

OUTLOOK 2012:

The Top 10 Investment Priorities for Nonprofit Organizations



With the expectation that global capital markets will continue to be volatile in 2012, nonprofit organizations face a challenging year ahead in the management of their investment portfolios. One paramount issue brought on by ongoing volatility has been how investment committees manage risk within the portfolio in conjunction with risks that economic trends present to the overall organization. This has become even more challenging in a time when due diligence requirements have increased, investment options continue to evolve and become more complex, and resources have remained flat or even decreased.

INTRODUCTION

While many nonprofit investment committees are focused on investment objectives and overall asset allocation, there is an increased need to focus on the impact that portfolio decisions have on organizational finances. When setting spending policies, what is the right balance between providing support to the organization and making prudent decisions in the best interest of the investment portfolio's perpetuity? Should the portfolio be more conservative to better support key metrics impacting the organization's credit rating? What portfolio changes should be made in response to reductions in outside funding? Does the organization have a formal liquidity policy and, if not, should there be one? These are just some examples of the types of strategic questions investment committees face on an ongoing basis.

As these questions become an even greater priority, investment committees are evaluating how they can effectively meet governance and fiduciary requirements with their current set of resources. Historically, committees might have spent the majority of their meetings reviewing investment performance or researching managers, but that is no longer acceptable. Time must be made to focus on these broader, more impactful issues, which has led to an increased trend in outsourcing some investment management functions. Many committees see the definite value in finding an outside fiduciary partner who can provide additional resources in achieving the overall goals.

With all of this as a backdrop, SEI's Nonprofit Management Research Panel conducted a quick poll asking executives and investment committee members overseeing U.S. nonprofit investment portfolios to identify their organization's investment priorities and challenges for 2012.

Conducted in January, the Quick Poll asked 150 participants to rank a series of statements as a "marginal," "high" or "extremely high" priority for their organizations. The results were tabulated using a weighted system awarding one point for a marginal priority, two for high and three for extremely high.

In addition, 50 poll participants representing U.S. college and university endowments were asked a series of questions on topics specific to the higher education sector, such as spending percentages and credit ratings. These results are included in sections III and IV.

DEMOGRAPHICS

Below are breakdowns of participating nonprofit organizations based on asset size and type, as well as the role of the poll participant.

CHART 1: RESPONDENTS BY SIZE OF ENDOWMENT ASSETS

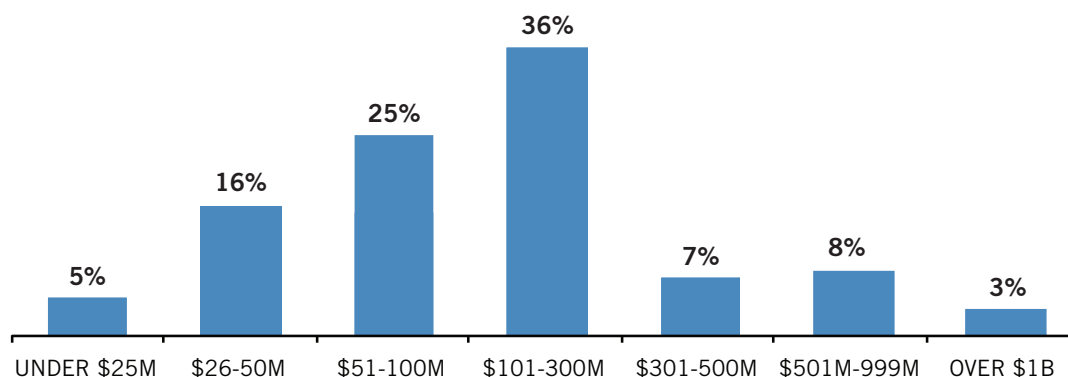
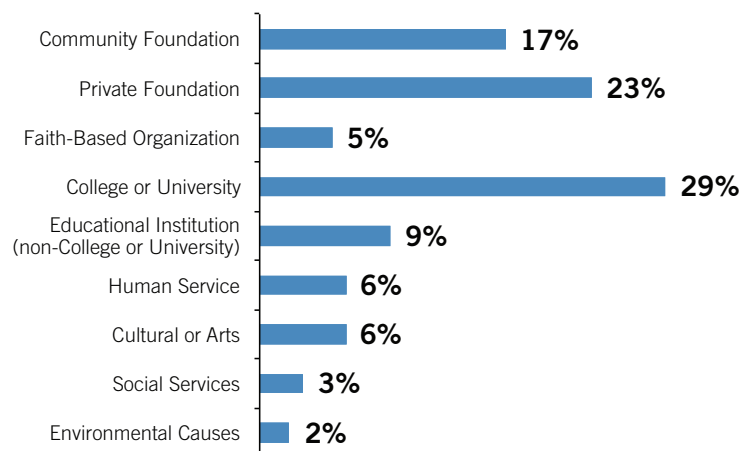


CHART 2: NONPROFIT ORGANIZATION BY TYPE



Roles of poll participants within their nonprofit organization:

- Chief Financial Officer—**44%**
- President or Chief Executive Officer—**13%**
- Chief Information Officer—**7%**
- Finance Executive (non-CEO)—**20%**
- Executive Director—**11%**
- Other—**5%**

FAST FACT: More than three-quarters (78%) of all poll participants are also members of their organization's investment committee.

SECTION I: TOP 10 INVESTMENT PRIORITIES FOR 2012

1. Finding ways to best make asset allocation decisions in conjunction with organizational finance decisions.

Historically, portfolio decisions have been focused on performance and not on the organization's broader financial goals. Times are definitely changing as liquidity needs, long-term spending plans, and donor expectations are just some of the issues now being considered when setting asset allocations. This is the top 2012 investment priority for nonprofit poll respondents with almost half (48%) saying it is a "high priority." The critical nature of better addressing this challenge is evident in that 13% said it is an "extremely high priority" this year.

"The biggest challenge this year will be keeping cash flows for operations positive so that we do not need to dip into our investments."

2. Making asset allocation changes focused on downside risk protection.

Having recovered some of the losses experienced over the last few years, institutional investors are taking strategic steps to de-risk their portfolios and insure their cash flows and investment assets remain steady in a continued volatile marketplace. Of those poll participants identifying this as a priority, almost half (48%) identified it as a "high priority" and 10% recognized it as an "extremely high priority."

"A big challenge is implementing downside risk protection while meeting current and near-term spending needs."

3. Attempting to decrease volatility by increasing portfolio diversification via new asset classes.

Equity markets have certainly improved since 2008, but volatility remains a constant concern. By diversifying portfolios through new asset classes, investors can mitigate risk to better control volatility. However, for many nonprofits this is easier said than done due to issues including manager minimums and potential lock-up periods. This has resulted in an increased interest in outsourcing models that provide access as well as diversification not just on the asset class level, but also on the manager level.

"We need to find quality investments that produce a relatively decent return while reducing volatility within the portfolio."

4. Defining investment management fiduciary responsibilities for trustees and investment consultants.

In recent years, unpredictable market swings have resulted in more common occurrences of investment-related events that historically happened less frequently. Events that had occurred once every 20 years are now happening each year. This has resulted in a demand for more timely decision-making capabilities and investment committees are transferring varying levels of fiduciary responsibility to an outsourced investment provider. One-quarter (25%) of the respondents said this is a “high priority” this year with 8% saying it is an “extremely high priority.”

5. Finding ways, such as investment market simulation tools, to best evaluate the effect of potential investment market changes on the invested assets.

As risk management continues to be an important focus, investment committees continue to look for tools that help manage against investment-related risks. In an ever-changing economic environment, market simulation technology allows investors to input various scenarios regarding asset allocations and evaluate potential outcomes of investments across various markets. These tools allow institutional investors to assess different portfolio constructions to not only select the best investment decisions, but to also create balanced budgets to meet overall financial goals. While many poll participants identified the use of market simulation tools as a priority for their organization in 2012, the majority (45%) said it is a “marginal priority,” while just over one-quarter (29%) said it is a “high priority.”

“Volatility. How do we move at the speed of the market as opposed to the speed of the investment committee?”

6. Implementing an asset allocation process aimed at exploiting shorter-term market inefficiencies to add return and/or mitigate risk.

In today's volatile markets, the ability to quickly and nimbly react to market swings has increased the popularity of short-term trading techniques to add return and hedge against risk. Historically slow to make investment decisions, nonprofit investment committees are focusing on implementing processes that promote the ability to make quicker decisions to take advantage of these scenarios. This is validated by the increased trend in outsourcing as many investment committees are delegating discretionary decision-making to outside partners when it comes to some asset allocation decisions. More than one-quarter (26%) of the respondents listing this as a priority said it is a “high priority” this year.

“A big challenge is figuring out how to take enough risk to support annual spending, but not so much as to put corpus at risk.”

7. Immunizing a portion of the portfolio to support spending policy needs.

During the financial crisis of 2008, many nonprofits were challenged from a liquidity standpoint, as many popular alternative investments had lock-up periods preventing investors from accessing their much-needed financial investments to support rapidly decreasing finances. The impact of that lasting memory, as well as the increased role of investment portfolios in supporting organizational budgets, has resulted in an interest in protecting short-term spending needs. More than one-quarter (27%) of those citing this as a 2012 priority said it was a “high priority” for the institution.

8. Implementing ways to increase donor confidence in investment

strategies. Most nonprofits are dependent on the charitable giving of their donors to meet funding gaps. Of course, fundraising is particularly challenging in a low economic environment with increased scrutiny and transparency regarding how contributions are invested. Almost one-quarter (23%) of those listing this as a priority indicated it is a “high priority” for their organization.

“One of the biggest challenges this year will be securing the fundraising we need for growth amidst a community still facing economic lows.”

9. Gaining additional transparency from investment managers.

The monitoring of investment managers is a complex and time-consuming task—one that many nonprofit investment committees are poorly equipped to effectively manage on a daily basis in conjunction with their more strategic and demanding responsibilities. These challenges, coupled with increased governance demands, have resulted in nearly one-third (32%) of those ranking this a priority to describe it as a “high priority” in 2012.

“A top challenge for 2012 is working with alternative managers regarding transparency and managing liquidity for all investments.”

10. Adding or increasing allocation to inflation protection strategies.

In the midst of the European financial crisis, institutional investors are continuing to increase asset allocations to new asset classes, such as Treasury Inflation-Protected Securities (TIPS) and commodities, to better hedge against high inflation rates. With the expectation that inflation is inevitable and the impact of inflation historically difficult to predict, 22% of poll respondents identified inflation protection strategies as a “high priority” for 2012.

SECTION II: OUTSOURCING TREND AMONG NONPROFIT ORGANIZATIONS

Recent industry reports suggest outsourcing the investment management of endowment assets is rapidly growing in popularity among institutional investors. According to consulting firm Casey Quirk,³ the investment outsourcing market will grow to \$510 billion in assets by the end of 2012, representing 13% of institutional assets and 25% of institutional investors.

Using an outsourced investment model, in which the fiduciary partner has decision-making responsibility for a portion or all of the portfolios, investment committees are able to focus more strategically on asset allocation decisions and organizational finances. The fiduciary partner oversees manager research, selection and monitoring within those chosen asset classes.

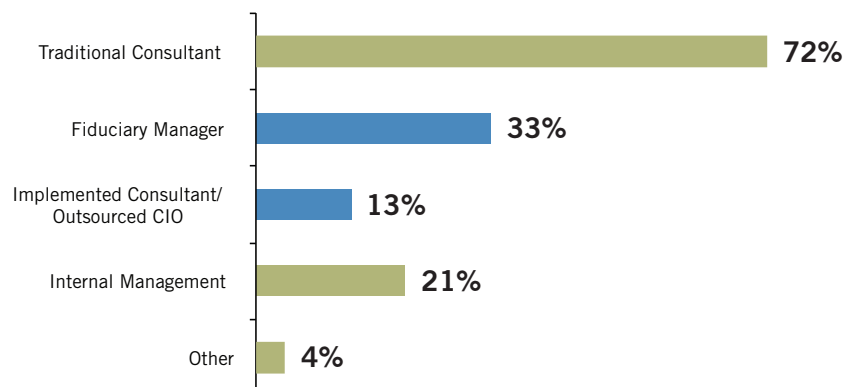
One of the key drivers in transitioning to an outsourced investment model is better risk management. In a volatile marketplace, the ability to streamline processes and enable more nimble and timely decision-making can improve investment outcomes. Also, by transferring varying degrees of accountability to a fiduciary partner, investment committees reduce liability to themselves and their organizations.

Poll participants were asked to identify which of the following models they have evaluated or would consider evaluating for the investment management of their endowment assets:

- **Traditional Consultant** helps with asset allocation decisions and investment committee selects managers from a list of finalists provided by the consultant
- **Fiduciary Manager** provides investment committee with varying degrees of limited to full delegation of asset allocation and manager decisions
- **Internal Management** makes all asset allocation and manager change decisions internally without any assistance from external providers
- **Implemented Consultant/Outsourced CIO** provides investment committee with varying degrees of limited delegation of asset allocation and manager decisions

Change is imminent with more than one-quarter (26%) of poll participants planning to go to RFP for a new investment management model within the next 24 months. Almost half (46%) of poll respondents indicated that their organization has evaluated or would consider evaluating an outsourced provider for investment management in the form of a fiduciary manager, implemented consultant or outsourced CIO model. *See chart 6 below.*

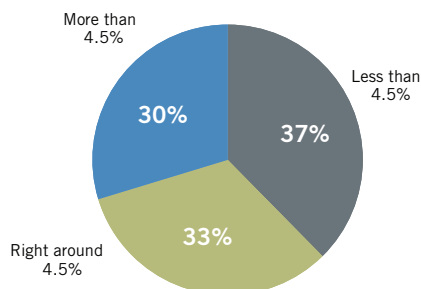
CHART 6: EVALUATION OF INVESTMENT MANAGEMENT MODELS



SECTION III: ADDITIONAL FINDINGS FOR COLLEGE AND UNIVERSITY ENDOWMENTS—SPENDING

According to the *2010 NACUBO-Commonfund Study of Endowments*¹ released last year, educational institutions spent an average of 4.5% of endowments to support expenditures in 2010. To determine the percentage endowments spent in 2011, poll participants were asked to indicate their spending in comparison to the 4.5% average for the previous year. See *chart 3* for the results.

CHART 3: AVERAGE SPENDING IN 2011

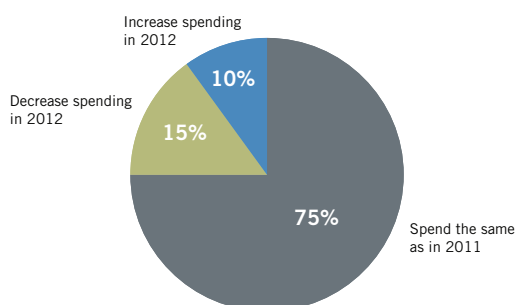


According to the quick poll, more than one-third (37%) of educational institutions spent less than the 4.5% average stated by the 2010 NACUBO study. According to the metrics below, the size of the endowment appears to directly impact the level of spending last year:

- More than three-quarters (88%) of the participating organizations with an endowment of \$501 million or more in assets said they spent more than 4.5% last year
- In contrast, almost two-thirds (62%) of those with under \$100 million in assets spent less than 4.5%
- More than half (58%) of organizations with between \$101 to \$501 million assets (about half of all poll participants) reported that they did in fact spend right around 4.5% in 2011

When asked about spending predictions for 2012, one-quarter (25%) of all poll participants said they were going to make a change. Only 10% of participants said their organizations would likely increase spending in 2012, while 15% said they would decrease it. The remaining majority (75%) of respondents said their educational institutions plan to spend the same percentage as 2011. See *chart 4* for the results.

CHART 4: EXPECTED SPENDING IN 2012



¹ 2010 NACUBO-Commonfund Study of Endowments® (NCSE), NACUBO, January 2011.

SECTION IV: ADDITIONAL FINDINGS FOR COLLEGE AND UNIVERSITY ENDOWMENTS—CREDIT RATINGS

In January, Moody's Investor Service released its annual industry outlook for U.S. higher education,² in which, the rating agency maintains the same mixed sector outlook for U.S. private and public colleges and universities that was forecasted last year.

Once again, Moody's has a stable outlook for the diversified colleges and universities with strong market positions and balance sheets. A negative outlook remains for the majority of rated colleges and universities, which are far more dependent on state grants and student tuition to meet financial goals.

Key credit factors driving Moody's outlook for 2012 include:

- | | |
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| 1. Evolving demand trends for undergraduate and graduate programs highlight flight to equality and affordability | 3. Pressure on non-tuition revenue underscore the importance of revenue diversification and operating efficiency |
| 2. Rattled consumer confidence puts intense spotlight on college affordability | 4. Liquidity and debt structure risks are reduced but not eliminated; University capital spending and borrowing have been cut back |

CHART 5: DOES YOUR ORGANIZATION HAVE A CREDIT RATING?



In regards to the importance of credit ratings in conjunction with portfolio decisions, poll participants were asked whether they felt credit rating agencies would view lack of diversification in an organization's endowment investments as a reason for a credit rating downgrade. Below are the results.

- 55% of poll participants, regardless of having a credit rating or not, felt that lack of diversification in investments could negatively affect a credit rating
- 45% of poll participants did not feel that lack of diversification in investments would negatively affect a credit rating

Interestingly, of the 55% identifying lack of investment diversification as measure for a credit downgrade, one-quarter (25%) said that increasing diversification via new asset classes is otherwise not a priority for their organization in 2012.

The benefits of diversifying a portfolio are not limited to a positive credit rating—it can also mitigate risk and protect against market volatility. These contrasting priorities may indicate that asset allocation decisions might not be aligned to support organizational finances.

² U.S. Higher Education Outlook Mixed in 2012, Moody's Investor Service, January 2012.

CONCLUSION

Top priorities for U.S. nonprofit organizations this year focus on aligning investment decisions with organizational finance decisions and implementing investment strategies that hedge against risk and market volatility.

Investment committees overseeing college and university endowments remain conservative in their spending as the endowments continue to recover from a turbulent past few years. Contradictions in viewpoints around credit rating strategies and investment strategies point to a need to better align the two to support organizational finance decisions.

Nonprofit organizations, as a whole, continue to consider new models for the management of their investment portfolios, with a fiduciary management provider now second in popularity to the traditional consultant model for its ability to promote faster, more strategic decision-making and shared fiduciary accountability.

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