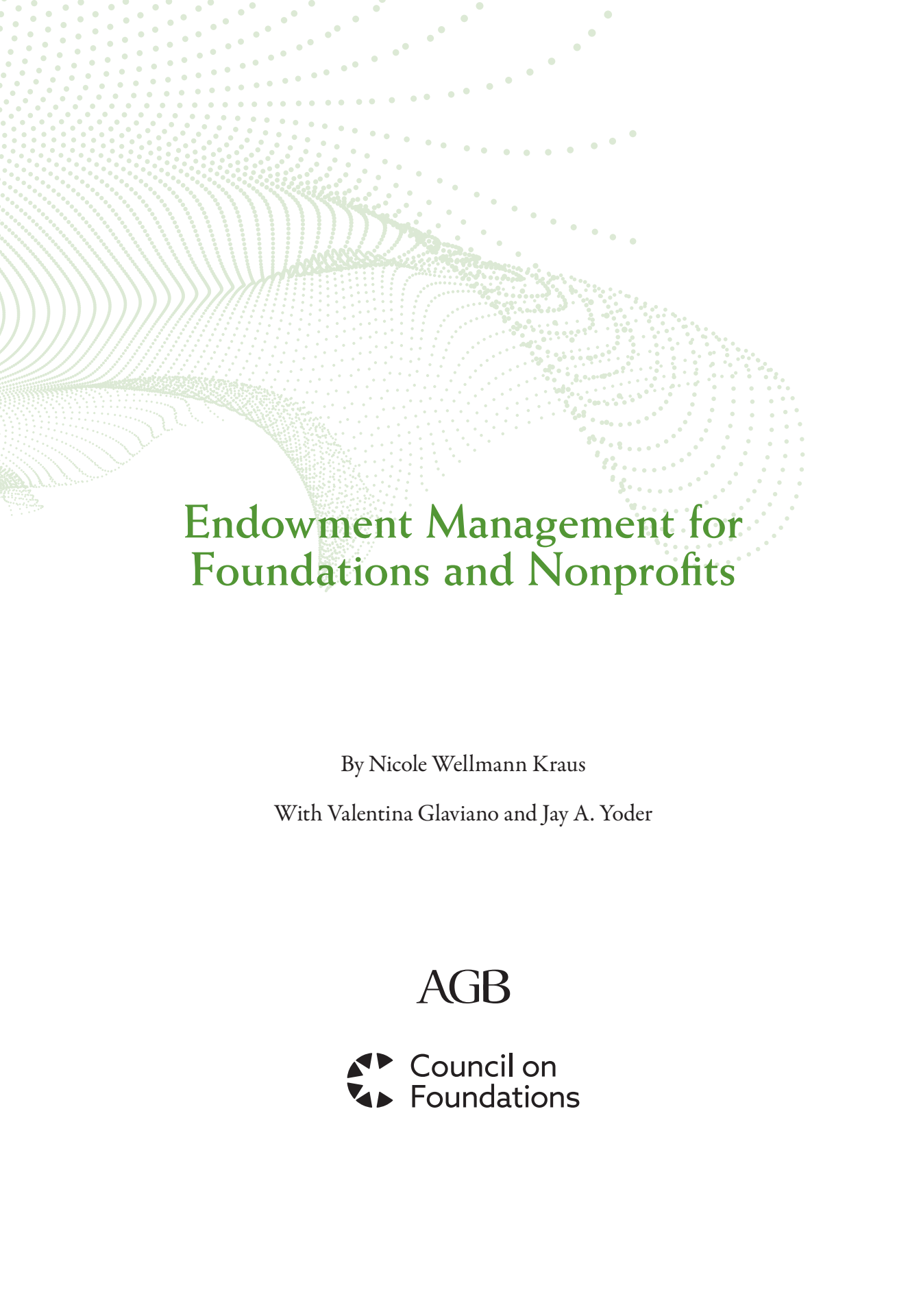


An abstract graphic composed of numerous small green dots arranged in concentric, wavy lines that sweep across the upper half of the page, creating a sense of movement and depth.

Endowment Management for Foundations and Nonprofits

By Nicole Wellmann Kraus

With Valentina Glaviano and Jay A. Yoder

AGB



Council on
Foundations



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About AGB

The Association of Governing Boards of Universities and Colleges (AGB) is the premier membership organization that strengthens higher education governing boards and the strategic roles they serve within their organizations. Through our vast library of resources, educational events, and consulting services, and with nearly 100 years of experience, we empower 40,000 AGB members from more than 2,000 institutions and foundations to navigate complex issues, implement leading practices, streamline operations, and govern with confidence. AGB is the trusted resource for board members, chief executives, and key administrators on higher education governance and leadership. For more information, visit www.AGB.org.



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About the Council on Foundations

The Council on Foundations is a nonprofit membership association that serves as a guide for philanthropies as they advance the greater good. Building on its almost 75-year history, the Council supports over 800 member organizations in the United States and around the world to build trust in philanthropy, expand pathways to giving, engage broader perspectives, and co-create solutions that will lead to a better future for all.



Strategic
Investment
Group

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About Strategic

Strategic Investment Group (Strategic) was founded in 1987 by the senior members of the investment office managing the World Bank's multibillion-dollar portfolio. They understood the complex and difficult role of a fiduciary and as a result, founded a firm intended to be a fiduciary partner, or investment office for hire, for a select number of clients. The organization was built with the vision to provide sophisticated, customized investment solutions for clients, which were traditionally only available to multibillion-dollar investors, allowing all clients to gain the benefits of our best ideas. A pioneer of the dedicated Outsourced Chief Investment Officer (OCIO) model, Strategic's mission is to provide the same type of comprehensive customized fiduciary investment solutions to organizations that do not choose to, or do not have the ability to, build this capability internally. This frees clients from the day-to-day business of managing investment portfolios so that they can focus on their core mission. We become our client's investment office and function seamlessly as an extension of their staff. For more information, visit www.strategicgroup.com.

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Our families are the ultimate gifts to us, and we would like to thank our supportive families and friends, who provided inspiration as well as inestimable help with the extra hours required to complete this labor of love.

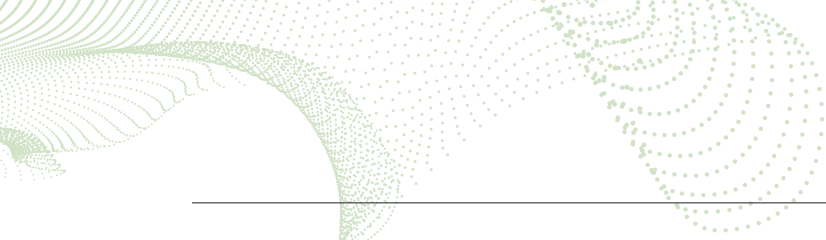
Foreword

It's difficult to overstate the importance of endowments in the charitable sector. In an environment of economic volatility, these pools of funds afford nonprofits a cushion as they tackle complicated societal issues. For the philanthropies that support those organizations, endowments offer the ability to give counter-cyclical support when markets dip and support is needed most, while also funding strategically over the long haul.

Effective endowment management, then, is critical. And that requires investment expertise to manage risk and protect principal and good governance practices to ensure integrity, commitment to mission and values, and transparency among financial managers. The Council on Foundations' members in philanthropy are increasingly wrestling with what it means to truly align investments with organizational values and mission. They're challenging themselves and each other to be more inclusive about who manages their funds and asking hard questions about the practices of the companies in which they invest. The past few years of pandemic upheaval, heightened attention to the importance of racial equity, and the continually widening wealth gap make these improvements not just timely but urgent.

As nonprofits and the philanthropies they depend on continue to refine their management of endowments, the sector will be better able to weather both the roller coaster of the financial markets and the tests of time. This is crucial for continuing to invest in communities across the world and working toward a better future for all.

Kathleen Enright,
President and CEO Council on Foundations
July 2022



Introduction

The volunteers who serve on the investment committees of foundations and non-profits assume important fiduciary responsibilities. Their challenge is to help secure the future of their institution and its mission by managing their endowments wisely. They often undertake the important social role of preserving intergenerational equity, ensuring that today's grant recipients and future deserving candidates benefit equally from the endowments. This book is dedicated to these volunteers' service. It has been written in the hope of providing guidance to facilitate their effective stewardship of the endowments underpinning our nonprofit organizations and the important support they provide to our communities.

The stark differences in wealth make endowments an increasingly precious resource to help people afford an education and attain adequate health care and childcare. The work of these investment committee members has never been more important. The future of so many is at stake.

Market returns since the Great Financial Crisis have been higher than average. These unusually high returns were accompanied by an increased capacity of donors to contribute to endowments and the stronger overall financial health of many non-profits. These favorable developments came to an abrupt end with the emergence of the COVID-19 pandemic. While the economic and market impact of the pandemic was relatively short-lived, there will be lingering scars from the pandemic's dramatic impact on economic activity, human behavior, and the significant increase in additional need for support in many communities. Many institutions will also likely bear scars that will take time to heal. The pandemic should serve as a wake-up call to all about the precarious footing on which many institutions operate. The darkest periods of the pandemic revealed the vulnerability of both our endowments and our operations and underscored the need to redouble our efforts to increase the resilience of the institutions we serve.

Husbanding endowment resources through complicated and unforgiving times in financial markets presents a whole set of additional challenges. For years, an 8 or 9 percent return on endowments has been commonly used in long-term budget plans. However, many members of investment committees believe that it will be more difficult going forward to generate the level of investment returns required to preserve intergenerational equity. This undertaking was best defined by economist and Nobel Laureate James Tobin, who aptly noted: "The trustees of an endowed institution are the guardians of the future against the claims of the present. Their

task is to preserve equity among generations.” Markets are becoming increasingly complex, and in slower-growth markets, more modest investment returns will be generated. Opportunities to beat the market are growing scarcer while the opportunities for costly missteps mount. Access to compelling managers continues to prove important to generate the returns needed, and the smallest institutions have an additional challenge that their portfolios are often not large enough to get the attention of the managers who could generate distinguished returns.

Yet growing endowments are indispensable to maintaining this support in our communities. Many charitable organizations rely on regular gifts from key foundations. Without this support, many of these important organizations would be unable to continue their work enriching the quality of life in our communities. Endowments need the benefit of the board’s guidance to meet the current demands placed on them and their long-term goal of providing a growing resource of support to the institution into the future.

The challenges of investing are both technical and human. To excel, endowment stewards must be as attentive to landmines in governance as they are to those in global markets. Stories abound of institutions with brilliant technical investment processes but poor governance practices that undermined the work of their investment teams.

Given all these challenges, those agreeing to serve on investment committees shoulder important responsibilities. Yet the emotional rewards are also great. Helping to support a beloved institution, and thus helping to secure its future, can be a source of great pride.

This book is based on *Endowment Management for Higher Education, Second Edition*, published in 2022. This new edition includes additional observations gleaned from the authors’ combined nine decades of working with investment committees that are relevant to any nonprofit investment committee.

Unfortunately, markets continue to teach painful lessons for all types of investors, including those charged with protecting and increasing institutional endowments. Drawing on our experience as well as insights shaped by this tumultuous era, the authors hope that this book will be useful for any member of an investment committee.

Before delving into the intricacies of endowment management, the following list reviews some of the important lessons of recent years, including those born of the COVID-19 crisis:

- *Many investment committees do not accurately assess their tolerance for risk.* Some committees may take too much risk (only to subsequently be forced to unwind it at an inopportune time) while others may take too little risk, creating significant opportunity costs. Additionally, after periods of sustained market highs, humans often overestimate their tolerance for risk or return volatility. Often, a lack of communication and coordination between a board’s finance and investment committees prevents the development of an integrated “enterprise risk management” approach that considers the overall operating,

financial, and investment risks of the institution rather than the suboptimal approach of assessing each in isolation. COVID-19 exposed these weaknesses in many organizations.

- *Maintaining appropriate liquidity is critical.* There is a risk that institutions undervalue liquidity and find themselves unable to meet liquidity requirements for their institutions. As John Maynard Keynes so famously observed, “The market can stay irrational longer than you can stay solvent.”
- *Creating asset tranches based on the anticipated use and the time horizon of funds can be valuable from a behavioral standpoint in creating discipline for boards.* These arrangements ensure that adequate liquidity has been set aside to meet anticipated budgetary needs for a few years. Those institutions that had set aside assets earmarked for near-term use in this way gave comfort that budgetary needs would be met despite the steep declines in asset values experienced during the COVID-19 crisis.
- *Many institutions seek to emulate others and focus too much on the investment strategies followed by a few large universities or large foundations.* This focus misses the essential point that the strategies pursued by each investment committee must be tailored to its particular institution’s circumstances, capabilities, and long-run strategic goals. The additional flexibility and organizational strength that the largest, wealthiest institutions have due to their balance sheets and competitive positioning should not be underestimated. Only institutions with access to top-tier investment talent—internally or through an outside advisor—should even consider this model; other institutional leaders must be more aware of their budgetary needs and level of dependence on the endowment.
- *Operational due diligence is critical.* While it is vital to understand each portfolio manager’s investment process and performance, cases of fraud and other scandals involving “investment” firms have made an entirely new level of due diligence—known as operational due diligence—a best practice for all investment programs.
- *Leadership is critical.* The leaders of investment committees must understand that their institutions’ futures may depend on the success of this committee. The best investment committee chairs act as servant leaders who ensure each member of their committee participates appropriately. Each member of the investment committee must be up to the task. This goes to the heart of the mission of the Association of Governing Boards of Universities and Colleges (AGB) and to that of the Council on Foundations. Each member must have the requisite skills and judgment and dedicate the necessary time to fulfill his or her obligations. This makes recruitment and vetting of prospective committee members a high priority. If warranted, failure to perform may lead to the removal of a committee member. It is far better to avoid this circumstance by fully informing potential candidates of the duties of committee members and the time and energy commitment before they accept.

- *Communication about the investment program among senior officials—including the chair of the board, the chair of the investment committee, the president, and the chief financial officer—must be frequent and clear.* The early involvement of all key leaders in certain strategic decisions regarding asset allocation, spending policy, and risk tolerance can be crucial. If any of these officials lose faith in the investment program at the wrong time, they may instigate changes that can wreak havoc on investment returns.
- *Institutional memory should be valued and preserved.* The stability of the investment committee's membership is important. Meeting minutes are also critically important to preserving institutional memory—key decisions, and the reasons for them, should be documented and referenced when issues resurface.
- *There is tremendous momentum to promote diversity, equity, and inclusion (DE&I) in manager selection. There are also increasing initiatives to improve DE&I within the investment management industry, and to implement investment practices that focus on environmental, social, and governance (ESG) considerations.* The emphasis we place on DE&I and ESG in our organizations has become an increased focus for our portfolios. This process also needs great stewardship and guidance by the board, which is why we have added a new chapter (4) dedicated to the ideal steps to take to make sure you arrive at the right place for your institution.

We are honored to partner with AGB and the Council on Foundations to bring you this new edition of the book. We encourage all board and committee members to avail themselves of AGB's and the Council's excellent publications and conferences, information about which can be found at AGB.org and COF.org. Each member of an institution's board has important obligations in carrying out the work of the full board and its committees. While this book focuses on the work of the investment committee, no single work can encompass every aspect of endowment management. There have been many excellent books published on the subject; in an appendix, we have provided a list of works that we consider essential reading for every member of an investment committee. Serving on an investment committee should be undertaken with as much information and preparation as possible. We trust this book will provide useful guidance to both new and experienced investment committee members.