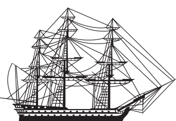
VANGUARD COMMENTARY

Asset allocation and market volatility: A nonprofit playbook

Vanguard's nonprofit clients periodically express concerns about how best to weather a market correction. A common question fielded by investment consultants in Vanguard's Institutional Advisory Services Group (VIAS) is "How do we protect ourselves and our spending against the inevitable downturn?" There is no one solution, but we've identified a common set of factors that we believe clients wrestling with this question should consider.



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There is no one-stop approach to addressing a potential downturn. Nonprofit boards and management should consider options based on the unique circumstances and risk profile of their organization. Factors to consider include those listed below.

A thoughtfully-crafted investment policy statement

- Does your organization have a target allocation within its Investment Policy Statement (IPS) that meets its long-term objectives, including appropriate asset diversification and rebalancing policies? A well-crafted IPS serves as an institution's roadmap and first line of defense.

The unique attributes of your organization's investment pool

- What restrictions are there on the investment pool (e.g., portion of assets that are restricted versus unrestricted) and does you organization tend to receive a large proportion of restricted gifts?
- How liquid are the assets in your investment pool?
- How much do costs impact your returns?
- How does your organization currently fund spending (e.g., keep one-year's worth of spending liquid or liquidate assets as needed?)

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 endowment distribution represent?)?
- How dependent is the overall enterprise on the market? Do gifts of marketable securities represent a noteworthy portion of your revenue stream? Are there other meaningful market-based dependencies of your organization?
- Are there other pools of assets outside of the endowment, such as reserve funds, sources of cash flows or funding, that your organization can use to meet operational needs?
- 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 enhancement)?
- If a foundation, how flexible is your institution's spending? For instance, are a major portion of the grants your organization makes for a multiple year period?

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

Asset allocation, diversification and rebalance policy

Maintaining a strategic asset allocation which meets your institution's long-term needs offers the best defense to an institution's portfolio over time. Diversification within an organization's portfolio also serves as an important line of defense in terms of reducing volatility. For instance, to the extent the equity market sells off, high quality bonds should generally serve as an offset. Importantly, a clearly articulated rebalancing policy to which an organization adheres is an important way to mitigate volatility, as you are "buying low and selling high."

Vanguard does not encourage tactical changes to an institution's asset allocation, but rather only encourages changes to the extent something has changed in the long-term (for example, you receive a very large gift, or a mission critical short-term need occurs). Tactical changes must be consistently accurate to be effective, which is virtually impossible. During the Global Financial Crisis in 2008/2009, Vanguard-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 from gifts

To the extent that an investment is unrestricted, the more flexibility there is to spend from corpus. That said, UPMIFA (adopted in almost all states) allows spending from corpus for "underwater endowments" (where market value is below gift value). 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 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 the institution some discretion to address its needs on a short-term basis, during a crisis period.

Liquidity of investment pool

The degree of liquidity of an investment pool can influence flexibility, and even the ability to easily rebalance. At Vanguard, we generally use 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 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. Some endowments with substantial allocations to less liquid assets are considering how they would source liquidity within their portfolios, recognizing that this is an important evergreen exercise.

Costs

Should we find ourselves in a low or negative return environment, using lower cost products may allow an institution to keep more of its returns than otherwise. Given the difficulty in predicting investment returns, we recognize that costs are one of the few factors that an institution can control.

Funding spending

Given today's relatively low interest rate and dividend yield 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. Some institutions with less tolerance for volatility have elected to liquidate and set aside in short term reserves 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. 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 an institution should consider and in the Appendix, we share an array of options sometimes used by 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 the fiduciary duty they have as members of investment committees for nonprofits. They are bound by duties of care, loyalty and obedience to their organizations, as described in *Duty, opportunity, mastery: Investment committee best practices* (Vanguard, 2018). These responsibilities speak to the degree of professionalism and responsibility to which committee members should adhere—which is different than the flexibillity they have with their personal assets.

No one stop solution

As we noted above, there is no single solution for every institution—clearly risk profile, investment pool structure and balance sheet flexibility are all part of the equation. But, we continue to recognize that a long-term perspective, low-cost, diversified and disciplined approach serve institutions well far into the future.

So, what should you do? If you are a Vanguard Institutional Advisory Services (VIAS) client and have concerns around market risk, discuss them with your assigned Investment Consultant. We would be happy to work with you to review your organization's Investment Policy Statement and to help craft a plan specific to your organization. Vanguard's relationship management team can also begin to address some of these issues with our investment only clients, who may not yet have a full consulting relationship with Vanguard. Finally, we would encourage you to explore the resources we have on our institutional website and nonprofit solutions section, in particular, for more information. 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.

Useful references for your organization

A guide to best practices for nonprofit fiduciaries

Sample *Investment Policy Statement*

Six key topics nonprofit organizations should consider in 2018

Is 5% the right return target for institutional investors?

Vanguard's Principles for Investing success

Duty, opportunity, mastery: Investment committee best practices (Vanguard, 2018

Appendix — Strategies considered to mitigate the impact of potential market changes to spending and assets

Focus	Strategy	Implementation	Considerations
Use market volatility to your portfolio's advantage	Rebalance	• Terms/timeframe typically in IPS • Can use calendar or % deviation from targets 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	• Opportunity cost of holding cash for extended time period
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
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 re-entry • Susceptible to emotion, intuition and hindsight bias
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 to your organization.

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