NEPC INTRODUCES TOTAL ENTERPRISE MANAGEMENT FOR ENDOWMENTS & FOUNDATIONS

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Overview

A primary concern for Endowments and Foundations is how to manage short-term spending needs, such that these expenditures do not eat into their long-term investment goals, according to a survey by NEPC, LLC. In particular, these institutions worry about the effect of investment returns on operations, and balancing day-to-day financial obligations with longer-term investment gains.

To this end, it is critical to understand the impact of longer-term asset allocation decisions on shorter-term operations. Enter: NEPC's new Total Enterprise Management (TEM) model. NEPC seeks to employ this model to efficiently bridge the decision-making gap between short-term operational decisions and spending needs, and long-term investment return and risk.

The groundwork for TEM was laid in January 2010, when NEPC published a white paper entitled "Endowment & Foundation Spending in an Integrated Asset/Liability Framework." In that paper, NEPC introduced the concept of spending as a liability for Endowment or Foundation assets. Widely adopted within the Endowment and Foundation community, NEPC called it the "holistic approach" to investing.

Now with TEM, we continue to build on this concept. TEM considers risk from an organizational perspective, enabling decision-makers to strike the critical balance between providing an adequate, reliable cash flow for today's operating budget and spending commitments, while investing for long-term portfolio performance that supports the organization's future goals.

To understand how the non-profit community currently utilizes TEM and what implications this may have on its investment programs, NEPC conducted a survey of Endowments and Foundations. Two themes emerged from our survey:

- There is a gap between the decision-making processes for investments and operational or day-to-day expenses; and
- There is a need for education in the Total Enterprise Management arena since it is a new concept for non-profit institutions. In the survey, 69% of respondents said they were either not familiar with TEM, or were just learning about it.

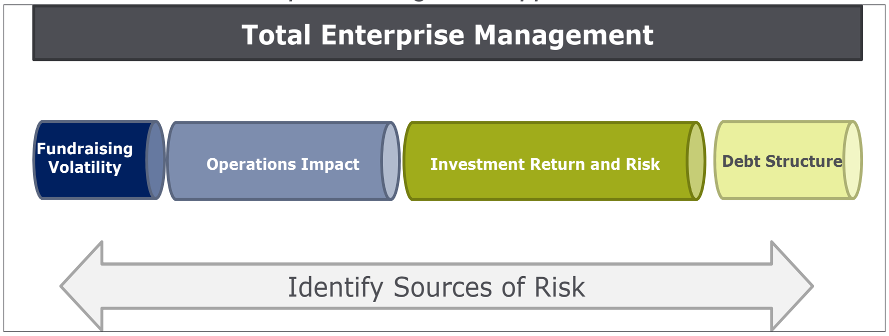
In this paper, we provide a summary of our survey results and share NEPC's thoughts on integrating Total Enterprise Management into the investment decision-making process. NEPC continues to be focused on discovering better solutions for our Endowment and Foundation clients.

NEPC'S DEDICATED ENDOWMENT AND FOUNDATION PRACTICE WORKS WITH 94 CLIENTS AND REPRESENTS $48 BILLION IN ASSETS

Total Enterprise Management: Background

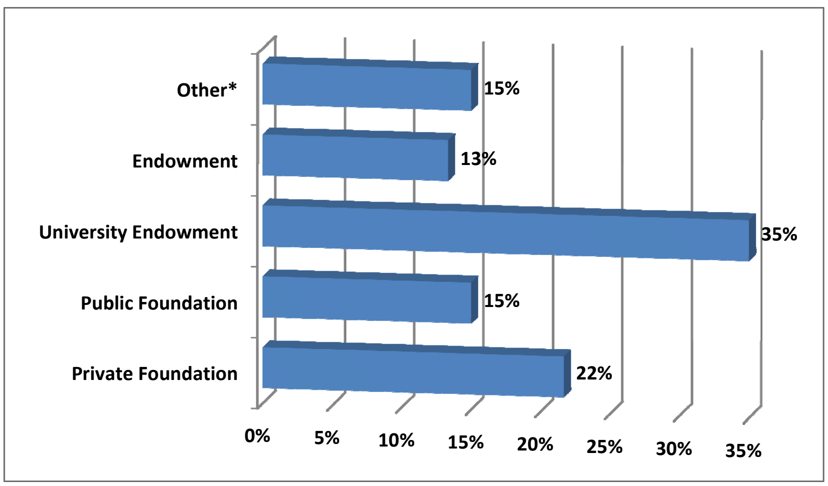
Historically, Endowments and Foundations have viewed decisions regarding fund management independently from operational decisions. For instance, decision makers--such as members of the finance committee--may give top priority to

Exhibit 1: The Total Enterprise Management Approach



shorter-term operational needs in an effort to meet their organization's mission, which may ultimately impact the investment program. On the other hand, members of the investment committee focus on growing the investment pool for the long-term. At that time, this separation made sense: it was thought that Endowment and Foundation funds should be managed with a long-term outlook, given the goals of maximizing return for an appropriate level of risk under certain liquidity constraints, and outpacing inflation to preserve the purchasing power of assets. Operational decisions were typically shorter-term in nature, and, therefore, had minimal impact on how funds were managed.

Exhibit 2: The Organizational Breakdown of Survey Participants



** Other includes multiple not for profits, 502(c)3 independent schools and community foundations*

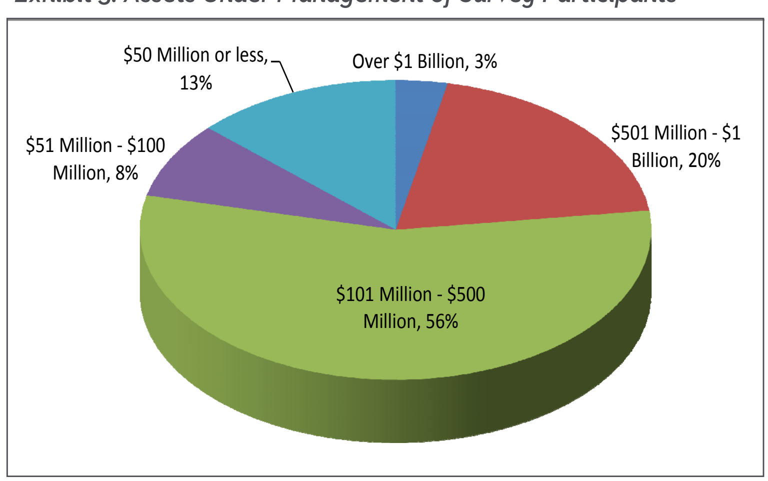
This potential mismatch of goals may have led institutions to underestimate the impact of all sources of risk to the organization and the investment pool. The issues with the traditional approach were laid bare during the Financial Crisis and the dramatic market events of 2008 and 2009. For the first time in their history, many cash-strapped institutions felt concern meeting their day-to-day financial obligations. This fueled a critical need to understand the impact of longer-term asset allocation decisions on shorter-term operations.

As a result, NEPC's Total Enterprise Management model shifts the focus from a more restrictive 'investment-only' framework to a more holistic approach, where we link the revenues, expenses, and pro forma budget of an organization to the spending policy and, ultimately, to asset allocation (Exhibit 1). Our model may be used to guide decision-makers on how to plan for the required cash flow for an operating budget and spending commitments, while investing in assets for long-term performance to support the organization's mission well into the future.

The Survey

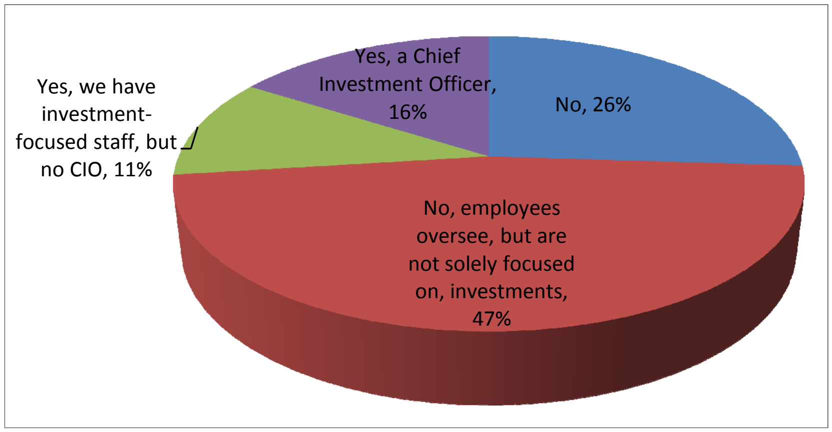
NEPC conducted a survey among a diversified group of Endowments and Foundations. The participants varied both by size and by organizational type. The highest concentration of survey respondents were university endowments (Exhibit 2). Over half of the respondents had assets between $101 million and $500 million (Exhibit 3).

Exhibit 3: Assets Under Management of Survey Participants



Given the mid-size focus of the respondents' assets, 72% of the participants in the survey did not have any staff dedicated full time to the investment programs (Exhibit 4). Additionally, the majority of participants, that is, 74%, relied on the investment committee to make investment decisions.

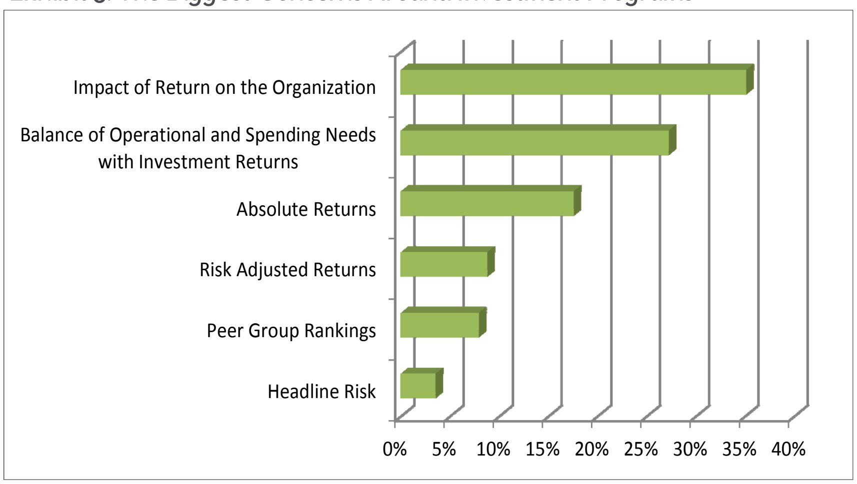
Exhibit 4: Do You Have Full Time Investment-Focused Staff Overseeing the Assets?



The Survey's Key Findings

The results of the survey corroborate our belief that many Endowments and Foundations do not have a process in place as yet to link operational and spending needs with investment return and risk, even though they are concerned about balancing the two (Exhibit 5).

Exhibit 5: The Biggest Concerns Around Investment Programs



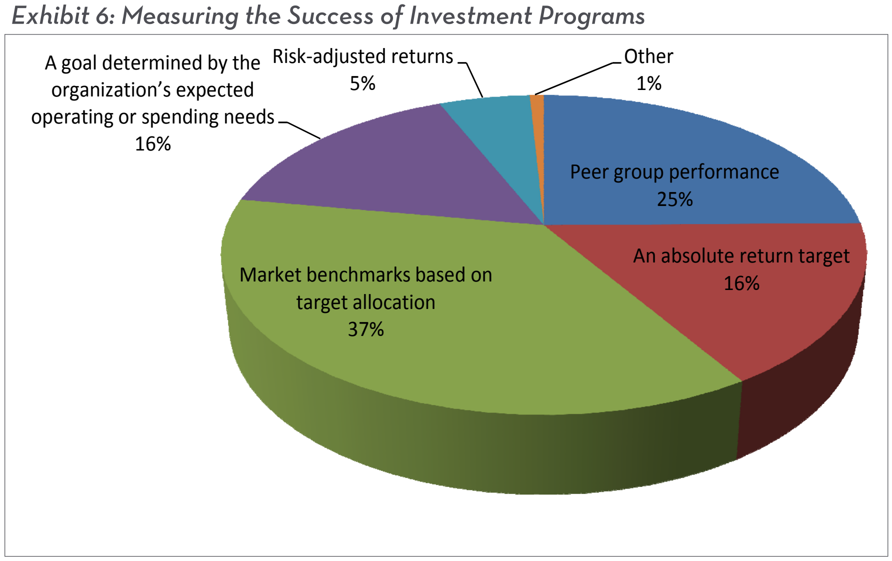
The biggest concerns of the respondents were the impact of investment return on operations, and balancing operational and spending needs with investment return. This is vital since Endowments and Foundations typically have a spending policy of around 5% of assets. That said, given the current low return environment, a 5% return after inflation may be challenging.

Additionally, 31% of respondents indicated operating needs comprised 20% or more of spending, which is high. The spending volatility associated with these institutions can hurt operations or impede their ability to make grants.

It is worth noting that there are no formal systems in place to address these concerns around spending, volatility of spending, and the impact on the operating budget.

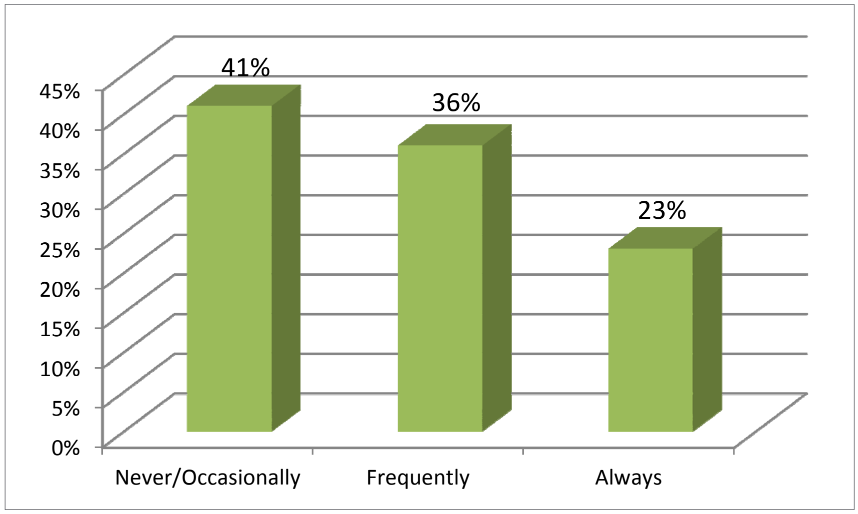
It is also telling that 62% of institutions evaluated the success of their investment program relative to market benchmarks or peer groups. In contrast, only 16% of respondents measured success by their ability to meet operating and spending needs (Exhibit 6), which we believe should be the primary goal. Additionally, 41% of the survey participants said

Exhibit 6: Measuring the Success of Investment Programs



they never or rarely discuss operational issues at investment committee meetings (Exhibit 7).

Exhibit 7: The Frequency of Budgets/Operational Issues Discussed at Investment Committee Meetings



Respondents were most worried about the following operational risks:

- Spending draw from the Endowment decreasing: 29%;
- Available cash for operations: 22%; and
- Volatility of revenues, (i.e., fundraising: 19%)

Respondents were least concerned about debt covenants and debt structure, pension contributions and volatility of grants.

The Case for Total Enterprise Management

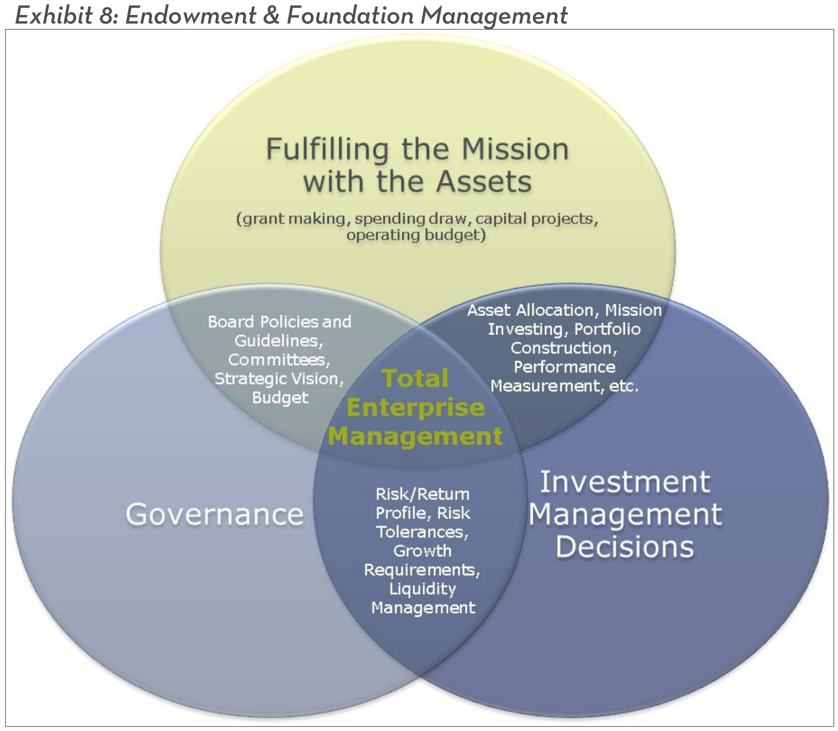
Endowments and Foundations seeking to better integrate short-term operating needs with long-term investment goals may find a viable solution in the Total Enterprise Management approach (Exhibit 8).

In order to start this process, we believe the easiest first step for TEM integration is to explicitly include budgeting and operational items as part of investment committee discussions. For example, an institution may consider incorporating, at least annually, an operational update as part of its agenda. An annual meeting with the finance committee, the president and financial staff can also help provide the framework for operational needs, both in the short- and long-term. This may include a review of the following:

- Financial statements
- Budget (approved vs. projected)
- Cash flows
- Capital projects
- Debt policy and debt covenants
- Fundraising volatility

NEPC's TEM model uses operating budget information to evaluate the needs and potential risks of the organization and the likely impact on the investment program. The most important inputs of this model come from the client's assessment of the organization's needs. The model utilizes budget items as the first step to address the organic asset growth attributable to fundraising activities, or the liability shortfall that needs to be minimized through the use of investment income and spending draw.

Exhibit 8: Endowment & Foundation Management

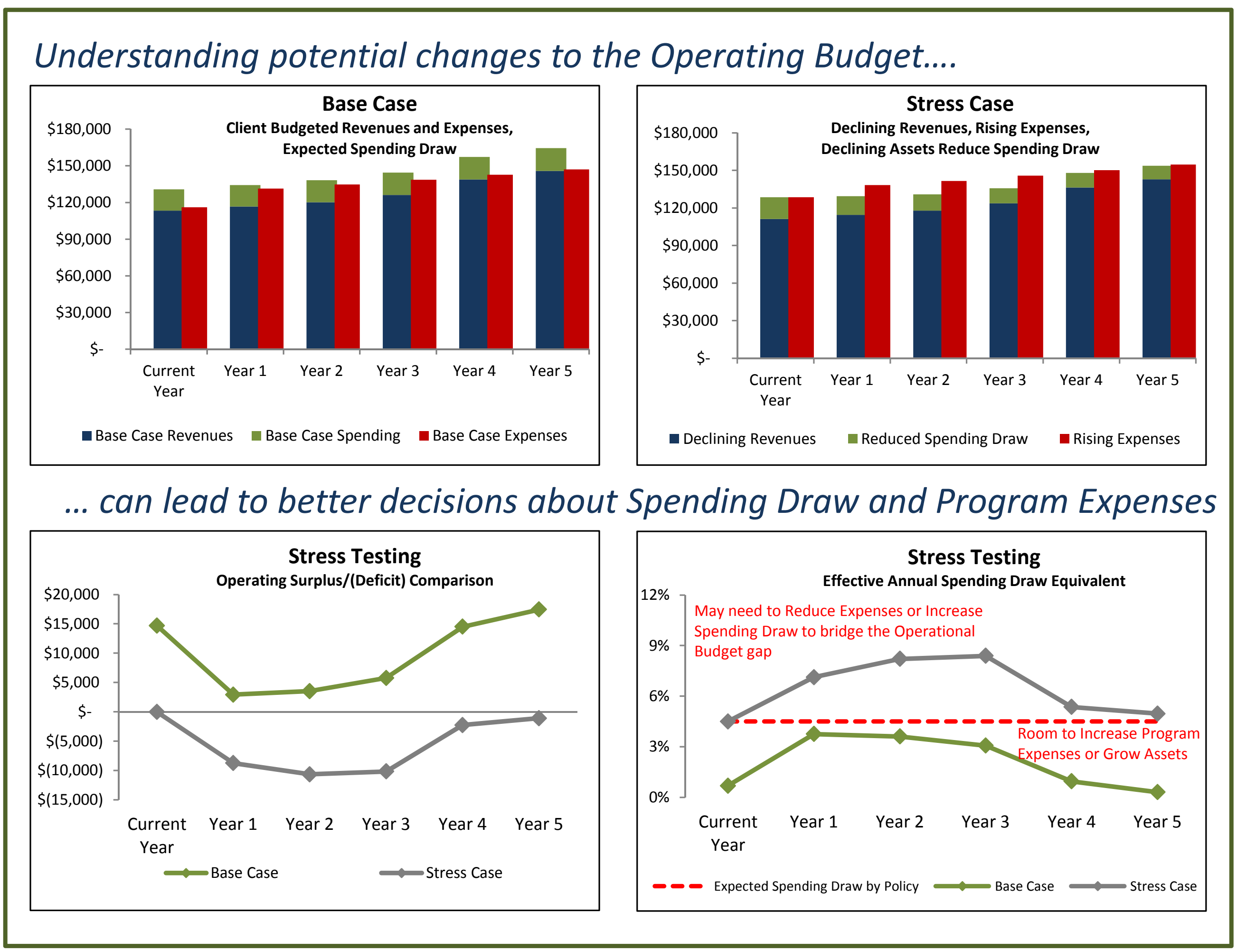


With this information we are able to determine the expected need from the assets. The expected need becomes the first building block of determining the true return goals for the assets. For instance, if your Endowment currently raises $97 million each year and the operational budget requirement is $100 million per year, then the shortfall liability to the operational budget is $3 million. If the Endowment assets total $150 million, the spending need from the Endowment starts off at 2% ($3 million in need divided by $150 million in assets). We use this input of 2%, plus inflation and growth as the building blocks to our total expected return target for the assets. With this baseline, we then conduct stress tests with the inputs of revenues, expenses, and asset value changes, which affect spending draw and investment income.

These stress tests help us determine a range of potential demands on the assets and build a diversified portfolio based on the risk profile of the organization. Building on the earlier example, if fundraising drops 5%, the revenues to the organization decline to $92 million with the operational budget still at $100 million. The demand on assets for the spending draw now increases to 5.3% ($8 million in shortfall liabilities divided by $150 million in assets). If this is a high probability event--based on conversations with staff and the investment committee--then the starting point for asset allocation may be 5.3% return, plus inflation. We may need to forego growth of the assets in order to avoid undue risk. While these variable factors may seem like a lot for investors to digest, we present the materials such that decision-makers understand the main driving forces of the organization. The end result is simple: TEM-focused outputs that help inform investment decisions.

The data in Exhibit 9 provides a snapshot of the information that ultimately gets presented to the decision-makers by NEPC and the organization's

Exhibit 9: Total Enterprise Model Sample Analysis



staff, who work together on the model. Our model can assist clients through this goal-setting and monitoring process.

Additionally, Endowments and Foundations who have adopted TEM typically focus less on peer rankings, and more on setting and meeting specific operational goals to measure the success of their investment program. These goals can range from minimizing spending as a percentage of the operating budget, to targeting a minimum required spending rate to meet operational concerns, or even maximizing the asset-to-expense ratio. Once these goals are set, they are regularly quantified and evaluated.

Conclusion

Total Enterprise Management is a natural extension to NEPC's "holistic approach" to investing, and we are excited to be one of the pioneers of the concept. In practice, our TEM model can be used to efficiently bridge the decision-making gap between short-term operational decisions and spending needs, and, long-term investment return and risk. The survey's findings have cemented our belief that there is a need within the Endowment and Foundation community to gain more insight into this process. NEPC offers this white paper, along with our proprietary TEM model, as a starting point for Endowments and Foundations beginning to focus on Total Enterprise Management.