Why Donors Are Not Investors

By Andrew Blau

Global Business Network and Monitor Institute, members of the Monitor Group

People, institutions, and even whole fields operate according to various models or assumptions about what they do and how to get results. These are the metaphors that guide their actions and through which participants make sense of their experience. Philanthropy has its own metaphors, and at least some of them contribute to why it is hard for the field or its participants to adapt and improve.

Perhaps the most influential metaphor currently circulating in philanthropy has developed from attempts to improve philanthropy by bringing in ideas and values from business and the commercial world. Assuming that noncommercial transactions operate within a marketplace where services and resources are exchanged, it is a simple step to draw an analogy between commercial markets and the noncommercial world. With the analogy in place, one can look to apply some of the tools that have successfully aided managers and investors in the commercial world.

This simple step, however, can easily start us down the path toward a dead end, because noncommercial markets don't have the same shape or dynamics as commercial ones. The splayed market in which nonprofits operate (a market divided among three participants: the provider of the service, the person with the money, and the recipient of the service) complicates efforts to draw a true parallel between the noncommercial world and what happens among commercial firms.

One result is that donors often misunderstand their position in the noncommercial economy, and most of the analysis that exists is based on this structural misreading of the donor's role in the nonprofit sector. Donors and much of the literature that analyzes the sector work from the premise that they are investors, but a careful reading of the relationships in the sector shows that donors much more clearly fit the role of consumers. They exchange money for the delivery of a product or service without any ownership rights, exchange of equity, or assumption of debt.[1]

If we look at some of the key attributes of investors and consumers side by side, we can see that the fit between what donors do and the attributes of a consumer is much better and more direct than that between donors and investors. For example:

	Investor (in an organization)	Consumer
Trades money for	A financial organization, usually either equity or debt	Delivery of product or service
Compelling attribute	Return/growth	Price/Value
After the exchange of money, the monetary value is	Meant to be convertible, tradable	Not meant to be easily tradable (although some part may be recoverable through resale)
The inputs and outputs of the relationship are	In the same denomination (i.e., money goes in, money comes back	In different denominations (i.e., money goes in, goods or services come back)
Get your money back if the exchange	Succeeds	Fails
Primary behavioral driver	Financial gain	Satisfaction
Realizes value	Over time	Immediately
Collective action expressed through a	Kereitsu, syndicate	Co-op
Successful markets provide	Transparency	Choice

Laid out this way, it becomes clear that what donors do when they make a philanthropic gift has most of the attributes of the consumer relationship. (The one exception—and the attribute that may contribute to the confusion about which is the more appropriate analogy—is that philanthropic donors often realize the value of their exchange over time, the way investors tend to, rather than immediately, as is normally the case with consumption.)

One immediate advantage of seeing donors as consumers is that it allows us to make sense of behavior that is widely seen as puzzling and frustrating. For example, donors move slowly and seem risk averse in part because they have no way of managing risk the way real investors do. One of the key innovations in twentieth-century finance was Harry Markowitz's theory of portfolio choice, which allowed investors to spread risk across a collection of diverse investments. This depends on the existence of varying returns that allow successful investments to cover the costs of unsuccessful ones. For donors, however, there are no returns that allow them to balance risk, except metaphorically. Once a donor makes a gift, the money is effectively gone, and it is only the quality of or satisfaction with whatever the donor supported that can be measured. As such, donor behavior might be modeled on consumers contemplating a series of discretionary "big-ticket" items—large purchases that are hard to reverse or to return to available cash. Spending on big purchases often merits careful consideration. Of course, the same might also be said for significant investments. The key difference is that in investing there is a cost to not acting—the possibility of losing returns on an investment with growing value—which can generate an urgency that consumers don't have.

Moreover, foundations and other donors are criticized for being easily distracted, for abandoning themes arbitrarily, for rarely learning from past experience, for rewarding weakness rather than strength, and for diffusing their interests rather than concentrating their attention. Here again, this begins to make more sense if we understand donors as consumers rather than investors. Investors' ability to make additional investments is based on past successes—if their investments pay off, they are rewarded with additional funds to invest. This tends to reward focus, strategy, and learning from experience. Conversely, whether consumers make good or bad spending decisions, their bank accounts are refilled with the next paycheck and they can spend again. (Put another way, their incomes don't vary based on the quality of their spending decisions.) So the internal incentives are weak for the kinds of behavior that would seem obvious and "natural" to even casual investors.

Foundations are also criticized for having a very limited appetite for learning from, emulating, or coordinating with the experience of others. Investors have clear incentives to coordinate their actions if they can, to the point that there are laws that keep investors from colluding or sharing information in various circumstances. Consumers have no such restrictions, yet because the interests of consumers are so varied and personal, consumer cooperatives—the most obvious tool by which consumers can leverage market forces to their own advantage—are the exception rather than the rule.

Another advantage of seeing donors as consumers is that it would allow us to make better judgments about some efforts to improve the performance of philanthropy and philanthropists.

Consider, for example, the case of venture philanthropy. Venture philanthropy entered the language of donors and the media with the publication of "Virtuous Capital,"[2] an essay in the *Harvard Business Review* that argued that philanthropy would be more effective if it drew some lessons from the practices of venture capitalists, who in the late 1990s were imbued with a great deal of cultural caché.[3] The argument became an enormously popular touchstone for the aspirations of contemporary philanthropy, even as it drew strong rebuttals on the merits.[4] More recently, experience has caused even some of its strongest public proponents to back away from the metaphor, as the results seemed not to warrant the amount of attention and excitement it had generated.[5]

From the vantage point of our alternative reading of the noncommercial marketplace, however, the metaphor of venture capital was always fundamentally inappropriate to philanthropy. Over and above the important substantive objections made by critics such as Sievers, Kramer, and Williams, donors never bore any structural comparison to venture capitalists: they don't exchange money for equity, they don't earn returns in any meaningful sense, and they don't bring nonprofits to market. Indeed, by this alternative account, foundations *are* the market for nonprofits, and part of the problem faced by nonprofits is that they have to build their organizations with only the money they can earn from the "sale" of their services.[6]

In addition, the ability of these "consumers"—at least some of them—to assume the role and rights of investors tells us something important about this market. Specifically, the normal balance of power between buyers and sellers in a classic, well-functioning market isn't the case here, because (especially when we deal with foundations and the nonprofits that depend on them) these are consumers in what economists would describe as an oligopsony—a market effectively dominated by a small number of buyers. When we buy sneakers or Snickers bars, we rarely conclude that we are thereby entitled to tell Nike or M&M/Mars how to run their business. But when there are very few customers, such as for large military equipment, those customers can often dictate terms to sellers. That doesn't make them "investors," though. That makes them super-empowered customers.

There are sure to be objections to this suggestion that philanthropic donors are best understood as consumers, not investors. For example, some may argue that even if donor gifts are not the structural equivalent of investments, they stand in special relationship to the state and society because of the tax status accorded to them by virtue of their socially beneficial purpose. But in fact there are many commercial purchases that are encouraged or rewarded through the tax code as being good for society in some way, even if we don't think of them as philanthropy. The best known is the tax-exemption on home mortgage interest as a means for encouraging home ownership. This is a purchase with significant tax advantages over other forms of spending money for equivalent aims. But the tax code also rewards the purchase of certain fuel efficient technologies, for example, and conversely may reward the purchase of large S.U.V.'s in certain cases.[7] Like the tax exempt status enjoyed by charitable foundations or provided for charitable donations, these provisions use the tax code to express official preference for certain ways of spending money.

Some may also object because this approach violates their sense of the special social benefit or purpose of philanthropic giving. Others may make the moral or philosophical objection that this puts an essentially non-economic relationship into a consumer framework: that by reducing an emotion-laden, value-driven act to buying and selling, it profoundly misconstrues an impulse that is about the love of humanity and often springs from religious or spiritual traditions and goals. If that were its exclusive goal—to argue that philanthropy is just the same as other consumer decisions with no other special attributes—that would certainly be a valid concern. But we are trying to understand the *structural* role played by donors in nonprofit markets distinct from their ethical role in society or the community or the affective role in the life of the donor. It may well be that the consumer-based model cannot account for all the dynamics of philanthropic giving, but donors do provide money so that something of value is produced or delivered, and understanding the dynamics of that trade are essential to improving our satisfaction with it, either as a practitioner or as an observer.

END NOTES

[1] There is one class of important if rare exceptions to this: those nonprofits supported by "program related investments," a vehicle by which a donor lends money to a nonprofit that is expected to repay it, often at a favorable (below market) interest rate. The relatively few funders who make PRIs could legitimately claim to be investors in the nonprofits they support with this vehicle.

[2] Letts, Christine W., William P. Ryan, with Allen Grossman, "Virtuous Capital: What Foundations Can Learn from Venture Capitalists," Harvard Business Review, March-April 1997.

[3] See, for example, Wired, September 1996, which featured an extended celebrity-style profile of Hummer & Winblad partner Ann Winblad ("Adventure Capitalist"); The New Yorker of August 11, 1997, which ran an extended and quite positive profile of Kleiner Perkins partner John Doerr (John Heilemann, "Letter from Silicon Valley"); numerous magazine stories touting Doerr as a potential running mate for Al Gore, including Fast Company, August 1997 ("Gore and Doerr in 2004?"), and The New York Times Sunday Magazine on June 20, 1999, which featured Steve Jurvetson, a 32-year old partner in the venture capital firm Draper Fisher, on the cover of the magazine and a hagiographic story about him ("Surfing on the Slippery Skin of a Bubble").

[4] See, for example, Bruce Sievers, "If Pigs had Wings…" in Foundation News & Commentary, November/December 1997, revised and republished as "If Pigs Had Wings: The Appeals and Limits of Venture Philanthropy," Waldemar A. Nielsen Issues in Philanthropy Seminar Series, Georgetown University, November 16, 2001; Mark Kramer, "Venture Capital and Philanthropy: A Bad Fit," The Chronicle of Philanthropy, April 22, 1999, pp. 72-73 (available at http://www.effectivephilanthropy.com/publications/articles/99_04_22_vc_bad_fit.htm); and Caroline Williams, "The Dividing Lines between Philanthropy and Investment" (available

at http://www.investorscircle.net/pdf/philanthropy%20vs%20investment.doc). These critiques tend to be formal arguments about the applicability of the venture model to philanthropy. By contrast, I am making a logical or structural argument. In another vein, Peter Frumkin tests the return on intellectual investment, so to speak, and makes the case that venture philanthropy is little more than a rhetorical innovation that delivers no benefits to either donors or recipients. ("[V]enture philanthropy must be viewed as a marketing triumph. As a set of practical philanthropic innovations, venture philanthropy's contribution to the field remains far harder to discern.") See Peter Frumkin, "Inside Venture Philanthropy," paper prepared for the Thomas B. Fordham Foundation, available through the New America Foundation (http://www.newamerica.net/index.cfm?pg=article&DocID=701).

[5] An article in Business Week observed,

Some [new philanthropists] were overzealous in pursuing a venture-capital model in their giving doling out seed money to social entrepreneurs and insisting on an unrealistic "social return on investment." The difficulty of achieving change in such intractable issues as drug rehabilitation or economic inequality has led to a sobering reassessment by many newcomers. "The trouble is, a lot of new people came into this cocky. We thought we had all the answers and wanted to do it ourselves," concedes Morino, 59. … "We should have been more respectful of the people who have done this all their lives."

John A. Byrne, "The New Face of Philanthropy," Business Week, December 2, 2002.

[6] This logic suggests that one place for further exploration is how to make an effective capital market for nonprofits—a complement to reforming philanthropy as it is by creating new financing vehicles that would add working capital to the financial flows entering nonprofits. See, for example, the effort among public radio stations in the Station Resource Group to get access for member stations to public debt markets, or the efforts of Greg Stanton and the Wall Street without Walls program to find ways to securitize assets that can be used by community development organizations to allow them to enter financial markets.

[7] On the tax advantages for buying an S.U.V., The New York Times reported that the Bush administration proposed new rules so that "small businesses could immediately deduct the entire price of S.U.V.'s like the Hummer H2, the Lincoln Navigator and the Toyota Land Cruiser…." According to the report, an official in the Office of Management and Budget explained, "Many small businesses have genuine needs for large vans, pickups and S.U.V.'s." (Danny Hakim, "Bush Proposal May Cut Tax on S.U.V.'s for Business," The New York Times, January 21, 2003) This is certainly not philanthropic, but it is a case where the state offers a significant tax advantage for spending private money in specific ways. In that regard, the special privilege accorded to tax exempt moneys given for charitable purposes may be a special class of a larger category of tax-advantaged transactions designed to promote various public benefits or goals.

About the Author

ANDREW BLAU

Andrew Blau, a practitioner at Global Business Network, is a strategist with deep experience working with foundations and other organizations developing programs for social benefit. Prior to joining GBN, he was an independent consultant, working with foundations across the country on program design and program evaluation, and he is best known for his work helping funders develop strategies that recognize the trends and pressures of the information age and their effects on the areas that funders support. He was a program director and member of the management team at the Markle Foundation (a grantmaking foundation), a program director at the Benton Foundation (an operating foundation), and has worked for nonprofits analyzing public policy. He is the president of the board of directors of WITNESS, an international human rights organization, and has served in leadership roles in numerous nonprofits. He can be reached via email: blau@gbn.com.

The Monitor Group, headquartered in Cambridge, Massachusetts, is a family of professional service firms, employing more than 1,000 professionals, operating in a closely-linked network of 29 offices around the globe.

The Monitor Institute is the vehicle through which Monitor Group works to amplify and accelerate the public benefit created by innovative private actors—citizens, nonprofit organizations, philanthropists, and corporations. Monitor has long excelled at addressing complex, integrated, and intractable *competitive* challenges. The Institute draws on the Group's extensive and varied expertise to create, test, use, and share innovations and insights aimed at transforming how complex, integrated, and intractable *social* challenges are addressed in the next generation.

Based in the San Francisco Bay Area, Global Business Network has been member of the Monitor Group since 2000. GBN is dedicated to helping organizations develop adaptive advantage and deal with uncertainty by collaboratively exploring and preparing for the future. GBN's services include scenario and strategy consulting with corporations, governments, and nonprofits.

For more information, visit www.futureofphilanthropy.org