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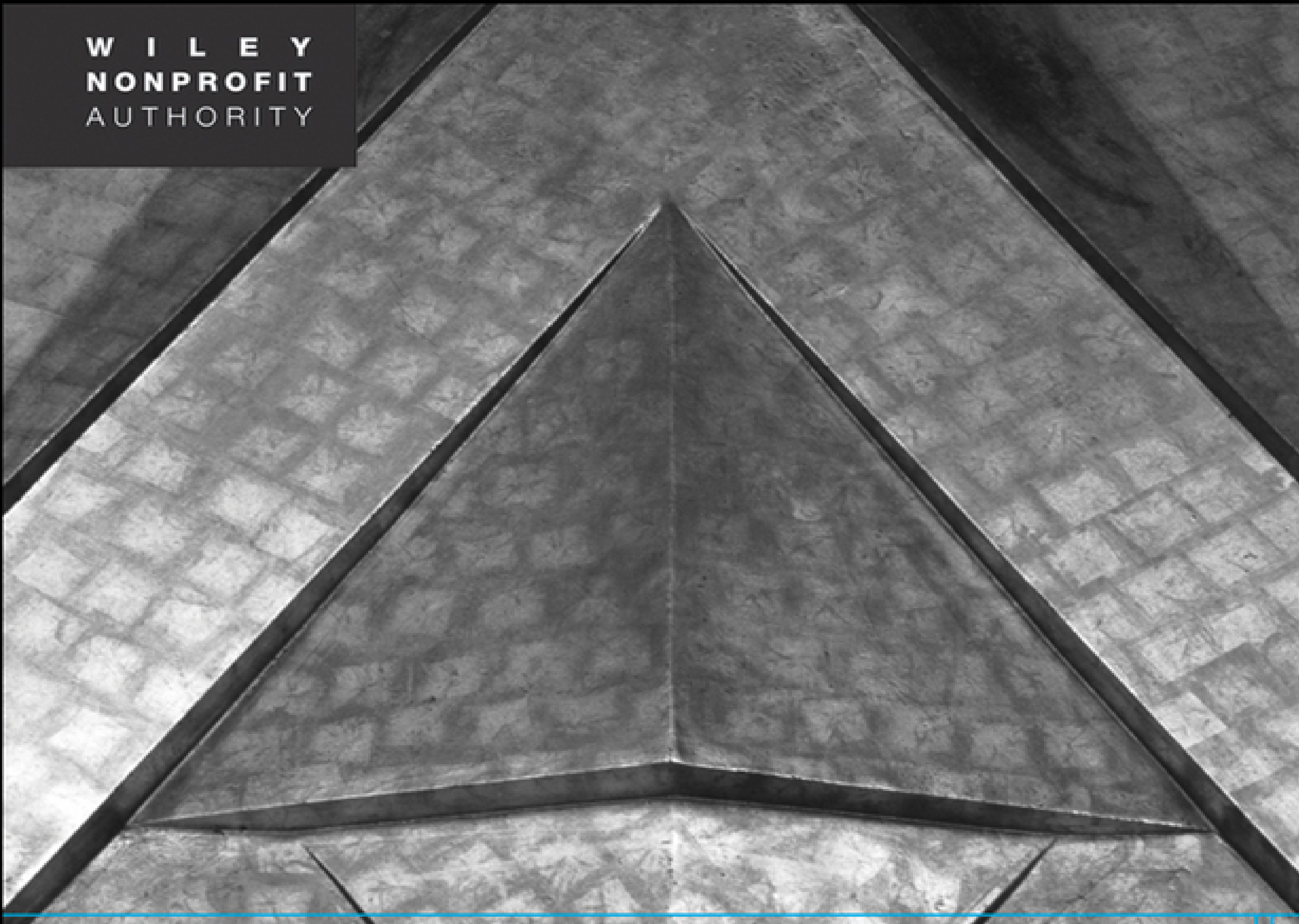

nonprofit asset management

Effective Investment Strategies and Oversight

Matthew R. Rice • Robert A. DiMeo • Matthew P. Porter

Contents

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Preface

“May you live in interesting times!” The ancient Chinese curse has never seemed more apropos. There are some positives for this tired old world, but no shortage of challenges!

On the one hand, scientific advances have increased life expectancies, enhanced global food production, and hold the promise of eradicating diseases that have plagued mankind for thousands of years. The fall of Communism promised to usher in an era of greater peace and stability. Increased computing power and new industrial production methods have led to a geometric increase in productivity. New forms of energy production such as wind and solar power are just beginning to have an impact.

On the other hand, there are more threats than ever before. First of all, global demographics work against us. While our technology has enabled food production to stay ahead of population growth, we may be approaching a tipping point. We can almost feed seven billion people if we could only solve the distribution problems. But how will we feed the nine billion expected before the middle of the century? What will be the impact on other resources or on the planet itself?

Secondly, there is a plethora of other problems. Worldwide religious intolerance is increasing. Fanatical terrorists welcome the chance to die if it means that they can simultaneously kill their perceived enemy (mostly innocent men, women, and children).

Disasters, natural and otherwise, somehow seem more numerous. From the devastation of Hurricane Katrina to unprecedented numbers of earthquakes, to massive oil spills, there seems to be no shortage of crises. New diseases, from AIDS to antibiotic-resistant strains of old scourges like tuberculosis, threaten to overwhelm the medical advances mentioned above.

Trade globalization is a double-edged sword. As a society we enjoy cheaper goods and services, but some workers find their jobs outsourced. Likewise, the Internet gives us instant connectivity and facilitates the flow of information around the planet but it also allows cyber-criminals to steal identities from half a world away. The 30-year war on drugs has been a monumental failure. Despite uncounted billions of dollars, and prisons filled to overflowing, a high school student in any town in the United States can buy pot by firing off a text message to one of his classmates.

If one were to count a dollar a second, working day and night with no breaks or days off, it would take 31 years to count out a billion dollars. Yet, our elected “servants” spend *thousands* of billions, seemingly with no other goal than rewarding their supporters and punishing their opponents. It's no surprise that the country has become more polarized than at any time in recent memory.

In short, there is a crying need for all of the services provided by nonprofit organizations.

Money Is Tight

Whatever the mission, there is undoubtedly more need than money. So far the twenty-first century has been a difficult financial environment. The 2000 to 2002 bear market was just a warm-up for the financial meltdown of 2007 to 2009. Fiduciaries for nonprofit funds have understandably become gun-shy. Many threw in the towel in early 2009 and abandoned equities for fixed income only to kick themselves for missing the run up of the next two years.

Persistently high unemployment is a near-term deflationary force that has politicians and central bankers running scared. No one wants a repeat of the Great Depression and its misbegotten offspring, World War II!

Unprecedented government spending (part “stimulus” and part social engineering) and our entitlement system have resulted in unsustainable budget deficits. There are only four possible solutions: default; raise taxes dramatically; severely cut discretionary spending and entitlement programs; or monetize the debt (e.g., let inflation reduce the real value of the debt). History provides no comfort, given that a current dollar is only worth four cents compared to a 1913 dollar (the year the Fed was created).

To add to the litany of woes, donating is down. Appreciated securities are in short supply. Tax and financial uncertainty may make even the wealthy clutch their purse strings a little tighter.

Topics

While we cannot solve the world's ills, we can help fiduciaries become better stewards for their funds. We will explore wide-ranging challenges for nonprofit funds of all kinds and provide the reader with practical solutions.

We will outline a systematic approach to fund oversight that includes determining the fund's *Three Levers* (inflows, outflows, and required returns) and the corresponding *Ability and Willingness to Tolerate Risk*. We will show how these important inputs are reflected in well-written *Investment Policy Statements* for nonprofit funds with varied objectives and risk constraints.

We will share our best ideas for optimizing *Asset Allocation Strategy*, which is the single most important step in the investment process. This includes a review of *Traditional Global Financial Asset Classes* and *Alternative Asset Classes* like *Hedge Funds*, *Real Assets,* and *Private Equity*, and the role each plays in well-diversified portfolios.

We will outline a systematic multi-step approach to improve success when *Selecting Traditional and Alternative Investment Managers*. We will also share a framework for evaluating the fund's investment managers on an ongoing basis and how to make the critical *Manager Retention and Termination Decisions*. We will also identify where *Active and Passive* management makes the most sense in a portfolio.

We will show investment committee members how they can identify and avoid traps set by our human *Behavioral Finance* quirks, and how they can save a nonprofit fund millions of dollars in opportunity costs.

We will also discuss *Fiduciary and Legal Issues* for nonprofits and provide a framework for evaluating and selecting *Investment Consultants, Brokers, Vendors, Record Keepers, and Other Resources* for the fund.

How to Use This Book

One can read it cover to cover. Alternately, each chapter is modular, and can be used as a how-to guide for a specific project or task. Wherever practical, this book includes charts, graphs, and case studies designed to make explanations as straightforward as possible.

Who Should Use This Book?

The primary audience for this book is fund fiduciaries. Included in this group are *investment committee members,* trustees, *officers, board members,* and *internal staff* should find it a helpful resource. Advisors to nonprofits should also find it useful. This group includes *accountants, auditors, consultants, and attorneys* who advise the fund. Vendors to nonprofit funds may also find it useful. This group includes *money managers, brokers, custodians,* and others who provide services for a fee. Finally, legislators, teachers, students, reporters, and any other interested parties may find useful information in this book.

Acknowledgments

In addition to our many terrific contributing authors, we want to thank all of the other talented individuals at DiMeo Schneider & Associates, L.L.C., whose valuable contributions to our firm and this book are far too numerous to count. We would also like to thank Richard Gallagher, who authored Chapter 15.

We also want to thank our wonderful clients who have given us the honor of making us trusted partners. We are grateful for your trust and friendship.

Chapter 1

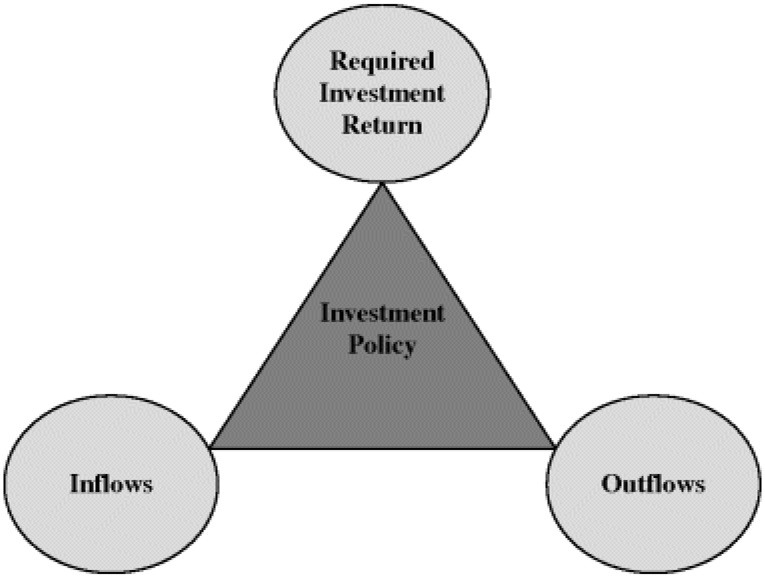
The Three Levers and the Investment Policy

The *investment policy statement* (IPS) articulates the nonprofit fund's purpose, objectives, and constraints. It also articulates the time horizon(s) and the fund's ability and willingness to assume risk. A well-designed IPS also acts as an investment committee's guide for procedures, principles, and strategies.

The Three Levers

A well-written IPS is an invaluable resource for an investment committee. However, in order to be effective, it must be written and periodically revised to accommodate the fund's *three levers*. The three levers are *inflows*, *outflows,* and *required investment returns*. The balance among these three components is unique to each investor. Whether the fund's purpose is to finance a perpetual spending need, a project over a finite period, act as a reserve for a "rainy day," or for any other purpose, its *three levers* will determine the appropriate objective (see Exhibit 1.1.).

Exhibit 1.1 The Three Levers



The three levers exercise is arguably a nonprofit investment committee's most important task when developing investment policy. If this crucial step is skipped, or done in haste, it is just a matter of time before painful symptoms emerge. Symptoms may include investment losses greater than the institution can afford during a bear market, or insufficient long-term investment earnings to fund spending needs. One needs to understand the size, volatility, and rigidity (or flexibility) of each lever, as well as how each interacts with the others in order to make effective investment objective, risk budgeting, and asset allocation strategy decisions.

You need to start by asking the right questions. Investment committees and nonprofit boards typically consist of smart people accustomed to making decisions, but they do not always focus on the right questions. Answers to the following questions should be instructive:

Inflows

- What is the expected size of annual inflows relative to portfolio assets?
- How predictable or volatile are these inflows?
- What control, if any, does the institution have over the size of inflows?

- Do any anticipated changes to the size or rate of inflows loom on the horizon?
- What factors have driven the historical variability of inflows?

Outflows

- What is the spending policy?
- Is there a formula that drives spending?
- What is the expected size of annual outflows as a percentage of assets?
- How predictable or volatile are the outflows (or spending needs)?
- What control, if any, does the institution have over the size of outflows?
- To what extent can outflows (or spending) be reduced or delayed in a crisis without jeopardizing the sustainability of the organization's basic mission?
- What factors have driven the historical variability of outflows?

Required Return

- What are expected annual *net* cash flows as a percentage of portfolio assets?
- What minimum rate of return (above inflation) is required to sustain the fund's long-term mission?

Desired Return versus the *Willingness* and *Ability* to Assume Risk

- Can the organization meet its basic long-term *spending needs* by investing solely in a laddered U.S. Treasury or Treasury Inflation-Protected Securities (TIPS) portfolio? If not, what incremental return is required?
- At what size loss do loan covenants, agency ratings, or other balance-sheet considerations become critical to the organization's health or survival?
- What rate of return above the minimum *required* rate of return would allow the fund to finance the "the next step"

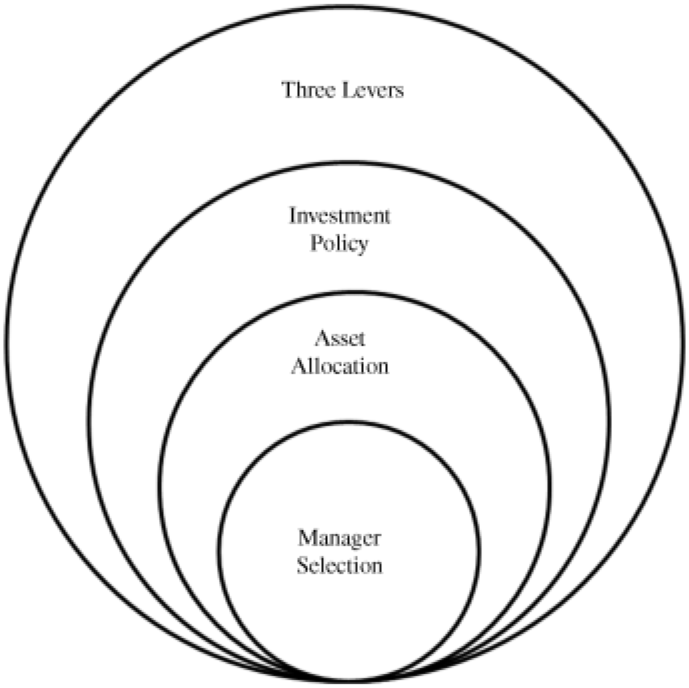
toward enhancing its mission?

- Are limitations on the fund's ability to assume risk compatible with its long-term spending objectives? If not, how will long-term *spending* and *risk* budgeting conflicts be reconciled?

Why invest in stocks, hedge funds, commodities, and other risky assets if objectives can be met without them? If an investment committee determines its fund can finance objectives by investing solely in U.S. Treasuries or TIPS, it should vote to do so, call it a day, and adjourn. Most funds cannot meet their objectives that way, but quantifying the expected shortfall of a Treasury-only investment creates a baseline to establish a minimum required rate of return.

A terrific asset allocation strategy implemented by excellent investment managers is insufficient to assure success unless the portfolio's investment policy objectives and strategy compliment the fund's three levers. Many institutional investors discovered the painful mismatch between their funds' three levers and their investment policies during the severe 2007 to 2009 bear market (see Exhibit 1.2).

Exhibit 1.2 Hierarchy of Importance

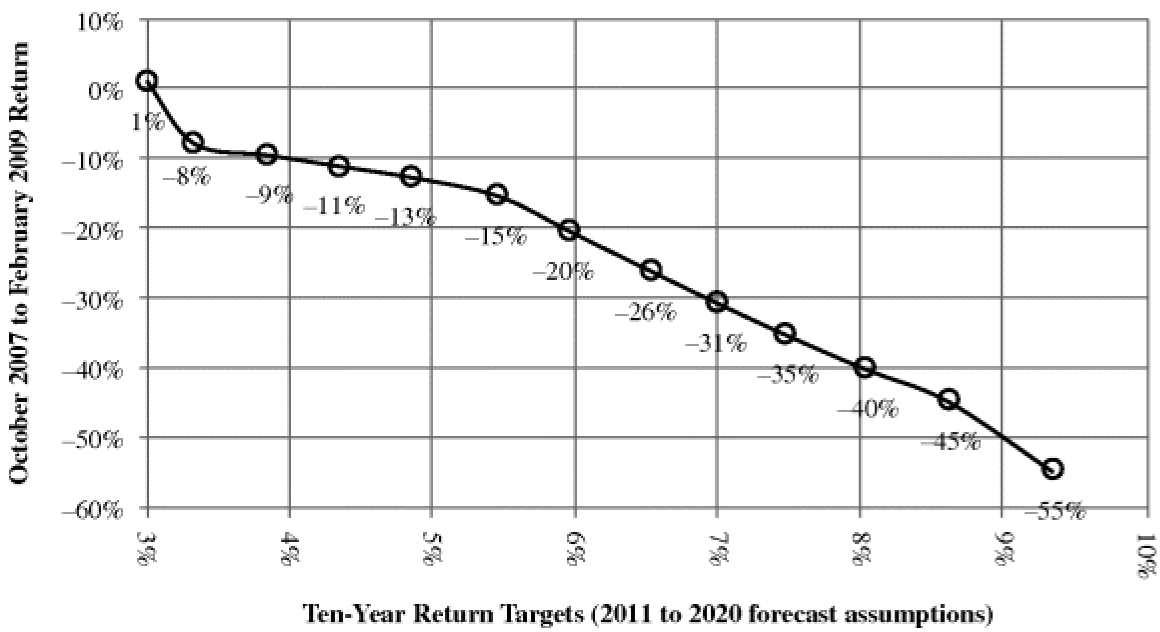


When the three levers exercise is skipped or given insufficient thought, the investment objective (and strategy) can end up being too aggressive. Policies set during periods of strong market performance often lead to overly aggressive portfolios. “Good times” also frequently lead to looser spending policies as boards begin to extrapolate recent performance indefinitely into the future.

During the 2007 to 2009 bear market, all investors who sought even a modicum of capital appreciation suffered losses, but those who invested more aggressively than necessary suffered *needlessly*. For example, perhaps a fund needs a 6.0 percent long-term annual return to fund its mission. If it instead was positioned to target an 8.0 percent annual return, the added risk proved to be significant. From October 2007 to February 2009, the global stock market declined about 55 percent. A well-diversified portfolio with an expected 8.0 percent long-term return declined about 40 percent peak to trough. But a well-diversified portfolio designed to earn a 6.0 percent return declined only about half as much (or 20 percent). See Chapter 2 for more information about capital market assumptions and asset allocation strategy.

In Exhibit 1.3, a 100 percent TIPS portfolio represents the 3.0 percent target-return mix. This laddered TIPS portfolio illustrates a theoretical risk-free portfolio over an investment horizon, assuming a 2.5 percent inflation rate. At the other end of the spectrum, the highest expected return portfolio allocates 100 percent to global stocks (with a 9.3 percent expected return). All portfolios between these two mixes are broadly diversified among bonds, stocks, and alternative investments. For reference, the portfolio targeting a 6.0 percent return allocates 58 percent to fixed income, 22 percent to global equity, and 18 percent to alternative investments; the portfolio targeting an 8 percent return allocates 26 percent to fixed income, 50 percent to global equity, and 24 percent to alternative investments. An investment committee that cannot articulate a rationale for the portfolio's heavy allocation to stocks or alternative investments is more prone to make reactive (and destructive) decisions during difficult markets.

Exhibit 1.3 Target Long-Term Hurdle Returns versus the 2007 to 2009 Bear Market



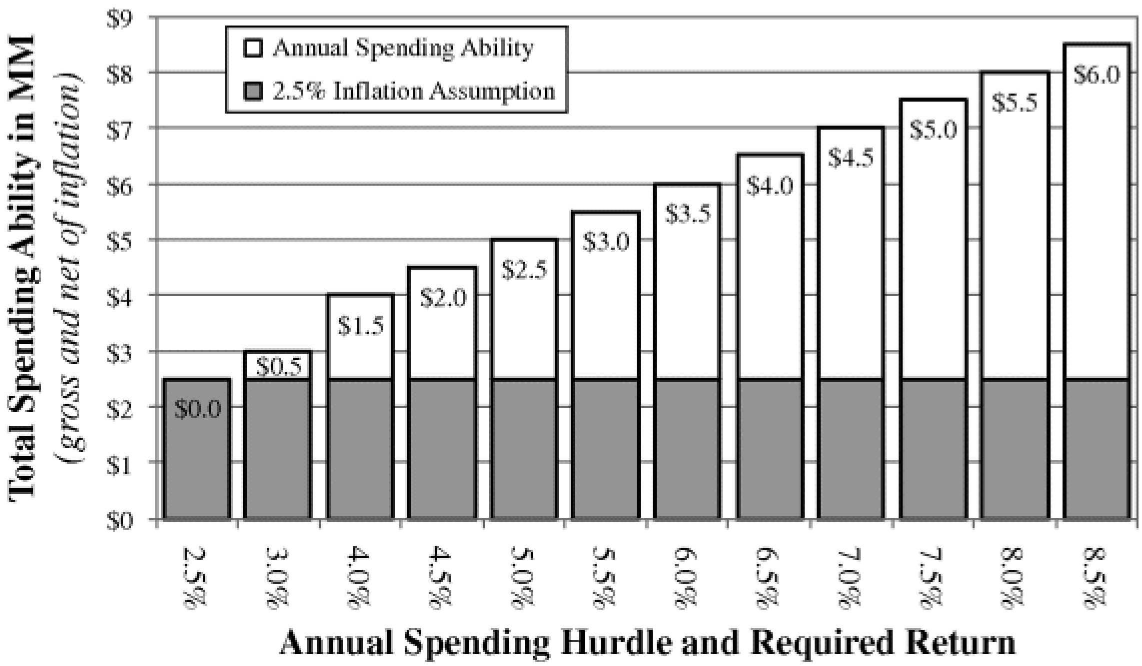
Rational investors allocate to risk-free assets if objectives can be met by doing so. Wise investors take only as much risk as they must to meet objectives. Unfortunately, most spending ambitions require taking investment risk. For example, a 5 percent spending policy may need to generate a real return of 5 percent above the inflation rate. If the inflation assumption is 3 percent, the endowment may need to target an 8 percent (or greater) return. As previously illustrated in Exhibit 1.3, an 8 percent return target requires significant investment risk. See Chapter 2 for more about capital market assumptions.

Investment committees with high spending hurdles have few choices:

- Slash the budget (and spending) and invest in Treasuries or TIPS.
- Invest in an equity and/or alternative investment-heavy portfolio that seeks to meet the long-term hurdle, while assuming considerable investment risk.
- Build a thoughtful and well-diversified portfolio that balances risk-aversion and disciplined spending targets.

Committee members must “connect all the dots” in order to determine whether an investment strategy can achieve the fund's objectives. It is wonderful when the investment pool is large enough to avoid taking risk. However, even large sums of money can generate small amounts of spendable investment return if invested too conservatively. Exhibit 1.4 shows how funds available for spending shrink considerably with lower investment returns.

Exhibit 1.4 $100MM Endowment with Various Spending Targets



Determining the appropriate level of risk is a complex chore for investment committees. Signing up for too little risk can adversely impact the organization's mission. A hospital may have to cut beds; a school may have to cut scholarships; or a community may have to cut projects and services. The decision to avoid risk must not be made in a vacuum. The organization's mission, objectives, and priorities are at the heart of the *three levers* exercise.

Investment Policy Statement

Only after the investment committee has a handle on the three levers should it draft or revise the IPS. As previously stated, the investment policy outlines the portfolio's purpose, objectives, risk tolerance, liquidity needs, and constraints. A well-written IPS is also clear and concise in outlining procedures and principles to govern future investment decisions.

The IPS is critical to the ongoing oversight of your investment process. It memorializes your vision. It sets the parameters by which you will monitor responsibilities and track the progress of associated parties. It also outlines your procedures for fund oversight and continuity of that oversight. It's not uncommon for committee members to serve limited terms, sometimes as short as one or two years. A well-written IPS is indispensable if your fund has a constant rotation of members.

New committee members want to make their marks. Unfamiliar with the initial three levers exercise, they may question the fund's objectives or investment strategy. They may have preconceived notions about the use of certain asset classes or overall asset allocation strategy. They may even have a basic misunderstanding of investment or diversification principles. A well-written investment policy helps educate new members. It acts as a manual to provide new and existing members with a clear, concise description of the fund's objectives and strategy.

Organization is the key to drafting a policy. The IPS should provide a clear road map for committee members. Specifically, it must provide policy direction and procedural guidelines. It is important to customize the document to address the organization's specific needs, but the following are elements that should be included in an IPS.

The following are summaries of various segments of an IPS, including examples for three fictional nonprofit investors:

- The Great State University Endowment Fund
- The Community Foundation of Bedford Falls
- The General Hospital Reserves Fund III

Statement of Purpose

The purpose section of the IPS summarizes why the fund or organization exists. Avoid the temptation to be long winded. A concise summary can be more effective. A simpler statement makes it easier for the “main thing” to remain at the forefront of investment committee members' thinking.

The following are examples of purpose statements for our three nonprofit funds:

- The *Great State University Endowment Fund's* mission is to promote, encourage, and advance education and to improve degree and non-degree educational functions by establishing scholarships, professorships, fellowships, academic chairs, and other academic endeavors as determined by Great State University's board of directors.
- The *Community Foundation of Bedford Falls'* mission is to bridge community needs with timely giving. The purpose is to improve the lives of Bedford Falls' residents by awarding grants to nonprofit organizations that improve the community.
- The *General Hospital Reserves Fund III* exists as a capital reserves fund that may be used to close unanticipated short-term budget gaps or for other purposes as determined by the board of directors.

Statement of Objectives

The *statement of objectives* articulates the definition of success. “Objective” and “strategy” are often incorrectly used interchangeably in investment policies. The *objective* is an expression of goals; the *strategy* is implemented by the investment committee to pursue that objective. Objectives vary significantly among different types of nonprofit investors. Even nonprofit funds that seem similar may have vastly different objectives. Objectives span a wide spectrum, ranging from “short-term capital preservation” to “multi-generational growth.” The statement of objectives should include return targets, risk constraints, and time horizons.

The statement of objectives must be reasonable and attainable and accommodate the fund's three levers. An example of an *unreasonable* objective is, “The endowment's primary goals are to generate a 7 percent real (after inflation) long-term return to increase real spending power AND to minimize short-term capital losses.” When an investment committee is faced with an impossible objective like this, it has no reasonable principle to guide investment strategy. Should they target an after-inflation return of 7 percent, or should they seek to minimize short-term losses? They certainly can't do both! A 7 percent long-term after-inflation return target is already a very ambitious goal without any risk constraints. This is the type of “objective” that should be weeded out during the three levers exercise.

You must also avoid the “say nothing” objective. An example of such an objective is, “The fund seeks a reasonable rate of return with reasonable risk.” An investment committee has very little basis to build an investment strategy that fits such a poorly defined objective. In this case, the term “reasonable” is never defined and investment committee members can have dramatically different interpretations of what it means. This type of objective sets the committee up for unnecessary conflicts, as well as a portfolio risk budget that can swing wildly and arbitrarily, depending on an evolving definition of “reasonable.” This is another type of objective that should get weeded out during the three levers exercise.

The best-written statements of objectives are straightforward. They can be understood by an investment committee with rotating membership (and varying world views). In 1999, *irrationally exuberant* investment committee members wanted heavy allocations to Internet stocks; in early 2009, nervous Nellies wanted to buy and store gold bullion in the basement. Some committee members even oscillate between *irrational exuberance* and *nervousness* from one quarter to the next. An effective statement of objectives helps rein them in. Inevitably, all investment committees face market turmoil as well as periods of excessive optimism. During such times, the investment policy's statement of objective anchors the committee to the "main thing."

The following are well-written statements of objectives for our three nonprofit funds:

- The primary objective of the *Great State University Endowment Fund* is to preserve the purchasing power of the endowment after spending. This means that *Great State University Endowment* must achieve, on average, an annual total rate of return equal to inflation plus actual spending. This purchasing-power-preservation objective emphasizes the need for a long-term perspective in formulating spending and investment policies.
- The primary objective of the *Community Foundation of Bedford Falls* is to earn 10-year annual rolling returns that preserve purchasing power of foundation assets, assuming a 3 percent minimum annual spending rate. Therefore, the primary objective is to earn 10-year total (rolling) returns that meet or exceed a total return of 3 percent (for spending) plus the annual inflation rate. Additional gifts to the foundation may be used to supplement spending, but current policies limit spending to 5 percent annually (3 percent of assets plus 2 percent gifts) of total assets. The secondary objective is to moderate short- and intermediate-term capital losses so the 3 percent annual spending policy can be preserved (without excessive spending of principal) over rolling five-year periods, regardless of market performance.
- The primary objective of the *General Hospital Reserves Fund III* is to preserve capital. The maximum one-in-ten-year annual expected (nominal) calendar-year loss should not exceed 5 percent (modeled on reasonable return,