INVESTING FOR IMPACT

MANAGING AND MEASURING PROACTIVE SOCIAL INVESTMENTS

Prepared for the Shell Foundation

By Mark Kramer and Sarah Cooch
Foundation Strategy Group

January 2006

SHELL FOUNDATION

FSG

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An open letter from the Shell Foundation

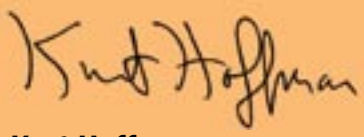
The business principles of the Shell Group include a commitment to sustainable development – taking account of the social, environmental and economic implications of all their activities. But Shell also invests in the community – as a way of engaging with the societies in which they operate, and to make sure their neighbors share in the benefits of their operations. The Shell Foundation is an essential element of this – an independent grant-making charity, dedicated to helping people help themselves. The Foundation is separated from Shell's commercial interest. But its ability to make a difference is strengthened by its relationship with Shell companies all around the world.

Beyond its charitable contributions, the Shell Foundation has discovered that investing its capital in private enterprise can provide a powerful lever for social and environmental progress, especially in our efforts to reduce the impact of fossil fuels, to help poor communities gain access to modern energy, and to help them raise their standard of living. Our flagship programs, such as Energise, Embarq, Breathing Space, and Counter Balance, have all worked to stimulate new enterprises that help to address fundamental economic and environmental problems.

We believe that investing in small and medium size businesses is a promising avenue to sustainable development. Social investments such as these have the potential to produce self-sustaining solutions to poverty and environmental degradation. We have found that combining charitable contributions and social investments, along with the resources and expertise of the Shell Group itself, has enabled the Foundation to achieve greater impact than through foundation grants alone. Yet this complex approach is extremely challenging to manage and we have sought to learn from other more experienced foundations to guide our progress.

To that end, we retained FSG to investigate how other foundations, corporations and multilateral organizations manage their social investments and measure the financial, social, and environmental benefits that they produce. We are grateful to our many colleagues who contributed to this report, and we are pleased to share the results of FSG's work in the hope that it may assist other foundations and corporations that seek to use their financial investments as a means of improving society.

Sincerely,



Kurt Hoffman
Director, Shell Foundation

Acknowledgements

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We are especially grateful to the three dozen leaders in the field of social investment who took the time to participate in our interviews. It is only by listening carefully to their candid insights and thoughtful ideas, as well as by reviewing the internal documents they so generously shared with us, that we have been able to gain insight into the challenges and opportunities of this field.

Research Support

The research and analysis for this report was compiled from interviews and a literature scan conducted by Sarah Cooch, Rebecca Graves and Marc Pfitzer of the Foundation Strategy Group.

Disclaimer

All statements and conclusions, unless specifically attributed to another source, are those of the authors and do not necessarily reflect the opinions of the interviewees, the Shell Foundation, or the Shell Group.

About Foundation Strategy Group

Foundation Strategy Group is a mission-driven social enterprise dedicated to advancing the practice of philanthropy, social investment, and corporate responsibility through research and consulting to foundations and corporations.

With offices in Boston, San Francisco, Seattle, and Geneva, our international team of full-time consultants combine the highest standards of strategy consulting with a deep understanding of philanthropy and the nonprofit sector. We invest heavily in research to learn and to develop new ideas, and our thinking is regularly featured in such publications as *Harvard Business Review, Stanford Social Innovation Review,* and *The Chronicle of Philanthropy*.

For more information, please visit foundationstrategy.com.

CONTENTS

EXECUTIVE SUMMARY

Social investment defies the absolute separation between investments and grants that is deeply embedded in the thinking, skills, incentives, and organizational structures of philanthropy. Nevertheless, a small but rapidly growing number of foundations, corporations, and multilateral organizations have begun to use investment capital as a means of furthering their social and environmental missions.

In recent years, the Shell Foundation has joined these pioneers by supplementing its grantmaking with investments in business enterprises that alleviate poverty or increase access to clean energy. Seeking to learn from the field, the Shell Foundation retained FSG to explore how other organizations manage their social investments and measure the financial and social benefits produced. FSG conducted three dozen interviews with representatives from foundations, corporations, and multi-lateral organizations engaged in proactive social investment. Although our survey was not comprehensive, we believe that this report accurately captures the state of the field today. We further hope that our research and analysis will contribute to the rapid expansion of social investment already underway, and to the ever-elusive pursuit of measuring social impact.

DEFINITIONS

There are many kinds of social investment. We use the specific term "proactive social investments" (PSIs) to describe debt and equity investments in enterprises that deliver social or environmental benefits that further the investor's mission. This definition excludes both shareholder advocacy and passive investment in screened portfolios of publicly traded companies – not because they are in any way less desirable – but because they require an entirely different approach to measuring impact. Specifically, PSIs include four types of investment:

- **Private Equity and Venture Capital** investments in small or early stage for-profit companies that generate social or environmental benefits.
- **Loans and Mezzanine Capital** provided to non-profit organizations, privately held for-profit companies, or through microfinance loans to individuals.
- **Guarantees** that secure debt and increase access to capital.
- **Bonds and Deposits**, including community development bond offerings and certificates of deposit at community development finance institutions (CDFIs).

FINDINGS

1 The field of proactive social investment is still nascent. In the United States, PSIs represent less than 0.2% of foundation assets, and in Europe, despite strong interest, there has been even less documented activity. A few organizations have been using PSIs for years, but most still view their social investments as an early experiment.

2 PSIs include a wide range of investments with either market-rate or below-market returns. Some are as simple as a low-interest loan to a nonprofit organization or a cash deposit in a neighborhood CDFI. Other kinds of investments, such as a biotech start-up or a small business loan in a developing country, require much more specialized expertise. Among the more experienced organizations interviewed, we found several examples of PSI portfolios that performed at or near risk-adjusted market-rate returns.

3 Our respondents gave five primary reasons for using PSIs:

a **Using a new set of tools to achieve social impact.** Social investments can complement grant dollars to nonprofits or in fields where private enterprise is integral to social change – such as economic development, alternative energy, and health care – PSIs can help stimulate business-based solutions to social problems.

b **Accessing funds beyond the normal grant budget.** Respondents found that their boards have been willing to approve an allocation of funds for PSIs above the normal 5% payout.

c **Preserving foundation assets by "recycling" funds.** Funds paid out as grants are permanently lost to the foundation, while PSIs return the capital used, "recycling" the funds.

d **Asset diversification.** Some respondents used PSIs to reduce portfolio volatility or increase investment returns.

e **Community recognition and market entry.** Corporations use social investments to enhance their reputation in the communities in which they operate. Some companies also find that social investment can assist them in entering new markets by building local partnerships and gaining familiarity with the region.

4 The largest foundations interviewed allocated only 1% to 3% of their assets for PSIs, although some smaller and more entrepreneurial foundations allocated as much as 40% of their assets. Foundations with a large percentage of assets in PSIs typically considered them part of their endowment funds and sought market-rate returns, while those with a smaller percentage tended to use program funds for low-interest loans.

Proactive social investment can help stimulate business-based solutions to social problems.

5 Depending on the nature of the investment, PSIs can require substantially more staff time, as well as a different set of skills, than either grantmaking or conventional investing. However, many foundations outsource this work to intermediaries or consultants. Investing in pooled funds or CDFI deposits requires minimal incremental effort, while intensive staff time may be required to invest in early stage enterprises, especially in developing countries.

6 Interviewees agreed that measuring both social and financial performance is essential in order to provide adequate internal reports to their governing bodies, improve financial and social performance over time, attract funds from

other investors, and assist investees in improving their own performance. Most interviewees tracked the financial performance of their investment portfolios and of their investees. Significantly fewer measured social, or environmental impacts, and those that did reported that they were still experimenting with ways to track these results efficiently.

7 In general, we found five different types of performance measurements:

a **Financial performance of the investment.** Conventional measures of investment results such as internal rate of return or non-performing debt ratios.

b **Financial performance of the investee.** Conventional measures of organizational finance, such as balance sheets, income statements, revenues, gross margin, cash flow, and liquidity.

c **Socio-economic benefits.** Monetary benefits to target populations, such as increases in employment and wages or cost savings.

d **Social benefits.** Improvements in the quality of life of the target populations.

e **Environmental benefits.** Environmental impacts of the investees' operations.

8 Social benefits, such as improvements in the quality of life, health of beneficiaries, or changes in government policy, were best tracked through interviews and other data gathered by independent consultants and reported qualitatively. Environmental impacts could be monetized if there were accepted market values, such as the trading price for carbon emissions credits. In many cases, however, they could only be documented non-monetarily.

CONCLUSIONS

1 Our research disclosed no necessary trade-off between financial returns and social impact. Investors who sought and obtained market-rate or near-market-rate returns on their PSI portfolios did not do so by accepting lesser social benefits. Social investments with high financial returns do require more innovation

and effort. However, it appears that with sufficient determination and creativity, one can pursue attractive financial returns and substantial social impact simultaneously.

2 The diversity of social investments available mirrors the range of traditional investment vehicles, from simple loans to complex financial transactions. Given the variety of options, any foundation could easily add some form of social investment to its portfolio.

3 Depending on the nature of the transaction, the administrative costs of sourcing, structuring, managing, and measuring the impact of PSIs can be substantial. In some cases, organizations supplemented their investments with almost as much additional funding for technical assistance to investees or to cover the cost of collecting financial and social performance data. PSIs tend to be much larger than grants, however, so the incremental staff time per dollar may not be as disproportionate as it is per transaction.

4 Most respondents found that their actual experiences with PSIs were better than initially expected. In general, loss rates were lower while profitability and program impact were higher than anticipated. This may be the result of a general tendency to overestimate the risks associated with new transactions or to anticipate a false trade-off between social benefits and economic returns. As a result, none of the three dozen organizations interviewed have decreased their PSI portfolios, and a majority have increased their allocation of assets to PSIs over time.

Social investment defies the absolute separation between investments and grants that is deeply embedded in the thinking, skills, incentives and organizational structures of philanthropy.

5 Financial metrics can be compared across investments and, everything else being equal, the investment with a higher financial return will be universally preferred. To a lesser degree, socio-economic benefits can also be meaningfully compared. Social or environmental outcomes, however, can rarely be compared. One reason for this is the lack of any widely accepted standard methodology for measuring social and environmental impact. A second reason, however, is the inherent subjectivity of social goals: different social investors may weigh the value of the same outcome differently, based on how it aligns with their personal or institutional priorities. Therefore, even if standardized measures of social impact could be developed, the non-financial benefits of PSIs would not be fungible in the way that financial returns are.

6 The case study of REED presented in this report captures well all five measures of performance, and it confirms that PSIs can deliver socio-economic and environmental benefits

that greatly exceed the amount invested while still recouping the initial capital and providing an attractive financial return. REED limits its cost/benefit analysis to readily quantifiable results that have occurred up to the time of the evaluation. Although this understates the full impact of their investments, it greatly increases the reliability and credibility of the results they report.

7 Four clear lessons for measuring performance emerged from our research:

a **Set clear goals and establish a baseline at the outset.** It is extremely important to have a clear set of both social and financial goals at the outset, and to establish baseline measures for indicators associated with each goal as part of the initial investment process, in order to be able to track the changes that occur as a result of the investment.

There is clear evidence that proactive social investments can yield reliable investment returns, preserve capital, and still provide significant social and environmental benefits.

b **Concentrate on only a few simple performance indicators.** Given the difficulty of collecting data on performance, selecting the fewest possible indicators will minimize the burden on both the investor and investee. A few timely and inexpensive measures are better than an elaborate system that may never be fully implemented.

c **Be prepared to allocate sufficient funding and staff time to collecting the data.** Collecting reliable data often requires technical assistance to investees and in-person interviews with many project stakeholders. Funders must be realistic about the staff costs involved – whether using foundation personnel or external consultants – if they plan to monitor performance effectively.

d **Report financial, socio-economic, and social/environmental benefits separately.** Our research suggests that it is preferable to use separate methodologies for measuring and reporting monetary returns, socio-economic benefits, and social/environmental outcomes. Social and environmental outcomes are extremely important but may be best presented qualitatively alongside the quantifiable financial returns and socio-economic benefits. Attempts to use a single "social return on investment" approach tend to increase the cost and complexity of reporting and, at the same time, often require numerous assumptions that may undermine the credibility of the results.

In conclusion, the field of proactive social investment is still in its earliest stages. Much more information needs to be collected about the current state of practice to inform and reassure new entrants to this field. Yet there is clear evidence that proactive social investments can yield reliable investment returns, preserve capital, and still provide significant social and environmental benefits. Given the hundreds of billions of dollars in foundation investment portfolios that are not currently achieving any direct social impact, PSIs represent a vast and powerful new world of opportunity that has only begun to be explored.

1 INTRODUCTION

We are used to thinking of a sharp line that divides the for-profit and nonprofit worlds. The former pursues financial gain while the latter is concerned only with societal progress or environmental protection. Each views the other's goals as secondary and is indifferent or even antagonistic to the other's priorities. The very idea of social investment – using profitable investments to achieve social objectives – seems deeply disconcerting because it contradicts these firmly entrenched attitudes. After all, if such an approach were possible, why wouldn't everyone do it?

Perhaps there is an inevitable trade-off between economic and social objectives – more social benefit means less profit, and vice-versa. But even the limited sample of social investments in this study refutes such a simplistic assumption. Although there are many opportunities to further social objectives by accepting a lower return or greater risk, there is clear evidence that one can also achieve returns at or near market rates. Admittedly, the range of market-rate social investment options is far more limited and the transaction costs are higher than is the case with ordinary investments. This may be partly due, however, to the absence of the economies of scale, well-established metrics, and vast infrastructure that support global capital markets today.

Why then is social investment such a rarity? It appears that social investing is an important opportunity that may have largely been missed because of self-reinforcing institutional structures. Foundations firmly divide their staff between program officers focused on social issues and investment officers focused on financial returns. Businesses separate corporate social responsibility and community investment from their daily value chain of activities. Business schools do not teach how to weigh the social and environmental impact of management decisions, just as schools

List of Interviewees

Lawrence Agbemabiese Energy Program Officer, AREED, UN Environment Program, Energy Unit	**Mildred Callear** COO, Small Enterprise Assistance Funds	**Laurence Cockcroft** Senior Advisor, Gatsby Trusts
Kathryn Dunn Community Investment Officer, Helen Bader Foundation	**Bob Embry** CEO, Abell Foundation	**Nate Fields** President, African Development Foundation
Wes Freeland Vice President of Donor Relations, Kalamazoo Community Foundation	**Tim Freundlich** Director of Strategic Development, Calvert Social Investment Fund	**Peter Heller** Founder, Canopus Foundation
Kurt Hoffman Director, The Shell Foundation	**Albert Hofsink** Director of Finance and Administration, Oikocredit	**Jackie Khor** Associate Director, ProVenEx, Rockefeller Foundation
John Kinghorn Vice President, Social Investments, Prudential Financial	**Xavier Lecacheur** Advisor, DFID Financial Sector Team and AfriCap Investment Committee	**Satheesh Namasivayam** Senior Program Officer, The Lemelson Foundation
Philip Napier Moore AREED, UN Environment Program, Energy Unit	**MinhChau Nguyen** Senior Vice President, Small Enterprise Assistance Funds	**Luther Ragin** Vice President for Investments, The FB Heron Foundation
Regula Ritter Research Analyst, ResponsAbility	**Gina Rodolico** Director of Information and Communication, E+Co: Energy Investment Service	**Harold Rosen** Director, Strengthening Grassroots Business Initiative, International Finance Corporation
Charles Ruys Manager, Rabobank Foundation	**Meaghan Smith** Contractor, USAID	**Mariko Tada** Metrics Manager, Acumen Fund
Delle Tiongson Deputy Head of Department of Credit Operations, Oikocredit	**Bert van der Vaart** CEO and President, Small Enterprise Assistance Funds	**Christa Velasquez** Director of Social Investments, Annie E. Casey Foundation
Don Weeden CEO, The Weeden Foundation	**Chris West** Deputy Director, The Shell Foundation	

of social work do not teach how to manage profitable enterprises. Social investment may offer a tremendous opportunity to increase the impact of our philanthropic capital, and yet it forces us to make comparisons between social and financial benefits that we are unused to making.

In fact, there is a tremendous imbalance between the sophistication and standardization with which we can measure financial returns and the techniques available to measure social or environmental impacts. Standard benchmarks exist for the financial performance of investments in every asset class. Unfortunately, there are no comparable generally accepted metrics for measuring social or environmental impact. Without such measures, it is hard to have a sophisticated conversation about choosing between social and conventional investments, let alone justify any precise asset allocation decisions. As a result, social investment has been primarily limited to those who, for personal or institutional reasons, are willing to experiment with unconventional investments knowing only that, to some degree, they may do some good.

In recent years, a number of people have begun to address this problem conceptually, from Jed Emerson's work on blended value[1] to David Bonbright's work at Keystone.[2] In practice, however, those who have been doing social investment for many years have had to devise pragmatic ways of measuring their results in order to manage their portfolios and report performance to their governing bodies.

The Shell Foundation, as a new entrant to social investing, retained FSG to survey these more experienced investors to learn how they allocate, structure, manage, and measure the performance of their proactive social investments. This report is therefore based on interviews FSG staff conducted with three dozen organizations that engage in social investing, including private, community and corporate foundations, development agencies, and investment intermediaries. Our sample is skewed toward those who work to alleviate poverty or provide clean energy because those are the primary interests of the Shell Foundation. Although our sample is not complete, we have interviewed a large proportion of the funders that currently engage in proactive social investment in these two fields.

Most practitioners have not yet solved the problem of measuring social benefit. Yet some are more advanced than others, and a few consistent lessons emerge.

It is immediately apparent that most practitioners have not yet solved the problem of measuring social benefit. Yet some are more advanced than others, and a few consistent lessons emerge. This report, therefore, presents neither a definitive study of social investment nor a comprehensive system for measuring impact. It merely reflects the state of the field today, offering a few examples and lessons that can, we hope, advance the current state of knowledge about social investment, encouraging further experimentation and research.

1 See blendedvalue.org.
2 See keystonereporting.org.

2 DEFINING SOCIAL INVESTMENT

The term "social investment" is extremely broad, encompassing any investment that brings with it the expectation of both a financial return and a social or environmental benefit. Among foundations, endowment funds that are used for social investment are often referred to as "mission-related investments" (MRIs) or "program-related investments" (PRIs) – although PRIs have a specific meaning under the US tax code, as discussed in the sidebar on page 14 below.

This report focuses on a narrower set of investments we have termed "Proactive Social Investments" (PSIs). PSIs provide direct financing to create or expand enterprises that deliver social or environmental benefits in furtherance of the investor's programmatic goals. In economically distressed regions, any enterprise that creates jobs, increases income and wealth, or improves the standard of living can be considered socially beneficial. In mature markets, this category is typically limited to new products or services with specific social or environmental benefits, such as workforce development or solar energy installations.

PROGRAM RELATED INVESTMENTS

The term "Program Related Investments," or PRIs, is often used to describe any social investment, although it has a very specific meaning in the US Tax Code.

In the United States, foundations are required to spend 5% of their assets annually, and this would penalize social investments that earn low rates of return. The IRS has, therefore, made an exception for investments that further the foundation's public purpose, designating them as PRIs. The test of whether an investment is a PRI depends on whether the primary purpose was to advance a social objective and not to earn income or appreciation. For example, low-interest loans to nonprofit organizations would clearly qualify because no commercial lender would ordinarily offer them.

If an investment qualifies as a PRI, it is counted toward the 5% payout requirement in the current year, and its value is excluded from the assets on which future payout is determined.[3] This means that a PRI can earn little or no financial return without increasing the burden on the balance of the foundation's assets to cover the annual payout requirement.

One consequence of this rule is that a foundation could substitute social investments for annual grants, thereby enabling the foundation to retain and grow its assets over time, rather than giving away its income every year.[4] For example, if the foundation earned a below-market return of 3% on its PSIs, its assets would grow more rapidly over time than through the 2% net annual growth rate from a conventional investment return of 7% coupled with a 5% required payout.

It is important to emphasize that whether an investment qualifies as a PRI depends on its purpose, not the financial results actually earned. Even an equity investment on which the foundation ultimately realizes a significant profit or a market-rate return might qualify as a PRI. Furthermore, it is the risk-adjusted return rather than the absolute return that is considered. Foundations might be satisfied with a return of 10% on social venture capital, or the prime interest rate of 6.75% on small enterprise loans, yet these would both be below risk-adjusted market rates for their respective asset classes.

PRI provisions do not apply to foundations outside the US, although there may be other governmental restrictions that must be taken into account. In several cases, European foundations had to apply for special government approvals to invest in PSIs.

3 For example, a foundation with $100 in assets would be required to pay out $5 per year. If the foundation invests $2 in a PRI, it is only required to pay out an additional $3 in the current year. In addition, since the PRI is not counted in the foundation's asset base, the 5% payout for future years will drop to $4.90 based on only $98 in assets. If and when the PRI is repaid or sold, the proceeds are added back in to the foundation's asset base at that time.

4 Most foundations allocate funds for social investment in addition to their normal grant payout. Although it is theoretically possible to substitute social investments in place of grantmaking, we are not aware of any foundation that has done so.

PSIs therefore exclude the most common type of social investment – the use of screened public equity and bond portfolios or socially responsible mutual funds, whether negatively screened to avoid harmful businesses such as tobacco companies, or positively screened to identify beneficial businesses such as alternative energy companies. PSIs also exclude shareholder advocacy – equity investments in publicly traded companies made with the objective of exercising stockholder voting rights to influence corporate practices.[5] In excluding these forms of social investment from this study, we do not mean to imply that they are in any way less desirable. Measuring their social impact, however, is an entirely different process from measuring the impact of PSIs.

Social investors need not sacrifice reasonable financial returns to achieve social goals.

PSIs do include four categories of investment:

- **Private Equity and Venture Capital,** consisting of debt or equity investments in small or early stage for-profit companies that generate social or environmental benefits.

- **Loans and Mezzanine Capital,** consisting of loans to nonprofit organizations, loans with or without equity participation to privately held for-profit companies that provide social or environmental benefits, and microfinance loans to individuals.

- **Guarantees** that secure loans or bond issues and lower the cost of or increase access to capital.

- **Bonds and Deposits,** including mortgage-backed securities, community development bond offerings, and certificates of deposit at community development financial institutions (CDFIs).[6]

It is important to recognize that each of these investments can be approached with the objective of obtaining either market-rate or below-market risk-adjusted financial returns. The F.B. Heron Foundation in New York City, for example, has 24% of its endowment in PSIs, and 72% of these funds are in market-rate investments. The Foundation compares its PSI returns to conventional benchmarks in each category of investment and routinely approximates or exceeds the relevant benchmarks with a similar level of risk and volatility.[7] There are other indications as well that, depending on the type of investment vehicle used, social investors need not sacrifice reasonable financial returns

5 For more information on the increasing use of shareholder advocacy by foundations, see CERES (ceres.org); The Foundation Partnership for Corporate Responsibility (foundationpartnership.org); Rockefeller Philanthropy Advisors & As You Sow Foundation, *Unlocking the Power of the Proxy*, 2004, available from rockpa.org.

6 CDFIs include community development loan funds, community development banks, community development credit unions, microenterprise lenders, community development corporations, and community development venture capital funds, all working to increase the availability of capital, credit, and financial services to low-income communities across the US. For more information, see cdfi.org.

7 The foundation compares CDFI deposits to the BanxQuote average of two-year deposits; fixed income investments to Lehman Brothers Aggregate Bond Index; private equity to the Venture Economics US Private Equity Performance Index; and PRIs to a benchmark of inflation plus 1%. Ninety percent of the foundation's fixed-income PSIs are investment grade and the portfolio R-squared is 0.84 compared to the benchmark of 1.00. For a complete list of the Heron Foundation's PSIs, see heronfdn.org.

to achieve social goals. For example, a study by McKinsey & Co. and Harvard Business School students revealed that, over a ten-year period, a portfolio of socially-motivated equity investments by "angel investors" generated returns of 8-14%. That is lower than the rate typically earned by angel investors but comparable to public equity market returns.[8] Such results are encouraging; however, as no comprehensive study of the average returns per social investment asset class has yet been done, social investors have little systematic research to substantiate this experience.

Other foundations deliberately choose below-market investments reasoning that the income they sacrifice enables them to accomplish more than the returns from a traditional investment portfolio coupled with the normal 5% payout in grants. The Kalamazoo Community Foundation, for example, calculated that it could invest $15 million in PSIs at a 1.5% annual return and the impact on its future grantmaking would be negligible (see sidebar on page 17).

Whether at or below market rate, the diversity of social investments made by the three dozen organizations we interviewed seems to be almost as varied as the types of conventional investments available. Consider some examples of the PSIs we encountered:

- **Commercial financing or venture capital in mature markets**
    - The Rockefeller Foundation's ProVenEx Fund invested in a start-up biotech company that is developing a microbicide to protect against HIV infections. The enterprise has since been acquired by a larger pharmaceutical company, and the product is now in clinical trials.
    - The Canopus Foundation in Germany invests in wind farms, earning an 8% annual return, secured by long-term government contracts to purchase the electricity.
    - The Abell Foundation invested in a start-up company that was developing a 'blocker' for cocaine, on the condition that the company locate in Baltimore. The company has since created 200 local jobs, gone public, and the foundation sold its stock for 12 times its initial investment.

Any foundation or organization willing to explore social investment opportunities is likely to find investments that fit their mission, level of expertise, risk profile, and financial constraints.

- **Financing for local community development**
    - The Columbus Foundation used $2 million to seed an $18 million low-cost housing fund to build 1,600 new units of affordable housing in the city.
    - The F. B. Heron Foundation has a balanced and diverse portfolio of PSIs that includes equities, fixed income, cash deposits and venture capital investments. Its holdings include:
        - An eight-year $500,000 loan, at 3% interest, to the $20 million Community Loan Fund of New Jersey to finance the development, construction, and renovation of 2,500 child care centers that serve low-income families.

8 *The McKinsey Quarterly*, 2004 Number 1.

- Mortgage-backed bonds issued by Habitat for Humanity International to finance the construction of affordable homes.

- A $2 million loan to the Community Reinvestment Fund, which is creating a secondary market in economic development loans by selling them to institutional investors at market-rate returns. The Fund's cumulative loan losses over 15 years have amounted to 0.19%.

- "Blight Bonds" issued by the City of Philadelphia to redevelop depressed urban areas.

- The MacArthur Foundation guaranteed a $15 million financing facility to enable the construction of mixed-income homes to replace public housing in a Chicago neighborhood. The city had pledged future tax increments to finance the construction, but without the guarantee, funds would not have been immediately available.

- **Start-up or expansion capital for businesses in underserved regions and developing countries**

  - In Uganda, the Shell Foundation invested $2.5 million, matched by $2.5 million from a local bank, to support increased access to modern energy services by small enterprises in ways that were financially viable. The portfolio has been delivering a 20% internal rate of return in the local currency.

  - The Heron Foundation has also invested $2.5 million in a limited partnership interest in the Yucaipa Corporate Initiatives Fund, a $577 million private equity fund that invests in businesses that locate in underserved communities. The fund has a stated goal of earning a 25% internal rate of return for its investors.

THE BENEFIT OF LOWER RETURNS

The Kalamazoo Community Foundation calculated that dedicating 15% or $15 million of their discretionary assets to social investment at a 1.5% return would enable them to put substantially more funds to work in their community with only a modest sacrifice in appreciation.

They calculated that over a five-year period, under a traditional approach, the Foundation would make total grants of $27 million and have $118 million remaining in its endowment.[9] After using $15 million for social investments, the foundation would still be able to make $23 million in grants and have $116 million in remaining assets. The $2 million reduction in future assets meant that the grant payout in year 6 was $100,000 lower than under the traditional approach, but it enabled the Foundation to use $11 million more for immediate community impact, a trade-off they considered highly advantageous.

The key to their analysis is the difference between the assumed return on social investments and the expected return on conventional investments after deducting the 5% payout rate. Kalamazoo assumed a 7.5% return on its overall portfolio, less the 5% payout, for a net growth rate of 2.5%. Since the social investments were assumed to grow at 1.5%, the Foundation only lost 1% of the appreciation on 15% of its portfolio, a reduction of 0.15% in overall annual appreciation.

9 Only private foundations are required to pay out 5% per year. Community foundations are public charities and are therefore exempt from this requirement. Most community foundations, however, voluntarily abide by the 5% guideline.

- **Low-interest loans to nonprofits**

  The Ford Foundation maintains a $200 million PRI fund that makes loans to their grantees in amounts ranging from $1-3 million, typically for ten years at an interest rate of 1%.

- **Acquisition of assets**

  - The Weeden Foundation invested $600,000 to purchase land in Bolivia that is being used as a nature preserve and center for conservation research.

  - The California Health Care Foundation paid for the development of software to qualify and register MediCal participants online. Owned by the Foundation, the software now handles one-fourth of all registrations in the state and is being licensed to other states through a partnership with a major accounting firm.

The reported dollar value of PSIs is less than 1/20th of 1% of US foundation assets.

The diversity of investments available suggests that any foundation or organization willing to explore social investment opportunities is likely to find investments that fit its mission, level of expertise, risk profile, and financial constraints. The easiest entry point might be making low-interest loans to grantees by relying on standard loan terms and the due diligence that is already in place for the grant approval. A second level might involve finding CDFIs, microfinance funds, and other social investment vehicles managed by experienced third-parties. Finally, the most innovative and sophisticated social investors can develop the expertise to identify and invest in for-profit enterprises that serve their specific social and financial objectives.

An obvious question is how some of these investments can earn attractive rates of return and yet not be served by traditional investors. We believe that the answer lies in the difference between *market failures* and *market gaps*. Philanthropy often addresses market failures – where there are no financial incentives to meet a need, such as providing food to the indigent. Social investments cannot address a complete market failure. There are other situations, however, where a viable financial model is possible but has not yet been developed. Such situations arise for a variety of reasons. For example, they may involve small transactions that lack any means of aggregation, as was the case with microfinance loans before foundations and nonprofits created the mechanisms to manage and consolidate portfolios, demonstrating that commercially viable rates of return could be earned.

Market gap investments may also require longer-term investment periods, involve unusual collateral, rely on untested concepts, or simply require extra attention in their origination and management. New financial instruments are invented all the time, but only the few social investors have any incentive to invent financial instruments that specifically address social problems. Once a viable solution is developed, conventional capital markets may also begin to participate, greatly expanding the pool of capital available. In short, if foundations are willing to take on the risk and complexity of pioneering financial solutions to these market gaps, they can achieve program objectives while still creating investments that earn market-comparable returns.

Despite these compelling reasons for engaging in social investment, it remains a rarity. Our research suggests that, at present, the majority of foundations that engage in PSIs are in the US, although there is substantial and rapidly increasing interest among European foundations. The available data indicate that 99.3% of all socially invested funds are in publicly traded screened portfolios rather than in proactive social investments. According to the latest data available from the Foundation Center,

Figure 1 **Estimated scale of social investment**[10]

INVESTMENT TYPE	ESTIMATED SCALE OF INVESTMENT (USD Millions)
PSIs	
Community development investments	13,500
Private equity and venture capital	585
Loans to nonprofits	300
Other Social Investments	
Screened public equity and bond funds	2,143,000
Shareholder advocacy	448,000

fewer than 1% of US foundations in 2001 reported having any PSIs, and the reported dollar value is less than 1/20th of 1% of US foundation assets.[11] Of these foundations, the vast majority (85%) are private foundations, while corporate foundations, community foundations, and operating foundations each make up about 5% of this group.

We found little current data about the magnitude of social investment activity by asset class in the US and no reliable estimates of social investment outside the US. However, Figure 1 above offers a sense of the relative magnitude of different types of social investment based on the most recent available data from 2000 and 2003. It is clear that much more timely and reliable collection of data about all types of social investments is an essential pre-requisite for further development of the field.

10 An estimated $441 billion of investments are classified as both screened public equity and bonds and "shareholder advocacy," so when totaling US social investments, one must subtract this to avoid double counting. The totals for screened public equity and bonds, shareholder advocacy, community development venture capital, and community investments in CDFIs are all 2003 numbers. All others provided are for 2000. *Sources:* "2003 Report on Socially Responsible Investing Trends In the United States," Social Investment Forum Industry Research Program; "The Investor's Toolkit: Generating Multiple Returns Through a Unified Investment Strategy," Jed Emerson, Timothy Freundlich, and Shari Berenbach, 2004; "Assessing ProVenEx Performance and Identifying Directions for the Future," Boston Consulting Group, August 2002.

11 PRI Financing: Trends and Statistics 2000-2001.

3 STRUCTURING THE SOCIAL INVESTMENT PORTFOLIO

RATIONALE FOR SOCIAL INVESTMENT

Although a few organizations have been solidly committed to social investment for many years, the majority of our interviewees still view their PSIs as experimental. Despite their caution, it is worth noting that none of the three dozen organizations we interviewed had been disappointed or had decreased their allocation of funds to PSIs. On the contrary, most had increased their allocation over time as they gained experience. This suggests that whatever the original rationale, the social and financial results these investors have encountered were better than originally anticipated.

In our interviews, the specific rationale given for deciding to explore PSIs varied, but five reasons, in particular, tended to recur:

Accessing additional funds outside the grantmaking budget

Most foundations are conservative in their annual spending, limiting their payout to the required 5% minimum in order to preserve their endowments. In addition, foundations generally maintain a clear separation between the investment of their endowment funds and the allocation of grant dollars to program objectives. As a result, at any given time, 95% of the foundation's assets are not employed in pursuit of its mission. As Luther Ragin of the F.B. Heron Foundation describes it, "Most foundations are actually investment companies that merely use a portion of their free cash flow for social purposes."

By utilizing endowment assets for social investing, foundations are able to dedicate more of their assets to social objectives and potentially increase their impact. In contrast to an increase in the grant budget, the cost of a PSI is only the difference in rates of return or the level of risk and, therefore, the extra allocation will not permanently deplete the endowment or set a new standard for annual payout. Most foundations start slowly with a one-time allocation above and beyond the normal grant payout in order to gain experience with the level of risk and return before committing any substantial portion of their assets to PSIs. Even allocating 2% of the portfolio to PSIs, however, would increase a normal grantmaking budget by 40%.

Even allocating 2% of the endowment to PSIs would increase a normal grantmaking budget by 40%.

Using a new set of tools to address social issues

Foundations have many ways of achieving social impact, such as convening, research, and technical assistance. When it comes to using their financial resources, however, foundations typically restrict themselves to the single mechanism of making grants. Many social needs and market failures are well served through grants, but they are not the only kind of funding needed. Nonprofits may need loans to get through a difficult time, to buy

equipment or acquire a building that can be gradually paid down, or to expand into new services that will ultimately produce income. Many of the foundations interviewed use PSIs to make loans to their own grantees, finding that by pairing loans with grants they can help their grantees establish credit, encourage more rigorous financial management systems, and offer greater flexibility in helping grantees meet their goals. Some foundations even develop explicit strategies that leverage the synergy between grants and investments to achieve a larger vision.[12]

The nonprofit sector, however, is not the only way to address social problems. Issues such as economic development, poverty alleviation, the provision of clean energy, or improved health care are inextricably linked with private enterprise. Many other social needs, from pharmaceutical research to the manufacture of anti-malarial bed nets can also be addressed through business-based solutions – especially if below-market capital is available to subsidize the start-up costs. In recent years, a new generation of social entrepreneurs has increasingly turned to the tools of business to achieve social change.[13]

This is not to suggest that the role of philanthropy could ever be replaced by commerce. All of the foundations interviewed believed that PSIs could effectively supplement their grants, but none felt that investments should replace grants. They merely expanded the options for solving a social problem.

Several interviewees found that they had obtained better returns on their PSIs than on their conventional investment portfolios.

A further advantage may be gained when market-rate returns can be earned. After all, the global pool of investment capital vastly exceeds the philanthropic capital available. As a result, when a commercially viable approach is discovered that addresses social needs, it can grow far more rapidly by tapping global capital markets than by remaining dependent on philanthropic support.

12 See Brophy, Paul, John Monahan, Kristin Siglin, and Christa Velasquez, *Integrated Philanthropic Investment Strategies for Community and Economic Development: A Briefing Paper*, 2005.

13 For an excellent description of the social entrepreneurship movement, see David Bornstein, *How to Change the World*, Oxford University Press, 2005.

Microfinance, cited above, is the most prominent example of a new approach, pioneered by foundations and nonprofits through grants and below-market investments, that has proven to be a commercially viable enterprise capable of generating market-rate returns. As a result, the field has attracted nearly $9 billion in capital, providing assistance to nearly 60 million households.[14]

Preserving the foundation endowment by "recycling" funds

Upon giving a grant, a foundation relinquishes any future use of those funds. In contrast, when making a PSI – depending on the level of risk – a foundation will most likely be able to recoup its capital together with a profit upon repayment of the loan or upon exit from the equity investment, enabling the funds to be "recycled" for future investments or grants. In the words of one interviewee: "We always say that when you make a grant you have absolute certainty of 100% loss of capital. As socially motivated people, we see PRIs as financially efficient grantmaking because the capital is preserved."

Although there has not been any definitive study of loss ratios on PSIs – and many of the investments described in our interviews were too recent to predict the final outcomes – a number of the organizations we interviewed reported that significant losses were rare. Most had begun with the expectation of substantial losses, but found instead that their loss experience was more often in the range of 1% to 3% of the portfolio. Those organizations that have deliberately sought to minimize losses have been able to do so. For example, Triodos, a bank that lends to socially responsible projects, reported a loss ratio of 1/10 of 1% on its loan portfolio over a twenty-year period. Other funders may embark on a PSI program with a much greater appetite for risk, deliberately setting loss targets of 10% to 30%, yet several of them reported that their actual loss was substantially below the authorized level.

In general, most of the interviewees we spoke with reported that they were achieving positive net returns on their overall PSI portfolio and were successful in recycling their philanthropic capital.

Asset diversification

Although social investments are often thought of as sacrificing financial returns, several interviewees found that they had obtained better returns on their PSIs than on their conventional investment portfolios, especially in the weak investment climate of the past few years. These foundations discovered – sometimes intentionally and sometimes unexpectedly – that PSIs offered an opportunity to diversify foundation assets beyond traditional investment options. In some cases, concessionary interest rates on below-market loans ended up outperforming declining stock market portfolios in 2000 through 2002. In other cases, PSIs led foundations to invest in venture capital and other alternative investments with higher risk but greater rewards than the more conservative investments in their conventional portfolios.

"We always say that when you make a grant you have absolute certainty of 100% loss of capital. As socially motivated people, we see PRIs as financially efficient grantmaking because the capital is preserved."

The board of the Abell Foundation in Baltimore, for example, was comfortable with the higher risk profile of venture investing. Their PSI portfolio is weighted toward venture capital funds that bring new businesses to Baltimore in order to create jobs or that fund environmentally beneficial ventures that traditional venture capitalists would consider insufficiently rewarding. As a result, they

14 See cgap.org.

have earned an average 12% return on their PSIs. In their words: "One reason we started making mission-related venture capital investments was our skepticism about the return on more traditional investments. Our first goal was a desire to make money with our available assets."[15]

Among the smaller foundations, we found much more aggressive PSI allocations.

Community recognition and market entry

Corporations, more than foundations, may feel the need to demonstrate publicly their commitment and generosity to the communities in which they operate. For these companies, social investments are one way to enhance their reputations, especially for banking, insurance, and financial service companies that are in the business of lending or investing capital. None of the corporations we interviewed suggested that achieving a business benefit was the primary reason they engaged in social investments, but one did acknowledge that "Social investments enable us to put our best face forward in the community. Businesses [that engage in social investing] will get credibility for sustained commitment and can mention the investments in certain settings to aid branding and corporate image enhancement."

In addition, some corporations use social investment as a way of entering new markets, especially in developing countries, by building local relationships and an understanding of the local market.

CAPITAL ALLOCATION DECISIONS

Among the organizations studied, there are a few long-standing PSI programs at foundations such as the Rockefeller Foundation, MetLife, the Ford Foundation, and the F.B. Heron Foundation. However, many foundations are testing this approach with a very small proportion of their funds. Some of these foundations do not even have any specific budget allocation for social investments because so far they have only made one or two small experimental investments.

Among those surveyed, debt was much more common than equity investments. Loans have a pre-set repayment time period and clear rates of return and are therefore relatively easy to forecast. Loans are also the only way to 'invest' in a nonprofit organization, since ownership equity does not exist. Equity investments are less predictable. The exit strategy is unclear, the time period before realizing the investment return is unknown, and the return rate – although it may be higher – is uncertain. In fact, equity investments in small enterprises may not have any realistic exit strategy if the proprietor is unwilling to sell or if there is no local buyer.

Once a foundation makes a sustained commitment to social investing, most set a dollar value or percentage of assets as a ceiling for social investments. None of our interviewees could articulate a clear rationale for why the particular ceiling had been chosen beyond a general sense of comfort by the board, or an inability to find additional attractive social investments. The largest foundations have set aside a substantial amount of money, yet it remains a very small percentage of their assets – the Ford Foundation has a $200 million PRI portfolio and the Packard Foundation has a $124 million portfolio, but these still represent only 2% of these foundations' total assets. Among the smaller foundations, we found much more aggressive PSI allocations. For example, the Kalamazoo Community

15 Note that this purpose clearly disqualifies such investments from being treated as PRIs under the US Tax Code.

Foundation sets a ceiling of 12% of its unrestricted assets, while the Heron Foundation has set a target of moving 30% of its assets into PSIs over the next few years, and the Canopus Foundation in Germany has 40% of its assets in PSIs.

Figure 2 on page 27 offers a sampling of the PSI capital allocations of a wide range of organizations.

The majority of foundations studied chose to use program funding to finance their PSIs, and they gave three reasons for doing so. First, US foundations that treated these investments as PRIs counted them toward the current grant payout and excluded them from the asset base on which future payout would be calculated. Second, this explicitly tied PSI activity to grantmaking by putting it under the control of program rather than investment staff. This ensured that investments would only be made when they served program objectives and encouraged the combination of loans and grants in devising strategies or supporting grantees.

The board's duty is not only to protect and grow the assets of the foundation, but to use those assets to help achieve its public purpose and social mission.

Finally, designating PSIs as program funds avoided any potential concern about the board's fiduciary duties, especially with regard to high-risk or below-market investments. In theory, the board's duty is not only to protect and grow the assets of the foundation, but to use those assets to help achieve its public purpose and social mission. In practice, however, some board members are wary of any investments that depart from maximizing the foundation's risk-adjusted financial returns. For them, the easiest solution is to circumvent the issue by accounting for PSIs as program expenditures.

CALVERT SOCIAL INVESTMENT FUND

Calvert, a $10 billion asset management firm, has long been a leader in social investment. The diverse array of conventional financial products and mutual funds that they offer also includes socially responsible investment funds – screened portfolios selected on the basis of both financial performance and social responsibility.

Calvert also offers proactive social investments through several vehicles:

- The Calvert Social Investment Fund is an $18 million fund that makes loans to more than 186 community organizations and returned 2.18% in annual interest income.
- The Calvert Special Equities Program invests in high-risk companies that provide market-based solutions to social, environmental, and health problems. For example, one investment is in PowerZyme, a company that is developing enzyme-based batteries that are more efficient and less environmentally harmful than lithium ion batteries.
- Calvert Community Investment Notes, issued by the affiliated nonprofit Calvert Foundation, provide below-market loans to community-based nonprofit organizations. The Foundation uses its own assets to subsidize the due diligence and monitoring of investments as well as to provide a layer of security that protects the Notes from borrower defaults. Proceeds from the Notes are invested in 60 different countries and in all 50 US states. At present, $75 million in Notes are outstanding.

In addition, Calvert will create and manage customized portfolios for foundations and other large social investors that target specific areas such as microfinance, health care, and social entrepreneurship.

On the other hand, those foundations that have a substantial portion of their assets in PSIs tend to treat them as endowment rather than program funds and, understandably, a majority of these investors seek market-rate returns. These foundations also seem to have a more aggressive entrepreneurial culture and a higher comfort level with alternative investments.

The corporate foundations we interviewed had a third option of using company funds for social investments, and under various circumstances there appeared to be clear advantages to the use of one or the other. For example, some social investments in the US – such as those that create employment in economically depressed areas – carry tax credits that repay through immediate tax savings as much as 30% of the funds invested. These credits can only be used if the investment is made with corporate funds. Conversely, investments that carry significant risk or very low rates of return can be made from the foundation without violating the company's investment parameters or lowering its return on equity.

INVESTMENT STRUCTURE AND MANAGEMENT

Staffing

The management of PSIs involves a unique set of challenges for foundations. Typically, foundations employ experienced program officers and experienced investment officers, but each has a very different set of skills, and it is rare to find someone who has the experience to combine social and financial analysis. Foundations also tend to be structured in ways that reinforce the separation between investment and grantmaking, so that it is not always clear where in the organization a PSI manager belongs or to whom he or she should report. This is reflected by the fact that several foundations had separate departments for their PSIs or had delegated responsibility to outside consultants. Finally, every interviewee we spoke to cautioned us about the amount of staff time required to source, structure, and monitor a PSI portfolio.

Figure 2 Sample PSI Allocations

FOUNDATION	Type of Social Investment Activity	Type of Funds Used	Percent of Assets in PSIs
Abell Foundation	Social venture capital	Endowment	15%
Annie E. Casey Foundation	Community investments in CDFIs, loans to nonprofits, social venture capital	Endowment	3%
Canopus Foundation	Social venture capital	Endowment	40%
Esmee Fairbairn Foundation	Loans to nonprofits	Endowment	<1%
F.B. Heron Foundation	Wide range of investment vehicles	Endowment and program	24%
Ford Foundation	Loans to grantees	Program	2%
Helen Bader Foundation	Socially targeted loans, loans to nonprofits, social venture capital investments	Program	7%
Kalamazoo Community Foundation	Socially targeted loans, loans to nonprofits, social venture capital	Program	12%
MacArthur Foundation	Loans to nonprofits	Program	2%
MetLife Social Investment Program	Loans to nonprofits, social venture capital	Company funds	NA
David & Lucile Packard Foundation	Loans to nonprofits	Program	2%
Prudential Social Investment Program	Loans to nonprofits (through foundation), socially targeted loans (through company)	Program and company funds	NA
Rockefeller Foundation (ProVenEx)	Socially targeted investments, socially targeted loans, social venture capital	Program	0.5%
Shell Foundation	Socially targeted investments, social venture capital	Program	NA
Weeden Foundation	Wide range of investment vehicles	Endowment and program	25%

Figure 3 **Direct versus indirect investments**

IMPLICATIONS	DIRECT INVESTMENTS	INDIRECT INVESTMENTS
Level of control in end-investee relationship	**High** By initiating and managing its own investments, a foundation can select specific investees, control the relationship, and monitor the investment as it wishes	**Low** A foundation typically has no direct contact with individual investees, nor does it control their reporting process.
Ability to tailor investments to fit foundation's mission	**High** A foundation can select specific investees and investment vehicles that are tailored to its mission and program focus areas.	**Low** A foundation can select investment intermediaries based on the issue areas (e.g., affordable housing) and geographies their investment fund addresses. However, a foundation typically can not select individual investments.*
Specialized resources required	**High** Unless it contracts with a third party, a foundation must have staff resources dedicated to sourcing investments, performing due diligence, as well as managing and monitoring all investments. Interviewees warn that these costs should not be underestimated.	**Low** The investment intermediary sources and manages the investments. The foundation pays the intermediary a management fee for this service or the intermediary may cover its costs through the spread between the interest rate charged borrowers and the interest passed on to the foundation.
Effort required to source investment deals.	**High** A foundation must seek out potential deals through networks and other sources. This process became easier over time for foundations as their reputation as investors grew.	**None** The investment intermediary sources all deals.
Reputational risk	**High** If a foundation is forced to pressure a borrower to repay a delinquent loan or the organization in which the foundation has an equity stake goes bankrupt or is implicated in a crime, the foundation might face negative publicity.	**Low** The investment intermediary insulates the foundations from all negative investment issues.
Investment diversification	**Low** Most foundations have too few social investments to diversify their social investment portfolio.	**Medium/High** By investing in a large pool of diverse investments, a foundation can diversify its risk.

* In fact, investors are often contractually limited from directing the intermediary to make specific investments to avoid increasing their exposure to liability.

Investing through intermediaries or affiliates

Little extra work is required for the foundations that choose to invest indirectly by using an outside fund as an intermediary, hiring consultants, working through local nonprofit partners, or limiting their social investments to deposits in CDFIs. In the words of one foundation: "If you invest in capable intermediaries, the work may not be very different from what you are doing today with grants." On the other hand, the costs are merely shifted to the intermediary, resulting in higher management expenses than in conventional investments. The Annie E. Casey Foundation, for example, invested in a private equity fund that was targeted toward investments in Baltimore-based companies which required an extra 1.5% management fee to cover the incremental cost of workforce development supports. Other funds, such as the Calvert Social Investment Fund or the Acumen Fund, report that they rely on grant support in addition to management fees to cover the higher costs of investing and measuring the social impact of their investments. In short, while foundations that invest through intermediaries do not directly incur added costs, they must be prepared to cover the added costs of the intermediary.

There are a number of other benefits and drawbacks associated with the choice of whether or not to invest through an intermediary. Direct investments provide investors with more control and focus. Indirect investments offer more diversification yet may not be as closely tied to specific program objectives. For example, one may invest in economic development funds or alternative energy funds and align the investments with program areas, but one cannot build synergies between grants and investments unless one can select specific investees who focus on the same issue, geography, and even theory of change as the foundation.

Some foundations create an affiliated "fund" housed within the organization to manage all of their social investments. This fund operates under the umbrella of the larger foundation, but is separate from grantmaking or traditional investment activity and has its own dedicated staff. For example, the Rockefeller Foundation created the Program Venture Experiment (ProVenEx), an $18 million fund for social investments. ProVenEx is funded with program dollars and its investments must stay within the foundation's four focus areas, but it is managed by an officer with relevant investment expertise.

Other foundations have set up separate organizations to handle their social investments in order to shield the foundation from liability. For example, the Kalamazoo Community Foundation uses a real estate holding company as an intermediary for its PSIs. The Foundation makes a PRI to the holding company, which then invests as a limited partner in real estate development projects. This arrangement twice shields the Foundation from liability through its role as a limited partner and again through its holding company.

Indirect investments, whether through affiliates or intermediaries, also shield the foundation from the less desirable aspects of enforcing liens or collecting on defaulted loans. Actions to recover funds or collateral carry significant legal expenses, but also risk the public relations debacle of a wealthy foundation foreclosing on a struggling nonprofit or small business. Said one interviewee, "There are financial costs, but also public relations costs, of going after a default whether of a for-profit business or a nonprofit organization. That's an issue we are grappling with at the board level right now. You need to make a conscious decision up front from a financial standpoint and a public relations standpoint, and the answer can be different for businesses than for nonprofits."

Yet another reason for investing through a separate organization is to engage other investors. The Helen Bader Foundation established a venture capital fund, MidCities Investment Management Inc., in concert with two venture capital funds, two individual investors, and a bank. All participate as limited partners in the fund and they plan to hire a general partner. Since a separate fund was established, outside investors can participate in its governance and gain a sense of ownership for the venture. As a result, the foundation may be able to leverage capital at a level significantly beyond what it alone could provide. With the participation of these investors, the Bader Foundation hopes to grow the fund from their initial $2 million investment to a total of $30 million.

Investing directly

Most of our interviewees took an active hand in managing their PSIs, although we found no consistency among staffing patterns. Some foundations assign the responsibility to program officers, while others hire dedicated staff or delegate responsibility to the investment department.

PSIs tend to be far more labor intensive than either conventional investments or grants. The Ford Foundation, for example, has a staff of 6 people to manage its $200 million PRI portfolio, and they originate a total of six to eight new transactions a year. The same number of program officers at a large foundation would typically make 160 grants in a year.[16] On the other hand, PRIs are often much larger than grants. The Packard Foundation estimates that their average PRI of $2 million is almost ten times the size of their average grant. For them, the 2 to 4 FTEs required to handle 10 new PRIs a year is less than half the staff typically required to handle $20 million in grantmaking.

Monitoring investments after they have been made is a major factor in causing social investments to be such a labor-intensive venture. One interviewee commented that the ongoing management of a PSI took at least three times the effort of the initial due diligence. Another estimated that 40% of their staff time is spent on new transactions, 40% on managing existing investments, and 20% on measurement and reporting.

16 The median number of grants made annually per program officer is 27 according to the Center for Effective Philanthropy operational benchmarking database.

This staffing burden is particularly difficult for foundations that strive to minimize administrative expenses. As one respondent said: "We could invest four times as much money – the limiting factor isn't the availability of deals but the availability of staff."

These incremental costs may well decrease as the field develops greater scale and experience, but it is a fact of life for foundations that pursue PSIs today. Some foundations have compensated for these costs in creative ways. The Heron Foundation, for example, has invested most of its non-PSI endowment in index funds or enhanced index funds with extremely low management fees. As a result, they are able to devote the time needed to manage their social investments and yet keep the foundation's overall investment costs down to 0.38%.

Taking legal action to recover a nonperforming loan risks the public relations debacle of a wealthy foundation foreclosing on a struggling nonprofit.

Despite the required staffing levels, the 'net cost' of social investment managers may be less than the cost of grant managers because the investments return income that offset staff costs, while grants generate no revenue. Yet none of the respondents took into account the income generated when describing the staff cost of PSI portfolios.

For those foundations that invest in developing countries, the cost of monitoring is even greater, and often must be supplemented by technical assistance to the investee. REED, the case study described in Chapter 5, invested a total of $1,161,000 in eight small clean-energy companies in Africa and Latin America, but spent another $400,000 in technical assistance and performance monitoring. The Shell Foundation seeded a $5 million loan fund in Uganda with a $2.5 million investment, but supplemented that with a $350,000 grant to set up the local infrastructure and provide related technical assistance. Although these extra costs may seem prohibitive relative to the return on investment, the foundations explain that providing technical assistance to improve the skills of small business owners in developing countries itself advances their missions.

Corporate investors have the additional option of leveraging other corporate staff for investment review and due diligence. For example, MetLife has found it beneficial to have an investment review committee that is broader than just the social investment staff. By including these employees, they can access investment skills and business perspectives and can also recruit these committee members to become internal champions for the program.

4 MEASURING PERFORMANCE

Social investments face skepticism from two perspectives: investors often doubt their safety and profitability, while donors may question their social impact. Even those investors already engaged in proactive social investment must decide what percent of their overall portfolio should be allocated to PSIs, and how to weigh the greater financial returns of one investment against the greater social impact of another. Each of these dilemmas can only be resolved by a deeper and more precise understanding of the outcomes that different social investments achieve. In short, more effective performance measurement is vital for the continued growth and success of the social investment field.

WHY MEASURE PERFORMANCE?

The social investors we interviewed provided three reasons for measuring the financial and social results of their PSIs.

Improving results

Careful measurement of results is essential to improving investment performance over time at both the investor and investee levels. At the investor level, it enables managers to test and improve their judgment about which deals are most promising and how best to structure them. It is also the basis for determining which investees merit follow-on funding and which do not. For example,

the Acumen Fund and the Heron Foundation periodically rank their portfolio of PSIs based on recent performance results in order to decide which investees will receive additional funds.

From the investees' perspective, performance data can help them improve their own operations or give foundation staff a basis for recommending changes in order to increase either social impact or financial returns. Clear and regular reporting of results also increases the accountability of the investees to their investment managers, and of the investment managers to their senior management or governing board.

The financial return on social investments can be measured just as one would measure the return on conventional debt or equity investments.

Attracting additional funding

Reporting results is essential to encouraging additional funding, whether internally through increased board allocations or externally through the participation of other investors. Whether growth in the field comes from the investment community, the philanthropic community, or a combination of the two, a serious increase in the scale of social investment capital will only occur if there are solid data about both the financial and social results.

Magnifying impact

Large-scale change often depends on the replication of an idea or on winning changes in government policy, and both depend on clear demonstrations of effectiveness. For example, in Ghana the United Nations Environment Programme invested in an LPG facility to provide cleaner alternative energy (see the REED case in Chapter 5). Their local partner, KITE, documented the results, then used evidence of the environmental impact to change government policy and evidence of the financial performance to stimulate local entrepreneurs to create additional LPG facilities. Well-documented results, therefore, are one tool for achieving social impact.

WHAT TYPES OF PERFORMANCE CAN BE MEASURED?

Our research suggests that there are five different ways that the performance of PSIs can be measured. In describing the results, we distinguish "returns" from "benefits" because financial returns do, in fact, return to the investor while the social and environmental impacts provide benefits to others.

Financial return on the investment is the direct monetary reward that social investors receive for undertaking the risk of investing their capital.

Financial performance of the investee includes conventional measures of business success such as revenues, assets, growth rates, and profitability.

Socio-economic benefits are improvements in the economic status of a target population as a result of the investee's activities arising from the investment. At the individual level, these benefits include job creation and higher salaries or benefits to employees, as well as any cost savings realized by customers. At the national or regional level, socio-economic benefits include increased government tax revenues, decreased costs in providing public services, along with increased regional investment and economic activity.

Social benefits are improvements in the well-being of a target population as a result of the investee's activities, such as better health or quality of life.

Environmental benefits are improvements in the natural environment resulting from the activities of the investee organization, such as cleaner water,

reductions in the emission of greenhouse gases, or reduced rates of deforestation.

Figure 4 summarizes the extent to which our interviewees attempted to measure each of these five metrics. It should be stressed that the chart reflects whether any effort at all has been made to measure each type of performance. The chart does not reflect the level of sophistication or the degree of success of the efforts made. In many cases, the attempts are still exploratory or incomplete, and the interviewees themselves expressed doubts about the adequacy of their own current measurements.

It is interesting to note that every one of the organizations we interviewed monitored the financial performance of their investment, 84% monitored the financial performance of the investee, 72% monitored socio-economic impacts, and 59% monitored social impacts. Only 19% monitored environmental impacts, but this was partly due to the very limited number of projects we found that had specifically targeted environmental outcomes.[17]

It is also interesting to note that, taken together, 79% of the development agencies, investment funds, corporations, and venture philanthropy funds measured all four financial, socio-economic, and social metrics, while only 31% of the foundations did so. Despite their social mission and resources, foundations tend to have a smaller proportion of their assets in PSIs and are not accountable to outside investors or government funders. As a result, foundations appear to have less external pressure to measure the social impact of their investments.

HOW ARE PERFORMANCE DATA COLLECTED?

Financial data were usually collected quarterly or, in some cases, monthly. Socio-economic data were collected less often – usually at intervals of one to three years – while social and environmental impacts were assessed after three years or longer. Among the social investors researched, three major data collection approaches emerged.

1 The most common approach is to have investees periodically provide data to the investor on preformatted templates. This approach requires few resources from investors, other than time spent enforcing template submission and contacting investees to fill in incomplete data.

A benefit of this approach is that the investees "own" the data they submit. However, this process can become a burden to the investee and the data are not externally verified.

More effective performance measurement is vital for the continued growth and success of the social investment field.

Unfortunately, small enterprises – especially in rural regions in developing countries – often lack the capacity to keep records or report even the most basic financial results on their own. If these investees are to report performance data accurately, the investor must be prepared to cover the costs of helping them build capacity. Very few interviewees, therefore, could simply rely on a report from the investee to determine its financial condition, and where they did so, most expressed skepticism about the reliability of the data. Said one: "We just have to rely on the integrity of the data – we don't have the resources to go out and audit the results."

2 The investors that sought dependable financial performance indicators sent their own representatives into the field to provide technical assistance to improve the business's record-

17 Some investors imposed environmental constraints on investees so that the social benefits would not come at the expense of environmental harms, but these investors did not measure environmental impact separately.

Figure 4 Types of performance measured *to some extent* by social investors studied

ORGANIZATION	FINANCIAL		NON-FINANCIAL		
	Financial Performance of Investment	Financial Performance of Investee	Social	Socio-economic	Environ-mental
Development Agencies					
African Development Foundation	✓	✓	✓	✓	
REED, United Nations Energy Program	✓	✓	✓	✓	✓
Strengthening Grassroots Business Intiative, IFC	✓	✓	✓	✓	
Sustainable Futures: Adventure Capital Fund	✓	✓	✓	✓	
USAID (former Summa Foundation)	✓	✓	✓	✓	
Venture Philanthropy Funds					
SROI / REDF	✓	✓		✓	
Acumen Fund	✓	✓	✓	✓	
Private and Community Foundations					
Abell Foundation	✓	✓		✓	✓
Annie E. Casey Foundation	✓	✓	✓	✓	
Blue Moon Fund	✓				
Canopus Foundation	✓	✓			✓
Esmee Fairbain Foundation	✓				
F.B. Heron Foundation	✓	✓	✓	✓	
Gatsby African Trusts	✓	✓	✓	✓	
Helen Bader Foundation	✓				
Jessie Smith Noyes Foundation	✓				
Kalamazoo Community Foundation	✓	✓			
Lemelson Foundation	✓				
ProVenEx, Rockefeller Foundation	✓	✓	✓	✓	
Weeden Foundation	✓	✓			
Investment Funds / Companies					
AfriCap Fund	✓	✓	✓	✓	
Andromeda Fund	✓	✓		✓	
Calvert Social Investment Foundation	✓	✓	✓	✓	
E+Co: Energy Investment Service	✓	✓	✓	✓	✓
Oikocredit	✓	✓	✓	✓	
ResponsAbility	✓	✓		✓	
Small Enterprise Assistance Funds	✓	✓	✓	✓	
Corporations and Corporate Foundations					
MetLife	✓	✓	✓	✓	
Prudential Insurance	✓	✓	✓	✓	
Shell Foundation	✓	✓	✓	✓	✓
Other					
Carbon Trust	✓			✓	✓
USAID's AIMS tools for Microfinance Institutions	✓	✓	✓	✓	

keeping and to collect or certify the data being reported. These field representatives visit the investee organizations, conduct interviews with investee staff and other stakeholders, and analyze financial metrics in order to develop a more complete picture of performance. Field representatives can either be foundation staff or local contractors. In the words of one investor: "We have found it's not worth flying an international person in to do the evaluation. They are too expensive and they don't have the necessary local context. It's better to hire a well-qualified local person."

Often the field representative can also provide technical assistance. Some investors go even further and supplement their social investments with grants to third parties for technical assistance and capacity building. Other investors, such as the Strengthening Grassroots Business Initiative at the IFC, use their own staff to work directly with investees to help them develop internal capabilities.

3 The third and least common approach is to conduct third-party research studies to develop a comprehensive understanding of the non-financial impacts of the investment activities. Although this approach can yield detailed results, conducting a comprehensive longitudinal assessment of social impact can be extremely expensive. Such studies are usually done only if grant funds are available to cover the cost apart from the investment capital. As one intermediary stated: "Since measurement of social impact is resource intensive, we can't afford to cover the costs with what we charge for fund management fees. As a result, we have to get grants to cover the costs."

At present, the majority of social investors interviewed rely on time-consuming manual processes of entering, formatting, comparing, and reporting their PSI performance results. Several organizations indicated that they are looking for outside software solutions to increase the ease of collection, reduce administrative costs, and help standardize data among different investors.

Our research focused in more detail on the metrics used for each type of performance, as discussed in the following sections.

FINANCIAL METRICS

Financial performance of investment

The financial return on social investments can be measured just as one would measure the return on conventional debt or equity investments. Standard financial indicators can be employed, and the returns on different investments can be compared directly against each other. The majority of PSIs we encountered were loans, whether low-interest loans to nonprofits, bonds and deposits, or investments in start-up companies that carried different forms of equity participation. Examples of the key financial performance indicators utilized by the organizations researched in this study are listed in Figure 5.

Loans are typically easy to value at their face amount, less any allowance for default based on signs of trouble at the investee or the historical default rate for the portfolio. Investments in pooled funds or CDFIs were equally straightforward where the fund regularly calculated and reported the unit value back to the investors. The returns on social investments like these were easily and reliably calculated with little difficulty or expense.

Equity investments that do not trade on the public markets, however, were not so easily valued and this was especially true for small businesses in rural or underserved regions. Some investors used the value of the equipment or manufacturing facilities acquired as a proxy for the value of their investment. Others looked to a range of measures used by the venture capital and private equity community, such as multiples of earnings or revenues, recent transactions involving similar companies, the price of the last round of equity raised, and a

Figure 5 Financial performance of investment – sample indicators

Internal Rate of Return (IRR) • Gross or net IRR on the fund level • Gross IRR on the debt or equity portfolio • Gross IRR on the realizations • Gross IRR at the portfolio company level	Debt specific ratios • % non-performing loans • Repayment rate
Funds dispersed and funds committed	Return on assets (ROA)
Capital returned	Assets under management
Multiple of capital invested on the portfolio company level and fund level	Cost of investment compared to best alternative option (Acumen)
Paid-in capital and distributed capital ratios on the fund level	Pro rata share of net worth of investment (equity investment)

number of other well-accepted valuation methodologies. For rapidly growing enterprises in developed markets these are valid metrics; however, these metrics were sometimes used to value small businesses in developing regions that do not have the same prospects for growth, liquidity, or a sale as normal venture capital investments and, in such cases, may not be reliable indicators of value.

There appears to be a trade-off between completeness and credibility in reporting socio-economic benefits, and our interviews suggested that credibility is the more important consideration.

Not all metrics used to measure the financial return on social investments are the same as those used for conventional investments. Conventional investors may look at the opportunity cost of capital – the return their investment might have earned elsewhere. In contrast, Acumen Fund looks at the best charitable alternative. For example, Acumen made a $325,000 loan to a company that makes insecticide-treated bed nets to prevent the spread of malaria in Tanzania. They calculate that the cost per person helped by their investment is less than $0.01, compared to $0.84 per person for the best available charitable option. Such a calculation is, of course, extremely difficult and depends on a large number of assumptions.[18] In reality, it is a measure of philanthropic effectiveness, not financial return. Such analyses may be helpful, however, in making the allocation decision between grants and PSIs – if a PSI produces social impact more efficiently, it has an advantage over a comparable grant even apart from the potential for financial returns.

Another atypical financial metric is the use of leverage as an indicator of success. The ability to attract capital to a project is important in conventional investments, but only to the extent that it increases the profits flowing back to investor. In social investments, however, attracting addi-

18 Acumen Fund, *Metrics Overview*, April 2005. How these numbers are calculated is not revealed in the document provided.

tional capital to a project is itself considered one measure of success, just as bringing additional grant funding to a nonprofit is considered a form of value creation in philanthropy.

Financial performance of investee

Strictly speaking, measuring the financial performance of the investee's organization proves neither that the investor will receive a good return nor that the organization is achieving its social or environmental objectives. It is, however, one predictor of both financial and social performance. A sound business is more likely to repay an investment and to deliver the social or environmental benefits intended. Tracking financial performance is also a necessary step in calculating many of the socio-economic benefits of an investment, such as increases in profits and wages or the expanded reach into a target population. These measures are also relatively easy to calculate and compare according to widely accepted business practices. Figure 6 shows a sample of the measures used.

While the metrics are straightforward, as noted earlier, gathering reliable and timely data often proves to be a serious problem. Even monitoring the use of proceeds can be tricky, as interviewees reported.

"If you're not careful, you may think you are successful but you're not really having a good impact. For example, you may have good repayment rates and you may think your borrowers are doing better financially because of your loan, but if you dig deeper, you'll find that they are borrowing from another microcredit program to pay back your loan. Or you'll find they used the funds to pay for something like a funeral or wedding rather than invest in some economic activity that will have longer-term positive impact for them financially."

In the case of PSIs in large organizations and more developed countries, such as deposits at CDFIs, or low-interest loans to established nonprofit organizations, the foundations we spoke with had confidence in the numbers being reported without any external verification. The cost of monitoring these investments, therefore, was substantially less than the cost of monitoring investments in developing countries.

SOCIO-ECONOMIC, SOCIAL, AND ENVIRONMENTAL METRICS

Although the promise of social and environmental benefits is what attracts most people to social investments, these dimensions of performance

Figure 6 Financial performance of investee's organization – sample indicators

Revenues (annual and CAGR)	Assets (resaleable asset value of the enterprise)
Pre and post money valuation of the portfolio company	Number of products/services sold
Gross margin	Cash flow analysis
Net profit	Liquidity ratios
Financial Rate of Return (FRR) = financial benefits to the investee divided by total investment costs	Microfinance institution specific indicators • Percent of loans repaid • Repayment rates • Number of clients with loans
Cost of goods sold	Cash flow

Figure 7 Socio-economic returns to individuals or investees – sample indicators

Number of jobs created	Cost savings to customers (e.g., due to access to cheaper fuel/energy)
Savings over conventional sources of financing	MFIs only: average loan size (proxy for the wealth level of clients to determine if the MFI is serving the poorest) *Note: this is an outreach measure, not an impact measure, but it is used as a proxy by many microfinance institutions.*
Increase in salary/benefits	

National or regional socio-economic returns – sample indicators

Reduction in cost of national oil imports (country level indicator)	Number of jobs created in related industries
Increase in investment in target region	Increased profits to other businesses
Reduced costs of environmental protection	Taxes paid

are much less frequently or comprehensively measured. "In general, financial returns get more attention than social/socio-economic returns. It's difficult for people to measure social returns, so many people don't report it. No organization is good at this yet." In fact, all organizations interviewed expressed an interest in better measuring and understanding their non-financial results. "We haven't done enough measurement. It's embryonic for us so far… Right now, measurement of social impact is based on if we can 'smell it.'"

One of the reasons social investors are less likely to measure non-financial results is the lack of a standard measurement approach. Every one of the respondents in this study approaches the measurement of non-financial benefits differently. Although many organizations may appear to measure the same types of returns, the quality and comprehensiveness of each measurement approach – even the meaning of the terms – vary significantly. As a result, comparisons of social, socio-economic, or environmental performance across investments is nearly impossible. "In business, we have established generally accepted principles of accounting and an international legal infrastructure to help manage the reporting of financial returns. A comparable standard for social impact reporting does not yet exist."[19]

Socio-economic benefits

Many of the benefits of PSIs are monetary or can be readily valued at market rates. Social investments often produce jobs, increase productivity, and generate higher wages to employees or profits to the owner. The business's products or services may save customers time or money that can also be valued. Other economic impacts may be external to the business, such as increased taxes paid to the

19 Double Bottom Line Project Report: Assessing Social Impact in Double Bottom Line Ventures.

government, or increased purchasing from other businesses in the region. All these dimensions can be quantified in monetary terms.

In the case of below-market loans to nonprofits or in affordable housing funds, the savings over conventional financing costs and the economic benefits to clients served can similarly be tracked. Environmental enterprises, too, may create cost savings either directly for their clients or for public agencies that save energy or incur fewer costs to remedy environmental problems.

Figure 7 on page 40 lists some of the measures of socio-economic impact we encountered in our interviews.

Every one of the respondents in this study approached the measurement of non-financial benefits differently. As a result, comparisons of social, socio-economic, or environmental performance across investments is nearly impossible.

Although valuing socio-economic benefits is not a problem, the challenges lie in collecting the data, determining the extent to which more attenuated or long-term benefits should be included, and comparing different kinds of benefits.

In general, collecting any socio-economic impact data beyond the direct increase in income to the investees' employees will require external research that must be commissioned and paid for apart from the investment. Such research will have to confront the question of which effects are attributable to the investment and which are due to external events, especially when looking at regional or national impact. The researchers will also need to decide how far out to project the impact and how many assumptions should be made about future events. For example, if a new job is created, should one value the earnings only up to the time of the evaluation, or project some future discounted value based on an expectation that the job will continue for many years?

The fact that these future benefits are attenuated or contingent does not diminish their significance, and they would necessarily be included in any attempt to catalogue the full impact of a social investment. However, the more remote the impact – either in time or in the chain of causality – the more assumptions must be made to establish its monetary value, and therefore the more open to question the final calculation will be. In other words, there appears to be a trade-off between completeness and credibility in reporting socio-economic benefits, and our interviews suggested that credibility is the more important consideration.

This is partly due to the early stage of the social investment field and the rudimentary tools currently available. Most investors lack sophisticated enough ways of collecting data and measuring impact to make complex calculations reliable at this point in time. More important, the limited experience that most investors today have with social investments means that any calculation is likely to be scrutinized with skepticism. A more modest impact, based on few assumptions and an ironclad methodology, is likely to carry more weight than the claim of a larger impact supported by complex or unstated assumptions.

Finally, socio-economic benefits cannot always be compared directly in the same way that financial returns can be. Social investors set out to accomplish many different objectives, driven by their organizational missions, investment parameters, or personal passions, and they are unlikely to consider different kinds of benefits interchangeable. For example, two social investors might agree on the equivalence of two loans that each pay $10 in interest, but they might not agree that a $10 increase in weekly wages to an impoverished fam-

ily has exactly the same value as the $10 market price of a two-ton reduction in carbon emissions.[20] From the investor's point of view, socio-economic benefits are not fungible in the same way that monetary returns are.

In recent years, considerable research has gone into the idea of developing a "blended value" return indicator that would capture the total value created by a social investment in a single number. Only two of the investors we researched have attempted to do this: Roberts Enterprise Development Fund (REDF) and Small Enterprise Assistance Funds (SEAF).

"Blending returns is an interesting but undeveloped art that is prone to 'black box' problems."

REDF's Social Return on Investment (SROI) approach attempts to calculate a blended total return for an investment in a socially beneficial enterprise. The process is extremely complex[21] and, even so, the SROI approach only captures financial returns and socio-economic benefits – it does not capture qualitative social or environmental outcomes.

SROI was developed to demonstrate that social investments can create benefits that exceed their cost, and it serves that purpose extremely well. It is less useful in comparing different social investments, however, precisely because it blends financial returns with social benefits. For example, a blended value return of 12% does not distinguish between an investment with an 8% financial return to the investor and a 4% socio-economic benefit to society, versus a 4% return to the investor and 8% to society, although two social investors would likely view these investments quite differently. In fact, among our respondents we found a wide range of preferences for the balance between financial return and social benefit. Some like the idea of having a positive social impact, but financial return is their highest priority. Said one intermediary, "Many of our investors focus only on financial returns and aren't interested in measuring concrete social results – they just assume those are there."

Other investors expressed the opposite sentiment: "We obviously want a decent financial return on the investments because getting our funds back will provide resources for other projects and will also demonstrate that these projects are worthwhile. However, financial return is not our main objective and we pay less attention to it than to social return." Said another: "Financial return is only 10% of our priority for this fund. The main purpose is social." Obviously, investors with these two different sets of priorities may not see the same blended value as equivalent.

SEAF has developed a different methodology that distinguishes the Financial Rate of Return (FRR) to the investor from the Economic Rate of Return (ERR) to society. The ERR is calculated by dividing the total socio-economic benefits of the investment for all stakeholders by total investment costs. In contrast to the REED case described in Chapter 5, SEAF includes many more attenuated impacts, such as a ten-year projection of future benefits, the impact on other businesses and competitors in the region, and

20 Calculated at the prevailing global price of $5/ton for trading carbon credits.

21 At a high level, this approach requires six steps:

1. Calculate the economic enterprise value of the company by conducting a discounted cash flow analysis of the business performance.
2. Calculate the social purpose value of the enterprise by estimating the socio-economic results of the enterprise's efforts and calculating a discounted cash flow analysis of these results. For this approach, socio-economic results include public cost savings (e.g., decreased welfare expenditures) and increased revenues (e.g., increased taxes, increased job income).
3. Calculate the blended value of the economic and social purpose results by adding the economic enterprise value and the social purpose value and subtracting any accrued long-term debt.
4. Calculate the enterprise index of return by dividing the enterprise value by the investment amount made to date.
5. Calculate the social purpose index of return by dividing the social purpose value by the investment amount made to date.
6. Calculate the blended index of return by dividing the blended value by the investment amount made to date.

For more information, see Gair, Cynthia, *A Report From the Good Ship SROI*, redf.org.

even estimated economic values of the social benefits. In order to monetize these benefits, SEAF must make detailed assumptions that are highly customized to each investment and its context, and this limits the potential for standardization or comparison with other investments.

Most social investors we interviewed did not attempt to develop a single comprehensive measure, viewing the time and effort required as prohibitive and expressing concern that the complexity, assumptions, and estimations necessary would ultimately reduce investor confidence in the results. "Blending returns is an interesting but undeveloped art that is prone to 'black box' problems. The assumptions underlying them are critical and doubt about them can swamp discussions of meaning and the impact being achieved – many in the field are skeptical about this approach."

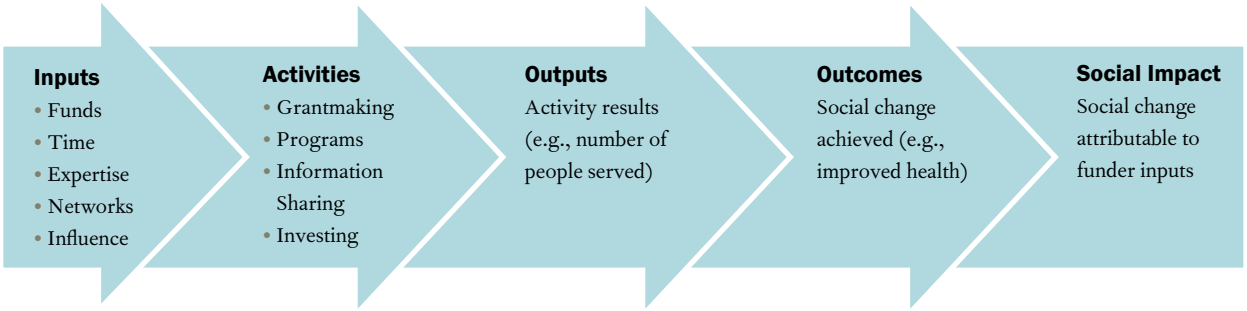
Figure 8 Sample quantitative output indicators

Increase in the number of households with access to energy (or cleaner energy)	Number of women-owned businesses participating in a program
Number of bednets sold	Reduction in kerosene used
Number of microfinance borrowers	Units of affordable housing built
Hectares of forest saved (by not using firewood)	

Sample qualitative outcome indicators

Improved health due to use of cleaner fuels	Reductions in CO_2 released
Quality of life indicators, such as increased time spent with family	

Figure 9 Summary of social impact chain



Social and environmental benefits

Unlike socio-economic benefits, social and environmental outcomes can rarely be monetized. They may include benefits such as improving the quality of life, influencing government policy, expanding the rights of women, preventing deforestation, or preserving biodiversity (see Figure 8). Often, it is possible to count the *outputs* of these efforts by measuring the level of activity such as the number of lives touched, products distributed, or area of habitat protected. Output measures are one predictor of impact, and they are easily tracked. However, tracking outputs is not the same as measuring *outcomes* – one may, for example, obtain a microfinance loan without necessarily increasing household income. Nor are outcomes the same as *impacts*, which require evidence that the outcomes would not have been achieved but for the intervention of the funder or investor (see Figure 9).

Most of the investors we interviewed, therefore, track outputs as a proxy for quantitative measures of social or environmental impacts and do not attempt to track outcomes or impacts. In addition, they usually supplement these statistics with a narrative description to give some sense of the program's less tangible outcomes.

If multiple investments are made with the same goal, such as different vehicles for financing affordable housing, there may be an opportunity to compare relative performance on an identical set of indicators. Even then, however, one must be sensitive to contextual differences that may affect the outcomes due to external circumstance beyond the investee's control, such as differences in the regional economy or housing supply. As one investor reported: "There is a constant struggle to present information in a comparable format across all projects while still keeping the appropriate level of context for each."

The fact that social investors have such varied social goals has implications for investees as well. Assuming a social investor is the only funder of a project, he or she can designate which performance indicators should be used. If multiple social investors with differing goals are engaged, however, the investee may not only be required to report on multiple sets of performance indicators, but might also feel pressure to pursue conflicting objectives, undermining his or her success. One must be especially sensitive to this issue when attempting to leverage funds by bringing in other investors.

Although social and environmental impacts can often only be described qualitatively, several of our interviewees stressed that this does not lessen their importance and recommended allocating equal weight to reporting qualitative and quantitative measures.

5 CASE STUDY: RENEWABLE ENERGY ENTERPRISE DEVELOPMENT (REED)

Background

In 2000, the United Nations Environment Programme, in partnership with the United Nations Foundation and E+Co, developed an initiative called Renewable Energy Enterprise Development (REED) which provides financing and business development support to small and medium-sized clean energy enterprises in Africa, Brazil, and China. E+Co manages the program in each country and provides business development support and seed capital to the investees. After thorough research and development, REED built a performance evaluation approach that carefully considers the full range of investment impacts from both quantitative and qualitative perspectives. REED's measurement approach is one of the most thoughtful examples we have uncovered in our research.

The program makes two- to five-year loans ranging from $30,000 to $250,000 with interest rates ranging from 7% to 12%.[22] Beyond the financial return on capital, REED has explicit environmental, social, and socio-economic goals.

- **Environmental goals.** Increase access to clean energy, reduce greenhouse gas emissions, prevent or reverse deforestation.
- **Socio-economic.** Contribute to economic development through the growth of small and medium-sized enterprises, increase employment and income, reduce the cost of energy to customers.
- **Social goals.** Improve quality of life through better working conditions, increased training, better health from the use of less harmful fuels, and less time spent obtaining fuel for homes.

22 At the time of the study, after roughly three years of investing, only 5 out of 30 loans had defaulted.

Figure 10 Performace indicators

PERFORMANCE TYPE	PERFORMANCE INDICATORS
Financial	• Return on investment • Financial performance of the investee enterprise (e.g., sales, gross margin, net profits, increase in assets)
Social	• Improved health of consumers from use of cleaner energy • Enhanced quality of life for consumers from spending less time obtaining other sources of fuel
Socio-economic	• Additional jobs created by the enterprise • Increased income of enterprise employees • Customer cost savings from access to cheaper energy sources • Increased income for related industries • Additional financing raised by enterprise as result of REED/ E+Co's investment
Environmental	• Greenhouse gas offsets (tons CO_2 equivalent), valued at the price of carbon credits traded on the global market • Deforestation avoided or forest reclaimed (hectares)

Indicators

For each of these goals, REED establishes a small number of performance indicators that relate directly to the goal. They then measure the baseline level of each indicator during the due diligence process before the investment is made. Figure 10 lists the indicators that REED uses, although not all indicators are relevant to every project.

All of the financial and socio-economic indicators can be quantified in monetary terms. However, REED does not attempt to monetize the social and other environmental impacts. Instead, these benefits are assessed and reported qualitatively and, in its report, REED places equal importance on both quantitative and qualitative measures.

REED's local program officers collect the financial and operational data from investees and enter it into a standard format as part of their regularly scheduled visits. REED has found that these program officers are sometimes called upon to provide capacity building for the enterprises so that they are able to record and report financial data properly.

REED works closely with its investee enterprises to ensure that its measurement demands are not a burden and its capacity building assistance helps to ensure easier measurement in the future.

REED staff and consultants also interview a wide range of stakeholders:

- At the enterprise, they interview the entrepreneur and enterprise employees.
- In the external community, they interview customers, local community residents, suppliers, distributors, competitors, governmental agencies, and national utilities.
- Within REED, they interview the local program officers.

This wide range of perspectives enables REED to take a broad view of impacts, looking beyond the investee itself to the community and supporting industries.

During the interviews, REED's interviewers ask about the most important social or non-financial benefits that resulted from the investment. The responses are categorized, and REED reports the five most often cited qualitative impacts as part of its summary, along with a one-page narrative about the enterprise and the results of the investment. Although such an interview process can be time-consuming and costly, REED has found that the wide range of interviews provides a valuable holistic sense of the performance of the enterprise.

Performance measured

For each variable, REED measures only the increase over the baseline during the period from the time of investment to the time of the evaluation. On the basis of these calculations, REED is able to determine a cost-benefit ratio for each investment. Among the eight investments measured, the ratio of benefits to costs ranges from 1:1 to 70:1, averaging 9:1 for the selected investments overall.[23] These benefits are separate from and in addition to the financial return to the investor of the 7-12% interest earned on the loan.

REED acknowledges that there are many other environmental and social impacts that cannot be reliably monetized. Their goal is to calculate the minimum demonstrable benefit from each investment rather than to quantify the full range of benefits that may result. For example, they do not count the increase in employment after the term of the loan, even though this increase is likely to be continued for many years. Nor do they attempt to capture more hypothetical or attenuated benefits, such as savings in future health care costs due to improved health among consumers who switch to less noxious fuels. As a result, the REED analysis almost certainly understates the true social impact achieved by the program.

REED appears to have accepted the inevitable trade-off between completeness and credibility. Being able to demonstrate a minimum of $14 million in socio-economic and environmental benefits from a $1.6 million investment is sufficiently compelling that they have chosen an irrefutable methodology for a narrow definition of impacts, rather than aiming for higher returns by falling back on more speculative calculations.[24]

23 The costs include not only the capital invested, but $50,000 per investee in technical assistance provided by E+Co.

24 Note that the REED report is only a preliminary analysis of 8 successful projects out of a total portfolio of 30 investments. We do not know, therefore, whether the 9:1 return earned on these projects is representative of the portfolio overall.

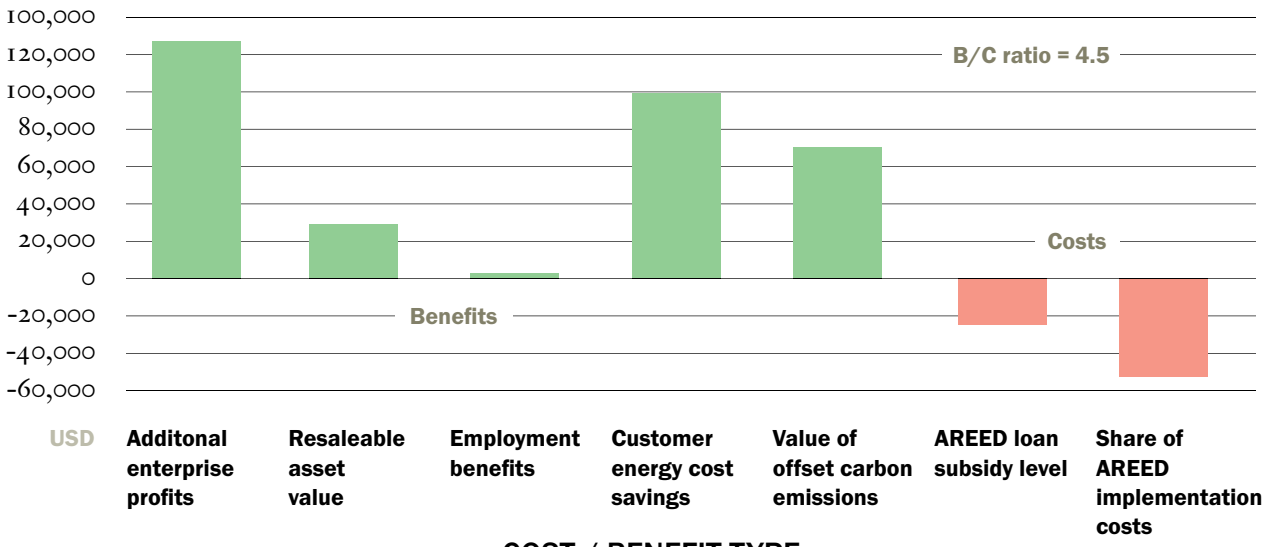
Sample REED Report

Tabular summary of project impacts

Management & Employees			
Average salary for additional staff, net of tangible benefits (USD/year)	360	# additional permanent staff directly employed by enterprise	2
Total value of additional wages and benefits to existing staff (USD/year)	760	# baseline staff at enterprise, benefiting from such increased wages and benefits	10
Provision of Service to Customers & Community			
Additional customer cost savings (USD)	98,500	Income creation for related industries (USD)	NA
The enterprise staff provide training to customers in the safe use of gas cylinders. This knowledge transfer has raised awareness on safety issues among customers, although many of those interviewed could not recall the specific details.			
Environmental Effects of Operations†			
Additional Greenhouse Gas offsets (tons CO_2 equivalent)	17,700	Value of additional Carbon Credits if sold, after transaction costs (USD)	71,000
Projected additional Greenhouse Gas offsets over loan term (tons CO_2 equivalent)	41,700	Projected value of Carbon Credits over loan term if sold, after transaction costs (USD)	164,800
Additional reforestation & avoided deforestation (hectares)	236	Projected total additional forest preservation over loan term (hectares)	560
Financials and Operations			
Annual sales (USD/year)	890,000	Annual sales (tons LPG/year)	2,050
Sales baseline (USD/year)	589,400	Sales baseline (tons LPG/year)	1,365
Gross Margin (%)	14.9	Net Margin, after tax (%)	9.7
Additional profits, after tax (USD)	116,300	Additional remuneration to entrepreneur (USD)	9,700
Profits reinvested for expansion (USD)	38,000	Increase in assets (resale value, USD)	28,000

† Offset GHG emissions are calculated using Government of Ghana data on household fuel consumption in Accra, customer survey data on previous fuel use of project clients, specific emissions data for substituted fuels collated in Kolominskas (2003) and assuming all new sales at the enterprise represent additional LPG consumption in Ghana, rather than customers switching from other gas providers. For valuation of the emissions, a CER price of $5/tCO2e is assumed and transaction costs taken directly from a CDM analysis of this enterprise in Medina-Gomez (2003). Avoided deforestation is calculated assuming that the forest used to provide urban woodfuel in Ghana has a density of 83 tons/hectare (FAO, 2004).

Quantitaive cost-benefit analysis



Qualitative impacts identified by beneficiaries

1	**More experienced and capable enterprise workforce, with transferable skills**
2	**Lifestyle benefits of improved energy supply – quality and time available for leisure**
3	**Creation of permanent jobs and improved working conditions for enterprise employees**
4	**Improved health conditions – through improved air quality, higher-quality water supply and extended community medical services**
5	**Customer cost savings leading to higher disposable household income**

Critical success factors

The project's commercial success is both impressive and key to the enterprise's most significant non-financial impacts. By focusing on a reputation for reliability, pushing to expand sales volume, and offering innovative new services like the auto-dispenser, the project is providing a boost to the LPG industry as a whole, which benefits from a reputation for profitability with investors. The improved investment climate is encouraging the growth of LPG supply networks. As improved accessibility of LPG increases household use in Ghana, displacing traditional fuels even outside of urban areas, huge social and environmental impacts are possible.

6 LESSONS LEARNED

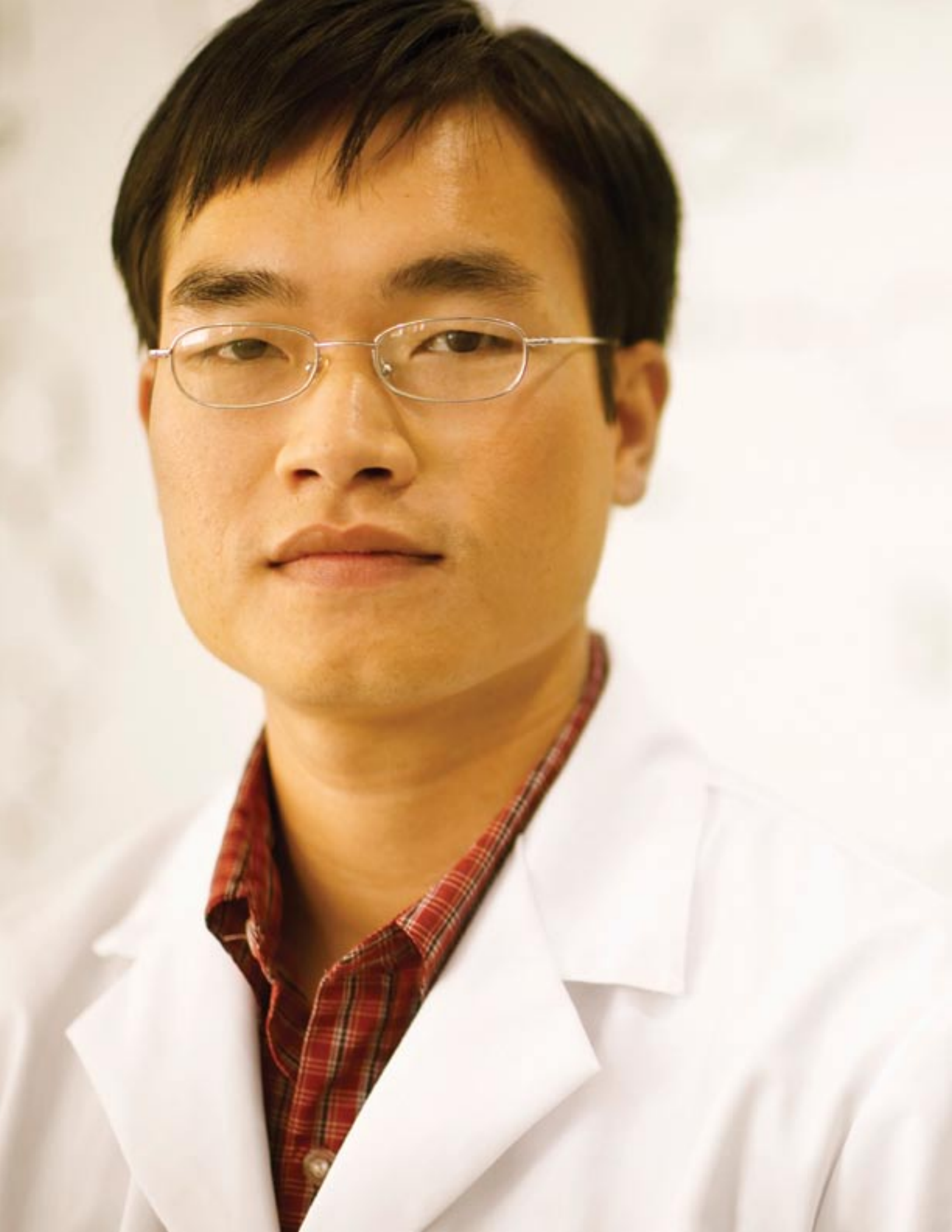
Four lessons for successfully measuring the performance of PSIs have emerged from our research.

Lesson 1
Establish clear performance targets and a baseline

Those investors who measure social, socio-economic, and environmental returns stress the importance of developing a "baseline" against which to measure net impact at the end of the investment period. The baseline is simply an assessment of the relevant performance indicators before the investment is made. As one interviewee stated: "If you don't have a baseline, you can't measure what you changed."

Ideally, the baseline will be established as part of the due diligence or business planning process at the outset of the investment. A number of organizations we interviewed had skipped this step and regretted it later when they realized that they were no longer able to assess fully the changes that were brought about by their investment.

In addition to the baseline, the most effective social investors we encountered had a clear understanding of their goals. By setting concrete targets for each dimension of performance – financial, social, socio-economic and environmental – these investors were able to identify the most relevant indicators to measure their progress. As one person said: "You need to decide up front what you want to



accomplish when you're selecting areas for investment, and then decide what to measure as outputs and outcomes."

Finally, clarity of goals at the outset makes it more likely that, in the well-meant effort to bring more money to a transaction, all investors in a project have the same definitions of success and will encourage the investee to act consistently.

Lesson 2
Concentrate on only a few simple performance indicators

Many of the investors we interviewed described a tension between wanting as much data as possible and the problem of overloading both their investees and their own staff with extensive measurement tasks. As the performance measurement process becomes more burdensome, it inevitably becomes more costly, less timely, and more likely to fail altogether. In general, data that are easily collected and readily available are preferable, even if the indicators are imperfect.

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If investees are forced to spend inordinate amounts of time collecting data or measuring performance, they will have less time to spend on executing and enhancing their operations. Said one interviewee: "We were too aggressive the first time we tried to measure social impact. We tried to measure far too many things and it didn't work. We have had to redesign our system and now we focus on just 3 to 4 indicators per business."

Several investors cautioned us that even when selecting only a few indicators, it is important not just to focus on quantitative results, but also to include qualitative measures. Finally, when identifying performance indicators, the investor should discuss with the investee how the data will be collected to ensure that both parties are comfortable with the process required.

Lesson 3
Allocate sufficient funding and staff time to assist in collecting the data

Respondents frequently cautioned us about the time and effort involved in implementing performance measurement systems, especially for non-financial benefits and for newer social investors who often begin by testing multiple measurement approaches simultaneously. Social investors who are serious about performance measurement must be prepared to invest the necessary time and funding for ongoing management. In some cases this resulted in below market-rate investment returns. In other cases, the investment was coupled with a grant to cover the cost of technical assistance or external performance measurement, and the grant was often equivalent to all or a substantial percentage of the investment.

Lesson 4
Report financial, socio-economic, and social/environmental benefits separately

In theory, comparing different investments on the basis of a single blended return would be ideal, but in practice it is extremely difficult. Some believe that such an analysis would be possible if only we had better measurement techniques, and there is indeed a great need for more standard approaches to performance measurement.

Our research suggests that there is an unavoidable subjectivity in the value accorded to social and environmental impacts. The degree to which people care about specific issues is what motivates them to engage in philanthropy or social investing and, as noted earlier, different social investors weight various social and financial benefits differently. Some put great emphasis on the financial return, others on one or another aspect of social

or environmental impact. Therefore, even if every aspect of social impact could be quantified, each component would have to be weighted differently for different investors.

It is also extremely difficult to quantify or monetize many social and environmental impacts; and even if a formula for valuing these impacts is developed, the methodology is likely to be complex, tied to subjective assumptions, and therefore open to question. Financial and socio-economic benefits are not interchangeable, even though both can be monetized. Our research suggests that it is preferable to value each type of benefit separately, using conventional quantitative measures for financial and socio-economic benefits, and using qualitative measures for social or environmental benefits – even at the risk of understating the overall impact of the investment – so that the final report is objective, readily understandable, and credible.

7 ADVANCING THE FIELD OF SOCIAL INVESTMENT

Proactive social investment is an activity that holds immense promise for foundations and other organizations dedicated to social progress, yet the field remains largely undeveloped. Most of the very limited funds in PSIs are simple low-interest loans to nonprofits which, while valuable, do not begin to exploit the potential for achieving program goals through investment activities. If the limited philanthropic resources of the world are to make any material difference in solving the vast social problems of poverty, disease, and environmental destruction, we will have to find ways to use every resource at our disposal. The hundreds of billions of dollars in foundation assets currently held in conventional investments are certainly one resource that must be tapped.

If social investment is to become widespread, several barriers must be overcome.

1. Better information must be collected about the financial performance of PSIs so that potential investors can accurately assess the risks and returns.

2. The confusing array of social investment options must be catalogued so that investors can easily understand the choices they face.

3. The constraints of fiduciary duty must be clarified as they apply to higher risk or lower return investments that serve the organization's program goals.

4. More intermediaries, pooled funds, or "prepackaged" options must be developed to reduce the staff time and transaction costs required for investors to participate in PSIs.

5. A standardized approach must be developed for measuring and comparing returns on social investments, including:

   a. Financial return and socio-economic benchmarks by asset class.

   b. Qualitative guides for social and environmental performance indicators.

   c. Technology that streamlines and automates the collection, aggregation, and reporting processes.

6. Better communication among those who are active social investors through the establishment of a forum for information sharing.

In conclusion, the field of proactive social investment is still in its earliest stages. Much more information needs to be collected about the current state of practice to inform and reassure new entrants to this field. Yet there is clear evidence that proactive social investments can yield reliable investment returns, preserve capital, and still provide significant social and environmental benefits. In short, social investments represent a new world of opportunity that has only begun to be discovered. It is our hope that this report will serve to stimulate further research and exploration.

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