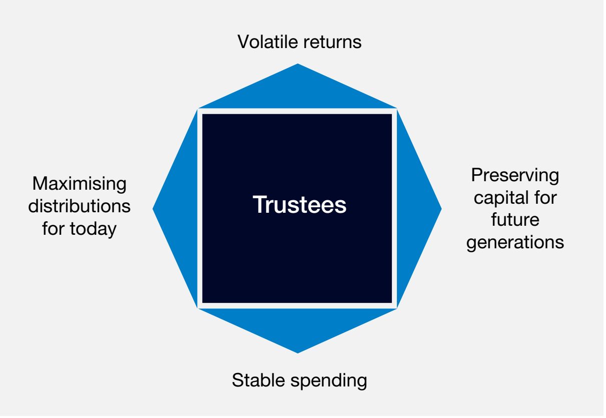
The foundations of investing for tomorrow, today

Kate Rogers, Head of Policy, Cazenove Charities

Recently published research from the Donors and Foundations Networks in Europe suggests that there are almost 150,000 registered 'public benefit' Foundations in Europe. These Foundations have a combined annual expenditure of nearly Eur 60 billion, with 90% of this expenditure accounted for by Foundations in Italy, Spain, France, Netherlands, United Kingdom and Switzerland. The same report puts the total assets of these Foundations at over Eur 500 billion. In the UK, the top 300 grant-making Foundations have some £52 billion of assets[1] with their investments representing over two thirds of UK charity investor assets according to the most recent NCVO Almanac.

Although definitions, laws and regulations vary across Europe, many of these Foundations share a common aim, to maximise their public benefit. They do this in two main ways, by spending on their projects today, or by investing for the future. In both cases Foundations are seeking to use the assets at their disposal to further their philanthropic purpose.

Finding the right balance



This raises two simple sounding questions for Foundation investors. What are the assets? And how can they be used to further the purpose through investment? The most obvious is the financial asset, but that is not the sole asset at a Foundation's disposal. Foundations can also use their reputations to effect change by challenging the companies that they invest in to meet the highest corporate responsibility standards. They can use their people to find interesting and specific new investment possibilities, and they can use their long-term time horizon to take advantage of short-term opportunities.

[1] ACF Giving Trends 2015

For the financial assets, investing to gain the maximum philanthropic benefit can be done through targeting a traditional financial return, to support spending; or through directly investing to bring about a desired social impact (social or impact investing). Increasingly Foundations throughout Europe are using a blended approach, considering both the financial and social return of any given investment choice, most frequently using responsible investment to reflect the aims and values of the Foundation in the investment strategy[2].

Many Foundations are established to be intergenerational, as social problems persist from one generation to the next. One way this sense of being tied to future generations of beneficiaries has been expressed in the context of investment is through what has come to be known as a desire to achieve ‘intergenerational equity’. This isn’t a legal formula, but it is an influential idea first articulated in 1974 by James Tobin, the former Professor of Economics at Yale, in an article on endowment management.

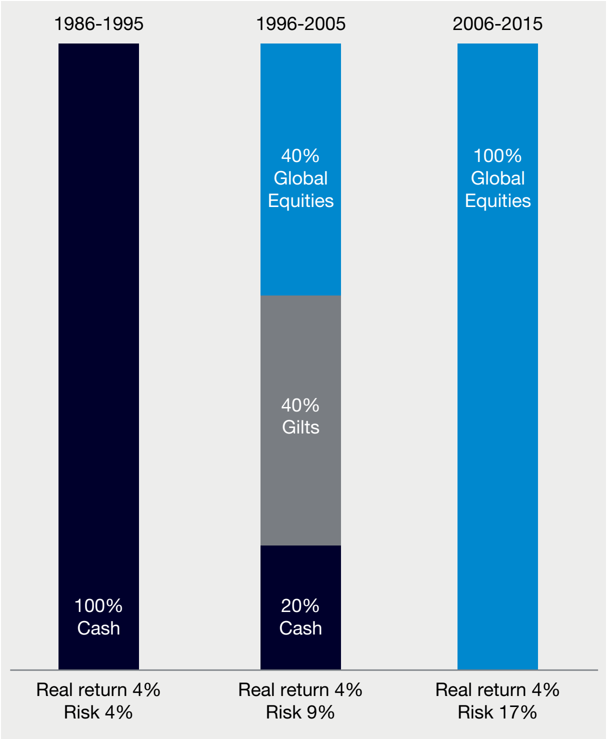
Tobin said, ‘the trustees of endowed institutions are the guardians of the future against the claims of the present. Their task in managing the endowment is to preserve equity among generations’.

This places trustees in a difficult position, attempting to find the right balance between spending today, and saving for the future, whilst also hoping to translate a volatile return pattern into stable year on year expenditure.

Foundation investment strategies are designed to meet these challenges. Frequently Foundations aim to maintain at least the value of the investment portfolio in line with inflation; whilst also maximising the spending that they are able to support today. This translates into a long-term financial objective of inflation plus spending. Much research, including my own in partnership with Richard Jenkins, has examined how to find the ‘right’ balance of spending and saving, with history suggesting sustainable spending rates of 4% per annum.

However, today’s investment environment provides problems for Foundations seeking these real returns (adjusted for inflation). With interest rates at historic low levels and diminutive, even negative, bond yields; investors are being forced to take more risk than ever before in order to achieve their target returns. Over the last three decades the capital volatility of a portfolio that achieved inflation plus 4% has increased by over four times.

Asset allocation of an inflation plus 4% portfolio



Source: Cazenove Capital. Datastream. Total return in GBP over 10 years, Inflation rate UK RPI; Global equities, MSCI World (NR); Gilts, FTA Govt All Stocks; Cash LIBOR. Risk measured by standard deviation of returns.

Lower returns also promote a focus on costs, and ensuring that the fees paid to investment advisors are compensated for by the value that they add, over and above other passive investment approaches. This is a focus for us, as charity investment managers, so that our clients can effectively demonstrate the benefit that they gain for the cost.

[2] See http://www.acf.org.uk/policy-practice/research-publications/intentional-investing

As we turn our backs on 2016, and look forward to 2017 we can reflect on a year that brought us two political earthquakes in the form of Brexit and Trump, but good investment returns for long-term charity investors. Unfortunately, the political uncertainty is far from over. For the UK economy and sterling, the Brexit negotiations will be a key determinant of sentiment and direction. For global markets, the implications of a Trump presidency will be closely analysed. Initial expectations that his policies are likely to be pro-business have supported the US equity market and dollar, raising short term US growth and inflation forecasts. His position on international trade is less clear, with the protectionist campaign rhetoric leading to concerns for markets exporting goods to the US. The anti-establishment theme could spread from the UK and US to provide Europe with some political shocks, with elections scheduled in the Netherlands, France and Germany in 2017.

What does this mean for our investments? The change in inflation expectations, accelerated by the US election result, is likely to have marked an important turning point for bond markets, with yields now adjusting upwards and prices falling. Inflation is not good news for Foundations holding on to cash, or for bond markets, so I'd avoid having too much exposure to conventional bonds in portfolios and take opportunities to invest excess cash. There is an unusually wide range of economic forecasts for the next few years, reflecting ongoing political and economic uncertainties and underlining the need for diversification. I expect this uncertainty to trigger volatility in equity markets, and would favour active management to take advantage of opportunities that any potential oscillations throw up.

Foundations are well placed to rise to these challenges. They benefit from a long-term time horizon; so unlike other institutional investors, corporates or individuals, Foundations are able to look through short-term capital volatility, accepting this as a necessary trade-off for long term inflation protection.

Successful investment strategies consciously tie the investment objective to the aims of the Foundation. For those seeking intergenerational equity, a long-term financial objective of inflation plus a spending rate could be appropriate. For Foundations seeking to achieve their aims more directly through their investment assets, the strategy may encompass responsible or social investment. The 'right' strategy will undoubtedly be specific to each Foundation, but sharing the common challenges and opportunities only serves to enhance our collective investment intelligence and hopefully our future philanthropic performance.

Kate Rogers

Kate is Head of Policy at Cazenove Charities, focused on managing assets for Charities, Foundations and Endowments. Kate is responsible for sector engagement as well as co-managing a charity investment fund. She has sixteen years investment experience, is chair of the Charity Investors' Group and has co-authored a number of Foundation investment research reports, published by the Association of Charitable Foundations.

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