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CONNECT COLLABORATE Innovate

Associations: Rethinking Investment Reserve Strategies

CLA National Association Conference

Our Session Objective

Improving the fit of your reserves strategy within the broader organizational mission

Why Organizations Need Reserves

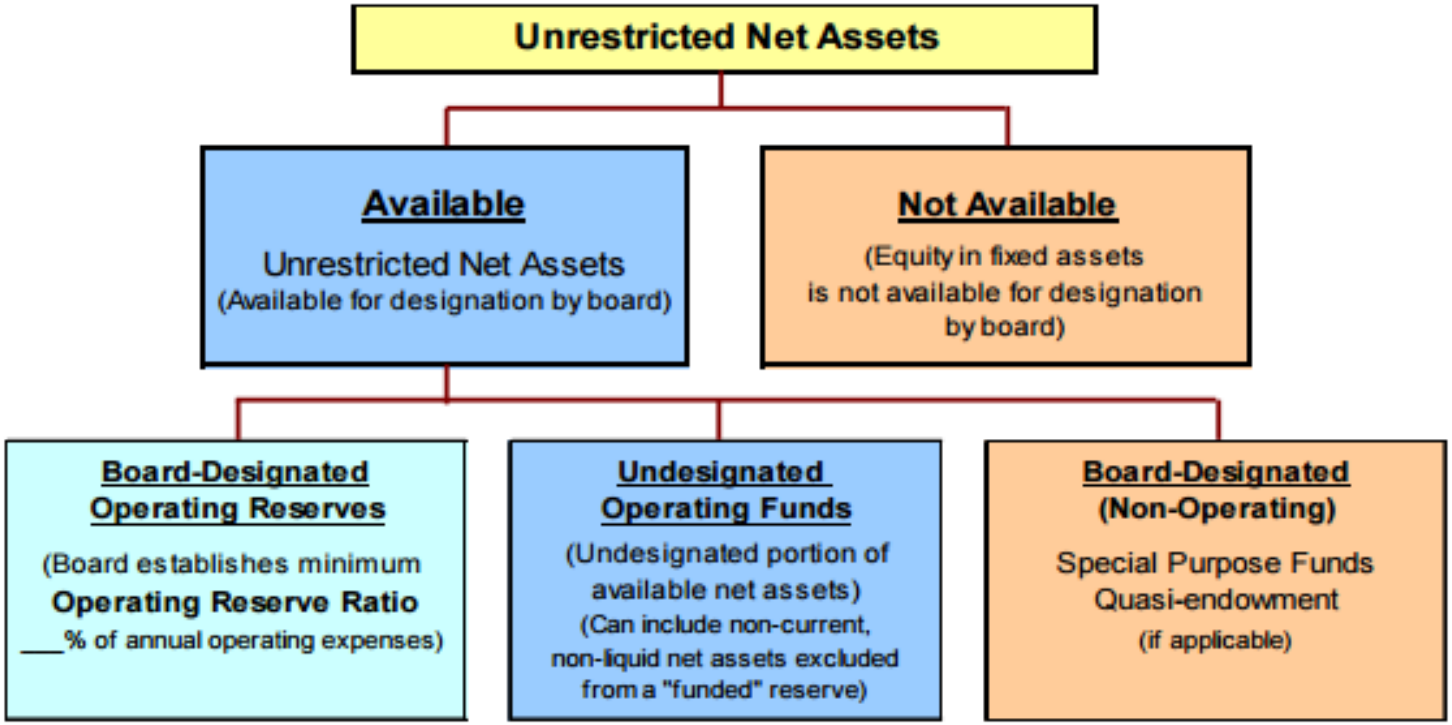
- Bridge cash flows
- Maintain financial solvency
- Weather economic cycles
- Fund unexpected opportunities

- Protect against unpredictable political behavior
- Maintain and purchase productive assets
- Drive capacity for new debt to fund major capital needs

The Nature of Association Reserves

- Reserves Represents Accumulated Surpluses Over Time. Investments represent a Portion of that Reserve.
- Performance is Generally Out of Management's Control
- In-house/Board Investment Expertise Typically Weak
- Ultimate Source of Internal Financing (i.e., Rainy Day)
- Perpetual Nature of Reserves
- Pressure for Sound Management & Governance

Unrestricted Net Assets ≠ Reserves



Reserves Are:

Liquid/available and unrestricted net assets:

- Liquid/available: can be converted into cash quickly with minimal impact to price received
- Unrestricted: not restricted for use by donors or organization

End game = Sustainability

Ability to carry out activities that will achieve your mission while also developing and maintaining capacity for mission relevance in the future.

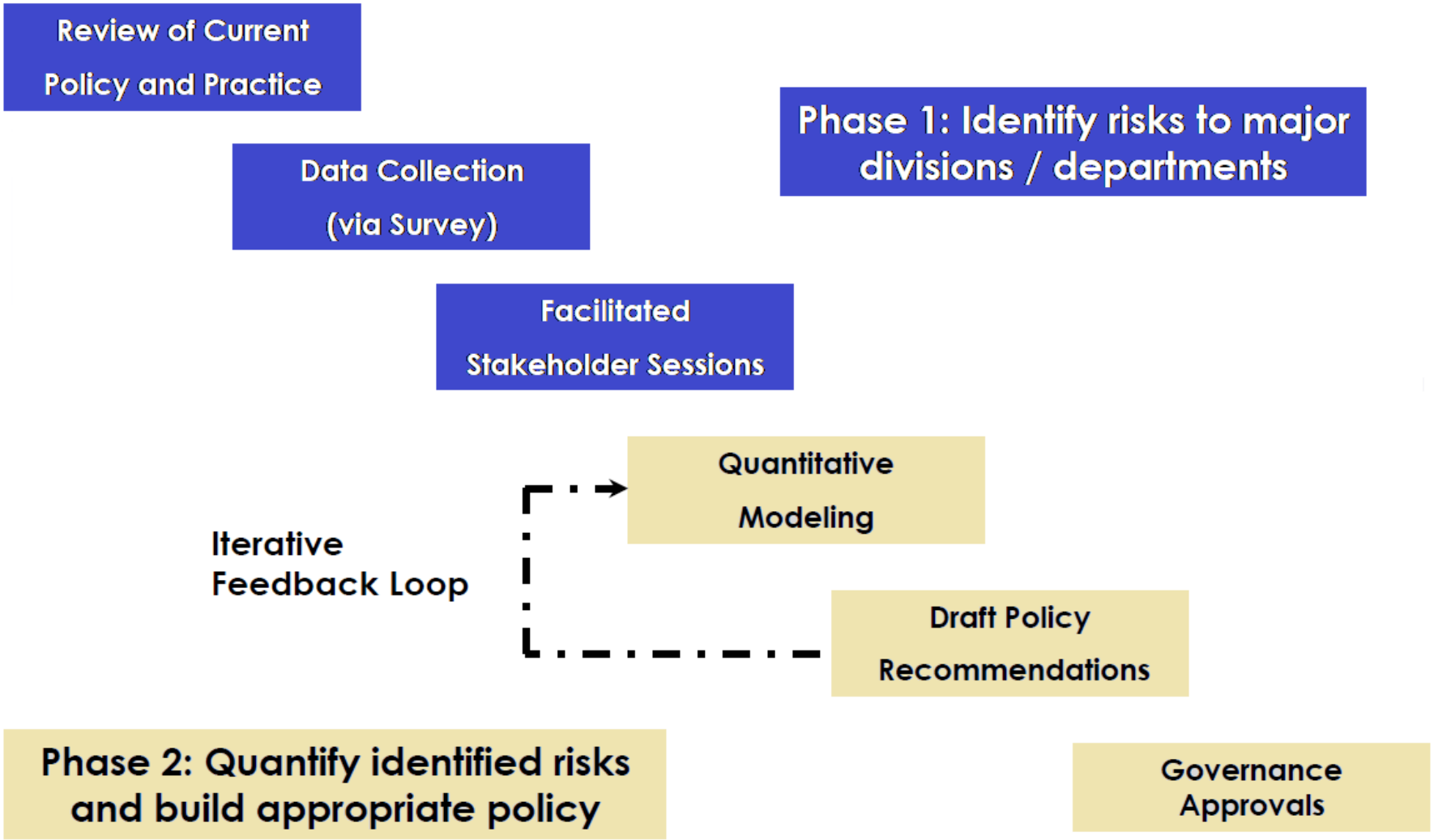
Developing Reserves: Considerations

- Historical expenditures, cash flow, and revenue
  - Monthly and yearly
  - Are there cyclical or seasonal trends?
- Budgeted expenditures, cash flow, and revenue
  - Evenly distributed or peaks and valleys
- Risk tolerance
- Planned expansion/contraction

Developing Reserves: Multiple Approaches

- Subjective scenario modeling
- Quantitative modeling
- Regression analysis
  - Expected value: simplistic, would likely undervalue reserve needs
  - Normal (Gaussian) distribution
    - ◊ 1 Standard Deviation = 68% of fully valued risks
    - ◊ 2 Standard Deviations = 95% of fully valued risks

Reserve Development Process



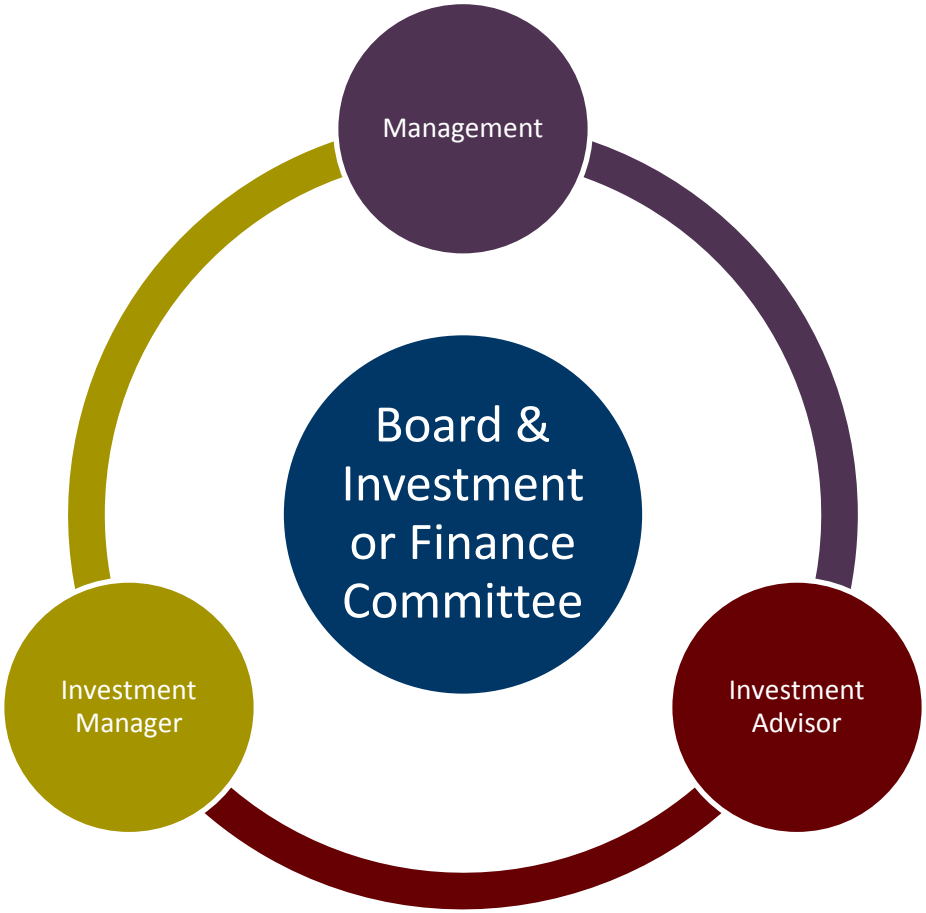
Risk Is…Well, Risky: What to Watch Out For

- Segregate current risks from hypothetical ones
  - Conversely, changes in strategic direction warrant reassessment
- Know which risks should be mitigated through insurance and/or litigation rather than reserves.
- Separate reasonable, ongoing risks to your business/program lines from singular catastrophic events that could jeopardize entity-wide solvency.
- Beware of duplicative risks.
- Address nuances of precedent relationships between risks when analyzing for aggregate financial impact.

Reserves Policy Development –
What to Include

1. Purpose of building and maintaining reserve.
2. Definitions of types of reserves, intended use, and calculation and timeline of target amounts.
3. Policy for contributing and building reserve funds.
4. Authorization procedures for using funds from each type of reserve fund.
5. Responsibilities for reporting reserve fund amounts and use of reserve funds.
6. An Investment Policy to support the Reserves Policy.

Critical Roles and Responsibilities



Essential Elements of Investment Policy Statement (IPS)

Purpose- What are the intended/restricted uses of the funds and how will they be invested/accessed to meet these needs?

Operational Needs/Spending Policy-What are the operational needs associated with these funds that will in part dictate their relative liquidity requirements.

- What policies, procedures and approvals will be required to transfer funds from reserves/endowments to operations?
- What are the operating requirements driving the spending need (e.g., budget contribution, seasonal cash flow, new program investment, etc.) and how will they inform the investment policy?

Essential Elements of Investment Policy Statement

Asset Allocation-What mix of assets (e.g., money market cash, equity, fixed income, real estate, private equity, etc.) will best achieve the risk and return objectives of the portfolio. Typically expressed in ranges (high, low, target) to avoid divestitures that may not make strategic/tactical sense. Required periodic rebalancing of the portfolio should also be specifically stated.

Risk Tolerance-The most critical element of any investment policy. What is the organization's (including member/donors) appetite for risk (i.e., volatility) based on the intended use of these funds and the return objective.

Essential Investment Reserve & Policy Statement

Reserves Funding Policy-What is the organization's target and plan for building reserves based on their intended use and what are the mechanics (formula) for crediting/transferring operating surpluses to reserves for this purpose?

Time Horizon-Over what period can these funds be invested and performance measured allowing for identified operational and spending policy needs?

Prohibited Investments-What investments for reasons of risk, social responsibility and/or organizational mission should be prohibited from the investment reserves/endowment portfolio (e.g., tobacco, alcohol, fire arms, etc.) and how will this be achieved and monitored? What is the potential impact on performance?

Best Practice Benchmarks

2015 Investment Reserves study of 446 nonprofits by Orion Investment Advisors for the ASAE Foundation:

- 56% Respondents $1M-$10M Budget
- 74% < 30 employees
- 76% of all respondents use outside manager/advisor
- Larger associations tend to delegate “discretion”

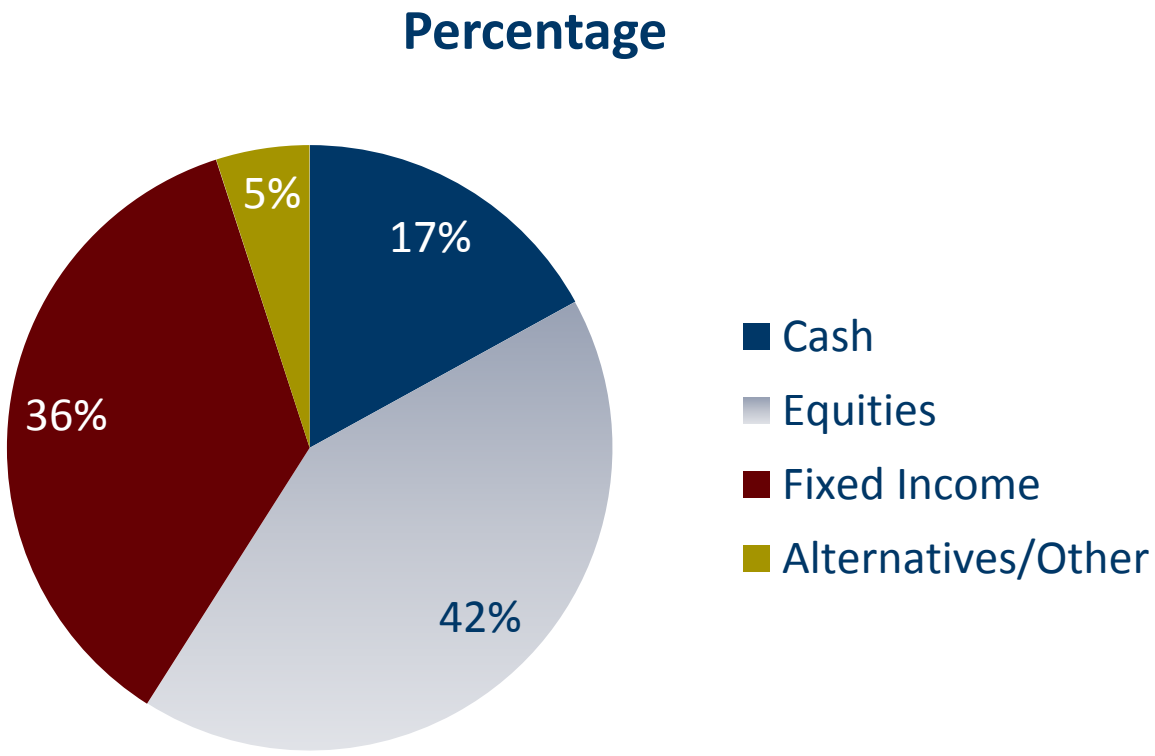
Best Practice Benchmarks (continued)

For Group $1M-$10M Budget:

- 71% draw some portion of reserve performance for operating/strategy needs
- 80% have a defined reserve target
- 33% employ passive index strategies along with some active management
- 10% employ socially responsible filters (e.g., alcohol, tobacco, fire arms, etc.)

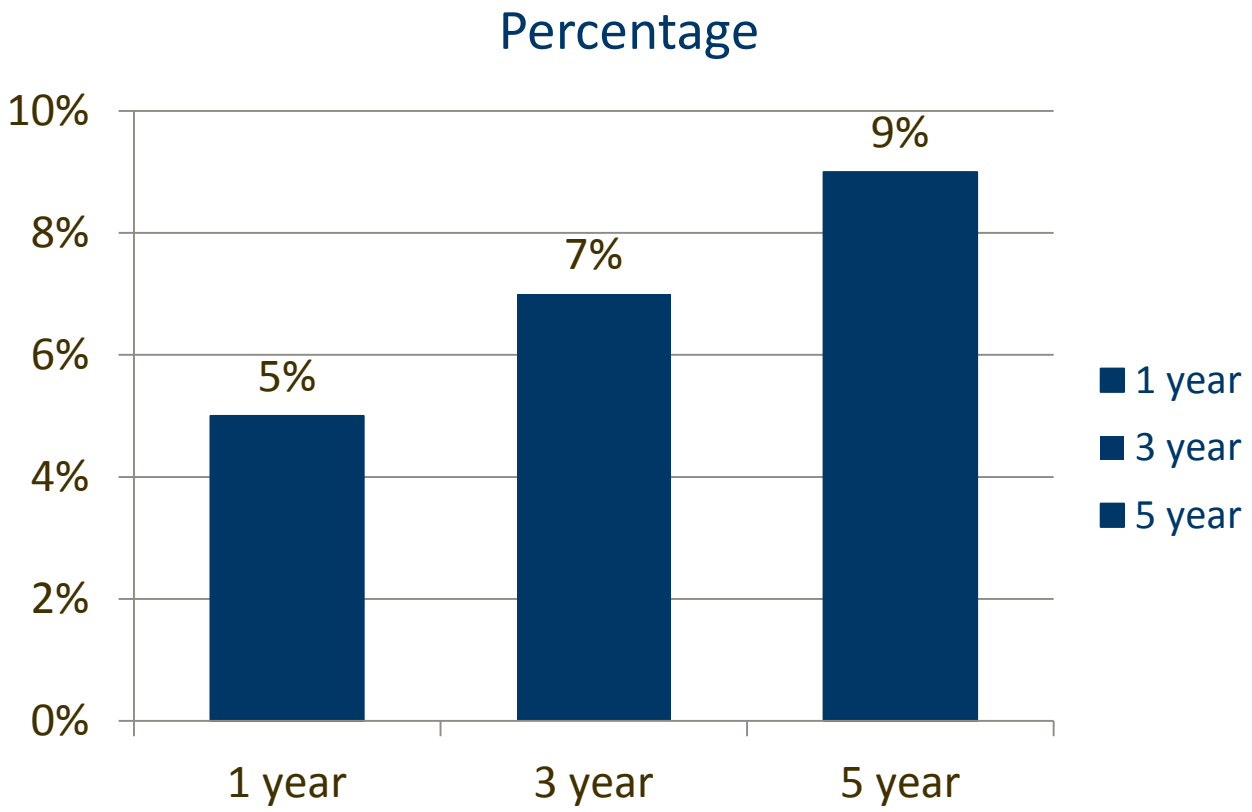
Best Practice Benchmarks (continued)

Of this group ($1M-$10M budget) average asset allocation employed:



Best Practice Benchmarks (continued)

Net of Fee Investment Performance $1M-$10M Budgets



Key Questions

- How Did Respondents Deploy Their Asset Allocation Strategies (Active/Passive)?
- Can Active Management *Beat* The Market?
- What Is The Nature/Behavior of Alternatives Employed?
- What Level of Risk Did Respondents Take To Achieve These Results?
- What Is The Impact of Fees on Performance?
- Can You Achieve Same or Better Performance While Taking Less Risk and Reducing Cost?

Evaluating Performance

- Key is to clearly outline roles, responsibilities and and expectations in the investment policy
- What are you buying when employing an Investment Advisor?
  - A consultant to ensure best practice expertise in the design and monitoring of your Nonprofit investment, reserve and endowment policies
  - An independent advisor to your management, board and relevant committees in evaluating performance and making responsible recommendations consistent with your return objectives and risk profile
  - An independent fund/manager platform best suited to deploy your strategy

Evaluating Performance

- Performance targets should be net of all costs and appropriate for each specific asset class (emerging market equities, domestic small cap, short-term municipal debt, etc.)

- Benchmarks should be chosen and compared for each element of the asset allocation and within the peer group of funds/managers (i.e., which managers did better or worse in beating the asset class benchmark?)

- An Overall *Composite Return* target should be established for the portfolio which takes the appropriate percentage of all the underlying asset class benchmarks to reflect the return you should be achieving based on your asset allocation

Investment RFP Process

- When To Bid Out
  - Not meeting performance targets over agreed upon investment cycle (no less than 3 years)
  - Client service issues
  - To assess the market (at least every 10 years)
- Three flavors:
  - Money Managers
  - Broker Dealers
  - Independent Advisors

Investment RFP Process

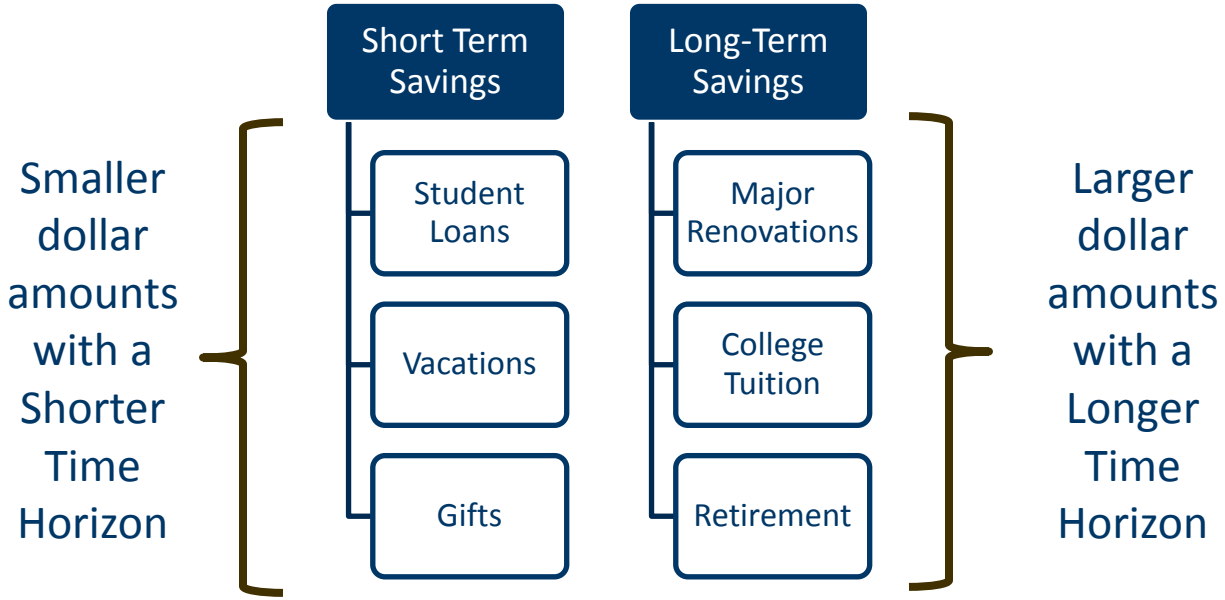
- Trade-offs:
  - Cost
  - Independence
  - Depth of Internal Resources

- Send Out 4-6 RFP's Covering the 3 Flavors
- Develop a Scoring Matrix
- Have 2-3 Finalist Present to Board Committee

Reserve Investment Policies

Best Practices

Personal Financial Planning



Can We Apply a Similar Planning Process to Our Organizations?

Financial Ratios– What Do They Tell Us?

PAST

TODAY

FUTURE

How have we done?

Liquidity and Capital Ratios

Operating Ratios

Where are we going?

Using Your Financial Ratios, We Can Project (Model) Your Financial Future

1. Establish a Financial Baseline
2. Establish Risk and Return Targets for Portfolio
3. Tie Investment Strategy to Your Balance Sheet
4. Tie Investment Strategy to Organizational Mission

Sample CLA Intuition™ Dashboard

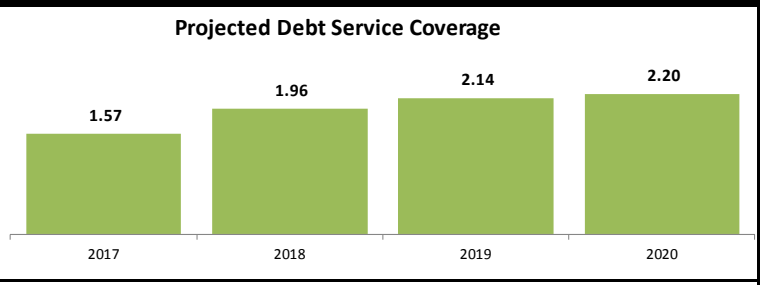
KEY ASSUMPTIONS					
# of AL Units	82				
# of MC Units	30				
MONTHLY SERVICE FEES	**2017**	**2018**	**2019**	**2020**	**2021**
Assisted Living	$4,777	$4,920	$5,068	$5,220	$5,376
Memory Care	$5,962	$6,141	$6,325	$6,515	$6,710
INFLATION RATES					
Assisted Living Revenue		103.00%	103.00%	103.00%	102.99%
Memory Care Revenue		103.00%	103.00%	103.00%	103.00%
Expense		103.00%	103.00%	103.00%	103.00%
REVENUE CONCESSIONS	**2017**	**2018**	**2019**	**2020**	**2021**
As a % of Revenue					
LEVEL OF CARE FEES	**2017**	**2018**	**2019**	**2020**	**2021**
Utilization					
Weighted Average Fee					

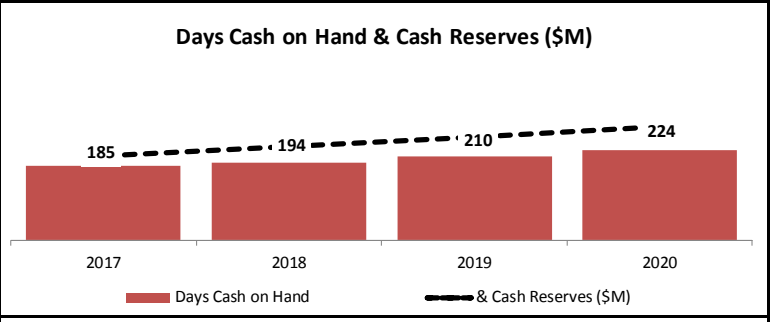
FINANCE ASSUMPTIONS				
Debt	$ 8,265	80%	Const. Loan Int Rate	2.79%
Equity	2,066	20%	Perm. Loan Int Rate	4.75%
Total	$ 10,332	100.00%		

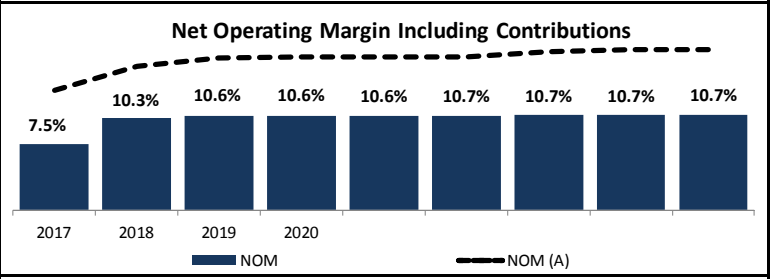
OCCUPANCY	2017	2018	2019	2020	2021
Assisted Living	15.14%	70.93%	90.85%	93.00%	93.00%
Memory Care	15.14%	74.03%	93.33%	93.33%	93.33%

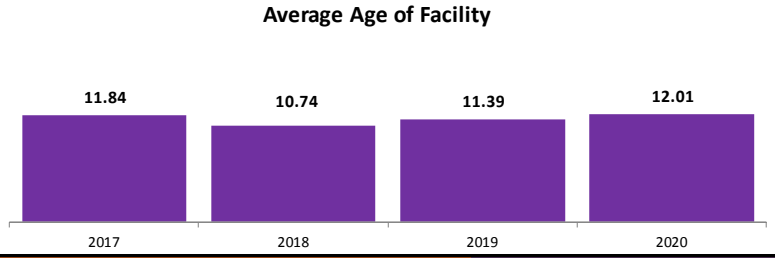
ROUTINE CAPITAL	2018	2019	2020	2021	2022
(per unit)	1,000	1,000	1,000	1,000	1,000

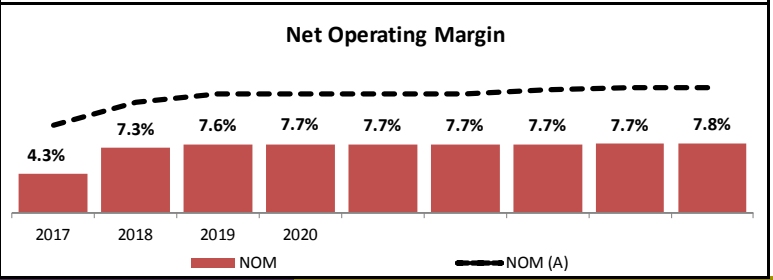
Debt Service Coverage Target	1.30		
Days Cash on Hand Target	100		
Class A Split	10%	Class A Pref	10.0%
Class B Split	90%	Class B Pref	8.0%











Solving for Gaps

- Do you know what your portfolio return target currently is?
- Do you know what it should be?
- Can you quantify your current risk exposures?
  - what would likely happen to the portfolio if interest rates rise by 1%?
  - What are the Beta (equity, credit, interest rates and Fx) of your overall portfolio?
  - What is the expected standard deviation of your portfolio?
  - What is your maximum drawdown exposure?
- Do you know what your risk exposures should be?

What is the potential impact to your organizational mission if your portfolio fails to deliver the return, or has too much volatility?

(covenant violations, footnotes in your financial statements, budget shortfalls, etc.)

These Should Match

Strategic Plan

- Geographic Presence
- Growth and Expansion
- Business Line Diversification
- Renovation/Replacement
- Affiliations/Partnerships
- Capital Deployment
- Infrastructure

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Investment Policy

- Liquidity Targets
- Level of Risk Tolerance
- Acceptable Level of Investment Return
- Portfolio Diversification

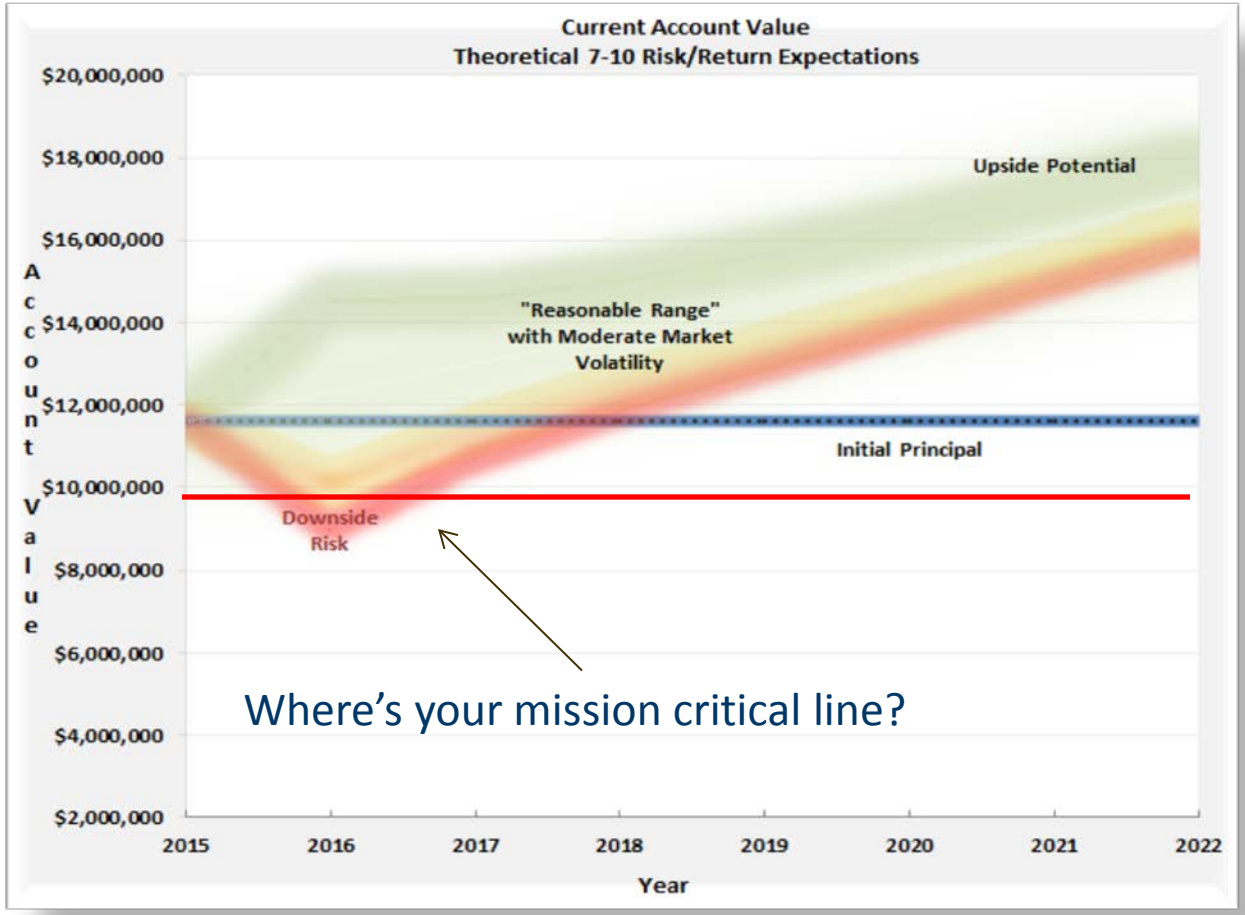
A Few Important Points

Where Do Investment Returns Come From?

- By definition, investment returns come from a risk exposure, whether that be due to equity markets, credit markets, currencies, insurance (aleatory), interest rates, inflation, time, illiquidity, etc.
- While not all risks are equal, we invest to gain exposure to that risk - so that we may earn a return.
- Said differently – we don't want more risk in a portfolio, we want more (disparate) risks.

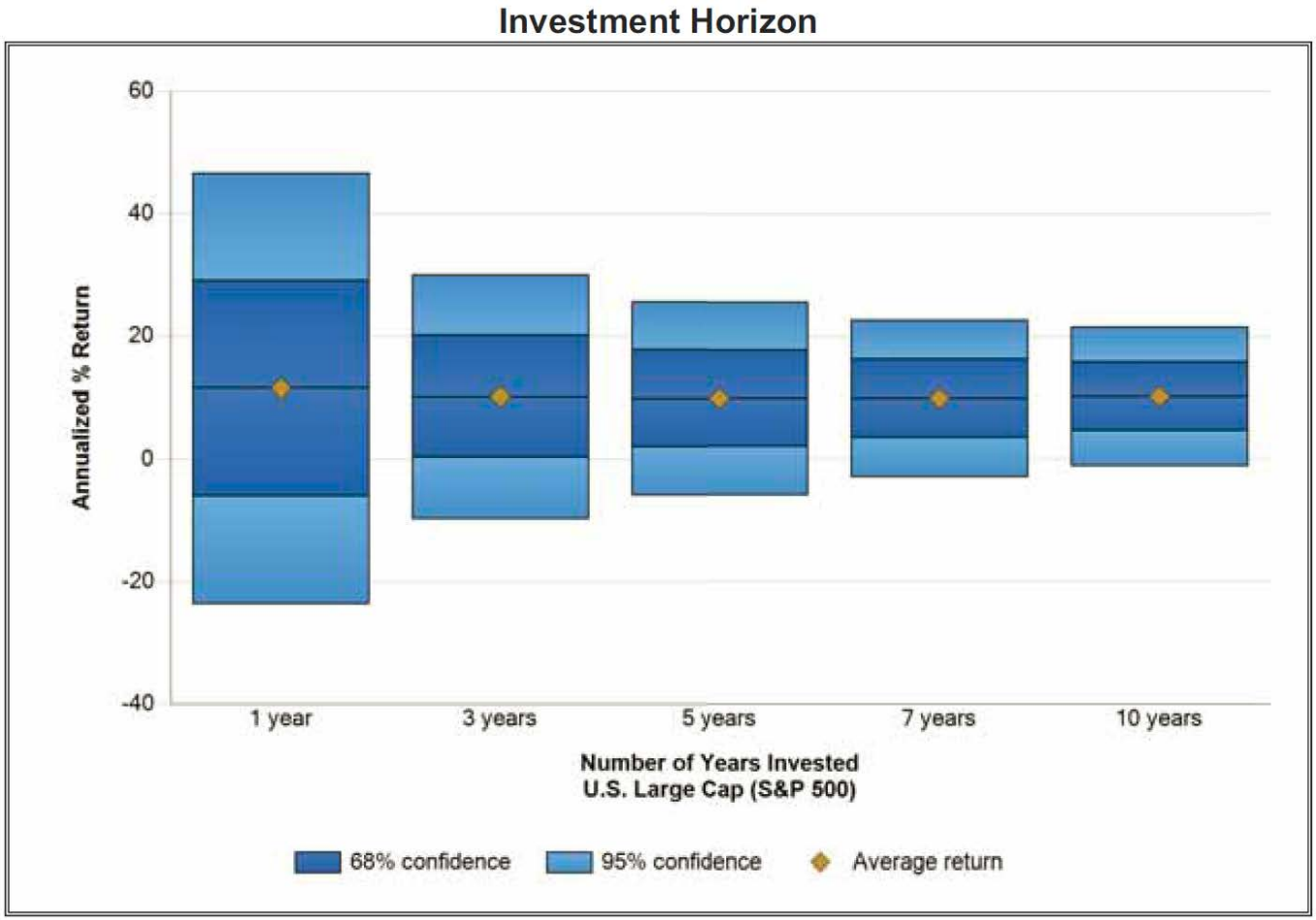
The Real Problem: Short Term Volatility

To an institution (presumably a patient and well-diversified investor), volatility must be managed in consideration of its short-term impact on the entity.

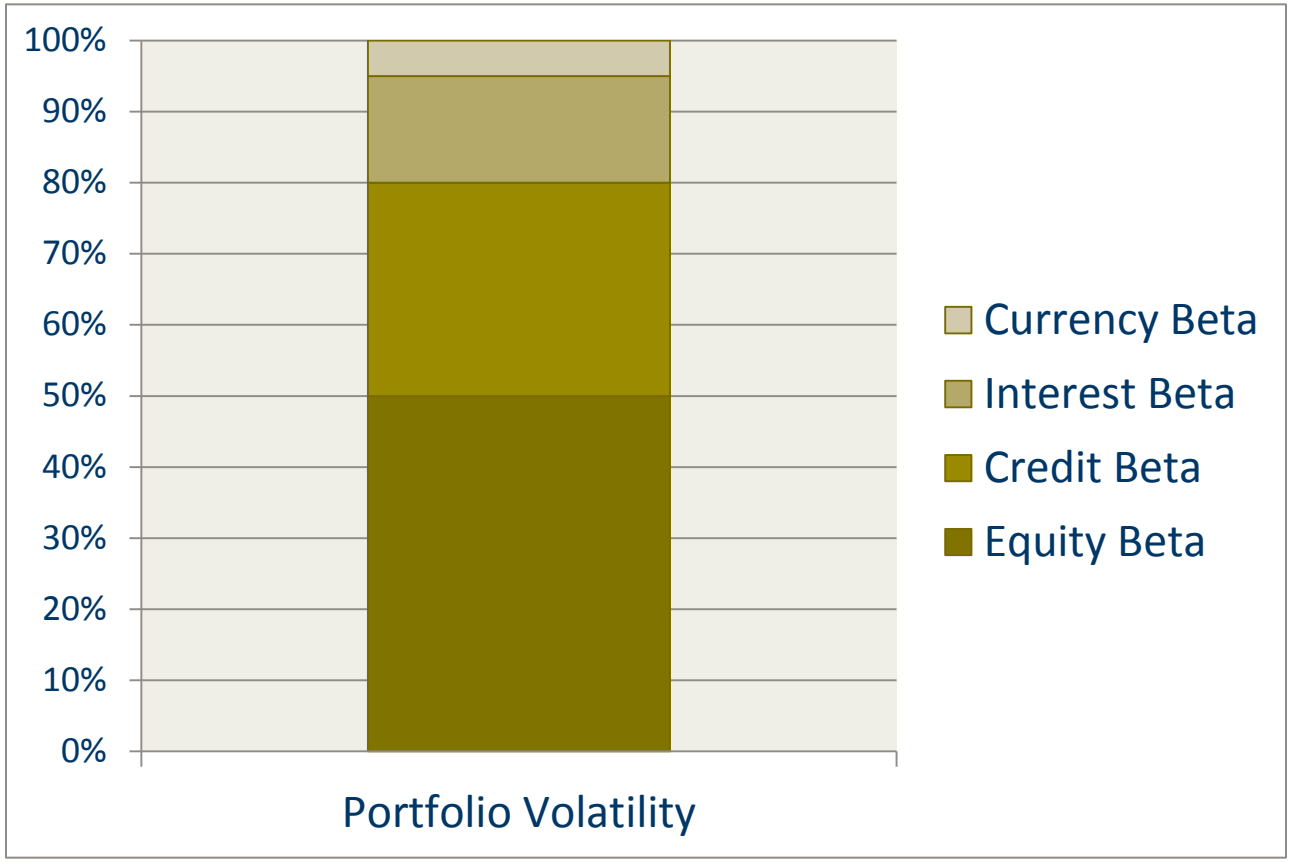


It's Counterintuitive:

Long Term Forecasts are More Reliable than Short Term Forecasts



Risk Budgeting: Best Practice Approach to Risk Management

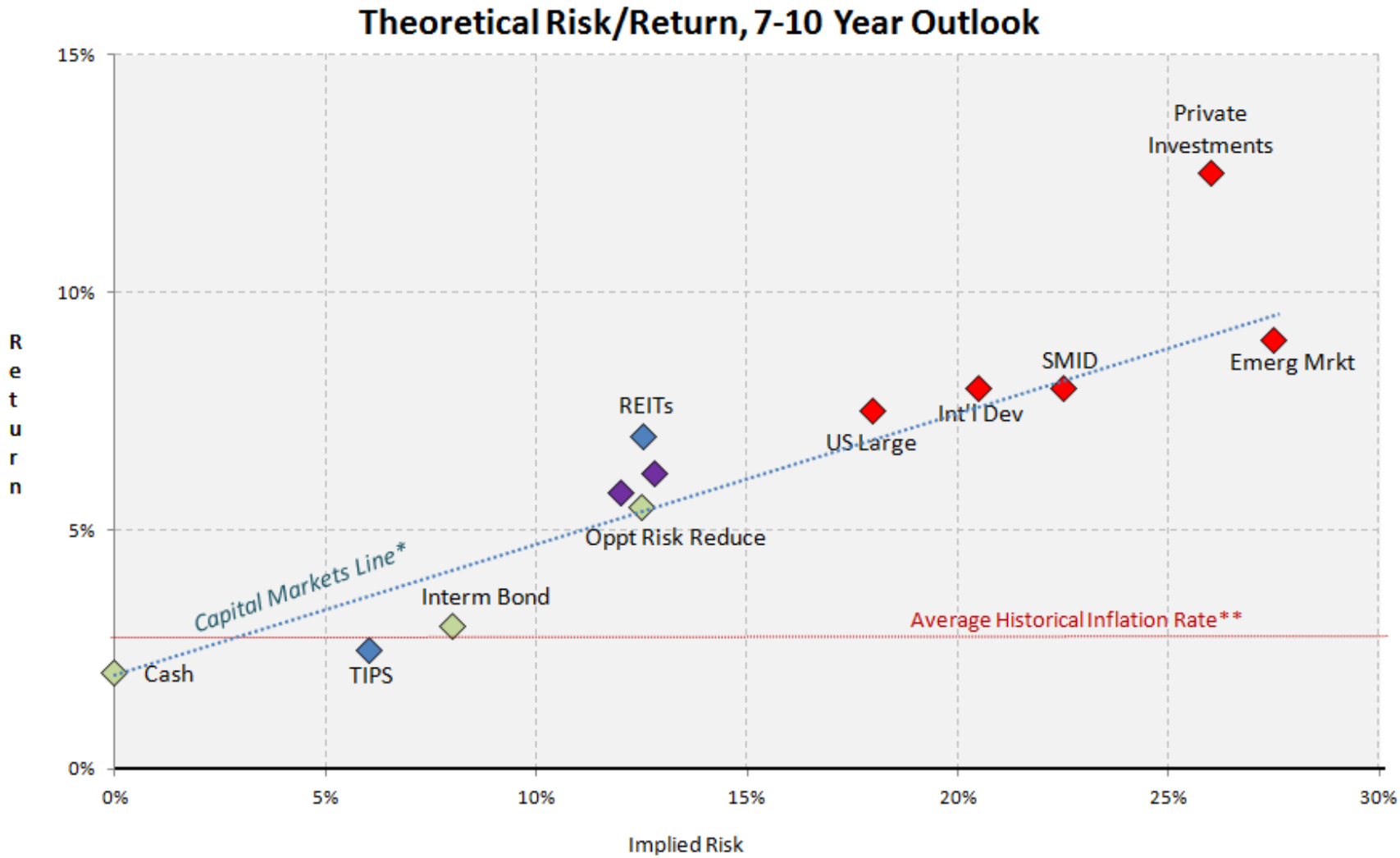


Risk Budgeting = Assignment of Beta exposures

Improving Diversification via Risk Budgeting

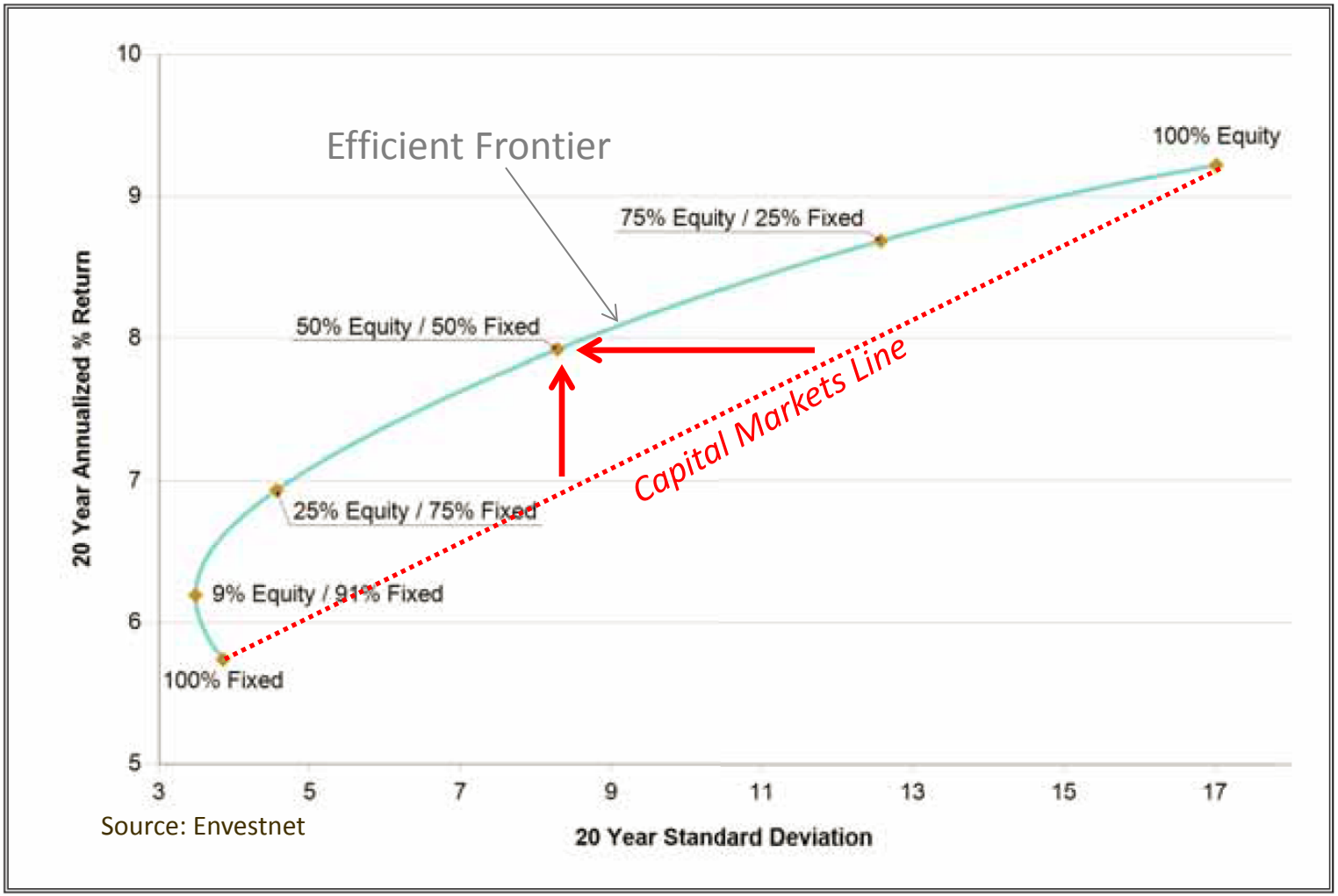
			Risk Contribution				
Purpose	**Allocation**	**Asset Class**	**Equity**	**Credit**	**Interest Rate**	**Currency**	**Composite Risk**
Growth	35%	US Stocks	12.3%	1.5%	2.3%	0.0%	16.1%
Growth	15%	Foreign Stocks	12.8%	1.3%	1.8%	2.9%	18.8%
Risk Reduction	30%	Inv Grade Corporates	0.0%	0.9%	2.9%	0.0%	3.8%
Inflation Protection	5%	TIPS	0.0%	0.0%	6.4%	0.0%	6.4%
Alternative Risks	15%	Beta Delta Beta	3.4%	1.3%	0.8%	0.1%	5.6%
Total Portfolio	100%		**6.7%**	**1.2%**	**2.4%**	**0.5%**	**10.8%**

Risk/Return Spectrum



**Source: Envestnet

Risk/Return Spectrum
Improved Diversification = Improved Return per Unit of Risk



Source: Envestnet

What Do Investors Want?

Earn a Return without Too Much Risk

Can you mitigate risk (protect on the downside or reduce volatility) through manager selection?

Manager Selection Presumes Alpha

$$\alpha = Rp - [Rf + \beta\{p\} * (Rm - Rf)]$$

Jensen's alpha = Portfolio Return − [Risk Free Rate + Portfolio Beta * (Market Return − Risk Free Rate)]

Alpha is the statistical measure of an investment's excess return in relation to it's risk-adjusted return.

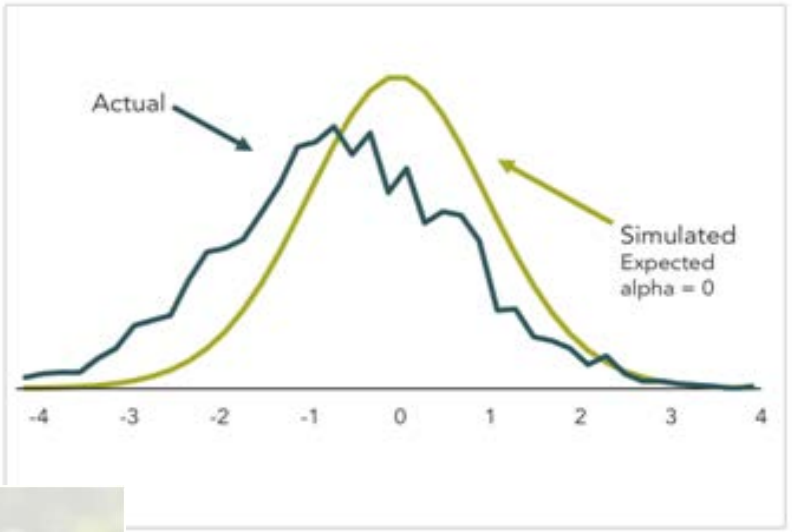
We believe the data is highly convincing:

Alpha (if it exists at all) is fleeting in traditional (public market) asset classes.

Active vs. Passive – Why is this still debated?

Skill versus Luck

Fama and French (2010), Journal of Finance



- Studied 3,156 US equity mutual funds from 1984 to 2006 (excluding index funds)
- "Few funds produce benchmark-adjusted expected returns sufficient to cover their costs."

There is no evidence that trying to outguess market prices adds value.

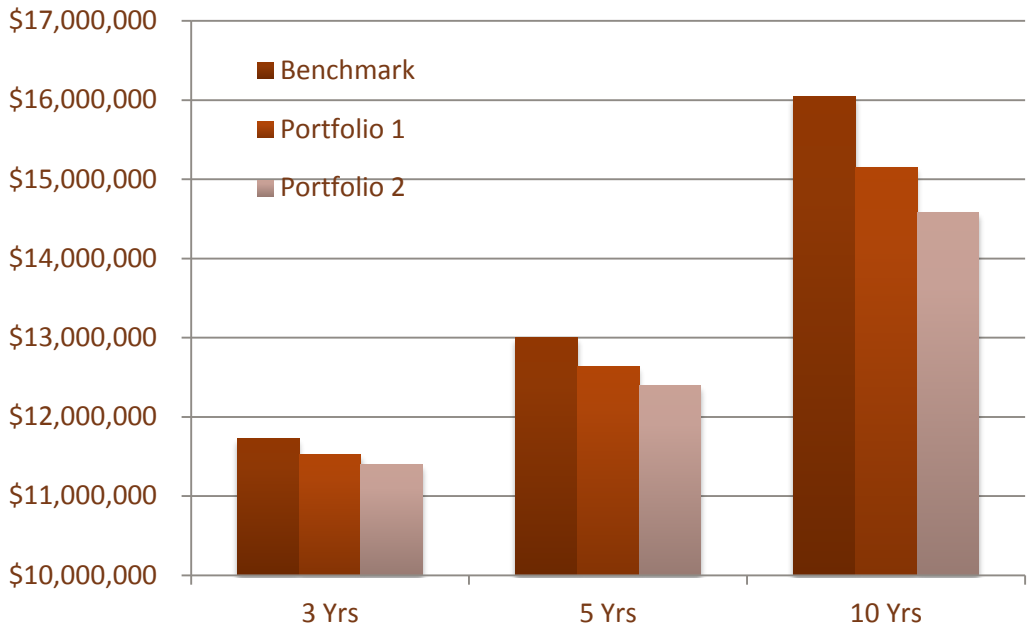
Conclusion: Active managers performed no better than what would be expected by pure luck, lagging behind their benchmark by the amount of their fees.

Positive Alpha?

We Call it Luck

However, there's plenty of "negative" Alpha. (aka expenses)

Expenses* are a Drag



	Total Expense	3 Yrs	5 Yrs	10 Yrs
Benchmark *	0%			
Portfolio 1	0.6%	($200,000)	($366,000)	($895,000)
Portfolio 2	1.0%	($330,000)	($605,000)	($1,467,000)

*** It is not possible to invest in an index without expense**

Expenses are Real and Necessary

You May Be Paying Too Much

Challenge

How to reduce expenses while keeping those other things equal?

(Assuming those other things are what they ought to be, of course.)

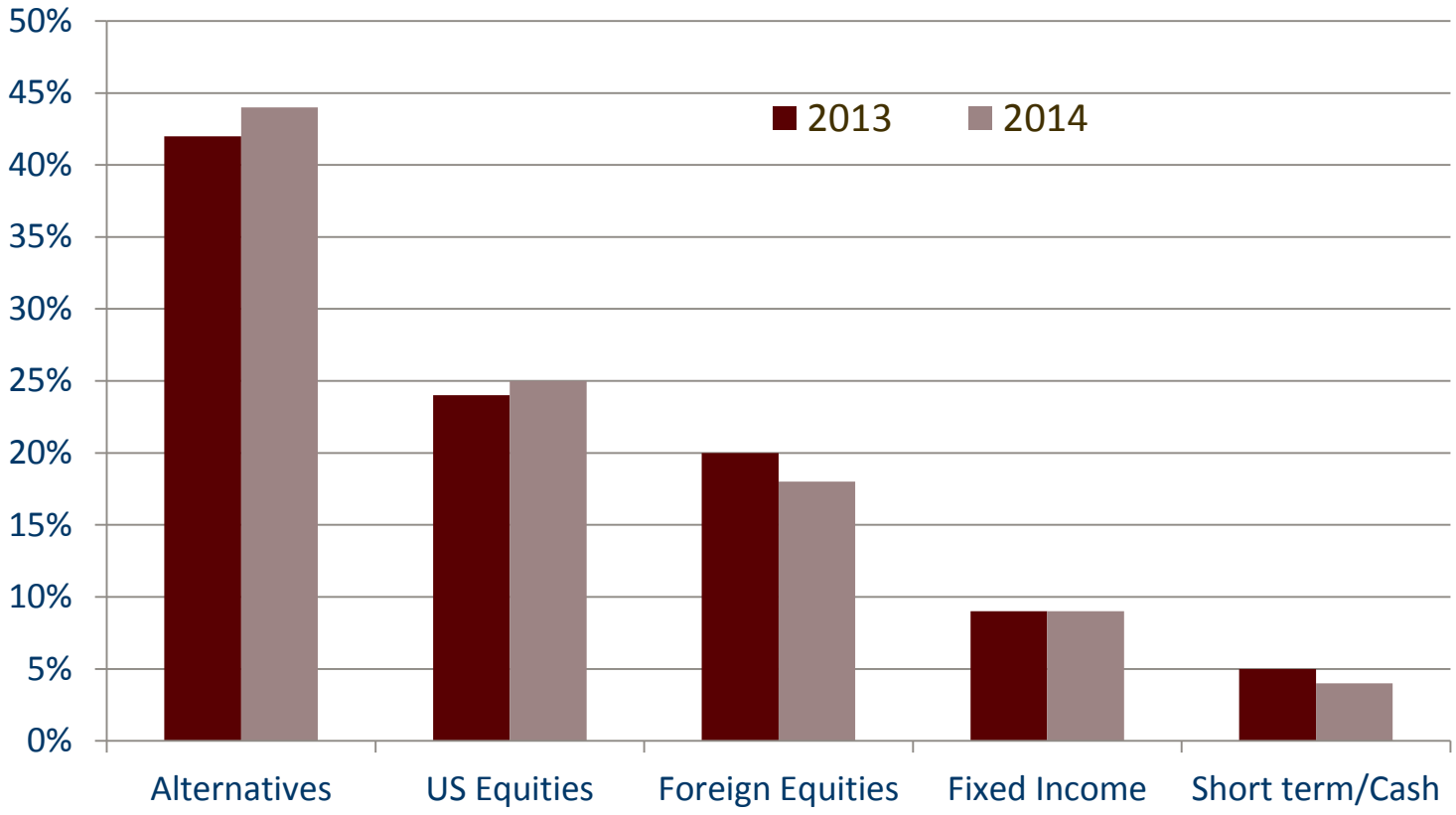
Reducing Expenses

- Emphasize passive over active funds where possible. You want the Beta as inexpensively as possible.
- Insist on institutional share classes instead of retail shares distributed by broker/dealers.
- Look for low turnover in actively managed strategies.
- Prefer ETFs over Mutual funds and closed end funds.
- Ensure ETFs have adequate volume before trading (to compress bid/ask spreads).
- Hire consultants/advisors who share these views.

Pulling it All Together

What Better Practitioners are Doing:

Private Foundations Asset Allocation, 2013-2014



Source: Cerulli Associates

Which means

Metric	Definition	Current Portfolio	60/40 and Alts	Alternative Only
Return Estimate	*7-10 Year, Annualized*	6.5%	6.2%	5.5%
Risk Estimate	*Standard Deviation*	13.0%	9.5%	6.6%
Sharpe Ratio	*Risk/Return Efficiency*	0.33	0.41	0.50
Value at Risk (Moderate Volatility)	*1-Year*	-19.5%	-12.8%	-7.7%
Value at Risk (High Volatility)	*1-Year*	-32.5%	-22.3%	-14.3%

1. Volatility can be reasonably estimated.

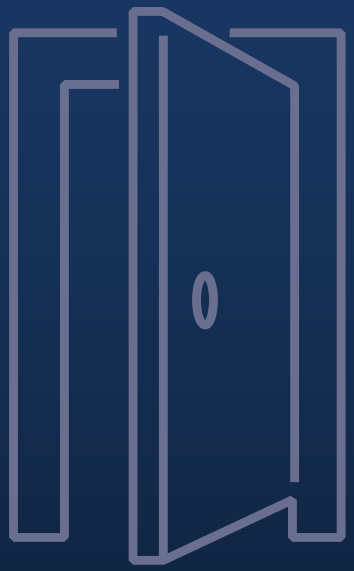
2. Forward looking returns can be reasonably estimated.

3. Portfolio can be structured to meet the targets set forth in your financial model.

Summary

- Solve for portfolio risk and return targets based on your strategic plan *(not subjectively according to risk "tolerance")*
- Set a risk budget (know where your exposure is and why)
- Structure portfolio diversification to risk budget
- Get your core exposures as inexpensively as possible

Questions?



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