The Practical Guide to Managing Nonprofit Assets

William A. Schneider,

Robert A. DiMeo,

Michael S. Benoit &
Associates

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To my wife, Caren, and children: Erik, Laura, Chris, Katie, and Jamie for their love and support.

William A. Schneider

To my wife Adriane and sons Chris and Danny for providing enormous joy in my life and to my partners and associates for being truly great teammates in building a wonderful firm.

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Trina Sweet

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Mr. Gallagher is the former chairman of the Exempt Organizations Committee of the American Bar Association (ABA) Section on Taxation, the past chairman of the Committee on Administration of Estates and Trusts of the Real Property, Probate, and Trust Law Section of the ABA, and a fellow of the American Law Institute, the American College of Tax Counsel, the American College of Trust and Estate Counsel, and the Milwaukee Bar Association Foundation, over which he presided as president from 1977 until 1983. He is listed in *The Best Lawyers in America* under Tax Law and Trusts and Estates.

Mr. Gallagher graduated from Harvard University Law School (J.D., 1967) and from Northwestern University (B.S. in business administration, with distinction, 1964). He was admitted to the Wisconsin Bar in 1967.

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CHAPTER 1

Introduction

A CRYING NEED

"It was the best of times; it was the worst of times." That's how Charles Dickens began *A Tale of Two Cities*, a novel about another turbulent era. Our own is more challenging. Information can travel around the globe at the speed of an electric current, but the ancient scourges of ignorance, disease, poverty, and hatred are far from banished. An optimist can find cause for gratitude: new advances in agriculture allow fewer and fewer farmers to feed the world. Biotechnology has changed the face of medicine. The fall of Communism has already freed millions of workers and is beginning to create more vibrant economies around the globe. But change creates turmoil. Some lives improve, others get worse.

Not-for-profit institutions (charities, hospitals, schools, and religious organizations) face a growing need for their services. Simultaneously, governments in the United States and around the world have been forced to cut back some of their traditional support. The money simply is not there.

Demographics have changed and will continue to change dramatically. Medical science makes it possible to live longer, but at a cost. An aging population taxes the infrastructure. Promised entitlements such as Social Security and Medicare will ultimately be cut back. Who will pick up the slack?

The extended family structure that served mankind for centuries has broken down. Millions of children are now raised by single parents. Even in the "traditional" family, if both parents need to work, the odds are the kids will be shipped off to a day-care center rather than to loving relatives. Many grandparents now live halfway across the country rather than around the corner. Incapacitated grandparents themselves face the prospect of ending up in a nursing home or assisted-care facility rather than in a spare room at their son's or daughter's home.

Increased globalization also creates serious challenges. On the one hand, society profits from free trade. Goods and services become more affordable and ultimately more jobs are created as entrepreneurs find ways to profit from the new economy. Think of all the people employed in importing, distributing, and retailing a portable compact disc player made in China. And since the player is so cheap, almost every teenager has one. The teens, in turn, become voracious consumers of compact discs, thus employing musicians, singers, artists, producers, sales people, and so forth. On the other hand, try explaining all that to an unemployed factory worker whose assembly line job will never return to the United States.

Our educational system has produced uneven output. Although our colleges and universities train the best and the brightest as future doctors and scientists, an alarming percentage of high school students fall through the cracks. Math and reading scores have fallen, and drop-out rates have increased over the past 30 years. In the mid-20th century, those failing students could still join the workforce as unskilled laborers or find a job on an assembly line—boring jobs to be sure. But it's exactly those boring or repetitious jobs that are being lost to automation or exported to countries with cheap labor.

SHOCKS TO THE SYSTEM

Other disturbing trends are afoot around the globe. First and foremost, the spread of AIDS may overwhelm all other forces. Sub-Saharan Africa provides an example. Just as the great plague threw Europe into the Dark Ages, AIDS has already destroyed the fabric of society in certain areas. Tens of thousands of orphans have been left to raise themselves. With no parents to teach them how to farm, even the basics of food production lie in jeopardy.

The world has become more polarized. The rise of Islamic fundamentalism has led to new levels of intolerance and barbarism. We live in a time when some parents and "religious leaders" train their own children to become suicide bombers! Even in the United States, politicians seek to exploit class warfare and partisanship for their own political ends.

Billions of dollars worth of illegal drugs and alcohol are consumed each year. By some estimates, the underground drug trade may be the third or fourth largest sector of the economy. The social challenges are enormous. Government attempts to stamp out the drug trade have been a spectacular failure. We have, however, succeeded in creating the largest prison population of all time.

In short, there is a crying need for all of the services provided by not-for-profit organizations. It does not matter whether your mission is extremely broad or quite narrow, the challenges are enormous.

FINANCES

Although the challenges are abundant, money is not. The 21st century began with a three-year bear market in stocks. This downturn (the worst in 100 years) devastated many nonprofit organizations. Even a strong market recovery in 2003 and 2004 hasn't restored financial health.

In the 1980s and 1990s, fund fiduciaries became accustomed to equity returns of over 15% per year and double-digit bond returns as well. Nonprofit investment committees debated whether to spend part of the "extra" return they had earned. Sometimes they did. Many universities issued bonds to finance new stadiums or other facilities, counting on return from the portfolio to help pay the debt. By 2003 some of the loan covenants were in jeopardy.

To put the magnitude of the equity decline into perspective, if returns on the Standard & Poor's (S&P) 500 index average 15% per year from 2004 through 2009, then the average annual return for the entire *decade* will be just 6.9%! And most experts doubt that the S&P 500 will return anywhere near 15% per year for that period.

There are only three possible components of stock return: dividend yield plus earnings growth plus (or minus) multiple expansion (or contraction). The dividend yield of the S&P 500 is currently under 2%. Assuming that analysts are not wildly optimistic, nominal earnings growth might be in the 5% to 6% range. This produces a 6.7% to 7.8% return— *unless* you expect multiples to rise.

Earnings multiples (the price-earnings ratio, or P/E) reflect the price investors are willing to pay to acquire a dollar's worth of earnings. The S&P 500's current multiple is around 21 times earnings. Unfortunately that number is near the high end of its historic range. The long-term P/E ratio average for the index is 16 times earnings. Bearish investors argue that P/E ratios are more likely to contract than to expand. Non-U.S. stocks seem more reasonably priced, but one can't build a portfolio of only foreign equities.

Bonds don't seem to be a compelling bargain either. With interest rates near a 45-year low and the threat of inflation increasing, rates may continue to rise. That is a problem for bond investors. Bond prices, of course, move in the opposite direction from interest rates, like the opposite ends of a teeter-totter. When rates go up, bond prices fall and vice versa.

We've heard the argument that "if we hold the bonds until maturity, we'll get all our money back." That may be true, but prior to maturity, one would not be able to sell without realizing a substantial loss. This means the investor would be locked into lower-yielding bonds and unable to replace them with higher yields available in the marketplace. This is still an opportunity cost. Investors who use bond funds rather than directly owning the bonds themselves do not even have this option. Bond *funds* never mature.

CONTRIBUTIONS

One additional component of this "perfect storm" for nonprofit organizations has been the effect on giving. There used to be a substantial incentive for wealthy donors to gift appreciated stock to charities. Not only did the donors avoid paying capital gains tax on the stock, but they also received a tax deduction for the full amount donated. After the bear market, highly appreciated stock may be in short supply. Additionally, the tax code now provides more favorable capital gains treatment than it did a few years ago. In any case, donations have dropped considerably.

THE PENSION PROBLEM

Some not-for-profit organizations face an additional challenge. Organizations that offer a defined benefit (DB) pension plan to employees may find their resources squeezed even further. Because of the way pension liabilities are calculated, DB plans face a double whammy. The lower interest rates act as a multiplier for pension obligations while lower asset values mean that there is less money to pay for those liabilities. This has forced some institutions to make required pension contributions instead of funding important programs.

ENVIRONMENT OF MISTRUST

Fund fiduciaries are also uneasy about their financial vendors. Corporate America is sporting a black eye. It now seems that a number of companies were cooking the books so that insiders could reap huge profits in the form of rising prices on their stock options. In some cases, auditors who were supposed to safeguard the public were in on the scam. Andersen, one of the oldest and most respected accounting firms, was driven out of business for its role in the Enron scandal.

Wall Street analysts in many cases were shown to be nothing more than shills for the investment bankers. E-mails revealed that certain analysts privately labeled stocks "dogs" that they publicly touted as strong buys. Several of the largest brokerage firms were forced to pay huge fines.

Even mutual funds, long considered to be the champion of the small investor, were tainted by the probes. A significant number of fund companies allowed certain hedge funds to trade in ways that harmed the rest of their investors. "Late trading" and "market timing" abuses led to hundreds of millions of dollars in fines. Some fund CEO's lost their jobs, and in one case the founder of the fund company was forced to resign.

In this environment, board members of not-for-profit organizations feel the added pressure of scrutiny themselves. The Senate Finance Committee has been reviewing the financial practices of public charities. Not-for-profit funds are categorically different from most other investment pools. (In most cases, there are no "beneficiaries" who have a claim on the funds—hence less chance of litigation.) However, in some cases dissatisfied donors have demanded refunds. Maybe board members are just feeling less confident then they did in the late 1990s. In any case, there is a clear increase in fiduciaries' desire for prudence. See Chapters 18 and 19 for more information on regulatory requirements.

THE GOOD NEWS

The bleeding stopped, at least temporarily, in 2003 and 2004. Virtually all of the capital markets performed well. Stocks and bonds, both domestic and international, turned in solid years. Furthermore, even the substyles (large-cap, mid-cap, and small-cap—both growth and value) did well. In addition, Congress has provided some legislative relief on pension funding requirements.

Perhaps the most important developments have come in the form of advances in investment theory. These should lead to improved risk-adjusted (and absolute) return. These advances will be presented later in the book. To take profit from these new techniques, fund fiduciaries will need greater knowledge and analytical capabilities. But the payoff from new investment strategies and asset classes will be substantial.

One outgrowth of the Wall Street scandal is that investment organizations are much more concerned with compliance. The treatment of investors should become much more even-handed. Mutual funds, in particular, will be working hard to avoid any hint of future scandal. Nothing focuses attention on governance issues more than a few highly public firings.

Finally, costs are coming down. Some of the mutual fund settlements have involved fee reductions. Also, the Securities and Exchange Commission (SEC) and other regulators are focusing on expenses. 12b-1 fees and trading costs will likely shrink dramatically. The use of "soft dollar" payments is coming to a screeching halt. *Soft dollars* are commissions (usually above market rate) awarded to compensate broker/dealers for other services, such as research and marketing.

THE FUND-RAISING CHALLENGE

Entire books are written on the subject of fund-raising, and it has become an industry unto itself. Here, rather than present fund-raising ideas, we wish to briefly address the important role that investment strategy and structure has in aiding the fund-raising effort for nonprofit organizations.

All fund-raising—whether a significant capital campaign or a single request for an individual gift—will have a better chance of success if you can articulate well-conceived gifting strategies and investment policies. Sure, potential donors want to know "what their donation will buy"; however, they also need to understand:

1. What gifting options or strategies are available to them; and,
2. How the money will be managed (investment policy).

GIFTING STRATEGIES

Nonprofit organizations that expand the ways in which donors can make gifts receive more contributions. Successful institutions move beyond year-end checkbook campaigns to offer donors true value-added gifting strategies.

To increase your raise, be flexible in how you'll accept gifts. Create mechanisms that allow you to accommodate and even encourage nontraditional gifting.

Noncash Gifts. Make it simple for individuals to donate appreciated securities, real estate, or other assets. It is important to have policies in place regarding the disposition of such assets. Also, and this is critical, be sure that appropriate acknowledgement and appreciation procedures are in place. There is perhaps nothing that will harm your fund-raising efforts more than not thanking donors on a timely basis. Too many nonprofit organizations tolerate sloppy procedures. Weeks or even months pass between the day a donor ships securities to the broker of record and when the charity is notified of the gift (Exhibit 1.1). Obviously the lack of a prompt "thank you" discourages future gifts.

INVESTMENT STRATEGY

The more that donors and potential donors know about your investment program, the better. Donors gain confidence when they see a well-conceived strategy that is clearly articulated. As a result, they are likely to give more.

EXHIBIT 1.1 KEYS TO WORLD-CLASS DONOR SERVICE

- Be committed
- Be properly resourced
- Be consistent
- Be quick
- Be personal
- Be known
- Be meticulous
- Be there
- Be honest

Source: CharityVillage.com/Ken Burnett, author of *Relationship Fund Raising-Based Approach to the Business of Raising Money.*

Consider the University of Notre Dame Endowment. At over $3 billion, it is among the 20 largest educational funds in the United States. A visit to the investment office link at www.nd.edu reveals a nonprofit organization that is serious about communicating investment strategy.

The site is flush with general information on the purpose of the fund, but, for those interested, they provide specific details on topics including:

- *Basic Objectives of the Fund:* Specific rate-of-return targets.
- *Investment Policy:* Long-term asset allocation targets by asset class.
- *Investment Management Strategy:* Selection criteria for hiring and evaluating managers.
- *Performance Results:* Historical results compared to key benchmarks.
- *Spending Policies and Trends.*

In attempting to raise money, nonprofit organizations must use every available resource. This book can help an institution create an outstanding investment structure. The key is to be sure to communicate this structure to donors and potential donors.

EXPECT TO FIND

In this book the authors will:

- Examine fund-raising challenges.
- Explore special issues facing hospitals, colleges, and religious orders.

- Examine spending policy and its impact on the health of the organization.
- Explore investment theory, including some of the new insights of *behavioral finance.*
- Discuss fiduciary issues, including the evolving state of the various uniform investment acts, as well as the impact of the Employee Retirement Income Security Act (ERISA).
- Provide a framework for evaluating and selecting consultants, brokers, vendors, record keepers, and other resources for the fund.

Most importantly, we will outline a systematic approach for the prudent steward. The coming chapters explore, in depth, each of these important steps:

- Goal setting
- Asset allocation
- Developing a written investment policy statement
- Selecting managers
- Portfolio rebalancing
- Performance evaluation
- Cost control

HOW TO USE THIS BOOK

Of course one could read the book from beginning to end. But the book is designed to be modular. That is, each section is self-contained. So if, for example, your immediate concern is manager selection, you could turn to that section. One important note: to create the optimal systematic approach, you need to follow all the steps listed above. If you skip any of them, you will do your fund and yourself a great disservice.

We have attempted to make this resource as user friendly as possible. Wherever possible, we have included checklists, forms, sample documents, and worksheets. We also list sources for information, software, and services. These lists, while not exhaustive, should provide helpful direction.

We examine the roles and responsibilities of various providers and vendors to the fund. Fiduciaries are often confused about the function of consultants versus money managers versus brokers versus custodians. We explain what you should and should not expect from each. We also provide a framework to help you select providers in each area.

WHO SHOULD USE THIS BOOK?

This book is written, first and foremost, as a practical guide for fiduciaries of nonprofit funds—board members and internal business managers. We hope to convey the best practices of the marketplace as well as current academic research. We try to keep this as readable as possible so that it can be a pragmatic guide. Wherever possible, we attempt to tell you "what time it is" rather than "how the watch is made." Some technical explanations are necessary from time to time, but we will stick to plain English as much as possible.

A second group that may find this book useful are the various advisers to nonprofit organizations. This group includes accountants, attorneys, and even consultants. Hopefully, this book will enable professionals and their client (the not-for-profit organization) to better communicate. It should also provide tools that can help add even more value for your client. In some cases, it may provide ammunition to persuade your client to take needed action.

Money managers, brokers, custodians, and other vendors will find this book useful. It may give you an enhanced sense of how your service fits into the client's world-view. It may even be a sales tool to help clients understand how your services benefit them.

Finally, anyone who is interested in the oversight of nonprofit funds should gain new insight. This group includes legislators, teachers, students, community activists, reporters, and others.

CHAPTER 2

Special Issues

HOSPITALS—THE RETIREMENT PLAN MESS

Regardless of how large or small a hospital might be, retirement plans are a big issue. Pension plans cover a growing number of retirees, and defined contribution plans have almost become a requirement for attracting and retaining quality employees. In this chapter, we discuss several topics, including underfunded pension plans, 403(b), 401(k) plans, and capital campaigns.

UNDERFUNDED PENSIONS

During much of the 1980s and 1990s, pension funding was an afterthought. Consistent double-digit returns from the equity markets kept the coffers full for most plans. Plan sponsors were not as interested in true asset allocation strategies as they were in just being "in the market." As we've noted, the bear market of the early 2000s changed all of that. Steep declines in the equity markets coupled with low interest rates helped create the current mess, but ill-conceived investment policies compounded the problems. For the first time in nearly two decades, pension plan committees are looking at hefty funding requirements. Hospital administrators face a serious challenge in dealing with underfunded pension plans.

Because government regulations require pension plan balances to stay within a certain percentage of outstanding liabilities (the amount owed to current and future retirees), organizations must ratchet up contributions to their plans if the ratio slips. Corporations face similar problems, but the cost of pension plan liabilities shows up in lower corporate earnings. When hospitals or other not-for-profit organizations are forced to make extra contributions to pension plans, important organizational goals may be jeopardized. If budgets are tight, a contribution to a pension plan may take the place of a new piece of much-needed medical equipment.

The pension quandary forces you to make sure that you have a full and real understanding of your pension plan. What does the demographic profile of the plan look like? Has an asset/liability study been done recently? Is there too much risk embedded in the plan's asset allocation? Too little? Do you properly monitor the investment managers? Although these questions are extremely important for all pension plans, they are crucial for not-for-profit organizations that may rely on donations or special funding for their success. In addition to pension problems, not-for-profit organizations face challenges with their other retirement vehicles.

403(b) versus 401(k)

Since its inception in 1958, the 403(b) has been the primary retirement savings plan available to not-for-profit organizations. Historically, most 403(b) vendors have been insurance companies. Some have been top-notch vendors, but many are secondary or tertiary players. Mutual fund companies have traditionally avoided this market, even though their record keeping, investment prowess, and educational materials make them the dominant providers in the 401(k) arena.

401(k) plans had their inception in 1981. They quickly grew to become the dominant retirement plan type. Competing vendors, mostly mutual fund companies, engaged in a kind of "arms race" of service offerings seeking to increase their share of this exploding market. Daily valuation, on-line account access, 24-hour call centers, robust educational capabilities, and almost complete investment flexibility became hallmarks of the 401(k) arena. Vendors commit millions of dollars each year for hardware, software, systems, and people to enhance their ability to service participant-directed plans. Simultaneously, competition has driven prices down.

Superficially, 401(k) and 403(b) plans look very similar. Both are sponsored by the participants' employer. Both allow participants to save their own money on a tax-deferred basis. Both allow for investment choice. However, there were small but significant differences in testing, record-keeping, and eligibility requirements. Maybe, more importantly, assets in 401(k) plans were showing enormous growth while 403(b) plan assets were not. Part of the problem for 403(b) plans has been that they have been just different enough that the mutual fund companies abandoned the field to the insurers.

With the passage of legislation in 1996, nonprofit organizations (including