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nonprofit investment and development solutions

A Guide to Thriving in Today's Economy

Roger M. Matloff and Joy Hunter Chaillou

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A Guide to Strategies and Solutions for Thriving in Today's Economy

ROGER MATLOFF

JOY HUNTER CHAILLOU

WILEY

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Preface: Here We Are

What our economy has recently experienced is more than just a crisis. The wake of the Great Recession has left a paradigm shift for nonprofit leadership and their Boards as Fiduciaries. This shift has changed how Boards evaluate and document investment decisions, the risks they are willing to take, and the way these details are communicated to donors. There has been a significant transference in donor behaviors and motivations and consequently the emergence of an increased need for precise development strategy and measurement techniques for communicating impact. Nonprofit competition for philanthropic dollars is fierce, and all organizations—big and small—need to conform to new standards of accountability and transparency. This book has been designed to be read by anyone who is involved with a nonprofit at the leadership level. We attempt to provide a balanced perspective around the priorities of investment and development strategy, and bridge the gap between those with backgrounds in investment management, nonprofit management, administration, and fundraising. Whether the reader's role is that of volunteer or staff leadership, he or she will be able to learn something new from taking the time to read this guide.

We will introduce investment and development strategies, tools, and techniques in hopes of providing some keys to success in this post-Great Recession environment, and provide answers to the following questions:

- What are the lessons we can learn from this crisis, to protect nonprofits from unnecessary investment risks and funding shifts in the future?
- What steps can be taken by nonprofit leadership and advisors to ensure that Boards and investment committees are prepared to make prudent decisions to protect the organization's financial resources and ultimately its mission and impact?
- What steps should be taken now to secure financial stability in order to ensure sustainability so that the good work and critical missions can have impact now and perpetuate for future generations?
- What steps should nonprofits be taking in order to ensure a donor will continue to support their cause? How are donors making their philanthropic decisions? What information are they seeking? What tools are they using and to whom are they turning for advice?

Background: Where We Have Been

Our country recently has been through devastating economic experiences, the effects of which have been and continue to be felt around the world. Essentially, the reverberation of decisions made across the biggest firms in the financial industry—taking on immeasurable amounts of risk—resulted in the obliteration of well-known multi-billion dollar investment companies and created a world of uncertainty for corporations, individuals, governments, and nonprofit organizations across the globe.

The walls of Wall Street came tumbling down in 2008. Lehman Brothers, Bear Stearns, and Washington Mutual filed for bankruptcy and fell off the map; others, like AIG, were crippled. The government concerns about bank stability encouraged mergers between powerhouse companies like Wachovia and Wells Fargo, and Merrill Lynch and Bank of America. Countless other investment companies experienced dramatic upheavals, limiting the extension of credit to other businesses. Who would have believed that in one year, both Chrysler and General Motors, symbols of preeminent American industrial strength and prestige, would both file for reorganization under bankruptcy laws?

So severe was the financial crisis, so close were the capital markets to unraveling, that the United States government took unprecedented steps as enforcer to the financial industry, to end the crisis and minimize the collateral damage. The Department of the Treasury was involved in shepherding the process of J.P. Morgan purchasing the remaining assets of Bear Stearns. The Federal government took further drastic action by investing in large national banks, insurance companies, and the auto industry, with those leaders navigating through the crisis, speaking *sotto voce,* that these corporations were "too big to fail." The Federal Reserve Bank, Department of the Treasury, and, at their urging, Congress, took dramatic action in the form of a stimulus package, to inoculate the economy from plunging into another Great Depression.

However, despite the stimulus legislation, which mandated the infusion of $787 billion, the aftershocks of the crises have been devastating and felt by all. Hundreds if not thousands of businesses shut their doors; individuals invested in the stock market saw no gain after a decade of investment; retirement savings vanished; and unemployment has been at an all-time high.

Multiple Factors

Some may have clear recollections of the relentless daily news featuring countless market declines. As the Dow Jones Industrial Average plunged below 7,000, even stalwart believers in the equity market were taking a

reality check—how far down could the markets go? As it happened, the year 2008 was the most volatile year in the securities markets since 1929. Two of the best *and* two of the worst days on record occurred in 2008; on October 13 and 28, the market gained 11.6 percent and 10.8 percent, respectively. And we witnessed September 29 and October 15, with the market sustaining stunning losses of 8.8 percent and 9.0 percent, respectively.

Looking back you may recall living through the media discussions in late 2008, recounting how the origins of the financial collapse had been seeded years before, when federal and banking policies shifted, loosening residential credit, allowing those Americans who had high credit risk to purchase homes. The easing of regulations during the Clinton era was well intended, to enable middle to low-income earners finally to enjoy the pride of home ownership. Their mortgages were bundled with others in complex financial packages and securitized as collateral debt obligations (CDOs). The purchasers of those packages fully believed that the mortgages underlying the securities would be paid to the underlying lenders and that the value of those CDOs would appreciate over time. It is when the CDOs on their books became devalued that the situation became worse.

As borrowers were unable to pay their mortgages *en masse* the value of the CDOs dropped, those insurance companies holding the financial portfolios that carried the insured value of the CDOs were called upon to pony up. But, what they had not expected was the cascading of failed CDOs, putting pressure on their balance sheets. Much of what occurred has been evocatively told in such books as *House of Cards* by William Cohan (Anchor, 2010; describes the collapse of Bear Stearns) and Andrew Ross Sorkin's book*, Too Big to Fail: How Wall Street and Washington Fought to Save the Financial System—And Themselves* (Penugin Books, 2010; the story of the decline of Lehman Brothers) that have focused on tracking, on an almost daily basis, the unfolding of events that led to the Great Recession.

What is most striking is the trail of destruction this crisis left in its wake. For all of 2008, the S&P 500, a standard measure of the strength of the U.S. stock market, declined by 38.5 percent (37.0 percent including dividends). From the market's apex to its lowest point, the market declined more than 51 percent (October 9, 2008 to November 20, 2008). Oil peaked in July of 2008 at $147 per barrel only to plummet to $35 per barrel near the end of December 2008, a sign that business and consumer demand had all but dried up.

During this crisis, the market declined more than 51.9 percent. Only three times since 1939, including this latest crisis, has the market declined by more than 40 percent. While a recovery during each recession took time, perhaps years, the average market increase after the two worst recessions

was 84.2 percent. This leads us to believe that we will experience positive growth in our future.

As if the declining markets weren't enough to cause fear and suffering, simultaneously a number of Ponzi schemes were exposed beginning with investment manager Bernard Madoff pleading guilty to defrauding more than 1,000 individuals, families, and charities of $60 billion dollars. The Madoff scheme was coined the largest in American history. Families were devastated, some victims committed suicide, and some nonprofits shut their doors, while others shed staff and programs. Nonprofit organizations across the country had major donors whose wealth disappeared instantly and endowments were depleted as a result of Madoff's fraudulent activity. Subsequent to the Madoff scheme, many more Ponzi schemes were exposed when their culprits were unable to continue to fuel their confidence games with new money.

To complicate matters further, as unemployment rose in response to the economic downfall, so did the demand for social services. Homeless shelters, food banks, and social service agencies had to increase their services and enhance their programs. The need in communities around the country rose at a rapid pace as the resources funding those organizations declined or even dried up completely. Individual donors, feeling their own personal economic crises, began to reduce or stop their funding. Government agencies revisited budgets, and funding allocations changed or were cut entirely. With resources retracting and individuals feeling less wealthy, donors began to evaluate their choices and be more selective in their charitable planning strategies. High net worth individuals became more strategic in their charitable plans. Decisions about which organizations to continue supporting were made with great care and guidance from outside advisors—accountants, attorneys, and financial advisors. More than 67.5 percent of high net worth households consulted their accountant when making a charitable giving decision, 40.8 percent consulted their attorney and 38.8 percent their financial/wealth advisor.[1] Additionally, the list of charities was slashed in some cases from 10 or 12 to 2 or 3. Therefore, as the financial needs of nonprofits rose and the need for services increased, the dollars available retracted and the allocation of those dollars, and the selectivity with which donors were making donations was building as well. Enter the growing accountability and transparency standards. In 2008, the government unveiled the new Form 990 (*Return of Organizations Exempt from Income Tax*), fiduciary responsibilities of board members were emphasized and many smaller nonprofits were eliminated based on their inability to comply with the new reporting standards. The tone had officially changed as the business

[1] The 2010 Study of High Net Worth Philanthropy, sponsored by Bank of America Merrill Lynch.

of running a nonprofit efficiently and effectively became more relevant both for obtaining funding and complying with regulatory requirements.

There is no question that the challenging economic and investment climate and scarce funding resources have left us all, individuals, for-profit corporations, governments, and nonprofits alike, with a new reality. Specifically for the nonprofits, there is more competition than ever before, and boards and nonprofit leadership are forced to reexamine themselves as leaders, stewards, and fiduciaries. Leadership must have a keen awareness around risk, sound policies, and practices to make prudent decisions to preserve the mission and impact goals of the organization. Our theory is that sound policies and prudent practices, from investment consultant selection to donor communication and collaborative Board and staff practices, are essential in coping with consistent volatility, heightened need for governance and oversight, and generally growing expectations around accountability and transparency. Focusing on these issues will provide leadership with an opportunity for self-examination and empower them with tools to be effective stewards of donors' dollars and help them to attain and maintain a fit and healthy existence along with the kind of focus for-profit companies are compelled to have by the nature of competition in the marketplace.

For discussions in this book relating to nonprofit investments, we assume that the board of the nonprofit delegates these responsibilities to an investment committee. We recognize that in some nonprofits, the board acts as the investment committee, although we see an increasing trend for nonprofits to use a separate investment committee, given both the level of work and time required to manage nonprofit assets and the increased regulation of endowment management

This Book's Setup

This book is intended to provide insight and easily adoptable principals for sound investment and development practices. Some of the topics are more technical than others. We have attempted to provide clear and basic definitions and examples throughout to facilitate comprehension of the more technical applications.

There is certainly more to managing a nonprofit's investment and development strategies than can be laid out in a couple hundred pages. However, by the end of this guided journey, regardless of a readers experience level in either strategy, he or she will have a strong basic understanding of the relationship between the two and the necessity for prudent practice around both. We hope you enjoy taking these lessons as much as we enjoyed learning them ourselves through practice over the years and putting our experience to paper through this process.

Each chapter is organized by key themes based on the broad chapter topic. The end of chapter questions are designed to help readers come up with one or two actionable ideas by leading them through the process of thinking about where their nonprofit stands relative to the strategies, solutions, and techniques. The questions are meant as a guide for readers to discover which issues are most relevant to their organization and help them begin to formulate ideas based on the suggestions in the material. Readers may discover that their organization has many challenges to overcome. It is important not to get discouraged by this, as identifying the issues and challenges is the first step to finding solutions and realizing the opportunities that will ultimately lead to success. Let us get started by reviewing history and its effects on the evolution of philanthropy and charitable giving.

Roger Matloff
Joy Hunter Chaillou

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Joy

To Erica, the *foundation* of my life, who has taught me that giving is important, but caring is essential . . .

To my children, Adam and Breanne, who have *endowed* me with much pride and joy . . .

Roger

CHAPTER 1

Philanthropy History and Statistics

The fragile state of our economy has had a severe effect on nonprofit organizations and how they operate. However, it has also provided us the opportunity to witness and reaffirm the deep philanthropic values of individuals in our country. Understanding a bit about the history and recognizing how our philanthropic culture is evolving will be very useful information as we begin to dive into the strategies and solutions for success in today's economy.

Individuals continue to be the single most important source of philanthropic contributions. Individual giving accounts for 88 percent of the total estimated U.S. charitable giving of $298.42 billion in donations made in 2011.[1] Additionally, donors are keenly aware of the increased needs that have arisen as a result of our depressed economic state. There has been an increase in giving specifically in the areas of human services, health organizations, and public-society benefit organizations. Loyal high net worth individuals have displayed an understanding of the immediate need organizations have to increase programs and services in our current environment. Statistics show them pulling back on growth project support like capital campaigns and long-term investments and increasing support for general operating expenses.[2]

What are the roots of this deep philanthropic nature and how has it brought us to where we are today?

American Philanthropy

American generosity can attribute much of its origins to our Judeo-Christian religious tradition, influential philanthropists, our government, and taxes.

[1] Giving USA Foundation, Giving USA Report 2012.
[2] The 2010 Study of High Net Worth Philanthropy sponsored by Bank of America Merrill Lynch.

The first American settlers were compelled by the inclination to unite and satisfy local needs, such as the building of churches and schools. *Barn raisings*, in which the local farmers gathered to join together to help in building the essential structures for new couples, were routine. This experience, plus the fact that so many early settlements were religious in nature, set the precedent for our tradition of charity and individual efforts to promote the common good.

The French economist Alexis de Tocqueville wrote in his 1835 book *Democracy in America*, "In no country in the world do the citizens make such exertions for the common weal." Andrew Carnegie, who acquired an enormous fortune as a result of his work in the steel industry, was by 1901 devoting himself totally to philanthropy, which he said was the responsibility of every wealthy individual. He took seriously his famous saying, "The man who dies rich, dies disgraced." By the time of his death, Carnegie had given away 90 percent of his fortune. He, John D. Rockefeller, and others established America's first private, grant-giving philanthropies.

In 1914, Frederick H. Goff established the Cleveland Foundation, our nation's first community foundation; it was quickly followed by many others. Just 16 years later, 21 cities had community foundations with assets exceeding $100,000. Today, there are more than 600 community foundations possessing assets in excess of $*25 billion* and in total, more than 76,000 grant-making foundations that give away over $*45 billion* annually!

In addition to the examples these incredible philanthropists were setting, the country was experiencing the advent of the personal income tax. It began in 1913 and was followed by the decision four years later that individuals could take a tax deduction for charitable giving. This event in our history created a tremendous spur to charitable contributions. As millions of Americans found themselves subject to the income tax for the first time during World War II, and given the patriotic spirit of the era, from 1939 to 1945, charitable contributions increased fivefold. Since then, charitable giving has continued to increase. During World War I, Americans gave the Red Cross more than $400 million, an enormous sum in pre-inflation dollars.

Additionally, during the Great Depression, the national government assumed a role in philanthropy that it has never entirely relinquished, though its focus has altered decade to decade. Funding was given to antipoverty and civil rights efforts, job training programs, and other social programs.

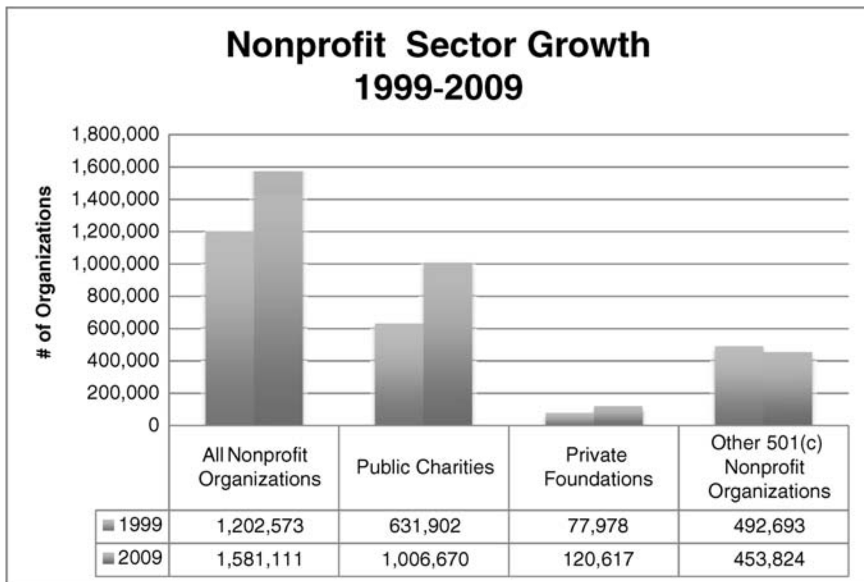
Now we have come to a point in our history where donors recognize the power of philanthropy. They are exhibiting confidence and dependence on the nonprofit sector as the primary provider for solutions to persistent needs and are focused on supporting broad-based non-governmental solutions. In a recent study more than 94.5 percent of high net worth households stated that they are more confident in the ability of nonprofit organizations over the

state or federal government to solve domestic or global problems.[3] So, let's take a look at what these strong philanthropic values have translated into statistically for nonprofit organizations.

Examining the Statistics

The development and evolution of American philanthropy is the envy of the world, and deservedly so. Many foreign countries are currently struggling to build a culture of philanthropy as they too feel the effects of economic crises and uncertainty and experience a retraction of government support.

According to Independent Sector (www.independentsector.org), in America 1.2 million charities and nonprofits support more than half of all hospitals, 58 percent of social service providers, 46 percent of all colleges and universities, 87 percent of libraries, and 86 percent of museums and public gardens. According to the National Center for Charitable Statistics, as of



	All Nonprofit Organizations	Public Charities	Private Foundations	Other 501(c) Nonprofit Organizations
1999	1,202,573	631,902	77,978	492,693
2009	1,581,111	1,006,670	120,617	453,824

EXHIBIT 1.1 Nonprofit Sector Growth

Source: IRS Business Master File 01/2010 (with modifications by the National Center for Charitable Statistics at the Urban Institute to exclude foreign and governmental).

[3] The 2010 Study of High Net Worth Philanthropy sponsored by Bank of America Merrill Lynch.