The Significance of The Aspen Principles to Endowments and Foundations

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The current global economic crisis has unveiled the adverse effects of "short-termism" and the need to promote long-term value creation. Investor focus on the short-term has had deleterious effects on global markets, including mispricing of risk and misallocation of capital in financial markets due to lack of good information about long-term prospects.

Investors faced an equally challenging economic environment five years ago following the market fallout related to Enron. At that time, participants of the 2004 CEO Summit of the Aspen Corporate Values Strategy Group were asked to become champions of a 'long-term' perspective, adopt policies and practices that promoted it, and openly communicate their successes and failures in applying these practices. Three years later, this group co-convened by the Business Roundtable (BRT) and the Council of Institutional Investors (CII), released Long-Term Value Creation: Guiding Principles for Corporations and Investors ("Aspen Principles" or "Principles"). The group endorsed the idea that a principled, long-term view fosters greater appreciation of the interdependencies between corporate entities and the society in which they operate. These ideas are pertinent to endowments & foundations today. Endowments & Foundations ("E&Fs") are uniquely positioned to effect change by focusing their efforts on long-term value creation, which includes all sources of capital—including financial, human and natural.

This article is intended to promote discussion and debate on the critical issues surfaced by the Principles, with the ultimate goal of improving long-term outcomes for stakeholders of E&Fs. The Aspen Principles start from the assumption that in order for corporations to perform at their best, they must commit to endeavors that may take years to yield both societal and financial benefits. The Principles urge companies to define firm-specific metrics of long-term value and use such metrics to communicate with investors around long-term measures and activities as well as better align executive compensation with the creation of long-term value. The Principles are not legally binding. Entities that adopt them are joining a coalition and taking a stand to support the fundamental notion that a favorable long-term perspective will result in better economic return and greater business contribution to the public good.

In recognition of the overlap with its values, Casey Family Programs ("CFP") has joined the CII, the BRT, pensions like TIAA-CREF and CalPERS and companies such as PepsiCo and Pfizer as signatory to the Aspen Principles. The focus on long-term value creation will significantly enhance resources CFP needs to safely reduce the number of children in foster care in the U.S. by 50% by the year 2020 and improve the wellbeing of vulnerable children and families in America.

Change is needed

The plan to de-emphasize short-term behavior in favor of the long-term is likely to encounter significant hurdles in the E&F milieu. For instance, E&Fs may have to seek and propose new performance reporting that recognizes the "brittle illusion of accounting exactitude" and the false precision of risk systems – the misapprehension that performance and risk of investment portfolios can be measured precisely. Furthermore, E&Fs may need to build the right framework to support good governance and emphasize appropriate investment and compensation policies – all with an eye to supporting long-term value creation. Enablers for change include the following:

- Eschew short-term focus

  It is crucial to eschew the visceral focus on short-term performance which may drive investments in opaque structures with unquantifiable embedded risks that are often magnified by leverage. Such short-term focus may lead investment personnel to exhibit behaviors that externalize the true costs of investment programs to beneficiaries or other stakeholders. A short-term outlook may drive high portfolio turnover and lead to high transaction costs, reducing returns to investors. Academic research suggests that investors who trade more frequently indeed sacrifice value.

- Improve dialogue between governing bodies and investment professionals

  Governing bodies should focus on long-term sustainable performance that transcends their tenure. Strict devotion to short-term financial results can have damaging effects on a fund's long-term growth. Members of governing bodies serve a specified term during which they aspire to deliver good investment results to support programmatic decisions. In reality, a fund may not reap the benefits of a good investment decision for many years. Changes in asset allocation and risk tolerance made solely to achieve short-term performance can significantly inhibit an entity's prospects for future growth. It is crucial to orient the planning horizon of governing bodies well beyond their stated tenure by transforming Boards and Committees into "Stakeholder Champions", working in the best interest of their constituencies.

- Avoid inappropriate peer group comparisons

  Peer group comparisons without regard to critical factors such as mission, goals, risk tolerance or asset allocation of an endowment or foundation is an impediment to long-term value creation. Misguided usage of peer group data stifles initiative and information sharing by investment staff and committees. This could potentially induce non-sustainable and harmful responses. Events of 2008 underscore the fact that there is no safety in the herd.

- Focus on risk and not just volatility around an index

  As purveyors of the wellbeing of many stakeholders, E&Fs are encouraged by the Aspen Principles to focus on real risks, not just risk metrics that depict false precision based on stale historical data. Investment professionals and governing bodies should strive to create a culture whereby greater attention is paid to the real risks and opportunities facing E&Fs. They will significantly add value by paying attention to value drivers, long-term risk factors such as non-accounting risk, and reevaluating the business models, compliance, and risk management practices of investment managers and vendors.

- Revisit proxy voting as a tool to influence long-term outcomes

  A deeper examination of the voting and investment policies of E&Fs (or their agents) may be called for in order to accomplish the objectives set by the endowment or foundation—objectives that likely include existing into perpetuity, while providing a measure of current liquidity. Fund managers should be required to take the unique interests of E&Fs into account when voting proxies or engaging in corporate governance activism. For example, as long-term equity holders, investment managers should vote proxies, but only consider the advice of proxy advisory services if such advice is given from the perspective of a long-term (5+ year) holder.

- Design appropriate reward systems

  The Aspen Principles advocate for compensation and incentives to align investor interests with the long-term health of the endowment or foundation. Reward systems must take into account the risks assumed in generating both short and long-term returns. The definition of risk in this context transcends well beyond mean variance metrics that dwell heavily on historical facts. The current economic crisis unveils the extensive value destruction that can result from investors' efforts to

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largest investments are with multi-strategy LCC managers, which make their asset class categorization more challenging.

We also like the separation in our Privates portfolio between real estate, natural resources, emerging markets and developed country (which includes venture capital, growth equity and leveraged buy-outs). And in this cycle we have invested in mandates which use a private investment structure for buying debt positions in distressed companies generally utilizing some matching leverage.

All of our existing mandates had to be categorized by investment type and asset class. And, obviously, all new mandates require categorization. We also implemented an annual review of all mandates for confirmation of correct categorization. Many (most) mandate categorizations are straightforward with respect to both asset class and investment type. Some, however, are not quite so obvious.

To assist us in making categorization decisions, we created a checklist with about ten points to help us categorize mandates by investment type; the points include mandate asset class limitations, liquidity requirements, use of derivatives and leverage, and others. To date, investment type categorizations have been the most straightforward. Asset class categorizations have proven more difficult in some instances, particularly as some of our multi-strategy LCC managers have shifted investments from equity strategies to distress strategies, typically with a rotation through cash. We have developed some analytics to help us assess exposures and some decision rules that help guide our final asset class recommendation.

A ‘matrix’ view of the portfolio can lead to – and in our case has led to – an organization structure that is also a matrix. We have Real Estate and Natural Resources staff as well as MCC, LCC and Privates staff. A matrixed organization can be – and in our case I believe is – extremely valuable in getting the most rigorous review and discussion about investments. A matrixed organization, however, can add management challenges as organizations naturally grow and evolve. Extra attention is required to investment processes and interpersonal interactions, both formal and informal, particularly in the early stages of implementing a matrix.

To end where we began: we have a strong belief that no one measurement system can begin to capture the complexities of a large endowment portfolio. Over the past two years, however, I believe we have found the grid a useful part of our internal discussions and processes. I believe we have also found that our Board and other constituents understand the grid after relatively brief exposure, and that they find it to be far more transparent of our investment allocations as well as extremely helpful in gaining a better-informed perspective on the portfolio. You will need to determine, of course, whether this approach might be helpful in the context of your own portfolio, staff and governance structure.

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make short-term profits through excessive risk-taking and leverage. Moving forward, it will be important to limit these types of attractive, yet ultimately value-destroying opportunities.

- Foster healthier relationships with investment managers based on trust and openness

  E&Fs may need to step away from micro-managing external investment managers. Upfront due diligence is essential; however, once selected, sufficient latitude should be given to skilled investment managers to make pertinent investing decisions. Extensive risk modeling and watch lists confine the managers from achieving what they are hired to do. A portfolio manager’s time should not be spent producing reports that have little or no significance to a long-term investment plan. They should be directing their efforts toward research and managing assets entrusted unto them.

- Consider Sustainable Investment Strategies

  Stakeholders are increasingly demanding sustainable and responsible investing as active ingredients for long-term value creation. However, actions taken by E&Fs solely based on image or impulse, without any measurable outcomes are potentially detrimental and fundamentally unsustainable. In the end, the capacity of E&Fs to continue to operate for a long time or in perpetuity depends on the sustainability of stakeholder relationships. In order to make a meaningful impact, an E&F’s sustainable investment strategy must be compatible with its governance, programmatic and investment beliefs. Such beliefs include environmental, social and governance integration, active ownership, collaborative engagement initiatives and a strong preference for long-term value creation over short-term performance.

  Further, the desire to allocate capital to community, thematic and special investments requires a long-term focus. To facilitate this process, governing bodies and investment professionals need a framework to measure and control their own behavior. This should include an assessment of whether or not they are appropriately responding to stakeholders’ concerns. The need for an integrated reporting system that tracks well thought out qualitative and quantitative metrics on overall performance across multiple dimensions of sustainability is imperative.

Potential Impact

The above list is not intended to be a panacea for all the structural and investment issues facing E&Fs. Change will not come overnight; however, the adoption of the Aspen Principles and the implementation of the suggestions noted above will have far-reaching spillover effects.

When E&Fs succeed in truly emphasizing the long-term, they will have much better success in serving as a catalyst for change. For example, they will be better positioned to contribute meaningfully to public policy debates in areas such as:

1. Holding Financial Intermediaries to a Higher Degree of Accountability
2. Encouraging Investment Managers and Operating Companies to Focus on Long-Term Performance Metrics
3. Increasing Transparency and Strengthening Investor Disclosures

The Way Forward

For those of us in the E&F milieu, the Aspen Principles provide a launch pad to start the conversation that might drive long-term value creation. As professionals charged with managing significant assets, we have the privilege to refocus our energies on long-term value creation. This goal cannot be achieved without the support of the governing bodies who oversee endowments and foundations. The Aspen Principles provide a way for us to lead by example and take a stand that a long-term focus is critical to long-term value creation. Ultimately, this will enable E&Fs to contribute meaningfully on a sustained basis to the public good, gifting the world with more and better quality capital: human, social, natural, built and financial.

For more information on the Aspen Principles, please visit www.aspeninstitute.org/bsp/cvsg or contact Rebecca Darr at Rebecca.Darr@aspeninstitute.org.

Contributions and comments from Rebecca Darr - Aspen Institute, Josh Humphreys - Harvard Business School, Dave Mills and Casey staff.

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[1] See Judith Samuelson, “The Aspen Principles: A Better Way Forward,” Directors& Boards, 32.4 (2008 Annual Report).

[2] See The Committee for Economic Development, “Corporate Governance Practices to Restore Trust, Focus on Long-Term Performance, and Rebuild Leadership,” (2009)

[3] See Brad M. Barber and Terrance Odean, “Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors,” Journal of Finance, 55.2 (April 2000).