



**THE GOVERNANCE
& FINANCIAL
MANAGEMENT
OF ENDOWED
CHARITABLE
FOUNDATIONS**

RICHARD JENKINS

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Association of Charitable Foundations
Central House
14 Upper Woburn Place
London
WC1H 0AE
020 7255 4499

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FOREWORD

This is a timely and welcome report: charitable foundations currently face the twin pressures of lower investment returns and higher demands from their beneficiaries as public funding shrinks in the new and harsher economic environment. It is a time when foundations need to ask themselves some central questions about the purpose of their trust, and what it sets out to achieve. This report suggests that those answers may sometimes be surprising.

With the largest 900 endowed charitable foundations having collective assets of over £48bn and an annual spend of £2.3bn, the importance of the foundation sector is clear. Questions of their governance and financial management have been comparatively overlooked, but have a potential impact that goes far beyond foundations themselves. The rewards of even small changes could be considerable.

Endowed charitable foundations are unique amongst trustee-led bodies. The obligations on trustees of private trusts or pension funds will begin and end with money, and how it is spent will be of no concern. A charity, on the other hand, starts (and ends) with its charitable object. How money is used will be trustees' first concern. How money is managed should come second. While advisers are abundant, it is only the trustees who are asked to judge the relative merits of money or mission.

Similarly, law and regulation are more concerned with the protection of assets rather than the promotion of charity.

This report highlights how a charitable purpose should be central in a foundation's self-perception. What these charitable foundations have in common is an ability, as a result of their endowments, to plan, invest and spend for the long-term – an important realisation when so much thinking concentrates on the short-term.

Importantly the report has been written for a lay audience. Many decisions can all too often be regarded as the preserve of specialists but I believe that all trustees should be able to consider the totality of their balance sheet and to connect the purpose of their foundation with its money, particularly when considering investments. Most simply this will be achieved by making more money, retaining less, or using assets more creatively, or any combination of the three. Foundations should be ambitious in what they expect of their assets.

I welcome this report, and hope that endowed charitable foundations will engage with the questions that it asks. I hope that readers will find it both reflective and provocative, and that it will shift the default argument away from the assets and back to the objects. At the very least it should help foundations in making more intentional decisions as they navigate the heavy demands of the next few years.

John Kingston OBE
Chair, The Association of
Charitable Foundations

EXECUTIVE SUMMARY

INTRODUCTION WHAT IS AN ENDOWED CHARITABLE FOUNDATION?

This report considers what is distinctive about endowed charitable foundations, and identifies key issues that might help improve their governance and financial management. It is aimed at the lay reader with no particular expertise in law, finance or investment management.

There are 900 endowed charitable foundations in England and Wales with annual income exceeding £500k, of an estimated UK total of 12,000 grant-making foundations. Although these 900 make up one percent of all registered charities, their combined assets amount to £48.5bn and account for over half the charity sector's total assets. They spend 4.8% of their combined assets each year - £2.3bn.

PART ONE LEGAL FOUNDATIONS

The first part of the report sets out the basic legal duties that empower the trustees of charitable foundations.

There is no legal definition of an endowed charitable foundation. They vary widely in size, internal organisation and field of work. But all consist of a gift of an asset, controlled independently by trustees and used exclusively for certain charitable purposes.

Trustees must act prudently and be loyal above all to their charitable aims. In terms of investment, trustees must decide what is prudent in their own context. The last five decades have seen increased emphasis being placed on making the maximum risk-adjusted return. In practice, foundations may have more freedom to act than they might imagine, for example in committing to longer-term investment strategies that may carry greater risk but bring greater reward.

Endowed charitable foundations exist to provide public benefit rather than serve specific beneficiaries. However, having a tangible sense of who the beneficiaries might be can potentially bring greater clarity to the use of resources.

PART TWO CONNECTING MISSION AND INVESTMENT

Part two considers the ways in which foundations balance risk and return when setting investment and spending strategies.

When making investment decisions and setting targets, foundations take account of various factors including inflationary pressures on beneficiaries; the needs of future and contemporary generations; the demands of cash flow as well as market volatility.

Often the aim of preserving the real value of the capital acts as a sort of proxy for fulfilling a foundation's obligations to future generations. However, the obligation is always to do what is right in terms of fulfilling their charitable aims or 'mission'. In different situations that could mean spending more, cutting back or allowing the value of the endowment to reduce over time if trustees have that freedom. It all depends on what best meets the aims of the charity.

All foundations use their balance sheets to deliver their charitable aims. As well as maximising return and expenditure, some invest in industries that are aligned to their mission, or exclude those which run counter to it. Some use their programme expenditure to generate a financial return and some invest their endowment to make a specific social impact. Often foundations do some of each. Charity Commission guidance¹ is pragmatic and permissive, but where the primary intention is to make a financial return foundations must consider taking advice.

¹ Charities and Investment Matters, A Guide for Trustees, (CC14), Charity Commission, 2011.

PART THREE TAKING ADVICE AND MAKING DECISIONS

Part three considers decision-making. Only trustees are able to make decisions about what is the best way to achieve their charitable purpose. In newer trusts this might be informed by a donor's intentions, but over time and with distance the personal influence of the donor will fade.

The issues trustees face can be complex and often highly technical. Lay trustees, in particular, can feel detached from decisions for which they are responsible. Support for trustees in articulating their views about how they wish to use the endowment to serve the aims of the charity is critical in achieving resilient governance.

Foundations have long time horizons that are seldom aligned with conventional targets and performance measures, and even the internal structure of foundations can work against joined up long-term decision-making. Advice, which comes from multiple sources, often focuses on the asset, whereas trustees will want to think about what is best for their beneficiaries as a whole. Overall trustees will want to spend as much as they can on their charitable purposes. Advice often takes preservation as its starting point.

Foundations can get more out of the advice they receive by clarifying their goals and needs before seeking technical support, and encouraging a range of views and options. Umbrella bodies can help by producing resources tailored to the needs of different types of foundations.

CONCLUSIONS

Fiduciary obligations require trustees to act in the best interests of their charitable aims. Foundations have freedom to take greater risks and work more creatively than they may at first feel. Their greatest danger may be exercising too much caution. The figures suggest that, as a sector, even a small increase in their investment returns and consequent spending could make a significant impact.

Law and regulation on investments has become more permissive and foundations may still be catching up. Taking a more intentional and thoughtful approach to their obligations could enable foundations to make and spend more money as well as use what they have more imaginatively.

Tailored relevant information, better knowledge of international good practice, and strengthened peer networks would support more confident and creative governance and financial management. The main danger for the trustees of endowed charitable foundations is in not thinking through all the options available.

ACKNOWLEDGMENTS

The author wishes to thank all the individuals who contributed to this report by agreeing to be interviewed for their time, patience and openness, and those who provided, recommended and helped him locate documents and sources of data and information.

Thanks are owed to John Kingston and David Emerson from the Association of Charitable Foundations for agreeing to publish the report, for their interest in and support of the project and for their permission to use the data concerning the incidence of the largest endowed charitable foundations, which was analysed by Katherine Duerden.

Appreciation is due to Elaine Graham-Leigh for providing help which contributed in many ways to the general smooth functioning of the project.

Finally, the author is especially indebted, for both guidance and inspiration, to members of the steering group, Claire Brown, Esmée Fairbairn Foundation, Jackie Turpin, Joseph Rowntree Charitable Trust, Lucy Palfreyman, Paul Hamlyn Foundation, Rory Landman, Trinity College, Cambridge, and Carol Harrison, Trust for London. Particular and warm thanks are due to James Brooke Turner, Nuffield Foundation who chaired the steering group, provided ongoing insight, enthusiasm and humour and whose idea it was in the first place.

Any expertise and insight belong to these people. Mistakes or errors are the author's.

ABOUT THE REPORT

This report has been written for those who run endowed charitable foundations, both trustees and staff, and those who advise them or who have an interest in the sector. It is aimed at the 'lay', or non-expert, reader with no professional legal, financial or investment experience who may find themselves involved in governing or managing foundations.

APPROACH

The report does not advocate a particular approach or set of answers to the difficult questions facing those who run foundations. It aims instead to describe some of the range of current practice, while also reflecting on it. It highlights key questions which may help focus the thinking of those who run foundations and draws some conclusions for trustees and staff, advisers, umbrella bodies and regulators.

The report sets out some of the basic legal principles relevant to the situation of endowed charitable foundations and introduces some of the issues which might arise when applying these principles in practice. The report does not present a comprehensive account of the law relating to endowed charitable foundations, and should not be relied on as a substitute for Charity Commission guidance or for taking legal or other professional advice where appropriate.

GEOGRAPHICAL SCOPE

The report addresses the situation of foundations governed by the law of England and Wales and regulated by the Charity Commission. Separate legal and regulatory frameworks exist in Scotland and Northern Ireland. Although this variation exists across the United Kingdom, foundations face similar issues in each jurisdiction and the principles set out in the report and the thrust of the reflections should broadly hold for foundations across the UK.

BACKGROUND

The report grew out of an emerging interest in asset management at foundations led by the Nuffield Foundation and others. The six funders decided to sponsor research into the governance and financial management of endowed charitable foundations.

The proposal was to think about endowments from the perspective of those who run them as opposed to those who regulate or advise them. That meant not thinking of an endowment simply as an investment problem, but seeing it as part of a broader financial or governance canvas. Within this lay complex inter-relationships between spending, investing, accounting and a governance mechanism that supports long-term thinking. The funders of the research felt that these issues presented problems that were peculiar to endowed foundations, as opposed to other classes of investors, but also represented opportunities for charitable investors to make larger returns and provide increased distributions to their beneficiaries.

As the foundation community is numerically small, it was felt that these issues are often overlooked in the regulatory framework. Conversely, because it is a wealthy community it was observed that foundations also benefit from a rich flow of advice from professional firms eager to help them solve their problems as they see them. While advice about legal obligations is vital, only trustees can properly reconcile their conflicting moral obligations to minimise the risk to the endowment while maximising the expenditure from it. In order for the endowed charitable community to get its own thinking in order, the funders wished to reflect together on what matters to it, and unpick and understand each component better. The intention was not to prescribe particular solutions, but to ask questions.

The funders of the report sponsored Richard Jenkins in 2011 to prepare a largely descriptive report based on the following terms of reference:

1. Review the current legal, financial and regulatory environment
2. Spending and investing – the moral obligations of endowments
3. Financial measurement – anticipating and recognising financial success
4. Governance and management – managing technocrats
5. Implications for investment strategies.

METHODOLOGY

A series of in-depth semi-structured interviews carried out from June 2011 to January 2012 formed the core of the research. Twenty-five individuals were interviewed including trustees and executive staff currently engaged in a total of ten foundations of various sizes, but representing experience accumulated in a greater number of foundations. A number of investment advisers and legal experts, governance and investment specialists and individuals with roles in umbrella bodies were also interviewed. Interviewees were invited to participate voluntarily and selected according to depth of experience, and to achieve a spread of different roles and functions. The foundations from which individuals were selected for interview all came from the largest 900 endowed charitable foundations in England and Wales which have been identified from Charity Commission data by the Association of Charitable Foundations (see next section).

Desk research augmented and tested findings from interviews.

Analysis of the qualitative information gained from the interviews was carried out in the first instance by the author, but findings were regularly tested with the steering group which met throughout the period during which the research was carried out.

A final draft of the report was subjected to peer reviewers with extensive knowledge of the governance and regulation of endowed charitable foundations before being approved for publication by the steering group.

DATA

The report makes use of data from published accessible sources which are attributed in the text.

It also presents for the first time data provided to the author by the Association of Charitable Foundations about the largest endowed charitable foundations in England and Wales based on an analysis of information taken from unpublished data extracted from Charity Commission for England and Wales' Register of Charities as at October 2011.

The data set comprises all charities on the register which, in their latest annual return, available at that time, had indicated that they make grants to organisations or individuals, or both. Of those, analysis focused on those charities which had an income over £500,000 during at least one year between 2008 and 2011 and who consequently completed Part B of the annual return which asks for detailed information about income, expenditure and assets. Analysis consisted in identifying those whose total resources expended in annual return form (Part B1.13) was 10% or less of their total assets (Part B3.6 - Total Net Assets/Liabilities).

The number of such charities identified was 896, of which 484 indicate that their only activity is giving grants (either to organisations or individuals). Based on the information available this data set, the total asset value for these 896 organisations is £48.5bn. The Wellcome Trust's total assets (to year end 30/09/2010) are £12.7bn. Total expenditure for all 896 is £2.3bn. Without The Wellcome Trust it is £1.5bn.

MEMBERS OF THE STEERING GROUP

Esmée Fairbairn Foundation, Claire Brown
Joseph Rowntree Charitable Trust, Jackie Turpin

The Nuffield Foundation, James Brooke Turner (Chair of the steering group)

Paul Hamlyn Foundation, Lucy Palfreyman
Trinity College, Cambridge, Rory Landman
Trust for London, Carol Harrison

ABOUT THE AUTHOR

Richard Jenkins is an independent researcher and consultant in the third sector. He has been a trustee of a grant-making endowed charitable foundation, chief executive of an educational charity, and as a civil servant led implementation of key funding elements of the 2002 Treasury Cross Cutting Review into the role of the voluntary and community sector in the delivery of public services. As an associate of Grant Thornton Consultancy he co-authored a report into the social and economic benefits of compact working for the Commission for the Compact. He has a degree (in Scots and English law) from the University of Dundee and has graduate and post-graduate degrees from the Universities of Oxford and Leeds. He holds a Law Society accredited certificate in mediation. In 2008 he set up Sperant Associates to help third sector organisations to improve their strategy and effectiveness.

www.richardjenkinsconsulting.com





1. INTRODUCTION: WHAT IS AN ENDOWED CHARITABLE FOUNDATION?

KEY POINTS

- Endowed charitable foundations have no specific legal definition.
- There are 900 endowed charitable foundations in England and Wales with an annual income exceeding £500k, of an estimated total of 12,000 UK grant-making foundations.
- Although they make up one percent of all registered charities, the combined assets of the 900 amount to £48.5bn and account for over half the charity sector's total assets in England and Wales. They spend 4.8% of their combined assets each year - £2.3bn.
- Trustees have freedom to determine their beneficiaries within the terms set out in their governing document.
- Unless the trust deed explicitly states that the endowment is permanent, trustees can choose to spend the endowment as they wish.

1.1 DEFINITION

There is no specific legal definition of a charitable endowment or foundation.

They do, however, share certain core features: a group of trustees in receipt of a gift of cash or property endowed to fulfil certain charitable objectives.²

The law does not distinguish charitable foundations from operational charities in terms of charity law, although some accounting requirements are unique to grant-makers. Charitable endowments, because their activity is dependent on the return from investments, also share some characteristics with pension funds and private trusts. Their trustees share similar duties known as 'fiduciary obligations'.

Foundations usually focus their charitable activity on supporting organisations through a cash stream which is substantially or wholly derived from their endowment.

Many charitable grant-making bodies support their work through donations and fundraising or income derived from a corporation, while a number of operational charities derive a proportion of their income from investments. This report focuses on foundations whose funding comes almost exclusively from their endowment.

1.2 NUMBER AND RANGE OF ACTIVITY

Recent analysis of Charity Commission data by the Association of Charitable Foundations³ has revealed that there are 63,000 charities in England and Wales which

² For a structural/operational definition in an international context see Creative Philanthropy, Anheier, Helmut K. and Leat, D., Routledge, London, 2006, p.9.

³ Charity Commission, 2011: Unpublished data extracted from Charity Commission's Register of Charities at 1 October 2011. The data set comprises all registered charities which had indicated a grant-making function and whose annual expenditure was 10% or less of the net asset value of the organisation.

1. INTRODUCTION: WHAT IS AN ENDOWED CHARITABLE FOUNDATION? CONTINUED

make grants to organisations or individuals as part of their activity. There are about 12,000 grant-making foundations in the UK.⁴ Analysis of the largest of those, based on Charity Commission data, shows that in England and Wales alone there are around 900 grant-making organisations⁵ with annual income greater than £500k and which are at least 90% dependent on investments to fund their activities. They represent, by number, less than one percent of registered charities in England and Wales.

The total value of the assets of those 900, as disclosed in their annual return, is just over £48.5bn. To give a sense of scale, this is more than half of total voluntary sector assets in the UK.⁶ The Wellcome Trust has the largest asset of £12.7bn. As institutional investors, charitable foundations are dwarfed in size by private pension funds.

The annual expenditure of these foundations amounts to 4.8% of their aggregate assets, or £2.3bn.⁷

Foundations' areas of activity cover the entire spectrum of charitable activity.

Like the rest of the charitable sector, the range of foundations appears to be pyramidal,⁸ with 58 foundations in possession of endowments exceeding £100m, and a wider range of smaller, local, foundations. Larger and medium-sized foundations are likely to have staff, with some of the largest employing their own investment experts. Smaller foundations may have executive and administrative staff to support the trustee body and deliver grant-making and other functions. The smallest foundations may be run



entirely by trustees without any paid staff.

Foundations' charitable missions can range from local projects, for example to support residents of a particular area, to national or international concerns. Foundations do not have to fund voluntary organisations: for example, foundations exist to support the work of local authorities, schools and universities or to fund scientific research. Some foundations assist individuals in need.

There are a variety of terms used in describing foundations, including trust, or endowment or even benevolent funds. It is possible to speak of the asset, the investment(s) or the gift as well as the endowment, while organisations themselves may speak of their trustees, board, or the governors. Oxford and Cambridge colleges may have endowments administered by fellows or members of

an elected council. Endowments overseas can operate differently, often as a result of different tax frameworks.

1.3 FOUR DIFFERENT TYPES OF ENDOWMENT

Within this varied landscape, it is possible to identify four kinds of foundations:

Permanent endowments, which are required by law to operate in perpetuity.

Expendable endowments, which are not technically obliged to exist in perpetuity but which may aim to preserve the value of the endowment for future generations.

Endowments that are spending out within a specific time frame.

Foundations that are building up an initial endowment to a specific target before beginning to start funding, although by law this period cannot last for more than 21 years.⁹ These can be either expendable or permanent.

Unless the trust deed states that the endowment must be preserved in perpetuity, there is no obligation for a foundation to operate in one way or another, although some expendable endowments may have a portion of their assets which are to be held in perpetuity. There is anecdotal evidence that some foundations do not know whether they are permanent or not and, even where the trustees accept that the endowment is expendable, if their powers allow them to pursue a 'spend out' strategy.

⁴ The UK Civil Society Almanac – 11th edition, NCVO, London, 2012, p.28 [Citing NCVO/TSRC, Charity Commission as the source].

⁵ Only charities with income in excess of £500k are required to disclose asset values.

⁶ Total assets of UK voluntary sector £90bn. The UK Civil Society Almanac – 11th edition, NCVO, London, 2012, p.57.

⁷ Distribution rate is calculated as total expenditure/total asset value.

⁸ Based on the distribution of third sector organisations in general. Source: The UK Civil Society Almanac – 11th edition, NCVO, London.

⁹ The Perpetuities and Accumulations Act 2009, (s)14.

1.4 CHARITABLE FOUNDATIONS COMPARED WITH OTHER KINDS OF ORGANISATION

Endowed charitable foundations share features with other kinds of institutions.

Charities. To be registered as a charity, a foundation's objectives and activities must provide a public benefit. Like all charities, foundations are governed by a board of trustees who are responsible for deciding the strategy and policy of the organisation. No rules specify the amount of operating reserves charities must keep, but if they are permanent, foundations are required to preserve their endowment in perpetuity. Charities are required to make their annual trustees' report and accounts publicly available and to file them with the Charity Commission.

Pension funds. Endowments are similar to pension funds in that they consist of cash funds held on trust and invested to provide a return for beneficiaries. Trustees of endowed foundations and pension funds are subject to similar fiduciary obligations. Charitable foundations, however, are regulated by the Charity Commission and pension funds by the Pensions Regulator. Pension funds have defined identifiable beneficiaries, unlike foundations whose beneficiaries are implied by their charitable objects. Pension funds have quantifiable future liabilities in respect of their beneficiaries, while foundations have freedom to shrink or expand their expenditure within their area of benefit.

Registered companies. Like many operational charities, endowed foundations are often registered as companies. Medium and larger-sized foundations will often have executive staff to help develop as well as implement policy and strategy. However, unlike registered companies, where the board is made up of executive and non-executive directors, in the charity world trustees are usually 'non-executive'. In some rare cases trustees may also be staff members. Foundations may be registered as not-for-profit companies limited by guarantee.

Private philanthropy. Finally, foundation giving should also be distinguished from private philanthropy which, even if derived from investment income, does not become 'foundation' giving until it is formally endowed via a trust deed and registered as a charity. Indeed there may be some advantages in not setting up a foundation, at least in terms of remaining free from regulation and its governance and reporting requirements.

1.5 INDEPENDENCE AND ACCOUNTABILITY

Foundations enjoy a considerable degree of independence in terms of their cash flow, their activities and in their regulatory environment.

Endowed charitable foundations, benefitting as they do from their investments, are independent of the state and the public sector for their funding. Unless they wish to, they don't have to raise public donations. In making the gift,

WHAT MIGHT CONSTITUTE FAILURE FOR AN ENDOWED CHARITABLE FOUNDATION?

the donor no longer controls the money, but in law cedes decision-making to the trustee body, even if she or he is a trustee.

The regulatory framework for charitable investors, overseen by the Charity Commission, is less intensive than that of the Pensions Regulator. Only the Charity Commission or Attorney General can bring an action against trustees of endowed charitable foundations for breach of their fiduciary obligations.

1.6 REFLECTIONS

Charitable foundations make a distinctive and significant contribution to civil society. They are not overwhelmingly responsible for funding civil society organisations, but because of their independence and longevity they have the potential to make a bigger impact than might otherwise be the case. They have freedom to support – or stop supporting – causes and organisations which other funders might ignore or which may find it difficult to raise public support. Foundations can stay with things for the long run. They can vary the amount of money they give and tailor their giving

1. INTRODUCTION: WHAT IS AN ENDOWED CHARITABLE FOUNDATION? CONTINUED

to make the biggest impact – supporting specific projects, covering the running costs of organisations over a long-term period, or injecting capital to promote growth or attract other funders.

Their liberty to act comes with a high degree of freedom from direct accountability. Although their fiduciary obligations mean that trustees have a duty to do the best they can when investing to pursue their charitable goals, if things don't turn out so well foundations have the option of reducing their expenditure or spending a greater proportion of their endowment to meet their objectives. Without shareholders, the choice is entirely the trustees'.

The light-touch regulatory environment, and the small number of foundations compared to the total number of registered charities, also means that foundations can operate in a fairly isolated way. They lack a formal legal definition and, while the wide range of Charity Commission guidance applies to foundations as well as to all other charities, there is no existing bespoke guidance on their governance or management. The lack of identifiable beneficiaries, such as might exist for private trusts for example, mean that the chances of individuals outside the organisation bringing to light possible cases of breach of trust could be remote.

Despite the data quoted, it is not possible to estimate the social or economic impact of the sector with any degree of certainty or to state the number the individuals involved in running foundations as trustees or members of staff.

These questions are not merely of academic interest. As public sector funding of charitable activity decreases and possible reliance on independent charitable foundations therefore increases, the answers form vital pieces of intelligence for fundraisers and policymakers alike.

In this context, how are foundations to understand their activity? How do the overlapping legal frameworks of fiduciary obligations and charity law apply to them? How do foundations in practice relate their investment activity to their charitable mission? And how do they take informed decisions to make the best contribution they can? The following parts of the report deal with these issues. However, reflection on the degree of independence and freedom from accountability highlighted in this introductory chapter raises the question 'what might constitute failure for an endowed charitable foundation?' We will return to that question in the conclusion.





PART ONE: LEGAL FOUNDATIONS

PART ONE KEY QUESTIONS

- How confident is your understanding of the legal framework in which charitable foundations function, especially the twin duties of prudence and loyalty?
- How does your governing document restrict your use of the asset, if at all?
- Do you have a clear sense of who your beneficiaries are? What difference does it make to your sense of what the endowment can achieve, and how quickly?

‘IT’S EASY FOR TRUSTEES TO BECOME CONFUSED ABOUT THE THRUST OF THEIR OBLIGATIONS.’

**JONATHAN
BURCHFIELD,
TRUSTEE AND
CHARITY LAWYER**

2. PRUDENT AND LOYAL

KEY POINTS

- Trustees' duties are undergirded by the concept of 'fiduciary obligation' which means acting prudently and solely in the interests of the charitable objectives.
- The notion of prudence has developed over time.
- Contemporary understanding emphasises the need to make the best investment return on assets while allowing for risk, but the Charity Commission now permits trustees to take social impact into account as well.
- Trustees must consider taking advice when making investment decisions.

At their core, endowed charitable foundations consist of the gift of an asset, entrusted to a group of trustees, to be used for charitable purposes.

This chapter sets out some of the basic legal principles accompanying that gift and introduces some of the issues which might arise when applying these principles in practice. The chapters that follow look at those issues in greater depth and provide some answers and reflections.

The legal and regulatory environment in which endowed charitable foundations exist derives from different legal sources and continues to evolve. It includes statute law relating to charities (especially The Charities Act 2011) and trusts, (especially The Trustee Act 2000). It also comprises case law - including that relating to the duties of trustees as investors. This case law has often developed as the courts have responded to actions involving private trusts or pension funds. It's important to bear this fact in mind when considering the situation of charity trustees who share similar duties but, as we'll see, have distinctive organisational aims. The Charity Commission regulates charities and issues guidance which interprets the law.

What follows is not a comprehensive account of the law relating to

endowed charitable foundations, and should not be relied on as a substitute for Charity Commission guidance or for taking legal advice where appropriate. It is, however, an attempt to map out some of the key features of the legal landscape for endowed charitable foundations.

2.1 FIDUCIARY OBLIGATIONS: BEING PRUDENT AND LOYAL

Underlying the obligations on the trustees of charitable endowments is the notion of **fiduciary** obligation (from Latin *fiducarius*, meaning "(holding) in trust").

In a fiduciary relationship, one person, in a position of vulnerability, places confidence, good faith, reliance and trust in another whose aid, advice or protection is sought in some matter. For example, in private trusts the fiduciary relationship arises between the trustees and the beneficiaries. It is a higher standard than the common law duty of care.¹⁰

Fiduciaries must manage affairs with **prudence**, knowing that the beneficiaries rely on them, and must be loyal to the interests of the beneficiaries, which means putting them above their own interests. This duty of **loyalty** is the reason why conflicts of interest must be avoided and/or declared by trustees, and why trustees are prevented from making any private gain. Situations in which fiduciary obligations arise include pension funds, family and private trusts as well as charitable foundations.

¹⁰ Bristol & West Building Society v Mothew – [1998] Ch 1 at 18 Lord Millet said: A fiduciary duty is the highest standard of care at either equity or law. A fiduciary is expected to be extremely loyal to the person to whom he owes the duty ('the principal'): he must not put his personal interests before the duty, and must not profit from his position as a fiduciary, unless the principal consents.

In the case of a charitable trust, trustees are obliged to ensure that the organisation delivers the public benefit set out in the trust deed, rather than managing affairs on behalf of specific beneficiaries. The relationship between the public benefit and beneficiaries is explored in the following chapter.

2.2 DUTIES OF CHARITY TRUSTEES

Charity Commission guidance states that trustees' obligations are to comply with any relevant legislation and to fulfil certain duties. For trustees of charities, the duty of prudence means that they must:¹¹

- Ensure that the charity is and will remain solvent;
- Use charitable funds and assets wisely, and only to further the purposes and interests of the charity;
- Avoid undertaking activities that might place the charity's property, funds, assets or reputation at undue risk;
- Take special care when investing the funds of the charity, or borrowing funds for the charity to use.

In addition, trustees have a common law duty of care which means that they must:

- Exercise reasonable care and skill as trustees, using personal knowledge and experience to ensure that the charity is well-run and efficient;

- Consider getting external advice on all matters where there may be a material risk to the charity, or where the trustees may be in breach of their duties.

Accounting regulations require organisations to report on their achievement of public benefit in their annual report, and larger charities – which will include many foundations – must report in detail on how their achievements deliver public benefit and must have their accounts audited.¹²

2.3 ACTING PRUDENTLY

As we've seen, trustees of all charities must exercise prudence in relation to the way they invest any funds the charity holds. To understand what this means in practice, it's worth looking more closely at how the concept has evolved and to see, as a recent report into fiduciary obligations concludes, how 'maximising return has ... taken the place of minimising risk as the presumed primary objective of the fiduciary investor.'¹³

In relation to a trustee's investment role, the classic statement, from the late nineteenth century in *Re: Whitely* is '... to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.'¹⁴

In earlier times, the emphasis in the duty of prudence was therefore on caution and the protection of the assets. In the case just quoted, that meant trustees had to 'avoid all investments of that class which are attended with hazard.' This meant that

trustees were unable to invest in equities, unless specifically authorised to do so by the trust deed.

Things changed. In order to keep up with developing investment practice, the Trustee Investments Act 1961 removed some of these restrictions and more strongly emphasised the importance of achieving return by placing a duty on trustees to have regard to the need to diversify.¹⁵

The Trustee Act 2000 updated the law still further to take account of modern portfolio management. It empowered trustees to make any kind of investment that they could make if they were absolutely entitled to the assets of the trust.¹⁶ It therefore removed the restrictions on various types of investments, allowing trustees to take greater risks in pursuit of potentially greater return. The Act also placed a duty on trustees to review their investments from time to time and vary them if appropriate to ensure that they are suitable for the needs of the trust.

The way in which prudence has been interpreted in the context of fiduciary obligations has therefore altered in emphasis: from stressing protection to encompassing balancing risk and return. It is now grounded in an understanding that being prudent entails obtaining the best possible return judged in relation to the risks.¹⁷ This has commonly come to be expressed as 'the maximum return possible judged in relation to the risks'.

It's important to know then that over time 'acting prudently' hasn't been a fixed

¹¹The Essential Trustee, An Introduction, Charity Commission, 2007, p.4.

¹² An audit is required when a charity's gross income in the year or the aggregate value of its assets exceeds certain levels. For more information see Charity Commission.

¹³ Protecting Our Interests – Rediscovering Fiduciary Obligation, Fair Pensions, Berry C., London, 2011.

¹⁴ *Re Whitely* [1886] Ch D 347, quoted Legal Underpinning, Charities and investment matters, (CCI4), Charity Commission Guidance, Investment Guidance Consultation, October 2011, p.8.

¹⁵ Trustee Investments Act 1961, Section 6 (1) (a).

¹⁶ Trustee Act 2000, Section 3.

¹⁷ *Cowan v Scargill* [1984] 2 All ER, 750 at page 760 [1985] Ch 270 quoted in Protecting Our Interests – Rediscovering Fiduciary Obligation, Fair Pensions, p.19.

2. PRUDENT AND LOYAL CONTINUED

concept. It needs to be applied in specific concrete circumstances by people who are thoughtful and aiming to do their best. This suggests that the prudent thing to do then will change from context to context.

For example, Professor Onora O'Neill, former chair of, among others, The Nuffield Foundation, says: 'Doing the best in terms of investment may not be the same as doing the best for your current beneficiaries, because it is prudent to think ahead for future beneficiaries.'

This equally means that interpreting the 'prudent' thing to do when making investments as simply making the maximum risk-adjusted return almost certainly will not cover all the range of factors foundation trustees need to take into account when considering how best to manage their investments so as to serve future and current beneficiaries. Chapter three considers the range of factors trustees frequently attempt to balance when trying to act prudently. Chapter four considers, among other things, how 2011 Charity Commission guidance gives greater scope particularly to charitable investors who may wish to express their values through their investment strategy.

2.4 PERMANENT AND NON PERMANENT ENDOWMENTS

As we noted in the previous chapter, some endowments have been created permanently and trustees have a duty to preserve the capital asset in perpetuity.

IN PRACTICE FOUNDATIONS MAY NOT TAKE FULL ADVANTAGE OF THEIR FREEDOM TO ACT.

Unless the trust deed allows otherwise, the default legal position for trustees of permanent endowments is that they must keep the capital fund invested and spend only the income earned from that investment on the charity's aims.

This restriction can be removed by an order of the Charity Commission enabling trustees to apply a 'total return approach', which allows trustees to spend any part of the return, not just income or dividend but also capital growth. This opens up wider opportunities in terms of investment objectives, enabling foundations to invest in types of assets that may yield low or zero income in order to achieve better overall returns or to improve diversification. But taking a total return approach brings complexity too, as trustees will have to decide what approach they will take to preserve the value of the asset in the long-term and balance the needs of future beneficiaries with those of the current generation.¹⁸

Foundations that are not permanent are not obliged to preserve the value of the endowment. If the trustees consider that the objects are best served by spending the money on the current generation, they

won't need to take the needs of future beneficiaries into account. Trustees are still under fiduciary obligations to manage the asset prudently and in the interests of the charity's objects, but that will entail taking a different approach to investment and financial management than that taken by permanent endowments.

2.5 DUTY TO OBTAIN AND CONSIDER ADVICE

When investing, all trustees are under a duty to obtain and consider advice from someone experienced in investment matters both before making investment decisions and when reviewing them, unless they reasonably conclude that in all the circumstances it is unnecessary or inappropriate to do so – for example, if they have sufficient expertise within the charity.¹⁹

Most commonly the investment decisions taken by trustees relate to asset allocation (the mix of investments that compose their portfolio) or which fund managers to choose. To help them make these key decisions foundations usually seek advice from investment advisers.

Advice may be given by a trustee who has sufficient experience, but they will have the same liability as any other adviser who causes the charity to make a loss as a result of poor or negligent advice, and trustees need to consider and use the advice from fellow trustees objectively and in the best interests of the charity's objects.²⁰

¹⁸ Endowed charities: A total return approach to investment. Charity Commission.

¹⁹ Trustee Act 2000 section 5.

²⁰ Charities and Investment Matters: A guide for trustees, Charity Commission, 2011, p.20.

More generally, as we have seen, trustees have a common law duty of care to ensure the good management of the charity. As part of this they will consider seeking external advice on all matters where there may be a material risk to the charity, or where the trustees may be in breach of their duties.

Foundation trustees, then, are under a duty to obtain and consider advice in relation to investment decisions, but not in relation to achieving their charitable objects. Nonetheless, trustees of foundations to a greater or lesser extent rely on a range of expert advisers. But given that charitable foundations have different objectives from, say, pension funds, which are the main customers for investment advice, do they always get the most from the advice they seek? Chapter six explores the role of advisers in the governance and management of endowed charitable foundations.

2.6 WHO CAN SUE TRUSTEES?

Like many organisations, foundations could be liable to legal action under contract law or employment law in relation to staff, as well as in relation to health and safety regulations and other statutory frameworks.

But in relation to their duties specifically as trustees, only the Attorney General or the Charity Commission may take action against board members for breach of trust. This would be a civil action where, for example, a trustee who gained unjustifiably

from their position would have to repay to the charity any private profit they made. While the Charity Commission would typically initiate an investigation on receipt of relevant information, formal legal actions are rare.

When it comes to making investments, the latest Charity Commission guidance states that 'if an investment falls in value or becomes irrecoverable then there will be a financial loss. However, provided that the trustees have taken and recorded their decisions properly, then they are likely to be able to address questions or challenges about their actions.'²¹ So, if trustees are able to demonstrate that they have taken into consideration all that it was prudent to do so, they are unlikely to face any action.

2.7 REFLECTIONS

The law places duties on trustees which they must interpret and apply in their own situation and context. How they do this in practice will vary. As noted in the introduction, trustees of foundations have fairly wide discretion to act as they think best.

In practice, however, foundations may not take full advantage of their freedom to act.

For example, although not all foundations are permanently established in law many, if not most, endowed charitable foundations consider their future as perpetual. This may be the best way to serve the charitable objects, but if permanence is assumed as the default, trustees could act less imaginatively than they might otherwise

do. Moreover, placing greater emphasis on preserving the asset than on making as much as possible to spend favours security over return when it comes to investing.

Similarly, when it comes to 'prudence', there is the danger that if trustees take it to mean only maximising risk-adjusted return, this could restrict their creativity. We consider in part two how foundations connect their investment activity with their duty to deliver their charitable objectives. It could also inhibit trustees from looking beyond their expenditure to their entire balance sheet – investment, reputation and assets – when considering their mission. Doing so could provide trustees with a wider range of tools to achieve their charitable objectives.

Part three focuses on the expertise and other factors which bear on foundations' decision-making around these issues.

Being prudent doesn't tell trustees what they must do, only how they must go about it.

²¹ Ibid. p.5.

3. PUBLIC BENEFIT AND BENEFICIARIES

KEY POINTS

- As charities, endowed foundations differ from other fiduciary investors because they exist to deliver a public benefit.
- Foundations, unlike pension funds, are not legally obliged to frame their investment objectives to meet the liabilities of known beneficiaries.
- It can make more sense in terms of achieving a charitable mission to 'spend out' than commit the foundation to a permanent future.
- Having a tangible sense of who their beneficiaries might be can enhance and focus a foundation's thinking about investment and spending.

As we saw in the previous chapter, trustees of endowed charitable foundations are subject to fiduciary obligations which similarly undergird the management of private trusts and pension funds. These are the duties to be prudent when managing the asset, and in so doing to be loyal only to the interests of the beneficiaries.

Charities, however, don't exist for the sole benefit of a limited number of private individuals. In the terms of the Charity Act 2011, they must fulfill their charitable purposes in such a way as to provide public benefit.²²

How does this important feature of charitable foundations distinguish them from other fiduciary investors?

3.1 IN WHOSE INTERESTS?

To qualify as a charity, an organisation must demonstrate that all its purposes serve the public benefit. The law defines the specific charitable purposes which may benefit the public,²³ but each charity will have a governing document which will contain a more specific set of objectives that describe or limit the particular aims of that organisation. At times these may be drawn quite widely.

When it comes to managing endowments, charitable foundations must ensure that everything they do serves the aims of the charity.

Charity Commission literature expresses this obligation in slightly different ways,

including 'acting in the charity's best interests, 'to further the charity's aims', 'in furtherance of the charity's aims', 'to deliver the strategic objects of the charity', 'to contribute to the charity's strategic aims' and 'in the best interests of the charity'.²⁴

Does it matter? Jonathan Burchfield, a specialist in charity law points out

It's easy for trustees to become confused about the thrust of their obligations. Quite often the duties are summed up as 'acting in the best interests of the charity.' But that's not right, and thinking about it that way can easily cause trustees to start thinking about supporting the immediate scene of desks, chairs and structures. It should be expressed as 'acting in the best interests of the objects of the charity'.

3.2 CHARITABLE FOUNDATIONS HAVE WIDE DISCRETION

Charities generally, because they exist to achieve certain social goals rather than serve a particular constituency, often have quite wide discretion to define their activity. In many cases they adopt an intermediating mission or values statement to provide clearer, more specific aims.

Foundations may adopt a mission or values statements, say, to define grant-making objectives. Nonetheless the existence of such statements, where the trustees have agreed them, doesn't detract from the independence endowed foundations frequently have in relation to their activity.

²² Charities Act 2011, s 2(1)(b).

²³ Ibid. s 3(1).

²⁴ See for example, Charities and Investment Matters, A guide for trustees, Charity Commission (CC14), 2011, pp.3, 8, 24, 36, 37, 38 and other places in the same publication.

An important aspect of that freedom is the scope it gives foundations to widen or shrink their beneficiaries according to circumstances. This can have a significant impact on the way foundations invest and spend.

For example, the Baring Foundation saw the money it had available to spend reduce substantially after the collapse of Barings Brothers Bank in 1995. After the bank failed the foundation lost the income it received from share dividends which disappeared with the bank. In that year, that income would have made up 87% of the £15m they expected to spend. After the collapse, the foundation continued with a £30m endowment received from an earlier merger in 1988 with the Manor House Trust, which remains the foundation's sole source of income, producing a return of around £2m each year. To adapt to the new circumstances the foundation carried out a full review and redefined its grant-making so that it focused on a more limited set of objectives.

As the finance director of another foundation put it, 'if we face a loss in spending power we have the option of removing a line of expenditure altogether if we have to, which in practice might mean losing a grant programme.'

On the other hand, Simon Hallett of Cambridge Associates says, 'We actually find that foundations are very reluctant to cut spending year on year. There is a sort of ratchet: in good years it increases; in bad years it's held flat, but that can be a very bad trade off in terms of preserving the value of the endowment. If you really don't want to cut, be very, very cautious when deciding spending.'

HAVING A TANGIBLE SENSE OF WHO THEIR BENEFICIARIES MIGHT BE CAN ENHANCE A FOUNDATION'S THINKING ABOUT INVESTMENT AND SPENDING.

3.3 FOUNDATIONS AND PENSION FUNDS HAVE DIFFERENT RELATIONSHIPS WITH BENEFICIARIES

If a pension fund had faced a similar fall in the return on its investments, as in the case of the Baring Foundation, beneficiaries would have to have been equally protected. Moreover, since the Maxwell affair, where the Mirror Group pension fund was raided to fund other parts of owner Robert Maxwell's business, pension funds are obliged to make regular forecasts to demonstrate that their assets will continually cover their liabilities to the death of the last fund member. The investment policies of pension funds are therefore geared towards beneficiaries in a very specific way, and are highly sensitive to solvency.

Because foundations have a different relationship with their beneficiaries, they aren't obliged to operate in the same way. So, unlike pension funds, foundations which are not permanent don't have to balance the

interests of future beneficiaries with today's generation, unless they have chosen to do so. And even where they are permanent, their financial objectives are generally not based on the needs of a determinate class of beneficiaries. There are exceptions in a minority of cases such as college endowments which are used to support students, but even then, that is a matter of choice.

Generally, therefore, foundations have great flexibility over the scope of their activity. In terms of investment it means that they are able - at least potentially - to tolerate the greater volatility associated with more risky but higher returning investments. Over the longer term, this means they have the potential to make and spend more money. This is important to bear in mind when thinking about investment strategy.

3.4 BENEFICIARIES

Nonetheless, charitable foundations do talk about their beneficiaries in concrete terms in relation to the organisations or individuals whom they fund.

Some foundations see their role as primarily that of being supportive of funded organisations' missions, within certain parameters.

An example of this is the Tudor Trust. Reflecting the Trust's general charitable objects, the trustees don't claim to have a mission of their own. Instead they are open to applications from a range of social concerns, focusing their funding mostly on smaller organisations or causes which would find it difficult to access funds from other sources.

3. PUBLIC BENEFIT AND BENEFICIARIES CONTINUED

'It means that we receive a very high number of applications for funding, with a success rate of about one in ten', says Christopher Graves, the Director of the Trust. 'But we feel that when we do fund an organisation we form a partnership which focuses on putting together a package of support which meets the needs of the beneficiaries rather than pushing an agenda of our own.'

Some foundations fund other organisations in order to deliver the foundation's mission.

3.5 CLARITY AND EFFICIENCY, SPENDING OUT AND STAYING AROUND

The experience of the Tubney Charitable Trust demonstrates how important it is to focus on the charitable objects. The decision to spend out was based on a conviction of the founders, but also made sense to the trustees in terms of achieving impact. Continuing to support the running costs of the charity didn't seem justified compared with the urgency of the charitable objects. Equally, some foundations which have the ability to spend out, decide to remain in operation making grants because the social issues they exist to address require a longer time scale. The Joseph Rowntree Charitable Trust is one example where trustees specifically set aside time every ten years to balance these judgements.

3.6 REFLECTIONS

As the last example shows, and in common with all charities, endowed charitable foundations can work much more

CASE STUDY: THE TUBNEY CHARITABLE TRUST

Miles and Briony Blackwell established The Tubney Charitable Trust with an explicit wish to spend out, and with general charitable objectives. The Blackwells died just four years after establishing the Trust, leaving the trustees to decide how to implement the founders' wishes.

The key factor that drove policy was the founders' stipulation to spend out. The Blackwells believed that it was difficult to justify spending money on running a foundation while there was great charitable need.

Initially established as a generalist trust with few specific guidelines, the trustees noticed quickly that they were turning down a high percentage of their applications. The foundation trustees were aware of how much work was going into each proposal, and how the inefficiency of their system was wasting applicants' often scarce resources.

As a consequence, an important early phase of the organisation's existence was the task of defining its charitable aims more closely. A strategic review led the trustees to concentrate on areas they knew were important to the founders: the conservation of the natural environment of the UK and the improvement of the welfare of farmed animals. Trustees enthusiastically embraced the strategic focus, believing that they were able to do more good by concentrating their resources, within a fixed time frame and a very specific area of interest. Their general view was that 'acting in the best interests of one's charitable objectives may lead to trustees deciding that those interests require that a charity should be wound up.'

Shaping Tubney's programme objectives provided a clear sense of the impact in terms of knowing who their beneficiaries were likely to be and helped sharpen the whole operation. Nonetheless, in the words of Sarah Ridley, the Executive Director, 'We understood our purpose as not being to support charities, but to achieve our own charitable objectives. Funding other organisations is the mechanism by which we did that.'

Sarah Ridley says 'the central financial issue when spending out is certainty. Particularly as we got into the final stretch, it was incredibly important for us to know with real accuracy how much money we had available to spend so that we could keep the commitments we were making to the organisations we were funding. The last years of the foundation's life were ruled by monthly meetings where we have pored over spreadsheets!'

The Tubney Charitable Trust closed in March 2012.

effectively if they have a clear sense of what it is they're trying to achieve and the environment in which they're working.

For grant-making organisations that will likely mean having programme objectives and/ or criteria based on what they want to achieve in terms of delivering their public benefit, and a sense of what the environment is like in terms of likely beneficiaries.

Because their relationship with beneficiaries is mediated through their charitable objects, which may be fairly wide, and which may be clouded by ideas like 'acting in the best interests of the charity', endowed charitable foundations can face the danger of running adrift through having a lack of clarity over why it is they exist. Calling to mind who might concretely benefit from funding, and what their concerns are, can help bring focus.

Recalling one of the historic situations which influenced the development of fiduciary obligations helps highlight the issue. It might seem like a quaint story but it can help focus thinking.

As the law relating to private trusts developed in the middle ages, one of the situations it evolved to cover was that of the landowner who left his property for a long time, perhaps to join a crusade or take a long pilgrimage. If he had dependents, then he might entrust his property to others to administer until he returned or, if he died, until his heirs were able to inherit. If he didn't return then the children would be the beneficiaries of the property. In this situation, the important point to note is

TRUSTEES GATHER NOT TO REPRESENT THEIR OWN INTERESTS, NOR THOSE OF THE FOUNDER, BUT SOLELY THOSE OF THE BENEFICIARIES.

that the trustees' fiduciary duty of loyalty was owed, not to the donor, but to the children. In other words the trustees' role was to act for, and in the best interests of the children, who were otherwise too young to act for themselves.

If we fast forward to today, and transpose this key idea to a charitable foundation, then certain things come into sharper focus.

In the first instance, the story reinforces clearly that trustees gather not to represent their own interests, nor those of the founder, but solely those of the beneficiaries. This is expressed in the fiduciary duty of loyalty.

While for foundations that means having an overriding obligation to deliver the 'charitable objects', foundations may get a clearer grasp of what that means in practical terms if they have a sense of how those translate into actual beneficiaries. Even in the hypothetical case of a foundation that exists, say, to protect certain forests, the trustees

might come up with sharper investment and spending objectives if they asked themselves, 'If the trees could speak for themselves, what would they do?' When the issue foundations are striving to address is known to be particularly acute in the present day, it is possible that the foundation could achieve greater impact, like The Tubney Charitable Trust, by spending out.

It also follows that the asset exists not to perpetuate itself, but to serve the interests of the beneficiaries as expressed in the charitable objects. When a foundation has been endowed with historic property, valuable assets, or donor stock - even if there isn't an absolute restriction in the trust deed - it can be easy to continue to hold onto those even if preserving them is not best for the charitable mission. It takes clear and far sighted trustees to decide to dispose of such assets to find better or safer long-term returns to better serve the interests of their ultimate beneficiaries.

The freedom which endowed charitable foundations have puts an onus on those who run them to be clear about what their objectives are and to keep them clearly and constantly in mind, not just when it comes to developing grants and spending programmes but also when deciding how most prudently to invest and use the entrusted asset. Nothing can trump the importance of delivering the charitable objectives. It's important to bear this in mind as in the following chapters we look at and reflect upon how different foundations decide what approach to take when investing and spending their money.





PART TWO: CONNECTING MISSION AND INVESTMENT

PART TWO KEY QUESTIONS

- When you consider making an investment what do you want it to do? What are the consequences of getting those judgements wrong? What are the consequences of getting those judgements right?
- Do all trustees know and understand the consequences of your approach to investing and spending in terms of the impact on current and future generations of beneficiaries?
- Do you wish to grow, maintain or spend out your endowment (after taking account of inflation)? How do you measure this, and what is the rationale for your decision?
- What are the values underpinning your charitable aims? What are the implications of those values for the way you use the whole balance sheet in terms of investment, expenditure, human capital and reputation?

‘TRUSTEE BODIES
OFTEN SPEND MORE
TIME DEBATING
GRANT PAYMENTS
OF THOUSANDS
OF POUNDS THAN
HOW THEY INVEST
MILLIONS.’

**GUY DAVIES,
TRUSTEE AND
INVESTMENT
ADVISER**

4. DECIDING HOW MUCH TO SPEND AND HOW MUCH TO KEEP

KEY POINTS

- Foundations balance a number of factors when setting investment and expenditure targets, beyond achieving a maximum annual return.
- For permanent endowments, adopting a 'total return' approach may open up more investment opportunities.
- Some foundations take inflation into account when setting targets for expenditure and preservation of the endowment.

4.1 INVESTING TO SPEND TODAY AND TOMORROW

The management of charitable foundations, as we have seen, is governed by the fiduciary duties to act prudently and to be loyal to the beneficiaries of the endowment. The duty to act prudently has developed over time, so that the test of behaving as would the 'ordinary prudent man' has come to be understood in legal terms as pursuing the maximum risk adjusted return on investments. We've already noted, however, that this simple formula is not entirely sufficient to deal with the variety of concerns held by those who manage endowments.

Foundations can have different objectives in relation to the endowment: to preserve its real value, to grow it or to spend out. How these are conceived and expressed can vary from one foundation to another. When those who are responsible for managing or determining policy on endowments describe what they do, they recount how they balance a number of different concerns when deciding how prudently to achieve their objectives.

4.2 FIRST THINGS FIRST: CONNECTING INVESTING WITH SPENDING

Trustees have two main approaches to the endowment.

The first, simplest, approach is to spend only the income derived from investments. This is the default position in law for permanent endowments.

The difficulty is that capital may not grow in line with inflation so that the real value of the endowment will diminish over time. And while regulation ensures that investment portfolios will contain a diverse range of assets (in order to mitigate the risk of over-exposure to a small class of investments), the policy of focusing on investments that bring the biggest income can backfire because these high yielding assets often lack inflation protection. Over time the value of the asset becomes locked and doesn't keep pace with the real value. One finance director observed 'chasing income to meet accounting expectations ends up determining the investment activity of the organisation. It feels like the tail wagging the dog.'

The second option is to adopt a total return approach.

Led by developments in the USA, the Charity Commission has, following a consultation in 2000, permitted permanent endowments to apply to realise the return on their investments not just in terms of dividend income, but also through the increase in market value: the total return. Non-permanent endowments have always been able to take this approach, but not all have done so.

Taking a total return approach allows foundations greater freedom to pursue higher rates of return to keep track with inflation, and to set more ambitious investment targets. However, freed from the restriction to leave capital untouched, foundations are faced with the dilemma of deciding for themselves how much to spend. They must also decide how much to reserve as the endowment and how to deal

CASE STUDY: THE WATES FOUNDATION

After the 2008 financial crisis, The Wates Foundation reformed its approach to investment and spending. According to Brian Wheelwright, the Foundation's Director, 'Foundation awards were accounted for as conditional liabilities so that only commitments falling in the current financial year are recognised. In times of better investment returns, this system worked well, but the impact of the crisis on the portfolio and its investment yield meant that we ran the risk of creating a bow-wave of forward grant commitments which could outstrip the amount available to spend.'

'Today all future grant commitments are shown as liabilities, and every grant decision is carefully scrutinised and backed by a family member before the grant offer is made. The investment strategy is now aimed at sustaining the real value of the capital endowment while generating sufficient funds to be able to keep making new grants.'

While the trustees remain concerned to seek the maximum return the market can offer with all the risk that implies, they are now more focused on generating sufficient funds to be able to meet their agreed grant-making objectives and rebuild the core investment portfolio. Within a ten-year plan, the investment strategy has been revised with a less optimistic return target, a rebalancing of strategic allocations to asset classes and a broadening of tactical allocations to capture immediate opportunities.

with the variation in returns, especially if they aim to keep expenditure stable.

Investing for total return exposes endowments to market volatility. Is this a problem?

According to James Brooke Turner of The Nuffield Foundation, 'Foundations' requirements are for a constant flow of cash for disposal. The most dangerous risk for us is inflation, which means that the 'safest' investment option, bonds, is actually the most risky because the income is fixed and won't grow with inflation. What

matters for foundations is not volatility but cash. Trustees investing for a lower return out of caution may be exercising short-term prudence, but long-term recklessness.'

4.3 KEEPING TRACK WITH INFLATION

The reason inflation matters is because the costs of the beneficiaries' work a foundation supports will rise with inflation. It therefore makes sense to build this into spending calculations. Doing so will have a knock-on effect on a foundation's investment target.

'Beating the stock market year by year seems like a fairly arbitrary target to set' says Guy Davies, a trustee of the ABF, The Soldiers Charity (formerly known as the Army Benevolent Fund) and also himself an investment manager. 'Ensuring that you generate sufficient surplus return to allow your grant-making to keep track with inflation is the main thing to bear in mind.'

There are different ways of calculating inflation – the Retail Price Index (RPI) and the Consumer Price Index (CPI) are the most commonly quoted.

Setting an investment target that is specifically tailored to expenditure and includes inflation is important for Trinity College Cambridge. 'We perhaps have less discretion than many other trusts', says Rory Landman, the Senior Bursar. 'We expect to fund certain things year on year from the endowment and so have regular expenditure targets that we must meet. We would also like to do more, so that our investment aim is not only to meet those costs plus inflation, but to grow real income over time.' To calculate inflation in a way which relates to their area of benefit, the College Investment Committee looks at the Higher Education Price Index (HEPI) as well as RPI and CPI.

For foundations such as these, keeping pace with expected inflationary pressure on their expenditure provides a helpful minimum level of achievement for their investments. Successful investment is therefore defined by the achievement of specific targets rather than by the ups and downs of the stock market. While it operates as a sort of 'floor target' however, as Rory Landman indicates, it doesn't limit the upward end of their ambition.

4. DECIDING HOW MUCH TO SPEND AND HOW MUCH TO KEEP

CONTINUED

4.4 PRESERVING THE VALUE OF THE ENDOWMENT

Foundations also consider inflation in relation to the value of the endowment. Although the Charity Commission requires permanent endowments to preserve the value of the capital when adopting a total return approach, there is no guidance which sets out exactly how they must do this. So, whether technically permanent or not, many endowments that aim to be around for a long time consider inflation in relation to the value of the endowment, and not just in relation to their spending power. Doing so provides trustees with one way of sensing whether they are discharging their fiduciary duties to future generations.

The key question is how to determine a fair value of the endowment.

It might be easy to base calculations on the single original gift. But many foundations are the result of successive windfalls, so need to find another value.

Generally accepted accounting principles, which don't require endowments to specify what they mean by the preservation of an endowment,²⁵ use the terms 'historical cost' or 'market value', neither of which takes account of the effect of inflation on an endowment's purchasing power. As the value of an endowment will fall and rise with the market, there is a danger that foundations could overspend in bubble markets or believe that sudden, temporary, falls in market value - as happened in 2008 - mean that the value of the endowment had been permanently eroded.

ACTING IN THE BEST INTERESTS OF THE OBJECTS OF THE CHARITY MAY NOT MEAN PROTECTING THE ASSET FOR TOMORROW, BUT SPENDING IT MORE WISELY TODAY.

Unless they have an objective way of measuring the value of the endowment which makes sense over time, foundations run the risk of over-reacting to sudden temporary fluctuations in the stock market.

Foundation investors therefore continually need to review their approach to keep on track.

4.5 SETTING TARGETS – INVESTMENT RETURNS AND DISTRIBUTION RATES

Foundations generally use one of three models to make a forward-looking assessment of what they might spend in the long-term.

They may decide to:

- distribute the income on the portfolio;
- increase the previous year's budget; or
- spend a percentage of the average market value of the asset.

Each approach presents challenges to organisations.

THE JOHM ELLERMAN FOUNDATION

Although the Foundation is not permanent in law, the trustees are clear that the foundation should continue in the long-term. Set up in 1971, the Foundation originally spent only the income from investments. After some years of income rising over inflation, in 1998 there was a fall, and, in order to budget, the trustees decided to determine spend by taking the previous year's grants adjusted for inflation and adding their running costs.

In 2001 the Foundation adopted a total return approach, but continued to calculate overall expenditure based on an inflation of the grant spend. When the market fell in 2002/3 the value of the endowment also fell and that policy was no longer sustainable without eroding the real value of the endowment. They changed approach and adopted a spending rate of 5% which had been linked explicitly to the value of the endowment.

In 2012, when inflation had been higher than 5% and outstripping any achievable return the foundation considered its options and decided to continue to spend at the same rate.

²⁵ Expressed in the Statement Of Recommended Practice (SORP), GL51.2.

CASE STUDY: THE NUFFIELD FOUNDATION

In 2003, The Nuffield Foundation, which has an expendable endowment, created an 'index of capital maintenance' to help trustees judge over time whether they were meeting their stated investment aim of preserving the value of the endowment.

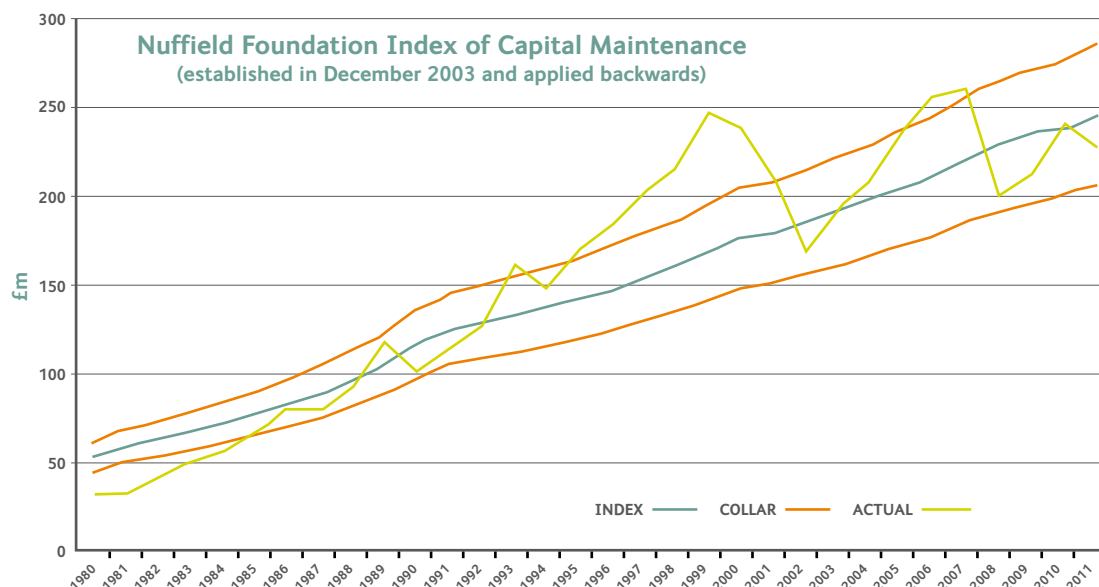
Because much of their grant spend is related to earnings, they chose a measure of one third RPI and two thirds average earnings to reflect the current and future value of their endowment, as linked to their expenditure.

In order to allow for the volatility of the market, the foundation chose an upper and lower limit based on two standard deviations of a similarly-invested investment portfolio.

Using this graph, the foundation is able to compare the actual value of the endowment with the other data over time in order to form a judgement on whether the performance of their investments is on track or not.

The advantage of this approach is that the trustees are able to form long-term judgements about their investment and spending decisions. For example, if over a period of years the investments were outperforming their inflation target, the trustees would be able to spend the gains which would otherwise unduly benefit future generations. On the other hand, if the target was to increase the investment (say for a particular project) then gains would be retained. And if the value of the endowment was diminishing in real terms, gains would be retained in addition to reviewing the investment policy and the annual distribution.

In addition, because higher returning portfolios experience more volatility, the trustees are able to feel more confident about pursuing greater returns. 'By having an index and an associated range for the expected volatility, trustees can understand these short-term swings as unexceptional, although occasionally uncomfortable', says James Brooke Turner, the Foundation's Finance Director.



4. DECIDING HOW MUCH TO SPEND AND HOW MUCH TO KEEP CONTINUED

4.6 BRINGING IT TOGETHER AND PLANNING FOR THE LONG-TERM

Endowed Foundations are able to weather greater volatility in returns because, as they are long-term investors, their assets will rise as well as fall over the market cycle. As we've seen they can be less concerned with short-term volatility than pension funds. Instead some foundations take an approach that calculates an annual spend target based on their historic total returns rather than on forward projections.

Esmée Fairbairn calculates a distribution rate of 4% (excluding investment costs) of the investment portfolio's average value over the previous five years.²⁶ The trustees' investment objective is therefore to make a total return of inflation, set at RPI, plus 4%, which adds an amount equivalent to inflation to the endowment value each year, while making enough additional return to spend at 4%. The foundation budgets its administration costs as a proportion of the total 4% (excluding investment costs) target - currently less than 7% of total spend. And although it calculates a distribution rate of 4%, if there is a need to, the trustees will spend more than that.

Using the longer-term average value of the portfolio, rather than a yearly valuation, prevents spikes in valuations leading to volatile grant-spending.

Professor Elroy Dimson notes that foundations have different time frames for different purposes. 'Each foundation will have a detailed annual budget, but will

THE TASK IS NOT JUST MAXIMISING RETURN BUT MAXIMISING DISTRIBUTIONS.

have a planning cycle of two or three years in terms of their grant-making and other expenditure and probably a sense of what their liabilities will be over the next three to five years. Beyond that they want to be considering what they can or can't do in 20 years. To address that question you need to understand liabilities more'.

4.7 DIFFICULT ECONOMIC TIMES

Professor Dimson also sounds a warning for the difficult circumstances foundations may find themselves in during the depressed market conditions accompanying the Eurozone crisis which began in 2011. While the economic crisis of 2008 saw many foundations continuing to spend at the same rate²⁷ there is evidence to show that what happens to asset values in one period tends to be reflected in levels of spending in the next.²⁸

The situation accompanying the Eurozone crisis, with a combination of continued high inflation in the UK, and a move downward in interest rates, accompanied by depressed market conditions, makes it less likely that foundations can confidently assume that they will be able to both

protect the real value of the endowment and keep expenditure in line with inflation.

It means trustees have to tackle opposing scenarios within their investment strategies: on one hand, that of keeping current expenditure in line with inflation and on the other maintaining the real value of the endowment for future generations.

Gauging the right way to balance the different factors is going to be more important than ever. It means making difficult decisions and understanding their impact on today's and tomorrow's beneficiaries.

Professor Dimson says, 'Foundations must ask themselves pressing questions about what sort of business they have. Do they have a permanent obligation? Are they really perpetual?'

4.8 REMAINING FLEXIBLE

The Tudor Trust monitors the real value of its endowment, but rather than committing to a particular distribution rate gauges the foundation's annual spend based on the capacity of the organisation to make high quality grants at the same volume and average amount year on year, while adjusting its spend to keep pace with inflation. 'We feel that the endowment is there to give us freedom to do what's right for our beneficiaries', says the Director, Christopher Graves, 'which means allowing ourselves sufficient room to manoeuvre each year to respond to new funding opportunities which present themselves, but maintaining a fairly constant rate of spend.'

²⁶ 'Myth Buster', Brown, C., Charity Finance, October 2011, p.46.

²⁷ Firm Foundations Report, Leat, D., Charity Commission, 2009.

²⁸ Family Foundations Giving Trends 2011, Pharoah, C., with Keidan, C., and Gordon J., Alliance Publishing Trust, London, p.19.

4.9 SPENDING OUT

For those foundations which have a specified end date in mind, at a certain point the central financial issue is certainty. At the end of their life, such foundations will need accurately to know how much money they have available to spend so that they can keep the commitments they make to the organisations they are funding.

Instead of ensuring the value of the endowment keeps pace with inflation, in the latter stages endowments that are spending out will wish to provide the maximum expenditure they can with the greatest degree of certainty. This means investing in vehicles that will both hold their value and provide the right level of liquidity, as well as being prepared perhaps to gift the residual assets.

4.10 REFLECTIONS

In practice those who deal with investments consider a number of different concerns and issues when deciding what the most prudent approach might be for them without simply assuming that chasing the maximum return year by year is the wisest way to treat the investment.

The distinctive relationship that foundations have with their beneficiaries has its greatest potential bearing in this area. As we've noted, pension funds are obliged to pursue investment strategies based on calculations of their known future liabilities, and to maintain a portfolio in such a way as always to be able always to meet those liabilities. Foundations have a different perspective as well as

a different regulatory regime. If they choose it, their measure of success can be the preservation of the real value of the endowment. This is an historical as opposed to a future measure, and one over which they have much more room for manoeuvre. Foundations, as a result of their ability to withstand greater volatility in their portfolio and pursue an approach over the long-term, are therefore able to take on more risky investments and make potentially greater returns.

Nonetheless, when foundations are not clear about what level of expenditure they are aiming for, or what the impact of inflation is likely to be, they may risk not spending enough, remaining content to let the endowment grow without being able to judge one way or another if they are fulfilling their own aspirations. For some this may constitute a bigger failure than spending too much, particularly when other funding is tight. The task is not just maximising return but maximising distributions.

Those foundations that are clear that they should be around permanently will need to align their investment and spending policies in a way which preserves the value of the endowment across generations (and not just from one year to the next) and so deal equitably with the needs of the future as well as the present.

However, there is a danger that preservation itself can act as a sort of proxy for fulfilling one's fiduciary obligations, especially where perpetuity is assumed as a default but where a deliberate decision to remain permanent has in fact never been

taken either by the founder or trustees.

Recognising this, some foundations use their freedom to act by taking a flexible approach and - because it seems to them the best way to serve their charitable aims - spend at a rate that over time could see the disappearance or diminution of the endowment.

If trustees have some way of monitoring the value of the endowment in inflation-adjusted terms they will be able to plan and predict for that eventuality or, if circumstances demand it, change tack to secure their ongoing future existence at an appropriate scale of operation.

The bottom line is always to act in the best interests of the charitable objects.

5. USING THE WHOLE BALANCE SHEET

KEY POINTS

- Some foundations – for pragmatic and principled reasons – use their endowment as well as expenditure to pursue their charitable objects.
- Charity Commission guidance is pragmatic and permissive, but where the main intention is to make a financial return, foundations must consider taking advice.
- Having a values statement to translate an archaic or broad trust deed can help foundations decide whether and how to use the whole balance sheet to deliver their charitable objectives.

In the previous chapter we looked at the different issues foundations attempt to reconcile when developing a strategy that links their investment with their approach to spending. The overarching aim for many foundations is to generate as much return as possible to further their charitable mission and, if they choose to do so, to preserve the real value of the endowment.

However, if endowed charitable foundations spend on average 5% of the value of the asset each year,²⁹ what of the other 95%? Is there any way in which that can be used to further the aims of the charity, beyond merely being the goose that lays the golden egg?

This chapter explores the different ways foundations take pragmatic and principled approaches to the question.

5.1 MAKING THE MOST OF WHAT YOU'VE GOT: A SPECTRUM OF TOOLS

When it comes to funding and investing, some grant-making foundations don't recognise a clear division between giving grants to pursue the mission and making investments which might equally further their work. They make the most of opportunities to increase their return and further their charitable objects when they present themselves.

For example, The Nuffield Foundation sees

an overlap between grant-making and investment when funding life sciences. When it is able to do so, the foundation makes conventional market-rate investments in companies that carry out research and development in life sciences as part of its overall portfolio. Equally, when the Foundation makes grants for innovative research, it makes sure that it stands to benefit from successful research which has a commercial outcome.

5.2 APPLYING VALUES TO INVESTMENTS

Other foundations, to varying degrees, attempt to express the values of the organisation when investing the endowment, as well as in the way they give grants.

The Tubney Charitable Trust, which aimed to protect the environment and promote animal welfare, chose to screen out from its list of possible investments those companies whose activities might cause environmental harm.

These approaches are normally known as ethical screening.

Some foundations also choose to use their share voting rights to influence the way the companies in which they invest are managed. In these cases, foundations will typically work with fund managers or devolve their voting rights to agencies who will act on their behalf to vote their shares, propose or support board resolutions and write directly to or meet with companies they have invested in.

²⁹ Distribution rate of 4.8% calculated based on ACF analysis of Charity Commission data. See section 1.2, note 7.

THE JOSEPH ROWNTREE CHARITABLE TRUST

The Joseph Rowntree Charitable Trust, a Quaker Charity, aims to use the Trust's financial resources for radical change towards a more peaceful, equal and just world and believe that the Trust's investments, and its behaviour as an investor, contribute to this.

The Trust engages with companies in the portfolio to try to improve practices and may, in the event of ongoing concerns, sell its shares. It also votes its shares and supports resolutions. It is happy to collaborate with other investors, for example, through the Church Investors Group and the Institutional Investors Group on Climate Change, and is a signatory to the United Nations Principles of Responsible Investment and the Carbon Disclosure Project. The trustees believe this to be in the interest of society at large as well as in the Trust's long-term financial interest.

This approach has both its proponents and those who question it.

Some, like Stephen Hine, head of responsible development at EIRIS, argue that it is in the best interests of investors to take into account the social and environmental impact of their investments as well as the effect of the way organisations are governed. 'Those companies which take a responsible approach to their activities are likely to perform relatively well over the long-term.

Taking account of environmental, social, governance (ESG) considerations in making investment decisions makes sense and goes hand in hand with being a long-term investor.'

Institutional investors who agree are increasingly signing up to instruments like the United Nations Principles for Responsible Investment, and the UK Stewardship Code, which commit them, as fiduciaries, to investing in ways which align with social and ethical objectives.

On the other hand, those who interpret their obligations as making the maximum return possible in order to spend on their charitable aims argue that limiting the range of investments restricts the portfolio in ways which will have a negative impact on the financial return and hence on their mission. Others feel that trustees would find it difficult to agree a common set of values. One finance director observed, 'Our trustee body is made up of individuals from very different backgrounds. We would find it very difficult to achieve consensus on for example excluding certain sort of investments from our portfolio. As a foundation we concentrate our efforts on making and spending as much as we can.'

5.3 APPLYING INVESTMENTS TO VALUES

A relatively recent way in which investors are spending to achieve a combined social and financial return is based on the recognition that grant-making isn't the only, or best, way to support a social

purpose organisation. So, especially where an organisation needs access to capital, a range of other funding options exist, all of which involve repayment or a return being made on the funding invested.

A loan or equity or similar kinds of investment can be more helpful than a grant to organisations where, for example, they are trying to attract or graduate onto commercial finance for their activity. The commitment of the social investor can help make their offer less risky for more conventional lenders.

Foundations like the Tudor Trust, Esmée Fairbairn, Joseph Rowntree Charitable Trust, Trust for London and The Wates Foundation all make these sort of investments.

From a foundation perspective, this sort of funding offers a dual benefit. Like a grant, it supports the activity of an organisation in ways which help to deliver the foundation's charitable purpose. On the other hand, it also generates a financial return, which needn't necessarily be below market rate. Even where the return is below market rate, some investors see social investing as an efficient form of funding because funding is 'recycled', allowing the same money to support more than one organisation.

One trustee of a foundation explained that they were committed to social investing as a matter of principle. 'It's a new and untried area, and that's precisely why we think it's important to invest in it. As a foundation we have the freedom and ability to take on new and risky things. We don't yet know how risky it will be in the

5. USING THE WHOLE BALANCE SHEET CONTINUED

long-term - although in fact the repayment rate on the investments we've made so far is very good. In the future we see that this could be an important way forward for the economy and for social purpose organisations generally, and we feel we must support it.'

A cautionary view is given by Guy Davies, a foundation trustee as well as an investment manager. He thinks that it is best to keep a clear distinction between financial and social objectives because they require different kinds of risk assessments. 'Where the aim is to generate a return, the private sector is more likely to do so because the sector is geared towards making a monetary profit and regulated accordingly. There is a danger that charities might invest in social enterprises because they feel they understand them better, but do so with less regulation and therefore less assurance that the money will be used wisely and efficiently. While the two outcomes can combine, it is important to be clear about what you're doing from a motivation and accounting point of view.'

The market for such social investments is still emerging, with only a few intermediaries available to broker deals between investors and investees. Some foundations work directly with organisations in structuring investments and carrying out due diligence. In so doing, they often find themselves offering more than just financial support through offering expertise and skills. One foundation member of staff reported that this closer relationship with organisations was something that the foundation's trustees and staff valued. In future they could

CONSIDERING THEIR ENTIRE BALANCE SHEET THROUGH THE SINGLE LENS OF THEIR MISSION MAY MAKE FOUNDATIONS MORE SUCCESSFUL ECONOMIC AND SOCIAL AGENTS.

well be reluctant to use intermediaries to manage things at arm's length, as the investment of human capital was an equally key part of their financial stake.

Recent Charity Commission guidance takes a permissive and pragmatic approach to these sorts of investments. The Commission classes investments where the primary purpose is to achieve a social purpose, while also generating a financial return, as 'programme-related investments'. The Commission defines a 'mixed motive investment' as one which trustees make on the basis that it has elements of both financial investment and programme related investment and which cannot be wholly justified as either one or the other. The Commission recommends that as far as possible for mixed motive investments the anticipated (and as far as possible

quantified) social outcome should offset a reduction in financial return.³⁰

The guidance is clear, however, that if the primary aim is to make a financial return, the normal rules of investment will apply and foundations will have to consider taking advice in relation to the investment. If, however, the aim is primarily social and the money comes from funds that a foundation has available for programme spend, there is no such obligation.

5.4 REFLECTIONS

Foundations have different ways of linking their investment activity with their charitable purpose.

For some, the aim is to use the endowment to generate as great a market return as possible to spend on their charitable aims. The emphasis is on what they can practically achieve.

At the other end of the spectrum, some foundations have a strong sense that their mission is not only to achieve certain goals but also to express certain values.

Between these two, many foundations may place some restrictions on their portfolio to take account of specific ethical concerns, but on the whole feel no contradiction between that and investing for maximum return on the market, while taking account of risk, in order to pursue their mission.

It could be that there is a danger of the debate on ethical investing becoming fixed, with an implicit sense of foundations

³⁰ Charities and Investment Matters, A guide for trustees, (CC14), Charity Commission, 2011. pp.48, 49.

having to adopt a ready-made set of ethical values, rather than determining their own organisational values and expressing them through the way they invest and give grants.

Some campaigners feel that fiduciary investors should begin with an ethical stance which addresses universal concerns. However the development of rules governing fiduciary investment - in England and Wales - in practice start from the other direction. Trustees have to justify why they *should* adopt an ethical stance, which could have an impact on maximum return, rather than why they haven't.

Foundations must find the approach which is right for them. As this chapter demonstrates, the question is not simply

one of values, but whether and how trustees might use the whole balance sheet to achieve their charitable aims.

How might foundations make these decisions?

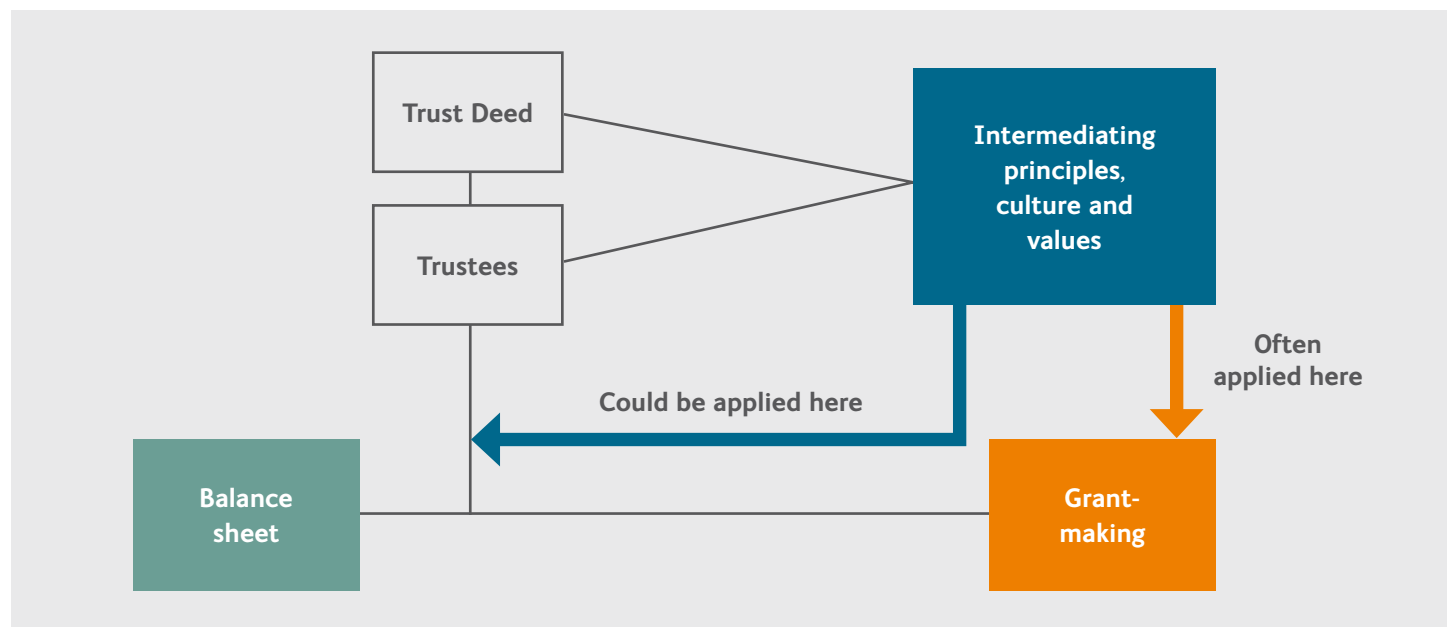
In the first place, they could reflect on their charitable mission and consider whether there are certain values underpinning it which have implications for the way they use the whole balance sheet, in terms of investment as well as expenditure, and including what they have to offer in terms of human capital and reputation.

In the second place, they could reflect whether their charitable aims could be served also by investing in certain ways, either to contribute to systemic change

in society or by offering a wider range of options to better serve the beneficiaries.

They will then have to bear in mind the cost of implementation. Bespoke investment strategies or funding arrangements could prove to be unjustifiably expensive, although intermediaries and developing socially responsible and social investment products can help.

If a foundation's aim is to express its own mission and values, it follows that there will be as many approaches to ethical and social investing as there are to grant-making. As an obvious example, an organisation with a pacifist ethos may at the very least want to screen out arms manufacturers. Foundations which support



5. USING THE WHOLE BALANCE SHEET

CONTINUED

members of the armed forces or veterans may have no problem in investing in armaments.

A key inhibitor may be a widely-drawn trust deed. Many foundations with such documents are nevertheless able to find a way to define in a pragmatic way the scope of their grant-making. In the same way, trustees could derive a set of values from the trust deed to apply to the balance sheet to support their charitable aims.

Such an approach would require trustees to apply values to the entirety of the foundation's resources, and only then deciding an investment mandate. In this way, trustees would be able consider their attitude towards the moral use of the capital before its financial use.

While the law and guidance remains as it is, foundations will continue to adopt different approaches to answering these questions. However, regardless of the answer they arrive at, it is possible that considering their entire balance sheet through the single lens of their mission may at the very least make foundations more intentional, successful economic and social agents.





PART THREE: TAKING ADVICE AND MAKING DECISIONS

PART THREE KEY QUESTIONS

- In what way are your decisions intentional rather than cultural?
- How might you benefit from support in developing an overall strategy for how you use your asset to serve your beneficiaries? Do you currently explain this understanding to those who provide advice?
- What mechanisms do the trustee board and committees use to support (or inhibit) good long-term decision-making? Are they good enough? How do you use advice?
- Can your foundation be more ambitious in view of the freedom it has to promote its charitable objects?

‘TRUSTEES ARE THE FIDUCIARIES AND THEY TAKE THE DECISIONS, BUT THEY DO THAT BEST WITH MULTIPLE SOURCES OF INFORMATION AND INPUTS. OTHERWISE IT’S BASICALLY DELEGATION IN ALL BUT NAME.’
**SIMON HALLETT,
ADVISER**

6. EXPERTISE AND EXPERT ADVICE

KEY POINTS

- There is no statutory duty to obtain and consider advice in relation to spending in the same way as for investment matters.
- In relation to investment advisers and professionals, annual performance measures can at times obscure rather than help with long-term investment strategy.
- Some advisers find that they can help least when foundations are unsure about basic strategy or are seeking advice mainly to provide an audit trail.
- Peer support and umbrella bodies can provide expertise and help foundations become more intelligent customers.

The previous chapters show that those who run endowed charitable foundations need to grapple with difficult strategic issues. One trustee observed that trustees can be the people with the least amount of technical knowledge, but take the most important decisions in foundations. To help them take these decisions, those who run foundations often rely on expertise.

How do trustee bodies in practice find expertise on some of the issues they face?

6.1 EXPERTISE WITHIN THE ORGANISATION

Some foundations build the expertise they need within the organisation, either by recruiting trustees or hiring staff with specific skills and experience.

Expert trustees. Boards may include individuals with financial or investment experience to sit on an investment committee. Some foundations co-opt investment experts to sit on their investment committee even if they are not members of the full board. One investment adviser observed that being a trustee or member of an investment committee was seen a good way for advisers to gain useful insights into the working of foundations. Even if it meant that their organisation wasn't able to bid for work because of the conflict of interests, advisers were still encouraged to take on roles within foundations.

If individual trustees do offer particular technical expertise which the board might rely on, then they will be subject to a higher duty of care than ordinary trustees in relation to their technical input.³¹

Foundations continue to seek external advice even when trustee bodies contain investment advisers or lawyers. It is not clear if one of the reasons expert trustees do so is if they feel that they cannot give sufficient time to give proper attention to issues requiring a professional judgement.

Professor Onora O'Neill, former chair of, among others, The Nuffield Foundation, highlighted a potential difficulty of having expert trustees on the board. 'When a trustee sets themselves up as having expertise in a particular area, say in relation to investing, they may be quite partial or exaggerate the importance of their particular area.' The risk then is that having a particularly focused expertise may limit the range of information a trustee body has available and result in less rather than better-informed decisions.

Nonetheless, it is common for trustee bodies to appoint trustees with particular skills or experience, not only in relation to technical areas like law or investment, but also in relation to the aims of the charity to improve decisions in relation to grant-making and funding.

Expert staff. Some foundations recruit expert staff, for example, with accounting or financial management or grant-making expertise. Larger foundations may also employ investment experts to provide in-house support to the trustee body on

³¹ Charities and Investment Matters: A guide for trustees (CC14), Charity Commission, 2011, p.20.

investment strategy and management. The advantages of having someone focused on the very specific needs of the foundation are clear. However, the costs of such in-house expertise may be prohibitively high for many foundations and in some cases trustees may feel more relaxed about paying high fees than high salaries.

Foundations therefore frequently seek expert advice from outside sources, often appreciating the rigour and structure which experts can bring to tackling issues which the various and ad hoc views of trustees may not provide.

6.2 INVESTMENT ADVISERS

Trustees have a legal duty to obtain and consider advice in relation to investment decisions unless it is inappropriate or unnecessary to do so.³² In practice that means trustees seeking advice in relation to asset allocation, or which fund managers to appoint to manage their assets.

Those running foundations raise a number of issues in relation to such advice.

A market geared to pension funds with different needs. As we saw in the introduction, pension fund assets dwarf those of endowments, and the investment market and products are primarily geared to the former. But they are different beasts. Pension funds have no flexibility about their liabilities, and have statutory obligations and a regulatory framework to ensure that their investment strategy is appropriate for these liabilities. On the

other hand, endowments usually have no defined future liabilities and no regulatory supervision of investment strategies.

Long-term performance and annual benchmarks. Investment professionals are usually judged on a set of annual measures which reflect the market value of the investments they work with at a particular point in time.

A chair of trustees questioned how helpful the system was for foundations. ‘Your policy is to prudently do the best in the long-term, then you see the managers chasing annual benchmarks which they chose in the first place. It’s been an extraordinary transformation for foundations from the original concept of prudence.’ The danger is that decisions come to be taken and performance judged on a year by year basis by a measure which can’t reflect long-term success.

An investment expert remarked, ‘there seems to be a rule of three in relation to investments. A manager is allowed one year where the targets aren’t met. If that stretches to two, then one may question their expertise. If they fail to meet targets over three years, then they usually aren’t thought of as any good.’

A recent report has also questioned the appropriateness of such benchmarks, finding that their existence can cause investment managers to ‘herd’: that is, to adopt similar strategies to pursue the same measure. As long as everyone performs in the same way, no one can be seen to have failed even when things go badly wrong.³³

A key measure for many endowments is preservation of capital which is an historic fact. The difference in financial objectives between pension funds and foundations intuitively suggests a difference in risk appetites. Do the benchmarks for an endowment properly reflect its unconstrained long-term horizon when compared to the shorter and more cautious approach required of pension funds? Can endowments make more money?

Industry standard advice and products. Many firms of advisers have specialist charity teams. Nonetheless, foundation staff and trustees report some frustration that the advice and products on offer aren’t always geared to their needs. It is possible for foundations to get more specialist advice, but there are few investment advisers on the market with expertise in the foundation sector. For smaller foundations particularly, such advice may prove to be too expensive or be geared towards a larger-scale operation. One advisory firm calculates that they can only begin to add value to a foundation’s activity when the endowment is more than £20m.

Too much technical information. Those who pay for advice sometimes complain about the sort of information they receive. Often, some observe, reports contain pages of standard market analysis, with little of that information related to their specific concerns and often couched in terms obscure to the lay reader.

In part to combat this, The Tubney Charitable Trust felt that, as well as investment advisers, they needed

³² See section 2.5 of this report.

³³ Protecting Our Interests – Rediscovering Fiduciary Obligation, Fair Pensions, p.23.

6. EXPERTISE AND EXPERT ADVICE CONTINUED

an independent expert to act as an intermediary. What they got was time spent on analysis, expertise and the ability to translate technical terms into language they understood. The extra advice helped the trustee body to have more informed discussions about their investments as well as frame better questions to ask the adviser.

For their part, advisers report that the relationship works best when foundations have a clear idea of their objectives. Simon Hallett of Cambridge Associates says, 'If fundamental objectives are unclear, or there's disagreement about fundamentals, investment experts can't help.'

6.3 LAWYERS AND AUDITORS

Foundations will seek legal advice, like any organisation, on employment and other matters relating to their statutory obligations (like health and safety) and other duties of care.

They may also seek more specialist advice in relation to their authority to make certain investments and make certain sorts of partnerships. Some report however, that legal advice can be received as a set of instructions rather than options for discussion. One finance director, who had moved from the private sector, felt an expectation from charity lawyers that their advice would be followed. 'In the private sector, I was used to having advisers coming to me with an analysis of issues for us to have a discussion. In the charity sector it feels that auditors and lawyers

arrive expecting to tell you what to do.'

A board member of a small benevolent fund reported similar pressure from auditors. The auditors advised the board to instruct lawyers to amend their trust deed to avoid the risk that it might fall outside the Charity Commission's definition of the public benefit test, even before the Commission published advice on the issue. The auditors based their advice on the fact that a similar charity had redrafted their deed. After some discussion the board resisted, as they thought that the likelihood of being censured by the Commission ahead of the decision was remote, and instructing a lawyer seemed a disproportionate response to the uncertainty of their position, given that they were already finding ways of making their operation more open.

6.4 GOVERNANCE AND GRANT-MAKING EXPERTISE

Foundations also invest in outside expertise to help improve their strategy and governance capacity.

Foundations, like many other organisations, will bring facilitators and advisers in to help with setting strategy, mission and objectives, or to build governance capacity through training days or away days.

Professor Onora O'Neill observes that the costs of governance for foundations can be high because the danger of not getting it right can be high, both in terms of impact and in relation to making a good return.

Professor Elroy Dimson points out that there are few training opportunities for those who work in foundations to gain expertise in investment strategy and decision-making. Those that exist can train only around a hundred professionals a year, a number that is far outstripped by potential demand.³⁴

6.5 ADVICE OR INSTRUCTION?

As the example of lawyers and auditors shows, when it comes at least to advice on regulatory or financial matters, there is a suggestion that foundations can receive advice as a set of instructions rather than options for consideration.

Simon Hallett of Cambridge Associates voices concern about this situation from the advisers' side too. 'If the advice is being sought as some sort of regulatory fig-leaf, simply to provide a paper trail to justify decisions, then the relationship will be difficult. In those cases people feel a regulatory or moral pressure to seek advice, but they don't really want it, and can get upset if the advice doesn't conform to their own intuitions. For others, advice is only ever value for money or interesting if it's different from what they would have thought themselves. In my view the relationship works best when we can have a full and frank conversation and I can say what I think, without them feeling they have to follow it. Trustees are the fiduciaries and they take the decisions, but they do that best with multiple sources of information and inputs. Otherwise it's basically delegation in all but name.'

³⁴ For example, the Commonfund Institute at Yale University and the Endowment Asset Management Programme at Cambridge Judge Business School.

6.6 SMALLER FOUNDATIONS

The dependence many foundations have upon advisers is heightened in the case of smaller foundations. Jacqueline Rae, Director of the Colyer Fergusson Charitable Trust - a smaller family foundation - observes, 'We couldn't function without having close relationships with our fund managers, accountants and lawyers. With a small part-time staff team and a small trustee body we rely on the long-term memory of our advisers to complement our own. Although we regularly review their performance and survey the market, running beauty parades every few years and changing advisers to make modest savings in the short term is rarely worth the time and effort it takes new people to get up to speed.'

To combat this, the foundation has a set of criteria that help trustees review the performance of their advisers each year and highlight areas where the service can be improved. The criteria focus on issues to do with the relationship, including things such as whether the foundation has continuous contact with the same individual and the quality and clarity of information received. Jacqueline Rae explains, 'We absolutely need to understand what our advisers say to us. For example, as well as receiving the statutory information from our investment managers, which can often run to many pages of complex information, they give us short summaries of the key issues in language that the trustees understand.'

THERE IS A DANGER THAT IN THE FACE OF COMPLEX ISSUES AND ADVICE, TRUSTEES LOSE CONFIDENCE IN THEIR OWN JUDGMENT.

6.7 REFLECTIONS

These experiences raise a number of issues for those who run endowed foundations and advisers.

The need to manage risk usually lies behind the need to seek advice. The question is, 'What sort of risk, and to what extent does it need to be mitigated?'

If foundations are more anxious to construct a paper trail to justify decisions rather than to seek a range of views, it could be that trustees are feeling anxious about the risk of things going wrong. But as we've seen it is difficult to find an objective measure to judge that a foundation has failed, at least in terms of serving the interests of the charity.

Trustees and their advisers may also have in mind the personal liability of trustees. Non-expert trustees will understandably feel nervous about refuting professional advice, and even trustees who are professionals may feel that doing so is a zero-sum game

where they won't get credit for refusing advice but can easily be criticised if they get it wrong. Yet trustees can make the same assessments about such dangers as they do in relation to operational risks: balancing the likelihood and scale of harm with the benefit of proceeding and costs of mitigation.

In each case, there is the danger of trustees of foundations playing things more safely and less ambitiously than they might, to the detriment of their impact in terms of mission.

It's also important to bear the following things in mind when thinking about the statutory duty to obtain and consider advice. First, it relates only to decisions involving investment matters. It doesn't apply to spending decisions. Second, while it sets the default that boards should take decisions informed by expert advice, the duty doesn't apply where that advice would be inappropriate or unnecessary. In other words, if trustees are sufficiently expert or well-informed themselves, or can draw on the right in-house knowledge, they don't have to seek outside advice just for the sake of it. And finally, even when they receive advice, they are obliged to consider it, not to follow it. Only trustees - not advisers - can decide what is in the best interests of the charitable aims.

Misunderstandings about the scope of the duty could explain why some report that foundations treat expert advice not as opinion but as instruction.

This attitude could also be connected with wanting to eliminate the risk of

6. EXPERTISE AND EXPERT ADVICE

CONTINUED

exposure to any kind of risk. Such attitude can, however, inhibit foundations from considering different options, and ultimately lead to their doing less well in delivering their charitable objectives.

The notion of acting prudently means taking the approach that an ordinary careful person would take in managing their own affairs. There is a danger that, in the face of complex issues, and perhaps even more complex advice, trustees lose confidence in their own judgement. Yet the duty to be prudent clearly does not mean taking all decisions based only on the information with which you come to the table. For complex or new situations it means seeking expert opinion.

Based on the above, there also seems at times to be a mismatch between the rather specific needs of foundations and what the adviser market provides.

For example, a key measure for many endowments is preservation of capital. Pension funds, on the other hand, are obliged to construct an investment strategy based on calculable future liabilities. Such a difference in financial objectives intuitively suggests a difference in risk appetites. Do the benchmarks for an endowment properly reflect its unconstrained long-term horizon when compared to the shorter and more cautious approach required of pension funds, given that more numerous pension funds have greater influence on the design of investment products. Can endowments make more money?

How can foundations get the most from the advice they receive?

IT'S IMPORTANT NOT TO UNDERESTIMATE THE SIGNIFICANCE OF A FOUNDATION BEING CLEAR ABOUT BASIC STRATEGY.

There are several things foundations can do.

Most importantly they can make themselves more intelligent customers. If the adviser doesn't quite understand the foundation's culture or way of working, then the foundation can take responsibility for accomplishing the act of translation themselves. There are specialist advisers, but not many, and the more time advisers spend on providing tailor made advice, the more it costs. This is an area where expert trustees, staff or co-opted committee members can most help. They can provide a more informed link with external professionals and help the process of communication become two way. Foundations can also think carefully about the real cost/ benefit equation of employing experienced and expert staff.

Foundations can also be clearer about their reasons for seeking advice. In relation to key investment decisions - the only area where trustees are obliged to consider taking advice - the Charity Commission has made it clear that if boards are able to

demonstrate that they took their decisions thoughtfully and reasonably, they are very unlikely to face censure.³⁵ That reassurance should help trustees to feel more confident about using their own judgement to take decisions, and to use their resources better by seeking a range of views, both in-house and externally, and documenting their discussion, rather than delegating decisions in all but name. Spending money on advice simply to fulfill an audit obligation could, in some circumstances, be an expensive way to avoid taking more informed decisions.

It's important also not to underestimate the significance of a foundation being clear about basic strategy. Going to an investment adviser, for example, might be best left until the trustees are clear about their financial objectives and values. There are few organisations which don't benefit from an outside view or from facilitation when developing strategy, and it could be better, and more efficient to engage a consultant or interim to help develop clarity about basic goals, philosophy and risk tolerance before engaging lawyers or investment advisers to implement an investment strategy to deliver the financial objective.

On the advisory side, many firms of advisers contain specialist teams who will have a good sense of the charity sector. Nonetheless there may be room to develop further tools and approaches to diagnose and respond to the particular needs and goals of foundations. There may also be scope for further, more niche services to evolve, say around growing expertise in social investing.

³⁵ Charities and Investment Matters: A guide for trustees (CC14), Charity Commission, 2011, p.5.

More widely, it would seem that there could be improved infrastructure to support foundations in becoming more informed and confident decision-makers and customers. The possibilities of joint action, for example in co-instructing lawyers, could be enhanced through better and more engaged peer networks. Beyond that, it could be possible for foundations to act collectively to produce advice and guidance and even training on shared concerns relating to the financial and strategic governance aspects of running foundations. Such advice would need to take account of different scales of operation and staffing, and governance structures: an area for more research. In the absence of such sector led advice – common in other areas – the suspicion must be that foundations are either taking decisions without access to the latest information or paying a premium individually to receive it. At a sector level this must be an inefficient way to go about things. The Charity Commission has indicated that it is supportive of and is willing to endorse umbrella bodies producing guidance and information for constituent members, partly in the absence of Commission resources to do so.

At their best advisers and consultants, alert to the particular position foundations occupy, can act as pollinators, efficiently sharing learning and expertise across organisations. Everyone can stand to gain from getting the relationship right - beneficiaries most of all.

7. CULTURE AND GOVERNANCE

KEY POINTS

- Founders and their memories exert a strong influence on foundations, but that influence tends to diminish as they fade from living memory.
- The way trustee boards are structured can support or hinder long-term decision-making.
- Governance structures, which include staff, need to be comprehensive and resilient enough to implement the investment and expenditure strategy.

Trustees of charitable foundations are required to make their decisions collectively in line with their fiduciary obligations in the best interests of the charitable objects.

Yet, like many organisations, when boards come to take decisions, they are often influenced by a number of factors, not all of which may be acknowledged. The presence or memory of founders themselves makes a difference. For older foundations, history and tradition may influence and even limit the sort of decisions trustees take. The presence of staff and a trustee's sense of belonging to a wider community also have a bearing on the way decisions are taken. This chapter attempts to identify the way these factors have a distinct bearing on the governance of charitable foundations.

7.1 FOUNDERS AND FOUNDATIONS

Founders usually have a profound impact on any organisation they set up. They bring their vision, drive, professional and social networks and personal skills. Often they provide their own financial resources. This is especially the case for foundations, which frequently depend for their existence on the wealth of an individual or on the company that created them.

For those who set up foundations, the transition from simply being charitable to establishing a charity can be significant. Channelling philanthropy through

a charitable foundation can signal a determination to be more committed and intentional in giving.³⁶ The existence of the foundation can also add presence and – if the founders choose – permanence to philanthropic work. In addition, creating a charitable endowment can make giving more efficient as the return on investment will be tax-free and expenditure and staff costs will be drawn from that untaxed source. However, as well as tapping into the tax advantages available, many foundations are created either because it is recognised that the work is likely continue over a period longer than the lifetime of the founder or because the gift is intended to provide some sort of ongoing memorial to the philanthropist or some other individual.

But establishing a charity brings greater scrutiny and new forms of accountability. The money is now no longer one's own to control or direct: it exists to support the mission as defined by the trust deed.

Nonetheless, a founder's wishes and decisions, particularly in the early stages of a foundation's existence, are usually the major factor in determining policy and action. For example, the Atlantic Philanthropies started spending down as the result of the founder's decision. In 1999, at a board meeting, the founder, Chuck Feeney read a short, prepared statement noting that the foundation's total donations would be close to \$400m that year, a level that, if sustained, would use up the endowment and all earnings within two or three decades. He then proposed that annual outlays be increased to \$450m and that the board consider setting the foundation's life expectancy at

³⁶ See Family Foundation Giving Trends, Pharoah, C., Alliance Publishing Trust, London, 2011.

20 to 30 years. The foundation adopted a spending down strategy.³⁷

Investment decisions too can also depend upon the founder's business or background. For example, the endowment may be formed of company stock; for some founders in itself a reason for setting up a foundation. The restriction to holding company stock can also be locked-in by the trust deed. Nevertheless the creation of a charitable trust means that, formally, decisions can no longer be taken solo but must be agreed collectively with the board of trustees.

Dorothy Dalton, a governance specialist who has also set up her own operational charity, points out the importance of separating one's own activity from that of the charity. 'From now on careful distinctions will need to be made about what counts as expenditure in pursuit of charitable aims and activity which must continue to be funded from sources which remain private'. Setting up a charity will mean letting go of personal control. Dorothy Dalton continues, 'It's a bit like having children: you have to see the joy in something becoming independent.'

7.2 FOUNDER'S MEMORY AND VALUES

A founder's memory will continue to influence a trustee body after a founder has moved on or died, particularly when remaining trustees are related to or knew the founder. What happens when knowledge of the founder fades from living memory?

The John Ellerman Foundation has been

in existence since 1971, and since that time the founder has died. After his death, family members and colleagues from the company remained on the board of trustees and continued to recall his values, personality and interests when making decisions. 'We intuited what John would have wanted to do', says the chairman, Sarah Riddell. 'But now, very recently, we face an interesting situation where no one on the board knew our founder directly, and we wonder how that will be.'

Charity Commission guidance on permanent endowments states that it is less likely to permit the spending of part of the endowment until at least 100 years has passed since the creation of the trust because, until that time, the circumstance in which the charity operates are unlikely to have changed substantially and 'the donor or donors, or people who knew them and were aware of their wishes when they gave the property, will still be alive and be able to object to the resolution'.³⁸

The guidance indicates that the intention behind the gift and the wishes of the founder have a sort of half-life. Applying the principle more widely, trustees are more free to take decisions independently when the founder and those who knew them have left the scene or the circumstances for which the endowment was originally made have changed.

Some foundations don't want to cut themselves loose from their origins altogether. As we saw in chapter five, the ethos and values of a foundation - often received from a founder - can have a significant influence on the way and in

what the organisation invests and spends. The commissioning of biographies and histories of foundations represent ways foundations can continue to capture, articulate or even create a guiding personality to influence their work, even centuries after the founder has died.

7.3 FAMILY MEMBERS

Foundations' boards can often be drawn partly or exclusively from the family of the founder. A member of such a foundation observed that 'family members have a sense that, on their watch "I don't want the family silver to disappear"'.

An adviser to foundations felt that 'this can mean trustees are much too cautious when taking investment decisions.'

If the deed specifies that trustees should continue to be drawn from members of the family, it can also mean that their connection with the mission can also diminish over time.

THE WATES FOUNDATION

The Wates Foundation was set up in 1966 by the three Wates brothers, Norman, Ronald and Allan. Trustees are drawn exclusively from members of these three branches of the family and are now from the fourth generation.

Brian Wheelwright, Director of the Foundation since 2000 says, 'From across the family we have a pool of about 50 individuals who may be trustees of the

³⁷ Winding Down the Atlantic Philanthropies, The First Eight Years, 2001 – 2008, Proscio, T., Duke University, 2010, p.6.

³⁸ Permanent Endowment: What is it and when can it be spent? CSD -1347A, para. C3.10, Charity Commission, London, 2011.

7. CULTURE AND GOVERNANCE CONTINUED

charity. As a foundation we've worked hard to engage the younger generation and, increasingly, spouses'.

Decisions about grants are delegated to three Family Grants Committees made up of family members, usually chaired by a trustee. All grant applicants must have the backing of an individual family sponsor, who will have visited the organisation they wish to support. Family members are also helped to develop the skills they need to be effective trustees and grant makers, with training covering such things as how to read and understand accounts, grant-making techniques and other relevant areas such as monitoring and evaluation.

7.4 TRUSTEES

There are further ways in which the identities and circumstances of trustees can have a distinct impact on the governance of endowed foundations.

Commercial and 'lay' trustees.

Some of those who run foundations report a distinction between trustees with a commercial background and those from other walks of life. Even though such trustees may not hold themselves out as having expertise which might replace professional advice, it can be the case that they are pushed towards concentrating on investment issues, while and, for these purposes 'lay' trustees make grants decisions. This can just as easily be a product of non-financial specialists not

AN INSTINCT NOT TO LOSE THE FAMILY SILVER COULD PROMPT TRUSTEES TO EMPHASISE PRESERVATION OVER DISTRIBUTION.

wanting to get involved as being excluded. 'I just didn't understand investments and finances', observed one arts trustee, 'so I didn't want to show my ignorance.'

Separate investment and grants committees.

Even if boards take key strategic decisions as a whole, the detailed work of preparation can often be carried out in separate grants and investment committees, reducing scope for cross-fertilisation. One adviser felt that this was not necessarily a bad thing, as long as the right decisions were taken. On the other hand, it raises a risk that decisions aren't either fully scrutinised or fully owned. 'By the time the paper came to be presented at the board,' said one trustee, 'it felt too far down the process to unpick the argument and as it was within the investment committee's terms of reference to prepare recommendations, other trustees generally let them get on with it.'

The John Ellerman Foundation tackles the issue head on. Dominic Caldecott, chairman of the finance committee,

which consists of three trustees with investment and finance experience, says, 'Lay trustees attend the finance committee and are encouraged to do so. We find their presence positive and helpful, especially when we're setting annual spending policies'. Non-expert trustees can just as easily articulate the broader strategic vision of the whole organisation, and also bring a welcome 'common sense' view to sometimes tricky discussions.

Length of tenure.

Time scales for trustees' tenure can make a particular impact on foundations. One adviser observes, 'Often the time horizon of institutions is very different from that of trustees. Organisations need to consider periods of 20 – 30 years to be able to plan in a stable strategic way, but sometimes trustees, quite naturally, want to feel that they've made an impact during their usually shorter time. The problem is that if you think about whether things have succeeded or failed in five years or ten then you'll be very beholden to those, quite inappropriate, starting and ending points.'

7.5 RESILIENT STRUCTURES, COMMUNICATION AND GOVERNANCE

Whether foundations employ staff or not, there are basic tasks which need to be fulfilled.

Simon Hallett of Cambridge Associates sees getting this right as key. 'All the bases must be covered. If there's no adviser or if trustees can't do it, then someone has

to. Having a clear governance document that specifies roles and responsibilities comprehensively and rightly assigns them to people that can actually do them is very important if the foundation is to avoid a governance gap.'

Governance needs to take account of delegations made, investment and expenditure policies recorded, review procedures, and spell out the roles of investment committees, full boards, advisers and fund managers.

He continues, 'When you move away from spending the income, which is an accounting figure, you need to create spending rules and policies that can be written into governance documents that can define how much can be spent in a year so that staff and trustees are clear when taking decisions to ensure that they are consistent with that policy. There needs to be a very strong governance framework around that, and the governance structure has to be able to survive stress.'

Different approaches to investment, for example including more opportunistic asset allocations or values based or social investing, also place different demands on foundations. Trustees need to decide what is the best strategy for their organisation but also what is manageable in terms of trustee and staff resources.

7.6 REFLECTIONS

However long a foundation has been in existence and no matter how the organisation is constituted, things will go

best if it is governed in a way that allows it to focus on the key issues for managing the endowment in the best way possible to achieve its charitable objectives. In a volatile and changing environment it needs to be able to hold its nerve when necessary and adapt when it has to.

As we've seen, a number of factors and actors, other than trustees, play a role in shaping the way a foundation is governed. Does it matter?

The memory of the founder might influence the trustees' attitude to risk, against the best interests of the charitable objects.

A strong instinct not to lose the 'family silver' could prompt trustees to pursue strategies which put too great an emphasis on preservation over distribution. One way round this is to follow the example of The Wates Foundation, where trustees have a definite strategy to involve wider family members in the work of the trust in ways which help them connect with and shape the forward mission and not just the history.

On the other hand, those who endow charitable foundations have provided the means by which they exist, not only in terms of cash but also direction and inspiration. The charitable objects are a crystallisation of their concerns and, as well as being legally obliged to fulfil mission of the charity, trustees will often feel a well-placed moral obligation to the individual whose generosity has made the enterprise possible. Especially where the objects are generally drawn, it is inevitable

and proper that the attitudes and interests of the founder inform action and planning, especially when trustees are grappling with issues which need some sort of guiding principle.

The governance of foundations clearly takes place within a matrix of interests, internal and external, with a centre of gravity that shifts. Sometimes the weight is felt most strongly with expert trustees, whether in programme or financial matters or with knowledge of the donor, sometimes with family members, sometimes with staff. Sometimes it seems that those outside the trustee body exert a pull. No organisation exists without context, and clearly technical expertise and other relevant knowledge should be valued and not ignored.

Communication is also key. The worst situation is that trustees should feel unsighted when things go wrong. But communication means more than being informed: it means understanding the rationale behind and implications of decisions and actions.

The role of trustees is always to be asking themselves, 'How might we best serve our charitable objectives?' At times that simple question may provide a sharp and uncomfortable spur to thinking.

8. CONCLUSIONS

Charitable foundations enjoy a remarkable degree of independence. Unlike most other charities, foundations operate free from accountability to funders for their activity. Unlike pension funds they invest free from a regulatory framework that lays down specific, forward financial objectives and conditions.

This freedom can be a gift, or a responsibility as great as the endowment itself. It also brings its own risk. The core legal duties, fiduciary obligations, originate in the intention to protect the asset from trustees who might act carelessly or in their own interest rather than in that of the beneficiaries. Is there another risk? That foundations are not taking full advantage of the freedom they have?

As a sector, even a small increase in their investment returns and consequent spending could make a significant impact.

Could foundations be more ambitious?

8.1 FOUNDATIONS

Being clear about the interests of the charitable objects.

Foundations often see themselves as being around for the long-term, but longevity should not be a goal in itself. Charitable mission must always trump the maintenance of the organisation. Having a

clear sense of the charitable aims and the interests of those intended to benefit from the endowment can help foundations take bolder decisions.

Thinking through attitudes to preservation and spending.

Often the aim of preserving the real value of the capital acts as a sort of proxy for fulfilling a foundation's obligations to future generations. However, the obligation is always to do what is right in terms of fulfilling the mission. At times that could mean spending more, at other times it may mean cutting back. And in some cases it could mean allowing the value of the endowment to reduce over time if trustees have that freedom. It all depends on what is best for the aims of the charity. Foundations will operate better if they have a clear sense of direction, even if it changes, rather than operating blindly or on the basis of assumption.

Taking a more distinctive attitude to risk for greater return.

Foundations make investments in an environment naturally geared to the

needs of pension funds. Products and benchmarks aim to provide a security of return in relation to known future liabilities. Pension fund investors should be cautious. However, if trustees feel a strong moral obligation to future as well as current generations, they could still have more room for manoeuvre. Even if they wish to maintain stable spending, foundations can potentially take greater risks to make greater long-term returns without behaving imprudently.

Using the whole balance sheet.

Having a sense of the values and aims inherent in a charitable mission and understanding how they might apply to expenditure and investments could suggest a wider set of tools than grant-making alone. Applied to their whole activity, foundations have the potential to become influential partners and change agents in civil society, using their reputation and human capital as well as their endowment to achieve their aims.

Understanding the long-term.

Foundations, if they are to take more risks for potentially greater rewards, will want to think about broad goals in the long-term – in cycles of 20 or 30 years. Governance structures which encourage short-term planning and reactive decision-making can mean that beneficiaries lose out and the temporary losses get locked in. Having a policy that clearly identifies and tackles all the factors relevant to a foundation's purposes, and understanding the impact of different timescales, will help those who run it to review and adapt their strategy regularly without being blown off course.

THE ROLE OF TRUSTEES IS ALWAYS TO BE ASKING THEMSELVES 'WHAT WILL BEST SERVE OUR CHARITABLE OBJECTIVES?'

Getting governance right.

Those who govern foundations may find themselves balancing the intention of the donor with the interests of current and future beneficiaries. This matrix of interests creates a tension which will play out in different ways for each foundation. For this to be creative structures need to be resilient, inclusive of different views as well as technical expertise and take spending aims into account when devising investment strategies.

8.2 ADVISERS

Foundations have distinctive needs, but make up a small part of the overall investor market. Firms with specialist charitable teams have expertise many foundations need, but there is a danger that their needs and aims may not be clearly transmitted. Annual benchmarks may work against long-term strategy. Foundations can do more to clarify their aims before they seek advice, and advisers can think more widely about the options available.

Advice, which comes from multiple sources, often focuses on the asset, whereas trustees will want to think about the whole mission. Trustees are interested in spending as much as they can; advice often focuses more on preservation. There may be a gap in the market for foundations to receive support in determining their whole approach to achieving their mission so that operational policies around investment and expenditure are made within a strategic context rather than separately.

FIDUCIARY
OBLIGATIONS
ORIGINATE TO
PROTECT THE ASSET
FROM TRUSTEES
WHO MIGHT ACT
CARELESSLY. IS THERE
ANOTHER RISK?
THAT FOUNDATIONS
ARE NOT TAKING
FULL ADVANTAGE
OF THE FREEDOM
THEY HAVE?

Expert opinion should be taken as advice and not interpreted as instruction. Trustees, as fiduciaries, are the ultimate decision makers.

8.3 UMBRELLA BODIES AND REGULATORS

Foundations in England and Wales are regulated by the Charity Commission, but in number they make up a small percentage of registered charities. With their distinctive needs, and diversity of activities and approaches, resources and frameworks generated from within and supported by the sector itself could offer a proportionate way to share good and developing practice

in governance and financial management.

This is an area where umbrella bodies – working in collaboration with the Charity Commission – could help.

8.4 FUTURE Research

This report aims to provide some initial perspectives and orientation points in largely unmapped territory. Further evidence and action research is needed to help produce the sort of resources needed to help foundations work more effectively and make and spend more money. For example, more information about the impact that size and type of charitable objectives makes can help shape shared performance frameworks and measures, diagnostic tools and other advice.

International

This report has focused on foundations in England and Wales. Many of the findings will be applicable to foundations working in Northern Ireland and Scotland, but those findings will need to be tested and adapted in those different legal, social and economic environments.

More widely, many foundations support work outside the United Kingdom, and UK philanthropy sits within a wider context where foundations may operate within very different international civil society contexts. More research would yield valuable lessons from other countries, for example the United States of America, or support more shared action.

8. CONCLUSIONS

CONTINUED

Economic challenges

The publication of this report comes at a time of ongoing stress in the global economy. The lessons and perspectives should hold good for the long-term. But foundations will come under increasing internal and external pressure to increase funding and therefore returns. More research and learning into how they might respond to those pressures will be of interest not just to those who run foundations but to other civil society organisations, policy makers and philanthropists.

8.5 GOVERNANCE: THE DIFFERENCE BETWEEN FAILURE AND SUCCESS

At the beginning, we asked the question, in governance terms, what might constitute failure for an endowed charitable foundation?

The different voices and experiences gathered in the previous chapters suggest some perhaps unexpected perspectives. Failure doesn't necessarily mean falling short of annual investment benchmarks. Not preserving the value of the endowment doesn't mean failure if the social needs for which the endowment was created demand it: at times that may mean spending more today and less tomorrow or even allowing the value of the endowment to reduce over time if trustees have that freedom. And failure doesn't mean following a specific path or model of success. As one member of staff put it, 'Once you've seen one foundation, you've seen one foundation.'

With such diversity within such an admittedly small sector is it possible to provide a single answer? How can foundations, as fiduciaries, be judged to have failed? In the absence of any single objective measure, one chair of an investment committee provided a succinct and credible, yet provocative answer. 'It's the failure to think.' What does thinking mean?

Fiduciary obligations require trustees to act in the best interests of the charitable objects. Sometimes however what foundations decide may be shaped by a misapprehension about what the law requires or prevents them from doing, by advice which focuses on only one part of the equation, a founder's memory or internal culture and structures which prevent them from viewing their activity as a whole.

Being thoughtful means trustees taking a more intentional approach to their obligations considering and understanding all the options available.

Law and regulation on investments has become more permissive and foundations may still be catching up. Taking a more thoughtful approach to their obligations could enable foundations, over time, to make and spend more money as well as use what they have more imaginatively for current and future generations.

WHAT MIGHT
CONSTITUTE FAILURE
FOR AN ENDOWED
CHARITABLE
FOUNDATION?
IT DOESN'T MEAN
FALLING SHORT
OF ANNUAL
INVESTMENT
BENCHMARKS.
IT'S THE FAILURE
TO THINK.

QUESTIONS FOR FOUNDATIONS

PART ONE

- How confident is your understanding of the legal framework in which charitable foundations function, especially the twin duties of prudence and loyalty?
- How does your governing document restrict your use of the asset, if at all?
- Do you have a clear sense of who your beneficiaries are? What difference does it make to your sense of what the endowment can achieve, and how quickly?

PART TWO

- When you consider making an investment what do you want it to do? What are the consequences of getting those judgements wrong? What are the consequences of getting those judgements right?
- Do all trustees know and understand the consequences of your approach to investing and spending in terms of the impact on current and future generations of beneficiaries?
- Do you wish to grow, maintain or spend out your endowment (after taking account of inflation)? How do you measure this, and what is the rationale for your decision?
- What are the values underpinning your charitable aims? What are the implications of those values for the way you use the whole balance sheet in terms of investment, expenditure, human capital and reputation?

PART THREE

- In what way are your decisions intentional rather than cultural?
- How might you benefit from support in developing an overall strategy for how you use your asset to serve your beneficiaries? Do you currently explain this understanding to those who provide advice?
- What mechanisms do the trustee board and committees use to support (or inhibit) good long-term decision-making. Are they good enough? How do you use advice?
- Can your foundation be more ambitious in view of the freedom it has to promote its charitable objects?

SELECTED FURTHER READING

ANALYSIS, TRENDS AND DATA

Endowment Asset Management: Investment Strategies in Oxford and Cambridge

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Family Foundation Giving Trends (Series, fourth publication 2011)

Pharoah, C., with Keidan, C., Gordon J. London, Centre for Charitable Giving and Philanthropy and Alliance Publishing Trust

The UK Civil Society Almanac – 11th edition

NCVO, London, 2012

FIDUCIARY OBLIGATIONS

Protecting Our Best Interests: Rediscovering Fiduciary Obligation

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SPEND OUT

Spending out: learning lessons from time-limited grant-making

Association of Charitable Foundations, London, 2010

Giving our all: reflections of a spend out charity

The Tubney Charitable Trust, 2012

DIFFERENT APPROACHES TO PHILANTHROPY

Creative Philanthropy

Anheier, Helmut K., and Leat, D. London, Routledge, 2006.

Philanthropy's new passing gear: Mission-Related Investing, A policy and implementation Guide for Foundation Trustees

Rockefeller Philanthropy Advisers, 2008.

GUIDANCE (CHARITY COMMISSION FOR ENGLAND AND WALES)

CC14 Investment of Charitable Funds: Basic Principles

Permanent Endowment: What is it and when can it be spent? CSD-1347A

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