

THE DIVIDING LINES BETWEEN PHILANTHROPY AND INVESTMENT

There is increasing talk of a blurring of the boundary between the non-profit and for-profit sectors, of a continuum from philanthropy to investment and of a “middle ground” where trade-offs are readily made between financial return and social benefit. However, that has not been the historic norm. There have been, and remain, some major dividing lines.

Philanthropy can be characterized as the process of distributing “excess” income through contributions to charitable causes. The question is whether the investment function and the charitable functions need to be kept separate. Alternatively, should the investor, be it an individual or foundation, consider some investments that may have a lower targeted financial return, but that have a significant social benefit or charitable purpose.

The usual model is to keep the investment and charitable contribution functions separate on the premise that the better the financial return on the investment portfolio, the more “excess” income there will be for distribution to charitable purposes. I would argue that other models are acceptable under certain circumstances. However, it is not a simple blending of the functions. Rather, it requires an understanding and respect for several interrelated factors: fiduciary responsibility, regulation and tax considerations.

Defining Some Frequently Used, Yet Ambiguous, Terms

Venture Capital vs. Venture Philanthropy

Venture philanthropy is generally considered the application of business-like approaches to making contributions to non-profit organizations. A more cynical view would be that it is simply the adoption of buzz words by the non-profit sector in order to attract money from the Silicon Valley generation of millionaires who have made their money through venture capital.

Venture philanthropy borrows its vocabulary from venture capital and some of the analogies are valid. The growth of any initiative or enterprise, for-profit or non-profit, usually depends on financial “capital” (a.k.a. money) raised from outsiders. “Venture,” defined by Webster as “an undertaking that involves chance, risk or danger,” can apply to either sector; we know from experience that most new businesses and non-profits struggle and ultimately fail.

Some have argued that venture capitalists provide a model for building organizations and that this can be applied to developing organizational capacity in the non-profit sector. However, venture capitalists are not benevolent mentors who nurture young organizations and develop human capital. If all goes well, that will happen. However, that is not the objective.

Venture capitalists are financial investors who are in it for the money. They take big risks in exchange for the prospect of big financial returns. Because the success rates for new businesses are low, venture capitalists usually invest in several companies in order to diversify their risk. If problems arise, the venture capitalist may take an active - occasionally ruthless - role in management. Investments that don't work are sold or liquidated. After the successes are offset by the failures, the venture capitalist might expect to earn an average of 25-40% – or more.

Venture capital and venture philanthropy are, in fact, very different. There may be similarities in analytic approach, but the objectives are different. Wealthy individuals who have made significant money through venture capital may well be interested in turning their attention to philanthropy. However, that is not a basis for assuming that they will change their investment objectives and start to blend the two activities into one.

Socially-Responsible Investing

Socially-responsible investing can be categorized across a spectrum from full commercial return to little, if any, commercial return.

At one end is the practice of screening socially-negative investments out of an investment portfolio. This segment has been growing rapidly as investors have realized competitive returns. From 1997 to 1999 total assets under management in socially-screened portfolios increased from \$0.5 trillion to \$1.5 trillion, slightly less than 10% of the \$16.3 trillion in investment assets under management in the United States. A 1999 study of 183 socially-screened mutual funds showed that on average they generated returns slightly in excess of their non-socially screened counterparts for the past three, five and the year periods.

At the other end of the spectrum is the practice, albeit limited, of making investments where financial return is not a primary purpose, but rather social benefit is. Fiduciary responsibility prohibits professional investment managers, i.e., managers of mutual funds, endowments, pension funds, 401(k) plans, etc., from even considering this type of investment. Foundations can operate in this arena under a provision of the Tax Reform Act of 1969 which establishes a “safe haven” for investments that would otherwise be considered “jeopardizing investments” under fiduciary responsibility requirements. Individuals can make these types of investments, but tax consideration (discussed below) will usually argue against their doing so.

An intermediate category would be investments that are structured to offer a combination of financial (internal) rate of return (IRR) plus social (external) rate of return (ERR). Some socially-responsible investments may offer a full IRR while others may offer a somewhat lower, but still reasonable, IRR. The first may

be hard to find, but are easy to evaluate; full IRR plus some ERR equals more than just IRR. Those that involve some trade-off, a somewhat lower IRR but clear ERR, may be easier to find in the venture capital market, but are harder to evaluate.

Making venture capital investments that are not expected to generate a full financial return is mostly the arena of individual investors. When doing so they are often called “angel” investors because they “save the day” for struggling young companies and entrepreneurs. This type of “trade-off” investing can be treacherous ground for foundations, though, because such investments do not fall cleanly within either the investment or program areas. However, properly managed, they represent an attractive opportunity for the investment of “excess” income, particularly as foundations are coming under pressure to increase their pay-out ratios.

Considerations for Individual Investors

For the individual investor / philanthropist the two functions – investment and contributions - need not be separate. Presumably, the individual investor / philanthropist has already made the determination that s/he has, or expects to have, “excess” income that s/he will use for charitable purposes. This “excess” income is above some base level of income the individual retains for her/his own use. If this “excess” income is to be donated for charitable purpose, in theory it makes no difference to the individual investor whether s/he actually receives the “excess” income and then redistributes it or provides the charitable support directly through a lower IRR from a socially-responsible investment. The individual’s resulting net investment income seems to be the same.

There are two problems here. First, this requires some implicit calculation of the trade-off between IRR and ERR. However, it is difficult to factor cleaner air, better schools and a lower poverty rate into the calculus of risk and return. Secondly, in this so-called “middle ground” of trade-off between financial and social benefit there is a very definite dividing line – the tax deduction.

An investment that produces little or no financial return is no longer a good investment; it’s a bad deal. Only if the company is liquidated or sold for next to nothing will the investor will be able to write-off the full investment. The resulting tax deduction will be a capital loss, which generally will not be as valuable as a deduction against ordinary income. However, bad deals often remain among the “living deal”, surviving, but with little or no return and no ability for the investor to take a tax deduction.

Charitable donors – including venture philanthropists - like to think they are “investing” in good causes, but their expectations are very different from those of financial investors. They do have an important financial expectation, not

of an investment return, but of a tax deduction, and one against ordinary income. Used appropriately, the tax deduction can yield very favorable financial results.

Take, for example, a wealthy individual with \$1 million in adjusted gross income (AGI) for the current year, who lives in a place like New York City, where her total tax bracket is 50%. Assume this person is presented with an opportunity to invest \$500,000 in a new, socially responsible enterprise that is expected in the best-case scenario to be marginally profitable. The individual pays \$500,000 in taxes, invests the other \$500,000 in the enterprise, and has no cash left. If the enterprise performs as expected, the individual will be lucky to get the \$500,000 back at some point in the future, a 0% return. If a best case scenario materializes and the enterprise generates maybe a 5% compound annual return (low when compared to the stock market, which has generated average annual compound returns of between 10 and 12% over the past 75 years and much high returns in recent years), the person's investment might be worth \$814,447 in ten years.

On the other hand, if the \$500,000 "investment" is donated to a tax-exempt organization, it is deductible to a maximum of 50% of the giver's AGI. The individual then has \$500,000 in taxable income, pays \$250,000 in taxes and has \$250,000 left for investment. If this amount is invested in a venture capital fund that generates a relatively low 20% annual compounded return, it will be worth \$1,547,934 in ten years. The donation produces a much better overall result for the venture philanthropist and, therefore, may increase the "excess" income available for additional charitable contributions.

Considerations for Foundations

Foundation investments may cover a broad spectrum with varying degrees of social benefit considerations. In considering possible trade-offs between financial return (IRR) and social benefit return (ERR) foundations have other considerations – not tax deductibility, but fiduciary responsibility and regulation.

Socially-Responsible Investments

Some foundations now screen out socially-negative investments such as tobacco stocks and some also screen for other issues such environmental and employment policies. These standards may be applied to marketable securities and privately sourced venture capital deals. This is all within the endowment investment portfolio and function and is consistent with fiduciary responsibility.

Program-Related Investments

At the other end of the spectrum a few foundations such as MacArthur and Ford have become expert at making PRI's, private investments aimed primarily at furthering program goals. These foundations have established separate, specialized expertise for this in the program, not the investment, area. The investments are structured from the perspective of what a deal requires and can support, not what return the market would require. They usually take the form of low interest rate (1-3%) loans with few restrictions.

As noted above the governing regulatory consideration for PRIs is the Tax Reform Act of 1969. PRIs are exempt from the fiduciary obligations imposed on management of the investment portfolio, but have to meet three qualifying criteria: charitable purpose, charitable effect and investment return not being the primary objective. Foundations usually meet these criteria by considering PRIs only in conjunction with established programmatic areas of interest and doing PRIs only if there appears to be no commercial source of capital, sort of a "but for" test.

For foundation "pay-out" requirements (discussed below) a PRI counts towards the distribution requirement when made, but counts as a negative distribution when repaid. Therefore, whether initially funded with program dollars or dollars transferred from the investment portfolio, monies used for PRIs become and remain program dollars.

"Trade-Off" Investments

Investments that involve some trade-off between IRR and ERR should be acceptable under fiduciary responsibility considerations if the trade-off is not substantial. For these types of investments, though, the issues may be regulatory and operational.

Generally speaking, foundations are required to make annual charitable distributions in an amount equal to 5% or more of the investment portfolio. This minimum level was set in 1981 as an estimate of reasonable investment returns overtime in excess of a provision for costs and an inflation factor. This has significant implications when considering "trade-off" investments. If the foundation's investment income available for grants is normally at the 5% level, it would be penalized for accepting a somewhat lower IRR from investing in a project that has a significant ERR. This is because its distribution requirement will not be reduced accordingly; it will still have to distribute 5% even if that means eating into capital. Therefore, it is only with the "excess" return over 5% that the foundation can consider making "trade-off" investments within the investment portfolio.

Assuming the foundation does have investment return in excess of the 5% level, there is then the operating issue of evaluating impact and quantifying the

trade-off. It can be difficult to determine the impact of grant-receiving projects; evaluating the ERR in order to calculate a trade-off with IRR is even more complex. Under an investment return analysis the expected ERR should be projected in dollars in order to determine whether the investment trade-off is balanced. In reality this may be impossible and it is certainly not part of the normal investment evaluation function.

While this may sound like an argument for foundations forgetting about pursuing investment opportunities that may have significant social benefit, it is not. Rather, it is meant to make the case for making socially beneficial, “trade-off” investments outside the normal investment evaluation process, for making them in the same manner as PRI’s.

This would mean removing the funds for “trade-off” investments from the investment pool and moving them to program. Technically, they will then need to meet PRI criteria. This may require some “pushing the envelop” on PRI practices, but some of the lawyers with particular expertise in this area believe there is significant room to do so. Within the foundation a transition period may be needed. It will take time to gear up this new program investment activity. In addition, changes may be needed in compensation formulae for the investment staff so as not to penalize them for a reduced amount of investment funds under their oversight or, if they remain involved in the investment decision process for these “trade-off” funds, planned lower financial returns.

Conclusion

With the increasing talk of venture philanthropy and socially-responsible investing some are assuming that there may be a merging of investing and philanthropy, a so-called “middle ground”. In this new calculus investors might value social benefit as well as financial return and be willing to accept a blended return on investments comprised of a low financial return (IRR) and a significant social benefit (ERR).

The implications of this for arts and culture organizations, actually all non-profit organizations, would be substantial. Many organizations are now looking to create earned income ventures. Such enterprises may generate substantial earned income for the sponsoring non-profit organizations, but insufficient financial returns to attract commercial investors. If less expensive capital from PRIs and “trade-off” investments could be attracted to such ventures, the result would be increased financial resources and, therefore, increased financial stability for the sponsoring non-profit organizations.

The working assumption has been that the source of such “middle ground” capital will be wealthy individuals. While there undoubtedly will be instances of such “middle ground” investment, it is unlikely to become a major factor. What

has been ignored is the importance of the tax deduction, a very real consideration for wealthy individuals as they make investment and philanthropic decisions. This is likely to remain a major dividing line between their investment and philanthropy.

Foundations may be a more promising source of such “trade-off” capital. Although constrained by fiduciary considerations and regulation, foundations can make much more aggressive use of the “safe haven” provided under the Tax Reform Act of 1969 for PRIs. In this period of high investments returns on endowments and increasing pressure to increase pay-out ratios, foundations could allocate a portion of their “excess” investment return to a new program area, an area that would provide capital to for-profit as well as non-profit enterprises with significant social benefits. The investments would be structured primarily on the basis of what the enterprises need, not what a commercial investor would require. This could be in conjunction with an expanded PRI function.

Increased use of PRIs and “trade-off” investments by foundations would increase the capital available to enterprises that may be created by cultural and other nonprofit organizations. It would also increase capital efficiency within the nonprofit sector. Unlike grants, investment instruments that are repaid, and possibly with an investment return, are available for reinvestment.