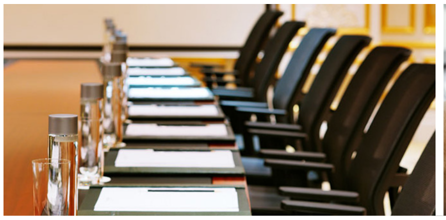

Effective Endowment Governance: What Savvy Nonprofits Are Doing

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In this article, we share some useful pointers on endowment governance to help nonprofits enhance oversight of their endowments and perform this role with distinction. Our comments are based on participating in hundreds of meetings, primarily with nonprofit Investment Committees with assets ranging from $25 million to over $1 billion. In these meetings, we developed a keen appreciation for best governance practices.

Nonprofit organizations fulfill a critical role in our communities, and the need to protect and grow endowment in support of program spending is an absolute Board responsibility. As global capital markets become increasingly dynamic and investment strategies more complex, savvy nonprofits are recognizing the need to strengthen their endowment governance.

The globally diversified portfolio of the Endowment Model - aligned to institutional risk/return objectives - remains, in our view, the proper strategic construct to invest a nonprofit portfolio. Its application alone, however, does not assure successful investment outcomes. Of equal importance is how well nonprofit leadership executes on its critical role. Below we provide some helpful ideas to increase chances of a successful outcome.

Smart Governance Contributes to Positive Investment Outcomes

Effective governance practices are as important as asset allocation and investment selection

Conventional wisdom suggests that **strategic asset allocation** and **manager selection** are essential long-term drivers of portfolio success. While both affect returns and risk, **effective governance practices** are also critical.

Effective governance is about a disciplined portfolio management process, and should be a high priority of nonprofit leaderships. Discipline is particularly important when considering the operational context of most nonprofits: pools of multiple investments subject to dynamic market forces in play 24/7, and typically overseen by part-time volunteers who may spend 18-30 hours per <u>year</u> on governance, assuming all participants engage. In such a reality, weak governance practices increase portfolio risk and may threaten mission. Conversely, strong governance enhances sound decision-making, financial viability, and achievement of nonprofit goals.

Below we share some effective practices that nonprofit endowments can employ without too much effort to enhance portfolio and process oversight.

Nonprofit Endowment Governance Structure

Endowment oversight begins with the Board of Directors which has ultimate fiduciary responsibility for investment decisions. Boards often delegate to an Investment Committee the oversight and management of the endowment.

Staff, perhaps assisted by outside investment advisors or consultants may provide administrative support, data, and analysis to support policy setting and investment strategy implementation.

Board of Directors

Boards set the overarching goals for endowments

Investment Committees drive the strategy to achieve those objectives

A Board's three most important investments-related tasks are to establish both an **investment objective** and a **financial return** goal that align with the organizational mission, and empanel a qualified **Investment Committee** to oversee management of the portfolio.

The investment objective is the long-term desired outcome for the portfolio over time. For charities that intend to operate in perpetuity, the normal investment objective is to sustain institutional purchasing power over time to deliver the same services tomorrow that are delivered today. For institutions that do not have a current spending requirement, portfolio growth might be the investment objective.

The financial return goal is the estimated nominal investment return necessary to preserve purchasing power and cover mission-related spending.

Assuming a common 5% spending rate, the financial return goal is 5% plus estimated inflation plus investment costs. If the inflation forecast is 1.5% and costs are 0.5%, the financial return goal is ~ 7%. Hence, to grow assets and cover spending, inflation and costs would require a higher return, and more risk. As risk and return are linked, Boards should be involved in setting spending rates, investment objectives and financial return goals since they are central to the core mission and values of a nonprofit.

With these factors established, the Board's third key task is to empower a competent Investment Committee to implement the investment strategy to achieve these goals.

Role of the Investment Committee

Investment Committees ("IC") establish and implement an investment strategy to achieve the investment and financial return objectives set by the Board.

Mindful that Boards oversee the entire enterprise, delegating investment authority to a qualified IC is a wise division of labor that also enables the Board to maintain a proper objectivity about the portfolio.

The IC oversees portfolio asset allocation, investment structure (individual securities holdings or dedicated managers), risk management, and performance tracking to evaluate investment strategy success.

ICs should delegate to Staff or third-party advisors the quantitative analysis helpful to make informed decisions on asset allocation and investment choices.

Upon setting its investment strategy, drafting a written Investment Policy Statement ("IPS") to document how the IC will implement the investment strategy is an important IC fiduciary duty. In addition to providing oversight continuity (as IC membership evolves), an IPS serves as the figurative "rules of the road" by which the portfolio will be governed over time - regardless of market conditions. During periods of market turbulence, the IPS helps the IC to refocus on the core investment principles and make reasoned decisions.

ICs are the most critical success factor and must adopt a disciplined investment process

Portfolio oversight is a demanding job, involving complex blends of asset classes and investment options that are subject to unpredictable and dynamic forces affecting global capital markets. Mindful that most ICs consist of part-time volunteers busy in other pursuits who may only meet 3-6 times per year, the importance of disciplined and accountable governance to protect endowment capital becomes clear. Below we share oversight techniques of market-seasoned ICs:

- Retain a strong IC Chair to oversee the investment process, ensure decisions are made and implemented, and interface with the Board
- Know their limitations and do not overreach their capabilities
- Obtain competent outside third-party advisors or internal Staff as needed to inform and support IC actions
- Report periodically to the Board on material changes to the IPS, allocation targets and ranges, portfolio performance and liquidity
- Periodically, pause to ensure IC approach remains aligned to current nonprofit needs and considerations

Smart ICs develop a written IPS to define portfolio goals, articulate portfolio strategy, and set risk management parameters. The IPS:

- Sets clear goals, asset allocation percentages, and risk tolerances
- Provides for risk management and periodic rebalancing
- Defines procedures to monitor and adjust investments (i.e., evaluate managers; track performance; change asset allocation)

Characteristics of an Effective IC

To contend with dynamic markets and complex portfolios, Boards identify competent IC members and support them with resources to oversee the portfolio, but otherwise entrust the IC to function independently under the IPS and institutional by-laws. Effective ICs are the primary driver of successful portfolios, and are the key differentiator between "best practices" and dysfunctional governance that adds unnecessary risk to nonprofit portfolios.

Membership

The majority of IC members should have significant investment experience: a nonprofit's endowment is simply too precious to entrust to well-intentioned but neophyte investors. Experienced investors learn the intricacies of portfolio management over many years, and this seasoned expertise typically contributes to better decisions. Members should exhibit intellectual curiosity about capital markets, be current on global market trends and events, and be willing to share their macro and portfolio perspectives readily. A strong commitment to the institution evidenced through active preparation for and participation in meetings is necessary. Sensitivity of committee decision-making dynamics is helpful for focused discussions given time constraints, reaching consensus on challenging issues and making decisions. The institution's well-being should always be placed ahead of personal investment biases.

Productive ICs have experienced members who commit to do the necessary work and participate actively

Five to nine members are enough to provide diverse expertise but still encourage active debate and build to a consensus. While consensus is not mandatory, the likelihood of sustaining a decision over time in volatile markets is greater if all participants have a stake in a decision. Having the Board Chair serve *ex-officio* assures direct communication to and alignment with the Board on matters of mutual interest.

Members should view IC service as a rewarding privilege, and not as a chore. As fiduciaries, members must promote IC effectiveness and efficiency. Committees fail if absenteeism derails quorums, personal agendas defer more important discussions, or members arrive at meetings unprepared, uninformed and unable to contribute. Members who cannot be constructive participants put the entire institution at risk, and should not be retained.

And, as tempting as it may be to place potential large donors on important committees such as the IC, this practice should be avoided, even if the donor has investment expertise. The IC is too critical to a nonprofit's well-being to be distracted by the politics of pay to play and such staffing may discourage the participation of qualified members.

Member Terms

Flexible "term limits" (versus tenured members) ensures healthy turnover, new ideas and perspectives. Three to four year terms – staggered to assure leadership and knowledge continuity - are sufficient. Additionally, in the case where some members may not add value, term limits are a polite way to remove underperforming members. Of course, many ICs function with no term limits and value the perspective of long time members. Either way, the litmus test is how well the IC operates: well-informed and deliberated decisions are made and implemented, and the IC performs its varied tasks diligently and within time constraints.

Code of Conduct

A Code of Conduct that clearly articulates Board expectations of each member's participation is a good management tool. Such a Code can specify behaviors that detract from IC effectiveness (i.e., chronic absenteeism, failure to prepare or participate, grandstanding, conflicts of interest) and the remedial actions - including removal from the IC. All members agree to abide by the Code as a condition of membership. For those who fail to meet its standards, a Code of Conduct affords the Chair a transparent and fair means to deal with underperforming members.

The IC Chair: A Benevolent Despot

ICs benefit from a strong, decisive leader who encourages robust debate on agenda topics and then moves IC to a consensus decision

Strong Chairs who effectively manage the IC process are hallmarks of effective committees. Whether a nonprofit has advisors or self-directs, good Chairs are decisive yet diplomatic, and keep the IC focused on completing the myriad components of fiduciary stewardship.

The best Chairs are "benevolent despots" with committee management experience who cordially but firmly guide the investment enterprise: agenda setting and prep, meeting deliberations, decision making/implementation and follow up of all open items. While they may have strong personal views on a topic, they do not impose their biases but rather encourage a healthy debate to find a workable consensus appealing to a majority of members. Good Chairs move through all agenda items deliberately, minimize distractions, and make decisions within the allotted period.

The relatively short time that volunteer ICs spend on endowment management requires discipline to manage risk and achieve fiduciary oversight. Broadly participatory democracy, in a dynamic investment context, can be dangerous.

Effective Chairs exhibit the following attributes:

- Cordial but decisive – has an executive mindset
- Knowledgeable about investments
- Effective in prioritizing issues
- Sensitive to Staff constraints
- Involves all members productively
- Keeps personal biases out of the debate
- Encourages dissenting viewpoints
- Drives a discussion to consensus and vote
- Serves on Board to facilitate communication

Effective Meetings

With a functional IC in place, holding meetings worth attending is a priority. Since governance begins to collapse in poorly structured and run meetings, we suggest below some best practices for productive meetings:

- Quarterly meetings lasting two to three hours should be sufficient to cover most key portfolio elements: investments, risk management, rebalancing, macro outlook, and new ideas. Meetings should coincide with receipt of quarter-end performance reports.

Effective meetings are planned well in advance and have clear agendas

Distribute concise, well-reasoned and actionable materials beforehand for IC review prior to the meeting

- Set meeting dates and locations (convenient for most members to assure turnout) a year ahead. As chronic absentees derail IC efforts, regular attendance should be a condition of membership.

- At the first meeting, the Chair provides a high-level summary of topics to be covered over the year, and seeks member input.

- Meetings are as good as their discussions, and thoughtful conversations come from concise and well-reasoned explanatory materials on agenda topics. Distribute materials a week in advance with an agenda listing the topics, and an executive summary defining the core items and action recommendations. Materials should provide enough information on the topic to enable a thorough discussion.

- Begin meetings with an affirmation by all members that they are not-conflicted on any business before the IC. The Chair can briefly summarize agenda topics and decisions to be made. The IC should plan to review straightforward topics: asset allocation, investment performance, rebalancing needs, capital markets outlook and manager updates before delving into more complex subjects: tactical opportunities, macro outlook impact on portfolio, meeting managers and educational updates.

- Off-agenda items should be discussed after agenda items are completed. Reserve time to summarize actions and determine responsibility for decision follow-up and implementation.

Many ICs get bogged down discussing recent investment performance – particularly underperformance – and steal time allocated to other agenda items and IC business. Assuming the IC has a long-term investment horizon, fretting about short-term performance that may be more a market cycle issue than a serious manager or investment issue wastes precious time.

Portfolios, investments and managers are all subject to cyclical forces and the wise IC takes these ebbs and flows in stride. It is right to question unexplained performance volatility, positive or negative, but assuming reasonable explanations, ICs should move on to other topics.

- Investment performance reports show progress towards financial and investment goals, and should include performance by asset class, manager, and total portfolio with appropriate portfolio and manager benchmarks. The focus should be on longer-term returns over multiple years and since inception.

- Devote one meeting per year to a high level review of: (a) asset allocation, portfolio risk, outlier managers, concentration, conflicts, valuations and liquidity; (b) changes at the nonprofit affecting its investment approach and (c) IC member views on how the macro economic outlook impacts the portfolio and if adjustments are due.

Don't forget the details: an annual "check-up meeting", clear Minutes, awareness of potential conflicts of interest

- Prepare detailed Minutes to document meeting actions and the rationale behind IC decisions. Minutes serve as a narrative of IC deliberations, and can serve as an acceptable audit trail to meet the fiduciary due process expectations of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). At a future date, they provide context and a window into why and on what basis the IC took a particular action. IC members should review draft Minutes, make edits and approve a final version at the next meeting.

- Once voted, execute investment-related decisions promptly. Minutes should mention follow up steps, time line, and who is responsible. Inaction on voted actions absent reasonable cause undermines IC authority and risk management.

- IC members must avoid any perceived or real conflicts of interest where they or a related person has a business or other dealing with the institution. Fiduciary principles demand that a nonprofit's interests are always paramount. In the wake of the Madoff scandal, some states have tightened oversight requirements of Boards (e.g., The 2013 New York Nonprofit Revitalization Act) with particular focus on stringent conflict of interest disclosures and protocols.

Staff

Nonprofit Staff often provide administrative and logistical support to the Board and IC on meeting prep and organization, asset allocation, manager and performance tracking and follow-up to meeting actions.

Boards need to be sensitive to Staff capabilities to serve the IC effectively. Particularly with smaller nonprofits, Staff may perform multiple other functions in support of mission. Layering on more duties in support of the endowment can severely impede Staff ability to do all their jobs well.

A 2013 Commonfund/NACUBO study reported that nonprofits with under $500 million in assets employed about 1.7 full-time equivalents to administer endowment - a small number indeed considering a portfolio's complexity and importance. Boards and ICs should be sensitive to Staff capacity and realize that overworked Staffs are an implicit endowment risk factor.

Investment Advisors

We have yet to meet a nonprofit whose mission statement read:

"We shall excel in investment management!"

Many resources can help nonprofits get the most from their portfolios

For many nonprofits, investment advisors are a valued participant in good governance. Overtasked Boards, IC members and Staff may lack the time and resources to access critical information and analysis to make good investment decisions. Advisors help to level the informational playing field, and liberate ICs and Boards to focus at a higher level on how investment strategy may impact the institution. Additionally, advisors who work with other nonprofits can share the best practices they observe, provide support for agenda setting and meetings and offer insights on trends affecting nonprofit investments.

The good news for nonprofits is the proliferation of advisory services to help them oversee their portfolios in a way that meshes with their operational culture. Smart Boards and ICs recognize that endowment oversight is an incredibly complex enterprise, and to obtain support in areas outside their capabilities is a prudent step that mitigates portfolio risk.

Savvy Endowment Governance

As we mentioned at the outset, we believe the "Endowment Model" portfolio remains a valid investment construct, and all things considered, we know of no better mouse trap.

What we have recognized in hundreds of meetings with nonprofits is an increased awareness that Board and IC good intentions do not always translate into good governance and importantly, good risk-adjusted returns.

Entrusting to part time volunteers the oversight of complex portfolios in dynamic global capital markets is very risky – even with the adoption of good governance principles. Boards need to assess what oversight model works best for them.

There are three basic investment oversight models that nonprofits adopt:

1. Self-management solely by internal Staff, investment office, or IC.

2. Self-management that is assisted by third-party advisory support.

3. Delegating management to a trusted outside advisory firm (the Outsourced Chief Investment Officer/OCIO model).

Many of the principles described in this paper can be applied to all of these oversight models, including those involving third-party advisors. Nonprofits need to take ownership of their internal governance since, regardless of outside support the ultimate fiduciary responsibility for endowment rests with the Board.

While employing the suggestions in this paper alone cannot guarantee achievement of endowment goals, their adoption greatly increase the chances of success.

Conclusion

Volunteer Boards and ICs must be honest about their ability to oversee - with distinction - the financial assets that support a nonprofit's mission

Nonprofit Boards need to be honest about what they do well (mission) and what their part-time, volunteer Boards/ICs may not do so well: oversee complex portfolios in rapidly changing markets. Recognizing one's limitations is an important step towards realistic self-awareness, and in the case of investment portfolios, risk mitigation.

Periodically, Boards should rigorously assess that their investment oversight capabilities, governance practices and support systems meet not only statutory standards such as UPMIFA, but also the high standards likely implicit in their institutions mission statement (which rarely addresses investment acumen!).

At the conclusion of such an analysis, leadership can best determine what governance model is best for them to protect and grow endowed resources – and more importantly – assure continuation of the institution's mission.

Please contact us to obtain a copy of our white paper entitled "*Which Investment Management Model is Right for Your Endowment, Foundation, or Family"* dated June 19, 2013 for a review of advisory alternatives.

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