Nonprofit organizations face mounting pressures: greater demand for their services, a more competitive fundraising environment, and an investment climate marked by rich asset prices and greater uncertainty over the geopolitical and economic landscape.

As one of the world’s largest investment managers, Vanguard has helped thousands of nonprofit organizations navigate their unique investing, organizational, and governance challenges.

Nonprofits differ by size, served market, and sophistication, and so content created for the chief financial officer of a hospital may not be as useful to the chief investment officer of a college nor to the executive director of a small public charity. Our research is intended to address issues that matter to the great majority of nonprofits, and each year we discuss issues important to our nonprofit clients in a key topics piece.
This publication contains our high-level thoughts on topics our nonprofit clients have been asking about.

We understand this covers a lot of ground. Please feel free to focus on those topics that come within your purview:

• Possible developments coming out of Washington, D.C.
• Fundraising.
• Risk management.
• The role of fixed income in nonprofit portfolios.
• How nonprofits can think about cash and short-term liquid investments.
• Granting discretion over the management of investment assets.
• Thinking about alternatives.
Key topics for 2020

Possible developments coming out of Washington, D.C.

Vanguard has written extensively about the impact of Presidential election years on markets. The short answer is markets don’t move nearly as much as we fear (or hope). Additionally, passage of legislation grinds to a halt beginning a year before any Presidential election. Large issues, such as the fate of the Affordable Care Act, will depend on a change in the White House, as well as Congress, which is beyond our ability to predict.

There remain items of particular relevance for nonprofits, which we discuss below. We endeavor to handicap the likelihood of changes by doing our best to assess sentiment in two places: Congress (House and Senate) and the Treasury Department/Internal Revenue Service (IRS). In Congress, we note whether staff in both chambers and on both sides of the aisle have expressed interest in a given issue. However, interest doesn’t rise to legislation without elected officials in both chambers—and, better yet, from both parties—making an item a key issue, introducing legislation, and initiating the process of gauging interest and gathering votes. We don’t see any items rising to that level before 2021.

There are also issues that the Treasury/IRS have raised over time, chiefly regarding loss of revenues or inconsistent treatment of different entities. As a general rule, political will as expressed by Congress trumps administrative concerns as expressed by the Treasury Department/IRS.

Higher than average likelihood—recently passed

- Flattening of the excise tax. In 2019, private foundations were required to pay a 2% excise tax on net investment income. This tax could be reduced to 1% if certain distribution requirements were met. Introducing a flat rate between 1% and 2% has been proposed in previous years and would allow foundations to concentrate on grant distributions without having to spend time on tax considerations, although some foundations will now pay more.

- Changes to the income tax reform passed in 2017, notably an end to the “parking lot” tax. Earlier in 2019, the House Ways and Means Committee passed H.R. 3300, which would repeal the unrelated business income tax (UBIT) on nonprofits providing employees with qualified transportation fringe benefits (which has been widely vilified as the “parking lot tax.”). On December 17, 2019, the House of Representatives passed a measure repealing the parking lot tax and simplifying the excise tax to a flat 1.39% on net investment income for private foundations as part of a year-end budget reconciliation bill. This was then signed into law by the President on December 20, 2019.
Fundraising

As clients increasingly believe that near-term capital markets’ returns will be modest, they’ve grown more interested in learning about other ways of financing their missions and fundraising has grown in perceived importance, as reflected in the number of questions we’ve received on the topic.

Nonprofit fundraising is a story of “haves” and “have-nots”:

- Sophisticated organizations have large, paid development staffs and long time horizons. They also often have national and international reach to complement local and regional efforts and specialists in annual giving, capital campaigns, major gifts, legacy giving, etc. They can spend years getting to know prospective donors, and they’re used to the issues involved in raising restricted as well as unrestricted gifts. They also have the sophistication to be able to capture the full scope of fundraising costs and make them explicit (both internally and externally).

- Small organizations often alternate between having one paid development person and outsourcing fundraising. They tend to be highly focused on immediate funding requirements, and concentrate on a local donor base. They often rely on internet-based fundraising methods but can resort to more questionable methods, such as “donate your car” campaigns (a legitimate technique often marred by misrepresentation and only a small percentage of proceeds going to charity). They often fail to understand or capture the full scope of fundraising costs.

It can be more difficult for small nonprofits because they often have a perennial revolving door issue: development director positions exhibit very high turnover rates (they stay in their jobs less than two years, on average), lengthy vacancies (the mean time to fill vacancies in small nonprofits is more than 21 months), and a shrinking pool of qualified candidates.

Low likelihood

- Extension of the excise tax on large university endowments.
- Lowering (or raising) the 5% spend requirement on private foundations.
- Passage of the CHARITY Act (sponsored by Senators Thune and Casey), which would, among other provisions:
  - Permit people to make required minimum distributions (RMDs) directly from their IRAs to DAFs.
  - Create an exception that would make it possible for private foundations to own and operate taxable businesses that pour their earnings into various charitable foundations.

Recurring themes that we believe are unlikely to change

- The most likely path is for Congress to avoid taking action on proposals that would augment or diminish charitable giving.
  - On the augment side: make charitable deduction an above-the-line item; permit taxpayers to claim a charitable contribution deduction after the close of the tax year but before the due date of the return for the following tax year.
  - On the diminish side: place a cap on deductible amount of charitable contributions for individual and joint; or put a 2% floor in place before contributions are deductible.
- Repealing the tax-exempt status of professional sports leagues.
- Taxing royalties from licensing an organization’s name or logo as unrelated business income.
- Treat certain corporate sponsorship payments as taxable advertising revenue.
- Imposing a 2.5% excise tax on private foundations that engage in self-dealing transactions. At present, taxes on self-dealing are applied to individuals, whereas these proposals would tax the foundation itself.
Fundraising has elements of a zero-sum game

- Philanthropy in the United States, as best as observers can measure, has composed 2% of GDP for many years. The bad news is it’s not growing as a percentage of GDP, but the good news is it’s not shrinking. The deeper issue is that because philanthropy’s share of GDP appears fixed, one organization’s success, to some extent, comes at the expense of another nonprofit. This means it’s essential for even the smallest organization to view fundraising as a critical competency that requires attention from the executive director and the full board.

Ways of improving fundraising effectiveness

The Association of Fundraising Professionals, the Better Business Bureau (BBB) Wise Giving Alliance, BoardSource, and GuideStar developed a framework for evaluating fundraising effectiveness that emphasizes a balanced approach. The framework begins with three simple measures of fundraising effectiveness for internal and external use:

1. **Total fundraising net.** The amount of money fundraising efforts made available to spend on an organization’s mission, defined as:

   \[
   \text{Total amount raised} - \text{total fundraising expenses} = \text{total fundraising net}
   \]

   Example: If an organization raised $1,000,000 and spent $200,000 on staff and other expenses to do it, its total fundraising net is $800,000 ($1,000,000 – $200,000).

2. **Dependency quotient.** This measures how dependent a charity is on its top donors to fund its work (making it vulnerable to changing priorities), so all things being equal, a charity wants a lower dependency quotient. Here’s how it’s calculated:

   \[
   \frac{\text{Sum of contributions from five largest funders}}{\text{organization spending}} = \text{dependency quotient}
   \]

   Example: If an organization’s top five donors contributed $250,000 during the past three years, and the total organizational expenditures for the same three-year period was $1,000,000, then its dependency quotient is 25% ($250,000/$1,000,000), meaning it would have to replace 25% of its budget if it lost its top five donors.

3. **Cost of fundraising.** A measure of efficiency, the cost of fundraising measures how much it costs to raise money within your organization. All else equal, a lower cost of fundraising is better. Here’s how it’s calculated:

   \[
   \frac{\text{total fundraising expenses}}{\text{total fundraising}} = \text{cost of fundraising}
   \]

   Example: If an organization spends $50,000 to raise $150,000, then its cost of fundraising is 33% ($50,000/$150,000). Or it spent 33 cents to raise $1.

   It can be hard to achieve both a low level of risk (low dependency quotient) and a high rate of return (low cost of fundraising), in part because the dependency quotient and the cost of fundraising tend to have an inverse relationship: A low cost of fundraising typically exists alongside a higher dependency quotient, and vice versa.

   Broad-based fundraising efforts—tactics like direct-mail campaigns or special events—typically bring in a larger number of low- to mid-level donors and tend to be more expensive compared with major gift solicitation or foundation fundraising, which tend to bring in a smaller number of large-scale gifts that cost less but result in greater dependency.
Other actions nonprofits can take to enhance fundraising effectiveness

- **Match donor behavior.** We encourage nonprofits to study why their donors donate to their organization specifically—and tailor their messaging accordingly.

- **Leverage analytics.** Charities need to know their data to understand the demographics of their core contributors and to identify new prospects.

- **Reduce obstacles to giving.** Charities must update their donation channels (including online and mobile giving platforms) to keep pace with changing consumer behavior.

- **Improve donor communications and impact reporting.** What story does a charity want to tell its stakeholders? What would mission success look like?

- **Be transparent and consistent in reporting.** Report data at least quarterly to keep stakeholders apprised. Share metrics and finances broadly.

**Key questions, issues, and recommendations**

- **Who are your donors and why do they give to you?**
  We are struck by how often nonprofit boards are unable to answer this question. Knowing the demographics of your donor base is critical in terms of what types of fundraising you choose to emphasize, how you communicate with donors, the information you provide, etc.

- **What type of fundraising best fits the profile of your donors?**
  Nonprofits should focus on the methods that best fit their situation and are most effective for their donors. Even the largest and most sophisticated nonprofits understand they can’t be all things to all people. There are good reasons Harvard doesn’t run radio ads encouraging listeners to “donate your car, working or not” and why your local food bank doesn’t have a staff of 20 looking for major gifts with naming rights.

- **Executive director/president and the board must play a role.**
  It’s essential that the leadership of any charity be ready to serve as the face of that nonprofit and help raise funds. Donors don’t just donate because they identify with the charity’s mission, but also because they feel connected with and trust the organization’s leadership.

- **There are no shortcuts to success.**
  Four full-time equivalents will, with a high probability, produce reasonable sums in five or six years, but you can’t short-circuit the process. Hiring one person and firing them because they haven’t produced results in two years will ensure that you never escape the revolving door of fundraising failure.

- **Think twice before you engage third-party fundraising firms to save money.**
  The problem is that the third party—not the nonprofit—develops the contacts, knowledge, and expertise. We encourage nonprofits to use internal resources wherever possible to build and control the organization’s knowledge of donors.

**Risk management**

As nonprofit organizations consider risk management, we encourage them to ask:

- **What are our major risks?**

- **How do we know we have identified all risks?**

- **What is our plan to mitigate the identified risks?**

We think about nonprofit risk management in terms of two buckets:

1. Investment risk
2. Organizational risk
1. Investment risk: Risks to the investment portfolio of the nonprofit

In recent years, as bond yields have fallen and U.S. equity benchmarks have reached all-time highs, many nonprofit investment committees have increased their allocation to risky assets in the hope of higher returns. We encourage them to think about whether they’ve examined all the potential sources of investment risk and whether their portfolios have the right risk profile for their institution.

One of the trends we’ve witnessed is that many nonprofits have been so focused on improving returns by playing offense that they’ve allowed their defensive asset allocations to wither away. We suspect that they are so focused on low standard deviation of returns that they’re not thinking about other measures of investment risk.

For example, many alternative investment strategies exhibit low standard deviation of returns during normal markets. Hedge fund managers pursuing long/short strategies, and who are focused on risk controls, will often display bond-like standard deviations during placid markets, but the deviations can spike during market disruptions (though typically less than long-only strategies). Returns don’t appear volatile because private investments in buyouts, venture, and real assets are not marked-to-market daily. However, returns are highly correlated with equities over time.

We encourage nonprofit investment committees to examine the underlying properties of their investments and to think about other metrics for measuring investment risk—not just standard deviation of returns but drawdown risk, permanent loss of capital, shortfall risk, and risk versus uncertainty.

A 60/40 stock/bond portfolio for the 100 years from 1913 to 2013 had an annual real return of 5.1% with volatility of 11.8% (compared with returns of 1.8% for bonds and 6.6% for stocks, with respective volatility of 6.7% and 18.6%). So stocks have standard deviations that are almost three times greater than bonds.

Drawdown risk

Most nonprofits care more about negative variation from the mean, so committees also look at drawdown, which is the decline in net asset value from a historical high point.

The bond portfolio cited above, with an average real return of 1.8% and volatility of 6.7%, had a maximum drawdown of 59%. The stock portfolio had a maximum drawdown of 79%, but the 60/40 portfolio had a maximum drawdown of 52%. Nonprofits with clear spending requirements must design portfolios that constrain drawdown.

Permanent loss of capital

During the global financial crisis, the Standard & Poor’s 500 Index suffered a drawdown of about 50% from October 2007 through March 2009. It has recovered all of that decline (and more). However, if a nonprofit saw an S&P portfolio drop from $1,000 to $500 and then sold it, it locked in a permanent loss of capital because it couldn’t benefit from the rebound of what it had sold.

Shortfall risk

Shortfall risk refers to the likelihood that a portfolio will not exceed the minimum return needed by a nonprofit. Shortfall risk, like drawdown, measures downside risk.

Uncertainty versus risk

In 1921, Frank H. Knight of the University of Chicago published Risk, Uncertainty and Profit. In this classic study, Knight offered: “Risk applies when the outcome of a given situation is unknown but we can measure the probabilities” (we don’t know what the next toss of the dice will yield, but the odds of rolling “12” are 1 in 36).
Uncertainty arises because of incomplete knowledge about the manner in which events occur, a lack of predictability, and the possibility of unprecedented behavior or events (the dice roll off the table). It is not quantifiable.

Our message to nonprofits is straightforward: No single definition of investment risk is sufficient, and we encourage nonprofits to use multiple measures of risk, with a particular focus on downside measures.

2. Organizational risk: Threats to the existence of the nonprofit

In Risk Management for Nonprofits, authors from SeaChange Capital Partners and Oliver Wyman highlight that “nonprofits lack the indicators of organizational health that reach the directors of for-profit businesses, such as stock prices or credit spreads. They also lack outside parties like activist investors, rating agencies, stock market analysts, and short-sellers to encourage them to step back and take an objective view of the situation.”

This perspective underscores the importance of assessing organizational risks for nonprofits. We see organizational risk as being composed of internal factors and external factors.

Internal risk factors
Theft: Embezzlement of funds could be perpetrated by an employee, a volunteer, a vendor, or even a client. It can also take the form of fundraising fraud, which has grown more prevalent as online opportunities for giving have increased.

Financial insololvency: While financial health may differ across nonprofit verticals, 10% of nonprofits are technically insolvent, according to GuideStar, an information service specializing in reporting on U.S. nonprofits. Financial health affects small and large organizations alike and can pose a critical threat to the organization’s mission.

Lack of controls: A lack of accounting controls or procedural controls (what oversight exists of nonprofit officers, for example) is a common source of nonprofit risk.

Poor governance: A board’s directors and officers are responsible for maintaining the nonprofit’s vision and developing its long-term strategy. Poor governance can result in lack of oversight and loss of mission.

Regulatory compliance: Nonprofits must ensure they are following IRS regulations to maintain their tax-exempt status. They must demonstrate that the funds are being used for charitable causes and not for personal gain.

Succession planning: The departure of key personnel or unplanned executive retirements can create hiring challenges for nonprofits and compromise institutional memory. Effective succession planning should incorporate all possible scenarios.

External risk factors
Funding variability: Nonprofits differ greatly in their dependence on philanthropy. Depending on your organization’s funding model, potential changes—such as nonrenewal of an important funder or a change in government priorities—should be considered.

Cybersecurity: Cybersecurity planning is a complex but mandatory element of today’s risk management landscape. According to a November 2018 report released by the Nonprofit Technology Enterprise Network, nearly 39% of nonprofits don’t have a cybersecurity policy and 6% of nonprofits don’t know if they have a cybersecurity policy.

Given these events often have significant reputational, legal, and financial costs attached, it’s imperative for organizations to develop and implement policies as well as train staff. These measures may not prevent a cybercrime, but they will allow the organization to better understand the risks involved and enable faster recovery should an event occur as stated in guidance released by the American Institute of Certified Public Accountants (AICPA).
Emergencies: Nonprofit organizations should consider the possibility and impact of emergencies, such as natural disasters, political riots, and other disruptive events.

Reputational issues: Nearly all the risk factors listed above can result in varying degrees of reputational risk if they are not successfully identified and mitigated. Reputational issues can be particularly damaging to charities that rely heavily on fundraising.

The role of fixed income in nonprofit portfolios

Ballast against market downturns—bonds versus equities and bonds versus cash

Bonds, particularly government bonds, play a unique role in portfolios, as they have historically been negatively correlated with stocks and other risky assets. They have served as a ballast against equities—which are a much more volatile asset class—and consequently are a key weapon for weathering market downturns.

We hear nonprofits express two fears to justify their low weightings to fixed income: they worry that a sizeable fixed income allocation in a low-rate environment will negatively affect their portfolio return, and they worry about the possibility of capital losses should interest rates increase meaningfully. These are both reasonable concerns.

Low interest rates are an indicator of an environment where returns on all assets are likely to be modest. We are not in a world where we can ignore bonds and blithely assume returns in other asset classes will be better. (There is no free lunch in capital markets apart from diversification.)

Rates are low for a variety of reasons beyond central bank easing: aggregate global demand remains subdued, trillions of dollars of capital around the world are searching for investments and chasing returns, and ever-increasing computerization and technology penetration coupled with excess global supplies of labor appear to be exerting continued downward pressure on goods pricing.

Given the prospects for low returns across a range of asset classes, nonprofits should be clear about the risk-return trade-offs they are making. If they believe they can make 2.5% in bonds and 4.5% in equities, is the incremental possible investment gain from risky assets enough to justify a much higher standard deviation of returns?

It’s a financial truism that the price of a bond (or a bond fund) with a duration of five years will decrease by 5% for every 100 basis-point increase in rates. This ignores at least two important considerations: owners of the bond or managers of bond mutual funds will collect the same coupon and principal payment they were promised when they purchased the bond (particularly if it is a risk-free government obligation). Moreover, if rates are rising because central banks are tightening, the magnitude of losses in riskier assets can be many times greater than losses in bond portfolios. Historically, equity market declines of 20%-25% are not atypical.

We believe the return foregone by including high-quality fixed income pales in comparison to the magnitude of equity losses incurred during market downturns, losses that can be mitigated through diversification.

It’s critical to note that not all bonds have this defensive property: high-yield bonds are highly correlated with equities and quite risky. Although high-yield bonds tend to be less sensitive to interest-rate risk than investment-grade bonds, they are subject to significant credit risk.

Cash also doesn’t have this defensive property. It may hold its value during equity downturns but does not have the same inverse relationship as high-quality bonds. While cash yields may seem more attractive in a flat or inverted yield curve environment, cash does not help to offset temporary declines in equity values. Conversely, bonds have been shown to appreciate in price during equity downturns, depending on credit and duration factors. This underscores the critical role played by core bonds in a diversified portfolio.
**Shift to risky assets—bonds versus hedge funds**

Given the diversification properties of fixed income, nonprofit portfolios have traditionally been benchmarked against a 60/40 stock/bond allocation. Yet many nonprofits have very small (less than 10%) allocations to fixed income, a far cry from the 40% of a 60/40 blend.

This is due in part to a trend over the past decade where nonprofits have purchased hedge funds or other illiquid alternative assets using portfolio funds formerly allocated to bonds. Given that hedge funds have exhibited bond-like volatility over the past decade, investors hope to generate returns that are more attractive than what they can get from bonds while providing the portfolio with the same correlation properties as bonds.

The problem is that there is nothing inherent in the holdings of most hedge funds that will serve to ensure the returns are negatively correlated with the equity market. In fact, the low standard deviation is more the result of careful risk management than of the intrinsic properties of the assets owned. The correlation properties of hedge funds can vary widely depending on the strategy and may become less negative during periods of market volatility.

**Allocating within fixed income—government bonds versus corporate bonds**

If you have less than 10% allocated to bonds, you’ve reduced your defensive assets and need government bonds, as nothing else has the needed negative correlation properties. If you have a larger allocation to bonds and are in it for the long term, you can take some credit and spread risk in order to obtain additional return.

However, nonprofits need to understand that spreads to Treasuries move over time. High-yield spreads gapped out to as much as 1,800 basis points over comparable Treasuries during the 2008–2009 global financial crisis (versus recent levels of 400). Even investment-grade bond spreads went to 650 basis points over comparable Treasuries (versus recent levels of 115).

Also worth noting is that investment-grade bonds have seen a steady decrease in overall credit quality and an increase in leverage, differentiating them from investment-grade bonds of the past. In particular, the amount of debt in BBB-rated bonds—the lowest tier considered to be investment-grade—has increased substantially, making up almost 60% of the investment-grade universe now as opposed to 33% in 2010. There is a high likelihood that some portion of BBB bonds will be downgraded in the coming years, shifting the risk profile of investment-grade and high-yield bonds.

**How nonprofits can think about cash and short-term liquid investments**

- We’ve long observed that nonprofits mean several different things when they use the term “cash,” which can create confusion. Cash can refer to:
  - Liquid funds used to pay wages and benefits, fund grants, pay bills, etc.
    - The IRS recognizes this use when it permits private foundations to reduce their endowment value (for purposes of calculating the 5% payout requirement) by 1.5% for “cash deemed held for charitable purposes.”
  - A source of liquidity for emergency operating needs, such as cash reserves.
  - A source of liquidity for planned spending over a defined period of time. A foundation plans to fund grants at the end of a quarter and liquidates a portion of its endowment to make the payments. Alternatively, a university is constructing a new building and sets aside funds to be disbursed over the next two years.
  - “Dry powder” that can be used to buy securities during times of distress or to fund capital calls.
  - An investment option, either explicit or default.

As an explicit investment option, cash (defined here as 91-day Treasury bills) has not produced outstanding returns (from 1970 to 2017 it returned 4.8% annualized with a 3.5% standard deviation).
Why do people invest in it? Generally for two reasons:

1. It is a short-term store of value, particularly during periods of inflation, which affects most other forms of investable assets (except some commodities).
2. When the yield curve inverts, investors will often move into cash for defensive purposes.

Cash can become a default investment option, often as a result of investment committee uncertainty or as a result of other portfolio shifts. For example, an unexpected distribution from a buyout fund might catch a committee by surprise with no immediate plans for how to invest the proceeds; or a redemption from a manager is received before a new manager is ready to accept the funds.

Organizations that seek to support their geographies will often invest in certificates of deposit (CDs) issued by minority-owned institutions (community development financial institutions, or CDFIs).

- How nonprofits invest cash is largely a function of how the cash will be used.
  - Cash that is needed near-term to pay grants has to be available, and the nonprofit typically doesn’t want to risk any variability in the nominal value. Many nonprofits will put near-term cash into a checking account, which generally pays no interest but comes with a level of government protection.
  - Cash that is part of the asset allocation might be invested to produce a higher return, as the nonprofit is willing to take on the possibility of some downside risk to obtain some extra yield.

- How nonprofits invest cash may also be a function of time horizon and desire for yield.
  - A nonprofit with a construction fund designed to be spent over several years might allocate the near-term portion to highly safe instruments while taking some investment risk with a longer-dated portion of the pool.
  - We encourage nonprofits that would like to attain some extra yield on their reserves to think about reserves as comprising three tranches: short-, intermediate-, and long-term needs.

The first tranche is the equivalent of a working capital pool for funds needed for the ongoing operational and day-to-day expenses. The second tranche would be the “reserves” pool, and the third would be for unspecified longer-term needs. It’s important to manage the different types of instruments within each pool (whether the pool is restricted, unrestricted, or board-designated).

- Different nonprofit sectors (verticals) have vastly different experiences with cash. Hospitals and universities, for example, routinely have large operating cash requirements and can have cash pools in the billions of dollars. They are more familiar with the ins and outs of “tiering” of cash, meaning having varying time frames and risk appetites for different pools (or even different parts of the same pool).

- We encourage organizations to spell out their approach to treating cash in their investment policy statements (IPS). Nonprofits with large and/or varied cash pools might think about having a separate IPS for cash.

- We think it’s helpful for nonprofits to think about whether they wish to make short-term investments themselves or work through intermediaries, such as mutual fund companies, banks, or brokers. If they choose to work through intermediaries, are they comfortable with their understanding of the investment and of the intermediary?

An entity can purchase T-bills directly at auction if it has the $100,000 minimum needed and a brokerage relationship to execute the paperwork. However, it’s easier for most nonprofits to invest in a money market fund to avoid administrative complexity.
It boils down to how a nonprofit answers two questions:

1. Does it have the staff needed to pay attention to the administrative requirements of a given investment?

2. Is staff (or the investment committee) comfortable with their understanding of the nature of the intermediary (bank, brokerage, mutual fund, or other entity) and about the regulatory regime that governs dealings with the intermediary and informs the safety of the investment?

• The instruments nonprofits use to invest cash vary by default risk, principal risk, volatility, liquidity, and maturity.

**Default risk**

As Professor Aswath Damodaran has written, to be truly free of the risk of an issuer defaulting, investors must “rule out any security issued by a private firm, since even the largest and safest firms have some measure of default risk. The only securities that have a chance of being risk-free are government securities, not because governments are better run than corporations but because they control the printing of currency. At least in nominal terms, they should be able to fulfill their promises.”

**Principal risk**

We define this as the chance of getting back less than a (nominal) dollar for every dollar invested. There is a spectrum of risk, ranging from very low (FDIC-insured checking accounts and CDs as well as money market funds that invest in government securities), to low (commercial paper and money market funds that invest in issuers other than the federal government), to moderate (short-dated municipal and commercial bonds).

**Volatility**

How much does the price of an instrument move around? Once again there is a spectrum. Many short-term investments don’t trade, so have no visible standard deviation (think about a CD or a bank account). Many others, such as 91-day T-bills, are sold at discounts to par and don’t see much volatility. However, the price of a short-term instrument might vary, though the standard deviation is generally less than 1.

**Liquidity**

It’s always important to differentiate between the liquidity of the underlying instrument (e.g., commercial paper) and the liquidity of the vehicle used to make the investment (e.g., a money market mutual fund). Often the instrument is not liquid, but the vehicle owns thousands of them with staged maturities, so the fund is highly liquid.

Nonprofits need to be aware that investments such as retail CDs are sold for long terms and an early redemption will impose a penalty. This is also the case for exchange-traded notes sold by investment banks.

**Maturity**

Many cash investments are sold with a fixed maturity (30-day commercial paper, 91-day T-bills, 2-year CDs), while others (checking accounts or money market mutual funds) have no stated maturity.
Granting discretion over the management of investment assets

In the 2019 edition of this publication, we outlined four questions nonprofits should think through before granting investment discretion to an outsourced chief investment officer (OCIO):

1. Why would we grant discretion?
2. What sort of OCIO do we wish to hire?
3. What are some of the questions we must ask as part of our due diligence?
4. What is the role of the investment committee after we’ve granted discretion?

As clients contemplate these questions, it’s important to consider how the OCIO model, as well as client needs, have evolved and whether these changes are relevant for your organization.

Fiduciary awareness

An increase in awareness around fiduciary responsibility—the duties of loyalty, care, and obedience—has prompted nonprofits to focus on how they are spending their limited time. For investment committee members who find themselves spending most of their time on short-term decisions (i.e., manager search and oversight), hiring an OCIO can enable them to shift their focus to critical long-term topics, such as investment strategy and governance.

Alternative capabilities

Since the inception of the OCIO model, institutions have decreased their allocations to traditional investments, such as stocks, bonds, and cash, and moved into illiquid alternative strategies to generate additional return or decrease portfolio volatility. As these strategies have grown in popularity, so too has the complexity of managing the requisite due diligence and monitoring. For nonprofit organizations that are interested in alternative investments but lack the time and resources to analyze them, an OCIO can add value. However, it’s critical to work closely with your OCIO to understand your contract terms. It is often the case that should you decide to switch your OCIO, you may still be required to pay fees to your previous provider for select illiquid alternatives (especially private equity).

Client service

Historically, performance has often defined how nonprofits select and assess OCIO providers. However, search consultants, who are charged with assisting nonprofit organizations to evaluate and hire an OCIO, have observed that client service has emerged as a key driver in these conversations. Nonprofits highly value clarity around investment strategy and frequency of communication, and we may see providers recalibrate their approach to align with these shifting expectations.

Holistic approach

Increasingly, OCIO providers are being asked to take a more holistic approach to investment management and demonstrate an understanding of the environment in which their nonprofit clients operate. For example, a foundation may ask its OCIO for education on subjects such as the impact of multiyear grants on spending policy. A hospital may request a system-level perspective on managing multiple pools in an effort to bolster its liquidity and debt rating.
Due diligence considerations for alternatives

Illiquid alternatives have the potential to offer nonprofits additional sources of return, portfolio diversification, risk reduction, or inflation protection depending on the type of investment involved. However, challenges such as dispersion of returns (leading to high rates of fund closures), shifting persistence of returns, access to the best managers, and continuing high fees make it difficult to obtain these benefits.

Due diligence of manager

We believe robust due diligence is essential to effectively combating such challenges and establishing a successful alternatives program. Adequate due diligence on alternative managers is more complex and labor-intensive than that performed on long-only managers of conventional assets. It involves assessing operational risk (risks associated with accounting, operations, compliance, audit, etc.) as well as financial risk (risks associated with bad investment performance and excessive investment risk). Relevant areas of focus when conducting due diligence on an alternatives manager include backgrounds of personnel, commitments to the fund, firm structure, investing process, strategy, service providers, and competitive environment.

Questions to ask a consultant or advisor:

- How do you charge us for using your illiquid alternatives capabilities?
- How do you find, assess, select, access, and monitor alternative investments?
- What are your due diligence capabilities and processes?
- How will you manage our capital calls and distributions?
- Do you have any conflicts of interest?

Framework for investing in alternatives

We encourage nonprofits who wish to successfully invest in illiquid alternatives to:

1. Ascertain the reasons behind their decisions.
2. Be clear about the beliefs they possess concerning alternatives.
3. Question the veracity of their beliefs.
4. Prepare for the challenges associated with going down that path.

Due diligence of consultant/advisor

It’s usual for due diligence providers to spend 400–450 hours performing initial diligence on a fund and then 75–100 hours each year updating their findings—a labor-intensive, expensive process. If your nonprofit can’t afford to invest the requisite time and money, you may decide to hire a consultant or OCIO. If so, you must be certain that they are willing to invest the hours and dollars required to do the job properly. Additionally, they must be able to engage personnel with the necessary skills and experience, as well as secure access to the desired investments.
References

American Institute of Certified Public Accountants (AICPA).


GuideStar, information service specializing in reporting on U.S. nonprofits.

Knight, Frank H. 1921. Risk, Uncertainty and Profit.


Important information

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

Investments in bonds are subject to interest rate, credit, and inflation risk.

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

Although the income from the U.S. Treasury obligations held in the fund is subject to federal income tax, some or all of that income may be exempt from state and local taxes.

Please remember that all investments involve some risk. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. 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.

Past performance is no guarantee of future returns.