A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

Of Opportunity and Risk

This paper has documented just some of the improving prospects for applying mainstream investing practices toward achieving social and environmental goals. Strategies such as microfinance and social enterprise, initially having been launched primarily with philanthropic support, are now approaching the status of "mainstream" investment opportunities for banks, foundations and high net worth individuals interested in doing well while doing good. For those who believe in the power of market forces and free enterprise—as well as the need to create a more just world—these are exciting times.

These transitions from philanthropic capital to financial investment capital are particularly unusual and even anomalous events in the history of capital markets. While investors may analyze and learn from the "non-profit to for-profit" transformation of hospitals as well as specific financing innovations such as the affordable housing tax credit, there are virtually no historical examples of wide-scale economic initiatives that began on a philanthropic (wealth *transferring*) platform and segued to a risk-oriented (wealth *creating*) platform capable of attracting private capital. In this nearly unprecedented situation, one must carefully re-evaluate the usual rules for gauging risk and return as they apply to this major capital markets transformation.

In the context of a blended value capital market, there is real risk and there is real return. However, to an outsider trying to determine whether or not to invest in or contribute to a microfinance entity or a for-profit social enterprise, the investment decision is quite simply not as straightforward as it would be for investors considering traditional investment opportunities. This complexity arises from capital markets that heretofore did not reflect the true nature of value; instead, they artificially broke value into components that over simplified the goals of creating value. Those capital markets corresponded to two very different sectors (one non-profit and the other for profit) that, of course, still exist today. Each has its own rules, regulations and relevant approaches to analysis. Nevertheless, value is a more complicated construct, and maximizing it with consistency will require that investors revise their rules for investing capital. They must be careful to combine the best aspects of philanthropic and financial investing, and they must be especially wary of combining the strategies in ways that obscure risks and jeopardize overall, long-term blended value creation.

Developments in financial instruments, portfolio theory, creative market-based problem solving, and their underlying conceptions of value are very encouraging. They should be supported, expanded and celebrated as being revolutions in thought and practice that create real value. At the same time, *it is critical to reflect on the risks present in <u>any</u> emerging market and to define what mechanisms should be in place to minimize those risks.* If efficient markets capable of attracting significant capital to blended value investments are ever going to emerge, would-be market participants must observe and address the characteristics that currently prevent the nascent blended value capital markets from functioning as efficiently as more established, efficient capital markets.

Many of the extraordinary projects documented in this paper—and so many other innovations not addressed herein—are, quite simply, in jeopardy. At this stage of development, blended value investing strategies are poised either to become victims of their own success or—with careful guidance—to emerge victorious as new waves of capital are prudently deployed in blended value investments. Should significant new blended value investments turn out to be founded on poor due diligence or faulty risk-management, those mistakes could sour the market for years to come. The collapse of any of the initial funds and investment instruments currently capitalizing the next stage of blended value investing would not only spell the end of that particular offering; it would make it extremely difficult for future offerings to find investors. The Chinese character for "change" is a combination of those for "risk" and "opportunity", and such is the change in process.

Early financial failures would deal a significant set back to *all* those around the world who are attempting to bring new investment strategies to other emerging areas of economic development. Funds targeting small- and medium-sized enterprises in emerging economies, newly seeded renewable energy funds, community development venture capital funds, and many others have reason to be concerned and to ensure that early investment decisions are made wisely. This concern is not to say that mistakes cannot or should not be made. If the risk associated with these deals is appropriately priced and the markets are indeed efficient, some investors will lose money. These markets do not need to ensure that investors never lose money (doing so would distort the market in ways that would ultimately hurt value creation). Instead, the emerging market participants must ensure that every deal either succeeds or, in the

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words of Tom Peters, "fails forward". Participants do not need to prevent all losses of money, but they must avert the catastrophic failure that arises from incompetence, hubris or malfeasance.

Looking to the Future of a Blended Value Capital Market

For years the focus of a great deal of work has been upon the challenge of how to build the microfinance capital market—and many have worked to address that challenge. At the same time, another, broader question remains:

How do we create investment strategies that are bankable and socially valuable, capable of providing capital to microfinance, social enterprise, small- to medium-sized enterprises, community development finance and more?

Microfinance and other blended value creation systems share challenges in gaining access to mainstream capital flows, though each programmatic area stands in a unique position—its own particular distance from that ultimate goal. Nevertheless, a series of approaches, principles and concrete steps will help participants respond to the common challenges shared by everyone interested in applying financial investment strategies for social and environmental gain.

Defining the "Push" Investing Past and the "Pull" Investing Future

Several decades ago, the hundreds of millions of dollars initially needed to launch and grow microfinance were provided with little or no expectation of financial return to the initial investors. One might characterize this investment as a "push strategy," driven by the suppliers of capital:

- It was pushed by donors, philanthropic organizations (foundations) and governmental organizations, which in turn created the MFIs to deploy the funds.
- They pushed capital into microcredit because of its remarkable ability to create sustainable microenterprises started and owned by the poor.
- Philanthropic investors pushed it with little initial regard for whether the capital would be returned and, in many cases, limited understanding of whether it had been well deployed.

And it has been a successful strategy!

These early individual and institutional philanthropic investments demonstrated that poor people in developing countries could "help themselves" in a sustainable manner. These early philanthropic "investors" played the role of risk-tolerant angel investors as they helped capitalize a new industry. Nevertheless, they differed from traditional angel investors in that they had no expectation of an eventual liquidity event that would provide them with not only a return of capital invested, but a return *on* capital invested—a reward for their assumed risk.

Now, contrast this "push" flow of capital with the typical risk-seeking capital flow, wherein instead of being pushed, risk capital is "pulled" into a deal by the demand for capital:

- Entrepreneurs and investment opportunities pull early investors into investments with upside financial potential, and there is an expectation of future liquidity events. Typically, venture capitalists do not create the enterprises they fund; instead, entrepreneurs approach them with opportunities (and most venture capitalists reject more proposals than they fund).
- The early successes are tempered by early losses.
- If early success is sustained and scaled, this condition pulls even more capital, and mezzanine investors buy out early-stage investors as a new capital market is created.

Where this system works well—and there are numerous examples—great wealth is created, and revolutionary businesses are born. Along the way, the providers of capital come to learn about the risks and returns associated with the new businesses and investment strategies in part because they expect, accept and analyze failed investments. Furthermore, the investment opportunities become more standardized and the emerging markets form the necessary infrastructure to facilitate future flows of capital.

In the rush and enthusiasm for creating new capital markets that support blended value systems, investors must not forget this axiom of investing:

Mainstream capital is not brave. It does not like going places where the rules are unclear or subject to multiple interpretations. It does not like to go where the expected returns are not calculated clearly and plausibly and where the risk is not fully detailed and explained.

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Furthermore, mainstream capital does not flow to investments simply because it might have positive social impact. In fact, conventional wisdom suggests that pursuing financial return on investment (ROI) is agnostic at best and antithetical at worst to social return on investment (SROI). Blended value investing stipulates that investors *can* generate both types of value as an integrated, blended return, but it recognizes that investments must provide the reasonably predictable potential to generate financial ROI to attract (or pull) capital into deals in the first place. Without the potential for ROI that approaches the risk-adjusted market rate return, investments will be confined to philanthropic capital flows and will never have access to the much larger mainstream capital flows that have ROI as their highest priority. Importantly, such investments do not necessarily need to offer large ROIs; instead, it is crucial they have relatively predictable returns subject to well-understood risks. This mainstream capital currently is not flowing to blended value investments in large enough volumes, and the only way to pull it toward these investments is to structure them so that they can generate financial returns.

Blended value market participants must ensure that the present enthusiasm does not eclipse the tasks and disciplines required to build a functioning, efficient, liquid, self-correcting capital market that will provide ongoing, *sustainable* value for investors and entrepreneurs. The balance of this paper will present the core elements necessary for the creation of an effective, vibrant emerging market not simply for microfinance, but for the entire blended value arena made up of microfinance, social enterprise, for-profit social ventures and, indeed, any alternative financial offering that seeks to combine financial returns with social and/or environmental value creation.

Bringing such a global infrastructure into existence will not be easy. While this paper sets out a series of goals, the path to reach them is not clear, nor is achieving them at all assured. All practitioners need to assess what structures must be created and—perhaps more importantly—what business and investment principles must be maintained in order to achieve these goals. As explained later, these emerging markets require not only new and refined investment products and infrastructure, they also need participants to conduct their business with greater transparency, being more publicly thoughtful about failures and mistakes. A fundamental first step in building this infrastructure is for all potential investors in *any* investments that aim to generate both financial and social returns to vet each offering according to the degree to which the investment under consideration meets the relevant conditions described below.

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Creating an Emerging Capital Market Framework for Blended Value Investing

It is especially useful to examine the infrastructure of successful mainstream financial markets to evaluate the blended value capital markets' infrastructure. Mainstream financial markets work for both investors and those seeking new capital because they allow investors to evaluate potential investment risk/return objectively. Virtually any mature industry that has grown to scale and has attracted private capital has in place the following elements:

1. Common terminology
2. Transparency
3. Adherence to standard accounting practices
4. Regulation by third parties
5. Investment rating services
6. Fund comparison data
7. Insurance
8. Liquidity through secondary markets

Microfinance is the most well developed example of blended value investing. The industry has grown in 30+ years such that at this time is has millions of borrowers, thousands of lenders (MFIs), billions of dollars in loan portfolios, and countless donors and investors with a great deal of money looking for "investment" opportunities. Further, perhaps as many as 1,000 (an estimated ten percent of the total) MFIs are profitable in one way or another.

At first glance one might conclude that this industry represents a "breakout" – an industry delivering a true blended value return and doing so at scale. Upon closer examination, one must conclude that as good as it is, microfinance still has not developed the requisite infrastructure needed to attract mainstream capital.

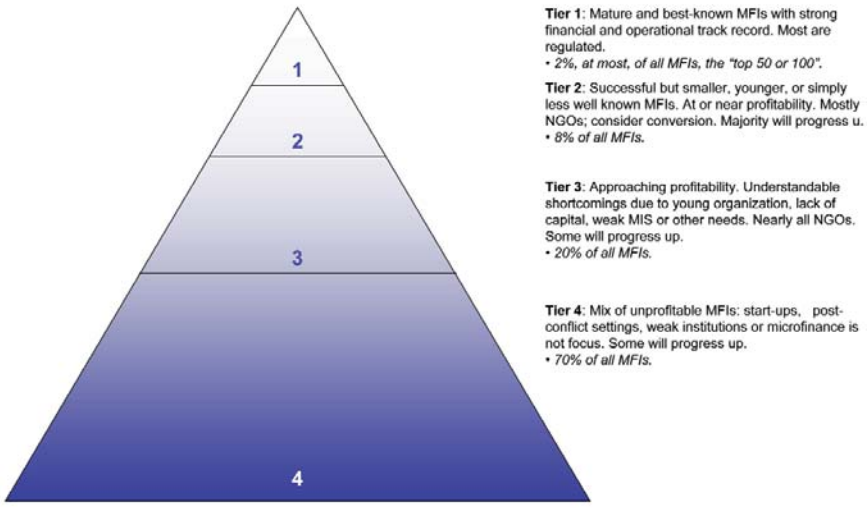
Tier-One MFIs and the Overall Market Critique

Microfinance experts segment the MFI market in a variety of ways, often referring to different "tiers" of MFIs, depending on their professionalism and financial health. (See figure 9 for one such segmentation.) Commonly, these experts distinguish about two percent of all MFIs as "tier-one", meaning that they have established track records, highly professional operations, healthy finances and, often, many of the characteristics of commercial banks. Many are affiliated with ACCION, Grameen and other prominent MFI networks. Tier-one MFIs have developed significant scale and expertise in structuring capital to advance social and financial returns. Through both leveraging subsidies and loan guarantees effectively and by securing market rate capital, these groups and their peers have lead the overall field in its development and expansion; they pioneered and disseminated microfinance's best practices.

At the same time, there are many more organizations—98% of all other MFIs—that may be pursuing (but are still lacking) many of the characteristics one would expect to find in formal capital market participants. The MFIs not included in the tier-one designation vary dramatically from one another, and the diversity in their business models, scale and financial health cannot be understated. While the Tier One organizations have succeeded in building networks and leveraging capital, they are not even close to the entire microfinance market. A vast majority of organizations both make up this larger market and fall well short of the operating capacities of tier-one institutions.

While some enterprises in microfinance and across the blended value investing universe do successfully exhibit market-leading characteristics, the state of the overall market lags those leading investments.

Figure 9: MFI Market Segmentation
Grameen Foundation USA



Source: Jennifer Meehan, "Tapping Financial Markets for Microfinance", Grameen Foundation USA, 2004

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The following section assesses the broad state of play within the blended value investing arena by focusing on the particular silo of microfinance. The critique of the broad field should not take away from the work and quality organizations that have been created by many individuals, nor should it be taken to apply to every MFI. Rather, *this assessment raises concerns about the overall state of the market and its implications for achieving real sustainable scale capable of tapping into mainstream financial service sectors.*

Market Characteristics Explained

1. **Common Terminology:** Any industry must be able to describe its inner workings to outsiders wishing to evaluate performance. Microcredit has done an admirable job of developing terminology and metrics that facilitate description and analysis of MFIs. Numerous industry descriptive manuals and financial models are available. Unfortunately, many of these descriptions and associated metrics were developed to identify, describe and quantify the subsidies that are available to non-profit MFIs. Most MFIs are still operating as not-for-profit entities today and, as such, account for their operating results using not-for-profit terminology, this language can be confusing if not misleading to potential investors, especially those who typically invest only in for-profit entities. For an investor to understand and evaluate the operational performance of a given MFI, there must be a clear delineation of subsidies and the role they have played and will play in the future performance of the MFI.

   Even the contemporary measures of financial performance tend to evince MFIs' non-profit origins. *The Economist*'s recent survey of microfinance makes this point clearly:

"The foggiest place in the industry is 'on the ground' (another favourite microfinance term), where familiar words suddenly become oddly unintelligible. An item labelled 'profit' lets you keep mum about the losses transferred to a money-losing charity affiliate. An 'operationally sustainable' business is one that can pay for its running costs but not its capital, which is often the largest single expense for a financial firm. But the worst thing are the acronyms, which make learned analyses of microfinance next to unreadable. All this may sound trivial, but industry practitioners seem to care deeply."[76]

   No matter whether those terms and acronyms are defensible or not, they clearly befuddle mainstream financial actors as represented by the authors of the article, whose statements suggest that microfinance's vocabularies make the industry appear parochial and quaint.

   A second and more problematic issue with terminology is that no consistent and objective measure of impact is promulgated. As the capital markets develop and capital is "pulled" to microfinance, there should be objective standards by which investors can judge the social impact of their investment. Unfortunately, what passes for impact measures today is usually a simple tabulation of microborrowers served and the average size of their loans. Many MFIs have established their own impact measurement regimes, but there appears to be little successful effort to pull those measurement schemes into a single unified approach.

   Opportunities for improvement:
   - Commercial financiers and regulated MFIs could continue to develop a common set of terminology that reflects the language and assumptions of mainstream international capital markets.
   - After MFIs have standardized their language around inputs and financial performance, foundations and other NGOs might sponsor impact-assessment studies by independent third parties and academic research professionals.

2. **Transparency:** As not-for-profits operating in developing countries, many MFIs have few public reporting requirements. The transparency of the industry is driven primarily by two factors: the decision of individual MFIs who voluntarily make their results public and the mandatory reporting performed by the MFIs that are regulated and therefore obligated to report results. Even with this level of transparency, rigorous evaluation of MFIs is difficult. MFIs in many parts of the world now voluntarily report results to industry associations and these results are aggregated and benchmarked. For investors wanting to analyze an MFI and to compare results to other organizations by size, geography, product, etc., the transparency issue is problematic.

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Organizations like the Microfinance Exchange (MiX) are working to increase outsiders' access to the characteristics and performance of MFIs, but that information is voluntarily provided and in some cases may not be current. While many MFI investment funds and MFI networks have detailed information about the MFIs with which they work, that information is not necessarily being shared and aggregated in any one place so that the MFIs' initial transparency becomes opaque.

Opportunities for improvement:

- Market participants can encourage efforts like MiX and related efforts.
- Investors and MFI networks can combine due diligence and isolated market intelligence from various actors, making them available through clearinghouses like MiX.

3. **Adherence to Standard Accounting Practices:** Many MFIs operate as not-for-profit organizations, and many control wholly owned subsidiaries engaged in related endeavours. Furthermore, most MFIs are not audited, and those that are tend to use small, country-based auditing firms. While many such firms utilize International Accounting Standards (IAS), application of these standards remains questionable. For investors, this condition poses a problem.

Opportunities for improvement:

- Market participants can form a reporting standards-setting board like the International Accounting Standards Board used to determine generally accepted international accounting standards. Such a board can focus on fitting international accounting standards to microfinance instead of creating a new set of microfinance-specific standards.
- Any emerging accounting standards must incorporate means of tracking subsidies as well as their intended outcome.
- Individual investors and funds can then demand financial statements prepared in accordance with those standards.
- Lobbying in appropriate legislatures can ensure that the international accounting standards will fit the emerging regulatory regimes for MFIs.

4. **Regulation by Third Parties:** In the developed world, financial services businesses are regulated by governmental agencies. Alas, it is not often the case with MFIs. In the developing world there is often, at best, a loose regulatory framework either in place or under development.

The net result is that MFIs *function* as banks but are not *regulated* as banks. Such mandated performance requirements such as capital adequacy, liquidity, reserves, reporting, etc. are often either non-existent or ignored. MFIs tend to be viewed by their host governments as NGOs (non-governmental organizations) and are relatively free to operate as they wish with virtually no oversight. For investors this condition poses obvious risks.

This condition varies dramatically depending on MFIs' corporate structures. In some counties, NGO MFIs can make the same loans as can regulated MFIs, while the latter will be bound by much more stringent regulations than the former. Countries that do regulate MFIs have regulations that vary from one anther dramatically (allowing or not allowing MFIs to raise capital in certain ways, promulgating different capital adequacy requirements, etc.), which forces potential investors to become experts in a variety of regulatory regimes.

The question of regulation is complicated by a number of factors. First, many MFIs are NGOs and therefore not regulated as financial institutions—but some are indeed regulated under other frameworks. Second, regulations differ from one country to the next (coordinating them would be overwhelmingly daunting). Finally, on a case-by-case basis, some of those regulations might be cumbersome and burdensome. In general it should be acknowledged that this is a significant issue being addressed by a number of actors.

Opportunities for improvement:

- Investors like ProFund can help MFIs convert to regulated MFIs.
- Market participants can support the creation of third-party international recommendations or templates for MFI regulations.

5. **Investment Rating Services:** Within mainstream capital markets, most investors are unable or unwilling to conduct the type of comparative analysis that leads to sound investment decisions. Instead, they rely on third-party credit rating entities such as Moody's, Standard and Poor's and others. The microcredit industry has not developed in a way that has prompted the development of independent rating agencies, a problem that may remain in place until MFIs and their associated financing deals grow sufficiently large to warrant the cost and attention of mainstream ratings agencies.

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Early investors did not expect a "financial return" on their philanthropic investments so they had no need for ratings. Microfinance agencies do exist, but unlike the large rating agencies, these microcredit-specific rating agencies look only at microcredit. Accordingly, mainstream investors see such agencies as lacking credibility, sometimes reporting in terms that do not coincide with those used in mainstream investing. As microfinance and related industries begin to attract funds from risk-seeking investors, this lack of rating services will pose significant problems for achieving meaningful scale. Furthermore, standardized and reputable rating agencies will lower the cost of investments' due diligence, which currently exceeds the typical costs associated with initiating similarly sized investments in more mainstream markets.

Opportunities for improvement:

- Ratings services such as Standard and Poor's, Moody's and others must have incentives to enter this realm
- Local branches of some of these agencies have rated some MFIs (see ACCION affiliates section); their experience would surely be valuable in expanding the practice.
- Here, a "smart subsidy" or creative blended value investment would advance the cause if it could creatively encourage the mainstream ratings agencies to develop microfinance rating methodologies and to overcome the hurdle of scale.
- MFIs need to see value in being rated, and so financiers and foundations alike can give them incentives—in the form of a lower cost of capital or a subsidy to purchase the rating services—to be rated by an appropriate agency.

6. **Fund Comparison Data:** While there is some public information to allow comparison between MFIs themselves, virtually nothing exists to allow investors to compare the operating results of the increasing number of funds investing in MFIs. For a variety of reasons, these funds are likely to be the vehicles of significant capital flowing into microfinance. There are between 50 and 100 of these funds in operation today around the world—with more on the way. Virtually all of them are private funds and publish little to no public data. A prospective microfinance investor has little if any means of finding a complete list of funds, comparing their investment terms, and understanding their investment results and non-financial impact.

The MFI fund world is relatively small, with relatively few actors. Accordingly, the information on past funds should not be difficult to aggregate. Nevertheless, the relatively early stage of many of these funds (which have not fully repaid principal lent or have not liquidated equity investments) makes some of them hesitant to share data. A recent report published by CGAP aggregates data (as of 2004) on many foreign funds (though the data are not rendered for side-by-side comparison).[77] The report indicates that many of those funds shared investors. Some funds have been focused on keeping their investors through emotional appeal (characteristic of not-for-profit investors) instead of through a clear statement of performance and a comparison to the investors' other options.

Opportunities for improvement:

- MFI fund investors need to invest on the basis of expected performance and should demand performance and comparison data.
- An independent group should study existing funds and assemble the data in a way that makes comparison easy.
- The industry would also benefit from a definitive forum (a *Wall Street Journal*, of sorts) in which fund managers can announce and promote new funds and where existing funds can report performance data.

7. **Insurance:** Most investors, or the funds in which they invest, are able to obtain insurance to help manage risk. The microcredit industry has yet to develop the scale necessary to interest the insurance industry. Accordingly, such things as foreign exchange risk, errors and omissions risks, directors and officer's risk, asset appropriation risk, political risk and others are generally uninsurable. While there is some ability to account for these risks through aggressive underwriting and risk sharing within funds, most investors would appear to have few options and relatively little appreciation of the true relative risk associated with an investment in microcredit or similar offerings.

Opportunities for improvement:

- The small scale of MFIs (relative to mainstream financial institutions) will remain a barrier to creating these insurance products, but mainstream insurers operating in MFIs' home countries may have the means and experience to offer such products.

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- Early iterations may need to be subsidized by other (possibly philanthropic) actors who might provide assets to underwrite policies that would be administered by the mainstream insurers.
- Ultimately, as the insurers learned more about the associated risks, mainstream underwriting capital would enter the market.

8. **Liquidity through secondary markets:** At the risk of stating the painfully obvious, for a true capital market to exist there must, in fact, be a market. Clearly, there is a primary microfinance capital market where equity is placed or loans made. From that point on, virtually all of the equity and debt invested in microfinance is simply illiquid. It can not be traded or sold freely among willing investors. This simple fact makes it very difficult for the average investor to consider taking a position. At present there is not even discussion among those in the microcredit industry on how or when a secondary market might develop.

Opportunities for improvement:

- The conditions above suggest that there is not yet the demand to buy microfinance investments on a secondary market; instead investors seem interested in investing their capital in new issues, in part because those new issues directly help poor entrepreneurs, while transactions on a secondary market would not.
- Spurring a secondary market when there seem to be no buyers would be a dubious prospect, and creating such a market place before it is demanded would amount to a new "push" investment strategy that would likely not bear fruit.
- Pushing MFIs and investments to adhere to the conditions enumerated above would help make a secondary market more viable and likely.

Implications for the Creation of a Blended Value Capital Market

Moving the entire industry in the direction of the tier-one institutions (and even beyond them) will be very difficult. Traditional market forces will certainly push some institutions in the right direction (indeed, those forces are already doing so, and they are bringing mainstream commercial banks in to microlending in many parts of the world). Nevertheless, subsidies—some with very legitimate social-value creating outcomes, and some with counter-productive outcomes—will prevent the entire sector from looking like those tier-one institutions.

At a recent conference on microfinance, Bowman Cutter, Managing Partner of Wall Street investment firm Warburg Pincus and Chair of the Board of microfinance fund Microvest, shared his perspective on the state of the microcredit capital market. Cutter spoke at length about the effort, time and resources expended to bring Microvest into being.[78] He observed that he and his colleagues created from scratch virtually all of their work; they had no templates or standard procedures to use as models. He observed that if every step toward building a microfinance capital market turns out to be as hard as starting Microvest, maybe the industry should rethink its strategy.

Fortunately, Cutter also provided real hope. He noted that he started in the investment banking profession more than 30 years ago. At that time, the profession was effectively in a start-up mode and that everything they did then was a "one-off" creation. He noted that today investment banking is a robust and very successful industry attracting and successfully managing billions of dollars annually and that microcredit feels like investment banking did 30 years ago.

The success of investment banking was built on a firm's appetite for capital and an investor's desire to put capital at risk. That situation exists today in the broad range of BVI investment opportunities. The microfinance business needs many billions of dollars to fund loan portfolios so that hundreds of millions of people can begin to create income and wealth and ultimately raise themselves from poverty. Similar demand for capital exists in the BVI segments that would fund affordable housing and community development, environmental protection, health, education and related services for the poor in all countries. As was the case in microcredit

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there are many case studies that could have been added to those in this paper to make the point that there are successful, hard-won interventions already in the market.

However, there are a number of steps that precede the creation of this blended value capital market.

Silos Versus Value Chains

First, blended value market participants, both investors and investees, must collaborate across their relative areas of interest (for example community development finance and banking actors could work more directly with microfinance practitioners to address common challenges). All should work to "come out of their silos".

Silos breed isolation and the need of every organization in a given field of endeavour to do everything in virtual isolation. When applied to industries such as microcredit or community development, it means the major players within their respective organizations are both vertically and horizontally integrated. They build their organizations and attendant support structures. Because the connecting tissue that ties entities together into value chains is not present, they go about doing everything for themselves. They develop no set of core competencies that when paired with others with different core competencies allow the formation of a true network of firms all aligned in their purpose and relying on each others' strengths to add value to the end customer.

These value chains or collaborative networks are how business is done in the for profit arena. One need only look as far as a Wal-Mart, Boeing or Cisco Systems to see business models based, at their very foundation, on the assumption that networks add value; going it alone does not.

What are the implications of this for those interested in building a blended value capital market? Leaders in the various BVI areas could construct value chains, ensuring their organizations develop core competencies and distribute common work. What is more, they should reach out to existing players operating outside their BVI area and enlist them in this effort.

This is exactly what the Calvert Foundation did by going to the Depository Trust Company (DTC) to handle the clearing and holding of community investment notes. The foundation knew this service was vital to its business model. It also knew mainstream investors require such a service. Rather than build an alternative or survive without it, Calvert Foundation created with DTC a value chain that added value for the customer. In reflecting on how the case studies presented in this paper evolved, one is struck by how often the successful initiative was characterized by the sponsor reaching out to others and building value chains.

Value chains are resource-conserving by design. A successful value chain involves bringing together the best firms in a way that minimizes overlap or redundancy. Who, exactly, benefits when redundancies are eliminated and the very best players are joined along a line where each is there because of a core competency? Quite simply, everyone. Scarce resources are preserved, firms are there because they add value in their areas of strength and investors get the best return because the customers get the best good or service at the best price. The value chain should become the model of how every BVI initiative is organized.

The second and concluding thought is that this process will take time—a lot of time—and will require the building of systems that are, today, not in place. The time is necessary because, at its most basic, building successful BVI initiatives capable of attracting and rewarding large amounts of capital is about changing culture—the culture of traditional financial services groups, NGOs, foundations and other participating entities structured to address the needs of either for-profit or non-profit actors. Conceptually and technically, it really is not hard to imagine microcredit or affordable housing or community development being able to arrange themselves into competitive value chains. In most cases the leaders of the various BVI segments have a foot in each world, the economic and the social. Their employees, boards and stakeholders expect them to be mission-oriented yet financially successful. That is very hard to do and requires that culture change to accommodate the needed alteration in mission execution.

But if it will be hard for the operators of BV endeavours to change culture, imagine how hard it will be for investors. The dominant culture asserts that one cannot mix mission with money. Even the socially motivated investor merely winks at the notion that a very well-run microfinance institution can address poverty and earn a respectable return on investment. They hear the story and see the pictures but suffer a cognitive dissonance. This dissonance is, of course, what led the founders of the microcredit industry to initially approach philanthropists.

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A Progression of Investors

Many critiques of microfinance-backed assets address barriers to the widespread adoption of those securities by institutional and other mainstream investors. While emerging blended value capital market participants must not forget this investor segment is its long-term goal, it would be wise to pursue a systematic plan that will bring these investments ever closer to that mainstream investor pool by targeting other strategic investors who can help advance the cause.

Most institutional investors require a defined asset class (wherein the securities bear a certain uniformity of structure so that the securities' behaviour can be better understood if not predicted). Most mainstream market participants would assert that most blended value investment products can not yet be considered legitimate members of an asset class. In spite of the recent and effective productization of microfinance bonds, the issues remain too different, there remain too few of these securities, and they have existed for too little time for financial analysts to understand their aggregate behaviour.

Furthermore, institutional investors with fiduciary responsibilities will often not even invest in a new fund or investment product in the mainstream capital markets. Typically, professional investors will avoid fund managers and funds that do not have a demonstrated multi-year track record of managing that particular investment with that particular investment style. They do so because they need to build the expected performance of any given investment into sophisticated asset allocation and portfolio models. As long as such quantitative models are built on historical performance information, such investors will need to wait for years until blended value securities can reach sufficient scale and can generate several years of performance data. This condition is a factor of time and it cannot be accelerated.

Instead, market participants offering blended value investments can target other investors strategically (as indeed many already have). Currently, it is a rare blended value investor who can construct a reasonably diversified portfolio even of microfinance-backed investments. To do so, investors must have sufficient capital (in the tens if not hundreds of millions of dollars) to dedicate to such a portfolio, and they must have a dedicated staff that can research potential deals and can thoughtfully assemble it.

Thus far, many of these investors have been development banks and foundations that have both the scale of investment and staff to effect it. This condition leaves high net worth individuals—those with limited staffing resources and a desire to deploy capital in the hundreds of thousands to the low millions of dollars—limited options for blended value investing. As more and more such investors express interest, there may be a place for investment funds that can syndicate high net worth individuals' investments and then place those funds into a well-diversified portfolio of blended value investments. Such intermediaries could help these investments get "pulled" closer to mainstream investments by making them accessible to the next stage of investor (after the way has been blazed by development banks and foundations). If these financial intermediaries build properly diversified portfolios, they will be able to sustain the occasional inevitable losses on individual investments.

When high net worth individuals can buy blended value investments, they will eventually and increasingly ask their professional wealth advisers to incorporate such investments into their overall portfolios. Those advisers, in turn, will bring a new set of mainstream capital resources to bear on these emerging investments as they research and analyze these new investments.

Accordingly, blended value market participants should continue to focus on "socially responsible investors", individuals who would purchase blended value investments first because of their expected SROI and second because of their expected ROI, because those investors can help these asset classes establish a track record and because they can bring additional resources to bear on the analysis of such assets. Nevertheless, in doing so, advisers and investors must diligently focus on the fundamentals and risks of such investments as though they were purchased purely for their expected ROI.

Failing Forward

In any market, particularly an emerging market that has few precedents, there will be occasional imbalances of supply and demand. At times prices will be too high, and at other times they will be too low. As the markets learn to price risk and digest market and non-market events, prices will likely swing; some people will make money, and some will lose. The blended value capital markets must anticipate this sort of volatility and must face it without avoiding it.

A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

Market participants should structure their investments so that market shocks engender market corrections, not market collapses. Keys to doing so are diversification (at least in terms of geography, financial instrument and fund managers) and conscious risk mitigation. As mentioned elsewhere in this study, foreign exchange risk remains largely unmitigated in many international blended value financing strategies. Drastic currency devaluations have the potential to destroy returns and collapse private-investor-supported markets for international lending unless market participants can develop facilities to understand and begin to manage foreign exchange risks.

Fortunately, a number of such initiatives are under development. Investment advisers such as Omtrix and others have been at the forefront of advancing such foreign exchange hedges where they have not existed in the past.

Furthermore, open communication about investment methodologies, pricing, failures and equity-holders' profits will be essential to pricing these blended value investments correctly. Keeping the data private introduces the chance that other funds will erroneously price risk. When substantial capital enters (or fails to enter) a market based on mispriced risk, that market is prone to dramatic failure. Markets cannot accurately price the risk associated with their securities unless they openly explore failures as well as successes.

Investors must also be exceedingly rigorous about entering and exiting investments. They must be especially careful to understand how the drive to create SROI can affect an inclination to enter ill-advised investments and their decisions to exit (or not exit) underperforming investments. Investors must have the fortitude to take losses and cut off investments that are not obviously salvageable.

The emerging blended value capital markets simply cannot afford for participants to be secretive about their data, ashamed of their failures, or fragmented in their terminology.

Conclusion

This paper explores various capital structures that have successfully been used to finance microfinance, community development and related areas. We suggest these blended value investing practices be extended to other value-generating projects or sectors. It must be stated that such a progression will not be easy, swift or painless. Microfinance has the benefit of over 30 years of refinement—a three-decade head start on other blended value investments. Furthermore, microlending itself has some very appealing characteristics that are not necessarily shared by other blended value strategies. The fundamental economics of microfinance are so strong because they are built on many loans to many people diversified across business sectors. Given that those microentrepreneurs are operating in predominantly cash-oriented economies, often times providing essential goods and services, they are somewhat insulated from macroeconomic fluctuations. Furthermore, those entrepreneurs can shift their businesses very quickly, exiting and entering new business areas as conditions dictate.

Other potential blended value investment vehicles may not possess such appealing risk-reward fundamentals. Accordingly, investors and intermediaries will need to structure and price investments such that they account for those unique risk characteristics. Microfinance's lessons cannot be applied wholesale and unthinkingly to other blended value investment systems. Nevertheless, the market participants aiming to bring new capital flows to low-cost housing, small scale irrigation, and so many other systems can and should learn from the laborious 30+ year journey that microfinance and its capital markets have undertaken. Undoubtedly, much can be learned from careful research into the major microfinance innovations that led it from a philanthropically supported enterprise to one supportable by mainstream capital. Building upon the great strides made by those within microfinance and community banking, sustainable financial innovations hold the promise of expanding into countless areas of both social need and market demand.