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Morgan Stanley

Investment Policy Statements for Nonprofit Organizations

SUMMARY

As a nonprofit trustee, keeping your organization's portfolio on track through the market's ups and downs can be a challenging proposition. To help with this process, many institutions benefit from creating a clearly defined investment strategy to guide present and future portfolio decisions.

A formal, written investment policy statement can provide ongoing guidance on a number of critical subjects, including individual roles and responsibilities; investment guidelines; performance evaluation standards; and the frequency of communications and policy statement review. By understanding how investment policy statements come together—and how they can go awry—you can be better equipped to help your organization make prudent financial decisions for the long-term management of its assets.

A TEMPLATE FOR PRUDENT INVESTMENT DECISIONS

Through their philanthropic efforts, foundations from Maine to Maui have been making a lasting impact on their region, nation and the world. Taking on the responsibility for a nonprofit organization, such as a foundation, means assuming responsibility for that organization's stewardship and maintaining compliance with federal, state and local laws that govern your entity.

Many institutional investors have long used formal, written investment policy statements to set fiduciary guidelines and define their decision-making process. While not specifically mandated in the federal or state regulations that govern nonprofit organizations, a carefully crafted and well maintained investment policy statement is one of the best ways to document a prudent investment process.

While the importance of investment policy statements is rarely questioned, some nonprofit organizations continue to operate without this governing document. Unfortunately, the annual survey conducted by Exponent Philanthropy (formerly the Association of Small Foundations) found that more than a quarter (26%) of its members surveyed were operating without a formal written investment policy.[1]

THE IMPORTANCE OF INVESTMENT POLICY

Following the severe market downturn in 2008 and 2009, investment policy statements for nonprofit organizations have become more important than ever. Trustees and other governing board members are bound by the "prudent investor" standards that judge investment decisions. Prudent investors are required to invest with the care, skill, prudence and diligence under the circumstances prevailing at the time.

Investment policy statements, which include asset allocation strategy as one of their most important components, form the essence of endowment and foundation investment practices. The investment policy statement becomes a compass that guides organization fiduciaries. It can also help:

- Demonstrate procedural prudence;
- Define strategic and tactical asset allocation parameters;
- Guide the evaluation and selection of investment managers and advisors;
- Discourage random or emotional investment decisions inconsistent with prudent management principles;
- Promote long-term investment decision-making; and
- Provide written documentation against allegations of fiduciary imprudence.

Studies have shown that non-profit fiduciaries and directors meet on average four times per year.[2] Written investment policy statements can provide committees and board members with the structure necessary to conduct regular discussions about investment oversight as part of these meetings.

WHAT'S IN THE INVESTMENT POLICY STATEMENT?

Typical investment policy statement features may include:

- Investment objectives of the institution
- Asset allocation strategy
- Performance benchmarks
- How endowment earnings or returns relate to spending policy
- The degree of risk permitted in the investment portfolio
- Portfolio rebalancing strategies and frequency of rebalancing
- Considerations relevant to the hiring, retaining and firing of investment managers
- Use of social investing criteria and/or mission-related investing along with related investment restrictions
- Endowment sustainability as an influence on investment decision making
- The degree of liquidity required in the investment portfolio
- Definitions of roles and responsibilities of members involved in the investment process
- Frequency of investment policy statement review

The following sections describe some common components of an investment policy statement in more detail.

STATEMENT OF PURPOSE

The statement of purpose should define your entity, its mission and include information about overall investment operations. It should:

- Define and assign the responsibilities of all involved parties
- Establish a clear understanding of the overall investment goals and objectives
- Discuss how the investment policy statement will meld with the spending policy statement
- Establish the relevant investment horizon for which the foundation's assets will be managed

In general, this section will outline your philosophy governing the management of assets. It is intended to be sufficiently specific to be meaningful, yet flexible enough to be practical and effectively implemented.

STATEMENT OF RESPONSIBILITY

Your foundation most likely has a board that oversees your mission, guides operations, makes investment decisions and ensures ethical conduct. Members of your governing board should be involved with the creation of the investment policy statement and possess the knowledge and experience to make informed investment decisions.

The statement of responsibility section should clearly define who is responsible for directing and monitoring assets. It should also outline

Institutional Asset Allocation

The chart below shows the dollar-weighted asset allocations of institutions grouped by the size of their endowment assets over the past two years. Average allocations to nearly all asset classes changed significantly as the size of the institutions increased.

Institution Size	$101 - 500 MILLION		$51 - 100 MILLION		$25 - 50 MILLION		UNDER $25 MILLION	
	2012	2013	2012	2013	2012	2013	2012	2013
Asset Class								
Domestic Equities	25%	27%	31%	33%	35%	36%	39%	43%
Fixed Income	16	15	22	20	24	22	29	26
International Equities	18	19	18	20	16	17	14	14
Alternative Strategies	36	34	24	23	19	20	11	11
Short-term Securities/Cash/Other	5	5	5	4	6	5	7	6

Source: Consulting Group, based on data in the 2012 and 2013 NACUBO-Commonfund Study of Endowments the delegation of responsibilities to investment consultants, investment firms and custodians.

Additional specialists such as attorneys, auditors and actuaries should have their responsibilities and obligations outlined in this section.

GENERAL INVESTMENT PRINCIPLES AND OBJECTIVES

In general, this section should define liquidity needs, investment time horizon, investment restrictions and unique circumstances. It should include general guidelines for:

- Adherence to prudent investor standards
- The overall investment goals of the foundation
- Allowable assets including the use of alternative investments
- Definition of annual spending policy and liquidity requirements
- Asset allocation and diversification requirements
- The selection, hiring and monitoring of investment managers

General guidelines for investment management might cover:

- Preservation of capital
- Risk aversion
- Investment discipline adherence
- Attitude towards future gifts and bequests
- The use of socially responsible investment strategies
- Any investment restrictions, prohibited assets and prohibited transactions

SPECIFIC INVESTMENT GUIDELINES

This section should provide details about your organization's specific asset allocation strategies. For example, an endowment seeking current income with capital appreciation—or a moderate investor profile—may wish to state investment guidelines like those in the table on the previous page.

This section should also include guidelines for the selection, hiring and monitoring of investment managers. It should include any restrictions on certain assets such as fixed income investments (e.g., only investment grade bonds rated BBB [or equivalent] or better).

Some of these stipulations would in turn govern the selection of investment managers, a process that must be based on prudent due diligence procedures. These procedures could include a review of key qualitative factors such as the overall financial health of the firm, the depth of its portfolio management and research team, its technological capabilities and the strength of its investment process. Other key factors could be quantitative, such as a review of past performance results and levels of investment risk.

The specific investment guidelines section should also include the market benchmarks that will be used to evaluate the performance of each asset class, investment style and the investment manager responsible for each portion.

STANDARDS OF REVIEW AND EVALUATION

The standards of review and evaluation should stipulate the type and frequency of performance reports and who is responsible for their preparation and review. The investment performance of the total portfolio as well as the asset class and manager components should be measured against commonly accepted performance benchmarks, which are defined in the investment policy statement and are consistent with the investment objectives, goals and guidelines established by the foundation's statement of purpose.

This section could also include guidelines for the termination of an investment manager. Some reasons could include:

- Investment performance that is significantly less than anticipated given the discipline employed, market conditions and the risk parameters established, or unacceptable justification of poor results
- Failure to adhere to any aspect of the statement of investment policy, including communication and reporting requirements.
- Significant quantitative or qualitative changes to the firm or its investment process.

Over time, market forces may pull your portfolio away from its stated long-term targets, which may leave your organization exposed to more risk than you want or expect. This section of your investment policy statement should also include guidelines on rebalancing strategies and how frequently those periodic course corrections will be made.

COMMUNICATION, REPORTING AND REVIEW

Foundation governing boards and trustees should outline their policies for maintaining the investment policy statement and how frequently it will be reviewed. In general, investment policy statements should be reviewed no less frequently than annually and distributed to all investment managers, consultants and other advisors responsible for providing advice to your foundation.

It is advisable to collect signatures from all individuals responsible for adopting and abiding by the policies outlined in the statement. To be effective, the investment policy statement should be monitored, re-evaluated and modified as needed to reflect your organization's mission.

COMMON PITFALLS OF INVESTMENT POLICY STATEMENTS

A poorly written investment policy statement may often do more harm than good. Some common problems of a poorly crafted policy include:

1. Lack of consensus. Your investment committee and board of directors, whether they are one and the same, should possess a level of agreement about your foundation's general investment guidelines and goals.
2. Unclear language. Investment policy statements should be specific

and clearly state their guidelines. Avoid vague and misleading statements. For example, few investors would probably state that their "tolerance for investment risk is a standard deviation of 10.5%." A statement like this would be more useful when translated into something more tangible.

3. Unrealistic goals. Ensure that your investment committee and governing board understand historical market performance and investment results. Obviously, while it would be well received, it would be unrealistic to expect a 30% annual rate of return over an applicable market benchmark.
4. Overly restrictive guidelines. Investment policy statements can often be overly restrictive. Minimize restrictive language as much as possible—especially when delegating investment authority to professional managers. For example, each investment manager should be allowed to invest in specific sectors depending on their individual investment philosophy and process.
5. Failure to set risk parameters and liquidity requirements. The severe market downturn that accompanied the 2008-2009 Recession alerted nonprofit investment committees and boards to the true meaning of risk management and liquidity requirements. Establishing a process to re-evaluate risk tolerance and setting liquidity guidelines directly within the investment policy can help your foundation stay on track during times of market stress.
6. Lack of communication. A copy of your investment policy statement should be sent to each investment manager, consultant and advisor involved with your foundation. You should ask each individual or firm to acknowledge, in writing, their understanding of the policy and their responsibility to the endowment.
7. Failure to review. Your policy statement should be regularly reviewed to ensure the continued relevance of its guidelines, objectives and capital markets expectations. In general, investment policy statements should be reviewed no less frequently than annually.

> *"Accepting the role of trustee in the past was often more of an honorary title. It involved a high degree of community recognition with little personal risk, time commitment or aggravation, unless you were selected to be a member of the inner circle of leadership. Today, in our litigious society, the role of a trustee requires a high degree of active participation, searching inquiry into management decisions and careful monitoring of investment activities, personnel and other operating policies."* [3]

CONCLUSION

Your investment policy statement cannot be a simple boilerplate document; it must reflect the goals and objectives of your individual foundation. It should represent the hearts and minds of your trustees and governing boards. To be effective, trustees and board members should have a clear understanding of its contents and agree on its key sections.

Your organization should view its investment policy statement as a roadmap to the investment process. Only then can it provide the guidance necessary for your trustees, board, investment managers and consultants.

1 2013 Foundation Operations & Management Report, Exponent Philanthropy.

2 Ibid.

3 Meadows, Curtis W., "Duties and Responsibilities of a Trustee - The Family Advisor: Trustee Orientation." Council on Foundations, www.cof.org. (Originally published in *Family Matters*, Fall 1996.)

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