FAMILY Matters

Volume 7, Number 1 Winter 2002

INVESTING WISELY

A quarterly publication of the
COUNCIL ON FOUNDATIONS
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Investment Planning in a Changing Economy

Roderick K. von Lipsey, Vice President
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How do we reconcile this year's grantmaking needs with last year's investment results? If you find yourself asking this question, especially given the volatility of financial markets in 2001, don't feel alone. Many family foundations are challenged by the lack of rigorous—and coordinated—investment and spending policies. In this changing economy, there is no time like now for your foundation to adopt or revisit these policies to ensure they will meet your grantmaking goals.

But when it comes to investing, how do you plan for the future? If last year's spending based on 2000 market results provided pause for some, this year's challenge is downright alarming for many.

> **"If last year's spending provided pause for some, this year's challenge is downright alarming for many."**
>
> —Roderick K. von Lipsey

Prudent investment planning requires more than just an up-front determination on the balance between equities and fixed income, and then holding on tight as the ride begins. The investment cart must follow the spending horse: trustees need first to review philanthropic goals, granting requirements and operational costs in the context of the desired foundation legacy. Trustees might ask themselves:

- Is the need for spending to achieve a charitable aim greater now, or in the future?
- Is perpetuity a foundation goal?
- Will additional contributions flow into the foundation, or will asset growth be achieved through investment performance only?

Foundations striving for perpetuity will need to accept trade-offs in both risk acceptance and spending capacity. In a November 2001 study, *Sustainable Spending Policies for Endowments and Foundations*, Goldman Sachs Investment Strategy Group (ISG) indicated that in order to reasonably protect against the likelihood of corpus erosion, based on market performance over the last 30 years, annual spending levels as low as 3–4 percent of principal should be maintained. At the current IRS-mandated 5 percent spending rate, the probabilities of a 10 percent decline in corpus value over 5, 10 and 20-year horizons are highlighted below:

When perpetuity is a goal, foundations often consider an asset allocation at 70/30 equity to fixed income. At times, however, costs associated with non-qualified foundation expenses (such as administrative costs associated with investments) can push the total spending, including the annual distribution, higher than planned. Much of the research suggests that when aggregate spending levels exceed 6 percent, even with a 70/30 asset allocation, there is better than a 50 percent probability of corpus erosion—a risk that many foundations might find unacceptable. Thus, foundations may wish to consider targeting a total spending rate (exclusive of investment costs but inclusive of administrative costs and qualified distributions) of 5 percent.

In order to improve the picture, many foundations are asking investment managers to

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In Hard Times: Family Foundations Respond

Warning Grantees

Like most foundations, the Marshall L. and Perrine McCune Charitable Foundation in Santa Fe, New Mexico, has been affected by the continuing downturn in the economy. Although the foundation maintains a "thoughtful and diverse" investment strategy, according to executive director Owen Lopez, "as goes the market, so goes our portfolio."

In the spirit of openness, the foundation sent letters to all of its grantees advising them to prepare for possible grant cutbacks. "We thought it would only be fair to let grantees know so that as they prepare their budgets for the coming year, they won't have false expectations," says Lopez. The foundation made it clear that it still encourages requests and it will honor its multi-year commitments.

How did grantees react to the news? According to Lopez, the response has been overwhelmingly positive. "We've received notes and calls from many of our grantees, thanking us for letting them know in advance."

Staying the Course

The William J. and Dorothy K. O'Neill Foundation keeps to a basic investment philosophy: be invested in stocks and be fully invested at all times. Because the foundation is destined to remain in perpetuity, it invests in stocks as opposed to bonds or cash equivalents to get the greatest growth over a long time. "We don't feel we can time the market successfully—when to get in, when to get out, so we stay fully invested," says president William J. O'Neill, Jr. "We don't particularly like the volatility of the market, but we feel we can stand it in order to reap the greater rewards over time."

Will the foundation change its strategies in light of the bear market? O'Neill responds that they are considering two changes in the coming year—investing in foreign stocks and setting aside some funds to cover net cash outflows for two years or so. "In order to hedge against a situation where the stock market goes down below long-term trend lines and stays down, we may set aside one to two years of spending in cash equivalents or short-term bonds. This way, we will have our cash needs covered without having to sell stocks when they are unduly depressed."

FAMILY *Matters* is the quarterly newsletter for family foundations, published by the Family Foundation Services department of the Council on Foundations. Complimentary subscriptions for trustees of Council members are available by contacting Family Foundation Services at 202/467-0433 or gaste@cof.org.

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MEMBERSHIP INFORMATION

For information on becoming a member of the Council on Foundations, call 202/467-0463 or e-mail membership@cof.org.

Looking for past issues of *Family Matters*?

These old issues may be new issues to you. Read about succession, collaboration, nonfamily board members, technology, self-assessment and more. Visit the *Family Matters* index at www.cof.org/newsroom/newsletters/familymatters/index.htm.

Investment Planning in a Changing Economy

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take more risk in the portfolio by increasing the use of alternative investment vehicles (such as private equity or hedge funds). This can be a successful strategy, but must be implemented prudently, as these investments may expose the portfolio to both illiquidity and increased volatility. Although Goldman Sachs believes there can be a role for alternative investments in a foundation's portfolio, they also believe the most significant factor in investment performance is: "allocation, allocation, allocation…."

Like most professional investment managers, Goldman Sachs believes that foundations can best achieve their long-term goals by setting the right strategic asset allocation. But what is the right asset allocation? In order to keep pace with inflation and earn investment results that enable grantmaking over the long term, foundations may want to consider a U.S. equity allocation of at least 60 percent. And although bonds might provide a cushion to the volatility of equity markets, it may be a disadvantage to exceed a 60 percent allocation in fixed income in even a mildly inflationary market (which we can assume we are likely to experience over the long term).

The beginning of the year is an excellent time to plan ahead by revisiting your goals and policies. A formal spending policy and investment policy along with the right asset allocation will help your foundation put its charitable gifts to work.

Probability of a 10% Decline in Real Assets
(Selected Equity/Fixed Income Allocations; Selected Withdrawal Rates)

	5-Year Horizon			10-Year Horizon			20-Year Horizon		
	70%EQ/ 30%FI	50%EQ/ 50%FI	30%EQ/ 70%FI	70%EQ/ 30%FI	50%EQ/ 50%FI	30%EQ/ 70%FI	70%EQ/ 30%FI	50%EQ/ 50%FI	30%EQ/ 70%FI
3% Spending	15.2%	13.1%	12.3%	12.6%	12.0%	12.7%	9.3%	9.9%	13.0%
4% Spending	20.6%	20.1%	20.2%	19.6%	20.8%	25.4%	17.5%	20.3%	29.1%
5% Spending	27.2%	27.6%	30.5%	29.2%	33.9%	43.7%	29.2%	37.2%	54.5%
6% Spending	34.1%	37.1%	43.4%	40.6%	48.2%	62.1%	45.0%	57.8%	77.0%

EQ: Equity FI: Fixed Income

Source: Goldman Sachs Investment Strategy Group, November 2001

Modeled or hypothetical performance results do not reflect actual trading and have certain inherent limitations. Simulated results are also achieved through retroactive application of a model designed with the benefit of hindsight and may not reflect material economic and market factors.

Colleague Q&A: Changing Asset Allocations

With Stephen J. McCarthy
Trustee, The Mary A. & John M. McCarthy Foundation

Q. How are foundations changing their asset allocations to be "recession proof?"

A. Given the general downtrend in the public equity markets during the past 21 months, many family foundations are continuing to reassess their overall asset allocations and rebalancing their commitments to both the traditional and alternative asset classes. Because of their payout requirements, trustees of smaller foundations have become a bit more conservative by raising cash levels, holding more fixed income securities and positioning the equity portfolios more defensively (e.g., consumer staples, drugs) while trying to weather the downturn and recession. Trustees of larger foundations who have the policy discretion (and wherewithal/access) are tapping into hedge funds and private equity vehicles in an attempt to balance the overall risk/return profile of the portfolios.

Stephen J. McCarthy has more than 24 years of diversified experience in the financial services and foundation management sectors. He currently is the senior vice president of KCG Capital Advisors, an asset management/foundation administration venture he co-founded with his father in 1994.

Who's Who in Investing?

Investment Managers: An individual, firm or committee responsible for making day-to-day decisions to buy, hold or sell assets. Also known as money managers or investment advisors.

Investment Consultants: Advisors who develop or refine investment, asset allocation and spending policies of individuals, committees and officers. In addition, they can help select and evaluate the investment managers and report on the portfolio performance.

Investment Custodians: A bank or trust company that holds and safeguards assets placed in its care. For a fee, custodians settle transactions, invest cash overnight, handle accounting and provide accounting reports.

Glossary of Investment Terms

Asset Allocation: The distribution of a pool of assets among various asset classes, including, but not limited to, domestic and foreign bonds, cash, real estate and venture capital.

Asset Classes: Types of investments commonly divided into the categories of equity (common stock), fixed-income (bonds), cash and cash equivalents, and alternative investments (real estate, oil and gas, venture capital, distressed securities, leveraged buyouts, risk arbitrage, etc.).

Hedging: Hedging can include one or more strategies used to offset specific investment risk. A perfect hedge is one eliminating the possibility of future gain or loss.

Investment Objectives: A written statement describing the goal of each investment the foundation makes.

Investment Policy: A written statement of the overall investment philosophy, describing what the foundation is trying to accomplish with the endowment. The policy lists individual investment objectives and how they contribute to the overall goals of the foundation. It also includes the foundation's asset allocation criteria and its spending policy. The policy should describe what is expected day-to-day of investment managers, as well as the standards to evaluate a manager's performance.

Spending Policy: An agreed-upon policy that determines the annual percentage of assets a foundation will spend to cover both operating costs and grants. Typical spending rules combine calculations based on previous years' spending, the current year's income and investment return rates, and the policy of the foundation covering grant commitments.

How to Use Investment Consultants

Although some foundations rely on a knowledgeable board member, family member or in-house investment committee to manage their assets, most go to the outside for help. According to the newly released *Trends in Family Foundation Governance, Management and Staffing, Fourth Edition*, most family foundations (79.6%) hire outside investment managers to administer their funds. Many foundations hire more than one manager, mixing their assets among different classes as well as retaining managers with different attitudes, outlooks, risk tolerance and more. With several managers and asset classes, how can a foundation keep track?

The answer is an investment consultant. One in three family foundations (37.6%) hire outside investment consultants, among other reasons, to manage their investment managers. Especially in this economy, foundations are relying on investment consultants to hire managers of different stripes and to oversee their decisions.

What do investment consultants do?

Investment consultants can help foundations by

- Developing or refining an investment policy,
- Formulating an asset allocation policy and rebalancing decisions,
- Formulating spending and gift policies,
- Selecting, evaluating and—if necessary—terminating investment managers,
- Monitoring and reporting on investment performance.

Do we really need an investment consultant?

When working with diverse asset classes or with many managers, contracting a consultant may be the best approach. However, some consultants require a hefty fee up front and will not work with a foundation with assets less than $10 million. If your foundation assets are smaller and/or your investment program is relatively simple, you may do just as well with a financial planner, mutual fund consultant or custodian.

How do we find an investment consultant?

Ask your coleagues. Foundations near you may be able to help you identify someone. Read the Council's *Foundation Management Series, Tenth Edition, Volume 1* (see *On the Bookshelf*) for a list of investment consultants your colleagues use.

What should we ask in an interview?

When interviewing an investment consultant, ask them:

- Is your firm independent/unaffiliated, or a subsidiary of a larger organization such as a custodial bank or brokerage, money management or actuarial firm?
- How do you and your firm make money? Does the firm manage money? Do you or the firm accept revenue from investment managers (commissions, fees, etc.)?
- Are you the owner of the firm or an employee?
- What is your expertise and experience?
- For whom do you work/have you worked? How many foundation and endowment clients do you currently have?
- What is your work process and style? How will you work with us to accomplish our goals?
- What are the characteristics and standards of your firm's manager search—how many firms, which types, which asset classes?
- Under a retainer contract, are there any limits on consulting hours or any additional fees?

Always ask for references—and check them. Speak with clients (other family foundations, if possible) who use that specific consultant so they can tell you about both the firm and the individual.

This article contains excerpts from "How to Select an Outside Investment Consultant," by William McCarron, Foundation News & Commentary, *May/June 1996.*

Sites to See

Associations

The Investment Fund for Foundations (TIFF)—www.tiff.org

TIFF offers a variety of investment vehicles and educational resources for nonprofits.

Institute for Private Investors (IPI)—
http://rarc.rutgers.edu/memberlinkpublic/

IPI provides educational programs where individuals can compare notes with each other confidentially.

Magazines

Forbes—www.forbes.com
Fortune—www.fortune.com
Worth—www.worth.com
Smart Money—www.smartmoney.com

ON THE BOOKSHELF

NEW for 2002!
The Guide to Small Foundation Management: From Groundwork to Grantmaking. Council on Foundations, 2002. Whether you are looking for the basics or hope to improve upon your work, this desk reference describes the operating tools you need to structure—and run a small foundation. In 12 chapters, you will discover crucial legal requirements, operating tips, investment advice, office technology tools, board and staff dynamics, and more. Member $30; nonmember $60. To order, call 888/239-5221, order #826, or visit www.cof.org.

Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix, Third Edition. Council on Foundations, 1999. This book examines how various spending policies affect real and nominal values of assets and the long-term funding capabilities of endowed foundations. Member $35, nonmember $60. To order, call 888/239-5221, order #219, or visit www.cof.org.

Foundation Management Series, Tenth Edition. Volume 1—Finances, Portfolio Composition, Investment Management and Administrative Expenses in Private Foundations. Council on Foundations, 2002. Covers portfolio composition and investment management for foundations: asset allocation, use of investment consultants and managers, and spending policies. Member $40, nonmember $80. To order, call 888/239-5221, order #222, or visit www.cof.org.

The Family Advisor: Investment Policies and Practices. Council on Foundations. This information packet contains articles, sample policy statements and a glossary of financial terms. For a free copy, contact Family Foundation Services at 202/467-0407 or family@cof.org.

Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Assets. National Center Journal, Volume 2, 1999. This journal provides easy-to-understand answers to a full range of questions including spending policies, investment guidelines, mission-related investing, and risk tolerance. 169 pages, $45. To order, visit www.ncfp.org.

Creating and Using Investment Policies. BoardSource (formerly National Center for Nonprofit Boards), 1997. This booklet helps board members understand investing, spot and avoid shady investments and safeguard nonprofit assets. To order, call 800/883-6262 or visit www.boardsource.org.

Program-Related Investment Primer. Council on Foundations, 1993. By outlining the laws that govern program-related investments, this book teaches you how to preserve your charitable assets while expanding the reach of your programs. Member $15, Nonmember $25. To order, call 888/239-5221, order #505, or visit www.cof.org.

Financial Management for Nonprofits: Keys to Success. By Peter Konrad and Alys Novak. Regis School of Professional Studies, 2001. To order, call 800/798-4153 or 303/458-4150.

CALENDAR

February 21–22
Managing Your Small Foundation
Association of Small Foundations
Atlanta, GA
Lisa Cooke: 301/907-3337
lisa@smallfoundations.org

February 27–March 2
Annual Meeting on Health Philanthropy
Grantmakers in Health
The Waldorf-Astoria, New York City
GIH: 202/452-8331

March 6–8
Capacity Building for Impact
Grantmakers for Effective Organizations (GEO),
Washington, DC
CarolJLapp@aol.com or
www.geofunders.org/geo2002/

March 7–8
Trustee Leadership Seminar
Association of Small Foundations
Naples, FL
Lisa Cooke: 301/907-3337
lisa@smallfoundations.org

March 9–12
Ethics of Plenty in an Age of Uncertainty
Jewish Funders Network
International Conference 2002
Houston, Texas
JFN Office: 212/726-0177

March 10–14
WINGS (Worldwide Initiatives for Grantmaker Support) Conference of members of the WINGS and WINGS-CF Network,
Sydney, Australia
Jane Millar Wood: 202/467-0399

March 14–16
Neighborhood Funders Group
Annual Conference
Grand Hyatt, San Francisco, CA
NFG: 202/833-4690 or www.nfg.org

April 29–May 1
53rd Annual Conference of the Council on Foundations
Hilton Chicago and Towers
Chicago, IL
Conference Information:
202/466-6512
www.cof.org/conferences

What's New at the Council?

NEW

New Member Services!

The media relations department announces two new Council member benefits:

- **Breaking News**, posted each morning at www.cof.org/membersonly/headlines, puts you just a click away from the day's top philanthropy articles from around the world. Subscribe by e-mailing media@cof.org.
- **Newsroom**, posted at www.cof.org/membersonly/newsroom, offers a host of media relations tools including how to write press releases, develop a targeted media list, work with reporters, and build a relationship with the media. On the site's public side, the media and the public can browse through archived press releases, media alerts, and press kits developed specifically for each foundation type. For more information, contact media@cof.org.

Learn the Basics—Online

The Council on Foundations and the David & Lucile Packard Foundation announce *Grantmaking Basics Online*, a course in grantmaking fundamentals along with desktop resources. Discover critical topics for new grantmakers, written and online text, quizzes, study guides, references, and a toolbox of essential resources and much more. Go to www.cof.org/grantmakingbasics for a free preview of Chapter One.

New Grantmakers Salary Report

How does your salary and benefits package compare with those of other foundations? Find out in the new *2001 Grantmakers Salary and Benefits Report*, now available from the Council on Foundations. The report was compiled from survey responses from 728 foundations and giving programs, which employ a total of 5,993 full-time employees. Member $80, nonmember $150. To order, call 888/239-5221, order #221, or visit www.cof.org..

Correction

Building Community, Creating Justice: A Guide for Organizing Tzedakah Circles can be ordered by contacting the Shefa Fund at its new number, 215/483-4004.

"Your pot o'gold is doing nothing for you sitting at the end of the rainbow. At the very least, you should put it into a no-risk interest-bearing account."

Disaster Response Report

The European Foundation Centre and the Council on Foundations have issued Disaster Grantmaking: A Practical Guide for Foundations and Corporations. Based on a year-long study, the report includes lessons learned and eight principles of good disaster management. Read it at www.cof.org/whatis/types/international/publications/disasterguide.pdf or order a free copy by calling 202/467-0435.

Find out what's REALLY going on in Family Foundations.

NEW and IMPROVED!
Trends in Family Foundation Governance, Staffing and Management. ***Fourth Edition, 2001***
Packed with compelling information and anecdotes on how family foundations invest assets, select and orient board members, compensate board and staff—and more! 92 pages; member $35, nonmember $60. To order, call 888/239-5221, order #825, or visit www.cof.org.

Family Foundation Conference Web Archive

Your key to cost-effective, up-to-the-minute **professional development!**

The conference Web Archive is an online databank of summaries, links, references and speaker information from the Family Foundation Conference in New Orleans.

It's easy—and free for Council members! All you need is your member user name and password and at least a 56K modem.

E-mail webmaster@cof.org if you need assistance with your member password.

Beginning February 15, 2002, members can log onto www.cof.org/goto/ff02 for selected sessions from the 2002 Family Foundations conference.

Want a sample? Go to www.cof.org/simulconference and view content from the 2001 Family Foundation Conference archive.

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