

DEVELOPING *and* OVERSEEING *an* INVESTMENT STRATEGY

By Jeffrey Leighton

A successful investment strategy for family funds and foundations depends critically on both a sound process and well thought-out, written policies. A holistic approach is advisable, in which foundation spending policy and organizational objectives are linked to development of a cohesive and integrated investment strategy. Trustees need to understand their fiduciary responsibility, how spending relates to their foundation's investment return requirements, and how that requirement relates to formulation of the foundation's asset allocation policy. From their consideration of these matters, trustees can develop cohesive and coherent investment management policies and guidelines for investment advisors and managers. In implementing these policies and guidelines, trustees will want to focus particularly on selecting investment managers, monitoring and evaluating investment performance, and rebalancing the portfolio.

THE TWO PRIMARY OBJECTIVES OF FAMILY FOUNDATION financial and investment management are to invest prudently and to meet the legally mandated 5 percent payout requirement. A foundation's board and management assume a fiduciary responsibility to meet these two objectives.

Developing an investment strategy for a family foundation requires consideration of several interrelated factors. The ideal strategy takes into account the spending policy of the foundation as well as its growth objectives, time horizon, and risk tolerance. These factors should be addressed in written spending and investment policy statements that can be referred to by those responsible for investing the foundation's assets. Investment strategies are usually long-term in nature and not time-period specific. Investors who take a long-term approach and avoid the temptation to "chase the markets" by responding to current conditions tend to do the best in the long run. Thus, it is helpful to have a written policy that reminds that "this is our policy and this is why we are doing what we are doing." Such written policies are particularly helpful during those inevitable periods when it feels as though one is invested in the wrong place.

DETERMINING LONG-TERM FINANCIAL OBJECTIVES

The development of an investment strategy should begin with the determination of the foundation's investment return requirement and its long-term financial objectives. A foundation's return requirement is primarily a function of its payout—what it needs to earn to pay its grants and operating expenses. Once spending policy is set, the return requirement can be determined. It is the return requirement that largely



determines how the foundation must allocate its assets among classes of investments to achieve its financial objectives. Having determined an appropriate asset allocation, the foundation must then establish a plan for management of the assets, management guidelines, a process for monitoring the results of its investment program, and a rebalancing policy to ensure that the actual asset allocation remains within policy guidelines.

THE IDEAL STRATEGY
takes INTO ACCOUNT
THE SPENDING POLICY
of THE FOUNDATION
as WELL AS ITS
GROWTH OBJECTIVES,
TIME HORIZON, *and*
RISK TOLERANCE.

Meeting the Payout Requirement and Setting Spending Policy

At a minimum, federal law requires that private foundations must pay out 5 percent of the average value of their noncharitable use (investment) assets, less the excise tax on net investment income, by the end of the next tax year. Qualifying distributions include grants, grant program administrative expenses, direct charitable expenses, the costs of assets acquired for charitable use, and program-related investments. Investment-related expenses such as consultant fees, manager fees, custody fees, and administrative costs allocable to investment activity do not count toward the 5 percent minimum distribution requirement.

Surveys conducted by the Council on Foundations and others indicate that the payout percentage of most foundations is around 5 percent, with family foundations paying out a slightly higher percentage than independent foundations.²⁹ Many believe that it is difficult to sustain a long-term payout rate that is much more than 5 percent without eroding the foundation's endowment and impairing its future grantmaking ability. Some foundations choose to pay out more than the 5 percent minimum. They may feel that focusing a large amount of funds on one area in a short amount of time will have a greater impact than spreading out contributions over a longer period of time. They may have program objectives that they want to fund sooner rather than later, or they may feel that the payout percentage should be higher in years when inflation-adjusted returns are exceptionally good. Foundations that are not fully funded may also have higher payout percentages. For example, the David and Lucile Packard Foundation (1998 assets: \$9 billion) distributed more than 8 percent of its average assets for several years in which its main priority was the establishment of programs. This temporary spending level was not a concern because the board knew that it would be receiving substantial additional assets when the donors died. Finally, some foundations may be intentionally spending down their endowment, although the majority of foundations have a perpetual life.

(For a full discussion of the issues and questions to consider when developing a spending policy for a family foundation, see Chapter I, "Considering the Question of Perpetuity," and Chapter II, "Developing a Spending Policy.")



Calculating the Annual Return Requirement

Once a spending policy is established, a foundation can calculate its investment return requirement. The return requirement, like the spending objective, is generally expressed as a percentage of average assets. It is calculated by taking the spending objective, adding the expected average annual inflation rate over the investment time horizon, and adding estimated investment fees and expenses. Here is an example of a return requirement calculation:

FIGURE 1: CALCULATING THE RETURN REQUIREMENT

Return Component	Percent of Average Assets
Spending objective	5.00
Expected rate of inflation over investment time horizon	3.50
Estimated investment-related fees and expenses	0.75
Average annual investment return required	9.25

This calculation shows why most foundation financial advisors believe that a foundation must have an average annual investment return of between 9 percent and 10 percent just to maintain the value of its endowment.

A few key points should be kept in mind when contemplating the required return. First, it is highly unlikely that a foundation could achieve an average annual return in the 9 percent to 10 percent range without investing a substantial percentage of its assets in stocks. The average annual returns on domestic stocks were approximately 13.5 percent from 1926 through 1998, versus 5.8 percent for bonds.³⁰ Second, these average returns are “total returns,” which means that they reflect current income (interest and dividends) plus capital appreciation. Third, most institutional investors invest for total return, not just yield or current income. They understand that selling securities to meet payout obligations is not an invasion of the endowment, provided that the total return exceeds the payout percentage plus the rate of inflation. A foundation that invested primarily to generate current income would have most of its portfolio invested in bonds. Although it might be able to generate enough interest and dividend income to meet its payout requirement, it would not have a high enough total return to maintain the spending power of its endowment in future years.



THERE IS
ALMOST UNIVERSAL
AGREEMENT *that* ASSET
ALLOCATION
IS *the* SINGLE
MOST IMPORTANT
INVESTMENT
strategy DECISION.

Diversifying Asset Allocation

Asset allocation is at the heart of a foundation's investment strategy. Asset allocation policy can be defined as the plan of diversification or distribution of a foundation's endowment among the various types or classes of investments. Stocks, bonds, real estate, and alternative investments are the classes of assets most frequently specified in an asset allocation policy.

Numerous studies demonstrate that asset allocation is the primary determinant of investment returns. It is far more important than individual security selection or what particular manager is hired. Perhaps as much as 90 percent of an investment portfolio's total return results from the asset allocation decision. There is almost universal agreement that asset allocation is the single most important investment strategy decision. Consequently, asset allocation policy should be the primary focus of those having fiduciary responsibility for the investment of the endowment.

The diversification of assets among asset classes also reduces investment risk. The old adage about not putting all of one's eggs in the same basket is particularly important with respect to investments. Harry Markowitz received the Nobel Prize in Economics for his work, a portion of which demonstrated how combining assets with different characteristics could both increase returns and decrease risk. Even the inclusion of risky assets such as low-grade bonds or venture capital can reduce the overall risk of a portfolio while increasing long-term returns by providing additional diversification.

Another aspect of portfolio management addressed by Markowitz's work was the relationship between risk and return. He demonstrated that rational investors seek the highest available returns for any level of risk, which is why it is almost always true that greater returns come at the price of greater risk. The paramount goal of asset allocation is to invest the endowment in that combination of assets that is expected to meet the return objective with the lowest level of risk, over the investment time horizon.

Developing an asset allocation strategy requires a consideration and understanding of two sets of factors. One set relates to asset class characteristics. The second pertains to foundation-specific issues.

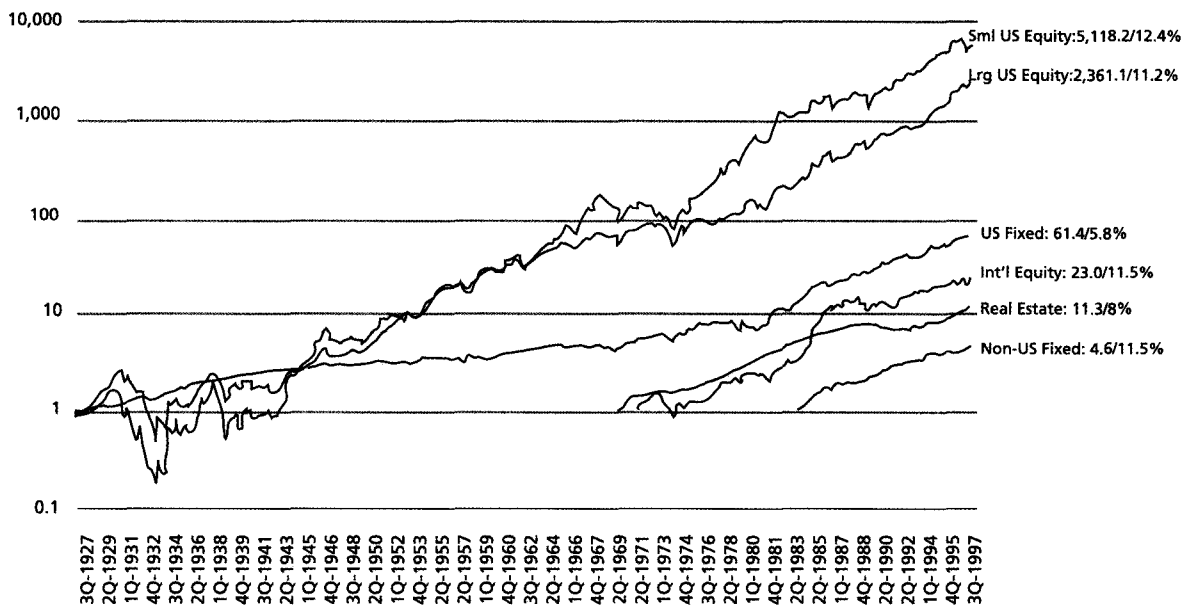
Understanding Asset Class Characteristics

Asset classes have four characteristics that are particularly relevant to the asset allocation decision. Figure 2 shows the growth of an initial \$1 investment in various asset classes during the period 1926-1998. Close examination of relationships between the lines tells a number of things:

1. *Returns vary among asset classes over time.* Historically, only stocks produce average annual returns approaching the 9 percent to 10 percent return requirement that most foundations must meet to keep pace with inflation.
2. *Some asset classes are less volatile than others.* They have smoother and less jagged lines, meaning that they produce more reliable levels of return from year to year. In short, they are less risky.

3. *Asset classes that are more volatile or risky produce higher returns over time.* They compensate investors for their erratic behavior by providing greater average annual returns. Long-term investors who can tolerate higher volatility can increase their returns by investing more heavily in these riskier asset classes.
4. *Finally, the best-performing asset classes differ from year to year.* Asset class returns are not always in tandem. Some asset classes do well in years when other asset classes perform poorly. The extent to which asset class returns move in harmony or diverge is called their correlation.

FIGURE 2: ASSET CLASS RETURNS 1926-1998



*Source: Toni Brown, Callan Associates

These four factors are of great importance when developing an asset allocation policy. Consideration of these factors should enable the foundation to construct a diversified portfolio that will satisfy the dual goals of achieving the return objective and minimizing risk. To summarize, asset allocation and diversification are effective strategies because:

- Asset classes have different risk and return profiles;
- Asset classes perform differently under different time periods and conditions; and
- Returns can be stabilized or improved and risks reduced by mixing asset classes that have different characteristics and patterns of return.



MARKET
 “CORRECTIONS”
 and MAJOR
 UNEXPECTED EVENTS
 OCCUR ALMOST
 ANNUALLY. RECOVERY
 MAY COME QUICKLY
 or MAY TAKE YEARS.

Assessing Foundation-Specific Factors

The three organizational factors a foundation must consider in developing its asset allocation strategy are its return requirement, its tolerance for risk or volatility, and its investment time horizon. Other factors, notably investment preferences and the capacity to manage and exercise due diligence with respect to more complex asset classes, may also come into play. These factors, like most issues in the investment process, are somewhat interrelated.

Return Requirement

The return requirement, discussed previously, is being mentioned again here to reinforce the assertion that it should be the starting point in developing an investment strategy. If it appears that the return requirement is too high when other factors are taken into account, the foundation must either lower its return requirement (which probably means reducing its spending plans), be willing to accept greater investment risk, or achieve its objectives over a longer time horizon.

Tolerance for Risk or Volatility

Investors face many different types of risk. Examples of risk include interest rate changes, currency devaluations, inflation, liquidity, and natural disasters (see Appendix B., “Glossary,” for full descriptions of these and other types of investment risk). Risk in an investment sense can be conceptually encapsulated as the concern that actual returns will fall below expected returns, resulting in a failure to achieve the return objective. Risk is not necessarily a bad thing. An unfortunate event for one investor may benefit another or create new investment opportunities. Riskier asset classes can be thought of as those that have greater potential payoff, but also a greater chance of disappointing earnings or loss. The important thing to remember is that investment return is the compensation that investors receive for investing their dollars and accepting risk. Investors must make their own judgments as to whether they will be adequately compensated for the risk they are assuming. William F. Nichols, treasurer of the William and Flora Hewlett Foundation (1998 assets: \$1.8 billion), has characterized the trade-off between risk and return as the decision of whether to “eat well or sleep well.” John Maynard Keynes, the economist, is reported to have advised a friend who was greatly concerned about his investments to “sell down to the sleeping point.” Two factors that affect risk are diversification, which was discussed earlier, and the investment time horizon.

Investment Time Horizon

Future investment returns cannot be predicted with any certainty. Foundations that are implementing a new investment strategy, investing in a new asset class, or even hiring a new manager should be prepared to suffer a decline in value of up to 15 percent or more soon after implementation and should invest with a time horizon of at least five years. This is not to say that such a loss will necessarily occur, but market

“corrections” and major unexpected events occur almost annually. Recovery may come quickly or may take years.

The best strategy under such circumstances is usually to stay the course and ride it out. If the foundation has large near-term commitments, it should consider investing a corresponding portion of its portfolio in cash equivalents or in bonds with maturities coinciding with its payment obligations. An alternative strategy is to invest in more volatile or risky assets (with the expectation of higher long-term returns), while maintaining short-term flexibility in the uncommitted balance of the spending budget so that payout can be readily adjusted if necessary. This approach requires careful thought as many family foundations have significant “entitlements” embedded in their annual spending and program budgets. Foundations with longer investment time horizons can afford to invest more in risky assets if they can tolerate year-to-year volatility. Figure 3 illustrates this point.

**FIGURE 3: AVERAGE ANNUAL RETURNS ON U.S. STOCKS:
ROLLING TIME PERIODS FROM 1925 TO 1998***

	1-year periods (%)	5-year periods (%)	10-year periods (%)
Best Period	54.0	23.9	20.00
Worst Period	-43.3	-12.4	-0.90

*Source: Toni Brown, Callan Associates

This figure shows the best and worst returns for large company U.S. stocks for 1-year time periods as well as over rolling 5- and 10-year time periods. Single-year returns were as low as -43 percent and as high as +54 percent between 1925 and 1998. A foundation that evaluated its returns over a five-year time period would have had annual average returns as low as -12.9 percent for the worst five-year period or as high as +23.9 percent over the best five-year period. If the time horizon is further extended, the average annual return over the worst 10-year period would be -0.9 percent (nine-tenths of 1 percent) and the average annual return over the best 10-year period would be 20 percent. It is clear from this chart that volatility and risk of loss decrease as the time horizon lengthens.

Many foundations choose to use investment consultants to help determine an appropriate asset allocation. Investment consultants typically use analytical software and historical data to determine, through optimization techniques, that combination of assets that is expected to meet the returns objective of the foundation with the least volatility. The output of these models is input-sensitive and driven by assumed future rates of return, correlations between asset classes, and constraints on the minimum and maximum percentages that may be invested in the included asset classes.



A Sample Asset Allocation

A foundation's asset allocation strategy is most easily expressed as a table. The fictional Sample Foundation has assets of \$20 million and has identified its asset allocation strategy as follows:

Asset Class	Estimated Asset Class Returns (%)	Target Allocation (%)	Expected Return (%)	Allocation Range	
				Min (%)	Max (%)
Cash and T-Bills	5.0	5	0.3	5	10
U.S. Stock	10.5	55	5.8	40	60
Foreign Stocks	12.0	15	1.8	10	20
U.S. Bonds	6.5	25	1.6	20	40
		100	9.5		

The Sample Foundation first determined that it needed a return of 9.5 percent to achieve its spending objectives. It then considered the asset classes in which it was willing to invest. The board decided to invest in cash equivalent investments (this asset class includes money market funds, Treasury bills, and commercial paper), domestic stocks, foreign stocks, and U.S. bonds. The board decided not to allocate any part of the portfolio to alternative investments or real estate. It determined that it preferred more liquid investments and was concerned about the level of expertise, due diligence work, and management time that would be needed properly to manage those asset classes. The Sample Foundation was also aware of studies that indicate that most of the benefits of diversification can be obtained by investing in domestic stocks, foreign stocks, and U.S. bonds.

The Sample Foundation then estimated the returns that it could expect from the included asset classes over a five-year time horizon. The estimated asset class returns were based on both historic returns and the board's view of likely future returns. In developing the return estimates, the board considered political, economic, demographic, and business factors as well as trends with implications for the future.

The next step was to determine a target or normal allocation for each asset class. Developing the target allocation for the included asset classes was an iterative exercise. The 5 percent allocation to cash equivalents was based on the amount the Sample Foundation thought it would need to access to pay grants and expenses, plus the average uninvested cash balances that it estimated its investment managers would be holding. The 25 percent allocation to bonds was the amount considered necessary to provide diversification and some return stability in the form of the regular interest payments that bonds provide. After allocating a total of 30 percent of the portfolio to cash equivalents and bonds,



70 percent remained for allocation to stocks. A higher allocation to foreign equities was initially considered because of the higher level of estimated future returns. After giving consideration to the greater volatility of foreign stocks and board member preferences, however, it settled on a 15 percent foreign stock allocation. The remainder of the portfolio was allocated to domestic equities.

The Sample Foundation then calculated the expected return for this asset strategy. The expected return was calculated by multiplying the target allocation percentage by the expected asset class return. The total expected return turned out to be 9.5 percent, which met the Sample Foundation's return requirement.

The final step in the asset allocation process was to establish range minimums and maximums for each asset class. The ranges were determined primarily on the basis of the board's preferences and comfort levels with respect to the various asset classes. The board determined that cash equivalent balances in excess of 10 percent would be excessive. It also determined that the allocation to U.S. bonds should not fall below 20 percent or exceed 40 percent. The board then made similar judgements in establishing allocation range guidelines for domestic and foreign stocks. The Sample Foundation plans to adopt a rebalancing policy that will require that an asset class be rebalanced back to the target allocation at the end of any year in which the minimum or maximum is exceeded.

The Sample Foundation is currently formulating its plans for asset management. It plans to index some portion of the domestic equity and U.S. bond portfolio because it believes that these markets are so efficient that few active managers can consistently outperform the indexes on an after-fee basis. It plans to hire investment managers to manage its foreign and small domestic company stocks because it believes that skilled managers can generate excess returns for these asset classes. The Sample Foundation is also developing investment management policies to guide its board, investment managers, and employees.

Summarizing Asset Allocation

A family foundation's asset allocation policy is the key element of its overall investment strategy. It is the primary determinant of investment return and risk. The goal of asset allocation is to construct a portfolio that is expected to achieve the foundation's return objective over the investment time horizon; and has the lowest level of volatility or risk of any portfolio likely to produce the same level of return.

A foundation's spending policy, return requirement, and asset allocation strategy are all linked. Balancing payout against income requires either earning more or spending less. Earning more requires increasing the allocation to asset classes with higher expected returns. Asset classes with higher expected returns have more volatile return patterns and are thus "riskier." Finally, tolerance for risk increases as the investment time horizon lengthens or if spending can be readily adjusted.



CREATING WRITTEN INVESTMENT MANAGEMENT POLICIES

A family foundation should have written investment policies to guide those responsible for investment management and oversight. Model investment policies are provided in Appendix C. Investment management policies often address the aspects of investing discussed below.

Assigning Responsibility for Formulating Policy, Implementation, and Oversight

The investment policy statement should assign investment-related responsibilities. Typically, the board or a board committee sets policy and provides oversight. Oversight responsibilities typically include ensuring that policies and guidelines are being followed, and monitoring investment performance. The implementation of investment plans and policies may be delegated to an employee or a consultant. The board should, however, remember that it has a fiduciary responsibility to exercise due diligence and ensure that the endowment is managed prudently. (See Chapter VI, “Trustee Responsibilities and Duties Regarding Endowments of Family Foundations.”)

Investment Philosophy, Goals, and Objectives

The policy should address the investment goals of the foundation and specify the return objective and the types of investments in which the foundation may invest. It might state the foundation’s views on other investment issues such as socially responsible investing, liquidity, the use of leverage, and how the investment objectives relate to the goals of the foundation.

Asset Allocation Policy

The asset allocation policy is generally included within the investment policies and guidelines. The foundation should also establish a policy for rebalancing the portfolio when the actual asset allocation falls outside the allowable ranges.

Method of Management

The foundation should develop a plan of asset management and describe it within its policy statement. It may authorize the use of external investment managers, or elect to invest in index, pooled, or mutual funds. Some foundations may even manage part of the portfolio in-house.

Performance Benchmarks

Benchmarks should be established for each manager and class of assets so that the foundation can determine whether its investment goals are being achieved.



Investment Guidelines

Investment guidelines can be used as a tool to control risk. Most foundations limit the percentage of the portfolio that can be invested in the stock of a single issuer. The foundation may want to limit the extent to which its managers can make “sector bets” on various industries such as healthcare, energy, financial services, or technology. Minimum quality standards might be specified for debt securities such as commercial paper and bonds held in the portfolio. The foundation may also establish policies that encourage socially responsible investing or that prohibit investments in companies that derive a significant part of their revenue from alcohol, tobacco, weapons, etc. Some foundations also have proxy-voting policies relating to shareholder rights and social issues.

SELECTING INVESTMENT MANAGERS

David Salem, president of The Investment Fund for Foundations, has stated that selecting superior managers is harder than selecting winning stocks because only limited information is available about managers and most of it is self-generated. Barr Rosenberg, an investment manager and researcher, has commented that it would take about 70 years of observations to prove statistically that an investment manager’s claims were the result of skill rather than luck. Nevertheless, most family foundations use outside investment managers for some tasks.

When selecting a manager, a foundation should examine performance information over 3-, 5-, and 10-year periods. It is important for the trustees to ensure that the manager is calculating performance in accordance with guidelines promulgated by the Association for Investment Management and Research (AIMR). The AIMR standards require that managers report their performance on the basis of a composite of the portfolios that they manage, rather than a single best-performing portfolio. A foundation should also inquire as to whether the managers within the firm who were responsible for the historic performance are still with the firm. If so, is there a plan of succession if they retire, become ill, or leave the firm?

Apart from the information that managers provide about themselves, the best sources of information about prospective managers are other foundation clients and investment consulting firms that maintain databases on manager performance. Obtaining and following up on references can provide valuable information and useful insights. Take time to interview prospective managers, meet their staff, discuss investment objectives, and learn about their approach. Find out who will have primary responsibility for the management of foundation assets and ascertain whether trustees will feel comfortable working with them. The foundation should also be sure to communicate its investment policy guidelines and performance expectations to each manager. (For a full discussion of investment advisors and consultants, see Chapter VIII.)

MOST FOUNDATIONS
LIMIT *the* PERCENTAGE
of THE PORTFOLIO
THAT CAN BE INVESTED
IN THE STOCK *of a*
SINGLE ISSUER.



THE MOST IMPORTANT QUESTION *to* ASK WHEN EVALUATING MANAGER PERFORMANCE *is* WHETHER THE FOUNDATION IS RECEIVING ADDED BENEFIT *for* THE FEE DOLLARS IT IS SPENDING. IF NOT, IT MAY WANT *to* CONSIDER INVESTING *those* ASSETS IN AN INDEX FUND THAT MIRRORS THE BENCHMARK.

MONITORING AND EVALUATING MANAGER AND PORTFOLIO PERFORMANCE

Performance benchmarks should be established for each investment manager. The best way to establish a benchmark is by agreeing with the manager on an appropriate index. Indexes frequently used as benchmarks include:

- The S&P 500 or Russell 1000 for large domestic company stocks;
- The Russell 2000 index for small domestic company stocks;
- The Morgan Stanley Capital Markets “EAFE” indexes for foreign stocks (Europe, Asia, Far East); and
- The Lehman Aggregate or Government /Corporate Bond Indexes for bonds.

If there is difficulty agreeing on a benchmark, it may be a sign that the foundation’s performance expectations differ from the manager’s. In such cases, the foundation may want to consult with its peers to determine if its expectations are reasonable or to interview other managers.

Investment managers should be expected to outperform their benchmarks on a net-of-fee basis. Investment performance figures can be obtained from the manager, the foundation’s investment consultant, or its custody bank. Manager performance should be reviewed at least annually. The manager’s performance should be compared with the agreed-upon performance benchmarks for the most recent year and rolling three- to five-year periods. The foundation should also compare the manager’s performance with that of other managers who manage similar assets and employ similar styles. It is important to keep in mind that even the best managers will have quarters or years where they under-perform their benchmark or their peers.

The foundation should consider terminating a manager that has underperformed both its benchmark and its peers for more than a couple of years. In periods of underperformance, it is important to inquire as to the reasons. For example, it is important to know if the manager has changed its investment style or is undergoing personnel changes. Such changes may prompt an earlier reevaluation of that manager relationship.

The final and most important question to ask when evaluating manager performance is whether the foundation is receiving added benefit for the fee dollars it is spending. If not, it may want to consider investing those assets in an index fund that mirrors the benchmark.

In addition to reviewing manager performance, foundations should review total portfolio performance at least annually. The board should ensure that the actual asset allocation stays within guidelines, determine that policy guidelines are being followed, and evaluate whether the investment goals and return objectives are being met. If the investment objective is not being achieved, the foundation should revisit its investment policies. Is a change in management approach or investment managers warranted? Are the investment objectives realistic? Does the asset allocation need to be revisited? Is the spending policy too ambitious?





REBALANCING THE PORTFOLIO

Over time, the actual asset allocation will diverge from the target asset allocation and may even fall outside the approved ranges. When this occurs, the foundation should rebalance back to a point within its approved allocation ranges. The failure to rebalance the portfolio is tantamount to a decision to change the asset allocation strategy. It effectively changes the risk-and-return structure of the portfolio and leaves the foundation overexposed to some asset classes and underexposed to others. Rebalancing requires discipline, particularly when faced with the prospect of taking assets away from a manager or out of an asset class that has done particularly well. Foundation trustees should remember, however, that rebalancing is consistent with the concept of buying low and selling high.

Foundations can generally rebalance as they go because most of them must draw money from their portfolios to pay grants and expenses. To the extent that formal rebalancing is needed, there are two primary rebalancing strategies: calendar and threshold. Calendar rebalancing is typically done on a quarterly or annual basis. Threshold rebalancing is done whenever guideline ranges are exceeded. Under either method, trustees can choose to rebalance back to the endpoints of the asset allocation guideline ranges or back to the target or normal allocation. Many consultants favor rebalancing back to the target on an annual basis because it results in lower transaction costs than other approaches.

Strategies for Smaller Foundations*

For most smaller foundations, growing assets—without subjecting the endowment to significant risk—is a basic goal. The two most common strategies for achieving that objective are diversification and reduction of investment costs.

Diversifying Assets

In general, asset diversification is an important risk-reduction concept for all investors. It is, however, particularly relevant for smaller foundations that hold a large (or total) concentration of their assets in a single stock. This situation arises because many donors use stock in which they hold significant concentrations and have an extremely low tax basis to fund their foundations. In this case, the foundation portfolio should be viewed in the context of the donor's total portfolio. Although assets which the donor has not designated for philanthropic purposes cannot be sold without tax consequences, assets assigned to the foundation can be diversified without significant tax costs. Thus, diversification of foundation assets can cut the risk of the donor's total portfolio by taking advantage of the unique tax aspects of the philanthropic assets held in the private foundation.

Reducing Investment Costs

By reducing costs, a foundation board may be able to adopt a more conservative portfolio and still achieve the returns needed to maintain or increase purchasing power. Many smaller foundations look to an indexed approach to attain the excellent returns historically associated with equity markets, without the drag of investment costs. Three common methods for developing a portfolio with limited investment costs are mutual funds, separate accounts, and self-implementation:

- *Mutual Funds.* Mutual funds are the vehicle of choice for many smaller foundations. Advantages include ease of implementation, moderate costs, low thresholds for investment, and a huge selection of alternatives. On the downside, mutual funds must maintain a cash reserve to meet redemptions, and returns are diminished accordingly. In addition, costs tend to be somewhat higher than either separate account management or self-implementation. Finally, because contributions tend to pour into the funds during market highs and to be withdrawn during market lows, investors in mutual funds are often forced into a “buy high/sell low” scenario by the managers. On the whole, however, mutual funds are an excellent choice for investing the endowments for smaller foundations.
- *Separate Account Managers.* Many foundations hire advisors to manage separate accounts on their behalf. Advantages include the potential for lower costs and negotiated fees; direct input to and feedback from the manager; and the potential for developing a customized portfolio. This type of investing is appropriate for foundations interested in socially responsible investing or in developing other individualized approaches. Many of the better investment managers do, however, have investment minimums ranging from several million to tens of millions of dollars. Thus, smaller foundations may be precluded from employing separate account managers. Moreover, even for those for smaller foundations that are able to meet one manager’s established minimum, diversification may be limited because the foundation endowment is not sufficient to meet the minimum for multiple managers with their various investment styles.
- *Self-Selection.* Many boards of small foundations are comfortable establishing portfolios by making their own investment selections. Advantages to this approach include flexibility to customize the portfolio and minimal investment expenses (assuming the individual or individuals involved work without remuneration). Disadvantages include: a lack of expertise or experience, which may result in diminished returns; an inability or lack of time to deal



with the sometimes overwhelming mechanics of the investment process, including custody considerations and recordkeeping and; a lack of time to monitor and review holdings, which may also result in reduced returns.

Several other low-cost management options exist, including the use of a bank or other financial institution, community foundations, and the use of pooled funds such as The Investment Fund for Foundations.

- *Use of a custodian.* Smaller foundations or funds may choose to make use of existing relationships with the banks or other financial institutions that serve as custodians for their organizations. Because the foundation may already be paying the custodian for other services, it can often obtain competitive rates on investment management fees and other costs.
- *Community foundations.* In addition to their traditional grantmaking and administrative services for advised funds, some community foundations offer investment management services to private foundations. Investment management fees are generally based on the type of fund that the family has, and are sometimes negotiable. Although the investment choices available through a community foundation may be limited because of existing relationships with managers, community foundations that group funds with managers may be better able to meet minimum asset requirements, and thus may be able to secure lower investment expenses for family foundations who use these services.
- *The Investment Fund for Foundations.* The TIFF Investment Program (TIP)—a family of commingled investment funds of grantmaking foundations—is an example of a pooled fund that is open to smaller foundations. TIP's mission is to enhance the net investment returns of foundations that lack the resources needed—a sufficient asset base, time and expertise needed to select money managers, and the bargaining power needed to obtain competitive rates—to earn superior net investment returns. TIP employs a performance-based fee system, and maintains relatively low investment minimums (\$100,000 for all but one fund, which has a \$50,000 minimum). For a prospectus and information on recent performance and fees, contact Foundation Advisers, Inc., at 804-984-0084.

* Contributed by Greg Nelson, chief financial officer of Family Financial Strategies, Inc.



THE BEST
INVESTMENT
STRATEGY *is* TO
focus ON THE
INVESTMENT PROCESS
and POLICIES, NOT
THE DETAILS.

SUMMING UP

When developing and overseeing an investment strategy, trustees of family foundations should keep the following points in mind:

- The best investment strategy is to focus on the investment process and policies, not the details.
- The single most important strategy decision is the asset allocation policy. Manage risk by diversifying and investing to meet return objectives, not to maximize returns.
- Give policies and strategies time to work and stay the course through market upswings and downswings. Don't abandon a new strategy too soon. Investors who chase after the best returns end up doing just that—chasing after the best returns.
- Don't try to time or outguess the market. William Sharpe, a recent winner of the Nobel Prize in Economics, noted that the markets, on the whole, are likely to do just as well when an investor is out as when the investor is in.
- Avoid fads. David Salem, president of The Investment Fund for Foundation, has noted that by the time a new asset class has been proven to be worthwhile, the big bucks have already been earned.
- Review manager and total portfolio performance at least annually. Make sure that investment guidelines are being followed.
- Control costs. The best way for many organizations to improve overall returns is by exercising better cost control over fees and transaction costs.
- Rebalance the portfolio when asset allocation guideline ranges are exceeded.

The guidelines in this chapter offer trustees a framework for developing an investment strategy; no two family foundations are likely to develop exactly the same strategy. Yet a written strategy can link investment to the donor's goals and the foundation's mission, inform family members and others of how assets are being invested and why, and concentrate the energies of investment advisors and managers on achieving strategic outcomes.