NUVEEN

# Building Your Practice by Serving Foundations and Endowments

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**"I deem it the duty of every man to devote a certain portion of his income for charitable purposes; and that it is his further duty to see it is so applied as to do the most good of which it is capable."**

***Thomas Jefferson, 3rd President of the United States***
***Writings, vol. xi, p. 92***

## The Opportunity

The above quote from Thomas Jefferson indicates a twofold opportunity for financial advisors to work with charitable organizations, including foundations and endowments. First, there is an opportunity to help affluent households fulfill this duty and desire to support causes about which they are passionate; and second, there is an opportunity to provide guidance to managers of foundations and endowments to fulfill their fiduciary responsibility by ensuring these assets are managed appropriately to achieve stated objectives.

The number of affluent households continues to grow, and as their level of wealth increases, research tells us they also become more charitably disposed and are inclined to seek guidance on philanthropic strategies such as foundations and endowments. This philanthropic initiative is expected to continue over the next 50 years, as $50 trillion is projected to be donated to US nonprofits.[1] This interest has led to significant growth in the ranks of foundations and endowments. Between 1990 and 2014, the number of private foundations in the United States more than tripled and their assets grew to over $865 billion.[2]

As assets in nonprofits have grown, so has the scrutiny of their management by the Internal Revenue Service, state and federal regulators, and even family members who may feel the family foundation is being mismanaged. New laws and regulations continue to be passed impacting how nonprofits, foundations, and endowments are run, and how their assets are managed.

For financial advisors, working with foundations and endowments can be very rewarding, both personally and professionally, but it is a complex market to penetrate. Just providing investment solutions is not sufficient to be truly successful. To successfully engage these clients, advisors must first understand the mission and motivation of the foundation or endowment, as well as the administrative issues they face, including how they operate, the composition of their board and how investment decisions are made.

[1] Bank of America 2014 Study of High Net Worth Philanthropy: Issues Driving Charitable Activities among Wealthy Households.

[2] Foundation Stats, Foundation Center, foundationcenter.org.

## Defining Foundations and Endowments

**Private foundations** are nongovernmental, nonprofit organizations typically funded by an individual, a family, or a corporation, with a principal fund or endowment to maintain or aid charitable, educational, religious, or other activities serving the public good. They are managed by their own trustees and directors and are required to file an IRS Form 990-PF annually.

There are three different types of private foundations:

- **Independent or family foundations** which receive endowments from individuals or families (and, in the case of family foundations, they continue to show measurable donor or donor-family involvement).
- **Company-sponsored or corporate foundations** which receive funds from their parent companies, although they are legally separate entities.
- **Operating foundations** which run their own programs and services and typically do not provide much grant support to outside organizations.

Many of the wealthiest families in the United States have established private foundations to support the causes about which they feel most passionate, including the Bill and Melinda Gates Foundation, the largest foundation in the world, which focuses on bringing health and learning to the global community.

**Public foundations**, also known as "grant-making public charities," are also non-governmental, nonprofit organizations, managed by their own trustees and directors and make grants primarily to other nonprofit organizations. Public foundations are required to file an IRS Form 990 each year.

Unlike private foundations, however, public foundations typically receive their funding from numerous sources and must continue to seek money from diverse sources in order to retain their public charity status. In addition, they often operate grants programs benefiting unrelated organizations or individuals as one of their primary purposes. Private grant-making foundations can and often do provide support to public charities.

Public foundations are generally grouped by whether they are a community foundation or a non-community public foundation:

- **Community Foundations** seek support for themselves from the public, and usually provide grants. Their grants primarily support the needs of the geographic community or region in which they are located. Due to their broad public support, the IRS does not consider these to be private foundations.
- **Other Public Foundations** include funds serving other population groups and field-specific funds, such as health funding foundations set up with proceeds from health care conversions – often referred to as "new health foundations." Public foundations which are not community-oriented generally operate without geographic limitations in their organizing charters.

While the terms foundation and endowment may at times be used interchangeably, endowments are usually thought of as organizations specifically excepted from the Internal Revenue Code's ("IRC's") private foundation classification: principally schools, churches, hospitals and organizations receiving substantial support from the public (referred to in the code as public charities). Often foundations establish “endowment funds” within the foundation for specific purposes.

There are two types of endowments:

- **True endowments** are funds that prohibit spending principal. The only sources of investment funds are gifts and bequests; they do no fundraising.
- **Quasi-endowments** are funds not subject to any legal prohibitions against spending. They may originate from gifts or from surplus operating funds designated by the institution’s governing board.

Two well-known endowments include the National Endowment for the Arts, which is the nation's largest annual source of funding for the arts and the National Endowment for the Humanities, an independent federal agency that is one of the largest supporters of humanities programs in the United States.

Public foundations, private foundations, and endowments have many needs that are often similar and non-investment related, such as the:

- Development of written mission, spending and donation policy statements.
- Assistance with fundraising.
- Guidance on grant-making decisions.
- Introductions to other endowments that have similar goals.
- Developing and maintaining strong, knowledgeable boards by recommending and introducing new qualified candidates for board membership.

Many advisors, who have established successful relationships with foundations and endowments in the past, have responded to these many non-investment needs that the organizations face. However, helping foundations and endowments address their many investment needs is the primary reason they look to a financial advisor, and there are many ways to meet these needs, such as helping them:

- Address their fiduciary obligations.
- In the creation/analysis of interrelated written investment, spending, and donation policy statements that support their mission statement.
- Learn about and manage their financial market expectations.
- Establish an investment strategy.
- Select investment managers.
- Monitor performance results in relation to established guidelines on an ongoing basis.

The following chart presents a comparison of the most common types of foundations.

**Comparison of Foundation Types**

| Type of Foundation | Major Attributes | Key Advantages | Key Disadvantages |
|---|---|---|---|
| Private Grant-Making | ■ Established, funded, and controlled by donor/family | ■ Donor/family control over administration, | ■ Subject to excise taxes prohibiting self-dealing, |

| | | | |
|---|---|---|---|
| | ■ Makes grants to existing public charities | investment, and grant making<br>■ No limitations on public charity recipients | excess business holdings, etc.<br>■ Minimum distribution of 5% each year<br>■ Restrictions on deduction of contributions |
| Private Operating | ■ Established, funded, and controlled by donor/family<br>■ Operates a charitable activity or facility | ■ Donor/family control over administration, investment, and operations<br>■ Avoids minimum distribution requirements<br>■ Favorable deduction limits available | ■ Subject to excise taxes prohibiting self-dealing, excess business holdings, etc. |
| Private Conduit | ■ Established, funded, and controlled by donor/family<br>■ Makes grants to existing public charities | ■ Donor/family control over administration, investment, and grant making<br>■ Favorable deduction limits available | ■ Must distribute all contributions shortly after end of tax year<br>■ Cannot build endowment |
| Private Common Fund | ■ Pooled contribution of donors<br>■ Makes grants to existing public charities | ■ Donors have absolute right to select public charity recipients<br>■ Favorable deduction limits available | ■ Must distribute all contributions shortly after end of tax year or donor's death<br>■ Cannot build endowment |
| Support | ■ Established and funded by donor/family<br>■ Supports one or more designated public charities | ■ Favorable deduction limits available<br>■ Not subject to private foundation excise tax rules | ■ Family cannot have full control |
| Community | ■ Pooled contributions of donors | ■ Favorable deduction limits available<br>■ Not subject to private foundation excise tax rules | ■ Donor can only "advise" as to selection of public charity recipients |

Source: CCH Incorporated

## Prospecting Foundations and Endowments

Any time an advisor expands his or her practice into a new market, there are two primary opportunities for prospecting: existing clients and prospects. As addressed earlier, many affluent clients are seeking guidance on how to best support philanthropic organizations. This interest has propelled the growth in private family foundations. In addition, many existing clients may be involved with nonprofits in your community, either by supporting them financially or participating on the board. These clients may not be aware that their personal financial advisor may also have the capability to manage their nonprofit assets as well.

Creating awareness of their capabilities both with existing clients and with prospects is critical for advisors, because foundations looking for investment advisors generally find them in one of four ways:

- **Through others in the philanthropic community**. Just as with any target or niche market, those involved with philanthropy often network and are likely to ask each other about their financial advisors.
- **Through public resources** such as the Internet, or the printed media. Make your name visible in the appropriate places on the Internet, in the newspaper, in fund raising magazines, with the Alliance for Nonprofit Management, the Association of Fund Raising

Professionals or your local planned giving council. Many planned giving councils have monthly or quarterly meetings at which you may be able to make a presentation.

- **Through professional associations** like lawyers and accountants. Establish relationships with attorneys and accountants whose practices also focus on foundations and endowments. Many advisors host continuing education seminars for attorneys and accountants on issues germane to nonprofits to increase awareness of their competencies and services.
- **Through family offices** that manage family foundation assets. Create relationships with these family offices as there are some that look outside their organization for investment expertise.

Once you have decided on a strategy to increase awareness and visibility for your services and you've identified your specific opportunity, it is important to:

- Have a plan for how you will work with them, and identify with whom you will be working most closely at the foundation.
- Position yourself as a partner and not a vendor.
- Emphasize stewardship, donor confidence, community visibility and prudence.

Many advisors also gain invaluable experience by participating as board members of local charitable organizations. Not only do they get the satisfaction of helping out a charitable organization, but they also gather knowledge on how decisions are made and how organizational politics can impact the decision making process. In addition, they have the opportunity to meet other board members who may be involved with other nonprofits in the community.

## Utilizing IRS Form 990

Much information about foundations and endowments can be gathered from their annual IRS Form 990 filing, many of which can be found at www.guidestar.org. When reviewing IRS Form 990, some key areas to focus on include:

- Heading Items, including I (tax-exempt status), L (year of formation), and M (state of legal domicile).
- Part I: Summary – describes the organization's activities and governance, including its mission or most significant activities, number of voting members of the governing body, total number of employees and total number of volunteers; summarizes assets, liabilities and net assets.
- Part IV: Checklist of Required Schedules – provides information on additional required schedules to be completed if the organization engaged in certain activities. For example: did the organization engage in direct or indirect political campaign activities? Did the organization engage in lobbying activities? Did the organization engage in certain business transactions with a current or former officer, director, trustee or key employee?
- Part VII: Compensation – provides compensation data for officers, directors, trustees, key employees, highly compensated employees and independent contractors.
- Part VIII: Statement of Revenue – states dollar amounts and sources of the organization's revenues.

- Part IX: Statement of Functional Expenses – states dollar amounts and sources of the organization's expenses.
- Part X: Balance Sheet – provides assets, liabilities, and net assets for beginning and end of year.
- Schedule D Part V: Endowment Funds – provides information, including end of year balance, for the organization's endowment funds (if applicable).

Properly utilized, IRS Form 990 provides additional insight into the operations of a foundation or endowment, which the advisor can use to better understand the organization's mission, key people and important activities. A deeper understanding of the organization often leads to more effective prospecting and an improved ability to serve the organization as a valued advisor. More information on IRS Form 990 can be found at www.irs.gov.

## Seven Steps to Working with Foundations and Endowments

### Step 1: Understand their mission

The mission for most nonprofit organizations is available online at www.guidestar.org. Advisors that have developed successful relationships with nonprofit organizations, foundations and endowments have done so by first identifying and then understanding the organization's mission and in the case of a foundation, the donor(s) intent in establishing the foundation. This is important because the framework for all investment decisions is rooted in these statements of vision and expectation.

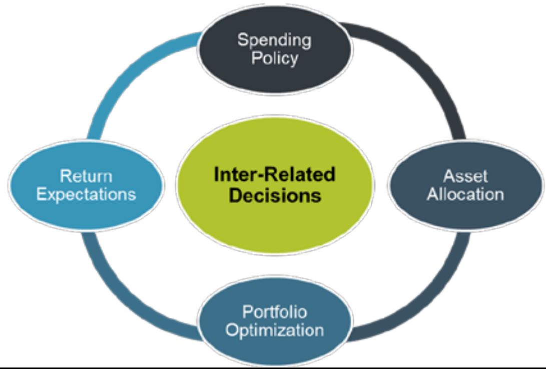
### Step 2: Analyze current situation

Review current financial statements, including their Form 990 which is their annual IRS filing, separating statements for investment assets from those for operating capital. Evaluate existing investment programs including current asset allocation and diversification strategies, investment managers and historical performance. Also, be sure to address any socially responsible requirements or restrictions on acceptable or unacceptable investments.

### Step 3: Review spending and donation policies

Consider cash flows, including administrative and investment expenses, any expected contributions, required payouts, if any, and their current spending levels. The business of a foundation is to accomplish its mission by making charitable grants. Everything else regarding the administration of the foundation, from managing the organization to investing the assets, is subordinate to this purpose. While there is no rulebook to grant making or to developing a spending policy, the more formalized the processes are, the higher the likelihood of success. The chart below demonstrates the different factors which influence the investment decisions of a foundation or endowment.

**Spending Policy: An Inter-Related Process**




This step is critical because the spending policy melds together the mission, philosophy, and daily operations of a charitable organization. Spending policies, which may also be called grant making, payout or endowment management policies, generally outline the organization's mission and its guidelines for spending its assets. In evaluating the spending policy, keep in mind the foundation's mission statement and any constraints revealed from analyzing its current position. Determine the payouts necessary to comply with tax laws, factoring in growth and inflation, and considering current and future spending needs.

Spending policies may be markedly different across foundations depending on their needs. Their choice of payout may be based on one of three methods:

- Moving average: A payout based on a moving average of the value of assets over the past one to three years which allows for more consistent and predictable spending strategies.
- Annual determination: A payout determined annually based on performance, spending excess earnings in good years and maintaining a dollar floor in difficult years.
- Spend down: A payout structured to spend down the entire account over a period of years.

Most organizations are willing to accept funding from any donor, either in cash or in kind, provided that it does not impair their independence to pursue their mission or endanger their integrity and reputation. Donation policies provide guidelines for these donations, such as:

- Clarifying who may solicit donations on behalf of the organization.
- Defining the various roles and responsibilities of the parties involved in the donation process.
- Identifying the circumstances under which a donation receipt will be issued.
- Ensuring the organization is in compliance with the appropriate regulatory agencies – especially important as fundraising over the internet has increased.
- Establishing criteria for valuing gifts.
- Providing guidelines on named gifts and gifts with specific terms of reference.

## Step 4: Address fiduciary responsibility

Directors, board members and trustees of nonprofit organizations are held to a very high ethical standard of fiduciary responsibility. However, there are no federal or state agencies that provide education to help these individuals handle this responsibility, creating an opportunity for financial advisors to provide guidance for clients in this situation.

The legal basis for defining fiduciary responsibility as it pertains to nonprofits, including foundations and endowments, is currently under review. The first piece of legislation, the Uniform Management of Institutional Funds Act (UMIFA), was passed in 1972. The second primary piece of legislation, the Uniform Prudent Investors Act (UPIA) was passed in 1994. In July of 2006, legislation was introduced to update and combine these two older Acts. This legislation, called the Uniform Prudent Management of Institutional Funds Act (UPMIFA), has been enacted by most state legislatures. To check the approval status for individual states, visit www.upmifa.org.

Based on existing legislation, however, a fiduciary's liability is determined not by the performance of the investments chosen, but rather, by the process in which the investments were selected and monitored on an ongoing basis. Following specific practices and guidelines demonstrates prudence. The Foundation for Fiduciary Studies and its affiliate, the Center for Fiduciary Studies, upon reviewing all the legislation, case law and regulatory opinion letters pertaining to fiduciary issues, have identified specific practices that define a global standard of excellence for individuals responsible for managing an overall investment strategy. Their "Periodic Table of Global Fiduciary Practices" is shown in the Appendix.

## Step 5: Evaluate and articulate investment policy

Establishing reasonable investment objectives is critical to developing appropriate asset allocation policies and investment strategies necessary to manage an institution's assets and achieve its spending targets.

In establishing the written investment policy, it is important to discuss and set appropriate expectations for performance and to review rates of return both in absolute terms and relative to appropriate benchmarks. Additionally, it is important to discuss the desirability of total return versus current income, the amount of risk the foundation or endowment is willing to assume in pursuit of its investment objectives, and determine the asset allocation of the fund's assets.

In the past, when interest rates were higher, foundations and endowments often relied heavily on fixed income investments to meet their spending targets. The 1990's ushered in a period of declining interest rates, and many foundations implemented more aggressive portfolio asset allocations utilizing equities. In the current market environment, foundations are emphasizing total return in their investment objectives, rather than income yield or growth, and are utilizing alternative investments such as hedge funds at a much higher rate.

Once an investment objective that harmonizes the mission of the organization with its investment goals is decided, it is important for the foundation or endowment to take the extra step of putting it in writing as an investment policy statement.

The investment policy statement must be comprehensive and include a review of these important considerations:

- The time horizon over which the returns are expected to be achieved.
- The amount of risk the institution will be willing to accept to achieve the targeted return.
- The institution's current and projected cash flows including its anticipated growth of grant spending and inflow of gifts.
- The economic outlook, its impact on investment issues, and the expected real growth in fund assets.

- Investment quality requirements and restrictions.
- The asset allocation, investment mix and investment management style that will be employed, including acceptable turnover.
- Pertinent socially responsible investing restrictions.

## Step 6: Select investment managers

Selection of the investment managers to implement the agreed upon investment policy should be as formalized as possible and incorporated into the investment policy statement. Specific criteria for the investment manager search and evaluation process should be included, such as:

- Performance relative to peer group
- Performance relative to assumed risk
- Inception date of the product
- Correlation to peer group
- Assets in the product
- Holdings consistent with style
- Expense ratios or fees
- Stability of the organization

Candidates should be interviewed for management of each specific asset class, reviewing specific objectives and policy constraints, setting standards for communication and service, and determining performance benchmarks by which the investment managers will be evaluated.

Once the managers are chosen, advisors can help to:

- Negotiate contracts and fee schedules, review and compare industry standards for manager fee schedules and negotiate reasonable fees to achieve an effective working relationship for both parties.
- Coordinate custody and brokerage services by reviewing the needs for a central custodian to minimize accounting and performance measurement services, and negotiate transaction cost agreements for brokerage services.

## Step 7: Measure and monitor performance

Performance should be monitored by utilizing criteria similar to those used to select the managers. Building some flexibility into the monitoring process may reduce the chances of an ill-timed manager change and provide managers additional time to perform to the expected standards. A useful approach may be to place underperforming managers on “watch,” with additional due diligence and monitoring performed before removing the manager. The goal of monitoring is to verify that the managers are achieving their objectives in a manner that meets or exceeds their peers.

In the ongoing reviews, all portfolio activities should be addressed, including all transactions in the portfolio and any changes to the asset mix. Investment activity for both investment managers and the total fund should be within the constraints and guidelines of the investment policy statement. Performance should be evaluated not just by looking at the absolute performance numbers, but also by reviewing:

- Performance relative to appropriate benchmarks, including "style" benchmarks and peer group.
- Performance relative to objectives and guidelines.
- A risk-adjusted performance analysis. Several different statistical measurement tools, including standard deviation or volatility of returns, (mean-variance) "Scattergram Charts," "downside risk" or semi-variance returns, manager beta, alpha, correlation to the benchmark and up/down capture ratios may be utilized.

## Conclusion

Building relationships with foundations and endowments takes time. It will take phone calls, one-on-one visits with board members, event participation, and most importantly, patience. Understanding IRS Form 990 can aid advisors working with not-for-profit organizations, and much information can be gathered quickly for those who know what to look for and where to look. Once you have established yourself as an advisor in this community and have developed your plan, the potential rewards may be exceptional for your clients, for you personally and for the growth of your practice.

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Investing entails risk including the possible loss of principal and there is no assurance that an investment will provide positive performance over any period of time.

# Appendix: The Periodic Table of Global Fiduciary Practices

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Practice M-1.1**<br>Senior management demonstrates expertise in their field, and there is a clear succession plan in place. | **Practice M-1.2**<br>There are clear lines of authority and accountability, and the mission, operations, and resources operate in a coherent manner. | | | **Practice S.A.- 2.1**<br>An investment time horizon has been identified. | **Practice S.A.- 2.2**<br>A risk level has been indentified. | **Practice M - 2.1**<br>The organization provides disclosures which demonstrate there are adequate resources to sustain operations. | **Practice M-2.2**<br>The organization has a defined business strategy which supports their competitive positioning. |
| **Practice M-1.3**<br>The organization has the capacity to service its client base. | **Practice M-1.4**<br>Administration operations are structured to provide accurate and timely support services and are conducted in an independent manner. | **Practice S.A.-1.1**<br>Investments are managed with applicable laws, trust documents, and written investment policy statements (IPS). | **Practice S.A.-1.2**<br>The roles and responsibilities of all involved parties (fiduciaries and non-fiduciaries) are defined, documented, and acknowledged. | **Practice S.A.- 2.3**<br>An expected, modeled return to meet investment objectives has been identified. | **Practice S.A.- 2.4**<br>Selected asset classes are consistent with the identified risk, return and time horizon. | **Practice M - 2.3**<br>There is an efficient process for allocating and managing both internal and external resources and vendors. | **Practice M - 2.4**<br>There are effective and appropriate external management controls. |
| **Practice M-1.5**<br>Information systems and technology are sufficient to support administration, trading, and risk management needs | **Practice M-1.6**<br>The organization has developed programs to attract, retain and motivate key employees. | **Practice S.A.-1.3**<br>Fiduciaries and parties in interest are not involved in self-dealing | **Practice S.A.-1.4**<br>Service agreements and contracts are in writing and do not contain provisions that conflict with fiduciary standards of care | **Practice S.A.- 2.5**<br>Selected asset classes are consistent with implementation and monitoring constraints. | **Practice S.A.- 2.6**<br>There is an IPS which contains the detail to define, implement, and manage a specific investment strategy. | **Practice M - 2.5**<br>The organization has a defined process to control its flow of funds and asset variation. | **Practice M - 2.6**<br>Remuneration of the company and compensation of key decision-makers is aligned with client interests. |
| | **Practice M-1.7**<br>There is a formal structure supporting effective compliance. | **Practice S.A.-1.5**<br>Assets are within the jurisdiction of courts, and are protected from theft and embezzlement | **1 ORGANIZE** | **2 FORMALIZE** | **Practice S.A.- 2.7**<br>The IPS defines appropriately structured, socially responsible investment (SRI) strategies (where applicable). | **Practice M - 2.7**<br>The organization has responsible and ethical reporting, marketing, and sales practices. | **Practice M - 2.8**<br>There is an effective risk-management process to evaluate both the organization's business and investment risk. |
| **Practice M-4.1**<br>There is a defined process for the attribution and reporting of costs, performance, and risk | **Practice M-4.2**<br>All aspects of the investment system are monitored and are consistent with assigned mandates. | **Practice S.A.-4.1**<br>Periodic reports compare investment performance against appropriate index, peer group, and IPS objectives | **4 MONITOR** | **3 IMPLEMENT** | **Practice S.A.- 3.1**<br>The investment strategy is implemented in compliance with the required level of prudence. | **Practice M - 3.1**<br>The asset management operates in a sustainable, balanced, and cohesive manner. | **Practice M - 3.2**<br>The investment system is defined, focused, and consistently adds value. |
| **Practice M-4.3**<br>Control procedures are in place to periodically review policies for best execution, "soft dollars," and proxy voting. | **Practice M-4.4**<br>There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities. | **Practice S.A.-4.2**<br>Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers | **Practice S.A.-4.3**<br>Control procedures are in place to periodically review policies for best execution, "soft dollars," and proxy voting | **Practice S.A.- 3.2**<br>The fiduciary is following applicable "Safe Harbor" provisions (when elected). | **Practice S.A.- 3.3**<br>Investment vehicles are appropriate for the portfolio size. | **Practice M - 3.3**<br>The investment research process is defined, focused, and documented. | **Practice M - 3.4**<br>The portfolio management process for each distinct strategy is clearly defined, focused, and documented. |
| | | **Practice S.A.-4.4**<br>Fees for investment management are consistent with agreements and with all applicable laws. | **Practice S.A.-4.5**<br>"Finder's fees" or other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented | **Practice S.A.- 3.4**<br>A due diligence process is followed in selecting service providers, including the custodian. | | **Practice M - 3.5**<br>The trade execution process is defined, focused, and documented. | |
| | | | **Practice S.A.-4.6**<br>There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities | | | | |

Legend:
*Practices in brown that begin with an "SA" define a fiduciary standard of excellence for Investment Stewards and Investment Advisors.*

*Practices in blue that begin with an "M" define a fiduciary standard of excellence for Investment Managers.*

*"SA" Practices highlighted are best reviewed in conjunction with Investment Managers Practices.*