RBC Global Asset Management

Impact investing and donor-advised funds

Extending your philanthropic dollars

Executive summary

A donor-advised fund is a charitable giving vehicle administered by a public charity created to manage charitable donations on behalf of organizations, families, or individuals.

The nation's array of community foundations and donor-advised funds do important work in advancing the needs of the communities they serve. Through their grant making, community foundations and donor-advised funds have helped serve the non-profit organizations that serve their communities. Improvements made by these organizations are broad reaching and have been made in a wide variety of public sectors. Examples include increasing access to healthcare and education, adding services for people experiencing homelessness and creating community green spaces. Given the importance of these projects and the role played by community foundations and donor-advised funds in bringing them to fruition, the significance of these organizations and the impact they make is undeniable. Recent market trends have revealed yet another way for these organizations to achieve even more by re-examining the other side of their balance sheets. Specifically, by responding to the growing interest in impact investing, these organizations can invest assets in ways that contribute to their philanthropic mission and social goals while also earning a financial return.

Several investment vehicles now make it possible for donor-advised funds to be invested in securities that are focused on helping the same communities as those served by donors' philanthropic grants. These vehicles can utilize investments that offer high credit quality, substantial liquidity, and government guarantees to advance such goals as enhancing access to affordable housing and home ownership and expanding access to education and healthcare. They may also provide funds for small businesses and infrastructure development in a specific neighborhood or community that is underserved and that has particular meaning for the donor. Employing impact investing in donor-advised funds can enhance and expand the overall impact of a philanthropy by focusing the investment portfolio on pursuing the donor's philanthropic goals while also generating the returns necessary to sustain and maintain a grant-making program.

The growing interest in impact investing

> Impact investing is an investment approach intentionally seeking to create both positive financial return as well as positive social or environmental impact that is actively measured.
>
> - World Economic Forum

In recent years there has been a growing interest in impact investing, an idea which grows out of more than a century of efforts to combine traditional return-seeking investment approaches with efforts to also pursue non-financial goals. In the past, these efforts were often labeled "socially responsible investing" and focused on the negative: avoiding or divesting holdings in companies that engaged in activities deemed inappropriate, whether that might be producing armaments or tobacco products or having employment policies seen as retrogressive. As this impulse has continued to evolve, however, it has moved from avoidance to a more positive approach of seeking out—and often developing—investments that make an affirmative contribution to the investor's social or environmental goals while earning an economic return. This approach, called "impact investing," can take a variety of forms.

The Global Impact Investing Network estimates that impact investments totaled over $1.164 trillion in 2022, up from $77 billion in 2015.[1] Impact investors allocate their capital across a broad spectrum of asset classes and investments.

A variety of foundations, endowments, and pension funds are involved in making impact investments, in addition to individuals, and more recently, corporations. Impact investors understand that the portfolios they are overseeing must continue to generate the financial resources needed to support and advance their objectives, which may range from paying pensions to supporting universities or funding charitable giving. However, they also understand it is possible to achieve those goals while simultaneously advancing social or environmental goals. Impact investors frequently talk about a "double bottom line," in which both financial and impact goals are advanced.

Impact investing and community foundations

Although a growing number of individuals and institutions have embraced impact investing, one area where this approach clearly has an opportunity to play a much larger role is in the investment process at community foundations. Since the first community foundation—the New York Community Trust—was established in 1931, hundreds of metropolitan areas across the United States have developed sizable community foundations. These pool the resources of donors who wish to provide benefits to their local community without having to create and maintain their own foundation or philanthropic apparatus in order to make charitable grants.

Some of the funds at community foundations are commingled and invested as a single fund which the community foundation draws upon to support its own grant-making agenda. But substantial portions of community foundation resources are in the form of separate donor-advised funds. The administration of donor-advised funds is under the general oversight of a community foundation, but the donors specify the charitable contributions they wish to make with the funds.

Donor-advised funds are the fastest-growing charitable giving vehicle in the United States because they are one of the easiest and most tax-advantageous ways to give to charity. In 2020, there were over one million donor-advised funds, with aggregate assets of some $160 billion, according to the National Philanthropic Trust.[2]

One of the appeals of donor-advised funds is that the original contributions generate an immediate tax benefit, even though the money may not be dispensed to charities until a later date. Another significant appeal is that donations can be made in many forms. While many charities can only accept cash contributions, gifts to a donor-advised fund can take the form of publicly traded securities, certain restricted securities, mutual fund shares, real estate, and a vast assortment of complex assets, such as privately held C-corporation or S-corporation shares. Because these can be donated directly to a donor-advised fund rather than needing to be cashed out, these contributions do not trigger a taxable event. Moreover, the donor-advised funds approach provides simplified collective administration and record keeping yet permits contributions to be made in ways that maintain an ongoing identity as "the Jones Family Fund" or "in memory of" family members.

[1] Hand, D., Ringel, B., Danel, A. (2022) Sizing the Impact Investing Market: 2022. The Global Impact Investing Network (GIIN). New York.
[2] National Philanthropic Trust 2021 Donor-Advised Fund Report.

Investing donor-advised funds

The assets in donor-advised funds at a community foundation can be managed in three alternative ways: the community foundation can manage them through a pooled or commingled fund, the donor can manage them directly, or the donor can engage an outside manager to invest the funds. Each option has its own merits, hence, the choice is generally up to the donors.

While the appeals of a donor-advised fund have long been recognized by those pursuing philanthropic goals, more recently a growing number of donors are recognizing that impact investing can be brought to bear on the investment management side of donor-advised funds. Many families donate to a community foundation because it is focused on the locality in which they live, and it makes sense to focus the investment of their donation in ways that benefit the locality as well. But many individuals or institutions don't want to incur the costs that may be required to invest at a local level. They are not about to create an office to make mortgage loans or to search for neighborhood businesses to invest in. Now, however, there are vehicles to pursue meaningful social and environmental objectives through donor-advised investments. One of the easiest vehicles to utilize is the mutual fund. Over the last five years, there has been an increase in the number of impact-related mutual funds available for purchase. Mutual funds can easily be made an investment option for donor-advised funds. These vehicles advance their impact goals by constructing a portfolio of carefully selected high quality, liquid securities that are generally backed by government guarantees. A prime example of the impact investing approach that could be attractive to donor-advised funds would be to modify a traditional portfolio benchmarked to the Bloomberg U.S. Aggregate Bond Index. Such a portfolio could be altered to include various impact-related investments, in particular, agency mortgage-backed securities (MBS), commercial mortgage-backed securities (CMBS) and taxable municipal bonds (munis). These three security types are most easily customized by borrower's income level, by geography/community and by social causes/missions, making them ideal for donor-advised funds.

Impact agency MBS may align with donor-advised funds that are interested in supporting low- and moderate-income families, access to affordable housing and/or home ownership in local communities of their choice. There are no "sub-prime" or "no doc" mortgages involved in creating these securities. The backing consists of loans to low- or moderate-income households—defined as households with incomes below 80% of the median income in the area—but the borrowers are carefully vetted to ensure they have both the resources and the character to make their mortgage payments. Moreover, these mortgages are guaranteed by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), or the Government National Mortgage Association (Ginnie Mae). Ginnie Mae securities may also be targeted to veterans purchasing a home.

While significantly limiting risk, these traditionally underwritten long-term mortgages to low- and moderate-income households have often performed slightly better than mortgages made to more affluent households. One of the unique attributes of the mortgage-backed market is prepayment risk: when interest rates decline, home owners often pay off their mortgages or refinance their homes, leaving investors with funds to reinvest in a falling interest rate environment. However, these targeted mortgages have proven to be less likely to be refinanced, and because they have better prepayment characteristics, this makes for a higher total return.

Another type of security that may be of interest to donor-advised funds is the impact agency CMBS. These bonds can support a wide range of social missions, including affordable rental housing for low-income families, availability of healthcare facilities in underserved areas and supportive care for the elderly and disabled. They are mainly issued through the

FNMA Delegated Underwriting and Servicing (DUS) and GNMA project loan programs. FNMA DUS bonds offer many attractive characteristics such as the full credit backing of FNMA, good liquidity and stable cash flows.[3] GNMA project loans are administered by the Federal Housing Administration and are backed by the full faith and credit of the federal government. In terms of efficiently earning yield, impact agency CMBS have been competitive with other fixed income security types held in more traditional fixed income portfolios.

Lastly, donor-advised funds may invest in taxable municipal bonds that are aligned with various missions such as affordable housing, access to education, economic growth and job creation. Taxable munis with a focus on social or environmental impact can be a very practical replacement in a portfolio's allocation to non-impact taxable munis. Yields on impact taxable munis are competitive with investment grade corporate yields. In addition, AA-rated munis have higher credit ratings than the corporate component of the Aggregate Index and experience less spread volatility in times of distress. Donor-advised funds may also consider shifting a portfolio's allocation to securities backed by loans of the U.S. Small Business Administration. This is a powerful way to support job creation.

The three impact security types discussed above can compete with generic security types in terms of investment performance, transparency, liquidity, cash flow predictability and quality. By implementing an impact strategy, donor-advised funds can help advance their specific social or environmental goals with their investment dollars while also earning a competitive market-rate return. Investors can utilize a wide range of state and federal loan programs that support goals around increasing access to affordable housing, healthcare, infrastructure and economic development, education and training. Agency CMBS, taxable municipal bonds, GNMA project loans, DUS bonds and other programs make it possible for responsible investors to make secure investments because of guarantees from government agencies.

The aspirations and objectives that lead a family to create a donor-advised fund at a community foundation are the same aspirations that should lead many of them to impact investing. And now there are well-established vehicles for making these kinds of investments. By investing through an impact investing program, donor-advised funds are spared the complexities and administrative burdens and costs of finding and making individual investments.

Making a double impact at donor-advised funds

Since 1931, families have been able to outsource the administration of their philanthropic dollars to community foundations by creating donor-advised funds. A growing number of donors are recognizing that they can also advance their philanthropic goals by making impact investments, and they can transfer many of the tasks associated with meeting that commitment to a fund manager who specializes in creating impact investment structures and placing donor-advised funds into them.

Bringing impact investing to donor-advised funds

RBC GAM's impact investing strategies have been pioneers in bringing impact investing to donor-advised funds. The Access Capital Community Investment strategy was established in 1998 to facilitate impact investing for a host of individuals and institutions. Investors who agree to commit a threshold level of assets to Access Capital can designate a specific geographic region in which they want their investments focused. The Access Capital team then creates custom-tailored portfolios based on the investor's guidelines.

Over the years, our Access Capital and Impact Bond strategies have played important roles in creating mechanisms for donor-advised funds to make impact investments in support of climate change solutions and a host of social causes, from healthcare and education to job creation and infrastructure development. Investors may participate in these strategies through separately managed accounts or through the affiliated mutual funds.

[3] The cash flows of FNMA DUS bonds are designed to be more certain than single family agency MBS. FNMA DUS bonds have a cash flow profile similar to the profile of corporate bonds.

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