

# An Auspicious Time for Private Foundations?

Foundations can make sense for charitable giving—but with the investment environment looking less favorable, success will require strict management.



PRIVATE FOUNDATIONS HAVE BECOME A widely used vehicle for establishing a long-term, if not perpetual, philanthropic legacy for private investors of means. The financial benefits for foundation donors include tax-efficient diversification of low-basis assets, virtually tax-free asset growth,<sup>1</sup> and an immediate tax deduction (applicable to the donor's entire contribution<sup>2</sup> even though the charitable distributions are typically stretched out over a long period of time). Further, foundations give donors the opportunity to set up a philanthropic legacy that can span multiple generations, thereby establishing a family tradition of charitable giving. Between 1982 and 2002 (the latest year for which data are available) these features, coupled with healthy capital-market returns, spurred a seven-fold growth in private-foundation assets, from \$59 billion to \$435 billion.

In recent years, however, the landscape has changed; indeed, some observers are now questioning the attractiveness of foundations. For one thing, expectations for the capital market are far lower than the levels they achieved in the heady 1980s and 1990s. This makes foundations' required minimum annual payout of 5%<sup>3</sup> a tougher hurdle to clear without dipping into principal, and their ability to last for multiple generations more uncertain. Income-tax rates are also down, making foundations' tax benefits worth less.<sup>4</sup> At the same time, an array of other charitable vehicles—donor-advised funds among them<sup>5</sup>—have seen increased interest.

Despite all these developments, while a 5% payout rate may be more challenging now, it's still achievable without decimating a foundation's capital. Nor have foundations lost their place as an important vehicle for long-term philanthropic giving; with carefully crafted asset allocation and clearly stated goals, foundations can remain on a viable path.

## HOW "STINGY" GIFTS BECAME "GENEROUS"

*Display 1* (next page) shows the compound returns from 1980 to 1999 for portfolios ranging from all bonds to all U.S. stocks; the bottom portions of the bars show that to maintain their value after the 4% inflation rate, foundation assets had to return 9% a year. Nine percent is a high hurdle—but not for the 20 years at issue here. Even bonds compounded at 9.5%, so a foundation entirely invested in fixed income would have grown in real value (and hence in charitable giving power)—minimally, to be sure, but *any* real growth after payout is enough to sustain a foundation in perpetuity. With a classic 60/40 stock/bond mix, the additional real return would have been close to 6% per year. It's no wonder that many commentators were suggesting that a 5% distribution was stingy.<sup>6</sup>

As of this writing, with our research suggesting long-term returns in the 8% range for the S&P 500, 5% for intermediate-duration bonds, and around 2.5% for inflation, a donor today with aspirations of creating a perpetual foundation must invest more in stocks than in bonds to clear the 5% bogey.

1 Private foundations are subject to a small annual federal excise tax of 1% to 2% of net investment income.

2 Subject to a cap of 30% of the donor's adjusted gross income

3 A private foundation is required to distribute annually 5% of the net aggregate fair market value of all assets of the foundation as defined in Section 4942 of the Internal Revenue Code of 1986, as amended.

4 We are considering only federal income taxation of individuals and private foundations in this analysis.

5 A donor-advised fund is a charitable plan administered and controlled by a public charity, although donors can recommend how grants are to be spent.

6 See, for example, Perry Mehrling, "Spending Policies for Foundations: The Case for Increased Grants Payout," National Network of Grantmakers, 1999

The situation is all the more challenging for foundations with high annual expenses and a desire to maintain a healthy level of charitable giving.

Display 1

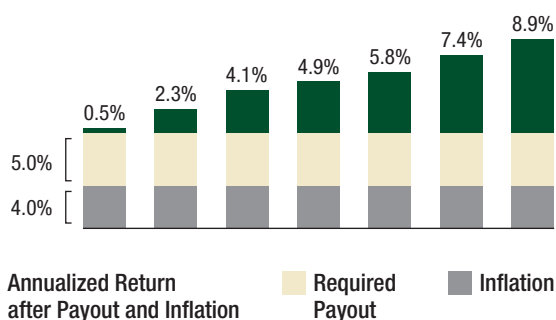
**The long bull market was great for private foundations:  
It was hard *not* to preserve capital value even after payouts**

**Results: 1980–99**

**Asset Allocation**

Stocks	0%	20%	40%	50%	60%	80%	100%
Bonds	100	80	60	50	40	20	0

<b>Annualized Return*</b>	<b>9.5%</b>	<b>11.3%</b>	<b>13.1%</b>	<b>13.9%</b>	<b>14.8%</b>	<b>16.4%</b>	<b>17.9%</b>
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\*Total annualized return calculated using blended index returns for stocks and bonds. Stocks are represented by the S&P 500; bonds by five-year Treasuries. Source: Bureau of Labor Statistics, Compustat, Lehman Brothers, and Bernstein

Success requires looking hard at the range of investment opportunities available to enhance return and reduce risk—perhaps by adding asset classes, diversifying the mix by investment style (including both value- and growth-oriented stocks, for example), or considering alternative investments like hedge funds. This approach has long been prudent investment policy; the current environment makes a full assessment of possibilities even more important.

**ALLOCATION FREQUENTLY SUBOPTIMAL**

Are foundations taking these lessons to heart? Yes and no. As *Display 2* shows, today’s average foundation, with some 60% in equity-oriented investments and 40% in fixed income, has adopted a mix tilted toward long-term appreciation. The allocation seems appropriate, but on closer analysis we found that it could be made more effective.

On the one hand, the allocation is *insufficiently aggressive* (the foundation might benefit from yet more stock), and on the other, it is *too risky* (it depends too much on single-stock positions). This latter point is particularly puzzling, given donors’ ability to use foundations to sell large stock positions and diversify the proceeds tax-efficiently. In addition, the average

Display 2

**Focus on growth potential and diversification**

**Allocation of Average Foundation\***

Asset Class	Weight†	Bernstein Assessment
Domestic Equity	52%	■ Often too much in single stock
Foreign Equity	6	■ Too low: International reduces risk and can add return
Alternative Investments	4	■ May be suitable for certain foundations
Real Estate	4	■ Too low in REITs: good return and diversifier‡
Bonds	24	■ In the appropriate range for many foundations
Cash	11	■ Too high: drag on portfolio growth

**A Commonfund survey found that 27% of private foundations still held concentrated positions in a single stock, averaging 40% of their equity exposure**

\*As of 2004

†Does not equal 100% because of rounding

‡Our analysis assumes that the REITs in a foundation’s allocation are structured to prevent the characterization of income as “unrelated business taxable income” (UBTI), which would be subject to income tax. Consult your legal advisor regarding the nature of any particular REIT and whether it will generate UBTI.

Source: Association of Small Foundations, Commonfund, and Bernstein

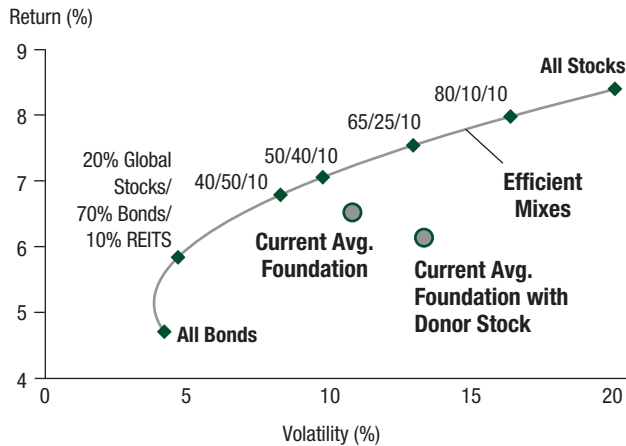
foundation relies too much on cash and on U.S. stock at the expense of foreign markets and real estate.

*Display 3* plots our risk/return forecasts for the average foundation overall, as well as for the average foundation that relies heavily on a single stock, against a range of efficient mixes (the curved line). In most of the efficient mixes we've eliminated cash, increased foreign stocks (both major and emerging markets) to 30% of the equity allocation, and upped real estate from 3½% to 10% of total assets with the use of real-estate investment trusts (REITs).<sup>7</sup> Our research indicates that this optimal construction would improve a foundation's risk/reward profile versus either of the current averages (although the best mix for any given foundation is driven by its unique objectives). Remember, too, that these results assume no benefit from active management—simply market-level returns.

Display 3

### Most foundations can get more return for the risk they're taking

#### Average Foundation Allocations vs. Efficient Portfolio Mixes 20-Year Forecasts (Annualized)\*



\*Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Note on the Wealth Forecasting System, page 24, for further details. The forecasts for the average foundations are based on their allocation as of 2004 (see Display 2). In optimized portfolios, stocks are globally diversified (35% U.S. Value, 35% U.S. Growth, 25% Developed Foreign, 5% Emerging Markets). Bonds are a composite of intermediate-duration taxables with a maturity of seven years. REITs are represented by the NAREIT Index. Volatility is represented by the annualized standard deviation of quarterly returns.  
Source: Bernstein

### A FAVORABLE TRADE-OFF

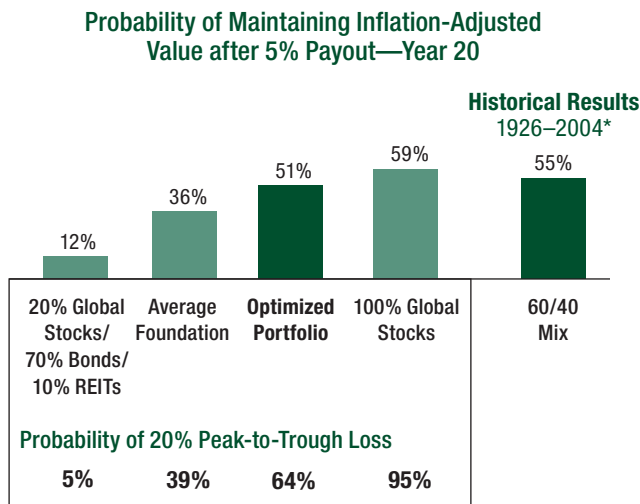
We'd expect the average foundation, with a little more than 60% in risky investments (mostly equities and REITs) to return about 6½% per year (or under 6% if it held a large single-stock position). We believe that by optimizing, it could own the *same* 60% in risky assets but generate close to a 7% compound return. Or it could ratchet down the equity allocation by 10 percentage points, thereby reducing the risk, and still maintain the same annual return potential. However, in today's lower-return environment, many foundations may be best served by recalibrating *both* risk and reward: moving up and to the right on our efficient frontier. An allocation with 65% in stocks, 25% in intermediate-duration taxable bonds, and 10% in REITs, for example, may be a reasonable alternative. It would provide an extra percentage point of compound return over the average foundation without incurring excessive additional risk.

How might this change affect a foundation's ability to meet its long-term objectives? *Display 4* (next page) provides one perspective on the answer. It compares our projected success rates for a foundation hoping to maintain its inflation-adjusted value using several different allocations. To quantify the odds over 20 years, assuming a 5% distribution, we used our proprietary Wealth Forecasting Analysis, which arrays 10,000 possible outcomes based on market history and our research projections. We also assessed expected volatility: the probabilities that the assets would register a 20% decline at any time over the two decades.

With a bond-heavy portfolio, our research suggested fairly minimal odds (not much better than 10%) that a foundation would be able to stay even with inflation. The average foundation's odds were better, but not impressive: approximately a one-in-three chance of pacing inflation. With some additional risk of temporary loss during the 20-year period, the 65%/25%/10% (stocks/bonds/REITs) allocation raised the probability to an estimated one in two. Interestingly, the odds of an all-stock portfolio staying "whole" were only slightly higher—and they came with virtual *certainty* that the assets would suffer a large loss at some point. Only foundations with the greatest appetite for risk are likely to find an all-stock allocation appealing.

7 See third footnote to Display 2.

**Optimized allocations boost return at acceptable risk levels**



Based on Bernstein’s estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Note on the Wealth Forecasting System, page 24, for further details. See Display 2 for allocation of the average foundation. “Optimized Portfolio” allocated 65%/25%/10% to stocks/bonds/ REITs; see footnote to Display 3.

\*Historical results are based on 709 20-year periods, rolling forward monthly, using the S&P 500 and its predecessors, long-term government bonds through 1974, and intermediate-term government bonds thereafter.

Source: Roger G. Ibbotson and Rex A. Sinquefeld, “Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns,” University of Chicago Press *Journal of Business* (January 1976), for historical data through 1974; Lehman Brothers; Standard & Poor’s; and Bernstein

Another conclusion can be drawn from the display: The viability of foundations may be as strong in the future as in the past. Since the mid-1920s—a swath of history encompassing some 700 20-year periods starting on successive months (January ’26 through December ’45, February ’26 through January ’46, etc.)—a foundation with a 60/40 U.S. stock/bond allocation and a 5% annual payout would have had a 55% chance of keeping pace with inflation (the bar on the far right of *Display 4*). That’s remarkably close to our projections for the future for a foundation with an *optimized* portfolio (though not today’s average foundation). We believe matching the historical record is an achievable goal for foundations managed prudently and monitored regularly.

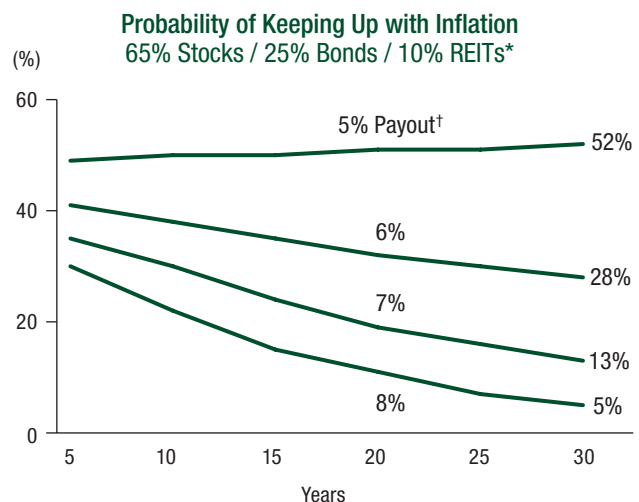
**THE MAKE-OR-BREAK DECISION**

Thus far, we’ve focused on how asset allocations influence a foundation’s sustainability, but the other critical determinant of a foundation’s staying power is its payout rate. It’s a highly sensitive touchstone. As with return, even a single percentage point a year can make a big difference. In *Display 5* we show the probabilities of a stock-heavy but balanced foundation portfolio maintaining its real value at different payout rates. We estimate that raising the annual bogey from 5% to 6% would reduce the odds of pacing inflation over 20 years from 52% to less than 30%. We project that with a payout as high as 8%, the foundation has only a 5% chance of preserving its real value over the two decades.

**GOAL-DIRECTED STRATEGIES**

The poor results for payout rates above 5% illustrate the need for certain foundations to confront difficult long-term decisions. After all, many distribute more than the 5% minimum payout requirement. According to data from The Foundation Center, charitable gifts as a percentage of total foundation assets have averaged above 5% for more than

**Even small payout increases can decimate the chance of matching inflation**



\*A globally diversified balanced portfolio; see footnote to Display 3.

†Payout is calculated as a percentage of annual assets. Based on Bernstein’s estimates of the range of returns for the applicable capital markets over the next 30 years. Data do not represent any past performance and are not a promise of actual future results. See Note on the Wealth Forecasting System, page 24, for further details.

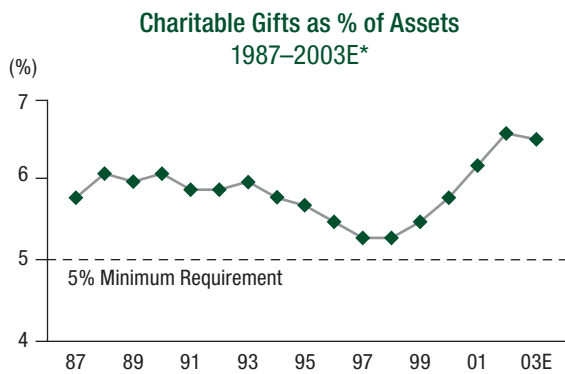
Source: Bernstein

a decade. Indeed, they spiked up even as the 1990s bubble burst and asset levels declined—and remained high in the ensuing bear market (*Display 6, top*).

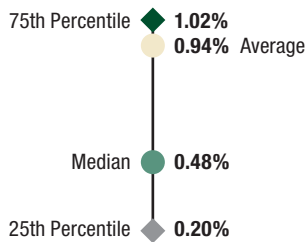
Moreover, these figures do not factor in any annual operating and administrative foundation expenses. Not only do expenses eat further into assets, they're also peculiarly distributed (*Display 6, bottom*). Although half of all foundations are paying only about half a percentage point a year, in some cases expenses have reached a level high enough to pull up the *average* to virtually twice the median; smaller foundations are most at risk here. Since high costs can have a corrosive effect on the remaining value available for charity, those overseeing the foundation's affairs need to be vigilant. Even for donors

Display 6

**Foundations pay out much more than 5%—not even counting expenses!**



**Range of Operating and Administrative Expenses as % of Assets†**



\*Latest year for which data are available. The giving rate is the payout divided by the foundation's average annual assets.

†As of 2004

Source: Association of Small Foundations, The Foundation Center, and Bernstein

intending to give the minimum 5% of assets to charity, total distributions often end up far higher.<sup>8</sup>

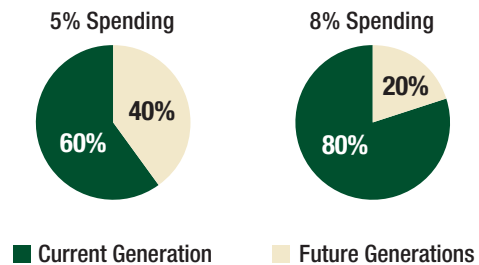
Many donors, however, wish to pay out at rates in excess of 5% because they want to make their gifts as useful as possible as soon as possible. High payout rates combined with high expenses inevitably result in low odds of a foundation's maintaining its real value in perpetuity. But there's nothing magical about "perpetuity." In fact, a recent survey by The Foundation Center found that 69% of foundations articulated an explicit goal to last in perpetuity. The others were either undecided or wanted to spend down their assets over time. So for any foundation intent on maintaining a healthier level of giving, the key is to understand the trade-off: how much importance to give to current charitable goals and how much to place on keeping the foundation going for a long time, or maybe even forever.

One way to illustrate this trade-off is by quantifying the amount that will be paid out by the current generation compared with those to come (*Display 7*). With a 5% spending rate, for example, in the median case we'd expect that 60% of the inflation-adjusted value of the assets would be distributed over the next 30 years; 40% of the foundation's value would remain to benefit future causes. Hike the rate to 8%, and in average markets we project that only 20% of the foundation's value will remain to be gifted down

Display 7

**The higher the payout rate, the more charitable giving decisions will be made by the current generation**

**Percent of Charitable Distributions Made Year 30\***



\*Invested 65% in global stocks, 25% in bonds, and 10% in REITs; see footnote to Display 3. Cumulative distributions and 30-year remainder value are adjusted for inflation, based on Bernstein's estimates.

Source: Bernstein

<sup>8</sup> Foundations that have paid staff tend to have significantly higher expenses than those that do not. Also note that many foundation expenses (though not all) are deductible against the payout rate. Nonetheless, net distributions usually end up considerably higher than 5%.

the road. That would suit some donors just fine. For example, a donor might wish to make most of the charitable decisions himself and leave a much smaller (albeit still meaningful) portion of the foundation assets to be managed by his children or grandchildren—who will presumably learn the virtue of philanthropy in the process. This is one of many areas where finances and estate planning intersect with the emotional aspects of life. After all, foundations are often family affairs—and different donors will want to handle them differently.

### OUR PERSPECTIVE

In our view, private foundations remain important vehicles for intergenerational philanthropic giving. At the same time, with the prospect of lower capital-market returns in the future, foundations are unlikely

to achieve their substantial asset growth of yesteryear. A key to reaching long-term objectives is careful allocation—which in most cases should include a broad use of the available asset classes and a heavy equity tilt. But just as critical, if not more so, is the need for a foundation to define its charitable goals clearly. Working together with a donor or a foundation's full advisory team, we can help determine an allocation and spending rate suited to the foundation's annual philanthropic objectives while preserving its long-term value. ■

*Bernstein does not offer tax or legal advice. There are tax and regulatory issues involved in establishing a foundation, and investors interested in the strategy should consult their tax and legal advisors.*