Financial Advisors and Non-Profits,
Seven Standards for Service
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Synopsis:

The phone call was unexpected. A major donor had passed away and, unknown to your organization, they left a large cash bequest that will be arriving in the form of a check in thirty days. Who said all phone calls from attorneys were bad news? But, now what? Clearly, such gifts can be transformative for organizations without a history of endowed or board-directed funds. But who should you hire to help you? What should you be looking for? What questions should you ask?

This paper addresses the need for a defined process, deliverables and a service model for non-profit investment funds. The amount of these funds are growing. Unrestricted gifts are more common and lead to large cash balances or board-directed investment funds. How boards and finance committees handle these funds and hire professionals to guide them will have profound effects on the financial and fiduciary obligations of your board.

Back Story:

Some years ago, as the Treasurer of a non-profit board of directors, I led our finance committee through the Request for Proposal (RFP) process to find an investment provider to manage a significant board-directed investment fund. What ensued was a multi-day ordeal of PowerPoint presentations, lectures on Sharp ratios and discussions about the efficient frontier. At the end, my fellow board members sat glassy eyed. They turned to me, the lone financial professional in the group, and said: "Well, what do you think?"

I admit, I was a bit stunned. We had brought in bright financial professionals who knew their stuff when it came to the minutiae of portfolio construction. Yet, no one talked about service. No one talked about education. No one asked *us* any questions. No one had a process for providing value above and beyond their proposed portfolios. What did I think? I thought we were being underserved.

Some of this is our fault as charitable organizations. As one advisor later told me about his lack of success during such RFPs: "I give them my best but about half the time I get beat out by the brother-in-law of someone on the board." In an era of increased oversight for non-profit entities, such decisions seem dangerously naive. Missions are too critical, donors too wary and the fiduciary obligation is too great to ignore the full spectrum of an organization's needs and/or be unwilling to find advisors who will meet or exceed expectations. Here then is an outline of what a good advisor *should* do to complement that potentially transformative gift.

I. **Address values, vision and goals:** Non-profits, unlike many private clients, should have the advantage of a clearly defined mission. But their vision and values may be somewhat fuzzier and overrun by marketing lingo and scope creep over years of building on their original mission.

Yet values and vision are essential to reaching a consensus on what financial goals the funds managed by an advisor will address. An advisor should lead the committee and board members in a discussion of the following:

- Mission
  - What is the current mission statement? How has it changed or evolved?
- Vision
  - Looking to the future, how will your mission fulfilling activities change? What do you want to create or achieve over time?
- Values
  - What do you stand for? What words do you use to describe your organization and how it tackles your mission?
- Goals
  - How does this money help you achieve your mission? Will this money reflect your values? Will these funds help take your mission forward into the future?

II. **Create a Spending Plan:** Once Mission, Vision, Values and Goals have been thoroughly vetted and agreed upon, advisors should then address the spending needs of the organization and how they will affect the accounts managed by the advisor. This is relatively common with private clients, creating a cash flow summary and testing various spending strategies based on the desired allocation, but usually lacking in preparation to manage non-profit assets.

Creating the spending plan is an important check to balance the conflicting desire to protect funds from loss while providing sufficient growth to meet expenditures. Modeling and demonstrating the results is a relatively straightforward process that can be done using widely available financial software. Findings should utilize statistical testing, including Monte Carlo analysis, to ensure the funds will meet their intended lifecycle with an acceptable margin for error. Skipping this important step, the organization runs the risk of creating an investment policy at odds with the desired spending rate.

III. **Draft an Investment Policy Statement(IPS):** Once spending is addressed and modeled alongside the desired asset allocation, an IPS can confidently be formulated. There are numerous templates available to create an IPS from places like the National Council of Nonprofits. At a minimum, it should include:[1]

- Executive Summary: *Type of organization, charitable intent and current assets.*
- Background: *Date established, number of accounts, purpose of each account, contributions and withdrawals to funds.*
- Intent: *Coverage of procedures and fiduciary standards etc.*
- Objectives of the Fund: *Growth versus Income, timeframe for objectives to be met and total return expectations.*
- Duties of Associated Parties: *Identify parties involved and summarize their responsibilities.*
- Description of Asset Classes: *General overview of broad asset classes and specific asset classes.*
    - Don't feel as if you have to be fancy here to be effective. Simple is often a strength. A portfolio constructed using traditional asset classes will outperform the vast majority (90%) of professional endowment portfolios using esoteric assets such as hedge funds or "alternative assets."[2]
- Target Asset Class Weightings: *A Table of columns indicating min and max weightings.*
- Investment Restrictions: *Detail and clarify any restrictions.*
- The Investment Advisor: *Explain the process for choosing and replacing advisors.*
- Review and Monitoring: *Explain how often the IPS will be reviewed and the schedule for rebalancing and monitoring of costs.*

IV. **Demonstrate Their Value:** Value is not synonymous with "returns." Returns should be expected to be in line with historical averages determined during the planning process and referenced in the Spending Policy and IPS. That is what is modeled and that should be what is expected over the long run. Yet an advisor can continue to deliver <u>value</u> beyond mere market returns in exchange for their fee by paying attention to several best practices.

Vanguard Research began identifying value added tools for advisors in 2001, continuing to support the project with updated information and recommendations. Directed primarily at the individual investor market, not all suggestions (such as those emphasizing tax efficiency) are pertinent to the non-profit. However, the following five tools offer significant potential to add value through planning, discipline and guidance.

1. <u>*Asset allocation*</u>: If an advisor has gone through the planning steps to develop an asset allocation, then they have determined the most important factor that will affect the portfolio's return variability and long-term performance and, thus, will have already

[1] For more information: https://www.councilofnonprofits.org/tools-resources/investment-policies-nonprofits

[2] Bennyhoff, Kinniry, Jaconetti, DiJoseph & Zilbering: Vanguard Advisor 's Alpha, Vanguard Research, September 2016. pp. 11.

created significant value for the portfolio as that asset allocation will create a strong foundation from which to build a successful investment program. But the job is nowhere near being complete as you need to find investments to fit, rebalance them periodically and stick with the plan through a variety of market cycles.[3]

2. *Low internal fee structure*: Choosing assets to complete the asset allocation plan means choosing from a nearly infinite variety of mutual funds, exchange-traded products, index funds or individual securities, each with its own cost structure. The potential value-add of an advisor using low-cost options could be up to 0.4% of the portfolio's value annually. "When you pay less, you keep more, regardless of whether the markets are up or down."[4]

3. *Rebalancing*: Asset allocation only works if the allocation is monitored and rebalanced to avoid unintentional drift in the proportion of assets assigned to a given class. For instance, a portfolio of 60% stocks and 40% bonds over the last twenty years would have endured significant variance. When stock prices declined in 2008-2009 the original allocation would have turned to a 52% stock allocation and 48% bond allocation. By 2016, as stock prices rebounded, it would have been 69% stocks and 31% bonds. This significant variance changes the risk/return profile for the portfolio in unknown ways. Board and finance committee members should be hearing warning bells. Unintended risk and lack of management are not in keeping with their fiduciary duties. Additionally, rebalancing may potentially add up to 0.35% in portfolio value annually. Finally, advisors who "systematically direct investor cash flows into the most underweighted asset class and/or rebalance to the "most appropriate" boundary are likely to reduce their clients' rebalancing costs and thereby increase the returns their clients keep."[5]

4. *Behavioral coaching*: Vanguard found that investors who deviated from their initial asset allocations received returns that trailed comparative benchmark returns by as much as 1.5%, suggesting that an advisor, properly coaching a board or finance committee to stick with the plan in difficult times could potentially add that much in value to the portfolio. Other academic studies have concurred including Morningstar's Mind the Gap and Dalbar's Quantative Analysis of Investor Behavior. Note that maintaining a long-term perspective and being disciplined will be much easier if a solid plan is in place for spending and investment that can be referred to when temptations to chase performance or engage in market timing rear their heads.

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[3] Bennyhoff, Kinniry, Jaconetti, DiJoseph & Zilbering: Vanguard Advisor 's Alpha, Vanguard Research, September 2016. pp.10.

[4] Bennyhoff, Kinniry, Jaconetti, DiJoseph & Zilbering: Vanguard Advisor 's Alpha, Vanguard Research, September 2016. pp.12

[5] JPMorgan Guide to the Markets. March 31st, 2017. pp. 65.

5. *Total return focus*: Historically, it has been possible for investors, institutional or retail, for-profit or non-profit, to spend only the income from a diversified portfolio. This "income only" approach, however, is no longer viable for most of them. At times, it will be necessary to spend earnings or even principal with interest rates and yields at generational lows. Again, with a proper long-term plan and perspective this is perfectly acceptable. What is not acceptable is trying to "find yield" by indiscriminately extending duration, haphazardly overweighting high-yield bonds or arbitrarily increasing the exposure to dividend stocks. Focusing on both income and capital appreciation can help manage total portfolio risk, increase diversification and lengthen the lifespan of the portfolio.

Each of these strategies modifies the risk/reward profile of a portfolio, perhaps increasing the lifespan or probability of success during recessionary periods or cycles of rising interest rates. The value added by these strategies is generally viewed as significant, but oftentimes to unique to each investor to quantify.

V. **Agree on a Service Model:** Yes, you read that correctly, "agree on" meaning there is some amount of negotiating that should be done regarding how an advisor services your relationship. Here is a hint: the amount of services you require should affect the fee you pay. Given that we identified 2.25% or more in potential value-add in the previous section, theoretically any fee below that where those services are provided should still have some value to it. Of course, this doesn't mean you should pay 2.25% or anything near that, but you should expect to pay toward the top of an advisor's range if your board, staff and donors want to rely on the advisor for education (see below). And you should expect to pay toward the bottom of the scale if all you require is a semi-annual review delivered to your finance committee.

At a minimum, the service model should be a written document briefly describing the following:

- Contact cycle: How and when will the advisor proactively contact you?
- Review cycle: How often and when will you meet for formal reviews? Will reviews be in person or via phone or screen share?
- Call turn-around times: How long before someone gets back to you when you ask a question, send an email or leave a voicemail?
- Publishing Calendar: What is sent out to educate you and when should you expect it?
- Education: Is the advisor qualified and available to give educational presentations to the board, staff and/or donors? Does he or she have a specific designation demonstrating knowledge in these areas, such as the Chartered Advisor in Philanthropy(CAP®)?
- Client events: Are client events hosted for education or networking opportunities? Will you be invited? How many of your board are welcome?

- Participation: Will the advisor accept invitations to *your* fundraisers? Will they participate, volunteer or donate?

Having an idea of what you are looking for in a service relationship will help you quickly pare down the possibilities in an RFP, especially if you put your requirements in the original letter or posting. It will also help you to negotiate a fee commensurate with the value you expect to gain from the relationship.

VI. **Educate Board Members & Staff:** If an advisor is to attend, say, four finance committee meetings and one board meeting per year, what will he or she talk about? Yes, a review of account and fund-level performance is certainly warranted as is a brief overview of capital market conditions. But why not use a resource that you are paying for to educate members of your organization at all levels. Topics on which advisors could/should educate the board or finance committee include:

- Capital market assumptions: Interest rates, inflation and changes to the tax laws all have positive or negative effects on stock and bond markets as well as the market for philanthropic giving. A brief summary of trends from a trusted third party is valuable for purposes of the organization's strategic planning.
- Investment theory: Now is the time to educate on efficient portfolios and the inner workings of a portfolio.
- New member orientation: Breakout sessions may be necessary or desirable for new board or committee members so they can fully understand the language used in the IPS and Spending Policy.
- Charitable giving strategies: It is highly unlikely that most of the board or staff has much background in the workings of various charitable strategies such as the Charitable Remainder Trust or Charitable Annuity. Who better to educate than an advisor with proper credentials and experience using such vehicles? And how better to prepare your board to raise its share of funds than giving them the tools to broadly discuss planned giving opportunities?

VII. **Educate Donors:** Once board and staff are aware of the potential planned giving opportunities available, they can speak in generalities with a donor. But they should have a resource or resources to extend donors the same educational opportunities on a more personalized, more specific basis. Unfortunately, the default answer for many organizations is to "have the donor contact their own financial advisor." But they have no idea who that advisor is, what their credentials or reputation are, or if he or she has a basic working knowledge of philanthropy. Small wonder then that most of these gifts are never completed and that advisors are often blamed for discouraging or delaying charitable intent. We discourage what we don't understand.

Non-profit consultants such as Kathryn Miree recommend bringing together vetted professionals to help with policies and educate donors. Some even have formal structured advisory boards with local attorneys, advisors and accounting professionals serving in this capacity. But most organizations don't have that kind of capacity or the ability to attract a deep pool of local professionals. But if you have properly interviewed and vetted your very own financial professional, then you have someone to turn to. This may be as simple as explaining the available vehicles and their advantages/disadvantages for the average donor. Or it could be as in depth as creating a strategic giving plan that maximizes the impact of the donor's charitable dollars. The latter may even be a relationship where the advisor is paid for his efforts in some manner. Yes, conflicts of interest are certainly possible. These, however, can be addressed in writing before an engagement begins. Miree notes that it is an expectation of any advisor providing consulting services to donors that they may end up with referral business from it. If your advisor isn't someone you'd be comfortable introducing to your best, most loyal donors, then they shouldn't be *your* advisor. Period.[6]

Patrick Huey has over 20 years of leadership experience, and over a decade in the financial services industry. He is a **CERTIFIED FINANCIAL PLANNER™** and **Chartered Advisor in Philanthropy®**, and holds a Master of Business Administration from Arizona State University.

Patrick is also volunteer Treasurer for a food and clothing relief organization. In his spare time, he enjoys travel, reading historical fiction and writing ***History Lessons***, a blog that teaches investment lessons through historical tales.

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6 Identifying Professional Relationships That Make a Difference, Kathryn W. Miree & Associates, Inc. 2005.