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Vestry Papers

EPISCOPAL CHURCH FOUNDATION
empowering congregations

To inspire, affirm and inform Episcopal leaders in their work

*This Issue: **Imploding Market Challenges***
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Dealing with risk and falling markets...

by Jerry Keucher

In bad times and good, the principles that vestries should follow in their fiduciary oversight of long-term investments are the same. Especially when the markets are down, it is essential not to lose your head. Certain key decisions made ahead of time will enable you to stay the course.

Overall objectives

- **Remember the big picture.** Your investment objectives are the same regardless of market conditions. First, you want your investments to keep their value with respect to inflation; second, you want a reasonable stream of funds for your current purposes.
- **Investing in the stock market has been key.** Historically, the only way to achieve rate of return over time has been to invest in the stock market because the average returns of stocks have been higher than fixed income funds.
- **Deal with risk.** You cannot avoid risk in investing; your job is to manage risk.
- **Investment and spending decisions are crucial.** You achieve (or fail to achieve) goals by the investment decisions you make and by the spending decisions you make.

Investment decisions

- Consider using your diocesan investment vehicle or another similiar service. The fees are typically low, and accountability is high. Many dioceses provide a "turnkey" program that provides an investment policy, manager selection, asset allocation, spending rate, and reporting, all in one. Most parishes — even the largest ones — have trouble making all these decisions themselves.
- Make key investment decisions up front. If you're doing it yourself, you need simple guidelines that set out an asset allocation model — such a percentage in different classes of stocks, such a percentage in fixed income vehicles. You need to make the allocation decisions up

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Declining market conditions are playing havoc with investments, and such a situation can be devastating for churches — for when there is less money in the bank, the roof may not get fixed, programs may be cut, and staff may be let go. This issue explores a range of issues, financial and programmatic, to help congregations address these challenging economic times.

No endowment fund means just that

by Ken Quigley

Tithing can be hard in these tough economic times. We suggest that vestry members take the lead on gently reminding parishioners that if not accomplished in this life, tithing can occur through a bequest in one's will.

An elderly woman who was a lifelong member of a small Episcopal congregation recently informed the vestry that she had received a large inheritance and would like to make a significant gift to the church. She wanted the gift to provide resources for the church for generations to come; however the church did not have an endowment fund.

A vestry member from another church called to say that a major donor to their capital campaign was ready to give another major gift to the church, but he wanted to see an endowment structure in place before he made the gift.

Two stories, one problem. Both were small churches. Perhaps they thought they were too small to have an endowment fund. Or perhaps they thought the vestry would deal with a major bequest when the time came. In both cases, the churches quickly established endowment funds and built the structure to receive and manage legacy gifts.

But consider the fact that it was the donor who asked the church for a way to make a legacy gift to the church. Think of the other potential donors who may not have been as persistent, or who were never asked to make a legacy gift.

Recently an Episcopal bishop asked the Episcopal Church Foundation to help him develop simplified endowment structure documents for churches. His goal: to make sure that every church in his diocese, no matter the size, and no matter if they have any endowment funds at all, has an endowment structure in place…just in case.

Colleges, universities, hospitals, museums, and dozens of nonprofit organizations target the members of your congregation with regular mailings and other contacts encouraging them to make a bequest in their will or a life income gift to their cause. It is tough to compete if your church can't explain how a legacy gift to your church will be used, invested, spent, and managed over time.

Failure to establish an endowment fund commits two sins at once. You squander the

chance to gather resources for the ministries of your church in perpetuity; and you deny your members the opportunity to make a meaningful legacy gift to the church that has meant so much to them over the years.

Ken Quigley is the Director for Endowment Management Services at the Episcopal Church Foundation.

A Word about Accounting

In addition to the legal requirements for the proper administration of endowments, endowment funds are also subject to certain financial accounting standards. These standards are set forth in the "Statement of Financial Accounting Standards No. 117: Financial Statements of Not- for-Profit Organizations." SFAS No. 117 requires an organization to classify, for accounting purposes, its assets into three categories, based upon the existence or absence of donor restrictions: (1) permanently restricted net assets, (2) temporarily restricted net assets, and (3) unrestricted net assets. The vestry should confirm with its outside accountants that any endowment funds are being properly classified under SFAS No. 117. Vestries should also be familiar with The Episcopal Church Canons: Title I, Canon 7 ("Of business methods in church affairs").

Using endowment income for operating needs is like swimming naked...

by Ken Quigley

Swimming naked, you say? How is that like using endowment income for operating needs? Answer: No one notices 'til the tide goes out.

For those churches that have been using their endowment income to balance the operating budget, 2008 is a year they would rather forget.

The S&P 500 was down 37 percent for 2008 with most other indexes far worse. So if now is the time you need to draw down cash to spend in your operating budget, you are locking in your losses and selling at the worst possible time. Using the endowment fund to plug holes in the annual budget is like using your home equity to pay for a vacation.

Great Depression, their return was -11.4 percent; their draw: 41 percent. For 2009 they asked to double their monthly draw.

At best, we told a member of the vestry who called to express his concern, you have less than a year's worth of draws until the fund is depleted. Then what? He said he knew they were spending well beyond their means, yet no one wanted to face reality. You could buy yourself another year by halving the draw and addressing the problem, we said — increasing annual stewardship and reducing expenses. Or the congregation will have a sudden and rude awakening before the New Year is over.

People who give to endowments expect them to be around for awhile. If you drain the

A sure sign of trouble is when the vestry requires an infusion from the unrestricted endowment to make ends meet in the annual operating budget. Case in point: a small church had set aside some $300,000 in an endowment fund and invested it through the Episcopal Church Foundation. In 2006 Vestry Members began to make monthly draws on the account to meet expenses.

The fund returned nearly 10 percent that year, yet they drew down 23 percent. In 2007 the fund returned about 7 percent; their draw was 30 percent. In 2008, one of the worst years for the stock market since the

endowment for current operating needs, the chance of receiving the next legacy gift is severely diminished. Spending rules which protect the principal need to be in place and applied assiduously.

Also, churches need to distinguish between shorter-term operating reserves (to be invested conservatively) and longer-term endowment funds (with an infinite time horizon) that have time to recover from market downturns. When you mix the two or tap the endowment for current operating needs, you are setting yourself up for trouble.

"And other seeds fell into good soil and brought forth grain, growing up and increasing and yielding thirty fold and sixty fold and a hundred fold."

Mark 4:8-9

Dealing with risk and falling markets...

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front, so you have a road map when the terrain of the markets gets rough. Decide on the benchmark market indices you'll use to evaluate performance.

- Rebalance as needed. Maintain your asset allocation model by rebalancing. Rebalancing is a rough way of forcing yourself to buy low and sell high. If the stock market goes way up, and you sell stock to the amount invested in stocks back down to your target allocation, you have sold high. When the markets are down, and you put money into stocks to maintain your allocation, you have bought low.
- Rebalancing isn't easy. Because rebalancing means investing against the market — selling stocks when the market is rising and buying them when it falls — it is difficult to do. It is especially difficult to put money into a weak market. If you don't have the stamina for this, the trustees who run your diocesan investment vehicle will. That's another reason to use them.
- Monitor and report. Be sure the vestry gets quarterly reports that compare the portfolio's return to your benchmarks. Dollars figures are less important than percentage returns compared to benchmarks.

The investment decisions are difficult enough. Make sure you get the help you need in order to make those decisions or to delegate them to a trusted body. However, when endowments or long-term investments get depleted, investment decisions are usually not the problem; it's almost always because the investments have been overspent. This is where things get rough when markets are down.

Spending decisions

- Don't overspend. In general, assuming an allocation in the neighborhood of 60 percent stocks and 40 percent fixed income, you are jeopardizing the long-term health of your investments if you take out more than 5 percent of a three-year moving average each year. You can't make up for overspending by hoping that your returns will be higher than market averages. When markets go down, the most important principle is this: don't overspend your investments.
- Don't let your operating budget depend too much on investments. If your operating budget depends on investment return, you will have a very difficult time adhering to this principle, but you will shortchange the future of your parish unless you maintain the discipline necessary not to overspend your investments.
- Let your investments fund the capital reserve. My strong recommendation is usually to have the investment drawdown go into the capital reserve fund. If the drawdown goes down because of market conditions, you can usually postpone a part of your capital plan without jeopardizing the existence of your parish.

If your operating budget depends on your investments, you face a dilemma when the markets go down. You can either make large (and unpopular) cuts in your budget, or you can take more than you should from your investments. It's no wonder vestries usually choose the second course of action. The investments won't complain when you overdraw them, and the future members of your parish are not represented on your vestry unless you remember to take them into account and do right by them.

You may promise yourselves that it is only temporary and that you'll pay it back. Alas, these promises are almost never kept despite your good intentions. Once you start overspending your investments, you'll almost certainly continue to do so. And thus you'll probably never be in a position to pay it back.

The principles of managing your investments are the same whether the markets are up or down. Foresight and discipline are always required.

The Rev. Jerry Keucher is the author of Remember the Future: Financial Leadership and Asset Management for Congregations *and currently serves as the bishop's vicar at the Church of the Intercession in New York City.*

Future members of your parish are not represented on your vestry unless you remember to take them into account and do right by them.

*Please realize that these are complex issues and that the purpose of **Vestry Papers** is not to provide financial, investment, or legal advice in these areas. The authors' opinions are their own. Therefore, we encourage you to consult you own financial advisors prior to making any investment decisions.*

What about endowment spending policies?

by Ken Quigley

There are two basic ways of distributing money from your endowment fund: an "income-only" policy, or a "total return" policy.

In the "income only" policy the vestry spends only the money earned on debt (interest) or received as dividends. In the "total return" policy, the vestry considers both the income earned and capital appreciation of the investments, thus "total."

Using the "total return" policy the vestry will also need to establish a "spending rule", which is usually stated as a fixed percentage of an average net asset value of the funds held. The current average percentage selected by most churches is between 4 and 5 percent. It is usually applied to a rolling three-year average value of the endowment fund taken at the end of the previous twelve quarters. If you are just starting the fund, you could apply the percentage to 90 percent of the value of the fund in the first year or use some other formula.

By restricting the spending to a fixed percentage, and applying it to a rolling average value of the fund, the "total return" policy should capture the ups and downs of the market (in terms of appreciation/depreciation) and over time thereby not invade principal.

If you use an "income only" policy, you may be inclined to invest in more fixed income investments so as to generate more "income" and miss out on capital appreciation. Or, if you enjoy significant capital appreciation but relatively little income generation, you will begin to see the value of the fund grow, but will not see much growth in the money available for expenditure.

One advantage of using the "total return" policy is that you are able to spend both the income received and some of the capital appreciation. The discipline of setting an annual spending rule, in light of current market conditions, helps to preserve the principal.

Another important consideration in setting the percentage of the draw, or in using the income earned, is the effect of inflation. For example, if you set an annual draw of 5 percent and experience 3 percent inflation, you will need to achieve a total return of 8 percent in order to stay even in spending power of the endowment. On the other hand, if you use fixed income investments only, such as a certificate of deposit, and spend the income earned, you will deplete the spending power of your endowment by the rate of inflation.

When a gift is given to a parish, whether it be a financial legacy or a memorial, the vestry should vote to accept the contribution or, as will be necessary in rare circumstances, to decline it. Such an action acknowledges that the vestry accepts the conditions of a will or finds itself unable to support the generosity of the donor. (For example, a yacht was once given to a large east coast parish. While the attraction of sailing away from vestry meetings seemed alluring, potential maintenance costs ultimately doomed the gift.)

Administering charitable endowments

By David T. Leibell, Esq.

Healthy endowments play a significant role in the long-term stability of a church. Part of the stewardship responsibility of a vestry, therefore, is to understand the rules associated with the proper administration of endowment funds. A poorly administered endowment program will not only have a chilling effect on future contributions from existing endowment donors, but will also discourage other donors from establishing future endowment funds. A well administered endowment program should have the opposite effect, resulting in larger, more frequent gifts.

What is an endowment?

Although we tend to speak of an endowment as a single fund, it usually consists of several, sometimes hundreds of, different funds. The majority of these are subject to restrictions on their usage that donors impose and with which the church is legally obligated to comply. By definition, all endowments are subject to the restriction that only a portion of the endowment may be expended annually. In addition, many endowment funds require that the expended funds be used for specified purposes, such as religious education, choir, flowers, etc.

How are endowments regulated?

Although most endowments are set up as charitable donations (donor-restricted endowments), certain endowment funds can be set aside by the church's vestry (board-restricted endowments). Donor-restricted endowments are subject to a large body of state common and statutory law protecting the wishes of the donors from unauthorized use by the recipient charity. Board-restricted endowments, on the other hand, may be unrestricted by a vestry vote at any time and are not subject to the large body of state law protecting donor-restricted endowments from improper use.

The common law of each state protects the donors of restricted gifts by requiring charities to strictly comply with the terms of the restricted gift. As the attorney general of each state is the protector of restricted charitable gifts, it is not unusual for the attorney general to sue a charity for failing to comply with the terms of a restricted gift. In addition, in some states the donor has legal standing to enforce the terms of a restricted gift. Most states, however, limit the ability to sue to the state attorney general.

State statutory law of charitable endowments is governed in virtually all states by either the Uniform Management of Institutional Funds Act (UMIFA) or the more recent Uniform Prudent Management of Institutional Funds Act (UPMIFA). UMIFA and UPMIFA set forth the legal requirements for the administration of charitable endowments, including investment standards, spending limitations, and the process for releasing donor restrictions. Whichever statute has been adopted in your state should act as your primary guideline for the proper administration of your church endowment. Ignoring the relevant state statute is a recipe for disaster.

What is the proper way to invest endowment assets?

Both UMIFA and UPMIFA statutes require that investments must be handled as a prudent investor would handle the investments. Assets should be diversified (don't

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In the works: a comprehensive guide to planned giving. What's the best way to encourage legacy gifts? What do potential donors need to know? How can the whole thing be framed theologically? And what's the connection between endowments and planned gifts? Stayed tuned for a new guide to planned giving, to be published by the Episcopal Church Foundation this summer. For more information on how to order, call 1-800-697-2858.

Resources for Financial Planning

The Episcopal Church Foundation is the primary source in the Episcopal Church for "one-stop shopping" in terms of helping congregations secure a financially viable future: capital campaign consulting; annual campaign information, planned giving assistance and endowment management services. For more information, go to www.episcopalfoundation.org or call 1-800-697-2858.

Diocesan investment pools: Many dioceses have their own investment opportunities, and a substantial number of them invest their assets with the Episcopal Church Foundation. Check with your diocese to find out what options are available.

Jerry Keucher, the author of the cover story, invites dialogue and questions about financial planning for congregations. Contact him at 718-873-4599 or jerrykeucher@gmail.com put all eggs in one basket); and unless the donors have put restrictions on how the funds may be invested, there should be proper asset allocation based upon the spending goals of the endowment. The investments should be monitored on a regular basis.

Many endowments outsource investment management to a professional. Proper choice and proper monitoring of the investment advisor is crucial to satisfying the prudent investor requirements. In states that have adopted UPMIFA (currently 25), the vestry should consider legally delegating its investment management responsibility over the endowment to a professional investment advisor. The requirements for delegation are set forth in the state statute. If the vestry complies with these requirements, the vestry is legally relieved from liability for the investment management of the endowment. If the attorney general or a donor were to sue for mismanagement of the endowment's investments, it would be the professional investment manager that would be liable, not the vestry.

Case in point regarding "underwater funds": If $25,000 was donated in 1954 for choir robes, and the funds have risen to $50,000 through investing and time, only the top $25,000 may be spent now; the original $25,000 must remain unspent.

How does the church determine how much may be spent each year?

Many charities have a spending policy which states that a certain percentage (say 5 percent) of the endowment may be expended each year. Although this seems prudent, it actually may be in violation of relevant state law. UMIFA, enacted in 1972, initiated the concept of total return expenditure for endowment purposes, expressly permitting prudent expenditure of both capital appreciation and income and replacing the old trust law concept that only income (that is to say, interest and dividends) could be spent.

Thus, in states that have adopted UMIFA, both asset growth and income can be appropriated for program purposes, subject to the rule that a fund cannot, under any circumstances, be spent below the "historic dollar value," defined under UMIFA as the amount contributed by the donor.

UPMIFA also permits the expenditure of appreciation, but eliminates the concept of "historic dollar value". UPMIFA states that a charity may appropriate for expenditure so much of an endowment as the charity determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund has been created.

What can be spent if the amount in an endowment fund is less than the amount a donor contributed?

Recent market declines may have resulted in what are called "underwater endowment funds" (a fund where the assets are currently

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ECF's Mission
To strengthen the leadership and financial capabilities of Episcopal congregations, dioceses and related organizations to pursue their mission and ministry.

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Reader's Corner

Remember the Future: Financial Leadership and Asset Management for Congregations

In this classic book, Jerry Keucher from the Diocese of New York offers clear, step-by-step methods and advice for both managing and increasing the assets of Episcopal congregations. Developed as a result of hands-on work with struggling parishes, Keucher uses a positive, concise tone to help readers imagine, and then work toward, financial stability and growth. See cover story for article by Keucher.

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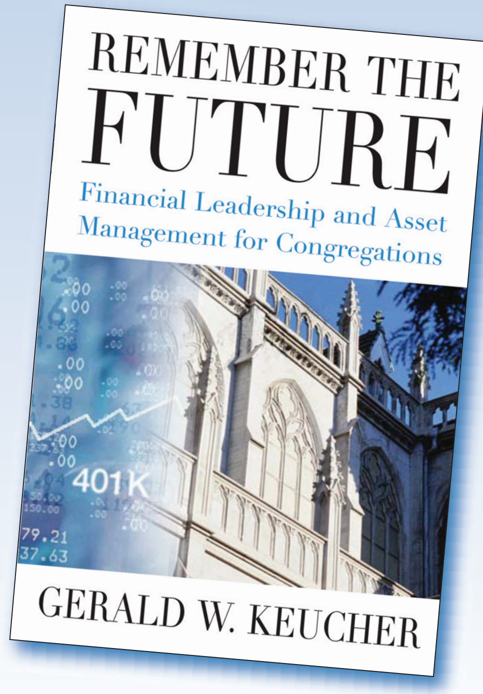

Administering charitable endowments

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less than the amount contributed by the donor). Under UMIFA, a church would not be able to spend any assets in an underwater endowment fund (see sidebar page 7) until the specific fund assets increase above the amount contributed by the donor (the "historic dollar value"). Under UPMIFA, there is no floor on spending because there is no historic dollar amount requirement. As a result, UPMIFA permits assets in an underwater endowment fund to be spent if the expenditure is prudent. Unfortunately many state attorney generals and the Financial Accounting Standards Board don't agree with UPMIFA and still seem to require protection of the historic dollar amount. Until this issue is resolved, even in states that have adapted UPMIFA, a church should avoid spending assets in an underwater endowment fund until the assets increase above the amount the donor contributed.

What can be done if donor restrictions no longer make sense?

Certain endowment funds, particularly older funds, may contain provisions that no longer make sense because the restricted purpose may no longer be being carried out by the church. Both common law and UMIFA and UPMIFA provide legal mechanisms for releasing donor restrictions that are no longer practical. If the donor is still living, the church can ask the donor to release the restriction. If the donor is not living or will not release the restriction, the church may go to court to have the restriction changed to one that makes current sense, taking into consideration the donor's original intent.

> ...a church should avoid spending assets in an underwater endowment fund until the assets increase above the amount the donor contributed.

David T. Leibell, Esq. is an attorney in private practice in Stamford, Connecticut and former senior warden at Christ Church, Easton, Connecticut.