(4)

SPECIAL SUPPLEMENT: CHARITABLE GIVING

By Roger D. Silk & James W. Lintott

Investment Policy for Endowed Charitable Organizations

All nonprofits should have their own carefully thought-out plans and procedures

lthough the body of investment and finance literature is vast, it helps for endowed charitable organizations (including public charities, charitable remainder trusts (CRTs) and private foundations (PFs)) to be aware of the important investment issues that are likely to arise. While the specifics will vary for each organization, depending on the situation, all such organizations should have their own carefully thought-out investment policies (IPs). "Indeed," notes estate-planning attorney Salvatore J. LaMendola, of Troy, Mich., "adhering to a written investment policy statement that is updated periodically can go a long way in protecting directors and trustees against liability under the Uniform Prudent Investor Act (UPIA) or the Uniform Prudent Management of Institutional Funds Act (UPMIFA)."1

We'll highlight issues that may not be the usual focus of professional investment managers or, for that matter, attorneys and accountants. Among these are the expected life of the organization, anticipated future inflows of cash, applicable prudent investing rules, taxes, including unrelated business income (UBI) tax, risk analysis and management and cash management.

Most non-profit trustees or directors will want to assume a high level of responsibility for these issues, either directly or by obtaining expert help from trained consultants. The board's consensus should then be reflected in a written IP statement.

 $\textbf{Roger D. Silk} \ \ \text{(far left)} \ \ \text{is chief executive officer}$





and **James W. Lintott** is chairman of Sterling Foundation Management in Herndon, Va.

IP Statement

This document provides a set of guidelines by which an organization can govern the investment of its assets. A basic IP statement should take into account:

- The organization's expected or planned life;
- The organization's expected or planned cash flows;
- Any applicable rules from Internal Revenue Code Section 4944 on jeopardizing investments;
- Any applicable rules on UBI;²
- The implications of the organization's tax-exempt
- The board's attitude toward risk; and
- Expected, planned and required cash flows out.

An appropriate IP statement will seek to optimize the achievement of the organization's goals, while respecting the above constraints and any others that may be applicable.

Expected or Planned Life

Depending on the type of organization, its expected or planned life might be anything from a few years (in the case of a term trust) to indefinite (as is the case with most public charities and many PFs).

It's clear, for example, that the investment horizon for a 10-year term trust will be different from that of, say, a well endowed university. As such, investments, such as 12-year lock-up partnerships, which might be appropriate for a long-lived organization, won't be appropriate for a short life one. Organizations with a fixed and finite life, for example a PF with a plan to spend down its assets by a date certain or a term CRT with a known termination date, when close to that termination date, will likely pursue a policy with lower expected risk and,



SPECIAL SUPPLEMENT: CHARITABLE GIVING

therefore, lower expected returns, than an organization with a long or indefinite life.

Anticipated Cash Flows

An endowment that won't receive any future cash infusions may have very different characteristics from an otherwise similar endowment that will receive significant future infusions.

For example, a small PF that's funded with \$2 million at a donor's death will have to generate its annual 5 percent distribution, cover costs and expenses,

More recently, some new foundations that weren't diversified saw their assets crumble by 50 percent to 95 percent, and in some cases, they effectively disappeared.

generate growth and limit risk solely from its initial \$2 million. An identical small PF, started by a living donor who funds it with \$2 million and also plans to fund it each year thereafter, while he's alive, faces a different situation entirely.

When there's an expected long-term series of cash flows into an organization, whether from a founder, the public or some other source, the trustees, directors and investment managers can logically think and plan in terms of a large overall portfolio, consisting of both the cash (or securities) actually in the organization's hands, plus the expected future cash flows.³

When large future inflows are expected, the investment portion of the portfolio may be wielded more aggressively (take on more risk) than if the future cash flows aren't expected, because, to the extent that those future cash flows are certain, the overall impact of the portfolio risk is reduced. That is, a given number of

dollars at risk are spread over a larger base of value (the actual portfolio plus the future inflows).

Jeopardizing Investments

Various standards of fiduciary responsibility exist for different types of organizations. The standards may overlap, although it would take a true legal scholar to determine the locations (if any) of bright lines marking the boundaries. We won't attempt to review the fiduciary standards applicable to trustees,⁴ nor will we attempt to provide a rigorous discussion of the IRC Section 4944 rules on jeopardizing investments. While such investments aren't clearly defined, the rule is analogous to the prudent person rules; common law requires that trustees manage assets in accordance with what a prudent person would be expected to do. Generally speaking, a portfolio will comply with the rules if it's well diversified, doesn't use debt and limits itself to conventional investments in stocks, bonds and cash.

The application of these rules can sometimes be surprising. Under certain conditions, other investments may be permitted, including options, futures, private equity, hedge funds, real estate and venture capital. For instance, the Internal Revenue Service has ruled that a managed futures trading program could be viewed as adding diversification to an overall portfolio, because it has little or no correlation with other asset classes. (The foundation in this case proposed to allocate 10 percent to the managed futures program.) Note, however, that some types of charities, such as PFs, are prohibited from direct use of debt. Trustees considering the use of debt should obtain advice from a qualified advisor, particularly with respect to any potential issues of prohibition or potential taxation resulting from the use of debt.

All too often, from a legal prudence point of view, investments that turn out, in hindsight, to jeopardize the organization may seem, in advance, to have been prudent and widely held by similar investors with similar knowledge. For example, consider the experiences of the early 2000s, with companies like Enron and WorldCom, which were world-beaters, before the wheels came off those wagons. Or, more recently, consider the widespread participation by some of the investment world's smartest people in "great investors," like Bernard Madoff, who



SPECIAL SUPPLEMENT: CHARITABLE GIVING

turned out, in the fullness of time, to be anything but.

A third issue that some charities face is what to do with a large grant of a single stock. In the case of PFs, such blocks are safe-harbored from the jeopardizing investment rules. But, this doesn't mean it's necessarily a good idea to hold them. This issue isn't a new one. For example, in the second half of the 20th century, scientific genius Edwin Land's Polaroid Corp. reaped huge profits from his invention of Polaroid cameras and other advances in photography and color television. But, he kept all the assets of his foundation in Polaroid stock. After Polaroid stock plummeted in the 1970s, he had to shut down his foundation.

More recently, a number of new foundations were created with high-flying tech stocks, before that market crashed in 2000. Many of the foundations that weren't diversified saw their assets crumble by 50 percent to 95 percent, and in some cases, they effectively disappeared. For example, the well-respected David and Lucille Packard Foundation announced in late 2002 that it was cutting its staff nearly in half and dropping its giving plans by over 50 percent, as compared with 2001, because of the steep drop in its endowment's value caused by the more than 60 percent drop in the value of its very large holdings of Hewlett Packard stock during the tech meltdown.

This sad story was repeated as many foundations found themselves grievously exposed to the market collapse of 2008 to 2009. Even some of the oldest and most well established charitable organizations, such as Harvard University, which were exposed to aggressive investment strategies, saw their assets or endowments cut by a third or more.

UBI

All charities, whether public or private, must be aware of the rules on UBI. As the name implies, UBI is income from a business that's unrelated to the exempt purpose of the charity. This income will generate a tax, called the UBI tax, which foundations must avoid.

UBI can arise from a number of sources, including the direct (and sometimes indirect) ownership of businesses, leverage and even through investments that appear to be (and may even be from the charity's point of view) passive, such as some hedge funds.

There's a broad exception to the UBI rules, which allows charities to own a variety of portfolio-type investments. Generally, such permitted investments include stocks, bonds, money market instruments, cash, mutual funds and, depending on the specifics, a variety of other alternative investments. A charity that plans on investing in anything other than these common types of assets should pre-screen prospective investments for potential UBI.

Tax Status

Most charitable entities (with the primary exception of charitable lead trusts) are exempt from income tax. But, that doesn't mean that it's a good idea to completely ignore taxes.

A charity's tax-exempt status means that it doesn't need to engage in all the usual efforts to defer, play down or otherwise manipulate taxable income.

For example, CRTs, while themselves tax-exempt, pass out their income, under the provisions of IRC Section 664, to the income beneficiaries of the trust, and these beneficiaries may care greatly about the tax character of such income. Or, PFs, while exempt from income taxes, do pay a small, but non-zero, excise tax on most investment income.

And in some cases, the tax-exempt status may allow a charity to pursue a strategy that a taxable investor would avoid. For example, some bond investment programs may seek to maximize their pre-tax yield by focusing on high coupon bonds, which trade at large premiums to their maturity value. Whereas a taxable investor might balk at buying such a bond, because he doesn't want high, taxable ordinary income now and a deferred, capital loss later, such an investment may offer



SPECIAL SUPPLEMENT: CHARITABLE GIVING

an opportunity for enhanced return with no additional risk to a non-taxable investor.

In general, a charity's tax-exempt status means that it doesn't need to engage in all the usual efforts to defer, play down or otherwise manipulate taxable income. The investment manager can straightforwardly seek high yielding investments, collect dividends and take profits or hold onto temporary losses, all without worrying about taxes. This should

The first step in developing a charity's cash management policy is to project both incoming contributions and outflows of cash.

be explicitly recognized in the IP, for example, by directly stating that income can be pursued without regard to income taxes.

Risk

The whole point of an IP is to have a carefully thoughtout, coherent approach to managing investment risks that can't be avoided.

Risk means different things to different people. To many financial academics and Wall Street purveyors of financial products, risk is represented by a mathematical model, statistical distribution or similar highly technical, blackbox-like piece of financial technology.

For many businessmen acting on their own account, risk means the risk of losing money. For some third-party advisors, risk may mean the risk of looking bad, being out of step or losing the client.

These are all valid meanings and interpretations of risk. And, there are others. For most charities, however, the board is trying to manage the real risk of not having enough money to accomplish the charity's goals.

No matter which view of risk is taken, there are several issues charities should take into account. These include: losing so much in assets that the charity can't

accomplish its goals or is forced out of business; the gradual, long-term shrinkage of foundation assets, in real (inflation-adjusted) terms; and fluctuations in assets big enough to affect the stability of programs. If these pitfalls can be avoided, the risk-management program is probably satisfactory.

In addition to these basic survival issues, many charity directors and investment professionals view the possibility of underperformance relative to established benchmarks as a risk worth taking into account. This is the investment world's version of the bandwagon thinking embodied in the adage "nobody ever got fired for buying IBM." In an investment environment in which real (inflation-adjusted) interest rates are low (which is most of the time), there's no such thing as a risk-free IP for a charity, unless that charity plans to spend itself out of existence over a relatively short period of time.

Perhaps long ago, investment risk was viewed as a simple and obvious concept, but it's now seen as having many facets. It's important to remember that there's no riskless option and no matter how sophisticated the quantitative model, it can't replace or





Fall Foliage

"Indian Summer" (19.7 in. by 29.7 in.) by Yuri Vladimirovich Matushevski recently sold for \$1,569 at Christie's Interior Sale in London on Aug. 14, 2012. Matushevski is known for his work in landscape and his use of oils to depict scenes from the Russian countryside.



SPECIAL SUPPLEMENT: CHARITABLE GIVING

eliminate the need for human judgment.

There are currently a number of popular quantitative approaches to risk management. Among the most common of these are various forms of the capital asset pricing model (CAPM), mean/variance optimization models and Monte Carlo models. If you hear "beta," it means someone, even if he doesn't explicitly realize it, is using a CAPM approach. If you hear "efficient frontier," you're listening to a discussion involving some kind of mean/variance optimization, and if you hear "simulation," you're probably hearing about a Monte Carlo method.

Each of these approaches has its advantages and disadvantages. Each of them, while simple in some sense, rests on some fairly heavy-duty mathematical foundations and assumptions. While the math is easy to get right (it's almost all done by computers), knowing when to use each approach, when to trust it and when not to, requires far greater skill.

Cash Management

Different charities will have different needs to spend from their endowments. Some may spend very little; some, such as PFs, are required by law to spend at least 5 percent each year; and some, such as CRTs, may, by the terms of their trust agreements, have to spend considerably more.

Whatever the amount, it's important to consider these expenditures as a part of the IP. The first step in developing a charity's cash management policy is to project both incoming contributions and outflows of cash in the form of program expenditures, grants and other spending.

If cash inflows are expected, pay particular attention to expected regular annual additions. If these regular annual additions can be relied on, they may serve as the core of the cash flow necessary to fund the organization's operations, whether that's programming, salaries or grants, meaning that the endowment won't have to produce these cash flows.

In the early years of a growing PF, this stream of expected future cash inflows might well exceed, in present value terms, the actual value of the PF. For example, consider a PF that's started with \$1 million and expects to receive \$500,000 a year for the next 10 years. The value of

the stream of \$500,000 inflows is much greater than the \$1 million the PF already has. In this case, a more aggressive IP may be appropriate, because the risk taken with the \$1 million won't affect the \$5 million in cash the PF will be receiving over the next 10 years.

The average PF spends just above the 5 percent annual disbursement required by law; most perpetual-life PFs distribute just the amount required.

For organizations that have to produce spending

Especially in a low interest rate environment, cash management is an important, if often overlooked, issue.

cash from their endowments, the central cash management issue is how to handle the fluctuation of investment returns while accomplishing philanthropic goals. Such planning requires decisions about philanthropic priorities, tolerance of risk, desire for preservation and growth of the real (inflation-adjusted) size of the PF and the time horizon (either finite or perpetual life) of the organization.

Especially in a low interest rate environment, cash management is an important, if often overlooked, issue. Without a deliberate policy, charities can end up losing money by holding on to cash for too long or by not holding enough cash at the right time. The first kind of loss is easy to understand. The charity holds more cash than it needs, missing opportunities to earn higher returns. If the differential between expected returns on cash and the rest of the portfolio is 5 percent per year, this loss may be in the range of 0.25 to 0.50 percent per year.

The other kind of loss is more subtle, but just as real. Essentially, the charity can find itself forced into a policy of selling low. That is, it systematically sells relatively more assets when investment markets are low and fewer assets when the markets are high. Here's an example: Imagine that in Year 1, a charity has assets of \$1 million.



SPECIAL SUPPLEMENT: CHARITABI F GIVING

Suppose it has expenses funded by the endowment of \$50,000. In Year 2, let's say the assets are at \$1.1 million and the charity will distribute 5 percent again, or \$55,000. But, in Year 3, suppose that just as that check is to be written, the market is down, so that the assets are again worth only \$1 million. Now the \$55,000 that the PF must give away represents 5.5 percent of its assets. In this way, the PF is forced to systematically sell relatively more assets when the market is down.

Over time, this can create a meaningful drag on performance. My analysis suggests that for a PF with perpet-



SPOT LIGHT

Such a Pretty Name

"Portrait of Ludmilla" (37.5 in. by 28.5 in.) by Genrikh Frantsevich Brzhozovsky sold for \$2,745 at Christie's Interiors Sale in London on Aug. 14, 2012. Russia played an important role in bringing ballet to the masses, as the Imperial School of Ballet, founded in 1740, offered cheap bench seating in a section called a "rayok" or "paradise gallery."

ual life (and, consequently, a portfolio heavily weighted with equities), this drag can amount to 0.25 percent to 0.50 percent per year (coincidentally, the same amount of loss incurred by holding too much cash).

Expenditure Planning

Since investment results aren't predictable, there's no perfect way to plan expenditures. But, there are some tools. The central problem is clear: Generally, it's desirable to keep program spending stable or, at least, predictable. But, fluctuating investment markets create pressure to vary expenditure levels. The goal of a long-term plan is to find the best balance between maintaining effective program support and not spending too much in years when the portfolio value is down.

In up years, charities may feel pressure to increase spending, and in the case of PFs, that pressure has the force of law, because the 5 percent distribution requirement makes no allowance for exceptionally good years. However, once grant support has increased, as the result of a good year, there may appear to be good reasons to keep it at such increased levels, even in a bad year.

Unfortunately, the mathematics of investment returns mean that if endowed charities keep their spending up even in down years (and, thereby, spend significantly more than 5 percent), they may find themselves forced into a pattern of an ever-shrinking asset base. This pattern may eventually force the organization out of existence. Keeping grant support up in years in which investment returns are negative is an option that should be adopted only after careful evaluation of the long-term effects.

How big a problem this is will depend on a number of factors, particularly the expected long-run return on the portfolio and the volatility of those returns. Each situation needs to be analyzed individually.

Endnotes

- Email Interview on Aug. 13, 2012 between Roger D. Silk and Salvatore J. IaMendola
- 2. See, e.g., Internal Revenue Service Publication 598.
- In fact, most public charities operate in exactly this way, often (too often probably) even borrowing against expected future cash inflows to finance current expenditures.
- The reader requiring a book-length treatment may wish to review Tim Hatton's The New Fiduciary Standard: The 27 Prudent Investment Practices for Financial Advisers, Trustees, and Plan Sponsors (Bloomberg Press) 2005.