2010 Annual Report

Treasurer's Report

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John E. Craig, Jr.

The investment committee of The Commonwealth Fund's board of directors is responsible for the effective and prudent investment of the endowment, a task essential to ensuring a stable source of funds for programs and the foundation's perpetuity. The committee determines the allocation of the endowment among asset classes and hires external managers, who do the actual investing. Day-to-day responsibility for the management of the endowment rests with the Fund's executive vice president and chief operating officer/treasurer, who, with the assistance of consultants from Cambridge Associates, is also responsible for researching investment strategy questions to be addressed by the committee. The committee meets at least three times a year to review the performance of the endowment and individual managers, reassess the allocation of the endowment among asset classes and managers and make changes as appropriate, deliberate investment issues affecting the management of the endowment, and consider new undertakings.

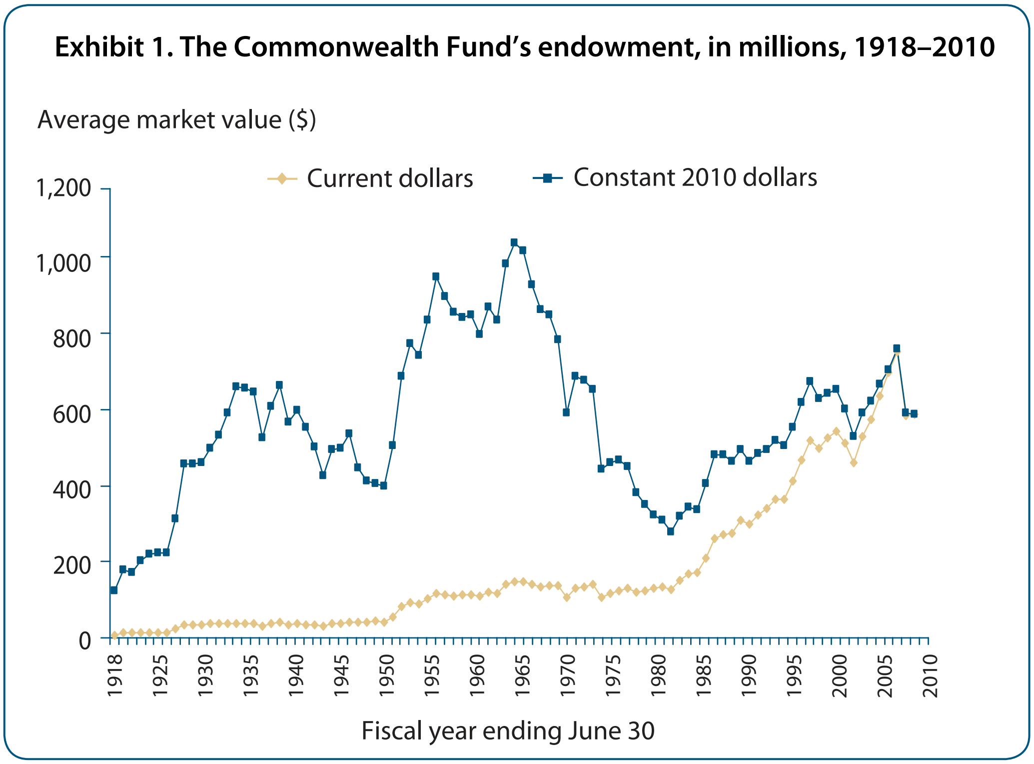
In the fiscal year ending June 30, 2010, the value of the Fund's endowment began to recover from the losses arising from the major global financial crisis and stock market crash of 2008–09 (Exhibit 1). The market value of endowment assets rose from $503 million at the depth of the market crisis in March 2009, to $550 million at the beginning of the fiscal year, to $598 million on June 30, 2010. At the same time, the foundation expended $33.8 million during the year in pursuit of its mission of advancing a high performance health system (Exhibit 2).

The net return on the Fund's endowment over the 12 months ending June 30, 2010, was 14.0 percent (Exhibit 3). Because of the defensive asset class allocation of the endowment, it underperformed the market benchmark during the year (14.0% vs. 15.9%). But the foundation's average annual returns through June 30, 2010, for the last three-, five-, seven-, and 10-year periods are well above those of the market benchmark.

The performance of the Fund's endowment is also quite competitive with that of peer institutions (Exhibit 4). For example, in the 12 months ending June 30, 2010, the Fund's return of 14.0 percent was well above that of the median return (12.3%) of 82 peer endowments with assets between $500

About the cover: The Investment Committee of The Commonwealth Fund's Board of Directors oversees the management of the foundation's endowment. Chaired by William Yun (top photo), the committee makes the asset class and manager allocation decisions that are key to ensuring strong endowment performance. Robert Pozen is among the committee members bringing their expertise to bear on promoting the Fund's fiscal health. The foundation delegates the actual investment of assets to external managers, such as TIFF, whose president and chief investment officer is Larry Lebowitz (bottom photo). Management of most of the foundation's hedge fund portfolio is outsourced to TIFF, where Nina Scherago is deputy chief investment officer and in charge of the organization's hedge fund investment pools.

Photos by Roger Carr.

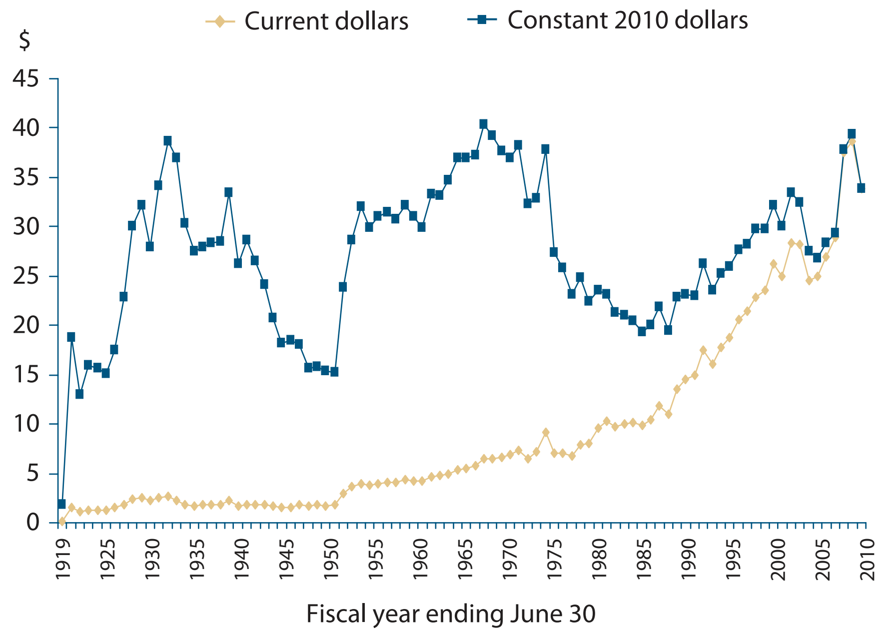


million and $1 billion. This year's return was also well above that of many very large leading university endowments. Over longer periods, the return of the Fund's endowment, as of June 30, 2010, was also significantly better than that of peer endowments—for example, over the last 10 years, the Fund's average annual return was 5.6 percent, while the median peer institution's return was 3.8 percent.

The salient features of the Fund's current investment strategy are summarized in Exhibit 5. Key among these are an overall target commitment of 88 percent of the portfolio to equities (publicly traded and private) and 12 percent to fixed-income securities; a 20 percent commitment to publicly traded U.S. equities, paired with a 20 percent commitment to international equities, including a 5 percent to 10 percent allocation to emerging markets; assignment of responsibility for 20 percent of the endowment to marketable alternative equity (hedge fund) managers; a 10 percent commitment to nonmarketable alternative equities (venture capital and private equities); and an 18 percent allocation to inflation hedges, including oil and gas, commodities, gold, and TIPS.

The board's investment committee has recently devoted particular attention to restructuring the management of the fixed-income portfolio. Aimed at preventing a repeat of the 2008–09 failure of the fixed-income portfolio to provide the expected protection in periods of financial market crisis, the committee has reduced the extent to which it delegates to managers the responsibility for determining the allocation of the portfolio among different types of fixed-income securities. As a result, 42 percent of the fixed-income portfolio is now invested in a passive U.S. government intermediate-term bond portfolio, while another 20 percent is similarly indexed, but with the manager employing a variety of strategies to increase returns by exploiting inefficiencies in fixed-income markets. The committee continues to employ a global fixed-income manager (23% of the fixed-income allocation) and another 8

Exhibit 2. The Commonwealth Fund's annual spending, in millions, 1919–2010: Total spending of $840 million over 91 years, or $2.5 billion in constant 2010 dollars



percent of the fixed income portfolio is allocated to an emerging markets short-term debt and currency manager—the remaining 7 percent being in cash reserves.

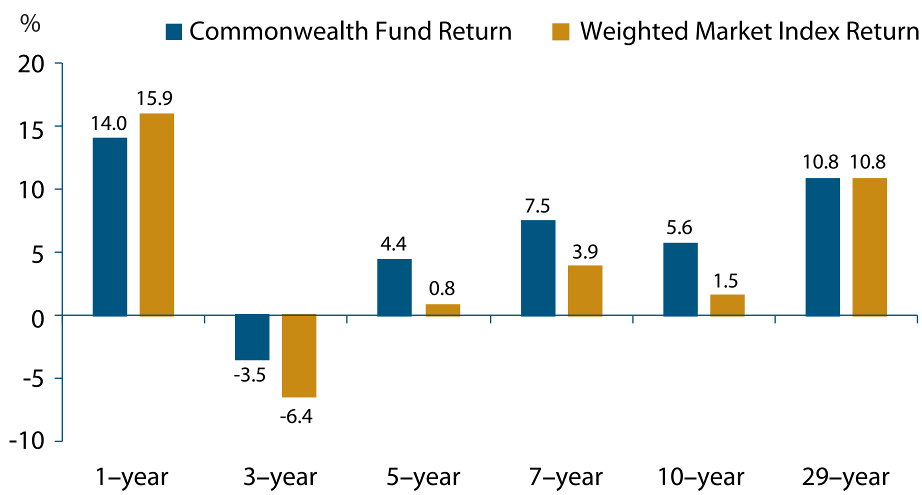
The committee periodically reviews asset class allocation targets and the permissible ranges of variation around them. Except in very unusual circumstances, the portfolio is rebalanced when market forces or manager performance cause an allocation to diverge substantially from its target.

Three considerations determine the Fund's annual spending policy: the aim of providing a reliable flow of funds for programs; the objective of preserving the real (inflation-adjusted) value of the endowment and funds for programs; and the need to meet the Internal Revenue Service requirement of distributing at least 5 percent of the endowment for charitable purposes each year.

Like most other institutions whose sole source of income is their endowment, the Fund has continued to adjust spending plans to the new realities resulting from the recent financial crisis (Exhibit 6). Following a 15 percent reduction in the Fund's budget in 2009–10, the board of directors approved a further 10 percent reduction in the 2010–11 fiscal year, lowering the total for the year to $31.3 million. In order to reduce the spending rate to the long-term target of 5.4 percent of the endowment—and barring a major rebound in the market value of the endowment—we expect further reductions in the budget over the next two fiscal years of 6 percent and 2 percent. The budget should ultimately stabilize at around $28.5 million (its level preceding the global asset price bubble that led to the 2008–09 financial crisis), and then grow with inflation.

As a value-adding foundation, the Fund seeks to achieve an optimal balance between its grantmaking and intramural research, communications, and program management activities, while minimizing purely administrative costs. Recognizing that data

Exhibit 3. Because of the defensive asset class allocation of the Fund's endowment, it underperformed the market benchmark over the 12 months ending June 30, 2010, but average annual returns through June 30, 2010, for the last 3-, 5-, 7-, and 10-year periods are well above those of the market benchmark.

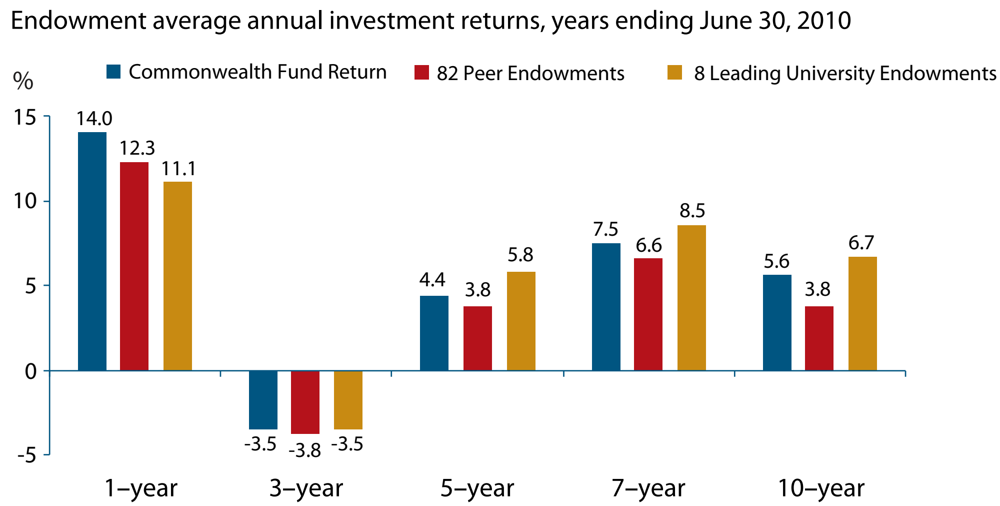


on expenditures reported in the Internal Revenue Service 990PF annual tax return inadequately reflect the purpose of many expenditures, the analysis in Exhibit 7 sorts out the foundation's 2009–10 expenditures according to four categories recommended by the Foundation Financial Officers Group: direct public-benefit activities (extramural grants and intramurally conducted programs, such as research, communications, and fellowships); grantmaking activities, including grants management; general and administrative activities; and intramural investment management. In 2009–10, the Fund's total direct public-benefit activities accounted for 85 percent of its annual expenditures. Value-adding oversight of grants took up 9 percent of the Fund's budget, and the intramural costs of managing the endowment, 1 percent. Appropriately defined, the Fund's administrative costs amounted to 5 percent of its budget.

Throughout the recent belt-tightening, Fund staff have demonstrated creativity in achieving cost savings and reordering spending priorities to maximize the impact of the foundation's resources. As painful as the budget reductions have been, given the still-subdued inflation within the U.S. economy, the Fund is fortunate that it continues to have the resources needed to maintain its role in helping inform the health policy debate and promote a high performance health system.

Since at least the 2001 Enron scandal, all American institutions have become more attuned to the possible risks they face, and that sensitivity has risen markedly since the 2008–09 financial crisis. Private foundations learned during the financial crisis that the unusual comfort zone that their endowments normally provide them can be unexpectedly and rapidly eroded by global financial forces. The Madoff scandal of 2008 provided another wake-up call to private foundations about the risks that can go undetected in the management of their endowments if investment and audit committees are not

Exhibit 4. The Commonwealth Fund's returns are very competitive with those of peer foundations and universities/colleges.



Source: Peer Endowment comparisons provided by Cambridge Associates

experienced, alert, adequately staffed, and committed to best endowment management practices.

In an environment of heightened awareness of, and concern about, risk, many nonprofits and foundations have assigned increased responsibility to board audit committees and staff to regularly undertake thorough reassessments of potential risks. The aim is to develop countermeasures to control risk and therefore reduce or prevent harm from negative events. The Commonwealth Fund instituted in 2006 an Enterprise Risk Management (ERM) tool that has helped it better assess risks and identify areas requiring the most attention.

As shown in Exhibit 8, the Fund's ERM tool assesses the potential risk of negative events and their potential severity in 16 domains:

- A catastrophic loss in the market value of the endowment;
- A terrorist event impairing the viability of New York City as the Fund's headquarters;
- Legislation adversely affecting private foundations' business model, or their ability to help inform public policy debate;
- Activities undercutting the Fund's standing as a nonpartisan organization;
- The strength of the foundation's board and executive leadership;
- The quality of the Fund's research and publications, on which the organization's reputation largely depends;
- Compliance with IRS regulations on such issues as conflicts of interest;
- The functionality of the Fund's landmark New York headquarters building;
- Compliance with tax payment requirements and myriad federal and state regulatory filings;
- The safekeeping of securities composing the foundation's $645 million[1] endowment;

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[1] As of November 30, 2010.

Exhibit 5. The Commonwealth Fund's endowment management strategy

	Allocation on September 30, 2010	Long-term target	Permissible range
Total endowment	100%	100%	
Asset Class			
Total Equity	83%	88%	75%–90%
U.S. equity marketable securities	17%	20%	15%–30%
Non-U.S. equity marketable securities	19%	20%	15%–30%
Marketable alternative equity	18%	20%	15%–30%
Non-marketable alternative equity	12%	10%	5%–15%
Inflation hedges	17%	18%	5%–20%
Fixed Income	17%	12%	10%–25%

- The strength and vitality of Fund grants programs;
- Conduct of the Fund's staff or board;
- Financial fraud;
- Compliance with a very large number of human resources regulations;
- Malfeasance by a grantee; and
- Failure of funded projects.

Since its development, this tool has been continually improved. Today, the foundation's independent auditor and a substantial number of the Fund's Board, management, and staff—each with different vantage points—participate in an annual exercise in which they are asked to assess independently the potential for a negative event, and such event's potential severity, across all 16 domains. The scoring is done confidentially, on a scale of –2 (very low risk/severity) to +2 (very high risk/severity), and the scores are averaged to produce an overall assessment.[2]

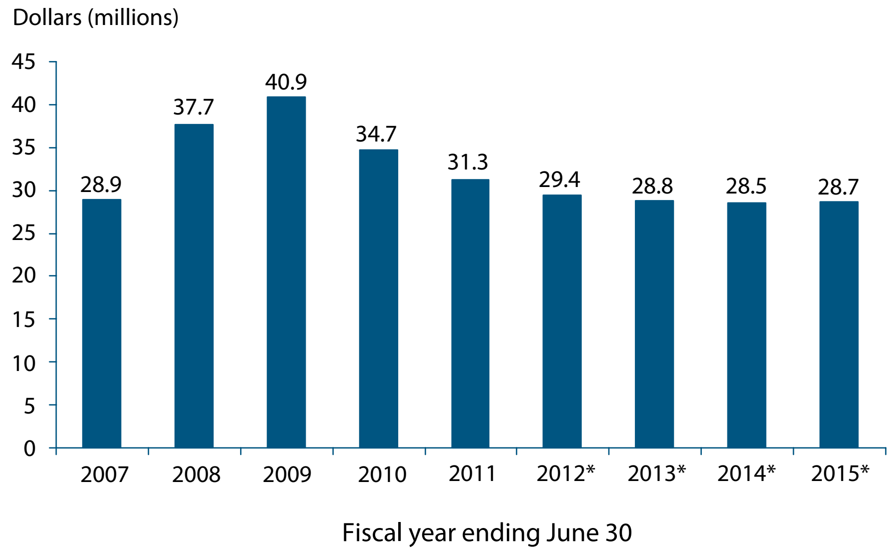
[2] Other points along the scale can be properly translated as follows: –1 = low; 0 = moderate; +1 = high.

The June 2010 ERM analysis reveals that none of the domains for the Fund is accorded both a high impact and high risk (probability of occurrence) rating. The domains with greatest potential impact ratings (1.0 or greater) are as follows: a catastrophic loss of endowment market value; a terrorist attack on New York; activities that undercut the Fund's nonpartisan standing; adverse legislative/regulatory actions against foundations; and diminished performance of the Fund's leadership. The domains "publications/research damaging the Fund's reputation for high-quality and reliable work" and "IRS regulatory compliance" also received severity scores approaching 1.

None of the domains has a risk rating of "high" or "very high," and only "project failure" (a grantee's failure to produce expected deliverables) has a risk assessment approaching "moderate." While the impact severity of an endowment-threatening event is rated the highest, the risk of a catastrophic loss in market value is rated as "moderate–low."

The Fund's Investment Committee seeks to control endowment risk through a clearly

Exhibit 6. As a result of the 2008–09 financial markets crisis, the Fund's budget will return to approximately its pre-asset-bubble level of $29 million annually.



* Projected

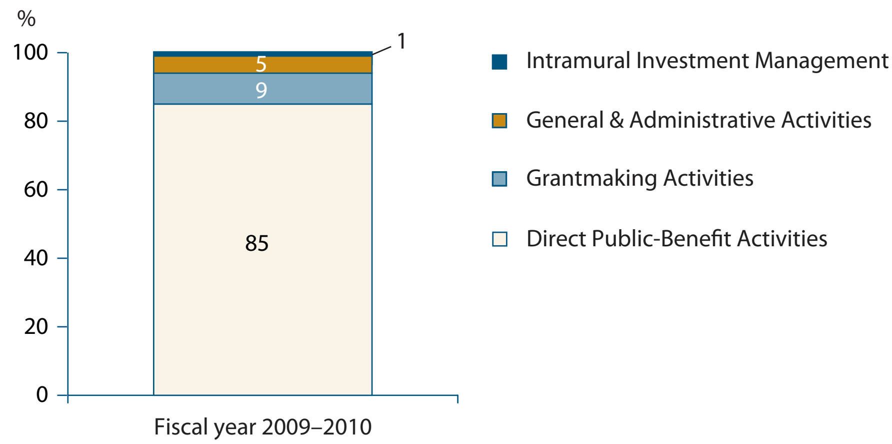
articulated investment policy statement, diversification, and strong oversight of investment strategy, including use of a top-ranked endowment management adviser, Cambridge Associates. Mitigation of the impact of a potential terrorist event affecting New York is attempted through a detailed Business Continuity Plan that is updated annually and shared with key staff and Board members, and includes backup offices in other cities and regions.

Management seeks to control the "partisanship" risk through careful review of publications, clear policies for staff regarding types of events in which they may participate, written guidelines for interaction with members of Congress and presidential candidates, and education of staff on prohibited lobbying activities. Staff responsible for monitoring adherence to guidelines and providing guidance are the Fund's executive vice president/COO, its senior policy director, and its president. The Fund's success in attracting both Republicans and Democrats to its annual Bipartisan Congressional Retreat for discussion of health policy issues has helped control this risk, by establishing working relationships that cross party lines. The attendance of Board members at this event, as well as other major events like the Fund's International Symposium on Health Care Policy, is also helpful in monitoring this risk.

On the regulatory risk front, management is quite active in identifying and advocating best practices in the foundation sector, and the Fund's work with legislators on health care reform has heightened bipartisan appreciation of the unique role that foundations play in informing debate on public policies and advancing social improvements. The close ties that have been developed with members of Congress on both sides of the aisle also help to reduce the risk of legislation or regulations that might impair the foundation's business model or programmatic strategy.

The Fund's Board has a strong Governance and Nominating Committee and Executive and Finance Committee, which, along with the rest of the Board, are responsible for ensuring effective leadership at the Fund. Measures to control the risk of

Exhibit 7. The Fund's total direct public benefit activities—including extramural grants and intramural research, communications, and programs conducted by the foundation—account for 85 percent of its annual expenditures. Value-adding oversight of grants takes up 9 percent of the Fund's budget.



diminished leadership capacity include the following: annual Board reviews of the performance of the Fund's president and executive vice president/COO, the Board's annual participation in the Center for Effective Philanthropy's Survey of Foundation Trustees, annual external reviews of major programs, the Fund's own performance scorecard (encompassing annual audience and grantee survey findings), and the attentiveness of the chairman of the Board and Board committee chairs.

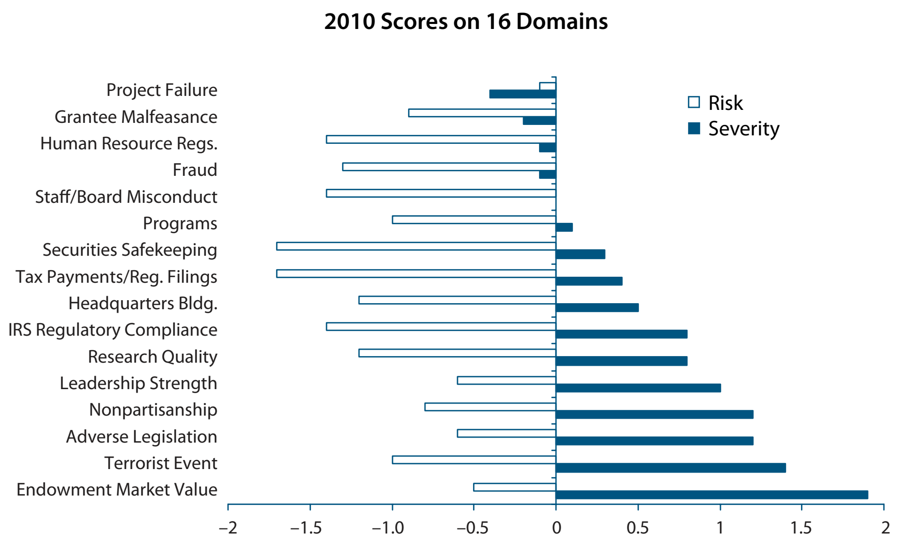
The risk of publishing research of questionable quality is regarded as low (score of –1.2), given the internal and external pre-publication review processes that the Fund employs and the strong professional standards of staff. Risk of conflict-of-interest policy and other IRS regulatory violations is also regarded as low, given the high level of integrity of Fund Board members and staff and an enforced conflict-of-interest policy.

The Fund's system for vetting proposals and its strong professional staff help control the risk of project or program disappointments. An annual report to the Board on completed grants provides feedback on the extent to which projects are executed successfully, as well as lessons learned in the selection and management of grantees. Review each year by the Board and an external expert of a Fund program, annual meetings of the chairman with each program officer and with management to discuss program strategy, and Board meetings' focus on discussion of Fund strategy all help control the risk of program failure and enhance the potential of success. Attendance by Board members at key Fund-sponsored events also helps in assessing the effectiveness of program strategies.

Management seeks to control the risk of capital loss and business interruption arising from damage to the foundation's headquarters building at One East 75th Street in New York through a high level of maintenance, replacement-cost insurance coverage, and an up-to-date business continuity plan.

The Fund's Enterprise Risk Management tool reveals that, while important, most of the traditional points of risk focus—projects, grantee malfeasance, regulatory filing requirements, routine financial fraud—are unlikely to effect lasting, significant damage on the organization should

Exhibit 8. Commonwealth Fund Enterprise Risk Management Assessment



Severity and Risk of Possible Negative Events Assessed on Scale of –2 (minimal) to +2 (high)

they occur. Greater potential for major harm lies in domains where risk is more difficult to control and may go undetected, to the point where improvised controls are too late in preventing significant harm. Foundations that do not pay sufficient attention to the management of their endowment, the legislative and regulatory environment in which they operate, the performance of their board and management, and the quality of the work they generate do so at considerable risk to their effectiveness, vitality, and longevity.