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Foundations Face an Uphill Battle, But Active Credit Can Help

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The emergence of higher inflation and the consequent global shift to tighter monetary policy has prompted market volatility and dampened expected returns for many asset classes.

This challenge is especially pressing for foundations due to their obligation to distribute a minimum percentage of their asset base annually.

Following the increase in the Disbursement Quota to 5% in 2023, foundations must now secure a long-term annual rate of return of around 9% to preserve the real value of the asset base. In other words, foundations must generate much higher returns to meet their spending commitments at a time when achieving robust returns is becoming more elusive.

To contextualize this new reality, the 9% target exceeds the historical returns of the Canadian stock market over 10, 20, and 30-year investment horizons. Foundation CIOs and fiduciaries are rightly concerned about how they will meet this challenge.

In response, foundations are revisiting their asset mix, and many have increased their allocations to private asset classes (including private equity, infrastructure, and private debt).

In a recent survey conducted by Mercer, foundations were asked about their response to this topic and their outlook over the next few years. Survey findings indicate that 90% of large foundations have already increased or intend to increase their private asset allocations. More than half of the foundations surveyed expect increased spending as they strive to meet higher return targets over the next three years.

However, private allocations are not a panacea, and often come with additional risk.

Private Allocations: Cracks in the Foundation

Over the last decade, money has poured into private asset classes given the ultra-low interest rate environment that persisted until 2022. However, the sharp increase in interest rates has revealed potential problems with this approach, particularly for private debt firms.

Because private loans don't trade like public bonds or loans in a secondary market, they are generally marked in portfolios at par. Some allocators view this lack of volatility in valuations as an advantage because it dampened overall portfolio volatility, but that is not the case for long.

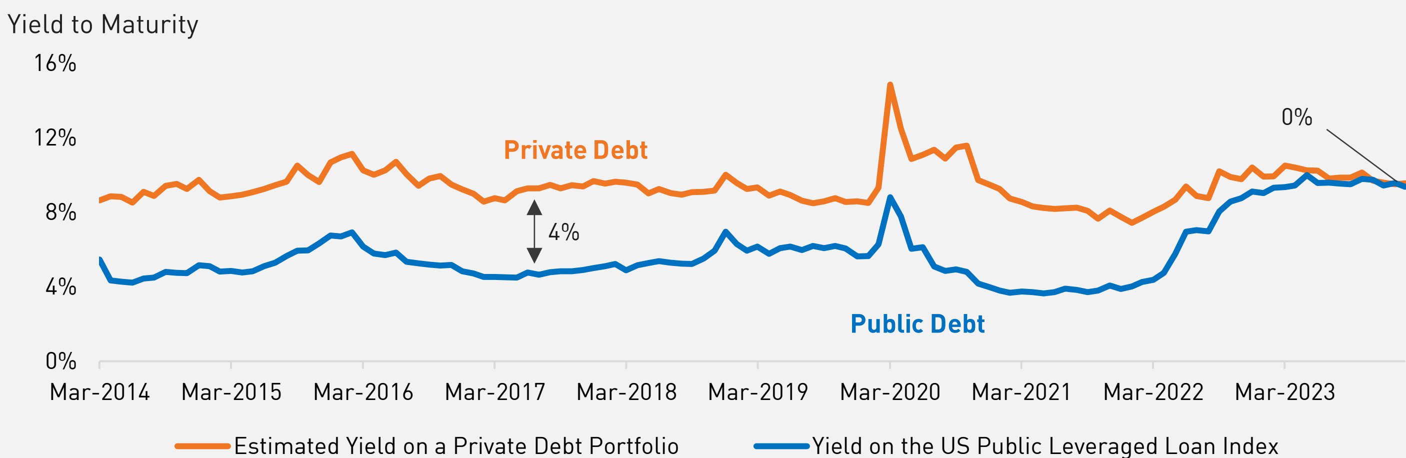
In recent quarters, we've seen some direct lending and private real estate lending firms take significant portfolio write-downs as higher interest rates and a slower economy have permanently impaired borrowers' ability to repay their debt.

Since the underlying loans in private debt portfolios are illiquid, many firms are forced to suspend or restrict redemptions, effectively handcuffing investors.

In this environment, investors need more liquidity to adapt to changing markets as the monetary policy paradigm continues to evolve – especially CIOs who need to opportunistically respond to market changes and ensure they can meet disbursement obligations.

The chart below illustrates how investors can achieve comparable returns by investing in more liquid, less risky asset classes.

The Estimated Liquidity Premium Has Fallen from Around 4% on Average to Almost 0%



Source: Bloomberg, Morningstar LSTA. Data as of February 27, 2024. Estimated Yield on a Private Debt Portfolio is estimated by the dividend yield on the Ares (ARCC) BDC Portfolio. This chart compares the Net Dividend Indicated Yield and the Morningstar LSTA US Leveraged Loan 100 TR USD Yield to Maturity; the credit quality of the indices/portfolios will differ. For illustrative purposes only.

Foundations that pursue larger allocations in private markets must also consider the heightened governance risks and the added burden of monitoring, which are typically not associated with public market investments. A larger allocation to privates means more complexity in your portfolio, which may prove particularly demanding for smaller foundations or those without private markets expertise on their Investment Committee.

Active Credit: A Better Alternative to Privates

In contrast, active credit can strike the right balance, enabling foundations to earn a reasonable return without sacrificing liquidity or adding undue complexity.

There's a wide spectrum of approaches to adopting or increasing the active credit allocation within your portfolio. Active credit strategies backed by the right expertise, investment processes, and risk management can capture inefficiencies in credit markets, diversify your portfolio, and provide attractive all-in yields with less risk than privates in both absolute and relative terms.

Simply put, you don't need to reach for riskier asset classes when the "safe" part of your portfolio can pull in returns over 6% with the possibility of additional returns through alpha generation.

In uncertain macroeconomic conditions, active credit strategies that focus on downside protection can also help hedge unwanted portfolio risks while providing liquidity when you need it most. This provides you the flexibility to fund disbursements and the ability to rebalance the portfolio to seize new investment opportunities.

Facing the uphill battle of maintaining their asset base and meeting their return objectives, foundations should consider active credit strategies as a better, more liquid alternative to private investments.

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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