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.