Kevin Curry

A **halo** for angel investors

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A portfolio of investments in socially responsible companies can generate returns similar to those of the S&P 500.

Socially responsible businesses sacrifice financial returns to pursue social or environmental objectives; that much is known. Just how much of a trade-off they make has always been unclear, however, and evidence from the capital markets is inconclusive. A recent study has produced some surprising results: over the ten-year period we examined, a portfolio of investments defined as socially responsible generated returns of 8 to 14 percent. That is lower than the rate typically earned by "angel" investors—wealthy people who make direct equity investments in entrepreneurial ventures, usually at an early stage—but comparable to capital-market returns.

We studied investments made by members of Investors' Circle, a US-based network of angel investors who put their money into companies they view as socially responsible.[1] Representative investments include Earth's Best, an organic baby-food manufacturer recently acquired by HJ Heinz, and Sonic Innovations, a manufacturer of low-cost hearing aids. The latter company went public in 2000.

Since Investors' Circle doesn't manage the investments centrally, its members were keen to know whether the aggregate returns from such a portfolio of companies were competitive with those from other angel-investment opportunities. In a survey, 77 percent of the group's members said that they expected returns of at least 10 percent, but the majority would accept a "social discount" in exchange for social or environmental benefits derived from a company's business.

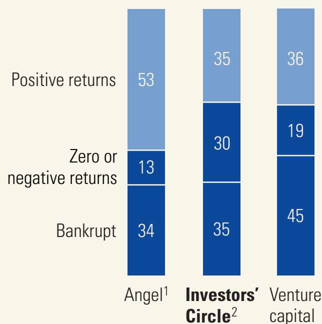
To determine how large a discount, we gathered information on 110 of the 128 companies financed since the organization's founding, in 1992. We then used the data to build a portfolio that covered the ten-year period from 1992 until the end of 2001. Instead of analyzing the actual returns of individual investors, we used standard investment and current-valuation data.[2] Our portfolio simulated investments of $72 million—the aggregate amount that the organization's members had invested—in 95 operating companies as well as 15 venture capital funds, all of which had social missions as part of their charters.[3]

Next, we tested our portfolio under two investment strategies. The tests for the first—buy and hold—looked at the performance of a single initial investment in each

EXHIBIT 1

Boom and bust

Distribution of returns for selected portfolios, Jan 1992–Dec 2001, %



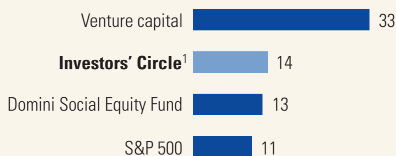
[1]Data, from study undertaken in United Kingdom, is most comprehensive available; US industry dynamics may differ.
[2]Derived from information on 110 of 128 companies financed since founding of organization, in 1992.

Source: Colin M. Mason and Richard T. Harrison, "Is it worth it? The rates of return from informal venture capital investments," *Journal of Business Venturing*, 2002; McKinsey analysis

EXHIBIT 2

Doing good does well

Returns for selected portfolios, Jan 1992–Dec 2001, %



[1]Returns for 6-month liquidation strategy; returns for buy-and-hold strategy = 8%; derived from information on 110 of 128 companies financed since founding of organization, in 1992.

Source: Morningstar; Standard & Poor's; Thomson Financial; McKinsey analysis

company in the portfolio and assumed that these investments were being held for the long term. The holdings were valued at the IPO price of the company (if it went public), at its acquisition price, or at its annual revenue (if it was still privately held). The tests for the second investment strategy, called six-month liquidation, modeled the initial investments plus participation in each additional funding round before an initial public offering or acquisition, as well as an exit six months following the IPO or acquisition.[4] The buy-and-hold and the six-month-liquidation strategies generated returns of 8 and 14 percent, respectively. Two things explain the performance advantage of the latter approach. First, since investors can participate in subsequent rounds of funding, their initial equity position isn't significantly diluted. Also, the IPO or acquisition allows them to realize higher returns than the natural rate of appreciation generated through the buy-and-hold strategy.

As with typical angel or venture capital portfolios, it is very hard to pick individual winners, so a good deal of value was derived from the portfolio effect of investing in a range of companies that delivered a range of returns. About a third of the companies went bankrupt and about a third delivered positive returns—results comparable to those of a venture capital fund (Exhibit 1). The subset of 14 companies that were sold or went public drove the overall returns of our portfolio. Its distinguishing feature was the relatively high number of companies that were acquired (9 percent) and the relatively low number that went public (6 percent). This depressed company values at the time of divestiture below the levels that venture capitalists usually enjoy.

Although our portfolio's performance fell short of typical venture capitalists' returns during the same period, it was comparable to the returns of the Domini Social Equity Fund, which describes itself as "the oldest and largest socially and environmentally screened index fund," and of the S&P 500

(Exhibit 2, on the previous page). Returns for angel investments are difficult to quantify because of the individual nature of the investment activity, but interviews with industry experts suggested that angels generally expect returns better than capital markets offer but worse than those of venture capitalists. Most angel investors never achieve venture capital returns, because angels have lower levels of diversification and not enough capital to participate in follow-on rounds, so their equity is diluted.

The track record of the 110 Investors' Circle companies we studied is a promising indication that social-purpose ventures can generate financial returns that meet investors' expectations. Although our study is too small to make sweeping claims about early-stage social investing, it does present a methodology and a set of results that can aid others looking for both a financial and a social return on their investments. Q

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[1] Unlike venture capital or private equity firms, which raise money from individuals and institutions and then invest directly in portfolios of companies, Investors' Circle serves as a matchmaker for individual investors and promising companies with social missions.

[2] Several factors influenced this approach. For one thing, we wanted to focus on evaluating companies and not on the skill of investors. Moreover, the results could have been skewed by a handful of big investments, and the availability of data on specific investment terms was a challenge.

[3] Our data covered 142 people who made 444 investments, with an average initial investment of $174,000 and an average of $114,000 in follow-on investments. The data represent the average investments modeled rather than the specific investments these individuals actually made.

[4] After an IPO, during what is called the "lockup period," employees and other early investors usually can't exercise their stock options.