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GOVERNANCE IN TURBULENT TIMES: An Endowment Perspective

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Report Contents

Legislation: Primarily Good News....1
Accounting: What Exactly Is Endowment?....3
Disclosures: The New IRS 990 Form....6
Risk: A New Focus....9
Governance and Organization: The Bigger Picture.... 15

Related Cambridge Associates Research Reports.... 17

Governance in Turbulent Times: An Endowment Perspective

Recent years have seen a torrent of new developments in the governance of nonprofit institutions and the management of their endowments. While fundamental "best practices" indirectly triggered by the 2002 Sarbanes-Oxley legislation remain in place, some have been augmented. In addition, certain critical aspects of endowment management have been singled out for particular attention. These include the very definition of "endowment," the spending of endowment, the measurement of liquidity, and the amount of disclosure regarding Board and committee matters. The agents of change have been state legislation, federal legislative inquiries, accounting rules, and tax filings. Yet while these changes were being pursued, they were overtaken by the 2008 market crash, in turn followed by unprecedented close scrutiny of risks associated with endowments. Together these events have led to a reassessment of both organization ("management") and governance of endowed institutions.

The discussion that follows addresses the following key developments:

- **Legislation:** more flexibility in investing and spending.
- **Accounting:** less flexibility in accounting for funds.
- **Disclosures:** even more disclosures are now required by the legislative changes, the accounting changes, and particularly the revised IRS 990 tax form.[1]
- **Risks:** increased focus on risks, with particular emphasis on liquidity, leverage, and operations in the aftermath of the significant diminishment of most endowments since 2008.
- **Governance structure and process:** reappraisal of organizational and governance details, with an eye toward avoiding undetected or underappreciated risk.

While encyclopedic lists of particulars nearly always induce drowsiness (even to the author), it is the intent of this report to serve as a handy reference to recent changes in the overall terrain of governance. If one section is old hat to the reader, please proceed to the next.

Legislation: Primarily Good News

The Uniform Prudent Management of Institutional Funds Act (UPMIFA), promulgated as model legislation in 2006, has been undergoing state-by-state adoption ever since. With a few exceptions—including Florida, New York, and Pennsylvania—it has now been adopted by nearly all states. Each state's law varies from the model law in certain particulars. Thus, each nonprofit organization must consult the law of its own state. Notwithstanding certain statutory variations, the main consequence of UPMIFA adoption is to "modernize" the fiduciary guidelines of previous legislation.[2]

The effect of most of the changes is to increase trustees' flexibility in investment and spending

[1] Senate and House inquiries focusing on tax-exempt status, conflicts of interest, executive compensation, and erstwhile "bloated" endowments have been among the reasons that the IRS 990 form was so extensively revised.

[2] UMIFA (Uniform Management of Institutional Funds Act) applied to charitable entities governed by corporate law—the majority of nonprofit entities. UPIA (Uniform Principal and Income Act) is applicable to entities organized as charitable trusts.

decisions, assuming that certain conditions are met. Highlights of the new requirements are provided below.[3]

Pertaining to Investing

- **Investment management costs:** must be "appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution." Scale, complexity, and the ability to hire adequate staff would be among the considerations.

- **Duty to investigate:** trustees should make "a reasonable effort to verify facts relevant to the management and investment of the fund." Audited financial statements, external performance reports, and the use of consultants and peer comparisons are among the due diligence steps that can be taken.

- **Investment decisions must be taken with the following eight factors in mind** (unless otherwise directed by donor intent):
    1. general economic conditions;
    2. the possible effect of inflation or deflation;
    3. the expected tax consequences, if any, of investment decisions or strategies;
    4. the role that each investment or course of action plays within the overall investment portfolio of the fund;
    5. the expected total return from income and the appreciation of investments;
    6. other resources of the institution;
    7. the needs of the institution and the fund to make distributions and to preserve capital; and
    8. an asset's special relationship or special value, if any, to the charitable purposes of the institution.[4]

- **Use of investment strategy:** investment decisions must be made in the context of the overall investment portfolio and "as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution."

- **Duty to diversify:** "prudence requires diversification [except] . . . under exceptional circumstances."

- **Use of special expertise:** persons with fiduciary responsibility and possessing special expertise in investments have "a duty to use that expertise in managing and investing institutional funds."

Pertaining to Endowment Payout or Accumulation

- **Spending versus accumulating:** in deciding whether to spend from an endowment fund or to accumulate, trustees must consider the following seven factors (subject to donor intent):
    1. the duration and preservation of the endowment fund;
    2. the purposes of the institution and the endowment fund;
    3. general economic conditions;
    4. the possible effect of inflation or deflation;
    5. the expected total return from income and appreciation;
    6. other resources of the institution; and
    7. investment policy of the institution.

- **Underwater endowments:** the above removes the necessity (under previous legislation) to maintain the historic dollar value of the original gift to endowment,

[3] The points below are extracted from the *Uniform Prudent Management of Institutional Funds Act*, National Conference of Commissioners on Uniform State Laws (NCCUSL), July 2006, www.upmifa.org.

[4] An example would be prohibition against investing in tobacco products. Assets held *primarily* for program-related purposes are not subject to UPMIFA but to other state law.

assuming the seven factors are adequately weighed when spending permanently restricted net assets.[5]

- **Optional 7% rule:** spending in excess of 7% of the endowment market value averaged over at least the preceding three years "creates a rebuttable presumption of imprudence." Although a given state may not have adopted this rule, its articulation in UPMIFA may create an expectation that an endowment should be prepared to defend to its constituents, if pressed, its reasons for exceeding this suggested guidance. Note that "the seven percent figure includes charges for *fundraising* and *administrative expenses other than investment management fees*."[6] (italics added)

In sum, the adoption of UPMIFA has generally been good news for trustees charged with endowment investment responsibilities. It goes even farther than previous legislation (UMIFA and UPIA) to align investment committee decisions with modern portfolio theory. It provides flexibility in decision-making by serving up a roster of considerations that should be taken into account—and can be used to bolster—complex decisions made during times of extraordinary financial and economic stress, such as the present time. And it unfetters access to endowment gifts that have fallen below their historic dollar value. On the other hand, it does focus more explicitly on such matters as investment management costs, the "duty to investigate," the duty to use one's special expertise, and (where adopted by a given state) a rebuttable presumption of imprudence when spending more than 7% of the endowment's market value.

Recommendations

- Rewrite your investment policy statement, if necessary, to cover the eight considerations for prudent investing, listed on page 2.

- Revise your endowment spending policy, if necessary, to reflect the seven considerations for prudent spending, listed on page 2.

- Document consideration of these factors in meeting minutes, materials prepared to support the agenda discussions, or both.

- Review gift acceptance terms to align the long-term goals of the endowment and the institution with any constraints imposed by endowment gifts, avoiding restrictions that would prevent default to the relatively flexible UPMIFA guidelines.

- Seek legal counsel to ensure compliance with your state's version of UPMIFA.

Accounting: What Exactly Is Endowment?

First, some history: over decades of endowment growth, trustees had become comfortably settled in dealing with the concepts of "true" endowment (the original gift), quasi-endowment, and term endowment. Then in 1993, the Financial Accounting Standards Board (FASB) issued FAS 117, which required that investment assets be classified into permanently restricted net assets (donor-restricted), temporarily restricted net assets (term endowment[7]), and unrestricted net

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[5] Specific donor intent, expressed in the gift instrument, can rule out the spending from the original gift amount. "However, if the gift instrument uses more general language, for example directing the charity to 'hold the fund as an endowment' or 'retain principal and spend income,' then [UPMIFA] provides a rule of construction to guide the charity." *UPMIFA*, page 21.

[6] *UPMIFA*, page 27.

[7] "The portion of a term endowment that must be maintained for a specified term is classified as temporarily restricted net assets." *FSP FAS 117-1*, page 1, www.fasb.org.

assets. Thereafter, unrestricted net assets came to include virtually anything *not* donor-restricted nor meant to be drawn down over a specified term. With the rapid growth of endowments through the 1990s and until the recent market collapse, unrestricted net assets swelled with the addition of capital gifts, unspent earnings on all categories of assets (including those that are permanently restricted), and operating surpluses. Unrestricted funds could be broken down into board-designated endowment, operating reserves, stabilization reserves, reserves for capital improvements or maintenance, and many other purposes—all considered unrestricted. Significantly, debt rating agencies used "unrestricted net assets" as a key measure of funds available to support debt.

Now FASB has tweaked the new typology. Citing the needs of donors, credit rating agencies, and regulators, and the "tremendous growth" of endowments over the previous decade, FASB seeks to address "significant questions about the reporting of donor-restricted endowment funds." The more immediate impetus was the state-by-state adoption of UPMIFA, which, among other things, eliminated the historic dollar value threshold and triggered the question of how to reflect on the books any spending from an "underwater endowment."

The new guidance includes two major changes: (1) a potentially significant portion of endowment that was previously classified as "unrestricted" will now have to be classified as "temporarily restricted" and (2) audited financial statements will now have to include vastly expanded disclosures on endowment management and endowment payout policy.

Reclassification of Endowment Assets

Over the years, some endowments have accumulated significant earnings on restricted gifts to endowment. The portion of earnings not spent has typically been classified as "unrestricted net assets" associated with the donor-restricted funds. Beginning in 2009, such assets will be classified as "temporarily restricted net assets," with the result that unrestricted funds will decline.

Does this matter? In many if not most cases, the answer is no. If the temporarily restricted net assets are *not restricted as to purpose* (for example, the unspent earnings from an unrestricted gift to endowment), then the budgetary impact should be zero. Even if there is a purpose restriction, there should be little or no impact unless there are a significant number or scale of gift assets that have very narrow purposes—for example, if a sizable percentage of the endowment consists of a gift for a very specific and incremental program. In contrast, a gift to a university endowment restricted for the purpose of student financial aid will generate earnings—now to be classified as "temporarily restricted net assets"—that can be used to replace financial aid funds from an unrestricted source (such as tuition). Such substitution is known as "fungibility," and the greater an institution's budgetary fungibility, the less the impact of any reassignment of erstwhile unrestricted net assets.

Note that unlike donor-restricted funds, board-designated endowment funds are always to be considered unrestricted in an accounting sense. Some organizations will need to research which portions of their endowment are effectively board-designated, because some boards have treated a portion of their assets as permanent for planning purposes, and such treatment over many years can obscure the accounting origins of portions of the endowment. *Permanently and temporarily restricted net assets are always driven by donor intent.*

Because of FAS 117-1, the definition of an institution's "endowment" now rests more explicitly on state law. Since UPMIFA is newly

enacted—or not yet adopted by a given state—and there is little or no case law relating to its interpretation, FAS 117-1 suggests that "organizations could look to other sources, such as the discussion that occurred in the legislative committees leading to the law adopted in a particular state, announcements from the state attorney general, a consensus of learned lawyers in the state, or similar information, to help them understand what the law requires."[8]

Extensive New Disclosures

The new accounting guidance requires that financial statements and footnotes disclose at least the following:

1. A description of the governing board's interpretation of the law(s) that underlies the organization's net asset classification of donor-restricted endowment funds.
2. A description of . . . its endowment spending policy(ies).
3. A description of the organization's endowment investment policies . . . [including] return objectives and risk parameters; how those objectives relate to the organization's endowment spending policy(ies); and the strategies employed for achieving those objectives.
4. The composition of the organization's endowment by net asset class . . . showing donor-restricted endowment funds separately from board-designated endowment funds.
5. A reconciliation of the beginning and ending balance . . . including . . . investment return, separated into investment income . . . and net appreciation or depreciation of investments; contributions; amounts appropriated for expenditure; reclassifications; and other changes.[9]

In addition, based on previous accounting guidance, the institution must disclose the types of permanent and temporary restrictions on the donor-restricted portion of the endowment, and the amount by which such funds are "underwater."

Recommendations

- No need to start from scratch. Examples of all of the above disclosures are provided in Appendix C of FAS 117-1, and should be consulted for the purposes of compliance. These examples also provide language that may be adapted to the circumstances of a particular endowed institution.

- Keep your eye on strategic objectives. Neither legislation nor accounting should distract from the operating and strategic role of the endowment and other funds, however those funds may be defined for legal and accounting purposes. Accordingly:

  – Be clear about which funds are part of the permanent capital base of your institution for strategic planning purposes. These are likely to include, where possible, unrestricted as well as restricted assets. And they will include both donor-restricted and board-designated funds. Whatever they are called, they must be invested with long-term return objectives adjusted for risk.

  – However, be careful when determining (beyond explicit donor stipulations) "the amount that . . . must be permanently retained consistent with relevant law." Because FAS 117-1 requires that in underwater situations spending come from unrestricted funds (despite no legal obligation to restore a permanently restricted fund to historic dollar value), "a Board will want to be careful about making a determination that a portion of

[8] *FSP FAS 117-1*, page 3.
[9] *FSP FAS 117-1*, page 5.

a fund is permanently restricted."[10] For example, it may be wise to avoid placing an entirely unrestricted bequest into permanently restricted net assets, no matter how unrestricted its purpose—because, after all, it could be regarded (for strategic planning purposes) as permanent capital even if it is placed into unrestricted net assets. And think twice before determining that inflation must be a factor in defining what is permanently restricted—unless required by the donor or otherwise by your state law.

- Review donor intent in order, where possible, to increase fungibility. The broader the applicability of donor intent, the more that accumulated unspent gains on restricted endowment (now "temporarily restricted" instead of unrestricted) can be used to replace the use of unrestricted funds.

- Consider your debt ratios. If your institution has issued debt, the new definition of "unrestricted" will mean that those debt ratios that are based on unrestricted net assets will now appear less favorable. One debt rating agency (Moody's) has issued a report that states that in most cases this will have no effect on the institution's bond rating.[11] However, Moody's has just begun to supplement its analysis with additional detail on liquidity, and the new liquidity ratios add an extra dimension to consideration of whether even unrestricted funds are effectively accessible for the purposes of debt service. (See Risk: A New Focus section on page 9.)

- Look to your loan covenants. The diminishment of unrestricted net assets, because of the accounting change, might trigger a technical covenant violation. If this is the case, seek a waiver of any such covenants, which might be found in bank agreements or swap agreements. Unfortunately, in a tight credit environment, the creditor might be unreceptive or tighten other terms.

Disclosures: The New IRS 990 Form

The newly revised Internal Revenue Service (IRS) 990 tax form, first filed during 2009 for the 2008 tax year, is sweeping in its range of new disclosures.[12] Of particular relevance to trustees involved with investments are disclosures regarding governance structure and process, expenditure of endowment funds, executive compensation, outsourcing, investment management costs, and conflicts of interest including investment dealings with former officers and "key employees." In the voluminous pages of forms and instructions that the new survey now extends to, the following points appear to be more probing and of particular import to investment committees.

Governance structure and process. The form asks for the number of voting members and the number of "independent" board members.[13] It inquires whether meetings of the board and its committees are "contemporaneously documented." It asks whether any officer, trustee, or key employee has a family relationship or

[10] Ropes & Gray, *Underwater Endowment Funds: Legal and Accounting Considerations*, March 31, 2009. www.ropesgray.com

[11] Moody's, *UPMIFA Implementation by Endowed Organizations Will Not Alter Credit Evaluation Following Changed Accounting Treatment: Balance Sheet Will Appear More Restricted, But Economic Fundamentals Are Largely Unchanged*, April 2009.

[12] The IRS 990 PF for private foundations has not yet been revised.

[13] "Independent" is defined as a board member who is not an officer of the organization nor any related organization; not receiving more than $10,000 for board duties; and not (nor any family member) involved in any transaction with the organization that is reportable on Schedule L, *Transactions With Interested Persons*.

business relationship with any other officer, trustee, or key employee. It requests information on board policies in place, such as whether there exists a conflict of interest policy and a compensation policy, and on certain particulars of these policies. (*Form 990*, Part VI)

Expenditure of endowment funds. The new 990 form now requests five years of data on endowment balances, gifts, and investment earnings. More unusual, it asks for expenditures from the endowment for "grants or scholarships,"[14] programs and facilities, and administrative expenses. Looking forward, it asks for "the intended uses" of the endowment funds. (Schedule D, *Supplemental Financial Statements*, Part V)

Executive compensation. An organization must list the names of *all* officers, trustees, key employees, and highest compensated employees. The compensation of each of these individuals must be listed, along with "average hours per week." Certain former officers, employees, and trustees must also be listed. On a separate schedule (Schedule J) questions are asked about the process used to establish the compensation of officers and key employees—compensation committee, independent compensation consultant, peer survey, etc. The schedule then requires a breakdown of compensation for all officers, key employees, and highest compensated employees into such categories as base compensation, bonus and incentive compensation, deferred compensation, and nontaxable benefits. (*Form 990*, Part VII and Schedule J, *Compensation Information*)

[14] No doubt driven in part by the Senate Finance Committee 2007–08 inquiry into whether large endowments in higher education provided adequate financial aid to deserving students. In a follow-up to this initiative, around 400 tax-exempt institutions are now subject to even more detailed inquiries by the IRS.

Outsourcing. Organizations must report whether they have "delegated control over management duties customarily performed by or under the direct supervision of officers, trustees, or key employees to a management company or other person." Excluded are "administrative services (such as payroll processing) that do not involve significant *managerial* decision-making." (italics added) "Investment management" is also excluded, although it is unclear whether this exclusion is limited to asset management functions. (*Form 990*, Part VI, including accompanying instructions)

Investment management costs. In a section requiring a list of fees for services, "investment management fees" are listed along with fees for management, legal, accounting, lobbying, and professional fundraising services. Investment management fees are described as fees for "investment counseling and portfolio management," including "monthly account service fees" but excluding brokerage fees and commissions. This language appears to include asset management, investment consulting, custody, research, performance reporting, and "outsourced chief investment officer (CIO)" arrangements. (*Form 990*, Part IX, including accompanying instructions)

Conflicts of interest. Along with executive compensation, this is one of the key areas of the revised 990 form. One item that is highlighted is business transactions "between the organization and a management company of which a former officer, trustee, or key employee of the organization . . . is a direct or indirect 35% owner, or an officer, director, trustee, or key employee." If such is the case, the amount of the business transaction is reportable for five years after the departure of the key employee. Thus, with respect to investments, if an institution purchases services from an independent contractor—such as an investment consulting firm or an "outsourced

CIO" arrangement—*and if a key position in that firm is occupied by a former officer, etc., of the institution*, then the institution must report the amount of the fees paid to this independent contractor on the same schedule that is used to report conflicts of interest. (Schedule L, *Transactions With Interested Parties*, including accompanying instructions) Other elements of Schedule L are not different from most conflict of interest policies already in place. In addition to other "interested" business transactions, the schedule covers "excess benefit transactions" (an old chestnut of conflict of interest situations), loans to or from interested persons, and grants that benefit interested persons. There is a "reasonable effort" provision that relieves the institution of having to report information on conflicts of interest that are not identified "after making a reasonable effort to obtain it." An example of a "reasonable effort" is the annual distribution of a questionnaire to all current and former officers, trustees, and key employees listed earlier in the 990 filing. This process point is not a requirement, but a suggestion.[15]

Recommendations

- Start early on your annual IRS 990 filings: the core survey and the numerous additional schedules are extensive, and the accompanying instructions even more so. Annual processes such as the financial audit, financial aid and program expense allocations, the conflict of interest survey procedure, and so forth, should tie into your IRS filing.

- For the sake of efficiency and internal consistency, incorporate where possible the disclosures already required *both* by FAS 117-1 (above) and the IRS. However, do not disclose more information than required by the 990 form unless you are prepared for public disclosure of the information, because all information on IRS 990 filings is more readily in the public domain, excepting redaction of individuals' social security numbers.

- Identify "sensitive" information, such as compensation levels, conflicts of interest, and fees for investment managers, and be prepared with answers in the event of press coverage.

- Ensure that sensitive decisions are well documented and supported by minutes and discussion materials, as well as by measures to provide context to any given decision: peer comparisons, outside expert advice and due diligence, historical trends (e.g., toward outsourcing), and governance structure (e.g., a compensation committee) and process (e.g., formal approval and/or contract).

- If necessary, tighten conflict of interest policies and procedures to align with IRS reporting requirements and with due consideration of "headline risk."[16]

- Make sure that executive compensation levels and business transactions with interested parties are appropriate in terms of dollar amount, scale and scope of responsibilities—and in terms of potential *alternative* transactions or hires.

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[15] See also our 2005 report *Conflicts of Interest: A Trustee's Guide to Conflict of Interest Policies with a Particular Focus on Investment Committees.*

[16] The IRS asks whether officers, trustees, and key employees are "required to disclose annually interests that could give rise to conflicts." Such interests have recently been the subject of embarrassing headlines. Hence, it is advisable to require and to monitor closely disclosures by investment staff of any employment arrangements with, or compensation from, other entities. Guidelines prohibiting sharing with external parties information available to the investment committee or the investment office should also be in place. This guideline should apply to trustees as well as officers and key employees, including trustees who serve on the investment committees of two or more institutions.

- Consider tweaking your governance structure and process in order to put your best foot forward. For example, a board might change the ratio of independent to non-independent trustees, reduce conflicts of interest, add a compensation committee, change the relationships among committees, increase or reduce overlap among committee members, and the like.

Risk: A New Focus

Market turbulence, the credit crisis, and a grinding recession have had a deleterious effect on the financial condition of endowed institutions, in some cases savaging the ability of the endowment to support its institution. Leverage, liquidity, and volatility are risks that are present in an investment portfolio and also in operations. When it comes to governance, it is safe to assume that most investment committees have increased their deliberations about portfolio risks.[17] Beyond the discussion of portfolio risk, however, there is now also a question of risks that are related to the portfolio but external to it.

Operating Risk: No Longer in the Wings

"Operating" risks, like portfolio risks, include leverage, liquidity, concentration, and volatility. Typical operating risks are high fixed costs, volatility of other (non-endowment) revenue sources, revenue concentration, endowment access and flexibility, low working capital, excessively restricted gifts, and tenuous debt ratings. Most of these topics do not belong *first* on an investment committee agenda, as they are more properly the business of the finance or budget/planning committee, the development committee, and/or the audit committee. Nevertheless, events over the past two years have amply demonstrated that investment committees cannot afford to be uninformed about at least some of these ancillary factors. Indeed some have already addressed the interface of endowment and operations by devising (for example) stabilization reserves or by setting and maintaining new liquidity measures to fund expanded endowment spending as well as to meet capital calls and to harbor sufficient "dry powder." Two critical questions are:

- To what degree and in what manner should investment committees be cognizant of operating matters and operating risks in particular?

- Should portfolio construction be informed by the operating picture? If so, would that be an informal nod? A tweak to the deliberation process? Or a more formal mechanism such as "dashboard warning lights" for tactical positioning, re-sizing of stabilization reserves, revision of strategic policy asset allocations, and so forth?

Debt: Do More Disclosures Lead to More Risk?

For those institutions that have issued debt, one topic that is likely to become more prominent in endowment management is an important upcoming change in the debt ratios used for rating debt issues. In January 2010 Moody's sent to its rated institutions a set of worksheets requiring that they report on *the degree of liquidity in both their endowment and their operating funds*. All the assets in each of these two buckets—endowment and operations—are divided into three liquidity groups: cash-liquid within a month, cash-liquid within a year, and "liquidity with lockup of greater than a year." These new measures will be used by Moody's to calculate the new ratios, such as the

[17] On portfolio risks, see, for example, our February 2009 Asset Allocation in the Current Environment report *Hard Choices for Hard Times*, our October 2008 report *Liquidity Considerations in Today's Environment*, and our 2009 report *Behavioral Risk*.

ratio of monthly liquidity to demand debt. Once a sufficient number of institutions have returned their worksheets, Moody's will develop benchmarks based on the new ratios. These, in turn, will influence their rating actions.

Is this something that investment committees want to worry about? Certainly not. But these granular liquidity disclosures are likely just the beginning of questions that might be raised about the role of the endowment in the financial strength of the institution. While Moody's itself believes that there is little likelihood that many bond issues will be downgraded, there is palpable concern on the part of some institutional investors. Moody's concedes that this added liquidity information is unlikely to lead to any upgrades at all, and so investors perceive only potential downside to this new information, particularly since some of the institutions rated AAA that have been major issuers of debt are also reported to have more difficulties with liquidity—although others have generous reserves as well as taxable-debt capacity to help see them through the short term.

"Dependence Risk"

In addition to these operating risks, which are imminent short-term budget issues, there is also the fundamentally *strategic* issue of the extent to which an institution depends upon its endowment for current revenues—a metric that might be termed "dependence risk" or concentration risk. The issue is strategic because it typically requires a long-term plan either to increase materially the endowment's contribution to an institution's revenue structure, or to decrease it. This "dependence risk" can range easily from a relatively inconsequential 5% or less, to a formidable 50% or more. An institution that depends upon its endowment for 20% or more of its revenues is well advised to anticipate measures that might be taken—both in its portfolio and in its operations—to hedge the risk of a market collapse or even a more modest diminution of endowment. Indeed, our own modeling has shown that there is about a 28% probability that endowment spending distributions will decline by at least 10% in real dollars over a five-year period, assuming the asset allocation of the Cambridge Associates universe of endowments of $1 billion or more and a spending policy of 5% of a 20-quarter rolling average. Obviously this is not a trivial risk.[18]

Another way to frame this issue is in terms of "enterprise risk." Just as an insufficiently diversified endowment portfolio carries excessive risk, so too does an inadequately diversified revenue structure. An organization that depends upon this single revenue source for over 40% or over 50% of its revenues can be characterized as having excessive exposure to the capital markets. Historically, this exposure grew not only because of a long-running succession of bull markets, but also because rising asset values were allowed to drive more spending and bigger budgets (i.e., a higher cost structure) at endowed institutions. As one long-time observer put it, with plenty of salt:

> Suddenly we are reading of serious college cutbacks and janitors being laid off. What has precipitated this crisis is a decline in a broad range of assets to . . . <u>fair price</u>!
>
> So why would a drop to fair value induce so broad a crisis? <u>Clearly this was a budgeting problem rather than an investment performance problem</u>. Because asset prices had been above normal prices for most of the last 20 years (defined, as usual, by normal profit margins times normal p/e ratios), the budgeting departments, sometimes perhaps

[18] Other results of our spending model simulations can be found in our letter to the Senate Finance Committee dated February 20, 2008, which was a response to their January 24, 2008, inquiry to large colleges and universities. This letter is available on our client website under the Investment Planning section of our research report library.

> advised by investment committees, had built abnormally high prices into normal income assumptions. The percentage of the budget coming from the endowments had been allowed to increase with the rise of valuations.[19] (emphasis in the original)

This particular observer is an asset manager. Others who are not asset managers, or who are asset managers with investment committee experience, have made similar observations about dependence risk.[20] The point here is *not* that high exposure to endowment performance is necessarily a bad thing, but that such dependence should drive steps to offset this risk. Over the years, such steps to moderate strategic dependence risk have varied. They include: restraint in taking on additional fixed costs, conversion of fixed to variable costs, strategic enhancement of other revenue streams to increase revenue diversification, adjustments in program "pricing" (tuition, gift terms, financial aid, indirect cost recovery rates, etc.), stress-testing debt capacity during "tail risk" events, expansion of contingency lines of credit, relative centralization of program objectives and cost growth, higher hurdles for acceptance of non-fungible restricted gifts, the sizing and appropriate investment of operating reserves, and "financial equilibrium" modeling. Institutions that had undertaken such measures suffered less severe adverse consequences from the market crash.

However, virtually no one anticipated or modeled such a precipitous market decline, and thus even those institutions that had taken precautionary steps found it necessary to scramble for budget adjustments if not liquidity. The chart on the next page shows the asset allocation of 66 private universities and colleges as of June 30, 2008, the last fiscal year before the major market decline was reflected in their financial reports. Although those with "small" endowments ($200 million or less) generally had greater allocations to fixed income and public equities than did the larger endowments, asset allocation did not vary much with endowment dependence. This was also the case with the large endowments ($1 billion or more), although they of course had substantially greater exposure to alternative assets. In other words, asset allocation tended to reflect endowment size (with concomitant investment opportunity set) rather than degree of endowment dependence. In fact, among the "medium" sized endowments ($200 million to $1 billion), asset allocation was the *reverse* of what might have been expected, with the institutions most dependent on endowment also having the greatest exposure to alternative assets and the lowest to fixed income.[21] This, of course, begs the question of whether it is appropriate to set asset allocation on the basis of endowment dependency with its potential impact on operations. And, if appropriate, then to what extent and by what means and approaches?

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[19] Jeremy Grantham, "Just Deserts and Markets Being Silly Again," *GMO Quarterly Letter*, October 2009, page 7.
[20] See, for example, Burton A. Weisbrod and Evelyn D. Asch, "The Truth About the 'Crisis' in Higher Education Finance," *Change* magazine, January/February 2010. Weisbrod is professor of economics at Northwestern University, and Asch is research coordinator at the Institute for Policy Research at Northwestern University. William F. Massy of the Jackson Hole Higher Education Group, and former vice president for finance at Stanford University, has modeled enterprise risk. A former director of Harvard's endowment and chairman of other endowed institutions, Edward H. Ladd, has written a white paper on the subject, "Lessons We Might Learn from the Financial Panic: For Institutional Investors, Especially Endowments and Foundations," *Standish (BNY Mellon Asset Management Company)*, September 2009, page 6. See also our 2003 report *Reversal of Fortune: The Effect of the Market Decline on the Budgets of Endowed Institutions*.

[21] There is, of course, a meaningful difference in liquidity among alternative assets: hedge funds have varying degrees of liquidity, while non-marketable investments such as private equity are not only illiquid but have a call on liquidity.

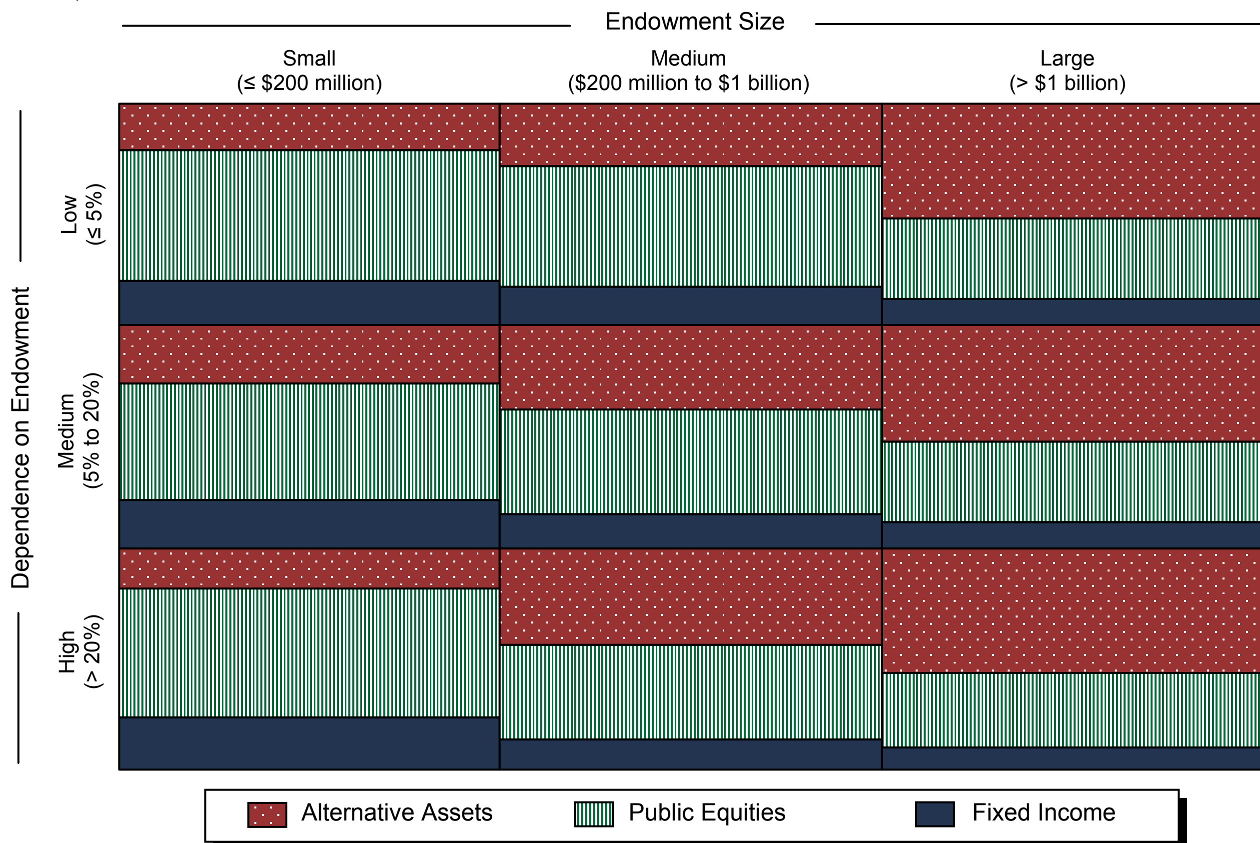
A related and important question is: what is the role of the endowment at any given institution? A few institutions with little endowment dependence may seek to grow their endowments aggressively to support a given long-term objective. Some other institutions may decide to invest in strategic program initiatives today, at the expense of endowment growth. However, most investment committees simply seek to preserve the purchasing power of the endowment while mitigating portfolio risk. Over many years, the most frequently articulated risk has been failure of endowment to keep pace with budget growth.[22] Within the context of the robust bull markets of the past two decades, however, this investment objective in fact led to a speedy ramp-up in endowment spending at many institutions, with sizable payouts arguably *driving* budget growth instead of failing to keep up with that growth. For example, one university doubled its already sizable endowment dependency from 1996 to 2005, a compound annual growth rate of 7.2%, about triple the inflation rate over that period. Thus, outstanding investment performance, without operating and strategic regulators to moderate the payout stream or to restrain the growth of fixed costs, can materially increase the enterprise risk for the university as a whole.[23]

[22] Nominal expense growth has been projected on the basis of either the Consumer Price Index (CPI) or the more accelerated Higher Education Price Index (HEPI). The use of such inflators for budget projections and concomitant endowment growth targets appears to assume that expense growth cannot be controlled.

[23] It would be unfair to single out the role of the endowment in the current difficulties. The role of debt, growth of fixed costs, and (sometimes) allocation of capital campaign proceeds were also major factors within a situation precipitated, of course, by exogenous events—market collapse, credit squeeze, and deep recession.

Asset Allocation by Endowment Size and Endowment Dependence

June 30, 2008



Note: Based on data from 66 colleges and universities.

A final question to consider is whether one's compensation structure provides appropriate incentives. Although generally in favor of incentive compensation, we would caution that a potential unintended consequence of performance-based compensation may be the creation of incentives to take more risk than reflected in the policy portfolio (e.g., through leverage) in order to outperform the lower-risk policy portfolio benchmark. Trustees need to be fully aware of any such risk-seeking behavior and fully conscious of its potential dangers.

Incentive compensation based on peer comparisons has even greater potential for unintended consequences. While it is valuable to know how other institutions are performing, determining CIO pay based on this method has several important limitations. First, any performance benchmarks should be transparent and fully investable *ex ante*. This is not the case with regard to peer-based benchmarks, as the constituents of peer portfolios are not known on a timely basis or in sufficient detail. Further, performance calculation methodologies are somewhat inconsistent across institutions. Second, trustees should question the degree to which these arrangements actually align the interests of the CIO with those of the institution. A CIO whose annual compensation is predicated (even if only in part) on performance relative to peers has every incentive to focus on the short term. Finally, we find that inadequate time and attention is spent on constructing appropriate peer universes. When selecting a peer group for benchmarking purposes, one criterion should be the role of the endowment at a given institution, including endowment dependence. While in the past it appears that endowment dependence rarely if ever affected portfolio decisions, it is likely that in the future this will be a factor in portfolio construction. By extension, any performance-based incentive compensation should also recognize that CIOs may be working toward investment objectives linked to financial and strategic objectives that differ markedly from institution to institution. Peer benchmarking for compensation purposes makes little sense given vastly different operating risk profiles unless one selects peers on the basis of comparable risk profiles. However, this is a daunting task, since operating risk is not limited to endowment dependence but varies also with differences in institutional operating structures and decision-making environments. While good governance requires the identification of an appropriate peer universe to inform *relative* performance measurement, it is by no means desirable to have such peer comparisons drive incentive compensation.[24]

Recommendations

Here we cannot make specific recommendations, since the operating risks facing any given endowed institution will vary significantly both in character and scale from other endowed institutions. Instead, we recommend that investment committee members and (as appropriate) other trustee committees consider questions such as the following:

- Is it appropriate to adopt a more conservative portfolio asset allocation? (The answer is not necessarily yes.)
- Or should tail risk (i.e., macroeconomic shocks, exogenous events) protection be increased through higher allocations to asset classes such as high-quality sovereign bonds, commodities, etc.? Should the entire portfolio—to the degree possible—be hedged through the use of derivatives?
- Might the endowment be divided into several pools differentiated on the basis of liquidity

[24] The "Ivy League" peer group, for example, contains universities whose reliance on endowment ranges from as low as 8% to over 45%. Among universities and colleges, peer groups appear to be defined by relative selectivity in student admissions, a criterion not entirely relevant to investment objectives.

horizon, with essentially a different asset allocation for each pool? And what percentage of total assets belongs in each of these pools?

- Should risk indicators be used to drive tactical reallocations of the portfolio when the light changes from blinking yellow to red? Should this be based on operating indicators as well as capital markets, credit, or portfolio indicators?

- Should portfolio construction attempt to consider the volatility of other revenue streams, such as current gifts, tuition, and grants?

- Or should a stabilization reserve be established or expanded and, if so, how to determine its size and asset allocation?

- Should peer group selection, performance benchmarking, and performance-based incentive compensation be adjusted for endowment role and endowment dependence among peers? Is it possible to craft a sensible peer performance–based incentive compensation plan? What do such incentive compensation schemes achieve relative to those based on policy portfolio benchmarks that reflect institutions' risk tolerance as expressed in their policy asset allocation?

- Should debt ratios, such as the new liquidity ratios, become part of investment committee deliberations, or do they properly belong in another venue?

- What happens when additional debt drives the need for additional liquidity—is this an operating decision or an investment decision?

- To the extent that proceeds from the issuance of taxable debt are used for working capital purposes, does this constitute (in effect) a leveraging of the investment portfolio?

- Should the treasury function be more closely integrated with the endowment investment function? What is the appropriate trade-off between liquidity and long-term investment performance, and where (in terms of governance) should liquidity decisions be made?

- Should limits on portfolio illiquidity be established and codified in investment policy statements?

- In terms of strategy, as distinct from operations, should the institution seek to reduce its endowment dependence risk by (for example) expanding its other sources of revenue?[25]

- How does one define the responsibility to ensure that the endowment and the institution serve "future generations," and to what extent (if any) should near-term exigencies be allowed to diminish future prospects? More provocatively, can near-term overspending (including "borrowing" from endowment) be justified in terms of long-term objectives, and what is the discipline involved in making such judgments and then later restoring balance?

- What are the trade-offs among cost cuts (budget reductions), changes in endowment payout or asset allocation, and long-term strategic positioning within the institution's local, national, or global market?

All of these questions, and more, have become germane to the discussions of trustees, whether on the investment committee, the finance committee, the executive committee (if any), or the audit committee. This is uncharted territory, although pockets of "best practice" exist in many

[25] Note that a sharp reduction in the expense base will serve to *increase* dependence risk, all other things being equal. Thus it does not by itself address the issue of dependence risk.

institutions. Most fundamental to good governance is identification of who, exactly, should address which issues, and how best to frame the issues with respect to governance and organizational structure. Which brings us to the last, brief section of this report.

Governance and Organization: The Bigger Picture

Many of the mishaps triggered by the market, credit, and economic crises were attributable not just to endowment investment performance, but to insufficient integration of all the moving parts of an endowed institution. Those "moving parts" consist of portfolio construction, operations, fundraising goals, debt issuance (including the use of variable rate debt and interest rate swaps), treasury or "internal bank" investment decisions, and strategic choices with respect to program expansion and facilities construction with their attendant incremental costs to be supported (to an increasing extent) by endowment.

Integrating these moving parts is most difficult—some would say impossible—at decentralized institutions at which significant financial discretion is held by multiple more or less autonomous operating units. Given such a structure, centralized authority may be exercised through budget review, endowment investment (through unitized accounting), debt issuance, sometimes pricing (e.g., tuition), sometimes fundraising, and sometimes an internal "tax" upon operating units. Through the decades of robust endowment expansion, there may have been insufficient thought given to the *spending choices* of autonomous units, choices with strategic implications for the institution as a whole. As those autonomous units availed themselves of rising endowment payouts, they often increased the operating risk of the institution by taking on more fixed costs in the form of such measures as more buildings and more tenured faculty.

Even without the particular difficulties of organizing and governing a decentralized institution, the new questions about risk must be discussed in an appropriate and effective venue. While endowment portfolio construction should remain firmly within the purview of the investment committee, clearly attention needs to be paid to bringing into the discussion certain risks that are external to the portfolio: financial leverage (debt), operating liquidity (which may depend upon volatility in other revenue streams), and endowment dependence risk. How best to introduce these risks to investment committee discussions and—more sweepingly—to ensure adequate cross-communication in the organization as well as on the board?

- Tweak certain areas of governance. It would probably be impractical and redundant to have the investment committee agenda regularly include discussion of items that are on the agenda of other board committees (e.g., the finance committee, the strategic planning committee, the development committee, the audit committee). Instead, measures might be taken to ensure that the investment committee is informed of these "external" risks:
  - Overlapping committee memberships: e.g., individuals who sit on both the investment committee and the finance committee (or the audit, development, or strategic planning committees).
  - Occasional joint meetings of committees with overlapping responsibilities: e.g., discussing liquidity from the perspective of debt ratings and from the perspective of portfolio construction.

- Circulation to investment committee members of regular reports (from other committees or staff) on such matters as debt ratios and covenants, revenue volatility, and the levels of operating reserves.

- Investment committee member experience in important contingent areas: seek one or two investment committee members with some experience in strategic planning, operations, debt, and/or fundraising.

- Inclusion of the chief financial officer (CFO) in investment committee meetings, as an *ex officio* member, with or without a vote.

• Undertake an organizational review, in order to address both the structure and process of the institution as a whole with respect to the identification and treatment of "external" risks.

  - For example, should the CIO and CFO both report to an executive vice president (EVP) or, alternatively, should the CIO report to the CFO?

  - Who should be in the room when decisions about debt issuance and debt covenants are made?

  - Should the top development officer report to the CFO or EVP, in order to ensure that gift terms are congruent with strategic priorities?

  - Who should decide the appropriate levels of operating funds? Who should administer and invest such funds?

  - Is the rationale for an internal bank strengthened or weakened by recent events? Should internal bank policies be adjusted in light of recent events?

  - Perhaps most telling, who should decide the appropriate trade-off between liquidity and investment return, and should this decision be made at the level of the autonomous unit or at the level of the institution as a whole?[26]

  - Who, in the institution, is responsible for calibrating, controlling, or hedging dependence risk? Who brings this to a discussion of asset allocation, financial leverage, and debt issuance?

• Assess the relationships between fundraising and endowment. For example, take a hard look (with the help of counsel) at the language of gift terms—both for prospective donors and past gifts to endowment. The goal is to maximize fungibility and flexibility. Make sure that development officers' incentives are properly aligned with the institution's long-term goals for its endowment.

Alas, in this particular section, we leave the reader with more questions than answers—unavoidably — because each institution can resolve these questions only in the context of its particular current organizational structure, its history, its constituents, and its personalities, in addition to the authority assigned by its particular charter and bylaws. The main recommendation, however, remains this: consider whether a review of governance, and of the organizational structure, is warranted in light of heightened awareness of risks both within and without the portfolio. For some institutions that weathered the storm without large and nasty surprises, such a review may be unnecessary. For others, it should be a consideration. ■

[26] The corollary question is whether the institution as a whole is "responsible" for fall-out from excessive risk-taking on the part of its autonomous units.

Related Cambridge Associates Research Reports

Endowment Management
Our flagship report on the questions and issues that those responsible for managing an endowment must resolve if they are to invest the institution's assets effectively.

Investment Operations and Governance

Comparative Debt Issuance Practices, May 2009
Data from colleges and universities, museums and libraries, and independent schools on debt management as it relates to overall investment policies.

Liquidity Challenges in Today's Environment, October 2008
Due to the recent market volatility, many investors may be facing a liquidity crunch, and some a severe liquidity crisis. This report is designed to outline a coherent process for assessing the sources and uses of cash, examine the implications of different decisions investors might make about their liquidity needs, and recommend some general guidelines for how much liquidity reserve we regard as appropriate in the current environment.

Surviving the Bear Market: An Investor's Guide, July 2008
During prolonged bear markets, investors naturally focus on how best to allocate portfolio assets to ensure they are not wholly exposed to the full brunt of declining equity prices. However, as the economy deteriorates and the financial sector in particular suffers declining revenue and job losses, investors should also consider whether they have increased exposure to operational and financial risks. This report is a guide to six strategies for survival, targeting the main trouble spots investors should evaluate in case the market environment continues to deteriorate.

Organization and Staffing for Endowment Management, February 2008
As endowment assets have grown and the range of investment options has expanded, the demands on those charged with managing endowment funds have increased commensurately. This report covers topics related to governance, staffing, and general compensation plan topics. Also included is a commentary on the use of peer-based performance comparisons as a component of incentive compensation plans, a topic that is of interest to many clients.

Investment Committee Governance, August 2006
A concise review of issues pertinent to investment committee members, particularly (1) the law applicable to fiduciary responsibility; (2) its enforcement; (3) its evolving interpretation; and (4) second-order effects centering on changing views of accountability and risk, and coming from auditors and debt rating agencies.

Conflicts of Interest, 2005
Examines state and federal law governing the fiduciary responsibilities of nonprofit entities, particularly investment committees, and IRS enforcement of transactions involving "excess benefit" and "disqualified persons."

Investment Planning

Behavioral Risk, 2009
Managing behavioral risk is arguably prerequisite to effective implementation of other risk mitigation strategies. This report identifies ways investors can counter the urge to stampede for the exits during times of crisis.

Spending Policy Changes: Endowments, June 2009
An update to our spending policy materials that includes data from 113 institutions regarding their current spending policies, recent and future changes to these policies, and expectations for endowment withdrawals for the current and next fiscal year.

Spending Policy Changes: Colleges and Universities, April 2009
In March 2009 a group of U.S. colleges and universities was invited to participate in a brief survey on spending policy as an update to a similar survey conducted in 2008. The survey asked about the policies in place, as well changes that were being implemented or were under consideration for future implementation.

Strategic Implications of the Market Meltdown, March 2009
An update to our October 2008 web publication, this brief piece revisits strategic questions and advises investors to think carefully about the economic and political dimensions of investment decisions.

Reversal of Fortune: The Effect of the Market Decline on the Budgets of Endowed Institutions, January 2003
Describes the circumstances surrounding the accelerated rise of expenses at many institutions with large endowments during the unprecedented market rise of the 1990s, and the budgetary implications of the three-year decline in the equity markets, not seen since 1941.

Endowment Spending in a Bear Market, 2002
Three suggestions for institutions whose spending rules now dictate a cut in spending.

Papers in the Asset Allocation in the Current Environment Series

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