

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

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**May, 2010**

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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 Management.....13**


**Mission Driven Investing and Advantages .....14**

**Mission Driven Investing Summary.....16**

**Appendix A – A Foundation Case Study .....A-1**

**Appendix B - Sage Contact Information .....B-1**

**Appendix C - Disclaimer .....C-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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### Institutional Funds - Purposes and Restrictions

- Must consider operational needs of foundation or charitable organization when developing specific investment goals for funds
- Some Fund Types:
  - **Investment** – **expendable currently** and institution should identify investment criteria to accomplish charitable goals
  - **Endowment** – the most well known, essentially the assets in the fund are **not wholly expendable on a current basis (7% Rule in UPMIFA)**
  - **Program-Related Purpose** – must be spent for a **specific charitable purpose**
- Institutional Requirements
  - **Private Donative Foundations**, to maintain tax status, must **distribute 5%** of assets (based on 12-month average)
  - **Private Operating Foundations**, to maintain tax status, must expend substantially all of the lesser of its **net investment income or the minimum 5%** for its own charitable purposes (inside the charity)



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### UMIFA and UPMIFA – Increased Standards and Guidelines

	UPMIFA	UMIFA
<b>Investment Conduct</b>	<ul style="list-style-type: none"> <li>▪ Express cost management obligation</li> <li>▪ <b>Whole portfolio management standard of performance</b></li> <li>▪ Express diversification requirement</li> <li>▪ Portfolio rebalancing required</li> <li>▪ <b>Special skills standard of performance</b></li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>General obligation to invest prudently</b> using ordinary business care</li> </ul>
<b>Delegation of Investment Management</b>	<ul style="list-style-type: none"> <li>▪ Prudent delegation in good faith, care standard of prudent person</li> <li>▪ Agent has duty of reasonable care</li> <li>▪ Agent subject to court jurisdiction</li> <li>▪ Delegation to committees, officers or employees as authorized by other law</li> </ul>	<ul style="list-style-type: none"> <li>▪ Delegation allowed without express standards</li> </ul>
<b>Expenditures</b>	<ul style="list-style-type: none"> <li>▪ <b>Express prudent total return standard</b>, 7 factors:                             <ul style="list-style-type: none"> <li>- Fund duration</li> <li>- Fund/ institution purposes</li> <li>- General economic conditions</li> <li>- Inflation/ deflation effects</li> <li>- Expected total return</li> <li>- Other resources</li> <li>- Institutional investment policy</li> </ul> </li> <li>▪ <b>Optional, over 7% of total return presumed imprudent for Endowments</b></li> </ul>	<ul style="list-style-type: none"> <li>▪ Not appreciation may be spent for purposes of endowment</li> <li>▪ <b>Historic dollar value limitation on spending</b></li> </ul>

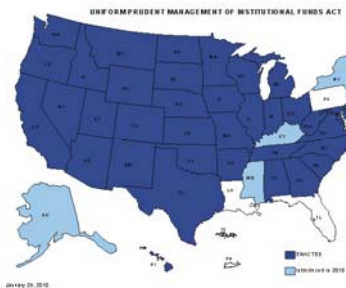


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### UPMIFA Enactment



Source: Uniform Law Commission, <http://www.upmifa.org/DesktopDefault.aspx?tabindex=5&tabid=68>

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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 <sup>1</sup>
- 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 <sup>2</sup>
  - Increased pressure on ability to meet spending goals
- Additionally, Foundation giving is expected to have declined in 2009 <sup>3</sup>

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”<sup>1</sup>
- 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

#### Saver Foundation

- 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

#### Investor Foundation

- 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**



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11

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### 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"



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12

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### 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

Client Asset Portfolio vs. Market Asset Portfolio Client Asset Portfolio vs. Client Disbursements



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13

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### 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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Appendix A – A Foundation Case Study

- Foundation: provides assistance to those who are unable to afford corrective optometric medical procedures
- Contributions:
  - \$500,000, \$1 million, and \$1 million in the remainder of 2009, 2010, and 2011
  - Beyond 2011, expected to grow at 2% per year
- Disbursements:
  - \$12 million, \$18 million, and \$12 million in the remainder of 2009, 2010, and 2011
  - Beyond 2011, expected to be 5% of the average fund balance at the beginning of the year for the previous three years
- Administrative Expenses: Assume none
- Discount Rate: I.R.C. § 430(h)(2) Corporate Yield Curve, as of June 30, 2009
- Period: 40 years
- Goals:
  - Create a 5 year cushion of certain funding
  - Assess the viability of the current spending projections based on the expected contributions and capital market assumptions



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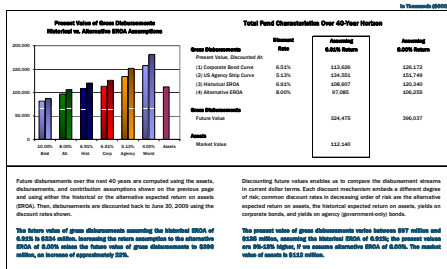
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Appendix A – Total Fund Characteristics

Sample Foundation, as of June 30, 2009

- Does the market value of assets meet or exceed the present value of projected disbursements under various discount rates?
- If Historical EROA assumed? Projected EROA assumed?



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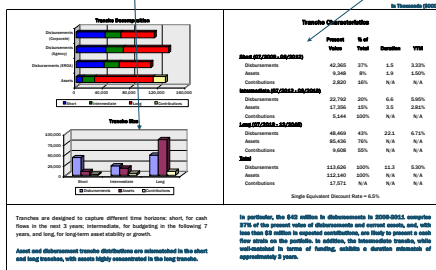
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Appendix A – Asset and Disbursement Tranche Structure

Sample Foundation, as of June 30, 2009

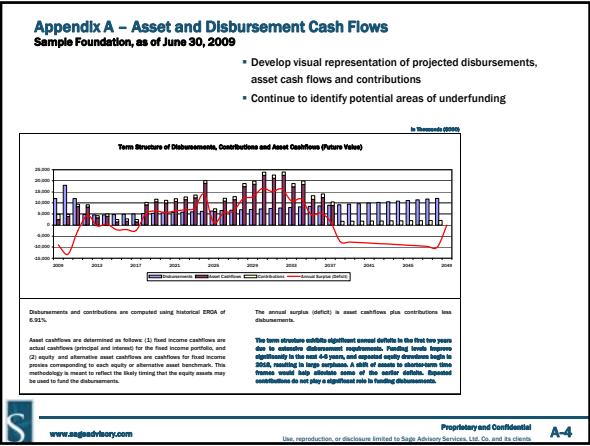
- Clearly identify underfunding by tranche
- Decompose assets and disbursements into tranches (short, intermediate, long OR short and long)
- Calculate key statistics for each tranche



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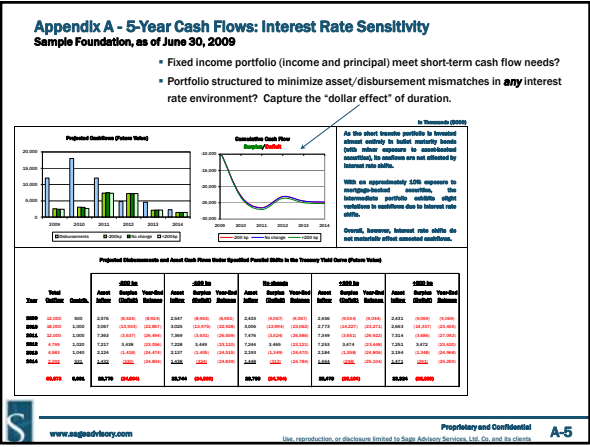
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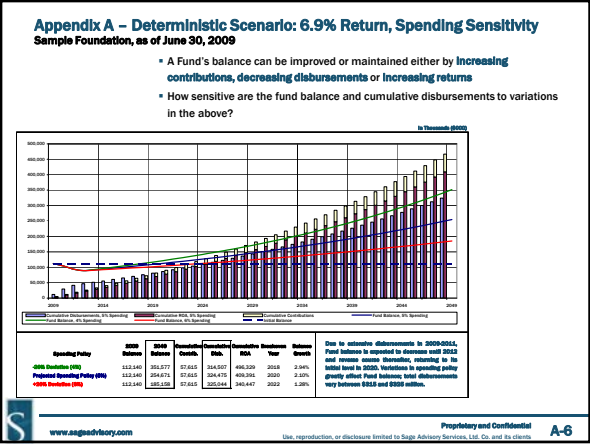
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### Appendix A – Deterministic Scenarios: Summary Sample Foundation, as of June 30, 2009

- What are the guideposts for returns, contributions, and disbursements under various investment, spending and contribution scenarios?

Historical (2004-2009)				Alternative (2004-2009)			
2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million
2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million
2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million	2004-2009 Total Range \$120-\$171 million

Fund total disbursements, but not total disbursements, is extremely sensitive to variations in spending policy. Assuming contribution growth of 2%, a 2% change in spending policy leads to changes of more than 20% in the total disbursements. A lower spending policy results in lower total disbursements in the first 10 years and higher total disbursements thereafter.

On the other hand, both total fund balance and total disbursements are relatively stable despite changes in contribution growth rate assuming a spending policy of 2%. A 2% variation in the contribution growth rate results in changes of less than 5% in both the total fund balance and total disbursements. This is to be expected since contributions are relatively small compared to disbursements.



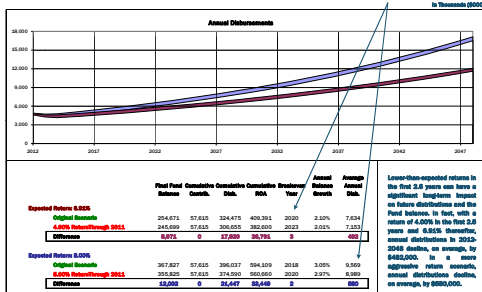
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A-7

### Appendix A – Deterministic Scenarios: The Cost of Underperformance Sample Foundation, as of June 30, 2009

- Is the Fund's spending policy achievable in any market environment?
- If underperformance occurs, how large of an impact is it likely to cause?



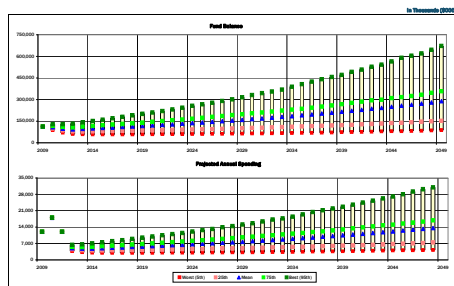
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A-8

### Appendix A – Stochastic Simulations: Fund Balance and Annual Disbursements Sample Foundation, as of June 30, 2009

- What kind of variation can the Fund expect in its returns, fund balance, and disbursements?



- Monte Carlo simulations used to generate statistics for asset returns and cash flows.



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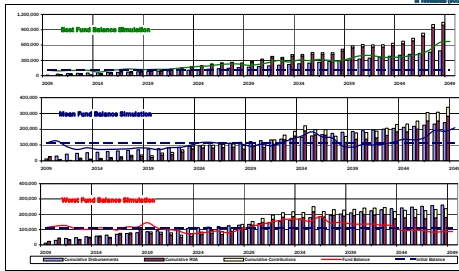
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A-9

**Appendix A – Stochastic Simulations: Best, Worst, and Mean Fund Balance Paths**

**Sample Foundation, as of June 30, 2009**

- What might a best, worst and mean fund balance path look like?
- Variation in returns, fund balance, and disbursements
- How important is timing and magnitude of variation?



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**Appendix B – Sage Contact Information**

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B-1

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C-1