

FINANCE:

INTANGIBLE REFORMS

During the next decade and beyond, natural and social crises will create volatility in the financial economy. Because awareness of some issues will be sudden, even rational investments may feel like bubbles. As the financial community struggles to deal with these uncertainties, systems for measuring the generation, accumulation, and preservation of many different kinds of capital will begin to gain widespread support. The result? The next ten years will be a transformative period characterized by rapid learning, volatility, and proliferation of financial methods and tools for measuring capital—as well as a profound evolution of financial and other institutions engaged in the generation and protection of assets.

ECOLOGIES OF CAPITAL: THE INTERPLAY OF VALUE

A confluence of forces has led to a reevaluation of how financial capital is related to social, intellectual, and natural capitals—and the roles that these might play in risk mitigation. Economists have begun incorporating actual human irrationalities into economic thought rather than relying on an idealized “rational” human. Many influential investors, seeking improved ways of detecting undervalued companies, have identified intangible assets as the ultimate creators of future value.

Meanwhile, new tools have also emerged for quantifying these alternate capitals, as accounting expands its purview. Firms, particularly international firms that must meet the needs of the most forward-thinking markets, have begun incorporating corporate social responsibility (CSR) metrics into their public communications. At the same time, the labor force is relating to firms in ways that transcend the financial. For several decades now, young workers have been drawn to jobs with socially entrepreneurial missions and credos.

Finally, environmental upheavals—or projections of upheavals—may become sufficiently dire that the only possible route for avoiding widespread chaos is an all-hands-on-deck engagement in finding solutions. The more dramatic the natural and social catastrophes, the more social and political will is likely to be generated to prevent future occurrences. Harnessing that drive will reform the institutional landscape to better manage alternative capitals—preserving natural capital via learning (intellectual capital) and organization (social capital).

RISK AND UNCERTAINTY: THE TRANSPARENCY OF CAPITAL FLOWS

Whereas risk can be more effectively managed in controlled or “closed” communication, uncertainty is better managed by fluid or “open” information management. During the transition to new capital-based institutions, financial volatility will increase

and new ideas about risk mitigation will proliferate. Just as the Internet followed a path from obscurity to hype to bubble and crash and then toward integration and true institutional innovation, so will the new risk-management products and services. The confusion will look familiar: Where are the standards? Who are the real thought leaders? And how can their insights be tactically implemented for return on investment?

However, managing the risk is only half the battle. Mitigating uncertainty is an exercise in lessening the likelihood of being caught off-guard. The path through this transition will be an increasing transparency of capital flows, whether traditional financial capitals or alternative capitals—or a blend of both. Communities will become more scrutable, reporting multiple dimensions of value creation to provide financial support for local needs and to increase the cohesiveness, flexibility, and resilience of the community as a whole. Aggregation of community-based data, in turn, will enable a more explicit view of the externalized effects of corporations and other players, whether public or private.

New measurement tools and new ways of signaling value will emerge. A guiding metaphor here is the musical concept of “voicing”—the way that the same chord progression can be organized in different ways, yielding different experiences for the listener. If multiple capitals represent the notes in a chord, asset management will require facility in combining and recombining those capitals into different configurations.

Ultimately, at the level of the individual, this increasing transparency of value creation and risk will shift awareness from narrow concepts of financial planning to a more complete picture of one’s “personal capital ecology.” As people engage with such diverse instruments as personal carbon credits and social-reputation accounts, personal investing will take on entirely new meanings and new forms—and in turn, spawn new institutions to support it.

— Jessica Margolin



COMPLEX
ECOLOGIES OF
RISK WILL DRIVE
EXPERIMENTATION
WITH NEW WAYS
TO VALUE
INTANGIBLE ASSETS
AND ALTERNATIVE
CAPITALS



TEN-YEAR FORECAST
Perspectives 2007
SR-1064

www.iftf.org

JED EMERSON

is a Senior Fellow with the Generation Foundation in London and a fellow with the Saïd Business School at Oxford University.



Jed Emerson is the author of the “Blended Value Proposition,” which states that all organizations, whether for-profit or not, create value that consists of economic, social, and environmental value components—and that investors (whether market-rate, charitable, or some mix of the two) simultaneously generate all three forms of value through providing capital to organizations. Jessica Margolin asked him about the evolution of this concept and how it is playing out in investment and philanthropic circles today.

Q: HOW DID THE IDEA OF BLENDED VALUE FIRST OCCUR TO YOU?

I started in 1989 at the Roberts Fund in San Francisco, looking at how to take philanthropic capital and structure it so it can be used for nonprofits that are running market-based businesses employing formerly homeless people. So right from the beginning we were grappling, not with the tension of the double bottom line, but the reality of what I’ve come to think of as blended value.

We took very seriously the concept of social returns; we wanted to create a formal methodology to track “social return on investment.” I’d heard a lot of people use that phrase, but most folks, I think, use it in the sense that they assume some broad social good is coming from their activities. I found that a lot of social investing—certainly the social investing that was leading the pack ten or twenty years ago—was more a question of understanding what you were *not* doing as opposed to the positive value that you were creating. That leads to the “screened funds” concept, where you don’t invest in tobacco or firearms or alcohol; but there’s very little that speaks to the idea of positive valuation and how the overall value proposition is enhanced by virtue of considering social and environmental factors. It’s not that the previous practices are necessarily wrong, but there’s an expanded way to think about this work.

Q: WHAT YOU’RE TALKING ABOUT BRIDGES ACROSS THE BUSINESS AND PHILANTHROPIC SECTORS. DID YOU FIND THERE WAS A FUNDAMENTAL DISCONNECT BETWEEN THESE GROUPS?

Yes. For example, in foundations, a lot of organizations really have no formal capital-allocation strategy. The reason that one nonprofit gets more than another has more to do with politics and perception and persuasion than it does with the actual value they’re creating in a community or in a given neighborhood.

In my own case, I started in nonprofit work when I was a kid as a peer tutor in Spanish Harlem. I was 13. By the time I hit 30, I had run an entire career track in nonprofit management and social work. On the nonprofit side, if we got good media exposure with the mayor, people would send us money because they assumed

that we were doing good work. But the capital was not connected to the value creation that we were engaged with in the street.

For a lot of business people, there’s a certain level of social drive. But at the end of the day, a lot of these folks are looking for a more effective way to manage their philanthropy and their work with the nonprofit community. They’re not saying necessarily that it’s broken, but they’re saying, “Gosh, couldn’t we do this more effectively and with greater impact?”

We need to think of philanthropy as a form of capital investing. We need to challenge foundations to manage not just the 5% payout that is their grantmaking budget, but the 95% that is their financial investing that actually is often invested in the very companies that are contributing to the problems that their institution and their grantmaking are trying to address.

Q: YOU’VE SPOKEN ABOUT BLENDED VALUE FROM THE PERSPECTIVE OF SOCIAL ENTREPRENEURSHIPS—THAT IS, SOCIALLY MOTIVATED FOR-PROFIT ENTERPRISES. HOW DOES BLENDED VALUE INFORM ETHICAL OR SOCIALLY RESPONSIBLE INVESTMENT IN THESE KINDS OF ENTERPRISES?

I think of ethical and social investing as a subset of a larger conversation about how to maximize value and how we understand the potential to maximize the value of the assets that we have under our management. So I’m talking about not simply about doing screening funds—although that could be one part of the answer—but also doing a whole host of concessionary-rate investing. In essence, we’re saying we will take some discount to market-rate risk-adjusted return in exchange for an added increase in the social and environmental value we think can be generated from our assets.

For example, the microfinance industry started with philanthropic capital and as it became more of a proven business model, you now see a whole range of securitizations being offered where you can buy bonds that in essence are helping refinance microfinance institutions across the world.



JESSICA MARGOLIN

is a social entrepreneur and consultant, as well as an IFTF Research Affiliate investigating issues relating to uncertainty, risk, valuation, and wealth.

IF ALL YOU DO IS MARKET-RATE INVESTING, YOU'RE NOT GOING TO SEE HOW SOCIAL AND ENVIRONMENTAL ASPECTS OF YOUR PORTFOLIO AFFECT YOUR FINANCIAL RETURNS OVER TIME ... THE INTERESTING EVOLUTION OF THIS CONVERSATION IS WHAT YOU MIGHT CALL "SUSTAINABLE FINANCE."

It's a question of pulling a variety of tools from a tool-kit, and social and ethical investing is one of those tools. But all of these tools should be used to answer: how do we maximize the total impact and value of the assets under management?

The converse of that is, if all you do is market-rate investing, you're not going to see how social and environmental aspects of your portfolio will affect your financial returns over time. So I do think the interesting evolution of this conversation is what you might call "sustainable finance."

Q: DO YOU SEE SPECIFIC AREAS OF INNOVATION IN TERMS OF THE CREATION OF NEW FINANCIAL INSTRUMENTS?

Well, one of the papers that I wrote with Josh Spitzer was called "Blended Value Investing." It was published by the World Economic Forum this last year. We looked at ten different examples of how people are taking foundation assets and using them to leverage economic and social value. It's just fascinating to watch the creativity that some of the Wall Street bond folks have when it comes to figuring out how you "wrap assets" in order to decrease risk and then take those assets out and sell them to third-party investors who don't care about the social or environmental aspect but view it as simply another way to diversify their portfolios.

Q: HOW DO YOU SEE GOVERNMENTS AND INDEX MAKERS OR STANDARDS PANELS EVOLVING—WHETHER SHARI'A PANELS, INDEXES, STANDARDS COMMITTEES, OR COMMUNITY STANDARDS?

Again, it's an interesting enterprise; in order for markets to work most effectively, you have to have a level of trust and confidence in those markets. You have to be able to have confidence that the numbers that you're looking at are the numbers that the next person is looking at—that you can trust the valuations that are placed on these. So in the absence of these outside entities, whether they're governmental or NGO or third parties that are set up by industry groups to create more effective market functioning, you need to have these other

actors out there because they provide that third eye, if you will, that's observing and commenting and calling attention to inefficiencies in markets that are functioning on bases that are not going to be sustainable in the long term.

Q: DO YOU HAVE A SENSE OF HOW THIS IS GOING IN THE UNITED STATES VIS-À-VIS OTHER PARTS OF THE WORLD AND WHETHER THERE ARE REGULATORY EVENTS THAT WOULD BE INTERESTING TO WATCH GOING FORWARD?

Well, I think that people and forces are working despite the lack of national leadership in the United States on some of these issues. We see a lot of activity at the state or regional level—whether it's California or a coalition of Eastern pension funds. But you see a whole set of actors who are basically saying, "You know, even if the mainstream doesn't get this, we understand that these issues will affect the long-term performance of the funds that we have responsibility for and we're going to manage those dollars on that basis." So it's almost despite itself that the United States is beginning to see the evolution of some of these practices in a very significant way.

The other thing that I think is kind of funny is that when I go to Europe and I talk with people about what's happening there, I've actually had some folks say, "Gosh, there's so much initiative and entrepreneurship taking place in the United States on these things," and they almost bemoan the fact that the government has been such a big part of the process there. And when I'm in the States, I hear a lot of people say, "Gosh, the Europeans have it made because they've got a governmental sector that is moving these policies and practices forward."

I think that when you step back from the entire conversation you can't help but be impressed by the degree of innovation and change that's taking place at a speed that we have not seen for a long time. And it really does give me hope and make me proud to be a part of this whole community.

INSTANTIATING CAPITAL: A SPECTRUM OF TANGIBILITY

Four main types of capital—financial, intellectual, natural, and social—each have aspects of tangibility. Over time, as people experiment with methods to measure and monitor these capitals, new forms of tangibility may emerge for each.

FINANCIAL CAPITAL Financial capital involves money and securities as well as property, plants, and equipment. It encompasses the wealth that is accounted for in the gross domestic product (GDP), namely the sum of goods and services consumed. If it's paid for with money, owned with money, or if it's a risk-management instrument that involves the protection of money, it's financial capital. Some aspects of financial capital can be intangible, but most are sufficiently defined by their relationship to tangible assets to be considered well-defined.

INTELLECTUAL CAPITAL Intellectual capital has been incorporated in the financial world as intellectual property. However, intellectual capital also includes concepts before they've been written up, contractualized, and submitted for protection; ideation, artistic expression, and other articulated but intangible items are all assets. Intellectual capital has existing mechanisms that give value to the output of these assets. Intellectual capital also has the ability to "price" the assets themselves through the provision of wages, for example, though the market for people is notoriously uneven, volatile, and contentious.

NATURAL CAPITAL Natural capital is often expressed as a service. For example, trees provide carbon binding as well as air-cleaning services (tangible) and a sense of beauty and peacefulness (intangible); they also provide habitat to other species (both intangible and tangible components). Ameliorating risks to natural capital has encouraged the development of "market-based" or financial exchanges as a means of environmental management, such as carbon- and water-trading markets. However, a considerable amount of detailed information about how natural services are performed will be necessary to accurately value these stocks.

SOCIAL CAPITAL Though the term "social capital" has existed for decades, Robert Putnam popularized it in the 1990s. Generally definitions of social capital are founded on typical characteristics of social networks, trust, and social norms, but since these aren't readily measurable, they are often proxied by indicators like "number of close friends." In his paper *The Empirics of Social Capital and Economic Development: A Critical Perspective*, Fabio Sabatini points out that social capital is more of a code word than a concept. Information about social capital is not only imperfectly transmitted but actually varies from group to group. Further, it can be perceived as deleterious as well as beneficial: nepotism is an exercise of social capital that is generally disapproved. An enormous amount of social capital is entirely unaccounted for in economics: that which accrues in the household, during school, and in volunteer communications ranging from ad hoc to formal. Social indicators have been introduced by communities to begin to address this gap; however, the effectiveness of "social entrepreneurship" depends in part on gauging outcomes from within this informational void. A prominent subtype of social capital is political capital.

POST-FINANCE: TOWARD AN EXCHANGE SYSTEM OF MULTIPLE CAPITALS

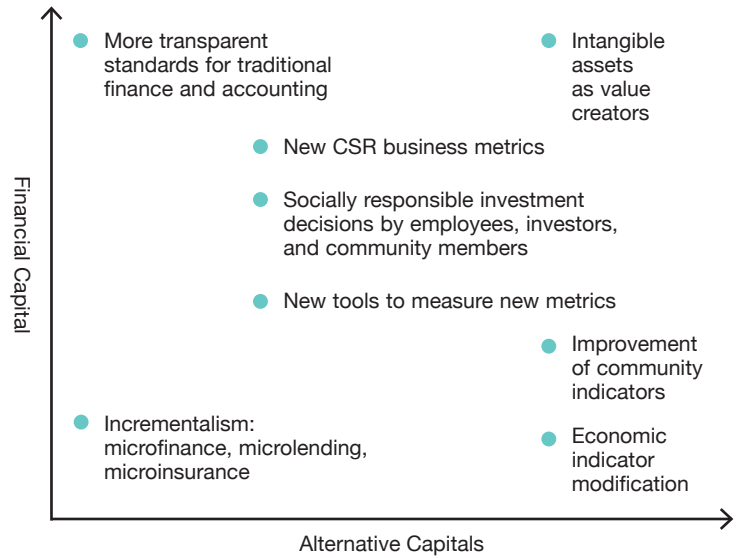
Though accounting, in a highly primitive form, has been around since before the Renaissance, modern cost accounting techniques weren't adopted until 1923 (by General Motors), and regulation didn't ensue until the SEC was formed in 1933 and GAAP was developed in 1936–1938 (and finally codified in 1953). The GDP was developed as a mechanism in the late-1930s to track the goods needed specifically for wartime production but was embraced afterward as a method to show the size of an economy, and thereby its robustness.

Since then, technological advances have increased the ability to analyze tremendous amounts of data, leading to refined and sophisticated mechanisms to support this framework. But beginning in the 1990s, reformers from many disciplines began to experiment with the idea that value doesn't begin in the tangible assets—raw material and physical labor—that are needed for production, but that the tangible assets themselves are the result of some earlier step. Further thought yielded the realization that value is originally created by assets that are intangible; it is created by having smart, knowledgeable people who can work well together in an effective company that has visibly shown itself to its market to be respectable and relevant.

Yet intelligence, knowledge, relationships, processes, reputation, and brand are almost entirely unaccounted for. Why? Because it's not an easy thing to do. In *Intangible Assets*, Baruch Lev points out that these assets are desirable in that they are prone to high returns due to network effects, but they are also only partially excludable: what if you train people and then they go work for your rival? Also since they're not tangible, such assets are illiquid at best and indefinable at worst.

Nevertheless, combining investors' desire for transparency, stakeholders' demands for social and environmental accountability, and a regulatory push on the largest firms to be aggressive rather than "safe" in representing their true value, a host of corporate social responsibility metric systems, indices, and standards committees have emerged over the last few years. Taken together, these efforts suggest the emergence of a system of capitals with increasingly clear relationships—and thus an increasingly sophisticated understanding of the ways that capitals interact.

AN EVOLVING SYSTEM OF CAPITALS



Source: Institute for the Future

NEW RISK-MANAGEMENT METHODS: CROSS-FERTILIZATION OF CAPITALS

MANAGING RISKS IN ONE DOMAIN BY HARNESSING ASSETS IN OTHERS

Financial risks are often managed using financial instruments such as insurance. But financial risks have always also been moderated using alternative assets. Windbreaks minimize farm crop losses. Employing knowledgeable workers minimizes the chance of making bad business decisions or producing bad products. And of course, the practice of leveraging social standing or even fame for monetary gains is well acknowledged (if occasionally distasteful).

If we see different types of assets as worthy of protection, we can see that this type of risk management is already familiar. For the next decade, these mechanisms will be explored—as well as exploited—in much more systematic ways, leading to much more sophisticated strategies for managing risks in one capital domain by harnessing assets in another.

	FINANCIAL ASSETS	NATURAL ASSETS	INTELLECTUAL ASSETS	SOCIAL ASSETS
FINANCIAL RISKS	<p>Financial assets mitigate financial risks:</p> <p>Trading options allows investors to limit their losses if a security loses value.</p>	<p>Services provided by natural assets protect financial investments:</p> <p>Coral reefs protect hotels from storm damage.</p>	<p>Open learning economies leverage knowledge:</p> <p>Research consortia and technology-transfer groups are formed among several large corporations.</p>	<p>Personal reputation serves as a form of credit score:</p> <p>Social reliability lowers risk for microfinancial vehicles; activist investing ties desired social behavior to financial gain.</p>
NATURAL CAPITAL RISKS	<p>Financial value creation for natural capital supports demand and increases liquidity:</p> <p>Eco-economics, such as carbon and water trading, create smoother allocation of scarce resources.</p>	<p>Natural asset services protect against natural capital risks:</p> <p>Hillside vegetation limits erosion.</p>	<p>R&D creates alternatives that avoid natural capital degradation:</p> <p>Alternative energy and transportation reduces CO₂ consumption emissions; filters and sensors enable data collection and remediation.</p>	<p>Access to social networks increases resources for natural capital restoration:</p> <p>Clean Mobs provide data for research and facilitate rehabilitation of natural ecosystems.</p>
INTELLECTUAL CAPITAL RISKS	<p>Financial investment in education creates a virtuous cycle:</p> <p>Extracurricular programs reduce drop-out risk; teacher mentoring and continuing education improves student outcomes.</p>	<p>Physical health impacts the ability to concentrate:</p> <p>Nutrient replacement and clean environments support good mental function.</p>	<p>Intellectual assets mitigate intellectual capital risks:</p> <p>Documentation of organizational processes protects organizational knowledge when employees leave.</p>	<p>Social networks support the development of relevant educational materials:</p> <p>Online experts and peer-to-peer production expand the learning economy.</p>
SOCIAL CAPITAL RISKS	<p>Investment in cooperative processes and conflict resolution improves civil cohesiveness:</p> <p>Community indicators measure participation and improvements; transparency improves financial support.</p>	<p>Balanced natural ecologies enhance social resilience:</p> <p>Community gardens enhance interpersonal interactions and solidify relationships.</p>	<p>New tools enhance social connection and create new methods for resolving social dilemmas:</p> <p>Cooperation Commons aggregates an understanding of cooperative sciences; WiserEarth creates a platform for collaboration.</p>	<p>Social capital protects against social risks:</p> <p>Reputation built when undertaking projects for the public good counterbalances potential future negative publicity.</p>

Source: Institute for the Future

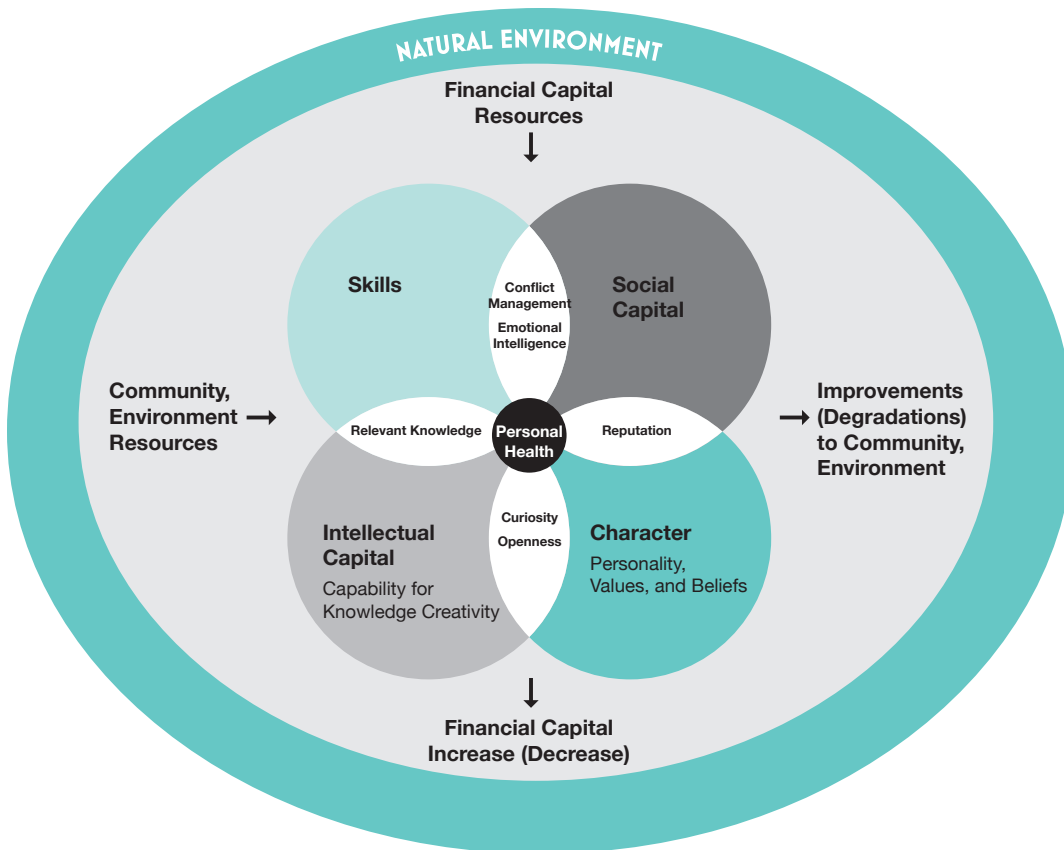
PERSONAL CAPITAL ECOLOGIES: BEYOND FINANCIAL PLANNING

While a lot of the discussion about financial reform and intangibles has focused on macro-level changes in society or new corporate behaviors, it also touches the daily lives of individuals.

In the same way that multiple capitals are increasingly seen as ways to manage corporate or community risks, individuals will become more engaged in managing their own personal risk through a combination of capital strategies. They will become more aware of their personal capital ecologies: the ways their skills, assets, and choices translate into capital flows that either increase or decrease the value of the larger community and ultimately of the natural environment, which in turn, flows back into their own ecologies to increase (or decrease) their personal security and well-being. In short, they will be able to draw more explicit links between their individual “wealth” and the “wealth” of the larger community.

This growing awareness will create a broader and more flexible framework for people to manage their economic well-being—and indeed their social and physical well-being as well. In addition to new instruments, such as personal carbon credits, they will draw on new tools for tracking these personal flows and assets and new, more diverse strategies for managing them over time. These broader strategies will be particularly welcome for boomers, the majority of whom are about to enter retirement with what appears, by traditional measures, to be less-than-adequate financial resources and a failing government safety net. In addition, the tools for defining, tracking, and managing personal capital ecologies can suggest innovative strategies for other capital-poor populations, such as the growing urban slum population or people with disabilities.

3 A FRAMEWORK FOR MAPPING PERSONAL CAPITAL ECOLOGIES



Source: Margolin Consulting, 2005.

WHAT TO DO

STRATEGIC ACCOUNTING:

EXPLORE ALTERNATE FRAMEWORKS FOR BLENDED VALUE

Creating new frameworks for thinking about blended value will be one way to bring new capital strategies into the organization. Consider a program of scenario development for different accounting frameworks, with the goal of seeing how the organization fares under each scheme. Key points to focus on include mitigation of uncertainty as well as risk exposure and management. When developing scenarios, it will also be important to think broadly about new kinds of capital—from longevity and education to online reputation and children’s health futures.

WORKERS:

TRAIN WORKERS FOR NEW ACCOUNTING FRAMEWORKS AND TOOLS

In the future, accounting may well become the hot, new eco-frontier—and moreover, accounting won’t just be for accountants anymore. Everyone in an organization will need to be trained to think in new ways, integrating new ways of budgeting with outcome measures for intellectual, social, and natural capital. And as new methods for data visualization and interaction—including simulation—are developed, more employees will be required to learn how to use these new tools. In the short term, start with an experimental group to develop internal processes that incorporate new tools and ways of thinking.

MARKETING:

TARGET PERSONAL CAPITAL ECOLOGIES

As people become increasingly aware of their personal capital ecologies—and look for ways to manage them more effectively—marketing strategies for all kinds of products will have to speak to these needs, whether through environmental labeling or leveraging social networks for product and service users. Understanding the diversity of personal capital ecologies, region by region, will be an important first step.

WHAT YOU MIGHT WANT TO KNOW

activist investor: an investor who participates in governance decision making

asset: something that a firm or a person owns or controls

behavioral economics: a branch of economics that endeavors to more accurately characterize actual human behavior compared to the so-called “rational economic actor”

blended value: a method of uniting financial, social, and natural capital to evaluate investment and philanthropic activities within one framework (developed and articulated by Jed Emerson)

capital: accrued assets, particularly those that can create more assets

community indicators: measures that communities use to evaluate the effects of their programs as and those from externalities of firms and other institutions located in their jurisdictions; these may include number of volunteer hours or air and water quality, for example

corporate social responsibility (CSR): the idea that corporations have a responsibility to measure and monitor the value and impact of their operations beyond what has traditionally been considered relevant to financial operations

ethical investment: investment choices that meet the investor’s social responsibility criteria

expense/outflow: assets flowing out of a firm or from a person

externality: those impacts that have traditionally been considered external to the firm; emissions and effluent would create the externalities of dirty air and water

financial risk management: the use of financial instruments to manage changes in price

gross domestic product (GDP): a mechanism developed in conjunction with World War II munitions production to track the resources of the country available for production, and considered one factor that enabled the Allies to win the war;

since then, considered a measure of overall “growth” of a country but recently under dispute as an inadequate metric

liability: something that a person or firm owes to someone else; an obligation for a future expense

liquidity: a measure of how easily an asset can be exchanged; a bank account is liquid while a house is not

revenue stream/inflow: assets flowing into a firm or a person

socially responsible investment (SRI): investment choices that meet the investor’s social responsibility criteria

volatility: in finance, the statistical standard deviation of a set of prices; for example, if 1,000 trades of a security yield an average trade price of \$5, the volatility will describe whether those trades ranged widely from \$2 to \$8 or narrowly from \$4.85 to \$5.15