ROLLER COASTER MARKETS

What Keeps CFOs Up At Night?

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What keeps CFOs up at night?

BY JULIUS A. KARASH

Five years after the beginning of the economic recovery, financial managers at nonprofit organizations are still contending with major monetary concerns and the resulting impact on their operations.

What’s keeping investment and portfolio managers up at night revolves around equity market corrections, U.S. monetary policy and low operating reserves. Other worries focus on a decline in federal research funding, the whims of donors and even the vulnerabilities of a particular geographic location.

Many managers have responded to their concerns by adjusting investment strategies. Depending on circumstances and points of view, some managers have taken on more risk and others have pulled away from it.

No matter their circumstances or investment philosophies, most nonprofit portfolio managers have had to contend with volatility in the markets. “Somebody said the recovery was going to be a bunch of Ws, and it certainly was,” said Eileen Heisman, president and CEO of National Philanthropic Trust in Jenkintown, Pa., referring to the up and down nature of markets. “We saw a correction a couple of weeks ago. Those corrections can be hard on the budgets of everyday charities.”

That means financial managers must plan for robust markets as well as lean markets, Heisman said. To strike that balance, to do well in good years and not get trounced in bad years, an organization’s managers must decide how much risk they are willing to take. But, how much is too much?

Monica Issar, global head of J.P. Morgan’s Endowments and Foundations Group based in New York City, said the nonprofit managers “who have gotten it right during the recovery have shifted their portfolios more toward traditional equities globally. They have added to private equity, looking at areas like mezzanine (a hybrid of debt and equity financing), and the private credit mar-

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kets, for more mid-double digit returns.”

Some managers could benefit from increasing their risk assets, “because the capital markets environment has improved so much,” Issar said.

One nonprofit where managers have taken on more risk in search of better returns is Camp Fire, a youth development organization in Kansas City, Mo.

One of the reasons they have gone this route is low operating reserves. An organization such as Camp Fire should have nine to 12 months of operating revenue in its reserve account, said President and CEO Cathy Tisdale.

But Camp Fire’s national headquarters has only about three months’ worth of reserves, while reserve levels at most Camp Fire community-based affiliates (known as councils) range from zero to four months, Tisdale said.

They also face a challenge from donors who do not want to make long-term commitments to the organization, or only want to give to certain programs.

“Camp Fire is serving kids and teenagers and engaging their families,” Tisdale said. “If you’re talking about low-income kids who are typically academically disadvantaged, we’re not going to fix it in a year or two. So as long as a foundation takes a short view, then there’s no way we’re going to achieve the kinds of results that require more than a year or two of investment.”

To shore up its financial position against those challenges, Camp Fire’s board “determined that it would take more risk, by investing in a mixed investment of equities and bonds and other income-producing types of investments,” Gardner said.

She acknowledged the downside to that strategy. “In a recession or downturn in the market, you could lose a big piece of that. So, it’s a balance you have to take,” Gardner said.

Tisdale characterized Camp Fire’s portfolio as “mid-risk, mid-yield.” She said the strategy has enabled the organization to grow and revitalize its brand during the past three years. “When you’re rebranding and repositioning yourself in the marketplace, what you need during that first three to five years is capital,” she said.

Other organizations have sought to improve their finances and avoid risk at the same time. One example of where managers are following this strategy is Cold Spring Harbor Laboratory in Cold Spring Harbor, N.Y., which does research in areas such as cancer, neuroscience and quantitative biology. The laboratory’s leadership was forced to rethink investment strategy because of a decline in federal research funding.

“We have always relied heavily on grants from government agencies, most notably the National Institutes of Health (NIH),” said W. Dillaway Ayres, Jr., chief operating officer. “That’s a huge part of our income pie here. The problem is the pie is shrinking.”

Ayres said NIH funding of Cold Spring Harbor’s research budget has declined from around 60 percent to 40 percent in recent years. To make up for the shortfall, managers have focused more on private fundraising and made adjustments in investment strategy.

“When I first joined here 17 years ago, the (investment) portfolio allocation was more what I call plain vanilla,” said Ayres. “It was standard for endowments of our size, in the $200 million range, to be 60 percent in long equities in domestic and international stocks, and 40 percent in fixed income.”

They have added to private equity, looking at areas like mezzanine (a hybrid of debt and equity financing), and the private credit markets, for more mid-double digit returns. --Monica Issar

If you’re talking about low-income kids who are typically academically disadvantaged, we’re not going to fix it in a year or two. --Patti J. Gardner

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--Cathy Tisdale

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Ayres said institutions such as Harvard, Yale and Princeton universities changed that model by shifting toward investments such as hedge funds, private equity, venture capital and real estate. Cold Spring Harbor’s investments have changed along the same lines. Since 2008, the investment position in long-only stocks and fixed-income instruments has plunged, while the portfolio’s investment in hedge funds has shot up from zero to 44 percent.

However, Ayres said Cold Spring Harbor’s strategy is designed to lower the risk of its portfolio. “We used very conservative hedge fund strategies to do that. One of those strategies is called a long-short hedge fund. It’s a less risky strategy than just going long on stocks.”

Ayres said Cold Spring Harbor doesn’t expect its investment portfolio to outperform the S&P 500. “What we’re looking to do is perform nicely in a bull market, but protect ourselves on the down side.”

Another organization where managers have taken action to lower the risk profile is the Health Care Foundation of Greater Kansas City (HCFGKC). “Our foundation is a sustaining foundation, in that we have to live off our investments,” said the organization’s CEO Bridget McCandless, M.D. “We don’t do any work with donors, we don’t do any fundraising.”

McCandless said HCFGKC has moved more into investments such as real estate funds, hedge funds and infrastructure portfolios. “Those are much less liquid assets, and have a longer time horizon to maturity, but they also protect you against downside risk in the market,” she said.

McCandless said HCFGKC also has moved to passive management of most of its equities to minimize fees. “You should be able to meet the S&P for your returns without paying for the cost of someone to actively pick and trade stocks, hoping that they can beat the market.”

The New York Public Library’s managers adjusted its investment portfolio to make the risks more discernible, said Chief Investment Officer Todd Corbin.

The library’s portfolio has tilted toward more traditional investment strategies, such as long-only equities, he said. “We don’t do very much in fixed income, but I would say there’s a greater emphasis on traditional strategies as opposed to private equities and things like that. Those are represented in the portfolio, but incrementally we have more in traditional strategies today than before.”

The reasoning behind the library’s investment adjustment is that the risks that come with more traditional investments are “somewhat more transparent,” Corbin said. “You know what they are – that’s the important feature.”

Corbin has been concerned regarding issues such as the direction of Federal Reserve Bank policies and high asset prices, as well as the vulnerability imposed by the library’s “New York-centric” nature.

“The correlation of our funding sources is quite high,” Corbin said. “We are heavily reliant on public funding, primarily from the City of New York, and to a lesser extent from the State of New York. Obviously the financial services industry is very important to the city and the state. When we went through the crisis, the city and state faced their own sets of challenges financially, and the library felt the impact of that in the form of reduced funding.”

Besides the greater transparency of risks that come with the new investment strategy, Corbin said the library managers also like the lower fees that accompany more traditional investments. “If we agree that forward-looking returns are going to be more modest than what we’ve seen over the past five years, paying high fees eats up a bigger percentage of your return.”