

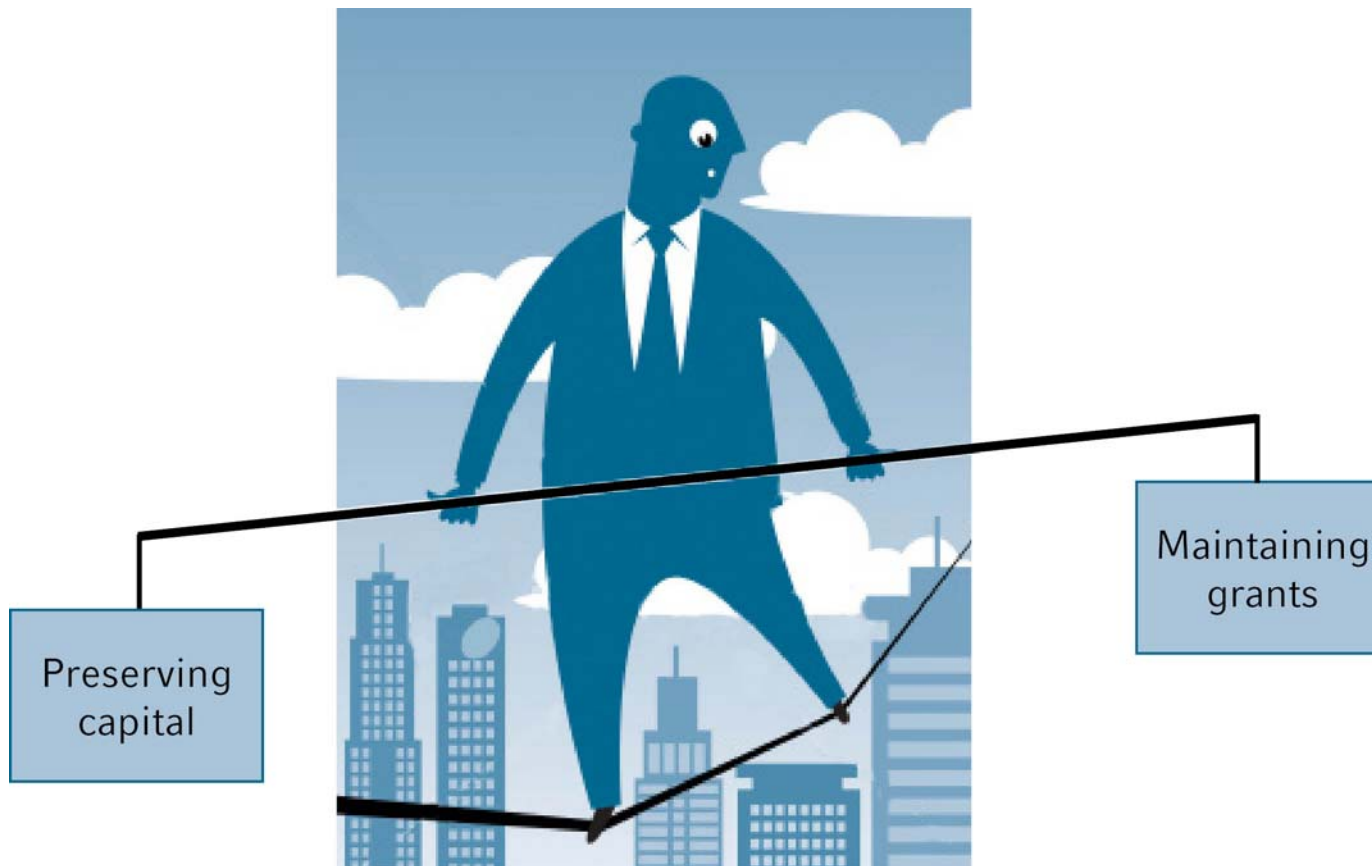
Philanthropy Conference 2009

Preserving Capital & Maintaining Grants

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Russell Investments, Auckland, New Zealand

18 March 2009

Preserving Capital & Maintaining Grants – A Balancing Act



Preserving Capital

- **Perpetual nature of charitable trusts/endowment funds means that any investment and granting strategy must have a long-term focus.**
- **Initial capital provides the main source of future income.**
- **It is not always clear how inter-generation equity can be achieved. However, a pragmatic and commonly accepted approach is to do so via preserving the purchasing power (i.e. real value) of initial capital.**

Maintaining Grants

- **Charitable trusts are not set up to ‘hoard’ money. They must make grants to fulfil their founding purposes.**
- **Trustees need to decide on a strategy to maximise the amount of grants to the community. This usually involves:**
 - **Maximising investment returns subject to a prudent level of risk**
 - **Maintaining a stable programme of grants to minimise disruptions to community groups**

Preserving Capital or Maintaining Grants?

- **The objectives to preserve capital and maintain grants are often conflicting, e.g.,**
 - **If there is a significant erosion of capital value, should grants be maintained?**
 - **Should the level of grants be permanently reduced in order to lower the risk of capital value being eroded?**
- **Which objective is more important? Preserving capital or maintaining grants?**
- **What are the trade-offs?**

Looking Back Twenty Years

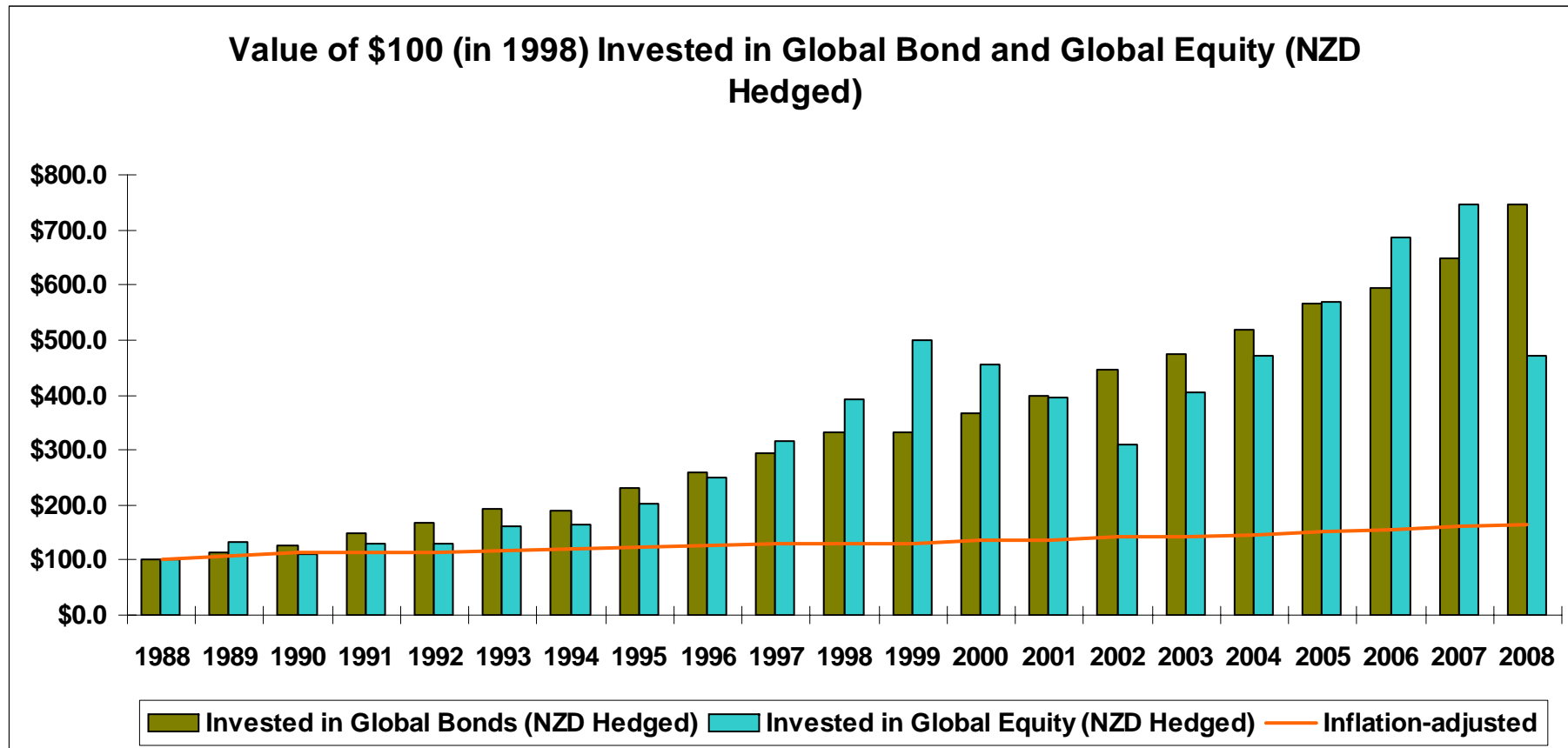
- **Time period: Mar 1989 to Dec 2008 (80 quarters)**
- **Asset classes:**
 - **Global equities (NZ\$ Hedged)**
 - **Global bonds (NZ\$ Hedged)**
- **Entity: A perpetual charitable trust set up at the beginning of 1989 with \$100m**
- **Investment strategy: a portfolio with varying proportions in global equity and global bond**
- **Expenses: 1% p.a. of fund size**

Looking Back Twenty Years

- Drawdown approaches:
 - Residual:
Drawdown = available excess above real capital
 - Smoothing:
Drawdown = expected earnings after allowing for inflation
 - Reserving:
Drawdown dependent on the level of reserves
- The fund size and amount of drawdown are calculated every quarter (but they are aggregated and presented on an annual basis in this exercise).

Looking Back Twenty Years

- Inflation and Performance of bonds and equities



Approach 1: Residual

- **Under this approach, the amount of drawdown equals any 'excess' amount in the fund above real (inflation-adjusted) capital.**
- **No grants will be made if the value of the fund is below real capital. In that case, only the amount of expenses will be drawn from the fund.**

Approach 1: Residual

- **Example of the 'Residual' approach:**

Starting fund size in 1989 = \$100m

Fund size in 1990 = \$120m

Real capital in 1990 = \$106m

Drawdown = \$120m - \$106m = \$14m

Grants = Drawdown – Expenses = \$14m - \$1m = \$13m

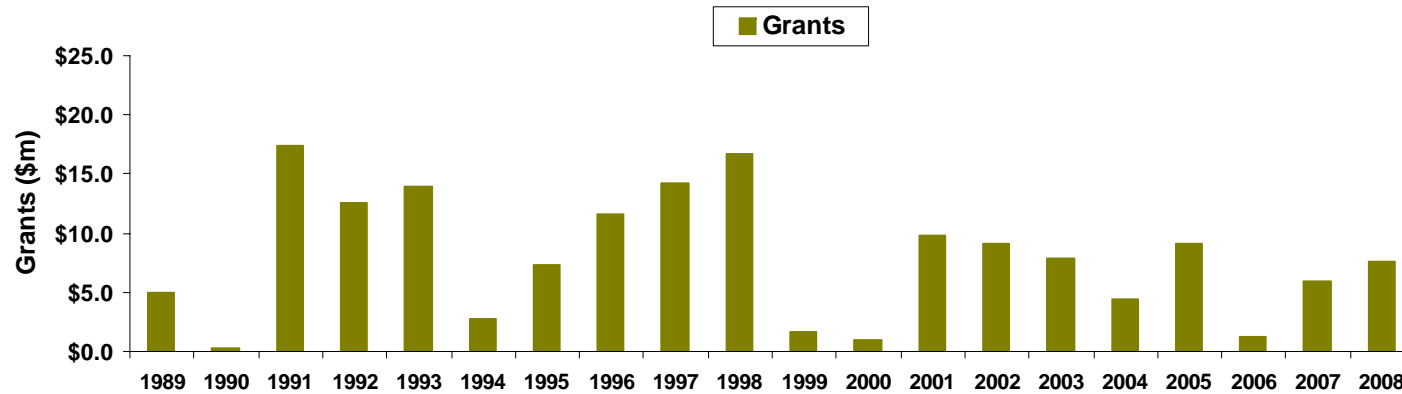
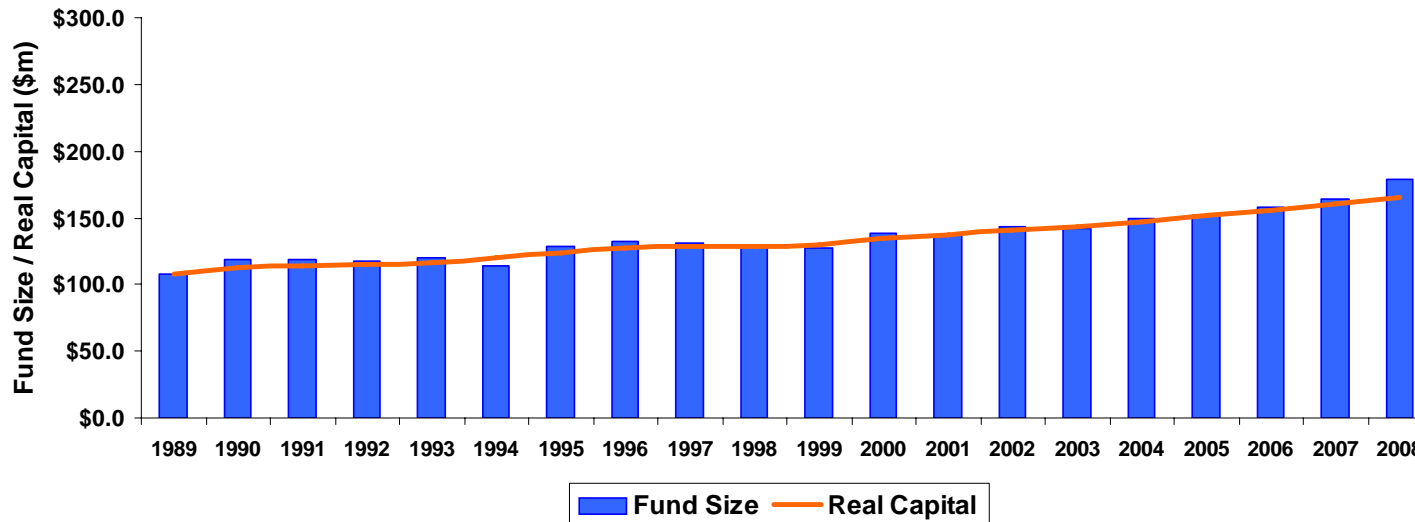
If fund size in 1990 < \$106m, then:

Drawdown = expenses only = \$1m

Grants = \$0

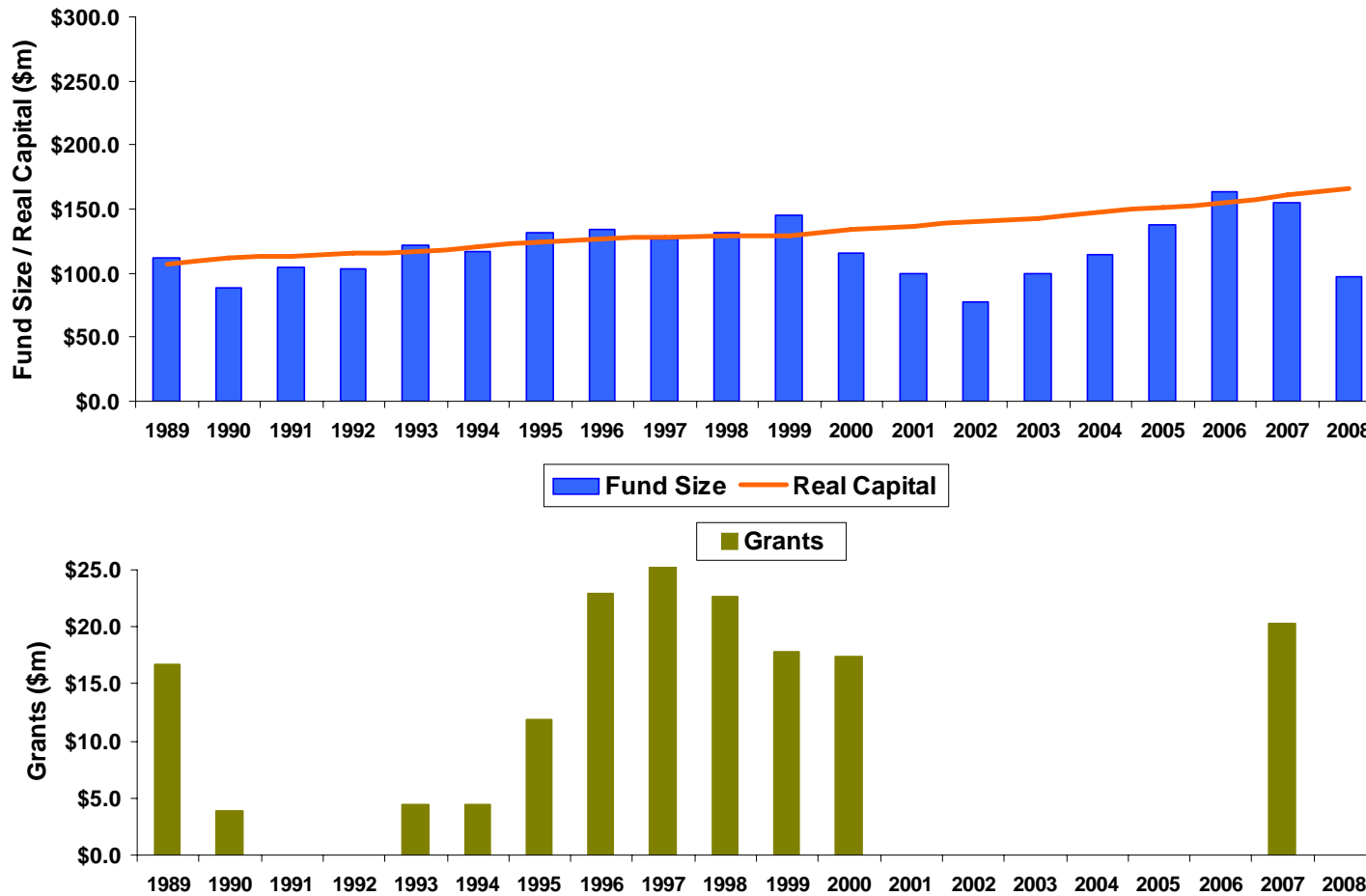
Fund Size & Grants under the Residual Approach (0% Global Equity & 100% Global Bond)

Fund Size, Real Capital and Grants with 0% Allocation to Equity under the Residual Approach



Fund Size & Grants under the Residual Approach (100% Global Equity & 0% Global Bond)

Fund Size, Real Capital and Grants with 100% Allocation to Equity
under the Residual Approach



The Residual Approach

- Under the 'Residual' approach, the variability in investment returns is mainly 'absorbed' by grants.
- This is especially evident under a high-risk investment strategy, e.g., grants would have been suspended in 9 of the past 20 years under a 100% global equity strategy.
- While this approach is meant to put an emphasis on protecting real capital, it only works well under a low-risk investment strategy. It fails to deliver as risk increases.

Approach 2: Smoothing

- **Under this approach, the amount of drawdown will be set equal to the fund's expected earnings after allowing for inflation.**
- **The amount of drawdown will be calculated the same way and grants will continue to be made even if the value of the fund is below the value of real capital.**
- **In this exercise, it is assumed that the fund's expected earnings equal actual average earnings and the rate of inflation equals actual average rate of inflation over the period.**

Approach 2: Smoothing

- **Example:**

Starting fund size in 1989 = \$100m

Expected return on portfolio = 9%

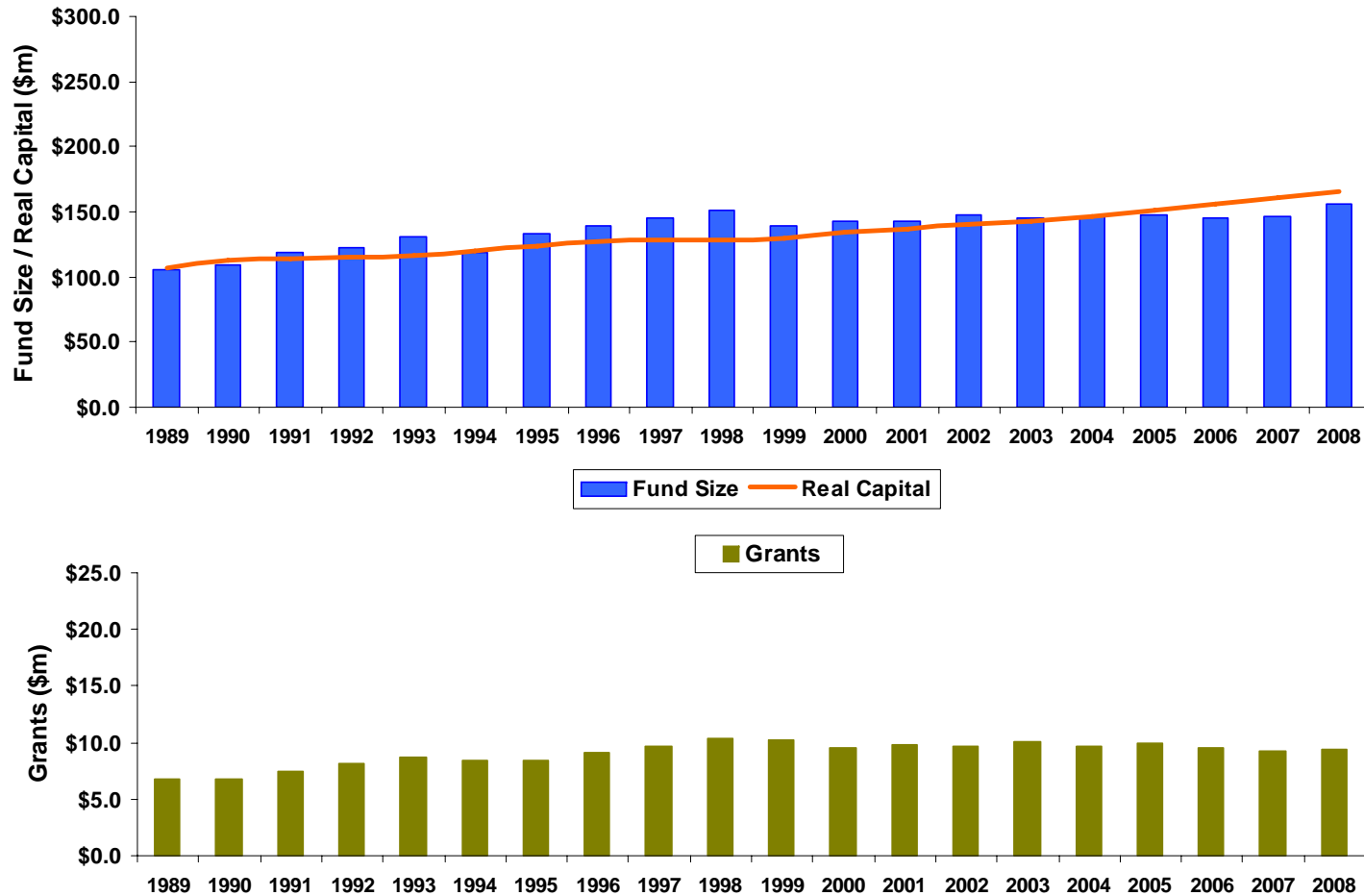
Expected inflation = 2.5%

Drawdown = $\$100m \times 9\% - \$100m \times 2.5\% = \$6.5m$

Grants = Drawdown – Expenses = $\$6.5m - \$1m = \$5.5m$

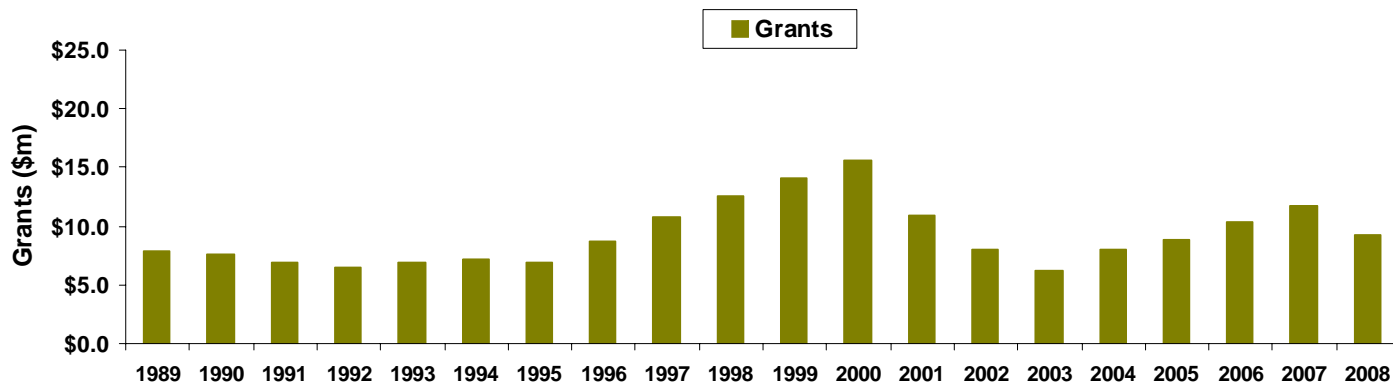
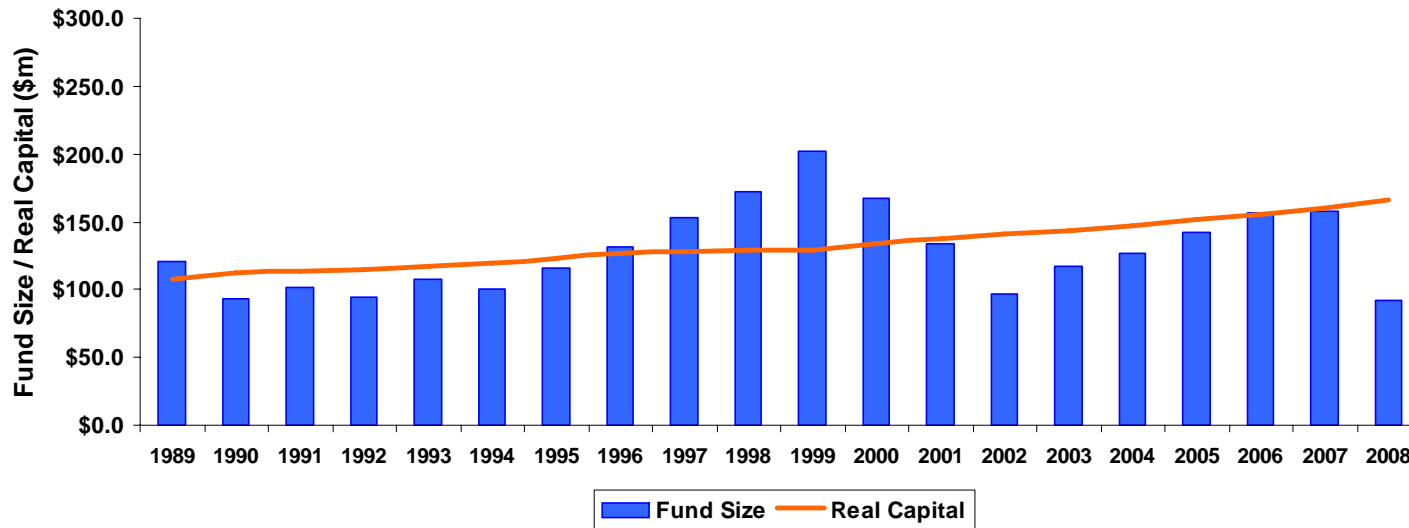
Fund Size & Grants under the Smoothing Approach (0% Global Equity & 100% Global Bond)

Fund Size, Real Capital and Grants with 0% Allocation to Equity under the Smoothing Approach



Fund Size & Grants under the Smoothing Approach (100% Global Equity & 0% Global Bond)

Fund Size, Real Capital and Grants with 100% Allocation to Equity under the Smoothing Approach



The Smoothing Approach

- **Under the ‘Smoothing’ approach, the variability in investment returns is mainly absorbed by fund size.**
- **Under a low-risk investment strategy, this approach meets both the objectives of maintaining grants and protecting real capital.**
- **Under a high-risk investment strategy, grants would still be relatively stable. However, fund size would have fallen short of real capital in 11 of the past 20 years.**

Approach 3: Reserving

- **Under this approach, the amount of drawdown will be set according to the actual fund size in relation to the value of real capital.**
- **If the actual fund size is significantly above the level of real capital, then drawdowns would be set at ‘normal’ levels. Otherwise drawdowns would be set at reduced levels or suspended.**
- **The basic idea is to build up and maintain an ‘adequate’ level of reserves so that ‘normal’ drawdowns are unlikely to push the fund size below real capital. (Reserves are defined as fund size less real capital.)**

Approach 2: Reserving

- **Example:**

**Fund size in 1989 = \$100m; Expected return on portfolio = 9%;
Expected inflation = 2.5%**

Suppose desirable level of minimum reserves = 10% above real capital (i.e. fund size needs to be $> \$106m \times 1.1 = \$116.6m$ in 1990 before normal level of drawdown can commence).

If fund size = \$120m ($> \$116.6m$) then:

**(Normal) Drawdown = $\$100m \times 9\% - \$100m \times 2.5\% = \$6.5m$
Grants = Drawdown – Expenses = $\$6.5m - \$1m = \$5.5m$**

If fund size $< \$116.6m$ then:

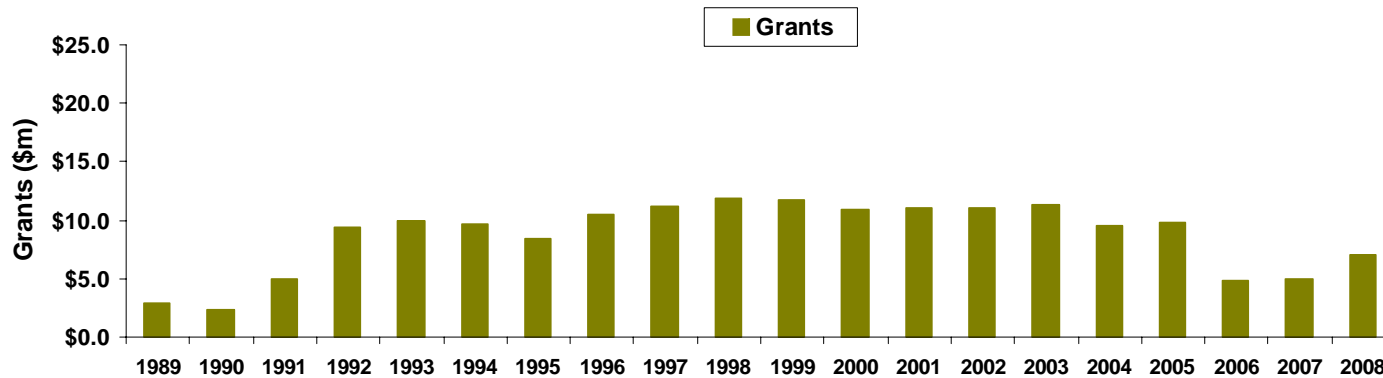
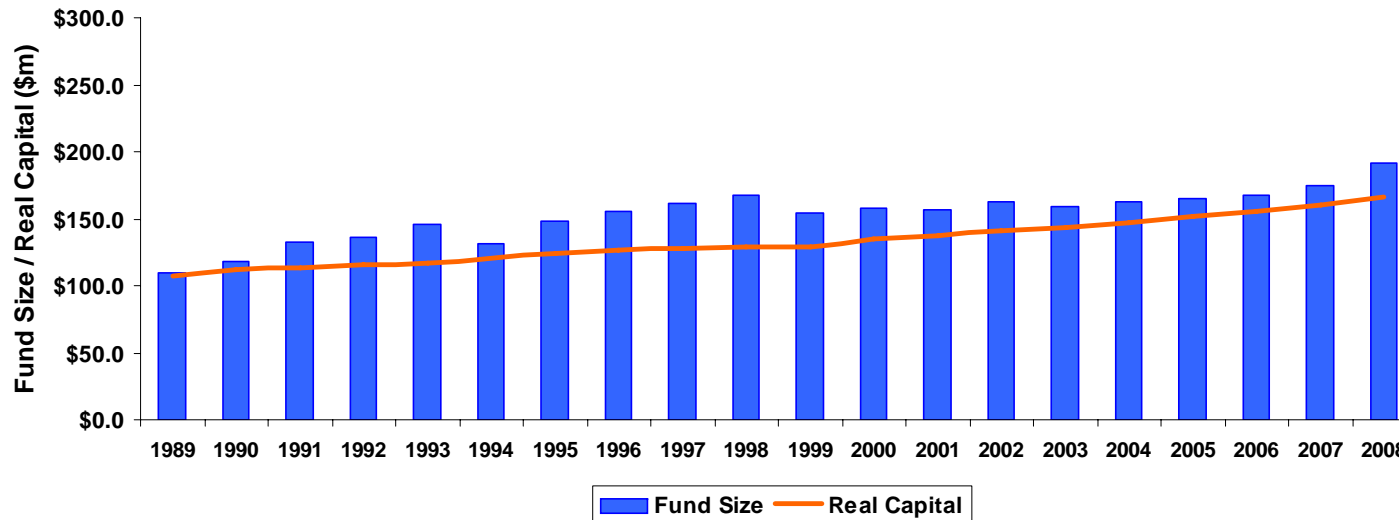
**(Reduced) Drawdown = $(\$100m \times 9\% - \$100m \times 2.5\%) / 2 = \$3.25m$
Grants = Drawdown – Expenses = $\$3.25m - \$1m = \$2.25m$**

If fund size $< \$106m$ then:

Drawdown = expenses only = \$1m; Grants = \$0

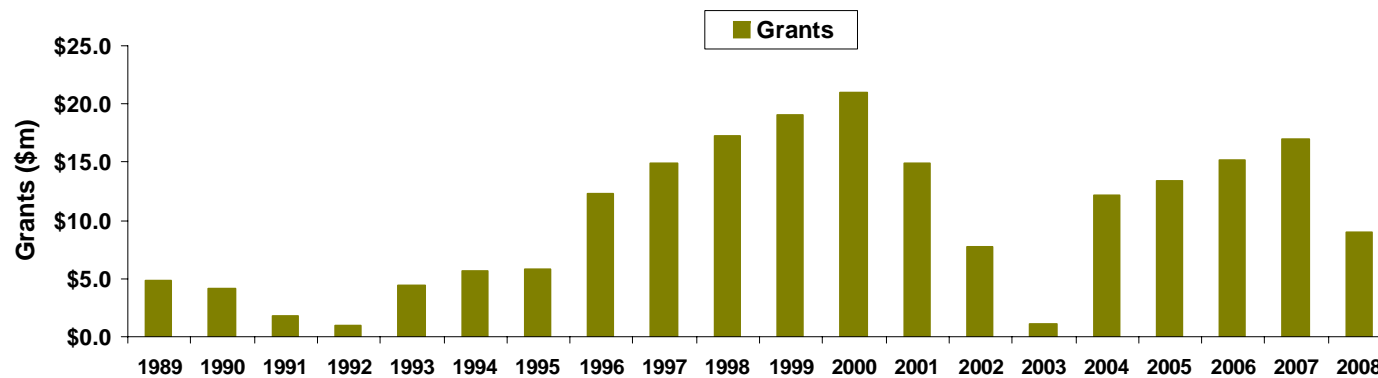
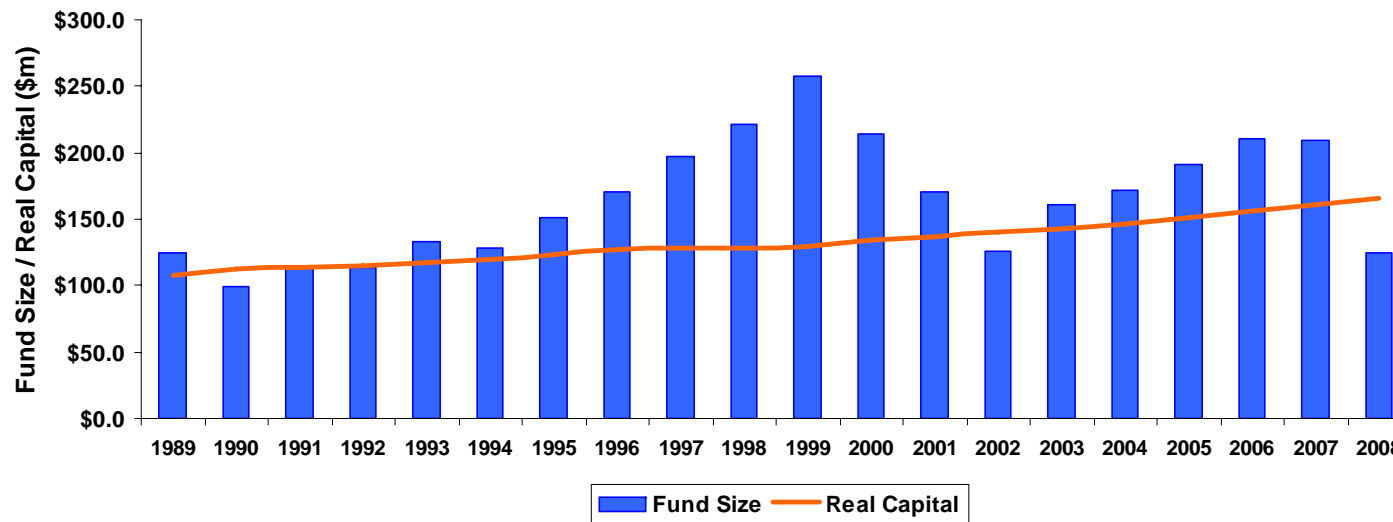
Fund Size & Grants under the Reserving Approach (0% Global Equity & 100% Global Bond)

Fund Size, Real Capital and Grants with 0% Allocation to Equity under the Reserving Approach



Fund Size & Grants under the Reserving Approach (100% Global Equity & 0% Global Bond)

Fund Size, Real Capital and Grants with 100% Allocation to Equity
under the Reserving Approach

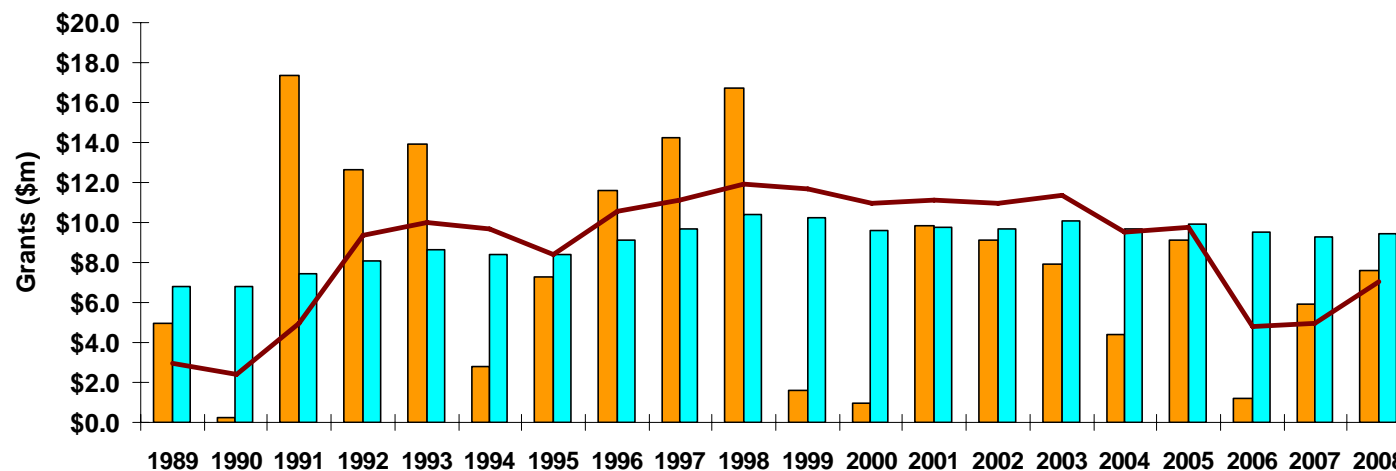
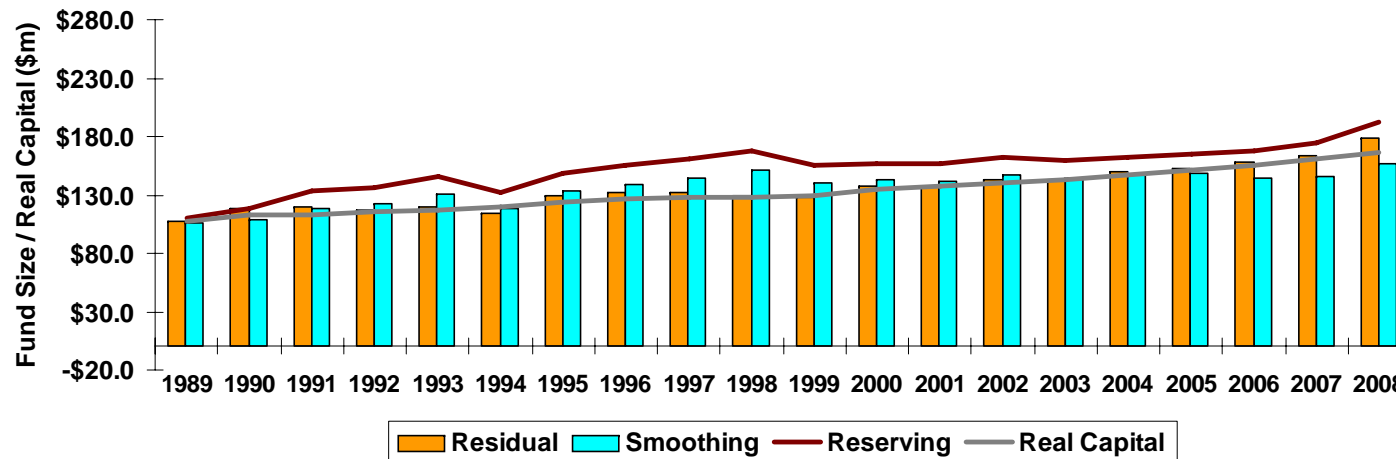


The Reserving Approach

- Under the ‘Reserving’ approach, the variability in investment returns is absorbed by both grants and fund size.
- The emphasis of this approach is on preserving real capital. Therefore, when investment returns are volatile, grants would still be volatile under this approach, although less so than under the Residual approach.
- This approach has worked well across all investment strategies in terms of preserving real capital. Even under the highest risk strategy of 100% equity, fund size would have fallen short of real capital in only 3 of the past 20 years.

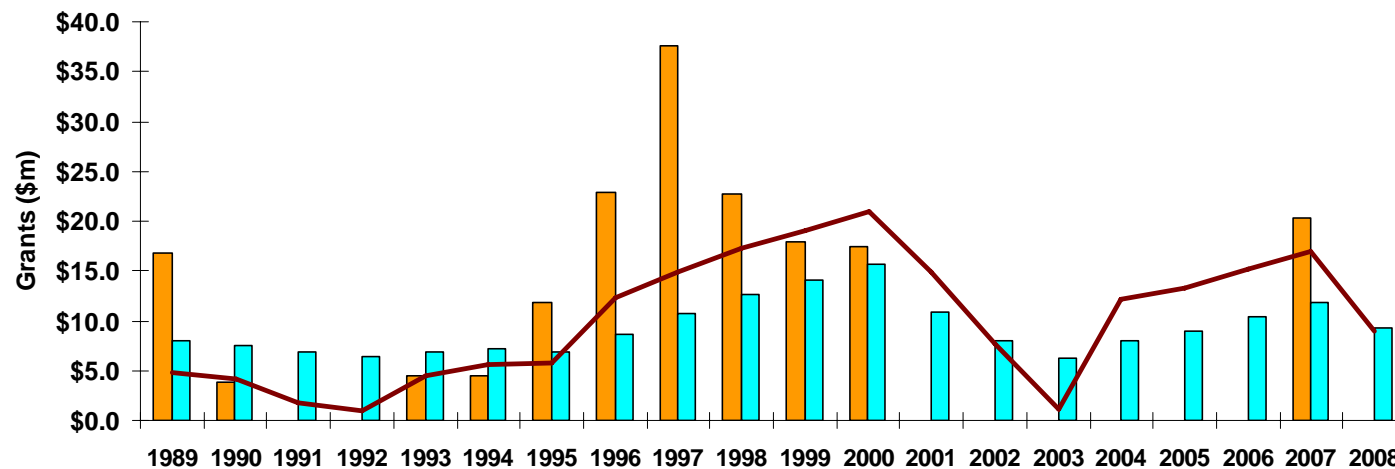
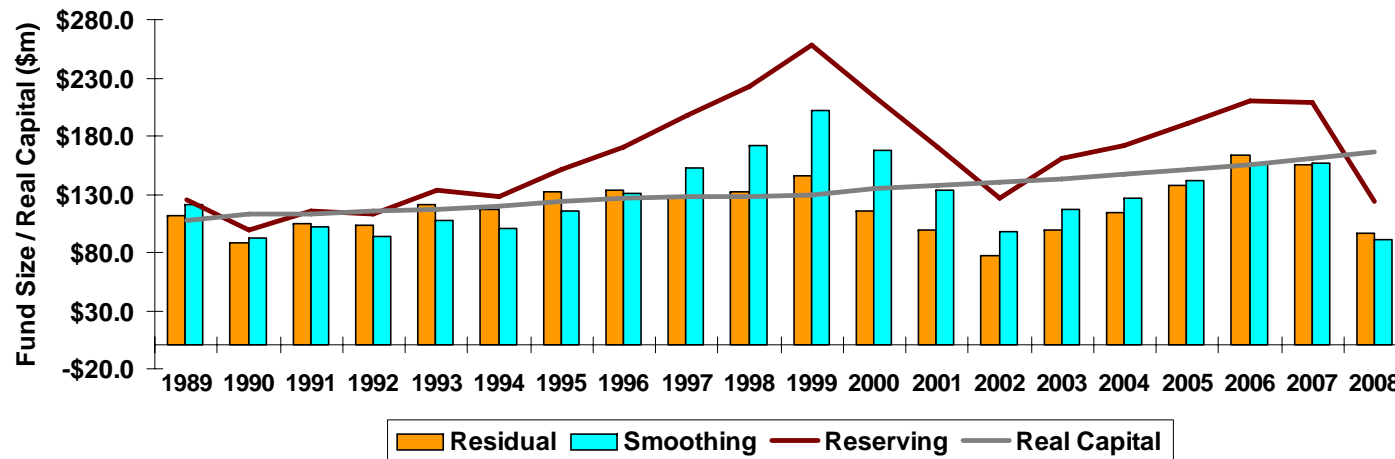
Comparing Fund Sizes & Grants under all 3 Approaches (0% Global Equity & 100% Global Bond)

Comparison of Fund Size and Grants under the Residual, Smoothing & Reserving Approach with 0% Allocation to Equity



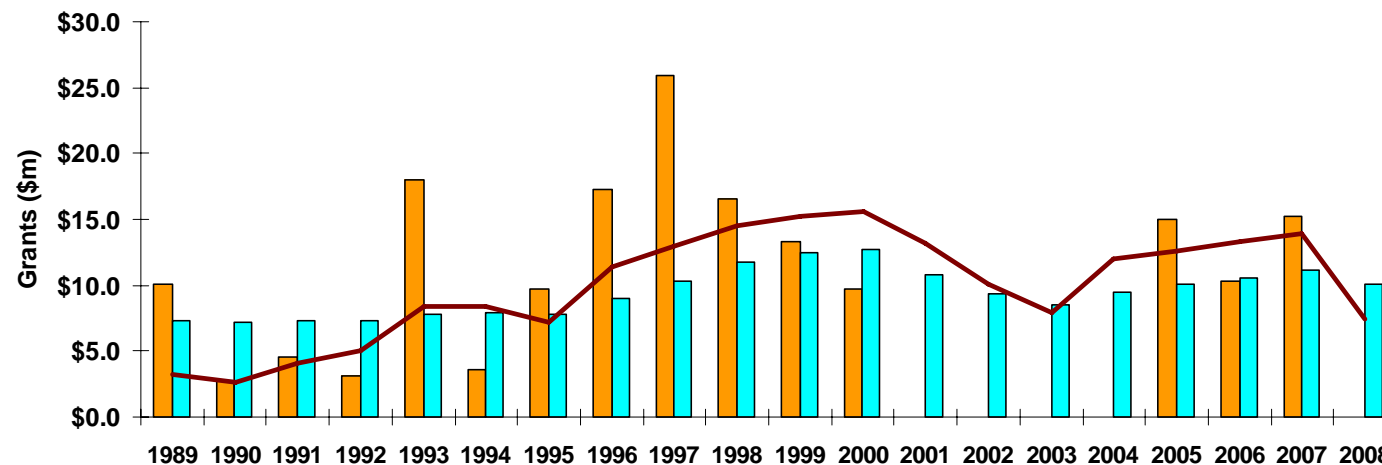
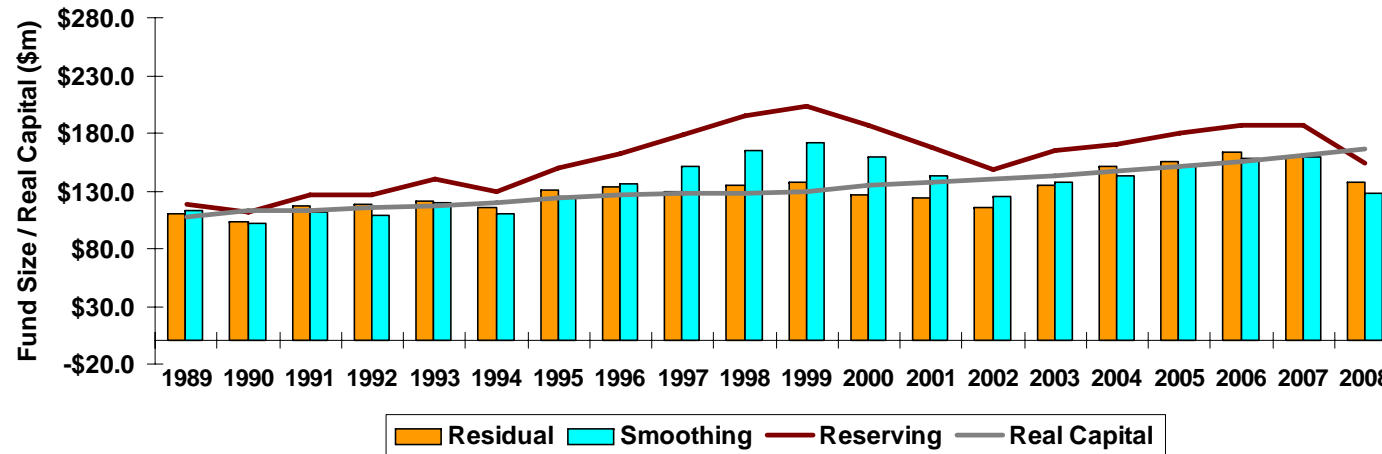
Comparing Fund Sizes & Grants under all 3 Approaches (100% Global Equity & 0% Global Bond)

Comparison of Fund Size and Grants under the Residual, Smoothing & Reserving Approach with 100% Allocation to Equity



Comparing Fund Sizes & Grants under all 3 Approaches (50% Global Equity & 50% Global Bond)

Comparison of Fund Size and Grants under the Residual, Smoothing & Reserving Approach with 50% Allocation to Equity



Why has the Reserving Approach outperformed?

- **Why has the Reserving approach outperformed the Residual and Smoothing approach in preserving real capital over the past 20 years?**
- **Note that the Reserving approach requires an initial build up of reserves. Therefore, compared to the other two approaches, the Reserving approach also delivers smaller grants in the early years. This initial build up of capital, together with a more disciplined drawdown of funds, has contributed to the outperformance.**

Summary

- **Many perpetual charitable trusts have the dual objectives of preserving capital and maintaining grants. These two objectives are not always compatible.**
- **We have looked at three granting approaches. The Residual and Reserving approach focus on preserving capital while the Smoothing approach focuses on maintaining grants.**
- **Provided that a trust does not ‘overspend’ (i.e., set a drawdown rate higher than what the assets are expected to earn after allowing for inflation), all three approaches work reasonably well in preserving real capital under a low-risk investment strategy.**

Summary (continued)

- **As the risk of the investment strategy increases, both the Residual and the Smoothing approaches struggle to cope with the volatility of investment returns, resulting in an increasing number of occasions of real capital shortfalls.**
- **The Reserving approach is more able to cope with higher volatility. However, it does require the discipline to build up an adequate level of reserves, during which the level of grants will be substantially lower.**
- **The higher the risk of the investment strategy, the more important it is to consider a reserving approach in order to preserve the real value of capital.**

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