ROBERT P. FRY, JR.

WHO'S MINDING THE MONEY?

AN INVESTMENT GUIDE FOR NONPROFIT BOARD MEMBERS

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PREFACE

The five years since the publication of the first edition of this book (then called *Minding the Money)* have been among the most turbulent in U.S. investment history. Stock markets both at home and abroad have been through exhilarating highs and staggering lows. Given this recent history, only a fool would approach investing with an easy confidence that he knows exactly what he is doing.

The good news is that if we can honestly face our lack of understanding with even a modest admission of ignorance — perhaps by admitting we did not expect global stock markets to lose half their value in 18 months — then there is hope of doing a much better job going forward. Humility is a powerful investment management tool.

Unfortunately, humility is more often preached than practiced, especially in the business world. Humble people are often at a disadvantage when trying to sell their services, and this sad truth applies to investment managers as much as anyone else. However, when markets lose trillions of dollars in a single year, largely through professionally managed funds of one sort or another, it is at least fair to wonder if the managers' self-confidence is misplaced.

With that in mind, I have tried to model some humility in updating this book by including a number of Practical Observations. In these Observations, I share real-world examples of implementing the policies the book recommends, and in some cases I admit my own fallibility. By including these stories, I hope to make it a little easier for all of us to wrestle with the investment world in which we now live.

Closely related to humility is transparency about what people in the investment industry actually do, and how they are compensated. All of us tend to skew our advice toward activities for which we are paid. Even as I look back on earlier editions of this book, I see the occasional place where my work at that time colored my advice. To anticipate my prejudices, the reader should understand that I work as an investment management consultant to institutional investors. My consulting role is the lens through which I see the investment world.

As consultants, we advise clients on overall investment strategy, which ultimately takes the form of an asset allocation model for each portfolio or fund. In addition, we then search for appropriate managers, mutual funds, hedge funds, and other instruments through which to implement the recommended allocations. Finally, we regularly report on the resulting investment performance.

In addition, we work very closely with the officers and directors of our largest client, the National Christian Foundation (NCF). For them, we are effectively an outsourced Chief Investment Officer, doing everything from pure, institutional-style consulting to advising on daily corporate cash management. In that arena, my daily work life is more like that of an inside officer than that of an outside consultant. I meet at least twice per year with the investment committee of the board of directors and every month with the internal investment management team. In addition, I speak a couple of times a day with NCF's Chief Financial Officer and/or other members of his team by phone, e-mail or text message.

Since the publication of the first edition of this book, I also wrote a more extensive book on the same subject: *Nonprofit Investment Policies: Practical Steps for Growing Charitable Funds.* The publisher, John Wiley & Sons, has graciously allowed me to excerpt passages from that book in this one. Those of you wishing to read more detailed discussions of the concepts presented here may find the longer book useful.

WHAT YOU'LL FIND IN THIS BOOK

This book contains information intended to help all those who assist not-for-profit organizations with the investment of their funds. The material includes a discussion of portfolio theory as well as an overview of the relevant legal environment. It also covers hiring advisors and monitoring their performance. Along the way, there is advice on appropriate board and committee structures as they relate to investing an organization's funds. The book concludes with a discussion of current investment issues. The appendices include a sample set of policies, a copy of applicable laws, a sample self-guided investment audit, and some alternative investment due diligence guidelines. Also the attached CD-ROM includes customizable versions of each appendix.

INTRODUCTION

This book is a guide to key investment management issues for anyone involved in managing the financial assets of a nonprofit organization. Because of the central role and key responsibilities of the governing board, we will often discuss matters from the perspective of a trustee or director. However, what we say should be equally valuable help to corporate officers, employees, outside advisors, and even key volunteers. Throughout, we will emphasize those aspects of investment management that tend to be unique or of particular importance in the nonprofit world.

In that regard, we assume that the reader understands basic investment concepts apart from the nonprofit context. Thus, we will not review the definitions of stocks and bonds; the operation of the markets; the normal business functions of banks, brokers, and other advisors; or the fundamentals of corporate finance. (There are already a great many books on the market that cover these topics. For readers who want an enjoyable discussion of investment basics, my personal favorite is *A Random Walk Down Wall Street,* by Burton Malkiel, first published in 1973 and now in its ninth edition. For other useful references, see the list of Suggested Resources at the end of the book.)

WHO'S IN CHARGE?

In the nonprofit world, the answer to the question "Who's in charge?" is not always obvious. As in the for-profit world, executives frequently think and act as if they were in complete control. Often, in fact, they are — because the board has taken no interest in investment decisions. Sometimes major donors believe they are in charge, by virtue of the organization's dependence on their financial support. Even when such donors have no legal authority over the organization's funds, they may still exercise a great deal of *de facto* control. Finally, there is the occasional nonprofit that is controlled by one or more third parties. The community foundations run by various commercial investment firms, such as Fidelity or Vanguard, are examples of this model.

In virtually every case, however, *legal* responsibility for supervising investments resides squarely with the board of directors. Whatever authority other parties may have to influence or implement investment decisions, such authority ought to be shaped, guided, and constrained by the oversight of an informed board, following well-designed policies and procedures. The alternative, as we will see in later chapters, can be a legal nightmare in which the board members incur personal liability for the actions of people they have not effectively supervised.

The fundamental challenge for board members is to balance their legal responsibilities against the organization's practical needs. The executive staff is almost always responsible for daily operations, with the CEO or (more commonly) the CFO handling investment operations, including the supervision of outside service providers. But as much as the board needs the executive team's service, the board may not abdicate its responsibility to supervise. Good policies help maintain the right balance. With effective policies and procedures, a board can be very active in supervising investments while still delegating authority, encouraging teamwork and community spirit, and articulating a common vision. To do all this, however, board members also need a working knowledge of the key features of their investment environment.

We'll begin addressing the knowledge requirement in Chapter One. In the meantime, for board members there's a short answer to the question of who's in charge. You are. Who's minding the money? You are. The goal of this book is to help you do the job enjoyably and well.

PRACTICAL OBSERVATION 1
YOU CAN'T JUST "FIRE AND FORGET"

The single most difficult aspect of supervising investments, at least for me, is that you can never take your eyes off the target. What I would really like, truth be told, is for investment management to be just like a Sidewinder missile. This heat-seeking missile, once fired, tracks the target aircraft automatically. The pilot can fire and forget, or fire and turn hard toward home — things I have often wanted to do as an investor.

The reality, cruelly driven home in the last couple of years, is that investing, and supervising those who invest, requires ongoing diligence, ongoing involvement and ongoing review. There are no Sidewinder investment formulas. Recognizing that fact, however, makes the task of investing the right way a little easier. Everything in this book is intended to provide a rudimentary framework within which to conduct ongoing supervision. Don't expect your investment missiles to hit their targets if you aren't providing regular guidance.

WHY INVEST?

Since investing seems fraught with all kinds of problems, before we talk about how to do it correctly we should address a more fundamental question: Why invest at all? The answer has several parts: the need to offset inflation, the value of a reduced need for fundraising, and (most fundamentally) the imperative of good stewardship.

Inflation

The insidiousness of inflation is that it erodes the value of cash. If one holds currency or cash equivalents during a period in which there is any inflation at all, the purchasing power, and therefore the true value, of the assets declines. In a noninflationary environment, the failure to earn adequate interest results in lost opportunities but not true economic losses. Money in the bank at 2 percent interest generates a real return of 2 percent. But adding inflation to the mix can be lethal: A mere 3 percent inflation rate means that 2 percent annual interest paid on a bank account means a true economic loss of 1 percent per year. Even in a very low-inflation economy, if your organization is not able to "out-earn" inflation, you are effectively allowing funds to waste away over time. Inflation, then, compels an organization to invest as a means of caring for and preserving the value of its assets.

Opportunities for Growth

An additional reason to invest assets is to exploit the growth potential such funds represent. Accumulated funds with a longer time horizon represent an opportunity to increase revenues by investing for higher anticipated returns. An extra few percentage points of total return can, over the years, make an enormous difference in the financial health and asset base of an organization.

Additional investment income can be of even greater benefit to organizations whose principal support requires active fundraising. The true cost of fundraising in the nonprofit world tends to be understated. No matter how accurate the accounting of fundraising expenses, that accounting rarely (if ever) captures the "lost opportunity" costs in time, effort, and energy that fundraising exacts from staff, executives, and board members. Additional funds from investment returns can ease these pressures.

Good Stewardship

Whenever other people entrust their assets to you for a charitable purpose, you assume an obligation to handle those funds responsibly. Of course that means trying to grow the money without losing it. But more fundamentally: Investing is *unavoidable.* Any surplus, even cash in a non–interest-bearing checking account, is invested. The organization, as the owner of the funds, is allowing another institution — a bank — to hold those funds in exchange for a return, which in this case is the providing of checking services. While that might not be a *good* investment, since the organization can probably get both checking services *and* interest on its funds, it is nonetheless an investment. Once we understand this, we realize that "Why invest?" is not exactly the right question to ask. The real question, if we want to be good stewards, is "How do we invest well?"

At the end of the day, the payoff for good stewardship is not measured merely in dollars. Nonprofits typically invite others to join their cause or mission by supporting the organization with gifts of time, talent, or treasure. Employees who work for nonprofits often make a significant personal contribution by choosing a

lower-paying career track. One of the ways a nonprofit compensates its supporters for their sacrifices is by giving them the joy of being involved with an organization worthy of their support. The existence of well-managed funds, and the public commitment to good management through published policies and procedures, can heighten both the perceived and the actual worthiness of the entire organization. Among other things, it can help allay fears of the future by implying, "We plan to be here for the long haul." Doing a good job with the money is simply part of all we do as nonprofits to encourage and honor the commitments we ask of others.

PRACTICAL OBSERVATION 2
THERE'S NO SUCH THING AS A FREE-INTEREST LUNCH

In the first edition of this book, I strongly hinted that holding funds in a non–interest-bearing checking account was a poor investment. That sentiment was informed by a number of assumptions, some of which were proven wrong by the credit crisis that began in the summer of 2007. For one thing, I tacitly assumed that money market mutual funds offered by or through major brokerage firms were, practically speaking, just as safe as checking accounts at federally insured banks. It followed that if you could earn greater interest by using a money market fund in conjunction with a commercial checking account, that was obviously the right thing to do.

The assumption proved fallible. In September of 2008, following the bankruptcy of Lehman Brothers, the Reserve Primary Fund (a large, well-established money market fund) announced that it had "broken the buck," shortly after which it froze investor redemptions. Investors in the fund, who probably thought of it as a substitute for cash in the bank, could no longer get at their money. For anyone with bills to pay, lack of access to one's funds can be almost as devastating as actual losses.

It is easy enough to see why investors in the Reserve Primary Fund were confident of its safety. This was the first money market mutual fund in the United States and, at more than $60 billion just prior to its collapse, one of the largest. The resulting rush of investors trying to withdraw their money from this and other money market funds was so potentially damaging to the entire financial system that on September 19, 2008, the U.S.Federal Reserve used emergency powers to guarantee all institutional and retail money market funds whose sponsors chose to participate in the program. Virtually all fund sponsors accepted the offer.

One practical lesson of this episode is that even extremely safe investments require constant monitoring. In short, we have to approach decisions about where to deposit our cash with the same level of scrutiny and due diligence we would apply to hiring an investment manager, picking a stock, or investing in a hedge fund. Risk is everywhere.