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Kenneth G. Winans

A lot of attention is paid to how efficiently charities spend the public's donations. Indeed, it has long been a focus of the Forbes Largest U.S. Charities list. But in this guest post, veteran investment manager Kenneth G. Winans raises important questions about how not-for-profits invest your contributions in the years before they spend it on their missions. He points to new data showing that operating charities, foundations and universities have all been increasing their exposure to higher fee alternative investments, including hedge funds.

Winans' answer is to take a cue from Microsoft co-founder Bill Gates and set up a private foundation or to set up what's known as a supporting organization, as Facebook co-founder Mark Zuckerberg has done with his donations of stock and establishment of an education foundation at the Silicon Valley Community Foundation. That makes sense for those with millions or billions to donate. But I think Winans underestimates the value of using a donor advised fund if you have less. The Fidelity, Schwab and Vanguard charitable funds, for example, all allow you to direct that your charitable kitty be put in low risk, low cost investments. And, since they're public charities, they can provide you the maximum tax deduction if you're donating appreciated stock or other assets.

Why Do Universities, Foundations and Charities Speculate With Your Donations?

By Kenneth G. Winans

Did you reduce your gifts to charity after the economic meltdown? With the tax pendulum swinging towards higher rates and the stock market peaking again, 2013 is a good year to ramp up your donations—especially if you're wealthy.

Before you write any checks, though, be warned: That nonprofit may be among the many that have developed a taste for fee-laden, high-risk investments in the past few years. And there may be very little you can do about it.

Gone, apparently, are the days when you could depend on nonprofits to make preserving your gift a top priority. These days, if they have endowments to invest, most nonprofits have little interest in conservative investments like corporate bonds and preferred shares that produce moderate, stable returns. Even high-dividend common stocks are passé. These old standbys have been supplanted by "alternative" investments—the term of art for hedge funds, venture capital, private equity and the like. These investments are widely diverse, but most have a few key things in common: questionable performance, high fees, complexity and restrictions on investors' ability to sell.

The trend among nonprofits mirrors that among pension funds, which have poured $2.5 trillion into hedge funds and are reportedly boosting their allocations again now, worrying critics. Commonfund Institute, the research arm of a Connecticut-based money manager that invests $26 billion on behalf of 1,600 nonprofits, produces invaluable annual surveys that explore investment returns and asset allocations of nonprofits. Commonfund's researchers have queried 831 universities, 179 independent and private foundations and 68 operating charities, tailoring the sample groups to make them representative of their peers. The researchers found that, on average, in the past three years the operating charities had boosted their allocations to alternative investments to 28 percent. Foundations had increased theirs to 43 percent, university endowments to 54 percent.

Meanwhile, how much were these nonprofits keeping in conservative, old-timey income-oriented investments—you know, the kind that have beaten stock and real estate investments since the Great Recession ended? Commonfund reports average allocations to bonds at a mere 13 percent for foundations, 22 percent for operating charities and 9 percent for universities with endowments larger than $1 billion.

The returns that charties, foundations and universities have gotten in exchange for their warm embrace of hedge funds and other alternatives are not good. Commonfund reports that the average university endowment lost 0.3 percent of its money in the fiscal year ended June 20, 2012, a period when the S&P 500 was up more than 5 percent and the Dow Jones Corporate Bond Indexwas up 11 percent. The endowments' average five-year return was 1.1 percent—below the 3 percent total return produced by the S&P 500 and well below the 8 percent for corporates. As for foundations and operating charities, says Commonfund, they also fared poorly, finishing the 2011 calendar year in slightly negative terriory and lagging the broader stock and bond markets.

How comfortable would you feel donating money to Harvard, which invests aggressively in hedge funds and private equity and mostly avoids the conservative stuff? In the fiscal year ended June 30, 2009, Harvard's endowment lost $11 billion, a 27 percent haircut, lagging the stock market slightly and trailing the bond market by a country mile. It bounced back smartly in 2011, but in the fiscal year ended June 30, 2012—a year in which stocks produced a 6 percent return—Harvard was down again, by $1 billion.

Sadly, the list of victims in Bernard Madoff's massive Ponzi scheme included numerous public 501(c)(3) nonprofits. Some went out of business after the scheme was discovered in 2009, but several are still raising money from the public.

That nonprofits are pushing into more speculative investments didn't surprise many of the experts we interviewed. "I would say we're absolutely seeing more of it, and I'd go further to say that in five years, it will be even more," says Rick Smetanka, whose Southern California accounting firm, Haskell & White, advises 20 or so charities. "It's not just because nonprofits are getting savvier and more comfortable with alternative investing. It's because the risk-free rate is so very, very low. You can't get 5 percent returns in CDs anymore."

This is primarily a big-nonprofit problem. Most small charities don't have any investments in hedge funds or private equity. "For the vast majority of charities, the notion of their having a problem with investments is irrelevant," says Ken Berger, chief executive of Charity Navigator. "Half the charities in the U.S. have less than $25,000 in annual revenue." A small subset—roughly 15,000 of the 1.6 million nonprofits in existence, Berger estimates—hauls in 85 percent of the nearly $300 billion a year in donations Americans make annually. "Their assets," he says, "are worth trillions."

Berger says trustees aren't watchdogging those trillions carefully enough. "The overwhelming majority of boards do not take their responsibilities seriously, and many operate like social clubs," he says. "Investments are not managed as thoughtfully as they should be—very conservatively and with great care."

"You may be shocked at how irresponsible, or even reckless, charities can be when it comes to managing their investment portfolios," says Edward "Ted" Siedle, a former SEC attorney who regularly contributes to *Forbes* and has written on this subject. Siedle, who has spent much of his career investigating malfeasance at pension funds, has occasionally been asked to scrutinize the investment activities of a nonprofit. The boards he's researched, he says, were dominated by members who liked high-flying alternative investments and felt donors should be invested heavily in them. "Charities should be 100 percent conservative," he says. "But most of the charities that have money to invest have an instinct to put it in hedge funds and other alternatives."

Despite its research arm's findings, Commonfund's money-management arm invests in hedge funds and other alternatives on behalf of its 1,600 nonprofit clients. "Some hedge funds really are hedges against market corrections and really do operate like insurance policies," says Commonfund Insitute analyst William Jarvis.

Even if that's so for a few, that's obviously not how alternative investments are behaving for most. What if you're fortunate enough to have money you can give away to good causes but share the view that nonprofits have no business speculating with donated funds? What do you do?

Well, you can try to get your favorite nonprofit to promise you that your gift will be invested only in bonds. Expect some fairly stiff resistance. You may get more traction if you're a major donor and/or you band together with other donors.

If battling trustee politics isn't for you, consider taking control by establishing your own nonprofit. Then your foundation can manage the money wisely, with your favorite charities, schools and foundations in mind, and dole it out as their specific needs arise.

Private family foundations have the fewest expenses and requirements. The most important is that they are obliged to disburse 5 percent of total assets as donations to public 501(c)(3) organizations each year.

If you don't mind a little more organizational structure and want more financial flexibility, set up a quasi-public 501(c)(3) supporting organization. These can directly support multiple public nonprofits on a project-by-project basis—there's no annual minimum distribution of assets.

Both of these time-tested, cost-effective charitable structures give you direct control and flexibility. You can donate cash, stocks, real estate, art and other assets at a time that is convenient for you. You choose their investments. You decide how their funds are disbursed. Along the way, you reduce your current tax bill and give yourself a powerful estate-planning instrument. You can bequeath your estate (in part or all) to your private foundation and have your family run it for generations. And you get access to a potent annual tax deduction—cash donations are deductable up to 30 percent of donor's AGI and exempt from the alternative minimum tax.

Yes, you will hear horror stories from accountants, attorneys and financial planners about the time, expense and liability involved in setting up and maintaining your own philanthropic structure. I think the challenges are frequently exaggerated. In 2002, I established my own foundation, and I've since helped some wealthy clients establish their own as well.

The costs are really not too bad. The legal fees to set up the foundations I've worked on have averaged $4,000. (They, too, are tax deductible.) As for the time commitment, my clients hold an annual board meeting and sign the IRS filings by November—no big deal. All in all, your own foundation is an effective estate tool if you have over $1 million in assets.

The financial industry offers alternatives to setting up your own nonprofit. While the options are convenient, I find them problematic. The financial planners particularly like Charitable Remainder Unit Trust (CRUTS). When a donor pours assets into a CRUT, the income thrown off by the assets is passed to the donor or a noncharitable beneficiary until the donor's death, at which point the assets are transferred to a chosen nonprofit. Alas, at that point the donor and heirs are powerless to prevent the beneficiary charity from buying hedge funds and the like.

Another solution peddled by Wall Street is the donor-advised mutual fund. The sponsors of these funds, unfortunately, often boast of their prowess at investing in hedge funds and other alternatives. You can advise some to avoid alternative investments and focus on bonds—Vanguard's fund offers this option. Even then, though, you may not be able to prevent them from bringing a high-churn trader's mentality to their work.

Now suppose instead you set up your own foundation. With Treasury yields so low right now, won't that 5 percent distribution minimum send you searching madly for alternative investments too? Plenty of "experts" will insist that boring income investments can't possibly keep up. Some would advise you to stuff the foundation's portfolio into stocks, real estate and, of course, hedge funds and private equity.

Actually, it's not true that conservative investments can't do the job. Since 1950, corporate bonds and preferred stocks have both produced average annual returns above 7 percent. They've weathered the record volatility we've experienced since 2000 quite well, too, with returns of 7 and 11 percent respectively. And while stocks have had negative total returns in more than a third of the years since 2000, the trailing one-year returns of major coporate bond indexes have slipped into negative territory only 8 percent of the time.

Nonprofit investments should resemble retirement plans that are bound by strict ERISA laws and abide by the "prudent person rule." That rule says a person in charge of investing somebody's else's money should balance the desire for a high return against the risk tolerance and needs of the client. All nonprofits need investments that produce cash flow. I suggest investing at least 50 percent of a nonprofit portfolio in corporate bonds, laddering by maturity (between two and 10 years), and planning to hold them until the maturity or call date. (By the way, don't assume bond mutual funds are good substitutes for buying and holding corporate bonds. I've written before about why that's a mistake.)

I would even advise caution before investing in common stocks, given the potential for mayhem that stock-rich portfolios can create in bearish years. Your foundation will be withdrawing funds whether or not the stock market is in mid-plummet. For charities, overallocating to stocks (or stock mutual funds) is committing one of investing's worst sins: using long-term investments for short-term cash needs. So put most of your foundation's assets into income-oriented investments like corporate bonds and preferred shares.

If you want a good deed done right, you might need to do it yourself. Take a cue from Bill Gates and the Rockefellers: Set up your own nonprofit organization.