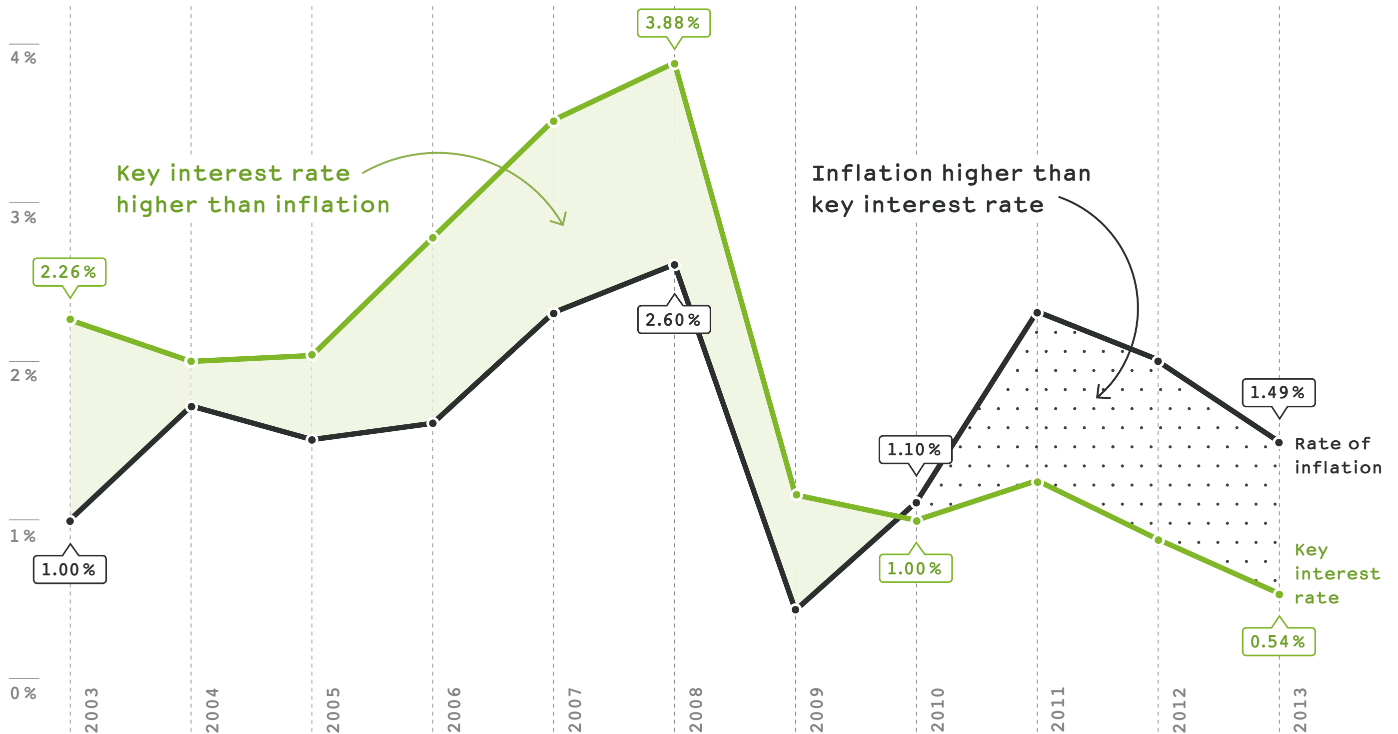
Fluctuating exchange rates and falling interest are not only a headache for stock traders. Numerous foundations in Germany and elsewhere often suffer from lower revenues in times of crisis and difficulty in financing their foundation work.

Lean years for foundations



Development of the ECB's key interest rate and the inflation rate in Germany from 2003 to 2013

Low interest rates and high inflation are a tough challenge for foundations. In Germany, they are obliged to preserve the foundation's real capital. Since 2010, there have been serious problems: the inflation rate is higher than the key interest rate and there are no signs of a shift in interest policies.

Source: Munich Re Foundation, own blueprint 01/2014;
basis for data: statista (de.statista.com)

The unconventional monetary politics of the major central banks are helping the global economy. However, institutions that depend on capital growth, such as foundations, are coming under increasing pressure as a result. This raises the question of how reasonable returns can even be achieved in times of low interest rates and potential state bankruptcies.

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In Germany there are some 20,000 foundations that finance their work to a greater or lesser extent from returns earned on the foundation's capital. They suffer from the fact that the revenues for "secure" investments such as government bonds with good credit standing have fallen strongly in recent years. This not only reduces the financial scope for projects but also jeopardises the objective of preserving the foundation's real capital. For this purpose, inflation must be offset by the regular accumulation of free or undisclosed reserves. However, how can this work if almost no returns can be achieved with a reasonable risk?

The historically low interest rates are the result of a massive market intervention on the part of the central banks. The good news is that this has prevented major states from going bankrupt – at least so far. On the other hand, the central banks are overriding certain market mechanisms with the promise of unlimited bond purchases and other unconventional measures. The frequently invoked "too big to fail" theory distorts the decisions of the market participants, as the possibility of failure is, after all, a major component of our market economy. If this necessary corrective mechanism is immobilised, the prices and revenues of assets no longer reflect the actual risk involved. Flooding the markets with freshly printed money also has adverse effects. Although inflation is still not visible in daily life, many economists are expressing their misgivings in view of such a glut of money.

What action can the asset manager of a non-profit foundation take under such conditions? A closer look at one's own portfolio can offer valuable clues. First of all it must be clarified how the capital investments are reacting to changed market and framework conditions and where credit risks could be lurking. Further important indicators include equity weighting and the duration of the average cash conversion cycle for bonds. At present the motto is "the shorter, the better". When the unavoidable interest rate rebound comes, as come it must, bonds with long-term durations will suffer overproportional capital losses.

Many foundations have paid too little attention to their asset management in recent years, some allowed themselves to be led into taking higher risks because of the allegedly higher revenues. Both approaches are misleading as the whole point is actually to secure the foundation's capital. The importance of this priority can be demonstrated by a look at the USA: here the foundation of the elite Harvard university is still struggling with the losses incurred during the financial crisis which, according to estimates, at times amounted to 30 % of the foundation's capital. This leads to the conclusion that the objective of capital preservation can only be achieved with a long-term investment strategy and realistic revenue expectations.

The present market situation makes it difficult to generate satisfactory revenues with appropriate risks. For this reason, expectations should not be oriented to the results of earlier years. The Munich Re Foundation has generated an average revenue of more than four per cent per annum since 2002 and has never experienced a year with losses – despite the difficult framework conditions. For the coming years, capital preservation, in other words, a break-even result, is the main priority. Depending on whether the interest rates soon leave their all-time low behind or remain on the present level for a longer period of time, a different positioning will be required. Both scenarios require different strategies for which the course must now be set.

Regardless of scenario, a decisive rule of asset management holds that capital investments must be broadly diversified. This succeeds with a mixture of corporate and state bonds from different regions supplemented by a blend of shares and real estate. This is often easier said than done. A sophisticated and broadly diversified investment strategy requires resources that are often only available to larger foundations.

Even if everything for the capital investment is done correctly, the foundation's own formalities make the goal of capital preservation more difficult under the current conditions. As long as not more than one third of the ordinary income can be reserved for this purpose, this cannot be achieved with returns that scarcely balance out the impact of inflation. What is required here is an adjustment of taxation and foundation legislation to give the foundations more flexibility. We should not succumb to any illusions: safety-oriented investors are still facing lean years ahead. One can only hope that the supervisory authorities will take the changed financing market environment into consideration and support foundations accordingly.

The financial crisis keeps the whole of Europe on tenterhooks. Spain has the highest unemployment rate on the continent. This leads to repeated and heated protests and demonstrations. There are still no signs of an end to the financial crisis.