

Prudent Investing for Nonprofit Organizations and Public Charities

By Susan M. Walton

When it comes to investing, charities, foundations and other nonprofit organizations share some basic objectives with most other prudent investors, whether individuals or businesses. Charitable groups seek such universal goals as principal protection, an acceptable level of risk, reliable income and the potential for long-term growth.

Yet there are also fundamental differences. Because of the nature of their missions and their tax-exempt status, nonprofits that invest are unlike any other entity. They must conform to requirements both legal and philosophical, taking care to ensure that their search for investment returns stays within the bounds of strict regulations as well as the groups’ own values.

“There’s just a different level of oversight all around when you’re talking about a nonprofit,” says Susan Walton, senior vice president, U.S. Trust Institutional Investments & Philanthropic Solutions group. “Investment decisions have to take into account an organization’s spending needs, its charitable purposes and its near- and long-term objectives.” While a careful consideration of risk is at the heart of any investment strategy, nonprofits are required to invest in such a way that does not jeopardize their underlying functions — for example, by leaving them short of capital needed for annual spending on their charitable works, or even by tying up their assets so that cash isn’t accessible when it’s needed.

Regulatory guidelines

Investments by nonprofit organizations are regulated under a 2006 model statute known as the Uniform Prudent Management of Institutional Funds Act (UPMIFA). Some version or portion of UPMIFA has been adopted by every state except PA. It broadened and strengthened rules first laid out for nonprofits in 1972 by establishing investment and money management principles for charities and organizations that invest on their behalf.

For example, groups that fall under the statute must “act in good faith, with the care an ordinarily prudent person would exercise,” keep costs reasonable when investing and managing charitable investments, make decisions as part of an overall investment strategy, diversify investments, and make sure that the investment strategy is appropriate for a particular fund.¹

The 2006 guidelines also revised the benchmarks for satisfactory management and investment for nonprofits. Under the previous rules, nonprofits had only to keep the total value of assets above a fixed “historic dollar value” dating to when the organization was founded.

About the Author

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Setting a framework

The first step for the investment committee of any nonprofit—before it selects assets for the organization’s portfolio, and even before it decides on a specific investment strategy—is to establish a framework around which that strategy will be built, says Susan Walton.

To arrive at that framework, she suggests that an investment committee provide detailed answers to these questions:

- **What is the purpose of the organization?** In clear, direct language, the organization lays out its reason for being, the mission or missions it hopes to accomplish, and the work it aims to support.
- **What are the investment committee’s objectives?** “This is really an expression of your underlying goals of investing, rather than your specific strategy,” Walton says. A detailed statement of objectives might, for example, outline such goals as achieving average returns that at least keep pace with the organization’s spending as well as inflation, in order to ensure long-term spending capabilities. “How you implement those goals is the strategy,” Walton adds. “That comes later.”

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That benchmark became almost meaningless for organizations that had been operating for many years. The new guidelines keep much closer track of ongoing practices, year in and year out, Walton says. For example, UPMIFA requires that investment strategies for nonprofits reflect modern portfolio theory, so that managers consider diversifying assets and select specific investments in the context of an overall strategy.

In order to not just conform to those regulations, but also to achieve its goals and remain viable over many years, a nonprofit, its investment committee and those who invest on the organization’s behalf face a far more complex task than simply choosing an array of solid investments.

The investment policy statement

The answers to such questions form the basis of a formal investment policy statement (IPS) — a sort of constitution for the investment committee to follow, as well as a vital document enabling regulators to determine whether the organization is staying within its proper investment framework. The IPS outlines the purpose of an organization’s investment fund, its objectives and whatever constraints might preclude certain types of holdings. The policy statement’s timeline sets out the nonprofit’s time horizon and its willingness to accept investment risk.

Three basic factors help determine the overall investment strategy: the organization’s income (from donations, grants and other sources), its spending, and the return on investment it needs to support that spending.

Income takes into account not just how much money comes in each year relative to overall portfolio assets, but also how predictable that income is, how much control the organization has over its income, where the money has traditionally come from, and what changes may lie ahead. Since nonprofits spend at a fixed rate per year (say, 5% of the endowment), a major new donation, rather than being spent outright by the organization, becomes an integral part of the greater investment strategy. In the same way, a spending analysis looks at how much an organization spends each year as a percentage of assets, the predictability of that **spending**, and whether the organization has the flexibility to weather a time of crisis without disrupting its underlying mission.

Taking into account a group’s profiles for income and spending, **required return** is the minimum return on investment the organization needs in order to sustain its operations. Having this figure in mind can help the investment committee decide whether a highly conservative approach (such as holding only U.S. Treasuries) can meet those objectives. If not, what other types of investments might earn a higher return while remaining within the organization’s risk tolerance?

Setting a framework (Cont'd.)

- **What is its risk tolerance?** If the value of portfolio assets were to drop by a given percentage, how would that affect the organization's ability to serve its purpose? The answer to this and related questions can go a long way toward helping a nonprofit stay within prudent bounds.
- **What are the liquidity and spending policies?** Whatever its overall investment portfolio may be, a nonprofit needs a certain level of readily available (liquid) assets. That level is determined by how much is spent each year. "It's important to know your liquidity needs up front," Walton says. "Do you need to spend 4% of your assets each year to fund endowment needs?" Such considerations will directly affect potential investment choices.

Knowing the constraints

Another key consideration in forming an organization's IPS is determining what types of investments may not belong, for a variety of reasons.

For example, nonprofits need steady access to cash to spend on their missions. An investment in thousands of acres of timber or a hedge fund that requires investors to tie up cash for more than a year might produce attractive returns from a purely financial perspective but may not provide sufficient liquidity for a nonprofit to support its mission.

To help bring uniformity to decisions about the appropriateness of an organization's investment holdings, the Financial Accounting Standards Board in 2006 issued a framework known as SFAS 157 that divides investments into three "hierarchies" based on liquidity. These range from level 1 assets such as cash, stocks, Treasury bonds, mutual funds and other securities traded on public markets, to level 3 investments such as hedge funds, private equity and others that may be difficult or impossible to sell quickly.

Based on this hierarchy and an organization's own liquidity needs, a nonprofit can devise a formal liquidity statement establishing that level 3 assets will comprise no more than, say, 20% of the overall portfolio, and that if liquid assets drop below a pre-established threshold, the committee will rebalance holdings to bring the portfolio back into line.

Staying true to values

A nonprofit, because of its particular values and mission, may also decide it doesn't want to invest in certain areas for philosophical reasons. For example, an organization devoted to promoting environmental causes may seek to avoid investing in companies or industries seen as major polluters, while a health-related charity could choose to shun the manufacturers of products that may contribute to sickness or disability.

In the past, screening out undesirable but potentially profitable investments — a process known as socially responsible investing (SRI)—was widely regarded as a well-meaning but money-losing proposition, says Walton. "Even a decade ago, if someone mentioned SRI, the typical response was, 'Will you still be able to get performance?' Thanks to a growing interest in SRI in the United States and worldwide, that has changed," Walton says.

Today, an investor who is committed to staying within a framework of social or environmental values can choose from thousands of mutual funds and other investments. Increasingly, these include not just funds that "screen out" companies or industries one views as undesirable, but sophisticated strategies that actively include

promising investments that promote one's values. "You've got an incredible array of options," Walton says. "What we're finding is we can build social-minded investment strategies that can be competitive on the basis of yield and total return."

The importance of the fiduciary standard

A key partner for a nonprofit's investment committee is the financial services organization that handles assets and investments on the group's behalf. Such organizations, including U.S. Trust, act as fiduciaries, meaning they are required to act in the best interests of the client in all investment recommendations and decisions, and may be authorized to make decisions on financial matters.

While all fiduciaries, whether representing individuals or businesses, must act in the interest of their clients, those working on behalf of nonprofits must go a step further, taking into account both the long-term financial health of the organization and its charitable purposes. To do that, the fiduciary must be intimately familiar with the investment policy statement, and aware not just of the organization's financial profile but also its operations, programs and services. The fiduciary helps establish an appropriate financial strategy and is responsible to regulators in demonstrating that investment decisions are prudent and within the bounds of the organization's mission and goals.

"Because of our fiduciary standard, we're very rigorous," Walton says. A good fiduciary will examine an organization's IPS or existing portfolio and spot "red flags" that may cause investments to stray from guidelines for liquidity or other needs. "We can correct those things if we need to," Walton says. "Our compliance group can work with the investment committee members to update the guidelines. In that sense, we can take some of the pressure off of the committee."

While the process of setting, executing and evaluating a nonprofit's investment strategy can be onerous, the investment committee, the fiduciary and the regulators, in the end, all are working to achieve the same basic goals. They're helping keep nonprofits, charities and private foundations healthy, stable and ready to pursue their missions to create a better world.

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¹ "Uniform Prudent Management of Institutional Funds Act" drafted by the National Conference of Commissioners on Uniform State Laws, July 7-14, 2006. Page 2. http://www.uniformlaws.org/shared/docs/prudent%20mgt%20of%20institutional%20funds/upmifa_final_06.pdf

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