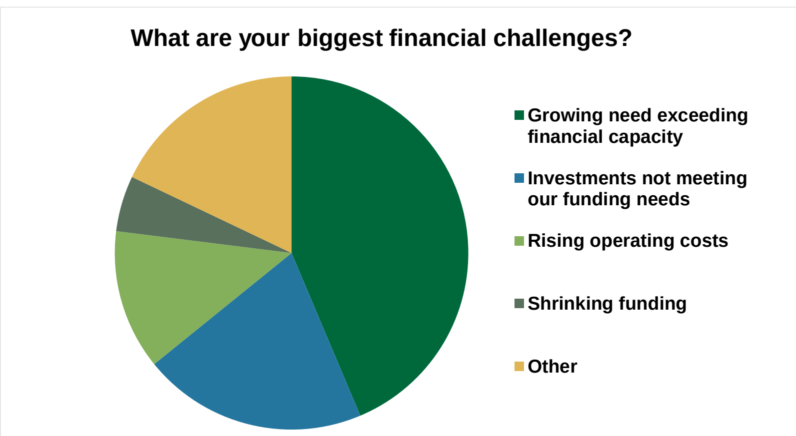
Making Ends Meet: Investment Challenges and Solutions For Canada's Community Foundations

Canada's community foundations face a constant challenge ensuring their annual funding matches their disbursement commitments. A recent nationwide survey[1] by Community Foundations of Canada and Manulife Asset Management revealed some common challenges and some possible new solutions.

Foundations cite a number of concerns on the financial front. The most widely cited is that growing community needs are exceeding financial capacity. Second ranked is a perceived disconnect between the performance of a foundation's investments and the funding needs those investments are meant to support. Other concerns include rising costs and shrinking funding.

Among those citing the first concern, most simply said that the need is growing faster than in the past. But many also noted that investment returns were lower than expected. Among those perceiving a disconnect between investment performance and funding needs, most said it was because interest rates on their investments were too low or because they were in safe, but low-returning investments.

It's no coincidence that low investment returns are happening at the same time as community foundation needs are growing. The low investment returns are associated with slowing economic growth rates, which can also boost local community needs for foundation grant-making activity.



The outlook is for investment returns to remain low (and volatile) for the foreseeable future. Many of the leading asset managers in the industry – including Manulife Asset Management – forecast bleak returns in bond markets. While it is unclear whether bond yields will continue to rise or remain near historic lows, in our opinion it does appear that the current risk/reward environment for bonds is tilted to the negative.

The story is similar within equity markets. Manulife Asset Management's team of global economists and portfolio managers believe that the current low-growth environment in the developed world is likely to persist for the next three to five years, while risk levels stay the same. In other words, investors face the prospect of getting half the returns they are accustomed to, without a commensurate drop in volatility.

In response, institutional investors have been considering a broader set of investment options compared to the more traditional Canadian, US and International equities, or Canadian bonds. This broader market set can include global or emerging market equities or bonds. It may also involve a narrower focus within developed markets, such as by market cap, investment style, or industry sector.

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In recent years, demand has grown for alternatives like real assets, which can offer steadier returns and low correlations to public markets. Direct investment in commercial real estate has been one of the more easily accessible such asset classes. Timberland and farmland investments have also been popular among large institutional investors.

A frustration for many smaller institutional investors has been that there are few investment vehicles available that offer such direct ownership of real estate and other private market asset classes.

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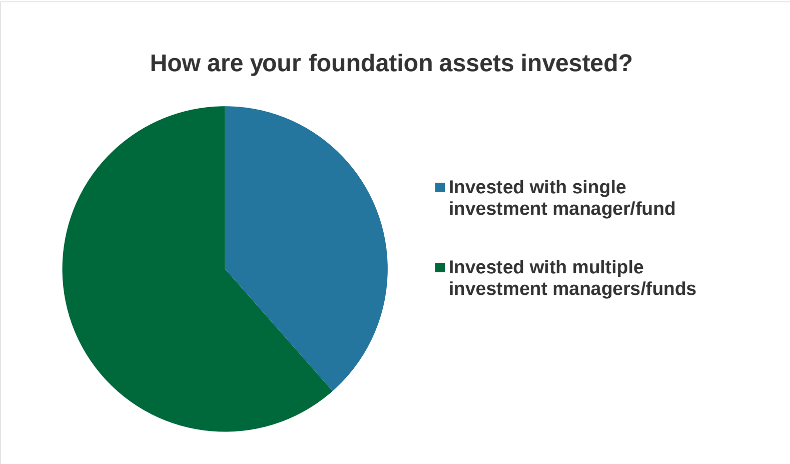
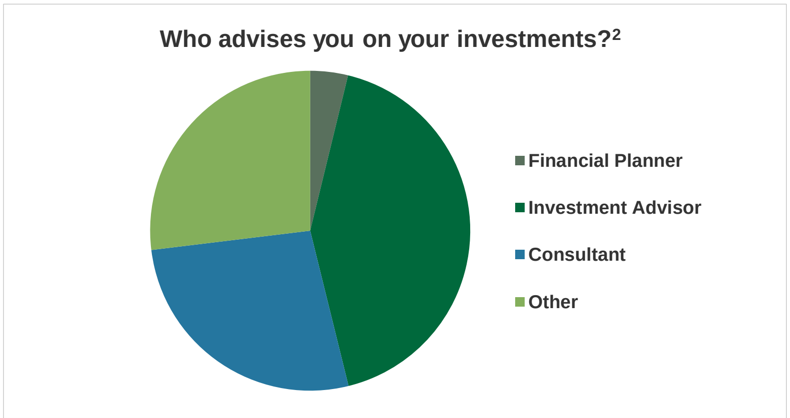


This situation is changing, however. Funds that pool the investments of several institutional investors and offer direct exposure to commercial real estate are now available. The latest innovations involve such pooled funds that combine direct investments in real estate, timberland and other private market asset classes, allowing the portfolio manager to adjust exposures depending on risk and opportunity.

This speaks to another investment trend of recent years – giving investment managers broader decision-making authority and more flexibility in managing a portfolio. In the spirit of leaving no stone unturned in the search for returns, institutional investors are allowing their managers to tactically adjust portfolios to generate returns and even employ techniques like currency management. Of course, an important requirement with this approach is the skill and expertise of a robust portfolio management team. This team must have the conviction to forecast an outlook over the long term in order to construct portfolios consisting of a number of different asset classes and tools noted above. They must also have the conviction to move quickly and efficiently when adjusting over- and under-weight exposures to various asset classes and subsectors.

The innovation around eking out returns in a difficult investment environment also has implications for performance evaluation. Institutional investors the world over are increasingly seeking to judge performance of their investments in terms of how well those investments support their financial obligations. Yet 65 per cent of respondents to our survey say they evaluate investment performance against market benchmarks like the Toronto Stock Exchange or to an average balanced fund return on a publicly available web database (e.g., GlobeInvestor, Morningstar, etc.).

Market benchmarks don't measure what really matters to a foundation – a return that keeps pace with inflation and allows the foundation to meet its payout obligations.



Such benchmarks don't measure what really matters to a foundation – a return that keeps pace with inflation and allows the foundation to meet its payout obligations. In keeping with the broader institutional trends, a foundation could instead adopt an approach that measures investment performance based on how well it enables the foundation to meet its financial obligations over a normal market cycle. For example, a target investment return of 5 per cent plus inflation (as measured by the Consumer Price Index) over a rolling period would dovetail extremely well with the objectives of most foundations and endowments to preserve existing capital, and meet payout targets mandated by regulators. An investment return target that seeks to preserve capital each year regardless of what is occurring in the market, and also covers a payout ratio, can give foundations better longer-term confidence when it comes to planning disbursement programmes.

The innovations discussed above have made a wider variety of sophisticated investment tools available to a wider range of investors at a competitive cost. Given an outlook for a more challenging investment environment for the foreseeable future, we believe foundations would be well served by doing research into whether any of these innovations are suitable for them.[2]

Learn more about Canada's community foundation movement, including fund types and assets, in this **infographic** produced by Community Foundations of Canada, available at: http://communityfoundations.ca/wp-content/uploads/2017/02/CFC_2015FastFacts_EN.pdf

To discuss your foundation's investment challenges, please call Manulife Asset Management's Managing Director for Institutional Investments, Dario Di Napoli, CAIA (Tel: 416-926-5455; Email: dario_dinapoli@manulifeam.com).

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[1] Methodology: The survey was distributed via direct email to the key financial/investment decision maker at each of the 191 members of the Community Foundations of Canada. It took place during Nov. 3, 2016, to Jan. 30, 2017. Results are based on 60 completed responses.

[2] In Canada, financial planners advise on and sell a wide range of financial products and are certified by the Financial Planning Standards Council. Investment advisors typically focus more narrowly on investment products like stocks and bonds and are associated with an investment dealer. Investment consultants typically advise owners of larger pools of assets (like some foundations and pensions) about their long-term investment objectives.