



On Nonprofit *Investment* Income

by Woods Bowman and Elizabeth Keating

Editors' Note: *The following article is an excerpted chapter from a much anticipated book to be published by the National Center for Nonprofit Enterprise (NCNE) in conjunction with Rowman & Littlefield, entitled Financing Nonprofits: Bridging Theory and Practice. Additional material from this chapter regarding whether nonprofits should establish endowments has been adapted by chapter co-author Mark Hager on page 57.*

INVESTMENT INCOME, CONSISTING OF INTEREST, dividends, and capital gains, is very important to a small group of nonprofits. Excluding foundations, one in five nonprofits receives at least 5 percent of its income from investments. The major sub-sectors where investment income exceeds 5 percent of income are arts/culture, education, health care, disease-related organizations, public safety and disaster relief, youth development, human services, com-

munity improvement, research institutes, and mutual benefit societies.

Whether your organization is thinking about joining this select group of nonprofits, or whether it has only a few thousand dollars to invest, you will still need to consider how best to manage your assets. There is a common core of management issues that should be considered—legal fiduciary duties, socially responsible investing, and the costs of investing. This article

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attempts to guide investors through this thicket, while touching briefly on two issues that become more important as the amount of money increases—decision-making structures and use of hedge funds.

Before discussing management, a few simple definitions may be helpful. The *total return* on an asset is the sum of an increase or decrease in its value and any current income (like interest and dividends) it produces, usually expressed as a percent of the initial value. *Risk* is the variation in total return over time—a wider range of variation implies greater risk. Finally, a *portfolio* is any collection of assets managed in accordance with a common set of investment objectives.

Legal Framework

Though state laws and gift instruments vary considerably, directors of nonprofit corporations have three fiduciary duties in most states: a *duty of care* to be diligent in their oversight of the organization, including its finances and investments; a *duty of loyalty* to act in the interest of the organization rather than to benefit any personal, business, or private interest; and a *duty of obedience* to keep the organization true to its mission and in compliance with applicable laws. The definitive work on the subject is Marion Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* (Harvard, 2004).

If an organization is harmed by an error in judgment rather than a breach of duty, then the directors and officers are not liable under the *business judgment rule*. If the duty of care, loyalty, or obedience is breached, trustees and officers may be held personally liable for monetary damages. In many states, the three duties translate into laws that impose prohibitions on related-party transactions, such as personal loans, use of organizational assets by board members, or sale or lease of land or other key assets to a board member without valuations and/or court approval. The law requires evidence that only disinterested board members approve related party transactions and that the transactions are at arm's-length or produce a net benefit for the organization. Nonprofits must also disclose related-party transactions to the board and/or the public.

The risk of owning an asset is generally related to total return—higher returns expose

an investor to greater risk. Fifty years ago the law governing fiduciaries' investment practices consisted of "legal lists" of permissible types of investments—generally the safest or least risky types of securities. Modern portfolio theory caused a revolution in fiduciary law by showing how a portfolio can be less risky than any single constituent asset. The trick is to invest in a variety of different assets across different industries and countries—that is, to diversify.

Now the duty of care requires that fiduciaries be "prudent" in their business decisions. A few states still have legal lists of permissible types of investments, but 39 states and the District of Columbia have adopted the Uniform Prudent Investor Act (UPIA) in some form. Under UPIA the standard of prudence, known as the Prudent Investor Rule, is applied to the total portfolio rather than to individual investments. UPIA identifies the tradeoff between risk and return as the fiduciary's central consideration and diversification as an appropriate tool to manage it.

Fiduciaries are given great latitude in determining what kinds of investment instruments are appropriate to achieve their risk/return objectives, and they may delegate investment and management functions, subject to safeguards. A companion law, the Uniform Management of Institutional Funds Act (UMIFA), adopted in some form by 45 states and the District of Columbia, clarifies that an institution can spend a reasonable portion of capital appreciation, in addition to current income (e.g., interest and dividends). These two models incorporate modern portfolio theory into endowment management.

Socially Responsible Investing

Unlike a for-profit corporation, a nonprofit organization has a public mission, which might be expected to influence its investment decisions. In the *Report on Socially Responsible Investing Trends in the United States, 2003* the Social Investment Forum defines socially responsible investing (SRI) as "an investment process that considers the social and environmental consequences, both positive and negative, within the context of rigorous financial analysis." A complete arsenal of institutional SRI strategies includes screening investments that are purchased for the institution's portfolio, taking

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advantage of the institution's position as a shareholder to advocate for changes at shareholder meetings, and investing in communities underserved by traditional financial services. The prudent investor rule and the business judgment rule are sufficiently flexible to permit using all of these SRI strategies.

Interest in SRI surged in 1989, when the supertanker Exxon Valdez ran aground in Prince William Sound, dumping millions of gallons of crude oil on the Alaskan coast. The Coalition for Environmentally Responsible Economies (CERES) created a 10-point code of corporate environmental conduct and eventually organized the Global Reporting Initiative to press for an international standard for corporate reporting on a "triple bottom line" of economic, social, and environmental performance. Lately, the Global Reporting Initiative has added global climate change as a significant risk to the long-term value of corporations and the viability of financial assets. According to the Social Investment Forum's 2003 report, assets under management in portfolios assembled according to SRI principles (i.e., screened portfolios) rose by 7 percent between 2001 and 2003, reaching \$2.14 trillion.

SRI screens can be exclusionary, qualitative, or inclusionary. *Exclusionary* screens proscribe "sin stocks" in certain industries (e.g., alcohol, gambling, tobacco), or in companies with bad records on the environment, human and animal rights, or corporate governance. *Qualitative* screens identify companies with socially desir-

able products or services, or companies with good records on particular issues (e.g., diversity, executive compensation). *Inclusionary* screens, based on such things as CERES's 10-point code, identify companies that pledge themselves to specific conduct.

Fiduciaries are often concerned about a possible adverse effect that an SRI screen might have on a portfolio's return. They reason that, since a social screen restricts investment choices based on factors other than return, it could preclude them from owning securities that could improve a portfolio's performance. But "could" is not the same as "would." A 2003 analysis conducted by Morningstar, the mutual fund research company, provides evidence that SRI screens are not necessarily detrimental to financial performance. However, the average domestic stock SRI mutual fund tends to charge fees that are 0.21 percentage points above the average non-SRI domestic stock fund, so socially responsible investors will need to shop around to avoid high-priced funds.

Dos and Don'ts

Organizations should have a written investment policy that spells out duties, responsibilities, and range of discretion of the board, the investment committee, investment advisors, and investment managers. It should identify which asset classes are permitted and which are prohibited. If the board approves the use of a social responsibility screen for investments, the investment policy should specify the precise criteria.

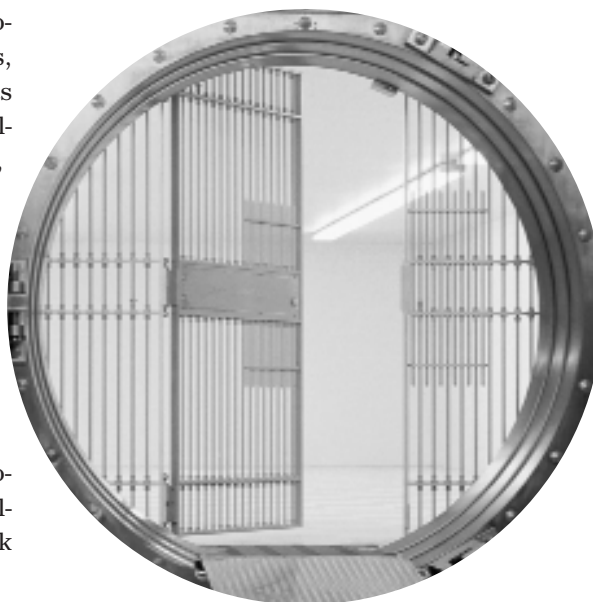
Board members can play an important role in connecting nonprofits to wealthy donors. They themselves may not have the potential to make major gifts, but they may simply know someone who is wealthy. Ordinarily, major gifts are cultivated over an extended period of time and major donors want to be connected to the top: to the board and the chief executive. As the organization accumulates more and more resources, it becomes increasingly important to have board members with investment expertise to guide the investment committee, which may include non-board member experts. People with investment expertise are more likely to know wealthy people.

Diversification is the main tool for controlling the balance between return and risk. The sim-

plest method is to specify the desired asset allocation among types of investments: stocks, bonds, real estate, etc. If an organization has very little money to invest, it can rely on one balanced mutual fund. As endowment increases, other asset classes can be added. Because the value of each asset in a portfolio will change over time, an investment policy should also address rebalancing, which involves *periodically buying and selling assets in a portfolio so that each asset or asset class remains more-or-less the same proportion of the total*. Rebalancing is a proven way of increasing returns over time without exposing the portfolio to additional risk. If the portfolio is not rebalanced, the control exercised over the return/risk tradeoff will steadily erode.

Increasing numbers of nonprofits are investing in vehicles other than garden-variety stocks and bonds, including hedge funds, which were once the sole domain of wealthy, sophisticated investors. A hedge fund is an investment vehicle that is structured like a mutual fund but exempt from the rules and regulations that govern traditional mutual funds. Therefore, it can own assets and employ strategies that are generally unavailable to a traditional mutual fund such as selling short, leverage, program trading, interest rate swaps, arbitrage, and derivatives. Due to lack of regulation and transparency, investing in hedge funds requires extra care and attention. No law requires hedge funds to report their returns, or standardizes the method of calculating returns. No regulatory agency currently has the authority to verify that reported hedge fund returns are accurate, although hedge funds seeking pension fund investors sometimes voluntarily register with the Securities and Exchange Commission.

As portfolios become more complex and institutions hire more managers, cost control becomes increasingly important. However, according to a recent Commonfund study, only 287 of the 657 educational institutions sampled even monitor this information. Investment management fees cost them 0.542 percentage points. Consulting fees account for 0.119 percentage points and custodial fees, 0.053 percentage points. These fees total 0.714 percentage points, which may seem trivial, but it is enough to reduce earnings by 18 percent over a 30-year period! Hedge fund fees are higher than fees



charged by traditional mutual funds, plus they usually take a share of the profit.

It is a good idea for nonprofits with significant investments to have committees composed of board members as well as investment professionals who may or may not serve on the board. The number of investment committee members generally increases with the size of portfolio. Institutions that make heavy use of alternative investment strategies are also more likely to have a high proportion of investment professionals on their investment committees, regardless of the size of endowment. High-performing institutional investors use more managers than other institutions and are more likely to hire external managers to implement alternative investment strategies. They also have larger internal staffs.

Three golden rules of investing are: (1) never invest money in a vehicle if you do not understand the associated risks; (2) never entrust money to a manager that you have reason to believe is inexperienced, incompetent, or unethical; and (3) make your own independent assessment of the investment and the manager. An organization with a lot of money to invest should have investment advisors who are different from and independent of the investment managers as a check and balance. Venturing beyond listed stocks, bonds, and mutual funds requires extra care. One cannot always tell whether a manager is competent by his or her client list. Question them about how they make their investment decisions, and invest a small amount on a trial basis with an escape clause.

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Put your money
to work . . . You
owe it to your
donors.

These rules may seem simple and commonsensical, but many very reputable charities were taken in by the Foundation for New Era Philanthropy because they did not follow one or more of them. The Foundation for New Era Philanthropy derived its name from allegedly offering a new approach to fundraising, with a heavy emphasis on matching grants from “anonymous benefactors.” In the early 1990s, hundreds of individuals and religious, educational, cultural, and charitable organizations invested funds with the Foundation, believing that these funds would be doubled in six months by guaranteed monies that the founder, Jack Bennett, had secured from several very wealthy benefactors. However, there were no anonymous benefactors. New Era was using new funds to repay principal and matching funds to prior depositors. In other words, it was actually a Ponzi, or pyramid, scheme, in which money from later investors is used to pay earlier investors. Such schemes always fail and they are illegal.

Conclusions

Nonprofit organizations have a responsibility to be good stewards of resources entrusted to them. Keeping a fat checking account, larger than needed to pay daily bills, is not good stewardship. Put your money to work. If you still are mystified by the arcana of investing, consult your banker or your accountant. If you have a lot of money to invest, hire an investment advisor. You owe it to your donors. You can be sure *they* don't waste investment opportunities.

WOODS BOWMAN is Associate Professor of Public Service Management, DePaul University. **ELIZABETH KEATING** is a Senior Research Fellow, Hauser Center for Nonprofit Organizations, Harvard University.

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