



MARKET-RATE SCHMARKET-RATE!

THE NEW RISK-RETURN PARADIGM

BY TIM FREUNDLICH

I've been increasingly interested in why people get so caught up in the pursuit of market-rate financial returns. Not surprised, mind you...just intrigued. Why, you might ask? Two reasons:

People and institutions make decisions of little financial sense all the time.

Individuals and institutions all over the world give away money to nonprofits—a financial transaction with guaranteed 0% returns and a loss of 100% of principal (minus one's marginal tax rate if getting a charitable deduction). And, they loan money to "friends and family" for all manner of questionable (ad)ventures, with unlikely repayment schedules at little to zero rates of interest. In short, a lot of pretty "unmarket-rate" financial transactions are going on around us every day. Folks are actively involved in an internal calculus on what else matters in addition to amassing maximum wealth, and drawing some lines in the sand about how much is enough.

Costs are externalized and therefore earnings are subsidized.

The above sort of concessionary transactions aside, what is market-rate anyway? We look at indices and benchmarks for equities and bonds—offered up as what the market will bear, what the status quo would expect. But, when an extractive industry pushes environmental remediation off onto future generations of taxpayers, what's a current investor to do with these skewed earnings? When a

big-box employer doesn't pay a living wage and forces its employees to tap social services and government health plans to make ends meet, immediately increasing an investor's tax bill, how is one to compute returns? Without true and full internalization of costs, market-rate benchmarks are often meaningless in an absolute sense.

"Market-Rate, Schmarket-Rate!" is therefore the story of an ongoing wrestling match, between investors and investments living somewhere in between the supposed dichotomy of philanthropy and market-rate, where conventional wisdom and Milton Friedman think nothing can survive. But, is this true?

There is an emergent crush of "unconventional market-rate" investment activity going on... it's all over the place and messy as hell. But does it make less sense than philanthropy? Is it harder to really understand its returns than those of a firm that's offloading much of its true costs beyond its financial statements? Those down in the trenches of tomorrow's capitalism think not. The current sensibility of risk-adjusted market-rate return flounders around on this foundation of irrationality, and runs into walls of doing things that make no sense, or off cliffs of the aforementioned externalities. But, it's no wonder the brave new world's capital market is having so much trouble firing on all cylinders—these investments ask fundamentally challenging questions of investors. Little zingers like;

How do we really define value and return? Can we cross the conventional lines that force either return maximization or philanthropy?

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How much financial return (and wealth) is enough? (What first world robber-baron wants to tackle this question? Although, it's worth noting that Bill Gates has given away 58% of his net worth.)

Simply put, today's investors face a challenge and an opportunity. By changing how we think about value within an investment frame, we can adopt the concept of "blended value,"¹ to utilize all available resources to promote environmental, social and financial equitability and sustainability. By changing how we define our appetite for returns, and shifting towards the concept of a "living return,"² we can begin to rebalance wealth in the world with consideration for how much is enough.

Conventional investing, and the subsequent creation of economic value, has by and large been viewed as an activity separate and distinct from efforts to create social value and positive environmental impact. The convention is that social responsibility of companies and investment managers is fulfilled by simply generating the greatest possible financial return, leaving it to each investor to then decide how best to "do good" with the profits, regardless of the social and environmental costs involved.

Essentially, we say, "Let's maximize the risk adjusted financial return in a vacuum, and then give it away later." But, then, we come back to the above discussion. Is that what we're supposed to be doing? Or, even, is that what we really are doing?

LET 100 FLOWERS BLOOM

The very language of "below" market sticks in one's throat. Those working in this emergent hybrid investment space therefore come up with new words such as "unconventional," "hybrid" or "blended value"—to provide breathing space for investments that deliver social or environmental returns to an investor, in exchange for some trade-off of risk or return.³ Examples include the full range of equity and debt placements in microfinance, cooperatives, community development and social enterprises. They reach a broad spectrum of activity, both in sector and geography. Let us explore some real world examples from the current field—ones that rewrite the conventional wisdom of risk and return, and carve out real estate between traditional philanthropy and investment:⁴

Education_ Associação Nacional de Cooperação Agrícola (ANCA) is a Brazilian cooperative nonprofit organization that represents the settlements connected with the Movimento Sem Terra (Landless Workers Movement). ANCA provides educational opportunities to school age children, as well as adults and community activists, by producing publications for the training and education of leaders in various worker movements. Approximately 7,000 books are sold each month, and that number continues to grow. ANCA has taken soft debt from a range of investors to provide working capital, and financing to its members.

Health_ Voxiva is a for-profit voice and data solutions provider that has developed new ways to use technology to address some of global health's most pressing challenges. From disease surveillance to adverse event reporting, Voxiva's applications allow public health agencies from Peru to Iraq to collect critical data from, and communicate with, front-line health workers in real-time, empowering them to respond immediately. Investors have

placed "patient" equity into this social venture to grow the budding enterprise.

Housing_ The Federation of Appalachian Housing Enterprises (FAHE) is an association of 30 nonprofit housing organizations producing affordable housing for low-income families across Appalachia, one of the most impoverished regions in the US. FAHE clients have a median family income of \$12,110. Cumulatively, FAHE groups have constructed or preserved almost 40,000 affordable homes. As a nonprofit, FAHE has been able to put to use millions of dollars in soft debt from investors to finance its housing activity.

Enterprise Development_ MicroVest is a debt and equity fund that invests in leading microfinance institutions throughout the developing world. It has raised limited partnership equity units to form a core of capital, to which it adds leveraged debt raised from individuals and institutions throughout the 10 years of the LP. It blends debt and equity, and private partnership and nonprofit structures.

Media_ The Media Development Loan Fund (MDLF) is a nonprofit organization dedicated to assisting independent news outlets in emerging democracies to develop into financially sustainable media companies. MDLF invests in a range of debt and equity placements to TV and radio broadcasters, newspapers, magazines, news agencies and on-line media across Eastern Europe, the former Yugoslavia, the former Soviet Union, Asia, Africa and Latin America. As such, MDLF is a revolving fund that takes soft debt from a range of investors.

These investments vary considerably; direct and intermediary, nonprofit and for profit, debt and equity. Yet all have one thing in common—they are examples of the rich landscape of activity that investors use to blend social, environmental and economic returns, while re-imagining the risk/return

paradigm. In so doing, they have created value both for the investor, the enterprise and the world.

And, though the rate or risk of these investments is perhaps out of line with the conventional markets, does that make their impacts less compelling? What if jobs are created and homes built, and funds come back whole, with even the most modest of returns, to be deployed over and over again? The new hybrid investment models growing up around the world posit strongly that it can be more efficient and effective to place this capital to work to effect change now, rather than maximizing returns for years on end to create a trickle of donor capital each year taken from the gains.⁵

The landscape can shift if we drive toward a new set of values and behaviors. Investment cannot be our only tool, but it is one of the more ubiquitous representations of underlying value, and as such, is a great opportunity to effect substantive change. By channeling investment dollars into new, hybrid propositions that re-imagine risk and reward, and support community development, microfinance and other social enterprises, we can drive significant social change.

The false dichotomy between philanthropy and maximized investment return is just that...false. ■

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