

*Managing Foundation  
Investments:  
Policies and Practices*



COUNCIL *on*  
FOUNDATIONS

Building Strong and Ethical Foundations:  
*Doing It Right*



# Table of Contents

**INTRODUCTION**.....1

**ARTICLES**

***Legal Brief: Conflicts of Interest, Part III  
Managing Foundation Investments***  
Jane C. Nober .....3

***Investment Planning for Family Foundations***  
Charles A. Bundy .....7

***Legally Speaking: Safely Crossing  
the Investment Intersection***  
George R. Grange II and Jane Allison Austin.....11

**RESEARCH**

***Median Annual Investment Fees Paid in 2003 by  
Community Foundations***  
Judith Kroll .....6

***Investment Consulting Fees Paid in 2001 by  
Private Foundations***  
Judith Kroll .....6



# Introduction

## INTRODUCTION

Grantmaking foundations in the United States have a strong history of being created with honorable motives and operated with unquestionably high standards—standards that reflect the honor, respect for society and philanthropic impulse of their founders. That foundations continue to adhere to these high standards has been borne out repeatedly by numerous studies by the Internal Revenue Service and thousands of anecdotal experiences in the Council’s more than 50 years of serving philanthropic institutions.

Today, however, foundations are being challenged to rebuild trust with the public and policymakers in an environment of increasingly negative public opinion and more aggressive legislation. To regain the long-standing public support of philanthropic traditions, the Council on Foundations, working with its philanthropic partners, has established a national ethics and standards program.

Building Strong and Ethical Foundations: Doing It Right is a two-year initiative designed to take the lessons of good philanthropy and moral suasion to grantmakers, their advisors, foundation executives and trustees across the country. The program also will build partnerships with state and federal regulators to halt bad practices through legal means while educating regulators about the appropriate role and functions of foundations.

Specifically, the Council will:

- Develop new guiding **principles and governance standards** that more specifically reflect the existing Principles and Practices for Effective Grantmaking to which all Council members currently subscribe.
- Increase **professional development materials and outreach** about strong legal and ethical governance practices to foundation professionals, foundation advisors, and state and federal charity officials.

The enclosed materials are designed to encourage greater compliance and adherence to legal and expected standards of accountability. Resources include articles by the Council on Foundations and sample conflict of interest policies for community foundations, private foundations and corporate giving programs.

**Dorothy S. Ridings**  
President and CEO  
Council on Foundations



ARTICLE

# Conflicts of Interest Part III

by Jane C. Nober  
*Foundation News & Commentary*  
September/October 2004 Vol. 45, No. 5

*In previous articles (“Conflicts of Interest,” [www.foundationnews.org/CME/article.cfm?ID=2561](http://www.foundationnews.org/CME/article.cfm?ID=2561) and “Conflicts of Interest Part II,” [www.foundationnews.org/CME/article.cfm?ID=2747](http://www.foundationnews.org/CME/article.cfm?ID=2747)), we’ve reviewed the importance of developing a conflicts of interest policy for board and staff members. We’ve also examined the issues that may arise when the foundation’s lawyer serves as a director or trustee. This column focuses on foundation investments. May foundation board members (or other closely affiliated individuals or businesses) manage foundation investments? May they be paid for this service? What factors should foundation managers consider before they select an investment manager who has a close relationship with the foundation? When is it a bad idea? What special procedures should be followed when a board member or other close affiliate is also an investment manager?*

It is often tempting to look close to home for foundation investment expertise. Family foundations may wish to retain children of the charity’s founders to manage the foundation’s portfolio. Foundations sponsored by corporations, especially financial institutions, may consider putting their assets under the watchful eyes of corporate investment managers. Community foundations that work with local investment advisors may seek to tap the money management abilities of board members who are professional investors. While federal law is fairly permissive in that area, it is not always wise to mix investment management with those close relationships.

## THE RULES

The Tax Code generally allows both public charities and private foundations to retain and compensate individuals and businesses with close connections to the charity that manage the charity’s investments. If the entity is a private foundation and the investment manager is a “disqualified person”—the label the Tax Code uses to describe major donors to the foundation, foundation directors, family members of both of those groups and businesses in which they are large stakeholders—the private foundation must avoid committing an act of self-dealing. To comply with the rules, the manager may be compensated only for *personal services* that are reasonable and *necessary* to the foundation’s work and the compensation may not be *excessive*.

Investment management services are expressly included in the definition of personal services in the Internal Revenue Service's (IRS) private foundation regulations. An example in the regulations discusses a private foundation manager who owns an investment counseling business and provides investment management services, for a fee that is not excessive, to the foundation. Under the relevant rules, the example concludes, the arrangement does not constitute an act of self-dealing.

Assuming the investment manager's services are *necessary*, what's a rate of compensation that's *not excessive*? The IRS's position is that the amount similarly situated people are paid for similar work will be considered reasonable compensation. If the investment manager customarily bills clients similar to the foundation at the rates it proposes to charge the foundation, this may serve as evidence of the reasonableness of the rates. Ideally, a foundation would periodically compare the rates it pays with other similarly sized foundations or put its investment management work out for bid.

If the grantmaker is a public charity, such as a community foundation, the relevant legal rules on compensation for an investment manager with close ties to the foundation come from the Tax Code's intermediate sanctions provisions. [For more information on intermediate sanctions, see Lloyd H. Mayer, Caplin & Drysdale, Intermediate Sanctions Checklist (5/31/2001), available for download (PDF) at: [www.cof.org/files/documents/legal/checklist.PDF](http://www.cof.org/files/documents/legal/checklist.PDF).]

Intermediate sanctions rules penalize excess benefit transactions, in which charity insiders (such as directors) receive more value from an organization than they have provided to it. Charities must pay no more than fair market value for services provided by insiders. They may establish a rebuttable presumption that the investment manager's compensation meets this standard by having an independent committee consider data on comparative rates and approve the compensation, being sure to fully document this determination. Ideally, community foundations would periodically put their investment management work out for competitive bids.

Community foundations face an additional requirement in connection with investment management. Compliance with Treasury Regulations requires that they establish a target standard for investment performance and that they retain the right to fire investment managers who do not meet these goals.

In all cases, an investment manager who is also a board member should not participate in decisions relating to the retention or compensation of his or her investment firm. The manager may participate briefly in the discussion leading up to the vote in order to answer any factual questions, but should then leave the room to allow the remaining board members to discuss and decide the issue. The investment manager should refrain from participating in board discussions of investment performance and should not be named to the investment committee if the board has one. The foundation should avoid having its investments managed and evaluated by the same individuals or firm.

Like any other foundation fiduciary, investment managers should disclose other potential conflicts of interest. For example, where a grantee requests an endowment grant and the foundation's investment manager/board member has a contract to manage the grantee's funds, this tie should be disclosed.

## BEYOND THE LAW

Just because the Tax Code allows an action doesn't necessarily make it a good idea all the time. Before selecting a disqualified person to manage a foundation's portfolio, foundation managers should consider not only legal, but also ethical and other factors.

Having an investment manager with close ties to the foundation does present ethical challenges. Will foundation managers feel comfortable firing an investment manager whose performance is not satisfactory? Will they delay terminating a relationship—to the detriment of the foundation's finances—because of the investment manager's other work on behalf of the foundation or because of his or her relationship with other foundation managers? No one wants to be the private foundation CFO who has to tell a major donor that his child's investment performance is terrible. Similarly, if a community foundation's investment manager is also a big fundraiser for the organization, how likely is it that foundation executives will immediately pull the foundation's assets from her company when she fails to meet performance benchmarks?

Other conflicts can arise when foundation investment managers are also family members of a donor or hold positions in the donor's business. Loyalty to family or the family business could lead the investment managers to retain a foundation's large stake in an enterprise when a more objective investor might diversify.

Finally, a foundation should consider the public relations aspect of hiring a closely affiliated individual or firm as an investment manager. If the foundation's assets decline in value, it will be tempting for reporters and other commentators to assume that it was the investment manager's personal or other ties that earned her the privilege of mismanaging the charity's funds. Even when assets increase in value, reporters and others may try to argue that foundation insiders received excessive compensation for their work.

Despite those concerns, many foundations will still choose to select investment managers with close ties to the foundation. To ensure that those relationships are legal, ethical and publicly defensible, foundation managers should document:

- The selection process by which the manager is picked
- The professional skills and achievements on which the selection of the investment manager is based
- The benchmarks used to set the manager's compensation
- The performance standards used to evaluate the manager's work
- The contract or other agreement under which the manager can be fired
- The procedures, including policies and disclosure forms, that the foundation has adopted to avoid conflicts of interest

When a foundation's assets increase, the foundation's ability to effect positive change also increases. Good investment management can help this happen. But foundations need to ensure that the deals they make with money managers are wise investments as well.

*Jane C. Nober is special counsel in the Legal Services and Ethical Standards Department at the Council on Foundations.*

**Median Annual Investment Fees Paid in 2003, as a Percentage of Assets,  
by Community Foundations, by Asset Group\***

Asset Group (in millions)	Median Fees Paid (as a percent of assets)	Number of Respondents
\$250 or more	0.57	10
\$100 to \$249.9	0.49	15
\$50 to \$99.9	0.50	11
\$25 to \$49.9	0.50	22
\$5 to \$24.9	0.56	42
Total	0.52	100

\*The survey instrument asks for an annual fee total which includes investment advisory, custodial and bank fees. This figure does not include brokerage commissions or investment consulting fees.

Note: These data are reported by each foundation and have not been verified for accuracy. For more information, contact Judith Kroll, director, Research, Council on Foundations.

**Investment Consulting Fees Paid in 2001, by Private Foundations, by Asset Group**

Asset Group (in millions)	Investment Consulting Fees as a Lump Sum			Investment Consulting Fees as a Percent of Assets			Number of Respondents
	Median	Mean	Range	Median	Mean	Range	
\$500 or more	135,800	416,931	25,000 to 5,337,343	0.0086	0.0334	0.0008 to 0.4063	23
\$250 to \$499.9	70,332	78,763	31,500 to 164,359	0.0175	0.0222	0.0068 to 0.0459	14
\$100 to \$249.9	52,084	75,632	15,000 to 548,394	0.0309	0.0478	0.0075 to 0.3740	31
\$50 to \$99.9	42,373	46,587	10,000 to 181,821	0.0588	0.0621	0.0124 to 0.1838	22
\$25 to \$49.9	25,000	37,546	9,000 to 142,165	0.0720	0.0923	0.0244 to 0.3575	9
\$10 to \$24.9	15,302	27,626	2,500 to 85,135	0.0947	0.1522	0.0131 to 0.3941	15
\$5 to \$9.9	10,000	17,003	2,400 to 42,000	0.1058	0.2651	0.0246 to 0.6532	5
Less than \$5	16,400	16,400	9,274 to 23,526	0.5191	0.5191	0.4895 to 0.5488	2
All	49,700	123,403	2,400 to 5,337,343	0.0363	0.0777	0.0008 to 0.6532	121

\*Insufficient data. For more information, contact Judith Kroll, director, Research, Council on Foundations.





## ARTICLE

# Investment Planning for Family Foundations

By Charles A. Bundy

From the spring 1996 issue of *Family Matters*, the Council on Foundation's quarterly newsletter for family foundations.

Through the years, it has been my impression that trustees of family foundations are very serious about their fiduciary responsibilities. They want to see that the funds in their care are invested well and productively. If the returns are successful, they in turn will be able to be more effective grantmakers.

Trustees are aware, too, of the scrutiny they receive from a wide range of publics—grantseekers and recipients, their peers, their families, the general public and regulating authorities. They are required to manage foundation assets in a prudent manner. Laws governing family foundations—and private foundations in general—require that these groups pay out, in grants and other administrative expenses, an amount equal to five percent of the value of their non-charitable use assets each year (see *Family Foundations and the Law*, Chapter IX). To do this, these foundations must earn at least five percent while also earning enough to offset the effects of inflation, provide for operating expenses and excise taxes, and still protect the value of the foundation endowment. This is a challenge in any kind of investment climate.

Most of us get our greatest work satisfaction when we see foundation dollars making life better for people, helping to solve societal problems and finding ways to improve the delivery of services to the general public. All of these results require that the foundation's investment program produce the income needed to accomplish these endeavors.

Whether the family foundation is new or well established, it is appropriate to periodically examine investment goals, policies and practices. This helps to establish an orderly plan and agreed-upon procedure and also allows for the review and adjustment of existing operations.

Just who has responsibility for overseeing a family foundation's investment policies? The overall accountability must rest with the board of trustees. Whenever a trustee accepts a position on the board, this responsibility is also accepted. The board, and its individual members, must ensure that the assets of the foundation are invested productively. At the very least, they need to be familiar with the foundation's investment results and insist that staff or an outside investment manager provide them with the information needed to ensure that their responsibility is being discharged properly.

The chair and the CEO should set the process in motion. This is best accomplished through an investment committee made up primarily of board members. Sometimes a foundation will invite non-board members with particular talents, knowledge and experience to sit with the committee; in any case, the majority should always be board members.

The investment committee should have a regular meeting schedule. One strategy is to have a meeting prior to each regular board meeting, an annual meeting with managers and “emergency” meetings when necessary. Such a schedule assures some discipline in the committee’s work. Each regular meeting should include some attention to investment policy with an opportunity to make any course corrections necessary. The CEO or the committee’s designee should constantly review investment reports and carefully monitor activity and performance.

## **SEVEN STEPS TOWARD EFFECTIVE INVESTMENT MANAGEMENT**

- 1. Agree on the foundation’s investment goals.** The payout requirement is a primary consideration. What investments are necessary to meet this plus the effect of inflation and expenses? Careful attention should be given to the protection of the value of the assets. What limitations will be placed on investment options? For instance, the Springs Foundation does not permit high risk instruments, heavy concentrations in one industry or group, or investments in gold, derivatives and similar investments.
- 2. Decide if the investment committee will manage the assets or seek outside help.** We went through several stages in our two family foundations. We managed totally in-house for many years. Then we combined that with partial outside management and later put all funds in the hands of outside managers.

This later action was interesting and successful. We established a dedicated fund with a portion of assets invested in fixed amount each year with a three percent annual acceleration for a period of ten years. The remaining assets were invested in equities that would accumulate growth and income during the ten-year period. When all the fixed income portion was completely paid out and used, the equities were supposed to triple in value. That is exactly what happened and we considered it an extremely successful move. It can only be done in a period of high interest rates but it certainly provided us with stability of income as well as growth during the ten-year period.

We now manage our fixed income funds in-house and employ two outside managers for our equity funds. If a foundation can afford it, I recommend the use of consultants to help develop a plan and find managers to execute it.

3. **Have the investment committee recommend an investment policy to the board of trustees.** The policy should:
  - a) include a statement of fund objectives;
  - b) assign investment responsibility to the investment committee; and
  - c) set forth an asset allocation formula to achieve investment objectives.

The particular objectives of foundations may vary widely. Some feel comfortable with 60 percent fixed income and 40 percent equities. I know of several foundations now that have a mix of 65 percent equities and 35 percent fixed income. Our foundations now have 75 percent in equities and 25 in fixed income because of the growth in equities during the bull market we have seen in recent years. Any further tilt toward equities will likely cause us to re-balance our formula.

4. **Set long-term performance objectives.** Usually this will recognize a three to five year investment cycle and call for a real rate of return of five to six percent.
5. **Set specific guidelines for each manager.** How much in a single stock? How much of a company can they own? Excessive fees and turnover should be avoided. Certain areas may be determined to be off-limits (commodities, art objects, real estate, gold, etc.). Equity managers should be told when they can invest in fixed-income securities. General quality levels should be set: AA or A bonds, no junk bonds, no derivatives, investment grade stocks.
6. **Agree upon the basic asset allocation strategy.** We have two outside equity managers and they divide \$35 million about equally. The remaining approximately \$8 million in fixed income securities is managed in-house. Again, the board of trustees should at least approve the asset allocation plan. You may also want to use a consultant in the selection of an investment manager. They will review the universe of managers that meet the foundation's need and bring recommendations. They will also help with the interviews and often with the continued evaluation of performance.
7. **Require that regular reports be provided to the board by investment managers and custodians.** I believe that a custodian is essential. We use a regional bank for this and they are worth the cost to keep up with all the transactions, values, results and performance measurement. The reports should be available monthly. The investment committee should meet with managers at least once a year and more often if needed. Managers should be evaluated against one or more of the major indices: Dow Jones, S&P 500, Russell 2000, Russell 3000, EAFE (for international stocks), Lehman Brothers aggregate index for fixed income securities.

## **SUMMARY**

Every foundation should have an investment plan. The specific details of the plan will vary with the needs and personality of the trustees and the foundation itself. Progress should be carefully monitored. The foundation investments committee should expect results, be tough-minded and be willing to discharge poor performers.

At the same time, the investments committee should keep the board of trustees fully informed, and should keep the overall objective of the foundation in mind at all times: we invest to earn money for grants. Sometimes we get so tied up in the details that we forget this should always be the guiding motivation behind our investment decisions.

The process of overseeing the investment strategy of a foundation is serious business and, if done right, it is also interesting and exciting. Investing may be a housekeeping chore for some, but it is essential to the greater work of family foundations. It will fund what we wish to accomplish and society will be better as a result.

*Charles Bundy is president of the Springs and Close foundations, two family foundations based in Lancaster, South Carolina. He is in his 25th year as the chief executive officer of the foundations.*





ARTICLE

# Legally Speaking

## Safely Crossing the Investment Intersection

By George R. Grange II and  
Jane Allison Austin

From the spring 1996 edition of *Family Matters*, the Council on Foundations' quarterly newsletter for family foundations.

As a foundation manager or board member, you recognize that investment decisions are like crossing a busy intersection, with traffic flowing in several directions. Coming from one direction are the fiduciary duties you owe to your beneficiaries and the public—typically enforced by the State Attorney General. Coming from the other direction is your accountability to the IRS, under the rules prohibiting private inurement and jeopardizing investments. Private inurement considerations have previously been addressed in this column. But how do you keep from being blind-sided by a “jeopardizing investment?” What is a program-related investment? What fiduciary responsibilities must you exercise to avoid the personal and corporate five percent excise tax penalty? The IRS addresses these in IRS-ease; let's try to translate into plain English.

**Jeopardizing Investments.** The Internal Revenue Code and Regulations generally prohibit investments that “jeopardize the carrying out of any of [the foundation's] exempt purposes.” In choosing investments, foundation managers must (1) exercise ordinary business care and prudence under the facts known or reasonably expected to be known at the time of the investment (in other words, use the same sound and thoughtful judgment you would reasonably use in managing your personal financial matters of similar type and complexity); and (2) consider the long- and short-term financial needs of the foundation to carry out its exempt purposes. Foundation managers are expected to consider such factors as the:

- potential investment's expected return;
- risks of rising and falling price levels; and
- need for diversification within the foundation's portfolio.

Contrary to popular belief, there are no per se jeopardizing investments. Whether an investment jeopardizes a founda-

tion's exempt purposes is determined on an investment-by-investment basis. However, certain kinds of investments are subject to increased scrutiny by the IRS:

- trading in securities on the margin;
- trading in commodities or futures;
- purchase of working interests in oil and gas wells;
- purchase of puts, calls, and straddles;
- purchase of warrants; and
- selling short.

**Donor Gifts.** An important exception to the jeopardizing investment rules are donor gifts. When a donor gives your foundation an income-producing asset it will generally not be subject to jeopardizing investment scrutiny unless the foundation provides consideration to the donor upon transfer.

**Program-Related Investments.** An investment whose primary objective is to accomplish a charitable purpose, which does not significantly seek the production of income or appreciation of property, and is not used to influence legislation or promote or oppose the political campaign of any candidate for public office is a program-related investment. Program-related investments are an exception to the jeopardizing investment rules. Once an investment is determined to be program-related, it will always be considered a program-related investment, as long as any change in the form or terms of the investment is not for the purpose of the appreciation of property or the production of income.

**Disposal of Jeopardizing Investments.** The IRS will recognize the removal of an investment from jeopardy where the investment is sold or otherwise transferred and the investment of the proceeds from the disposal is not jeopardizing. However, a transfer of a jeopardizing investment from one private foundation to a related foundation will not remove the investment from jeopardy unless the transfer can qualify as a program-related investment by the transferee foundation.

**Penalties for Jeopardizing Investments.** In addition to a five percent tax on the foundation, the IRS can levy a tax on a foundation manager (including board members) equal to five percent of the amount of any investment determined to be jeopardizing, subject to a \$5000 cap, unless the manager's participation in the investment was "not willful" and was "due to reasonable care," and the ordinary business care and prudence standards are satisfied.

**Have Counsel Put it in Writing.** It is wise for foundation managers to seek an opinion of legal counsel concerning whether any suspected investment is jeopardizing. The regulations provide that a manager's reliance on a reasoned, written opinion of counsel, which does more than recite the facts and express a conclusion, is sufficient for a finding of reasonable care even if the investment is subsequently found to be jeopardizing.

In your role as foundation manager or board member, heed the advice you would give your children at a busy intersection: Look both ways and proceed with caution. Understanding the flow of legal duties and what the signals mean can spell the difference between a stroll in the park and memorable encounters of a regrettable nature.

*George R. Grange II and Jane Allison Austin are attorneys at Gammon & Grange, P.C., a law firm specializing in nonprofit legal issues.*



COUNCIL *on*  
FOUNDATIONS

1828 L Street, NW, Suite 300, Washington DC 20036 • ph 202/466-6512 • fax 202/785-3926 • [www.cof.org](http://www.cof.org)