

Nonprofit Guide to Prudent Investing

From The Merrill Lynch Center for
Philanthropy & Nonprofit Management

Traditionally, nonprofit organizations invested charitable funds relatively conservatively. However, as knowledge about the behavior of capital markets expanded and Modern Portfolio Theory (MPT) gained acceptance, the laws governing the world of charitable investing evolved.

Current investment standards require that charitable assets be managed as a prudent investor would, considering the purposes, terms, distribution requirements and other circumstances of the trust, endowment, foundation or other charitable fund. Reasonable care, skill and caution must be exercised in satisfying these standards. All investment and management decisions must be evaluated in the context of the investment portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the terms of the trust or needs of the nonprofit organization.

Over the past decade, the investment landscape for board members, trustees and other fiduciaries responsible for charitable funds has changed significantly. This Guide provides an overview of those changes and what is required of individuals who oversee and administer charitable trusts, endowments and other nonprofit assets.

Fiduciaries and Their Duties

Are you a fiduciary? If you are an officer of your organization (paid or unpaid), a board member (paid or unpaid), the executive director or another organization employee with financial duties, the answer very likely is, yes. And, as a fiduciary, it is important that you comply with the prudent investor standards.

NONPROFIT FIDUCIARY DEFINED

By definition, a fiduciary is an individual or organization holding assets for another party, often with the legal authority and duty to make decisions regarding financial matters on behalf of the other party. In all cases, fiduciary duty requires that actions taken on behalf of the other party be in the best interests of the other party.

However, fiduciary duty has a broader significance for nonprofits, because they are considered to hold all of their assets, including investment funds, in trust for the benefit of their constituencies and the charitable purposes for which the organization exists. Board members need to balance their duty to make sure the organization is doing well financially with their charge to represent the organization's commitment to its mission.

FIDUCIARY RESPONSIBILITIES

As a nonprofit fiduciary, your responsibilities fall into three broad legal categories, as follows:

Care (Prudence). Board members should act in their positions as any prudent person in a like position would act under similar circumstances. This duty of care requires you to read relevant documents, prepare for and take an active part in board meetings and be fully aware of the organization's finances, operations, programs and services. You can delegate certain responsibilities to staff, committees, task forces and experts, such as Merrill Lynch Trust Company*, but you must stay informed of their activities and take appropriate action when indicated.

Loyalty. The duty of loyalty requires you to avoid conflicts of interest. When managing and investing charitable assets, you must give your undivided allegiance to your organization without regard to personal, business or social interests. In addition, you cannot use any information gained through your position with the nonprofit organization for your personal or business benefit or to benefit anyone else personally connected to you.

Obedience. You must act within the scope of federal and state legal authority, including ethical standards, and in accordance with the organization's articles of incorporation.

Investing charitable assets requires adherence to the tenets of all three of these categories—along with a working knowledge of current investment standards.

*Merrill Lynch Trust Company is a division of Merrill Lynch Bank & Trust Co., FSB.

The Road to Current Standards

In the past, when a nonprofit's investment activities—trust activities in particular—were legally challenged, a court would typically hold the fiduciary accountable on an asset-by-asset basis. Consequently, investments were chosen individually with an emphasis on protecting principal. The standard of accountability has changed considerably with the adoption of the Uniform Management of Institutional Funds Act (UMIFA), the Uniform Prudent Investor Act (UPIA), and the Uniform Prudent Management of Institutional Funds Act (UPMIFA).

Under the prudent investor standards of these laws, your investment management decisions will be evaluated in light of overall investment performance—or total return. The performance of individual assets is no longer the key issue—as long as the asset is chosen as part of an overall investment strategy having risk and return objectives reasonably suited to the charitable investment purpose. In fact, the inclusion or exclusion of a particular individual asset, in and of itself, is not determinative of liability under modern prudent investor standards.

The evolution of current investment accountability standards for nonprofit fiduciaries has taken several decades. The process started in the 1970s with the UMIFA which modernized many of the rules that apply to qualified retirement plan trustees.

Additional laws promulgated in the 1990s and after 2000 produced more guidance directed to nonprofit trustees and other fiduciaries.

TOTAL RETURN:

The entire amount an investment or portfolio earns, including capital gains and income from any dividends and interest. It is generally considered a better measure of investment return than dividends or interest alone.

It is important to note that not all states have adopted all of these laws and standards, and those that have may not have adopted them in their entirety and may apply the rules in different ways. It is important to consult your organization's legal counsel to learn exactly what laws and concepts apply in your state.

The Uniform Management of Institutional Funds Act (1972) sets investment standards of conduct for governing boards of nonprofit organizations. The statute gave the governing board broad investment authority, clarified that the board was not restricted to the investments then authorized for trustees and permitted boards to delegate authority to independent financial advisors and investment managers. It also enabled endowment fund managers to use modern investment techniques, such as total-return investing.



Restatement of the Law of Trusts 3d: Prudent Investor Rule (1992) guides trustees as to their legal duties and tells them to invest and manage trust assets as a prudent investor would in the “context of a trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suited to the trust.” Under this updated definition of the prudent investor rule, the trustee should consider the purposes, terms, distribution requirements and other circumstances of the trust. In satisfying this standard, the trustee must use reasonable care, skill and caution.

- Investments must be judged in relation to the total portfolio, not in isolation.
- No investment is specifically forbidden.
- Risk management is required. The trade-off between risk and return is identified as the fiduciary’s central consideration.
- Trustees can delegate investment management responsibilities.

The Uniform Prudent Investor Act (1995), which has been adopted by most states, recognizes modern investment principles (mainly MPT) and requires trustees of charitable trusts to use modern investment practices—similar to those required to be used by trustees of private trusts—when they invest charitable funds.

The Uniform Principal and Income Act (1997, amended 2000) furthered the principles of UPIA, providing tools for the use of investment techniques authorized under UPIA. It provides procedures for trustees and allows more flexibility in allocating investment returns between the income for income beneficiaries and principal for remainder beneficiaries to ensure that the intention of the trust creator is

the guiding principle for trustees. For example, a trustee pursuing a total return investment strategy could use part of the total return to meet the income needs of the income beneficiaries, whether or not that return consists of traditional income or capital gains.

To illustrate: A particular trust has an average 20% return on investment, but only 2% of that return comes from interest and dividends (the rest comes from capital gains). The trustee may distribute some of the capital gains to the income beneficiaries so that they receive reasonable income (such as distributions ranging from 3% to 5% of the portfolio’s market value).

The Uniform Prudent Management of Institutional Funds Act (2006) replaces the Uniform Management of Institutional Funds Act by updating the prudence standard that applies to the management and investment of charitable funds. It reflects the fact that standards for investing and managing institutional funds are the same regardless of whether an organization is organized as a trust, a nonprofit corporation or in some other manner. It also gives the board more flexibility in making endowment expenditure decisions so that the board can cope with fluctuations in the value of the endowment. It provides modern guidance for the prudence standards fiduciaries should follow in making investment decisions (MPT).

This act has been adopted by more than 20 states and introduced in a number of others.

All of these acts share the goal of eliminating outmoded concepts of charitable investment in favor of MPT. Consequently, it is important that you and other fiduciaries have a working knowledge of MPT and how to apply it to your organization’s investments.

Modern Portfolio Theory

No investment is free from the risk of loss. The challenge facing individual and institutional investors is how best to achieve an optimal return while managing the possibility of investment loss. In other words, it is about finding the ideal balance between risk and return.

The risk of losing principal or not achieving a minimum investment return is almost universally understood. However, loss of principal is not the only investment risk. Several other risks exist that pose a potential threat to portfolios:

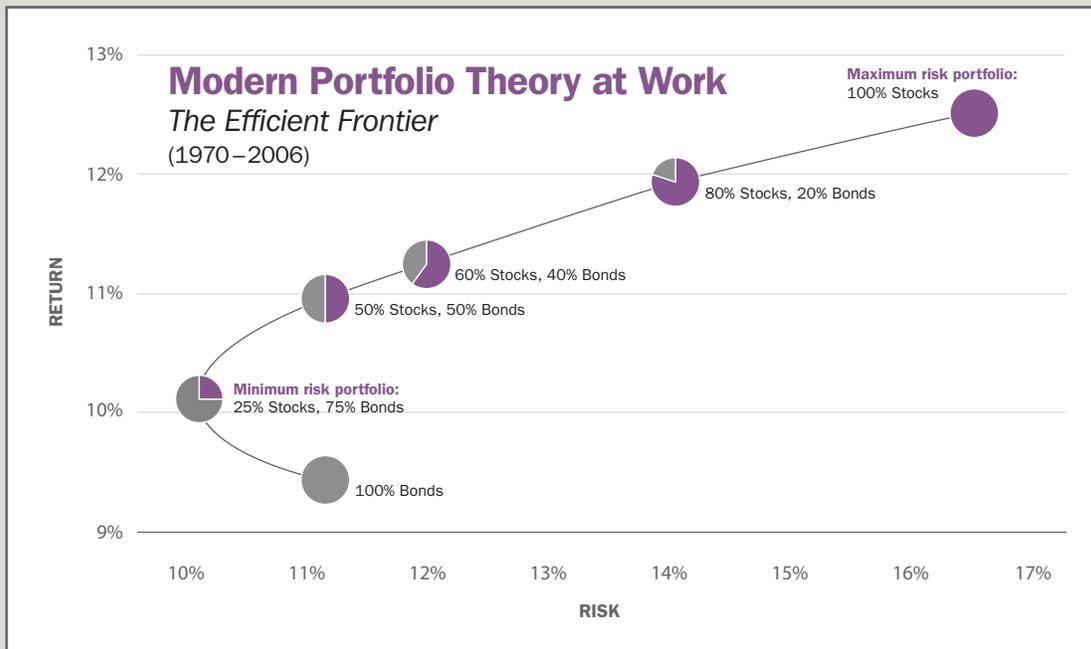
- **Individual investment risk** is the risk that the value of any one security will drop below the price the investor paid to buy the security. It is also referred to as specific risk.
- **Market risk** refers to the risk that the broader market and most of the securities in that market will decline in value.
- **Inflation risk** is the potential for inflation to reduce purchasing power and, ultimately, the true value of an investment return.
- **Liquidity risk** occurs when there are few buyers for the asset due to market conditions.
- **Interest-rate risk** is the risk that changes in interest rates will result in losses in the value of bonds and other interest-rate sensitive investments.
- **Currency risk** is produced by fluctuations in currency exchange rates that increase or reduce returns. If the dollar rises in value in relation to a foreign currency, the return on a security denominated in that currency is reduced upon conversion to U.S. dollars.

Identifying and controlling investment risk is critical for institutional investors. Contemporary attitudes about controlling risk derive from MPT. In essence, MPT says that all assets do not behave in the same way. Having the right mix of assets is crucial in determining how a portfolio will perform over time. By investing in different types of investments, which respond differently to economic conditions, a portfolio can reduce investment risk from market declines in any one asset class—or loss from any one security. Since risk is likely to be lower, the portfolio should be more efficient.

A combination of asset classes results in an optimal portfolio (“the Efficient Frontier”). To determine the efficient portfolio for various types of investors, the model uses historical data for different asset classes as a starting point. Historical data includes returns, risk and correlations among the asset classes.

MPT contends that the returns associated with different assets are related to the risks involved in owning them. The greater the risk of owning a particular asset, the greater the potential return should be. The accompanying graph illustrates that the risk of owning a portfolio composed of 100% stocks is far greater than the risk involved in owning a portfolio composed of 100% bonds. However, the expected return on the pure stock portfolio is significantly higher.

According to MPT, by holding investments in various asset classes—diversification—an investor reduces the risk to the portfolio if one asset declines in value. Diversification capitalizes on the advantages of each investment to produce more consistent returns. However, diversification works best when different asset classes have a low correlation with each other. (When returns move in the same direction at the same time, they are said to be highly correlated. When returns move in different directions, they are said to be uncorrelated, or inversely correlated.)



Risk is measured by standard deviation. Return is measured by arithmetic mean. Risk and return shown are based on indexes and are illustrative; they assume reinvestment of income and no transaction costs or taxes. Past performance is no guarantee of future results. Index sources: Stocks—Standard & Poor’s 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Bonds—20-year U.S. Government Bond. Direct investment cannot be made in an index.

Source: Morningstar, Inc. (Certain portions of this work were derived from the work of Roger G. Ibbotson and Rex Sinquefeld).

MPT also maintains that asset allocation further reduces investment risk and helps generate more consistent returns. Asset allocation is the process of deciding how much of your organization’s money should be placed in different asset classes—stocks, bonds and cash, for example. Successive studies have shown that the greatest determinant of the success or failure of an investment strategy is how assets are divided among the various asset classes. In fact, studies have indicated that asset allocation accounts for over 93% of a portfolio’s performance.

DIVERSIFICATION:

An investment strategy that spreads a portfolio’s investments—and, therefore, risks—among different asset types, market sectors, industries and individual securities. Diversification can help protect the portfolio’s overall value if the value of one security type, sector or security drops sharply.

STANDARD DEVIATION:

A measure of the amount of risk present in a portfolio. Standard deviation gives an indication of the range of the returns to be expected in an average year.

What Is Prudent Investing?

The exact details of what is prudent investing for your organization depends on the laws of your state. Generally, to make prudent investment decisions, you need to consider several factors.

It is important to consider overall economic conditions, the possible effect of inflation or deflation, expected total return from income and capital appreciation, the role that each investment plays within the overall portfolio, as well as cash flow and liquidity needs.

The expected tax consequences of various investment choices must also be considered. For example, it would normally be imprudent for the trustee of a charitable trust for which income is already tax exempt to accept the lower yields associated with tax-exempt securities.

PRELIMINARY QUESTIONS

Before making investment decisions, it is important for you and your board to ask yourselves some preliminary questions.

What assets are we, as fiduciaries, responsible for?

A nonprofit organization may own or control more assets than board members may initially realize. Common investable assets include operating reserves, retirement plan assets, capital campaign reserves, endowment funds, foundations and planned gifts such as trusts, annuities and pooled-income funds. These various assets may have to be invested differently because each category has its own purpose, time frame, investment goals and risk parameters.

What are the investment goals, time frames and restrictions? For each portfolio category, the board needs to provide the investment manager (in-house or external) with specific guidance on its purpose; growth, income and liquidity needs; time requirements and any restrictions. For example, with operating reserves, a nonprofit organization would most likely want to preserve capital, maintain liquidity and earn the level of income that is possible within those two constraints. Its time frame is likely to be immediate to very short. Checking accounts, money market funds and other cash equivalents would likely be appropriate investments.

Capital campaign funds, on the other hand, represent money for which growth is likely to be sought, but may not be essential. They have no current income requirement and a longer time frame than operating reserves as a whole. Medium-term fixed income investments often are suitable for capital funds.

What level of risk is tolerable for the fund?

It is important for fellow fiduciaries at nonprofit organizations to determine how much risk they are willing to assume for each type of portfolio being invested. Risk tolerance will vary from portfolio category to portfolio category, depending on time frame and purpose.



Prudent Investing Practices

WEIGHING RISK AND RETURN

Before determining whether an investment is appropriate for a particular portfolio category or investing purpose, it is helpful to consider the trade-off between risk and potential reward. Under the Prudent Investor Rule, liability for improper conduct is measured by reference to the total return that should reasonably have been expected from an appropriate investment program in light of the purpose(s) of the trust or portfolio and the relative circumstances of beneficiaries. A positive return, alone, will not necessarily protect the fiduciaries from liability. Nor does a fiduciary necessarily violate prudent investment standards if a particular investment does poorly.

What is important is that you are able to demonstrate how a trust or a portfolio's investments meet suitable risk and return objectives. Prudent investment rules recognize that potential investment returns correlate strongly with risk but that risk tolerance varies greatly, depending upon the circumstances.

RISK MANAGEMENT REQUIREMENTS

Investment diversification to manage risk is a must for most charitable investment portfolios—unless the particular purposes of the fund or trust would be better served without diversification. Diversification by asset class—asset allocation—and within the asset classes is considered prudent. Asset allocation helps limit your risk and increase return opportunities.

Prudent investment regulations and laws do not specifically limit investment in any kind of property or type of investment as long as that investment plays a suitable role in achieving your investment objectives and meets other prudent investment requirements. More sophisticated investment vehicles, such as derivatives, asset-backed securities and hedge funds, that may have been prohibited in the past, can be deemed to be prudent investments in the right situations.

Fiduciaries, however, should assess whether the use of a particular investment will jeopardize an endowment or the tax-exempt purpose of a fund, foundation or trust. IRS rulings suggest that fiduciaries wishing to invest in more aggressive and alternative investment vehicles should secure competent professional tax advice.

DELEGATING INVESTMENT MANAGEMENT

Acting as fiduciary of a nonprofit organization is a very significant responsibility. Most boards delegate actual management to an investment committee that includes some board members and may also include nondirectors with more financial experience. Still, many board members and officers may feel uncomfortable with the accountability involved.

Fortunately, the Prudent Investor Rule allows you to delegate investment and management functions, provided you select an agent carefully. Your board should set the scope and terms of the delegation in accordance with the purpose and terms of the fund or trust. In addition, you must monitor the agent's performance on a regular basis. Fiduciaries who delegate and monitor properly generally will not be held liable for the agent's decisions and actions.

An Investment Policy Statement

A written investment policy statement can go a long way toward keeping your organization in compliance with prudent investment standards and helping to mitigate potential investment liability. The policy should be developed with the assistance of an experienced financial professional and reviewed by legal counsel.

What should be included in your investment policy statement? In general, a nonprofit organization's investment policy should:

- Define general objectives
- Delegate asset management responsibilities to a financial committee or professional manager(s)
- Set asset allocation parameters
- Describe asset quality
- Define the investment manager's accountability
- Provide for regular review of the policy

You also may want to provide guidelines for selecting and terminating investment managers. The greater your organization's investable assets, the more specialized help you will be able to afford—and will need. While it is not unusual for organizations with smaller asset levels to use outside consultants, it is practically imperative for those with higher asset levels to do so.

PURPOSE AND BACKGROUND

An investment policy statement (IPS) begins with an explanation of the reasons for establishing the policy and the fund portfolio's purpose, legal structure and size. It may describe the fund's relationship to other assets the organization may own and the likelihood and amount of future contributions to and distributions from the fund.

INVESTMENT OBJECTIVES

Objectives are stated in terms of return requirements, risk tolerance and other constraints, such as time horizon, liquidity, legal and regulatory issues and unique needs and circumstances. Frequently, an organization's primary investment objective is to maximize total return while minimizing risk. The appropriate total return objective will depend on the purpose of the fund—operating reserves, designated funds, charitable trust funds, annuity reserves, endowment, etc.—and its time horizon. Specific total return goals should be set for each asset class and for each fund overall.



INVESTMENT GUIDELINES

This section defines the types of investments that can be used to pursue the investment objectives. Guidelines may detail authorized portfolio exposures to different securities, economic sectors, countries, cash holdings, and so on.

You may want to restrict investments based on the quality ratings of an outside organization, such as Standard & Poor's or Moody's. For example, your board might stipulate that 80% of its equity investments must be in stocks with a specified minimum rating or better and 80% of its fixed income investments must be in fixed income securities of a certain quality or better.

ASSET ALLOCATION

For each fund, you need to determine an acceptable percentage of assets to allocate to each investment class and set guidelines for rebalancing investments when they deviate from those percentages. To establish allocation percentages, your board should take into account the time horizon of each fund, the expected rate of return for each asset class, liquidity requirements and the organization's acceptable risk tolerance. Your investment advisor can help you evaluate each of these variables.

It is also important to set asset diversification guidelines to limit the percentage of assets that may be invested in any one company or industry. This decision will most likely directly affect your risk and the degree to which your portfolio fluctuates in value. By holding securities of several different companies, you reduce the specific risk associated with investing in an individual company. Additionally, investing across several industries reduces your exposure during an economic downturn that affects only a single industry.

PERFORMANCE STANDARDS AND COMMUNICATION

The IPS establishes guidelines for monitoring investment performance, economic trends, capital markets and compliance with applicable law. It also should describe the specific duties and requirements of service providers and the desired frequency and structure of reports. Generally, reporting should include details of each transaction and demonstrate how the portfolio is meeting each of the investment criteria.

Periodic reports should contain specific allocation percentages by asset class as well as by industry within each class. They should specify realized and unrealized gains and losses to avoid distortions of total return and annualized income and yield. Total return by asset class should be reported for several time periods and compared to appropriate benchmarks. Annually, the investment manager should provide a summary of all transactions for the fiscal year, together with a report of investment performance for the year by portfolio.

These are basic guidelines. You may want to include other provisions in your policy. But keep in mind that an effective investment policy is specific enough to provide guidance without being so detailed as to limit the manager's ability to successfully perform investment responsibilities.



Working with Donors

Many of today's donors are investors themselves. When it comes to planned giving, they may well expect sophisticated investments and investment strategies.

Consequently, it is important to provide development officers with the training they will need to work efficiently with these donors. Officers should be fully aware of what your organization can do in terms of investing charitable assets. They should be aware of the types of assets your organization will and will not manage. In addition, development officers need to have a working knowledge of the range of investments available and current practices and trends in charitable investing. Our philanthropic consultants can assist your organization in this regard as well.

Working with Merrill Lynch

The advantages of working with us include:

- A disciplined investment process
- Experienced, senior professionals focused on providing responsive service
- An investment portfolio based upon your unique investment goals for growth and/or income, with access to traditional and alternative investments— as well as socially responsible investments, as appropriate
- Knowledge of UPMIFA and other regulatory requirements
- Annual fiduciary investment review of client portfolios
- Assistance in developing or enhancing your investment policy statement
- Fiduciary oversight of the investment management process

A Full Range of Investments

Merrill Lynch Trust Company constructs portfolios using some of the leading managers and products to provide the best solution for specific investment goals.¹ We offer:

ALTERNATIVE INVESTMENTS

- Hedge Funds*
- The Endowment Fund*

EQUITY & FIXED INCOME INVESTMENTS

- Private Portfolio Management Option
- Wealth Diversified Portfolios® Option
- Managed Mutual Fund Option
- Exchange Traded Fund Option
- Unified Managed Account Option
- Third Party Managers: Consults (Multi Manager and CDP)
- Third Party Managers: SPA*
- FA Managed Account: PIA**

CASH EQUIVALENT INVESTMENTS

- Various Liquid Cash Instruments

* Not available in all circumstances

** Requires trust-accredited Financial Advisor

Accessing Advice and Support

An organization's ability to succeed in its mission is dependent upon having the financial resources to carry out its work. Your institution is likely focused on giving your donors — and leadership — confidence that you are capable of administering and managing a diverse range of assets in an appropriate and risk-adjusted manner.

When you are seeking advice and support in this area, there is no substitute for experience. Merrill Lynch offers you the global asset management strength of an organization that serves thousands of nonprofit organizations, like yours—and offers a broad range of proprietary and open architecture investment solutions. A dedicated Merrill Lynch Financial Advisor, together with The Merrill Lynch Center for Philanthropy & Nonprofit Management, provides consulting, investment management, fiduciary administration and financial management services designed specifically for nonprofit organizations, including:

- Investment management and administration of endowments, charitable trusts, pooled income funds and charitable gift annuities, delivered by highly experienced investment and fiduciary professionals.

- Comprehensive institutional financial management through state-of-the-art working capital and endowment investment platforms, offering you access to both proprietary and open architecture investment solutions.
- Education and planned giving support from a dedicated team of nonprofit and philanthropic consultants—and access to investment support from experienced Merrill Lynch investment consultants who assist large institutional clients.

If you wish, you can start by accessing our investment professionals in a purely advisory capacity. We can work with your organization if you want measured, objective investment advice on a stand-alone basis.

We can help you access Merrill Lynch investment consulting services designed to support virtually the entire portfolio management process—including investment policy development; strategic asset allocation modeling; manager identification and performance measurement.

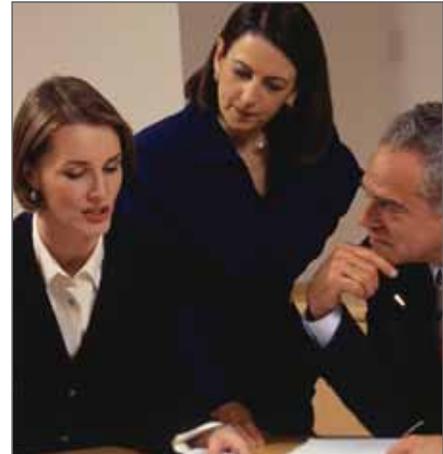
Should you desire additional investment or administration support, we offer a range of solutions to meet your needs. Our investment management approach starts with a focus on your organization's investment policy, which drives our underlying asset allocation process. Our open architecture platform facilitates construction of portfolios using both proprietary and outside managers to craft a solution for your specific investment needs.

When it comes to administration support, our team of professionals has deep experience in meeting the regulatory and other needs of nonprofit organizations. We will administer your endowment fund or planned giving assets with expertise and responsiveness.

Partnering with the Nation's Nonprofit Organizations

Experience, insight, technical skill, and commitment. These are some of the attributes that our team brings to its relationships with nonprofit organizations. Our comprehensive, systematic approach can provide your organization with the knowledge and information it needs to maximize its resources and further its mission and goals.

Your Merrill Lynch Financial Advisor can provide you with more information — then assist you, every step of the way, in accessing and implementing solutions that address your organization's needs. Your Merrill Lynch Financial Advisor can also introduce you to our experienced and dedicated team of philanthropic consultants and fiduciary investment managers.



Contact your Merrill Lynch Financial Advisor to arrange a meeting to discuss how the investment management and consulting services of The Merrill Lynch Center for Philanthropy & Nonprofit Management can help your nonprofit organization.

A Comprehensive Resource

The Merrill Lynch Center for Philanthropy & Nonprofit Management is a comprehensive resource for nonprofit organizations. Our multidisciplinary team of professionals will work closely with your organization to help you meet your objectives. We can call upon other specialists at Merrill Lynch whenever the need for their assistance is identified. The bottom line is that Merrill Lynch can become one of your organization's most valued financial partners.

If you would like more information about how our committed and experienced professionals can work with your organization, please contact a Merrill Lynch Financial Advisor.

¹ *For more complete information on any mutual fund or exchange traded fund, please request a prospectus from your Financial Advisor, and read it carefully. Before investing, carefully consider the investment objectives, risks and charges and expenses of the fund. This and other information can be found in the fund's prospectus.*

Asset allocation and diversification do not assure a profit or protect against a loss in declining markets.

Any information presented about tax considerations affecting client financial transactions or arrangements is not intended as tax advice and cannot be used for the purpose of avoiding any tax penalties. Neither Merrill Lynch nor its Financial Advisors provide tax, accounting or legal advice. Clients should review any planned financial transactions or arrangements that may have tax, accounting or legal implications with their independent, professional advisors.

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