COMMUNITY INVESTING MODELS FOR PORTFOLIO MANAGERS OF SEPARATE ACCOUNTS

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Section 1. Introduction

Community investing has emerged as an attractive asset class for high net-worth individuals and families who want more than fiscal gain from their investments, and for institutions in true pursuit of their mission. Portfolio managers (PMs) have found that developing a community investing service has allowed them to service the wholeness of their clients' financial objectives. It has added a personal dimension to asset management and solidified relationships with their clients. Community investing offers clients investments with visible social impact and a chance to become more involved in the development of their community or communities in other regions and nations. However, PMs have experienced technical and logistical challenges associated with investing in a new asset class. This paper will address the challenges facing PMs in community investing and help them to implement an appropriate and well-defined community investing service for their clients.

This paper presents "models" for community investing that have proven to be successful for other portfolio managers. Every PM serves their clients in a unique way and therefore, the models presented must be molded to work with the existing strategies and goals of the PM and the desires of her or his clients. This is a new field and the only "best practice" is one that works closely with community development financial institutions (CDFIs) and becomes active and involved in their community development work. Knowing personally the CDFI's management and its community development projects reduces investment risk, simplifies due diligence, and makes PMs more informed resource providers for their clients.

Section 2. Community Investments in Professionally Managed Portfolios

Portfolio managers are currently investing in two main types of community investing products: 1) market-rate certificates of deposit (CDs) issued by federally insured community development banks and credit unions; and 2) and promissory notes, issued by community development loan and guarantee funds (CDLFs) earning returns ranging from 0 to 4 percent, as established by the investor.

CDs in community development banks and credit unions fall in the same asset class as CDs in traditional banks and credit unions and are insured up to at least $100,000.

Investments in CDLFs belong to a new asset class and have no established benchmarks. Given the high degree of specialization of each CDLF, their quality and effectiveness in meeting the needs of low-income individuals is difficult to compare using a standardized system. Because investments in CDLFs belong to a new asset class, PMs need to have a clear view of where community investing "fits" into their clients' portfolios and into their portfolio investment strategy. Many PMs find it best to compare it to a more established asset class or investment strategy when discussing the opportunity with their clients. The role of community investments in professionally managed portfolios has been compared to:

- An inflation-hedger
- A fixed income investment
- A high-impact supplement to philanthropy
- A rolling grant

Comparing an investment in a CDLF to an inflation hedger or a fixed-income investment most clearly defines its expected financial performance and its minimum term of 1 to 5 years. While community investing is not philanthropy, clients who engage more with the social or moral dimension of the investment may prefer to approach it as a rolling grant or a high-impact supplement to philanthropy. PMs have found that this type of comparison, while not doing justice to the financial aspects of the investments, has allowed clients to enjoy the "feel good" aspect of philanthropy while actually yielding profit from a secure investment. Regardless of how the PM chooses to include community investing in her or his investment strategy, the financial and social impact expectations for the investment must be clearly defined. Well-defined expectations for CDLF investments help PMs communicate the purpose of community investing to their clients. They also begin to shape a more systematic way for PMs to evaluate if CDLFs are meeting their expectations and fulfilling their missions.

Section 3. Choosing Appropriate Community Development Financial Institutions

Choosing which CDFIs to invest in is largely a client-driven process. It is important that the CDFI's community development work is appealing and consistent with the clients' beliefs. There are more than 1,000 CDFIs in the U.S. and each one specializes in different community development projects, regions of the country and world, and follows distinct management and operational practices. The CDFIs must be financially, socially, and structurally compatible with the PM's investment strategy. During the preliminary stages of considering a CDFI for investment, a PM should carefully consider the following characteristics:

Geographical area of impact

In general, the most important CDFI option a PM can offer his or her clients is one whose community development work focuses on their clients' communities. There are several advantages to offering a local CDFI such as enhanced client interest, greater capacity for the PM and the client to become involved in the CDFI's community development work, and greater ease in gathering information for due diligence purposes. There are also advantages to offering investments at national CDFIs whose impact reaches many communities across the country, or international CDFIs. For PMs capable of forming relationships with several CDFIs, a diverse set of options will draw a larger pool of investors.

Clear and effective social impact

A CDFI's ability to provide information on its lending activities and community development projects speaks to its integrity as an organized and goal-driven institution. It also makes it easier for PMs to report to their clients the successes being financed by their investments.

Communication and responsiveness

Phone calls to CDFIs to request information, speak to financial professionals, or ask preliminary questions regarding investments, should be met with timely and sufficient responses. Investing in CDFIs requires easy access to information, good communication and attention to detail on the part of both the CDFI and the PM. The CDFI staff and management should express a level of commitment, responsiveness, and timeliness that makes the PM comfortable working with them in the future.

Stable management and financial performance

Assessing the stability of management and the CDFI's financial performance can only be done comprehensively by a due diligence process, see section IV. However, during the preliminary stages of considering a CDFI for investment, a PM can look for indicators of the CDFI's financial and managerial stability in its materials and correspondences.

Section 4. Due Diligence

Due Diligence has often been the barrier to developing community investing programs. The PMs contacted for this paper found that maintaining a close and active relationship with the CDFI's management and familiarity with their lending projects lessens the need for extensive due diligence each year and makes the process more personally rewarding.

Community Development Banks & Credit Unions

Community development banks and credit unions are federally insured. Thus, due diligence tends to be skewed more toward ascertaining if the CDFI is adhering to its stated mission. PMs focus this due diligence on evaluating the effectiveness of the CDFI's lending and community development projects. See the section below on "Evaluating social impact performance."

Community Development Loan Funds

<u>Initial due diligence process</u>: The initial process of assessing the risk associated with investing in a CDLF requires a comprehensive review of the CDFI's financial performance, mission, operations and programs, management, governance, capitalization, and social impact performance. A due diligence primer on assessing the risk of investing in CDFIs, as well as due diligence purchasing opportunities, can be found on the

Community Investing Center website at www.communityinvestingcenter.org. A rating system for CDFIs (CARS™) is in the first stage of implementation by National Community Capital Association (www.communitycapital.org), and the first ratings will be available in the first quarter of 2005. CARS™ analyzes CDFIs in the areas of Impact Performance and Financial Strength and Performance, and provides a separate rating for each area.

<u>Evaluating social impact performance</u>: Social impact performance refers to the positive change that CDFI programs make in the lives of low-income people and on the economic structures that perpetuate poverty. This component of due diligence is unique to community investing and has been described by PMs as more of an art than a science. It is an important focus of PMs' due diligence process because it is the distinguishing characteristic of each CDFI. Detailed knowledge about the CDFI's social impact assures PMs as well as clients that the CDFI's lending projects are meeting an effective and worthwhile social goal and are in accordance with the CDFI's mission. See the "informal methods" below for suggestions on how to evaluate social impact performance.

<u>Annual review of CDLFs</u>: Once a PM has formed a relationship with a CDLF and has begun investment, they usually conduct an annual review of the CDLF. PMs who are well versed in the CDLF's lending projects and stay involved, directly or indirectly, throughout the year find the annual review process to be less burdensome. PMs use many different methods for reviewing a CDLF's financial performance, social impact, and stability of management. The following were found to be the most useful methods for this analysis:

Formal methods:

- Send survey to CDLF
- If the CDFI is a member of NCCA or another trade association that requires an annual survey from CDFIs, request copy of the completed survey
- Review annual report and quarterly statements
- Review clients' rates of return on their statements (throughout the year)
- Analyze key financial statistics such as deployment ratio

Informal methods:

- Review newsletters and website
- Call loan fund manager
- Sit on the board of the CDLF
- Volunteer at community development organizations that work with CDLF

Section 5. Models for Offering Community Investing

Every PM has a unique capacity for offering, administering, and tracking community investments. Before forming relationships with CDFIs and establishing a community-investing program, each PM will need to assess her or his internal resources available for implementing such a program. These resources include staffing, time, expected client capital directed toward community investments, and the clients' custodian's ability to hold investments not traded electronically.

These restrictions must be kept in mind when deciding which model of offering is within the capacity of the PM:

5.A Intermediary Product Model

Portfolio managers with a smaller client base have often entered into community investing by offering intermediary products to their clients, such as Calvert Community Notes. Calvert Community Notes are investments underwritten by the Calvert Foundation that are in turn lent out to a variety of CDFIs that have met the rigorous social and financial standards established by Calvert. PMs have formed partnerships with Calvert in which Calvert and the PM's firm "co-author" a product specialized to the firm's needs. This model is the least administratively cumbersome.

Advantages:

- Less administrative labor for PMs
- Streamlined investment process due to Calvert's experience and expertise
- No due diligence for PMs
- Minimizes investment risk by diversifying clients' investments and underwriting investment note
- Ability to customize investments by region and social impact

Disadvantages:

- Clients and PMs loose the "direct connection" with the CDFI and its community development work
- Adds administrative costs not found in direct investments
- While invested in 180 CDFIs, cannot offer the broad universe of CDFI options

Although this model is not as direct, it does provide a way for PMs with limited resources to offer community investing products. However, working with CDFIs directly is the preferred method for PMs with the administrative capacity to do due diligence and the capital to implement a more direct community investing service with a diverse set of options. PMs have found that many of their clients and some of the CDFIs prefer to the extent feasible to minimize the intermediaries between the provider and the impacted.

5.B Limited Offerings Model

Some PMs have the ability to set up a more comprehensive community investing service, but still cannot offer investments in the broad universe of CDFIs. PMs choose a limited number (usually under 10) CDFIs that they cultivate a relationship with and invest in on behalf of their clients. This model offers many advantages, especially if the CDFIs are carefully chosen to represent a diverse cross section of the community investing industry.

Advantages:

- Diversity of community development impact resulting in greater client interest
- Direct connection with CDFI's community development work
- Limited administrative work
- Limited due diligence
- Established investment processes with CDFIs

Disadvantages:

- Limited options for clients

5.C Client-driven Model

Some PMs have the ability to offer community investing to their clients in much the same way as they offer other investment services. When the client displays a desire to include community investment in their portfolio, the PM is able to discuss options for making this type of investment and can draw from a broad spectrum of CDFIs.

To implement this community investment model, PMs must have the staffing and administrative capacity to do due diligence on a reasonable number of CDFIs and the desire to maintain a relationship with them throughout the year. They must also have a client base large enough to invest a reasonable amount in each CDFI, experience in working with CDFIs and a clear and established internal process for community investing.

Advantages:

- Most options for clients
- Most similar to other investment services offered

Disadvantages:

- Due diligence can be labor intensive
- More work to establish a relationship and process with each CDFI

Section 6. Administering Community Investments

The administration of community investments is still a process containing a lot of ambiguity for both the PM and the CDFI. Purchasing and tracking clients' community investments requires a commitment to devising a process that works for all parties as well as continued attention to detail. Although each PM will employ a unique process for administering, purchasing, and tracking her or his clients' investments, the PM should always serve as the communicator between the CDFI and the client. All correspondence and materials regarding the investment and investment decisions should go through the PM first. This not only preserves the traditional relationship between the PM and the client, but it also simplifies the PM's record keeping and shields the client from unwanted solicitation or material from the CDFI.

Community investments differ from traditional investments in that they usually are not traded electronically. The PM's administrative process for community investments, including bookkeeping, communication with CDFI, and tracking interest payments will largely be determined by the client's custodian's ability and willingness to hold community investments. Administering investments with banks, trust companies and non-bank custodians requires a similar amount of labor by the PM, although some of the steps are different. Regardless of the custodian, the majority of the administrative work involved in these investments will be the responsibility of the PMs.

There are a small number of federally insured community development banks' CDs that are electronically traded. Purchasing CDs from these CDFIs follows the same process as purchasing CDs from non-community development banks and credit unions, and will be tracked by the custodian.

6.A Steps for Purchasing Investments

<u>Certificates of Deposit (CDs)</u>

Non-Bank Custodians:

1. The client authorizes custodian to accept instructions from the PM.
2. The PM requests a check from the client's custody account in the amount of the CD.
3. The check is made payable to the bank or the credit union.
4. The PM sends the check to the bank or credit union and purchases the CD in the name of the custodian for the benefit of the client.
5. The bank or credit union sends a time deposit receipt to the PM.
6. The PM forwards it to the custodian. The custodian books the CD.

Banks and Trust Companies:

1. The client authorizes custodian to issue a check to the bank or credit union in the amount of the CD.
2. The custodian sends the check to the bank or credit union and purchases the CD in the name of the client.

3. The bank or credit union sends a time deposit receipt to the custodian. The custodian books the CD.

<u>Loan Fund Products</u>

Non-Bank Custodians:

1. The client authorizes custodian to accept instructions from the PM.
2. The PM requests a check from the client's custody account in the amount of the investment. The check is made payable to the CDLF.
3. The PM sends the check to the CDLF.
4. The CDLF issues a promissory note in the name of the custodian for the benefit of the client. The CDLF sends the promissory note to the PM.
5. The PM forwards the original promissory note to the custodian. The custodian books the investment.

Banks and Trust Companies:

Many PMs only do client directed investments. Those clients usually have their custody accounts with banks and trust companies. In these cases:

1. The client instructs the custodian to send a check to the CDLF for the amount of the investment.
2. The CDLF receives the check and issues a promissory note in the name of the client.
3. The promissory note is sent to the custodian and the custodian books the investment.

6.B Tracking Investments

<u>Certificates of Deposit (CDs)</u>

All PMs need to track their client's CD investments manually, regardless of their client's custodian. PMs usually track their client's investments using a software spreadsheet. The PM requests that the CDFI send notification to the PM of all transactions that the CDFI sends to the client's custodian. The PMs review the information and record the transactions into their records. The PM then reconciles the client's portfolio management account with the client's custody account. PMs must carefully track their clients' CDs and notify the client's custodian three weeks before the end of the CD's term.

<u>Loan Fund Products</u>

All tracking of loan fund investments and interest payments is done by the PM using a software spreadsheet. When an investment in a CDLF is purchased it is entered into the PM's record.

The PM keeps track of these investments and their interest payments, as they are due. PMs use spreadsheet software or an income map that displays when their clients' interest payments are due and when their investments will mature. The information for the spreadsheet is drawn from the promissory note, which lays out the details of the client's investment. This spreadsheet is then compared to the custodian's quarterly statement and the PM's quarterly appraisal of the client accounts to make sure they display the correct information.

6.C Interest Payments from CDFIs

PMs request that the CDFIs send the interest payments directly to the PM, so they can enter it into their tracking system. Using their spreadsheet PMs know when the interest payments are due from the CDFIs. If they are due to arrive but do not, PMs call the CDFI. When the interest payment arrives at the PM's firm, the PM sends it to the client's custody account.

There are some PMs who direct the CDFI to send their clients' interest payments directly to their custodian and not to the PM first. One possible complication to this method is how your client's custodian identifies the interest payments that come into the client's custody account. It is a common practice for non-bank custodian to list the interest payment in the clients' custody account as a "contribution." This may look like it is a contribution from the client and not an interest payment from a CDFI. This is one reason why it is important for PMs to use their spreadsheet to anticipate when payments are due from the CDFI, and identify the origin of the "contributions."

6.D Reinvesting Interest from CDFIs

Interest earned on community investments can be reinvested with the CDFI, however many PMs do not offer this service to their clients. Reinvesting interest requires the PM to monitor and change the adjusted value of the investment. There are some PMs that consider reinvesting interest an important part of their community investing program and do offer this service. Typically they devise their own materials to send to their clients before their investment matures to outline their options for reinvestment. The PM must change the principal amount of the investment in her or his spreadsheet and the amount of the interest payments due.

6.E Suggestions for easier administration of CDFI investments:

1. Limited number of offerings
2. Designated entry periods for purchasing investments (once per year)
3. Minimum investment amount ($3,000 - $5,000)
4. Common maturity and interest payout dates for all community investments
5. Limited interest payment schedule
6. Designated person at PM firm to handle all communication and purchasing of community investments from CDLFs
7. Designated person at CDLF to handle communication and administration of investments with PM

6.F Alternative option for community investing administration: Client as Custodian

An alternative option to using a third-party custodian for clients' community investments is to have the client custody his or her own community investments. Some PMs have found it easier to administer these investments outside of a formal custodian. Because the PMs still wish to report on their client's community investments, this model requires an agreement with the CDFI that the client's materials, statements, etc. be sent to the PM and not to the client. Alternatively, the CDFI can send dual copies of all documents, one sent to the PM, and one sent to the client. Identical to the other models for administration, the PM enters and tracks client's community investments, and serves as the middle person for all communication between the CDFI and the client.

6.G Steps and forms for purchasing an investment from CDLFs

<u>Application and Agreement</u>: Requires general information on the investor and terms of the investment; specifies when and where to send the interest payments. Application and agreement should be sent with a check for the amount of the investment to the CDLF.

<u>Promissory Note</u>: Signed by the CDLF and issued to the investor when their check clears and the application is accepted; contains details regarding terms of the investment.

<u>Interest payments and statements</u>: Sent to the party designated by the investor in the application. The PMs should receive the statements for her or his clients. It is not necessary for clients to receive quarterly statements from the CDLF because they appear on the quarterly statements prepared and sent by their PM.

<u>Renewal letter and agreement</u>: Sent to the designated party, client or PM, a few months before the loan matures. This document asks the investor to renew the investment. Some PMs prefer to receive these and send their own document outlining their options to the client before the loan matures.

<u>1099 Forms for taxed clients</u>: Generally sent directly to the client, although some PMs prefer to receive these to check if the amount is correct for the client's community investments.

Sample copies of the above documents are available on the National Community Capital Association website (http://www.communitycapital.org/) in their technical assistance memo entitled "Improving CDFI Access to Socially Responsible Investors."

Section 7. Presenting Community Investing Options to Clients

Presenting clients with the option to invest in CDFIs should be consistent with the PM's style for offering other types of investments. Some PMs describe their options for investing to clients mainly through conversation while others rely on materials and publications. Regardless of how the PM conducts client relations, when presenting her or his investment services, community investing should be included and clearly defined.

Common ways to effectively communicate to clients about their community investment options are:

<u>Define purpose and expectations for community investments</u>: As mentioned in Section 2, clearly present to client the financial and social goals that community investments will fulfill in their portfolio, as well as their performance expectations.

<u>Use PM's materials to describe community investing options offered by PM</u>: Community investing is a service offered by the PM and the PM's materials should demonstrate this relationship. Most PMs first present their clients with an overview of the community investing options they offer, containing descriptions of the institutions and their lending projects. The clients are then asked to identify which CDFIs they are interested in learning more about.

<u>Respond to client's interests with CDFI's materials</u>: Once the client has identified one or more CDFIs that she or he would like to know more about, send the client the CDFI's own materials. Choose publications that are relevant for the client, such as the CDFIs newsletter, prospectus, or annual report.

<u>Establish asset allocation with client</u>: Establishing the portion of the client's portfolio that will be dedicated to community investing follows a different process for every client and portfolio manager. Clients are typically allocating between 1 and 3 percent of their portfolio into community investments.

<u>Management fees</u>: There is no general practice for discounting management fees on the community investing portion of the client's portfolio. Some PMs consider community investing a regular investment service and charge full price. Others charge half price or do not charge at all, intending to encourage their clients and to participate with them in the investment.

Defining client's relationship with the CDFI

Clients invested in CDFIs possess varying levels of desire to communicate with the CDFI or receive its publications, and some clients prefer to remain anonymous. Many PMs have found it easiest and most pleasing to their clients to serve as the middle person for all communication between the CDFI and the client. When first establishing a relationship with a CDLF, the PM instructs the CDFI to direct all of their clients' quarterly statements, annual reports, newsletters, renewal requests, etc. to the PM. The

PMs can then decide what to pass on to their clients, according to their clients' desires or to an established policy of the PM's firm. Because the clients' community investments will appear on their quarterly statement prepared by their PM, it is not necessary to send clients any of the mailings from the CDFI, although some clients do prefer to see these publications and they should be offered this option.

Section 8: Legal and Regulatory Aspects

Investments in CDLFs are unsecured obligations and are not insured by the federal government or any other organization. They are generally illiquid and priced at par. Although PMs have not found this pricing method to be a misrepresentation of the value of the investment, its ambiguity has the potential to cause confusion in the event of an audit by the SEC. For this reason it is necessary to include a disclosure statement in the community investing materials, clearly outlining the characteristics and risks of the investments. Clients sign the disclosure and it is then kept on file at the PM's firm.

We hope to have sample disclosure statements available on the Community Investing Center website soon.