Impact Investing and Intentionality

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There is no Better Time for Foundations to Demand Better from Themselves and Their Investment Advisors

The COVID-19 outbreak launched a global health and economic crisis that disproportionately affects the most vulnerable in our societies. As a result, now more than ever, foundations and social entrepreneurs around the globe face an unprecedented imperative to focus on solutions and systems changes to meet existing and emerging needs. And while impact or values investing is not a new concept, there seems to be no better time for foundations to enter the space or, if they are already in the early stages, to strive for more defined outcomes and greater impact. Grants will not be adequate to overcome this crisis. Foundations should be considering how to tap into and/or leverage all of the resources at their disposal, partnering with and investing in innovators as well as demanding more from the financial industry to enable the sector to have greater, measurable impact.

This paper will not focus on the COVID-19 crisis; yet, the content is relevant to positioning foundations to be able to pivot and address crises. If more foundations start or further their impact investing journey, they will have many more tools at their disposal to both further their mission work and address challenging times like today.

An Innovator and Investor Walk into a Conference....

This is the story of how two people from very different backgrounds worked together to enable a well-established private foundation to transition its efforts from intangibly "doing good" to achieving measurable impact through its investment decisions. Specifically, the partnership includes a direct investment that addresses the affordable housing crisis and ensures that nearly 250 families will live in quality housing priced within their financial means. And the partnership inspired the foundation to dedicate staff and a carve out of its endowment to finding additional opportunities for investments that deliver both returns and impact.

We first crossed paths at a conference on foundation endowments and finance in 2018. It was an unexpected meeting place for the CEO of a private equity fund and a Senior Program Officer at a private foundation, neither of whom at the time held a role in foundation finance. We did click, however, around two central beliefs. First, that it is possible but not always easy for mission-oriented organizations to harness private sector capital to advance social impact, especially for people who are not commonly served by traditional capital markets. And second, that because of the overwhelming need in the communities in which we work, there is no time to waste.

We do not hold up our example to be the gold standard, yet, in the midst of a crisis at a scale that necessitates bold, sustained, and collaborative action well beyond that of grantmaking, we hope it can help others to navigate some of the barriers to impact investing.

The Spark within a Foundation

The Jessie Ball duPont Fund (the Fund) was established in 1976 to sustain Mrs. duPont's philanthropic support of nonprofit, religious, and education institutions in perpetuity. Chris' day-to-day attention was on furthering the mission of the Fund by managing its grantmaking in the American northeast. Grants awarded by the private foundation compose the vast majority of the I.R.S.-required 5% annual distribution of assets. But what about the other 95% that is traditionally invested to grow the corpus? He questioned whether or not the Fund was doing enough with its emerging impact investing program and what impacts, if any, were being achieved.

Following the Great Recession and the resulting precipitous decline in the Fund's endowment value in 2008, trustees agreed that the Fund had to bring more than grants to the table in order to effect positive change in the organizations and communities Mrs. duPont cared about. Thus, the Fund started its journey into impact investing. Trustees carved out up to 5% of its invested assets to create a staff-managed pool of program-related investment (PRI) loans/debt, primarily to support the preservation and development of affordable housing. Soon after, the Fund asked its outside investment advisor (the Fund does not employ internal finance staff) to recommend a few positively-screened investments (Environmental, Social, and Governance or ESG) to dip its toes into mission-related investing (MRI).

To better understand the impact of the Fund's investment capital, Chris participated to a greater extent in finance and endowment conversations between the Fund's trustees and its outside investment advisor (a trillion-dollar investment management firm). He ensured that impact investments were receiving attention during board meetings and pushed for more data on impact metrics from the consultant. Surprisingly, he saw little to no alignment between the Fund's mission priorities and the investments that were recommended to it by the outside advisor, even in the Fund's ESG holdings which grew to about 30% of its total portfolio.

After requesting to manage the Fund's PRI carve-out, Chris created a trustee dashboard to track impact investments and saw the potential and need to further expand the Fund's efforts. He understood with greater clarity that expecting 5% of the Fund's assets to deliver on 100% of the foundation's mission was untenable. The Fund's grant budget was simply not adequate to meet the needs or address the thorniest social ills of the communities it serves. Even more worrisome for Chris were the divisions in communication, values, and goals between the programs and finance groups. For example, he searched and found that the Fund owned shares in companies that work directly against its mission, nullifying its limited and precious grant dollars. Put another way…. How can foundations expect to have any hope at moving the needle for change when they are metaphorically choosing to box a much larger opponent with both arms tied behind their backs?

The Social Impact Entrepreneur – a Willing Partner

Dan established Center Creek Capital Group in 2013 as an investment fund that creates market-driven solutions to address the affordable housing crisis. In 2018, nearly half of U.S. renters were rent burdened (paid more than 30% of their incomes on housing)[1]. Following a long trend of rising rental prices and declining number of affordable housing units, COVID-19's impact on business closures yielded a record number of new unemployment claims in one week, suddenly digging the economic hole even deeper for American renters.[2] [3] Papers such as this one often elevate the economic disparity between the haves and have-nots, yet this crisis—like the 2008 Great Recession—adds many moderate-income families to the list of those who are considered financially vulnerable. The need to address the affordable housing crisis is now more urgent than ever, as it influences whether or not families are able recover from the financial tsunami stemming from the outbreak.

Even before the crisis started, Dan spent his day-to-day ensuring that his real estate investment fund was delivering affordable housing for his residents while driving superior financial returns for his investors – primarily high-net worth individuals, family offices, and foundations. He oversees the investment strategy for the Center Creek Housing Funds and ensures that his team is properly renovating and leasing the houses they acquire to generate strong cash flow to their investors. Dan focuses on workforce housing because of the following benefits:

- The ability to buy houses that generate 6.5% cash-on-cash returns – higher than most multifamily opportunities – along with long-term appreciation as housing markets continue to strengthen.
- Due to the severe shortage of affordable housing, the risk of vacancies is low, and there is downside protection in recessionary markets.
- The investment provides a natural hedge against inflation and rising interest rates in a way that is inversely correlated to bonds.

Center Creek believes that offering a quality, affordable, well-managed home for rent or sale is not only *doing good,* it is also good *for business*, resulting in lower tenant turnover and fewer vacancies, stronger revenue flow, and a responsible resident pathway to homeownership as well as an exit for investors. These are the anticipated outcomes that influenced the Jessie Ball duPont Fund to invest in Center Creek's Housing Fund and not passively approve an advisor's recommendation for a real estate fund that is only framed by financial performance.

Now, in the COVID-19 era, Dan is even more acutely aware of the need to provide safe and sustainable living opportunities to low- and moderate-income residents. Moreover, he believes that owning hundreds of homes comes with a responsibility to the local community. As a result, Center Creek is offering additional value and services to its renters, including credit counseling and a down payment savings match program to help its renter residents eventually become homeowners.

Barriers to Momentum in Impact Investing

Based on staff's recommendation and months of analysis, Jessie Ball duPont Fund trustees approved an equity investment in Center Creek Fund II in 2018. Center Creek was the Fund's first private equity investment sourced by staff. It is important to note that the Fund's decision was made without the outside investment advisor's official recommendation. Despite Center Creek's acquisition of an anchor investment by a leading institutional-level social impact investor in the U.S., the Fund's investment advisor declined to include Center Creek in its impact strategy for the Fund, partly because they did not source the deal and were unable or unwilling to arrange for their institutional team to conduct thorough due diligence on the opportunity. Regardless, the Fund's trustees were willing to assume greater risk with this mission-related investment in order to support the preservation of over 250 affordable, workforce single-family homes across several markets in the southeast U.S.— something it could not accomplish at scale solely through grants.

The investment advisor's response prompted a dialogue between Chris and Dan about the urgency for and the barriers to impact investing. It was clear that traditional approaches to managing foundation and family office investments were not conducive to a significant expansion of dollars flowing into impact vehicles, particularly with assets managed by the trillon-dollar investment firms. Dan and Chris believed the challenges they experienced were likely present in other foundations and that “old ways” created four key roadblocks that are stalling the progress of impact investing:

- **Concerns Over Financial Performance.** Some Chief Investment Officers, boards, and investment advisors aren’t willing to embrace impact investing because of concern about possible lower, or concessionary, returns; liquidity constraints; and perceived higher risk.
- **Insufficient High-Quality Investments that Offer Measurable Impact**. In general, the financial industry has done a poor job of meeting the demand for quality, measurable impact investment product (although there are bright spots). Some in the financial industry appear to have simply placated philanthropists by offering sub-par, off-the-shelf ESG funds that are ill-defined to meet foundation objectives.
- **Concern over Impact and Mission Mismatch**. Program Officers are held to account to deliver on the specific mission of foundations. But what if a quality impact investment opportunity sits outside of that specific mission—yet still does good in the world? Program Officers may be unfamiliar with specific impact investment opportunities, and if they become aware, they are less likely to expend their energy and clout to advocate for impact investments that are not squarely in their priority mission areas. This dynamic can impede quality impact investment vehicles from gaining traction among foundations that are seemingly open to impact investing.
- **Cost and Complexity of Sourcing Smaller Deals**. If staff source and bring forward a modest-sized impact deal for consideration, some large investment advisors might not sink resources or time into due diligence because the deal is too small (for example, $100M was the starting point for one advisor to consider a deal). To them, the juice isn’t worth the squeeze to look at a start-up, venture capital, or Series A deal. Yet, these are the types of deals that might be most attractive to program staff, particularly if a foundation is focused on issues of equity (e.g., small businesses owned by people of color or women who are under-represented or overlooked by fund managers).

With this quadruple whammy of obstacles, it’s not at all a surprise that impact investing hasn’t been adopted by more foundations.

Impact Investing through a Program Lens

Instead, let’s look at impact investing from each of the distinctly different roles: programming and investment. Start with the program perspective: say a foundation awards a $1M grant to a worthy cause—it gets a program benefit but $0 financial return—and then the money is gone. Some foundations therefore seek to complement grants with I.R.S.-designated tools like program-related investments (PRIs), which include debt, guarantees, and equity, among others. PRIs must provide a charitable benefit, yet the generation of income cannot be a significant motivating factor for the investment decision.[4] For example, the foundation can loan the same $1M as a PRI at 1.5% interest. The earned interest is not the point of a PRI. Instead, over the duration of the investment, those PRI funds support programs or outcomes that align with the foundation’s mission—similar to that of a grant—but, at the end of the investment, the foundation can get the $1M back and can lend it out again.

The beauty of a PRI is that it can enable formerly “locked up”—or invested—capital to be recycled and redeployed to support a foundation’s mission. Once foundations got a taste for PRIs, forward-thinking program staff and mission investors started eyeing other assets under management, planning to tap into these vastly larger sums of capital to make other investments that advance the foundation’s mission at best or to have their investments doing better in the world at a minimum. Enter mission-related investments (MRIs): investments that aim to achieve social/environmental benefits and that can, but not always, target market-rate returns. MRIs are invested assets (not program assets), and, unlike PRIs, neither constitute a charitable activity nor count toward foundations’ required distributions.

And here’s where one of the roadblocks spring up with regard to fully leveraging the 95% of invested assets and bringing on more MRIs. While foundation program staff like to employ PRIs because of the high mission alignment, PRIs are not “traditional” investments when one considers risk – even if they take the form of public or private equity. PRIs aren’t really investments that are directed in a programmatic fashion (as the name would suggest), but, more accurately they are programs that are financially structured as investments. If a borrower fails to repay interest or principal of a PRI loan or if a PRI equity investment in a for-profit company bombs, the foundation generally is no worse off than if it had given the money as a grant because the PRI amount had already been calculated into and credited for its required distribution when it was awarded.

That’s not the case with mission-related investments. A foundation’s endowment must be diversified and allocated in solid investments that generate strong financial returns if the foundation is mandated to exist in perpetuity. So, while it seems like making the jump from a PRI to a MRI is a natural step, the complexity in sourcing and vetting high-quality MRIs that meet or exceed portfolio benchmarks makes many Chief Investment Officers and advisors wary, setting up a potential conflict between the program and the investment sides of the house. So, too, are board members and trustees who are cognizant of their fiduciary role to ensure the long-term financial sustainability of the organization.

It can be difficult to find MRI opportunities that meet the trifecta of 1) driving strong social impact, 2) generating competitive financial returns, and 3) fitting with foundation’s mission focus. Viable Impact Investments that meet the first two criteria can get rejected because they are not aligned with a foundation’s programmatic or geographic focus. Program Officers don’t champion these—and may even question or block them—and CIOs/advisors are likely not going to take the time to vet them.

Impact Investing through a CIO Lens

Now, let’s consider the perspective of the Chief Investment Officer (this also includes outsourced CIOs and advisors) and the Board’s Investment Committee. Their mandate is to be a responsible fiduciary steward of the organization’s assets.

The CIO and the board who wish to integrate MRIs may take several approaches, including: 1) negatively screening out controversial business activities or divesting from companies or sectors, 2) positively screening for best-in-class business practices in environment, social, and governance (ESG), 3) direct investments in deals that are expected to achieve societal benefits, or 4) voting shareholder proxies.

For some foundations, negative screens can be an easy first step. Striving to improve public health? Lose the tobacco stocks. Care about the environment? Screen out industries that are active polluters or carbon emitters. But can this practice also lead to better returns? For some who divest from fossil fuel companies, their decision may be completely values based. Others, though, may be looking to the future, betting that clean energy alternatives will keep more oil in the ground and that future production/demand will lower prices and profits. Whether or not this practice has a financial impact on the fossil fuel companies is arguably irrelevant; foundations and colleges divesting from fossil fuel production are explicitly stating that their assets will not be complicit in a significant cause of greenhouse gas emission.

Implementing negative screens naturally leads to the idea of positive screens, which enable investors to “let in” to the portfolio investments that more closely aligned with their mission. For example, find companies that are involved in green energy, have diverse representation in their management ranks and board, have policies to support working mothers, or promote education, economic inclusion, or other positive outcomes.

Positive screens are tougher, however, since impact criteria may be only one of many factors in selecting an investment. Positive screens therefore require the CIO to spend more time examining individual investments — not simply looking at a company’s economic performance and diversification value. As a result, many organizations turn to specialized investment funds to achieve positive screens – investing in ESG funds, socially responsible exchange-traded Funds (ETFs), or similar vehicles. In theory, professional investment managers have done the work to identify companies that rate high on the ESG criteria for business practices. However, the reality is that many investment companies, fund managers, and investment advisors do not have the expertise or understanding to assess impact or mission alignment for their nonprofit clients.

Screened investments are a perfect example. In August 2019, both Vanguard and BlackRock faced blowback when it was revealed that their social investment funds owned shares of a gun manufacturer as well as a company that operated private prisons and participated in detention of immigrant children at the U.S. border.[5] While many Wall Street fund managers are not paying close attention to these issues, many foundations care deeply about them. And they award grants to address mass gun violence and to reunite immigrant families. Yet, foundations are investing in these companies via “impact” funds all the time.

Foundations continue to own questionable holdings that were vetted by managers who simply do not understand what foundations are trying to achieve through their grantmaking, what may or may not be in alignment with mission, and the responsibility of stewarding tax-exempt assets.

For example, when Chris first reviewed the Fund’s ESG holdings, he was shocked to find that they owned shares in companies that made cluster munitions, and in others that were embroiled in high-profile litigation for toxic chemical dumping in water systems or wage and hour violations. Of course, these holdings did not square with the Fund staff’s views of best-in-class impact performance or mission alignment. Clearly, positive screens and third-party stamps of approval aren’t the final word in impact investing.

The Holy Grail: Direct Investments

Even if ESG funds effectively weed out undesirable holdings, it is often difficult to trace the impact that a foundation or family office's investment is having on individuals, families, the environment, or communities.

By contrast, when a foundation or family office makes a direct investment in a mission-oriented company, that company should provide regular investor updates that quantify impact, in readily understandable terms, such as how many units (of energy, housing, or education) were created, how many people benefited from the services, or economic impact.

For most foundations and CIOs, finding high-quality direct investments that also deliver positive social impact is even more challenging than positive screens. They require sourcing and evaluating specific investment opportunities, which takes time and effort and possibly the involvement of the program team. Moreover, many CIOs are skeptical that investments can deliver impact without compromising financial returns.

However, high-performing impact investments do exist across asset classes and impact categories. There are early-stage venture capital funds that specialize in green energy, next-generation transportation technologies, or nutrition. There are funds that focus on supporting dynamic private companies led by women or people of color.
But the CIO doesn't have to find these opportunities on her own. Several organizations have compiled lists of impact investing funds, direct investment opportunities, and resources for investors – for example, the Impact Assets 50 or the Global Impact Investment Network (GIIN) ImpactBase. With these resources, much of the guesswork is taken out of the equation.

Now is not the Time to Hesitate: It is Time to Take Action

So, now what? Taken all together, while Chris and Dan come to impact investing from vastly different perspectives and roles, they have arrived at several key takeaways for those considering entering or expanding their Impact Investing activities, particularly at a time when boldness and intention are so important:

- **Eliminate the silos and pitch a bigger tent.** Be aware that the traditional fiefdoms of programs and finance sometime undermine the best intentions of doing good. If one hand doesn't know what the other is doing, they may be working at cross-purposes, and your organization may be perpetuating the status quo or inadvertently contributing to the problem you're trying to solve.

- **Know what you own.** Often suggested and extremely relevant, an important step in the impact investing voyage is to catalogue what your foundation or family office currently holds in its portfolio. Can you stand proudly behind each of the investments? Don't simply accept broad labels, such as ESG, and assume that the companies included in a fund align with your organization's goals. The absence of standards and transparency can mask trouble spots.

- **Lead with your values but don't let the perfect be the enemy of the good.** It is relatively easy to align PRIs with your mission and values. The perfect MRI, though, might be a unicorn. Don't reject an impact investment opportunity because it doesn't perfectly conform to your programmatic and/or geographic focus. Focus on your high-level values and evaluate impact investment opportunities against other holdings in your investment portfolio, not against your program portfolio. If it does not run afoul of your values and provides social return along with competitive market rate returns, consider putting it in your investment portfolio.

- **Direct investments can provide more transparency than funds**. Making an investment directly in a mission-oriented company usually provides the investor with more clarity around exactly what their investment dollars are supporting, and what the results are. It may be worth building or hiring out the expertise needed to vet these opportunities.
- **Do not shy away from asking the hard questions of your investment advisors**. If one is not a finance guru – let's say a Program Officer possibly – it is sometimes uncomfortable to participate in finance and endowment conversations. Foundations must ensure that finance and programs are working together at some level. If necessary, demand more from the investment advisor/staff to ensure mission alignment and to defend and evidence the "impact" in the impact investments that are recommended.
- **It's time to get going**. There are so many options and resources to help identify high-quality impact investments, there's no reason for CIOs or boards to continue hesitating. Leverage the resources that are out there and find investments that will meet your organization's financial goals. Even the most skeptical board or CIO can do something. You can park the foundation's cash at a Minority Depository Institution (MDI) or buy a CD at a low-income designated credit union. This takes very little effort. And then build from there!

It is imperative for philanthropy to think much more broadly about effecting change, rather than just dabbling within the confines of 5% of its resources. Philanthropic organizations cannot profess they don't know any better; they do. The genie is out of the bottle, and the stakes are too high.

Foundations and family offices–from the program staff to the CIOs to board members–need to come to consensus that impact investing is possible, and necessary. While the fiduciary duty of care and prudence is used as a rebuttal to adopting impact investing, one should remind naysayers that the duty of mission and purpose demands the same responsibility. It is difficult to argue that foundations should not be demanding more from themselves and their assets during the current crisis.

Philanthropy has the power and influence to demand better products from fund managers and investment companies. It is unconscionable to be sold ill-vetted and counter-productive funds labeled as ESGs, believing we're doing good in the world when that might not be the case. If a foundation or endowment owns assets that are working against its charitable purpose, it is arguable that the philanthropic organization is not deserving of the tax-exempt status entrusted it.

Impact Investing can have a multiplier effect well beyond the programmatic budget of the foundation and the philanthropic goals of the family office. This is how philanthropy can take serious steps toward influencing behavior and achieving real change.

Postscript: Taking Our Own Medicine and Reconfiguring to Invest for Impact

A chance meeting between an investee and investor led to a two-year long review of the Jessie Ball duPont Fund's endowment and the barriers to impact investing in general. As of January 2020, the Fund took action to put the principles this paper is espousing into action, with Chris assuming the new role of Director of Impact Investing. To really achieve transparency about the impact the Fund's invested assets are having, Chris is planning to focus more on direct investments. He relinquished 70% of his grantee relationships in order to focus on building out a more robust impact-focused investment portfolio, which will prioritize investments in the Fund's core geographies.

His first order of business was to revise the Fund's Investment Policy Statement to include a carve out for impact investments, which will be managed by a specialized investment advisor with oversight by Chris to ensure impact fidelity. To get its footing, the Fund is seeking additional MRI direct investments with the intention to achieve market-rate returns. The plan is to grow the carve out organically (but with purpose) and not prescribe a percentage or absolute amount right out of the gate. Staff will build capacity and seek investments inside and outside its core communities as well as further diversify its pool of fund managers in terms of race/ethnicity and gender.[6] Trustees will review each opportunity in the same way that they they approach grant proposals. If the investment meets the requirements for impact, risk, and return, it will be included in the carve out.

The current investment advisor will continue to manage the foundation's investment corpus—non-impact investments that also include the Fund's current ESGs—and track overall returns to meet the trustees' objectives. Ultimately, trustees will balance impact, risk, and available resources, which they have always done. However, now Chris' new role will ensure that the Fund is keeping impact squarely on its radar screen and that its assets are deployed in a manner that is even more intentional across the breadth of both

[1] Cost burden renter households made up 47.4% of the US renter population, with higher rates of burden among low-income renters and households of color. Harvard Joint Center for Housing Studies "State of the Nation's Housing 2019."
[2] https://qz.com/1826170/us-unemployment-claims-coronavirus-vs-the-2008-recession/
[3] https://www.brookings.edu/blog/up-front/2020/04/15/the-unemployment-impacts-of-covid-19-lessons-from-the-great-recession/
[4] https://www.irs.gov/charities-non-profits/private-foundations/program-related-investments
[5] "Vanguard Social-Investing Error Prompts Funds to Check Controls," Bloomberg, August 22, 2019; Wide Index Use Means ESG-Minded Investors Own Private Prison Stocks," Chief Investment Officer, July 3, 2019
[6] Currently 20% of the Fund's invested assets are managed by funds managed / owned by women or people of color. A goal is to reach 33% within two years (increase of 65%).