TIM PHILLIPS

Nonprofit Boards Must Keep an Eye on Hedge-Fund Investments

NONPROFIT ORGANIZATIONS have long relied on the income from carefully invested endowments to cover expenses. Those endowments are often run by professional money managers and overseen by financial officials at the nonprofit institution as well as members of the board and other volunteers.

Due to the nature of nonprofit endowments, managers traditionally have placed funds in relatively safe investments to protect the perpetuity of the endowment. That generally meant that the majority of the money was invested in a combination of conservative stocks and bonds. But as nonprofit organizations have faced growing demands on their endowments, many are looking for better returns than that mix can produce.

The biggest nonprofit endowments have turned to hedge funds—a type of private and unregistered investment pool, traditionally limited to sophisticated, wealthy investors.

For example, college endowments have more than 40 percent of their money in hedge funds and other alternative investments, up from just 27 percent in 2000, according to the National Association of College and University Business Officers.

The returns from hedge funds are a big reason some of the wealthiest institutions have achieved such stellar returns in recent years. However, as the crisis in the financial markets shows—especially with the collapse of Bear Stearns—the reason hedge funds can offer such great returns is that they are risky.

The trustees and other volunteers who oversee nonprofit endowments need to ask tough questions when their organizations are considering putting any portfolio assets into hedge funds. As a member of several nonprofit boards, I know that volunteers in charge of investing oversight are keeping a close eye on matters such as how much of the endowment has been invested in subprime loans—and that is wise—but few people who sit on investment committees are looking nearly close enough at hedge funds.

Hedge funds can be tricky to understand as they often rely on an array of creative investment practices. The fund's managers are able to "short" stocks (bet against them by selling them first and then seeking to rebuy them at a lower price).

Trustees and other volunteers who oversee nonprofit endowments need to ask tough questions before organizations put money into hedge funds.

Often, borrowing is a key aspect of what hedge-fund managers do. For example, a fund places $100,000 with a prime broker that then lends the fund $500,000 to invest, potentially increasing returns by six times. As a simple example, if the $600,000 returns 10 percent, the fund has made $60,000 return (not counting interest and fees from the initial $100,000 investment). Without the loan from the prime broker, the return on $100,000 would have been $10,000. This approach allows for much higher returns but also increases the possibility of greater losses since the loan needs to be repaid regardless of how the investment performs.

This approach to borrowing—known as leverage in financial circles—is not something to be avoided entirely; it is an effective and common practice in the banking, business, and real-estate industries. However, the public fall of the prime broker Bear Stearns was largely due to its aggressive lending to hedge funds. The collapse has frightened many other prime brokers into reducing the amounts that they will loan to hedge funds.

For certain hedge-fund clients, several investment banks have raised the minimum equity requirements. This tactic allows the banks to insure themselves from hedge-fund collapses due to market turmoil.

However, it alters the economics of the hedge funds and puts new pressures on them to maintain investment returns while using less leverage. As a result, John Griswold Jr., executive director of the Commonfund Institute—a research arm of the organization that handles the investments of many colleges and other nonprofit groups—told *The Economist* that "some investment committees, stuffed with alumni, may be starting to lose track of the risks their endowments are taking."

If an endowment's returns are largely due to effective use of leverage in hedge funds, and the source of credit needed to continue this practice no longer exists, what is to become of the nonprofit entities relying on this income?

At worst, an organization will face serious financial woes, and at the least, the mission of the organization will be compromised by a lack of money. It is therefore critical that those people in charge of endowment investments are aware of all practices, particularly practices such as leverage, which can lead a nonprofit organization to financial ruin.

Thanks to a lack of disclosure rules for hedge funds, many committees remain unaware of the potentially dangerous reliance on leveraged hedge funds.

Hedge funds are often very secretive about investment strategies and holdings, and because they do not have to register with the U.S. Securities and Exchange Commission, they are not required to report their results to the public. Many investors are even required to sign nondisclosure agreements, so they are unable to share information and may themselves have only limited information in the first place. This ambiguity creates a situation in which nonprofit investment-committee members are unaware of how much their portfolios rely on leveraged funds.

It is critical that all people in charge of endowment investments are aware of practices that can lead a nonprofit organization to financial ruin.

Because an endowment is essential to helping organizations do a good job of carrying out their missions, any loss of income due to bad investing practices would be extremely detrimental. According to a June 2008 article in *Pensions & Investments,* the Art Institute of Chicago held 87 percent of its endowment, then worth $667-million, in hedge funds in 2001. That year the institution lost $43-million in a failed hedge-fund investment, a fate any institution would prefer to avoid.

The main goal for an endowment must be preservation of capital for the use of future generations. The returns generated from the invested amount must be high enough to sustain the needs of the current generation, and the investment practices used to gain these returns must be prudent. It is imperative that each endowment committee is not only aware of, but also understands, all methods used by its fund managers.

To do so, each endowment committee must instruct staff members and consultants to conduct an immediate and exhaustive review of their hedge funds' reliance on leverage. It would be meaningful to include a review of all private equities as well, as many rely on leverage to conduct buyout practices. The results of each study should then be reported to the committee for full discussion. It is only through greater openness about investment choices that institutions can steer away from budget problems and ensure that they will have the resources they need to benefit future generations.

Tim Phillips is chief executive of Phillips and Company, a Portland, Ore., company that helps charities and foundations manage their endowments. A former board chairman of the Children's Cancer Association, Mr. Phillips currently serves as a regent for Pepperdine University and is on the committee that oversees the university's endowment.