Mercer

Increased disbursement quota

A new challenge for Canadian Endowments & Foundations

Endowments and foundations (E&Fs) have performed well this past decade, with strong returns mostly being the norm across all major asset classes. In fact, a basic investment strategy of 30% Universe Bonds and 70% World Equity just after the COVID-19 pandemic began would have meant a strong annualized return of almost 13.5%.

Many E&Fs also received increased donations. Overall, the health of many Canadian E&Fs has improved in recent years. We see this as positive given the higher demands on their philanthropic endeavours and key contributions to the well-being of more and more Canadians.

However, greater market volatility means the outlook for equity and bond markets is highly uncertain. Also, inflation is rising. So, how will your investments fare? The supply chain disruption caused by the pandemic created concerns over global growth and inflation, and now the crisis in Ukraine and COVID-related challenges in China are putting even more pressure on global growth forecasts. As a result, we're seeing inflation levels that a whole generation has never experienced, and this is looking less and less transitory.

These forces present a big challenge for E&Fs hoping to benefit from strong investment results to accomplish their mission, while also staying within their risk budgets.

Now the federal government is adding to the challenge by asking E&Fs to raise their disbursement quota from 3.5% to 5% for fiscal years starting on or after January 1, 2023.

To be fair, many Canadian E&Fs already have a disbursement quota above 3.5%. Mercer's 2021 Canadian E&F survey indicated that around 14% of respondents had one of 5% or greater, and roughly 50% were at between 4% and 5%. Most E&Fs want to protect themselves from capital erosion though, and the requested quota increase could present a challenge in this more difficult economic environment.

Levers available to overcome the challenge

Mercer believes that E&Fs can use three levers to face these challenges:

1. Increased risk-adjusted investment returns through revised policy asset mix
2. Decreased investment management fees
3. Increased donations

As increased donations have always been at the forefront of E&Fs' activities, we focus on the first two levers. Mercer has a long track record of helping Canadian E&Fs maximize the impact these can have on meeting philanthropic objectives.

Policy asset mix

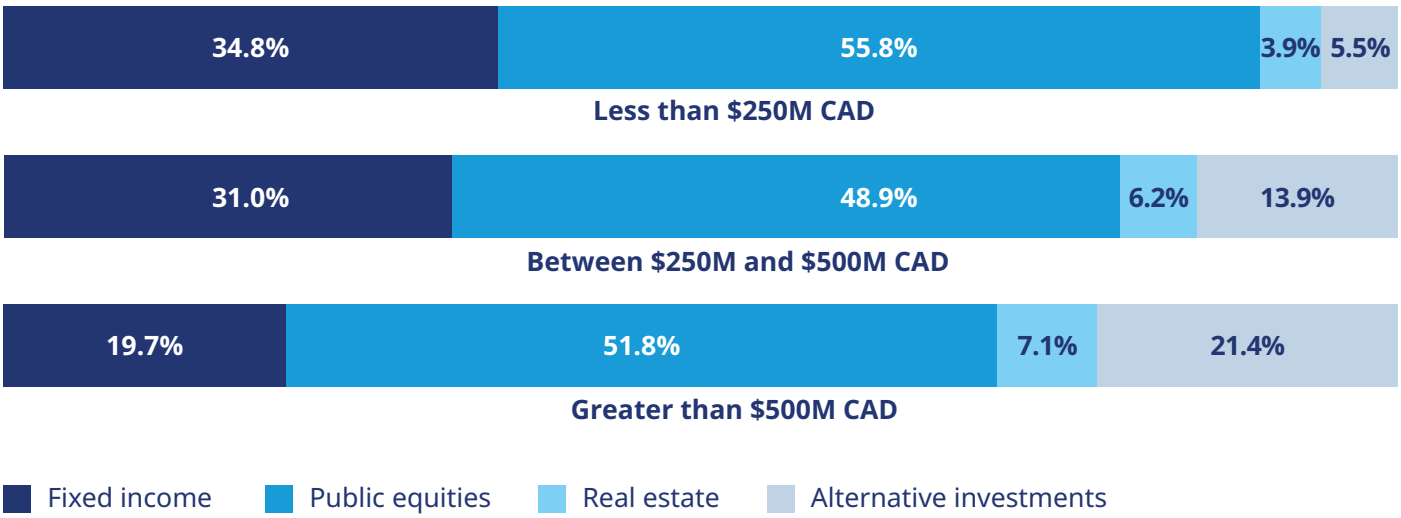
Now is not the time to simply try to boost expected returns by increasing the allocation to public equities or credit. This would lead to greater risk exposure. Investors should instead focus on achieving higher *risk-adjusted* returns, which requires a diversified approach to portfolio construction.

Our survey shows that most E&Fs are well represented in the areas of public equity and credit. Below, we highlight alternative asset classes that E&Fs should use to potentially improve the risk-adjusted profile of their investment portfolios:

- **Private credit:** To potentially improve the fixed income portfolio's return.
- **Absolute return strategies:** To potentially protect against increasing yields and equity down markets.
- **Private equity:** To potentially improve the equity portfolio's return (higher returns should also protect against inflation over the long term).
- **Real assets:** To potentially offer protection against inflation and improve the portfolio's return.

In Mercer's 2021 survey of Canadian E&Fs, we saw a strong correlation between size of the E&F and allocation to the alternative investments listed above (see Figure 1).

Figure 1. High level asset mix by AUM



We can't overstate the impact of alternative investments on risk-adjusted return. Using Mercer's March 31, 2022, Capital Market Assumptions to compare the expected return of the basic investment strategy and the asset mixes mentioned earlier gives the following numbers (see Figure 2).

Figure 2. Impact on alternative investments on expected risk-adjusted returns

AUM*	10-year return	Standard deviation	Ratio return/risk
Basic inv. strat.	5.4%	11.3%	0.48
<$250M	5.7%	10.1%	0.57
$250M to $500M	6.0%	9.8%	0.61
>$500M	6.6%	10.6%	0.62

*CAD

Based on this information, and all else being equal, it appears that smaller E&Fs might face stronger headwinds than larger ones when it comes to adequately compensating for the disbursement quota increase. Here are various possible reasons why alternative investments are less common at smaller E&Fs:

- Minimum mandate size requirements
- Greater complexity in selecting and contracting with investment managers
- Lack of access to superior investment managers
- Historical performance of traditional asset classes has been sufficient to date
- Perceived liquidity needs
- Lower risk tolerance
- Greater governance budget requirements
- Higher investment management fees

Lowering investment management fees

E&Fs face a key challenge of maintaining/lowering their investment fees while adding the complexity needed to achieve their objectives. Alternative investments often come with higher fees than traditional investments, but top-tier managers can provide strong net returns and play a vital role in the portfolio.

Also, lowering management fees on traditional asset classes (without compromising returns) is critical to successfully fighting the various headwinds. A passive approach to asset classes with lower alpha potential can be an attractive solution, especially for smaller E&Fs that don't have access to the lower tier of the typical manager fee structure.

One way to achieve scale and improve governance support and access to alternative investments is to implement an Outsourced Chief Investment Officer solution. In short, this means you benefit from the scale of a much larger institution while retaining control of your investments' risk-return profiles.

Conclusion

The increased disbursement quota mandated in the latest federal government budget poses a challenge for Canadian E&Fs, particularly in this period of market volatility and rising inflation. The impact of the disbursement quota increase will differ among Canadian E&Fs depending on size, current investment program and disbursement quota already in force. We recommend that you assess the impact and most appropriate remedial actions for your organization before the increase takes effect in 2023. We see the forward-looking economic environment as a trigger for conducting an asset mix review to ensure that you are well positioned to face the headwinds and keep meeting your objectives. The increased focus on ESG factors also warrants a review of the investment portfolio. Private markets provide access to impactful investment strategies in that regard.

Mercer has been helping Canadian E&Fs with these issues for more than 40 years. Please do not hesitate to reach out to us or your Mercer consultant to discuss your organization's specifics so that we can put you on the right track.

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