



BDO WEALTH ADVISORS, LLC

SPOTLIGHT ON BDOVA'S SERVICES

Investment Policy Statements for Endowments and Foundations

Endowments and foundations (E&Fs) have approximately \$3 trillion in assets in the United States. The funds comprising this asset pool range in size and mission, but they share a common challenge: they must grow their investment portfolio after funding their grants and expenses. Achieving this goal requires carefully constructed investment policies.

At BDO Wealth Advisors, we have a deep understanding of the unique investment needs of endowments and foundations. BDO Wealth Advisors provides assistance to E&Fs in a few primary areas: development of investment policies and guidelines, including the development of an appropriate asset allocation and spending rate; investment manager search and selection; and ongoing performance evaluation and portfolio rebalancing.

In this article, we explore how a thoughtfully designed investment policy statement (IPS) serves as the foundation for an E&F's investment program.

UNIQUE INVESTOR CHARACTERISTICS DRIVE NEED FOR IPS

Endowments and foundations are a unique group of investors. While there are similarities with individual investors, there are also important differences, all which drive the financial planning and execution process.

Most E&Fs are designed to exist in perpetuity, meaning they invest with a time horizon that is considerably longer than the 20-, 30-, or even 40-year horizon that is typical for individuals.

The missions of foundations and endowments vary widely, and the investment policy must address these differences. Endowments typically are more restrictive in their usage of funds. For example, major universities tend to limit spending to primarily support operating budgets.

Foundations may support a wide range of causes or they may be more selective. Many foundations are initially funded but don't receive additional contributions beyond that funding, which underscores the critical need for a careful spending policy to prevent the organization from exhausting its capital.


In addition to customized investment policies, there are third-party factors that influence management of E&Fs. For example, private foundations' spending rates must comply with the IRS's 5% spending requirement. Another third party that must be considered is the Uniform of Prudent Management of Institutional Funds (UPMIFA), which provides guidance on the management of endowments.



MORE THAN A STRATEGY — A BLUEPRINT

The IPS is a blueprint for an endowment or foundation's entire investment program. With an IPS, investment and spending decisions are based on parameters established by the organization. An IPS provides guardrails that are intended to keep the investment strategy on track regardless of market conditions.

A well-crafted investment policy can be a major contributor to an E&F's long-term success. It can prevent many mistakes such as:

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Inadequate investment risk in asset allocation that causes inadequate portfolio growth
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Excessive spending rates, which can permanently deplete the investment corpus
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Inadequate policies prohibiting conflicts of interest in the investment of funds
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Inadequate role definitions for various parties involved (e.g., trustees, staff, custodian, investment consultant, investment managers)
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Inadequate performance objectives of the overall fund and underlying funds

An IPS should address three main areas that come together to form an investment program: goals and spending; guidelines and parameters; and roles and responsibilities.

The goals and spending component addresses an E&F's need to both grow and preserve its capital as well as its spending rate. The IPS should address both a minimum and maximum spending rate, generally in the range of 4–7% of assets per year, which generally goes to areas such as operating expenses and grants. The spending rate should be on a rolling average so that the organization's spending rate adjusts based on the portfolio's recent performance.

An IPS needs to be flexible enough to achieve and balance its needs to preserve and grow assets as well as spend to support the institution. Investment policies today are generally dramatically different than they were 50 years ago, when the conventional practice was to spend the fund's income but avoid spending any appreciated capital. Today, it is much more common to spend a percentage of the overall total return, which includes both income and capital appreciation.



GUIDELINES AND PARAMETERS TO KEEP THE PORTFOLIO ON TRACK

An IPS sets the allowable percentage range for each asset class that the E&F invests in. Once an asset class falls outside these parameters, the IPS specifies when and how rebalancing occurs. An IPS will also list any prohibited types of investments, which may include over-the-counter derivatives or leveraged ETFs, for example. Although stocks and bonds are natural fits for an E&F's long-term time horizon, the investment portfolio needs to be properly diversified to help it ride out the market's inevitable ups and downs.

In recent years, alternative investments have become more popular with E&Fs. These include commodity funds, hedge funds, real assets, and private equity investments. When determining their annual spending rate and rules about restricted funds, endowments and foundations must keep in mind that many alternative investments are less liquid than stocks and bonds.

E&Fs' recent shift to a total return approach caused a corresponding increase in riskier assets, such as stocks, and illiquid assets, such as private equity. These moves generally were driven by the need for higher returns to support spending rates, and they underscore the need for a carefully constructed investment program given the complexity of today's markets and investment products. Investment policies must consider the proper amount of illiquid investments to achieve higher returns without depleting the organization of capital.

ROLES AND RESPONSIBILITIES — WHO IS AT THE HELM?

An E&F's board of trustees has a fiduciary responsibility for the organization's financial management, including how they manage and spend assets. Under the guidance of financial and legal advisors, board members develop and approve the IPS.

An IPS will describe the roles and responsibility of the E&F's investment committee that implements the investment policy. This includes such responsibilities as reviewing and selecting investment managers and working with consultants to implement the fund's strategy.

The investment committee should assign a benchmark to each asset class and monitor the portfolio's performance against it at least once per quarter. A review should also occur when there is a significant event, such as a change in a portfolio manager or an unanticipated need for additional cashflow.

In addition to the investment committee, an investment policy statement will define roles and responsibilities for consultants, investment managers, and other service providers and parties involved in the management of the fund.

If you are involved with an endowment or foundation and would like to learn more about BDOWA's expertise in this area, please reach out to your BDO wealth advisor.

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