Brown ADVISORY
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STRATEGIES FOR NONPROFITS

Making More From Less

Many nonprofits face difficulty maintaining their funding levels and have called upon their investment committees to relieve the budgetary stress. Brown Advisory has helped organizations improve their outlook by taking deliberate steps to modify their investment policy, portfolio construction, asset allocation and manager selection.

The directors at many nonprofits today are finding that, by some measures, working for the common good has never been so tough.

The budget gap for nonprofits has widened because of a slump in their three sources of funds—donations, grants and portfolio returns. Charitable giving to foundations in 2015 shrank 3.8% from the previous year to $42.3 billion, according to Giving USA.[1] Also, from fiscal year 2009 until fiscal year 2016, federal agencies cut annual grants to private and public organizations by 3.4% to $652 billion, according to usaspending.gov, a Treasury Department website.

Yet the hardest funding challenge for many nonprofits is achieving sufficient portfolio returns. Meeting a hypothetical annual gain of 7.5% has grown increasingly difficult during the past decade as interest rates sank to record lows. The slower advance in U.S. stocks since early 2015 has also constricted funding. Indeed, compared with 1995, investors in 2015 needed to take on nearly three times more potential volatility in order to achieve a 7.5% return, according to an estimate by Callan Associates.

Amid the tightening funding squeeze, some nonprofits must focus on maintaining rather than expanding their missions. Stopgap measures, such as increasing portfolio withdrawals, may erode the total amount of a portfolio, thereby impairing annual returns and eventually prompting deep budget cuts. As a result, nonprofits need to consider whether to stage an annual capital campaign or curtail their spending and missions.

Alternatively, nonprofits can boost potential portfolio returns, which often means tolerating more risk and illiquidity, through a recalibration of asset allocation—the single biggest driver of long-term gains. It also requires meticulous selection of investment managers and an openness to a more complex and diverse range of assets than was in the standard investment portfolio of the 1990s. We have found that the following four steps help nonprofits meet their investment goals:

Review investment policy. Nonprofits buffeted by the shift in the funding outlook should reexamine their spending, reserve targets, long-term budget objectives and expected income from outside sources. A stale investment policy may impede efforts to meet today's budgetary

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challenges. By ensuring the investment policy statement aligns with current market conditions, we can help nonprofits determine the return necessary to provide for planned spending or a buildup in reserves, while keeping pace with inflation and accounting for a spectrum of possible bull- or bear-case scenarios.

Consider changes to portfolio construction. Such a reassessment is essential given that the range of positive and negative outcomes for financial markets has widened during the past year. Rising economic and political risks—including weak global growth and increasing nativism and protectionism in several countries, such as the U.S., U.K. and Germany—have fueled volatility.

To maintain stability in such a climate, we recommend constructing a portfolio with three components: 1) sufficient liquidity to meet near-term operating needs and maintain proper reserve levels, allowing for a separation between financial and investment decisions; 2) a core, long-term component incorporating a diversified mix of investments offering both stability and growth; and 3) an opportunistic portion that seeks outsized returns from timely strategies. We believe that this structure enables our clients to contain risk while meeting their long-term objectives for returns.

Reassess asset allocation. Some studies have found that, over the long term, the balance of asset classes within a portfolio determines more than 90% of performance. With that in mind, to achieve a 5% return before inflation, we might recommend a 60%/40% mix of equities and bonds. In contrast, an investor would need to focus far more on equities and alternative securities* in order to secure a 7.5% gain. Such a return would allow for a spending rate slightly above 5%, assuming 2% inflation.

That was not the case two decades ago. An investor in 1995 could anticipate a 7.5% return with a portfolio invested exclusively in bonds. Moreover, the variance in return, or standard deviation, was a modest 6%, according to Callan.

Today, with interest rates near record lows, an investor aiming to hit 7.5% needs to assemble a more illiquid, complex and potentially volatile mix of assets, including small-cap stocks, real estate*, private equity* and non-U.S. stocks such as emerging market equities. For example, we added small-cap stocks to some nonprofit portfolios during their 2016 rally because of their relatively low valuations and limited vulnerability to flagging global economic growth. Similarly, emerging market stocks in Asia sold at attractive valuations, while posing less economic and political risk than their counterparts in Latin America and other regions, in our view.

Private equity and private equity real estate* increase portfolio diversification and, although relatively illiquid and complex, have the potential to meaningfully outperform traditional public investments such as equities and bonds. Private equity real estate—which includes debt and equity investments in property—reduces the risks to a portfolio from inflation and often generates steady cash flow.

With a tradition of offering customized solutions in partnership with nonprofit, foundation, and endowment clients, Brown Advisory continues to evolve in response to our clients' changing needs. This flexibility helps us to ensure that our approach addresses each client's goals. To better reflect our breadth of solutions, Brown Advisory has renamed the OCIO team as the Balanced Institutional team. While the landscape for our clients may have changed, our approach to navigating these challenges—from unusually low interest rates to increasingly complex investments—has not.

Such asset classes have taken up much of the share previously earmarked in the representative portfolio for fixed income, according to Callan. Callan estimated that a portfolio in 2005 could achieve a 7.5% annual return with a 52% allotment to bonds. Now, that allocation has fallen to about 12%, with the remainder in more volatile assets.

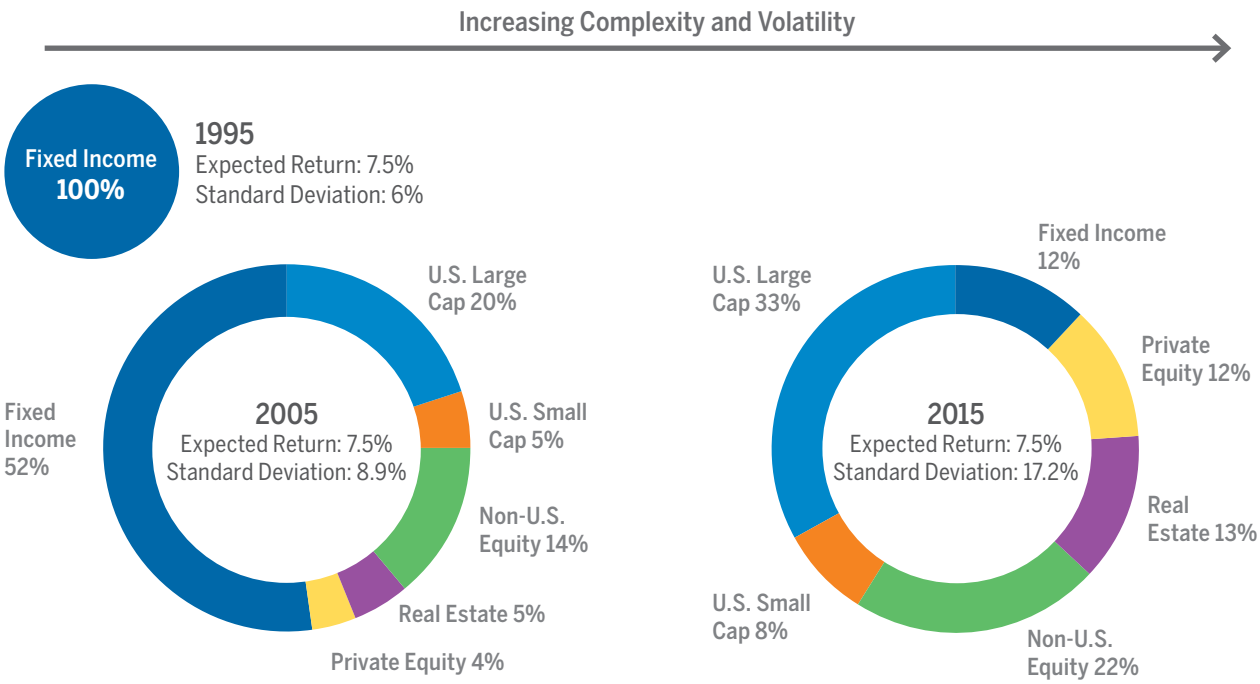
Indeed, with such a change in allocation, total asset valuation in any given year may swing in terms of standard deviation by as much as 17%. (Please see chart below.) Nonprofits are better positioned to aim for a 7.5% annual return if they are willing to accept higher volatility and illiquidity, and if they intend to sustain their portfolio at a steady level in perpetuity with a predictable rate of withdrawal.

Choose investment managers with solid long-term performance. Selection of managers who are unable to beat their benchmark over a full market cycle can undermine the performance gains from proper asset allocation. The record shows that active managers who outperform are rare among U.S. large-cap strategies. Only 12% of U.S. large-cap equity managers exceeded the gain of their benchmark during the five years ending Sept. 30, 2016, according to an analysis of Morningstar data.

The data reflect a cumulative trend and do not mean that a U.S. large-cap equity index beats 88% of active managers year after year. Moreover, even top managers are unlikely to outperform every year. Still, during the past 10 calendar years, the Standard & Poor's 500 Index lagged the average large-cap manager only once—in 2009. This is why it is important to partner with an investment advisor with a proven track record in selecting managers based on rigorous due diligence.

STAYING ON TARGET

During the past 20 years, achieving a target return has often meant adding more complex and volatile assets to a portfolio.



SOURCE: CALLAN CAPITAL MARKET PROJECTIONS

Active managers in some market segments beyond U.S. large-cap stocks have a higher tendency to generate competitive returns over the long term. About 40% of actively managed U.S. small-cap funds outperformed the Russell 2000® Index for the five years ending Sept. 30, 2016, according to Morningstar. The same can be said about funds invested in companies in developed countries other than the U.S.

The stakes of manager selection are especially high among venture capital funds. For the 20 years ending June 30, 2016, the top quartile of funds generated an annualized internal rate of return (IRR)[2] of roughly 20%, exceeding the gain among the median quartile by more than 23 percentage points, according to Greenspring Associates. In selecting managers, we look for strategies that focus on company fundamentals and that have repeatedly demonstrated success over an extended period of time.

We believe the harsh funding climate makes it imperative for nonprofits to take a hard look at their investment programs with the aim of averting budget cuts and a reduction in their missions. That means reviewing investment policy, amending asset allocation and enlisting strategies that add value over the long run. While not a panacea for all of a nonprofit's fiscal challenges, a thoughtful reassessment of investments from the ground up is a necessary and prudent step forward. *B*

The **Russell 2000® Growth Index** measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the small-cap growth segment. The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. Both indices are completely reconstituted annually. Russell® and other service marks and trademarks related to the Russell indexes are trademarks of the London Stock Exchange Group Companies.

The **S&P 500® Index** represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include market capitalization, financial viability, liquidity, public float, sector representation and corporate structure. An index constituent must also be considered a U.S. company. Standard & Poor's, S&P, and S&P 500® are trademarks/service marks of MSCI and Standard & Poor's.

*Alternative Investments may be available for Qualified Purchasers and/or Accredited Investors only.

1. *Giving USA 2016: The Annual Report on Philanthropy for the Year 2015.*
2. IRR is the aggregate, compound annual internal rate of return on an investment based on partnership inflows and outflows and the estimated value of unrealized investments at a specific date.