

Expanding Philanthropy: Mission-related Investing at the F.B. Heron Foundation

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Founded in 1992 with the mission of helping people and communities to help themselves, the F.B. Heron Foundation came into being during one of the greatest economic booms in U.S. history. The strong financial markets of the 1990s not only spurred rapid growth of Heron's asset base but also served to reinforce its focus on asset building and community economic development, given that so many Americans did not benefit from the wealth generated in the heated economy.

Faced with the challenges of making effective grants and managing a growing endowment, Heron's board of directors understood all too well that the scope of the social problems it sought to address required more significant resources than its mandated 5% payout. At a regularly scheduled meeting in 1996, Heron's board reviewed a particular investment manager's performance for what seemed like hours, leaving little time for program matters. This imbalance caused the board to step back and evaluate the effectiveness of the foundation.

After much discussion, the board suggested that because of Heron's social mission and tax-exempt status, the foundation should be more than essentially a private investment company that uses its excess cash flow for charitable purposes. Without changes, in the board's view, there could be very little to distinguish the foundation from a conventional investment manager.

The board began to view the 5% payout requirement as the narrowest expression of the foundation's philanthropic goals. By looking to the other 95% of assets, the "corpus," the board could conceive a broader philanthropic "toolbox" capable of greater social impact than grant-making alone.

Spurred by this "tipping point," the board encouraged staff to explore ways in which Heron could engage more of its assets through a combination of grant-making and "mission-related" investment strategies. The board made a deliberate decision to find ways to leverage an increasing amount of Heron's resources in pursuit of its mission and therefore maximize the foundation's impact in low-income communities.

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The Difference Between Mission Investing and Socially Responsible Investing

As defined by FSG Social Impact Advisors in its report "Compounding Impact: Mission Investing by U.S. Foundations," mission investments are "financial investments made with the intention of (1) furthering a foundation's mission and (2) recovering the principal invested or earning financial return." Socially responsible investing focuses primarily on (negative) social screening and proxy activity in public equities, while mission-related investing is a proactive approach in use across asset classes.

The Road to Mission-related Investing¹

Developing a mission-related investment strategy did not happen overnight. Heron spent time refining its mission and determining how it could be enhanced through a proactive investment strategy. Initially, there was some uncertainty about how far and how fast the foundation could move, and therefore a reluctance to establish specific mission-related investment targets.

By adopting an incremental philosophy, the foundation was able to test the concept without making any major missteps. Staff was encouraged to explore opportunities in core program areas that would build on existing networks and expertise, and to share lessons learned along the way.

The First Steps. Heron's first step was to transfer some of its actively managed investments into index and enhanced index funds. This decision was based on research, unrelated to mission investing, that showed no substantial long-term active management premium in many core asset classes. In addition to reduced investment-management fees, taking this step allowed Heron to redirect its resources away from managing dozens of active investment managers and toward building a mission-related investment portfolio. Investment performance is now as good as when the entire portfolio was under active management but comes at a lower cost.

Assembling the Skills: Internal Capacity and Investment Consultants. The board soon realized the extent to which it was challenging conventional thinking. As a result, the board

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decided to build internal management capacity, bringing certain functions in-house. In addition to encouraging staff to take advantage of training opportunities, the board authorized a new position, vice president of investments, that would be separate from the finance and administration functions. The foundation also conducted a search for an investment consulting firm that would appreciate Heron's commitment to mission-related investing, eventually retaining Evaluation Associates in 2004.

Learning from Foundations and Other Institutional Investors. Early on, Heron looked to other foundations and institutional investors (including commercial banks, insurers, and public pension funds) for examples of alternative asset deployment. Heron learned about below-market investments from both the Ford and MacArthur Foundations, the earliest and largest practitioners of program-related investments. Heron also found willing partners among large commercial banks, which, motivated by the federal Community Reinvestment Act, invested in so-called double-bottom-line real estate and venture-oriented private equity funds as a way to deliver both market-rate financial returns and positive social impact. In expanding its role beyond that of traditional grant-maker, Heron found itself in the company of other types of institutional investors and gained access to potential partners and co-investors.

Looking First at Existing Relationships. Through partnerships with community-based organizations and financial intermediaries, Heron has witnessed firsthand the transformative power of investing in America's low-income communities—primarily through home ownership, enterprise development, and access to capital. As such, Heron determined that its grantee pool was a natural place for below-market program-related investments, which the foundation began to make in 1997. Because Heron understands the management and operational histories of its grantees, the quality of the underwriting is often better than it otherwise might be. Today, nearly 75% of the foundation's program-related investments are in groups with which Heron has or has had an established relationship.

Program-Related Investments

The Internal Revenue Service defines these charitable investments using three criteria: (1) the investment's primary purpose must be to advance the foundation's charitable objectives; (2) neither the production of income nor the appreciation of property can be a significant purpose; and (3) the funds cannot be used directly or indirectly for lobbying or political purposes. Under these criteria, all program-related investments are mission-related investments because they contribute to the foundation's mission. However, not all mission-related investments are program-related investments given that some mission-related investments seek a market return.

Bridging the Program and Investment Functions. Initial discussions with grantees about potential program-related investments began with Heron's program staff, who reviewed business plans and discussed capital needs, management capabilities, and financial projections, but who also needed guidance in understanding the investment risks involved and how best to structure deals to mitigate those risks. As the foundation's prospecting efforts turned into a pipeline of tangible deals, Heron began a conscious effort to bridge the program and investment functions—a significant departure from how typical foundations are organized and staffed. Although many program staff members appreciated the benefits of having access to a new philanthropic tool, others did not feel as comfortable with the training, mentoring, and analysis that making program-related investments demanded. The result was some staff turnover through attrition—not uncommon with any significant programmatic change. In replacing staff, Heron looked for, and attracted, officers who felt comfortable with the financial analysis and the investment process. It took time, but Heron now enjoys a collaborative model, with staff in the two functional areas working side by side, and investment staff as the “tie breaker.”

Creating a Pipeline of Market-Rate Investment Opportunities. Heron's staff works to build the foundation's market-rate portfolio of mission-related investments in three primary ways:

1. Conducting active outreach efforts to identify opportunities within various asset classes;
2. Creatively adapting traditional investment vehicles and asset managers to mission goals; and,
3. Researching and developing new investment vehicles, such as the Community Investment Index, a positively screened, best-in-class method used to identify publicly traded companies with superior records of engaging with underserved communities (see box on page 29).

Leadership for Successful Implementation. To be successful in developing a mission-related investing strategy, a foundation must have the support of its board. While a foundation's executive and professional staff may lead the board to a discussion of mission-related investing, a foundation will miss the transformative effects of this shift in strategy without a true and dedicated commitment of its board. The staff, then, is responsible for successful implementation. The success of mission-related investing relies, in large part, on the ability of front-line staff members to think creatively and analytically about where and how they will identify, recommend and underwrite investment opportunities. A chief executive officer who encourages openness and flexibility in achieving goals will engender confidence in staff members responsible for implementation.

The Community Investment Index

In 2005, with assistance from Innovest Strategic Value Advisors, Heron created a methodology for selecting companies in each industry in the Standard and Poor's 900 on the basis of the quality of their engagement with low- and moderate income communities in the United States. The resulting Community Investment Index takes into account corporate strategy, workforce development, wealth creation, and corporate philanthropy.

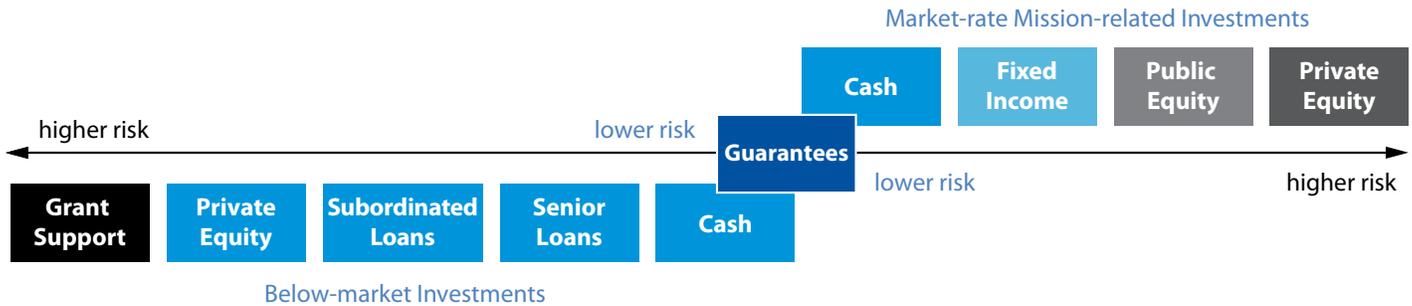
Past performance of the selected equities looked promising, so Heron committed a portion of its capital to test the index's approach. Managed by State Street Global Advisors, the index returned 15.0% in 2006, versus 15.3% for the Standard and Poor's 900 and 13.2% for the Domini 400, the most widely used benchmark for large-capitalization, socially responsible equity investing. Heron is creating a commingled investment product that the foundation hopes will be attractive to other institutions committed to investing in low-income communities. The performance of the index continues to compare well during the current market turmoil. In 2008, the index fell 17.99% in the first three quarters of the year, bringing the performance since inception (from November 2005 to September 2008) to -0.30%. The S&P 900 total return fell 18.89% in the first three quarters of 2008, and the Domini 400 fell 17.20%. In the fall of 2008, both benchmarks were just about at the same level they were three years before.

Developing a Mission-related Investment Continuum

To sort through the opportunities that mission-related investing presents, the foundation's staff developed the "Mission-related Investment Continuum," which lays out a set of asset classes available to mission-related investors. On the left side are below-market investments, including grants and program-related investments (private equity, subordinated loans, senior loans, and cash). On the right side are mission-related investments that generate market rates of return (cash, fixed income, public equity, and private equity). The least risky investments are in the center of the continuum; the risk level increases as one moves toward either end. (Guarantees are the exception, as their risk level depends on how they are structured.)

In developing the continuum, Heron staff considered the central tenets of traditional investing discipline: asset allocation, performance benchmarking, and security or manager selection. Heron's asset-allocation policy has not changed to accommodate its mission-related investing practice. That

CHART 2: HERON'S MISSION-RELATED INVESTMENT CONTINUUM



strategy is based on total return, as well as liquidity and diversification, which determines how its investments should be distributed among different types of investment classes and is paramount to portfolio performance. Rather, the foundation considers mission-related investing opportunities within the overall asset-allocation framework of a well-diversified portfolio.

Heron also has identified appropriate performance benchmarks by asset class to evaluate relative performance and to compare both risk and return for its mission-related investments versus standard, capital market measures. In choosing its mission-related investments, staff consider several variables, including track record, investment strategy, and market opportunity.

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Heron has taken advantage of mission-related investment opportunities across the continuum. In some ways, Heron's mission is well suited for such opportunities. Foundations that are active in fields of more limited investment and lending may find it challenging to identify the same breadth of opportunities. As such, not all foundations will employ mission-related investing along the entire continuum; one or two asset classes may be sufficient. In these cases, determining where to start depends on opportunities presented that are most consistent with mission and investment goals.

Examples of Below-Market Investments

As its program-related investment portfolio grows, Heron has found many investment opportunities with different risk and return characteristics:

Grants. Even though they provide no financial return, grants arguably represent the riskiest below-market "asset class." Grant-making helps the foundation establish and develop relationships with organizations on the road to "investment readiness";

Cash. Insured deposits in fledgling, rural credit unions at below-market rates through intermediaries such as the National Federation of Community Development Credit Unions;

Senior loans to small business loan funds, such as North Carolina-based Self-Help Ventures Fund, that invest in businesses and community facilities in low-income communities;

Using Grants and Program-Related Investments Together

The Heron Foundation provides both grant support and investment to The Reinvestment Fund (TRF), a national leader in financing neighborhood revitalization. Grants help fund operating costs, loan loss reserves, and policy work, including developing tools that help guide investments. Heron's half-million dollar investment in TRF's capital base is targeted to its small-business lending program, which TRF uses to make loans to businesses located in and hiring from low-income communities. In different ways, Heron's grants and program-related investments sustain TRF by helping meet its need for capital while also supporting Heron's program and mission goals.

Subordinated loans to provide credit enhancement for affordable housing development, such as the New York City Acquisition Fund, LLC; and

Private-equity venture funds, including New Markets Venture Capital Companies, Rural Business Investment Companies, and community-development venture-capital funds.

At nearly \$20 million, Heron's program-related investment portfolio offers a steady return, measured against a benchmark of the long-term inflation rate plus 1%, without any losses to date.

Examples of Market-Rate Investments

Cash. The Certificate of Deposit Account Registry Service (CDARS), a service of Promontory Interfinancial Network that allows community banks to "pool" their \$100,000 FDIC coverage limits to attract larger deposits, allows investors to make deposits in certain institutions, including more than a dozen community development banks, of up to \$30 million with full FDIC insurance coverage. Heron places \$5.8 million in deposits in a number of the nation's 60 community development banks and more than 1,000 "low-income designated" credit unions, selecting those institutions that have a significant portion of their lending activity in asset-building activities in low-income communities.

Fixed Income (Bonds). With input from Heron, the foundation's fixed-income manager, Community Capital Management, identifies investment-grade, fixed-income securities issued by both public and private entities. Mission-related bonds range from down-payment assistance for low-income, first-time homebuyers in Texas to "blight bonds" issued by the city of Philadelphia as part of its Neighborhood Trans-

formation Initiative. Some of the securities in Heron's fixed-income portfolio are backed by pools of loans originated by community-based nonprofit organizations and aggregated by the Community Reinvestment Fund. Community Capital Management has also worked with the Small Business Administration to add information to loan descriptions about borrowers' location in low- and moderate-income census tracts and number of employees. This information helps to develop pools that more closely fit Heron's mission. Heron's mission-related fixed-income portfolio stands at \$21 million and has outperformed its benchmark, the Lehman Brothers Aggregate, since inception.

Public Equity. Heron uses its Community Investment Index to invest in publicly traded equities (see box on page 29).

Private Equity. Heron's private equity is focused on real estate, such as commercial properties in inner-city communities, and later-stage venture financing. It currently has \$16 million in outstanding market-rate private equity commitments, measuring their performance against a benchmark of the Russell 3000 plus 3%. The real estate portfolio is generating net returns ranging from the low to the upper teens, and venture funds are producing net returns on realized investments of more than 20%.

Managing the Portfolio

Heron pays close attention to several factors to fulfill its fiduciary duty.

Asset Allocation. Heron's current asset allocation, established by the board, is approximately 65% in equities, 25% in fixed-income securities, and 10% in alternative investments, such as private equity. This allocation governs all investing, both traditional and mission-related.

Investment Fees. With nearly one-half of its investment portfolio in index and enhanced index investments, Heron's investment management fees were 34 basis points in 2006. This is below the mean of other private foundations in widely known investment surveys.

Underwriting and Due Diligence. Outside third-party consultants assist both program officers reviewing below-market, mission-related transactions and investment staff underwriting market-rate, mission-related investments. This "second pair of eyes" provides Heron with an independent, arm's-length review that supplements, but does not supplant, staff's judgment.

Monitoring. Heron monitors all aspects of its portfolio, with staff meeting quarterly and third-party monitoring reports by experts in each asset class. Monitoring efforts have revealed a number of issues that investees face, such as leadership transitions, fundraising disappointments and market changes that sometimes lead to deteriorating financial health. In most cases, Heron has taken steps to stay with its investees through tough times.

The Results: Better-than-Average Portfolio Performance

Contrary to the perception held by many other foundation trustees and staff that there is a trade-off between financial return and social impact, Heron's experience during the last 10 years demonstrates that competitive investment returns are possible, even when incorporating mission-related investments into an overall portfolio and asset allocation. As of December 31, 2007, Heron's total fund performance was in the second quartile of the Mellon All-Foundation Total Fund Universe on both a trailing three-year and five-year basis, with 20% of assets in market-rate mission-related investments; 6% in below-market, program-related investments; and 3% in grants.

Today's mission-related investing environment is very different from the one Heron encountered in 1996. Now, there are mission-related investment vehicles in virtually every asset class. As Vice President of Investments Luther M. Ragin, Jr., says, "That is really the story here. While each foundation will have to work at visualizing its own mission through an investment strategy, there is no need to reinvent the wheel."

The F.B. Heron Foundation has moved well beyond the tipping point toward a fully diversified, mission-related investing practice. Indeed, Heron continues to expand its vision and investment horizons, using its broad experience in working with community-based organizations to bring the full weight of its resources, and those of other investors, to bear on its mission. No longer does Heron view low-income people and neighborhoods merely as candidates for grant funding. It views them as good investments.

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¹ A full copy of the case study is available at www.fbheron.org/snhu_heron_casestudy.pdf.