

# MUTUAL FUND PRIMER ON COMMUNITY INVESTING



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## **Section 1: Introduction**

Mutual funds have an important opportunity to integrate community investments into their portfolios. While there are a range of compliance and risk management considerations in such untraded community investment instruments, more and more funds have found ways to increase their positive impact on underserved communities while at the same time achieving their financial goals.

The community investing options for mutual funds include, among other things, certificates of deposit as well as other direct investments that have an even greater impact. While the positive impact of these investments motivates some funds to pursue these opportunities, others do so to diversify a fund's portfolio. Increasingly, sophisticated socially responsible investors are looking to their mutual funds to attain the direct positive social impact associated with community investment.

## **Section 2: Definition of Community Investing and Why it is Important**

Community investing is capital from investors that is directed to communities underserved by traditional financial services. It provides access to credit, equity, capital, and basic banking products that these communities would otherwise not have. In the U.S. and around the world, community investing makes it possible for local organizations to provide financial services to low-income individuals, and to supply capital for small businesses and vital community services, such as child care, affordable housing, and healthcare.

Community Investment Institutions (CIIs) can give priority to people who have been denied access to capital and provide them with opportunities to borrow, save, and invest in their own communities. In addition to supplying badly needed capital in underserved neighborhoods, community investment groups provide important services, such as education, mentoring, and technical support. They also build relationships between families, non-profits, small businesses, and conventional financial institutions and markets.

### **Why are these investments important?**

CIIs have stepped in to work with the people in the communities they serve to provide them with capital, financial education, and technical assistance. In doing so, they educate people about their finances in order to make them successful borrowers and community members. As the reach of CIIs increase, more and more people have opportunities to improve their living condition and that of their community. The new market developed creates a capital flow to low-wealth and low-income communities, expanding their opportunities and involvement in the economy.

With improved access to financial and social services, individuals and communities become empowered to improve their living situation. Whole neighborhoods have

literally been transformed from crime-ridden, run-down blocks to diverse, affordable communities that now thrive with life. These basic, fundamental improvements in living conditions foster hope, encourage competition, and engender innovation.

### **How big is the community investment market?**

In recent years, community investing has grown substantially. According to the Social Investment Forum, the field has almost tripled in the size of its assets during the past five years. In 1999, community investment assets stood at \$5.4 billion, in 2001 they rose to \$7.6 billion, and they almost doubled in the next 2 years rising to \$14 billion in 2003. The growth in assets is accompanied by a growth in institutions and products, increased sophistication within the industry, and a successful track record of risk management, leading to greater acceptance of community investments by the financial services industry.

<b>THE FOUR PRIMARY TYPES OF CIIs, ASSETS AND GROWTH</b>		
<b>CII Institution Type</b>	<b>Current Assets</b>	<b>Growth Since 2001</b>
<b>Community Development Banks</b>	\$7.2 billion	+130%
<b>Community Development Credit Unions</b>	\$2.7 billion	+50%
<b>Community Development Loan Funds</b> <i>(Includes Micro-Enterprise Development Funds)</i>	\$3.6 billion	+50%
<b>Community Development Venture Capital Funds</b>	\$0.5 billion	+58%
<b>Total Community Investment Assets</b>	<b>\$14 billion</b>	<b>+84%</b>

\* Statistics from the *Social Investment Forum's 2003 Report on Socially Responsible Investing Trends in the United States*

For more information on community investing, visit the Community Investing Center at [www.communityinvestingcenter.org](http://www.communityinvestingcenter.org).

### **Section 3: Why Mutual Funds Should Invest in Community Investments**

Community investments offer mutual funds the opportunity to achieve greater levels of social impact while attaining their financial goals. These opportunities include, among other things, certificates of deposit as well as direct investments that have an even greater impact. While the positive impact of these investments motivates some funds to pursue these opportunities, others do so to diversify a fund's portfolio. Increasingly, sophisticated socially responsible investors are looking to their mutual funds to attain the direct positive social impact associated with community investment.

The increased interest in community investments has been paralleled by the growth of socially responsible investing in general. As of 2003, over \$2.16 trillion, or more than one out of every nine dollars under professional management in the United States today, is involved in socially responsible investing.

The growth in socially responsible investing can easily be seen in the mutual fund industry. Assets held by socially screened mutual funds grew 11 percent from 2001 to 2003 to \$151 billion. During these difficult years for investors, socially responsible mutual funds grew on a net basis while the rest of the mutual fund industry contracted. According to Lipper, socially screened mutual funds saw inflows of \$1.5 billion in 2002, while at the same time, U.S. diversified equity funds posted outflows of nearly \$10.5 billion. This increase in socially responsible mutual fund assets corresponds with the growth of mutual funds investing in community investments. See Appendix 1 for information on mutual funds that do community investing.

With each community investment made through a CII, mutual funds can tell a story about the positive impacts their investment made on the community. By supporting small businesses, affordable housing, and social services like education and child care in overlooked communities; investors will get the success stories that add character to the fund's reputation. Showcasing mutual funds in a positive light is certainly needed in the aftermath of the industry scandals still being reported on.

#### **Section 4: Compliance and Risk Management Considerations**

There are a host of compliance and risk management considerations associated with Community Investing. Several mutual funds, however, have found ways to participate in community investment, establishing norms and protocols that can be adopted by others. Specific areas of concern include:

**Product Offerings:** Very few community investment instruments are publicly traded and therefore need to be included within the 15% allocation of illiquid instruments that may be held by a Fund. While there are few community investment equity instruments, there are increasing arrays of debt products that can be held by mutual funds, many of which can be classified as cash equivalents. Given that most funds, equity and/or debt, may hold a limited cash position, community investment can be calculated within this cash position.

**Prospectus Disclosure:** Those who are launching a new fund and plan to include a community investment allocation are encouraged to disclose this in their prospectus. Some funds have incorporated community investment after the fund's launch. While this should also be incorporated into the prospectus, given its small position at one percent of the holdings, there may be some flexibility as to when the new provisions need to be incorporated within the prospectus.

**Valuation of Community Investment Holdings:** Since most community investment instruments are not publicly traded, the mutual funds must arrive at a pricing formula for these assets. Instruments that are fully federally insured are less problematic. The Certificate of Deposit Account Registry Service ([www.cdars.com](http://www.cdars.com)), makes it possible to place up to \$10 million into a fully insured certificate of deposit issued by community development banks. For direct investments, other policies have been adopted and consistently applied.

**Affiliated Non-Profit Model:** Calvert Group ([www.calvert.com](http://www.calvert.com)), MMA Praxis Mutual Funds ([www.mma-online.org](http://www.mma-online.org)) and Christian Brothers Investment Services ([www.cbis.com](http://www.cbis.com)) have established related non-profit entities responsible for conducting community investment activities on their behalf - Calvert Foundation ([www.calvertfoundation.org](http://www.calvertfoundation.org)), MMA Community Development Investments ([www.mma-online.org/cdi/contents.html](http://www.mma-online.org/cdi/contents.html)), and Partners for the Common Good ([www.pcg21.org](http://www.pcg21.org)), respectively. In this way, the mutual fund companies have been able to segregate the costs associated with managing community investments and to bring to bear additional credit enhancements.

**Custodial and Administrative Services:** State Street Bank ([www.statestreet.com](http://www.statestreet.com)) and other fund administrators like BYSIS have been willing to custody these non-standard assets, particularly when this is just one component within a more comprehensive service relationship. Funds should consider standardizing investment instruments used with direct community investments in order to streamline administrative costs.

**Third-party Due Diligence and Asset Administration Services:** A number of non-profit organizations now provide third party due diligence and asset administrative services on behalf of fund investors, including Calvert Foundation ([www.calvertfoundation.org](http://www.calvertfoundation.org)), National Community Capital Association ([www.communitycapital.org](http://www.communitycapital.org)), and others. By outsourcing these services, funds can benefit from economies of scale and industry knowledge of the service provider.

## Section 5: Frequently Asked Questions

### **What information is available about community investing opportunities for mutual funds?**

Information about community investment opportunities has become more accessible in recent years. Data on investment opportunities into regulated and unregulated community investment institutions (CIIs) and their product offerings can be accessed through the Community Investing Center website ([www.communityinvestingcenter.org](http://www.communityinvestingcenter.org)). Third-party due diligence reports can also be purchased through independent intermediaries such as Calvert Foundation ([www.calvertfoundation.org](http://www.calvertfoundation.org)), National Community Capital Association ([www.communitycapital.org](http://www.communitycapital.org)) and others in addition to industry trends, published by trade associations. CIIs are also developing in terms of sophistication and infrastructure, and many can now more easily handle transactions for

institutional investors. New investment-grade products are being issued by organizations like the Community Reinvestment Fund ([www.crfusa.com](http://www.crfusa.com)) and the Enterprise Foundation ([www.enterprisefoundation.org](http://www.enterprisefoundation.org)). Calvert Foundation's Community Investment Note, a professionally managed, diversified instrument, has a specific offering targeted to mutual funds that includes a three month re-pricing feature, facilitating an attractive pricing arrangement for such an instrument.

### **How easy is it to incorporate community investments into a mutual fund portfolio?**

Because most community investment options are unrated and illiquid, mutual funds need to establish appropriate protocols for selecting and holding community investment instruments. Furthermore, since community investment instruments are available in few asset classes, the ease of incorporating community investments into a mutual fund varies across asset class. Fixed income, money market, and balanced funds have an easier time incorporating community investments into their portfolios because they already invest in fixed income instruments. Equity funds face limits on the amount of their portfolio they can tie up in cash, which in turn limits how much they can put into existing community investment products. Furthermore, there are additional costs associated with identifying, securing and monitoring such un-standard assets. Increased information provided by the community investing industry and other specialized intermediaries is helping overcome these hurdles. See Appendix 1 for information about mutual funds that do community investing.

### **What community investments do mutual funds generally invest in?**

Certificates of deposit at community development banks and credit unions are the easiest community investments to make for mutual funds. They are insured, can provide comparable returns, and satisfy the cash component of a mutual fund portfolio. Mutual funds can have an even greater social impact through other investment opportunities, like deposits in community development loan funds and venture capital. As mentioned on page 7, some mutual funds have established non-profit affiliates to channel resources to community investment.

### **How risky are community investments?**

There is a wide range of credit quality among community investment options. However, as this market has gotten deeper over the last two decades, there are now a substantial number of low-risk options for investors. Community development banks and credit unions offer federally insured certificates of deposits. While the maximum insurance per deposit for credit unions remains at \$100,000; a recent innovation, the Certificate of Deposit Account Registry Service, permits investors to receive up to \$10 million of federally insured deposits placed with community development banks. Over 20 community development banks presently participate in this program.

CIIs excel at managing the risk of investing - by providing a hands-on approach to the communities they serve and having substantial loan loss reserves. By providing technical assistance to their borrowers and having sufficient equity and loan loss reserves, CIIs

with a diversified portfolio and their own credit enhancements present a more attractive alternative to specific real-estate transactions or others where direct project risk is borne by the investor. Mature CIIs and CII Intermediaries with performance track records provide an attractive option for mutual fund investors with investment policies that permit investment into non-rated instruments.

Like all venture capital, the risk parameters of community development venture capital are substantially greater than that of deposits into loan funds.

More information on the risk of community investing is available in the Evaluating Risk section of the Community Investing Center website ([www.communityinvestingcenter.org](http://www.communityinvestingcenter.org)).

For more Frequently Asked Questions on community investing, visit the Community Investing Center website ([www.communityinvestingcenter.org](http://www.communityinvestingcenter.org)).

### **Appendix 1. Profiles of Mutual Funds doing Community Investing**

The next pages feature profiles of mutual funds that integrate community investing into their portfolio. The funds differ in the amount and types of community investing they are currently doing - some funds are in the process of trying to increase their community investing, while others have successfully incorporated this asset class into their portfolio. Mutual funds that have placed 1% or more of their assets into community investments are on the Community Investing Honor Roll and are profiled on the Community Investing Center website ([www.communityinvestingcenter.org](http://www.communityinvestingcenter.org)).

The current profiles in this Appendix are:

- \* CRA Qualified Investment Fund,
- \* Dreyfus Premier Third Century Fund,
- \* New Alternatives Fund,
- \* Pax World Funds, and
- \* Women's Equity Fund.

**Additional profiles will be added soon.**

## **CRA Qualified Investment Fund**

**Fund Types:** 1 Fixed Income

**First Year of Community Investing:** 1999

**Current Community Investments:** 100% of Fund.



**1% or More in  
Community Investing**

**Community Investment Efforts:** To date, CRAFund Advisors has invested more than \$1 billion in community investments.

**Barriers Overcome:** The Fund has to invest in rated securities (A-rated or higher), which only slightly constricts the ability to make community investments.

**Barriers Currently Facing:** N/A

**Prospectus Situation:** An objective of the Fund is to provide “investments that will be deemed to be qualified under the Community Reinvestment Act of 1977.” The prospectus describes CRA and the definition of qualified investments which directly correlates with the definition of community investments.

**Board Involvement:** N/A

**Legal or Regulatory Issues:** 180 shareholders have been reviewed by their bank regulator regarding their investment in the Fund. All received “credit” (positive consideration) for their investment as a CRA-qualified investment. As well, the Fund has been referred to as “complex” and/or “innovative” 15% of the time.

**Valuation of Community Investment Holdings:** Most of the securities are priced by an independent third-party pricing service.

**For More Information, visit [www.crafund.com](http://www.crafund.com)**

An investment in the Fund is not a deposit or obligation of, or insured or guaranteed by, any entity or person, including the U.S. Government and the FDIC. To obtain a prospectus, and for a complete discussion of investment objectives, risks, charges and expenses, contact CRAFund Advisors at 877-CRA-1977. The Prospectus contains this and other information about the Fund and should be read carefully before investing. An investor's investment return and principal value will fluctuate, so that your shares when redeemed may be worth more or less than your initial cost. Holdings subject to change. Distributor: Citco Mutual Fund Distributors, Inc. (Member NASD).

Please Note: This is presented for information purposes only. The Social Investment Forum Foundation and Co-op America, and CRAFund Advisors, make no claim, promise or guarantee about the accuracy, completeness or adequacy of the information and assume no liability for any use of such information.

## **Dreyfus Premier Third Century Fund**

**Fund Types:** 2 Equity

**First Year of Community Investing:** 1999

**Current Community Investments:** Hold one 3-month CD with a CII in each fund for \$100,000

**Community Investment Efforts:** The Funds purchase CDs from CIIs.

**Barriers Overcome:** N/A

**Barriers Currently Facing:** N/A

**Prospectus Situation:** By prospectus, CDs are allowed but there is no language regarding CI.

**Board Involvement:** N/A

**Legal or Regulatory Issues:** N/A

**Valuation of Community Investment Holdings:** N/A

**For More Information, visit [www.dreyfus.com](http://www.dreyfus.com)**

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## **New Alternatives Fund**

**Fund Types:** 1 Equity

**First Year of Community Investing:** 1994

**Current Community Investments:** 1% of assets

**Community Investment Efforts:** Continue to hold CDs from CIIs.

**Barriers Overcome:** N/A

**Barriers Currently Facing:** N/A

**Prospectus Situation:** The prospectus states; “The Fund maintains modest amounts in socially concerned (federally insured) banks that are committed to serving community needs.”

**Board Involvement:** There was an initial discussion with the board before purchasing the CII CDs.

**Legal or Regulatory Issues:** N/A

**Valuation of Community Investment Holdings:** CDs valued at par.

**For more information, visit [www.newalternativesfund.com](http://www.newalternativesfund.com)**



**1% or More in  
Community Investing**

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## **Pax World Funds**

**Fund Types:** 1 Equity, 1 Balanced, 1 Fixed Income, 1 Money Market

**First Year of Community Investing:** 2001

**Current Community Investments:** 1% in Balanced Fund and High Yield. None in other two Funds

**Community Investment Efforts:** Portfolio Managers have some discretion as to whether to hold CI and which CI securities to hold. The Growth and Money Market Funds have not held any CI securities. We are educating the pertinent areas of our organization about CI and moving forward on developing a formal policy that will allow us to advance to the overall 1% goal.

**Barriers Overcome:** We have no official, prospectus-stated CI policy. It took some work to take care of operational issues such as CD interest payments and rollovers.

**Barriers Currently Facing:** We are constrained by prospectus language on types of securities allowed, liquidity requirements, daily pricing issues, Board of Directors involvement.

**Prospectus Situation:** The prospectus states that the Balanced Fund has a commitment to assist in the development of housing. The other Funds have no stated commitment.

**Board Involvement:** The board is apprised of the CI investments on a regular basis.

**Legal or Regulatory Issues:** Last SEC review (Fall 2003) resulted in some questions about our CI CDs. To date, no need for action on the item has been requested.

**Valuation of Community Investment Holdings:** CDs are valued at par.

**For more information, visit [www.paxworld.com](http://www.paxworld.com)**

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## **Women's Equity Fund**

**Fund Types:** 1 Equity

**First Year of Community Investing:** 2004

**Current Community Investments:** The Women's Equity Fund (WEF) portfolio holds notes issued by Blue Orchard Finance in conjunction with Developing World Markets. These notes are backed by loans to 7 microfinance institutions (MFIs).

**Community Investment Efforts:** We believe a fund's commitment to CI must fit its objectives. WEF's goal is to invest in stocks of companies that are proactive towards raising the social and economic status of women. Because WEF is primarily an equity fund, we are limited in the amount we can invest in CI. A better solution to promoting CI would be to create a separate fund focused primarily on CI. We are looking for potential investors who share our commitment, to create an investment that is market rate with managed risk and that supports real community development.

**Barriers Overcome:** We spent years pushing for the securitization of MFIs' loans. To be included in a mutual fund, these securitized notes have to be priced daily.

**Barriers Currently Facing:** We are seeking more investors who have a similar commitment to raising the social and economic status of women. We also seek investors who share our interest in creating a fund that focuses on CI.

**Prospectus Situation:** The MFI notes that the Fund holds are described in the Statement of Additional Information.

**Board Involvement:** The investment in MFI notes required board approval. The MFI pricing formula had to be pre-approved and the amount is limited to 2% as approved by board.

**Legal or Regulatory Issues:** N/A

**Valuation of Community Investment Holdings:** According to pre-defined calculation formula and priced daily.

**For more information, visit [www.womens-equity.com](http://www.womens-equity.com)**

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