BLENDED VALUE INVESTMENT AND A LIVING RETURN

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Investment Value within the Context of Global Poverty

Today's investors face a challenge and an opportunity. By changing how we think about value within an investment frame, we can adopt the concept of "blended value,"[1] to utilize all available resources to promote environmental, social and financial equitability and sustainability. By changing how we define our appetite for returns, and shifting towards the concept of a "living return,"[2] we can begin to rebalance wealth in the world with consideration for how much is enough. Blended value investment is posited as a leading indicator of a more equitable world.

Conventional investing, and the subsequent creation of economic value, has by and large been viewed as an activity separate and distinct from efforts to create social value and positive environmental impact. The traditional view is that companies and investment managers fulfill their social responsibilities simply by generating the greatest possible financial return, with each investor deciding how best to "do good" with the profits, regardless of the social and environmental costs involved. Essentially, the mainstream model says, "Let's maximize the risk adjusted financial return in a vacuum, and then give it away later."

[1] This paper borrows from certain sections and concepts of The Investor's Toolkit, by this author, Jed Emerson and Shari Berenbach, and other works in progress by the author and Emerson. Readers may download the Toolkit draft at www.blendedvalue.org, along with writings by Emerson on the Blended Value Proposition (to whom great credit must be given for the "BV" concept). Research and editorial support for this paper provided by Loren Berlin.
[2] The conceptual sister to a "living wage."

Today, unequal wealth and income disparity has created a global "barbell" in which the middle class is a thin band between two extremes. On the right end of the barbell is the "wealthy weight" of the world's richest people, the 500 individuals with a collective income of US$91 billion. [3] On the left end of the barbell is the "impoverished weight" of the world's poorest people, the almost 400 million people with a similar collective income of $91 billion. The weights are equal in size by dollar amount, but radically disparate by number of people. [4]

Clearly this polarization is not sustainable. Therefore, we must seek ways to flatten the wealth gap, and build a more resilient social contract. It is in the first world owners' enlightened self-interest to realign the practice of investment, to promote a more equitable environmental-social-economic system. This brings us to blended value investment – an effort to realign the risk/reward paradigm and investor focus—to reflect and reinforce a sustainable world.

What Is Blended Value Investment?

Traditionally, the social and environmental impacts of investment decisions have been considered externalities, superfluous to the investment equation. There are two explanations for this misconception.

First, society tends to discount the ways in which values affect investment decisions. That is to say, people often believe investing is merely the act of putting one's dollars into a financial instrument. However, investing is fundamentally based on the individual's pursuit of personal goals and very basic human needs. We seek to create wealth in order to have choices regarding how we live our lives, provide for our families, and pursue our dreams. We seek to create wealth to build thriving economic systems to ensure that we live in safe and bountiful communities that allow us, and others, to achieve our greatest potential. Truly, the goal of creating economic wealth is seldom pursued in the abstract. Instead it is a means to an end.

Second, investors can usually ignore the true costs of doing business, because social and environmental capital is not included in standard accounting practices. The social and environmental costs to doing business are pushed off corporations' financial statements. However, just because we do not consider the true implications of our investments does not mean that they don't exist. When we invest, we participate in a complex system of value creation that generates multiple returns with financial, social and environmental implications. If we are to support a sustainable world, we must restructure our thinking to account for the true costs to natural resources and society.

The starting point of the blended value investment proposition is the idea that realigning value (and values) is maximized when investors leverage their full assets in pursuit of their goals.

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[3] All $s hereafter in US$s.
[4] Statistics courtesy of UNDP.

This challenge of fully utilizing assets is perhaps most stark in terms of charitable foundation asset management. The traditional practice is to use 5% of the foundation's net income to support grant making activities, while 95% of the foundation's assets are managed with little to no consideration of the overall institutional goals of the foundation. In other words, five percent of the foundation's assets are driving 100% of the institutional mission, while 95% of the investor's assets are, at best, neutral with regard to supporting the foundation's overall goals. Often, these investments are actually invested in companies that engage in practices that directly contradict the institution's mission. [5]

Such an investment strategy is akin to a baseball team manager choosing to send just two of his three dozen players through the rigors of spring training, regular practices and coaching. The rest of the team members would be enrolled in "anti-training," in which they'd be encouraged to park on the clubhouse couch all day watching television re-runs, and then go drinking at a local pub until the early hours of the morning. You can imagine how disastrous the team's performance, as a whole, would look on the field—even if the two preferred players consistently hit homeruns.

It is hard to argue that leaving such a huge portion of one's assets in "anti-training" mode maximizes the ability to attain investor goals. Whether for foundations to fulfill the fiduciary responsibility of their charitable charter, or for all investors who wish to align the entirety of their assets with their societal goals, the point is to send the whole team to training camp, and then play the best game possible.

A blended value investment strategy seeks to identify an investor's full array of available assets—both financial and non-financial. [6] It then assertively deploys those assets in support of the individual or institution's mission, thereby achieving the financial, social and environmental goals the investor seeks to achieve.

A growing number of investors are executing strategies that intentionally seek to blend value. Consider the U.S.-based socially responsible investment landscape, for example. Strategies consist of issue screening, shareholder proxy voting and community development investments. The market share has grown from $40 billion in 1984 to $2.3 trillion in 2003, reaching 12% of all investment assets, as pension funds, institutional investors and others have taken a more active stance toward shareholder involvement or introduced one or more social screens into their investment selection process. And U.S. investment in community development and microfinance has increased to $14 billion, at a recent compound annual growth rate of 36%, while private equity venture funds that seek social and environmental value are estimated at $2 billion. [7]

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[5] See Emerson's *Horse Manure and Grantmaking*: www.foundationnews.org/CME/article.cfm?ID=1950.

[6] The author conceptualizes human capital as Time, Acumen and Network capital, while financial capital can be broken down to Grants, Lending and Equity—a "TANGLE" of resources. Also, readers should see www.blendedvalue.org for a discussion of *The 21st Century Foundation*, which presents a unified investment strategy for foundations that calls for full use of assets under management.

[7] *2003 Report on Socially Responsible Investing Trends in the United States*, Social Investment Forum, October 2003. The private equity figure comes from the RISE Report of 2003.

Conceptually, financial assets may be broken into three general categories: [8]

First, capital that generates a blend of social and financial return, delivering a conventional market-rate risk-adjusted financial return. Assets either are neutral relative to the goals of the investor (e.g. screening out industries or enterprises deemed to be in opposition to overall investor goals), or may be more proactively positioned to align with an investor's goals (e.g. an investment creating jobs in a specific region).

Second, capital generating a blend of social and financial return, but delivering financial returns that are lower than the conventional risk adjusted market rate, in exchange for greater social returns. Assets are proactively reaching a high value proposition in line with investors' goals, but trade off a certain and measurable financial risk/reward concession (e.g. a loan to an affordable housing development at less than going rates).

Third, capital generating a core mission-aligned social return, but no financial return to the investor (other than, arguably, the tax deduction value at the front end, if such a deduction exists). The most common form of this is a grant.

If investors aim to fight global poverty, then what should they target, and how should they think about financial assets as tools to this end?

Doing Well (Enough) While Doing Good

The first category of market-rate strategies seeks to exclude socially and environmentally "value subtracting" enterprises, such as egregious polluters and corporations that employ child or forced labor. These strategies attempt to stop driving capital to enterprises that detract from a given investor's broader intent. Therefore, blended value thinking has necessary implications for altering the flows of capital. If most—if not all—capital flowed away from these enterprises, while investors simultaneously exercised shareholder power to change corporate behavior, and, furthermore, moved capital towards beneficial corporations, a natural global correction would occur.

A good example is the anti-apartheid divestment movement in South Africa. More recent examples include:

- Cintas, a global garment manufacturer, which had been known for employing vendors who use sweatshop labor. Cintas recently agreed to adopt a code of conduct that all of their vendors must also adopt, promising to pay vendor employees minimum wage or industry wages (whichever is greater), provide safe and healthy work environments, refuse to use forced/prison labor and refuse to use child labor. Cintas acted in response to negative publicity and pressure from an assortment of shareholder and labor groups. [9]

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[8] In *The Investor's Toolkit* we found utility in this framework, but it still is worth observing that a quasi-continuum exists, with the line between one or the other category blurred as the instruments available in the emerging social capital market become increasingly numerous and complex.

[9] Source: www.cintas-corp.com.

- Home Depot, which agreed to phase out the sale of wood from environmentally sensitive origins, including primary tropical forest and old-growth stands, due to pressure from a consortium of shareholder and environmental groups. [10]

- ING, the 11th largest financial institution in the world, which agreed to stop financing and directly investing in companies that produce controversial weapons, including landmines, cluster bombs, nuclear weapons and uranium weapons. This was in response to the "My money. Clear Conscience?" campaign launched in Belgium. [11]

Most recently, in June 2005, World Resources Institute and Merrill Lynch have broken new ground by issuing stock recommendations that include climate change impact assessments – as seen in their report, "Energy Security & Climate Change: Investing in the Clean Car Revolution." This may herald a new trend of proactive, opportunistic and broadly driven change in mainstream investor behavior. .[12]

Again, these activities are examples of blended value strategies for traditional investment that exclude enterprises with negative social value, exercise shareholder power to promote positive corporate behavior, and proactively allocate capital to firms that build positive outcomes in society. Though somewhat radical in their corrective activism, they do not require a fundamental blurring of conventional financial risk and return. Instead, they add social and environmental consideration to the equation, without demonstrable cost to the investor. [13]

Perhaps more radical, the second category of assets is comprised of investments that offer lower than conventional market-rate financial returns, in exchange for greater social value. [14] Examples include equity and debt placements or loan guarantees in microfinance, cooperatives and community development enterprises. They may reach a broad spectrum of activity, both in sector and geography.

In market terms, these investments ask more fundamentally challenging questions of investors, such as:

- How do we really define value and return?

[10] Source: www.foe.org.

[11] Source: www.netwerk-vlaanderen.be.

[12] Source: www.socialfunds.com/news/article.cgi/1741.html.

[13] For example, the Domini Social Index's ten year annualized return is 10.87% vs. 10.18% for its benchmark, the S&P 500, for the period ended May 31, 2005. Similarly, a study of SRI funds in the US found that a higher percentage of SRI funds wind up in the top two quintiles, performing better than their conventional counterparts. Source: www.socialinvest.org and www.socialfunds.com.

[14] It is important to note that subtleties can delineate this category. It may be a question of instruments delivering a lower rate of return than comparables, or carrying a longer time horizon or a greater degree of risk. Longer-term time horizons may allow an organization an extended period to create mission-based impact, higher risk may be expressed as subordination of the investment to leverage other senior capital or non-compensated country risk, and lower return may be required due to hybrid business models' ability to service debt.

- Can we cross the conventional lines that force either return maximization or philanthropy?

- How much financial return is enough?

Admittedly, it will take more time for consensus on the answers to emerge.

But, there is no doubt that investment in education, health, affordable housing and enterprise development and independent media is a fundamental ingredient of positive social change. Already, path-breaking initiatives are rewriting the conventional rules of risk and return.[15]

- Associacão Nacional de Cooperacão Agrícola (ANCA) is a Brazilian cooperative nonprofit organization that represents the settlements connected with the Movimento Sem Terra (Landless Workers Movement). ANCA provides educational opportunities to school age children, as well as adults and community activists, by producing publications for the training and education of leaders in various worker movements. Approximately 7,000 books are sold each month, and that number continues to grow. ANCA has taken soft debt from a range of investors to provide working capital and financing to its members.

- Voxiva is a for-profit voice and data solutions provider that has developed new ways to use technology to address some of global health's most pressing challenges. From disease surveillance to adverse event reporting, Voxiva's applications allow public health agencies from Peru to Iraq to collect critical data from, and communicate with, front-line health workers in real-time, empowering them to respond immediately. Investors have placed "patient" equity into this social venture to grow the budding enterprise.

- The Federation of Appalachian Housing Enterprises (FAHE) is an association of 30 nonprofit housing organizations producing affordable housing for low-income families across Appalachia, one of the most impoverished regions in the United States. FAHE clients have a median family income of $12,110. Cumulatively, FAHE groups have constructed or preserved almost 40,000 affordable homes. As a nonprofit, FAHE has been able to put to use millions of dollars in soft debt from investors to finance its housing activity.

- MicroVest is a debt and equity fund that invests in leading microfinance institutions throughout the developing world. It has raised limited partnership equity units to form a core of capital, to which it adds leveraged debt raised from individuals and institutions throughout the 10 years of the LP. It blends debt and equity, and private partnership and nonprofit structures.

[15] These examples only barely scratch the surface of the wide spectrum of activity available. They come from a subsection of Calvert Foundation's Community Investment Note portfolio experience, which is itself a global pooled fixed income product used by retail and institutional investors. These groups are generally taking financing at longer terms and relatively low yield. More information available at the Community Investment Profiles database: www.calvertfoundation.org/individual/research/profiles.html. All of the examples are for illustration purposes, and are not meant as investment recommendations.

- The Media Development Loan Fund (MDLF) is a nonprofit organization dedicated to assisting independent news outlets in emerging democracies to develop into financially sustainable media companies. MDLF invests in a range of debt and equity placements to TV and radio broadcasters, newspapers, magazines, news agencies and on-line media across Eastern Europe, the former Yugoslavia, the former Soviet Union, Asia, Africa and Latin America. As such, MDLF is a revolving fund that takes soft debt from a range of investors.

These investments vary considerably; direct and intermediary, nonprofit and for profit, debt and equity. Yet all are examples of the rich landscape of activity that investors use to blend social and economic returns while re-imagining the conventional risk/return paradigm. In so doing, investors have created blended value both at the ground level, and for the investor.

The Impact of Investment on Global Poverty

Imagine the impact of each $1 billion invested in a global, diversified portfolio of microfinance, affordable housing, cooperative and social enterprises.

Roughly 1,140,000 jobs could be created, 160,000 affordable homes built or rehabilitated and 70,000 cooperatives and nonprofit facilities financed, each and every year. [16] And these are just the primary impacts. Each job, enterprise or home has many ripple effects that create secondary, but equally deep benefits over time. For example, microcredit increases household net worth, women's asset holdings, contraceptive use, and children's school attendance. [17]

$100 billion of private capital invested for a 10 year term could finance 1.14 billion microenterprise jobs, 160 million affordable housing units, and 70 million cooperatives or nonprofit facilities.

At just over ½ of 1% of the roughly $19.2 trillion in investment assets in the US capital markets, [18] $100 billion would hardly be missed. This impact could become part of a full-spectrum first world commitment to ending global poverty -- the investment compliment to the UN's Millennium Development Goals. [19] Like the 191 UN member countries that have vowed to work together to achieve these goals, the world's investors could unify as a community to assist the world's poor.

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[16] Based upon the Calvert Foundation's global social returns metrics collected from its portfolio organizations, these statistics are offered only to make a general point, not to stand up to academic test. Calvert Foundation administers portfolios that currently invest more than $100 million in 200 microfinance, community development, housing and social enterprises, active in 60 countries. Weightings were (relatively arbitrarily) set at 68% microfinance, 20% affordable housing and 12% cooperatives and nonprofit enterprises/facilities, operating outside of the US.
[17] Khandker and Pitt (2002).
[18] Source: *2003 Nelson's Directory of Investment Managers*. The author uses the US markets, but certainly the percentage would be only a portion thereof, of the total first world capital markets.
[19] Source: www.un.org/millenniumgoals.

Nor would the above commitment result in a variance of more than a few basis points of financial return on an annual basis. If these portfolios were to yield a net 3%,[20] versus a conventional market return of 8.85%,[21] the impact would be 3/100ths of 1% (3 basis points) per annum—a small price to pay by any standard.

Moving Blended Value Investment to the Bottom of the Pyramid

Do the global microfinance, social enterprise and community development markets have the capacity to deploy $100 billion in debt and equity investment? Could investors even find the groups in which to invest? Perhaps not tomorrow, but capacity is growing quickly. As myriad microfinance and community development organizations all over the world scale up, the amount of capital they can and must employ will radically expand. Of note, microfinance institutions today reach only $4 billion of the estimated $$300 billion demand for providing affordable financial services to the bottom of the pyramid. [22]

Would the capital market infrastructure require a significant “donor investment” in capacity building? Certainly, upfront outlays would be necessary, as would more efficient capital markets and a larger set of intermediaries. But the point here is that once the supply and demand emerges, the tactics and infrastructure to execute will follow.

So, what would it take to actually move this amount of capital from investors to far-flung enterprises? It’s true that managing many relationships between investors and investees is intensely inefficient and prohibitively costly. Investors often lack meaningful analysis of community development, microfinance and social enterprises at the local level, while enterprises are interested in identifying capital as efficiently as possible, but don’t know where to go.

In the case of this early stage market, the interests of both suppliers and users of capital will best be served by market intermediaries and a new generation of financial instruments that yield a blended financial and social return. We will need to rely upon aggregators, administrators and consultants in order to move funds at an increasingly large and efficient scale. Though there are emerging funds, managers and analysts, the number of intermediaries making up the market infrastructure is limited. It will be necessary to significantly augment the blended value capital markets to enhance their ability to handle greater flows of funds.

Finally, in addition to the amount of both time and expense related to working in this fragmented environment, the terms and conditions of capital are often out of alignment

[20] A reasonable return based upon Calvert Foundation’s experience, net of management expenses and losses over time.

[21] Using a benchmark comprised of 60% S&P 500 and 40% Lehman Aggregate Bond Index returns for the ten-year period ended May 31, 2005.

[22] There is little doubt that the broad landscape of development organizations will need significant new capital, assuming the market continues to grow at historic rates. One recent analysis of just Calvert Foundation’s core portfolio indicated an additional $5 billion would be required over the next few years to adequately capitalize them. The microfinance projection is from *Tapping Financial Markets for Microfinance*, Grameen Foundation USA Publication Series (2005).

with effective strategies for creating social impact in various sectors. New development of "equity-like" debt for nonprofits, and increased appetite in the markets for placing "patient" equity into social venture for-profits will need to occur.

Investing in Tomorrow's Global Contract

The social and environmental contract is stretched to the breaking point, and some might say beyond. But the landscape can shift if we drive toward a new set of values and behaviors. Investment cannot be the only tool, but it is one of the more ubiquitous representations of underlying value and values, and as such, embodies an opportunity to effect substantive change.

Through directing resources away from social value subtracting firms, flexing shareholder power, and moving capital affirmatively toward positive enterprises, market-rate investment can play a great role in increasing equitability and sustainability on the global stage.

And, by channeling investment dollars into new, hybrid propositions that re-imagine conventional risk and reward, and support community development, microfinance and other social enterprises, we can drive a significant shift in equity and income to the world's poorest.

To succeed, this blended value capital market will require a marked increase in the number and sophistication of a new generation of asset types, merchant bankers and funds. These developments will need to be centered squarely upon facilitating participation by the legions of newly minted blended value investors.

Through fully utilizing all financial resources, blended value investors and markets can create highly leveraged impact. It's a challenging proposition, to be sure—significant shifts to convention always are. But, the more complete our early adoption, the better positioned we will be to accelerate broad-based change.