

# Cash management for nonprofits

How to think about your liquid assets



# Understanding and managing liquidity reserves

It's no secret that the past few years have been particularly hard on nonprofit organizations. One opportunity area for nonprofits like yours is to develop a solid understanding and management of liquidity reserves, which can help you address a variety of factors. First, today's more challenging operating environment has put new emphasis on access to liquidity. Recent bank failures,<sup>1</sup> combined with lingering uncertainty about depositors with accounts above FDIC insurance limits, have caused concern. Finally, increasing short-term interest rates plus market volatility have generated interest in cash and equivalents.

<sup>1</sup> Mark Mauer. "SEC Seeks More Disclosure from Smaller Banks in Wake of Failures." *The Wall Street Journal*. June 22, 2023.

# Executive summary

## Defining liquidity reserves

Most nonprofits set aside monies to meet operating requirements or capital needs, as well as for emergencies (rainy day funds). These funds are commonly known as liquidity reserves, or often just as cash. But what does cash mean? It could reflect a variety of uses:

- Funds used to pay wages, benefits, regular operating expenses.
- A source of liquidity for planned routine and/or strategic spending over a defined period.
- Funds to cover debt-related expenses such as interest and principal payments.
- A source of liquidity for emergency operating needs.
- An investment option, either explicit or default.

In addition, this cash is often placed in separate accounts, or pools, based on purpose.

It's also important for nonprofit boards to minimize the risk of double counting when dealing with cash. For example:

- The same pool can't be earmarked to pay operating expenses and serve as a rainy day fund for unexpected situations.
- The same cash can't repay debt and function as dry powder in the event of a market downturn.
- Cash held to fund operating needs can't be part of the endowment or the investment portfolio.

## Assessing your nonprofit's liquidity needs

We encourage you to apply three factors to gauging your liquidity needs:

1. Review historical cash flows, cash balances, and funds to run the business, paying particular attention to seasonal patterns.
2. Identify unique or changing conditions for future cash flows.
3. Employ target financial ratios to size your optimal cash balances.

Finally, remember that cash pools are separate and distinct from long-term investment pools. They operate under different conceptions of risk and different time frames. And they are generally intended for reallocation and replenishment versus rebalancing.

## Defining individual pools

Purpose	Time horizon	Certainty of need	Amount needed	Replenishment
Wages; benefits; utilities; rent	Overnight to 1 yr	Highly certain	Highly predictable	Replenished as drawn
Tech spend; debt service	1–3 yrs	Mix of highly certain and uncertain	Somewhat predictable	Replenished as drawn
Construction costs; debt service	Multi-year; mostly medium- and long-term	Varies over time	Generally higher than estimated	Not replenished
Self-insurance	3+ yrs	Varies over time	Varies over time	Varies by nonprofit
Cover unforeseen events	Uncertain	Uncertain	Uncertain	Replenished as drawn

Please note that some bond issuance requires creation of dedicated debt service reserve pools.

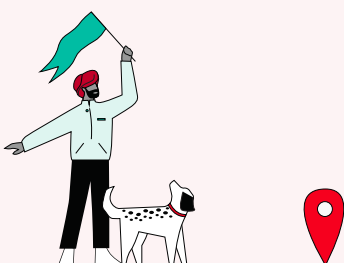
### How tiers and pools relate

Tiering is straightforward, though it has many variations. The basic notion is that an organization's cash is split into different tiers, determined largely by the timing of the need for cash and by how much risk you wish to assume. Other determinants include the certainty of the need and the nonprofit's willingness to replenish the funds.

Pools and tiers differ, though some nonprofit institutions invest certain pools in discrete tiers, given their unique restrictions. One commonly used tier invests funds that will be spent within a month on highly predictable needs and no tolerance for risk. This tier is often invested exclusively in FDIC-insured demand deposits at banks and government money market funds. It's possible for parts of all five pools (short-, medium-, and long-term operating needs; capital projects; and rainy day funds) to have investments in this tier.

### Types of investments for various tiers

Investing liquidity reserves can comprise a wide range of instruments, from demand deposits at banks, individual securities, and various pooled vehicles, including money market funds, mutual funds, and exchange-traded funds (ETFs). See the appendix to explore these investments in more detail.



## Getting started

As you establish the structure of your cash investment program, it is important to project your expected cash inflows and outflows regularly. It is essential to state your objectives for each pool and the risks you are willing to assume. Finally, it's critical to have an investment policy and to understand whether and how you plan to replenish cash balances.

# It's not "just cash": Helping nonprofits think about managing liquid assets

It's always been critical for nonprofits to manage liquidity reserves.

But three recent economic developments have led organizations to take an even deeper look at how they are handling this. First, today's more challenging operating environment has put new attention on access to liquidity. Recent bank failures, combined with lingering uncertainty about depositors with accounts above FDIC insurance limits, have caused concern. Finally, increasing short-term interest rates plus market volatility have generated greater interest in access to liquidity.

Most nonprofits set aside money to meet operating requirements and capital needs, or for emergencies and other unbudgeted outlays (rainy day funds). These funds are liquidity reserves, though they are often more simply referred to as cash.

These needs can be characterized as short-, medium-, or long-term. Short-term needs are ongoing expenses, such as wages and salaries, utilities, and other routine operating expenses that are typically due within a year. Medium-term includes technology purchases, interest and debt repayments, and other expenses that occur during a one- to three-year period. Long-term items often involve big-ticket capital spending projects, such as a new building planned by a hospital or a university.

You have a range of ways to invest these funds. For now, we'll focus on investing operating and capital pools and will not address the potential to hold cash within a long-term endowment. (See Appendix A for a discussion of rainy day funds.)

## What does *cash* mean?

Before you can properly address the maturity, liquidity, and stability of your short-term investments, you need to be clear about how you're defining cash. At best, using it to mean multiple things is confusing; at worst, it can lead to double counting. Depending on the context, cash can refer to:

- **Funds used to pay wages and benefits and recurring operating expenses.** This is the most common use of operating cash.
- **Liquidity for planned or expected spending over a defined period.** This is spending for a different time period than ordinary operating costs. For example, a foundation plans to fund grants at the end of a quarter and liquidates a portion of its endowment to make the payments. Or a university is constructing a new building and sets aside funds to be disbursed over the next two years.
- **Liquidity for costs associated with debt (interest and principal payments).** Many nonprofits with outstanding bonds establish debt service reserve funds, usually equivalent to about a year's debt service payments (both interest and principal). Some set aside a debt service reserve fund in a discrete account pursuant to their bond indenture.
- **Funds for emergency operating needs.** (See Appendix A for more information about rainy day funds). Best practice varies depending on the overall financial health and cash flow dependability of the organization, but many observers (from Candid [the parent of Guidestar] to BoardEffect, to the National Council of Nonprofits) encourage nonprofits to have reserves that cover 3–12 months of operating expenses.
- **An investment option.** Take a look at the following table: As an investment option, cash (defined here as 91-day Treasury bills) hasn't produced outstanding returns:<sup>2</sup>

Period <sup>2</sup>		S&P 500	Spliced Bloomberg US Agg	U.S. Treasury 3-mo T-bill
October 1989– December 2022	Annualized return	9.7%	5.2%	2.7%
	Standard deviation	14.9%	3.9%	0.7%
October 1989– September 2008	Annualized return	8.9%	7.0%	4.3%
	Standard deviation	13.9%	3.7%	0.5%
October 2008– December 2022	Annualized return	11.0%	2.8%	0.6%
	Standard deviation	16.2%	4.1%	0.3%

**Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.**

<sup>2</sup> This begins with 1989, the first year represented in the Vanguard Portfolio Construction Solution (PCS) tool, which is used by Vanguard Institutional Advisory Services® to model future portfolio returns. We've highlighted the 2008-2022 period as it reflects global monetary policy easing on the part of central banks. Prof. Aswath Damodaran of NYU tracks historical returns for different asset classes. For the period from 1973 to 2022, the S&P 500 returned 10.2%, T-bills 4.3%, and 10-year Treasury bonds 6.1%. These are not significantly different than the 1989-2022 returns shown above. Spliced Bloomberg US Agg: Bloomberg U.S. Aggregate Bond Index through December 31, 2009; Bloomberg U.S. Aggregate Float Adjusted Index thereafter.



So why do people invest in cash? Generally for two reasons: It's a short-term store of value, particularly during periods of inflation, and has less volatility than other asset classes—which is important when you know you need to spend a certain amount. And when the yield curve inverts investors may move into cash for defensive purposes. It's important to note that this sounds good in principle but can often be difficult to do in practice.

To minimize the risk of double counting funds, your investment committee and board should have agreed-upon definitions of cash. For example, you can't earmark the same money for two different purposes, like paying the bills and serving as a rainy day fund.

# Assessing your nonprofit's liquidity needs

As you gauge your organization's liquidity needs, it's a good idea to take these three steps:

1

**Review historical cash flows and cash balances, paying particular attention to seasonal patterns.**

Operating cash and liquidity needs will vary from one organization to the next. A look back at the actual cash inflows and outlays of your organization over the most recent 12–24-month period is a useful starting point for assessing your future cash needs. There may be cyclical determinants of cash flows or inflows, such as tuition receipts at educational institutions. Many nonprofits continue to experience persistent inflationary pressures, mostly in salary and wages, supplies, and other operating costs. And as the Federal Reserve potentially continues to raise rates to rein in inflation and the economy slows, we expect that the liquidity needed to support projected operating expenses will be higher than historical trends.

2

**Identify future changes to cash flows.**

Consider these key questions as you assess your operating cash requirements:

- Are there cycles to the inflows and outflows?
- Are there any known atypical liquidity demands in the future to account for?
- Are there any financing covenants or other institutional policies to consider? If so, what are the primary operating and financial metrics to be considered?
- Do you have access to a committed line of credit to fund rainy day needs, which could reduce the need for cash?
- Do you depend on contracts from various government entities? Do you have enough cash to weather a disruption?
- After evaluating their situation, many nonprofits will maintain a rolling forecast of anticipated operating cash requirements for up to three years in the future.

3

**Employ target financial ratios.**



## Common liquidity and leverage ratios

- **Monthly days cash on hand (DCOH).**

The number of days a firm can cover its operating expenses from unrestricted cash and investments that can be liquidated within 30 days, defined as:

- Unrestricted cash and investments that can be liquidated in 30 days<sup>3</sup>
- $(\text{Annual operating expenses} - \text{depreciation} - \text{other large noncash items}) / 365$

- **Spendable cash and investments to operating expenses.** This provides a rough measure of a nonprofit's operating reserve and is defined as:

- Spendable cash and investments (excluding permanently restricted investments) divided by total operating expenses<sup>3</sup>

- **Spendable cash and investments to total debt.** Financial leverage ratio measuring a nonprofit's ability to repay lenders from wealth that can be accessed over time or for a specific purpose, defined as:

- Spendable cash and investments (excluding permanently restricted investments) divided by total debt<sup>3</sup>

Note that you can use total adjusted debt to the extent there are noteworthy leases, pensions, or other debt-like obligations.

<sup>3</sup> Source: Moody's Investor Services.



## **What's different about the role, administration, and investing of cash versus long-term investments?**

Cash pools are separate from long-term investment pools. Each has its own risk tolerance and time frames, and there's a difference in reallocation and replenishment versus rebalancing.

Long-term investment pools are intended to increase in value over time to provide funding for your organization far into the future. That's why many investment committees are happy accepting more risk in return for the possibility of greater long-term returns, including investing in illiquid investments to achieve long-term growth objectives. Cash, on the other hand, is generally intended to be spent soon, if not tomorrow. So, there is a greater focus on liquidity, safety of your principal, and predictability of underlying investment cash flows.

Your organization's need for cash—and your ability to generate operating cash—can fluctuate based on underlying seasonal trends or changes in the external environment. It's crucial for you to routinely review and update cash flow forecasts to ensure that your funding of underlying investment pools is consistent with organizational requirements. It's also important to maintain open communications between the CFO/treasury staff and your investment committee and investment manager. Likewise, there should be good lines of communication between the CFO/treasury staff and the nonprofit staff responsible for generating and spending that cash.

Long-term investment pools generally follow a uniform asset allocation intended to remain in place for extended periods of time. In contrast, you should consider segmenting cash pools based on how soon the cash will be used, how liquid the pool needs to be, and how much risk a pool can take. Of course, these time horizons may change as capital forecasts and expenditures change.

Regular rebalancing is important for long-term investment pools, which typically have a mix of risk-seeking and risk-mitigating assets. Given that monies in shorter-term cash pools are, for the most part, being regularly spent, replenishment is more applicable than rebalancing. Your finance staff needs to make the decision whether to replenish funds drawn down from pools, and to what extent. Within each pool, the mix of underlying assets might change (overnight demand deposits at banks versus money market funds, for example), though this is generally the result of changing requirements regarding rates of return or liquidity.

# Defining individual pools

When you are defining individual pools, you should consider purpose, timing, the certainty and amount of the need, and replenishment.

Purpose	Time horizon	Certainty of need	Amount needed	Replenishment
Wages; benefits; utilities; rent	Overnight to 1 yr	Highly certain	Highly predictable	Replenished as drawn
Tech spend; debt service	1–3 yrs	Mix of highly certain and uncertain	Somewhat predictable	Replenished as drawn
Construction costs; debt service	Multi-year; mostly medium- and long-term	Varies over time	Generally higher than estimated	Not replenished
Self-insurance	3+ yrs	Varies over time	Varies over time	Varies by nonprofit
Cover unforeseen events	Uncertain	Uncertain	Uncertain	Replenished as drawn

Let's examine each of these factors.

## Purpose

**Short-term operating needs.** For example, personnel costs, utilities, rent, and bills. These are mostly predictable (salaries and rent), but the magnitude and timing can vary (travel expenses, conferences and meetings, other credit card charges).

**Medium-term operating needs.** For example, technology purchases, interest and debt repayments, professional services costs (audits, legal fees). Sometimes both the timing and magnitude of these disbursements is known ahead of time (interest payments); sometimes you know the timing, but the magnitude is not fixed (audit costs, an annual fundraising event, captive insurance premiums). In other cases, you won't be certain of the exact timing or magnitude (legal costs, technology spend).

**Capital projects.** This is big ticket capital spending, such as a new building planned by a hospital or university. Note that these could be medium- or long-term.

**Long-term needs.** Most common at large nonprofits in health care or higher education, these can include self-insurance pools and funds to bridge medical costs for retirees. This might also include capital projects.

**Rainy day or emergency needs.** Monies set aside to cover unforeseen events and unbudgeted expenses (a new roof after a tree falls) or an emergency (a delay in government funding for one of your programs). Both the timing and magnitude of the amount you'll need are unpredictable.

## Time horizon

There are many ways to categorize the time frame for each pool. Your choices should reflect your unique needs and circumstances. It is common to see three segments (e.g., <1 year, 1–2 years, >2 years) or four (e.g., <1 month 1–12 months, 1-2 years, >2 years), but there's no universal standard. Don't be too focused on time frames, as it may not be important whether a medium-term pool is for one to two years instead of one to three.

	Time horizon
<b>Short-term operating</b>	Overnight to 1 yr
<b>Medium-term operating</b>	1–3 yrs
<b>Capital projects</b>	Multi-year; mostly medium- and long-term
<b>Long-term needs</b>	Uncertain but generally 3–5 years out
<b>Rainy day</b>	Uncertain



## Certainty of amount required

While you can rarely forecast cash flows with precision, there's usually a relationship between the term and the certainty of timing of cash flows.

	Certainty	Investments
<b>Short-term operating</b>	Predictable; highly certain	Insured bank accounts; money market funds
<b>Medium-term operating</b>	Mix of highly certain and uncertain	Insured bank accounts; money market funds
<b>Capital projects</b>	Near-term predictable; longer-term less so. Assume costs higher than planned	Mix of less risky near-term fixed income assets and riskier medium-term assets
<b>Long-term needs</b>	Varies over time; timing of draw unpredictable	Higher share of riskier assets
<b>Rainy day</b>	Both timing and magnitude uncertain	Committed line of credit; mix of insured bank; money market funds; ultra-short and short-term bonds

## Replenishment

Pools are often, but not always, replenished. Here are some common practices outlined by pool:

	Replenishment
Short-term operating	Replenished as drawn
Medium-term operating	Generally replenished as drawn
Capital projects	Not replenished as funds drawn
Long-term needs	Varies by nonprofit
Rainy day	Replenished as drawn

## Tiering

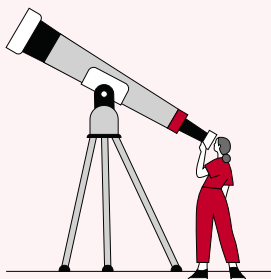
Tiering is straightforward but does have several variations. In general, investment tiers are aligned to the needs of cash pools. That said, monies to satisfy the needs of a particular pool (for example, capital projects) may be allocated to different tiers, given the timing of expected draws and the risk your organization is comfortable assuming. Imagine a capital projects pool for a building project. In the capital projects pool, funds needed to pay for plans and permits over the next 60 days would be placed in a short-duration tier with minimum risk. If construction is expected to start in 18 months and continue for two years, funds for this phase might be apportioned to a medium-term tier with a dual focus on enhancing return and preserving capital (e.g., a money market mutual fund). And a reserve to cover cost overruns might be allocated to a longer-duration tier.

## The number of tiers

We often see nonprofits employ tiers with four durations: Less than 30 days, one month to one year, one year to three years, and over three years.

The number and duration of tiers you use should reflect what's important for your organization, based on the interplay between how the funds are used and how much risk you can tolerate.

Tier	Duration	Instrument
Short	<30 days	Mix of insured bank deposits and government money market funds
Near-term	>1 mo and <1 yr	Insured bank deposits; money market funds; ultra-short bond funds
Medium-term	>1 yr and <3 yrs	Money market funds; ultra-short bond funds; short-term bond funds
Long-term	>3 yrs	Money market funds; ultra-short bond funds; longer-duration bond funds; stable value funds; conservative equity



There are other considerations as you develop your optimal cash investment program. Refer to the appendices for more on this topic.

## Appendix A: Rainy day funds

### Magnitude and timing

In contrast to the often-predictable magnitude of operating needs, rainy day funds are there to cover circumstances in which you can't know the timing and magnitude in advance. These can range from accidents (putting a new roof on after a tree falls) to emergencies (a delay in receipt of government funding for a program), or even an unforeseen mismatch between anticipated cash receipts and significant disbursements.<sup>4</sup>

### How should you size rainy day funds?

Your organization itself is the best judge of how much it should maintain in rainy day funds. A good starting point is having unrestricted resources (not cash) equivalent to about six months of operating costs. Hilda Polanco, of Fiscal Management Associates, advocates Liquid Unrestricted Net Assets (LUNA)<sup>5</sup>, defined as unrestricted net worth minus unavailable net worth (illiquid assets, such as property or buildings). LUNA divided by average monthly operating expenses equals months of LUNA. She encourages nonprofits to have three to six months of LUNA. That said, every nonprofit must look at its unique circumstances, including its overall financial resources and the cyclicity of its cash flows.

Generally, credit rating agencies don't like to see fewer than six months of reserves—and their benchmarks differ among nonprofit subsectors (i.e., health care providers, higher education, and other nonprofits).

The Better Business Bureau, however, suggests reserves should not exceed three years' worth of costs.<sup>6</sup> Your individual reserve needs are unique to your institution's overall operational and financial health, including your financial resources and the strength and predictability of your operations and cashflows.<sup>7</sup>

### How much of your reserves should be in cash versus other forms?

Cash is a scarce resource at most nonprofits, and it doesn't generate a substantial return. It's a good idea to explore establishing a committed line of credit with a bank. You can consider this equivalent to homeowner's insurance with the commitment fees a component of the insurance premium. As we learned during the Great Recession, an uncommitted line of credit may not be available to you just when you need it most.

If your institution has endowed assets, you have two additional tools at your disposal. You can pledge endowment assets to a lender, or you can make a loan from the endowment. Many lenders, such as trust companies and banks, offer loans secured, or collateralized, by liquid assets. In this case, the lender will evaluate the type and credit quality of the underlying assets serving as collateral and apply discounts to these underlying assets (smaller discounts on very safe assets such as Treasury securities and larger discounts on more volatile assets, like equities or those with lower credit quality) as part of their underwriting process.

<sup>4</sup> Although prepared in 2010, the Operating Reserve Policy Toolkit for Nonprofit Organizations remains an exhaustive examination of the issues around operating reserves. It was a joint effort of the National Center for Charitable Statistics, Center on Nonprofits and Philanthropy at the Urban Institute, and United Way Worldwide.

<sup>5</sup> Polanco, Hilda, "The Key to Long Term Financial Health: Liquid Unrestricted Net Assets," New York Nonprofit Press.

<sup>6</sup> BBB Wise Giving Alliance. BBB Standards for Charity Accountability. Alliance. 2022.

<sup>7</sup> The Financial Accounting Standards Board (FASB) mandated Accounting Standards Update (ASU) 2016-14 for all nonprofits in 2019. The ASU requires disclosure and discussion of the amount of liquid resources available to meet cash needs for general expenditures within one year of the balance sheet date. "Availability" means assets (cash, accounts receivable, contributions receivable, short-term investments, etc.) that can be accessed within 12 months and have no donor restrictions, have not been designated by the board for any special purpose, and have no other limitation on their use for general expenditures. This gives nonprofit boards a quick idea of the resources they have.

## Appendix B: Risk

There are fewer risks associated with cash and short-term investments than there are with long-term investments, whether equity or fixed income; however, there are a still variety of risks. Some of those risks can come as a surprise, like the recent bank failures. This was a powerful reminder to some nonprofits and other depositors who held checking accounts in excess of the \$250,000 FDIC limits.

Investing in professionally managed, commingled funds (money market funds, bond funds, or ETFs) or maintaining high credit quality on individual investments (e.g., Treasuries) can help mitigate some of these risks.

### Defining risk

It's wise to be as clear as possible when discussing risks for your cash investments. Let's start by laying out four manifestations of risk:

1. Permanent loss of capital (getting less than 100 cents on the dollar at maturity): Partial, meaning an investor who puts in a dollar gets less than that back, but still gets something.
2. Permanent loss of capital (getting less than 100 cents on the dollar at maturity): Total, meaning that all the money invested is lost.
3. Temporary loss of capital (mark-to-market): Imagine you buy a bond at par (\$100) and a rise in interest rates reduces the market price to \$99.25. If you hold the bond to maturity, you will get your \$100 back.
4. Loss of purchasing power (inflation): If you buy a 10-year bond for \$100 and hold it to maturity, you'll get your \$100 back, but the purchasing power of that \$100 has been eroded by inflation.

### Types of risk

There are two main sources of investment risk: Systematic and unsystematic. Systematic, or undiversifiable, risks are those arising from macroeconomic or market conditions while unsystematic, or diversifiable, risks are inherent and arise from events that impact how the market views a given issuer. This is often associated with developments in the

issuer's business or balance sheet. Systematic risks include liquidity, market risk, and interest rate risk. Unsystematic risk includes credit risk, downgrade risk, event risk, business risk, and financial risk (how indebted an issuer is).

### Measuring risk

There are multiple ways to measure risk. A few of the most common approaches are identified below.

- Standard deviation of returns.
- Value at risk (VAR).
- Interim loss of value.
- Final loss of value. (Note: for this risk measurement, the committee must decide whether it will accept no loss of capital or whether it would accept a bounded loss of capital or a percentage of initial investment.)

### Defining maximum acceptable risk

Is the goal of your cash portfolio to maximize returns, preserve principal, or something in between? Recognizing that higher returns are generally preferable despite the possibility of greater risk, it can be helpful to establish a baseline of the maximum acceptable risk for the portfolio. Maximum acceptable risk can be determined in several ways, including:

- Maximum drawdown: The maximum observed loss, typically expressed as a percentage of the portfolio, from a peak portfolio value (i.e., the high-water mark) to the trough after the high-water mark.
- Value at risk (VaR): This metric estimates how much a set of investments might lose (with a given probability), assuming normal market conditions, in a set time frame.
- Custom measures: Your institution may use its own metrics, such as an inability to realize a loss in two consecutive quarters.

## **Protecting against risk**

To help protect your investments, it's important to be aware of the risks in both pooled portfolios and portfolios of individual investments.

### **Mitigating risks in pooled portfolios**

- Large numbers of holdings (ultra-short bond funds may hold over 800 securities).
- Diversification of holdings by investment type, credit rating, and duration.
- Government reforms. For example, Securities and Exchange Commission (SEC) rule 2a-7 governs money market funds. The SEC implemented major money market reforms in 2016 requiring money market fund providers to institute liquidity fees and suspension gates, as well as to move from a fixed one dollar share price to a floating net asset value.
- Concentration limits put in place by fund shops.

## **Managing risks in portfolios of individual investments**

- Only purchasing instruments that have credit ratings higher than a given threshold (typically A or BBB/Baa for bonds and A-1/P-1 for commercial paper), though that behavior relies solely on historic ratings by credit rating agencies.
- Concentration limits. Typical IPS language doesn't impose limits on holdings of securities issued and guaranteed by the U.S. government. Smaller portfolios might limit a non-government holding to 10%–15% of the portfolio, falling to 5% for larger portfolios. Establishing these limits requires a deep understanding of the risks of particular types of securities.
- Over-collateralization or structural enhancement for asset-backed securities.



## Appendix C: How should our nonprofit invest?

### Things to keep in mind

Large institutions with experienced investment personnel may have the expertise to evaluate the nature of different instruments, the brokerage relationships to buy and sell the instruments, and the resources required to create portfolios tailored to their needs. However, most nonprofits aren't in this position. In fact, sophisticated investment teams who maintain sizeable cash balances often choose to invest in commingled vehicles, even though they could purchase cash instruments directly or through brokers. But why?

First, performing due diligence is labor-intensive. Intermediaries such as money market or fixed income mutual fund managers employ large teams of experts specifically trained to analyze credit quality. Nonprofits often prefer for their investment people perform diligence on opportunities with more upside and longer holding periods than cash.

In addition, individual cash instruments are always maturing and investors with large pools must continually decide whether to roll over a maturing instrument or buy a different one. Finally, mutual funds own hundreds of positions, reducing the risk of any single position, while most nonprofits don't buy large enough quantities to get diversified portfolios. They are often not able to obtain the attractive pricing opportunities that investment managers, who are in the market daily committing large amounts of capital, can.

### Nonprofits have many choices when it comes to investing liquidity reserves

Let's consider some of the options you have when it comes to investing your liquidity reserves.

#### **Pooled investments (mutual funds or ETFs: money market; ultra short bond)**

These can be mutual funds or ETFs, a money market fund, or ultra-short bond funds. The pros? Pooled vehicles are offered by firms with dozens, if not hundreds, of analysts and portfolio managers devoted to understanding the underlying instruments in their funds. The funds typically have hundreds of positions and are continually adding new ones as older ones mature or as attractive opportunities present themselves. The firms managing these funds have sizable trading departments with scale and purchasing power, so they can execute trades at the best prices. The number of positions reduces the impact of a failed investment on the performance of the overall fund.

As for the cons, consider that if a nonprofit buys an individual bond or cash instrument, it can hold it to maturity without concern for fluctuations in value and is not at risk of mark-to-market losses. At maturity it will receive par (assuming there is no default). It's the manager of a commingled fund who is empowered to sell a position at a loss, not the investor. That said, many nonprofits mark all their investments to market as a best practice and realize losses in individual securities.

### **Individual investments**

A portfolio of individual investments can be tailored to your unique requirements; you can hold securities until maturity without concern for changes in market price. On the downside, even large nonprofit pools may not own enough securities to obtain true diversification; their purchasing power doesn't rival that of large sell-side firms. Additionally, as noted previously, many nonprofits will mark all their investment securities to market.

### **Bond ladders**

Here's an example: Divide \$1million into \$100,000 tranches of bonds, each one maturing a year out from the one before. This a 10-rung ladder with one year distance between each rung. The number of rungs and the distance between rungs is your choice. You can structure ladders to your needs, vary the size of the rungs and the time between rungs, and help protect yourself against interest rate risk and reinvestment risk should you plan to spend at each maturity. If your organization creates a Treasury ladder there is no default risk. The potential cons include trading costs, purchasing power, the need to adjust the ladder as rungs mature, research complexity, and risks for non-Treasury bonds.

### **Laddered certificates of deposit (CDs)**

These are CDs with specific maturity dates that you can buy from a bank or a brokerage firm. They are insured up to \$250,000 per account and the amount can be tailored to your future needs. On the other hand, these are illiquid, there are penalties for early redemption, and brokered CDs can be costly to trade and have wide spreads. In addition, they are sometimes subject to call.

### **Investment policy statement (IPS) recommendations**

If your nonprofit buys individual securities, it's good practice to list permissible securities, along with credit and maturity guidelines. The permissible investments section of your IPS should outline the specific types of investment as well as additional restrictions regarding credit quality, maturities, and concentration limits. The list of permissible investment types should be transparent, and you should identify any limitations within each sector.

Your IPS should include a section of prohibited securities tailored to your risk tolerance. For example, these could include derivatives, securities with embedded options, short selling, and margin transactions. These are prohibited if their use increases the risk to the portfolio, but fine if used for risk management. Consider adding language that states unless a specific security type is approved by the board or investment committee, it should be viewed as prohibited.

## **Appendix D: Other issues concerning nonprofit cash**

Here are some additional considerations to keep top of mind as you evaluate your liquidity reserves.

Because cash is often a low-return, albeit low-risk, asset, having high cash balances can cost your organization in terms of foregone earnings. Since interest rates are currently low (but rising), it may be appropriate for you to explore using lines of credit with your bank.

If you set aside cash for long-term projects, such as the construction of a building, under what circumstances can the cash be invested in the endowment? Some nonprofits consider similar portfolios structured with similar asset allocations to their endowments; however, without exposure to illiquid investments.

Spell out your approach for treating cash in your IPS. Nonprofits with large and/or varied cash pools should have a separate IPS for cash.

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**All investing is subject to risk, including the possible loss of the money you invest.**

Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments. Investments in bonds are subject to interest rate, credit, and inflation risk.

Diversification does not ensure a profit or protect against a loss.

There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

U.S. government backing of Treasury or agency securities applies only to the underlying securities and does not prevent share-price fluctuations.

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