Investment Management for Non-Profit Organizations

Bradley, Foster & Sargent has worked with non-profit organizations for many years managing their endowments and helping them achieve their mission, long term goals and objectives. This white paper is intended to help Boards and Investment Committees of non-profit organizations identify some of their critical responsibilities and share what many consider to be best practices of successful organizations. It is not intended as a template for every organization, but rather, as a starting point to help organizations develop policies and procedures that are appropriate for them.

Most non-profit organizations have a Board of Directors that is responsible for establishing broad strategy, overseeing the implementation of that strategy, and working to achieve the mission of the organization. Overseeing the assets of the organization's endowment is among the most important responsibilities of the Board. Many organizations, though not all, delegate the responsibility for managing the endowment to an Investment Committee which reports to the Board.

Whether the Board directly oversees management of the endowment or delegates that responsibility to an Investment Committee, the duties are the same. These duties include deciding how the endowment's assets should be invested and who should invest them, establishing an investment policy and a spending policy which balances current spending opportunities with available discretionary funds, monitoring investment results and evaluating the performance of investment managers, and generally assuring that the endowment's assets have been appropriately invested to achieve the long term goals and objectives of the organization.

This paper will deal with the following topics:

- Investment Committees,
- Investment Policy Statements,
- Spending Policies, and
- Selecting an Investment Manager.

Investment Committees

Most non-profit Boards establish committees to deal with certain aspects of the Board's overall responsibilities – an Investment Committee is a common example. This practice allows for some specialization and reduces the time and effort required of Board members. Some smaller organizations perform these functions at the Board, rather than at the committee, level.

In both cases, the Board or Investment Committee Members responsible for overseeing the investment of the organization's endowment assets must understand and execute their fiduciary duties to the organization. They have duties of care and loyalty they must fulfill. The duty of care requires each of the Members to put in sufficient effort to carry out their responsibilities effectively. Members are not required to be investment experts and may delegate responsibility to investment experts but they must be diligent, informed, and objective when doing so. The duty of loyalty requires each Member to put the interests of the organization first and to avoid real, as well as potential, conflicts of interest.

In addition, Members should:

- Meet periodically as a Board or Investment Committee.
- Review periodically the portfolio to insure compliance with the organization's investment policy statement and guidelines.
- Review periodically the organization's investment policy statement to assure it continues to be consistent with the organization's current needs and long term goals and objectives.
- Establish a process for selecting an investment manager.
- Meet at least annually with the investment manager.
- Evaluate the investment manager's overall performance, including measuring investment performance using benchmarks contained in the organization's investment policy statement.

If the Board has delegated, or intends to delegate, its responsibility for overseeing the investment of the organization's endowment assets to an Investment Committee of the Board, the composition of the Investment Committee should be given careful consideration. Some Investment Committees include members who are considered investment experts. Some Investment Committees include individuals who are not members of the organization's Board of Directors. Most studies on group decision making support the notion that committees with members with broad backgrounds and experience make better decisions. As such, Investment Committees should strive for member diversity in knowledge, skills, abilities, personality, attitudes, and demographics.

There is no ideal size for Investment Committees, but groups between five and ten can reap the benefits of diverse membership without suffering the loss of coordination and decrease in motivation often associated with larger groups.

Investment Policy Statements

Establishing an Investment Policy Statement is among the most important steps toward successful investing. A well-crafted Investment Policy Statement represents the union of an organization's objectives and realistic expectations of the capital markets (i.e., return assumptions).

Ideally, an Investment Policy Statement will set forth all of the parameters of the investment management mandate and provide:

- A framework for evaluating performance,
- Continuity in decision-making (organization-based, not member-based, as members change over time), and
- Protection against arbitrary decision-making.

A typical Investment Policy Statement contains the following sections:

- Statement of objectives – the organization's long term goals, objectives, time horizon and risk tolerance, as well as the organization's Spending Policy.
- Asset class guidelines – a list of the asset classes in which the assets of the organization's endowment may be invested and relevant performance benchmarks and guidelines for rebalancing asset class allocations. Also, included are prohibited transactions such as short sales and the purchase of securities conflicting with the organization's mission.
- Duties and responsibilities – a list of responsibilities and activities assigned to the Investment Committee, if applicable; the investment manager; and the custodian.
- Investment manager selection – the criteria to be used for selecting an investment manager, such as minimum assets under management, risk-adjusted performance, investment process, investment style and fees, and the stability of the organization.
- Monitoring and reporting – a description of the frequency of performance reviews and how they are to be conducted.

Investment Policy Statements are intended to be robust and reflect the long term goals and objectives of an organization. Nevertheless, organization's needs do change over time; therefore, the organization should have a process in place to review periodically and modify, if necessary, the Investment Policy Statement to reflect the organization's current circumstances.

Spending Policies

Non-profit organizations establish endowments to support their mission. Spending Policies are essential to govern how endowment assets are spent and to ensure that capital is preserved and sustained for long term use. Maintaining a balance between current spending and asset growth is a critical responsibility of non-profit organizations. If too much is spent, assets may be depleted. If too little is spent, the organization may fall short in fulfilling its commitment to the people and/or causes it supports.

A typical Spending Policy provides the following:

- A definition of how assets are to be used in pursuit of the organization's mission,
- A disciplined and reasoned approach to determining the appropriate level of spending, and
- A predictable and consistent process (organization-based, not member-based, as members change over time).

Typically, Spending Policies are developed in conjunction with Investment Policy Statements. Some organizations start by developing an Investment Policy Statement while others begin by developing a Spending Policy and then formulating an asset allocation strategy designed to accommodate the requirements of the Spending Policy. The approach taken is not important – either approach will work. What is important is that the organization develops the two policies in concert, using compatible assumptions, recognizing that the Investment Policy Statement and the Spending Policy are interrelated and need to work together.

Over the years, two basic approaches to spending have emerged:

- **Total return.** Spending rates are often stated as a percentage of assets. To smooth out the effects of short term variations in market values, some organizations base their calculations on a moving average rather than just the last year end's market value. For example, an organization might set its spending rate as a percentage of the average value of the endowment portfolio over the last five years. It has been demonstrated that lower spending rates result in higher absolute dollar levels of payout after about 20 years due to the greater capital accumulation that occurs in the early years.
- **Income earned.** This approach limits spending to dividend and interest payments. This approach assures organizations that they will never spend all of their assets but the approach does not balance current and future needs effectively.

Selecting an Investment Manager

Your investment manager plays a critical role in your organization's success. If investment returns are "good," the organization has more funds to spend; if investment returns are not as "good," the organization has fewer funds to spend making it more difficult to achieve its mission.

Hiring an investment manager can be complicated and time consuming. A disciplined approach to this process is critical. First, organizations must decide how they want to work with their investment manager:

- Does the organization want to have direct contact with the portfolio manager for their endowment or will they accept working with a surrogate or a client service representative?
- Does the organization want to be consulted on the rationale for overall portfolio strategy?
- Does the organization want to be able to communicate directly with their portfolio manager when questions arise?
- Does the organization have any unique needs or will the organization be satisfied if their endowment is managed as a model portfolio shared with other investors?

Answers to these questions are vitally important given recent changes in the investment management industry. Many firms have separated their investment management and asset gathering functions into two distinct groups. Typically, such firms assign client service representatives to work with clients and do not provide direct access to their portfolio manager. Other firms that have not separated their investment management and asset gathering functions continue to provide direct access for clients to their portfolio manager. If the nature of the relationship the organization would like to establish with its investment manager is of great importance, than the ultimate selection of an investment manager may very well be influenced by the service model of the candidates.

The organization should now be ready to address the four key components of evaluating a potential investment manager:

- The quality and reputation of the firm and the experience of the investment team (portfolio managers, research analysts, traders, etc.). Does the team have an individual or a collective approach to making recommendations? How long has the team worked together? If a single person manages the portfolio, does the firm provide adequate support for that individual? How stable is the firm from a business standpoint? Answers to these and other questions are important in determining if there might be distractions related to the operating environment which could negatively impact an individual's focus on investing.
- The philosophy that guides the firm and its investment process – straightforward and meaningful is preferable.

- The firm's investment process should reflect its philosophy and be consistent over time.
- The firm's performance.

Using the Investment Policy Statement as a reference, the organization should establish criteria for the selection of an investment manager, making sure that the criteria are multidimensional. This is intended to avoid placing too much emphasis on any one criteria, for example, historical performance, and giving that criteria undue weighting in the organization's decision-making process.

In addition, the organization should:

- Clearly articulate to prospective investment managers the role they will be expected to play and the assignments for which they are being hired.
- Evaluate performance over the long term.
- Conduct both qualitative and quantitative reviews.
- Give weight to the firm's record of compliance with regulators.
- Allow adequate time for interviews, especially if the candidates are going to be making presentations to the organization. Script key questions ahead of time, being sure to include all of the questions you have, being tough, if necessary, but fair.
- Pay close attention to all investment fees (management, performance-based, etc.).

Most organizations begin the selection process by distributing a Request for Proposal, commonly referred to as an RFP, to investment managers they know. Others publish their RFP on their website and advertise to let prospective candidates know a search is underway. The RFP should request all of the information the organization will need to evaluate candidates and to select a small group of finalists that will be invited to make a formal presentation to the organization. A sample RFP follows at the end of this document.

After meeting with the finalists, the organization should be in a position to make its decision. However, there may be instances in which the organization has a difficult time coming to a conclusion. A suggestion – *all other factors being equal*, select the candidate with whom you are most comfortable and that you sense will be most likely to help you achieve the organizations' goals. Be sure you understand their approach and how they will work with you.

(Note: Some organizations retain consultants to assist them in selecting an investment manager. Consultants do not manage investment portfolios, they offer other services, including assisting organizations with the development of Investment Policy Statements, Spending Policies, and asset allocation strategies. In addition to incurring the additional expense for a consultant's services, evaluating the performance of a consultant can be difficult. For example, who is responsible for a manager who performs poorly, the consultant who selected the manager or the manager? Committees that try to minimize expenses and want a direct relationship with the people responsible for investment decisions tend to search for managers directly rather than with a consultant.)

Sample Request for Proposal
Proposal Requirements
(Source: Charles Schwab Institutional)

Organization

1. Provide your firm's name and address and the year the firm was founded, as well as the name, title, telephone number, and e-mail address for our primary contact with regard to this Request for Proposal .
2. Provide a brief history of your firm, including its credit rating, if applicable.
3. Provide a five-year history of:
   a. Assets under management and an explanation for any significant year-to-year changes.
   b. Accounts managed
   c. Client relationships
4. If your firm is an SEC registered advisor, provide your most recent Form ADV Parts 1 and 2A. If your firm is exempt from registration, provide an explanation.
5. Describe your organization's experience in managing funds for foundations and endowments.
6. Provide a description of the investment products and services your firm offers, including for each product:
   a. Investment strategy/objectives,
   b. Assets under management
   c. Performance for one, three, five, and ten year periods
   d. Benchmark(s)
7. Have there been any judgments against the firm or any of its employees in the last five years? Is there any litigation pending against the firm or any of its employees? Are any governmental agencies or other regulatory bodies investigating the firm or any of its employees? If so, explain.
8. Does your firm carry errors and omissions insurance? If so, provide:
   a. Policy period
   b. Limit of liability
   c. Deductible amount
   d. Carrier name
   e. Carrier rating by A.M. Best
9. Has your firm purchased a fidelity crime bond? If so, provide:
   a. Policy period
   b. Limit of liability
   c. Deductible amount
   d. Carrier name
   e. Carrier rating by A.M. Best

10. What is your firm's minimum size requirement for a separate account? What is the size of the firm's largest, median, and smallest separate accounts?
11. Provide the name(s) of your employee(s) who will be responsible for managing our portfolio. If your firm is an SEC registered advisor, provide their most recent Form ADV Part 2B. If you are not an SEC registered advisor, provide a complete biography for each employee who will be responsible for managing our portfolio.
12. Identify any other investment professionals (e.g., research analysts) who will be involved with our portfolio and their area(s) of responsibility. Provide a complete biography for each of these employees.
13. If your firm plans to employ sub-advisors or other third party contractors to perform any of the services you are proposing to provide to us, describe the functions that you are proposing to out-source and your approach to supervising the performance of your sub-advisors and/or third parties. Provide an executed copy of your confidentiality agreement with each of these sub-advisors and/or other third parties.

Asset Allocation

14. Describe your capabilities and recent experiences in reviewing and/or working with your clients to prepare investment policy statements and investment guidelines.
15. Provide a sample asset allocation for the proposed portfolio.

Investment Process

16. Describe the firm's investment philosophy and strategy. Your response should include, but not be limited to, your research efforts (external vs. internal), portfolio construction guidelines, risk control techniques, and sell disciplines.
17. Describe any changes or enhancements that have been made to the investment process in the last three years.
18. Describe how your portfolio managers interact with your research analysts.
19. Describe how an investment idea is originated, vetted, and approved.
20. Describe how investments are selected for a portfolio (for example, model portfolio approach, approved firm buy list, other).
21. Describe how research is organized and any changes in the last three years.
22. Detail the policies and procedures you have established to insure compliance with your clients' investment policy statements and guidelines and to assure quality control of the portfolio management process.

Additional Information

23. With regard to your reporting of information to us:
    a. Provide a brief description of the reporting process.
    b. Provide samples of all of the reports you propose to send to us.
    c. Indicate the frequency with which you are proposing to send each report to us.
    d. Confirm that the cost for all reporting is included in your fee quote.
24. With regard to your communication with our Board of Directors and/or Investment Committee:
    a. Provide a brief description of the communication process.
    b. Indicate the frequency with which you expect to initiate communication.
    c. Confirm that the cost for such communication is included in your fee quote.
25. Provide a representative list of your clients.
26. Provide a complete list of your clients that are foundations or endowments. Identify those clients (at least three) that you will be using as references and provide contact information.
27. Provide a copy of your most recent audited (or reviewed) financial statements and any management letter issued by your third-party independent accountants, if applicable.
28. Provide any additional information you believe is relevant.

Fees

29. Provide your standard fee schedule, indicating if you have a minimum fee and if your fees are negotiable.
30. Calculate your annual fee assuming a $x million portfolio, comprised of xx% equities and xx% fixed income instruments.
31. Provide details about any other fees (for example, performance-based), in addition to those included in your answer to item 30. above, that are routinely assessed.