Speech by Douglas W. Nelson
President, The Annie E. Casey Foundation
at the PRI Makers Network Conference
Stanford University, Palo Alto California
January 20, 2006

I'm delighted to be here, but must confess I'm a little bit chagrined to be addressing an audience that is, in every way, more expert and experienced than I am with the subject at hand. However, like most big foundation CEOs that won't stop me. In fact, like many of my peers, I've gotten quite comfortable speaking earnestly and authoritatively about things I barely understand. I think this grows out of years of being treated kindly and politely by listeners who will put up with almost anything in order *not* to diminish their chances of getting a grant.

I am genuinely sincere when I say that this network, the work you are doing, and the program related investing we are all learning more and more about – these things are enormously important to the future of effective philanthropy in this country.

I want to talk this morning mostly about how and why we at Casey have come to our conclusions about PRIs and, even more broadly, about social investing. Like the field as a whole, the Casey Foundation can trace the beginning of its PRI learning curve back to the pioneering work of the Ford Foundation that started making PRIs in 1968. When I joined the Casey Foundation in 1990 – my first foundation experience – I was vaguely aware that Ford had been using low-interest or forgivable loans to support organizations aligned with Ford's goals. I was intrigued enough to investigate Ford's and similar efforts and the modest PRI research that had grown out of it.

I have to say I was not encouraged in this curiosity by my otherwise sophisticated and brilliant CFO, a man of vast foundation experience, who had looked fairly deeply at PRIs. When all was said and done, his view was that PRIs amounted to either an inefficient or half-hearted grant, on the one hand, OR a high risk, low return endowment investment, on the other. Viewed either way, he concluded that PRIs couldn't produce enough benefit to the Foundation's goals or institutional interests to be worth the complexity, accounting burden, due diligence, tax challenges, and other headaches that went along with them.

New though I was, I pushed back on his assessment. I asked that if the limits and defects of PRIs were so clear, why would the Ford Foundation keep putting continued effort behind them. He assured me the Ford Foundation makes lots of mistakes.

The skepticism my CFO brought to the question of PRIs is, I want to stress, not an uncommon one. Indeed, such views continue to slow the breadth and depth of foundations' interest in program related investments. Moreover, there *are* some solid grounds for skepticism. PRIs *are* complicated, labor intensive, and they require skillful navigation through murky regulatory and tax treatment waters. This is especially true and burdensome for foundations during their early adoption stages – before they have the infrastructure, experience, and dedicated staff required to achieve efficiency in making PRIs. In fact, for many small foundations or foundations with modest commitments to PRIs, we may have to build pooling vehicles that can aggregate and manage pooled program related investments in order to make such investments practical and cost-efficient.

Second, PRIs, done badly, can weaken foundations. Using low-interest loans for social purposes that could more effectively be achieved through grants is just plain bad philanthropy. Similarly, making lots of below market, double-bottom line social investments can, unless well managed and communicated, actually confound or compromise a foundation's fiduciary obligation to steward its endowment principal.

In this regard, I suspect Casey is like lots of foundations. Our Finance Committee struggles mightily to steal every Yale or Harvard or Stanford gimmick and to scour investment choices to find the best alpha opportunity in order to squeeze out a few more basis points above benchmark returns for our endowment. After they're done laboring on that goal, we ask them to review, with enthusiasm, our decision to invest in a paperclip factory located in a brownfield, surrounded by an unprepared labor force, with a projected return of one-and-a-half percent – if all goes well.

To lots of reasonable folks, this simultaneous commitment to maximizing corpus and 'investing" in social goals comes across as a mixed message or a case of unaligned goals and goes far to explain why so many investment officers and investment committees remain resistant to program related investments.

Given all of these risks, complexities, and concerns, what would make a cautious outfit like the Casey Foundation set aside $100 million for social investing, put together a first rate, in-house social investing team, struggle to keep up with the best ideas coming from Heron, MacArthur, Rockefeller, Prudential, Ford, Meyer, Jacobs, and others; help found the PRI Makers Network, and widely advocate that more foundations put more of their endowments into PRIs and mission-related investments?

There are a lot of reasons. Some are fairly small and particular reasons, but some are big, and, I think, quite persuasive.

Let me start with a *tactical* reason. I'm convinced that market rate credit or below market or forgivable loans or equity investments are sometimes smarter, more appropriate, and more effective ways to support mission-relevant organizations or activities than are simple grants or gifts. There are instances – potentially many – where loans, loan guarantees or lines of credit can buy time, reinforce business discipline, create internal capacity, build credibility with other stakeholders, or demonstrate the market viability of a particular activity that *simply could not be as effectively achieved through a conventional grant or gift*. Favorable term, patient loans to cover the start-up and capital of new charter schools may well be an example of the superior value of a loan over a grant approach. If charter schools are ever to become a scaled and desirable part of the mainstream education system, such schools are going to have to secure financing streams capable of meeting their long-term capital, maintenance, and operating costs. Loans may well help charter schools address that challenge more quickly and completely than simple one-time start-up grants. Equally relevant, a loan approach (like I've described) clearly works to the benefit of a foundation that wants to broadly promote charter school start-ups. It does so by allowing the foundation to recycle repayments into fresh loans to a new cohort of charter schools. In other words, it helps with scale.

There are, of course, lots of other existing examples of this kind of tactical ending. My hunch, however, is that the more foundations think about and use tactical PRIs, the more we are going to discover new instances, opportunities, and objectives that can be more efficiently supported by loans than by grants. In other words, I think we are only at the beginning of appreciating the range of tactical opportunities for PRIs.

A second, slightly broader, reason for embracing PRIs is one I would describe as *strategic*. Over the years, a lot of us have discovered that there is power in creating more collaborative, synergistic, and mutually accountable relationships with our grantees than is possible in the conventional donor-recipient relationship. The venture philanthropy folks, in fact, go so far as to argue that effective giving requires that donors have a real stake in the success or performance of the organizations or enterprises they are supporting.

Clearly, extending a loan, providing a guarantee, or making an equity investment gives a Foundation an unmistakable stake in the performance of the benefiting organization. Grantors and grantees become “partners” – not just in spirit – but in fact. Not surprisingly, foundations with an *investment* interest in the programs they support are more likely to lend their own expertise, provide more operational advice, intervene in crises, and even take seats on the governance boards of their grantee. I am a board member of the East Baltimore Development Corporation – a newly created CDC that is managing a vast and multifaceted redevelopment of one of the nation’s most disinvested and disadvantaged neighborhoods. I’m on that board because I think we have an historic chance to revitalize a community in ways that actually benefit the low-income families who have suffered decades of disinvestment and neglect. But I am *also* on that board because I don’t want EBDI to default on a $19 million loan the Casey Foundation has guaranteed.

In an even more profound way, the Jacobs Family Foundation has deeply followed its investment in Market Creek Plaza – so deeply in fact, as to create a virtual merging of the resources, reputation, talents and interests of grantor, grantee and community. I am convinced that these new joint venture models emerging between foundations and their mission partners are producing more powerful engines of impact and change than could ever have been realized through traditional grantor-grantee relationships. They just may be the future form of philanthropy for a significant segment of the field.

The third reason that has propelled Casey (and I hope the field) toward increasing interest in PRIs and social investing is what I think of as a policy – maybe even ethical – consideration. If memory serves, there is today almost half a trillion dollars held in the endowments of independent grant making foundations in the United States. That one-half trillion in wealth is exempt from taxes because it is pledged to advance charitable social, civic and humanitarian purposes. However, less than five percent of that wealth is actually put to charitable activities in any given year. The overwhelming fraction (95 percent) is invested in profit generating activities usually unconnected to any charitable or social goals.

This seems wrong to me – or at least undesirable. There's something not right about the fact that in most years since 1980, charitable endowments in the U.S. earned more than they gave away – even after adjustment for inflation. This is even more worrisome when you recognize that the cost of solving most social problems is, like everything else, likely to rise with time. Hence, this pattern of spending less now and building endowments for later may actually carry a very high, if hidden, opportunity cost for the sector.

Finding practical ways to increase the payout rate – to put more charitable money to charitable work – is, in my view, one of the big challenges facing philanthropy. Of course, some institutions have addressed it head on. For example, those foundations that have committed to spend out their corpus in a specific timeframe have, in effect, concluded that they are going to put more of their assets to work sooner rather than later. Others, like the Casey Foundation, have decided to sustain an annual spending rate of above 7.5 percent, even at the risk of diminishing the real or absolute value of our endowment over time. But most independent foundations remain committed to the notion of perpetuity and thus to preserving the real value of their endowments well into the future. These are the folks who have and will continue to resist legislative proposals to raise pay out rate thresholds at the federal level. However, they may also be the most important target for advocates of PRIs and social investing to reach out to and engage.

The agenda here is not to encourage perpetuity foundations to use PRIs as a substitute for existing levels of grant spending, but rather to urge them to consider PRIs, mission investments, social investments as a complement or <u>supplement</u> to their 5 percent grant making budgets. Increased take up of social investing by mainline foundations (even one or two or three percent of their portfolios) would add scores of millions of dollars to charitable purposes without directly threatening the right to permanently preserve and protect endowment values. Put simply, *<u>expanding return bearing, recycling PRIs may be the most practical way for the philanthropic sector to increase the percentage of its tax-exempt wealth going to charitable objectives.</u>*

The final reason why Casey – and why I think the field – needs to deepen its commitment to intelligent social investing is the most important reason. Put plainly, I don't think Casey – and I don't think most ambitious foundations – can accomplish what they really want to accomplish without learning how to creatively invest more of their assets in mission related purposes.

Let me try to illustrate. The Casey Foundation exists to reduce the gap in opportunity that exists between advantaged and disadvantaged kids in this country. It's a big gap and there are at least 10 million American kids on the disadvantaged side of that divide.

The Casey Foundation's $200 million in annual spending isn't going to close that gap. It isn't going to change the economic prospects of the millions of poor families whose kids are at risk. It isn't going to reconnect the disinvested concentrated poverty communities (where most at risk kids live) to the nation's mainstream economy. In fact, if Casey granted all its $3 billion endowment tomorrow on the best grants we could make, I'm not sure we'd move all that much closer to realizing our mission.

The reason is that most of the social, human, health, economic, and environmental problems that foundations want to solve are well beyond the reach of even a trillion dollars worth of charitable spending. What ultimately happens to people, places, opportunity, the environment, health care, education, race relations, poverty, family structure does not turn on how philanthropy behaves, it turns on what the government does and what private markets do.

In my view, foundations with ambitious missions will only succeed when they learn how to use their resources to encourage greater alignment between public policy, private markets, and socially desirable goals.

The subject of philanthropy's intersection with public policy is a huge and critical one, but it's a subject for another time. What I want to leave you with is a focus on the potential of philanthropy to help private markets contribute more constructively to socially desirable outcomes. I'm not suggesting we persuade the private sector to become charitable; they can't and they shouldn't. But the behavior of our sector – as investors, as lenders, as guarantors, as depositors, as loss insurers, as stockholders, as creditors, as information suppliers, as patient capital – all these things can influence private market behavior: We can shape capital flows, capital costs; we can influence the speed and scale of investment and development; we can underwrite costs of new, more constructive financial products, and we can reduce the risks faced by private investors when we ask them to invest in people, places, projects, and purposes that heretofore have not been seen as competitive or prudent opportunities.

PRI making is, I think, at the cutting edge of this potentially transformative change in the use of foundation resources to advance our charitable missions. We are at the very beginning. I think we are only glimpsing at the possibilities and the potential. We need to foster experimentation, honestly measure results, scale up effective efforts, document best practices, and reach out to a much larger segment of the foundation world.

A lot of important progress is possible here and that's why I think the work of this network is so critical to the future of ambitious philanthropy in the United States.

Thank you.