the kinds of investments made by these institutions. Moy et al. (2008) suggests that CDFIs absorb costs for essential services to clients that allow them to connect to mainstream markets, but identifying and factoring these costs is difficult. Rubin (2007) argues that while the primary market failure in this industry may be information asymmetry, overcoming other types of barriers to development—such as discrimination, the lack of infrastructure in rural areas, and the lack of deal flow in both urban and rural areas—may require ongoing subsidies.

Conclusion

Institutional investors are playing an increasingly important role in financing economic development as well as in the financing of essential services (Torrance 2007). This trend is occurring at a time when the community development sector has seen a slowing of funds from both the public and the private sectors (Rubin 2007). Consolidation of the financial sector is thought to have led to a reduction of home loan purchases and small business loans by banks under the CRA. In recent years, there have been reductions in federal funding for community finance programs, including the CDFI Fund, the New Markets Venture Capital program, the Rural Business Investment Program, and others. There are opportunities to attract large amounts of institutional capital to the emerging domestic markets while promoting the mechanisms that help ensure these investments have a meaningful impact on underserved communities. This study shows that the partnership between the investment vehicle and community partner unlocks value for institutional investors and communities alike.

Investors and governments need to carefully choose fund managers with a proven track record of delivering strong social outcomes in partnership with community-based organizations. While previous research has focused on the financial outcomes of these investments, going forward, in-depth research should also give attention to the social outcomes (see Hebb 2005, 2006 and Hagerman et al. 2005, 2006 for detailed analysis of the financial impacts of urban investment). The increased use of social outcome metrics will bring transparency to the industry, but these outcomes need to be considered in light of how well the investment meets the needs of the community (Hagerman 2007c).

Investment vehicles and community partners work to overcome market barriers in a number of ways. One important way is by pooling assets and investors. Another is by leveraging public incentives. There will need to be more coordinated partnerships between fund managers, communities, as well as municipalities and other government entities. Governments will need to be strategic as they develop portfolios of incentives to attract investors such as tax credits, regulation, and legislation. These types of programs will need to be designed to facilitate the flow of large amounts of capital from institutional investors, but nuanced enough to account for the particular barriers to investment that they are expected to overcome. These programs will also need to be carefully constructed to prevent capital substitution as well as promote the participation of community partners.

The amount of capital committed by institutional investors is growing. Nonetheless, challenges remain. Deal flow remains a problem, and the relative complexity of these investments makes it difficult for some investors to classify them. The ability of investment vehicles to partner with community organizations is essential for generating more deals and successfully placing institutional capital in underserved areas. We have presented several models of investment vehicles and community partners. Investment vehicles that formally recognize the role of the community partner provide the understanding of the local area that is necessary to ensure social returns. Community partners such as not-for-profit fund sponsors and not-for-profit affiliates are deeply rooted in the community, engender community trust, and often bring with them financial, social and political, and material tools that help maximize community benefits.

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