The Effective Management and Investment of Charitable Funds

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In addressing a given topic, one naturally exhibits a bias reflecting one's area of special interest. The subject matter today strikes directly at some of the concerns that I share as a member of The Richard and Jean Ivey Fund, a charitable foundation in London, Ontario. My comments to you will, I know, reflect my particular business involvement, but I hope that what I say will be useful in the broader subject of charitable funds generally.

The effective management of the resources of any charitable enterprise must be influenced in large measure, I submit, by the perception of its role in society held by the Board of Directors or Trustees. Regardless of the type of charitable enterprise under consideration, whether it be charitable organization, public or community foundation, private foundation, corporate-sponsored foundation or special interest foundation, the common element is the voluntary character inherent in its operations. Within the legislative framework, that has so effectively been described in Arthur Drache's well-known publication entitled *Canadian Tax Treatment of Charities and Charitable Donations*, the charitable organization has the privileged freedom of dispensing its funds over a wide range of socially useful purposes. The scope of this opportunity is so wide and far-reaching that, as we know, the available resources are not, by themselves, adequate to meet the full challenge. In that apparent inadequacy lies, I firmly believe, a major opportunity for the charitable enterprise to, as Robert K. Greenleaf describes, "make itself a model of institutional quality, integrity, and effectiveness." Obviously, that is why we are here today.

In the most recent fourth edition published in 1978 of *The Canadian Directory to Foundations and Granting Agencies*, edited and researched by Allan Arlett, it is reported that "there are now close to 50,000 registered charities in Canada, whose total donations exceed half a billion dollars per year." The presence and importance of such a force in our society can neither be ignored nor relegated to an ignominious fate, the result of inadequate, disinterested or superficial management direction. In his excellent book *Trustees and the Future of Foundations*, John W. Nason observed that "times have changed, and the values by which we judge institutions today are different from those used earlier in the century." All institutions, I think you will agree, are judged by today's standards and expectations, and this applies as well to the charitable field as it does to government and corporate sectors. Whether we like it or not, Trustees and Directors of charitable organizations are increasingly subject to critical assessment from the outside. The responsibilities inherent

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in such positions demand careful attention and the development of policies and practices to ensure their effective conduct.

In recent years, an excellent bibliography has accumulated on the role and responsibilities of trusteeship. I mentioned before John Nason's book and, of course, the publications by Robert K. Greenleaf, the American philosopher of international renown in the field of trustee responsibilities, are significant.

You may also be familiar with a monograph published by the School of Business Administration at The University of Western Ontario entitled *The Role of the Voluntary Trustee.* This is a thought-provoking book as it records the expressions of views by some twenty individuals then involved as Trustees of various non-profit institutions and half a dozen senior administrators of similar bodies at a seminar sponsored by the university in May, 1975. Although it is now five years old, the contents of the book are still very much relevant.

The responsibilities of the Board of a charitable organization, as I see them, can be rolled into two key areas:

1. to address the difficult question relating to a determination of the business in which the organization is in and what it is attempting to accomplish in it.
2. to establish a framework within which the organization will operate.

The first responsibility will be defined in broad terms by the charter within which the Directors must work. However, the question of business direction and thrust is not so easily answered if the organization is to remain relevant and vibrant. Times are changing rapidly, and a responsible Board through the institution of planning activities—admittedly over a wide range of sophistication—will recognize the need to regularly review the operation of their business.

The business framework that flows out of the determination of the first responsibility involves the following specific Board functions. We are all familiar with these, I am sure:

1. set goals and approve plans for their achievement.
2. design administrative structure and appoint top administrative officers.
3. assess, at appropriate times, the performance of the institution.
4. adopt appropriate action based on the assessment of performance.

It is most important in performing effectively that the Trustees or Directors recognize their proper role. They have the obligation to perform an objective and critical role of management. In order to do so, they should avoid, as much as possible, a direct administrative involvement.

What has all this got to do with investments? Not much, you will probably say. However, my preliminary remarks are intended to first of all establish a base from which to move into the more specific topic of investments. In doing so, I am reminded of Alvin Toffler's statement in his book *Future Shock* that he attributes to the Chinese—"To prophesy is extremely difficult, especially with respect to the future". How true it is, particularly in the volatile markets currently being experienced!

In considering investment policies, some distinction perhaps should be made between charitable organizations directly carrying on a charitable activity and charitable institutions such as foundations. Cash flow needs between the two types of organizations might differ appreciably and in the former case, the need for income on a regular monthly basis, for example, is usually an urgent requirement. On the other hand, generally in the case of a foundation, aside from some administrative expenses, the income of the organization can be spent at will during its fiscal year subject, of course, to the minimum annual requirements of the *Income Tax Act*. For the purposes of discussion today, my comments will largely ignore the situation in which the charity is the recipient of funds from regular or ongoing fund-raising activities, grants and donations that represent the principal sources of income to that organization. Such bodies would include mainly charitable organizations with little or nothing in the way of endowment funds. They too, of course, if prudently managed, require an investment policy designed to maximize their pools of funds all of which are intended for distribution in the year of receipt. The investment needs, however, are of a fairly simple nature requiring in the main security of capital to be drawn down for operating needs over the course of the fiscal year. In making this distinction between investment requirements, I should make it clear that the substance of the responsibilities of the Board of Directors of the particular organization involved is not reduced.

The ability of charitable foundations to sustain grants programmes is affected by a number of elements. These include not only variations in market values of investment assets, but also investment income, inflationary rises in the costs of activities that are supported and the ever present provisions of tax law that complicate the accumulation of capital. The interaction of these various forces may well reduce the amount of real support that charitable foundations can provide if the capital base is not being augmented from time to time by significant gifts. A key question for the charitable foundation is how to keep assets and grants programmes ahead of the inflationary spiral. There have been individual examples of success in this regard but for the foundation field at large it is a difficult task. Statistical data on U.S. foundations with assets of $1 million or more reported in the November/December 1979 issue of *Foundation News* can be summarized by saying that, despite substantial gifts received, a gradually increasing number of foundations have been unable to offset the effects of inflation on their giving.

The Board of Directors of a charitable enterprise must recognize that the management of the investment portfolio is a demanding exercise. In addition to investment expertise, it requires a thorough understanding of the investment needs that result from cash flow characteristics and applicable tax regulations. In developing the policy framework and investment objectives within which an investment strategy can be implemented, the Board should consider two broad areas of concern:

1. the level of granting necessary to maintain an adequate programme.

2. the level or degree of risk pertaining to both asset mix or composition and quality of investment that is acceptable for the prudent management of the portfolio.

It can be argued in the case of the first point mentioned that this exercise is not necessary because the foundation will extend its giving programme to the extent of its available income. This attitude, while not entirely without merit, does tend to evade the responsibility of the Directors that I mentioned earlier to determine what the organization should endeavour to achieve—its thrust and direction. Is it to be a mover and active force, or is it to adopt only a passive and reactive stance? While I do not advocate that it is essential to be highly sophisticated in planning future income requirements, determination of future cash flow objectives, giving recognition to inflationary expectations and expanding areas of charitable activity, should form an essential element of the investment objectives. I revert to Alvin Toffler's Chinese saying about the problems of looking to the future with any expectation of certainty, but the need is there if Directors of charitable foundations are to effectively carry out their responsibilities.

Once the income requirements are established, the question of the investment portfolio arises. The active involvement by Board members in the investment strategy to be followed will vary between organizations, governed largely by their interests, in-house capabilities and/or the employment of outside counsel and administration. Regardless of the routes chosen, the Board must establish its risk parameters not only from the standpoint of the planned business activity of the organization for which they are responsible, but also the very personal interest of potential liability as a Trustee. In the determination of risk tolerance, relative risk tends to decline for portfolios with little in the way of liquidity constraints and able to adopt a long time horizon. Risk is affected by a number if factors, of course, but key determinants in establishing policy will be the organization's planned needs and objectives and the matter of prudency. The investment manager in formulating the investment strategy will require within the broad parameters of the investment policy developed by the Board of Directors a specification of the degree of risk acceptable.

The basic investment objective of a foundation is to generate a stream of cash income of sufficient size to enable the conduct of the business operation. A foundation experiencing a decline in real income is faced with the need to reduce the real size of its grants or the decision to invade capital in order to maintain its programme. A foundation intent upon ensuring its existence must therefore endeavour through its investment management policies to create a growing stream of income and capital appreciation over a period of time. Our tax laws do not allow much opportunity for the latter through income retention and therefore an investment policy should incorporate an appropriate element of potential capital appreciation which, for a registered charity, is non-taxable in Canada. It is my view that a combination of fixed income and equity strategies will maximize the potential achievement of a growing income

stream and meet the objectives for capital enhancement within a reasonable time frame.

Bonds or fixed income securities of an acceptable quality have the attraction, of course, of providing a known flow of current income. This advantage, however, tends to pale in times of high inflation such as the last few years we have experienced. Many of us become so shell-shocked by the creeping devastation of our bond portfolios that we take the vow forever to remain in the short end of the maturity spectrum because the days of the long-term bond are gone. In fact, bonds do provide capital appreciation opportunities when bought at the right time and total return from this investment avenue can result in returns well in excess of inflation in non-taxable situations. Depending on how clear our crystal ball is, we may have reason to feel that we have entered into such a period if even for only a relatively short time. Certainly, bonds with equity conversion or extendible/retractible features offer further interesting possibilities. As an investment manager, there is good reason to gloat over a portfolio that has some bonds carrying a 13¾% coupon, a 5- and 10-year maturity option with the federal government as the debtor trading at $10 over issue price. On the other hand, this paper will prove to be a trading vehicle if we perceive bank and prime rates climbing past their 1980 peaks in the next year or two. If this proves to be the case, these bonds could be attractive "discount" bonds at some time in the future.

The capital appreciation potential of equity ownership is widely recognized. The key feature of stocks, in my opinion, is their dividend growth potential assuming the selection of seasoned stocks with a track record. In addition, conventional theory suggests that an upward revision in a company's dividend prospects (which depend heavily on earnings prospects) would translate into an upward revision in the stocks' investment value. Hence, capital appreciation potential will contribute to a handsome overall return. There are, as we know, permutations and combinations that affect the end result. Times do change, as do the fortunes of companies and the earnings multiples accorded by the stock markets, and the investment policies of the organization must provide the flexibility to ride the crests of changing circumstances.

The span of my topic today includes the question of socially acceptable investments. I find this question difficult to address and the subject almost incapable of a universal definition. The subject of what is or is not socially acceptable has received much publicity at corporate annual meetings. Some well-meaning investors would question the dealings of the major banks or mining companies with countries whose political and human rights policies and practices do not conform to our perceptions of right and wrong. There are others, I suppose, who would question the moral virtues of investing in companies with "hot" gambling casino franchises in Atlantic City, for example. The question in my mind is one that each individual Board must decide as part of their investment policy.

The subject of social acceptability raises a tangenial consideration. This is

one dealing with conflicts of interest or what is sometimes described as incestuous relationships. The problem, I suspect, holds more concern in the United States where major banks' trust departments carry on significant portfolio management activities. Conflicts can arise, of course, in a number of ways including equity and bond selections for the portfolio and the use of brokerage and investment management services. I do not mean to suggest that Trustees so involved are in any way dishonest individuals conspiring to channel business to friends or enrich themselves. In using the term "conflict of interest", I am only referring to a situation in which an individual has two interests—his obligations as a fiduciary and trustee and his private financial interests—which may not be completely compatible. Prudent investment policies suggest that a portfolio should maintain a reasonable degree of diversification which implies avoidance of unusual risk through excessive reliance on one or a few investments. Examples of difficulties in this area are probably more prevalent in university funds which, if they are fortunate, are the recipients of significant endowments from time to time involving, for instance, large blocks of a single stock.

In the selection of brokerage and investment management services, to the extent that considerations other than the interests of the endowment fund influence the choice they may well affect or inhibit the efforts or ability to obtain services at low cost and to achieve the best performance. This is a subject that can easily consume the time of this seminar, and I do not propose to leave any further thoughts with you aside from those that I have mentioned. The question of potential conflict is a serious one and should be recognized by Directors or Trustees in the formulation of their investment policies. Although the booklet addresses the problem with an American flavour, I would recommend to any of you that are interested, a little book of some 80 odd pages entitled *Conflicts of Interest: Nonprofit Institutions* by Chris Welles. It is a report prepared in 1977 to the Twentieth Century Fund Steering Committee on conflict of interest in the securities markets. The Twentieth Century Fund, founded in 1919, is a research foundation engaged in policy-oriented studies of economic, political and social issues, and institutions.

Finally, having spoken at some length on the responsibilities of Directors and Trustees of charitable foundations and organizations, we are perhaps left with the question of the extent to which matters can be delegated to appropriate areas. Directors or Trustees hold what amounts to absolute power over the charitable institution but use it, as I suggested earlier, minimally, if at all, in a direct operational sense. Their role is to delegate the operational authority to administrators and staff who shall be accountable, but ultimate responsibility continues to vest in the Board of Directors or Trustees for actions taken. In the last analysis, the Director or Trustee is held accountable and cannot plead the delegation of authority in self defense.

I do not wish to venture out of my depth on this matter as I do not have legal background, but perhaps it would be worthwhile to highlight for a moment the question of liability of Directors of Ontario charitable corporations. The

general standard of care section in the *Ontario Business Corporations Act* for Directors of share capital corporations reads in the initial part as follows:

> Every director and officer of a corporation shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the corporation and in connection therewith exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

There is no provision comparable to this in the old *Ontario Corporations Act* which governs charitable and other non-profit corporations. The common law therefore continues to apply to Directors of corporations operating under the *Ontario Corporations Act.* It is my understanding that the case law on Directors' liabilities and standard of care has developed almost entirely with relation to share capital corporations. This leads us to the question of the Directors' duty in the case of a charitable corporation where there are members but no shareholders, and where the purpose of the corporation is not to make a profit or serve the members but to advance charitable works. There is opinion that a Director of a charitable corporation is liable as a Trustee of a charitable property. *The Charities Accounting Act* empowers the Public Trustee to request charitable corporations to furnish specified information of a rather intensive nature, with recourse to the Supreme Court for failure to do so. Penalties in the event of default on the part of a Trustee are covered in the Act.

As I understand the situation, present legislation is not clear on the responsibility of Directors of charitable organizations for mismanagement and misapplication of funds. However, there are good reasons expressed to suggest that Directors of charitable corporations can be subject to the rules that affect Trustees. To operate under this assumption seems to be the safest course and in their delegation of investment duties, Directors will be well advised to have in place an adequate monitoring device to ensure that performance and expectations are not drawing apart because of gross mismanagement, neglect or for other reasons.

In closing, Mr. Chairman, I am reminded of a biblical story which will be familiar to everyone. It was being enacted one Christmas time by a group of grade four pupils at a school pageant. You can picture the scene with proud parents in the audience and the tense teacher behind the scenes. Joseph and Mary were looking for a room for the night, and Joseph went and knocked on the door of the inn. The door was answered by a young boy playing the innkeeper who said, "What do you want?" Joseph said, "Well, I'd like a room at the inn." The boy playing the innkeeper said, "Well, we don't have any rooms left; we're full." Joseph said, "That's terrible. My wife Mary is pregnant. I've got to have a room. Can't you see she's about to have a baby?" The little boy playing the innkeeper said, "That's not my fault." And the boy playing Joseph said, "It's not my fault, either." The moral to this story for Directors and Trustees, I suppose, is that you have the power to delegate, but the responsibility cannot be escaped!