

Sage Advisory Services, Ltd. Co.
Mission Driven Investing
for
Foundations, Charitable Organizations
& Endowments

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Table of Contents

Non-Profit Institutional Funds – Purposes and Regulations 1

The Current Landscape and Industry Perspective 5

What Influences the Investment Process?.....10

Developing a Spending Policy.....12

Traditional Asset Management13


Mission Driven Investing and Advantages14

Mission Driven Investing Summary.....16

Appendix A – A Foundation Case StudyA-1


Appendix B - Sage Contact InformationB-1

Appendix C - DisclaimerC-1

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Non-Profit Organizations – a Quick Overview

- Non-governmental entity that is established as a non-profit corporation or a charitable trust
- Principal purpose is making grants to unrelated organizations, institutions or individuals for scientific, educational, cultural, religious, or other charitable purposes
- Several Types:
 - Public Charities and Supporting Organizations
 - Private Foundations
 - Donative or Non-Operating – solely provide grants
 - Operating – provide charitable services
- Diverse group of organizations that have varying regulatory obligations, funding processes, and spending needs

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The Current Landscape – Foundations

- Before 2007, the average Foundation, whether family, corporate, or community, had witnessed often positive annualized returns for relatively long periods of time
 - Large allocations to equities, international, and alternative strategies
 - Private and Independent Foundations led the charge, with Public Foundations remaining slightly more conservative

- During this decade, public interest in the tax free accumulation of funds put pressure on Foundations to increase spending ¹

- Flash forward to 2008 and the world has dramatically changed – Foundations experienced a 28% decline in the value of their assets over 2008
 - Portfolio allocation modification
 - Consultant and manager turnover ²
 - Increased pressure on ability to meet spending goals

- Additionally, Foundation giving is expected to have declined in 2009 ³

1. Time is of the Essence: Foundations and the Politics of Limited Life and Endowment Spend-Down, Thelin and Trollinger, the Aspen Institute, 2009
 2. Results of a Survey by the Council of Foundations, Second Edition, March 6, 2009
 3. The Foundation Center, Foundation Yearbook, 2009

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The Current Landscape – Educational Institutions

- Traditionally, the least restricted non-profit organizations, Educational Institutions expanded their exposure to alternative strategies during the past decade
 - Usually endowment funds – maintain the corpus first and foremost
 - **Yale Model** – pioneered the move recognizing that **liquidity came at a price** and that the long-lived endowment of Yale **did not need to pay for much liquidity**
 - Resulted in double-digit returns for many years

- For the 2009 fiscal year, the 842 colleges and universities surveyed in the NACUBO-Commonfund Study of Endowments experienced:
 - Average annual return of -18.7% (net of fees)
 - Average annualized 10 year return of 4.0% (net of fees)
 - Average spending rate of 4.4%
 - Average gift decrease of 45.7%

- Educational Institutions are now beginning to rethink their asset allocation process and spending policy to better combat future financial “hiccups”

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The Current Landscape – Nonprofit Hospitals

- “[Moody’s] expect hospitals that plan to use cash to fund capital will pursue a more conservative investment strategy that focuses on very limited downside risk in values and a very high degree of liquidity”¹

- During this decade, however, Hospitals and other healthcare providers sought to produce more investment revenue to reduce balance sheet operating liability by emulating the investment strategies of colleges, universities and foundations


- U.S. nonprofit health-care groups saw their combined average annual investment returns plunge 21.2 percent in fiscal 2008 – based on the Commonfund Institute’s analysis of 143 nonprofit hospitals

1. Not-For-Profit Hospitals Vulnerable To Investment Market Volatility , Moody’s, November 2007

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Industry Perspective

- 2009 Pyramis E&F Pulse Poll (conducted October, 2009)
 - Top two concerns are risk management and funding operating budgets**
 - Endowments ranked a low-return investment environment as top concern
 - Foundations ranked operating budget as top concern
 - Moving towards a factor-based asset allocation model (inflation, volatility, liquidity and interest rates)
- Fundfire Opinion – “An Old-School Approach to Lift Endowments” February 25th, 2010 by Lou Morrell, Managing Director at Wake Forest University
 - “Endowments exist, first and foremost, to provide both stability and a reliable income source to supplement receipts from tuition and fundraising.”**
 - Need to be responsible fiduciaries
 - Must be considered in light of the overall financial position of the institution – develop the line between risk management and risk avoidance

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The Road Ahead

- Foundations and other Charitable Organizations are now beginning to rethink their asset allocation process and spending policy to better combat future financial “hiccups”
 - Risk Management or Budget
 - Spending Policy Management
 - Tactical/Strategic Investment Decisions
- Mission Driven Investing** is a holistic approach to the investment process that many non-profit organizations are beginning to investigate
 - Essentially, once an organization understands the true cost of their mission, they can, with the aid of investment professionals, structure an appropriate, unique portfolio response specifically tailored to that mission
- In order to capture the mission, you must understand the institution

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Operating Nature Influences the Investment Process

<u>Saver Foundation</u>	<u>Investor Foundation</u>
<ul style="list-style-type: none"> Risk Averse Short-Term Oriented Yield Focus Ignore the effects of inflation Do-It-Yourself Approach to Investment Process Asset Allocation Heavily Biased Towards Fixed Income/Low Beta Equities 	<ul style="list-style-type: none"> Risk Tolerant Long-Term Oriented Total Return Focus Concentrate on “Real Return” Sophisticated Approach to Investment Process Asset Allocation Biased Towards Higher Beta Equities and Similar Risk Profile Investments

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You Know You're Not Yale When....

Many foundations and other charitable organizations spent the last decade mirroring the investment model of the Yale Endowment, without truly evaluating the appropriateness of the Yale model. In general, the Yale Model is not appropriate when:

- Your fund is **not an endowment fund**
- You have a **limited life or projected "spend-down"**
- You do not anticipate further receipt of gifts
- Your assets < \$10 million
- You are **required to spend 5% (due to tax considerations)**
- You have **specific spending obligations due to operational needs**

Developing a Sensible Spending Policy – Understanding the Mission

Need to identify an appropriate balance between:



Objective:

- Maintain a policy which sustains the **grant making goals** (i.e. capital utility) of the institution while promoting net real growth of the investment portfolio

Many Options to Consider: **Spending Levels, Contribution Levels, Inflation, Administrative Expenses**

Governing Priorities:

- Current spending and operating needs
 - Future spending objectives
- } **a.k.a. "Capital Utility"**

Traditional Investment Approach

- Establish "Policy Portfolio" based on long-term financial targets and return variability tolerance
- Assets are managed against an asset index, **not the organization's specific disbursements:**
 - Assets are allocated to match an "expected rate of return" or some "industry-wide standard" (e.g., the 60/40 portfolio)
 - Portfolios are built around asset index characteristics
- This approach is **misleading and inefficient:**
 - Not responsive to specific disbursement cash flows
 - Not responsive to particular client needs as a business or organization
 - Not responsive to disbursement "return" or growth rates



Mission Driven Investing

Step One:
Distribution & Cost Analysis
Understand the distributions/costs and construct a mission driven benchmark(s).

Step Two:
Risk Budget
Define objectives and risk tolerance, and set risk budget against this benchmark, taking into account policy constraints and funding strategy. Identify risk budget versus mission benchmark portfolio.

Step Three:
Asset Strategy
Create a portfolio that includes matching and return seeking assets. Optimize based on return expectations, assumed correlations and scenario analysis. Identify optimum asset policy within risk budget.

Step Four:
Implementation & Monitoring
As MDI is a dynamic strategy, proper implementation and monitoring procedures must be created to ensure that the plan portfolio continues to meet its benchmark, risk budget and return expectations.

Develop management strategies that incorporate a combination of approaches:

- Cash flow based
- Interest rate (Duration) based
- Time/Horizon based

Long-term requirements set alongside short- and medium-term objectives

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MDI Advantages

- Translate complex asset/disbursement issues into **balance sheet dynamics** and **"CFO-friendly" terms**
- Assess current structure of assets and disbursements and develop a **systematic means of meeting disbursements on an on-going basis**:
 - Term structure analysis and dynamic cash flow modeling
 - Interest and inflation rate sensitivities
 - Risk/return analysis
 - Deterministic and stochastic modeling of investment returns, spending projections, contributions, etc.
- Develop scenario analysis: market environments, cost of underperformance, spending policies
- Assumption sensitivity testing
- Implement desired investment strategy (optional)

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Mission Driven Investing Summary

Recognize the unique individual nature and mission of each institution

Perform an Asset/Disbursement Study – a dynamic "mission centric" method of analysis

- Identify desired operating expenditure objectives, projected liquidity needs, current and projected endowment support, as well as, management risk tolerances.
- Establish a comprehensive strategic financial management plan.

Implement a Mission Driven Investment Strategy

- Identify the distinct purpose or objective of each component of the mission invested assets
- Implement MDI to reflect the various purposes and objectives of each component of the mission

Monitor and revise after every Asset/Disbursement Study

- Develop a tool to evaluate and revise asset allocation and disbursement strategies

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