

WHAT'S YOUR EXPERTISE?

Avoiding the Tsunami

Practical Ideas for Managing Your School's Endowment

By Rob Olcott, CIMA

Rob Olcott, CIMA, is Managing Partner and a Senior Institutional Consultant of the Olcott Consulting Group, which provides investment consulting and asset management services to endowments and investment portfolios of nonprofit organizations throughout the U.S. For more information, visit www.olcottconsultinggroup.com.

The management of independent school endowments has never been more challenging. Historic volatility and disruption in global financial markets, a rapidly slowing economy and the corresponding increase in unemployment, slumping housing markets, and heightened regulatory scrutiny have combined to create what may be “the perfect storm.”

The coincidence of these events is a call to action for staff and volunteer leaders who have direct—or even indirect—responsibility over their school's endowment funds. Here are 5 practical tips for staying ahead of the tsunami so that it does not crash down upon you and your school.

1. Make sure there is a clear understanding of your fiduciary responsibilities—and liabilities.

An investment fiduciary is generally defined as a person who has oversight or the responsibility of managing someone else's assets. In an independent school, the fiduciary “umbrella” would typically include trustees, board members, finance/investment committees and, most likely, executive staff such as the head of school and business officer.

While much has been written about fiduciaries, few fiduciaries actually understand their liability, which today can include personal financial risk.

The key to fiduciary liability is simple: It's not whether you win or lose, but how you play the game. Liability of the fiduciary is determined by whether prudent investment practices are followed, not by investment performance. Prudence is demonstrated by the process through which investment decisions are made.

Fiduciary standards have been defined in “prudent person standards” and the “duty of care” is derived under state laws governing investments by nonprofit organizations. The National Business Officers Association has useful information on this topic in its Endowment Toolkit, online for members at www.nboa.net. Further resources are online at the National Association of College and University Business Officers, www.nacubo.org. Print out this information and share it with your trustees and the committee that oversees your endowment.

2. Review your investment process and portfolio—now!

Investment Policy Statement. Pull it out of the files and dust it off. Make sure personnel roles and responsibilities are clearly defined and appropriate for today's world, as well as investment goals, time horizon, and risk tolerance. Make sure the list of permissible investments provides adequate latitude to diversify—really diversify—your portfolio.

Asset allocation. The dramatic decline in global equity prices has likely changed your overall asset allocation. Is your current allocation within permissible boundaries? What

procedures are you following, if any, to rebalance? (Most academic studies suggest that some form of regular, disciplined rebalancing can be additive to portfolio performance.)

Moreover, is your current or “target” allocation likely to deliver the investment results necessary to fund current and future commitments? Recommendation: ask your advisor to prepare an asset allocation study which can project out potential returns and risks from different allocation mixes which fall within your policy guidelines. Add to this a Monte Carlo study¹ which can display potential outcomes in dollars, not percentages. While not perfect, these studies can nonetheless provide a useful reference point for helping determine an appropriate asset allocation mix for your endowment.

Is the portfolio’s long-term performance meeting its long-term (5+ year) objectives?

Obviously, stock market returns in 2008 hit endowment portfolios hard. And even though portfolio returns may not have met your spending target or absolute return objectives, returns should be in line with appropriate benchmarks. If not, make sure you understand the reasons why. If the reasons for underperformance don’t make sense, it may be time to reassess your advisor, your strategy, your members—or perhaps all three.

Speaking of benchmarks, make sure you’re evaluating the portfolio against a blend of indices that closely matches your portfolio. If you have a well-diversified portfolio, it’s probably not enough to compare your results against a simple 60/40 mix of stocks and bonds. And make sure your investment managers are pegged to an appropriate benchmark and peer universe.

Examine each investment manager, and investment in your portfolio. Ask your consultant or advisor for a one-page fact sheet that describes the investment manager’s firm, the investment team (including tenure), assets under management, as well as fees and performance over the past one, three, five, and ten years. Make sure your investment managers are adhering to their stated investment “styles” and investing in securities permitted by the policy. In difficult markets like 2008 there can be a temptation for managers to employ strategies or buy securities outside their normal universe. Fiduciaries should have a clear understanding of the manager’s investment strategy and holdings.

At each meeting of your finance or investment committee, take 20 minutes to have your advisor review one or two of your managers. Alternatively, ask your advisor to arrange a short conference call “briefing” from one or two managers at each quarterly meeting. This gives the board or committee the opportunity to hear directly from the manager and to discuss performance, portfolio positioning and economic/market outlook. By the end of the year, you will likely have heard from each manager. Repeat this process.

Performance evaluation: make sure your advisor is providing you with appropriate indices for each individual investment manager, fund, or investment. For example, an investment manager which invests in large-cap U.S. stocks using a “value” style of security selection probably should be evaluated against a large-cap “value” index, not just the S&P 500 Index. In addition, request peer-group performance evaluation so you can see how the manager is doing relative to comparable firms.

¹ A Monte Carlo simulation is a problem solving technique used to approximate the probability of certain outcomes by running multiple trial runs, called simulations, using random variables. Returns and probabilities generated by Monte Carlo Simulation are based on historical and hypothetical information; there is no guarantee that actual future results will perform in accordance with the probability assessment. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

3. Ongoing due diligence on your investment managers

The decision on hiring and evaluating investment managers is much more challenging today than it was ten years ago due to rapid growth in the number of investment choices, consolidation in the money management industry, and turnover of key portfolio staff. The departure of a key portfolio manager or a team of managers can have a dramatic impact on an investment manager's performance. How do you know when a manager change occurs? How do you know if a fund has "drifted" from its stated investment style? What is the impact of a merger of one money manager and another?

Schools must have a mechanism in place whereby they are alerted to changes affecting the investment managers they're using. According to a 2006 Endowment Study by NACUBO, 74% of respondents employ an outside consultant for investment guidance, including the ongoing due diligence of investment managers they use. If you don't use an independent consultant, the responsibility falls on staff or your volunteer leadership. But the responsibility does not fall away.

4. Assess any conflicts of interest.

Make sure to identify any real or potential conflicts of interest. Two not-uncommon issues: your investment advisor also manages funds for a member of your Board or Finance/Investment Committee or, even more problematic, a member of your Board or Finance/Investment Committee is managing money for your endowment. Conflict of Interest disclosure and prohibition language should be included in both the general Board policies and also in the Investment Policy Statement itself. Conflicts of interest are a ticking time bomb. Just ask Bernie Madoff's investors.

5. Document. Document. Document.

Maintain notes and records of what your school and your advisors have done to develop and implement a process that meets fiduciary standards. And remember: it's an ongoing process, not a one-time audit.

With these 5 steps, you should be able to help responsibly steer your school's endowment in the right direction...*and* you'll be able to sleep better at night.

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