Impact investing offers foundations greater impact per dollar

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How foundations can use impact investments to leverage their grant capital

Impact investing offers the promise of greater impact per dollar as funds are returned and recycled into new investments that generate new impact.

For foundations, impact investing offers a powerful opportunity to advance the mission through endowment investments and impact well beyond grant budgets. A lot of attention has been paid to evidence and examples of "doing well by doing good" and achieving financial returns through mission-aligned investments that are on par, or even above, those of traditional investments.

At the same time, while being able to achieve competitive financial returns is key for wide adoption, high returns are not necessarily an indicator of high-quality opportunities for impact. There *are* investments worth making where the returns are concessionary relative to the risk being taken.

This is the value proposition of catalytic capital, which, as the MacArthur Foundation describes it, is "investment capital that is patient, risk-tolerant, concessionary, and flexible, and "is an essential tool to support impact-driven enterprises and organizations that lack access to capital on suitable terms through the conventional marketplace."

Investments and grants

The potential impact of catalytic capital is highly compelling. Under the right conditions, it's more efficient than grant funding in generating impact through capital that is recycled to then deliver additional impact. Catalytic capital can also be used to support innovative business models in early stages, to increase access to capital for populations that are considered high-risk by banks and other lenders, to demonstrate that a particular asset class is investable, and to support proof-of-concept funds with impact objectives that can leverage follow-on capital from commercial funds after thesis is proven out.

Many spend-down foundations have embraced catalytic capital alongside grant funding to drive impact. But for the majority of foundations that are perpetual, catalytic capital offers a conundrum. If a foundation is required to make enough money on its investments to cover its grants budget and operations, then how can it also be willing to accept reduced financial returns in exchange for greater social or environmental impact?

In one sense, this dilemma was addressed by the IRS' designation of the Program Related Investment, a tool specifically designed for foundations which allows them to deploy catalytic capital as part of their program strategies and within their grants budgets. By definition PRIs must prioritize impact, and they can be a catalytic form of capital to deploy for many reasons. PRIs can also be counted toward a foundation's 5% minimum payout, which offers a clear advantage to perpetual foundations seeking to engage as impact investors but unwilling to concede overall financial returns in exchange for impact.

However, this approach requires carving up the grants budget—reducing it by an amount equal to the size of the investment. It does nothing to expand the amount of a foundation's dollars at work for impact, which should be a key benefit of impact investing. Program officers can be weary of the PRI precisely because of the implications for grants budgets.

If the goal of a PRI is typically to recover the invested capital without significant return, then one might ask, why count the investment out of your grants budget? Foundations seeking to maximize their total impact— even with a perpetuity goal— can do so through a different approach to balancing grants and catalytic investments that significantly increases the budget for impact capital overall. This balancing act can be accomplished by considering the return expectations for catalytic investments relative to the rest of the portfolio and reduce the grants budget by that much smaller amount.

Impact-first

These impact-first investments can (but needn't be) in the form of program-related investments that increase the foundation's payout well above five percent.

The Woodcock Foundation has experimented with this approach, creating a catalytic capital asset allocation to make investments that are directly contributing to solutions across our program areas. The goal for this asset class at the portfolio level is to recover invested capital without any additional returns. The investments within the portfolio are catalytic in different ways, and we expect returns on lower risk or very successful investments to cover losses on bets that don't work out.

In service of the perpetuity goal, we've calculated the difference between our return expectations on this asset class (0%) and average return expectations for the rest of our portfolio (7-8%). With an $80 million endowment, we have created a $4 million catalytic capital budget in exchange for a $300,000 reduction in our grants budget. By using this less conservative and still prudent approach to balance our grants and catalytic investment, we've been able to nearly double the amount of impact-first capital in our budget, optimizing the impact of scarce resources.

The foundation has 20 investments in its catalytic portfolio that expand our impact not just through the recycling of capital after repayment but also through enabling follow-on capital. For example, we've made loans to several CDFIs to support specific initiatives, such as financing resident ownership of manufactured home communities, expanding capacity to invest in native-owned businesses, and supporting the growth of businesses that provide quality jobs and pathways to employment.

> Woodcock made an early investment in the REDF Impact Investing Fund, which provides loan capital and technical assistance to grow employment social enterprises that employ formerly incarcerated people, individuals facing homelessness, and others facing significant barriers to employment.
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> The foundation has also invested in proof-of-concept funds, such as the Inclusive Creative Economy Fund at LISC designed in collaboration with Upstart Co-Lab. fter raising a $10 million pilot fund focused on NYC that demonstrated the potential of the creative economy lens, Upstart Co-Lab is now raising a $100 million fund. In other cases, the foundation has used catalytic capital as part of integrated capital stack in cases where grants alone or commercial capital alone would not be suited to achieve the impact objectives.
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> One of the foundation's most recent investments is in Potlikker Capital, a charitable loan fund that provides reparative capital to BIPOC farmers to advance racial and climate justice.

Promise of catalytic capital

Having a catalytic capital asset allocation has also allowed the foundation to take a more integrated approach internally, creating a pathway for investments to move across asset classes, including grants. Woodcock provided many years of funding to Calvert Impact Capital, and when it reached operational sustainability, Woodcock graduated Calvert from its grantee portfolio and made a program-related investment through its note offering to advance economic development and gender equity. This allowed the foundation to continue to invest in Calvert, recycle the capital for additional impact, and also free up room in its grants budget to fund new efforts.

Woodcock also made a catalytic investment in the first fund of Acumen Latin America Impact Ventures (ALIVE), a proof-of-concept $25 million fund seeking to transform the lives of low-income people across Latin America. After early success with the first fund's strategy, Woodcock invested in the $80 million Fund II out of its market-rate private allocation, crowding in other commercial capital thanks to its track record.

Catalytic capital may be the key to maximizing impact by increasing the resources being used with impact as a primary purpose, expanding the type of impact that's possible, and accelerating innovation that can unlock new capital for impact. If more foundations took this approach to asset allocation, a vast amount of additional impact-first capital could be unlocked.

In the shared quest to leave the world better than we found it, the promise of catalytic capital as an asset class is compelling.

Stacey Faella is executive director of the Woodcock Foundation.

Catch up on all of ImpactAlpha's coverage of catalytic capital, supported by the Catalytic Capital Consortium, or C3.