

METRICS 2.0? MEASURING SOCIAL INVESTING IN 2008

(WORKING DRAFT) By Hernan Pisano, July 2008

The significant amount of foreign aid, philanthropy, and even remittances flowing from the developed countries to the emerging markets (much of them targeting the Base of the Pyramid -BoP), has renewed interest in measuring the



impact these that investments generate. Straight-forward metrics as such the Total Capital Disbursed or the ratio of Administrative Expense versus Capital Disbursed are not longer enough. Investors' interest in optimal asset allocation adds to the ethical pressures other stakeholders have to optimize the "bang" of "help dollars" aimed to the poorest of the poor.

A wealth of money, brains and institutions are focused on the investment efficiency issue. Their approach feeds on two distinct sets of knowledge: the *program evaluation* tradition and *classic financial project evaluation*.

Philanthropy, welfare and social investment

Philanthropy and social investing at a large, societal scale is a relatively recent development in human history.

First, Philanthropic investing occurs in wealthy economies: it requires societal savings big enough to be disposed through it. This was a situation mostly off-limits for the European nations prior to the Industrial Revolution. Second, on the political side, social and philanthropic investing benefits from the existence of a representative government, for the most part in-existent in the western hemisphere until 18th century (England abolished slavery in 1772, Russia abolished serfdom in 1861) When the citizenry and middle class gained a voice in the state matters, the care of the less fortunate gained space in the political agenda as a government issue.

In the U.S., large-scale social policies and interventions during the nineteenth and twentieth centuries were financed by the U.S. taxpayers. This wave of public financing called for public scrutiny of the results and this, in turn, required a systematic, scientific program evaluation approach. Funds from the fiscal budget went

to respected universities to develop a large part of the social science as we know them today -disciplines based in the scientific method. Social Sciences, once considered the poor daughter of the unlikely marriage of Philosophy and Science, and with the pragmatism of William James as a backdrop, became a Scientific endeavor, and an empirically oriented-discipline.

The rise of program evaluation

All this funding aimed to resolve questions of impact: Did the intervention actually work at all? Did the intervention or policy have the impact predicted? If it worked, how did it work? Is there a cause/effect relation? Were other factor implicated? How this intervention compares with others?

Sophisticated, complex, and expensive research methods were used to increase *validity* of the answers and to attempt to isolate the *causal* variable. The famous random double-blind clinical trials became the golden rule of *validity*. It was possible to *compare* two –or more- of projects or programs, and, based on their evaluations decide which

was more efficient. (For example, what's best for the same population: \$1000 invested in give-away mosquito nets or \$500 invested in nets and \$500 invested in training on their use?

The “Randomistas”

Isolating *causality* is a major goal of science, and the new social science disciplines were no exception. B.F. Skinner wrote that his goal was to *describe, understand, predict* and *control* human behavior... which would be achieved by the use of appropriate research methods and a detailed understanding of causality.

The complexity of the social scenario, where isolation of independent variables is extremely difficult due to the nature of the subject -humans- made experimental designs like the Random Clinical Trial (RCT)

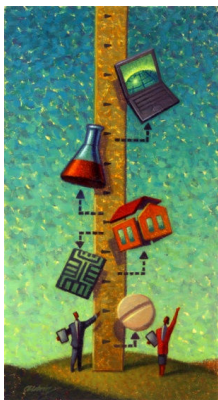
elusive for Social Scientists (Developmental Psychology, given its most common subject –single infants and animals- has benefited the most from the RCT as a method.) On the other side of the spectrum, Sociology and Economics have just recently been able to use the RCT with some degree of success, with special emphasis in Microeconomics research. The nascent fields of Behavioral Finance (Nobel 2002) and Mechanism



Theory (Nobel 2007) will likely benefit from the RCT as a research method as they evolve.

The research methods used in Economics have gravitated towards the less attractive outcome of *correlation*, instead of *causality* and Finance has used the well known “discounted cash flows” analysis and techniques to assess and compare alternative capital allocation alternatives.

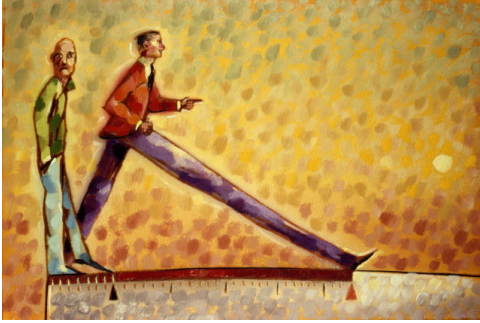
A tale of entrepreneurship, interest rates and project evaluation.



In 1490 when Columbus was given venture capital to finance his adventure, the court advisors didn't consider how the presumptive future gold payments would fare against the current investment: gold today and gold tomorrow were for all practical purposes, the same. Interest was banned by law and church. Selecting among different projects was subjective since there was not a proven technique to rank projects with different durations and different benefits (cash flows). The decision was left to the judgment of the Queen, but not for long.

In 1494 Venice was one of the busiest trade ports in the world, connecting Europe with the Middle and Far East. The accounting challenges posed by such complex international trade, along with the familiarity of algebra (imported from the Middle East) and the Greco-Roman mathematical knowledge provided the foundations for the Venetian Lucca Paccioli's cornerstone achievement: “Summa de arithmetica, geometria, proportioni et proportionalita”. In his treatise, he presented the modern accounting methods, and provided significant contributions to geometry. But most important he, the notions associated with the discounted cash flow including the concepts of Internal Rate of Return (IRR) and Net Present Value (NPV), likely the most used metrics in the field of financial project evaluation in the last 500 years.

The merits of the Net Present Value were immediately recognized by investors worldwide: it allowed them to compare different exclusive projects, regardless of their size (whether big and small), with different durations (days, years), with different benefits over time (upfront versus delayed benefits) in a systematic, quantitative way. It allowed ranking different projects in order of interest under



one single metric. Finally, the world could compare apples to apples. The world would never be the same. In words of the revered philosopher of sciences Thomas Kuhn, it was a Scientific Revolution, changing the paradigm of capital allocation models.

With this method, Finance has achieved a major feat: it has generated a standard, agreed-upon set of procedures and techniques to compare different capital allocation projects and rank them (further refinements of the NPV approach have permitted comparing projects that are non-exclusive, projects subjects to capital rationing, or potential gains to be obtain upon success of prior phases –e.g. Real Options-).

Evaluating social investments, 2008

As of July 2008, I have found close to 40 different initiatives and methods to assess/prioritize social investments. The shadow of the two traditions discussed cast over these initiatives: the lab-like sophistication of

the program evaluation discipline and the sharp financial approach.

Evaluating program evaluation

The program evaluation approach is particularly useful when the policy maker/investor faces the dilemma between two or a limited set of interventions and a limited set of populations: Here, prior program evaluation can illustrate the decision making process with unmatched clarity.

Unfortunately, the *Global Social Investor* faces a much more complex dilemma: *multiple disparate* interventions in *disparate latitudes* with different *durations* and different *benefits*. The investment options are globally limitless and present dilemmas like: is it better to invest in malaria nets in Mali, or in a microfinance project in Nepal? As much as the social investor acknowledges the value of program evaluation, *this method does not provide information that will allow investors to rank global alternatives of capital allocation.*

The question still holds: How can we decide if the dollar invested in microfinance in Nepal is more “effective” than a dollar invested in malaria in Mali? Which will provide more “bang” from each unit of input? The problem becomes clear; this is a problem of *capital allocation optimization.*

Adding a “social line” into the Balance Sheet? Triple bottom line?

Paradoxically, many of the new impact assessment efforts try to provide a framework for measurement while also relying on the assumption that much of the impact “cant be measured”. The rationale might go something like this: “how can we put a price on a human life! (...or whatever other outcome we are targeting). Human life is invaluable, and thus, a new set of measures should be put forward. The balance sheet of social enterprises should have a “social impact” line.”

The problems with this approach are several. First: we are doing social and philanthropy investing because we think it is *valuable*. If it is valuable, why are we resistant to value it in the way we tend to value other assets: that is through the social convention of *price*? Consider that: the U.S government has a “statistical price of a human life” metric agreed upon for years now. Can we do the same for, let’s say, our Mali citizens using bed nets?

Second: we want to measure it but we do not want to use the standard

measurement techniques. This approach presents a totally different challenge -not only we want to provide a plausible, and credible measurement to rank different investment alternatives; we also want to create a new knowledge paradigm. Certainly a daunting task with no minor intellectual pretensions! Unless we find our own twenty-first century Lucca Paccioli, is unlikely that a new revolution of knowledge in metrics will occur anytime soon.



On the more practical side: this approach might have serious consequences as the efforts in creating new metrics could be counterproductive given that mainstream society is reluctant to “buy” them and, therefore, the philanthropic effort fails to attract even more resources, due its lack of credibility and reporting transparency.

Finally, since these approaches are far from compliant with GAAP regulations, even in the most successful endeavors, they will be off-balance sheet for ever. Not good if we are planning on growing the initiative through financing from where financing comes: the highly overseen, regulated, “rulefied” competitive capital markets.

Metrics 2.0: Muhammad Yunus meets Milton Friedman.

The existence of economic outcomes (both good and bad) outside the main enterprise is not a new idea in the field of Economics, and is called “economic externalities”. A closely related concept is the Social Enterprise – the idea that through process and product innovations there is money to be made providing the Base of the Pyramid and, at the same time investors are served with market comparable returns.

From the *Global Social Investor* perspective regardless of our intention (creating social enterprise, positive externalities, or simply alleviating suffering) the issue is one *Optimal Capital Allocation*.

A successful metrics framework would be increasingly effective if it has widespread credibility among the society at large. Any approach involving “esoteric” metrics has a double challenge: creating the metric and convincing the rest of society of its validity.

Building on the shoulder of giants, a successful framework for *Capital Allocation Optimization* might

gain more traction if -informed by the program evaluation advances- builds on current financial standards on project evaluation (NPV, IRR) and capital allocation optimization.

How would this approach include all the soft issues (human lives saved, or increased education access for woman, or village income lift)? A credible approach would require computing at market prices – in money, old fashion style- all the externalities, benefits and liabilities generated by the initiative and consolidating them into a pro forma financial forecast to be discounted to the present.

If we value them, let’s count them proudly. Your accountant friends will love you, and you certainly will be able to generate more resources for your philanthropic initiative.

