

Treasury Trends

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Long-term Endowment Investment Funds – Distributions, Reserving Policies and Portfolio Construction

Introduction

Long-term endowment funds exist to provide benefit to current and future stakeholders, usually with the objective of doing so in a relatively equitable manner, through balancing portfolio growth and regular distributions to stakeholders.

A key tenet is ideally relative stability and predictability in distributions so that the stakeholders can apply these to the ultimate beneficiaries with a higher degree of certainty over a forward period.

Examples of this may include:

1. council contributions to infrastructure spending and/or minimising rates increases to rate payers and/or
2. abilities of funds to consistently make charitable distributions to those in need.

The concept of 'Investment Reserves held on the balance sheet' within an endowment fund assists sustainability of distributions through periods of poor market returns on the invested assets. A period of good 'or excess' returns over and above targeted distributions in prior years, rather than all being paid out, can be partially carried over to apply to future payments/distributions during a period of future poor, or negative returns. The Reserves having the effect of smoothing the payments over future periods consistent with the concept of inter-generational equity.

Types of Distributions Policies

Different types of distributions policies that funds may adopt to provide rules, guidelines and principles around disbursements can include the following:

- X% nominal distribution – paying out a certain percentage of the total (average) assets invested each year – which is a transparent, easy to understand and simple to communicate approach
- Paying a smaller proportion (e.g. half of X%) plus the rate of (average) CPI or OCR, i.e. also simple to understand and communicate and partially linked to a relevant measure such as either consumer prices or interest rates

Key Points

- Long-term endowments funds exist to provide relatively stable and predictable distributions to beneficiaries on an ongoing basis
- Distribution policies provide rules for how returns / income streams from the invested assets are paid out to beneficiaries, whilst also preserving the real capital of the fund for future generations
- Reserving policies provide rules around some excess returns being 'held over as invested reserves on the balance sheet' to meet distributions in a year(s) of poor returns performance
- The invested assets portfolio may be strategically constructed to assist these objectives on a probability-based approach, informed by quantitative modelling techniques.

- Pass through of investment earnings (such as dividends, interest received, capital gains) – however these may not be very stable and may also work against growing the real capital of the fund.
- Formal agreement with stakeholders as to the expected/required level of distributions over a future period, and which may only be reviewed in exceptional circumstances.

It would usually be preferable to base calculations on average asset values or average CPI/OCR (where relevant) etc, as this smooths out any spikes/outliers in the historical data.

A key and perhaps unsurprising concept is the distribution policy adopted should be very transparent so that all stakeholders can have clarity around the calculation of the distribution.

Note this may not be the same as having perfect clarity or certainty on the actual size of the regular distribution – particularly in the 'outer years' – as this will often be influenced by the actual level of market-based returns of the fund's invested assets.

Reserving Policies

Calculations behind the reserving policy should be such that the reserves can withstand at least an intermediate period of poor



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returns, whilst still being able to meet the regular and relatively stable distributions being made. One way to calculate the required reserves is to determine the 'value at risk' of negative returns eroding the fund over a certain forward period and at a certain probability (worst case) threshold across the portfolio. The sizing of the reserve amount should ensure that distributions can continue to be made across a period of poor/negative returns so as not to disrupt or compromise the planned use of those distributed funds.

Whilst the reserves held on the balance sheet (or excess returns not paid out) may be leaned on by the fund to make distributions, these reserves are not in of themselves held in any specific 'liquid' assets or pool of assets. Rather, these will be invested/held across the portfolio in line with the SIPO (Statement of Investment Policy and Objectives) targets, i.e. invested fully across the actual portfolio.

The Reserves are a nominal allocation rather than a specific portfolio 'ring-fenced' into lower risk /lower returning assets that may otherwise not fit within the objectives of the fund, such as growth and returns.

Portfolio Construction and Quantitative Modelling

The nature and strategic allocation of the assets making up the invested portfolio, if constructed in an appropriate manner, should be able to equally support:

1. meeting the distributions required by stakeholders,
2. sufficiently sized invested reserves that can be leaned on, and
3. satisfying portfolio growth and/or real capital preservation objectives of the fund.

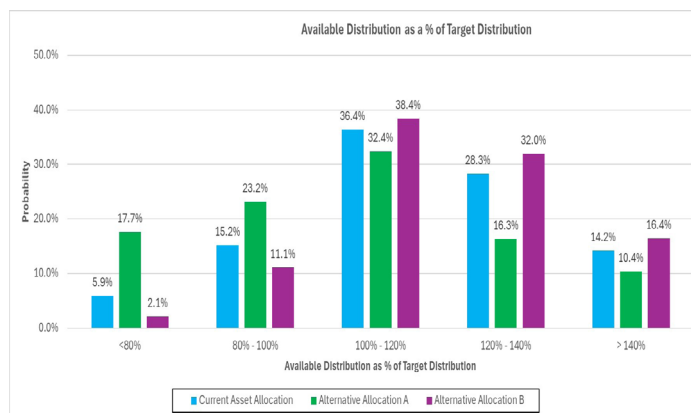
Quantitative modelling techniques can be used to test:

1. a range of different portfolio strategic assets allocations,
2. different policies around distributions and reserves, and
3. alternative market environments /performance of assets.

Outputs of the modelling can be measured against the criteria of stable and relatively predictable distributions, while also preserving and growing the real capital of the fund for future generations.

These modelling techniques may be based on different constructed or 'deterministic' scenarios as well as random Monte Carlo or 'stochastic' scenarios.

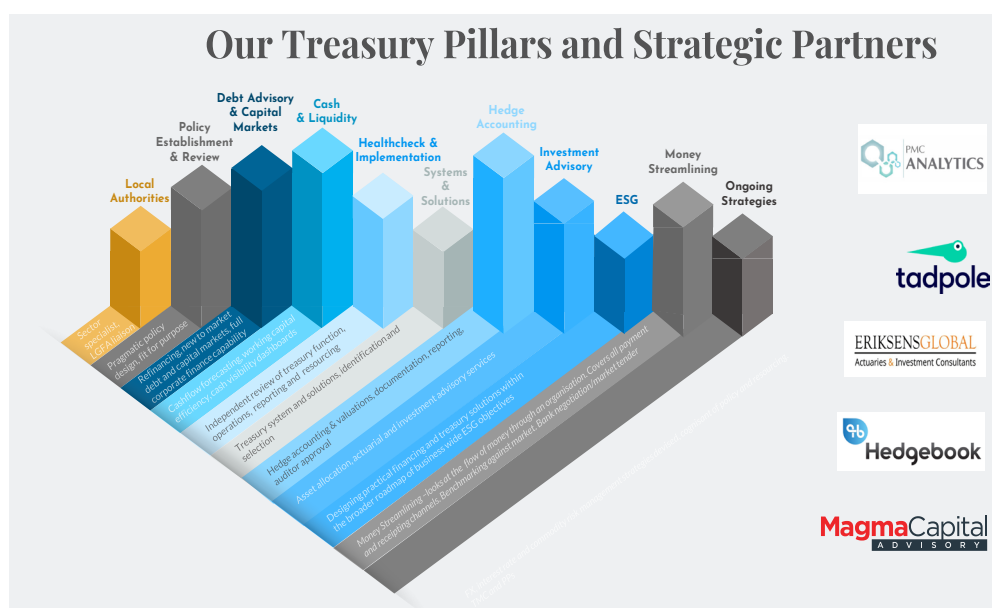
Hypothetical outputs of a modelling exercise could be viewed or presented such as the following:



Bancorp Group, along with our Investment Consulting partners EriksensGlobal are active in advising funds in these matters including the quantitative modelling.

We would be happy to have an introductory conversation should it be of interest to you.

WHAT WE DO



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