TD Asset Management

The Disbursement Quota Hike and Its Impact on Nonprofit Investment Portfolios and Strategies

The nonprofit sector is recognized as one of the most important contributors to Canadian society, not only because of its role in improving social outcomes, but also because of its impact on the economy. The charitable sector contributes 8.7% to Canada's Gross Domestic Product, an estimated $189 billion, according to the charity Imagine Canada[1]. It estimates that 86,000 registered charities employ 2.5 million Canadians full-time, approximately 10% of the Canadian workforce, and 13 million volunteers work 1.7 billion hours a year[2]. To ensure tax-supported donations are effectively deployed, registered charities are required to pay out a minimum amount on charitable programs that fulfill their mission. This is known as the disbursement quota (DQ). This year's federal budget raised the DQ from 3.5% to 5.0%, which has substantial implications for the charitable sector.

The 2021 federal budget committed the Department of Finance to a review and potential increase of the DQ. This became the subject of much discussion in Canada as a whole and the charitable sector specifically. Given that the 3.5% DQ rate had been in place for nearly two decades[3], it was appropriate that it should be evaluated to determine whether it still reflected long-term portfolio return expectations, while continuing to provide strong ongoing support for Canadians in need. In fact, there appears to have been strong support in the sector for regular periodic reviews of the DQ rate.

The widespread impact of the COVID-19 pandemic on Canadians and the important role the charitable sector has played in Canada's recovery underscore the urgent need for the sector to remain healthy and sustainable to meet future challenges.

With the announced change to the DQ from 3.5% to 5%, effective January 1, 2023, the way charities manage their investment portfolios will be impacted, increasing the importance of understanding the unique issues they face. A key challenge for nonprofit organizations, which depend on returns from investment portfolios to support programs, is to strike the right balance between the demand for current income and the need to grow capital to sustain funding over the long term.

Other investment needs and objectives that are common to charities include:

- Preserving capital and maintaining the purchasing power of the current assets and future contributions
- Maximizing the long-term returns on investment, consistent within the organization's risk tolerance and without exposing the portfolio to undue risk or permanent impairment

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[1] Source: https://www.imaginecanada.ca/en/360/sector-stats

[2] Source: https://www.imaginecanada.ca/en/360/sector-stats

[3] Source: https://www.canada.ca/en/department-finance/programs/consultations/2021/boosting-charitable-spending-communities/backgrounder-disbursement-quota-consultation.html

- Maintaining an appropriate asset allocation based on a total return policy and ensuring sufficient liquidity to meet the organization's cash needs on a timely basis

To further complicate the scenario, many philanthropists provide donations with the stipulation that there can be no encroachment of principal. The increase in the DQ, given the current low-income environment, requires a rethinking of the traditional approach to asset allocation, which has typically relied on a balanced portfolio of equities and fixed income to achieve real returns that meet the outgoing 3.5% requirement after fees. How will charities meet the challenge of a 5% DQ without taking on unacceptable risk? To answer this, prior to the budget announcement, we ran Monte Carlo simulations to analyze the investment impact of different disbursement quotas and how different portfolio mixes can improve outcomes under each scenario.

Investment Impact of Disbursement Quotas

To evaluate the investment impact of disbursement quotas, we ran 10,000 simulations of asset levels over time, assuming a traditional mix of 60% equities and 40% bonds. The key variables along with each DQ is the net fundraising or cash inflow for each program. We also assumed 1% for expenses. Figure 1 reveals the net flow accounting for each of the variables so that the reader can understand the scenario that best fits their program.

Figure 1: Investment Impact of Disbursement Quotas

	Scenario	A	B	C
	Disbursement Quota	3.5%	5%	7%
	Expenses	1%	1%	1%
	Total Spending	4.5%	6%	8%
			Net Flows	
Fundraising	0%	-4.5%	-6%	-8%
	2%	-2.5%	-4%	-6%
	4%	-0.5%	-2%	-4%
	6%	1.5%	0%	-2%
	8%	3.5%	2%	0%
	10%	5.5%	4%	2%

To understand net flow, we begin with scenario A, which reflects the current DQ of 3.5%. For example, as seen in the matrix above, at a disbursement level of 3.5%, with expenses of 1%, and no additional fundraising, an organization would have a net flow of -4.5%. With fundraising at 2%, the net flow for the same organization would be -2.5%. With the upcoming 5% DQ, this same organization would now have an outflow of -6% without fundraising, or -4% with 2% fundraising.

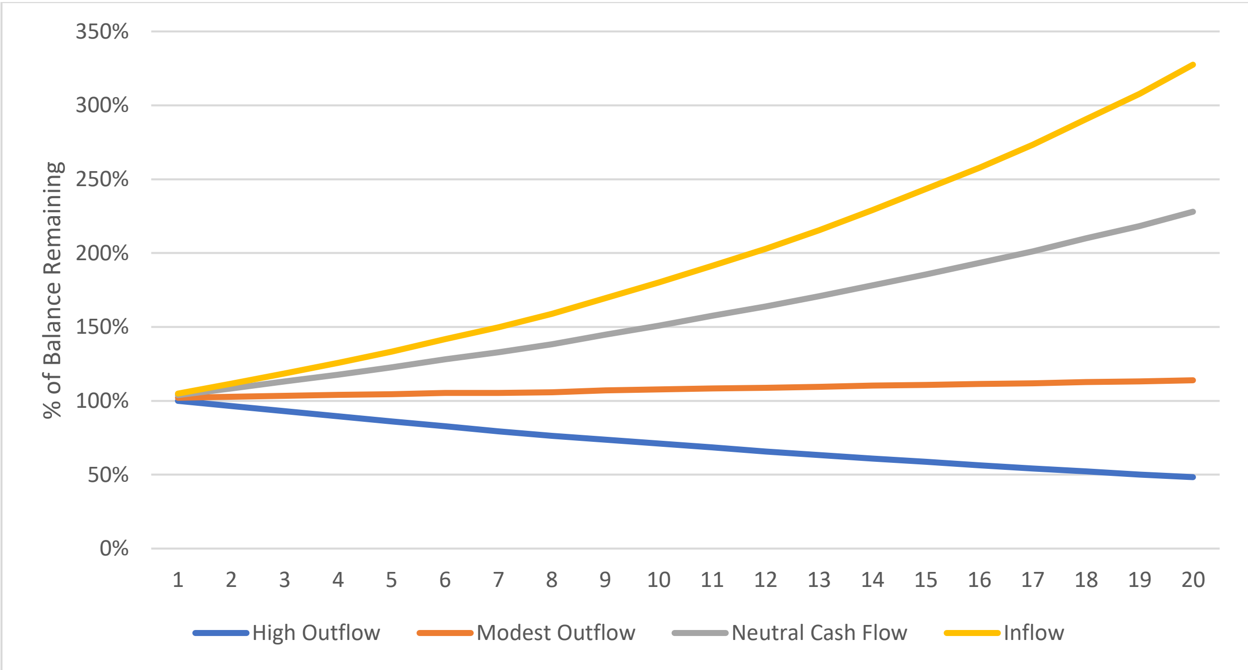
To maintain asset levels, investment returns must equal or exceed outflows. For readers who wish to adjust the capital value to inflation, we suggest reducing the net flow arrived at in Figure 1 by a further 2%. To simplify the analysis that follows, we have bucketed four scenarios that analyze the general impact based on net flows in Figure 2.

Figure 2: Outflow and Inflow Scenarios

-5 to -10	High Outflow
-1 to -5	Modest Outflow
1 to -1	Neutral
>0	Inflow

The long-term impact of different cash flow positions can be seen in Figure 3, where we show the median outcome of the 10,000 simulations. It is revealed that the standard asset mix of 60% equities and 40% bonds would struggle to maintain its account balance in real dollar terms (adjusted for inflation) if pushed towards a high outflow scenario.

Figure 3: Account Balance Over Time Using Traditional Balanced Inflation-Adjusted Portfolio



Almost all endowments and foundations can maintain assets at the lower, current DQ levels, with many able to grow balances over time depending on fundraising ability. One apparent challenge is maintaining real purchasing power where fundraising does not offset outflows, as capital value under the modest outflow bucket does not grow over time.

Beginning in 2023, with the increase to a 5% DQ, the risk is that more programs move into the high outflow scenario, which can drop nominal account balances by half (blue line), using a traditional 60/40 asset mix after just 20 years.

For Scenario B, where we analyzed a 5% DQ, any program where fundraising is less than 2% will fall into the high outflow scenario. On an inflation-adjusted basis, programs that raise less than 4% annually could witness the real value of capital drop by 50% over 20 years.

In scenario C with a 7% DQ, the situation for capital balances becomes more dire for a wider subset of endowments and foundations. Those raising under 4% (in nominal dollars) or less than 6% (inflation-adjusted) in fundraising will see the value of capital drop in half under a base case scenario. Note that the DQ is up for review every five years, as outlined in the 2022 federal budget.

Investment Solutions to Improve Potential Outcomes

To analyze potential investment solutions to meet the needs of a higher DQ, we compared the traditional balanced mix to one that adds private alternative investments - primarily private credit, real estate and infrastructure.

Liquidity is an important consideration for nonprofits, as they seek to fund their mission priorities. Alternative investments such as real estate, private equity and private debt are powerful tools that have the potential to offer attractive returns with low correlation to public markets and to provide diversification, potentially helping increase the efficiency of portfolios. An important consideration when including alternatives in a portfolio is how they affect the liquidity profile, as alternatives can be less liquid than publicly traded securities such as stocks or bonds. However, charitable endowments are typically designed to exist in perpetuity and can therefore withstand a less liquid portfolio in order to benefit from a liquidity premium.

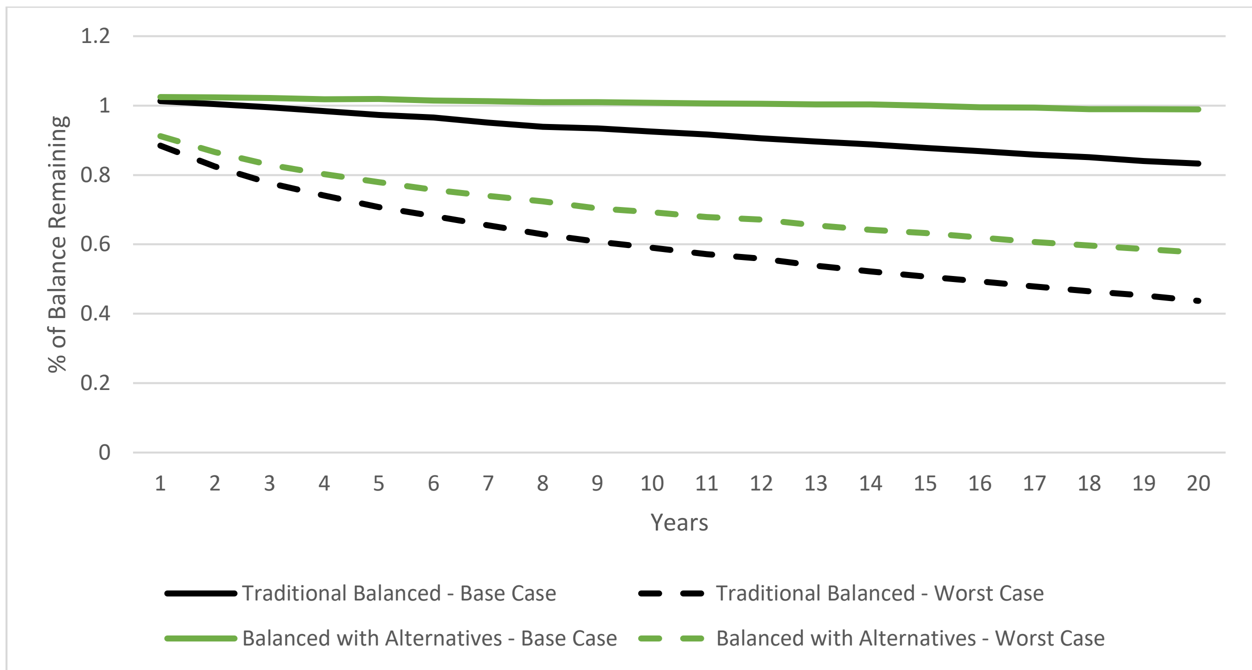
Less liquid assets such as those mentioned above can potentially generate enhanced returns and have risk diversification benefits (e.g., through lower volatility and/or lower correlation to other assets). Therefore, adding less liquid assets might help investors achieve a higher return for the same level of market risk or the same return with lower market risk.

The new proposed mix represents 50% equities, 22% fixed income, 8% private credit, 10% real estate and 10% infrastructure. We focused our analysis on DQs rising to 5%, which will result in most endowments and foundations migrating towards a modest or high outflow scenario.

We analyzed both the median outcome from our simulations (50th percentile) along with worst case scenarios (5th percentile of outcomes) to give a sense of expected returns and possible tail-risk outcomes. We assume here, for simplicity, that 2% inflation and 1% expenses are offset by 3% fundraising, leaving annual net outflows at 5%, the upper bound of a modest outflow scenario.

Results are shown in Figure 4. We can see that under a 5% net outflow scenario, capital value is very difficult to maintain using a traditional balanced fund mix. Integrating alternative investment asset classes could potentially help maintain real capital value over time, without adding undesired risk in worst case scenarios.

Figure 4: Comparing Investment Mixes With 5% Outflow



We believe there are additional steps endowments and foundations can explore within investments to achieve the higher returns required by a 5% DQ, to hedge against inflation risks and to maintain diversification. Solutions beyond a traditional balanced approach include:

- In fixed income: Move away from traditional universe bonds towards private credit and unconstrained approaches that can potentially enhance yield without taking on undue credit risk. Overall fixed income weights will likely need to be decreased due to the low-yield environment and its attendant impact on returns.
- In equities: Introduce a diversified style basket, blending dividend equities for yield, growth equities for return potential, and low volatility equities as a fixed income proxy.
- In alternatives: Explore increasing exposure to real assets, depending on the current asset mix. Look outside of Canada within infrastructure and real estate, where there are greater opportunities for value-add investments.
- Overall portfolio: Harvest premiums available through disciplined asset allocation. Leverage may be required through interest rate overlays or active options strategies.

We believe this DQ increase is an opportunity for organizations in the nonprofit sector to reflect on their investment structure in order to assure stable, reliable and long-term sources of funding. The nonprofit sector, already facing challenges in generating adequate returns in a low-rate environment, now has to adapt its investment strategies to meet a higher mandatory DQ. Given the prospect for lower investment returns in the foreseeable future, particularly from fixed income, and the erosive effects of rising inflation, the new 5% DQ could impact future sustainability for many organizations.

A 5% DQ is manageable, but it will challenge the ability of foundations and endowments to maintain real capital value over time. To provide stability for future generations, policy makers and the sector will need to revisit the way investment portfolios are structured and consider moving away from traditional views on portfolio asset allocation. Understanding and managing risk - for example liquidity

risk in addition to market risk, as well as the correlation between asset classes - could potentially provide more stable returns going forward. Our view is that adding alternative assets to a portfolio of equities and fixed income is likely to be a crucial component of success for endowments and foundations in an environment of low yields and higher disbursement requirements.

Contact us to find out how TDAM can bring new thinking to your most important challenges.

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