
Executive Vice President–COO's Report
2008 Annual Report
The Commonwealth Fund’s Mission

The Commonwealth Fund is a private foundation that promotes a high performance health care system providing better access, improved quality, and greater efficiency. The Fund’s work focuses particularly on society’s most vulnerable, including low-income people, the uninsured, minority Americans, young children, and elderly adults.

The Fund carries out this mandate by supporting independent research on health care issues and making grants to improve health care practice and policy. An international program in health policy is designed to stimulate innovative policies and practices in the United States and other industrialized countries.

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John E. Craig, Jr.

In recent months, the international financial system has experienced the most severe turmoil since the Great Depression of the 1930s—stresses that in September 2008 came close to completely freezing up the flow of credit that is the lifeline of all economic activity. The ensuing bankruptcies and fire sales of financial powerhouses, and the government’s interventions, have fundamentally changed the structure of Wall Street and international financial markets.

At this point, actions by the U.S. Federal Reserve, U.S. Treasury, and other countries’ financial overseers have brought the financial system back from the brink of collapse. The Obama administration and Congress have taken further steps, including the enactment of an economic stimulus package of unprecedented proportions. Efforts are also under way to identify improvements in regulatory and market structures needed to address the flaws that produced the crisis.

Although the real-world impact of financial chaos is just beginning to unfold, it is useful at this point to contemplate the implications for private foundations and the constituencies they serve. I begin with a summation of the causes of the crisis, and then discuss the impact on markets in general and private foundations in particular. Next, after presenting a framework for analyzing the extraordinarily diverse U.S. private foundation sector, I offer some lessons on endowment management that foundations might take from the ongoing crisis. Finally, I turn to thoughts on how the spending plans and program strategies of these institutions are likely to be affected as they survey the damage that has been inflicted in recent months.

Market Environment

In the words of Ben Inker of the investment management firm GMO, “In 2007, the world saw the most profound bubble in risk assets ever seen, and it is the bursting of this bubble [in late 2008] that has led to the enormous loss of wealth we have experienced to date.”

As shown in Figure 1, in 2008, outside the safe haven of conventional U.S. government bonds, there was no place to hide from the financial storm. U.S. stocks, for example, fell by 37 percent (as measured by the S&P 500); international stocks (MSCI EAFE index), by 43 percent; emerging markets stocks, by 53 percent; energy stocks, by 23 percent; Real Estate Investment Trusts (REITS), by 38 percent; commodities, by 36 percent; and hedge funds, by 18 percent (through November 2008). Similarly, high-grade U.S. corporate bonds declined by 3 percent, high-yield corporate bonds by 26 percent, and even “safe” investments, such as U.S. Treasury inflation-protected bonds (TIPS), by over 2 percent. Among all the major market sectors, only U.S. Treasury bonds yielded positive returns (12%).
The shock that institutional and individual investors experienced in the autumn of 2008 was compounded by the suddenness with which the collapse across so many markets occurred. The first signs of the coming storm appeared in July 2007, when short-term credit markets seized up and a few heavily leveraged hedge funds failed. Still, the U.S. stock market went on to achieve its all-time high in early October. A further sign was the –9.5 percent return produced by the S&P 500 for the first quarter of 2008, but most were lulled by the fact that the major market index fell by “only” 2.7 percent in the second quarter of the year, during which period the first major Wall Street bankruptcy occurred. Through August, the year-to-date return on the S&P 500 was –11.4 percent—worrysome, but perhaps normal, given the amount of concern about the financial system and the economy overall. Thus, when the storm finally broke with a fury in September 2008, there was tumult throughout the financial sector. In the last three months of the year, the S&P 500 fell by 23.2 percent, and investors were reeling.

The causes of the market bubble are as clear in hindsight as they were disregarded in the making. In summing them up, it is only fair to draw primarily on the insights of investor Jeremy Grantham, a self-described “perma-bear” whose warnings went unheeded for so long:2

- Sustained increases in the U.S. money supply, beginning as an antidote to the Y2K fears of 2000 and augmented in response to the bursting of the technology stock bubble in the early 2000s;
- As a result, enormous credit expansion, increased leverage, and indebtedness throughout the U.S. and, indeed, worldwide economy (private and public), evidenced particularly in the housing price bubble;
- At the U.S. Federal Reserve, the view that bubbles cannot be tackled by authorities and can only be allowed to run their course;
- A weakening financial regulatory environment;

\[ \text{Figure 1. The crash of 2008 devastated most financial markets, leaving few safe havens for endowment investors} \]

\[
\begin{array}{ccccccccc}
\text{Market sector} & \text{(*Return for hedge funds is through Nov. 30, 2008)} \\
\hline
\text{U.S. equities} & \text{Int'l dev. equities} & \text{Emerging markets} & \text{Energy} & \text{REITs} & \text{Commodities} & \text{Hedge funds*} & \text{High-grade U.S. corp. bonds} & \text{TIPS} & \text{U.S. govt bonds} \\
\hline
-37.0 & -43.4 & -53.2 & -23.4 & -37.7 & -35.7 & -18.2 & -3.1 & -2.4 & 12.4 \\
\end{array}
\]

Source: JPMorgan Chase and Cambridge Associates.
The development over the last 20 years of increasingly complicated financial instruments whose market value can be difficult to ascertain or whose risk can be easily misjudged;

Marked increase in risk-taking across all markets and investor groups.

In the crisis environment that has prevailed since September 2008, monetary authorities, U.S. Treasury officials, and their overseas counterparts have focused on massive temporary measures aimed at preventing a breakdown similar to that which led to the Great Depression. Missteps have undoubtedly occurred along the way, but recent narrowing of the difference between the cost of borrowing by corporations and the federal government (the “yield spread”) suggests that the medicine may be beginning to take effect. Much serious thinking, however, needs to be given to addressing the policy and structural faults that produced the crisis, and to the potential long-term inflationary effects of the medicine that is being administered.

THE BURST MARKET BUBBLE IN PERSPECTIVE

As severe as the current bear market in U.S. equities is, the data in Figure 2 reveal that it is not of unprecedented proportions. Three such markets in the Great Depression era exceeded its damage (return of −55.5%) by wide margins. More relevantly, the current bear market’s return (at least through March 3, 2009), while the lowest of any since the 1930s, is within striking range of two more recent severe bear markets: that of the 2000–02 technology stock bust (−49.1%) and that of the 1970s oil embargo (−48.2% in 1973–74).  

No one can say how this market will play out, but the historical record suggests three possible scenarios:

- A quick rebound, comparable to what happened after the crash of 1987;

![Figure 2. The current bear market in stocks is the fourth most severe since 1926, but is close in scale to that of 2000–02](image-url)

Source: Cambridge Associates.
• A two- to five-year period of market recovery, characterized by returns that are modest in comparison with that of the great bull stock market of 1982–2000 (S&P 500 average annual return of 19.5%), the principal reference point of the current generation of endowment managers;

• A “lost decade,” comparable to the experience of the stagflation era of the 1970s to early 1980s, when the average annual real return on U.S. stocks was 0.3 percent.

Of these, the first seems highly unlikely, given the excesses that had built up in markets and the gravity of the underlying causes of the downturn. The third is not out of the question, but it can be averted if the monetary policy interventions now under way work and if the federal fiscal stimulus package just enacted encourages productive economic activity and addresses underlying problems working against the long-term health of the U.S. economy.

The most likely scenario is the middle one. Even a perma-bear like Grantham believes that the severely battered market has left most asset classes so undervalued that real (inflation-adjusted) returns of 5.7 percent (small-capitalization stocks) to 10.4 percent (high-quality stocks) are possible in U.S. equities over the next several years—with generally better returns possible in markets that are more undervalued than the U.S. market (e.g., international stocks). As importantly, truly skillful investment managers, taking advantage of buying opportunities not seen in such quantity since 1982, should be able to produce returns superior to these averages.4

This guarded optimism, however, must be qualified by the following two cautions:

1. Markets tend to overshoot every bit as much on the way down as they do on the way up, which gives credence to the fear voiced by less-pessimistic managers than Grantham that the S&P 500 may yet dip below its low point so far (March 2009)—to 600 or worse—before rebounding.

2. The Japanese experience of the 1990s (following the crash of that country’s 1980s bull market) demonstrates that, despite all that has been learned about monetary and fiscal policy since the 1930s, experts and policymakers may still fail to prevent a decade of lost economic growth.

The Damage to Foundation Endowments

Comprehensive data on the impact of the market crash on private foundations will not be available for some time, but the data in Figure 3 are indicative of what has happened. Looking at net returns through December 31, 2008, for 89 foundations, including The Commonwealth Fund, as well as the Multi-Asset Fund of The Investment Fund for Foundations (TIFF), we see that during the 2008 calendar year the average return for this group—which includes arguably some of the best-managed foundation endowments in the country—was –25.3 percent.5 As a result of the market crash, the average annual return over the last three years was –1.6 percent. The average annual return over the last five-, seven-, and 10-year periods has been modestly positive, but not enough to keep up with inflation and, at the same time, enable foundations to meet their IRS-required spending rate of 5 percent. In contrast, at the end of June 2008, spending- and inflation-adjusted returns for all of these periods were decidedly positive for these foundations.

A very rough estimate of how much wealth has been lost in the entire private foundation sector can be arrived at by using the historical statistical association
between market returns (weighted according to the typical asset-class allocation of foundations) and year-to-year changes in foundations’ total assets. According to The Foundation Center, in 2007, the market value of the combined assets of all U.S. foundations was in the neighborhood of $670 billion. As a result of the market crash, total foundation assets by the end of 2008 were likely no more than $561 billion—a decline of $109 billion, or 16 percent (Figure 4). Knowledgeable observers argue that when the actual data are in, the decline will prove to be closer to 25 percent, or $167 billion.

How the institutions bearing these losses are likely to respond to this startling new financial reality, in terms of endowment management practices, spending policies, and program strategies, will be addressed below. But first, it is useful to have a framework for thinking about these questions that takes into account unique characteristics of the foundation sector.

**The Private Foundation Sector: A Framework for Analysis**

Every study of private foundations emphasizes their pronounced diversity—by size, mission, goals, business model, and program strategies. For the purposes of this analysis, it is useful to group the approximately 72,500 foundations that existed in 2006 (the latest year for which data are available) by asset size and by key differentiating features of their business models and program strategies (Figures 5 and 6). With respect to business model, foundations may choose to be either perpetual or to spend down assets over a designated period. A variation on the spend-down model is foundations that serve as “pass-through” conduits for annual giving by donors. Corporate-sponsored foundations are of the latter type, but so are many very small foundations. While there can be significant differences, both the investing and spending practices of spend-down and pass-
Figure 4. As a result of the 2008 market crash, total private foundation assets have likely declined by at least 16 percent.


Figure 5. 270 private foundations with assets of $250 million or more in 2006 controlled 50 percent of the sector’s resources; the vast majority of the 72,477 foundations are very small organizations, with assets under $10 million.

Mega foundations have assets of $15 billion or more; Very large, from $1 billion to $14.99 billion; Large, from $250 million to $999.99 million; Mid-size, from $50 million to $249.99 million; Small, from $10 million to $49.99 million; Very Small, from $1 million to $9.99 million; Micro foundations, less than $1 million. Source: The Foundation Center.
through foundations are generally quite similar. They are therefore not analyzed separately here.

On program strategy, foundations may choose to use funds principally for conventional charitable purposes—such as subsidizing the costs of building and running hospitals, schools, universities, social service organizations, and cultural organizations. Or they may seek to bring about fundamental improvements in society through investments in social infrastructure—for example, in the case of health foundations like The Commonwealth Fund, funding health policy research and demonstrations testing better models of providing health insurance and delivering health services.8

As shown in Figure 5, we know with a fair amount of precision the array of private foundations by asset size. It is a very concentrated distribution: the 270 foundations with assets of $250 million or more in 2006 controlled 50 percent of the entire sector’s wealth, and those with $50 million or more, 71 percent of all foundation wealth. Meanwhile, 66,330 foundations with assets of less than $10 million accounted for just 13 percent of the sector’s resources.

Much less can be said concretely about the frequency within each asset size category of perpetual/spend-down and social improvement/charitable giving organizations, but the data and notations in Figure 6 provide a close approximation. Setting aside the special case of the Bill and Melinda Gates Foundation (whose $33 billion in assets, prior to the recent infusion of funds from Warren Buffett, dwarf the Ford Foundation’s $12.3 billion, the second-largest endowment), the bulk of private foundation assets lodge with perpetual mid-size to very large foundations, the great majority of which have essentially charitable missions. Significantly, the number of perpetual foundations dedicated to addressing fundamental societal ills is relatively small, and their share of total foundation resources is also small.9 Given their share

Figure 6. Perpetual foundations aiming to address fundamental problems in society are relatively few in number and control a very small portion of total foundation assets in the U.S.

<table>
<thead>
<tr>
<th>Purpose/Endowment Size</th>
<th>Perpetual (# of foundations)</th>
<th>Spend-down/Pass-through (# of foundations)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Social Improvement</td>
<td>Charitable</td>
</tr>
<tr>
<td>Assets $15 billion or more (1, with 5% of sector assets)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Assets $1 billion–$14.99 billion (61, with 29% of sector assets)</td>
<td>19</td>
<td>40</td>
</tr>
<tr>
<td>Assets $250 million–$999.99 million (208, with 16% of sector assets)</td>
<td>20</td>
<td>176</td>
</tr>
<tr>
<td>Assets $50 million–$249.99 million (1,245, with 21% of sector assets)</td>
<td>Some</td>
<td>Numerous</td>
</tr>
<tr>
<td>Assets $10 million–$49.99 million (4,632, with 16% of sector assets)</td>
<td>Some</td>
<td>Numerous</td>
</tr>
<tr>
<td>Assets $1 million–$9.99 million (21,731, with 11% of sector assets)</td>
<td>Rare</td>
<td>Numerous</td>
</tr>
<tr>
<td>Assets less than $1 million (44,597, with 2% of sector assets)</td>
<td>Extremely Rare</td>
<td>Some</td>
</tr>
</tbody>
</table>

Source: The Foundation Center and The Commonwealth Fund.
of sector resources, the following endowment management analysis will concentrate on mid-size-to-large perpetual foundations.

LESSONS IN ENDOWMENT MANAGEMENT FROM THE MARKET CRISIS OF 2008

Over the last 25 years, many well-run large foundations have adopted an endowment management model featuring the extensive asset class diversification, shown in Figure 7, of 106 such institutions monitored by Cambridge Associates. Premised on financial market research showing that diversified portfolios with riskier assets can produce higher returns, with manageable risk, than less-diversified conventional portfolios, and drawing on the success of such major university endowments as that of Harvard, Yale, and Princeton in using this model, sizable foundations have successively dialed down the once-traditional 60:40 allocation between equities and fixed income: first to 70:30 (1980s), and then to 80:20 or lower (1990s). In doing this, they substituted riskier holdings like venture capital, real estate, emerging-markets equities, energy, commodities, private equity, and hedge funds for conventional stocks and bonds—in the end, leaving barebones fixed-income allocations to ensure liquidity and bolster returns in the event of deflation.

This model worked well through the second quarter of 2008, but faltered in the fall 2008 market collapse—as revealed by the widely reported large drops in the value of the Yale and Harvard endowments and the data on the recent endowment performance of large foundations. Yale’s veteran endowment manager, David Swenson, argues that the diversified portfolio management model remains valid despite the recent experience: “[W]hen you have a market in which any type of equity exposure is being punished, it’s going to hurt long-term performance.” Nonetheless, private foundations should consider the following lessons from this experience:

- As argued by Ben Inker and Jeremy Grantham at GMO, in the post-2003 “risk bubble,” all riskier assets became overvalued, all but negating the

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Figure 7. Over the last 25 years, larger private foundations have increasingly diversified their endowment portfolios, substantially increasing allocations to a variety of equity markets and reducing fixed income allocations

Median % allocation of 106 endowments with median assets of $266 million, June 30, 2008. Source: Cambridge Associates.
benefits of diversification. Thus, more attention needs to be paid to market valuations of asset classes, with the aim of underweighting those that appear to be overvalued. “Rather than having a static allocation to each class of...asset, it makes more sense to keep all of them on the menu, but shift the [policy] allocations as valuations, and therefore risk/return trade-off, shift.” To many, this advice may smack of market timing, a practice almost universally discouraged by experienced investors. But the core message is to pay more attention, particularly in frothy markets, to the relative valuation measures of different asset classes available from investment consultants. At a minimum, those responsible for foundation endowments should adhere more rigorously to the discipline of rebalancing to policy allocations—and those allocations merit more frequent reconsideration, especially in periods of excess.

The Yale/Harvard endowment management model requires extensive experience and great skill at the staff and trustee level to make it work effectively; it is not one likely to be successful for amateurs. Not all foundations that have adopted the model have the intramural capacity needed to ensure its success, even with the help of investment consultants. Thus, as shown in Figure 8, larger foundations consistently achieve more from it than do smaller foundations. Furthermore, the spread of the model helped to bid up the prices of the risky assets it requires and, given the limited supply of truly talented investment managers, to generate a supply of managers ill-equipped to manage such assets. As a result, enthusiasm in the endowment community for the model has probably heightened its risk.

Figure 8. Very large foundations are better equipped to execute sophisticated endowment management strategies than are smaller ones

<table>
<thead>
<tr>
<th>Foundation category</th>
<th>5-year average annual return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $20 mil.</td>
<td>6.4%</td>
</tr>
<tr>
<td>$20 mil.–$99 mil.</td>
<td>7.0%</td>
</tr>
<tr>
<td>$100 mil.–$499 mil.</td>
<td>8.0%</td>
</tr>
<tr>
<td>$500 mil.–$1 bil.</td>
<td>8.4%</td>
</tr>
<tr>
<td>$1 bil. +</td>
<td>9.6%</td>
</tr>
</tbody>
</table>

Returns are for the five years ending September 30, 2008, for 106 foundations. Source: Cambridge Associates.
The lesson here is that foundations that have adopted the model need to reassess their capacity for implementing it effectively. Smaller foundations may see as a better course using organizations like The Investment Fund for Foundations (TIFF) or the Common Fund, which have the expert and experienced staffs required to enhance the chance of success. Alternatively, they may wish to eschew such sophisticated approaches altogether and use a simpler, index fund–dominated endowment management model.

Certainly, foundations that intend to follow this model, but lack the resources to assemble internally the high-quality professional investment team needed to produce the expected results, should take great care in selecting investment consultants and in using a fund-of-funds to build specific portfolios.13

Ensuring liquidity. One of the great surprises of the recent crisis was the drying up of liquidity, even for asset-rich and debt-free institutions like private foundations. While hopefully the freeze-up in credit markets that occurred is a once-in-80-years event, the lessons of the liquidity crunch that in many ways precipitated the stock market crash are nonetheless worth putting on record:

- Many nonprofits, including some foundations, were caught in the trap of investing in poorly understood short-term investment vehicles that produced higher yields than conventional money market or custodian bank short-term investment funds. In their reach for yield, some of these institutions ultimately found it impossible to withdraw funds, or saw the value of supposedly risk-free funds decline. Lesson: The purpose of short-term cash funds is to provide a safe and ready source of liquidity, and the potential cost of obtaining a slightly higher yield in a nonconventional vehicle outweighs the benefit. A further lesson is that endowment managers should monitor regularly the holdings in the conventional short-term investment vehicles that they use.
  - The securities lending business is well developed and has long been regarded as a risk-free tool for increasing the return on an investment pool. This proved not to be the case in the recent market panic, when fears of counterparty risk and sharp declines in the market value of invested collateral for loans caused index funds and other pooled vehicles with securities lending programs to put limits on withdrawals or deny them altogether—often with no notice to clients, longstanding or otherwise. Lesson: Know what ancillary programs your index or other pooled funds use; seek contractual language guaranteeing liquidity; and, if need be, identify such funds not using securities lending programs.
  - The diversified endowment management model adopted by many large foundations creates liquidity requirements beyond those arising from the foundation’s philanthropic programs. Venture capital, private equity, real estate, and other partnership commitments are drawn down in unpredictable segments over multiyear periods. Moreover, hedge funds typically have once-a-year withdrawal dates and may have lock-ups for different vintages of invested funds. In the recent crisis, hedge funds put further restrictions on partners’ access to their capital. Thus, private foundation endowment managers have seen the need to pay greater attention to their institutions’ liquidity requirements and how best to manage them. Some have gone so far as to obtain lines of credit, should they be unable to sell securities to meet cash needs or unable to sell them at anything other than fire-sale prices.
Learning from the Madoff debacle. The current financial crisis has demonstrated that the market excesses that develop in a period of intense leveraging are rapidly exposed when deleveraging sets in. Bernard Madoff’s Ponzi scheme—said to have involved up to $50 billion—demonstrates that deleveraging reveals not only legal excesses, but also illegal activities that remained sub rosa in a speculative market. The Madoff event, where astute investors, including a number of foundations (mainly donor-controlled), placed funds in a vehicle that no one understood and whose returns could not be explained, underscores the enduring value of the rule against investing in something that one does not understand. This scandal reveals also the disturbing extent to which even some foundations failed to undertake the due diligence that is essential before hiring any external manager or advisor.

The apparent use of the Madoff scheme by funds-of-funds also reinforces the lesson that foundations should take great care in delegating fiduciary responsibility to such vehicles. While numerous funds-of-funds are well run and adhere to best-practice due-diligence procedures, the Madoff episode suggests that foundations should first consider nonprofit investment organizations—created and run for the benefit of the sector—when they are in the market for a fund-of-funds vehicle (although this is not to say that TIFF and the Common Fund are immune to making mistakes in picking managers). These lessons are particularly apt for smaller foundations, which often fail to see the need for engaging a trustworthy and skilled investment consultant to help guide their endowment management decisions.

Implications for Foundations’ Spending and Program Strategies

Under federal law, private foundations are required to distribute annually at least 5 percent of a rolling average of the market value of their assets. Many foundations, particularly very small ones, distribute considerably more than the minimum; indeed, U.S. foundations’ average giving rate (excluding most intramural spending) in 2007 was 6.4 percent.

Most perpetual foundations use the rolling-average value of their assets over the preceding 12 quarters to determine their giving in any year. Historically, giving as a percentage of total assets in any year generally rises in bear financial markets and falls in bull markets toward the minimum IRS-required payout rate (Figure 9). This variation in the annual giving rate for all foundations occurs for three principal reasons: 1) the lag between spending and assets just noted; 2) the policy of many foundations to allow their spending point create enormous opportunity—especially so for long-term investors like foundations that can weather short-term volatility. Real average equity market returns for the next several years may be modest by historical standards, but given current depressed asset prices, skilled investment managers will have the chance of a lifetime to achieve superior returns. To a considerable degree, only the fittest of hedge funds are likely to have survived, for example, and given the recent outflow of funds from both conventional and hedge fund managers, foundations will find open doors at previously inaccessible top-ranked hedge fund and other managers.14 Provided that their investment committees are appropriately staffed for identifying able managers, foundations should be forward-looking in seeking opportunities that have arisen out of the crisis.

Seeking out opportunity. A final reminder regarding the aftermath of financial crisis is that adversity always creates opportunity. Nearly all astute investors expect that the post-crash environment will at some
rates to drift upward in good times, and their tendency to be slow in adjusting those rates in bad times; and 3) the decision of many foundations to engage in countercyclical spending in bad times (discussed below).

No one can say for certain, but using the strong statistical relationship between total giving in any year and the lagged three-year average value of total foundation assets, a reasonable estimate of the effect of the financial crisis on foundation giving is that it will decline by about 6.5 percent, or nearly $3 billion, between 2007 and 2009.15 Thus, at least in the short term, the effect of the market crash on giving will not be as great as it has been on foundation assets. If a quick recovery does not occur, however, the full impact of the crash will gradually come into play over the next several years.

Foundations can be expected to respond differently to the financial crisis, however, depending on their business model, program strategy, and size.

**Perpetual charitable foundations.** The federally mandated 5 percent spending rate for foundations is just barely consistent with the goal of perpetuity, given historical market returns. Most perpetual charitable foundations, finding themselves with considerably higher spending rates as a result of the recent decline in value of their endowments, are already taking steps to ratchet down spending. As noted above, however, because of the widespread application of a spending policy based on a lagged three-year average asset base, spending by these foundations is unlikely to fall immediately by as large a percentage as their assets did in 2008.

Some perpetual charitable foundations will choose to set aside their normal spending rate constraint in a time of economic crisis and undertake some countercyclical spending where they can clearly identify opportunities to sustain their constituency institutions and programs. Survey results recently published by The Foundation Center, for example, revealed that numerous community foundations, as well as such organizations as the Kresge Foundation, are doing just this.16
Nevertheless, the lesson of the 1970s stagflation era is still fresh in the minds of foundation managers. From 1968 to 1982, many foundations saw their inflation-adjusted assets erode by 67 percent or more—mainly due to the combination of very low or negative investment returns and high inflation, but also to maintenance of unsustainably high spending rates based on the assumption that the economic and financial market malaise would be short-lived. Most perpetual foundations, therefore, are likely to be cautious about spending significantly beyond their normal policy rate in the coming years, at least until there are clear signs that the financial system has been mended and economic recovery programs successfully launched.

**Spend-down/pass-through foundations, and very small foundations.** As shown in Figure 6, spend-down/pass-through foundations are rare in the universe of mid-size-to-large foundations; foundations with this business model, like the many very small, essentially pass-through foundations, account for only a small portion of total foundation sector assets. Spend-down foundations, however, have more flexibility for adjusting spending plans than do perpetual foundations, and it is likely that in a period of economic stress, they will see fit to increase their spending. As revealed by recent Foundation Center surveys, some corporate foundations—particularly those connected to the housing and credit industries—are indeed stepping up in a significant way to provide relief in beleaguered communities. However, if the economic recession deepens and corporate profits decline further, these sources of foundation giving could quickly dry up.

Students of the foundation sector sometimes express concerns about the merits of very small foundations, owing to the challenges these institutions face in establishing and pursuing consistent missions and effective programs, as well as to governance issues. While their resources are insufficient to have much impact in fixing fundamental economic and social ills, small foundations have an opportunity during this period of economic stress to prove their worth, by helping institutions in their communities weather difficult times.

**Perpetual social-improvement foundations.** Perpetual social-improvement foundations are frequently described as the venture capital investors of the nonprofit and public policy sectors. They are by nature long-term investors, working on social and economic problems that at times seem all but intractable. To be effective, these institutions need to make large upfront investments in research to identify the underlying causes and implications of the problems they address; they must develop coherent program strategies to be implemented over an extended period; they need to invest in professionals who through career-long work advance understanding of issues and develop the expertise for developing and testing solutions; and they must work closely with their grantees to communicate the results of their work to influential audiences able to bring about the needed social changes. Foundations of this type do not just write checks: to be effective, they must develop strong intramural capacities giving them credibility in their fields and enabling them to develop and implement sophisticated grantmaking strategies, including working closely with grantees to design projects likely to produce results useful to change agents and partnering with grantees to communicate the results of research to policy audiences.

Given the long-term nature of the problems they address, perpetual social-improvement foundations must be particularly prudent in the management of their asset bases. As shown in Figure 6, foundations of
this type are comparatively few in number, and in any specific field, they are typically a rare breed, unlikely to be readily replaced should they disappear. With some exceptions, foundations of this type can therefore be expected to reduce their spending fairly quickly to accord with the new realities of their financial situations.  

Perpetual social-improvement foundations that are particularly threatened by the financial crisis are those that earlier had assets just barely sufficient to maintain ambitious grants programs in multiple areas—foundations with pre-crash assets of around $100 million. Such foundations now find themselves in substantially reduced circumstances that necessitate rethinking the feasibility of conducting work in multiple program areas and even the objective of perpetuity. Boards and management of such foundations will understandably find decisions on which programs to retain difficult, and they will be challenged in accommodating spending levels to altered financial circumstances. But addressing these issues head-on is preferable to setting the foundation on a slow death course, with attending diminishing program vitality. Among the options that should be entertained by foundations in this predicament is consolidation with another foundation, which would ensure the critical mass of financial and human resources needed to sustain the vitality of programs going forward. As an example, the James Picker Foundation, in 1986, transferred its assets of approximately $15 million to The Commonwealth Fund, thereby giving rise to a national program that has contributed significantly to the emergence of the patient-centered care movement.

While the reaction of The Commonwealth Fund to its endowment return of −27 percent in 2008 will not be typical of all perpetual social-improvement foundations, it is nonetheless instructive on how these institutions will go about addressing a difficult situation.

- Recognizing the need to address the pain early rather than to hope for the best, the Fund will likely reduce its spending by approximately 15 percent in 2009–10, and, barring a significant market turnaround, another 10 percent in 2010–11 and 8 percent in 2011–12. Even with these steps, the foundation’s annual spending rate will rise above 7 percent in the short term.

- The Fund will make decisions on where to pare back spending based on strategic priorities, rather than simply applying across-the-board cuts. This said, no aspect of the foundation’s activities will be exempt from consideration for contributing to the necessary belt-tightening.

- As a value-added foundation working on one of the most complex issues of the day—helping the U.S. move toward a truly high performance health system—the Fund regards its intramural professional staff as its most important asset, embodying intellectual capital that has taken years to develop and that is poised to make a unique contribution in the current favorable climate for U.S. health care reform. While the foundation will continue to devote most of its funds to extramural grants, it will aim to retain its skilled and experienced staff, even if the intramural share of total spending rises somewhat during a period of reduced total spending. To the extent that this share rises above the normal maximum level set by the Fund’s board of directors, however, it will do so only temporarily and by a small margin.

- Every crisis presents opportunity, and the Fund has undertaken a “strengths, weaknesses, opportunities, and threats” analysis of each of its programs. The result will be some reorganization of programs to concentrate the foundation’s work even more on the strategies that its Commission
on a High Performance Health System has identified for accomplishing health care reform:
1) achieving affordable health insurance coverage for all; 2) reforming the payment system to promote quality and efficiency in health care;
3) reforming the care delivery system to bring about patient-centered, coordinated care; 4) using benchmarking to promote high performance among health care organizations; and 5) achieving accountable leadership for the health system.

Within this framework, the foundation expects to be able to maintain its signature activities, including uniquely rich Web sites (commonwealthfund.org and WhyNotTheBest.org) for those engaged in advancing a high performance health system; its International Program in Health Policy and Practice; major recently launched initiatives to promote safety-net medical homes and reduce unnecessary rehospitalizations; its work with states to improve health system performance; and its Fellowship in Minority Health Policy program. Through each program strategy, the foundation will continue particularly to address health care disparities and the needs of vulnerable populations.

Rising numbers of uninsured and underinsured people, escalating health care costs, and growing recognition of quality and efficiency shortcomings in the U.S. health care system have created a climate, not seen since 1993–94, that is highly favorable for health care reform. If history is any guide, however, the road to reform will not be an easy one and could prove to be longer than anyone would like. Moreover, the experiences of countries that have long provided health insurance to all of their population offer ample evidence that, given the unique attributes of health care systems and marketplaces, the search for high performance is a continuing one. All countries, regardless of their chosen systems of delivery, finance, and regulation, struggle with questions of resource allocation, technology adoption, health care manpower, disparities, efficiency, and accountability that make the presence of independent bodies, like perpetual foundations, vital to developing and debating improved policies, as well as to stimulating and evaluating practice innovations. The mixed public–private health care system of the U.S., with its unusually strong role for for-profit enterprises both in delivering and paying for services and in influencing public policy, makes the role of independent private foundations in reform efforts an especially important one.

Thus, The Commonwealth Fund will simultaneously pare back spending as necessary to ensure that it remains a force for the long haul in the quest for health care reform, while concentrating its resources to help the nation seize the opportunity that lies before us.
Notes


5. The Multi-Asset Fund of The Investment Fund for Foundations (TIFF) enables small foundations to participate in a diversified portfolio with most of the asset classes shown in Figure 7. It has approximately $2.1 billion under management.

6. In addition to the varying quality of the underlying historical data on foundation assets, the methodological shortcomings of the regression analysis used to make this estimate include its inability to incorporate the effects of the appearance of new foundations and disappearance of spend-down foundations. The adjusted R-square of the relationship between the change in total foundation assets and the weighted market benchmark return in any year is .64.


8. J. Fleishman, The Foundation: A Great American Secret (New York: Public Affairs, Perseus Book Group, 2007), pp. 46–50. Fleishman uses the term “instrumental giving” instead of “social improvement,” and the term “expressive giving” instead of “charitable giving.” Other students of foundations and philanthropy use still different terms to distinguish between the two principal types of giving, but the basic difference in objective in each case is generally recognized.

9. Many large social-improvement foundations also engage in conventional charitable giving, and many large conventional foundations have some social-improvement activities, but most large foundations tend to be heavily oriented toward one or the other type of giving.


14. According to some estimates, institutional investing in hedge funds may fall by as much as 80 percent, resulting in the closing of numerous such funds (along with their proprietary trading desks) and across-the-board reduction in leverage in this sector. The surviving circle of hedge fund managers will typically have used the least amount of leverage, will have been the most skilled practitioners of their trade, and, going forward, will face less competition.

15. This estimate is based on a linear regression model (adjusted R-square of .99) of the historical relationship between foundation giving and three-year lagged average asset levels, and the regression model described above for predicting changes in total foundation assets.


17. Ibid.
As indicated in The Foundation Center survey noted above, perpetual social-improvement foundations able to temporarily set aside spending restraints or reorient giving plans toward economic recovery activities are primarily very large foundations like the John D. and Catherine T. MacArthur Foundation and the Ford Foundation.
