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 hori-