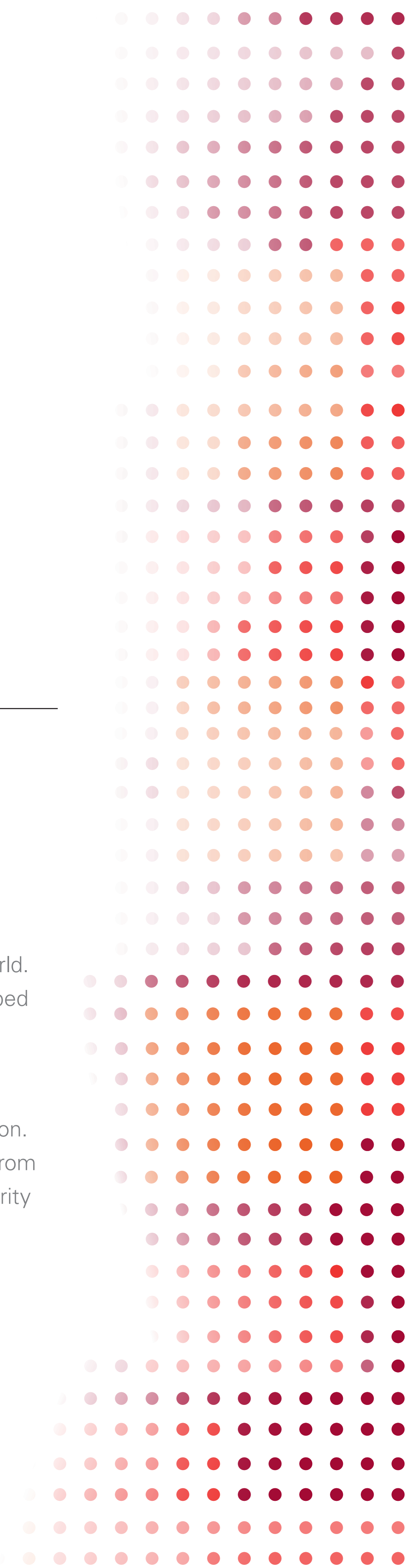
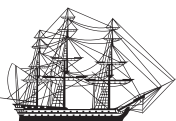


VANGUARD COMMENTARY

# Key topics nonprofit organizations should consider

Nonprofit organizations operate in a complex and evolving financial world. As one of the world's largest investment managers, Vanguard has helped thousands of nonprofit organizations navigate their unique investing, organizational, and governance challenges.

We recognize nonprofits differ by size, served market, and sophistication. The chief financial officer of a hospital will likely have different needs from the CFO at a college, while the executive director of a small public charity will have different needs from either.



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This white paper covers five key topics that we believe are of particular importance to the majority of nonprofit organizations in the coming year given recent developments in capital markets and trends among institutional investors:

- Assessing the financial health of the organization.
- Spending policy.
- Alternative investments.
- Granting investment discretion.
- Environmental, social, and governance investing.

We also will explore several "perennial" topics we believe are relevant to all nonprofits and should periodically be considered by boards and committees:

- Corporate governance.
- Improving investment committee performance.
- Investment policy statements.
- Liquidity and cash.
- Rebalancing.
- Benchmarking.

# Key topics for 2019

## Assessing the financial health of the organization

Although Vanguard's longer-term capital markets return expectations are more consistent with historical returns, our expectations for the next few years are somewhat muted, based on high valuation levels and our belief that the accommodative tailwinds of the past ten years are fading. Given subdued near-term expectations, endowments may well experience returns that are below their long-term assumptions. It is particularly important for nonprofits to assess their financial health in this environment. All nonprofits should periodically monitor their financial health regardless of market conditions, using a combination of financial ratios, examination of cash flows and balance sheets and an assessment of the impact of future actions, such as fund-raising efforts and the impact of new accounting standards, among others.

**Everything begins with one question: How long can we keep the doors open?**
Each organization will decide how much it needs. We suggest a good starting point is having unrestricted reserves (not cash) equivalent to about six months of costs.

**Cash flow**
It's not uncommon to see nonprofits post surpluses but have to borrow money to meet payroll because payers are slow to pay. Boards must have an unrelenting focus on the timing of cash flows and their organizational impact on organizations.

**Liquidity**
There are several questions that should be asked when examining an organization's liquidity: How much cash do you have on your balance sheet? How liquid is your investment portfolio? Do you have a liquidity profile? If you have illiquid investments, where do you stand in the funding cycle? Is a line of credit a better option than selling assets at depressed values?

**Financial ratios**
Board members should know and understand several key financial ratios from the organization's balance sheet: daily cash on hand, current ratio, quick ratio, and debt ratio. Members should also understand the operating margin and operating reliance (unrestricted program revenues divided by total expenses) from the organization's statement of operations.

**Liabilities**
An organization's liabilities are critical to its financial health. Key liabilities for boards to monitor include:

- Underfunded pension plans. Your organization's financial flexibility is limited if you have a pension that is not fully funded.
- Operating leases. In 2019, operating leases must have the associated asset and liability recorded on the balance sheet at the present value of future lease payments, which will attract more attention from donors and other readers of your financial statements.
- Debt. How much debt do you have on your balance sheet? What is the entity's plan to repay it? Is the debt fixed or floating? Have you guaranteed a loan or a repayment for another nonprofit entity?

**Accounting rule changes**
There are a number of recent and upcoming accounting rule changes that will affect nonprofits. We suggest that boards discuss these changes with their internal finance staff (if any) and auditors:

- Not-for-Profit (NFP) Presentation (ASU 2016-14), effective for fiscal years starting on or after December 15, 2017, on how nonprofits classify net assets, liquidity, and availability of resources, expenses, and investments.
- Revenue Recognition from Contracts with a Customer (ASU 2014-09, topic 606), effective for fiscal years starting on or after December 15, 2018, creates a single, principles-based revenue recognition standard under generally accepted accounting principles (GAAP).
- Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made (ASU 2018-08, topic 958), effective for fiscal years starting on or after December 15, 2018, impacts all nonprofits for whom grants are a significant source of revenue and those whose primary activity is making grants.

## Spending policy

The prospect of diminished investment returns also impacts spending policy for nonprofits. Spending policy refers to how much of an organization's investable assets may be spent annually in support of its mission. All too often, nonprofits try to jump to the answers (e.g., spend 4% of the 16-quarter moving average of assets) before they've examined all the factors.

**Intergenerational equity**

In order to achieve intergenerational equity, the real purchasing power of the endowment in the future should be the same as it is today. This goal is impossible to achieve but worth targeting. Spend too much today and you hurt future beneficiaries; spend too little and you favor the future at the expense of the present.

There is another trade-off: balancing the desire for stable spending versus maximizing the value of the endowment. Understanding these two trade-offs is critical to any discussion of spending policy, as the policy a board chooses will influence which side of each trade-off is favored.

**Classification of spending policies**

Spending policies come in two basic types and four categories:

**Types**

1. Policies that start with a percentage—however derived—of an asset pool (e.g., "4% of $100 million").
2. Policies that start with dollars spent in a previous period (e.g., "last year's budget was $4 million").

**Categories**

1. Simple. Simple rules, such as "spend 4% of the beginning market value of the portfolio," engender a lot of variability, whether of spending or of the change in the value of the corpus.
2. Smoothed. Organizations often use smoothing to help stabilize spending: "spend 4% of the 12-quarter moving average of the beginning market value of the endowment." The longer the moving average (16, 20, or even 24 quarters) the greater the smoothing impact.
3. Inflation-based. Inflation-based rules attempt to achieve stability in spending. "Take last year's spending and multiply by an inflation factor relevant to the organization as the basis for current year spending." Sometimes the rule will place an upper and lower band on the outcomes.
4. Hybrid. Hybrid methods try to find a balance between the flavors: part is based on the prior year's spending (to stabilize budgeting) with the remainder based on the value of the endowment. Hybrid methods are used by entities like Yale, whose rule is straightforward: {80% x (Prior Year's Spending x [1 + Inflation])} + {20% x (Current Portfolio Value x Spend Rate)}.

**Insulating spending from investing outcomes**

Although nonprofits can't control investment returns, they can control costs and spending. If organizations can keep spending low—4% or even lower—the compounding effect of these savings can result in larger corpus values and higher overall spending in nominal dollars.

**Questions committees should be asking**

Prior downturns have lasted anywhere from 3 to 30 months, so it's important to have a plan in place for lean times. Committees should ask:

- Do we know what is included in our spending rate assumptions? Do those assumptions cover administrative expenses as well as disbursements?
- How do we as a board think about the issue of intergenerational equity? Can "spenders" and "savers" get on the same page in times of market duress?
- Do we rely entirely on endowed pools or do we have other sources of support (tuition, memberships, annual giving)?
- Have we considered the seven factors mandated by the Uniform Prudent Management of Investment Funds Act?
- Are we minimizing investment costs to maximize net return outcomes?

**Further reading**

Vanguard has published a number of white papers on spending policy over the years, most recently *Is 5% the Right Return Target for Institutional Investors?* in February 2018. These white papers can be found online at institutional.vanguard.com.

## Alternative investments

We've seen the allocation to illiquid alternatives in many institutional portfolios continue to grow in the hope they will deliver higher returns than can be achieved from public markets. This may or may not be true, but fiduciaries must recognize how difficult it can be to successfully invest in alternatives and understand the impact that illiquid investments have on portfolio liquidity.

There is no universal industry definition of what constitutes an alternative investment. Generally, the term refers to securities outside of traditional stocks and bonds sold in highly regulated public markets that provide investors with daily liquidity. Alternatives often are either a class of physical assets (e.g., real estate or commodities) or private investments (which purchase different forms of financial and/or physical assets).

While popular among nonprofits, alternative investments pose unique issues.

**Reduced liquidity**
Private investments are characterized by constraints on their liquidity, some created by the illiquid nature of the underlying investments and others by the decisions of the general partners controlling the private investment. They generally fall into two broad categories:

1. Drawdown funds investing in illiquid assets (private companies, oil fields, timber, farmland, aircraft, start-up ventures, and the like). These can be called "private equity" or "real asset" funds.
2. Funds investing in less liquid parts of the financial markets (exotic mortgage-backed securities, bonds of firms that have filed for bankruptcy, when-issued securities, debtor-in-possession financing for bankrupt entities). These are often called "hedge funds," which is not particularly descriptive.

Both types of funds tend to be characterized by significant amounts of capital seeking returns from among a limited set of investments and significant variability in the returns managers generate for their investors. And they pose extensive due diligence challenges.

Investors used to transacting in two days in publicly traded stocks and bonds relinquish that flexibility when they invest in private investments. This is not necessarily a bad thing, but it has consequences which investment committees must contemplate. When a portion of the portfolio is invested in illiquid securities, the liquid portion must carry the burden of both providing liquidity and rebalancing.

**Dispersion of returns**
It is useful to look at the difference in returns between the top and bottom quartile of managers pursuing the same strategies. Core fixed income manager returns are tightly clustered with little performance dispersion, while illiquid alternatives show wide dispersion, with significant differences between top- and bottom-quartile performers.

**Due diligence challenges**
Many funds lack long performance histories. For funds that invest in less liquid parts of the capital markets, general partners can be reluctant to share holdings, making diligence more difficult. The largest nonprofits perform extensive background checks on the principals of the general partner, make dozens of calls to former colleagues, and examine legal proceedings or court cases. They spend dozens of hours of legal time reviewing fund documents as well as negotiating terms. Is your nonprofit willing to make a similar effort?

**Availability of access**
By some estimates there are several trillion dollars in capital ready to be invested in the best (top-quartile) alternative funds, so the general partners of the funds most in demand can be extremely selective about who they will let invest in the fund. If your nonprofit is not Yale, it is unrealistic to believe you will get into the most exclusive funds.

**Persistence of returns**
Studies in the early 2000s showed evidence of persistence of returns in private equity, meaning that managers with the highest past returns were likely to continue to show the best returns. Studies done a decade later suggested persistence of returns had declined significantly, attributed to the maturation of the sector along with more competition and more money chasing the same set of opportunities, driving down returns.

**Diversification challenges for smaller nonprofits**
To have a truly diversified private investment portfolio, institutions must invest over time, using what's called a "vintage year" approach. The need to make multiple investments, combined with larger minimum investment requirements can make it hard for smaller institutions to create diversified portfolios of alternatives; using funds of funds adds an additional layer of fees.

It is increasingly common to see the most sought-after general partners asking for minimum commitments of $25 million or $50 million, versus the $5 million or $10 million common just a few years ago. If your nonprofit can only allocate small amounts, you face difficulties.

## Granting investment discretion

Most nonprofits don't employ full-time investment staff, committee members have other duties, and nonprofit boards may feel they lack sufficient investment expertise to properly oversee an investment portfolio. This leads many to grant discretion to an outside firm as an outsourced chief investment officer (CIO).

There are several questions a nonprofit should consider before engaging an outsourced CIO.

**Why would we grant discretion?**
The nonprofit may not have the staff to oversee an investment portfolio and board members may feel they lack both the time and the requisite knowledge to oversee the entirety of the investment portfolio.

**What sort of outsourced CIO do we wish to hire?**
The growth in the number and size of discretionary mandates has exploded in recent years, which has attracted many entrants: firms run by former chief investment officers, investment consultants, retirement plan specialists, benefits consultants, registered investment advisors, and investment banks, among others.

**What are some of the questions we must ask as part of our due diligence?**
A nonprofit retains fiduciary responsibility when hiring an outsourced CIO, which imposes a strong duty of care. It must perform adequate due diligence. Possible questions to ask during the diligence process include:

- How long has the outsourced CIO firm been in existence? How long has it been providing discretionary investment services? Can it document its track record?
- What is the firm ownership structure?
- Who are the firm's clients? How many of its clients look like us (whether members of the same vertical, having similarly sized investment pools, etc.)?
- How much scale does the outsourced CIO have, in terms of customer service, investment research, or operations?
- Is the firm's investment approach customized or are all customers put in the same model portfolios?
- What services are included: asset allocation, rebalancing, assessments of portfolio risk, holdings-based analysis, factor exposures, etc.?
- Does the discretionary provider offer guidance on spending policies?
- How much support will we receive once the relationship has begun?

**What is the role of the investment committee after we've granted discretion?**
An investment committee's fiduciary responsibility requires oversight after granting discretion. The committee must continue to monitor the elements laid out in the investment policy statement, assess the health and stability of its outsourced CIO, discuss the policy portfolio and the return assumptions periodically, and continue to discharge its fiduciary obligations.

## Environmental, social, and governance (ESG) investing

More and more nonprofits want to align their behaviors—including how they invest—with their values. We recognize this desire, particularly among faith-based organizations, and want our clients to know the various steps involved in achieving this objective.

**Legal and policy framework**

Private foundations pursuing ESG investing must not run afoul of the jeopardizing investment rules. All nonprofits must be in compliance with state laws governing fiduciary duties of directors, such as the Uniform Prudent Management of Institutional Funds Act (UPMIFA) or the Uniform Prudent Investor Act (UPIA). All nonprofits must also understand the terms of their governing documents.

Since a version of UPMIFA has been approved in 49 states, boards should be aware the law calls out two sets of factors:

- The first set addresses general fiduciary principles and requires an organization—and those who manage and invest its funds—to:
  - Give primary consideration to donor intent as expressed in a gift instrument.
  - Act in good faith, with the care an ordinarily prudent person would exercise.
  - Incur only reasonable costs in investing and managing charitable funds.
  - Make a reasonable effort to verify relevant facts.
  - Make decisions about each asset in the context of the portfolio of investments, as part of an overall investment strategy.
  - Diversify investments unless, because of special circumstances, the purposes of the fund are better served without diversification.
  - Dispose of unsuitable assets.
  - In general, develop an investment strategy appropriate for the fund and the organization or charity.
- The second set addresses factors that must be considered when managing and investing an institutional fund:
  - General economic conditions.
  - The possible effect of inflation or deflation.
  - The expected tax consequences, if any, of investment decisions or strategies.
  - The role that each investment or course of action plays within the overall investment portfolio of the fund.
  - The expected total return from income and the appreciation of investments.
  - Other resources of the institution.
  - The needs of the institution and the fund to make distributions and to preserve capital.
  - An asset's special relationship or special value, if any, to the charitable purposes of the institution.

Some of these factors, particularly the ones that refer to the need to "develop an investment strategy appropriate . . . for the organization" and "an asset's special relationship . . . to the charitable purposes of the institution," have caused many industry observers to say that some ESG investing is permissible, assuming certain steps have been taken and that the investment relates to the organization's mission.

**Potential investment returns**

Many studies have tried to determine whether portfolios of securities that follow ESG guidelines outperform or lag the broad markets. The results have been inconclusive. The only thing we can say with certainty is that those portfolios will post results over time that will differ, sometimes materially, from the returns achieved by broad market indexes. Hence, investment committees contemplating ESG investments must acknowledge this and make decisions with their eyes open.

**Further reading**
In August 2018, Vanguard published a white paper titled *ESG, SRI, and Impact Investing: A Primer for Decision-Making*, which addresses many of the issues involved in assessing ESG products and deciding on their role in a portfolio. We outline four key steps institutions must take to make a prudent ESG investment decision:

1. Define your goals.
2. Evaluate your options.
3. Decide on action.
4. Reassess periodically.

The white paper can be found online at **institutional.vanguard.com**.

# Perennial topics

## Corporate governance

Vanguard is a permanent investor in thousands of companies around the world. Through a process we term "investment stewardship," we work with companies on issues of corporate governance to drive sustained long-term performance. In our most recent year, we voted proxies at nearly 20,000 meetings and engaged directly with more than 700 portfolio companies.

Stewardship rests on four pillars which are as relevant for nonprofits as they are for for-profit entities:

1. **Board composition.** *Good governance starts with a great board of directors, and we look for high-functioning, well-composed boards with effective ongoing evaluation practices.* Most nonprofits rely on volunteer boards, often pulled from a narrow geography and a small group of potential candidates (often tilted toward donors and people familiar with the organization's mission). Many nonprofits should consider broadening and deepening their pools of potential board members, having a reserve of candidates, and educating board members on the organization.
2. **Executive compensation.** *Pay structures should be constructed in a way that incentivizes outperformance over the long term.* The board of every entity filing a 990 is familiar with executive compensation and the need to document comparative compensation, as both are basic IRS requirements.
3. **Oversight of risk and strategy.** *Boards should maintain effective, integrated, and ongoing oversight of material risks and governance of a company's long-term strategy.* Nonprofits risk losing sight of long-term strategy because they are so absorbed by programmatic challenges, near-term financial performance, and fund-raising.
4. **Governance structures.** *We believe in provisions and structures that empower shareholders and protect their rights.* Nonprofits need clear bylaws and should have charters spelling out the existence and composition of committees, their responsibilities, and other procedural steps.

# Improving investment committee performance

Effective investment committees can help overcome the unique financial challenges nonprofits face.

**Role of the board chair**

The board chair plays a critical role in improving committee performance, and can take the following steps:

- Allow adequate time at meetings for full discussion of the topics on the agenda.
- Solicit topics for agendas well in advance of the investment committee meeting date, circulate agendas at least a week before the meeting, and, once the agenda has been circulated, not permit discussion on any topic not on the agenda.
- Insist all investment recommendations contain a clear articulation of return and risk assumptions.
- Think about the use of designated "naysayers" to question proposed investments.
- On complicated topics, create subcommittees to perform in-depth analysis to be reported out to the full committee.
- Keep detailed minutes to be shared with the board and with prospective committee members.

**Recognizing biases**

Traditional finance theories hold that markets are efficient and that investors make rational decisions, unswayed by their emotions. Over the past 30 years, however, behavioral finance has come to the fore, recognizing the impact of actual behavior and leading to the realization that individuals and groups are prone to biases that lead to suboptimal decisions.

Here are a few of the more common biases found in investing:

- Overconfidence. Most investors overestimate their ability to outperform the market and place greater emphasis on their own forecasts versus other forecasts.
- Home bias. Investors tend to place a larger-than-average weighting in domestic securities of their home country, often because the investor is more familiar with domestic products and services.
- Herd behavior. Investors often mimic the actions of a larger group even though the individual would not necessarily make the same choice.

With these biases in mind, here are some steps you can take to offset suboptimal human tendencies:

- Adopt an investment policy statement. This document formalizes the goals and objectives of the portfolio and can help prevent hasty decisions during periods of market volatility.
- Diversify the investment committee. Decision-making can be improved if the committee is diverse. In this context, diversity includes members without investment backgrounds as well as those versed in investing.
- Promote collegiality and questions. Ensure individual members are encouraged to share their views rather than simply fall into line with an influential member of the committee and try to avoid having one or two members speak more than other members.
- Commit to rebalancing. The policy should be agreed upon during calm periods and strictly followed during turbulent market conditions.

**Understand your capabilities**

You may wish to invest like Yale, but unless you enjoy all of that institution's advantages, you won't be able to do so. In fact, you may hurt your organization trying.

Institutions that lack those advantages must think twice about how they manage their investment pools. Do they have the capability to perform adequate due diligence of managers within traditional asset classes, let alone of alternative managers? How do they track and assess performance?

**Questions an investment committee must ask**

- Are we in compliance with the requirements of our state's version of UPMIFA?
- Does the strategic asset allocation align with our long-term goals and objectives?
- Does it make sense to consider investment options that are not highly correlated to the traditional equity and fixed income asset classes?

## Investment policy statements

We believe every nonprofit with investable assets must have an investment policy statement (IPS) to be in compliance with its fiduciary obligations.

Every IPS should include the following elements:

- A description of the covered assets and/or investment pools.
- Roles and responsibilities for the investments.
- Investment objectives and the length of the investment horizon.
- Asset allocation definitions and investment guidelines (portfolio construction).
  - Permissible asset classes and the target percentage allocated to each (policy portfolio).
  - Upper and lower ranges for each asset class.
  - The benchmark used to measure each asset class.
- Risk tolerance.
- Liquidity requirements.
- Performance objectives and benchmarks.
- Rebalancing.
- The framework for identifying, monitoring, and replacing investments.
- Other policies (conflict of interest, policies about the use of leverage and/or derivatives, etc.).
- Any unique circumstances.
- The process for reviewing and modifying the investment policy statement.

The following are frequently incorporated into the IPS but may also exist as stand-alone documents:

- The nonprofit's history and mission.
- The organization's spending policy.
- The investment committee charter and governance policies.

## Liquidity and cash

We encourage nonprofits to think about liquidity in several ways:

1. Having enough unrestricted reserves to cover six months of operating expenses.
2. Having sufficient liquid assets in the endowment to cover spending requirements.
3. Having a secured line of credit to avoid having to sell assets in a sustained down market environment.

## Rebalancing

Regular rebalancing keeps the portfolio in line with its long-term objectives and helps the committee resist being influenced by the state of the capital markets and the emotions triggered in committee members.

Institutions rebalance in three ways: according to the calendar, according to deviations from the policy portfolio allocations, and according to the timing of cash flows.

The calendar approach is what it sounds like: At a pre-specified interval (monthly, quarterly, or annually) the portfolio is rebalanced back to the policy target.

Deviation from the policy portfolio is more difficult, as the nonprofit must make decision rules. If the policy portfolio is 65% equities and 35% bonds, and the portfolio has gone to 70% equities and 30% bonds, does the institution rebalance all the way from 70% to 65%, or does it go to an intervening percentage?

Many institutions prefer to rebalance to fund cash flows. That can save transaction costs: If equities have appreciated significantly, the nonprofit can sell equities to fund spending without necessarily having to buy fixed income.

## Benchmarking

Benchmarking begins with a statement of the long-term goal for the portfolio. If you wish to maintain the real spending power of the pool, state the objective: e.g., the portfolio should grow at rate of Consumer Price Index inflation plus 5%.

Once the goal is established, an appropriate benchmark should be used to assess performance versus a strategic target allocation. The benchmark should be one of the following:

- One that reflects all the asset classes in which you're invested.
- A simplified one, such as one measuring the results of a portfolio 70% invested in a broad global stock index and 30% in a broad global bond index.

Organizations often compare themselves with their peers, but must ensure the comparison is relevant. When examining a potential peer, ask yourself the following questions:

- Do your organizational complexities and goals make you substantially different from peer institutions?
- What if you outperform your benchmark index but underperform your peers or vice versa?

Many nonprofits measure themselves against well-known endowments such as Harvard and Yale. These are unlikely to be true peers, as they are quite large and have different investment models and risk-return profiles compared with most nonprofit portfolios.

In the end, the best benchmark is one that considers the long-term goals of your investment program and the strategic asset allocation of your portfolio.

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