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An Even Keel in Stormy Markets:
Prudent Investing for Private Family Foundations

The 1990s were a boom time, not only for the stock market, but for foundations and endowments as well. As the stock market soared, their assets swelled with investment gains. The market's "wealth effect" prompted thousands of individuals to contribute to charities, and in many cases, start their own private foundations. All that has changed with a cloudy economic picture and the events of September 11, 2001.

Private foundations are being forced to re-examine their investment policies in light of an extremely challenging stock market—one that is marked by high volatility caused by exogenous shocks and cyclical economic factors. Many portfolios have been hit hard by losses. Some foundations that increased their charitable donations significantly during the flush years are now forced to decrease their annual distributions and cut back on discretionary spending.

"During the 1990s, even mediocre relative investment returns far outstripped historic norms," says Ralph Sinsheimer, Senior Vice President of Neuberger Berman Trust Company, N.A. and head of the Wealth Management Group. "The markets seemed always to be moving upwards. In this environment some family foundations became complacent and neglected to rigorously review their investment policy. Those family and small foundations with perpetual life charters often gave away more than was prudent. Long term capital preservation took a back seat to the illusion of endless positive stock market returns."

Whether we like it or not, this crisis has forced boards of foundations to turn their attention to a more systematic approach of "prudent investing," as codified in states' Management of Institutional Funds Acts, their Prudent Investor Acts and other related laws.[1] These laws require fiduciaries, including the trustees and boards of private foundations, to incorporate principles of modern finance and total net return into their investment policies. It means, in short, that they must consider their investment policy in light of their spending policies, taking market conditions into account.

The challenge, however, is to determine exactly what prudent investing means. "Fiduciaries no longer have 'bright line' tests on which to rely in making decisions," explains Stephen Brent Wells, President of Neuberger Berman Trust Company, N.A. "The Acts require them to take a prudent and thorough approach to decision making. The *approach* to decisions about asset allocation, target returns, risk and managers are more important than the decisions themselves," he says.

The recent provisions for prudent investing create a great deal more flexibility for fiduciaries than they had in decades past. But increased flexibility also means increased responsibility and liability. Foundations have long been responsible for investing their assets wisely. However, with the focus on modern concepts of "prudence," which are so varied and sometimes controversial, foundations now may be challenged by state attorneys general (and potentially even by their founders) if they fail to exercise common sense and think about what "prudence" means today.

The New Look of Prudence

In the days before the Management of Institutional Funds Act (1972) and the Uniform Prudent Investor Act (1997), many trustees and directors of family foundations believed that they were required to invest the foundations' assets in the least risky investments — usually bonds — and spend only income. Of course, this practice ignored the fact that inflation could undermine the value of bonds, slowly dissipating a foundation's assets. Today, fiduciaries are held to broader, more comprehensive standards of investment performance — which include balancing risk with return.

The Uniform Prudent Investor Act and the extensive commentaries about it can provide guidance for those responsible for the oversight of private family foundations. While the Act is concerned principally with investments by private trusts where at least some of the beneficiaries are individuals, trustees of charitable trusts have similar duties and concerns. Therefore they can look to these acts for guidance. The following tenets underlie most states' Prudent Investor Acts:

1. The standard of prudence is applied to the portfolio as a whole, rather than to individual investments. An investment that might appear highly risky by itself can be "prudent" if assessed in relation to the rest of the portfolio.

2. The tradeoff between risk and return is identified as the fiduciary's central consideration. A foundation that is created to exist in perpetuity will by definition be able to invest in "riskier" (i.e., more volatile) investments than a trust with a shorter lifespan.

3. All categorical restrictions on types of investments have been eliminated. The trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.

4. Diversification is a key component of prudent investing, unless special circumstances indicate that the purposes of the trust are better served without diversifying.

[1] The Uniform Law Commissioners in 1994 wrote a Uniform Prudent Investor Act which most states had adopted by 1997. The Uniform Law Commissioners are a national body of several hundred attorneys, judges and law professionals that for 109 years have drafted proposals for uniform laws on subjects where uniformity is desirable and practicable.

5. Delegation of investment management to investment professionals is not only permitted, but encouraged. Trustees of foundations may engage investment managers and direct those managers to invest trust funds for total return in accordance with modern portfolio theory.

Setting Investment Policy

Foundations have always faced a unique balancing act between donating and investing. To retain their tax-exempt status without penalty, they must give away at least 5% of their assets each year. Further, investment policies have to consider both the regular and special periodic spending needs that foundations have. But at the same time, foundations are generally established to exist in perpetuity, and many have no sources of income beyond investment returns on their capital. To sustain or increase the real value of their capital, they must earn returns at least in excess of that 5%, plus enough to stay ahead of inflation and pay investment management and administration fees. Some foundations may need to earn investment returns of roughly 9% percent on average. That is only 2% less than U.S. equities returned annually from 1926 through 2000.[2]

Most foundations simply cannot earn the returns they need to exist in perpetuity without investing at least a portion of their assets in equities as opposed to bonds. But given the inherent risks in equities, how much exposure is appropriate in light of Prudent Investor Acts?

Every foundation has different needs, but the first step to determining the right mix of assets lies in the process of developing an investment policy. The investment policy helps to keep a foundation on course — with assets assigned according to the risks the board or trustees must reasonably take without endangering the value of its capital over the long term, or indeed its very existence.

An investment policy should define: the foundation's investment objectives; its time horizon; its required return; its sensitivity to volatility in the value of the portfolios in any one year or other period; its current and desired future charitable donations; and its expected real growth in fund assets. It may also include preferences or restrictions on investments, such as a socially responsive investing style.

Consideration of any major funding requirements or significant future gifts is a prerequisite for trustees and advisors in setting investment policies. All of the investment related decisions flow from the goals of the foundation. This means foundations need three- to five-year plans. Foundations are operating in a business environment, and to steer clear of trouble, fiduciaries must run them as if they were businesses.

Investment policy leads to asset allocation guidelines, which in addition to setting the target allocations should include provisions for updating, rebalancing the asset mix and benchmarking the performance. Asset allocation guidelines must be firm, but also flexible. For example, operating ranges should be established which consider the long-term historical advantage of equity ownership as well as the higher volatility associated with stocks. These ranges provide for an asset allocation discipline and ensure that the foundation does not fall prey to outright market timing. At the same time, tactical decisions can be made within these ranges to reflect the current outlook for different asset classes. But whatever policy the guidelines set, it must take into account the fact that past performance does not indicate future results.

A well thought out investment policy will help trustees maintain an even keel even during volatile markets. To

[2] Source: Ibbotson (1926-2000).

succeed, all investment decisions — from broad-based asset allocation to issue-specific security selection — require sticking to an investment discipline, no matter how unpopular it may be at the time. Private foundations must take some lessons from the nation's most successful major endowments. "Casual commitments invite casual reversal," writes Yale University pension manager David Swenson, "exposing portfolio managers [and institutions] to the damaging whipsaw of buying high and selling low. Only with the confidence created by a strong decision-making process can investors sell speculative excess and buy despair-driven value."[3]

Alternative Asset Classes

Today's foundations face a larger universe of investment possibilities than ever before. Stocks, bonds and cash are no longer the only asset classes available. Advances in investment research, structured finance and technology have changed the investment world and created new asset types. "The types of asset classes available now and in the future are only limited by the imagination of man," says Sinsheimer.

In the last decade, alternative asset classes like hedge and private equity funds have grown very popular with foundations and endowments. Alternatives to traditional asset classes now account for some 23% of endowment investments, including 18% that go to hedge funds, according to a study by Commonfund Institute. About 60% of college endowments make some allocations to so-called alternatives. Foundations with assets of more than $100 million allocate between 15% and 29% of their assets to alternatives, the study found; institutions with less allocate 5% to 7% to such funds. Colleges and university endowments assign an average of about 45% of their assets to various classes of U.S. equities, about 21% to U.S. bonds, and more than 17% to non-U.S. equities.[4]

Large family foundations can qualify to invest in hedge funds that are closed to small investors. They are attracted to techniques that can provide absolute returns, regardless of the direction of the traditional markets — including "market neutral" funds that attempt to reproduce market returns with less risk and a variety of long-only styles that generally offer less volatility than traditional funds. Good alternative styles and managers generally aim for low correlation to stock and bond indices. As one study suggests, on average a 6% to 16% allocation to a diversified portfolio of such strategies can significantly cut volatility and therefore risk to the portfolio. It's not surprising that hedge funds mushroomed from $67 billion in 1990 to $500 billion at the end of 2000.[5]

Hedge funds are complicated vehicles that require detailed analyses before investment.

"One must be careful not to assume that absolute return investing will always produce positive returns with little or no market correlation. In fact, it seems that once every market cycle a liquidity-driven crisis has the effect of creating significant market directionality in these strategies" notes Sinsheimer. In addition, the use of leverage, which is itself a source of risk, can create unrelated business income that can jeopardize the tax-exempt status of a foundation unless the hedge fund is located offshore. No foundation should consider this asset class without close investigation and a complete understanding of the potential returns, the correlation of those returns with other asset classes in the portfolio, and the risks.

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[3] Swenson, David F., *Pioneering Portfolio Management: An Unconventional Approach*, The Free Press, 1999, p.3.

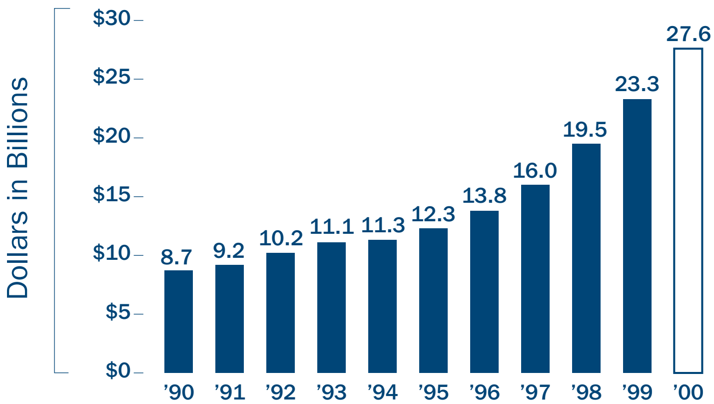
[4] Scognamiglio, Vincent, "Endowments: Alternatives Are A-Okay," March 19, 2001, www.fundfire.com.

[5] Beeman, David; Yip, Kenneth; Weinreich, Joshua; Russell, Craig; Barr, Dean, "Evolution of an Essential Asset Class — Absolute Return Strategies," *The Journal of Investing*, Winter, 2000, pp. 9-24.

Foundation Giving Keeps Growing

FIGURE 1

Foundation giving grew by an estimated $4.3 billion in 2000*

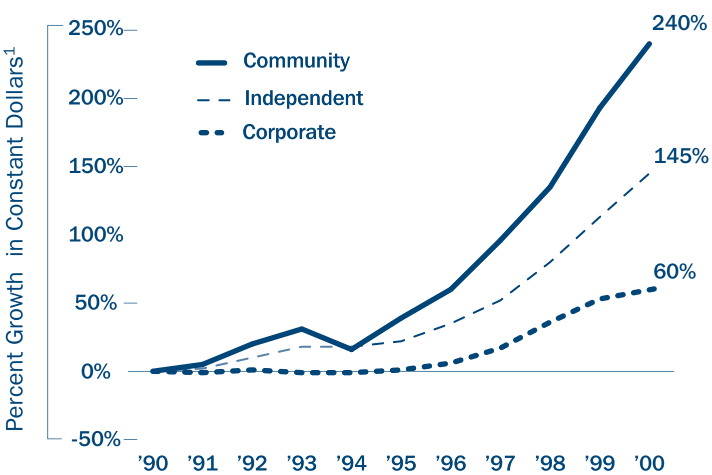


Source: *Foundation Growth and Giving Estimates*, 2001.
*Figures estimated for 2000. All figures based on unadjusted dollars.

Community Foundations Grow Fastest

FIGURE 2

After inflation, community foundations reported strongest cumulative growth in giving since 1990*



Source: *Foundation Growth and Giving Estimates*, 2001.
*Figures estimated for 2000.

[1]Percent change in constant 1990 dollars based on annual average Consumer Price Index, all urban consumers, U.S. Department of Labor Bureau of Labor Statistics, as of January 2001.

Spending in Good Times and Bad

In today's uncertain economy, what is the outlook for foundations and their grant-making? Surprisingly good, some experts say. Research by the Center on Philanthropy at Indiana University shows that over the past 40 years, philanthropy has grown at an average annual rate of 7.6%, while during recessions, it has grown at a slower rate of about 5%. However, in the years following crisis events, such as the assassination of President Kennedy or the Persian Gulf War, charitable giving has tended to grow at a faster rate than average.

A separate poll conducted after the September 11 terrorist attacks found that half (52%) of America's largest givers say an economic slowdown will have virtually no impact on their giving.

In recent years, foundations' grant-making has grown at a rapid clip. The Foundation Center reported that in 2000, more than 50,000 large and mid-sized foundations it tracks increased grants by 18.4%, to $27.6 billion, following a 19.9% rise during the roaring bull market year of 1999. While growth in grants was more moderate for small and mid-sized foundations, grants overall have doubled since 1996 — outpacing the growth in all other sources of private giving (See Figure 1).

In 1999 and 2000, The Foundation Center reports, independent foundations increased their giving by nearly 45%, making them the largest source of foundation grants overall.

Community foundation giving rose an estimated 21.5% in 2000, growing by a record $396.8 million to $2.2 billion. Community foundations have reported the fastest growth in giving every year since 1995, and their giving has nearly tripled in that time (See Figure 2).

[6] American Association of Fundraising Counsel, press release September 27, 2001.

[7] Independent Sector (a nonprofit coalition of foundations and corporate philanthropy programs), press release October 23, 2001.

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Conclusion

Prudent Investor Acts require trustees and boards to take into account today's and tomorrow's market realities. They permit fiduciaries to use common sense rather than feeling hamstrung by old laws that were out-of-touch with today's investment processes. In addition, the language of the trust instrument or other foundation organizational documents are typically very broad in allowing fiduciaries to make investment decisions and diversify assets. Under the Prudent Investor Acts, delegation is also encouraged if a fiduciary does not have sufficient investment expertise. However the fiduciary must use appropriate care in choosing an asset allocator, an investment manager, as well as in setting the terms of the delegation and monitoring their actions. Whether acting alone or by delegation, fiduciaries must pay attention to diversification and to risk/reward analysis.

Foundations today face volatile markets and investment choices limited only by the imagination of man. Like all investors, foundations must therefore carefully construct investment policies that include guidelines for future spending and investment. They must also choose at least some board members and advisors who thoroughly understand the dynamics of prudent decision making — including the principles of modern finance and the best methods to achieve total net return and minimize risk.

No one solution will fit every foundation's needs. Investment policies must take into account the foundation's purpose, its current asset mix, its future grant-making plans, and its plans to leave a large enough legacy for future generations. Thanks to the Uniform Prudent Investor Act, foundations' need for investment know-how has never been stronger. New assets and asset classes, the uncertain future of securities markets and the boom in new foundations have created a tremendous need for sound investment advice. Many foundations are created with little more than an initial endowment and good intentions. The ones that survive, most likely, will be those who pay careful attention to investment policy — and who implement the well considered plans they make.

For further information:

The Foundation Center: fdncenter.org

The Council on Foundations: cof.org

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