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# Trustee Investment Strategy

## for Endowments and Foundations

CHRIS RUSSELL

# Trustee Investment Strategy for Endowments and Foundations

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# Foreword

The invested assets of endowments and foundations are a major resource of society, both in the US and the UK. They support education and scientific research, as well as cultural and charitable institutions. Endowments of colleges and universities in the US total more than $250 billion, and US foundation assets are now more than $500 billion. While the size and scope of similar institutions in the UK is not nearly as large, endowments and foundations are very important resources for the same activities there. There are 60–70,000 organizations involved, and a very large number of Trustees who have assumed fiduciary responsibility for investing their assets by serving as a member of a finance or investment committee.

Forty years ago, when I was a young officer of TIAA-CREF*, I became aware that most college and university endowment funds were not being well managed. Endowments then were usually managed by committees of trustees who met periodically to choose specific stock and bond investments, which they did not monitor closely thereafter. Investment results were poor.

Working with William C. Greenough, then Chairman of TIAA-CREF, and aided greatly by studies sponsored by the Ford Foundation, in 1971 we established a new service called The Common Fund for Nonprofit Organizations (known as the Commonfund Group today) to pool endowment investments, and bring them high quality, full time professional management of their investments. This proved to be much more effective, and eventually led to a basic change in the way all endowments were managed. Professional investment management, which was rare in the 1960's, has become virtually universal today. The role of trustees has evolved from choosing investments to selecting and monitoring professional managers, as well as setting guidelines for investment policy and asset allocation.

These are neither simple nor easy tasks, and are made more difficult by the fact that it is quite common for membership on Finance or Investment Committees to rotate every few years. Trustees who assume the fiduciary responsibility for the management of an endowment or foundation need to have a clear understanding of what their responsibilities are, as well as what aspects of investment management are more appropriate to delegate to professional managers. There are probably something of the order of 250,000 individuals who find themselves serving on such committees, and perhaps as many as 50,000 are new to the task each year. These are typically people who have had success in business and professional careers, but may have had limited experience with the daunting challenge of successful investment management.

* TIAA-CREF provided a nationwide retirement program for US colleges & universities

When Chris Russell first spoke with me about writing this book two years ago I was very supportive, because I knew from experience how much it was needed. I have shared with him the insights I have gained from helping establish and manage the Commonfund programs, and working with hundreds of trustee groups for many years.

TRUSTEE INVESTMENT STRATEGY is a valuable resource and reference for all trustees of endowments and foundations. Chris Russell brings the knowledge and perspective gained from a successful career in professional investment management with the Robert Fleming group in London, and later in managing a large international investment program formed jointly by Flemings and T. Rowe Price in the US. His clients included a number of prominent endowments and foundations, and he has experience serving as director and trustee himself. He has done an outstanding job of distilling this knowledge and experience into a clear and comprehensive summary of the important principles and concepts that will help trustees discharge their responsibilities effectively, and avoid some of the mistakes that others have made. He has labored long and hard, and produced a valuable work that deserves to be on the bookshelf of every trustee who has fiduciary responsibility for the investment of endowment or foundation assets.

George F. Keane, University Park, Florida
President Emeritus, The Commonfund Group

# Preface

*Do what you will, the capital is at hazard.... All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.*

JUSTICE SAMUEL PUTNAM in the judgment in the administration of the estate of John McClean of Boston in 1830 and the origin of the 'Prudent Man Rule'.

This book is written for people who are responsible for the stewardship of endowment fund assets: trustees, governors or directors, members of a Committee, Board of Regents, Court or Council of any entity that has been given assets to generate a return to support some purpose. The entity may be a trust, a charity, a foundation or other 'not-for-profit' organization established to fulfill a need, educational, social or cultural, which is a fundamental motivation for giving. Those who have mastered the content of this book should be in a better position to satisfy the requirements of the law in respect of their responsibilities, including recognition of what can be spent and yet sustain an endowment, and better equipped to ask the key questions to help to make the right decisions.

The Uniform Management of Institutional Funds Act in the USA defines an endowment fund as 'an institutional fund, or any part thereof, which is held in perpetuity or for a term and which is not wholly expendable by the institution'. Implicit in the definition is the continued maintenance of all or a part of the endowment. In practice, a distinction is made between 'Foundations' and 'Endowments'. Foundations, whether private or community organizations, are endowed with a capital sum for a given purpose but typically have no other sources of income. 'Endowments' often receive periodic gifts and bequests and may have other sources of income. They are also treated differently for regulatory and tax purposes. In the USA there are many public supported colleges that have also created separate foundations.

The investment principles described in this book apply to all types and sizes of foundations and endowments, whether they are the largest charities or the smallest family trusts, whether the need is educational, social or cultural, or whether the time horizon is finite or perpetual. This book is about understanding, developing and implementing good policies and practices in investment strategy for endowment funds. Investment strategy is about selecting and combining classes of asset, investment themes and styles of management to create a portfolio that reliably generates spendable investment return to fund the objective of the endowment institution over the whole of its anticipated life. Strategy, however, involves more than simply combining the prospective return and risk of a number of asset classes. It must be integrated with spending rules, with other sources of income and with policy on non-financial issues such as socially responsible investing.

Spending rules are therefore an integral part of that overall strategy. The formula for spending cannot be divorced from the long-term return on the endowment. The amount that can safely be spent, as a proportion of the endowment, is often a misunderstood element of endowment fund policy. The legal requirement for foundations to spend at least 5% of their assets, irrespective of long cycles of inflation and deflation, could well lead, in any extended period of low inflation or, more especially, in a deflation environment, to the eventual demise of some foundations that were established to provide philanthropy in perpetuity. That could be a serious challenge for trustees of foundations and endowments.

Strategy is that part of the investment process that has the greatest impact on the financial risk and return. The focus of this book is therefore on the strategic decisions about which trustees should concern themselves rather than on security-specific questions that can sometimes take an inordinate and inappropriate amount of time at trustee meetings. Trustees have ultimate responsibility for endowment assets – a responsibility interpreted as a 'duty of undivided loyalty to the beneficiaries'. Trustees can also become personally liable for loss in respect of decisions made during their term of office, even after they have relinquished their role. In most US States, however, voluntary trustees are protected from civil liability other than gross negligence.

Trustees' responsibility was once interpreted as requiring them to choose specific investments, but today they can delegate the detailed portfolio management of their assets to professional managers. What cannot be delegated is trustees' ultimate responsibility for the assets under their stewardship. Trustees are required to exercise 'reasonable care, skill and caution' either in the management of assets or in the selection and monitoring of an agent who manages on their behalf. Monitoring means asking the right questions and making the right judgments. In a word it means governance, 'a hand on the tiller', in the original sense of the Latin word *guberno* 'I steer'.

Trustees are not expected to have the same degree of knowledge, skill and experience in investment as investment professionals, although as the financial world becomes ever more sophisticated there is increasing demand for professional training. In the UK 'non-professional' trustees of pension funds are already becoming required to be trained and this could begin to extend to endowments and foundations. In the USA, the Uniform Prudent Investors Act makes a clear distinction between amateur and professional trustees of non-institutional funds, placing a higher burden of responsibility on the latter.

This book therefore tries to bridge the comprehension gap, usually made wider by jargon and mathematics, between those who carry the ultimate responsibility for, and those who usually manage, the investments of endowment funds. In a famous UK legal case (Cowan v. Scargill 1984), Justice Megarry commented:

> The duty to seek advice on matters which the trustee does not understand, such as the making of investments, is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Honesty and sincerity are not the same as prudence and reasonableness.

In other words, the trustee must exercise 'prudent and reasonable' judgment in interpreting the advice given by those who provide it.

Some trustees, especially those who have established foundations, may have strong views on investment strategy. They may be high-powered business leaders who have created their own wealth and established an endowment or foundation of which they may also be one of a number of trustees. Trustees who have donated funds and whose personal success is testimony to their financial ability and independent judgment may have more difficulty than most in accepting some of the advice of consultants and investment managers.

They may often be right. There is sometimes a presumption that experts are infallible and that their advice must be sought before due judgment can be made on almost any matter. This has, in some endowment funds, reached a point where independent decision-making has become frozen, especially where the inclination is to action that may run counter, or at least at a tangent, to professional advice.

We will see, when we touch on the subject of behavioral finance in Chapter 3 that professionals do not have a monopoly of wisdom and can be caught by herd mentality. Professionals cannot sometimes see the forest for the trees; they are too close to the 'noise' of markets, and can be carried along by the psychological certitude of persons rather than the logical certainty of propositions. Winston Churchill's description of an economist as 'someone who will explain tomorrow why the events he forecasted yesterday did not happen today' applies as well to asset managers.

That said, investment is always about an uncertain future. Judgment on the future can be a humbling experience for even the most experienced and successful, except perhaps for those armchair investors who possess that perfect insight of 20/20 hindsight. Many investment managers would subscribe to Tennyson's words: 'there lives more faith in honest doubt, believe me, than in half the creeds.' Investment is not about perfect foresight, which is given to none. It is about decisions that are intuitive and rational in the sense of sound judgment, not in the Keynes's sense of 'there's nothing so disastrous as a rational investment policy in an irrational world'.

Understanding is the key issue. It is a cardinal rule of investment that one should only invest in that which one understands, but understanding is different from simply having knowledge. It is the use of knowledge that is the whole issue, but this begs the question of what kind and what level of knowledge is needed in a world of financial concepts and products that daily becomes more sophisticated. This book is designed to help trustees to gain knowledge of the principles that lie behind these sophisticated concepts and products as they apply in the management of an endowment fund. Trustees do not have to be investment professionals to gain a sufficient level of understanding to be able to ask the right questions, even it is useful to have some investment professionals on the board or on an investment committee.

Understanding the investment principles on which strategy should be based is understanding principles that outlive investment fashions. Fashions change; human nature does not but the foibles of human nature are a prime short-term driver of deviation of market price from underlying value wherein lies potential for excess return. New investment technologies and vehicles emerge but the underlying principles remain obstinately the same. The pricing of futures and forward contracts in wool contracts in Europe in the fourteenth century demonstrated a level of financial understanding that had not yet begun to be quantified in mathematical theory, but the principles of time value of money and volatility were still understood even if they were not articulated.

Understanding the principles of investment is not reinventing them. As Sir Robert Megarry commented in his judgment in Cowan v. Scargill 1984:

> There are some who are temperamentally unsuited to being trustees, and are more fitted for campaigning for changes in the law. This, of course, they are free to do; but if they choose to become trustees they must accept that the rules of equity will bind them in all that they do as trustees.

Justice Megarry went on to say:

> If trustees make a decision upon wholly wrong grounds and yet it subsequently appears, from matters which they did not express or refer to, that there are in fact good and sufficient reasons for supporting their decision, then I do not think that they would incur any liability for having decided the matter on erroneous grounds, for the decision itself was right.

Herein lies one important aspect of understanding by trustees of their ultimate responsibility for investment decisions. In investment what is obviously right so often proves to be wrong and vice versa. It is an Alice-Through-The-Looking-Glass-World where everything is not always what it seems to be. Expectation is as important a factor as reality in determining investment returns. So this book is designed to help to give trustees confidence in recognizing the rules that should apply to investment decision-making, whatever the grounds on which the decision may be made.

A message from the teaching of art applies equally to investment: 'one must learn the rules before one can break them properly' – not 'learn the rules properly before one can break them' as is often misquoted and not, of course, rules as in regulation but in method. As in chess, it is strategy and an understanding of the rules – then 'breaking' properly the apparently established patterns of behavior – that can lead to success in achieving an objective. In investment such success then facilitates and enhances, by value creation, the prime underlying purpose of an endowment organization, but such moves generally need confidence in the manager and moral support from the trustees.

Alastair Ross Goobey, a Governor of the largest endowment in the UK, the Wellcome Trust, observes that trustees often wish for three mutually incompatible outcomes: (1) consistent outperformance of a benchmark index; (2) outperformance of a peer group; and (3) never lose money. In other words, the instruction to managers is to outperform the competition and an unmanaged index portfolio but do not take any risk. This is an impossible request. As we will see, the art of managing assets is not to avoid but to manage risk and to seek opportunities that may not even exist in a benchmark or peer group universe.

Therefore, trustees also need to understand the potential for thinking 'out of the box', as well as the practical parameters of investment: what is feasible and what is not and where it can, and will, go wrong. There is often an assumption that experts must always be right but much of investment is a moving target and moving in unpredictable timeframes. Even the finest investors can prove to be wrong over significant periods of time and they must be given leeway to prove their judgment over a sufficient period of time, especially in the case of an endowment that has the luxury of a perpetual time horizon.

One of the great investment books of all time, *The Intelligent Investor*,[1] shows in the appendices the investment records of a number of the most successful investment managers of the 1950s to 1980s. They all have periods, sometimes up to four years running, of substantial underperformance of benchmark indices against which their results are compared. But in every case the long-term record of wealth creation is outstandingly higher than what would have been achieved by investing in an index rather than their actively managed portfolio. These are classic examples of how a mindset of rewarding short-term performance and punishing failure would have had the opposite effect to the one required. They are examples of the power of compounding high rates of return over longer time periods and they are proof of one of the messages of this book – that is, conventional approaches to benchmarks and measurement may not achieve the desired result.

Another message of the investment records of some of the great investors of the twentieth century was that the returns were achieved without fear of occasional loss. One of the greatest challenges for trustees is to avoid the mentality of hoarding cash, not required for operations, in order to avoid any sense of failure of financial duty. We will see that an overcommitment to cash is one of the sources of failure of an endowment to sustain itself in the long term. Overexposure to cash, and overdistribution of return, are the two main contributory factors to the long-term diminution in the power of an endowment to sustain, and even more to enhance, itself over time.

Good investment performance requires patience, and time is one of the great assets that most endowments enjoy. Too often, however, trustees feel goaded into making decisions over time horizons that are not appropriate. How often have trustees sacked managers at the bottom of a cycle, reinvested in last year's winner and compounded the error when last year's lion becomes this year's dog? Better a live dog than a dead lion.

The aim of this book is not only to provide a bridge between trustee and professional manager but also to bridge the gap between trustees of an organization today and between those of today and the same organization in the future. An endowment may have an investment time horizon of several generations, even if trustees may only serve for a three-year term. Investment managers may last longer in their position than the trustees who appointed them. Yale Professor Emeritus James Tobin described endowment stewardship in the following terms: 'trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations.'[2]

Professor Tobin was describing generations of beneficiaries but this also applies to generations of trustees. The trustees or their advisers may feel a need to 'make a difference' during their occupation of the role, but so often in investment management the right decision is to do nothing. Doing nothing constructively, with knowledge and understanding, can be as important as doing something. The advice should sometimes be: lie down until the feeling for action goes away.

The understanding of investment principles by trustees does not need familiarity with jargon or ability to conceptualize through the mathematical equations that may grace the pages of professional investment journals. Most people see and make practical judgments without precise quantification. Every spectrum of light within a rainbow is measurable in ångström units, but it is sufficient for most practical purposes, even if only for searching for the elusive pots of gold, to detect them by eye and describe the gradations of color.

So it is with investment. Where jargon or mathematical explanation is alluded to in this book, a fuller explanation can be found in the glossary of investment terms toward the end of the book. The glossary could prove to be a useful *aide-mémoire* for trustee investment meetings. Sensible investment is not rocket science even if some of the investment products are designed by rocket scientists. And even the rocket scientists can get it wrong. One of the most spectacular financial crashes in the last decade of the twentieth century was an investment entity, called Long Term Capital Management, created by investment professionals, which numbered among their executives some Nobel prize-winners in the field of finance. Trustees should not be overawed by the jargon of investment professionals. They must engage in debate with the confidence of understanding the fundamentals behind the jargon even if they cannot quite remember the technical words that describe the situation.

Through not being in the day-to-day mêlée of financial market activity, trustees are well placed to question the direction in which the advisers wish to take the endowment fund. Developing a sense of what determines the future in investment risk and return, and developing a confidence to back an unconventional view, is 'learning the rules', is being on the road to investment enlightenment, to becoming a proper guardian of the future and not just an agent of corporate governance. The goal of this enlightenment is enhanced resources to meet ever-present needs and the potential for enhanced practical benevolence in future.

It is therefore hoped that this book will help to demystify the investment experience and give trustees more confidence in asking professional advisers to justify their positions; to test the judgments of professionals for consistency of argument; to understand where the professionals may have failed in their homework or their performance and why; to understand the unpredictability of markets; to encourage calculated risk by taking a mature view of inevitable, if hopefully only occasional, failure. But even failure is a prerequisite for ensuring ultimate success in managing money. Piet Hein's 'Grook' on life applies also to investment: 'The road to wisdom? Well it's plain and simple to express: err, and err again; but less and less and less.'

# Acknowledgments

*If I have seen further... it is by standing upon the shoulders of Giants.*

ISAAC NEWTON (1642–1727). Letter to Robert Hooke. 5 February 1676

The author has certainly seen no further than other investment professionals, even if he has been looking for over 30 years. But he has had the enormous privilege, during a life in the investment business, of meeting, working with and reading the wisdom of various giants of the profession.

A proverb may be 'the wisdom of many and the wit of one' but so is a book such as this which draws shamelessly on the wealth of knowledge and experience of many giants in the world of investment. They have generously shared their experience and their ideas through publications, lectures and private conversation.

Due acknowledgment is therefore made throughout this book, together with specific references to further recommended reading on various topics. Profound apologies to any who may have been responsible for impressions that have formed judgments that are part of the book but who have not been remembered, and to any others who may have made an unacknowledged contribution, either directly or indirectly.

First and foremost, George Keane has helped generously with his knowledge of the history and development of US endowment investment, having made some of that history in the founding of the Commonfund. He has kindly written the foreword to this book and has helped with advice and comment on the book's various drafts. He has also assisted with introductions to others in the endowment field.

Tom Ingram, Stephen Watson and Andrew Fleming have also helped by constructive comments on a draft of the book. Charles Gave has inspired some of the thinking behind this book over many years with perceptive comment on economies and financial markets. Louis Gave is taking on Charles's mantle and has kindly helped by providing thoughts and charts with the help of Pierre Gave.

Hugh Acland contributed to the construction of the glossary; and Rodney Marian-Green and Tony Golding gave some helpful early advice. In the US endowment and foundation fund field those who have especially assisted, through interview mainly, include Rick Legon of the Association of Governing Boards of Universities and Colleges (AGB); Verne Sedlacek of the Commonfund; Wayne Pearson of the Meyer Memorial Trust; Dr Allan Bufferd of MIT; Jay Morley and Bill Dillon of the National Association of College and University Business

Officers (NACUBO); Harry Turner of Park Street Capital; and Keith Ferguson, Susan Ball and Garth Reistad of the University of Washington. Those in the UK who commented at an early stage on the proposed framework of the book included Professor Robert Mair, Master of Jesus College, Cambridge, and Charles Nunneley, formerly Chairman of the National Trust. Helpful comment also came from Alastair Ross Goobey, a Governor of the Wellcome Trust Ross Goobey and Adviser to Morgan Stanley.

The New York Public Library, the libraries of the Institute of Chartered Accountants in England and Wales and the Royal Society of Arts have all provided practical assistance in various ways. Meanwhile the internet remains a wonderful source of material that has all been acknowledged in the text and is a medium through which to buy the book and contact the author: www.tisef.com.

Last, but far from least, must be acknowledgment of the unseen contribution of tolerance and support for this project from my wife, Tory, and my four children, Emy, John, Kate and Alice.

# Contents

# 1 Introduction

*An investment in knowledge always pays the best interest.*

BENJAMIN FRANKLIN (1706–1790)

Endowments and foundations are entities that have been given assets to generate a return to support some purpose. Each endowment entity is unique in terms of its needs and financial resources, which implies that each endowment must have a unique investment strategy.

The largest pools of non-profit endowment assets today are to be found in the USA, representing educational, social, cultural, political and religious organizations such as museums, hospitals, orchestras, religious, universities and colleges and charities. The Giving USA Foundation estimates that Americans gave some \$248.5 billion to charity in 2004, an amount approximately equal to the national incomes of Norway or Indonesia. The largest foundation was that of Bill and Melinda Gates with assets at the end of 2004 just short of \$29 billion. The largest financial endowment of any academic institution was that of Harvard, which was nearly \$23 billion at the end of the fiscal year 2004. As long ago as the early 1930s the annual income from philanthropy in the USA was only exceeded by the incomes of the US and UK governments. Endowed assets in the USA at that time exceeded the estimated wealth of many nations.[1]

US endowment funds as a whole may not have been the first to exist but, apart from being the largest in the world, they are the most advanced in their investment thinking. This is probably due to the twentieth-century emergence of pension, insurance and mutual funds which all led to the demand for an intellectual foundation for good policies and practices.

Some of the oldest endowments can be found in Europe. Among the earliest examples was the gifting of agricultural land to the Church so that the income from tithes (a tax levied in kind of one-tenth of the annual produce of the land) and from rents and the sale or barter of produce would help to support the institution. Later examples include the medieval trade and craft guilds, called Livery Companies, of the City of London. They still exist today and some have their origins in the eleventh century. Other examples are the early universities and colleges, a number of which were started by the Church or were established following the dissolution of the monasteries in the sixteenth century when the tithe passed from ecclesiastic to lay hands. Yet others include the philanthropic, cultural and charitable organizations created out of the industrial wealth of the eighteenth and nineteenth centuries.

The largest endowment in the UK is the Wellcome Trust with assets of approximately \$18 billion. The Trust was created in 1936 by the Will of Sir Henry Wellcome in which the entire share capital of his pharmaceutical company, The Wellcome Foundation Ltd, was vested in trustees (now known as Governors) to distribute the income principally to support 'scientific research which may conduce to the improvement of the physical conditions of mankind'. The shares were sold in tranches over the 1980s and 1990s to diversify the asset base of what is now the largest endowed medical research charity in the world.