Fixed Income Manager Letter of Intent

F.B. Heron Foundation
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Heron invests in fixed income securities aligned with its mission to help people and communities help themselves out of poverty. We continually seek ways to improve the social performance of our investments. This process evolves in partnership with managers who can understand Heron's perspective and bring their own judgement, experience, and insight. This document is designed to bring greater clarity on what Heron seeks in terms of mission-alignment. Ultimately, we are seeking managers who can formulate an informed, independent opinion on social performance and work in partnership with Heron.

Social Performance Criteria

Understanding that impact measurement is imperfect, managers are expected to have an informed opinion on the impact of each security. This opinion should encompass the social characteristics of the issuer, the use of proceeds, and the community:

- **Use of Proceeds**: What is the impact of the specific projects, programs, transactions (in the case of housing), or entities being funded? The intent or stated purpose of the use of proceeds is not a sufficient criterion for selection.
- **The Issuer:** Independent of the specific project, what is the social performance of the issuing enterprise? Heron considers the impact and behavior of the entire enterprise that our capital is financing, not simply the specific project funded by the issuance or a subset thereof.
- **Needs of the Community:** How responsive is the financing to the needs of the specific communities affected? Managers should have an informed opinion on community needs that reflects their best efforts to understand a diverse set of perspectives, including those of underrepresented groups.

The evaluation of social performance on a thematic basis (such as "affordable housing" or "economic development"), without greater consideration of those three variables, is not a sufficient rationale for including a security in the portfolio. For example, green bonds are not assumed to be impactful without considering the social performance of the issuer as an enterprise. In addition, not all "green" projects necessarily have a net positive impact.

Likewise, even well-intentioned projects can have unintended consequences. One common example is how economic development projects can raise the cost of the living and displace low-income renters. For this reason, social performance of the projects or enterprises should be re-assessed throughout the holding period.

Understanding Net Contribution

Heron evaluates each of its investments based on their net contribution to people, place, and planet. Heron seeks partners who are committed to using this lens throughout the process of constructing a portfolio. To learn more about this framework, see the following resources:

- An introduction to the concept on our website (link)
- A case study applying the lens to Property Assessed Clean Energy bonds (link)
- A case study applying the lens to an Arkansas Development Finance Authority bond (link)

This approach to evaluating impact raises difficult questions. Heron simply expects its managers to try to answer these questions in good faith and have a close, ongoing dialogue with the foundation. We do not claim to be experts on the difficult questions raised in evaluating impact holistically. As such, Heron seeks a manager able to form an independent opinion on the impact of investments, yet also remain willing to accommodate feedback loops from Heron's philanthropic partners.

Feedback Loops

One reason Heron invests in fixed income securities is to cultivate feedback loops between capital markets and our philanthropic work. Capital markets are a rich source of knowledge about enterprises, communities, and individuals. For this reason, Heron is particularly interested in innovative projects and/or high-performing issuers with best practices that could be applied elsewhere.

Likewise, what we learn from our philanthropic partners on the ground occasionally informs investment decision making. For example, starting in 2006, Heron started to hear about deteriorating lending standards from our grantees and PRI recipients who were concerned about the financial health of low-income households. Our philanthropic partners in the housing industry noticed that households with poor credit began to qualify for mortgages they would not have previously. Our partners realized that the terms of these newer loans (floating rates in particular) posed a significant risk to these borrowers and, for the same reason, had dramatically different credit characteristics than traditional mortgages. As a result, Heron made mission-driven investment decisions based on that feedback loop. Additional information on how our manager incorporated this information can be found on our website here.

Target Geographies

Heron works in specific places in pursuit of its mission. The manager is expected to stay in contact with Heron to understand what geographies are of particular interest and use good-faith efforts to find mission-aligned investments in places of interest to the foundation. While we still expect geographic diversification, we believe there are significant mission benefits to being genuinely invested in the communities with which we work and in cultivating place-based feedback loops through greater exposure to those locations. The manager maintains discretion on the best way to maintain prudent levels of geographic diversification while also pursuing opportunities in places of interest when they arise.

Moreover, we seek to cultivate rigorous credit analysis of issuances in places we work in order to generate important feedback loops. Managers play a valuable role in helping us pursue our mission by understanding the risk factors for a community and the factors that may impair its ability to access capital markets (e.g., pension liabilities or dependence on a single large employer).

Benchmarks, Liquidity, Quality, Duration, and Diversification

Performance relative to the benchmarks should not be the driving force behind portfolio construction. Managers should determine what is an appropriate amount of risk to take for a desired level of social and financial performance. Divergence from the benchmark in terms of sector exposure, instrument type, liquidity, quality, duration, risk, or return is expected and encouraged to optimize the portfolio for mission performance. At the same time, Heron does not intend to take uncompensated risk in this segment of the portfolio. Managers are expected to use their judgement (in partnership with the foundation) on what levels of risk and return are best suited to help us pursue our mission. In general, the portfolio should reflect the needs of a healthy, balanced local economy.

Use of Cash Alternatives

Managers are expected to use their best efforts to use cash alternatives that exhibit a greater degree of mission-alignment than U.S. Treasuries. Examples of such alternatives may include the following:

- Variable Rate Demand Notes that meet the aforementioned social performance criteria
- Federal Farm Credit Banks Funding Corporation (FFCB) notes and bonds
- Federal Home Loan Bank bonds
- Small Business Administration 504 debentures
- Tennessee Valley Authority bonds

- Department of Housing and Urban Development Section 108 debentures

This list is simply intended to give some potential examples of how managers might manage liquidity without treasuries. As with the rest of the portfolio, managers should use their judgement about what best fits the mission of the foundation.

Mortgage-Backed Securities

When considering mortgage-backed securities, managers are expected to invest in securities backed by mortgages that are affordable and serve low-income borrowers. The characteristics of the specific lending program, issuer, and community are all relevant considerations.

Multi-family housing

At a minimum, multi-family rental housing should be considered insofar as it is likely to significantly reduce the costs of housing for low-income individuals and households in communities that demonstrate a need for quality affordable rental units. Additionally, housing should not be viewed solely through the lens of affordability. A holistic view of affordable housing developments and their community context is critical to understand their impact. For example, relevant considerations include proximity to quality schools and job opportunities, access to transportation, the quality of the units, and how healthy the broader neighborhood is for residents.

Single-family housing

Heron currently does not see significant long-term benefit for low- and moderate-income single-family home owners from most securities backed by the three main government-sponsored housing enterprises. While we are open to changing our opinion based on new information, we currently believe managers can find greater mission returns elsewhere. Specific loan programs that have a demonstrated benefit for underserved borrowers can still be considered.

Small Business Loan Pools

Heron believes small businesses are often important parts of healthy communities and access to capital can be important to their success. In addition to the general criteria above, the manager is expected to have an opinion on (1) whether the specific type of loans in a pool are beneficial to borrowers and (2) what the likely impact of those borrowers is on their stakeholders. For example, when looking at typical Small Business Administration loan pools, this would include looking at loans issued under the 504 and 7a programs (as well as the specific pool being considered) and developing opinions on the impact of these loans on the borrower and on how the borrowers contribute to (or detract from) underserved communities.

Sub-Sovereign Issuers

Securities issued by local governments should consider the performance of the issuer as a whole as well as the needs of the community. Issuers who rate highly on ESG or other social criteria are often located in high-income, healthy places. Heron seeks to invest in responsible, capable, and impactful issuers in underserved places. While Heron invests in a broad range of communities, of particular interest are communities that exhibit the potential to significantly change their mission-related outcomes by efficiently deploying capital raised in public markets.

Economic Development

Securities that finance economic development projects (such as downtown revitalization, industrial development, infrastructure, etc.) may have attractive mission characteristics given the important role they play in communities overall and for low-income people in particular.

However, simply belonging to this category of financing is not a sufficient criterion for inclusion. Projects such as parking garages or stadiums often do little for the stakeholders we care about. Moreover, some economic development projects may in fact harm a community over the long term by undermining the tax base, increasing demands on infrastructure and city services, or by simply failing to deliver the benefits needed to offset the cost of servicing the debt.

To include such securities in the portfolio, managers are expected to have an opinion on why this particular financing is likely to have an outsized impact on the community, as well as how it fits into the overall vision that the community has for itself.

Hospitals, Nonprofits, and Education

Hospitals, nonprofits, and educational institutions are not assumed to be positive net contributors just because of their tax status or stated purpose. These enterprises should be evaluated based on their impact in their communities. Hospitals, nonprofits, and educational institutions all have multi-faceted interactions with the communities as service-providers, economic anchors, employers, customers, and taxpayers.

Information on the social impact of enterprises is always incomplete. Nonetheless, Heron seeks to invest in enterprises that have the highest likelihood of generating a significant, positive impact in underserved communities based on the total mix of available information. Managers are not expected to guarantee the social performance of underlying enterprises but rather use their best efforts to have an informed, defensible opinion behind every investment made on behalf of the foundation.