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Endowments: What You Need to Know as You Explore, Create and Manage Them

May 17, 2023



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Vs



What Could Possibly Go Wrong?



What Could Possibly Go Wrong?

- Reputational risk
- Restrictions the nonprofit can't comply with
- Donor enforcement
- Donor actions
- Donor default
- Conflicts of interest
- Lack of clarity around agreement provisions
- Change in culture or values over time

Learning Objectives

At the end of the session, you will be able to:

- Recognize the pros and cons of creating an endowment
- Identify how to create and track an endowment
- Identify how to implement proven practices for investment, reporting and compliance requirements



What is an Endowment?

- An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity (NFP). The use of the assets of the fund may be with or without donor-imposed restrictions.
- Types of Endowments:
 - Perpetual
 - Term
 - Quasi-Endowment



Endowment Funds

GAAP describes the types of endowment funds as follows:

- ***A donor-restricted endowment fund*** is established when a donor stipulates that a gift must be invested in perpetuity or for a specified term. Donors or laws may require that a portion of the income, gains, or both be added to the gift and invested, subject to restrictions.
- ***A board-designated endowment fund*** is established when the nonprofit organization's governing board designates a portion of the organization's net assets without donor restrictions for investment for a long (but not necessarily specified) period of time.

True or False?

- Endowment funds can be either with donor restrictions or without donor restrictions?





UPMIFA

UPMIFA – The Law

- Institution “may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established.”
- It requires investment “in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.”
 - Nonprofits may delegate investment management as long as the Board acts prudently in doing so

UPMIFA – The Law

Seven criteria guide the institution in its yearly expenditure decisions:

- 1) Duration and preservation of the endowment fund.
- 2) The purposes of the institution and the endowment fund.
- 3) General economic conditions.
- 4) Effect of inflation or deflation.
- 5) The expected total return from income and the appreciation of investments.
- 6) Other resources of the institution.
- 7) The investment policy of the institution. These standards mirror the standards that apply to investment decision making, thus unifying both investment and expenditure decisions more concretely.

UPMIFA – The Law

- Eight criteria guide the institution in its investment management decisions:
 - 1) General economic conditions.
 - 2) Effect of inflation or deflation.
 - 3) Tax consequences.
 - 4) How an investment fits within the total portfolio.
 - 5) The portfolio's expected return.
 - 6) Other resources of the institution.
 - 7) Institutional needs and the relationship between distributions and capital preservation.
 - 8) An assets special relationship or value, if any, to the charitable purposes of the institution.





Common Endowment Issues Noted in Audits

Common Endowment Issues Noted in Audits

Endowment fund earnings (without explicit restrictions) are treated as without donor-restrictions

- UPMIFA (and related accounting rules) changed this!
- Should now be considered restricted until appropriated for expenditure

Common Endowment Issues Noted in Audits

Some other common issues:

- Improper tracking of investment earnings
- Board creating a donor-restricted endowment
- Missing endowment agreements
- The big spreadsheet



Accounting for Endowments

Accounting for Endowments

Net Asset Classification

The amount classified as with donor restrictions:

- The original gift amount, any additional gifts to that fund, and any resulting investment returns shall initially be classified as net assets with donor restrictions.

Accounting for Endowments

Appropriation for Expenditure

- In the absence of interpretation of the phrase *appropriated for expenditure* by legal or regulatory authorities (for example, court decisions or interpretations by state attorneys general), for purposes of the guidance, appropriation for expenditure is deemed to occur upon approval for expenditure.

Accounting for Endowments

Underwater Endowments

- What is an underwater endowment fund?
- If a donor-restricted endowment fund is an underwater endowment fund, the accumulated losses shall be included together with that fund in *net assets with donor restrictions*.

Example 1 – Donor-Restricted Endowment

- A donor of The Association for the Preservation of the Coelacanth (the APC) donated an Endowment specifying that the income be used to purchase scuba gear for the scuba department of the APC. The principal of the endowment is \$100,000. In the first year of the APC having the endowment, \$10,000 of investment income was generated.



To Record Initial Contribution

	<u>Debit</u>	<u>Credit</u>
Cash	100,000	
Contribution Revenue (With Donor Restrictions)		100,000

To Record Endowment

	<u>Debit</u>	<u>Credit</u>
Investments	100,000	
Cash		100,000

To Record Endowment Income

	<u>Debit</u>	<u>Credit</u>
Investments	10,000	
Investment Income (With Donor Restrictions)		10,000



Example 1 – Donor-Restricted Endowment

- Statement of Activities:

	2021		
	Without Donor	With Donor	Total
	Restrictions	Restrictions	
REVENUES			
Contribution	\$ -	\$ 100,000	\$ 100,000
Investment Income	-	10,000	10,000
Total Revenues	-	110,000	110,000



Example 1 – Donor-Restricted Endowment

- Statement of Financial Position:

ASSETS	
CURRENT ASSETS	
Cash and Cash Equivalents	\$ -
Investments	110,000
Total Current Assets	110,000
Total Assets	<u>\$ 110,000</u>
LIABILITIES AND NET ASSETS	
NET ASSETS	
Without Donor Restrictions	
Undesignated	-
Board-Designated	-
Total Net Assets Without Donor Restrictions	-
With Donor Restrictions	110,000
Total Net Assets	110,000
Total Liabilities and Net Assets	<u>\$ 110,000</u>



Example 2 – Community Foundation



- The governing board of Roundabout Appreciation Society (RAS) decides to raise funds to build an endowment. The governing board signs an agreement to establish a fund at Community Foundation. Community Foundation and RAS are not financially related.
- The campaign materials state the endowment will be owned and held by Community Foundation. The materials explain that gifts will be invested and that the return from their investment will be distributed to RAS, subject to Community Foundation's spending policy and to Community Foundation's right to redirect the return to another beneficiary without the approval of the donor, RAS, or any other party if distributions to RAS become unnecessary, impossible, or inconsistent with the needs of the community.



Example 2 – Community Foundation

- RAS is precluded from recognizing its potential rights to the assets held by Community Foundation because the donors explicitly granted variance power.
- RAS would recognize only its annual grants from Community Foundation as contributions.
- Community Foundation would recognize the fair value of gifts received as assets and as contribution revenue. The donors explicitly granted variance power by using a donor-response card that clearly states that gifts are subject to Community Foundation's unilateral power to redirect the return to another beneficiary.





Establishing & Maintaining Strategic Reserves

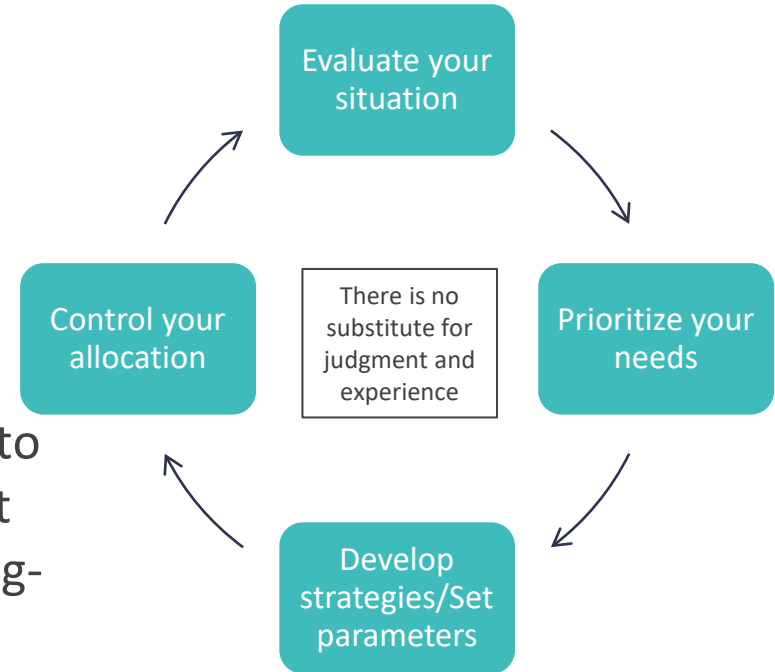
Understanding Your Investment Objectives

Before determining how and where to invest your endowment, it is critical to understand what your goals and objectives are:

1. Aligning the investment goals with your organization's goals
2. Risk management
3. Investment horizon
4. Restrictions & preferences
5. Distributions & liquidity

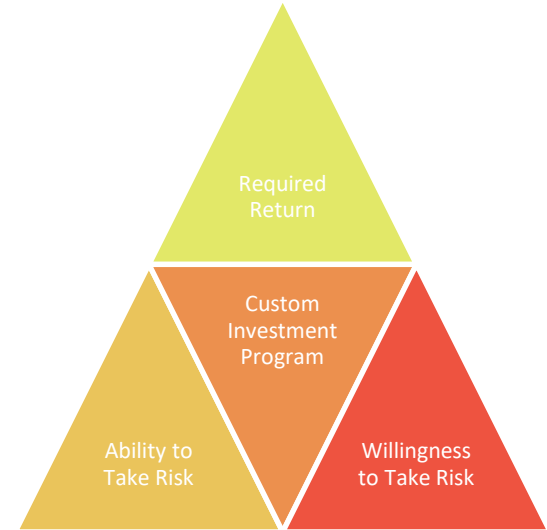
Aligning the Investment Goals with Your Organization's Goals

- What is the purpose of investing the endowment?
 - Generate income to support ongoing organizational needs?
 - Specific donor-restricted activities?
 - Develop a public facing pool of funds for fundraising purposes?
- Make sure you understand why you want to invest and have it clearly documented. Is it something that is perceived as a smart long-term investment?



Risk Management

- There is always risk associated with investing, so it is important to understand what level of risk the client is both **able** to take and **willing** to take.
- Establishing risk management is essential for dictating the eventual investment allocation.
- We have found that most of our nonprofit clients with endowments have a low to moderate tolerance for risk.



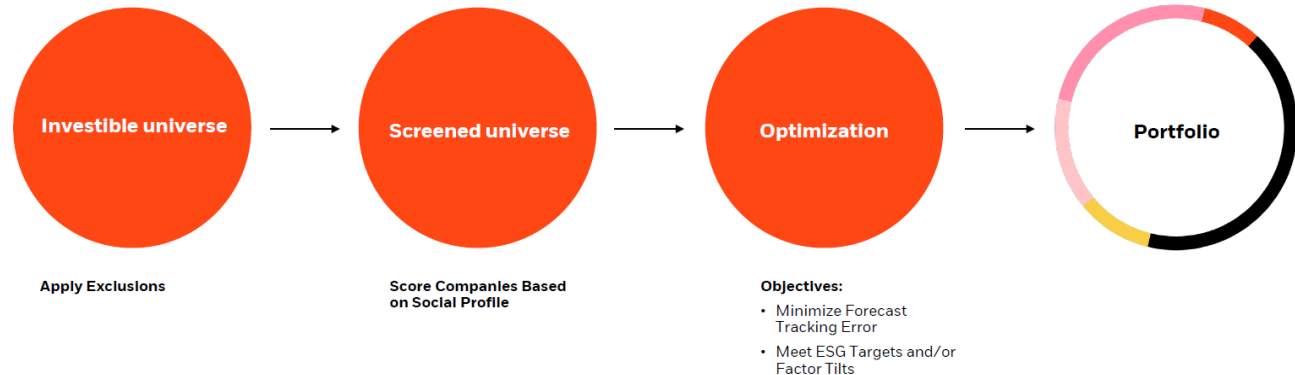
Investment Horizon

- Determine how long you plan to hold the investments, given shorter and longer-term goals.
- For many nonprofits, time horizons are generally longer, sometimes even perpetual. This is especially true for endowments and foundations.
- There can also be cases where short-term portfolios are appropriate, such as optimizing cash management for upcoming spending needs.

Restrictions & Preferences

What types of investment restrictions or preferences does the organization have?

- Examples may be avoidance of specific sectors & companies (i.e., fossil fuels, weapons, tobacco, etc.) or a preference towards sectors & companies that align with the organization's mission (i.e., DEI, low-carbon footprint, animal friendly, etc.)



Distributions & Liquidity

- Outline your cash needs as annual disbursements and develop a spending policy.
 - **Fixed Percentage model:** set **dollar value** of assets distributed annually (can be adjusted for inflation or not)
 - **Percentage of Assets model:** set **percentage value** of assets distributed annually (can be average over a period of years)
- Liquidity needs of the portfolio are based on these distribution assumptions.



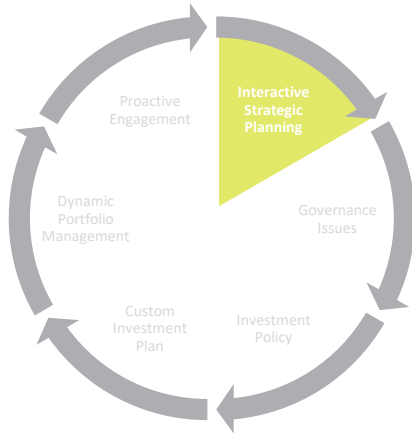
Spending Policies in Practice

SPENDING METHODOLOGY	DESCRIPTION	PERCENTAGE ENDOWMENTS USING RULE	PERCENTAGE PRIVATE FOUNDATIONS USING RULE
Percentage of moving average assets	Spending a fixed percentage of the average asset value over a determined number of years	74%	38%
Select spending rate each year	Annually determining the percentage of assets to spend	6%	23%
Hybrid rule	Spending based on a blended weighting of last year's spending and a percentage of the current assets	8%	2%
Spend all current income	Spending all income generated from your investment program in a given year	2%	0%
Percentage of beginning-of-year (BoY) market value	Spending a percentage of the BoY market value	3%	2%

Source: NACUBO-TIAA Study of Endowments, 2019

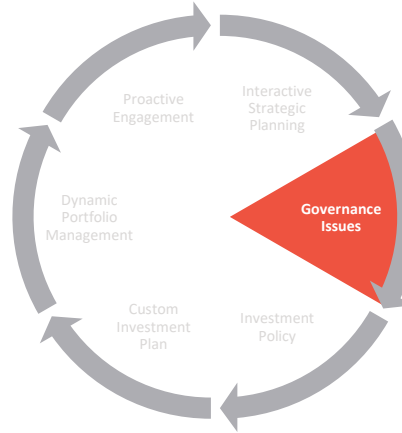


Endowment Management Lifecycle



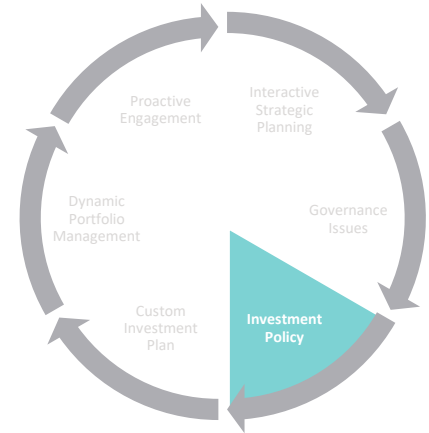
Strategic Planning

- Understanding investment objectives
- Determine what success means for the organization
- Stress testing, modeling, risk budgeting



Governance

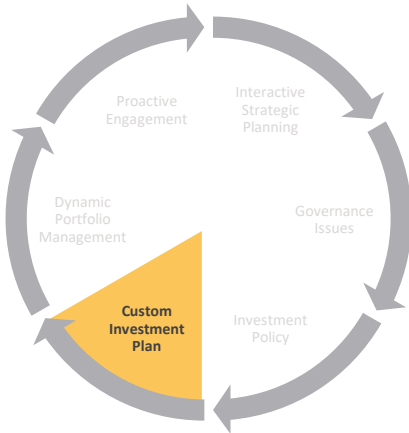
- Responsible parties?
 - Board of Directors
 - Investment committee
 - CEO/CFO/Treasurer
 - Advisor
- Fiduciary duty
- UPMIFA



Investment Policy Statement

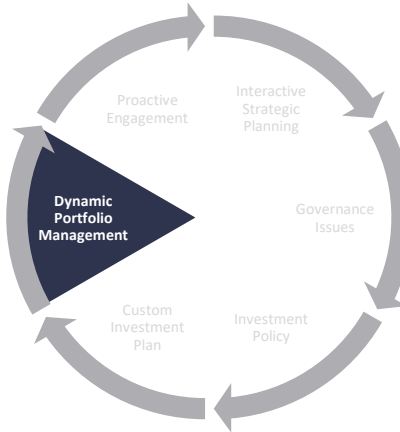
- Allowable asset classes
- Asset class ranges & targets
- Liquidity restraints
- Spending policy
- Risk budget

Endowment Management Lifecycle



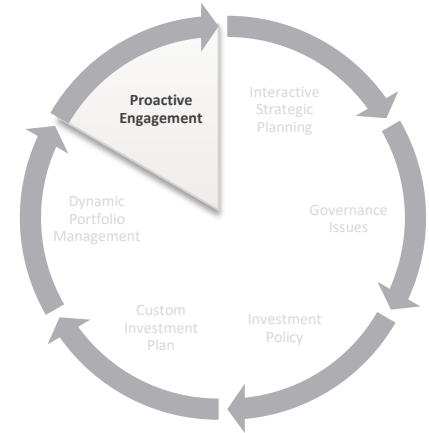
Creating the Investment Plan

- Integrate insights from planning to design a portfolio
- Collaborative process between Board and Advisor
- Primary driver of returns is **asset allocation**



Portfolio Management

- Ensure proper time horizon, risk, and liquidity are maintained in portfolio
- Monitor continued alignment of organizational goal with investment strategy



Ongoing Engagement

- Reporting tailored to goals
- Portfolio monitoring
- Regular review of IPS



Current Hot Topics

Cash Management – Are You Putting Your \$ to Work?

With limited interest rates the past 15 years, maximizing return on cash and savings was a non-issue.

With rising interest rates, opportunities to gain meaningful returns with minimal risk and flexible liquidity are now available.

\$1M Example

Investment Vehicle	Avg Rate of Return	Annual Interest
Savings Account (based on national average*)	0.24%	\$2,400
Certificate of Deposit – CDs (based on national average**)	0.97%	\$9,700
Schwab Treasury Money Market (SCOXX)^ (as of 5/11/23)	4.94%	\$49,400
6 Month Treasury Bills^^ (as of 5/11/23)	5.13%	\$51,300

[^]schwab.com/money-market-funds

^{^^}home.treasury.gov/policy-issues/financing-the-government/interest-rate-statistics

^{*} bankrate.com/banking/savings/average-savings-interest-rates

^{**} ycharts.com/indicators/us_6month_cd_rate



Values-Aligned Investing (ESG)

ESG-focused institutional investment seen soaring 84% to US\$33.9 trillion in 2026, making up 21.5% of assets under management: PwC report

Source: PwC Asset & Wealth Management Report 2022

ESG-mandated assets could make up half of all managed assets in the United States by 2025

■ ESG-mandated ■ non-ESG-mandated

Professionally managed assets in the United States (US\$ trillion)

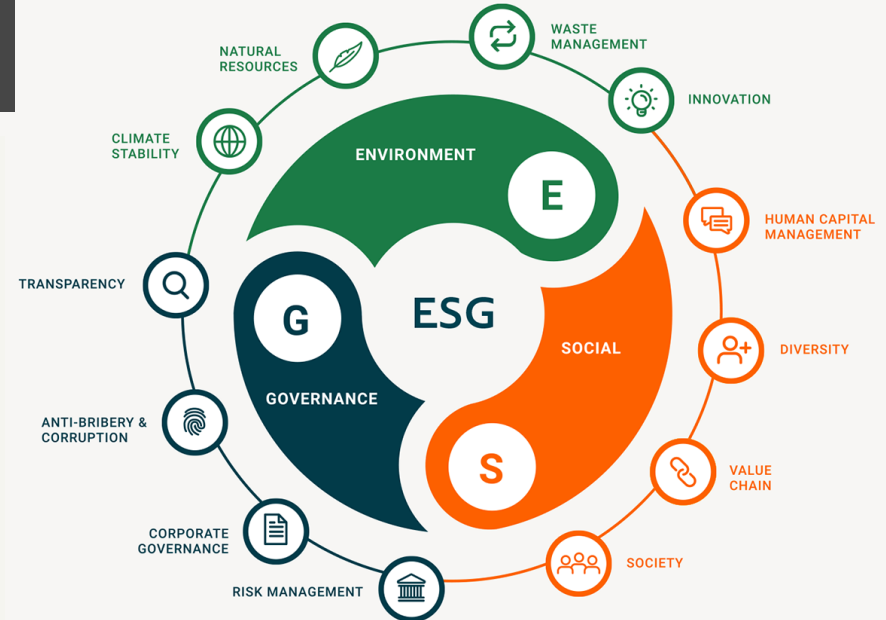


Share of ESG assets in overall professionally managed assets in the United States



Source: US SIF Foundation data through 2018; Deloitte Center for Financial Services analysis through 2025.

Deloitte Insights | deloitte.com/insights



Source: BWFA.com



Values-Alignment “Menu”

Do you want to choose a **strategy** building block?

Select only **ONE**.

☐ NONE

General ESG Strategy

☐ Aperio SRI: Scoring

Environmental Strategies

☐ Environment: Scoring

(US Green REIT is available as a standalone strategy.)

Social Strategies

☐ Animal-Friendly: Exclusions

Diversity

☐ Diversity, Equity, and Inclusion: Exclusions & Scoring

☐ Racial Justice: Exclusions & Scoring

☐ Women's Inclusion: Exclusions & Scoring

Faith-Based Strategies

☐ Catholic Values: Exclusions & Scoring

☐ Catholic Values: Exclusions

☐ Islamic Values: Exclusions

☐ Jewish Values: Exclusions & Scoring
(includes Israel Exposure Tilt)

Are you Interested In **active ownership**?

Values-Aligned Proxy Voting

Included for all accounts

Shareholder Advocacy

☐ Opt-in for notifications to sponsor shareholder resolutions

Do you want to **tilt** toward companies aligned with your values?

Choose as many as you wish.

☐ NONE

Environmental Tilts

☐ Low-Carbon Footprint

Clean Technology Solutions

☐ +50% over the benchmark

☐ +150% over the benchmark

Social Tilts

☐ Pro-LGBTQ Policies & Practices

☐ Reproductive Rights

Governance Tilt

☐ Governance
(embedded in Aperio SRI strategy)

Geography-Based Tilts

☐ Israel Exposure
(included in Jewish Values strategy)

Are there companies or industries you want to **exclude**?

Choose as many as you wish.

☐ NONE

Environmental Exclusions

Fossil Fuel Divestment

☐ Fracking

☐ Tar Sands

☐ Carbon Reserves

☐ Oil, Gas & Consumable Fuels

☐ Coal Companies

☐ Energy Equipment & Services

☐ Nuclear Power

Sustainable Agriculture

☐ Factory Farming

☐ GMOs

Social Exclusions

☐ Anti-LGBTQ Policies

☐ Animal Testing: Pharma Only

☐ Animal Testing: Non-Pharma

☐ Fur

☐ Civilian Firearms: Production

☐ Civilian Firearms: Distribution

☐ Military Weapons

☐ Predatory Lending

☐ Private Prisons

☐ Sudan

☐ Iran

Exclude at revenue threshold of:

	1st \$ of revenue	> 5% of revenue
Alcohol	<input type="radio"/>	<input type="radio"/>
Gambling	<input type="radio"/>	<input type="radio"/>
Life Choice	<input type="radio"/>	<input type="radio"/>
Pornography	<input type="radio"/>	<input type="radio"/>
Tobacco	<input type="radio"/>	<input type="radio"/>

Governance Exclusions

☐ No Women on Company Board

☐ No Racial or Ethnic Minorities on US Company Board

Company and Industry Exclusions

Specific Companies

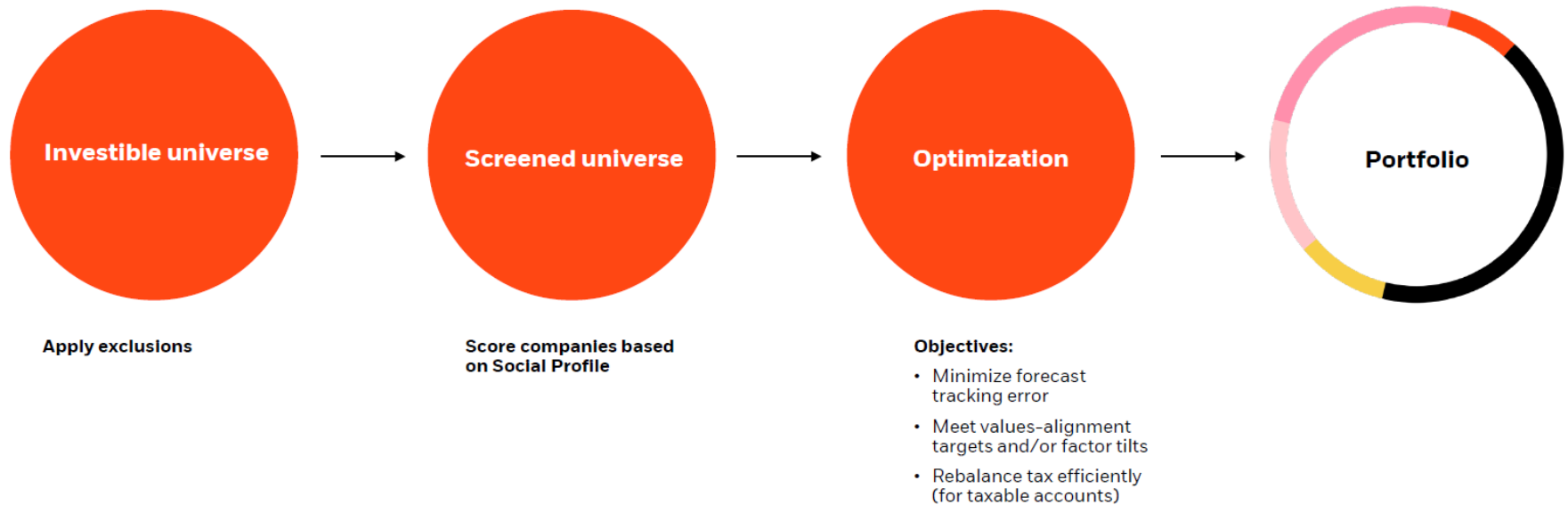
(Include identifier share classes.)

Specific Industries

(List industries or sub-industries.)



Portfolio Construction Process



Tools Available to Reflect Client Values

Exclusions

- Business activity
- Industry
- Company

Tilts

Shifting toward companies that more closely reflect specific client values using Social Scores*

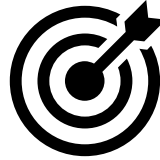
Active Ownership

- **Proxy voting:**
Voting in corporate meetings for board director elections, shareholder resolutions, and other items
- **Shareholder advocacy:****
Helping clients sponsor shareholder resolutions for corporate ballots on issues important to them

Values-Aligned Investing Example



Investable Cash:
\$2,000,000



Purpose:
Reconfigure reserves to reflect
organizational values



Specifications:
Transition to values-based investing,
specifically “women’s inclusion”

Challenge: Commonly known as “ESG”, we want to make sure that the investment portfolio matches the values of the organization rather than what Wall Street thinks it should be. Values-aligned investing can impact not only the investment strategy but portfolio performance.

Solution: It was crucial for this organization to fully understand values-aligned investing so they could document their decision making in the IPS. Additional education was then given to the Board and an implementation plan was agreed upon to transition the portfolio. Individual securities were used to better match the investments with the values of the organization.



Goal: Construct a Portfolio to Reflect “Women’s Inclusion”

Exclusions:

SAMPLE GENDER INITIATIVE	EXCLUSION	EXAMPLE CLIENT RATIONALE
Positions in Leadership	No Women on Board	Address lack of female representation in upper-level leadership, including direct management of employees and business units as well as representation on public boards
Employment & Promotional Opportunities	No Female Executives	

Preferences/Tilts:

SAMPLE GENDER INITIATIVE	DATA ELEMENT	EXAMPLE CLIENT RATIONALE
Positions in Leadership	Percentages of women in senior management and executive positions Women in leadership roles such as CEO, CFO, and board chair Percentages of women in the workforce	Address lack of female representation in upper-level leadership, including direct management of employees and business units as well as representation on public boards
Employment & Promotional Opportunities	Diversity in recruitment and training Senior executive or higher level of oversight of diversity issues	
Protection of Rights	Adoption of effective human rights policies Effective processes to monitor these policies Signatories to the United Nations Global Compact Diversity controversies	<ul style="list-style-type: none"> CEOs demonstrate leadership on gender equality and women’s empowerment and encourage fellow business leaders to bolster high-level corporate leadership for gender equality Mobilize the power, resources, and thought leadership of the business community to end all forms of forced labor and sex trafficking Publicly promote, proactively implement, and publicly report on human rights and fundamental freedoms



Outcome: A Portfolio that Addresses Women's Inclusion while also Maintaining Diversification

Portfolio Characteristics

Sample Portfolio	MSCI ACWI TM	Sample All Cash*	SMA: Sample Inclusion Portfolio	Women's
Forecast Tracking Error (%)*	0.00	0.47		0.91
Forecast Beta*	1.00	1.00		1.00
Forecast Volatility (%)*	18.50	18.51		18.53
Number of Stocks	2,939	500		492
Dividend Yield (%)	1.81	1.85		1.85
Social Score	56	58		68 ²
Social Score Tilt (%)		+3%		+20%

For illustrative purposes only.

Active Ownership in Action

While the wording of each proposal differed, they generally called for companies to disclose annually quantitative data assessing any gender pay gap, including the percentage mean and median difference between all male and female employees, across race and ethnicity where appropriate, "and would include base, bonus and equity compensation, and pay quartiles."

In 2022, **nine pay equity disclosure shareholder proposals were filed**. Three of them were withdrawn prior to companies filing their proxy statements, at Chipotle Mexican Grill, Target Corporation and The Home Depot. Each company agreed to make the disclosures requested in the proposal. One other proposal did not make it onto the ballot.

Of the five proposals that went to a vote, two received majority support, at **Lowes Company** and **The Walt Disney Company**, while another two received significant minority support, defined as greater than or equal to 30% of votes cast.

Average support for gender and racial pay gap proposals reached 42.6% of votes cast FOR and AGAINST, with median support of 33.7% of votes cast.

Source: Excerpt from 2022 ISS Report: Shareholder Resolutions in Review: Racial and Gender Pay Gaps





Thank You!

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