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Creating an investment policy:

Best practices for nonprofit organizations

Philanthropic Advisory

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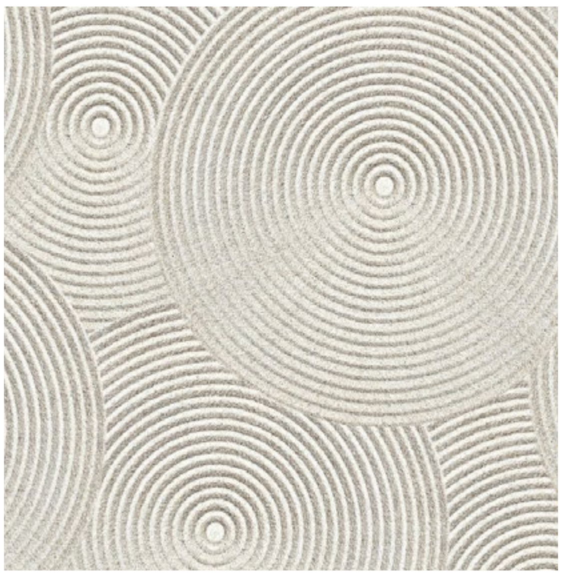

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The importance of spelling out investment policies

As their name implies, nonprofit organizations are businesses whose primary goal is operating for a collective, public or social benefit, rather than generating profits for their owners. However, this is not to say that nonprofits should not strive for financial gain or operate on shoestring budgets. In fact, the opposite is true. Financially healthy and sustainable nonprofits make every effort to build resources that can be reinvested back into their programs and operations.

Endowments of nonprofits can play a critical role in providing such resources. Unlike conventional corporate investment, every dollar held, managed and invested by a nonprofit is raised for a specific objective from donors and benefactors who share the values of the organization's stated mission. What is more, investments for nonprofits are typically made under the assumption that the organization will exist in perpetuity and thus requires planning over a longer horizon.

At the same time, situational short-term capital needs, future financing and/or financial flexibility may also place restrictions on the investment of endowment assets. The very nature of such an undertaking carries a special obligation. The fiduciary duty to protect investment assets and ensure that the nonprofit's operations and activities use the investment capital to further its mission rests with the organization's governing body.

Assets such as equities, bonds, private equity, venture capital and real estate are popular holdings for nonprofits. However, any investment – and the approach adopted by those charged with the governance of a nonprofit – carries a certain amount of risk. We believe that the approach to asset holding, investment objectives, time horizon, liquidity needs and the nonprofit's risk tolerance need to be developed and set out in a formalized investment policy statement (IPS).

Best practices for creating an IPS could prove essential and are the subject of this white paper. The IPS can serve to document a nonprofit's compliance with legal requirements of endowment asset management, if any. Since it provides the guidance and policy for prudent investment asset management, it helps to provide a safeguard against second guessing the decisions of those charged with the fiduciary responsibility of the asset management. Of course, no two nonprofits are the same or should have the same investment policy. But this paper is our attempt to give some general guidance to assist you with writing or updating an IPS suitable for your organization.

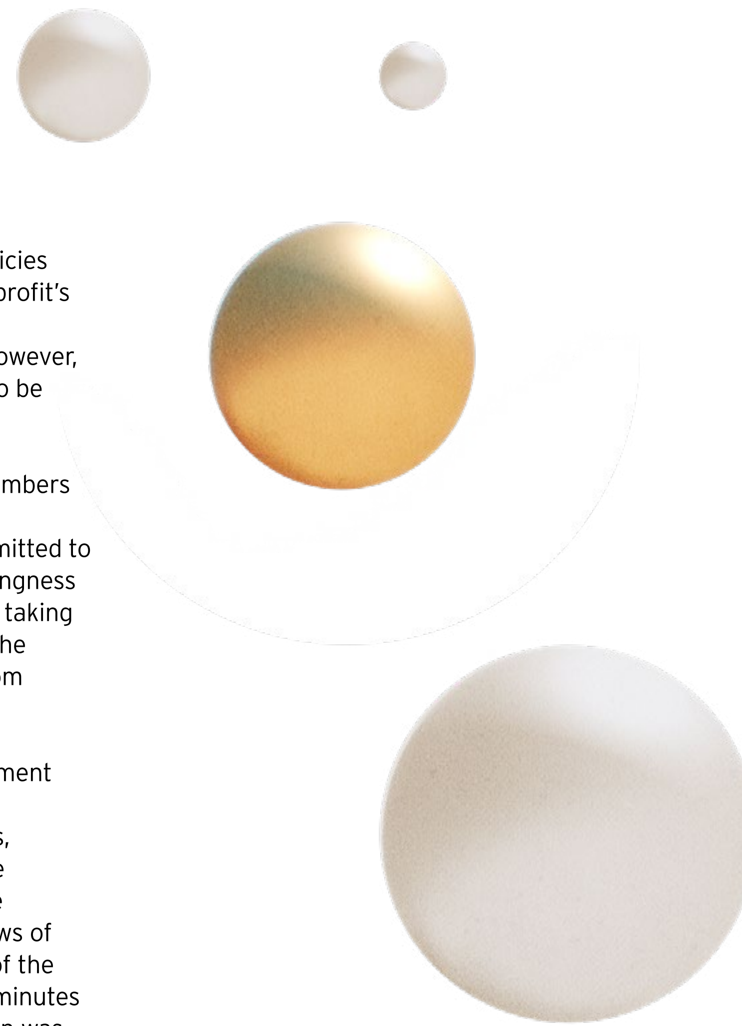
Role of the governing body

While every country's legal requirements differ, the roles of a nonprofit's governing body members are typically bound by a fiduciary duty. This principle essentially stipulates that those members are in a position of trust.

The terms "trustee" and "board member" are in some countries used interchangeably to describe someone in a position of governance. In other countries, these terms have slightly different meanings and involve differing degrees of service and accountability. That accountability extends to the prudent management of the nonprofit's endowment assets. Each region varies and some have enacted specific guidelines that outline not only the roles and responsibilities of those charged with governance but also considerations as to how endowment assets should be managed.

In this paper, the term "board member" refers to directors or trustees of a nonprofit's governing body, with the understanding that there may be legal distinctions between those positions. The board should make itself familiar and act in accordance with any regional or local investment management requirements as well as the fiduciary standard to which it will be held accountable. At a minimum, the board should act in good faith and with the care that a prudent person in a similar position would exercise under comparable circumstances.

Role of the investment committee



While the board cannot delegate its fiduciary responsibility for the management of the endowment assets, it may, if the nonprofit's governing documents allow, delegate the day-to-day management of those investments to an investment committee (IC). Depending on the nonprofit's size and the value, types and complexity of the investments comprising the endowment assets, an IC can help support the board in its fiduciary role.

However, for many nonprofits an IC is not warranted. Formation of an IC could ultimately add a layer of governance that would be burdensome and unnecessary. Each nonprofit has its own culture in terms of formality and rigor. It is ultimately the board's decision as to whether an IC fits within their culture and adds value in addition to the board. The IC is charged with the implementation of the investment framework and governance of the board, reporting directly to the board.

The board typically appoints an IC chairperson, in many instances a board member with investment management expertise. The remaining IC members can either be selected by the board or by the chairperson, subject to the approval of the board. IC members should be bound to the same conflicts of interest and code of ethics policies as board members. For this reason, a nonprofit's governing documents typically require IC members to be board members as well. However, many nonprofits allow their IC members to be non-board members.

Typically, an IC comprises three to five members with investments expertise and diverse backgrounds. IC members should be committed to the organization in terms of time and willingness to serve. They should also be comfortable taking on a sufficiently high level of risk to gain the potential investment return advantage from exposure over a longer horizon.

The number of IC members, their appointment method, length of service, reappointment terms, quorum required to ratify decisions, and compensation, if applicable, should be memorialized. This can be done within the governing documents, such as in the bylaws of the nonprofit as it relates to committees of the board; within an IC charter; or within the minutes of the meeting of the board in which action was approved to form the IC. There should also be a mechanism in place to allow for investment decisions to be made between meetings.

Responsibilities of the investment committee

The responsibilities of the IC can be articulated in an IC charter or within the IPS. The board should approve the initial IC charter and IPS as well as any changes to either. The primary mandate of the IC is to advise the board on the governance and operational investment framework for the endowment assets. If the board determines that an IC is not warranted for their nonprofit, they assume the responsibilities typically delegated to an IC. These include:

- Securing the annual approval of the IPS by the board - the IC typically makes the recommendation for the approval to the board based upon their collective approval of the IPS
- Determining whether the investment management role is filled by an internal chief investment officer (CIO) or an outsourced chief investment officer (OCIO)
    - Typically, an internal CIO is hired by the chief financial officer with input from the IC/board
    - An OCIO is typically selected by the IC with board approval or, in the absence of an IC, by the board
- Annually evaluating and delegating management and operational authority of the investments to the CIO/OCIO
- Approving the selection of investment managers, investment funds, custodians or other related professionals or authorizing the CIO to appoint those professionals with approval of the IC/board
- Reviewing and monitoring the performance of the investments in relation to the IPS objectives
- Monitoring the investments asset allocation
- Providing a request for proposal (RFP) for an investment advisor issued by the management at least once every five years; evaluating the RFP responses and engaging a new or incumbent investment advisor; and, at least annually, reviewing the investment advisor's performance and determining whether their contract should be renewed, terminated or lapsed without renewal

Meetings and reporting

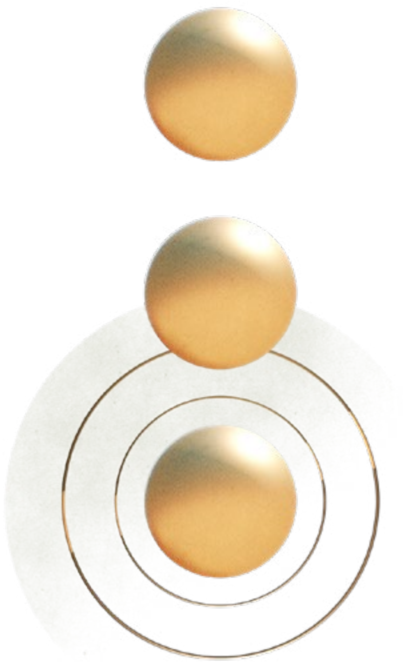
The IC should generally meet at least four times yearly at the chairperson's request. In the absence of an IC, the investments discussion should be included on the agenda for the regularly scheduled board meetings. It is always a good idea to set the meeting dates well in advance to ensure maximum participation. The materials to be reviewed should also be circulated well in advance to allow participants sufficient time for review.

Typically, the chairperson and CIO/OCIO set the meeting agenda, which should include a detailed investment review, actions to be implemented and future issues to be addressed. Meeting minutes should be prepared and include any IC decisions, as well as any decisions to be ratified by the board. These minutes should be approved at the next meeting and retained.

The CIO/OCIO should prepare and submit written reports that form the basis for the discussion of IC meetings. At a minimum, the reports should include investment information relating to performance as compared to the established benchmarks and the asset allocation as compared to that stipulated in the IPS. This can be further delineated by investment type, sector and portfolio manager with relevant information shown quarter to date, year to date, 3- or 5-year rolling and inception to date with comparisons to prior periods.

The fourth quarter or annual report should also address any proposed changes to the IPS or governance framework and a review of the investment professionals managing the investments. This in turn provides the basis for the IC's annual presentation to the board, which should also address key actions taken by the IC and any compensation of IC members.

Composing a robust investment policy statement



A robust IPS sets out the guiding principles for managing assets in line with the nonprofit's goals and objectives. Policies that are documented, reviewed and updated on a periodic basis tend to be more effective and easier to administer. An IPS is an internal governance document approved by the board. As such, it is not a legally binding document with the nonprofit's investment manager, custodian, bank provider or other service provider. Separate agreements with such service providers will govern the relationship between the nonprofit and the service provider. It is incumbent upon the IC/board to ensure those separate agreements are consistent with the IPS.

The components of the IPS provide the framework for helping the IC/board manage the nonprofit's resources efficaciously, make risk-weighted investment decisions and demonstrate that governance responsibilities are being met.

Holistically speaking, an IPS could be for everyone involved with the nonprofit including, but not limited to, the board, IC, employees, investment advisors, managers, beneficiaries and donors. It is intended to provide transparent guidance on the philosophy and attitude that will guide the investment management toward the desired results. It should be sufficiently specific to be meaningful, yet flexible enough to be practical.

Broad concepts for an IPS include administrative components, investment portfolio construction and review, and spending policy.

I. ADMINISTRATIVE COMPONENTS

As a starter, the IPS should give some context about the nonprofit. This might include its corporate structure, mission and regulatory compliance that will be fulfilled through the adoption of the IPS.

Scope: It is important to articulate the assets the IPS is to cover and those it will not. For example, for US private foundations, program-related investments that satisfy the minimum payout requirement are typically outside the scope of the IPS, as are employee benefit plans and general operating accounts.

Purpose: Practically speaking, this is the table of contents of what will be covered in the IPS. It sets forth the assignment of the responsibilities of all parties involved, establishing a clear understanding of the investment goals and objectives covered under the scope of the IPS, establishing a basis to evaluating the investment results, articulating the compliance with any investment regulatory requirements that the IPS will cover, and establishing a relevant investment time horizon.

Delegation of authority: Outlining all parties' authority provides clarity and helps to inform the responsibilities of each party to the investment management process. This includes internal parties such as the board, IC and senior management of the nonprofit, as well as external parties, such as investment advisors, investment managers, consultants and custodians.

For a discretionary investment management mandate, authority for the day-to-day investment operations is delegated to the OCIO or investment advisor, who in turn oversees the investment managers. Certain responsibilities can also be delegated; for example, if the authority to rebalance the portfolio is delegated to the investment advisor, this should be articulated within this section and the assignment of responsibility noted accordingly.

Assignment of responsibility: Since each party has differing roles and authority in the investment management process, their responsibilities will differ as well. For example, in discretionary investment management relationships, investment advisors are responsible for selecting investment managers and monitor their performance. Similarly, the investment managers are responsible for buying, selling or holding individual securities in line with their stated investment methodology and style. Responsibilities should also be specific as to number of meetings and should require external parties to disclose any conflicts of interest.

Investment principles: The factors taken into account in the management of the investments may be defined based on regulatory requirements. If not, typical investment principles include consideration of general economic conditions, effects of inflation or deflation, tax consequences of decisions and strategies, and diversification.

Investment management policy: Investment management policy sets forth how the investment program will meet the needs of the organization. The investment objectives, both primary and secondary, reflect how the investments will be managed to achieve those objective(s). Risk tolerance and investment time horizon are integral components of how assets are invested. For example, the primary goal may be growth, capital preservation or income generation, and this section ties together those objectives with the risk tolerance, time horizon and use of investment managers to manage portfolios within the guidelines of their investment discipline.

Social responsibility: This details whether endowment assets are to be managed according to environmental, social and governance (ESG) principles. Once regarded as a niche area, ESG investing is now regarded as mainstream. A sustainable investment approach can also help refocus portfolio performance from pure risk-adjusted returns to a combination of risk-adjusted return and measurable social and environmental impact.

Total investment portfolio objectives: A portfolio's overall goals are not meant to be imposed on each investment manager, asset class or investment account, but rather to reflect the aggregate. This section provides the details for the objectives and can be combined with the investment management policy section above. For example, if the goal is growth, objectives may include the investment portfolio return exceeding the rate of inflation as measured by the Consumer Price Index, net of the organizations spending policy. It may also include achieving a return above certain composite benchmarks.

Investment manager goals and objectives: Typically assessed over the investment time horizon, investment managers may have goals to match or exceed the performance of a specific market index or a blended market index. The level of risk should be consistent with their methodology.

Allocation policy and liquidity: The proceeds of the investment portfolio should generate sufficient income to sustain the activities of the nonprofit and may be allocated for operating needs or reinvested back into the portfolio. Since the investment portfolio is typically considered longer term in nature, it should therefore be fully invested while generating sufficient liquidity for the nonprofit to meet its operating requirements. Liquidity needs should be communicated to external investment advisors and investment managers.

II. INVESTMENT PORTFOLIO CONSTRUCT AND REVIEW

Marketability of assets (excluding alternative investments): Typically, the IC/board will require that liquid assets comprise securities that can be liquidated quickly with minimal impact on market price. This includes cash and equivalents, mutual funds, exchanged traded funds and separately managed accounts.

Alternative investments: This section codifies which types of alternative investments, if any, the IC/board may consider for diversifying the investment portfolio and improving its overall performance. Investments such as hedge funds, private equity and real estate should be defined in this section.

Prohibited investments: This section becomes particularly important when the goal of the investment portfolio is aligned to the mission of the nonprofit and environmental, social, and governance principles are applied. For example, filters may be applied to ensure that no investments are made in companies involved with tobacco or firearms. Prohibited investments should be clearly stated and communicated to investment advisors and investment managers.

Policy portfolio: The policy portfolio designates the percentage of the portfolio that is intended to be devoted to each asset class (e.g., cash, fixed income, equity, alternative assets) and should reflect one in which volatility, worst market declines and other risk considerations would be appropriate for the organization. It reflects the organization's view of a long-term allocation of capital across a variety of asset classes and sets forth the risk constraints for the actual portfolio. It provides the minimum and maximum range for each asset class that should not be exceeded by the actual portfolio.

Rebalancing policy: The portfolio should be rebalanced when any asset class is outside the minimum or maximum policy allocation. Rebalancing restructures the portfolio back within the target asset allocation ranges. Typically, in a discretionary investment arrangement, the investment advisor will rebalance the portfolio as necessary without the approval of the IC/board. This is generally communicated to the IC/board during the quarterly meetings.

Risk management: While there is inherent risk in all investment styles, this section articulates the understanding of the risk necessary to produce the desired investment results. It further provides that all parties associated with managing the portfolio will make reasonable efforts to control risk and ensure that risk taken is commensurate with the given investment objections. Things to consider include:

- Liquidity risk: Ensuring the organization can access money whenever it is needed and that adequate capital is available at short notice if needed
- Capital volatility: What is the organization's comfort level with any market fluctuations in the value of its assets? What are the plans for coping with inflation, interest rates and foreign exchange effects?
- Credit ratings risk: Will it be the organization's policy to only deposit monies with an institution with a pre-determined level of credit rating (e.g., AAA) or will there be flexibility?
- Counterparty risk: Mitigation and coping mechanism if another party involved in the nonprofit's transaction does not meet its obligations (e.g., failure of a brokerage firm)
- Diversification or concentration: Will the nonprofit's investment be focused on specific asset classes, regions or markets or will the investments be spread across a range of asset classes and regions?

Benchmark portfolio: The benchmark portfolio sets forth the asset classes whose index returns serve as the basis for the performance of the portfolio. This includes a portfolio of securities representing a designated market segment or index (e.g., S&P500, MSCI All Country World Index, FTSE100, Barclays Capital US Aggregate Bond Index) or specific asset classes like small-cap growth stocks, high-yield bonds and emerging markets exposure to name a few. Alternative assets are typically measured on an internal rate of return over the life of such investments, due to their long lives and illiquidity.

Investment manager guidelines: Investment managers are typically selected to manage a specific asset class of the investment portfolio and this concept can be articulated in this section, along with the indication that they are managing a specific asset class within the risk and return characteristics deemed appropriate for the asset class.

Investment review and evaluation: This section provides the evaluation criteria for the investment portfolio, as well as for the investment advisor and investment manager. Typically, a comparison of net absolute returns to the policy goals is performed quarterly, as are the relative returns. These are time-weighted to a composite benchmark formed of indexes in a similar asset allocation to the portfolio asset classes, and investment manager returns compared to the appropriate passive benchmarks.

Investment advisors are typically evaluated by the IC/board on a variety of criteria. These can include returns versus blended benchmarks, risk management, fees, reporting and services. Investment managers are evaluated by the investment advisor and are measured against selected performance benchmarks including standard deviation, beta, information ratio, etc. over a rolling period basis, as well as on personnel, strategy, research capabilities, organizational and business matters that may impact their ability to achieve the desired results.

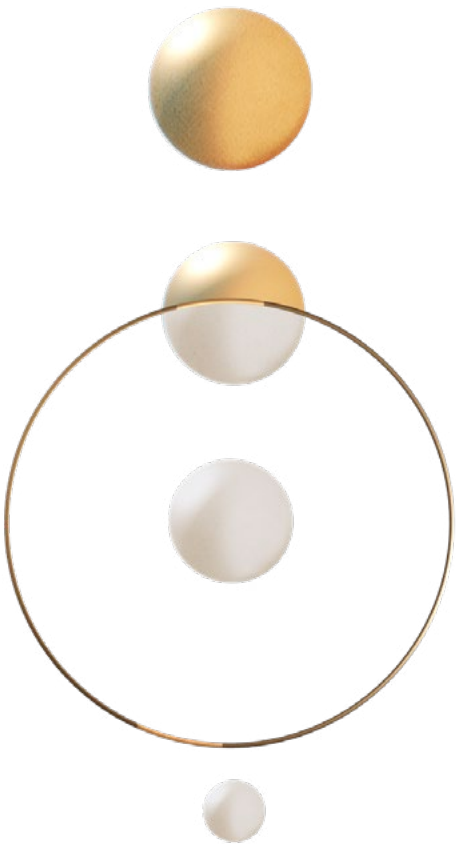
Management costs, fees and professional compensation: The IC/board have a fiduciary responsibility to understand and account for the costs in management of the investment portfolio. It is important for the IC/board to recognize where the allocation of management costs best affects the ability of the investment portfolio to obtain superior risk-adjusted performance and increase the probability of achieving the investment goals and objectives. This section can outline that understanding, as well as stating that the costs should be reasonable, that there should be no conflicts of interest and that resources should be prudently allocated.

III. SPENDING POLICY

Not all nonprofit organizations have a spending policy. However, for those that do, the text of the spending policy or reference thereto should be included in the IPS. The spending policy is typically set annually by the board as a fixed percentage of income from the endowment to be used to fund the nonprofit operations, whether administrative or programmatic. The rationale for a spending policy is to provide a consistent, predetermined amount for prudent use of the nonprofit's endowment.

It also allows the board to design an investment strategy that is more progressive, with a higher expected return than might be the case if spending were determined by annual investment performance. With the annual determination method, there is a tendency to pay out the excess earnings during periods of overperformance, while maintaining a certain absolute dollar floor of spending during periods of underperformance. Over the long term, this may result in an erosion of real principal. By smoothing the spending, therefore, the fund reduces the likelihood of real principal erosion due to portfolio volatility.

An IPS in your investment journey



A detailed IPS could serve an important first step on your investment journey or establish ongoing investment pathways. It will also serve as a guiding factor for your investment and risk managers. While there is much to consider when drafting or updating an IPS, it is important to keep in mind that each nonprofit has its own culture and will therefore have an individualized IPS. We hope the guidance outlined in this paper assists your efforts to draft a governing document that sets the governance and operational framework for effective management of the endowment assets.

The board is ultimately responsible for everything that the nonprofit does, and this extends to its investments. Therefore, the final section of the IPS – the investment policy review – stipulates that the IC/board will review the IPS annually, that any changes or policy amendments must be approved by the board, and the date on which the IPS has been approved by the board. A signature block for a board member to signify approval can complete the IPS.

About the author

Karen Kardos is the Head of Philanthropic Advisory and a Director at Citi Private Bank. She advises families, foundations and endowments on philanthropic strategic development and best practices to meet their philanthropic goals.

Prior to joining Citi, Karen spent 17 years with Geller & Co., and since 2007, served as the Director of Finance and Philanthropic Operations for a private foundation in their multifamily office practice. Her experience includes advising clients on their philanthropic giving strategies. She is also well versed in private foundation finance, operations, grants management, governance and compliance. She has extensive experience working with ultra-high net worth individuals on their personal charitable giving, charitable giving through donor advised funds, and political giving.

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