Community Investing:
Opportunities Across Asset Classes

Janet Kalwat, Ph.D.
Director – Responsible Investing Research

EvaluationAssociates
A Milliman Company

Community Investing – strategies that focus on economically disadvantaged communities and individuals – is receiving an increasing amount of attention within the Responsible Investing area. The expansion of market-rate opportunities and offerings across asset classes provides numerous ways for investors to begin or increase the Responsible Investing component of their portfolios and do so in a way that can have a direct and tangible impact. This paper discusses the various approaches to Community Investing and offers a framework for interested parties to consider an allocation. Responsible Investing is not a "one size fits all" approach. For investors who have an interest in Community Investing, there are various options depending on specific objectives and risk and return considerations. EAI is committed to identifying the most appropriate investment opportunities, performing the required due diligence, and recommending managers with the greatest potential to meet specific client objectives.

INTRODUCTION

Community Investing, a subset within the broad landscape of Responsible Investing, has received an increasing amount of interest among investors, asset managers, capital providers, community organizers, government bodies, and others who recognize an opportunity to achieve market rates of return (or better) while providing social benefits to communities and the wider surroundings in which they exist. The specific objectives and strategies for Community Investing products vary widely, but the underlying commonality is the goal to bring economically disadvantaged neighborhoods and individuals into the economic mainstream from which they historically have been absent or underserved. Community Investing encompasses a wide range of objectives that include affordable housing, literacy, skills development, childcare, healthcare, neighborhood stabilization and revitalization, and small business development and support.[1]

Community Investing strategies differ in their risk/return profiles as well as the extent of their impact on the geographic locations or issues on which they focus. Strategies range from the relatively low risk cash deposits at community development financial institutions to higher risk fixed income and equity strategies. At the farthest end of the risk spectrum are private equity and real estate funds. Private equity and real estate strategies potentially have the greatest and most direct impact in terms of positive measurable outcomes, for example, actual numbers of affordable housing units or jobs created, small businesses supported, or community facilities developed. To date, we are not aware of any hedge fund strategies with a Community Investing focus.

Community Investing has been a central component of the mission-related investing strategies of many foundations and endowments that have used program-related investments, typically at below-market rates, to support their charitable purpose. The expansion of market-rate offerings makes Community Investing an option for a broad range of investors and a natural extension for those who want to transition from exclusionary approaches (negative screening) to those that focus on positive criteria. Community Investing offers investors the opportunity to increase the proportion of their overall portfolio committed to Responsible Investing.

> The expansion of market-rate offerings makes Community Investing an increasingly attractive investment opportunity.

This paper discusses the various approaches to Community Investing across asset classes with the objective of providing investors with a framework to translate interest into implementation. Responsible Investing is not a "one size fits all" approach. Investors with an interest in Community Investing have options depending on specific objectives (geographic locations and issues) and risk and return considerations.

Community Investing differs from broader Responsible Investing strategies in terms of its narrower focus. It targets specific populations or geographic locations,

[1] For simplicity, this paper uses the term Community Investing. Double (or Triple) Bottom Line and Economically Targeted Investments (ETIs) are other terms that may apply to these kinds of strategies.

community concerns that transcend borders, or companies that contribute positively to the development of their workforce and the communities in which they are established. Community Investing nonetheless is integrally related to other Responsible Investing issues. Environmental goals, for example, can simultaneously be pursued by constructing residential and commercial structures according to "green" guidelines or integrating public transportation into community revitalization blueprints. From the broadest societal perspective, sound Community Investing strategies underlie the health of societies by improving the welfare of constituents at the grassroots level.

As a note, this paper focuses on Community Investing in the United States. International microfinance, which addresses small scale, community approaches to a multitude of objectives in developing countries, requires its own discussion and will be the subject of a subsequent paper.

I. ASSET CLASS STRATEGIES

Exhibit 1 displays the various approaches to Community Investing, which are described in detail below, as well as the levels of risk and potential impact associated with each. The concept of "impact" is difficult to define precisely and open to debate. While any approach that takes Community Investing into account is additive, higher levels of impact generally are associated with those that produce results that are more easily quantifiable. In the case of private equity and real estate (section IV below), the fact that these vehicles often involve an element of control over investments adds another, positive dimension to impact.

(I) CASH AND CASH EQUIVALENTS

A low risk approach to Community Investing is through cash deposits at community development financial institutions (CDFIs). These entities, which include community development banks and credit unions, receive the CDFI designation by meeting specific requirements of the U.S. Treasury Department. There are approximately 1,000 CDFIs throughout the United States in both rural and urban communities. Close to 800 are certified by the U.S. Treasury's CDFI Fund, which means they meet further eligibility requirements related to the target markets they serve and the development services they provide. Certification allows these entities to compete for funds from the CDFI Fund with the prerequisite that matching funds are obtained from private market sources. As a note, the CDFI Fund was the recipient of $90 million from the American Recovery and Reinvestment Act in 2009. For the fiscal year 2010 funding round, the Fund has $113 million to award.

As a concept, CDFIs have existed historically as a "self help" response on the part of immigrant, African American, Hispanic, and other groups that lacked access to traditional financial institutions. The current CDFI program had its beginnings in the 1960s, gaining momentum during the Johnson Administration's War on Poverty program. It received a meaningful boost in the 1990s with the creation of the CDFI Fund in 1994 and the revised Community Reinvestment Act (CRA) in 1995. The latter recognized loans and investments in CDFIs as a means to meet the CRA requirements that banks invest in and serve the communities from which they receive deposits.

The majority of assets invested in CDFIs is in community development banks, of which there are approximately 60. Community development banks offer the same services as conventional banks in their provision of market-rate investments through savings, checking, certificates of deposit (CDs), and money market accounts, but focus their lending on lower-income communities. Technical training and assistance also are a part of the banks' mission.

The products of community development banks have several features that may serve to increase their attractiveness to potential depositors:

- Community development banks, like their conventional counterparts, are federally regulated and FDIC insured; the deposits of credit unions are insured by the National Credit Union Administration.
- Rating agency A.M. Best began rating community development banks several years ago. Though it has internal ratings on every bank, to date, it has issued a public rating on only one entity (Central Bank of Kansas). A.M. Best currently is initiating an education campaign and offering incentives for community banks to pursue a public rating.

Exhibit 1:
Community Investing Strategies

	Cash & Equivalents CDFIs	Fixed Income Bonds, Loan Funds	Public Equity	Private Investments Venture/ Mezzanine/ Real Estate
Investment Risk	Low	Moderate	High	High
Social Impact	Low	Low / Moderate	Low	Moderate / High

- Through the CDARS (Certificate of Deposit Account Registry Service) program, an organization can invest up to $50 million in CD investments with full FDIC protection. CDARS was established in 2003 by Promontory Interfinancial Network (PIN), a financial technology company. There are currently more than 2,000 banks participating in the CDARS network. Using CDARS, an investor can enlist one member bank to distribute assets to a number of community development banks. In so doing, the one bank ensures that FDIC eligibility requirements are not exceeded at any one entity, and the need for the investor to monitor multiple banking relationships is eliminated. While CDARS is an appealing system, as a caveat, PIN has a fairly short history in operation. EAI believes it is important that users gain confidence in the level of due diligence performed at individual banks before such banks became part of the network.

- Recognizing the importance of measuring the impact of community development banks on an absolute basis and for establishing their credibility for future investments, the National Community Investment Fund (NCIF)[2] has developed a set of performance metrics for this purpose. This information is accessible in the NCIF Social Performance Metrics database.

Information and standardization of information is critical for developing confidence in the vehicles, attracting more capital, and for establishing a virtuous circle for meeting the needs of lower income communities. The information also provides a screening tool for potential investors to identify in what and where they want to invest.

In sum, Community Investing through the product offerings of community development banks and credit unions is easily achievable, deposits are insured, and investors can target specific geographic areas or social/economic issues. The progress being made in the development of ratings and performance metrics lends credibility to the ability of these entities to accomplish both their financial and social objectives.

(II) FIXED INCOME

Within the fixed income area, investors have access to Community Investing bond portfolios. These portfolios invest in fixed income securities that support community development by targeting affordable home ownership or rental housing, small business development, health care, job training, and educational programs. Portfolios also can be targeted toward specific geographical areas or census tracts. Investments typically are high credit quality; most are Agency issued, securitized bonds backed by residential mortgages; municipal bonds and asset backed securities also may be used. Regardless of the specific social goals of Community Investing bond portfolios, the financial objectives are risk-adjusted returns commensurate with or better than those of corresponding conventional portfolios over a full market cycle.

We are aware of only two investment management firms that offer dedicated Community Investing bond portfolios, and both offer separate account and mutual fund vehicles. The performance of both of these products has been competitive with their benchmarks and peer groups. Investors need to be aware, however, that both purchase out-of-index securities (due to the targeted nature of investments and relative small issuance size) and thus may encounter some liquidity constraints, particularly in the case of smaller separate accounts. There is also potentially more tracking error versus the benchmark.

There are other fixed income managers that offer portfolios with broader Responsible Investing mandates that include a Community Investing component. Either through mutual funds or separate accounts, these portfolios typically target upwards of 10% in community development initiatives primarily through community banks, credit unions, and loan funds.

Another Community Investing option is a Community Development Loan Fund (CDLF). CDLFs pool investments and make loans to individuals in support of initiatives in specific geographic locations in microenterprise, housing, small business development, and community service. There are approximately 500 CDLFs, which typically are structured as non-profit organizations. CDLFs offer market- or near-market rates in terms of one to 10 years through unsecured loans (investment notes or promissory notes).

While CDLFs are not regulated or federally insured, their repayment record reportedly has been strong and has been aided by loan loss reserves and technical assistance to those receiving loans. EAI believes it is important for managers who invest in CDLFs to demonstrate a due diligence process in their selection and monitoring of funds. It is often the case that portfolio managers will maintain Approved Lists of a diversified group of selected CDLFs from which to construct portfolios rather than try to cover the entire universe of funds. A rating system primarily designed for non-depository CDFIs was initiated in 2004 to help managers assess the social and financial performance of CDLFs. The Opportunity Finance Network (OFN), a national network of CDFIs, created the CDFI Assessment and Rating System (CARS) and, to date, has rated over 50 funds.

[2] Founded in 1996, the National Community Investment Fund is a non-profit, private equity trust that invests in financial institutions that generate financial as well as social returns. As part of its broader mission, NCIF facilitates transfer of knowledge to help institutions improve their financial and social returns.

Investors can also access CDLFs through an intermediary such as Calvert Community Notes, which is a managed portfolio of screened and monitored loans to over 200 nonprofit enterprises in the U.S. and overseas. Investors purchasing notes of $50,000 or more can customize their investments to target particular geographic regions or areas of interest (such as microcredit).

(III) PUBLIC EQUITY

Opportunities to pursue Community Investing objectives through publicly listed equity securities are more limited than those available in other asset classes, but do include a unique vehicle through the US Community Investing Index.

Broad Responsible Investing Approaches

Investment managers that offer broad Responsible Investing strategies typically include positive community relationships among their list of criteria in company selection. The assessment would include consideration of interactions with the local community in which the businesses operate, support of minority and women causes, and workforce development.

Investing in a broad Responsible Investing portfolio does not offer (nor is it intended to offer) a highly effective means of Community Investing; though additive, there is minimal direct impact. Some managers, with client approval, will take a designated portion of the total allocation to a broad Responsible Investing portfolio and build a separate portfolio of CDFIs and CDLFs in order to channel investments more explicitly to Community Investing. This would usually be done by a team member with expertise in the area.

> The US Community Investing Index is a unique offering that provides exposure to the U.S. equity market through a rigorously screened portfolio of companies that have demonstrated a commitment to underserved communities.

US Community Investing Index Strategy

Within the public equity domain, the US Community Investing Index (USCII) is a unique and credible option for investors who want to allocate a portion of their assets to a product that addresses community issues as an explicit objective.

The US Community Investing Index was developed by the F.B. Heron Foundation in conjunction with Innovest Strategic Value Advisors (now RiskMetrics) and an external Advisory Board. Launched in 2005, the objective of USCII is the identification of leading U.S. companies within the S&P 900 that have demonstrated success in and commitment to serving economically underserved communities. The associated USCII strategy is a passive approach (managed by State Street Global Advisors) that seeks to match the return and characteristics of the USCII with low tracking error.

The constituents of the USCII (approximately 330) have been selected through a rigorous process and are monitored on an on-going basis. Companies included in the USCII are evaluated and scored on the basis of 20+ criteria reflecting strategic alignment with the community (40% of aggregate score), workforce development and wealth creation (40%), and community engagement and philanthropy (20%). The company selection process essentially is a best-in-sector approach.

Since its November 2005 inception through August 2009, the USCII has modestly outpaced the S&P 500 on an annualized basis (-2.99% versus -3.20%). Counter to prevailing concerns regarding the impact of Responsible Investing strategies on performance, over the time period observed, the Community Investing Index has not sacrificed returns as a result of its screening processes.

The Community Investing Index strategy thus offers a competitive option for investors seeking broad exposure to U.S. equity markets, and one that does so in a responsible manner with an explicit focus on community investing. An active approach using the USCII may be available at some point in the future.

(IV) PRIVATE EQUITY AND PRIVATE REAL ESTATE

Private equity and real estate offer investors a wide spectrum of choices to pursue Community Investing objectives. Further, they have unique attributes relative to more traditional public equity and fixed income investments, which may include:

- **Control** – In contrast to investments in stocks and bonds, which effectively direct capital passively, many private investments involve control over the asset or entity by the investor. This may include outright control over the investment and/or board seats, allowing the manager to actively direct strategy and execution of each investment. An investment with a private real estate manager, for example, may facilitate the construction of moderate-income workforce housing to support community objectives. This would be as opposed to an investment in a listed REIT that may be a more passive owner/operator of existing properties. In some cases, one can point directly to the community value in such strategies (in the example above, the number of affordable units created in a workforce housing project), while it may be more difficult to do so in an investment in stocks or bonds.

> Many private equity strategies offer direct control over investments, thus enhancing their impact.

- **Focus** – Private investment funds can be very specialized and may invest in as few as 10 to 20 opportunities. Some funds may specialize in a specific geography (for example, Appalachia or New York City), while others may specialize in specific market segments (such as workforce housing or minority-owned companies). This feature can allow investors to target their community investment dollars with a relevant fund opportunity. However, not all funds are so highly focused.

- **Balance between social and financial returns** – Given the wide variety of private investment strategies, funds span the spectrum of targeting social versus financial returns. Investors must balance these considerations with their own objectives. For example, some venture capital funds effectively sacrifice some level of financial return to achieve enhanced social objectives. However, other managers may be focused solely on financial returns while social objectives are a secondary, but still important, consideration; these managers generally target market-competitive returns. Investors, thus, have the opportunity to select managers based on their preference for financial versus social returns.

- **Diversification** – Across the spectrum of private investment opportunities, there are numerous strategies that are not readily available to investors in “traditional” asset classes. In particular, some real estate, venture capital, and mezzanine debt investments are strategies in which it is difficult if not impossible to gain exposure through any other type of investments.

As noted above, private investments offer a wide spectrum of choices across strategy and risk/return profile to target Community Investing objectives. Some of the most common investment strategies employed in the Community Investing context include the following:

- **Venture capital** – Such strategies generally invest in small, fast growing companies with a high level of business risk in order to achieve very high returns. Venture capital funds that are generally considered Community Investing opportunities may invest in women- and minority-owned businesses and/or in underserved markets (for example, Appalachia or New York City). Venture capital returns are highly volatile and are often dependent on very successful investments (for example, Google or Yahoo). Given that Community Investing-oriented venture capital funds may invest in underserved markets, such funds may not have the same financial return potential as do “mainstream” venture funds. Still, such funds do potentially have a greater social impact in their target area of focus. This may include job and/or wealth creation and diversity of hiring.

- **Buyouts (including mezzanine)** – Buyout and mezzanine funds provide capital to businesses that are generally more mature and stable than those seeking venture capital. In the Community Investing context, such investments may be made in women- and/or minority-owned businesses or in underserved markets and may pursue objectives such as job creation or fostering a healthier economic and social climate in a particular market or segment. Community Investing-focused buyout and mezzanine opportunities may be more competitive from a return standpoint than venture funds, depending on the nature of the strategy, but the demarcation between mainstream and Community Investing-related funds may not always be clear.

- **Real estate** – Investments in private real estate range from passive ownership of existing assets, to rehabilitation of existing properties, to new construction. As such, some real estate strategies are highly consistent with Community Investing objectives. In particular, funds focused on rehabilitation, new construction, and related strategies provide opportunities related to smart growth, affordable and/or workforce housing, urban in-fill, and other community-focused initiatives. Investment opportunities vary depending on the focus on financial versus social return, but several opportunities exist that target market-competitive returns. In addition, given the local nature of the real estate business, some funds are highly specialized by geography, allowing investors to target Community Investing capital to specific markets.

Given the broad universe of private investment strategies, the descriptions above provide only an introduction to some of the opportunities available. The actual Community Investing-oriented investment opportunities are a small subset of each of these strategies, and one cannot assume that they are representative of the full universe in terms of resources and capabilities. Private investments, nonetheless, provide a spectrum of choices in which to align financial and Community investing objectives, and investors can build customized programs tailored to their specific community investment objectives. Private investments, however, operate fundamentally differently than “traditional” investments. For those investors without existing private investment programs, serious consideration should be given to the ramifications of beginning such a program.

II. MANAGER DUE DILIGENCE

The evaluation of an investment manager with a Community Investing strategy requires the same rigorous due diligence process as that of any other manager, whether of a conventional, a broader Responsible Investing, or any other specialist strategy. As with any approach that is generating attention, there will be many new entrants to the area and many claims of expertise. While evidence continues to emerge challenging perceptions that Responsible Investing sacrifices returns, vast differences exist among the capabilities of individual providers. Manager selection thus is paramount.

EAI subjects Community Investing strategies to the same rigorous due diligence process as any investment product. Not all strategies and providers are equally capable of delivering competitive results and meeting client objectives.

Across the asset classes considered in this paper, EAI's due diligence process considers an abundance of qualitative and quantitative information. Additional factors that differentiate managers with the greatest potential to deliver stated objectives of Community Investing and to meet specific client goals include:

- Experience and expertise in Community Investing issues
- Extent of resources dedicated to Community Investing
- Networks and strategic partners
- Internal versus external research
- Means to track and metrics to measure impact
- Extent to which strategies are interrelated with broader ESG issues
- Balance between social and financial returns

CONCLUSION

With its focus on the socioeconomic well-being of neighborhoods and the individuals that comprise them, Community Investing can establish a virtuous circle to establish underserved communities as viable economic entities, raise their constituents' standards of living, and integrate communities positively into the broader regions and networks in which they exist.

Investing in communities historically has received a great deal of attention from non-profit grantmaking and support programs. A new model may be emerging, furthered by trends in Responsible Investing, that recognizes an increasing role by for-profit entities in community development and revitalization and that seeks market rates of return for investors.

While we recognize the value of Community Investing, not all strategies and providers are equally capable of delivering high quality results and meeting client objectives. This paper seeks to educate and inform clients and ultimately to provide guidance on the best and most legitimate opportunities and managers within the Community Investing area. EAI would welcome the opportunity to discuss with clients ways of implementing a Community Investing program consistent with their mission or Responsible Investing objectives and their overall portfolio.

About the Author:
Janet Kalwat is the Director of Responsible Investing Research. She has worked with EAI for 12 years and has focused on Responsible Investing for the past two years. Janet earned an MA and PhD in Demography from Princeton University, an MA in Demography from the University of Chicago, and a BA from Upsala College. She is a project manager for the Canaan Foundation, which brings used computers to schools in rural Kenya and sponsors small business ventures and cultural initiatives there.

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200 Connecticut Avenue
Suite 700
Norwalk, CT 06854
USA
Tel +1 203 855 2200
Fax +1 203 855 2301

evaluationassociates.com