

**Economically Targeted Investments**  
**Key Success Factors**  
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# IN STUDYING SUCCESSES AND FAILURES AMONG ETI INVESTMENTS, 5 KEY PRINCIPLES HAVE EMERGED

## Key principles for success

1. Investments must target risk-adjusted, market-rate returns
2. ETIs must not exceed a reasonable weighting in the portfolio, including tracking the degree of exposure to the local economy and ensuring appropriate geographic diversification
3. Economically Targeted Investments should be placed with an experienced and capable manager through an objective and transparent process
4. ETIs should target a “capital gap” where there are likely to be underserved markets
5. ETIs must be tracked (both investment performance and collateral benefits) and managed with the same rigor and discipline imposed on other investments



**A conservative investment approach to economically targeted investments is most likely to be successful**

# CURRENT ETI PROGRAMS GENERALLY TARGET MARKET RETURNS AND REPRESENT A SMALL PERCENTAGE OF TOTAL ASSETS (2%)

## Examples of ETI investment policies among public funds

### Washington

- “The collateral benefits of an ETI shall not be considered part of the return of the investment, nor part of the risk reduction”

### California (CalPERS)

- ETI must match “financially comparable investments. Comparability will be judged on a risk-adjusted basis with the System being willing to accept no less in return and incur no additional risk or cost”

### New York City

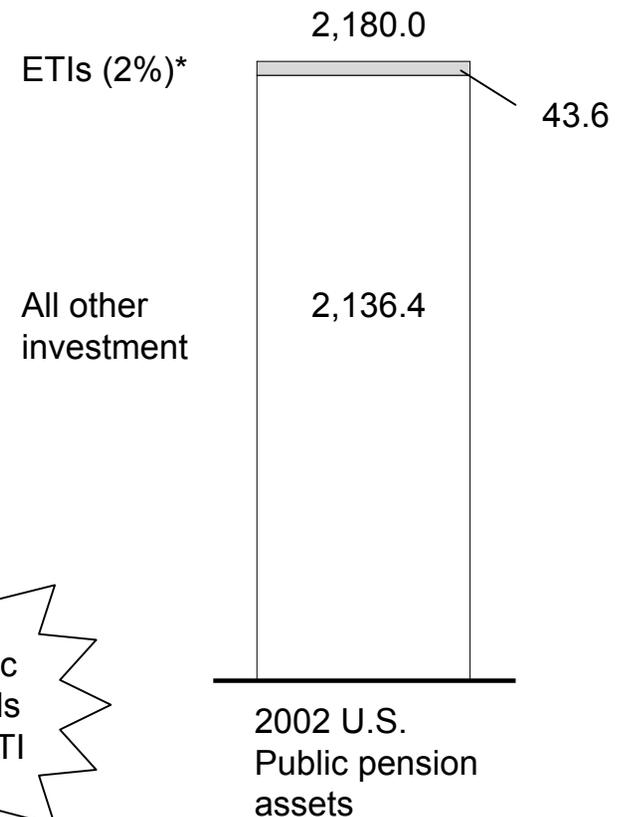
- ETI must “provide a market rate of return that is commensurate with the risk assumed”

### Missouri

- ETI must offer “the safety and rate of return comparable to other investments available”

55% of public pension funds engage in ETI

## Total state & local public pension assets \$ Billions



\* 2% estimate based on latest available research; GAO survey in 1995 and a comprehensive Boice Dunham Group survey in 1993; confirmed by team interviews

# MOST ETI PROGRAMS FOCUS ON A SET OF PRIMARY CAPITAL GAPS

	<b>Capital gaps targeted</b>	<b>Investment thesis</b>	<b>Typical investment vehicle</b>
<b>Affordable housing</b>	Increase availability of quality housing for low-to-moderate income individuals	<ul style="list-style-type: none"> <li>• Other sources of capital are unlikely to be able to secure guarantees or structure pass-throughs</li> </ul>	<ul style="list-style-type: none"> <li>• Mortgage programs targeting LMI individuals</li> <li>• Construction/perm. lending for affordable housing projects</li> </ul>
<b>Fund small business</b>	Provide flexible funding to underserved small business <ul style="list-style-type: none"> <li>• Domestic emerging markets</li> <li>• Unique financing needs</li> </ul>	<ul style="list-style-type: none"> <li>• Targets the gap between bank loans (focused on low risk) and VC (focused on high-growth, high-tech)</li> <li>• In some states, jump start a high-tech economy</li> </ul>	<ul style="list-style-type: none"> <li>• Low-cap mezzanine funds</li> <li>• Targeted VC activity</li> <li>• Lending programs targeting underserved businesses</li> <li>• Purchase of guaranteed SBA loans</li> </ul>
<b>Urban development</b>	Encourage real estate development in urban areas	<ul style="list-style-type: none"> <li>• Lack of available data on investments and over-estimation of risks</li> </ul>	<ul style="list-style-type: none"> <li>• Separate accounts with 3<sup>rd</sup> party managers</li> <li>• Commingled urban development funds</li> </ul>
<b>Lending in underserved areas</b>	Increase liquidity/incentive for lending activities in underserved areas	<ul style="list-style-type: none"> <li>• Ability to drive CRA activities without sacrificing on risk/return</li> </ul>	<ul style="list-style-type: none"> <li>• Cash deposits in local banks/credit unions</li> </ul>

Source: Public pension fund annual reports; Factiva; team interviews

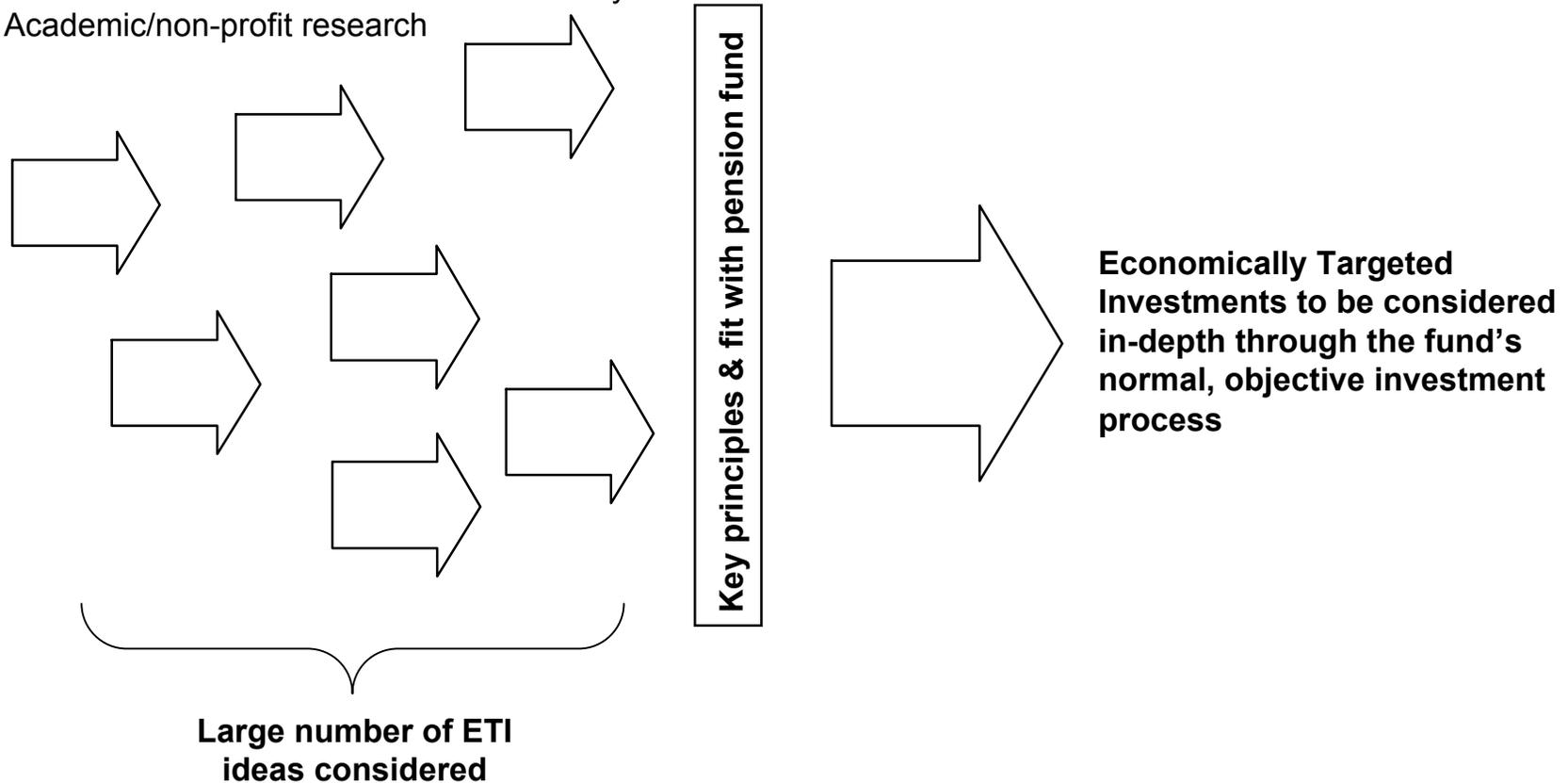
# ETI PROGRAMS SHOULD TAKE INTO ACCOUNT THE UNIQUE CHARACTERISTICS OF THE FUND'S STRATEGY AND ORGANIZATION

	<b>Current situation</b>	<b>Implications for ETI</b>
<b>Current in-state holdings</b>	<ul style="list-style-type: none"> <li>• Is the fund considerably overweight in-state for an asset class that is likely sensitive to the regional economy?</li> </ul>	<ul style="list-style-type: none"> <li>• ETI programs need to balance risk of additional in-state exposure</li> </ul>
<b>Structure and staff</b>	<ul style="list-style-type: none"> <li>• What types of capabilities have been developed in-house? Does the fund extensively leverage external managers?</li> </ul>	<ul style="list-style-type: none"> <li>• ETI programs should leverage existing capabilities where possible. Leveraging these capabilities will require incremental resources</li> </ul>
<b>Risk profile/ asset allocation</b>	<ul style="list-style-type: none"> <li>• What are the current and future asset allocation targets?</li> <li>• What is an acceptable amount of investment risk for ETI?</li> </ul>	<ul style="list-style-type: none"> <li>• ETI should be managed within the existing asset classes/allocations</li> <li>• In many instances, ETI programs will likely need to leverage guarantee/insurance programs as well as other risk mitigation and management techniques</li> </ul>

# ETI OPPORTUNITIES SHOULD BE SCREENED FROM A LONGER LIST OF POTENTIAL OPPORTUNITIES

## Idea sources

- Other state treasuries
- Other pension funds
- Members of the states' financial community
- Academic/non-profit research



# ORGANIZATIONAL COMMITMENT AND RESOURCES REQUIRED TO ADAPT ETI PROGRAM OVER TIME

## Surface new ideas

- Periodic research into new ETI programs successfully implemented by other states/municipalities
- Ongoing dialogue with key members of the states' financial, business, non-profit and academic community to ascertain investment opportunities/capital gaps

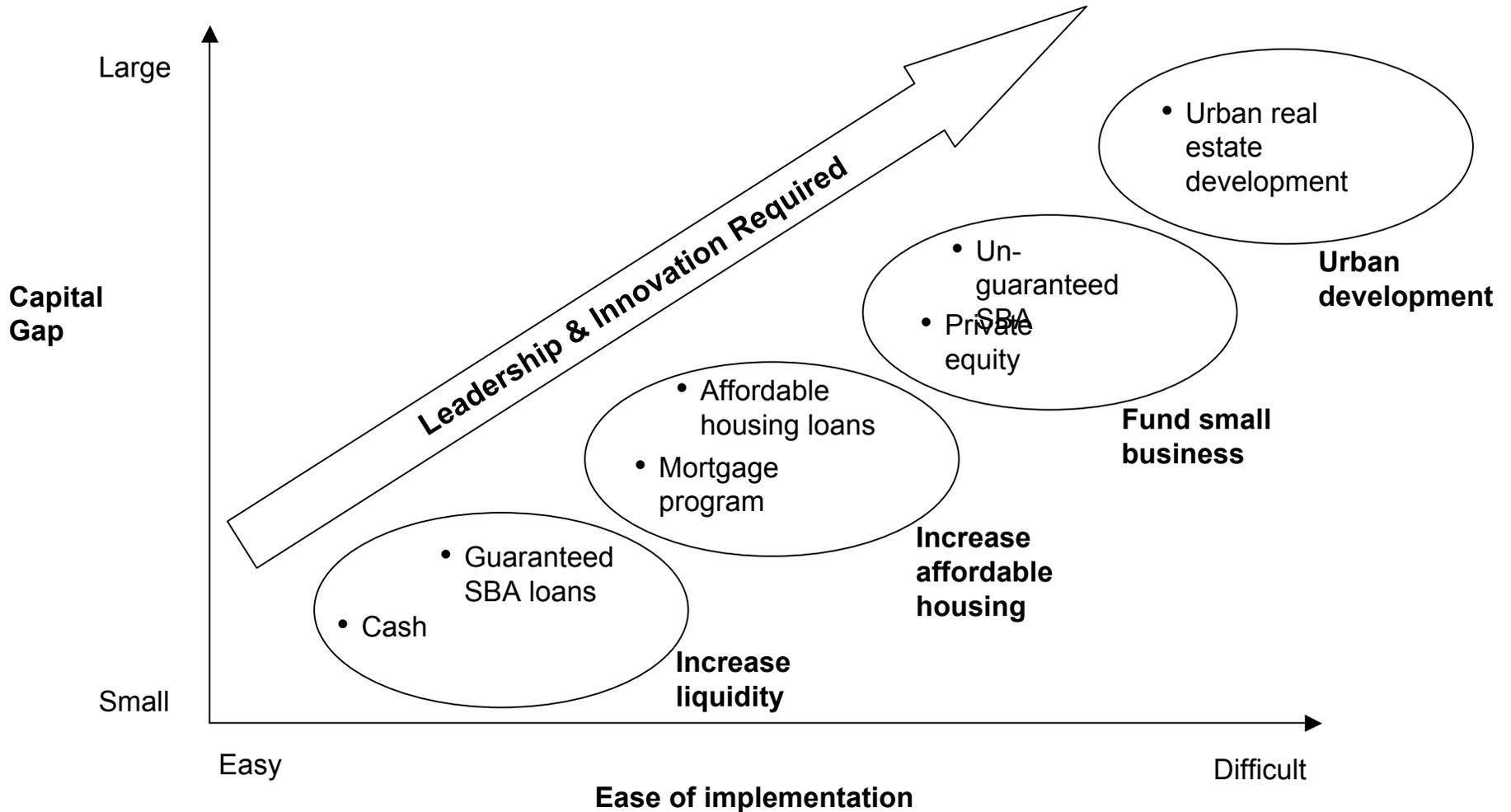
## Implement ETI opportunities

- Program management for the implementation of ETI opportunities and integration into the fund's investment process

## Track and report performance

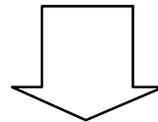
- Periodic reporting to advisory committees/boards on ETI program including investment performance and collateral benefits generated for the state

# SUCCESSFULLY TARGETING THE LARGEST CAPITAL GAPS IS DIFFICULT, REQUIRING SIGNIFICANT LEADERSHIP AND INNOVATION



## AND FINALLY, SOME KEY LEARNINGS ALONG THE WAY . . .

- **ETI's must be thought of as “*domestic* emerging markets”**
  - There are fewer funds that have long, established track records but, as with foreign emerging markets, the promise of an unexploited capital gap and diversification applies
- **If you think you can do double bottom line investing without any additional effort, you are mistaken**
  - Conventional investing for just the first bottom line will always be easier
  - You need to be willing to pay a price in terms of time and effort to achieve second bottom line goals *without* sacrificing returns
- **Like traditional investments, a successful ETI program is all about portfolio diversification**
  - There is opportunity to balance higher “beta” double bottom line investments with low-hanging fruit that is little-to-no risk



- **Public pension fund involvement will send an important message to the market and generate more interest/incentive among experienced investors to focus on a second bottom line**