U.S. TRUST
Bank of America Corporation

THE ENDOWMENT CHALLENGE

Supporting nonprofit missions with goals-based investment strategies

EXECUTIVE SUMMARY

The financial crisis of 2008 is nearly five years behind us, yet its impact on nonprofit organizations persists. The bull market that began in the early 1980s delivered historically strong returns for most long-term investment portfolios through 2008, but the factors that contributed to that performance may have run their course. Equity returns weakened over the past decade, and despite better results from bonds, overall portfolio returns have declined. Looking ahead, inflation is likely to remain low, but investment returns are also expected to be lower for the next few market cycles within more volatile markets. This will make it difficult for nonprofits to rebound from portfolio losses suffered in the 2008 downturn. Nonprofits face a "New Reality" of lower returns, higher volatility and increased scrutiny from boards and regulators.

In this paper, we will discuss the challenges and opportunities nonprofit organizations face in a changing market environment, including:

- Recovery from the 2008 downturn will be slow and long-term growth harder to come by. U.S. Trust's current forecast predicts lower returns for 11 of 13 asset classes over the next decade and a half.
- Maintaining liquidity for current spending is more costly than ever when short-term assets have negative after-inflation returns.
- Nonprofit boards have increasing fiduciary responsibilities. They are under more scrutiny than before — from government agencies, regulatory bodies and their own donors — and must be more effective in managing assets and setting spending policies.
- Nonprofit boards will need to evaluate investment strategies and spending policies together, aligning portfolio strategies with their current and future needs
- Success should be measured according to how well investment policies meet an organization's stated mission — not whether individual elements of a portfolio beat their benchmark. This goals-based approach is the key to success in the new environment.

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ADAPTING TO A LOWER-RETURN ENVIRONMENT

The secular bull market in both stocks and bonds that began in the early 1980s resulted in historically strong investment returns for most long-term investment portfolios leading up to the 2008 financial crisis. Bond returns in the U.S. were especially high during this period. The defeat of high inflation in the early 1980s, however, led to a significant decline in the real yield of U.S. Treasury bonds. This translated into lower interest rates and higher prices in most fixed income assets. These lower interest rates, along with aggressive fiscal policies, spurred economic growth. This in turn helped equity markets achieve new highs on a consistent basis through the end of the 1990s.

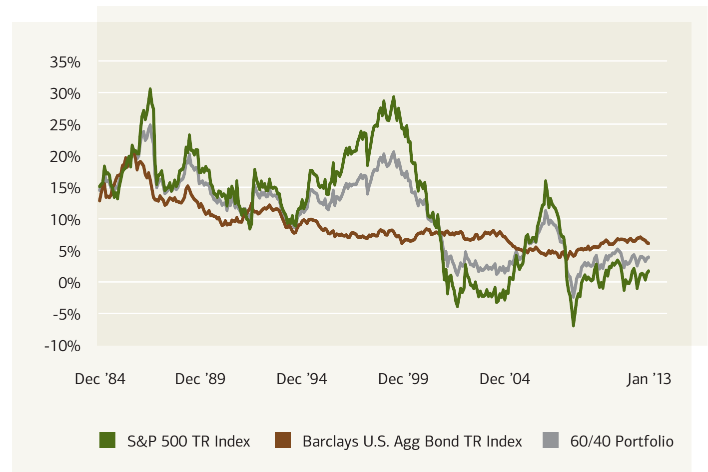
While equity returns weakened from 2000 to 2010, bond returns continued to maintain a higher level of total return relative to stocks and helped prop up the returns in balanced portfolios, as illustrated in Exhibit 1.

EXHIBIT 1

LOWER TOTAL RETURNS IN THE LAST DECADE

5-year rolling total return (annualized)

Dec '84 to Dec '12



Source: U.S. Trust, Morningstar EnCorr. As of April 2013.

*60/40 Portfolio assumes monthly rebalancing, reinvestment of all dividends, and no additional contributions or distributions.

Past performance is no guarantee of future results.

A SLOW RECOVERY SINCE 2008

The good news is that inflation has been low and is likely to remain so, which keeps the pressure of rising costs at bay for now. The bad news is that **investment returns are expected to be lower for the next few martket cycles as the global economy recovers more slowly than in past recessions.** Moreover, volatility in the capital markets is likely to continue. All this will make it difficult, if not impossible, for nonprofit investors to rebound from portfolio losses suffered in the 2008 downturn in the near term.

Because the 2008 crisis had a significant negative effect on overall returns, many nonprofits are still struggling to recover the value they lost in their investment portfolios. The reason for this is nonprofit investors must continue to maintain liquidity and make regular withdrawals to fund operations even when portfolio values are down.

For example, a typical nonprofit organization spending 5% per year and following a traditional investment strategy of 70% equities and 30% bonds/cash would have a portfolio that is still approximately 20% below 2008 levels. Consider that in 2008, the S&P 500 lost 37%. The average nonprofit portfolio lost approximately one quarter of its value in that year alone.

These losses were bad enough, but many organizations then made them worse through ill-advised liquidity management after 2008:

- Before the market downturn, many investment committees thought they had more liquidity in their portfolios than they actually had; others thought they needed less liquidity than turned out to be the case.
- When the market turned negative in 2008, some nonprofits had to borrow money to provide the cash flow they needed to meet their spending and capital commitments. A major university, for example, sold $2.5 billion in bonds to boost liquidity as a result of investment losses in its endowment.
- Subsequently, some committees overreacted by increasing cash holdings to cover two to three years of spending. Today, as a result, many portfolios continue to have too much liquidity. **Holding excess cash and other liquid investments has reduced returns and prevented many organizations from recovering lost portfolio value.** Indeed from 2008 to 2012, a 10% cash position would have cost the portfolio more than 100 basis points in return and a 15% position more than 150 basis points (Exhibit 2).

EXHIBIT 2

THE COST OF EXCESS LIQUIDITY

	10% CASH DRAG	15% CASH DRAG
DECEMBER ’08	-0.72%	-1.08%
DECEMBER ’09	-0.29%	-0.44%
DECEMBER ’10	-1.23%	-1.85%
DECEMBER ’11	-1.79%	-2.69%
DECEMBER ’12	-1.06%	-1.59%
AVERAGE	**-1.02%**	**-1.53%**

Source: U.S. Trust

These overly “safe” portfolios failed to benefit from significant market appreciation in 2009 and 2010, when stocks and bonds earned cumulative returns of over 45% and 15% respectively. This was an important time to make up ground for what was lost in the sudden downturn of 2008.

In fact, a simple 70/30 portfolio strategy that held its course during the period of 2008 to 2010 would have experienced a cumulative three-year return of about 4.75%. Investors who maintained an appropriate long-term strategy would have at least been on the way toward recovery by 2010. Unfortunately, many nonprofit organizations continue to maintain overly conservative portfolios that over time will impede the successful completion of their missions.

The impact of significantly **lower market values in nonprofit portfolios after the crisis has created a situation in which for the first time in years, perhaps decades, many organizations have begun to question whether they can continue to fulfill their mission.**

Additionally, as highlighted in the 2012 *Bank of America Study of High Net Worth Philanthropy,* developed in partnership with Indiana University, charitable giving by high net worth households in the U.S. saw a decline of nearly 7% from 2009 to 2011, largely attributable to the experiences of the financial crisis and concerns related to future economic uncertainty. This is a reversal from precrisis levels where many not for profits enjoyed steady increases in annual giving.

CONTINUING CHALLENGES FOR NONPROFITS

Market conditions have improved since the depths of the 2008 downturn, but nonprofits continue to face strong headwinds in low returns on stocks and bonds, below-inflation yields on cash and short-term securities, and continued volatility,

LOWER RETURNS ACROSS MOST ASSET CLASSES

To expect the high fixed income returns of the past 30 years to continue for the next 30 years would be unreasonable. Indeed, history suggests that recent experience is unusual and most likely unrepeatable. Once global growth improves, we expect interest rates to rise. This will have a negative effect on fixed income returns over time.

Further, while equities performed well during the better part of the past 30 years, the bursting of the tech bubble in 2000 and the 2008 financial crisis have caused investors to view risk somewhat differently. Equities will likely produce lower returns than in the 1980s and 1990s, since developed markets are likely to grow slowly for quite some time.

Moreover, inflation is likely to increase as central banks around the world continue to pursue stimulative monetary policy.

The challenge to nonprofit organizations going forward will be in maintaining, and even increasing, the resources needed to fulfill their missions. **Organizations will rely more than ever on their investment portfolios to help fill resource gaps.** Yet they will do so in an environment where future returns are likely to be lower and less reliable than in the past.

LIQUIDITY WILL BE COSTLY

Over the next 15 years, U.S. Trust forecasts lower expected returns across most asset classes. For example, we expect the S&P 500 to return 8.2%, as opposed to the historic average of 9.8%. We also look for bonds to return 3.3% versus their long-term return of 6.1%. At the same time, real returns on cash investments are expected to be negative — that is, the 2.2% return on cash will lag expected inflation at 2.3 percent. This makes liquidity — or access to a stable reserve of safe money — very costly, and it must be managed carefully in every portfolio.

Real returns on cash investments are expected to be negative, which makes liquidity costly.

VOLATILITY WILL REMAIN HIGH

Lower returns are already causing a great deal of concern among many nonprofit investors. Organizations are recognizing that a typical investment portfolio, invested as in the past, is unlikely to provide an adequate return to support historical spending levels while preserving the real value of the portfolio. In addition, volatility is likely to stay high or increase.

Volatility is particularly problematic for nonprofits, because typically they must withdraw funds for distributions (for some, 5% or more) regardless of market performance. Withdrawals made during market downturns push the portfolio value even lower, making it ever more difficult to recover from asset price declines. The combination of lower returns and higher market volatility presents a significant challenge to nonprofit portfolios. In a later section, we will discuss various techniques that can be used to minimize the impact of significant negative return years on the organization's spending.

TRADITIONAL INVESTMENTS ARE CLOSELY CORRELATED

Higher correlations among traditional investments pose yet another substantial challenge. As the economies of the developed world become more integrated, their investment markets are likely to move more closely in sync, reducing the benefits of traditional diversification. **Nonprofit organizations will have to reach beyond traditional assets to capture additional return opportunities.**

SOLVING FOR THE "NEW REALITY"

As outside funding dries up and as investment returns decline, nonprofit organizations are now, more than ever, relying on their own internal resources to fulfill their missions. They will need to be flexible and creative to maximize these resources. Investment strategies cannot be viewed in isolation, but must be aligned with policy in the areas of fundraising, spending and overall management of the organization.

In facing these imperatives, there are several key areas where nonprofit organizations can add long-term value and build resources to continue and even expand the organization's mission. These include strategic global asset allocation, tactical management of the allocation, the use of nontraditional investments for incremental return, and active manager selection All are critical to success today and in the future.

In this section, we will outline strategies that address these areas of concern.

STRATEGIC ASSET ALLOCATION

A strategic asset allocation defines the broad asset classes that will be represented in the nonprofit's portfolio. It then specifies the portion of the total portfolio that will be invested in each of these asset classes. The asset allocation decision is critical because overall portfolio performance and volatility are largely influenced by the allocation of funds among different asset classes.

Strategic asset allocation is particularly important to nonprofit organizations since the right mix and proportion of assets can substantially increase their ability to meet two critical goals: **providing the income to sustain current spending and mission activities, and conserving and even growing the portfolio to ensure future activities.** A sound asset allocation can also help to minimize the likelihood of failure, or losses so severe that they jeopardize the continued existence of the nonprofit. When constructing an asset allocation, it is important to have a deep understanding of the specific factors that will define success of the investment strategy.

Asset allocation theory was first developed by Nobel Prize Winner Harry Markowitz and codified in his works on Modern Portfolio Theory (MPT). However, the world has changed in the half century since Markowitz first advocated diversification. Today:

- Capital markets are global.
- New investment markets and asset classes have emerged.
- Investment products and strategies have proliferated and grown more complex.
- Investors themselves have become more aware of opportunities and more sophisticated in their expectations of their advisors.

Yet, traditional asset allocation methodologies have not kept pace with these changes. To create an appropriate asset allocation for today's world, we need to rethink the asset allocation process.

In our Blue Paper *More Eggs, Better Baskets,* published in Spring 2008, we discussed the importance of asset allocation in the portfolio construction process. The paper described how incorporating a wide variety of asset classes from around the globe—including nontraditional investments such as private equity and hedge funds—provides the most effective and comprehensive approach to investment management in today's world.

To create an appropriate asset allocation for today's world, we need to rethink the asset allocation process.

Our asset allocation process marries two critical components:

- Forward-looking capital market assumptions derived from a rigorous testing of potential market outcomes
- Selection of asset classes in the appropriate proportions to achieve the client's spending and capital preservation goals.

All asset allocation strategies seek to obtain the maximum level of return for an acceptable level of risk. By diversifying, investors can obtain additional return for every unit of additional risk. Thus, diversification is the key to efficiency. Our asset allocation process starts by optimizing diversification. Then we look for a strategy that provides enough return to support the spending policy.

In past decades, it was possible to sustain the typical 5% spending rate with relatively modest diversification; a domestic portfolio of traditional stocks and bonds would have been successful. However, we believe **the traditional "60/40 domestic stock/bond" strategy is unlikely to support the challenges nonprofit organizations face going forward.** By creating a truly well-diversified portfolio, a nonprofit organization can reasonably expect to earn an adequate return while minimizing the risk of year-to-year market volatility.

Optimizing asset allocation to fuel the virtuous cycle

A sound asset allocation strategy can help nonprofits consistently generate the returns they require to sustain spending. This minimum required return is typically equal to the spending rate compounded by the rate of inflation. However, **organizations must also plan to earn an extra return cushion to build a surplus of money in good market years that can then be used to preserve spending in poor market years.** We refer to this as the ***virtuous cycle:***

- This virtuous cycle can allow organizations to increase their mission's support during poor market years when the needs of the beneficiaries may increase.
- It can also help them differentiate themselves among their peers, many of whom may be forced to lower their charitable support during market downturns.
- Finally, it can strengthen ties with donors, by demonstrating good stewardship of an organization's assets.

This goals-based approach to investing and measuring success is a key strategy in facing the increased challenges of the markets that lie ahead.

Global diversification for incremental return

While investors tend to think of diversification as a way to manage and reduce risk, in reality, effective diversification provides the additional benefit of increasing long-term portfolio return. In the lower return markets we anticipate going forward, global diversification can be another source of incremental return.

Consider that more than half of the world's available investment opportunities lie outside the United States. Projected returns in many global equity sectors are significantly higher than those for domestic equities. For example, we expect the equities from emerging economies to earn approximately 13% compared with U.S. equity returns of about 8%. Non-U.S. bonds and non-U.S. equities are expected to produce higher yields than U.S. investments, providing a greater source of liquidity to support spending. As a result, we expect to see an increase in the proportion of foreign investments held in nonprofit portfolios in the years to come.

Through prudent and effective global diversification, it is possible to increase portfolio yield from a little over 2% to almost 3%. This increases the proportion of spending that is automatically generated by the portfolio from about 45% to almost 60% of what is required. The remaining liquidity may be provided through periodic rebalancing of the portfolio. Regular rebalancing effectively spends the gains earned on higher-returning assets and manages concentration risk. In this way, it is possible to coordinate several risk management functions while providing both required return and required liquidity. Stated differently—organizations can manage liquidity without giving up return; they can seek return while enhancing diversification and reducing potential concentration risk.

Extending diversification with nontraditional investments

Nonprofit organizations can further extend their portfolios' diversification by investing in nontraditional asset classes including real estate, commodities, private equity and hedge funds.

Real estate: Real estate can provide a high yield (which increases liquidity) while increasing diversification and helping protect against inflation. Though inflation has been modest in recent years and is not expected to be a problem in the near term, inflation is a key risk for any investor with a long investment horizon, such as a nonprofit organization that is expected to exist in perpetuity. Since real estate investments tend to benefit from inflation, they allow us to take a source of risk and turn it into an opportunity for profit.

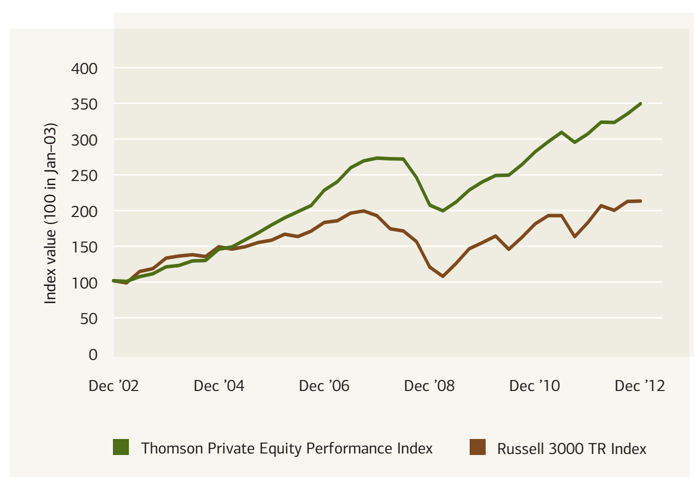
While real estate is often considered a traditional asset class, investment vehicles in this sector are not always available in registered, publicly traded form. Investments are sometimes offered in the form of private placements, but are also available through more traditional channels such as REIT funds, making them appropriate for smaller organizations and those concerned about the risk of illiquidity.

Commodities: Commodities are another source of inflation protection, which provide additional diversification relative to traditional stocks and bonds and are also available in either illiquid, privately listed vehicles, or in publicly traded form such as a mutual fund.

Private equity: Private equity, as its name implies, is an opportunity to capitalize on entrepreneurial capital and closely held companies. These investments require a longer investment horizon, typically five to 10 years. During this time, the investment is almost completely illiquid, and so portfolios that invest in private equity may need to provide for liquidity through other parts of the investment portfolio. These investors may, for instance, substitute short-term, high-quality bonds for cash. We believe that such a strategy can be expected to provide about 150 basis points over cash (or 1.5%) while providing essentially equivalent liquidity and stability. Private equity has been a source of outperformance during the last decade; while public equity returned roughly 6.4% since 2003, private markets have returned 13.1%, reflecting a liquidity premium that investors have received for placing long-term capital with managers in this space (Exhibit 3).

EXHIBIT 3
PRIVATE EQUITY: RETURN ENHANCEMENT POTENTIAL

Private equity vs. public equity
10-year performance (Jan '03 to Dec '12)



Source: U.S. Trust, Thomson One, Morningstar EnCorr. As of April 2013.

A private equity investment involves significant risks and will be illiquid on a long-term basis. Investors may lose their entire investment.

Past performance is no guarantee of future results.

By taking advantage of creative strategies to provide liquidity, we believe investors can take on the illiquidity risk of alternatives such as private equity, earning a potentially significant return premium, while also providing diversification among the various sources of return within the portfolio.

Hedge funds: Less-diversified portfolios typically rely almost exclusively on market- and credit-related sources of risk. Traditional stocks and bonds are an example of this type of risk. To achieve meaningful diversification, it is necessary to incorporate other sources of risk and return, preferably those that are less correlated with the traditional credit-related risks.

Some of these diversifying risk/return opportunities include currency, illiquidity, and a meaningful degree of the risk found in *actively managed strategies,* including hedge funds. By allocating capital to skillful managers who specialize in investing within each market sector, we expect to earn an *excess return* that can help compensate for the low-returning markets we face. Like all sources of return, this extra return comes from taking *manager risk* in addition to market risk. This *idiosyncratic* risk premium is the defining characteristic of hedge funds.

Investing in a hedge fund is equivalent to granting a high level of discretion and latitude to an active manager in whom we have a high degree of confidence, with the expectation that this manager can seek and find superior investment opportunities across all market environments. This type of strategy is especially important at times of low expected market returns. Hedge funds provide the potential to support consistent spending throughout volatile market cycles.

KEY CHARACTERISTICS OF NONTRADITIONAL INVESTMENTS

Real estate

- Provides a relatively high yield
- Increases diversification
- Protects against inflation
- Available in relatively liquid vehicles including publicly traded REITs

Commodities

- Returns uncorrelated with public markets
- Protect against inflation
- Relatively volatile

Private equity

- Relatively illiquid — lock-up periods typically five to 10 years
- High return — 13% annual return since 2003, versus 6.5% for publicly traded equities

Hedge funds

- Uncorrelated to publicly traded securities
- Returns highly dependent on manager skill
- Alternative strategies such as hedge funds can provide positive returns in flat or declining markets

The case for adding alternatives

Our work has shown that adding illiquid alternative investments to long-term portfolios can add anywhere from 30 to 90 basis points in additional annualized return over the holding period, which is a significant positive result.

Exhibit 4 illustrates a set of investment opportunities that show the value of diversification in controlling both risk and return. We can see that the traditional domestic 70/30 portfolio lies well below the opportunities provided by an equivalent risk portfolio of global public investment, and even lower relative to the portfolio strategy that includes nontraditional investments such as hedge funds and private equity.

EXHIBIT 4

OPPORTUNITIES TO INCREASE EXPECTED RETURN BY EMPLOYING ALTERNATIVE INVESTMENTS

Source: U.S. Trust

A significant increase in expected return, *without* an increase in risk, can be realized by adopting a more fully diversified asset allocation within the public markets. We believe that in a lower yield/lower return environment, it is imperative to optimize diversification as much as possible through a global portfolio that includes public market as well as nontraditional investments.

Our work has shown that adding illiquid alternative investments to long-term portfolios can add anywhere from 30 to 90 basis points in additional annualized return.

Tactical investment management

In the current challenging market environment, achieving the optimal total return necessary for an organization to meet its goals requires more than establishing a long-range strategic asset allocation. **A tactical approach can enable investors to capitalize on temporary opportunities that surface in a global investing environment.** By actively managing asset allocation and manager selection, investors have an opportunity to earn an additional return over what can be forecast using only capital market assumptions and strategic allocation.

Tactical asset allocation captures opportunities in markets and asset classes

The first opportunity for additional return comes from *tactical asset allocation.* At U.S. Trust, we begin the process by using the insights of our Investment Strategy Committee (ISC), our "top of house" thinking. These recommendations enable us to make periodic adjustments to short-term market exposure based upon near-term market forecasts over the next business or market cycle. The Investment Strategy Committee typically evaluates current trends in the economy and financial markets to make its recommendations.

Using these recommendations, our portfolio teams underweight and overweight specific asset and subasset classes. For example, we may overweight stocks and underweight bonds or underweight large cap equities and overweight small caps.

The size of tactical shifts—that is, how much we over- or underweight specific market sectors—reflects our views on risk, both in the market and in the context of a client's specific portfolio guidelines and constraints. Tactical asset allocation can protect capital by lowering exposure to markets that are expected to have lower-than-average short-term returns. It also provides the opportunity to enhance return by increasing exposure to markets with higher expected short-term returns.

A tactical approach can enable investors to capitalize on temporary opportunities that surface in a global investing environment.

Tactical strategies work best in combination with prudent risk management. In *"Think Forward, Act Now,"* a blue paper we published in Summer 2009, we discussed the concept of risk budgeting. In this approach, a manager can break risks down into two broad categories: active risk and passive risk.

- Passive (or beta) risk refers to market (or systematic) risk.
- Active risk really measures the risk to active returns, or excess return (which is the difference in returns between a portfolio and its benchmark).

The clear delineation of active and passive risks budgeted within a portfolio allows investors to efficiently "spend" their risks where they are most appropriate: passive risk in up-trending markets, where a rising tide lifts all boats; active risk in range-bound, reversal markets, where skilled managers with superior security selection ability are most crucial to achieving above-market returns. Tactical asset allocation could be the decision to over/underweight equities relative to fixed income, or over/underweight U.S. equities relative to international developed equities. It could also be the decision to over/underweight U.S. large cap equities relative to U.S. small cap equities.

The decision tree becomes quite extensive and requires a thorough process by which each choice is evaluated independently as well as collectively within the overall asset allocation framework. Tactical asset allocation guidance at U.S. Trust involves monitoring market and macro developments, applied to strategic ranges and risk budgets, and then reviewed and approved by the ISC. We have found that by implementing this extensive process we can add meaningfully to excess return within investment portfolios.

ACTIVE MANAGER SELECTION

Another source of active return comes from employing specialist managers within each asset class. Active strategies are attractive because they offer the potential to earn higher than benchmark returns, which can more than offset the additional fees such strategies require. Still, active management can be very unpredictable. Even top-tier managers face periods of underperformance relative to their benchmarks.

Investors can manage this underperformance risk in the same way they manage any other type of risk: through diversification. And, as stated earlier, beating the benchmarks doesn't necessarily translate into achieving the stated mission of the organization. The proper pairing of managers that complement each other is key to maximizing returns in a low return world.

Successful active manager selection requires a robust due diligence process. At U.S. Trust, we analyze managers intensely, seeking to identify well-managed investment firms with results that demonstrate a rigorous and effective active investment process. We examine managers individually and also in combination with each other, looking for managers whose active investment processes are complementary, in order to provide an additional degree of diversification within the area of "active risk."

The proper pairing of managers that complement each other is key to maximizing returns in a low return world.

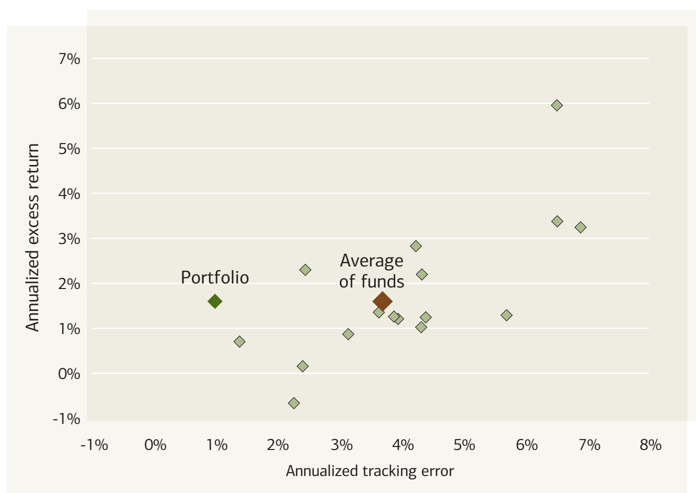
By combining qualitative judgments with quantitative analytical techniques, we believe we can assemble a "team of managers" that provides a high probability of reliable, long-term outperformance. This analysis increases the likelihood that one manager's outperformance comes at a time when another manager is experiencing the inevitable short-term underperformance. By combining complementary processes, we expect to produce a more reliable excess return at the total portfolio level. Reducing this performance risk also increases the likelihood of producing a higher minimum expected excess return.

In fact, we expect to make up occasional periods of below-average market performance through active management. The rigor of this excess return enhancement process increases the likelihood that we will deliver more than the minimum return required to meet the nonprofit's spending needs. Indeed, this approach can often deliver enough return to build a surplus that will support the mission in times of market stress.

EXHIBIT 5

BENEFITS OF DIVERSIFYING THE TEAM OF MANAGERS

Portfolio vs. individual manager active risk and excess return



Source: U.S. Trust

By combining managers, we expect to reduce their individual performance risk, while keeping all of their excess return, substantially increasing the likelihood of success for the total portfolio.

On an individual basis, fund managers typically incur a high level of tracking error—that is, their performance diverges sharply from benchmark returns as shown in the example in Exhibit 5. After we analyze the expected long-term excess return for these managers, using rigorous statistical tests of confidence based on their observed returns, we may conclude that the likelihood of any individual manager's success in beating the markets is quite low. On a risk-adjusted basis, it is quite difficult to have a high degree of statistical confidence in the ability of any single manager to outperform the market.

We believe that we can overcome this individual manager weakness by applying diversification to the process of manager selection, overcoming much of the individual weaknesses of manager performance by forming them into a portfolio or "team" of portfolio contributors. In doing so, we expect to reduce their individual performance risk, while keeping all of their excess return, substantially increasing the likelihood of success for the total portfolio.

LEARNING FROM THE INFORMATION RATIO

Active managers are often evaluated and ranked by their ability to earn an excess return over their benchmarks without generating too much tracking error. One way to evaluate and rank their success is in terms of the information ratio (IR), which is simply a ratio of their excess return relative to their tracking error. The higher the number, the better.

Why does this matter?

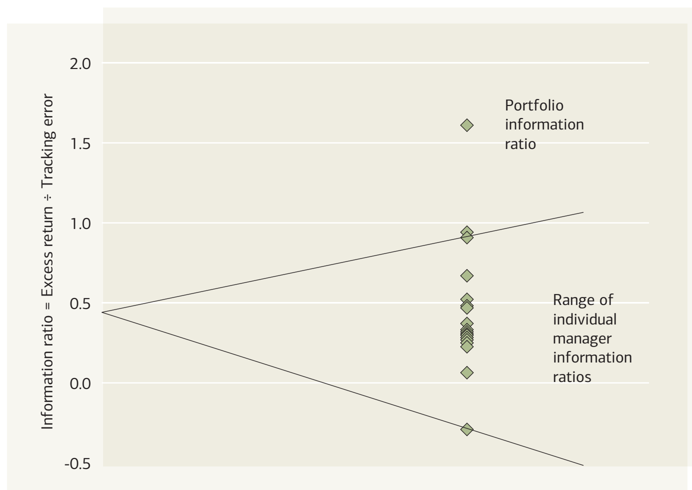
- First, the higher the IR, the greater the likelihood that the manager will actually beat the market.
- More important, the higher the IR, the higher the minimum excess return that can be earned with a high degree of confidence.

We expect this minimum return to be meaningful in terms of meeting the client's goal. Exhibit 6 is an example which shows the benefit of manager diversification, and helps to achieve a portfolio IR that is four times the average of its individual managers.

EXHIBIT 6

IMPROVING THE PORTFOLIO'S INFORMATION RATIO AND LIKELIHOOD OF BEATING THE MARKET

Manager diversification improves portfolio information ratio



Source: U.S. Trust

The selected funds exhibit an IR of about 0.4, meaning that for every 40 basis points of excess return, they incur 100 basis points of risk. However, through diversification of these managers' active returns, a portfolio with an IR of over 1.6 can be achieved. As a result, the portfolio's likelihood of beating the market is increased. These are examples of the kinds of analyses that can be performed to achieve the best mix of managers in helping achieve the mission.

LIQUIDITY

One very important aspect in constructing an investment portfolio for nonprofits is making sure there is enough cash on hand to meet current demands. For not-for-profit organizations, as with for-profit businesses, maintaining reserves that can meet unexpected obligations, lean funding periods or a negative investment return environment is critical. Indeed, many organizations that did not maintain sufficient reserves during the last financial crisis no longer exist today.

While maintaining insufficient reserves can be devastating, holding too much liquidity can also be detrimental. In a period where yields are expected to be low for quite some time, cash on hand is actually earning a negative yield when inflation is taken into account. Organizations need to carefully assess how much liquidity they need, both for regular operations and to prepare for unexpected events. Boards that have not yet analyzed true liquidity needs relative to the mission of the organization may be sacrificing additional return opportunities that can be gained by deploying cash more effectively. At U.S. Trust, we take a holistic approach to portfolio construction which includes liquidity analysis and recommendations based on the unique needs of the organization.

While maintaining insufficient reserves can be devastating, holding too much liquidity can also be detrimental.

The first step is determining what minimum level of liquidity is needed for the organization to meet its obligations. A cash flow analysis which takes into consideration all sources of revenue and a schedule of distributions is imperative to understand cash needs, and this type of analysis can be extrapolated beyond the near term to inform the asset allocation decision, as well as determine the level of risk the organization is willing to take with its short-term investments. For example, low duration investments such as a structured fixed income portfolio, which has a certain small degree of credit risk, may be more suitable for a portion of the liquidity bucket than very low yielding money market funds. These portfolios can have average maturities of one year to eighteen months, and provide a meaningful yield enhancement alternative to "cash."

RETHINKING SPENDING

The first responsibility of a fiduciary is to protect assets for their intended purpose: supporting the mission over the life of the organization. A nonprofit organization must plan not just for today's needs, but also for decades, even generations, of charitable activity.

Thus, while immediate financial needs may be pressing, fiduciaries are responsible for balancing the needs of the current "generation" with the expected needs of future generations. For endowed assets, we encourage organizations to think in terms of a 30-year life for each generation. For foundation assets, the mission's life may be shorter and should be determined by the board, if not by governing documents. Be aware that the life of a mission may change. An organization may decide to spend assets more rapidly, for instance, if it has an opportunity fulfill its charitable mission by doing so. However, the spending rate should reflect the strategic plan to achieve the mission not only for today but long into the future as well.

Fiduciaries are responsible for balancing the needs of the current "generation" with the expected needs of future generations.

DETERMINE A SUSTAINABLE SPENDING RATE

The first decision a board must make is how much it can spend every year to support the organization's mission. That spending rate must be consistent and sustainable. That is, the board needs to know up front that it can maintain this level of spending, year after year, regardless of short-term investment performance. As a result, we define a sustainable spending policy as a withdrawal rate that can be maintained over the long run without putting the portfolio value at undue levels of risk of permanent loss.

A sustainable long-term spending rate must be developed in conjunction with an appropriate long-term asset allocation strategy. The key to success in this regard is to match a reasonable expectation of investment return with an equally reasonable expectation of spending and inflation.

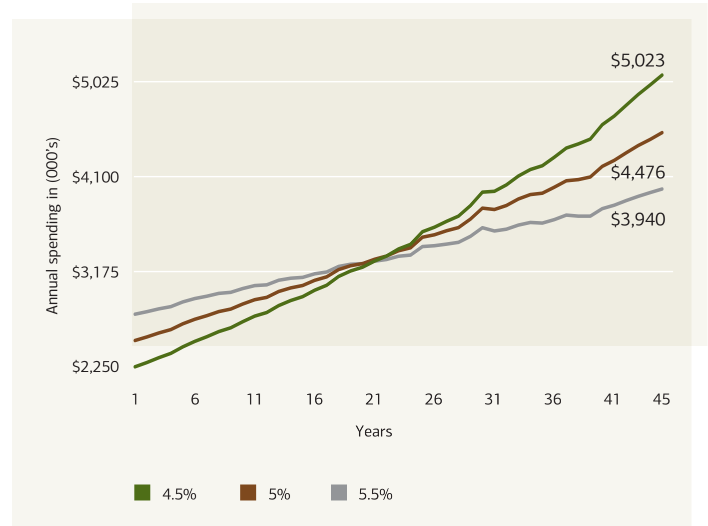
We also need a view on risk: a reasonable expectation of market volatility and the degree of diversification provided by each investment opportunity. When the spending rate and the return from the investment strategy are in balance, we can reasonably expect to sustain the spending even through periods of market volatility—even such unprecedented volatility as we experienced in the downturns of 2000 through 2002 and the significant single-year downturn of 2008.

Our research has shown that the determination of a proper spending rate is a critical factor in determining the long-term success in meeting the mission. **While many organizations prefer to maximize spending to have the biggest impact on current beneficiaries, this practice may jeopardize the long-term mission.** As illustrated in Exhibit 7, a modest reduction in current spending (to a 4.5% spend rate from a 5% spend rate, for example) may have a significant impact on the organization's ability to serve the needs of the next generation. In fact, the amount of available spending down the road will actually be higher, assuming expected returns are met.

When the spending rate and the return from the investment strategy are in balance, we can reasonably expect to sustain the spending even through periods of market volatility.

EXHIBIT 7

SPENDING UNDER DIFFERENT RATES



Source: U.S. Trust

Just as the mission of a nonprofit organization provides it with a sense of direction, a sound spending policy provides the road map. In a lower-return world, where organizations can no longer rely strictly on strong investment returns to fund the mission, stakeholders and donors should have greater confidence in an organization with a clear spending policy and a sound investment policy that is inextricably tied to fiduciary responsibilities.

While many organizations prefer to maximize spending to have the biggest impact on current beneficiaries, this practice may jeopardize the long-term mission.

VALUE THE PORTFOLIO: THE SMOOTHING APPROACH

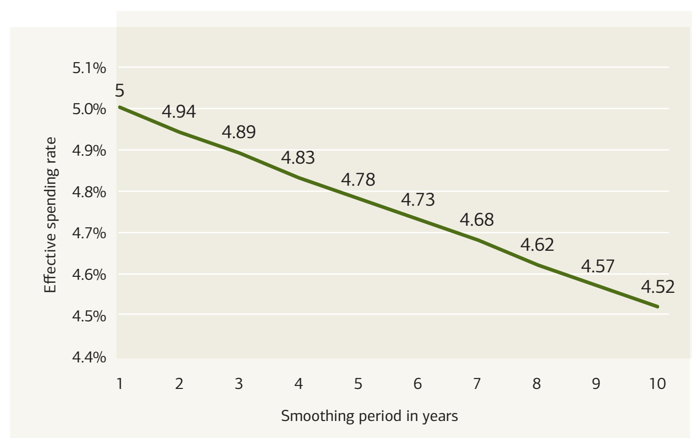
In addition to choosing the proper spending rate, nonprofit organizations must decide how to value the portfolio that this spending rate will be based upon. Many organizations base their spending rate on the current market value of the portfolio; however, given market volatility and the long-term nature of the charitable mission, it may make more sense to average that market value over a period of three to five years. This process is commonly referred to as "smoothing."

Why might smoothing be appropriate? In most years, market values tend to be higher than the prior year; in fact, equity markets have tended to be higher year over year about 75% of the time. This results in an average market value over a five-year timeframe that is lower than the current value. By applying the spending rate to the lower "smoothed" amount, the organization meets its stated spending rate but at a lower value, thereby preserving principal while effectively lowering the spending rate.

Exhibit 8 demonstrates how smoothing a 5% spending rate over time actually decreases the effective spending rate, and helps the organization preserve more principal for future spending.

EXHIBIT 8

IMPACT OF EXTENDING THE SMOOTHING PERIOD ON A 5% SPEND RATE



Source: U.S. Trust

Our testing has demonstrated that a move from a three-year to five-year smoothing period helped increase ending value over the long term by about 5%. By combining a lower spending rate with a smoothing process, nonprofits can achieve the dual goals of maintaining spending and preserving principal for the future.

TEST THE STRATEGY AGAINST SPENDING GOALS

Up to this point, we have presented the rationale for determining a spending policy and developing an asset allocation. The next step is to consider how these two decisions work together to achieve portfolio goals. We do this by testing whether the proposed strategy is likely to sustain spending while preserving real portfolio value over the long term.

To evaluate this match, we will use 30 years as a representative horizon, roughly a "generation." Let us take a $25 million endowment as an example:

- Employing Monte Carlo analytics, we project thousands of scenarios that illustrate the range of possible outcomes that result from spending according to plan while invested in the proposed asset strategy.
- We then rank our outcomes, using a few key metrics: total spending, real ending portfolio value and likelihood of "mission failure."
- We define "mission failure" as an expected long-term loss of 15% or more of real portfolio value.
- Losses of less than 15% can be recovered within a reasonable period of time.
- Losses greater than 15% may require a change in strategy to improve recovery time.

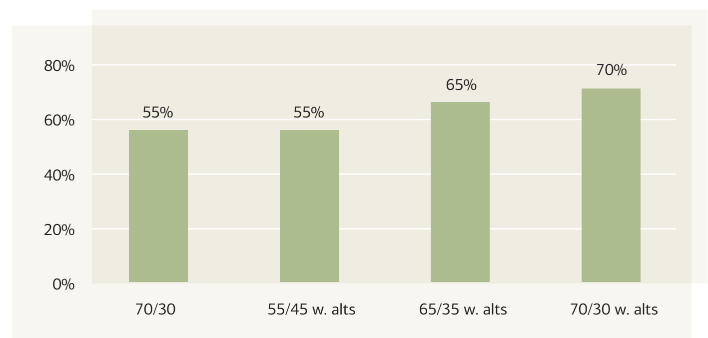
It's important to point out that we test our solutions under two conditions: earning the returns we expect and also earning the lower quartile of returns. In this way, we take a hard look at the likelihood of a "downside" market that produces lower returns than we predicted. This allows us to control for a type of risk that is often ignored: the risk that our forecasts are wrong, and the market conditions we experience turn out to be worse than expected. By doing so, we hope to demonstrate that the "worst case" outcome will still result in accomplishing the mission, while our expectation is to exceed the goal.

Exhibit 9 summarizes a key risk. In it, we measure how likely the portfolio is to lose principal after factoring in the impact of market volatility, spending and inflation. The graph compares risk based on the portfolio's expected value after spending and inflation if invested in each of the potential strategies. The vertical axis represents the probability of maintaining or exceeding the principal value given the strategy. The horizontal axis represents each of the investment strategies (70% equity/30% bonds, with and without alternatives). It is clear that the undiversified strategy has a likelihood of failure that is unacceptably high; its likelihood of success or failure is nearly a coin flip.

As fiduciaries, we must provide a higher likelihood of success and a lower probability of failure. **Through diversification and its benefits of higher returns and lower levels of risk, we can bring the expected likelihood of success up to more acceptable levels, closer to a three-in-four chance of success.** This allows us to balance the risk to this generation (insufficient spending support) against the risk to the next generation (failing to preserve portfolio value.)

EXHIBIT 9

LIKELIHOOD OF REAL END PORTFOLIO VALUE (NET OF SPENDING) EXCEEDING $25 MILLION AT 30 YEARS

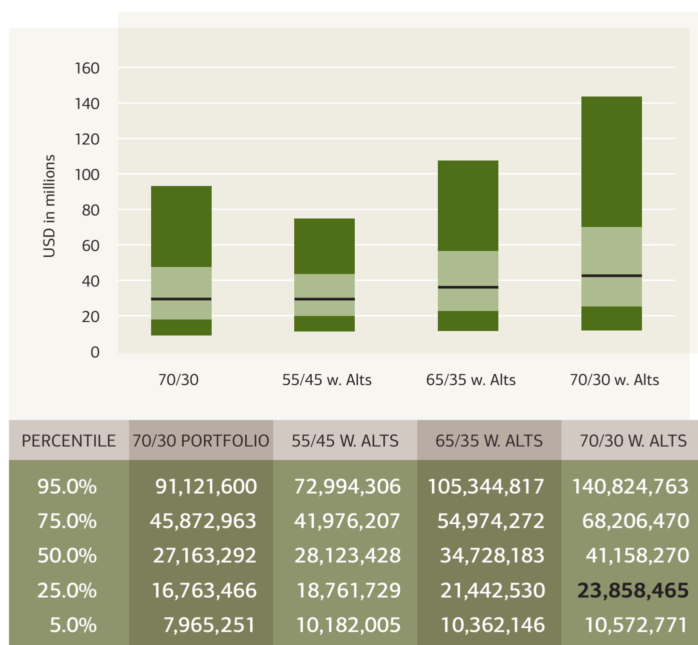


Source: U.S. Trust

As seen in Exhibit 10, all strategies were able to sustain the portfolio's original $25 million value over the long term as long as they earned the expected returns, which can be defined as at least a 50% chance of success. However, all of these strategies failed to preserve the portfolio's original value in the event of an unusually negative market environment, as seen in the 25% probability. The only strategy that provided close to original value with this probability is the fully diversified 70/30 portfolio with alternative investments. This demonstrates the value of diversification and active management. In fact, in a weak expected market environment, an active return enhancement will be necessary for investors to meet their goals.

EXHIBIT 10

REAL PORTFOLIO VALUE PRESERVED OVER 30 YEARS—NET OF SPENDING AND INFLATION



PERCENTILE	70/30 PORTFOLIO	55/45 W. ALTS	65/35 W. ALTS	70/30 W. ALTS
95.0%	91,121,600	72,994,306	105,344,817	140,824,763
75.0%	45,872,963	41,976,207	54,974,272	68,206,470
50.0%	27,163,292	28,123,428	34,728,183	41,158,270
25.0%	16,763,466	18,761,729	21,442,530	**23,858,465**
5.0%	7,965,251	10,182,005	10,362,146	10,572,771

This testing of "worst case" scenarios provides a high degree of confidence that, at a minimum, we will maintain close to the original value of the endowment even if market returns are less than we expect. By focusing on the ability to fulfill the mission, we strive to create a direct link between the investor's strategy and successful fulfillment of its mission.

In a weak expected market environment, an active return enhancement will be necessary for investors to meet their goals.

MEASURING SUCCESS AGAINST THE MISSION

Traditional evaluations of investment performance typically measure the success of individual fund managers relative to their respective benchmarks. There are two problems with this approach:

- First, this fails to evaluate the return of the total investment portfolio—it simply measures the success of the individual pieces. It also puts the emphasis on evaluating the managers, rather than answering the essential question: *Did the portfolio achieve the organization's goals?*
- The second problem is that this approach is typically applied only to the short term: one-year, three-year, five-year and perhaps ten-year evaluations of fund performance. The nonprofit organization's mission, by contrast, is expected to remain in perpetuity. Success is measured over generations, not years. To evaluate true mission success, we must align performance measures with the organization's goals and do so over meaningful time horizons. This means that the emphasis of performance must shift away from the traditional focus on the fund managers to a focus on the organization's goals. Unfortunately, traditional measures of success seem to measure everything *except* whether the organization is achieving the mission and its goals.

Measuring the success of the individual fund managers is important, but it is a secondary factor in measuring success. After all, even a perfectly executed strategy will fail if it does not provide enough money to sustain spending while preserving the real value of the investment portfolio. The more important measure of success is whether the total portfolio is supporting the organization's mission.

To evaluate this, we must measure the performance of the portfolio in the context of its goals rather than in the context of its asset benchmark. This is actually a simple analysis. We begin with the portfolio value, and then evaluate the spending that was supported by the strategy. We then calculate the return that reconciles the beginning value and its withdrawals to the current value. This return, known as the internal rate of return, is what reconciles these three critical components of the mission.

> We must measure the performance of the portfolio in the context of its goals rather than in the context of its asset benchmark.

GOALS VERSUS BENCHMARK PERFORMANCE

The most relevant measure of success for nonprofit organizations is not rate of return, but rather, how much money these organizations have to support their missions. After all, the goal is to support beneficiaries with a level of money support, and to retain the money value of the portfolio so that this support can be sustained for future generations. This should include the accumulated amount of spending, including an examination of the pattern of that spending. We want to answer questions such as: *"Did spending remain at or above our expectation? "Was spending ever below the amount that was expected?"* Similarly, we examine the portfolio's market value, with questions such as: *"Did we manage to earn a surplus in strong market years?" "Did this surplus sustain spending through weak market years?" Did portfolio value ever fall so far below its inflation-adjusted value that we were at risk of failing to support the mission going forward?"* Finally, the essential question is this: *"Do we currently have the capital required to support the monetary spending that we expect to provide to our beneficiaries?"* These goals are all money goals, rather than return goals.

GOALS-BASED MANAGEMENT: AN ILLUSTRATION

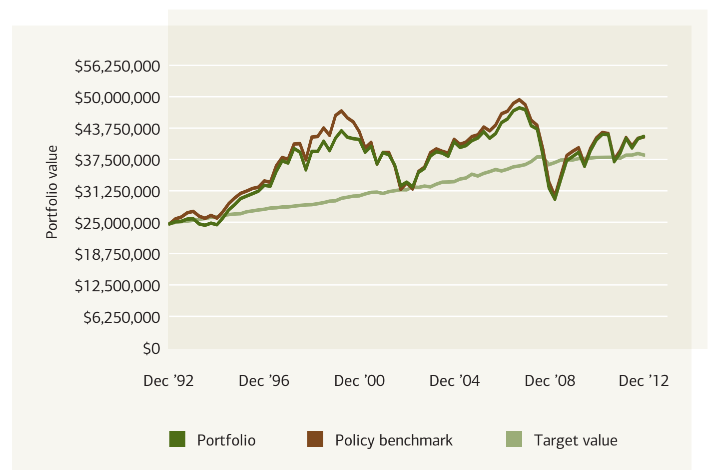
Let's take a look at a sample analysis of a nonprofit portfolio, shown in Exhibit 11. The organization has the goal of spending 5% of the average portfolio value over the prior five years. Its investment strategy includes an allocation to both global stocks (60%) and bonds (30%) along with a modest allocation to alternative investments (10%.) The 20-year time horizon we are analyzing includes the market run-up that ended with the burst of the tech bubble (2000 to 2002) and the subsequent liquidity/credit bubble that led to the severe market downturn in 2008. We examine the pattern of spending and market value relative to the organization's goals and then combine these results to examine the total value produced to benefit both current and future beneficiaries.

During this 20-year period of relatively benign inflation, the nominal value of the portfolio increased by over 50%. This is illustrated by the steadily rising lower line in Exhibit 11.

EXHIBIT 11

PORTFOLIO VALUE VS. BENCHMARK AND TARGET VALUE

1993–2012



Source: U.S. Trust

Any time the portfolio's value was above the target line, it was in surplus—that is, it earned enough to support its spending with an additional amount to cover inflation. The downturn of 2000 to 2002 began with a significant surplus and ended with a modest surplus.

The subsequent period, being shorter, generated a surplus that was insufficient to maintain the portfolio's value through the wrenching downturn over the five quarters beginning in 2008. As a result, the portfolio moved into a deficit for a brief time.

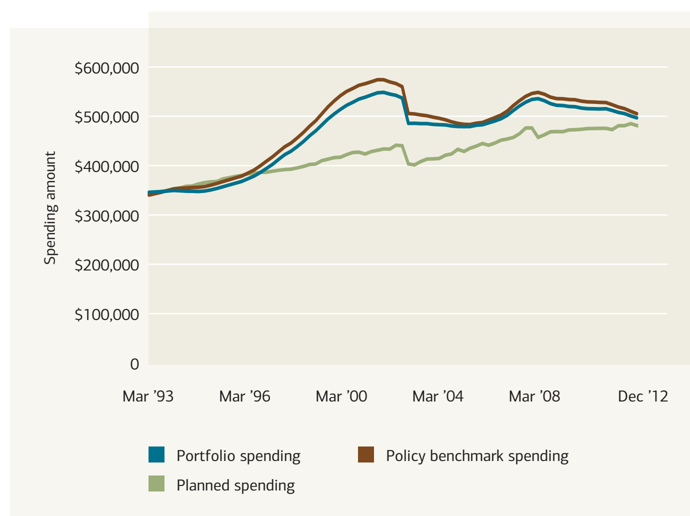
However, the strategy quickly recovered and then sustained the portfolio's value through the following period of unusually high market volatility. This 20-year period of two historic market upheavals provided an excellent stress test of the portfolio's strategy and its ability to sustain the mission. The key to this insight is using the right performance benchmark, or measure of success, which in this case is sustaining the portfolio's inflation-adjusted value net of spending (Policy Benchmark). But what about the other goal of sustaining the spending?

Exhibit 12 shows the initial spending goal increasing with inflation over the 20-year period. (The spending rate was cut from 5.5% to 5.0% during 2003.)

EXHIBIT 12

SUSTAINING ADEQUATE AND SMOOTH SPENDING

Portfolio and benchmark spending vs. planned spending



Source: U.S. Trust

This demonstrates the benefits of setting a sustainable spending rate and applying it to an average of prior market values.

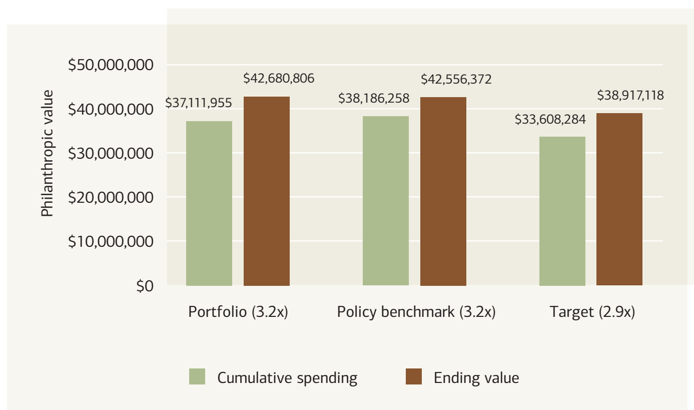
- The blue line reflects actual spending from the portfolio, versus planned spending.
- The change to a lower spending rate in 2003 allowed the actual spending from the portfolio to stay higher than planned, even during the financial crisis in 2008.
- Once the portfolio generates an adequate surplus, the amount of spending increases steadily and remains above the goal, even through the periods of severe market downturns.
- The year-to-year changes in money distributions are smooth and stable. In times of market stress, when beneficiary needs may increase, the spending naturally increases.
- This is another benefit of the virtuous cycle of building surplus value during good years.

Over this 20-year period, the portfolio distributed $1.48 for every $1.00 initially invested (Exhibit 13). This exceeded the target multiple of $1.34. In addition, the cumulative distributions and ending market value were 3.2 times the original value, versus the target of 2.9 times. Both the strategy and the implementation of the strategy added value in exceeding the goal.

EXHIBIT 13

EVALUATING "TOTAL MISSION SUCCESS"

Total philanthropic value 1993–2012



Source: U.S. Trust

This simple attribution of results is meaningful since it shows the value of the strategy and its implementation, and also because these results are expressed in terms of the mission, all expressed in terms of money.

These measures of success provide the information organizations need to answer questions that arise regarding their stewardship of the assets that have been entrusted to them. They also provide the information necessary to make changes in the investment program to increase the likelihood of success in fulfilling obligations to the next generation.

It is perfectly possible to outperform asset benchmarks while failing to meet organizational goals. In fact, we need look no further than the pension industry over the past several decades for proof. Because plan sponsors saw their investment goals in terms of a rate of return, and because they saw risk embodied in a single statistic such as volatility of return, they put their focus on the traditional measure of success in evaluating the fund managers and their products, rather than on their clients and their goals. As a result, many of them produced returns that outperformed their asset benchmarks while failing to preserve the capital needed to pay future beneficiaries.

FINDING THE RIGHT TIMEFRAME FOR MEASURING SUCCESS

A goals-based approach evaluates investment results according to the spending results. It seeks to create a portfolio that can be sustained over the long-term, net of spending and inflation. When results are measured this way, many nonprofit organizations are encouraged by the success they have had so far in meeting their goals. However, it is important to choose the right timeframe to evaluate success. Depending on the years examined, an identical portfolio could appear to be underperforming its goal, meeting its goal, or enjoying significant outperformance relative to its goals. The difference lies solely in the time horizon for the performance evaluation. So which is the right answer?

Let's take the example of a portfolio invested in a well-diversified portfolio strategy of 70% equity investments and 30% bond investments. We will examine three time periods ending December 31, 2012. Further, let's specify that this portfolio has adopted a 5% spending rate applied to the average portfolio value over the prior five years.

- **If we choose a five-year investment horizon** to evaluate the nonprofit's success, the portfolio seems to have underperformed. The ending portfolio value is 20% below its target amount. We reach this conclusion because we assumed that the portfolio was adequately funded to support its mission at the beginning of 2008. But, what if we had already developed a surplus of value?

- **If we expand our evaluation to a 10-year period,** we find that in the initial five years, our strategy built a surplus that was sufficient to carry it through the weak period of 2008. This means that our portfolio demonstrated its ability to provide its planned spending while preserving the expected portfolio value. In fact, this evaluation was like a stress test of the strategy, providing validation that the strategy and its implementation did indeed perform as expected: generating a surplus of portfolio value in good years that sustained its mission even though subsequent market returns were lower than expected.
- **Doubling the horizon to a 20-year period,** the strategy generated a strong surplus in the initial years that provided the spending while generating a significant surplus of value by the end of 2008.
- **If we start our analysis in 2000, the results are even more dramatic.** This portfolio would have generated a 50% surplus by the time the market bubble burst. This surplus would have supported 5% spending while also providing inflation protection throughout the market's dramatic downturn. In 2008, many portfolio strategies lost one third of their total value through the combined effects of spending in the presence of significant market losses. However, a portfolio with a 50% surplus can sustain the loss of one third of its value during such a stressful market period. In fact, that's the reason to build surpluses: to generate excess value that can be spent down in periods of stress. This allows nonprofits to maintain their activities at a time when current market returns are low.

We cannot predict *when* the market will turn down; we can only plan against the time when it *does* turn down. We don't know *when* markets will lose value, but we know that they *will* do so. These downturns are unexpected but not unplanned for; it is our responsibility to be prepared for them. Our only defense against market downturns is to begin with an appropriate, goals-based strategy, diversify the portfolio, manage it effectively, and in doing so, generate a surplus of value in good times. We can then spend this surplus without fear of putting the portfolio's principal value at peril.

Now, imagine if this client with the successful portfolio had cut back on its support of its mission, simply because its perspective was the traditional one; focusing on the loss of market value from a recent peak value. The cut in support for the mission would have been unfortunate because it was unnecessary. Given the perspective gained from this goals-based approach, nonprofit organizations begin to understand that peaks of market value are really surpluses that may be spent down in order to sustain the charitable mission.

This perspective helps organizations to focus on the most important measure of performance: the amount needed to sustain the mission going forward. They should not focus on the high-water mark of the market peak: those peaks will likely be followed by downturns. Instead, nonprofits must answer the essential question: *What is my funding level relative to my expected support of the mission?* It is imperative that every fiduciary of charitable assets is aware of this funding level. Only then can an organization make informed and appropriate decisions regarding support for the charitable mission going forward. This is the goals-based investment process at its essence.

Depending on the years examined, an identical portfolio could appear to be underperforming its goal, meeting its goal, or enjoying significant outperformance relative to its goals.

KEY ORGANIZATIONAL CONSIDERATIONS

While investment strategy and spending policy are key components in addressing the "New Reality" of lower returns going forward, there are other areas that nonprofits should focus on to ensure the maximum opportunity for achieving the mission. Fundraising and board governance, including the idea of outsourcing critical functions such as investment management, also need close attention by board members in fulfilling their fiduciary duty.

THE DONOR DILEMMA: INCREASING FUNDRAISING OPPORTUNITIES

The financial crisis has affected both donors and the nonprofit organizations they support. Generally speaking, both are more resource constrained, requiring them to do more with less. As such, donors are increasingly focused on efficient use of their contributions and tangible indications that their gifts are having a impact and furthering the mission of the organization.

Organizations can address this increased focus and successfully meet donor expectations by having a well-thought-out strategic development plan that provides insight into three critical factors: donor motivation, communication strategies, and diversification of revenue sources.

A development plan should also include effective donor communication strategies to provide clarity around the Case for Support and Impact Goals, so that prospective donors can fully understand the organization's mission and how it aligns with their own interests and passions.

Investment strategy and spending policy may play a role in this education as well, as donors want to be assured of an organization's financial viability. By having a strong development plan and sound policies in place, nonprofits have a better chance of cultivating prospective donors and communicating to them how their investment will make a meaningful contribution to the mission.

Donors are increasingly focused on efficient use of their contributions and tangible indications that their gifts are having an impact and furthering the mission of the organization.

BOARD GOVERNANCE

Without a strong governance culture, even the best-designed investment strategies can fall short of fulfilling the mission.

Well-crafted board governance increases the likelihood that day-to-day decision making as it relates to the asset allocation, diversification and monitoring of the investment portfolio aligns with the overall goals and mission of the organization. Investment committees today must be active participants in the formulation of the overall strategy, not merely stewards overlooking a consultant or investment manager.

Fiduciary risk falls squarely on members of the committee and board and in a period of lower returns and increased volatility, a nimble approach to decision making is critical to ensure that strategic and tactical management leads to ultimate success. The backward-looking approach of measuring returns against benchmarks must be augmented with forward-looking opportunistic implementation. Information must be dissected and acted upon if an organization is to capture the additional returns that are available in today's world. For these reasons, it is imperative that boards and committees choose providers who are able to use sound judgment in portfolio construction, using the latest tools and information available.

In *"More Eggs, Better Baskets,"* which we published in Spring 2008, we discussed the importance of using both top-down and bottom-up methodologies in constructing appropriate allocation frameworks, and then using the information to assess on an ongoing basis how the strategy and the implementation are working against the goals of the investor. We also stressed the importance of looking at alternative investments as a means to provide "better" returns over time when compared with more traditional strategies that focus solely on the public markets. Best practice board governance addresses these issues by looking at how the investment committee can be most effective at addressing the challenges and opportunities in the investment space today.

Investment committees today must be active participants in the formulation of the overall strategy, not merely stewards overlooking a consultant or investment manager.

Successfully developing and implementing a tactical asset allocation strategy is difficult for committees unless the governance structure is modified. As most boards and investment committees consist of volunteers that frequently have other full-time responsibilities, many investment committees meet only quarterly on a formal basis. At these meetings, the investment committee usually reviews the portfolio performance and makes important decisions such as whether or not an investment manager should be replaced or added, or whether the asset allocation should be adjusted. Unless the committee has a process in place to convene a quorum of members on very short notice to review or debate an investment manager or allocation change, important investment decisions could take three to six months to execute. In today's constantly evolving markets, incorporating a three- to six-month delay into the process does not result in optimal tactical asset allocation strategy.

Investment committees face the same challenges when moving through the process of assessing and, if necessary, replacing an investment manager. **This dilemma is precisely why outsourcing these activities to a professional "outsourced chief investment officer" (OCIO) has been embraced by many institutions in the last few years.**

In the current and anticipated low-return environment, it is imperative that boards/investment committees build and maintain a governance structure that can effectively utilize all three tools. Along with determining the spending policy, the board/investment committee's most important responsibility to the nonprofit organization and its donors is setting the strategic asset allocation along with the spending policy.

OUTSOURCED CIO

Over time many investment committees have changed their thinking regarding their ability and willingness to manage responsibilities related to the organization's investment portfolio. Decisions that were once straightforward have become complicated and require a high degree of technical knowledge and skill. Historically, many organizations turned to their consultants and managers for advice, leaving themselves with the final decisions on implementation. This leaves committee members and trustees in the position of having to choose among multiple providers, numerous investment vehicles and seemingly endless products and strategies. Given that many trustees and committee members have many other responsibilities, this creates an untenable situation with a high margin for error. It can also shift too much focus on this one area of overall management, thereby leaving less time and resources for the organization's core business objectives.

To overcome these challenges, nonprofits can delegate decision-making authority to a small group of board or investment committee members, or to an outside service fiduciary partner with these capabilities. Outsourcing the entire investment function to a qualified provider is an effective and prudent way for organizations to ensure they are using their resources in the most efficient manner possible, while also getting the expertise and access to the best available investment managers. Results are measured based on how the endowment's returns are contributing to the overall success of the mission, rather than arbitrary benchmarks which, in and of themselves, do not provide the value, in terms of real money, that organizations need.

Given the significant fiduciary responsibilities that all board and investment committee members face, partnering with a professional fiduciary can help navigate a more complicated investing environment.

Outsourcing the entire investment function to a qualified provider is an effective and prudent way for organizations to ensure they are using their resources in the most efficient manner possible, while also getting the expertise and access to the best available investment managers.

CONCLUSION

The financial crisis of recent years has changed the landscape for institutional investors. Investment returns have declined. Volatility has increased. Resources have been constrained. Fiduciaries have had to deal with increased scrutiny by regulators and donors alike.

Unfortunately, these difficult conditions seem likely to continue. Additionally, the investment returns of the past are unlikely to be repeated going forward, as asset classes which make up a large portion of many nonprofit portfolios, such as fixed income, are likely nearing the end of a long secular bull run. The impact of lower returns will force boards to look for additional sources of return, as well as more efficient ways to make required distributions, all in an attempt to fulfill their duties to current beneficiaries as well as future generations. **By taking an approach that is goals-based rather than the more traditional returns-based view, we feel nonprofit organizations will be better prepared to deal with this "New Reality."**

On the investment side of the equation, we believe that **strategies that employ sound strategic and tactical asset allocation methodologies, superior manager selection and better diversification using exposure to nontraditional sources of portfolio excess return are fundamental to setting the foundation for success.** By testing these strategies using rigorous "what if" scenarios, we can obtain a high degree of confidence about whether we achieve mission success or mission failure.

We also believe that **spending policy is a key driver of success in fulfilling the mission.** Organizations need to weigh the expectations of today against the obligations of the future. Several techniques can be employed to maximize the overall spending of the organization, including setting a proper spending rate, using smoothing techniques to capitalize on lower average market values to calculate distributions, and managing overall operational effectiveness to maximize available resources. Testing the effectiveness of all of these techniques by using scenario analysis and looking at potential “worst-case” results can help provide an acceptable level of confidence to board members.

Finally, addressing ongoing fundraising needs and board governance issues by having well-documented plans and processes will provide potential donors with confidence that the organization is well run, and that the investments that are made go directly toward achieving both the near- and long-term mission. Engaging professional fiduciaries like U.S. Trust can go a long way in dealing with the challenges posed by the “New Reality” of a lower-return world.

IS YOUR PORTFOLIO SUPPORTING YOUR MISSION?

Nonprofit organizations face a challenging environment going forward as they seek to maintain and expand their mission activities in an era of lower returns. Success in this “New Reality” will require creativity and flexibility, as nonprofits strive to do more with less. At U.S. Trust, we understand how critical it is to support your mission in this climate, and welcome the opportunity to discuss goals-based investing further. For more information, please contact your U.S. Trust Bank of America representative or email institutional_investments@ustrust.com.

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