CATEGORY: FOUNDATION

POLICY SUBJECT: INVESTMENT (CTCFCK-004)

EFFECTIVE DATE: 2009/02/18

I. Development of this Policy

The purpose of this policy is to help provide a framework within which the Children's Treatment Centre Foundation of Chatham-Kent (the "Foundation") can manage its funds prudently[1] and show the Foundation supporters that their generosity is well placed.

II. Nature of the Foundation

Understanding the nature of the Foundation is important to understanding the Board's investment responsibilities. The Foundation is a non-profit,[2] charitable[3] corporation, incorporated under the Ontario *Corporations Act.* The objects[4] of the Foundation are as follows:

(a) To receive and maintain a fund or funds and to apply all or part of the principal and income therefrom from time to time to any charity registered under the *Income Tax Act* (Canada) which benefits directly or indirectly the premises, facilities, programs, services, research, initiatives, operations, training, human resources and/or any other aspect from time to time of the Children's Treatment Centre of Chatham-Kent (the "Centre").

(b) To establish, equip, maintain and operate facilities for the benefit of the Centre.

III. Canada Revenue Agency ("CRA") Classification

CRA classifies each charity it registers into one of three categories: charitable organization, public foundation or private foundation.[5] The Foundation has been registered with CRA and is currently classified as a charitable organization.

Each of the CRA classifications for charities has specific rules as to how funds must be disbursed.[6] These rules are referred to as "disbursement quota." The disbursement quota for the Foundation are set out in Appendix A. The disbursement quota can impact liquidity requirements in the context of investment planning.

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[1] Paragraph 27.1(2)(b) of the Ontario *Trustee Act,* R.S.O. 1990, c. T-23 as amended, requires that a charity's written investment plan be intended to ensure that investment functions will be exercised in the best interests of the purposes of the charity.

[2] The essential difference between a non-profit organization and a for-profit business lies in what is done with any profits. In a for-profit business, profits can be used to benefit shareholders whereas with a non-profit organization, profits can only be used to further the objects of the organization and cannot be used to benefit the members – see "Identifying the Variety of NPO's", a paper by Milena Protich presented May 29, 2001 at the Canadian Bar Association seminar: "The ABC's of NPO's: Getting Oriented in the World of "Not-For-Profit"

[3] In order for a non-profit corporation to qualify as a charity, its objects must be be for one or more of the following: relief of poverty, advancement of education, advancement of religion and/or any purpose beneficial to the community – see "What is a Charity", a paper by Lisa Goldstein presented November 3, 1995 at the Canadian Bar Association seminar: "Without a View to Profit: Non-Profits and Charities."

[4] The objects of The Association are set out in its Letters Patent.

[5] Canada Customs and Revenue Agency Booklet, "Registered Charities and the *Income Tax Act"* RC4108(E), page 4.

[6] Canada Customs and Revenue Agency Booklet, "Registered Charities and the *Income Tax Act"* RC4108(E)*,* at page 11.

IV. Investment Powers

To ascertain the investment powers of the Foundation, attention must be paid to the following:[7]

1. Incorporating Documentation.

Directors are required to adhere to the letters patent and by-laws of a corporation in the management of its affairs. In the context of investments it is therefore important to review these documents.

(a) **Letters Patent.[8]** The letters patent of the Foundation is the document that brought the Foundation into existence and require the Foundation:

> To invest the funds of the corporation in such manner as determined by the directors, and in making such investments the directors shall not be subject to the *Trustee Act*, but provided that such investments are reasonable, prudent and sagacious under the circumstances and do not constitute, either directly or indirectly, a conflict of interest.

(b) **By-laws.** By-laws are typically approved once letters patent for a charity have been issued and generally specify who may do what on behalf of the charity, the procedures for decision-making and details as to the organizational structure. Insofar as investments, the by-laws of the Foundation are silent. [9]

2. Restricted Funds

A charity must adhere to any restrictions attached to any donation received.[10] If the charity is unable to comply with such restrictions, the charity should decline the donation.[11]

Appendix B attached, lists all assets currently held by the Foundation that are subject to specific restrictions, including a summary of those restrictions.

Charities must keep and invest funds that are subject to restrictions separate from their general funds.[12] It is now, however, possible to invest restricted funds with other restricted funds.[13] The regulations under the *Charities Accounting Act* detail the requirements that must be met for such commingling.[14]

3. *Trustee Act* – Investment Provisions

The *Trustee Act* requires that the Foundation manage its investments with the care, skill, diligence and judgment that a prudent investor would exercise in making investments.[15] The *Trustee Act* provides some guidance in this regard by setting out seven criteria that must be considered by directors when making investment decisions, in addition to mandating consideration of any other criteria that may be relevant in the circumstances and providing for diversification.[16] A more detailed discussion of the mandatory criteria follows in sections VII and VIII of this Investment Policy as well as Appendix C.

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[7] A charity's investment powers may also be additionally defined by special statutory provisions having specific application to a charity or certain contractual relations such as an affiliation agreement with a national charity. Any additional items such as these should be identified in this part of the Investment Policy.

[8] Terrance Carter in his September 20, 1999 article, "Legal Issues in Investments of Charitable Funds" available at www.charitylaw.ca states that it "is essential that each charity review its Letters Patent or Special Legislation to determine if the new trustee investment power will apply."

[9] Typically, by-laws do not contain specific provisions relating to investments.

[10] See page 59 of "Donor Restricted Charitable Gifts: A Practical Overview Revisited" a paper by Terrance S. Carter presented October 27, 2000 at the Canadian Bar Association seminar: "Fundamental New Developments in the Law of Charities in Canada".

[11] See page 12 of "Looking a Gift Horse in the Mouth: Avoiding Liability in Charitable Fundraising" a paper by Terrance S. Carter presented November 24, 1999 at the Law Society of Upper Canada Second Annual Estates and Trusts Forum; and page 93 of "Donor Restricted Charitable Gifts: A Practical Overview Revisited" a paper by Terrance S. Carter presented October 27, 2000 at the Canadian Bar Association seminar: "Fundamental New Developments in the Law of Charities in Canada".

[12] See page 3 of Charities Bulletin #6 published by the Ontario Office of the Public Guardian and Trustee dated March 7, 2001 available at www.attorneygeneral.jus.gov.on.ca.

[13] *Charities Accounting Act*, Regulation 4/01 which took effect on January 17, 2001 permits commingling where it was previously prohibited.

[14] See *Charities Accounting Act,* Regulation 4/01 Section 3.

[15] Subsection 27(2) of the Ontario *Trustee Act*, R.S.O. 1990, c. T-23. Technically, the investment powers of charities, which by their letters patent are not restricted to *Trustee Act* investments, are not governed by the Act but if the letters patent require investments to be prudent; practically, it will amount to the same thing.

[16] Subsection 27(5) of the Ontario *Trustee Act*, R.S.O. 1990, c. T-23.

4. *Charitable Gifts Act* - Restriction

The Ontario *Charitable Gifts Act* prevents charities, other than religious organizations, from owning more than 10% of any business.[17]

5. *Charities Accounting Act* - Restriction

The *Charities Accounting Act* prevents a charity, other than a religious organization, from holding land if it is not used for its charitable purposes.[18]

All investment decisions will be subject to the applicable law, the Letters Patent and By-laws of the Foundation.

V. Investment Counselor

1. Authority to Obtain Advice

The *Trustee Act* permits a charity to obtain investment advice.[19] This is generally advisable if the investment assets of the charity are significant or when there is insufficient investment knowledge or experience within the organization to carry out all investment responsibilities. A charity may follow the advice of an investment counselor but only when a prudent investor would do so.[20]

The Foundation will obtain external investment advice when there is limited investment knowledge or expertise within the Foundation or when investment assets exceed $50,000.

2. Authority to Delegate Investment Functions

A charity may manage its investment assets on its own or subject to meeting certain requirements, delegate this responsibility to an investment counselor.[21] In either case however, the directors of a charity retain the responsibility for reviewing the investment assets regularly.

The Foundation will delegate investment functions when the additional income and/or growth anticipated to be earned by delegation is expected to more than offset the additional related expense.

3. Selection of an Investment Counselor

The *Trustee Act* requires that a charity exercise prudence in the selection of an investment counselor whether it is for the obtaining of investment advice or managing investments.[22] At the current time, there are no regulations outlining the required qualifications of such investment counselors, however, the following is generally suggested:

- **Registration with the Ontario Securities Commission.** Generally, firms selling or providing advice on investments in Ontario must be registered with the Ontario Securities Commission.[23] Moreover, any individual selling or providing advice on investments must also be registered. The Ontario Securities Commission registration of any individual investment counselor or firm that is retained will be confirmed.

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[17] Section 2, of the *Charitable Gifts Act*, R.S.O. 1990 c. C.8.
[18] Section 8, of the *Charitable Gifts Act*, R.S.O. 1990 c. C.10.
[19] On June 29, 2001 amendments to the *Ontario Trustee Act* took effect, permitting charities to obtain investment advice (see subsection 27(7)).
[20] Subsection 27(8) of Ontario*Trustee Act* R.S.O. 1990, c. T-23.
[21] On June 29, 2001, amendments to the Ontario *Trustee Act* took effect permitting charities to delegate investment functions to an investment agent (see section 27.1). Prior to these legislative amendments, the permissible role of investment agents was unclear. Some commentators have cautioned that the investment adviser should be different than the investment manager, stating that since, “an investment manager normally earns commission income from transactions in an investment account, such an investment manager would be in a conflict of interest if he or she also acted as the investment adviser. Therefore, it would be better if the investment adviser retained by the organization directly and paid on a fee for service basis – see page 25 of “Endowments by Design: Creating a Legacy of Faith and Trust” a 2000 paper by Elaine Roberts at www.cuc.ca.
[22] Section 27.1 of the Ontario*Trustee Act,* R.S.O. 1990, c. T-23.
[23] Ontario Securities Commission article, “Types of Advisers” at www.osc.gov.on.ca.

- **Appropriate Level of Licensing.** The Ontario Securities Commission offers different levels of licensing. It is therefore important to ensure that the investment counselor and firm being retained have the appropriate level of licensing. The appropriateness of the licensing level of any individual or firm will be confirmed.

- **Custody Arrangements.** All investments owned by a charity should be retained in a safe place. The Foundation will consider the available options for the safe custody of investment assets.

- **Knowledge and Experience.** The investment counselor should have a demonstrated understanding of charity law and trust law in addition to investment knowledge and experience. The knowledge and experience of any investment counselor considered will be assessed by, among other things, reviewing the investment counselor's credentials, the firm brochure and compliance manual.

- **No Conflict of Interest.** Any investment counselor or firm retained by the Foundation should not have any conflicts of interest. Any investment counselor or firm retained will provide a declaration indicating that he/she or it is not subject to any conflict of interest.

- **Confidence.** The investment duties of directors are onerous and any failure to fulfill these duties can carry significant consequences. Directors will want to rely on any investment counselor retained to help them meet their investment duties. Any investment counselor retained must be approved by the Board.

4. Documenting the Investment Counselor Relationship

If a charity retains an investment counselor to manage its investments, it is required by the *Trustee Act* to enter into a written agreement with that counselor.[24] In any event, a written agreement is recommended even in those situations where the role of the investment counselor is limited to providing advice. The *Trustee Act* requires that, at a minimum, the investment management agreement provide that:[25]

- The investment counselor complies with the investment plan of the charity.

- The investment counselor report to the charity at regular stated intervals. The *Trustee Act* is not specific regarding the reporting intervals or content for reports. Standard practice, however, provides for quarterly reporting intervals. Reports should include a schedule of the market value of all investments, a listing of all transactions (including income received) since the previous report, and investment performance measured on a total return, time-weighted basis and presented for the most recent quarter, year-to-date and the trailing year, 3 years and 5 years as available along with comparative industry data. It is also generally recommended that the investment counsellor annually report on how shares held in the investment portfolio were voted if they were voted against management recommendations.

In addition to the minimum requirements, it is generally advisable that the investment management agreement also addresses the following:

- How instructions are to be communicated to the investment counsellor, with it generally recommended that all instructions be in writing.

- Conflict of interest issues on the part of the investment counselor.

- Scope of authority delegated.

- Obligation on the investment counselor to provide notice in writing of any material changes in its investment outlook, strategy, portfolio structure, and ownership or senior personnel.

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[24] Subsection 27.1(3) of the Ontario*Trustee Act*, R.S.O. 1990, c. T-23; however, note that this does not apply where the charity invests directly in mutual funds, pooled or segregated funds – see *subsection* 27.3.
[25] Clauses 27.1(3)(a) & (b) of the Ontario*Trustee Act*, R.S.O. 1990, c. T-23.

- Termination of the agency agreement, with it generally recommended that the charity retain liberal termination rights.

It is generally advisable that the investment management agreement not:

Provide any kind of indemnity in favor of the investment counselor, especially if the indemnity is unlimited or relates to the acts and omissions of persons other than the charity.

Any Investment Management Agreement entered into by the Foundation will reflect the above and will require the investment counselor and related firm to comply with this Investment Policy. To evidence agreement in this regard, the investment counselor will initial each page of this Policy which should be attached to any Investment Management Agreement.

5. Monitoring the Performance of the Investment Counselor

If an investment counselor is retained by a charity for investment management, the directors of the charity must exercise prudence in monitoring the performance of the investment counselor.[26] At a minimum, this includes:[27]

- Reviewing the investment reports of the investment counselor.
- Regularly reviewing the investment management agreement and how it is being put into effect, including considering whether the investment plan should be revised or replaced, replacing the plan if appropriate, and ensuring that the plan is being followed. To assist in assessing compliance, it is generally advisable that any investment counsellor retained be required to provide a compliance report on a quarterly basis confirming compliance or detailing any breach of policy or plan.
- Providing directions, when appropriate, to the investment counselor.
- Terminating the appointment of the investment counselor, if appropriate.

The Board[28], either as a whole or delegated to their investment committee, will review, at least annually, the performance of the investment counsellor(s) retained by the Foundation for investment management.

VI. Investment Criteria

This part of this Investment Policy elaborates on each of the seven mandatory investment criteria under the *Trustee Act.*[28] Directors must consider each of the criterion to an equal extent, unless it can be demonstrated that it was prudent to prefer one criterion to another.[29] Attached as Appendix C are explanatory notes regarding each of the investment criteria.

1. General Economic Conditions[30]

In light of the long-term horizon and specified liquidity needs of the Foundation, investments should be selected on the basis of a low level of risk.

[26] Subsection 27.1(5) Ontario*Trustee Act,* R.S. O. 1990, C. T-23.
[27] Clauses 27.1(5)(b)(i)-(iv) Ontario *Trustee Act,* R.S. O. 1990, C. T-23.
[28] Subsection 27(5) Ontario*Trustee Act,* R.S. O. 1990, C. T-23.
[29] The Attorney General of Ontario stated in a letter that a director who does not consider each criterion to the same degree will have to demonstrate that it was prudent to prefer one criterion to another.

2. Possible Effect of Inflation or Deflation

When possible, investment income equal to the rate of inflation should be retained each year and reinvested to prevent erosion of purchasing power over time***.***

3. The Expected Tax Consequences of Investment Decisions or Strategies

A higher level of fixed income investments should be maintained than would be the case for a taxable account with a similar risk tolerance.

4. The Role that Each Investment (Asset Class) or Course of Action plays within the Portfolio

Investment asset selection should be co-ordinated with the Foundation's needs for liquidity, regularity of income and capital preservation or appreciation. The need for re-balancing of the investment portfolio should be assessed quarterly.

5. The Expected Total Return from Income and the Appreciation of Capital

The annual budgeting process for the Foundation including a forecast of cash requirements will be co-ordinated with an annual review of this Investment Policy.

6. Needs for Liquidity, Regularity of Income and Preservation or Appreciation of Capital

Capital Preservation and Appreciation: to prevent the erosion of the investment capital and protect the future well-being of the Foundation, the Foundation should try to ensure to the extent possible that the market value of the investments appreciate in an amount at least equal to inflation over the long term.

Liquidity: The need to use capital is low and, therefore, liquidity needs are also low.

Regularity of Income: The Foundation will eventually need to have a certain regularity of income to the extent it relives on the same to fund operating or capital projects. However, while the Foundation is being built up, income will not be taken except as may be necessary to comply with disbursement quota.

7. An Asset's Special Relationship/Special Value, if any, to the Purposes of the Charity

The Foundation will segregate all assets where there is a special relationship or special value and consider these assets separately from those assets where there are no such special requirements. An annual review of these assets, including a third-party appraisal if required, should be undertaken to ensure that the sentimental value is still valid.

8. Other

There are no other investment criteria relevant to the Foundation's Funds.

VII. Diversification

The *Trustee Act* requires diversification of investments to the extent that is appropriate to the requirements of the charity and general economic and investment market conditions.[30]

What is this?

The concept of diversification is, simply, 'not putting all of your eggs in one basket.' In the investment context this means that an investor should buy different types of investments.

[30] Subsection 27(6) Ontario *Trustee Act*, R.S.O. 1990, c. T-23.

Why is this important?

Diversification is a mechanism to reduce volatility or market risk. By buying different types of investment assets and different investments within the same asset class, an investor is less likely to be adversely impacted in the event of a loss on any one investment. This is because the loss is hopefully isolated and hopefully offset by gains from another investment in the portfolio. This concept of diversification however only works as long as investments are allocated among assets that are not affected in the same way by economic, political or social developments. To achieve this, it is generally advisable to diversify investments along the following lines:

- **Equities.** Publicly-traded companies and their related shares provide varied benefits and no single stock offers all of the benefits available in a diversified portfolio. For example, some securities provide a good dividend yield and reduce the volatility of portfolio returns, while others may provide a good capital gain. By acquiring investments that are not subject to the same influences on market value, a charity can reduce the covariance within the investment portfolio and increase safety of the principal.[31] Accordingly, it is generally advisable to diversify as follows:

  - **Country.** Different countries offer different investment advantages. It is generally advisable though that no equity holding exceeds 10% of the total equity portfolio no matter the country.

  - **Industry.** The investment industry recognizes 10 industry groups, as identified by recognized rating agencies.[32] It is generally advisable to diversify investments among these groups using individual securities, conglomerate stocks (those in more than one industry) or exchange-traded funds (closed end funds).

  - **Size.** Stocks may also be diversified by size, which is typically measured by asset size (small, medium or large capital corporations), market capitalization and/or total earnings. Given the nature of a charity, a majority of equity investments should be in large capital corporations.

- **Fixed Income Securities.** Diversification is also relevant for fixed income securities. For example, high quality and short-term bonds provide less yield but more protection against inflation and loss of principal while low quality and long-term bonds provide a higher yield but less protection against inflation and loss of principal. Therefore, a fixed income portfolio should generally be diversified by both its term to maturity and its quality. Canadian federal bonds are of the highest quality and only need to be diversified by term. Unlike Canadian federal bonds, the quality of provincial, municipal and corporate bonds does vary and they should be diversified.

  Equities should be diversified as follows:

  - The Foundation should not invest only in Canadian investments but foreign investments as well.
  - International investment should be diversified in line with the related international index and/or country indices, as appropriate.
  - Any one corporate issuer should not exceed 10% of the equity portion of the investment portfolio based on market value.
  - At least 75% of the equity holdings in the portfolio should be of large capital corporations as rated by a recognized rating agency.33
  - The exposure to the equity and fixed income securities of any single publicly-traded corporation and its related entities should not exceed 10% of the total portfolio.
  - Investments should be diversified among industry groups and the Foundation should have the ability to invest in any and at any times all industry groups.

  Fixed income securities should be diversified as follows: Federal fixed income issues should represent at least 50% of the fixed income section of the portfolio; provincial bonds should represent no more than 30%; and municipal and corporate bonds should be no more than 20% each.

[31] Uniform Law Conference of Canada: Civil Section – Prudent Investors – 1996 at page 6 – available at www.ulcc.ca.
[32] Recognized rating agencies include: Dominion Bond Rating Agency, Moody's Investor Services and Standard and Poor's.

VIII. Investment Objectives and Strategy

1. Investment Objectives

Investment objectives should be detailed and specific, based on sound rationales, and their implementation should be measurable.

Having regard to the mandatory investment criteria referred to in parts VII and VIII of this Investment Policy, the investment objectives for the Foundation are as follows:

a) To maintain sufficient liquidity to meet all spending requirements as they arise which for the buildup phase of the Foundation shall be nominal.

b) To provide sufficient capital growth over time to preserve the purchasing power of the Foundation.

c) To optimize the total return with due regard for the investment criteria in Sections VI and VII.

2. Asset Mix Strategy

Establishing the asset mix combines the analysis of the investment criteria referenced in Parts VII and VIII of this Investment Policy and Plan, along with the investment objectives.[33]

The asset mix for the Foundation should be as follows:

Asset	Minimum Allocation	Target Allocation	Maximum Allocation
Cash	2%	5%	15%
Fixed Income	75%	85%	95%
Equity	0%	10%	20%

Fixed income investments should be at least 50% in Canada and Canada guaranteed bonds; not more than 30% in provincial and provincial guaranteed bonds; and not more than 20% in municipal, municipal guaranteed and corporate bonds.

All percentages are based on the current market value of the securities and may include exchange-traded funds (shares) in the related asset class, as appropriate.

3. Permitted Investments

(a) Cash and Short Term:

- Canadian and U.S. short-term investments with a term of less than one year to maturity. All such investments must be rated at least A-1[34] or equivalent by a recognized rating agency.

(b) Fixed Income:

- Canadian bonds, debentures, notes or other debt instruments of governments (federal, provincial, municipal) and corporations rated at least A[35] or equivalent by a recognized rating agency.

- U.S. bonds, debentures, notes or other debt instruments of governments (federal, state, municipal) and corporations rated at least A[36] or equivalent by a recognized rating agency.

- Foreign bonds, debentures, notes or other debt instruments of governments (federal, state, municipal) and corporations rated at least A[37] or equivalent by a recognized rating agency.

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[33] If endowment, capital program and/or cash flow assets of the charity are commingled in one investment portfolio, the objectives for each should be weighted to determine the appropriate asset mix for the specific portfolio.
[34] Recognized rating agencies include: Dominion Bond Rating Agency, Moody's Investor Services and Standard and Poor's.
[35] Same as footnote 57.
[36] Same as footnote 57.

- Guaranteed Investment Certificates[38] and term deposits (and the equivalent) of banks, trust companies, insurance companies or other eligible issuers.[39]

(c) Equity:

- The common and/or convertible preferred shares of A-rated Canadian and U.S. corporations and internationally recognized companies.

In all cases where investment assets are not denominated in Canadian dollars consideration should be given to the related currency exchange risk. Currency exchange risk refers to the uncertainty about the rate at which revenues or costs denominated in one currency can be converted into another currency.

IX. Investment Policy and Plan Review

Investment Policies will be reviewed at least on an annual basis and whenever there is a material change in circumstances[40]. Initial review will be undertaken by the Finance and Investment Committee who will report the results of that review and any related recommendations to the Board on an annual basis.

X. Publication

Recognizing that our supporters want to know that their gifts are well placed; this policy will be posted on our web site at **www.childrenstreatmentfoundation-ck.com** and copies shall be provided to anyone requesting the same.

Approved by the Board of the Children's Treatment Centre Foundation of Chatham-Kent.

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President	Date
______________________	______________
Executive Director	Date

[37] Same as footnote 57.
[38] In connection with the purchase of guaranteed investment certificates it is generally recommended that the availability of insurance coverage such as from Canadian Deposit Insurance Corporation be considered.
[39] Dominion AAA and other recognized agencies.

Appendix A: Disbursement Quota (Public Foundation)

Each year, a registered charity is required to spend a minimum calculated amount for its disbursement quota on its own charitable programs or on gifts to qualified donees. The disbursement quota for a public foundation is the sum of the five calculations described below:

1. 80% of the amounts for which official tax receipts were issued in the previous fiscal period less:
    - any amounts that were issued for enduring property;
2. 80% of enduring property spent in the current fiscal period. (This does not include enduring property received as a specified gift or a bequest or inheritance received by the charity prior to 1994);
3. 100% of enduring property transferred to qualified donees in the current fiscal period (This does not include enduring property received by the charity as a specified gift);

    The total of 2 and 3 may be reduced by the amount, if any, that the charity is allowed to claim as a capital gains reduction.
4. 80% of the amounts received from other registered charities in the previous fiscal period less any amounts that were received as enduring property or as specified gifts.
5. 3.5% of the average value of assets owned over the previous 24 months that were not used directly in charitable activities or administration [line 5900] (if the amount is greater than $25,000), **less**:
    - 100% of the amount for which official donation receipts were issued in the previous fiscal period;
    - 100% of enduring property spent in the current fiscal period;
    - 100% of enduring property transferred to qualified donees in the current fiscal period; and
    - 100% of the amount received from other registered charities in the previous fiscal period.

Appendix B: Children's Treatment Centre Foundation of Chatham-Kent

The following lists all assets currently held that are subject to specific restrictions, including a summary of the respective restrictions:

Appendix C: Investment Criteria

Below is an elaboration on each of the 7 mandatory investment criteria under the *Trustee Act*.[40] Directors must consider each of the criterion to an equal extent, unless it can be demonstrated that it was prudent to prefer one criterion to another.[41]

1. General Economic Conditions

What are these?

Economics is the study of how societies end up choosing to employ scarce productive resources.[42] Those choices are affected by a variety of factors including production, prices, unemployment and interest rates. These factors are referred to as 'general economic conditions'.

Why are they important?

The general economic conditions affect the financial strength of a charity since they influence, among other things, the amount of new funds a charity may attract and the amount of income (interest, dividends and capital appreciation) an investment may provide. Given that the general economic conditions are always changing, analysis of investment potential is not precise, which in turn gives rise to an element of risk.

Historically, investors have received additional investment return for taking on additional risk. For example, equities have tended to be riskier and exhibit more price volatility than bonds and over time have provided a higher investment return than fixed income securities. Therefore, when considering the general economic conditions, it is important to also assess levels of acceptable risk.

Market risk (or volatility) tends to be reduced as the investment time horizon lengthens. The problem for investors however, is that at any particular point in time, the market may be up or down. If the market is down at a time when a charity needs cash and thus needs to liquidate its investments, the charity may realize a loss, depending on the nature of its investments. The challenge for a charity is to coordinate investment choices and the risk those choices present, with the charity's time horizons. In this way, a charity can position itself to benefit from upward market trends, without unduly risking its investment assets by having to liquidate the same at inopportune times.

2. Possible Effect of Inflation or Deflation

What is this?

Inflation is the persistent increase in the level of consumer prices while deflation is the persistent decrease in the level of consumer prices. Inflation erodes the purchasing power of money – with the same amount of dollars you get less. Conversely, deflation increases the purchasing power of money – with the same amount of dollars you get more.

Why is this important?

Both inflation and deflation can impact the value of an investment portfolio and in turn the future well being of a charity.[43] The effects of price changes are different depending on their direction and magnitude.

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[40] Subsection 27(5) Ontario*Trustee Act,* R.S. O. 1990, C. T-23.
[41] The Attorney General of Ontario stated in a letter that a director who does not consider each criterion to the same degree will have to demonstrate that it was prudent to prefer one criterion to another.
[42] Paul A. Samuelson, *Economics*, (10th ed.), McGraw-Hill, 1976, Page 3.
[43] In a 2000 paper entitled "Endowments by Design: Creating a Legacy of Faith and Trust" by Elaine Roberts at page 17, cautions that, "some trustees have interpreted the 'Prudent Man Rule' to mean that they must avoid all risk when making investments, and choose only fixed-income instruments that provide a guaranteed return and safety of principal. This is one definition of prudence, but it has its drawbacks. An investment strategy that is very conservative will not provide for growth of principal, which can threaten the future well being for an organization. An endowment that cannot grow to compensate for inflation is as problematic as one that actually loses dollar value."

Given that the directions and magnitude of price changes are not predictable, it is generally advisable that a charity determine the asset mix held and then maintain that asset mix until, and unless, the factors used to establish that asset mix vary.

3. The Expected Tax Consequences of Investment Decisions or Strategies

What is this?

'Tax consequences' refer to the implications that tax laws have on an investor.

Why is this important?

As a charity, any investment returns earned by the Foundation are not taxable and thus the Foundation need not concern itself with after-tax rates of return. Nonetheless, tax consequences are still an important consideration for charities since they impact the decisions of taxable investors who may purchase the same securities. Taxable investors prefer investments that provide a high, after-tax rate of return and are, therefore are attracted to investments offering capital gains and dividends that are taxed at a lower rate than interest. Taxable investors bid up the price of these preferred investments making them less attractive to charities and making interest-bearing investments more attractive.

Since a registered charity is non-taxable,[44] the percentage of assets invested in fixed income securities (versus equities) should be higher than it would be for a taxable investor in similar circumstances. Given that a balanced portfolio for a taxable investor would have about 50% in fixed income securities, it is generally suggested that this should be minimum fixed income weighting for a non-taxable portfolio.

4. The Role that Each Investment Asset Class or Course of Action plays within the Portfolio

What is this?

The reference to the 'role that each investment plays within a portfolio' refers to the need to understand what can be expected from each different type of investment and how that can impact on what a charity seeks to achieve through its investment portfolio.

Investment assets or securities are generally categorized into one of three classifications, each yielding returns in a different way:

- **Equities**, another term for common stock or share capital, signify an ownership position in a corporate business and, entitle the owner of the stock to share in any profits of the business. Equities yield income in two ways:

    - **Dividends** refer to a distribution of a portion of a corporation's business profits. When a business is profitable, the profits can be reinvested back into the business or distributed to the shareholders as dividends – a payment on each share held by the shareholders. Different stocks have different dividend payout rates with some not paying any dividends. In all cases dividends are not guaranteed.

    - **Capital appreciation (gain) or depreciation (loss)** refers to the difference between the purchase price of a stock and the current market price of the same stock. Capital appreciation or depreciation is considered to be 'unrealized' until the stock is actually sold.

- **Fixed income securities** refer to securities that have a guaranteed principal value and stated interest rate, the payment of which is an obligation of the issuing entity. Treasury-bills, guaranteed investment certificates (GICs), bonds and debentures are examples of fixed income securities.

- **Cash** investments, such as holding money in a bank account, yield returns in the form of interest.

Why is this important?

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[44] Subsection 149(1)*Income Tax Act* (Canada), R.S.C. 1985 c.I.1.

Since different types of investments (asset classes) yield returns in different ways - interest, dividends and capital gains - the choice of investment assets needs to be coordinated with a charity's needs for liquidity, regularity of income and capital preservation or appreciation.

Understanding the role that each investment or course of action plays in an investment portfolio is also important to appreciating the need to rebalance the portfolio from time to time as follows:

- **Equities versus Fixed Income.** If the equity portion of an investment portfolio, originally established at 30% of the total portfolio, appreciates in value so that it subsequently represents 40% of the market value of the portfolio, for example, then it is generally recommended that some of the equity portion should be sold and the proceeds reinvested into fixed income such that it is, once again 30% of the portfolio. It is generally recommended that declines should be treated in a similar fashion.

- **Among Equities.** Diversification among equities may also require rebalancing if a particular stock appreciates significantly in market value. In such circumstances, it is generally recommended that a portion of that stock be sold to bring it back in line with the planned asset allocation.

5. The Expected Total Return from Income and the Appreciation of Capital

What is this?

The expected total return from an investment portfolio is the sum of interest, plus dividends plus capital changes (realized and unrealized), usually stated for a twelve- month period. The 'expected total rate of return' is the expected total return divided by the beginning market value of the portfolio. In other words, how much money can you earn from the portfolio. Interest and dividend income can typically be estimated with a reasonable degree of accuracy. Capital changes, both appreciation and depreciation which are most often associated with stocks, are more volatile and, as such, impossible to predict in the short term. Historically over the long term equities have appreciated more than fixed income securities.

In Canada, the risk-free rate of return is usually considered to be the rate earned on a 30 day Canada T-bill.[45] Fixed income securities are expected to earn the risk-free rate of return plus some additional return for reduced quality and/or any extension of term. Equities, over time, can be expected to earn the five-year term Canada bond yield plus 2.5% per annum for the additional associated risk.

Why is this important?

The amount and source of income (dividends, interest) capital appreciation can have important implications for the general budgeting process and spending policy of a charity, and as such, these should be coordinated with the selection of investment type (fixed income versus equities).

6. Needs for Liquidity, Regularity of Income and Preservation or Appreciation of Capital

What is this?

- **Liquidity** is the speed with which an investment can be converted into cash. High liquidity occurs when there is a high level of trading activity in that security, resulting in transactions taking place with minimal price disturbance.[46] The liquidity needs in connection with the Endowment Fund are low since the intention is to simply generate an annual income stream to fund operations but otherwise keep the principal intact.

- **Regularity of income** refers to the likelihood that a stream of income from an investment will remain constant.[47]

- **Preservation or appreciation of capital** refers to the ability of an investment to maintain or increase its market value.[48]

[45] Finance Glossary, Campbell R. Harvey, Fuqua School of Business, Duke University, 2002, at www.duke.edu/-charvey/classes/wpg/bfglosl.htm.
[46] Finance Glossary, Campbell R. Harvey, Fuqua School of Business, Duke University, 2002, at www.duke.edu/-charvey/classes/wpg/bfglosl.htm
[47] Paul A. Samuelson, *Economics*, (10th ed.), McGraw-Hill, 1976, Page 3.

Why is this important?

Different types of investments yield income in different ways - interest, dividends and capital gains. Since investment selection impacts on the type of income earned, which in turn impacts on liquidity, regularity of income and the ability for capital preservation or appreciation,[49] a charity should coordinate its investment decisions with its budgeting process and spending policy.

7. What is This?

An asset's 'special relationship' or 'special value' refers to any value an asset has in addition to its actual (or intrinsic) market value.

Why is this Important?

If the asset is to be retained in its current form on account of its special value, it is generally advisable to clearly document the special value and treat the asset separately from the general investment assets of the charity. This action ensures that the general investment assets may be managed and monitored without limitations that skew performance statistics.

It is generally recommended that charities should ensure that retention of an asset in its donated form for sentimental reasons does not result in excessive risk to the charitable purposes. If an asset has significant sentimental value and nominal intrinsic value, then the retention of the asset in its current state is likely to have little or no effect on the overall performance of the total assets of the charity. However, if the reverse is true, serious thought should be given to treating the asset as any other asset, if possible.

8. Other

The *Trustee Act* requires that any other investment criteria that are relevant in the circumstances also be considered.[50]

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[48] Paul A. Samuelson, *Economics*, (10th ed.), McGraw-Hill, 1976, Page 3.
[49] Three basic situations:

Funding Required from Investments	**Effect on Portfolio**	**Level of Risk**
Greater than Expected Interest and Dividends	Declines	Low
Equal to Expected Interest and Dividends	Constant	Medium

[50] Subsection 27(5) Ontario *Trustee Act*, R.S.O. 1990, c. T-23. The ability to consider other relevant criteria arguably permits charities to consider ethical investing. The appropriateness of selecting or screening investments on the basis of moral considerations is a matter of debate with no clear lines of authority having been defined to date. In light of the controversy over ethical investing, it is recommended that a charity obtain specific legal advice if it is considering investing on the basis of moral or ethical criteria.