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PROGRAM RELATED INVESTMENTS: DO THEY COST, OR DO THEY PAY?

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Almost twenty years ago I met a downstate Illinois legislator who was a strong advocate of higher education. He may have been influenced by his associations with the University of Illinois (he is an alumnus and it was in his district), but there could be no doubting his sincerity. He summed up his case in six words: "Higher education doesn't cost; it pays."

This obviously is a bit of hyperbole as far as higher education is concerned. Any parent facing tuition bills knows that, no matter how much it pays, higher education also costs. But the downstate lawmaker's phrase can be applied with less exaggeration to program related investments, a greatly underutilized philanthropic tool.

The term "program related investments" ("PRIs") sometimes misleads people to think of PRIs only as a below market investment option, something any prudent trustee would avoid altogether, or tolerate only in small doses. PRIs, however, are more properly conceived as highly leveraged grants, grants whose beneficial effects greatly exceed the philanthropic resources they require.

PRIs have been used to develop thousands of homes for low income people, to preserve historic buildings, to "bring back" deteriorating neighborhoods and business districts, to create parks, to support research facilities, to help poor people become economically self-sufficient, to capitalize books and films, and to provide working capital and important services to non-profit human service agencies.

Sound PRIs work in philanthropy the same way that commercial loans and investment capital work in the economy; they add capacity and increase productivity. Their impact is great because they advance philanthropic enterprises that can generate a lot, but not all, of their own steam.

If PRIs are so powerful, why are they underutilized? Part of the answer is undoubtedly limited demand; only a handful of charitable organizations consider seeking debt or equity financing and most of these are in the fields of housing and economic development. But this is changing as the competition for grants intensifies and non-profit managers become more sophisticated.

A second reason is limited supply. Only a few foundations systematically seek program related investments, and many will not seriously consider requests. Part of the reason may be that the financial workings of program related investments are somewhat complicated, and the advantages of PRIs many not be fully understood. Although the complexities of the law tend to obscure them, the tax code includes provisions that make PRIs a modestly attractive financial investment for a private foundation as well as an effective philanthropic option.

The primary objective of this paper is to analyze the financial aspects of program related investments; what do they cost, how do they pay? The analysis will show that program related investments can make both a programmatic and a financial contribution to the work of a private foundation.

Legal Definition

Under the tax code program related investments must be investments for which:

1. "the primary purpose ... is to accomplish one or more [charitable] purposes;"
and
2. "No significant purpose ... is the production of income or the appreciation of property"
(I.R.C. 4944 (c).

The charitable purpose requirement means that PRIs must meet essentially the same conditions required for grants. (In addition, the law indicates that program related investments must be related to the expressed programmatic interests of the foundation.) The I.R.S. Regulations' test for the second requirement considers whether investors "solely engaged in investment for profit would be likely to make the investment on the same terms as the private foundation." Reg. 53.4944-3(a).

When a PRI is made, it counts toward a foundation's distribution requirement as if it were a grant. In addition, while it is an investment, it is not included in the asset base used to calculate the distribution requirement.

Income from a PRI is treated the same as all other investment income. When the principal for a PRI is repaid, however, it counts as a negative distribution. In effect, this means that a foundation must recycle PRI funds to grants or other PRIs in the year that the principal is returned.

What do PRIs cost?

Obviously as an investment PRIs do not "cost" unless:

- 1) The foundation loses an opportunity to achieve a higher return by investing funds in the usual investment vehicles;
- 2) PRIs fail to repay principal or interest; or
- 3) The foundation loses opportunities to use funds for other programmatic purposes that might be of greater value.

These three categories of cost, Investment Opportunity Costs, Default Costs, and Programmatic Opportunity Costs are considered separately below.

Investment Opportunity Costs

From the perspective of the foundation's tax return, a program related investment is a distribution, not an investment. As a distribution it functions as a returnable grant (with or without interest) and, with one exception, there are no investment opportunity costs.

The exception to this occurs when a foundation chooses systematically to distribute more than 5% of its assets in grants and/or PRIs. Any distribution of grants or PRIs above the 5% federal requirement causes the foundation to incur investment opportunity costs. In the case of grants exceeding distribution requirements the cost is both the amount of the grant and the earnings that would have accrued had the funds been invested. In the case of PRIs exceeding the distribution requirement the investment opportunity cost equals the difference between the PRI return and the return on regular investments.

(A foundation starting a PRI program might choose as a matter of policy to make PRIs in excess of the distribution requirement while maintaining a grants budget at about 5% of assets. While this is a legitimate policy choice, such PRIs are not part of the foundation's corpus (asset base) from the perspective of the tax law -- instead they are simply charitable distributions in excess of the amount required.)

On the surface the comparison of PRI returns to regular investment returns will favor regular investments, but PRIs have a financial advantage that is easy to overlook. Normal investments are included in the asset base used to determine the annual 5% distribution requirement of a private foundation. Because PRIs are not included in this asset base, they have a 5% head start on regular investments. In terms of the effect on total assets, a PRI earning 3% may be compared favorably with a regular investment earning 8%. (Of course, a PRI when paid back becomes a negative distribution which must be converted into another PRI or a grant. It cannot be converted into regular assets unless the total

distribution requirement for the year, including the returned PRI funds, has already been paid out.)

Because they generally choose to conserve, rather than deplete the assets that support their work, most foundations are not likely substantially to exceed distribution requirements over the long haul. In this case the concept of investment opportunity costs does not apply, and as demonstrated by the financial model described below, PRIs will increase, rather than decrease a foundation's assets and grant making capacities.

The model used to examine the financial effects of program related investments was developed with the help of my colleagues at the MacArthur Foundation, particularly George Ptacin, Director of Financial Planning, and Phil Grace, Treasurer. The model was used to examine the effects on a foundation's assets of 1) an all grant, no PRI strategy and 2) various combinations of grants and PRIs with different yields and loss rates. The simulations address the question of investment opportunity costs, the effects of various annual yields in the PRI portfolio, and the effects of capital losses from PRIs. The results after twenty years for nine simulations are summarized on Tables 1 and 2 at the end of the paper.

All the simulations are for a foundation with assets of \$200 million and an annual distribution requirement of \$10 million. The simulations on Table 1 assume no inflation and a return on regular assets of 5%, which would maintain the assets at \$200 million if the foundation distributed 5% in grants and other qualified distributions each year. The simulations on Table 2 assume inflation of 5% annually, and a 10% return on normal investments, conditions that would maintain the constant dollar value of the foundation's endowment if it distributed 5% of assets annually. The terms of PRIs used in this modeling exercise ranged from 5 years to 16 years, with an average maturity of about 10 years.

Comparing the results of various models permits one to make the following generalizations about investment opportunity costs.

A. PRI's increase assets and possible distributions if they are part of the required 5% distribution.

If program related investments are part of the annual 5% distribution requirement they result in a net gain in the Foundation's assets over the "all grant" approach. (Compare Model 1 with Models 2, 5, 6, and 7; compare Model 8 to Model 9.) In effect, all the returns from PRIs work to increase a foundation's assets while the capital functions as a grant. This increase in assets is augmented by the "recycling" of PRI funds; both factors enable a foundation to increase its charitable distributions.

Depending on the assumptions used for inflation and investment return in

various models, a practice of allocating 10% of the annual distribution to PRIs over twenty years added 2.7% to 3.3% to the regular assets of a foundation and 6.8% to 8.3% to its combined PRI and regular assets. The amount of growth in assets depends on the rate of return for the PRI portfolio.

Over twenty years the effect on annual distributions is even greater. Allocating 10% of the distribution to PRIs results in increases from 9.4% to 14.0% in the annual distribution requirement. Eventually, a PRI program included within annual distributions of 5% of assets will pay for itself and increase the funds available for grants.

- B. If the distribution requirement is consistently exceeded, whether by grants or by PRIs, some erosion of the foundation's assets will almost certainly occur. The amount of erosion is less, however, if PRIs are used.

Over twenty years Model 3, which distributed 5.5% of asset value each year (10% of which was PRIs), yielded a 6.1% decline in regular assets and a 1.5% decrease in total assets (PRI plus regular). In this model, however, the foundation's distributions did not decline proportionately after twenty years (in fact they increased slightly) due to the recycling of PRI funds. Eventually, however, charitable distributions as well as assets would decrease, other things being equal.

Model 4 demonstrates the effects of distributing 5.5% of assets each year with no PRIs. In this case assets dropped 9% in twenty years, and distributions (at the 5.5% level) dropped from \$11.0 million to \$9.9 million.

Default Costs

When a program related investment defaults, the net effect on a foundation's assets is minimal. A comparison of Models 2, 6, and 7, where the default rate is 5%, 10%, and 15% respectively, shows almost no impact on assets from higher default rates after twenty years. (Each 5% increase in the default rate costs about \$100,000 in assets over twenty years, an amount far exceeded by the returns from PRIs.)

The reason the impact on assets is so small is that a defaulted PRI relieves the foundation from the obligation of recycling the funds through a qualified distribution. Defaulted PRIs simply become a grant that would have been required in any case. The financial impact of a defaulted PRI comes, not from the loss of capital, but from the loss of earnings from the PRI. In effect, a PRI is a grant in limbo that provides a return to the foundation. If it defaults it leaves limbo and becomes a grant with no further return.

Of course, the real costs of a defaulted PRI are the programmatic opportunity costs. To the extent that a defaulted PRI represents failure in a philanthropic effort, it represents a lost opportunity to make a contribution through a wiser grant or PRI. A bad PRI costs no more than a bad grant, but neither is worth the money.

Programmatic Opportunity Costs

Every grant and every PRI has a programmatic opportunity cost. Dollars spent for one purpose cannot be spent for another, and the philanthropic "return" from every grant and PRI must be weighed against the potential returns from other grants or PRIs.

While program opportunity costs are permanent for grants and (usually) temporary for PRIs, they are real, nevertheless. Accordingly, program related investments need to have philanthropic integrity in their own right, and it is important to consider the relative merit of opportunities to make grants and PRIs. Before considering the programmatic merits of PRIs more directly, it may be helpful to examine programmatic opportunity costs more closely.

Ultimately, programmatic opportunity costs are permanent only when a PRI defaults. PRI capital that is repaid can be redistributed to grants as well as to new PRIs. But a foundation that decides to make PRIs part of its 5% distribution will initially be forced to forego some opportunities to make grants with those funds. In the systematic PRI programs outlined in these models, the distribution requirement is divided into 90% grants and 10% PRIs. Thus, in the first year there is an initial programmatic opportunity cost of 10%.

Each year, however, the annual programmatic opportunity cost becomes smaller due to growth in regular assets from PRI returns and the recycling of repaid PRI capital into grants and new PRIs. A comparison of detailed data for Model 8 and Model 9 (probably the most realistic and conservative comparison), shows the annual programmatic opportunity costs declining from 10% in year 1 to 4.6% in year 10 to 1.5% in year 20. In the "no inflation" PRI models there were no programmatic opportunity costs by year 20. (By the twentieth year of Models 2, 5, 6, and 7 grants exceed the \$10.0 million possible in the non-PRI model; in these scenarios the PRI program paid for itself and helped finance small increases in both the PRI and grant budgets.)

Even though annual programmatic opportunity costs get smaller each year and ultimately disappear, it is clear that it will take a number of years for a systematic program related investment strategy to offset all the programmatic opportunity costs that will accumulate over time. Their financial advantages notwithstanding, program related investments need also to stand on their philanthropic merits.

The Programmatic Case for PRIs

In essence, a program related investment should fill an economic gap, the gap between what is possible in the normal economy without philanthropic intervention and what can be achieved only through a direct grant. Philanthropic involvement in this segment of economic life is highly leveraged almost by definition; PRIs support philanthropic activities that are almost, but not quite self-supporting, and they usually help bring non-philanthropic capital to the task.

Program related investments can work in philanthropy in the same way that capital investments work in the economy -- they build capacity and self-sufficiency, they contribute to growth. The built in discipline of a loan helps both the lender and the borrower to think more carefully about ends, means, and ways to anticipate and deal with potential obstacles to success.

While legitimate program related investments can be made in virtually any field, the most common PRIs support economic development efforts in depressed areas and programs to develop affordable housing for low and moderate income people. Such persistent social problems are not addressed by the usual capital markets, and they are too massive to be addressed directly with grants. And although government plays a crucial role in this field, it is clear that progress requires the support and creative involvement of the private sector.

The most cost-effective (and perhaps the only effective) approaches to such pervasive problems are likely to be those efforts that generate some or even most of their own resources. These are exactly the approaches to problem solving that will make good use of a program related investment. Foundations willing to look can find a number of good organizations who can use low cost capital very productively.

Only a handful of foundations routinely make program related investments, and PRIs usually represent less than 10% of their annual distributions. Perhaps PRIs should never represent more than a modest percentage of a foundation's distributions over time, but there is plenty of room for growth in the field. The financial and programmatic advantages of PRIs make them an especially powerful philanthropic tool. They pay.

CONSTANT DOLLAR PROGRAM RELATED INVESTMENT MODELS*

Assets and Annual Distributions After Twenty Years

Model Specifications	ASSETS			DISTRIBUTIONS		
	Non-PRI	PRI	Total	Grants	PRIs	Total
#1 All Grants, No PRI's Distribution @ 5% of assets	\$200.0 M	\$ 0.0	\$200.0 M	\$10.0 M	\$ 0.0	\$10.0 M
#2 Grant/PRI Ratio 9:1 PRI 4% return, 5% capital loss Distribution @ 5% of assets	206.5 M	10.1 M	216.6 M	10.3 M	1.1 M	11.4 M
#3 Grant/PRI Ratio 10:1 PRI return, 4%, 5% capital loss Distribution @ 5.5% of assets	187.8 M	9.2 M	197.0 M	10.3 M	1.0 M	11.3 M
#4 All grant, No PRIs Distribution @ 5.5% of assets	181.8 M	0.0	181.8 M	9.9 M	0.0	9.9 M
#5 Grant/PRI Ratio 9:1 PRI 3% return, 5% capital loss Distribution @5% of assets	205.1 M	10.0 M	215.2 M	10.2 M	1.1 M	11.3 M
#6 Grant/PRI Ratio 9:1 PRI return, 4%, 10% capital loss Distribution @ 5% of assets	206.5 M	10.0 M	216.5 M	10.2 M	1.1 M	11.3 M
#7 Grant/PRI Ratio 9:1 PRI return, 4%, 15% capital loss Distribution @ 5% of assets	206.4 M	10.0 M	216.4 M	10.1 M	1.1 M	11.2 M

* All models assume no inflation, and a regular investment return of 5%.

INFLATED DOLLAR PROGRAM RELATED INVESTMENT MODELS*

Assets and Annual Distributions After Twenty Years

Model Specifications	ASSETS			DISTRIBUTIONS		
	Non-PRI	PRI	Total	Grants	PRIs	Total
#8 All grant, No PRIs Distribution @ 5% of assets	505.4 M	0.0	505.4 M	26.5 M	0.0	26.5 M
#9 Grant/PRI Ratio 9:1 PRI return, 4%, 5% capital loss Distribution @ 5% of assets	518.9 M	21.1 M	540.0 M	26.1 M	2.9 M	29.0 M

* All models assume 5% inflation and 10% return on regular investments.