Fashioning an Investment Strategy

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By Jason Born

ABSTRACT: This chapter from *Splendid Legacy* contains background, ideas, and suggestions to help family foundation boards develop investment policies and practices that meet legal requirements and are consistent with the goals and mission of their philanthropy. Sections in the chapter address linking resources to philanthropic purposes; establishing spending policy; overseeing the investment strategy; determining the family's role; reducing investment costs; and revisiting goals and objectives.

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The highest use of capital is not to make more money, but to make money do more for the betterment of life.

—**HENRY FORD**—

The returns on a family investment in philanthropy are — or can be — extremely high, both internally and externally. When such an investment is well executed, a family can achieve the cohesion that comes with a sense of higher purpose and cooperative effort.

—**PAUL YLVISAKER**—

Although Henry Ford and Paul Ylvisaker were not talking specifically about the investments that a family foundation's endowment makes, their comments are equally appropriate to this process. Investing the assets of a family philanthropy is — or can be — both a challenging and rewarding experience, and is probably best thought of not only in terms of assets, but also of what those increased assets can accomplish.

As someone who has established or is about to establish a family foundation, you may be familiar with and skilled at thinking about your own investment goals and strategies. If you have served on boards of other nonprofits or corporations, you may also know what it takes to oversee management of an institution's portfolio and assets.

As the founder and a trustee of your family's foundation, however, you will encounter very special circumstances related to your investments. You and your board will make important investment strategy decisions about funding a legal entity that is regulated by the Internal Revenue Service (IRS) and state agencies. You and your board will assume legal and ethical duties of obedience, loyalty, and care to the foundation. Those duties require you to adhere to the foundation's charter and mission, avoid self-dealing and conflicts of interest, keep the foundation's best interests in mind, and act as a "prudent investor" on behalf of the foundation. You will also be acting within an environment of your family: siblings, children, in-laws, and next generations. You may want to train family members who may not be knowledgeable about their fiduciary responsibilities with regard to the foundation.

Most important, you will need a strategy that allows you to carry out your hopes and dreams for the foundation. A thoughtfully fashioned investment strategy, implemented with discipline and flexibility, seems all the more important in today's world. The first year of the 21st century brought extraordinary levels of volatility to the financial markets. Concerns about terrorism, the collapse of Enron, and the bursting of the dot com bubble created a new set of conditions for investment managers. Although there will always be uncertainties about the future, founders of family foundations today may face an especially challenging task in developing their investment strategy.

This chapter contains background, ideas, and suggestions to help you and your board think about how to develop investment policies and practices that meet all legal requirements and are consistent with the goals and mission of your philanthropy. Sections in the chapter aim to help you in:

- Linking resources to philanthropic purposes;
- Establishing the spending policy;
- Overseeing the investment strategy;
- Determining the family's role;
- Reducing investment costs;
- Revisiting goals and objectives; and
- A final word: reviewing the checklist.

Linking Resources to Philanthropic Purposes

Some founders plan their philanthropic purposes well ahead of time, while others are more given to let those purposes evolve over time. In either case, it is helpful for you and your board to have a clear, shared understanding about investment goals and strategies. It's desirable to agree on policies and practices regarding the management of money: bookkeeping, reports, audits, archival records, etc. Your philanthropic goals will drive both the spending policy of the foundation and the investment strategy designed to support that spending policy.

Many founders spend considerable time in the first few years of their foundation's life exploring these issues. You may want to discuss your thoughts on these matters with other members of your family before passing the reins of the foundation to the next generation.

Considering Perpetuity

Consider perpetuity. Simply put: will your foundation last for a specific term of years, cease to exist when it achieves a specific goal, or exist in perpetuity? Depending on the answer to this question, your investment strategy will be very different.

If your main goal is to support an issue that requires urgent attention, you may choose to focus your foundation's grantmaking activities over a short and concentrated period of time. One foundation that took this approach is the Aaron Diamond Foundation. In the late 1980s, foundation president Irene Diamond and the rest of the trustees recognized that they had an opportunity to make a real difference in AIDS research, an area that at the time was sorely lacking funding. With this in mind, the foundation increased its annual grantmaking to a level that allowed it to become a key supporter in AIDS research. Despite the fact that this decision resulted in the foundation spending itself out over the next decade, the board felt that the subject was important enough to warrant such an approach.

An equally compelling case can be made for creating philanthropic funds that build resources now and for the future. This approach guided the Harris and Eliza Kempner Fund in Galveston, Texas. Started in 1946 by five members of the Kempner family, the fund has grown from an initial asset value of $38,500 to almost $50 million today. The original donors, as well as the current trustees, recognized the value of a perpetual foundation, as described in the fund's 1996-1997 biennial report:

> The impetus for starting a foundation in 1946 came from the family's concern for the many local charities it supported. They realized that conditions that typically follow economic depressions and wars could affect their ability to support charities in times of greatest need. A philanthropic philosophy thus evolved: "Allow the more prosperous years to provide for the lean ones."

Many good reasons support either spending out a foundation's assets or establishing a foundation in perpetuity. Key reasons for the former approach include:

- The founders want to work with

fig. 1

Glossary of Key Investment Terms for Family Foundations

ASSET ALLOCATION. The practice of spreading risk across a range of investment assets and management styles to balance the effect of market forces and volatility in relationship to the risk level that is acceptable to the investor. According to modern portfolio theory, as much as 95 percent of the return of a diversified portfolio of assets is attributable to the distribution (allocation) and regular rebalancing of a range of investment classes and styles within those classes.

EXCISE TAX. The tax on the net investment income of private foundations of 2 percent per year. This tax may be reduced to 1 percent under certain circumstances.

FIDUCIARY RESPONSIBILITY. The task of investing money or acting wisely on behalf of a beneficiary. In the foundation field, such responsibility is exercised on behalf of the donors and the grantees.

LIQUIDITY. The ease with which a financial asset can be converted to cash.

PAYOUT REQUIREMENT. The Internal Revenue Service requirement that private foundations must distribute 5 percent of the value of their net investment assets annually in the form of grants or eligible administrative expenses.

REBALANCING. A common strategy used to ensure that asset allocation guidelines are met over time, as changes in the portfolio occur due to changes in the values of individual assets. 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.

RATE OF RETURN. A measure of investment performance for a specified pool of assets. The rate is determined on a total return basis, including realized and unrealized changes in market value in addition to earned income (i.e., dividends and interest income). Managers may report returns before or after management advisory fees, but returns are always reported after brokerage and trading costs.

RETURN REQUIREMENT. The rate of return on investment needed by a private foundation to meet its spending goals. For example, for a foundation that intends to exist in perpetuity, the return requirement is that its investment returns be equal to (or greater than) the total of (1) its grants spending objective, (2) the expected average annual inflation rate over the investment time horizon, (3) its estimated annual operating expenses, and (4) its estimated investment fees and expenses.

RISK. The measurable possibility of losing or not gaining value.

SOCIALLY RESPONSIBLE INVESTING. A style of investment decision making that takes into account social and environmental, as well as financial, concerns. One form of this is known as “mission-related investing,” which attempts to align an institution’s mission with its investment strategies.

SPENDING POLICY. An agreed-upon policy that determines what percentage of a foundation’s endowment will be spent to cover both the operating costs and grants of an institution. Typical spending rules combine calculations based on previous years’ spending, the current year’s income and investment return rates, and the policy of the foundation for covering grant commitments.

VOLATILITY. A measure of the degree to which the price of a security goes up or down over a specified period. Highly volatile stocks tend to move up or down more than the market as a whole, while those with low volatility move up or down less than the market as a whole.

other family members to see their philanthropic assets at work during their lifetimes.
- The founders want to commit the full resources of the foundation to address a specific problem now, in the hopes that more resources in the short term will help solve it.
- The founders expect others (including heirs) to engage in their own personal philanthropic efforts and to address the problems of future generations.
- The founders are concerned that the foundation may lose the family's involvement over time, and/or may lose touch with their original purposes in establishing the foundation.

Key reasons for establishing a foundation in perpetuity include:
- A foundation established in perpetuity can grow its endowment to become larger and potentially more effective in bringing about lasting improvements in society.
- The founder can empower the trustees to alter the foundation's mission, thus ensuring that its grantmaking will be directed to relevant social needs over time.
- Many social problems are deeply seated, and only a foundation with a perpetual endowment can press reforms for many years in its effort to make a difference.
- Many founders feel that a foundation is an important part of their legacy — to the family, to the community, and to society at large.

The spending policy of a family foundation determines what percentage of a foundation's endowment will be spent annually to cover both operating costs and grants.

Trustees of a foundation destined to spend out by a certain date will want to emphasize current income and liquidity in their investment strategy. Those governing a perpetual foundation will likely want to develop a strategy designed for long-term income growth in principal.

However you may feel about the question of perpetuity, consider carefully what you want to accomplish — and what you want your family to accomplish — prior to committing to a long-term investment strategy or spending policy.

Establishing the Spending Policy

The spending policy of a family foundation determines what percentage of a foundation's endowment will be spent annually to cover both operating costs and grants. Internal Revenue Service (IRS) regulations require that private foundations spend at least 5 percent of their net investment assets as "qualifying distributions" each year. Qualifying distributions — also referred to as "payout" — of a foundation generally include:
- Grants to public charities, nonprofit organizations, and individuals (including scholarships or aid to those in distress);
- Administrative and programmatic expenses associated with grantmaking; and
- Amounts paid to acquire assets used directly in carrying out the charitable purposes of the foundation.

Bottom Line: You Must Meet Payout Requirements. Your family foundation must meet federal annual minimum payout requirements (5 percent of net investment assets), as well as current costs of grantmaking and administration.

Expenses incurred in managing the endowment of a family foundation do not count toward the 5 percent distribution. These expenses include:
- Investment management fees;
- Brokerage fees;
- Custodial fees; and
- Salaries or board meeting expenses to oversee investments.

Families must address a number of important questions when setting — or evaluating — the spending policy of their foundation, including:
- Is the foundation fully funded or will additional assets be received?

- Does the foundation board want to exceed annual, minimum payout requirements? If so, by how much? In every year or only in years in which the foundation's investments do well?
- Does the board want to grow the foundation's endowment or is it satisfied maintaining the value of the endowment on an inflation-adjusted ("real") basis?
- How can program objectives best be achieved: By spending more now? By constant and sustained effort over time? Or by growing the endowment so that more can be spent in the future?

A spending policy often includes guidelines and conditions for investment and portfolio growth. When establishing the spending policy, you and your board must also determine whether the return requirement implied by the policy is realistic and achievable over time.

Examples of the primary goals for spending policies adopted by foundations include suggestions to:

- Meet the minimum distribution requirement (5 percent annually);
- Distribute 5 percent of assets in grants, plus administrative expenses;
- Spend 5 to 6 percent of the average value of the endowment over the previous 12 quarters, making additional grants toward the end of the year as needed to fulfill the distribution requirement;

fig. 2 Example of a Family Foundation Spending Policy

INTRODUCTION:
The foundation is adopting the following spending policy in order to:

- Provide a more predictable and stable stream of revenue for its grantmaking and other activities; and
- Maintain the purchasing power of this revenue stream and the foundation's assets over the long term.

To achieve these goals, over a multiple-year period the trustees will take actions that will result in total spending equaling no more than 5.3 percent of a 3-year average of the market values of the foundation's assets at the beginning of the fourth quarter.

SPENDING RULE:
In calendar year 2002, the foundation will set its annual spending at the 2001 spending level, plus funding needed for one-time capital expenses of the __________ project.

In calendar year 2003, spending will be set at the 2002 spending level or 5.3 percent of the average of the market values of the foundation's assets on October 1, 2001, and October 1, 2002, whichever is greater.

In subsequent calendar years, spending will be set at the previous year's spending level or 5.3 percent of the average of the market value of the foundation's assets at the beginning of the fourth quarters of the preceding 3 calendar years, whichever is greater. In no case will spending exceed 6 percent of the previous year's market value (as determined as of the beginning of the previous year's fourth quarter).

The trustees will undertake a formal review of the spending rule at least once every 5 years. Should future market values either increase or decrease dramatically, the trustees will reconsider the spending rule, and either adjust spending or make changes in the spending rule as appropriate, keeping in mind the above stated goals.

- Spend 5 to 5.5 percent, while focusing on qualifying for the reduced excise tax rate of 1 percent;
- Meet the 5 percent distribution requirement but consider paying out a bit more, depending on program objectives and current investment returns;
- Maintain or moderately increase the value of the endowment and distribute the remainder of the investment return; and/or
- If the foundation is considering spending out, pay out 10 percent per year, with the expectation that all assets will be paid out within a predetermined horizon;

As these examples show, foundation spending policies usually begin with grants payout requirements and then include other factors such as administrative expenses, past grantmaking by the foundation, grantee needs, and the status of current market returns. Whatever the criteria, the 5 percent minimum mandate set by the IRS must always be met.

Developing an Investment Strategy and Policies

Once you have established an initial spending policy for your foundation, you are ready to develop an investment strategy to help meet requirements of that policy. Several important steps are involved in developing an investment strategy. These include:

- Calculating the return requirement;
- Developing an overall asset allocation strategy;
- Considering foundation-specific factors; and
- Developing the strategy and a written investment policy for the foundation.

Calculating the Return Requirement

The return requirement for most foundations (those not planning to spend out) is the amount needed to maintain the value of the endowment while also meeting the spending objectives of the foundation. One return requirement calculation is illustrated in the sidebar.

Thus, to maintain the real value of its endowment, a foundation with a 5.5 percent spending policy (and with these expectations for inflation and fees) needs to achieve an annual investment return of 9.75 percent.

fig. 3 Calculating the Return Requirement

RETURN COMPONENT	PERCENT OF AVERAGE ASSETS
Spending objective	5.50
Expected rate of inflation over investment time horizon	3.50
Estimated investment-related fees and expenses	0.75
Average annual investment return required	**9.75**

Creating an Overall Asset Allocation Strategy

The asset allocation strategy is the primary determinant of your investment returns. This strategy is the key investment focus of your board (and/or investment committee), and is far more important than individual security or manager selection. Some observers estimate that as much as 95 percent of a foundation's investment returns result from the asset allocation decision. (This estimate comes from Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, in their "Determinants of Portfolio Performance," *Financial Analysts* Journal, July-August 1986, pp. 39-44. While some practitioners dispute this exact figure, the fact that asset allocation is the single most important determinant of portfolio performance is almost universally accepted.)

Diversification among asset classes reduces risk because each type of asset responds differently to changes in the market. Because asset classes perform differently under different time periods and conditions, foundation rates of return can be stabilized and/or improved by mixing asset classes that have different characteristics and patterns of return.

The average annual return on domestic stocks was approximately 13.5 percent from 1926 through 1998. Over that same period the return for bonds was 5.8 percent. Thus, to achieve a rate of return that allows your foundation to maintain or grow the real value of its endowment, you will almost certainly need to invest a substantial percentage of the foundation's assets in stocks or other assets with the potential for high rates of return (real estate, venture capital, hedge funds, etc.).

Still, private foundations have significant cash flow requirements, and bonds are often used to provide a steady stream of income over time. Therefore, some mixture of stocks, bonds, alternative investments, and cash equivalents is usually necessary for a family foundation. See the profile of the Sample Family Foundation in the sidebar for more information about how one (fictitious) family foundation decided on its own asset allocation.

Considering Foundation-Specific Factors

A number of foundation-specific factors influence a foundation's asset

fig. 4 **The Sample Family Foundation Asset Allocation Decision**

The fictional Sample Family Foundation in the table below 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 MINIMUM (%)	MAXIMUM (%)
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 Family 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 Family Foundation also decided to focus on investing in domestic stocks, foreign stocks, and U.S. bonds, as it had been advised that the benefits of diversifying beyond these types of standard asset classes would be more than offset by the significant additional costs that this would entail.

The Sample Family Foundation then estimated the returns that it could expect from the included asset classes over a 5-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 Family Foundation thought it would need 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 income flow 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 Family 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 Family 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 judgments in establishing allocation range guidelines for domestic and foreign stocks. The Sample Family 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 Family 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 Family Foundation is also developing investment management policies to guide its board, investment managers, and employees.

SOURCE: Jeffrey R. Leighton. "Developing and Overseeing an Investment Strategy," *Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Dollars*. Washington, DC: National Center for Family Philanthropy, 1999.

allocation decision. The question of perpetuity and the return requirement of the foundation have been discussed. Other important factors include the board's risk tolerance and the foundation's investment time horizon.

Risk tolerance refers to the board's concern regarding the likelihood and frequency of realized investment returns falling below expected returns. Riskier asset classes have greater potential payoff, but a higher likelihood of falling outside of expected returns (sometimes above, sometimes below). Some board members are uncomfortable with highly volatile asset classes, and choose to steer clear of them in the asset allocation decision. By definition, riskier investments can also result in significantly lower returns in some years, potentially making it difficult to meet multiyear grant commitments and future cash flow requirements. Used in moderation, however, riskier asset classes can actually lower the overall risk of the total portfolio.

The time horizon of a foundation's investment strategy also relates directly to the asset allocation decision. The longer your foundation's time horizon — which reflects its willingness to ride out declines in the value of individual assets, as well as its ability to meet short-term payout commitments — the more you will be able to use diversification and other strategies to take advantage of high-risk (and potentially higher return) asset classes. If your time horizon is short, as is the case if you are spending out the foundation or if your board has a high level of risk aversion and is not willing to sustain short-term losses, your asset allocation decision will want to steer clear of more volatile asset classes. The illustration in the sidebar clearly shows how volatility and risk of loss decrease as the time horizon lengthens.

Adopting the Strategy and a Written Investment Policy

The foundation's investment strategy and policy helps guide the board, the investment committee, and managers and consultants who manage portions of the foundation's portfolio. This policy addresses the following:

- Statement of objectives: ties the investment policy to the mission and goals of the foundation (may include the specific return requirement, description of time horizon, diversification, and target risk levels, etc.).
- Oversight of the policy: describes who will be responsible for various investment-related tasks (the investment committee, key staff person, outside investment managers, etc.).
- Asset allocation: provides guidelines for the acceptable range for each asset class as a percentage of the overall portfolio (see sidebar).
- Rebalancing procedures: describes how and when the portfolio is rebalanced (usually either on an annual basis, or if one of the asset classes reaches the threshold of its acceptable range).

fig. 5

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

This table 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 negative 43 percent and as high as +54 percent between 1925 and 1998. A foundation that evaluated its returns over a 5-year time period would have had annual average returns as low as -12.9 percent for the worst 5-year period or as high as +23.9 percent over the best 5-year period. If the time horizon is further extended, the average annual return over the worst 10-year period would be -0.9 percent and the average annual return over the best 10-year period would be 20 percent.

SOURCE: Toni Brown, Callan Associates, in Jeffrey R. Leighton. "Developing and Overseeing an Investment Strategy," *Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Dollars*.

- Performance benchmarks: include any of a number of possible common indexes and measures to help review ongoing performance (examples include the S&P 500, the Russell 2000, and the Lehman Aggregate Bond Index). Benchmarks are chosen based on their relevance to each asset class.

Jeffrey Leighton, former chief financial officer for the David and Lucile Packard Foundation and an experienced foundation investment consultant, summarizes the key points for developing an investment strategy as follows:

- The best investment strategy focuses 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.

fig. 6

Example of an Investment Policy for a Family Foundation

The purpose of this statement is to establish the investment policy for the management of the assets of the ____________ Foundation.

OBJECTIVES: The goals for the foundation's investment program are (1) to earn sufficient investment returns to provide for a 5 percent level of annual charitable distribution plus operation expenses, (2) to earn an additional return to maintain the purchasing power of the foundation's invested assets after distributions and expenses, and (3) to enhance the purchasing power of the invested assets, if possible. These goals will be pursued without incurring undue risk relative to the practices of comparable charitable foundations.

DISTINCTIONS OF RESPONSIBILITIES: The Investment/ Finance Committee is responsible for establishing the investment policy that is to guide the investment of the foundation's assets. The investment policy describes the degree of overall investment risk that the Committee deems appropriate, given prudent investment principles and the basic objective of the preservation of the purchasing power of the foundation's assets.

Investment managers appointed to execute the policy will invest foundation assets in accordance with the policy and assigned policy guidelines, but will apply their own judgment concerning relative investment values. In particular, investment managers are accorded full discretion, within policy limits, to (1) select individual investments and (2) diversify assets.

ASSET ALLOCATION: It is the policy of the Investment/Finance Committee to invest the foundation's assets as follows:

ASSET CLASS	TARGET ALLOCATION (%)	ALLOWABLE RANGE (%)
Domestic Stock	55	51 – 59
Non-domestic Stock	15	11 – 19
Total Stock	70	67.5 – 75
Bonds*	30	26 – 34

******Bonds will have a minimum rating of BBB or its equivalent.*

REBALANCING PROCEDURES : Normal cash flows will be used to maintain actual allocations as close to the target allocations as is practical. At times, markets may move in such a way that normal cash flows will be insufficient to maintain the actual allocation within the permissible ranges. In these cases, balances will be transferred as necessary between the asset types to bring the allocation back within the permissible ranges, as described above. Rebalancing shall take place no less than once, and no more than twice, per year.

DIVERSIFICATION: The investment program shall be broadly diversified in a manner that is in keeping with fiduciary standards to limit the impact of large losses in individual securities on the total invested assets of the foundation.

LIQUIDITY: The foundation will advise investment managers of any anticipated needs for liquidity as such needs becomes known. Investment managers are to presume no need to maintain cash reserves other than those identified by the foundation.

PROXY VOTING: The Investment/Finance Committee delegates the responsibility for proxies to the individual investment managers. The Committee will vote proxies consistently and in the best interest of the foundation.

PERFORMANCE BENCHMARK: The foundation's investment objectives are to achieve a rate of return consistent with the asset allocation policy stated earlier. Over reasonable measurement periods, the rate of return earned by the foundation's assets should match or exceed that of a policy benchmark comprised of the following broad market indices and weights:

	POLICY BENCHMARK
Wilshire 5000 Stock Index (%)	55
MSCI All Country Ex-U.S. Index (%)	15
Lehman Brothers Aggregate Bond Index (%)	30

The individual managers' returns will be compared with appropriate market indices. For performance evaluation purposes, all rates of return will be examined after the deduction of investment management fees.

- 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 Foundations, has noted that, by the time a new asset class has proven 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. Failure to rebalance the portfolio is tantamount to a decision to change the asset allocation strategy.

SOURCE: Jeffrey R. Leighton. "Developing and Overseeing an Investment Strategy," *Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Dollars*.

An example of one investment policy, with descriptions of each of these components, is presented in Figure 6 (on p. 147).

Overseeing the Investment Strategy

Many family foundations oversee their investment strategy through the establishment of an investment committee. Ideally, this committee is comprised of individuals with broad and diversified knowledge of investments. Members of the committee will be able to articulate the policies, actions, and results of the investment strategy to all current and prospective board members (whose understanding and experience in investments may be quite varied).

Some foundations work with investment consultants to develop their investment strategy and policies, and to select individuals to manage aspects of the portfolio.

Determining Investment Committee Responsibilities

The investment committee generally assumes some or all of the following responsibilities:

- Ensures that the foundation's investment goals and objectives are in line with its grantmaking goals and objectives;
- Determines long-term allocation among asset classes;
- Determines choice of preferred investment manager styles;
- Determines whether to use separate accounts or mutual funds;
- Selects individual managers, consultants, and advisors (if necessary);
- Reviews the performance of individual managers and asset classes; and
- Reports to the full board on the endowment's recent and long-term performance.

Depending on the complexity of these decisions, the committee may engage investment consultants to help them think through these responsibilities. In addition, a number of endowment management tasks must be undertaken regularly by committee members, foundation staff (if they exist), or an outside professional (accountant, lawyer, etc.). These activities typically include:

- Managing endowment cash flow;
- Monitoring asset allocation;
- Ensuring accurately reported quarterly and cumulative investment performance for individual managers and the endowment as a whole;
- Ensuring proper custody of endowment holdings and necessary recordkeeping on investment transactions;
- Preparing agreements with managers, mutual funds, brokers, and securities custodians;
- Ensuring that shareholder proxies are voted;
- Managing the investment consultant (if present); and
- Providing necessary staff support for the investment committee (scheduling meetings, distributing reports for discussion in advance, as well as providing advance reports on the endowment for board of trustees meetings).

SOURCE: John E. Craig, Jr. "Understanding Trustee Responsibilities and Duties," *Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Dollars*.

Finding Investment Advisors

Many family foundations work with outside investment managers for some

fig. 7 Family Foundation Investment Advisors

Trustees may find it useful to identify the particular talents they need. The following descriptions may offer a starting place:

- **Investment Committee:** Boards of many family foundations, even small ones, assign oversight duties to an investment committee, which typically reports to the full board quarterly.
- **General Advisor:** A family member, lawyer, accountant, consultant, or other person who offers general advice to the board.
- **Consultant:** A person who can help trustees to establish a decision making structure for investment management, develop a strategic plan, and find investment advisors and managers.
- **Manager:** A trustee, foundation employee, or outside manager who selects actual investments, buys and sells stocks and bonds, handles administrative aspects of investments, and reports to the investment committee.
- **Custodian:** A bank or trust company that holds assets, collects income, and reports periodically on investment activities.

SOURCE: Excerpted from Kathryn McCarthy. "Engaging Investment Advisors," *Resources for Family Philanthropy: Finding the Best People, Advice, and Support*. Washington, DC: National Center for Family Philanthropy, 1999.

tasks. Steps to consider when looking for outside assistance include:

- Determine what types of assistance you are looking for (see sidebar);
- Develop a position description that lists the attributes you are looking for, including educational, experience, and performance requirements, as well as personality requirements and investment style;
- Talk with foundations, institutions, and individuals you know to get suggestions for prospective managers and consultants;
- Send a request for proposal (RFP) to those individuals/firms you would like to meet. This RFP will help your foundation determine each firm's experience, performance, fee structure, and staffing, as well as its research policy and practices, reporting procedures, and client service procedures; and
- Set up interviews with those candidates who meet your qualifications and requirements.

Selecting Investment Advisors

Any investment firm or individual you approach will have tailored information on its performance over specific time periods. To ensure that you get helpful performance figures, make sure that those you meet with calculate performance in accordance with the guidelines of the Association for Investment Management and Research, and that they give you returns for 3-, 5-, and 10- year periods.

Questions you may wish to consider when interviewing managers include:

- What is their general approach to investing?
- What is the succession plan if they retire, become ill, or leave the firm?
- What other foundation clients do they work with? May you talk with them?
- What type of reporting and evaluation arrangement do they typically follow?
- What questions do they have about the position?

Questions you may want to ask yourself include:

- Am I comfortable working with this manager? Does his or her style match my own?
- Am I confident that the foundation will receive significant added benefit for the fee dollars I am spending?
- Are there other options (index funds, mutual funds, etc.) I may wish to explore as an alternative to hiring an investment manager at this time?

Working with Investment Advisors

If you decide to hire advisors, you will want to establish reporting arrangements that make sense for both of you. Identify and agree on the performance benchmarks you would like to use, and establish reporting schedules for each of your managers. Investment managers should be expected to outperform their benchmarks on a net-of-fee basis, and if they fail to do so over an extended period (a couple of years or more), inquire as to the reasons why. Remember that even the best managers will have periods where they underperform in relation to their peers or benchmarks.

Determine how often you would like the manager to report to the board, and in what form these reports are presented (for instance, quarterly written reports and annual board presentations). Evaluations should also take into account the manager's investment style, and how this style may have affected recent performance. Ensure that the manager continues to follow the specific guidelines he or she has been given.

Determining the Family's Role

Because you have set up your foundation as a family foundation, you and your board may want to consider issues with implications for individual family members. Which family members show interest in serving on the investment committee? Must they be board members to do so? Which bring special knowledge or skills to the work at hand. To what extent should branches of the family, or generations, be represented? Also important, of course, are the personalities and interpersonal skills of family members who are called upon to serve in a group environment.

Members of the family who are selected to serve on the investment committee must be prepared to spend additional time on foundation-related activities. Determining who serves on the investment committee can be a difficult task. Traditionally, these committees have been made up of the founder and those trustees with the most experience in this area. Because all members of the board are considered fiduciaries of the foundation, however, it is important that each current and future trustee has a general understanding of investments activities.

Family foundations employ a wide variety of methods to teach younger and/or less experienced family members about financial stewardship. Common practices — both informal and more structured — include:

- Placing next-generation and less-experienced trustees on the investment committee with more experienced board members/advisors;
- Spending a day with foundation money managers at their offices;
- Requiring money managers to conduct a 2- to 4-hour instructional seminar for new/future board members;
- Making occasional educational seminars part of the investment counselor's job description;
- Incorporating at least one learning segment related to finances at every board meeting;
- Developing a formal orientation-training program of from 1 to 3 days for next-generation members (a significant portion of which covers financial management);
- Sending trustees to professional conferences, seminars, and workshops on investment-related topics; and
- Establishing a separate Next Generation Advisory Board that includes a small fund to manage and a requirement that the advisory board report on its activities at every full board meeting.

SOURCE: Lester A. Picker. "Training the Next Generation," *Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Dollars*.

Reviewing Disqualified Persons Requirements

Family members sometimes find themselves playing a direct role in managing one or more of the asset classes or individual funds in the foundation's portfolio. This practice may be illegal under certain circumstances. It is very important, therefore, that you and the rest of the board be familiar with the self-dealing rules. Situations to keep a close eye on include:

- Compensating investment managers who are disqualified persons. All family members are disqualified persons.

The general rule here is that the amount of the compensation must be reasonable, where reasonable means that a similar organization would pay such an amount for similar services under similar circumstances.

- Compensating property managers who are disqualified persons. This act is defined by the IRS as self-dealing and is, therefore, not permissible.
- Lending money or extending credit to a disqualified person. This act is defined as self-dealing and is not permissible.
- Benefiting from joint investments. Disqualified persons are generally not allowed to make investments in the same investment partnership.

fig. 8

Roadblocks and Bumps in the Road

Family foundation boards may experience challenging situations while overseeing the investments of the foundation, including:

- **Family members as paid investment managers:** Prudent boards will be wary of arrangements in which a family member is paid to manage the investments of the foundation. Reviewing the performance of a family member is not always easy, and trying to remove a family member as manager can be even more difficult. Combined with the need to ensure that the compensation arrangement is within the self-dealing rules, this practice may not be one that you will want to tangle with.
- **Liquidity considerations:** Foundations have annual payout responsibilities and, in most cases, ongoing operations costs. As such, you need to ensure that an adequate amount is kept in cash or some other easily converted investment type for annual (or more frequent) grant payments and other expenses.
- **Over-management of the endowment:** Just as individual investors do, foundation boards have a tendency to over-manage their investments — buying and selling new funds, changing advisors, and even changing investment styles regularly. Because of the high cost of these transactions, and because foundations usually invest for the very long-term, it is important that the board resist these temptations and, whenever possible, stick to a predetermined strategy through the inevitable ups and downs of the markets.
- **Time lags between meetings:** At the same time, cases arise where individual stocks or classes of stocks experience rapid shifts in price, and action may be needed either to rebalance the portfolio or take other more radical action. Because many foundation boards do not meet more than one or two times per year, it is important to have some system in place to account for these situations — this could be as simple as giving one or more of the trustees discretion to make these decisions.
- **Disparity of interests and abilities:** All board members — regardless of their investment background and experience — need to understand the strategy and decisions made with regard to the foundation's investments. This can be accomplished in a number of ways (see above for specific ideas).
- **Excise tax on net investment income:** Private foundation endowments are subject to an excise tax of at least 1 percent, and up to 2 percent, of investment returns each year. These taxes are paid on realized net gains, and a portfolio with constant turnover will likely trigger the maximum tax payments. Although it may not be possible to avoid the maximum tax in any given year, families may wish to consider working with advisors who have sensitivity in managing the portfolio in a tax-efficient manner.

Just as the foundation's grantmaking goals and objectives may change over time, so may its spending and investment objectives and strategies. Keep in mind that program goals, rather than the performance of individual managers or asset classes, should drive these changes.

For more information about the self-dealing rules, consult with legal counsel or refer to resources listed in the Appendices. You may also wish to develop a conflict-of-interest statement to make clear the limitations on board member's interaction with the foundation. (See Facing Important Legal Issues, p. 59.)

Considering the Role of Future Generations

At some point, you and your board will need to determine what the role of the next generation will be with regard to the foundation's investments. Common questions that families face in this area include:

- Should the next generation have the option of changing spending policy?
- How can we best prepare the next generation to manage the investments of the foundation?
- What guidelines can we provide the next generation with regard to the investments of the foundation?

Developing these guidelines can be an important and potentially time-consuming task.

Reducing Investment Costs

By reducing costs, a foundation board may be able to adopt a more conservative portfolio, yet 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, while minimizing investment costs. Three common methods for developing a portfolio with limited investment costs are mutual funds, separate account managers, 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. Also, because contributions tend to pour into mutual funds during market highs and flow out during market lows, mutual fund investors 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, if the foundation is looking to minimize the excise tax on investments. 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, 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 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-Implementation. The boards of many foundations are comfortable with 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); limitations on diversification (unless the foundation is of significant size); 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 (see below). Options include:

- 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 their custodian. 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 employs a performance-based fee system, and in the past has maintained relatively low investment minimums.

Revisiting Goals and Objectives

Just as the foundation's grantmaking goals and objectives may change over time, so may its spending and investment objectives and strategies. Keep in mind that program goals, rather than the performance of individual managers or asset classes, should drive these changes. Because well thought-out grantmaking and investment strategies often require that you stick with a philosophy over an extended period, it is important that you allow these strategies time to develop without making radical or frequent shifts in approach.

Situations may develop, however, in which changing the spending policy and investment objectives may make sense. Specific reasons to consider revisiting the spending policy (and associated investment strategy) may include:

- Underperformance: Foundations should review their overall portfolio performance at least annually. In some cases, the board may find that the investment objectives are not being achieved over a period of time. This outcome could be because the investment objectives are not realistic, or the spending policy itself is too ambitious.
- Sustained growth in the markets and economy: In some situations, the opposite is true. The market occasionally experiences sustained periods of growth, which may lead to significantly higher endowments than expected. In such cases, the foundation might want to consider increasing its payout rate for an indefinite period of time.
- Opportunities for significant social investment in a particular issue or cause: In some cases, you and the board may identify a well-defined cause that you think the foundation might be able to correct with a substantial influx of funds. In such cases, revising the spending policy may be necessary.

fig. 9

Checklist of Fiduciary Responsibilities

1. Does the foundation file 990-PF and related state forms? **Yes No**
2. Does the foundation publish in a local newspaper the location and availability of the 990-PF? **Yes No**
3. Do staff and board periodically disclose to the governing body the nature of any personal or family affiliations or involvement with any organization that might be considered an act of self-dealing or a conflict of interest? **Yes No**
4. Do you believe that the board fully understands its legal responsibilities? **Yes No**
5. Does the board annually approve a budget and periodically review its implementation? **Yes No**
6. Do board members understand the data presented in regular financial reports? **Yes No**
7. Does the board have members with special expertise who give advice and leadership in:
   a. Long-range fiscal planning? **Yes No**
   b. Investment practices? **Yes No**
   c. Fiscal management? **Yes No**
   d. Budget review? **Yes No**
   e. Analysis of audit reports and recommendations? **Yes No**
8. Do you feel that the board fully accepts its responsibility for prudent fiscal management? **Yes No**
9. Does the board or a board committee hold regular meetings with its investment advisors or investment staff? **Yes No**
10. Does the board get adequate and comparative information on the investment portfolio's performance? **Yes No**
11. Does the board have a policy to guide those responsible for selecting/monitoring foundation investments? **Yes No**
12. Are you generally satisfied with the performance of the foundation's investment managers? **Yes No**
13. Does the board or an appropriate board committee take direct responsibility for voting on shareholder resolutions affecting companies whose stock the foundation owns? **Yes No**
14. Does the board have a conflict-of-interest policy statement that all directors and officers are expected to execute?
   a. Should it be reviewed for substantive content? **Yes No**
   b. Was it, in fact, signed by all directors **Yes No**
15. Was there a meeting at which a director disclosed a conflict of interest regarding a decision? **Yes No**
16. If so, was there an adequate record in the minutes of that disclosure? **Yes No**
17. Was there a vote on the issue to which the director had a conflict? **Yes No**
18. If so, was there a quorum (as defined by the statute of incorporation) for such a vote? **Yes No**
19. If so, was there a vote of an adequate number of disinterested directors? **Yes No**
20. What material is distributed in advance of board meetings?
   a. Minutes of last meeting? **Yes No**
   b. Current financial statements? **Yes No**
   c. Current reports of committees? **Yes No**
   d. Summaries of decisions to be made? **Yes No**

SOURCE: Compiled from the Guidebook for Directors of Nonprofit Corporations of the American Bar Association. Republished from Appendix E. *Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Dollars.*

- Decision to sunset the foundation: Whether you make this decision on your own or with the family, or whether this is a choice that will be made at some point in the future, the decision to sunset or spend out the foundation will have radical implications for how the foundation spends and invests its resources.

A Final Word: Reviewing the Checklist

John Craig, executive vice president and treasurer of the Commonwealth Fund, offers the following checklist for managing a family foundation endowment:

- Does the foundation have a clear spending policy? Does that policy reflect a consensus among trustees regarding the life expectancy of the foundation?
- Do members of the investment committee have relevant experience for overseeing the management of the endowment?
- Are members of the investment committee fully engaged in the foundation's mission and equally attentive to its grantmaking?
- Does the foundation have written investment guidelines for the endowment as a whole and for individual managers? Do these guidelines include targeted allocations to named asset classes with permissible ranges for each?
- Is the allocation of the endowment among asset classes regularly monitored? Is corrective action taken when market trends cause allocations to veer beyond the targeted ranges?
- Does the investment committee report at meetings of the board of trustees on the endowment's recent and long-term performance?

SOURCE: John E. Craig, Jr. "Understanding Trustee Responsibilities and Duties," *Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Dollars*.

These questions provide a helpful context for the types of conversations and decisions you and your board will be making in the future regarding the investment of your foundation's endowment and the role of the family in that process. You probably will not be able to answer "yes" to each of these questions at this time. As you review the development of your strategy, policies, and practices, consider revisiting these questions at each board meeting until you feel comfortable with your answers. As John Kunstadter, president and long-time trustee of the Albert Kunstadter Family Foundation, once wrote,

> In the end, your satisfaction and joy will come not so much from good investments, but from the grants you have made, the lives you have affected for the better, the Earth which is a little better place for your efforts. There are many roads to these goals, as many roads as there are foundations; so use your common sense, don't take up with the latest fad, keep things in perspective, and your foundation will gladden your heart as you see it accomplish your goals.

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Starting a family foundation?

Splendid Legacy will help you answer these key questions:

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- Funding the foundation.
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