

THE INVESTMENT MONTHLY

THOSE WHO ASK NO QUESTIONS

Canada's philanthropic sector is like an asset management industry that pays out annual dividends.

Of course we think of foundations differently but from a governance and management perspective this is what they are.

Many foundations have investment committees that watch managers and watch the market.

The focus is mostly on returns, rarely on risk, and few ask the big questions: what return can we expect and what risk can we afford to take?

DO YOU KNOW WHAT YOUR INVESTMENT COMMITTEE IS DOING?

While primarily a charity, a foundation trust is a charitable organization that also holds assets, from which cash flows to support the foundation's granting activities. The principal objective is charitable activity, but foundations and their boards should understand that the foundation has a non-trivial financial subsidiary sitting in the heart of its operations. Assets have to be managed.

The foundation creates annual liabilities that extend indefinitely, and it is expected to exist in perpetuity. Foundations that own assets should be able to take significant investment risk to meet their infinite-life liabilities. But before the rubber of investing hits the road, foundations need a governance process, an investment policy statement, and once that's done an agent to manage the assets for them.

Who does what?

The Board delegates authority for asset management to an investment committee, which is charged with governance of the assets and oversight of the investment management process. The investment committee must issue an investment policy statement to define how the assets are to be managed.

Sitting at the core to the investment policy statement are two key parameters: setting the asset return target, or the hurdle rate, and the risk of loss the foundation is willing and able to bear. Many investors do not fully appreciate the need to put the expected risk of an investment on an equal footing to the expected return.

Sound investment management requires the foundation to state the risk it is willing to take; the investment committee must balance its desired return with the foundation's ability to remain a going concern.

While the investment committee is responsible for the assets, and defines the investment management parameters, a committee focused on governance and fiduciary matters hands day-to-day management to

professional manager. The committee then has oversight over the chosen manager and so it needs to know what it wants the manager to do, and then what to look for to make sure the manager is doing what it is supposed to. Not all foundations have the asset left to choose an OCIO, and their challenges are to discharge governance and fiduciary duties and manage the assets. More on this in another letter.

Setting the hurdle rate

Focusing solely for a second on asset-based financing, the foundation must meet a minimum annual rate of return to do all the things it wants to do. First, it wants to distribute grants, and as tax-exempt entities the Canadian Revenue Agency sets a minimum annual distribution of 3.5% of assets. Second, the foundation needs to cover the administrative costs of the organization, say 0.5%. Also, it would like to grow the assets over time for another 1.0% of return, and finally it wants to protect the purchasing power of the foundation from inflation so that one generation of recipients is not favoured at the expense of another and that's 2.0%.

This all adds up to 7.0% per year which is, well, very high and meeting that return implies the foundation will have to take quite a lot of investment risk.

Consider that the returns on risk free assets are very low. The yield on a three-month T-Bill is about 9 basis points, or less than one-tenth of 1.0%. Moreover, a thirty-year government of Canada bond yields just 1.17%. It takes thirty-years to earn an additional 66 cents on each dollar. Alternatively, to attain a 7% return on risky assets would take just 7 ½ years for the same return. So how much risk is there in risky assets?

A day at the fairground



Before we can answer that question, we must first ask: "What do we mean by risk?"

At the fairground, two rides reflect an investor's likely risk-reward experience. The roller coaster and the drop of doom. The roller coaster provides the thrill of ascent and

descent. It's like going up the escalator and down the elevator many times in a row. Riding the drop of doom leads one to experience a slow-ride up that is instantaneously overwhelmed by a sudden descent – once. It's all over before you realize it.

Many of us have been sold on the idea that risk is measured by a variability around an average annual return – the roller coaster. But to



experience risk is really to ride the drop of doom.

Warren Buffet's first rule of investing is don't lose money. His second rule is don't forget rule number one. Buffet is defining investment risk as risk-of-loss. And as an investor, once you lock-in a loss, that capital is likely gone forever. You are unlikely to ever get it

back. It's best not to ride the drop of doom.

Short-term Losses get lots of attention

Since 1957, the S&P500 has experienced ten "drawdowns" defined as the decline from the most recent peak to the recent trough. The most serious decline was during the 2008-09 great financial crisis of about 57%.

Now, a market decline isn't a loss unless you sell assets at the lower price, but by marking your assets to market you know what you'd get for them if your risk policy compelled you to sell. And this can happen if you are not careful.

If, for example, your maximum portfolio loss tolerance was 30% and a steep market decline led to a 40% loss, then compliance demands you sell assets to stem any further loss at likely the worst possible time. And, once you have sold your risky assets, what if the market starts to rally? You are then faced with the agonizing decision on when to re-enter the market just as you have been traumatized by loss.

At a time like this, volatility of return can easily deliver a crystalized loss. This is an emotional roller-coaster best avoided. A competent investment manager should create a portfolio of asset and investment style exposure that maximizes the probability that you meet the required return for the stated risk-loss tolerance. The manager should be able to do this by capturing a diversification benefit, where the manager reduces risk proportionately more than any reduction in return that comes as a result of putting your investment eggs in different baskets.

Setting your maximum loss threshold is one of the most important sections in your investment policy statement. Even if the expected diversification benefit fails to protect against exceeding the risk-loss threshold, remember that a foundation with an infinite expected life doesn't need to liquidate at its maximum loss threshold. It has the investment horizon to wait it out.

That said, short-term losses tend to get a lot of attention. But to be able to tough-it-out through a severe market drawdown, you need an investment plan, and a liquidity policy that leads to a liquidity plan.

Don't be insolvent because you are illiquid

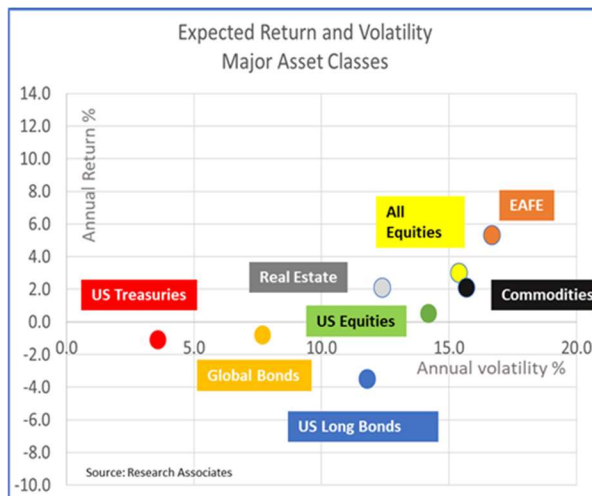
A foundation wants to have cash on hand at all times, if only to pay its bills. While the investment horizon should be much longer than a year, short-term losses and underperformance put the spotlight on the competency of the investment committee and the performance of its investment manager.

A severe drawdown can create just as many opportunities to capture higher expected returns as it creates management problems. After a major market event, you need to be able to rebalance your asset mix towards the asset with the highest expected return.

In order to avoid selling assets at the bottom of the market, its best to have some cash on hand to do your rebalancing, cover your costs, and continue to disburse grants. Moreover, foundations are increasingly exposed to illiquid alternatives to meet their return needs, which demands you need more cash on hand than if you owned just stocks and bonds.

It's a tough world out there

Risk-free interest rates are either very close to zero or are even blow zero in some countries. For foundations to come anywhere close to the 7.0% returns they need to be a going concern, to be in compliance with tax regulations, and to protect against inflation, they must take eye-watering amounts of risk.



As figures 1 and 2 here show, the expected returns across a broad array of asset classes have expected returns that are far lower than the historical averages.

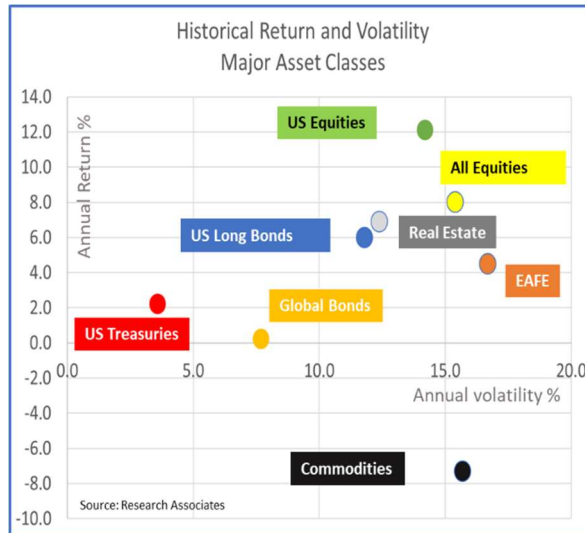
But, notice that the risk as measured by

the volatility of returns remains the same.

In other words, you are taking the same risk today as you did ten years ago, but with much lower returns.

How much to spend depends on how much you can spend

Much is written about choosing the right disbursement rate given uncertain future asset values. While this is an important decision, so are the decisions about how much risk to take, and how to take it. Spending decisions must be integrated into a comprehensive asset management approach.



The investment committee should talk as much about risk and liquidity as it does about returns and investment choice. After all, you don't want to reduce the dollar value of your grants because of poor asset performance, or because you were

taking more risk than you thought because the diversification benefit wasn't there.

As we move through the next ten years, and the world begins to normalize after a traumatic health and economic experience through the pandemic, scaling and managing risk, and providing for liquidity, will be crucial to your foundation's investment success.

Lest you keep your investment committee up at night, you should require them to watch these three key triggers when they monitor their managers.

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