LAGUNA BEACH COMMUNITY FOUNDATION

PRUDENT INVESTING

Standards for the investment of endowments and other funds of non-profit organizations

2016

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INTRODUCTION

As a board member of your non-profit organization, you have a fiduciary duty and responsibility to help ensure the prudent investment of your organization's funds. To help you guide your decisions, we have developed some background on prudent investment standards for non-profit organizations and endowments.

WHO IS LBCF?

A community foundation is a tax-exempt public charity that guides philanthropy for the betterment of the community it serves. The Laguna Beach Community Foundation (LBCF) is dedicated to enhancing philanthropy through building funds to improve the quality of life for Laguna Beach residents.

Many non-profit organizations will choose a community foundation such as LBCF to manage their assets rather than choosing a commercial asset manager (a bank, broker or consultant). This is because community foundations provide specific non-profit expertise in investment management and oversight for endowments, operating funds, reserve funds, and other funds of non-profit organizations.

We are proud to serve our community by offering institutional quality investment management exclusively to our non-profits, private foundations, and donor-advised funds. Our investment philosophy may be summarized as follows:

- Provide broad diversification across asset classes to reduce risk
- Invest in a balance of growth (stock) and income-oriented (bond) assets
- Ensure exposure throughout the global markets
- Employ index funds to lower costs and virtually eliminate individual security risk

The result is superior long term investment returns and increased opportunities for those we serve.

PRUDENT MANAGEMENT: IT IS THE LAW

Laws governing endowments do not state specifically that assets be diversified. However, the intent of the lawmakers is clear: barring only exceptional circumstances, endowments should diversify their investments, taking into consideration spending needs.

The management and investment of charitable funds is an enormous responsibility that requires standards and enforcement to uphold quality. As such, the National Conference of

Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) in July 2006.

UPMIFA provides strong guidance in establishing the fiduciary standard for charitable organizations. The fiduciary's central consideration is the tradeoff between risk and return. An investment manager could keep a portfolio uninvested and therefore immune to market risks – but, as the act states, the very definition of "prudence requires diversification," because a portfolio in cash is still subject to other risks (for instance, foregoing growth, eroding principal, and even underperforming inflation).[1] Prudent diversification means, among other things, that an organization cannot normally invest all of its assets in cash and bonds.

The focus for any portfolio should be portfolio total return (not simply dividend and interest income). As such, it is necessary to employ a diversified approach to generate return. Fiduciaries are expected to "invest in a manner that could generate better returns for the fund,"[2] to generate "long term investment success"[3] – none of which can occur without putting money to work prudently. The law generally "follows modern portfolio theory for investment decision making,"[4] suggesting that diversifying a portfolio by investing in an array of assets to optimize return for a given level of risk is the way to "generate sufficient gains to be able to make ongoing distributions from the fund while at the same time preserving the purchasing power of the fund."[5]

However, UPMIFA acknowledges that there may be times in which diversification is not the most prudent strategy: "this subsection assumes that prudence requires diversification but permits an institution to determine that nondiversification is appropriate under exceptional circumstances."[6] It is clear to us from the context and commentary of the law that this is meant to be only an exception, and that the intent of the law is not to create loopholes for charities but to emphasize the importance of prudent investing through diversification.

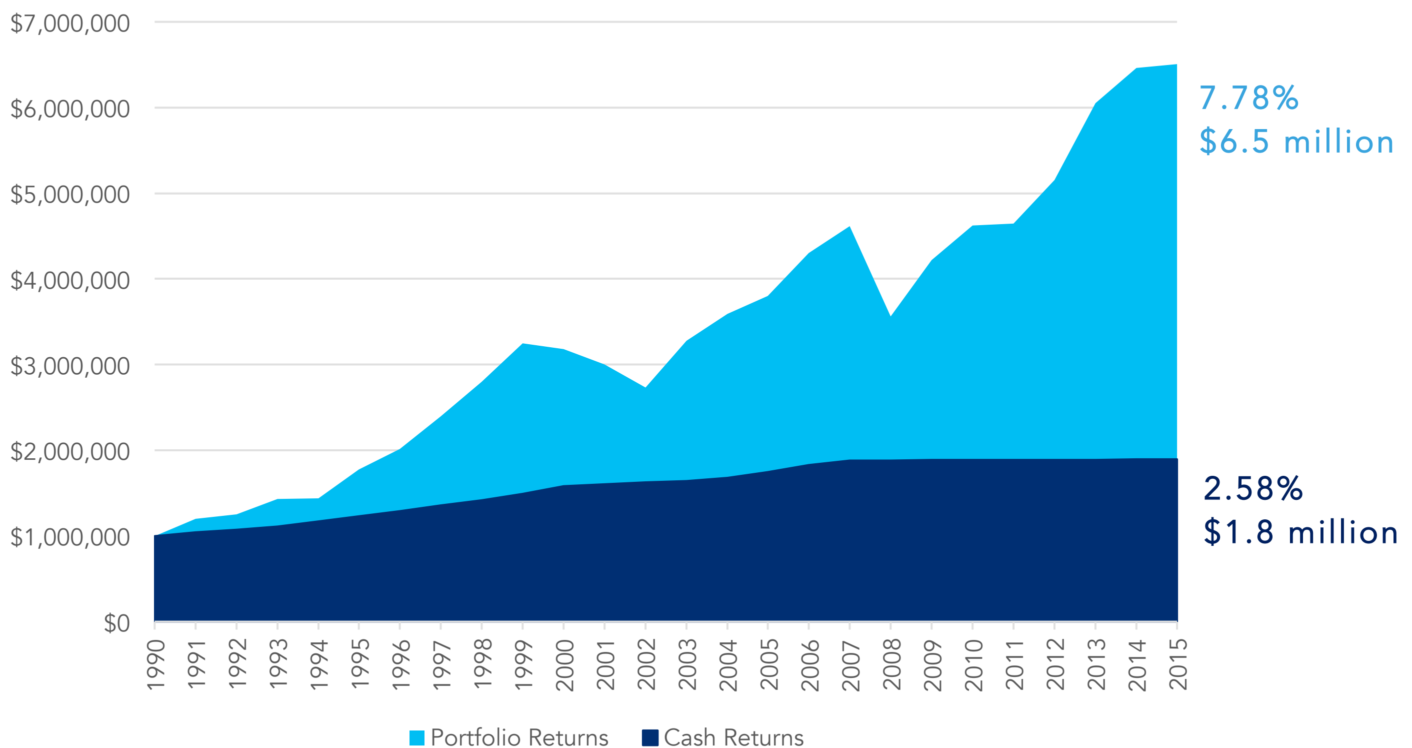
PRUDENT MANAGEMENT: THE PROOF IS IN THE DATA

Results show that a stable or cash portfolio actually generates a net loss over time when taking into account inflation and spending. The very nature of prudence is to prevent losses and maximize the effectiveness of an endowment.

[1] The Uniform Prudent Management of Institutional Funds Act 2006, *With Prefatory Note and Comments.* Page 30.
[2] Ibid., Page 21.
[3] Ibid., Page 3.
[4] Ibid., Page 13.
[5] Ibid., Page 21.
[6] Ibid., Page 17.

We conducted a study to evaluate the benefits of a fully diversified investment portfolio for endowments. We consulted the respected NACUBO-Commonfund Study of Endowments for 2015 to build a sample portfolio based on the average asset allocation of over 800 real endowments.[7] For endowments under $25 million, the average asset allocation is 42% Domestic Equities, 24% Fixed Income, 15% International Equities, 11% Alternative Strategies, and 8% Cash and Short-Term Securities.[8]

We constructed a hypothetical $1,000,000 portfolio with two scenarios: one invested in the average allocation determined by the NACUBO-Commonfund study, and one held in cash.



Even weathering the market during two of the worst financial crises in history, the invested portfolio demonstrates superior long term returns. We chose to calculate these returns over a long 25-year timespan, as nothing truly has a longer investment horizon than an endowment, which may be expected to last in perpetuity. Furthermore, after inflation and spending/withdrawals from the portfolio, the result of a portfolio invested solely in fixed income and cash is a substantial net loss.

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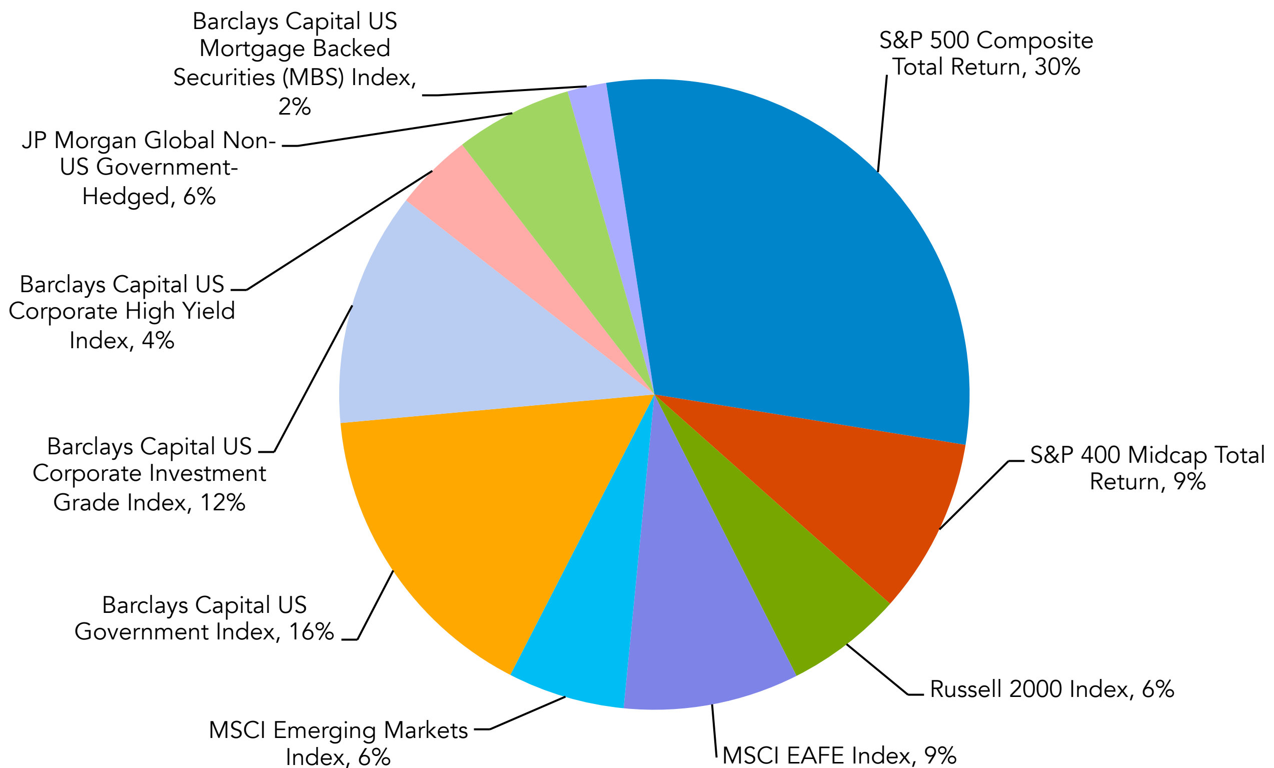
[7] 2015 NACUBO – Commonfund Study of Endowments® (NCSE).

[8] We used the S&P 500 Index for Domestic Equities, the MSCI EAFE Index for International Equities, the Barclay's Aggregate Bond Index for Fixed Income, the Hedge Fund Research Fund of Funds Index for Alternative Strategies, and the 3 Month Treasury Bill for Cash and Short-Term Securities. For each of those categories, we found the associated indexed returns dating back to 1991, along with the returns on the 3 Month Treasury Bill as a proxy for cash, and the rates of historical inflation.

LET LBCF HELP YOU

The Laguna Beach Community Foundation is the first choice of many non-profits, private foundations, and donor-advised funds for many reasons, one of which is the sound and prudent investment management that enables endowments to be successful and help many people. Our experienced investment committee manages funds on a pro-bono basis, where the administrative fee goes to charity instead of an outside commercial provider. Our indexing strategy is employed for diversification, superior long term returns, reduction of risk, and expense savings.

While organizations are free to choose whatever blend of fixed income and equity investment pools they like, below is our "LBCF Core" Portfolio, which is often a good starting point for most organizations:



This allocation has historically demonstrated success throughout the years. We adhere to a long-term prudent strategy, combining diversified global equity holdings with diversified global fixed income holdings. Risks are balanced to help assure long-term growth which allows for a consistent annual spending rate and growth of capital.

For more information, please feel free to contact the Laguna Beach Community Foundation at 949-715-8223 or via email at info@lagunabeachcf.org.