November 24, 2020

Accelerating Impact Investing for Foundations and Endowments: Aligning Your Leadership and Stewardship with Your Fiduciary Responsibilities

EXECUTIVE SUMMARY

Nonprofit leaders, particularly inside foundations and endowments, are increasingly interested in aligning their long-term investment portfolios with their stated mission. The opportunity to engage in impact investing has been a growing trend for foundations and endowments over the past decade. The implementation of impact investment strategies has been confronted with a variety of obstacles over the years that has created some resistance to the adoption of impact investing in the nonprofit community. This paper will introduce a potential solution for nonprofit leaders with investment responsibilities to accelerate their impact investing with the application of behavioral governance, which is a new body of research that studies the interrelationships between leadership, stewardship and governance.

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Introduction

Over the past decade, we have observed many nonprofit leaders after they have attended impact investing conferences and heard them identify an abundant list of potential impact investing ideas that get them very excited about the potential to change the world with their investment portfolios. Unfortunately, some of these same nonprofit leaders run into a wall of opposition when they propose their exciting new impact investment ideas to their investment committees, board members and fellow colleagues.

Well-intentioned people go to conferences and come back with some great ideas but then have a very hard time getting any results. Why is this? What are the obstacles to impact investing?

We have developed this research paper to help these nonprofit leaders identify the specific hurdles that they are encountering and offer some potential solutions that may help them to accelerate the impact investing strategy within their organizations.

We believe that the conflict between the desire for impact and the need for a prudent investment decision-making process is a chasm that can be overcome with thoughtful planning. We hope that a systematic approach to addressing the obstacles to impact investing will be effective in helping fiduciary investment decision-makers with a traditional investing perspective embrace the new world of high impact investing. Our research paper will explore the obstacles to impact investing for foundations and endowments and give the nonprofit leader some strategies to help their organizations to accelerate impact investment strategies for their long-term investment portfolios.

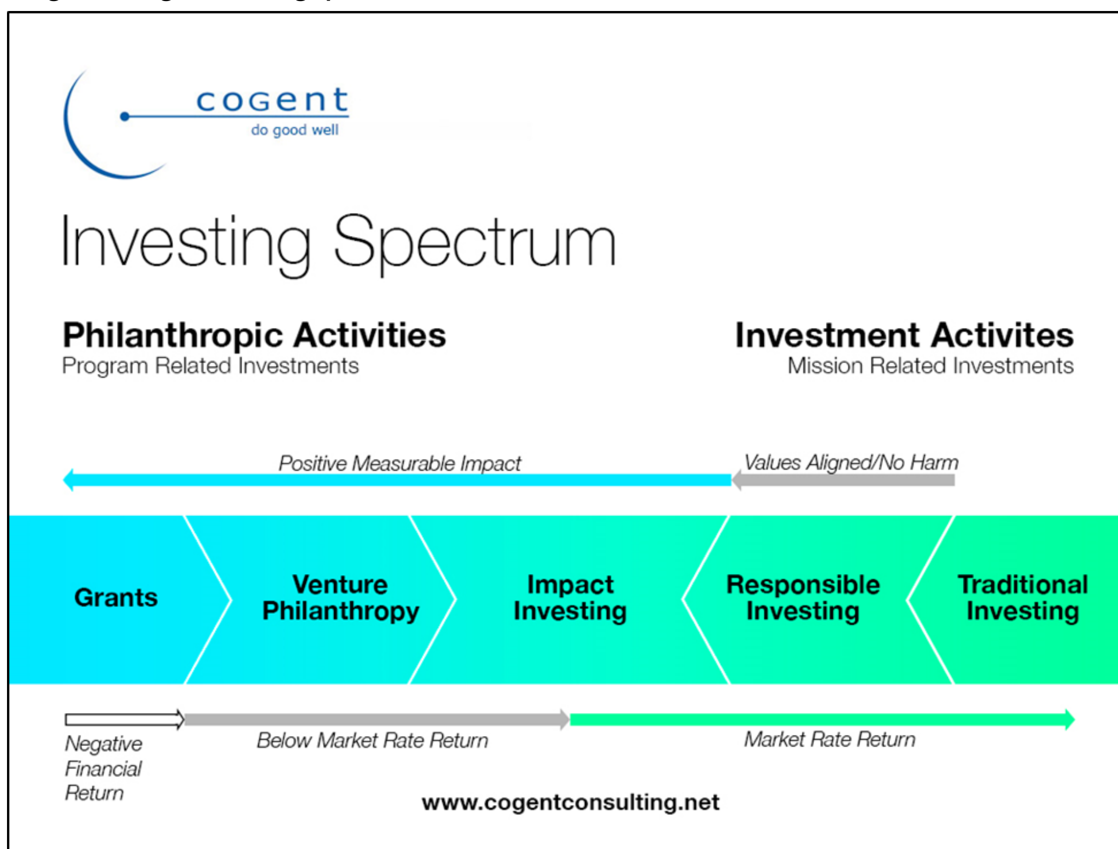
In particular, our research incorporates the concept of *behavioral governance*—a practical tool which might help nonprofits to begin and/or enhance their impact investment programs. Behavioral governance is a new body of research that studies the interrelationships between leadership, stewardship and governance. The quality of leadership and stewardship can influence the quality of the governance and the decision-making process. Impact investors must learn how to balance the desire for targeted impact with achieving a diversified investment portfolio. Research suggests that the application of behavioral governance concepts is one of the most important factors to attaining this balance (Waldman et al., 2013).[1]

While impact investing is an opportunity for both individual and institutional investors, this paper will focus on helping the investment decision-makers of foundations or endowments with a long-term time horizon. These institutional investors are often subject to the "prudent person rule" and the related concept of fiduciary duty to act in the best interest of the entity.

We will frequently be using the terms "responsible investing" and "impact investing" in this paper. For the purposes of clarity, we will be using the term responsible investing to refer to daily liquid investments in publicly-traded debt and equity investments. This would include mutual funds, index funds, exchange-traded funds (ETFs) and separately managed accounts (SMAs). Our use of the term impact investing is referring to less liquid private debt and equity funds and direct investments. While there are impediments to responsible investing in daily liquid investments, we believe that the hurdles to the illiquid impact investments are more difficult to overcome.

The following diagram from Cogent Consulting (Diagram A) allows the reader to better understand the possible investing spectrum and the relationship between the themes of traditional investing, responsible investing and impact investing.

Diagram A: Cogent Investing Spectrum



Impact investing does not always have to happen in the context of an endowment investment portfolio. For a more adventurous idea that is beyond the scope of this paper, Program Related Investments (PRIs) offer nonprofits and foundations the opportunity to invest as part of their programmatic activities to advance their mission. PRI investments are not made for the sole purpose of making money, therefore can make below market rate investments. When a foundation makes Program Related Investments (PRIs), these impact investments are completely exempt from all of the traditional endowment and fiduciary considerations. In the context of **IRS 4944**, PRIs are actually defined just to exempt them from the normal "jeopardizing investment" rules of the endowment. In other words, if a nonprofit is making an impact investment primarily to advance its mission (i.e. a PRI), it simply doesn't have to worry about fiduciary issues. See more on this topic in **Appendix C: Impact Investing through Program Related Investments (PRIs).**

At Allodium Investment Consultants, our perspective is that all investment service providers should be viewed as potential advocates for impact investing. We work with foundations and endowments to provide fiduciary education of board members, development of an investment policy, asset allocation strategy and due diligence research on investment managers. Our work includes interactions with different types of professional investment managers including mutual funds, index funds, exchange-traded funds (ETFs), and separately managed account (SMA) managers. We also provide research on more illiquid investment vehicles such as private debt funds and private equity funds. Collaboration between like-minded investors and investment professionals can contribute to the development of a viable impact investment program. Our view is that modern impact investors should be able to coordinate a team of professionals that can help to develop and implement an effective impact investment strategy for their organization. We hope that this document provides some ideas that will help you to accelerate impact investing within your organization.

Impact Investing

Impact investing is defined by the World Economic Forum Mainstreaming Impact Investing Working Group as an investment approach that intentionally seeks to create both financial return and positive social or environmental impact that is actively measured.[2]

Interest in impact investing has increased as investors become more aware of investment choices. Global Impact Investing Network (GIIN) defines impact investing on their website (https://thegiin.org) as: "Investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending on investors' strategic goals."[3] "The growing impact investment market provides capital to address the world's most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education."[4]

GIIN cites four characteristics of impact investing:

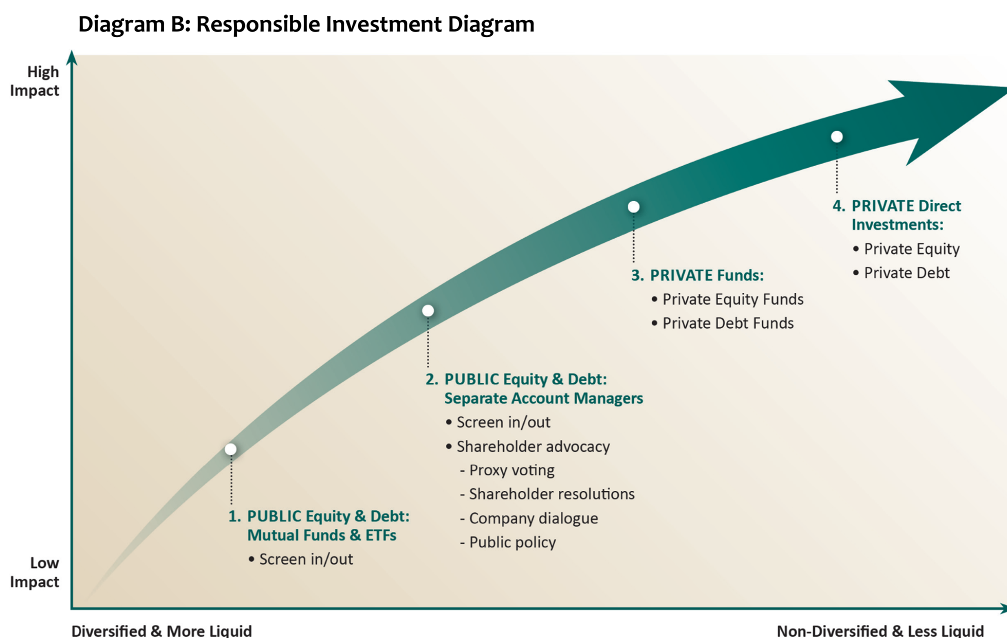
1. ***Intentionality:*** An investor's intention to have a positive social or environmental impact through investments is essential to impact investing.
2. ***Investment with Return Expectations:*** Impact investments are expected to generate a financial return on capital or, at minimum, a return of capital.
3. ***Range of Return and Asset Classes:*** Impact investments target financial returns that range from below market (sometimes called concessionary) to risk-adjusted market rate, and can be made across asset classes, including but not limited to cash equivalents, fixed income, venture capital, and private equity.
4. ***Impact Measurement:*** A hallmark of impact investing is the commitment of the investor to measure and report the social and environmental performance and progress of underlying investments, ensuring transparency and accountability while informing the practice of impact investing and building the field.[5]

GIIN also believes that impact investing challenges the long-held views that social and environmental issues should be addressed only by philanthropic donations, and that market investments should focus exclusively on achieving financial returns.[6] The impact investing market offers diverse and viable opportunities for investors to advance social and environmental solutions through investments that also produce financial returns.[7]

In recent years, nonprofit leaders have been asking for ways to incorporate impact investment strategies into their nonprofit organizations, but they are sometimes frustrated by their inability to get broad support to implement these ideas. While responsible investing has been a growing trend over the past few decades, and many nonprofit leaders are familiar with daily liquid investments like mutual funds, index funds and exchange-traded funds (ETFs), the desire to have even greater environmental and social impact is leading nonprofit organizations to consider non-publically traded securities which are illiquid. The risks of illiquid investment securities introduces a potential impediment to the implementation of an impact investment strategy. The dichotomy of the desire for greater environmental or social impact with the potential divergence from a disciplined fiduciary investment management program is a dilemma that needs to be addressed.

Responsible investors tend to get their feet wet initially with daily liquid investments. As they learn more about the benefits of shareholder advocacy and proxy voting they may add the use of separately managed accounts (SMAs) into their portfolios to allow them to "vote their shares" on specific impact issues. Eventually the responsible investors may look to have even greater measurable social and/or environmental impact with their portfolio which may lead them to add illiquid investments such as private equity fund and private debt fund investments. The ambitious high impact investor may then take on even more "specific stock" investment risk and illiquidity risk to maximize the impact of their investments by investing in private direct investments (see diagram B). The primary value of illiquid private direct investments is that they can focus on niche markets which allows the focused impact investors to direct their investment in a laser-like focus on a specific area of desired impact.

Diagram B: Responsible Investment Diagram



Obstacles to Impact

Responsible investors strive to align their investments with their core values, but sometimes run into "obstacles to impact"—the impediments or roadblocks that thwart the development of a responsible investment strategy. Identifying the challenges that you might face from both internal and external influencers is the first step to overcoming these obstacles to impact investing.

Sometimes the obstacles to impact investing come in the form of people and/or entities such as lawyers, accountants, regulators, financial advisors, investment advisors, investment managers, investment management consultants, board members, investment committee members, board chairs, executive directors, staff, influencers and other thought leaders.

There are many obstacles to impact investing. These are some common barriers to developing an impact investment strategy:

1. ***Lack of time.*** Smaller organizations with a small staff may have less time to devote to developing a robust impact investment strategy. This obstacle can be overcome by outsourcing the investment due diligence research.

2. ***Other priorities.*** The organization may have other priorities that are considered more important at the current time than to take on the responsibility of starting and/or developing an impact investment program. For example, in 2020, the COVID-19 pandemic reordered the priorities of many nonprofit organizations as survival of the organization became the number one priority.

3. ***Overwhelmed by too many ideas.*** The investment decision-makers are overwhelmed by too many impact investment ideas. There are numerous impact investment opportunities, but the work to develop a prudent investment decision-making process that allows for the decision makers to assess all of the information has not been completed. This issue can be addressed with objective investment due diligence research and a robust procedure for evaluating the investment ideas.

4. ***Resistance to adopting new strategies.*** Nonprofit leaders with investment responsibilities might not always be perceived as "early adopters" of new investment strategies.

5. ***Divisive politics in the culture of the organization.*** Political divisions can get in the way of intelligent, rational and unemotional discussion and deliberation.

6. ***Perceived higher risk for impact investments.*** A common obstacle to impact investing is the perception that there is an additional investment risk to impact investing. This perception is like a moat with a deep trench and a high wall. Nonprofit leaders often hear their investment committee members talk about fulfilling their fiduciary duty to manage investment risk by diversifying the portfolio by asset class. This understanding of fiduciary duty is commonly used by investment committees as a reason for not pursuing an impact investment approach. The traditional definition of investment risk is viewed as either risk of loss or volatility risk. However, new definitions of the role of the fiduciary are starting to include the concept of fiduciary duties to future generations. Investment decision makers must consider many more risk factors besides the risk of investment loss or portfolio volatility. They must also consider environmental, social and governance (ESG) factors that require the investment committee to predict the impact of the current investment holding on future generations. Investment risks are not one dimensional in terms of financial dollars and cents, but the environmental, social and governance (ESG) factors of the impact of the investment portfolio on the environment and on society should also be considered.

7. ***Fear of being cheated.*** Possible fears that a new impact investment will turn out to be a Ponzi scheme and that the nonprofit organization will lose their money may surface. Some unethical or criminal people will use the high demand for impact investing to take advantage of nonprofit organizations who do not have proper due diligence research procedures in place to identify potential investment scams. This risk is not necessarily limited to impact investing as incidents of fraud occur across all forms of investments. The impact investor's new focus on less-regulated and illiquid private fund vehicles requires additional, specialized due diligence and expertise. This risk can be mitigated with objective investment due diligence research.

8. ***Fear of "greenwashing."*** Investors may have diminished confidence in the impact investment manager's promises to actually provide an attractive investment with a positive impact on the world. Investors wonder if the investment managers will actually be able to deliver on the promises that are being advertised or if they are engaged in a technique called "greenwashing." Greenwashing is when an investment manager conveys the false impression that their investment management approach will provide positive impacts on the environment and society. It is an unsubstantiated claim that deceives investors into believing that the manager is providing a positive approach to impact investing. Investment managers that engage in greenwashing typically exaggerate their marketing claims in order to win new business from nonprofit organizations. The investment managers are capitalizing on

the growing demand for impact investing from nonprofit organizations who want to invest their portfolios in a responsible manner that aligns with their mission. This situation can potentially be avoided with objective investment due diligence research.

9. ***Fear that impact investments will perform poorly.*** Fear may affect new impact investors. Investment decision makers are afraid that the performance of the impact investments that they choose might lag behind the performance of more traditional investments. They are worried about the negative fallout in the future if outside observers compare the relative investment performance of the new impact investments with the more traditional investments that were in place prior to switching to the responsible investment approach.

10. ***Overwhelmed by too many impact investment choices.*** Nonprofit leaders may be overwhelmed by the number of different options of impact investments that are available in the current marketplace. There are thousands of different types of responsible investment choices in multiple investment vehicles — mutual funds, index funds, exchange-traded funds, separately managed accounts, private equity, private debt, individual companies, etc.—but there is no central location where all of these investment choices can be compared and evaluated. Due diligence research can be performed to bring clarity.

11. ***Biased sources of information.*** Education about impact investing may come from a biased source. Sometimes the nonprofit organizations are educated by the investment product providers which creates a conflict of interest between the product provider and the impact investor.

12. ***Difficulties in finding impact investment advice.*** Sometimes the existing investment service providers for the nonprofit organization are reluctant to help with the development of an impact investment program because it might require more time or work on their part. Nonprofit leaders will need to find out why the investment management consulting firms are reluctant to help. It could be that the investment service providers want to avoid the additional work or it could also be that they do not have the expertise in house to provide adequate due diligence research on illiquid impact investments. Either way, the astute nonprofit leader should be cognizant that their current investment advisor might actually be a potential obstacle to impact investing.

13. ***Either/or mentality between philanthropy and investing.*** Nonprofit board members may perceive a conflict of interest between the organization's ability to grant money to their chosen philanthropic targets and their opportunity for investing the funds for greater positive social impact. This "wall" between investment management and philanthropic activity creates an either/or mentality that produces resistance to implementing impact investment strategies. However, many nonprofit organizations are beginning to see that a balance between current giving and long-term impact investing is possible for thoughtful nonprofit organizations that make their decisions based on their values and mission. The nonprofit leaders are learning that they can build an investment portfolio that can generate a market return while producing or contributing to a social good.

14. ***Fear of loss of reputation.*** Reputational risk may be a consideration for foundations and endowments who are highly visible and held to higher ethical and social impact standards than other organizations. The investment staff may have to look very carefully at how they make impact investments and consider the potential for negative publicity on the investee.

15. ***Influence of federal and state governments.*** The Federal Government often influences responsible investing—especially as it relates to the Department of Labor and the oversight of ERISA law governing retirement plans. At the national level, the political pendulum tends to swing back and forth from one political administration to the next. Over time, it is likely that the role of impact investing will find a place in the retirement plans of American workers. At the state level, state law

and the state attorney general could potentially hinder impact investment programs, as the state government has a greater influence on nonprofit organizations.

16. ***Inertia and resistance to change.*** Even after researching the opportunities in the impact investment space, many nonprofits may be resistant to change and choose to stick with the status quo. Nonprofit leaders may wonder how to overcome the bureaucratic inertia in their organization in order to pave the way for a more impactful investment approach.

Questions to Identify Obstacles

Listening to the questions that are asked about impact investing by your board members, investment committee members and staff can help you to identify some of the specific obstacles to impact investing. Here are some common questions that the nonprofit leader might hear about responsible investing organized by the four steps of the investment decision-making process:

1. **Organizing Your Investment Decision-Makers:**
   - Legal: Do our bylaws allow for this new approach?
   - Fiduciary duty: Will we be in breach of our fiduciary duties?
   - Investment advisors: Can we find an investment advisor to help us?

2. **Formalizing Your Investment Strategy:**
   - Articulating core values: Will we be able to agree on what we care about the most?
   - Defining investment policy: What will be our responsible investment policy?
   - Defining impact metrics (benchmarks): How will we measure our impact?
   - Definition of terms: What do all of these acronyms and terminology mean?
   - Time horizon: Will we need to make long-term commitments?
   - Investment risk: Don't we need to take more investment risk?
   - Liquidity: Will we need our portfolio to have daily liquidity?
   - Diversification by Asset Class: Will we still diversify by the major asset classes?
   - Diversification by Market Sector: Will we still diversify by market sector?
   - Diversification by Individual Security: Will we still diversify by individual security?
   - Investment Cost: Will this increase our investment management costs?
   - Investment Performance: Will we need to sacrifice investment returns?

3. **Implementing Your Investment Strategy:**
   - Investment strategy: Will this new investment approach be prudent?
   - Access to Responsible Investments: How will we access responsible investments?
   - Investment vehicles: Are these investment vehicles appropriate?
   - Custodian: Will we need a new custodian?
   - Due diligence research: Who will help us to conduct the due diligence research?
   - Due diligence research: Who will document the due diligence research?
   - Due diligence research: Could we get swindled in a Ponzi scheme?
   - Due diligence research: Is the investment manager misrepresenting via greenwashing?
   - Due diligence research: How will we know if an investment is sustainable?
   - Due diligence research: Do we own companies that contradict the mission of our organization?

4. **Monitoring Your Investment Strategy:**
   - Reporting: Who will provide the periodic investment performance reporting?
   - Reporting: Who will provide the measurement of nonfinancial impact?
   - Risk management: Who will help us to manage our ongoing investment risk?

We believe that nonprofit organizations can overcome the obstacles to impact investing with the appropriate changes to their leadership, stewardship and governance practices. Don Trone, author and pioneer in the field of behavioral governance, has developed concepts at 3ethos that can be used to refine the investment decision-making process at foundations and endowments to accelerate their impact investment programs.

Behavioral Governance

Behavioral governance (BG) is a new body of research that studies the interrelationships between leadership, stewardship and governance. Research suggests that behavioral governance is the single most important factor that will determine your level of success.[8]

Don Trone, CEO and founder of 3ethos, has defined these three core components of behavioral governance:

1. ***Leadership:*** Leadership is the ability to inspire and engage others.
2. ***Stewardship:*** Stewardship is the passion and discipline to protect the long-term interests of others.
3. ***Governance:*** Governance is the ability to manage a prudent decision-making process.

The *behavioral governance framework* is designed to provide the details of these interrelationships.

Using Behavioral Governance to Accelerate Impact

Often, an impact investor is serving in a fiduciary capacity. What impact investors and fiduciaries share in common is the need to demonstrate both leadership and stewardship. It can be said that a *fiduciary is a steward cloaked in a legal shawl.* Fiduciaries have an outward orientation that takes the best interests of others into account.

For more than 40 years, the financial services industry has made significant investments in defining fiduciary best practices in an effort to support a prudent decision-making process. With such vast investments of time, money and people, one would think that we finally mastered the ability to develop exemplary fiduciaries. But something has been missing. In 2008, 3ethos began to study the factors that distinguish great fiduciaries. The presupposition was that there has to be more to being an effective fiduciary

As a starting point, 3ethos drew upon the research that was being conducted on the U.S. Coast Guard's response to Hurricane Katrina in 2005. In the first nine days of the crisis, the Coast Guard rescued 24,500 people. No other government agency put up a similar response.[9] People wanted to know, *what was the secret to the Coast Guard's success?* The research showed that the Coast Guard can demonstrate a well-defined ***ethos***—a balanced continuum between its core values, behavior, and decision-making. Applying these lessons to impact investing, great organizations can also demonstrate a balanced continuum between their leadership, stewardship, and governance.

Before we continue, it's important that we further examine certain terms:

Leadership is your ability to inspire and engage others. When leadership is missing, you'll find disengagement.

Stewardship is your passion and discipline to protect the long-term interests of others. When stewardship is missing, you'll find anxiety.

Governance is your ability to manage the details of a prudent decision-making process. When good governance is missing, you'll find confusion and uncertainty.

In 2015, research that was being conducted in the new field of neuro-leadership was added to this framework. The academic team conducting the research included Dr. Sean Hannah (a co-founder of 3ethos), Dr. Pierre Balthazard, Dr. David Waldman, Dr. Peter Jennings, and Dr. Robert Thatcher. The research team demonstrated that exemplary leaders have different brain mapping—they're wired to lead. They found that men and women who have a propensity to rise to leadership roles have greater neurological capacity in six areas.[10] These six areas include:

1. ***Procedural justice:*** The capacity for ethical leadership, particularly one's ability to enact a fair, just, and transparent process to resolve moral conflicts or to allocate limited resources.

2. ***Vision/Inspiration:*** The capacity for transforming leadership — the ability to connect with others and provide shared visions and strategies that engage, gain commitment and alignment, and inspire higher levels of performance.

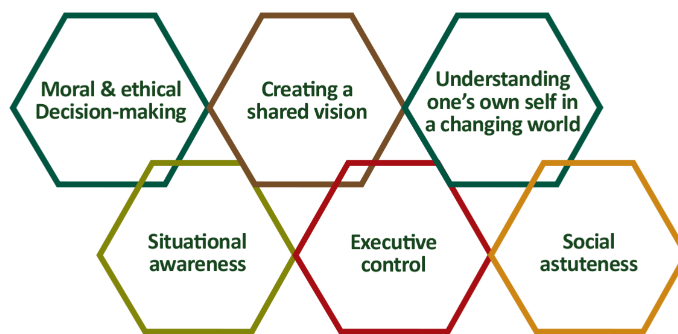
3. ***Self-complexity:*** The capacity to understand one's own self within changing roles and requirements, and the ability to adjust and adapt thoughts and behaviors to enact more appropriate responses to ill-defined, changing, and evolving situations.

4. ***Executive control:*** The capacity to regulate thoughts and emotions and to resolve conflicts between impulsive desires and adherence to the achievement of higher order and longer term goals.

5. ***Situational awareness:*** The capacity to: (a) perceive changes in one's environment, (b) interpret changes to determine whether and how changes may impact goals and objectives, and (c) make predictions as to how changes may impact future events.

6. ***Social astuteness:*** The capacity for: (a) social intelligence, (b) interpersonal influence, (c) networking ability, and (d) sincerity.

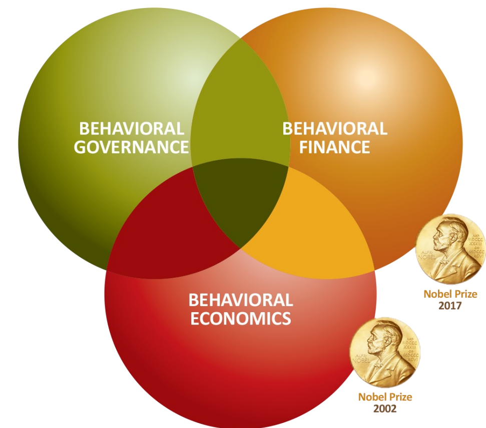
Diagram C: Areas of Neurological Capacity



When Don Trone and his colleagues began to map neuro-leadership to their leadership, stewardship, and governance constructs, they began to realize they were creating a new field of research. They decided to call this new research, *behavioral governance*, and positioned it as the third leg of the Behavioral Sciences stool.

1. *Behavioral economics* is the study of the behavior of capital markets.
2. *Behavioral finance* is the study of the behaviors of individual investors.
3. *Behavioral governance* is the study of the behaviors of key decision-makers (fiduciaries).

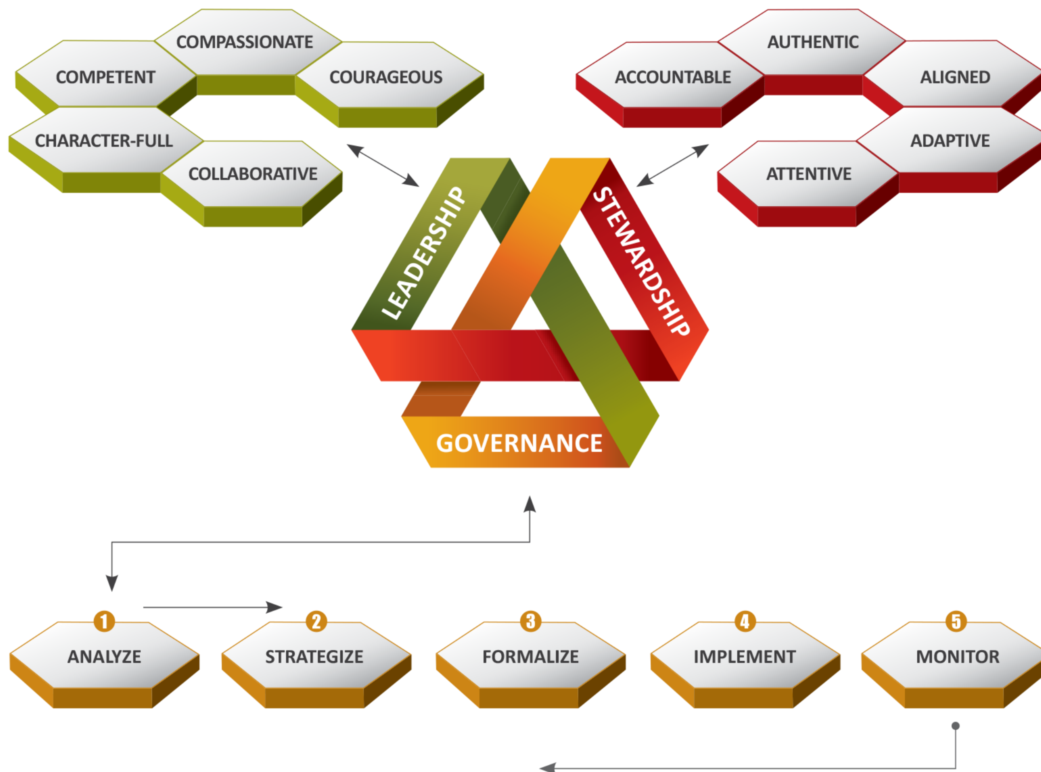
Diagram D: Behavioral Sciences



Behavioral Governance Today

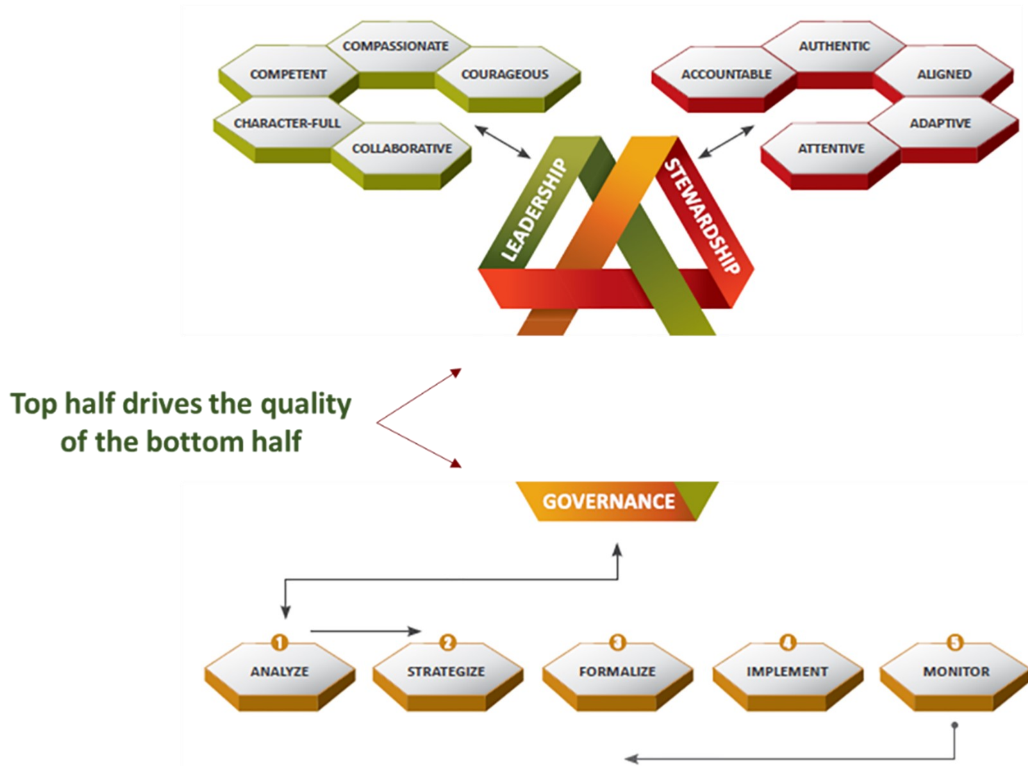
Their research has evolved, and today the behavioral governance framework consists of 15 elements: five leadership behaviors, five stewardship behaviors, and five governance steps. The leadership and stewardship behaviors are derived from the six neurological markers. These are outlined in Diagram E.

Diagram E: Neurological Markers



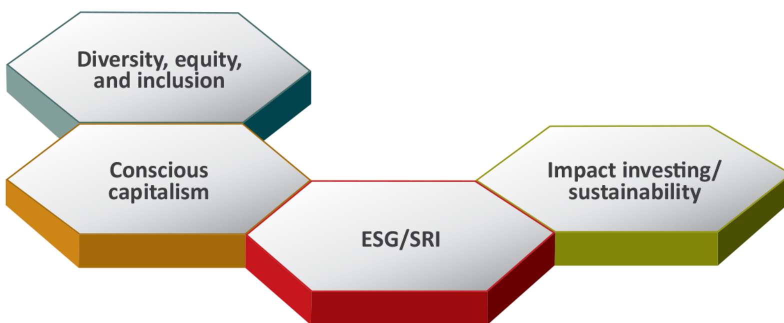
The research in neuro-leadership shows that the upper-half of the framework is going to determine the quality of the lower-half. There are certain leadership and stewardship behaviors that will amplify and improve the quality of a decision-making process.[11]

Diagram F: Neurological Framework



In regards to the obstacles to impact investing outlined previously, each obstacle can be more fully explained and avoided in the future by understanding where there has been a breakdown in behavioral governance. The odds are that an obstacle was the result of one or more shortfalls in leadership and stewardship that resulted in poor decision-making outcomes.

Diagram G: Purposes



In order for any worthwhile endeavor to succeed, your actions must flow from a place of integrity and sense of purpose.

There are two additional assumptions to the behavioral governance framework that are highly applicable to impact investors. These features include:

1. The framework is universal, and can be used to define a fiduciary standard for the investment committee; a governance standard for the board of directors; and, a project management standard for staff.
2. The framework can be used to substantiate any worthwhile endeavor.

Diagram H: Indigenous Fiduciary

By using the same framework for all key decision-makers, impact investors may be less likely to get in trouble. We believe most liability associated with impact investing is the result of an omission as opposed to a commission. It's not what the impact investor did… it's what the impact investor forgot to do.

Don Trone, CEO of 3ethos, has worked extensively with indigenous populations. In his experience, the behavioral governance framework can be applied to various cultures. Diagram H, the chart he developed, shows how behavioral governance looks through the lens of Indigenous wisdom.[12]

Outer ring: traditional Indigenous values of love, respect, bravery, truth, honesty, humility, and wisdom

Middle ring: *the binding of leadership, stewardship, and governance*

Inside circle: the guide whose sacred duty is to bind traditional values and wisdom to help develop leaders and stewards.

Behavioral Governance for Nonprofit Leaders

The behavioral governance model can be applied to nonprofit leaders and their organizations. Each of the three elements will be examined in detail with the five corresponding behaviors and steps.

Leadership

Leadership is your ability to inspire and engage others. When leadership is missing, you'll find disengagement.

The first step to developing an impact investment program is to define what impact investing means to the organization. An impact investment approach will be dependent on the values of the organization, therefore nonprofit leaders will need to clarify, refine and document their core values as a first step in developing an impact investing strategy. The nonprofit organization will often find the foundation for the impact investment program buried in the language of the mission statement for their organization.

Diagram I: Leadership

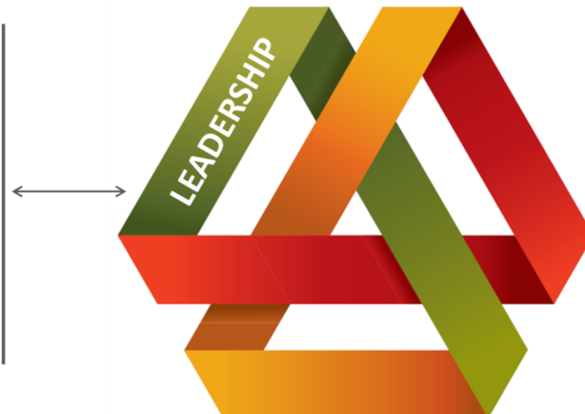
Courageous

Collaborative

Character-full

Competent

Compassionate



Nonprofit organizations may find that their current investment portfolio is invested in a manner that is in direct contradiction to the mission of the organization. For example, if a nonprofit organization is established to protect the environment and their investment portfolio includes individual stock holdings of the major air and water polluters in the world, the obvious question would be to ask if they could avoid investing in companies that oppose the mission of the organization.

A powerful action is for the nonprofit leaders to ask the question: Could our organization further our mission by including particularly positive investments in our portfolio rather than simply screening out the "bad" companies? For example, a social service organization established to promote poverty reduction might find that investing in microfinance debt to produce investment income for their portfolio might be a powerful impact investment that aligns with their mission to promote poverty reduction.

It is possible that making changes to the existing investment approach may require developing the five leadership behaviors within the leadership and culture of the organization. The five leadership behaviors are: courageous, collaborative, characterful, competent, and compassionate. By increasing the compassion, character, courage, competence, and collaboration of the board and organization members, the DNA of the culture of the organization will be transformed. The members of the organization may find that they can create an investment portfolio that is increasingly more aligned with their mission and values.

Stewardship

Stewardship is your passion and discipline to protect the long-term interests of others. When stewardship is missing, you'll find anxiety.

Effective stewardship encompasses a fiduciary standard of care, fostering reliance and trust on behalf of the organization. The duty of the fiduciary is to act with loyalty and due diligence, avoiding conflicts of interest. As a nonprofit impact investor, this includes understanding any ethical, regulatory or legal parameters and executing fiduciary responsibilities toward the organization through specific goals and objectives. The five behaviors of stewards from the Behavioral Governance model are: aligned, adaptive, attentive, authentic and accountable.

These behaviors work together to enhance stewardship. For example, trust is developed by engaging in authentic communication. Being attentive and adaptive to unforeseen opportunities or needs of the situation will increase your ability to be an effective steward. Accountability and alignment show a willingness to look for understanding and take responsibility.

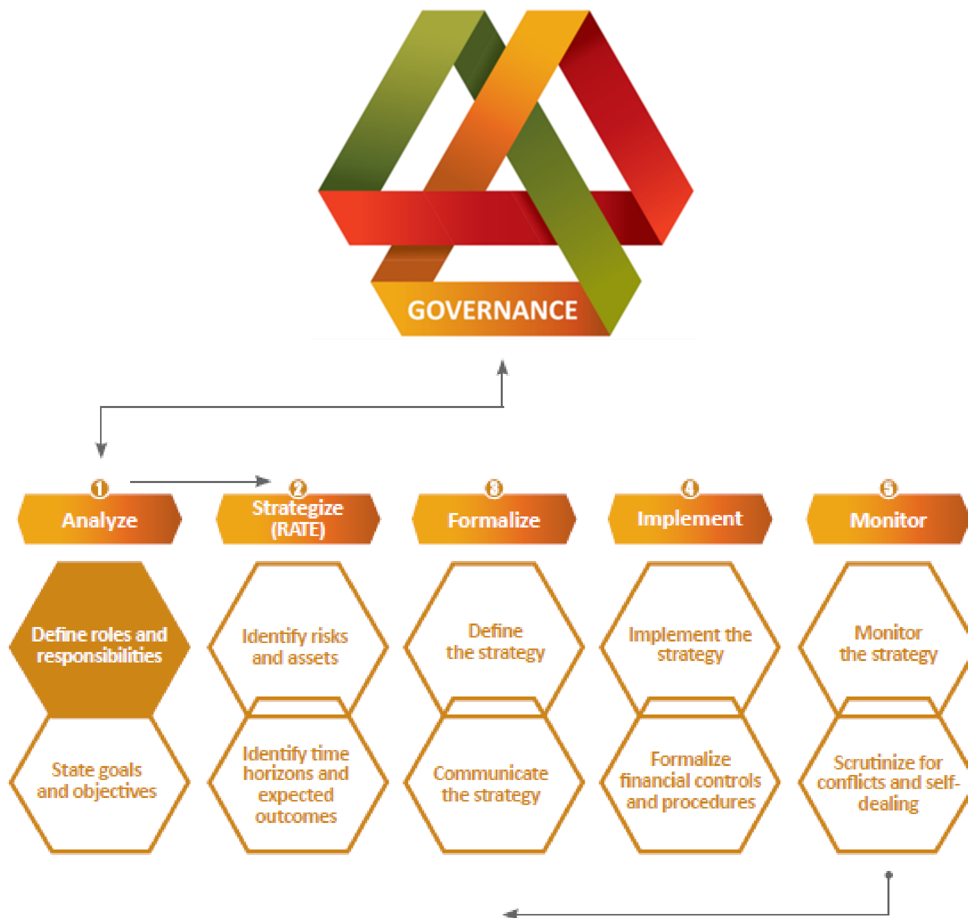
Diagram J: Stewardship

Governance

Governance is your ability to manage the details of a prudent decision-making process. When good governance is missing, you'll find confusion and uncertainty.

After defining the concept of impact investing for the organization, the next step is to develop the associated goals and objectives. 3ethos has developed the following sequence in their behavioral governance model. Successful governance follows a process of five steps, each comprised of goals and objectives called dimensions.

Diagram K: Behavioral Governance Sequence



Step 1 Analyze

Define roles and responsibilities: Roles and responsibilities are clearly understood and decision-makers are aware of what is expected. Decision-makers are subject to legal, moral, and ethical standards.

State goals and objectives: Objectives are aligned with the vision and mission of the organization. They are also aligned with regulations, policies, and procedures. Collaboration can be verified by decision-makers.

Step 2 Strategize

Identify risks and assets: Evaluate risks and determine which are acceptable, can be mitigated or should be avoided. Look at which risk may hinder obtaining assets. Examine types and sources of assets.

Step 2 Strategize continued

Identify time horizons and expected outcomes: Assess the time required for each long-term goal and objective. Determine if there are short-term objectives that must be completed beforehand.

Step 3 Formalize

Define the strategy: Analyze the RATE (Risks, Assets, Time Horizon(s), and Expected Outcomes of your goals. Research and identify all related facts that provide direction for key decision-makers.

Communicate the strategy: Key decision-makers understand the strategy and have the time and skills to properly implement the strategy. The strategy aligns with standards, procedures, and best practices.

Step 4 Implement

Implement the strategy: Make sure that appropriate resources, people, and technology are available. Delegate when expertise is lacking.

Formalize financial controls and procedures: Define the budget for strategy and make sure all expenses are approved and taken into account. Make sure costs, fees, and expenses are reasonable.

Step 5 Monitor

Monitor the strategy: Make sure a process is defined to periodically evaluate progress towards meeting goals and objectives. Reallocate resources if needed. Periodically monitor and evaluate experts that were selected.

Scrutinize for conflicts and self-dealing: Determine whether key decision-makers or hired experts have acted deceptively or unethically. Make sure there is a code of ethics and conduct in place that reflects the organization's values.

Behavioral governance shows that effective governance is not achieved by simply following procedures alone. The leadership and stewardship behaviors come from within—the organization leader's or board member's inner moral code, core values and purpose. The leadership and stewardship behaviors combined with the process and procedures transform and shape the five governance steps and corresponding dimensions.

Diagram L: 3ethos Indigenous Fiduciary

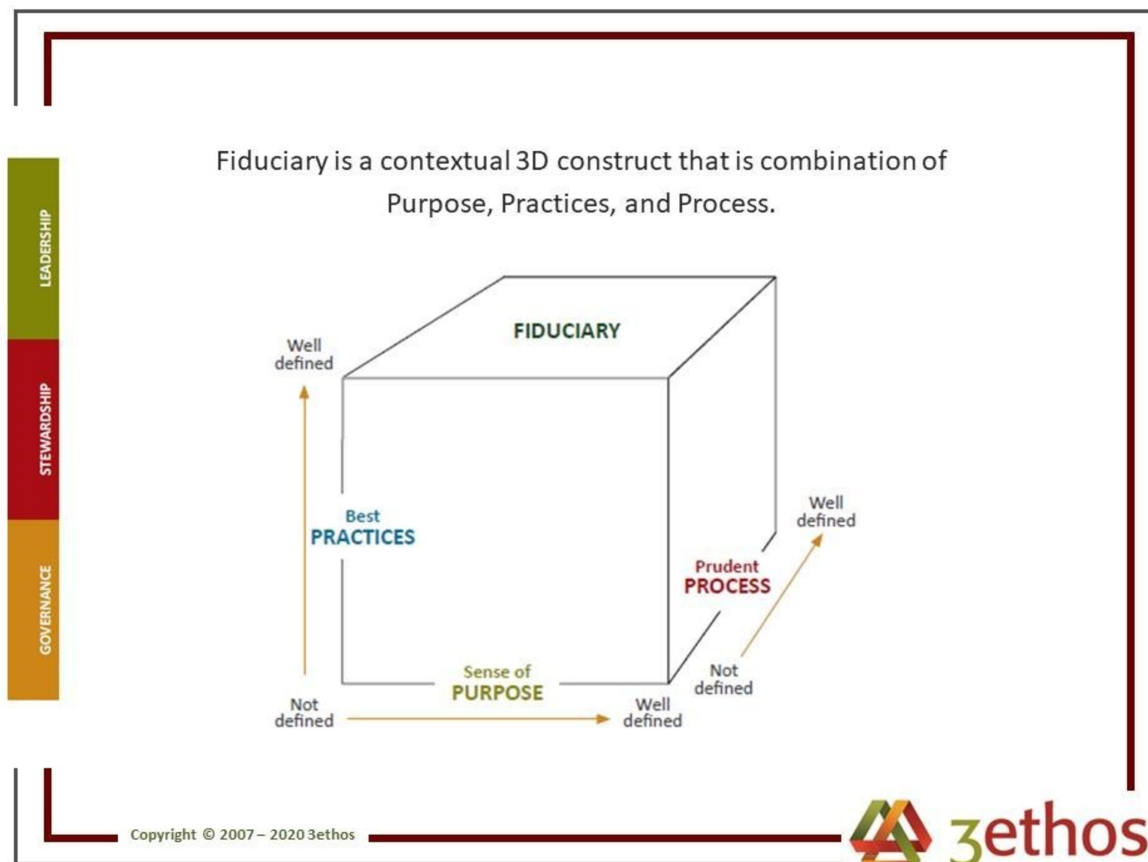
The Indigenous Fiduciary is a guide that uses traditional values and wisdom to develop leaders and stewards.

Fiduciary Responsibilities

Don Trone defines fiduciary as a contextual 3D construct that combines the concepts of purpose, practices, and process. He writes "that 'fiduciary' is a transformational process that takes place over a lifetime of selfless service (Trone, 2018)."[13] The process of becoming a fiduciary is not a one time transaction, but the journey through which effective behavioral governance becomes ingrained throughout the leadership and within the organization. The concepts of purpose, best practices and prudent process fall on a continuum of how well they are defined and executed. The more defined and developed these concepts are, the more likely that the fiduciary responsibilities will be carried out.

- ***Sense of Purpose:*** What is the driving ethos of the organization? The deeper purpose or the sense of mission? Is the mission well defined?
- ***Best Practices:*** What are the organization's practices? How are the goals being achieved? To help better define practices, Fi360 has published a series of handbooks outlining prudent practices in the financial services profession. We believe the *Prudent Practices for Investment Stewards* is a great resource and reference guide that gives detailed direction very much aligned with the governance steps .
- ***Prudent Process:*** Is the process well-defined? How are the practices executed? Do all stake holders agree—leadership, board, other team members?

Diagram M: 3D Fiduciary



Practical Ideas and Strategies

Here are some practical ideas for nonprofit leaders to explore that may help to accelerate their impact investing strategies:

Governance

1. ***Solidify support from your Board of Directors.*** Start with your Board of Directors as a first step. It doesn't make sense to spend a lot of time on developing a strategy without board support.

2. ***Identify similar organizations.*** Persuade the board to adopt an impact investment approach by identifying similar organizations who have already moved down this path.

3. ***Recruit like-minded individuals.*** Recruit board members who understand that impact investing is possible. Some people may be more interested in responsible investing and might be more motivated to adopt impact investment strategies.

4. ***Educate the board.*** Explain behavioral governance concepts to the board.

5. ***Define and document the core values for your organization.*** Clearly itemize the organization's values as this will provide a foundation for your decision-making and drive the impact investment discussion.

6. ***Define and document the mission for your organization.*** Adhering to the mission of the organization provides a strategic direction for your impact investment program.

7. ***Align your portfolio with your mission.*** Decide to align your investment portfolio with the mission of the organization.

   Sample Questions:

   - Should a nonprofit organization that has been established with a stated mission to protect the environment have their largest investment portfolio holding in oil companies?
   - Do we have holdings that are not consistent with the mission of our organizations?
   - Could our organization further our mission by including particularly "positive" investments that support our mission as opposed to just screening out the nasty investment?
   - If our mission is to alleviate poverty around the world, would high social impact investments in microfinance funds be a positive impact for our organization?

8. ***Adopt a global and long-term mindset.*** Consider the impact that your organization will have on all of your potential constituents. For example, an environmental organization needs to think about protecting the environment for hundreds of years. When discussing their fiduciary duties, some of the board members may consider the risks of losing money in a stock market decline this year, rather than considering that they might not be fulfilling their fiduciary obligations to the global community for the years ahead.

9. ***Cross pollinate ideas across the organization.*** Share information across the various committees within your organization so that the members of the investment committee, who may be concerned with their fiduciary duties, can also understand the objectives of the grants committee and the underlying philanthropic strategy for the organization. Provide opportunities by establishing joint meetings or by adding committee members who serve on each of the two committees at the same time.

Policy Development

1. ***Investment Policy development***

   Determine impact areas. Identify your primary areas of impact that you want to focus your energies on. For example, Calvert Impact Capital has identified nine primary sectors of impact investments: Affordable Housing, Community Development, Education, Environmental Sustainability, Health, Microfinance, Renewable Energy, Small Business, and Sustainable Agriculture. Calvert groups their available impact investments into these nine sectors to help impact investor focus their efforts. Choose one or more sectors that your organization would like to focus on with your impact investment strategy and decide which sectors are secondary in importance to your goals or could be avoided as not important.

   Articulate your impact investment goals. Some organizations use the United Nations Seventeen Sustainable Development Goals (SDGs) to provide greater focus on their primary impact objectives.

   Establish risk tolerances. Determine the various investment risks for the portfolio including illiquidity risk, individual security risk and asset allocation risk.

2. ***Investment Policy Statement***

   Responsible investing. Add a responsible investing paragraph to your investment policy statement. In the investment objectives section of your investment policy statement, describe your responsible investing approach and how you will strive to implement your definition of responsible investing. See Appendix A for a *Sample Investment Policy Statement Paragraph: Investment Objectives–Responsible Investing Strategy.*

   Illiquid impact investing. Add an illiquid impact investing paragraph to your investment policy statement. Describe your impact investment strategies and your willingness to go into illiquid investments and/or non-diversified investments to achieve greater impact. See Appendix B for a *Sample Investment Policy Statement Paragraph: Asset Allocation–Illiquid Impact Investment Strategy.*

   Spending Policy Statement. The spending policy statement for your organization should address any impact investment goals that discuss the relationship between the organization's philanthropic activities and investment activities.

Investment Committee

1. ***Encourage collaboration.*** Use readily available responsible investing questionnaires to get all investment committee members to contribute to the discussion about the most responsible investment preferences for the organization. Investment questionnaires are not necessarily the easy answer to your questions but rather a helpful tool to get the investment committee to collaborate on the development of your responsible investment strategy.
2. ***Plan your portfolio.*** Start your investment portfolio implementation with daily liquid investments like mutual funds, index funds and exchange-traded funds (ETFs) and then graduate into separately managed accounts (SMAs) for greater impact using the securities of individual companies. To advance to investment with the potential for even great impact, consider the opportunities available in more illiquid investments such as private equity funds and private debt funds.

Investment Advisors

1. ***Find skilled investment professionals.*** Select investment professionals that have the interest and capability to support your impact investment program. Be open to using a team of collaborating investment advisory firms with complementary skill sets who will be willing to work in tandem to help you to develop and implement your impact investment program.

Summary

While some nonprofit leaders are eager to accelerate the impact of their investment portfolios, they are finding that some of their colleagues are hesitant to adopt the new impact investment paradigm for multiple reasons. Addressing these obstacles to impact investing may be overcome by adopting a disciplined investment decision-making process that incorporates open discussion amongst and between the nonprofit leaders, an appropriate definition of terms, and a decision-making framework that includes an understanding of behavioral governance.

Based on our research and the passion we see for implementing these ideas, we are optimistic that the adoption of best practices in the field of behavioral governance that nonprofit organizations, foundations and endowments will be able to accelerate impacting investment programs in the coming years.

Acknowledgements

Allodium appreciates all of the input provided in the development of this paper and would like to thank the following individuals for their help in identifying the specific obstacles to impact investing: Jon Bishop, David Bromelkamp, Brad Brown, Rochelle Gunn, Susan Hammel, Eric Hutchens, Nancy Jacobs Bill King, Kahne Krause, Keith Loveland, Kate McBride, Chis Morris, William Nelson, Jeff Ochs, Colin Rennich, Rob Scarlett, Geetu Sharma, Suzanne Tudor, Derek Van Calligan, Jeanne Voigt Eric White, as well as numerous other unnamed individuals. We acknowledge the concise editing of Ilona Avraamides from Allodium Investment Consultants and are especially thankful for the high quality content contributions on the behavioral governance concepts shared by Don Trone from 3ethos. We are grateful for all of the individual and collective contributions to this effort to accelerate the development of impact investing as a core component of a comprehensive and holistic investment decision-making process.

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Other Resources

3ethos **https://www.3ethos.com/**
Intentional Endowment Network **https://www.intentionalendowments.org/**
Venn Foundation **https://www.vennfoundation.org/**
Allodium Investment Consultants **https://www.allodium.com/**
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Appendix A

Sample Investment Policy Statement Paragraph: Investment Objectives – Responsible Investing Strategy

Values-based investing is of utmost importance to the Foundation. The Foundation desires to retain professional investment management firms to identify responsible investments that meet strict environmental, social and governance (ESG) criteria. The Foundation is also including an allocation to illiquid investments that may provide the opportunity for higher social impact. In addition, it is the goal of the Foundation to support shareholder advocacy efforts to encourage the improvement of corporate ethics and policies. The Foundation desires to target market rate or above market rate returns while pursuing values-based investing as part of a well-diversified investment portfolio that manages investment risk.

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Appendix B

Sample Investment Policy Statement Paragraph: Asset Allocation – Illiquid Impact Investment Strategy

As a complement to the Foundation's broadly diversified portfolio of daily liquid investments, the Foundation has decided to adopt a policy that will allow for up to 20% of the Foundation assets to be invested in illiquid, high social impact investments. The Foundation board believes that the mission of the Foundation allows for seeking out high social impact investments which may require the Foundation to invest in investments that are generally illiquid (not traded daily on a public securities market). The Foundation wants to earn a market return from these illiquid, high social impact investments. To mitigate investment risk and to provide some additional level of potential liquidity in the secondary markets, the Foundation plans to utilize primarily professionally-managed funds (such as private debt funds and private equity funds) to implement the illiquid, high social impact investments, as opposed to direct investments in individual companies. The selection of the illiquid, high social impact investments will be closely aligned with the core mission of the Foundation.

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Appendix C

Program-Related Investments

As mentioned briefly earlier in this paper, foundations do not have to limit their impact investing activities to their *endowments*. Impact investing can also happen as a part of the foundation's *programmatic* activities through the use of Program-Related Investments (PRIs). PRIs are actually defined in **IRS 4944** as an exemption from the normal "jeopardizing investment" rules of a private foundation's endowment. Because PRIs are programmatic, private foundations can count PRIs as a charitable distribution just like a grant in the year the PRI is deployed.

Program-Related Investments are concessionary investments that private foundations and public charities make primarily to advance their charitable missions. To be classified as a PRI, an investment must meet two main requirements: (1) the primary purpose of the investment is to advance the organization's charitable purpose; (2) the financial terms of the investment are in some way "below-market" or concessionary.

Beyond these two main requirements, however, PRIs are quite versatile. PRIs can be structured in any form (equity, loans, etc…); made to any type of recipient (nonprofits, businesses, social businesses, government, and individuals); and used to advance any IRS charitable purpose. Common examples include low-interest loans to Community Development Financial Institutions as well as low-interest student loans for low-income individuals.

In addition to making a direct charitable impact, each PRI can earn financial returns, as long as production of income or appreciation of property is not a significant purpose. Any financial returns from a PRI get recycled and put to new charitable uses, leading to compounding charitable impact. PRIs also enjoy a number of tax advantages, which allow philanthropists more impact leverage for their dollar.

PRIs have existed since the Tax Reform Act of 1969, and they have long been used by national private foundations like Ford, Heron, MacArthur, Gates, Otto Bremer, and McKnight, among many others. PRIs have been used effectively to launch the microfinance movement, spur economic development, advance research for orphan drugs, and provide affordable housing.

While PRIs are not new, they are broadly underused in philanthropy. Individuals and businesses, which together comprise about 75% of charitable giving annually, cannot directly make PRIs, regardless of the purpose or terms of the investment. And while public charities, donor-advised funds (DAFs), and private foundations legally can make PRIs, they face many practical challenges. **The Lilly School of Philanthropy** reports that in 2004, the peak year for PRI activity from 2000-2010, only 137 out of approximately 66,000 US private foundations made a PRI and less than 1% of all US charitable distributions were structured as PRIs.

In coordination with Minnesota Council on Foundations, Venn Foundation conducted extensive research on the historical use of PRIs by Minnesota private foundations from 1998-2016. The results, full downloadable report, and case studies can be found at **www.pripulse.org**. Venn Foundation also has made a library of quality PRI resources available on its website at **www.vennfoundation.org/resources**.

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