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Chapter 16 - Hiring an Investment Management Consultant

Once nonprofit organizations cross a certain financial threshold they are well-advised to obtain assistance in the management of their assets. The problem is that there are far more pretenders than players. Most vendors offering “help” have a product to sell that may or may not provide a solution.

Nonprofit organizations tend to be passionate about their programs and missions. This is good. Their desire to manage their money prudently sometimes takes a back seat. This is not good. However, a nonprofit organization’s ability to fulfill its mission is almost always constrained by financial resources. Higher investment returns translate directly into accomplishing more.

Identifying the Need: A Tale of the Typical Nonprofit Organization

Investment for nonprofit organizations, at least in the beginning, is practically an afterthought. The portfolio is small and the organization’s dependency upon it is minimal. But over time, assets grow and the portfolio takes on greater importance.

An investment committee is eventually formed, and its members include key individuals on staff as well as successful businesspeople gracious enough to volunteer their time. The committee considers suggestions and adopts policies on everything from asset allocation to the hiring of managers to socially responsible investing.

A local bank is hired to “handle” the investments. The portfolio continues to grow. A shrewd committee member contends that diversification is good and a second local bank is hired. Over the years, the committee continues to diversify. Money is placed with a mutual fund that uses social screens, a money manager that a staff member met at a conference, and a well-intentioned broker, the brother-in-law of a committee member.

Is the nonprofit fund prudently diversified? Hardly! Although each decision was made with the best of intentions, committee members did not truly possess the information and expertise to make good decisions.

Unless you are knowledgeable in all of the following areas, it may make sense to hire a consultant:

- *Investments.* Working at a financial institution in an unrelated role does not qualify. Do committee members possess direct knowledge and experience in the capital markets? Do they oversee similar investment pools for other nonprofit organizations?
- *Fiduciary Stewardship.* Do committee members understand their legal (and moral) duties and can they effectively document their compliance?
- *Impartiality.* Do committee members apply a completely independent and objective perspective in the decision-making process?
- *Fees and Expenses.* Do committee members understand pricing structures? Are they capable of negotiating favorable terms with investment managers and other vendors?
- *Time.* Can they commit the required time?

The General Contractor – A.K.A. The Investment Consultant

You can imagine how difficult it would be to construct a home by haphazardly hiring tradesmen without a clear understanding of the role each plays. Although each carpenter, plumber and electrician may be a skilled worker and possess good references, they may not be right for the specific assignment. Is there a rationale as to

when and how each subcontractor should be hired? Are they are capable of following the blueprint? Who coordinates all of this? Every well-run construction project has a general contractor. In the investment world, an investment consultant is the general.

A good investment consultant will help to:

- Crystallize the organization's goals and objectives.
- Develop a "blueprint" (investment policy, spending policy and asset allocation).
- Hire subcontractors (appropriate investment managers).
- Closely monitor performance to ensure that the project is a success.
- Negotiate fees.
- Coordinate time lines among the various parties.

Simply put, a good investment consultant should help the nonprofit organization to achieve its goals with less time, cost, and burden. Most importantly, a good consultant will accomplish this in a completely impartial fashion. There is neither a product to sell nor an ax to grind. Each and every recommendation should be the result of independent analysis. Developing the very best solution should be a good consultant's only goal.

There are several resources which list consulting firms. The Investment Management Consultants Association (IMCA) can provide references and The Nelsons' Consultants' Directory is quite comprehensive.

Exhibit 16.1 is a questionnaire which can help one decide if it makes sense to seek outside expertise.

Exhibit 16.1 - Do We Need a Consultant?

Do I have the expertise to handle this project?	yes	no
Do I understand all the fiduciary requirements?	yes	no
Am I clear on all the players and their exact duties (e.g., custodian, trustees, asset manager, etc.)?	yes	no
Can I establish successful spending and investment policies?	yes	no
Do I understand portfolio theory and asset allocation?	yes	no
Do I have the expertise to analyze investment managers or funds?	yes	no
Do I adequately understand risk as well as return?	yes	no
Do I understand the operational/administrative procedures?	yes	no
Do I have enough time to devote to this project?	yes	no
Do I have staff to work on this?	yes	no
Do I have the budget for this (data sources, software, etc.)?	yes	no
Do I even want to do this on my own?	yes	no

Key: Two or more “no” answers – find a consultant!

Source: DiMeo Schneider & Associates, L.L.C

Although properly overseeing the management of a nonprofit fund may not be rocket science, it is time consuming. And the stakes – the long-term existence of the fund – are high!

An experienced consultant has probably already dealt with every challenge the organization faces. And there’s no substitute for objective advice. Even if committee members happen to be expert and have the time to devote to this task, they still may not have all the resources needed. Good consulting firms have all the necessary hardware, software, and, and most importantly, people.

Identifying a Qualified Investment Consultant

Assuming that you have made the decision to seek outside help, it rapidly becomes apparent that every salesperson with a financial product to push now is identified as “consultant” or “adviser”. How can a fund fiduciary identify the real thing?

It's relatively easy. A true consulting firm derives virtually all of its revenue from consulting; it is not a part-time occupation. A good consultant does not recommend proprietary money management or financial products. The firm should be able to provide numerous references from current clients similar in structure. The IMCA Code of Professional Responsibility (Exhibit 16.2) provides a good sense of the proper mind-set.

Exhibit 16.2 - Investment Management Consultants Association Code of Professional Responsibility

Each professional investment management consultant shall:

- Serve the financial interests of clients. Each professional shall always place the financial interests of the client first. All recommendations to clients and decisions on behalf of clients shall be solely in the interest of providing the highest value and benefit to the client.
- Disclose fully to clients services provided and compensation received. All financial relationships, direct or indirect, between consultants and investment managers, plan officials, beneficiaries, sponsors or any other potential conflicts of interest shall be fully disclosed on a timely basis.
- Provide to clients all information related to the investment decision making process as well as other information they may need to make informed decisions based on realistic expectations. All client inquiries shall be answered promptly, completely, and truthfully.
- Maintain the confidentiality of all information entrusted by the client, to the fullest extent permitted by law.
- Comply fully with all statutory and regulatory requirements affecting the delivery of consulting services to clients.
- Endeavor to establish and maintain excellence personally and among colleagues in all aspects of investment management consulting and all aspects of financial services to clients.
- Support and participate in the activities of the Investment Management Consultants Association to enhance the investment management consulting profession.
- Maintain the highest standard of personal conduct.

Source: Investment Management Consultants Association.

Exhibit 16.3 is a sample Request for Proposal (RFP) that you can adapt. As with all RFPs, shorter is better. Ask only for information that will help the committee make a decision. Identify only needed services.

Exhibit 16.3 - Request for Proposal

- I. Background Information
 1. Name and address of firm.
 2. Name, address, telephone numbers and email of key contact.
 3. Business focus/client base.
 - (a) Provide a brief history of your firm and parent organization and a current organization chart.
 - (b) Discuss the ownership structure of your firm. Are there unique attributes in the ownership structure that act to encourage the retention of key personnel?
 - (c) What is the median and mean size of the portfolio of your foundation/endowment clients?
 - (e) List any senior level hires and departures over the last 2 years. Indicate reasons for departure.
 - (f) What is the number of clients the consultant has that would be handling our account? What is the maximum number of clients you allow each consultant to service?
 - (d) List the personnel you would expect to assign to the foundation. Please provide brief biographical information on each individual including position in the company, education, years and type of experience in investment management.
 - (e) Is your firm affiliated with a brokerage firm or other financial service enterprises? Do you manage money for any clients?
 - (f) What percentage of your income comes from consulting activities?
 - (g) Identify other sources of income.
 - (h) How many clients have you added in the past two years?
 - (i) How many clients have you lost in the past two years?
 - (j) Indicate any future plans, which your firm has regarding investment consulting, investment management or other business activities?
- II. Investment Management Process
 1. Asset allocation methodology
 - (a) How are projections of your capital markets derived?
 - (b) Is your asset allocation software developed in-house or externally? Please provide a sample.
 2. Investment Policy Statements
 - (a) Describe in detail the process you undertake to analyze and make recommendations regarding our investment policy statement. Please provide a sample statement.
 3. Money manager structure and search (see attached list of Current investment managers)
 - (a) Does your firm maintain a database of money management organizations? If so, is the database compiled internally or purchased from an outside source? Does the database include minority and female owned firms?
 - (b) How many managers do you currently track?
 - (c) How do you gather your money manager information and how often is the data updated?
 - (d) Are managers required to pay a fee for inclusion in your database?
 - (e) Please describe your due diligence/search process for manager selection.
 - (f) How often does your staff visit money managers, both in – house and onsite? What type of reports do you provide the client after meetings with the money manager? Do you have a proprietary quality rating system for managers in your database?
 - (g) What guidelines do you utilize in respect to a possible money manager termination?

4. Performance Measurement

- (a) Describe your process of monitoring money manager for a client.
- (b) List comparisons, including databases, used to analyze the performance of portfolios. What peer groups would you propose and what are the characteristics of those groupings (foundations, endowments, pension funds, etc.) Do you have information on endowment funds comparable to us?
- (c) How soon after the quarter-end are your reports available?
- (d) Please provide a sample report that includes performance measurement and other portfolio analysis.
- (e) What is your position on the effectiveness of performance fees?

III. Conflicts of Interest

Please disclose any potential conflicts of interest, or appearance of conflict, which might arise if selected to represent the Foundation.

IV. References

Please provide a list of at least three references, preferably including any INSERT YOUR TYPE OF PLAN clients. Please indicate contact name, address and phone number.

V. Fee Schedule

1. Please outline your proposed fee structure for the foundation, including fixed and variable fees, and any performance based fees. Please indicate all services you propose to provide and their associated fees. Assume participation at quarterly meetings of Investment and Finance Committee.
2. The stated fee schedule must include all charges associated with your service provisions.
3. If hired, will firm receive any other form of compensation, including soft dollars, from working with this account that has not yet been revealed? If so, what if form of compensation?
4. Do you provide modified or specialized fee schedules for foundations, and/or philanthropic organizations?

Useful Hints

Send the RFP only to viable candidates. For example, if the committee would not really consider the consulting department of a large broker-dealer, don't waste the committee's time or the broker's. One should narrow the list of candidates before sending out the questionnaire.

Keep the RFP short and insist on complete but concise responses. Describe minimum selection requirements – “deal-killers”. This will keep noncandidates out of the process.

Exhibit 16.4 may prove useful when you check references. These questions are designed to help solicit information which the reference might not volunteer.

Exhibit 16.4 - Consultant Reference Questionnaire

- How long have you worked with _____ [the consulting firm?]
- What do they do best?
- Where is there room for improvement?
- Describe how they reduce your workload.
- What could have been streamlined?
- Rate their capabilities in each of these areas from highest (5) to lowest (1):
 - General expertise
 - Goal setting / fund design
 - Spending policies
 - Asset allocation
 - Manager search
 - Performance evaluation
 - Pricing
 - Overall client service

Note: This is designed for a phone interview. Although the list of questions is short, it is designed to uncover areas of weakness. It's important to keep the questions in this order.

Once the committee has sent out the RFPs and evaluated the answers, it is time to narrow the field. The goal should be to perform face-to-face due diligence on no more than four finalist candidates. It is best to interview all candidates on the same day or at least during a two-day period. If too much time elapses between interviews, distinctions among the finalists will blur.

The Interview

Your committee already knows most of the quantitative information about the finalists before the face-to-face meeting. Presumably all are competent. What, then, is the purpose of the interview?

First, which of the candidates best fits the organization's objectives? Personal compatibility is important as well. The committee will work closely with the consultant on important projects with tight deadlines. You shouldn't be too quick to overlook personality quirks which may become hugely irritating with constant contact.

Try to understand the philosophy of the firm. If the nonprofit organization and the consultant share a common point of view, many of the details will fall into place. Philosophical differences can lead to friction.

The interview is the time to confirm, or deny, initial perceptions developed earlier in the process. For example, several years ago our firm, a midsize, Midwest-based consult, was in competition for an assignment for a \$60 million foundation. Close to a dozen consulting firms were in the RFP process, and the firm was selected as one of two finalists to be interviewed by the committee.

Although we enjoy a strong reputation for client service and "outside the box" pro-active thinking, the other finalist was a very large East Coast firm. They enjoy a fine reputation and an absolutely star-studded list of endowment and foundation clients.

As the process unfolded, we interviewed with the committee, our references were checked, and we were fortunate enough to be hired. After the fact, it came to light that, before the interviews, one of the committee members strongly felt that meeting with us would be a waste of time. Why wouldn't the committee simply make the "IBM decision" and hire the big firm with the sterling client list?

It turns out that, during the interview, the committee members truly appreciated the time we had spent preparing for the meeting and some of the potential solutions presented. It was also only in the meeting that the committee learned they'd work with Principals of the firm compared to relatively junior professionals from the big firm.

So what is the message? Not that the big firm was bad or even that they could not have done a nice job. The lesson is that fit is important and that certain things can only be learned in these important face-to-face meetings.

Proof

In the interview, the committee should ask for demonstrations or specific examples. For each area of service, don't let the candidates claim to be good – make them prove it. Each candidate should review the fund specifics prior to the meeting and make observations and suggestions. The investment committee will be able to easily judge the candidates' level of preparation and expertise.

Verification

What have the finalists done for other clients? How have the strategies they've recommended performed? Get the numbers.

Exhibit 16.5 provides some sample interview questions. Make certain to ask each finalist the same questions. Keep the list of questions relatively short. You won't get through a long list anyway. Finally, open-ended questions ("essay questions") will help the committee understand how the consultant candidates think.

Exhibit 16.5 - Consultant Interview Questions

1. Why do you want to do business with us?
2. Describe your ideal client.
3. What sets you apart?
4. What is your greatest shortcoming?
5. How would you foresee helping us?
6. When you don't win a competition, why do you lose?
7. How many clients have you lost in the past year?
8. Why did they leave?
9. If I were to hire two consulting firms, what would I hire you for?
10. What would I hire the other firm to do?
11. What steps have you taken to eliminate conflict of interest with regard to fund or manager selection?

Note: Most factual information should come from the response to the RFP. Of course, any questions that are raised by a response should be addressed.

Source: DiMeo Schneider & Associates, L.L.C.

The on-site visit

Often nonprofit investment committees want to skip this step. They are well advised not to. It is very telling to visit the finalists in their shop. Anyone can talk about their capabilities, but it is quite another thing to demonstrate the hardware and software. Reading a biography is a poor substitute for actually meeting the personnel who will provide the work.

The Agreement

Once the committee has made its decision, it's necessary to get the agreement in writing. What services will be provided? Is there a satisfaction guarantee? What are the remedies if the consultant fails to meet expectations? What is the term of the contract? How do they bill?

The client should have the right to end the contract with 30 days written notice and to be obligated only for services rendered up to that point. The nonprofit organization's attorney should review the contract. We are not in the business of rendering legal advice, and so have intentionally excluded a sample contract or worksheet. Suffice it to say, legal review is not the area in which to cut costs.

Fees

Fees are typically quoted in one of three ways:

1. *Project Basis*. There is a fee for each specific service; e.g., X dollars for an investment policy, Y dollars for a manager search, and so on.
2. *Fixed Retainer*. There is an annual fee to include all services. If the organization's needs are fairly broad, the retainer may be more cost-effective than project-based fees. Retainer fees quoted as a set dollar amount are generally more restrictive in terms of the services covered than the asset-based retainer.
3. *Asset-Based Retainer*. The annual fee is quoted as a percentage of assets. This is generally the broadest contract in terms of services ("all services, when needed"). The asset-based retainer has the advantage that your committee will make full use of the consultant without worrying about "starting the meter." This arrangement is most advantageous if the organization may have stable or even declining asset balances or if the committee is concerned about the market outlook.

Effective use of a consultant

How does the organization get its money's worth after it has hired a consulting firm? First, think of them as an extension of staff, and help them understand what is expected. Also, someone on the committee should help them understand the organization, including the personalities of the players.

Next, give them as much of the work as possible. They'll make it obvious if they don't consider a certain task to be a part of their assignment. If the committee is unsure of which way to go at key turning points, let the consultant research the alternatives. Instruct them to succinctly present the pros and cons. Let them create the detailed backup.

Ask them to explain their process. How do they come to their conclusions? For instance, in conducting an investment manager search, get the details. How are candidates to be screened? The committee may want to add or subtract certain criteria.

Use their experience. They probably know what works and what doesn't. Trust them. For example, if the committee wants 11 different fund choices, but the consultant says that 5 or 6 will be sufficient and a more manageable number, listen. Obviously, the client controls the decision, but it pays to be open minded.

If committee members don't understand something, they should make the consultant explain. Part of their job is to educate the committee so you can be better trustees.

Summary

A good investment consultant should add value many times its fee by:

- Improving investment performance.
- Helping committee members satisfy their fiduciary responsibilities.
- Reducing expenses.
- Providing continuity for a committee with regular changes in its membership.
- Increasing contributions to the non-profit by helping to communicate well founded investment and spending policies.

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