

Ready: Selling the Idea

From the Hallway to the Boardroom

The Kellogg Foundation's mission-driven investing program began with a simple suggestion made to Sterling Speirn, the Foundation's chief executive officer, outside of his office.

"Mission-investing is showing promise among the few foundations who have ventured into the field," noted Tom Reis, who at the time was a Program Officer and the Director of Innovation at the Foundation. "We are seeing more and more social innovators using the markets as venues and as tools for positive change. They're creating social enterprises, so-called double bottom-line or triple bottom-line enterprises. The time is right for us to join in this experiment."

Reis and a couple of his colleagues had been intrigued by the idea and had done some initial research on the nascent field. It did not take more than a few minutes to get Speirn's attention and his support for a deeper discussion.

"Mission-driven investing fit into the Kellogg Foundation's new strategic framework," Speirn recalls. And, in the same conversation, he asked the team to be ready to share the idea with the Board when they met the following month.

Normally, such an important proposal might take several months to percolate through the leadership channels and several more to be fleshed out into a comprehensive paper. Instead, the idea gained traction through the crucial decision to move quickly, and through yet another important decision, to have an informal "generative" discussion with the Board on the high-level benefits and pitfalls of double-line investing.

This fast "first move" was the beginning of a methodical 10-month process that was led by a slightly expanded group of staff. It marked a new chapter in the history of a global organization that had never ventured into the mission-driven investing space before.

The Readiness Factor

In early 2007, representatives from the Kellogg Foundation's Africa and U.S. staff made the presentation at a regular Board meeting in Battle Creek, Michigan. Together, they proposed a simple objective with tremendous potential: let's think about investing a significant amount of dollars from the Foundation's endowment in enterprises that generate social as well as financial returns.

As the team explained, they were eager to "action test" whether mission-driven investing could actually work. More specifically, they were eager to find out if mission-driven investing could, at a minimum, preserve the endowment and recycle capital,

while improving program outcomes. As the staff explained to the Board, they were particularly interested in using mission-driven-investing capital to address the perennial program challenges of sustainability, scale, and exit strategy.

Critical in this first discussion was the notion that if the Foundation were to really pursue this idea it needed to do it in a “learn by doing” mode; therefore, discussion would not suffice. The concept resonated with the Board. It built upon earlier conversations initiated by international staff about the importance of going beyond grantmaking to leverage change. After nearly 90 minutes of discussion, the Board asked the team to begin work with their colleagues in the Foundation’s Investment and Finance units to develop a more fully fleshed out proposal.

The mission-driven investing team agreed to return to the Board in a couple of months with market scans, proposed investment objectives, and specific investment criteria. They also agreed to develop an early reading on the level of deal flow in the Foundation’s U.S. and southern African program areas.

Deepening the Discussion

The next several months involved a systematic investigation based on the best available data on the field. After the initial Kellogg Foundation Board meeting, staff members began the critical work of due diligence, including the following specific tasks:

- Scanning and Analyzing the Current Marketplace of Social Investing
- Meeting the Players
- Determining What Works and Doesn’t Work
- Getting a Real Sense of Potential Deal Flow

Scanning and Analyzing the Current Marketplace of Social Investing

One of the first things that the mission-driven investing team did was to research the roots of social investing. They knew that social investing had gained widespread visibility in the 1980s South African disinvestment movement, but they needed to be able to tell the story of its evolution. What they discovered was that, over time, social investing had come to refer to three methods of incorporating social criteria into financial decisions:

- Screening of assets to avoid holdings in companies with perceived socially destructive practices (and later, proactive selection of companies as best in class)
- Shareholder activism, including voting of proxies and other forms of engagement to influence management practices
- Proactive investing, or selection of investments for specific expected social and/or environmental benefits.

Although less widely publicized, the team learned through a literature scan that social investing actually had its beginnings in the foundation world with the launch of program-related investing by the Ford Foundation in 1968. By 1969, the federal government ruled that program-related investments were exempted from jeopardizing investment penalties and qualified for inclusion in a private foundation's charitable distribution, provided they meet three criteria:

- The primary purpose is advancing one or more of the foundation's exempt purposes
- No significant purpose is the generation of income or appreciation of property
- No purpose is lobbying or political action otherwise prohibited for private foundations.

Over several decades, a small number of major philanthropies led the program-related investment field, namely the Ford, MacArthur, and Packard Foundations. They developed significant loan portfolios – and in some cases equity investments – in organizations that advanced their programs for affordable housing, economic development, and environmental conservation. The Kellogg Foundation team made note of the fact that the Kellogg Foundation itself had endorsed this approach but had made only several program-related investments, both in support of economic development.

The team's literature search turned its attention to the much broader category of "mission-related investing" that had begun to emerge. As defined by FSG Social Impact Advisors in its 2007 report, *Compounding Impact*, mission investing is the foundation practice of making both market-rate and below-market-rate investments "with the intention of:

- Furthering a foundation's mission and
- Recovering the principal invested or earning financial return.

Subject to prudent due diligence and investment monitoring, mission-related investments could clear the jeopardizing investments tests and be included in a foundation's portfolio of endowment assets.

FSG's report described some \$2.3 billion in cumulative mission investments by 92 foundations starting with Ford's programming related investments in the late 1960s and continuing through 2005. It also documented significant increases in the volume and diversity of mission investments in recent years.

As the team dug deeper into the literature, it found that foundations cite a variety of reasons for their mission investing activities. Some of the more notable ones included:

- The scale of social needs and charitable opportunities dwarfs the funding available through traditional 5% charitable distributions.
- Equity or debt structures are a better fit with certain organizations or projects. Examples include for-profit businesses producing "double bottom-line" results and revenue generating nonprofit organizations with working capital needs.
- Early stage equity and debt investments from foundations can help investees build performance records, which these organizations can leverage to raise later stages of financing from a broad range of investors.
- The investment process taps the energy and discipline of capital markets, prompting investees to build management capacity and allowing foundations to share risk and accountability with investees.
- Mission investments allow foundations to leverage their assets and influence attracting a range of investors to transactions that generate social as well as financial return, including other foundations, banks, insurance companies, pension funds, and government agencies.
- Mission investments foster longer term, higher engagement relationships with investees and other partners, broadening the perspectives that foundations bring to grantmaking. Foundations may allocate grants more strategically, leveraging these with PRIs and MRIs to accelerate desired outcomes.
- Mission investing offers a means to extend and manage distributions: Foundations receiving repayments of PRI principal must re-distribute those funds as PRIs or grants in the year received, allowing a recycling of philanthropic distributions. This recycling makes it possible for foundations of any size to continue stable distribution levels in down markets.
- Foundations with significant asset increases can make PRIs as a means of meeting immediate payout increases, using the time during the life of those PRIs to more thoroughly develop grant or PRI strategies.
- Some foundations have found that fixed-rate mission investments help to reduce overall portfolio volatility, thereby enhancing risk adjusted return. Even when those fixed-rate investments are below market-rate, this can contribute to increased assets and payout over time.
- Mission investing offers foundations a means to better align assets and operations with institutional mission. In the conventional paradigm, 5% of assets

are deployed for mission, while the balance of 95% of assets is deployed exclusively to maximize financial return.

Against this broad backdrop of thinking and practice, the Kellogg Foundation mission-driven investing team began strategizing how best to share their findings with the Board. Because they wanted their next conversation to be grounded in a deep understanding of the field, they turned their attention to getting direct feedback and advice from those who were already active in the field.

Meeting the Players

Considerable research needed to be done to forge a strong mission-driven strategy and with enthusiasm and optimism running high, the team embraced this challenge. Members began the task of interviewing outside practitioners of mission investing. Ultimately, some 60 outside practitioners of mission investing were identified and surveyed. Each was questioned regarding their approach to mission investing, i.e., what they invested in, what they were seeing in terms of deal flow, how they structured their investment programs, how they did due diligence, who they had as partners, etc. Specific attention was paid to who was doing work in support of vulnerable children, and who might be a potential advisor for future work.

One name always rose to the top of the list, the F.B. Heron Foundation. The Heron Foundation is a well-known champion of mission investing with extensive experience in mission-driven investing strategy, program management, and product innovation. Their sage advice, which included everything from valuable suggestions for setting up a program to helping the team envision a model portfolio that identified specific investment selections while leaving plenty of room for new opportunities in the future, proved invaluable in the months ahead.

Determining What Works and Doesn't Work

Practitioners were asked what they thought worked well, as well as what had not worked. Often they gave us good advice, including:

- **Set clear objectives and start with small steps** - a large complex universe of diverse possibilities can make focusing and getting started difficult.
- **Apply rigorous, disciplined investment methodology across the range of asset classes** - employing only a grantmaking mindset for mission investment drives poor results.
- **Build a mission-driven investing management team with investment and program expertise** - many organizations have failed to mobilize the appropriate mix of expertise and skills.

- **Build a sourcing network to access a range of “off-the-shelf” deals and develop new Kellogg Foundation-driven deals** – to ensure robust deal flow you will need both off-the-shelf and your own developed opportunities.
- **Build partnerships and remain open to compromise** - putting together deals can be complex and time consuming.
- **Improve social metrics and push to measure impact not just outputs** - effectively and efficiently measuring social returns is difficult.

The interviews proved very worthwhile. The practitioner scan provided the raw material for making recommendations on how a social investment opportunity should be identified, evaluated, structured, and implemented in subsequent discussions with the Board.

Getting a Real Sense of Deal Flow

One of the topics explored throughout the scanning process was determining the availability of deal flow. The team’s conversations with practitioners pointed toward ample deal flow around at least two of the Foundation’s interest areas: education and food. It also revealed that a successful program would require staff who were dedicated to the sourcing of appropriate deals. Not only did most of the Foundation’s current programming staff lack direct experience in this area, they knew they would never have a sufficient number of staff internally to do all aspects of the portfolio management. Due diligence would require significant amounts of time and would require talent not readily available on the team.

All of these findings soon become fodder for an in-depth discussion with the Foundation’s Board of Trustees.