

A Tale of Two Foundations

For most investors, even social investors, it was the worst of times. I have agreed to discuss real world differences in the performance of mission invested portfolios and portfolios invested for pure return. I will not make any general claims. Placing all mission invested funds into a single performance class makes about as much sense as placing all hedge funds in a single performance class. Mission investing is not a strategy, unless you are betting on carbon futures, it is an expanded framework of fiduciary responsibility.

So rather than looking for general rules, let's see what we can learn from a specific case study. I am going to share a little detective work I did examining the returns of two foundations, one of which is 100% mission invested and the other of which invests for pure return. The interesting thing about this sample is that they were founded by the same family, they use the same investment consultant and they employ very similar investment strategies. I am on the finance committees of both.

The Needmor Fund is a small foundation whose mission is very focused; we support multi-issue, membership based community organizing. Needmor's investments have been 100% mission related for over fifteen years. All of Needmor's equities are screened, our fixed income portfolio is focused on loans to low income communities, their cash is in certificates of deposit at community banks, we have an active share owner engagement program and a financial field presence program. The other foundation prefers to remain anonymous, so for today's purposes we will call it the "traditional" foundation. The traditional foundation's investment objective is to "Earn the highest level of investment performance that is compatible with the foundation's risk tolerance and prudent investment practices."

Both foundations work with Asset Consulting Group (ACG), a St. Louis based investment consultant. ACG's investment philosophy is based on two central tenets. First, they remain fully invested throughout market cycles. Their second core tenet is disciplined diversification across asset classes. About ten years ago, ACG began to encourage their clients to diversify into alternative investments as evidence emerged that these investments may be counter cyclical or may provide positive absolute returns. ACG maintains a large data base of managers, tracking their performance, their adherence to their benchmarks and their fees. They look for managers with very little style drift who consistently outperform their benchmarks. Both foundations work closely with ACG to set target asset allocations, select and evaluate managers, and re-balance their portfolios as needed.

So, let's cut to the chase, how did their returns compare? Many of you probably assume that the larger, more diverse foundation outperformed the smaller foundation with the mission invested portfolio. Well, they both had an absolutely dreadful year. But based on October 31st numbers, Needmor was down 24.1% for the year and the traditional foundation was down 28.6%. However, over a five year period the difference

was much smaller, Needmor was up 3.6% compared to the traditional foundation's 3.2%. What explains the mission invested fund's 4.5% short term out-performance? And does this teach us anything useful about mission investing?

Not surprisingly asset allocation explains some of the performance difference. Although both foundations were 65% in equities, due to pure luck Needmor was sitting on cash from the sale of an under performing large cap index fund. As a result, it was 10% over its 25% target allocation to cash and fixed income. The traditional foundation had 25% in cash and fixed income and almost 10% in alternatives. The alternative investments did what they were supposed to do. They provided total return and hedged the losses in the equity portfolio. Performance varied between hedge funds, alternative fixed and private equity, but on average the alternatives were down only 6%. This helped the traditional foundation, but not as much as Needmor's 3.5% return on its extra cash helped Needmor. All in all, the differences in asset allocation explain 2% of Needmor's 4.5% total out-performance. And to be fair, the traditional foundation is in a better position, fully invested and more diversified, to capture future market gains.

Let's pause a moment to consider the question of alternative investments. The traditional foundation's best performing alternatives were their private equity fund of funds, which reported impressive gains of 12.9%. However, lack of transparency makes it difficult to verify the reliability of these valuations, or to guarantee that none of these funds will shut down due to over-leveraging, redemption runs, or risky or unethical investing practices. Even if we assume a reasonable margin of error on these reported returns, we could safely argue that the traditional foundation would have been better off if it had had 20% in alternatives, which is in fact its target allocation. But does it follow that they would have been even better off with 30%, 40% or 50%? Many foundations, following the lead of high performing university endowments, moved more than half of their portfolios aggressively into alternatives. And some, at least, have encountered their own liquidity problems as a result. I have heard of at least one foundation that is borrowing money to honor multi-year grant commitments. I have yet to get a clear answer to the question of how an institution, especially one with defined payout requirements, should determine liquidity ratios. My guess is that for private foundations 20% is about right. Even if the rest of your portfolio is cut in half, you are still 60% liquid.

Needmor was not in alternatives, because there were none that met both its social and financial standards. These scruples cost us some performance. Needmor's commitment to community investing, however, cost us very little. Even though one of our bond managers was down 4.6%, due to having to mark to market some of its portfolio, our other manager, in the secondary mortgage market, posted a steady 5% return and the fixed composite was flat. This compares reasonably well to the traditional bond managers' composite returns of 1%. Needmor's mission related deposit program actually earned more, 3.9%, than the commercial money markets' 2.2%. This is in part because our certificates of deposit at community banks are laddered from 3-18 months

and do not have overnight liquidity

If differences in asset allocation only explain 2% of the mission invested fund's out-performance, the rest of the 4.5% difference must be found in the 65% of each foundation's portfolio invested in diversified equities. These were the hardest hit asset classes for each foundation. Needmor's equity composite, with only screened equities, was down 33.2 %, while the traditional foundation's was down 37.2%. However the 5 year returns of the two foundations' equity composites were identical, 2.2%. Why did the screened managers do better in these awful markets than their peers investing without screens?

Is there a sectoral explanation? Is it possible that Needmor was protected from the collapse of the energy sector because screened funds are typically underweight in energy? But screened funds are typically overweight in financials, and that sector also took a beating. Perhaps differences in sub-allocation to equity capitalization classes explain the difference. There are minor differences in sub-allocation, but Needmor's managers did better in every equity class; large cap, small cap and international.

Having been on Needmor's investment committee through several market cycles, I am going to share a secret with you. If this had been a banner year in the stock market, like 2003, I would have expected Needmor's managers to have been a few points behind their benchmarks. Why? Our equity managers exhibit a consistent quality bent. They lose less in down markets and gain less in bull markets. My theory is that companies with good environmental policies, good employment policies and good corporate governance tend to have management that is ethical, cautious, unwilling to incur large debt, willing to defer immediate gain to protect the company from future risk, and slow to capitalize on short term trends that do not increase long term value. In other words, the Needmor's progressive values lead us to invest in conservatively managed companies, and shares of conservatively managed companies tend to be less volatile than the markets as a whole. I do not want to suggest that every investment manager that offers a screened equity product will exhibit this quality bent. The quality of the investment manager is also critical.

So, in conclusion, I can make no case for the long term financial advantages or disadvantages of mission investing. I believe that investment performance is primarily determined by asset allocation, quality research, and investor discipline, regardless of whether a portfolio is screened or unscreened. But I can present a very small case study that suggests that disciplined equity screening modulates portfolio volatility. The quality bent functions like a hedge, a modest hedge, to be sure, but it dampens the downside and the upside alike. This should be of interest to other foundations, who have programmatic, as well as financial, reasons to limit the volatility of their portfolios.

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