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MEMORANDUM

Investment Policy for Endowment Funds

By Eliot Williams

This commentary addresses issues regarding the development of investment policy for an endowment fund. First, it discusses the reasons why investment policy objectives are so critical to the success of a fund. Secondly, it identifies a number of important policy issues to be considered. Finally, it outlines some of the factors that influence an organization's ability to assume investment risk.

Why is investment policy important?
In the practice of medicine, diagnosis and treatment are critical elements in patient care. Treatment without careful diagnosis is irresponsible. Similarly, a successful investment program requires a careful assessment of needs and goals (diagnosis) and thoughtful determination of appropriate investment policy (treatment). This is particularly true when fiduciary responsibility exists. Without a clear written statement defining objectives, constraints, parameters of risk-taking, and performance benchmarks there is little basis to determine if the actions followed are consistent with the goals and needs of the fund. Further, there is little to anchor the fund's investment strategies as the trustees change over time.

In investing there is a maxim: *every asset exists to satisfy a future need for cash*. Investment policy requires an understanding of the amount and timing of future cash needs and their implications for the investment management of the assets. Whether the need is to build a building in three years, or to provide funds in support of operations on an ongoing basis, or to have funds available for unexpected adversity or new opportunities, has a significant bearing on a fund's investment objectives and strategy.

In his wonderful book, **Investment Policy**, Charlie Ellis states, "*The high purpose of investment policy, and the systematic discovery process prerequisite to it, is to establish useful guidelines for investment managers that are genuinely appropriate to the realities both of the client's objectives and the investment markets*." In a nutshell Charlie argues that investment policy must be undertaken rigorously and diligently, that it must develop realistic expectations of returns, and that it must provide clear directives for the investment manager.

What are the attributes of a successful policy statement?
Drawing further from Charlie Ellis' book, the measures of a successful investment policy statement consider the following factors:

- Does the policy meet the fund's needs?
- Do the trustees understand it and agree with it?
- Is it reasonable to expect that future trustees will understand and agree with the policy absent any changes in the needs of the organization?
- Can the organization live with it through unfavorable markets?
- Could any competent investment professional implement the policy on a sustained basis?
- Does it clearly define limits on the types and amounts of risk the manager(s) can take?
- Does it provide a basis for evaluating results?

The very nature of these questions requires that the investment policy statement be a written, clear, and comprehensive document of understanding for present and future trustees and investment managers.

What are the important policy questions?

A former mentor of mine taught that wisdom is more about knowing the right questions than having the right answers. In this spirit, it is necessary that the fund's trustees address key questions regarding the overall goals and values of the endowment fund before determining the specifics of an investment program. Some of the general questions to be addressed include:

- What is the balance of interests between present and future generations in the use of funds?
- Should expected future donations be considered as a means to replenish or to enlarge principal?
- To what extent might future contributions to the fund be encouraged by present spending policies and/or investment policies and results, or discouraged by poor investment results?
- What other criteria, consistent with the organization's values and interests are appropriate for spending and investments (e.g., social responsibility)?

Additionally, there are specific spending issues to be considered:

- Are there plans to increase or reduce the use of endowment funds in the future?
- What would be the impact of a material reduction in the amount of investment distribution in any single year?
- How much volatility, upside and downside, in investment distribution can be tolerated on a year to year basis?
- Is there willingness to invade principal on a short-term basis if investment results fall short of distribution targets? And how is principal to be defined?

Finally, there are issues that relate specifically to the investment policy. These have bearing on the how much risk the portfolio can assume and what freedom is to be given the investment manager(s). These issues include:

- What goals exist with respect to the growth in the value of funds over time in absolute terms and relative to inflation?
- How much decline in market value can be tolerated in any given one year and three-year period?
- How much discretion should the investment manager(s) be allowed?

As these issues are addressed, important trade-offs, between risk and return, spending and retention, become easier to resolve. For example, if it is a policy goal to preserve the real value of the endowment fund over time, and if inflation is assumed to be 3%, then the following equation helps to frame the trade-offs between spending policy and the risk and return characteristics of the investment portfolio:

A Defining Equation

Target change in real value of Fund	0%
+ Inflation rate	3%
= Target change in nominal value of Fund	3%
+ Annual spending rate (% Assets)	5%
= Required investment return	8%

The issue then focuses on how much risk is required to achieve an 8% return and whether this amount of risk is acceptable. If it is not, then either the spending rate must be reduced or expectations for future growth of the endowment funds must be modified in order to invest in less risky assets which have lower expected investment returns.

How much risk is acceptable?

The question of risk tolerance is one of the real art forms of investing. Investment theory typically has used standard deviation to quantify risk, but most individuals and institutions have little idea of their 'standard deviation tolerance'.

If risk is defined as "not having the funds you need when you need them", then tolerance for risk is determined by the *consequences of funding shortfall*. Therefore, it is important to assess the factors that impact an institution's ability to handle a shortfall of return on either a temporary or sustained basis. These include a number of considerations:

- ***Dependency on Investment Income*** - to what degree is investment income and principal needed to support the annual operating budget?
- ***Predictability of Financial Needs*** - how stable are annual contributions and operating expenses?
- ***Time Horizon*** - what expectations exist for using principal to meet specific future needs?
- ***Portfolio Diversification*** - is the institution willing to invest in alternative markets, e.g., international equities, real estate?
- ***Potential Future Financial Resources*** - what expectations exist for future bequests into the endowment fund?
- ***General Tolerance for Risk*** - how might the institution's governance, members and contributors react to adverse investment results?

Conclusion

The investment policy statement represents an interpretation of this process of self-examination. It defines the fund's purposes and goals, describes return expectations and risk limitations and sets an investment time horizon. Further, it establishes acceptable asset classes in which to invest, sets asset allocation targets and ranges, and defines constraints and diversification parameters for the management of the investments. Finally it describes special interests and preferences of the organization. It is this document that must pass the tests of a successful investment policy statement mentioned above.

In a letter to the trustees of a pension plan, Keith Ambachtsheer of KFA Advisory Services writes, "It is good to remember that 'being right' is not the standard by which your conduct ought ever to be judged. It is an impossible standard for anyone to live up to. Rather, the issue is the conduct of '*due process*' using the best judgments and information available." This is good counsel for all those who have fiduciary responsibilities.