



# The Investment Policy Statement

*"Chance favors only the prepared mind." - Pasteur*

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INSTITUTE

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## About Commonfund

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Commonfund was founded in 1971 as an independent nonprofit investment firm with a grant from the Ford Foundation. Commonfund today manages customized investment programs for endowments, foundations and pension funds. Among the pioneers in applying the endowment model of investing to institutional investors, Commonfund provides extensive investment flexibility using independent investment sub-advisors for discretionary outsourcing engagements, single strategies and multi-asset solutions. Investment programs incorporate active and passive strategies in equities and fixed income, hedge funds, commodities and private capital. All securities are distributed through Commonfund Securities, Inc., a member of FINRA. For additional information about Commonfund, please visit [www.commonfund.org](http://www.commonfund.org).

# The Investment Policy Statement

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## Introduction

Successful investing for long-term funds requires a strategic plan. This is true despite—indeed, because of—the fact that the future is unknowable. The plan must be specific, embodying in concrete terms the best thinking of the board of trustees about the investment pool, its goals and purposes; but it also needs to be sufficiently flexible to guide the board through environments that may be very different from those prevailing at the time of its adoption.

This paper reviews the key features of such a plan – the investment policy statement. Since investment policy statements are as varied as the organizations they serve, there is no one-size-fits-all solution.

For institutions with endowed perpetual funds, one of the gravest risks is that, in periods of economic turmoil, crucial investment decisions may be made in haste, under pressure, and without adequate consideration of the long-term consequences. During the working lifetimes of many of today’s trustees, market crises have occurred at a rate of around

two per decade. In such cases, the temptation to listen to urgent voices claiming that ‘this time is different’ has been very difficult to resist. For trustees, the risk to the fund of a permanent loss of purchasing power as a result of poor investment decisions is compounded by the potential for after-the-fact second-guessing and possible legal challenge by attorneys general, donors and beneficiaries.

The investment policy statement sets forth in writing the operating plan of the board of trustees for the management, investment and spending of the investment pool. While strategic in approach and long term in scope, the investment policy statement also sets forth parameters or ranges within which more tactical actions may be taken. Composed in calm to be used in crisis, it is both a shield, guarding trustees from the pressure to make unwise decisions in an atmosphere of panic, and a sword, by which the board establishes the territory it intends to occupy and cultivate, through its investment practice, as fiduciaries for the institution.

## Components of the investment policy statement

Endowed institutions differ in their missions, capabilities and resources, and investment policy statements naturally mirror these differences. In that sense, there is no single 'right' investment policy statement; each institution's board must craft a statement that responds to the needs of the institution and the preferences and risk tolerances of the trustees. Annual review of the statement by the board can help to ensure that it remains an appropriate distillation of the institution's investment philosophy and practice.

It can be said, however, that a properly drafted investment policy statement should address, at a minimum, the following issues:

- What is the purpose of the investment pool? What is its role in supporting the mission of the institution?
- Is the fund intended to be perpetual in duration, or will it have a finite life? To what extent is maintenance of purchasing power an explicit goal?
- Who will have responsibility for investment decisions? What are the required qualifications of these individuals, and how are they to be recruited?
- If the board of trustees intends to delegate its authority to an investment committee or some other body or entity, how should that delegation be evidenced and documented? Which investment decisions, if any, should be delegated to outside advisors or investment managers? How should these and other service providers be selected and monitored?
- What is the investment pool's target return, both in nominal and real (i.e., after inflation) terms? What is its expected annual contribution as a proportion of the institution's operating budget or other relevant criterion?
- What should be the overall investment strategy of the fund, including asset allocation targets and ranges, permitted and prohibited investment strategies and instruments?
- What kind and degree of risk is the board prepared to take in pursuit of its investment goals? How are risks to be defined and measured?
- How much liquidity should be maintained by the fund, either for investment needs within the fund or for wider institutional purposes?
- How much of the endowment should be spent and how much reinvested? What rules determine how this amount is calculated?
- To what extent is the fund expected to assist in maintaining the balance sheet of the institution (for example, by supporting its credit rating)?

In the following sections, we review and discuss each of these issues.

## Discussion

### Purpose of the investment pool

Endowments are typically composed of individual funds given by donors over time, usually to support particular activities or missions of the organization. Apart from these restricted funds, donors sometimes give with no restriction as to purpose. In addition, institutions themselves may elect to treat operating surpluses, unrestricted bequests and other similar amounts as 'quasi-endowment', to be invested and spent alongside other endowed funds.

These differing purposes influence the investment strategy for the funds. For example, a fund dedicated to providing scholarships at a college requires a steady flow of cash, year in and year out; ideally, the amount should not only remain steady but should rise with inflation. A fund, on the other hand, that is intended to cover the cost of awarding an occasional prize every five years does not have the same need for ready cash. These two funds have different tolerances for year-to-year fluctuation in their value and for liquidity, among other characteristics; and their asset allocation may, as a result, be different.

### Duration of the pool: perpetual or not?

Historically, most donors to endowments have contemplated a perpetual life for their funds. In recent years, however, some endowments—including some very large ones such as the Bill and Melinda Gates Foundation—have been established with a finite life. The expected lifespan, or term, of a fund is an important factor to consider when crafting an investment policy.

In this context, the maintenance of purchasing power, also called intergenerational equity, becomes an issue of key importance for a perpetual fund. While donors may occasionally state that intergenerational equity is not a goal for their fund, under the [Uniform Prudent Management of Institutional Funds Act](#) (UPMIFA), which is the law in virtually all the states, maintenance of purchasing power is assumed to be the intention of donors in the absence of a specific provision to the contrary.<sup>1</sup>

For example, a series of funds to endow the conductor's and section chairs' positions at a symphony orchestra will need to be invested with a perpetual horizon in mind, including considerations of intergenerational equity. On the other hand, a fund dedicated to constructing a new concert hall for the symphony ten years from now does not need to generate any cash during its life and should, accordingly, be invested using a different strategy (although a fund for ongoing maintenance of the hall would be perpetual).

### Who has responsibility for investment decisions?

Authority over institutional investment pools such as endowments, foundations and pension funds resides with the governing board, the members of which are fiduciaries. Under common-law concepts of fiduciary duty, and also under UPMIFA, whoever has responsibility for investment decisions must exercise prudence.<sup>2</sup> UPMIFA sets forth a list of factors that those responsible for endowed funds must observe in managing and investing, and states that "a person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills

or that expertise in managing and investing institutional funds."<sup>3</sup> Thus, while the law is flexible in not demanding that board or investment committee members exercise expertise that they do not possess, it also implicitly disapproves of arrangements whereby an illustrious individual lends his or her name without actually participating in debate and decision-making.

Apart from purely legal considerations, the task of recruiting a competent and committed group of individuals to oversee the investment pool requires a nominating process that acknowledges the seriousness of this portion of the organization's mission. If the board as a whole is to retain this responsibility, then trustee nominations should include an assessment of candidates' financial literacy and investment-related experience.

### Delegation to a committee, a consultant, or a manager

Delegation of the trustees' responsibilities with respect to a particular fund is permitted under UPMIFA, unless prohibited by the donor.<sup>4</sup> Under this standard, the board can delegate its fiduciary responsibility for investment matters to a committee or to outside advisors, but must exercise prudence in doing so.<sup>5</sup> Upon accepting the delegation, the new fiduciaries are bound by the same standard as the trustees in carrying out their new responsibilities. And if an investment committee or similar body is to be created, the committee chair (who should be a trustee) should seek out members – whether trustees or not – who have sufficient skill, experience and commitment to be good fiduciaries for the pool. All of these actions should be evidenced by appropriate board discussion and action, and recorded in the minutes.

What is the right size for an investment committee, and what kind of individuals should be asked to serve? Data taken from the most recent *NACUBO-Commonfund Study of Endowments* (NCSE)<sup>6</sup> show that the investment committees of educational institutions number about eight voting members on average. A companion Study, the *Council on Foundations-Commonfund Study of Foundations* (CCSF)<sup>7</sup>, pres-

1 For a summary discussion of UPMIFA and its requirements, see Sedlacek and Jarvis, "Endowment Spending: Building a Stronger Policy Framework" (2010), pp. 2-4. For other information about the law, see <http://www.upmifa.org>.

2 UPMIFA § 3(b). [http://www.law.upenn.edu/bll/archives/ulc/umofa/2006final\\_act.pdf](http://www.law.upenn.edu/bll/archives/ulc/umofa/2006final_act.pdf), p. 11.

3 Ibid. § 3(e)(6), p. 13.

4 Ibid. § 5(a), p. 29.

5 Ibid.

6 Citation is to data from educational institutions' 2015 fiscal year, July 1, 2014 – June 30, 2015.

7 Citation is to data from foundations' 2015 fiscal year, January 1, 2015 – December 31, 2015.

ents similar data for private and community foundations. In this case, the most recent Study shows that private foundation investment committees have smaller committees of around five voting members, since for many foundations the committee is composed of the founder's family and a few outside advisors. Community foundations were found to have larger investment committees—about the same as educational institutions. Within the investment committee, around four or five members are investment professionals (among private foundations, the number of investment professionals averages slightly more than two, while for community foundations the average is five). Between two and three members across all types of institution have alternative strategies experience, a key requirement for fiduciaries of highly diversified portfolios.

It is thus apparent that in recruiting trustees, investment committee members, and others who will have responsibility for managing endowment funds, care must be taken to select individuals who will understand and be able to fulfill their duties as fiduciaries and will bring their particular skills to bear in overseeing or managing the funds. It is important to note that, while UPMIFA does not set a minimum standard for those to whom the responsibility is delegated, it does require that the board, in choosing those individuals, act prudently.<sup>8</sup> Thus, sound investment policy would indicate that those to whom the responsibility for managing institutional funds is assigned (whether trustees or others) should, at a minimum, have some familiarity with and experience in investment management.

What about outside investment managers, consultants and other advisors? Most smaller and mid-sized nonprofit organizations lack the financial and staff resources to manage their own portfolios, and so must rely on such outside entities, overseen by volunteer boards of trustees or investment committees that meet several times a year. Many commentators have criticized this model as lacking in rigor, but it remains the standard for most nonprofits.

Across the nonprofit sector, internal staff resources are minimal. The NCSE and CCSF research shows that the average number of full-time equivalent (FTE) staff overseeing investments averages 0.8 to 1.7 FTEs. Only at institutions with endowments above \$500 million do the data show average

staffing levels greater than 1.0 FTE. Yet manager use, even by smaller nonprofits, is high: institutions with assets below \$100 million use a total of 12 to 16 managers on average across all asset classes, while for endowments above \$100 million it is not unusual to see 25 to 35 separate managers hired directly for various alternative strategies, in addition to between three and five managers for each of the traditional asset classes such as domestic equities, fixed income, international equities and cash.

Nevertheless, the fiduciary standards outlined above require that the same prudence be exercised in retaining, monitoring, evaluating and dismissing these advisors as in all other matters undertaken by the board. And, given the highly diversified portfolios that underpin the endowment model of investing, it is not surprising that the NCSE and CCSF research shows that one-third to nearly one-half of institutions have decided to delegate their investment responsibilities, in full or in part, to [outsourced investment providers](#). Even here, however, the same standards of prudence and diligence in choosing and monitoring the provider apply.

### Target return and endowment dependence

If the board aspires to maintain the purchasing power of the investment pool over time, then assumptions must be made about the long-term spending rate from the endowment, the anticipated rate of inflation and any other costs the fund may incur. As to the spending rate, both practical experience and economic modeling tools have demonstrated that it is not possible to spend in excess of five percent of the portfolio each year without suffering erosion in purchasing power over time. A proxy rate of no more than five percent, therefore, is frequently used. Inflation has fluctuated considerably over the past half-century, but in recent years has been negligible; an assumed long-term rate of three percent is common. And administrative and other costs are typically considered to add one percent to the expense base. Thus, five plus three plus one, or nine percent, is often the target return cited as necessary to maintain purchasing power.

It is important to try to reduce this number, because a nominal nine percent return, year after year, is probably unachievable without incurring a level of risk that most trustees would deem unacceptably high. Academic research has shown that, in the United States, the long-term equity

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<sup>8</sup> Ibid

premium over the risk-free rate of return has averaged approximately six percent, of which two percent has been dividends rather than capital appreciation.<sup>9</sup> To the extent that a portfolio is diversified away from U.S. equity securities—for example, into fixed income—this long-term return is even lower. Therefore, the assumptions for spending, inflation and expenses need to be examined carefully.

Spending, in particular, is the largest item of these three and is most directly within the control of the board. The NCSE research shows that policy spending rates for educational institutions are quite uniform, at 4.6 to 4.7 percent, across all endowment sizes. Among foundations, the federally required minimum annual spending rate of five percent for private foundations means that policy spending rates for these institutions range between 5.1 and 5.3 percent. For community foundations, which have more flexibility in spending, policy rates are somewhat lower, ranging from 4.6 to 5.1 percent.

Equally important, when considering long-term return targets, is the degree to which the institution's operating budget is dependent upon support from the long-term investment pool. This ratio of endowment dependence ranges from zero, at institutions for which the pool is truly a 'rainy-day fund', to much higher figures—for example, the 30 to 50 percent endowment dependence ratios that are observed at well-endowed U.S. private colleges and universities. The NCSE research shows that endowment dependence ratios at institutions of higher education average 9.7 percent, from a low of just 4.7 percent at institutions with endowments under \$25 million to a high of 16.5 percent at those with institutions with assets over \$1 billion.

An endowed institution ideally would like to receive a steady, and steadily increasing, amount of dollar support each year from its endowment. Where endowment dependence is high, the institution's tolerance for volatility in this amount becomes lower, and the imperative for realism in setting expected returns and acceptable risk levels becomes correspondingly more urgent.

### **Investment strategy of the fund, asset allocation, and permitted and prohibited investment strategies and instruments**

The investment strategy section forms the conceptual core of the investment policy statement (for operational ease, it may be contained in an appendix to the main body of the document). Its chief component is a table in which target allocations for each permitted asset class and strategy are specified. The table also prescribes ranges or bands around the target allocations, within which they will be permitted to fluctuate. It is important that the ranges not be so broad that they lack discipline or fail to reflect the actual portfolio construction preferences and risk tolerances of the institution. For this reason, where possible, financial modeling using long-term simulation tools should be used to help the board or investment committee to understand the range of probable outcomes and risk parameters of various alternative portfolio choices.

Rebalancing is another key component of the asset allocation policy. Different asset classes and investment strategies will of necessity produce different returns over the same investment period, with the result that the portfolio's actual allocations to each asset class or strategy will become higher or lower than the targets. To the extent that the allocations move outside the permitted bands as a result of such market fluctuations, rebalancing is required. Across all the different types of endowed nonprofits surveyed in the NCSE and CCSF research, this practice is nearly universal: well over 80 percent of institutions report having rebalanced their portfolios during the fiscal year reported upon by the most recent Studies.

The process is somewhat counterintuitive, since it involves selling investments that have appreciated in value and using the proceeds to purchase investments that have declined; but the result, from an investment policy point of view, is highly beneficial as the institution is able to reap gains on successful investments and buy other investments that are desired components of the portfolio cheaply.

<sup>9</sup> Dimson, Marsh and Staunton, *Triumph of the Optimists* (2002), pp. 163-175.

The two most frequently used approaches to rebalancing are those in which the process is conducted a certain number of times a year (calendar-based) and those in which rebalancing takes place whenever the targets or ranges in the asset allocation table have been exceeded (target/range-based). In the former the portfolio may be rebalanced monthly, quarterly, annually or at some other time interval; in the NCSE and CCSF research, around one-fourth of institutions report rebalancing quarterly. In the latter, as noted above, the rebalancing is triggered when the ranges or bands are exceeded; more than 85 percent of survey participants report using this method, probably in coordination with one of the calendar-based alternatives. Rebalancing may also be triggered in response to major gifts or other changes in cash flow, in order to ensure that the portfolio remains within its permitted asset allocation ranges. Whichever method is used, it is important that the rebalancing process itself not become the subject of subsequent debate (apart, that is, from the annual review of the investment policy). If it is regarded as optional, the board or committee may be tempted to engage in market timing and the policy will lose its effectiveness.

The investment policy statement should also contain descriptions of permitted and prohibited asset classes, investment strategies and instruments. The purpose of this list is to enable the board or committee to focus on the role of the various strategies in the context of the portfolio and its goals. To this end, it should include not only strategies that the institution intends to use immediately, but those that it may use in the future. For example, the statement might permit certain classes of alternative investments while assigning them a weighting of zero in the current portfolio. Going through the work of considering and describing their potential role and advantages enables the board or committee to be prepared for the time when a place will be made for them in the portfolio.

The question of permitted and prohibited investment strategies and instruments has gained in importance today because the complex nature of many investment products can make it difficult for a client to understand clearly what investment practices are being employed by a manager. Many disclosure documents and offering memoranda are lengthy and densely written, and can as a result be hard to understand, even if the information in them is accurate. The

board should not find itself in a situation where, as a result of this complexity, the language in the investment policy conflicts with decisions actually taken. If, for example, an investment policy statement prohibits instruments such as derivatives or strategies such as short selling, the committee should be careful not to invest with a hedge fund that uses derivatives and routinely goes short unless it has first inserted language in the investment policy statement to allow for the use of derivatives and short-selling as part of a hedging strategy. The institution should know what it is investing in and be sure that permissions and prohibitions in the investment policy statement reflect the reality of the decisions being made for the portfolio.

### **Risks the board is prepared to take in pursuit of its investment goals**

Historically, most investment policy statements treated investment risk as an undesirable by-product of investing rather than as an essential precondition to earning investment returns. References to risk typically spoke of it as something to be 'managed' in a general sense, while avoiding specific metrics or parameters. Where risk was defined in investment policy statements, it was usually as volatility of returns, measured in terms of standard deviation – a definition first used by Markowitz in his [Modern Portfolio Theory](#) dating from the 1950s.

The 2007-2009 market collapse, and the subsequent (and as yet incomplete) recovery, have brought home to fiduciaries the inadequate nature of this definition and the multiple nature of the risks that are undertaken in investing. Investment risk is now understood to comprise a wide variety of potential threats, chief among which is the risk of loss that would be permanent or require an unacceptably long time to recoup. Financial models are available to enable fiduciaries to estimate the probability and range of possible losses associated with given investment strategies over time, but it is important to emphasize that while risk can be modeled and to some degree understood, it cannot be eliminated if the portfolio's goal is to achieve a long-term return after spending and costs that is in excess of inflation. The question for fiduciaries, then, becomes whether the risks described are acceptable. How many years in twenty, for example, will the board be faced with a decline in dollar spending from year to year? What is the projected worst loss, and how many years would be required for the

portfolio to recover its purchasing power? These important questions should be asked and resolved as part of the investment policy formation process.

### **Liquidity: How much and for what purposes?**

During the financial crisis, many nonprofits found themselves with insufficient liquidity. For these institutions, the normal process of selling investments to raise cash for payroll and ongoing operations became a harrowing race to the bottom as sellers greatly outnumbered buyers and even high-quality securities could not be sold except at steep discounts from their previous prices. This situation called into question the validity of the ‘Endowment Model’, which uses a highly diversified portfolio with a higher-than-usual tolerance for illiquidity. Under the Endowment Model, endowment cash was held in small amounts, primarily to satisfy capital calls for partnership investments and to provide ‘dry powder’ to take advantage of attractive investment opportunities. Cash and near-cash allocations in excess of these requirements were viewed as a drag on performance and kept to a minimum. The crisis greatly increased the need for liquidity at the time when it was least available, and led to a reassessment of the place of cash in the endowment, with many institutions maintaining higher cash levels during the 2010-2012 period. In recent years, cash allocations have declined again, due in large measure to the very low interest rate environment created by global central bank policy. Data from the NCSE and CCSF Studies show that most institutions now include an allocation to endowment cash in their policy portfolios of between two percent and four percent.

### **Spending versus reinvestment and the rules guiding it**

Endowments have different purposes and uses for different organizations. At one end of this broad spectrum are institutions whose philosophy is to spend nothing and simply let the investment pool grow. These endowments are typically not composed of restricted funds (or at least not of those that require regular spending) and their institutions are, by definition, not heavily dependent on the endowment for support of the operating budget. It may be that trustees want to build up a rainy-day fund or have some other long-term goal in mind, such as a major capital project. At the other extreme are those funds that are not intended to be perpetual in duration, where spending during a set period is part of the donor’s purpose. As noted above, some very

large private foundations are currently operating on this basis.

Occupying the middle ground, and defining the vast majority of institutions and assets, are those institutions whose goal is that the endowment provide a source of perpetual support for the mission of the institution. The touchstones for this goal are prudent investing and spending, concepts that inform UPMIFA. Under UPMIFA, trustees may spend or accumulate as much of an endowment fund—including principal or income, realized or unrealized appreciation—as they deem prudent, taking into account the intended duration of the fund, the fund’s purposes, economic conditions, expected inflation or deflation, investment returns, other institutional resources and the institution’s investment policy.<sup>10</sup> This direct reference to investment policy highlights the central role of the statement in forcing an explicit consideration and articulation, in the statement itself, of the respective roles of investment and spending in the endowment.

### **Role of the fund in supporting the institution’s balance sheet**

Most endowments have as their primary goal the support of the institution’s operating budget. In some cases, however, an endowment may have different, or even multiple, roles. For example, unrestricted or quasi-endowment may be pledged to secure a credit line, or it may support a bond rating. In the case of nonprofit healthcare organizations, bond rating agencies have requirements for liquidity and underlying assets; these considerations affect asset allocation, and must be worked into the organization’s risk and return expectations. In this sense, the question of the purpose of the investment pool, which we considered at the outset, continues to inform the endowment management process even in areas that are not directly related to investment decision-making.

Indeed, there is a strong case to be made for linking the investment policy not only with the institution’s balance sheet but also with its long-term strategic plan. A growing number of institutions are doing this, and many are also addressing gifts and debt either in their investment policy or in separate but coordinated policy documents.

<sup>10</sup> UPMIFA § 4(a). [http://www.law.upenn.edu/bll/archives/ulc/umoi-fa/2006final\\_act.pdf](http://www.law.upenn.edu/bll/archives/ulc/umoi-fa/2006final_act.pdf), p. 19.

## Conclusion

In the past, many investment policy statements gave relatively cursory treatment to risk, its quantification and its potential impact on the asset pool. The market collapse and credit crisis of 2007-2009 demonstrated that many institutions' portfolios carried unacknowledged risks, that their risk profiles in general were higher than they thought, and that the risk tolerance of their fiduciaries was lower than acknowledged. Today, then, it is entirely appropriate to put risk at the top of the process of investment policy development.

Financial models, as the crisis demonstrated, are anything but infallible and, when consulted, must be used with care and a healthy degree of skepticism. It is nonetheless true that the results of an appropriate simulation or modeling study can assist fiduciaries in going beyond traditional risk definitions such as volatility to examine such critical parameters as the risk of permanent loss, year-to-year declines in spending, and recovery periods. These metrics both enable and force a discussion about tolerable levels of risk, the conclusions from which can be used to guide the construction of a range of potential portfolios that embody those risks that are deemed acceptable. Projected returns from these portfolios are an outcome which, if considered insufficient, indicate either acceptance of lower contributions for the acceptable level of risk or mandate a more robust discussion about the relationship between risk assumption and needed long-term returns.

Thus, in this proposed structure, instead of starting with return, committees work toward it. If, ultimately, the projected range of returns is seen as 'too low' compared to anticipated institutional needs, then the fiduciaries must either reconcile themselves to the fact that the target return is beyond their reach given their risk limits, or accept the necessity of embracing additional risks and explicitly acknowledge them in the investment policy statement.

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