KODA

The Principles of Endowment-Style Investing

PART II

A guide to investment governance for trustees, directors and committee members of non-profit organisations

Sabil Chowdhury
Adviser & Partner, Koda Capital

Investing for Non-Profits | February 2024

“Endowments face two daunting responsibilities: help fund the institution’s current operations and ensure resources with adequate purchasing power are available to support its activities in the future.

The solution lies in achieving satisfactory investment returns. Fortunately, endowments benefit from long time horizons and, for the most part, insulation from sudden large withdrawals of capital.

These advantages should allow endowments to pursue creative investment solutions without undue concern for short-term volatility.”

Howard Marks Co-founder & Co-chairman of Oaktree Capital Management

Contents

Introduction

As one of the oldest classes of institutional investors, endowments are dedicated sources of funding established by non-profit organisations. Endowments are intended to be invested over the very long-term, while generating sufficient returns to support the objectives and mission of non-profit organisations.

The trustees of endowment funds accept the responsibility of stewardship and act as the guardians of the bestowed capital. They are responsible for protecting and growing an endowment's capital over multiple generations. While this role is a privilege, it also comes with significant challenges, given the constant changes in market, economic, geopolitical and regulatory conditions.

To ensure the financial stability of endowments, trustees require a fiduciary mindset and a strong understanding of investment governance frameworks. This paper provides a comprehensive guide for trustees, directors and members of non-profit organisations to help protect and grow capital over the long-term.

This paper builds on the principles discussed in Koda's first endowment investing paper[1] and incorporates best practises observed with clients and leaders from the non-profit sector. In this paper, we discuss the importance of defining an endowment's purpose, building effective investment governance policies and prudently managing capital to help achieve the mission and objectives of non-profit organisations.

> "Someone's sitting in the shade today because someone planted a tree a long time ago"

Warren Buffett | Berkshire Hathaway

[1] The Principles of Endowment-Style Investment (2021), Koda Capital, https://kodacapital.com/wp-content/uploads/Koda-Capital_The-Principles-Of-Endowment-Style-Investing_April-2021.pdf

An Endowment's Purpose

All financial decisions made by non-profit organisations should be driven by their core mission and purpose. Endowments have unique circumstances and defining an endowment's purpose sets a clear path for key decision making.

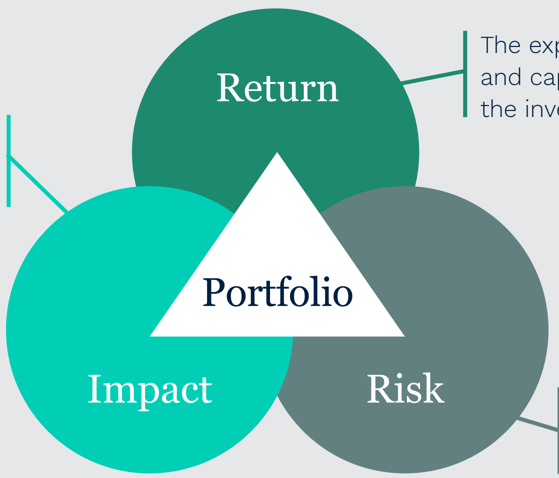
Defining an endowment's purpose may seem obvious, but many decision-makers overlook this step and move straight to discussions on financial outcomes. Once an endowment's purpose is clearly articulated, it should be documented in its governing policies. This avoids any ambiguity amongst trustees, directors and committee members when making key financial decisions.

An endowment's purpose should not be limited to financial metrics alone. The increasing trend towards responsible investing has led to a greater focus on aligning investment strategies with environmental, social and governance (ESG) factors. In recent years, Koda has seen a significant increase in responsible investing requirements in non-profit mandates as community and stakeholder expectations continue to evolve.

Traditionally, endowments have focused on maximising financial returns and minimising risk. As responsible investing grew in relevance, a third dimension of investing emerged: impact. Impact investing aims to achieve positive social and environmental outcomes while generating strong financial returns. Incorporating responsible investing allows endowments to better align portfolios with the organisation's values, mission and purpose.

> "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society"
>
> Larry Fink | Chairman & CEO, BlackRock, 2020 Annual Letter to CEOs

Exhibit 1. Three Dimensions of Investing[2]



[2] Responsible Investment – Using Your Capital for Profit and Purpose (2020), Koda Capital, https://kodacapital.com/wp-content/uploads/koda-capital-responsible-investment-november-2020.pdf

Effective Investment Governance

Investment governance encompasses the policies, processes and procedures related to oversight and decision-making when allocating capital. Effective investment governance fosters a culture of responsible stewardship and empowers trustees, directors and committee members to make informed decisions while upholding their fiduciary responsibilities and obligations.

Governance Structure

A clear and robust governance structure is essential for effective investment governance. Well-crafted governance policies delineate the roles and responsibilities of trustees, board of directors and investment committee members, outlining their respective roles and responsibilities in setting investment policy, monitoring performance and adhering to regulatory requirements. These roles and responsibilities are explained below.

Trustees are entrusted with overseeing the investment activities, establishing governance frameworks and upholding the highest standards of legal and ethical conduct. The role of trustees encompasses fiduciary duties, strategic decision-making and the stewardship of protecting and growing an endowment's bestowed capital.

The board of directors oversees the organisation's operations, finances, strategy and risk management. The board's responsibilities include approving strategic decisions and ensuring compliance with legal and ethical guidelines and policies.

An investment committee is often a subset of the board, or in larger endowments, a subset of the finance committee. An investment committee oversees the portfolio administration, investment management and maintains the investment policy statement (further discussed below).

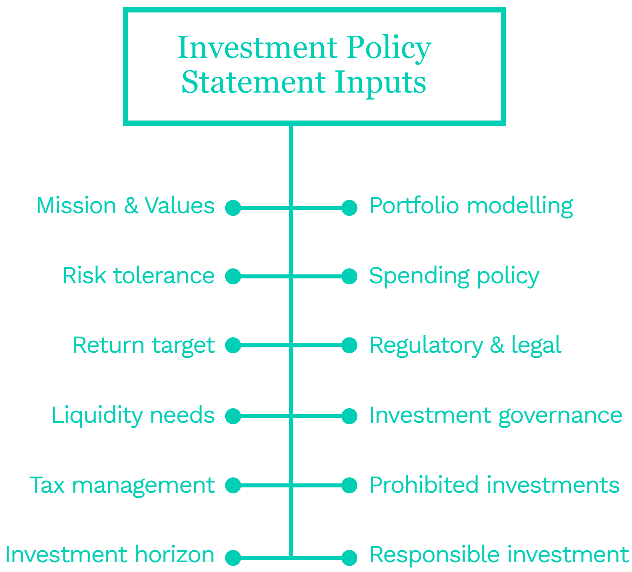
Investment Policy Statement

An investment policy statement (IPS) is a governing document providing instructions and guidance on managing and reviewing investments. An IPS is an iterative document that should be reviewed and updated regularly to consider any changes to the non-profit's situation and objectives.

A well-written IPS provides clarity to all stakeholders and preserves the organisational memory for new trustees, directors and committee members. A clear and structured IPS helps guide the board, trustees and other key decision-makers to a consensus on specific requirements, including risk and return profile, asset allocation parameters, liquidity requirements, performance benchmarks and responsible investing guidelines.

The key components of an IPS should help provide a structured framework for investment decision-making, monitoring and reporting. For an investment policy statement to be effective, it should contain several key attributes, as shown in the diagram to the right.

Exhibit 2: Investment Policy Statement Inputs[3]



[3] Investing for Non-Profits: An Effective Investment Policy Statement (2016). Financial Standard, https://rainmaker-s3-media.s3-ap-southeast-2.amazonaws.com/prod/media/library/FS_PrivateWealth/FS_Private_Wealth_-_Investing_for_non-profits_-_Simon_Duckett.pdf

Measuring Performance

Governance policies that specify regular portfolio monitoring and performance measurement help non-profits remain compliant with their IPS and ensure they are on track to achieve their objectives. A key component to measuring performance is selecting which relative and/or absolute return benchmarks to use.

Relative returns measure a portfolio's performance compared to a specific benchmark or index, for example, comparing the returns of an Australian equity portfolio relative to the S&P/ASX 200 index. In contrast, absolute returns measure a portfolio's overall net performance, irrespective of market performance or conditions and can be linked to inflation, for example, a CPI + 2% annual return target.

Regular portfolio monitoring allows key decision-makers to identify and address any issues or deviations from the investment strategy and act accordingly to rebalance a portfolio's allocations to stay invested throughout market cycles. An investment adviser can help with determining the appropriate benchmarks for measuring performance, monitor portfolios and recommend investment changes when required.

Risk Management

Managing risk and compliance are also integral components of investment governance. Effective risk management policies are essential for identifying, assessing and mitigating risks that may impact an endowment's portfolio. At the same time, robust compliance measures are vital for aligning key decision-making with the regulatory framework.

A comprehensive risk management framework encompasses the assessment of regulatory, operational and market risks, among others, providing a holistic view of potential threats that may affect the endowment. Trustees, directors and investment committee members should regularly review and update their risk management processes, policies and controls that safeguard endowments while adhering to regulatory requirements.

Discussion for Decision-Makers

1. Does the endowment have defined roles and responsibilities for making key decisions?
2. Are all the board members aware of the relevant legal requirements they must uphold?
3. Has the board aligned the IPS to the endowment's purpose statement?
4. Does the endowment have a capital management policy defining the objectives of each pool of capital, how large it should be, how it should be treated and who is authorised to make decisions about it?
5. Does the board have regular times scheduled to review all relevant policies, including the IPS?
6. Has the board selected suitable financial benchmarks to measure the portfolio performance and does this align with the board's risk tolerance?

Prudent Financial Management

Prudent financial management is best demonstrated through the policies and processes by which a non-profit's balance sheet and cash flows are managed proactively. This section discusses how genuine portfolio diversification, effective spending policies and liquidity management are essential for prudently managing capital.

> "The most treasured asset in investment management is a steady hand at the tiller"
>
> Robert Arnott | Research Affiliates

Genuine Diversification

Diversified portfolios can better withstand market corrections, minimise portfolio volatility and help investors stay the course during turbulent market conditions while preserving long-term capital. Allocating to a variety of investments with little correlation between them is the key to achieving genuine portfolio diversification.

In their influential paper, "Determinants of Portfolio Performance" (1986) Gary Brinson, Randolph Hood and Gilbert Beebower showed that asset allocation accounts for more than 90% of investment portfolio outcomes. These findings complement Harry Markowitz's earlier paper "Portfolio Selection," which showed that a diversified portfolio exposed to uncorrelated asset classes will have lower volatility and generate consistent long-term returns.

Spending Policy

It can be challenging to balance the need to preserve an endowment's long-term capital whilst also providing budgetary support for ongoing operations. Spending policies can help resolve this tension between these competing priorities.

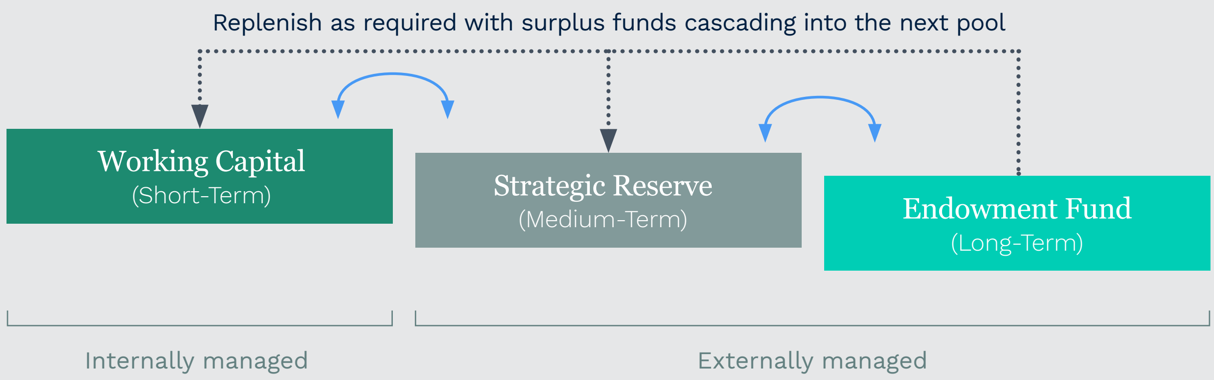
Effective spending policies include target payout rates, determined by estimating the income generated from an endowment's portfolio used to support ongoing operations. The income generated should match the spending rate without the need to diminish any capital, ensuring that the endowment's capital is preserved over multiple generations. For example, the Harvard Endowment targets an annual payout rate of 5.0% to 5.5% of the endowment's total portfolio value[4].

Liquidity Management

Supporting short-term operating cashflows while preserving long-term capital requires careful planning and management of liquidity. Liquidity can be managed by utilising Koda's 'purpose of funds' approach, illustrated in the diagram on the next page.

[4] Harvard University's Endowment Website, Accessed on 16.12.2023, https://finance.harvard.edu/endowment

Exhibit 3: Managing liquidity across separate capital pools



This approach involves segregating a non-profit's assets into separate pools of capital. The separate pools of capital are interrelated and mutually support each other in meeting liquidity and cash-flow requirements.

When surplus funds build up beyond a mandated minimum pool balance, they can flow into the next pool, enabling the funds to be invested for better returns over a longer timeframe. When funds fall below a mandated minimum pool balance, that pool may be replenished from the most appropriate reservoir.

Tracking a non-profit's operating reserves ratio helps with managing liquidity, especially during unforeseen events when having access to available cash is essential. The operating reserves ratio measures the longevity of an organisation's ongoing expenses covered by its operating reserves. Operating reserves are the portion of contingency funds set aside in the case of emergencies, such as during the COVID-19 pandemic. The calculation for the operating expense ratio is shown below:

Operating Reserves Ratio = Operating Reserves / Annual Expense Budget

Discussion for Decision-Makers

1. Does the endowment have a capital management policy, which defines the objectives of each pool of capital, how large it should be, how it should be treated and who is authorised to make decisions about it?
2. Has the board considered the diversification of the portfolio and what 'diversification' looks like to them?
3. Has the board reviewed the endowment's spending policy and considered an appropriate annual target payout rate?
4. Has the board considered the amount that should sit in a strategic reserve fund?
5. Is the endowment's operations reserves ratio appropriate to circumstances?

Conclusion

Effective investment governance helps non-profit organisations achieve better clarity, trust and confidence. It also gets them in better positions to attract and retain donors by demonstrating a commitment to responsible stewardship of financial resources.

The first step in the investment process involves determining the endowment's purpose, which sets a clear path for key decision-making. Well-articulated governance policies such as the IPS help guide non-profit boards, trustees and investment committee members when making key investment decisions. Prudent financial management ensures financial stability and helps protect and grow capital over the long-term.

By following the best practices discussed in this paper, non-profit organisations will be in better financial positions to navigate the uncertainties and complexities of the investment landscape to fulfill their mission and purpose.

> "Opportunity comes to the prepared mind."
>
> Charlie Munger | Berkshire Hathaway

Selecting a Trusted Adviser

Investment governance is not a one-size-fits-all approach. It requires customisation based on the deep understanding of the specific needs and circumstances of a non-profit organisation. For this reason, selecting the right investment adviser is a critical decision for non-profits.

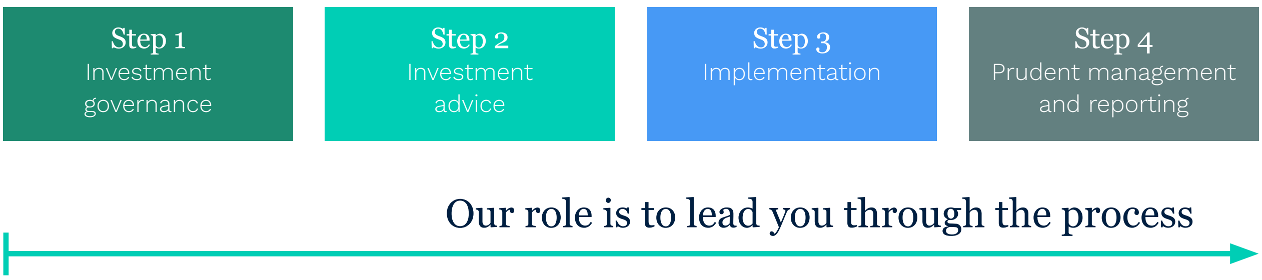
The selected adviser should be independent and always act in the best interests of the organisation. The selected adviser should also demonstrate specialist skill sets and expertise in investment governance and understand the nuances and intricacies of managing long-term capital on behalf of endowments.

As Australia's largest independent wealth adviser, Koda thinks and acts like a fiduciary when advising clients. A key differentiating factor in Koda's advisory process relative to our peers is the up-front work and due diligence to ensure that the appropriate governance frameworks and policies are in place and aligned with our client's objectives, mission and purpose.

Developing an appropriate investment governance framework is the first step in Koda's advisory process as shown in the diagram below. This step involves taking the time to carefully review, improve, and develop governing documents and policies aligned with each client's regulatory requirements, objectives, and purpose.

Once an appropriate governance framework is set, the next steps involving portfolio construction, implementation, ongoing management, and reporting fall into place and Koda's role is to guide trustees, directors and committee members through this process.

Exhibit 4: Koda's Investment Advisory Process



We hope you found the second instalment of Koda's endowment-style investing paper valuable. We welcome the opportunity to discuss how we may be able to assist your organisation with our independent and award-winning investment advisory service and team of specialists.

Please email info@kodacapital.com if you would like to schedule an appointment with a Koda Partner to review your organisation's governance frameworks, policies and investment strategy.

About the Author

Sabil Chowdhury
Partner | Investment Adviser to Non-Profits
Koda Capital

Sabil is a Partner and Investment Adviser at Koda Capital and has worked in financial services since the mid-2000s. Sabil specialises in advising non-profit organisations, family offices and executives with their investment management.

His specialisations include advising on customised investment mandates, strategic and tactical asset allocation, alternative investments, financial modelling, risk management, governance and compliance for non-profit organisations. Sabil has authored several papers, some of which have been published in the Financial Standard and Journal of Family Office Investment.

Before joining Koda, Sabil was a Private Wealth Adviser at Macquarie Private Bank, providing holistic wealth management and investment advice to executives, family offices and non-profit organisations. Prior to that, he had advisory roles at Perpetual Private Wealth and KPMG Risk Advisory.

Sabil holds a Bachelor of Mathematics from the University of New South Wales, a Master of Management (Graduated with Distinction) from the University of Sydney Business School and a Diploma of Financial Planning (RG146) from Kaplan. Sabil is FASEA accredited and has qualifications in SMSF, Gearing/Lending and ASX Derivatives Levels I and II.

Contact

E sabil.chowdhury@kodacapital.com

M +61 438 668 768 | T +61 2 8651 3458

References

1. Cambridge Associates (2016). The Foundation of Good Governance for Endowments and Investment Committees. Cambridge Associates Enterprise Edition. https://www.cambridgeassociates.com/wp-content/uploads/2016/05/The-Foundation-of-Good-Governance.pdf
2. Clemson University's Endowment Definitions (2023). Clemson University Website. https://media.clemson.edu/toolkit/devtoolkit/enterprise/140523-02%20Endowment-Inserts_Revised_May14_w.pdf
3. David Chambers, Elroy Dimson & Charikleia Kaffe (2020) Seventy-Five Years of Investing for Future Generations, Financial Analysts Journal.
4. David Knowles (2022) Establishing an Investment Portfolio. Koda Capital. https://kodacapital.com/wp-content/uploads/Establishing-an-Investment-Portfolio.pdf
5. David F. Swensen (2009) Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment. New York: Free Press.
6. Ekam Juneja (2021) Picture of University Endowment. Pexels. https://www.pexels.com/photo/chemistry-building-in-the-university-endowment-lands-british-columbia-10471589/
7. Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower (1986) Determinants of Portfolio Performance, The Financial Analysts Journal.
8. Harvard University's Endowment Website, Accessed on 16.12.2023, https://finance.harvard.edu/endowment
9. Michelle Sanchez (2021) Nonprofit Ratios: How to Use Them and What They Measure for Your Organization. Warren Averett. https://warrenaverett.com/insights/nonprofit-ratios/
10. Richard Franz and Stephan Kranner (2019). University Endowments: A Primer. CFA Institute - Research Foundation Briefs. https://www.cfainstitute.org/-/media/documents/article/rf-brief/rf-brief-franz-university-endowments.pdf
11. Simon Duckett (2016) Investing for Non-Profits – An Effective Investment Policy Statement, Financial Standard, the Journal of Family Office Investment. https://rainmaker-s3-media.s3-ap-southeast-2.amazonaws.com/prod/media/library/FS_PrivateWealth/FS_Private_Wealth_-_Investing_for_non-profits_-_Simon_Duckett.pdf
12. Victoria Lindores (2020) Responsible Investing – Using your capital for Profit and Purpose. Koda Capital. https://kodacapital.com/wp-content/uploads/koda-capital-responsible-investment-november-2020.pdf

Important Information

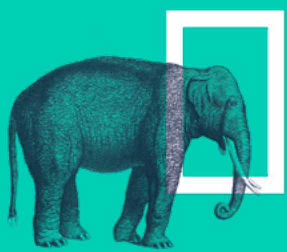
This material has been delivered to you by Koda Capital Pty Ltd ABN 65 166 491 961 AFS Licence No. 452 581 (Koda) and has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation. This material does not take into account your investment objectives, financial situation or particular needs. This material does not constitute an offer or inducement to engage in an investment activity nor does it form part of any offer documentation, offer or invitation to purchase, sell or subscribe for interests in any type of investment product or service. You should read and consider any relevant offer documentation applicable to any investment product or service and consider obtaining professional investment advice tailored to your specific circumstances before making any investment decision.

Past performance is not necessarily indicative of future results and no person guarantees the future performance of any strategy, the amount or timing of any return from it, that asset allocations will be met, that it will be able to be implemented and its investment strategy or that its investment objectives will be achieved. This material may contain forward-looking statements. Actual events or results or the actual performance of a financial product or service may differ materially from those reflected or contemplated in such forward-looking statements. This material may include data, research and other information from third party sources.

Koda makes no guarantee that such information is accurate, complete or timely and does not provide any warranties regarding results obtained from its use. This information is subject to change at any time and no person has any responsibility to update any of the information provided in this material. Statements contained in this material that are not historical facts are based on current expectations, estimates, projections, opinions and beliefs of Koda. Such statements involve known and unknown risks, uncertainties and other factors and undue reliance should not be placed thereon.

Any trademarks, logos and service marks contained herein may be the registered and unregistered trademarks of their respective owners. This material and the information contained within it may not be reproduced, or disclosed, in whole or in part, without the prior written consent of Koda. Please refer to our Financial Services Guide (FSG), using the link below for further information about the type of financial services provided by Koda Capital Pty Ltd.

FSG Link: https://kodacapital.com/wp-content/uploads/Koda-Capital-FSG-Version-8.4-September-2023.pdf



kodacapital.com