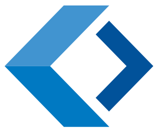


Re-positioning the Foundation Portfolio

Solutions for the New Environment

August 2023

Overview

In 2022, the Government of Canada increased the disbursement quota for foundations from 3.5% to 5%. This means that these institutions now need to make a real (after inflation) return of at least 5% per annum to meet their spending commitments and preserve the value of the asset base. In the current inflationary environment, this means foundations will likely need to make at least 7-8% per annum in nominal terms.

This change to the disbursement quote came as foundations were already facing return challenges with the expected returns across many asset classes (such as equities and real estate) potentially being lower in the near future as economies cool and monetary and fiscal policies are scaled back.

The good news is, for the first time in over a decade, foundations can earn an attractive yield on fixed income investments due to the significant increase in administered interest rates across the globe. The uncertain outlook also provides specialized fixed income managers with attractive opportunities to add additional value through active management.

In light of this, we believe foundation executives and trustees should be taking stock of the new environment and re-evaluating their asset allocation with fresh eyes. Given the market uncertainty and the dramatic shift in valuations for fixed income, we think foundations should be adding exposure to "Active Credit" strategies that can help them meet the required return while also contributing to portfolio resilience.

Background

For context, the COVID-19 crisis of 2020 put unprecedented demands on Canadian charities and foundations to help cushion the blow for individuals and families. From a policy perspective, governments and central banks responded to the economic impact of the crisis with a combination of monetary and fiscal stimulus measures unlike ever before. This decisive approach enabled economies to bounce back quickly while there was a sharp rebound in global asset prices.

However, central banks were too slow to remove emergency stimulus measures, which fueled inflation. Then, the situation was made worse by the Russian invasion of Ukraine in 2022 and the consequent supply chain disruptions. The culmination of these events resulted in the Federal Reserve and the Bank of Canada raising overnight interest rates by almost 500 bps from a near-zero level to above 5% in under a year. This monetary tightening in 2022 led to the worst returns for fixed income in 40 years, but it also created strong return potential moving forward.

Revisiting the Need for Liquidity

Over the last few years, Canadian foundations have increasingly embraced private market allocations for both equity and credit. There were several justifications for this:

1. Incremental return potential given public market valuations
2. Foundations having excess liquidity
3. Additional portfolio diversification

While we still acknowledge private asset classes can play a key role in a well-balanced portfolio, we would make the following points:

- With the significant reset in public market valuations, particularly for bonds, there is less need (from a return perspective) to explore riskier private options than in previous years.
- In this new, more volatile environment, we believe it makes sense for foundations to have more liquidity at their disposal to respond to changes in the market environment.

We believe significant value can be captured by rebalancing the portfolio as valuation discrepancies expand and compress. This rebalancing is only possible if you have sufficient public market or liquid allocations. In short, we believe that going forward, foundation trustees and fiduciaries should tilt back toward public rather than private market opportunities.

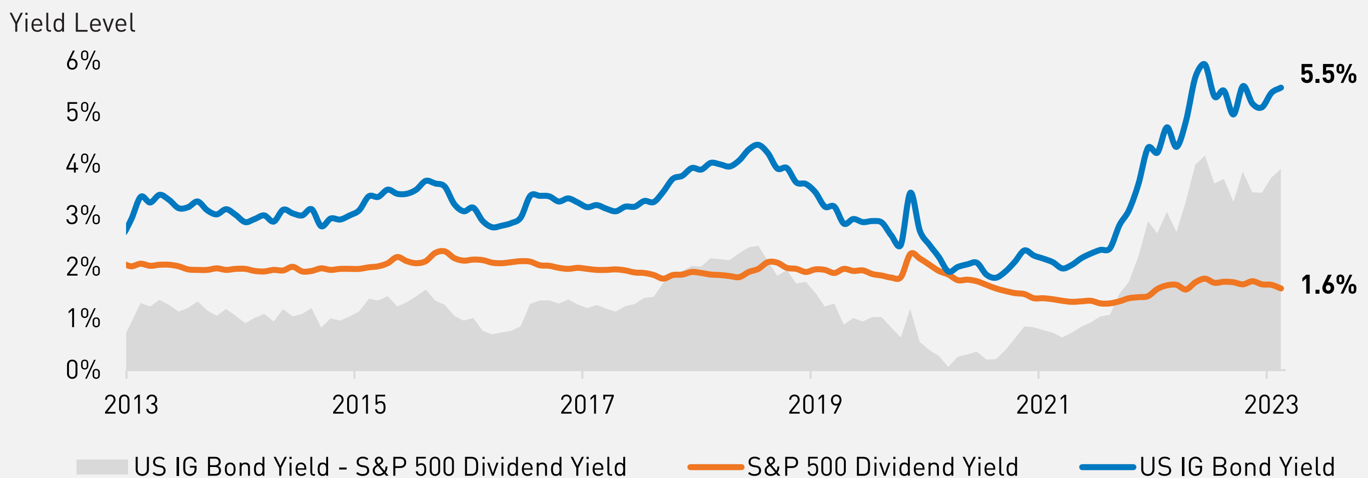
Higher Yield Expected from Fixed Income Going Forward

The silver lining is that the significant drop in bond prices means the yield available in the fixed income market today is higher than it has been in many years. As a result, fixed income offers investors strong return potential and a degree of protection in the asset class that simply wasn't there in the low interest rate era. Bond investors can collect returns while sitting at the top of the corporate capital structure, finding comfort in the knowledge that they have seniority compared to equity investors. In our opinion, investing in bonds today means experiencing the best of both worlds – sitting high in the capital structure while earning an attractive yield.

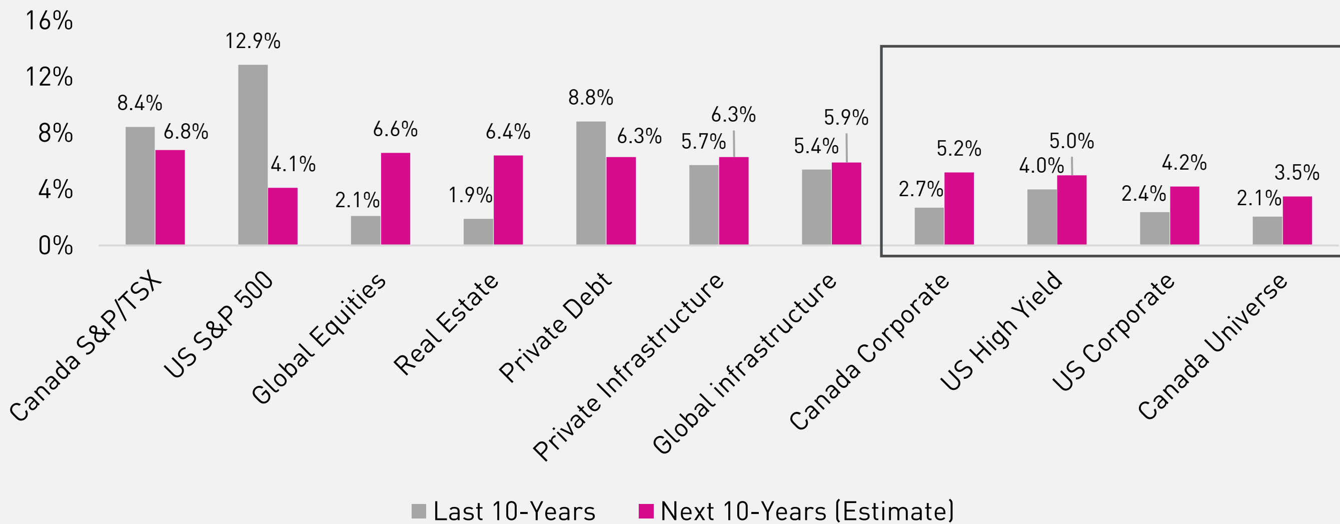
The picture for other return-seeking asset classes is less clear. Price-Earnings multiples for equities are still above average by historical standards despite weaker corporate earnings and a slowing economy. When looking at real estate, cap rates (the expected rate of return on a real estate investment) arguably have not corrected sufficiently to factor in the new reality of financing costs (with perhaps the exception of office real estate). The projected future returns of these asset classes are significantly less than the returns available to investors over the last decade.

In our view, what worked well over the last decade will not continue to work in the present environment. Consequently, fiduciaries need to think carefully about the risks they want in their portfolios in the coming years.

Bonds vs. Equities Dividend Yields Paint a Very Different Picture Today Compared to 10 Years Ago



Source: Bloomberg. Data as of June 30th, 2023. US IG Bond Index: BarclaysLive.



Past 10 Years as of June 30th, 2023. Private Debt past 10 year return as of March 31st, 2023. All returns in CAD. Source: RPIA, FTSE, MSCI. Next 10 Years from CIBC AM 2023 long-term expected returns for capital markets (cibcassetmanagement.com).

Global Equities = MSCI EAFE Index; Real Estate = NAREIT Developed Real Estate; Private Debt = Cliffwater Direct Lending Index; Private Infrastructure = MSCI World Infrastructure Index; Global Infrastructure = Dow Jones Brookfield Global Infrastructure Index; Canada Corporate = FTSE Canada All Corp Index; US High Yield = Bloomberg Barclays US HY Index; US Corporate = Bloomberg Barclays Corporate IG Index; Canada Universe = FTSE Canada Universe Bond Index.

The Role of “Active Credit” in Improving Your Fixed Income Return Potential

Foundations are blessed with much more investment flexibility than other institutional investors, such as pension plans and insurance portfolios. Therefore, CIOs and foundation board members can “get creative” to meet this return challenge.

We believe foundation trustees and fiduciaries should ask themselves the following questions:

1. Given the economic outlook and relative return projections, do we have enough fixed income in our portfolio?
2. Within the fixed income portfolio, are we utilizing the right approach to maximize risk-adjusted returns?

On average, Canadian foundations have 30% of their portfolios allocated to fixed income. This percentage steadily decreased during the low-yield era as investors searched for yield elsewhere.[1] We believe allocators should now be redeploying capital back into fixed income for better portfolio returns, diversification, and liquidity.

[1]Source: Bloomberg.

When thinking about the composition of the fixed income portfolio, we believe active strategies focused on Investment Grade ("IG") corporate bonds should be a key component of the solution for foundations for a few reasons:

- **Attractive Risk-Reward Profile:** Investors in corporate bonds generally earn an extra ~2% per annum in coupon income compared to investors in government bonds due to the credit risk of these instruments.[2] Historically, this additional coupon has been more than sufficient to protect investors in IG bonds from the risk of default. Active managers often do even better by employing active management techniques to generate alpha.
- **Returns from Market Inefficiencies:** Active management in corporate bond markets works because the inefficiency of credit markets allows a skilled manager to add excess returns while still maintaining the traditional defensive characteristics that investors require from their fixed income allocation.
- **Diversification:** Global active managers can opportunistically invest in both Canadian and non-Canadian securities, which offers a wider opportunity set. A knowledgeable investment team can provide investors with better value and diversification through expertise in global security selection.

What is an Active Credit Strategy?

- **Typically focuses on generating returns by opportunistically managing a portfolio of public corporate bonds.**
- **Often uses hedging techniques to manage risk and ensure investors are compensated in any market environment.**
- **Highly liquid and does not require an investor to lock up capital for any particular time period.**

Final Thoughts

We believe last year's change in the DQ and the shift in outlook presents a material change for the way foundation executives and trustees approach investment decisions. In our view, it is incumbent on fiduciaries to take a fresh look at their portfolio mix. We think foundations should have more fixed income in their portfolio today as what has worked in the last decade cannot work in the current environment. Beyond this, Active Credit strategies can form an important component of a foundation's optimal asset mix by providing a way to generate better returns from their fixed income allocation through active management.

Please get in touch with us if you would like to learn more about our active global expertise and how our solutions can help foundations across Canada achieve important risk-return objectives.

[2]Source: Bloomberg.

Important Information

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