

ULTIMATE IMPACT:

Unifying an Investment Portfolio within
a Donor Advised Fund

**An ImpactAssets issue brief exploring
critical concepts in impact investing**

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PRÉCIS

Donor Advised Funds (DAFs) have grown in use over recent decades, serving as the core philanthropic vehicle for community and public foundations and, more recently, being offered through commercial investment firms as a philanthropic option for clients. When linked with an impact investing strategy, the DAF may serve as a unique, focused asset management vehicle for creating a unified portfolio generating financial performance with social and environmental impacts. This Issue Brief introduces the concept and structure of DAFs and explores their potential as impact investing vehicles. The DAF as a core component of a unified investment approach is explored together with discussion of why DAFs are especially suited to impact investing. The potential for DAFs to expand options for impact investors is discussed along with possible barriers to their introduction.

THE DONOR ADVISED FUND, DEFINED

The Donor advised fund (DAF) is a tax-preferred philanthropic vehicle similar to a private foundation. A donor can establish a DAF with an initial tax-deductible contribution, and then recommend the DAF donate funds to other nonprofits at a later time. This 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 (or years) 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 a private foundation is 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. Additionally the cap on deductible donations to a DAF is higher than to a private foundation. Add to this, no set up fees, no annual

accounting and tax filing, no requirement to provide 5% in grants annually, and low administration fees, and DAFs become a very compelling philanthropic vehicle for many donors!

In 1931, The New York Community Trust established the first DAF in order 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 expansion of the field of DAF providers to include financial institu-

tions offered donors the ability to closely tie their DAF to their overall financial plan.

The benefits of DAFs have convinced many colleges, universities and cultural institutions to offer them, as well. The total number of donor advised funds operating in the United States now exceeds 152,000, with 72% of them having been established since 2001. 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 donor advised funds is significant. In 2009 DAF assets totaled \$25.2B, down from a high of \$29.4B in 2007 (compared to ⁱⁱⁱ private foundation assets of \$652.5B in 2007).

IMPACT INVESTING, PHILANTHROPIC CAPITAL AND THE DAF OPPORTUNITY

The term “Impact Investing” has grown in popularity over recent years. Other resources explore the term and practice of impact investing more thoroughly than space allows us here,¹ but the core aspect of investing for impact may be defined as investments that pursue various levels of financial return together with a defined measure of social and environmental impact. Impact investing may also be viewed as either a broad investment strategy informing how one manages all the assets within a given portfolio or as its own asset class, into which one allocates investments just as one might have an allocation to fixed income, hedge funds or private equity. Regardless of how one executes an investment approach, what is critical is a focus upon

intent—that impact is not simply a by-product of one’s asset management approach, but rather a deliberate outcome of one’s investing practice.

While impact investing may embody many aspects of traditional investing, it also has other characteristics. First, it often has 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/planet. Therefore, impact investing vehicles often fill a need for investment capital that is structured with consideration of not short term financial gain, but rather long-term total performance.

Second, since the goal of impact investing is the creation of financial returns with social and environmental impact, it goes without saying that an impact investing strategy values multiple returns. Again, other documents explore this notion in greater depth, but suffice it to say that what level of return is thought to be “appropriate” varies based upon the investor profile and what long term goals are being pursued through this investment approach. Generally speaking, a level of financial return is expected (unlike philanthropy, where the capital of grants are not paid back to those providing them), but that level of financial return may or may not be a fully, market-rate risk adjusted return (meaning, the greater the risk of the investment, the higher anticipated financial returns). The element of social and/or environmental return may also vary depending upon the type of investment (microfinance as opposed to, say, water or sustainable timber), but 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, a third aspect of impact investing is a commitment to take risks, to go where traditional, market-rate capital either will not go 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.

Impact investments often seek out ventures to invest in that have the potential to move toward greater market orientation over time but today are viewed as too risky or ill-defined for traditional capital. For example, for many years microfinance institutions operated solely with philanthropic and development aid support while they refined their model of making micro-loans to small scale entrepreneurs. Over time they created a track record of both knowledge and lending experience; and those involved in microfinance were able to bundle their debt into bond instruments, which could then be offered on the open market—and 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 which is today a multi-billion dollar investment market bringing significant, appropriate capital to those who most need it.

As discussed above, a Donor Advised Fund (or “DAF”) is created when a donor allocates a pool of capital for charitable purpose into a defined philanthropic vehicle. DAFs are managed by a community or public foundation, which may be operated by a commercial

market investment management institution, a university or other 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

which promises to solve 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 more than financial returns; in fact, when one makes a philanthropic investment one does not expect to receive funds back at some point in the future, but instead entrusts the financial stewardship of that gift to the nonprofit organization receiving support.

STRENGTHS AND BENEFITS OF DAFS

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 the annual payout (in the United States, usually 5% of the total assets) for pursuit of their mission. The rest of the funds—ninety-five percent!—are most often managed for the generation of financial returns alone. Therefore, the traditional philanthropic model asks donors to reserve 95% of their philanthropic investment for doing what those funds were originally doing—being managed for 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 Donor Advised Funds!

Donor Advised Funds 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.

- Again, depending upon 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. This also raises the prospect of investors being able to manage capital for total performance as opposed to simply managing three independent pools of capital.

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

- The potential pool of DAF assets is significant, totaling \$28bb (with \$10B DAF assets in the top 35 community foundations). If existing DAFs allocated 10% of their assets to impact investing that could represent close to \$3bb 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 sense a potentially highly receptive audience for these types of strategies and may potentially create new generations of impact investors.
- The philanthropic capital represented by DAFs can take greater risks in backing social enterprises or innovative nonprofits than traditional capital could manage—and such capital could also take 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 donors will then build on this successful experience with their non-philanthropic capital, thus further increasing the overall amount of capital moving into both philanthropy and impact investing. Additionally, having funds granted and invested through one vehicle enables more fluid use of different capital to a single organization or social venture to support growth (e.g., an investor could make a seed grant to an enterprise, then provide a later stage investment to scale into other locations).
- 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 recycling that capital for greater leverage, benefit and impact as any sound investor might seek to do.

UNIFIED INVESTING AND TOTAL PORTFOLIO PERFORMANCE

The idea of linking commercial market investing with philanthropic goals may seem new and provocative; however it actually is a notion that builds upon many traditional strategies for effectively managing assets. Issue Brief Number One, *Invest with Meaning: An Introduction to a Unified Investment Strategy for Impact*,² outlines core principles of Unified Investing while other papers offer ideas for a new theory of portfolio management;³ however, the core concepts are fundamental:

- Asset owners should seek to maximize the overall performance of their capital by investing across a continuum of instruments. This continuum ranges from philanthropic to below-market rate to fully market rate capital vehicles.
- Asset owners should have clarity with respect to the unique purpose and goals of their investment—beyond solely financial returns—and these goals should be central to the investment process.⁴
- 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.

- Consideration of investment opportunities should complement discussions of risk—in fact, investments in emerging markets (both domestic-U.S. and international) are a cornerstone of many sound investment strategies.
- 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.⁵
- 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.⁶

CURRENT EXAMPLES OF IMPACT INVESTING BY DAFs

The bulk of impact investing by DAFs today is being done by a number of leading DAF providers. ImpactAssets, RSF Social Finance and Tides have pioneered these practices together with a small but growing movement among community foundations to offer investments with local impact. At present, the only

impact investing activity among commercial DAF providers is Schwab Charitable’s “Double Give” program which allows donors to dedicate no more than 10% of their assets to guarantee microfinance loans offered by the Grameen Foundation.

Specific examples of how this paper's authors, as leading DAF providers, are working to execute impact investing include:

Impact Assets

ImpactAssets offers donors a number of ways to incorporate impact investing into their portfolios. These options range from Calvert Foundation's Community Investment Note to direct investments in individual companies seeking social and environmental as well as financial returns. They can best be thought of in 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 from. These funds offer a range of risk and return across various asset classes and impact issue areas and are chosen from 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 US, or a fund that provides capital to public media ventures. The second is the Calvert Community Investment Note, a pooled loan fund that makes low-interest loans to nonprofits and social enterprises worldwide. By providing affordable capital, the Community Investment Note offers investors of increments as small as \$1,000 the option of

participating in an impact investment strategy. And a similar note is offered by RSF Finance (further described below).

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 twenty direct investments annually in companies that have gone through a Village Capital social enterprise accelerator program and then been selected by their peers in the program.

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

RSF Social Finance

RSF Social Finance began offering Donor Advised Funds in 1984 as part of its strategy to provide impactful organizations with a variety of funding options and investors an opportunity to engage in whole portfolio activation. RSF's DAF offerings have evolved as the organization looks to achieve the

deepest possible social impact by supporting organizations and funds that are direct, transparent, long-term, relationship-based and have a focus on place-based economies when applicable. RSF makes financial investments that are decoupled from Wall Street and that are focused on relationships that support social entrepreneurship to create local living economies. Areas supported include, but are not limited to, food & agriculture, social equality, environmental conservation and livelihood improvement. Donor advisors are able to participate in one of two portfolios based on their grantmaking goals as follows:

Liquidity Portfolio

The Liquidity Portfolio is a low risk portfolio designed to maintain account balances and to allow for active grant making. The portfolio is comprised 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 US and approaches community development by combining 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. The portfolio consists of smaller funds where RSF can build strong relationships with the underlying organizations, thus decreasing risk exposure

due to the direct and transparent relationship. Investments include public and private debt, private equity and real asset holdings that are consciously and effectively dealing with the risks and opportunities of ecological limits. One holding in the Impact Portfolio that demonstrates RSF's strategy is Elevar Equity. Unlike most private equity funds that only invest 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.

Tides

Tides focuses philanthropic and financial investments on equity, education and the environment, especially in opportunities at the intersections of these areas, including nonprofits and enterprises that address racial and economic justice, LGBTQ and global development issues. Additionally, the organization ensures that its investment portfolio reflects these priorities and values by partnering on investment options that embody mission through purpose, communities and geographies served, and inclusion of diverse asset managers. Tides has directly invested over \$10M from DAFs, to date, in innovative socially responsible companies ranging from fair trade coffee to clean energy. They have also made low interest loans to microfinance institutions and nonprofits. Additionally, Tides donors have made significant investments in film related projects, including The Story of Stuff, Taxi to

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 ImpactAssets 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.

the Dark Side, Amreeka, and the production company Chicken and Egg Pictures.

Building on its strategic focus and investment experience, Tides is creating a pooled Mission Related Investing fund for institutional and individual donors to support investments in selected sectors. The fund will leverage the partnership of participating donors to support more aligned, impactful and sustainable work that furthers the mission of the network and provides solid financial and social returns. Tides is also launching new collective action funds (funds that accept contributions from diverse funding sources, such as government agencies, foundations, corporations and individuals) for collaborative grants and invest-

ments in gender equity and education, and engaging people across sectors on the role of social impact bonds in driving more evidence-based social change efforts in the United States.

Community Foundations

In addition to the three organizations profiled above, a number of community foundations are also taking innovative approaches to investing DAF dollars in their local communities. The Seattle Foundation, for instance, has invested in three loan funds: one focuses on small business development to foster entrepreneurship and address the needs of small businesses, primarily immigrant and minority

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

The Greater Cincinnati Community Foundation is also a leader in the field. They began making impact investments in 2008, and received a grant from The Rockefeller Foundation to document their work and create a tool kit for other community foundations interested in following suit. They have seen significant uptake both from donors (several new DAFs opened as a result) and from their grantees. In fact, they have started a new grantmaking program to help nonprofits increase their capacity in order to become “investible.” The Greater Cincinnati Foundation invests only in Cincinnati, and only in funds—not directly in companies. They endeavor to tie the investments to their donors’ passions — education, arts, environment and health care. This has been challenging for them as many local investment opportunities come from the community investment world and do not address these particular passions. The Greater Cincinnati Foundation has partnered with Imprint Capital to document their progress and present it to other community foundations through a series of webinars, and ultimately to

create a tool kit for community foundations to use to roll 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 a number of reasons for this, however it has to do primarily with a lack of donor awareness and demand combined with a resistance to change at the management level of some community foundations. Commercial investment management DAF providers such as Schwab and Fidelity have made their reputations on 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 are generally drawn from the ranks of the local successful business men and women 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% 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 DAFs AND IMPACT INVESTING

In reflecting on where the future of DAFs and Impact Investing may find us, there are a number of areas within which we may see real expansion of the initial ideas presented in this Issue Brief:

- ▶ 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 insured, operate in geographically bounded communities, and re-lend the capital to low to moderate income populations. While locally specific private equity/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 provide loan guarantees to established social enterprises at scale that are working globally, 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, the program has leveraged over \$20 million of bank financing with no defaults.ⁱⁱⁱ
- ▶ DAF providers could offer donors the ability to make investment recommendations as well as granting recommendations. This would require rethinking their investment policies and fees, but those willing to undertake it would be providing a great resource for their donors as well as differentiating 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 coop, 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 \$28B in donor advised fund 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 Brief, or connect with their local community foundation to partner with professionals capable of assisting them in executing an effective impact investment strategy through their donor advised fund. The potential leverage and impact donors can have upon their world literally has no limits!

FOOTNOTES

- ¹ National Philanthropic Trust 2010 Donor Advised Fund Report <http://www.nptrust.org/images/uploads/DAF-Report-2010.pdf>
- ² For a deeper discussion of this concept, please see, *Impact Investing: Transforming How We Make Money While Making a Difference*, Bugg-Levine and Emerson, Wiley & Sons, 2011.
- ³ Please see IA-Issue Brief Number One, titled *Invest with Meaning: An Introduction to a Unified Investment Strategy for Impact*.
- ⁴ 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..
- ⁵ Please see “A New Foundation for Portfolio Management” by Leslie Christian (2011) for a deeper discussion of this topic.
- ⁶ Ibid.
- ⁷ Ibid.
- ⁸ <http://www.communityphilanthropy.org/downloads/Equity%20Advancing%20Equity%20Full%20Report.pdf>

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