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INSTITUTE

Principles of Investment Stewardship for Nonprofit Organizations

"The trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve intergenerational equity.

— James Tobin, 1981 Nobel Laureate,
Sterling Professor of Economics, Yale University

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INTRODUCTION

A critically important asset for many nonprofit organizations is their endowment, sometimes referred to by a different name such as long-term investment fund. So important is this pool of financial assets that for many institutions it is the difference between fulfilling their missions and being forced to lower their aspirations or even ceasing to operate. That makes wise management the essential task for those charged with responsibility for these funds: boards of trustees, members of the investment (or finance) committee and senior staff members.

This publication is a survey of the fundamental principles of effective endowment management—precepts that can be applied across the nonprofit sector: to public or private colleges and universities; independent schools; private, family and community foundations; and nonprofit healthcare organizations. Institutions may define their missions in very different ways, but all see a healthy endowment as essential to their long-term viability.

We have organized this publication around what we call "the six Ps of Investment Stewardship."

- Purpose
- Policy
- Process
- Portfolio
- People
- Perspective

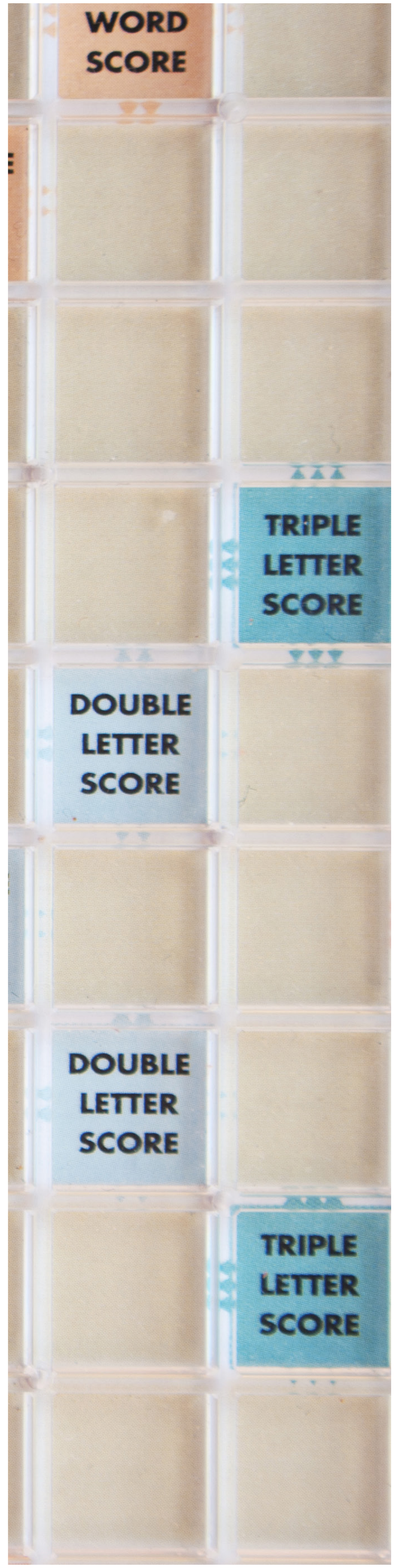
We believe this is a helpful way to think about endowment management, especially for those who are new to the field, perhaps because they are serving on an investment committee (IC) for the first time. Even those with previous experience stand to benefit from refreshing their working knowledge and gaining new insights into familiar topics. Indeed, while there are core principles undergirding endowment management, it is a discipline that is constantly evolving to support changing institutional needs and respond to developments in investment management.

An endowment is a portfolio of assets donated to a nonprofit institution to help support its mission, usually with the idea that the life of the institution will be perpetual. The concept is not new. In medieval England, churches and other religious establishments received gifts and bequests of land that they then rented to tenants, using the income for the relief of the poor and other charitable initiatives. Later on, as universities became established, donated land began to support secular causes. Over the centuries, endowments came to include not only land holdings, but financial assets. The rules governing endowment use followed English trust law, which limited fiduciaries to investing only in securities appearing on court-prescribed lists. In 1830 in the U.S., the famous case of *Harvard v. Amory* freed trust managers from the requirement of using an approved list of investments. The case established "The Prudent Man Rule," which essentially stated that managers were free to make any investment they thought wise as long as they did not exceed the bounds observed by a prudent man. Today, endowment assets are held primarily in financial instruments, although they may include real estate investments or other real assets. Endowments realize income from dividends and interest payments on the underlying securities but also from capital appreciation (increases in the value of the assets).

Today and in the foreseeable future, a range of factors makes the work of investment committees more important, yet more challenging, than ever before. Trustees are challenged to understand and use a greater range of investment tools and strategies than ever before. New ones are evolving constantly, many quite sophisticated. The total value of endowment funds overseen by nonprofit boards has grown enormously in recent years as has the size of the nonprofit sector itself (there are some 2.2 million IRS-recognized nonprofits in the U.S., according to GuideStar). Public awareness—owing to both traditional and social media—makes nonprofit organizations more visible today and subject, as well, to increasing scrutiny by regulators at all levels of government. For many endowed nonprofits—from private colleges to family foundations—the endowment is the financial bedrock of the institution both in terms of supporting current operations and enabling progress toward future goals.

In this environment, Commonfund seeks to help nonprofit institutions shepherd and grow the financial resources that enable them to achieve their mission and objectives over the long term. One way we do that is through knowledge sharing and the promulgation of best practices in endowment management. That is the objective of this publication. How well boards function makes a big difference in the fortunes of the organizations they guide. If they are dysfunctional or even close to it, the organization's existence may be at risk. Middling performance, or functioning at a satisfactory level, will place the institution in the middle of pack—surviving, yes, but hardly thriving. Superior performance and leadership will percolate throughout the organization and its constituencies—energizing, inspiring, motivating.

If you serve a nonprofit in any investment stewardship capacity—staff, trustee/director or committee member—we hope you find this publication useful and supportive of the important work you are performing.



PRINCIPLE I.

The nonprofit sector in the United States is the largest and most vibrant in the world. As noted in the introduction, more than 2 million registered nonprofit organizations serve a diverse spectrum of societal needs, including education at every level; healthcare and human services; arts, culture and humanities; the environment; and community services, among others. Many nonprofits are fortunate enough to have an endowment, and for these organizations this pool of assets is the financial cornerstone supporting their primary objective: the fulfillment of their mission.

Endowments are composed of individual funds given by donors over time, usually to support particular activities or programs of a nonprofit organization. These are referred to as restricted funds, and they generally comprise the greatest share of an institution's endowment. That is to say, an endowment is not monolithic, but composed of a great many smaller endowments. Donors sometimes give with no restriction as to purpose—that is, gifts in support of the broad mission of the institution and referred to as unrestricted. In addition, institutions themselves may elect to treat operating surpluses, unrestricted bequests and other similar amounts as what is known as "quasi-endowment."

These differing purposes influence the investment strategy for endowment funds. For example, a fund dedicated to providing scholarships at a college requires a steady flow of cash, year in and year out; ideally, the amount should not only remain steady but rise with inflation. A fund that is intended to cover the cost of awarding a prize every five years does not have the same need for ready cash. These two funds have different tolerances for year-to-year fluctuations in their value and their need for liquidity.

Increasingly today, nonprofit organizations are taking a holistic view of their financial resources and commitments. In this approach, long-term funds (endowment), annual operating budget, development capabilities (fund raising) and forecasted capital needs (facilities expansion, for example) are considered together. The demands on long-term funds and annual operating fund needs vary widely across the nonprofit spectrum; educational institutions, for instance, will have very different needs than foundations and they, in turn, will have very different needs than nonprofit healthcare institutions. This requires closer communication and coordination between the investment committee, financial staff, facilities management and development office.

Historically, most donors to endowments have contemplated a perpetual life for their funds. In recent years, however, some endowments—including some very large ones such as the Bill and Melinda Gates Foundation—have been established with a finite life. The expected lifespan, or term, of a fund is an important factor to consider when crafting an investment policy.

In this context, the maintenance of purchasing power becomes a key issue for a perpetual fund. For example, a series of funds to endow the conductor's and section chairs' positions at a symphony orchestra will need to be invested with a perpetual horizon in mind. On the other hand, a fund dedicated to constructing a new concert hall for the symphony 10 years from now does not need to generate any cash during its life and should, accordingly, be invested using a different strategy (although a fund for ongoing maintenance of the hall would be perpetual).

THE BOARD AND INVESTMENT COMMITTEE ARE RESPONSIBLE FOR INVESTMENT POLICY DECISIONS

Authority over institutional investment pools such as endowments resides with the governing board. There is general agreement that it is the responsibility of the investment or finance committee—with the advice and consent of the full board of trustees and in consultation with the administration or chief executive—to determine the objectives of the endowment and to establish policies that will guide its management. These objectives and policies should be articulated in a written statement with which all trustees are familiar and that is periodically reviewed and updated.

The members of the governing board—and the investment committee—are fiduciaries. If you are on the board of a nonprofit, you have a particular responsibility in that you are a fiduciary with regard to financial matters. In the law, a *fiduciary* is one who is entrusted with the property of another, and who is charged with a high degree of responsibility in carrying out that trust. Classic common law formulations of the duties of fiduciaries focus principally on two: (1) the duty of loyalty, which is the duty to act in the best interests of the beneficiary (in this case, the institution), and to avoid conflicts of interest; and (2) the duty of care, which demands that one pays attention and exercises reasonable prudence. (The duty of responsibility is often cited as well, but those responsibilities are already part of the duty of care.)

In the context of investment oversight, modern fiduciary law has focused mostly on the duty of care. It has been reformulated into a broad concept that is often called the "Prudent Investor Rule." Key components of the modern Prudent Investor Rule include:

Standard of care. The fiduciary should exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of action or decision. In general, the question of whether fiduciaries have met this standard will not be judged with the benefit of hindsight.

Total return investing. Fiduciaries are permitted to consider expected total return, including capital gains as well as income.

No requirement to consider investments in isolation. Fiduciaries can consider investments in the context of the portfolio as a whole (thereby encouraging diversification and taking into account the impact of inflation), and may also consider the institution's mission and its short-term and long-term spending needs.

Delegation. Fiduciaries may delegate the making of investment decisions, or other investment-related functions, to others, provided they use reasonable care and skill in selecting and overseeing the outside advisor.

The Prudent Investor Rule has been incorporated into various widely-adopted statutes, including the Uniform Management of Institutional Funds Act (UMIFA) and its successor, the Uniform Prudent Management of Institutional Funds Act (UPMIFA). Upon its passage in 1972, UMIFA established standards for the management, investment and expenditure of the endowment funds of nonprofit institutions. Previously, there had been no specific statutory law to guide nonprofit decision-making concerning investment authority and the use of appreciation for endowed funds. Overly conservative and restrictive investment laws in the various states caused institutional funds to be invested largely in low-yielding bonds that delivered reasonably dependable income but whose market value was constantly eroded by inflation. With great success, UMIFA significantly broadened the restrictions imposed by traditional trust law and enabled institutions to pursue total return investing. While UPMIFA, drafted in 2006, added only one word to UMIFA, the underlying change in the law was significant as it modified the rules governing expenditures from endowment funds to give a governing board more flexibility in making expenditure decisions, enabling the board to cope with fluctuations in the value of the endowment.

In sum, various definitions of "prudent" invariably include phrases such as "showing care and thought for the future" or "acting wisely under existing circumstances." Those who act as stewards of endowment funds will be well-served to remember that they are not called upon to be mistrustful or wary, but wise and informed.

'GUARDIANS OF THE FUTURE AGAINST THE CLAIMS OF THE PRESENT'

This publication opened with a brief statement quoting the late economist and Nobel laureate James Tobin, who eloquently articulated the principal task before those responsible for the endowments of nonprofit organizations. Writing in 1974, Tobin defined this challenge as maintaining "intergenerational equity," which he expanded upon by saying:

> ***The trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations. The trustees of an endowed university... assume the institution to be immortal. They want to know, therefore, the rate of consumption from endowment that can be sustained indefinitely ... In formal terms, the trustees are supposed to have a zero subjective rate of time preference.***
>
> ***Consuming endowment income so defined means in principle that the existing endowment can continue to support the same set of activities that it is now supporting. This rule says that the current consumption should not benefit from the prospects of future gifts to endowment. Sustainable consumption rises to encompass an enlarged scope of activities when, but not before, capital gifts enlarge the endowment.***

PRINCIPLE II.

POLICY

The central document guiding the management of a nonprofit institution's endowment—essentially, the strategic plan of the investment committee—is the investment policy statement (IPS). The IPS should be specific, embodying in concrete terms the best thinking of the board of trustees about the investment pool, its goals and its purposes; but it also needs to be sufficiently flexible to guide the board through environments that may be very different from those prevailing at the time of its adoption. It is recommended that an institution work with its financial advisor in the crafting of its IPS and that it consult with counsel to confirm that the IPS conforms to the version of UPMIFA adopted in its state.

Endowed institutions differ in their missions, capabilities and resources, and investment policy statements naturally mirror these differences. In that sense, there is no single "right" IPS; each institution's board must craft a statement that responds to the needs of the institution and the preferences and risk tolerances of the trustees.

There are five key points that should be addressed specifically and in some detail in the IPS: return targets, spending (formula and rate), asset allocation, risk management and liquidity.

RETURN OBJECTIVES

If the board aspires to maintain the purchasing power of the investment pool over time, then assumptions must be made about the long-term spending rate from the endowment, the anticipated rate of inflation and investment management costs. In addition, many institutions add an increment for the growth of the endowment's corpus. With regard to the spending rate, both practical experience and economic modeling tools have demonstrated that it is rarely possible to spend in excess of 5 percent of the portfolio each year without suffering an erosion in purchasing power over time. As for inflation, it has fluctuated considerably over time; an assumed long-term rate of 2 percent is generally used. Administrative and other costs typically are considered to add 1 percent to the expense base. Thus, 5 plus 2 plus 1, or 8 percent, is often a target return cited as necessary to maintain purchasing power. Return targets are often expressed as a specific number, for example, a rate between 6.0 and 9.0 percent, or as the rate of inflation plus “X” percent, e.g., CPI plus 5.0 percent. In the case of colleges and universities—for whom the elements comprising the CPI are not always relevant—the Commonfund Higher Education Price Index® (HEPI) more accurately reflects the higher costs borne by these institutions. Data show that annual increases in HEPI hover in the 3 percent range.

SPENDING

Spending (sometimes referred to as “payout”) is the amount withdrawn from the endowment on an annual basis to fund the institution’s operations or, on occasion, to support an exceptional, specific expenditure.

The two key components of the spending policy are the rate of spending and the formulas used to calculate it. The actual rate will vary with the methodology, spending rates typically average between 4.5 and 5.5 percent of the net asset value of the investment pool (private foundations are required to spend a minimum of 5.0 percent of their endowment’s market value each year, subject to certain adjustments). Over the long term, spending restraint increases the likelihood that the fund will be able to grow in dollar terms and is most likely to maintain or increase its purchasing power. The chart on page 8 shows how three spending rates (4, 5 and 6 percent) will impact the value of an endowment over a long period of time (50 years). All things being equal, the lower spending rate is most likely to achieve long-term purchasing power parity.

There are three types of spending formulas in wide use. (The primary spending methodologies are summarized in a table on page 9.) The most widely used approach involves spending a percentage of the fund’s market value each year, usually calculated by using a smoothing or averaging technique that aims to reduce the variation in spending from year to year. Another group of methods relies less on the fund’s market value and seeks instead to maintain a stable level of dollar spending from year to year. Still a third group of methodologies uses a hybrid approach in which a market value-based rule is combined with an inflation-based rule.

ASSET ALLOCATION

The implementation of an asset allocation policy will be discussed in greater detail in Principle IV (“Portfolio”). But to underscore its importance, a landmark study on the subject attributed more than 90 percent of the variability of return not to manager selection or market timing but to asset allocation.[1] The objective of allocating across various asset classes and strategies is to ensure the proper level of diversification within the endowment. The purpose of diversification is pursuit of the highest *risk-adjusted* return, or the highest expected portfolio return for a given level of risk (or the lowest expected risk for a given level of return). This is referred to as “the efficient frontier” and is expressed graphically as the efficient frontier curve because portfolios lying beneath the efficient frontier do not provide enough return for the level of risk incurred.

In the IPS, asset allocation is referred to as the “policy portfolio” or “policy allocation,” which specifies the percentage target weightings for each asset class or strategy and the ranges around those targets. The actual allocation at any point in time may vary from the policy portfolio owing to the market performance of the various allocations. It is the return on this portfolio that is measured against the benchmarks specified in the investment policy statement. Within the policy portfolio’s target asset allocation categories, the IPS may indicate percentage ranges above or below which the endowment may vary from the target. These represent opportunities to express a more tactical view on particular investment opportunities without departing from the overall allocation scheme.

As time passes, certain asset classes/strategies will have higher or lower returns than others and the portfolio will need to be rebalanced in order to restore it to the target levels. This is accomplished by proportionally selling those assets that have increased in value and using the proceeds to purchase those that have lagged or decreased—a practice that may seem counterintuitive until it is realized that buying low and selling high is the goal of every good investor.

1 Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower. 1986. “Determinants of Portfolio Performance,” Financial Analyst Journal, July/August, Vol. 42, No. 4: 39-44. See also, Brinson, Singer and Beebower. 1991. “Determinants of Portfolio Performance II: An Update,” Financial Analyst Journal, May/June, Vol. 47, No. 3: 40-48.

RISK MANAGEMENT

What kind and degree of risk is the investment committee prepared to take in pursuit of its investment goals? How are risks to be defined and measured? How long would an institution be faced with a decline in endowment spending in the event of a market shock? These are the kinds of questions that are asked in the process of formulating an approach to risk management.

Indeed, the risk tolerance of a nonprofit organization with respect to its long-term investment pool is one of the most important topics to be considered when framing an IPS. Historically, many policy statements treated investment risk as a byproduct of investing rather than as an essential precondition to earning investment returns. References to risk typically spoke of it as something to be "managed" in a general sense. Now, with powerful financial models available to enable fiduciaries to estimate the probability and range of possible losses associated with given investment strategies over time, risk is no longer treated as a byproduct of investment decisions but, rather, a primary input. The widespread use of consultants and outsourced investment advisors provides institutions with the ability to do the requisite quantitative modeling, thus placing a portfolio that thoughtfully integrates risk considerations within the reach of nonprofit organizations of just about any size.

Investment risk comprises a wide variety of potential threats, chief among them the risk of loss that would be permanent or require an unacceptably long time to recoup. While great progress has been made in risk management, it is important to emphasize that although risk can be modeled and to some degree understood, it cannot be eliminated if the portfolio's goal is to achieve a long-term return after spending and costs that is in excess of inflation. The question for fiduciaries, then, becomes whether the risks associated with a particular investment strategy are acceptable.

New thinking about questions such as these has emerged in recent years. One approach, in particular, focuses on strategic asset allocation based on an institution's specific objectives and risk constraints. This strategic asset allocation modeling process accounts for quantitative risks such as market beta, diversification and volatility but also includes drawdown relative to return objective and time to recovery from drawdown. With this type of analysis, the investment committee can understand the probability of achieving its long-term return objectives as well as potential drawdowns relative to those return goals. This may be a more relevant way to understand and interpret portfolio risk because the process defines risk as the inability of the institution to meet its financial objectives. Mission-based organizations may be well served to focus not on standard deviation as their definition of risk because their time horizon is perpetual. Thus, they can tolerate more short-term volatility than other investors and instead focus on optimizing the portfolio to minimize the time spent in drawdown while maximizing speed to recovery.

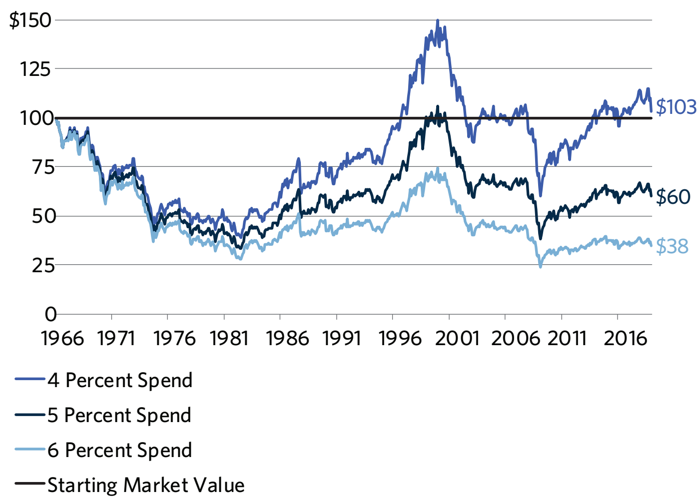
LIQUIDITY

If the endowment is there for supporting the budget, its role is quite clear. But if it is also meant to support a credit rating—as in the case with hospitals—that introduces a new set of considerations and it should be worked into the institution's risk and return expectations. There is a strong case to be made for linking the investment policy with the institution's balance sheet as well as its long-term strategic plan. A growing number of institutions are doing this, and are also addressing gifts and debt in their investment policy.

EFFECTS OF VARIOUS SPENDING RATES* OVER TIME

January 1966 – December 2018

Lower spending rates allow for greater capital accumulation in the pool and result in a higher absolute dollar payout level.



*Inflation-adjusted using Commonfund Higher Education Price Index® (HEPI)

The equity portion of the hypothetical portfolio is based on monthly returns of the S&P 500 Index (1/66-current quarter-end), and the fixed income portion is based on monthly returns of the Bloomberg Barclays US Aggregate Index (1/73-current quarter-end) and the Ibbotson Associates Long Term Corporate Bond Index (1/66-12/72). Returns for this hypothetical inflation-adjusted portfolio assume that it is rebalanced to 70/30 annually on 1/1/yy and 5% is distributed annually on 1/1/yy.

Sources: Bloomberg, Commonfund Institute, Ibbotson

SPENDING POLICY EXAMPLES

Assumptions and Starting Points	
Endowment	$100,000,000
Spending Rate	5%
Prior Year Spend	$5,000,000
Inflation Rate	3%

Spending Policy Approach	**Definition**	**Spending Equation**	**Spend**
Category I: Simple Rules			
Income-Based	Spend all current income.	Endowment Income (assume income of 4.5%)	$4,500,000
Decide on an appropriate rate each year			
Spend a pre-specified percentage of beginning market values			
Meet IRS minimum of 5 percent	For private foundations subject to this requirement.		
Category II: Inflation-Based Rules			
Inflation-Based	Increase spending each year based on rate of inflation.	(Endowment x Rate) + Inflation Adjustment	$5,150,000
Banded Inflation	Last year's spending plus an inflation rate, but bound by range— e.g., no more than 6.5% nor less than 3.5% of market value.	Prior year Spend x (1 + Current Inflation Rate) *If calculated spending dollars are below Lower Band then default to Lower Band amount and if dollars are above Upper Band then default to Upper Band.*	$5,175,000
Category III: Smoothing Rules			
Traditional	Pre-specified percentage of moving average of market value— typically 5% of a three-year moving average of beginning market values.	Endowment x Rate	$5,000,000
Spending Reserve	Segregation of 5–10% of market value in separate account, invested in 90-day Treasury bills. Reserve is drawn down when endowment performance is less than policy target.		
Stabilization Fund	A fund created from endowment returns in excess of the target spending rate which is used to control the long-run growth of the total endowment. The stabilization fund is invested alongside the endowment, but with a different (higher) spending rate.	(Original Endowment x Spending Rate) + (Stabilization Fund balance at end of previous fiscal period x Spending Rate)	
Category IV: Hybrid Rules			
Yale Rule	The amount released under the spending rule is based on a weighted average of prior spending adjusted for inflation (80% weight) and the amount that would have been spent using 5% of current endowment market value (20% weight).	(Prior year Market Value x Spending Rate x 20%) + (Prior Year Spend x [1 + Inflation Rate] x 80%)	$5,120,000
Stanford Rule	The amount released under the spending rule is based on a weighted average of prior spending adjusted for inflation (60% weight) and the amount that would have been spent using 5% of current endowment market value (40% weight).	(Prior year Market Value x Spending Rate x 40%) + (Prior Year Spend x [1 + Inflation Rate] x 60%)	$5,090,000

PRINCIPLE III.

The work of boards of trustees and investment committees can be viewed as a process, one by which trustees or directors lead, serve, decide and communicate, and by which they set strategic priorities and strategic direction. One of the foundational documents for good governance is the bylaws of the organization—because they address the processes of communication and decision-making. Boards have a fiduciary duty to make decisions, so they should want to make them in a way that is fair and affords due process to every trustee or director. The board of trustees is the governing body at nonprofit institutions. An investment committee that is properly aligned with the board is also focused on governing. Ultimate fiduciary responsibility remains with the full board, with the investment committee being responsible to the board.

Fiduciary effectiveness is a matter of structure, processes and people, i.e., the governance structure of the organization, the processes within that structure and the people who inhabit that structure (the decision-makers). The key elements of structure are professionalism, the composition of the board, how engaged the board is and how transparent the organization is to its constituencies and beneficiaries—whomever has a stake in what the board is doing. Processes within the structure focus on the tasks the board must perform and the decisions it must make.

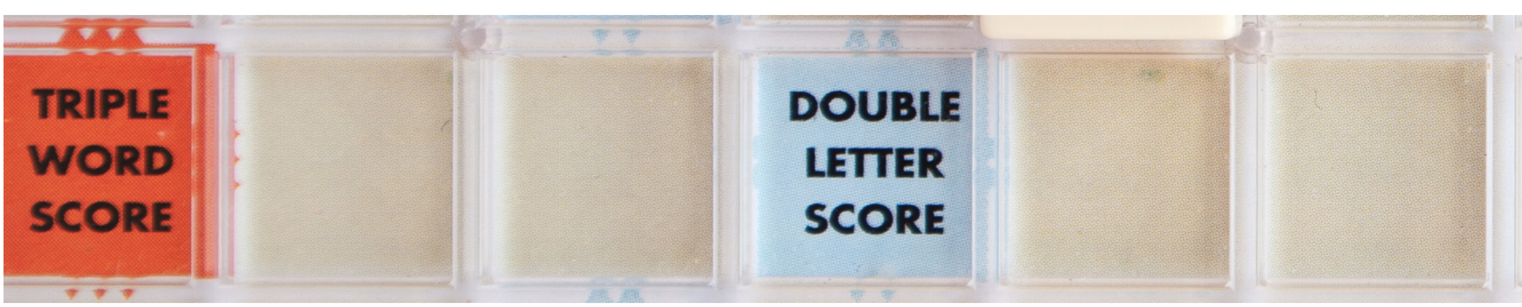
It is also important to emphasize that trustees should concern themselves with governance, not management; strategic issues, not tactical ones. There is a difference between governance and management and boards should distinguish between the two. It's useful to keep in mind that the word governance comes from a Greek term meaning "to steer." Discussions about choosing one supplier over another, for instance, are best left to staff members as opposed to occupying the time and energy of the board.

In the case of investment manager selection, the investment committee's role is one of oversight. Internal staff, external consultants or an outsourced chief investment officer ("OCIO," explained further under Principle V) can perform the detailed and time-consuming work of investment manager evaluation and make recommendations to the committee for final selection. Much has been written about this particular process, the conclusion of most experts being that committees spend too much time on manager selection and evaluation to the detriment of overarching issues such as asset allocation, spending and risk management.

A SHARED WORLD VIEW CAN LINK INVESTMENT MANAGER AND CLIENT

The common ground for manager and client is a world view that is consistently reflected throughout the portfolio. A client institution can't be confident in a new manager hire unless it is first satisfied that there is a strongly-held investment thesis; that is, the manager is not simply acting in way that will bring in assets or is taking a particular action because it will promote client retention. Rather, the firm has a well-grounded view of its own discipline and is able to articulate how this view is put into action.

Similarly, the hiring institution should hold a world view, and look for managers whose world view, if not totally consistent with the institution's, can be implemented with confidence within the broader portfolio. It is the institution that constructs the overall portfolio and must be certain that the managers complement each other in support of its worldview. It's entirely possible to retain excellent managers and find that they do not function optimally in the context of the overall portfolio. The practice of reviewing managers every few years and firing



them when they're underperforming is inimical to the model just described. Building relationships based on trust and candor—the presumption of loyalty—is the basis for a productive long-term partnership.

As it looks at hiring an investment management firm, the investment committee should also focus on the firm's investment process, the desirable attributes of which should be discipline, consistency, sustainability, clarity, flexibility and success. The following questions enumerate these points:

Discipline: Are there clearly articulated investment objectives and is there a credible rationale for the thinking behind them?

Consistency: Does the manager adhere to its style and strategy through time and all market conditions?

Clarity: Is the investment process understandable and does it make sense?

Flexibility: Is there latitude to adapt to evolving market conditions or learn and adapt based on previous experience, while remaining true to the manager's core philosophy and strategy?

Success: Has the process proven to produce results over the long term (three, five and 10 years or a full market cycle)?

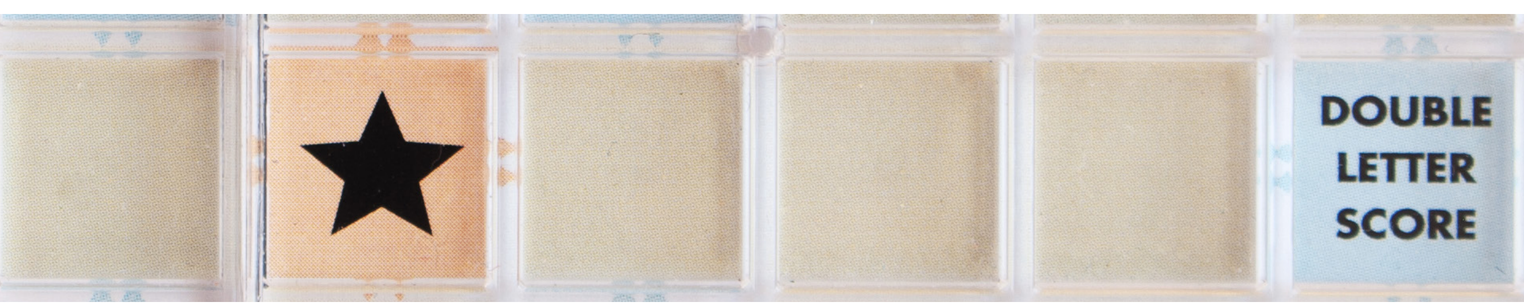
Continuous improvement: Does the investment management firm reflect a culture that encourages learning, and does management believe in continuous improvement?

Like so much in endowment management, manager selection and evaluation ultimately are matters of sound governance, a thoughtful investment policy statement, the strength of the investment committee, and the self-knowledge and self-discipline of the institution to sustain long-term manager relationships.

MONITORING

Obviously, the process does not end with manager retention. Both individual managers and the portfolio itself must be monitored through time. With regard to the managers, any review should start with the mandate and investment objectives and then extend to the rationale for investment decisions relative to the manager's assignment. Obviously, there are many metrics available for measuring performance, starting with absolute and relative returns for the immediate past period, the calendar or fiscal year to date, and for trailing one-, three- five- and 10-year periods (as well as since inception of the relationship). Typically, relative returns are compared with external benchmarks relevant to the manager's mandate or, in some instances, to a custom benchmark constructed in the case of managers with a multi-asset or multi-strategy assignment. Beneath the topline returns are many other metrics that provide color and context such as portfolio characteristics and risk measures. Indeed, performance is not just a number, but, rather, the outcome of the balance between risk accepted and return gained.

Typically, the staff prepares a monthly, quarterly and/or annual report to the investment committee rolling up all the inputs received from the investment managers into a comprehensive report. Based on inputs from the managers, this will usually include an assessment of the market environment and the rationale behind changes to the portfolio. In many cases, internal staff resources are not sufficient to do this work in a timely and thorough manner, so it (along with manager selection and monitoring) is often outsourced to a consultant or is outsourced under the previously mentioned OCIO model.



THE INVESTMENT COMMITTEE ROLES AND RESPONSIBILITIES

The board of trustees is the governing body at nonprofit institutions. An investment committee that is properly aligned with the board is also focused on governing. Ultimate fiduciary responsibility remains with the full board, with the investment committee being responsible to the board.

When created as a standing committee, the primary purpose and functions of the investment committee are:

- **To provide the institution with an experienced and manageable group of people who take responsibility for developing and maintaining (with full board approval) the guiding document of endowment management—the investment policy statement.**
- **To be the source of specialized skill, knowledge and experience required to oversee an investment portfolio as a fiduciary under the board-approved policy.**
- **To handle risk in a world in which financial markets change rapidly.**
- **To bring to bear the necessary experience with and knowledge of the highly complex financial instruments and investment strategies that have emerged over the past several years, and demonstrate a willingness to understand these complex instruments.**

PRINCIPLE IV.

PORTFOLIO

Constructing and overseeing an investment portfolio is at the heart of endowment management—the nucleus around which everything revolves. If the strategic document behind the portfolio is the investment policy statement, the most fundamental tenet underpinning a wide range of decisions is asset allocation.

Fundamentally, asset allocation is apportioning investment funds among categories of assets. Broadly, those categories are stocks, bonds, cash and real assets. Today, however, these categories are divided and subdivided in an effort to optimize returns while managing risk. A traditional stock portfolio, for example, may include allocations to growth and value styles; small, mid- and large cap stocks; international (non-U.S. developed markets); and emerging markets. For many nonprofits today, the largest single allocation is to alternative investment strategies. These include private capital (venture capital, private equity and international private equity), real estate, natural resources, commodities, distressed debt and marketable alternative investments, (hedge funds, absolute return, market neutral, long/short, 130/30, event-driven and derivatives).

WAYS OF LOOKING AT ASSET ALLOCATION GO BEYOND TRADITIONAL ASSET CLASSES

Historically, asset allocation decisions have been based on the asset classes and strategies identified in the previous paragraph. Today, however, there are other ways of looking at portfolio diversification. Many endowments employ a functional classification in combination with traditional asset allocation. This approach diversifies across asset classes/strategies based on their role in the portfolio: growth, risk reduction, inflation protection, liquidity, opportunistic investments and duration. Another approach is factor-based asset allocation, factors being the attributes that can explain differences in returns. Most factors fall into two broad categories: macroeconomic factors (a focus on broad risks across asset classes, e.g., inflation, credit and economic growth) and style factors (a focus on risks and returns within asset classes, e.g., growth, value and momentum). A factor-based strategy involves tilting equity allocations toward or away from specific factors. Investors are also mindful of the liquidity position of their portfolios in order to meet short-term cash needs. Typically, there are three liquidity categories: Liquid, or the ability to convert an asset into cash in one months or less; semi-liquid, or being able to convert to cash in one month to one year; and illiquid, or an asset requiring more than one year to be converted to cash.

Asset allocation and spending policy are closely linked and must be compatible. A critical challenge is choosing a strategic asset mix that will generate the returns necessary to support the agreed-upon spending policy at an acceptable level of risk.

When experienced investors make asset allocation decisions, they do not seek to maximize returns, but instead focus on *risk-adjusted returns*, or maximizing returns for a given level of risk. What investors seek to do by diversifying their portfolios is to combine assets that are relatively uncorrelated. Investing in asset classes that can be expected to move together produces little diversification benefit. However, adding asset classes that on their own might be considered risky can lower an endowment's overall risk profile if these classes have a low correlation with each other.

The IPS may be reviewed once every two or three years, unless extenuating circumstances intervene. Asset allocation, however, should be reviewed at every meeting of the investment committee—not necessarily with the idea of making changes, but to review how the portfolio is currently allocated versus the policy allocation and to rebalance, if necessary. A decision to rebalance should be made when the agreed-upon asset allocation (the policy portfolio) has become distorted by the relative performance of one or more allocations. Outperformance by one or two allocations and/or underperformance by others will alter the risk/return profile of the portfolio. Traditionally, endowment managers have rebalanced annually, or even less frequently. Rebalancing too often can be disruptive and costly, while rebalancing every two or three years may incur excessive portfolio risks.

One approach to rebalancing that is widely accepted is establishing a series of ranges or "bands" around a target percentage for each asset class in the portfolio. For example, a fixed income policy allocation might be 15 percent of the portfolio. Under a banded approach, fixed income could increase to 18 percent or shrink as low as 12 percent. If either the upper or lower limit is breached, the allocation is returned to its target policy weight. Because this approach it not time-based it may result in more frequent rebalancing during times of high volatility and less frequent rebalancing (potentially over a period of years) in times of relative calm.

COSTS CAN BE DIFFICULT TO CALCULATE BUT HAVE AN IMPACT ON RETURNS

Few aspects of financial management are more important for fiduciaries than an understanding of the costs paid for the management of the perpetual funds for which they have responsibility. Indeed, astute management of costs can make the difference between mediocrity and superior performance in otherwise identical portfolios. But unlike other factors that affect investment returns, such as asset allocation, costs are almost certainly the least well understood.

Costs generally fall into four basic categories:

- Costs related to portfolio construction and management
- Activity—and transaction—related fees and costs
- Fund servicing costs
- Investment oversight costs

Within each category, some costs are charged directly, or invoiced, while some are netted from the fund. This dual system of charging can make it difficult to assess actual expenses. In addition, certain items such as direct management costs can straddle the two areas.

In the final analysis, costs in themselves are less important for most institutions than achieving the investment objective of a long-term, risk-adjusted return that will enable them to fulfill their missions. Thus, evaluating performance net of all fees whenever possible is a good practice that focuses on bottom-line results. Inevitably, however, costs and fees should be considered among the decisive factors affecting portfolio performance.

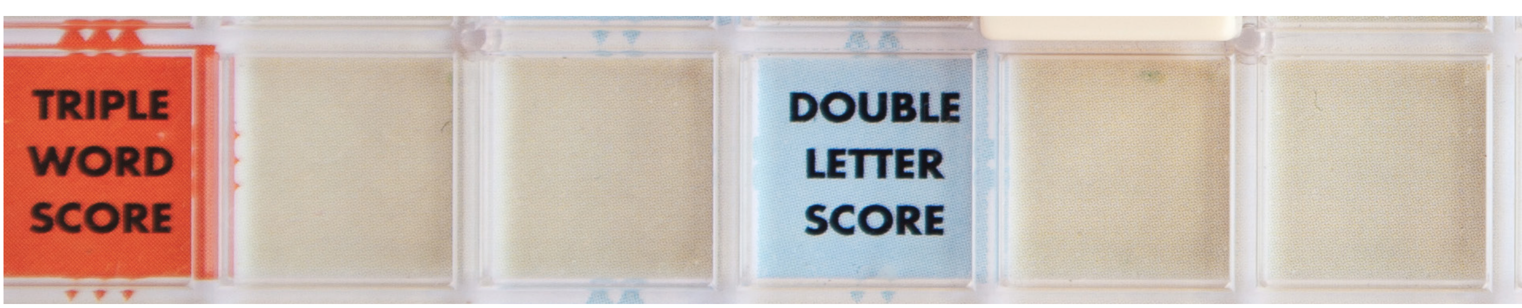
RESPONSIBLE INVESTING, WHILE NOT NEW, EMERGES AS A SEPARATE DISCIPLINE

Terms such as responsible investing, socially responsible investing, mission-related investing, impact investing, and environmental, social and governance (ESG) criteria have entered the investor's lexicon in recent years. In fact, responsible investing's roots go back a few hundred years to the colonial era when religious groups refused to invest in the slave trade. Yet it wasn't until the 20th century that various forms of responsible investing took hold as specific disciplines. Today, it is clear that acceptance of responsible investing is more than a passing trend and, at the least, institutions should understand what it means for them.

For many decades, responsible investing was associated with negative screening, or avoiding investment in companies whose products and/or business practices are harmful to individuals, communities or the environment. Typically, these included alcoholic beverages, tobacco-related products, pornography, unfair labor practices and weapons. Today, a much broader discipline has gained momentum—ESG, or investing in accord with environmental, social and governance criteria. ESG addresses the three main non-financial factors measuring the sustainability of a corporate enterprise, and is an investment approach developed and promulgated globally by the widely-adopted Principles for Responsible Investing (PRI).

Surveys show that allocations to responsible investing are growing among institutional investors and being discussed by the boards of institutions that are still debating a commitment. While some studies indicate that corporations managed in adherence with responsible investing principles or ESG criteria perform better over time and are inherently less risky, there are concerns on the part of fiduciaries that limiting their investment set may hinder portfolio returns. Other concerns have been confusion over definitions of the various forms of responsible investing and a relative lack of performance data. Still, the field is maturing rapidly as more institutions allocate part or all of their portfolios to responsible investing, experience grows and a network of practitioners and advocates emerges.

Institutions considering responsible investing/ESG may want to create a working group or subcommittee of the investment committee to develop their thinking and approach. They may also create an advisory committee composed of stakeholders (student or employee representatives, for example) to inform the committee's efforts. Institutions may also want to work with an outside adviser on these issues and perform an initial analysis of their portfolios to determine a baseline of exposure to certain issues. As an institution's approach to ESG develops, it will also be important to determine how to measure and monitor exposure to ESG issues. Exposure to ESG issues is not one-size-fits-all, and institutions will need to determine the appropriate way for them to integrate ESG.



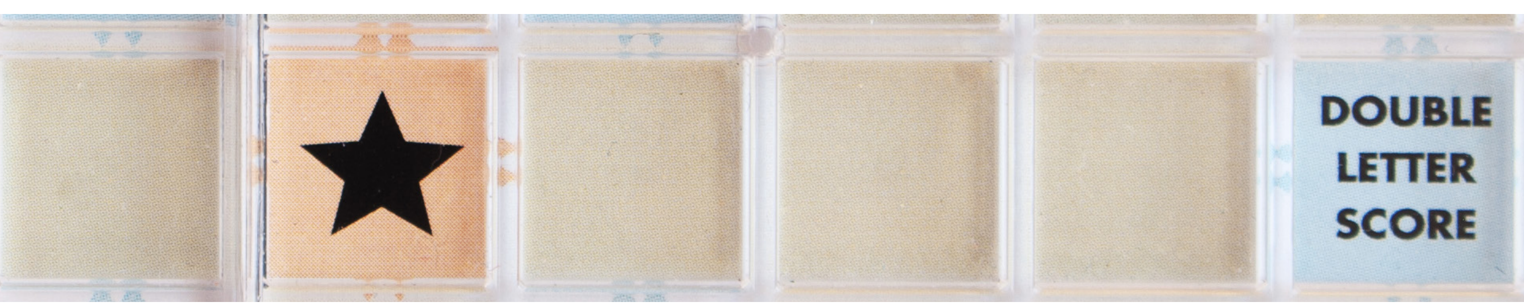
CONTEMPORARY THINKING IS REFLECTED IN THE ENDOWMENT MODEL

As they have over the years, academic institutions led the way with thinking about what today is referred to as "the endowment model." The key tenets of the endowment model are: a bias toward equities; the time value of invested capital and the related corollary of exploiting inefficiencies in markets; and the significance of diversification. A portfolio constructed on the tenets of the endowment model will be highly diversified; have larger allocations to equities over fixed income; and reflect a substantial commitment to illiquid or semi-liquid alternative strategies, such as private equity and hedge funds, in order to pursue the illiquidity return premium associated with these strategies.

The endowment model and related contemporary thinking about asset allocation policies and practices could not have evolved without acceptance of concepts such as total return investing. The model was promulgated by nonprofits' need to pursue higher absolute returns, protect against inflation and smooth annual spending in support of operations. Asset allocation emerged as the pivot point for these decisions and others. Spending rates could not be set independent of expected returns, and returns could not be forecast until the asset allocation policy was in place. Even more important, nonprofits recognized that growth of principal through the pursuit of alpha was central to their ability to fulfill their mission over time. ("Alpha" is the return on an investment over and above a relevant market index or benchmark.)

THE EMERGENCE OF ARTIFICIAL INTELLIGENCE AND MACHINE LEARNING IN INVESTING

Artificial intelligence (AI) and machine learning (ML) are impacting numerous industries, investing among them. Applications of AI and ML to quantitative investing go back to pioneering academic research in the 1990s. These approaches give quantitative investors new tools for forecasting and modeling and adding value by making better use of large, complex data fields. At the same time, AI and ML pose challenges; principally the need for specialized knowledge, sophisticated analytical skills and intensive computational resources. For all but the largest institutional investors, the skills and experience of consultants and OCIO partners will be essential for institutions interested in investigating potential applications of AI and ML to their endowment portfolios.



PRINCIPLE V.

Oversight of an endowment brings a wide range of topics before the members of an investment committee—from mission-critical decisions regarding asset allocation and spending levels to recruitment of new IC members and formulating the agenda for committee meetings. Yet it has been said that governance is really about people and the interpersonal relationships among them. There was a time when some board or IC positions were more or less "honorary," without any real demands as to time, knowledge and responsibility. That era is long gone. Trustees are no longer passive participants outside of mainstream decision-making and policy formulation. The bottom line is simple: How well boards function will make a big difference in the fortunes of the organizations they guide.

What makes a board "excellent"? One answer lies in the previously-mentioned difference between governance and management. The board's role is strategic, not tactical. Its primary responsibilities are to establish and clearly articulate the mission of the organization, to hire a management team to run the organization in accordance with policies and objectives that further that mission, and to monitor progress toward the mission's fulfillment. The execution of ongoing operations and the development and implementation of institutional programs are the responsibility of management and staff, not the board. On an ongoing basis, the board's role is one of oversight, in which it reviews and assesses management's success in carrying out its job. Indeed, once the mission of the organization has been defined in its charter and bylaws, fiduciary principles require that the board guard that mission as it has been defined. For example, the chair and trustees should be aware of situations like "mission creep," in which an institution gradually strays from or broadens its original mission and purpose in unintended ways.

While the board does not manage, it does not simply preside. The board engages in active supervision of management and staff: this means setting standards that are clear and objective, being sure that position descriptions are known and understood, and ensuring that the actual running of the organization is well supervised by senior staff members. The board needs to have confidence that management is effectively running the organization and that staff are competently executing those actions that advance the mission. It is in this role of defining the mission and monitoring progress that the board provides purpose and direction for the staff, while in its oversight duties it remains focused on governance and avoids becoming involved in operations.

THE INVESTMENT COMMITTEE: GUARDIANS OF THE ENDOWMENT'S PURCHASING POWER

The investment committee, found at organizations that possess endowments or other long-term pools, is charged with fulfilling the intentions of donors with respect to donor-restricted funds and maintaining the endowment fund's purchasing power, often for perpetuity. Duties of this committee include creating and maintaining an investment policy, setting the investment portfolio's policy asset allocation, developing an appropriate spending policy, rebalancing the portfolio on a regular basis and providing an annual report to the board on the state of the endowment. The investment committee should work in close coordination with the finance committee and the organization's senior staff; at smaller nonprofits, the investment committee is often a subcommittee of the finance committee. Together, these two groups should determine and recommend to the board a sustainable spending practice for the endowment.

Questions about investment committee dynamics—such as size and frequency of meetings—often arise. In terms of size, an average of six to eight members is common. That makes it large enough to benefit from a variety of perspectives, have a healthy mix of generalists and specialists, and spread the workload evenly. How often should an investment committee meet? Generally, no more than three or four times a year. More frequent meetings can tempt committee members to micromanage and lead them to develop a short-term time horizon. However, in addition to meetings, committee members should make themselves available for interim conference calls and set aside time for reading reports and staying current with institutional matters.

COMPLEXITY DRIVES GREATER RELIANCE ON CONSULTANTS AND OUTSOURCING

Investment committees have long retained consultant organizations to help them with various aspects of endowment management. Consultants may deliver a range of services, from performance attribution and measurement to manager selection and policy review.

In addition to traditional consultant relationships, the practice of delegating the bulk of the investment office function to a third-party provider has increased steadily over the past decade. Outsourcing, as it is broadly known (the terms "outsourced chief investment officer" or "OCIO" are also used), encompasses a wide range of models depending on the degree of portfolio delegation the institution prefers and the operational methodology it employs.

Both models—assistance from consultants or the OCIO approach—developed and grew in response to changes in the institutional investment environment over the last two decades. One driver of external assistance is the more complex investment environment that has emerged along with the proliferation of investment managers across all asset classes. Another is institutions' pursuit of enhanced investment return and decreased portfolio volatility through allocations to global, well-diversified and less liquid alternative investment strategies. Typically, these strategies demand much closer analysis, time-consuming due diligence, specialized knowledge and ongoing monitoring. Volunteer boards and investment committees, meeting only a few times a year, have been challenged to construct and monitor these complex portfolios. New legal and regulatory requirements, too, have placed a heavier load on fiduciaries. Taken as a whole, the investment process is far more time- and resource-intensive than ever before.

In a typical application of the OCIO model, the outsourcing provider designs a custom solution for the institution based on its risk tolerance, return targets and other requirements. Such a comprehensive approach includes investment policy review and counsel, portfolio construction and asset allocation, manager due diligence and ongoing monitoring, portfolio rebalancing, risk management and reporting. The provider thus assumes responsibility for the institution's entire investment process, filling a role equivalent to that occupied by the internal investment office staff at institutions with very large investment pools.

As a legal matter, the extent to which fiduciary responsibility is delegated by the institution's board of trustees to the outsourcing provider depends upon the model selected and the preferences, needs and capabilities of the trustees, the investment committee and the OCIO provider. Some institutions may prefer that the investment committee and staff retain hands-on control, remaining involved in all investment decisions. Other institutions and committees may find it best to delegate essentially the entire investment function to the OCIO provider.

CHAIRPERSONS ARE CRITICAL TO HIGH-FUNCTIONING INVESTMENT COMMITTEES

The chair is key to an effective investment committee. Among the parameters of this role, the chair traditionally ensures the integrity of the investment policy; sets the agenda for committee meetings; maintains focus and discipline in the committee's deliberations, ensuring that they reach a course of action; and facilitates the full board's fiduciary responsibility through effective reporting. The chair should also take the lead in recruiting qualified committee members, making sure that incoming committee members are properly oriented as to their roles and responsibilities, and that some form of ongoing education is offered to all committee members to keep them abreast of changes in the industry, the regulatory regime and other external factors.

One of the key goals in orienting new committee members is familiarity with the history of the committee's decision-making; this can be accomplished by reviewing minutes of prior meetings and/or having long-standing members brief them. This in turn calls for keeping written records of key decisions made by the committee so that they can form a fiduciary record and provide a means for evaluating their outcomes. In the case of the investment committee, it is best to have an experienced investor as chair, but the other members should be chosen to bring a diverse mix of backgrounds and skills to the group.

PRINCIPLE VI.

PERSPECTIVE

This publication is built on the pillars—the principles—underpinning endowment management...precepts that have been driven by ever-evolving legal precedent and changing practices in institutional investment management. While being guided by these principles, every institution is different and thus will want to think about them in the context of their own mission, objectives, culture and resources. In that light, we close by offering some perspective:

Just as most endowments are perpetual in their time horizon, trustees should think strategically and position the institution for the long term. At the same time, however, it's important to stay flexible and remain open to new ideas. Trustees should think of themselves as innovators and recognize that a steady hand on the helm does not preclude fresh thinking and a willingness to try new things.

Perhaps the most straightforward way to achieve the attributes of openness and flexibility is board diversity. Differing backgrounds, experiences and points of view are the characteristics of a strong, healthy board (and investment committee). Diversity creates an environment that encourages member inclusion and engagement and values constructive debate. Additionally, there is a growing evidence base that diverse boards are more engaged and diverse investment committees outperform those that are more homogeneous.

As we have noted throughout this publication, the investment policy statement is the document guiding the decision-makers responsible for managing endowments. That doesn't mean it is carved in stone. In the spirit of flexibility, it is a good idea to review the IPS every two years. This review is not an obligation to make changes, but a time to hold the IPS up to the light and consider whether there are aspects that need to be modified. It also helps to ensure that reviews are not reactions to stress in the financial markets—the very time when changes should not be made.

The boards and investment committees of nonprofits have the opportunity to make meaningful contributions not only to their institutions, but to society at large. Higher education, foundations and healthcare organizations contribute meaningfully to our society and way of life. Helping these institutions preserve and grow the financial resources necessary to fulfill their missions is a richly rewarding form of service.

"Leaving a Stewardship legacy requires that we see ourselves not just as individual actors in economic or social systems, but that we see ourselves as members of communities. It also requires that we define our purpose not in terms of self-interest alone, of 'what's in it for me?,' but in terms of how we can serve others. Finally, our Stewarship legacy is defined not just by how we serve others during our lifetimes, but by the impact of our actions on generations in the future.

— John G. Taft, Author, *Stewardship*

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Commonfund was founded in 1971 as an independent asset management firm with a grant from the Ford Foundation. Together with or through its affiliates, Commonfund today manages customized investment programs for endowments, foundations and public pension funds. Among the pioneers in applying the endowment model of investing to institutional portfolios, we provide extensive investment flexibility using independent investment sub-advisers for discretionary and non-discretionary outsourcing engagements. Investment programs incorporate active and passive strategies in equities and fixed income, hedge funds, real assets and private capital. All securities are distributed through Commonfund Securities, Inc., a member of FINRA. For additional information about Commonfund, please visit www.commonfund.org.

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IMPORTANT NOTES

Market Commentary

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