

SAN BRUNO

Community Foundation

August 25, 2015

The attached presentation was presented to the San Bruno Community Foundation Board of Directors by Mark Hayes, Ph.D., on August 24, 2015.

To better understand how establishment of a quasi-endowment with a long-term investment strategy might affect its program strategy, the Foundation enlisted the pro bono assistance of Dr. Hayes, a former managing director of the Stanford Management Company, the investing arm that manages Stanford University's endowment portfolio. Dr. Hayes developed a simple model to demonstrate various scenarios in which a different portion of the restitution funds is treated as a quasi-endowment. These endowment scenarios show how the size of a quasi-endowment might affect the Foundation's operating budget and ability to fund programs and projects.

The presentation includes the reasons why the Foundation might want to set aside funds as a quasi-endowment, the potential trade-offs between putting funds in a quasi-endowment and designating funds for near-term one-time expenditures, key principles in understanding endowments, the assumptions built into his quasi-endowment scenario model, sample quasi-endowment payout scenarios, and the benefits of a smoothing formula.

In reviewing this presentation, please note:

- The Foundation has made NO decision regarding the establishment of a quasi-endowment with some portion of the restitution funds, nor has it made any decisions about an investment strategy to follow. Dr. Hayes' endowment model is a high-level model that is based on general assumptions about the Foundation's investment risk profile and near-term market performance and illustrates what level of payout might be realized depending on the size of the quasi-endowment corpus.
- The Foundation plans to retain the services of an investment management firm to help develop an investment policy and to manage the Foundation's investment portfolio. At this time, the Foundation has made no decisions regarding the hiring of an investment management firm. It will likely issue a Request for Proposals for investment management services later this year.

Quasi-Endowment Scenarios

San Bruno Community Foundation

Presentation to the Board of Directors

By Mark Hayes

August 24, 2015

Why might SBCF want to set aside funds as an “endowment”?

- To reap benefits of long-term investment of some/all of the restitution funds
- To provide long-term, ongoing funding so that SBCF continues to serve the San Bruno community for years to come

*This exercise will illustrate the tradeoffs between
putting \$\$ in endowment*

vs.

setting aside \$\$ for one-time program expenditures

True Endowment	Quasi-Endowment
Established at the direction of the donor	Set up at the discretion of the Board and not by direction of the donor
Must be maintained inviolate and held in perpetuity	Legally, the principal can be withdrawn and spent at any time...
Principal cannot be spent. Only income earned from the assets can be spent	...but because the purpose is to reap long-term investment potential, only funds that will NOT be needed for 7+ years should be included in QE
	Also known as “funds functioning as endowment”

*** SBCF = Quasi-Endowment ***

Quasi-Endowment Planning Exercise

Key Assumptions

Projected Long-Term Inflation Rate¹

2.00%

Notes:

- 1) Inflation is a significant risk to maintaining the purchasing power of funds set aside as endowment. In periods of “normal” inflation, expected inflation can be captured by endowments holding appropriate equity and fixed income investments. Inflation spikes, as occurred in the 1970’s and 1980’s, significantly eroded most endowment investment portfolios in those decades. We are not addressing such risk in this exercise, but advise this risk be discussed as the endowment investment portfolio is created.

Quasi-Endowment Planning Exercise

Key Assumptions

Investment Portfolio Mix¹	
Global Public Equity	70%
High-Quality US Fixed Income	30%

Notes:

- 1) Most US endowment and foundation investment portfolios are heavily weighted toward equity investments at the expense of fixed income. A range of 65%-80% equity investments likely captures the vast majority of all US endowment and foundation portfolios. Larger institutional investment portfolios (e.g. >\$300MM USD) incorporate significant private equity, venture capital and hedge funds. At \$70MM or less, the increased fees associated with stewarding a more complex portfolio are likely to outweigh the potential benefits of increased gross returns. The exact portfolio mix should be determined in the construction of the endowment investment portfolio. The return behavior exhibited by this 70/30 mix should be generally indicative for the current stage of SBCF Board planning.

Quasi-Endowment Planning Exercise

Key Assumptions

Projected Returns over next 7 Years

Investment Type	Nominal Returns ¹ (a)	Inflation Rate ² (b)	Real Returns (a)-(b)
Equity	7.00%	2.00%	5.00%
Fixed Income	3.00%	2.00%	1.00%
Cash	0.05%	2.00%	-1.95%
Projected Long-Term Portfolio Returns	5.80%	2.00%	3.80%

Notes:

- 1) Nominal returns are assumed net of investment management fees, including fees paid to financial advisor and cost of ETF's, mutual funds etc. Per notes on simplified 70/30 portfolio, these returns are indicative of low cost index-like equity and fixed income products.
- 2) A modest increase in expected inflation, closer to trailing 100-year US average of 3.0%, would flow through to higher nominal equity, fixed income and cash returns (with an immediate impact on the value of fixed income principal). The impact of an inflation shock is beyond the scope of this analysis.

Indicative Risk Metrics

Single-Year Impact on Quasi-Endowment

Equity Shock =	-25%
Fixed Income =	+2%
Portfolio Drawdown =	-17%

**Four events of this magnitude
have occurred since 1970...**

Sample Payout Scenarios

Endowment (\$MM)	One-Time Project/Program Expenditures (\$MM)	Projected Real Investment Returns (average, annual)	Projected Long Term Sustainable Endowment Payout (\$MM)
\$70	\$0	3.8%	\$2.66
\$60	\$10	3.8%	\$2.28
\$50	\$20	3.8%	\$1.90
\$40	\$30	3.8%	\$1.52
\$30	\$40	3.8%	\$1.14
\$20	\$50	3.8%	\$0.76
\$10	\$60	3.8%	\$0.38

Market Volatility & Projected Payout

**Indicative Annual Investment Returns¹ vs. Payout Rates²
(sample US endowments, June Year End 2005-2014)**



Notes:

- 1) Median endowment returns for fiscal years ending June 30, 2005 to June 30, 2014. Sourced from the 2014 NACUBO-Commonfund Study of U.S. Endowments and Affiliated Foundations. Nominal returns net of all investment and management fees. www.nacubo.org
- 2) For reference, shown here is projected 3.8% payout implied by the 70/30 portfolio and assumed forward equity and fixed income returns. For comparison, U.S. endowments shown in this chart realized a 4.5% annual growth rate net of all inflation and fees for the 2005-2014 period shown here.

Benefits of Payout Smoothing



Notes:

- 1) This chart highlights the variability in annual budget that would occur if 3.8% of trailing year endowment value were simply used to determine annual SBCF operating budget for the period 2005-2014.
- 2) Most endowments and foundations use some form of smoothing to manage year-to-year volatility in investment returns, while still maintaining the core objective of maintaining long-term endowment principal. The smoothed line shown here uses the average of payouts from prior 3 years with the simple payout implied by 3.8% of June year end value. For further discussion of smoothing see Sedlacek and Jarvis 2010.