



UPMIFA: Crowe Risk Assessment and
Investment Policy Review
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Introductions

Stuart Miller, CPA

Partner

Not-for-profit Practice

Millicent Holmes

Illinois Regional Manager

Crowe Wealth Management

Objectives

- Provide guidance to assist you in reviewing and updating your investment policy statement in relation to UPMIFA
- Help you to identify your financial and investment risks
- Investment Policy Statement (IPS) Review
 - Once you have identified your financial and investment risks, you will be prepared to:
 - Use your investment policy statement as a tool to manage these risks;
 - Identify areas where your portfolio diverges from your investment policy statement and take proactive steps to correct this divergence.



UMIFA Becomes UPMIFA



UPMIFA Overview

- The *Uniform Prudent Management of Institutional Funds Act* (UPMIFA) of 2006 replaces the *Uniform Management of Institutional Funds Act* (UMIFA) of 1972.
- Has been enacted or introduced in 47 states.
- Sets standards for endowment spending and preservation of the original gift in accordance with donor intent.
- UPMIFA applies retroactively to not-for-profit charitable entities.

It does not govern:

- Trusts managed by noncharitable entities – such as corporations – or trusts managed by individuals; and
- Management of board-designated endowments.
- The new Act provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending.

Evolution from UMIFA to UPMIFA

- UMIFA was drafted almost 35 years ago, and portions of it are now out of date. The prudence standards in UMIFA have provided useful guidance, but prudence norms evolve over time.
- UPMIFA provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending.
- The *Uniform Prudent Investor Act* (UPIA), an Act promulgated in 1994 and already enacted in 43 jurisdictions, served as a model for many of the “prudence standards” in the UPMIFA revisions.

UMIFA vs UPMIFA

UPMIFA improves on UMIFA in the following areas:

- **Incorporates the prudent investor standard of UPIA.** Each person responsible for managing and investing the fund shall act in good faith, with the care an ordinarily prudent person would exercise.
- **Eliminates the historic dollar value limitation on expenditures that were part of UMIFA.** States can adopt an optional provision – rebuttable presumption of imprudence if an institution expends more than 7 percent of the fair market value of a fund, calculated at least quarterly over a minimum period of three years prior to expenditure.
- **Expenditure of funds.** Total return expenditure is expressly authorized under comprehensive prudent standards relating to the whole economic situation of the charitable institution.
- **Donor Intent.** The rules of construction allow the institution to focus on donor intent in relation to investment and grantmaking.
- **Provides framework to modify restrictions on gifts (doctrines of deviation and cy pres).** UPMIFA allows restrictions on older, smaller funds (less than \$25,000, held for 20 years or more) to be removed.

UPMIFA – Prudent Management and Investment

- Incorporates the prudent investor standard of UPIA: Each person responsible for managing and investing the fund shall act in good faith, with the care an ordinarily prudent person would exercise.
 - Incur only reasonable costs in investing and managing charitable funds.
 - Make a reasonable effort to verify the facts (due diligence) relevant to the management and investment of the fund.
- Make decisions about each asset in the context of the portfolio of investments, as part of an overall investment strategy.
 - As such, the institution can invest in any type of property or type of investment consistent with the prudence standard.
 - Diversify investments unless, due to special circumstances, the purposes of the fund are better served without diversification.
- Subject to the intent of a donor, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.

UPMIFA – Managing and Investing Funds

- In managing and investing an institutional fund, the following factors, if relevant, must be considered:
 - General economic conditions;
 - Possible effect of inflation or deflation;
 - Expected tax consequences, if any, of investment decisions or strategies;
 - Role that each investment or course of action plays within the overall investment portfolio of the fund;
 - Expected total return from income and the appreciation of investments;
 - Other resources of the institution;
 - Needs of the institution and the fund to make distributions and to preserve capital; and
 - An asset's special relationship or special value, if any, to the charitable purposes of the institution.

Example IPS: Return/Risk Objectives

INVESTMENT POLICIES AND OBJECTIVES

General investment philosophy objectives:

- 1. Return:** The long-term objective of the foundation is to earn a **return sufficient to preserve the purchasing power** of the foundation for generations to come, as well as to provide for current scholarship needs. As a result, the return goal shall consist of a spending rate, an assumed rate of inflation, investment management fees, and any desired real portfolio growth. As of the date of this Statement of Investment Policy, these items and their function in the overall return are as below but may be modified in the future at the direction of the committee and board:

Components of return goal:

- | | |
|---------------------------------------|---------------------|
| • Spending Rate | 3.0% to 4.5% |
| • Inflation Rate | 2.5% to 3.0% |
| • Administrative Fees | <u>.35% to 1.0%</u> |
| • Real Portfolio Growth | ----- |
| • Long-Term Return Goal (Net of Fees) | 5.85% to 8.50% |
- 2. Risk:** The committee will permit the foundation's portfolio to experience an overall level of risk consistent with the risk generally associated with the committee's policy asset allocation. The foundation is particularly risk-averse to the probability of not meeting the return goal.

UPMIFA – Prudent Appropriation of Spending

- Seven factors to consider in prudent appropriation of spending:
 - Duration and preservation of the endowment fund;
 - Purposes of the institution and the endowment fund;
 - General economic conditions;
 - Possible effect of inflation or deflation;
 - Expected total return from income and the appreciation of investments;
 - Other resources of the institution; and
 - Investment policy of the institution.

Example IPS: Spending Policy

Spending Policy

Total Return Approach

The board has adopted a "total return" approach to calculating investment returns.

In recognition of these facts, the committee will consider the foundation's total return from both income and net realized and unrealized capital gains when recommending the spending policy. When distributions are made, they will be withdrawn from the foundation regardless of the portion of the total return that is from capital gains or from income.

Spending Policy

The distribution rate of endowment accounts is based on investment returns and is annually determined by the audit committee and approved by the board of directors. In an attempt to maintain inter-generational equity, the foundation will take into account the rate of inflation when calculating the distribution rate. Generally, the distribution rate is applied to the estimated fair market value of each fund at the beginning of the fiscal year. **The foundation may review individual accounts to determine if the approved distribution rate would reduce available amounts below prudent reserve thresholds** and, if so, reduce or freeze the approved distribution. The foundation will attempt to maintain a consistent distribution annually. During the year, the executive director may approve amounts in excess of the approved amounts providing there are sufficient funds in excess of corpus and a valid need presented in writing. Periodically, a report should be provided to the committee that oversees the spending policy to inform them of accounts approved for expenditure exceeding the distribution amount.

The foundation receives designated gifts that have permanent restrictions on their use. Fluctuations in marketable investments are expected in the short term and the foundation will use wise spending policy decisions to maintain funds in excess of the permanently restricted balance. If the value of the investment pool decreases to a point where the fund's share of the fair market value is below the permanently restricted amount, the foundation will freeze spending until the balance is made whole.



Risk Assessment

**Identifying Your Organization's
Financial and Investment Risks**

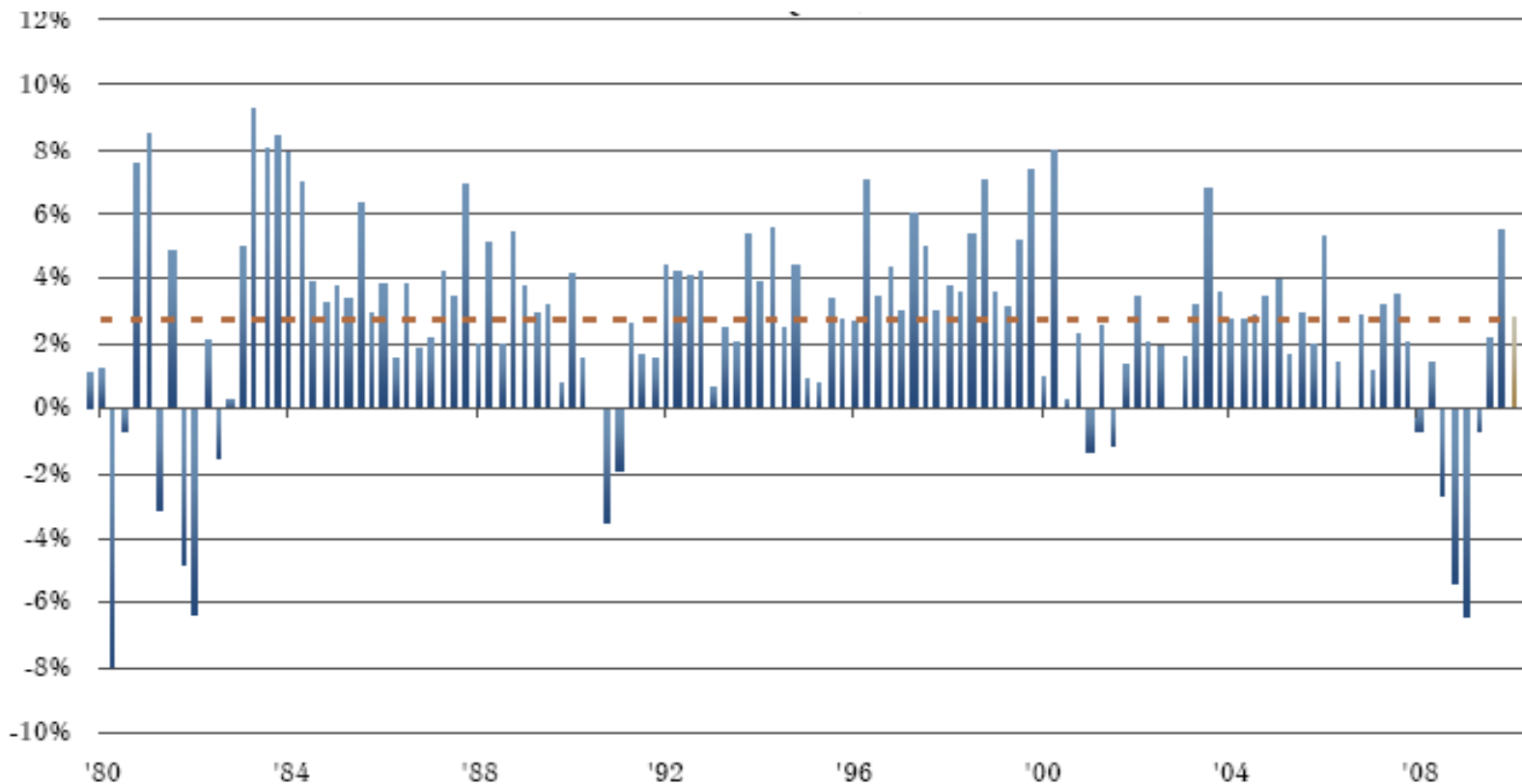


Selected Financial and Investment Risks

- Economic
- Inflation
- Interest rate
- Concentration
- Liquidity and cash flow
- Credit and default
- Banking and custodial safety
- Alternative investments
- Reputation or "headline" risk

Real GDP: Percent Change at an Annual Rate

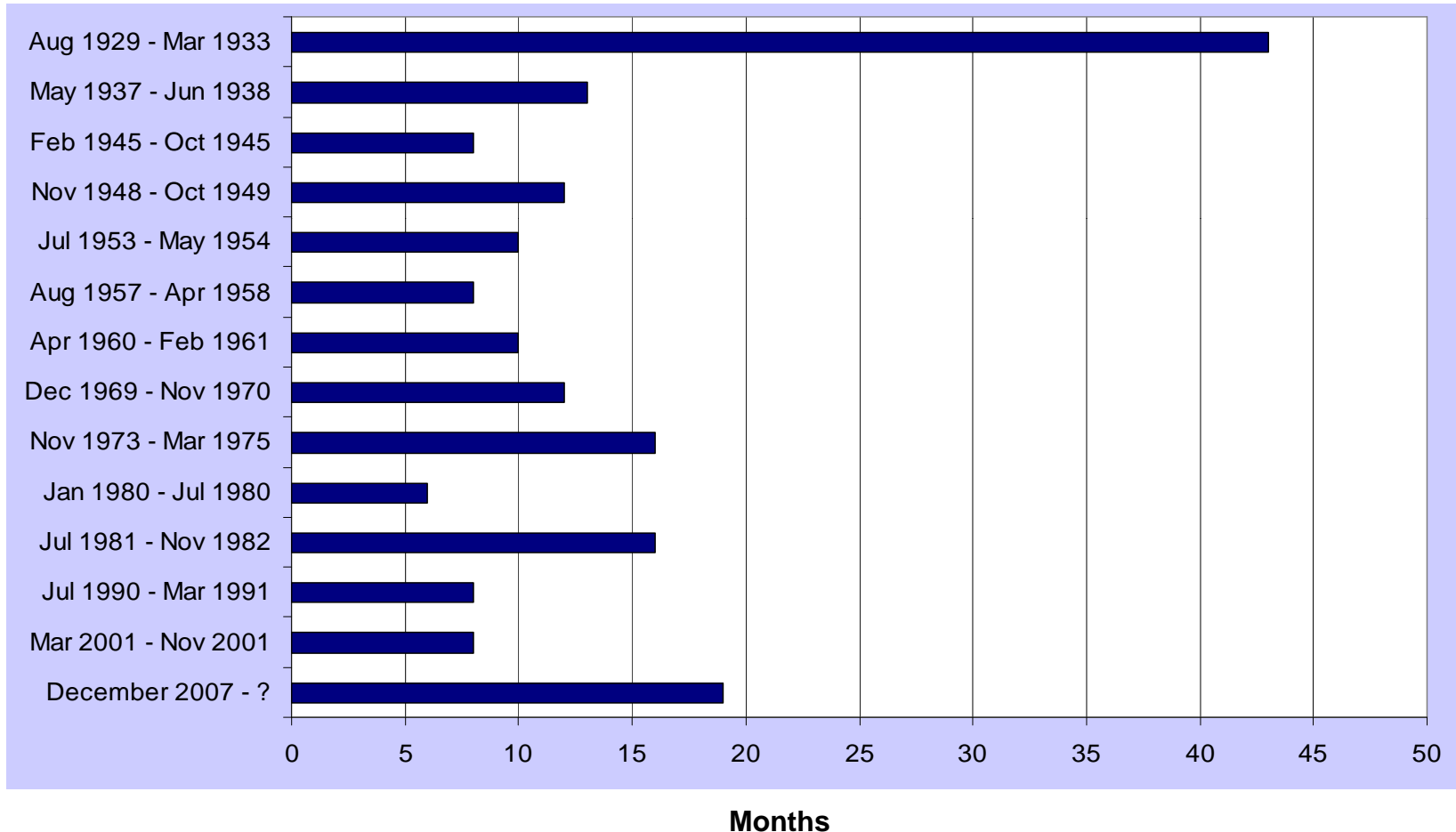
Real GDP: % Change at Annual Rate
1980 – Q2 2010



Prepared by Oxford Financial Group Ltd., Source: St. Louis Fed

Longest Recession Since the Great Depression

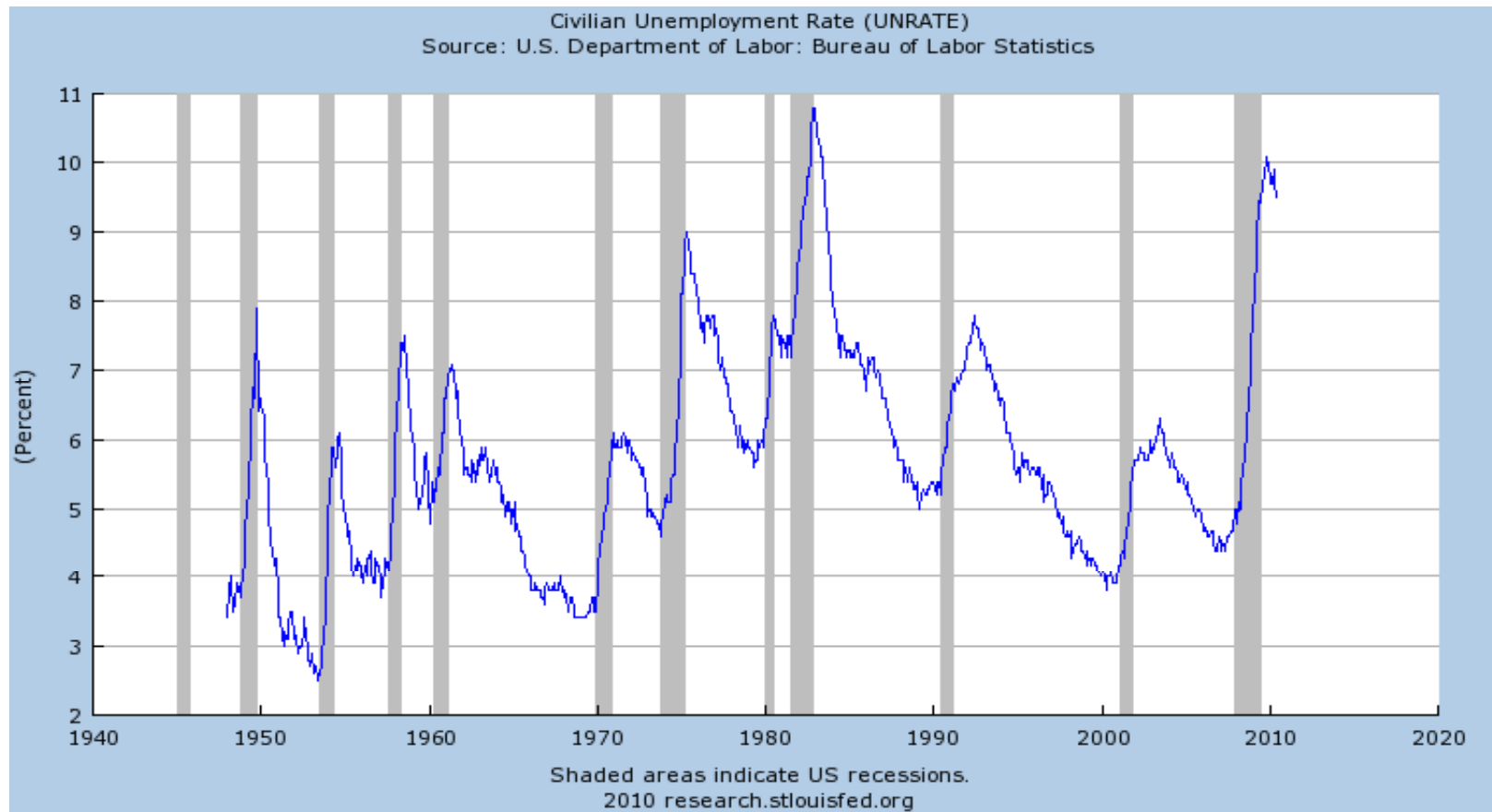
The Great Recession likely ended in June 2009, but NBER has still not set the ending date



Source: National Bureau of Economic Research

Unemployment at Historic Levels

U.S. Civilian Unemployment Rate (%) 1948-2010
Shaded Areas Indicate Recessions

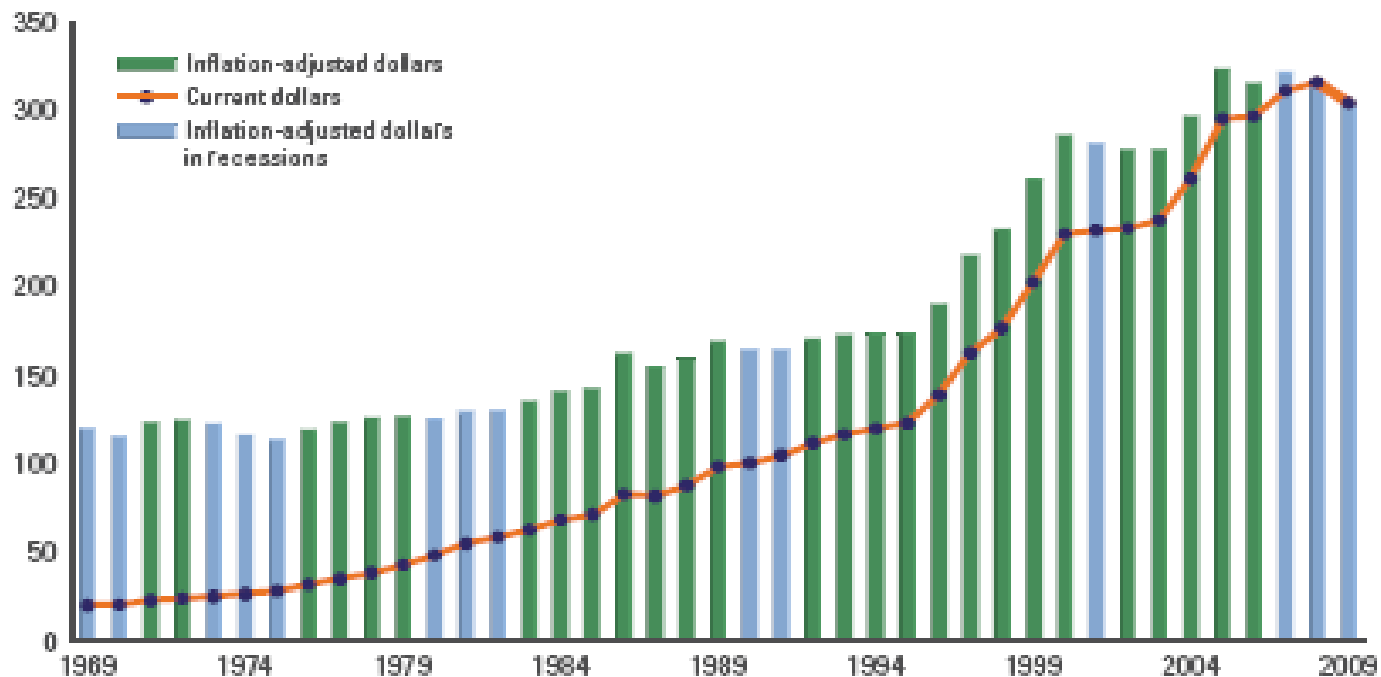


Sources: St. Louis Fed, US Department of Labor: Bureau of Labor Statistics

Charitable Giving in the United States

Charitable Giving experiences largest decline in current dollar terms in 50 Years

Total giving, 1969–2009
(\$ in billions)

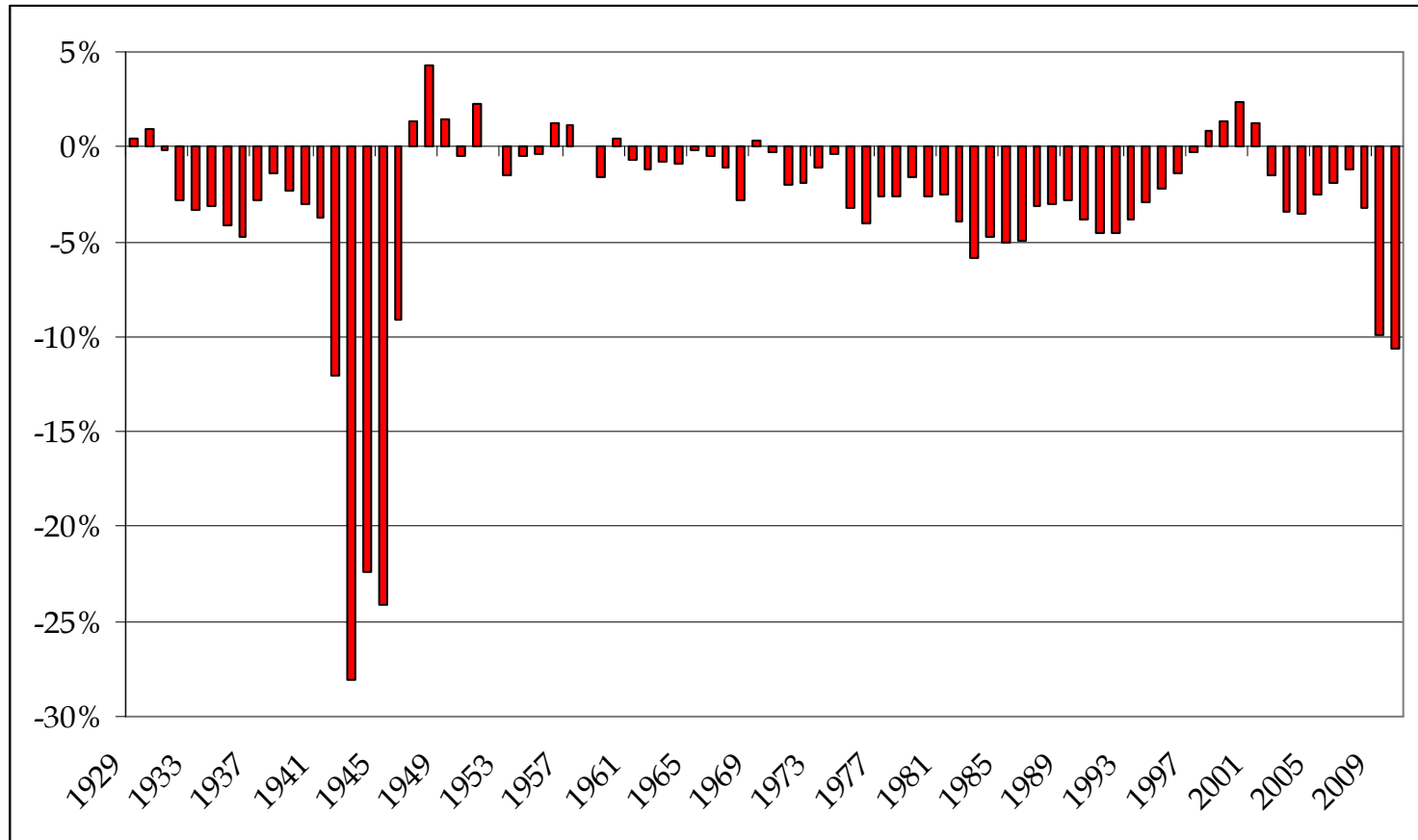


Source: Giving USA Foundation

Future Inflation and Interest Rate Risk

Fiscal Stimulus Programs Have Generated a Rapidly Swelling Deficit

Federal Budget Surplus / Deficit as a % of GDP



Fiscal Years 1929 - 2010

Liquidity Risk: Gates on Withdrawals

Hedge Fund Gate

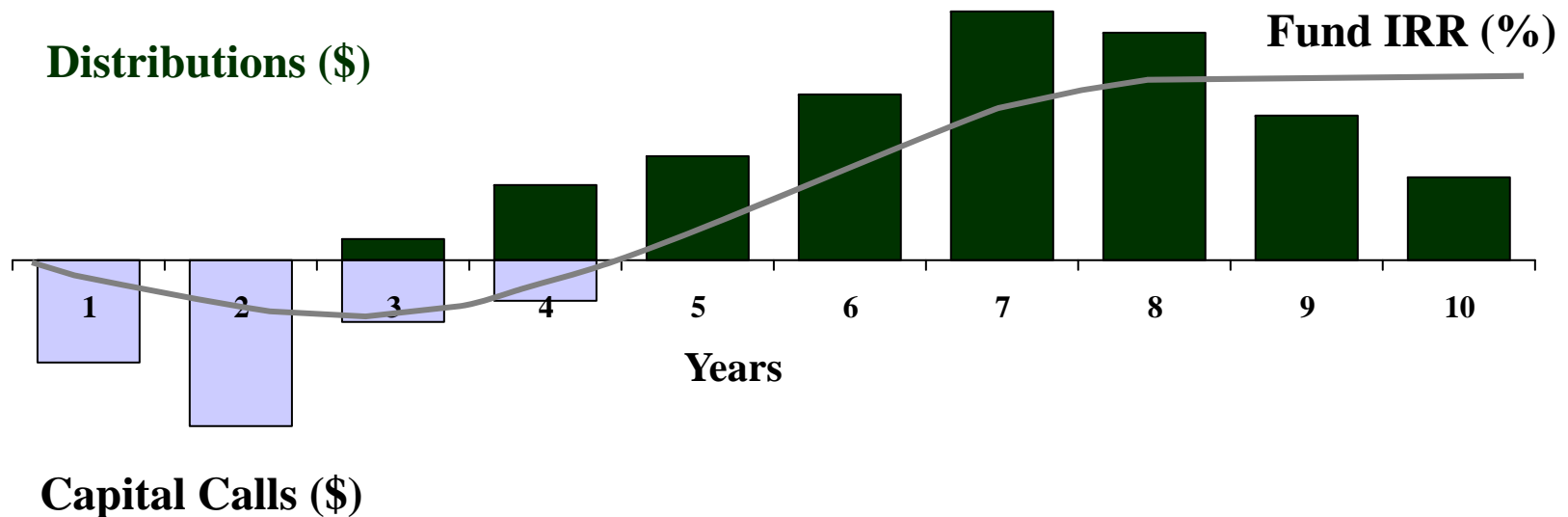
An Often Overlooked Clause in Partnership Documents

“Suspension of Withdrawals: The Fund may suspend the calculation of its Net Assets and the withdrawal of capital during: (i) all or part of any period when any Portfolio Fund has limited or suspended the Fund’s right to withdraw its investment, or (ii) the existence of any state of affairs as a result of which the General Partner is unable (or, in the opinion of the General Partner, it is not reasonably practicable or would be prejudicial to Limited Partners) to value or dispose of the Fund’s assets. The General Partner will promptly notify Limited Partners of any such suspension, and the termination of any such suspension, by means of a written notice.”

Liquidity Risk: Private Equity “J-Curve”

- Investor “commitments” are called down on an as-needed basis during the first few years of the fund.
- Distributions flow back to investors as underlying portfolio companies are exited.

Hypothetical Fund Example

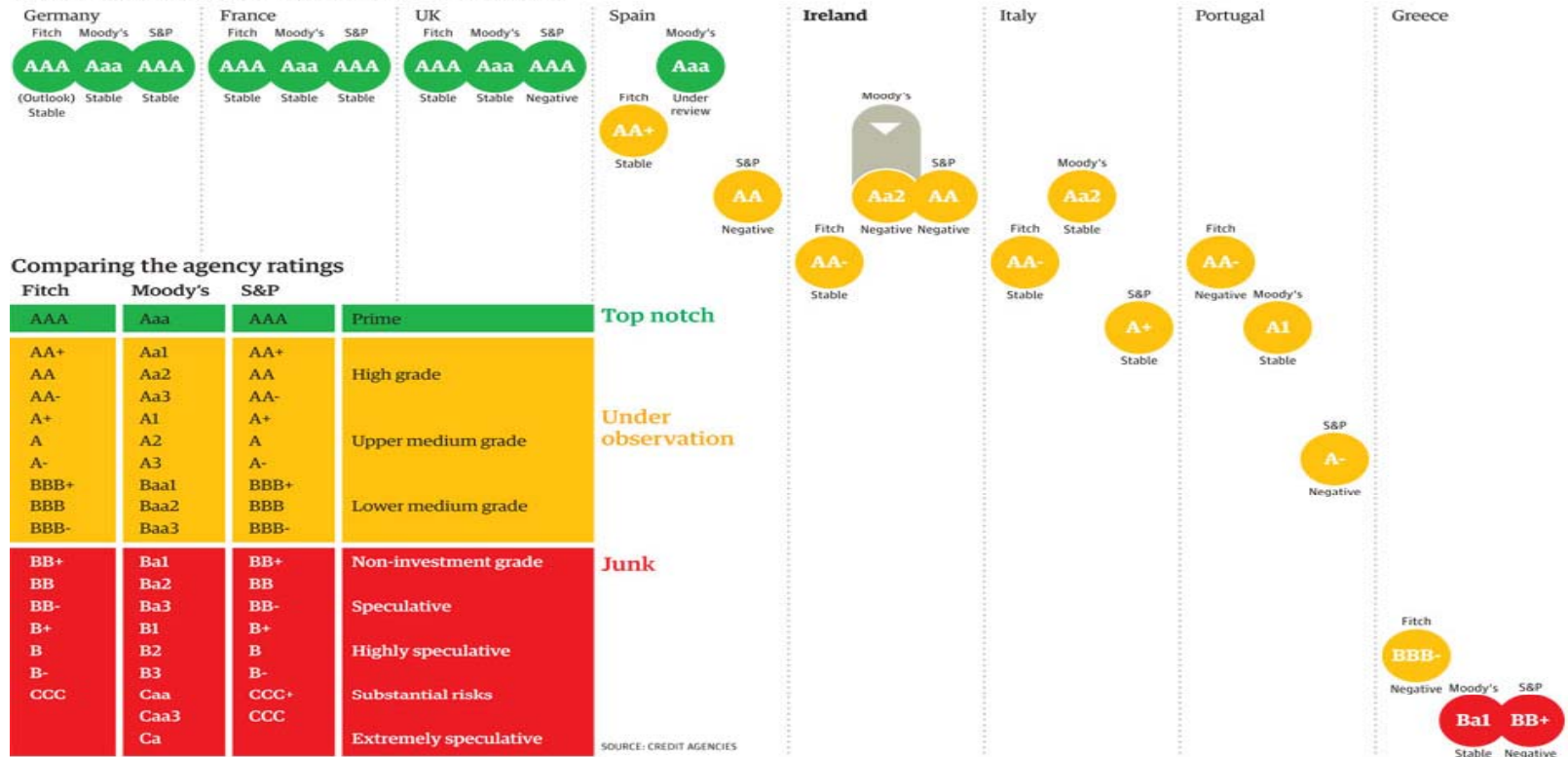


Credit/Default Risks

Sovereign Downgrades in 2009 and 2010

Ratings war How governments are measured by the agencies

Long-term sovereign debt ratings from the big three agencies



Banking/Custody Risks: OCC "Canary Report"

Period End, Adjusted to December Cycle	OCC Project Canary Risk Tolerances	12/31/2008	12/31/2007	12/31/2006	12/31/2005	12/31/2004
Credit Risk						
Adjusted Reserve/ Adjusted Loans	<0%	(3.20)	(2.45)	(2.65)	(2.05)	(1.08)
Change in Portfolio Mix	>7%	5.32	6.29	8.10	1.19	2.91
Net Loan Growth	>20%	11.99	6.70	(2.08)	4.94	49.29
Net Loans/ Assets	>70%	63.10	64.91	71.39	72.08	75.62
Loans/ Equity	>8x	8.36	7.37	7.12	8.18	8.05
Tax-adjusted Yield on Loans and Leases	>Peer 75% Value	6.22	7.65	7.42	6.10	4.95
Number of Credit Risk Indicators		2	1	3	3	4
Interest Rate Risk						
Asset Depreciation of Tier 1 Capital	>15%	28.32	(1.56)	0.09	4.12	(4.86)
Long-term Assets/ Assets	>25%	22.18	24.49	22.10	22.49	21.95
Non-maturing Deposits/ Long-term Assets	<140%	217.74	199.63	249.48	242.63	258.68
Residential Real Estate Loans & Securities/ Assets	>25%	33.55	36.65	39.72	46.04	48.07
Number of Interest Rate Risk Indicators		2	1	1	1	1
Liquidity Risk						
Net Loans and Leases/ Deposits	>80%	98.05	88.35	91.35	91.00	98.32
Net Non-Core Funding Dependence	>20%	34.01	32.16	23.92	30.28	26.74
Net Short-term Liabilities/ Assets	>20%	10.02	16.14	NM	NM	NM
On-hand Liquidity/ Liabilities	<8%	-1.15	3.23	0.53	-0.3	0.95
Reliance on Wholesale Funding	>15%	34.24	31.05	17.11	13.73	14.71
Number of Liquidity Risk Indicators		4	4	4	3	3
Number of Risk Indicators		8	6	8	7	8

Alternative Investments: Benefits and Drawbacks

Alternative Investment Benefits

- Enhance portfolio returns while reducing risk and increasing overall portfolio risk-adjusted returns;
- Low correlation to both stocks and bonds; and
- Access to superior managers.

Alternative Investment Drawbacks

- Fees are higher than traditional strategies;
- Not completely “hedged” against market volatility;
- Many strategies are tax inefficient; and
- Strategies are not transparent .

Alternative Investments: Experienced Losses in Declining Markets

Hedge Funds (as of 6/30/2010)	2010	2009	2008	2007
HFRX Global Hedge Fund	-1.2	13.4	-23.3	4.2
Equity Hedge	-3.4	13.1	-25.5	3.2
Equity Market Neutral	1.9	-5.6	-1.2	3.1
HFRI Distressed/Restructuring Index	4.0	28.1	-25.2	4.0

Natural Resources (as of 6/30/2010)	2010	2009	2008	2007
DJ UBS Commodity Index	-9.6	18.9	-35.6	16.23

Real Estate (as of 3/31/2010)	2010	2009	2008	2007
NCREIF National Property Index	0.80	-16.9	-6.5	15.8

Private Equity (as of 3/31/2010)	2010	2009	2008	2007
Cambridge U.S. Venture Capital	0.80	-0.3	-16.5	16.3
Cambridge U.S. Private Equity	3.9	6.8	-24.2	20.5

Alternative Investments: Fair Value

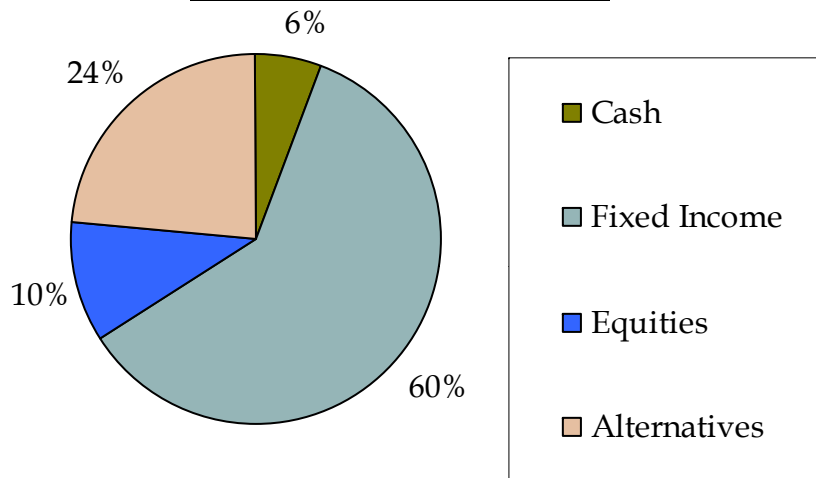
Level 1	Level 2	Level 3
U.S. government and agency securities	Corporate and municipal bonds	Private equity and real estate fund investments
Exchange-traded equity securities	Equity securities that are less actively traded	Equity securities that are not actively traded
Derivatives that are actively traded (futures and options)	Derivatives that are less actively traded (OTC)	Derivatives that are not actively traded
	Investment-grade and high-yield debt	Distressed debt securities
Other sovereign government debt (G7)	Other sovereign government obligations	
	Mortgage-backed and asset-backed securities	Mortgage-backed and asset-backed securities
	Physical commodities	

Identifying and Managing Financial and Investment Risks

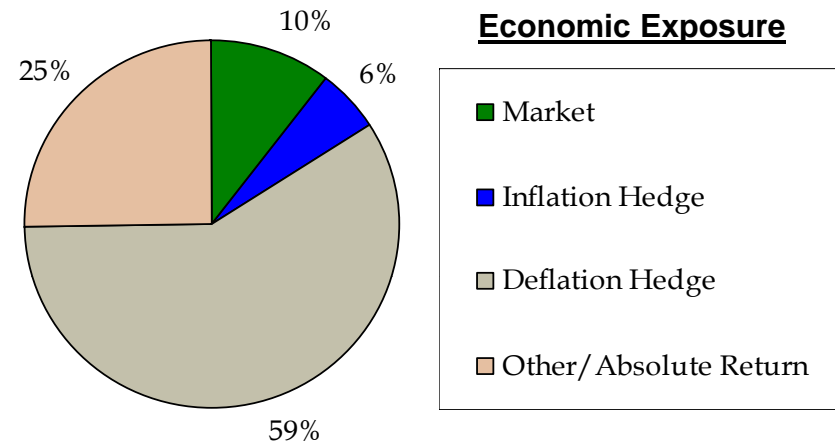
- **Economic**
- **Inflation**
- **Interest rate**
- **Concentration**
- **Liquidity and cash flow**
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- **Banking and custodial safety**
- **Alternative investments**
- **Reputation or "headline" risk**

Multi-dimensional Risk Assessment

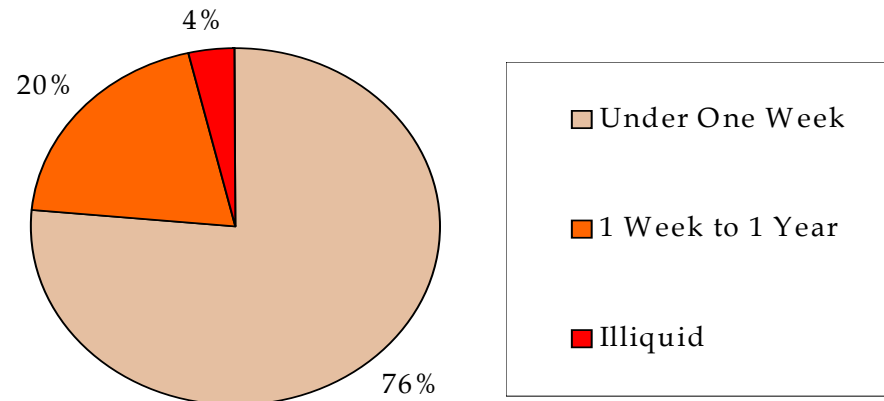
Traditional Asset Allocation



Economic Exposure



Liquidity Risk





Investment Policy Statement Review

Investment Policy Statement Review

- **“Prudent Practices for Investment Stewards” handbook**
 - **Organize**
 - **Formalize**
 - **Implement**
 - **Monitor**

Investment Policy Statement

- **ORGANIZE**

- **Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements.**
- **The roles and responsibilities of all involved parties (board of trustees, investment committee, consultants, managers, custodian, etc.) are defined, documented, and acknowledged.**
- **Fiduciaries and parties of interest are not involved in self-dealing.**
- **Gather information on appropriate benchmarks and peer groups for portfolio investments in addition to the levels of expected returns and inflation.**
- **Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.**
- **Assets are within the jurisdiction of appropriate courts, and are protected from theft and embezzlement.**
- **Gather information on an asset's special relationship or special value, if any, to the charitable purposes of the institution.**

Example of “Self Dealing”

“Although the partnership generally invests with independent portfolio managers, it is possible that **persons associated with the general partner may have an equity interest in one or more portfolio managers utilized by the partnership.**”

Investment Policy Statement

- **FORMALIZE**
- **An investment time horizon and inflation/deflation factors have been identified.**
- **The appropriate risks (economic, interest rate, inflation, deflation, credit, liquidity, etc.) have been identified.**
- **A range of spending policies, inflation/deflation, and expected total returns (income plus capital appreciation) have been modeled to determine appropriate levels in order to achieve capital preservation.**
- **Selected asset classes are consistent with the identified risk, return, time horizon, as well as implementation and monitoring constraints. (Prohibited asset classes are included as well.)**
- **If alternative investments or niche strategies are utilized, they are appropriately structured.**

Investment Policy Statement

- **IMPLEMENT**
- **The investment strategy is implemented in compliance with the required level of prudence.**
- **Investment vehicles are appropriate for the portfolio size.**
- **A due diligence process is followed in selecting service providers, including the custodian.**

Investment Policy Statement

- **MONITOR**
- **Periodic reports compare investment performance against the appropriate index and peer group.**
- **Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers.**
- **Control procedures are in place to periodically review policies for best execution, “soft dollars,” and proxy voting.**
- **Fees for investment management are consistent with agreements and with all applicable laws.**
- **“Finder’s fees” or other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented.**
- **There is a process to periodically review the organization’s effectiveness in meeting its fiduciary responsibilities.**

Questions



Contacts

Stuart Miller, CPA
312.899.5495
stuart.miller@crowehorwath.com

Millicent Holmes
630.575.4212
millicent.holmes@crowewealth.com

Chris Racz, CPA
614.280.5203
chris.racz@crowehorwath.com