Family Foundations and the Challenge of Low Interest Rates

Actively managing investments improves chances of continuing long-term philanthropic mission.

When it comes to interest rates, "Lower for Longer" has been the mantra for the past 11 years. Low rates, while good for borrowers, have been challenging for investors. Traditional asset allocation models, like 60% equity/40% fixed income, are harder to live with when the yield on Treasuries is only 2% and stock dividend yields aren't much better. This is especially true for private foundations, which have a federally mandated minimum distribution requirement of 5% per year. Although Donor Advised Funds (DAFs), which are classified as public charities, offer a way around the 5% requirement, many family foundations (i.e., those under $25 million) wish to retain their independent identity. For these foundations, the challenge is even more acute.

Assuming the foundation wants to exist in perpetuity, a 5% annual distribution rate in the current low return environment is a real challenge. So, how can foundation managers meet that requirement and continue the foundation's philanthropic mission in perpetuity with such low return expectations? There is no easy answer to this question. However, there are ways to actively manage the foundation's investments and, thus, improve the chances that the foundation will continue its long-term philanthropic mission.

Managing the payout

A private foundation, unlike a pubic charity, is subject to a federally mandated payout requirement of 5% of its assets very year. While that rule sounds simple enough, the payout rules are actually more complex and nuanced. The rules contain a carry forward provision. If a private foundation distributes more than 5% in one year, it may apply excess distributions against required distributions for up to 5 years. As a way to manage the distribution requirement, some foundations work towards building up a reserve of excess distributions when portfolio returns are high, thereby providing flexibility to make smaller distributions in years when returns are poor. A foundation's board can also adopt a smoothing method for budget purposes (such as 3-year averaging) which allows them to better manage the payout amount and have greater predictability as to their financial commitments year over year. On the accounting side, the foundation can apply indirect expenses in furtherance of the foundation's mission, such as rent, administration expenses, management fees, and accounting fees, toward meeting the 5% minimum. In addition, under IRS rules, the value of real estate and illiquid privately held assets may be discounted using accepted valuation methods, thus leading to lower required payouts.

Managing investment risk

Achieving real returns in excess of the minimum distribution amount will become more challenging if interest rates remain low. With the 10-year U.S. Treasury note hovering around 2.0% for the past 7 years, stocks have had to work harder to bring up the rate of return for the total portfolio. For example, assuming 40% of the portfolio is invested in U.S. Treasuries at 2.0%, stocks would have to achieve an average annual return 10.3% for the total portfolio to compound at 7.0%. Assuming 2% inflation, the real return would be 5% just equal to the minimum distribution. Complicating matters further, stocks, as well as most investments, tend to sell at higher valuations when interest rates are low because investors can borrow inexpensively to buy risk assets. Today, the stock market is valued at 17x next twelve month earnings. Historically, when the stock market sells around 17x earnings, future

returns have been below the long-term average of approximately 10%. Of course, all this could change and we could see interest rates rise if global growth accelerates at some point, perhaps as a result of trade war settlements. Over the past 10 years, the Fed has been absorbing most of the new supply of Treasury debt helping to keep interest rates low. As Fed policy returns to normal, the heavy supply of U.S. debt may require higher rates to find investors. While interest rates may drift higher, it is unlikely there will be any increase in excess of two percentage points in the foreseeable future due to the weight of weak demographics and large debt burdens.

What other options do foundations have? Most, if not all, options require investors to take on more risk, which may not be the best solution, especially with global growth slowing. Pockets of high debt levels around the world and anti-capitalist trends contribute to risky conditions. To gain greater returns, some investment managers have turned to alternative asset classes, such as hedge funds, private equity, and "real" assets like timber. For many years, hedge funds were pitched as a way for investors to reduce overall portfolio risk without sacrificing returns. After producing good returns during the stock market correction from 2000-2002, hedge funds, on the whole, have performed relatively poorly in recent years versus domestic stocks.

In theory, private investments offer investors higher returns than the public markets to compensate investors for locking up money for a period of time (usually 7-15 years). However, management fees and minimums for private investments are relatively higher, especially for smaller investors. Because private investing by endowment funds has become popular over the twenty years, there is a great deal of money bidding up asset values, which means future returns may not be as positive as in past years. Further, for income oriented investors, these investments typically don't pay much (if any) income. Most private investment funds use leverage, which increases risk in a challenging environment like a recession or a sudden rise in interest rates. Leverage can also cause tax issues for a private foundation because of the rules on "Unrelated Business Taxable Income" (or "UBTI"). These rules require private foundations and other charities to pay taxes on income derived from activities unrelated to their charitable purpose. Debt-financed investing will trigger the UBTI rules. For these reasons, it is essential to have an advisor who understands these issues before investing.

Another important consideration for a foundation board is liquidity. In times of market volatility, alternative assets can be very difficult (if not impossible) to exit. Exiting in times of distress could be very costly as steep discounts will be applied in the secondary market. One benefit is that for purposes of computing the 5% minimum payout, alternatives may be valued at less than par because of such factors as lack of liquidity and marketability based on an appraisal.

Managing expenses

Foundation boards and trustees are fiduciaries. As such, they will need to examine the cost structure of any investment they make. They also will seek professional guidance in making those decisions. It's no surprise that many foundations and endowment funds are focusing on cutting costs by using low-cost index funds. Although these passive strategies can offer market returns, they pose their own set of challenges, namely choosing which index funds to invest in, what proportion, and when to make changes. Moreover, when the fees of consultants and asset allocators are included, the overall cost is not that much lower than hiring an active manager. As a result, the fee structure might not be so compelling when you add up the total cost. Moreover, overall portfolio returns could be lower when employing passive strategies, especially if there are major regime changes in different asset classes or sectors of the market.

Conclusion

Meeting the challenge of managing a private foundation in times of low interest rates and volatile equity markets is not any easy one. However, by approaching the problem holistically, financial advisors working with family foundations can improve the ability of their clients to meet their objectives. Actively managing the annual payout to charity, carefully analyzing the investment risks and understanding the costs are three ways in which a family foundation board can improve their chances of carrying out their fiduciary as well as their philanthropic duties. To achieve that goal, having the right team of advisors is essential.

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