DADE COMMUNITY FOUNDATION

Professional Notes

September 2003

ABOUT DADE COMMUNITY FOUNDATION

For 36 years, Dade Community Foundation has been the community foundation for Miami-Dade County, an aggregate of funds created by individuals, families, and corporations to benefit the world around them -- especially the people of our community.

Grants made from these funds meet the changing needs of children, youth, and families; aid in community development; improve the environment; promote health; assist people with special needs; and support education, arts, and the humanities. The Foundation also has taken the initiative in responding to urgent problems -- such as Hurricane Andrew, the AIDS epidemic, and the needs of recent immigrants.

ENDOWMENTS AND THE PRUDENT INVESTOR REQUIREMENTS

By Henry H. Raattama, Esq.

Introduction. The most important and common function of a director is usually the investment of assets. Over the years fiduciary liability has probably focused more on prudent investing than any other single area. There is a great deal of literature available on prudent investing. The current process for prudent investing probably find its geneses in the Employee Retirement Security Act of 1974 ("ERISA"). This is simply because ERISA contained the first comprehensive investment procedure for fiduciaries. The modern prudent investor standard was codified in Florida in 1993 (see Section 518.11, Fla. Stat.). It is assumed that Section 518.11, Fla. Stat., definition of fiduciary includes non profit corporation directors. If not, the concepts would probably apply under the statutory (Section 617.0830(1)(b), Fla. Stat.) prudent man rule. In other words, trustee of a charitable trust and the director of a not-for-profit corporation are required to apply the prudent investor standard unless the governing documents or something else directs otherwise.

Private foundations are subject to IRC § 4944 - Jeopardy Investments. Section 4944 imposes an excise tax (5% 1st tier; 25% 2nd tier) on the Foundation on the amount of a jeopardy investment and an excise tax (5% 1st tier, 5% 2nd tier) on a manager who knowingly participates in a jeopardy investment. A jeopardy investment is simply an "imprudent investment". While one could compare the "prudent trustee" standard under § 4944 and the "prudent trustee" standard under Florida law, suffice it to say there is very little practical difference. Note: the § 4944 prudent investor requirement is absolute (See IRS § 508(e) and § 737.504(3)(c) Fla. Stat.; § 617.0835(2)(c) Fla. Stat.); the general Florida prudent investment rules (applicable to non-private Foundation § 501(c)(3) organizations) may probably be modified by the governing documents.

The following is a generic discussion of some guidelines for prudent investing. It is reiterated that Florida does not have a list of approved investments and no single investment loss (if prudently made) should result in fiduciary liability. The critical element is the process used to make investments, including hiring professional investment advisors and not a particular investment decision.

The Process. The following four steps are suggested as a process that should lead to prudent investing under any of the prudent investor rules.

1. *Analyze the Organization's Needs and Resources.* Review the long and short term needs and goals of the organization. How much money will the organization need to accomplish its goals and what are the sources of funds? At the conclusion of this review, the organization should have a realistic handle on the amount its endowment needs to generate. This amount (converted to a percentage) is called the target rate of return. The organization should also have a good handle on how much investment risk it can afford. The risk will increase as the target rate of return increases, thus, a part of the review will be to conclude whether the target return is feasible in light of the associated risk. The decisions reached in the review will set the parameters of the organization's investment portfolio. The end result is an optimal portfolio that takes into account the organization's risk and return objectives.

2. *Formalize the Investment Policy.* It is critical that the conclusions reached in the analysis stage and the proposed optimal portfolio stage be set forth in a formal written investment policy. The written investment policy is probably the most important of the four steps as it will both document the due diligence of the organization and provide a road map for the organization to follow in the future.

3. *Implement the Written Investment Policy.* Once the written investment policy is finalized, the organization will need to hire professionals to implement the policy. The optimal portfolio design will no doubt include multiple asset classes. A manager will need to be hired for each asset class, even if the manager is a mutual fund of some nature. The implementation will include contracts with investment managers, custody arrangements and similar documentation of relationships needed to implement the investment policy. Unless the organization board has expertise in investments, the implementation will involve delegating the responsibility for investments to professionals.

4. *Monitor and Supervise.* After the investment policy has been implemented, it will be necessary to monitor and supervise both the particular investments and the overall investment policy. There will no doubt be benchmarks established for investment performance. When a manager falls below that benchmark, the organization much decide whether to replace the manager. As investment value increase or decrease, there may be a need to rebalance. As the organization's needs change, or the economy changes, it may be necessary to review the optimal portfolio design. The organization, or a committee responsible for investments, should meet periodically during the course of the year to evaluate investments and should, at least once a year, review the investment policy. The meetings and investment policy review should be documented.

Delegation. A matter of particular concern to individual fiduciaries is the extent to which investment responsibility may be delegated. The law has recognized that it would be proper for a fiduciary to delegate certain acts which it would be unreasonable or imprudent to require the trustee to personally perform. Again, this raised the concept of acting "prudently" in that it could well be argued an individual fiduciary who is not particularly versed in the business and investment world would be acting imprudently in not seeking investment advice or delegating investment responsibility to someone more competent.

Historically, trustees of private trusts were not allowed to delegate the selection of trust investments while directors of corporations could so delegate. Both rules developed in the purely private or business context as the case may be. However, in the charitable context, the private and business contexts intermingle such that much has been written by charitable trustees, their counsel, and legal scholars to the effect that trustees of charitable foundations should be allowed to delegate investment authority. Florida law (Section 737.402(2)(y), Fla. Stat. and Section 518.11, Fla. Stat.) specifically provides that a trustee may employ investment advisors to assist the trustee in the performance of his duties and may act without independent investigation on the advisor's recommendation. Although there is not any case law construing these statutes, there is generally believed to be sufficient authority to permit the outright delegation of investment authority to outside investment advisors, circumscribed as always by the caveat that the choosing of the investment advisor must be done with "prudence". However, it must be kept in mind that trustees/directors must act prudently in their delegation of investment authority. Accordingly, trustees/directors should take reasonable steps in making the delegation, including the following:

- Periodic review of the qualifications and reputation in the investment community of the advisor.
- Periodic review of the actions and performance of the advisor (reports, at least monthly, of income, sales, acquisitions and asset values are recommended).

Written Guidelines for Investment. If you are responsible for investing assets owned by a charity, you are a fiduciary. As a fiduciary, you are required to perform prudently -- at the same time you will not benefit from outstanding performance. Additionally, you are probably serving gratuitously as a community service. In one sense, this is a no win proposition and in another sense, you are doing a great service. In your capacity as a fiduciary, a written investment policy will provide both protection and enhance investment returns.
A fiduciary is legally responsible to "prudently invest assets". Although each jurisdiction is different, prudence generally means that you are required to act as an ordinary prudent business person, i.e., you should conduct yourself as similarly situated persons conduct their affairs. If you do not act prudently, you are theoretically liable for losses that might result. In addition to potential legal liability and, maybe of more significance, you may be subject to media reporters and community scrutiny. Publicity (i.e., a newspaper article reporting on your performance) is probably more likely than legal liability and is possibly more detrimental. The goal of this paper is to briefly state the case for fiduciaries to establish a written investment policy.
There have been monumental changes in the role of fiduciaries investing assets during the past decade.The law, depending upon one's view, has either led or followed these changes. ERISA requires diversification, a spending policy and clearly makes fiduciaries responsible for the investing of qualified plan assets. Most states (all but 10) have enacted some version of the Uniform Management of Institutional Funds Act. Scott on Trusts, the leading source of rules for trustees, recognizes in its 3rd Edition two extremely important new trust principles: (1) that overall return (not individual investments) is the proper measurement of performance; and (2) trustees may delegate investment responsibilities. The Uniform Prudent Investor Act, or some form of it, has been adopted in some form by 47 states, including Florida. Section 518.11, Fla. Stat. While there can be academic discussions of these rules, the bottom line is that you have a fiduciary responsibility to invest assets to produce an overall return without undue risk. In carrying out your duties you will be compared to the practices of similarly situated fiduciaries, the many indices that are published and your overall return compared to similar situated fiduciaries (e.g., all foundations). How do you demonstrate to the courts, the newspaper, your donors, your beneficiaries and others, that you measure up?

A minimum is to develop a written investment policy with the help of a professional that provides written documentation that you considered all factors and decided upon a definite course of action. That "process" is, in the view of the writer (assuming it is competently done), almost as important as the investment results. As an aside, the process will usually produce good or better than average rates of return.

A written investment policy takes many forms. There is no one form. Most consultants have a format that will provide a starting point. The following topics are usually contained in an investment policy:

- Risk Assessment
- Investment Goals
- Liquidity/Spending Needs
- Asset Allocation
- Permitted Investments
- Anticipated Returns and Benchmarks
- Timeliness for Review
- Spending Policy

In preparing and implementing a policy, a professional consultant should be retained. There are two principal reasons. First, unless you are a full time professional financial consultant, you are not in a position to develop an investment policy or to implement the policy. Second, and maybe more important, most fiduciaries retain consultants. The fact that many fiduciaries retain consultants is not necessarily a reason to follow suit, except that if you do not, a jury or a reporter may ask if everyone else did so, why didn't you? Recall that at the outset we said you, as a fiduciary, have everything to lose and nothing to gain (except self satisfaction -- maybe the most important reason to be involved).

A written investment policy provides several important advantages. These advantages include:

- *Discipline* -- You analyze where you want to go and how to get there. Investment discipline may be the most important decision you make. Many routes will get you where you want to go if you maintain the route you select at the outset.
- *Monitoring* -- Investment guidelines permit you to continually evaluate whether you are "on course".
- *Diversification* -- Written investment guidelines will force you to look at diversification in an overall sense. Diversification will reduce volatility and improve your overall return.
- *Focus* -- When you implement your written invest ment guidelines you will focus on each investment in the context of your overall goals. This process will cause you to avoid investments that are risky and/or volatile.
- *Fees* -- Your investment guidelines should require that your returns be calculated "net of fees" and, thus, your decisions regarding retaining investment managers and consultants will not be based on fees. If your returns net of fees reach your investment guidelines benchmarks, you are successful.

Critical Starting Point. The starting point for prudent investing is setting the fund's target rate of return. Then the asset allocation is established. The asset allocation is a function of the target rate of return, i.e., target rate of return will dictate the asset allocation. Both a target rate of return and an asset allocation are part of the attached investment policy serving as an illustration.

Target Rate of Return. The target rate of return consists of the factors that establish the return needed to accomplish the purpose of the invested assets. The most critical and flexible is the spending policy. That is, how much, as a percentage, will be spent each year for charitable activities (this assumes we are dealing with an endowment). The most traditional spending policy or rate is probably 5% (usually of a 3 to 5 year rolling average of fair market value). Today (2003), that spending rate may be high if there is long term concern about maintaining the purchasing power of the fund.

Asset Allocation - The Percentage of Each Asset Class (Equity, Fixed Income, and Other) or Modern Portfolio Theory. Academics have concluded that 90% plus of a fund's return is a result of how its assets are allocated among asset classes. The asset allocation is the most critical decision that will be made. If the fiduciary does not understand the components of asset allocation, e.g., standard deviation, correlation, etc., the fiduciary should hire a consultant or begin to learn the components. These concepts taken together are called "Modern Portfolio Theory", which was first written about or invented in a University of Chicago PhD Dissertation by Harry Markowitz in the early 1950's (and for which he was awarded the Nobel Prize in economics in 1990).The concepts have been expanded, refined, etc., since that time. The fiduciary must understand, or at least be acquainted with, Modern Portfolio Theory concepts, from a personal liability standpoint and, more importantly, to do a good job as a fiduciary.

Conclusion. It would require volumes to cover this topic. Hopefully, the few thoughts in this paper will provide a context in which a fiduciary may start the prudent investor process. The topic is complex. However, there is help and that help should be sought out. Below a form of investment policy serving as an illustration.

Florida Big Disgusting Bug Research Foundation, Inc.

Investment Policy

(THIS IS AN ILLUSTRATION; NOT A RECOMMENDATION)

Background

The Florida Big Disgusting Bug Research Foundation, Inc. (the "BRF") is a Florida not for profit corporation that, for federal income tax purposes, is an exempt organization - IRC § 501(c)(3), and classified as other than, i.e., it is a public charity, a private foundation (IRC § 509(a)). The only tax paid by the BRF is the private foundation audit tax of 2% (or 1%) of investment income (IRC § 4940). All of the BRF assets were contributed by Mr. and Mrs. Afraid O. Bugs and no additional contributions are expected. At the present time, it is anticipated that the BRF will make grants to carry out its charitable purpose. The specific purpose for which the BRF was established is "to provide support for research into mating habits of Florida's huge flying cockroach, a/k/a palmetto bugs, or just plan 'Big Disgusting Bugs!'" The goal is to reduce the mating of or render sterile these loathsome insects in an environmentally friendly manner (that does not involve the use of pesticides) in an effort to reduce substantially the population of these truly despicable creatures. Since they have survived since the dinosaur era the BRF expects, unfortunately to exist in perpetuity. Because BRF is a public charity, it is not required to make any distributions.

Governance The BRF is governed by four Directors.

Preparation of Policy This policy presents the investment process of the BRF. The Directors have prepared this policy in consultation with its investment consultant and legal counsel.

Investment Goals The investment goal is to provide a long term real total rate of return that will increase the purchasing power of BRF assets net of expenses and distributions. In order to achieve its investment goal, the BRF will adopt a strategic asset allocation that will achieve its optimal long term return goal with acceptable volatility. Optimal return is defined as maximum return for a given (acceptable) risk level.

Long Term Investor The BRF will exist in perpetuity. As such, it is a long term investor that seeks a high rate of return consistent with reasonable volatility. The BRF understands that volatility can be reduced by allocating assets among asset classes and also among investment styles and strategies within asset classes. The BRF will adopt strategic targets for each asset class and will, from time to time, rebalance between asset classes, investment styles, and strategies to maintain its strategic targets.

Rate of Return The Directors have adopted a target rate of return that incorporates the BRF investment goals and distribution policy. It is recognized that the target rate of return, investment goals, and volatility are interrelated and must be viewed as such. It is also recognized the investment horizon of BRF is long term (perpetuity) and the target rate of return will reflect that long term view. The initial target rate of return goal is set forth in Appendix A on page 6. The rate of return goal will be reviewed at least annually.

Distributions The BRF will adopt a distribution policy that balances a realistic achievable rate of return, expenses, and its investment goals. Appendix A (on page 6), is the distribution policy adopted by BRF. The distribution policy will be reviewed at least annually.

Income, Appreciation, and Gains The Directors recognize the BRF pays no tax on investment income and, therefore, its investments are not tax sensitive. Its distributions are not limited by income and, therefore, the Directors will ignore income and principal analysis when implementing its investment goals and implementing its distribution policy.

Cash Flow Because it will exist in perpetuity, its only cash flow needs will be to cover expenses (and tax) and the then current distribution policy. It is recognized that additional spending can be controlled and that the BRF, from time to time, may change its distribution rate temporarily.

Performance/Style Measurement The Directors have adopted a market driven benchmark for each asset class and management style. For the portfolio as a whole, the Directors will adopt a benchmark that consists of a suitable passive index for each asset class weighted in accordance with the overall portfolio asset allocation and style allocation.

The Directors will also adopt appropriate peer group data to measure the performance of each managed portfolio. The Directors expect performance of each managed portfolio to be in the top one half of the peer group data base for that particular management style or strategy. The Directors will evaluate investment performance over a three to five year period, anticipating it will not make changes on the basis of short term (less than two years) results.

However, the Directors recognize there are factors, such as changes in personnel, that would require immediate attention and action.

Performance should be measured in a manner consistent with the standards of the Association of Investment Management and Research (AIMR).

The performance measurement will include an analysis of managers adherence to the investment styles set forth in Exhibit B on page 6.

Investment Preference The BRF prefers, but does not require, that managers avoid investment in companies whose primary or significant (greater than 30% of gross revenue) businesses are the manufacture or distribution of pesticide products. This shall not apply to investments in index funds.

Proxies The Corporate Trustee will vote or see to the voting of proxies, including review of proxy voting guidelines. The Directors will receive an annual report of proxy voting decisions

Specific Functions for the Board of Directors
1. Establish investment objectives for the portfolio.
2. Establish and review its distribution policy.
3. Set strategic asset allocation.
4. Establish and continue to update the investment policy.
5. Establish, monitor and update the investment process.
6. Review investment performance in accordance with its performance measurement policy.
7. Review at least quarterly investment activity to insure compliance with investment policy and adherence to in vestment style.

Specific Functions of the Investment Consultant
1. The Investment Consultant shall review regularly all investments of the BRF.
2. The Investment Consultant shall recommend to the Board of Directors such investment and investment related policies as it deems appropriate.
3. The Investment Consultant shall make periodic investment performance reports (no less than quarterly) to the Board of Directors.

Asset Allocation (1). To achieve its investment objective the BRF's assets shall be allocated among various asset classes. The initial strategic asset classes adopted by the Board are outlined in Appendix B on page 6. It is recognized that the asset classes selected are the initial asset classes and, in the future, one or more fixed income asset classes may be adopted in addition to cash or cash equivalents.
(2). The BRF investments will be allocated among asset classes and diversified within asset classes. Within each asset class, securities (for example) will be allocated further by economic sector, industry, quality, and size.

The purpose of allocation and diversification is to provide reasonable assurance that no single security or class of securities will have a disproportionate impact on performance of the total fund. As a result, the unsystematic risk level (sometimes referred to as unmanageable risk) associated with a portfolio investment is reduced significantly. Extreme concentration can produce volatility so great as to cause a complete loss of the portfolio. In the longer term, the market does not reward a fiduciary for assuming unsystematic risk. That is because it can be eliminated through appropriate diversification.

(3). In any asset class, no more than 5% at cost or 10% at market may be held in the securities of a single issuer.

(4). Allocation by investment style is also an important step in reducing the risk (volatility) of the BRF's portfolio. Investment styles within equity asset classes are defined as follows:

Value Equity Investment in companies believed to be undervalued or possessing lower than average price/earnings ratios, based on their potential for capital appreciation.

Small Cap Equity Investment in companies with total market capitalization of less than Two Billion Dollars (this amount may be adjusted periodically).

International Equity International equity investments are permitted in listed equity securities traded on developed non U.S. markets. Developed markets are defined as those included in Morgan Stanley's EAFE Index plus Canada. American depository receipts (ADRs) traded on major U.S. markets are considered to be domestic securities.

Growth Equity Investment in companies that are expected to have above average prospects for long term growth, earnings, and profitability.

Core Equity Process The Corporate Trustee believes that style weighting decisions should begin from a reference point of neutrality. However, in order to create incremental returns over the target benchmark the Corporate Trustee will adopt "style tilts" in response to current market and economic conditions while maintaining similar characteristics to the underlying benchmarks. Portfolio characteristics closely tracked include: Average Market Cap, Beta, Sector Weightings, Average P/E multiple. The Core Equity's "style tilts" can be divided broadly into two main types: growth and value. There are many theories regarding which economic variables are likely to cause superior returns from one equity investment management style versus another. Some theories have evolved into generally accepted notions of fact. The Corporate Trustee believes the successful implementation of "style tilting" (emphasis of one style versus another) requires an accurate assessment of macro economic trends. The potential rewards argue for implementing such a strategy. However, the potential performance penalty for being wrong also argues for moderation.

Custodian The Directors will select a third party custodian for the BRF. The Investment Consultant shall recommend to the Board appropriate policies and procedures for custodianship and access to securities held by the BRF as it may deem appropriate.

Soft Dollars The Investment Consultant will annually review the "soft dollar" policy and activity of each actively managed portfolio and report its findings to the Directors. Each active manager is expected to enter into equity transactions on a best execution basis. The Directors may designate certain brokers by which commissions may be recaptured or provide for the payment of services rendered to the BRF.

Guidelines for Corrective Action Corrective action will be taken during the review of active management. The following are instances where immediate corrective action, or termination of active management, may be in order:

- Organizational and/or personnel changes in the active manager. Failure to notify the BRF of such changes is grounds for immediate termination.

- Violation of terms of any investment management agreement between the Directors and an active manager.

- Change by an active manager in the management style for which the manager was selected. The BRF, through the Corporate Trustee, will closely track the investments of each active manager to insure adherence to manage ment style for which the active manager was retained.

Rebalancing Procedure Should the range for a particular management style be violated by reason of gains, losses, changes in an active management, or any other reason, the Directors will meet or conference to decide whether to rebalance the assets to the target class and style allocation policies. In addition, the Board shall review the actual allocations at each quarterly meeting in order to insure conformity with the adopted strategic allocation. The assets will not be automatically rebalanced on any set schedule.

This material was originally developed for use in the 2003 Nonprofit Manual distributed by Leave A Legacy. Henry “Hank” R. Raattama Jr. of Akerman Senterfitt law firm penned this article, its appendixes and attached illustration.

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APPENDIX A

Target Rate of Return for Florida Big Disgusting Bug Research Foundation, Inc.

Expenses	1%
Allowance for Inflation	4%
Distribution from the BRF	5%
Growth	1%
Target Return	11%

This is an Illustration; Not a Recommendation

APPENDIX B

Florida Big Disgusting Bug Research Foundation, Inc.

Equity Portfolio Guidelines

Asset Class	Target Weight	Benchmark	
Large Cap (Dom. Equity)	30%	24-36%	S&P 500
Mid Cap (Dom. Equity)	15%	12-18%	S & P 400
Small Cap - Growth	10%	8-12%	BGI Small Cap
Small Cap - Value Value	10%	8-12%	BGI Small Cap
Non-U.S. Equity - Major Markets	20%	16-24%	MSCI EAFE
Managed Real Estate Investment	5%	4-6%	NAREIT- Equity
Domestic High Grade Fixed Income	10%	8-10%	LT GVT/Corp

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DADE COMMUNITY FOUNDATION

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ABOUT DADE COMMUNITY FOUNDATION

The Foundation is governed by a 21 member Board of Governors composed of community leaders. Its staff is recognized for experience in grant making, financial administration, and donor services.

Dade Community Foundation has made grants of over $75 million to Greater Miami's non-profit agencies.

For more information about the Foundation call Joe Pena, Director of Development and Communications at ***305-371-2711***.

Professional Notes was designed by: Carla Rowe, Communication Associate.