

SEI RESEARCH:

The Four Key Considerations in Developing a Formal Liquidity Policy for Nonprofits

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As an aspect of the investment policy statement, nonprofit institutions should consider incorporating a framework for governing the accessibility of the portfolio by establishing a target allocation to illiquid investments. The development of such a target should be based upon a formal and periodic review of both investment characteristics as well as institutional financial requirements that should, together, establish an organizational tolerance for illiquidity. Nonprofit investment committees could benefit by considering the following four key components when establishing the organization's formal liquidity policy:

- **Total Portfolio Value-at-Risk (VaR)**

VaR remains important to nonprofits because it helps determine the probability of and potential loss of asset values over a set period of time. When an investment committee is determining the organization's appetite for illiquid investments, it is important to use a form of drawdown risk as a risk measure instead of the more commonly used standard deviation. When a commitment is made to private areas of the market, the remaining public investment performance will influence the fluctuating weight the private investment represents as a piece of the overall portfolio.

For example, a \$20M (20%) allocation to illiquid assets is paired with an \$80M (80%) weight to public markets that represents a potential drawdown of 15% in poor market scenarios. A prolonged market downturn for 4 years would see the public allocation drawdown to approximately \$42M over that period. The \$20M private allocation now represents 32% of the total portfolio and places increased pressure on the liquidity of the investment pool.

- **Organizational Spending Policy and Expenses**

The above example was conducted without assessing the impact of the most crucial liability of the portfolio, the organization spending policy or distribution requirements. Whether it is supporting an operating budget or various community programs, distributions are expected regardless of the performance of the markets. These liabilities need to be combined with the VaR of the portfolio to gauge the true impact or reduction in portfolio values. Using the above example, what happens when these liabilities (standard 5% of assets) are added? The result is that the public investments would draw down to approximately \$30M, with the illiquid allocation now representing around 40% of the total assets. This would still be a comfortable weighting for many organizations, but depends significantly on the sensitivity of the institutional liquidity needs. For instance, a private university whose annual spending policy supports 18% of the operating budget will be much more sensitive than a public university whose spending policy supports just 2% of operations.

- **Organizational Fundraising and Gift Expectations**

The amount of fundraising, or gift intake, a nonprofit organization receives will be a key factor in its ability to tolerate an allocation to private investments. These inflows into the portfolio serve as important support mechanisms in times of poor returns and act as a supplement to steady portfolio values or meet spending requirements without having to liquidate securities from the investment pool. A rise in fundraising expectations has a direct correlation with an organization's ability to tolerate illiquidity, and serves as a lever to allow the investment portfolio to execute strategies aligned with a longer time horizon.

It is important for investment committees to consider the organization's ongoing fundraising abilities when determining the ability to invest in illiquid assets. For example, the liquidity needs of a private foundation are very different than that of an educational institution. The stark difference in incoming flows into the portfolio leads to significantly different average asset allocations between these institutional investors, with educational institutions allocating a significantly higher percentage to private investment strategies.

- **Investment Committee's Resources and Comfort Level**

When considering illiquid investment strategies, it is important to realize the much heavier dosage of due diligence required of the investment committee. Compared to public markets, illiquid investments require significant oversight mainly stemming from the lack of transparency within these strategies and the markets in which they invest. The inefficiency in terms of information flow generates both opportunity and risk in terms of a manager's performance relative to a stated benchmark. The dispersion of returns generated by the universe of private investment managers will be significantly wider than that of a universe of managers in the public markets. This significantly increases the complexities involved in managing these investments and committees need to have a solid understanding of the requirements of their time and focus. Investment committees who dedicate focus or delegate the due diligence function to a partner in these important areas can reap substantial benefits.

The Benefits in Implementing a Formal Liquidity Policy

As nonprofit investment committees consider implementing a formal liquidity policy, it is also important to consider the following benefits this process could offer:

- **Increased Diversification** – The nature of these strategies exhibits a performance record and expectation that will have low or negative correlations to other more traditional components of the portfolio. These strategies will help to improve the overall risk/return profile and could increase the consistency of the returns being generated.
- **Return Enhancement** – In theory, investors could be compensated for accepting illiquidity by garnering a premium over a similar strategy in the public markets. Accessing these areas of the market where information flow is not quite efficient may allow managers to better seize opportunities and could produce higher returns. One example of an illiquid asset class where this applies is private equity, where investors would be looking to return a premium over the S&P 500 Index over time.
- **Inflation Protection** – Many of the strategies more recently being implemented in the natural resource area such as timber, energy, and farmland have significant benefits in terms of protection from inflation. Inflation is a key focus for nonprofits because its movements are closely aligned with the preservation of purchasing power over time. These strategies exhibit positive correlations to inflation and should provide more efficient protection from inflation than traditional investment strategies.

Conclusion

To effectively invest in illiquid assets, investment committees need a solid understanding of the movement of these classes, the lock-up periods and the organization's tolerance for illiquidity. For many nonprofits, the hurdle remains to be the lack of resources needed to gain this knowledge and in some cases it's a lack of access to these products. While these obstacles are valid, the benefits suggest that investment committees may want to find holistic investment management solutions that enable the organization to take advantage of these asset classes.

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