SeaChange

Ford's $1.0 Billion Bond

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The Ford Foundation's $1.0 Billion Bond

The Ford Foundation ("Ford") announced last week that it would roughly double its grantmaking in each of the next two years. This is terrific as the immense challenges of the present moment require this type of outside the box thinking by foundations. But what made the news "historic" and "unprecedented" was not the extra grants; it was the plan to finance them through the issuance of a $1.0 billion, AAA-rated, 30-year (with perhaps a 50-year tranche), unsecured bond. Why is a $1.0 billion bond financing such a big deal given that a staggering $1.0 trillion+ of investment-grade bonds have already been issued in 2020 to take advantage of record-low interest rates? What does it mean for other foundations?

Although it has been labelled a "Social Bond", the bond issuance is a financial transaction, so it is useful to consider it in the context of Ford as a financial entity. As a financial entity, Ford is a mid-sized investment management company (about #400 in the world by assets) running a "Yale Model" strategy whereby the vast majority of its portfolio is invested in various forms of alternative assets—private equity, hedge funds, natural resources, etc.—using outside managers. As of 4/30/2020, Ford had 87% of its $12.2 billion portfolio invested with these managers and a further 17% in outstanding (i.e. unfunded) commitments. The strategy is overseen by an investment team which includes four of Ford's top five executives.

Over the past five years, Ford has paid out an average of ~75% of its investment income in the form of grants (~85%) and the associated costs (~15%). By paying out less than 100% of its real (i.e., inflation-adjusted) investment income, Ford has grown its portfolio by an average of 1% per annum over the last 25 years in real terms. Interestingly, the real growth over this 1994-2019 period is roughly equal to the $1.0 billion in extra spending that Ford has announced.[1]

As a financial entity, Ford appears to be under-leveraged (i.e., it should borrow more money). The risks it would face from "levering up" are modest given its very low fixed costs (its only hard obligation is to give away 5% of its assets—net of debt—each year), small long-term commitments, and almost infinite time horizon.[2] By increasing its leverage, Ford could expect to earn a spread on the difference between its borrowing costs and its investment returns. While the past is no guarantee of the future, there has never been a 30-year period since Ford was founded in 1936 where stock market returns did not exceed the interest rate on long-maturity, investment-grade bonds. With the benefit of hindsight, it seems like Ford has left money on the table by not using more leverage; money which would have allowed it to make more grants.

However, this analysis is misleading because Ford is *not* a financial institution solely seeking to maximize its income. In fact, it would probably be criticized for "inappropriate speculation" were it to borrow against its endowment with the stated intention of

1 Critics who think that perpetual foundations should not grow in real terms should be pleased that Ford is making a one-time correction for a quarter century of underspending. Others might argue that Ford demonstrates the wisdom of building real reserves in normal years that can be used in special, rainy-day circumstances. Of course, the real growth might just be the unintended consequence of a 25-year period in which real investment returns just happened to have outpaced the 5-6% nominal payout rates used by many larger foundations.

2 It does have a modest amount of debt in the form of a $270 million 30-year bond issued in 2017 in conjunction with the renovation of its New York headquarters.

generating extra profits by investing in higher-risk alternative investments. But if this is true, what makes the Social Bond any different? Here are a few things to consider:

1. *The Social Bond proceeds are being used for grantmaking not investing.* Although this is true in the formal sense—i.e., the bond proceeds are being put in a separate account from which grants will be made—whether it is substantively true, or just a convenient accounting convention, depends on whether Ford is sufficiently committed to the extra grants that it would make them even if it were unable to issue the bonds (i.e., by selling existing investments)[3].

2. *Selling investments to fund grants would be particularly painful at the present time.* Funding the extra grantmaking through asset sales would require Ford to sell almost 25% of its liquid (i.e., maturing/redeemable in <1 year) investments. Ford might have to sell some of these investments anyway to cover its outstanding capital commitments since capital calls from private equity managers are likely to exceed distributions for a while.

3. *Long-term interest rates are at an all-time low.* Not only are investment-grade bonds being issued in record volume but brand name nonprofits have recently issued bonds on attractive terms. In April, Harvard University issued $500 million in 30-year AAA-rated bonds at 2.5% (currently trading at 2.4% YTM). The risk of announcing the Social Bond but being unable to issue it on attractive terms is low.

4. *Ford has the scale and prominence to issue a bond on attractive economic terms with minimal covenants.* The Social Bond is large enough that the transactions costs—underwriters' discount, legal, rating, etc.—will not meaningfully detract from its all-in economics. Ford has in place the elements for a AAA unsecured credit rating, allowing it to borrow with limited restrictions on its future activities.

The Social Return

The documents describing the Social Bond (available through MUNIOS) highlight that the Social Bond will *increase* grants by $1.0 billion in the short term but they not consider that it will also *decrease* future grants by $1.8 billion ($840 million in interest costs, assuming 2.8% over 30 years, and $1.0 billion in repayments). On this basis, it seems more like an "Anti-Social Bond" that will actually reduce total grantmaking by the amount of interest paid to investors. However, this analysis is incomplete because it ignores the impact of the Social Bond on Ford's future investment income.

Any additional grants made now by Ford (or any foundation) will *always* reduce the amount of grants that it would otherwise make in the future. No amount of clever financial alchemy can get around this brute intertemporal constraint, but the relevant questions are: How much do current grants cost in terms of future grants? What are the benefits of making grants now versus later?[4]

The real value of the Social Bond is that it reduces the cost of the additional grants by allowing Ford to make them *without* giving up future income from investments it would otherwise have to sell. This value will vary depending on what the otherwise foregone

3 There might be other legal or UPMIFA considerations that limit Ford's ability to use more of its endowment for increased grant-making even though one in five foundations–-albeit smaller ones—already spend at this level.) For a good discussion on fungibility and additionality in impact investing see Unpacking the Impact in Impact Investing.

4 "Social Discount Rates" are very complex but foundations cannot avoid grappling with them.

investment returns turn out to be.

The table below shows the estimated impact of the Social Bond—modelled as $1.0 billion at 2.8% interest with 30-year maturity—on Ford's total grantmaking, assuming a payout rate of 5% of net charitable assets (after the first two years of extra grant-making) and an existing investment portfolio of $12.2 billion.

The table shows that if 30-year investment returns turn out to be 0%, the Social Bond will reduce total grant-making by the $840 million in interest paid to bond holders. However, at a 6% investment return, the $1.0 billion bond will increase grants by close to $1.7 billion (a 1.7x social multiple); at a 9% return, grants will increase by $5.0 billion (a 5x multiple). Those who believe—as most professional investors probably do—that annual investment returns are likely to exceed the all-in costs of the Social Bond (~3%) over the next 30 years should find the expected "social" return on the bond very compelling.[5]

	30 Year Investment Return		
Social Bond Scenario	**0.0%**	**6.0%**	**9.0%**
Grants (30 Years)	$ 9,462	$ 21,296	$ 34,479
Residual Investments (@ Year 30)	$ 1,945	$ 16,146	$ 39,710
Total	$ 11,407	$ 37,442	$ 74,188
		$ -	$ -
Sell Investment Scenario			
Grants (30 Years)	$ 9,862	$ 20,632	$ 32,697
Residual Investments (@ Year 30)	$ 2,385	$ 15,115	$ 36,517
Total	$ 12,247	$ 35,747	$ 69,215
		$ -	$ -
Bond versus Investment Sale ($)			
Grants (30 Years)	$ (400)	$ 664	$ 1,781
Residual Investments (@ Year 30)	$ (440)	$ 1,031	$ 3,192
Total	$ (840)	$ 1,696	$ 4,974
		$ -	$ -
Bond versus Investment Sale (%)			
Grants (30 Years)	-4.1%	3.2%	5.4%
Residual Investments (@ Year 30)	-18.5%	6.8%	8.7%
Total	-6.9%	4.7%	7.2%
Increase in Grants per $ of Bond	$ (0.84)	$ 1.70	$ 4.97

Lessons for Others

The announcement of the Social Bond should motivate other foundations to consider whether similar long-term, low-cost financing might allow them to make additional short-term grants. In theory, this seems like an attractive idea although it may not be so easy to pursue:

- *Scale*: Foundations seeking to borrow the same 10% of investment assets will probably need to have assets of $1.0 billion or more since bonds of less than $100 million have prohibitive transaction costs.
- *Processes*: As a prominent, long-standing, national foundation, Ford already has in place

5 Counterintuitively, those bullish on prospective investment returns should see a lot of social vaue in the bond but would presumably find it less attractive from a financial perspective; bears attracted by the return may not find the social argument compelling. It's a moot point since the "social" appellation is not expected to change the yield.

the processes and procedures required for an unsecured, investment-grade rating in terms of legal and regulatory compliance, investment strategy, risk management, and quality and expertise of personnel. Smaller or less prominent foundations may not be viewed as sufficiently institutional to allow investors to make a 30-year bet.

- *Terms*: A foundation without sufficient scale or "investment grade" processes can probably still borrow at an attractive interest rate by taking out what would be, in effect, a 10% margin loan against its endowment from a conventional bank. However, the short maturity and associated restrictions might make this unattractive despite the low initial interest rate.

For these reasons, most foundations will struggle, if acting alone, to avail themselves of long-term, low-cost money. However, various types of pooled vehicles (e.g. the California Educational Facilities Authority) have been structured to allow nonprofits to solve similar issues of scale and cost. Although these vehicles have usually been created to support capital investments into facilities, a similar pooled approach could be used to support additional grantmaking by endowed foundations. In the same vein, entities sitting on "dead cash" or short-term, fixed-income investments—for example, community foundations or donor advised funds—might consider "borrowing from themselves" to do more in the present since the fair, arms-length market-price they would have to reimburse themselves in the future is low given where interests rates are (i.e. the opportunity cost of using the money is low).

Ideally, Ford's bold example should inspire creative, socially motivated finance and legal professionals—perhaps working in partnership with a large sponsoring foundation or financial institution—to structure a vehicle to allowing interested foundations to tap the capital markets on similarly attractive terms. Nonprofits need additional grants right now, philanthropy is under pressure to do more, and rates will not stay low forever.

It would be a shame to miss the window for lack of trying.

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