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**SCAN OF THE COMMUNITY INVESTMENT SECTOR IN
CANADA**

**BY:
CORO STRANDBERG
STRANDBERG CONSULTING**

**BRENDA PLANT
BRENDA PLANT CONSULTING**

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EXECUTIVE SUMMARY

Most of the attention and strategizing around whether and how capital markets can lever sustainability—improved social and environmental conditions in Canadian communities—goes to considerations of whether there are links between sustainability and financial performance. Relatively little attention is placed on the potential of the fledgling Canadian community investment sector—one of the three pillars of socially responsible investment—to advance sustainability at much more local levels. This paper is a beginning attempt to bridge the gap in awareness of the community investment sector as a sustainability driver and to identify the operating constraints confronting the sector in today's marketplace.

Community investing (CI) is defined as investment for the purposes of financing deep-seated needs of local communities not addressed by mainstream finance, including poverty alleviation, community and cooperative development and environmental regeneration. For the purposes of this paper, CI includes economically targeted investing and sustainable venture capital—additional investment strategies that generate double and triple bottom line returns for investors and communities.

This paper takes a unique perspective in its analysis—that of the investor or fund manager, who is called upon to consider the track record of the American CI experience where market and near-market rates of return are possible. The U.S. track record has proved that many CI investments are non-concessionary, low- to no-risk and viable asset allocation strategies. It is generally concluded that while the CI sector is very small in Canada, if supports similar to those in the U.S. were available, its scale and impact could increase considerably. Specifically, a leadership role by the federal government (including a favourable tax and regulatory regime, operating and capital programs, and other supports), as well as strengthened industrial infrastructure (such as intermediaries, networks, product standardization, investor education and awareness), could go a long way to significantly scaling up the sector. Following the American lead, a Canadian version of the *Community Reinvestment Act* could provide similar impetus for the sector's development.

The paper notes that sub-markets such as those found in Aboriginal communities, where opportunities go unexplored because of the lingering perceptions of risk and security constraints, languish for lack of better information of the gaps and opportunities. In the U.S. such underserved markets, often perceived as high-risk, are proving themselves to be viable investment niches.

Within the paper, these underserved markets, which are not well understood by the traditional financial sector, are placed within a social capital market framework. Located on the investment continuum between traditional finance and philanthropy, the social capital market is viewed as generating both a social and financial return, that is, a “blended return.” The paper touches on the potential of advances in the understanding of social (including environmental) returns on investment and social value creation to

attract further interest in the CI sector as a means of leveraging sustainability benefits over the long term.

This paper, admittedly, raises more questions than it answers regarding the community investment sector in Canada. But if it has also served to raise awareness and interest among readers as to the role CI might play as a capital market strategy for advancing sustainability it will have met its objectives.

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ACRONYMS

ACC	Aboriginal Capital Corporations
ACFDC	Aboriginal Community Futures Development Corporations
ACOA	Atlantic Canada Opportunities Agency
AFI	Aboriginal Financial Institutions
AIM	Alternative Management Investment
BCIMC	British Columbia Investment Management Corporation
BEA	Bank Enterprise Award
CalPERS	California Public Employees' Retirement System
CCEDNet	Canadian Community Economic Development Network
CDC	Community Development Corporations
CDCU	Community Development Credit Unions
CFDABC	Community Futures Development Association of B.C.
CFDC	Community Futures Development Corporations
CDFI	Community Development Financial Institutions
CDLF	Community Development Loan Funds
CDMB	Community Development Municipal Bonds
CDP	Caisse de Dépôt et Placement du Québec
CDVC	Community Development Venture Capital Funds
CED	Community Economic Development
CEDIF	Community Economic Development Investment Funds
CERES	Coalition for Environmentally Responsible Economies
CI	Community Investing
CRA	<i>Community Reinvestment Act</i>
CRAQIF	CRA Qualified Investment Fund
CSN	Confédération des Syndicats Nationaux
DBL	Double Bottom Line
DÉC	Développement Économique Canada
EQ2	Equity Equivalent Investments
ERISA	<i>Employee Retirement Income Security Act</i>
ETI	Economically Targeted Investing
FAQDD	Fonds d'action québécois pour le développement durable
FEÉCQ	Fonds d'emprunt économique communautaire de Québec
FIDD	Fonds d'investissement en développement durable
GAO	General Accounting Office
HOOPP	Hospitals of Ontario Pension Plan
IPPC	Pollution Prevention and Control
LIHTC	Low Income Housing Tax Credit
LSIF	Labour-Sponsored Investment Funds
MSCI	Morgan Stanley Capital International
NMTC	New Market Tax Credit
OISE	Ontario Institute for Studies in Education
OMERS	Ontario Municipal Employees Retirement System
PMIA	Pooled Money Investment Account
PCV	Pacific Community Ventures
RRSP	Registered Retirement Savings Plan
SCP	Social Capital Partners
SDTC	Sustainable Development Technology Canada
SIF	Social Investment Forum
SIO	Social Investment Organization (Canada)

Scan of the Community Investment Sector in Canada

SOCARIAQ	Société de Capital de Risque Autochtone du Québec
SRI	Socially Responsible Investment
SROI	Social Return On Investment
SSHRC	Social Sciences and Humanities Research Council
SVC	Sustainable Venture Capital
VC	Venture Capital
WD	Western (Economic) Diversification

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1. INTRODUCTION

Increasing attention is being placed on the role of capital markets and their potential for leveraging positive sustainability outcomes. Much of the effort to date has looked at the degree to which there are links between sustainability and financial performance. This paper looks at the issue of sustainability and capital markets from a different perspective. It seeks to assess the potential of capital markets—the trading of debt or equity securities—to generate positive social, economic and environmental outcomes for communities, regions, disadvantaged groups and underinvested sectors. In other words, this paper explores whether there is evidence that institutional and retail investors can invest proactively to fill capital gaps and advance the sustainable development of communities and regions without compromising their financial objectives.

The socially responsible investment (SRI) industry, which has emerged to become a significant force in capital markets over the past few decades, is the home for targeted investing that generates double and triple bottom line returns. Called *community investing* (CI), this sub-sector of mainstream investment has grown significantly in the U.S. and struggles for legitimacy in Canada. In order to provide a better understanding of this sub-field of community investing and the related asset allocation strategies of economically targeted investing (ETI) and sustainable venture capital (SVC), this paper:

- summarizes some of the key recent findings of the CI, SVC and ETI literature in Canada and the US
- describes the sector and compares the Canadian and U.S. community investment industries;
- sets out examples of best practice in community investment, economically targeted investing and sustainable venture capital;
- reviews the capital allocation processes that fund managers typically follow in deciding to place double and triple bottom line investments, including fiduciary considerations; and
- outlines barriers and opportunities in expanding the size, scale and impact of the community investment sector in Canada.

This is admittedly a significant field of study, which cannot be considered in depth in a short introductory paper. This paper is thus a high-level scan of the challenges and potential of the CI sector, which aspires to point the way for further debate and research to address the issues presented above. Conducted over one month in the summer of 2004, the study is based on recent Canadian and U.S. literature in the fields of CI, ETI and SVC and on interviews with U.S. and Canadian academic and industry leaders. The capital allocation process was developed through key informant interviews with five U.S. and Canadian fund managers representing two mutual funds and an asset management firm, pension fund and foundation. Collectively they manage over \$100 million in

community investments from an asset base of \$3.7 billion.¹ The interviews also provided insights into the barriers and opportunities confronting the CI sector in both countries.

The rationale for community investing is that public capital markets and traditional financial intermediaries such as banks overlook or are structurally biased against non-traditional investments. Community investments are designed to fill this capital market gap. As will be discussed below, such investments can yield “at market,” “near market” and “below market” returns² and differ from charitable donations in the expectation of financial returns in addition to social returns—hence the expression “double bottom line.”

The following analysis is primarily based on the definition of community investment developed by the Canadian SRI industry, elaborated below. For the purposes of this paper, community investment is also defined to include the related sectors of economically targeted investing and sustainable venture capital. These additional investment approaches also represent targeted investment strategies, often for institutional investors such as pension funds, as will be explored further. Specifically, *ETI* is defined as institutional asset allocations that obtain both market-grade returns commensurate with risk and collateral (social) benefits by addressing perceived financing gaps and underinvestment. *Sustainable venture capital* refers to the sub-sector within the venture capital industry that proactively invests in social and environmental technologies, processes and enterprises within professionally managed venture capital portfolios.

It is important to note that due to the infancy of the CI sector as a legitimate asset class and to the explosion of largely American innovation in this capital market sub-sector, the definition of community investment is still in evolution. As such, the approach taken in this paper should be perceived as a snapshot in time, again for the purposes of highlighting a little-understood but high-impact asset allocation strategy.

As the literature review and analysis will reveal, the CI sector is poised for growth in Canada and with it sustainability benefits in the form of jobs, affordable housing, regional development, social and environmental enterprise, infrastructure and conservation financing, clean technology and urban regeneration. For its potential to be realized, however, more research and study will certainly be needed. But, much more significantly, other programmatic support, education and awareness are essential.

2. LITERATURE REVIEW: SUMMARY

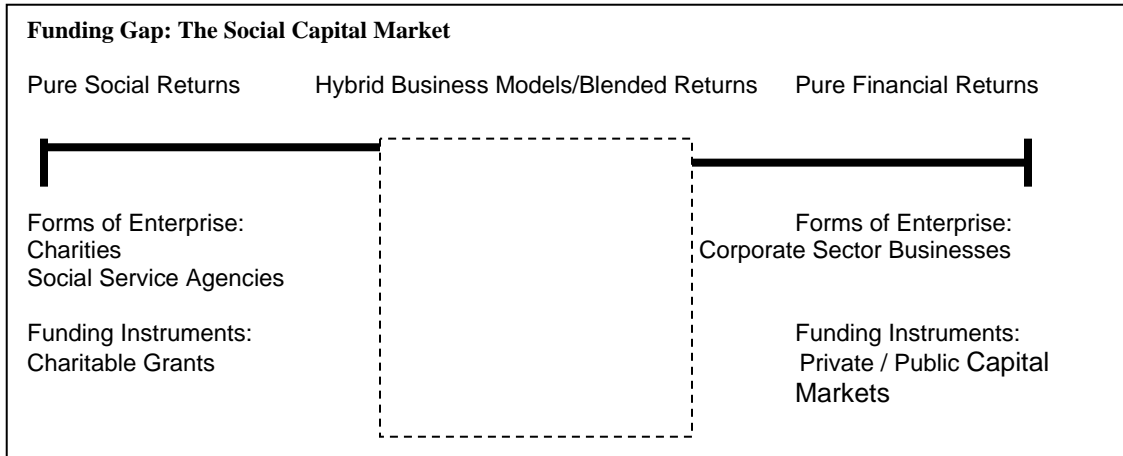
The following is a summary extract from a more complete literature review on community, economically targeted and sustainable venture capital investing in Canada and the U.S. (see Appendix A for full literature review).

¹ All dollar denominations are in Canadian currency except where noted.

² For the purposes of this paper, *at market* refers to risk-adjusted returns benchmarked to traditional financial instruments that most closely approximate the term, rate and risk parameters of the CI investment in question. *Near market* is a term given to investments that generate returns very close to market rates, which when applied across an entire investment portfolio have negligible impact (See Appendix B – Sensitivity Analysis). *Below market* in this context refers to those investments that intentionally result in concessionary returns and are undertaken because they create the greatest social value at the community level. In CI terms, these returns deliver commensurate levels of social return to create a blended value proposition for the investor and society. See the Literature Review for a discussion of blended value returns.

2.1 Community Investing

Traditional financing focuses entirely on financial returns while charitable financing seeks social returns. This leaves a gap in community financing as illustrated in the following figure:



Source: Social Capital Partners, 2003.

While risk and rates of return vary widely, CIs finance seemingly high-risk transactions in a prudent and effective way. Nonetheless, even allowing for the differences in scale, the U.S. dwarfs Canada in its innovation in bridging this funding gap with CI:

- There are 800 to 1,000 community development financial institutions (CDFIs) in the U.S. representing US\$14 billion (2003 statistics). CI assets have expanded by 84 percent since 2001, when they were estimated at US\$7.6 billion.
- There are 50 or so community investment funds identified to date in Canada, representing \$69 million in Canada for 2002, down from \$85 million in 2000.

In the U.S., government legislation and programming have been key drivers of the community investment industry. Canada lacks a broad framework of national legislation and government programming to encourage CI.

2.2 Sustainable Venture Capital Investing

The sustainable venture capital market is still maturing, and it is mostly in expansion-stage financing as startup-stage financing is even higher risk. Fund sizes and deal sizes are still relatively small, and there is no clear story to tell about their financial success and only incomplete stories about their social or environmental impact.

A few conditions are deemed essential to the growth of SVC:

- successful exits from deals and more consistent and reliable financial returns data;
- awareness and education on both “sides” of SVC investment;
- co-investors (Sustainable Development Technology Canada represents the approach of the federal government on this industry requirement); and
- environmental mitigation regulation imposing internalization of externalities by polluting sources to further facilitate investment in this sector.

2.3 Economically Targeted Investing

SVC or community investing by pension funds and other institutional investors is often referred to as economically targeted investment. ETI forms an investment perspective that, with all else being equal, recognizes collateral benefits such as the creation of jobs, affordable housing or regional economic development. Advocates of ETI argue that the present and future financial health of trust funds is inextricably linked to the economic health of their communities.

Some key points from the literature are set out below:

- Unlike the U.S., Canada has no broad legal framework that clarifies and establishes parameters for economically targeted investing.
- A 1995 U.S. General Accounting Office (GAO) survey found that most ETI programs in the U.S. were outperforming their benchmarks.
- In Canada, between 1991 and 1996 close to 17,000 jobs were created by 420 venture-backed companies at an exponential growth rate of 26 percent per year.
- While private and public sector pension funds in the U.S. were typically responsible for approximately 50 percent of all new venture capital on an annual basis during the 1990s, only a handful of extremely large public sector pension funds in Canada are engaging in private placement investment.
- Labour-sponsored investment funds (LSIFs) control more than 50 percent of the available venture capital market in Canada. Federal and provincial tax credits act as incentives for investment in these funds.

It becomes evident that in the U.S., as in Canada (with the LSIFs), where there is a legal structure and government support, ETIs represent an effective strategy for job and wealth generation.

2.4 Social Impact Metrics

Social impact methodology, like the CI sector, is very much a work in progress, though attempts to further quantify the social and environmental venture field promise to go a long way in bridging the information gap in the social capital marketplace.

A generally accepted standard (such as those for accounting) for social impact accounting does not yet exist. Attribution analysis is an issue, so current working metrics tend to look at outputs rather than true impacts. The social return on investment (SROI) is one method of assessing social value, while the “blended ROI” is perhaps the ultimate goal in metrics as it integrates both social and financial returns to create a blended value proposition.

The balance of the paper delves into the CI sector in more detail, providing further background to the emergence of this asset class within the investment industry.

3. DESCRIPTION AND ANALYSIS OF THE CANADIAN CI SECTOR

3.1 The Canadian CI Sector

The Social Investment Organization (SIO) defines community investment as investment for the purposes of financing deep-seated needs of local communities not addressed by mainstream finance, including poverty alleviation, community and cooperative development and environmental regeneration. The SIO does not provide specific statistics on sustainable venture capital or economically targeted investments due to the difficulty of verifying asset values in these investment categories. The 2004 *Canadian Social Investment Review*, to be released in November 2004, will report on the following CI categories: (1) micro-finance; (2) equity and debt financing for cooperatives and not-for-profits; (3) community venture capital; and (4) investments in sustainable ventures operating in local and regional markets.

The SIO excludes from its CI definition assets that have been contributed by government and charitable donations, such as those as found within the federally sponsored programs (Community Futures Development Corporations and Aboriginal Financial Institutions), as these programs are not established to generate investor returns.³

A small sector by any standard, the CI field in Canada is limited to a handful of investment-grade opportunities for the retail and institutional investor. High-impact social investors would have to be highly motivated to find appropriate at- or near-market CI opportunities, given the precarious nature of the CI sector in Canada. The field is marked by the entrance of two mutual funds—Acuity's Social Values Global Equity Fund and Meritas Mutual Funds Inc.—both of which have committed 3 and 2 percent respectively of their funds' assets to community investment.⁴ Both firms advise in their prospectuses that while rates of return are factors in the selection process, they will be secondary to the social criteria. Their experience in Canada is such that there are few qualified community investment vehicles that would satisfy their fiduciary responsibilities. Some credit unions, such as VanCity Savings Credit Union, offer modest return term deposits that channel community investments into environmental and social enterprises. One institutional investor has \$1 million invested in VanCity's International Community Investment Deposit, which provides up to 2 percent returns (the return is selected by the investor) on investments that support micro-credit programs in Third World communities. However, as some of the examples below demonstrate, there is an emerging track record of modestly priced market-grade CI in Canada. There are no aggregated data available on financial performance of CI in Canada.

³ While community futures corporations are not themselves recipients of significant CI investment, some of their trade associations have acted as intermediaries for institutional investors. The Community Futures Development Association of B.C., profiled in this paper, provides an example of the intermediary roles played by the provincial associations.

⁴ To date, Meritas has invested \$500,000 in "stable, well-run, socially productive institutions, and with carefully chosen community development banks, credit unions and loan funds" (Meritas, 2004). At the time of writing of this report, Acuity had not placed any CI investments.

3.2 Canadian CI Examples

3.2.1 Ecotrust Canada

Ecotrust Canada's mission is to support the emergence of a conservation economy in the coastal temperate rainforest region of B.C. In 1999, it set up the Natural Capital Fund to provide non-bank, higher-risk loans, which today stands at \$3.8 million in assets. To date, it has provided over 40 loans to entrepreneurs who incorporate socially and environmentally responsible practices in their businesses, including loans to an organic food company, a First Nation-owned sawmill, an employee-owned fish plant, a green office supply company and a botanical garden. Over three-quarters of the loans have been made to businesses on Vancouver Island, and altogether these investments have supported about 500 seasonal, part-time and full-time jobs. The Natural Capital Fund has received over \$520,000 in community investments, which currently provide a return of 2 to 3 percent to investors.

3.2.2 Community Futures Development Association of B.C. (CFDABC)

Established in 1992, the Community Futures Development Association of B.C. (CFDABC) represents 33 community futures development corporations (CFDCs) located throughout rural B.C. CFDCs offer a variety of entrepreneurial programs, business counselling, loan programs and business information to community members interested in expanding or starting their own businesses. Since its inception, CFDABC has acted as an intermediary for CFDCs, managing over \$23 million in debt instruments from an insurance company, a venture capital firm and B.C. credit unions. These investments have generated returns of 6 percent, 2 to 3 percent and prime minus 1 to 1.5 percent respectively. Using the CFDC job multiplier of 21 businesses financed per \$1 million and 326 jobs supported per \$1 million (Weicker and Co., 2002, p. 10), the SROI of these investments results in approximately 483 businesses financed and 7,498 jobs supported.

3.2.3 Community Economic Development Investment Funds (CEDIF) Programs

Nova Scotia's CEDIF tax credit program has resulted in the creation of a number of new community investment initiatives.

BCA Investment Co-operative Ltd., based in Sydney, N.S., has a mission to build a better community through creating rewarding and well-paying jobs, to be accomplished through equity investments in local businesses. Capital raising began in 2000 under the CEDIF program, and to date the investment cooperative has raised over \$1.5 million from nearly 400 shareholders. Key investment sectors include earth and resource industries, manufacturing, oil and gas, tourism and culture, and knowledge-based industries. Investments so far have created or saved more than 200 full-time jobs for Cape Bretoners.

The Scotian Windfields funds were also created under the CEDIF regime to generate investments in renewable energy assets, primarily wind power. Established in partnership with Renewable Energy Services Limited, over nine funds are currently in operation, collectively comprising a multi-community network of renewable energy development projects.

3.3 CI Impacts

While there have been few attempts to measure the social and environmental impacts of community investing in Canada, the Community Futures Program in Western Canada has determined that every \$3,059 of financing supports the creation of one job. Applying this metric to the \$69 million in CI results in an estimated 22,556 jobs supported or assisted through community financing vehicles in Canada. Ecotrust Canada has generated a more conservative metric at \$10,000 per job, resulting in the support of 6,900 jobs for the \$69 million invested. Applying Calvert Foundation's U.S.-based SROI metric—that is, roughly 522 small business jobs are supported for every US\$1-million five-year investment—suggests that CI supports 36,018 small business jobs in Canada.⁵ While each of these job creation multipliers points to significant job creation benefits, the range of estimates reinforces the need to develop standardized SROIs for the CI industry.

3.4 Economically Targeted Investing in Canada

Because ETIs are investments that fill capital gaps (through predominantly private placement markets) in underfinanced areas of the economy while earning risk-adjusted market rates of return, they are considered a community investment for the purpose of this paper. One significant distinction between the CI and ETI fields is that community investments may earn below-market returns while ETIs exclude below-market investments, consistent with fiduciary obligations. ETIs are largely an American phenomenon, having evolved over the past four decades. They gained traction in the U.S. in the 1990s when regulators made their approval of ETIs official, acknowledging their focus on collateral (social) benefits and precipitating the entry of major public pension funds into the ETI field. Institutional investors (including pension funds, foundations, mutual funds, religious institutions, insurance companies and the like) that pursue an ETI strategy typically invest in affordable housing and other real estate, technology startups, small and micro-businesses, investments preferring unionized workers, minority and women entrepreneurs, restructuring manufacturers and infrastructure or community development. The choice depends on the social priorities of the investor among other factors. Proponents of ETIs claim they produce a competitive rate of return commensurate with risk while creating collateral economic benefits for a targeted geographic area, group of people or sector of the economy (Harrigan, 2003, p. 241).

There is no accepted definition of ETIs in Canada and no regulatory framework to sanction their existence. Canadian pension funds and other fiduciaries necessarily turn to the U.S. for this justification. In the absence of a definition and measurement methodology, there is only limited tracking, trend and impact research on ETI investments in Canada. Canadian academics in this field speculate there are at most less than 20 ETIs, including the seven labour-sponsored investment funds, which have adopted a set of social standards. That said, the ETI asset base is not insignificant once

⁵ Calvert Foundation is a US\$100-million non-profit foundation with a mission to increase awareness and participation in CI. They have a program called Calvert Community Investment Notes that pays below-market fixed rates of interest to investors seeking to place investments with non-profit intermediaries that service disadvantaged communities and people working their way out of poverty. Launched with the help of the Calvert Group \$10-billion socially responsible mutual fund family, Calvert Foundation has been a leader in bringing CI to the broader retail market across the U.S. for almost a decade. It has financed the creation of over 100,000 jobs, 5,000 affordable homes and 6,000 community facilities for low-income communities.

the assets of the seven LSIFs (\$5.62 billion) and the Caisse de dépôt et placement du Québec (\$4.5 billion) are factored in, topping roughly \$11 billion of known ETI investment in 2002. The federal government, through its Social Sciences and Humanities Research Council (SSHRC) program, has provided a \$1-million grant to the Ontario Institute for Studies in Education (OISE) of the University of Toronto for a study of “Pension Fund Transformation,” including an investigation of ETI in Canada, in an attempt to bridge this research gap.

While there are no comprehensive statistics on ETI impacts, a number of LSIFs maintain records of their employment impacts on investee firms. Independent studies show that these funds have had a dramatic impact on job creation and retention (Perrin, Thorau and Assoc., 1998; SECOR, 1996). Crocus Fund management estimates that the cost for each job they create is on average \$23,000, far less than the \$40,000 average for most venture capital investment (Hebb and McKenzie, 2001, p. 146). The Crocus Fund has recently launched the \$25-million Manitoba Property Fund in conjunction with co-investors the Workers Compensation Board and the Teachers’ Retirement Allowances Fund. The purpose of the fund is to invest in real estate primarily focused on the historical sector of Winnipeg’s downtown.

3.5 ETI Examples

Two additional examples of Canadian ETIs with longer track records are described below.

3.5.1 Concert Properties

Twenty-one B.C.-based union and management pension funds pooled \$27 million to form Concert Properties in 1989 (originally named VLC) with the objective of financing affordable rental housing in B.C. and creating jobs in the unionized construction industry. Today, the wholly pension plan–owned real estate corporation has \$800 million in assets, with a track record of creating 10 million hours of on-site employment for unionized construction workers.

3.5.2 Fondation

Fondation pour la coopération et le développement de l’emploi was established in 1966 by la Confédération des syndicats nationaux (CSN), the second largest labour federation in Quebec. While similar to Fonds de Solidarité and other LSIFs, Fondation has made a particular commitment to investing in the social economy⁶ in Quebec.

Filaction (le Fonds pour l’investissement local et l’approvisionnement des fonds communautaires) is a subsidiary of Fondation with a mandate to finance enterprises in the social economy, including local community and micro-credit funds (loans from \$50,000 to \$150,000). Notably, Filaction was instrumental in the creation of five regional investment funds for female entrepreneurs in Quebec. Fondation also created Le

⁶ The Quebec government defines social economy enterprises as fulfilling the following objectives: (1) financial viability; (2) capacity to create stable employment; (3) responding to social needs; (4) producing goods and services that correspond to unmet needs; and (5) contributing to improving the quality of life of workers in local communities.

Fonds de financement coopératif with a mission to invest between \$100,000 and \$250,000 in cooperative or non-profit enterprises.

In collaboration with the Fonds d'action québécois pour le développement durable (FAQDD), Fondation established Le Fonds d'investissement en développement durable (FIDD), which supports businesses developing technologies or products that optimize the use of natural resources or that have a significant impact on the reduction of waste, pollution or energy consumption.

Fondation participates in a number of different specialty funds, like the Fonds Waskahegen, which aims to create and maintain jobs for non-reserve Native peoples, and the Fonds d'emprunt économique communautaire de Québec (FEÉCQ), which supports employment-generating projects by marginalized individuals.

On May 31, 2003, the realized or committed economically targeted investments of Fondation reached \$144 million, financing almost 100 businesses and directly or indirectly creating thousands of jobs. Average annual returns for shareholders were 2.29 percent (excluding the tax credit).

3.6 Sustainable Venture Capital

As neither the Social Investment Organization in Canada nor the Social Investment Forum in the U.S. tracks the SVC sector, we propose our own definition: *sustainable venture capital* refers to the sub-sector within the venture capital industry that proactively invests in social and environmental technologies, processes and enterprises within professionally managed venture capital portfolios. Because of the lack of tracking within the SRI industry, it is impossible to provide figures on the assets allocated to social and environmental venture capital as a sector. Turning to the traditional venture capital field, Macdonald and Associates in their *2003 VC Industry Overview* put the Canadian sustainable venture capital sector (specifically energy and environmental technologies) at \$45.46 million invested in 2003 (26 companies) compared with VC overall at \$1.49 billion and 616 companies. (Cleantech Venture Network [2003, p. 3] estimates \$78 million in 2003 down from \$150 million in 2002.) The statements of interest that Sustainable Development Technology Canada⁷ (SDTC) receives each funding round provide insights into the status of the SVC market in Canada: in the five funding rounds conducted since April 2002, 806 statements of interest have been received representing \$5.2 billion of clean-technology project potential. The average project size is \$6.4 million; 95 have proceeded to proposal phase and 37 projects have been approved for funding. Should these 37 to 95 projects come to fruition and should they result in the leverage of additional venture financing, this will represent a significant leap forward for the Canadian environmental technology sector.

The Cleantech Venture Network (2003) reports that the clean technology sector has emerged as the sixth largest venture investment category in the U.S. and Canada, behind information technology, software, biotechnology, health care and telecommunications. In 2002, investments in energy-related clean technologies

⁷ Sustainable Development Technology Canada is a not-for-profit foundation established by the Government of Canada in 2001. SDTC finances and supports the development of clean technologies, drawing from an investment fund of \$350 million.

represented nearly half (45.5 per cent) of all clean technology investments. The remaining investments in clean technologies included enabling technologies (technologies developed by biological, computational and physical scientists and engineers that enable better use of natural resources and greatly reduce ecological impact) (14 percent), materials and nanotechnology (13.8 percent), materials recovery and recycling (8 percent), and water-related technologies (4 percent). As of the first quarter of 2004, according to the Cleantech Venture Network (2004), the average investment deal size in the sector was up 15 percent from the previous year, to just under US\$7.1 million per deal; the average investment in venture deals across all industries was US\$7.5 million.

According to one industry observer, clean and environmental technologies are not a sector but an investment theme or category, with applications across all venture capital sectors. He predicts large and highly disruptive market opportunities emerging in the multi-billion dollar agricultural, manufacturing and transportation sectors, as well as in the fundamental enabling areas of energy and water (Parker, 2004). Pension funds and banks are more known for their investments in mainstream venture capital, while primarily high-net worth individuals are driving investments in sustainable venture capital.

There are a limited number of community development venture capital (CDVC) funds in Canada, which are similar to those in the U.S. (for a description of CDVC funds, see Appendix A Literature Review); at present, no statistics are readily available on this group. SOCARIAQ in Quebec provides an example of a CDVC fund that includes an ETI investor.

3.6.1 SOCARIAQ

SOCARIAQ (Société de Capital de Risque Autochtone du Québec), a \$6-million equity investment fund, provides financing to new and existing businesses controlled by members of Quebec First Nations. It is a First Nation-controlled non-profit organization governed by five investors, including two non-profit Aboriginal capital corporations, the Native Benefits Plan Fund, the Mouvement des Caisses Populaires et d'Économie Desjardins and the Fonds de Solidarité, an LSIF. Established in March 2002, it is projected to invest in 40 businesses during its first five years of operation, with investments expected to range from \$75,000 to \$500,000 and a target ROI of 15percent.

A significant potential beneficiary of SVC, ETI and community investing is Aboriginal businesses. However, for the most part, neither Aboriginal capital corporations (ACCs) nor Aboriginal community futures development corporations (ACFDCs) receive external investments for their loan and equity programs—they are primarily capitalized by the federal government. There are a few unaffiliated Aboriginal venture capital corporations in Canada that receive outside market-rate investments, SOCARIAQ being one of them. Since there is no comprehensive data about them, little is known about them as a sector. Possible reasons for the lack of external investment into Aboriginal finance vehicles include the following:

- difficulty in understanding the regulatory framework for financing activities on Indian reserves (e.g., the *Indian Act* and Indian oil and gas legislation, as well as Indian and Northern Affairs Canada policies that affect land title, asset registration, security, taxation and zoning); and

- absence of standard rating for Aboriginal capital instruments.

A study conducted in 2000 for Industry Canada concluded:

Key informants see Aboriginal Financial Institutions (including ACCs and ACFDCs) as being different than the mainstream financial sector. They are smaller in terms of their loan portfolios, with fewer assets in terms and cash. Their clients are distant, more likely to be in remote locations and slightly less credit worthy. AFIs have relatively higher costs and slightly higher net interest on their loan rate. They have a greater percentage of total revenue derived from loan interest and the per cent of their portfolio in developmental loans is more than for a bank. All key informants suggest AFIs fill a gap in the products or services offered to Aboriginal business by the mainstream financial sector (Vodden and Cook, 2002, p. 1).

As AFIs are intended to provide developmental (higher risk) lending to Aboriginal businesses, they would be an ideal candidate for CI programs, save for the significant regulatory, perception and standardization issues mentioned above.

4. DESCRIPTION OF THE U.S. CI SECTOR

4.1 The U.S. CI Sector

As has been noted, the U.S. has the largest community investment sector in the world, at US\$14 billion as of 2003, with roughly 800 to 1,000 CDFIs operating domestically. The fastest growing sector of SRI in the U.S., CDFIs experienced asset growth of 84 percent from 2001 to 2003, nearly doubling their total assets during this period. Over the past few years, considerable effort has been directed toward tracking and monitoring the community investment sector in the U.S. The creation of various community investment trade organizations, with their focus on documenting and standardizing the CI industry, has further helped catapult this sector into more mainstream circles.

From their recent studies we learn that financial institutions, including institutional investors such as pension funds, make up the largest source of borrowed capital, shares and deposits for CDFIs, at 42 percent. However, the largest single contributor to CDFIs since 1995 has been the U.S. Treasury Department, which has provided US\$534 million in awards to the sector through three funding programs. Interest rates charged by the sector reportedly range from 5.6 percent (to individuals for housing) to 9.2 percent (to micro-enterprise). The capital adequacy ratio for reporting CDFIs is 27 percent equity capital, which, when combined with average loan loss reserves of 5 percent, is more than sufficient to absorb portfolio and operating losses (CDFI, 2002, pp. 3, 5, 7).

The CI impacts of CDFIs go well beyond the easily measurable. Those that can be measured are as follows: in 2002, CDFIs in the U.S. are credited with having provided US\$2.6 billion in financing; financed and assisted 7,800 businesses that created or maintained more than 34,000 jobs; facilitated the construction or renovation of more than 34,000 units of affordable housing; built or renovated more than 500 community facilities in economically disadvantaged communities; provided mortgages to 4,100 people; and provided more than 4,800 alternatives to payday loans (CDFI, 2003, p. 4).

As for performance, CDFI portfolios for the most part performed well, even during the economic slowdown. Overall, net loan loss rates for CDFIs were 0.7 percent ranging

from a total of 0.2 percent in the community development bank sector to 0.9 percent in the community development credit union sector; this rivals the net loan loss ratio at conventional financial institutions of 0.97 percent in 2002 (CDFI, 2003, p. 20).

With the multitude of U.S. CDFIs, it is difficult to narrow the field down to a few exemplary organizations to profile. The following have been chosen because they demonstrate some interesting approaches to community investing: environmental enterprise creation; a secondary capital market for community investments; and an environmentally screened mutual fund that invests in conservation finance as part of its CI portfolio.

4.1.1 ShoreBank and Shorebank Pacific

ShoreBank was the first and is the leading community development and environmental banking corporation in the U.S. Since its founding in 1973, Chicago-based ShoreBank has invested more than US\$1.7 billion in its priority communities—those traditionally underserved by other banks—and minority-owned companies. Since its inception, it has created, retained or placed nearly 11,000 jobs and rehabilitated 38,000 units of housing, while investing US\$305 million in small businesses (2002 figures).

With 2003 overall consolidated assets of US\$1.5 billion, ShoreBank also operates a real estate development company, a not-for-profit organization in each of its five priority markets, a consulting company and a mezzanine finance company—all of which support ShoreBank's mission to build strong, sustainable communities, protect and restore the environment and help its customers build wealth. ShoreBank offers a full suite of banking products and services in addition to its community investment options.

Over 4,000 individuals, corporations and non-profit organizations have supported ShoreBank's work by placing deposits in ShoreBank's banking subsidiaries—US\$324 million at year-end 2002. Called *Development Deposits*® and *EcoDeposits*®, these investments offer the same features and market rates as other bank deposits and are equally federally insured. The bank converts these ordinary bank deposits into development loans in support of the bank's overall community and sustainable development objectives.

While Development Deposits® help to finance economic activity in underserved communities, EcoDeposits® offer community investors the opportunity to support the work of ShoreBank Pacific, the first regulated financial institution in North America dedicated to sustainability-based economic revitalization. Based in Washington State, ShoreBank Pacific aims to create a conservation economy in the rainforest of the Pacific Northwest by targeting its lending to local companies that use energy efficiently, work to reduce waste and pollution, and conserve natural resources. In 2002, EcoDeposits® attracted US\$57 million in deposits. By June 2004, this figure had risen to US\$81.4 million, representing 2,073 investors with an average investment of roughly US\$40,000.

ShoreBank Pacific lent out US\$12 million in 2002, and across the group, ShoreBank financed a total of US\$56 million in conservation loans for hundreds of conservation projects. Borrowers have used the proceeds to conserve energy, reduce negative environmental impact, produce "green" products and market to "green" consumers, significantly extend the useful life of old buildings, and restore abandoned buildings to productive use. ShoreBank Pacific companies focus on organic farming, environmentally

responsible fishing, non-timber forest products, redeveloping contaminated sites and financing green buildings. Over the past year, financing from ShoreBank Pacific has helped support 1,378 full-time and over 2,000 seasonal jobs. Since inception they have helped put 535 acres of crop under organic production.

4.1.2 Community Reinvestment Act (CRA) Qualified Investment Fund

The CRA Qualified Investment Fund is a mutual fund devoted exclusively to community investment. As of August 2004, 250 institutional investors with US\$1.6 trillion in combined assets had invested in the fund. Current assets stand at US\$475 million. The fund has recently been made available to individual investors through Charles Schwab, a no-load, no-transaction fee service with a minimum investment of \$2,500. Since its inception five years ago, the CRA Fund has generated annualized returns of 6.27 percent (July 2004), placing it in the top 20 percent among 79 funds in its category. Named after the federal *Community Reinvestment Act* of 1977,⁸ the fund seeks to provide equal access to credit and capital for low- and moderate-income families, who are typically underserved by mainstream financial institutions. Over the past five years, the Fund has directed nearly US\$900 million to community development, supporting the generation of 61,515 affordable rental housing units, 2,159 homes for low- to moderate-income families and 1,285 affordable health care beds. For example, recently the Fund purchased bonds issued by the St. Vincent de Paul Society in Seattle. The purchase helped the charity to expand both its network of six thrift stores and its mattress factory, which is helping to create jobs for low-income residents.

4.1.3 Portfolio 21

Portfolio 21 is a US\$51-million global growth stock mutual fund for individuals and institutions, with a mandate to invest in companies with demonstrated leadership in sustainable business practices. Investee companies are those that have made an explicit commitment to sustainable business practices and allocated significant resources to achieve the fund's goals. Companies are scored against criteria tailored to their industry group and are compared with their competition in such areas as the life-cycle impacts of their products and services, relationships with suppliers, investments in sustainable technologies and processes, leadership, resource efficiency and environmental management. Portfolio 21 looks most closely at earnings improvements derived from ecologically superior product lines, efficient use and reuse of resources, investments in renewable energy, innovative transportation and distribution strategies, and fair and efficient use of resources with respect to meeting human needs. Portfolio 21 has committed to investing 1 percent or more of the fund's value in community investments, which totalled nearly \$500,000 in summer 2004. Shorebank Pacific is included among its three community investments because of its commitment to The

⁸ Enacted because formal financial institutions were closing down branches in low-income areas, the "CRA and its implementing regulations require federal financial institution regulators to assess the record of each bank and thrift in helping to fulfill their obligations to the community and to consider that record in evaluating applications for charters or for approval of bank mergers, acquisitions and branch openings. The law provides a framework for depository institutions and community organizations to work together to promote the availability of credit and other banking services to underserved communities"(SIO and Riverdale, 2003, p. 11).

Natural Step.⁹ Portfolio 21 is currently posting five-year returns of 2.29 percent against the MSCI World Equity Index benchmark of -1.08 percent.

4.2 Economically Targeted Investing in the U.S.

As in Canada, there is no comprehensive tracking of ETI investments in the U.S., making it difficult to gauge the size and growth of ETI activity on the part of pension funds and other institutional investors. A 1995 report estimated the combined assets invested in the ETI programs of public pension plans at 2.4 percent of the total investments in these plans—or roughly US\$55 billion. At that time, there were at least 29 states in which public pension plans had some form of ETI program (GAO, 1995), the most common being residential housing (32 percent) and venture capital (25 percent) (Hoffer, 2004b). Another estimate (produced over a decade ago) indicated that 84 percent of all ETI funds were invested in residential housing and other real estate, with 3 percent in venture capital and 0.2 percent in small business loans (Institute for Fiduciary Education, 1993). According to the Social Investment Forum, several public pension plans are required by their board of trustees or department of fiscal services to commit to an investment goal of 5 to 10 percent in ETIs (SIF, 2003, p. 27). These investments are made possible, in part, by a variety of government risk management and subsidy programs, which provide opportunities for market rates of return for pension fiduciaries.

As ETI impact data are scarce, one needs to look at the track record of existing ETI programs to better understand the potential of ETI to yield sustainability benefits. The California Public Employees' Retirement System has one of the largest, most comprehensive, ETI programs in the U.S.

4.2.1 California Public Employees' Retirement System (CalPERS)

CalPERS is the largest public pension fund in the U.S. with assets of US\$167 billion. In 2000, it launched the Double Bottom Line initiative, targeting investments in urban neighbourhoods to generate market returns for the fund and spur economic development in California communities (Office of the Treasurer, 2004a). Since then, more than US\$9 billion has been directed into these communities, ranging from equity investments in urban businesses to mortgages for working Californians in urban and rural neighbourhoods. Approximately 13 percent of the Pooled Money Investment Account (PMIA) is now in California double bottom line investments. As of March 2004, the PMIA:

- had invested over US\$1.7 billion in home loans to low- and moderate-income individuals and neighbourhoods—currently yielding more than 5.87 percent annually;
- had invested US\$537 million in small business loans—these loans have yielded from 1.3 percent to more than 7 percent annually; and
- was yielding returns of 1.04 percent on its US\$5.8 billion in community lending institution and credit union deposits, many of which serve inner city and rural areas. This is an increase from US\$1.9 billion in deposits in 1999, and yields are typically 0.03 to 0.1 percent higher than yields from comparable Treasury securities in which these funds might otherwise be placed; and

⁹ The Natural Step is a science- and systems-based approach to organizational planning for sustainability. www.naturalstep.ca

- had earned an annualized return of 10.3 percent since 1966 on its California Urban Investment Partnership, part of the commitment to inner-city real estate development. CalPERS' original investment of US\$50 million in this program has increased to US\$290 million.

Additionally, CalPERS has adopted a goal of investing 2 percent (approximately US\$3.3 billion) of its portfolio in domestic emerging markets, primarily in California. Under the "California Initiative," it has committed over US\$1.3 billion to urban, infill real estate ventures, including US\$150 million for affordable housing and US\$475 million for private equity investment in businesses in underserved areas. According to CalPERS, underserved markets are urban and rural areas with limited access to needed goods and services. Underserved markets offer companies untapped assets, such as large labour pools, low real estate costs and underutilized infrastructure (Harrigan, 2003, p. 245). CalPERS' US\$20-billion investment in California is estimated to have created more than 54,000 jobs (Harrigan, 2003, p. 251).

Last spring, CalPERS launched its Environmental Technology Investment Program (Office of the Treasurer, 2004b). Under the program, CalPERS will invest up to US\$200 million in the environmental technology sector over the next few years, making private equity investments, venture capital and project financing available. The program will target investments in environmental technology solutions that are more efficient and less polluting than existing technologies such as recycling, minimize the use of natural resources, and reduce emissions, refuse and contamination to air, water and land. It will be managed under the Alternative Management Investment (AIM) Program, which has committed more than US\$19 billion to private equity investments.

4.2.2 United Methodist Church General Board of Pensions and Health Benefits (General Board)

The General Board, one of the nation's 100 largest pension funds, has a dedicated investment manager for affordable housing and community development. It is the largest institutional investor in affordable housing and community development with nearly US\$1.6 billion in CI investments. As with all General Board investments, CIs are designed to earn a market rate of return commensurate with risk to participants while supporting underserved communities and the development of affordable housing.

4.3 Sustainable Venture Capital in the U.S.

Comprehensive data on the SVC sector in the U.S. are not readily available, particularly when SVC is defined using the definition in this paper, which includes venture capital invested for both social and/or environmental returns. However, the Social Investment Forum's 2003 SRI trends report does provide data on community development venture capital funds, which use the tools of venture capital to create jobs, entrepreneurial capacity and wealth, thus improving the livelihoods of low-income individuals and the economies of distressed communities. "With US\$485 million of capital under management [a 58 percent increase over 2001] CDVC funds make equity and equity-like investments in small businesses that hold the promise of rapid growth. Investments typically range from \$100,000 to \$1 million per company, smaller than most traditional venture capital investments. The companies in which CDVC funds invest generally employ between 10 and 100 people" (SIF, 2003). Most CDVC funds are still too young for a definitive assessment of the financial returns, but preliminary results for some of the

older funds show gross internal rates of return of between 8 and 17 percent (CDFI 2003, p. 38).

Cleantech Venture Network provides statistics on the “environmental” venture capital sector in the U.S. It reports that in the U.S., overall venture activity declined by 14 percent from 2002 to 2003, while “cleantech” increased 8 percent over this period from US\$1.1 to \$1.2 billion, with investments financing 179 clean-technology companies in this period. As a result, cleantech grew in relative terms from 5.1 percent of total venture investments in 2002 to 6.4 percent in 2003.

These statistics for both environmental and social venture capital suggest that the SVC sector is growing year over year, with corresponding benefits for the environment and society. Pacific Community Ventures, a CDVC fund with a strong social mission, provides insights into how community development SVC vehicles are structured in the U.S.

4.3.1 Pacific Community Ventures

Pacific Community Ventures (PCV) is a non-profit organization, based in California, which manages two funds from which it makes equity investments in selected businesses. The purpose of these investment funds is to attract and channel institutional investment dollars into private companies that provide good jobs with benefits, wealth creation vehicles (e.g., stock option and profit-sharing plans) and job training in low-income communities. CalPERS and Citigroup (one of the world’s largest financial services companies) are two such institutional investors. With current assets of US\$18.5 million, PCV has invested US\$8 million in seven companies to date.

Over nearly four years, PCV-financed portfolio companies have employed a cumulative total of 850 employees from low-income communities and paid average wages of US\$11.59 per hour, well above California’s living hourly wage of US\$10.25.

4.4 Analysis and Implications for the Canadian CI Industry

Even taking into account the difference in population between the two countries, the Canadian CI sector—including the ETI and SVC fields—lags the American experience by a wide margin. Clearly there are a number of conditions in the U.S. that have given rise to this disparity. Most observers attribute the growth of the CI sector in the U.S. to a combination of the following factors:

- Government programs—federal and state governments have developed a comprehensive array of government risk management, tax incentives and other subsidy programs.
- Government regulation—1995 revisions to the *Community Reinvestment Act*, which recognized CDFI investments as qualified CRA activity, and 1995 *Employee Retirement Income Security Act* (ERISA) regulations permitting pension fund ETI activity.
- Track record—CDFIs have established a successful track record of making effective and prudent use of capital to serve economically disadvantaged markets.
- National trade associations and intermediaries—the recent emergence of national trade associations and intermediaries to organize and develop the

industry have played a key role, especially in the standardization of the CI industry and the creation of secondary markets.

- CDFI growth—more institutions result in more investment opportunities for retail and institutional investors.
- Increased awareness—the 1 percent campaign of the Social Investment Forum has generated over US\$1 billion in assets for CI since its inception in 2001 (SIF, 2003, p. 29). The SIF campaign includes a website, “how to” manuals and other initiatives to help promote CI to fund managers and also address their needs for qualified CI investments.
- Lousy market—some CI fund managers suggest that poor returns in the equity market have prompted investors to move out of equities and into fixed-income CI options. For many, their CI portfolios have shown solid returns relative to other asset classes for the past few years. Indeed, fund managers find that even when there is nothing positive to tell clients about financial returns (ROI) they are happy to report on clients’ SROI.

More statistics on SVC and on ETI programs are needed before a comprehensive comparison can be made of the two countries’ performance in these fields. However, this brief exploration suggests that the U.S. CI market has made considerable gains in recent years and is well poised for growth. There is significantly more funding available in the U.S. from investors, the banking industry, government and donors to help fuel this expansion. Indeed, industry observers (Ellman, 2004) suggest that the growth in the U.S. CI sector is a direct result of the *Community Reinvestment Act*, the CRA Qualified Investment Fund (CRAQIF) and the federally funded CDFI Fund.¹⁰ All of these initiatives had their roots in the civil rights struggles of the 1970s and 1980s, when local communities fought for federal mechanisms to rebalance local economic inequities (referred to as bank redlining). These early victories have now led to the capital transfusion from the private sector (via the banks through the CRA and from the investment community through CRAQIF) and from the federal government through the CDFI Fund. Canada, on the other hand, lacks a strong government role, a banking presence in CI, investor awareness and a significant donor base. These gaps limit its ability to capitalize on the lessons that can be learned from the U.S. CI sector. (It is interesting to speculate, for example, on how a fraction of the five big banks’ \$128 million in Canadian charitable donations could boost the fortunes of Canadian CI.) More will be said on this topic in the barriers and opportunities section.

5. INVESTMENT ALLOCATION ISSUES

The success of the U.S. 1 percent campaign—which saw 54 SIF member institutions (including investment managers, advisers, brokers and mutual fund companies) invest over US\$1 billion in CI, with an average investment of US\$15.7 million (SIF, 2003, p. 29)—points to the significant role fund managers can play in targeting CI financing. In Canada there may be 20 fund managers channelling CI financing in this way, if one includes ETI financing and excludes the SVC sector, for which there are limited Canadian data. The following pages provide an introductory assessment of some of the

¹⁰ The *Community Development Banking and Financial Institutions Act*, enacted in 1994, led to the creation of the Community Development Financial Institutions Fund. This fund, housed within the U.S. Treasury Department, supports community investment funds through equity investments, capital grants, loans and technical assistance support (SIO and Riverdale, 2003, p. 11).

fiduciary and capital allocation issues that fund managers confront when considering CI investing.

5.1 Fiduciary Issues

As noted by Gil Yaron—one of Canada’s leading experts in interpreting pension fund legislation as it relates to socially responsible investing—trustee fiduciary duties arise from common law and are codified to an extent in federal and provincial pension and trustee legislation (Yaron, 2001, p. 4). Trustees’ duties and investment decisions are governed first by the trust instrument wherein trustees are bound to follow specific criteria for asset investment as set out in the trust instrument. Accordingly, “if the trust provides instructions to consider non-financial criteria ... then the trustee may follow the terms of the trust without fear of being in breach” (Yaron, 2001, p. 4). When the trust instrument does not provide investment management direction, the following precepts provide guidance:

- duty to be prudent: to act with the care, skill and diligence of a prudent person in managing the assets of another;
- duty to be loyal: to act in good faith and in the best interests of ... beneficiaries treating all with an even hand;
- duty to diversify the portfolio; and
- duty to avoid conflicts of interest (Yaron, 2001).

In the case of pension trustees considering ETIs as part of their pension plan’s investment strategy, Yaron and Kodar (2003, p. 93) recommend their investment policy include, for example:

- the types of investments of interest to plan members;
- the percentage of assets to be allocated to such investments and the plan’s overall risk/return profile;
- a provision restating the fiduciary duties of trustees, including reference to avoiding conflicts of interest;
- a requirement that trustees obtain expert legal and investment advice in considering ETIs;
- a mechanism for independent arm’s-length valuation of such investments; and
- an assessment of the performance of such investments against comparative benchmarks where available.

The U.S. Department of Labor¹¹ requires that pension funds investing in ETIs must ensure that expected ETI returns are commensurate with similar types of investments with similar risk profiles (Yaron and Kodar, 2003, p. 91). The fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally (ERISA Interpretive bulletin, 1974).

¹¹ The Interpretive Bulletin 29 CFR 2509.94-1 “...sets forth the Department of Labor’s interpretation of sections 403 and 404 of the Employee Retirement Income Security Act of 1974 (ERISA), as applied to employee benefit plan investments in ‘economically targeted investments’ (ETIs), that is, investments selected for the economic benefits they create apart from their investment return to the employee benefit plan. ...[T]he Department has issued a regulation...[which] provides that the prudence requirements...are satisfied if (1) the fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary’s investment duties, the fiduciary knows or should know are relevant, and (2) the fiduciary acts accordingly... (The Interpretive Bulletin 29 CFR 2509, 94-1).

This is admittedly a very superficial treatment of fiduciary matters, but it serves to highlight the fiduciary responsibilities of trustees and their fund managers when considering investments that generate social in addition to financial returns. Indeed, practising Canadian and U.S. CI fund managers report that they adopt very prudent guidelines in selecting their CI investments, as the discussion on capital allocation issues below reveals.

5.2 Capital Allocation Issues

For the purposes of this review, five U.S. and Canadian managers were interviewed to understand the typical capital allocation decisions they execute in fulfilling their social objectives and fiduciary responsibilities.¹² Together with web and other research conducted on this question, their experience points to the following capital allocation considerations:

- 1) Fund objectives—in every instance, institutional investors publicly disclose their commitments to invest in CI, whether for social and/or environmental returns. They may be guided by one of two different motivations: (1) to provide capital to the community and generate a return to the fund or (2) not to generate financial returns but simply to provide capital to the community without the loss of principal.
- 2) Client guidelines—fund investment policies and client guidelines typically set out the fund's approach to the following client considerations including their social priorities:
 - geography, target groups, social record and social/environmental impact of fund; capital deployed (funds look for CI vehicles with significant capital deployed to maximize social impact);
 - asset allocation targets of 1, 2 or 3 percent (or client-driven up to 100 percent) with no known rules of thumb, save for the modest allocation to limit financial impact on the overall portfolio; and
 - equity or debt and type of institution as determined by policy.
- 3) Risk—all fund managers report applying the same standard of care as for their other investments. They:
 - look for risk—share provisions, limited or principal guarantees, and insurance backups provided by governments or other donors;
 - use a CI intermediary who performs underwriting authority and delegated servicing;
 - set investment limits—assets are arrayed across a diversified group of intermediaries with no intermediary originating over, for example, 20 percent of program assets; no individual CI should be more than, for example, 10 percent of the total CI pool;
 - look for ability to repay—CI investors are seeking investment quality (A or higher rating) or have an insurance backup; they assess the calibre of management,
 - co-invest with other institutions;
 - look for local comparable benchmarks (e.g., local bank term deposit rates) or benchmark CI investments against other comparable indexes; and
 - (in the case of U.S. mutual funds) require that all investments be priced daily, so require same of their CI investments.

¹² All five fund managers were invested in CI debt instruments; the survey does not include the views of CI equity investors. See Appendix C for a list of interviewees.

4) Rate—investors are seeking reasonable, not maximum, rates of return, at or near market, depending on the fund guidelines. Some look for inflation-protected rates of return, and others seek market rates of return commensurate with risk and risk-adjusted rates of return. Depending on investment guidelines, some funds manage their CI investments such that returns before fees on the overall fund are approximate to their fund benchmark, and in this fashion are satisfied with CI investments that may generate near-market rates of return.

Some funds, such as the Canadian Acuity Social Values Global Equity Fund (Acuity), include in their prospectus a very conservative outlook on the performance of their CI investments, with the expectation that their CI investments will underperform the market. Acuity's prospectus defines CIs thus: "CIs offer a rate of return below the then-prevailing market rate, and are considered illiquid, unrated and below-investment grade. They also involve a greater risk of default or price decline than investment grade securities." (Acuity, 2003, p. 29). Not all investors would define their CI investments in this way, demonstrating the diversity in approaches to, and expectations for, community investing on the part of practising CI fund managers.

It is also interesting to note that some Canadian funds are having difficulty finding qualified Canadian investments that meet their capital allocation criteria, a factor that may result in Canadian use of qualified American CI intermediaries with the resulting loss to the Canadian CI sector.

6. BARRIERS AND OPPORTUNITIES IN GROWING THE CI SECTOR IN CANADA

Compared with the burgeoning CI sector in the U.S., Canada's CI sector is weak, once LSIFs and the CDP are factored out of the ETI equation. Previous analysis points to some of the critical drivers underpinning the growth of the American CI industry. Additionally, the foregoing review of capital allocation and fiduciary issues points to critical infrastructure that needs to be in place for the successful development of a strong CI sector—one that contributes significantly to sustainable development in Canadian communities. This section puts these thoughts together as "barriers and opportunities" to the growth of community investment, including ETI programming and sustainable venture capital.

6.1 CI Barriers

- Lack of capacity—community investment funds in Canada for the most part are not only undercapitalized but also struggle for lack of consistent operating support. Mostly small funds, they are underskilled, with a modest track record and a limited regional focus. They lack reporting infrastructure and customer service capacity and are not in a position to deal with the due diligence demands of institutional investors.
- Tax and regulatory barriers—most CI investments are not RRSP-eligible, CI vehicles are structured as charities and thus constrained in their investment activities, and there is no regulatory regime—all these factors work against the community investment sector.
- Challenges in conducting due diligence:

- Lack of standards—there are no standardized assessment procedures for qualifying creditworthy sustainable impact investments; each CI fund has a different, non-standardized methodology, program and approach.
- Small transactions/small deal size result in higher transaction costs—products that require special handling result in slow adoption. Investors also lack the skills to conduct due diligence. The cost of due diligence is prohibitive.
- Pricing—there are no standard comparisons against which Canadian CI can benchmark, no established benchmarks for fiduciaries and nothing that is perfectly comparable. This results in uncertainties regarding how to price CI products.
- Lack of a compensation scheme for financial advisers—broker/dealers perceive the lack of fees and commissions for CI sales as a barrier; as a consequence, there are few sales and compensation agreements executed between broker/dealer firms and sources of community investment products. One notable exception is the Calvert Foundation, which has 25 sales agreements in place with broker/dealers.
- Lack of product knowledge—it is difficult for the CI investor to find CI opportunities. There is no database and no CI investment network for the motivated investor. Additionally, the prevailing belief is that all CI investments are concessionary and high risk.

6.2 ETI Barriers

- Lack of pension fund awareness and trustee education:
 - Lack of knowledge about this type of investing in Canada.
 - Misinformation about ETI characteristics and their permissibility. The general belief is that they are illegal, concessionary and too time-consuming and costly to administer.
- Lack of vehicles and expertise for delivering products; competent ETI managers are unavailable.
- Lack of performance benchmarks.
- Lack of a track record in Canada.

6.3 SVC Investment Barriers

- Generic barriers to growing venture capital.
- SVC not seen as a viable investment category by institutional investors.
- Lack of expertise, skills and understanding on both “sides” of green VC investment.
- Startup stage of financing too high risk for most investors.
- Perceived political risk with respect to predicting the fortunes of government subsidies to the environmental technology sector.
- Few community development venture capital funds in Canada.

6.4 CI Opportunities

- Government support programs—modelled after U.S. federal and state programs, Canadian governments could proactively invest in strengthening the core capacity of the sector to better position it to receive private financing. The federal

government has made a start with its 2004 Budget, by committing \$162 million over five years to help establish regional patient capital funds for organizations producing goods and services on a not-for-profit basis, with surpluses going to social or community goals.¹³ Additional commitments within this envelope include promoting other sources of lending to benefit these organizations, build capacity and undertake research.

- Favourable tax and regulatory scheme—following the lead of Nova Scotia with its community investment regulations, other governments can follow suit. Community investments could qualify for RRSP tax credits, and the federal government could explore the potential of a CRA or other framework to increase the role of Canadian banks in financing and supporting community economic development.
- National network and intermediaries—a network and other intermediaries could assist the sector to further develop the infrastructure for community investments, including rating systems for CI funds, benchmarks, standards, staff training, best practice and other “how to” information. Financial intermediaries could deal with due diligence issues and help raise private capital.
- Education and awareness for retail and institutional investors—the Canadian SRI industry could launch a campaign to promote community investing, putting in place tools similar to those developed for the U.S. SRI industry, including “how to” manuals, a database on product availability, supporting data on strength and track record of community investments, resources on how to manage fiduciary issues and how to diversify and price risk.

6.5 ETI Opportunities

- Permissive legislative framework, similar to that in the U.S.
- Legislation requiring pension fund disclosure regarding their social and environmental policies.
- “Fund of funds” that intermediates cost-effectively between institutional investors and external managers and provides due diligence expertise.
- Creation of private placement returns databases, performance assessment and measurement tools.
- Education for pension managers and trustees (Falconer, 1999; Falconer, 2002).

6.6 SVC Investment Opportunities

- Education and awareness for institutional investors including success stories that demonstrate the availability of deal exits and draw attention and capital.
- Legislation requiring pension fund disclosure regarding their social and environmental policies.
- Awareness of the community development venture capital model as an alternative to debt financing programs for the community economic development sector.

¹³ The federal government defines the social economy as organizations producing goods and services on a not-for-profit basis with surpluses going to social or community goals. www.fin.gc.ca/budget04/pamph/pacom.htm See Glossary for the Quebec government’s definition of the social economy.

This is a simple canvass of the barriers and opportunities in growing the CI sector in Canada, including ETI and SVC investing. However, it points the way to potential strategies for industry representatives, governments, investors and others seeking to generate double and triple bottom line investment opportunities and the sustainability benefits they create.

7. CONCLUSION

The list of barriers and opportunities in growing the community, economically targeted and sustainable venture capital investing sectors can seem daunting. No doubt the field looks similar to the banking sector in its early days—with haphazard development and lack of standards, benchmarks, guarantees and other elements of a soundly functioning financial system. Looked at from this perspective, as well as from the vantage point of the U.S. community investing sector, the prospects for the growth of the Canadian CI sector seem more promising. As this study shows, some critical supports are needed before CI can fulfill its promise of generating high-impact benefits to underinvested communities, regions and sectors in Canada along with acceptable returns to investors.

Essentially this high-level scan points to the following general conclusions about the CI, SVC and ETI sectors in Canada:

1. All three sectors are thought to be very small in Canada, once the Quebec and LSIF funds are factored out of the ETI equation. As a group and even singly these sectors are not well studied and little information exists to fully quantify their scope, scale and impact. As CI is a relative newcomer on the SRI scene, significant knowledge gaps remain.
2. The SVC sector is experiencing some growth in both Canada and the U.S.; the SVC sector in the U.S. in particular is growing exponentially. (Canada's growth is more anticipatory, with the emergence of SDTC on the scene.)
3. It seems evident that in the U.S. as in Canada (with the LSIFs), where there is a legal structure and government support, ETIs represent an effective strategy for job and wealth generation.
4. The Aboriginal finance sector in Canada is poised to take off, once these investment opportunities are better understood. Further research into the capital gap faced by Aboriginal communities and what it would take to close this gap could facilitate their integration into the economic mainstream.
5. The scale of the community investment sector in the U.S. is largely attributable to strong federal government support both legislatively and financially (including the much heralded *Community Reinvestment Act*), the existence of a secondary capital market for CI with risk-adjusted market rates of return, and the recent SIF awareness campaign. These government and industry programs have resulted in a proliferation of CI vehicles, intermediaries and investment opportunities. Industry networks and trade associations have further helped to scale up the field.
6. Unlike the U.S., Canada lacks a strong federal government role. Largely absent from the Canadian scene are regulatory frameworks, tax incentives, and risk mitigation and credit enhancement programs. Such measures induce the banking sector to support community economic development and attract capital and operating support to shore up the capacity of the sector. Were these to be in place, the Canadian CI sector would likely follow the American lead, developing into an increasingly credible and viable sub-sector of the SRI industry and of

mainstream finance. The federal government's recent social economy initiative—while limited in scope compared with the broader approach advocated in this paper—could well have positive long-term implications for the CI sector in Canada.

7. That U.S. investors have opportunities available to them for market, near-market and below-market returns, depending on the degree of social and environmental impact sought and other fiduciary constraints, suggests that the Canadian CI sector can similarly grow to provide a range of investment opportunities for fiduciaries and others. Further standardization of the CI industry in Canada—achievable only through increased capacity funding—would foster the sector's growth, as would investor and public education awareness programs.
8. The recent discourse on blended returns, SROI, social capital markets and the social economy points to increasing practitioner, academic and government interest in gauging the potential of community investing through capital markets to lever sustainability benefits for communities. Further research on this emerging field would accelerate the creation of a viable social capital market in Canada.

Capital market watchers will know that there is growing discontent and cynicism over mainstream capital markets, which are seen by some as disconnected from such basic public values as social and environmental responsibility. Within this discontented investment community there is a growing network of private investors looking for blended returns—looking for a way to use their investment dollars to lever sustainability benefits. Mixed in with this group are inheritors and self-made wealthy adults who are willing to take the risks called for in this fledgling Canadian industry. They and other institutional investors who can see the double bottom line benefits for their clientele need government and industry leadership to address the barriers and take advantage of the opportunities, thus bolstering the potential of the Canadian social capital market. This is the vision of community investment—the commitment of diverse participants to bridge the capital gaps in the economy with the goal of advancing the social and environmental quality of life of Canadians.

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APPENDIX A—LITERATURE REVIEW

The following is a brief synopsis of the literature on community, economically targeted and sustainable venture capital investing in Canada and the U.S. It is worth noting that, because this is a niche and emerging investment field in both countries, there is a dearth of comprehensive, analytical and data-driven literature available for review. In Canada, particularly, the literature on issues faced by the community investment sector is scarce. Industry association–sponsored trends reports and community economic development (CED)¹ financing issue analysis make up the bulk of the Canadian literature on CI.

i. Community Investing

Although relatively few assets are attributed to the sector, CI is a growing field of investment activity. The U.S. has the largest market for community investment in the world, with an estimated US\$14 billion in this asset class according to 2003 figures of the Social Investment Forum (SIF); this figure has expanded by 84 percent since 2001 (US\$7.6 billion). Definitive comparisons between U.S. and Canadian CI volumes are hampered by differing definitions on each side of the border. However, Canada's Social Investment Organization (SIO) estimates that Canada had roughly \$69 million in this asset class in 2002, down from \$85 million in 2000 (\$15 million of the drop is attributed to the windup of a single community investment provider).

The range of community investment vehicles and methods is growing. Again, the U.S. leads the way with the greatest array of investment vehicles, called community development financial institutions (CDFIs).² There are an estimated 800 to 1,000 CDFIs across the U.S. compared with Canada's 50 or so community investment funds. The investment risk depends on the product, with some fully guaranteed and others not. Risk is managed through a combination of adequate equity capital and loan loss reserves, close monitoring of portfolios, and the provision of technical assistance when needed. Rates vary as well, with some CI products offering market returns and the majority providing near- or below-market returns to investors. Access to below-market-rate capital and operating subsidies from governments and private donors is a vital part of CI both in Canada and the U.S. (SIF, 2003; Mendell et al., 2000b; SIO and Riverdale, 2003).

The three streams of support critical to the development of CED in Canada according to the literature include (1) organizational funding, (2) human capital development and (3) access to financial capital.³ While lack of skills and capacity problems are cited as secondary limitations to the development of CED in Canada, the most significant

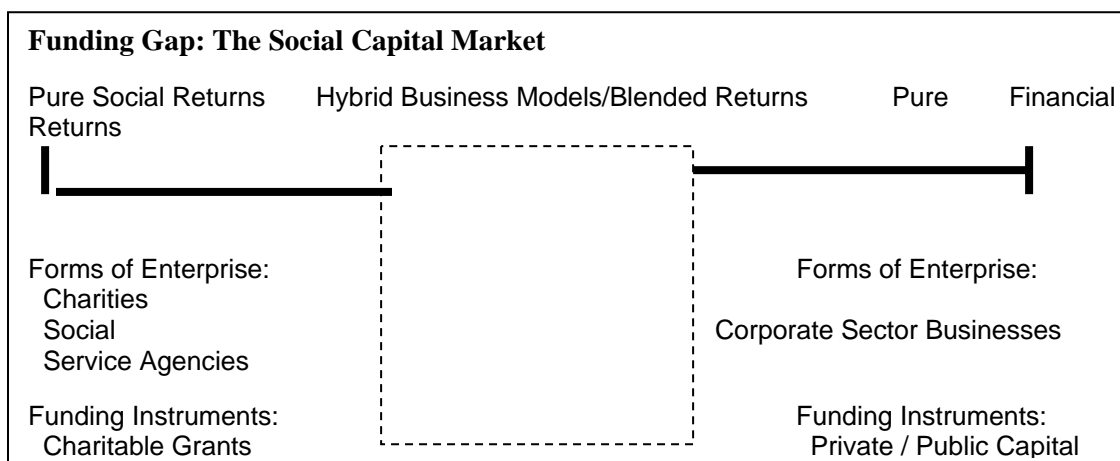
¹ The Canadian CED Network defines CED as action by people locally to create economic opportunities and enhance social conditions in their communities on a sustainable and inclusive basis, particularly with those who are most disadvantaged.

² CDFI is the U.S. expression used to describe institutions that provide financial products and services to economically disadvantaged people and communities. The CI sector in the U.S. is broken into four CDFI sectors, characterized by their different business models and legal structures: community development banks, community development credit unions (CDCUs), community development loan funds (CDLFs) and community development venture capital funds (CDVCs) (CDFI, 2002). It is important to note that we do not have the equivalent of community development banks in Canada and at most have a handful of CDCUs.

³ All recommendations by CCEDNet are to be taken in tandem with complementary and supporting recommendations in the CCEDNet trilogy: *Human Capital Development in Canada: Closing the Gaps* (2003); *Development of Federal Tax Credits to Support Community Investment in Canada* (2003); and *CED Funding and Delivery in Canada* (2003).

limitation is inconsistent and inadequate financial backing, especially lack of patient capital and governmental support (CCEDNet, 2002, p. 12).

Community investment vehicles have been placed between two traditional silos: philanthropy and capital market equity—also between traditional private, non-profit and public sector splits (Davis, 2003, p. 13; Social Capital Partners, 2002; Emerson, 2000). Traditional financing focuses entirely on financial returns, while charitable financing seeks social returns. This leaves a gap in community financing as illustrated in the following figure:



Source: Social Capital Partners, 2003.

This position in the financial marketplace—the home of community and social investment that generates both financial and social returns—is referred to as the *social capital market*. The gap is a measure of the lack of traditional and non-traditional financing available to support the growth of social and environmental enterprises. In the U.S., which has a more developed social capital market, double bottom line loans account for 97 percent of CDFI financing activity, although new equity, near-equity⁴ and guarantees are growing segments in the industry, with 94 percent of all equity investment made by VC funds (CDFI, 2002, pp. 4, 19). Current legal and normative structures and institutions for capital markets inhibit the growth of CI (Mendell et al, 2000b).

In the U.S., government legislation and programming have been key drivers of the community investment industry. The *Community Reinvestment Act (CRA)*⁵ and *Community Development Banking and Financial Institutions Act*⁶ have facilitated the

⁴ Debt-with-equity-features are loans that allow the CDFI to receive additional payments based on the performance of the borrower's company. They include convertible debt, debt with warrants, participation agreements, royalties and others (CDFI, 2002, p. 19).

⁵ Enacted in 1977 because formal financial institutions were closing down branches in low-income areas, the "CRA and its implementing regulations require federal financial institution regulators to assess the record of each bank and thrift in helping to fulfill their obligations to the community and to consider that record in evaluating applications for charters or for approval of bank mergers, acquisitions and branch openings. The law provides a framework for depository institutions and community organizations to work together to promote the availability of credit and other banking services to underserved communities" (SIO and Riverdale, 2003, p. 11).

⁶ The *Community Development Banking and Financial Institutions Act*, enacted in 1994, led to the creation of the Community Development Financial Institutions Fund, which supports community investment funds

creation of a more buoyant social capital market through targeted tax incentives and mandated investment by the U.S. banking sector. Complementary programs and vehicles include the Low Income Housing Tax Credit (LIHTC),⁷ New Market Tax Credit (NMTC),⁸ Bank Enterprise Award (BEA) Program,⁹ community development municipal bonds (CDB),¹⁰ equity equivalent investments (EQ2),¹¹ community development corporations (CDCs), community investor pools¹² and trade associations (CDFI, 2002 SIF 2003; SIO and Riverdale 2003; Davis, 2003, p. 14). In addition, in 2000, the SIF launched the “1% in Community Campaign,” aiming to increase assets devoted to CI by encouraging all social investors—including institutional social investors—to shift 1 percent of their investment dollars into CI. Much of the success of this campaign—which has witnessed 159 percent growth¹³ in the CI sector since its launch—is attributed to the fact that the overall negative impact on investor returns is arguably minimal (if not absent) while the social returns are seen as significant (see Appendix A for an example of fund performance impact) (SIF, 2003, p. 26).

Canada lacks a broad framework of national legislation and government programming to encourage community investment activities. However, a number of provincial initiatives aimed at raising equity for certain business sectors, disadvantaged regions and small businesses do exist (Davis, 2003). These include a fixed loan loss reserve supported by Western Diversification (a regional development agency); Nova Scotia Equity Tax Credit and the Nova Scotia Community Economic Development Investment Funds;¹⁴ Manitoba

through equity investments, capital grants, loans and technical assistance support (SIO and Riverdale, 2003, p. 11).

⁷ Enacted in 1986, the LIHTC program gives investors a credit against their federal taxes in exchange for providing funds to build or renovate housing at rents within reach of low-income people (SIF, 2003, p. 27).

⁸ The NMTC was approved as part of the *Community Renewal Tax Relief Act* of 2000 to encourage new private capital in CDFIs. Individuals and corporate investors can receive an NMTC worth more than 30 percent of the amount invested over the life of the credit in present value terms (SIF, 2003, p. 27).

⁹ The BEA provides financial incentives to banks and thrifts to invest in CDFIs and support other community development finance work (CDFI, 2003, p. 9).

¹⁰ CDBs are securities issued by states, cities, towns, counties and special districts. They have community development as their primary purpose, and the interest on them is generally exempt from federal income tax and, in some cases, from state income tax (SIF, 2003, pp. 27–28).

¹¹ Initiated in 1996 by the National Community Capital Association and Citibank, EQ2s are loans to CDFIs that are deeply subordinated and have a rolling term and other features that allow them to work like equity. These investments provide banks with enhanced CRA credit (SIF, 2003, p. 28).

¹² Non-profit Community Investor Pools offer registered investment products, portfolio diversification and professional management.

¹³ From US\$5.4 billion in 1999 to US\$14 billion in 2003 (statistics were not recorded in 2000).

¹⁴ Nova Scotia has two tax credit initiatives targeted at raising private investment in community initiatives:

- 1) The Nova Scotia Equity Tax Credit (1994) gives investors a non-refundable provincial tax benefit of 30 percent of the amount invested to a maximum credit of \$9,000 that can be carried back three years and forwarded seven years. A number of criteria apply for eligible issues of shares, for more on these see www.gov.ns.ca/econ/cedif. From 1994 to 2001, a total of \$49.4 million was invested by 4,030 investors into 439 companies. These investors received personal tax credits of \$14.1 million. With an assumed survival rate (close to the actual) of 75 percent for businesses, the cumulative net benefit to government from the tax credit is \$6,889,000. This includes employment benefits, household income and provincial government revenue (Davis, 2003, pp.16–17).
- 2) the Community Economic Investment Funds Tax Credit (1999) expanded the Equity Tax Credit by offering a partial guarantee on the last 20 percent of an investment in areas outside Halifax, Dartmouth, Bedford and Sackville for the first four years. Shares in community investment funds are also pre-approved as holdings in self-directed RRSP accounts.

To read the positive reviews see: Government of Nova Scotia, *Equity Tax Credit Act and Community Economic Development Investment Funds Review*, 2002. The creation of CEDIF tax credits required a modification to the *Nova Scotia Securities Act*; see Davis, 2003, pp. 17–18.

Grow Bonds;¹⁵ and Manitoba Community Enterprise Development Tax Credit¹⁶ (Davis, 2003). Other complementary initiatives include a formal community credit network in Quebec; informal micro-credit networks in the Atlantic provinces and a formal association of Aboriginal financial institutions in British Columbia; community futures associations¹⁷ and community business development corporations; a national forum of cooperative funders and financiers; a national CED forum for credit unions (SIO and Riverdale, 2003, pp. 7–8); and the very recent creation (June 2004) of a Canadian CI Network.

The literature confirms the existence of a variety of CI instruments servicing niche markets that are not adequately served by conventional financial institutions; that CIs finance seemingly “high risk” transactions in a prudent and effective way; and that they generate a variety of impacts in the communities they serve. The impacts go well beyond the new jobs and new affordable housing units created, but accounting for other impacts remains somewhat elusive.

ii. Sustainable Venture Capital Investing

Sustainable venture capital (SVC) is often considered a subset of CI, though some see it as falling broadly within SRI-screened portfolios. For the most part, place-based SVC initiatives are included within CI, and national or international SVC investments are included within SRI screening. The academic literature does not treat SVC in this fashion, in any case, with most authors addressing either the environmental or clean technology aspects or, alternatively, the community development angle. Indeed, researchers (O'Rourke and Randjelovic, 2003; Dick, 2004) have found a lack of fundamental research and virtually no basic information as to who is doing what in the sustainable venture capital area.

In terms of the overall SVC industry, the SVC market is still maturing: fund sizes and deal sizes are still relatively small; most funds are not as active in startup stage investment as they are in the expansion stage; and there is no clear story to tell about their financial success (Clark and Gaillard, 2003, p. 10). Only half of all SVC funds evaluate the social or environmental impact¹⁸ of their investments, and the funds tend to be more confident about their commitment to achieving impact than about the impact itself (Clark and Gaillard, 2003, p. 9).

¹⁵ Initiated in 1991, Manitoba's Rural Development Bonds Program (Grow Bonds) was established to assist rural entrepreneurs in attracting investment while protecting investors with a provincial guarantee for every dollar invested. Since 1991, there have been 24 Grow Bond issues worth a total of \$12,360,000. Twenty-two projects were funded and 707 people have been employed by companies that receive this financing (Davis, 2003, p. 18).

¹⁶ The Manitoba CED Tax Credit (2002) is a non-refundable, 30 percent personal income tax credit for resident investors in eligible community enterprise development projects (Davis, 2003, p. 18).

¹⁷ Community futures organizations have provincial associations that come together under a pan-Canadian association. They are funded by Industry Canada's regional development agencies and so are grouped as Atlantic Canada Opportunities Agency (ACOA), Canada Economic Development for Québec Regions (DÉC), the federal government's Initiative for Northern Ontario (FedNor) and Western Economic Diversification (WD).

¹⁸ A variety of external resources and tools are used for this evaluation: metrics have been developed in collaboration with McKinsey & Company, AtKisson Index of Sustainability, CERES standards on global environmental impact reporting, the CDCV criteria, and the Roberts Enterprise Development Fund's Social Return on Investment (SROI); the Rockefeller Foundation has been working on tools to assess and/or monetize the social impact of SVC funds.

A few conditions are deemed essential to the growth of SVC: (1) successful exits from deals and more consistent and reliable financial returns data (Cleantech, 2003; Clark and Gaillard, 2003; Wüstenhagen and Teppo, 2004); (2) awareness raising, education and training of both VC investors and sustainable project promoters seeking VC financing (Randjelovic et al., 2002); and (3) co-investors, or the participation of major institutional investors to complement the strategic investors who have anchored the leading SVC funds to date (Cleantech, 2003; Clark and Gaillard 2003). On this third issue, Sustainable Development Technology Canada (SDTC), a not-for-profit foundation established by the Government of Canada in 2001, was created to “de-risk” clean technologies and help render them more attractive to the investment community. In addition, environmental mitigation regulation imposing internalization of externalities by polluting sources could further facilitate investment in this sector. Traditionally, environmental externalities are not adequately priced or valued in the market, and these market imperfections can hinder eco-innovations. “As long as markets do not punish environmentally harmful impacts, competition between environmental and non-environmental innovation is distorted” (Rennings, 2000, p. 326). Regulatory guidelines, such as the IPPC Directive¹⁹ in the EU, are one way of curbing such imperfections (Randjelovic et al., 2002, p. 14).

Although united by a desire to achieve social and environmental impact through private equity investing, community development funds have evolved into four “types” in the U.S.: VC with a conscience funds,²⁰ representing about 22 percent of all SVC community development funds; industry change-focused VC funds,²¹ representing about 29 percent; leadership- or development-focused VC funds,²² representing about 32 percent; and non-profit social investment funds,²³ representing about 17 percent (Clark and Gaillard, 2003, pp. 6–7).

iii. Economically Targeted Investing

SVC or community investments by pension funds and other institutional investors are often referred to as *economically targeted investments*. ETIs are not by definition an asset class in and of themselves. Rather, they form an investment perspective that, all else being equal, recognizes collateral benefits (Hebb, 2001, p. 10). Indeed, in recognizing that capital markets are not neutral on issues of local development, jobs or other social goods, long-term institutional investors can decide to be more strategic

¹⁹ The Integrated Pollution Prevention and Control (IPPC) directive was issued in 1996 for EU countries. Integrated pollution prevention and control concerns highly polluting industrial and agricultural activities (energy industries, production and processing of metals, mineral industry, chemical industry, waste management, livestock farming, etc.). The Directive defines the basic obligations, which cover a list of measures for tackling discharges into water, air and soil, as well as waste, wastage of water and energy, and environmental accidents. They serve as the basis for drawing up operating licences or permits for new or existing installations, thereby driving eco-innovation. A transitional period (October 30, 1999 to October 30, 2007) is laid down, during which existing installations can be brought into conformity with the requirements of the Directive. See Council Directive 96/61/EC of September 24, 1996 concerning integrated pollution prevention and control (Official Journal L 257 of 10.10.1996).

²⁰ Mainstream VC that has made a commitment to devote some portion of capital to deals or entrepreneurs with explicit social or environmental goals.

²¹ The primary products or services of the businesses in which they invest are inherently pro-social or pro-environmental.

²² Invest in projects owned, managed or employing marginalized populations, regardless of the product or service they provide.

²³ Exist within a private foundation or public charity and make equity investments in private companies as a means to support the mission of the charity.

about obtaining collateral benefits while treating earnings as the first priority (Falconer, 1999, p. 5).

Compared with their American counterparts, pension funds and other institutional investors in Canada have very limited exposure to private capital markets, and there is no broad legal framework in Canada that clarifies and establishes parameters for the targeted investment concept (Canadian Labour and Business Centre, 2001; Yaron and Kodar, 2003). In the U.S., the ETI model was given a decisive boost in the mid-1990s, when ERISA regulators made a series of official pronouncements confirming its fiduciary permissibility if appropriate risk-adjusted returns were ensured (Falconer, 1999, p. 80).²⁴

Despite the lack of permissive legislation in Canada clarifying the legality of ETIs, several important Canadian models exist, especially in Quebec and British Columbia.

The ETI literature generally seeks to raise awareness and knowledge of the profound effects of pension funds. It highlights both the danger (Baker and Fung, 2001) and the opportunity (Calabrese, 2001; Hebb, 2001) that the growth of these enormous capital pools presents to working people; examines the obstacles facing ETI (Zanglein, 2001; Falconer, 1999; Canadian Labour and Business Centre, 2001; Quarter and Carmichael and , 2003), and suggests that pension fund trustees and money managers consider the macroeconomic implications of their investments on long-term portfolio performance.

All policies and processes for investing the assets of pension funds originate with the promise to provide plan members with retirement income using strategies chosen to reliably meet that promise (Falconer, 1999, p. 17). Promoters of ETI point to inefficiencies and gaps in the financing continuum of national economies, arising in part from costly and asymmetric information—and making the combination of market-rate returns *and* collateral benefits possible (Calabrese, 2001; Hebb, 2001). Advocates of ETI argue that a rising tide raises all ships. For the California Public Employees' Retirement System (CalPERS), for example, "[i]t is clear...that the present and future financial health of our trust fund is inextricably linked to the economic health of California" (Harrigan, 2003, p. 241).

While no systematic financial evaluation of the various ETI programs exists, in 1995 the U.S. General Accounting Office (GAO) surveyed a majority of public pension funds in the U.S. and found that most ETI programs were outperforming their benchmarks (GAO, 1995 , p. 7).²⁵

²⁴ The Interpretive Bulletin 29 CFR 2509,94-1:

...sets forth the Department of Labor's interpretation of sections 403 and 404 of the Employee Retirement Income Security Act of 1974 (ERISA), as applied to employee benefit plan investments in "economically targeted investments" (ETIs), that is, investments selected for the economic benefits they create apart from their investment return to the employee benefit plan....[T]he Department has issued a regulation...[which] provides that the prudence requirements...are satisfied if (1) the fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant, and (2) the fiduciary acts accordingly.... (The Interpretive Bulletin 29 CFR 2509, 94-1)

²⁵ The benchmarks used to analyze the financial returns of ETI programs for the purposes of the survey were designated as such by the GAO and were generally similarly rated, conventional instruments. The ETI programs that were underperforming these benchmarks were short-term funds (three- and six-month certificates of deposit), younger VC funds and about half of older VC funds.

While comprehensive evaluation and documentation of the impacts of ETIs are limited, figures related to job creation are available. Venture-backed technology firms in the U.S. are credited with creating high-paid knowledge worker jobs at four times the rate of similar job creation by that country's top 500 publicly listed corporations (Falconer, 1999, p. 27). In Canada, between 1991 and 1996 close to 17,000 jobs were created by 420 venture-backed companies at an exponential growth rate of 26 percent per year (Falconer, 1999, p. 27). The ETI literature generally believes that pension funds and other institutional investors will be able to replicate this labour market growth rate provided they obtain more significant private placement holdings.

While private and public sector pension funds in the U.S. were responsible for approximately 50 percent of all new venture capital on an annual basis during the 1990s, only a handful of extremely large public sector pension funds in Canada are engaging in private placement investment. The ability of the Caisse de Dépôt et Placement du Québec (CDP), Ontario Municipal Employees Retirement System (OMERS), British Columbia Investment Management Corporation (BCIMC), and Hospitals of Ontario Pension Plan (HOOPP) to enter these markets is attributed to their size (Falconer, 2001).

Labour-sponsored investments funds (LSIFs)—a uniquely Canadian approach to economically targeted investing—control more than 50 percent of the available venture capital market (Quarter and Carmichael, 2003, p. 18). LSIFs represent capital that is designed to meet gaps in markets for small- and medium-sized firms in particular provinces, as defined by the funds, and possibly in particular sectors of the market, if the funds are specialized. They are required by law to diversify their investments and to minimize risks. To encourage participation in labour-sponsored investment funds, participants receive tax credits (federal and provincial) of 30 percent of their investment (Quarter and Carmichael, 2003, p. 16–17).

It becomes evident that in the U.S. as in Canada (with the LSIFs), where there is a legal structure and government support, ETIs represent an effective strategy for job and wealth generation.

iv. Social Impact Metrics

Many observers believe that an important future driver of the growth of CI, including SVC and ETI, will be the ability to quantify its social and environmental impact. In business, there are generally accepted principles of accounting and an international legal infrastructure to help manage the reporting of financial returns. A comparable standard for social impact accounting does not yet exist. The Double Bottom Line Project (2004) released a catalogue of methods that for-profit and non-profit social ventures and enterprises can use to assess the social impact of their activities. The catalogue analyzes the feasibility and credibility of nine methods and provides examples of them in use.

An issue that frequently emerges relates to attribution, the degree to which the result of an activity would have happened anyway and the percent that could be attributed to the activity in question. As a result, current working metrics tend to look at outputs rather than true impacts (Clark et al., 2004).

The social return on investment (SROI) is one method of assessing social value. In the broadest sense, SROI is an attempt to quantify the social value being generated by an organization as a result of an investment made in that organization. SROI is proposed as an evaluation strategy to determine what organizations and programs are delivering the “best” social returns. The term *return* is used because it is a result of resources (financial and human) invested. SROI is distinguished from the more traditional return on investment (ROI) in that the units being measured encompass social and/or environmental impact. SROI also includes the measurement of social value creation through the use of proxies to measure the broader ripple effects or outcomes (REDF, 2004). Some use SROI as a monetization of the social benefits and costs relative to the financial costs of an enterprise’s operations. In this interpretation, the SROI is based on the net present value of these non-market outputs in dollar terms. SROI methodology is deemed more credible than most other impact measurement approaches currently employed in the social venture field, because it is based on the actual data of a venture’s outputs and outcomes as well as on proxy research (Clark et al., 2004).

Simple cost–benefit analysis typically frames benefits and costs as trade-offs, and it does not facilitate planning or prioritizing that results in the optimization of both financial and social value creation. Emerson (2003) argues that financial and social values are wrongly viewed as two separate aspects of an investment; he posits a “blended ROI” that provides an optimal measurement by integrating both social and financial returns.

Social impact methodology, similar to that used in the CI sector, is very much a work in progress, though attempts to further quantify the social and environmental venture field promise to go a long way in bridging the information gap in the social capital marketplace.

Conclusions:

1. In the U.S., government legislation and programming have been key drivers of the community investment industry. Canada lacks a broad framework of national legislation and government programming to encourage CI, and it is assumed that this explains much of the relative lag in community investment in Canada as compared with the U.S.
2. The sustainable venture capital (SVC) market is still maturing; it is mostly in expansion-stage financing as startup stage financing is even higher risk. A few conditions are deemed essential to the growth of SVC:
 - successful exits from deals and more consistent and reliable financial returns data;
 - training, education and awareness raising on both the benefits and risks of SVC investing;
 - co-investors (Sustainable Development Technology Canada is a first initiative on this issue); and
 - environmental mitigation regulation imposing internalization of externalities by polluting sources
3. It seems evident that in the U.S. as in Canada, where there is a legal structure and government support, ETIs represent an effective strategy for job and wealth generation.

APPENDIX B—SENSITIVITY ANALYSIS

The following are two related but different analyses, proposed by the U.S. SRI industry, which attempt to demonstrate that, on the one hand (Table A), below-market CI investments (this paper would use the term *near market*) by and large have a negligible impact on overall portfolio returns, and, on the other hand (Table B), community investing can leverage higher social returns than can simple charitable donations.

A) SENSITIVITY ANALYSIS ON ANNUAL RETURN			
	Principal	Annual Return*	Appreciation
1) 95% 60/40 Equity/bond investment*	\$95,000	8.52%	\$8,094
5% Traditional cash component**	\$5,000	4.18%	\$209
100% Balanced portfolio	\$100,000	8.30%	\$8,303
<hr/>			
2) 95% 60/40 Equity/bond Investment*	\$95,000	8.52%	\$8,094
4% Community invest. cash component**	\$4,000	4.18%	\$167
1% Below-market community investment***	\$1,000	2.00%	\$20
100% Portfolio with community investment	\$100,000	8.28%	\$8,281
<p>*Based on the average return for the 20 years ending 12/31/02 of 60% S&P 500 equity and 40% Lehman's bond indices. **Based on the average return for the 10 years ending 12/31/02 of the Lipper Money Market Fund Index. ***This example uses below-market community investment with an average 2% dollar weighted return.</p>			

Source: Calvert Social Investment Foundation.

B) THE IMPACT OF COMMUNITY INVESTING VERSUS CHARITY	
When an individual makes a \$20 donation:	When an individual invests \$1,000 in a community investment at 3%:
The individual gives \$20	The individual's interest earnings may be reduced by \$20, compared with a 5% T-bill investment
And only \$20 goes to work helping people	While the entire \$1,000 goes to work helping people help themselves

Source: Calvert Social Investment Foundation.

APPENDIX C—FUND MANAGER INTERVIEWEES**Fund Manager Interviewees**

	Total Assets	CI Assets
VanCity Community Foundation	C\$10 million	C\$1 million
Domini Social Investments	US\$1.7 billion	C\$55 million
Loring Woolcott Coolridge	US\$1 billion	US\$25 million
Meritas Mutual Funds Inc.	C\$54 million	C\$0.5 million
Public Service Alliance of Canada Pension Fund	C\$178 million	C\$5 million

GLOSSARY OF TERMS

Blended Return on Investment (Blended ROI)—Originating from return on investment (ROI), this term describes the integrated and aggregated social and financial returns of a business operation.

Community Investment (CI)—Investment for the purposes of financing deep-seated needs of local communities not addressed by mainstream finance, including poverty alleviation, community and cooperative development, and environmental regeneration.

Capital Gap—Refers to the lack of traditional and charitable financing available to support the growth of social and environmental enterprises—because traditional financing focuses entirely on financial returns while charitable financing seeks social returns. As the sector between these two traditional approaches (the social economy) generates both social and financial returns, financing is relatively scarce.

Double Bottom Line (DBL) Investing—Investing that strives to achieve measurable financial and social or environmental outcomes.

Economically Targeted Investment (ETI)—ETI is defined as institutional asset allocations that obtain both market-grade returns commensurate with risk and collateral (social) benefits by addressing perceived financing gaps and underinvestment.

Micro-credit—Refers to loans under \$25,000 made to entrepreneurs who typically cannot access traditional forms of commercial financing for their businesses. These loans are generally paired with business training and technical assistance.

Social Capital Markets—Capital markets specifically for community and social investment, which generate both financial and social returns, typically considered to include the range of capital instruments from outright grants to below-market or concessionary capital to risk-adjusted rates of return. Often further considered to include certain human capital (e.g., volunteering, pro bono services, network capital).

Social Economy—Enterprises that fulfill the following objectives: (1) financial viability; (2) capacity to create stable employment; (3) respond to social needs; (4) produce goods and services that correspond to unmet needs; and (5) contribute to improving the quality of life of workers in local communities. (Quebec government definition. The federal government defines the social economy as organizations producing goods and services on a not-for-profit basis with surpluses going to social or community goals.)

Social Return on Investment (SROI)—In the broadest sense, social return on investment (SROI) is an attempt to quantify the social value being generated by an organization as a result of an investment made in that organization. SROI is proposed as an evaluation strategy to determine what organizations and programs are delivering the “best” social returns. It is defined as a “return” because it is a result of resources (financial and human) invested. SROI's distinguishing feature compared with the more traditional return on investment (ROI) is that the units being measured encompass social and/or environmental impact. SROI also includes the measurement of social value creation using proxies to measure the broader ripple effects or outcomes. See www.redf.org for industry leadership in this area.

Sustainable Venture Capital (SVC)—Refers to the sub-sector within the venture capital industry that proactively invests in social and environmental technologies, processes and enterprises within professionally managed venture capital portfolios.

Triple Bottom Line (TBL)—Investing that strives to achieve measurable social, environmental and financial outcomes.

Underserved Populations/Disinvested Communities—A business opportunity overlooked by traditional financial institutions and other profit-oriented businesses, typically including economically depressed areas such as rural and inner-city locales, racial and ethnic minorities, recent immigrants and low- and moderate-income households.