# CHAPTER VI

# UNDERSTANDING TRUSTEE RESPONSIBILITIES *and* DUTIES

*by John E. Craig, Jr.*

*Protecting and prudently investing the endowment are among the most important responsibilities that fall to members of every family foundation board. What are the responsibilities of the board members with regard to endowment management? How, and by whom, can those responsibilities be met? And, how will the full board know if the endowment is being managed to the optimal benefit of the foundation? These and other related topics are the subject of this chapter.*

ENSURING THAT THE ENDOWMENT is invested to achieve the highest possible return—commensurate with an acceptable level of risk—is a key responsibility for foundation trustees. Whether serving a family foundation or other private foundation, trustees wrestle with a set of issues that are fundamentally the same. Trustees of family foundations often face challenges that their private foundation counterparts need not contend with. These include negotiating the dynamics of family relationships, learning to develop and establish effective programs, policies, and practices, and dealing with the greater role of large blocks of donor stock in their investment portfolio. Most family foundations have assets of less than $100 million, and many do not have the staff capacity or access to investment consultants that larger, private foundations may have. Despite these challenges, it is vitally important that family foundations establish guidelines for investing the endowment and monitoring performance, organize the work of the investment committee, and choose board and committee members with care. Accepting and overseeing each of these responsibilities is essential for achieving the return on the endowment necessary for accomplishing the foundation's mission.

## Key Issues in Endowment Management

Like the trustees of other nonprofits, family foundation trustees have three commonly recognized duties to the organizations they serve: obedience (adherence to the foundation's charter and mission), loyalty (concern for the foundation's best interest and for avoiding conflicts of interest), and care.[20] This last duty is particularly applicable to management of an endowment, where trustees are expected to carry out their responsibilities using the "care that an ordinarily prudent person would exercise in a like position and under similar circumstances." Much has been written and argued in the courts on this "prudent investor" responsibility, but most family foundation trustees will find the following summation to be a helpful guideline:

> *Ordinary prudence means that directors are expected to possess and exercise sound, practical judgement, to employ common sense, and to reach sound, informed conclusions (although the conclusions they reach need not be the right*

*ones). Directors, acting as ordinarily prudent persons, do not, thereby, guarantee the success of investments or activities, programs, or grants. And prudence is not to be equated with excessive caution, whether in making investments or programmatic decisions.*[21]

EFFECTIVE INVESTING DEMANDS SPEEDY RESOLUTION *of* ISSUES, ALWAYS INVOLVES RISK, AND *frequently* REQUIRES CHOICES THAT RUN COUNTER *to* PREVAILING MARKET WISDOM.

The Uniform Management of Institutional Funds Act (UMIFA) and The Prudent Investor Rule set forth standards for prudent management of investment assets. Both rules recognize the importance of process in setting investment policy. UMIFA requires that consideration be given "to the long and short term needs of the institution in carrying out its mission, anticipated financial requirements, the expected total return on its investments, price level trends (inflation) and general economic conditions." The Prudent Investor Rule states that satisfaction of the standard of due care is to be viewed "in the context of the trust portfolio and as part of an overall investment strategy." The development of a prudent investment strategy is thus largely about process.

Responsible monitoring of endowment performance depends on deliberate board decisions in six key areas:

- Who will serve on trustee and investment committees, and who will provide assistance to those committees;
- Foundation spending policy;
- Foundation asset allocation;
- Whether use of investment managers or investing through the use of mutual funds best suits the foundation;
- If investment managers are to be hired, what style and type of investment manager will work best with the board; and
- What securities should or should not be purchased.

**Trustee 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?

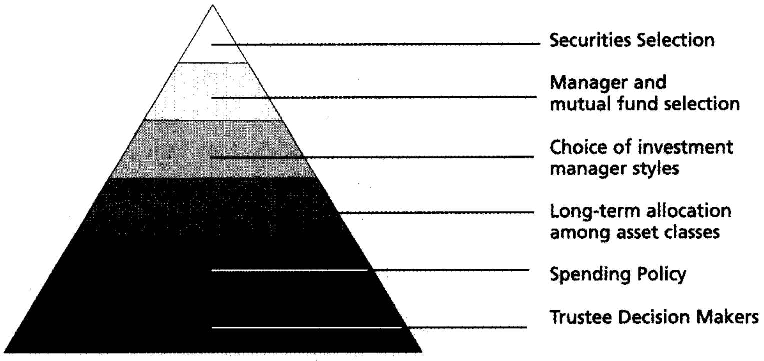
## Empowering Trustee Decision Makers and Their Aides

William G. Bowen once observed that "trustees of foundations have more opportunity to affect institutional performance than do the directors of any other set of entities in either the for-profit or non-profit sector."[22] Thus, the most fundamental influence on endowment performance, shown at the base of the pyramid in Figure 1, is the decision making group held accountable for the endowment's performance: the foundation's board of trustees and the investment committee of that board.

Most aspects of foundation management require the entire board's involvement, and the board should certainly be kept apprised of all major decisions. However, many investment decisions require a level of experience and knowledge of the financial marketplace not common to all board members. Effective investing demands speedy resolution of issues, always involves risk, and frequently requires choices that run counter to prevailing market wisdom. Making informed investment decisions to the benefit of the foundation is, therefore, difficult, if not impossible, in a large, consensus-oriented group that convenes infrequently. Thus, the board should delegate broad decision-making authority on investments to an investment committee, whenever possible.

Investment committee composition and the division of labor between it and any staff, consultants, and investment managers are important issues that are best addressed after review of the other determinants of an endowment's performance.

**Figure 1: The Endowment Performance Period**


Securities Selection
Manager and mutual fund selection
Choice of investment manager styles
Long-term allocation among asset classes
Spending Policy
Trustee Decision Makers

**The principal determinants of a foundation endowment's well-being**

**Source: Treasurer's Report, 1994 Annual Report of the Commonwealth Fund*

## Establishing Prudent Spending Policy

Family foundations should address at an early stage in their development the question of the expected lifetime of the institution—the options ranging from spending down assets over a stated period to aiming for perpetual existence. Decisions on this issue affect both program and endowment investment strategies, and trustees have few responsibilities greater than that of assuring an annual rate of spending consistent with the life expectancy of the foundation. Thus, the second most important factor of an endowment's investment strategy and performance is the annual rate of spending as a percentage of assets. (See Chapter II, "Developing a Spending Policy," for a full discussion of this topic.)

In establishing prudent spending policies, board members of foundations that aim for perpetual existence should be mindful of the realities of long-term market returns. The math is simple: an asset mix in the neighborhood of 70 percent equities and 30 percent fixed income will maximize the risk-adjusted returns of permanent endowments.23 Since 1900, the average annual return has been 10.3 percent on domestic equities and 5.4 percent on domestic bonds. This produces a weighted return of 8.8 percent. The average inflation rate for this period has been 3.1 percent, while average annual investment costs (brokerage and investment manager or mutual fund fees) have been around 0.7 percent. Thus, a foundation that spent around 5 percent annually—the minimum required under federal law—maintained the real value of its corpus over the course of the century.[24]

Ultimately, the very high returns that domestic stocks have earned since the current bull market began in 1982 (18.3 percent average annual return as measured by the S&P 500) and the unprecedentedly high back-to-back returns over the past four years may call for reconsideration of the long-term market returns data employed since 1900 as a guide for prudent spending.[25]As yet, however, few market seers are prepared to set aside the very long-term record or advise spending strategies based on a few years' of unusually high returns.

Because it is the primary determinant of a foundation's life expectancy, the spending rate clearly should be a full-board decision. Regrettably, boards too often fail to address the implications of current spending rates for the endowment's future purchasing power and longevity. This failure may arise from lack of information on spending rates or out of a reluctance to confront the issue of whether the foundation should exist in perpetuity. (See Chapter 1, "Considering the Question of Perpetuity.")

## Allocating Assets

The literature on endowment management is replete with demonstrations of the major role played by asset allocation—the third layer of the pyramid—on an endowment's performance. Indeed, allocating assets among domestic stocks and bonds, cash, and such classes as international equities and real estate is the most important task of the investment committee. Each asset class has a distinct return and risk profile, characteristics that generally dominate the behavior of individual securities within the class. As already noted, a foundation required to distribute 5 percent of assets each year holding perpetuity as an objective must concentrate on equities, the only class that can realistically be expected to produce the needed 5 percent real return over any length of time.

Foundations with shorter chosen life expectancies face a very different, and generally simpler, set of asset allocation options. They do not need to pursue investment strategies that would preserve capital over a long period. Moreover, less short-term investment risk can be assumed; thus the percent of assets allocated to equities should be less.

REGRETTABLY, BOARDS TOO OFTEN FAIL *to* ADDRESS THE IMPLICATIONS *of* CURRENT SPENDING *rates* FOR THE ENDOWMENT'S FUTURE PURCHASING POWER AND LONGEVITY.

Most investment committees have the expertise needed to make the basic asset allocation decision: how much of the endowment to place in domestic stocks and bonds, and how much in cash. Sophisticated analyses that take into account the correlations of returns and risks among a broader range of asset classes (including, for example, international stocks and bonds, venture capital, and real estate) are now readily available in the investment literature or can be obtained from consultants and investment managers. These analyses encourage perpetual foundations to diversify beyond the traditional basic asset categories—the argument being that higher returns can be achieved with only marginally greater risk—and provide useful guidelines for more complex asset allocations.[26]

Still, family foundations—particularly small family foundations ($50 million or less in endowment)—should approach sophisticated diversification strategies with care. First, many endowment investors learned during the global financial crisis in 1998 that historical relationships between the performance of different asset classes may break down in extreme circumstances or change in response to fundamental shifts in the global economy and financial markets. In addition, because data are limited, some of the newer asset classes may simply have been misjudged. Some believe that the experience of 1998 suggests that highly diversified investment strategies using nontraditional asset classes and types of securities may be riskier than was previously thought.

A further argument for caution is this: the more asset classes employed, the more time investment committee members will have to spend on portfolio oversight. Thus, the smaller the foundation, the less venturesome it should be in going beyond the traditional basic asset classes.

Overdiversification is only one of the pitfalls that investment committees face in the asset allocation process. Another hazard stems from the fact that a bull market in one asset class causes its share of the endowment—if left untended—to rise above the range assigned to it by policy, while a bear market causes that share to fall below. An investment committee must have the courage and wisdom to reduce exposure in an asset class as a bull market progresses, and to increase exposure as a bear market unfolds to ensure that their specified policy range is maintained.

Some investment committees are also prone to engage in market timing—setting aside agreed-upon asset allocation policies and moving funds into or out of an asset class on the basis of sentiment regarding the short-term outlook for that market. Few professional investors have extended records of successful market timing, and it is unlikely that an investment committee can do any better.

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These pitfalls can be avoided by adhering to a discipline of establishing policy allocations for each asset class and not allowing actual allocations to range far from those norms. Some committees lack this discipline, and all are vulnerable to lapses in it. A safeguard is to review asset allocation at all committee meetings and revisit the rationale for policy allocations regularly. Committees can also allow qualified managers some discretion to invest outside the asset class assigned to them in periods when they are more likely to meet performance objectives by doing so. This practice reduces the burden on the committee for making short-range asset allocation adjustments. Some committees go a step further by delegating asset allocation responsibilities to a multi-asset manager who is held accountable for keeping asset class allocations within agreed-upon ranges.

## Determining Investment Manager Style and Type

After asset allocation, an investment committee's second most important prudent-investment decision concerns the style and type of investment managers to hire or mutual funds to purchase within each asset class—the next layer of the performance pyramid. Recent studies show that in periods when growth stocks, for example, perform well, most growth stock managers are also successful and that when small capitalization stocks perform well, so do most small capitalization stock managers. Given the stock market's tendency to experience lengthy cycles in which groups of stocks—such as large capitalization growth stocks recently—are in favor, committees should take care to ensure that most major groups are always represented in the endowment's portfolio.

Thus, board attention should focus as much on the type of manager hired—value or growth stock manager, small capitalization or large capitalization stock manager—as on the choice of particular managers. Some committees rush into hiring managers without giving sufficient thought to the types of manager the foundation needs, or to what pattern of returns a group of selected managers is likely to produce, given their styles and investment philosophies. Many committees are equipped to analyze manager styles and can add value by deciding how to allocate assets among styles, but others request staff or consultant research to further inform their decision making.

## Prudently Selecting Managers or Mutual Funds

Over the past two decades, prudently selecting managers or mutual funds—the fifth layer of the performance pyramid—has become the principal activity of most foundation investment committees. This focus supplanted an earlier preoccupation with the sixth layer of the pyramid, securities selection. This shift in emphasis occurred with the realization that, with tens of thousands of securities available worldwide and thousands of full-time investment professionals picking promising stocks and bonds and culling disappointments, securities selection is a poor use of the time and talents of a part-time committee.

If investment committees are more likely to add value by selecting managers than by selecting securities, the trend toward emphasizing manager or mutual fund selection has been a mixed blessing. The field of managers is immense, with over 11,000 U.S. stock and bond managers, 7,400 U.S.-based mutual funds, and many hundreds of overseas investment managers operating today. Many committees are poorly equipped to sort through this universe to identify truly skilled managers.

Track records—the major selection criteria for many committees—do not make allowance for skillful managers whose investment styles are temporarily eclipsed by market trends, or for recent successes that may not be sustainable. Managers are too often hired at their performance peak and fired at their trough. Sometimes confusing activity with diligence, committees are often over-zealous in the hiring and firing of managers, failing to judge a manager's performance over a market cycle or to allow for market cycles in investment styles, and failing to recognize the transaction costs of manager changes.

Diversifying into more aggressive asset classes or hiring more skillful managers has the potential of increasing the return on a foundation's endowment. But the more aggressive the asset class or type of manager, the wider tends to be the range of manager returns. Picking winners becomes increasingly difficult, requiring more and more skill. Thus, the higher an investment committee sets its sights, the greater the risk of missteps.

Staff or consultants can help broaden the range and depth of manager searches, while also enhancing a committee's ability to assess the performance of existing managers. The challenges of manager selection have been compounded, however, by the underperformance over the past 18 years of the typical stock manager within the U.S. market as measured by the S&P 500. During that time, few managers have consistently outperformed the market index.

The high costs and comparatively poor records of the majority of active managers have led some foundations to place parts of their endowments in index funds. In taking this course, care should be taken to choose a fund that is broadly representative of the market,[27] and many foundation indexers wisely hedge their bets by also allocating money to actively managed mutual funds or accounts.

Recognizing the difficulties faced by smaller foundations in identifying and selecting highly qualified managers and allocating assets among them appropriately, The Investment Fund for Foundations (TIFF) was organized in the mid-1990s as an investment cooperative to which foundations could delegate those responsibilities.[28] Thus, through the services of consultants, index and other mutual funds, and TIFF, foundations now have a range of aids and options for reaching decisions on the important manager selection questions.

**Basic Endowment Management Responsibilities**

Certain essential endowment management tasks should be placed in the hands of a capable foundation representative—a trustee, staff person, or external professional (e.g., investment consultant, accountant, law firm). The job description for this person should include the following:

- Manage endowment cash flow;
- Monitor asset allocation;
- Ensure accurately reported quarterly and cumulative investment performance for individual managers and the endowment as a whole;
- Ensure proper custody of endowment holdings and necessary recordkeeping on investment transactions;
- Manage preparation of agreements with managers, mutual funds, brokers, and securities custodians;
- Assure that shareholder proxies are voted;
- Manage the investment consultant (where there is such); and
- Provide necessary staff work for the investment committee (scheduling meetings, distributing in advance reports for discussion, and providing advance reports on the endowment for board of trustees meetings).

## Selecting Securities Under the Duty of Care

Securities selection forms the cap on the performance pyramid. Its size, relative to other levels on the pyramid, is not intended to minimize the importance of well-chosen individual securities in ensuring an endowment's performance. Rather, it dramatizes the far greater importance of prior decisions, further down the pyramid. In fact, many investment committees delegate responsibility for selecting securities to full-time investment managers or mutual funds, choosing to dedicate their time to monitoring the overall strategies of their investment managers rather than to critiquing individual portfolio holdings.

For some foundations, "socially responsible" or "mission-related" investing—whether by avoiding securities in companies involved in activities that are seen as harmful to society or by playing the role of activist shareholder to encourage certain kinds of socially responsible activities and discourage harmful activities and policies—is of particular interest. Foundations whose leaders are well suited to the added responsibilities of this type of approach may add social investing to their endowment management responsibilities. Mutual funds and investment managers with social investing mandates are available to assist in pursuing this mission. (See Chapter IX, "Thinking About Mission-Related Investing," for further discussion of this topic.)

### Guidelines to Help Prudent Investment Committees

Seven guidelines for prudent investment committees emerge from this analysis of the determinants of a foundation endowment's performance:

THE MORE AGGRESSIVE *the* ASSET CLASS OR TYPE *of* MANAGER, THE WIDER TENDS *to* BE THE RANGE OF MANAGER RETURNS.

- *Delegate responsibility for as many investment decisions as possible to professionals.* It is unreasonable to expect a part-time, voluntary committee to deliver the same level of performance achievable by full-time investment professionals. The economies-of-scale of investment management are such that few foundations can manage their investment portfolios themselves. Hiring external managers or using mutual funds is therefore the best practice. Family members who are themselves investment professionals may of course be appropriately employed, with due attention given to potential conflict-of-interests issues.
- *Retain the services of investment consultants who specialize in the endowment field.* Because even large foundations have minimal investment staff and small foundations have none at all, committees may benefit from the expertise of consultants who can provide the research and analysis necessary for allocating assets appropriately and for conducting well-informed manager searches. Very small family foundations with assets under $10 million will not be able to meet the minimum asset level required by many consultants, which makes the need for committee members with some investment experience all the greater.
- *Place day-to-day responsibility for investments in the hands of a capable representative.* Consultants produce their best work when guided by a foundation representative able to devote substantial time and thought to the foundation's investments, and who has a close working knowledge of the foundation's finances. Given the demands on the time of voluntary investment committee trustees, whenever possible that person should be a qualified staff person, with responsibility for orchestrating the work of the investment committee, consultants, and investment managers. Any foundation with assets of $100 million or more should ensure that a qualified staff member acts as de facto chief investment officer, reporting to the investment committee. Small foundations are typically unable to afford such staff, but may wish to delegate authority to a committee member with the requisite time and expertise.
- *Give clear mandates to hired professionals.* The division of labor among committee members, staff, consultants, and investment managers must be well understood if each is to perform his or her role effectively. Guidelines for managers should include the universe of stocks, bonds, or other securities from which managers may select, as well as agreed-upon performance expectations relative to market indexes.
- *Monitor hired managers' performance and that of the total endowment vigilantly.* Investment returns for each manager and for the total portfolio should be calculated each quarter and cumulative performance records

should be compiled. The investment committee should ensure that analyses of performance are undertaken on a regular basis and that they focus on cumulative returns. The committee should also meet with external investment managers with sufficient frequency to assess each firm's ability to continue satisfying the rigorous demands on intellect, energy, and time that produce superior long-term performance. Two meetings per year are normally sufficient for this purpose, and one of these might be by conference call.

- *Focus on the long term, and never mistake investment committee activity for a measure of diligence.* Committees should resist the common penchant for being over-zealous in hiring and firing managers and for engaging in market timing. Foundations are almost uniquely privileged among investors in their freedom to focus on the distant horizons rather than short-term market fluctuations and returns. Trustees should be mindful that a truly long-term investment perspective is appropriate for perpetual foundations, and that adhering to a well-considered strategy is almost always the best policy, whatever the current market crisis.
- *Keep the rest of the board of trustees well informed on the investment committee's strategy for managing the endowment, issues currently requiring attention, and the endowment's short- and long-term performance record.* Whoever is chosen to make the investment decisions should be expected to explain those decisions to the rest of the board in language that all can understand. The full board should understand the level of risk inherent in the chosen investment strategy. If so informed, board members are likely to maintain their confidence in the investment committee—even during periods of market volatility.

## Summing Up: Criteria for Selecting Investment Committee Trustees

Most family foundations have but one source of income: their endowment. Because that endowment makes possible all the foundation's philanthropic work, those who manage it should have as much knowledge, skill, imagination, and courage as those who manage the foundation's grantmaking programs. Recruiting investment committee members who are able to guide the management of a foundation's endowment is, therefore, an essential task. The responsibilities of foundation investment committees suggest six criteria for selecting investment committee trustees:

- They should meet the qualifications required of other board members, among the most important of which are commitment to the foundation's mission, intellectual capacity and experience relevant to the foundation's fields of interest, standing in the community, integrity, and ability to work cooperatively with other trustees and staff. Able investment professionals who do not meet the other criteria for trustee service can weaken a board and are likely to be handicapped in fulfilling their responsibilities for oversight of the endowment.

- They should have broad knowledge of the investment world, although they need not necessarily have worked in it.
- Ideally, they should have had previous committee experience in overseeing investment managers.
- Committee membership should be diversified with respect to investment experience, philosophy, and outlook.
- No member of the committee should have an overwhelming advantage over other members in investment knowledge and experience, nor should any member be overwhelmingly disadvantaged in this respect. The results of investment decisions are never certain and such balance guards against dominance of a single point of view.
- All members, but particularly the committee chair, must be able to devote a substantial amount of time to committee work. To the extent that this last criterion cannot be met, delegation of committee responsibilities to staff, consultants, or an organization such as TIFF becomes all the more important.
- The committee chair should be skilled in articulating policies, actions, and results to board members, whose investment acumen and experience may be quite varied.

> THERE IS A *real* ADVANTAGE IN HAVING NON-EXPERTS ON THE INVESTMENT COMMITTEE *to* ENSURE THAT DECISIONS ARE MADE AND EXPLAINED *in* WAYS THAT THE REST OF THE BOARD CAN UNDERSTAND.

In applying these criteria, consideration must be given to the fact that many family foundations do not have access to as wide a range of possible committee members as larger, independent foundations. Further, it should be acknowledged that there is a real advantage in having non-experts on the investment committee to ensure that decisions are made and explained in ways that the rest of the board can understand. Anyone serving on an investment committee, however, should be intellectually engaged in investment issues, have good investment instincts, and be committed to learning.

Family foundations doing all the "right" things will not invariably avoid mistakes in managing their endowments or produce superior returns. Yet chronically poor endowment management practices and prolonged deteriorating investment performance may indicate fundamental problems that extend to a foundation's overall performance. Thus the investment performance of a foundation's endowment can be a useful barometer of its overall health, and good practices regarding the management of the endowment can contribute to correspondingly good practices in grantmaking.