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Fulfilling your mission

A guide to best practices for nonprofit fiduciaries

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Fiduciary best practices

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Introduction

The value of nonprofit service in today's society

Serving on the investment committee of a nonprofit or other charitable organization can be a rewarding way to serve your community and society. Nonprofits provide a large share of services critical to quality of life both domestically and internationally. They are on the front lines of some of the world's greatest challenges: providing food, medicine, and college scholarships for the underprivileged; protecting the environment; and eradicating diseases worldwide.

Such service is not without its share of unique challenges, however. Chief among them is often the limited financial resources available to support your institution's mission. Financial sustainibility, has long been a concern. The pandemic made things even more difficult, according to a 2021 survey from the Urban Institute, which highlighted declines in donations and fee-for-services, as well as staffing.

To the extent that a nonprofit investment portfolio exists, it may not be large enough to attract and retain qualified staff to manage the daily operations of the investment portfolio. These difficulties underscore the importance of establishing strong financial principles and practices within the nonprofit community.

The investment decision-making group for nonprofits can range from a large, diverse investment committee to a finance committee, board, staff, or other decision-making entity. For the purposes of this reference manual, we will refer to any decision-making entity as the investment committee.

Reflecting the resource challenges of many charitable institutions, this reference manual offers investment committee members and their staff valuable guidance on a number of functions vital to serving a nonprofit in an investment-oriented role, including:

- At the board level, the critical importance of a well-written, thoughtful investment committee

Figure 1. Challenges indicated by nonprofit leaders

Erosion of donations

Donation trends	2020	2015-2019
Increased significantly	25%	28%
Increased moderately	30%	21%
Stayed more or less the same	32%	17%
Decreased moderately	6%	14%
Decreased significantly	5%	24%

Staffing	Urban	Suburban	Rural
Full-time staff	1%	4%	0%
Part-time staff	–1%	–12%	–18%
Regular volunteers	–23%	–24%	–41%
Episodic volunteers	–42%	–35%	–58%

Fee-for-service declines	
<$100,000 annual spending	–33%
>$100,000 to $499,999	–25%
>$500,000 to $999,999	–38%
>$1,000,000 to $9,999,999	–20%
>$10,000,000	0%

Source: Urban Institute, *Spring 2021 National Survey of Nonprofit Trends and Impacts*, https://www.urban.org/research/publication/nonprofit-trends-and-impacts-2021.

charter that clearly defines roles and responsibilities so committees can function efficiently.

- At the committee level, the essential role the investment policy statement plays in specifying your organization's investment strategy, portfolio construction, risk tolerance, spending policy, manager selection, and criteria for success.
- The need to establish an effective communication plan that disseminates information to committee members in a timely manner.
- The importance of maintaining diversity of thought and an orderly decision-making process through effective committee meeting agendas.
- Your responsibility as a fiduciary and key statutes and precedents you need to understand to help avoid legal jeopardy.

Unfamiliar territory for some

Nonprofit boards and investment committees may be different in structure from customary corporate board membership (Figure 2).

- Nonprofit investment committee members often come from more diverse backgrounds with a wider variety of skill levels. Some are extremely knowledgeable and have professional investment experience while others are relative newcomers to the financial world but bring more expertise on their organization's mission.
- Service on a nonprofit investment committee is generally performed on a volunteer basis, whereas many corporate board members are compensated for their work.
- Spending decisions for nonprofits can be more subjective, particularly for a foundation. By comparison, corporate boards are generally restricted by a variety of constraints, including the need to fund regular pension payments.
- Nonprofits, particularly those with perpetual endowments or foundations, have much longer investment time horizons, which can encourage a focus on long-term asset allocation and investment structure rather than short-term performance. Longer time horizons also place higher priority on managing the entire portfolio, with

Figure 2. Different roles: Nonprofit and corporate boards

Difference	Nonprofit	Corporation
Member backgrounds	Wide variety of investment expertise. Board members tend to come from more diverse backgrounds with a wider variety of investment expertise.	Usually have professional financial backgrounds. Board members are more likely to come from professional financial backgrounds.
Compensation	Volunteer. Investment committee service is usually performed on a volunteer basis.	Paid. Board members are more likely to be compensated financially.
Spending authority	Board members generally have more flexibility.	Restricted by a variety of constraints, including money to fund regular pension payments.
Time horizons	Generally longer, sometimes perpetual. Some nonprofits, particularly those with perpetual endowments or foundations, can have much longer investment time horizons.	Generally shorter. Shorter time horizons because of strict pension funding rules and financial statement impact.

Source: Vanguard.

less attention on the performance of individual asset classes, securities, and sometimes liquidity.

Subtle differences among nonprofits

There is also significant diversity within the nonprofit sector in terms of goals, objectives, and investment management strategies. Private foundations and endowments held by public charities may appear to share many of the same characteristics, but there are critical differences between the two.

For example, private foundations must distribute at least 5% of the average market value of their investment assets each year or face significant tax penalties. They generally receive few new infusions of capital to boost operations and must rely almost exclusively on investment income to support obligations. Private foundations must also focus on meeting short-term obligations even at the expense of long-term purchasing power. In contrast, endowments held by public charities do not face the same restrictions and can focus on preserving long-term purchasing power.

A tool kit for your responsibilities

Both seasoned and prospective committee members face new challenges unique to nonprofit investing. Each organization has to tailor its investment practices to fulfill its mission and make adjustments when necessary.

At Vanguard, we adhere to the highest ethical standards and continually strive to help clients achieve their missions. While we provide many services to help our nonprofit clients meet their fiduciary responsibilities, there are other steps investment committees should take on their own. These are presented in this guide, as well as in a number of companion pieces that can be found online at vanguard.com/nonprofitresourcecenter.

Defining your role

Defining the fiduciary role

Fiduciary: Someone having legal authority for managing another person's or organization's money. The primary duty of a fiduciary is to manage a prudent investment process without which the components of an investment plan cannot be defined, implemented, or evaluated.[1]

A brief history of U.S. fiduciary law

To better execute your fiduciary responsibilities, you should first have an understanding of the origins of your legal obligations. While much of the historical context behind the role of a fiduciary pertains to the management of individual trusts, the advances that took place in this area during the second half of the 20th century are also relevant to nonprofits.

Significant events

Fiduciary responsibilities in the United States have evolved over the past half century to the point where modern investment committees have much wider latitude to support their organizations' long-term objectives. This has not always been the case. Until recently, judicially created restrictions based on English common law have mandated that fiduciaries be judged on an individual investment basis rather than on the overall performance of a well-diversified portfolio (Figure 3).[2]

This perspective reduced potential returns by forcing fiduciaries to rely almost exclusively on conservative investments to meet court approval. Traditional trust law included a number of restrictions on investments, including a prohibition on junior mortgages and new ventures, with some states taking the extreme step of creating legal lists of approved trust investments.[3] This restrictive environment not only limited potential returns but also allowed asset values to be eroded by inflation.[4]

In the early 1950s, Harry Markowitz published his landmark paper. Portfolio Selection, which has become the generally accepted origin of modern portfolio theory.[5] This theory combines speculative and safe investments in an effort to generate consistent portfolio returns.[6] Markowitz developed the concept that a diversified portfolio is considered prudent in most cases because the expected rate of return

[1] Foundation for Fiduciary Studies, 2004.
[2] Borkus, 2001.
[3] National Conference of Commissioners on Uniform State Laws, 1994.
[4] Borkus, 2001.
[5] Borkus, 2001.
[6] Phillips Jr., 1997.

Figure 3. Key events in fiduciary history

Event	Significance
South Sea Company (1720)	• Financial collapse of English company established fiduciary doctrine in England and America of protecting portfolios through conservative bond investments.
Harvard v. Amory (1830)	• Massachusetts Supreme Court ruling established modern prudent man standard. • Permitted fiduciaries to incorporate riskier investments into portfolios, provided they used good judgment.
King v. Talbot (1869)	• New York Court of Appeals decision restricts fiduciaries to government- and mortgaged-backed securities.
Modern Portfolio Theory (1952)	• Concept developed by Harry Markowitz that a diversified portfolio is considered prudent in most cases.
Ford Foundation Studies (1969)	• Cary and Bright report argues that traditional trust law does not apply to endowed funds and fiduciaries for such funds balance current and future spending needs, taking into account loss of purchasing power caused by inflation. • The Barker study recommends that educational endowments adopt total return strategies and that the management of those funds be delegated to professional money managers.

Sources: Borkus, 2001, Gary, 2007, McElhaney, 2010.

increases without substantially increasing the portfolio's overall risk.[7]

Modern portfolio theory stands in sharp contrast to the policy of "safe" investing under traditional fiduciary doctrine. The ultimate goal is to balance portfolio risks and returns through diversification of assets. By using a wide range of investments to build a portfolio that more closely reflects the overall market, higher returns are possible.[8] A diversified portfolio is considered prudent because it minimizes the specific risk associated with any one investment. Using a broad spectrum of investments, including those once considered speculative, can improve the portfolio's expected rate of return without inherently increasing its exposure to uncompensated risks.[9]

In 1969, the Ford Foundation published two studies that were particularly influential in helping to advance portfolio theory for endowed funds. The first report, The Law and Lore of Endowment Funds by William L. Cary and Craig B. Bright, Esq., argued against the traditional trust law concept of prioritizing current income requirements over generating realized gains. Instead, the authors called for endowments to give equal consideration to capital appreciation needs.[10]

The second Ford Foundation report, Managing Educational Endowments by Robert R. Barker, analyzed the investment returns of 15 large educational endowments and compared their performance with 21 randomly selected balanced funds, 10 large growth funds, and 1 university endowment from 1959 to 1968. The average annual return for the 15 endowments lagged significantly behind the others during this 10-year period. The report attributed its findings to the endowments' focus on avoiding losses and maximizing present income.[11]

Markowitz's work and the Ford Foundation studies led to the development of the Uniform Management of Institutional Funds Act (UMIFA), the Uniform Prudent Investor Act (UPIA), and, more recently, the Uniform Prudent Management of Institutional Funds Act (UPMIFA). All of these statutes create a fiduciary standard that essentially warns against exercising extreme conservatism.[12]

[7] Phillips Jr., 1997.
[8] Phillips Jr., 1997.
[9] Phillips Jr., 1997.
[10] Schneider, 2002.
[11] Schneider, 2002.
[12] Borkus, 2001.

Statutory breakthroughs—UMIFA, UPMIFA, UPIA

In 1972, the National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted UMIFA. The act is significant because it embraced the concept of total return. In contrast to previous statutes and policies that restricted endowment spending to income investments such as interest and dividends, UMIFA authorizes organizations to spend from capital appreciation on endowment fund assets (Figure 4).

UMIFA also grants investment boards the authority to pursue any investment authorized under law and to delegate investment authority not only within their committees and sponsoring organizations but also to outside advisors and managers.

At the time, UMIFA was seen as groundbreaking legislation for advocates of modernizing fiduciary standards, but its prohibition on endowments from spending below their historical dollar value limited many smaller organizations to investing in cash equivalents, such as certificates of deposit. This strategy forced these institutions to retain sufficient funds and not break the law by dipping into their corpus.

Twenty years later, the Prudent Investor Rule, ratified by the American Bar Association in 1992, built on many of the advances made by Markowitz and UMIFA. This policy recommendation gives fiduciaries greater flexibility to consider any investment to create a desirable balance between risk and return for a given trust and includes the following features:

- Duty to balance risks against total returns. In contrast to the previous trust doctrine, which characterized return as income yield alone and condemned trustees for speculative investment practices, the Prudent Investor Rule acknowledges that excessive conservatism can prove equally harmful to trust beneficiaries and considers increases in market value as part of the trust's return.[13]
- Duty of impartiality. The Prudent Investor Rule expands the concept of trust preservation to include the protection of trust capital and its purchasing power from the threat of inflation. An investment strategy that seeks maximum income yield may minimize growth of trust capital. Such a strategy may satisfy the income needs of current trust beneficiaries but leaves the trust with diminished purchasing power for future beneficiaries. This approach violates the duty of impartiality by favoring one group's interest over another's.[14]
- Authority to delegate. The Prudent Investor Rule builds on UMIFA by encouraging trustees to use outside expertise to identify investment opportunities.
- Investing in a cost-conscious manner. The new policy requires trustees to balance transaction costs associated

[13] Phillips Jr., 1997.
[14] Phillips Jr., 1997.

with outside advice, investment fees and commissions, and additional capital gains taxation against the prospect that these activities will lead to increased returns.[15]

The new rule was codified by the NCCUSL as UPIA in 1994. While UPIA applies primarily to family trusts, the act has served as the foundation for further modernization of fiduciary standards for charitable organizations.

In contrast to UMIFA, which maintains strict prohibitions against spending below endowments' historical dollar value, UPIA grants fiduciaries more flexibility to spend both principal and income for funds held in trust. This flexibility allows trustees to select investments without having to realize a particular portion of the portfolio's total return from traditional income investments.

As the focus of endowment management has shifted from growing assets to preserving long-term security, UMIFA has increasingly been seen as obsolete by the fiduciary community. For this reason, the NCCUSL approved UPMIFA in July 2006 to update and replace UMIFA.

In addition to further modernizing best practices for nonprofit fiduciaries, UPMIFA differs from its predecessor in the following ways:

- UPMIFA abolishes UMIFA's historical dollar-value limitation and provides better guidance on prudent investing, which makes the need for a floor on spending unnecessary.
- Investment managers are not limited in the kinds of assets they may seek for the portfolio under UPMIFA.
- UPMIFA requires prudence in incurring investment costs, authorizing only costs that are appropriate and reasonable in relation to the nonprofits' assets, the purposes of the institution, and skills available to the institution.

Figure 4. Key model statues modernizing U.S. fiduciary law

Laws governing charitable trusts	Laws governing nonprofit corporations	Significance
	Uniform Management of Institutional Funds Act (UMIFA) (1972 et seq)	Provided uniform rules for the investment of funds held by charitable institutions and the expenditure of funds donated as "endowments" to those institutions. Embraced concept of total return. Prohibited endowments from spending below their historical dollar value.
Uniform Prudent Investor Act (1994)		Increased the duty to diversify trust assets. Directed the trustee to consider the entire portfolio when making investments by allocating risk across the portfolio rather than on an asset-by-asset basis.
	Uniform Prudent Management of Institutional Funds Act* (UPMIFA) (2006 et seq)	Expands on UMIFA and has replaced it in every state except Pennylsvania as of 2018. Designed to mirror UPIA. Abolishes UMIFA's historical dollar-value limitation on expenditures and provides for diversification of assets, pooling of assets, and total return investment.

Source: Gary, 2007, Langbein, 2004, Uniform Law Commision, 2018.

[15] Phillips Jr., 1997.

Figure 5. Accounting terms and statues

Accounting standard/law	Timeframe	Description
FAS 116 (1993)	Published in 1993 and updated in 2008	Addresses accounting for contributions received and contributions made.
FAS 117 (1993)	Published in 1993 and updated in 2009	Establishes standards for general-purpose external financial statements provided by nonprofits.
FAS 124 (1993)	Published in 1993 and updated in 2010	Focuses on accounting standards for certain investments held by nonprofits.
Sarbanes-Oxley (2002)		Required publicly traded companies and other entitites to adhere to stricter corporate governance standards that broaden board member roles in overseeing financial transactions and auditing procedures. Primarily applies to for-profit corporations but is relevant to the accounting and control standards for nonprofit organizations. Prohibits retaliation against whistleblowers. Prohibits destruction, alteration, or concealment of certain documents or the impediment of investigations.
Revenue Recognition from Contracts with a Customer (ASU 2014-09, topic 606)	Amended in 2014 and effective for fiscal years starting on or after December 15, 2018	Creates a single, principles-based revenue recognition standard under generally accepted accounting principles (GAAP).
Presentation of Financial Statements of Not-for-Profit Entities (ASU 2016-14)	Amended in 2016 and effective for fiscal years starting on or after December 15, 2017	Describes how nonprofits classify net assets, liquidity, and availability of resources, expenses, and investments.
Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made (ASU 2018-08, topic 958)	Amended in 2018 and effective for fiscal years starting on or after December 15, 2018	Provides clarifying guidance on accounting for the grants and contracts of nonprofit organizations as they relate to the new revenue standard (ASU 2014-09 Revenue from Contracts with Customers). Delineates a more detailed framework for nonprofits in defining whether a transaction should be considered a contribution or exchange transaction.

Sources: BoardSource, 2006, Financial Accounting Standards Board (FASB) 2018, 2016, 2014, 2008.

Accounting standards and other criteria

In addition to being informed of the legal statutes affecting nonprofits, investment committee members also must be familiar with other general legal, accounting, and tax terminology impacting their responsibilities. It is beyond the scope of this document to cover all the different laws and rules governing charitable organizations. However, nonprofit fiduciaries at a minimum should be well versed in the following accounting standards, laws, and regulations to protect their sponsoring organizations and themselves from potential difficulties. (Figures 5 and 6).

Figure 6. Key filings and investment regulations

Tax law/Term	Description
Form 990	• Annual reporting document that nonprofits file with the IRS. • Provides information on a filing organization's mission, programs, and finances. • Has several variations including 990PF for private foundations.
Jeopardizing investments	• Investment by a private foundation considered to jeopardize the carrying out of the exempt purpose of a private foundation. • Foundation managers who knowingly participate in jeopardizing investments are subject to substantial excise taxes.

Source: Internal Revenue Service, 2018.

Your fiduciary role

The modernization of U.S. fiduciary standards has made it considerably easier for nonprofit investment committees to serve the best interests of their sponsoring organizations.

At Vanguard, we view your fiduciary role as focusing beyond the technical meaning of a statute or regulation and concentrating on how that legal requirement can be used to maximize the welfare of your sponsoring organization in pursuit of its mission. This means applying personal experience, judgment, and knowledge in concert with understanding the regulatory framework. More specifically, nonprofit fiduciaries have an obligation to bring the highest level of ethical conduct and care to the operation and ongoing management of the organization's portfolio.

Investment committee members should meet certain standards of conduct and attention in fulfilling responsibilities to their sponsoring organizations. Under most state laws, nonprofit fiduciaries have three major duties:

1. Duty of care: Nonprofit fiduciaries must use the same degree of care, skill, and diligence that a prudent person would use in handling corporate affairs. Board members can fulfill their responsibility largely by being informed about matters of importance to their sponsoring organization. This means keeping apprised of relevant information before making important decisions or acting on behalf of the nonprofit.

2. Duty of loyalty: Fiduciaries must put any personal or private interests aside and always act in the best interests of their sponsoring organization. Self-dealing, conflicts of interest, and even the appearance of impropriety should be avoided at all costs. Self-dealing occurs when a fiduciary stands to gain financially from a nonprofit decision.

3. Duty of obedience: Nonprofit fiduciaries must comply with applicable fiduciary law while keeping the organization true to its mission.

We have identified five additional responsibilities essential to good fiduciary conduct:

- Fiduciary liability. Investment committee members must understand their fiduciary responsibilities and the potential liabilities of serving on the committee.
- Investment committee organization. Committees should be carefully organized and staffed with individuals who understand their organization's mission and what they must do to support it.
- Investment selection and monitoring. Fiduciaries must select appropriate investments that are consistent with the unique needs of the organization. They also must decide whether a prospective manager's approach and philosophy fit the portfolio's objective.
- Portfolio costs. Costs incurred by the portfolio must be reasonable, paid out by the portfolio, and aligned with your spending policy.
- Administrative oversight. Investment committee members must oversee the creation of committee documents to ensure the committee is operating in accordance with those documents. They must also satisfy all legal and regulatory rules issued by relevant agencies.

Laying a strong foundation

Creating an effective committee charter

Many nonprofit investment committees make asset allocation decisions or select investment managers before establishing a charter. Vanguard believes this sequence is ill-advised and that nonprofits should first lay a foundation by having a serious discussion about the structure of an investment committee and the responsibilities of its members.

Given the relatively informal nature of most nonprofit investment committees, which often are composed of volunteers from a wide range of backgrounds and investment skill levels performing multiple tasks, a clear outline of duties is a crucial first step. A nonprofit cannot develop an effective investment strategy without first having identified potential committee members and staff to execute this plan.

To accomplish this, nonprofits should craft a well-written and clearly articulated charter clarifying the role of each committee member. Even the most thoughtful investment plan will have difficulty succeeding without the right people in place to implement it. Therefore, serious discussion of any other issue related to the formation of the investment committee is somewhat irrelevant until a committee has determined who is going to serve on its board and in what capacity.

An effective charter helps investment committees avoid the following common mistakes:

- Conferring committee membership as a reward.
- Relying too heavily on a single committee member for either financial support or investment expertise.
- Allowing potential conflicts of interest.
- Making portfolio decisions based solely on industry peers.[16]

A charter should identify the length of time members are expected to serve and be clear about which ex-officio positions are permanent (e.g., CFO) and which should rotate. We recommend that nonprofits consider a minimum of five years of service by members and be wary of rotating more than one-third of the committee members in any one term. Gradual shifts in committee composition are one of the most effective ways to balance the need for continuity and institutional memory with the importance of fresh perspectives.

The charter must also familiarize new committee members with the organization's investment goals and approach while educating them on their fiduciary responsibilities. Other important components of an effective charter include:

- Eligibility requirements for serving on the committee.
- Committee size.
- The process for appointing a committee chair.
- Member guidelines for establishing and monitoring the portfolio.

[16] Vanguard, 2004.

- The roles and responsibilities of permanent staff and outside consultants.
- The frequency with which the committee meets to review the investment policy statement (IPS), investment manager and fund performance, and financial statements.

A well-formulated investment committee charter not only defines roles and responsibilities but also serves as a useful tool for uniting committee members behind the purpose and mission of your organization. By having members agree up front to the principles detailed in this document, your charter will encourage the committee to unify behind the organization's purpose and policies for achieving its goals.[17]

Developing a strong investment policy statement

Once your organization has clarified roles and responsibilities, your next step is to develop a well-written IPS that outlines a financial strategy that will support the mission of your nonprofit. An IPS defines the purpose, objectives, and measures of success for your portfolio. It also summarizes the portfolio's investment strategy and outlines the process for evaluating investment managers.

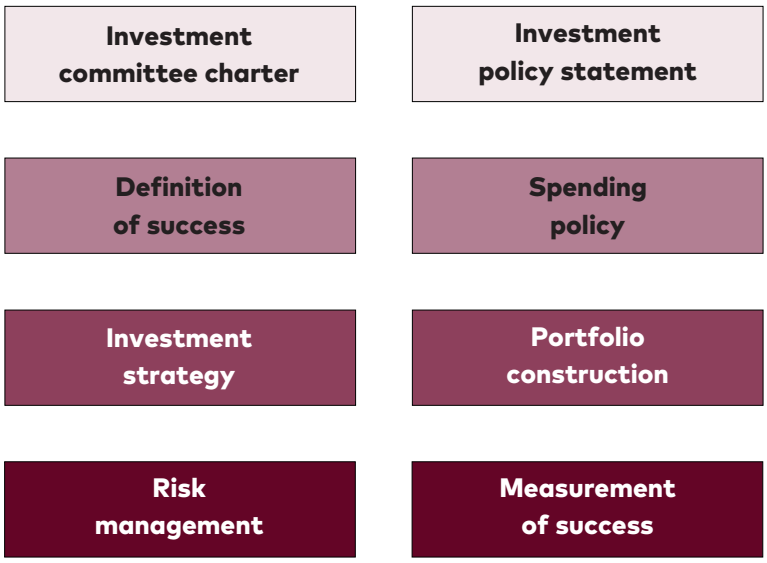
A clearly articulated, realistic IPS is arguably the most effective way to define a portfolio's purpose and measure a committee's success at fulfilling its goals. It also can help establish productive communications and expectations with outside investment managers and other fiduciaries.

Finally, a well-crafted IPS can protect a nonprofit from the emotional element that often inhibits a committee's decision-making process. Nonprofits are too often tempted to follow the investment strategies and practices of top-performing organizations.

This approach is ill-advised in most cases because larger institutions may have expertise, staff, and other resources beyond those of most nonprofits.

Investment policy statements should always address the organization's investment purpose and strategy.

Figure 7. Laying a strong foundation



Investment policy statement: Clearly defining your investment plan and how it will be executed

[17] Swensen, 2000.

Investment purpose and strategy

An investment committee should have an explicit understanding of its portfolio's purpose and a clear definition of success for fulfilling its objectives. An example of such a strategy would be investing your organization's assets with the goal of preserving their long-term, real purchasing power while providing a relatively predictable and increasing stream of annual distributions in support of the sponsoring organization.[18] Committee members must agree on a common purpose for the assets they oversee and articulate that objective as explicitly as possible. A goal without a definition can be difficult to understand and can make it challenging for committee members to evaluate their progress.[19]

In developing an investment purpose, board members must be wary of the trade-off between the competing goals of supporting short-term operations and preserving long-term assets. Committees that emphasize the former run the risk of losing long-term purchasing power, while those that focus on the latter may not have the resources to support their organization's short-term operating budgets.

There are three main investment strategies for nonprofits:

Preservation. The goal of a preservation strategy is to maintain enough growth to preserve equity and purchasing power across generations. This strategy, known as intergenerational equity, establishes a sustainable rate of consumption.

Growth. Nonprofits with unlimited time horizons, such as many university endowments, often pursue a growth strategy or a target rate of return greater than spending, inflation, and expenses. These organizations are invested in perpetuity and need to grow their corpus to adequately prepare for future responsibilities.

Consistency. A consistency strategy provides funding for spending needs in real terms. This approach tends to be a more suitable option for nonprofits with shorter time horizons that place higher priority on meeting pending obligations.

Fiduciaries should consider the diversification of portfolio assets, portfolio liquidity, donor requirements, and short-term income needs before formulating a strategy. Investments should be based on fully funding intended obligations, while various factors—including liquidity, risk, return, and funding status—should be used as metrics for success.

These considerations need to be revisited from time to time to ensure that new circumstances within the organization, the markets, or the broader economy haven't altered the portfolio's objectives. Fiduciaries should also review the portfolio as a whole and recognize that some assets will outperform while others will lag.

[18] Vanguard, 2017.
[19] Vanguard, 2017.

Building your structure

Building out the framework

Portfolio construction

Developing and maintaining an asset allocation strategy that meets your organization's short- and long-term goals is one of the most important responsibilities of a nonprofit investment committee and should be reflected in the investment policy statement.

In a landmark paper published in 1986, Determinants of Portfolio Performance, Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower concluded that asset allocation is the primary determinant of a portfolio's performance, with security selection and market-timing playing minor roles.[20] The research of Brinson et al. was confirmed by Brian J. Scott, James Balsamo, Kelly N. McShane, and Christos Tasopoulos in the 2016 Vanguard study, The Global Case for Strategic Asset Allocation and an Examination of Home Bias. Vanguard believes that asset allocation is indeed the most important determinant of return volatility and long-term total return in a broadly diversified portfolio with limited market-timing.

The 1986 Brinson et al. study represents a time-series analysis of the effect of asset allocation on performance. The methodology compared the performance of a policy, or long-term asset allocation represented by appropriate market indexes, with the actual performance of a portfolio over time. The findings indicated that, on average, most of a portfolio's return variability was attributed to its policy of asset allocation return variability. Active investment decisions—market-timing and security selection—had relatively little impact on return variation.[21]

Forecasting returns is an inexact science requiring experience, intuition, and judgment. For this reason, committees should use conservative assumptions and consider a portfolio's performance history as a guide but not a predictor of future returns.[22] This is especially true for committees responsible for assets that an organization needs to meet near-term expectations. If expected returns and spending assumptions aren't considered together, committees run the risk of having insufficient assets when they are needed to fulfill a spending obligation.

Within the nonprofit world, there is great diversity in the approach to asset allocation strategies. Institutions with urgent distribution commitments and shorter time horizons usually opt for lower-risk investments such as short-duration, high-liquidity fixed income products. For example, the IRS guidelines stating that private foundations must in general achieve a minimum annual payout of 5% of investment assets can impact the asset allocation and liquidity requirements for these portfolios.

Organizations with long time horizons, incremental gifts, and rising payout pressures may opt to take on greater risk through more aggressive portfolio strategies such as hedge funds and other absolute return investments, which may achieve higher long-term returns.

[20] Vanguard, 2007.
[21] Vanguard, 2007.
[22] Vanguard, 2004.

Risk management

Investment committees should adopt a clear investment strategy that includes a reasonable set of assumptions about the organization's risk tolerance and the portfolio's expected returns. It could be based on a traditional measure such as volatility, a loss of principal, or donor opinions of how the committee is managing its assets. The committee should attempt to identify all possibilities for failure based on the likelihood of their occurring and their potential impact.

Committees should discuss risk before setting standards and ask the following questions (Figure 8):

- What are the risks involved?
- Which risks are most likely to happen, and which ones will have the greatest impact?
- How much risk is manageable?

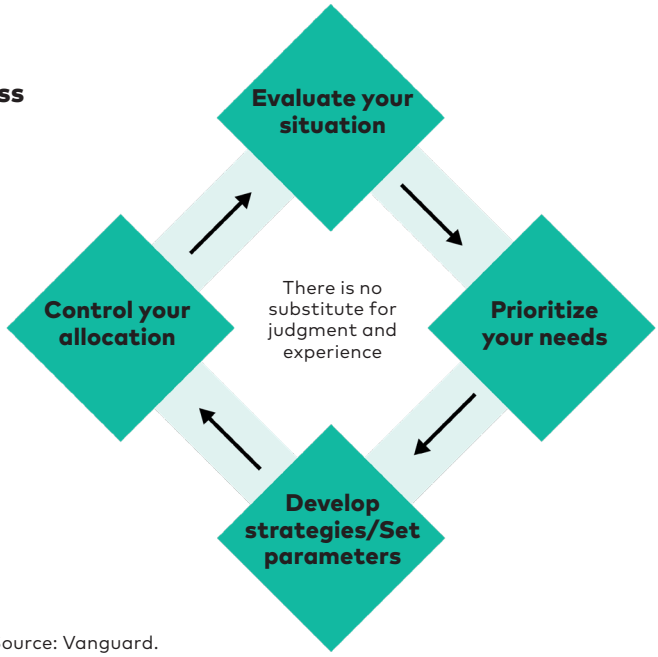
Best practices dictate that your organization's IPS should clearly develop a risk control framework that includes asset allocation and rebalancing as key strategies. Committee members should specifically avoid rebalancing as a market-timing exercise.[23] Rebalancing requires buying and selling securities on a regular or systematic basis to return your portfolio to its target allocations. Without a disciplined approach, portfolio weightings may quickly become inconsistent with policy targets and undermine your organization's funding needs.

Generally, investment committees should review asset allocation targets no more than once a year. However, if there is a fundamental change to your organization's unique situation, you may need to meet more frequently to discuss this subject.

Annual reviews allow managers to make the changes necessary to move their portfolio in a desired direction. At the same time, limiting such discussions to regularly scheduled intervals diminishes the possibility of ill-advised decisions made in response to short-term market conditions.

Once you have defined risk, it is easier to discuss how much you are willing to take

Figure 8. Risk management process



Source: Vanguard.

on to achieve your return objectives. Committees should establish return expectations that are commensurate with their organization's risk/reward profile. Some may decide to assume more risk with the potential reward of higher returns. Other committees may be willing to forgo the potential for large gains in return for a more secure return.

Measuring success

Nonprofit investment committees can measure success in a variety of ways, such as:

- In absolute terms.
- Against a market benchmark.
- Relative to a policy portfolio or competitive group.

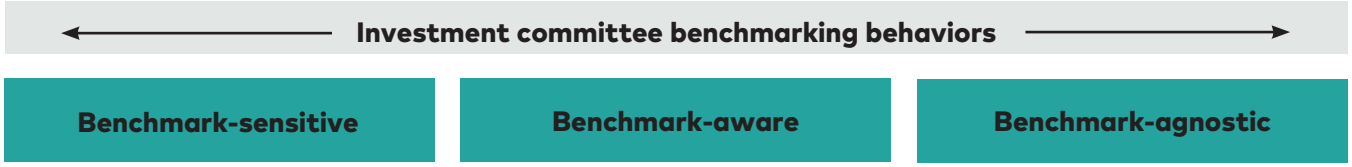
Each measure has its potential drawbacks. For example, committees often measure manager performance relative to a market benchmark because of the wide availability of this information. Under this approach, outperformance relative to the benchmark is considered a success, while underperformance causes consternation among investment committee members.[24]

Measuring success via a competitive group can also be an artificial measure of portfolio success unrelated to the portfolio objective, given the difficulty smaller institutions may have competing with larger nonprofits because of a lack of scale, staffing, and expertise.

In general, nonprofit investment committees should measure the success of their portfolios relative to their ability to meet the goals of the organizations they serve rather than on how their investments compare with a benchmark of portfolios from their peers. Committees should recognize that there might be differences between conventional measurements of performance and those the committee is using to assess the portfolio's progress.

An example of an appropriate benchmark would be whether your investment strategy meets a specific payout percentage necessary to fund the critical needs of your sponsoring organization. This approach increases the likelihood that your investment strategy will remain consistent over time with your organization's objectives and goals.[25]

Figure 9. Measuring success against benchmarks



[23] Vanguard, 2004.
[24] Vanguard, 2006a.
[25] Vanguard, 2004.

Spending policy

Selecting a spending policy that best supports your organization's mission is a major challenge for nonprofit investment committees. Nonprofit fiduciaries generally develop an approach that balances two fundamentally different goals:

- Maintaining the level of current spending.
- Growing the size of current investments to keep pace with inflation and support future obligations.

At a minimum, your organization's spending policy should support the needs of both current and future obligations. Which goal takes on a higher priority will vary depending on the objectives of your organization. A private foundation, required by law to spend 5% of its assets or face significant tax consequences, will generally emphasize short-term spending needs ahead of preserving long-term purchasing power. In contrast, a university endowment invested in perpetuity is likely to assume additional risk to grow current investments and achieve intergenerational equity.

This decision is an important one. An overly aggressive spending policy could force future cutbacks at critical times, while underspending to preserve future assets potentially deprives an institution of funds that could be put to productive use. A clearly defined spending policy helps to resolve these conflicts.

We have identified the following four spending policies that are most frequently adopted by nonprofits:[26]

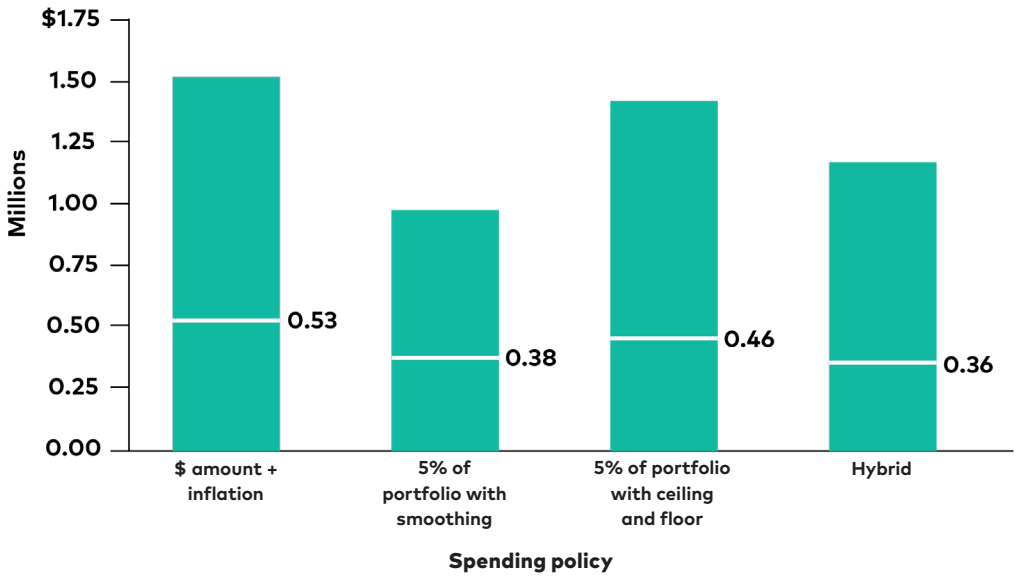
Dollar amount grown by inflation. A dollar amount of spending is calculated in the organization's first year on the basis of need or other criteria, usually expressed as a percentage of initial portfolio value. The spending amount for each subsequent year is then determined by multiplying the prior year's spending by an inflation factor. While this policy typically produces stable annual spending in the short term, it makes no adjustments for spending reductions during periods of poor market performance.

Percentage of portfolio with smoothing term. This policy bases annual spending on a stated portion of the portfolio value at the end of the prior year. A smoothing term modifies this to a percentage of the average ending balance over a period of time. For example, each year's spending level could be equal to a percentage of the average ending balance for the prior three years. Spending is automatically reduced when markets have been doing poorly and increased after periods of strong market performance. Poor investment returns are at least partially offset by reductions in current spending, helping to preserve the portfolio's value, and sustain future spending.

This approach makes budgeting more difficult in the short run because spending levels vary based on investment returns. On the positive side, the smoothing portion of this policy helps to dampen volatility. For this reason, this approach provides the most consistent spending levels over the long term.

[26] Vanguard, 2006b.

Figure 10. Deviation below target spending



Source: Vanguard Investment Strategy Group.

Percentage of portfolio with ceiling and floor. Instead of using a smoothing term, the amount of spending is held within a fixed range using a ceiling and a floor. If an investment committee selected a 15% ceiling and a 15% floor, the annual spending level would always be between 85% and 115% of the initial dollar amount adjusted for inflation.

The ceiling-and-floor approach can be an effective tool for budgeting purposes because it prohibits market-based spending variations from moving outside a set range. This can result in surplus returns in strong market years that can be reinvested and spent in future years. Its limitation is that while it provides for some downward adjustment to spending in poor markets, these corrections may not significantly reduce the potential for a material decline in principal, necessitating reductions in future spending levels below the spending "floor."

Hybrid combination of dollar amount grown by inflation and percentage of portfolio. The level of annual spending under this policy is determined by combining a fixed percentage of the dollar amount grown by inflation with a fixed percentage of portfolio spending. The approach, which has increased in popularity recently, may, for example, combine 40% of the prior year's spending amount adjusted for inflation with 60% of an amount determined by calculating a percentage of the portfolio with a three-year smoothing term.

A portion of spending varies, based on market performance, and a portion is predictable, which eases budget concerns. The existence of a hard floor on spending again does not protect a nonprofit's corpus from being exhausted under extreme market conditions.

Vanguard analyzed which of these four spending policies provides the best long-term spending stability and asset growth using 45 variations of return data from 1960 through 2004. The study findings include:[27]

- The 5% of portfolio assets with smoothing term strategy provides the most consistent spending levels with the tightest range of deviations below target and the second lowest

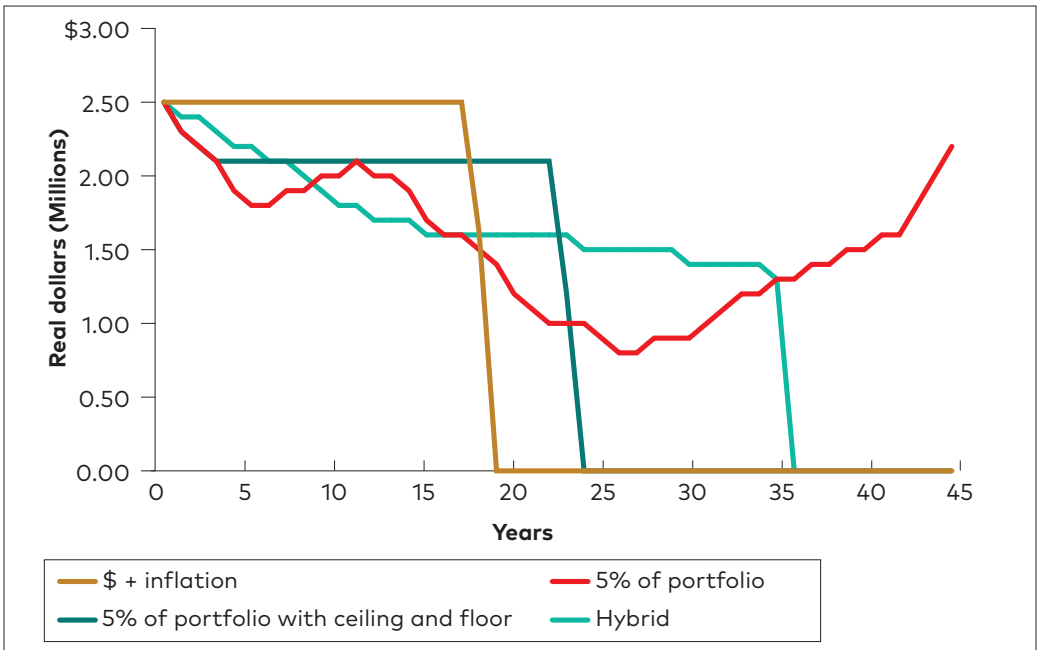
level of average shortfalls (Figure 10). In addition, this approach was the only one of the four spending policies to maintain some level of spending throughout the entire 45-year period under our "worst case" scenario (Figure 11).

- In contrast, relatively high levels of downside volatility make the 5% of portfolio assets with a ceiling-and-floor strategy (second highest range in deviation below spending target, as well as average shortfalls) better suited for institutions with longer time horizons.
- The dollar amount grown by inflation policy shows the highest range of downside volatility with spending dropping to zero within 20 years. However, this approach also provided the greatest short-term spending stability and could be the most suitable option for foundations with limited time horizons.

Nonprofit fiduciaries should keep the following considerations in mind before deciding on the spending policy that best fulfills the organization's mission:[28]

- Determine the extent to which your institution can accept volatility in near-term spending. This decision should consider a number of factors including your institution's level of annual contributions, access to additional funding sources, degree of flexibility in annual spending, and overall risk tolerance.
- Periodically evaluate your spending policies. Rigid spending rules cannot eliminate investment volatility. Spending policies that disregard returns are risky. Assuming that the portfolio will recover before levels reach a crisis point may lead to more dramatic reductions in spending later.
- Determine if your organization can tolerate short-term fluctuations in spending. The more a nonprofit can tolerate some short-term fluctuations in spending, the more likely it is to achieve its long-term goals. If the portfolio includes volatile investments likely to produce high average returns, you must accept

Figure 11. Most volatile spending paths



Source: Vanguard Investment Strategy Group.

[27] Vanguard, 2006b.
[28] Vanguard, 2006b.

regular, relatively small changes in spending or run the risk of having to make more abrupt and significantly larger adjustments later.

- Because returns frequently fall below 5%, private foundations should consider reinvesting excess funds during periods of strong market performance to help offset poor investment returns in the future. This helps to protect the portfolio during periods of severe underperformance.

- Understand how the portfolio assets are priced, and ensure that the portfolio can support your organization's spending requirements.

Manager selection

Virtually all nonprofit investment committees hire at least one outside investment advisor to manage their assets, with a majority hiring multiple managers. Many committees don't make this decision on their own. In general, there are three different approaches for manager selection: 1) hiring an outside consultant to make the decision for you, 2) hiring a consultant to identify several candidates and letting your committee make the final decision, and 3) hiring a manager directly.

Before hiring a manager, you should be convinced that his or her investment philosophy fits within the role you expect it to play in your portfolio. Selecting someone whose investment approach is inconsistent with your portfolio requirements can jeopardize the ultimate success of your organization.

Fiduciaries face a number of challenges during the manager selection process. Investment committees should clearly spell out guidelines in the IPS governing the selection, compensation, evaluation, and termination of their managers. Fiduciaries also should identify mandates that prospective managers will be expected to fulfill in administering various portions of their portfolio.

Nonprofits should base their selection of investment managers on multidimensional criteria rather than on a single factor.[29] Investment committees too often overemphasize past performance at the exclusion of other important criteria. This approach can be problematic because past performance is often time-period-dependent and has little to do with investor skill.

The most widely used data for evaluating manager performance is generally short-term returns, which may not be meaningful. Because of the wide availability of this return data, it is not unusual for an investment committee to have a bias toward using it to frame its view of a manager.

However, Figure 12 demonstrates the challenge of using past success as a predictor of future success. Our evaluation of fund performance since 2009 showed that only a substantial minority of funds managed to outperform their benchmarks in consecutive five-year periods. This inconsistency in performance is also a reason why abandoning managers simply because their results have lagged can lead to disappointment. In many cases, the most appropriate response is to stick with your original strategy.[30]

[29] Vanguard, 2004.
[30] Vanguard, 2013.

Regular review of short-term data, which increases the likelihood that investors will be confronting underperformance, may put pressure on investment committees to take dramatic action such as changing managers or strategies in response to the bad news. The best committees look beyond statistics and test manager credibility by speaking with both current and former clients.[31]

Other aspects of a manager's record that should be assessed include his or her compliance history with regulators and any potential conflicts of interest, such as prior relationships with members of the investment committee.

We recommend the following best practices in evaluating a potential investment advisor (Figure 13):

Understand each investment manager's investment process, which should be consistent over time and reflect your organization's philosophy. A nonprofit that places top priority on preserving long-term purchasing power and asset growth should be targeting its search for prospective managers willing to take on greater risk in return for higher long-term returns. In contrast, a foundation more concerned about short-term spending stability will be much more focused on finding risk-averse advisors.

Analyze the nature of a manager's investment team and firm. Assessing the stability of a potential outside advisor's investment team and firm is an important step because managers can easily be distracted if they operate under uncertain conditions.[32]

Fiduciaries should, therefore, ask the following questions before hiring an outside manager:[33]

- Does the investment manager's team have an individual or collective approach to making recommendations?
- If a single individual manages the portfolio, does that individual have strong relationships with the firm's analytical group and trading professionals?
- How long has the team worked together?

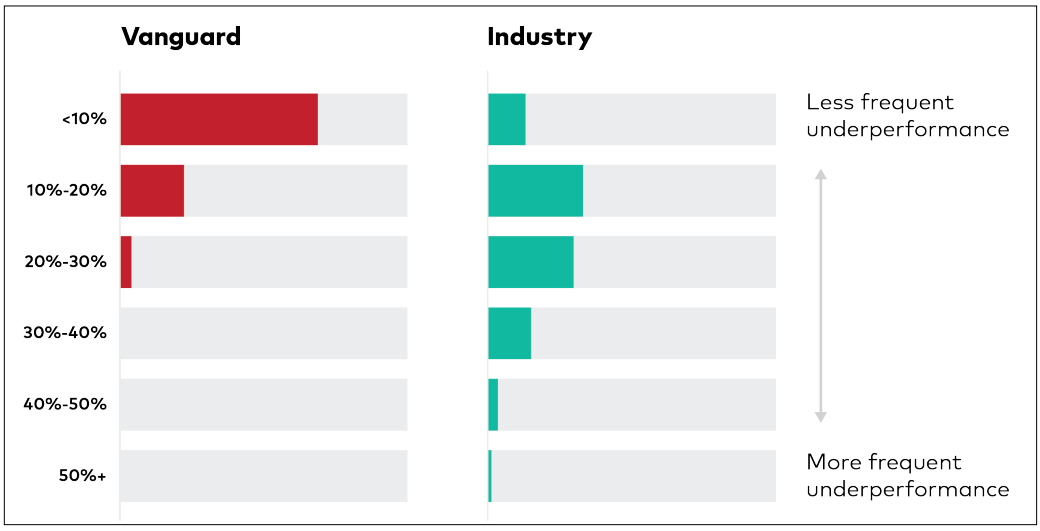


Figure 12. Percentage of years outperforming funds falling into bottom quartile versus peers

Note: We screened all actively managed U.S. and international funds with a minimum of 10 years of performance data during 1995 through 2019 and identified all net outperforming funds relative to their style benchmark. We calculated funds' rolling one-year performance and measured it relative to their 25th percentile peer returns over the same time period. The data presented is the percentage of years over a 10-year period that funds underperformed.
Sources: Vanguard and Morningstar, Inc., as of December 31, 2019.

[31] Vanguard, 2004.
[32] Swensen, 2000.
[33] Vanguard, 2004.

Review the firm's long-term performance in light of its philosophy and process. Past performance should be considered part of the selection process but should never drive your decision. Investment committees must recognize that markets are cyclical and there will be periods when a manager or group of managers will perform well and periods when they will perform poorly. A keen understanding of what drives results helps committees maintain the proper perspective. This requires a sound understanding of the markets and a manager's investment approach. For example, one should not expect a value-oriented manager to outperform in a market environment that favors growth investing.

Align manager's fees to your organization's goals. Committees must pay close attention to manager fees. Under UPMIFA, investment committees are required to manage expenses prudently in relation to the nonprofit's assets, the purposes of the institution, and the skills available to the committee.

Excessive investment advisor fees can eat into a nonprofit's investment return over time. According to industry averages, an organization with a $6 million annual distribution can lose more than 1% of a nonprofit's value to manager expenses (Figure 14). This can seriously damage an institution's ability to fulfill its mission. Over a period of several decades, the inability to control manager fees and expenses can mean inadequate funding for dozens of scholarships at a university, a multiyear delay or even cancellation of a new hospital wing, or insufficient resources to provide enough vaccines to cure an infectious disease in the underdeveloped world.

Fiduciaries also should ensure that a manager's fee structure is aligned with their portfolio's goals and time horizon. Applying a short time frame to analyze a portfolio positioned for long-term results can end in poor investment decisions that compromise the ability to meet established objectives. Fees for an active equity manager whose investment returns can vary significantly over short periods should be based on performance of at least three years.[34]

Figure 13. Manager selection criteria

Firm	People	Philosophy	Process	Portfolio	Performance
• Ethics • Stability • Ownership • Account and asset trends • Client list Incentives	• Deep investment team • Succession/ contingency • Limited turnover of key professionals • Tenure and experience • Proven expertise in subject matter • Demonstrated ability to handle large mandates	• Shared by investment professionals • Enduring • Easily articulated	• Understandable • Stable/proven • Generates a portfolio consistent with philosophy	• Clear reflection of philosophy and process • Consistent characteristics over time • Indication of willingness to take risks	• History of competitive results versus benchmarks and peers • Demonstrated success in different environments

Source: Vanguard.

[34] Swensen, 2004.

Conduct manager reviews

The appropriate time frame for performance review depends on the asset classes involved. While assets in particularly efficient markets, such as certain money market and fixed income products, may require less time to assess investor skill, performance of assets in less efficient markets, such as equities and various alternatives, should be evaluated over a longer time frame–a three- to five-year period, for example.[35]

More frequent evaluations or a termination may be necessary should a substantial change occur in the mission of the manager's firm, its people, or philosophy.[36] A manager change may be warranted if the committee determines, over a sufficient time frame, that manager performance is lagging and unlikely to improve in the foreseeable future.

Once you have hired a manager, Vanguard recommends establishing an ongoing managerial review process. Fiduciaries should regularly revisit the premises on which their original hiring decisions rest, periodically reviewing initial assumptions and subsequent behavior.

Figure 14. Manager expenses can impact nonprofit funding

Initial portfolio value	$150,000,000
Spending/Distribution (4.0%)	$–6,000,000
Investment management/Custody fees (0.3%–2.0%)	$–450,000 to $–3,000,000
Total expenses	$–6,450,000 to $–9,000,000
Residual portfolio value (accounting for spending and expenses)	$143,450,000 to $141,000,000
Difference of residual portfolio values	$2,550,000

Source: Vanguard.

This hypothetical illustration does not represent any specific investment and holds true only if the returns delivered by different managers are identical.

[35] Swensen, 2000.
[36] Swensen, 2000.

Maintaining the structure

Maintaining diversity of thought and open communication

Once you have clearly established roles, investment policies, and fiduciary responsibilities, your organization must remain vigilant in adhering to its fiduciary duties. Unlike corporate retirement plan investment committees where the organization plays a more hands-on role, nonprofit investment committees tend to regulate themselves or report to a self-regulated board. While this more ad hoc arrangement can foster an atmosphere of creativity that benefits the institution, it can also lead to a lack of discipline and focus if not carefully monitored.

This unique environment makes it even more critical for committee members to establish strong working relationships and discussions with one another. A group's size, expertise among its members, and approach to conflict resolution are all critical components to productivity and the overall performance of the institution.

There are three basic strategies for protecting a committee from the risk of losing focus:

Establish an effective communications plan

Keeping your fiduciaries apprised of key events and milestones concerning the institution is crucial, given the part-time nature of service on a nonprofit investment committee. Events and milestones about which you should be in regular contact with your committee members include:

- Your organization's overall investment strategy.
- The performance of your portfolio.
- The overall effectiveness of your investment strategy.

Ensure that your committee includes members from diverse backgrounds

Heterogeneity is vital for fostering an atmosphere in which unconventional and independent thinking will flourish. Diverse investment boards also are less likely to fall into bad habits, including allowing one person's opinion to dominate the discussions even if that person is an investment professional or a major donor.

Maintain an orderly decision-making process within your committee through effective meeting agendas.

Common investment committee agenda topics

Topics of discussion and frequency of meetings will vary depending on the investment committee's charter, the complexity of the portfolio, and the size and capabilities of the staff.

At a minimum, committees should meet semiannually to evaluate the performance of the portfolio and at least annually to review asset allocation characteristics. Other committees may choose to meet on a quarterly basis with at least one of the meetings focusing on education, such as reviewing a particular asset class or investment strategy.[37]

New committee members in particular should review prior meeting minutes and committee materials from the past one or two years to gain a better historical perspective.

Below is a summary of items that your committee should consider including in its meeting agendas.

At each meeting:

Approve minutes.
Approval of the prior meeting's minutes serves as a helpful reminder for members to review recently discussed topics and allows for a common starting ground at each meeting. This step is usually mandated by charter or statute.

Portfolio review

Review investment performance.
While total portfolio and component performance should be reviewed at each meeting, committees should evaluate them with a longer-term perspective. Best practices dictate that committees evaluate investment performance in the context of overall capital market conditions/returns to provide an attribution and understanding of portfolio returns.

Review asset allocation for rebalancing as necessary. Asset allocation decisions should be long-term in nature. Rebalancing should be considered at least every one to two years unless there is a major change in strategy or manager investment philosophy. However, a small component of the portfolio may be more tactical and opportunistic based on capital market conditions. In such cases, more frequent reviews of asset allocation may be necessary.

Identify agenda items for subsequent committee meetings

Discussion at a meeting often leads to agenda items for subsequent meetings. At each meeting, committees should present a schedule of future meeting dates and proposed agenda items.

[37] Swensen, 2000.

Annually:

Approve investment committee members
Generally, committee members are reviewed and appointed annually. Board members should rotate on a continuous cycle, typically after five years of service, with no more that one-third of the membership rotating off the committee at a given time.

Reaffirm objectives
It is important for the committee to review and reaffirm the portfolio in light of the organization's mission statement and goals. Should any of the above mentioned change, the committee should modify its investment strategy as necessary.

Investment policy statement (IPS)
The committee should formally review the IPS. Changes in the asset pool and board constituencies may necessitate modest modifications to the IPS over time. Such a review also creates a shared understanding of the objectives for each asset pool and is particularly useful following turnover among committee members.

Spending policy
Similar to the IPS, it is useful to have a regular discussion about spending policy. Many committees need to approve the spending policy annually by charter. While it is unlikely to change often, setting the spending policy is a key role of the investment committee and should be reviewed periodically.

Asset allocation
Committees should discuss their asset allocation annually, addressing the risk level, the likelihood of meeting spending and growth objectives, and the impact of changing strategic asset allocation. Major strategic changes to asset allocations should be made infrequently and only after careful consideration. However, conducting an asset allocation assessment in conjunction with a spending policy review helps committees evaluate and validate their assumptions.

Major asset classes
Committees should review each major asset class throughout the year to analyze the objective of the asset classes, their construction, and success to date in meeting their stated objectives.

Risk management review
Some committees find it useful to assess portfolio risk annually, either as part of an asset allocation study or separately. A regular review process should be implemented to help committees develop a shared understanding of portfolio risks—from asset class to operational risks—in the portfolio.

Review costs associated with the portfolio
Because costs diminish a portfolio's net return, it is always important to keep a close eye on fees and expenses. A regular cost review should include custodian, consultant, accounting, legal, and asset management fees.

Periodically:

Review investment managers
Managers should not be evaluated solely on performance but also on criteria such as consistency of investment philosophy, fees and expenses, and stability of the investment team and firm.

Discuss relevant regulatory changes
Because regulatory changes may impact the management of the portfolio, it is important for the committee to discuss such changes.

Review other contractual vendor agreements (custodians, consultants, etc.)
Typically, these agreements are reviewed every five years. While this responsibility is often delegated to the staff, the committee may be required to review and approve any changes. All insurance policies, including Directors and Officers Liability Insurance and Errors and Omissions Insurance, should be reviewed to ensure they are in good standing and up to date. The committee also should discuss its satisfaction with the quality of the service and responsiveness provided by all vendors, including trustees.

Review ancillary pools of assets
Nonprofit organizations sometimes receive unique gifts or have pools of assets outside of the endowment/foundation. A review of outside asset pools should be conducted when they require board approval or when the committee feels it is warranted.

Conclusion

We hope this reference manual has provided insights into what it means to be an investment committee member for a nonprofit organization, including critical information on the following key subject matters:

- Your role as a fiduciary. Keeping abreast of important legal statutes, accounting practices, and other policies affecting nonprofit fiduciaries.
- Investment committee charter. Identifying and clearly establishing roles and responsibilities of investment committee members through a clearly articulated investment committee charter.
- Investment policy statement. How an effective, multifaceted IPS can lead to nonprofit investment committee success by clearly stating an organization's investment strategy, asset allocation, manager selection and evaluation criteria, risk management, spending policy, and performance assessment.
- Meeting agendas and communication strategies. The importance of keeping members of your committee apprised of significant events related to their responsibilities through well-defined meeting agendas and effective communications strategies.

The importance of ensuring that nonprofit organizations have sufficient funds cannot be overstated given the crucial role they are playing in solving many of society's greatest social, cultural, educational, and health-related challenges.

To this end, nonprofit committee members must fully understand their organization's mission and the investment strategy necessary for achieving success. Nonprofit fiduciaries also must develop an effective organizational structure for meeting goals and achieving successful outcomes.

While there are many unique requirements and practices within the nonprofit market, your main goal should be to promote the success of your charitable organization through sound investment decisions and practices. In Vanguard's view, the fiduciary standards for nonprofit investment committees can be summarized in a single phrase:

"Providing the financial resources necessary to maximize the welfare of your sponsoring organization's mission."

Glossary and references

Glossary

Financial Accounting Standards Board (FASB). The Financial Accounting Standards Board is the designated organization in the private sector for establishing standards of financial accounting and reporting, which govern the preparation of financial reports. Organizations, including nonprofits, comply with these accounting standards to help ensure their financial reports are credible, transparent, and comparable by the users of the financial information presented. FAS 116, 117, and 124 are particularly foundational and relevant for these organizations.

- FAS 116 addresses accounting for contributions received and contributions made. In general, this statement requires investment committees to recognize contributions received, including unconditional promises to give, as revenue at their fair values in the period made. The standard also requires recognition of the expiration of donor-imposed restrictions in the period in which the restrictions expire.
- FAS 117 establishes standards for general-purpose external financial statements provided by nonprofits. This statement requires nonprofits to provide a statement of financial position, a statement of activities, and a statement of cash flows. In accordance with FAS 117, nonprofits also must report accounts for the organization's total assets, liabilities, and net assets in a statement of financial position.

  The standard extends provisions of FAS 95 (Statement of Cash Flows) to nonprofit organizations and expands its description of cash flows from financing activities to include certain donor-restricted cash that must be used for long-term purposes. It also requires that voluntary health-and-welfare organizations provide a statement of expenses by both functional and natural classifications.
- FAS 124 focuses on accounting standards for certain investments held by nonprofits. It requires that investments in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value with gains and losses included in the statement of activities. FAS 124 also establishes standards for reporting losses caused by a donor's stipulation to invest a gift in perpetuity or for a specified term.[38]

In July 2009, FASB released their Accounting Standards Codification, which aimed to capture and codify essential standards and provide implementation guidance. In the years following the Codification, three accounting standards updates were issued that are relevant to nonprofit organizations.

- Accounting Standards Update 2014-09, Topic 606 (Revenue Recognition from Contracts with a Customer) highlights that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that

[38] FAS, 1993.

directive, an entity should: identify the contract(s) with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the entity satisfies a performance obligation.

- Accounting Standards Update 2016-14 (Presentation of Financial Statements of Not-for-Profit Entities) addresses several issues including complexities relating to the use of the previously required three classes of net assets, deficiencies in the transparency and utility of information used to assess an entity's liquidity, inconsistencies in the type of information provided about expenses of the period, and the impediment of preparing an indirect method reconciliation if the direct method is already being used to present operating cash flows.
- Accounting Standards Update 2018-08, Topic 958 (Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made) provides a more robust framework to determine when a transaction should be accounted for as a contribution under Subtopic 958-605 or as an exchange transaction accounted for under other guidance (i.e., Topic 606). The update also provides additional guidance about how to determine whether a contribution is conditional.
- IRS Form 990. Form 990 is the annual reporting document that nonprofits file with the IRS.
- Sarbanes–Oxley. In 2002, Congress passed and President Bush signed into law the Sarbanes–Oxley Act. Passed in response to accounting scandals and other corporate malfeasance, the law requires that publicly traded companies and other entities adhere to stricter corporate governance standards that broaden board member roles in overseeing financial transactions and auditing procedures.[39]

Most of Sarbanes–Oxley's provisions apply directly to publicly traded companies. Two, however, are directly relevant to all organizations, including nonprofits:

- Whistle-blower protection. Sarbanes–Oxley provides protections for whistle-blowers and imposes criminal penalties for actions taken in retaliation against those who risk their careers by reporting suspected illegal activities in the organization. It is illegal for any organization—for-profit and nonprofit alike—to punish a whistle-blower in any manner.[40]
- Document destruction. The act makes it a crime to alter, conceal, falsify, or destroy any document to prevent its use in an official proceeding such as a federal investigation or bankruptcy proceeding.[41]

Jeopardizing investments by private foundations. An investment is considered to jeopardize the carrying out of a private foundation's exempt purpose if it is determined that the foundation managers have failed to exercise ordinary

[39] BoardSource and Independent Sector, 2003.
[40] BoardSource and Independent Sector, 2003.
[41] BoardSource and Independent Sector, 2003.

business care and prudence in providing for the long- and short-term financial needs of the foundation. In exercising the necessary standard of care and prudence, foundation managers may take into account the expected return on the investment, the risks of rising and falling price levels, and the need for diversification within the investment portfolio.

An excise tax equal to 10% of the amount of the investment is imposed on the private foundation for each jeopardizing investment. Foundation managers who knowingly participate in jeopardizing investments also are subject to a 10% excise tax on the amount of the investment, capped at $10,000 per investment. An additional excise tax equal to 25% is imposed on the private foundation if it does not remove the investment from jeopardy, and an additional excise tax equal to 5% is imposed on any foundation manager who refuses to agree to the removal of the investment from jeopardy, capped at $20,000.

Determinations whether the investment of a particular amount jeopardizes the carrying out of the foundation's exempt purposes must be made on an investment-by-investment basis, and in each case, the foundation managers must take into account the foundation's portfolio as a whole.

The following investments and practices, while not prohibited, are closely scrutinized by the IRS:

- Trading on margin.
- Commodity futures.
- Working interests in oil and gas wells.
- Puts, calls, and straddles.
- Warrants.
- Selling short.

Foundation managers must be diligent in monitoring the types of investments in their organization's portfolio and must be willing to meet with their respective portfolio managers and periodically review asset allocation decisions to avoid potential harm.

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All investing is subject to risk, including the possible loss of money you invest. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

Diversification does not ensure a profit or protect against a loss.

Past performance is not a guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

For additional information and one-stop access to other valuable resources, please visit vanguard.com/nonprofitresourcecenter.

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