Economically Targeted Investing:

Capitalizing on Opportunities in Emerging Domestic Markets

RBC Global Asset Management™

Introduction

Private investment, by individuals and institutions, is an essential ingredient to support economic growth of industries and communities. Therefore, it is extremely important that communities have an opportunity to access the capital that is needed to stimulate increased economic growth. The goal of economically targeted investing (ETI) is to help meet the capital needs of underserved areas in an efficient and sustainable manner.

ETI has become an increasingly important niche in the socially responsible investment (SRI) universe. As part of the SRI focus on corporate responsibility, ETI takes a more direct approach, allowing institutions that invest an opportunity to have a more direct impact on local organizations and communities.

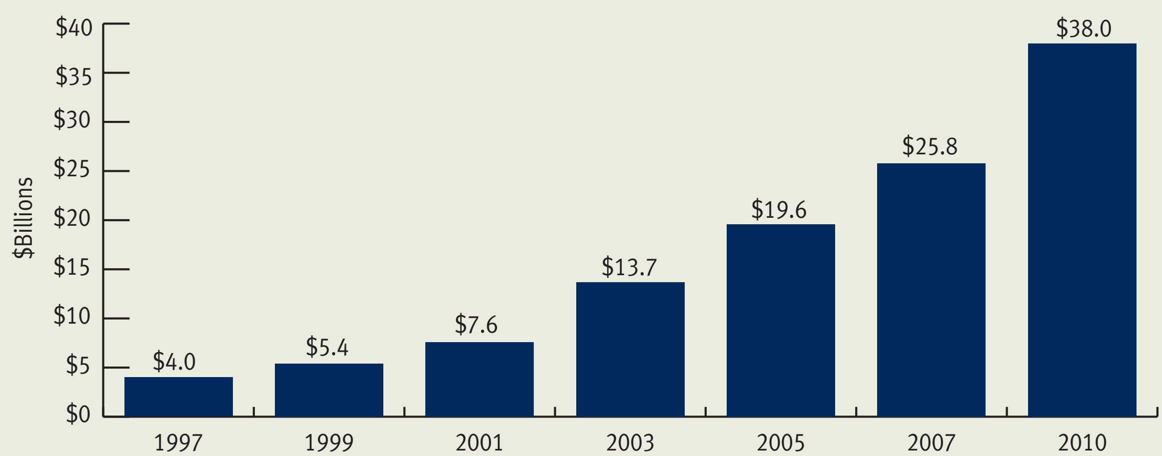
Economically targeted investments may provide financial backing for:

- Equity capital to help fund business growth for industries with a competitive advantage that operate in underserved communities
- Real estate development that supports economic growth
- Fixed income securities to underwrite projects that provide essential services in underdeveloped areas
- Infrastructure projects needed to stimulate or facilitate economic growth
- Credit enhancements for businesses and service providers that are essential to the community

Economically targeted investments represent a "niche" opportunity that may be attractive to banks, public pension funds, institutions and foundations that recognize the value and importance of furthering their missions by making investments that provide a competitive return and have the collateral benefit of supporting the economic well being of the communities they serve.

While there are important social outcomes attributable to ETI funding, investing entities do not lose sight of the need to generate a competitive return. This often requires a well-informed and experienced investment management team that can identify opportunities and overcome obstacles that are part of this unique marketplace. The goal is to enable investors to realize market-comparable gains in less recognized and less traditional markets.

Growth In Community Investing (1997-2010)



Source: Social Investment Forum Foundation "2010 Report on Socially Responsible Investing Trends in the United States"

An Overview of Economically Targeted Investing

This form of socially responsible investing has its roots in the recognition that more private investment may help improve the economic well being of communities, particularly those that face significant social challenges. Identifying investment opportunities in certain targeted regions is a necessary supplement and an important leverage to government spending designed to mitigate the effects of economic disparities that may exist in certain areas. Given the growing budget pressures facing governments on the federal, state and local level, an influx of private capital to these underserved communities can be even more critical. One of the most important objectives of those who promote this form of investing is to help demonstrate how certain “emerging domestic markets” can become more economically viable and generate profit opportunities for investors. These investments have the potential to foster, encourage and facilitate the activities and conditions that are a prerequisite to increased capital formation.

Government initiatives to promote private enterprise in targeted areas are nothing new. At least as far back as the New Deal, with programs designed to save farms and put people to work, efforts have been made to promote job creation and private enterprise via government policy. Some programs have worked more effectively than others. Over the years, an increasing emphasis has been placed on the concept of encouraging private investment to promote economic development in areas that have been underserved through traditional investment vehicles and institutions.

The Community Reinvestment Act (CRA) became law in 1977, requiring banks and thrifts to meet credit needs of all borrowers in their communities, with a specific emphasis on low-to-moderate income communities. This program has proven quite effective in encouraging more lending and investment activity directed to low and moderate income communities and individuals.

ETI as a best practice goes beyond the mandates that have been placed on banks with CRA by focusing on identifying and capitalizing on investment opportunities in emerging domestic markets. Like their counterparts who manage investments on a global scale with an emerging market focus, managers of ETI funds must be able to discern between real, market driven investment opportunities and those that attempt to meet a social need through below-market pricing of the risks associated with certain investment products.

ETI that is ultimately focused on generating competitive returns (matching or exceeding other alternatives an investor could have selected) in combination with positive economic development in targeted communities is a sustainable concept with the potential for aggregating relatively large pools of capital.

ETI as Part of the SRI Universe

Socially responsible investing now comprises about $1 out of every $8 under professional management in the U.S. Within that $3.1 trillion universe, Community Investing, a category that includes the investment approach of economically targeted investing, is today only a very small piece of the pie. In 2010, $38.0 billion was invested in U.S.-based community funds.

Nevertheless, growth in the community investing segment of the SRI marketplace has been dramatic. Just ten years earlier, the total amount of assets put to work in community investing was $4 billion. As the accompanying chart demonstrates, the rate of growth in the marketplace for community investing has jumped dramatically in the current decade.

Economically targeted investing is playing an increasingly important role for those who seek to uncover new investment opportunities and wish to make a contributory role to societal improvements, all while seeking competitive market returns. The ideal ETI investment is a perfect, two-way street. Funding from investors helps generate critical economic improvements to underserved communities that can take advantage of access to capital. Returns on the investment, particularly when market inefficiencies are properly utilized, can generate valuable economic benefits for investors.

Capitalizing on the "Emerging Domestic Market" Opportunity

Any individual responsible for overseeing the portfolio of an institution is cognizant of the importance of generating risk-adjusted market returns. In many cases, a goal is to identify specific investment opportunities that are not yet fully recognized by the market.

That summarizes the concept of "best practice" economically targeted investing. Through a careful research and analysis process, professional managers with a strong understanding of the marketplace can identify potential opportunities for investment. As a result, investors have the ability to generate competitive returns and achieve significant collateral social benefits through the management of their portfolios.

It is important to recognize that ETI is not designed to be a strictly philanthropic endeavor. A truly effective ETI approach should include the ability to provide market rates of return when compared to accepted benchmarks and provide clearly defined collateral benefits. Without these types of results, the purpose of the investment is lost in two ways. If ETI fails to generate favorable investment results, the appeal of continuing investments in the targeted markets is less apparent. The result will be that capital becomes more difficult to obtain, and future development for these targeted emerging domestic markets is sidelined.

There is clearly an incentive to "get ETI right." The more success such a program can generate, the better the potential to continue to draw investment dollars in targeted communities across the country.

Finding "Niche" Opportunities

Certain segments of the U.S. economy have traditionally attracted limited investor interest. These economically underserved areas are, in effect, comparable to what are termed "emerging markets" in the overseas context. Just as investment potential is coming to the forefront in many developing markets around the globe, the same is true of emerging domestic markets. In the hands of an effective manager, this can prove to be a solid-performing asset for investors. In addition, it provides an important opportunity to diversify a portfolio.

The changing demographics of the U.S. highlight the increasing importance of the ETI opportunity. Ethnic groups now constitute majorities in four states and the District of Columbia, a number that is expected to triple in the coming decades. As a result, the makeup of the nation's business ownership is changing as well. The number of firms owned by racial minorities grew two times faster than the rate of all firms over the past ten years. The number of women-owned firms is also growing rapidly. This is one indication that businesses in certain low-to-moderate income communities have the potential for significant growth, but the key objective for these groups is is to have access to capital.

Investors are recognizing that emerging domestic markets have been greatly overlooked by the capital markets and financial industry. As a result, select businesses that are well managed and poised for growth within these markets are often overlooked or undervalued. Individual consumers located in some of these underserved markets, earning solid incomes and building net worth, also present a favorable market for financial products. The lack of capital to support business activities in these areas contributes to a talent drain that can further impede the economic well being of these communities.

One of the major deterrents that limits the growth in emerging domestic markets is the lack of information for investors to utilize in order to make knowledgeable investment decisions. Efforts are underway to improve data standards for these markets, which may present in greater transparency for investors. Information is critical for the proper function of any investment market. At the same time, the lack of data creates opportunities for fund managers with experience in the marketplace to capitalize on market inefficiencies. Those who are successful are able to identify investments with particularly strong value, creating greater potential to generate competitive, risk-adjusted returns on dollars that are put to work in emerging domestic markets.

One of the primary benefits of economically targeted investing in these communities is that it contributes to the ongoing growth of the nation's economy. Given the increasing share of the overall population located in these emerging domestic markets, the financial success of these communities is likely to have a bearing on the country as a whole.

Social Benefits of ETIs

Promoting economic vitality in emerging domestic markets is one of the highlighted objectives identified by those that advocate for economically targeted investing.

The broader category of community investing grew as a way to support the work of community development organizations that focused on underserved areas. These can exist in city neighborhoods, rural areas and even on Native American reservations. Typically, these are markets that have had limited access to financial services and private funding to back economic development efforts. One important goal of ETI investing is to help lower-income families and communities gain more control over their financial well being.

Some common areas of investment include:
- Affordable housing
- Small business development
- Community services (child care, health care, education)
- Job creation
- Expansion of existing businesses
- Support of sustainable development initiatives

Investments may be direct or may involve the creation of new loan pools and the structuring of existing secondary loan issues to meet the needs of residents and businesspeople in underserved communities. In the latter case, the investment team works with traditional and non-traditional originators to ensure that borrowers have improved access to capital markets.

The result of the growing interest in economically targeted investing is improved access to capital in support of economic opportunities for underserved populations in America.

Broad-Based Benefits
Successful ETI investments at the community level can have far-reaching consequences. The most effective strategies integrate interests at both the community, regional and national levels. The interest of national and regional leaders in the economic well being of all communities they serve can play a big role in helping to determine the viability of investment opportunities in emerging domestic markets.

Today, some ETI-related investments are being developed in the context of regional economic efforts. The ultimate goal is to create an improved and lasting link between low-to-moderate income (LMI) neighborhoods and their respective regional economies. Typically, LMI neighborhoods have underperformed the broader economy in the area in which they are located due in large part to the failure to integrate on an economic level. Rather than requiring neighborhoods to initiate and manage their own revitalization, it is becoming increasingly common for regional entities to take a greater interest in the needs of LMIs. By helping underserved communities more fully integrate into the region's economy, the opportunity for successful outcomes from ETI investments is likely to be improved.

Benefits to the region include:
- An available workforce to fuel further regional economic growth
- A financially more viable consumer base from LMIs
- Enhanced housing, commercial and business development
- The potential to put under-utilized infrastructure to use as emerging domestic markets become better developed

All of these factors can have major benefits for an entire region, and the effort on a regional level has the potential to improve prospects for investors in ETIs.

As LMI communities achieve greater financial viability, the benefits to the nation's economic well being are also likely to be favorably affected. The net result of ETI investing can be far reaching, beyond the specific returns (both financial and social) that are generated at the local level.

A Range of Opportunities in the ETI Marketplace

Economically targeted investments can focus on a variety of different opportunities. Following is a brief summary of the prime areas and what they have to offer:

Private Equity

These are investments in unlisted companies. Funding can be in the form of venture capital (for start-up firms), mezzanine capital (for established companies) or company buy-outs.

In the case of ETIs, private equity focuses on investing in businesses that are located in underserved areas. The role of the investor is not only to help finance the business, but also, in many cases, to provide guidance and input on the strategy of the firm and its operational functions. Companies are selected for ETI funding if the fund managers are convinced of the economic potential of the firm.

In addition, other results may develop. These include the creation of jobs in economically challenged communities and the residual benefits of positive economic development for neighborhoods.

Investing in Small Businesses

Investors can promote business development in "emerging domestic markets," by investing in a fund that is focused on making investments in businesses owned or managed by minority entrepreneurs or those that are located in underserved urban communities. Much of the focus is on companies that are looking to expand operations and, as a result, employment opportunities. Dollars invested provide these firms with access to capital that might otherwise be unavailable to them, creating greater opportunities to grow their businesses.

Real Estate

This is a broad category that can range from creating financing that promotes home ownership for individuals to direct investments in rental properties and office and commercial space. It can also entail investment in publicly traded real estate investment trusts and mortgage-backed securities focused on funding home ownership for underserved markets.

Real estate investments require a long-term focus, perhaps a longer time horizon than other types of investments under the ETI category. Investments made in real estate affect land use, development plans and transportation strategies for communities for years to come. Real estate is a relatively illiquid asset. But targeted funding in underserved communities can positively benefit residents and business owners. Properly selected and managed properties and other real estate-related investments can offer investors with reward potential, particularly considering that many of these properties may be undervalued due to their location and the economic environment in which they are located.

Ultimately, real estate investments can provide important diversification for a portfolio, along with attractive return potential. The impact on communities can be significant.

Real Estate Development

ETI is put to work in a real estate development effort designed to benefit underserved communities in one of America's largest cities. Assets are invested in development firms that are focused on revitalizing an urban area through efforts such as office space rehabilitation, redevelopment of industrial buildings to create space to attract new tenants and condominium and retail development of vacant buildings. In some cases, the ETI fund takes an equity position, and in others, provides debt financing.

Fixed Income

This involves bonds and other fixed income securities and other short- and long-term fixed-return debt securities that may be issued by governments, quasi-government bodies, corporations and non-profit entities. Just as fixed income is generally viewed as an investment that is less risk-oriented in a standard portfolio, the same can be true for fixed income investments with an ETI focus.

Bonds are often used to finance projects such as home ownership, healthcare, education, business development, and public infrastructure (more on that below). In many cases, mortgage and government programs are tied to securities, which provide a guarantee against default risk.

Fixed income securities in the ETI marketplace can help promote important civic goals as well as generate competitive returns. Government guarantees play a vital role in assuring that some of these securities meet return objectives.

Fixed Income Investing

One form of fixed income investing in the ETI universe is to buy pools of loans that are guaranteed by the U.S. Small Business Administration. The fund can work with national and local partners to help small businesses gain access to loan programs in their area. Many managers who are not focused on the ETI marketplace will avoid SBA-guaranteed whole loans due to extra record-keeping requirements. Yet these assets may offer attractive yields for investors while still helping to create social benefits for a community through private sector investment.

Infrastructure

It is generally accepted that updated infrastructure is a critical requirement for positive economic development in any locality. Investing in infrastructure is also an important element as an ETI strategy. Just as community, state and federal government entities use securitized debt to help fund long-term infrastructure improvements; the same is true as it relates to underserved communities.

Funds can be put to work to help underwrite bonding and to back projects such as the development of transportation corridors, educational institutions, public works and environmental programs and health care facilities. All of these offer the potential to generate a favorable and competitive returns for investors. At the same time, these infrastructure improvements play a vital role in boosting the economic fortunes of emerging domestic markets.

Infrastructure

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Credit Enhancements

Prior to the establishment of community investment standards, many institutions utilized a practice known as "red-lining," meaning loan applications were denied based on the characteristics of a neighborhood rather than the applicant's specific ability to repay a loan. This practice proved to be crippling to many communities, encouraging the flight of a merchant and middle class.

ETI funding can be used to enhance credit opportunities for well-qualified families and businesses that operate out of underserved neighborhoods and communities. By providing financial support in these areas, investors have an opportunity to not only stabilize and promote economic development, but also benefit from premiums that are applied to these credit programs.

Specialized mortgage-backed securities, such as Ginnie Mae, Freddie Mac and Fannie Mae, provide certain guarantees by the government or government-sponsored agencies, which limits the credit risks.

Securities targeted by income and region to benefit underserved populations is an example of the type of credit enhanced lending that can be funded through ETI investments.

Credit Enhancements

A common ETI focus is on affordable homeownership securities. This involves a fund buying mortgage-backed securities of screened and selected loans. A borrower's income, expressed as a percentage of federal government statistics on area median income helps to define a capital gap for homeownership. A fund will typically purchase mortgages of borrowers who are at or below the accepted median income standard. The fund will often make forward commitments to high-impact lending programs as well. This allows loan originators to look to the fund to be the takeout program for loans such as those focused on first-time homebuyers. As a result, the fund acts as a counterbalance against predatory lending practices.

Who Invests in ETIs

The universe of investors who seek to participate in ETI investments is expanding. Typical investors can include:

Commercial Banks

The concept of investing in economically targeted areas gained a major impetus from the Community Reinvestment Act, which encourages bank participation in community investments. However, it should be noted that beyond the regulatory aspects, many banks continue to funnel dollars into ETIs due to the favorable returns they have experienced. A number of banks will focus on investments in their geographic area. In this way, they have the potential to benefit from a growing customer base as a result in successful development in their region, on top of the investment and social benefits generated by ETI funds in which they invest.

Pension Funds

Major public pension funds, including many of the largest, now diversify a portion of their portfolios into ETIs. Outside of commercial banks, public pension funds are among the largest ETI participants. Union pension funds have also become active investors in funds that target communities where their members live and work. To date, pension fund investment in ETI has been somewhat limited, and union pension funds are considered a prime untapped market.

Corporations

Insurance companies initially had interest in ETI due to the possibility that requirements of the Community Reinvestment Act would be extended to them. While this has not yet occurred, it is clear that many are responding to favorable return rates and the ability to diversify their portfolios into an underrepresented asset class and the development of new markets for their products. Large nonprofit corporations also have put money to work in ETI funds as a way to extend their mission through targeted investments.

Foundations and Endowments

Many foundations will have an interest in putting dollars to work toward causes or communities that they typically serve. In their program-related investments, rate of return may be less of an issue for them than the social aspects of the investment, though they will certainly be attracted by the ability to potentially achieve a return on their investment. ETI may be an area where they can meet both their mission and rate of return hurdles. University endowments are another example of an investment group with increasing interest in ETIs, in this case, quite often for the investment aspects, but also with an eye towards town and gown relationships and services targeted to their students.

Individuals

While the vast majority of dollars invested in ETIs comes from institutions, high-net-worth individuals are also becoming participants in this marketplace. In some cases, investments of $50,000 can be put to work in ETIs, providing a way to generate competitive returns in a socially-responsible fashion. This can be particularly appealing to those who want to invest in their community.

While ETI as a whole remains a fairly modest piece of the entire universe of investing, there is broader recognition by many large organizations of the value they provide. Most of these institutions are focused, primarily on whether the investment can provide a satisfactory level of risk-adjusted returns. The fact that many are repeat investors indicates that this hurdle has been overcome. There is an obvious value-added attraction in helping to generate economic benefits that can play a role in revitalizing communities by investing in ETIs.

Identifying Qualified Managers for Economically Targeted Investing

The area of economically targeted investing is one of the more specialized aspects of the investment universe. In addition, dealing with a market that has significant inefficiencies means that proper management can make a notable difference in determining the outcome for investors.

Here are some issues that should be considered when choosing a manager for assets that are allocated to ETI:

Experience
Critical to this specialized field of investing is to work with managers who have a proven track record in the marketplace. It is important to be comfortable not only with their abilities, but also their areas of expertise. Assess, too, the backgrounds of the primary managers of the fund to determine how their previous experience contributes to their capabilities in identifying viable ETI candidates.

Style and Discipline
There are a variety of approaches that a manager can take in overseeing an ETI portfolio. The selected manager should have a strategy that is consistent with the desired objectives that have been laid out by the investor. If they adhere to a particular discipline or philosophy, determine what the driving force is behind that approach and assess how effective it has proven to be for other investors. Ask for evidence of the manager's success using the preferred investment style and discipline. Also inquire as to how the manager's style has contributed to returns as well as the desired outcomes at the community level.

Analytical Capabilities
In an environment that offers limited information and significant inefficiencies, the manager's ability to assess risks and determine which investments offer the greatest potential for the fund is a vital component of the selection process. Managers must demonstrate their knowledge of this specialized market, the approach they use to analyze risks and identify inefficiencies, and why their approach is more effective than those of competing managers.

Reporting
Delivering timely and accurate information about investment results is expected of any manager. Be sure to understand how often performance reporting will occur and in what form to expect it. Be aware that, as it relates to ETIs, non-financial reporting also plays a vital role. This includes evidence of how specific investments have benefited targeted communities. This type of "performance" verification is becoming increasingly critical to those who have fiduciary responsibility for investments that must be managed with positive social outcomes in mind.

Economically Targeted Investing Summary

Economically targeted investing is playing an increasingly important role for those who seek to uncover new investment opportunities and wish to help play a contributory role to societal improvements, all while generating competitive market returns. The ideal ETI investment is a perfect, two-way street. Funding from investors helps generate critical economic improvements to underserved communities that can take advantage of access to capital. Returns on the investment, particularly when market inefficiencies are properly utilized, can generate valuable economic benefits for investors.

The most successful ETIs fully capitalize on the promise and opportunity that can be found in emerging domestic markets through all geographic areas of the country, including both urban and rural communities. Ultimately, creating access to capital is designed to benefit not just the investors and the community directly affected, but also regions and even the national economy as a whole.

As the U.S. population becomes more diverse, creating financial instruments to help meet the economic needs of underserved areas is more critical to the nation's financial health.

From an investment standpoint, ETIs are becoming an area of increasing interest. It provides the ability to invest in emerging domestic markets, a specialized environment that is difficult to access by other means. A number of firms that are experienced in managing investments targeted at underserved communities can provide institutions and other types of investors with a valuable way to add portfolio diversification to their asset mix.

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http://www.socialinvest.org

Terms

There are a number of terms that can be used in relation to discussions of investments with a social mission. Here is a rundown of some of the key terms and what they mean in relation to this specialized market:

Socially Responsible Investing
The integration of social values and issues as part of the investment process. Along with assessing an investment's risk-adjusted return, it also includes consideration of the impact on a community.

Mission Related Investment
An investment that provides competitive returns with specific collateral benefits that are aligned with the programmatic mission of the investor.

Community Investing
One aspect of socially responsible investing that focuses on providing funding for goods and services targeted to low- and moderate-income communities.

Economically-Targeted Investing
An investment that combines competitive returns with specific collateral benefits relating to the economic well being of a targeted community.

Community Reinvestment Act (CRA)
An act of Congress that encourages banks and other lenders to provide credit and other banking services to low- and moderate-income communities.

Double Bottom Line
Investments that target market rates of return while creating measurable economic and social returns. In some cases, if an environmental component is also a factor in the investment decision-making process, this is referred to as triple bottom line.

Emerging Domestic Markets
A term that refers to economically underserved communities in the U.S. where growth potential exists but has not been realized due to limited access to the resources needed to help reach their full potential.

It should be noted that all of these terms are closely related, with only nominal differences separating their meanings. While the focus of this paper is on economically targeted investing, much of the material being discussed relates to many other aspects of the socially responsible marketplace.

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