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Principles of Nonprofit Investment Management

The key issues facing trustees and financial officers

PRINCIPLES OF NONPROFIT INVESTMENT MANAGEMENT

A publication of Commonfund Institute

For the Nonprofit Community

Commonfund Institute is dedicated to the advancement of investment knowledge and the promotion of best financial management practices among nonprofit organizations. It serves educational institutions, foundations, health care institutions and other types of charities.

The Institute's programs and services are designed to serve financial practitioners, fiduciaries, and scholars. Its programs include seminars and roundtables on such topics as nonprofit investment and treasury management, publications, and special events such as the Commonfund Forum. Annually, the Institute undertakes proprietary and highly comprehensive research among institutions to study the practices and performance of nonprofit investment management. The research results are published in the Commonfund Benchmarks Studies and are widely used by institutions to measure their individual results against a body of peers.

We are grateful to our advisory panel members whose experience and dedication to the nonprofit world helped make this brochure possible. Those we want to thank in particular are Jennifer Neppel, Director of Cash and Investments for Denver's Catholic Health Initiatives; Laurance Hoagland, Jr., Vice President and CIO of the William and Flora Hewlett Foundation; and Linda Strumpf, Vice President and CIO of the Ford Foundation and member of the investment committee of Penn State University.

The financial world has changed dramatically since the first edition of this brochure was published in 2001. Well-publicized stories of corporate scandals, dubious trading schemes, public dissensions and individual fraud have spilled out of the media into our offices and homes. Rigorous new legislative and administrative rules have been established. It would be a great mistake to think that these changes affect only the corporate sector. Increased public scrutiny has placed even more intense pressure on all boards to rigorously discipline their financial operations and fiscal integrity. The breadth of these changes as they affect the nonprofit world has been covered in Commonfund Institute's Monograph, "Governance. Your Board: Dynamic or Dysfunctional?" (See References, page 30.)

Those responsible for the management of a nonprofit investment fund bear a special burden, which is both ethical and legal, for they are charged with the preservation of capital and the responsibility to fund the institution's mission. And there is no universal measure of what these responsibilities are and how long they will endure; appropriate time horizons can range from one year to perpetuity.

The roles and responsibilities of the investment committee members and staff of a nonprofit are varied and complex. For that reason, we at Commonfund Institute have created this publication. In the following pages we endeavor to summarize a comprehensive approach to nonprofit investment management that all concerned can share: both the financial professionals and those with less expertise; both the trustees, who establish policy, and the officers who execute it.

This publication identifies and defines the seven key issues governing nonprofit investment management. These are the issues that you must focus on as you assume your responsibilities in managing your institution's investment assets. These time-tested principles outline a clear and rational way for you to make sound investment decisions while providing your board with best practices on setting objectives and policies for your investment activities.

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Basics

The very existence of a nonprofit investment fund poses a number of difficult questions that the institution's policy makers must continually reconsider.

To start, we will define a few basic terms and describe basic connections. Different types of institutions use different terminology. Educational institutions and foundations generally refer to their long-term investment funds as their endowments, while health care organizations typically use long-term operating funds to describe their long-term investments. We will use these terms somewhat interchangeably. It is important to note that this brochure does not deal with pension funds, insurance reserves, or short-term cash, although many of the principles apply.

A nonprofit investment fund can be defined as a portfolio of assets donated to a nonprofit institution to aid in its support. In their medieval origins, endowments consisted of farmland donated to churches, which would earn rental income from the land's tenant farmers.

In modern times, endowment assets are held in a variety of financial instruments, which may include real estate and limited partnerships. Investment "income" in a modern portfolio can be comprised of capital appreciation as well as traditional income, i.e., interest, dividends, rents and royalties. In the U.S., investment of endowment funds is generally governed by the Uniform Management of Institutional Funds Act (UMIFA), introduced in 1972 and now enacted in most states.

What benefit does the endowment bring to the institution? In the short term, a portion of its annual return on investment can be transferred to the institution's operating budget.

Many institutions can realize their missions and achieve a high quality level in their programs only because of endowment income.

Institutions may periodically run capital campaigns to attract new contributions to their endowments. Depending on the wishes of the donors, gifts may include restricted as well as unrestricted funds, the former limited to such purposes as faculty compensation, community programs or causes, specified research activities or disease treatment centers, athletics, arts, or expansion of facilities.

Inherent in this brief description you can sense a number of difficult questions that the trustees and investment committee members, as the policy makers for the institution, must face:

What is the real objective of the endowment? How should the endowment relate to the institution's mission? How much should it contribute to the operating budget? How can an investment fund's value be preserved for the future? How should it be invested for maximum return? How to control investment risks? Who should make the decisions? Who should assume which responsibilities in managing the investments?

Generally, six of the seven investment principles speak to all types of institutions. The exception is Principle Two, Payout Policy, which is dealt with specifically for each type of institution.

Objectives

The governing board, through its investment committee, must define the investment objectives that will best support the nonprofit's philanthropic mission. The committee should write the objectives into an investment policy statement and use it continually as a guide for its investment managers and its own decisions.

All involved in nonprofit governance and management certainly know their organization's mission and – at least in general terms – the kinds of programs most likely to realize its goals. But when it comes to assuring the financial resources to support those programs, different perspectives and expertise are required.

Members of the governing board who came of age in the private sector may tend to think of ultimate objectives in terms of net profit, return on investment, and shareowner value, all of which are measurable. In their nonprofit roles, however, they have to cope with more subjective goals.

These goals must be understood first in terms of the social and intellectual utility of the institution, however intangible that may seem. Ultimately, the board must view the pools of assets that support the mission within the context of the entire organization and the optimization of its mission. What can create confusion is that the terms employed resemble those used in business; profit and growth certainly have relevance to the management of a nonprofit's investment fund. But in a nonprofit environment, success has very different implications.

The board, usually through its investment committee, exercises that responsibility by defining the objectives that will guide its assigned investment experts. While the statement of the objectives should be clear and simple, the process of formulating – as well as maintaining – those objectives is never simple.

The committee has to weigh several potentially vexing issues that can affect how the mission will be translated into investment policy. The issues may include:

- The role of the fund in supporting the institution's mission, as well as in maintaining a healthy balance sheet
- The total real return goal needed from investment activities
- The additional bequests and/or donations that can be expected
- The legal requirements affecting the fund
- How much of the endowment's return should be spent, and how much reinvested, and how this should be calculated
- The liquidity required to cover distributions and expenses over a reasonable time frame
- The level of risk the board members believe they can tolerate, including definition of acceptable (and unacceptable) types of investments
- Formal documentation of the decision-making process, and responsibility, accountability and authority, including which investment decisions, if any, should be delegated to outside consultants, advisors, or investment managers
- Special characteristics of the nonprofit's programs, distributions, and other financial decisions that can affect spending or tax exposure
- Special limitations on investment imposed on portions of the fund by donors or by particular constituencies, such as a community nonprofit's governance requirements
- The impact of policy decisions on future giving
- The strengths and weaknesses of the institutions, the investment committees, staff and any outside consultants.

The committee's deliberations will almost inevitably provoke some argument. Members must be cautious of impasse, delays or compromises that can weaken their decisions. It will help smooth the process if the committee, at the outset, establishes a timetable, final deadline and a few ground rules for resolving disagreements, and achieving resolution.

These deliberations are best carried out in a formal manner, with the resulting policy expressed in a written statement. An informal or hurried approach risks confusion, misunderstanding, second-guessing, and delay. The members of the committee, after all, represent various backgrounds, points of view, and priorities. As in any such deliberative body, conclusions inevitably depend on compromise.

One very important consideration is that a nonprofit's mission, and the way it is translated into investment policy, makes a fundamental difference in its investment strategy. If needed, expertise can be obtained through outsourcing. But the fundamental responsibility remains with the nonprofit's governing board – the responsibility for preserving, growing and allocating the funds that will be needed.

One nonprofit might be facing an urgent humanitarian challenge or an imminent construction project that demands large near-term distributions. In such a situation, the nonprofit may have to invest all or a large portion of its funds in short-term, fixed-income instruments to minimize any value fluctuations during the period of heavy disbursements.

Another nonprofit might be committed to supporting educational missions that are presumed to be perpetual. That nonprofit might allot a portion of its portfolio to a variety of higher risk investments with the potential for higher returns in the future. Yet another might be managing its funds to build a particular set of physical facilities and opt for a portfolio of guaranteed returns providing liquidity at the key points in the construction process.

Time horizons create a key consideration for many endowments and a powerful definition of their management requirements. The length of time between a defined term and perpetuity creates important considerations in management perspective. There is an enormous difference between the duration of a construction project to build a new hospital wing and a mission to provide services in perpetuity. But for anyone sharing responsibility for a nonprofit investment fund, the term "capital preservation" takes on incomparable gravity; it can mean safeguarding assets during a period of market decline so as to be able to finish a contracted-for construction project, or it can mean preservation forever.

All of these considerations need to be examined and codified by the committee, as well as legal considerations that may apply to given funds or to an endowment as a whole. The output of the committee's deliberations will be a written document: the investment policy statement.

The written statement brings the tensions of the varied perspectives to a resolution, opening the way for action – at least until the next round. The writing style should be clear and plain enough – free of jargon or technicalities – to be understandable by everyone concerned, inside and outside the nonprofit's organization. The use of numbers and specifics helps achieve the needed clarity.

The statement should be as short as possible but as long as necessary to cover all relevant points. The final document should reflect the unique character of the nonprofit. The investment committee presents the statement to the full governing board for approval. The statement should then be used continually as a guide for investment manager selection and investment strategy decisions.

At least once a year, the board should review the statement critically against changing realities and make necessary revisions.

You'll find further discussion of some of these in the following pages.

Payout Policy

The board and the nonprofit's management should budget the total amount the nonprofit will spend in the next few fiscal years. Their decision process should take into account the nonprofit's time horizon and any other considerations such as special requests from management, other constituents, or any legal payout requirements.

We define "payout" as the total amount of money distributed from the nonprofit's investment fund to support current programs. We use the term payout policy for all types of institutions, but there are significant differences among the ways various types of institutions create and execute their policies.

For those nonprofits covered by the UMIFA, there is no specificity as to what the payout percentage should be; the nonprofit's governing board still bears the burden of that decision. Certain rules of thumb, however, have become apparent from surveys of general practice.

The overriding objective of the pool of assets is to create a stream of cash flow to fund programs consistent with the nonprofit's mission. The establishment of the objective of the pool will determine the time frame for payout. If the pool is perpetual, the liability stream associated with the pool is difficult to predict. In most cases, the objective will be to maintain a stream of distribution that grows by the rate of cost increases impacting the mission.

Ultimately, the payout rate will prove to have a great effect on investment strategy and the longevity of the nonprofit. Experience has shown that a payout in excess of 5 percent challenges the ability to achieve maintenance of purchasing power.

This is why budgeting the payout for the next few fiscal years is essential. Obviously, the payout rate will have a crucial effect on the formulation of investment strategy and vice versa.

The process of developing the budget requires a number of definitions and decisions; some of them are fine points that can try the patience of the unwary. In fulfilling the nonprofit's mission, the board decides how much to distribute in the coming years, taking into consideration the claims on its resources and the level at which the institution can and will respond. Income defined as capital gains, dividends and interest alone is not a complete determinant of payout policy or rates, because for quite some time income-oriented investments have failed to keep pace with economic growth.

When the total payout rate has been tallied, the board or its financial team must consider the level of liquidity it will need in its asset base and what strategies to use in its cash management.

This being said, it must be recognized that the types of institutions covered in this brochure have very different influences affecting their payout policies, as described on the following pages.

Payout Policies for Educational Institutions

Educational institutions have a significant degree of latitude in setting their own payout policies, as there are no statutory mandates dictating minimum payout levels. However, there are certain practical considerations affecting payout policies, as these institutions are generally dedicated to fulfilling their educational missions in perpetuity. Therefore, a balance must be struck between building the value of the endowment to provide for the needs of future generations and contributing to the quality of education in the present by supporting staffing levels and programs.

Traditionally, the popularly accepted formula has been "5 percent of a three-year moving average of market value." However, the recent bear markets have exposed the weakness of this approach as many schools saw their returns plummet, creating shortfalls in the funds available to support their operating budgets. An example of this phenomenon can be found in the 2004 Commonfund Benchmarks Study™ in which 22 percent of respondents increased their spending rate with 17 percent increasing the dollar amount; 25 percent decreasing their spending; and 17 percent decreasing their dollar spending. Overall, only 51 percent held their spending rate stable year-over-year.

Recently, there has been much discussion about spending levels and methods. There has been an increasing use of formulas that use cost increases as part of the determination of the new distribution amounts. Many institutions that have converted to this method use the Consumer Price Index plus a percentage of the Higher Education Price Index compiled by Commonfund Institute.

Another consideration concerns spending from restricted funds for which the market value has fallen below their "historic dollar value." These are referred to as "underwater funds." Once this has occurred, endowment managers must refer to applicable laws in their state (most states have adopted the UMIFA for guidance on whether spending of any sort can be continued from these funds).

In certain states, spending from underwater funds is restricted to "income" – interest, dividends, rents and royalties – per the old trust law definition. In others, spending may be forbidden altogether. But, in many cases, the programs endowed by these restricted funds continue, such as the support needed to underwrite an endowed professorship, and the shortfall must be met from other sources. The 2004 Commonfund Benchmarks Study found that 54 percent of respondents reported having underwater funds. Of these, 35 percent were no longer spending from these funds, while 25 percent were spending "income" only. Ten percent had asked the original donor for additional funds so that the programs supported by the fund could be continued.

The volatility of markets in recent years – euphoric gains followed by crushing declines – means that investment committees must take a more active role in managing their spending to deal with the tension created by balancing the needs of today's students and those of future generations.

Payout Policies for Foundations

Foundations have very special legal requirements concerning their minimum payout level, currently a minimum of 5 percent of the endowment value (subject to possible legislative change as this is being written). Further, there are fairly technical requirements as to what types of spending may be counted against the 5 percent minimum. In the most recent Commonfund Benchmarks Study, 39 percent of foundations responding – the largest proportion – indicated that they set their spending rate by targeting the 5 percent distribution requirement. In other words, it appears that the most they plan to spend is the minimum required by law.

However, in practice the 5 percent target is often exceeded. The same Benchmarks Study found that the average spending rates for all foundations was about 6 percent, ranging from 6.1 percent for the largest foundations to 5.5 percent for foundations with between $50 million and $100 million in assets.

Several factors account for the difference between the traditional targets of 5 percent and the actual level of spending. The items allowed in computing the statutory spending level include payments to support the operating budget, distributions to grantees, the cost of services the nonprofit may provide grantees, and the overhead and administrative costs incurred in running the nonprofit.

The relatively high spending rate of 6 percent is also due to a number of other factors, including the effect of lower market values of the underlying funds during a prolonged bear market. Multi-year commitments to grantees and an unwillingness to reduce the volume of new grants to increasingly hard-pressed charities has also played a part in keeping spending rates higher than the legal minimum, in spite of the declared policy of many foundations to spend no more than 5 percent.

In deliberating and managing its payout rate, the board navigates through rocks and shoals. Are there legal or regulatory changes ahead? Might environmental or societal changes create pressures to modify the foundation's mission? Are the number of grantees and their needs increasing?

A community foundation is likely to have a regular fundraising program that, in good times, can make up the difference. A private foundation may receive further donations, in time, from the founding family.

Many foundations spend down their assets in about fifteen years. A foundation that aspires to a longer time horizon or to perpetuity, unless it will receive further infusions, is driven to take a more conservative payout policy – and a more aggressive investment strategy.

It appears that a large proportion of the nation's foundations are striving to restrain payout and project a long time horizon. But the distribution goal does not encompass all payout. Investment costs must be counted outside the payout. Whether you count those costs as a deduction from total return or an addition to payout, they are weighing against mission.

Foundations often face the challenge of managing a large amount of the donor's stock and developing an acceptable diversification process.
In addition, in the course of making their decision concerning payout policy, boards must keep in mind the prevailing definition of "distribution" and the current legal restrictions under which their foundations function.

They could then calculate the payout rate as a percentage of the investment fund's total net asset value. The overriding consideration is the relevant section of the Internal Revenue Code stipulating that foundations must distribute at least 5 percent of their assets every year if they are to preserve their status as tax-protected entities.

The calculation of the 5 percent is based on the average of the market value of the foundation's portfolio at the end of each month of the previous calendar year. Once that is known, the pressure is on to debit at least 5 percent of that average from the foundation's balance sheet and to make sure the money has been spent – deposited into the bank accounts of qualified grantees – by the end of the current year. Making this calculation even more complex are the regulations concerning attribution of administrative and overhead expenses, as well as excise taxes.

The calculation must be timely enough to facilitate accounting and execution. Overhead and all other expenses must be precisely defined to determine which are attributable to distribution. Program expenses and staff time spent in grant making may be included.

Meanwhile, another factor enters the board's deliberations about its distribution rate: the excise tax that the federal government imposes. The tax amounts to 2 percent of annual net investment income and realized gains, unless total distribution reaches a certain tipping point which then brings the tax rate down to 1 percent. Because the formula used to determine qualifications for the reduced rate is so complicated, relatively few foundations apply for the reduction. The new legislation proposes to reduce the rate to 1 percent overall.

As it has stood, the two-and-one percent excise-tax formula has tended to motivate foundation decision makers to raise their distribution rate higher than they might have otherwise; better to pay more to grantees and less in tax. The old tax formula could also influence decisions about when to take investment gains or losses.

And so, the foundation's financial team determines its optimum course, weighing income, distribution and tax issues.

To be sure, distributions are not the only payout impacting a foundation's life expectancy. Expenses related to management of the foundation's investments are counted outside of the distribution allotment.

These include not only fees paid to outside consultants and investment managers but also related investment overhead expenses, e.g., administrative salaries, space costs, and expenses of the board and investment committee.

Inevitably, ambiguity arises. Some administrative expenses are not clearly classifiable as part of either distribution, administration or investment management: certain costs of research, for instance, or conferencing. If a foundation sponsors a forum for grantees, is that counted as part of the 5 percent distribution requirement?

In recent years, new federal legislation has been proposed (the timing of possible passage is unclear) that could eliminate the attributable administrative and overhead expenses that can now be included in the 5 percent total. Such a law would tend to accelerate the rate of total payout of most foundations, possibly bringing some of them to depletion somewhat sooner than they would have planned or wished.

Aside from these pressures, a foundation may be impelled by its mission to distribute more than 5 percent of its assets. The needs of its grantees and the urgency of their work may demand it. A foundation so inclined must recognize it may ultimately be limiting its time horizon.

Payout Policies for Health Care

Health care organizations differ from endowments both in how assets are obtained and how funds are spent. First, health care organizations generate revenue from the services provided. These funds are obtained from insurance companies, government programs and patients. Additionally, some health care organizations receive donations from individuals or organizations that wish to support overall operations or to assist in funding a specific project (i.e., a cancer wing). Both of these funding sources serve to build the long-term investment assets of the organization and are needed to support the mission of providing health care services.

Health care organizations typically have significant capital requirements. The capital is spent on items such as medical equipment, construction or remodeling of the physical structure, information technology, etc. Most health care organizations review their capital needs on an annual basis and then determine which projects will be funded. Projects can be funded through cash generated from operations, issuing tax-exempt bonds, fundraising initiatives and/or withdrawing funds from the long-term investment assets. Typically, a mixture of these funding sources is used to pay for the capital expenditure.

While there is no predetermined "payout policy" for health care organizations, one important consideration is how the funding method impacts the overall strength of the organization's balance sheet. One way to measure this strength is by the number of "days cash on hand." A day of cash on hand is equal to the amount of money it takes to operate the health care organization for one day and is indicative of the liquidity of the entity.

Days cash on hand is one of many indicators used by the rating agencies (e.g., Moody's, Standard & Poor's, etc.) to assign a rating (i.e., AA) on the tax-exempt debt issued by the health care organization. For example, an AA-rated health care organization typically has 175 days cash on hand or greater. Many consider it advantageous to obtain the highest rating possible as the best-rated health care organizations typically pay a lower interest rate on debt.

Another important indicator is the debt-to-capitalization ratio. This ratio is also closely monitored by the rating agencies to ensure that the health care organization does not utilize unreasonable amounts of leverage to pay for its capital expenditures. A health care organization with a AA rating, for example, normally has a debt-to-capitalization ratio of 30-40 percent.

The next section, Principle Three – Asset Allocation, discusses the key issues in managing investment strategy.

Asset Allocation

Allocation of the portfolio among the principal asset classes is the committee's most crucial investment strategy decision. Considering the nonprofit's mission, the investment committee must weigh the investment risks the nonprofit can afford to take in seeking the return needed to support its obligations.

The inevitable ebb and flow of markets pose a special challenge to nonprofits, whether they are striving to preserve their capital base over the long term or concentrating their distributions within a limited time period.

Anyone faintly aware of the behavior of the stock and bond markets from the early 1990s into the early 2000s has seen how extreme and rapid the ups and downs can be, and how unpredictable. Even within short time frames – single trading days, for instance – market volatility has become more extreme than in almost any time in the past century.

Nonprofits obliged to make relatively frequent withdrawals from their portfolios may naturally wish for some semblance of consistency in their investment results. This suggests a low-risk, low-volatility strategy. Nonprofits with urgent distribution commitments and shorter time horizons, such as international relief organizations, might well concentrate a portion of their portfolios in fixed-income investments of short duration and high liquidity, a strategy that minimizes volatility.

On the other hand, nonprofits with a long time horizon may find that risk avoidance has a very significant cost. Over the long term, high returns generally come as the reward for taking greater risks. And, with rising payout pressures, nonprofits certainly need higher returns.

Either way, nonprofits face difficult decisions in investment management. Obviously this challenge calls not only for financial expertise but also for great prudence in managing the investment process.

Historically, prudence was a legal requirement of fiduciary responsibility and fostered a highly conservative investment bias. In some early common law rulings, common stock were deemed "per se" imprudent. The experience of the 1930s, however, proved that bonds could be risky, too. The century-old legal principle, popularly known as "the prudent man rule," then became the pervasive guide for trustees, giving them greater discretion in selecting investments, but still requiring them to invest for current income rather than total return.

Since the introduction of the UMIFA in 1972 broadened the "prudent man rule" into a "prudent investor rule," fiduciaries are permitted to take into account many of the new developments that have changed the landscape of the investment world during the past half century. The so-called "prudent investor rule" permits them to consider the expected total return (i.e., capital appreciation as well as income) of the institution's investments. They could then calculate the payout rate as a percentage of the investment fund's total net asset value. Most nonprofits now use this approach.

But in the post-World War II decades, the concept of prudence changed from one of avoiding risky investments altogether to one of balancing the risks of various kinds of investments against one another.

This change in attitude was encouraged by the theoretical work, often referred to as "modern portfolio theory," that won Nobel Prizes for the economists who originated it. Their aim was a better understanding of the relationship between investment risk and return. A highly simplified summary of these ideas might go as follows:

The degree of risk entailed in an investment can be expressed as its volatility, which can be calibrated statistically. This measurement, called the "standard deviation," indicates in percentage terms the degree to which an investment's value has varied – up and down a fixed 66⅔ percent of the time – in the course of arriving at its mean return over a given time period. Investments with higher standard deviations will generally produce greater gains over the long term. Therefore, if you aim to get the most out of your investments long term, you have to own some that have a higher degree of risk.

But you can offset their volatility by also holding investments that perform differently – whose performance has a low degree of correlation with the rest of your holdings. The volatility of one investment tends to lower the volatility of a portfolio without impairing the combined return potential. Combining risky assets can lower the overall volatility of the portfolio.

This thinking widened investors' focus from the selection of individual securities to include the design of their overall portfolios, as reflected in the proportions of stocks to bonds to cash they held in their portfolios. In fact, the allocation of the portfolio among principal asset classes has been shown to be the main determinant of investment success.

Increasing diversification within each of the principal asset classes can further dampen volatility. A well-diversified portfolio may include small-capitalization stocks as well as large-cap stocks, international stocks as well as U.S.-based stocks, corporate bonds as well as Treasury bonds, short-term fixed income as well as long- and intermediate-term, and so forth.

Commonfund conducts Benchmarks Studies covering educational institutions, foundations and health care organizations that measure a variety of different practices among them. The following table compares the asset allocations made by educational institutions, foundations and health care organizations, which are derived from three Commonfund Benchmarks Studies conducted recently. It should be noted that there is a significant amount of distribution around the allocations averaged out in the survey data.

Generally, these Commonfund surveys have found that institutional asset allocations have moved strongly away from fixed income in favor of equities (both U.S. and international) and toward alternative investments, a broad category that encompasses hedge funds, private equity, venture capital, equity real estate, distressed debt strategies, commodities, and energy and natural resources. In general, the performance of alternatives tends to have a reduced correlation to that of publicly traded investments (stocks and bonds); many nonprofits have been increasing the proportion of alternatives they hold.

A huge accumulation of historic data on portfolio performance has provided the basis for suggesting a point of optimum portfolio balance for each of various long-term return targets at given standard deviations. Laid out on a graph, these optimal allocations appear as a rising convex curve, known as "the efficient frontier."

Asset Allocation *Dollar Weighted*

Equities are the largest asset class for all types of institutions, but the largest variations are found in Fixed Income and Alternative.

Type of Institution	U.S. Equity	International Equity	Fixed Income	Alternative	Cash
Education*	32%	14%	19%	33%	2%
Foundation**	48%	10%	24%	14%	4%
Health Care [1]***	37%	10%	43%	9%	1%

Note: [1] *All long-term operating funds*
Sources: * *Commonfund Benchmarks Study – Education 2004*
** *Commonfund Benchmarks Study – Foundation 2003*
*** *Commonfund Benchmarks Study – Health Care 2003*

Many such analytical tools are available to institutional investors to aid them in making asset allocation decisions. Their utility, of course, varies. Those models that use the concept of the efficient frontier must, by definition, assume the predictive validity of historic data. But it's axiomatic that past performance does not necessarily predict future results. Economic and financial events often swing far outside of past ranges, and the ranges are not always reflected clearly in the averages (e.g., the average temperature of a man sitting on a cake of ice with his feet in a stove).

The allocation planning model used at Commonfund factors in many different economic scenarios to project a very wide range of possible outcomes for any given asset allocation. In a complex statistical process, the model uses "Monte Carlo simulation" to randomly generate a thousand different yield curves for next year and then projects how each of these is likely to affect the results of each of nineteen asset classes.

For each of the thousand scenarios, the model then generates another thousand yield curves for the second year and again projects the probable results for those nineteen asset classes. The model runs these simulations for each of twenty years into the future.

Having processed so many different possible values for each variable, the model's output will show not just a mean outcome but also a distribution of possible outcomes for each projected investment period and the probability of each of those outcomes. This approach, as you can see, goes beyond historically based averages and looks at what economic and financial conditions might really turn out to be down the road. It also allows for the examination of risk in the tails of potential outcomes beyond one standard deviation.

As a further guide for their decision making, investors are also advised to take a hard look at the present environment, consider what the economic and market outlook might be for the next few years and what that suggests for investment strategy.

No matter how sophisticated the planning tools employed, the future is unknowable. Ultimately, it comes down to human judgments about what could happen, based on the best information available at the time. Sometimes basic questions can tip the balance. For example, in an environment of rising interest rates, shouldn't you be underweighting your bond allocation? When the returns of the broad indexes are expected to be comparatively modest, shouldn't you be giving greater emphasis to skillful stock picking and opportunistic tactics to help achieve the returns needed to cover payout and inflation rates?

In the fast-moving world of nonprofits, where investment returns can be so crucial, a detailed point of view about the trends in the economy and markets is essential.

For all the information and analytic tools used to guide decision makers, the asset allocation decision still remains difficult; it involves more than numbers. For nonprofits, this decision must embody the philanthropic mission and perhaps deeply held feelings of founders and members of governing boards, their risk tolerance, their sense of the nonprofit's time horizon, and any number of policy issues that cannot be expressed in numbers alone.

Private nonprofits, established on the stock of the founder's company, remain in a highly risky predicament until the portfolio can be diversified. That in itself needs careful planning – assuming that liquidation is allowed.

In any scenario, the determination of the asset allocation target must be carried out in a disciplined manner. At the outset, the investment committee, or the full board, ought to agree on a moderator and an agenda for the discussion. Every member should have the opportunity to express his or her concerns and expectations. Allow each one to propose the level of risk he or she considers tolerable.

In writing its investment policy statement, the committee should include a rationale for the asset allocation on which it has decided. A brief, well-stated explanation could help achieve the concurrence of the full board and founder or founding family and help guide portfolio managers in implementing investment strategy.

In time, as markets change, the portfolio's actual asset allocation will deviate from the targets set down in the policy statement. This is a natural consequence of the markets granting higher returns to certain asset classes than to others. Therefore, adjustments must be made on a regular basis.

The theory underlying asset allocation strategy prescribes periodic rebalancing to bring the portfolio back into targeted ranges. This means selling some of the appreciated assets and reinvesting the proceeds in asset categories that have declined.

For the inexperienced, selling successful investments may seem counter to long-held beliefs. But, looked at another way, it forces action that gets to the very essence of successful investing – buying cheap and selling dear.

The investment committee must maintain oversight of the portfolio through all the cycles of the investment markets. But for implementation of its asset allocation policy it employs professional investment managers. And that is the subject of the next section, under Principle Four.

Manager Selection

The investment committee or investment staff hires an array of investment managers to implement the plan presented in the investment policy statement. The selection of managers requires a diligent investigation of each candidate's entire set of qualifications, not just past performance and philosophy.

An asset allocation plan calling for a diverse selection of investments requires a diverse selection of investment managers. Expertise is needed for each type of investment.

Recent Commonfund Benchmarks Studies found a wide range in the number of managers used by nonprofit institutions, with the greatest diversification to be found among educational institutions.

A nonprofit's investment policy statement might indicate the kinds of specialized managers needed, and it might state their required qualifications. But the actual selection process usually turns out to be more than the investment committee or staff can comfortably handle. Furthermore, the character of the institution may also dictate policies for manager selection, such as avoiding tobacco and alcohol-related securities, focusing on socially responsible companies, or other qualitative criteria.

Selecting investment managers is itself a specialized capability. The process includes not only selection of candidates but negotiating the engagement and monitoring the managers on a continuing basis. That is why nonprofits often outsource the entire selection process.

In the interest of full disclosure, we must point out that selecting and managing investment managers constitutes one of the chief occupations of Commonfund. We manage managers for many hundreds of nonprofit institutions. The following discussion, while admittedly based on our approach to managing managers, is not consciously intended to promote our own services.

What makes manager selection so complicated? Start with the fact that there are thousands of managers to choose from and new firms crop up regularly. Local sources, though convenient for face-to-face meetings, do not necessarily provide the best match. And the well-known stars are not necessarily the best choice.

Numbers of Managers Used

The number of managers increases with fund size.

		Endowment Size			
Type of Institution	**All Institutions**	**Over $1 Billion**	**$500-999 Million**	**$200-499 Million**	**$100-199 Million**
Education*	13	81	30	14	14
Foundation**	13	35	16	10	10
Health Care***	8	15	11	6	5

Sources: * *Commonfund Benchmarks Study – Education 2004*
** *Commonfund Benchmarks Study – Foundation 2003*
*** *Commonfund Benchmarks Study – Health Care 2003*

Selecting investment specialists has itself become a specialized skill. Candidates must be investigated in depth. Performance data alone can prove misleading, especially if they cover only a short term – less than five years. Performance in less than one market cycle could tell more about the firm's luck than skill. And past performance alone has never provided a reliable prediction of future success.

For each specialization, the selection goes forward step by step:

- Compiling an initial list of candidates
- Gathering basic information about each one
- Narrowing the list
- Conducting preliminary due diligence
- Selecting the finalists
- Completing due diligence and comprehensive portfolio attribution analysis
- Hearing presentations of the finalists
- Making final selections
- Conducting negotiations

A key resource of the manager of managers is the database of the expanding world of investment managers. The information collected on any one manager covers every aspect of that firm's business. In our manager information template at Commonfund, the questions alone take up twenty-three pages.

You must also be aware of possible conflicts of interest. Does the firm have any connection with any member of your board or management?

And, after all of that, you have to consider the "alpha" factor – the talent the manager demonstrates within a risk parameter for achieving results beyond the average of the market in which he or she functions. Effective active management – as opposed to passive, index-centered management – now makes the difference to the financial life of a nonprofit. And your effective managers should now be given the freedom to maximize investment opportunity as they know best.

After selection and engagement, the manager of managers regularly monitors the "combination effect" of various managers within a single portfolio. They review performance against benchmarks and remain vigilant for significant changes in any of the management firms.

To facilitate portfolio building, a manager of managers may package groups of investment managers into specific kinds of investment pools or funds. For instance, it may create a small-cap fund, grouping managers with different investment styles or strengths. It may offer funds that represent particular strategies. It may also create a fund around a particular manager, using its group-buying position to lower fees and make that manager available to smaller investors than it normally accepts.

The manager of managers may, in addition, provide related services to enhance the institution's investment capabilities; services such as risk management, legal oversight, investment education, integrated reporting and analysis.

Ideally, the manager of managers develops a working partnership with the nonprofit's investment committee and consultants, working together to realize the objectives set forth in the nonprofit's investment policy statement.

In evaluating managers, here are some of the things you need to know:

- The firm's investment style and philosophy
- Actual evidence of its commitment to that philosophy
- How the firm's decision-making process works
- The kinds of internal controls the firm uses
- The quality and timeliness of its reporting system
- How the firm complements the other investment firms working for you
- The firm's ownership structure
- The quality of its senior management
- The qualifications of its professionals
- The stability of its professional staff and management
- The size of the firm in terms of staff and assets under management
- How the firm has changed over time
- Its fees
- Risk management capabilities

Risk Management

You should think of risk as the possibility of failing to fulfill the nonprofit's mission in any way. More immediately, you may be at risk of failing to meet current financial commitments. You must establish a discipline to first recognize the risks inherent in every facet of your investment system and then to control them.

Because so much is at stake, a governing board must give the subject of risk a permanent place on its agenda. If and when losses occur, those involved might well wonder if they could have been avoided. The answer is often yes, if the question had been asked before the losses happened.

To make sure the right questions are asked at the right time, a systematic approach to risk must be built into a nonprofit's investing process.

In the dictionary sense, "risk" is simply "the possibility of harm or loss." In the investing arena, risk commonly refers to the effect of market volatility and the possibility that the investor may have to sell when valuations are down. But for a nonprofit, risk has broader significance.

A nonprofit's investment risk means the possible failure to meet its commitments to beneficiaries. Think of it as the failure to earn a sufficient return to cover this year's distribution requirement or the intended transfer to the operating budget. But the risks do not stop there. Failures can occur in any part of the investment process, internal or external – in operations, in the safekeeping and accounting of assets, in legal or regulatory issues, in outright fraud. Any such failure could reverberate for generations.

In the investment industry, the response to this challenge is a specific risk management discipline. While the board must lead in this effort, the responsibility must become pervasive through the investment system. Ideally, it becomes ingrained in the organization's culture.

The practice of risk management starts by identifying every possible reason why the nonprofit might fail to achieve its objectives. The board, the staff, and all relevant outside sources must be sensitive to the "galaxy of risks" that their decisions and actions might entail. All possibilities for failure must be evaluated and controls put in place.

It's difficult because it's contrary to our natural inclination toward optimism, our reluctance to think the unthinkable or ever appear negative.

A matrix approach has proved effective for us at Commonfund; it helps promote the needed discipline. The investment process is divided into specific steps. For each step you enter every risk you and your team can think of. The listed risks must be evaluated for degree of possibility and seriousness of consequences. For each prioritized risk, you consider possible alternatives, controls, or defenses. And then make sure the controls are put in place and regularly monitored.

With the matrix as your base, you continually recycle this process, seeking to sharpen and enlarge the matrix. It requires taking a skeptical attitude and asking tough questions, such as:

- In whose name are the assets in our portfolio being held?
- Where are the securities being held?
- Is the valuation accurate?
- Are we applying all the resources actually needed to manage effectively?
- What are the laws and regulations for compliance?
- Who is responsible for compliance?
- What makes us sure we can trust our investment managers and our other providers?

One overriding question runs throughout the process: "What can go wrong?" And everyone involved should keep asking it.

An emotionally difficult and potentially controversial process like this can quickly peter out if it does not have visible support from the top. An experienced risk manager with appropriate authority is essential. So is the outspoken agreement of the board. If the board or staff does not seem to have the wherewithal for an integrated risk management program, you may need consultative support to get you started.

Costs

Continually ask: "Can we get the same results for less?" The costs of your investment program can quietly undermine returns and cut into the corpus of the nonprofit's assets. Make sure you keep investment costs under control.

Various changes in the investment industry during the postwar decades have helped raise the awareness of investment costs. Some argue that cost control is the key to investment success, since in the long run no investment can beat the averages.

Cost control lacks glamour; no one aspires to the job. It requires detailed analysis, review and monitoring, both before selecting a manager and then on an ongoing basis. In addition to investment manager fees, a host of other investment costs must be watched: custodial, legal, accounting, consulting, overhead. Cost increases can be surprising and difficult to restrain.

Controlling the cost of investment management involves three types of activities:

- Diligent investigation of alternative investment management candidates
- Tough negotiation of fees
- Efficient management of the management firms

You need to look at the prospective manager's portfolio turnover rate. In other words, how much buying and selling does the manager do to achieve its results? Every transaction incurs cost; good management means avoiding needless transactions. Are the managers negotiating the best prices for their investors? Are the managers' fees and compensation structure aligned with their investors' interests?

You need to continually ask: "Can we get the same results for less?"

But keep in mind that cost reduction itself can have a cost. For instance, you don't want to compromise the effectiveness of your risk management for the sake of cutting costs, or settle for less than optimal diversification. Keep the balance.

It is also important to recognize that different investment products can have substantially different costs and cost structures. Understanding these differences is important in evaluating the costs. Many managers, particularly in alternative asset classes, have a base fee, plus incentive fees which can be substantial. Ultimately, the important issue is total return on the asset net of the costs.

Responsibilities

To promote harmonious effectiveness of your investment program, define the roles of the trustees, the investment committee, the business or investment officer and staff, key donors, and your consultants, in writing, and make certain that each understands and agrees.

Our first six principles have been concerned with the kinds of planning, processes, and controls essential to an effective investment program. The ultimate issue is execution. And that depends on allocation of responsibilities – our seventh principle.

While you have an array of investment management firms implementing your plan, you must make sure that you have a clear organizational structure for decision making and oversight within your organization itself.

To avoid slippage or confusion, responsibilities should be spelled out in an "investment program responsibilities" document that should be part of the investment policy.

Completeness and clarity are important. Let all players make suggestions. Who's in charge? Who is responsible for risk management? Who for liaison with the investment managers? Who is keeping an eye on investment costs? What do those individuals have to do to prove the success of their efforts? To whom do they report? How often?

The answers, of course, depend on the particular nonprofit and the talents of its people. The difficulties you might encounter are also quite individual.

In allocating responsibilities, it is important to fully evaluate the strengths and weaknesses of the entire organization and develop a clear understanding of the resources needed for each decision. This is particularly important in setting priorities for decision making to assure that the most important decision has the highest level of resources.

For a foundation, the founder or founding family could pose an organizational difficulty. How much responsibility do they want to take? It should be spelled out in the document. The family's natural authority could overhang the structure of responsibilities you set up. Having family members participate actively in development of the responsibilities document could help achieve clarification of their own roles.

The investment committee typically plays the key role. The latest Commonfund Benchmarks Study indicates six members make up the average investment committee, somewhat more among community foundations. In nearly half the nonprofits surveyed, the investment committee had members who were not trustees; among community foundations, 80 percent included non-trustees.

A diverse membership is desirable, but you do want to have some members with investment knowledge and experience. Among the committees of a typical board, the investment committee deals with the most complex and specialized subjects. Special expertise is required, but so is common sense and a variety of viewpoints.

Experience suggests a few pointers for an effective investment committee:

- Keep it small enough to allow discussion by all members.
- Four or five meetings a year should be enough.
- When a decision seems too difficult to reach, try referring it to a subcommittee or consult an outside expert.
- Seek knowledge from your investment managers and other outside experts.
- Strive to maintain continuity of membership, attitudes, and philosophies.
- Keep your board informed.

As in any group effort, the strength and character of the people involved make the ultimate difference. We can assume that all responsible participants understand the nonprofit's mission and are committed to its fulfillment. Still, they have to make sure they know how to work together.

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About Commonfund

Commonfund provides vital financial services for institutions dedicated to bettering society.

Our mission is to enhance the financial resources of nonprofit institutions and to help them improve investment management practices. As the largest nonprofit investment manager, we place the fulfillment of this mission ahead of profit, unfettered growth, and asset gathering. This allows Commonfund to offer thoughtfully constructed, high-quality programs and services at competitive costs.

Through well-managed, long-term investment programs, we endeavor to help these institutions strive to build the financial resources they need to maintain and improve their programs, staff, physical plant and infrastructure. And our state-of-the-art treasury management tools help them increase financial productivity and reduce administrative costs.

Commonfund was founded in 1971 as a nonprofit corporation. Together with our subsidiaries, we have approximately $30 billion in assets under management for more than 1,500 nonprofit clients.

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