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Executive Vice President's Report
2003 Annual Report

AN UNDERVALUED SPECIES: PRIVATE VALUE-ADDED FOUNDATIONS

At a recent meeting of the Fund's Task Force on the Future of Health Insurance, James J. Mongan, M.D. (speaking), president and CEO of Partners HealthCare System, discussed with other members the potential of various private and state-led initiatives to expand and improve health insurance coverage and access to care.

Permanently endowed private foundations that work directly with grantees to develop projects, carry them out effectively, and communicate results to policymakers and institutional leaders have a long record of accomplishment in this country. "Value-added" foundations like The Commonwealth Fund perform an important function by underwriting policy research, service delivery experimentation, and infrastructure development within their fields—health care, in the case of the Fund. As professors Michael Porter and Mark Kramer described in a seminal 1999 *Harvard Business Review* article, other permanent, value-added private foundations play comparable roles by informing discussion and encouraging service innovation in other sectors.

Despite their importance in American society, the debate around the recently proposed Charitable Giving Act of 2003 (H.R. 7) revealed serious misunderstandings about the role and finances of value-added foundations. Congress received strong encouragement from a variety of quarters to increase the required annual payout for private foundations to a level inconsistent with the maintenance of their purchasing power over the long term. Congress also heard that the administrative expenses of most foundations are too high and was urged to impose a provision that would have placed an especially heavy burden on foundations that devote internal resources to program development, monitoring, communications, and research—effectively increasing their payout requirement.

In the end, Congress was unable to take action on charitable giving legislation in the session that closed in December 2003 but may well resume its deliberations in 2004. It appears that, had Congress taken action in 2003, it would likely have chosen not to increase the basic payout requirement and to enact an administrative expense measure that, properly implemented, would not severely penalize well-managed and productive foundations incurring appropriate intramural expenditures. Whether Congress will maintain that course should it enact charitable giving legislation in 2004 remains to be seen. In any event, the misconceptions revealed by the debate should be unsettling to anyone with a commitment to improving social policy and practice. It seems clear that foundations should do more to promote a fuller understanding of the financial realities that govern their existence, the strategies and management practices that make them effective, and the role they play in society.

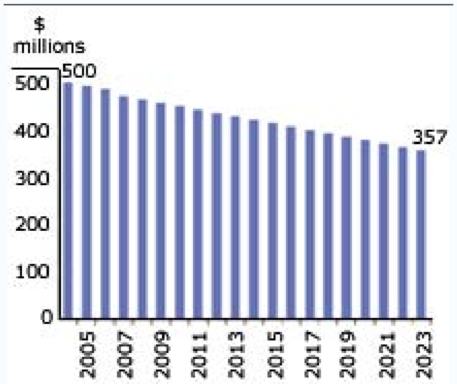
Balancing Payouts with Endowment Returns

The long-term historical record regarding investment returns on endowments is well documented, and the math for arriving at a payout consistent with the objective of perpetuity is simple. Permanent endowments can maximize their risk-adjusted returns with an asset mix in the neighborhood of 70 percent equities and 30 percent fixed income. As reported by Cambridge Associates and other institutions that track financial markets, from 1900 through 2002, U.S. equities had an average annual return of 9.7 percent, and bonds of 5.5 percent, producing a weighted return of 8.4 percent. The average inflation rate for this period was 3.0 percent, while average annual investment costs and taxes were at least 0.4 percent for large foundations. Thus, using history as a guide, a foundation can just maintain the real value of its corpus by spending around 5 percent each year. Such analysis underlay the 1981 federal requirement that foundations spend at least 5 percent annually.

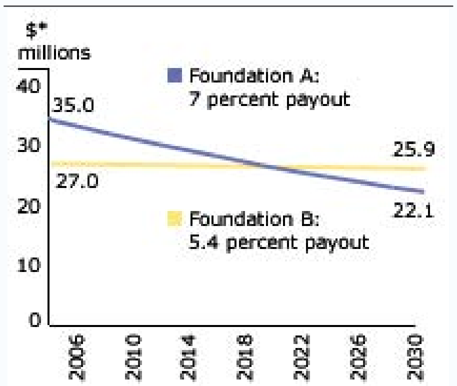
In the extended 1982-2000 bull stock market, the average annual return on stocks rose to 18.3 percent, increasing the long-term (1900-2000) average return to 10.5 percent and leading some to believe that foundations could afford higher payouts than those based on the earlier long-term market record. The bear market experience of the last three years, however, has demonstrated again the proclivity of equity market returns to regress to their long-term mean of 9-10 percent, and indeed to dip well below the long-term average in the course of correcting the excesses of a bull market. There is no debate, therefore, among financial experts on the appropriateness of 5 percent as the maximum annual spending rate for foundations with long-term objectives.[1, 2]

In the course of the debate on the Charitable Giving Act of 2003, a number of articles appeared in the media advocating annual payout requirements of 7 percent or more. Yet, as the first figure shows, an imbalance between the real return (after inflation) and a required payout of that magnitude would steadily corrode the asset base of a foundation, with negative consequences for all aspects of its work. A foundation endowment of $500 million and generating a payout of $35 million in 2004, for example, would be reduced, in real terms, to $357 million in 2023. Its inflation-adjusted payout would be reduced to $25 million—a drop of almost 30 percent. The road to extinction would still be a long one, but the continued loss of

Inflation-adjusted value of a $500 million starting endowment with an average annual return of 8.4 percent and payout requirement of 7 percent



Spending of two foundations with starting endowments of $500 million, 8.4 percent return, and experiencing 3 percent inflation



*Inflation-adjusted spending

purchasing power would fairly quickly move the foundation out of the league of institutions able to operate effectively in any major public policy arena.

Further, because of the effects of compounding returns on a stable capital base, spending at 5 percent actually enables a foundation to generate a larger flow of dollars over the long term than it could by spending at a higher rate. As illustrated in the second figure, the annual expenditures of foundation A (experiencing 3 percent inflation, earning 8.4 percent each year, and paying out 7 percent of its endowment annually) would initially exceed the expenditures of foundation B (paying out 5.4 percent annually) by $8 million. By 2020, however, the annual expenditures of the two foundations would be equal; thereafter, the foundation with the lower payout rate would expend more each year than the foundation with the higher rate as a result of the depletion of the latter's capital base. In terms of the discounted present value of cumulative expenditures, the expenditures of the two foundations would be the same over a 56-year period, but the annual outlays of the foundation with the lower annual payout rate would thereafter be more than twice as high as those of the foundation with the higher rate.

The Cost of Adding Value

Private foundations can be grouped into two major categories: those that pursue an essentially "hands-off" style of charitable giving, and those that seek to add value in the grantmaking process. The former focus their efforts on fiduciary due diligence; they leave to the grantee full responsibility for implementation, outcomes assessment, and communication of results. These foundations should, and typically do, have low administrative costs, and most of their expenditures are in the form of extramural grants.

The best value-added foundations, in contrast, are run essentially as nonprofit businesses. They require professional staff and strong leadership by recognized leaders in their fields. They devote resources to developing programs internally and to research that makes their grantmaking more effective. Their programs have specific goals, and their staff are evaluated for productivity and the quality of their work. A premium is placed on communications, outcomes assessment, and accountability. Value-added foundations sometimes manage certain programs directly, rather than delegate the role to a grantee—when, for example, the appropriate expertise is not available externally, or when a high degree of management control is essential to a project's success. As cases in point, The Commonwealth Fund conducts its International Program in Health Policy and Practice, including Harkness Fellowships in Health Care Policy, and the Task Force on the Future of Health Insurance internally. Not surprisingly, it costs more to manage a foundation of this type than it does to run a foundation that essentially writes checks to grantees.

One argument put forward during the recent debate was that the administrative expenses of many foundations are excessive, and that higher payouts should be required of such institutions. Spending on administration was branded in some commentary as "spending on themselves," and Congress was encouraged to disallow administrative expenses in the calculation of the annual payout requirement. Some advocated a very broad definition of administrative expenditures: any expenditures that are not extramural grants, possibly even including those arising from the direct conduct of research, communications, and other intramural activities. Such policies would have affected value-added foundations primarily.

The universe of 62,000 foundations in the United States is extraordinarily diverse, and the great majority of institutions are small: in 2001, 93 percent of foundations had assets of less than $10 million, and only .4 percent (214) had assets of $250 million or more. Simply because of their size, few foundations with assets below $250 million are equipped to pursue a value-added foundation strategy, and many large foundations also eschew this approach. Thus, value-added foundations constitute a small group whose combined assets in 2001 were probably not more than $200 billion, with a current annual payout of approximately $10 billion. Most have perpetuity as one of their institutional goals, consistent with the long-term nature of the problems they seek to address and the intent of their donors to make a sustained difference in perpetuity.

The Case for Perpetual Foundations

In the recent congressional debate and accompanying media coverage, arguments were made that cast doubt on the value of perpetual foundations and suggested that their resources would be better used to address current social needs. The case for preserving a long horizon for some part of the universe of 62,000 private U.S. foundations, however, is a strong one:[3]

American foundations originated in the early 1900s as an alternative to traditional annual giving. Early foundation donors, like their counterparts today, wanted to improve society, not just dispense charity. They believed that social progress required research into the causes of complex problems, systematic and long-term approaches, careful monitoring of the use of funds, and partnerships involving the active participation of the foundation. In short, early foundation leaders believed—and demonstrated—that their consistent engagement could add value to the work they sponsored. It was from this ethos that the concept of perpetual value-added foundations emerged.

Annual charitable giving fluctuates with the ebb and flow of economic activity. It is wise to have a permanent core of endowment-based giving that is there through thick and thin. History shows that a prolonged booming economic environment generates new foundations, but that the emergence of new foundations is minimal during long economic slumps.

Foundations are the source of a unique form of social capital. Foundations play a role that business and government do not in making long-term investments to improve society. No small part of the sense that "anything is possible" in this country derives from the presence of foundations with long-term horizons and the capacity to underwrite research, innovation, and new talent. John Evans, M.D., has written about the importance of foundations staying the course when tackling social problems: "Foundations have to make a choice between making the wave and riding the wave. To make the wave requires intensive investment over an extended period of time." Perpetual value-added foundations provide this capacity.

Perpetual value-added foundations enrich the work of their grantees and the fields in which they operate. They demand a wholesome degree of accountability from the institutions that receive their grants, however much recipients may chafe under a foundation's productivity- and quality-enhancing procedures. Permanent foundations provide a body of experience on which new foundations draw, thus shortening the period of casting about for direction that foundations commonly experience in their formative years. Foundations with short lives sometimes seem to be closing their doors just as they gain sufficient experience to be truly effective in their fields, or they may build up expectations for continuing support that other institutions are unprepared to assume.

Foundations provide the capital for infrastructure in the nonprofit sector that makes volunteerism, fundraising, and new program initiatives possible. The nonprofit investment banker and venture capitalist is a role to which perpetual value-added foundations are particularly well suited, and the voluntary sector would suffer in the absence of those reliable sources of financing.

The perpetual foundation model stimulates a larger amount of charitable giving than would otherwise occur. The first minimum payout requirement for private foundations, established by Congress in 1969, was higher than 5 percent. It was reduced to the current level in 1981 after careful study and public hearings produced evidence that the higher rate had dampened the creation of new foundations. Raising the minimum payout requirement and closing out the opportunity for perpetuity could well divert transfers that are now expected.

Permanent foundations are an important part of the social fabric of many communities around the country. Permanent foundations are admired in their communities for the work they do, regarded as performing essential tasks, valued for their independence, and seen as a part of the American tradition. In cities where permanent foundations survive beyond the lives of their benefactors and even the industries that generated their wealth, they can be especially important in later renewal and revitalization.

Rapid distribution of the assets of all perpetual independent foundations would produce a one-time surge in current revenues but a drought thereafter in nonprofit capital. Raising the required payout rate to 7 percent, for example, would generate approximately $4 billion in additional annual outlays from all foundations initially. Spread over many fields, that increment would be a minor addition to any sector: if 20 percent of the increase went to the health care sector, for example, it would amount to .06 percent of national health expenditures. The price paid for this short-term increase in philanthropy, amounting to a very modest increment in any sector, would be serious depletion of the ranks of value-added foundations over a 20-30 year period.

The country benefits from a decentralized voluntary sector that helps address the needs of a diverse society. Diversity in the foundation sector accounts in part for its adaptability and flexibility in responding to a wide variety of changing social needs. The 5 percent minimum payout requirement now in force assures that foundations do not become sterile warehouses of wealth, but allows a variety of choices regarding spending strategies and longevity.

In sum, there is a place for permanent, value-added foundations, just as there is for those that choose to spend down their assets over a relatively short period. Value-added foundations should be expected to have higher administrative expenses precisely because they employ professionals who are leaders in their fields, able to contribute directly to the work of grantees, carry out research, publish, and present reliable analysis in congressional testimony, scholarly publications, and other forums.

A far more important question is whether or not foundations are accountable and making a difference in society. All foundations—and especially those with perpetuity as an objective—should regularly and rigorously examine their activities and frankly assess whether their accomplishments justify their internal expenses.

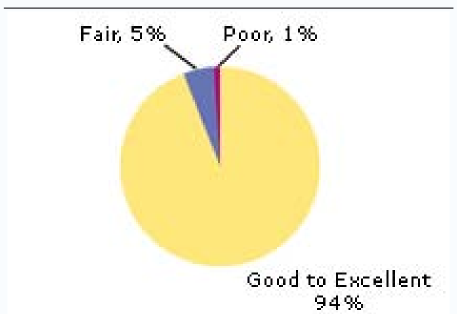
Views of The Commonwealth Fund's Performance

In 2001, Harris Interactive, Inc., conducted a confidential survey of all major grantees of the Fund over a seven-year period to ascertain whether they regard the foundation as adding value to their work. As described in last year's annual report, the response of grantees was highly confirmatory: 79 percent of respondents believed that the foundation's support helped to focus their work on well-targeted, timely contributions to the health policy debate or service improvements, and 65 percent said that their projects were strengthened by the foundation's staff in the proposal development and vetting stage.

With respect to publication and dissemination of results, 71 percent of respondents cited important contributions by Fund staff in clarifying their overall message and findings, and 62 percent said they had been assisted by Fund staff in drawing out policy and practice implications. According to grantees, a major value-added function of Fund staff is synthesizing project results and translating research findings for policy-making audiences: 89 percent of grantees rated the Fund highly in that regard. A large majority (79 percent) of project directors reported that the Fund's internal research and professional capacity strengthens the foundation's contribution to their work, and 88 percent said the quality of work produced by the Fund's research unit is high.

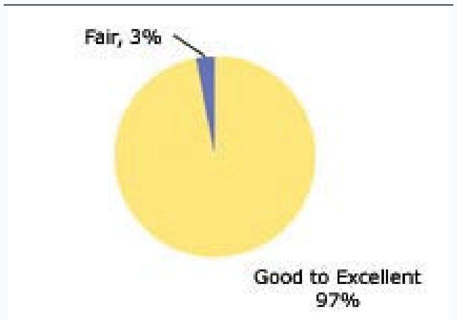
This year, Harris Interactive pursued the analysis further by conducting an anonymous survey of Commonwealth Fund audiences. The 7,200 people surveyed were those who regularly receive e-mail alerts announcing Fund publications and events, including government officials and staff (U.S. federal and state, as well as international officials familiar with the Fund's work through its international program); policy analysts, research consultants, lobbyists, consumer advocates, and private sector executives and other leaders who engage in the policy process; private sector health care leaders, including heads of hospitals, health systems, group practices, nursing homes, health plans, and purchasers; journalists; academic researchers and students; and foundation executives and program officers. The response rate for the 20-minute e-mail

The Fund's performance in providing timely information



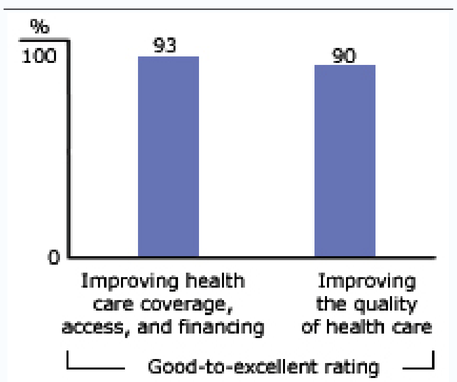
2003 Audience Survey

Quality of research in Fund publications



2003 Audience Survey

Overall quality of the Fund's work in major national program areas



2003 Audience Survey

survey was 20 percent, which is regarded as high for this type of survey. Survey respondents were broadly representative of the Fund's target audiences.

The Fund's 2003 audience survey provided further evidence that the foundation is fulfilling its value-added mission:

- 92 percent of respondents said that the Fund is working on the right issues most of the time
- 94 percent said that the foundation is providing unique information, not available elsewhere, on health policy and service delivery issues
- 95 percent said it is delivering timely new information
- 97 percent rated the quality of research in Fund publications as "good" to "excellent," and none gave it a "poor" rating
- 97 percent said that the Fund provides credible and reliable information on health care policy and service delivery issues
- 81 percent rated Fund publications as valuable to their work, and 80 percent gave a similar rating to the Fund's website
- 93 percent gave high marks to the Fund's work in stimulating and contributing to solutions for problems of health coverage, access, and financing
- 90 percent approved of the foundation's work to promote constructive action on health care service delivery issues
- 84 percent said that the Fund is quite effective in reaching policymakers and health care leaders
- 100 percent of responding journalists rated the quality of the Fund's work, its publications, and its surveys and chartbooks as high, and 90 percent said that the foundation's website is helpful to their work

Respondents said that Fund reports are as reliable and credible as those of the Institute of Medicine, the General Accounting Office, and the Urban Institute, and that they seek out the Fund's publications and visit its website more often than they do those of other health policy and research organizations. Survey responses show that the Fund is reaching not only officials from all branches of the federal government but also state government officials, and that its work is highly valued at all levels of government. The Fund is also valued as a key information resource by minority groups, particularly by black leaders.

The 2003 survey of Fund audiences provides convincing evidence that the foundation's program and communications strategies are sound and that—particularly for its modest size—the foundation is having an impact in improving health care policy and practice.

Improving Understanding of Value-Added Foundations

Grantee and audience surveys are one mechanism value-added private foundations can use to test and improve their own effectiveness. Indeed, rigorous feedback mechanisms are essential for institutions that face no market or electoral tests. Unfortunately, good management and hiring practices were not given their due until late in the recent debate on the Charitable Giving Act of 2003.

While in the end no charitable giving legislation was enacted in 2003, Congress appeared to have reached the conclusion that the basic 5 percent payout requirement remains appropriate and that excluding all administrative and other intramural expenses from what can be counted toward meeting the requirement would discourage accountability and good management practices. Had it taken action, it appears that Congress would have wisely allowed foundations to continue to count expenditures on intramural “direct charitable” activities and associated indirect administration expenses toward the payout. The effect of disallowing basic administration expenses would have been to increase the payout of a foundation like The Commonwealth Fund by approximately 0.2 percent. Congress may well take final action in 2004 on the separate charitable giving legislation voted by the House and Senate in 2003; if so, it is to be hoped that it will stick to the reasonable approach on foundation spending issues just described.

The recent debate revealed value-added foundations to be a severely undervalued species. Foundations and the institutions that benefit from their existence should work to improve understanding of the role of foundations, and especially that of value-added foundations, in society. The following steps would be a good place to begin:

Promote greater accountability and efficient management by individual foundations. The tendency to extrapolate from isolated instances of mismanagement or misconduct is undoubtedly encouraged by the limited amount of attention foundations normally receive from government officials and the media—and by the very fact that foundations are shielded to an unusual degree from routine public scrutiny. Plus, in the post-Enron environment, the public is even more ready to assume that governance lapses and financial misdeeds are unacceptably frequent in all sectors.

In fact, informed observers testify that truly major strides have been made toward foundation accountability over the last 35 years. Most large (and many small) foundations publish annual reports on their activities and maintain public websites explaining their work and encouraging use of it; and the tax returns of all foundations are now available on websites of independent monitors. Certainly among larger foundations, boards have become more diverse and have instituted better governance practices. There is a large and growing literature on best practices, promulgated through *Foundation News and Commentary*, professional journals such as the *Harvard Business Review*, and publications of the American Bar Association, the Peter F. Drucker Foundation for Nonprofit Management, and other professional organizations.

This is not to say that concerns about administration expenses that led to congressional action were completely unfounded. Instances do occur of executive compensation out of scale with responsibilities and industry standards, as occasionally do other expenditures not in keeping with best practices. The most constructive way to identify and tackle these excesses, however, is through standards-setting by industry leaders, awareness by foundation boards, and appropriate monitoring by the Internal Revenue Service and state attorneys general.

Communicate more effectively. Foundations' vulnerability to misconceptions regarding their work and expenses could be reduced by better and more public communication. Most foundations, including some very able value-added ones, still leave communication about their own work and the accomplishments of their grantees to their grantees, many of whom are researchers or institutional leaders with relatively little experience with communicating or time to devote to it. Foundations need to be proactive in communicating about all aspects of their work, especially to influential audiences. As indicated by the Fund's 2003 audience survey, reliance on a traditional, printed annual report is unlikely to do the job in a web-oriented world, and all foundations should harness the powerful and relatively low-cost technology of the web to advance their missions and understanding of their work.

Interact more regularly and deliberately with members of Congress. Foundations exist at the behest of Congress. Few congressional districts lack a foundation of significance, and even fewer lack foundation grantees whose work is important to the social and economic environment of the region. No small part of the information that informs major public policy debates is generated by foundations, yet foundations themselves are poorly understood by many policymakers. Foundations should seek more opportunities to sponsor work useful to policymakers and devote more attention to developing communications activities appropriate for reaching them.

REFERENCES

[1] Goldman Sachs Investment Management Division, *Sustainable Spending Policies for Endowments and Foundations*, November 1999.

[2] Cambridge Associates, Inc., for the Council of Michigan Foundations, *Sustainable Payout for Foundations*, April 2000.

[3] John E. Craig, Jr., "In Favor of Five Percent: There's a Place for Permanent Foundations," *Foundation News and Commentary*, May/June 1999.