

New World, New Reality: Rethinking the Governance Model for Nonprofit Investment Management

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Introduction

“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 a new phenomenon; 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.

In this new world, the task before trustees, investment committee members and senior financial officers is, first, to acknowledge and identify these new priorities; and, second, to think in *nontraditional* ways in order to adapt their organization’s processes, policies and people. In so doing, they will create a governance model that enables their endowment to perform its *traditional* role of support for the institution’s mission.

There are two powerful forces shaping the environment for 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. The same resource constraints in the economy, government and society that have thrust this expanded role on nonprofits also affect nonprofits’ ability to respond and perform up to expectations.
- 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 were 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.

This paper looks at these powerful trends and offers thoughts that may open new paths for nonprofits to adapt their investment management governance models to the realities of today and position themselves for the promise of tomorrow. The topics covered in this paper will be: the demands of society; the traditional governance framework for funds management; challenges to investment management today; and ways to rethink the old model. By addressing the stresses that are weighing on investment management, nonprofit institutions increase the odds that they will be able to meet the demands of society generally and fulfill their own specific missions.

As trustees and staff members read this paper, they may want to ask themselves:

- How did your endowment perform on a relative basis during the financial crisis and market collapse? If it lagged peers or benchmarks, to what extent was this exacerbated by shortcomings in your governance structure, policies or processes?
- What types of risk cause you the greatest anxiety, especially those that are out of sight or out of your control?
- Should you undertake a review of the governance section of your investment policy statement, focusing, for example, on the assigned roles and responsibilities for implementation of policies?
- How do you set the agenda for your board or investment committee meetings? Are your deliberations focused on policy matters or details of execution and implementation? Reflecting on past agendas, is your committee really forward-looking or are meetings just a rehash of history?
- How could you strengthen the composition of your investment committee? Does your institution or organization have sufficient staff resources and/or external help to support the committee's work?
- How effectively is your investment committee dealing with the complexity of today's investment environment? What would it take to get ahead of events instead of reacting to them?

Part I

The Demands of Society

The nonprofit sector is playing an increasingly important role in society, as demand for the enormous variety of services provided across the sector rises. According to the Giving USA Foundation, 54 percent of human services charities reported increasing need for their services in 2008. Similarly, according to a 2008 survey by GuideStar, a source of data and information about the nonprofit sector, 58 percent of nearly 2,300 responding nonprofits reported increasing demand for their services. But, in 2009, according to Giving USA, 60 percent of human services organizations were cutting expenses, including services or staff, due to funding shortages. Among youth development organizations, the foundation reports that 74 percent of surveyed organizations said they were underfunded or severely underfunded, and among organizations working to provide basic needs, such as food, shelter and clothing, more than half said they were underfunded/severely underfunded in 2009. A June 2009 survey conducted by the Bridgespan Group, a consultant and adviser to nonprofits, reported that 56 percent of surveyed nonprofits reported an increase in demand for their services—double the rate of a survey conducted just eight months earlier.

The situation has been aggravated by the financial crisis and economic recession. According to The Urban Institute's Center on Nonprofits and Philanthropy, "Foundation endowments recently have been hard hit and individuals who traditionally give to charity have suffered financial reversals. But many nonprofits in their communities are in truly desperate straits. They have endured a triple whammy on the revenue side—donations, grants and government support are all down—while community needs and demands for services have skyrocketed during the current economic crisis."

Another Urban Institute study revealed that one in six public charities that filed tax returns in 2000 did not file in 2006, meaning that they either closed or shrank so much they didn't have to file an annual return. The Institute reported, "With the large declines in foundation assets, many of the organizations that have historically relied on foundation grants can expect to see their accounts shrink or be eliminated altogether. The nonprofits cut loose are in a tough spot. It's very hard to find new funders in this environment...a lot of small organizations [are] struggling. They don't have steady sources of income and their contributions are declining. Larger organizations are struggling too, so they're pinching pennies, cutting programs and laying off staff."

At the state level, as of this writing, 46 states faced budget deficits for fiscal year 2011. At least 33 of those states are cutting services and/or not responding to rising needs—putting additional pressure on nonprofits to fill the gap. Many governments have delayed or stopped paying nonprofits for services they have contracted the nonprofits to provide.

At the same time, there are decreasing resources in many cases. For the first time in a long time, we are seeing a decline in giving (with some exceptions). According to Giving USA, charitable giving totaled \$303.8 billion in 2009, a 3.2 percent decline in real dollars compared with 2008. It was the second decline in giving in current dollars since 1987, according to the foundation, and the third since Giving USA began publishing reports in 1956.

Another foundation study confirmed the correlation between recessions and donations to nonprofit organizations. After an economic downturn, charitable giving typically does not keep up with increases in inflation. Not including the 2008–2009 economic contraction (for which data are not yet available) giving declined in five previous recessions: 1973–1975, 1980, 1981–82, 1990–91 and 2001. Colleges and universities—traditionally beneficiaries of steady alumni giving—suffered in the recent economic malaise. The Council for Aid to Education’s annual Voluntary Support of Education Survey for FY2009, released in February 2010, showed that donations to colleges and universities dropped \$3.75 billion from the previous year. The 11.9 percent decline was the steepest in the survey’s 50-year history. Alumni participation dropped to a record low and the size of the average alumni gift fell as well. Commenting on the study, the president of a private university in the Southeast said he believes fundraising will be challenging in the decade ahead, as the economic downturn will have lasting psychological and emotional effects.

One form of giving—volunteerism—is showing strength. The U.S. Bureau of Labor Statistics reports that some 63.4 million people, or 26.8 percent of the population, volunteered through or for an organization at least once in the year ended September 2009. This figure was up modestly from 26.4 percent the previous year.

One measure of the increasing role of the nonprofit sector is its ongoing growth. According to the National Center for Charitable Statistics (“NCCS”), there are some 1.57 million tax-exempt organizations in the U.S., including 501(c)(3) public charities, 501(c)(3) private foundations and other 501(c) exempt organizations.¹ According to the 2008 Nonprofit Almanac, published by The Urban Institute, nonprofits accounted for 8.1 percent of all wages and salaries in the U.S. According to the prior year’s Almanac, the nonprofit sector accounted for 5.2 percent of U.S. GDP. Also in 2007, public charities reported more than \$1.4 trillion in total revenues and nearly \$2.6 trillion in total assets.

The number of nonprofit organizations registered with the Internal Revenue Service grew by 60 percent to 947,274 in 2008 from 593,802 in 1998. Based on Form 990 and Form 990-EZ data, the number of organizations reporting to the IRS increased by 73 percent to 420,187 in 2008 from 243,430 in 1998; total revenues for reporting organizations grew 91 percent to \$1.3 trillion from \$695.3 billion; and total assets grew by 106 percent to \$2.4 trillion from \$1.2 trillion.

Pressure on the Sector

In addition to increasing needs for services, comments and proposals from politicians, self-appointed watchdogs, pundits and the media are another source of pressure on nonprofits. Most of the time they urge nonprofits to spend more. In particular, the Senate Finance Committee scrutinized colleges and universities for a perceived mismatch: Educational institutions with multi-billion dollar endowments versus parents and students who are hard pressed to keep up with annual tuition increases that outpace the rate of inflation. Some critics maintain that colleges and universities should dig deeper into their endowments to hold down tuitions and provide more financial assistance. Some even suggested that institutions with investment returns over a certain threshold should be forced to share their gains with less wealthy institutions—essentially a tax on an endowment’s earnings.

1 Source: NCCS Business Master File, October 2009

The idea that received the most attention came from Senator Charles Grassley, ranking member of the Senate Finance Committee, and that was setting a minimum spending rate for colleges and universities, such as 5 percent, as has been required of private foundations since 1981. The Senate Finance Committee also made a point of the fact that gifts to educational institutions and the investment returns on endowments are both tax-exempt. By implication, the argument advanced by advocates of higher spending is that intergenerational equity—a key tenet of endowment management—should not be a goal; rather, spending should meet present needs, such as scholarships and/or lower tuitions.

Most people easily forget that there are only 52 institutions (mostly private)—out of about 4,300 two- and four-year colleges and universities in the U.S.—with endowment assets of \$1 billion or more. In fact, fewer than 400 institutions have endowments of \$100 million or more. So, the proposal for a minimum spending rate is really aimed at a very small percentage of the higher education community. If extended to include all educational institutions, it could become a serious burden to the great majority of institutions, especially in periods of financial stress when all sources of revenue decline.

The mood of the public is sour as well. The Brookings Institution issued a report some years ago based on a survey that showed public confidence in nonprofits fell drastically after September 11, 2001, and that confidence has not recovered. It did not help that media stories reporting excessive compensation, self-dealing and questionable ethics rocked a number of high profile nonprofits. In addition, several well-known universities became embroiled in governance battles, excessive compensation schemes, and conflicts of interest among top administrators and trustees. The emergence of doubts about the non-profit sector represents a sea change among the public, legislators, donors and the media, which previously had high levels of confidence in the efficacy and ethics of the sector.

The Internal Revenue Service announced a new enforcement effort to halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers and other insiders. The IRS also made major changes to Form 990, which nonprofits (including private universities and colleges) must file to keep their tax-exempt status. In addition to more detailed reporting in general, the changes included requiring information about conflict of interest policies and reporting transactions or financial relationships with trustees.

Declines in Asset Values Hit the Sector

Investment returns have been hit hard by two bear markets in the past decade, the most recent widely regarded as the worst financial crisis since the Great Depression. Eight hundred forty-two institutions of higher education participating in the 2009 NACUBO-Commonfund Study of Endowments® (“NCSE”), reported an average 18.7 percent decline in endowment values for the fiscal year ended June 30, 2009. The largest institutions in the study, those with assets over \$1 billion, reported even poorer performance, -20.5 percent. FY2009’s sharp losses lowered the average three-year return into negative territory, -2.5 percent annually. The corresponding five-year return figure was a meager 2.7 percent, while for 10 years the average annual return was 4.0 percent—a rate that is insufficient to maintain endowment values after spending, inflation and investment management costs.

Turning to other nonprofits, the severe losses reported in FY2008 have only been partly replenished by the strong gains in FY2009. The 290 independent/private and community foundations participating in the Commonfund Benchmarks Study® *Foundations Report* for FY2008 reported an average return of -26.0 percent, but a positive return in FY2009 of only 20.9 percent.

The fallout from the severe drop in asset values experienced across the nonprofit sector has not been felt in its entirety at this stage. Reducing staff, deferring maintenance, postponing or cancelling capital projects, decreasing or eliminating funding for some programs, and cutting scholarships are actions that have taken place throughout the sector and will doubtless continue into the foreseeable future. A powerful multi-year bull market would do much to reverse course, but, despite the equity market's recovery in 2009 and so far in 2010, that seems unlikely in light of economic headwinds not only in the U.S. but throughout the developed world.

We would further observe that recent surveys have shown a measurable fall-off in gifts, confirming the comment earlier in this paper that overall giving is down. Sixty percent of educational institutions participating in the 2009 NCSE reported a decrease in gifts versus just 26 percent reporting an increase. Among community foundations participating in the FY2009 Commonfund Benchmarks Study, 55 percent reported lower gifts in 2008 compared with 16 percent that reported an increase.

The lower return environment that colleges and universities experienced in FY2009 forced some to deviate from their spending plan. Nearly a quarter (24 percent) of NCSE participants did so. In addition, of the 18 percent of Study participants reported having made a special appropriation in FY2009 (defined as draws over and above the rate indicated by the institution's spending rule), 24 percent devoted their special appropriation to supporting the operating budget—once again underscoring the difficult financial straits confronting some institutions in the credit squeeze/financial crisis that characterized the year.

Part II

The Traditional Governance Framework for the Management of Funds

Before turning to the current and emerging challenges facing nonprofit institutions' management of their funds, it is useful to review practices that have been in use for many decades and are so widespread as to be the norm for most nonprofits. This is not intended to be a comprehensive review of governance and investment committee structure. Instead, as we probe further in this paper this section will serve as a backdrop for our thesis that the traditional model has inherent flaws that make it difficult to adapt in today's environment.

The board of trustees is the governing body at nonprofit institutions. An investment committee that is properly aligned with the board is also focused on governing. Ultimate fiduciary responsibility remains with the full board, with the investment committee being responsible to the board. This structure—in which the board delegates authority to the investment committee for the investment of long-term funds—has generally enabled the investment management process to work well for many decades.

The primary functions of the investment committee are:

- To provide the institution with an experienced and manageable group of people who take responsibility for developing and maintaining the guiding document of endowment management—the investment policy statement.
- To be the source of specialized skill, knowledge and experience required to manage an investment portfolio as a fiduciary.
- To manage risk in a world in which financial markets change rapidly.
- To bring to bear the necessary experience with and knowledge of the highly complex financial instruments (e.g., derivatives) and investment strategies (e.g., hedge funds) that have emerged over the past several years.

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

Members of the committee should bring to their task several attributes, including character, education, and a willingness to be a part of a team and to place the best interests of the institution first and foremost. If committee members understand and appreciate the fiduciary's duties of care, loyalty and responsibility, they are usually able to be effective and contribute to the committee's work. As committee members are unpaid volunteers who are usually very busy with their own careers, meeting any more frequently than quarterly can be a challenge. As needed, however, members usually make themselves available for conference calls and should be willing to study materials and be well-read on current financial and economic news.

The size of investment committees varies, but most seem to be in the range of six to eight members. In general, investment committees should be kept as small as possible to facilitate decision-making but large enough to fairly allocate work among members. The 2009 NCSE found that the average size of 842 participating educational institutions' investment committees was 8.1 members. Larger participating endowments, those with more than \$1 billion in assets, averaged 9.8 members while smaller endowments, those with assets under \$25 million, reported an average of 6.9 members. In terms of investment committee credentials, an average of 4.0 investment committee members were investment professionals; the average number of investment committee members with alternative strategies experience was 2.5. Data from the most recent Commonfund Benchmarks Study *Foundations Report* (for FY2009) showed somewhat smaller investment committees—an average of 5.8 members, with an average of 2.8 members being investment professionals.

While it is important to have investment professionals on the committee, diversity is also important, as it brings differing perspectives and backgrounds to the table. In the past, homogeneity has led committees to operate in a “culture of collegiality” as opposed to a “culture of inquiry.” Experience has shown this can lead to reputational problems, and governance thought leaders today are advocating more diverse boards and investment committees. In this case, diversity not only is defined by gender, age and race, but also by “cognitive diversity,” or differing professional backgrounds, education and life experiences. (Although all committee members should have some degree of financial literacy, the best questions are often asked by members with experience outside the world of investments and finance.)

The investment policy statement is the document that guides the management of the endowment in support of the institution's mission. A sound investment policy is all-inclusive—starting with the purpose of the endowment and its role in supporting the mission of the institution—and typically spells out who is responsible for what, including internal staff and external resources, such as consultants, managers and custodians.

Traditionally, the fundamental elements of the investment policy are objectives, payout (spending) policy, target asset allocation (policy portfolio), rebalancing, manager selection and evaluation, risk management, costs, guidelines for gift acceptance, and roles and responsibilities. Generally, the two most critical issues that committees face are asset allocation and spending policy. While substantial time and effort have been devoted to asset allocation, spending policy has not received as much attention until recently. In this area, there are two key issues: spending rate and spending method.

Prior to moving on to review the challenges to investment management today, it is worth observing that the ways in which investment committees order their priorities and spend their time are long-standing issues. Writing on investment committees in the September 1, 2009, issue of a newsletter entitled *Mauboussin on Strategy*, published by Legg Mason Capital Management, Michael Mauboussin, Chief Investment Strategist, writes:

Problems come in different types, and one of the first tasks of a committee is to determine what type of problem it faces and how best to solve it...Understanding problem types leads to better time allocation and crisper decision-making...Addressing complex problems not only requires an appropriate approach, it demands thoughtful time allocation...The chart below is a simple two-by-two matrix considers issues based on how knowable and how important they are. Committees should spend the vast majority of their time on important topics, and in particular those topics that are unknowable. Dealing with important issues with unknowable outcomes requires a probabilistic mindset and discipline. Issues that are known and unimportant should receive little time.

	Unimportant	Important
Unknowable	No time	Most time
Knowable	Little time	Some time

But the time allocation of investment committees is far from this ideal. A recent survey...found that they spend over one-half of their time, more than that on any other issue, discussing past investment performance—an unimportant knowable. (Unimportant in the sense that there is nothing the committee can do about it.) In fact, committees report spending the bulk of their time (40–50 percent on average) on topics like “market dynamics” and “managing the managers” even though committee members themselves do not rank those topics as the most important. In contrast, a topic of high importance, investment policy, used only 5–15 percent of committee time.

Part III

Challenges to Investment Management Today

The traditional model for governing and managing a nonprofit's long-term financial assets, as summarized in the preceding section, is being challenged in today's world. The primary hurdle can be summed up in one word: complexity. It is, however, a single word with many facets. And, while complexity has been increasing for years, over the last decade it has accelerated dramatically.

A main source of complexity is the changing composition of investment portfolios, from the simple days of stocks and bonds to much more sophisticated alternative strategies, including hedge funds, private capital, commodities, and all manner of derivative strategies and structured products. Generally, alternative strategies are less transparent, potentially more "risky" and certainly demanding of a different level of due diligence, oversight and monitoring than anything that has gone before. Almost nothing about these strategies suggests a "set it and forget it" type of behavior. Moreover, so-called "alternatives" are now, in fact, mainstream investments. Many nonprofit institutions—especially colleges and universities—have allocated more than half of their endowment assets to alternative strategies. The 2009 NCSE showed that the average participating institution had an allocation of 51 percent to alternative strategies in FY2009. Among educational institutions with endowment assets over \$1 billion, the allocation to alternatives grew to 61 percent. Even among three size cohorts of institutions with assets below \$100 million, the allocation to alternative strategies ranged from 13 to 22 percent.

Healthcare institutions have generally invested in alternative strategies at a lower rate than their educational counterparts. The 85 nonprofit healthcare institutions participating in the Commonfund Benchmarks Study *Healthcare Report* for FY2009 reported an average allocation to alternatives of 15 percent. Of note, that represents a significant increase over a three-year period, as the average allocation reported in the 2006 study was just 13 percent. The 173 foundations participating in the Commonfund Benchmarks Study *Foundations Report* for FY2009 had an average alternatives allocation of 35 percent—up from 28 percent in just two years' time. What recent studies have also shown is the tendency of some smaller nonprofits to concentrate their alternatives allocation in one or two strategies, a practice that can heighten risk in any asset class, even traditional ones. There is also a question of whether these nonprofits are able to access top-tier investment managers, as there is often a wide gulf in performance between first quartile and median managers in the world of alternative investments.

Limited Human Resources

Against this backdrop of greater complexity, we see in the following charts (based on data from the 2009 NACUBO-Commonfund Study of Endowments) that the additional human resources needed to manage alternative investments have not been forthcoming.

CHART 1

Total Number of Separate Investment Management Firms Used
FY2005-FY2009

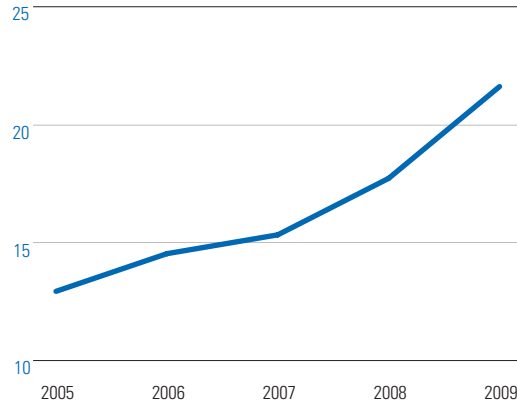


CHART 2

Average Number of FTE (Full-Time Equivalent) Professionals Staffing Investment Function
FY2005-FY2009

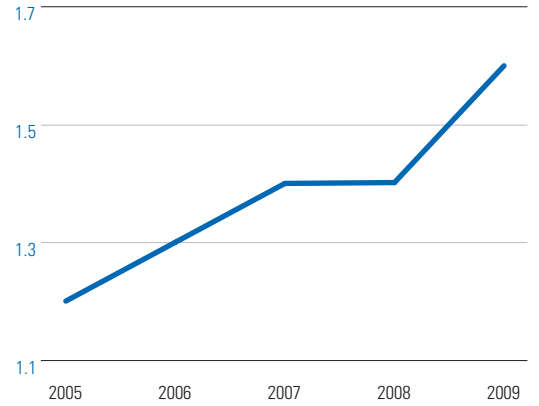


CHART 3

Average Number of Investment Committee Members
FY2005-FY2009

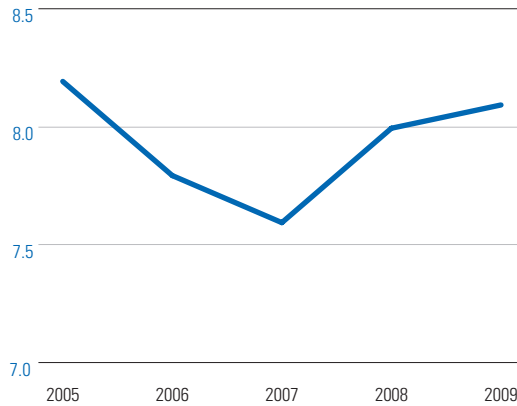


CHART 4

Average Number of Direct Alternative Managers Used
FY2005-FY2009

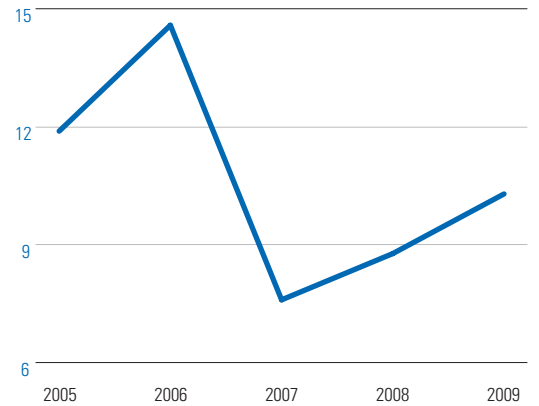


CHART 5

IC Members with Alternative Strategies Experience

FY2005–FY2009

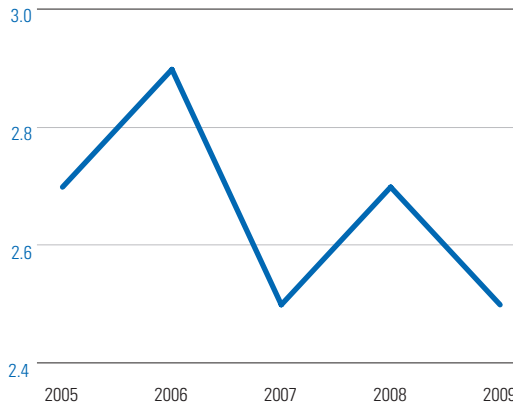


CHART 6

IC Members that are Investment Professionals

FY2005–FY2009

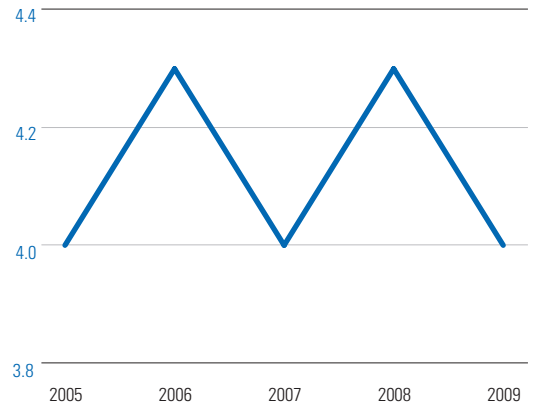


Chart 1 shows that the average number of investment management firms used has increased dramatically—by more than half—in a span of five years. However, the average number of full-time equivalent staff members (“FTEs”) dealing with investment matters has been flat (Chart 2). We note the recent rise to an average of 1.6 FTEs, but to have any meaningful effect that trend line will have to continue upward. Meanwhile, the average size of investment committees (discussed in the previous section and shown here in Chart 3) has only recently returned to the approximate level of FY2005. Chart 4 shows an increase in the average number of direct alternative managers over the past three years. (Direct manager relationships are distinct from investing through funds of funds.) The following Chart 5 shows, however, that the average number of investment committee members with alternatives experience is declining. Chart 6 shows that the average number of investment committee members who are investment professionals is flat over five years.

Constraints on human resources apply not only to staff positions, but also to trustees and investment committee members. Today, it is increasingly difficult to recruit well-qualified people to boards and committees. While the time commitment is one obvious challenge, prospective board members often decline to serve because they know that they will be serving in an environment of potential liabilities, heightened scrutiny, and more stringent regulatory and compliance regimes. (Refer to the following section, “Regulatory and compliance environment.”) In fact, some investment companies are starting to forbid their employees from serving on investment committees.

Regulatory and Compliance Environment

Another source of complexity is the regulatory and compliance environment, which seemed to undergo a sea change in the wake of corporate scandals such as those at Enron, Tyco International, WorldCom and others. As noted in the first section, the nonprofit world did not go untainted, either. Many abuses that snared nonprofits could have been avoided had trustees and committee members been more diligent and participated more proactively in governance, particularly compensation and finances. Thus, the first line of defense, and the action with the greatest potential reward, is to recruit and train fiduciaries who fulfill their roles and responsibilities.

The corporate scandals of the previous decade led to the enactment of the Sarbanes-Oxley Act, the sweeping governance reform law that was passed by Congress in 2002 to regulate publicly traded companies. While not generally applicable to nonprofits, Sarbanes-Oxley changed the dialogue as many thought leaders believed that relevant parts could and should apply to the nonprofit community. Some in the nonprofit sector—including BoardSource, Independent Sector and NACUBO—analyzed the act's provisions for their applicability to foundations and higher education. California enacted a law regulating large numbers of nonprofits (excluding educational institutions and hospitals) that incorporated some of the elements of Sarbanes-Oxley. And, at one time, the idea of extending Sarbanes-Oxley to the nonprofit sector was floated by a former attorney general of New York.

One of the chief provisions of Sarbanes-Oxley focuses on the audit. Among other things, the act requires an independent and competent audit committee and that auditors must be independent of the clients they audit. An empowered audit function can only help nonprofits, and a separate board-level audit committee was established by many. Other Sarbanes-Oxley provisions that are applicable to nonprofits touch on corporate governance, internal controls and enhanced financial disclosure.

The Panel on the Nonprofit Sector was formed in 2004 at the encouragement of the U.S. Senate Finance Committee. The panel prepared a series of recommendations for Congress to improve the oversight and governance of charitable organizations and for individual nonprofit organizations to ensure high standards of ethics and accountability. The panel issued a report to Congress and the nonprofit sector, *Strengthening Transparency, Governance, and Accountability of Charitable Organizations*, in 2005, and followed up with a supplemental report by the same name in 2006. In 2007, the Panel released *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*.

The point is that nonprofits are operating in a much more transparent and potentially hostile environment. Sarbanes-Oxley may not have directly addressed nonprofits, but it nonetheless set new standards for governance best practices as it became clear that there would be increased external focus on fiduciary responsibilities, board independence, conflicts of interest, bylaws and investment policies. Greater accountability is ultimately a good thing—but, once again, it requires investment committee members and trustees in general to be vigilant, careful, informed—and willing to commit the requisite levels of time and energy.

Revised Form 990

More recently, the IRS revised and greatly expanded its Form 990, which is required of tax-exempt nonprofit organizations. In December 2007, the IRS released the new form, which calls for significant disclosures about the filing organization's governance and boards of directors. These new disclosures were required for all nonprofit filers for the 2009 tax year, with more significant reporting requirements for nonprofits with over \$1 million in revenues or \$2.5 million in assets. In addition, certain nonprofits have more comprehensive reporting requirements, such as hospitals and other healthcare organizations.

Writing in the winter 2009 issue of Commonfund's magazine, *Mission Matters*, an expert on Form 990, Tom Hyatt, a partner in the law firm Sonnenschein, Nath & Rosenthal, pointed out that trustees regarding the form as only a tax document do so at their peril:

If you ever were of the mind that the Form 990 was a tax document that didn't require board involvement, it is time to change your point of view. The IRS uses the 990 as its primary tax compliance tool for tax-exempt organizations. It is a public record document, readily available on the Internet. Most states also rely on the form to perform charitable and other regulatory oversight. Moreover, the new Form 990 is so much more than a financial reporting document. It contains questions designed to delve deeply into the governance processes of the organization, its compensation mechanisms and its operating policies. Certainly, the financial disclosures remain a key portion of the form, including all-new disclosures about compensation and endowments. However, it is essential that the board goes through the exercise of answering the governance-related questions and making informed choices about which practices and policies to adopt so as to ensure effective governance.

IRS College and Universities Compliance Project

The Internal Revenue Service's Exempt Organizations office has initiated a compliance project focused on colleges and universities. The project began with a compliance questionnaire sent to 400 colleges and universities allowing the IRS to gain a better understanding of how colleges and universities:

- Report revenues and expenses from taxable trade or business activities on Form 990-T
- Classify activities as exempt or taxable activities
- Calculate and report income or losses on Form 990-T
- Allocate revenues and expenses between exempt and taxable activities
- Invest and use endowment funds
- Determine types and amounts of executive compensation

This is another signal that colleges and universities, as well as other nonprofits, can expect increased scrutiny, media reporting, IRS audits and additional Form 990 reporting obligations.

(We would also note that the IRS Governance Checksheet of December 2009 is used by Enforcement Office agents in their examination of 501(c)(3) public charities. The checksheet inquires about the governing body and management, compensation, organizational control, conflicts of interest, financial oversight, and document retention.)

UPMIFA

Another wave in the regulatory sea change is UPMIFA, or the Uniform Prudent Management of Institutional Funds Act. Nonprofit investors are familiar with the Uniform Management of Institutional Funds Act (“UMIFA”), the landmark statute that, upon passage in 1972, established standards for the management, investment and expenditure of the endowment funds of nonprofit institutions. UPMIFA is the new UMIFA, and it has been enacted in 47 states and the District of Columbia as of this writing. UPMIFA has widespread implications for nonprofit organizations, including:

- Elimination of the historic dollar value limitation on spending (the so-called “underwater funds” rule).
- Greater investment freedom, as managers would not be limited in the kinds of assets that may be sought for the portfolio.
- Expressly addressing the needs of nonprofits by providing for diversification of assets, pooling of assets, total return investment and whole portfolio management.
- An optional provision that allows states to find that an organization spending more than 7 percent of its endowment in one year is acting imprudently.

FAS 117-1

While generally bestowing greater freedom on boards (subject to certain factors and the overarching standard of prudence), UPMIFA also places new responsibilities on boards, chiefly through the response of the Financial Accounting Standards Board (“FASB”) to the new law, which came in the form of Staff Position Number 117-1. This guideline reinforced the fiduciary role that governing boards play in preserving the perpetual nature of endowment funds and highlighted a need for greater reporting transparency. FAS 117-1, in effect, raised the need for non-expert readers of financial statements to be guided in their interpretation of, for example, how underwater funds are spent in accord with the legal standards of UPMIFA and how such spending is treated from an accounting standpoint. In addition, it raised the need for dialogue with lenders regarding covenant ratios in credit agreements that may be affected by the new reporting format in FAS 117-1.

UPMIFA was a welcome advance over UMIFA, which was in need of revision. Still—along with FAS 117-1—it once again raised the level of complexity confronting trustees and investment committee members.

Additional Reporting Requirements

As investors have allocated an increasing share of their portfolios to illiquid investments that cannot be valued by regular transactions in the marketplace, additional guidelines have been forthcoming from standards-setting organizations. In 2006, the American Institute of Certified Public Accountants (“AICPA”) issued a practice aid with standards for confirming the existence and valuation of securities that have been fairly valued. The July release was especially difficult for educational institutions, most of which had just closed their fiscal year. But it proved to be a challenge across the sector, as foundations and their auditors struggled to understand the practice aid and respond effectively. Under tight deadlines, nonprofits had to provide their auditors with “substantive audit evidence” to support valuations. Once again, the demands on trustees—and, in this instance—financial/investment staff were ratcheted up.

Seventy-five percent of colleges and universities participating in the 2009 NCSE reported that they conferred with their auditors about AICPA guidelines in FY2009, a jump from 58 percent in the previous year’s *Educational Endowment Report*. Sixty-nine percent provided documentation to auditors, up from 51 percent the previous year. In addition, in round terms, roughly 60 to 90 percent of the four largest size cohorts (educational institutions with \$51 million or more in assets) reported increasing internal due diligence efforts.

FASB issued its own fair value statement, FAS 157, which became applicable to fiscal years beginning after November 15, 2007. The statement defines fair value, establishes a framework for measuring fair value according to generally accepted accounting principles (“GAAP”) and expands disclosures about fair value measurements. In the 2009 NCSE, 86 percent of respondents said they were familiar with FAS 157 fair value measurements, and 27 percent reported having a written valuation policy as part of their investment guidelines. Eighty-five percent of participating private colleges and universities reported greater interest in fair value accounting on the part of their auditors. (Some public institutions are subject to Government Accounting Standards Board [“GASB”] guidelines, not those of FASB.)

Information Requirements of Rating Agencies

Many nonprofits—especially colleges and universities and healthcare institutions—have added significant amounts of debt to their balance sheets over the past 15 years. Historically, low rate debt issued through tax-exempt bond authorities in many states and growing facilities needs have driven the expansion; capital-intensive science and medical/information technology investments, plus the need to play catch up with deferred maintenance are among many specific factors accounting for heavier debt loads. Rating agencies typically look at a range of factors in rating nonprofit issuers’ debt, among them market demand, operating results, strength of the balance sheet and leverage. With the decline in market value of endowments and operating reserves, rating agencies may be looking more critically at nonprofits’ debt issuance, especially at their levels of available liquidity. Of course, the rating agencies themselves came under harsh criticism during the financial crisis for not being sufficiently diligent in their investigations into issuers’ financial strength, and that may heighten their scrutiny of nonprofits’ bonds going forward. As debt levels grow, the ability to service debt becomes an issue as well.

In the 2009 NCSE, among the 654 respondents reporting that they carry debt, average total debt stood at \$167.8 million as of June 30, 2009. By comparison, the average debt level reported by 309 institutions of higher learning with debt in the previous year's *Educational Endowment Report* stood at \$145.6 million. (Median debt, however, trended lower year over year—to \$44.3 million from \$46.4 million—chiefly because the average was skewed higher by institutions with assets over \$1 billion.) The Commonfund Benchmarks Study *Healthcare Report* for FY2009 showed higher debt levels for the fifth consecutive year. Overall, debt rose to an average of \$903 million in FY2009 from \$681 million in FY2008, \$580 million in FY2007, \$509 million in FY2006 and \$395 million in FY2005. In the companion *Foundations Report* for the same year, foundations reporting that they use debt had an average indebtedness of \$113.1 million and a median of \$24.0 million. These figures were sharply higher over the course of just one year, as the FY2007 Study showed that foundations using debt had an average indebtedness of \$75.4 million and a median of \$21.8 million.

Heightened Need for Effective Risk Management

Risk management has taken its place alongside asset allocation and spending policy as a major focus for investment committees and trustees in general. Some thought leaders believe it will be the primary concern for investors over the next decade. It would be difficult to challenge that thought in the wake of a period that all too recently saw the collapse of Bear Stearns and Lehman Brothers; the takeover of giants like Countrywide, Washington Mutual, Merrill Lynch and Wachovia; government rescues of AIG, Citigroup, Fannie Mae and Freddie Mac; coordinated infusions of capital into financial institutions by global central banks; and TARP, which allowed the U.S. Treasury to purchase or insure up to \$24 trillion of “troubled assets.”

Traditionally, investment risk was defined by market risk, interest rate risk and liquidity risk. These risks still exist, obviously, but have been joined by a universe of risks that have the potential to be equally harmful. Once again, the creation of complex new financial instruments has outstripped the ability of the controlling infrastructure and processes to keep pace, despite the development of models to analyze changes in portfolio market values in response to changing market conditions.

Writing in the winter 2009 issue of *Mission Matters*, Commonfund Chief Risk Officer Bill Martin said:

Active collaboration [across the organization is key to] effective risk management. We refer to this *continuous, collaborative risk assessment* as “connecting the dots.” This is not designed to be an exercise in trying to predict the unpredictable; instead, it is a process of analyzing and considering all possible outcomes, ensuring that an action plan is aligned to each possible outcome and moving effectively to mitigate risk rapidly as new or unexpected developments arise...The critical first step for any nonprofit institution in creating the ability to effectively connect the dots is ensuring that the risk management process is dynamic, forward-looking and comprehensive in its coverage of potential sources of financial harm, reputational damage or operational failure. Within any risk management framework, the following risk factors will be present. It is important to note that there is overlap and seepage between and across risk factors, and that none of the factors should be treated as isolated or independent.

- *Strategic risk*—A forward looking, top-down stress/scenario assessment of the potential impact to the organization’s long-term strategy and investment policy due to fundamental shifts in external factors.
- *Investment risk*—This risk factor covers all aspects of market risk as well the returns associated with any investment. Moreover, while bank-oriented risk management focuses on the potential loss distribution (e.g., VaR, or value at risk), investment risk also assesses the potential gain distribution to ensure that any investment opportunity offers the potential for a consistent, risk-adjusted return over time.
- *Liquidity risk*—It is important that liquidity needs, from both an organizational and investment perspective, are understood and considered fully when setting both business strategy and investment strategy...Any need for short-term liquidity, including a budget for the unexpected, must be assessed fully within the longer-term strategy and annual business planning cycle.
- *Balance sheet risk*—It is necessary to consider all potential risk implications of other activities that would hit the organization’s balance sheet, be it short- to intermediate-term financing, swaps transactions to manage interest rate exposure, swaps to manage currency exposure and other structured products.
- *Credit/counterparty risk*—Assessing the creditworthiness of one’s trading counterparties—looking at long- and short-term ratings, downgrades, bond credit spreads, credit default swap credit spreads and equity trading indicators—and to have in place a robust process for collateral management.
- *Operational risk*—In addition to the strategic and financial risks described above, it is equally important for organizations to have the ability to assess the risk of loss resulting from human error or failed internal processes or systems, or from external events.
- *By-product risk*—This is the risk that arises through the interplay of the risk types described above and the need for active risk mitigation. Recently, crisis management has become an important by-product of the risk management process as the ability to respond effectively to unexpected events is critical.

Limits to Volunteerism

There is a legacy of volunteerism in America dating back centuries. And, as was pointed out in the first section of this paper, 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. Smart, skilled and experienced people 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. They also have their own reputational risk to think about, as nonprofit board disputes or scandals often spill over into the public domain, and detailed financial data will be reported in the new IRS Form 990 more quickly than ever before. In addition, there is no proven way to attract skill and talent to a nonprofit's board. Much depends on the size and quality of an organization's network. For example, colleges and universities are usually successful in tapping alumni and religious organizations may call upon their followers. But foundations, operating charities and healthcare organizations often lack this built-in constituency.

Another pressing need—important, but again increasing both complexity and the demands on committee members' time—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). We saw the need for this in the recent financial crisis, for example, when credit markets froze solid and nonprofits had difficulty accessing liquidity to respond to capital calls from investment partnerships. Similarly, development staff and volunteers need a good understanding of endowment policies in order to do an effective job of fund-raising, particularly among large donors.

The Challenges of Building and Maintaining a Staff

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. Today, in our view, a nonprofit below the level of \$500 million or more probably shouldn't consider an internally staffed management group or even a CIO-level professional.

Part IV

Rethinking the Model

Can an investment committee create alpha, i.e., that much-sought-after excess return above market averages or benchmarks? We believe it can—but only if it is willing to recognize the need for change in its governance structure, process and behavior. The question to be answered is, What is the best means to fulfill trustees' fiduciary duties and serve the institution's beneficiaries? A closely related question is, How does one identify the solution most appropriate for a particular institution—a solution that leverages existing knowledge and expertise, ensures appropriate fiduciary and risk oversight, and, most importantly, provides the best path to the kind of long-term performance needed to fulfill the mission?

The recent environment has challenged the traditional governance model as never before in our lifetimes. But, the fact is the traditional governance model has been challenged for some time. While the model is evolving, it is a slow process—not nearly fast enough to keep up with the world around it. Mostly, however, governance as it relates to investment management is uneven—good in some non-profit organizations, but mediocre to poor in many others.

There are impediments to better implementation because there are still committees that think that a structure and process that were adequate for managing a simple portfolio of traditional stocks and bonds can do the same in today's much more complex and sophisticated environment. Too many are unwilling to consider alternatives to their being able to pick stocks, managers or strategies, even though they are not equipped to do so. Some have tried to emulate Harvard or Yale when they simply shouldn't have.

This antiquated model should give way to one of three options: 1) A fully staffed, fully capable, internal management team; 2) Outsourcing most of the investment management function while retaining 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 limited capacity to appropriately manage the risks of more complex portfolios.

We believe 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. This would include tracking results carefully and benchmarking their institution against selected indices and a peer group of institutions.

Looking at option number one—the fully staffed, fully capable, internal management team—we believe that those nonprofit entities that will have them in the future in all likelihood already do. And they are very few and far between. For all the reasons we cited in the previous section, building and maintaining a staff of talented investment professionals is fraught with challenges, the chief one being enormously high cost. 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.

Consultant Use

A few thoughts about the use of consultants: This is 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 allocation, helped develop policies and evaluated managers. Beginning in the 1990s, as compensation in the investment management industry grew, consultants increasingly were hard-pressed to attract and retain experienced and proven talent. In addition, consultants who were long accustomed to managing traditional stocks and bonds sometimes found themselves under-equipped 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 allowing them to charge an asset-based fee, which generated significantly higher revenues than pure fee-based consulting.

The majority of nonprofit institutions utilize the services of a consultant. Of the 842 institutions of higher education participating in the 2009 NCSE, 80 percent use consultant services. That rate of use was well ahead of the 66 percent reported in the prior year's Commonfund Benchmarks Study *Educational Endowment Report*. (In light of the history-making volatility that convulsed markets and heightened risk awareness on the part of investors, it is not surprising that "second opinions" were much sought-after in FY2009.) The year-over-year increase was driven largely by smaller endowments. While institutions with assets under \$25 million reported using consultants in FY2009 at a rate below the overall Study average, 62 percent, that rate tripled in just one year.

It's also important to determine why one wants to use a consultant and what an institution expects the consultant to deliver. Again turning to the 2009 NCSE, data show that 86 percent of Study participants used consultants for asset allocation and rebalancing, unchanged since the previous year. Eighty-four percent used consultants 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. The category showing the most change was outsourced investment management, where 29 percent of respondents reported using consultants versus the previous year's 19 percent. Data rose across all size categories for this type of consultant activity, even among the largest endowments with assets in excess of \$1 billion, where it increased to 9 percent from 6 percent. The largest increase occurred among the smallest endowments, those with assets below \$25 million, where it jumped to 48 percent from 29 percent.

The Outsourced Investment Management Office

Another model is that of the outsourced investment management office, and the data cited in the preceding paragraph indicate that it is growing in acceptance. In this approach, the investment committee and board assign responsibility for day-to-day 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?

A close relative is the “outsourced CIO” model. A number of fairly well-known CIOs have left their positions at nonprofits over the last few years and set up their own outsourced CIO business. They have attracted a lot of attention and, in some cases, substantial capital.

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 relationship. The adviser may implement the asset allocation/rebalancing or may recommend subadvisers to manage various allocations within the portfolio.

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. A potential drawback 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.

Part V

Summary

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 in 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." This is increasing the trend among some thought leaders in the nonprofit world favoring the establishment of a governance committee alongside other standing committees.

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. Hence, 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.

Those responsible for nonprofit investment management may want to start by: 1) Reassessing their organization's governance structure and processes to determine if they add value to their investment policy statement—or actually inhibit it; and 2) Having a frank discussion about available human and financial resources to determine if they are adequate "to steer" the organization over the next 20 years. If your organization is not satisfied with where it is today, it is likely to be even more dissatisfied in the future—unless it does something different.

Appendix I

About the Author

John S. Griswold

John S. Griswold is Executive Director of Commonfund Institute (see the following paragraph for further information about the Institute). He joined Commonfund in 1992 as head of Client Services. Griswold initiated and supervised the Commonfund Benchmark Studies,[®] which are separate annual studies of the investment performance and governance practices of educational endowments, foundations, operating charities and nonprofit healthcare organizations. More recently, he led the Institute to team with the National Association of College and University Business Officers (NACUBO) to produce the first NACUBO-Commonfund Study of Endowments[®] (“NCSE”). In addition, he supervises and speaks at Commonfund’s annual Endowment Institute and Commonfund Forum as well as at monthly Trustee Roundtables and nonprofit investor conferences in the U.S., Canada and Europe. A member of numerous nonprofit boards of trustees, he graduated from Yale University.

Appendix II

About Commonfund Institute and Commonfund

Commonfund Institute

Commonfund Institute houses the education and research activities of Commonfund and provides the entire nonprofit community with investment information and professional development programs. Commonfund Institute is dedicated to the advancement of investment knowledge and the promotion of best practices in financial management. In addition to teaming with NACUBO to produce the NCSE, Commonfund Institute provides a wide variety of resources, including conferences, seminars and roundtables on topics such as endowments and treasury management; proprietary and third-party research and publications, including the Higher Education Price Index (HEPI); and events such as the annual Commonfund Forum and Commonfund Endowment Institute.

Commonfund

Founded in 1971, Commonfund is devoted to enhancing the financial resources of educational and other nonprofit institutions including endowments, foundations, healthcare and service organizations through superior fund management, investment advice and treasury operations. Directly or through its subsidiaries—Commonfund Capital, Commonfund Realty, and Commonfund Asset Management Company—Commonfund manages approximately \$25.5 billion for approximately 1,580 nonprofit educational institutions, foundations, healthcare and other nonprofit institutions. In response to the growing needs of nonprofit institutions, Commonfund, together with its subsidiary companion organizations, offers more than 30 different endowment investment programs. All securities are distributed through Commonfund Securities, Inc. For additional information about Commonfund, please visit www.commonfund.org.

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