

Mission

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Wisdoms, conventional and sometimes otherwise

In an age of complexity, revisiting some tried and true fundamentals—
with a little updating—may help nonprofits chart a sure course.

by Laurie Hoagland, Vice President and CIO, the Hewlett Foundation, and Chair, Commonfund Board of Trustees

One is rarely, if ever, credited for espousing conventional wisdom. I'll take that chance. I've picked five "conventional wisdoms" that I think are fascinating by themselves—and merit revisiting in the wake of the past three years.

The first is diversification, and how it worked—or didn't work—in the current investment cycle. Diversification is supposed to be the biggest free lunch in investing. But, all of us have been concerned by recent instances when everything seemed to go down together. Even over one-, six- or 12-month periods, all correlations seemed to go to 1.

I would like to suggest that what's really important in thinking about diversification is time horizon. Since many nonprofits use a three-year rolling average to determine payout, perhaps this three-year time horizon is quite important for us, and we should look at the asset classes that comprise our portfolios over three-year periods. When you do this, I believe you will find there is more diversification than you expect. Look at returns from U.S., international and emerging markets equities over three years and you'll find very different outcomes. If we were smart enough to guess which of those to overweight in each three-year period, we would do extremely well because there is a lot of variation among them. Obviously, nonprofits need to figure out some way to deal

with those short periods when market returns converge. But, if we can get through them, my contention is that diversification continues to be very helpful.

The second "wisdom" addresses one of what we nonprofits believe to be our birthright: The presumption that going forward we will earn 5 percent real returns from a diversified portfolio. Over the course of the 20th century, there were 15- and 20-year periods when real returns were much better than 5 percent and similar periods when returns were much worse. But, over time, nonprofits could generally presume a 5 percent real return.

Let's hypothesize and say we have an urn full of balls, each representing a century's returns. What's the next return we're going to pull out? When we pulled out the 20th century in the U.S., was that a mid-range number out of all the balls in our urn? Or was that a top decile number? Part of the problem is that there haven't been many centuries for us to look at.

Let me illustrate how powerful 5 percent real returns are with a couple of little mind benders. Assume that in the year zero you have one of today's dollar's worth of gold, which at that point would be smaller than a pinhead. From that date on, that speck of gold expands in volume (not diameter) by 5 percent each year. After about 2,000 years, the radius of that tiny sphere would exceed 93 million miles—more than the distance from the earth to the sun!



NEW YORK STOCK EXCHANGE

Another example: Assume you were a tax-exempt institution that had a dollar in the year 1340 and you compounded it at a 5 percent real return. What would it be worth today? The reason I picked the year 1340 is that the answer is \$157 trillion, which is roughly the value of all investment assets in the world today. Five percent may not be as easy as it looks.

The third wisdom asks if, given the experience of the last couple of years, we should put on a permanent hedge against left tail risk. Is that a good idea or a bad one? If it's a good idea, are there ways to do it?

The most obvious way to hedge tail risk is to buy out-of-the-money S&P 500 puts. Now, we know that if you did that continuously over the last 50 or 60 years, you would have had some handsome payoffs along the way. But, overall, you'd have been a loser. Those puts are just too expensive. Whenever I've looked at them, I've concluded that they are so costly you can only justify buying them if you have a strong view that over a reasonably short period of time the market will fall sharply.

We spend a lot of time at the Foundation trying to find ways to protect the portfolio that don't carry as hefty a price tag as out-of-the-money puts. We haven't found any. We could put on a collar and buy options at both ends, but that's expensive, too. So, while I think we should keep searching, by and large, it's a loser's game to try to hedge the left tail of your portfolio.



“Protecting against inflation and deflation: Can you have it both ways?”
—Laurie Hoagland

The fourth wisdom concerns hedging our portfolios against inflation and deflation. Basically, I have two thoughts about this. I have heard some people say, “I’ve got a deflation hedge in my portfolio.” It’s usually long-dated Treasuries. Some say, “I’ve also got some inflation

hedges in my portfolio.” It’s usually real estate, natural resources, TIPS and so forth. Some of those people go on to say, “My deflation hedge will protect me if we have deflation and my inflation hedge will protect me if we have inflation.” The point I would like to make is—and it may be kind of obvious—if your inflation assets are doing well because there’s a lot of inflation, what’s happening to those deflation assets? Can you really have it both ways?

My second thought asks what it is that endowed institutions need to hedge against. If you look at our liability—that is, supporting an institution’s mission in perpetuity—in an inflationary environment, payout needs to rise over time. Hence, we need inflation hedges to help protect us. The footnote is that if you are heavy on inflation hedges and there is zero inflation or deflation, your portfolio returns are going to be pretty unexciting. So, even though it’s the right thing to do for your institution, some career risk may be involved.

Fifth and finally, there is the matter of private investments. How should we think about private investments given what’s happened recently, particularly the liquidity crunch that hit so many non-profits? What I would say about private investments now is exactly what I said shortly after I got into the endowment world in the early 1990s, and that is don’t go into private investments unless you have at least a 20-year time horizon. I say this for two reasons: **1** The balance sheet of your institution should be strong enough for you to fund the program in the early years because they are mostly cash outflow years; and **2** You should have confidence that your governance structure will remain supportive of the effort through at least 20 years. If you decide to bail out after five or 10 years, you will likely find that to have been a pretty bad decision.

One other observation: If you’re going to invest in private capital, you need sufficient chutzpah to believe you can access top quartile managers—because that’s where the excess return over the S&P is to be found. Incidentally, about liquidity premiums, I believe they are above average at this time.

Part of the disappointment with private returns in recent years traces to the point that if just one of us had tried to invest like Yale, we might have gotten away with it. But when we all tried to do it, we overwhelmed the asset classes.

As I said at the outset, conventional wisdom usually won’t take one too far. But in an age when investing has become so complex, it’s worth remembering and rethinking some of the fundamentals that got us where we are. They may just help get us where we’d like to be in the future. |

Remembering and rethinking some of the fundamentals that got us where we are may just help get us where we’d like to be in the future.



ENDOWMENT SPENDING

The other volatility

Institutions construct portfolios to dampen volatility of returns.

Now, some are looking to level the spending side of the equation.

*by William Jarvis,
Managing Director, Commonfund Institute*

A large and growing body of work exists on the subject of endowment investing, but the equally important topic of endowment spending is treated less often. Yet, the two major market declines of the last decade have exposed significant weaknesses in prevailing endowment spending policies and practices, as spending methodologies have failed to protect endowed institutions against excessive volatility in the financial support they expect from their endowments.

Most nonprofits' spending policies are based on a methodology first developed in the 1970s, which had as its goal the dampening of volatility in spending. Under this method, spending is determined by applying the endowment's policy spending rate to a moving

average of the beginning-period market values of the endowment over a defined past period, most often three years or 12 quarters, but sometimes up to five years/20 quarters.

In practice, the interaction of the spending rule with market values and the laws of compounding can lead to some unanticipated results. For example, when market values are rising faster than the institution's policy spending rate, the unspent amounts are added to the endowment's value each year and become part of the base for the calculation of its market value in the following year. This compounding process results in an accelerating curve of upward spending during boom times, as the spending rate is applied to higher and higher endowment

Many institutions have made special appropriations from the endowment to cushion the blow from spending cuts demanded by the moving average rule.

values each year. This pattern can foster a false sense of security and a misplaced belief that these higher spending levels are sustainable when, in fact, they are simply the result of the interaction of the formula with temporarily higher market values.¹

Conversely, when markets decline, the resulting shrinkage in endowment values leads the formula to demand cuts in spending. In moderately fluctuating markets, these changes are minor and are dampened by the three- or five-year averaging formula. When, however, markets decline sharply or for a prolonged time, as has happened on several occasions in recent decades, the formula quickly begins dictating cuts in dollar spending that can be very painful for an institution to implement, particularly over multi-year periods.

Cushioning in down markets

Data from the NACUBO-Commonfund Study of Endowments[®] (NCSE) and the Commonfund Benchmarks Study[®] of Educational Endowments show that use of the moving average rule by institutions fluctuates as markets move up and down—and that, for many, special appropriations from the endowment are used to cushion the blow from spending cuts demanded by the rule. Thus, the moving average rule, while serving as a nice tailwind during upwardly-rising markets, becomes a challenging headwind during market declines. This forces endowed institutions to seek resolution by cutting budgets and/or drawing special appropriations from the endowment corpus.

A small group of institutions has chosen to control volatility in spending by separating their spending formula from the market value of the endowment. These institutions calculate their spending by taking last year's dollar amount and inflating it by either the Consumer Price Index (CPI) or the Higher Education Price Index (HEPI),² within upper and lower bands (for example, a low of 3 percent and a high of 6 percent of endowment value). Use of this rule tripled between FY2004 and FY2006, and has since remained stable at 3 percent of institutions.

Separation of spending from the market value of the endowment has three results that illustrate the strong contrast between the banded inflation method and the moving average method. First, institutions using banded inflation will spend less during rising markets than those using the moving average method. This is because, over time, equity market returns exceed inflation. This reduced spending during good times enables the institution to retain prudent amounts in the endowment that can be used for operating budget support during times when markets are declining.

Second, the banded inflation method allows the institution to spend more during down markets than the moving average method. This is because, by severing the spending formula from the endowment's market value, the banded inflation rule frees the institution from crippling budget cuts during periods of declining asset values. Yet, because the amounts being spent come from the accumulated "savings" that were set aside during rising markets, the overall amount spent over time is not higher than that required by the moving average method and may, in fact, be lower because

of the compounding effect that pulls endowment values—and spending—up with the moving average method.³

Third, and importantly, the banded inflation method is the least volatile and most predictable of methods. Institutional budgets are supported through bad times and good in real, after-inflation terms, enabling institutional leaders to plan over the long term. The lower band supports spending at a basic level in the event of a deflationary period; if inflation increases, the upper band provides a cap on spending.

Other methodologies

Still another group of institutions takes a middle road between the moving average and banded inflation methods. These institutions, which tend to be more endowment-dependent, use a weighted average methodology in which the predominant weighting (for example, 80 percent) is given to the banded inflation method, with the remainder (for example, 20 percent) being calculated according to the moving average method. This technique results in reduced volatility of spending due to the lower reliance on market value-based calculations, while honoring the fact that market values do have an influence on the ability to spend. Use of this rule has risen from 3 percent in FY2004 to 6 percent in FY2009, but it is more prevalent among the largest institutions. Among those with assets above \$501 million, 12 to 15 percent of institutions use such a hybrid method.

In strongly rising markets, spending under a hybrid method will not increase as fast as with a moving average rule. Conversely, in falling markets, a hybrid rule will not mandate cuts as deep as the moving average method. In addition, the total amount spent over time under a hybrid method will tend to be less due to the reduced spending that occurs in rising markets. As a result, the likelihood of maintaining purchasing power over time is somewhat higher with a hybrid rule.

The legal structure for endowed institutions has been changing as well. The Uniform Prudent Management of Institutional Funds Act (UPMIFA) supports the concept of the maintenance of purchasing power over time as a key test of honoring the intent of donors in creating endowed funds. This is contrary to those commentators who have argued that endowments should spend more, even at the risk of losing purchasing power. In addressing this concept, the UPMIFA drafters stated clearly that endowed funds should generally be interpreted to be of permanent duration and that investment and spending practices should be structured in such a way as to preserve their purchasing power.

Current expectations are that, despite the recent market recovery, it will take many years for endowments to regain the nominal value lost in FY2008–FY2009. One significant measure is the percentage of endowment underwater in dollar terms, which, according to the NCSE, nearly quintupled from 4.6 percent in FY2008 to 22.4 percent in FY2009.

Lower endowment values have led institutions to reconsider their spending plans. In a leap from last year, 24 percent of institutions reported that they had deviated from their spending plan—more than double the previous year’s 11 percent. Strong jumps were observed across all size groups, particularly the endowments with assets over \$1 billion, where the rate went from 2 percent last year to 23 percent this year. Perhaps as a corollary, 18 percent of institutions made special appropriations.

The primacy of mission support

Looking ahead, anecdotal evidence indicates that more institutions are considering moving away from the moving average spending formula toward inflation-based and hybrid methods. For institutions where intergenerational equity remains a priority, policy spending rates will have to be restrained, which may force some difficult choices with respect to spending for mission support. Where, on


the other hand, mission support is a priority, spending levels will remain robust but at the risk of eroding the future purchasing power of the endowment. |

1 For a more complete analysis of this issue, see the white paper “Why Do We Feel So Poor? How the Overspending of the ‘90s Has Created a Crisis in Higher Education” by Verne Sedlacek and Sarah Clark (Commonfund Institute, 2003), pp. 5–6, at www.commonfund.org.

2 HEPI is calculated annually by Commonfund Institute, with forecasts from January through June each year and the final number in July. For more information about HEPI, see www.commonfund.org.

3 Sedlacek and Clark, *op. cit.* at 6.





The economics of nonprofits: seeing the big picture

Stepping back to look at the broader picture shows that the revenue sources of nonprofits are correlated and, therefore, volatility of revenues is the most challenging risk factor the sector faces.

by Verne Sedlacek, President and CEO, Commonfund



The “new normal” is a term that seems to have found a permanent place in our nation’s vocabulary. It’s a term that can be applied to the economics of nonprofit organizations, as well, especially in the context of what the nonprofit sector has lived through over the last two years and what its prospects appear to be over the next few. These new realities actually existed for a very long time, but they were obscured by a set of historically robust factors that had been in place for the 25-year period ending in 2007. I have evaluated this new economic scenario, both researching the past and contemplating implications for the future. My work has led me to several observations:

- The first is that economic trends in nonprofits are very long term. I know everyone has heard the “long-term” mantra over and over. But, the fact is when we look at “steering currents” that truly shape the nonprofit environment, they extend over decades.

TAKEAWAY Nonprofits need to stay the course over the long term, even through several generations of trustees and senior managers (a challenge unto itself). Managing through these long cycles requires a different approach and skill set when times are good than are required in challenging periods.

- Second, not all nonprofits share the same revenue model. Endowment-dependent foundations were heavily impacted by market losses. Other institutions have more diversified sources of revenue. But, when you study even varied sources of revenue, they are actually rather highly correlated.

TAKEAWAY The challenge for trustees and senior managers is how to lower the correlations of those revenue streams and to focus on enterprise risk management.

- Third, while revenues are very highly correlated, expenses seem to be on their own divergent paths. Expenses are correlated to revenues over long periods of time, but they aren’t subject to the same kind of modifying effects as the revenue side.

TAKEAWAY Managing expenses through all periods of time is very important. Building flexibility into the expense base to match potential volatility of revenue will be critical going forward.

- Fourth, over the long run, nonprofit investors have to take risk. I’ve been trying to figure out a way not to take risk and generate the type of returns that nonprofits need—but I can’t find a way to do it. In fact, the biggest risk is no risk.

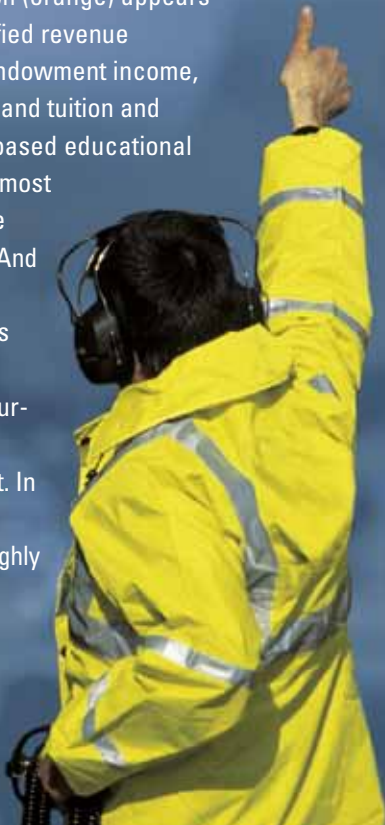
TAKEAWAY Taking investment risk is the only way nonprofits are going to fulfill their future obligations, but taking investment risk does not guarantee success, it only guarantees volatility.

- Fifth and finally, development and fund-raising are critical. Like not taking risk, nonprofits cannot afford not to engage in a persistent and ongoing fund-raising effort. It will be the key differentiator between success and muddling along.

TAKEAWAY Take the same organized, focused approach to fund-raising that you take in the investment arena.

DIFFERENT NONPROFITS BUT CORRELATED REVENUE STREAMS

A closer look at two educational institutions and a foundation allows us to understand the ramifications of the new economics of nonprofits. All three are hypothetical: a donor-dependent educational institution, a tuition- or enrollment-dependent educational institution and a donor-dependent foundation. The figure below shows the sources of revenue for these three institutions. The donor-dependent educational institution (orange) appears to have fairly diversified revenue streams, including endowment income, sponsored research, and tuition and fees. For the tuition-based educational institution (green), almost all the revenues come from tuition and fees. And for the foundation (blue), revenue comes entirely from the endowment. On the surface, these three appear quite different. In fact, from a revenue standpoint, they are highly correlated and have similar challenges.



Looking broadly at the financial resources of educational institutions, we find that there are two components: capital—in the form of endowment and facilities—and flows to and from operations—in the form of revenues and expenses. While some may think of these two components as being relatively independent of each other, they are, in fact, very much interrelated. The point to remember—a fresh and painful recollection for many—is that over the past two years almost every one of these relationships suffered negative impacts. On the capital side: Annual giving, capital campaigns, endowment performance, debt and facilities were all disrupted. On the operations side: Enrollment, tuition, endowment income, state support and interest expense were all challenged. Ultimately, they all feed into and affect the institution's investments, debt, PP&E (property, plant and equipment) and net assets. So, this is a model in which there are very strong interconnections between revenue and capital and expenses and capital, and policy-makers should view all these variables and factor them into their decisions.

As we look back, we can discern these very long-term trends. The 1930s and '40s were challenging decades for nonprofits. During the '50s and '60s, institutional revenues were robust. The 1970–82 period was very difficult, but once again fortunes reversed and the period from 1982 to 2007 was another golden era for nonprofits. As we look forward, the question is whether we have entered another prolonged period of challenge.

Let's look more closely at some of the component parts of the nonprofit economic model.

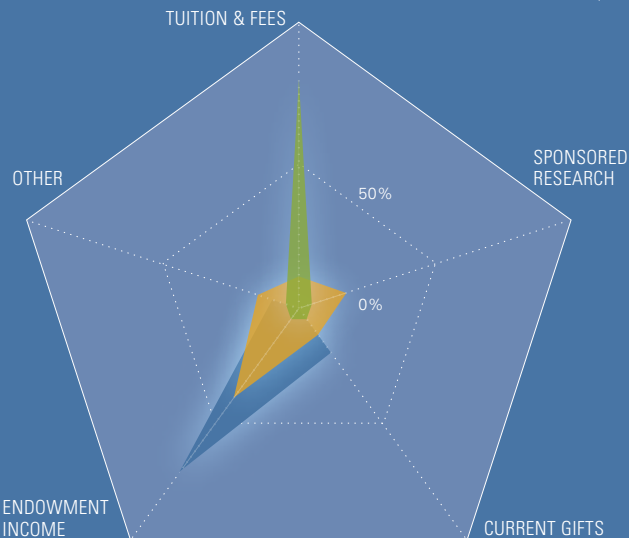
Enrollment

Enrollment growth has been slowing over time and will continue to do so. From 1966 to 1975, the average annual growth in enrollment was 11.4 percent, or a total growth of 75 percent over the period. From 1975 to 1983, however, growth fell to an average annual rate of just 1.4 percent, or 11 percent for the period. It grew only slightly to an average of 1.6 percent annually, or 53 percent overall, between 1983 and 2010. Looking ahead, between 2010 and 2018, it's anticipated that growth will be just 0.9 percent annually, or 7.8 percent for the period. So, we see a decades-long challenge that administrators and trustees should be aware of and address.

The other dynamic for higher education is the new player in the market—the for-profit institution. The largest university in the country now is the University of Phoenix. Data from 1990 to 2007 show almost 10 percent of total enrollment can be accounted for by for-profit institutions, and that's going to continue as an added pressure for traditional higher education.

SOURCES OF REVENUE

- DONOR DEPENDENT (EDUCATION)
- DONOR DEPENDENT (FOUNDATION)
- ENROLLMENT DEPENDENT (EDUCATION)



As we look ahead, this lessening demand, along with more competition—compounded by the difficult economic environment, a weak housing market, less use of leverage and lower stock prices—in all likelihood will not allow institutions to raise tuition at the high rates we have experienced over the last 25 years.

Returns

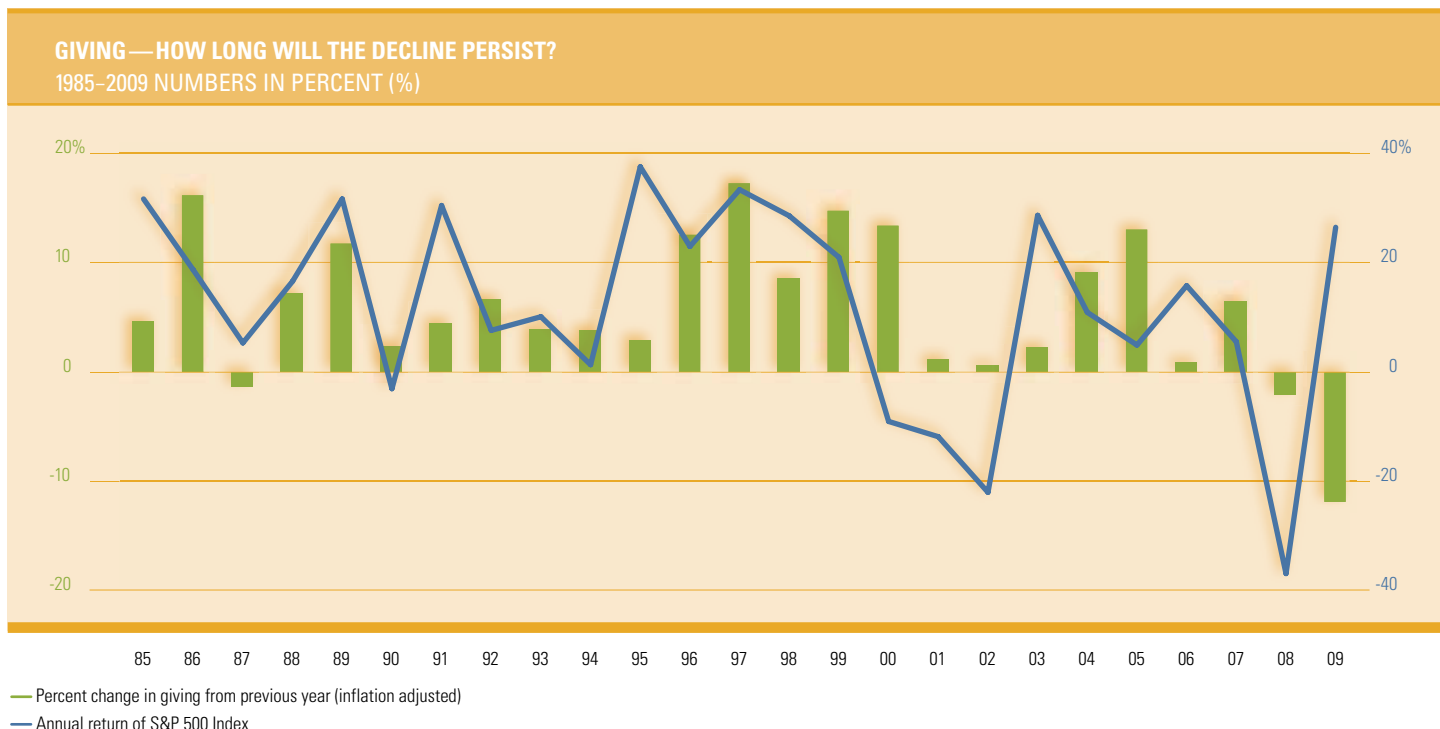
We all know how difficult the trailing 10-year period has been. While data from the 2009 NACUBO-Commonfund Study of Endowments® have actually been negative for the trailing three years, they are a lot better than the S&P 500 Index. Lesson: Diversification pays! If you look at the five-year numbers, they make an even more compelling case for diversification. But nonprofits' long-term goal—spending at an annual rate of 4.5 to 5 percent and covering inflation and costs—is not being achieved. Another long-term concern is the difference between returns earned by the largest institutions and the smallest institutions; endowments with assets over \$1 billion reported a 6.1 percent net average annual return for 10 years ending June 30, 2009, while those with assets below \$25 million reported a net average annual return of 3.9 percent for the same period (even less, 3.4 percent, for institutions with endowment assets between \$25 million and \$50 million). We know that larger institutions have considerably larger allocations to illiquid investments, so their greater diversification and taking illiquidity risk actually worked.

Fund-raising

According to Giving USA, charitable giving totaled \$307.7 billion in 2008, a 2 percent decline in real dollars compared with 2007. It was the first decline in giving in current dollars since 1987, according to the foundation, and the second since Giving USA began publishing reports in 1956.

Giving correlates highly with market performance, as shown in the chart below which traces annual giving and the returns of the S&P 500 Index between 1985 and 2009. Interestingly, giving has been down only three years over the 25-year period, but two of those three are very recent. As the chart shows, giving has a fairly high correlation with the S&P 500. If we look at reductions in giving in economic recessions, once again we find a high correlation. In the past four recessions, giving to higher education consistently declined.

How quickly we can get back to historical levels of giving bears watching. A rebound will be especially important for some educational institutions. Using data from the Council of Higher Education, the bottom quartile of colleges in terms of funds raised saw a decline in giving of more than 32 percent versus a little more than a 9 percent drop for the top quartile. Neither is good, but for the third and fourth quartiles it could have permanent implications. Yet, it is hard to see how giving will rebound rapidly, as the largest sources of giving to higher education are all stressed: alumni, foundations, corporations and non-alumni individuals.



Sources: Giving USA Foundation, 2009 estimates Voluntary Support of Education Survey, Council for Aid to Education, Bloomberg

Tuition

Tuition seems to be the one thing that continues to have pricing power. In fact, with states so strapped for cash, it is public institution tuitions that have risen the fastest over the past decade. We may have reached the tipping point, however. The question colleges and universities have to ask is, When we are in a difficult economic environment, can we continue to raise tuition at rates of the past few decades? In fact, the data show a reasonable correlation between S&P 500 annual returns over the past 10 years and changes in tuition—good market, higher tuitions and vice versa. The tuition discount rate is edging up—reaching 24.8 percent in 2009 from 24.2 percent five years earlier—which is hard on tuition-dependent schools. Despite net tuition being flat, expenses continue to grow at an average annual rate of about 5 percent, according to the Integrated Post-secondary Education Data System (IPEDS).

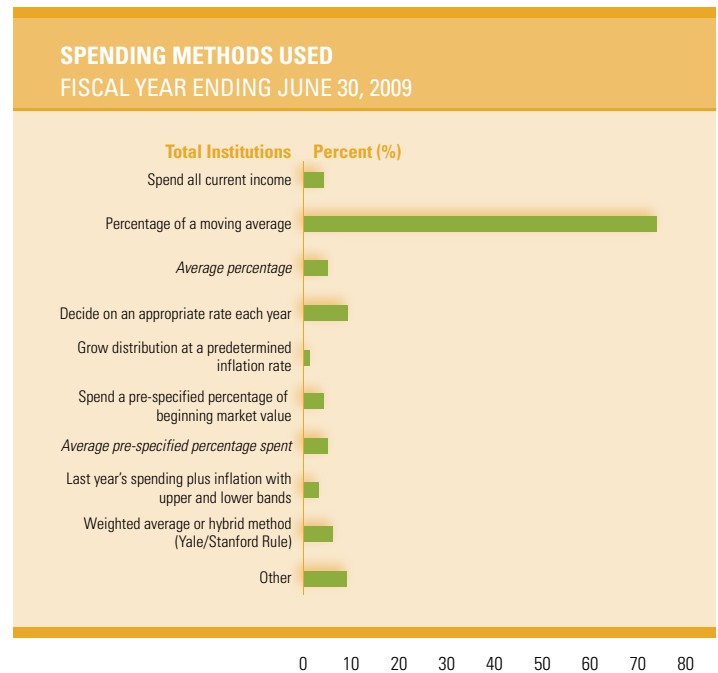
As we think about the challenges ahead, I recall a statement from the American Council on Education Studies that was issued in 1942: “We are facing a situation today where the very survival of some institutions is at stake. So many things today are subject to change we almost come to the conclusion that we must prepare for changes in everything.” How apropos today.

To get a handle on what may happen in the future, nonprofits may want to think about stress testing their revenues against expenses. I looked at expenses and revenues at two institutions: an enrollment-dependent educational institution that receives 88 percent of its revenues from tuition/fees and a more diversified, donor-dependent institution receiving 38 percent of revenues from endowment income, 19 percent from sponsored research, 18 percent each from tuition/fees and “other,” and 8 percent from current gifts. At the former, expenses have been growing at 7.1 percent annually (which, granted, is not likely for most nonprofits, although this is an actual figure from a university). Even if tuition rates grow at 6 percent for this institution and investment returns are in the 95th percentile (16.5 percent annually) there is still a revenue shortfall. Looking at the second institution (another actual example), long-term expense growth averages 7.9 percent annually. Once again, even with returns in the 95th percentile, there is a shortfall—and a drastic one if returns should fall into the 5th percentile. My premise is that we are going to be in an expense-controlled environment for a fairly long period of time.

So, as you think about stress testing your institution, look at all of these pieces. Bear in mind, revenues are highly correlated while expenses are not—indicating that there are going to be difficult decisions ahead. As we look forward, the challenge will be to build more flexibility into the expense side, so expenses can be adjusted to match with the more volatile revenue side.

Spending methods

On several occasions, I have challenged the three-year rolling average method of determining annual spending from endowment. Still, as the chart below shows, this method is by far the most widely used despite its inherent problems, which I can summarize as: **1** three years is not a very long period of time; **2** it doesn’t balance effectively between the challenges of the institution’s operations and the endowment; and **3** it tends to create volatility in spending—that is, overspending during boom times and underspending when markets decline.



Note: Multiple responses allowed.

Source: NACUBO-Commonfund Study of Endowments 2009

In the wake of the financial crisis, nonprofits are searching for ways to reduce the volatility of their portfolio, particularly on the downside. There are a few reasons to do that. One is you like to sleep at night; another is that you have to be able to exist through the short run to achieve the long run; and third is that if you have a spending method that is so sensitive to the value of the endowment, it will add volatility to your operations. In fact, the best spending method would make changes in distributions negatively correlate with the value of the endowment.

What I am suggesting is that the nonprofit community take a serious look at other spending methods—perhaps empower a sub-committee of the investment committee to study other methods and come up with a recommendation. A little-used but attractive option for spending is the utility curve methodology. It functions very well as a “volatility smoother” and has the attraction of some give-up on the upside while protecting on the downside. (Refer to the bibliography accompanying this article for additional reading on this topic.)

Endowment investment

History shows that the concept of actually being able to generate returns better than inflation and spend 5 percent is really difficult. It didn't seem that hard in 1999, but it certainly does today. From an investment perspective, one could argue in favor of less risk. In fact, the record shows that moving from equities to bonds hurts, not helps. So, first, you have to take equity risk.

Secondly, you have to take some degree of liquidity risk. If one goes back through NACUBO Endowment Studies since 1985, we find that adding illiquidity and diversification to a basic 70 percent S&P 500/30 percent Barclays portfolio produces significantly better returns. I believe that there is a fundamental advantage that comes from taking illiquidity. The key is knowing how much illiquidity you can take. Once again, using industry data, it's interesting to note that in every case for the last five years in every size cohort, the least liquid entities have had the highest rates of return. And this goes through June 2009, so it picks up this very difficult period that educational institutions have been through.

Third is active management (moving away from indexation). If we're really in an environment in which we're not going to see the kind of robust stock market returns of the past, we have to think about ways to add value. Going back to 1965 and using it as base 100, what happens if you could obtain 100 basis points of alpha per year over an index return of 70/30? You would end up at 107 versus 70 for index returns. People talk about indexation as a great panacea. It's not. One has to take active management risk in concert with equity and liquidity risk.

Conclusions

To conclude, I will return to the observations I offered at the outset. To summarize these very briefly, the pillars of the new nonprofit economic model are:

- Revenue sources are more correlated than they appear
 - Smooth spending from endowment over good times and bad
 - Build flexibility into the expense side of the equation
- Nonprofits are subject to very long-tailed trends (20 years)
 - Stress test interrelated variables: investment returns, other sources of revenue and expenses
 - Be prepared for long-term challenges
- Nonprofit investors must pursue alpha through equity risk, liquidity risk and active management risk
- Fund-raising and development are critical
 - Don't cut costs in this area |

Bibliography

Some related readings go into more detail about central points contained in this article.

- | "Less pain, more pleasure: navigating the utility curve," *Mission Matters* Winter 2010 by Verne Sedlacek. The article examines the usefulness of employing the utility curve to create a more effective spending policy.
- | "Alpha unplugged," *Mission Matters* Winter 2010 by Lyn Hutton, CIO, Commonfund. The article posits that nonprofits cannot avoid risk assets and achieve intergenerational equity.
- | "Thinking about liquidity: philosophy and practice," *Mission Matters* Spring/Summer 2009 by Verne Sedlacek. Liquidity as a policy issue should command the same thought and attention that are devoted to asset allocation.
- | "Why Do We Feel So Poor?" a Commonfund Institute white paper 2003 by Verne Sedlacek and Sarah Clark, Managing Director, Commonfund Strategic Solutions. How down markets expose weaknesses in the percentage of a rolling average of endowment value method of determining spending.



Located in Stanford's shadow, but stepping into the limelight on its own

There's an educational institution in Palo Alto, California, that's spoken of alongside the likes of Harvard, Yale and MIT, among others. No, it's not Stanford University, and technically this institution is in East Palo Alto. It's Eastside College Preparatory School, founded in 1996 with a focus on first-generation students. While Eastside may be on the other side of Highway 101 from Stanford, its graduates have crossed the divide and matriculated to that institution as well as just about every other highly selective educational institution in the country. Of the 40 graduates in the class of 2010, 100 percent are going on to four-year institutions. In fact, 2010 marks the 11th year in a row that 100 percent of the graduating class has been accepted to four-year colleges.

Eastside was founded by a Stanford graduate, Chris Bischof, who today serves as principal. The impetus grew out of the 1976 closing of East Palo Alto's only high school, which meant local students were bussed to other communities and often assigned to non-college track classes. As a result, East Palo Alto students dropped out at a rate of 65 percent. Bischof began to explore the



Eastside Prep sends its graduates—all of them—to four-year colleges.

feasibility of bringing a high school back to the community. In 1996, he and fellow Stanford graduate Helen Kim—who today serves as vice principal—welcomed eight ninth-grade students to the new school, which bounced around in temporary locations for a few years until a donor offered a 1.6-acre site and an Eastside board member volunteered to build a modular classroom building.

From those modest beginnings, Eastside has grown to an institution with a 5.25-acre campus, 32 faculty members and 255 students in grades 6 through 12. Eastside also has a boarding program for 42 students. Expansion plans call for 275 students next year, including 50 boarders, and for 300 students the year after that.

World War II Museum tells a story in the tradition of its founder

The National World War II Museum tells the story of American contributions to the Allied victory in World War II. It's a story that could have been written by the museum's founder—the late Stephen Ambrose, author of World War II histories *D-Day*, *Citizen Soldiers* and *The Victors*; historical adviser to the film *Saving Private Ryan*; and executive producer of the television series *Band of Brothers*.

The museum is located in New Orleans, where Ambrose was a longtime professor of history (at the University of New Orleans). But the museum is really situated there because that's where "Higgins boats" were manufactured. Named for Andrew Higgins, these landing craft were used in numerous amphibious invasions and won high praise from President Eisenhower for being a key to the Allied victory.

The museum opened its doors on June 6, 2000—the 56th anniversary of the Normandy invasion—and was originally called the National D-Day Museum. It was designated as "America's National World War II Museum" by an act of Congress in 2003. This June, the museum celebrates both its 10th anniversary and the 66th anniversary of the invasion. And, while it preserves an important era in America's past, the museum is looking to the future with a \$300 million expansion, quadrupling gallery space to 300,000 square feet by 2015.

Currently, visitors take a self-guided tour that goes in chronological order from the political, social and economic conditions that led up to WWII and to events such as D-Day and the strategy of island-hopping in the Pacific. A major attraction is *Beyond All Boundaries*, a 4-D cinematic journey from Pearl Harbor to VJ-Day showing in the new Solomon Victory Theater. |

The World War II Museum recounts the American experience in Europe and the Pacific.





Good governance: the overlooked investment strategy

A focus on strategy and policy-making—not managing investments—is the new model for volunteer investment committees to meet the rigors imposed on them today.

by John Griswold,
Executive Director, Commonfund Institute

The model in which volunteers manage the endowment assets of nonprofit institutions may be stretched to its limits. The complexity of today's investment strategies, an increasingly rigorous regulatory regime and the difficulty of recruiting experienced, talented individuals to volunteer their time are serious challenges to the centuries-old system of independent citizens acting on behalf of public-benefit institutions. Compounding this difficult situation, the nonprofit sector itself has grown to enormous size and—especially in the wake of a withering recession—the demands on nonprofit institutions of all types have stressed their resources and their ability to fulfill their mission.

Given the limits on the capacity of the traditional governance model to cope with today's complexity, time constraints and liabilities, are there any attractive options? Can an investment committee create alpha, i.e., that much-sought-after excess return above market averages or benchmarks? Can it even produce returns to keep pace with spending, inflation and costs? The record isn't good—not even counting portfolio losses suffered in the recent financial crisis. We believe that better governance practices alone can add value to endowment portfolios, but only if investment committees are willing to recognize the need for change in their structure, process and behavior.

Steering the institution

“Governance” comes from a Greek word that means “to steer.” While we would like to think that governing boards are steering their nonprofits toward their objective—that is, the fulfillment of their mission through time—all too often today, boards are steering to avoid shoals and currents that hold potential threats to their institution.

A world that once seemed familiar and comfortable no longer exists. A series of disruptive events and the momentum of several long-running trends have combined to change the playing field—and create urgent new priorities for those responsible for governing the investment process at nonprofit organizations. This is not an entirely new phenomenon; the fact is, the traditional governance model has been challenged for some time. While the model continues to evolve, it is not changing nearly fast enough to keep up with the world around it. Mostly, however, governance as it relates to investment management is uneven—pockets of excellence in some nonprofit organizations, but mediocrity in many others.

There are three powerful forces shaping the financial management of nonprofit institutions today:

- *Far greater need for—even dependence on—the services provided by nonprofit institutions, as the nonprofit sector is called upon to play a far greater role in our society.* Just to cite an example, according to the Giving USA Foundation, 54 percent of human services charities reported an increasing need for their services in 2008. But, by 2009, according to Giving USA, 60 percent of human services organizations were cutting expenses, including services or staff, due to funding shortages.
- *Greatly increased complexity in investment management.* Forty years ago, when endowment management practices began to break away from traditional trust law concepts, the bulk of endowment funds was invested in domestic equity and fixed income instruments. Today,

highly complex investment strategies and financial instruments have created a world moving at very high speed, littered with unintended and unknown risks, not to mention a legal and regulatory environment that is increasingly complex and difficult to navigate.

- *The shortage of human resources to manage investments at nonprofits.* This trend is not new, but has been exacerbated by the financial crisis of the past two years. On top of this is the growing difficulty of recruiting experienced and talented, but increasingly busy, people to volunteer their time.

Volunteers as leaders

A highly complex investment environment and greater demands on the nonprofit sector are two imposing challenges. But another is the challenge of recruiting and retaining outstanding leaders—both staff and trustee. There is a legacy of volunteerism in America dating back centuries. Today, some 63.4 million people, or 26.8 percent of the population, did some form of volunteer work in 2009. Laudable as this is, there is a difference between volunteering a few hours a week to help a local community service organization and a volunteer trustee making investment decisions affecting the long-term future of a nonprofit organization. These people are valuable, as demand is high and supply is limited. They have heavy commitments in all aspects of their professional and personal lives and may not be able to devote adequate time to the myriad details that go into informed investment management decisions. When it comes to nonprofit financial management, we may be approaching the capacity limits of volunteerism.

Another pressing need is developing and maintaining an integrated financial plan for the institution. Committees should work together more closely to mesh long-term investing (investment committee) with

budget, operations and liquidity needs (finance committee), audit and risk management (audit committee) and fund-raising (development committee).

The answer to limited trustee resources is a staff that is large enough to cover most, if not all, the bases. Ideally, the staff will complement investment committee policy-making and review by effectively implementing the policy, monitoring the investment program and providing reports to the committee.

The difficulty for all but a handful of the largest nonprofits is the cost of attracting, building and retaining staff. It is costly to recruit experienced chief investment officer talent—an estimated \$500,000 or more for a CIO in major markets. The CIO will need to be supported by a staff of analysts and researchers and, in today’s environment, a senior risk manager should be a mandatory position. Aside from salaries, there is a range of associated costs, including benefits, IT support, research services and travel. As expensive as it is to hire a CIO and other staff talent, it is often costlier still when they move on to a higher visibility position elsewhere in the industry.

Rethinking the model

In light of the radically changed environment for nonprofits, the traditional model should give way to one of three options: **1** a fully staffed, fully capable, internal investment management team; **2** outsourcing most of the investment management function while retaining strategy and policy-making; or **3** accepting that organizations that choose not to pursue a more viable option will need to pursue simpler portfolio construction strategies consistent with their capacity to appropriately manage the risks of more complex portfolios.

It is difficult to do anything in between, with the possible exception of heavy involvement from an investment consultant firm or a multi-product firm. Even then, investment

committees will need to maintain a very high degree of objectivity to determine whether they are being well served.

Looking at option number one—the fully staffed, fully capable, internal management team—in all likelihood, those nonprofit entities that will have them in the future already do. And they are very few and far between. Building and maintaining a staff of talented

Consultant use

Consultants are a popular alternative, but often a costly one. And the consulting industry has faced a fair share of challenges imposed on it by changes in the investment environment. For many years, consultants were nonprofits' "external staff" or "staff extension." They gave advice on asset alloca-

allowing them to charge an asset-based fee, which generated significantly higher revenues than pure fee-based consulting.

It's important to determine why one wants to use a consultant and what an institution expects the consultant to deliver. Data in the 2009 NACUBO-Commonfund Study of Endowments® show that 86 percent of Study participants using consultants used

"Governance" comes from a Greek word meaning "to steer."



investment professionals is fraught with challenges, the chief one being enormously high cost closely followed by the ability to attract and retain an experienced, skilled leader. As to option three, that is something that boards and investment committees will have to decide for themselves. Let us, therefore, more closely analyze option two and focus on three potential ways of implementing it: consultants, the outsourced investment office and multi-product firms.

tion, helped develop policies and evaluated managers. Beginning in the 1990s, as compensation in the investment management industry grew, consultants were hard-pressed to attract and retain experienced, proven talent. In addition, consultants who were long accustomed to managing traditional stocks and bonds sometimes found themselves underequipped to manage in the new world of alternative investments. At the next stage of their evolution, some consultants phased into a hybrid consultant/outsourced model in which they not only offered advice but also made investment decisions and implemented them on a discretionary basis. This had the advantage of

them for asset allocation and rebalancing, while 84 percent used them for performance attribution and measurement; 83 percent for manager selection; 74 percent for policy review; and 7 percent for review of socially responsible investing (SRI) policies and practices.

Outsourced management

Another model is that of the outsourced investment management office. In this approach, the investment committee and board assign responsibility for day-to-day

Rather than being separate, nonprofit governance and investment management are intertwined, with one affecting the other.

investment management to a qualified external provider that manages all or a portion of the institution's investment funds. For example, some institutions outsource a portion of their assets—like their alternatives allocation—to the external manager. Typically, such a move is undertaken to lower costs, generate greater efficiencies and free up resources. One way to think about this approach is to look at the answers to two questions: **1** How can trustees exercise their responsibilities in a manner consistent with those expected of a fiduciary? and **2** How can a group of individuals focus their limited resources in a way that they can fully address the range of issues spanning everything from high-level policy to manager selection?

Many institutions have concluded or, we believe, will do so in the future, that full portfolio outsourcing is a viable option given their size and limited resources. Perhaps, most importantly, by outsourcing discretion in investment decision-making, institutional clients are better able to focus on strategy, policy-making and core governance issues. It is evident that this trend has been growing among smaller institutions, but recently there have been some sizeable nonprofits opting for this approach as well.

The multi-product firm model

Another option is the multi-product firm model. In this approach, the committee puts its investment policy to work through a single adviser/fund manager relationship. The adviser may implement the asset allocation/rebalancing or may recommend subadvisers to manage various allocations within the portfolio, often in a multi-asset structure.

In this model, the investment committee is able to make a single decision—selecting the adviser that best suits its needs from several multi-product firms—instead of performing the due diligence and monitoring of many individual managers itself. Reporting is consolidated as well, and there may be complementary services, such as advice concerning fund-raising and philanthropy management, that the multi-product firm can offer.

Like other outsourced models, the multi-product firm frees up investment committee time to focus on higher level strategic and policy issues. Many committees are overwhelmed by the “fiduciary checklist” of tasks that must be performed, such as initial and ongoing due diligence on managers, monitoring and analyzing levels of portfolio risk, daily oversight of securities holdings, and performance attribution and reporting. A potential drawback of the multi-product firm model can be limiting the investor to the provider's own funds or to investment managers and funds that are on the provider's “platform.” In some cases, the use of separately managed accounts can provide flexibility and customization of portfolios. A single quarterly or annual fee includes trading, administration, custody and reporting, but can be fairly high; the investor should ask for a full description of any fees that may be paid in addition to the basic management fee.

Conclusion

The model for management of the long-term funds on which nonprofits depend to fulfill their mission is distinctly different than it was just a decade ago. The changing demands of society, a vastly different legal and regulatory environment, and an infinitely more complex investment industry have permanently

altered the traditional investment committee structure and process and, in a great many cases, left committees overmatched. Further, the sharp downturn in securities markets and the accompanying deep recession of 2007/2008 exposed fissures in many nonprofits' governance structures. Without a doubt, there are consequences for those nonprofit organizations that don't “get governance right.”

Trustees would do well to take a wholly new look at alternatives that may be much more effective in today's environment, including outsourcing much of the investment management process. In doing so, they may be able to increase their own effectiveness and better utilize institutional resources in pursuit of their mission.

Rather than being separate, nonprofit governance and investment management are intertwined, with one affecting the other. Outsourced models have the potential not only to enhance investment management but also lead to better governance. In this approach, the investment committee remains central to the investment management process, but refocuses to devote time and energy to strategic, policy-level issues and fiduciary matters. Outsourcing is especially appropriate for those institutions whose funds are managed by a volunteer committee with relatively little staff support. |

Editor's note: This article is drawn from an in-depth white paper, “New World, New Reality: Rethinking the Governance Model for Nonprofit Investment Management,” published by Commonfund Institute. The paper is accessible on Commonfund's Web site, www.commonfund.org. Printed copies are available by contacting Commonfund Institute at 203-563-5021.

Quants: recounting the story

Over the course of a few days in mid-2007, quantitative investing unraveled. But reports of its death have been greatly exaggerated.

by Bob Litterman, Retired Managing Director, Goldman Sachs Asset Management, and Trustee, Commonfund

One of the more fascinating stories to come out of the investment world in recent years is that of quantitative investing. After a decades-long evolution, this approach to investing grew enormously over the past 10 years—until the events of July and August 2007. I view that not as the end of the story, but, rather, the beginning of a new chapter. Let's take a closer look.

To start with a definition, I like to think that quantitative asset management draws on the best knowledge from the academic theory of finance—which tells us that return should be commensurate with risk—to take advantage of systematic opportunities in the marketplace. Some risks are better than others, of course. Quantitative investors, just like all investors, attempt to identify investments offering a premium that more than justifies the risk. A recent example occurred in early 2009 when the premium on credit risk seemed very high. The stock market was clearly on the mend by the end of April, but credit spreads remained quite wide. Many investors thought the nation faced a prolonged recession. Coming out of a severe crunch, credit spreads were wider than at almost any time in history, including at the height of the Great Depression. So, for investors willing to take credit risk, there was an opportunity to be well rewarded.

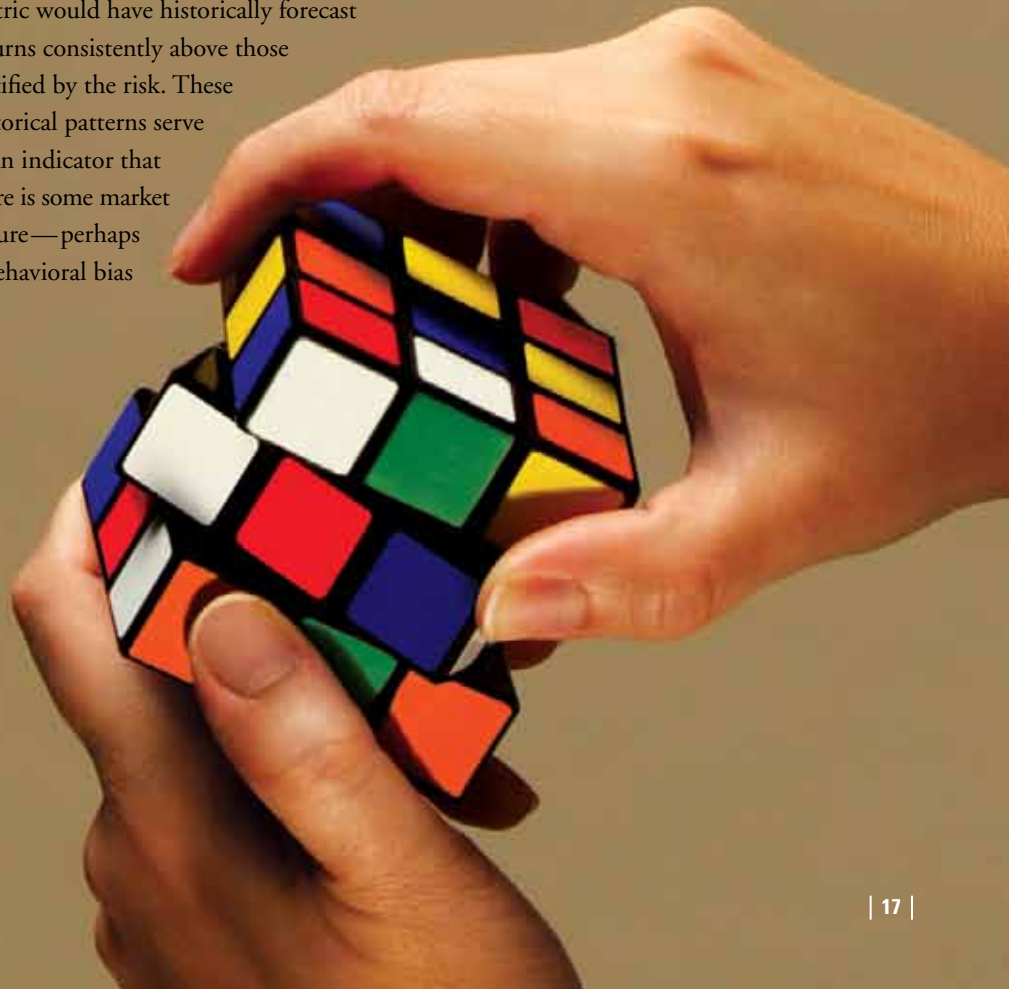
While there is a certain amount of commonality among quants, they don't all do the same thing. Some work at a very high frequency, trading thousands of times a day.

They seek to take advantage of short-term movements in securities that are driven by other investors. A low frequency quant—what I was when I was at Goldman Sachs Asset Management (GSAM)—looks for patterns in data, as well, but at much longer time intervals. One can think of value investing as a simple example of low frequency quantitative investing.

In that context, let me focus on the difference between a quant and a fundamental value investor. A quant looks at hundreds of metrics of value, such as price-to-book or price/earnings ratios. Basically, quants employ the scientific method to test various hypotheses and determine if a particular metric would have historically forecast returns consistently above those justified by the risk. These historical patterns serve as an indicator that there is some market failure—perhaps a behavioral bias

or an institutional feature that results in the set of securities with this characteristic being consistently mispriced.

When they find these patterns, and assuming these patterns are consistent with what would be expected given economic analysis, quantitative investors will construct a portfolio with exposure to that “factor,” for example, by overweighting high book/price stocks and underweighting low book/price stocks. Quants like to use the term factor, and what they mean by it is something that forecasts something else. Quants generally look for these factors and invest in them. Quants also typically do considerable analysis of risk and transactions



costs and try to use the results of these analyses, together with computerized trading, to improve the net returns of the portfolio.

Fundamental managers are not as systematic

Fundamental managers are doing something similar, but not in the quant's systematic way. Instead, fundamental managers may look at the book/price ratio of 1,000 stocks and posit that there must be a reason why some seem to be cheap. They will then go to work to understand what makes certain companies different. They are trying to bring something to the table that is either not public or is public and not widely appreciated.

Fundamental research is not systematic and, therefore, it is not easy to replicate. This is an important point. Because what quants do is systematic, it is actually fairly easy to replicate. That wasn't true 20 years ago, but today the barriers to entry have come down. One can imagine that anyone with a computer, a database and some simple programs can take advantage of the well documented approaches that rely on standard techniques and databases. And anything that is that easy to take advantage of is eventually going to go away. This brings us to what happened in August 2007.

In brief, there was so much money flowing into the quant space that it became crowded. There was also a lot of risk in the market owing to the credit crunch that started in 2006 with subprime mortgages. As the subprime problem grew, it created a lot of anxiety, particularly among hedge funds with exposure to the mortgage sector. As the anxiety spread, it eventually spilled over into quantitative investing. I don't believe anyone

knows exactly how that happened, but my sense is that it started with the multi-strategy hedge funds. These funds employ lots of different strategies, each designed to take advantage of one or more anomalies in the marketplace. In the years leading up to 2006, big hedge funds had raised billions of dollars and were looking for strategies that could accommodate a large amount of capital. Quant was one of them. Because quantitative investing is relatively simple to replicate, hedge funds could hire a few quants to put together a portfolio with billions of dollars in positions that tried to add alpha, i.e., returns from risk uncorrelated with the market.

Multi-strategy hedge funds also allocate capital among different strategies. For example, they might have some of their capital devoted to fixed income, credit and mortgages, and some to quantitative equity strategies. When a strategy looks particularly attractive, they give it more capital and vice versa. So, capital flowed into quantitative strategies. For those who were already in the space, it was a nice tailwind. The performance of standard quant strategies was good, even though those strategies were based mostly on standard factors.

At GSAM, our quant strategies had very high Sharpe ratios. The highly levered, pure version of our equity strategies had done very well since inception in 2003, and had to be capped at \$6 billion in capital under management. By June 2007, the strategy was up another 15 percent for the year. We had positions of over \$20 billion each in long and short equity portfolios. We hedged every risk we could, while at the same time

maximizing our exposure to quantitative factors. By the time the year was over, the fund was down 30 percent. What happened?

Difficulties in the quant space can be traced to the subprime problem. As the subprime problem grew, investors started to get nervous and their fears spilled over to quantitative investing. Liquidity began to dry up, and managers who had fixed positions in mortgages and/or credit started to feel some pressure. Some high profile hedge funds got into trouble. Soon, I believe, the multi-strategy hedge funds decided they didn't want to be in positions that could be difficult to exit, and as these funds lost money in mortgage bets—and later in credit positions—they were forced to raise capital by selling out of other more liquid positions, such as quantitative equities.

We, of course, also worried about exiting positions, but our portfolios were very liquid and each position was designed to be held for months at a time. And we had no direct exposure to mortgages or to the level of the stock market. We didn't have any particular anxiety about our portfolios.

Major quant investors begin to liquidate positions

Personally, given the growth in assets, I had expected the returns from quantitative investing to decay over time. I thought there might only be a few more really good years. What I didn't expect was an implosion.

So it was that in July 2007 some significant quant investors started to liquidate their positions. The factors made small moves lower almost every day that month, and that pattern is consistent with a controlled liquidation or reduction in risk

Because what quants do is systematic, it is actually fairly easy to replicate.

And anything that is that easy to take advantage of is eventually going to go away.



“As long as markets are not perfectly efficient, there will be opportunities for quants.”
—Bob Litterman

of quant portfolios. That action, in itself, caused quants to experience a very bad month and, toward the end of July, investors who were probably relatively new to quant began to panic, leading to an implosion in quant portfolios in the first week of August. It is a strange thing to talk about movement in quant factors because you can't go to a Bloomberg screen to see it. One of my colleagues said that in order to see what was going on as the quant space delevered, you had to be wearing “quant goggles.”

The overall movement of factors generating returns is typically pretty small. In August 2007, factors started moving 10 times as much as they usually did, and their moves were all in the wrong direction. So, every factor in quant portfolios went the wrong way at the same time—and by a factor of 10.

The whole episode only lasted about a week and was largely concentrated in the equity markets. By Friday of the second week in August, four days after quant factors fell off a cliff, all the factors started coming back very strongly.

I'm sure every quant felt that he or she was at the center of the storm, and being the chairman of the quant group at GSAM, I was no exception. Gary Cohn, one of the co-presidents of Goldman Sachs at the time, spent a lot of time on our floor that

week. Our highly levered quant equity hedge fund was running dangerously low on capital. On Wednesday we decided to delever our portfolio by raising new capital for the fund. By Thursday evening, the firm had put together a group of investors who would join the firm in injecting \$3 billion of new capital into the fund, effectively halving its leverage. The capital came in at Friday's close. The quant rebound began on Friday morning.

Discipline exposes quants to liquidity shock

Nonetheless, the damage was done. There were several factors that made the quant strategies susceptible to this liquidity shock. One was the fact that they were so disciplined. Unlike most investors, quants minimized exposure to the idiosyncratic components of a portfolio and maximized exposure to their factors, many of which were well known and used by many other quants. This commonality across quant funds was a second key reason why quant strategies were susceptible to the August 2007 shock and subsequent deleveraging. Correlations across different quant portfolios weren't especially high before “the event,” so the risk wasn't so obvious. It's like equity markets around the world. Day to day they are not that highly correlated, but in a big move they can become very highly correlated. That is what happened to quants.

What does this mean going forward? Clearly, one lesson is that when there is a crisis, it will tend to spill over from one market to others, just as subprime did, even if they are unrelated, like quant. Another lesson is crowded trades. Those of us who had been managing assets using quantitative techniques for many years didn't think of what we did as “a trade.” But, because we were competing against managers who did think of it as a trade, it became a trade. In July 2007, it was a case of hot money leaving the space. Once that became clear it was a race to get out.

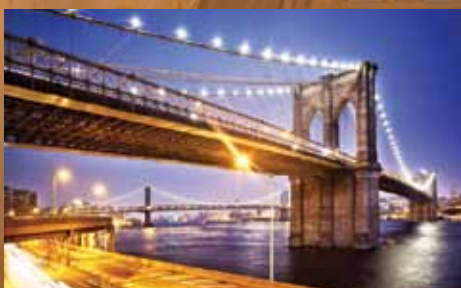
Because the technology and knowledge behind quantitative strategies are now widely available, if an opportunity is too obvious or easy, it will quickly disappear. So, to be successful going forward, what quants need to do is avoid the “recipe approach” by doing original research and concentrating on more subtle opportunities. They won't be able to hold onto well-known factors and expect that they will work well. The opportunities are likely to be much smaller because as soon as an opportunity is significant, money is going to flow in and take it away. Personally, I don't believe that markets are perfectly efficient, and as long as they're not, there will be opportunities for quants to exploit.

How should those managing funds for nonprofits now think about quantitative investing? Quant is really just like any other strategy in that you want skilled managers with a particular approach or process that you believe has the potential to deliver alpha. Obviously, you would like them to be smaller rather than larger because they are going to be able to take advantage of more opportunities that way. Moreover, the opportunities themselves are likely to be smaller.

The lesson from the crisis is not that systematic analysis of data and the disciplined scientific/quantitative mode of analysis no longer work, but rather that this analysis needs to be employed in a more thoughtful way. |



Brooklyn Public Library



Brooklyn's most famous landmark is a 5,989-foot-long span—at one time, the longest suspension bridge in the world—connecting the borough to Manhattan on the other side of the East River. But the Brooklyn landmark that touches more lives day in, day out is Brooklyn Public Library (BPL). The fifth largest library system in the United States, BPL houses more than 5 million circulating and reference items and its branches are visited by more than 12 million people annually. The library was created by an act of the New York state legislature in 1892, and it continues today as an independent system separate from those operated by other New York City boroughs. In 1912, construction began on BPL's main building,

which fronts on Grand Army Plaza and is designed in the shape of an open book. (Construction was not completed until 1941.) The system has now expanded to include 58 neighborhood libraries located within a half mile of each of Brooklyn's 2.5 million residents. The main building's 50-foot, limestone-clad entrance portico (shown here) features gold leaf Greco-Roman figures depicting the evolution of art and science. The bronze entrance screen features beloved characters from American literature, including Brer Rabbit, Moby Dick, the Raven, Rip Van Winkle, Hiawatha, Tom Sawyer and others.

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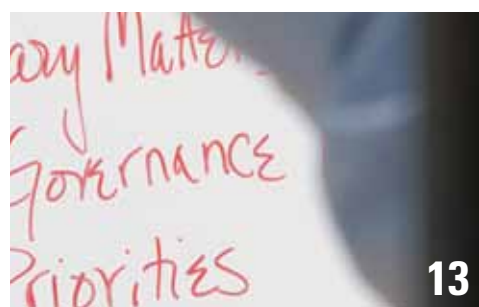
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