A highly complex investment environment and greater demands on the nonprofit sector are two imposing challenges. But another is the challenge of recruiting and retaining outstanding leaders—both staff and trustee. There is a legacy of volunteerism in America dating back centuries. Today, some 63.4 million people, or 26.8 percent of the population, did some form of volunteer work in 2009. Laudable as this is, there is a difference between volunteering a few hours a week to help a local community service organization and a volunteer trustee making investment decisions affecting the long-term future of a nonprofit organization. These people are valuable, as demand is high and supply is limited. They have heavy commitments in all aspects of their professional and personal lives and may not be able to devote adequate time to the myriad details that go into informed investment management decisions. When it comes to nonprofit financial management, we may be approaching the capacity limits of volunteerism.

Volunteers as leaders

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Another pressing need is developing and maintaining an integrated financial plan for the institution. Committees should work together more closely to mesh long-term investing (investment committee)
with budget, operations and liquidity needs (finance committee), audit and risk management (audit committee) and fund-raising (development committee).

The answer to limited trustee resources is a staff that is large enough to cover most, if not all, the bases. Ideally, the staff will complement investment committee policy-making and review by effectively implementing the policy, monitoring the investment program and providing reports to the committee.

The difficulty for all but a handful of the largest nonprofits is the cost of attracting, building and retaining staff. It is costly to recruit experienced chief investment officer talent—an estimated $500,000 or more for a CIO in major markets. The CIO will need to be supported by a staff of analysts and researchers and, in today’s environment, a senior risk manager should be a mandatory position. Aside from salaries, there is a range of associated costs, including benefits, IT support, research services and travel. As expensive as it is to hire a CIO and other staff talent, it is often costlier still when they move on to a higher visibility position elsewhere in the industry.

Rethinking the model
In light of the radically changed environment for nonprofits, the traditional model should give way to one of three options: 1 a fully staffed, fully capable, internal investment management team; 2 outsourcing most of the investment management function while retaining strategy and policy-making; or 3 accepting that organizations that choose not to pursue a more viable option will need to pursue simpler portfolio construction strategies consistent with their capacity to appropriately manage the risks of more complex portfolios.

It is difficult to do anything in between, with the possible exception of heavy involvement from an investment consultant firm or a multi-product firm. Even then, investment committees will need to maintain a very high degree of objectivity to determine whether they are being well served.

Looking at option number one—the fully staffed, fully capable, internal management team—in all likelihood, those nonprofit entities that will have them in the future already do. And they are very few and far between. Building and maintaining a staff of talented investment professionals is fraught with challenges, the chief one being enormously high cost closely followed by the ability to attract and retain an experienced, skilled leader. As to option three, that is something that boards and investment committees will have to decide for themselves. Let us, therefore, more closely analyze option two and focus on three potential ways of implementing it: consultants, the outsourced investment office and multi-product firms.

“Governance” comes from a Greek word meaning “to steer.”

Consultant use
Consultants are a popular alternative, but often a costly one. And the consulting industry has faced a fair share of challenges imposed on it by changes in the investment environment. For many years, consultants were nonprofits’ “external staff” or “staff extension.” They gave advice on asset allocation, helped develop policies and evaluated managers. Beginning in the 1990s, as compensation in the investment management industry grew, consultants were hard-pressed to attract and retain experienced, proven talent. In addition, consultants who were long accustomed to managing traditional stocks and bonds sometimes found themselves underequipped to manage in the new world of alternative investments. At the next stage of their evolution, some consultants phased into a hybrid consultant/outsourced model in which they not only offered advice but also made investment decisions and implemented them on a discretionary basis. This had the advantage of allowing them to charge an asset-based fee, which generated significantly higher revenues than pure fee-based consulting.

It’s important to determine why one wants to use a consultant and what an institution expects the consultant to deliver. Data in the 2009 NACUBO-Commonfund Study of Endowments® show that 86 percent of Study participants using consultants used them for asset allocation and rebalancing, while 84
percent used them for performance attribution and measurement; 83 percent for manager selection; 74 percent for policy review; and 7 percent for review of socially responsible investing (SRI) policies and practices.

Outsourced management
Another model is that of the outsourced investment management office. In this approach, the investment committee and board assign responsibility for day-to-day investment management to a qualified external provider that manages all or a portion of the institution’s investment funds. For example, some institutions outsource a portion of their assets—like their alternatives allocation—to the external manager. Typically, such a move is undertaken to lower costs, generate greater efficiencies and free up resources. One way to think about this approach is to look at the answers to two questions: 1 How can trustees exercise their responsibilities in a manner consistent with those expected of a fiduciary? and 2 How can a group of individuals focus their limited resources in a way that they can fully address the range of issues spanning everything from high-level policy to manager selection? Many institutions have concluded or, we believe, will do so in the future, that full portfolio outsourcing is a viable option given their size and limited resources. Perhaps, most importantly, by outsourcing discretion in investment decision-making, institutional clients are better able to focus on strategy, policy-making and core governance issues. It is evident that this trend has been growing among smaller institutions, but recently there have been some sizeable nonprofits opting for this approach as well.

Rather than being separate, nonprofit governance and investment management are intertwined, with one affecting the other.

The multi-product firm model
Another option is the multi-product firm model. In this approach, the committee puts its investment policy to work through a single adviser/fund manager relationship. The adviser may implement the asset allocation/rebalancing or may recommend subadvisers to manage various allocations within the portfolio, often in a multi-asset structure.

In this model, the investment committee is able to make a single decision—selecting the adviser that best suits its needs from several multi-product firms — instead of performing the due diligence and monitoring of many individual managers itself. Reporting is consolidated as well, and there may be complementary services, such as advice concerning fund-raising and philanthropy management, that the multi-product firm can offer.

Like other outsourced models, the multi-product firm frees up investment committee time to focus on higher level strategic and policy issues. Many committees are overwhelmed by the "fiduciary checklist" of tasks that must be performed, such as initial and ongoing due diligence on managers, monitoring and analyzing levels of portfolio risk, daily oversight of securities holdings, and performance attribution and reporting. A potential drawback of the multi-product firm model can be limiting the investor to the provider’s own funds or to investment managers and funds that are on the provider’s “platform.” In some cases, the use of separately managed accounts can provide flexibility and customization of portfolios. A single quarterly or annual fee includes trading, administration, custody and reporting, but can be fairly high; the investor should ask for a full description of any fees that may be paid in addition to the basic management fee.

Conclusion
The model for management of the long-term funds on which nonprofits depend to fulfill their mission is distinctly different than it was just a decade ago. The changing demands of society, a vastly different legal and regulatory environment, and an infinitely more complex investment industry have permanently altered the traditional investment committee structure and process and, in a great many cases, left committees overmatched. Further, the sharp downturn in securities markets and the accompanying deep recession of 2007/2008 exposed fissures in many nonprofits’ governance structures. Without a doubt, there are consequences for those nonprofit organizations that don’t “get governance right.”

Trustees would do well to take a wholly new look at alternatives that may be much more effective in today’s environment, including outsourcing much of the investment management process. In doing so, they may be able to increase their own effectiveness and better utilize institutional resources in pursuit of their mission.

Rather than being separate, nonprofit governance and investment management are intertwined, with one affecting the other. Outsourced models have the potential not only to enhance investment management but also lead to better governance. In this approach, the investment committee remains central to the investment management process, but refocuses to devote time and energy to strategic, policy-level issues and fiduciary matters. Outsourcing is especially appropriate for those institutions whose funds are managed by a volunteer committee with relatively little staff support.

Editor’s note: This article is drawn from an in-depth white paper, “New World, New Reality: Rethinking the Governance Model for Nonprofit Investment Management,” published by Commonfund Institute. Printed copies are available by contacting Commonfund Institute at 203-563-5021.