



Creating a Successful Long-Term Investment Program for Not-for-Profit Organizations

Oversight of endowment funds for not-for-profit organizations falls to the board of directors, and most typically is carried out by a finance or investment committee. While some boards may direct their own investments, a far more common approach is to delegate decision-making authority to one or more professional investment managers in order to reduce the fiduciary burden of board members. In this scenario, the investment committee attempts to identify and hire the right managers considering various criteria, usually giving significant weight to historical investment performance. Typically, the retained managers are fired when they fail to outperform their benchmarks and a search begins for new managers to replace the outgoing managers. This costly and time-consuming cycle of chasing performance often leads to subpar investment results and frustration for board members and management. There is a better, and more efficient, way to implement a systematic investment process using measurable criteria, besides past performance, which increases the odds of achieving the long-term investment objectives.

Responsibilities

Directors and officers of not-for-profit organizations are fiduciaries with respect to their duty of overseeing investment portfolios, as stipulated in New York's Not-for-Profit Corporation Law (NPCL). Accordingly, directors and officers are bound to duties of prudence and loyalty. They are also obligated to obey special restrictions such as those imposed by law or donors, as well as the charity's own constraints. What does it mean to act with prudence and loyalty? At the most basic level it means to not make decisions without adequate knowledge and deliberation, and to be honest. Specifically, NPCL holds that directors will be held to the standard of the so-called "prudent person" who finds himself in similar circumstances. While that may sound subjective, there are a couple key actions directors can take to help ensure they are fulfilling their fiduciary duty. One is to have a thoughtful, updated investment policy statement (IPS) and two, make sure the portfolio is adequately diversified to reduce risk. The NPCL states: "a governing board shall consider...the long and short term needs of the corporation in carrying out its purposes, its present and

anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions." All of these items may be addressed in the IPS and revisited regularly to be sure the board acts in compliance with NPCL.

After the IPS is written, there are other factors to consider that can help increase the odds of a successful long-term investment program. These include reducing costs, eliminating unnecessary trading in the portfolio, making sure managers adhere to their mandate, and a decreased reliance on historical performance records when hiring managers. While not required by law, implementing these ideas could result in significantly improved long-term investment performance.

Part I: The Investment Policy Statement, An Essential Tool

An IPS defines a disciplined and acceptable investment philosophy and articulates the investment management procedures as well as the long-term goals of the investment portfolio. The IPS becomes the guide for current, and more importantly, future board members. It also serves as a rulebook for investment managers that may be retained. A good IPS will help ensure the continuity of the investment program despite board, management, or investment manager turnover. This is a key point since investment programs are much more likely to be successful if they are executed consistently over long periods of time. The IPS also protects against ad hoc changes to the investment strategy when they are most likely to occur: during times when short-term market movements may be distressing and emotional reactions are likely.

The development of an IPS follows the basic approach underlying financial planning: assessing the current financial condition of the organization, identifying objectives for the fund, developing a strategy to achieve the objectives over time, implementing the strategy, regularly reviewing the results, and adjusting the strategy as circumstances (not market fluctuations) dictate.



Setting Objectives

The typical IPS includes background information on the organization, which should include its mission and short-term and long-term objectives. This will tie into investment objectives, which should be specifically and clearly laid out in the IPS. An example of a typical objective might be: "achieving a return, net of all fees, of 8% annualized over a full market cycle." However, this might not line up with the objectives of the organization. Why was 8% selected as a goal? A more descriptive objective could be:

To meet the current operating demands of the organization, as described in the spending policy, while continuing to maintain the purchasing power of endowment assets to ensure future needs of the organization will be satisfied.

Given the spending policy of 5% annually, and assuming an annual inflation rate of 3%, a long-term annualized return of 8%, or better, over a full market cycle is required.

Thus the primary goals would be income to meet current spending needs and principal protection and capital appreciation to meet future spending needs (these will be key considerations when developing an asset allocation plan). Of course investment objectives will vary with each organization.

Investment constraints are also important to achieve the investment objectives of the organization. Risk tolerance, time horizon, liquidity needs, special restrictions or regulations, and prohibited investments are specific to each organization and should be explicitly discussed in the IPS.

Asset Allocation: Balancing Risk and Return

Asset allocation is one of the most important sections of the IPS and probably the most important consideration in the overall investment program. Asset allocation, or the mix of investments targeted within the portfolio, is how you control risk and optimize return, and will largely define the return characteristics that can reasonably be expected over the long term. For example, if the investment objective requires an annualized return of 8%, an allocation of 100% bonds is unlikely to get the job done. Ideally, the portfolio will achieve the return objectives with the least amount of risk.

Modern Portfolio Theory (which isn't really that modern, since it was developed in the 1950s) tells us the way to achieve maximum returns with minimal risk is through diversification. For example, it may seem that a portfolio of all bonds would pose the least amount of risk. However, including a modest allocation to stocks in an otherwise all bond portfolio can actually result in superior returns with less volatility. The main point of modern portfolio theory is that investments shouldn't be judged on their own merit, but rather on how they affect the risk and return characteristics of the overall portfolio. Commodities, for example, are generally considered a high-risk asset class. However, because their returns are largely

uncorrelated to the returns of stocks and bonds, the inclusion of commodities into a stock and bond portfolio can actually reduce risk.

The idea of reducing risk by investing in various asset classes is known as diversification. Effectively, don't put all of your eggs in one basket. Therefore, your IPS should include targets and acceptable ranges guiding how much of the portfolio may be invested in each specific asset class. A simple asset allocation plan might look like this:

	ACCEPTABLE RANGE		
Asset Class	Target	Low	High
Stocks	65%	60%	70%
Bonds	27%	23%	30%
Real Estate	5%	2%	7%
Cash	3%	0%	5%

The IPS should also include targets and ranges for sub segments of each broad asset class. For example, how much of the stock allocation will go to international stocks versus domestic stocks? The allocation to sub segments of the stock market can have a big impact on expected returns. How much is invested in small-cap stocks versus large-cap stocks and growth stocks versus value stocks can significantly alter the long-term expected return and risk profile of the portfolio. Asset allocation modeling, best accomplished with the help of an investment manager or consultant, can guide the board in determining how the investment funds should be divided among the various asset classes and sub segments.

Choosing the Right Benchmark

Finally, how the portfolio will be monitored and benchmarked should also be addressed in the IPS. Expectations of how investment managers will report investment performance and the frequency of reporting should be included. However, the more important piece is specifying the benchmarks to be used. Let's say a small-cap manager achieved returns of 11.0% annually over the past ten years. Is that good performance or not? In order to properly analyze performance, we need to measure the performance against a benchmark of how well smallcap stocks in general performed. Using the Russell 2000 index as a benchmark, the manager performed quite well, as the Russell index earned 10.2% annually over the past 10 years. However, the S&P 600 Small-Cap index returned 12.6% over the same period, making the manager's results less attractive. So, if an organization blindly selects a benchmark, such as the Russell 2000, merely because it is popular, sub-par managers may be retained and optimal returns may not be achieved. Understanding the strengths and weaknesses of the various market indices can help enhance returns by making sure managers are held to a high standard.

After the IPS is drafted it should be approved by the full board. Then it needs to be reviewed annually to ensure it adequately reflects the current circumstances and objectives of the organization and the fund. If circumstances change, such as losing a major funding source, the IPS may need to change. However, all changes should be made for the right reasons. Making changes to the investment strategy because of short-term market fluctuations is akin to market timing, a practice discredited by numerous studies.

Part II: Characteristics of a Successful Investment Program

Once the IPS is approved, it is time to put an investment program into place. This will involve selecting one or more managers and conducting a request for proposals. Fortunately, with the IPS as a guide, making these decisions should be a more systematic process. Here are some characteristics to consider:

Investment Costs

Vanguard founder John Bogle notes that when it comes to investing, “you get what you don’t pay for”. That is, you end up with the gross investment return minus fees. So, if you aren’t paying high fees, your return should be higher. While that may sound obvious, what is less obvious is the significant impact fees and expenses can have on long-term investment returns. A number of academic studies have attempted to figure the total all-in costs for a typical investment portfolio. Clearly there are the explicit manager fees, but there are also a host of hidden costs to investing. These include brokerage commissions, losses because of securities bid/ask spread, market impact costs, and cash drag (see sidebar for a description of these costs). The sum of these costs has been estimated to be somewhere between 2% and 4% annually. If we assume a balanced portfolio has a long-run expected return of 9% annually, that all-in fees amount to 2%, and that inflation is 3% each year on average, then the investor bearing the risk to participate in the capital markets receives a net real return of only 4%, or less than 50% of the gross market return. Minimizing fees and other investment expenses is of the utmost importance to help make sure your portfolio has the best chance of achieving your long-term return objectives.

Portfolio Turnover

A good way to gauge the efficiency of a portfolio and to make sure that costs are minimized is to look at portfolio turnover. Turnover is generally presented in the form of a percentage and gives the portion of the portfolio that is traded each year. For example, if a \$100 million stock portfolio does trades with a principal value of \$50 million, the turnover that year would be 50%. The average turnover rate for investment portfolios currently exceeds 100%. At that level, a large amount of trading occurs, resulting in higher costs. Every time a trade is executed, brokerage commissions must be paid and bid/ask spreads and market impact costs are incurred. Just by implementing a long-term buy-and-hold philosophy, turnover can be reduced, costs can be minimized, and returns should improve.

Side Bar: Investment Costs

Manager fees:

These are the fees a manager charges to oversee your portfolio.

Brokerage commissions:

The cost a broker charges to execute a trade on your behalf. These can range from less than \$10 levied on trades by professional investment managers to several hundred dollars or more for small retail investors.

Bid/ask spread: This is the difference between what one pays to buy a security and what one receives upon the sale of a security at a given point in time. For example, the price to buy Microsoft shares differ from the price to sell Microsoft shares at any point in time by around \$0.01. For less liquid shares such as small-cap stocks or some international stocks, the bid/ask spread can amount to 5% or more of the value of your trade.

Mark impact cost:

When portfolio managers decide to take a large position in a fairly illiquid stock, the manager’s own buying can drive the price of the stock higher. Likewise, large-scale selling can drive the price of a stock down. This can have a large impact on the final average price an investor pays to purchase shares.

Cash drag:

Over long periods of time cash has returned just over 3.5%, while stocks have approached double-digit returns. Therefore, if a manager who is supposed to be holding stocks has a large cash position, long-term returns could suffer.

Style Purity

Style purity involves making sure your managers invest in what they say they will invest in. For example, the domestic large-cap stock manager should only buy domestic large-cap stocks. This may sound obvious, but “style drift” is very common. According to data provider Morningstar, the average domestic, large-cap stock investment manager held 4.0% of the portfolio in cash and 8.2% in international stocks at the end of May 2007. What this means is that if the investment committee specifies a 35% target for domestic large-cap stocks, the portfolio will likely be overweight in cash and international stocks, and underweight large-cap stocks relative to target. Over time this could have a significant adverse impact to achieving the investment objectives specified in the IPS.

Past Performance versus A Consistent, Repeatable Methodology

What if there was a method of predicting the stock market that had been right over 80% of the time going back to the late 1960s? Would you use it? The Super Bowl Indicator has such a track record. Supposedly if the team representing the National Football

Conference wins, the market will advance. If the team representing the American Football Conference wins, the stock market will decline. The startling accuracy of this measure has been the subject of much discussion. However, this is a perfect case of correlation without causality. Clearly a relationship exists, but it is merely coincidental. Football conferences and the stock market do not have any concrete economic link that causes them to move in tandem. This principle is a good one to keep in mind for less obvious cases. The Securities and Exchange Commission of the Federal Government mandates that managers footnote their performance with the warning: past performance is not indicative of future returns. This is done for a reason. There is scant evidence that past winners continue to outperform. In fact, the opposite is generally true. Managers who have outperformed their benchmark have a statistical likelihood of underperformance in the future. Accordingly, when searching for a manager, investment philosophy and process are much more important than past performance. Managers should be selected because they employ a consistent, repeatable methodology in all market environments.

On-Going Responsibilities

After investment managers are hired, you must monitor implementation and performance. Semiannual or quarterly reviews are probably the norm. Because even the selection process can be tedious, some organizations hire a consultant to review advisor applications. Selection of the consultant also requires prudence but the level of investigation is necessarily reduced. The investment committee should ensure the managers are rebalancing to target and not influenced by the fear or greed environment of the marketplace. Trimming back outperforming managers or asset classes and reallocating assets to underperforming managers or asset classes may sound counterintuitive, but it is an easy way to instill a "buy low, sell high" discipline. Most committees focus on investment performance when monitoring their managers, but making sure the asset allocation is on target, that holdings are consistent with the managers' style, and that portfolio rebalancing is being carried out efficiently are much more important.

Conclusion

The creation of a disciplined investment policy statement is essential to protect board members in the event of a lawsuit and also to help ensure the investment program has the best opportunity of achieving its objectives. Beyond that, focus on the details, such as fees, portfolio efficiency as determined by turnover, holding managers to their stated mandate, and by all means, don't

be fooled by past performance. Interestingly, many organizations that spend a lot of time fundraising spend very little time making sure their investment portfolio is invested in an efficient manner. Making cost saving changes within an investment portfolio is much easier than identifying new donors. Saving just 1% on each \$1 million of portfolio value will result in \$10,000 annually in incremental value in the investment fund. Remember, most managers incur total expenses of at least 2% annually.

There are many ways an investment committee can ensure solid portfolio design without doing a lot of footwork. The first is to hire a consultant. There are firms that will work with the investment committee to write an IPS (or to enhance an existing IPS), create an appropriate asset allocation plan, and implement a comprehensive investment program. In addition, the committee may want to consider using index funds rather than active money managers. An index-based investment philosophy will result in low costs, minimal trading, style purity, and a consistent, repeatable methodology.

[Editor's Note: Whatever investment strategy your organization employs, a well-informed investment committee with access to knowledgeable resources is the clear winner in crafting and implementing an effective investment policy statement.]



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