



Investing for Nonprofit Endowments, Foundations and Donor- Advised Funds

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Investing for Nonprofit Endowments, Foundations and Donor-Advised Funds

- I. Current Climate
- II. Direct Impact on Endowments and Foundations
- III. Direct Impact on Donor-Advised Funds
- IV. Implications for Advisors
- V. Looking Ahead

I. Current Climate

Current Climate

- Amidst the turmoil of the past year, several themes have emerged and remain at the forefront of investor concern including

Volatility

Liquidity

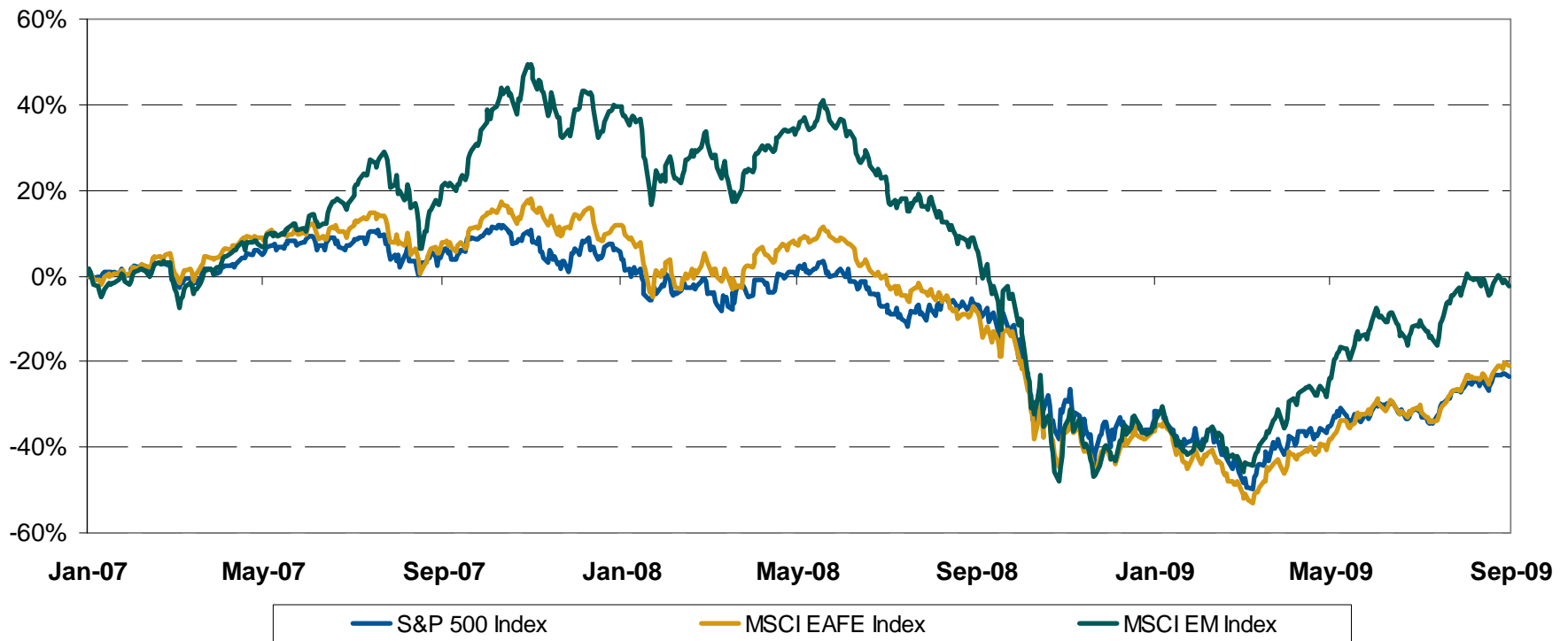
**Complexity and Proliferation
of Investment Choices**

**Risk and Return
Expectations**

Scandals and Transparency

Performance of Major Equity Markets

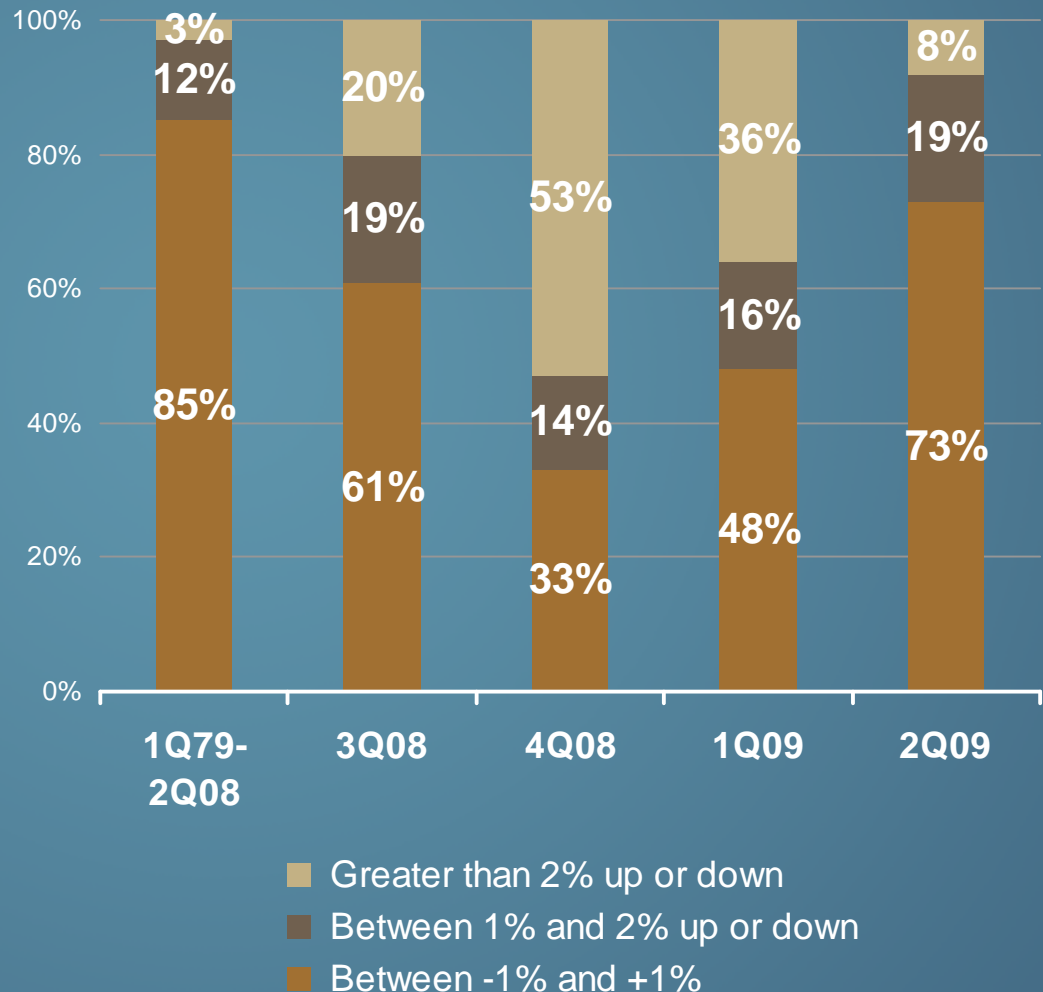
Major Indices Comparative Total Returns



Source: S&P, MSCI

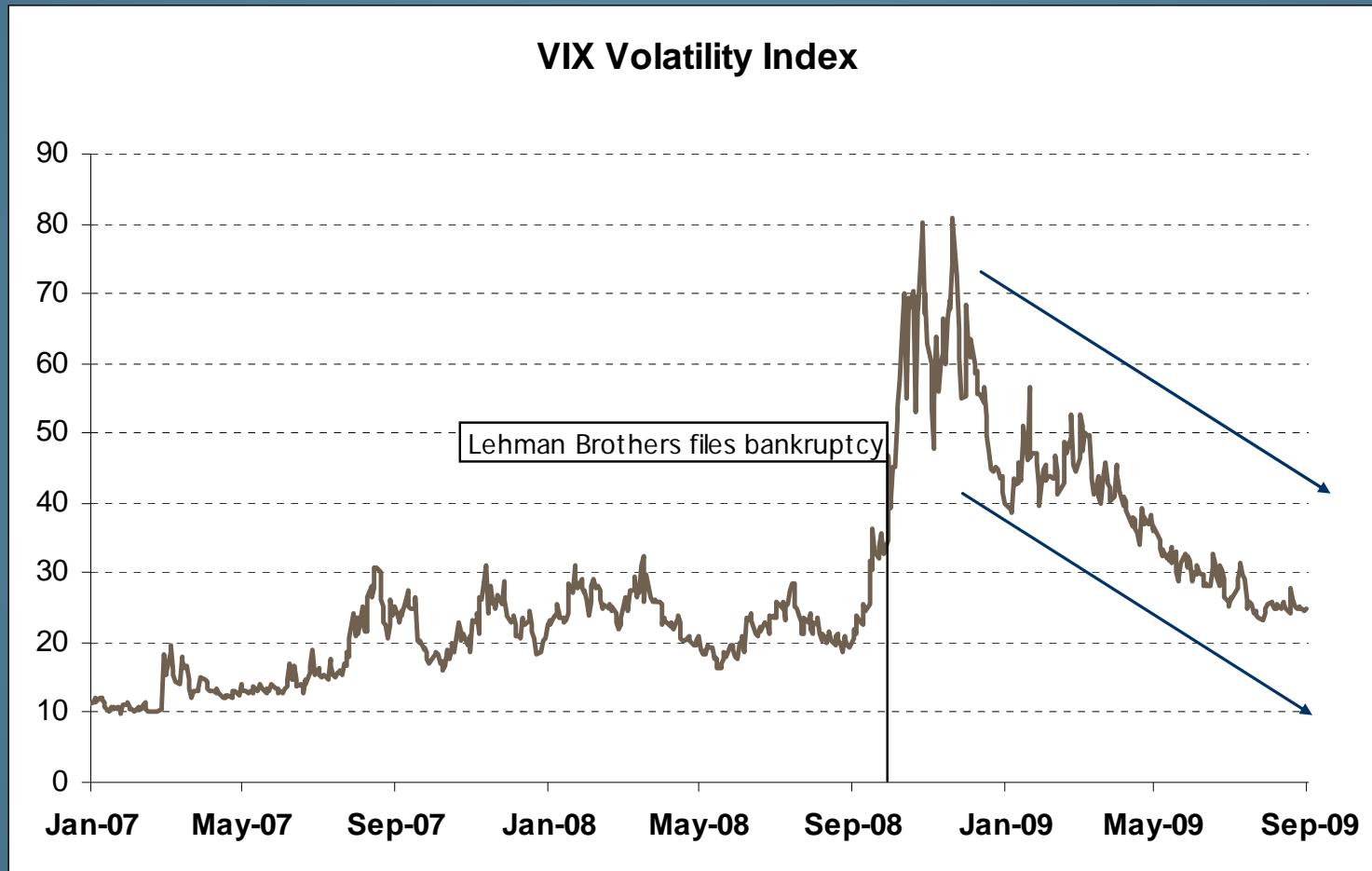
Dramatic Volatility in Global Markets

- During the period from January 1979 through June 2008, the S&P 500 only experienced moves of more than 2% (up or down) on 3% of days as compared to 53% of days in 4Q08



Source: S&P

VIX Peaked in November



Source: CBOE

Note: The VIX index is an index of implied volatility on S&P 500 index options

Liquidity or Lack Thereof....

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"I'm sure you recall the penalty for early withdrawal."

Liquidity or Lack Thereof...

Investment Managers

- Some investment managers found an asset/liability mismatch when faced with large redemptions
- Those with leverage tended to be impacted more greatly
- Techniques employed to stem the outflows include
 - Gates
 - Sidepockets
 - Liquidating pools
 - Fee concessions

Liquidity or Lack Thereof...

Endowments

- Endowments have experienced significant draw-downs
- “Denominator effect” results in outsized allocations to private investments
- Pursuit of creative solutions to alleviate liquidity issues
 - Sales of private equity investment portfolios
 - Sales of other assets
 - Accessing capital markets

Evolving Investment Landscape

- Proliferation of investment opportunities exists
 - Across asset classes
 - Globally
- Increasingly difficult to evaluate and distinguish amidst quickly changing and complex investment options
- Due diligence requires greater expertise and time commitment
- Global perspective is essential

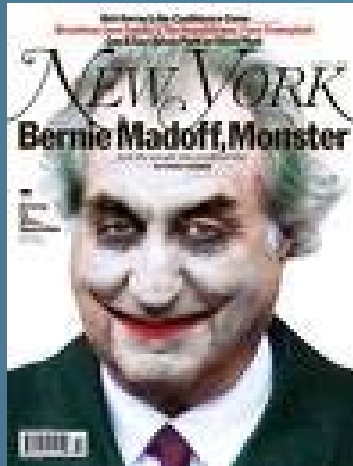
Risk and Return Expectations

- Investment risk and return expectations are being re-evaluated and a deeper understanding of underlying drivers of value is required
 - Volatility: Risk vs. return trade-off
 - Appropriate capital base and liquidity to weather significant short-term volatility
 - Duration of opportunity
 - Balance appeal of high short term tactical returns with re-investment risk
 - Underlying exposure: Greater granularity
 - Impact of leverage
 - Illiquidity premium: Investors must be significantly compensated for illiquid capital

"If it's too good to be true..."

- Scandals have rocked the investment world over the past year and have spanned both the corporate world and Wall Street

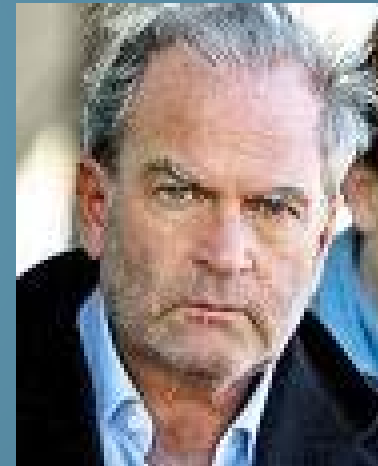
Bernie Madoff



Satyam



Marc Dreier



- Investors ranging from small individuals to sophisticated endowments to hedge funds have been impacted by these schemes

II. Direct Impact on Endowments and Foundations

Current Climate Impact on Endowments and Foundations

- Operational challenges
- Investment policy reevaluation
 - Spending policy
 - Objectives and guidelines
 - Asset allocation
 - Governance
- Heightened scrutiny of investment decisions

Operational Challenges Due to Budget Constraints

- A sizeable percentage of the operating and/or grant-making budget is often funded by the investment pool
- With declines in these pools, endowments and foundations are
 - Cutting budgets
 - Establishing hiring freezes or reducing staff
 - Curtailing expenses (e.g., grant-making, financial aid)
- Reduced donations and more requests for financial aid and grants in difficult markets compound these challenges

Revisiting the Investment Policy Statement

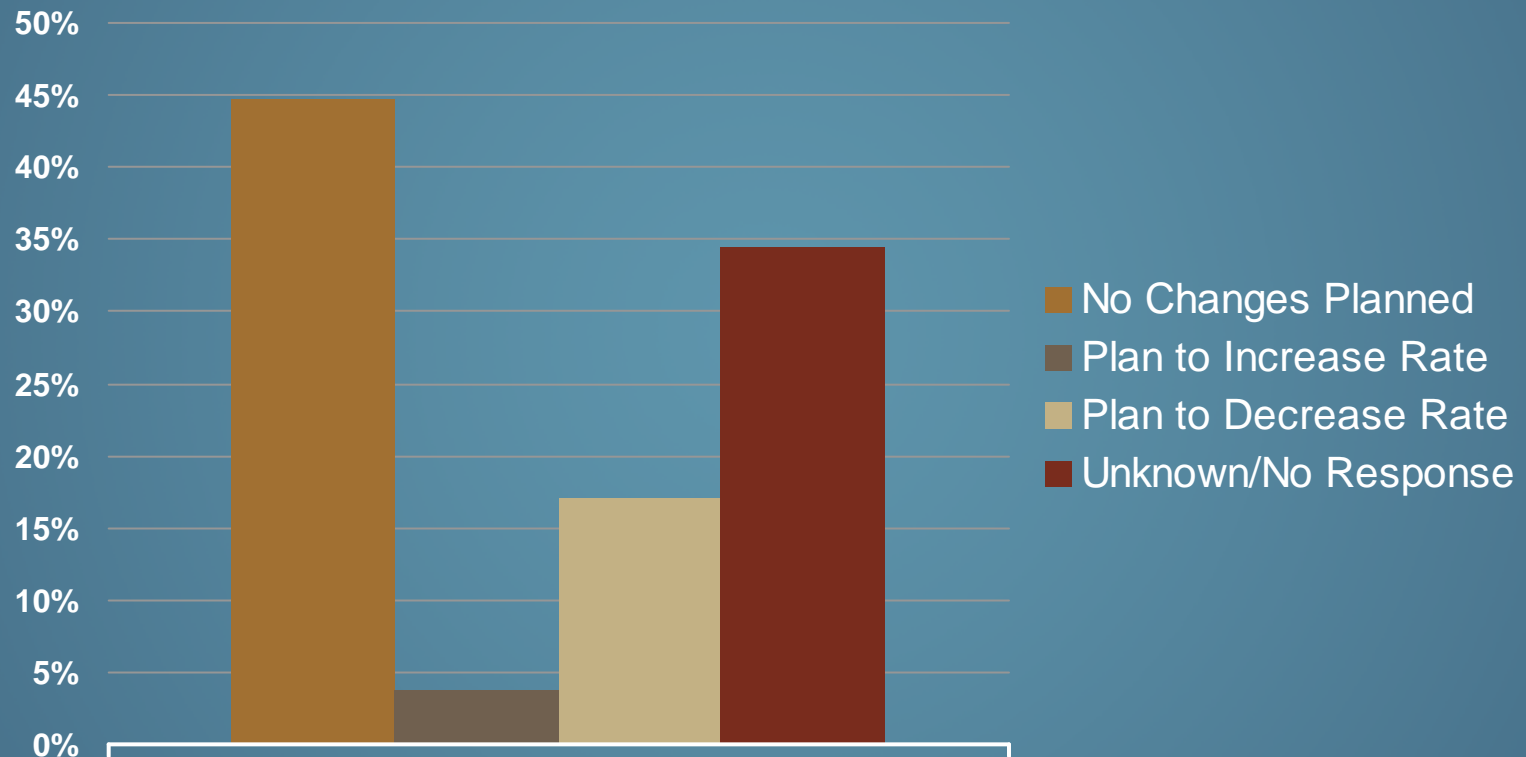
- An investment policy statement provides the framework for investing and defines important roles and responsibilities
- Critical elements are under review
 - Spending policy
 - Objectives and guidelines
 - Asset allocation
 - Governance

Spending Policy and Intergenerational Equity

- Spending policies define an institution's choice to balance the needs of past, present and future generations
- Intergenerational equity requires consideration of short-term needs and long-term asset preservation
- The current market environment has tested these two competing objectives
- Flashback two years ago, Congress was arguing that payouts were too low and universities were stockpiling money; now that concern has changed

Spending Policies Open for Debate

PLANNED CHANGES TO SPENDING RATES FOR FY2010



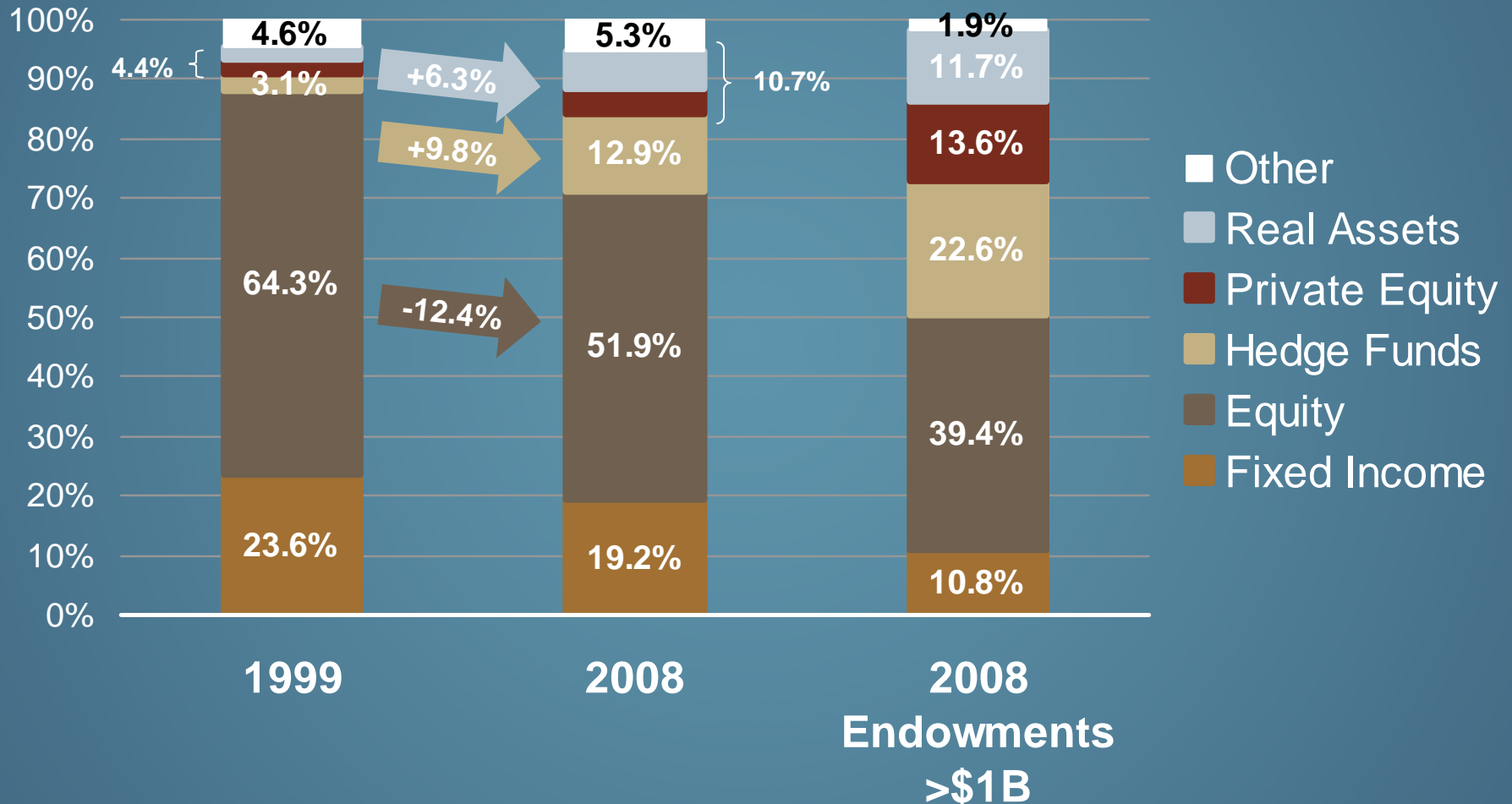
Source: NACUBO-Commonfund Endowment Study, Follow-Up Survey, Nov. 2008

Investment Objectives Subject to Constraints

- The investment objective defines an investment return goal for an organization and is impacted by constraints
- Key constraints faced by institutions
 - Spending policy
 - Percentage of operating budget funding the institution
 - Predictability of cash flows
 - Time horizon & liquidity
- As these constraints come under pressure, the ability to fulfill objectives is challenged

Asset Allocation Transition

HISTORICAL ASSET ALLOCATION FOR ENDOWMENTS



Source: 2008 NACUBO Endowment Study

Key Lessons of Asset Allocation

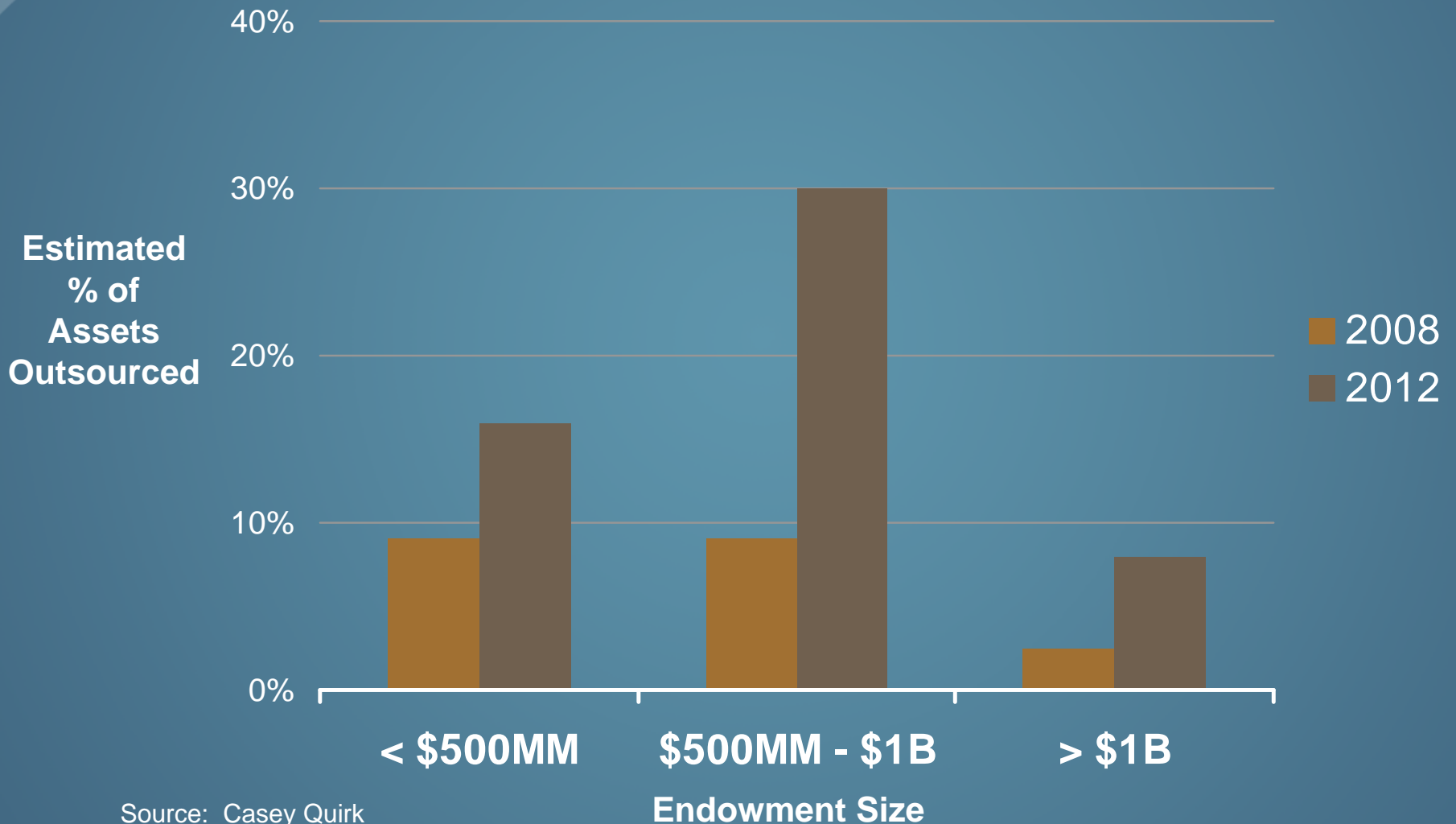
- Asset allocation provides the framework to achieve the investment objective
- Key lessons and considerations
 - Appropriate liquidity is paramount
 - Illiquid investments should generate a sizeable premium
 - True diversification must be an investment goal
 - Leverage should be evaluated carefully
 - Flexibility is valuable
 - Each Investment Committee should follow its own path

The Decision-Making Challenge

- Today's complex environment renders governance more challenging than ever before
- Structures vary from internal CIO and staff oversight to fully outsourced solutions with variants in between
- Fiduciaries are reevaluating their current governance structure and, in some cases, contemplating changes
- Ineffective decision-making can lead to paralysis
- There is no one right solution

Rethinking Roles

Expected Growth of Outsourced Nonprofit Assets



Source: Casey Quirk

Why Use an Outsourced Investment Advisor

- Enhances the ability of the Investment Committee to maintain a long-term strategic orientation when the “real time” decision-making is thoughtfully delegated
- Provides collaborative opportunity for the advisor to leverage the insights and specific expertise of the Investment Committee members
- Allows for proactive, tactical responses to rapidly evolving market dynamics

The Bar Has Been Raised

- Heightened scrutiny on all investment decisions
 - Transparency and disclosure
 - Liquidity terms
 - Return expectations and risk
 - Fee structure
- Higher standards apply to all participants
 - Advisors
 - Investment committees
 - Investment managers

III. Direct Impact on Donor-Advised Funds

Appeal of Donor-Advised Fund Increased in Current Market

- Donor-advised funds offer advantages to private foundations for smaller and mid-sized pools of charitable capital
 - Upfront tax deduction
 - Cost advantaged
 - Administrative ease
 - Privacy
 - No minimum distribution requirements
- These advantages are more pronounced in today's market environment
- Demand is growing, especially among larger pools of capital

Investment Choice Expansion

- Recent growth in donor-advised funds has fueled demand for further enhancements to investment options
- Investment advisors are gaining the ability to manage charitable assets in largest donor-advised funds and desire ability to construct multi-asset class portfolios
- Key areas of interest and new options include

**Socially
Responsible
Investments**

**Asset
Allocation
Vehicles**

TIPs

The Challenge of Implementation

- High payout rates, recent value declines and heightened scrutiny on investment decisions provide strong tailwinds to drive for greater variety of investment options
- Challenge that emerges is balancing the goals and responsibilities of multiple audiences
 - Advisors and donors desire expansion of investment options both within existing asset classes and to include a broader range of alternative assets
 - Donor-advised fund administrator as fiduciary must judiciously and carefully expand allowable investments

IV. Implications for Advisors

Drivers of Success Today

- Investment success, experience and conviction continue to be key attributes for advisors
- Today's focus includes

Increased Transparency

**Greater Accessibility and
Accountability**

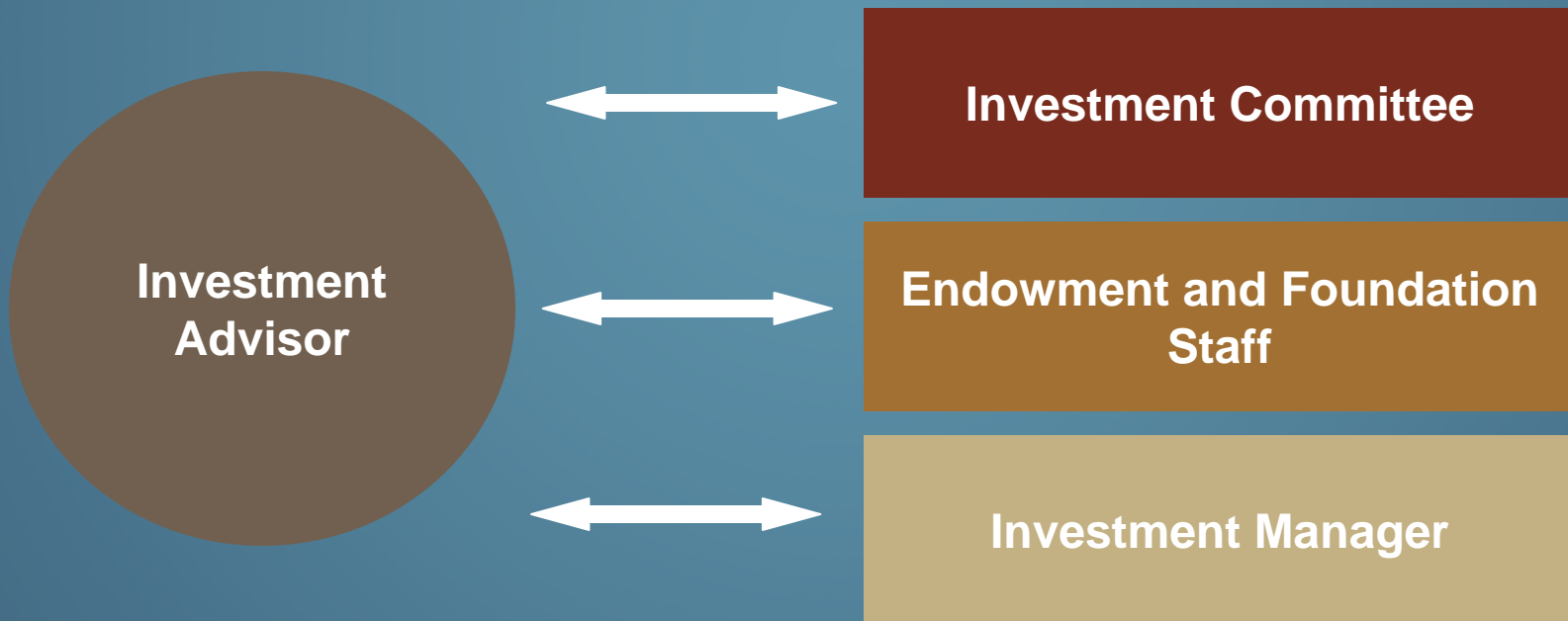
Enhanced Risk Management

Organizational Stability

Customization

Differentiate through Flexibility

- As decision-making models evolve, flexibility in working with multiple audiences is essential
- Proactive engagement and partnership will differentiate top investment advisors



Attributes for Outsourced Advisors

- As the need for an outsourced or partially outsourced investment advisor increases, those who can fulfill this role will benefit
- Essential elements of the outsourced model
 - Global scale and access
 - Ability to customize
 - Client advocacy
 - Exceptional due diligence
 - Conflict-free business

V. *Looking Ahead*

Evolving Landscape

- Investment model will continue to evolve as investors recover from the past year
 - Investment policies
 - Asset allocation
 - Liquidity assessment
 - Decision-making process
- Higher governance standards
- Regulatory developments will continue to emerge

Due Diligence – Tougher Questions

- Investment strategy
 - Defined vs. actual: Lower tolerance for “drift”
- Liquidity
 - Stated terms vs. characteristics of underlying portfolio
- Fees
 - Importance of aligning incentives and understanding implications for managers during drawdowns
- Team
 - Understanding role, impact and potential distractions of each person
- Risk Management
 - Systems, firm culture, potential conflicts of interest

Expectations for Asset Managers

- Remain forward-looking to adapt to evolving policy and regulatory changes
- Increase transparency and improve communications
 - Develop capabilities to provide appropriate level of information tailored to individual investor needs and interests
- Review investment terms and update policies to best match strategy of underlying investments

Be Nimble but Faithful to Key Principles

Investment Advisors & Investment Committees

- Appropriate investment policies and asset allocations
- Evolving performance evaluation metrics
 - Shift towards absolute return vs. relative performance on benchmarks
 - Fulfillment of intended role and differentiated return pattern within portfolio
- Effective decision-making for hiring and firing managers
 - Avoid paralysis!
- Suitable liquidity and flexibility to invest strategically in dynamic markets