Nonprofits Are Different and So Are Their Investments

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Overview

After years of experience advising nonprofits about the legal and operational management of invested funds, and reviewing reams of literature on investing, we eventually realized that too little attention is paid to the unique aspects of investment of nonprofits' funds. Optimization of investment results for nonprofits requires more attention to their unique attributes. The management of nonprofit funds has a tendency to become routine, but with the precipitous decline in the investment climate the past few years, that will no longer be the case. As recent times have vividly demonstrated, historic averages and traditional forms of investing may not be a reliable foundation for current planning. Nonprofits have experienced substantial losses in apparently well-managed portfolios. This phenomenon will and should invite closer scrutiny of issues such as: how broad is the proper scope of diversification; do "alternative investments" increase or decrease risk; and how does investment differ from speculation, all issues we have had to address with thoughtful nonprofit fiduciaries.

Return on investments, however, is but part of the story. Knowledge of the legal requirements as well as best practices is important to nonprofits that manage investments internally, to those that delegate management to investment consultants, managers and trustees, to persons who accept such responsibilities, and to lawyers, CPA's and other third party professionals serving nonprofits. We aspire to help nonprofit fiduciaries, staff and advisors to (1) be fully aware of the special investment needs, issues and compliance requirements of nonprofits, (2) use that awareness to optimize investment results, (3) understand the concepts and terminology they hear from vendors and investment professionals, and (4) ask the right questions and make good decisions.

Nonprofits are Different and so are Their Investments

To the casual observer principles of investing might seem to be universal, regardless of the ownership of the assets in question. Sometimes even investment professionals fall into this trap. We have observed numerous presentations by prospective money managers who tout their particular skills, experience and style as though they were universally applicable regardless of the nature of the owner of the assets. The astute fiduciary, advisor or investment professional, however, realizes that an investment policy and its implementation must be very carefully tailored to the nature, biases and requirements of the owner. The vast differences between types of owners and appropriate investment approaches can perhaps be most quickly illustrated with a chart listing some types of owners, the purposes for which they are investing, and some of the relevant characteristics that would need to be taken into account in determining their investment policy.

Type of Owner	**Purpose of Investment**	**Income Tax Status of Assets**	**Investment Time Horizon**	**Current Distribu-tion Require-ments**	**Sensitivity to Type of Income Generated**	**Sensitivity to Risk**	**Are Fiduciary Considera-tions Relevant?**
30-year old's IRA/401(k)	Retirement	Exempt	35 to 70 years	None for 35 years; then moderate	None	Low	No
55-year old's IRA/401(k)	Retirement	Exempt	10 to 45 years	None for 10 years; then moderate	None	High	No
Trustee of a "sprinkling" generation skipping transfer trust in perpetuity	Family endowment and bank for generations	Taxable	Unlimited	Variable	Tax sensitivity	Low	Yes

Trustee of a 6% lifetime charitable remainder unitrust for 60-year old	Current support for life beneficiary; remainder to charity	Exempt	35 years	6% of asset value	Tax sensitivity only	Low to moderate	Yes
Trustee of a corporate pension plan	Meet current and future pension plan obligations to retirees	Exempt	Unlimited	Variable	None	Moderate	Yes
Trustees of a university's endowment fund	Current support for university	Exempt	Unlimited	Usually 3%-5% of asset value	None	Moderate	Yes
Trustees of a hospital capital expansion fund	Pay for construction of planned new facilities	Exempt	Governed by tax expansion schedule	None until start construc-tion; then substan-tial	None	High	Yes

Even when one narrows the category of investors down to "nonprofit organizations" there is still great variety. Nonprofits range from churches to universities to hospitals to operating charities to private foundations to social clubs, labor unions, chambers of commerce, trade associations, and homeowners' associations. In fact, the Internal Revenue Code recognizes at least 63 categories of tax-exempt organizations, some of which have several subcategories. From an investment perspective the three key characteristics of most nonprofits are: 1) exemption from income tax, 2) potentially perpetual existence, and 3) ownership of assets in a fiduciary capacity. Two possibly less universal factors are that some nonprofits have a "mission" that can affect investment policy and that most have significant current cash flow requirements. To illustrate the significance of these factors compare the investment requirements of a university's endowment fund with those of a 55-year-old's IRA account in the above table.

Investment managers and advisors are not, of course, oblivious to these differences. However, too often their approach still tends to be a one-size-fits-all approach. The mantra under which they proceed is "asset allocation" and ascertaining the "risk tolerance" of the client. The factors most often underemphasized in this process are sensitivity to types of income generated and to tax rates and cash flow requirements.

Tax Exemption and Unrelated Business Income Tax Considerations

When the income tax was first enacted in 1913, the statute included an exemption for charitable nonprofits. The exemption applied to virtually all types of income of qualified nonprofits until 1950 when the Congress enacted the first version of the unrelated business income tax.

The effect of the law is to exempt from tax the most common types of current passive investment income, such as interest, dividends, rents or royalties, as well as the capital gains on assets which are held for investment purposes, provided that the assets are not subject to acquisition indebtedness. Thus a principle requirement in structuring the investment portfolio of a typical nonprofit is avoidance of acquisition indebtedness. The nonprofit should be able to ascertain whether it acquired its investment assets with borrowed money. However, when the assets take the form of investments in so-called "pass-through entities," such as a partnership or limited liability company ("LLC"), the inquiry is a bit more complicated. That is because the acquisition indebtedness concept also applies to the assets of the pass-through entity. Income of a pass-through entity that would have been unrelated business taxable income ("UBTI") had the nonprofit itself engaged in the same transactions, will retain its character as such when the income is deemed distributed to a nonprofit owner. Thus advisors to nonprofits need to give special scrutiny to investments in partnerships or LLCs of all kinds but especially those holding real estate or operating "hedge funds".

This is not to say an investment generating UBTI is forbidden.[1] The investment may be sufficiently attractive and may have a role to play in the nonprofit's overall investment portfolio even though it is subject to the unrelated business income tax. The important point is for the nonprofit to make a fully informed decision and to know in advance whether the yield from the investment is going to be reduced by that tax. Obviously it is very important for the fiduciaries, staff and advisors of nonprofits to be somewhat familiar with these rules and to inquire when there is any doubt as to the nature of the income produced by proposed investment. Moreover, astute money managers and investment advisors will also be thoroughly familiar with these consequences when proposing investments to nonprofits and should be prepared either to provide assurances that the income will not be UBTI or to demonstrate the advantages of the investment notwithstanding the taxation of its income.

Some nonprofits may have unrelated business activities that tend to generate a loss. Unless that loss is offset by other unrelated business income, it is of no value to the nonprofit. Therefore, notwithstanding the fact that an investment is taxable and ordinarily would not be attractive, it could be attractive to such a nonprofit.

"In Perpetuity" Considerations

The second key characteristic of most nonprofits is that, at least theoretically, they can last forever. The oldest university in the United States, Harvard University, was organized in 1636. However, it is a mere babe compared to predecessors in England. Oxford University was created in 1096 and Cambridge University in 1226.

Of course, not every nonprofit that could last forever manages to do so. However, those that aspire to be among the long-lived will, sooner or later, seek to build an endowment. In a nutshell, an endowment consists of investment assets that are set aside, either on the books of the nonprofit or in a separate trust or corporation, the purpose of which is to produce a stream of income to help support the nonprofit through good times and bad but the principal of which can never be consumed. This restriction, properly imposed, is legally enforceable. It is often of great importance to contributors to endowment, who want to be sure that the fiduciaries of the nonprofit, in a time of temporary need or out of laziness, do not resort to endowment principal to keep the doors open.

The relevant investment time horizon for an endowment fund is unlimited. Under the law as it existed prior to enactment of the Uniform Management of Institutional Funds Act ("UMIFA"), absent variance in the donative instrument, endowment capital could not be distributed for expenditure by the nonprofit; only the "net current income"—typically, interest, dividends, rents or royalties—could be distributed. The nonprofit's natural interest, therefore, in maximizing current cash flow put pressure on the fiduciaries of the endowment fund to invest in assets that produced a high level of current income. This investment philosophy, however, skewed the investment allocation toward fixed income and necessarily made it difficult for the assets of the endowment fund to experience real growth or even maintain purchasing power vis-à-vis inflation.

Moreover, in recent decades common sense and a due regard for lower capital gains tax rates have led investors to embrace "total return" styles of investing, where the most important factor is the total return, in whatever form, produced by a portfolio, not the type of gain that produces the return. Trustees of endowment funds of nonprofits that took a longer view and were satisfied with relatively low current yields in order to facilitate principal growth eyed the escalating levels of capital gains, both realized and unrealized, in the endowment portfolio as a logical source of current funds, provided reasonable restraint were exercised. This led to the enactment of the original version of UMIFA on a somewhat experimental basis in a number of states starting in 1972. As originally enacted in California in 1974 UMIFA was only applicable to colleges and universities. The benefits of the act were not extended to other nonprofits in California until 1991.

[1] One tax-exempt entity to which UBTI is fatal, instead of just an inconvenience, is the qualified charitable remainder trust under Code section 664. If the trust has any UBTI in a tax year, it loses its exemption for that year. Legislation (H.R. 7) has been introduced that would eliminate this draconian penalty.

The critical section of the California act, Probate Code § 18502, reads as follows:

> The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established under Section 18506. This section does not limit the ability of the governing board to expend funds as permitted under other law, the terms of the applicable gift instrument, or the charter of the institution.

This is, of course, a default rule that can be overridden either in a specific gift instrument or in the published endowment policies of the nonprofit. Under it, endowment fiduciaries may use a total return investment policy knowing that, subject to prudence in the decision as to how much of the total return to distribute, they need not be concerned about the particular form of the yield that produces the return.

The potentially perpetual existence of a nonprofit and particularly its endowment funds presents the fiduciaries with the delicate task of (1) determining how much current yield it is prudent to distribute and (2) determining and achieving a total yield over a long period of time that will enable them both to maintain the desired level of current distributions (presumably a growing distributable amount) and the inflation-adjusted value of the principal and, ideally, some real growth in the principal.

The Nonprofit's Mission and its Investments

Although it is currently fashionable for everyone from individuals to international mega-corporations to have missions and mission statements, most nonprofits have always had missions whether or not they had a mission statement. At one time, the investment funds of nonprofits might have been invested simply for return and preservation of capital without regard to the activities of the companies whose stock was owned. Now, however, another type of fashion, and indeed political correctness, has invaded the world of nonprofits as well.

Some nonprofits probably have long been sensitive to investing in the stock of companies that produce products or engage in activities that are obviously inconsistent with the tenets of the nonprofit. For example, it is highly unlikely that the Catholic Church would invest in a company that owns and operates abortion clinics nor is it likely that the Church of Jesus Christ of Latter Day Saints would invest in a company that produced cigarettes or liquor. In recent decades, however, the concept of "socially responsible" investing has emerged and has become a cottage industry. This takes the notion of sensitivity to the nonprofit's mission to another level. Not only must the company not produce a product in obvious conflict with the principles of the nonprofit or with the arbiters of social responsibility, it must also operate its business in a socially responsible manner.

The nonprofit's mission might impact its investment policy in other ways. For example, if the nonprofit were endeavoring to raise large amounts of money for a particular cause (e.g., Live Aid) with the expectation of expending them rapidly, that would obviously influence the manner in which those funds would be invested.

Cash Flow Requirements and Investments

Nonprofits commonly have predictable and essential cash flow requirements some portion or all of which may be dependent on yield from investments. Those requirements are usually internally determined and therefore presumably somewhat malleable. However, in some instances they may be externally imposed. For example, private foundations are required by IRC § 4942 to make "qualifying distributions" in an amount equal to five percent of the fair market value of their investments. It is a common practice for fiduciaries of an endowment fund to manage their own expectations and those of the managers of the benefited nonprofit by establishing a fixed percentage of capital to be distributed each year, perhaps based on an average fair market value over a number of years.

All these considerations mean that cash must be withdrawn from the pool of investment assets periodically and distributed or expended for operating purposes. Interest rates may ebb and flow; years of net capital gains may be followed by years of capital losses. However, it is not likely that the cash flow needs will track these variations.

Therefore, it is often important for the managers of the investment portfolio of a nonprofit to find a way to produce a relatively steady annual cash flow.

The Heart of the Matter: Fiduciary Duties

One thing that all nonprofits have in common is that fiduciaries are in charge of their assets, both investment and non-investment. The applicable standards with which the fiduciaries must comply will vary from state to state and among types of nonprofits; however, these are just variations on a common theme. The fiduciaries are not accountable to individual owners, as the fiduciaries of a business corporation are. Nor are they typically in the business of taking entrepreneurial risks with the hope of achieving entrepreneurial rewards.

The levels of fiduciary responsibilities are compounded in the case of nonprofits holding assets for charitable or other public purposes. Such nonprofits are seen as subject to fiduciary responsibilities to the public at the entity level, over and above the normal fiduciary obligations of their own fiduciaries to the entity itself. Both levels of fiduciary responsibility are subject to enforcement by state attorneys general, acting on behalf of the public as beneficiaries. The fiduciary responsibilities, of course, include managing the assets for public benefit but also derive from state law prohibitions on substantial modifications of the purposes for which contributed funds can be used: for example, not changing the nature of a medical college from osteopathic to allopathic in the absence of impossibility to pursue the original goal. The investment responsibilities of fiduciaries of nonprofits are generally a matter of state law.

The Impact of Planned Giving on the Investment Activity of Nonprofits and Vice Versa

The advent of extensive planned giving activity in the development offices of large nonprofits has caused most such institutions to enter the investment management business. Being in the investment business, both for internal and external funds, e.g., charitable remainder trusts, pooled income funds, endowment funds, and charitable gift annuity reserves, requires a process driven by both statutory and donor relation responsibilities. The discharge of these responsibilities should include a high level of understanding and communication between those soliciting planned gifts and those managing them, both during and after the solicitation of the contributed funds. For example, coordination in setting return assumptions that are utilized in planned giving illustrations as well as knowledge of the results actually achieved on previously solicited gifts are critical to a long-term successful relationship between the organization and donors.

The challenge faced by the planned giving group within most organizations is the separation of the group from those responsible for the management of the assets. Many long-time planned giving professionals have enjoyed the benefit of additional contributions and referrals of other prospects from satisfied donors. However, they are probably equally aware of the damage that can be done to their donor relationships if those in the administrative and investment departments of their institutions do not do a good job of setting and managing the donor’s expectations, administering and investing the gift funds, and communicating with the donor/beneficiary. They realize that it behooves them to know how those functions operate, to monitor their performance, and to stay in touch with the donor.

Strategic and Tactical Issues

Investing the financial assets of an exempt organization requires two distinct process considerations: those that are strategic in design and those that are tactical in implementation. Exempt organizations must fully understand the nature of their investment funds and what the true expectations are for them before implementing any investment decision. Strategically, the basis for the asset allocation among various investment categories, e.g., stocks, bonds, real estate, etc., centers on when the funds are required to be liquid. For example, nonprofit organizations such as hospitals, schools, colleges and universities will have investments in plants and equipment. These investments are generally wasting assets, meaning they require replacement at some time in the future. Consequently, a reserve should be established to meet such replacement requirements when necessary. The nature of the investment of these reserves is dependent on the time frame in which the funds will be required.

In permanent fund investing, the strategic issue is that of the mandatory, board-designated, or budget-required distribution. Distributions may be a fixed valuation or, in most instances, they represent a percentage of the assets valued on some specific date. The nature of the distribution, the timing of it, and the definition of what constitutes funds available to meet such distributions are strategic issues that must be identified prior to any implementation decisions.

Publicly supported nonprofits have a unique strategic issue, that of donor relations. Donors may require or advise that contributions be invested in a restricted way. It is not unusual for contributed real estate or securities be given with a suggestion that they be retained rather than sold. To do so has strategic connotations that must be factored in to the overall investment strategy of the organization.

As stated previously, the responsible investing of nonprofit assets is based on cash flow. This cash flow centers on the needs placed on the funds through the budget process of the organization, statutory requirements of funds within an endowment, donor-designated restricted gift requirements, provisions within a split-interest trust, pooled income fund, or government mandated gift annuity reserves.

In addition to the cash flow requirements placed on the invested funds, cash flow plays an additional role in the selection of the investments that will constitute the portfolio for meeting those requirements. In investing in general, all investment options are judged by their ability to generate cash flow, now or in the future. It is important to know the nature of the cash flow when judging the investment options available.

Investing in the Organization Comes First

The investment process for most nonprofits requires focus on the difference between the types of capital assets available for investing. For operating nonprofits, the investment capital includes plant and equipment necessary for the fulfillment of its mission. How much capital is invested and how it is invested in those operational capital assets becomes critical to the success of the organization. An often-overlooked aspect of the investment of funds within an exempt organization is the return on that operational capital.

Calculating the return anticipated from operational capital is as important as calculating the anticipated returns on passive capital investments. Such calculations are critical when the organization is floating a bond issue or borrowing from a bank to acquire those assets. In either loan situation, repayment of the principal plus interest is required. The source of that repayment is the revenues generated from program fees, annual charitable contributions, and investment of reserves and endowments. Just as with a for-profit entity, or an individual, there must be a game plan in place for repayment before the borrowing occurs.

Passive Investment Choices

Creating realistic expectations for investment returns on the capital available for investment is critical to the fiduciary responsibility of the governing body of the nonprofit. Failure to do so has consequences unlike those inflicted upon individual investors. Those consequences are most often breaches in the fiduciary oversight responsibilities that can cause personal liabilities as well as a negative impact on constituents.

There are two basic categories of passive investments: loans to other entities and shares of ownership in operating businesses. Loans to an entity, be it a corporation or unit of a government (federal, state, or municipality), are made in the form of purchasing a bond or note issued by that entity. Bonds and notes are often referred to as a fixed income investment. Buying a percentage ownership of an operating business that is manufacturing goods or providing services allows an investor the opportunity to participate in its profits (and losses). Such a position is referred to as equity and the certificate of that ownership is referred to as stock in the company.

In addition to loans and ownership in an operating business, nonprofits may invest in real estate and commodities such as oil and gas or timber. Such investments may be direct or through the pooling of assets with other entities in a specially formed partnership or registered or unregistered investment company. It is not uncommon for investments other than bonds or stocks to be referred to as "alternative investments". As mentioned earlier, ownership in certain of these entities may cause the organization to pay tax on the returns from that investment even though it is exempt from paying taxes on returns from other investments or operational program activities.

Fixed Income Investments

Fixed income securities, bonds, commercial paper, etc., are acquired at a price that reflects current interest rates and the creditworthiness of the issuer. General economic cycles of growth and recession impact interest rates and the ability of the companies to repay their debt. Predicting where interest rates will be at any point of the economic cycle is popular, but very difficult to do with any degree of accuracy. Most who do so in the short-term will find disappointment in the long-term. Fixed-income management generally focuses on maintaining principal values through modifications of the duration (the length of time it takes for the bond holder to receive the present value of the bond's future interest and principal payments) as well as changes in the creditworthiness of the entity issuing the bond.

Equity Investments

Equity investments constitute ownership in an operating for-profit company. One acquires an ownership position through the purchase of shares of that company. In addition, this equity ownership could be achieved through the participation in a company in which its sole purpose is to pool the resources of many investors into one entity that will then acquire such equity holdings. This pooling of financial resources for investment purposes is called a registered investment company, mutual fund, a bank common trust fund, or an unregistered private placement investment entity.

As previously stated, whatever form of investment, debt or equity, that is desired, the cost of that security is normally based on the anticipated cash flow, now or in the future, on the invested capital. The ratio of debt holdings to equity holdings within an investment portfolio is determined by a combination of the total return desired and the accepted level of risk assumed on the funds so invested. Return is a fairly simple term to define. It represents the income paid as well as the growth or loss in value of the underlying holding. Risk, on the other hand, should be a significant item of concern in investing nonprofit assets.

Risk: What is it

Investment risk is commonly thought of in terms of losing the capital invested. If an investment in only one company is made, either through a loan or an equity investment, and that company goes out of business, all invested can be lost. Consequently, one of the requirements of a fiduciary is to diversify the risk of a company going out of business by owning several other businesses with a broad range of products or services. Such diversification eliminates total loss of invested funds but it does not insure that the value of the funds will always be more than the original amount of capital so deployed. The value of the diversified holdings will fluctuate based on current and future results in both the general economy and each business.

Risk is also present in even the "safest" of investments. Suppose, for example, the organization decides to invest its operating reserves in bonds that have a 30 year maturity. To avoid losing the investment due to the borrower going out of business, the bonds are purchased from the Federal Government (U.S. Treasury bonds). This investment could be deemed speculative in nature. How can that be? If interest rates move up 1% from the level when the bonds were purchased, the value of the bonds could go down substantially. While payment on the interest rate would continue and payment would be made on the full par value of the bonds (the value stated on the face of the bond certificate) at the maturity date 30 years from issuance, should the organization need to convert the bonds to cash to meet its operational expenses, a significant loss could be incurred. Moreover, even though the organization will ultimately get all of its capital dollars back, the purchasing power of those dollars could be literally decimated 30 years out. Consequently, even a very "safe" investment could be deemed speculative depending on the appropriateness of that investment for the liquidity requirement of the funds.

During the late 1990's, diversified portfolios of equity investments often became speculative as investment committees tilted the holdings towards technology. Those who allocated more than a reasonable percentage of their equity investments to the technology sector experienced severe market value declines during the first three years of the new century. While the companies may still be in business, their stock value may never again reach the highs of 1999.

During the 1990's several fraudulent schemes were also promoted to nonprofits. Investments were sold on the basis that there would be excellent returns and increases in anonymous donor contributions. One such promotion was clearly fraudulent and the many prominent organizations that participated lost millions of dollars. Greed and speculation are two traits of investing that should not be part of the nonprofit process. Unfortunately, they can creep into the decision-making activity of even the best organizations.

Measuring Risk

Risk of loss is measured by the potential for the investment to become worthless as well as the change in value that occurs during the holding period. No further explanation of the need to avoid absolute losses is required. What should be addressed, however, is the impact of price volatility on cash flow needs.

The value on any given day of the investment portfolio holdings does not normally impact the cash flow from the investments. Interest on bonds is paid regardless of the value of the bond if it were sold on any given day. Likewise, dividends paid to stockholders of a company are normally fairly consistent and do not fluctuate a great deal with the market value of the stock. Changes in market value of a bond or stock will normally only have impact, for better or worse, on the organization's portfolio when sold. However, under current accounting standards, exempt organizations are required to "mark-to-market" the value of their investments when preparing financial statements. This can often be highly detrimental to bond or loan covenants and detrimental when determining the amount of distribution that will be required from a portfolio.

To measure the level of mark-to-market valuation risk within a portfolio, the general tool utilized is that of standard deviation (standard deviation is the measurement of the variance of actual returns from the average or expected return). The standard deviation of a portfolio is the volatility in value of that portfolio. Normally standard deviations are measured for one year periods. However, in order for them to be reasonably accurate as a predictor of the expected ranges of return, at least 36 data points (months, quarters or years) must be employed in the calculation.

Determining the average return over a period of time and then measuring the maximum and minimum returns that occurred two-thirds of the time calculates standard deviation. To determine the range of returns that occur for 95% of the time measured, two standard deviations are applied to both the positive and negative side of the mean (average). For example, the returns on a portfolio that was made up of 60% large company stocks and 40% bonds are compiled for each year from 1926 to June 2003. During that time, the annual expected (average) return was 8.83% and the standard deviation was 13.83%. That means that 66 2/3rds of the recorded returns fell in a range of –5.00% to +22.66%. It also tells us that 95% of the measured returns ranged from –18.83% to 36.40%.

The Legal Perspective on Risk and Risk Management

Historical Background

Fiduciaries of a nonprofit face two different kinds of investment risk management: (1) weighing and managing the risk of loss associated with an individual investment or a portfolio of investments and (2) minimizing the risk of personal liability for acts or omissions leading to actual investment losses. The law governing the investment of nonprofit funds has always been about the latter, but is increasingly blended with the former.

Until relatively recently, the focus of the law was on individual investments. Trustees of trusts, in particular, were required to avoid "risky" investments and to pick only non-losers. Indeed, there were once statutory "legal lists" of permissible investments for trusts; such lists completely ignored the effects of inflation (itself a significant risk). Under the old "prudent man" rule, trustees could held be liable for losses on losers without being able to offset gains on winners and show an overall positive result. Focusing on the overall results was seen as too close to "speculation," which was forbidden. Moreover, "income" was viewed in the narrow sense of interest, rents, royalties and dividends. The combination led to portfolios weighted heavily toward fixed income instruments that were decimated by the effects of inflation over time.

The rules applicable to nonprofit corporations were usually slightly less rigid, but still similar. California Corporations Code § 5240(b)(1) still says the board shall "avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital."

Changes in Investment Objectives Influence Changes in the Law

In the meantime, the investment world, driven by common sense, by a desire to achieve both income and capital appreciation, and by capital gain tax rates that were substantially lower than ordinary income rates, moved emphatically in the direction of "total return" investing and "modern portfolio theory." The former rests on the indisputable points that gain is gain, whatever the form, and that what counts is the overall result, not just avoiding losers. It also asserts that more real gain is possible over time when growth in value is built into a portfolio. The latter espouses the concept of the "efficient frontier" between risk and reward–i.e., that the overall risk of a portfolio can be reduced by including non-correlated assets that in and of themselves were seen as too risky under the prior thinking, but when blended other components of the portfolio actually reduce overall risk.

Fortunately, a number of years ago, in connection with work on the Restatement of Trusts Third, Professor Edward Halbach and others modernized the law of *trust* investing by creating the Uniform Prudent Investor Act ("UPIA"). Somewhat earlier, the National Conference of Commissioners on Uniform State Laws developed the Uniform Management of Institutional Funds Act ("UMIFA"), which was eventually adopted in some form by nearly all states and evolved into a law governing the investment of both endowment and non-endowment funds of *nonprofit* corporations (but not trusts). UMIFA originally was best known as an experiment in allowing the allocation of a prudent portion of capital gains on endowment funds to income A lesser known feature of UMIFA was its first-generation articulation of more modern investment principles. Its provisions, however, have been eclipsed in clarity, common sense and comprehensiveness, however, by UPIA.

The enactment of UPIA, together with the losses on endowment funds incurred in the recent prolonged bear market and the resulting constraints on distributions from endowment principal, caused some in the nonprofit community to urge the National Conference of Commissioners on Uniform State Laws ("NCCUSL") to initiate significant changes in UMIFA. A drafting committee was convened and has proposed to NCCUSL a new version of UMIFA. Among other things, it would conform the investment provisions of UMIFA to UPIA and to expand the scope of UMIFA to cover trusts, both of which are desirable. However, it would also dramatically alter the concept of an endowment fund by (a) doing away with the "historic dollar value" limitation on expenditures from endowment funds and (b) giving the board disturbingly broad latitude to make distributions from endowment principal. If this change is promulgated by NCCUSL and enacted by the states, planned giving officers would have a duty to make it very clear to donors of endowment gifts that a dramatic difference probably exists between their expectations about what an endowment means and what the new law provides and that they have the ability to override the new law in their gift instruments. An up-to-date report on the proposed changes and their status will be included when this paper is presented.

The Laws Applicable to Nonprofit Investing

Federal law has little relevance to the investment of funds of nonprofits other than private foundations. State law is where the action is, and it will, of course, vary from state to state. However, California law provides a useful illustration of the fact that there is not a single set of uniform rules that governs the process by which the investments of a nonprofit should be selected and monitored. In California, and elsewhere, the investment of nonprofit assets may be governed by one or more of the following laws, depending on the form of the entity and the types of assets.

Cal. Corporations Code § 5240.	Sets out a general, very conservative rule governing the investment of assets, with a nod, but not total deference, to UMIFA.
Uniform Management of Institutional Funds Act ("UMIFA"). Cal. Probate Code §§ 18500-18509.	Supplies more detailed rules governing the investment of nonprofit funds, with special rules regarding distributions from assets that constitute "endowment."
Uniform Prudent Investor Act ("UPIA"). Cal. Probate Code §§ 16045-16054.	Directly applies only to a nonprofit's assets held in an express trust; however, see discussion below.
IRC Section 4941	Indirectly can affect private foundation investments by prohibiting certain transactions with disqualified persons.
IRC Section 4943	Limits extent to which a private foundation may hold investments defined to be excess business holdings.
IRC Section 4944	Supplies general rules designed to avoid risky investments of private foundation assets, which are defined as jeopardizing investments.

The specific set of rules defining the duties of the nonprofit's directors in managing the investments of the nonprofit depends on the classification of the assets being managed. The three California laws potentially applicable to a nonprofit's investments are briefly summarized and compared in Attachment A. While UPIA applies only to assets held in trusts, not the endowment or non-endowment investment assets of nonprofit corporations, it does represent the most advanced and current thinking with respect to the integration of fiduciary responsibility and investment principles. We anticipate that the inherent logic and level of specificity of UPIA will result in its filling a relative vacuum that currently exists in the California law and elsewhere applicable to nonprofit corporate investments and that courts will inevitably look to UPIA for guidance in evaluating compliance with nonprofit corporate investment duties under both California Corporations Code Section 5240 and UMIFA. This view is supported by the legislative history of UPIA . Therefore, the following summary of general investment rules is essentially a recap of UPIA rules.

The Common Sense Approach of UPIA

UPIA Provisions

First, it should be noted that the following discussion applies only to the unrestricted investment assets of the nonprofit, not operating reserves, assets received or held for a charitable use (other than to generate income), or assets received subject to a permissible restriction that they be held intact and not sold.

Prudence is, of course, required. What prudence means in the UPIA context is best illustrated by first noting five fundamental alterations to prior prudent investing law. They are:

Portfolio Viewpoint. The prudence standard is applied to any investment as a part of the total portfolio, not standing alone. In other words the process is seen as constructing and managing a total portfolio of investments, not the selection of individual investments.

Risk v. Return. The fiduciary's central consideration in investing is the tradeoff between risk and return. Various kinds of risk are recognized and must be addressed and managed: market risk v. the risk of a single company; risk of loss of principal; risk of loss of purchasing power; and risk of loss of other opportunities. The law is influenced considerably by modern portfolio theory.

No Per Se Imprudent Investments. A corollary to the portfolio viewpoint is that no specific type of investment is categorically prohibited. The question will be whether it is likely to help achieve the prudently determined risk/reward objectives of the portfolio. One premise of modern portfolio theory is that some types of investments deemed (in isolation) too exotic or risky under the old law can, used appropriately and skillfully, actually either reduce portfolio risk or enhance return without increasing risk.

Diversification Required. UPIA provides "the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." (Emphasis added.) In effect, the fiduciary who fails to diversify a large single holding assumes a burden of proving that it was prudent to retain it. The fact that it was the asset which created the donor's wealth is of little consequence. In a tax-exempt entity, that burden will be particularly difficult to fulfill, absent provisions in the governing instrument of the entity or the instrument of gift which override the duty to diversify as to the particular asset.

Delegation to and Reliance on Professionals. The law not only permits, but encourages fiduciaries to engage and rely on the services of qualified professionals. The board must use care and good business judgment in the selection of advisors and must monitor the performance of the advisors. Subject to these requirements, the board may delegate the day-to-day investment management—e.g., buying and selling stocks—to such advisors.

UPIA Is Default Legislation

Having noted those significant aspects of UPIA, it is also important to note that the law is default legislation. It can be overridden by the governing instrument of the entity or an instrument by which a gift is made. For example, provided that the provisions of the Internal Revenue Code are not violated, it would be permissible under California law for a donor to a nonprofit to expressly relieve the nonprofit of the duty to diversify with respect to an investment asset contributed to the nonprofit and, indeed, require it to retain the asset intact. Cal. Corp. Code § 5240(c).

Preserving Purchasing Power of Principal

UPIA charges the fiduciary with devising an investment policy designed to preserve not only the dollar value of the principal, but also its purchasing power—to meet or beat inflation as well as produce an investment return.

Controlling and Justifying Investment Expenses

UPIA charges the fiduciary with the duty to avoid unnecessary and unjustified expenses in the management of investments. Some commentators have criticized the law as being too enamored of theory—modern portfolio theory and efficient markets—and having a bias toward index fund investments. This is probably a fair comment, but it points out that the fiduciary who chooses to hire and compensate active management should be able to identify some reasonably predictable benefit of doing so—e.g., reducing risk or increasing return or a combination of both.

Facts and Circumstances Must Be Taken Into Account

The law allows and encourages the fiduciary to take the particular facts and circumstances of the entity into account in determining an appropriate investment policy. These include, for example, the tax status of the entity, its investment time horizon, and its spending needs, as well as more general considerations such as economic conditions and the prevailing inflation level.

Process Is More Important Than Hindsight

UPIA makes it clear that a fiduciary should be judged by the quality of the process undertaken to comply with the law, not the results. Hindsight is specifically discredited as a measure of fulfillment of fiduciary duty.

Investment Policy Statements Should be Standard Procedure

Because of the importance the law places on the *process* employed by fiduciaries in managing investments, it is important to document that process. For this reason and for the guidance of the board and other professionals it engages, the board should have prepared and adopt a written Investment Policy Statement ("IPS") documenting the investment objectives of the nonprofit, all relevant facts, the investment advisors and/or managers engaged by the nonprofit, the process used to select those professionals, the respective roles of the board and the various professionals, reporting requirements, the standards of performance by which the professionals will be evaluated, the arrangements for monitoring performance, and the arrangements for safekeeping of the assets of the nonprofit. If the nonprofit is a private foundation, the IPS also should specify procedures to avoid violating the Internal Revenue Code's investment-related restrictions.

The board should be aware that, while investment managers have in recent years begun to use memoranda called investment policy statements to document *for their own protection* the investment objectives agreed upon with clients, their forms are almost always lacking *from the point of view of protection of the board*.

As noted above, the Internal Revenue Code imposes important restrictions on a private foundation's investments. The Code sections listed above define and regulate (a) investments that constitute self-dealing transactions; (b) investments that create excess business holdings; and (c) jeopardizing investments. These three types of investments can give rise to federal excise taxes on the foundation and its foundation managers. They can also give rise to director and officer liability under state law. Further discussion of these rules is beyond the scope of this paper. See McCoy & Miree, Family Foundation Handbook (Aspen Publications, Inc., 2001). California law includes statutes that make the violation of the federal statutes described above a violation of California law as well. See, e.g., Cal. Corp. Code § 5260.

Navigating the Investment Rules Maze

The multiple laws potentially applicable to a nonprofit's investments can be analogized to multiple layers of screens which must be aligned properly in order to see daylight. Given the number of screens, this may seem a daunting task. Fortunately, however, the screens are each not overly restrictive and usually several are simply inapplicable. *It is nonetheless important to recognize that investments of a nonprofit's funds that do not violate the Internal Revenue Code may nevertheless violate state law, and vice versa, potentially exposing the directors of the nonprofit to personal liability for losses arising from investments or for penalty taxes.*

Fortunately, UPIA now provides a road map for both sensible management of a nonprofit's investments and management of fiduciary risk. Knowing that a nonprofit to which funds are being committed is thoughtfully following that road map should also be reassuring to potential and existing donors. Our experience has been that having an investment policy statement (approved in advance by the donor) for each split-interest gift and periodically meeting with the donor to review portfolio performance in relation to compliance with the IPS goes a long way toward building donor confidence and reducing angst during periods, such as the last few years, when results are less than desired. Such donors are likely to be prospects for repeat donations and for referrals. Therefore, we would recommend that planned giving officers know and communicate to donors the sound investment practices of their institutions. And, if you investigate and find that the policies and practices of your institution are lacking, you do it and yourself a favor by seeking to initiate change for the better.

What Impact Does Risk Have on Portfolio Design

In order to determine how funds within each of the various nonprofit accounts previously described should be invested, it is important to understand the various ways that returns are illustrated for planning assumption purposes. The most common method is to look at historical returns for some period of time. The illustration below assumes that the portfolio is invested 60% in the S&P 500 index of large U.S. common stocks and 40% in U.S. Intermediate Government Bonds for the period 1926 – June 2003. As previously stated, the expected return each year from this portfolio is 8.83%. The variability of that return (standard deviation) is 13.83%.

The next step is to take that expected return (average annualized return) and apply it to a cash flow scenario. The following chart illustrates a $1 Million dollar value in a fund with a requirement to pay out 5% of the value of the fund at the end of each year. This distribution amount is consistent with the requirements of a private foundation, the minimum distribution from a charitable remainder unitrust, or most board directed endowment account payouts. The illustration represents how general planned giving presentation or budget projection software typically computes future values and distribution amounts.

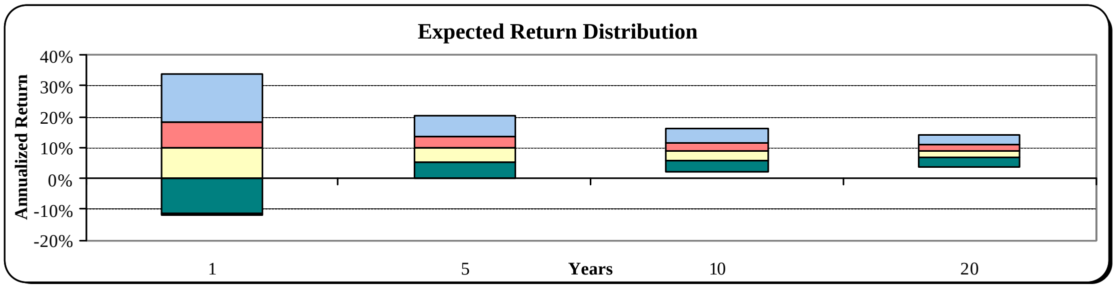
Assumptions	
Return	8.83%
Distribution	5.00%

Year	Beginning Value	Earnings	Distribution	Ending Value
1	1,000,000	88,300	(50,000)	1,038,300
2	1,038,300	91,682	(51,915)	1,078,067
3	1,078,067	95,193	(53,903)	1,119,357
4	1,119,357	98,839	(55,968)	1,162,228
5	1,162,228	102,625	(58,111)	1,206,742
6	1,206,742	106,555	(60,337)	1,252,960
7	1,252,960	110,636	(62,648)	1,300,948
8	1,300,948	114,874	(65,047)	1,350,774
9	1,350,774	119,273	(67,539)	1,402,509
10	1,402,509	123,842	(70,125)	1,456,225
11	1,456,225	128,585	(72,811)	1,511,999
12	1,511,999	133,509	(75,600)	1,569,908
13	1,569,908	138,623	(78,495)	1,630,036
14	1,630,036	143,932	(81,502)	1,692,466
15	1,692,466	149,445	(84,623)	1,757,287
16	1,757,287	155,168	(87,864)	1,824,592
17	1,824,592	161,111	(91,230)	1,894,473
18	1,894,473	167,282	(94,724)	1,967,032
19	1,967,032	173,689	(98,352)	2,042,369
20	2,042,369	180,341	(102,118)	2,120,592

The problem with such an illustration is that the EXPECTED RETURN is the annualized return for the entire period. In fact, it is highly unlikely that over the projected period, there will be any one year that the actual return will equal the expected return.

As previously discussed, the standard deviation of 13.83% is the measurement of the actual return dispersion around the mean return. For example, the following chart illustrates the range of returns that occurred 95% (2 standard deviations) of the time during various periods from 1926 through June 2003. Keep in mind, the challenge faced when making valuation projections based on averages is that the projections are seldom achieved in any one year. It should be noted that the range of returns for one year is significant versus the average over the average 20 year period.

Range of Annual Returns



For example, the statistical process presented above illustrates that the average range of returns over twenty years is fairly narrow. However, it is critical to keep in mind that a twenty-year period consists of 20 annual returns with 20 annual fluctuations in return that fall within the range illustrated in the one year column.

What is difficult to impart in illustrations that utilize averages is the fact that investment committees are not average. They vary significantly in group personality and dynamics. They will seldom be tolerant of averages and will rarely leave personal emotions and investment concerns at the door of the committee meeting. While the time horizon for investing the majority of nonprofit funds is much longer than the investment time horizon of the individual committee members, short-term concerns and biases dominate discussion and, often, decisions.

The collective decision-making process of the investment committee, trustees, or directors can have significant impact, for better or worse, on the long-term results of an organization's investment activity. Beware of expecting average returns. They are seldom achieved. For example, while the average return previously discussed was 8.83%, during the most recent twenty years, 1983 – 2003, the average annual return was 11.6% while over the past three years the return was -4.53% annualized. It all depends on where you enter the cycle as to what your returns will be. This is particularly true for funds with a 10 year or less time horizon.

Distributions Impact the Effect of Average Returns

In the previous illustration of a $1MM investment growing at the average return of 8.83% and a 5% distribution being made at the end of the year, the growth in value of the portfolio is consistent year to year. However, in the real world of investing, there will be times when the return exceeds 5% and times when it will be below the 5%. Consequently, the annual range of returns plays a major role in what the future values of both the distributions and the ending value will be.

In order to properly set donor or finance committee expectations for return results based on various investment allocations as well as distribution requirements, a Monte Carlo projection analysis should be completed. This analysis takes into account the range of valuations that could be expected in the future. This range includes the value of the original capital account plus the actual returns received during 10,000 possible time periods.

The following is a chart of the value range that an initial investment of $1MM, subject to a 5% annual withdrawal, could be expected to fall within over the various designated time periods.

Ending Portfolio Value

Year	3	5	10	20	35
95%	$755,033	$724,110	$693,522	$729,667	$928,158
75%	**$953,025**	**$980,800**	**$1,077,523**	**$1,359,757**	**$1,976,542**
50%	**$1,118,905**	**$1,195,228**	**$1,430,782**	**$2,016,224**	**$3,351,116**
25%	**$1,302,244**	**$1,461,458**	**$1,886,054**	**$2,994,806**	**$5,691,785**
5%	$1,593,902	$1,899,750	$2,750,623	$5,089,467	$11,786,020
Value @ Inflation:	**$1,092,727**	**$1,159,274**	**$1,343,916**	**$1,806,111**	**$2,813,862**
% Port. was Depleted:	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.0%**

The above valuations were based on data from Ibottson & Associates for the S&P 500 index and the U.S. Government Intermediate Term Trust from 1926 through June 2003.

As can be seen, for the twenty-year period, 95% of the time, the ending portfolio value would be no less than $729,667 for each $1MM invested. The most likely value would fall within the 75% to 25% probability range. It is interesting to note that the 50% occurrence value of $2,016,224 or greater is fairly close to the simple compounded value as provided by most planned giving offices ($2,120,592). However, when viewing the two tables, considerable difference in expectations becomes evident. In addition, it should be observed that the original $1MM grown at an assumed annual inflation rate would equal $1,806,111. Thus it can be concluded that there is at least a 50% chance that an annual distribution of 5% will not provide a principal value at the end of twenty-years equal to or greater than the original principal grown by inflation.

The importance of the inflation adjustment is not only a factor for the nonprofit organization, assuming its annual expenses will also grow by inflation, but should also be a concern to the income beneficiary of a charitable remainder unitrust. The following chart illustrates the impact on the annual income distributions for each of the periods covered in the preceding principal growth chart.

Ending Annual Distribution Amount

Years	3	5	10	20	35
95%	$37,752	$36,205	$34,676	$36,483	$46,408
75%	**$47,651**	**$49,040**	**$53,876**	**$67,988**	**$98,827**
50%	**$55,945**	**$59,761**	**$71,539**	**$100,811**	**$167,556**
25%	**$65,112**	**$73,073**	**$94,303**	**$149,740**	**$284,589**
5%	$79,695	$94,987	$137,531	$254,473	$589,301
Value @ Inflation:	**$54,636**	**$57,964**	**$67,196**	**$90,306**	**$140,693**

The data source for the above illustration is Ibottson & Associates. The data is based on the 60% S&P 500 and 40% U.S. Government Intermediate Term Trust indices for the period 1929 through June 2003.

The conclusion that should be drawn from the above chart of the annual ranges of income distributed is that the original payment is only increased by the annual rate of inflation during approximately 50% or more of the time. The rest of the time, the cash flow of the income beneficiary or from an endowment could lose purchasing power.

One of the problems with any forward projection of values or income based on historical returns is that they are just that – historical. There is no assurance that future returns will equal past returns. In fact, the current historical data is somewhat tainted with the inclusion of the middle to late 1990's bull market speculation. Consideration should also be given to developing a future return expectation for each asset class based on current economic and market circumstance. Both methods combined, despite individual flaws, provide a range of returns that could be achieved, offering the opportunity to properly set the expectations of the finance committee and donors.

Reality investment planning requires constant attention to the results expected versus what actually occurred. Creating an investment strategy, implementing that strategy, and then failing to monitor its performance does not generally provide the type of outcome for fiduciaries that leads to meeting expectations. It requires periodic due diligence and follow-up on all aspects of the original decisions.

The due diligence process requires an understanding of how and why each account was established. It demands that the integrity of the investment activity be maintained. Occasionally, it may be necessary to redefine the investment strategy or even the specific gift strategy in light of changing circumstances and the general economic and market conditions of the time.