Addressing the Foundation Return Challenge

Meeting Return Targets in a Changing Environment

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Foundations in Canada support a vast array of organizations and by nature, they are each quite unique in terms of their size, governance and granting philosophy. When it comes to stewardship of endowed capital, however, foundations have a common purpose. They are keenly focused on meeting the distribution and granting needs of the organizations they support while simultaneously preserving capital and growing it at a reasonable pace through long term investment returns and, in some cases, fundraising.

Meeting these goals and stewarding a foundation has never been straightforward, but thankfully, over the last decade or more, equities have been a steady return stream for investors. Many foundations have also had success using alternatives such as real estate, private equity, private credit, and infrastructure to provide income during an era of low rates.

Looking ahead, foundations face new challenges in light of recent changes in tax rules as well as a changing market environment. Not only have the needs within the supported communities and organizations continued to expand, but foundations also face the formidable hurdle of the CRA's new minimum disbursement quota made into law in 2023. When you add in lower forward-looking returns from asset classes across the board, foundations face even more pressure to meet their return goals, even on a short-term basis.

The need to meet this new distribution goal in a risk-controlled way has quickly become one of the primary considerations for investment committees and boards when they are setting asset allocation and considering manager selection.

Active fixed income can play a key role in meeting this challenge. This paper outlines a solution using liquid high quality corporate bonds and offers a case study for consideration.

The New Return Challenge

Over the last decade, foundations had a good margin between the expected return and their spending rate, but that is no longer the case. A survey conducted by Mercer revealed that most foundations indicated a spending policy rate of over 4% as of 2020 – before the new, higher minimum disbursement quota. While spending goes up, expected return has gone down, upsetting the vital equilibrium foundations need for long-term sustainability. Back in 2013, the expected 10-year return of a foundation's portfolio was close to 7%. By 2020, that had shrunk to 5%, leaving foundations with an extremely narrow margin, which has likely been worsened today due to continued economic uncertainty.

Based on the new quota, most foundations will now need to aim for a target return of 7 – 8% in order to fulfill their dual goal of meeting distributions and preserving existing capital and new donations beyond inflation.

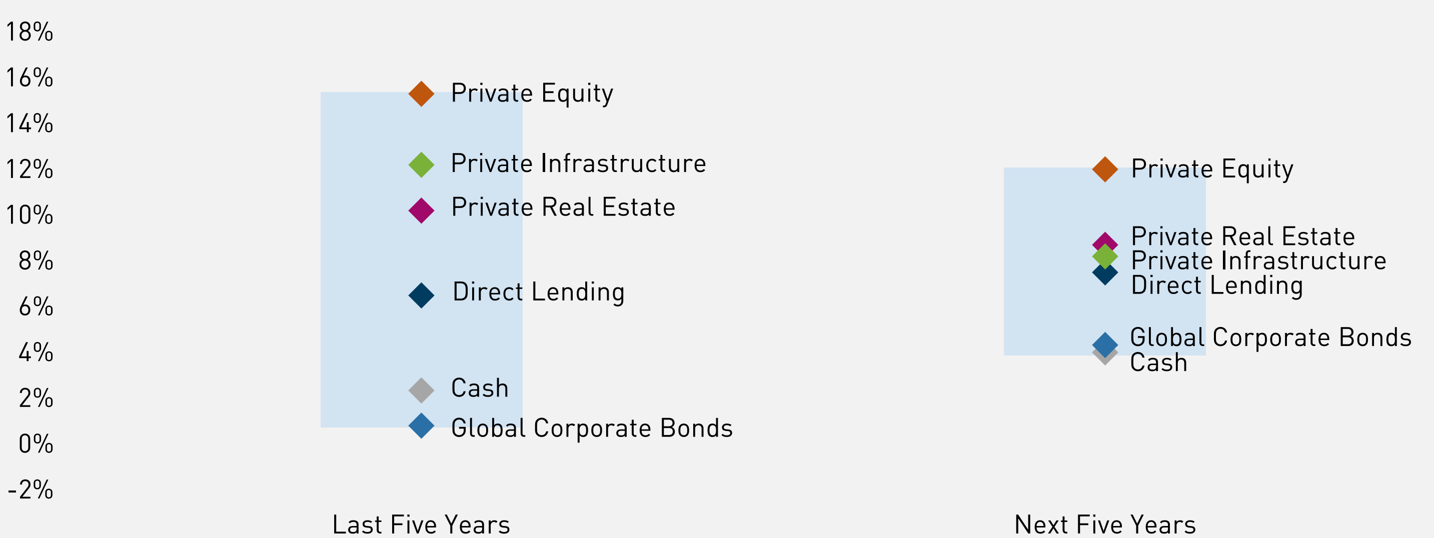
5% CRA distribution quota + **0.5%** expenses + **2%** inflation = **7.5%** minimum return target

Meeting the Goal

Although each foundation in Canada is unique, most investment committees came into the 2000s with a fairly traditional asset mix of 30-40% fixed income and 60-70% equity. After a period of low interest rates, a common shift recommended by consultants has been to make larger allocations to private asset classes (e.g., private equity, infrastructure, and private debt), which have historically provided investors with both good income and low volatility. In a world of low interest rates, these private assets helped foundations meet return goals and take advantage of the long-term nature of the investment profile of an endowment.

But does this still work? Allocation analysis by KKR revealed that expected returns in most private asset classes will compress over the next five years as private markets mature. If this materializes, the additional return foundations were once able to obtain through a liquidity premium and in some cases higher risks will shrink, and traditional asset classes will need to pick up the slack to meet minimum return targets.

Return Expectations are Predicted to Shrink Considerably Over the Next 5 Years



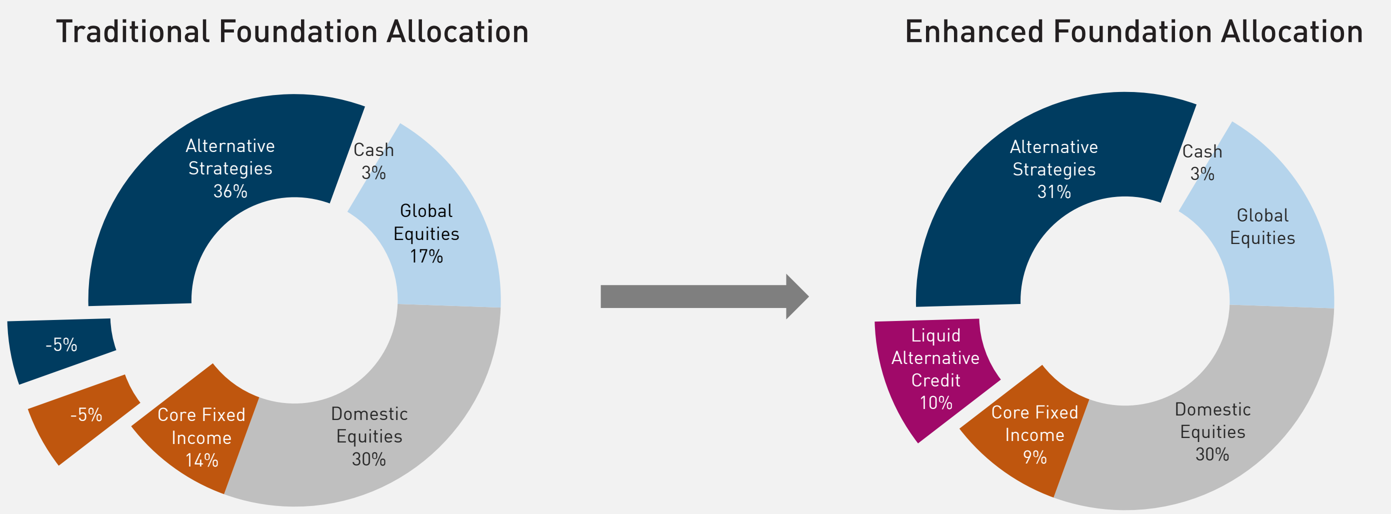
Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, FTSE. Data as of September 30, 2024.

While return expectations are diminishing, the level of due diligence and governance required to maintain private asset classes remains an additional cost for foundations. These costs are a direct result of the inherent lack of transparency in the asset class, in terms of both volatility and valuations. Given it is more difficult to exit these asset classes, the resources needed to undertake due diligence will continue to be a burden foundations need to account for. The additional governance requirements were an acceptable cost when private markets were burgeoning and delivering strong returns with minimal volatility. As this asset class matures, the additional effort required for private allocations becomes counterintuitive to meeting the goal in a cost-efficient manner.

A Simpler Solution

A simpler and potentially more effective solution can be to reallocate a portion of the existing fixed income allocation toward active fixed income and alternative fixed income strategies. Unlike the past decade, today's rate environment has increased the attractiveness of fixed income as an asset class. Layering on diversification through different investment styles within this allocation can add meaningful return without increasing risk and taxing the governance of a foundation board. With an expanded fixed income sleeve, including liquid credit strategies and alternative fixed income, foundations can benefit from the best of both worlds – higher returns without higher risks.

Adding an Active Long/Short Credit Strategy to a Traditional Foundation Portfolio Can Improve Returns and Lower Volatility



Data as of January 31, 2025. Source: Bloomberg, eVestment, Commonfund. Traditional foundation allocation based on Survey done by Council on Foundation for the year ended 12/31/2023. Indices used as return proxies: Liquid Alternative Credit = RP Select Opportunities (Net); Alternative Strategies = Average of HFN Hedge Fund Aggregate Index and Refinitiv Private Equity Index; Cash = FTSE TMX Canada 91-Day T-Bill Index; Global Equities = MSCI World Index; Domestic Equities = S&P 500 Index; Core Fixed Income = Bloomberg Barclays Global Aggregate Corporate Index (CAD Hedged).

There's a wide spectrum of approaches to adopting or increasing the active credit allocation within a portfolio.

Active credit strategies backed by the right expertise, investment processes, and risk management can capture inefficiencies in credit markets, add diversification, hedge unwanted portfolio risks and provide enhanced returns without sacrificing liquidity or adding higher levels of governance. Unlike private asset classes, active credit strategies can provide weekly or monthly liquidity to fund disbursements and allow foundations to efficiently rebalance the portfolio to stay on-side with the investment policy.

Simply put, foundations don't need to reach for riskier illiquid asset classes when the lowest risk and most liquid part of the portfolio can generate robust returns.

For more information on how incorporating active credit into your foundation portfolio could help you achieve your investment objectives, please reach out to a member of the RPIA Client Team.

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