BANK OF AMERICA

Investment policy:

an overview for long-term funds

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GOVERNING INTELLIGENCE

About the author

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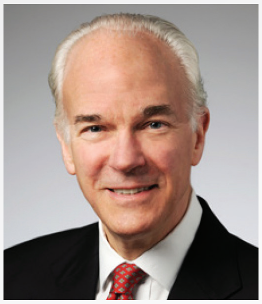

For fiduciaries of endowments, foundations and other long-term investment pools,[1] the consensus that once surrounded the formation and execution of investment policy has in the past decade been placed under severe stress. Central bank policies of ultra-low interest rates and liquidity support for the equity and residential real estate markets, introduced to counter the effects of the global financial crisis of 2008–09, were successful in ameliorating its worst effects; but the distortions they created, which we describe more fully below, have led some market participants to question the validity of the endowment model of diversified investing and of the policies and practices that accompany it.

In this paper, we briefly describe the characteristics and priorities of the endowment model before proceeding to a detailed examination of its central governing document, the investment policy statement (IPS). We argue for the continued relevance of the endowment model, documented and supported by a strong IPS, as the best bulwark against ill-considered investment decisions in the management of long-term pools.

Investment policy and the endowment model

The endowment model today can be characterized by three main attributes:

- A focus on the long-term strategic goal of achieving returns that, over time, equal or exceed the sum of (i) the institution's distributions, if any, (ii) the long-term inflation rate (usually the Consumer Price Index or the Higher Education Price Index) and (iii) investment costs
- A highly diversified investment portfolio, comprising assets that are intended to be uncorrelated with each other
- A high tolerance for less-liquid investment strategies such as marketable alternatives (for instance, hedge funds), private equity, venture capital and natural resource investments, in pursuit of greater diversification, lower portfolio volatility and potentially higher return

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Endowments: a brief history

An endowment is a pool of assets designated for the support of the mission of a nonprofit institution by donors or by its Board, and invested for the long term (usually for perpetuity) by the Board or other authorized fiduciaries.[2] Endowments have been found throughout history in many different societies,[3] but the modern form of this type of fund as found today in Western society has its roots in the English Middle Ages, when gifts of land and financial assets to the Church or to universities were defined under common law as being held "in trust" for the benefit of the groups or causes identified by the donors. Those who were given authority over these pools were accordingly called trustees, and their duties of care, loyalty and obedience were held to outrank all other obligations and interests — including, of course, their own personal interests. At a time when wealth was frequently held in the form of land or bond-like assets, and currency took the form of gold or silver, the goal of preserving the original nominal value of the donation — its "principal" or "corpus" — was paramount and was held to be among the first duties of a trustee. Income, in the form of rents, royalties, interest or (less often) dividends, was, in this system, used to provide benefits such as food, clothing and medical care for the poor; scholarships for students; salaries for professors; or books for a college library.

In the 20th century, and particularly following the eventual abandonment of precious metal-based currency systems in the global economic structure that evolved following World War II, the idea of a principal or corpus that would always maintain its value became increasingly difficult to sustain. Inflation eroded the value of the paper-based fiat currencies that were adopted by postwar governments, and adherence to the traditional trust-law concept of investing the original gift and spending the income could mean, over time, that the beneficial effect of the gift would be severely compromised. For example, a gift of $10,000 in 1900 — a substantial amount at that time — was by 2000 a rather small amount, and the income generated by such a fund could do substantially less in the form of good works. It became clear that simply preserving the nominal value of the original gift would not be sufficient to honor the intent of the donor. Instead, maintenance of the purchasing power of the gift after inflation, distributions and investment costs became — and remains — the central goal of endowment investing.

This trend was aided by two major developments in investment theory and practice. The first, beginning in the 1950s, was Modern Portfolio Theory, developed by economist Harry Markowitz at the University of Chicago and refined in subsequent decades by a series of practitioners such as David Swenson, chief investment officer of the Yale University endowment. The theory held that a diversified portfolio, including both liquid and less-liquid assets, whose returns did not move in parallel but were instead uncorrelated with each other, could potentially offer higher investment returns with a reduction in volatility and, perhaps, in other risk factors as well. This form of investing was further fostered by changes in the law governing investment of endowments, notably the Uniform Management of Institutional Funds Act (UMIFA), first proposed in 1972, and later by its successor, the Uniform Prudent Management of Institutional Funds Act (UPMIFA), proposed in 2006 and now the law in every U.S. jurisdiction except Pennsylvania and Puerto Rico.[4] Under these new laws, fiduciaries were freed to invest in broadly diversified portfolios and could include capital appreciation, in addition to the traditional income categories, in calculating investment return. Maintenance of the endowment's purchasing power over successive market cycles was strongly encouraged by the drafters of UPMIFA, thus bringing the law into line with the investment practice of leading endowments.

Endowment governance is typically carried out either by the Board or by an investment committee or similar body chartered by the Board and responsible to it. These fiduciary bodies, usually made up of volunteers who meet four or five times a year, may be assisted by a professional investment consultant in identifying, hiring, evaluating and, when appropriate, dismissing the investment managers who are in turn responsible for investing all or a portion of the portfolio using strategies in which they have demonstrated expertise. Other service providers may include a custodian, charged with safekeeping of the assets; a firm of auditors, who prepare the annual financial statements; and internal or external staff such as controllers, bookkeepers and accountants.

Creating and documenting investment policy

With this historical summary as background, we can now turn to investment policy and its embodiment in the Investment Policy Statement (IPS). The purpose of investment policy is to provide a framework through which the endowment's long-term goals can be achieved. This is done via the IPS, which is one of an endowed institution's most important documents. At a practical level, the norms and behaviors embodied in the IPS, taken as a whole, provide a single authoritative source to which fiduciaries, service providers and staff can refer for guidance. By representing the institution's highest and best thought, entered into after calm deliberation, the IPS creates a refuge for rationality in times of turbulence. Metaphorically, it serves as both a sword and a shield, enabling the fiduciaries to define the area they intend to occupy (one original meaning of the word "invest") while defending them against ill-considered decisions entered into under pressure when time is short and arguments are made that "this time is different."

Matters to be addressed by the IPS

An investment policy statement should address the following items, among others:

- The purpose of the endowment
- Its role in supporting the institution's operating budget, balance sheet, credit rating or other goals as applicable
- Its long-term return target
- Definition and, where possible, quantification of the risks that will be accepted in pursuit of the target return
- The roles and responsibilities of those involved in the oversight and management of the endowment
- Permitted and prohibited investment strategies and vehicles
- Asset allocation targets, with permitted ranges within which each allocation may be allowed to vary
- Liquidity policy
- Rebalancing policy
- Spending or distribution rate and methodology
- Schedule for review of the IPS
- Other matters as appropriate

In the following sections, we describe these topics in greater detail.

What are the endowment's purpose, its institutional role and its long-term return target?

Nonprofit institutions come in many types, but they frequently share one major characteristic: They cannot always recoup all of their operating and mission-related expenses from revenue flows alone. Memberships, tuition, fees and other sources of revenue are usually insufficient to balance the operating budget. While annual giving may go some way toward filling this gap, it is often endowment income that enables the institution to continue over the long term. Endowments also, as we will see, perform an important function in enabling an institution to offer specialized services or to achieve a level of excellence that would otherwise not be possible.

An endowment can be made up of a single fund or many. For a family foundation, which is frequently created through contributions from a single donor or group of donors, just one fund may constitute the entire endowment. For other types of nonprofits, such as educational institutions, community foundations and public charities, the endowment may be made up of many gifts, received over time, upon which the donors have frequently placed restrictions regarding how the investment proceeds may be used and, less frequently, how the funds themselves may be invested. It can readily be seen that the presence or absence of donor-restricted funds can have a strong influence on the nature of the institution itself. This is particularly true when the institution relies upon distributions from the endowment to fund a significant portion of its annual operating budget.

In writing an IPS, therefore, it is important to state with clarity the purpose for which the endowment exists and, to the extent possible, the role it will play in providing budgetary support. Where the institution has other goals, they should be stated as well. For example, an institution that has issued bonds or borrowed money may be required by rating agencies or by the covenants governing those transactions to maintain a certain level of liquidity, or "days cash on hand," in its balance sheet overall. This type of requirement can have an effect on the endowment's asset allocation, even where endowment assets have not been directly pledged to support the extension of credit.

The IPS should also state the endowment's long-term return target, and should explain how it is derived. This is typically achieved by taking the institution's annual distribution from the endowment, frequently expressed as a percentage of the endowment's market value,[5] and adding to it an estimate of inflation and investment-related costs. To give an example, for an institution with a 4.5% policy spending rate, a long-term estimate of 2% for inflation and investment-related costs of 1% of assets, the target return would be 7.5%.

What risks will be accepted in managing the endowment?

It goes without saying that an institution's long-term return goal for its endowment is intimately connected with the types and degrees of risk that the fiduciaries, acting prudently, are willing to accept. Risk comes in many forms; while investment theory has traditionally used volatility of investment returns as a proxy for risk, other significant risks exist that should be addressed and, if possible, quantified in the IPS. This need not be an onerous exercise. Many consultants and investment advisors now possess the analytical and computational tools to assist fiduciaries in this process. Among the risks that should be considered, in addition to volatility, might be:

- **Capital loss:** What is the likelihood that the portfolio could suffer a significant decline in value from which it would take an unacceptably long time to recover? This form of risk is perhaps the most fundamental for long-term investors. Quantitative modeling processes are used to estimate the probability of such a loss, enabling identification of the outlying "tails" where more extreme possibilities — both negative and positive — can be assessed.
- **Liquidity:** How dependent is the institution on cash distributions from the endowment to support its operating budget or grantmaking activities? How might the realizable price of liquid assets change in response to economic and market events? What is the expected amount of cash to be generated from maturing private capital programs? In the global financial crisis of 2008 – 09, lack of liquidity meant that for many institutions assets could not be sold at the price at which they had been valued only a short while before, and many private assets could be sold only at a steep discount or not at all. An analysis of liquidity risk should form a core part of the process by which the policy, or target, portfolio is constructed.

- **Stress testing:** How would the portfolio behave in a variety of specific economic, market and policy environments? While a repeat of the global financial crisis may seem unlikely, other circumstances such as rising interest rates, a resurgence of inflation or a strengthening dollar can be modeled and their effects on the portfolio examined. By using these tools, fiduciaries can obtain a clearer understanding of the concrete effect on the portfolio of various market events and regimes.
- **Reputational risk:** From a governance point of view, what risks are posed by the current processes and procedures by which the portfolio is managed? Poor governance can take the form of unacknowledged or unmanaged conflicts of interest, a Board or investment committee that lacks sufficient competence and meets infrequently, or a failure to adjust the portfolio to observable changes in the market environment, the investment regime or the environment in which the institution is operating, among other factors. The results can be potentially catastrophic for the institution: a loss of reputational trust among donors, stakeholders and beneficiaries that can be permanently damaging to its ability to carry out its mission, regardless of how well-intentioned the oversights might have been.
- **Quantitative measures of risk:** In addition to volatility, other measures of risk have long been integrated into individual managers' reporting to investors. They are most relevant to fiduciaries at the portfolio level, where they can illuminate otherwise unacknowledged risks. The two best-known of these measures are:
  - Sharpe ratio — a measure of risk using the volatility of returns, it yields the amount of return obtained per unit of risk taken
  - Sortino ratio — this measure calculates downside deviation, or volatility that results in losses, and is used to estimate the risk of potential drawdowns
- **Other strategic and tactical risks:** The investment process exposes the institution to various risks that are side effects of the investment process. These operational, legal, environmental, credit, currency and competitive risks should be considered when framing the IPS and, if appropriate, addressed in that document.

What will be the roles and responsibilities of those involved in the oversight and management of the endowment?

The number and qualifications of the individuals involved in the management of an endowment will necessarily vary depending upon the resources available to the institution. At base, however, there are essentially three types of role:

- Fiduciaries
- Staff
- Service providers

Fiduciaries. Absent donor instructions to the contrary or a valid delegation of authority, all fiduciary power rests with the Board. At most endowed institutions, the Board works using a committee structure. In some cases, the endowment is managed by the finance committee, whose charter includes both financial and investment matters. At many institutions, however, the Board creates a separate Investment Committee (IC) or, less often, an Investment Sub-Committee under the finance committee, which is charged with the management of the endowment. While the Chair of the Investment Committee, in order to sustain the validity of the delegation of fiduciary duty, should be a Board member, the other members need not be drawn from the Board. Indeed, a strong IC can frequently be created from qualified and dedicated individuals who do not have the time to serve on the Board, or who do not want to be exposed to the potential liability associated with Board service.

What types of investment are permitted for the endowment? Are there any types that are prohibited?

Contemporary endowment investment law and practice encompass and permit every type of instrument and strategy, subject only to the rule of prudence set forth in both UPMIFA and UPIA. Apart from legal considerations, Modern Portfolio Theory and investment practice hold that a well-diversified portfolio with many independent and uncorrelated sources of return is likely to have lower volatility and may produce a higher long-term return. There may nevertheless be some investments that an institution's fiduciaries decide to circumscribe or prohibit. This section of the IPS is the place to specify those limitations.

Reasons for limiting the endowment's ability to invest in a particular strategy or vehicle may be related to one or more of the following factors, among others:

- The fiduciaries may doubt their ability to act as competent overseers of more complex, opaque or illiquid strategies
- Certain instruments may be deemed excessively speculative, considering the goals of the institution and the endowment
- For fiduciaries whose duty includes expressing the values of the institution and its donors through the portfolio, prohibition or limitation of investment in certain industries, sectors or vehicles may be seen as part of that duty

In each case, the IPS should be as specific as possible and, where appropriate, should link any exclusion or prohibition to the purposes of the institution and the endowment, to the intent of donors, and to other relevant factors.

What are the portfolio's asset allocation targets, and are there permitted ranges within which each allocation may be allowed to move?

Since the IPS is a document to guide not only those who write it but those who come afterward, it is essential that it include a target or policy portfolio. This will typically take the form of a list of asset classes, categorized either by type of instrument (such as U.S. equity, non-U.S. equity, fixed income, private equity, venture capital, among others) or by the function that each allocation is intended to serve within the portfolio (for example, growth assets, deflation protection, inflation protection, diversifying strategies). Each item on the list should be accompanied by a number that represents the percentage of the total portfolio that should, on average, be invested in that asset class or strategy.

This target or policy portfolio should represent the highest and best thought of the Committee and the Board, and should not, in the absence of changed circumstances for the organization or a change of long-term investment regimes in the market, vary significantly over time.

In the shorter term, however — and particularly where discretion over the investment of the portfolio is delegated to an internal or outsourced Chief Investment Officer — it can be beneficial for the institution to define ranges for each asset class or strategy within which the actual percentage invested is permitted to vary. For example, if the target U.S. equity allocation is 45% of the total portfolio, the actual amount invested may be permitted to vary within a range of 10% above or below that amount, leading to a low of 35% and a high of 55%. Should the allocation exceed that low or high, a rebalancing would be automatically triggered to bring the portfolio back within the permitted range (although not necessarily to the target).

Another major benefit of a portfolio with targets and ranges is that it can be subjected to quantitative modeling and stress testing, allowing fiduciaries to obtain a clearer understanding of the potential risks to which the portfolio is exposed and the corresponding potential benefits that may accrue from adhering to the target or allowing a given set of allocations to vary within the permitted ranges. This is different from attempting to time the markets, which is extremely difficult and not accepted as good practice; rather, it enables the portfolio to exist flexibly within market environments that can frequently be volatile and, at times, to benefit from that volatility in a controlled way.

What is the policy with respect to portfolio liquidity and rebalancing?

How much of a nonprofit institution's perpetual investment portfolio should consist of securities that are liquid — in other words, that can be bought and sold daily in reasonable volume at a readily ascertainable price? Viewed objectively, the answer to this question could be said to depend, in turn, on how much the institution requires in cash distributions from the portfolio each year, and the timing of these distributions. For most institutions, this is a relatively easy question to answer, but policy preferences also play an important role.

Portfolio distributions can be made from investment income that comes in as cash — for example, dividends, interest, rents and royalties. If additional distribution amounts are required, two alternative methods of obtaining cash are available. The most obvious is to sell existing securities from the portfolio. Alternatively, for institutions that have strong annual giving campaigns that yield sufficiently large amounts of unrestricted cash donations, these can to some extent take the place of liquidations from the endowment.

Endowment liquidity: an unending debate?

Fiduciaries at many institutions, if nonprofit industry surveys[6] are correct, find it difficult to make the decision to allocate a significant portion of the portfolio to less-liquid or illiquid investments. The reason is frequently stated as "conservatism," by which is meant a preference for liquid, listed investments; yet financial theory and practice demonstrate that a more-diversified portfolio should have less volatility and a higher long-term return than one composed of liquid stocks and bonds — in short, should be more truly conservative. For this reason, a better term for this strong preference for portfolio liquidity might be "traditionalism."

The legendary British economist John Maynard Keynes famously deprecated liquidity, calling it a "fetish" and noting correctly that "there is no such thing as liquidity of investment for the [investment] community as a whole."[7] In this sense, he was correct: Liquidity requires a willing buyer and seller who meet at a mutually agreeable price that should, in normal and reasonably efficient markets, be not too far from the fair value or listed price of the security in question.

If, however, the entire market becomes one of sellers, then not only may prices fail to adjust sufficiently but there may, in fact, be no willing buyers at any price. In this sense, the experience of the 2008–09 global financial crisis — and, indeed, of the Great Depression during which Keynes was writing — while seared into the experience of many investors, is not particularly relevant for investment policy, which must assume that markets will be functioning more or less normally most of the time.

Rather, the issue here is the question of how the portfolio is matched to the institutional purposes that it is designed to support. To take another example, at one extreme, an endowment for which perpetuity is not a goal — for example, one given to support the construction of a new building within the next five years — will of necessity be invested in instruments that are more liquid. At the other extreme, an endowment given to fund a key position within the organization in perpetuity should be able to take advantage of the illiquidity premium and be invested in a more diversified portfolio.

The endowment model of a highly diversified portfolio with a high tolerance for less-liquid investments is based on the principle that less-liquid instruments should, in compensation for their relative lack of liquidity, dampen portfolio volatility and contribute to a higher total long-term portfolio return. The calculation of the percentage of the portfolio that should be liquid is therefore, for many institutions, a process of first determining the proportion required to support cash distributions and then crafting a prudent zone of comfort (for example, some percentage of asset values) around that required amount. The remainder of the portfolio can then, in principle, be allocated to less-liquid or illiquid investments.

Portfolio rebalancing is linked to this liquidity decision in obvious ways. Portfolio rebalancing is linked to this liquidity decision in obvious ways. Rebalancing becomes necessary when the permitted allocation ranges in the target portfolio are exceeded. It requires that fiduciaries reaffirm their commitment to the broadly defined target portfolio by returning it to compliance with the ranges that are set forth in the IPS. If a large proportion of the portfolio is semi- or illiquid, then rebalancing must of necessity occur via income flows, unrestricted annual gifts or adjustments to the liquid portion of the portfolio. The fact that less-liquid investments are typically valued at monthly, quarterly or even annual intervals can lead to less volatility in the reported value of the portfolio, which can in turn reduce the requirement for frequent rebalancing. Similarly, provision in the IPS for relatively wide permitted ranges around the target portfolio can make rebalancing less frequent. It is nonetheless true that the decision to pursue less-liquid investments changes the rebalancing process in important ways when compared with a portfolio comprising listed investments with daily liquidity. The benefits of rebalancing have been repeatedly demonstrated. By adhering to its broadly defined target portfolio through rebalancing, an institution is harvesting gains from appreciated assets in a disciplined way that should, over time, lead to higher returns. At the same time, it is important that the costs of rebalancing be considered, since when investments are sold and bought the institution must pay the expenses associated with the transaction, including among others the spread between the selling and asking price of the relevant securities, custodial and other transfer costs, and potential legal expenses. For this reason, rebalancing should when possible be carried out using income and gift flows, with the sale and purchase of securities being the final option.

What is the appropriate spending or distribution rate for the portfolio? What methodology should be used in calculating it?

Except in rare cases, endowments are intended to be spent — either for the designated purpose for which they were given or, in the case of unrestricted or Board-designated funds, to support the operating budget of the institution in other ways. Furthermore, in the absence of donor instructions to the contrary, endowment funds are required to maintain their purchasing power, after accounting for inflation and investment-related expenses, over successive market cycles into perpetuity. Thus, in principle, the amount distributed should be as high as prudently possible, consistent with this fiduciary imperative of intergenerational equity, in order to balance the interests of present and future beneficiaries over the long term. These seemingly conflicting goals must be reconciled not only by the asset allocation and portfolio construction process that is devised by the institution and documented in the IPS, but also by the spending policy — the spending rate and methodology — that is adopted to govern distributions from the endowment.

A complete discussion of the various spending methodologies used by institutions is beyond the reach of this paper. For our present purposes, we believe it is appropriate to note the key points of the most commonly used methods.

Moving average methods. Institutions for which endowment distributions are not essential to the operating budget can tolerate a degree of volatility in the endowment distribution from year to year. They may distribute a set percentage of the endowment's asset value or simply decide on an appropriate rate or amount each year. Most institutions, however, desire a constant, and ideally constantly growing, flow of distributions from the endowment. Volatility in distributions is disruptive to their budgeting process and can lead to impairment of the institution's mission. As a result, a large majority of nonprofit institutions use a smoothing methodology to create a more stable base of valuation, from which a stated percentage is withdrawn to be spent. Even many private foundations, which must under law spend a minimum of 5% of their assets in qualifying distributions, simultaneously employ a smoothing methodology to help stabilize their grantmaking, consistent of course with the 5% minimum floor.[8]

The smoothing methodology most commonly used is to calculate a rolling three-year or 12-quarter average of beginning market values of the endowment. Less often, a five-year or 20-quarter average may be used; other periods such as seven or 10 years are seen still less frequently. The result achieved by using the three-year/12-quarter period has proved to be not very stable in the volatile investment environment that has prevailed in the current century; the longer periods, on the other hand, while providing greater stability, also have the defect of leaving years of boom and bust in the calculation for longer periods, leading to situations in which the endowment may over- or under-spend relative to its potential and the desire of the Board.

Once the valuation base has been calculated, a set percentage, or policy spending rate, is applied to it to determine the amount to be distributed. When the moving average method was first devised in the early 1970s, it was widely assumed that a policy rate of 5% would be sustainable over the long term — that is, it would be consistent with maintenance of intergenerational equity. The extreme volatility of returns during the last decade, however, has caused institutions (other than private foundations) to revise their policy rates downward, and most institutions now average between 4% and 4.7%.[9]

Banded inflation method. For institutions whose operating budgets are more dependent upon endowment distributions, two other methods are commonly used. One simply takes the distributions from the previous year and applies an inflation rate to it. This rate may be the familiar Consumer Price Index, the more specialized Higher Education Price Index or some other, customized rate. The resulting distribution is usually constrained by a minimum and maximum of endowment asset values (again, frequently a smoothed average of some number of previous years). To give an example, the distribution might be required to be no less than 3% and no more than 6% of the average of the last three years' endowment values.

The benefit of this methodology for endowment-dependent institutions is the tremendous stability it gives to the endowment distribution from year to year. This facilitates multiyear planning and budgeting, and thus enables the institution to rely on the endowment for the long term. Because endowment returns vary from year to year, however, this method does place more pressure on the endowment in years of low returns. For this reason, it is imperative that, when adopting this method, the institution give careful consideration to whether the amount distributed will be sustainable into the future. This is particularly important if the institution has been using a moving average method and the recent period has been one of rising markets.

Hybrid methods. Some institutions may be dependent upon the endowment but may hesitate to sever completely the relationship between the endowment's market value and the spending calculation. These institutions choose to use a mix of the banded inflation and moving average methodologies; a typical example might give a 70% weighting to the amount derived using the banded inflation method and a 30% weighting to the amount that results from the moving average method. The result, while somewhat less stable than that derived using banded inflation alone, honors the fact that market values do matter and leaves endowment spending tethered, albeit in a limited fashion, to the endowment's size.

Other methods. The methods outlined above are those most often in use by nonprofit institutions. Some institutions create customized formulas to meet their particular circumstances. In all cases, however, the method chosen must be aligned with the purposes of the endowment and the institution, and absent donor instructions to the contrary must have intergenerational equity as a central goal.

Review of the IPS

The IPS is a permanent document, and unless the institution's purposes or the portfolio's goals have changed, it should not be in need of frequent revision. It should, however, be reviewed on an annual or biannual basis, in concert with the review of the institution's strategic asset allocation. Recommendations for changing the IPS may be made to the Board at that time and an appropriate revision submitted to the Board for approval.

Conclusion

The investment policy statement is one of the most important governing documents for an endowed nonprofit institution. While it need not be long, it must address the issues mentioned in this paper, in addition to any others that may be relevant to the investment and spending process. It goes without saying that the IPS should also be closely coordinated with the institution's other policies, including those regarding gifts, conflicts of interest, financial controls and other matters relevant to the smooth integration of the endowment into the mission of the institution.

Perhaps most important, the IPS should be sufficiently complete that a new trustee or investment committee member could, upon reading it, understand how the endowment is to be invested, managed and spent. It should thus be a self-explaining document that does not require oral interpretation or "tradition" for a newcomer to achieve a complete understanding of the investment process.

As memory of the global financial crisis recedes, it will become more important than ever for fiduciaries to craft and adhere to policies that are consistent with their institution's mission. While the investment policy statement is not sufficient in itself for the accomplishment of that goal, it is an essential place from which to start.

[1] For purposes of convenience, we will use the term "endowment" to refer to the long-term investment pools of public and private foundations, operating charities, educational institutions and other nonprofits. These pools may be made up of funds with and without restrictions imposed by donors, and may also include board-designated funds (sometimes referred to as "quasi-endowment").

[2] While donors to some nonprofit institutions (such as the Bill & Melinda Gates Foundation) have directed that their endowments be fully distributed within a certain number of years, the vast majority of endowed nonprofit funds are intended to last into perpetuity. Indeed, even in the case of the Gates Foundation, the period within which the funds must be distributed — 20 years following the death of the founders — is itself long enough to justify the application in some measure of the approaches outlined in this paper.

[3] Imperial China, for example, had a long tradition of perpetual endowments in support of temples and other causes. These funds were confiscated by the new government following the proclamation of the People's Republic of China in 1949.

[4] Pennsylvania's arrangements are based on its State Law 141 and the standards set forth in the Uniform Prudent Investor Act (UPIA), which has been interpreted by courts to support the concept of maintenance of purchasing power. Puerto Rico's Trust Act of 2012 also incorporates the UPIA language and standards. For endowment funds in trust form where the trustee is not itself a charity (for example, trusts with a corporate trustee), UPMIFA by its terms does not apply, and UPIA is the governing law.

[5] Spending policy and spending rates are summarized in more detail on pages 11–13.

[6] See, for example, the 2017 NACUBO-Commonfund Study of Endowments, p. 19 (Fig. 3.3, "Detailed Asset Allocations for Fiscal Year 2017"). Commonfund Institute, 2017.

[7] Keynes, *The General Theory of Employment, Interest and Money*, Ch. 12 §V(4) (1936).

[8] See, for example, 2017 Council on Foundations-Commonfund Study of Investments for Private and Community Foundations (Commonfund Institute, 2018).

[9] See, for example, 2017 NACUBO-Commonfund Study of Endowments (Commonfund Institute, 2018); 2017 Council on Foundations-Commonfund Study of Endowments (2018).

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