

THE IMPACTASSETS HANDBOOK FOR INVESTORS

GENERATING SOCIAL AND ENVIRONMENTAL
VALUE THROUGH CAPITAL INVESTING

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5

Targeted Impact: Donor-Advised Funds and Impact Investing

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Many of those interested in impact investing come to the practice with thousands to invest—not millions. While those with larger asset sizes often turn to donor advised funds (DAFs) to augment their direct and fund impact investing work, perhaps the best part of DAFs is that they can act as a tool to help “democratize” impact investing since they are available to those of virtually any level of wealth. Even if one just wants to support a set of local charities through making annual gifts—and would also like to move beyond grants to leverage charitable dollars through impact investing—DAFs offer an effective way to expand one’s impact. Charitable giving is increasing annually in the United States and internationally and the expanding use of DAFs is a large part of that growth.

In addition to being a good tool to augment one’s other impact investing practices, DAFs are also appealing in that they allow the investor without a lot of support or infrastructure to “off-load” on to a community foundation or DAF intermediary (such as the groups profiled below) some of the paperwork, sourcing, reporting and other aspects of impact investing that can be onerous for individuals working on their own. For those who might otherwise create a family foundation, DAFs enable one to plug

into an existing administrative infrastructure to support your efforts, while decreasing the need to hire operating personnel to manage your philanthropic investments.

Finally, DAFs offer the impact investor an opportunity to “dip a toe” into impact investing by funding higher risk projects that may still be in seed or early stage development. Depending upon what institution you’re working with, your grants can cover research and development or program initiatives while the actual funds you have placed in your DAF may be simultaneously invested in a variety of impact investments, ranging from seed to growth to mainstream market-rate opportunities.

This chapter will help you understand how you may use DAFs to engage in impact investing and build upon your market-rate investments to advance positive change in the world.

The Donor Advised Fund, Defined

The Donor Advised Fund, commonly referred to as a DAF, is a tax-preferred philanthropic vehicle similar to a private foundation. A donor can establish one with an initial tax-deductible contribution, and then recommend the DAF donate funds to other non-profits at a later time. The arrangement allows donors to separate the timing of the tax decision from the giving decision, and to give money out over time while claiming a tax benefit in the year(s) most beneficial to her.

The resemblance to private foundations ends here. DAFs are offered by public charities that draw their support from many donors, whereas private foundations are endowed by one source. Private foundations must pay an excise tax on investment income, while DAFs are exempt from this requirement. Effectively, this means donors’ dollars may grow tax free. In addition, the cap on deductible donations to a DAF is higher than to a private foundation. Add to this: no setup fees, no annual accounting and tax filing, no requirement to provide 5 percent in grants annually, and low administration fees. And suddenly, DAFs become a very compelling philanthropic vehicle for many donors!

In 1931, The New York Community Trust established the first DAF to provide living donors with the comparable ability to support their community through their philanthropy. Until the early 1990s

DAFs were offered exclusively by community and public foundations and faith-based organizations. In 1991, Fidelity offered the first commercially sponsored DAF, and many mutual fund companies and brokerages followed suit. The growth in the field of DAF providers to include financial institutions offered donors the ability to closely tie their DAF to their overall financial plan.

In 2010, the total number of donor advised funds operating in the United States exceeded 152,000, with 72 percent of them established since 2001. As of 2015 the total number of DAFs operating is 269,180.¹ DAFs now outnumber private foundations by two-to-one and are the fastest growing charitable vehicle. As a result, the amount of money under management within DAFs is significant. In 2015, DAF assets totaled \$78.64 billion. This represents an 11.9 percent growth from a total of \$70.27 billion in 2014. These numbers continue a trajectory of double-digit growth in assets that began in 2010.²

Impact Investing, Philanthropic Capital and the Donor Advised Fund Opportunity

While impact investing may embody many aspects of traditional investing as explored elsewhere in this book, it also has other characteristics that make it of special interest to those using DAFs as part of a Total Portfolio Management strategy. First, investing for impact often requires a longer-term investment horizon—referred to as “patient capital”—than other mainstream investment strategies. The overall goal of impact investing is the creation of long-term, sustainable value for investors, stakeholders and the broader community and planet. The structure of impact investing vehicles often reflects that consideration for long-term total performance.

Second, impact investing values multiple returns. The level of return thought to be appropriate for these investments varies based upon the investor profile and what her long-term goals are through this investment approach. Generally speaking, investors expect a level of financial return, unlike in philanthropy where capital grants are not repaid. But that level of financial return may or may not be a full market-rate risk-adjusted return (i.e., the greater the risk of the investment, the higher the anticipated financial returns). The measure of social and/or environmental

return may also vary depending upon the type of investment (e.g., microfinance as opposed to, say, water or sustainable timber). In either case, the expectation is that there is a defined level of impact generated through the investment—not simply a general assumption of “good” or broad sense of “social return.” Again, this is an exciting and complex area of discussion within impact investing, but this general commitment to financial performance with social/environmental returns is consistent across impact investing.

Finally, the third component of impact investing is the commitment to take risks, to go where traditional market-rate capital either will not or cannot go due to the form of capital it represents. If one thinks of philanthropic capital as being invested in social solutions for market failures and mainstream capital as being invested in market opportunities, impact investing can be considered a bridge across the capital chasm between philanthropic and market-rate capital, leveraging the one against the other. And DAFs may serve as an excellent vehicle in this regard.

Impact investors often seek out ventures to invest in that have the potential to move toward greater market orientation over time but are today viewed as too risky or ill defined for traditional capital. For example, for many years microfinance institutions operated solely with philanthropic support and development aid while they refined their model of making microloans to small-scale entrepreneurs. Over time, they created a track record of both knowledge and lending experience. Those involved in microfinance soon were able to bundle their debt into bond instruments, which they could then offer on the open market. The result: microfinance exploded around the world. This process of moving from philanthropy to market-rate investing would not have been possible without impact investors placing capital in the middle, connecting the parts into a new whole that is today a multibillion dollar investment market bringing significant, appropriate capital to those who most need it.

As discussed above, a DAF is created when a donor allocates a pool of capital for charitable purpose into a defined philanthropic vehicle. A community or public foundation can manage a DAF, but so may a commercial market investment

management institution, a university or another entity. This philanthropic capital is money committed to “doing good” and creating positive social or environmental value in the world—as opposed to capital you invest in your child’s education, which you hope will demonstrate value in the future! Philanthropic capital may seed new nonprofit programs, support the expansion of existing organizations with proven records, fund public policy advocacy or support high-risk research that promises to cure the diseases plaguing humankind. Since it is money dedicated to promoting the welfare of others and our planet, philanthropic capital values social and environmental returns over financial gains. When one makes a philanthropic investment, one does not expect to receive funds back at some point in the future and instead entrusts the financial stewardship of that gift to the nonprofit organization receiving support.

Strengths and Benefits of Donor Advised Funds

The use of DAFs across the world offers a solid system of charitable giving, but it has its limits. For example, most private charitable funds only make use of their annual payout in pursuit of the mission. (In the United States, it is usually 5 percent of total assets.) The rest of the funds—95 percent!—are most often managed for the generation of financial returns alone. Therefore, the traditional philanthropic model asks donors to reserve 95 percent of their philanthropic investment for doing what those funds were originally doing: earning financial returns. But what if you could use all your philanthropic assets for the charitable purpose you intend? What if you could structure some or all of your funds to support the causes you care about while maintaining your commitment to a philanthropic strategy of charitable giving? That is the impact opportunity offered through DAFs!

DAFs are especially suited to an impact investing strategy for a number of reasons:

- Many DAF providers are small and nimble philanthropic institutions and well positioned to take on innovative strategies for advancing social and environmental agendas.

- Depending on the charitable purpose of the DAF, below-market investments—if selected—are exempt from the traditional regulations regarding prudent investor requirements.
- With a lower administrative cost level than that of most foundations, DAFs make it possible to spend more funds on due diligence and research to help ensure an effective impact strategy.
- If a donor selects a DAF provider with expertise in a certain area, the process is simplified, frictionless and extremely cost effective.
- Depending on the organization, DAFs are highly responsive to donor requests and interests, making it possible to engage in a deeper partnership to address areas of shared interest and concern.

All in all, a DAF makes it possible for donors to pursue philanthropic, impact and traditional investment strategies simultaneously through effective management of these three aspects of capital management. The setup also raises the prospective ability of investors to manage capital for total performance as opposed to simply managing three independent pools of capital.

Furthermore, the structure of a DAF offers donors many benefits:

- The potential pool of DAF assets is significant, totaling \$79 billion. If existing DAFs allocated 10 percent of their assets to impact investing, it could represent close to \$8 billion in investable assets for the field.
- DAFs have the potential to coordinate outside parties and aggregate capital from many accounts into impact investments.
- DAFs can work to educate their donors, who are in some ways a highly receptive audience for these types of strategies and may potentially create new generations of impact investors.
- The philanthropic capital in DAFs can take greater risks in backing social enterprises or innovative nonprofits than traditional capital could afford. Such capital could also take on a subordinate position in stacked deals, making possible organizational strategies that traditional capital or market-rate capital alone might not be able to accommodate.

- Because DAFs are aggregators of philanthropic capital, they have the potential to allow investors to manage assets across the capital continuum. By providing an easy, positive introduction to impact investing, DAFs increase the likelihood that donors will then build on this successful experience with their nonphilanthropic capital, thus further increasing the overall amount of capital moving into both philanthropy and impact investing. Plus, having funds granted and invested through one vehicle grants principals more fluidity in supporting the growth of a single organization or social venture using various forms of capital (i.e., one could make a seed grant to an enterprise and then provide a later stage investment to scale operations).
- DAFs involved in impact investing could function as an investor “on ramp”—making expanded use of capital already committed to improving the world and potentially recycle that capital for greater leverage, benefit and impact as any sound investor might seek to do.

Total Portfolio Management through Donor Advised Funds

The idea of linking commercial market investing with philanthropic goals may seem new and provocative; however, it is a notion that builds upon many traditional strategies for effectively managing assets.³ And the Total Portfolio Management approach is explored at length in the first chapter of this book. The core concepts may be summarized as follows:

1. Asset owners should seek to maximize the overall performance of their capital by investing across a capital continuum offering diverse strategies and instruments. This continuum ranges from philanthropic to below-market rate to fully market-rate capital vehicles.
2. Asset owners should have clarity on the unique purpose and goals of their investment—beyond solely financial returns—and these goals should be central to the investment process.⁴
3. The performance of capital should be viewed as consisting of various levels of financial risk and return combined with consideration of social and environmental returns and impact.

4. Consideration of investment opportunities should complement discussions of risk. In fact, investments in emerging markets—both domestic-US and international—are a cornerstone of many sound investment strategies.
5. The possibility of long-term, continuous zero or negative economic growth should be incorporated into an investment strategy by selecting particular sectors and companies where growth can occur rather than relying entirely on a function of rising per capita material consumption.
6. Considerations of risk should include traditional economic analysis as well as consideration of “off balance sheet” risk represented by environmental and social factors such as health, climate change, water and so on—factors that will continue to affect any company’s ability to execute its business strategy.

Current Examples of Impact Investing by Donor Advised Funds

A core group of leading DAF providers perform the bulk of impact investing by DAFs today. ImpactAssets, RSF Social Finance and Tides Network have pioneered these practices together with a small but growing movement of community foundations focused on more local opportunities. Impact investing activity among commercial DAF providers has, as yet, not been picking up much steam, though there have been modest, somewhat short-lived experiments at Schwab, Fidelity and Vanguard Charitable.

Specific examples of how this chapter’s authors, as leading DAF providers, are working to execute impact investing are discussed below.

ImpactAssets

ImpactAssets offers donors several ways to incorporate impact investing into their portfolios. These options range from ImpactAssets Community Investment Pool to direct investments in individual companies seeking social and environmental as well as financial returns. One can place the offerings into two categories: donor selected and donor sourced.

Donor Selected

While all investments offered to ImpactAssets DAF holders provide positive social and environmental returns in addition to financial returns, there are two that merit additional description. The first is Global Impact Ventures, a platform of private debt and equity impact funds donors may select. These funds offer a range of risk and return across various asset classes and impact issue areas, and are chosen by the top impact investment fund managers. For example, donors may invest in a fund that promotes sustainable agriculture in the developing world, a fund that encourages job growth in green industries in the United States, or a fund that provides capital to public media ventures.

The second is the ImpactAssets Community Investment Pool, a professionally managed portfolio of affordable loans to more than 250 leading nonprofit organizations and social enterprises working in 120 countries that focus on poverty alleviation in key impact sectors (e.g., affordable housing, microcredit, small business funding, and fair trade). By providing affordable capital, the Community Investment Pool offers investment minimums as small as \$100 for the option of participating in an impact investment strategy.

3 Ways to Help

Express Opportunities is a partnership between Express Credit Union and Express Advantage in Seattle. Express Credit Union provides affordable financial services to low and moderate income families, helping them build assets and achieve financial security with products specifically designed for them. Express Advantage, their non-partner nonprofit, coordinates financial literacy & education, credit counseling, and language support.

Through her donor advised fund, an Impact Assets donor made grants to Express Advantage. However she wanted to do more. After all, once people understand how to manage their finances and improve their credit, they still need tools to actually do it! Express Credit Union provides affordable car loans and credit building credit cards—the exact tools people need to actualize what they learned from Express Advantage. As a credit union, Express Credit Union is not eligible for a tax-deductible grant. However the donor was able to support the credit union by making an investment directly from her DAF. These investments allow them to increase their capital base, providing more loans to their members. And lastly, the donor also personally helped grow the institution as a direct consumer by taking a car loan out from Express Credit Union. The interest she pays on that loan is part of the earned revenue that sustains them.

Donor Sourced

ImpactAssets also offers its donors the ability to source their own impact investments. These investments have ranged from a dairy cooperative in New England to a credit union in Seattle to a company utilizing mobile technology to enable convenient and affordable financial services to the “last mile.” One particularly compelling example is Village Capital, a nonprofit dedicated to increasing the success of social entrepreneurs worldwide by providing funding and peer support organizations to social innovators. Village Capital established a DAF with ImpactAssets to make 20 direct investments annually in companies that have gone through its social enterprise accelerator program and then selected by their peers for funding.

Finally, it is worth mentioning that for larger accounts, ImpactAssets will create a custom portfolio for a donor, thereby enabling them to target their entire philanthropic investment portfolio toward the realization of customized charitable goals.

RSF Social Finance

RSF Social Finance (RSF) began offering DAFs in 1984 as part of its strategy to provide impactful organizations with a variety of funding options and provide investors with the opportunity to engage in whole portfolio activation. RSF’s DAF offerings have evolved as the organization looks to achieve the deepest possible social impact. It does this by backing organizations and funds that are direct, transparent, focused on the long term and relationship-based. RSF has decoupled its investments from Wall Street, and it places a premium on opportunities that strengthen community ties, promote social entrepreneurship and enhance local economies. Areas supported include but are not limited to food and agriculture, environmental stewardship and livelihood improvement. RSF invests new DAFs in its Liquidity Portfolio. (RSF previously offered donor advisors an Impact Portfolio option, but is no longer accepting investments for this offering.)

Liquidity Portfolio

The Liquidity Portfolio is a low-risk portfolio designed to maintain account balances and allow for active grant making. The

portfolio is composed primarily of deposits with leading community development and environmental banks, as well as bond offerings that support economic development projects, affordable housing and environmental initiatives. One portfolio company, Southern Bancorp, is the largest rural development bank in the United States and has an approach to community development that combines banking with nonprofit services to reduce poverty and improve education.

Impact Portfolio

The Impact Portfolio aims to grow grant dollars by investing in institutional-quality funds and asset managers that generate competitive risk-adjusted returns. Investments include public and private debt, private equity, and real asset holdings that are consciously dealing with ecological concerns. One holding in the Impact Portfolio that demonstrates RSF's strategy is Elevar Equity. Unlike most private equity funds that invest only in microfinance institutions and then take all returns out of the local communities, Elevar invests in businesses that are adjacent to microfinance lenders, ensuring that more money is recycling within the local economy and that local entrepreneurs are getting more support. RSF is no longer accepting investments into this portfolio.

Tides Network

Tides Network is a philanthropic partner and nonprofit accelerator dedicated to building a world of shared prosperity and social justice, believing that everyone should have a quality education, access to healthcare, a sustainable environment and equal rights. Tides provides its donor partners with philanthropic grantmaking and impact investments opportunities at the intersections of these areas, including granting to nonprofit organizations and investing in social enterprises that address racial and economic justice, LGBTQ and global development issues.

Tides begins the investment management process with the recognition that its responsibility includes not only the traditional goals of maximizing return, minimizing risk and portfolio diversification, but also of benefiting the environment, addressing issues of social and economic justice and promoting healthy

communities and societies. Tides' individual and institutional donors invest into various impact-oriented strategies across multiple asset classes. As of March 2017, the following portfolios available to Tides' donor-clients represent over \$200 million in impact investments. Clients may invest in:

- a diversified portfolio of equities and fixed income of companies that undergo a comprehensive analysis of company policies and practices to assess their impact on employees, society and the natural environment;
- a fossil fuel free portfolio of equities and fixed income of companies that are not overly dependent on fossil fuels;
- a fixed-income portfolio of overlay strategies in impact areas of gender equity, education and environment; or
- a private equity strategy that focuses on philanthropy for its impact area.

In addition to the above fund offerings, Tides Network also facilitates investment of donor-client funds through Mission-Related Investments in individual for-profit social enterprises that target specific social and environmental impact areas. Tides has made equity investments in innovative green businesses (biochar), fair trade and sustainable business ventures; film and video projects (*Years of Living Dangerously*); and nonprofit real estate and green shared spaces developments (Thoreau Centers in San Francisco and Manhattan). Tides has also made direct loans to nonprofit organizations and microlending institutions, as well as direct land purchases to protect land or to provide nonprofit retreat facilities.

Community Foundations

In addition to the three organizations profiled above, a number of community foundations are also taking on innovative approaches to investing DAF dollars in their local communities.

The Seattle Foundation has invested in three loan funds. One focuses on addressing the needs of small businesses, primarily those operated by immigrant and minority owners, and

fostering entrepreneurs with the goal of creating jobs and investment. Another targets commercial or mixed-use projects that support small business development. The third invests in multifamily housing energy retrofits that support job retention and creation and conserve energy and water. These funds are open to Seattle Foundation DAF holders at a \$25,000 minimum. The Seattle Foundation is also exploring higher-yield mission-related investment options.

The Greater Cincinnati Community Foundation is also a leader in the field. They began making impact investments in 2008. And with a grant from The Rockefeller Foundation, the foundation documented its efforts via a toolkit that other interested community foundations could use to follow suit. As a result of this work, the Greater Cincinnati Community Foundation has seen a significant uptick in both donors—several new DAFs have opened up—and interest from grantees. It even started a new grantmaking program to help nonprofits increase their capacity to become “investible.” The Greater Cincinnati Foundation invests only in Cincinnati, and only in funds—not directly in companies. They endeavor to tie investments to their donors’ passions: education, arts, the environment, and health care. It has been challenging for the foundation as many local investment opportunities come from the community investment world and do not address these particular passions. Ultimately, they aim to create another toolkit for community foundations to use for rolling out place-based impact investing.

In spite of these and other inspiring examples, the vast majority of DAFs do not use their assets to further their philanthropic goals. There are many reasons for this. However, it has to do primarily with a lack of donor awareness and demand combined with resistance to change at the management level of some community foundations. Commercial investment management DAF providers such as Schwab and Fidelity have built their reputations by investing conventionally. The clients they attract are drawn to them in part for this reason, so there is neither client pull nor management push for the adoption of impact investing. Community foundations are usually place-based, and the members of their investment committees generally are drawn from the ranks of the local successful business executives who, likewise, have built

their reputations on conventional investing. In each case, a lack of familiarity presents obstacles to adoption of impact investing practices.

Another reason for the dearth of impact investing from DAFs is the lack of regulatory incentives. Foundations are required to grant 5 percent of their assets annually and are allowed to count mission-aligned, below-market-rate investments or program related investments as part of their required payout. As DAFs do not have a required annual payout, there is no equivalent to a program related investment for DAFs and, therefore, little regulatory incentive to pursue impact investing strategies.

Future Opportunities for Donor Advised Funds and Impact Investing

In reflecting on where the future of DAFs and impact investing may find us, there are several areas in which we may see expansion:

- Community foundations could facilitate greater amounts of local investing. Expanding the financing of local community development financial institutions (CDFIs) is an easy first step for community foundations. They are FDIC (Federal Deposit Insurance Corporation) insured, operate in geographically bounded communities, and relend the capital to low-to-moderate income populations. While locally specific private equity or debt opportunities are limited, they are growing. For example, La Montanita Fund in New Mexico offers investors the opportunity to invest in a fund that makes loans to local farmers. Community foundations could also invest with fixed-income managers who select bond issues that support local projects such as affordable housing.
- Large, national DAF providers could offer loan guarantees to established social enterprises working at a global scale, such as Accion or FINCA.
- DAF providers could offer donors the opportunity to use their DAF assets to guarantee loans to local nonprofits. For example, Orange County Community Foundation donors can guarantee bank loans to local nonprofits. Since 2006,

this program has leveraged over \$20 million of bank financing with no defaults.⁵

- DAF providers could offer donors the ability to make investment recommendations as well as grant recommendations. Such an offering would require a rethinking of investment policies and fees, but those willing to undertake it would provide a great resource to donors and differentiate themselves from their competitors in what is a dynamic and growing DAF market. For example, a donor at ImpactAssets recommended an investment in her local dairy cooperative, which allowed her to use invested dollars to support her charitable giving in local food and sustainable agriculture.
- All DAF providers could expand their investment options to include impact investments. They wouldn't have to replace all of their investments with impact investments but could augment their options. By rethinking their investment policy statements to address the full complement of returns, DAF providers could mobilize a significant amount of the more than \$28 billion in DAF assets.

Impact investing through DAFs is an exciting, evolving edge of both philanthropy and investing. Individual donors interested in exploring these ideas should either engage the groups mentioned in this chapter or connect with their local community foundation to partner with professionals capable of assisting them in executing an effective impact investment strategy through their DAF. The potential leverage and impact donors can have upon their world literally has no limits!

Notes

- 1 National Philanthropic Trust 2010, Donor Advised Fund Report, Published 2010, Accessed April 4, 2017 <http://www.nptrust.org/images/uploads/DAF-Report-2010.pdf>; <https://www.nptrust.org/daf-report/market-overview.html>.
- 2 National Philanthropic Trust 2010, Accessed April 4, 2017, <https://www.nptrust.org/daf-report/market-overview.html>.
- 3 Most recently, in 2011 RSF Finance released "A New Foundation for Portfolio Management," which joins "Modern Portfolio Theory—with a Twist! The New Efficient Frontier" by Brian Dunn (2006) and "A Capital Idea: Total

Foundation Asset Management and The Unified Investment Strategy” by Jed Emerson (2002) as papers advancing new ideas regarding portfolio management and theory.

- 4 Please see “A New Foundation for Portfolio Management” by Leslie Christian (2011) for a deeper discussion of this topic.
- 5 Community Philanthropy Report, Published September 2009, Accessed April 23, 2017, <http://www.communityphilanthropy.org/downloads/Equity%20Advancing%20Equity%20Full%20Report.pdf>.