Vanguard

Market volatility and asset allocation

A NONPROFIT PLAYBOOK

Leading a nonprofit organization, you've likely experienced the impact volatile markets have on your investment portfolio.

Your concerns may have increased amid the market turmoil caused by recent geopolitical events and economic challenges, just as they did during the COVID-19 outbreak in 2020, the global financial crisis of 2008–2009, and the dotcom bubble of the early 2000s. During these tumultuous periods, our nonprofit clients often ask, "How do we protect our investment portfolios and our spending against downturn?" There's no turnkey solution, but we've identified a common set of factors that we believe you should consider.

When determining your response to a market downturn—amid concerns about significant volatility, liquidity, and cash flow—your nonprofit board and management should evaluate options based on your organization's unique circumstances and risk profile.

Having partnered with nonprofits to manage their investment portfolios for more than two decades, we have identified the following considerations as you seek to meet your liquidity needs and preserve your investment portfolio during times of stress.

Assess the unique attributes specific to your organization's overall financial structure

- How dependent is your organization on spending from the investment pool (e.g., what portion of the budget does the distribution represent)?
- How dependent is the overall enterprise on the equity market? Do gifts of equity securities represent a noteworthy portion of your revenue stream? Are there other meaningful market-based dependencies of your organization?
- Are there other assets outside the investment pool, such as reserve funds or sources of cash flows or funding, that your organization can use to meet operational needs through uncertain periods of volatility? If there are, how tied to market returns are these other asset pools?
- How much financial flexibility does your organization have in terms of willingness or ability to issue debt to meet its needs (either long-term debt or short-term credit)?
- If a foundation, how flexible is your spending? How many of your grants are multiyear?

Evaluate the unique attributes of your investment pool

- What restrictions apply to the investment pool (e.g., portion of assets that are restricted versus unrestricted) and do you receive many restricted gifts? How flexible are your donors and how willing are they to make unrestricted gifts?
- How liquid are the assets in your investment pool? Does your organization have the amount of liquid resources it needs to carry out its mission during a market decline?
- How do you currently fund spending (e.g., keep one year's worth of spending liquid or liquidate assets as needed)?

Maintaining a strategic asset allocation that meets your institution's long-term needs offers the best defense for your portfolio over time and in times of extreme market volatility.

A thoughtfully crafted investment policy statement

Do you have a target allocation within your investment policy statement (IPS) that meets your long-term objectives, including appropriate asset diversification and rebalancing policies? A well-crafted IPS serves as an institution's road map and first line of defense during periods of volatility—and should help guide you through a significant market correction.

We address these factors in more detail below and in the appendix.

Asset allocation, diversification, and rebalancing policy

Maintaining a strategic asset allocation that meets your institution's long-term needs offers the best defense for your portfolio over time and in times of extreme market volatility.

Diversification within your portfolio also helps to reduce the impact of volatility. For instance, to the extent the equity market sells off, high-quality bonds should generally serve as an offset. While this may not be the case every quarter, it is the expected outcome over time. Importantly, adhering to a clearly articulated rebalancing policy is an important way to mitigate volatility, as you are "buying low and selling high."

We do not encourage frequent tactical changes to your asset allocation but rather recommend adjustments only to the extent there is a significant event that impacts your financial position (for example, you receive a very large gift or a mission-critical, short-term need occurs). During the global financial crisis in 2008–2009 and the COVID-19 pandemic in early 2020, our advised portfolios availed themselves of rebalancing (buying equities as they declined and selling fixed income assets), which served these portfolios well.

Restrictions to investment pool and gifts

To the extent that an investment is unrestricted, the more flexibility there is to spend from corpus. That said, UPMIFA (the Uniform Prudent Management of Institutional Funds Act, which has been adopted in almost all states) allows spending from corpus for "underwater endowments," where market value is below gift value. Most states apply an upper recommended prudent limit to spending of 7%, although some increased the limit during the COVID-19 crisis. Spending from corpus, however, will obviously reduce the size of the investment pool overall and limits the potential for growth.

One technique used during the global financial crisis and again during the COVID-19 crisis was to encourage donors to give more unrestricted gifts, rather than restricted gifts, in order to provide budgetary flexibility. While spending unrestricted gifts for current purposes would limit the opportunity to include them in a long-term investment pool and grow the assets, it allows you some discretion to address your needs on a short-term basis during a crisis period. This was particularly helpful during the COVID-19 crisis, when many nonprofit organizations couldn't generate revenues from traditional in-person events.

Liquidity of investment pool

In periods of extreme market volatility, we understand that liquidity may be your top concern. The degree of liquidity of an investment pool can influence flexibility and even the ability to easily rebalance. At Vanguard, a majority of our investments are in no-load, low-cost, investments—including liquid alternative asset strategies—that allow clients to rebalance in a costless manner.

To the extent that an organization's investment pool holds a significant portion of less-liquid alternatives, there is a cost in terms of a significant discount to sell, and/or liquidity restrictions, to withdraw from a limited partnership. While we believe it may make sense to hold some portion of your portfolio in less-liquid investments, such as private equity or private real estate, we also acknowledge that some endowments with substantial allocations to less-liquid assets will often plan how they would source liquidity within their portfolios in the event of a sudden market downturn.

Costs

When we find ourselves in a negative- or low-return environment, using lower-cost products may allow you to keep more of your returns than otherwise. Based on the difficulty in predicting investment returns, we emphasize that costs are one of the few factors that you can control.

Funding spending

Given the present interest rate environment, a portfolio's current or distribution yield would typically not meet most endowment or foundation spending draws, which generally range from 4% to 5%. To the extent there is a shortfall, assets must be liquidated. If you have less tolerance for volatility, you may elect to liquidate assets and set aside in short-term reserves for the next 1–3 years' worth of spending.

Of course, there is a potential opportunity cost to holding cash should stock and bond markets appreciate, but this strategy clearly offers greater certainty of having spending resources available. That said, to the extent that you may choose to replenish the balance, that reintroduces uncertainty.

Additionally, while it is beneficial over the long term to reinvest dividend income until needed, some institutions have elected to keep income earned in a reserve to mitigate the volatility of its sources of distribution. There are a series of tradeoffs that you should consider, and in the appendix, we share an array of options sometimes used by our clients as well as considerations relative to each strategy.

Fiduciary duty to do the right thing for the organization

One of the things we remind investment committees with whom we work is that they have a fiduciary duty as members of investment committees for nonprofits. These responsibilities speak to the degree of professionalism and responsibility to which committee members should adhere—which is different than the flexibility they have with their personal assets.

No one-stop solution

As we noted at the outset of this commentary, there is no single solution for every nonprofit since an organization's risk profile, investment pool structure, other financial resources, and balance sheet flexibility are all part of the equation when attempting to reduce the impact of extreme market volatility. But we continue to recognize that a long-term perspective, combined with low costs, diversification, and a disciplined approach, serves you far into the future and helps sustain organizations through the inevitable volatility periods.

So, what should you do? If you are a Vanguard client and have concerns around market risk, discuss them with your investment consultant. We would be happy to work with you to review your investment policy statement and to customize a plan specific to your risk profile. Our relationship management team can also begin to address some of these issues with our investment-only clients, who may not have a full consulting relationship with us. Finally, we would encourage you to explore the resources we make available to nonprofit organizations on our Institutional Investor website.

Appendix

Strategies to mitigate the impact of potential market changes on spending and assets

FOCUS	STRATEGY	IMPLEMENTATION	CONSIDERATIONS
Use market volatility to your portfolio's advantage	Rebalance	• Terms/time frame typically in IPS • Can use calendar or % deviation from target allocation to implement	• Market driven • Does not depend on market forecasts • Historically testable • Does not eliminate the possibility of fluctuations in value
Increased certainty around generating spending	Do not reinvest any dividends/income received	• Simple direction	• Opportunity cost of not reinvesting dividends
Increased certainty around generating spending	Raise enough cash to cover operating expenses for a period of time (1–3 years)	• Simple direction • May perform in concert with rebalancing from overvalued asset	• Opportunity cost of holding cash for extended time period and uncertainty around when to fund any future liquidation
Further refine your risk/return profile	Reallocate assets (Long term)	• Make change to IPS	• Risk/return considerations • Allocations should be reviewed/reevaluated every 3–5 years • Consider any impact on your financial metrics/ratios
Attempt to take advantage of perceived future short-term changes to the market or meet short-term mission critical need	Reallocate assets (Short term)	• Short-term tactical direction	• Risk/return considerations • Undefined time horizon • Timing error risk on both exit and reentry • Susceptible to emotion, intuition, and hindsight bias • Consider any impact on your financial metrics/ratios • Not generally advised by VIAS
Access liquidity from sources outside of portfolio	Use a credit facility (e.g., line of credit)	• Must complete forms/ obtain approval from financial institution providing support	• Cost • Availability when most needed • Must be repaid
Refine spending needs	Reduce spending	• Evaluate budgetary impact of spending needs • Potentially change spending rule	• Difficult to cut expenses on a short-term basis, particularly if there are other market impacts on your organization

If you would like more information on any of the topics covered in this commentary, please contact your Vanguard representative or call us at 888-888-7064.

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