Evaluating Foundation Investment Policies, Performance and Advisors

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IPS: Purpose

- Ensure investment strategy is appropriate, prudent, and time tested.
- Memorialize agreed upon investment objectives and guidelines, benchmarks, and risk parameters.
- Reduce opportunities for mistakes which might result in permanent loss of capital, or in the failure to meet investment objectives.
- Provide framework for measuring success within the portfolio, or lack thereof.
- Ensure continuity of processes over time.

Value of the IPS– Depends on your Viewpoint

- To the Foundation, an IPS is an important framework for ensuring good stewardship, appropriate portfolio construction, and continuity of process and goals to successors.
- To a regulator, an IPS may offer a cornucopia full of opportunities for criticism.
- To a compliance officer at an investment firm, an IPS can become a sizable liability if too narrow or specific.
- To an investment firm, an IPS becomes constraining if too narrow or specific.
- To an Investment Committee, an IPS loses most of its utility if it is too broad, is never reviewed, or doesn't relay the Foundation's real intent.

IPS: Often Overlooked Elements

- History and Purpose – Why does the portfolio exist, and who does it serve and support?
  - Ideally, IPS should tie governance and management of the portfolio to the sponsor – not treat portfolio as a stand alone asset.
- Investment philosophy held by Sponsor
- Target return (not just target allocations), both real and nominal.
- Risk budget – Volatility Bandwidth.
- Rebalancing policy – why, when, and how.
- Annual fee review addressing all portfolio expenses, and annual Affirmation.

Investment Philosophy Should Promote Stewardship, Accountability, and Consistency of Process

Sample:

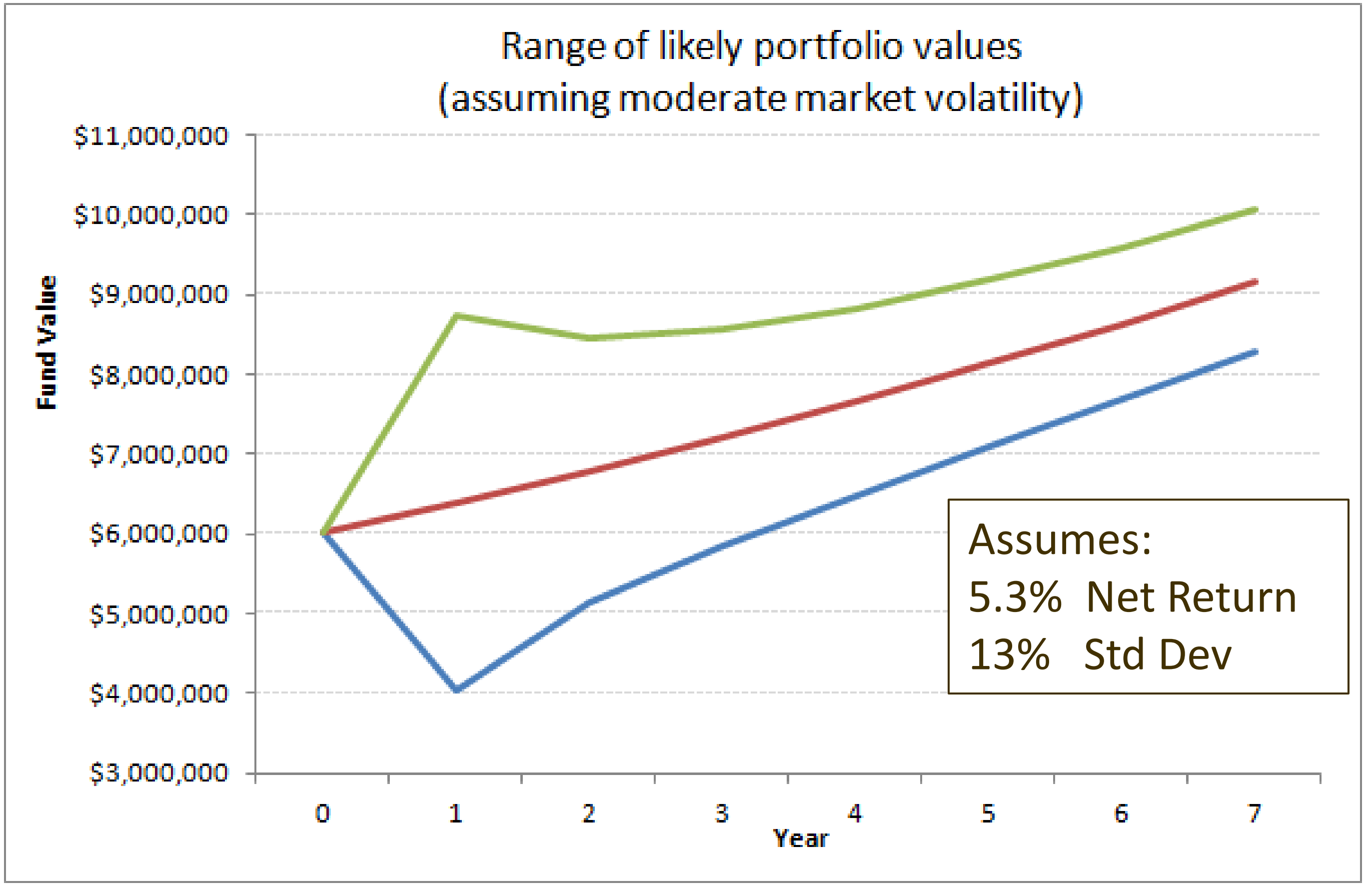
- We believe most capital markets are highly efficient, integrating information into prices very quickly, leading us to favor lower cost passive investments, particularly in areas deemed to be more efficient.
- We believe a disciplined, long-term, and strategic (not tactical) approach to investing rewards investors over time and assists in the avoidance of permanent and catastrophic loss due to concentration risk, timing errors and allocation errors.
- We believe additional value can be achieved through disciplined re-balancing, and focusing on reducing investment costs.
- Etc.

IPS: Risk Budgeting

By definition, you must have risk exposure to earn a return. Risk introduces uncertainty (volatility) and widens the range of potential outcomes.

To an institution (presumably a patient and well-diversified investor), volatility must be managed in consideration of its short term impact on the entity. This is the essence of a Risk Budget.

Hypothetical Risk/Return, 7-year Outlook

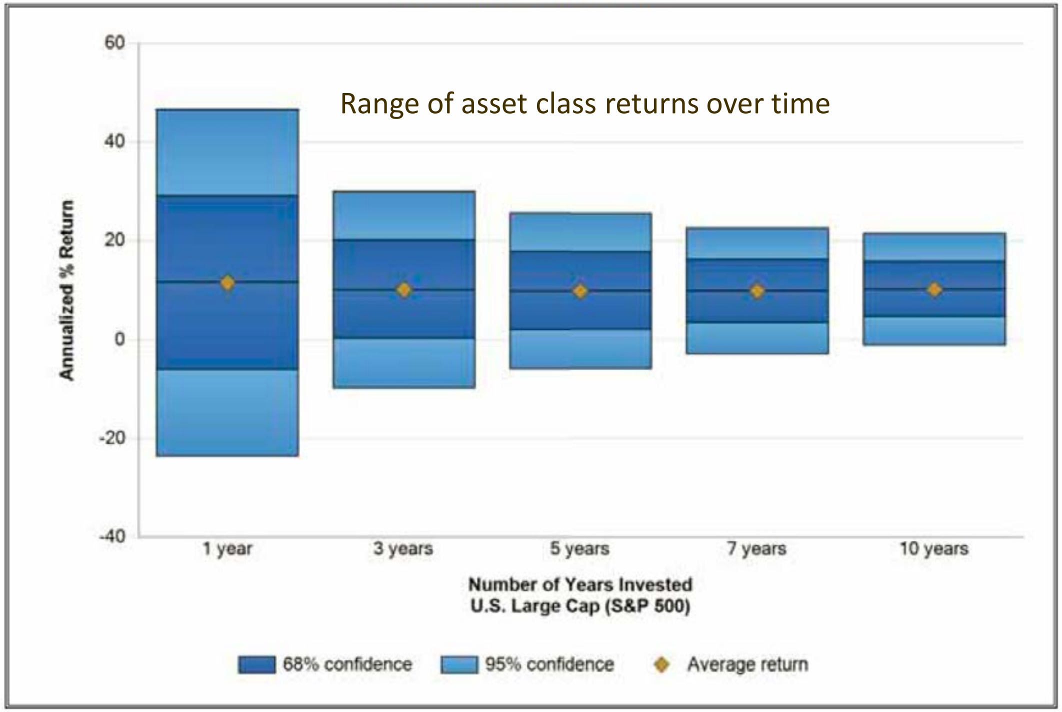


Why Are Risk Budgets So Important?

Return Expectations are a Residual of Risk Exposure

Non-intuitively, long-term forecasts are ***more accurate*** than short-term forecasts

Investment Horizon



Source: Envestnet

Diversification: A Functional Approach

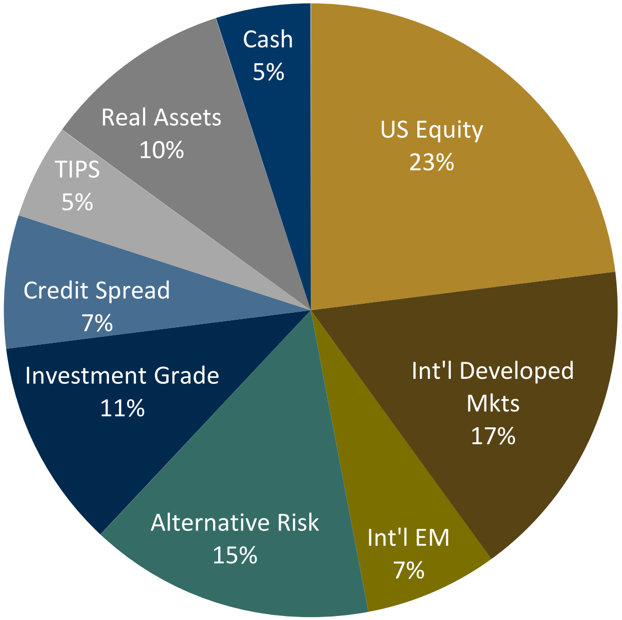
Inflation Protection Assets help protect a portfolio from unanticipated inflation.

Liquid Real Assets
- TIPS
- REITs
- MLPs
- Energy & Commodity Stocks
- Managed Futures

Private Real Assets
- Real Estate
- Energy, Mining and Minerals

Risk Reduction Assets dampen overall portfolio volatility through their own low volatility and by having a low correlation to Growth Assets.

Investment Grade Credit
- Cash
- Municipals
- Treasuries
- Investment Grade Credit
- Emerging Market Debt



Growth Assets generate returns based on growth of the world economy.

US Equity
- Large Cap
- Small Cap

International Equity
- Developed Markets
- Emerging Markets
- Frontier Markets

Private Equity
- Venture Capital
- Buyouts
- Mezzanine Financing

Alternative Risk Assets exhibit low correlation to traditional strategies

Risk Reduction
- Multi-Asset Managers
- Long/Short Equity
- Market Neutral
- Merger Arbitrage

Opportunistic
- Global Macro
- Distressed Debt
- Concentrated and Special Situation managers

Better Governance starts with focusing on what can be controlled

Return Expectations are residual & systematic.

Fiduciaries have control over the following three factors – all of which should be memorialized in the IPS:

1) **Risk** (overall portfolio volatility and market capture)
2) **Diversification**
3) **Fees**

Fiduciaries should **act prudently** and weigh the above issues carefully in order to construct an "efficient" portfolio, consistent with the guidelines in the IPS, and consistent with the assigned Risk Budget.

Fiduciaries should **develop and maintain** proper **documentation** to support their decisions.

IPS: Summary Do's and Don'ts

- Do - Review Annually and Affirm.
- Do – ensure that investment objectives are realistic, and actually achievable within IPS guidelines and risk budget.
- Do – consider having IPS drafted by a consultant rather than by the Sponsor's investment committee.
- Don't – Have your IPS drafted by your investment manager(s).
- Don't – Assume all parties are familiar with the Policy and are following guidelines.
- Don't – allow too much latitude in policy such that risk budgets can be exceeded.
- Don't - assume that any IPS is better than no IPS.

The Nature of Nonprofit Investment Reserves & Endowments

- Foundations Investments Typically Represent Initial Corpus, Additional Gifts and Accumulated Surpluses from Realized & Unrealized Investment Performance
- Performance Largely Out of Management/Boards Control
- For Private Foundations Return Expectation Must at a Minimum Cover Statutory Payout (i.e., 5%)
- In-house Investment Expertise Often Weak
- Pressure for Sound Management & Governance over Funds is Intense and Growing

Critical Roles & Responsibilities

- **Foundation Management** Develop policies for board approval that clearly outline the nature, use, restrictions, goals and accountabilities associated with investment portfolio
- **Foundation Board** Review, Understand and Drive Consensus around investment consistent with their fiduciary role, mission, strategic priorities and regulatory compliance. Monitor and update on a periodic basis.

Critical Roles & Responsibilities

- **Investment Advisors**
  Responsible for consulting with management and the board/investment committee to ensure adoption of sound investment policies, strategies and accountable reporting consistent with the intended use and restrictions associated with the underlying funds.
  - Includes defining risk tolerance, time horizon, asset allocation, return objectives, asset class and peer benchmarks, reporting format and frequency
  - Can act with or without "discretion"
  - Best when independent of underlying investment managers
  - Typically paid a management fee percentage of the market value of Assets Under Management (AUM)

Critical Roles & Responsibilities

- **Investment/Fund Managers**
  Those organization and funds actually deploying the asset allocation strategy as set forth in the board approved investment strategy (e.g., large cap, small cap, fixed income, real estate, private equity etc.).
  - Report to the organization directly and/or through the Investment Advisor
  - Are hired, retained or fired based on investment advisor/management recommendation to the board based on performance and adherence to the investment policy and meet associated objectives
  - Typically paid a management fee percentage of the market value of Assets Under Management (AUM) in addition to internal fund fees

Key Considerations

Asset Allocation-What mix of assets (e.g., money market cash, equity, fixed income, real estate, private equity, etc.) will best achieve the risk and return objectives of the portfolio. Typically expressed in ranges (high, low, target) to avoid divestitures that may not make strategic/tactical sense. Required periodic rebalancing of the portfolio should also be specifically stated.

Prohibited Investments-What investments for reasons of risk, social responsibility and/or organizational mission should be prohibited from the investment reserves/endowment portfolio (e.g., tobacco, alcohol, fire arms, fossil fuels, etc.) and how will this be achieved and monitored? What is the potential impact on performance?

Key Considerations

- Whether Investment Advisors are Acting With or Without "Discretion" (i.e., needing organizational approval for before taking actions-i.e., replacing a manager, even when consistent with the investment policy guidelines)
- Report Frequency & Format and to Whom-Management, Board/Investment Committees against asset class benchmarks, peer performance and personal composite

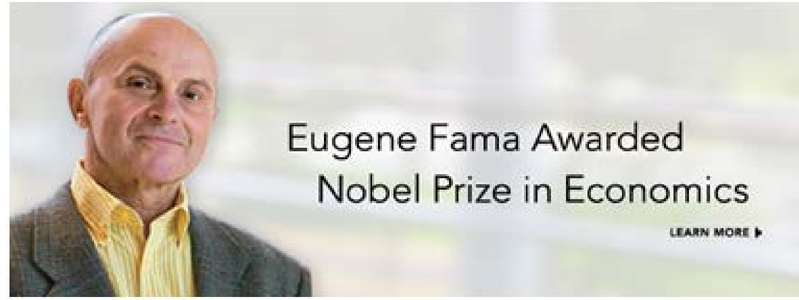
Evaluating Performance

- Key is to clearly outline roles, responsibilities and and expectations in the investment policy
- What are you buying when employing an Investment Advisor?
  - A consultant to ensure best practice expertise in the design and monitoring of your Foundation investment, reserve and endowment policies
  - An independent advisor to your management, board and relevant committees in evaluating performance and making responsible recommendations consistent with your return objectives and risk profile
  - An independent fund/manager platform best suited to deploy your strategy

Evaluating Performance

- Performance targets should be net of all costs and appropriate for each <u>specific</u> asset class (emerging market equities, domestic small cap, short-term municipal debt, etc.)
- Benchmarks should be chosen and compared for each element of the asset allocation and within the peer group of funds/managers (i.e., which managers did better or worse in beating the asset class benchmark?)
- An Overall *Personal Composite Return* target should be established for the portfolio which takes the appropriate percentage of all the underlying asset class benchmarks to reflect the return you should be achieving based on your asset allocation

Does Active Management Pay?

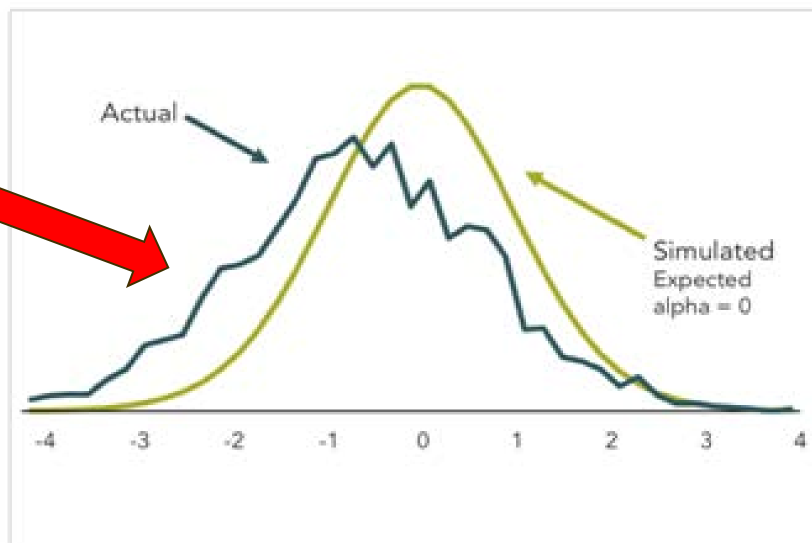


Skill versus Luck

Fama and French (2010), Journal of Finance

Active managers perform no better than what would be expected by pure luck.

Active managers cost significantly more than passive managers.



- Studied 3,156 US equity mutual funds from 1984 to 2006 (excluding index funds)
- "Few funds produce benchmark-adjusted expected returns sufficient to cover their costs."

There is no evidence that trying to outguess market prices adds value.

SAMPLE REPORT - Estimated Annual Fees			
Provider	Current Balance ($millions)	Expense Ratio	Estimated Annual Fee
Manager ABC	$12.3	0.75%	$92,250
Manager XYZ	$16.8	0.37%	$62,160
Custodian	$29.1	0.05%	$14,550
Consultant	$29.1	0.20%	$58,200
Total		0.78%	**$227,160**

Fiduciaries should review fees at least once per year.

What Does Warren Buffett Think?

"My advice to the trustee (i.e., of his estate): Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund (I suggest Vanguard's). I believe the trust's long-term results from this policy will be superior to those obtained by many investors-whether pension funds, institutions or individuals who employ high-fee managers"

2014 Annual Letter to Berkshire Hathaway Shareholders

Investment RFP Process

- When To Bid Out
  - Not meeting performance targets over agreed upon investment cycle (no less than 3 years)
  - Client service issues
  - To assess the market (at least every 10 years)
- Three flavors:
  - Money Managers
  - Broker Dealers
  - Independent Advisors

Investment RFP Process

- Trade-offs:
  - Cost
  - Independence
  - Depth of Internal Resources

- Send Out 4-6 RFP's Covering the 3 Flavors
- Develop a Scoring Matrix
- Hold Bidder's Conference Call
- Have 2-3 Finalist Present to Investment Committee/Board

Questions & Further Information

- Questions
- For further information

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