Investment Policies for Foundations

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Introduction

A recent article carried the alarming headline "Ford Foundation may be forced to cut grants by 50 per cent". The Ford Foundation, squeezed like most private philanthropies by falling stock and bond markets, has seen its assets plummet from $3 billion to $2 billion in market value over the past year. Mounting inflation has increased costs, yet the real investment income of the Foundation has declined.

The plight of the Ford Foundation, the world's largest foundation, is currently shared by many Canadian charitable organizations. The growing crisis over the ability of endowed foundations to maintain their philanthropic activities highlights the importance to these organzations of "Investment policy". Clearly, a foundation's effectiveness is limited by the money it has available to spend. This article is addressed to those charitable organizations having principal funds of their own requiring investment management. Little attention is paid to the large number of foundations that serve as instruments for the current giving of persons, families and businesses, as such foundations ordinarily maintain only a working balance of assets, to be drawn down as charitable gifts are made, and replenished by the donors as circumstances permit. Investment policy for such foundations ordinarily consists of investing temporary balances in short-term interest bearing obligations. Investment income as such supports only an insignificant portion of such a foundation's program.

Charitable Foundations in Canada

It is estimated that in Canada there are more than 1,400 charitable foundations ranging in origin, size, nature and purpose from those with a few thousand dollars in assets to the giant of Canada's foundations the J. W. McConnell Foundation, founded in 1937 and ranked amongst the twenty-five largest in the world. All of these variables have a significant impact on the investment policies of the individual foundations.

While the investment portfolio mix of foundations is influenced by the nature and timing of their establishment, as well as by their cash needs, most Canadian endowments have relatively conservative investment portfolios. The Atkinson Charitable Foundation, for example, in its latest annual report (December 31, 1973) had close to 83% of its portfolio in bonds. The J. P. Bickell Foundation had porportionally greater holdings of equity securities, but still over 54% of its portfolio was in bonds. In a survey conducted in 1967, the endowment fund of the University of Toronto was listed as having the most conservative portfolio composition of major North American university funds. At that time 82% of its funds were in bonds and preferred stock, 16% in common stock, and 2% in other investments.**

* *Both of Ernst & Ernst, Chartered Accountants, Toronto*

** *See Frederick Amling,* Investments, *2nd ed., Prentice Hall, 1970, p. 749.*

Despite some change in the pattern in the late sixties, Canadian foundation portfolios have tended to ignore trading as a source of income. Few Canadian foundations embraced to any extent the U.S. shift to equity trading gains as an "inflation hedge" source of income. In the short run, this debt-oriented caution has helped limit severe portfolio losses, and in some cases recent high interest rates have netted portfolios their highest yields ever. Nevertheless portfolio market values of many debt instruments have also plumetted, and continual demands for operational funding have outstripped the ability of most foundations to service their needs from income alone.

Although to our knowledge there have been no specific studies of the investment performance of Canadian foundations, similar studies in the United States have indicated their foundation investment performance is substantially lower than the investment performance of balanced mutual and pension funds. *Among investment experts there is general agreement that returns on foundation assets tend to be significantly lower than on other types of professionally managed funds.

While there is a general feeling that the investment performance of foundations could be improved, one must keep in mind the statutory constraints and other investment determinants that set foundations apart from other investment pools. These are discussed in the following sections.

Statutory Considerations

The Income Tax Act has prescribed the form of entity assumed by charitable foundations. There are three kinds of entities defined under Section 149 of the Act. They are: the Charitable Organization defined in Section 149(1)(f); the Non-Profit Corporation defined in Section 149(1)(g); and the Charitable Trust defined in paragraph 149(1)(h).

To be granted exemption from tax, these entities must comply with certain prescribed conditions.

Charitable Organizations

Charitable Organizations can be either incorporated or not, but it is essential that *all* of the resources of the Organization be devoted to charitable activities which it carries on itself.** A Charitable Organization as defined in the Act is an "operating" charity, that is, it must carry on direct charitable activities of its own. Non-Profit Corporations and Charitable Trusts, on the other hand, may carry on direct charitable activities or may act as "conduits", receiving donations and passing them on to other active charities.

Religious and educational institutions are generally considered to be Charitable Organizations.

**See Ford Foundation's publication, "Managing Educational Endowments".*

***Note: An interpretation of the requirement that all the resources of a Charitable Organization be devoted to charitable activities might preclude the carrying on of a business, even if the income from this business is devoted to charitable activities.*

Non-Profit Corporations

Non-Profit Corporations must be constituted exclusively for charitable purposes and must not "carry on any business" in order to be exempted from taxation. The meaning of the term "business" is not completely clear in this context in that it is debatable as to whether it would include an inactive business or an "adventure in the nature of trade". The Act does state, however, that the Non-Profit Corporation may not, after June 1, 1950, have acquired control of any other corporation.

It should be noted that a corporation is *not* deemed to have acquired control of a corporation if it has not purchased or otherwise acquired for a consideration any of the shares in the capital stock of that corporation. Thus if a corporation subsequent to June 1, 1950, as a result of gift or gifts of shares acquires control of another corporation, then, provided it has not purchased or otherwise acquired for a consideration any of those shares subsequent to June 1, 1950, it will still be eligible for exemption from tax.

Also, the Non-Profit Corporation must have no debts which were incurred after June 1, 1950, other than obligations arising in respect of salaries, rents or other current operating expenses. This prevents any borrowing for investment purposes. For example, the corporation could not give back a mortgage on a property. This prohibition against incurring debts also applies to Charitable Trusts, but does not apply to Charitable Organizations.

A final major investment constraint on Non-Profit Corporations is the requirement that the corporation must have expended (unless prior to 1940 it was constituted exclusively for charitable purposes) in the aggregate, 90% of "the corporation's income for the year":

(a) on charitable activities carried on by the corporation itself;

(b) on gifts to exempt Charitable Organizations in Canada;

(c) on gifts to other resident exempt Non-Profit Corporations;

(d) on gifts to the governments of Canada, or a province, or a Canadian municipality; or

(e) in any combination of the ways specified in (a), (b), (c) and (d).

Note that gifts to Charitable Trusts are *not* included in the list of permissible expenditures set out above.

The Income Tax Act provides that there shall be included in computing income all gifts received by the corporation with certain exceptions. Gifts *not* to be included in the corporation's income include gifts received subject to a trust or direction that they or property substituted therefor are to be held permanently by the corporation for the purpose of gaining or producing income. These are discussed further below.

A second type of gift which is not to be included in a corporation's income is a gift from a donor who has not obtained a deduction therefor under Section 110(1)(a). A gift from a donor who was not taxable under Part I for the taxation year in question is also exempt from inclusion in income. Also, the Act provides that taxable gains are not to be included in the determination of whether the charity utilized 90% of its income in the prescribed manner.

Section 149(9) and (10) allow for the building up of a reserve in the case of a Non-Profit Corporation. The effect of these provisions is that the corporation may accumulate a type of reserve in an amount equal to its income for the preceding year. In addition, of course, all or any part of the 10% not required to be expended each year may be accumulated. Also any reserves accumulated prior to 1950 can be used as a discretionary funds pool.

Charitable Trusts

The restrictions placed on Charitable Trusts are basically the same as those outlined above for Non-Profit Corporations. The property of the Trust must be "held absolutely in trust for charitable purposes"; the Trust cannot have acquired control of any corporation since June 1, 1950; the Trust cannot carry on any business; the Trust must have no debts incurred since June 1, 1950; and at least 90% of the income of the Trust must be expended. In the case of the 90% expenditure requirement, a minor difference exists between Non-Profit Corporations and Charitable Trusts. Unlike Non-Profit Corporations, the Trust cannot satisfy the 90% rule by giving funds to various levels of government (option (d) above). The income of the Trust must be expended in one or more of the ways set out in (a), (b) and (c) above. Also, in the budget measures presented on November 18, 1974 there is a provision that for the purposes of Section 82(1)(b) of the Income Tax Act, a Charitable Trust shall be deemed not to be an individual. This treatment would thus exclude from income of a Trust the ⅓ gross up of taxable dividends received from Canadian Corporations. In summary, there are many restrictions applicable to Non-Profit Corporations and Charitable Trusts. Charitable Organizations, on the other hand, can carry on businesses (subject to the requirement that they devote all their resources to charitable activities and subject to provincial legislative restraints as noted below), can incur debts and can purchase control of corporations. A Charitable Organization, however, cannot act as a conduit for other charities. It must carry out its own charitable activities. Also, there is no provision for building up a reserve of income in a Charitable Organization; all of the resources of the Charitable Organization must be devoted to charitable activities in the year.

All three types of charities may receive permanent capital. As noted earlier, Section 149(7)(b) of the Income Tax Act provides that all gifts are included in the charity's income other than:

> "a gift received subject to a trust of direction that the property given, or property substituted therefor, is to be held permanently by the corporation or trust for the purpose of gaining or producing income therefrom".

If a gift is made, however, subject to a condition that it is to be held for a stated period for the purpose of earning income and that thereafter the corporation may encroach on the corpus, the value of the gift would be included in the corporation's income in the year when the gift was originally made.

Once such permanent capital has been donated to a charity, the charity has control over what will be done with the gift. Unlike the case with other tax sheltered funds (such as RRSP's), there are no statutory restrictions in the Income Tax Act at the present time on the type of investments that can be made by charities. In terms of federal regulation, subject only to the prohibitions against carrying on a business and other indirect constraints as noted above, a charity can make essentially any investment that it wishes. However, there are certain provincial restrictions that must also be considered.

Investment Determinants

In addition to statutory considerations there are a number of other determinants affecting the investment performance of charitable foundations. Among these are the nature and terms of the initial endowment, the cash requirements and funds flow of the foundation, the size of the endowment, and the social aims of the charity.

Provincial Legislation

A review of the Ontario legislation may demonstrate the relevance of provincial constraints. The Ontario Mortmain and Charitable Uses Act deals with the holding of land by charities. Land may be given to a charity. However, if the charity does not require the land for actual operation for the purposes of the charity, the land must be disposed of within two years. Thus, charities in Ontario cannot hold land as an investment for an indefinite period of time.

The Ontario Charitable Gifts Act deals with the ownership of an interest in a business by a charity. The Act provides that a charity cannot own directly or through the ownership of shares of another corporation more than a 10% interest in a business that is carried on for gain or profit. This provision does not apply to an interest in a business given to or vested in any organization of any religious denomination. There is a seven-year period within which the excess interest must be disposed of. This provision, too, introduces a significant constraint on the investment alternatives of charities.

Nature And Terms of Endowment

In many cases, charitable foundations are established with an initial endowment in the form of assets that the donor has held for some time. These holdings are most frequently the securities of companies in which the donor was active and through which he built his fortune. Seldom is a diversified portfolio of investments transferred to a foundation.

This lack of control over the composition of the initial endowment may affect future investment patterns. As noted above, the Ontario Charitable Gifts Act requires that any interest in a business gifted to the charity in excess of 10% must be disposed of by the charity within seven years. Thus, in many cases, a significant portion of the initial endowment will be liquidated in the early years of the foundation's operation. This compulsory divestiture may not lead to the substitution of a more balanced portfolio because the timing and magnitude of the divestitures may not correspond to the market availability of desired investments.

The terms and provisions attached to the initial endowment may have an effect upon investment patterns as well. Most commonly, the requirement is merely that the trustees select "such securities as are legal and proper for trust estates" in their jurisdiction. There are exceptions to this blanket authority, however, and these exceptions may impose restrictions on the investment alternatives for the foundation.

The investment opportunities facing a foundation will also be affected by the attitude and approach of the members of its governing body. In the past, many foundations have been directed by extremely cautious and conservative trustees. Many such trustees felt obligated to resist change in the portfolio management of the foundation because of their interpretation of the "prudent man" rule. This "rule" was defined by Justice Samuel Putnam in an 1830 decision as follows:

> "All that can be required of a trustee is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds".*

Cash Requirements Of The Foundation

The investment policies of a foundation must be closely integrated and coordinated with its operational requirements. Foundation endowments generally require not only the assurance of a reasonable regular income, but in many cases the capacity to meet grant payments in excess of income. This need for liquidity imposes certain investment constraints on some foundations.

Size Of The Endowment

The size of the endowment fund can also have a significant influence on the investment policies of the charitable foundation. The high fixed costs involved limit the availability of professional management to funds large enough to justify these fees. Similarly the capacity to diversify depends to a great extent on the amount of capital available. The growing utilization of pooled investment vehicles in recent years has helped reduce these limitations.

Impact Of Social Aims

In recent times the doctrine that foundation investing should be guided by some of the same social concerns as foundation grant-making has been finding growing acceptance.

To date the major thrust in this area has been the use or the threat of use of their proxies by philanthropies to support shareholder resolutions being sponsored by public interest groups.

A second focus of a social investment policy involves the effort on the part of some foundations to devote part of their endowments to program-related investments (PRI's) in enterprises which directly advance the foundations' philanthropic goals. Despite the involvement of some major U.S. foundations

* *Charles D. Ellis,* Institutional Investing, *Dow Jones-Irwin Inc., New York, 1971, p. 194.*

(e.g., Ford) program-related investments remain a controversial approach. One strong argument against such investments is the inability of foundation management to judge the viability of such projects. Most PRI's are basically venture capital-type undertakings. The various restrictions in most jurisdictions precluding the acquisition of control of a business enterprise create difficulties to this approach as well. Perhaps pooled investments by charities would help overcome the above problems. However, the difficulty of locating investment opportunities that relate to the philanthropic objectives of the foundations still remains.

A Comprehensive Investment Policy — The Key to Improved Performance

Charles Ellis summarized the importance of adopting a comprehensive or systems approach to the financial management of foundations as follows:

> "Perhaps the most valuable result of a systems analysis of an institution's finances will be a clearer focus on the opportunity and the need to make endowment capital more productive; to make it catch up to the need for increasing spendable funds; to use endowment capital not as an insurance reserve, but as the vital equity capital of the institution; to make the endowment fundamentally progressive and oriented to achievement rather than defensive and passive as has been the case all too often in the past".*

While it is recognized that the continual demands for current "operational funding" discourage capital accumulation aimed at longer-term growth, and the Income Tax Act constraints noted above require current disbursement of 90% of each year's yield, the case for adoption of an investment approach known as the Total Return Concept is nevertheless valid.

The Total Return Concept emphasizes the deliberate pursuit of investment profits from all sources. The emphasis is on the amount rather than the form in which profits are earned, and the expenditure of a portion of capital gains as well as current income is accepted. The Ford Foundation under Vice-President Finance, Roger Kennedy, led the introduction of this concept to endowment funds in the early seventies. The total return objective has been generally accepted by most large institutional investors and is being applied increasingly to corporate pension funds and endowment funds.

The key to the future is a balanced management approach founded in a good portfolio mix. The concept of a balanced portfolio mix to offset the vagaries of the market is hardly unique, but its value has been ignored by many. A balanced portfolio approach recognizes the interdependency of debt and equity markets and provides further avenues for diversification. Such an approach also provides for consideration of other markets and investment opportunities.

* *Charles D. Ellis,* Institutional Investing, *Dow Jones-Irwin, Inc., New York, 1971, p. 190.*

For example, consider the following investment alternatives:

Mutual Funds — A Professionally Managed Diversified Portfolio

1. It should be recognized that there are in North America, mutual funds that have almost every conceivable investment philosophy, e.g., growth . . . income . . . stocks . . . bonds . . . mortgages . . . real estate . . . convertibles . . . preferreds . . . commodities . . . high technology . . . closed-end . . . open-end . . . domestic . . . foreign . . . balanced . . . diversified . . . A Fund For Every Taste. Why duplicate their efforts in every charitable investment portfolio?

2. Many of these funds are "no-load" funds, i.e., no 8% sales commission is payable either at the time of purchase or at the time of redemption. Why pay a sales commission — history indicates that no-load funds have performed as well as load funds.

3. Annually, the Financial Post (in Canada) and Forbes (in the United States) rank the investment performance of the popular mutual funds. When buying a mutual fund, ignore the sales literature and instead, study the reports of these two independent financial publications.

4. There is such a thing as superior fund management. The difference between superior and inferior performance cannot be measured over short periods, but manifests itself over fairly long ones. That performance should be tested in bad markets as well as good.

Real Estate

1. In recent years almost everyone has fared better in real estate than in bonds and common stocks. Obviously the trend upward is not an infinitely unbroken one. Real estate, unlike stocks and bonds, frequently lacks liquidity — but its illiquidity is overstated . . . and the liquidity of many bonds and stocks is overstated. In those provinces where charitable organizations are precluded from investing in real estate, the time has come for the lawyers who so generously give their time to the boards of charities to give even more of that time to working to update investment provisions of various provincial statutes. It is merely human inertia within and without government that keeps the investment provisions antiquated.

2. Money is scarce — take full advantage of your lending position. Share in long-term real estate appreciation by asking for:

(i) warrants to acquire shares in the company to which you make a mortgage loan;

(ii) an option to acquire, at a future date, an interest in the property;

(iii) a mortgage rate that increases when rents increase.

Does any one of these sweeteners violate those provincial laws precluding direct investment in real estate? Options can be sold in future at a profit without ever being exercised!

Debt

Double digit inflation and soaring interest rates have sent the bluest of blue chip bond portfolios plummetting 20% to 30%. "Straight debt" may be "straight foolishness"! Even the most conservative debt investor should hedge his fixed term, fixed return investment in a number of ways.

1. Look for bond issues that are extendable or retractable.
2. Select high grade issues that are convertible into common shares.
3. Look for fluctuating interest rate bonds . . . the vogue of the currently depressed bond market.
4. Consider private placements — and the advantages discussed below.

Private Placements

There are to-day listed on the Toronto Stock Exchange a vast range of profitable companies that are unable to attract long-term capital. Only Canada's famous fifty corporations (e.g. Bell Telephone, C.P.R.) have the clout with underwriters and institutional investors to finance in the tough capital markets of 1974.

Beyond the famous fifty are many Canadian companies that can offer security and growth prospects. It is with these companies that charitable organizations can do private placements and be rewarded with equity sweeteners (warrants and convertible features) . . . fluctuating interest rates and sinking fund amortizations.

Just about every underwriter would welcome an opportunity to act as middleman between the charitable organization and the company . . . so finding users of funds is really no problem.

Real Estate Investment Trusts (REIT's)

REIT's have not had a good reputation in the United States, but in Canada, our five REIT's have had the finest of sponsorship (e.g., TD Realty's sponsor is the Toronto Dominion Bank).

Let us examine some of the advantages of a REIT — with "TD Realty Investments" as our example.

1. The REIT is listed for trading on the Toronto Stock Exchange thereby providing a degree of liquidity.

2. As already mentioned the investment advisor is available at a reasonable cost and involves such qualified people as the bank's own employees. In short, experienced, cautious, well-informed investment advisors.

3. Because the REIT's trust units trade there is the prospect of capital appreciation (as well as the income expectation) in periods of changing interest rates.

4. The monies subscribed into the REIT by the trust unitholders are leveraged with additional borrowing by the REIT. Leverage should raise the overall return to the unitholders.

5. Income, currently earned is disbursed to the REIT unitholders.
Canadian REIT's are a good income investment and have resisted the overall decline in security values.

Dual Purpose Funds

In the United States in the mid 1960's, the dual purpose funds achieved some popularity. Only one Canadian dual purpose fund is known to the writer — Fulcrum Fund (listed on the Montreal Stock Exchange).

The concept of the dual purpose fund is to bring together in one fund two investors each with a different investment objective. One investor seeks income exclusively, while the other seeks growth exclusively. An example will illustrate . . . Mr. A. (seeking income exclusively) puts $10 into the fund while Mr. B (seeking growth exclusively) also puts $10 into the fund. When the $20 are invested, Mr. A gets all the income and Mr. B gets all the growth. Only if the net assets decline from $20 to *below* $10 is Mr. A's invested capital threatened. The decline in value from $20 to $10 is borne entirely by the growth oriented investor.

How can charitable organizations use the ignored dual purpose fund concept? Simply by finding a growth oriented investor seeking leveraged investment. To-day, Noranda and C.P.R. yield in excess of 6%. If a charitable organization were prepared to invest in these stocks, forego growth and had its investment matched by a growth oriented investor who would forego all income, the charity could get an immediate income return of 12% (6% on its investment plus 6% on growth investor's investment) and risk no decline in capital until Noranda declined more than 50%.

Dual Purpose Investing is an underexploited concept — it has its place. It may offer, believe it or not, greater income and greater security than can be achieved in most fixed income investments.

Where is the growth oriented investor to be found? He is the same individual who ordinarily buys Noranda on margin and is now foregoing all income by paying 12% and 13% interest on his margin account, and faces margin calls the minute his $10 investment on margin in $20 of Noranda drops by 1¢ or more. In short, dual purpose investing is a more stable and less expensive form of margin for the growth oriented investor.

Need for Professional Management

The vigorous exploration of investment alternatives should lead to improved investment performance. This aggressive management approach requires access to professional management.

A Louis Harris poll conducted in 1972 among 660 leading non-profit institutions in the United States* indicated that funds with internal management earned only a 4.7% average over the preceding ten years, while externally managed funds averaged 5.6%.

* *See* Institutional Investor, *Volume VI, #8 (August, 1972), p. 45.*

There has been a growing tendency for foundations to move to outside portfolio management. Often the approach has been to split off portions of the endowment, creating "critical masses" of funds which are, in turn, apportioned to various money managers. These individual managers' performances are then carefully monitored. For smaller institutions, arrangements for pooling investment funds with others of their size have been devised, such as the Common Fund a pooled managed portfolio organized by the Ford Foundation in 1971 and made available to numerous small endowments. These pooled arrangements make the aggregate fund financially attractive to outside managers and thus make it possible for smaller foundations to use top money management services. In some circumstances, the cost to the foundation of professional investment counsel can be reduced by other means as well. For example, fees can be reduced by:

1. inviting leading stock brokers to review the portfolio, to make suggestions and by reciprocating with "brokerage business";
2. emulating the common stock activities of the investment funds whose activities are reported on a timely basis in the Financial Post (e.g., McNabb and Beaver Funds);
3. investing only in mutual funds where professional investment management is a feature of the funds.

The use of outside professional money managers will not displace the management role of the Board of Trustees of the foundation, however, the critical decisions regarding investment strategy must still be made. The day-to-day management of the portfolio will take place within the broad parameters established by the individuals legally responsible for the foundation. Among these parameters will be the specification of the degree of risk acceptable in the fund and the determination of any social investment direction to be pursued.

Investing for an organization should involve an Investment Committee. A special Committee has the following advantages:

(i) Improve internal control over the organization's assets.

(ii) Expand the expertise going into the investment decision.

The Investment Committee should develop a written investment policy to direct current and future decisions.

Conclusion

It was noted earlier that historically the investment performance of endowed funds has fallen short of the performance of other managed pools of capital.

It could be argued that to some extent this lacklustre performance is attributable to statutory constraints, particularly the requirement that a high degree of income be expended each year and the various limitations on the types of investment vehicles available to foundations. It could also be argued that certain special needs and social determinants of foundation investment policy impede available rates of return to some extent. Nevertheless, it is felt that the investment performance of many endowed funds could be improved susbtantially.

This improvement is desirable and indeed necessary if our charitable institutions are to continue to serve their role in society. This improvement can be achieved by the adoption of new approaches in the areas of investment policy, portfolio structure and portfolio management.