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Sink OR Swim?

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Positive Tension

BY TIM PHILLIPS

Imagine the following scene: Board members are sitting at a conference table, listening to an investment professional who is explaining the meaning of several different pie charts and graphs and earnestly describing the importance of pertinent returns figures and reports. Throughout the presentation the board members are attentive, shuffling papers and appearing very interested. The pitch ends, the floor is opened to questions and the board is silent.

What happened? Is it possible that no member on the board had questions about what was presented? Maybe, but not likely. A more probable culprit is a boardroom culture of silence and acquiescence.

The common boardroom culture of resignation—or even worse, negative tension—must be replaced with a culture of open communication and positive tension if boards are to be successful in providing optimally for their endowments.

From Fundamentals, Page 31

Fundamentals

investment policy may require board education to allow all board members to understand diversification, modern portfolio theory and various asset classes such as alternatives. This education will take time because many board members will struggle with modern investment approaches such as diversification, international exposure, hedge funds and REITs, among others. Board members do not need to become investment experts, but they need to understand investment concepts sufficiently to assess a proper investment policy and to understand adjusting it when appropriate. They also need sufficient understanding to assess the choice of and performance by the investment professionals.

4. When considering asset investment policies, nimbleness is a crucial consideration. Events happen fast these days, and the board cannot wait for a quarterly meeting to adjust the investment assets. Nimbleness dictates having an investment committee with authority to act and allowing the investment professional some flexibility, within investment limits, upon which the manager can act to keep the investments sound and in sync with the ever changing marketplace.

5. In addition to holding and protecting investments, a charity and its board need to understand spending their investments. All spending decisions involve fiduciary duty and prudence. In addition, donor and board restrictions, as well as state law, can affect the decisions governing which assets are available to spend and for what purposes. Restrictions can greatly impact the charity's budget process and use of funds.

6. Donors like to restrict their gifts to charity. For example, they often call their gifts "endowments," from which they expect the income to be spent but not the principal. Donors also often provide use of assets for certain purposes. Boards can also restrict assets by board policy, saying, for example, use is restricted except for an annual percent of the rolling average of investment values. These restrictions need to be honored, though sometimes the restrictions can be changed. The board needs to analyze its restrictions to determine that they continue to serve the charity across time or if they should be changed, if allowed.

7. State law often fills in gaps with regard to spending endowment funds. The older Uniform Management of Institutionalized Funds Act (UMIFA) forbids spending below historic dollar values of endowment assets. In other words, income and growth can be spent but not the originally donated funds. These rules have frozen many endowments in these depressed economic times to the surprise and often horror of charities. Luckily the majority of the states have now adopted the more modern Uniform Prudent Management of Institutionalized Funds Act (UPMIFA) allowing the charity to spend endowment funds without express limits as long as the board acts prudently considering many factors. UPMIFA also provides methods to alter some restrictions on investments.

8. The various restrictions imposed by donors and boards also have important financial statement implications. Audited financial statements must show the restricted assets in specific ways. Charities need to consider this financial statement presentation and adopt policies and work with their auditors to assure proper and desirable financial statement presentations.

Protecting investments is critical for all charities, both in the investment decisions and in asset use. This prudent focus also will protect the board members from questions and perhaps even liability. In today's roller-coaster economy and investment environment, such protection will help charities survive and their board members sleep easier at night.

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From Positive, Page 32

The Oregon 529 plan's recent fall from grace has served to highlight many shortcomings in current systems of board oversight, namely the lack of pertinent questions asked. (A 529 plan is a state-sponsored, tax-advantaged investment vehicle designed to help and encourage families to save for the future higher education expenses of a designated beneficiary. The plans are governed by Section 529 of the Internal Revenue Code. See **www.oregon529network.com**.) Once one of the nation's top 529 plans, the value of Oregon's plan fell almost 25 percent in 2008, negatively affecting 70,000 investors and the futures of some 100,000 students.

While the falling markets themselves were the main reason for this decline, the losses were exacerbated by the risky investments incorporated into the plan. While Oregon is suing Oppenheimer Funds Inc. for investing conservative and even ultraconservative funds in risky mortgage-backed derivatives, was it possible to avoid—or at least mitigate—this financial tragedy? After all, there was a board of five individuals who approved these investments—people whose duty it was to ask the right questions and ensure that there was proper oversight of all investments.

The situation with the Oregon 529 plan makes another common shortcoming apparent: the frequent lack of due diligence or research performed by board members. While laws in the case of this 529 plan do allow a firm to provide both a product and the supervision for that product, (an arrangement which is, in fact, common in this specific industry) critics feel that the oversight board for the 529 plan should have employed a method similar to that used by PERS, Oregon's Public Employees Retirement System, where management and investment duties are separated. Had the members truly considered possible outcomes of a situation where a firm is both managing and investing funds, the damage might have been minimal rather than the drastic $36.2 million loss.

To keep the interest in initial investment-related questions at the forefront of future discussions, the board might want to keep a seed list of ongoing issues. This can be reviewed at meetings to refresh board members' minds and make sure that the necessary issues are addressed. Following through and answering the necessary questions all endowment boards should ask will make it more likely that your group's investments are successful:

- What type of due diligence are you performing?
- What are the liquidity goals of the organization?
- How do you generate manager choices?
- What is the appropriate benchmark?
- How do you budget risk for this allocation?

One of the most important assets a member brings to any board is experience. The exact combination of experience, expertise and knowledge varies by individual, and this complex mixture of strengths aids in decision making. However, when board members are uncertain of how their own knowledge might compare with that of others, this breadth of information might not be fully utilized. No member wants to be seen as a know-it-all or as someone who steps on toes. Also, it is always easier to assume that other members know what you know, or even more than you do, about an issue, which allows some to avoid the personal risk involved in speaking up. However, assuming others know more, or at least enough to make an informed decision, can cause major problems.

It is also easy to fall into the groupthink habit or the bystander effect. Instead of positively changing the direction of a group or process, members choose instead to go with the flow and concede to the group, just sitting back and assuming that other people are taking care of the tough job of researching an idea.

The best way to establish effective group interplay is to actively foster a culture of open communication. Start by establishing a common focus, employing a system of group norms or expectations, and establishing roles. Set aside time to work together as a board and determine the group's true priorities of focus, rather than working off of assumptions. This will ensure all members know what is most relevant, and they will not be as inclined to second guess themselves.

Having an open discussion about each other's experiences and strengths also should lead to realizations about who is best suited for which type of position on the board. These "positions" do not have to be static or generic, but change depending on the task at hand. For example, the type of conversations needed to create roles in the board room could lead to a common understanding about whose expertise is best suited to determining how much liquidity a fund should have. While this is not something that would be necessary for each board decision, it demonstrates how the right communication would allow for the proper person to step forward confidently when the time is right.

Endowments would benefit enormously from the deeper relationships built and mutual respect realized among board members as a result of better idea flow. Working together in an environment of positive tension would allow each board member to participate more fully to the benefit of the endowment, and that, after all, is the point.

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