

Lessons for philanthropy

What philanthropy can learn from the financial information services industry

By Sunand Menon

Introduction

The nonprofit sector is an essential part of our society and our economy. Roughly 1.5 million organizations in the United States account for more than \$1 trillion in economic activity—6 percent of GDP—and employ 11 million people—10 percent of the workforce. And donors of all sizes give approximately \$300 billion annually to more than one million nonprofit organizations—and that’s in the United States alone.

However, there seems to be no clear way to gauge how well these resources are being used. **When it comes to information on how nonprofits perform, there is insufficient transparency, access, quality, and utility.**

It doesn’t have to be this way. If we can collect the right data and create the right analytics, we could pinpoint the highest performers. That will consequently lead to better decision making and more efficient allocation of resources, which ultimately will provide greater value to those in need.

As it happens, the world of philanthropy can learn valuable lessons from an unlikely sector: the financial services industry.

Information in the financial services market

For years now, financial services companies have been successful in collecting, analyzing, and disseminating data, analytics, and research to help investors make better investment decisions.

Large financial information companies such as Thomson Reuters, Bloomberg, and Factset have succeeded in the marketplace by understanding their customers' needs and workflow, and providing solutions that service these needs in three general areas. First, they provide accurate and reliable **data**. Second, they make sense of the data by providing **analytics**. Finally, they provide elegant **access** to the data, via a delivery system and an intuitive interface that a customer finds easy to work on.

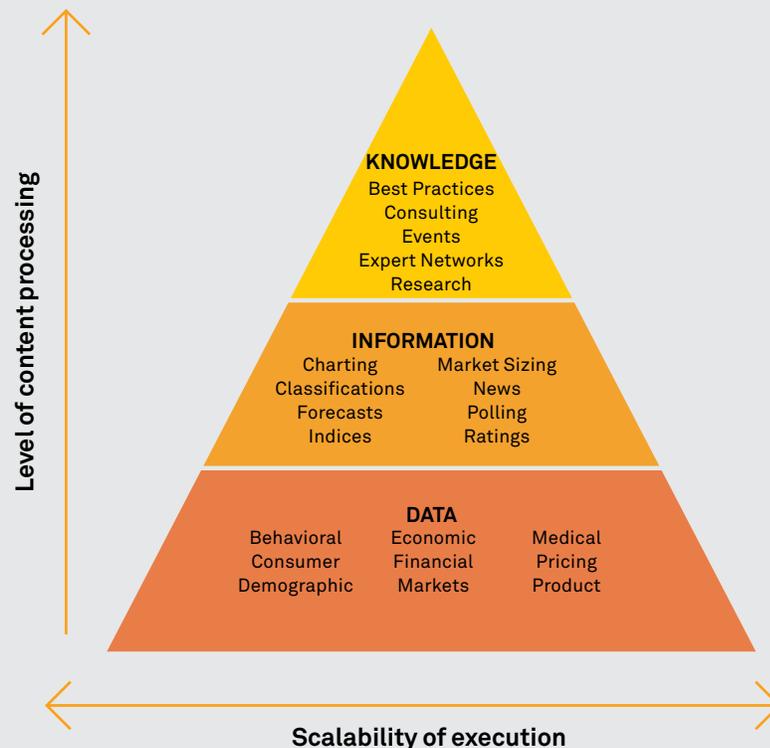
What, then, does the financial services industry have to teach the world of philanthropy? In some ways, the two realms are actually very similar. In both cases, substantial money and other resources flow from “givers.” They are provided to the “takers,” who in turn promise to deliver a “service.” The process is aided by “facilitators” (e.g., Thomson Reuters, Bloomberg, and Factset in financial services; organizations like GuideStar in the nonprofit sector), who have created “tools” that help articulate the value of the service.

But there are differences as well. **The major difference, at least from this vantage, is that the financial services industry possesses clearly defined tools that increase transparency.** Their data, metrics, and analyses help their customer to succeed, whether the customer is a fund manager, a performance analyst, or an investor—capabilities that just aren't there yet in philanthropy.

Here's the thing: **This difference need not exist.** As a close examination of the financial services industry underscores, there is much that the nonprofit world can learn to improve its data collection, analysis, transparency, and effectiveness. And we look to three case studies in financial services to help us develop a vision for informed decision making in philanthropy: the mutual fund ratings system, the financial index system, and the classification system.

From data to knowledge: The KID triangle

Financial information services firms provide a spectrum of services characterized by the KNOWLEDGE-INFORMATION-DATA (KID) triangle.*



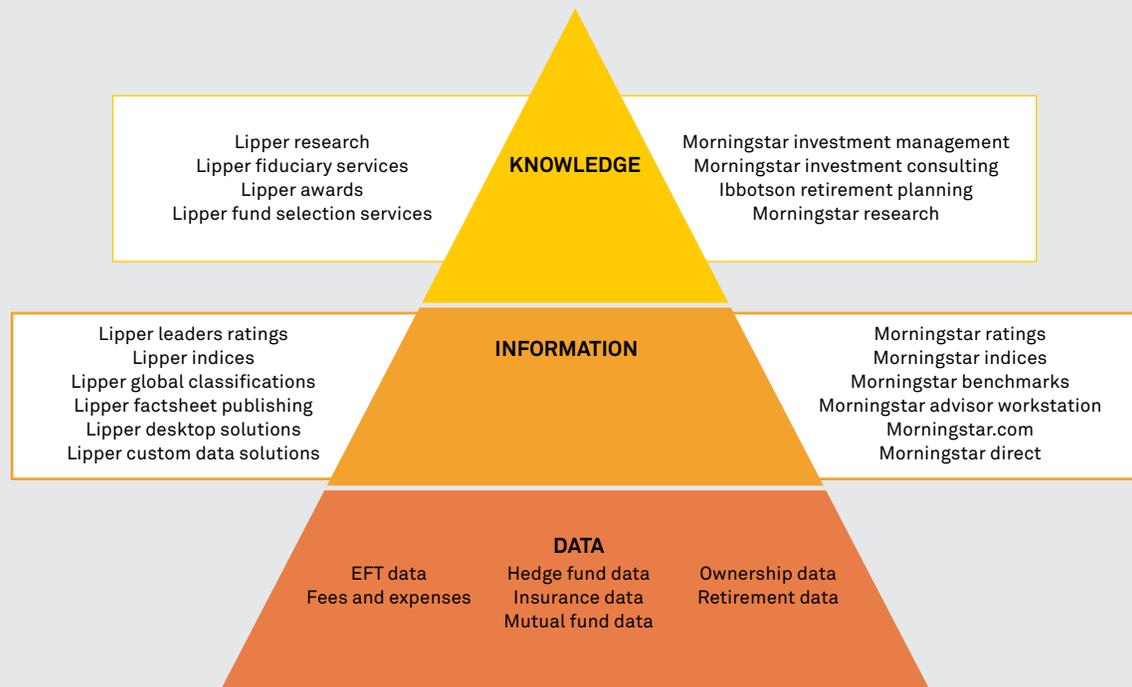
Knowledge—or processed information. Knowledge is generally dependent on some human involvement, which makes it the least scalable part of the content spectrum. It can be the most valuable of all content because it can generate complex insights that are not easily programmed into algorithms. Examples of knowledge content are research reports, best practices, and consulting.

Information—or processed data. This is content that has been derived from data through

various analytical processes. Examples of such content are market sizes, indices, ratings, and polls. Generally, the common link is the use of a standard methodology or mathematical model to generate the derived, value-add content.

Data. The foundation for most content offerings. Examples of types of data collected are product/price/sales information, and financial and markets data. Data is increasingly collected and disseminated automatically and is therefore scalable.

*Adapted from a general information framework proposed by R.L. Ackoff (1989).



KID triangle for Lipper and Morningstar

How do Morningstar and Lipper provide this knowledge? First they both collect similar data (at the bottom of the triangle) either via sophisticated software-based, automated methods or manually. However, they diverge in their Information and Knowledge offerings since they use different analytics and different subjective criteria.

Their data are not perfect, but these firms have shown that it is possible to establish credibility through years of collecting, acquiring, and maintaining data (sometimes manually, sometimes automatically), no matter how opaque it might seem, or how (in)frequently they are able to collect it.

Companies such Morningstar and Lipper (which service the mutual fund industry)

provide their customers content solutions across the KID landscape. A customer—say, an investment manager—has access to research and fundamental analyses; does trend analyses, screening, and peer comparisons; and monitors its success using appropriate classifications, benchmarks, and ratings, which can significantly help the decision-making process.

They have also shown that once they have acquired the data, they are able to create products and services across the whole KID framework—even if there is some level of subjectivity involved (e.g., via research or ratings methodologies). Customers continue to appreciate Lipper and Morningstar for their reliability and freedom from bias, which has helped them build powerful and trusted brands as independent information providers.

Case study: Financial indices

A financial index is a good example of an analytical product that helps investors make more informed investment decisions. It is essentially a statistical measure of the value of a certain portfolio of securities (such as stocks or bonds) that changes depending on the aggregate value of the underlying constituents and their relative weights.

The power of a good index lies in its ability to be a benchmark for the performance of whatever it is tracking. For example, one of the most well known indices in the world is the Standard & Poor's 500 Index, which consists of the largest 500 stocks in the United States in terms of market capitalization. For decades, the S&P500 has been a U.S. benchmark—a proxy for how well the U.S. stock markets are performing. Another example is the Dow Jones Industrial Average, which is a price-weighted index consisting of the 30 largest blue-chip companies in the United States.

Both indices have different methodologies and are rebalanced at different times, and do not fully characterize the whole market. Despite that, the investment community has come together and agreed that these two are the easiest and most recognizable characterizations of the U.S. equity markets. Other indices exist that may be more accurate representations of the overall market, but they have not had much traction and adoption. An example is the Thomson Reuters U.S. Index, a market cap-based index that characterizes 97.5 percent of the total market capitalization of the U.S. stock market by tracking more than 1,600 companies.

What factors contribute to the selection of a particular index as a benchmark?

- Simplicity—Is it easy to understand and track for the institutional and retail investment community?
- Sufficiency—Is it sufficiently tracking the market in question in order for customers to get their jobs done?
- Relevance—Is it correctly capturing the characteristics of the specific industry or geography that it is supposed to track?
- Marketability—Is it marketable to investment management and consulting organizations—the firms that will use and mandate it?
- Productizability—Can it serve as the basis for an investment product (such as an exchange-traded product that tracks the index) or a tradable product (such as a future or option that is based off the index)?

The index industry is an over a billion dollar a year industry, with the larger participants such as MSCI, S&P Dow Jones, and FTSE Russell achieving astounding operating margins (in the range of 40-70 percent) due to the inherent scalability of their subscription and licensing-based revenue model. How have these firms achieved such success?

- **Endorsement by investment consultants** who advise institutions on their investment strategies. They determine what success or failure looks like in terms of performance against established benchmarks and prefer independent, established brands with transparent methodologies.
- **Continual demand for data** by investment managers who have to subscribe to the index data so that they can continually benchmark their own portfolios, perform attribution analyses, and market their success.
- **New opportunities to monetize the data** such as index licensing to create ETFs or other investment vehicles based on existing or custom-built indices. These can be lucrative because the licensing fees are based on a small percentage of the total assets under management of the fund tracking the index.
- **Increasing demand for transparency by the media and individual investor community**, who rely on the movements of the index to understand market trends. Their continued reliance on the index for investing decisions results in increased engagement and adoption—which means more subscriptions and licenses sold to the investment management community.
- **Highly scalable operations capabilities.** The cost to build an index is front-loaded; in the early stages, it is dependent on expertise in the form of research, methodology, and software development, and involves several iterative cycles in order to prototype, test, and approve the index. Once the criteria are achieved in the test phase, the index is put into production and distributed, which is much more automated and therefore scalable.

The factors above have been instrumental in the emergence of a handful of dominant providers who have increased revenues and margins considerably over the years. It is important to note that despite the dominance of larger players, a number of smaller providers have thrived in terms of brand recognition and adoption as a benchmark. Several specialist index providers have created their own brand names due to the credibility of the data that they own, normally because of the relative difficulty to collect the specific datasets. An example is the Credit Suisse Hedge Fund Index (now co-branded with Dow Jones), which over the years has managed to collect data on hedge funds (manager information, performance data), and correlate that to be the most well-known benchmark for the hedge fund industry. Another example of a specialist index is the Cambridge Associates Venture Capital Index, which is seen as the benchmark for the performance of the venture capital industry.

Lessons for philanthropy

It does not have to be the perfect index. Statistically relevant quantitative data is important to characterize an industry, but it does not have to be a perfect dataset. “Good enough” is the mindset for the investment consulting, investment management, and individual investor communities. An S&P500 is good enough to characterize the overall U.S. stock market—one does not necessarily need to have 99 percent of the total market capitalization represented to make it a more trustworthy representation. “Good enough” here means simplicity, sufficiency, relevance, marketability, and “productizability.”

Know who your customer is, but know who their influencer is as well. Marketing to the investment consulting community and the media and general public are key components to gain adoption with investment managers.

It’s all in the marketing and brand recognition. The awareness of the S&P500 as the most well-known stock market index has contributed to the fact that more than \$5.5 trillion of assets are benchmarked against it, and that more than \$1.3 trillion in assets are tracking it in the form of passive mutual fund or ETF products. It helps that S&P also benefits from the strategies of companies such as Vanguard, which believe that index investing delivers better performance versus putting money into an active manager.

Scale DOES matter. Scalability is a competitive advantage, both in terms of speed of delivery as well as cost efficiency. For an index provider, speed of prototyping and speed of delivery affects the top line; an efficient production/delivery cost helps the bottom line.

Long live the niche player—especially if its data is proprietary. There will always be space for the clever niche player that owns its data and is able to profitably monetize it. Credit Suisse’s Hedge Fund Index and Cambridge Associates Venture Capital Index are examples; they thrive on their proprietary data obtained via carefully cultivated relationships and research-based processes. Not scalable, but headline-worthy, and certainly creating a high barrier-to-entry.

Case study: Classification systems in finance

Classification systems aggregate data and organize them into relevant, understandable groups that have as little overlap as possible. In financial services, classification systems characterize companies across various industries. There are three competing methodologies: **GICS (Global Industry Classification Schema)**, jointly developed by Standard & Poor's and MSCI), **ICB (Industry Classification Benchmark)**, established by Dow Jones and FTSE, now managed by FTSE), and **TRBC (Thomson Reuters Business Classification)**, originally developed by Reuters).

GICS is the oldest and most commonly used schema, with widespread recognition throughout the financial services world as a result of its first mover advantage and deep usage across the industry. Interestingly, even though GICS is by far the most widely used schema, there is no unanimity on what the best methodology is. One of the main reasons why they continue to co-exist is that they serve the majority of the investment communities' present needs, since they are not significantly different at the broadest level of segmentation. Their classification rules can be based on a product sold, or on the line of business. For example, does the category Airlines fit under Travel and Leisure, or under Transportation?

On close inspection, GICS appears more granularly segmented. This allows it to classify companies with a greater degree of accuracy. From a practical perspective, however, very few financial services practitioners currently work with segmented categories with such granularity. In fact, in some cases there may not be sufficient constituent companies to populate an overly segmented category; the performance of that category as an index or a barometer for performance may not be statistically significant. As a result, an important aspect of categorization is *practical* relevance. Yes, one *can* segment gold mining from precious metals/minerals mining companies, but *should* they?

Lessons for philanthropy

Don't underestimate the power of the “first mover advantage.” GICS was introduced first and remains the most popular financial classification system. It's the way investment managers, consultants, investment bankers, media, and individuals looked at the world and still look at the world.

Gravitas works. If key influencers band together and endorse a specific mindset, their credibility can be used to sway opinions. A collaboration between “big brand” industry giants MSCI and S&P, working together with all the large banks, helped gain adoption.

“Good enough” is ... exactly that. GICS's two top-level sectors were sufficiently relevant for sector benchmarking and analysis purposes. They won there. GICS subsequently had much more elaborate third- and fourth-level sector segmentations, which were granular but not relevant.

Transparency and scale are valued. As in any information business, in an increasingly data-centric world, the more automated and scalable your capability, the easier and faster you are able to stay on top of things and make changes. Similarly, the more transparent and rules-based your offering, the more trustworthy your content is—or more aptly put: “What you see is what you get.” TRBC is gaining traction (albeit slowly) precisely because of these factors.

Stay relevant. Classification methodologies that are relevant are the ones that will survive. Whether it is based on a combination of revenues and profitability criteria, or something else, if it ultimately does not represent the industry or sector that you are trying to characterize, it will fail. But having the right starting methodology or framework is not enough; it should be flexible enough to constantly adapt. The introduction of a Renewable Energy category is an example of a flexible methodology structure that takes into account the evolving landscape. The offerings that win are the ones that recognize the landscape change and plan for it.

Case study: Mutual fund ratings

There are ratings for practically everything, from TV shows (Nielsen ratings) to movie content age levels (the MPAA's Classification and Rating Administration rating system) to credit ratings for governments and corporations. Mutual fund ratings are an interesting case study for how a rating system might be applied to nonprofit and impact investing. To take two examples, Lipper ratings and Morningstar ratings are essentially a “boiling down” of analyses of the performance of different mutual funds.

Morningstar uses an easily understandable star rating, similar to a hotel quality/service rating. The company rates mutual funds from one to five stars based on how well they've performed in comparison to similar funds. Funds are rated for up to three time periods—3, 5, and 10 years. The top 10 percent of funds receive five stars, the next 22.5 percent four stars, the middle 35 percent three stars, the next 22.5 percent two stars, and the bottom 10 percent receive one star.

The main advantage of such a rating scheme is that it is easy to grasp. The disadvantages are that it may be overly simplistic, and it is a formula based solely on past performance of funds—which is not predictive of future performance. Indeed, the company is quick to point out that the ratings should be used primarily as a tool to research promising funds, and not for recommendations on whether to buy or sell.

Lipper's ratings scheme is also based on quantitative models that analyze funds against clearly measured criteria, but with notable differences from the Morningstar system. Funds are ranked against their peers on five measures: Total Return (i.e., best historical return without considering risk), Consistent Return (i.e., superior consistency and risk-adjusted returns), Preservation (i.e., ability to preserve capital over a variety of markets), Expense (i.e., the annual fees/expenses paid to managers are low), and Tax Efficiency (i.e., success in postponing taxes versus peers). For each of these rating categories, Lipper employs a one-to-five rating. Scores are evaluated monthly and calculated for multiple periods. The overall calculation is based on an equal-weighted average of percentile ranks for each measure over 3-year, 5-year, and 10-year periods.

The advantage of such a ratings measure is the ability to segment, review, and perhaps choose appropriate funds based on one's specific needs—for instance, if one were to prioritize tax efficiency, Lipper ratings would be very useful. The disadvantage is that it is not as easy to grasp as an overall 5-star Morningstar rating, and it is still a calculation based on past performance, which may not be a predictor of future returns.

Both these ratings mechanisms are very powerful. Morningstar and Lipper have invested in building their brand awareness, and have worked especially well with the media. The investment community and the public in general have embraced these ratings, presumably under the premise that “something is better than nothing.”

The successful adoption of these ratings is particularly visible in the media, where it is routine to advertise the performance of a particular fund by its Morningstar or Lipper rating. The asset management community has noted the power of a rating in order to generate fund inflows from individual and institutional investors. Typically the rating will pique investors' curiosity and spur them on to research the fund, and many subsequently may invest into the fund. Both the investment management firms and the investors benefit (as long as the funds continue performing), and so do the information providers, since investment firms will continue to subscribe to Lipper and Morningstar in order to extract data that demonstrate their funds' outperformance against peer groups.

In summary, Morningstar and Lipper are good examples of organizations that have been able to profitably collect a dataset, process it and provide some level of insight (in this case ratings) that can help investors in their investment process, and help investment managers market their products and services better. They have developed visible ratings systems that are well adopted and part of the customers' workflow.

Lessons for philanthropy

Keep it simple. Part of the allure of a ratings schema is the assumption that simplicity leads to understanding, which in turn leads to adoption and retention by an industry. It isn't ratings per se that consumers seek, but the simplicity and clarity that they promise. A ratings scheme may ultimately be too simplistic to represent nonprofits accurately, but the nonprofit world should pay heed to its appeal to the public.

Help the customer make a decision. Simplicity in itself is not helpful if it does not give an appropriate answer to a question—in this case, “Which fund should I look into and invest in?” By assigning transparent rules and segmenting the funds in a consistent and relevant manner, the ratings provider helps the user navigate through the funds universe with greater ease, and narrow down their analyses further. For example, if a retiree is looking to invest in a conservative fund, they will be able to look at Lipper's ratings for all funds that are classified as “capital preservation funds,” and select or research an appropriate fund.

There need not be only one. Ratings offerings in the financial services industry are characterized by multiple ratings companies (usually dominated by two to three well-branded organizations). Much like research, it is part art, part science, part objective, and part subjective. As a result, there is yet to be one defining ratings brand. As the level of information ambiguity rises, so must the number of alternate opinions solicited in order to make a decision. Why? In the absence of absolute data, aggregation of information from multiple sources allows for understanding which views are common and which views are divergent, thereby giving room for further analysis by the user to come to their own conclusion.

Market, educate, adopt. It's one thing to build a usable rating system, it's another thing to have customers adopt it and tailor their daily workflows around it. Companies have made it a strategic priority to invest in marketing programs and client education that ultimately lead to adoption.

Summary

In some ways, the financial services industry and the nonprofit world are very similar. Substantial money and other resources flow from “givers.” They are provided to the “takers,” who in turn promise to deliver a “service.” The process is aided by “facilitators” who have created “tools” that help articulate the value of the service.

A major difference between the two worlds, however, is that the financial services industry possesses clearly defined tools that increase transparency. Their data, metrics, and analyses help their customers succeed, whether the customer is a fund manager, a performance analyst, or an investor.

This difference need not exist. Many of the systems and processes that are readily available and taken for granted in financial services can also be implemented in the nonprofit world. In fact, the financial information services industry of today provides a snapshot of what the future nonprofit information sector could look like. Companies such as Thomson Reuters, Bloomberg, Factset, Morningstar, and Lipper have thrived by collecting data (no matter how opaque or infrequent), developing performance criteria that help make sense of the data, and distributing it in a manner that allows for better decision making. They achieved this success by investing in high-quality, scalable operations, and by building brands that signify independence, accuracy, and reliability.

Interestingly, they have all co-existed while developing different types of performance metrics, some of which are more accepted than others. Lipper and Morningstar use different fund ratings criteria; S&P and Thomson Reuters advocate different data classification schemas.

There is rarely one universally agreed-upon criterion. As long as the metrics are simple and generally representative; as long as they are being used and are helpful to the customer; and as long as they are initially endorsed by a few key players in order to gain traction, they can succeed.

These are valuable lessons that can help make the nonprofit world more performance oriented and effective in the future. The solutions do not have to be perfect; they just have to be good enough to ensure that the end user is able to access and make use of the raw data and transform it to actionable, informed decisions.

About the author

Sunand Menon has spent the past two decades incubating and scaling data and analytics businesses across multiple sectors. He currently serves on the board of Candid.

He was the founder and Managing Director of Thomson Reuters Indices, and was responsible for the rollout of Thomson Reuters Business Classification. Previously, he also served as Global Head of Business Development at Lipper, where he spearheaded its growth across the Knowledge, Information, and Data sectors.

© 2020, Candid.

This work is made available under the terms of the Creative Commons Attribution-NonCommercial 4.0 International License.

creativecommons.org/licenses/by-nc/4.0

doi.org/dkcr