THE COMMONWEALTH FUND

RETHINKING THE MANAGEMENT OF FOUNDATION ENDOWMENTS

Executive Vice President and COO's Report
2009 Annual Report

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As the implications of the 2008–09 financial crisis for the world economy and markets have become clearer, many foundation executives and investment committees are reassessing their approach to endowment management. This essay reports on the effects of the recent turmoil on foundation endowments thus far, and offers lessons from the crisis and earlier ones that could help boards and investment committees responsible for foundation endowments avoid mistakes going forward. The essay concludes with an analysis of alternative models available to foundations for managing their endowments, highlighting the strengths and weaknesses of each and providing recommendations on preferred models.

A Bear Stock Market of Epic Proportions: The Impact on Private Foundations

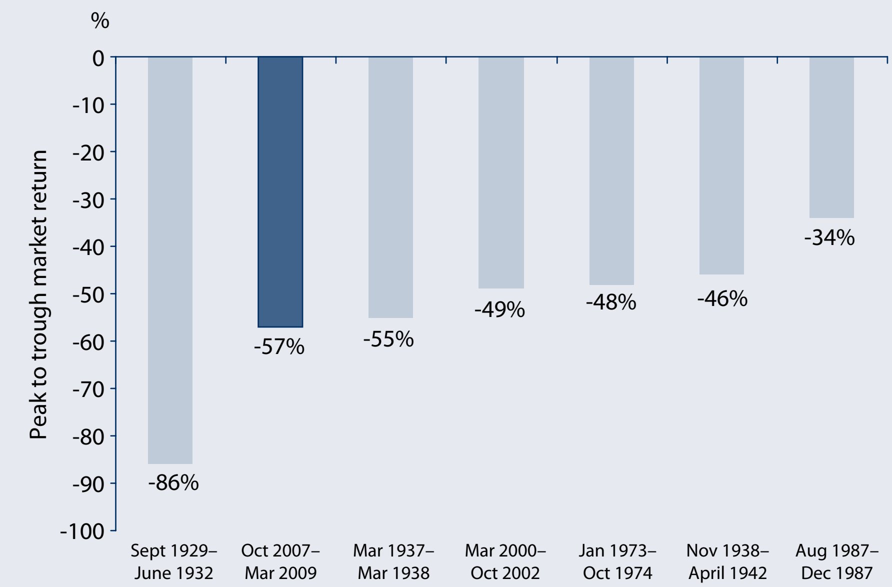
The bear market in stocks that began in October of 2007 and apparently bottomed in early March 2009 constituted the second most severe crash in stock prices on record—exceeded only by the September 1929 to June 1932 crash that ushered in the global Great Depression (Exhibit 1). Tellingly, the recent market decline exceeded by substantial margins any of the bear market declines that the current generation of endowment managers had experienced in their careers.

As a result of the market crash of 2008–09, the returns of most foundation endowments in the fiscal year ending on June 30, 2009, were severely negative: the average for 420 university and foundation endowments tracked by Cambridge Associates was –19.1 percent for the year (Exhibit 2). The crash has changed the financial landscape for foundations: most are now faced with three-, five-, and 10-year average annual returns well below the 5-percent-plus-inflation rate needed to ensure perpetuity.

Prior to the recent market crash, large foundation endowments with sophisticated investment strategies, patterned on those of major university endowments like Yale's, outperformed smaller endowments with more conservative investment strategies.[1] Because all asset classes except U.S. government bonds joined in the 2008–09 market rout, the risk-reducing benefits of diversification expected of the Yale endowment management model disappeared during the recent financial crisis—with the result that larger endowments uncharacteristically performed no better than smaller ones over the last year, and many did worse (Exhibit 3).

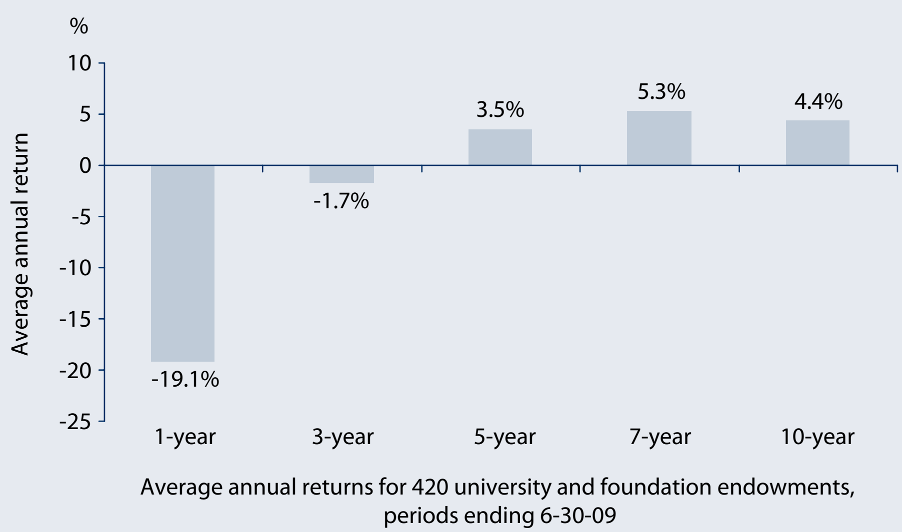
Photo: Robert C. Pozen, chair of MFS Investment Management, and William Y. Yun, executive vice president of Alternative Investments for Franklin Templeton Investments, are members of the Fund's Investment Committee, which Mr. Yun chairs. The Investment Committee, supported by the Fund's executive vice president-COO and Cambridge Associates consultants, oversees the management of the foundation's endowment, including determining the allocation among asset classes and selection of investment managers and closely monitoring investment performance.

Exhibit 1. The 2007–08 bear market in U.S. stocks was the second-most severe since 1929.



Source: Cambridge Associates.

Exhibit 2. In the July 1, 2008–June 30, 2009 fiscal year, university and foundation endowments suffered severely negative returns, pulling down their long-term average annual returns to levels insufficient to cover both inflation and the 5 percent payout required of foundations.



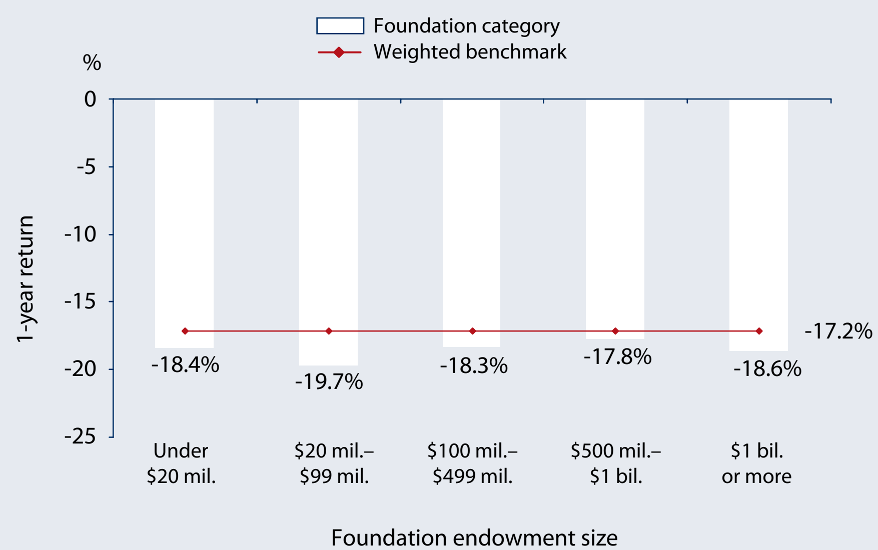
Source: Cambridge Associates.

Following the market crash, private foundation assets have likely declined by over 20 percent (Exhibit 4). March 2009 survey results reported by the Council on Foundations reveal that three-quarters of foundations experienced asset declines of 25 percent or more in 2008, and 47 percent reported a drop in endowment market value of 30 percent or more.[2] Since many foundations base their spending on the lagged three-year rolling average market value of their endowment, the immediate impact of the market crash on giving has been muted thus far. Even so, the Council on Foundations survey revealed that 48 percent of foundations reported plans to reduce the value of their total grantmaking by 10 percent or more in 2009. Sixty percent of responding foundations reported cutting their operating budgets in 2009, and 45 percent implemented salary freezes.

Will the 2009 Market Rally Last?

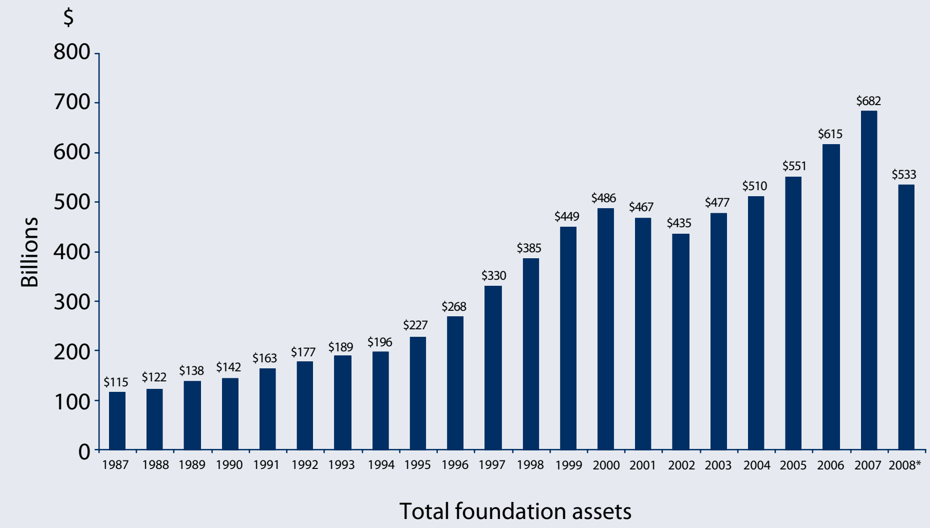
Along with other investors, foundation managers have been heartened by the global market rally that took off in early March 2009 (Exhibit 5). As impressive as the bounce-back returns have been thus far, however, they have not been sufficient to restore much of the wealth lost in the crash: the value of a dollar invested in U.S. stocks at the October 2007 peak was still worth only 70 cents (before inflation) on December 31, 2009. More worrisome, the history of stock market episodes following major financial system crises is marked by bear market rallies that raise hopes, dashed by subsequent corrections—as exemplified by the 2010 stock market correction that began on January 19 and pushed down U.S. stocks by 6.5 percent by February 12.[3] Further, there is widespread agreement that the rally to date has been concentrated in speculative, lower-quality stocks and based on the expansion of price/earnings ratios, rather than sustainable increases in corporate earnings.

Exhibit 3. In 2008–09, the endowments of very large foundations uncharacteristically did not outperform those of small foundations.



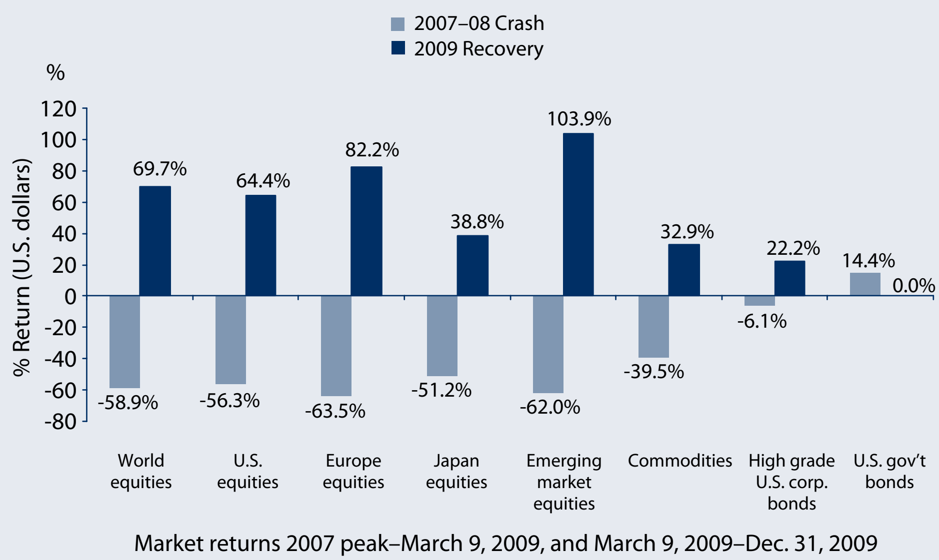
Returns are for the year ending June 30, 2009, for 22 foundations.
Source: Cambridge Associates.

Exhibit 4. As a result of the 2008–09 market crash, total private foundation assets have likely declined by more than 20 percent.



* Projected.
Source: Trend data, The Foundation Center; estimates, The Commonwealth Fund.

Exhibit 5. The post-crash recovery—will it last?



Source: Cambridge Associates.

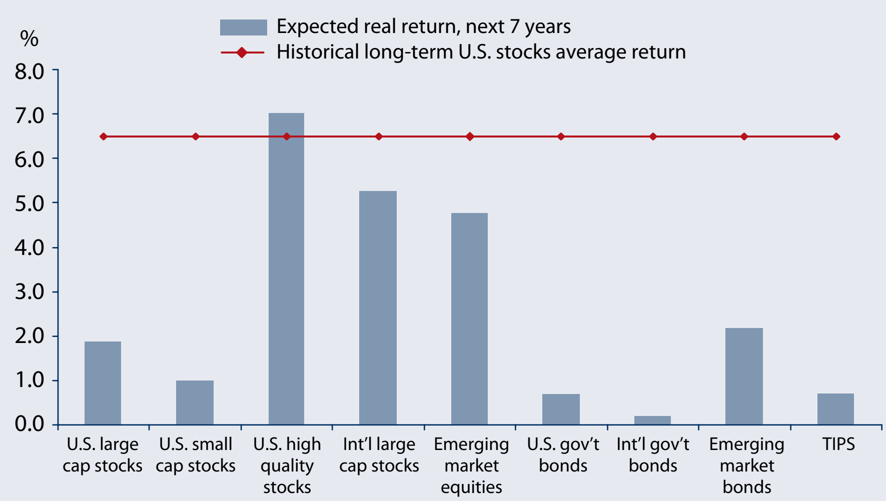
Thus, venerable investors like Jeremy Grantham of the investment management firm GMO predict modest investment returns over the next seven years, especially in the United States: as of December 2009, the predicted average annual real return for large-capitalization U.S. stocks is about 1.3 percent, and that for small capitalization U.S. stocks, 0.5 percent (Exhibit 6). Grantham does hold out the possibility that these returns might be increased by skilled active managers, but the probability of achieving better returns depends crucially on whether the fault lines in the global financial system that caused the crash are being properly fixed, and on the prospects for the revival of economic activity.

Lessons from the Financial Crisis and Progress Toward Financial System Reform

Among the best of the numerous books analyzing the causes of the crisis in the financial markets is one written by Robert Pozen, chairman of MFS Investment Management and member of The Commonwealth Fund's board of directors and its investment committee. In *Too Big To Save?*, Pozen describes how the Federal Reserve set interest rates too low from 2001 through 2006, leading dollar investors across the world to search for higher yields from mortgage-backed securities than obtainable with U.S. Treasuries.[4] This global demand, given lax regulation of many mortgage lenders and excessive leverage allowed in Wall Street banks, drove housing prices to bubble heights. Pozen documents how the spread of new financial instruments such as collateralized debt obligations and credit default swaps introduced unappreciated major risks into the financial system, a problem compounded by the trading of such securities outside regulated exchanges and by the conflicted position of credit-rating agencies, whose compensation depended on favorable ratings for securities they were supposed to score objectively.

In his book, Pozen proposes a wide array of system reforms that he sees as key to putting the U.S. and global financial system on a firm footing for economic stability and growth. A number of these proposals are included in the financial system reform

Exhibit 6. Many analysts predict quite modest inflation-adjusted returns on equities over the next seven years, with the result that foundations will be challenged in meeting their objective of 5 percent annually.



Source: GMO LLC, January 2010 forecast. GMO notes that skilled active managers can improve on these predicted market returns.

legislation that is now being debated in Congress. In the debate, there is wide agreement on the need for the following reforms: a systemic risk monitor, higher capital requirements for financial institutions, more transparent and better organized markets for financial derivatives, as well as expansion of the federal government's resolution authority to cover insolvent nonbank financial firms. Passage of reform legislation, however, has been delayed by major points of disagreement, including the following: the scope of the Federal Reserve's authority, the proper agency for regulating consumer financial products, and the supervisory framework for mega-financial institutions in the system—how to insure their accountability and define a contained, low-cost role for government when they get into trouble.

Along with all Americans, foundation endowment managers have a great deal riding on the outcome of the ongoing financial system reform debate in Congress. The above-noted modest investment returns forecast for the next seven years are predicated on at least a modest economic recovery and average annual inflation of 2.5 percent. However, as documented by Carmen M. Reinhart and Kenneth S. Rogoff in a recently published landmark study of financial crises, the typical aftermath of a major bank-centered financial crisis involves a protracted period of falling GDP, often lasting two years or more.[5] In their review of eight centuries of financial crises, with special focus on those in this century, these scholars label the current turmoil as the "Second Great Contraction," ranking just below the one that produced the Great Depression. Thus, there is substantial risk that the nation may face slow growth and high unemployment for an extended period. This risk puts a premium on getting financial system reforms "right," and in place as soon as possible. As Rogoff notes, "If we don't re-regulate the banking system properly, we'll either get very slow growth from overregulation, or another financial crisis in just 10 to 15 years."[6]

Added to these risks are those posed by the state of U.S. finances—the level of government debt and persistent international balance of payments (current account) deficits that threaten long-term growth and stability. As Alice Rivlin, former vice chair of the Federal Reserve and founding director of the Congressional Budget Office, argues, "[T]he biggest economic challenge for 2010 is enacting credible future deficit reduction without derailing the fragile recovery."[7]

Avoiding Mistakes

In his book, Pozen lays out the mistakes made by many modelers responsible for the introduction of the complex financial instruments, such as mortgage-backed securities and credit default swaps, that played key roles in bringing the financial system to its knees in 2008.[8] Reinhart and Rogoff similarly identify recurring fallacies and lessons to be drawn from the history of financial crises. These two bodies of work can help foundations avoid mistakes in managing their endowments.

1. *Simple extrapolations of the past are dangerous.* Pozen cautions that "the differences between past and future trend lines can be as important as the similarities." For example, given the gravity of the current financial crisis, foundations should be careful about assuming that the historical average of market returns will prevail over the next several years.

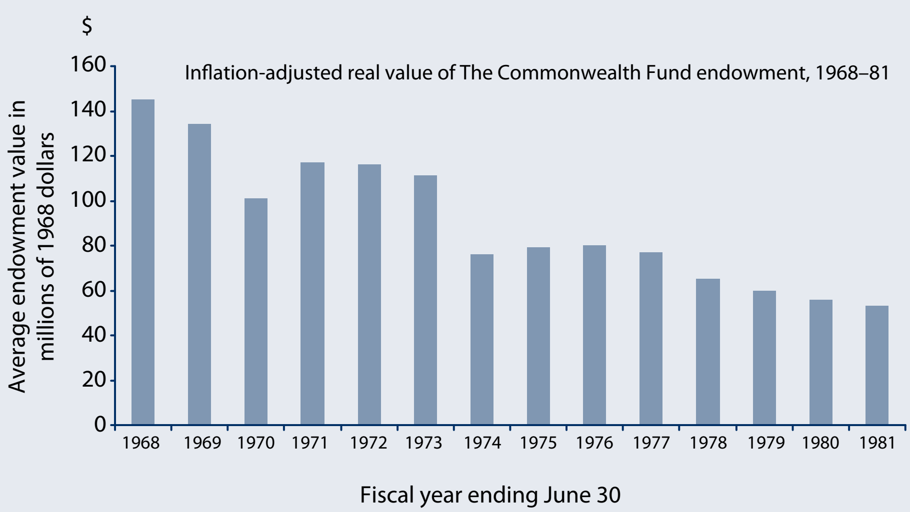
2. *Be patient in riding out financial bubbles.* As Pozen reminds us, investment bubbles can last for years, but economic fundamentals

ultimately win out. In safeguarding against bubbles, foundations should base their budgeting and investment strategies on what they perceive to be long-term realities. As Jeremy Grantham points out, this means in practice that in a financial bubble like that of 2003–08, perpetual foundations should allow their spending rate (spending as a percentage of endowment average market value) to fall—thereby setting aside "fat years" funds for use in the lean years that are inevitably to come.[9] More difficult, of course, is sticking to fundamentally sound investment strategies that produce below-benchmark returns in periods of market excess. As Pozen concludes, "the timing of the burst of any bubble is impossible to predict, so be very patient."

3. *"The frequency of extreme events is greater than people think,"* to quote Pozen again. Major global banking crises have occurred, on average, every 12 years since 1900, as Reinhart and Rogoff document, and every 11 years since 1945. For perpetual foundations, the occurrence within a 40-year period of two endowment-shaking crises like the financial crisis and oil shock-induced stagflation of the 1970s (when, as shown in Exhibit 7, it was not unusual for the inflation-adjusted market value of foundation endowments to decline by 60 percent) and the 2008 global financial disorder indicates that such crises are not "black swan" events. Foundation managers would be wise to heed Pozen's advice: pay more attention to low-probability events and hedge or insure against them if possible.

4. *Beware of the "This Time Is Different Syndrome."* As Reinhart and Rogoff describe, the thinking of the mid-2000s in the U.S. was "Everything is fine because of globalization, the technology boom, our superior financial system, our better understanding of monetary policy, and the phenomenon of securitized debt." In their research covering multiple centuries, these

Exhibit 7. The real value of a typical U.S. foundation's endowment declined by over 60 percent in the financial and stagflation crises of the late 1960s and 1970s.



Source: The Commonwealth Fund.

authors find similar thinking preceded virtually every financial crisis. Foundation managers should conclude that the siren call of "This Time Is Different" is a sure signal to lower the risk profile of the endowment.

5. *Be knowledgeable of the predictors of financial crisis.* Reinhart and Rogoff present a convincing body of evidence that markedly rising asset prices (particularly housing bubbles), slowing real economic activity, large current account deficits, and sustained debt build-ups (public or private) generally precede a financial crisis. Attention to such systemic risk measures can help foundations position their endowments to better weather financial crises.

6. *Understand how the origins of a financial crisis can greatly affect the depth and duration of its impact on economies and markets.* Reinhart and Rogoff's research informs us that bubbles are far more dangerous when they are fueled by debt, as was the case with the global housing bubble of the early-to-mid-2000s. Their study reveals that global financial crises arising from excess leverage are typically followed by very severe, multiyear slowdowns in economic activity accompanied by high unemployment. Just as such crises produce major bear markets in stocks, so they entail bear market rallies followed by resumed slumps. Endowment managers ignore this pattern at considerable risk.

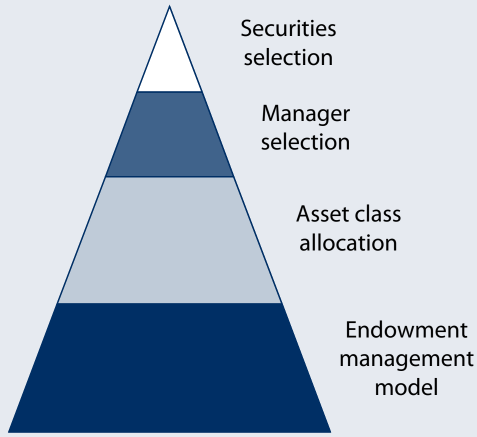
7. *Ignore liquidity risk at your peril.* With their deep endowment pockets and significant fixed-income holdings, foundations generally do not worry much about liquidity. But with increasing commitments to private equity and hedge fund partnerships, liquidity risk was already a real concern for many endowments before the recent financial crisis. The crisis demonstrated that this risk rises significantly as leverage increases within the financial system. Thus, foundations should keep necessary reserves on hand and take increasing care that they are cautiously invested as financial storms gather. As yields fall on short-term investments, foundations will be lured to higher-yielding alternative products, but the risks and liquidity profiles of such products require very close examination. In light of recent experience, a number of foundations have taken out lines of credit, and more should consider doing so.

8. *Be ready to question the experts.* Adapting Pozen's advice on how banks and investment firms should manage their expert modelers, a primary role of a foundation's investment committee is to understand the limitations of the foundation's financial staff, consultants, and investment managers. Committee members should ask questions that push the so-called experts to explore fully the risks involved in each strategy and the assumptions underlying any quantitative model.

Managing Foundation Endowments

The uncertainties arising from the 2008–09 market crash, the Second Great Contraction, the path of financial system reform, and the need to put the U.S. financial house in order mean that foundations face more challenges in managing their endowments than at any time since the interrelated monetary system crises of the late 1960s and the oil-shock-induced stagflation of the mid-1970s. In response to their

Exhibit 8. The management model of a foundation endowment ranks with asset class allocation as a key determinant of long-term performance.



Source: Adapted from J. E. Craig, Jr., "Treasurer's Report," *The Commonwealth Fund 1994 Annual Report.*

disappointing investment performance over the last several years, a number of foundations have already overhauled their approach to managing their endowment. The remainder of this essay will address options available to others that have misgivings about the suitability of their current model.

By the early 1980s, foundation managers, their investment consultants, and academic researchers had come to recognize that decisions regarding asset class allocation generally have greater impact on investment performance than does the choice of investment managers or individual securities—important as the latter two components of endowment management are. The widely used pyramid shown in Exhibit 8 reflects this consensus, indicating that the most important function of endowment fiduciaries is to determine the asset class allocation appropriate to current market circumstances, then to select investment managers best suited to implement the allocation decision—leaving the task of portfolio construction to full-time investment professionals.

While the literature on endowment management is replete with research and advice on asset class allocation, the manager selection process, and of course the selection of securities for different types of portfolios, it is remarkably silent on the makeup of the base of the endowment performance pyramid: the endowment management model specifying the role of investment committees, internal financial/investment staff, investment consultants, and external entities assigned with responsibility for making asset allocation and manager decisions.[10] Reflecting the bias of the research literature, foundation investment committees spend most of their time on investment strategy, when it is often the case that as much attention needs to be given to discussion of the ideal management model for making the most of the endowment.

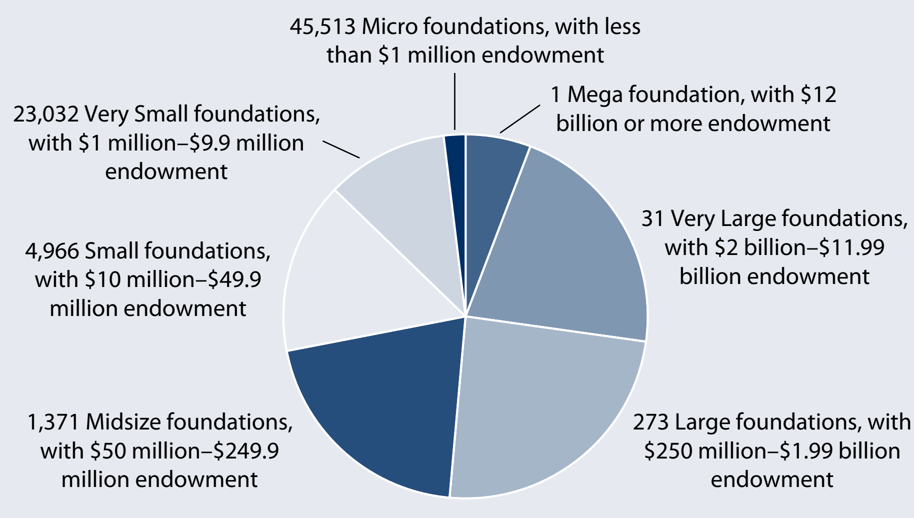
The universe of private foundations is far more diverse than that of colleges and universities, comprising some 29,000 organizations in 2008 that range in size from tiny foundations with assets of less than $100,000 to the Bill and Melinda Gates Foundation, with assets of $38 billion. As shown in Exhibit 9, the distribution of foundation assets is heavily concentrated in some 300 organizations with assets of $250 million or more, but even within this group, the size range is enormous. This diversity, as well as the uniqueness of each foundation's mission, culture, and history, makes it difficult to develop general lessons on how best to structure the management of an endowment. Even so, it is hoped that the following analysis will help fill an important gap affecting the performance of the foundation sector.

Foundation Endowment Management Models

The schematic in Exhibit 10 presents five basic models available to foundations for managing their endowments and the approximate level of delegation of authority by investment committees that goes with each. As the chart indicates, the delegation level for each model ranges substantially from foundation to foundation.

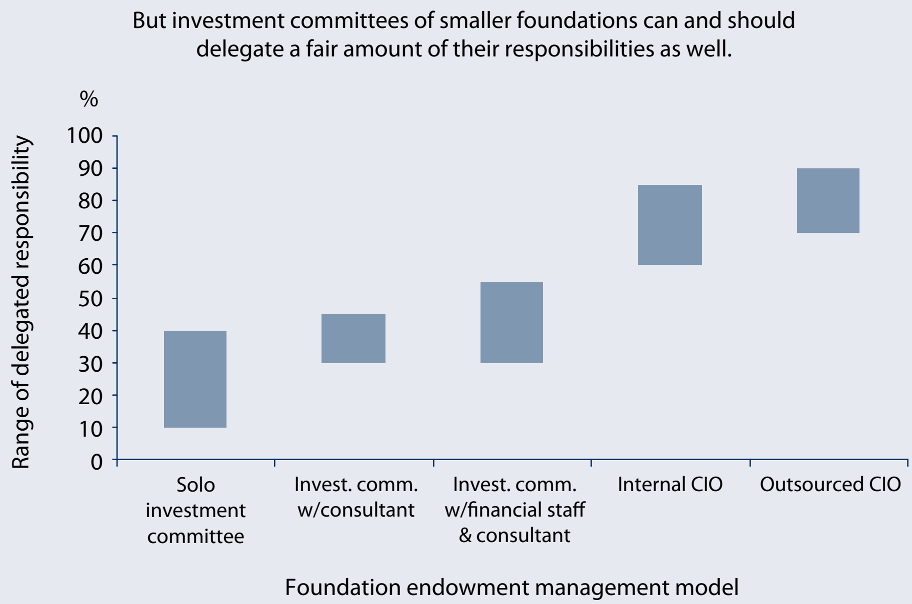
- **Solo investment committee model.** In this common approach, typically employed by very small foundations but also by many small and even midsize ones, the investment committee of the board has virtually all strategic and operational responsibility for the endowment—working with little or no internal staff or consultant support, although generally delegating portfolio management to a brokerage firm, mutual funds, or external investment managers (typically using commingled funds shared with other investors).
- **Investment committee-investment consultant model.** As foundation size and investment strategy complexity increase, many investment committees recognize the need for an investment consultant to help inform and guide their decisions, and sometimes to help implement them. The amount of responsibility

Exhibit 9. The distribution of foundation assets is heavily concentrated in some 300 foundations with assets of $250 million or more.



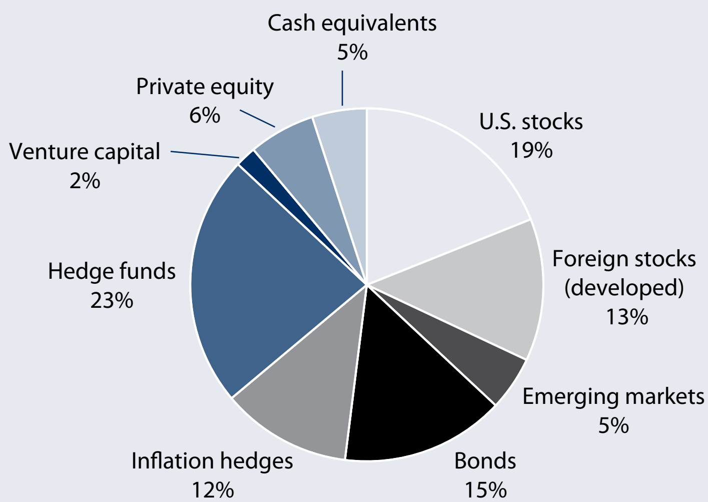
Source: The Foundation Center. 2007 data for 75,187 foundations with assets totaling $682 billion.

Exhibit 10. The larger the foundation, the more responsibility investment committees must delegate to consultants, internal chief investment officers, or outsourced CIOs.



Source: The Commonwealth Fund.

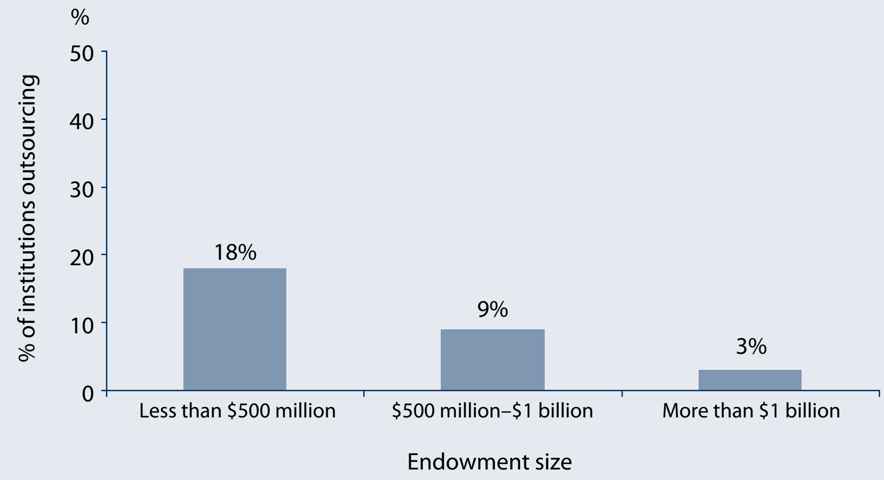
Exhibit 11. Over the last 25 years, larger private foundations have increasingly diversified their endowment portfolios, substantially increasing allocations to a variety of equity markets and reducing fixed income allocations.



Median % allocation of 85 endowments with median assets of $508 million, June 30, 2009

Source: Cambridge Associates.

Exhibit 12. Increasingly, nonprofits are fully outsourcing the management of their endowments.



Source: Casey Quirk & Associates, *The New Gatekeepers: Winning Business Models for Investments Outsourcing,* 2008.

delegated by the committee ranges significantly under this model, depending on the capacities and preferences of the committee and the ability and services offered by the consultant.

- **Investment committee-internal financial staff-investment consultant model.** Any foundation with assets of $250 million or more is likely to pursue the sophisticated diversified investment strategy shown in Exhibit 11. Under these circumstances, the day-to-day responsibilities of managing the endowment require qualified staff; moreover, barring an investment committee member with the time, inclination, and expertise for working closely with the consultant on strategic and operational issues like manager searches, a professional staff member is needed to ensure best use of the time and skills of the consultant and committee members. Thus, this model entails still higher de facto (if not formal) levels of responsibility delegation by the investment committee.
- **Internal CIO model.** Once a foundation reaches the $2 billion or so level in endowment assets, it becomes economic and feasible for it to hire a full-time, highly trained, experienced chief investment officer (CIO) and recruit a sizeable, dedicated professional investment team, compensated at the necessary competitive levels.[11] As described by Lawrence E. Kochard and Cathleen M. Rittereiser, a number of very large foundations including the Carnegie Corporation and William and Flora Hewlett Foundation use this model and have achieved considerable success.[12]
- **Outsourced-CIO (O-CIO) model.** Given the shortcomings of the solo investment committee, committee-consultant, and committee-financial staff-consultant models discussed below, the trend in recent years is for foundations with under $2 billion dollars in assets to fully outsource the management of their endowment to a firm that essentially offers a packaged set of services comparable to those that very large foundations obtain with an in-house CIO (Exhibit 12). The O-CIO firm—the best being the creation of a stellar former CIO

> of a large university endowment or pension fund—assumes most of the responsibility for managing the endowment. While the amount of delegated authority varies from foundation to foundation, most investment committees using this model have an essentially advisory role and, beyond consultation on broad strategy, leave decisions on managers and tactical moves to the O-CIO. The spectrum of actual services offered by O-CIOs is wide, ranging from somewhat customized portfolios to one-size-fits-all proprietary portfolios.[13]

Small foundations are leading the trend toward the O-CIO model, but foundations in the $250 million to $2 billion range are also attracted to it—in large part because of their increased use of "alternative" investments like hedge funds, private equity, venture capital, real estate, and timberland, and the difficulties of identifying and gaining access to top-ranked managers of this type on their own. Contributing to the trend also is the disappointment of many midsize and large foundations with their existing investment committee- or consultant-driven management model in the recent financial crisis.[14] Foundations that have gone this route include the Rockefeller Brothers Fund, Colonial Williamsburg Foundation, John A. Hartford Foundation, Teagle Foundation, and Chichester DuPont Foundation.

It should be noted that the universe of firms offering the O-CIO model is diverse. While firms established by distinguished former CIOs of large university endowment or pension funds attract the most attention, many traditional investment consultants now offer such services (partly out of competitive necessity). Additionally, some traditional top-ranked balanced managers serve as O-CIOs to institutions like the Greenwall Foundation, although their products do not include alternative investments. Some offices of wealthy families also offer O-CIO services to selected clients other than the founding family, and, of course, banks have for years performed this function for foundations organized as trusts.

The strengths and weaknesses of each of these models are summarized in Exhibits 13a and 13b. The primary strength of the solo investment committee model is that it leaves, in theory, no doubt regarding where accountability for the management of the endowment lies. All too often, however, foundations employing this model shy away from the investments performance tracking that would help tell them how well their investment committee is functioning. Even when a record of below-market performance is clear, some boards are unwilling to hold the investment committee accountable for it. Small and even midsize foundations can find it difficult to attract board members with sufficient investment experience and expertise and the time or inclination to fully direct their skills to management of the endowment. Further, committee members are likely to develop a very limited set of investment managers from which to choose and may favor those they know—with attendant potential conflicts of interest. Indeed, board member conflicts of interest in the management of endowments arise all too frequently, and require firm attention by board and audit committee chairs.

Even with effective leadership, investment committees operating alone are sometimes challenged in reaching consensus and taking action, or fall into the trap of "group think." Under these circumstances, most small foundations using this model are best off employing only mutual funds, with a strong bias toward low-cost mutual fund indexes. Even so, the

Exhibit 13a. The *strengths* of foundation endowment management models.

Solo Investment Committee	Investment Committee-Consultant	Investment Committee-Consultant-Internal Staff	Internal CIO & Dedicated Investment Staff	Outsourced CIO
Committee exercises full responsibility for the endowment—no question of where accountability lies, provided performance is tracked and board holds committee accountable	Consultant brings: • Advice on asset allocation based on wide range of contacts and experience • Strong financial research base • Information on and access to a wide range of investment managers, including managers of nontraditional alternatives like hedge funds and venture capital • Independent voice, helping build consensus, avoid conflicts of interest	• More effective use of consultant, customization of services to foundation's particular needs • Better oversight of investment managers and endowment operations • More accountability • More safeguards regarding conflicts of interest • More integration of investment mission with program mission	• Full and measurable accountability for management of the endowment • High level of internal investment experience, expertise, and research capacity • Capacity to Identify and gain access to top-ranked managers, especially to nontraditional alternatives and rising-star managers • Undivided loyalty of CIO to the foundation • Potential contributions of CIO to foundation's program strategy (investment insights)	• Potential solution to "missing chief investment officer" problem for foundations with assets <$2 billion • Full and measurable accountability for management of the endowment • High level of investment experience and expertise • Pre-hiring investment track record • Capacity to Identify and gain access to top-ranked managers, especially to alternatives and rising-star managers • Proactive, rather than passive advice • Performance fees • Limited number of clients, low conflict-of-interest risk with O-CIO, if not also an investment consultant

weaknesses of the solo investment committee model are such that it is prone to being suboptimal.

Adding a qualified investment consultant to the investment committee model helps address many of these issues, but not all. The chief weakness of the investment-committee-with-consultant model is that responsibility for decision-making is muddied, and it is difficult for the board to hold either the committee or consultant accountable if things go wrong. While investment consultants bring research, experience, and contacts that are extremely valuable in building consensus, setting strategy, and hiring and firing managers, they can be more passive in providing advice than is desirable. Additionally, the quality of investment consulting firms can range widely, as can the value-adding capacity of any single consultant within even a strong firm.

There are other weaknesses as well. First, the performance record of investment consultants is reputational, not statistical, which presents a challenge in the hiring decision.[15] Second, consultants have many clients competing for their best ideas and

Exhibit 13b. The *weaknesses* of foundation endowment management models.

Solo Investment Committee	Investment Committee-Consultant	Investment Committee-Consultant-Internal Staff	Internal CIO & Dedicated Investment Staff	Outsourced CIO
• Challenges in recruiting members with sufficient investment experience and ability to commit required time and attention • Significant conflicts of interest risk • Potential board reluctance to hold committee accountable • Challenges of achieving consensus while avoiding "group think" • No investment research capacity • Limited capacity for identifying and gaining access to top-ranked managers—especially managers of alternatives and rising stars	• Accountability weakened by diffusion of responsibility and resulting difficulties regarding performance attribution • In hiring a consultant, reliance on references unsubstantiated by verifiable track records • Variable quality of individual consultants within a firm • Competition among many clients for consultant's attention and firm's best ideas and access to best managers—significant consultant conflicts of interest risk • Can be passive in offering advice—when conviction is needed • Unlikely to identify or propose innovative rising-star managers • Effective management of consultant can be an issue	• Weaknesses of Investment Committee-Consultant model mitigated, but not eliminated, and performance of model depends heavily on ability of internal financial staff to add value • Given multiple responsibilities and compensation issues, difficulties of attracting staff able to add value • Competing responsibilities of internal financial staff, limiting their ability to add value to investment process	• Economic only for foundations with $2 billion or more endowment • Challenges of recruiting and retaining star CIO, compensation issues • Potential oversight issues • Potential culture conflicts between program and investments staffs	• Key person risk • Possible limits on customization of strategy/services to individual foundation needs • Significant conflicts of interest risk for O-CIO, if also an investment consultant • Adequacy of oversight by foundation investment committee • Limited number of truly able O-CIO firms available, and limitations on their client capacity • Concern that outsourcers will, over time, add clients beyond optimal level

access to the best firms in their pools of investment managers. Third, consultants are unlikely to recommend partially tested, rising-star managers or cutting-edge products—although achieving above-market performance virtually depends on beating other investors to new investment approaches. Finally, as with any consultant, investment consultants provide their best work through a strong working relationship with, and guidance from the client; yet many investment committee chairs lack the time required to provide such guidance.[16]

Foundations with assets of roughly $150 million or more find it economic to seek to enrich the potential of the investment committee-consultant model by assigning a qualified foundation staff member responsibility for managing the consultant and orchestrating investment committee meetings. With the right experience, training, and judgment, an internal chief financial officer can greatly strengthen the committee's ability to make the most of the investment consultant's skills, ward against any problematic conflicts of interest, ensure firmer daily oversight of endowment operations and their integration with the foundation's operating needs, and bring helpful investment insights to program strategy and grantmaking. Even so, while accountability can be enhanced by the addition of qualified staff, it remains an issue. More seriously, staff in these roles typically have multiple and substantial other responsibilities within the foundation, and may lack either or both the time or expertise to produce all the benefits of this approach. Foundations employing this model, moreover, often face a major challenge in identifying and adequately compensating a staff person able to meet the many demands of the assigned role.

The vitally missing piece in the first three models is a chief investment officer—a role which should arguably be assigned, at least de facto, to someone in any organization totally dependent on an endowment for income. Well executed, the internal CIO model addresses most of the shortcomings of the first three models. Besides being unaffordable for all but about 30 of the largest private foundations, however, the chief weaknesses of this approach are the challenges of recruiting and retaining a highly qualified CIO, particularly given the compensation such individuals draw in other settings.[17] While CIOs can add value to the foundation's programs, culture clashes between programmatic and investment staffs do arise, and the foundation needs to take care that the values of the foundation and the CIO are fully aligned, and that the strong personality that is typically a CIO trait fits into the foundation's management structure.

Like the internal CIO model, the outsourced-CIO model also addresses most of the weaknesses of alternative management approaches. The constraint here is the number of highly qualified individuals and firms to which such responsibility can be safely delegated. As predicted in a study by Casey Quirk and Associates, many former large university or pension fund heads will set themselves up as O-CIOs in the coming years—but not all will be true investment stars.[18] The ability of the largest group of entrants into this business—established investment consultants—to deliver high-quality O-CIO services stands a substantial risk of being compromised by their responsibilities to existing consulting clients and their questionable ability to attract truly outstanding investment professionals. There are also concerns that while existing O-CIO firms restrict the number of clients to the small number needed to ensure above-market returns, they will be pressured over time to grow the firm beyond an asset level that is optimal for clients.

Other issues with O-CIO firms include the extent to which they can customize services to the needs of individual foundations and the extent to which an investment committee feels it has adequate oversight of the O-CIO. Among the best of existing O-CIOs, any shortcomings on these issues are more than offset by their skills and thus performance. The remaining risk, "key person," is thus the primary one—the viability and strength of the firm should it lose its star CIO. This risk is real, as most outstanding O-CIO firms are small. At the same time, given the newness of this model, few such firms are likely to face a transition in leadership for the foreseeable future.

To sum up, the three existing endowment management models used by most foundations—solo investment committee, investment committee with consultant, and investment committee with consultant and limited financial staff—all have serious limitations that make it unlikely that they will produce, over the long term, returns greater than those of the market and present considerable risk of generating below-market returns. Yet very few foundations are likely to be able to pursue the two alternative models, because of the economic infeasibility of the CIO approach for most foundations and the limited availability and capacity constraints of truly outstanding firms able to serve as outsourced CIOs.

Fortunately, The Investment Fund for Foundations (TIFF) was established in 1991 to help overcome many of the shortcomings of the principal endowment management models available to most foundations. Patterned after the CommonFund, which was established for educational institutions in 1971, TIFF enables foundation and other nonprofit investment committees to get out of the business of identifying and selecting managers by offering pooled funds invested by teams of multiple managers hired by the TIFF board.[19] The range of products offered by TIFF is wide—from mutual funds for conventional U.S. equities, international equities, and bonds, to hedge fund, private equity, and natural-resources investment pools. In addition, TIFF's Multi-Asset Fund provides foundations an efficient vehicle for fully outsourcing the management of the endowment. While not offering investment consulting services, TIFF staff does help educate foundation trustees on asset class allocation and other investment issues. Operating as a nonprofit cooperative and with a highly trained and experienced staff and board, including some of the most respected endowment and pension fund CIOs in the country, TIFF avoids many of the pitfalls, articulated so well by Yale University's David Swensen, of management approaches dominated by for-profit fund-of-fund managers, consultants, and inadequately equipped investment committees.[20]

Given the strengths and weaknesses of this array of approaches for managing foundation endowments, the following recommendations seem appropriate:

- Foundations with assets of $2 billion or more will generally be best off by hiring a highly qualified chief investment officer, supported by a sizeable dedicated internal investments staff.
- For other foundations, particularly those with assets in the range of $500 million to under $2 billion or so, identifying an outstanding outsourced-CIO firm is the preferable approach. Foundations with assets of $20 million–$50 million are also prime candidates for this approach, as their size is well suited for rounding out an O-CIO's portfolio of clients. The limited supply and capacity of outstanding O-CIO managers, however, means that relatively few foundations will actually be able to successfully execute this model.

- Great care, obviously, must be taken in selecting an O-CIO, with respect not only to their qualifications but also to potential conflicts of interest involving board members. Given the amount of delegation of board responsibilities involved, any conflicts of interest should be avoided, and most committees would benefit from using a consultant to professionalize the search for, and screening of, candidates. The obvious conflicts of interest that investment consultants face in simultaneously serving traditional and O-CIO clients lead to the conclusion that, with rare exceptions, the O-CIO responsibility should not be delegated to consultants. As with any investment manager, the performance of an O-CIO should be judged over a market cycle.
- Foundations with assets under $2 billion that are unable or disinclined to outsource should make the most of the investment committee-consultant-internal financial staff model by taking maximum advantage of the products offered by TIFF or other nonprofit fund-of-fund managers.
- Foundations with less than $100 million in assets may not be able to retain internal staff capable of adding value to the investment committee's work, but only the smallest foundations (assets of $20 million or less) can justify, for economic reasons, going without the benefits of an investment consultant. Smaller foundations that choose not to use an investment consultant should make all the more use of TIFF by taking full advantage of the investment educational services and advice that it offers.

Making the Most of Investment Consultants

Since most foundation investment committees should supplement their skills with those of an investment consultant, it is well to consider guidelines for selecting and using such consultants effectively. As Robert Marchesi has written, there are more than 100 investment consulting firms in the United States, and the scope and quality of their services vary enormously.[21]

In selecting a consultant, the first task of an investment committee is to define the level of services it needs to address gaps in the committee's capacities. Most committees need a significant number of services from their consultant, including investment research, investment strategy, manager searches and selection, and regular consultation with the committee and internal staff. If the foundation lacks internally or through its securities custodian the ability to measure and report investment performance, this service should also be sought from the consultant.

Exhibits 14a and 14b summarize desirable and undesirable traits to look for when selecting an investment consultant for a foundation endowment. A strong weight should be placed on the consultant team's investment experience and training, but equally important is the firm's business structure, with particular attention to conflicts of interest. The investment committee should probe to see if the consultant is honest about its own strengths and weaknesses, and whether it is willing to recommend competitors (e.g., TIFF or low-cost index funds) when they offer superior products. As the Madoff scandal of 2008 demonstrates, the investment consultant should be able to explain the investment strategy of any firm in its stable of managers, and should demonstrate deep knowledge of each firm's business. Regardless of recommendations from the consultant's existing clients, a foundation investment

Exhibit 14a. Selecting an endowment investments consultant—essential traits.

- Firm is independent, with no ownership conflicts.
- Firm displays high level of integrity and appreciation of conflicts of interest that arise regularly in investing.
- Firm recognizes its limitations—does not, for example, offer O-CIO services that it is poorly equipped to provide.
- The lead consultant offered by the firm is skilled and experienced, and interacts well with investment committee members and staff.
- The lead consultant is backed up by a deep team of researchers and investment professionals with a wide range of contacts in the investment manager business.
- Lead consultant advises with conviction, strengthening committee's decision-making process.
- Firm is transparent on the investment managers with which it works and is able to fully document and explain any recommended manager's investment strategy, performance, and risks.
- Firm has a range of investment manager types in its stable—with respect to size, investment style, age, risk/reward profile—and has a record of identifying promising new managers and recommending them for clients' consideration when appropriate.
- If the foundation is large enough to invest in the "alternatives" areas, the consulting firm has demonstrated capacity to identify top-ranked managers of this type and gain access to them for its clients.
- Firm is willing to recommend TIFF and other nonprofit pooled fund products, as well as low-cost index funds when these can serve the client best.
- The foundation will be an important client to the consulting firm, ranking high in its pecking order for recommending clients to leading investment managers.
- Firm and proffered lead consultant produce multiple strong client references.
- Firm offers a competitive fee structure, with no imbedded conflicts of interest.

Exhibit 14b. Selecting an endowment investments consultant—traits to be avoided.

- Firm owned by a larger business selling investment products posing conflicts of interest.
- Firm has a record of involvement in conflicts of interest, questionable practices.
- Firm is essentially a "feeder" for large investment managers, mainly serving to steer clients to established managers.
- Firm offers services—e.g., O-CIO, that it is ill-equipped to provide.
- Firm's team has questionable investment training and experience.
- Concern that the proffered lead consultant may not be their best, or that interactions with the lead consultant could prove problematic.
- Lead consultant is passive in giving advice, weakening committee decision-making process.
- Firm is secretive regarding its investment manager pool and is unable to document and explain some managers' strategy, performance, and risks.
- Firm is so small that it is likely to offer the same set of investment managers to all clients, and be limited in its ability to identify and recruit promising new managers to its stable.
- Firm is unable to identify and gain access to leading managers in important areas in which the foundation wishes to invest.
- Firm is unwilling to recommend TIFF or other nonprofit pooled funds or low-cost index funds when appropriate, instead offering up inferior products for its own business reasons.
- The foundation will be a marginal client for the firm, unlikely to receive "preferred customer" attention in opening doors to skilled investment managers.
- Client references on the firm or proposed lead consultant are limited and inconclusive.
- Firm has noncompetitive fee structure or fee arrangements posing potential conflicts of interest.

committee and staff should focus on the ability of the lead consultant to meet the particular needs of the foundation and on the personal chemistry that emerges in the screening process.

Consultants, in general, are no better than the individual directing the use of their services, and this rule applies equally in the endowment management business. Thus, investment committees should lay out clearly in the foundation's investment policy statement the division of responsibilities among committee members, any internal staff, and the consultant, and assign a specific committee member or staff person with responsibility for guiding the consultant's work. The foundation person charged with this responsibility should have available the time needed to advise and direct the consultant effectively. To play this role well, the committee member (usually the chair) or staff member should be well informed about the foundation's overall financial picture and program objectives and skilled in using the consultant's services to advance effective committee decision-making.

Just as most foundations judge the performance of their investment managers over a market cycle, so should the performance of the investment consultant be reviewed periodically—about every five years. Such reviews are best carried out in the context of considering a small number of alternative consultant firms, as the strengths and weaknesses of the existing consultant are more clearly illuminated by comparisons with other firms.

Conclusion

Every crisis presents opportunity, and many foundations should at this time take a hard look at their basic structure for managing their endowment. In doing so, they should aim for accountability on the part of each major player sharing responsibility for the endowment, and for a management model likely to make the most of their resources while protecting against major risks. In a period of great uncertainty, foundations should give heightened attention to the composition of their investment committees and to the skills and time priorities of members. They should also reassess the extent to which their investment committee is adequately staffed to do its job, and whether external resources need to be tapped to ensure strong endowment management.

NOTES

1 John E. Craig, Jr., "New Financial Realities: The Response of Private Foundations," *The Commonwealth Fund 2008 Annual Report* (New York: The Commonwealth Fund, March 2009).

2 Council on Foundations, *Foundations Respond to the Needs of Families Even as Their Assets Have Declined,* May 6, 2009, www.cof.org/economicdownturn.

3 Cambridge Associates, "Living on Borrowed Time? Dissecting the Current Equity Market Rally," Sept. 2009.

4 Robert Pozen, *Too Big To Save? How to Fix the Financial System* (Hoboken, N.J.: John Wiley & Sons, Inc., 2010).

5 Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, N.J.: Princeton University Press, 2009). Ms. Reinhart is professor of economics at the University of Maryland; Mr. Rogoff is the Thomas D. Cabot Professor of Public Policy and professor of economics at Harvard University.

6 "After the Bailouts, Washington's the Boss," *Wall Street Journal*, Dec. 28, 2009.

7 Alice M. Rivlin, "U.S. Debt Scolds Can't Be Ignored Much Longer," Bloomberg, Jan. 6, 2010.

8 Pozen, *Too Big To Save?* 2010, pp. 82–94.

9 Jeremy Grantham, "Just Desserts and Markets Being Silly Again," *GMO Quarterly Letter,* Oct. 2009. Although the Internal Revenue Service requires private foundations to distribute 5 percent of their endowments annually, in practice the payout rules enable foundations to meet the requirement over a period of years. This makes Grantham's advice practicable, and it is heeded implicitly by the many foundations that base their annual payout on a lagging three-year (or longer) average endowment market value.

10 The definitive book on endowment management, David F. Swensen's *Pioneering Portfolio Management* (Free Press, 2009), for example, focuses on the circumstances of very large universities, which are able to afford and recruit internal professional investment staffs that assume responsibility for management of the endowment.

11 Dennis R. Hammond, "Choosing the Best Investment Management Structure: Use of Consultants to Drive the Investment Process," Hammond Associates, Foundation Financial Officers Group meeting, Sept. 27, 2007.

12 Lawrence E. Kochard and Cathleen M. Rittereiser, *Foundation and Endowment Investing* (Hoboken, N.J.: John Wiley & Sons, Inc., 2008).

13 Casey Quirk & Associates, *The New Gatekeepers: Winning Business Models for Investments Outsourcing*, Dec. 2008. Lawrence Kochard and Cathleen Rittereiser describe the business models and investment strategies of such leading O-CIO firms as Investure and Morgan Creek Capital in Kochard and Rittereiser, *Foundation and Endowment Investing*.

14 Cambridge Associates: "'Fiduciary Fatigue' CIO Outsourcing: Leaner Times Increase Demand, and Raise New Questions," 2009.

15 Investment consultants should be able to produce the "blinded" investment performance records of their clients, but only in the limited number of cases where consultant firms have virtually total responsibility for the endowment can they attribute the extent to which the record reflects their decisions, as opposed to those of the investment committee or internal staff.

[16] Many foundation investment committees reject the idea of retaining a consultant because of the cost. In fact, the fees of most such firms, measured as a percentage of the market value of the endowment, are quite reasonable. Reflecting the economies of scale enjoyed by larger foundations, standard investment consultant fees range from approximately 60 basis points on the endowment market value for a foundation with a $20 million endowment, to 8 basis points for one with a $250 million endowment, to 6 basis points for a foundation with a $500 million endowment. Given that most foundations have only one source of income, and are typically otherwise dependent on volunteer trustee services for overseeing the endowment, they are well advised to spend at least these levels of resources to enhance their endowment management capacities.

[17] A novel approach to solving this problem is provided by three Indianapolis foundations that recently jointly together to hire an experienced CIO to manage the three endowments. The foundations have combined assets of around $1 billion, and they share the costs of the CIO office.

[18] Casey Quirk & Associates, *The New Gatekeepers,* 2008.

[19] Over the years, the CommonFund and TIFF have opened their doors to other nonprofits, and both now serve both educational organizations and foundations.

[20] Swensen, *Pioneering Portfolio Management*, 2009, pp. 309–12. The author of this essay is a member of the board of the TIFF Education Foundation, but not of TIFF Advisory Services or TIFF Investments Program, the investments arms of the TIFF organization.

[21] Robert F. Marchesi, DeMarche Associates, www.demarche.com.