Investment Issues for NPO Directors

Nonprofit Management Center of the Permian Basin

Presented by
Robert P. Fry, Jr.
Makarios LLC
Investment Advisors
Outline of Today’s Presentation

➢ NPO Investment Environment
  ▪ Interest Rates, Credit Crisis and Credit Contraction

➢ Industry Trends
  ▪ Spending Rates and Asset Allocations

➢ Practical Steps for Supervising Fiduciary Assets
  ▪ Adopting an attitude of Humility
  ▪ Creating appropriate Spending Policies
  ▪ Assessing your tolerance for risk
  ▪ Delegating authority
  ▪ Reviewing the results
We live in a complex world

- Life Styles
  - My work . . . her work . . . volunteer work
  - Sport’s Club . . . Curves . . . AYSO
  - “Was that my cell phone, your Blackberry or my Trio?”

- Finances
  - Is this the credit card with my frequent flyer points?
  - Why do I want to own Spiders?
  - Isn’t the Hedge Fund a British environmental group?

“Knowledge increases Vertigo,” W. H. Auden
We live in a world we can’t control

- Disruptive Technology
  - Cell phones and traditional long distance carriers
  - Internet and outsourcing
- Random Acts of Government
  - Recent cuts in Fed Funds rates
    - Reduces interest on short-term savings
    - Increases likelihood of inflation
- Nothing is Absolutely Secure
  - US Banks have *LOST* at least $250 Billion . . .
    . . . just in the last 12 months
Rapidly Changing Interest Rate Expectations

ML Institutional Fund
Fed Funds
90-Day T-bill
Merrill Lynch Rate Accounts up to $1,000,000
Merrill Lynch Rate Accounts less than $100,000

Makarios LLC Investment Advisors
Unexpected Consequences at home . . .
Depositors withdrawing funds at Northern Rock, the UK’s one-time largest mortgage lender
Tremendous Contraction of Available Credit
What does all this mean?
- I don’t know!

But it does suggest that . . .
- There is always risk when investing
- Stock market returns may be lower than we have come to expect
- One can never be too humble in approaching money and markets

Humility is a key step toward effective fiduciary investment management
Think back to this time last year. . .

Who predicted more than one of the following . . .

- $50 Billion dollars in losses . . . just at Citibank and Merrill Lynch?
- Hillary Clinton would say something nice about Barack Obama?
- Oil at $140 a barrel?
- The failure of Bear Stearns?
- Odessa Permian 31, Midland Lee 7?
The “Fully Diversified” Yuppie Portfolio - Late 1990’s

16% Utilities

32% Consumer Non-Cyclical

52% Financial Services

The Humility of Diversification
Sample Long-term Growth Portfolio - 1999

- 55% Equities
- 25% Fixed Income
- 15% Alternatives
- 5% Cash
The Humility of Diversification

Intuitively, which is the lower risk approach?

A tiny slice of the potential pie!
Asset Allocation – A Fully Diversified Portfolio

Sample Long-term Growth Investment Model - 1999

- Equity: 55%
- Fixed Income: 25%
- Alternative: 15%
- Cash: 5%

Makarios LLC Investment Advisors
Three Year “Growth” of $1,000 Sample 1999 Portfolio

Relative Performance of Diversified Portfolio
September 1999 through September 2002

$1,800
$1,600
$1,400
$1,200
$1,000
$800
$600
$400

Sep-99 Dec-99 Mar-00 Jun-00 Sep-00 Dec-00 Mar-01 Jun-01 Sep-01 Dec-01 Mar-02 Jun-02 Sep-02

Diversified Growth Portfolio

Makarios LLC Investment Advisors
Relative Performance of Diversified Portfolio
September 1999 through September 2002

Three Year “Growth” of $1,000
Sample 1999 Portfolio

Diversified Growth Portfolio
S&P500
Relative Performance of Diversified Portfolio
September 1999 through September 2002

Your Most Annoying friend's Portfolio
St. Patrick’s Day Party, 1999

Your Portfolio
St. Patrick’s Day Party, 1999

Diversified Growth Portfolio  S&P500  NASDAQ
Industry Trend - Spending Rates

Distribution of University Endowment Spending Policies

% of Schools using Rate

Annual Endowment Spending Rate

- < 4%: 5%
- 4%: 28%
- 5%: 57%
- 6%: 7%
- > 6%: 3%
Spending Levels are Deeply Established

- Very consistent institutional desire to spend 5% of endowment Net Asset Value

![Graph showing College and University Endowment Spending Rates, 1995-2004]

- Equal-weighted
- Dollar-weighted
Practical Response: Establish a Spending Policy

- Important to base spending on Total Return
  - Frees spending from yield objectives
  - Total Return is Different than Yield
    - Key concept in the professional investment world
    - Definition: Dividends and Interest
      Plus Capital Gains
      Less Capital Losses and Expenses
    - Includes unrealized gains and losses
    - Fundamental to all modern portfolio theory tools
      - Risk adjusted returns
      - Correlation

- Establish Net Asset Value Spending Policies
  - 1.25% per quarter
  - 12 trailing quarters
Sample Endowment Spending Policy

The fund shall annually distribute an amount equal to 5% of its then current value which shall include contributions to the fund, income earned on such contributions and all gains and losses on such funds, whether realized or unrealized. These distributions shall be made, quarterly, by distributing an amount equal to 1 1/4% of the: [Option]  
- current fair market value of the fund on the first business day of each calendar quarter.  
- average fair market value of the fund as of the first business day of each of the 12 preceding calendar quarters.  

To the extent that it may legally do so, the organization shall interpret this policy as satisfying a gift provision which calls for retaining principal and distributing annual “income.”
Assessing Your Tolerance for Risk

- Most people, including directors, often overstate their tolerance for risk.
- Why?
  - Bonds are Boring
  - Fear of not keeping up with others
  - Asset Allocation is counter-intuitive
  - Humility is a difficult “sell”
  - True goal is participation . . .
    . . . not out performance
Practical Risk Assessment Questions

- What is the purpose for which we are investing?
  - Does that purpose require inflation protected returns?
- What is the true duration of our funds?
  - Less than 1 year, 1 to 5 years or longer than 5 years?
- How much are we willing to lose without changing our strategy?
  - Maximum percentage loss over two years?
  - Maximum dollar loss over two years?
- What asset allocation is consistent with our true limitation on losses?
The Importance of Asset Allocation

- Asset Allocation is a form of diversification
  - Same underlying principals apply
- True value of Asset Allocation . . .
  - is NOT in generating returns
  - it IS in controlling risk
- Non-Correlation
  - Airplane Stock and Oil Stocks
  - Stocks and Bonds
  - Financial assets and real estate
  - Traditional Investments and Hedge Funds
Asset Allocation as Risk Control

Annual Performance by Asset Class
Bear Market - 1973 & 1974

Percentage Total Return


S&P 500  Inter. Gov't Bonds

Makarios LLC Investment Advisors
Asset Allocation as Risk Control

Plotting Return and Volatility (“Risk”) in the Same Curve, creates the so-called “Efficient Frontier”
Asset Allocation as Risk Control

Relative Bear Market Performance – 1970 to 1980
S&P 500 and Mid-Term Government Bonds

Winning by not Losing!

S&P 500

Lowest Risk Portfolio (30% Stocks)
Industry Trend: More Aggressive Asset Allocations

Growing use of Alternative Investments particularly among larger, long-term investors

- For the 10 years ending June, 2007, total allocations by university endowment to alternative investments:
  - Hedge funds
  - Private equity
  - Venture capital
  - Natural resources

  increased from 4.1% to 15.4% of AUM

- Fixed Income and Cash decreased from 30% to 22%

### Average Allocation to Selected Asset Classes, FY 1998 & 2007

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>1998 Allocation</th>
<th>2007 Allocation</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>63.5</td>
<td>57.6</td>
<td>-9.3%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>25.6</td>
<td>18.6</td>
<td>-27.3%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>2.1</td>
<td>3.5</td>
<td>66.7%</td>
</tr>
<tr>
<td>Cash</td>
<td>4.3</td>
<td>3.5</td>
<td>-18.6%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>2.8</td>
<td>10.6</td>
<td>278.6%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>0.4</td>
<td>2.3</td>
<td>475.0%</td>
</tr>
<tr>
<td>Venture Capital</td>
<td>0.7</td>
<td>0.9</td>
<td>28.6%</td>
</tr>
<tr>
<td>Natural Resources</td>
<td>0.2</td>
<td>1.6</td>
<td>700.0%</td>
</tr>
<tr>
<td>Other</td>
<td>0.4</td>
<td>1.4</td>
<td>250.0%</td>
</tr>
</tbody>
</table>

Industry Trend: More Aggressive Asset Allocations
Limitations of Long-Only Asset Allocation
Limitations of Long-Only Asset Allocation

Non-Correlation of Hedge Funds to Major Equity Markets During Period of Market Stress (May 2006)

Dates in 2006

Makarios LLC Investment Advisors
Performance Profile - Cumulative Returns

Most Recent Full Market Cycle (2000 through 2006)

- **Bull Markets (2003-2006)**
  - CSP: 22.0%
  - NASDAQ: 73.3%
  - S&P 500: 80.9%
  - LBIGC: -43.5%

  - CSP: 61.2%
  - LBIGC: 31.8%
  - S&P 500: -37.6%
  - NASDAQ: -67.2%

- **Both Markets (2000-2006)**
  - CSP: 96.6%
  - LBIGC: 49.6%
  - S&P 500: 8.2%
  - NASDAQ: -40.6%
Sample Aggressive Investment Pool
Before and after Hedge Fund Allocation

Former Growth Allocations:
- US Small Cap: 15%
- US Large Value: 20%
- US Large Growth: 20%
- REIT: 5%
- International: 20%

New Target Allocations:
- Hedge Funds: 10%
- US Small Cap: 10%
- US Large Value: 20%
- US Large Growth: 20%
- International: 20%
- Fixed Income: 20%

Reduced Allocations:
- US Small Cap: 15%
- REIT: 5%

Substitute Allocations:
- Hedge Funds: 10%
Investing is an “a-typical” discipline

- No one “creates wealth” solely by investing
  - Wealth creators:
    - Start companies
    - Hit 310 drives . . . Straight . . . Every time!
    - Write children’s mysteries
  - Other paths to wealth are even less instructive
    - Inheritor of the carried interests in Dad’s oil leases

- Absence of well-established academic path
  - MBA in Finance ≠ Knowledge of Investing

- Therefore . . .
  - Rich people don’t necessarily know how to invest!
Delegation of Investment Authority

- Effective delegation relieves directors of liability
  - Reasonable Manager Search
  - Formal policies
  - On-going review

- Delegation facilitates acquisition of expertise
  - Consultant Role
    - Manager search and selection
    - Strategic Asset Allocation
    - Performance Reporting
  - Managers and Manager Substitutes
    - Specialization by sectors; e.g., small cap, emerging markets
    - Technique becomes tactical – funds, ETF’s, direct portfolios
  - Lot’s of room at the table
    - Custodians, RIA’s, Brokers, Attorneys and CPA’s
Performance Reporting

- **Monthly Asset Statement**
  - Custodial statement showing assets at cost, fair market value and all transactions

- **Quarterly Performance Statements**
  - Returns relative to benchmarks
  - Risk-Reward Analysis
  - Manager performance relative to appropriate Asset Class Index

- **Annual Review**
  - Portfolio Performance relative to Goals and Objectives
  - Asset Allocation Review
  - Manager Reviews
Excerpts from Recent Performance Report

Asset Allocation Targets

### Growth Strategy
- **Hedge Funds**: 16%
- **US Smaller Cap**: 10%
- **US Large Value**: 20%
- **US Large Growth**: 20%
- **Fixed Income**: 20%
- **International**: 20%

### Representative Returns

<table>
<thead>
<tr>
<th>Growth Pool</th>
<th>Last Quarter</th>
<th>One Year</th>
<th>Three Years</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Actual Pool Performance (Net)</strong></td>
<td>-5.3%</td>
<td>2.0%</td>
<td>8.4%</td>
</tr>
<tr>
<td>80% S&amp;P 500 - 20% Bond (Gross)</td>
<td>-7.0%</td>
<td>-2.3%</td>
<td>5.8%</td>
</tr>
</tbody>
</table>

There is additional information on a subsequent page that describes pool performance and manager performance on a risk-adjusted basis relative to various indices.

Asset Allocation @ March 31, 2008

- **Common Sense**: 9%
- **Laddered Bond Portfolio**: 5%
- **Earnest Small Mid-Cap Core**: 9%
- **Lehman Fixed Income**: 13%
- **Cash**: 9%
- **Gulf US Large Value**: 19%
- **The Boston Co International**: 18%
- **Friess Associates US Large Cap Growth**: 18%
- **Friess Associates US Large Cap Growth**: 18%
- **NCF Laddered Bond Portfolio**: 3.65%
- **CMA**: 1.73%
- **Friess Associates Log**: (11.98%)
- **OFI Gulf Investment LCDV**: (6.28%)
- **Earnest Smid Core**: (2.98%)
- **The Boston Company Asset Mgmt**: (9.87%)
- **Lehman Taxable Int. Mat.**: 2.81%
- **TOTAL PORTFOLIO (GROSS OF FEES)**: (5.05%)
- **STYLE INDEX**: (6.43%)

*The **Style Index** for this pool is 40% S&P 500 with dividends, 15% Russell 2000, 20% MSCI EAFE with Net Dividends in USS. 5% NAREIT Reits and 20% ML US Corp & Govt 1-5 Years.*
Risk Adjusted Return Reporting

NATIONAL CHRISTIAN CHARITABLE FOUNDATION, INC.

Risk/Return Analysis (Gross of Fees)

July 31, 2004 to December 31, 2007

- The chart compares different investment options based on their average annual return and risk level.
- Each point represents an investment category, with the position indicating its performance relative to risk.

<table>
<thead>
<tr>
<th>Investment</th>
<th>Avg. Annual Rtn. (%)</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Portfolio</td>
<td>12.81</td>
<td>6.20</td>
</tr>
<tr>
<td>Style Index</td>
<td>12.05</td>
<td>6.90</td>
</tr>
<tr>
<td>Custom</td>
<td>12.18</td>
<td>7.70</td>
</tr>
<tr>
<td>S&amp;P 500 with Dividends</td>
<td>11.13</td>
<td>7.70</td>
</tr>
<tr>
<td>Fress Associates (spg)–lg</td>
<td>14.62</td>
<td>8.90</td>
</tr>
<tr>
<td>OFI Gulf Investment LCDV</td>
<td>12.16</td>
<td>7.20</td>
</tr>
<tr>
<td>Earnest Smid Core</td>
<td>11.40</td>
<td>9.40</td>
</tr>
<tr>
<td>The Boston Company Asset Mgmt</td>
<td>17.30</td>
<td>8.90</td>
</tr>
<tr>
<td>Invesco Inc Reits</td>
<td>18.38</td>
<td>17.30</td>
</tr>
<tr>
<td>Lehman Taxable Int. Mat.</td>
<td>4.21</td>
<td>4.60</td>
</tr>
<tr>
<td>Russel 2000®</td>
<td>12.41</td>
<td>13.50</td>
</tr>
<tr>
<td>MSCI EAFE with Net Divs in US$</td>
<td>21.11</td>
<td>9.60</td>
</tr>
<tr>
<td>ML US Corp &amp; Govt 1-5 Yrs</td>
<td>4.16</td>
<td>1.80</td>
</tr>
<tr>
<td>T-Bills</td>
<td>3.99</td>
<td>0.40</td>
</tr>
</tbody>
</table>

Makarios LLC Investment Advisors
Final Thoughts for Board Members

➢ Discipline beats wizardry over time
   - The key to most market returns is being in the game
   - True goal is measured participation not out performance
   - The judgment of “normal people” matters

➢ The most important investment decisions are independent of pure investment selection
   - Hard ball analysis of risk tolerance
   - On-going cash flow and spending planning
   - The humility to maintain broad diversification

➢ Active and informed supervision helps
   - Be careful what you ask for