Investment Management for the Nonprofit Industry: Best Practices

Lynx Investment Advisory is pleased to summarize a series of guidelines designed to assist nonprofit institutions in developing and maintaining clear policies for endowment governance and oversight that will benefit both current and future staff, trustees and committee members alike. While not exhaustive, we believe there are six key areas deserving the most attention:

1. **Constructing the Investment Committee**
    a. To begin, a document should be created that outlines the make-up of the investment committee. This record should include the number and role of each investment committee member, as well as any staff required to manage the designated pool(s) of capital.
    b. It is important that the investment committee members have relevant but differentiated traits and experience in order to ensure an effective team with a broad scope and reach in connection with the mission of the nonprofit.
    c. This document should clarify which positions are permanent and which are designed to be a limited time assignment. It is also important to create a schedule of members' tenure and when they are due to roll off the board; only a percentage of the team should be leaving/entering at any given time to ensure continuity of efforts, discussions and objectives.
    d. Other areas to consider when constructing this document might be:
        i. Committee member eligibility requirements
        ii. Chairman appointee process
        iii. Guidelines for establishing and monitoring the portfolio
        iv. Roles/responsibilities of staff and outside consultants
        v. Timing for committee meetings
        vi. Investment policy statement (IPS) review/change process

2. **The Role of a Fiduciary/What is a Fiduciary?**
    a. Definition: A fiduciary (a board member and any employed consultants) has the duty to:
        i. Operate the nonprofit only in the interest of participants and beneficiaries, for the sole purpose of providing benefits and paying nonprofit expenses
        ii. Act "prudently," meaning how a professional would perform under similar circumstances
        iii. Diversify the nonprofit's investments in order to minimize the risk of large losses
        iv. Follow the terms of the nonprofit's documents written to govern the capital
        v. Avoid conflicts of interest with the nonprofit; require annual conflict of interest disclosures

   b. It is the duty of the fiduciaries to understand responsibilities and any liabilities while in the role. They must select those investments most appropriate given the return/risk objectives of the nonprofit. They should be aware of the costs associated with all investments and ensure they are not too onerous given the nonprofit's spending policy.

3. **The Investment Policy Statement (IPS)**
   a. The purpose of the IPS is to define a nonprofit's return objectives, risk tolerances, cash needs and appropriate performance measures to ensure the mission of the nonprofit is being met in the most effective and efficient manner.
   b. In developing the IPS, board members/fiduciaries should be aware of the needs on both a short-term/operational basis, as well as the long-term portfolio objectives. Therefore, it must be clearly stated whether the goal of the portfolio is capital preservation only or capital growth and whether the fund will exist in perpetuity or if the timeframe is shorter-term in nature and may incorporate a sunset clause.
   c. Board members/fiduciaries should be aware of: diversification of assets, portfolio liquidity, potential investment risks, donor requirements and working capital needs.
   d. The IPS should include a schedule for revisiting the objectives/constraints of the policy to ensure the nonprofit's needs are being accurately reflected and met. Guidelines for asset reallocation or portfolio rebalancing should be clearly stated in terms of timing and flexibility allowed if any.
   e. Any spending requirements should be subject to a rule, e.g. up to 5% of the average market value of the preceding 3 years. The moving average concept smooths portfolio values for spending purposes and avoids large draws after a strong performance year which could potentially have adverse long-term effects on the portfolio.

4. **Portfolio Performance Measurement/Benchmarking**
   a. Portfolio performance can be measured in absolute terms, against a benchmark and relative to a policy benchmark. It should be common practice for a nonprofit to assess its investment success in conjunction with its organization's goals, while placing less emphasis on how the performance compares to its peers or the general market indices. Taking this approach will help to ensure that the investment strategy continues to produce the necessary performance and cash flow overtime as is outlined in the objectives section of the IPS.
   b. Inflation, plus a static premium, e.g. CPI + 3%, can be an instructive benchmark or hurdle focusing on portfolio sustainability over multiple periods, especially for those organizations with regular spending needs. It is important to emphasize, however, that an organization's specific inflation rate should also be determined by examining budgetary trends; this "internal inflation rate" could differ significantly from published CPI data.

5. **Costs**
    a. Board members/fiduciaries must pay close attention to manager fees. Excessive annual manager fees, incentive fees or fund administration fees can reduce a significant part of a nonprofit's gross performance, which might hurt its ability to meet the goals set by its mission statement.
    b. These fees should also be reviewed in relation to a nonprofit's time horizon. For example, if a fund manager has a long-term focus, its short-term performance may not be representative of expectations (i.e. an alternative investment), therefore, the nonprofit should be prepared to analyze performance accordingly, as the short-term return may not justify the higher fee. If this is not commensurate with their objectives, the fiduciaries should redirect the manager selection.

6. **Hiring an Outside Advisor**
    a. If the nonprofit board has elected to hire an outside advisor, this decision should be viewed as a delegation of fiduciary authority, especially if the investment agreement is discretionary in nature. Given this, it is important to identify advisors governed by the Fiduciary Standard, which requires them to place their clients' interests first.
    b. Ensure the advisor has the right credentials. For example, an advisor with the Chartered Financial Analyst designation must comply with the standard ethics as prescribed by the CFA Institute.
    c. All advisory relationships should be reviewed periodically for adherence to process, expense, and goal attainment for the nonprofit.

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