THE FUNDING TIGHTROPE

20/06/2017

Not-for-profits (NFPs) walk a fine line between funding existing projects and leaving enough capital aside to finance future requirements. It's a difficult balancing act made more challenging in today's low yield environment where returns on cash and fixed income are at or near all-time lows.

So what can NFPs do about it? It comes down to controlling the controllables – which starts with a tailored spending policy.

DEVELOPING A SPENDING POLICY – THE BUILDING BLOCKS

When structuring a spending policy it is useful to think of the 3 S's as the building blocks – Significant, Stable and Sustainable.

For NFPs with long term or in perpetuity goals often this means ensuring there is a high probability that the portfolio value is grown at least in line with inflation, or some measure of its costs, to protect the real (after inflation) spending from the portfolio in the future.

SPENDING POLICY FIRST, INVESTMENT POLICY SECOND

A spending policy is a required first step before designing an investment policy for the portfolio. This is because the spending policy is one of the primary inputs into how the investment portfolio should be designed to best deliver on the spending goals.

Consider a NFP with a spending target of 4%pa and a requirement to increase the portfolio value at 2.5%pa in line with inflation. This would take the total return on the investment portfolio to at least 6.5%pa. If the portfolio was already invested in cash and fixed income with an expected total return of 5%, the spending target would not be achieved. That's why it is crucial to establish the spending policy first and then use the objectives as the basis to construct the investment portfolio.

TYPES OF SPENDING POLICIES

Spending policy approaches in practice can be thought of generally as on a continuum from what are called Constant Growth policies at one end of the spectrum and Market Value policies at the other. In between are Hybrid type policies that contain elements of both.

Constant Growth

These spending policies typically provide an initial fixed dollar amount of funding to the NFP budget, and they grow that dollar level of funding each year at a specified rate – often inflation or some margin above inflation, or a fixed percentage rate.

For example, with a 4% spending target on a $100 portfolio the first year's funding would be $4. If this was grown in the second year in line with inflation (let's say 2.5%), then funding in the second year would be $4.10.

Market Value

These spending policies typically apply their spending target percentage (again say

4%) to the market value of the portfolio to determine the level of spending each year.

A 4% spending target on a $100 portfolio would see $4 of spending in the first year. If however in year two the portfolio value dropped to $50 because of market movements (perhaps due to a severe recession), then only $2 of spending would occur in the second year (which is 4% of $50).

As can be seen, Market Value policies can provide much less stable levels of funding for a NFP. One way to mitigate this effect, that many NFPs use, is a smoothing rule that applies the spending target (say 4%) to a moving average of the market value of the portfolio over time. The most common smoothing rules are averaging market values over the last three or five years, often using quarterly market values, as opposed to market values only at year end.

CONSTANT GROWTH VS MARKET VALUE

A Constant Growth policy provides a higher level of funding certainty for a NFP. This is because the rate applied to grow the dollar level of spending is either fixed, or in the case where the inflation rate is used, less variable than investment returns on most typical market-based portfolios.

The downside is that these policies commit to a level of spending without considering the investment return environment. If the performance of the portfolio is below expectation but spending levels are maintained, it can erode the value of the portfolio so that funding becomes unsustainable.

The primary benefit of a Market Value spending policy is the flipside of the major pitfall of a Constant Growth policy. That is, because spending is adjusted down in a poor investment return environment, some protection to the sustainability of funding is provided. Of course the challenge associated with this policy is that the NFP has less stability in funding levels from year to year. The sustainability of a Market Value spending policy, combined with the fact that NFPs on average don't rely fully on their investment portfolio for funding, means around 75% of institutions use a Market Value based spending policy, generally with a smoothing rule in place[1].

CHOOSING THE RIGHT SPENDING POLICY

The appropriate spending policy depends on the level of funding the investment portfolio needs to contribute to the NFP's operating budget.

Where the required contribution is high, and there are large recurring fixed expenses, the predictability of Constant Growth policies are favoured. When the funding requirement is smaller, NFPs can tolerate an element of market volatility because the operating budget is less dependent on the investment portfolio. In these circumstances Market Growth policies are often favoured.

Of course it is not always a case of choosing one spending philosophy over another. The secret is in tailoring each policy to the specific requirements of the organisation. Sometimes a Hybrid policy is required – a middle road where elements of each policy can be adopted in a bespoke solution.

RETHINKING POLICY IN A LOW YIELD ENVIRONMENT

We are currently in a low yield environment where yields on cash and fixed income investment in particular, both in Australia and other developed economies, are at or near their all-time lows. This may cause NFPs to review how sustainable the current level of funding is if no changes are made to policy.

There is some evidence that some NFPs are adjusting down their target spending levels (e.g. from say 5% to 4%) in light of this environment[2]. Advice may need to be sought about whether an adjustment to policy is required in the current low yield environment. Such a review of spending policy is good practice at least annually, whatever the market conditions, or in line with what is set out in your investment policy guidelines.

GETTING THE BALANCE RIGHT

Without due consideration of spending requirements, a NFP may commit too much –

or too little – of its investment returns to fund current and future requirements. If the level of volatility in the portfolio is too high, budgeting becomes difficult which ultimately undermines a NFP's ability to manage current commitments and plan for new projects. A tailored spending policy goes a long way to addressing these risks and should be developed before the investment portfolio is constructed.

[1] Cambridge Associates, Spending Policy Practices (2016); SEI, The Current Landscape of Nonprofit Spending (2013)

[2] Cambridge Associates, Spending Policy Practices (2016).