RPIA
Global Fixed Income Experts

The Hurdles Facing Foundations Have Never Been Higher

Responding to a higher disbursement obligation in a lower return environment

Overview

The Government of Canada is increasing the disbursement quota for foundations, which presents a particular challenge for institutions that now need to make at least 7% per annum to meet their spending commitments and preserve the real value of their asset base. This comes as foundations are already facing return challenges given the expected investment returns across many asset classes will be lower going forward as monetary and fiscal policy are scaled back. In light of this problem, we believe foundation executives and trustees should look to "Active Credit" to improve the return potential of their fixed income allocation.

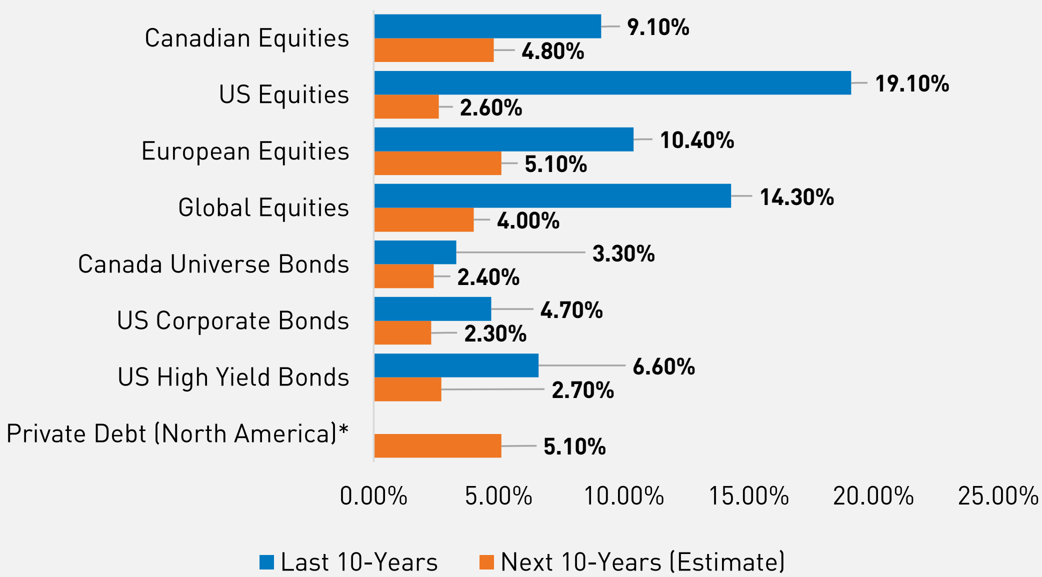
Lower Returns Expected From Fixed Income Going Forward

The COVID-19 crisis of 2020 and the severe public health crisis put unprecedented demands on Canadian charities and foundations that aimed to cushion the blow to 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 have been slow to remove emergency stimulus measures, which has fueled inflation. Market consensus is that central banks are "behind the curve" and now need to increase interest rates 6-7 more times in 2022 to cool inflationary pressures that were only made worse by the Russian invasion of Ukraine and consequent supply chain disruptions.

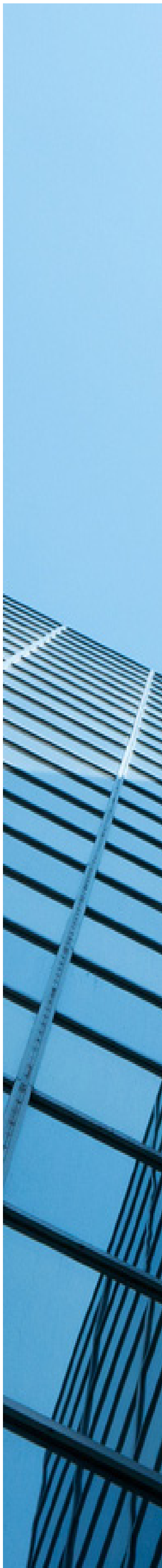
This combination of elevated asset values and tightening monetary policy does not bode well for future returns, as reflected in the l capital market assumptions of investment consultants globally. Forward-looking returns across the board are lower than the returns experienced over the last decade. Fixed income returns will be particularly difficult to come by in the coming years, given low yield levels and increasing interest rates.

Asset Returns - Past & Next Ten Years (CAD)[1]



[1]Past 10 Years as of December 31, 2021. All returns in CAD. Source: RPIA, FTSE, MSCI. Next 10 Years from CIBC AM https://www.cibcassetmanagement.com/email/assets/documents/pdfs/CAM2022-Long-Term-Market-Returns_En.pdf

Can Foundations Meet Spending Commitments and Preserve the Real Value of Their Asset Base?



This return outlook presents a challenge for all investors, particularly foundations. Under Canadian tax law, foundations must spend a minimum amount each year on their charitable programs or gifts to other charities to maintain their "tax-free" status. This Disbursement Quota ("DQ") for Canadian foundations had been set at 3.5% since 2004, which had been a manageable hurdle for foundations during a terrific market for most asset classes. However, the DQ is currently expected to increase to 5% per annum[2]. This alone is enough reason to re-evaluate a foundation's asset mix, which is now even more important given the economic headwinds.

Foundations typically target investment returns sufficient to cover this spending commitment plus inflation. With elevated inflation estimates today, Bank of Canada's longer-term 2% inflation target, and the increased DQ of 5%, foundations might need to aim for a 7% target return net of fees from the investment portfolio.

In previous years, foundations could rely on a traditional asset mix of Canadian stocks and bonds to deliver a 5.5% return (DQ of 3.5% and 2% inflation). Going forward, foundations will need to get creative. While a 60/40 portfolio of stocks and bonds historically delivered 7.5% , it is expected to deliver only 4% going forward, or 2% in real terms. With the Canadian bond universe yielding only 3% as of March 31, 2022, the fixed income segment of the portfolio will not be able to deliver sufficient returns to meet the DQ, let alone meet the required return to stop the assets from shrinking in real terms.

This means foundations either need to reduce disbursements (which is very hard to do), draw down upon the capital base (undesirable), or make changes to the investment portfolio composition. We believe the latter approach is the preferable one.

[2] The DQ is based on the fair market value of a foundation's assets, averaged over a 24-month period. The DQ was cut from 4.5% to 3.5% in 2004 because that lower rate was considered "more representative of the historical long-term real rates of return earned on the typical investment portfolio held by a registered charity" according to the Department of Finance. The proposed change to 5% was included in the 2022 Federal Budget.

Foundation Executives and Trustees Should Consider "Active Credit" to Improve Their Fixed Income Return Potential

Canadian foundations have an average of 30% allocated to fixed income , which has served foundations well over the last decade. However, given the outlook for fixed income returns, this allocation will drag foundation portfolio returns in the coming years. The silver lining is that 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 the most logical first step is to explore ways to adjust the fixed income allocation to ensure a better balance between risk and return. Active credit strategies can be a key part of the solution for foundations because they can deliver additional returns from fixed income without taking undue risk. Credit markets are inefficient, making it possible for a skilled manager to add excess returns while still maintaining the traditional defensive characteristics that investors require from their "safe" assets. Therefore, allocating active credit strategies can be a quick and effective solution to help move a foundation's expected returns toward the higher Disbursement Quota. Furthermore, active credit strategies can make an ideal complement to government bonds or private debt allocations.

What is an Active Credit Strategy?

1. **Active Credit strategies typically focus on generating returns by opportunistically managing a portfolio of public corporate bonds.**
2. **Strategies of this type can often invest in both Canadian and non-Canadian securities, meaning a wider opportunity set and better diversification.**
3. **These strategies can have low or minimal exposure to rising interest rates – a sharp distinction from "traditional" bond allocations.**
4. **Active credit strategies can be highly liquid and do not require an investor to lock up capital for any particular time period.**

We believe that the increase in the DQ presents a material change for foundation executives and trustees. Foundations were already facing a return challenge in a lower return environment, which is now compounded by requiring a higher return target. In our view, it is incumbent on fiduciaries to take a fresh look at the risk-reward of the fixed income allocations in place. At this point in the cycle, an incremental change can be better placed than materially increasing portfolio risk. We believe active credit strategies are a key part of the solution.

Please get in touch with us if you would like to learn more about our solutions to foundations across Canada to help them meet their risk-return objectives.

Important Information

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As Head of Client Portfolio Management, Liam leads the team responsible for developing client relationships and developing new investment solutions. Prior to this role, Liam spent several years managing corporate bond portfolios for the firm, with a focus on the Canadian corporate bond market.

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