COVID-19 AND INVESTMENT RETURNS

Implications for Philanthropy and NFPs

Perpetual

Our locked-down world has helped to shine a light on the fragility of many things. High among them is the vulnerable nature of the revenue streams of many non-profit organisations on which our communities desperately rely in difficult times.

Community organisations are unique during times of economic crisis; as demand for their services increases, many face a scenario where their revenues track downward. Where philanthropic dollars might typically be seen as a core response to a crisis, trustees of foundations will be facing into their own unique set of challenges in the coming years.

Perpetual's Philanthropy team has the privileged role of spending time in rooms with some of Australia's most thoughtful philanthropists as they tackle many of our most pressing health, social and environmental challenges. Those conversations focus on approaches to philanthropy and social investment and are underpinned by the stewardship and growth in funds to be applied for purpose.

This paper aims to provide an analysis of the likely impact of COVID-19 on philanthropy, both as it pertains to the dollars available in the coming years and on the behaviours we are witnessing from philanthropists as they navigate through this period of uncertainty. Using a mix of currently available data on giving and giving practices, as well as commentary from families looking to give effectively, we hope this paper provides some support and insight for not-for-profit (NFP) Boards, leaders and vital fundraising professionals at this difficult time.

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Not all foundations are created equal

When considering the impact of COVID-19 on future funding availability in philanthropy there are several considerations. The most important is understanding that not all philanthropic foundations are structured in the same way.

There are typically three kinds of structures used to support philanthropic giving in Australia.

1. **Private Ancillary Funds** (PAFs)
2. **Public Ancillary Funds** (including community foundations, sub-accounts or endowments) (PuAFs)
3. **Private Charitable Trusts** (PCTs)

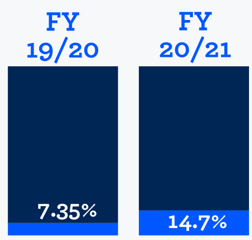
To understand the impact of market volatility on philanthropy, it's important to first understand the unique form of distribution requirements for the three charitable trust structures that are set by legislation and by governing documents.

Once we understand the structures we can, to a general extent, understand how market-related returns and volatility may impact current and future funding from each.

For PAFs and PuAFs, there is a mandatory distribution requirement which is the *minimum* funding amount the trust must distribute each financial year. This means that the trustee(s) have discretionary capacity to do more should they wish. It should be noted that distributions from PAFs and PuAFs can only be made to deductible gift recipients with Item 1 status. For some PCTs, there can be more flexibility regarding beneficiaries, but restrictions within the trust deed may limit the trustee's ability for increasing distributions, and could provide the trustee with capacity to pull back its distributions entirely for a given period.

We can see this difference in granting level requirements play out in Philanthropy Australia's May 2020 survey of its members[1], who are not homogenous in foundation type.

The 100-plus respondents to the survey indicated that in FY19/20 only **7.35%** of respondents *planned* to reduce their giving in response to COVID-19. In FY20/21 this figure of *planned* reduction increased to **14.7%.**



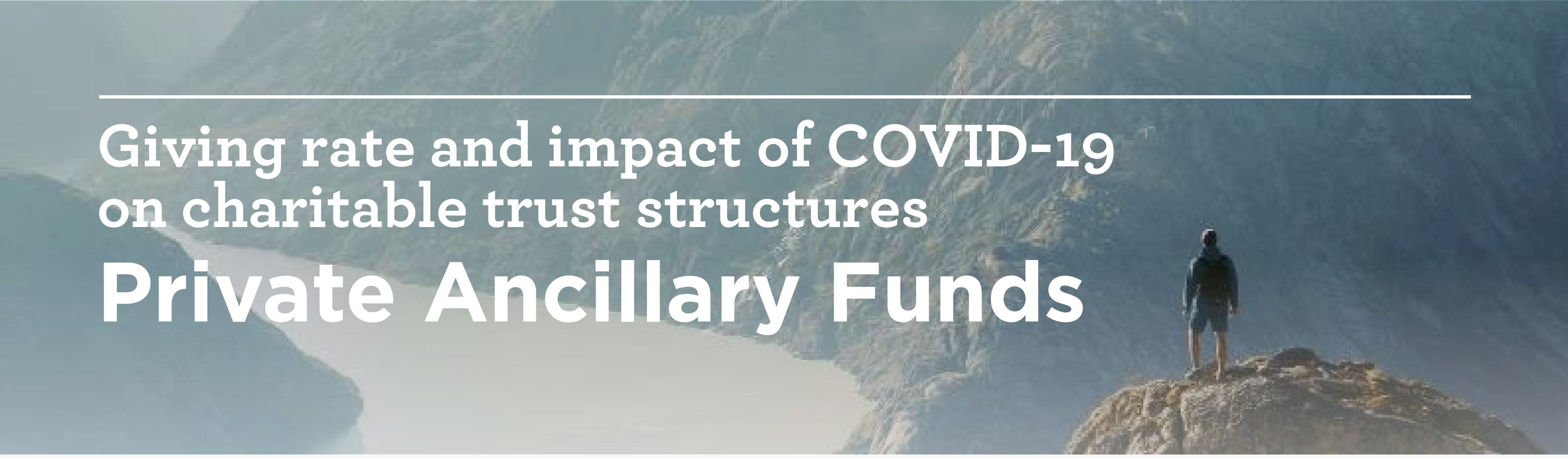
The difference between *planned* reduction and *forced* reduction, however, becomes evident when nearly 33% of respondents to the survey indicated that the impact of market volatility on their investment portfolios would see a forced reduction in giving.

Encouragingly, however, more than 50% of respondents indicated that, while their corpus has taken a hit, they would be maintaining their current giving levels.

So why do we see the impact of the markets come into play for some and not for others? Is it simply that some funders are willing to do more during this crisis and others are not? In short, the answer is both no and yes.

The key to anticipating what this crisis will mean for the 2021 financial year and beyond lies in understanding the relationship between investment value, income, discretionary capability and distributions requirements.

[1] Philanthropy Australia, May 2020, *Grant-Maker Survey Response to C19 May 2020*, https://www.philanthropy.org.au/images/site/news/2020/GrantMaking_survey_C19_25_May_2020_v2.pdf



Giving rate and impact of COVID-19 on charitable trust structures

Private Ancillary Funds

Private Ancillary Funds

Private Ancillary Funds (PAFs) have a mandatory annual distribution rate of 5% of the value of the fund at the previous 30 June. This was originally established so that funds could broadly rely on dividend income to fund distributions, leaving capital intact to grow over time.

Under current conditions, however, investment managers are anticipating a meaningful reduction in dividends from their portfolios – Perpetual's research team calculates that average dividend distributions from core ASX100, ASX300 and Responsible Investment portfolios were down by just over 31% in the year to 30 June 2020. The good news, however, is that the team currently anticipates some recovery in dividends in the year to June 2021, although not quite back to levels of FY2019.

The table below shows these estimates in dollar terms, based on a sample A$1 million portfolio for our Core ASX100 portfolio, as an example. The outcomes from our other portfolios were very similar.

Bear in mind that dividends are not the only source of income in a diversified portfolio, but given that low interest rates have driven interest income down, and that most charitable portfolios have a growth bias, the bulk of income for distribution from a trust is likely to depend on dividends.

Lower dividend payments will have two effects – firstly they will have reduced the likely flow of payouts from the NFP's own investments to its operations (and possibly those valuable franking credits).

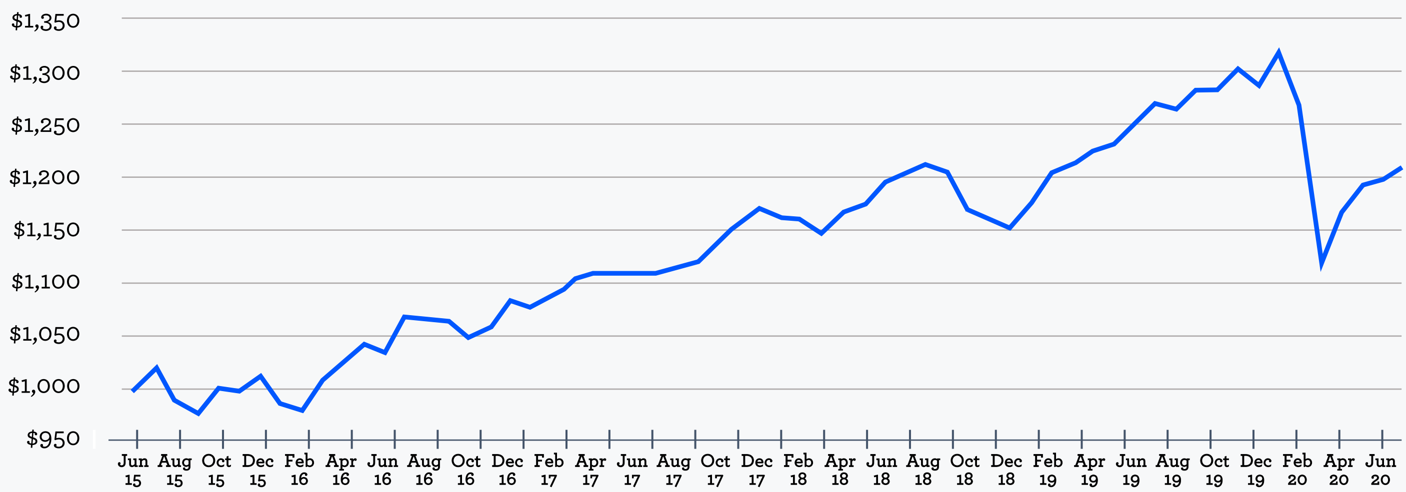
Secondly, trustees of PAFs will need to decide how to manage distributions to their favoured beneficiaries in FY2021. As the 5% rate must at least be maintained, reduced dividend income may mean the trustee(s) will have to distribute from capital. Without further donations into the PAF, distributions to beneficiaries from capital today may ultimately have an impact on future distributions, as the mandatory rate will be based on a reduced capital value.

As it happens, a review of Perpetual's charitable trust investments shows considerable recovery from late-March 2020 to the end of June 2020. Our key charitable trust investment strategy saw a reduction in value of less than 5% from June 2019 to June 2020. Although PAFs across Australia are not invested in exactly the same way, most are likely to be following some form of Balanced to Growth asset allocation.

Model portfolio	FY19 Dividend Income	FY20 Dividend Income	Change relative to FY19	FY21 Dividend Income forecast	Change relative to FY19	Change relative to FY20
Core ASX100	A$45,766	A$31,494	-31.2%	A$37,212	-18.7%	18.2%

Source: Perpetual Private. Adjustments have been made to remove the impact of special dividends paid by BHP, Wesfarmers and Flight Centre.

Perpetual Charitable and Community Investor Fund (PCCIF) growth of $1,000



Source: Perpetual Private, July 2020

To help illustrate the impact of market volatility and reduced income on PAFs, here is a worked example.

If we think about a Private Ancillary Fund that was worth **A$1 million** as at 30 June 2019, then its minimum distribution amount in the year to June 2020 would have been **A$50,000.** From our table on the previous page (and assuming FY19 dividends are received in FY20), **A$45,766** of this would have been met from dividend income (ASX100 model). Some drawdown on capital would be required to meet the minimum distribution, but this would depend on how capital was distributed through the year.

Now by June 2020, the capital value of the PAF could have dropped by up to 5%, to **A$950,000** in our example, given the sharp reaction to COVID-19 in the early part of 2020. This would have been even worse if measured in March, but the markets showed some recovery in the subsequent quarter. Therefore, the required distribution in FY2021 would drop from **A$50,000** to **A$47,500.**

From our table on the previous page, dividends in FY2020 are estimated to have dropped to **A$31,494.** So to meet the minimum **A$47,500** (5%) distribution, the PAF will be distributing **A$16,000** from capital, further reducing the value of the PAF – which starts a snowball effect when it comes to receipts by NFPs, until markets recover.

Extending this to FY2021 (bearing in mind that timing differences in receipts and payments will impact on the calculations), the PAF will have reduced in value to **A$934,000** just from capital drawdown (and assuming no market movements), so the forward distribution requirement is **A$46,700,** against dividend estimates for FY2021 of **A$37,212.**

The chart above shows the track record of one of Perpetual's charitable funds (Perpetual Charitable and Community Investor Fund) over the past few years, and the effect of the sharp drawdown in March, subsequent to the June quarter recovery. The growth bias of this fund has built capital over time, and should allow patient trustees to be able to balance fluctuating dividend income and capital growth when considering distributions.

Most PAFs have a perpetual investment horizon and this does impact the investment approach trustees should consider. Perpetual takes a long-term view in its investment advice and generally seeks to maintain exposures to financial markets, in order to avoid the impact of short-term, knee-jerk reactions. This allows investors to mitigate the immediate effects of a downturn such as we had in March 2020.

Recommendation for NFPs:
If a significant proportion of your trust and foundation funding comes from PAFs, it is very important to understand the likely medium-term impact of distribution provisions. If the founder(s) is still actively making donations into their PAF, some of the impact may be mitigated.

Conversations with those key donors and strong relationships become critical.

Giving rate and impact of COVID-19 on charitable trust structures

Public Ancillary Funds

Like PAFs, Public Ancillary Funds (PuAFs) and the sub-accounts or endowments that sit within them have a mandatory distribution rate calculated on net assets of 30 June the prior year. The primary difference is that the PuAF distribution rate is 4% rather than 5% for PAFs. Using a pooled investment strategy, those accounts are all likely to see the same impact from markets within a single structure.

The PuAF structure tends to be used by community foundations and other philanthropic service providers as an alternative to a PAF structure. A benefit of these structures in philanthropy is that philanthropists can set up a sub-account with smaller donor amounts than is practical for a PAF. These accounts can nevertheless be utilised by significant donors and as key philanthropic structures for Estates. They are growing in popularity compared to PAFs due to the fact that the donor is less likely to be bogged down in the compliance obligations of a PAF, as there tends to be a single trustee for all the accounts, as illustrated in the diagram below.

Typical Public Ancillary Fund structure

TRUSTEE

Assets

☐ ☐ ☐ **Donor accounts** ☐ ☐ ☐

4% of net assets

⬇

Annual distributions to charity

Deductible Gift Recipient (DGR) 1 Charity	Non-charitable DGR1s

The 4% minimum distribution rate applies across the entire PuAF, not the individual sub-accounts that sit within the structure. That said, many PuAF trustees simplify the process for their donors by encouraging giving at a 4% rate at a sub-account level.

Like a PAF, the market impact will depend on the investment strategy implemented across the PuAF. Similarly, the dollar amount of distribution for future years will be impacted by the expected reduction in dividend receipts, like in our example, though overall the 4% requirement will mean less pressure on capital than that faced by PAFs.

Recipients of funding from PuAFs are likely to be somewhat better off over time than recipients of PAF funding, assuming distributions are kept to the minimum requirement of 4%.

While the capital erosion is likely to be evident, at the end of the day these accounts are still distributing at a reduced level compared with PAFs. A potential short-term trend for people looking to establish a philanthropic structure may be to preference a PuAF sub-account and its lower distribution rate over the higher distribution rate and compliance costs of a PAF.

Recommendation for NFPs:
Create strong working relationships with PuAF managers to understand how to connect with their donors. In the event that a PuAF becomes the preferred philanthropic vehicle, these relationships and processes for applying for support will become even more critical.

Giving rate and impact of COVID-19 on charitable trust structures

Private Charitable Trusts

There is no minimum distribution requirement for Private Charitable Trusts (PCTs), rather all of these trusts are essentially bespoke in that their objectives are determined by the Will or Trust Deed under which they are established. These trusts were the standard vehicle for philanthropic foundations prior to the establishment of PuAFs and PAFs into legislation in Australia in the 1960s and 2000s respectively. The earliest of these trusts were established pre-Federation in Australia, meaning families and individuals have been setting up and growing these structures for more than 135 years. So while there is much talk of PAFs and PuAFs as the preferred tool of today's philanthropists, the foundation sector in this country is still, by weight of numbers, tipped towards PCT structures.

More than half of the charitable trusts and endowments managed by Perpetual are PCTs. A review of charitable structures in Australia estimates a similar percentage are PCTs[2]. In short, it's vital to understand the impact of COVID-19 and subsequent market volatility on these structures.

Furthermore, these structures tend to be used by families and via Estates to provide ongoing income to named beneficiaries. Their historic nature and numbers mean they provide significant funds to many well-established charities in Australia through recurrent income. It is therefore more likely that where a charity in this country is the named beneficiary of ongoing income support from a charitable foundation, it is coming from a PCT.

A common form of distribution arrangement within the deed of a PCT is that capital is restricted and only income can be distributed to beneficiaries. In those instances, there is an expectation from the regulator that the majority of income is distributed every year. For most trustees of these foundation types, simply distributing all net income is the best way to deal with the vagaries of language such as 'majority'.

Where they are capital restricted (ie. cannot access any of the capital), and unlike PAFs and PuAFs where investors can look holistically at the total return of their portfolio to fund distributions, trustees of PCTs are often limited to paying out from income only. In an extremely low-income environment, such as the one that we're experiencing now, this can have a significant impact on the distribution of funds from these trusts and the revenue source of the NFP sector.

Drawing on the numbers that we indicated in our PAF example, a **A$1 million** PCT as at 30 June 2019 that distributed close to **A$50,000** in FY 2020, might be distributing as little as **A$37,212** in FY2021 – more than a 25% reduction, depending on the investment strategy of the trust.

By weighting to a higher risk category of income generating assets, such as hybrids or equities, to offset the low-income environment, trustee(s) may increase the risk profile and affect longer-term returns. This is a delicate dance that trustees play as they marry up portfolio construction with the needs of beneficiaries today and the needs of the beneficiaries of the future. Intergenerational equity is a key consideration.

Importantly, PCTs can in some circumstances withhold distributions in any one year to increase the level of distributions available in future years. In those instances, the trustee(s) nevertheless need to maintain their charitable intent in the medium term and demonstrate that not distributing is in the best interests of the trust and its beneficiaries in order to retain their status (ie. they cannot simply hoard the funds).

[2] Perpetual analysis, conducted in September 2020, based on charitable structures registered with the Australian Charities and Not-for-profits Commission (using most recent data available – 2018)

There is a very real chance that this situation will play out over the coming years, especially for those PCTs that are funding scholarships and awards (ie. to maintain the value of the award the trustee may need to accumulate income for more than one year).

Recommendation for NFPs:
The steady decline in interest rates that started after the GFC in 2008, and which has brought Australian interest rates to all-time lows and some international rates into almost inconceivable negative territory, is distorting financial markets. The impact on interest-bearing investments has been extreme, and investors have been chasing higher-risk investments that may not be appropriate for charitable investment funds. Prudence and a long-term strategy are critical for both trustees and beneficiaries at this time.

For not-for-profit funding recipients, the changes in financial markets mean that fundraisers will be faced with additional challenges as the role of investment income in earnings and in NFP receipts is reduced in the medium-term. It is therefore vital that charities that are income beneficiaries of PCTs are aware of, and are planning for, a reduction in income. Fundraising teams should spend some time examining the deeds of key prospect PCTs via the Australian Charities and Not-for-profits Commission website to establish whether they are capital restricted.

Non-capital restricted private charitable trusts

In the instance where a PCT is not capital restricted, the trustee(s) have an extra tool in the kit bag. They have the flexibility of looking at a total return approach to their distribution in any one year or can take an income *plus* approach to their giving. In each of those instances, the trustees will themselves be staring into volatile markets and making a commitment in most instances to taking a long-term view to the investments of the trust.

Recommendation for NFPs:
The recommendation to NFPs where they are income beneficiaries from non-capital restricted PCTs is to ensure you can develop a strong working relationship with the trustee that enables open conversations regarding short, medium and long-term needs.

In the room – The philanthropic response to COVID-19 and community need

Throughout the course of this year Perpetual's Philanthropy team has been in the trenches with our clients, both philanthropic and non-profit, as they have determined the right funding mechanisms and approaches to address what has been an unprecedented year for communities. During that period, we've had devastating bushfires, loss of ecology, livelihoods and homes and then the double-whammy of a global pandemic. This section of the paper aims to shed some light on the conversations and considerations taking place in the room with philanthropists. We hope this assists NFPs in conversations with philanthropists as we move through this challenging funding period.

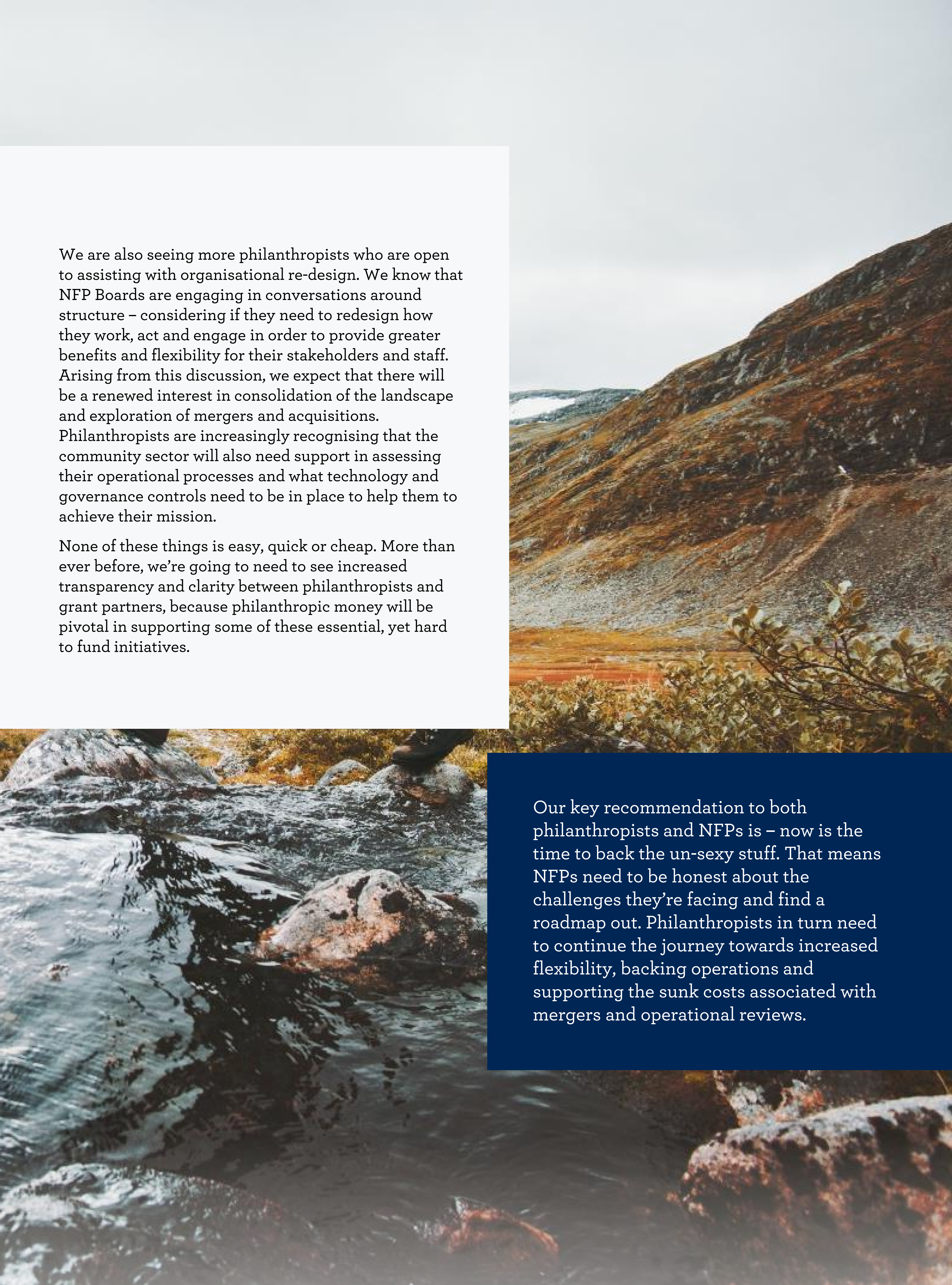
Evolving conversations

We found over the Australian summer when families were spending physical time together, that conversations were being had across the dining room table on the bushfires and the important topic of climate change. Like many Australians, the philanthropists that we work with donated funds to a variety of different causes – many of which they had not engaged with previously. Some of these funds were distributed via their PCT, PAF or PuAF sub-account, but many also donated outside of their structure in a responsive and direct way.

The immediacy of need stemming from the bushfire crisis, with families displaced and businesses ruined, was in many ways a catalyst for a relationship shift between philanthropists and community organisations. Instead of having detailed oversight and involvement in how funds would be utilised, highly engaged donors needed to trust organisations on the frontline to determine how the funds would be best spent. This flexibility and responsiveness has extended through the COVID-19 crisis. There's a greater appreciation that not-for-profits are at the coalface and are experts in understanding the response needed to deal to complex societal issues.

There was also much publicity within philanthropic circles regarding the approach taken by MacKenzie Scott (formerly married to Jeff Bezos) to her philanthropy this year. Announced via her blog, Scott indicated that she would be distributing more than US$1.7billion to organisations that are primarily run by leaders with lived experience of the issues that they are working to solve. She also committed to giving, where possible, her donations upfront and unrestricted in order to provide the maximum flexibility. She announced that there would be little by way of required reporting, instead she committed to investing in organisations that were positioned for impact.

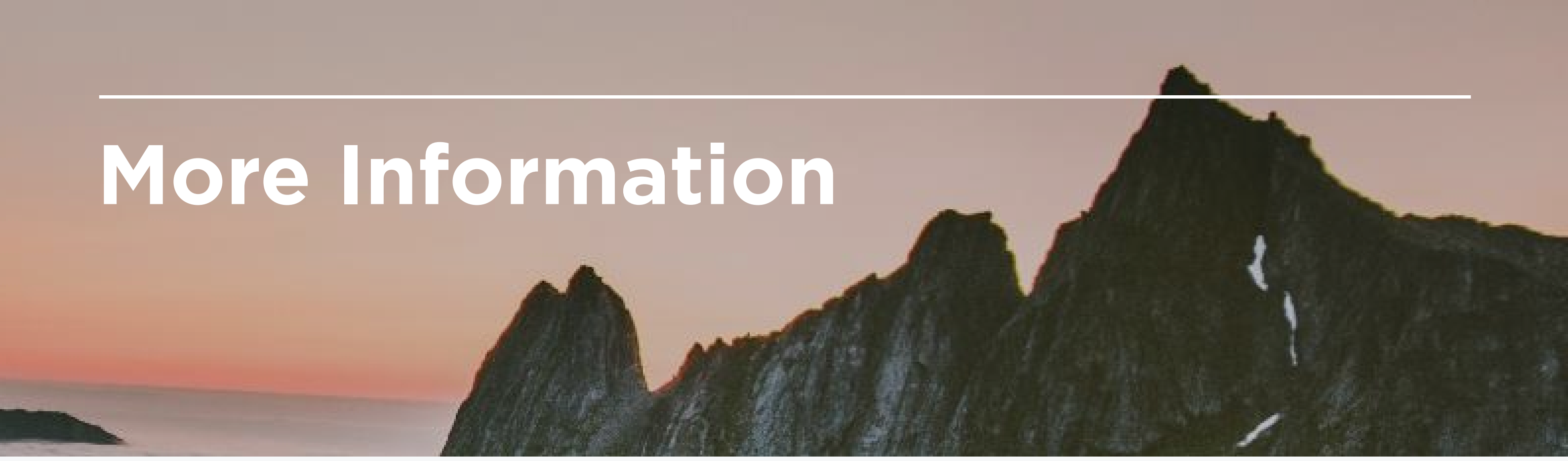
While the funds Scott has at her disposal are on an incredible scale, the formula that she has followed is consistent with how many Australian philanthropists have responded in the last year and how we see them increasingly engaging with grant partners in the future. This approach, of finding quality organisations and backing them with flexibility, is a philanthropic philosophy we espouse wholeheartedly with the individuals and families we work with.



We are also seeing more philanthropists who are open to assisting with organisational re-design. We know that NFP Boards are engaging in conversations around structure – considering if they need to redesign how they work, act and engage in order to provide greater benefits and flexibility for their stakeholders and staff. Arising from this discussion, we expect that there will be a renewed interest in consolidation of the landscape and exploration of mergers and acquisitions. Philanthropists are increasingly recognising that the community sector will also need support in assessing their operational processes and what technology and governance controls need to be in place to help them to achieve their mission.

None of these things is easy, quick or cheap. More than ever before, we're going to need to see increased transparency and clarity between philanthropists and grant partners, because philanthropic money will be pivotal in supporting some of these essential, yet hard to fund initiatives.

Our key recommendation to both philanthropists and NFPs is – now is the time to back the un-sexy stuff. That means NFPs need to be honest about the challenges they're facing and find a roadmap out. Philanthropists in turn need to continue the journey towards increased flexibility, backing operations and supporting the sunk costs associated with mergers and operational reviews.



More Information

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About Perpetual

Perpetual is one of Australia's largest managers of philanthropic funds, managing $2.9 billion in charitable funds as trustee for over 1,000 charitable trusts and endowments (as at 30 June 2020). In the 2020 financial year we distributed more than $100 million to not-for-profit organisations on behalf of our clients.

We provide individuals and families with advice on establishing charitable foundations and structured giving programs and also assist charities and not-for-profits with financial governance, investment advice and management. As an experienced trustee and wealth manager of charitable funds we understand the ongoing needs and challenges facing both philanthropists and not-for-profit organisations. When it comes to advice, investment management and trust establishment, our team of specialists offers a partnership with tailored advice and strategies designed to meet the unique needs of not-for-profit organisations and donors alike.

Contact us

To find out how Perpetual can help your organisation navigate through periods of uncertainty, contact our contributors above, email **philanthropy@perpetual.com.au** or call **1800 501 227.**

www.perpetual.com.au/nfp