

# ENDOWMENT INVESTMENT OBJECTIVES, POLICIES AND IMPLEMENTATION GUIDELINES

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## *I. Objectives and General Policies*

### **A. Financial Objectives**

1. Endowment: The AIA's primary objective for the endowment is to preserve or, if possible, to enhance the purchasing power of the endowment's assets over time so as to at least maintain the endowment's ability to support AIA's activities. The endowment's annual support should be reasonably stable and to that end, both spending policy and asset allocation, as noted below, would be constrained.
2. Unrestricted Funds: The AIA needs to maintain a level of unrestricted funds sufficient to:
  - Provide reasonably stable support of annual operations;
  - Provide for unforeseen requirements. In this case the appropriate level should be the larger of two components determined as follows:
    - The first component would provide "insurance" against unexpected short-term fluctuations in revenues. Without such funds, any need to meet unforeseen cash requirements would require invading temporarily or permanently restricted funds, usually in violation of the donor's intentions. This the Institute cannot do. After study, including reviewing historical short-term revenue fluctuations the AIA experienced, the Finance Committee concluded that an appropriate amount would be 25% of revenues (i.e., an amount providing "coverage," as it were, of 2.5 times a potential 10% decline in revenues).
    - The second component of unrestricted funds for unforeseen requirements would provide for a portion of unfulfilled subscriptions. The Investment Subcommittee felt it unrealistic to maintain a reserve equal to 100% of that balance, but also felt it unwise to maintain a reserve of zero. After deliberation, the Committee concluded that an amount equal to 35% of unfulfilled subscriptions would be appropriate.

The required total level of unrestricted funds incorporating both the support of annual operations and the emergency calculation is not currently present and in seeking to achieve this level as soon as possible, spending must be constrained as discussed in the rest of this policy statement.

*\* The objectives and general policies set forth above were based in part on the study, dated as of May 6, 2000, done for the AIA by Cambridge Associates, Inc., a well-known investment consultant. This study compared the status and history of AIA's investment management and endowment practices to a universe of comparable institutions. The Investment Subcommittee also reviewed historical data bringing the Cambridge Associates study up to date.*

3. Liquidity: The AIA needs to maintain a sufficient level of cash and short-term investments to provide for operating cash requirements (salaries, rent, utilities, and the like) and a liquidity reserve. The level of operating cash balances would ordinarily be related to ongoing operating and program expenses, which would be as contemplated by the annual budget. Operating cash

would not normally be considered part of the endowment. The remainder of cash and short-term investments would be the liquidity reserve, the amount of which would normally be determined by the Finance Committee as a fraction of the total endowment.

## **B. Spending Policies**

In order to preserve or enhance the purchasing power of the endowment's assets over time, the total return achieved by the endowment must exceed the sum of the spending rate, investment expenses, and the inflation rate.

Given the long-term nature of the endowment, recent periods of extraordinarily high and volatile returns cannot provide useful guidance for spending. Over very long periods, institutions spending in excess of 5% of endowment assets annually tend to lose purchasing power. Thus, AIA's objective is for the spending rate to be 5%.

Even with conservative asset allocation, as noted below, short-term movements in equity or fixed income markets can affect the current market value of the endowment's assets, and thus potentially, the annual support the endowment provides. To achieve reasonable stability of support, and to take account of the long-term average peak-to-trough periodicity of market behavior, AIA's spending rule would be to apply the spending rate to a trailing 12-quarter average of the endowment's market value.

To achieve its primary objective, the total return earned by the endowment must be at least equal to the sum of the inflation rate, investment expenses, and the spending rate. The Consumer Price Index ("CPI") is the most commonly accepted measure of inflation. Thus, AIA's minimum investment return objective, expected to prevail over rolling three-to-five-year periods, would be to achieve a total net return of 5% in excess of the CPI.

Over the long term, equity investments have returned in excess of the sum of inflation and AIA's 5% target spending rate. But such long-term returns entailed some considerable volatility. Institutions with unrealistically high total return objectives found themselves emphasizing equity investments. While during certain periods, such as the late 1990s, this paid off handsomely, there are other periods, such as the mid-1970s and ever since mid-2000, where total return was adversely affected by a concentration in equities. Since AIA's objective is to enhance, where possible, the purchasing power of the endowment's assets and annual support, a real (i.e., inflation-adjusted) return objective, net of spending and expenses, of 0.75% is appropriate.

Therefore, AIA's investment return objective is to achieve an expected total return—net of expenses, over rolling three-to-five-year periods—of 5.75% in excess of the CPI.

## **C. Asset Allocation**

The mix of the endowment's investments will affect the total return. It will also affect the volatility of the endowment's assets, and thus the total return and the endowment's annual support for AIA's programs. Too much emphasis on fixed income investments undercuts the objective of at least maintaining the purchasing power of the endowment. Too much emphasis on equity investments, on the other hand, undercuts the objective of reasonable stability of the endowment's annual support.

The AIA's asset allocation objectives consist of acceptable asset classes, a target allocation, and an acceptable range; and periodic rebalancing (i.e., selling and purchasing investments to restore the mix of investments to their target proportions). The AIA's allocations and ranges are as follows:

**Asset Class Target Allocation Acceptable Range**

- Equity Investments 65% (55%–75%)
- Fixed Income Investments 35% (25%–45%)
- Alternative Investments 0% (0%–10%)

Given the size of the AIA's endowment, complicated technical methods of rebalancing are unnecessary, serving only to increase costs without corresponding benefit. Thus, AIA's rebalancing policy will be to review the mix of investments annually, and to rebalance to the target allocation percentage if and to the extent any asset class exceeds its acceptable range.

The Finance Committee will seek to meet quarterly, but in any case, will meet a minimum of three times a year to review the current state of the endowment, the desired asset classes, their target allocations, and acceptable ranges. Should that review lead to the need for rebalancing, a decision will be made accordingly.

**D. Investing Endowed Gifts**

Under normal circumstances, the AIA does not invest endowed gifts separately. Doing so is neither cost-effective nor would it produce a satisfactory return on the money. Therefore, the AIA pools all of its endowment funds and invests those assets collectively according to Board-established policies. The endowment funds are similar to mutual fund shares, in that they share income and investment expense in proportion to their own value. In our pooled endowment, a fund that represents 3% of the total value of the endowment would receive 3% of the investment income. The 5% endowment draw is also allocated in this manner, although that draw is only taken if the AIA can spend that amount of money towards the donor's stated restriction. If the full amount is not spent, the balance is put back into the endowment, and the fund is only charged the amount spent.

When the auditors conduct their annual review, they verify that the AIA's investments comply with the Board's investment policy, that the income and net appreciation and endowment draw are accurately reflected in the financial statements, and that the funds were used in accordance with the donor's stated restrictions.

**E. Change in Endowment Value**

Over time, various AIA activities change the value of the endowment within the three categories of net assets. A brief description of these possible activities follows.

1. Investment Income: When the AIA invests money, be it permanently restricted, temporarily restricted, or unrestricted, the AIA earns investment income in the form of interest and dividends. This income increases the value of the endowment.
2. Capital Appreciation: The value of the AIA's investments varies according to market fluctuations. The organization regularly buys and sells equities, resulting in realized and unrealized gains and

losses. If the sum of the gains is greater than the sum of the losses, the value of the endowment increases.

- **Realized Gains and Losses:** If the AIA purchases an equity and later sells it at a higher price, then the AIA has a realized gain. Conversely, if the AIA sells the equity at a price lower than the original purchase cost, the organization has a realized loss. The gain or loss is realized because the AIA sold the equity and the value of the investments goes up or down accordingly.
- **Unrealized Gains and Losses:** Sometimes the AIA buys equities that increase or decrease in value, but does not sell them. If their current price is greater (less) than the original purchase price, then the AIA has an unrealized gain (loss) and the total value of the AIA's net assets goes accordingly up (down). The gain or loss is "unrealized" because the value of the investment will continue to fluctuate as long as the AIA owns that equity.

## **F. Contributions**

Numerous types of contributions are added to the net assets of the AIA. The three most common types of contributions are Annual Fund donations, grants, and endowing gifts.

1. **Annual Fund Donations:** Donations to the Annual Fund are classified as general operating funds within the unrestricted category of net assets because we will spend them at the Board's discretion during the year in which they are received. Therefore, Annual Fund revenues are not a part of the AIA's endowment.
2. **Grants:** Grants to the AIA are typically made by foundations, corporations, or individuals. The grants are given for a specific purpose and the Institute is expected to spend all of the money. Hence, in many cases, the grant money appears as part of general operations. It is possible that the grant might be a multiyear one. In this case, and especially because the grant is given for a specific purpose, the grant monies are classified as temporarily restricted net assets and are released to general operations as required. The Institute retains grant funds only as long as it takes to spend all of the money and fulfill the donor's intentions.
3. **Endowment Gifts:** Whereas grant donors expect their gifts to be completely used up in a short period of time, some donors want their gifts to generate income in perpetuity for the AIA. Donors who wish to provide ongoing support make endowment gifts to the AIA, which are added to the endowment as a permanently restricted asset. As such, the principal of the gift can never be spent, but the Board can invest the money. The income and capital appreciation earned from the investment become temporarily restricted assets until the AIA spends the money as specified by the donor.

## **G. Deductions**

Deductions may be made from unrestricted and temporarily restricted endowment assets, but never permanently restricted assets. As long as deductions are less than the sum of the investment income, capital appreciation, and contributions, then the value of the endowment will increase and income and appreciation will continue to accumulate over time.

## *II. Implementation Guidelines*

Generally, implementation will be left to the Finance Committee. Guidelines that would apply are as follows:

1. Rebalancing will be done as soon after the end of the fiscal year as is practical.
2. Custody and other administrative arrangements will be reviewed annually.

## *III. Administrative Fee on Restricted Gifts Effective as of 4/1/2013*

Based on the audited financial statements for the fiscal year ended 6/30/2012, it was observed that administrative and fundraising costs run about 23% of total expenses, that is 10.5% in administrative and 12.5% in fundraising. Considering these costs have gone up over the years, the AIA Management recommends that an amount be allocated from restricted gifts to help pay the administrative costs to run programs and manage funds. Management recommended a 15% fee for administrative costs.

### **Details of the policy:**

Management will implement an administrative fee on restricted gifts, which will support the base of the AIA to ensure that the organization continues to be run in an efficient and cost effective manner and that its programs meet the highest levels of excellence. 15% of most restricted gifts to the AIA will be allocated to the administrative fee. Details are as follows:

1. The 15% contribution to the administrative fund will not apply to gifts pledged or received prior to 4/1/2013, unless the donor has agreed to such a charge. Planned gifts are considered to have been pledged if the amount and the restriction have been disclosed by the donor in writing to the AIA.
2. For temporarily restricted gifts, the contribution to the administrative fund will be released to operations as the gifts are received.
3. For restricted endowment gifts, the contribution will be deposited into the endowment fund when received. 15% of appropriated funds will be allocated to unrestricted income in each year.
4. AIA officers can negotiate a different contribution to the administrative fund for gifts of \$10,000 or more, but this will be rare as it is critical to support the base of the organization at an appropriate level.