CHAPTER 1

The Three Levers and the Investment Policy

The *investment policy statement* (IPS) articulates the nonprofit fund's purpose, objectives, and constraints. It also articulates the time horizon(s) and the fund's ability and willingness to assume risk. A well-designed IPS also acts as an investment committee's guide for procedures, principles, and strategies.

The Three Levers

A well-written IPS is an invaluable resource for an investment committee. However, in order to be effective, it must be written and periodically revised to accommodate the fund's *three levers*. The three levers are *inflows*, *outflows,* and *required investment returns*. The balance among these three components is unique to each investor. Whether the fund's purpose is to finance a perpetual spending need, a project over a finite period, act as a reserve for a "rainy day," or for any other purpose, its *three levers* will determine the appropriate objective (see Exhibit 1.1.).

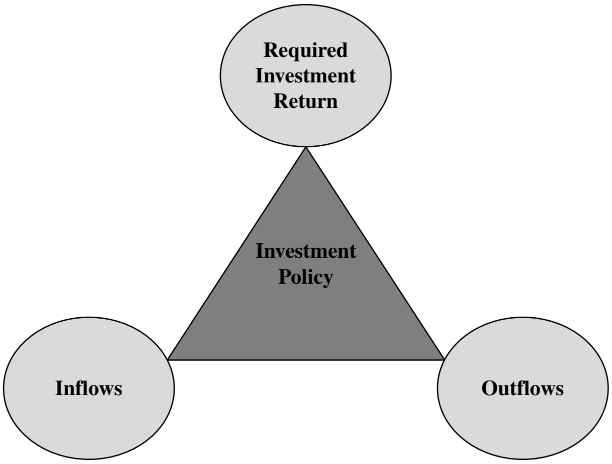
The three levers exercise is arguably a nonprofit investment committee's most important task when developing investment policy. If this crucial step is skipped, or done in haste, it is just a matter of time before painful symptoms emerge. Symptoms may include investment losses greater than the institution can afford during a bear market, or insufficient long-term investment earnings to fund spending needs. One needs to understand the size, volatility, and rigidity (or flexibility) of each lever, as well as how each interacts with the others in order to make effective investment objective, risk budgeting, and asset allocation strategy decisions.

You need to start by asking the right questions. Investment committees and nonprofit boards typically consist of smart people accustomed to making decisions, but they do not always focus on the right questions. Answers to the following questions should be instructive:

Inflows

- What is the expected size of annual inflows relative to portfolio assets?
- How predictable or volatile are these inflows?

EXHIBIT 1.1 The Three Levers



- What control, if any, does the institution have over the size of inflows?
- Do any anticipated changes to the size or rate of inflows loom on the horizon?
- What factors have driven the historical variability of inflows?

Outflows

- What is the spending policy?
- Is there a formula that drives spending?
- What is the expected size of annual outflows as a percentage of assets?
- How predictable or volatile are the outflows (or spending needs)?
- What control, if any, does the institution have over the size of outflows?
- To what extent can outflows (or spending) be reduced or delayed in a crisis without jeopardizing the sustainability of the organization's basic mission?
- What factors have driven the historical variability of outflows?

Required Return

- What are expected annual *net* cash flows as a percentage of portfolio assets?
- What minimum rate of return (above inflation) is required to sustain the fund's long-term mission?

Desired Return versus the *Willingness* and *Ability* to Assume Risk

- Can the organization meet its basic long-term *spending needs* by investing solely in a laddered U.S. Treasury or Treasury Inflation-Protected Securities (TIPS) portfolio? If not, what incremental return is required?
- At what size loss do loan covenants, agency ratings, or other balance-sheet considerations become critical to the organization's health or survival?
- What rate of return above the minimum *required* rate of return would allow the fund to finance the "the next step" toward enhancing its mission?
- Are limitations on the fund's ability to assume risk compatible with its long-term spending objectives? If not, how will long-term *spending* and *risk* budgeting conflicts be reconciled?

Why invest in stocks, hedge funds, commodities, and other risky assets if objectives can be met without them? If an investment committee determines its fund can finance objectives by investing solely in U.S. Treasuries or TIPS, it should vote to do so, call it a day, and adjourn. Most funds cannot meet their objectives that way, but quantifying the expected shortfall of a Treasury-only investment creates a baseline to establish a minimum required rate of return.

A terrific asset allocation strategy implemented by excellent investment managers is insufficient to assure success unless the portfolio's investment policy objectives and strategy compliment the fund's three levers. Many institutional investors discovered the painful mismatch between their funds' three levers and their investment policies during the severe 2007 to 2009 bear market (see Exhibit 1.2).

When the three levers exercise is skipped or given insufficient thought, the investment objective (and strategy) can end up being too aggressive. Policies set during periods of strong market performance often lead to overly aggressive portfolios. "Good times" also frequently lead to looser spending policies as boards begin to extrapolate recent performance indefinitely into the future.

During the 2007 to 2009 bear market, all investors who sought even a modicum of capital appreciation suffered losses, but those who invested more aggressively than necessary suffered *needlessly*. For example, perhaps a fund needs a 6.0 percent long-term annual return to fund its mission. If it instead was positioned to target an 8.0 percent annual return, the added risk proved to be significant. From October 2007 to February 2009, the global stock market declined about 55 percent. A well-diversified portfolio with an expected 8.0 percent long-term return declined about 40 percent peak to trough. But a well-diversified portfolio designed to earn a 6.0 percent return declined only about half as much (or 20 percent). See Chapter 2 for more information about capital market assumptions and asset allocation strategy.

EXHIBIT 1.2 **Hierarchy of Importance**

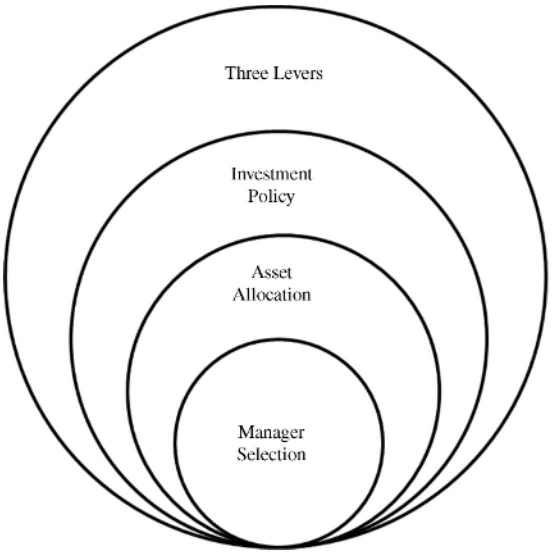


EXHIBIT 1.3 Target Long-Term Hurdle Returns versus the 2007 to 2009 Bear Market

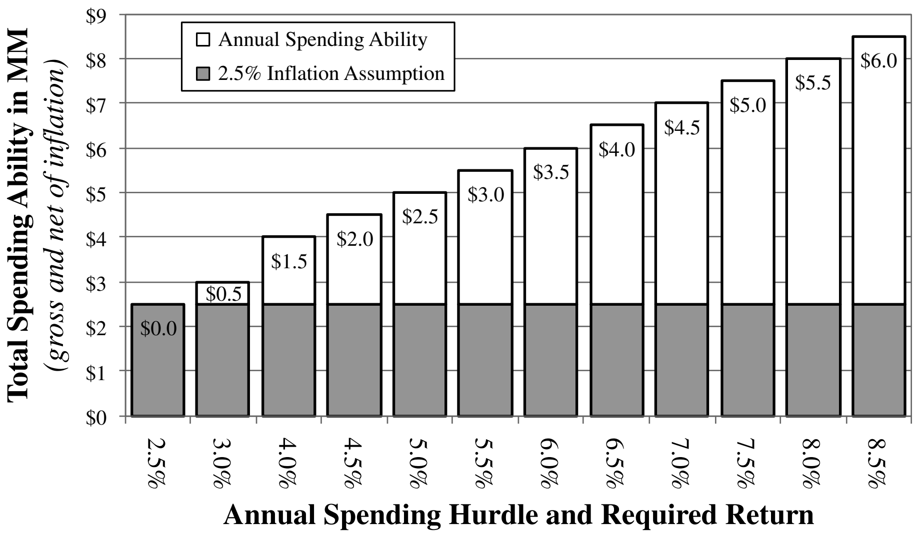
In Exhibit 1.3, a 100 percent TIPS portfolio represents the 3.0 percent target-return mix. This laddered TIPS portfolio illustrates a theoretical risk-free portfolio over an investment horizon, assuming a 2.5 percent inflation rate. At the other end of the spectrum, the highest expected return portfolio allocates 100 percent to global stocks (with a 9.3 percent expected return). All portfolios between these two mixes are broadly diversified among bonds, stocks, and alternative investments. For reference, the portfolio targeting a 6.0 percent return allocates 58 percent to fixed income, 22 percent to global equity, and 18 percent to alternative investments; the portfolio targeting an 8 percent return allocates 26 percent to fixed income, 50 percent to global equity, and 24 percent to alternative investments. An investment committee that cannot articulate a rationale for the portfolio's heavy allocation to stocks or alternative investments is more prone to make reactive (and destructive) decisions during difficult markets.

Rational investors allocate to risk-free assets if objectives can be met by doing so. Wise investors take only as much risk as they must to meet objectives. Unfortunately, most spending ambitions require taking investment risk. For example, a 5 percent spending policy may need to generate a real return of 5 percent above the inflation rate. If the inflation assumption is 3 percent, the endowment may need to target an 8 percent (or greater) return. As previously illustrated in Exhibit 1.3, an 8 percent return target requires significant investment risk. See Chapter 2 for more about capital market assumptions.

Investment committees with high spending hurdles have few choices:

- Slash the budget (and spending) and invest in Treasuries or TIPS.
- Invest in an equity and/or alternative investment-heavy portfolio that seeks to meet the long-term hurdle, while assuming considerable investment risk.
- Build a thoughtful and well-diversified portfolio that balances risk-aversion and disciplined spending targets.

EXHIBIT 1.4 **$100MM Endowment with Various Spending Targets**



Committee members must "connect all the dots" in order to determine whether an investment strategy can achieve the fund's objectives. It is wonderful when the investment pool is large enough to avoid taking risk. However, even large sums of money can generate small amounts of spendable investment return if invested too conservatively. Exhibit 1.4 shows how funds available for spending shrink considerably with lower investment returns.

Determining the appropriate level of risk is a complex chore for investment committees. Signing up for too little risk can adversely impact the organization's mission. A hospital may have to cut beds; a school may have to cut scholarships; or a community may have to cut projects and services. The decision to avoid risk must not be made in a vacuum. The organization's mission, objectives, and priorities are at the heart of the *three levers* exercise.

Investment Policy Statement

Only after the investment committee has a handle on the three levers should it draft or revise the IPS. As previously stated, the investment policy outlines the portfolio's purpose, objectives, risk tolerance, liquidity needs, and constraints. A well-written IPS is also clear and concise in outlining procedures and principles to govern future investment decisions.

The IPS is critical to the ongoing oversight of your investment process. It memorializes your vision. It sets the parameters by which you will monitor responsibilities and track the progress of associated parties. It also outlines your procedures for fund oversight and continuity of that oversight. It's not uncommon for committee members to serve limited terms, sometimes as short as one or two years. A well-written IPS is indispensable if your fund has a constant rotation of members.

New committee members want to make their marks. Unfamiliar with the initial three levers exercise, they may question the fund's objectives or investment strategy. They may have preconceived notions about the use of certain asset classes or overall asset allocation strategy. They may even have a basic misunderstanding of investment or diversification principles. A well-written investment policy helps educate new members. It acts as a manual to provide new and existing members with a clear, concise description of the fund's objectives and strategy.

Organization is the key to drafting a policy. The IPS should provide a clear road map for committee members. Specifically, it must provide policy direction and procedural guidelines. It is important to customize the document to address the organization's specific needs, but the following are elements that should be included in an IPS.

The following are summaries of various segments of an IPS, including examples for three fictional nonprofit investors:

- The Great State University Endowment Fund
- The Community Foundation of Bedford Falls
- The General Hospital Reserves Fund III

Statement of Purpose

The purpose section of the IPS summarizes why the fund or organization exists. Avoid the temptation to be long winded. A concise summary can be more effective. A simpler statement makes it easier for the "main thing" to remain at the forefront of investment committee members' thinking.

The following are examples of purpose statements for our three nonprofit funds:

- The *Great State University Endowment Fund's* mission is to promote, encourage, and advance education and to improve degree and non-degree educational functions by establishing scholarships, professorships, fellowships, academic chairs, and other academic endeavors as determined by Great State University's board of directors.
- The *Community Foundation of Bedford Falls'* mission is to bridge community needs with timely giving. The purpose is to improve the lives of Bedford Falls' residents by awarding grants to nonprofit organizations that improve the community.
- The *General Hospital Reserves Fund III* exists as a capital reserves fund that may be used to close unanticipated short-term budget gaps or for other purposes as determined by the board of directors.

Statement of Objectives

The *statement of objectives* articulates the definition of success. "Objective" and "strategy" are often incorrectly used interchangeably in investment policies. The *objective* is an expression of goals; the *strategy* is implemented by the investment committee to pursue that objective. Objectives vary significantly among different types of nonprofit investors. Even nonprofit funds that seem similar may have vastly different objectives. Objectives span a wide spectrum, ranging from ''short-term capital preservation'' to ''multi-generational growth.'' The statement of objectives should include return targets, risk constraints, and time horizons.

The statement of objectives must be reasonable and attainable and accommodate the fund's three levers. An example of an *unreasonable* objective is, ''The endowment's primary goals are to generate a 7 percent real (after inflation) long-term return to increase real spending power AND to minimize short-term capital losses.'' When an investment committee is faced with an impossible objective like this, it has no reasonable principle to guide investment strategy. Should they target an after-inflation return of 7 percent, or should they seek to minimize short-term losses? They certainly can't do both! A 7 percent long-term after-inflation return target is already a very ambitious goal without any risk constraints. This is the type of ''objective'' that should be weeded out during the three levers exercise.

You must also avoid the ''say nothing'' objective. An example of such an objective is, ''The fund seeks a reasonable rate of return with reasonable risk.'' An investment committee has very little basis to build an investment strategy that fits such a poorly defined objective. In this case, the term ''reasonable'' is never defined and investment committee members can have dramatically different interpretations of what it means. This type of objective sets the committee up for unnecessary conflicts, as well as a portfolio risk budget that can swing wildly and arbitrarily, depending on an evolving definition of ''reasonable.'' This is another type of objective that should get weeded out during the three levers exercise.

The best-written statements of objectives are straightforward. They can be understood by an investment committee with rotating membership (and varying world views). In 1999, *irrationally exuberant* investment committee members wanted heavy allocations to Internet stocks; in early 2009, nervous Nellies wanted to buy and store gold bullion in the basement. Some committee members even oscillate between *irrational exuberance* and *nervousness* from one quarter to the next. An effective statement of objectives helps rein them in. Inevitably, all investment committees face market turmoil as well as periods of excessive optimism. During such times, the investment policy's statement of objective anchors the committee to the ''main thing.''

The following are well-written statements of objectives for our three nonprofit funds:

- The primary objective of the *Great State University Endowment Fund* is to preserve the purchasing power of the endowment after spending. This means that *Great State University Endowment* must achieve, on average, an annual total rate of return equal to inflation plus actual spending. This purchasing-power-preservation objective emphasizes the need for a long-term perspective in formulating spending and investment policies.
- The primary objective of the *Community Foundation of Bedford Falls* is to earn 10-year annual rolling returns that preserve purchasing power of foundation

assets, assuming a 3 percent minimum annual spending rate. Therefore, the primary objective is to earn 10-year total (rolling) returns that meet or exceed a total return of 3 percent (for spending) plus the annual inflation rate. Additional gifts to the foundation may be used to supplement spending, but current policies limit spending to 5 percent annually (3 percent of assets plus 2 percent gifts) of total assets. The secondary objective is to moderate short- and intermediate-term capital losses so the 3 percent annual spending policy can be preserved (without excessive spending of principal) over rolling five-year periods, regardless of market performance.

- The primary objective of the *General Hospital Reserves Fund III* is to preserve capital. The maximum one-in-ten-year annual expected (nominal) calendar-year loss should not exceed 5 percent (modeled on reasonable return, standard deviation, and correlation assumptions). The secondary objective is to maximize total nominal expected returns within risk constraints.

Liquidity Constraints

The three levers exercise and the statement of objectives help the investment committee to determine liquidity needs and develop liquidity constraints. However, one must consider institution-specific information before crafting liquidity constraints.

Many nonprofits found they had underestimated liquidity needs during and after the 2008 financial crisis. As stock markets collapsed, liquidity dried up in some bond market segments and hedge funds threw up gates, yet private equity capital calls still came in. Many nonprofits with heavy (illiquid) real estate, timberland, and/or private equity allocations faced a dilemma: Should they indiscriminately sell *all* available liquid assets just to meet short-term liquidity needs? Many of those liquid assets (e.g., publicly traded global stocks, high-yield bonds, etc.) were also trading at depressed levels.

2008 taught many investors painful lessons about managing liquidity needs. When investors need liquidity the most in order to either rebalance or meet spending obligations (in the context of a shrinking asset base), liquidity can be at its driest. As investors were forced to spend down liquid assets, the remaining *illiquid* assets became a larger and larger percentage of the portfolio. Some high profile endowment funds had to resort to dumping private partnerships onto the secondary market (at steep discounts) just to meet short-term liquidity needs. If there was a silver lining to the 2008 crisis, it created opportunities for investors to opportunistically allocate to distressed (and illiquid) investments. Unfortunately, many investors already had too much allocated to illiquid investments and were unable to capitalize on the opportunities.

In 2006, the Financial Accounting Standards Board (FASB) issued SFAS 157 (currently called Revised FASB ASC 820), a pronouncement that defined fair value measurement and created ground rules for financial statement footnote disclosures. The pronouncement defined fair value as the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the financial statement measurement date.

SFAS 157 established a three-level hierarchy that categorized valuation inputs. It also created new accounting and auditing challenges for nonprofits. The levels of fair value are defined as follows:

- *Level 1*—Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- *Level 2*—Quoted prices for instruments that are identical or similar in markets that are not active and model derived valuations for which all significant inputs are observable, either directly or indirectly in active markets.
- *Level 3*—Prices or valuations that require inputs that are both significant to the fair value measurement and are unobservable.

The hierarchy requires observable data when available, and investments are classified in their entirety based on the lowest level of input that is significant to fair value measurement.

The SFAS 157 framework provides one way for nonprofits to classify assets based on relative liquidity. For example, assets that can be valued with *Level 1 inputs* have price quotes in active markets. These are typically the most liquid assets. Some asset classes that are (usually) compatible with *Level 1 inputs* include the following:

- Cash/Treasury-Bills
- TIPS
- Investment-grade U.S. bonds [treasury, agency, corporate, mortgage-backed securities (MBS), asset-backed securities (ABS), etc.]
- Foreign publicly traded bonds (sovereign and corporate)
- High-yield bonds
- U.S. publicly traded stocks
- Foreign-developed publicly traded stocks
- Emerging-markets publicly traded stocks
- Publicly traded real estate investment trusts (REITs)
- Commodity futures contracts
- Publicly traded energy infrastructure master limited partnerships (MLPs)
- 1940 Act mutual funds
- Exchange-traded funds (ETFs)
- Closed-end funds

Level 2 inputs are not from directly quoted prices like *Level 1 inputs*, but are from price quotes for similar assets in active (or inactive) markets. *Level 2* assets are usually less liquid than *Level 1*. Some of the asset classes or investment strategies that are compatible with a *Level 2 input* include:

- Less liquid fixed income market segments (or securities) such as convertible bonds.
- Some very liquid hedge fund strategies
- Swaps and other OTC derivatives

Level 3 inputs are unobservable. There is little, if any, market activity for the asset at the measurement date. Level 3 assets are usually the least liquid. Some of the asset classes or investment strategies that are compatible with *Level 3* inputs include:

- Hedge funds
- Fund of hedge funds
- Private equity
- Timberland
- Private infrastructure investments

Deciding whether an asset should be classified as a Level 1, 2, or 3 is a complex task and requires analysis of each underlying investment by accountants with SFAS 157 expertise. All investors are advised to seek advice from legal and accounting experts; the above examples are for illustrative purposes only.

Some liquidity constraints are necessary to maintain the integrity of investment strategy and rebalancing policies and to ensure that spending obligations can be met. Other constraints may be needed in order for some nonprofits to meet bond covenants or ratings requirements. For example, bond covenants may require nonprofits to maintain a minimum collateral allocation to *Level 1 assets*.

Each of our three nonprofit investors has different liquidity needs and constraints:

- The *Great State University Endowment Fund* will limit investments with less than annual liquidity to no more than 30 percent of total portfolio assets. Total daily liquid assets must exceed 50 percent of portfolio assets (at the time of investment).
- The *Community Foundation of Bedford Falls* will limit investments with less than annual liquidity to no more than 20 percent of total portfolio assets. Daily liquid assets must exceed 70 percent of portfolio assets at the time of investment. If market action drives daily liquid investments below 65 percent of total assets, the committee will return liquid assets to at least the 70 percent level over a reasonable period of time (so as to not dispose of illiquid assets at distressed levels).
- The *General Hospital Reserves Fund III* will limit investments with less-than-annual liquidity to a maximum of 10 percent of portfolio assets. However, a minimum of 80 percent of total assets must be compatible with Level 1 (SFAS 157) inputs. Assets consistent with Level 3 (SFAS 157) inputs must be capped at 5 percent of assets at the time of investment. If Level 3 assets rise above 8 percent, the committee will use reasonable means over a reasonable period of time so as to not dispose of illiquid assets at distressed levels to reduce Level 3 assets below 5 percent.

Unique Constraints or Priorities

Other portfolio constraints may also include anything that is unique or specific to a nonprofit institution's mission. For example, it is common for nonprofits to practice *Environmental, Social, and Corporate Governance Focused (ESG) Investing* (see Chapter 11). Another constraint example might be a cap on the fixed-income portfolio's allocation to below-investment-grade securities. ESG and any other unique constraints (or priorities) must be reflected in the broad investment policy and in any manager-specific investment guidelines. Each of our three nonprofit investors has different priorities and constraints:

- The *Great State University Endowment Fund's* emerging markets stock investment manager must refrain from purchasing securities of companies that have been identified as doing business in Sudan or with the government of Sudan when the same investment goals can be achieved through the purchase of another security.
- The *Community Foundation of Bedford Falls* will support the local community by allocating up to 3 percent of total portfolio assets to local community investments. Community investments will flow through local community banks, credit unions, community loan funds, and microenterprise development funds.
- The *General Hospital Reserves Fund III* will cap "high-yield" corporate securities to no greater than 5 percent of total assets (at the time of investment). High-yield corporate securities are fixed income securities that have long-term credit ratings below Ba1 (Moody's) or BB+ (S&P and Fitch). If any *single* rating agency lists a security below investment grade, it will be considered a high-yield security. Furthermore, the *General Hospital Reserves Fund III* will limit total non-U.S. denominated fixed income assets to no greater than 5 percent of the total fixed income portfolio allocation (at the time of investment). If foreign denominated or high-yield fixed income securities rise above these caps at the end of a quarterly measurement period, timely action will be taken to reduce these securities back to their constrained levels over a reasonable period of time.

Investment Strategy

The investment committee must develop an *investment strategy* to pursue the portfolio's objectives as articulated in the *statement of objectives*. The investment strategy must also accommodate all liquidity and other unique constraints outlined in the investment policy.

The investment strategy is usually reflected in a target asset allocation (or ranges among assets) to various asset classes or investment strategies. Since portfolio rebalancing is a critical component of any investment action, the investment strategy should also include rebalancing procedures (see Chapter 2).

There are typically two ways to reflect the investment and asset allocation strategy within an IPS. The first is to establish specific targets for each underlying asset class (e.g., 25 percent large cap stocks, 10 percent small caps, 14 percent hedge funds, etc.). The second method is to establish ranges for asset classes (e.g., 15 to 40 percent U.S. stocks, 5 to 20 percent hedge funds, etc.). This second method allows the investment committee to evolve the explicit target asset allocation without revising the IPS. Depending on internal processes both methods have merit.

If the investment committee plans to revisit the target asset allocation on an annual basis and draft explicit targets, the nonprofit needs a mechanism for timely revisions to the IPS. This either requires the board to delegate that authority to the investment committee, or for the board to be able to make timely responses to the investment committee's investment policy recommendations.

The *Great State University Endowment Fund's* investment strategy (shown below) is *broad enough* that it does not require revision if the asset allocation strategy changes modestly. It gives significant latitude to the investment committee to design and implement investment and rebalancing strategy. This approach puts a premium on establishing a very clear *statement of objectives*. It also requires trust and effective communication between the board and investment committee.

> *The Great State University Endowment Fund's investment strategy will be reviewed and updated by the investment committee on at least an annual basis to ensure it remains consistent with investment objectives. In addition to meeting investment objectives, the goal is to outperform (on a risk-adjusted basis) a custom benchmark of underlying indices that reflect its evolving asset class allocation over full market cycles. The investment committee will be charged with rebalancing the portfolio to make sure the portfolio allocation remains consistent with investment objectives. The investment committee will establish explicit target asset allocations within the following broad guidelines:*

	Min	***Max***
Global Fixed Income (cash, TIPS, U.S. bonds, foreign bonds, high-yield bonds)	*10%**	*25%*
*Global Public Equity (domestic, developed foreign & emerging markets**)*	*50%*	*80%*
Real Assets (real estate, infrastructure, commodities, MLPs, timberland, etc.)	*10%*	*25%*
Absolute Return Strategies (hedge funds)	*5%*	*25%*
Private Equity (buyout, venture capital, etc.)	*3%*	*15%*

* *High-yield bonds must be excluded when calculating the minimum fixed-income requirement.*
** *Emerging markets allocation must reflect ESG constraints.*

At the opposite end of the spectrum, the *Community Foundation of Bedford Falls'* investment strategy (shown below) is very *specific* and requires revision whenever the explicit asset allocation targets are revised. Therefore, there should be a *timely* IPS revision process by the board and investment committee.

> *The Community Foundation of Bedford Falls investment strategy will be reviewed annually by the investment committee to ensure it remains consistent with objectives. The portfolio will be rebalanced back to its target allocation whenever any broad asset class (i.e., fixed-income, equities, or alternatives) are 3 percent above or below target allocations at the end of any evaluation period. The current investment strategy's target asset allocation is designed to achieve a*

7.2 percent total (nominal) annualized return over the next 10 years with the lowest possible volatility:

Asset Classification	***Target Allocation***
Total Fixed Income:	*40%*
Cash	*0%*
TIPS	*10%*
U.S. Investment-Grade Bonds	*14%*
Foreign Bonds	*6%*
High yield Bonds	*10%*
Total Equity:	*32%*
U.S.	*17%*
International Developed	*10%*
Emerging Markets	*5%*
Total Alternative Assets:	*28%*
Commodity Futures	*7%*
Real Estate	*6%*
Hedge Funds Portfolio	*10%*
Energy Infrastructure MLPs	*5%*

The *General Hospital Reserves Fund III's* investment strategy (shown below) is highly *constrained* and *restrictive*. Presumably, the board is in a better position than investment committee members to understand and anticipate liquidity needs or evolving objectives. This warrants still tighter reins.

The General Hospital Reserves Fund III's investment strategy will be reviewed on a periodic basis. Any revision to the investment strategy must first be approved by the General Hospital's board of directors. The current allocation is:

Asset Class	***Min***	***Target***	***Max***
Cash	*50%*	*55%*	*60%*
TIPS	*1%*	*3%*	*5%*
U.S. Bonds	*17%*	*21%*	*25%*
International Bonds	*1%*	*3%*	*5%*
High-yield Bonds	*0%*	*2%*	*5%*
U.S. Equity	*2%*	*4%*	*6%*
REITs	*0%*	*1%*	*3%*
International Equity	*1%*	*2%*	*4%*
Emerging Markets	*0%*	*1%*	*3%*
Commodity Futures	*0%*	*1%*	*3%*
Hedge Funds Portfolio	*0%*	*5%*	*7%*
Energy Infrastructure MLPs	*0%*	*2%*	*4%*

Our three fictional nonprofit investors have very different investment strategies. The investment strategies require three different levels of board and investment committee interaction. Take into account the structure of the board and investment committee when drafting the investment strategy section in your investment policy. Make sure the procedures for revising the IPS are workable.

Duties and Responsibilities

The IPS should include a summary of duties and responsibilities of all parties involved in overseeing fund assets. There can be some natural overlap among parties. In particular, board and investment committee duties and responsibilities should be clearly delineated. Nonprofit investors should customize the list based on their structures, but the following is an example of how duties might be divided:

Board of Directors/Trustees

- Select qualified members to serve on the investment committee.
- Review investment committee's proposed changes to investment policy statement.
- Ratify investment committee's proposed changes to the IPS before any changes are implemented.
- Periodically request a performance summary from the investment committee.
- Avoid prohibited transactions and conflicts of interest.

Investment Committee

- Oversee the management of assets.
- Act solely in the best interest of the fund and its mission.
- Determine investment objectives, develop investment (and asset allocation) strategies, and create performance guidelines.
- Set and revise the investment policies and receive board approval before IPS implementation.
- Select investment consultants, investment managers, custodians, and any other vendors required to administer and manage the fund.
- Periodically review all fund-related expenses to ensure they are competitive and appropriate. Take action if they are not.
- Review and evaluate investment results and make changes as needed.
- Provide periodic performance reports to the board.
- Avoid prohibited transactions and conflicts of interest.

Investment Consultant

- Assist in the development and periodic review of the investment policy.
- Proactively recommend changes to enhance the effectiveness of the investment policy, investment strategy, or asset allocation.
- Make proactive investment manager hire and fire recommendations.
- Monitor aggregate and manager-level performance to ensure compliance with stated objectives.

- Provide the investment committee with quarterly performance and attribution updates.
- On a timely basis, notify the investment committee if there are pertinent developments with any of the fund's investment managers.

Investment Managers

- Manage assets in accordance with the guidelines and objectives outlined in prospectuses (mutual funds), investment agreements (commingled funds, private partnerships, etc.), or manager-specific investment policies (separate accounts).
- Exercise investment discretion to buy, manage, and sell assets held in the portfolios.
- Promptly vote proxies and related actions in a manner consistent with the long-term interest of investors.
- Communicate all organizational changes, including but not limited to ownership, organizational structure, financial condition, and professional staff.
- Seek "best price and execution" for all transactions. Both explicit and implicit transactions costs should be considered.
- Use the same care, skill, prudence, and due diligence under the circumstances then prevailing that experienced investment professionals acting in a like capacity and fully familiar with such matters would use in like activities for like portfolios with like aims in accordance and compliance with Uniform Prudent Management of Institutional Funds Act (UPMIFA) and all applicable laws, rules, and regulations.

Custodian(s)

- Safeguard portfolio assets.
- Accurately value portfolio holdings.
- Collect all income and dividends owed to the Portfolio.
- Settle all transactions (buy-sell orders) initiated by separate account investment managers.
- Provide monthly reports that detail transactions, cash flows, securities values, and changes in the value of each security and the overall portfolio since the previous report.
- Provide all requested portfolio information to investment consultant and investment committee in a timely manner.

Investment Manager Evaluation

Investment manager benchmarks guide the committee's review. We recommend a multidimensional approach that compares managers to *appropriate market indices*, style-specific *peer groups*, and *risk-adjusted* performance benchmarks over multiple time periods. In Chapter 8, we discuss performance benchmarks, performance evaluation, and instituting an effective oversight process.

In Chapter 4, we discuss the process for hiring and terminating investment managers. The procedures to select and terminate managers should be outlined in the investment policy. As we discuss in Chapter 4, virtually all quality investment managers will experience stretches of underperformance. Similarly, investment managers who deviate from their processes and investment styles may undergo periods of outperformance, but that should not make them immune from termination. Therefore, be careful to use language that doesn't *arbitrarily* force the committee's hand, and allows it to use its collective talent and insight when making manager hiring and termination decisions. (Firing a good manager at his or her performance nadir is a classic rookie mistake.)

Conclusion

The IPS states the fund's objectives and outlines processes. Once finalized and approved, it serves as the blueprint for governing the investment program, so it requires careful thought and must be "executable." Generic template language such as what was included in this chapter may be a helpful place to start, but the most effective investment policies are customized to fit the fund's specific three levers, objectives, and constraints. Rarely are any two nonprofit funds identical. Your investment committee will face questions and even criticism from time to time. An effective IPS is the anchor to windward during turbulent times.