THE END OF ENDOWMENTS?

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THE ECONOMIC SWELLS OF THE LAST 18 MONTHS STRESS-TESTED THE SYSTEM of charitable endowments. Headlines announced spectacular losses to these long-term funds. My favourite was the headline to a Vanity Fair article that chronicled "Harvard's Big, Dumb Financial Train Wreck." The world biggest endowment lost $11 billion of its $36.9 billion.[1] While it is tempting to chortle along with the voyeurs and cynics, Harvard is experiencing the worst financial crisis in its 373-year history. When the need to draw down capital is factored in, it will probably take more than a decade for the endowment to return to its peak.

Closer to home, Canada's largest endowment, belonging to the University of Toronto, gained unwanted attention for losing $545 million, or 31% of its previous year-end value of $1.75 billlion. After using up its $543.7 million cushion built in good years, the university suspended distributions of $63 million in 2008-09 to preserve capital, stating: "The University decided not to erode the endowment capital further so that a baseline for future growth may be maintained."[2] In fiscal 2009, the university had 45% of its assets in alternative investments and was overweight in hedge funds.

Neither university is entirely representative of the endowment crisis. True, most other charities with endowments experienced losses – the average balance fund lost approximately 18% in 2008 – and a number also ceased making payouts, but these two institutions are colossuses relative to their domestic charity environments. Size provided them with expertise in endowment management and investments that had served them well despite investment decisions that were clearly poor in retrospect. If these two giants failed to live up to the stated goals of their endowments, this may indicate a problem with the whole concept. Perpetual in aspiration, endowments promise charities a steady – and steadily increasing – annual income over the long-term. During a time of great need in the charitable sector, they proved wanting. The notion of endowments as reliable generators of funds for the charitable sector was shaken.

So what did the stress test teach us? What should be done to ensure the events do not reoccur, or at least reoccur with the same severity, in the future?

The dominant reaction to the crash at charities and within the investment industry is to reexamine investment practices: change the asset mix, fire an investment manager, become more conservative, employ better hedging techniques. Many charities found comfort in theoretical models that demonstrate the short-term shocks are irrelevant to long-term returns. Markets have proved remarkably resilient, with the TSX bouncing back 28.6% in 2009. Even so, North American indices are still 20% off their peak in early 2010. Important as investment management is, however, it is only one piece of the puzzle.

The largest Canadian charities – the only ones that have the resources to build endowment funds – embraced the concept over the last 20 years, a time of unparalleled growth in wealth and asset values. Harvard's endowment grew from $4.8 billion in 1990 to $36.9 billion in 2008 and the University of Toronto's grew from $300 million to $1.75 billion during the same period. While I hope that the strong economic times that supported this growth continues, it is prudent to acknowledge that a "permanent" model should not based on the experience of an historically anomalous economic period.

The underlying assumptions and mechanics of charity endowments need to be looked at with fresh eyes. Endowments are an important resource within the charitable sector, but they represent an ideal that may at times be too lofty, too strict, and too seductive. We should revisit the concept of endowments – not to abolish it, but to review whether it best serves charities and provides appropriate public benefit. By focusing on the long-term goals, endowments make inefficient use of capital in the short-term. What is the right balance between current and future needs? Should we be so doctrinaire in the protection of capital, or is some erosion over time inevitable? And is perpetuity a harmful pipe-dream that prevents charities from making better use of their funds?

To attempt to answer these questions, I will take three tacks. First, I will look at the history of endowments and how they have been adopted and promoted by charities. Second, I will assess how Canadian charities have imposed legal and policy restrictions upon themselves that are neither prudent nor necessary. Third, I will examine the disbursement quota rules in the Income Tax Act, which are overly complex and often limit the use of charitable funds. History, self-imposed restrictions, and statute: these are the overlooked elements in the Canadian endowment mix.

THE ORIGINS OF ENDOWMENTS

An endowment is a perpetual fund in which the capital is kept intact and only the income, or a portion of it, is used annually for charitable purposes. There are common notions about endowments, which are accurate when everything works well. Endowments provide steady, long-term annual support for mission. They enable future planning. They provide a financial infrastructure and protect the charity from the harmful effects of the swings of government and philanthropic funding. They are also a mark of a mature charity, as only the largest charities have the stability, support, and wherewithal to build them. No wonder endowments are considered essential – even sacred – by charity trustees and administrators.

According to Canada Revenue Agency data, Canadian registered charities had total investment assets of $68.1 billion in 2006, an increase of 41.6% over the $48.1 they held in 2001.[3] This represents all investible assets held by charities, not just endowments. Benefits Canada reports growth in endowment funds from $14 billion in 1997 to $41 billion in 2007. The breakdown by sub-sector was: Education, 35.1%; Welfare, 26.2%; Health, 19.1%; Religion, 13.6%; and Community Projects, 5.9%. These assets are concentrated disproportionately with a handful of Canada's 84,000 registered charities. The top 20 charities held 23.2% of all investment assets in the sector. Interestingly, private foundations controlled $13 billion or 19.1% of assets in 2006 compared to public foundations with $10 billion or 14.7%.[4]

The endowment is as much a creature of charity culture as it is of law. Although grounded in trust law, "endowment" is not a legal term. A charitable trust is different from other trusts in that it is not subject to the rule against perpetuities. That said, there is nothing in trust law that stipulates that charitable trusts must be perpetual. There is a rich tradition of limited charitable trusts. These trusts could, for example, be spent over time or terminated when charitable purpose changed. Britain's now repealed *Law of Property Act* (1925), even created a statutory restriction on accumulation of funds within charitable trusts. This law caused the distribution of income and, over time, would have caused the real value of investments to decline due to inflation. It was one generation's way of balancing current and future charitable purposes in an evenhanded fashion. It also made sense in a historical context. Medieval endowments started as income-generating land banks and progressed to hold fixed income instruments, particularly bonds. Over the course of the 20th century, charities began to add equities to the mix. More recently, inspired by the big funds in the U.S., endowments began to make use of alternative investments such as derivatives, hedge funds, emerging market debt, and private equity. True to their origins in land, endowments treat capital as untouchable.

The concept of the "endowment" as we now know it emerged to serve the needs of charities in the United States in late nineteenth century. Private educational institutions viewed endowments as their financial underpinning. No longer frills or enhancements, endowments were subject to great attention, which lead to innovation in the structure and investment of funds. For example, new management theories have developed since the 1960s, shaped by the seminal Ford Foundation sponsored study, *The Law and the Lore of Endowments Funds.* The Hartford-based nonprofit Commonfund and top-ranked U.S. colleges adopted the recommendations of this study and implemented practices based on total-return investing, fixed payout rates, investment goals based on long-term time horizons, and preservation of capital mechanisms. The new model based on careful asset allocation and strategic investment in equity arrived just in time to address the stagflation of the 1970s and then reap the rewards of the 1990s and 2000s.

The U.S. innovations provided a model that larger Canadian charities emulated. Starting with the universities in the early 1990s – largely through the Canadian Association of University Business Officers (CAUBO) – endowment practices were overhauled. Educational institutions, community foundations, hospital foundations, arts organizations, and religious organizations all expanded their focus on building investments to provide steady annual income for the long-term. The measure of success became preservation of capital in real, inflation-protected terms, which meant the generation of steadily increasing returns.

One of the key innovations was total-return investing, which treats all returns as potentially expendable on an annual basis, whether derived from interest, dividends, or capital gains. It is an immensely influential model that was adopted by the investment industry and large institutions with endowments. Now most computerized custody systems do not track capital and income separately. With its use of fixed payout and total-return investing, the U.S. model broke away from the strict separation of capital and income that exists in trust law.

This evolution to total-return investing also creates contradictions in the Canadian context that persist to this day. Most investment managers operate and report on a total-return basis, yet provincial trustee acts are grounded in trust law. "Endowment" is not a term used in the *Income Tax Act*, and the Canada Revenue Agency Charities Directorate's website does not provide a definition in its glossary of terms. By contrast, the Canadian Institute of Chartered Accountants has adopted "endowment" as a technical term in its generally accepted auditing standards for charities. This clash of authorities makes it difficult for charities to get clarity.

ENDOWMENT FUNDRAISING

The U.S. charitable sector also invented modern endowment fundraising, which represents a further subtle break from trust law. A traditional trust is assumed to be self-initiated by the settlor. This would also be a true of an old-style testamentary trust for charitable purposes. The modern endowment donor, while analogous to a settlor of a trust in the philanthropic context, is more likely to be responding to a specific fundraising request or, at least, the well-articulated expectations of a charity about endowments.

My first project when I was starting out in fundraising in 1990 at the University of Toronto was to draft a brochure for public consumption about the new "preservation of capital" policy. The policy changes were partly to address donor concerns. How can you solicit large sums of money without sound management practices? In a number of situations, it was not simply a matter of adopting state-of-the-art practices going forward; rather, it was addressing a failure in confidence due to past management practices. One example loomed large. The endowment of the oldest privately endowed chair at the university, founded during World War I, had eroded in real value over time, was no longer sufficient to meet the requirements of the position, and had not kept pace with inflation. The university had returned to the family after whom the chair was named and asked for additional funding to bring the chair up to current capital requirements. The family, not unreasonably, requested assurances that the university put policies in place to forestall similar future requests. In response, the university adopted a suite of new policies, and my rookie task was to make them presentable for public consumption.

I've often thought back to the contrast between my optimistic faith in the new policies and the problem it was meant to address. One of the oldest segregated university endowments in Canada had not managed to preserve its real value or retain its original purchasing power. Time and unknown circumstances had eroded intent. The promise of perpetuity was salvaged only by a fresh infusion of capital: a mid-life renovation. This example has always tugged at my faith in endowments. Although I have many positive examples of endowments that have performed well – one private foundation managed by my employer has grown from $13 million to $105 million over 55 years and distributed in excess of $120 million – the run-of-the-mill underperforming endowment does not receive much scrutiny. While charities have been responsible for putting in place a series of progressive policies, few Canadian endowments have been tested over 75 years. A lot can happen in that time.

In the spring of 2008, the Toronto-based fundraising consulting firm KCI featured endowment fundraising in its *Charitable Trends* newsletter.[5] The article is a telling articulation of the classic arguments for endowments and endowment fundraising. The CEO of YMCA Canada is quoted as saying, "Endowment means permanence and enables long-term planning." Implicit is the idea that endowment fundraising raises the bar for charities in securing funds. The old-style capital campaign has been replaced as "universities regularly conduct comprehensive campaigns whereby fifty percent or more the institution's fundraising priorities require endowed gifts." The implication is that endowments not only advance mission but also have become an important fundraising technique.

Except for a few rare exceptions, fundraisers at most charities find it difficult to raise funds for unrestricted endowments. This is partly the result of targeted "major gift" fundraising and the prevalence of individual named endowment funds, often for a special purpose, for example, a scholarship. A number of major charities in Canada have used unrestricted funds to leverage or match new donations for restricted endowments. It's effective fundraising, but it ultimately decreases organizational flexibility. KCI states that U.S. charities with large endowments have the challenge of informing donors that "the income from most endowments is inherently inflexible as the vast majority of gifts to endowment are restricted. As a result, having a large and robust endowment does not mean that the institution is about to respond to urgent and emerging needs." The same observation is made about Harvard in the Vanity Fair article. The University of Toronto reports that 84.1% of its endowments are restricted. Bob Skillen, chief advancement officer at UNB is quoted in the KCI newsletter as saying, "Our endowment grew by $40 million in the last campaign. The success came primarily from raising money for chairs and scholarships. We found it very difficult to raise money for unrestricted endowment." Large gifts are typically restricted gifts, and endowments are one of the most compelling destinations of large gifts. The life savings of the donor become the life savings of the charity – segregated in a personal fund.

Charities frequently ask me, wishfully, how to build an endowment. Images of large pots of money inspire boards to engage in collective "what if" fantasies. "If only we had an endowment of $10 million, we would not have to worry about annual fundraising," one board chair told me (with a straight face). To a small charity, the prospect of having an endowment is like winning the lottery. The irony is that contemporary endowments rarely provide organizations with the flexibility that directors want.

CHARITY RESTRICTIONS

If perpetual endowments are primarily created by donors who provide a direction of perpetuity, the desire for perpetuity and many of the restrictions placed on endowments are largely fostered by charities themselves.

One distinction I learned early in my fundraising career from a U.S. mentor was "true endowment" versus "quasi-endowment." While this terminology has never fully caught on in Canada, it is reflected in practice at many charities. A true endowment is a donor-restricted fund that is perpetual and in which capital is sacrosanct. A quasi-endowment is, at least in Canadian parlance, a reserve or rainy-day fund. A quasi-endowment is managed as a "true endowment" and in most years only income (or later, a limited fixed payout) is utilized for mission; fundamentally it is a discretionary fund. In some charities, quasi-endowments are considered to be "board-" rather than "donor-" restricted endowments. As a result, when capital is needed for immediate charitable purposes, the board can authorize its use. The logic is that it is imprudent for boards to restrict themselves in their fiduciary duties. Quasi-endowments tend to be created using unrestricted bequests and ancillary revenue. They are the most valuable form of charitable fund. But it is true endowments that are taking over, and this unfortunately reduces responsiveness to charitable priorities.

In the early 1990s, an experienced U.S. fundraiser gave me a tip. "Donors respond enthusiastically to the idea of perpetuity," he said. "A fund that lives forever addresses a deep emotional need for many donors – a way to defy death and be remembered by an institution they love. Mention perpetuity and you've got them." At the time I was struck by both the brazenness of his technique and the articulation of a human need to be remembered and appreciated, and to contribute. Endowment fundraising, if not done carefully, can become a sales job that has long-term implications. Perpetuity is something charities sell – a bit like the medieval church sold indulgences – partly because they want to build permanent pools of money and partly because it is an attractive "product." Particularly over the last 20 years, the larger Canadian charities have taught donors to ask for and expect perpetual endowments. As the conditions were made at the time of the gift, the charity, as trustee, developed systems to protect capital.

Over time I have worked with many donors who have responded to the message of permanence and legacy. As a gift planner, I have tired to promote the concept of personal endowment funds without being manipulative. Often donors are planning for the distribution of a large portion of their estate. Through *their* endowment, their personal legacy becomes associated with the causes they hold dear. Since endowment funds often become a proxy for a donor's legacy, they are naturally treated with respect and conservatism. Capital is protected. What is objectively a financial resource becomes laden with emotion and meaning, which may, at times, get in the way of an organization's mission.

One lesson from the endowment crisis has been the lack of flexibility that charities have to meet immediate needs, despite the fact that they may still have millions of dollars invested. Charities are partly to blame, however, and the fault lies in few areas.

1. Donor expectations about the perpetual nature of funds are fostered by charities through the fundraising process (as discussed above).
2. Endowment agreements often stipulate that funds are perpetual and capital protected. To be fair, this is partly in response to disbursement quota rules, which will be discussed below. These agreements create funds that are subject to trust law and provincial trustee acts, and can only be changed through court cy près applications.
3. Endowment policies often provide formulas that restrict the use of capital, either in outright terms or in response to the formula (as was the case with University of Toronto in 2009).
4. In a few cases, charities are subject to statutory restrictions. For example, the Vancouver Foundation had to change its founding provincial act in order to access capital to make grants in 2009.

Charities should promote endowments that enable greater flexibility in the long-term management of funds. The standard practice adopted over the last 20 years led to some progress. Endowments moved away from distributing income only and started to use the total-return model, which enables limited use of capital. Most standard endowment agreements introduced the "right to vary purpose" clauses that enable the charity to redirect the use of the annual payout if the original purpose is no longer relevant. But charities need to go further to reduce unnecessary restrictions on endowments. They need to consider mechanisms like time limits, greater use of capital, and sunset clauses. I don't say this lightly. Part of the value of endowment restrictions is that they protect funds for the future from the potentially spendthrift ways of current trustees. But there should be consideration to taking endowments closer to the "quasi-endowment" model.

An example of this evolution can be found in the "donor-advised funds" of certain public foundations in Canada. One such foundation with which I have been closely involved, Aqueduct Foundation, has attracted over $200 million in donations in three years by offering the donors the option of granting both capital and income from donor-advised funds. Hence, in 2008 a number of Aqueduct donors recommended grants of capital in response to community needs, despite the market downturn. Other funds have short-term mandates and grant out the whole fund within a year or two. Using the mechanism of donor recommendations, donor-advised funds can shift from a model that focuses on protecting funds from capital erosion to one that is built for the long-term but that can respond in the moment through use of capital. Donor-advised funds are a type of donor-restricted fund, but their terms can be more flexible than those of traditional endowments. While it is not easy to apply this model to large institutional endowments, this kind of thinking also works in the context of private foundations.

DISBURSEMENT QUOTA

In 2008 and 2009, the disbursement quota rules in the *Income Tax Act* proved to be one of the biggest barriers to the effective use charitable funds. These rules create a system in which tax receipted donated funds are either short-term or long-term. The majority of donated funds – ordinary gifts – are subject to the so-called 80/20 rule under which 80% of the money must be spent on charitable purpose by the end of the year following receipt. In order for a charity to hold receipted funds for the longer term, they must be designated as "ten-year gifts" of enduring property if given during a donor's lifetime. The ten-year gift mechanism is a trust mechanism whereby the donor instructs the charity to hold onto the capital of the donation for a minimum of ten-years per section 149.1(1). Due to fear on the part of tax authorities that funds will languish within charities unspent without this legal framework, the disbursement quota ends up having the reverse effect. There is no simple or direct mechanism for charities to receive donations from living donors and spend down the funds over, for example, seven years.

The ten-year hold mechanism is particularly harmful for charities. Grounded in trust law, the provision forces charities to track each ten-year gift separately and keep the capital intact. This is a highly impractical system that serves no apparent purpose. First, many charities receive multiple ten-year gifts, often from the same donor to the same fund. For example, a five-year pledge would result in five gifts with ten-year restrictions, each of which has to be tracked. Needless to say, very few charities are able to be compliant at this level. Second, as previously mentioned, most modern computerized custody systems do not separate capital from income; only trust-based systems do. This means that many charities are unable to get investment reports that enable their compliance. Third, the ten-year period for holding capital is entirely arbitrary and confuses both donors and charities. (Charities and donors frequently asked if the funds must be expended after ten years.) Finally, the trust that the ten-year hold triggers is largely redundant. If there is a desire to hold the funds as a perpetual endowment or for a specific length of time, the gift documentation will state it. Tax law does nothing except add unnecessary compliance requirements.

In 2005, the disbursement quota was overhauled and made even more complex. The concept of "enduring property" was introduced into the disbursement quota. The long-standing mechanism of the ten-year gift became just one of five types of receipted gifts that are considered to be enduring property. The other four types are bequests, life insurance proceeds, registered retirement funds received through direct designation, and enduring property received through inter-charity transfer. (Revenue that is not receipted and that is invested in a quasi-endowment becomes enduring property by default because the T3010 charity return does not separate out this category of charity investment assets.) The ten-year gift is the only type of enduring property that does not allow for the use of capital. With the other categories of enduring property, capital can be spent on charitable purposes. Spending capital of enduring property creates an 80% disbursement quota obligation for the amount expended, which is also an extraneous requirement, but at least it allows access to capital. So Canadian charities have a system where not all types of a master category of charitable property are treated the same, yet neither are they consistently distinguished for tax reporting purposes. The complexity is absurd. It is also harmful to charities and public benefit because it puts charities in a position where they are potentially breaking the law if they wish to use the capital of a ten-year gift. This occurred more than once in 2008 and 2009.

The chair of the parallel public foundation of a noted performing arts organization came to me last year with just this conundrum. The foundation had a disbursement quota surplus going into the year but, like many charities, experienced significant investment losses in its endowment. The foundation did not have sufficient income to pay out to the performing arts company, and the company, faced with declining ticket sales, was contemplating cancelling performances and laying off artists. The foundation board wanted to use capital from its endowment to help out the associated charity but was hampered by the disbursement quota rules because most of its endowment was subject to the 10-year rule. The 2005 changes to the *Income Tax Act* provided a formula – B.1 of the disbursement quota – whereby capital could be used to satisfy the disbursement quota, but this foundation had a disbursement quota surplus. The foundation was informed by legal counsel that it could only use capital to meet the disbursement quota formula, which was already satisfied because the surplus. In other words, the formula, in this case, prevented the charity from using funds for public benefit.

A recent paper published by Imagine Canada demonstrated that information provided by charities on the T3010 charity return has a high error rate, although this study did not focus on disbursement quota reporting errors.[6] A casual review of T3010s of major charities with long-term investments shows that even large, well-run charities often are not compliant with the disbursement quota requirements. Foundations, like the one discussed above, become tied in knots, which is galling became the system is not equitable to all charities. Frankly, the disbursement quota system does not, in practical terms, apply to large government-funded charities. Universities, for example, receive so much government funding and earn revenue relative to receipted donations that they are effectively exempt from the rules that apply to smaller registered charities that are reliant upon donations. They were first to adopt a total-return investment model for endowments, which violates any fund that contains ten-year gifts. However, the universities adopted the total-return model to be prudent and in the process ignored the *Income Tax Act*. It is just another example of how this level of regulatory overlay is ineffective at enabling all charities to sensibly use their resources for public benefit.

This topic requires a lengthy discussion. Indeed, both the Canadian Bar Association and Imagine Canada argued in submissions to the Federal Government in 2009 that disbursement quota needs to be scrapped, particularly the 80/20 and ten-year gift provisions. These initiatives are to be applauded. The *Income Tax Act* often promotes a conservative definition of endowments and needlessly prevents the use of charitable resources for the public good. It mandates charities to create investment funds in which the capital is untouchable for ten years, and this creates a system in which capital is given greater protection than is required or desired.

In the U.S., foundations are required to pay out the equivalent of 5% of capital per annum versus the 3.5% minimum in Canada. There have been calls for the minimum to be raised to 5% if the disbursement quota is scrapped. A 5% annual disbursement would dictate the long-term erosion of capital for most endowments, as the historical real rate of return is approximately 4%. There is an argument to be made from a public policy perspective for a higher payout rate, but there is likely to be a significant backlash from large charities with endowments. Protection of capital in the long-term depends on lower payout rates.

CONCLUSION

Endowments can be attacked in a number of ways:

- Endowments are an inefficient use of charitable capital: why spend only four cents on the dollar?
- It makes no sense for the government to allocate current tax dollars in the form of donation incentives to fund future public benefit.
- Endowments cause charities to hoard funds, which impedes innovation.
- Endowments can outlive their purpose due to perpetuity clauses.
- When push comes to shove, endowments are structured to protect capital, which often means they do not serve the charitable purpose to their full potential.

While any of these arguments can be pursued vigorously, due to the congruence of utility, history, law, and market pragmatism, endowments are not going away. Nor should they. They are a key component in the Canadian charitable sector. But they need to be better understood. We should be less entranced by the myth of perpetuity and continual growth and more humbly aware that nothing lasts forever and that we have a responsibility to use the funds wisely. Charities should make every effort to build long-term funds without creating a system with unnecessary restrictions. In particular, charities engaged in endowment fundraising should review their use of endowment terminology and documents to avoid limiting future flexibility. The disbursement quota, in particular, should be overhauled to remove mechanisms that provide needless complexity and inhibit use of funds for charitable purposes. A more flexible, responsive endowment system is more likely to pass the next stress test when it occurs.

NOTES

[1] Munk, Nina. (2009, August). Rich Harvard, Poor Harvard. *Vanity Fair,* pp. 106-112, 144-148.
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