Long ago I served as founder and executive director of an inner-city educational opportunity program. One night while passionately encouraging a group of working-class parents to enroll their children in our program, I was confronted by a fine example of nonprofit truth telling.

A parent approached me and in no uncertain terms told me how frustrated she was having well-intentioned folks (like me) come through the neighborhood promising the world or at least a better position in it. Looking me square in the eye, she asked: “How do we know you’ll still be around in three years? Why should we trust you with our kids? What if you can’t really deliver on what you’re promising?”

I was humbled and yet encouraged. Her questions were right on, refreshing and deserving of only the most candid response.

Sometimes people mistakenly assume that to work with the nonprofit world requires a soft touch, a conciliatory approach, and tolerance of inefficient use of time and money. How wrong they are. If anything, those who—with few resources—are directly involved in addressing the world’s greatest social, environmental, and spiritual challenges must be the most direct, resolute, and efficient.

For investment advisers, there are certain truths that we need to be willing to tell the nonprofit officers with whom we work. Seven of these truths are explored below. If we are clear about these understandings, we can be of great service to those who have taken on serious fiduciary responsibility.

Truth #1: You Are Not Conservative

Countless investment policy statements and casual comments by investment officers speak to the allegedly “conservative” nature of being an officer for a nonprofit organization. Apparently, some such officers feel they are being better fiduciaries by presenting themselves as “conservative” when helping the organization make investment decisions.

However, consider table 1, which shows the annual liabilities against the corpus of typical endowments and foundations, which represent large components of the nonprofit sector.

In this economic environment, total liabilities of 6–12 percent per year would compel almost all nonprofit organizations with long-term time horizons to take on more volatility than what would be indicated by “conservative.”

There is an unfortunate by-product of this well-intentioned “conservative” mislabeling: Many foundations and endowments are inadvertently positioned to spend down their corpus in real terms. They have done this by having total liabilities that exceed the target return of the asset allocation they selected when they were striving to be “conservative.”

For example, based on the average foundation portfolio asset allocation (Association of Small Foundations, 2006) many founda-

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**TABLE 1 Annual Endowment and Foundation Liabilities**

<table>
<thead>
<tr>
<th>LIABILITY</th>
<th>ANNUAL TARGET</th>
<th>COMMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spending Policy</td>
<td>3–5%</td>
<td>Covers most required and voluntary spending policies. Smaller foundations tend to spend a higher percentage than required by the IRS.*</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>0–1%</td>
<td>Forward-looking estimate (current). PROJECTED inflation is higher for healthcare and education-related institutions.</td>
</tr>
<tr>
<td>Inflation</td>
<td>2–3%</td>
<td>Forward-looking estimate (current). PROJECTED inflation is higher for healthcare and education-related institutions.</td>
</tr>
<tr>
<td>Annual real growth</td>
<td>1–3%</td>
<td>Be aware of the required spending for any given organization based on legal or other directives.</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>6–12%</td>
<td>Be aware of the required spending for any given organization based on legal or other directives.</td>
</tr>
</tbody>
</table>

tions have a 50-percent likelihood of earning approximately 7.18 percent a year over the next 7–10 years, based on UBS’s current forward-looking asset class risk/return assumptions. This is well below what a typical private foundation requires to last into perpetuity and maintain its real spending power.

The same survey indicates that more than 90 percent of private foundations are concerned with perpetuity. Thus, their investment strategy in practice is set for spending down when their objectives clearly state an intention to keep pace with (or exceed) inflation and last into perpetuity.

If an organization requires an annual total return of 8 percent, then it cannot behave as a truly conservative investor would by investing in the “riskless” Treasury bill. At the very least it must consider diversifying into small-cap and international equities, assess nontraditional fixed income strategies, and perhaps include other “alternative” asset classes as appropriate.

The challenge to investment advisers is to help these clients recognize the following two essential points related to defining their risk tolerance:

1. To reach its objectives, the typical private foundation requires to last into perpetuity and maintain its real spending power.
2. Instead of describing themselves as “conservative,” the officers need to see themselves first and foremost as fiduciaries charged to act with the care, skill, prudence, and diligence commensurate with their responsibilities. If a conservative investment strategy comes out of that fiduciary process, so be it. Most often, it will not.

If officers accept the precepts of the first truth, then several traditional notions about endowment management fall apart, starting with the old standby about blue chip stocks and Treasury notes.

### Truth #2: 60/40 Won’t Cut It
For many years, endowments and foundations that allocated 60 percent to U.S. large-cap equity and 40 percent to U.S. investment grade bonds could do quite well, earning well above their required spending without having to make astute asset allocation or investment decisions. Even those endowments that were not keeping pace with the higher inflation of the early 1980s felt the psychological benefit of rising assets.

But the economic environment has changed, and it’s having a dramatic impact on nonprofit organizations that adhere to their “old” asset allocation models. With many investment advisers projecting forward-looking equity returns in the 6–8 percent range and fixed income returns in the 4–6 percent range, a 60/40 blend is projected to earn endowments just 5.2–7.2 percent per year, before fees.

If one agrees with this analysis, then it profoundly influences discussions about passive vs. active investing (i.e., from where will the required excess return come?), inclusion of less-traditional asset classes (i.e., are you willing to utilize high-yield, long/short, emerging markets, private equity, etc.), and the role of risk in the portfolio (i.e., how much risk are you willing to take to potentially offset your liabilities?).

But we know that investing is not just about the rationality of numbers (even forward-looking ones). More often than not, the challenges facing endowments tie to matters of investor psychology.

### Truth #3: No, It Is Not Your Money (Anymore)
Occasionally a key decision maker for an endowment forgets that the monies do not belong to him or her personally. Sometimes it is the patriarch or matriarch who funded the family foundation. Other times it is the rich alumnus who built the new dorm. Then there is the well-meaning philanthropist who made a fortune in business, sits on multiple boards, and is accustomed to getting his or her way.

This situation becomes a problem when the trustee decides that he or she does not need to follow investment policy statement guidelines or commonly accepted fiduciary best practices. He allocates foundation money to his son’s friend without researching the investment track record, expertise, or compliance history. He sends money off for a private investment that fails to account for the liquidity or transparency requirements of the foundation. Or she decides that she is one of the finest stock pickers available.

### TABLE 2 60% Large-Cap U.S. Equity (S&P 500) and 40% Investment Grade Bonds (LBIGC)*

<table>
<thead>
<tr>
<th></th>
<th>DECEMBER 1979 TO DECEMBER 1999</th>
<th>DECEMBER 2003 TO DECEMBER 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annualized Return</td>
<td>14.82</td>
<td>7.43</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>9.88</td>
<td>4.32</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.78</td>
<td>0.98</td>
</tr>
<tr>
<td>Down Quarters (% of whole)</td>
<td>16.0 (20%)</td>
<td>4.0 (33%)</td>
</tr>
<tr>
<td>Up Quarters (% of whole)</td>
<td>64.0 (80%)</td>
<td>8.0 (67%)</td>
</tr>
</tbody>
</table>

Source: PSN database

* Assuming a 50-percent allocation to S&P 500 and 40-percent allocation to Lehman Brothers Intermediate Government/Credit Bond Index, rebalanced quarterly.
The Voice of the Investment Management Consultants Association

>> "ADVISING NONPROFITS" CONTINUED

Many nonprofits depend on volunteer efforts, particularly with their investment committee members. And precisely because volunteers often are engaged in many activities, it can be hard to organize and focus their efforts. I recall one large foundation that kept 25 percent of its equity portfolio in cash through the 2003 equity recovery primarily because the very busy investment committee members over several quarters could not arrange a meeting to pick a new money manager.

Many nonprofit organizations face constant financial and programmatic pressure, which makes it hard to focus on long-term investment decisions. For example, a nonprofit organization might be so concerned about meeting current cash flow needs that it cannot attend to the basics of stewarding its long-term funds. It is not uncommon for nonprofit organizations to face periods of crisis; sometimes in such cases the adviser’s primary challenge is to help the otherwise distracted officers keep their focus on long-term strategy.

Thus the proactive investment adviser needs to help the nonprofit officers keep their collective eye on the ball with regard to investments. The investment adviser never should mimic an organization’s less-disciplined approach; if anything, the investment adviser should counterbalance it with a focused, organized structure.

For example, it may be up to the investment adviser to do the following:

• Initiate scheduling the investment committee or board meeting
• Forward the quarterly report even if it has not been requested
• Conduct the risk analysis
• Provide the feedback on allocation and other policy decisions
• Raise the tough spending-policy questions

At times the investment adviser may need to quantify the opportunity cost for failing to make a decision as well and put it in language that the organization can understand. For instance, it can be helpful to say something like, “By being out of sync with your target allocation, the organization has lost approximately $1 million on the table. Would you ever turn away a $1-million donor? Of course not. So let’s make time to get this rebalancing done.”

Truth #4: You Need to Care as if It Were Your Money

As frustrating as it can be to work with decision makers who treat nonprofit monies as their own, it can be all the more difficult to work with nonprofit officers who are inattentive.

Many nonprofits depend on volunteer efforts, particularly with their investment committee members. And precisely because volunteers often are engaged in many activities, it can be hard to organize and focus their efforts. I recall one large foundation that kept 25 percent of its equity portfolio in cash through the 2003 equity recovery primarily because the very busy investment committee members over several quarters could not arrange a meeting to pick a new money manager.

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Truth #5: You Are Experiencing a ‘Tragedy of the Commons’

In environmental and social terms, the “tragedy of the commons” refers to commonly held property or other resources that are neglected or abused because they are not owned by any specific party (Commoner 1971). Without a clear trail of accountability, the concept holds, it is easy and perhaps natural that no one would take personal risk to protect or serve a common resource such as a field for grazing or a pond for watering animals.

Now apply this concept to nonprofit investment management: Consider a pool of money that does not (usually) provide a clear personal benefit to the volunteers, officers, and staff stewarding the money. Consider the pressures of time, energy, and attention. Now add the personal considerations such as politics, relationships, family dynamics, conflict, and potential conflicts of interest. Consider how difficult it can be for a paid staff person to compel an influential board member (who also is his or her boss) to act more quickly or in a new direction.

Essentially, it can seem much easier for the organization to not make a decision than it would be to make any changes. Sure, the investment pool may suffer, but with no one’s personal wealth, employment, or reputation truly at stake it can be easy to let matters slide. As with any business assessing its risk, it may feel like there is more liability attached to action (errors of commission) than to lack of action (errors of omission).

The investment adviser can address this inertia simply by identifying it and pointing out the observation. For example, it is fair for an investment adviser to say: “I know that some of you are passionate about indexing, while others are advocates for active management. We have been having the discussion for six months while the funds sit in cash awaiting investment. I’m concerned that we are stuck and feel strongly that you need to make a decision before we leave this meeting.”

It is one thing for the volunteer committee to have a hard time making an asset allocation or money manager decision; it is inexcusable, however, when the (often well-compensated) investment adviser fails to proactively guide the organization toward taking action.
Truth #6: Hire Advisers Who Tell You What You Need to Know, Not What You Want to Hear

Sometimes the most important truths are those we must tell ourselves as investment advisers. First and foremost, we need to establish whether or not we really are advising. Are we proactively giving advice? Do we raise critical issues that the organization needs to consider but may not even know exist?

For example, have we had thoughtful discussions with organizations about the impact of a flat to inverted yield curve and low interest rates in general? Have we pushed them to consider how their social screens impact their potential returns or how their antipathy toward international markets may actually be increasing—rather than reducing—their risk?

A common reason for nonprofit organizations to seek new investment advisers is that their previous investment advisers simply did not give them advice. They did not receive education from their investment advisers on more-innovative investment strategies such as structured notes or private equity. They did not get suggestions about strategic asset allocation adjustments. The investment advisers waited to comment on underperforming managers until the endowment officers raised the question. The investment advisers failed to point out that asset allocations no longer were in line or appropriate.

As investment advisers, we often want to reassure our clients that they are properly positioned, that we have anticipated contingencies, and that everything is fine. It can be hard to tell an intelligent and influential board of directors that the allocation or manager we recommended two years ago no longer is suitable.

To effectively serve, we cannot be investment advisers who just tell institutional clients what they want to hear. We are bound to tell officers of these organizations what they need to know so that they can be good stewards.

Truth #7: Nonprofit Organizations Deserve the Best

The financial challenges faced by most nonprofit organizations are complex, intense, and sensitive to political, economic, and mission-driven pressures. The atmosphere around nonprofit finances often is highly charged because of the very personal nature of the mission and the passion of the people committed to that mission.

In reviewing the investment strategies of nonprofit organizations throughout the country, I have been shocked by how often nonprofit officers accept poor service, high fees, unresponsive counsel, inappropriate guidance, unsuitable investments, incomplete follow-through, inaccurate reporting, and poorly educated investment advisers. These deficits are experienced regardless of asset size, geographic location, fee structure, and strangely enough, even board sophistication.

Indeed, some of the most blatant examples of poor investment process I have witnessed have been with organizations that possess the most financially sophisticated investment committees. Bear in mind that many of the volunteer officers for these organizations have served or still serve in the business world as very successful professionals and leaders.

For some reason, many otherwise well-meaning volunteers take off their business hats when they are addressing nonprofit issues. They tolerate levels of service and expertise that are far below what common fiduciary standards would demand. Yet their business acumen often is an important part of why they were asked to serve the nonprofit in the first place. The investment adviser is in an excellent position to remind such volunteers of their expertise and the genuine need for their attentiveness.

In choosing to advise nonprofit organizations, the investment adviser takes responsibility for not only the traditional analytic investment functions but also for facilitating a consultative process that is honest, open, and effective. We cannot ignore the individual investor psychology and group dynamic that profoundly can impact our ability to effectively serve our clients.

Just as our industry has become ever-more attuned to behavioral investing for individuals and families, we investment advisers to nonprofit organizations must hone our ability to facilitate what essentially is group behavioral investing. Our investment experience is only of value if we can effectively communicate our insights in a manner that enables our institutional clients to make better decisions.

While raising difficult topics can be challenging, there is a special motivation to do so when advising nonprofit organizations. After all, our ability to effectively serve nonprofit organizations directly impacts the quality of life in our communities and around the world. Keeping the missions of these organizations in mind can make telling a difficult truth all the more satisfying.

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References
