


Foundations and social investment

October 2005



Conventional wisdom is that charities are required to keep their money in two silos: for investment or for grantmaking. It is often assumed that trustees should maximise returns by investing only in mainstream financial products. Income is then distributed in accordance with their charitable purposes.

Social investment challenges this model. Over the last thirty years or so, practitioners in the UK and US have engaged in a range of social investment activities — defined as investments which generate a social as well as a financial return.

“The issue for the FB Heron Foundation is not whether private philanthropy has done well but whether it can do better.”

Luther M Ragin, Jr

Overview

Charitable grantmaking foundations work for the public benefit and have a wide variety of charitable purposes. They strive to make the best use of their resources. Social investment is a valuable tool which enables them to achieve more by making their money work harder. This briefing is based on a full report (see back cover) which includes more detail on the pros and cons of different approaches, and key learning points.

What is social investment?

Social investment may be defined as investment which generates a social, as well as a financial return. It takes two main forms: programme related investment and socially responsible investment.

Programme related investment

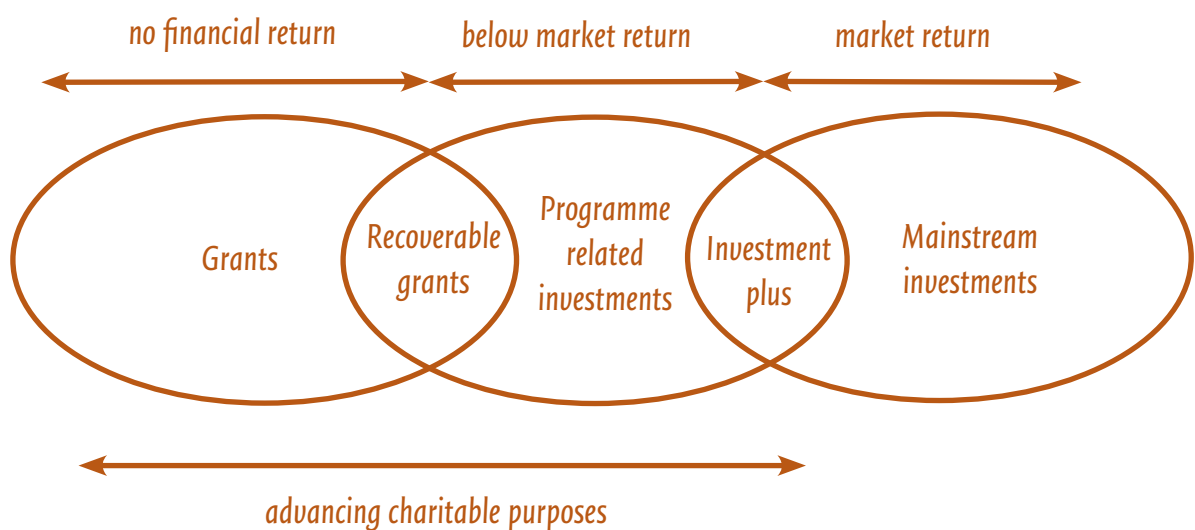
Loans, equity purchases, or quasi-equity funded from the foundation’s income or capital, with the primary aim of advancing the foundation’s charitable purposes.

Socially responsible investment

Loans, equity or fixed asset purchases (funded from the foundation’s capital) with the primary aim of producing income or appreciation in value but with some weight given to social considerations in choosing which investments to make and/or how to manage them. Socially responsible investment takes three main forms:

- **Negative screening** — to avoid socially harmful ways of getting a good return an ethical investment policy is developed and companies which do not match up are excluded.
- **Positive screening** — socially beneficial ways of getting a good return are sought out and investment is made, for example, in companies with responsible business practices or which offer beneficial goods or services.
- **Shareholder action** — investors encourage more responsible business practice by voting their proxies and/or making direct contact with companies.

Investment plus: we have used this term where positive screens are used to help the foundation select investments which also help it advance its charitable purposes. In the US this is sometimes referred to as mission-related investment.



Why do it?

Making resources go further

The same funds can be used more than once, for example, as loans are repaid.

An interest in building stronger voluntary organisations

Provision of loans, equity and quasi-equity often enables voluntary organisations to acquire an asset which can help secure medium to longer-term sustainability. The process of securing and managing a loan or equity also means that organisations develop their financial and management capacity.

An increased emphasis on accountability and transparency

Charities, including foundations, are likely to come under increased pressure to demonstrate that their practices, including their investment approach, reinforce rather than undermine their mission.

Background and recent developments

There is comparatively little data about the extent to which UK or US foundations are engaged in social investment. A recent survey conducted by the Association of Charitable Foundations indicates that over 20 of its 300 or so members have offered loan finance. In the US the Foundation Centre identified 255 foundation providers compared with over 61,000 foundations active in the US in 2003. Only limited, often anecdotal, evidence exists about foundation engagement in other forms of social investment in both countries. **Most foundations' knowledge and experience of social investment may as yet be underdeveloped but interest is growing.**

Programme related investment

Programme related investment is not new, it is an approach which has been remodelled to meet twenty-first century needs. Its **history goes back to the efforts of 18th and 19th century philanthropists to develop affordable housing, and provide those without other backing the capital necessary to set up in business.**

In the US, programme related investment (which traditionally financed community development finance) now supports a much wider range of causes, such as the arts and social services. **Partly as a result of programme related investment, a strong network of specialist intermediaries providing community development finance has developed in the US. These intermediaries are normally known as Community Development Finance Institutions (CDFIs).**

City Parochial Foundation

The City Parochial Foundation exists to benefit the poor of London — people who are socially, culturally, spiritually, environmentally and financially disadvantaged.

The Foundation owns playing fields in Bellingham, a predominantly white, working class area in Lewisham. It has dedicated £1.2 million from its endowment and raised a further £3.3 million from other sources to develop a Sport and Healthy Life-style Centre there. The Centre also houses Ladywell Gymnastics Club, a soft play area for young children, the largest Sure-Start project in London and an IT learning project. Opened in April 2004, it has already made a significant contribution to the regeneration of the area. The Bellingham Centre is owned by another charitable subsidiary of the Foundation — the Bellingham Community Project. It has leased the property to Greenwich Leisure a not-for-profit organisation which will manage the Centre for a ten year period. Greenwich Leisure will share profits with the Foundation but not losses.

The Tudor Trust

The Tudor Trust aims to help break cycles of disadvantage and dependency and to prevent people from being drawn into these cycles. The Trust holds assets of around £250 million.

The Trust has made programme related investments over a number of years. Over 75 loans (mostly interest free) have been made since 1985, usually to assist in the purchase or refurbishment of properties.

In 1989 and 1990 equity linked loans were made in partnership with a housing association to buy properties in East and South East London for letting at affordable rents — part of a package of measures to attract newly qualified teachers to work in these parts of London. When the need diminished the properties were re-valued and sold, either back to the housing association or on the open market. This resulted in Tudor receiving not only the full repayment of the original loans, but also a small surplus.

The Trust applies socially responsible guidelines and positive screening when deciding which shares to invest in. The Trust also uses negative screens.

Socially responsible investment

Negative screening can be traced back to the early 20th century, when religious institutions divested their portfolios of alcohol, gambling and tobacco stocks. A number of UK and US foundations engage in limited negative screening of investments (e.g. not investing in the tobacco industry).

Positive screening, including investment plus, is much rarer. The development of investment plus in the US has been influenced by a number of factors including:

- a growing number of profitable companies with social purposes, such as the Body Shop, and greater awareness of them;
- the development of ethical pooled funds (e.g. funds investing in companies aiming to develop sustainable development, or environmentally-friendly technologies);
- the maturing of community development finance with some CDFIs proving themselves capable of offering healthy returns.

The number of US foundations engaged in **shareholder action** has increased, albeit from an extremely small base. Some US foundations consider that they have a fiduciary duty to vote on shareholder resolutions (commonly called proxy voting). They also see shareholder action as an effective means of changing corporate policy on crucial issues such as environmental protection. Relatively few UK based foundations currently engage in shareholder action.

Nathan Cummings Foundation

In 2002 the Nathan Cummings Foundation made four grants totaling \$650,000 aimed at holding big agribusiness environmentally accountable. At the same time it had shares valued at \$720,000 in Smithfield Foods. After the Chief Financial Officer reviewed the portfolio, she placed a resolution on the company's ballot paper. It noted that Smithfield 'has been cited for serious environmental violations, most notably from the breaching of hog waste lagoons into public waterways'. It points out that these pose not only environmental but also 'financial and reputational risks'. It asked the management to prepare a report describing the environmental impacts of its hog production operations. 20 per cent of shareholders voted in favour of this resolution. Smithfield will soon release an environmental impact report.

Different approaches

Foundations with an interest in social investment mostly adopt a 'pick and mix' approach. Some, however, develop an integrated approach, combining programme related and investment plus, wider investment screening and shareholder action.

Providing programme related investment to individual organisations

Some UK and US foundations provide loans and equity alongside grants to individual organisations to build their capacity and to make their money go further. This enables them to:

- deploy a range of funding tools — sometimes loans and equity are better suited to particular projects than grants;
- leverage more capital investment — including mainstream investment, into the voluntary sector;
- improve the terms on which voluntary organisations are offered finance — enabling finance to be accessed at a lower cost.

In practice in the US programme related investments tend to be larger than grants and require a greater degree of engagement by both funder and beneficiary.

Foundations with successful programme related investment initiatives tend to:

- lend to organisations rather than individuals;
- know well either the organisation receiving the finance or the sector in which it is working;

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- make clear at the outset whether or not they are prepared to convert loans into grants and under what circumstances;
- engage specialist agencies to undertake due diligence checks, monitoring and receipt of payments on their behalf;
- include programme related investments as part of a package with grant funding and assistance with capacity building.

Providing programme related investment using specialist intermediaries

Many foundations have decided to make programme related investments to intermediaries, generally CDFIs. The approach enables foundations to:

- reduce the transaction costs associated with loans or the purchase of equity;
- mitigate the risk of investing capital direct into particular communities or areas of activity.

Venturesome (part of the Charities Aid Foundation)

Inside Out Trust (IOT) develops and supports workshop projects in prisons. Offenders work voluntarily to provide goods and services for the benefit of other people. IOT makes an important contribution to the criminal justice system in the UK, both through its direct work and indirectly through advocacy.

IOT's newly appointed Director contacted Venturesome in summer 2004. Difficulties with a major contract had led to a funding crisis. Venturesome and the Director agreed that the charity required both development capital to underpin reserves and working capital to assist cash flows. Venturesome provided £35,000 in development capital — as an unsecured medium term loan, with repayment linked to the level of reserves over five years, and a £65,000 working capital facility, repayable from cash flow.

Specialist intermediaries can add value by:

- pooling risk across a large number of loans thus reducing investor exposure;
- providing expertise in assessing and managing the financial risks associated with the projects they support;
- providing knowledge about the communities and markets in which they are investing;
- being in business to recover the debt — borrowers may assume that foundations will not pursue it.

Screening investments and/or engaging in shareholder action

US and UK foundations cite the following main barriers to investment screening:

- the difficulty of developing a credible screening policy particularly since discussion may raise complex ethical issues on which views may differ;
- numerous fine subjective judgements have to be made in implementation;
- screening means additional work for fund managers and this increases the charges they make for their services.

US foundations which have found investment screening the least problematic have a number of features in common:

- one or more trustees has a commitment to socially responsible investment;
- their screening policy fits perfectly with their purposes — they therefore have considerable expertise on which to base screening decisions;
- they do not expect the process to be perfect; only a proportion of their investments are screened and they invest in funds subject to standard screens, discussing with fund managers any potential breaches raising concern.

Shareholder action has the following positive features:

- compared with other social investment methods, **transaction costs are low**;
- the numbers of organisations engaged and their influence (particularly that of the large pension funds) means the research and administration can be shared;
- there are a number of sources of help and advice.

The Ashden Trust

Established by members of the Sainsbury family, The Ashden Charitable Trust has investments of around £20 million.

The Trust has made two programme related investments and has agreed a third. One is an interest free loan of £100,000 to Tropical Wholefoods, a fair trade company which purchases dried fruit and vegetables from small scale producers in the developing world. It builds partnerships with small businesses in Africa and Asia to provide them with improved access to expertise and markets.

In lieu of interest payments, the Trust took a 1 per cent (equivalent to £25,000) stake in the enterprise which it has given to another of its beneficiaries the Ashden Awards for Sustainable Energy.

This loan enabled the Trust to avoid the issues that arise from holding equity and has enabled Tropical Wholefoods to grow its business substantially and thereby work with significantly more individuals and entrepreneurs in developing countries.

Esmée Fairbairn Foundation

Esmée Fairbairn Foundation funds organisations which aim to improve the quality of life for people and communities in the UK, both now and in the future. The Foundation holds assets of around £740 million.

In 2003, the Foundation launched a pilot loans programme to help test demand for loan finance in the voluntary sector. £3 million was dedicated to the pilot over three years, with loans reflecting the Foundation's programme areas: Arts & Heritage, Education, Environment, Social Change: Enterprise and Independence. Charity Bank provides due diligence assessments on loan applications and collects repayments.

So far loans have been made to individual charities and to intermediaries such as Venturesome and Portsmouth Savers Credit Union.

The Foundation has in addition, made a small number of programme related investments. These have included a loan of £150,000 to Investors in Society which was converted into an equity stake in Charity Bank, a loan of £200,000 to the Aston Reinvestment Trust and an investment in a ten year bond issued by Golden Lane Housing Ltd providing interest at 1 per cent over inflation.

Some see it as a preferable alternative to other forms of social investment because of its simplicity. Since the objective is to improve corporate practice, they can invest in what they like. If foundations succeed they have performed a significant public service.

The Jessie Smith Noyes Foundation

The Jessie Smith Noyes Foundation provides funding for environmental and reproductive rights work. Its endowment values around \$60 million.

The first board of the Foundation, the family members, agreed that they did not want to own shares in tobacco companies and nuclear power. Its current policy sets out both exclusionary and inclusionary screens related to the mission of the Foundation, such as excluding companies that are significant producers of synthetic agricultural chemicals such as pesticides and fertilisers and including companies that produce, distribute or sell organic food. Trustees have agreed that no more than 20 per cent of their portfolio should be in unscreened stock. If investing in unscreened funds they have discussions with the fund managers about any investments that might violate their policy.

Investment plus

The main advantage of investment plus is that it enables foundations to:

- maximise their impact — they apply part of their capital as well as their income to achieving their charitable purposes;
- diversify their portfolios thereby spreading risk over the longer term;
- contribute to the development of a market in investment plus in particular asset classes — this holds the promise of generating wider and more profound change in general investment patterns.

The barriers are:

- a lack of trustee awareness and confidence in the approach, and a deep seated fear of erosion of capital;
- a desire on the part of trustees to keep things familiar and simple;
- trustees have to play a more active role in decision making about investments;
- a scarcity of investment plus opportunities in certain asset classes.

Investment plus is often regarded as complex and demanding, but some types are relatively easy to deploy, such as investment plus in property.

To guard against erosion in their capital base, US foundations which have a significant stake in non fixed asset investment plus tend to:

- invest in companies operating in markets in which they have expertise (e.g. companies with environmental goals);
- use pooled funds, such as social venture capital funds, in order to reduce risk;
- only invest in the highest quality investment plus opportunities;
- use industry benchmarks for particular asset classes to monitor performance — making adjustments in their portfolios as necessary.

Summary findings

Small and medium are beautiful

Social investment is not restricted to just larger foundations. Many foundations which have successfully engaged in social investment are small or medium sized and have used this investment as a means of achieving greater impact with limited resources.

Stimulate trustee interest and support

The US foundations developing innovative approaches to social investment had strong advocates for the approach on their boards, who invested time and energy in building support across the organisation.

Most foundations engaged in programme related investment and/or investment plus have allocated only a small proportion of their funds to the approach. This allows for experimentation.

Experiment by allocating a small percentage of funds to social investment

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Vary approaches to risk

Programme related investment runs the risk that funds will not be returned or that the return will be lower than promised. However, foundations can choose a level of risk exposure with which they are comfortable. Aspects which determine levels of risk include:

- the nature of the organisations supported — whether they and/or the market in which they operate are well known to the foundation;
- the nature of the projects supported — for example whether they are building projects and rental income will cover repayments, or whether they are new social ventures for which the market is untested;
- the terms of the loan — for example, whether the foundation is first or second in the line of creditors and whether the loan is expensive or not.

Use/support intermediaries

Foundations often prefer to provide finance direct to ‘front line’ organisations, but investing in specialist intermediaries significantly reduces the risk of losing money. Foundations in the UK and US support specialist intermediaries by:

- making grants which reduce the price of borrowing;
- taking an equity stake to capitalise the specialist intermediary;
- making a loan to the intermediary to help it finance its loan programme;
- purchasing services from the intermediary, e.g. due diligence, monitoring and repayment services to support programme related investment initiatives;
- ‘buying’ part of the intermediaries loan fund, i.e. a portion of the loan fund is transferred onto the foundation’s books, recapitalising the intermediary so it can make more loans.

Acknowledge programme related investment as a funding tool

In the US, programme related investment is increasingly regarded as a valuable tool to be used alongside grants in appropriate circumstances. In some successful initiatives, programme related investment forms part of an investment package that includes a grant and support.

Acknowledge the opportunities for investment plus

The full report (*for details see back page*) illustrates that generally foundations have less experience of investment plus. This is in part because it is difficult for some foundations to find appropriate high quality investment opportunities.

However, foundations have a number of investment plus options – they can invest in companies:

- producing products or services which advance the foundation’s charitable purposes for example, environmental improvement or funds comprising such companies;
- owned, managed or employed by a sector of the population the foundation aims to help for example, women or people with disabilities;
- located in disadvantaged areas in cases where the foundation has charitable purposes dedicated to employment creation or regeneration.

Property can also provide investment plus opportunities for foundations.

Foundations should bear in mind that there are likely to be some high quality investment plus opportunities in certain fields for example environmental protection and conservation. And, as the growth in businesses with explicit social purposes continues such opportunities will increase in number across a broad range of charitable purposes.

The FB Heron Foundation

The FB Heron Foundation aims to build wealth in low income communities. It has led the field in the US in developing investment plus but it also provides programme related investment and has commissioned its own screening methodology.

In 1996 the Foundation began to look at how its endowment could support its charitable purposes. As a start the Foundation made deposits in community development credit unions. It has since purchased asset-backed securities issued by Habitat for Humanity to expand the organisation’s self help housing programmes, bought municipal bonds that provide ‘soft-second mortgages’ for low income first time homebuyers, and has invested in private equity funds supporting commercial real estate and businesses in low income communities.

Tie investment screening policies to charitable purposes

Those foundations successfully screening their investments generally have policies tied to their charitable purposes. A foundation which supports environmental improvement, with a screening policy concerned with environmental practice, has the knowledge to make the necessary judgements.

The future

Grantmaking will remain the predominant activity for most foundations, social investment may add value to this. The likely picture is of a social investment market growing in size and, in the longer term, gaining maturity, in which programme related investments are likely to be:

- **more common** — there is likely to be growing demand for subordinated loans or loan guarantees;
- **more complex** — involving multiple parties and higher proportions of private finance;
- **more speculative** — with an increasing number of requests for support for more speculative ventures, particularly social businesses without a proven market niche.

An increasing number of foundations are also likely to engage in socially responsible investment, including investment plus.

A number of pioneering foundations are making social investments and working to promote the approach amongst their peers. However, although much impressive work has already been done, most agree that the journey is only just beginning.

This briefing is based on a full report written by Margaret Bolton working in collaboration with a group of trusts including The Ashden Trust, Esmée Fairbairn Foundation, Tudor Trust and Venturesome (part of the Charities Aid Foundation).

It is available in full from:
www.esmeefairbairn.org.uk



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