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MISSION UNAFFORDABLE – WHY THE CASH CRASH MATTERS TO NFPS

PERPETUAL IMPACT
17/10/2019

In August 2008 the RBA Target Cash Rate was 7.25%. Today (October 2019) it is 0.75%.[1] Good news if you're servicing a mortgage, but not such good news if you're an NFP CEO, CFO or board member.

If you're in those roles you face the classic economic problem – unlimited needs and limited resources.

As Scott Hawker, Perpetual's National Manager for Not for Profit Endowments, puts it, "NFPs have a mission that is always growing, government funding that seems to be shrinking and a fiercely contested battle for donations. When rates of return on their accumulated capital fall it just makes the fight even harder."

Policies, structures, mindsets.

There are three governance-related reasons why falling cash rates can have a particularly significant effect on NFPs:

- Some are locked into outmoded **investment policies** that mandate a high exposure to low-growth assets like cash, bonds and term deposits – all of which have been affected by the fall in interest rates around the world.
- Others are confined by **structures** that don't allow drawing down on capital when income returns are low. Kyle Lidbury, Perpetual Private's Head of Investment Research, says, "for any portfolio, the ability to draw down capital when required gives

you more short-term flexibility. If your portfolio is optimally managed you can seek to “replace” that capital during parts of the cycle when investment returns exceed your needs.” It’s also important to note that in a tax-free NFP environment, the idea of a total investor return is more relevant than seeking to draw on yield alone.

- Leaders at some NFPs are stuck in a risk-averse **mindset,** convinced that only supposedly safe assets like cash and government bonds are suitable for organisations needing regular cashflow to fund their mission. “It’s counter-intuitive,” says Kyle Lidbury, “but only investing in ‘safe’ assets actually puts the corpus **most** at risk in terms of running out of money. To maintain the purchasing power of the corpus, you must allocate to growth assets in order to keep up with inflation.”

To strive, to seek, to chase the yield

Of course, in a world where cash rates are close to zero it’s a rational response to move to assets where yields are higher. Indeed, that’s the whole point of low rates and Quantitative Easing – governments and central banks want people spending and investing their money rather than sitting in cash.

However, blindly diving into risky assets is not a cure-all for maintaining returns. Chasing yield can end up concentrating risks in the portfolio, for example ending up overexposed to equities or possibly too high an allocation to illiquid assets. Attention needs to be paid to all of the underlying risks in the portfolio and ensuring that balance and diversification is maintained.

Too much of a good thing

That can mean charities moving towards assets like hybrids, property trusts, residential property and high-yield shares. All of these assets can have a place in your NFP portfolio.

The issue is that ad hoc changes to your asset allocation in search of yield can put your capital at more risk. “Changes in asset allocation are always about risk *and* return,” says Kyle Lidbury.

“You need to think it through so you can control risk and where appropriate *increase* your diversification. One way of doing that is investing in alternative assets – but that’s still a new area for many charity boards”.

Scott Hawker says, “There are investment strategies you can implement to manage low cash rates without a dangerous chase for yield.” A well-articulated **Spending Policy** (as part of the overall Investment Policy Statement) can also help by defining and controlling the pace of drawdowns from a portfolio across market cycles.

“What you need is *intelligent* governance,” says Scott Hawker. “Tailored investment policies, good internal accountabilities, quality external advice and investment management relationships that help you manage whatever the economy throws at you. That’s how you deliver to your mission over the long-term.”

1.https://www.rba.gov.au/statistics/cash-rate/

For more information, contact Scott Hawker at 02 9229 9319 or scott.hawker@perpetual.com.au