Best Practices: Investing for Nonprofits

By Kevin Chambers

The National Council of Nonprofits defines the role of board members to act as “the fiduciaries who steer the organization towards a sustainable future by adopting sound, ethical, and legal governance and financial management policies, as well as by making sure the nonprofit has adequate resources to advance its mission.” (National Council of Nonprofits, 2017) For large endowments and foundations, the support staff within the organization can provide assistance with the execution of specific duties. For smaller nonprofits, the responsibility passes to the individual board members. This means that for nonprofits that do not hire an investment advisory firm to manage investments, the investment committee must not only develop and approve investment and spending policies, but also manage investment portfolios within risk and cost constraints.
policies, they must also take on the responsibility of selecting appropriate funds, implementing investment policies, monitoring, rebalancing, and reporting to the full board.

At the heart of a nonprofit, the goal is to fulfill a charitable mission in the community for which it was organized to serve. The hope of its founders is that it will survive beyond their own involvement. To do so, the board must find a way to be financially sustainable. Since fundraising efforts will have “down years,” an important strategy is to set aside funds for the future with the creation of an investment account. Nonprofits with $5 million or more in funds for investment often hire consulting or advisory firms to act as managing fiduciaries for their investment accounts. The larger the asset level, the higher the degree of service and the lower the cost per investable dollar. However, there is a significant hole in the investment industry. This means that non-profits with investment accounts under $5 million don’t always get the services they need for their board members to meet their fiduciary duties. Instead, these organizations get basic cookie-cutter advice, minimal support, and still pay more per investable dollar for limited service.

For our purposes, we will group nonprofits into two types, based on their primary need for investments: operating nonprofits and grant-making nonprofits. Operating nonprofits use the majority of their budget to fund operations for their charitable work. They have investment accounts to aid in their operations and to maintain long-term savings. Grant-making organizations do not have regular operations. They use their funds to fund other organizations and have little to no operations of their own.

In the United States, there are 1.4 million registered public charity nonprofit organizations. This excludes private foundations. The majority of nonprofits are small, with 66% of the...
organizations having annual expenses under $500,000. For all charities, their revenue is primarily from fees for services and goods. On average, 72% of all revenue comes from goods and services. Only 5% of all revenue comes from investment income (McKeever, 2015).

Why Nonprofits Invest

Many board members we have worked with over the years have expressed skepticism about investing money for a non-profit instead of using it to fund operations. Nonprofits invest for a myriad of reasons, but here are a few primary reasons:

**Building assets**

Many grant-makers, auditors, and donors look at an organization’s balance sheet to determine the financial health of an organization. Some organizations have land holdings or buildings that they own. These show up as assets on their balance sheets. Other organizations may rent space and not own much capital. Therefore, funding an investment portfolio can bolster their balance sheets and give their organization more legitimacy.

**Long-term saving**

Organizations often have reasons to save money over many years. Possibly they are saving for a large capital expenditure, or just for an emergency pot of money. Either way, if they have a long time horizon, a minimum of a few years, investing can give their assets return, instead of sitting in low-interest rate bank accounts.

**Courting large gifts**

Another reason non-profits might entertain building an investment account is to encourage large donations from supporters. For donors who have the desire to give large amounts, they often don’t want it to be spent quickly. They like to know their money is going to help the organization for many years. This is why it is often easier for fundraisers to elicit such sums during a capital campaign. The donor knows their assets will help build a building that will serve the organizations charitable work for years to come. Alternatively, if a nonprofit has a well-managed and governed investment account, designed to promote the organizations interests for many years, donors may be more likely to donate a large sum. It also gives the donor the option to donate the sums in the form of securities, which can give them the added bonus of not paying capital gains tax on the donation.

Regardless of revenues and expenditures, nonprofits with under $5 million in investable assets are considered small in the institutional investing sector. Large portfolios are those over $25 million (Raffa Wealth Management, 2017).
This includes operating, grant-making, public charities, associations, and private foundations. For all organizations that invest in securities, their board members should adopt certain documents and procedures to meet their fiduciary duty.

**Overview of Nonprofit investing**

Collectively, the 5 largest foundations in the US have over $90 billion. The Bill and Melinda Gates Foundation is the largest in the country with over $44 billion in assets. The largest university endowment is Harvard with $33 billion in assets (National Philanthropic Trust, 2017). Because of the large amounts of money and the market power these large institutions have, they are followed very carefully by investment professionals. Their tactical decisions can affect the thinking of the finance world.

A prime example of large endowments influencing the financial world is the implementation of the investment philosophy of David Swensen from the Yale endowment. Swensen has been the Chief Investment Officer of Yale since 1985. His 2000 book Pioneering Portfolio Management described his theories for endowment investing. Swensen argued for lowering allocations to traditional stocks and bonds and increasing allocations to alternative investments such as hedge funds, private equity, and exotic real assets including mining, oil fields, and forestry. Following the implementation of this new model, other endowments and institutional investors have emulated the strategy.

One of the reasons the Yale Model became so popular is that they posted very good returns. In the decade ending in 2008, the Yale Endowment earned an annualized 16.3% return, net of fees. The largest endowments now average more than 60% in hedge funds, private equity, and real assets. In 2009, after a strong decade, the endowment lost -24.6% (fiscal year ending June 30th). However, the ten-year return ending June, 30th 2014, was still 11% annually. The Yale Model
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has been implemented and imitated by other university endowments, pension funds, and foundations, with varying success. After the 2008 crisis, the Yale model was questioned by many in the investment profession as being excessively risky.

The one major foundation that has never embraced the Yale Model is the Bill and Melinda Gates Foundation. They have maintained a pretty simple stock and bond portfolio. A major part of their equity allocation is B-shares of Berkshire Hathaway donated by Warren Buffet.

The Yale model and the prevalence of alternative investments in endowment investing is not very applicable to smaller organizations. Alternative investment companies usually have very high minimum investments. It can range from $1 million to $20 million depending on the fund. Alternative investments are also very illiquid. Endowments lock up their money for many years investing in hedge funds and private equity.

To analyze organizations that are closer to our clients, we are going to rely on The Study of Non-Profit Investing (Raffa Wealth Management, 2017). They surveyed 700 participating organizations ranging from under $5 million to over $25 million in assets. They break up their analysis between public charities, associations, and private foundations.

Their analysis shows that as organizations get larger, they are more likely to invest in alternative investments. This is especially true for private foundations. Even for foundations between $5 and $25 million, they have 25% alternative allocations. Interestingly, these organizations are usually taking away from their bond allocations to
add to alternative investments, as the stock allocations stay roughly the same as the organizations grow, but the bond allocations drop.

**Governance Practices**

Although there is little for endowments under $5 million of investable assets to emulate from the bigger nonprofits in the investment sphere, there is a lot they can learn regarding governance. There are a few necessary investment governance items that all nonprofits that invest should have:

- Investment Policy
- Asset Allocation Targets
- Process for investment selection and monitoring
- Custom Benchmark

**Investment Policy**

An investment policy statement is a document that outlines how a board of an organization wants to invest their money. A good investment policy should include a few different items:

**Purpose of assets**

Why is the nonprofit saving these funds? Is it an endowment to aid the organization in perpetuity? Is it a long-term savings account? Is it an emergency fund? Are their multiple accounts, with different goals?

**Allowable Investments**

Are there certain investments that the organizations would like to avoid? Are there investments the organizations would like to target?

**Spending Policy**

How often is the organization going to take withdrawals? Who has the authority to initiate the withdrawals? How much a year would the organization like to take out of the account?

**Asset Allocation Targets**

Boards interested in investing should also adopt asset allocation guidelines for their investments. Regardless if they are working with an advisor or consultant, the board should decide on the way their money should be invested. The allocation should be tailored to the goal of the assets. More long-term goals allow the organization to allow for more risk in the portfolio. Short-term accounts should be more conservative.

The board should also discuss and vote on how often they want their account rebalanced. If markets swing the portfolio off the target allocation, how much flexibility should be built into the account? Frequent rebalancing can keep the account closer to the agreed-upon targets, but depending on the fee structure of the account, can be costly. The asset allocation and rebalancing policy can also be included in the investment policy statement for convenience.

**Investment Selection and Monitoring**

The board should decide on a process for selecting and monitoring investments. Even if they have a consultant or advisor, the board
should understand their process and ask for reports. This can include reports such as past performance, performance against a benchmark, performance compared to peers, and consistency of investment style. If using mutual funds’ investments, which most portfolios include, it is important to also have criteria to test the composition of the funds. This should include the diversification of the fund and understanding the different risks to which the fund is exposed. For example, country risk, currency risk, sector weighting, company weighting, and turnover. Finally, if using mutual funds or ETFs, the board should consider the cost of the investment.

The board should also stipulate how often these managers are reviewed and monitored. If a manager is not meeting the same goals for which the board decided to use them upon selection, they should be removed from the portfolio. Often boards will decide to look at their investments on a quarterly or annual basis. This review should focus on the progress of the portfolio toward the attainment of the organization’s goals.

Both the investment selection and monitoring are often outsourced by an organization to an advisory or consultant firm. Even with these relationships, it does not excuse the board from reviewing the firm’s work. Board members should be asking for regular updates on their account and expect the advisor or consultant to answer questions on the investments and report on their due diligence process for the investments they make on behalf of the organization. Just like the asset allocation targets, this process can be formalized and included in an investment policy statement.

Custom Benchmark

A good tool for monitoring investment performance is a custom benchmark. Common benchmarks include the S&P 500 for monitoring stock and the Barclays Aggregate Bond Index for monitoring fixed income. A custom benchmark mirrors the target allocation decided upon by the board. Different indexes, appropriate for different asset classes, are weighted according to the asset allocation target. A custom benchmark allows the board to determine the efficacy and performance of the portfolio as a whole, versus just the individual investments. It allows them to understand if their target parameters and rebalancing policy are correct. Especially if working with an advisor or consultant, this allows the board to monitor their ability to manage the portfolio as a whole.

SONI Analysis

According to the Study of Non-Profit Investing analysis, nonprofits with smaller investment funds are underserved and overcharged compared to their larger counterparts (Raffa Wealth Management, 2017). The SONI analysis had 700 participating organizations ranging from under $5 million to over $25 million in assets.

While 100% of large public charities and associations use an IPS, only 88% and 91%, respectively, of the under $5 million organizations have adopted this essential governing document. The study found that
smaller organizations rarely update their IPS: 46% of public charities and 28% of associations had no IPS review in 2016. Furthermore, only about 60% of under $5 million have a target investment allocation. This is compared with 80% for the bigger ones. Only 30% of under $5 million have a custom benchmark compared to around 60% for the big non-profits. Advisor fees are higher for small non-profits. Advisors tend to charge organizations with over $25 million in investable income only 20-40 basis points. Organizations with under $5 million are charged around 60 to 70 basis points and those with under $1 million often get charged 1%. Unfortunately, the SONI study shows that non-profits with smaller investment accounts don’t always get the services they need for their board members to meet their fiduciary duties.

The fiduciary responsibilities of board members to find financial sustainability for the nonprofit are the cornerstone to the board members’ role. By emulating the largest nonprofits, even those with smaller pots of investable assets can put into place governing practices that include a fully formulated Investment Policy. Hiring an advisory or consulting firm to take the burden of selecting and monitoring investments, tracking custom benchmarking, and providing on-going support at a reasonable cost could be a key factor in the success of nonprofit ready to invest. Regardless of the investment portfolio size, nonprofits should not settle for basic cookie-cutter advice and minimal support, but seek out a firm that will use their expertise to provide customizable fiduciary management for a reasonable cost.


