THE PSYCHOLOGY OF INVESTING

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One of the fundamental but little-understood truths governing nonprofit fund raising is that philanthropists are, *ipso facto* (by nature), investors in society. The fact that they also become benefactors as a result of their giving does nothing to change or diminish this underlying reality. Indeed, philanthropists come in many forms, each with his or her own philosophy, priorities, means, motives, methodology, idiosyncracies, virtues, vices and values. Some pursue philanthropy on a part-time basis while others devote their full energies and attention to it. Some are personally involved; others operate at a distance through intermediaries. Some view it as a calling while others see it as a duty or responsibility.

Despite such individual differences, however, this essay asserts that "sophisticated" philanthropists (within the legally-recognized meaning of the term) seek to: (1) minimize risk and exposure in much the same way as professional (market) investors, and (2) produce an optimal social (as opposed to economic) return on investment.

Based upon past scholarship, this essay rests upon several key assumptions, including the following: (1) philanthropic behavior results from the confluence or convergence of two dimensions--the rational and moral, (2) philanthropic behavior is best characterized or explained by a mixed-motive model combining enlightened self-interest and altruism, (3) philanthropy is different from annual giving, (4) philanthropy and charity have different aims and purposes, and (5) economic and social exchanges have distinguishing characteristics.

These assumptions have all been addressed in considerable detail elsewhere and for purposes of this essay will be touched on briefly if at all (Andrews, 1950; Blau, 1964/1986; Bremner, 1960/1988; Cook, 1994, 1997; Cook & Lasher, 1996; Emerson, 1987; Fisher, 1989a; Gurin & Van Til, 1989; Kelly, 1991; Martin, 1994; Nagai, Lerner, & Rothman, 1994; Payton, 1988, 1990; Van Til, 1990; Van Til & Gurin, 1990).

Having stated my central thesis, then, the issue of taxation offers a logical starting point for comparison since both philanthropists and market investors must consider tax laws and the tax implications of their investment decisions. In this regard, several laws govern professional investing such as the Securities Act of 1933 (as amended), the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Employee Retirement Income Act of 1974, and the Financial Services Act of 1986, among others. Similarly, philanthropists must be familiar with regulations affecting capital gains and other appreciated assets, various types of trust and insurance agreements, bequests and estates, and Section 501(c)(3) of the Internal Revenue Service Code.

For example, several tests are enumerated for qualifying as an "accredited investor" under Regulation D of the Securities Act of 1933, as amended. Examples include having a minimum net worth of $1 million, individual net income of $200,000, or joint net income of $300,000; operating as a bank, insurance company, or investment management company with a minimum of $5M in assets, etc. Accredited investors are exempted from restrictions placed on novice and other types of investors under the Safe Harbor Rule, and so this designation or status is highly desirable in the investment world.

In philanthropy there is no equivalent term since philanthropists are not "accredited" other than by possessing excess wealth to invest in society. However, case law offers the less-well-defined but separate, distinct and legally-established companion term "sophisticated" to also describe and define certain investors. Basically, this class of investor is financially knowledgable, able and willing to live up to whatever terms are agreed upon and contracted for, and will not ask for their money back prior to maturation or sue if the investment fails due to normal risk factors. In this sense, then, prudent, mature and/or disciplined philanthropists may also be said to be "sophisticated."

A second point of comparison is found in risk. Among the basic types of risk faced by professional investors as well as philanthropists are business risk, financial risk, operating risk, and market risk. Business risk relates to organizational survival--whether or not a particular enterprise continues to exist. Financial risk looks at the amount of leverage, or debt, a business employs and how effective the organization is at servicing that debt. Operating risk is concerned with whether or not a company is managed well--i.e., the degree of competence of the leadership team. Finally, market risk--perhaps the broadest category of all--refers to external factors which can impact or affect the overall value of an investment. Such factors can include inflation levels, degree of political stability in a nation or region, currency stability, sector stability, industry stability, and product stability, among others. In addition, liquidity risk--determined in part by the type of investment and length of investment period--would also fall within the scope of market risk, broadly speaking (Adams, 1995; Bernstein, 1996).

In the marketplace, professional investors try to minimize or guard against these and other types of risk while optimizing profit and return on investment. Diversification is one strategy used by many investors to facilitate these dual goals; conducting detailed financial analyses (including cash flow projections, quarterly earnings history, payback period, and estimated return on investment) is another; and in-depth market, industry, corporate, brand, product, and personal research is yet another. Through this process, known as "due diligence," investors and/or their research staffs seek to obtain enough information about potential investments to make informed decisions.

As part of this process, nonproprietary information and personal judgments are also shared among peers within the investment industry as a matter of professional courtesy. This "prudent person" duty of care is the standard expected and required of such investors. In fact, in recognition of the responsibilities inherent in being a professional investor, most investment contracts and/or subscription agreements contain a provision certifying that, as a class, large-scale investors--whether individuals or organizations--are either “accredited” (as defined by the SEC) or “sophisticated” (i.e., capable of making not only a sizeable investment but an independent judgment as to the merits or deficiencies of a particular investment vehicle) or both.

Professional investors are presented annually with many more investment opportunities than they can participate in due to various limiting factors such as policy constraints and/or a lack of time, information, expertise, staff support, financial capital, etc. Most investors specialize in one of four primary areas: Public Equities (primarily stocks), Fixed Income (bonds, commercial paper, money markets, etc.), Commodities, and Private Equities (Derivative Securities can also be a separate specialty or a subclass of the first four). Each area is sufficiently complex to require special expertise and knowledge, and while a few investors are generalists, the majority specialize in a particular category.

For example, within Private Equities, a partial list of investment categories or asset classes might include corporate finance, venture capital, special equities, mezzanine, distressed securities, hedge funds, oil and gas, real estate, and leveraged buyouts. Likewise, a partial list of investment considerations for the Private Market arena could include: 1) track record (performance of prior investments, size of investments, and length of time as an investor), 2) personality (is this person or group courteous and considerate of others), 3) compatability (does this person or organization function well as a team), 4) character (is this person or organization trustworthy and dependable), 5) competence (is this person or group knowledgable and qualified by education and/or training and experience), 6) reputation (is this person or group well-respected by peers and knowledgable others within the investment community), 7) responsiveness (is this person or group prompt and cooperative in responding to questions and requests for information), 8) timing (are research, recommendation, and approval as well as funding availability possible within the time frame presented by this opportunity), 9) policy/strategy objectives (does this investment meet or fall within established guidelines, policies, and/or goals of the operating unit/division or organization), 10) identity and sophistication of co-investors (who are my partners in this enterprise), 11) contractual terms and conditions (is the agreement a beneficial one for all parties concerned, including my organization), and 12) compliance with applicable laws (does this investment present undue legal, ethical, or tax problems or concerns, or appear to violate or deviate from existing laws, statutes, ordinances, regulations and/or practices.

In similar fashion, philanthropists (collectively speaking) are also faced with more funding requests annually than they can consider, afford, or willingly invest in, and are confronted with essentially the same types of risk discussed previously each time they commit funds to a project, cause, organization, or individual. Thus, “sophisticated” philanthropists also find it expedient to gather information and conduct research (typically through their staffs, foundations, consultants or advisors) on the potential recipients of their beneficence. Again, this research is of two types: formal and informal. In the latter case, philanthropists often gather information from their peers--many of whom are members of elite social networks and thus valuable sources of "privileged" or nonpublic information--about potential recipients of their beneficence. Predetermined criteria and other delimiting factors, as in the case of foundation guidelines, also help to reduce the pool of requests/opportunities to a more manageable level. However, philanthropists typically reserve their largest gifts for organizations with whom they have been intimately acquainted and involved over a substantial period of time, usually in a voluntary position of service and/or responsibility (Cook, 1997; Panas, 1984).

Quite obviously, then, there are a number of valid reasons for philanthropists to scrutinize closely and become thoroughly familiar with potential beneficiaries, but first and foremost is that no donor wants to make the last investment in a sinking ship (the “Titanic Tenet”). Similarly, most donors are loathe to invest their time or funds in an enterprise in which the integrity, judgment, and/or ability of the leadership or top management is in question, where mediocrity is condoned and the status quo is entrenched, where there is a lack of vision or the mission of the organization is unclear, or where there is a history or strong likelihood of scandal, crisis, failure, or other adverse and potentially-damaging publicity.

In other words, sophisticated philanthropists, like their for-profit counterparts, tend to be risk-aversive and return (results)-oriented. This by no means precludes spontaneity or innovation; indeed, most major gifts are restricted as to purpose, and private gifts (in conjunction with corporate, foundation and government grants) have had and continue to have a major impact on social policy, programs, and institutions (e.g., AIDS awareness and prevention, literacy, womens' suffrage movement, Civil Rights movement, historically black colleges, International and American Red Cross (Bremner, 1960/1988; Curti & Nash, 1965; Cutlip, 1965/1990; Fisher, 1989a, 1989b; Marts, 1953/1990).

To conclude, however, as have some scholars (e.g., Odendahl, 1990; Ostrower, 1991), that philanthropy is primarily a transfer of wealth among individuals and organizations of interest or benefit to the social elite, is not only to miss the point, it is to misunderstand the process. True, there are reciprocal gifts made by the wealthy (i.e., "I'll give to your favorite charity or cause if you'll give to mine") out of obligation, prestige, pride of association, or other nonaltruistic motives, just as such gifts originate from the middle and lower classes of society for similar reasons.

True also, many great ideas and organizations are founded and funded through modest grassroots efforts at the local or regional level. Harvard, for example, derived much of its early income from a government-imposed tax on the colonists known as the annual "colledge corne" collection (Curti & Nash, 1965; Foster, 1962; Harris, 1970; Morison, 1936). Approximately 200 years later, Mount Holyoke College [then Seminary] was begun after Mary Lyon, a determined teacher, personally visited 90 communities and obtained 1,800 subscriptions totaling $27,000 in less than two months, with an additional

$8,000 donated by the community of South Hadley, Mass. to secure the site of the proposed school (Cutlip, 1965; Fisher, 1989; Sherratt, 1975; Stover, 1930).

However, just as professional investors expect to receive a favorable return (the optimum under existing conditions) on their investments, "disciplined" philanthropists aspire to greater productivity than normal or customary as a result of their gifts. In other words, enlightened or discriminating philanthropists try to invest where they can get the most "bang for the buck," or the greatest leverage with exponential rather than incremental growth and/or improvement.

Philanthropists, along with professional investors, have the capability to be "change agents" for society, though in different ways, through their investment decisions. That the two are not mutually exclusive is illustrated by George Soros and others who have left their mark in both areas. Philanthropy, however, is first and finally about values rather than economics--i.e., it is about giving to perpetuate values that coincide with or reinforce one or more of the core values which a particular donor holds dear or cherishes.

In this regard, the president of a private university commented, "I think people give to a set of values backed up by a set of people they believe are credible stewards for those values" (quoted in Cook, 1994, p. 386). Similarly, Taylor noted, "Mega gifts reflect a donor's soul--an individual's dream for a better world. A mega gift reflects the individual's ultimate voice, vision and values" (1997, p. 8).

Such giving requires an intimacy between donor and recipient, but also self-understanding on the part of the donor, since major gifts usually involve a sense of identity with or ownership of an organization (Cook, 1997). Philanthropy, to put it simply, is about heart as well as head.

A decision to invest scarce resources--whether made by philanthropists or market investors--ultimately has two dimensions: rational and moral. The former is concerned with personal or fiduciary economic growth and increased financial value, while the latter is concerned with social, spiritual and psychological growth and improvement for particular individuals, groups, classes, races, or the society as a whole. Stewardship and information characterize the rational dimension while caring and altruism tend to be associated with the moral dimension (Kelly, 1991).

According to Douglas, " a choice is 'rational' in terms of market economics when in any transaction the *quid* received is equal to or greater than the *quo* foregone in terms of the individual's self-interest" (1983, p. 23). In contrast, the laws governing charitable organizations do not require the total absence of any quid in exchange relationships, only that the benefits "must not be fully captured by the *quid pro quo* but must spill over into society at large" (p. 62).

Wall Street in general and professional investors in particular are often portrayed as greedy, ruthless, and in need of a moral compass, valuing fame, fortune and success above all else. However, a few economists have written on the moral and ethical dimensions or aspects of capitalism (Hayek, 1944, 1988; Novak, 1981; Novak & Cooper, 1981; Kristol, Johnson & Novak, 1980). Two highly-publicized examples include the holding of stocks in companies doing business in South Africa and, more recently, the holding of tobacco stocks. Less obvious, perhaps, are the moral implications of routine stock market or bond transactions which, by their investment of capital in a particular company, industry, sector, nation or region, their lack of such investment, or their sale of ownership in a company, industry, sector, nation or region, over time help to validate or reinforce social and economic trends and eventually bring about economies of scale through improved technology, lower costs, and the subsequent reduction or disappearance of competing companies, industries, or sectors whose technology has fallen behind or become obsolete.

Yet despite the presence of moral and rational dimensions in both types of exchange, there are obvious and significant differences between market and gift transactions. According to Blau (1964/1986), the most important difference between social and economic exchange is that social exchange entails unspecified obligations. Second, benefits received in a social exchange have no exact price (i.e., their value or worth cannot be precisely measured). Third, social exchange generates personal obligations and feelings of gratitude whereas economic exchange does not. And according to Emerson (1987), social exchanges emphasize relationships while market exchanges emphasize markets. Thus, social exchange is based on trust and reciprocity/mutual aid, while market exchanges are based on price/value and self-benefit/utility.

Both parties in a gift exchange give and receive something, but perhaps more importantly, ideally both giver and recipient are changed in some way as a result of the transaction. As philosopher Mike Martin stated, "At its best, philanthropy unites individuals [and organizations] in caring relationships that enrich giver and receiver alike" (1994, p. 1). Martin added, "Philanthropy tends to work best when it is a two-way interaction between donors and recipients who regard each other as moral equals, rather than a one-way abandoning of resources from the rich to the poor. The more both parties actively participate in what is viewed as a shared enterprise, the more both benefit from meaningful exchanges and relationships" (1994, p. 16).

Economics teaches that human nature is such that people have a greater quantity of wants (demand) than resources to meet them (supply). The nonprofit equivalent is the principle of stewardship. That is why nonprofit governing boards are said to have a “fiduciary” responsibility or duty to their organizations (i.e., both governing boards and the organizations they serve represent the greater society or public). Stewardship is a two-edged sword in that it is expected, though not required, of both philanthropists and their nonprofit recipients.

As did earlier philanthropists such as Carnegie and Rockefeller, many contemporary philanthropists tend to view themselves as trustees of society, and seek to act in the "best interests" of society, as they define and conceive that to be. In so doing, today's givers follow the path blazed by these two pioneers--the Lewis & Clark of philanthropy-- at the turn of the century. Rather than the Oregon Trail, however, this path is known variously as intelligent or scientific or professional philanthropy in order to emphasize its rational nature (and to distinguish it from its more compassionate kinsman, charity).

But in philanthropy, as in the settling of the nation, there are multiple routes, multiple destinations, and multiple agendas. Thus, there are always innovators, visionaries, rebels, mavericks, and counter-culturalists to reflect the concerns of new generations, new social problems and challenges, and new ideas and values (Nagain, Lerner & Rothman, 1994; Ostrander, 1995; Rabinowitz, 1990).

To be sure, some people are “single-issue” philanthropists--giving only to a certain area such as health care, the environment, or religion, or to a single nonprofit organization--rather than participating in “broad-brush” philanthropy. It is also true that some people are eccentric or unorthodox in their giving, such as leaving fortunes to care for a pet, and that it is possible to so offend the sensibilities of society as to be blatantly misguided in benevolence (e.g., if someone were to endow an Adolph Hitler Institute for the Study of Peace or International Peace Prize).

The beauty of philanthropy is that it is a vibrant, dynamic force for good, creative and often unpredictable, and limited only by law, military intervention, and human imagination (Carnegie, 1889; Fink, 1993; Hopkins, 1987, 1991; Miller, 1961; Palmer, 1986). As Taylor so aptly stated, “Being a philanthropist is reaching your fullest potential as a human being” (1997, p. 9).

However, philanthropy, like market investing, is an imperfect science fraught with risk. “Sophisticated” philanthropists thus seek to (1) minimize risk and exposure, and (2) produce an optimal social return on investment. But although there are similarities in the decision process for these two types of investing, and elements of the rational and moral are present in each, it is clear that philanthropy follows a moral rather than an economic compass, with society the ultimate beneficiary.

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