SEPTEMBER 2022

FIERA CAPITAL

Increased Disbursement Quota for Canadian Charities

How Can Foundations and Endowments Preserve their Wealth?

Introduction: New Challenges and Investment Objectives

In the latest Federal Budget for the fiscal year 2023, under the initiative "Boosting Charitable Spending in our Communities," the government is mandating that Canadian registered charities increase their disbursement quota from the current 3.5% to 5.0% annually with the goal of deploying capital for the benefit of Canadian communities.

Thus, effective January 1, 2023, all Canadian registered charities will be required to pay out 5% of their assets not used in charitable activities or administration that exceeds $1 million. Registered charities include foundations, endowments, and trusts in Canada but the term charity will be used throughout this article.

Executive Summary

What has changed?

The disbursement quota requirement for Canadian registered charities increases from 3.5% to 5% annually

When will it take effect?

Expected enforcement starting January 1, 2023

What is the impact?

All charities have individual objectives but share a common goal of generating total return higher than the projected net outflows and preserving capital to ensure their organization's sustainability and philanthropic mission. All things equal, increasing disbursements will reduce capital reserves and decrease the probability of maintaining portfolio wealth over time, especially in volatile market conditions.

Based on our long-term capital market expectations as of June 30th, 2022, a traditional 60/40 portfolio now has a lower probability of maintaining wealth given the higher spending requirement, expectations for market returns, and heightened market volatility.

How can we prepare?

The Multi-Asset Class Solutions Team has evaluated the impact of this change and proposes steps to help charities meet the increase in the disbursement quota. First, we evaluate the impact of the increase in the disbursement quota on the status quo portfolio positioning. Second, we look at potential portfolio solutions through strategic asset allocation to make up for any projected shortfalls. Strategic asset allocation (SAA) involves selecting appropriate asset classes for investment and optimizing weights for each asset class to maximize return for given risk tolerance and liquidity needs.

How should we position our portfolio?

Each charity and portfolio have unique needs and characteristics. We build a customized framework to evaluate strategic asset allocation optimization for the specific needs of charities. Through this framework, we evaluate the characteristics and value-proposition of expanding the strategies included in the SAA beyond traditional-only asset classes to include private market strategies.

In general, an allocation to private market strategies, in addition to traditional asset class exposure, will provide the following benefits to a portfolio:

- A hybrid combination of capital appreciation and income generation
- Attractive long-term expected return
- High and stable income return
- Total portfolio diversification
- Some level of inflation protection

The benefits of investing in private markets must be weighed against more complexity and less liquidity in portfolios which contribute to the premium of these investments. Private market investment options include private credit, real assets (real estate, infrastructure, agriculture), and private equity.

An optimized portfolio will depend on each charity's specific goals; we present standard steps to diversify sources of return and maximize the probability of preserving portfolio wealth under this additional disbursement quota requirement.

All charities have individual objectives but share a common goal of generating a total return higher than the projected annual net outflows and preserving their capital to ensure their organization's sustainability and philanthropic mission. Current market uncertainty including monetary policy risk, the energy crisis, inflation levels not seen in decades, and continued effects of COVID-19 have created strong headwinds for investors, particularly for the traditional 60/40 portfolio that relies entirely on public equities (60%) and public fixed income (40%).

This increased spending requirement should prompt charities to look at their current and projected wealth position to evaluate whether the current portfolio can support it. Looking at the Strategic Asset Allocation of the portfolio is the first step to begin evaluating the impact on wealth preservation over time.

The SAA is the long-term plan that will govern how the capital is invested; it includes:

- Which asset classes will be included in the portfolio?
- How much to allocate to each asset class?
- What are the allowable ranges around the target weight for each asset class?

Optimizing an SAA means answering each of these questions to meet the investor's objectives as efficiently as possible. It is important to update the return objectives of the portfolio given the increase in distribution quota while reevaluating risk tolerance and liquidity needs to preserve capital over time.

Inputs Into Strategic Asset Allocation

Acknowledging hurdles investors are facing, this article focuses primarily on charitable organizations' strategic asset allocation to maximize both the income and capital appreciation components of the portfolio. Achieving the highest total return and income return for the lowest level of risk alongside sufficient liquidity is an objective shared by most of our clients.

First, we look at the projected impact of the change in the distribution quota and evaluate the impact on the status quo portfolio positioning. Second, we look at potential solutions through the SAA to make up for any projected shortfalls.

Impact of Distribution Quota on Portfolio's Sustainability

Quantifying the impact of the distribution quota change on projected portfolio wealth helps to assess if changes are needed, and which aspects of the total portfolio should be changed.

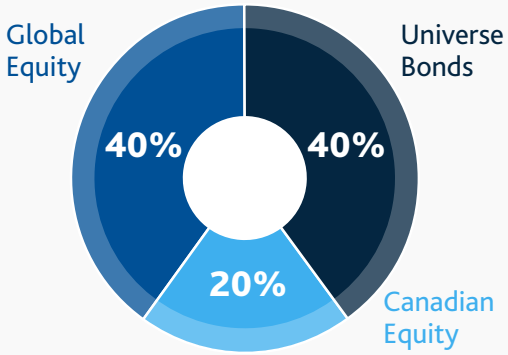
Let's start with an illustrative charity that has an existing portfolio of $20M invested in a traditional 60/40 portfolio. We look at the current and projected wealth position for a charity that has a traditional allocation **(Chart 1)** focusing only on the changing disbursement quota and ignoring any inflows from fundraising or grants.

Based on our long-term capital market expectation[1] as of June 30th, 2022, the traditional portfolio presented in Chart 1 is projected to return 5.3% annually with a volatility or expected risk of 8.8%.

In **Chart 2** we project the portfolio value of the illustrative charity based on these returns and account for an annual outflow set to the disbursement quota over the next 10 years. We set expectations of inflows other than investment returns to zero for simplification.

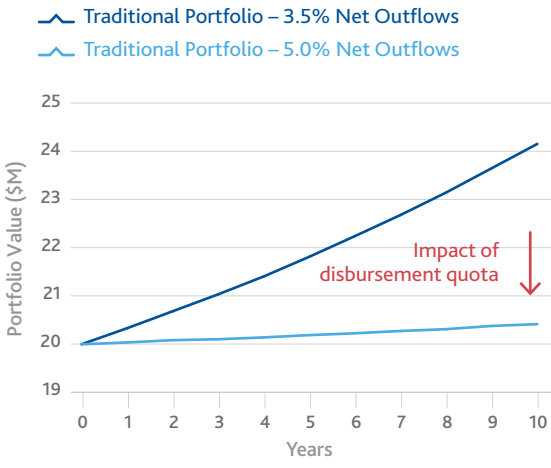
Prior to the increase in disbursement quota, this charity would have been expected to meet its spending goals and preserve capital comfortably. Indeed, assuming an annual spend of 3.5%, the currently projected return of the traditional portfolio of 5.3% would have sufficed to meet the outflows needed, generate sufficient liquidity, and allow the charity to build up some reserve capital year-after-year if reinvested. The excess capital would have allowed the charity to build up to a wealth position of slightly more than $24M after 10 years, allowing the charity to sustainably maintain its disbursements over time and support the philanthropic mission. The increase in the disbursement quota changes the financial position of the illustrative charity. The impact of the disbursement quota change from 3.5% to 5.0% is highlighted in the chart below. The increase in outflows translates to a decrease of nearly $4.5M in the average projected wealth of the charity over 10 years. **The traditional portfolio's 5.3% projected return is now just enough to meet the newly enacted disbursement quota of 5%, thus leaving no breathing room to build a reserve cushion for charities that rely on a traditional portfolio.**

CHART 1 Traditional Portfolio Allocation



Expected Return	5.3%
Expected Risk	8.8%

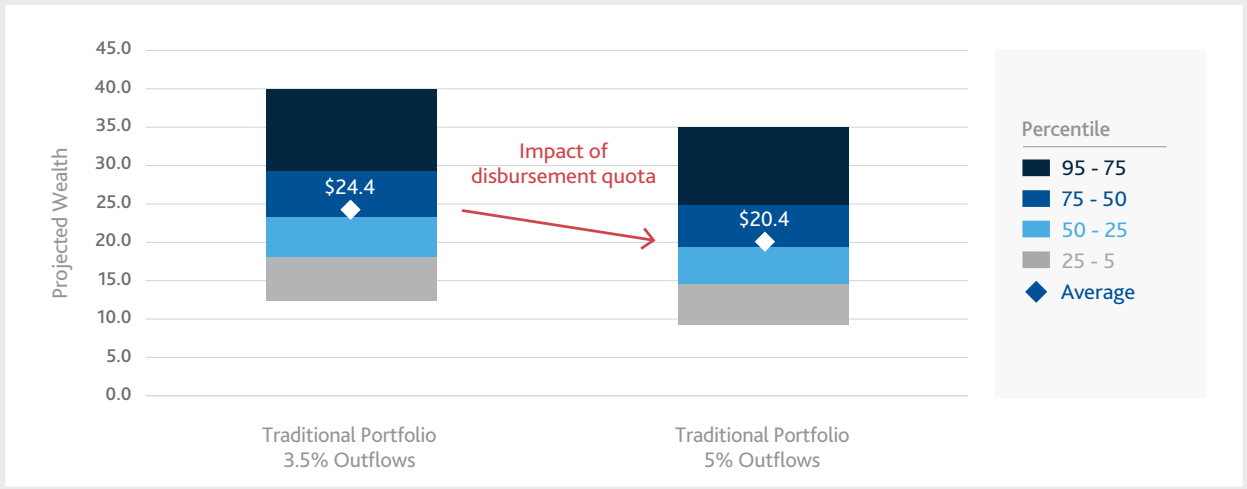
CHART 2 Traditional Portfolio - Average Projected Wealth after Outflows



1 Projections for this Chart and all other illustrations use 20,000 stochastic scenarios with assumptions based on most recent market consensus and the yield curve for bonds as of June 30, 2022. All capital gains and current income are reinvested and portfolios are rebalanced quarterly. Details of the assumptions provided in reference at the end of this article.

After 10 years, the charity can now expect to remain in its starting wealth position in normal market conditions. But, as recent turbulent markets and rampant inflation reminds us, these projections do not consider the other very important variable here: risk. Indeed, a year of poor market returns, coupled with additional spending pressure, will further complicate portfolio construction for charities. If we evaluate the potential dispersion of outcomes considering different market returns, we get a sense of how dramatically the wealth position could change for charities with a traditional portfolio asset mix under different economic scenarios. We used projections to look at thousands of potential future scenarios representing both good and bad states of the economy. The below **Chart 3** showcases the distribution of wealth that can be expected from the traditional portfolio for the same illustrative charity facing the increase in disbursement quota. In each scenario we begin with the charity's initial wealth of $20M and then, year after year, we consider a potential investment return from the market (based on the expected return of 5.3% and expected risk of 8.8%) and pay out the funds required under the disbursement quota before and after the change. After 10 years, we can see the potential average wealth outcome as well as the many potential outcomes in different market environments.

CHART 3 Potential Wealth Range After 10 Years Including Outflows



When we look at the distribution of potential final wealth positions, we see that the traditional portfolio struggles to keep up with the additional spending requirement and fails to support the charity's long-term wealth accumulation objective in the case of poor market performance. The full distribution of projected portfolio wealth shifts down by approximately $4M after increasing net outflows by 1.5% based on the thousands of scenarios determined stochastically from our long-term capital market expectation as of June 30th, 2022.

As the projected wealth decreases after the distribution quota change - keeping all else equal - increasing expected total return while managing volatility and downside risk should be a priority. This article will showcase how the SAA can be used to help charities re-evaluate portfolio construction in anticipation of this increase in disbursement quota. First, we explore whether new investment strategies should be included in a portfolio and then by evaluating the investment mix through different portfolios that increase the probability of achieving return objectives while managing risk.

The traditional 60/40 portfolio is not enough. How can charities build and preserve wealth?

The traditional 60/40 portfolio delivered tremendous performance following the recovery from the Global Financial Crisis of 2008, driven by above-average equity returns and downward trending interest rates. As an illustration based on market indices, from January 2010 to June 2022, a traditional portfolio invested 20% in Canadian equity, 40% in global equity and 40% in public fixed income generated an annualized 6.86% return, even after posting a -14.32% return through the first half of 2022[2]. Following this painful repricing in public markets in 2022, seeing both bonds and equities down double-digits, long-term market expectations have somewhat improved, but many challenges remain over the short- and medium-terms. Higher bond yields support higher long-term returns for investment-grade public bonds which increases the attractiveness of bonds compared to one year ago. Public fixed income now provides a cushion for downside protection in case rates were to decrease following an economic slowdown. Equities valuations have declined which alleviates some downside pressure, although further downward earnings revisions over the short and medium terms could have a negative impact on equity market returns.

During the last decade, large institutional investors such as Canadian Pension Funds and US Endowments have moved away from traditional markets and built investment portfolios that include significant exposure to alternative investments including private markets investments, now commonly referred to as "The Canadian Pension Model and Endowment Model". At the same time, smaller institutional clients have benefited from the creation of new investment vehicles that require smaller commitments and that provide some level of liquidity, making private market investments more attractive and easier to access. Fiera Capital has supported its clients in the transition from traditional to private asset classes. Investments in these new asset classes require careful planning and thoughtful consideration given the additional complexity.

A higher distribution quota requires a higher total return to preserve capital over time while maintaining sufficient liquidity. In the next section, we present a case study presenting steps to add private investments to a traditional portfolio which improve the probability that the portfolio can preserve wealth with higher expenses.

The term "private investments" is broad and covers multiple asset classes and categories but is typically included in a portfolio for one or more of these reasons:

- A hybrid combination of capital appreciation and income generation
- Attractive long-term expected return
- High and stable income return
- Total portfolio diversification
- Some level of inflation protection

2 Portfolio performance in Canadian dollar calculated based on FTSE Universe for public fixed income, S&P/TSX Composite for Canadian equity and MSCI World in Canadian dollars for global equity with quarterly rebalancing.

Private investments are heterogeneous by nature but share common investment characteristics: illiquidity premium, complexity premium, and diversification benefits driven by lower correlations with public markets. The table below further describes the characteristics of three broad non-traditional investment categories included in the portfolios described in the following section.

	PRIVATE CREDIT	REAL ASSETS	PRIVATE EQUITY
		Real Estate, Agriculture, Infrastructure	
Characteristics	Private loans to firms	Equity ownership of real estate properties, farmland and infrastructure assets related to essential services	Private equity ownership of firms
How?	Direct investments through a limited partnership or pooled funds		
Return Characteristics	Strong and stable income stream relative to public fixed income	Hybrid combination of income generation and capital appreciation potential with attractive long-term risk-adjusted return	Long-term return enhancement potential due to illiquidity and complexity premia
Outlook	Favorable long-term expected return and strong diversification benefits from the private nature of assets that diversify risk exposures compared to traditional asset classes		

The Importance of Strategic Asset Allocation

There are many potential changes to a portfolio to address the change in the disbursement quota. Our case study will show standard steps to gradually move away from traditional investments to diversify sources of return and risk exposure by investing in private markets. Assuming a charity relies only on returns from its investment portfolio, the target total return must be at least 5% on a real basis to meet the distribution quota and keep up with inflation. A change in SAA to meet these objectives must be evaluated under a complete framework; the Multi-Asset Class Solutions Team has built a framework tailored to charities which we explain below.

Strategic Asset Allocation Optimization Framework for Charities		
Expected Return	↑	**Maximize:** Must be at least 5% plus a margin for adverse market conditions and inflation
Income Return	↑	**Maximize:** Income return will help meet the disbursement quota and ensure the portfolio remains sufficiently liquid
Expected Risk	= or ↓	**Keep steady or ideally decrease.** As we work to increase return, we will aim to decrease expected risk by building a better-diversified portfolio
Sharpe Ratio	↑	**Maximize:** The Sharpe Ratio is a measure of return for a unit of risk taken, we aim to increase the Sharpe Ratio
Probability of Maintaining Wealth After 10 years	↑	**Maximize:** We project potential wealth to get an idea of the dispersion of potential capital position after 10 years of returns and evaluate the chances of having at least as much capital in 10 years as the charity has today

In addition, the investment portfolio must maintain sufficient liquidity to meet disbursements, rebalance the portfolio, potentially implement tactical investment opportunities and make sure no illiquid assets are sold at unfavorable prices due to an untimely sale. The optimal allocation to illiquid investments is related to liquidity needs and varies according to a client's specific constraints. We use income return and allocation to liquid assets to help gauge the overall liquidity of the portfolio. It is also important to consider the particulars of each charity such as the ability to raise inflows through donations and grants in assessing the SAA.

Starting with the traditional 60/40 portfolio discussed above, we will expand the asset classes included in the strategic asset allocation step by step to illustrate the impact over the long term.

Liquidity	
What?	Capacity to get in or out of positions in normal and turbulent market conditions at a price close to the asset's prevailing market value
Why?	Rebalance the total portfolio to maintain an appropriate risk level and diversification, meet liquidity needs for disbursements and take opportunities in market pricing such as having the ability to effectively implement tactical shifts in allocations
How?	Assess the appropriate illiquidity level of the portfolio according to specific objectives and constraints and implement effective risk management tracking

Steps in Achieving Optimized Portfolio

Step 1

↑ Private Credit
↓ Public fixed income / equities

Exposure to private credit gives the portfolio access to additional return per unit of risk thanks to the illiquid nature of the asset class and the complexity required to source deals and manage the investments.

Step 2

↑ Real Assets
↓ Public fixed income / equities

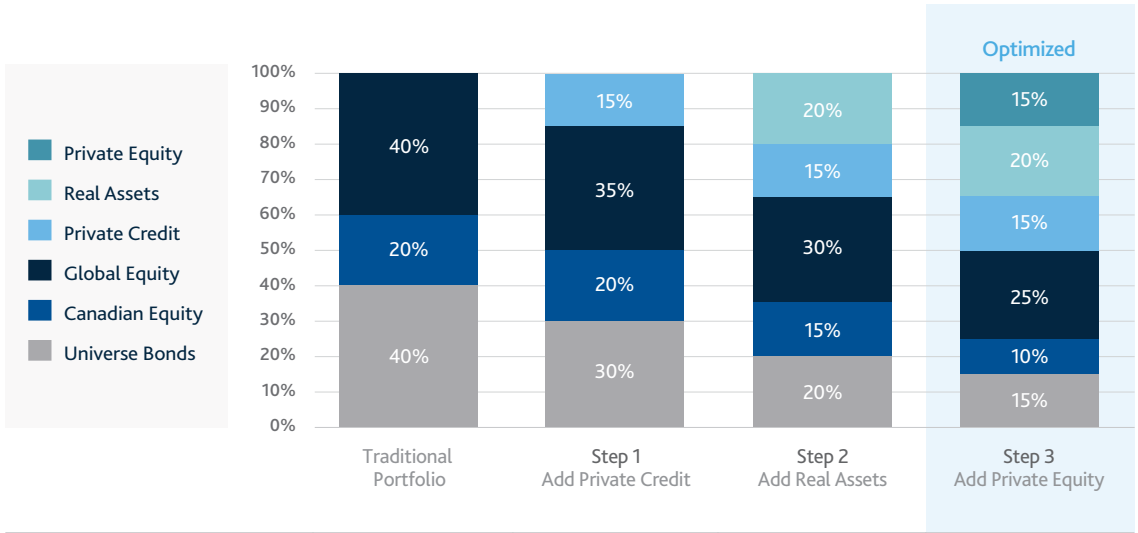
Exposure to real assets further increases the expected return and reduces expected risk and downside risk. Over the long term, real asset returns are attractive and have strong diversification benefits. Real assets also act as a hedge against inflation.

Step 3

↑ Private Equity
↓ Equities

Exposure to private equity increases long-term expected return and provides access to investment in a more diverse opportunity set of companies since most companies globally are not listed on a stock exchange.

CHART 4 Allocation Step-By-Step



Expected Return	5.30%	5.70%	6.20%	6.70%
Income Return	2.70%	3.30%	3.60%	3.20%
Expected Risk	8.80%	8.60%	7.80%	8.40%
Sharpe Ratio	0.29	0.35	0.44	0.47
Probability of Maintaining Wealth after 10 years under 5% distribution quota	47.3%	53.0%	60.4%	65.4%

Projections for this chart and all other illustrations use 20,000 stochastic scenarios with assumptions based on most recent market consensus and the yield curve for bonds as of June 30, 2022. All capital gains and current income are reinvested and portfolios are rebalanced quarterly. Details of the assumptions provided in reference at the end of this article. Sharpe Ratio based on CDOR 3M of 2.76% as of June 30, 2022.

Based on our optimization as showcased in Chart 4, compared to a traditional 60/40 portfolio, each incremental step aims to:

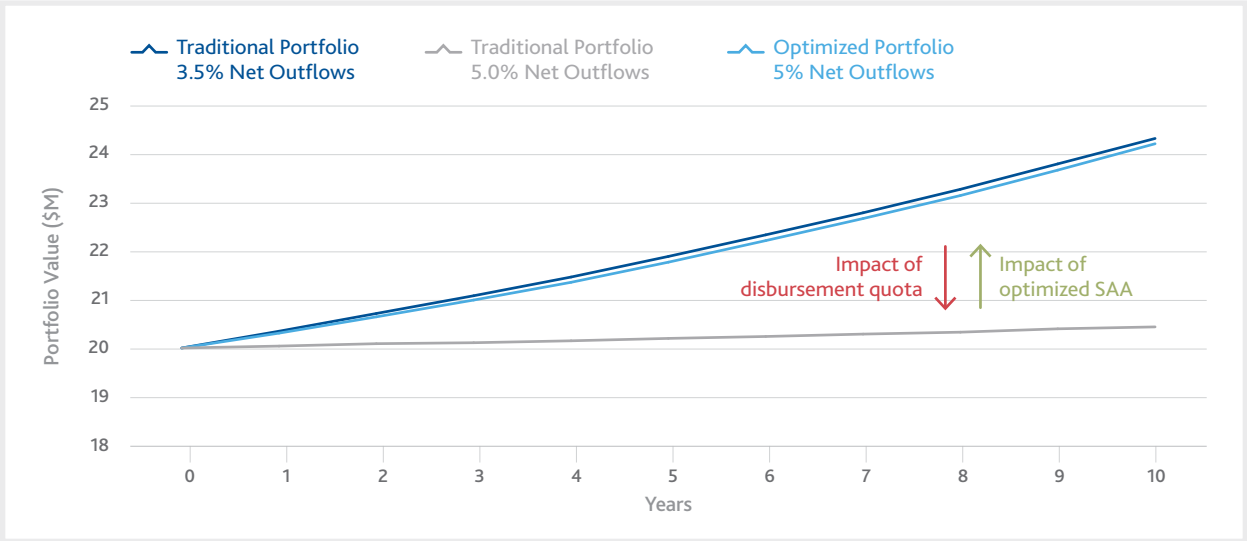
- Increase the probability of meeting the target return on an absolute and risk-adjusted basis
- Increase income return to enhance liquidity
- Ease ability to meet higher spending
- Decrease overall and downside risk over a 10-year horizon
- Increase probability of maintaining wealth

Metrics	Traditional Portfolio	Optimized Portfolio	Change
Expected Return	5.30%	6.70%	↑ Expected return increased, supporting need required by higher disbursement quota
Income Return	2.70%	3.20%	↑ Income return increased, helping to meet liquidity needs
Expected Risk	8.80%	8.40%	↓ Volatility decreased as the optimized portfolio shows better diversification
Sharpe Ratio	0.29	0.47	↑ The portfolio provides more return per unit of risk meaning the portfolio is more efficient
Probability of Maintaining Wealth After 10 Years Under 5% Distribution Quota	47.3%	65.4%	↑ Increased probability of maintaining wealth position

All else equal, a higher disbursement quota requires an increase in expected return. The incremental steps outlined in this example achieve this objective without taking undue risk and provide appropriate diversification to preserve capital.

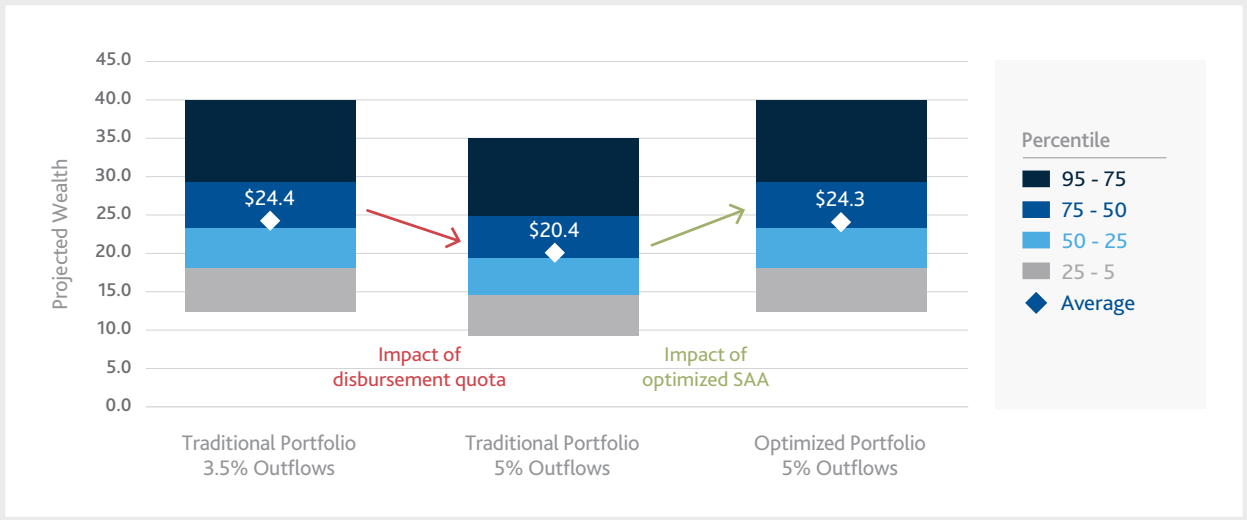
Projecting wealth over a long-term horizon should be part of the strategic investment review to assess the full range of outcomes given different economic regimes. In addition, different cash flow schedules can be included to assess the impact of different inflow scenarios which can be hard to forecast for charities. The three incremental steps in the design of the strategic asset allocation aim to decrease downside risk, increase average projected wealth, and reduce return dispersion. There is no one size fits all solution for all clients. The Multi-Asset Class Solutions Team collaborates proactively with clients to establish a solid long-term plan to maximize the probability to achieve their objectives. The graph below adds the optimized portfolio discussed above to the chart presented in Section 2 to illustrate how the strategic asset allocation changes help bridge the gap created by the distribution quota change.

CHART 5 Average Projected Wealth after Outflows



By updating the SAA in light of the increase in the disbursement quota, we have been able to bring back the illustrative charity to its starting position and help build a comfortable cushion that will help meet its philanthropic priorities and withstand uncertainty. Furthermore, looking at the dispersion of outcomes, we have significantly improved the wealth position on average as well as limited the risk of capital depletion in unfavorable events as confirmed in **Chart 6**. **We see the changes to the SAA have been able to respond to the additional disbursement quota and has brought back the distribution of potential wealth for the charity near its starting point.**

CHART 6 Potential Wealth Range After 10 Years Including Outflows



Conclusion

Establishing an appropriate long-term strategic asset allocation and maintaining it even during turbulent times has proven to be beneficial for clients and avoids making emotionally driven investment decisions. At a time when charities have many competing financial priorities, including an increased disbursement quota, an examination and implementation of a long-term strategic asset allocation will help to preserve wealth and, more importantly, ensure that charities can continue to meet their philanthropic mission. Expanding the investment universe, both in public and private markets, should be considered to ensure all appropriate asset classes are being included in an optimization framework that is tailored to the needs of charities.

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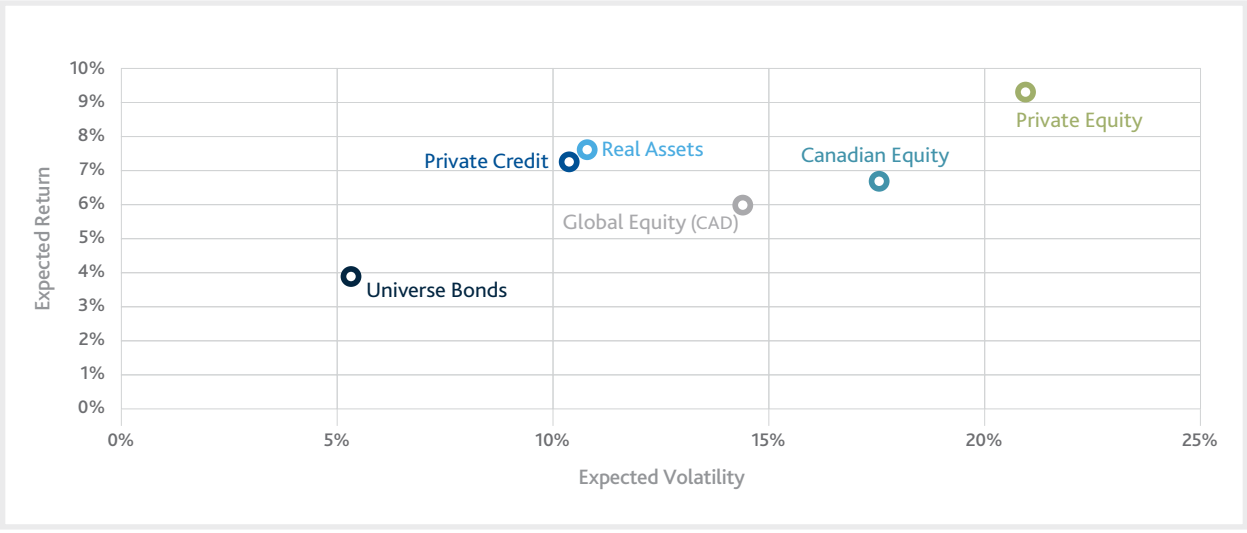
Reference

Asset class assumptions used throughout the article are based on the most recent Fiera Solutions long-term capital market assumptions as well as the yield curve for bonds as of June 30, 2022 as detailed in **Chart 7**.

CHART 7 Asset Class Assumptions



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