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INVESTING APPROACHES FOR

endowments and foundations

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There has never been a more difficult time to be a trustee of an endowment or foundation. The performance of the markets in the past year has had a dramatic impact on these pools, and questions swirl about the validity of the "endowment model" of investing. Trustees are acutely aware of the numerous challenges in overseeing an investment portfolio including unprecedented market volatility and government interventions. The events of the past two years have thrown the challenges facing Investment Committees of foundations and endowments into sharper relief, and Investment Committees can expect to continue to operate in an environment of increased market risk, a proliferation of investment choices, and the additional complexity of investing globally.

As fiduciaries, Investment Committees also find themselves operating in an environment which has featured several extremely damaging and embarrassing frauds. The burdens of both initial and ongoing due diligence have increased as have requirements for continuing assessment of risk and risk management systems for the charitable pool's investment portfolio and that of underlying managers. New requirements for audit and other monitoring have created additional layers of cost and frictions. Investment Committees are also re-visiting the spending formulas pursuant to which the endowment contributes to the institution.

Each charitable investment pool is unique. Pools differ in many aspects including size, duration, whether further donations can be counted upon or not, or whether spending or granting purposes are tightly restricted or not. The time horizon of various institutions can vary from a virtually "perpetual" one to a quite short horizon based on the mission of a non-profit to spend itself out of existence in a defined period. Investment Committee structures differ as well. Investment Committees can be large or small; they can be quite distinct from the Finance Committee of the Board or a sub-committee of the Finance Committee. The investment skills of Committee members vary dramatically as does the level of engagement of committees. However, whatever the nature of the charitable investment pool or of a Board's Investment Committee, at the core of the Investment Committee's task is the question of how to manage the assets of an endowment to generate the best possible returns and fulfill the fiduciary duties assumed by the Committee. Finally, it is critical for the Investment Committee to be well integrated with the broader institution to ensure that there is a good alignment with broader institutional objectives, budget and other operating constraints.

In this challenging and complex environment it is not surprising that many non-profits are delegating or outsourcing a portion or all of their portfolios to investment advisors. Casey Quirk estimates that in the past four years fully outsourced assets have grown from $97 billion to $195 billion and that the outsourcing pool will grow to $510 billion by 2012, representing 13% of assets and 25% of investors.

Detailed below are some of the key questions that Investment Committees are discussing today:

What is the investment objective and what are the relevant constraints?

The investment objective defines an investment return goal for an organization and asset allocation provides a framework to achieve that investment objective. The most important test of an asset allocation plan is whether it is appropriately customized and designed to help an organization achieve its investment objective while staying within its constraints. For example, a foundation that is in "spend-down" mode will clearly have a different investment objective and asset allocation than a perpetual endowment that has annual inflows from new donations.

There are several ways for Investment Committees to think about investment objectives which serve to frame its goals. These typically include a relative performance measure in which the investment objective is to earn an average annual compound return that consistently exceeds median institutional performance for its peer group as well as an absolute performance measure where the investment objective is to meet an x% distribution requirement, plus y% to account for inflation and preserve "purchasing power."

Key constraints or defining characteristics that often are faced by Investment Committees and need to be factored into both objectives and asset allocations include:

- Calculation of spending rate
- Percentage of the operating budget of the organization that is expected to be funded by the endowment
- Predictability (or lack thereof) of cash flows into and out of the investment portfolio
- Time horizon and the amount of capital that can be deployed in illiquid investments

It is essential for Investment Committees to consider how different factors will interact in "perfect storm" scenarios. It is quite likely that in difficult investment markets an institution will also be faced with reduced annual fund support and more requests for financial aid.

What is the endowment model? Is that model of investing still valid? How should the Investment Committee think about asset allocation and investment decisions?

Like the term "hedge fund" the term "endowment investing" has come to refer to such a broad range of approaches that it requires further definition to be meaningful. Endowment investing, in its simplest form, is not one asset allocation or approach. Rather, it is based on the premise that an endowment's inherent advantage of a long time horizon may be maximized by creating a globally diversified pool of investments, including some which are illiquid.

In any investment environment, it is critical for endowments and foundations to make thoughtful asset allocation decisions. Below are some key lessons and considerations:

- *Appropriate liquidity is paramount.* During the recent crisis some investment pools were forced to sell investments at trough prices to fund short-term liquidity needs that could not be delayed. An appropriately sized liquidity pool allows investors to hold assets during periods of interim volatility. It is important that this liquidity pool is comprised of truly conservative investments, ideally Treasury Bills, rather than other assets that can create incremental risks, such as "cash plus" or corporate bonds. All Investment Committees need to have a clear understanding of the potential liquidity needs of their institutions in both benign and adverse market conditions. Illiquid commitments should be sized appropriately within these constraints. Further, a careful liquidity analysis upfront can spare a punitive forced liquidation in difficult markets. Some endowments may find it useful to create a segregated liquidity pool of relatively short duration to provide the institution with operational flexibility to meet several years of liquidity needs and to avoid having such short-term requirements unduly dominate or be "lost" within asset allocation.
- *Illiquid investments should generate a substantial premium.* It can be very beneficial for long-term pools to take advantage of their investing horizon by making long-term investment commitments. However, these illiquid investments should be expected to generate a substantial premium over more liquid alternatives. This concept will be important for a Committee to grapple with as past returns are no guarantee that prospective returns will

continue to generate a sufficient premium. The bar for new illiquid commitments should be quite high.

- *True diversification must be an investment goal*. During the past year, when all investments seemed to trade down in lockstep, it was critical to be able to have a more nuanced understanding of the underlying assets within investment managers' portfolios and to understand which losses were permanent and which were marked to market. Thoughtful diversification is a critical piece of any investment portfolio. However, investors should not be afraid of prudent concentration. Limiting the overall number of investments in a portfolio creates the potential to generate superior returns. Investors should build portfolios with real diversification by moving beyond labels and understanding what the underlying strategies imply on a granular level.
- *Leverage should be evaluated carefully*. Too frequently, leverage can lead to forced sales or liquidations at exactly the wrong time. Investment managers who employ leverage should be used judiciously and the terms of the managers' leverage must match the duration of their underlying assets. In some cases charitable pools have employed additional leverage at the endowment level. This "leverage on leverage" should be carefully analyzed, if not, in most instances, avoided.
- *Flexibility is valuable.* The best investment results are often achieved by retaining investment flexibility rather than being overly constrained by conventional asset class "buckets." Investment analysis and portfolio decisions must be constantly reviewed within the changing context of the marketplace to incorporate changes in market dynamics. For example, many of the interesting investment opportunities in credit today are with funds that are raising hybrid structures that live in between private equity and hedge fund formats. Investment Committees should give serious consideration to having a hybrid/ opportunistic allocation within their asset allocation so that they can invest with structures that defy easy categorization.
- *Each Investment Committee should follow its own path*. It can be difficult to break with peer institutions when making investment and policy decisions. Committees should not lose sight of their institution's particular objectives and constraints and should make decisions that are right for their institutions even if that means taking a different path from their peers.

Should the institution hire an internal CIO and staff to manage the investment pool or consider a full or partial outsourced investment solution?

As committees try to resolve the question of whether to hire an internal CIO and staff to manage the investment pool or to seek a fully or partially outsourced investment solution, a number of factors must be considered including: organizational culture, management capabilities and capacity, costs, investment and portfolio management skills, additional resources (administrative, accounting or otherwise) and the ability to customize.

In-house staffs often include a CIO, one or more investment professionals and several administrative support positions. Quite frequently, the in-house staff also retains and works with an investment consultant to provide greater coverage of investment landscapes and access to and evaluation of alternative investments like hedge funds or private equity. Historically, small and mid-sized endowments and foundations have found it quite challenging to recruit and maintain a highly professional investment team within a reasonable budget.

Investment managers require continuous monitoring and this oversight may be more effectively delegated to an outsourced advisor who can respond in real time to market issues as compared with a committee that meets infrequently. Outsourced investment teams usually benefit from a greater scale of assets to gain access to top tier managers, negotiate fees and terms and have the resources to continually monitor the global investment landscape. Because outsourced providers manage a significant amount of assets they typically have a substantial number of investment professionals.

Most providers of outsourcing solutions, whether consultants or CIOs, charge fees that range from 0.30 to 0.60%. Thus, for the Trustee of a charitable pool, an important question is whether the Board can run a fully staffed investment team, covering the breadth and depth of the global investment landscape, including alternatives, for a comparable cost. In many cases small and mid-sized charitable pools may be better served by hiring an outsourced CIO who will be fully accountable to the Board for the investment results. For many institutions, "hybrid" solutions where outside investment advisors work closely with an in-house Investment Director or Treasurer and the Investment Committee may be a good alternative.

Should an endowment appoint a CIO or hire a consultant?

The primary role of a consultant is to provide thoughtful data and analysis to decision makers so that they can make more informed choices. The primary role of a Chief Investment Officer is to make investment decisions and then be held accountable for those decisions by the Board. According to the 2008 NACUBO study, 79% of the largest endowment pools ($1B+) have a CIO and additional investment staff whereas fewer than 11% of the pools that are between $100 – $500 million have in-house CIOs. It is difficult to generate superior investment returns without a deep either in-house or outsourced investment team.

In the investment world, many charitable pools are evaluating whether they would be better served by having a CIO (in-house or outsourced) or a consultant rather than an in-house team. It is neither realistic nor practical for Trustees who typically have their own "day jobs" to serve as CIOs making individual manager decisions. Tactical portfolio decisions are not well suited to the typical quarterly schedule of Investment Committees. However, when organizations have Investment Committees that want to have a direct impact on the day-to-day management of investment portfolios, a consulting model will be a better fit.

If the Investment Committee hires a fully or partially outsourced CIO or investment advisor what are the key characteristics to look for?

- *Experience and Judgment* – The outsourced CIO should have a proven track record of investing and a well resourced investment team.
- *Accountability* – CIOs should be willing to own investment results and act as CIOs rather than act as consultants who provide data. The CIO is ultimately accountable to the Investment Committee.
- *Transparency and Partnership* – The outsourced CIO should have open and ongoing communication with the Board as well as transparency into the advisor's research and investment decision-making process. Clear reporting of manager performance, investment results, liquidity and other risk measures is essential.
- *Global Scale and Access* – An outsourced CIO should have a deep history of global, multi-asset class investing with a proven ability to source and access top-tier managers.
- *Investment Dialogue* – The outsourced CIO and its research platform should be able to provide a robust investment dialogue which gives context to the portfolio – ranging from

liquidity analysis to a particular investing segment or topic.

- *Customization* – Initially it may be most efficient for organizations to invest in a "one-stop-shop" commingled investment vehicle. However, as assets grow it is often preferable to have a CIO who also has the capabilities to build customized investment portfolios.
- *Advocacy* – The outsourced CIO should be working to get access to top-tier managers, negotiating fees and determining responses to amendments and other business developments at managers.
- *Risk Management* – The CIO should have deep experience in evaluating the risk management systems and procedures in place at each of the institution's investment managers.
- *Due Diligence and Heavy Lifting* - What separates the average investor from the exceptional is the maintenance of an uncompromised, disciplined approach, regardless of past intellectual or financial success. In investing, short cuts can often lead to missed opportunities or inappropriate investment conclusions. Though oftentimes tedious and redundant, one should look for an advisor who is always willing to do a complete and thorough job of investment diligence or "heavy lifting" prior to investing capital.
- *Conflict-Free* – The outsourced CIO should have a clear fee structure and a business that does not have conflicts.

If the Investment Committee hires an outsourced CIO how much discretion should be given to that CIO?

There is not a simple answer to this question that will work for all Investment Committees. A key piece of the solution is for the Investment Committee and the CIO to have clarity about roles and expectations. Investment Committees that prefer to give CIOs or investment advisors very limited discretion will probably be more comfortable with a consulting model, whereas Investment Committees that are comfortable allowing a CIO to have some discretion may be better served by full or partial outsourcing. Allowing a CIO to have some discretion does not undermine the key fiduciary role of Board Members, rather it allows them to focus on the long-term issues facing the endowment rather than getting mired in the details of manager-by-manager decisions.

Investment Committees in many cases find their ability to maintain a long-term, strategic orientation and to "dig deep" into the key questions of endowment investment policy enhanced by thoughtful delegation of "real time" decision making. The most recent NACUBO study indicates that almost half of the largest pools ($1B+) have already "outsourced" the decisions on hiring and firing of managers to their CIOs.

An outsourced CIO can also leverage the expertise of Investment Committee members, for example the CIO might organize a "credit subcommittee" to leverage the insights and perspectives of those Investment Committee members that have experience and insights in that area.

As acknowledged at the outset of this paper, it is a challenging time to be an investment fiduciary for a charitable organization. Investment Committees today must evaluate their investment objectives, asset allocations, staffing and structure against a backdrop of extreme market volatility, a wide array of investment choices and increasingly complex and time-consuming due diligence requirements. In these challenging times, Investment Committees are taking a fresh look at what investment decision making mechanism will best serve their organizations. Some Investment Committees will determine that their organizations are best served by a consulting model while other Investment Committees are concluding that outsourcing the CIO function allows their organizations to benefit from the larger global footprint of an investment advisor at a lower cost than creating a comparable investment platform in-house.

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