



EVERGREEN DIRECT INVESTING

Co-Creating the Regenerative Economy



Evergreen Direct Investing: Co-Creating The Regenerative Economic by Capital Institute was released in September 2013.
It is licensed under a Creative Commons Attribution-Noncommercial-NoDerivs 3.0 Unported License.
Based on a work at www.Capitalinstitute.Org.

CONTENTS

INTRODUCTION BY JOHN FULLERTON	3
GETTING BACK TO BASICS WITH A CASH FLOW SHARING MODEL	6
SIMPLE BY DESIGN	10
HOW EDI STACKS UP AGAINST CONVENTIONAL INVESTING	11
HOW THE CAPITAL MARKETS HAVE ALSO FAILED ENTERPRISE	12
WHAT KINDS OF ENTERPRISES MAKE SUITABLE EDI PARTNERS?	16
HOW EDI GOVERNANCE WORKS — NEXT GENERATION ESG	19
THE CHALLENGES OF EVERGREEN DIRECT INVESTING	23
KEITH L. JOHNSON TALKS ABOUT FIDUCIARY DUTY	27
A WALK THROUGH THE EVERGREEN DIRECT INVESTING METHOD	30
TIM MACDONALD, PRINCIPAL ARCHITECT OF EDI	32
ABOUT CAPITAL INSTITUTE	35
FOOTNOTES	36

INTRODUCTION BY JOHN FULLERTON

With this study of the Evergreen Direct Investing (EDI) method we highlight a viable alternative to conventional investing that represents both a reengineering and bold repurposing of time-tested techniques. As this study will illustrate, the EDI architecture is purpose built to bring together large perpetual investors, like pension funds, sovereign wealth funds, and endowments, with values-aligned business leaders, empowering them to act as co-creators in the rapid transition we must make to a truly sustainable, regenerative economy.

Pension funds exist for a defined purpose and have known contractual financial obligations to fulfill to their beneficiaries, in increments, over time. There is little doubt that today's boom-bust cycling capital markets, frequently hi-jacked and manipulated by short-term speculators and algorithmic traders who together account for the vast majority of exchange trading, are no longer well suited to deliver the dependable stream of returns that large, purposeful, powerful and perpetual pension investors, who now account for \$30 trillion in investable capital, require to fulfill their fiduciary obligations. Meanwhile, Modern Portfolio Theory and the Capital Asset Pricing Model that builds on it fail to account for those "black

INTRODUCTION BY JOHN FULLERTON

swan” events that are occurring with increasing frequency in today’s public markets, metastasizing across asset classes and creating correlations across markets in times of stress where none previously existed. Yet Modern Portfolio Theory continues to dictate how pension funds, and their asset managers, allocate capital.

At the same time this growing dysfunctionality of the capital markets, coupled with its narrow focus on quarterly earnings and shareholder-value maximization, is depriving enterprise of vital strategic investment partners, and limiting business leaders’ ability to undertake the kind of strategic decision-making required to harmonize the long-term interests of people, planet, and profits in the transition to a regenerative economy.

But what if one were to take the often unloved mature, stable cash flow enterprises of the mainstream economy, and combine them with certain cash flow sharing investment architectures that have proven successful in other stable cash flow sectors of the economy such as infrastructure and

INTRODUCTION BY JOHN FULLERTON



*John Fullerton,
Founder & President,
Capital Institute*

real estate, and apply them to broader categories of enterprise investment, and enlist them for a higher purpose? The Evergreen Direct Investing method, the brainchild of Tim MacDonald, who spent his career as a limited partnership attorney, does just that. It enables large, perpetual investors with predictable, long-tail liabilities and enterprise leaders of the mature, stable-cash-flow businesses that represent a large share of the global mainstream economy to be free from the speculative, growth-at-any-cost tyranny of shareholder value maximization. EDI makes possible a shift to real enterprise investment through negotiated partnerships in which the long-term interests of investors, management, financial intermediaries, and all enterprise stakeholders are truly aligned.

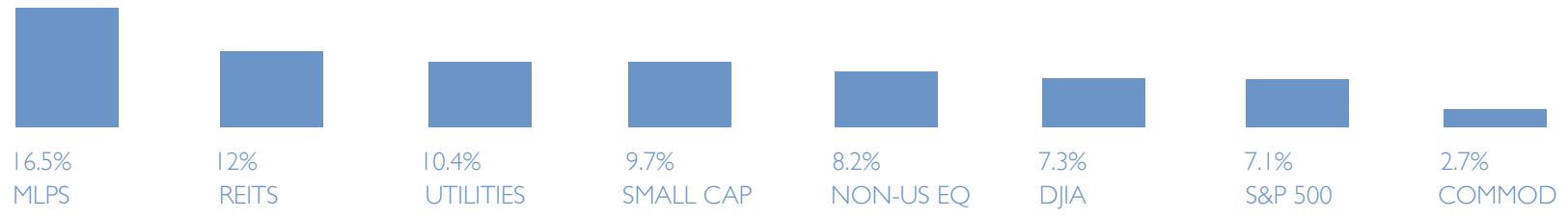
Could EDI address investor risk-adjusted return needs and usher in “ESG 2.0” at scale? We think the answer is a resounding “yes!”

GETTING BACK TO BASICS WITH A CASH FLOW SHARING MODEL

The EDI model is designed to enable pension funds and others who consider themselves “stewards” of capital — including certain sovereign wealth funds, endowments, ultra-high-net-worth individuals, and family offices — to bypass the public capital markets to make direct enterprise investments. Unlike conventional private equity, however, EDI is not dependent for its realized returns on the ultimate sale of an enterprise, determined by public market valuations prevailing at arbitrary “sell-by” dates. Nor does EDI require paying outsized fees to external private equity managers whose promised returns are often predicated on excessive leverage. Instead, in a structure similar to private Real Estate partnerships, the EDI investor negotiates a share of the stream of the sponsored enterprise’s cash flows on an ongoing basis to realize its target returns over time. As with publically traded REITs and MLPS, since minimal cash is retained in the enterprise, at least in the early years of the investment, business leaders must make their case to investors for funding successive new capital projects. As the table on the following page illustrates, these stable cash generating businesses that pay out most of their cash flow to investors have long been market outperformers:

GETTING BACK TO BASICS WITH A CASH FLOW SHARING MODEL

How REITs and MLPs Outperform: TEN YEAR ANNUALIZED RETURNS 2003-2012



Source: Bloomberg as of 12/31/12 (as reported in Alerian Index research)

To meet the needs of investors like pension funds that require a defined, dependable stream of cash flows to match their payouts to beneficiaries, EDI tweaks the REIT and MLP investment models by stipulating upfront a projected “base case” of cash flows from the enterprise. Cash payouts to the investor are then intentionally structured at the outset to create a close match with its ongoing obligations.

In the early years of the investment, most of the cash in the EDI enterprise after operating expenses and debt obligations goes to the pension fund investor. Over time, and as the investors gets closer to achieving their

GETTING BACK TO BASICS WITH A CASH FLOW SHARING MODEL

“If asset managers want to follow each other over the cliff with our retirement savings, then let's look for some with more courage.... There are no jobs on a dead planet and we know that the risk of climate catastrophe requires an alternate approach to safeguard investments. With both these imperatives looming down on us like the proverbial train, where are the visionary thinkers?”¹

—Sharan Burrow, General Secretary, International Trade Union Confederation



desired threshold return, the share of cash flows shift rapidly in favor of the enterprise. This structure provides a strong incentive to the enterprise leaders to accelerate the timeline of threshold returns to investors, reducing the latter's risk, and as a result, the cost of capital to enterprise.

For example, EDI investors might contractually receive 90 percent of the distributable cash flow (after maintenance capex) from the enterprise until their capital is returned and they earn their preferred return, while

GETTING BACK TO BASICS WITH A CASH FLOW SHARING MODEL

the remaining 10 percent is controlled by enterprise management either for incentive compensation and profit sharing or to be reinvested in the business. After the investors receive their preferred return, the equity split might shift to perhaps 40/60, with 60 percent of the cash flow controlled by management.

It should be noted that, even after achieving their required returns, the investors continue to receive an ongoing, smaller percentage of the cash flows from the business in perpetuity or until the enterprise ceases to be a going concern. The terms of this cash flow sharing and the ownership structure can, of course, be tailored to the investor's specific requirements and the unique characteristics of the enterprise business model. Stipulations can be made that a higher percentage of cash flows be allocated to investors if the base case is not realized, mitigating their downside risks.

SIMPLE BY DESIGN

One of the most striking characteristics of EDI is its design simplicity. Modern portfolio theory requires the construction of a complex web of diverse investment products that must be continually rebalanced and reconstituted in an attempt to deliver desired returns for a given level of risk under ever-shifting market conditions and perceived trends. **In an EDI portfolio each investment is engineered to add incrementally to the fund's required returns in such a way that all investments in the portfolio sum up to the fund's required schedule of returns.** Not every EDI investment will be constructed identically of course, and thoughtful identification and diversification of sound enterprise investments will be especially critical. That said, the overall portfolio construction process will be considerably simpler and more streamlined than is typically the case with conventional portfolio design, and there will be far fewer "moving parts."

HOW EDI STACKS UP AGAINST CONVENTIONAL INVESTING

PUBLIC MARKET INVESTING

Returns at risk to boom/bust cycles and asset management strategy

Matching returns streams to obligations problematic

Investor has no direct engagement with portfolio enterprise

Corporate governance inadequate

Returns exit driven

CONVENTIONAL PRIVATE EQUITY

Company is bought with a deliberate view to resale

Sale can be forced by artificial "sell-by" date

Returns realized through gain-on-sale, at risk to current market values

Goal is to maximize value extraction on sale

Structural conflicts of interest

EVERGREEN PRIVATE EQUITY

Returns and risks managed by negotiation

Returns streams designed to match obligations

Investor collaborates directly with enterprise on terms of deal

Enables genuine corporate governance

Returns built into partnership terms

EVERGREEN PRIVATE EQUITY

Investment continues as long as enterprise is a going concern

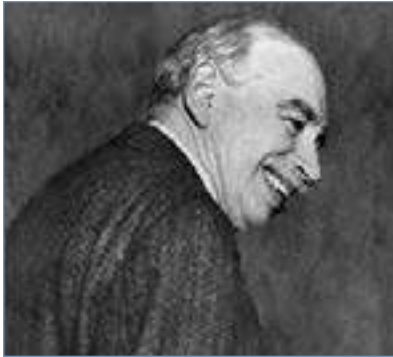
Capital returned to investor through contractual negotiation

Returns realized in increments, over time, as cash flows are generated

Goal is to optimize wealth creation through sustainable commercial competitiveness

Alignment of interests assured

HOW THE CAPITAL MARKETS HAVE ALSO FAILED ENTERPRISE



John Maynard Keynes, himself a successful speculator and investor, warned against losing the balance between investing and speculating: *“Speculators may do no harm as bubbles on a steady stream of enterprise. But the situation is serious when enterprise becomes the bubble on a whirlpool of speculation.”*

Thus far we have focused on EDI primarily from the perspective of the pension fund investor. The flexibility of the EDI model both empowers and incentivizes management of the sponsored enterprise in ways that are much more aligned with the goal of securing its long-term health and that of its stakeholders than incentives linked to stock options or deferred equity stakes. EDI is thus likely to appeal equally to the growing group of business leaders who are actively seeking to engage with long-term investors. A trend currently more in evidence in Europe, but gaining traction among US CEOs, is fatigue with the fixation on short-term

HOW THE CAPITAL MARKETS HAVE ALSO FAILED ENTERPRISE

shareholder value maximization. Paul Polman, Chief Executive of the Anglo-Dutch multinational Unilever, is just one among many CEOs who have stated publicly that their businesses decisions will no longer be dictated by short-term shareholder value considerations. As a Dutch company, unconstrained by well-intended SEC quarterly disclosure requirements, Unilever has renounced the quarterly earnings report (although revenues are reported quarterly) and the associated “guidance” game that has driven the mirage of “success” (and ultimate share price collapse) of many public companies, most notably industrial stalwart General Electric, which lost a stunning 83 percent² of its market value during the recent financial crisis, and continues to trade significantly below its pre-crash peak. Leaders like Polman are likely to welcome the new breed of EDI investor.

In an EDI financing, the cash flow to equity is split among the investors, as sponsors, and management, as enterprise leaders, and an employee profit-sharing pool. Cash flows not allocated to the investors to meet their return expectations remain inside the enterprise, under the discretionary control of its leadership and board. They can be reinvested to support

HOW THE CAPITAL MARKETS HAVE ALSO FAILED ENTERPRISE

optimization of commercial competitiveness, or paid out to management and employees as profit sharing, as the leadership may determine.

This point about reinvestment is a critical difference between EDI and public equity and its exit-by-sale alternatives. In the public model, reinvestment is driven by the need to support continued growth in share price. In the EDI model, reinvestment is made at the discretion of business leadership. They can reinvest, if that makes good sense, or pay out profits, if reinvestment options are not the better choice at the time.

If management identifies attractive opportunities for investment requiring additional capital, they can either re-negotiate the sharing formulas with their existing investors or construct a separate EDI financing with existing or new investors who will have an opportunity to evaluate the use of capital on its merits. They do not only and always have to “maximize shareholder value”—often a euphemism for continually driving their share price up in the short-term. They are instead empowered to exercise their best business judgment in the pursuit of long-term sustainable prosperity

HOW THE CAPITAL MARKETS HAVE ALSO FAILED ENTERPRISE

“In the origins of many companies, people were working in the interests of society, not in the interests of shareholders alone. Focusing only on shareholder value is a very destructive concept.”— Paul Polman CEO, Unilever³



within an architecture that aligns their personal interests with that of the firm and its stakeholders. If they choose to reinvest, they are literally reinvesting their own share of the profits.

Such an approach to enterprise capitalization raises many new questions: how to attract and retain the right talent to match the needs of the enterprise; how to motivate qualitative improvement, not just quantitative growth; how to handle deferred earn-ins, perhaps a decade-long, to profit sharing pools; how to contractually embed a broad diversity of stakeholder interests into the sharing of profits. There will be as many approaches to these issues as the creative talent of EDI financiers and managers can muster.

WHAT KINDS OF ENTERPRISES MAKE SUITABLE EVERGREEN DIRECT INVESTING PARTNERS?

“What we’re looking for is boring, predictable, long-term cash flows. And so the more seasoned the asset is, the more interesting it becomes to us... and the better the alignment of interest....One thing that we insist on is that we don’t actually build in exit assumptions. Literally, when we buy an asset, we assume that we will hold it indefinitely or until the end of the concession.” — Mark Wiseman, CEO of the Canadian Pension Plan Investment Board, speaking of infrastructure investment ⁴



A business whose cash flows are steady and predictable obviously represents the most attractive EDI candidate. That might be an early stage project whose future revenues have been stabilized by long-term purchase agreements; for example, a wind power developer who has secured contracts to deliver power to the grid over a period of years. Numerous project-equity-type infrastructure investments already use variations of this investment method in the real world.

WHAT KINDS OF ENTERPRISES MAKE SUITABLE EVERGREEN DIRECT INVESTING PARTNERS?

However, many more business models lend themselves to the EDI method. At the enterprise level, EDI will typically be utilized in “value investing” opportunities in mature, stable businesses requiring only modest capital reinvestments.

For example, consider a mature, exchange-traded software company that has captured a dominant market position in its particular niche. Its low growth characteristics leave it orphaned from sell side equity research, uninteresting to the typical technology-focused investment funds, and as a result, fairly if not undervalued in the public markets. Stable businesses like this example that generate consistent free cash flow make ideal candidates for the EDI method.

Many large mature companies (or businesses within diversified companies) across a variety of sectors, minus their acquisition budgets, also exhibit similar stable cash flow and valuation qualities and are therefore attractive EDI candidates, if we let our imaginations run a bit. For example, a pension

WHAT KINDS OF ENTERPRISES MAKE SUITABLE EVERGREEN DIRECT INVESTING PARTNERS?

“In this volatile environment...there is a disproportionate effort by CEOs to satisfy current shareholders. But who are they? You can easily become [distracted] if you listen to all of them, so you have to spend far more time selecting the right shareholders ... You have to find shareholders who fit the philosophy of your company.”

—Paul Polman, CEO, Unilever⁵

fund investor would likely earn a reliable 8 percent return if it were possible to invest in Microsoft Windows (separate from the acquisition driven parent whose stock has sat static for a decade) through a responsibly leveraged EDI deal. On the other side of the coin, a large public company might very well seek to improve its stock market valuation by identifying an EDI counterparty to purchase one of its mature, low growth divisions in order to free up capital to either return it to shareholders, or to make an acquisition in a business with higher growth prospects.

HOW EDI GOVERNANCE WORKS – NEXT GENERATION ESG

Pension funds, like many other large institutional investors, are under increasing pressure from a variety of increasingly vocal advocacy groups to pay more than lip service to incorporating ESG factors into their investment decisions.

Many leading funds have required little outside prompting to practice ESG activism, recognizing the observable linkage between ESG risk and financial risk. CalPERS, for example, which manages \$231 billion in assets, describes in detail in its 2012 “Towards Sustainable Investment” report the resources it commits to ESG, including casting its votes at more than 10,000 companies around the world on a total of 446 shareholder proposals in the United States alone. With its Focus List program CalPERS targets individual companies in its portfolio that are both underperforming financially and in terms of their governance factors. The fund then engages directly with these companies over a period of years to press for remedial action, following up with shareholder proposals to put teeth into their interventions.

HOW EDI GOVERNANCE WORKS—NEXT GENERATION ESG

“The nonsense of quarterly earnings [is the] tragedy of the commons. It leads to catastrophic results—a lot of very small, short-term decisions mean companies collectively are not putting the time and the effort and the money into training, R&D, reputation, and all the other good stuff on which healthy economies are based.”

—Anne Simpson, Director of Corporate Governance, CalPERS ⁶



However, even ambitious ESG programs like CalPERS invariably fall short of delivering their desired outcomes. Although CalPERS views itself as a long-term investor and its portfolio turnover rate is relatively low, it is often a transient holder of myriad individual stocks in its huge, highly diversified equity portfolios. In the case of the publicly traded assets it holds, it is purchasing interests in companies whose ESG behaviors are, for better or worse, well-entrenched. Pension funds like CalPERS thus face tremendous challenges as they seek to have real and lasting influence on the ESG performance of these enterprises.

HOW EDI GOVERNANCE WORKS—NEXT GENERATION ESG

EDI, in contrast, gives these pension investors a more direct point of leverage to achieve their ESG goals as they negotiate with enterprise the environmental, social, and governance considerations they want to see embedded into their investments, before those investments are made. Like all private direct investment activities, EDI portfolios will tend to be far more concentrated than CalPERS's public stock holdings of 10,000 companies. Risk mitigation comes instead from appropriate diversification, in-depth knowledge, direct engagement and governance, often including board seats, and critically, structuring preferred financial returns while incorporating custom ESG values in partnership with the management of mature, stable-cash-flow businesses.

In the EDI method of investing, the ESG investor begins by selecting an enterprise to sponsor that is aligned with both its financial objectives and its stewardship values. Because these deals require the investor to participate in the budget process, they provide a unique opportunity for investors and enterprise leaders to work together to embed, on a line item basis, desired nonfinancial outcomes, everything from governance,

HOW EDI GOVERNANCE WORKS—NEXT GENERATION ESG

“Importantly, investors in EDI will no longer require that all enterprises perpetually grow cash flows exponentially, without proper reference to the social and environmental costs, in order to satisfy their fiduciary obligations. Indeed, if EDI becomes broadly embraced and ESG values embedded into its structure, the result will be a more resilient and sustainable economy.” — John Fullerton, Founder & President, Capital Institute

to fair dealing with all counterparties and stakeholders, to investment in innovations that minimize energy and resource throughput. The EDI model thus turbo-charges the power of investors to assume stewardship roles as they help engineer a robust, dynamic, adaptive, and sustainable enterprise.

EDI represents a powerful additional tool for the next generation of ESG investing. Many of the now evolving frameworks to embed ESG values and track ESG outcomes — including the integrated reporting initiative and ESG key performance indicators by industry — can be pressed into the service of this new ownership structure purpose-built for the task.

THE CHALLENGES OF EVERGREEN DIRECT INVESTING

The EDI method suggests that stable, attractive, risk-adjusted returns are indeed within reach of pension fund investors who have the wherewithal to seek out appropriate investment targets and to define their fiduciary duty of prudence as the spirit of the law intended, not as a directive to continue to follow investment strategies that have failed them, simply because their peers are also continuing to do so.

While some large pension funds are already likely to have the in-house expertise to test the EDI model, collaborative investment partnerships among investors will be essential. Smaller funds without the same economies of scale will need to be more resourceful. This will require collaborating in co-investments with larger institutions, pooling in-house expertise, or putting out EDI RFPs to current or prospective private equity managers.

However, the many additional challenges that will confront pension fund managers who wish to test the EDI method should not be minimized. Courage will be required to shift away from the established Wall Street

THE CHALLENGES OF EVERGREEN DIRECT INVESTING

paradigm of investing (speculating really) based on price and the dictates of Modern Portfolio Theory. Nor will EDI be a riskproof method of investing. What may appear to be mature stable businesses can change course quickly, and for the worse, in a dynamic economy.

Funds must also be prepared for resistance and skepticism from their current private equity managers who have promised them double-digit returns using highly leveraged strategies to justify (and drive) their compensation structures. However, pension funds should have confidence that they can achieve 7 to 10 percent returns with relatively low volatility from EDI, while at the same time mitigating the need to stabilize their overall portfolios with large allocations to bonds. EDI allows asset and liability matching with lower risk equities, not just with bonds.

Identifying a values-aligned enterprise in an attractive business will of course be critical to the success of any EDI investment. It may indeed be a challenge to identify enterprise leaders who are willing to abandon the short-term-focused, stock-option-driven compensation game and who

THE CHALLENGES OF EVERGREEN DIRECT INVESTING

“When we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever.”— Warren Buffett⁷



will agree to turning over the lion's share of their enterprises's cash to investors in the near term when they may want maximum control over it. However, as noted above, seasoned enterprise leaders with long-term vision are increasingly appreciating the value of partnering with truly values-aligned investors who have faith in what they are trying to accomplish as business builders. What's more, once an enterprise leader is identified, the investment is likely to be a surer bet for the investor. That's because the EDI incentive structure is likely to attract business leaders who have deep knowledge of the underlying investment opportunity and confidence in its ability to deliver quickly on the promised returns to investors, at which point they begin to deservedly enjoy the rapid acceleration of their own rewards.

THE CHALLENGES OF EVERGREEN DIRECT INVESTING

“In a financialized portfolio, Wall Street is the center of the trading universe. In an Evergreen Direct Investing portfolio, stewardship investors will become the centers of a new stewardship investing universe.”

— Tim MacDonald,
Principal Architect,
EDI

PENSION FUNDS NOW HAVE THE SIZE AND THE CLOUT TO DICTATE THE TERMS OF HOW THEY INVEST

MARKET	TOTAL ASSETS (USD BILLION) YEAR END 2002	TOTAL ASSETS (USD BILLION) YEAR END 2012e	GROWTH RATE (USD) 10-Year CAGR
Australia	292	1,555	18.2%
Brazil	53	340	20.4%
Canada	754	1,483	7.0%
France	107	168	4.6%
Germany	186	498	10.3%
Hong Kong	27	104	14.4%
Ireland	34	113	12.7%
Japan	2,289	3,721	5.0%
Netherlands	503	1,199	9.1%
South Africa	73	252	13.2%
Switzerland	333	732	8.2%
UK	1,120	2,736	9.3%
US	8,968	16,851	6.5%
TOTAL	14,740	29,754	7.3%

Source: Towers Watson

KEITH L. JOHNSON TALKS ABOUT FIDUCIARY DUTY



Keith L. Johnson heads the Institutional Investor Legal Services team at Reinhart Boerner Van Deuren where he represents pension funds and institutional investors on fiduciary, investment, securities litigation, and corporate governance program matters. He is a recognized and widely published thought leader on the topic of fiduciary duty and investment.

Investment fiduciaries — those who are charged with the legal responsibilities for managing other people’s money — have a duty under the law to incur only reasonable and appropriate costs in managing those assets.

This duty applies not only to payment of fees and costs but also to decisions on whether an external investment manager or other service provider should be engaged. Projected benefits of delegating responsibilities to a third party agent must be weighed against the likely costs. Such decisions can often have cascading effects on other investments or portfolios in a fund, so analysis of costs and benefits should be done over the long term on a risk-adjusted net (after costs) basis across the entire fund.

When fiduciaries have the prospect of reducing management costs by using a more appropriate investment approach to meet investment goals with equivalent investment and risk exposures at a lower cost, or by accessing comparable investment opportunities that are less costly and better aligned with beneficiaries’ interests, it is their duty to consider those options.

KEITH L. JOHNSON TALKS ABOUT FIDUCIARY DUTY

The duty of loyalty is also a fundamental legal obligation of fiduciaries. It precludes them from engaging in self-dealing with assets that belong to beneficiaries. Loyalty also requires that, when fiduciaries delegate responsibilities to investment managers or other service providers, efforts must also be made to minimize the potential for harm from those agents' conflicts of interest. The most effective way to control exposure to third party conflicts of interest is to simply avoid unnecessarily adding intermediaries to the chain of service providers engaged to manage trust fund assets. However, when responsibilities are delegated to agents, attention must be paid to aligning their incentives with the interests of fund beneficiaries to the extent practicable.

More and more pension fund fiduciaries are also undertaking efforts to improve their governance by adopting a set of investment beliefs. The process of developing investment beliefs can help to identify investment approaches that are better aligned with fiduciary duties and the interests of fund beneficiaries over the long term. Statements of investment beliefs can also guide fiduciaries in the next

KEITH L. JOHNSON TALKS ABOUT FIDUCIARY DUTY

critical step — adopting investment practices that are aligned with those beliefs.

The combination of these leading practices for management of fiduciary obligations has fostered a global trend toward greater use of direct private market investment structures that reduce the fees and costs lost to multiple levels of conflicted service providers and that give the investor greater control over structuring of investments to fit the fund's investment strategy goals. Fiduciaries at smaller funds have begun to collaborate with each other to access cost-effective strategies once thought only available to larger funds.

Within the context of these leading practices, **fiduciaries are well advised to explore tools designed to address cost containment, that minimize conflicts of interest and give them more control over implementation of their investment strategies. The Evergreen Direct Investing method is one such tool.**

— *Keith L. Johnson*

A WALK THROUGH THE EVERGREEN DIRECT INVESTING METHOD

MATCHING FIDUCIARY
RETURNS TO FIDUCIARY
OBLIGATIONS

This video (click on icon to the left to access) takes the reader through the mechanics of a hypothetical portfolio created by privatizing three mature public companies using the Evergreen Direct Investing architecture: the consumer products company Procter & Gamble, the oil field services and pipeline company Schlumberger, and the information technology giant Microsoft. The modeled \$350 billion portfolio is based on recent public market capitalizations, and then makes assumptions about utilizing modest leverage and existing balance sheet cash.

Our sole purpose is to offer a step-by-step illumination of how a pension fund investor might match the return on assets to fiduciary obligations with far more certainty using the EDI method than through a public market investment in these same companies. We included Microsoft, whose management has been widely criticized for imprudent acquisitions, as one of our portfolio companies, to invite the reader to reflect on how much more appealing this company, with its numerous stable cash flow businesses, might be as an EDI than as a publicly traded company. (Windows, Office Applications, and servers and tools businesses, reported

A WALK THROUGH THE EVERGREEN DIRECT INVESTING METHOD

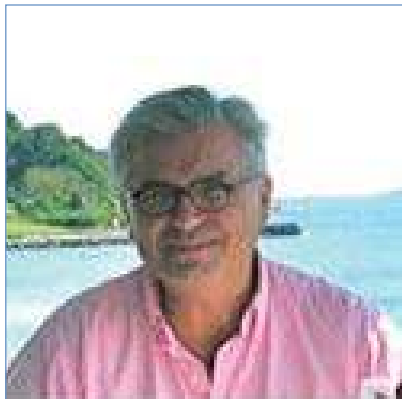
revenues in the last fiscal year of \$19, \$25, and \$20 billion, respectively.) It should also be noted, of course, that EDI can be utilized to create a much smaller portfolio that includes new sponsored projects in currently private enterprises.

Note: The Evergreen Direct Investing method is referred to in this video as the Evergreen Equity Split method.

TIM MACDONALD, PRINCIPAL ARCHITECT OF EVERGREEN DIRECT INVESTING

*“Enterprise needs to be relieved of the tyranny of ‘maximizing shareholder value.’
Fiduciaries need a more satisfying alternative to ‘maximizing shareholder returns.’
Society needs fiduciaries to become good stewards of sustainability. What they all
need is a holistic-value-creating tool to engage with to make it all happen.”*

—Tim MacDonald



Tim MacDonald joined Capital Institute as a Senior Fellow to collaborate with us as we explore the applications of Evergreen Direct Investing.

Tim is an attorney who has spent the last 30 years negotiating the contractual agreements for limited partnerships in tax-favored projects like affordable housing, equipment leases, and renewable energy projects. An optimist by nature he believes, against the odds, that pension and other stewardship investors are ready to embrace their Copernican moment —

TIM MACDONALD, PRINCIPAL ARCHITECT OF EVERGREEN DIRECT INVESTING

to shift the center of their investing universe from opportunistic trading on price to a new investment paradigm that is purposefully aligned with their role as intergenerational, perpetual trustees of capital.

Born in 1955 in Fall River, Massachusetts, a once thriving center of technological innovation in textile manufacturing, the son of a firefighter, MacDonald grew up learning how money moves around the economy, primarily, he says, “from the nosebleed seats.” That vantage point may have much to do with his natural inclination to think outside the box seats for solutions to our broken financial system.

MacDonald never got comfortable with the rhythms of the capital markets and gravitated instead, after earning his law degree in 1980 from Boston College, to a career that bypassed them altogether — structuring limited partnerships for affordable housing, equipment leases, renewable energy projects, and other tax-favored vehicles.

He spent the ensuing 30 years helping to negotiate the contractual agreements for business partners as they divvied up the cash flows from these projects. Over time he found himself thinking more and more about how this cash flow sharing could be adapted more broadly to serve a more transformative role in the larger economy, and, in particular, how it could be tailored to the requirements of pension funds and other long-term stewards of fiduciary funds. Out of these ruminations over the course of the past 5 years came the idea for the EDI model.

ABOUT CAPITAL INSTITUTE



Capital Institute is a non-partisan, transdisciplinary collaborative, launched in 2010 by former JPMorgan Managing Director John Fullerton.

The Institute's mission is to explore and effect economic transition to a more just, regenerative, and sustainable way of living on this earth through the transformation of finance.

FOOTNOTES

1 <http://www.theguardian.com/sustainable-business/investment-strategies-push-reset-button>

2 GE stock fell from a high of \$41.40 on September 28, 2007, to a low of \$7.06 on March 6, 2009.

3 <http://www.theglobeandmail.com/report-on-business/careers/careers-leadership/paul-polman-rebuilding-capitalism-from-the-basics/article9577971/?page=all>

4 http://www.mckinsey.com/insights/engineering_construction/mark_wiseman

5 <http://www.theglobeandmail.com/report-on-business/careers/careers-leadership/paul-polman-rebuilding-capitalism-from-the-basics/article9577971/?page=all>

6 <http://www.c-suiteinsight.com/index.php/2011/10/anne-simpson-calpers/>

7 <http://www.berkshirehathaway.com/letters/1988.html>

Photos of Paul Polman, Sharan Burrow, Warren Buffett, and Mark Wiseman are licensed under the Creative Commons Attribution-Share Alike 2.0 Generic license. <http://creativecommons.org/licenses/by-sa/2.0/deed.en>