BAIRD

Move Over, 5%, and Let Mission Drive

By Peter Frumkin, Chris Didier and David Klenke

Synopsis

Many donors to private foundations focus on the tax benefits and logistical questions involved in setting them up and don't pay as much attention to the larger question of their missions. Of particular influence is the IRS requirement that foundations distribute 5% of their net assets to charity each year. Set by Congress, this arbitrary number dictates the spending policies and corresponding investment strategy of most foundations. However, donors may increase the likelihood of the success of their foundation by defining their mission separately from tax law, creating spend policies that correspond with those missions while meeting the minimum distribution requirement and, finally, setting investment strategies that are appropriate for those policies.

Introduction

In May 2009, the two richest men in America, Bill Gates and Warren Buffett, presided over a confidential dinner meeting of billionaires in New York City. In June 2010, the true purpose of that meeting was revealed. Gates and Buffet challenged America's billionaires to give away the majority of their wealth to charity – either during their lifetimes or at death – in an effort called the Giving Pledge. If successful, this effort could raise an estimated $600 billion and may alter philanthropy for decades to come.

The History of 5%

Prior to 1969, the federal government had little control over how foundation funds were used or managed. With the Tax Reform Act of 1969, Congress responded to concerns that had been raised for decades regarding the size of assets in foundations and the role they played in society.

The act prohibited self-dealing by foundations, regulated their grants to individuals, restricted their ownership of businesses and limited their involvement in legislation and political campaigns. It also taxed foundations for the first time and required that they distribute the greater of their total investment income or 6% of their assets to grantees each year. Later legislation changed the distribution policy to 5% of a foundation's net investment assets.

By defining distribution policy, federal tax law may have unintentionally hijacked foundation spending policy. Because most private foundations base annual payouts on the 5% threshold today, they may have lost the ability to be flexible in the spending policies that fulfill their missions.

Many wealthy individuals, not just billionaires, will likely follow the example of Gates, Buffet and countless others before them who have taken philanthropy seriously. Most want to solve a social problem or simply give back to the communities that fostered their success. Many are also motivated by income and estate tax rules that promote charitable giving. Setting up a private foundation, which provides some measure of control during the donor's lifetime while creating a family legacy, may be the preferred giving platform for the bulk of these philanthropists.

The tax code encourages charitable giving in return for special treatment under the assumption that some social benefit will be realized. However, the code neither ensures that significant social benefits will be achieved or defines what a social benefit would be. It often comes down to the intent of the donor. Unfortunately, the history of philanthropy is littered with examples in which donor intent was fuzzy or misinterpreted once the donor could no longer provide guidance. In cases like these, the results are often disappointing.

By focusing on the tax and logistical issues involved in setting up foundations, lawyers, accountants and other advisors may put off or ignore the opportunity to help donors define the core missions of their foundations. Once the foundations are up and running, the focus tends to shift to managing assets and complying with IRS guidelines.

To realize the social benefits their donors seek, foundations must clearly define their missions, create spend policies that correspond with those missions and set investment strategies that suit those policies.

Defining the Mission

From the start, foundation donors have appreciated the tax and legal implications of philanthropy but struggled to pin down what their foundations should achieve. We believe that the one important driver of this lack of focus on mission is the IRS requirement to pay out 5% of net investment income (see sidebar, "The History of 5%"). This rule highly influences the spending policy of the foundation and, in turn, the way the assets are invested. What gets lost in the focus on the 5% payout are the mission of the foundation and the shape of the problem being solved. It is our contention that because the rules are defined and the mission is not, spend policy is predetermined, investment strategy standardized, and mission becomes a tertiary thought.

The most successful foundations, however, take the time to do a little soul searching and clearly define their intentions. Arabella Philanthropic Investment Advisors suggests that a written mission statement be developed that reflects a donor's values, guides the work of their foundation and helps others understand their larger purpose. A mission statement defines the change the donor wishes to see and how it will be achieved.

A Focus on Mission

In Chicago, the Steans Foundation decided to focus its philanthropic energies on fashioning a comprehensive and sustained intervention in the Lawndale neighborhood on the west side of the city. Lawndale is an area with all the problems that can beset a community, including violence, high levels of unemployment and poverty, and weak schools. Rather than rush in and begin developing programs and funding activities, this small family foundation took a very different route.

They hired an executive director who had credibility in the community, having run popular youth programs. He was charged with the task of setting up a store front office in Lawndale and listening to what residents thought were the real needs of the neighborhood. Additionally, the Steans Foundation hosted a policy conference on urban poverty to learn about approaches that had been tried and studied in other neighborhoods. As the Foundation became more confident about its ability to assess and respond to the neighborhood's true needs, it began to fashion a broad program aimed at assisting residents.

Because it was a relatively new player in the nonprofit scene, the Steans Foundation began by listening to the community and then sought out partners to aid in its work. The focus of it mission, which was a single neighborhood, never changed. By taking their time to understand how to best match their spending policy with their mission they increased their chance of success.

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The following is an example of a written mission statement:

> "The Sara Hutcheson Foundation's mission is to ensure that the poorest families are treated with the respect and dignity all people deserve. We believe that helping women and children is the most effective way to improve life in under-served communities."

Most donor families have specific passions that can serve as the basis for foundation goals. If these passions are not obvious, there are professionals, like Arabella, who can help the family identify their goals and define a mission that suits these goals. Taking the time to be thoughtful upfront can alleviate guesswork by others in the future.

The story of the Ford Foundation offers a well-documented example of what can happen when the charitable mission is open to interpretation. In 1936, shortly after Congress raised the top estate tax rate above 70%, Henry Ford sought to protect his family's control of the Ford Motor Company by creating the Ford Foundation. When Henry Ford died in 1947, the Ford Foundation received 95% of the economic interest in the Ford Motor Company while his family maintained voting control.

From the outset, Ford's grandson, Henry Ford II, decided that the family would not try to control the foundation. Although Henry Ford II was chairman of the board of both the Ford Motor Company and the Ford Foundation, he believed that the amount of money was so great that the foundation needed outsiders as well as family members to serve as trustees. It was a decision he would regret for the rest of his life.

The next several decades were filled with many adventures and misadventures. The "outsiders" led the Ford Foundation into areas that were well beyond its founder's vision and values. By 1976, Henry Ford II resigned from the board saying he no longer recognized the institution – an acrimonious parting between the Ford family and the philanthropy it had spawned. In spite of this, many have argued, the Ford Foundation has produced significant public benefits. Still, it may have failed to achieve the benefits that Henry Ford had expected.

Creating a Spend Policy

Once a foundation clearly defines its mission, it can more successfully create a spend policy with a payout rate that supports that mission. There are three primary issues that influence this rate:

Effectiveness – whether an accelerated payout will help to resolve a social issue sooner, or just use up funds that may be more greatly needed down the road

Generational equity – whether an accelerated payout can help to even out the relative benefits and tax burdens of different generations

Values expression – whether donors want to see their goals fulfilled during their lifetimes or in perpetuity

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The Steans Foundation Mission Statement:

"The Steans Family Foundation concentrates its grant making and programs in North Lawndale, a revitalizing neighborhood on Chicago's west side. By dedicating time, money, and skills, this small family foundation works in partnership with local residents and institutions to build and enhance the North Lawndale community. The Foundation's work supports the idea that effective revitalization can occur within the embedded social and economic networks that create and sustain communities."

Effectiveness

Consider how a foundation might address environmental problems versus curing polio. Plotting environmental problems over time would create a relatively steep ascending curve (Figure 1) that represents increases in greenhouse gases, air and water pollution, and other global indicators of environmental distress. Plotting the progression of polio over time would produce a downward slope, as the number of children victimized is projected to drop precipitously. As you can see below, the "shapes" of these issues are quite different.

Giving away larger amounts of money in the short and near term, as Gates and Buffet have urged with the Giving Pledge, may make it easier to cure social problems rather than merely treat their symptoms.

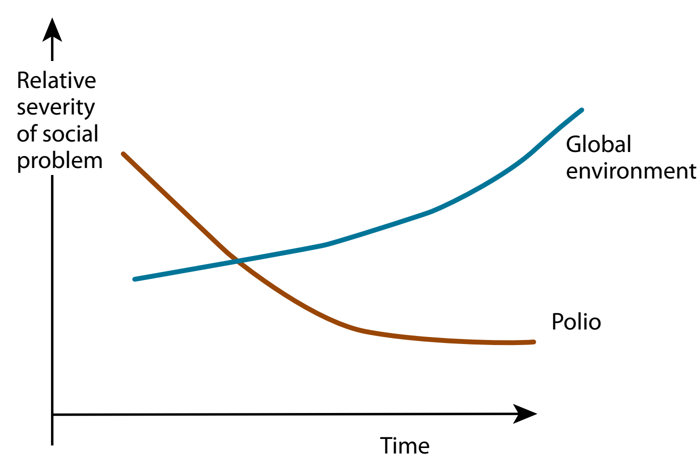
To determine the effectiveness of such a strategy, one must understand the shape of the specific social problem a donor wishes to solve. This requires an understanding of the degree to which the problem is likely to increase, decrease, or stay the same.

Generational Equity

Foundation payout rates also have serious fairness implications – especially given the exponential growth in philanthropic assets that is expected in coming decades. When donors fund private foundations, they receive current tax benefits. Because these benefits reduce tax revenue, they decrease government resources for current social programs. If a foundation exists in perpetuity, future generations will receive benefits, but the generation that experienced the lost tax revenue may not. Although there is no moral or legal obligation to use money earned in one generation to benefit the same generation, some donors want to return some of their wealth to the generation that helped them earn it.

FIGURE 1:

Projected Severity, Over Time, of Environmental Issues and Polio



Making a Difference

Donors who want to "do something bold, break new ground, and address the root cause of an issue" must take the time to thoroughly research their missions, says Curtis Meadows Jr., past president and director emeritus of the Dallas-based Meadows Foundation. "If they care about how their money is spent, they have to get involved up front."

Meadows, an attorney who also advises other charitable foundations, notes that "the biggest problem in being effective is time." Some donors who've spent their lives making money don't want to be the driving force in their philanthropy.

"People do care," he says. "They just don't always recognize that disposing of wealth wisely requires the same effort as creating that wealth. If a donor has strong feelings about the mission of the foundation, there is no one better suited to carrying out that desire."

The Meadows Foundation, a perpetual institution, has a very simple mission: benefitting the people of Texas. Still, "the trustees have been carefully trained in applying the vision of the founder in an ever-changing world," Meadows says.

Values Expression

Current spending strategies may be particularly attractive to donors who wish to participate fully in the act of giving. They may also alleviate concern about having others make decisions about donors' gifts after they're gone.

There is little doubt that donors who spend the bulk of their wealth while still alive ensure that their philanthropy is animated by their specific passions – convictions that professional foundation managers may not share. Having the philanthropic principals, rather than their agents, make the actual gifts is also the best way to ensure that philanthropy's unique voice continues to be heard in the public sphere in ways that are different and less constrained than the voices of government agencies.

Setting an Investment Strategy

Once a foundation establishes its mission and creates a spend policy based on the shape of the problem, it must design an investment strategy to support the spend policy. While foundation missions are as unique as their donors, they can be placed in three primary categories:

- Long-term missions
- Short-term missions
- Long-term missions with inflection points

Long-Term Missions

Donors that fund long-term missions have concluded that their funds have a greater effectiveness in the future than they would have today. Warren Buffett, who continues to control Berkshire Hathaway, seems a good example of such donors.

Achieving sufficient returns over time will likely involve more risk, however. For long-term missions, it is appropriate to seek a rate of return that maintains the corpus (core assets) over time. The 5% minimum set by the IRS may make this effort more challenging. To meet the IRS requirement, a foundation must earn at least 5% just to stay even. Larger distributions require higher returns and, typically, greater risk.

When the Economic Recovery Tax Act of 1981 set the payout minimum at 5%, the 10-year Treasury (which many would consider a "risk-free" investment) was yielding about 15%. Given current yields, a foundation must thus take much greater risk today to reach the 5% threshold (and avoid invading its corpus) than when the law was written. Greater risk means investing in instruments that have higher volatility and the potential for large losses.

In seeking higher returns, a foundation may actually find itself with *less* money to give away when losses occur. Table 1 below shows four portfolios that invest $100 million over two years at different rates of return. Assuming no interim distributions, all the portfolios end up with the same arithmetic average return. (See the Average Returns column.) However, Portfolios C and D, which have lower volatility, end Year 2 with $3 million more than Portfolios A and B, which have higher volatility. (See Assumption #1 column.)

Now assume Portfolios A through D represent four foundations that must make distributions. Each commits to paying $5 million at the end of each year for two years. Once again, *volatility* matters. Portfolios C and D have more money at the end of Year 2 than Portfolios A and B (see Assumption #2 column). It is also clear that the *timing* of returns matter when distributions are introduced. Portfolios A and C, which have negative returns in Year 1, both end Year 2 with less money than Portfolios B and D, which have negative returns in Year 2.

TABLE 1

Portfolio	Returns			Initial Capital	Ending Capital – Year 2	
	Year 1	Year 2	Average*		Assumption #1 No Distributions	Assumption #2 Annual $5M Distributions
A	-20%	20%	0%	$100	$96	$85
B	20%	-20%	0%	$100	$96	$87
C	-10%	10%	0%	$100	$99	$89
D	10%	-10%	0%	$100	$99	$90

In the 1980s and 1990s, foundations minimized the impact of volatility on returns by using modern portfolio theory to allocate investments to cash, bonds, and stocks. They still experienced significant volatility, however. Following the volatile markets of 2000–2002, more embraced the “endowment model” of investing.

Made popular by foundations at Yale and Harvard, the endowment approach seeks to lessen volatility by allocating significant assets to non-public, illiquid markets. Typically, fixed-income investments are replaced with market-neutral hedge funds. Equities are replaced with private equity funds, venture capital funds, and real estate. Because there may be times (such as 2008) when most asset classes decreased in value at the same time, this strategy is most appropriate for foundations with longer spending horizons that will give their investments enough time to normalize in price. Even with a longer-term horizon, a foundation must maintain an appropriate level of liquidity to meet the IRS distribution requirements.

Short-Term Missions

An endowment strategy becomes less appropriate for short-term missions because a financial crisis could cause the riskier assets to decrease in value simultaneously and for potentially long periods of time. Foundations with shorter time horizons should thus invest primarily in less risky, lower-return assets such as cash equivalents and bonds, with perhaps a minor amount allocated to liquid equities.

The Beldon Fund

The Beldon Fund was created by John Hunting in 1982 as a national foundation committed to promoting sound environmental policies. In 1998, Beldon received a major infusion of money from the sale of Hunting's stock in the Steelcase Company. Hunting set his foundation on a new course by deciding to spend all its principal and earnings over the next 10 years on efforts that would build a national consensus for achieving and sustaining a healthy planet.*

Foundations with short-term missions, like Beldon, conclude that the present value (discount rate) of future cash flow is greater than the return they could earn on financial assets. Because these foundations believe their effectiveness is greatest in the short term, their investment goals should thus focus on preserving the wealth that they expect to disburse.

* Beldon Fund, "Giving While Living: The Beldon Fund Spend-Out Story," 2009.

Unfortunately, not all shorter-term foundations take this approach. In 1999, Steven Kirsch created the Steven and Michele Kirsch Foundation and endowed it with $50 million. He set a relatively high payout rate of 10% to 12%, indicating a commitment to making a difference sooner rather than later. The foundation's board invested 90% of the assets in high-tech stocks – the same investment from which Mr. Kirsch had earned the wealth that made his gift possible. When the dot-com bubble burst, the foundation's assets plunged to $9.2 million. Clearly the foundation's funding status would no longer allow Mr. Kirsch to make the difference he perhaps had planned.[1]

Long-Term Missions With Inflection Points

Many foundations with long-term missions recognize that near-term opportunities to increase benefits may arise from time to time. The HKH Foundation strives to protect civil liberties and the environment, which most would see as a long-term mission. During the 2004 election, however, HKH saw a short-term opportunity for using a large payout to make a significant impact. With the potential to be highly effective during this window of time, HKH disbursed funds beyond its typical 5% target.[2]

Another example is the Whitaker Foundation, created in 1975 by Uncas Whitaker to pioneer advances in biomedical engineering. In 1991, the foundation's board sensed an inflection point in their cause. Despite significant technological advancements in the 1980s, few universities had biomedical engineering departments. The foundation decided it could have a greater impact by spending its assets down than by continuing in perpetuity. It then fully distributed its assets over the next 14 years.[1]

Foundations that have long-term missions with inflection points can combine the endowment method with short-term portfolio strategies. How far they stray from the endowment approach will depend on the frequency and magnitude of the expected inflection points. The greater the frequency and/or magnitude, the more they should depend on shorter-term strategies.

No matter what time horizon a foundation chooses, it is important to correlate investment strategy with mission. For example, assume a hypothetical foundation seeks to maintain and protect the Gulf of Mexico and splits its portfolio evenly between non-traditional equities and bonds, which are considered to be less risky. The values of these two types of investments would appear, at least on the surface, to have relatively low correlation with each other.

But what if both the bond and equity allocations had a heavy weighting in energy companies? Suddenly, the BP oil rig accident of 2010 occurs, and charitable

[1] Deanne Stone, "Alternatives to Perpetuity: A Conversation that Every Foundation Should Have," 2005.

[2] http://www.ncg.org/s_ncg/bin.asp?CID=9349&DID=24751&DOC=FILE.PDF

demands on the foundation rise dramatically. Because the accident was caused by an energy company, all investments in that industry are punished. The energy bonds decrease in value – as do the non-traditional investments, which cannot be liquidated. At a time when the need is greatest, the foundation's capacity to help is reduced because its investment portfolio correlates too closely with its mission.

Distribution Challenges With the Endowment Approach

While using non-traditional investments can smooth out volatility, they generally have lock-up periods on the front end and limited liquidation windows. This can keep a foundation from accessing the funds it needs.

Assume a foundation with $100 million splits its investments evenly between traditional and non-traditional vehicles. To make grants, it must raid the traditional portfolio, where the only liquidity exists. Over time, if not carefully monitored, the investment mix becomes more heavily weighted toward the non-traditional, less liquid investments. If a financial crisis strikes before corrective measures are taken, the foundation may find itself in a liquidity bind and be forced to sell illiquid assets at drastically reduced values. This was the experience of many who followed the endowment model during the financial crisis of 2008. Because of this experience, many will likely adjust that model to make more room for cash or equivalents.

Foundations should consider both liquidity and portfolio correlation when contemplating a program-related investment (PRI). With PRIs, foundations use their investment portfolio to provide capital through equity investments or loans directly to the non-profit organizations they support on preferred terms. These strategies include private equity or loan funds (partnerships) that provide diversification while complementing a foundation's overall mission. Generally, PRIs are illiquid and highly correlated to the foundation's mission. As a result, even though they don't count when considering net investment assets and the minimum distribution requirement, the more liquid portion of the total investment portfolio still must be managed differently to provide the flexibility and the return the foundation needs to achieve the rest of its mission.

Factoring Taxes Into Returns

While tax savings is often a major force behind the establishment of a private foundation, once up and running, they can be overlooked. Currently, there is a 2% maximum excise tax on the net investment income (including capital gains) of private tax-exempt foundations. However, the rate was historically higher. The Tax Reform Act of 1969 first imposed this tax at a rate of 4%. Given that the IRS now claims that the tax does not raise enough revenue to cover audit and compliance costs, Congress could decide to raise the rate in the future.

Case Study: Matching Investment Strategy to Mission

Mike and Linda Smith set up a $100 million, Texas-based family foundation prior to the partial sale of their business to support local inner-city educational programs. Their goal was to give back to a community that had helped them and their family and make a difference in the lives of those less fortunate than themselves.

The Smiths worked with their advisors to set up a structure that would handle administrative tasks, grant making and investment management for the foundation. Their investment strategy was built on traditional asset allocation concepts and the Endowment Model popularized by major universities like Yale and Harvard. Anxious to make an immediate impact, they quickly made several very large grants and easily exceeded the 5% annual payout rate used by many private foundations.

With the financial crisis of 2008, the foundation's assets declined substantially at the same time that the needs of organizations it served grew dramatically. This strain caused significant concern for the Smiths and their advisors. In February of 2009, their primary investment advisor was asked to update an analysis of spending policy that been completed shortly before the crisis.

The original analysis had yielded the following conclusions:

- Spend policy, like any planning, requires flexibility.
- Spend policy should also relate to the foundation's time horizon.
- This time horizon is a function of the purpose of the foundation and the expected role, if any, of future generations.
- Asset liquidity should match both horizon and spending policy.
- A foundation's "return" on giving, while difficult to measure, must be considered.

Upon revisiting the foundation's spend policy seven months later, these conclusions helped improve both the spend policy and the investment strategy. The Smiths and their advisors had realized that their original investment strategy had too many moving pieces to provide the flexibility they required. Multiple advisors, essentially doing the same thing, had not provided additional diversification, just additional complexity – making it difficult to make changes efficiently. Even rebalancing the foundation's investment portfolio had become an overwhelming task.

Just as importantly, the Smiths zeroed in on what they wanted their foundation to accomplish and the role that their children might eventually play. Because this had not been clear at the beginning, the foundation had, by default, ended up with an asset allocation designed for a long-term horizon that included many illiquid investments. As other foundations that follow the endowment model had found, a lack of liquidity can be a serious problem during a financial crisis.

Regardless of the rate, foundations can reduce the impact of this tax by matching capital gains and losses. During the financial crisis of 2008, most foundations saw the value of their assets decline. Many then realized those losses in 2009 as they made distributions or adjusted their investment strategies. Unlike individuals, however, they could not carry the losses forward to offset gains in future years. If a foundation recognizes $50 million in gains in the year following a loss, it pays the 2% tax on those gains (or $100,000). If the foundation claims the $50 million gain and the $50 million loss in the same year, it would eliminate the $100,000 tax.

Staying True to the Long-Term Mission

Preserving a donor's intent over time requires accountability systems that help to preserve a foundation's mission once the donor is no longer on the scene. Some donors try to maintain control and avoid mission drift by specifying that family members, long-time business associates, attorneys, and other influential members of the local community serve as trustees. Others define the selection criteria for naming trustees in the future. But most donors rarely foresee how the tension between time and mission will play out.

Examples of mission conflicts after a donor dies are legendary and numerous. One of the most high-profile disputes has pitted the friends and associates of Milton Hershey against each other in a struggle for control of the chocolate magnate's philanthropic legacy.

In the Pennsylvania town bearing his name, Milton Hershey endowed a school for orphans. Today, the school serves 1,500 students, mostly from single-parent families – not orphans. The school's endowment, now at more than $5 billion, is greater than all but a small number of private universities in the country. With about 650 full-time employees, the school spends more than $60,000 per student each year. It is located on a plush campus with a new library, arts center, swimming pools, and the latest technology. Given these substantial expenditures, some alumni and community members believed the school should expand its mission rather than spending lavishly on new facilities.

The school's leadership created significant controversy in 1999, however, when it proposed a foray into research and training related to educating needy children. To make this important shift in priorities, the school took the unusual step of going to probate court to seek permission to divert $25 million to the construction of a Catherine Hershey Institute for Learning and Development and use additional funds to support its future operating budget.

The school's board had to show that it was unable to use the funds left to the school efficiently and that the modification sought was in keeping with the general charitable intent of the Hershey's. The move created a major division within the community. Some argued that the creation of a research institute, far from allowing the school to help more children, abandoned the real values and commitments of the Hershey family. The battle led to court cases and ultimately went to the Pennsylvania Supreme Court in 2003. The Court decided to let the state attorney's office mediate between the embittered sides. The dispute has quieted down for the moment as both sides are focused on celebrating the school's centennial.

Choosing between current giving and the slow disbursal of funds in perpetuity is ultimately a personal choice for donors that has profound implications for the organizations and individuals that benefit from their gifts. One thing is certain, however: treating time as something complex and contingent – rather than simply accepting perpetuity as the default – is critical to fulfilling philanthropy's goal.

Conclusion

It is up to donors and their advisors to shift the focus from the tax benefits to the larger question of missions. Once mission is defined, appropriate spend policies that correspond with those missions and investment strategies will follow. By putting "mission" in the driver's seat, donors may have a better shot at getting to where they want to go with their philanthropic efforts.

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