Portfolio management for institutional investors. Foundations & Endowments.

Portfolio Management
for Financial Advisers

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Foundations & Endowments

- Foundations and Endowments are similar in that **both operate to support charitable activities** and **are functionally tax-exempt**

Foundations	Endowments
normally grant-making entities funded by gifts and may have a limited or perpetual life	**are long-term fund owned by non-profit entities such as universities and museums to support the activities of those entities**

Foundations

There are four types of foundations:

1. **Independent foundations** (also called private or family foundations): must adhere to specific distrubution requirements or become subject to taxation

2. **Company-sponsored foundations**

3. **Operating foundations**

4. **Community foundations**

Foundations

Foundations vary widely in their objectives and contraints:

- Some are the sole source of funding for a charitable program and must provide a stable income source, while others make only short-term grants

- **Payout requirements vary**

  EXAMPLE: Independent and company-sponsored foundations must pay out 5% of their average 12-moth net asset value plus investment management expenses; Operating foundations must spend 85% of dividend and interest income on the programs of the institute they support; community foundations have no spending requirements

- **Tax constraints and payout requirements are closely intertwined**

- **Perpetual foundations can have high risk tolerance and return objectives**

- **For perpetual foundations, intergenerational equity or neutrality is important** – The foundation's return must equal its annual distribution requirements plus inflation to allow the principal and future distributions to increase at the level of inflation

- **Legal and regulatory standards vary depending on the foundation**

Foundations

IPS for a foundation would typically include:

- Brief overview of the foundation and its purposes
- Discussion of relevant objectives and contraints
- Strategic assets allocation

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1. **Foundations**
2. **Endowments**
   1) IPS for Endowment (ASNE example)

Endowments

- **Endowments share many characteristics with foundations**, but true endowments have a perpetual investment portfolio owned by and operated to support a non-profit institution (e.g. school, museum)
- They are established with a contribution from an original donor, but they are free to actively seek to grow by soliciting contributions on an on-going basis
- They are perpetual funds, prohibited from expending their principal
- They are almost always fully tax-exempt, unless they have business income unrelated to investment cash flows
- They normally seek to preserve the inflation-adjusted purchasing power of their principal and future income distribution

Endowments

- **Return objectives**: are usually high and stated as a distribution requirements plus the rate of inflation
- **Risk objectives**: high risk can be tolerated to achieve the high return objective, but particular attention is directed to income volatility so that the incomes distributions are not erratic
- **Liquidity** needs are generally limited and endowments are well suited to holding long-term illiquid assets
- **Time horizon** is perpetual
- **Tax considerations** center on maintaining tax-exempt status (in the U.S.)
- **Legal and Regulatory** restrictions vary but are generally limited

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IPS for Endowment

The **IPS** of the **foundation and an endowment are very similar**

The IPS for an endowment can be illustrated with the Alternative Schools of the Northeast (ASNE) endowment

IPS for Endowment

BACKGROUND:

ASNE was founded in 20X1 to support member charter schools that seek to provide a high quality alternative to secondary public education in the northeastern United States.

ASNE is composed of 10 independent schools (the Schools) and owns the ASNE Endowment. The distribution of the endowment are distributed in equal shares annually to the Schools, which depend heavily on the distrbutions to support their operations.

Spending goals of the endowment are to distribute 4,5% of the 5-year average market value

IPS for Endowment

RETURN OBJECTIVE

The endowment should maintain the 4,5% distribution plus operating expenses over the long term, adjusted for inflation in the expenses of the Schools.

Current Target for Long-Term Return

4,5%	Spending
3.0%	Inflation
0,5%	Endowment Expenses
8,0%	

IPS for Endowment

RISK OBJECTIVES

The portfolio must maintain the long-term purchasing power of the portfolio while minimazing annual fluctuations in spending.

Changes in spending over any one year of more than 3 times the inflation rate forecast in the return objective should be minimized

IPS for Endowment

CONSTRAINTS

1. **Liquidity** should be minimized due to the low long-term return and income volatility on short-term assets and because expected contributions from new donors can be used for temporary liquidity
2. **The time horizon is perpetual**
3. **The endowment** is **tax exempt**
4. **Legal and Regulatory**: The endowment is subject to UMIFA and IRS reporting requirements
5. **Unique Need and Circumstances**: Due to the small size of the fund, investments involve specialized expertise such as international securities, real estate or venture capital should be avoided. Hovewer, this policy will be reviewed annually and is expected to change as the portfolio grows because of the new donations

CASE STUDY