

# Special Challenges for Organizations with Small Investment Portfolios: A Case Study\*

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In managing their financial assets, smaller foundations and endowments are affected by practical issues that large organizations may not need to consider. The main challenge facing organizations with smaller portfolios is twofold: gaining access to professional portfolio management and achieving that goal at a reasonable cost. I address these challenges from the vantage point of an investment advisor, not an expert. The opinions expressed are my own not those of my firm.<sup>1</sup>

Using a case study based on a \$1.5 million hospital foundation, I will review the steps a small foundation followed in its evolution toward professional money management. The case will provide an example of how creative strategies and prudent policies can accommodate a size constraint. The process will demonstrate that the twin challenges of professional management and reasonable cost can be met.

Many of the issues raised in this discussion pertain to charitable foundations of any size. The focus, however, is on how a small organization was able to create and implement a realistic and workable investment policy.

## **Background**

In the early years, the investment policy of the hospital was driven by a need for liquidity and preservation of capital for both its operating and capital accounts. Accordingly, the list of approved securities was brief – Canada T-Bills, Banker's Acceptances, and the Ontario Hospital Association Short Term Investment Fund.<sup>2</sup> The original investment policy was a half page document restricting investments to short-term low-risk investments. While protecting capital and providing an (unnecessary) amount of liquidity, the opportunity for higher income by adding longer-term bonds or growth through equities, was being missed. Managing the surplus funds was among the duties of the Executive Director or Director of Finance. Transactions were reported to the Finance Committee of the Board.

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The author's original involvement was to advise regarding this treasury or cash management function. In this phase the Finance staff was encouraged by the author to consider broadening the list of approved investment vehicles. Subsequently, judicious use of step-up (wherein the interest rate "steps up" on specified dates by a predetermined amount) cashable savings bonds provided a rising return, as well as liquidity if required.

As time passed, the hospital realized that its capital account was continually growing with bequests and donations. Drawdown of capital was not occurring. This led to consideration of a longer-term investment strategy.

### **Development of a Long-Term Strategy**

The logical next step was to create a foundation using funds from the capital account. Legal matters were handled locally.

[As an aside, employing professional services within the community may be commendable as loyalty to local business, however expertise in the required field must be ensured. In another case I am familiar with, the local lawyer provided for investments outside the Ontario *Trustee Act*.<sup>3</sup> The wording used stated "the Directors shall not be limited to investments authorized by law for Trustees". That foundation was being funded entirely with founder's shares of one company. Had that foundation been governed by the *Trustee Act*, this single holding would have been in question, both from the perspective of the 35 per cent maximum corporate weighting and because of the lack of diversification. Persuading the directors to diversify beyond the original holding would require some eloquence about the unsystematic risk of one holding. The *Red Tape Reduction Act, 1998*, which was recently passed in Ontario, removes the 35 per cent maximum corporate weighting, replacing it with the "prudent investor rule", thus providing much greater flexibility (and responsibility).<sup>4</sup>]

In the case under study, the hospital's Finance staff prepared a proposed Investment Policy Statement. The principles of the previous policy governing the capital account were continued and the primary objective continued to be preservation of capital. The secondary objective was to generate sufficient income to meet cash flow requirements. To this end, GICs and short-term Canada and provincial bonds were added to the portfolio.

A provision that the portfolio would be managed by the Board of the Foundation was of concern. The issue was the potential for personal liability of Board members. Consequently, I received an invitation to attend a meeting of the Investment Committee of the Board. (The Investment Committee was aware of my advisory relationship with the hospital's Finance staff.)

A proposed one-page Investment Policy was reviewed at the meeting in the context of the following Foundation concepts:

- Time horizon – much longer than envisioned in the earlier structure;
- Income stream – to fund the commitments;
- Unpredictable funding of foundations;
- Spending rule – how much to be committed each year for programs;
- Stability fund – to meet liquidity needs in the first year.

This, in turn, led to a lengthy discussion of a number of investment issues including:

- i) Expected rates of return of various asset classes and various blends of asset mix, ranging from income-oriented to growth-oriented;
- ii) The growth potential of equities as compared to fixed income investment with its increased probability of providing a required income stream;
- iii) The Board's fiduciary responsibility and members' personal liability, particularly since the initial investment policy proposed management of the portfolio by the Board;
- iv) The "prudent investor rule" – a concept that business people on the Committee grasped immediately; and,
- v) The necessity of a realistic and workable investment policy statement, which would provide (a) a focus to the Committee on the needs and objectives of the Foundation, (b) guidance to the money manager(s), (c) continuity when Committee members changed, and (d) a sense that a strategy and discipline would be in place during difficult markets.

By design, this first meeting with the Investment Committee was informational and educational. No specific investment approach or product was discussed. However, it was assumed that if the Committee did recommend a long-term strategy to the Board, a competitive situation vis-à-vis other financial advisors could exist. Putting the client's interests first was a logical strategy. There was a concern that the heavy load of topics in the first meeting might be overwhelming. Perhaps it was – the next committee meeting was not until some months later!

The second meeting with the Investment Committee commenced with a review of its objectives as presented in the Foundation's *Policy and Procedures Manual*. For the most part, the objectives were quite sound. It made sense that the Committee would make recommendations to the Board regarding the investment of the Foundation's assets. Similarly, an Investment Policy Statement should be developed and reviewed periodically along with the portfolio. However, the Manual provided for the Foundation along with a bank or investment company to administer its investments, again raising the issue of

Board liability. The adequacies of the proposed Investment Policy Statement were reviewed in light of the discussions of the previous meeting.

An examination of the Investment Policy Statements of other foundations proved to be an effective way of determining whether the Statement should be further refined. The strengths or shortcomings of other foundations' policies helped focus the Committee on what was required in its own Policy Statement.

A discussion ensued as to whether the Foundation was governed by the Ontario *Trustee Act*. At the time, all documentation pertaining to the Foundation's incorporation and bylaws remained with legal counsel. Investing outside the *Trustee Act*, specifically increasing the corporate weighting beyond 35 per cent, would have the potential to provide greater growth and thus greater ability to meet future spending requirements.

At this point it was necessary to differentiate the role of an advisor from that of a portfolio manager. The author explained to the Board that an advisor could facilitate a search for the necessary expertise but should not provide it.

The discussion then returned to a previous topic – the personal liability of directors and committee members, especially if the Board chose to manage the investment portfolio. Typically, Board members are doing a community service for altruistic reasons – they have no expectation of personal gain but wish to be protected from potential downside risk, particularly uncontrolled personal liability. The meeting ended with agreement to seek outside expertise to assist the Committee in developing an Investment Policy Statement for the Board.

The formal development of an Investment Policy Statement followed. The Policy had to be both realistic and workable while accommodating the constraints imposed by the small size of the fund.

A round of consultations began with an investment consultant and managed-money specialists. These discussions covered all aspects of an investment policy statement, however the primary focus was on asset allocation. At this stage, the assumption was that the Foundation was not governed by the Ontario *Trustee Act*. Legal guidance was sought as to whether this position was correct.

Wording was developed that allowed the Foundation to invest outside the *Trustee Act*. Either way, the equity weighting could exceed the 35 per cent corporate weighting of the *Trustee Act*, provided it was appropriate. The resulting asset mix allowed for a balanced approach which would provide growth with some certainty of dependable income flow. The emphasis within the equity weighting was toward international equities. Straightforward reporting and benchmarks were formalized in the proposed Policy Statement. In reviewing other foundation policy statements, it was interesting to note that some did not contain specific reporting requirements or indication of the return expectation.

The hope throughout this process was that *The Red Tape Reduction Act* would be passed into law. Its passage would allow the use of pooled funds or mutual funds and remove the 35 per cent corporate weighting cap. The issue of whether the Foundation was governed by the *Trustee Act* (and therefore what the corporate weighting could be) would then become moot. The expectation was that the actual equity holdings would be raised over time toward the benchmark weighting. This would allow the Foundation to become comfortable with its new approach to investing while the equities began to prove their value in the new portfolio.

The next step was to present a draft Investment Policy Statement to the Investment Committee. A binder containing the draft statement, together with supporting reference material, was prepared for each Committee member. Included were articles on asset allocation and conflict of interest. Conflict of interest was a straightforward issue for this Foundation to deal with as there were no apparent conflicts.

In addition, two articles on the development of investment policy statements were placed in the binder. (See “References”, Charles D. Ellis and S. Kelly Rodgers, p. 40.) A copy of Bill 122 (the predecessor to the *Red Tape Reduction Act*) was enclosed, partly to indicate the proposed changes to the *Trustee Act* but also to illustrate the current restriction of the *Trustee Act*.

It seemed appropriate to demonstrate that managers and vehicles existed which could fulfil the objectives of this nascent policy statement. Accordingly, material was provided on a segregated bond fund that was managed in compliance with the *Trustee Act*. A Nesbitt Burns publication, “Does an Actively Managed Bond Portfolio Enhance Returns Relative to GICs or T-Bills?” substantiated the belief that returns can be enhanced with active management and with vehicles other than T-Bills and GICs. Also enclosed was an example of a pooled international equity fund. Again, at the time, it was assumed that the *Trustee Act* guided, but did not govern, the Foundation. The equity fund example was helpful as a guide in generating the Investment Policy Statement and asset allocation. This provided further education for the Committee and an example of how the overall process should proceed. Finally, review of the proposal by legal counsel was recommended to the Committee.

A meeting with the Board followed. The draft Investment Policy Statement was presented and approved after some discussion. Concerns as to liquidity needed to be addressed. Specifically, if a large cash need arose, could this be accommodated? The inherent risk raised questions about the wisdom of the long-term allocation of funds. It was hoped cash needs could be met from the short-term portion of the portfolio and thus not interfere immediately with the long-term allocation of funds. A “stability fund” would assist in the event a cash call arose in the near term.

The benefits and implications of investing outside the *Trustee Act* were discussed. The wording of the draft providing for Directors to “authorize the investment in securities outside the *Trustee Act* given that they and the investment manager are knowledgeable, prudent and sagacious” was carefully reviewed. The preference of the Board was to remain within the *Trustee Act* for the most part, particularly if the Foundation was governed by the *Trustee Act*. It was resolved to ask for a written legal opinion as to whether the Foundation was so governed.

The equity portfolio decision was postponed pending receipt of such opinion. The pooled international equity fund would have been acceptable under the Policy Statement but was outside the *Trustee Act*, which was not the Board’s preferred course of action. However, use of the fixed income manager was approved, as this was both compliant with the *Trustee Act* and cost-effective. The Board appreciated the good business gesture – the \$2.5 million minimum for this particular Trustee Account was waived to allow the \$1.15 million investment.

Subsequent to the Board meeting, counsel questioned whether investments other than bonds were suitable. The relevant section of the *Trustee Act* on common stocks and how their eligibility for investment is determined, was sent to Committee members for their perusal. Three possible courses of action were then suggested to the Committee:

- i) remain invested in short-term securities and bonds until *The Red Tape Reduction Act* was passed;
- ii) amend the Letters Patent and bylaws to allow prudent investing not constrained by the *Trustee Act*; or
- iii) invest to a maximum corporate weighting of 35 per cent (including equities as permitted by the *Trustee Act* or outside the *Trustee Act* as provided for in the Investment Policy Statement).

The drawback to the first possible course of action was the risk of poor portfolio performance arising from failure to hold equities for growth – the hidden risk of seemingly “conservative investing”. The concern arising from the second approach was the possible perception by others in a small community that the risk of the portfolio was being increased by a Board with no previous experience in equity investing.

In the meantime, Letters Patent and bylaws were delivered to the Foundation. Upon examination of these documents it became evident that the Foundation was governed by the *Trustee Act*. After discussion, the Policy was revised to reflect that the Foundation was governed, not guided, by the *Trustee Act*.

The investing constraints imposed by the *Trustee Act* were noted in the revised Investment Policy Statement. Clearly the reduced equity weighting could lower the return. A maximum equity weighting of 25 per cent was imposed in response to the maximum 35 per cent corporate weighting and the fact that the Trustee Account bond portfolio could allocate as much as 25 per cent to corporate bonds. As two separate managers would be engaged to manage the bond and equity portfolios, responsibility for monitoring the corporate weighting would rest with the Treasurer and Investment Committee. Such was noted in the revised Policy Statement. The impact of the changes to the Policy was the elimination of a pooled funds approach to the equity portfolio. Given the Board's wish to remain within the *Trustee Act*, despite the provision allowing investment outside, a segregated fund would be required.

Brief consideration was given to passive index investing, due to its cost effectiveness and tracking of the markets. This approach was discarded because it would have involved equities not qualified under the *Trustee Act*. In addition, the index approach could raise the question of personal liability, given that there would be no third party professional portfolio manager involved in the process.

Compliance with the *Trustee Act* could be obtained through a number of wrap programs<sup>5</sup> offered by investment firms. Such programs have equity managers willing to manage a portfolio within the constraints of the *Trustee Act*. Given that only 15 per cent of the (Toronto Stock Exchange) TSE 300 stocks meet the dividend paying criteria of the *Trustee Act*, while over 70 per cent of the (Standard and Poor) S&E 500 meet such criteria, it was decided to focus on an international mandate for the equity portfolio. The better stock selection and performance potential of global markets would somewhat offset the smaller equity allocation. Both the revised policy and the selection of an equity manager with a global mandate were approved by the Board upon the recommendation of the Investment Committee.

The challenge was to provide the necessary professional management with a percentage cost similar to that paid by a three- to five-million-dollar portfolio. The all-in cost of operating this segregated portfolio is 89 basis points. No additional custodial or reporting fees and no additional execution costs are involved.<sup>6</sup>

With respect to the expensive part of the portfolio management – the equity portfolio – it should be emphasized that that portion of the portfolio is 15 per cent initially, or approximately \$220,000. Its mandate is global and it must be managed in compliance with the *Trustee Act*. A reputable money manager will handle the portfolio through a wrap program at a cost of 275 basis points. This fee is on a sliding scale, declining to 225 basis points at \$500,000. The management of the portfolio's fixed income component, at 65 basis points, is

much less costly. The Canadian fixed income account chosen complies with the *Trustee Act*. Representing approximately 70 per cent of the portfolio, its low cost serves to pull down the overall cost quite effectively. The significance of curtailing costs is that it either reduces fundraising needs or provides the Foundation with additional income to distribute.<sup>7</sup>

A local investment advisor can add value but must remain competitive as to cost and quality of service. A considerable amount of the advisor's time and educational effort may be required to develop a workable investment policy. In outlying areas of the country, Chartered Financial Analysts and other qualified investment professionals may simply not be available as volunteers for a foundation or endowment investment committee.

In addition to providing money managers with "operating instructions", preparing the Investment Policy Statement was helpful in several ways:

- i) Drafting the Policy helped focus the Committee on defining the financial needs and objectives of the Foundation;
- ii) Reviewing various aspects of its proposed design assisted in determining the knowledge level of Committee members which in turn allowed for explanation of investment concepts and principles where needed; and,
- iii) The final document is available for reference when membership changes on the Investment Committee or Board, or when markets decline and members need to stiffen their resolve by acknowledging that a long-term plan and discipline are in place.

## **In Conclusion**

Communication with a foundation, as with any client, goes beyond performance reporting. There will always be a need to reaffirm the strategy, as well as to update and further educate. Interestingly, for foundations and endowments of any size, the responsibility and risk will increase under Bill 25. Specifically, as the restrictions of the *Trustee Act* are removed, the choice of investment is broadened and the risk increases commensurably.

Professional money management is available at a reasonable cost for smaller investible portfolios. As this article demonstrates small organizations have alternatives to T-Bills, GICs and mutual funds. A key element in developing such alternatives is a carefully worked out investment policy statement.

A workable investment policy is not only necessary for the portfolio managers but also useful in focusing all participants in the process on the key issues. Foundations and endowments need to choose competent advisors and portfolio managers. Smaller organizations in particular should treat their advisors, consultants, and money managers as an extension of their staffs by making use



of all the resources that these professionals have to offer. Creativity may be required, but the problem of a small portfolio size is surmountable.

### **Addendum**

Ontario's Bill 25, *The Red Tape Reduction Act*, has been proclaimed in part. When those portions of the *Trustee Act* affecting the Foundation are brought into force, the Foundation will revisit its asset allocation strategy. Specifically, the equity weighting may be raised, given that the 35 per cent maximum corporate weighting constraint will have been removed. A maximum equity weighting of at least 40 per cent would be more appropriate in light of both the long-term needs of the Foundation and the superior long-term potential of equity investments. The cost of operating the portfolio will increase as the equity component rises. At a 30 per cent equity weighting the all-in cost will be 119 basis points. Meanwhile, the Treasurer's need to monitor the corporate weighting disappears.

Greater flexibility in asset allocation has the potential to increase risk within the portfolio. It is the responsibility of the Board to make suitable allocation decisions. This fact may weigh heavily on the Board given the group's inexperience in long-term investing. The ultimate outcome may be a "ramping up" of the equity weighting over time as experience and comfort are gained.

### **FOOTNOTES**

1. Mark Wilson has been in the investment industry for 24 years – three years with the Montreal Exchange and the balance with Merrill Lynch and Nesbitt Burns or its predecessors. A Fellow of the Canadian Securities Institute, he has completed two years of the Chartered Financial Analysts courses.
2. Canada T-Bills are Government of Canada Treasury Bills issued with a term of one year or less; highly liquid and riskless. Banker's Acceptances are a form of short-term corporate finance (180 days or less) where the "acceptance" means a bank guarantees payment – highly liquid and low risk. A money market fund such as the one available to Ontario Hospital Association members – the Short Term Investment Fund – invests in instruments such as those above as well as commercial paper and other short-term vehicles.
3. R.S.O. 1990, C.T. 23 ss 26 and 27.
4. Also known as "Bill 25". For the provisions of the *Trustee Act* see T. Youdan, "New Investment Powers for Charities", p. 23.
5. A wrap program, as the name implies, "wraps" a number of investment management services together and provides them at a single annual fee.
6. The U.S. experience with wrap fees is that they are dropping as competition increases.

7. In practical terms, lowering the cost by approximately \$7500 per annum means an extra piece of diagnostic equipment for the hospital every two or three years.

#### REFERENCES

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