WILLIS INVESTMENT COUNSEL
Principled Investing

INVESTMENT PRINCIPLES FOR ENDOWMENT AND FOUNDATION FUNDS

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Portfolio complexity does not equal superior performance. Complexity often increases risk. Therefore, employ only the degree of complexity that is required; and no more.

OVERVIEW

Willis Investment Counsel's first clients in 1981-1985 were trust clients. We have been working with fiduciary principles, charitable trusts, pension funds, endowment and foundation funds for decades. This paper provides Willis Investment Counsel's (WIC) view of the most important principles surrounding the prudent management of endowment and foundation funds. Discussed herein are the following risk management and investment principles:

- Enterprise/organization risk identification and its bearing on portfolio risk management
- Investment policy statement as the essential roadmap
- Reflection of non-investment **inflows** (cash and gifts in kind), and its variability
- Reflection of **outflows** required to support the organization's mission, and its criticalness
- Diversification and asset allocation (required, but there is no one method)
- Risk management
- Portfolio design, construction, and management, including a targeted return
- Ongoing monitoring and related fiduciary responsibility

This paper will ask questions to help trustees and investment committee members evaluate the inherent investment conflict between (i) generating sufficient reliable cash flow to fund the desired **spending policy** to support programs, (ii) the need for **growth to deal with inflation** and provide support for growing programs, and (iii) stability of portfolio values, or at least **contained volatility**. We will also list some common misunderstandings that often lead to poor investment results, and even harmful outcomes for the organization.

It is important to understand there is no "required way" to diversify, to construct portfolios, or to allocate among asset classes/strategies. Throughout this paper, we side with Bob Maynard, CIO of the Idaho State Pension Fund, who summarizes it this way: …*the best risk control in a non-linear world is simplicity, transparency, and maintaining sufficient liquidity to survive market disruptions. The worst approach is an overly-complicated opaque portfolio that relies on a lot of moving parts*[1]…

[1]Robert Maynard; *Conventional Investing in a Complex World*; The Journal of Investing, Spring 2013.

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THE PORTFOLIO CANNOT BE DESIGNED UNTIL THE ORGANIZATION IS UNDERSTOOD

The unique risks of the organization and its culture should heavily influence the development of investment policy and strategy.

Of course, the organization's mission, goals and objectives are critical elements to understand. Because that is well understood, this summary will not develop those principles.[2] What is often misunderstood is the fact the portfolio should always be complementary and supportive to the organization's mission, never detrimental. The portfolio should be a reliable, positive factor; not a negative surprise that has to be dealt with. In order to minimize the odds of the portfolio becoming "a problem", the operational risks of the organization – of the entire enterprise – must be understood. These operational risks are not the traditional investment, market, and volatility risks most focus on. Understanding operational risks should precede the usual investment issues.

Enterprise risk management. Stability of the investment committee, reliability of non-investment cash flows, debt covenants, balance sheet strength, threats to the enterprise if the portfolio value drops below $X, threats to the enterprise if supporting cash disbursements have to be reduced 25%, etc. are examples of risk factors that should inform the design of the portfolio.

The organization's mission versus beating the S&P 500. Unfortunately, the investment world is myopically focused on short-term returns and beating an index or benchmark. Clearly, returns should be competitive and ongoing comparisons should be made to ensure accountability.[3] But the main purpose of the portfolio is to assist the organization in achieving its goals and attaining its mission. Therefore, the portfolio should not be designed to beat an index, to be positioned at "the optimal point" on an asset allocation model's efficient frontier, or to compare well to peer-institutions. While those are considerations, the portfolio should be designed to:

- Be a reliable source of cash flow to support the spending policy
- Deal with inflation risk
- Withstand inevitable and unpredictable market drops

Understanding the organization and its governing members is critical to designing a portfolio that can withstand the markets' inherent volatility. It is easy to assume the organization has a perpetual life and therefore the endowment or foundation fund has a perpetual life also; and thus the ability to theoretically endure relatively greater risk. While the organization may have a perpetual life, the portfolio's life span – or investment planning time horizon – is far more about the volatility tolerance and patience of its governing committee. The ability and the temperament to follow the roadmap are almost dispositive. The psychological influence on the governing committee (on the constituent members and on the committee as a group) is far more influential than many realize.

[2] When designing an appropriate investment strategy, WIC seeks to fully understand the organization's history, mission, what is most important to the investment committee, what the committee wants to avoid, how the committee defines risk, the driving goals and objectives, and constraints, etc.

[3] WIC provides the investment committee with complete performance reporting to facilitate accountability and proper fiduciary monitoring.

INVESTMENT POLICY STATEMENT – THE CRITICAL ROADMAP

Identifying what would most harm the organization and jeopardize its mission, along with stress-testing the spending policy, are among the most important elements of investment policy development.

Because it is well known the investment policy statement (IPS) is fundamental to best practices, all of its elements will not be developed here.[4] The IPS should begin with a detailed explanation of the organization's history, purpose and mission to provide important context; the IPS should be as much about this as about numbers and percentages.

Risk should be defined not in terms of standard deviation and benchmark short-falls, but in terms of what is most unacceptable – what would most harm the organization and jeopardize its mission. The IPS is an important beacon during times of market stress and committee member anxiety. The IPS should use strong language aimed at present and future committee members imploring them to not deviate from the asset allocation and investment parameters during times of market euphoria or despair. Properly designed, the IPS is the roadmap that is referred to over and over as a reminder of the destination and the roads to get there (and which to avoid). It is also the vehicle to enable the committee/trustees to execute their most important investment charge – to monitor the portfolio and supervise the investment management firm(s). Later herein, it is suggested this monitoring be multi-faceted.

The IPS should provide detailed, but not rigid, guidelines to provide a clear roadmap for these essential elements of portfolio design and management:

- Reflect non-investment **inflows** (cash and gifts in kind), and its variability
- Reflect spending policy **outflows** and how reliant thereon is the organization
- Describe diversification and asset allocation in several ways, not just in percentage terms
- Define risk and risk management in several ways
- Target a long-term **investment return** in a multi-dimensional manner (e.g., cash flow)

A review of each of these elements follows.

Non-Investment Inflows

Not all organizations and funds receive significant non-investment inflows (cash and gifts in kind). If donor gifts, alumni gifts, ongoing family additions, and similar inflows from non-investment sources are material, those inflows can be a vital element of portfolio design and risk management. Generally, the greater the amount and reliability of such inflows the less pressure on funding the spending policy. Inflows also provide opportunities for portfolio re-balancing. *Reliable* inflows can reduce enterprise risk and thereby increase the flexibility to increase portfolio risk. Here, the degree of variability of inflows and the reliability and dependability of inflows can have a significant impact on enterprise risk and portfolio design. *Reliable* is a key word because during times of economic and market stress, gifts will often decline.

[4] WIC is experienced in guiding governance committees in the IPS process, and can draft the IPS.

On the other hand, when the organization expects an insignificant or unreliable level of non-investment inflows, there will be greater reliance on the portfolio. In turn, the spending policy will be more reliant (perhaps even wholly reliant) on the portfolio and its cash flow generation. All else being equal, this increases risk; which increases the need for greater risk management constraints.

Outflows – Spending Policy Distributions

The organization's reliance on consistent, predictable spending policy distributions may be the most important risk factor in developing an appropriate portfolio strategy.

How detrimental would it be to the organization's mission, or to its viability, if the planned-on spending distribution was decreased by X% due to an unexpected market drop? That one question should play a very large role in drafting the spending policy section of the IPS and in designing the portfolio's asset allocation and related strategies. The organization's *dependence* on spending policy distributions (e.g., 4% of the portfolio's rolling three year average value) may be the single most important portfolio design risk factor. This is a classic example of the unexpected having unacceptable consequences; or low probability risks with high negative impact.

If the organization has little operational cash flow flexibility, and if it is highly dependent on portfolio cash flow to fund the spending policy, a more disciplined portfolio strategy is called for. Generally speaking, such circumstances indicate lower tolerance for large portfolio value declines, low tolerance for reduced spending policy distributions, and a greater emphasis on portfolio predictability and reliability. This significantly impacts portfolio design and management.

If the organization is not critically dependent on the spending policy distributions, portfolio value volatility and cash flow generation may be less important to portfolio design. A longer-term view may be appropriate and the higher risk often associated with higher equity allocations may be acceptable. Here, if there is ample flexibility to suspend or reduce spending, the risk of having to sell securities at an inopportune time to generate cash may be manageable.

Diversification and Asset Allocation – Does it Really Need to be That Complex?

The primary role of the portfolio is to minimize the probability of negative outcomes that could prevent the organization from reaching its objectives and attaining its mission. The investment policy, portfolio design, and performance measurement should revolve around this driving principle.

Diversification is absolutely fundamental to risk management and prudent portfolio design. It is the first line of defense against hard-to-recover-from-setbacks and spending policy threats. There is no one "right way" to manage risk, and there is no one or two or three "right ways" to design and manage an endowment or foundation portfolio. Fiduciary law does not specify any particular asset allocation or combination of strategies; of course, it does require diversification.

WIC believes endowment and foundation portfolios are often over-engineered and unnecessarily complex – and expensive. WIC believes the guiding principles in medicine and engineering are useful to portfolio design. In medicine, a guiding principle is *first, do no harm*. In engineering, simple, clean design is preferred, *make it only as complex as necessary, and no more so*. While we understand and reflect mean variance analysis, asset class correlation, efficient frontier principles, and portfolio optimization in our thinking, we do not believe the frequently used modeling that embodies those principles is necessarily the only way, or the best way, to design portfolios.

Before asset allocation decisions can be made, the enterprise risk principles discussed on page two have to be addressed. Broadly speaking, the weaker the organization, the greater the external risks, and the less control the organization has on spending needs, the tighter the portfolio risk constraints must be. Conceptually, the portfolio might have fewer constraints and more flexibility when the organization is not burdened with debt covenants, highly variable revenue, and a spending policy that has to be maintained regardless of market conditions. These principles are critical in evaluating how much of a decline in portfolio value and/or spending the organization can shoulder. And, equally important, how much the investment committee can tolerate.

WIC believes, in addition to the fundamental risk management principles of (i) asset class diversification, (ii) avoidance of excess concentration in any one industry or security, and (iii) recognition of correlation risk among sectors and markets, risk is also managed by avoiding unnecessary complexity. As one adds more asset classes, more strategies, more funds, and more layers, not only does complexity increase, but there is a point of diminishing benefit from all of those moving parts. More is not necessarily better; and more makes it increasingly difficult for the committee to *really understand* what is "under the hood" and to monitor risk. Accordingly, WIC is guided by these principles when advising investment committees and trustees on diversification and asset allocation:

- Think about unexpected **enterprise**/operational developments, events, perfect storms
- Stress-test those enterprise risks with **declining market scenarios**
- Evaluate possible **negative outcomes** with various asset allocation configurations in conjunction with
    - **Spending policy dependency** – how much can spending be reduced
    - **Line in the sand portfolio value** – committee does not want the portfolio to decline below $X
    - **Target rate of return** – committee wants to target an average annualized return of X%; with said target, what might be the range of portfolio values
    - **The risk of being too conservative** and failing to effectively deal with inflation and grow the portfolio to provide a growing cash flow to support the mission
- Err on the side of being too conservative to accommodate the almost impossible task of forecasting and the tendency to overly-rely on modeling
- Common sense

Effective, cost-efficient asset allocation is about resisting unnecessary layers and unnecessary fees and designing a common sense portfolio that has sufficient, not excessive, diversification. We suggest such a structure on page 7.

Risk Management

The cornerstone of risk management is about skepticism and questioning. Risk management is not about modeling, it is about questioning modeling.

What is risk? Risk is multi-faceted; in addition to the usual market issues, risk should reflect the organization and its governing committee. Unfortunately, academia narrowly defines risk in terms of monthly, quarterly or annual volatility of portfolio value (standard deviation). Falling short of a market return benchmark over a three year period is a common, and harmful, benchmark.

Most consultants and investment management firms embrace academia's narrow definition of risk and believe risk management is primarily about volatility reduction and beating an index over a 3-5 year period. They believe risk management is about finding that combination of asset classes, strategies, funds and managers that will theoretically generate the best risk-adjusted return (according to the asset allocation efficient frontier model). WIC does not embrace the industry's narrow and incomplete view of risk.

WIC understands those theories and reflects them in our analysis, but we believe risk and risk management is a much broader concept. We are skeptical of the extent to which most firms rely on those theories and models. Our skepticism is based on studies that indicate (i) forecasting economic and market trends is unreliable, (ii) historical correlations are not static and can be unreliable, and (iii) equal and often superior outcomes with less complex, less expensive strategies, are available. We believe most portfolios quickly reach the point of little incremental diversification benefit after several asset classes are combined – the common practice of combining a dozen asset classes and strategies is often overkill. [5]

The cornerstone of risk management is a skeptical, questioning mindset. WIC considers and evaluates a wide range of possible portfolio outcomes, but we accept we don't know which outcomes will materialize. Therefore, we rely more on stress-testing and looking for possible unacceptable outcomes that could cause irreparable damage than on forecasting. We also believe an equally important definition of risk is the *permanent loss of capital*; therefore, WIC focuses on minimizing the permanent loss of capital which is less concerned about temporary market fluctuations. WIC focuses most of its risk management attention on:

- Understanding the organization and its operational risks (non-portfolio)
- Valuation – avoiding over-paying for securities
- Effective, but not excessive diversification
- Psychology, including the harmful impact of euphoria and despair
- Counseling the committee with useful education, including the power of patience
- Questioning and debate within WIC's investment committee to avoid becoming dogmatic

[5] Emanuel Derman, *Models Behaving Badly*; Wallick, Wimmer, and Balsamo; Vanguard's *Assessing Endowment Performance*, September, 2014.

Portfolio Design, Construction and Management

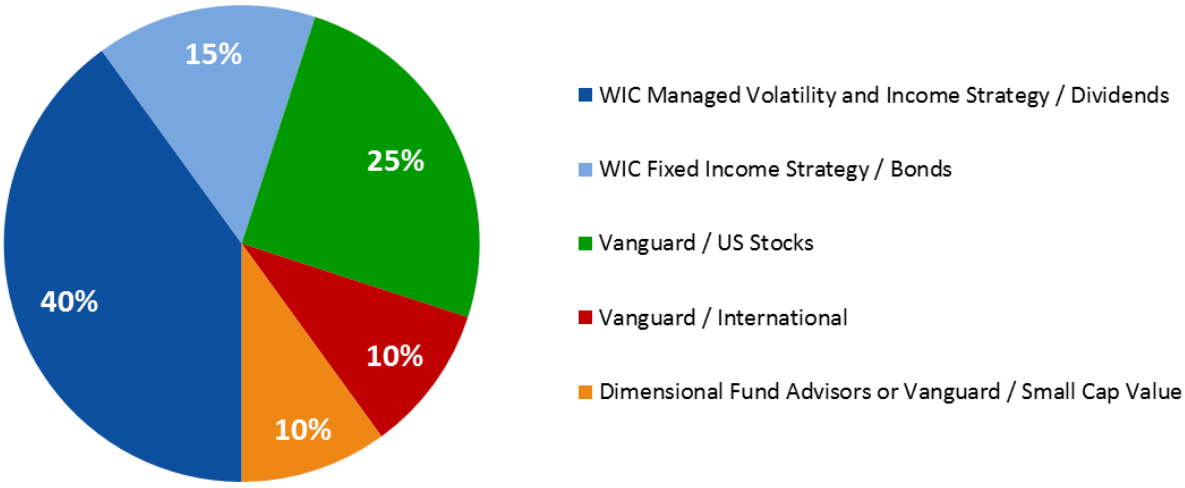
In the current low yield, low return environment, the Managed Volatility and Income Strategy provides an effective cornerstone. Five-to-six strategies generally provide effective diversification and risk management. By also including low cost Vanguard index funds, total portfolio fees are reduced.

Pulling all this together, WIC believes effective diversification and risk management can be secured by combining the following asset classes and strategies:

- **Managed volatility** via U.S.-based, large-cap companies that provide a reliable and growing cash flow stream to support the spending policy[6]
- **U.S. investment-grade bonds**, mainly corporate bonds[7]
- **Large-cap U.S. *value* equities** via a Vanguard index fund
- **Global equities** via a Vanguard index fund to provide inexpensive global diversification
- **Small-cap *value* equities** for further diversification and growth

Portfolio allocation is comprised of 70 – 85% equities.

The above is a general baseline composition that has to be tailored to each organization's unique history, philosophy, objectives, preference and temperament. As discussed above, enterprise risk management and spending policy pressure are important factors in portfolio construction. The following pie chart illustrates the diversification the above baseline provides; the blue slices are managed internally by WIC:



This portfolio structure provides more than sufficient diversification, global exposure, a combination of active and passive (index) management, and anchors the portfolio to a hedged, managed volatility strategy that generates above-average cash flow in this low yield environment.

[6] Willis Investment Counsel directly manages this Managed Volatility and Income Strategy.
[7] Willis Investment Counsel directly manages this Fixed Income Strategy.

Targeted Rate of Return

The portfolio rate of return should be the result of a process, not the objective of a process. The targeted rate of return in the IPS should be the result of evaluating the spending policy, downside risk issues, time horizon, asset allocation, etc. Once that process has been completed, the targeted rate of return will be the outcome – the return that is required over long periods of time, over full market cycles, to achieve the organization's objectives.

In essence, a targeted rate of return is a scorecard that is used to evaluate if the portfolio is performing satisfactorily. It attempts to distill the entire endeavor down to a single number. That, in and of itself, is a serious mistake. Very few organizations will choose what may be a better approach – measure performance in terms of congruence with the drivers in the investment policy statement: (i) adequacy and reliability of spending policy funding sources, (ii) efficacy of downside protection, (iii) alignment with asset allocation guidelines, and (iv) the quality of counsel. The targeted rate of return should be considered the residue of these key drivers of long-term return. The return should be compared to a customized and broad array of market indices for competitiveness.

GOOD FIDUCIARY PRACTICE – PROPER PORTFOLIO MONITORING

Fiduciary monitoring of endowment and foundation portfolios is much more than outcomes or rate of return, it's about the process of questioning and monitoring. Good fiduciary practice includes these key elements that WIC can assist with:

- Portfolio review at periodic investment committee/trustee meetings
- Monitoring and accountability that tracks investment policy statement
    - Asset allocation within stated range
    - Strategies consistent with policy and what has been agreed to
    - Cash flow generation supporting spending policy
    - Downside protection in place and effective
    - Fees reasonable and competitive
    - Returns versus IPS and versus a range of indices
    - Any changes needed
- Qualitative monitoring of an investment management firm is equally as important as performance data
    - Reporting and accounting
    - Overall communication
    - Education
    - Overall responsiveness and *partnering*
- Minutes of meetings with portfolio reports

WIC can lead this discussion and provide supporting documentation for the minutes.

For additional information on fundamental principles of foundation and endowment fund management, please read *Non-Profit Asset Management, Effective Investment Strategies and Oversight*; Matthew R. Rice, Robert A. DiMeo, Matthew P. Porter.