

THE INVESTMENT MONTHLY

BIRDS OF A FEATHER

Canada has \$100 bn under management across its public and private foundations.

But only a few have assets in excess of \$1bn.

A large asset base is thinly spread over many foundations meaning fewer investment opportunities...

Are accessed at higher cost limiting outcomes.

Establishing a foundation pooling entity would expand investment opportunities for lower costs.

Its time has come.

FOUNDATIONS AND POOLING: TAKING A STEP TOWARDS INSTITUTIONAL STATUS

Assets are plentiful but thinly distributed

There are many public and private foundations in Canada managing assets close to \$100bn. Yet there are only a handful of foundations that have assets exceeding \$1bn. Most foundations use high-cost investment counsels, advisors and investment managers to steward their assets, and many also use investment consultants to identify managers and execute due diligence before handing oversight to the foundation as fiduciary. Often the resulting returns are a matter more of luck than skill, so where do all the fees go? Before we address that issue, let's look at the overall foundation model.

The foundation model has been around for a long time, and accumulates assets that are then invested in financial markets and real property to generate an annual return. The foundation takes those annual returns and distributes the dollars they create to sponsor the charitable activities of its choice, preserving its capital.

Choosing the distribution rate, or budgeting the dollars spent each year, is a significant challenge as investment returns are not equally distributed between years. Some years witness strong returns which raises the temptation to increase grants, only to face grant reductions in the lean years to maintain the capital value.

What is the minimum amount a foundation needs to earn annually to achieve all of its goals? First, CRA requires a minimum distribution of 3.5% a year to minimize the tax cost of potential tax avoidance. Next the foundation will want to preserve the value of its grants in the face of 2.0% inflation every year. Finally, the foundation has to earn its expenses, which are usually trivial relative to the asset base, and finally it will likely aspire to grow the value of the assets net of donations by at least 1% per year.

When you add it all up the foundation needs to earn about 7.0% a year on its assets. Some foundations have pledged to distribute a minimum of 5% a year, raising the annual return target to 8.5%.

Making 7.0% or 8.5% a year was no great challenge in 1985, when the risk-free rate of return from a three-month Government of Canada T-Bill was about 9%. But, earning 7.0% to 8.5% today means the foundation has to take a significant amount of risk to get there: by comparison, today's three-month T-Bill yields just 9 basis points. Even a ten-year bond yields just 1.5% so anything above that means taking much bigger risk of loss than is generally appreciated or warranted.

The crucial questions to ask in the face of such a high required return for many foundations compared to the risk-free rate is how much risk are you taking, and is that risk consistent with your tolerance for loss? Moreover, how does the investment manager ensure that the risk is acknowledged and managed consistent with their fee?

What Route Do You Take?

Most foundations do not manage the investments themselves, rather they discharge their fiduciary responsibility. They define investment beliefs, set investment goals, and choose the investment advisors and managers they want to manage their assets. In a separate article we will examine the role of the board and its fiduciary responsibilities, dividing-up who does what for optimal results, but the board and the investment committee should be charged with setting strategy, ensuring it gets executed, and then monitoring performance.

Often, the investment counsel, investment advisors, and investment managers deliver little more than public market returns for a relatively high fee. The investment returns they source are available to most investors from low fee ETFs, free of the adviser levy. How you choose, and which manager you choose, matters a lot.

That said, some investment counsels and advisors do a reasonable job of generating returns, but what is missing from the ongoing conversations between the managers and the foundation is the risk the managers are taking on the foundation's behalf. Showing annual returns and the distribution of those returns about an average does not constitute a wholesome discussion about risk.

Standard deviation of returns is not quite the same thing as risk of loss.

Moreover, any attempt by advisers and counsels to allocate to alternative assets seeking higher returns in exchange for tying-up capital for an extended period, does little more than access the same risk of loss you get in public markets while paying-away most of the return pick-up in higher fees. Avoiding daily mark-to-market valuations doesn't get rid of the risk. It might avoid the odd rainy day along the way, but it can equally save the rain up for one torrential downpour when one is expecting a sunny day when your fund matures.

Institutional Investors

Some foundations are big enough to be considered an institutional investor, and so could access low-fee professional services. Institutional investors are professional asset managers who take investment decisions on behalf of the capital owner that the capital owner would neither know to take, nor would have the capacity to execute those decisions even if they knew what decision to take.

Some storied names are known to many of us as institutional investors, Ontario Teachers Pension Plan is the prime example. IT is also well known that these investors are sophisticated, and invest across the world, across many different assets and investment strategies at relatively low cost for a known risk tolerance.

Yet many more foundations do not have the asset weight to be considered institutional investors, and so pay too much for investment services and do not get full access to all potential investment avenues. In a survey of its 112 members, the Philanthropic Foundations of Canada found that just 10% of them had assets in excess of \$200 million. This means that the ability to access professional investment management expertise and duplicate the investment experience of an institutional investor at a reasonable cost is out of reach.

Indeed, some of the larger foundations have chosen to place their assets with an Outsourced Chief Investment Officer, or an OCIO and this delivers a measure of the institutional investor experience. The bigger foundations have more resources and time to spend on governance and investment strategy, and can rely on well qualified professionals to execute investments, taking the

pressure of well intentioned but less professional volunteers to oversee investment management.

What can we do for the smaller foundations to level the playing field?

Many Hands Make Light Work

In Canada and across the world, the benefits of investment pooling are well recognized, and this is especially evident in the Canadian pension space. Canada's top seven pension plans manage 50% of the assets of the top 100 pension funds. These large institutional investors are some of the most sophisticated investment managers in the world, and they have access to many different markets, assets, and strategies allowing them to meet their investment goals often for much lower risk than is achievable with smaller scale, and at much lower cost. Every basis point of cost saved is a basis point of extra return.

The smaller pension plans attempt to replicate the investment experience of the bigger plans by pooling their assets. Here the assets are given over to a single large asset manager who act on behalf of more than one single plan.

Asset pooling achieves economies of scale, lowering operational and investment costs relative to that which a small foundation can achieve on its own; it delivers a critical resource mass to maximize operational competence and efficiency, facilitating cheaper outsourcing of investment activity.

Lower costs come from using one consultant in investment manager search, and one agent executing due diligence. Pooling opens the door to institutional investor fee schedules which are substantially lower than the high fees charged by retail providers and advisors.

Pooling foundation assets under one management roof would achieve a number of beneficial features, namely that the pooling entity could face an OCIO with a critical mass of assets. The OCIO, if carefully chosen, would present operational support beyond the capability of individual foundations and smaller investment organizations. Given the high cost of the IT infrastructure necessary for even the smallest of foundations to deliver investment reporting, this is a major advantage. Accurate risk calibration and manager monitoring are done as a matter of course. Finally, on top of all this the OCIO provides the cash

management and treasury functions that the foundation might once have done for itself.

Put Pooling on the Table

What is left for the foundation to do? In a pooled structure, the pooling entity would likely take the place of the foundation's investment committee. Here the pooling frees-up foundation resources to ensure that the oversight board of the pooled entity is comprised of professionals who can avoid agency capture, and are able to understand complex financial, actuarial, investment and risk challenges ensuring the agent's fiduciary duty is well executed.

Ownership of foundation granting rates, required return hurdles, and risk tolerance rests with the foundation's board. Only oversight of the investment activity of the OCIO is given to the pooled entity, ensuring that the rules of the road are given to the OCIO so that they can complete the return journey safely and effectively.

If the OCIO is given the right parameters and sufficient field on which to play the game, then they can deliver the required investment returns at the lowest possible cost raising the probability that the foundation can preserve its capital and meet its granting objectives all for an acceptable level of risk.

Many hands make light – and in this case – good work.

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