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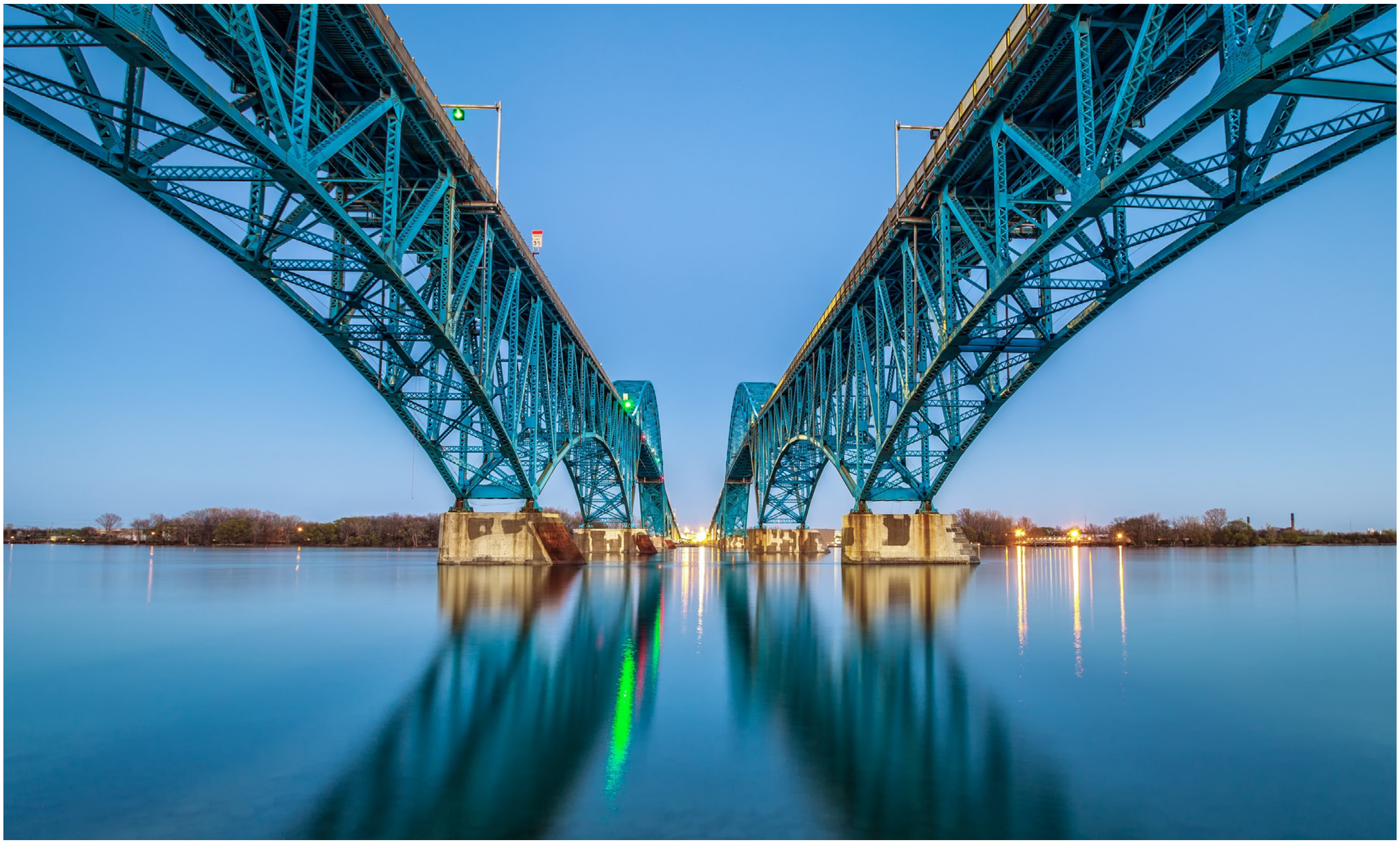
OUTSOURCED CHIEF INVESTMENT OFFICE
ENDOWMENTS | FOUNDATIONS | FAMILIES

Creating a dynamic partnership

Rethinking the investment committee/investment advisor relationship



Overview

Christopher Fletcher
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Finding new ways to collaborate

Over our long history, J.P. Morgan has worked with endowments, foundations, families and nonprofits through many market cycles. This tradition continues today—and provides us with valuable insights into the best practices of the most forward-thinking nonprofits across the world. Taken together, these many relationships also afford us an attractive vantage point from which to share observations and pose meaningful questions about effective investment management and governance.

This was the impetus for Tony Werley, Chief Investment Officer for J.P. Morgan Endowments & Foundations, to develop this paper. As Tony notes, "When the partnership between the investment committee and its chosen investment advisor(s) is fully empowered—and fully leveraged—an institution and its many stakeholders benefit in incrementally significant and long-lasting ways."

The converse is also true: Inappropriate policy and/or disappointing performance can limit an institution's ability to meet its objectives, serve its stakeholders and maintain its competitive position against its institutional peers.

Walking the fine line between these two outcomes has become increasingly difficult for many nonprofits, given the market dynamics of the past few years. However, as we propose, a rethinking of the investment committee/outside advisor relationship can provide an important step forward in an organization's ability to fulfill its mission.

Clearly, as with any approach, one size will not fit all nonprofits. However, we believe that rigorous dialogue can benefit any group. To that end, we think the ideas presented in this paper can help enrich the conversation between an organization's leadership and those charged with managing its investments.

We thank you for giving some thought to these views, and we look forward to hearing your own views on the subject.

Sincerely,

Christopher Fletcher
Global Head of Outsourced Chief Investment Office
J.P. Morgan

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We provide tailored investment strategies and portfolio solutions for endowments, foundations and families worldwide, so they can achieve their goals. J.P. Morgan's Outsourced Chief Investment Office is a trusted advisor to over 300 clients, with $34.3 billion in assets (as of September 30, 2022) .

Endowments, foundations and families are not part of a homogeneous group. Thus, we do not mean to suggest the ideas set out here can be uniformly applied or universally embraced by all not-for-profit organizations. Certainly, the smallest and largest organizations will approach investment management in distinctive—and vastly different—ways in order to serve the needs of their stakeholders.

However, a far larger number of organizations (i.e., those that already retain or have the scale and resources to work with an outsourced CIO) may find that a more dynamic partnership with an external advisor could net the investment committee (IC) the time and mental space to pursue policy and strategy, distribution, institutional cash flow and other significant issues to a greater degree than is possible when its members are tasked with all aspects of the investment program.

A challenging investment environment invites questions

Forward-looking investment management organizations spend significant resources continuously refining the structure of their portfolio teams, and enhancing processes to better navigate the economic environment and the uncertainties facing financial markets.

Are there similar steps investment committees should consider?

We assume that each member of the IC has: the requisite skill to fully evaluate the people and resources needed to strategically manage the institution's legacy assets, a high level of dedication to the organization, and a commitment to ensuring that the right team dynamics are in place for achieving committee success. With this premise in place, the question then becomes: What would be the next higher-order mandate for policy, performance and risk management success?

A good starting point is to consider the necessary skill set, timing and other limitations imposed by a standard investment committee organization:

- Have the current members of the IC mastered the micro issues of investing well enough to:
  - Develop multi-asset-class investment policy?
  - Meaningfully critique overall risk-adjusted investment performance?
  - Evaluate active managers, and especially alternative strategies?
- Can the IC's membership, within the context of quarterly meetings, adequately:
  - Create and monitor policy decisions?
  - Assess changing market conditions?
  - Consider legacy fixed assets, such as real estate?
  - Select and/or evaluate investment managers?
  - Address regulatory and compliance issues?
  - Evaluate the impact of distribution policy?
  - Manage administrative issues?

The need for perspective, information and timely decision making

Since 2000, capital market conditions have made it difficult for many endowments and foundations to meet their return objectives and simultaneously fulfill their fiduciary obligations. Not surprisingly, this stems from the fact that most not-for-profit organizations continue to operate with limited staff and resources, even as the range and complexity of investment opportunities and the volatility of the economic environment have all intensified.

These developments accentuate the need for a broader mindset, and ever more sophisticated risk analytics and timely investment management decisions—even as a large majority of ICs continue to confront these challenges within the framework of quarterly meetings. This has driven many ICs to choose to delegate market strategy, tactics and execution to an investment advisor—and, in so doing, they have gained more time to devote to the crucial levers of establishing or redefining policy, performance and people appraisal.

We view this as an important evolutionary first step for many institutions—one that lays the groundwork for a strategic partnership with carefully planned roles and synergies that can further enhance the IC formation process—which, in turn, can help advance the mission of the overall institution.

Preparing for a marathon, not a sprint

Investment policy is the single most important component of long-term financial success; yet many ICs remain deeply absorbed in the specifics of portfolio manager screening, selection and short-term performance tracking—often at the expense of strategic policy and liquidity decisions that are at the core of long-term endowment success.

The IC/advisor partnership we envision puts in place a framework that is likely to grow more effective over time. For example, as the IC absorbs the knowledge and skill set of its investment advisor, its ability to supervise assets is likely to increase. This, in turn, eventually could lead to the IC reassuming a full investment management role. Meanwhile, members can focus on refining governance and strategy—and the assets can grow to critical mass. This alternative model, which places responsibility for policy and supervision with the IC and charges the advisor with tactics and execution, has the potential to substantially improve how the organization's many stakeholders are served.

Specifically, by freeing the IC of the time-intensive and skill-specific requirements of successful investment management, committee members can give more attention to the most important levers of portfolio success without losing sight of the sub-policy issues.

Just as critically, they could also take on responsibilities that have not been part of the traditional purview of the IC, but which could uniquely benefit from committee members' institutional knowledge and judgment, as well as add transparency to the overall investment process, such as:

- Communications: Committee members can help ensure that stakeholders are well informed about the macro and micro issues likely to impact the institution's assets—and its ability to maintain distribution levels and fulfill its commitments

- Institutional goals: Help manage the multiple goals of most nonprofits regarding environmental, social, governance and impact investing issues

- Sharing the organization's values and vision: Bring the organization's mission to life for advisors and managers to help underscore the importance of smart stewardship of the institution's assets

Both partners are likely to gain strength from this division of labor: The advisor can model and bring clarity to policy issues in support of the IC's decisions. Similarly, committee members—given their intimate understanding of the organization's goals, priorities and biases, enhanced by an insider's view of cash flows and balance sheet issues—can provide a layer of critical judgment to advisor decision making regarding execution and the resources being brought to bear on behalf of the institution.

Optimizing the advisor's role

The advisor's ability to deliver a robust set of capabilities—from a long-term outlook for return and risk to tactical market assessments—is critical to the partnership's long-term success. As the IC works to frame the requirements for investment policy, strategy and successful execution, it must clearly define the advisor's role and the breadth of services needed—and expect critical contributions to be made at every turn.

Policy development

One of the core functions of the advisor is to enhance the IC's ability to focus on investment policy. This happens through the advisor's ability to:

- Provide perspective and analytics regarding policy issues
- Assume responsibility for tactics and execution
- Formulate the building blocks of good policy: informative risk and return assumptions; insightful and rigorous analytics; investment theme identification
- Help educate all interested parties on an ongoing basis
- Free up time for the IC to consider, for example, when well-managed illiquidity can enhance long-term investment performance and other forward-looking issues, such as the benefit of ESG/impact investing

The quality of the strategy, tactics and execution of the advisor is the analog to the quality of the policy decisions. Most investment advisors can help the IC navigate active manager alpha cycles, manage costs and achieve best multi-asset-class execution. The best advisors can provide differentiating value-added services, such as tactical allocation or shorter-term allocation tactics. Given their infrequent meeting schedule, tactical investing is outside the ability and/or inclination of many ICs.

Portfolio construction

Customizing portfolios around existing investments, illiquid exposures and one-off assets, such as operating real estate, is part of sound portfolio construction. However, it takes considerable experience and resources—including cutting-edge risk assessment—to successfully perform due diligence of existing assets, whether they are real or financial holdings.

Communications

Broader and potentially more important than quarterly performance reviews, communications must include a steady flow of market information that purposefully informs relevant stakeholders. Specifically:

- High-quality and time-relevant information on economies and markets also confirms that an advisor fundamentally understands what is transpiring in markets, and uses that understanding to position, and prepare portfolios for forward conditions

- Timely communications can also help reaffirm the IC's trust in the advisor's market and portfolio acumen for the purpose of staying the investment course. No amount of policy, tactics and execution skill can overcome a collapse of portfolio risk at the bottom of the market

EXHIBIT 1: SUPPORT FOR A ROBUST PARTNERSHIP IS ROOTED IN BROAD ADVISOR CAPABILITIES

CONSULTATIVE ANALYTICS	BEST EXECUTION STRATEGIES	CUSTOMIZED PORTFOLIO ANALYTICS	MARKET ADVISORY	COMMUNICATION
• Capital Market Assumptions • Strategic allocation modeling • Cash flow analysis • Strategic portfolio risk modeling • Thematic white papers • Education opportunities • Best practices	• Passive strategies • Other derivative solutions • Ideas and advice • Full trading capabilities • Execution and settlement of donated funds • Single- and multi-asset-class recommendations	• Building portfolios around unique institutional risk profile, cash flow and biases • Incorporating existing investment positions • Execution preferences • Customized portfolio metrics	• Market analysis • Tactical advisory	• Daily market commentary on active market issues • Weekly written synopses of market highlights • Quarterly formal portfolio reviews with investment committee, staff • Annual formal portfolio reviews and discussions with managers

Taking a fresh approach to IC membership

Generally speaking, investment committees, by their own volition, are made up of senior institutional administrators, alumni/friends of the organization with some financial market experience, dedicated fundraisers and institutional boosters who have rightfully been invited to take a seat at the table. However, by moving to a partnership model, and assigning tactics and execution responsibilities to the advisor, the traditional perspective of the required skill set for IC members could be augmented by a more systematic—and functional—approach to selecting IC members—similar to the best practices approach of most corporate boards, which subdivide roles and responsibilities into various committees, such as audit, governance, regulatory and compliance.

Clearly, one approach will not fit all: The desirable qualifications for IC members working in a dynamic partnership with an outsourced investment advisor will necessarily vary from organization to organization. These many variables include the size of the internal staff; the importance of distributions to the operating budget; the size and scope of the distributions; the level of sophistication and experience of the IC members, if any; the amount of time members are expected to devote to the committee; and the existing management/administration framework.

We have seen some very successful and experienced ICs organized to primarily consider those policy issues that can have a significant impact on long-term results. At other institutions, the IC is charged with the dual functions of investment policy and execution—everything the organization needs, from tactics to manager selection.

EXHIBIT 2: CORE FUNCTIONAL IC ROLES

INSTITUTIONAL DEVELOPMENT	**MEMBER(S) WHO REPRESENT:** • Ties to the donor community
INSTITUTIONAL GOALS	**MEMBER(S) WHO REPRESENT:** • Institutional goals, priorities, preferences and trade-off insights
CAPITAL/BUDGET	**MEMBER(S) WHO REPRESENT:** • Understanding of institutional cash dynamics, liquidity, long-term spending needs and potential constraints on portfolio construction • Operational and administrative issues
BEST PRACTICES/ COMMUNICATION	**MEMBER(S) WHO REPRESENT:** • Knowledge of peer group; issues and practices related to governance, portfolio practice and risk standards • Knowledge of peer group; issues and practices related to governance, portfolio practice and risk standards • Understanding of forward-thinking agendas, such as impact investing, ESG (environmental, social and governance) issues and SRI (socially responsible investing)
FINANCIAL MARKETS/ SOLUTIONS	**MEMBER(S) WHO REPRESENT:** • Financial market experience • Exposure to markets over multiple market cycles and conditions • Direct experience regarding alternative investment options and structure • Due diligence exposure

For those organizations wishing to more fully consider the IC/advisor partnership framework, we suggest the following:

Representing institutional goals and priorities

A well-established investment policy incorporates an institution's goals, standards and biases into the investment process. The priority of the institution's outlook in the active management of its assets should not change with the financial environment. The question of who within a given organization—or within its IC—best represents the institutional viewpoint likely has an idiosyncratic answer. From our perspective, leadership commentary on institutional goals and investment policy issues is always helpful in guiding investment practice. Indeed, we have observed many instances where an institution's core attitudes about risk taking, liquidity management and longer-term investment goals provide a successful rallying point for clarifying key investment decisions—especially during turbulent market conditions. Experience also confirms there often is no better way to inform and inspire external advisors/providers as to the importance of their roles than to hear firsthand the commitment and passion of an organization's leaders.

Asking the right questions and staying the course

It hardly seems necessary to cite the need for investment experience on an investment committee. Maybe, the more important credential is for long-term perspective and balanced judgment to be well represented on the committee. Well-organized investment programs can be derailed by strong opinions from marquee committee members. In contrast, a strong mix of balanced and informed opinions, and a strong appreciation for the underlying institution's risk appetite along with technical knowledge, can provide the IC with the long-term center of gravity needed to potentially generate strong operating returns over an extended period of time.

By technical expertise, we mean the full spectrum of investment management knowledge—from portfolio construction concepts and alternative manager strategy practices to performance benchmarking and the intricacies of fees. Having knowledge of operational and regulatory issues (to cite a niche example), such as the hypothecation of securities in exchange-traded funds, is another dimension of technical knowledge altogether. When organizations possess this level of sophistication, it falls to the internal staff and/or external advisors to enhance awareness and create a program for confronting the non-policy issues that are an increasingly important part of successful investing.

However, given the complexity and volatility of today's financial markets—and the widespread adoption of multi-asset-class portfolios and the proliferation of alternative strategies—the knowledge bar for successful oversight and informed decision making has been raised significantly.

Experienced practitioners know that individuals serving on an investment committee cannot be expected to become experts in the minutiae of portfolio execution. However, the IC can be an effective partner in thinking through the key issues impacting a strategy's performance. Some of the best questions, insights and challenges to investment managers and advisors often come from IC members with specific asset class experience. Their insights can both help reaffirm the IC's commitment to an asset class and keep outsourced advisors at the cutting edge of knowing their execution strategies, particularly within the alternative space. For example, many ICs were caught off guard by the impact of a rule change (FASB 157) on the NAV of private equity investments and the cash flow dynamics of commitments versus distributions during the turbulent 2008/09 timeframe. Similarly, within the hedge fund arena, over the same two-year period, the wide use of gates and side pockets prompted more than a little consternation among ICs. Having committee members generally familiar with the nuances of asset class issues can help the IC monitor and respond to issues as they surface and as commitment to an asset class begins to wane. Especially in the past few years, we have seen IC commitments to various asset classes ebb for want of a comfortable understanding of the technical aspects of investment.

Creating an integrated financial outlook

Active consideration of asset and liability issues has become an area of broad interest to the endowments and foundations community. While nonprofit organizations are typically not candidates for extending asset liability integration to the extent of the liability immunization programs of pension plans, the sharp decline in portfolio values in the early stages of the 2008 credit/deleveraging crises—and the resulting distribution shortfalls—generated keen awareness of the need for institutions to closely integrate their asset and operating budget and fixed-dollar commitments. Whether a distribution was required, as in the case of a foundation's mandate, or simply expected, given an endowment's previous years of successful investing, distribution shortfalls had a powerful and disruptive effect. Moreover, even if the organization employed rolling averages or other means to balance current asset distributions versus longer-term distributions, they could not offset the magnitude of the declines we saw in FY 2007/08 and FY 2008/09. (And while the outlook for better returns going forward is an assumption of J.P. Morgan

Capital Markets, potentially sharp drawdowns on a one-year basis and resulting distribution shortfalls are also part of our view.)

While many approaches have been devised to mitigate the harm of a potential shortfall, the most practical outcome of the recent fiscal crises may be the logic of closely integrating both sides of an institution's cash flow statement. Faced with such challenges—and given the variability of distributions and the logic of asset/operating budget/distribution cash flow integration—giving a voice or voting seat on the IC to a senior financial representative seems like a practical idea. The benefit of cash flow information can move in two directions: Understanding the pressure on the organization to meet distribution goals for operating purposes can inform the investment process; similarly, the investment process, aided by good modeling, can help the operating side of the institution understand what is possible—and what is not.

Balance stakeholder interests

To understand why strategic communications to stakeholders with little knowledge of financial markets and investments should fall within the purview of the IC/advisor, think back to the reactions of stakeholders (and Congress) to the distribution discontinuity of the 2008/09 period. Particularly vulnerable were institutions that had enjoyed superlative performance for an extended time period. The seeming suddenness of sharply reduced distributions caught many administrators off guard—forcing cutbacks in the number of offered scholarships and funded grant requests. In some instances, the consistent investment success that made possible very high levels of distributions in the years prior was completely overshadowed by the 2008/09 downturn.

Investment professionals understand that all strategies, styles and models have trade-offs. Everyone benefits when those trade-offs produce a higher compound rate of return over the long run. However, when short-term results and liquidity are emphasized over long-term returns along with some illiquidity, it is tantamount to a policy shift that favors today's beneficiaries over those 10 to 20 years from now.

This may be a good reason for the IC/advisor partnership to make it a priority to message and/or educate stakeholders outside of the immediate need-to-know group.

As the financial markets continue to work through U.S. and global deleveraging, it seems likely there will be a wide range of performance outcomes, not just over a 12-month period, but for three-to-five-year periods. Transparency and communication around a variable range of potential investment outcomes (as well as a potentially uncertain path for distributions) might be valuable when informing stakeholders of the trade-offs of a given investment approach. This, in turn, may help soften reactions to any resultant disruption in the flow of funds to various initiatives. Such communications might also contain peer group and best practices information, as well as insights into forward-looking issues, such as SRI/ESG/impact investing, which may further enrich internal investment committee dialogue as well as external conversations. To this end, we view the communications role as being filled by one or more internal professionals with the seniority and judgment needed to advance the IC's overall agenda.

Conclusion

Optimizing IC effectiveness

Given the current economic backdrop and turbulent financial market environment, this may be exactly the right time to reshape and refocus the composition of the committee, with special focus on searching for skills and experience that fit the changing environment and needed execution options.

As we noted earlier, a starting point for such considerations could be to delegate investment management, analytics and execution to an outside advisor, while the IC focuses on the key policy and supervision levers of legacy management. Further, this would allow the IC to expand its traditional role to include communications and other up-until-now missing considerations.

An expanded set of skills and oversight capabilities would more than complement those of the external advisor—it would be additive: Allowing the IC to fully integrate the external manager functions into the institution's overarching goals and policies effectively "in-sources" the investment management capability. Whatever the ultimate policy/management framework comes to look like, asking about the readiness of investment committee members to successfully negotiate the current investment environment—and to anticipate future objectives—poses questions that seem well worth considering.

We are ready to help

Outsourced Chief Investment Office (OCIO) works with endowments, foundations and families around the globe, advising on and implementing tailored endowment-style investment solutions.

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