

# Philanthropy Focus

## Strategies for not-for-profit investors

Most financial managers or board members of not-for-profit (NFP) organisations know they should manage their assets in a distinctive way compared to other organisations or to individuals. This is equally true for both grant-making and grant-recipient organisations. Often they know why different techniques should be used, but they rarely do it. Why?

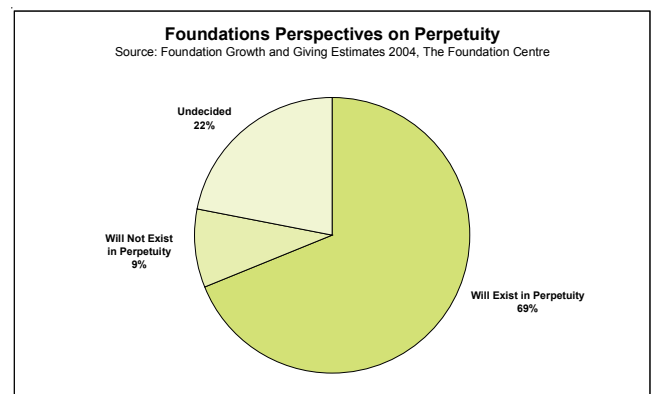
There are a variety of reasons why boards don't get around to good investment practice. But the main one is a lack of appreciation for their different financial environment. Some organisations understand these implications but don't have the time or resources to act. Others adopt the 'not on my watch' syndrome.

But first let's first look at the reasons why NFPs are different. Remember that their measure of success isn't financial – the dollars are really just a tool. And, usually, their time frame is in perpetuity because they are established by a legacy or with a permanent mission to address a particular cause. Next, they operate with different legal and trust deed requirements and they have tax concession charity (TCC) status. However this also means they can't use tax deductions for costs incurred in managing investments.

### The dollars are really just a tool

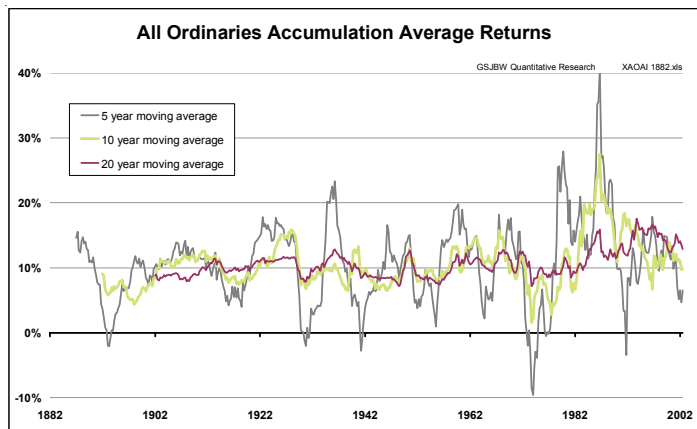
A NFP exists to provide a social return. While it's true that generating large investment returns may help pay for those social returns, it is important to keep the real mission in mind. So the investment manager must understand and ask the question, 'How are investments affecting my mission?' The most common such investment technique is ethical investing and community finance. In each case, thinking about maximising the total social returns generated by the

investments, should be the goal. As Jed Emerson ([www.blendedvalue.org](http://www.blendedvalue.org)) might say, why just use 5% of your assets to do good, when you could use 100%?

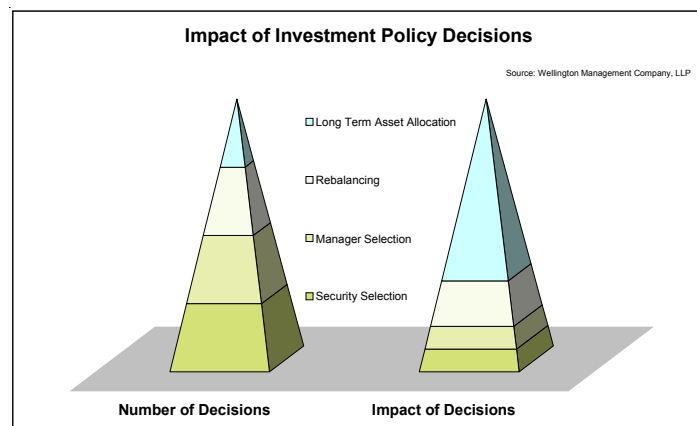


Next, the importance of investment timeframe can't be overstated. Consider the different needs of a NFP who has a grant to buy a piece of medical equipment available in 12 months time, compared to a grant being used to fund the future administration costs of a hospital. Any fall in value in the former grant could prevent the equipment's purchase; the amount earned in the 12 months is not critical. With the latter grant, what's important is the capacity to earn money at a rate capable of paying a wages bill, which will rise in nominal and probably real terms, for as long as the hospital exists. Here, the value of the corpus is not critical, only its capacity to earn at an increasing rate in perpetuity. The risk/reward profile for these two funds is completely different. Usually a NFP will have a combination of funding time

frames to meet, but understanding these different time frames and their implications is vitally important, especially those invested for perpetuity. In the wages bill example, the real enemy to not achieving the desired outcome is inflation. With an annual inflation rate of 2.5%, wages will double in under 30 years and investments without a growth component will be eaten in to.



Now the volatility (variability of returns over any given time frame) of investments depends heavily on how much time funds can be left invested. Equity markets viewed over a rolling 10-year time frame show only a quarter of the volatility of that over a one-year period. Equally, combining asset classes with low or negative correlations (i.e. they don't move in the same direction at the same time) will lower the volatility of a portfolio. The combining of different asset classes (or asset allocation) is one of the key methods used by all investors to optimise risk and return. For many of the long established US foundations, this matching of a perpetual time frame with asset choice and allocation has been very powerful, guiding them to large holdings in both equities and alternative assets, such as private equity, real estate and even hedge funds. While tax laws and foundation payout requirements differ between the

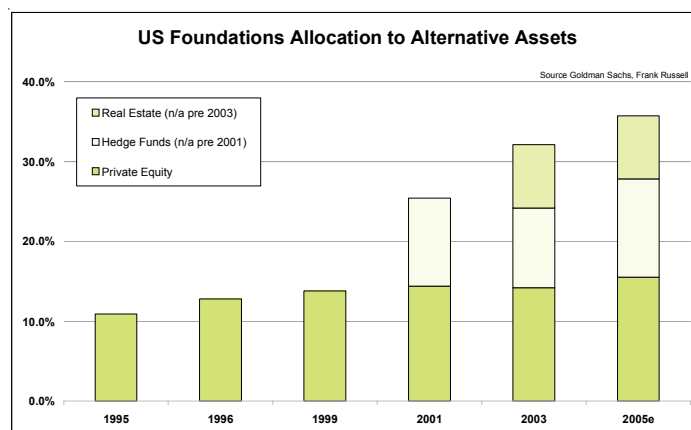


US and Australia, these investment decisions have given superior long-term returns.

When NFP investors really understand their organisation's time frame and its implications for asset allocation, they will be well placed to best provide for their future.

### Tax-free status makes a difference

Quite different legal rules govern NFP investors compared to private and even superannuation investors. The 'prudent person principle' requiring that an investor act faithfully and exercise sound discretion, as do 'men of prudence, discretion and intelligence,' is a basic guide for NFP investors. This will require adequate diversification of investments, an understanding of each asset's individual risk/return characteristics and its correlation with other assets.



This can either be undertaken by the NFP itself or by an appointed manager or committee. Further to this, however, is the requirement to be faithful to the trust instrument or constitution, which may impose further restrictions on investment options. This can also determine the ability to use or pay out capital and the resulting choices between investing for capital or income returns. Even the distinction between capital and income or between Trust law and Tax law can be issues.

The implications of a NFP having TCC status are obvious; you don't pay tax. But the ability to obtain a refund of franking credits on dividends paid by Australian companies is another important benefit. A NFP actually gets back the tax paid by a company. This means for a company paying tax at 30%, a dividend of \$35 (fully franked) is actually worth \$50 to a NFP investor with TCC status. This is also highlighted when

companies buy back their own shares and the payment is partly made with a large fully franked dividend. Often, the pricing of share buybacks is effectively set by the major superannuation fund investors. This means that anyone with a greater tax rate wouldn't find them attractive. But those with a lower rate (i.e. tax exempt status) would enjoy a pricing advantage. The desirability of capital versus income returns for the NFP investor may also need to be considered in these cases. Many NFP investors prefer to have directly owned equity investments (individually managed accounts or IMAs) which give them, rather than a fund manager who may not be managing solely for TCC status investors, the choice in these situations.

Fees are horrible and no-one likes them, especially NFP organisations who can't even claim them as a tax deduction. However, like the earlier comments on

social return being the important benchmark, here the important focus should be on net returns after fees, not the fees themselves. Earning 10% before fees of 2% is twice as good as earning 4% with no fees, regardless of your tax status. This is not to suggest that fees are unimportant, as clearly they are a major part of the net return calculation but they are only a part. Taking no action to avoid fees is false economy if either an attractive opportunity or a necessary portfolio re-balancing were called for.

These various implications for NFP investments can often conflict, meaning some compromise and optimisation will be needed. Continually trying to achieve best practice can be time consuming and require special skills that may not be in the organisation.

### First steps on the NFP investing road

Work with a financial adviser who understands the sector and your organisation. Understand where your costs come from: wages, fuel, IT, US\$ imports etc. and incorporate these into your financial model (e.g. if fuel is a big cost there may be a greater reason to own oil shares).

Understand and fully utilise your time frame and TCC status advantages.

Match the time and effort of each investment policy decision with its importance and impact. Many spend far more time on stock or manager selection than on asset allocation, the opposite of the likely impact on portfolio performance.

And, most importantly, have the money makers and users working to the same goal, the organisation's mission. Once this is achieved, the 'not on my watch' syndrome of misplaced conservatism and false economy will be replaced by a vision which maximises your organisation's total social return.

If you are interested in discussing these issues further, please contact your Investment Adviser or Goldman Sachs JBWere Philanthropic Services:

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