Nonprofit Investing Fundamentals

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Whatever the mission of a nonprofit, it’s almost a certainty that there is a need for additional funds.

Recent economic downturns saw a decline in contributions that strained budgets even further. This forced many nonprofits to rethink their funding sources. Instead of relying strictly on donors, nonprofits have begun considering endowments as a way to supplement their budgets.

> *An endowment is a fund set up by an institution where donations are invested over time to build a permanent source of funding. Withdrawals from the invested assets are used to support the mission of the nonprofit while earnings in excess of this distribution are used to build the fund’s market value. This allows the endowment fund to grow and provide support in perpetuity. -Investopedia*

An endowment is a way to build a more sustainable nonprofit. It provides a financial bedrock that gives organizations a way to offset funding shortfalls in lean times and also the ability to increase annual budgets and seed new work as the endowment matures.

This presentation touches on many aspects of endowments. We’ll discuss whether an endowment is right for your organization and how to get started if it is. Then we’ll look at how an endowment should be governed, the regulations that affect it, and the options in how the funds can be invested.

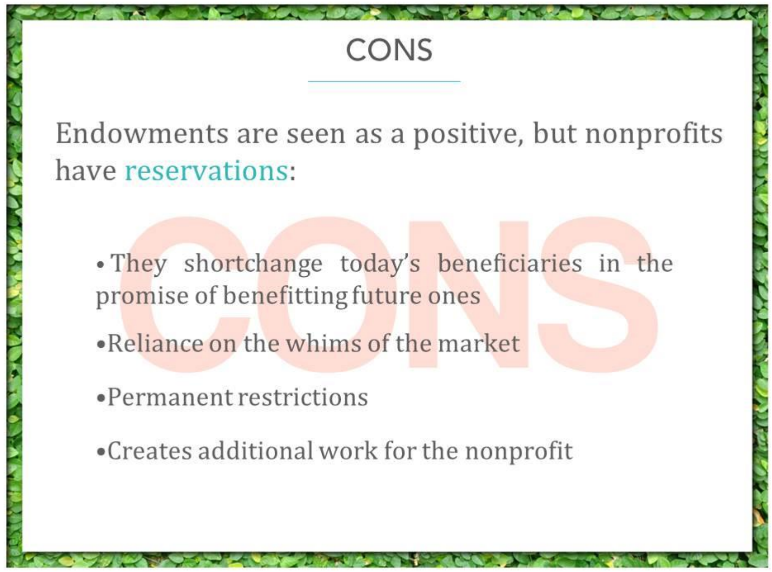
PART I

Intro to Endowments

This section serves as an introduction to endowments and whether one may be right for your organization. We’ll look at:

-The pros and cons of an endowment
-The importance of saving and investing
-The various endowment options available to a nonprofit

DRAWBACKS



Nonprofits generally agree that an endowment is a positive for their organization. However, several common objections are raised when thinking about establishing one. We'll take a look at these first.

<u>The most common objection is that the organization can't justify diverting funds from current programs</u> and putting them into savings.

This view is completely understandable. These assets could have otherwise been used to fund current operations. Today's beneficiaries are shortchanged in the promise of benefitting future ones. Most budgets are already tight so diverting funds to savings is especially difficult.

<u>Another argument against endowments is their reliance on investing.</u> Since endowment funds are invested, the value of the account is subject to the whims of the markets. Sharp market declines seen during the dot-com bust and recent financial crisis raised doubts about investing altogether. Many nonprofits conclude that the potential risks don't outweigh the benefits.

<u>Then there are the myriad of constraints endowments present.</u> They can have "permanent restrictions" which complicates a nonprofit that needs to stay flexible in a changing environment.


THE WALL STREET JOURNAL.

Battered Nonprofits Seek to Tap Nest Eggs

By JOHN HECHINGER and JENNIFER LEVITZ

Updated Feb. 11, 2009 12:01 a.m. ET

Universities, museums and other nonprofits battered by investment losses are pushing states to ease legal limits on spending so they can tap their endowments to avoid imminent layoffs and deep cuts to programs.

Most restrictions are on the use of the principal (or *corpus*, the original amount of money invested). A certain amount cannot be spent at all, and only a specified percent can be spent per year.

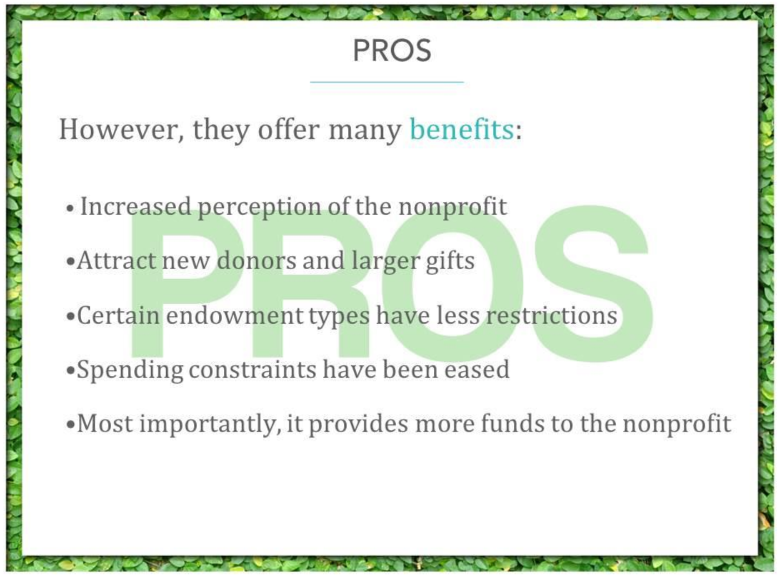
In some cases, there are also restrictions on how the funds can be spent – they may be used only to fund scholarships, for example.

Finally, <u>managing an endowment creates an additional chore for the nonprofit.</u> Endowment funds are invested and this requires staff or board members with investment knowledge. Otherwise the nonprofit must pay an outside firm to manage these funds, which is an additional expense. Plus, an endowment introduces new accounting topics that can complicate the reporting of financial statements.

Clearly, nonprofits have many reasons to not like endowments.

POSITIVES

However, endowments offer many benefits.



A major advantage is an increase in the public's perception of the nonprofit. It signals to the community and potential donors that the nonprofit is an established organization that plans to be around for many years to come.

This is great for long-term development. The perception helps attract donors who have confidence their donations will make a long-term impact.

Donors also tend to make larger gifts to an endowment than they would to, say, an annual fund. Estates are often bequeathed to endowments since their perpetual nature is seen as a way for donors to establish a legacy.

Endowments don't need to be saddled with restrictions, either. Savings of the nonprofit can be invested through a board-designated or "quasi" endowment fund. A quasi-endowment does not have donor restrictions of a regular endowment and funds are available for spending when and where the board deems prudent. More details on quasi-endowment are found later in this presentation on page 11.

The restrictions on spending from an endowment have been eased in recent years, as well.

Previously, funds from an endowment could not be spent if the value was below the "historic dollar value" (meaning the value is below the initial investment). This created a problem in times when investments lose value and are underwater – *which lead to articles like the one seen on the previous page.*

Recently passed regulations have eased these requirements. Underwater endowment funds can be spent to stabilize services as long as there is a long-range plan to restore the funds. The amount that can be withdrawn is more flexible, too, but several factors must be considered first. This is discussed more in the section on UPMIFA Spending, found on page 30. (UPMIFA is a regulation governing endowment funds and is discussed in more detail on page 20.)

Finally, the goal of an endowment is to ultimately provide more funds for the nonprofit. An endowment of decent size can smooth out financial shortfalls in lean times, can be used to cover ongoing overhead costs, or even fund new projects.

PRIOR TO STARTING AN ENDOWMENT

An endowment is designed to be savings for the long term.

<u>Before setting any money aside for the long term, a nonprofit must have sufficient savings for the short term.</u>

An operating reserve (also called a cash reserve or working capital) will cover unexpected shortfalls without cutting back on programs, services, and staff.

Most nonprofits aim for four to six months of expenses in reserve.

Savings will grow as money is continually put aside, which will eventually create long-term endowment options for the nonprofit.

A nonprofit study from Raffa Financial found most nonprofits keep 4-6 months of operating expenses in reserve.

Operational Budget in Reserve	Public Charity
4 - 6 Months in Reserve	36.6%
1 - 3 Months in Reserve	31.7%
7 - 12 Months in Reserve	24.4%
More than 1yr in Reserve	4.9%

2014 Raffa Study on Nonprofit Investing

CharityNavigator uses working capital as a metric in gauging a nonprofit's strength:

"Charities depend upon their reserves of liquid assets to survive downward economic trends and sustain their existing programs and services. If a charity has insufficient working capital, then it faces the difficult choice of eliminating programs or staff, amassing debts and liabilities, or dissolving. On the other hand, when giving flows, those charities that build working capital develop a greater capability for expanding and improving their programs."

WHY INVEST?

Why invest when there is the potential to lose money?

Investing allows your money work for you by creating wealth over the long-term. Investments can earn interest and increase in value, with returns compounding over time to create additional wealth.

Of course, this does involve taking on more risk than simply keeping savings in cash.

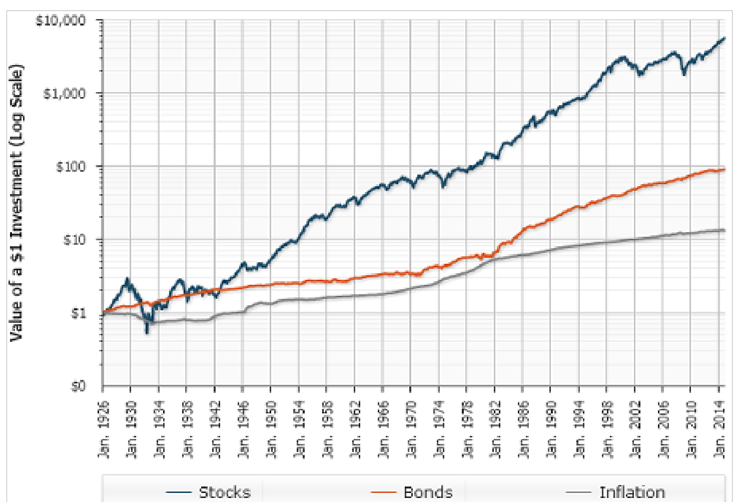
Remember, though, that endowments have a long-term time horizon (infinite, in theory) which allows time for a portfolio to recover from a downturn.

It is possible to reduce investment risks, too. Diversifying the portfolio into different types and styles of investments can reduce volatility and increase returns, which also helps weather any storms. Diversification is discussed more on page 22 of this report.

> "Forecasting is tough, especially if it involves the future"
>
> -Yogi Berra

Another benefit of investing is protection against inflation. This usually isn't a consideration, but an annual inflation level of just 2% will leave you with 60 cents on the dollar after 20 years.

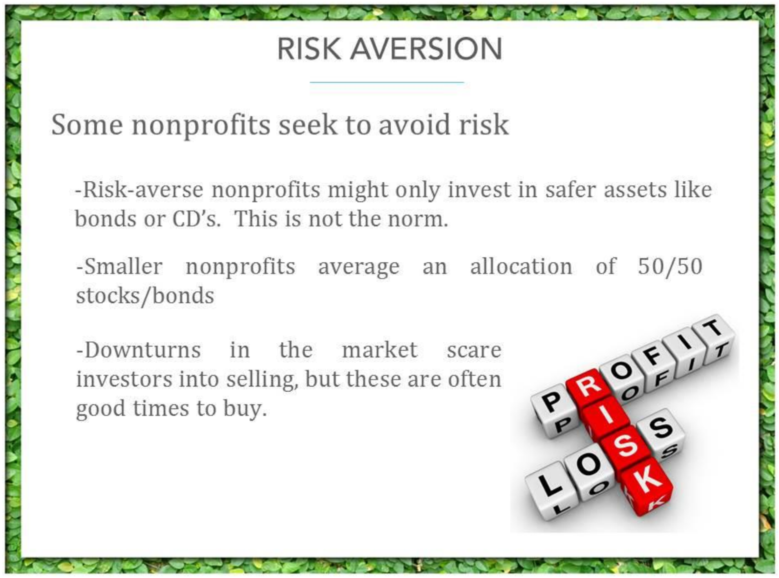
Stocks have historically provided the best protection from inflation, as can be seen in the nearby chart,



Source: Axa

With a nonprofit's board having a fiduciary responsibility to protect the assets of the organization and use them to further the philanthropic mission, investing can make a lot of sense.

RISK AVERSION



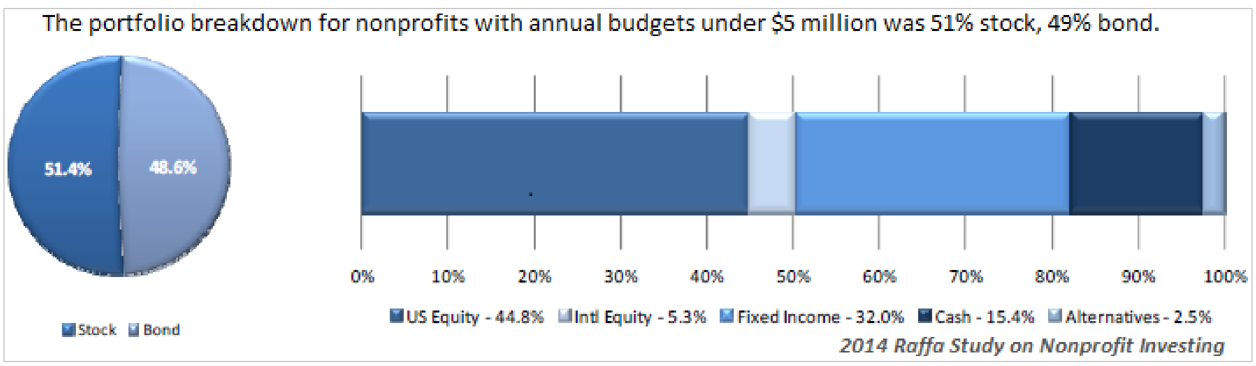
Some organizations believe the risk from investing is not justified and seek as little risk as possible. Any investments are usually safer options like bonds or CD's.

This is not the norm, though.

A 2014 study of nonprofits by Raffa Financial found that on average, nonprofits with budgets under $5 million had an asset allocation of roughly 50/50 stocks/bonds.

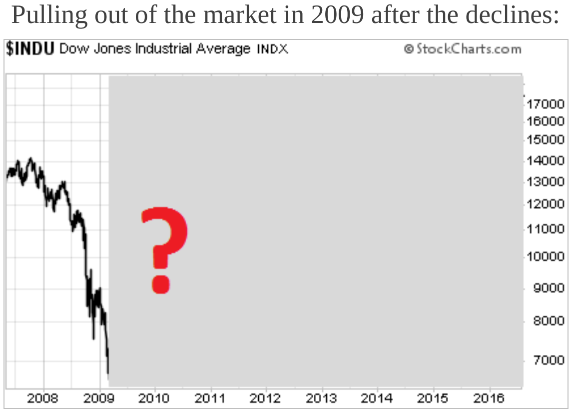
This is a fairly conservative allocation, which may come as a surprise to risk-averse investors. Larger nonprofits usually take even more risk!

That said, there is no right or wrong level of risk in a portfolio – risk should be at a level that allows the board to sleep soundly at night. We'll discuss the right risk levels more on page 20.

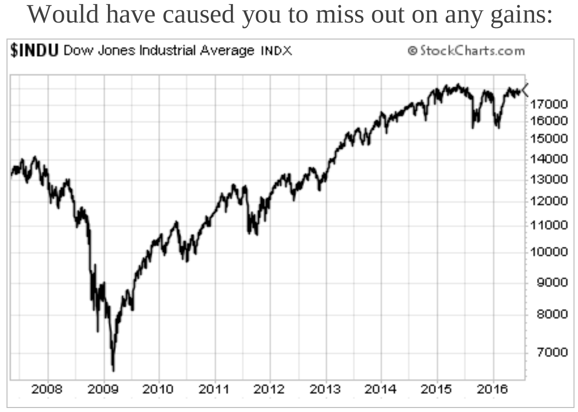


Risk aversion also increases after a large downturn in the market. Panicked investors often sell when stocks fall – the exact opposite reaction they should have. A long term perspective is important!

Pulling out of the market in 2009 after the declines:



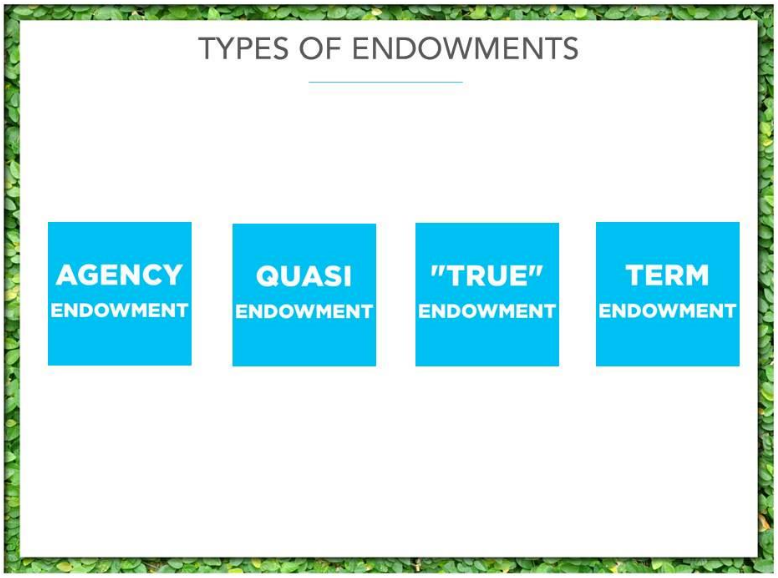
Would have caused you to miss out on any gains:



TYPES OF ENDOWMENTS

All endowments involve investing to meet the goals of the charity, but different structures result in different restrictions and regulations.

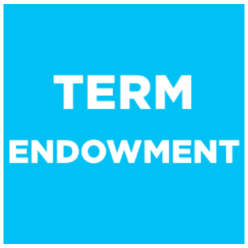
Here we'll take a look at the different types in more detail.



An Agency Endowment is a fund held and managed by a community foundation for the benefit of the nonprofit.

Also referred to as a Board-Designated Endowment or Funds Functioning as Endowment, quasi's are created with surplus, unrestricted funds of a nonprofit. They are not created with gifts from donors and do not have many of the restrictions typically found with an endowment.

This is the permanent endowment style most people think of when they hear the word "endowment." It is very similar in nature to the quasi-endowment, but it is created with donated funds. That makes it subject to the full scope of UPMIFA, and therefore has restrictions on spending.



Term endowments are created with a limited time period, expiring when a specified event occurs, like the completion of a hospital wing or construction of a playground.

AGENCY ENDOWMENT

An Agency Endowment is a fund held and managed by a community foundation for the benefit of the nonprofit. It is sometimes referred to as a "Nonprofit Endowment at a Community Foundation."

This endowment type is most appealing to smaller nonprofits who are able to take advantage of the size and resources of the community foundation. Benefits include:

- -Investment expertise and administrative services provided by the community foundation.
- -The nonprofit receives annual distributions for unrestricted use.
- -Fiduciary responsibilities of managing and reporting on the endowment are assumed by the community foundation.
- -Access to donors who gift to the community foundation.
- -The money will be managed in perpetuity even if the nonprofit ceases operation.
- -Access to advisors, attorneys, and accountants on staff.
- -Exempt from filing a tax return or reporting on this fund since they are included in the community foundations reports.

-Agency Endowments are permanent and irrevocable.
-Minimum balance of $50,000.
-Can receive up to 5% of endowment annually (12-quarter rolling average of market value).
-1% fee on assets below $2 million.
-Will assist with donors and marketing.
-Contact John Zell, (904) 356-4483.

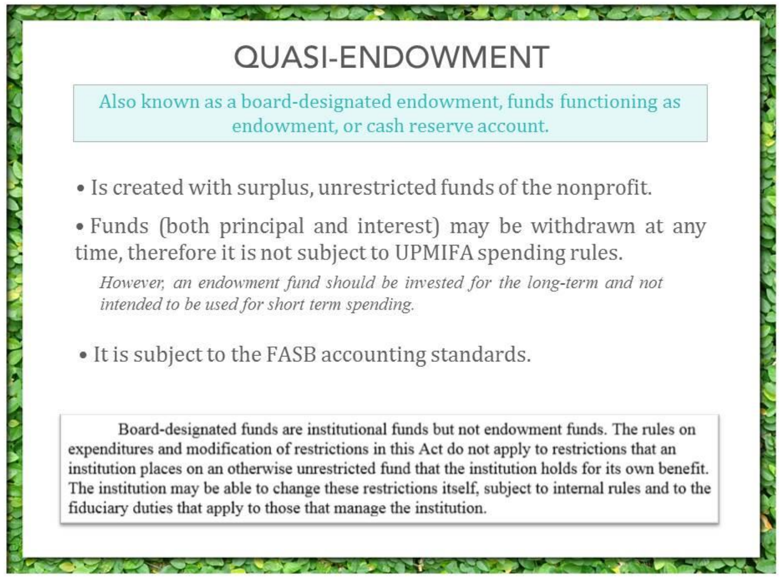
THE COMMUNITY FOUNDATION FOR NORTHEAST FLORIDA

The nonprofit would recognize the agency endowment as an asset on their balance sheet, classified as permanently restricted (consult your tax advisor for specifics).

Further, they should disclose the following in their financial statements:

1. The identity of the community foundation,
2. Whether variance power (the ability to modify restrictions on disbursing funds) was granted to the community foundation and, if so, a description of the terms of the variance power,
3. The terms under which the community foundation will distribute amounts to the nonprofit,
4. The aggregate amount reported in the statement of financial position and how that amount is described.

QUASI ENDOWMENT



Quasi endowments can go by several other names, including board-designated endowments, funds functions as endowment, or cash reserve accounts.

They are created with surplus, unrestricted funds of a nonprofit – basically long term savings. They are not created with gifts from donors for endowment purposes. This means they are not "true endowments," hence the name "quasi."

Quasi's are popular with nonprofits that may not be ready to launch a true endowment campaign, but still want to provide long-term stability by investing some of their savings.

Their unrestricted classification means they don't have many of the restrictions typically associated with endowments – both the principal and interest of the fund can be withdrawn at any time (typically through a simple majority vote by the board). It is not bound by the spending rules under UPMIFA, which is a regulation governing endowment funds (again, UPMIFA is discussed in more detail on page 20).

However, they still must adhere to institutional fund rules laid out by UPMIFA, which means prudent investing standards must be followed.

> An organization's governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes called "funds functioning as endowment" or "quasi-endowment") to be invested to provide income for a long but unspecified period. The principal of a board-designated endowment, which results from an internal designation, is not donor restricted and is classified as unrestricted net assets.
>
> *SFAS 117 definition of Quasi Endowments*

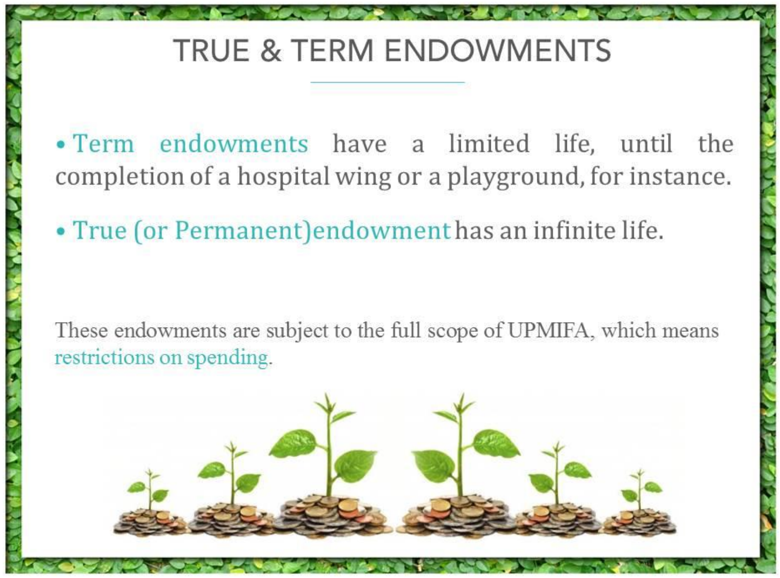
They are also subject to the accounting rules spelled out in the FASB accounting standards.

An important note – the endowment will no longer be considered "quasi" if the nonprofit solicits donations to the endowment. Gifts to the endowment are generally considered "restricted" because the donor assumes the gift was for a long term endowment and cannot be spent in the near future. The endowment will then be subject to all the restrictions of UPMIFA.

Quasi-endowments are reported on Form 990, Part X, Line 27 (unrestricted net assets). They are also reported on Schedule D (Supplemental Financial Statements), Part V (Endowment Funds).

> Board-designated funds are institutional funds but not endowment funds. The rules on expenditures and modification of restrictions in this Act do not apply to restrictions that an institution places on an otherwise unrestricted fund that the institution holds for its own benefit. The institution may be able to change these restrictions itself, subject to internal rules and to the fiduciary duties that apply to those that manage the institution.

TRUE & TERM ENDOWMENTS



These are the endowment types most people think of when they hear the word "endowment."

Also known as a Permanent Endowment, a "True" Endowment is very similar in nature to the quasi-endowment, but it is created with donated funds. That makes it subject to the full scope of UPMIFA, which includes restrictions on the amount of funds that can be spent.

The permanent nature can seem restricting, but the permanence encourages donors to make gifts because they know their support will create a legacy. They know the funds will not be used for day-to-day operations that will quickly erode the value of their gift.

Term endowments are created with a limited time period, expiring when a specified event occurs, like the completion of a hospital wing or construction of a playground.

For accounting purposes, a true endowment is classified as permanently restricted while the term is classified as temporarily restricted.

IS AN ENDOWMENT RIGHT FOR YOU?

The question remains, *is an endowment right for your organization?* There are good reasons to have one and good reasons not to have one.

Unfortunately there is no right or wrong answer – *deciding on an endowment is entirely up to you.*

To help get a feel for whether an endowment is right for your organization, here are some topics to consider:

-Both the positives and negatives of an endowment should be brought up with the Board. Do the pros outweigh the cons?

-Are short-term savings at a sufficient level?

-Make a ten-year financial projection. Consider different funding and expense situations – will a steady stream of income from the endowment be the best way to cover shortfalls?

-Talk with donors and evaluate their willingness to support an endowment. You would like to see if they would contribute to both an annual fundraiser *and* endowment.

-Are Board members open to contributing to an endowment – would anyone in their social circle be willing to contribute?

-Does your organization have the staff willing to support an endowment and any campaigns?

After review, the lack of any agreement means the decision should be put off for another day.

Pros:

-Increased perception from the public
-Attract new donors
-Larger contributions
-Reduced restrictions on spending
-Provide more funds to the nonprofit

Cons:

-Long-term focus shortchanges today's beneficiaries
-Reliance on investment markets
-Restrictions on spending
-Added complexity to current operations

This author's personal take:

Endowments – particularly true endowments – make the most sense for established nonprofits. An organization with a long-term successful track record, solid leadership and financials, a competent and willing staff, and large donor base is the prime candidate for an endowment.

However, nonprofits of all sizes should recognize that savings for both the short- and long-term are necessary to be successful. This means smaller nonprofits can also be good candidates for an endowment. They must first set aside savings for the short-term that is easily accessible to meet unforeseen expenses. But they should also have funds saved for the longer term. These funds can be invested to grow over time.

A quasi-endowment without the restrictions of a full endowment makes the most sense in this case.

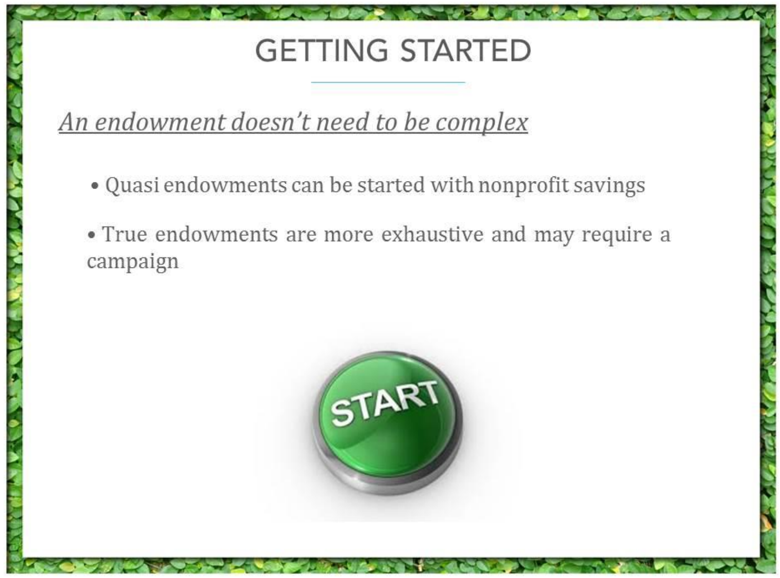
PART II

Endowment details

There are additional details to consider if a nonprofit decides to establish an endowment. This section touches on topics like:

- The funding options for the various endowment types
- The governance needed, from the board to investment committee to outside advisors and the policies they establish
- The regulations affecting the management of charitable investments
- An overview of managing investments

FUNDING SOURCES



A significant step after establishing an endowment is funding the account. Where these funds come from depends on the type of endowment the nonprofit is pursuing.

Nonprofits that prefer the less-restrictive quasi-endowment will have a simpler task.

That endowment is created when the board designates a portion of savings to be invested (the savings would be unrestricted net assets). The amount they decide to invest is entirely up to them – there are no requirements on the amount that must be invested.

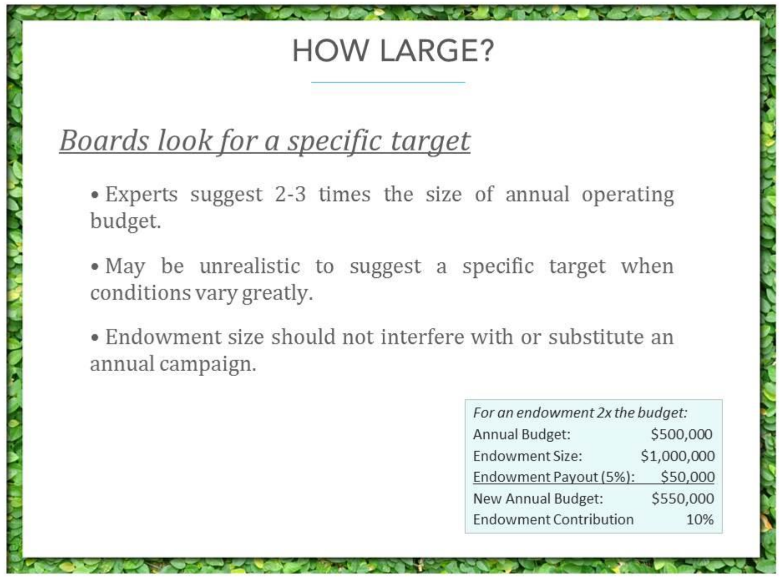
Nonprofits opting for a true endowment will take a different path which can be more extensive.

This may require soliciting donations to the endowment. It can be as simple as asking someone to remember the nonprofit in their will, solicit the existing donor base, or embark on a campaign to build the fund. Or all of the above. The campaign can end up being similar to a major donor campaign, which can be a large task involving a lot of resources that can be time consuming. This is why it is better suited for larger nonprofits.

Why should a donor give to an endowment?

Donors often want to make an impact by giving directly to the cause rather than an endowment. However, endowments should be described as part of a good financial plan that ensures the nonprofit will be around for the long-term.

HOW LARGE SHOULD THE ENDOWMENT BE?



A common question is how much a nonprofit should ultimately set aside for an endowment.

It's impossible to give any definite recommendations as financial conditions can vary greatly by the organization and fluctuating markets.

Still, boards like to have a goal to reach for.

With that in mind, some experts suggest an ideal, sustainable endowment size is two or three times the size of the annual operating budget.

The reasoning is that when a nonprofit withdraws 5% from an endowment that is twice the size of the annual spending, it would add 10% to that annual budget. This is a sustainable level that is considered not too large or too small.

For an endowment 2x the budget:	
Annual Budget:	$500,000
Endowment Size:	$1,000,000
Endowment Payout (5%):	$50,000
New Annual Budget:	$550,000
Endowment Contribution	10%

An endowment cannot provide the support a nonprofit needs if it is too small. Too large, and the nonprofit risks depending too heavily on the endowment and becoming lethargic.

This target may be an overly simplistic suggestion, but it gives the board a target to aim for. In reality, the endowment should be at a size that doesn't interfere with or act as a substitute for an annual campaign.

Figure 5.10 Percentage of Operating Budget Funded by Endowment 2014 NACUBO-Commonfund Study of Endowments

numbers in percent (%)	Total Institutions	Over $1 Billion	$501 Million–$1 Billion	$101–$500 Million	$51–$100 Million	$25–$50 Million	Under $25 Million
	832	91	77	262	168	125	109
Average percentage of operating budget funded by endowment	9.2	16.9	11.1	10.1	6.7	8.8	4.2
Median percentage of operating budget funded by endowment	3.4	9.5	4.4	5.6	2.6	2.1	0.5

BOARD AND INVESTMENT COMMITTEE

For a small nonprofit, overseeing investments may not be a high priority. The investment account may be small and does not yet provide any support to the organization.

However, it is prudent to have a formal process and full documentation – an investment committee can be created to provide that oversight.

The board of directors or trustees can designate members to the investment committee. Fiduciary responsibility ultimately remains at the board level with the committee responsible to the board.

A financial background is beneficial in committee members, but it is only one trait. It is helpful to also consider people with leadership experience, a background with other charities, and people who are smart and passionate about the charity. The CEO, CFO, and Treasurer of the organization should also have a role.

The size of a committee can vary. Larger nonprofits tend to have more members than smaller ones (those with more than $1 billion average close to ten members while those with less than $25 million averaged around 7). The ideal amount of members is in the 5-9 range, keeping in mind that odd numbers allow for a majority vote. The typical term lasts 3-5 years, so long as there is someone capable of filling their position.

Responsibilities of the committee:

- Establish the investment policy
- Set and monitor asset allocation
- Hire and terminate investment managers
- Periodically rebalance
- Verify compliance with Investment Policy Statement

COMMITTEE MEETINGS

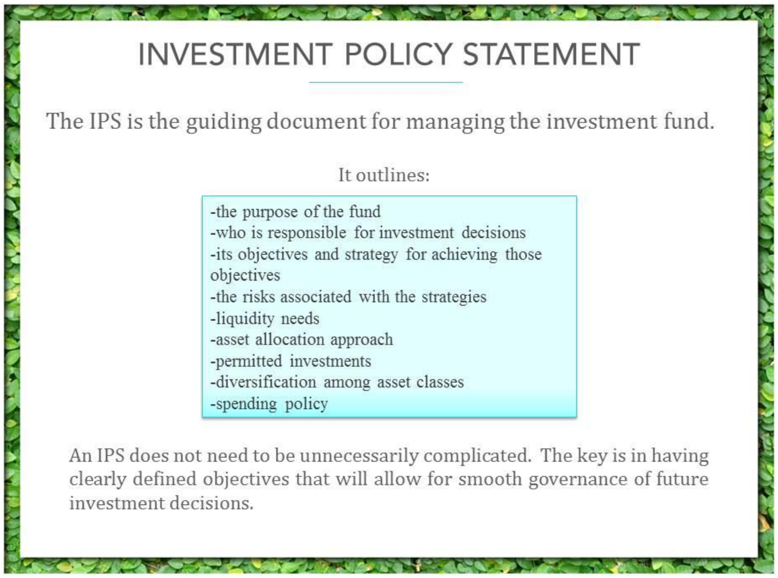
Meetings are usually held once a quarter, though semi-annual and annual meetings are not uncommon, especially among smaller nonprofits.

Meeting participants are likely pressed for time already, so meetings should be efficient. If possible, it is helpful to give an agenda in advance of the meeting.

Each meeting should have a review of the minutes from the previous meeting, which helps to refresh memories. When keeping the minutes, include a list of the people who attended, the topics discussed, and the materials presented. Also make note of the decisions made and the rationale behind them.

The bulk of the meeting should be a review of the investments. Discuss the performance and any reasons for outperformance or underperformance. *Don't wade too far into the minutia, though.* Ultimately, the goal is to make sure the portfolio is in line with the IPS.

INVESTMENT POLICY STATEMENT



Guidelines should be established before first investing any funds. The Investment Policy Statement (or IPS) is the guiding document for managing the investment fund of the nonprofit.

It should outline:

-the purpose of the fund
-who is responsible for investment decisions
-its objectives and strategy for achieving those objectives
-the risks associated with the strategies
-liquidity needs
-asset allocation approach
-permitted investments
-diversification among asset classes
-spending policy

The board, thru the investment committee, should establish these guidelines. Preparing the policy statement cannot be delegated to an outside advisor, though the board can take their advice. It may be helpful to prepare the IPS in consultation with the advisor to make sure its terms are practical.

An IPS does not need to be unnecessarily complicated. A modest endowment may have a rather simple and straightforward policy while an organization with millions to invest is likely to need a more complex and detailed policy. The key is in having clearly defined objectives that will allow for smooth governance of future investment decisions.

The IPS should be reviewed on an annual basis and updated when appropriate.

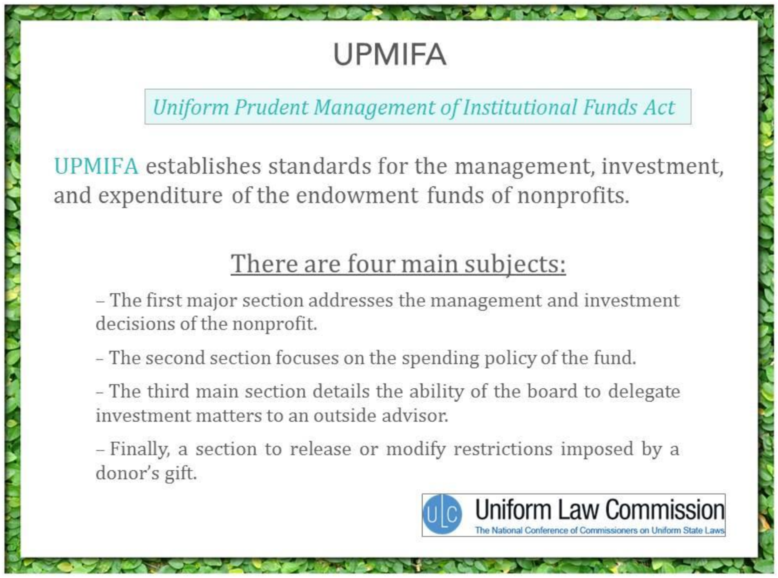
According to the Commonfund Institute, a properly-drafted IPS should include the following:

- What is the purpose of the investment pool? What is its role in supporting the mission of the institution?
- Is the fund intended to be perpetual in duration, or will it have a finite life?
- Who will have responsibility for investment decisions?
- If the board of trustees intends to delegate its authority to an investment committee or some other body or entity, how should that delegation be evidenced and documented? Which investment decisions, if any, should be delegated to outside advisors or investment managers?
- What is its expected annual contribution as a proportion of the institution's operating budget or other relevant criterion?
- What should be the overall investment strategy of the fund, including asset allocation targets and ranges, permitted and prohibited investment strategies and instruments?
- What kind and degree of risk is the board prepared to take in pursuit of its investment goals? How are risks to be defined and measured?
- How much liquidity should be maintained by the fund, either for investment needs within the fund or for wider institutional purposes?
- How much of the endowment should be spent and how much reinvested? What rules determine how this amount is calculated?
- To what extent is the fund expected to assist in maintaining the balance sheet of the institution?

UPMIFA

There are regulations on investing that a nonprofit must be aware of.

Investment of charitable funds is governed by the **Uniform Prudent Management of Institutional Funds Act, or UPMIFA**. It provides the rules and responsibilities for nonprofits on investing and spending. Florida has adopted this law, which is referred to as *FUPMIFA*.



There are four major subjects addressed by UPMIFA:

-The first major section addresses the management and investment decisions of the nonprofit and is outlined starting on the next page.

It requires the nonprofit to act prudently, keep costs reasonable when investing and managing charitable investments, make decisions as part of an overall investment strategy, diversify investments, and make sure that the investment strategy is appropriate for the fund.

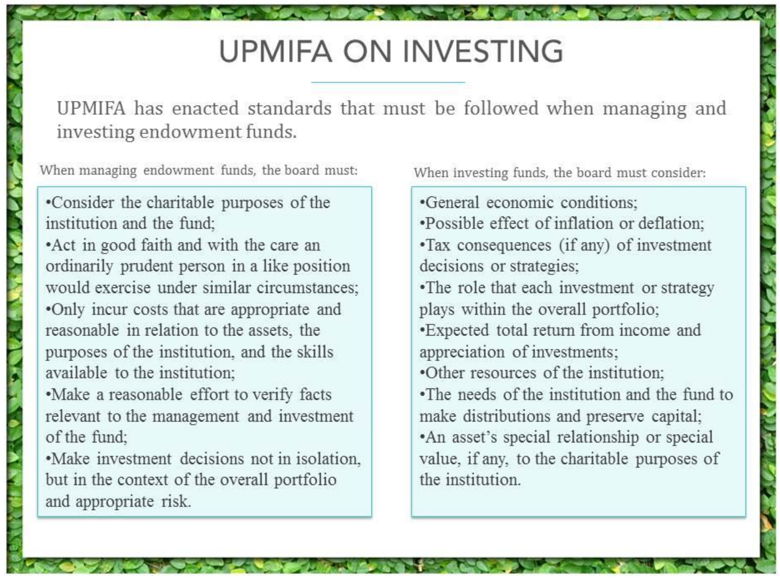
-The second section focuses on the spending policy of the fund. This subject is also addressed more thoroughly on page 30. In summary, the intent of the investment fund should be to create a stream of cash flows to fund programs consistent with the nonprofit's mission.

Those funds must be spent prudently, in a manner consistent with the charitable purpose of the nonprofit. However, spending more than 7% of the investment fund is seen as imprudent. A spending rate of 5% or less is preferable, although private foundations are required by law to spend 5% annually. Investment funds may be spent even if the portfolio's asset value has fallen below its historic dollar value (the amount deposited in the account).

-The third main section details the ability of the board to delegate investment matters to an outside advisor. We will have more on this on page 33. While the board has the option to form an investment committee and handle investment functions in-house, many choose to outsource this responsibility to firms with more experience handling these matters.

-Finally, UPMIFA includes a section to release or modify restrictions imposed by a donor's gift, but specific conditions must be met in order to do so.

INVESTING



UPMIFA has enacted standards that must be followed when managing and investing endowment funds.

"Each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."

<u>When managing endowment funds, the board must:</u>

- •Consider the charitable purposes of the institution and the fund;
- •Act in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances;
- •Only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution;
- •Make a reasonable effort to verify facts relevant to the management and investment of the fund;
- •Make investment decisions not in isolation, but in the context of the overall portfolio and appropriate risk.

<u>Further, when investing funds, the board must consider:</u>

- •General economic conditions;
- •Possible effect of inflation or deflation;
- •Tax consequences (if any) of investment decisions or strategies;
- •The role that each investment or strategy plays within the overall portfolio;
- •Expected total return from income and appreciation of investments;
- •Other resources of the institution;
- •The needs of the institution and the fund to make distributions and preserve capital;
- •An asset's special relationship or special value, if any, to the charitable purposes of the institution.

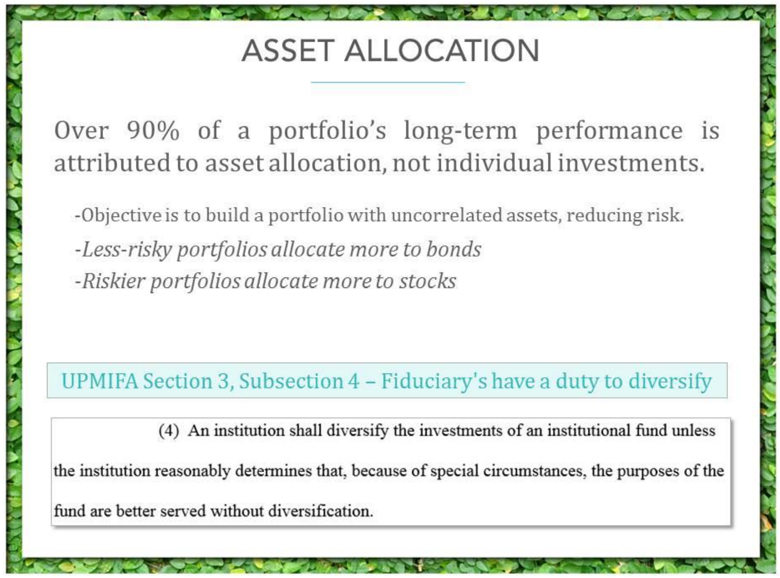
> Investing should be thought of like a person's retirement plan – the money is set aside for a longer term goal, not immediate benefit.

ASSET ALLOCATION

Properly diversifying a portfolio is a key of fiduciary responsibility.

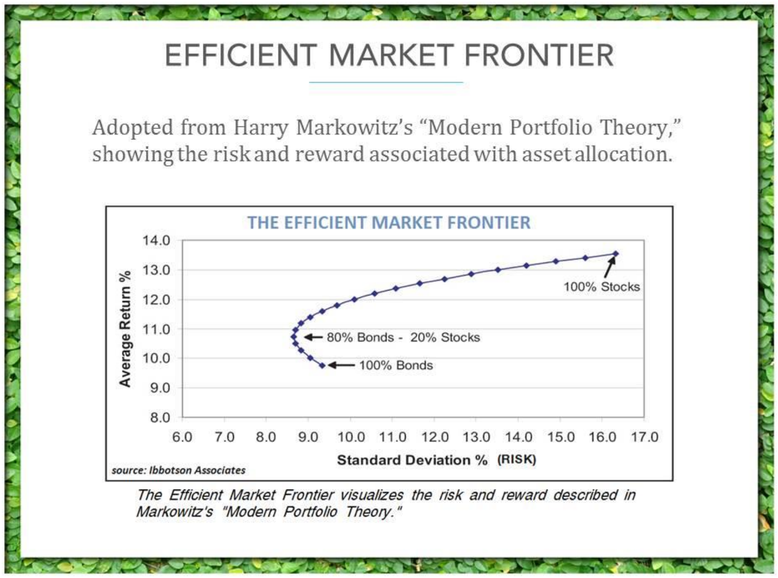
According to a number of studies, over 90% of a portfolio's long-term returns can be attributed to asset allocation – not from the selection of the individual investments themselves. This means diversification is the most important factor in a portfolio's long-term performance.

UPMIFA specifies that fiduciaries have a duty to diversify the portfolio.



(4) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification.

MODERN PORTFOLIO THEORY



Why is diversification so important?

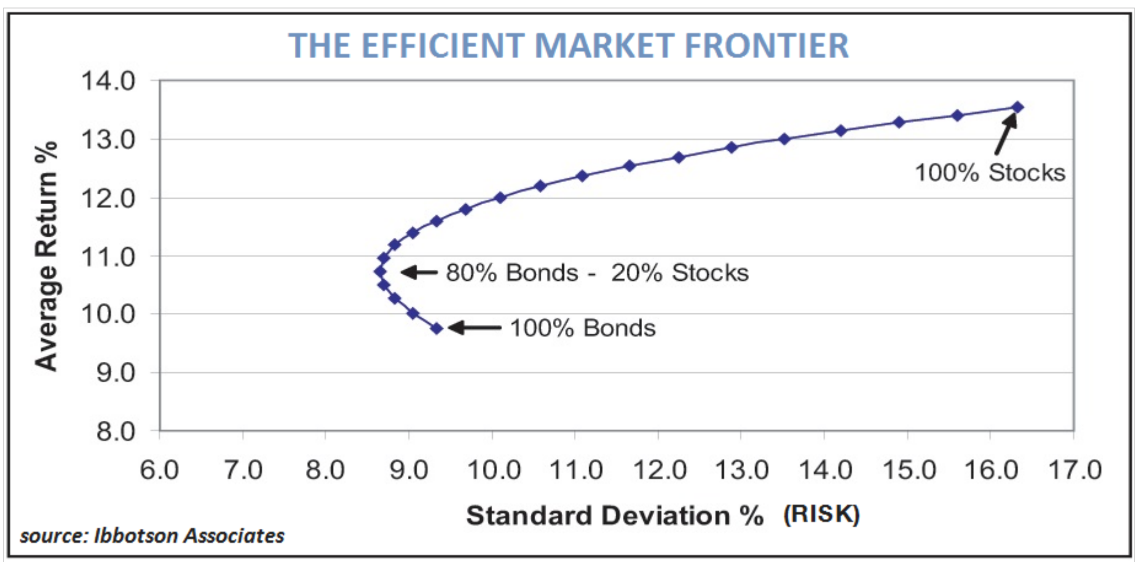
In 1952, an economist by the name of Harry Markowitz created a theory showing portfolio risk could be reduced and returns enhanced through asset diversification.

Called "Modern Portfolio Theory," it won him a Nobel Prize in Economics and became the widely accepted standard for managing investment portfolios ever since.

When building a portfolio, an investor needs to include uncorrelated assets and securities, which will reduce risk. More funds can be allocated to less-risky assets like bonds to reduce overall portfolio risk, or allocate more to riskier investments like stocks to increase risk and potentially increase returns.

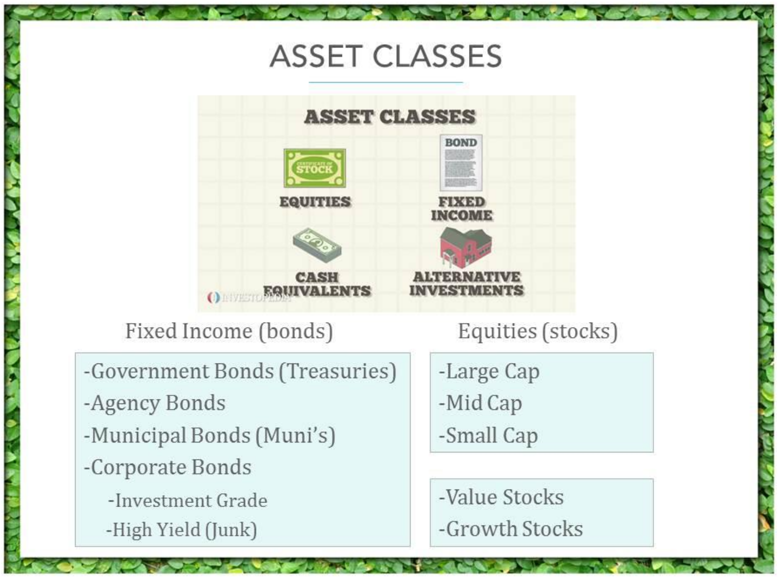
Further asset allocation is achieved through different investments within stocks and bonds. Plus, other asset classes can be added for additional diversification (like commodities, real estate, etc.).

The *efficient market frontier* helps visualize the modern portfolio theory.



The Efficient Market Frontier visualizes the risk and reward described in Markowitz's "Modern Portfolio Theory."

ASSET CLASSES



There are three main asset classes: bonds, stocks, and cash. Below are descriptions of the various types of bonds and stocks.

Bonds

<u>Government Bonds (or Treasury Bonds)</u>

These bonds are issued by the federal government. Because they are backed by the government's taxing authority, they are considered credit-risk free. A lack of risk makes their yields (interest) very low.

<u>Agency Bonds (Agencies)</u>

Are other government bonds issued by agencies of the government, like Fannie Mae, Freddie Mac, Ginnie Mae, and Sallie Mae. Agency bond yields are higher than Treasury yields because they are not full-faith-and-credit obligations of the U.S. government, but the credit risk is still considered low.

<u>Municipal Bonds (Munis)</u>

Issued by states and local governments, most are free from federal income taxes. The yield is lower than that of taxable bonds to compensate for the taxes, making them appealing to investors in high tax brackets.

<u>Corporate Bonds</u>

-*Investment grade*

Are bonds issued by companies with relatively strong balance sheets, giving them a credit rating of at least BBB from ratings agencies like Standard & Poor's or Moody's. They pay a higher interest rate than government bonds since they have more risk, but the chance of default is still very low.

-*High Yield Bonds (Junk Bonds)*

Are bonds issued by companies with relatively weak balance sheets, giving them a poor credit rating below BBB. The chance of default is high with these bonds, giving them a higher interest rate to compensate for the higher risk.

Further, bonds contain different maturities. "Maturity" is when the original amount of funds loaned to the bond issuer is to be repaid in full. A long-term bond matures in 10 year or more, intermediate-term bonds mature in three to10 years, and short-term bonds mature in three years or less. Generally, the longer the term of the bond, the higher the yield will be.

Stocks

Classifications of stocks, applicable to both domestic and international stocks:

Large cap stocks – large, well established companies seen as least risky.
Mid cap stocks – medium sized companies
Small cap stocks – smaller, less known companies, seen as most risky.

“Cap” refers to *market capitalization*. The capitalization is calculated by multiplying the price of a stock by the number of shares outstanding. This generally reflects the size of the company.

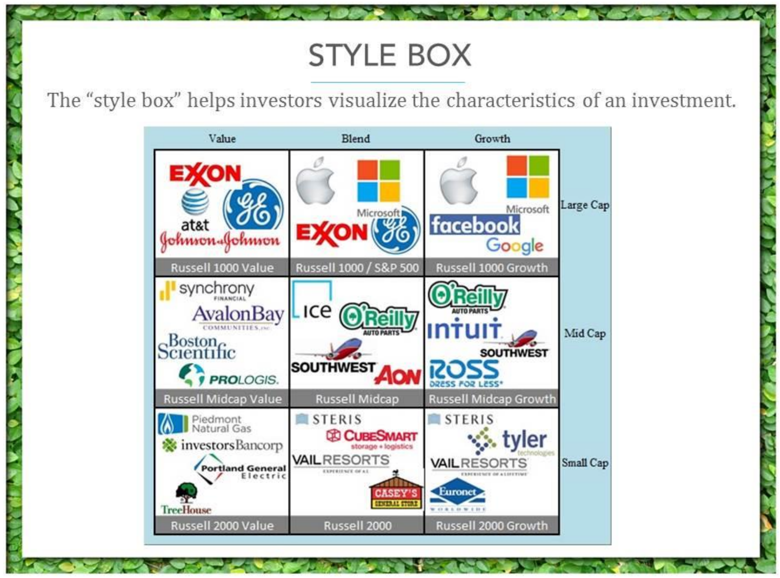
Stocks can also be classified as “Value” or “Growth.”

Value stocks
Trade at prices that are below their true value for temporary reasons (hopefully). It may have high dividend payout ratios or low financial ratios such as price-to-book or price-to-earnings ratios.

Growth stocks
Companies that are growing at a rapid rate. They often devote much of their current revenue toward further expansion.

STYLE BOX

A “style box” is a common tool that helps investors visualize the characteristics of an investment, whether it is a stock, bond, or fund.



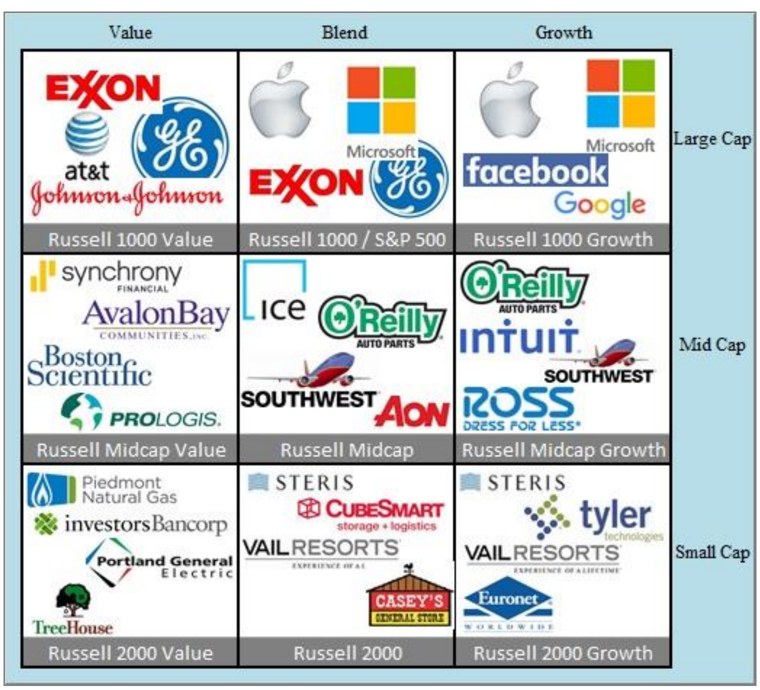
The style box for stocks is most popular, with the vertical axis divided by size of the investment (market cap) and the horizontal axis is divided by its valuation (growth or value).

A fixed income (bond) style box is less commonly used, but it measures credit quality of the bond or bond fund on its vertical axis and maturity on its horizontal axis.

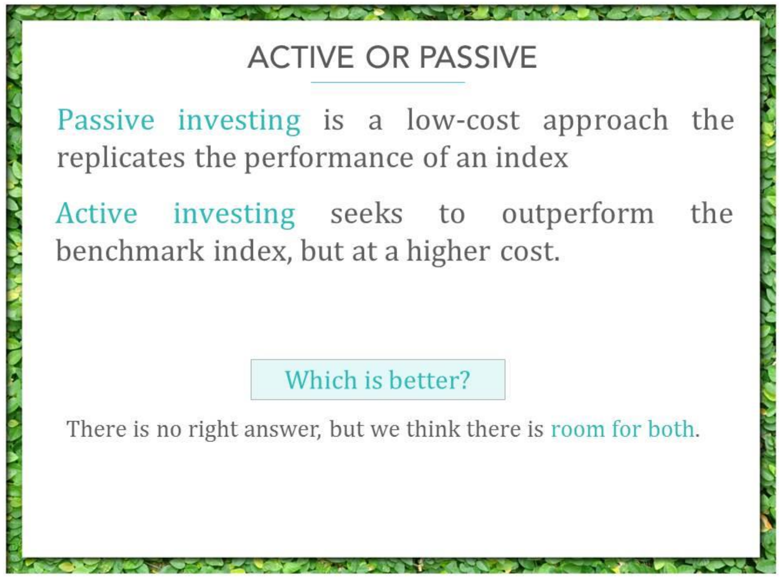
A style box is also useful over the long term, where historical data can be used to verify the consistency of a portfolio's holdings. Deviation from an investment manager’s “benchmark index” is call *tracking error*.

Below is an example of the style box. To better understand the investments that can be found in the categories, the equity style box contains examples of companies and the popular benchmark index for each category.

Equity Style Box



ACTIVE OR PASSIVE?



There is a debate in the investing community whether active or passive investing provides the best results for investors.

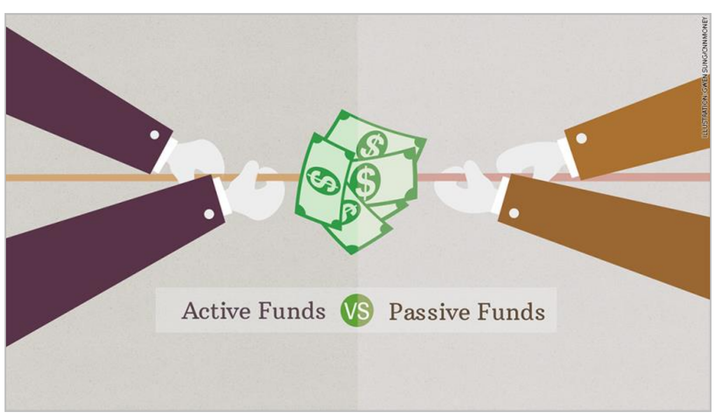
Passive investing is a low-cost approach that replicates the performance of a certain benchmark index.

Active management seeks to outperform that benchmark index. They often require patience as active managers sometimes outperform their benchmark – and sometimes they don't. But they always have a higher cost.

Which method is best? There really is no right answer and we believe there is room for both.

Certain asset classes are better candidates for passive management. More liquid, efficient sectors of the market like domestic equities, government bonds, and some investment-grade bonds are best suited for passive management. International investments and certain bond sectors are better candidates for active management.

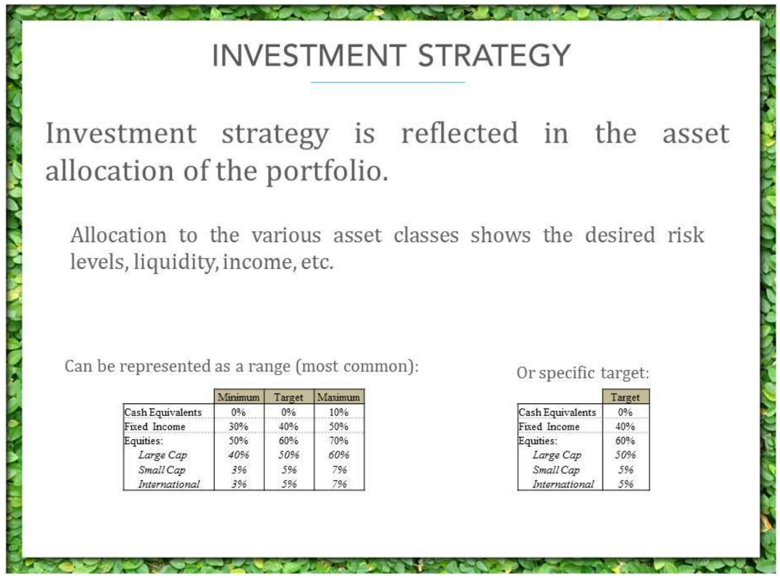
Smaller endowment funds would probably best be served by a diversified portfolio of broad-market replicating index investments.



INVESTMENT STRATEGY

The investment strategy of the endowment is reflected in the asset allocation of the portfolio. It will take into consideration the level of risk desired, liquidity, income, etc.

There are typically two ways to create an asset allocation strategy. One is to identify a specific target allocation, the other establishes a range. The "range" method is more common, in our experience.



"Target" allocation method

	Target
Cash Equivalents	0%
Fixed Income	40%
Equities:	60%
Large Cap	*50%*
Small Cap	*5%*
International	*5%*

"Range" allocation method

	Minimum	Target	Maximum
Cash Equivalents	0%	0%	10%
Fixed Income	30%	40%	50%
Equities:	50%	60%	70%
Large Cap	*40%*	*50%*	*60%*
Small Cap	*3%*	*5%*	*7%*
International	*3%*	*5%*	*7%*

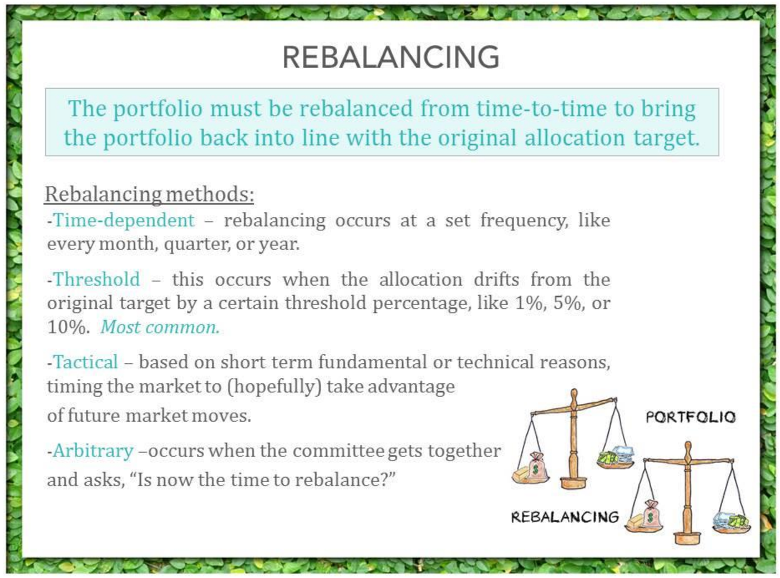
Asset allocations can vary widely by the size of the fund. Smaller endowments often have a simpler allocation with less asset classes. Even one broad-market index fund or ETF can give exposure to the entire equity sector. The same applies to most other asset classes, like fixed income, international equity, etc.

Larger endowments usually add additional asset classes for extra diversification. They also tend to have a more aggressive allocation and a longer perspective.

Size of Endowment	Domestic Equities %	Fixed Income %	International Equities %	Alternative Strategies* %	Short-term Securities/ Cash/ Other %
Over $1 Billion	13	7	19	57	4
$501 Million to $1 Billion	21	9	20	44	6
$101 Million to $500 Million	27	13	21	34	5
$51 Million to $100 Million	33	17	20	25	5
$25 Million to $50 Million	40	20	18	16	6
Under $25 Million	42	24	15	11	8

2015 NACUBO-COMMONFUND STUDY OF ENDOWMENTS

REBALANCING



Rebalancing is an important consideration in any investment strategy. Over time, the portfolio's assets will grow or shrink depending on market fluctuations, reaching levels outside the original targets.

The portfolio must be rebalanced from time-to-time to bring it back into line with the original allocation target. There are several methods for doing so:

- <u>Time-dependent</u> – rebalance at a set frequency, like every month, quarter, or year.
- <u>Threshold</u> – this occurs when the allocation drifts from the original target by a certain threshold percentage, like 1%, 5%, or 10%.
- <u>Tactical</u> – based on short term fundamental or technical reasons, timing the market to (hopefully) take advantage of future market moves.
- <u>Arbitrary</u> – essentially occurs when the committee gets together and asks, "Is now the time to rebalance?"

Rebalancing is not something that should be done too often as trading costs must be considered. Studies have shown that long-term portfolio returns show very little difference when rebalanced every month, quarter, or year.

The 5% threshold is usually a sufficient method for rebalancing.

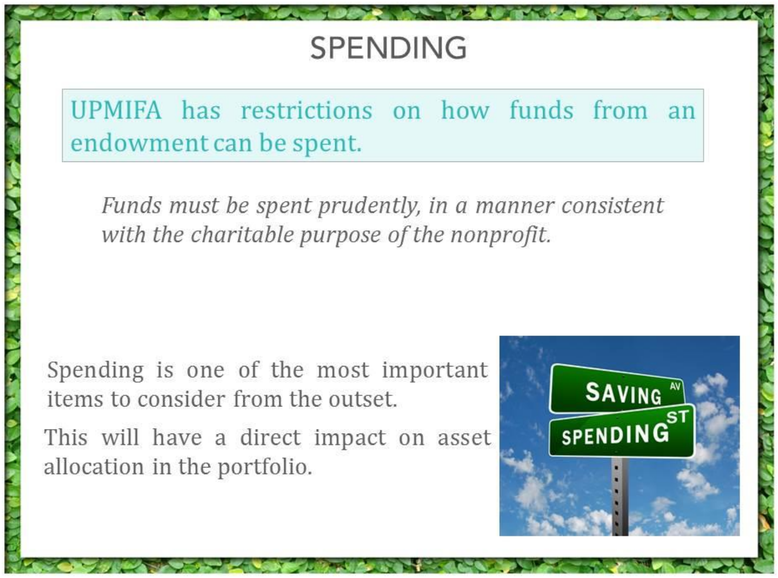
Figure 3.9 Portfolio Rebalancing Frequency* for Fiscal Years 2013 and 2014

numbers in percent (%)	Total Institutions		Over $1 Billion		$501 Million–$1 Billion		$101–$500 Million		$51–$100 Million		$25–$50 Million		Under $25 Million	
Responding institutions	757	752	75	83	66	73	241	245	152	151	111	110	112	90
	'13	'14	'13	'14	'13	'14	'13	'14	'13	'14	'13	'14	'13	'14
Calendar-based														
Annually	9	9	3	1	9	7	9	9	10	6	12	14	11	14
Semi-annually	4	3	4	2	2	1	4	3	3	4	5	6	4	2
Quarterly	26	25	9	12	20	15	28	28	29	33	26	24	31	23
Monthly	8	9	12	12	6	11	7	9	13	11	5	6	5	7
Other	2	3	5	8	5	4	1	2	0	1	2	3	0	1
Market value-based														
Target- and range-based	90	88	83	80	91	90	92	89	94	91	88	89	90	86
Response to major gifts or other cash flows	35	38	25	25	33	32	35	39	32	42	36	35	44	47
Other	1	1	3	2	2	0	0	1	1	1	2	1	0	0

* *multiple responses allowed*

2014 NACUBO-Commonfund Study of Endowments

SPENDING



One of the most important items to consider from the outset is the amount of funding you want to come from the endowment.

Considering future projects and contributions, will the nonprofit want to tap the investment fund to meet future spending needs? If so, how much? These considerations will directly affect potential investment choices.

If the nonprofit needs little from the endowment, less risk can be taken and a conservative portfolio can be established. Conversely, a desire for more risk and with a longer timeline, a more aggressive portfolio can be created.

UPMIFA has restrictions on how funds from an endowment can be spent. Funds must be spent prudently, in a manner consistent with the charitable purpose of the nonprofit. Spending any more than 7% of the investment fund is generally deemed imprudent.

UPMIFA requirements on Spending:

An institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established.

In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

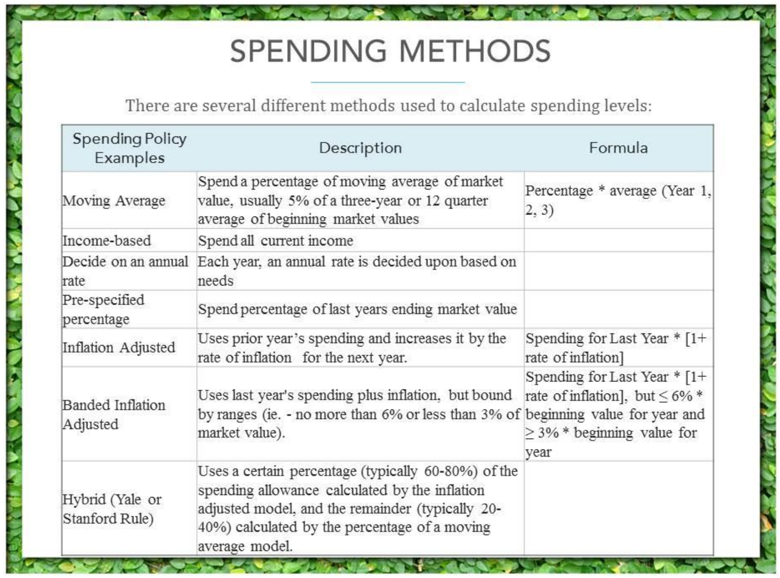
(1) the duration and preservation of the endowment fund;
(2) the purposes of the institution and the endowment fund;
(3) general economic conditions;
(4) the possible effect of inflation or deflation;
(5) the expected total return from income and the appreciation of investments;
(6) other resources of the institution; and
(7) the investment policy of the institution.

UPMIFA does allow funds to be spent if the account is below its “historic dollar value” (the original amount invested). In that case, the nonprofit must make sure the withdrawal is within the standards of prudence and follows the seven guidelines from above.

SPENDING METHODS

Spending from an endowment is not as simple as just spending the money from the account. Nonprofits must specify the method it used for calculating how much it is withdrawing.

There are several different methods for calculating spending levels. A description of the types of spending policies can be seen in the image below.


SPENDING METHODS

There are several different methods used to calculate spending levels:

Spending Policy Examples	Description	Formula
Moving Average	Spend a percentage of moving average of market value, usually 5% of a three-year or 12 quarter average of beginning market values	Percentage * average (Year 1, 2, 3)
Income-based	Spend all current income	
Decide on an annual rate	Each year, an annual rate is decided upon based on needs	
Pre-specified percentage	Spend percentage of last years ending market value	
Inflation Adjusted	Uses prior year's spending and increases it by the rate of inflation for the next year.	Spending for Last Year * [1+ rate of inflation]
Banded Inflation Adjusted	Uses last year's spending plus inflation, but bound by ranges (ie. - no more than 6% or less than 3% of market value).	Spending for Last Year * [1+ rate of inflation], but ≤ 6% * beginning value for year and ≥ 3% * beginning value for year
Hybrid (Yale or Stanford Rule)	Uses a certain percentage (typically 60-80%) of the spending allowance calculated by the inflation adjusted model, and the remainder (typically 20-40%) calculated by the percentage of a moving average model.	

Spending Policy Examples	Description	Formula
Moving Average *(most common)*	Spend a percentage of moving average of market value, usually 5% of a three-year (12 quarter) average of beginning market values	Percentage * average (Year 1, 2, 3)
Income-based	Spend all current income	
Decide on an annual rate	Each year, an annual rate is decided upon based on needs	
Pre-specified percentage	Spend percentage of last year's ending market value	
Inflation Adjusted	Uses prior year's spending and increases it by the rate of inflation for the next year.	Spending for Last Year * [1+ rate of inflation]
Banded Inflation	Uses last year's spending plus inflation, but bound by ranges (ie. - no more than 6% or less than 3% of market value).	Spending for Last Year * [1+ rate of inflation], but ≤ 6% * beginning value for year and ≥ 3% * beginning value for year
Hybrid (Yale or Stanford Rule)	Uses a certain percentage (typically 60-80%) of the spending allowance calculated by the inflation adjusted model, and the remainder (typically 20-40%) calculated by the percentage of a moving average model.	

The Moving Average method is most common, used by about 75% of nonprofits.

A common approach with smaller endowments is to decide on a spending rate each year based on their needs (usually between 4-5.5%). This method will see the most volatility from year to year, but can be responsive to the spending needs of the nonprofit.

The banded inflation method is arguably the best option. It allows for more spending in a falling market, but less in a rising market. Spending can be more predictable because it is the least volatile and budgets can be supported through good times and bad.

The popularity of spending methods can vary widely by the size of the institution, seen below:

Figure 5.4 Spending Policy* for Fiscal Year 2009

numbers in percent (%)	Total Institutions	Over $1 Billion	$501 Million–$1 Billion	$101–$500 Million	$51–$100 Million	$25–$50 Million	Under $25 Million
	842	52	60	219	164	137	210
Spend all current income	4	2	2	5	4	4	6
Percentage of moving average	74	56	70	75	82	79	68
Average percentage	4.8	4.9	4.9	4.8	4.8	4.8	4.6
Decide on appropriate rate each year	9	8	7	6	7	12	14
Grow distribution at predetermined inflation rate	1	4	0	2	0	0	0
Spend pre-specified percentage of beginning market value	4	0	0	2	5	7	6
Average pre-specified percentage spent	4.9	N/A	N/A	4.8	4.9	4.7	5.2
Last year's spending plus inflation with upper and lower bands	3	19	5	5	1	1	1
Weighted average or hybrid method (Yale/Stanford Rule)	6	15	12	7	7	4	2
Meet IRS minimum of 5 percent	**	0	0	0	0	0	1
Other	9	13	13	9	7	4	12

*multiple responses allowed
**less than 1 percent, results not meaningful

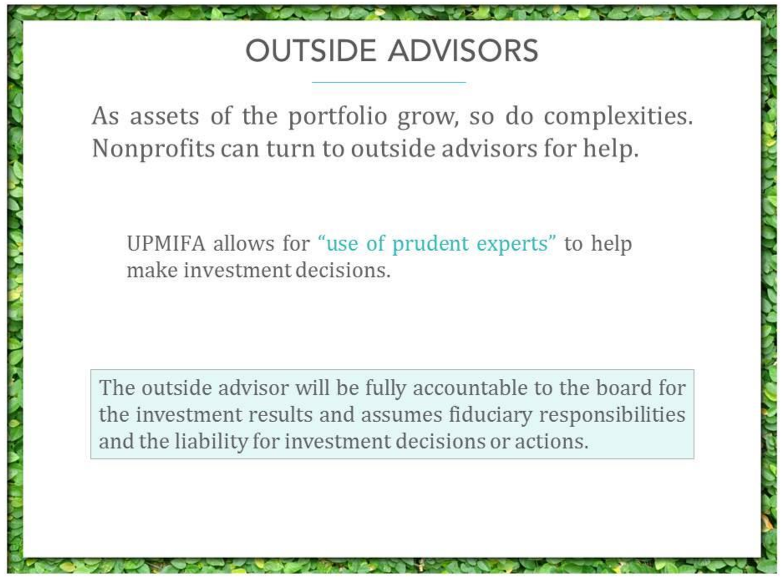
Source: Commonfund

Worth noting, UPMIFA does not specify how often the board can change their spending policy method, although a stable policy is preferred.

OUTSIDE ADVISORS

As the assets of the investment portfolio grow, proper oversight becomes critical. It requires significant time, attention, and swift action – which can be overwhelming for a volunteer board meeting only a handful of times a year.

For this reason, many nonprofits turn to an outside advisor who has more experience handling investment matters. This is particularly useful for organizations with limited resources.



UPMIFA does allow for the "use of prudent experts" to help make investment decisions. However, institutions and their boards still must exercise due diligence and an appropriate standard of care in delegating to an outside provider any responsibility for making investment decisions.

As long as the nonprofit complies with UPMIFA requirements, they are not liable for the actions of the outside advisor. The advisor assumes fiduciary responsibilities and the liability for investment decisions or actions.

[SECTION 5. DELEGATION OF MANAGEMENT AND INVESTMENT FUNCTIONS.

(a) Subject to any specific limitation set forth in a gift instrument or in law other than this [act], an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in:

The nonprofit has options in the amount of responsibility it delegates, too. If they wish to delegate a limited amount of discretion, they are probably better served with a consulting model.

Organizations seeking to delegate a larger amount of discretion can outsource the role of chief investment officer.

More details are found in the following pages.

"OK, all those in favour of delegating decision-making, shrug your shoulders"

UPMIFA on delegating to an outside agent:

(a) an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the institution to exercise reasonable care to comply with the scope and terms of the delegation.

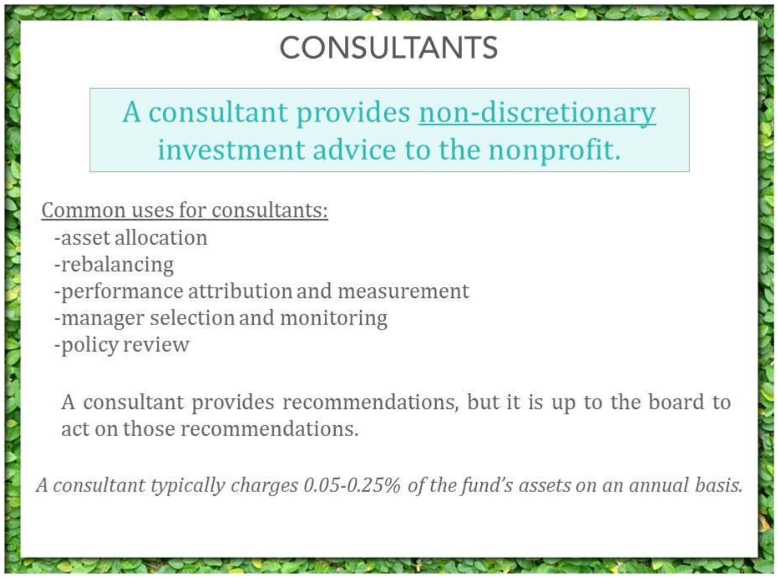
(c) An institution that complies with subsection (a) is not liable for the decisions or actions of an agent to which the function was delegated.

(d) By accepting delegation of a management or investment function from an institution that is subject to the laws of this state, an agent submits to the jurisdiction of the courts of this state in all proceedings arising from or related to the delegation or the performance of the delegated function.

(e) An institution may delegate management and investment functions to its committees, officers, or employees as authorized by law of this state other than this [act].

CONSULTANTS

A consultant provides non-discretionary investment advice to the nonprofit. This means they make recommendations to the board or committee, and the board must act on those recommendations.



A majority of nonprofit institutions use the services of a consultant. According to a 2015 Commonfund study, 84% of all nonprofits used a consultant. Similarly, 62% of smaller nonprofits with under $25 million in assets used the services of a consultant.

Common uses for consultants:

-asset allocation
-rebalancing
-performance attribution and measurement
-manager selection and monitoring
-policy review

A consultant typically charges in the neighborhood of 0.05-0.25% of the fund's assets on an annual basis.

OUTSOURCED CHIEF INVESTMENT OFFICER

An outsourced chief investment officer (or OCIO) provides <u>discretionary</u> investment management to the nonprofit. In this approach, the responsibility of all investment functions is assigned to an external manager who uses their discretion in determining the best approach.

Outsourcing discretion in investment decision-making allows nonprofits to focus on strategy, policy-making, and core governance issues, leaving investment matters to an advisor whose core competency is managing these endowments.

The board will not be liable to the institution for the actions of the manager if certain conditions are met.

Outsourcing is a popular strategy with smaller endowments, with nearly half of all nonprofits with assets under $25 million using the services of an OCIO.

There are no exact rules as to what can be outsourced and the degree of discretion can be left to the board or committee. Some nonprofits will outsource all investment functions. Others may outsource just a sliver, like alternative investments, for instance.

Regardless, when a nonprofit chooses to outsource, the board or committee must establish an overarching investment framework, usually found in the IPS, and then turn over implementation to the OCIO. Both parties must sign the document.

The nonprofit should keep their oversight responsibilities. They know the spending needs and risks of the organization, so they should continue to set the asset allocation policy, although the OCIO can provide input.

A nonprofit can expect to pay in the neighborhood of 0.80-1.0% of the fund's assets on an annual basis. It is more expensive than a consultant, but they handle all the work for the nonprofit, plus have an explicit fiduciary role and higher level of accountability.

Neither a consultant nor OCIO should recommend proprietary products. It is best to use the services of an independent firm to provide unbiased recommendations.

Many nonprofits have chosen to outsource their investment functions:

2015 Outsourced-Chief Investment Officer Survey
Total Investable Portfolio/Staffing Resources/Outsourcing Situation

Portfolio	Avg Size of Investment Staff	% That Outsource / Plan To
<$100MM	1	68%
$100MM–$500MM	1	57%
$500MM–$1B	2	64%
$1B–$5B	4	27%
$5B–$15B	10	16%
>$15B	41	35%

Source: www.ai-cfo.com/surveys

ABOUT BRIAN RUSSELL

Mr. Russell formed investment firm Bluefin Investments in 2009 after spending 10 years in the investment industry.

He started his career at the age of 20 with brokerage firm PaineWebber (now UBS) and went on to work at Merrill Lynch, independent firm Cassedy Financial Group, and institutional consultant Aon Investment Consulting.

In that time, he worked on accounts of all size, ranging from accounts with a limited amount of assets to ones over $1 billion.

He holds a bachelor's degree in finance from Belmont Abbey College in Charlotte, NC and an MBA with an advanced concentration in finance from the University of South Florida in Tampa, FL.

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