

## Why Community Foundations and Charities with Foundations Need to Think About Their Investment Governance

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### *Executive Summary*

More than 750 community foundations operate in the United States with assets ranging from \$100K to \$1.7B<sup>1</sup>. The purpose of this paper is to explain what investment governance is and to explain its importance and value in the context of community foundations and other charities with foundations.

This paper argues that community foundations have the potential to hold a special, privileged position by virtue of their structure and community role in defined geographic regions and that this privileged position heightens the level of fiduciary obligations they owe to their communities. It will also be argued that the scrutiny of their internal investment governance practices will only increase in the near future for several reasons. Together, these factors mean community foundations must act now to put in place strong, objective and standardised investment governance procedures and be able to outwardly demonstrate to those whose support they rely on to grow (their communities, donors, lawyers and other professionals) that they have done so.

Further, charities that have their own foundations must do the same in order to be able to compete for funds on the basis of investment governance capability and trustworthiness.

### *What is Investment Governance?*

#### *Investment governance and investment fiduciaries*

**Investment governance** is a specialised discipline focusing on the legal duties of care and loyalty (broadly, the **fiduciary obligations**) owed by investment fiduciaries.

**Investment fiduciaries** are people who either give investment advice or manage the assets of another person (for example, those in governance roles) and who stand in a special relationship of trust, confidence and/or legal responsibility. For the purpose of this paper, the term investment fiduciary is used specifically in relation to people in governance roles. Examples include trustees of charitable trusts that invest funds to generate income for charitable purposes, such as community foundations, and boards of superannuation funds; these people have been trusted to look after and oversee the investment of money for the benefit of other people or charitable purposes.

Investment governance seeks to define what investment fiduciaries should do and the systems and processes they should have in place in order to fulfil their fiduciary obligations relating to investments to the greatest possible extent. It involves working to a defined, objective fiduciary standard and conducting assessments in order to outwardly demonstrate the adopted processes are consistently and effectively applied.

### *The Changing Charitable Sector and the Impact on Foundations*

The charitable sector and the structures of entities within it are complex and hugely varied, but one interesting development is the changing form and community positioning of charitable foundations. Many charities that receive donations for immediate operating expenditure can see the merit in establishing their own related investment foundation or growing their existing foundation, if they have one. There are many reasons charities do this: it makes them financially self-sustainable, it reduces reliance on annual fundraising efforts and the resources that go into them, it reduces the risk and uncertainty associated with government support and it creates valid repositories for large donations supporting the charity's mission.

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<sup>1</sup> [www.cof.org](http://www.cof.org) Council on Foundations

The last two and a half decades have also seen the emergence of community foundations, which are a special form of foundation enabling regional, community-sourced philanthropic funds to be pooled and the benefits applied across a range of charitable purposes, some of which are donor-directed.

What these two players in the foundation space perhaps do not properly appreciate is how the environment in which they operate is going to change and how these changes will impact their success in attracting donors, growing their funds and affirming their credibility with donors and centres of influence, such as lawyers and accountants.

The first factor that will cause change impacting these organisations is the trend for strengthened governance standards to which investment fiduciaries of entities such as ERISA 401(k) retirement plans are now subject.

Another factor already causing change impacting community foundations and other charities with foundations is the clear international trend of governments handing over responsibility for funding charitable purposes to the philanthropic community. For this to be successful, community foundations and other entities receiving philanthropic funds must be able gain donor confidence by demonstrating investment governance competence and, therefore, their trustworthiness in investing the funds.

*In this changing environment, for community foundations to be successful in growing and demonstrating trustworthiness, they need to acknowledge their heightened level of fiduciary responsibility and employ investment governance practices that match it.*

*The catch for other charities with foundations: they will need to follow suit.*

### ***So What Are Community Foundations?***

The community foundation concept was born in the United States over a century ago, but there has been a surge in the number and financial size of these organisations around the world since the 1990s.

Thanks to their varying cultural, social and historical contexts, community foundations come in all shapes and sizes. However, they usually have certain attributes in common.

Community foundations are independent, not-for-profit organisations governed by a board of trustees for the benefit of charitable purposes in a defined geographic community. They help individuals and organisations achieve their philanthropic goals and contribute in a lasting way to their local community.

Community foundations do this by taking donations of all sizes from individuals (for example, gifts of cash, securities, property or bequests in wills) or other organisations and making grants to local charities. Grants can be from donated capital, but most commonly, donations are pooled together and invested with a view to building a permanent fund (or funds), the income from which can be distributed to local charities for generations to come. Donors can specify the charitable purposes that are most important to them and community foundations strive to ensure the returns from specific donations are distributed in line with this.

#### *Structures*

The operational fund structures of community foundations can vary in many ways. The community foundations themselves are generally charitable trusts managing a pool of invested funds. Within that pool, there may be **sub-funds**: certain amounts of money earmarked for a particular charitable purpose or charity and certain amounts earmarked for general charitable purposes at the discretion of the community foundation's trustees. Some sub-funds may be made up of money donated by just one donor and other sub-funds may be made up of funds from various donors. There are two broad types of sub-fund: an endowment fund where funds are invested permanently so that the annual income can be distributed for many years to come and a flow-through fund where funds are distributed over a period of time. Sometimes, other charities donate capital to a community foundation to form an endowment fund for the purpose of supporting that donor charity's activities.

## **Community Foundations - A Privileged Fiduciary Position?**

*Can community foundations be seen to have a privileged fiduciary position and what does this mean for them and other charities with foundations?*

At face value, community foundations appear to hold a unique position in their local communities. Their reach is defined by a specific region and the impact of their function is felt community-wide within that region. They seek donations through recommendations of respected local professionals, such as lawyers. They seek to be the single hub in their region for funnelling philanthropic giving. Most importantly, donors are attracted first and foremost to their structure (long-term investments for multiple possible charitable purposes), flexibility and potential size, as opposed to being attracted primarily to a particular charity's single purpose and mission.

These factors point to community foundations having the potential to hold a unique and privileged position in society.. Whenever an organisation holds such a privileged fiduciary position (whether it results from legislation, as for retirement plans, or from market uniqueness, as in the case of community foundations), greater expectations of fiduciary obligations inevitably descend on those individually responsible for the governance of the organisation.

As discussed below, for community foundations to be successful in growing and demonstrating trustworthiness to donors and professional advisors like lawyers, they need to acknowledge their heightened level of fiduciary responsibility and employ investment governance practices that match it. That is, they need to strive for fiduciary excellence in investment governance.

The catch for other charities with foundations: they will need to follow suit.

## **What is Fiduciary Excellence in Investment Governance and Why Pursue It?**

Fiduciary excellence in investment governance is about more than trustees believing they govern investments to an acceptable standard. It is about being able to demonstrate to donors and others outside the organisation a commitment to excellence, accountability and transparency and, in turn, maximising an organisation's impact.

What does this mean in practice for investment fiduciaries?

- First, it means working to a recognised and credible standard with sufficient prescribed detail, not just broad principles.
- Secondly, it means being accountable and welcoming of the opportunity to objectively demonstrate effectiveness to parties outside the organisation.
- Thirdly, it means having objective processes in place to monitor performance of investments, investment providers and the meeting of the relevant governance standard and the subsequent ability to demonstrate this to stakeholders.

Crucially, investment fiduciaries can only truly achieve excellence in investment governance when their governance processes are aligned with those of the investment managers and investment advisors to whom they delegate their duties as trustees. Trustees must remember they retain ultimate responsibility when they make delegations.

*Why should community foundations pursue fiduciary excellence?*

Community foundations are built on trust, especially the trust of donors and professional firms. As with any fiduciary organisation, a community foundation's reputation is possibly its most valuable asset. To maximise their impact, they need to grow the pot as much as possible. With these factors in mind, embracing fiduciary excellence in investment governance will empower community foundations in several ways:

- First, it will help them maximise their accumulation rate through enhanced donor confidence and stronger referrals from centres of influence like law firms and other professional advisors.

***Fiduciary excellence in investment governance is about being able to demonstrate to donors and others outside the organisation a commitment to excellence, accountability and transparency and, in turn, maximising an organisation's impact.***

Anecdotal evidence suggests some donors love the idea of a community foundation, but when it comes to making a large donation, they are not confident enough in the foundation's investment practices to go through with it. Some donors have instead chosen to manage the funds themselves and make smaller donations from the returns. Donor confidence will be enhanced if community foundations strive for fiduciary excellence in investment governance and can verify they do so.

As discussed above, community foundations aim to receive donations through encouraging lawyers who advise on wills to suggest making a bequest to the local community foundation to appropriate clients. It is important to understand that whenever lawyers refer their clients to any third party, their professional and firm reputation is at stake and can be affected by the present and future reputation of that third party. This means lawyers need to be confident in their referrals. However, lawyers often do not have the capacity to do their own detailed evaluation and due diligence on third parties, including community foundations and their investment service providers. If a community foundation striving for excellence in investment governance were able to present lawyers (and in fact, the same is true for donors) with external verification of their investment governance, this would help them overcome this hurdle and result in stronger referrals.

- Also, fiduciary excellence in investment governance can help maximise the performance of investments and make a meaningful difference to returns. Established research shows that good investment governance can increase returns by as much as 1-3% per annum.<sup>2</sup> For example, effective governance practices can highlight opportunities for lower cost structures or improved diversification, which can be more effective in improving net outcomes than taking on more investment risk and complexity, as is often promulgated by investment providers. In today's economic environment where lower returns are fast becoming the new norm, the gains to be made from good investment governance can make quite a difference to the ability of community foundations to make distributions without diminishing capital.

Consequently and most importantly, the impact each year of community foundations around our country will be maximised and community foundations will be a strong and sustainable charitable force for generations to come.

#### *Why should other charities with foundations follow suit?*

Charities with their own foundations are similar to community foundations in that their aim is to grow the pot in order to maximise impact and donors, especially those making large donations, must have confidence in their investment practices before giving their support. As distinct from the flexible, multi-purpose structure of community foundations, charities with foundations are often single-purpose entities and it is a donor's love of the charity's specific purpose and mission that primarily brings them to donate. Despite this, donors will want to see evidence of the same level of investment governance competence, accountability and transparency as they will be seeing from community foundations. Donors could even set up a sub-fund with a community foundation for the sole purpose of supporting a specific charity instead of donating to that charity's foundation if they were more confident in the investment governance of the community foundation than that of the charity's foundation.

Call it competition if you like, but the point is that lack of accountable, transparent and standardised investment governance and the ability to demonstrate this could become a barrier between these charities and big donors who love their purpose and mission. This should not be the case as it is important that charities are able to maintain their own foundations for the reasons set out at the beginning of this paper.

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<sup>2</sup> M E Drew and A N Walk. "Governance: The Sine Qua Non of Retirement Security" *The Journal of Retirement*, Vol 4, No 1 (2016), pp 1-10; K Ambachtsheer. *Pension Revolution: A Solution to the Pensions Crisis*. New York, NY: John Wiley, 2007.

## *Our Recommendations as to the First Steps Investment Fiduciaries Should Take*

When challenged to think about investment governance, investment fiduciaries often respond ‘but we are all good people here.’ We agree entirely. Trustees of charities give their time and skills for the love of the charitable purpose and that is as it should be. However, pursuing fiduciary excellence in investment governance is about boards working to a recognised, objective standard, being able to demonstrate this to donors and others outside the organisation and, most importantly, reaping the subsequent benefits in the name of charitable purpose.

It is a journey to excellent investment governance; it cannot and should not be achieved overnight. Fiduciaries must prioritise tasks and make meaningful, gradual improvements. With that in mind, the journey consists of three overarching steps investment fiduciaries of community foundations and other charities with foundations can take.

***Without investment fiduciaries’ having a willingness to examine their conduct for consistency with the values they proclaim, the meaning of their fiduciary role will be undermined.***

### *1. Make a cultural shift*

We encourage investment fiduciaries to be open and make themselves vulnerable to scrutiny when beginning to strive for fiduciary excellence in investment governance. This is an essential ingredient in advancing their entity’s trustworthiness. After all, without a willingness to examine their conduct for consistency with the values they proclaim, the meaning of their fiduciary role will be undermined. Good investment governance helps fiduciaries move from appearing to be doing the right thing to having substance with which they can prove they are doing the right thing. It helps them make sure they do not have any blind spots or areas where they attribute the wrong meaning to information. For example, one barrier to removing blind spots can be conflicts of interest, whether economic or relationship-based. Conflicts are bound to exist, both at a board level and at an investment provider level. It is how they are managed that is important and good investment governance processes guide this management.

### *2. Build capacity and knowledge: understand and apply a defined investment governance standard*

CEFEX Analysts provide investment fiduciary training seminars throughout the United States. The basis of the training is a globally recognised, objective and step-by-step investment governance standard made up of what are known as Prudent Practices. The Prudent Practices represent a standard of excellence that can be the foundation of the trust placed in them by investors, beneficiaries or donors. Investment fiduciaries can implement the Prudent Practices to ensure they fulfil their fiduciary obligations and can easily demonstrate to their stakeholders how they do so.

The Prudent Practices help boards take ownership of their organisation’s investment governance by:

- ensuring investment fiduciaries are aware of how legal requirements and governing documents, such as trust deeds and service agreements, affect their organisation and all parties’ roles and responsibilities;
- ensuring investment fiduciaries know the difference between a statement of investment policy and objectives (SIPO) prepared by an investment provider and an organisation-owned investment governance policy;
- creating a framework within which effective thought processes can be applied, in contrast to the commonly observed behaviours of over-reliance on investment providers who are often selected due to brand or other business relationships rather than objective evaluation;
- assisting investment fiduciaries in ensuring that their governance is effective;
- helping investment fiduciaries to identify investment providers that are truly aligned to their entity’s purpose, values and investment policy and the trustees’ investment capacity (time, inclination and skill); and
- helping investment fiduciaries gain a full understanding of where performance gains and cost controls can be secured to the benefit of their organisation.



### *3. Regularly monitor and assess investment governance performance*

Investment fiduciaries can check they are doing a good job in their investment governance and find out the areas in which they need to focus next to improve through initial and then regular assessment against the investment governance standard.

The assessment methodology we recommend follows the well-established and recognised approach of ISO19011 (International Organisation for Standardisation) and consists of three levels.

- **Level 1:** This is an informal review based on discussion with key staff and investment fiduciaries. This can be a self-assessment that is undertaken by someone internally (provided they are familiar with the investment governance standard). However, it is typically carried out by an external analyst who can then provide valuable commentary and insights.
- **Level 2:** This is a more in-depth review and is more evidentially based, with interviews of both internal and external parties. It can still be used for internal, confidential deliberations, as is the case with Level 1 assessment, and can also be released for external review to satisfy external scrutiny. It can also be used to prepare for Level 3 assessment.
- **Level 3:** This is a more formal, independent assessment and results in certification. In the case of Level 3 assessment, an analyst contracted to the Centre for Fiduciary Excellence (CEFEX), an international body providing certification against the Fi360 standard, completes the assessment. It provides annual verification of fiduciary excellence that is publically notified and is issued to evidence capability and trustworthiness.



It is critical to note that investment fiduciaries typically delegate some of their responsibilities and some of the key elements of the investment governance standard to their investment service providers. Because fiduciaries remain responsible for any trustee duties they delegate, it is important that fiduciaries know their providers carry out the delegated functions to the same fiduciary standard. Those in governance should never assume that investment providers have put themselves in the shoes of a trustee before performing the services.

Assessment of their own investment governance practices help investment fiduciaries identify which of their duties they have delegated to providers. Also, the three levels of assessment set out above can be applied to providers themselves to evaluate how well an advisor's practices align with trustees' investment governance responsibilities. Providers can also obtain CEFEX certification.

## **Conclusion**

The successful growth of all charitable foundations in order to fulfil their valuable roles in society is at a critical point. Available funding is entwined with the massive intergenerational transfer of wealth we will see of the next 20 years, so the opportunity to make meaningful, long-term impact is there. The key to growth is trustworthiness in all respects and fiduciary excellence in investment governance is key to demonstrating this.

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