THE LONG FALL:

NFP investment strategies in a low rate world

Executive summary

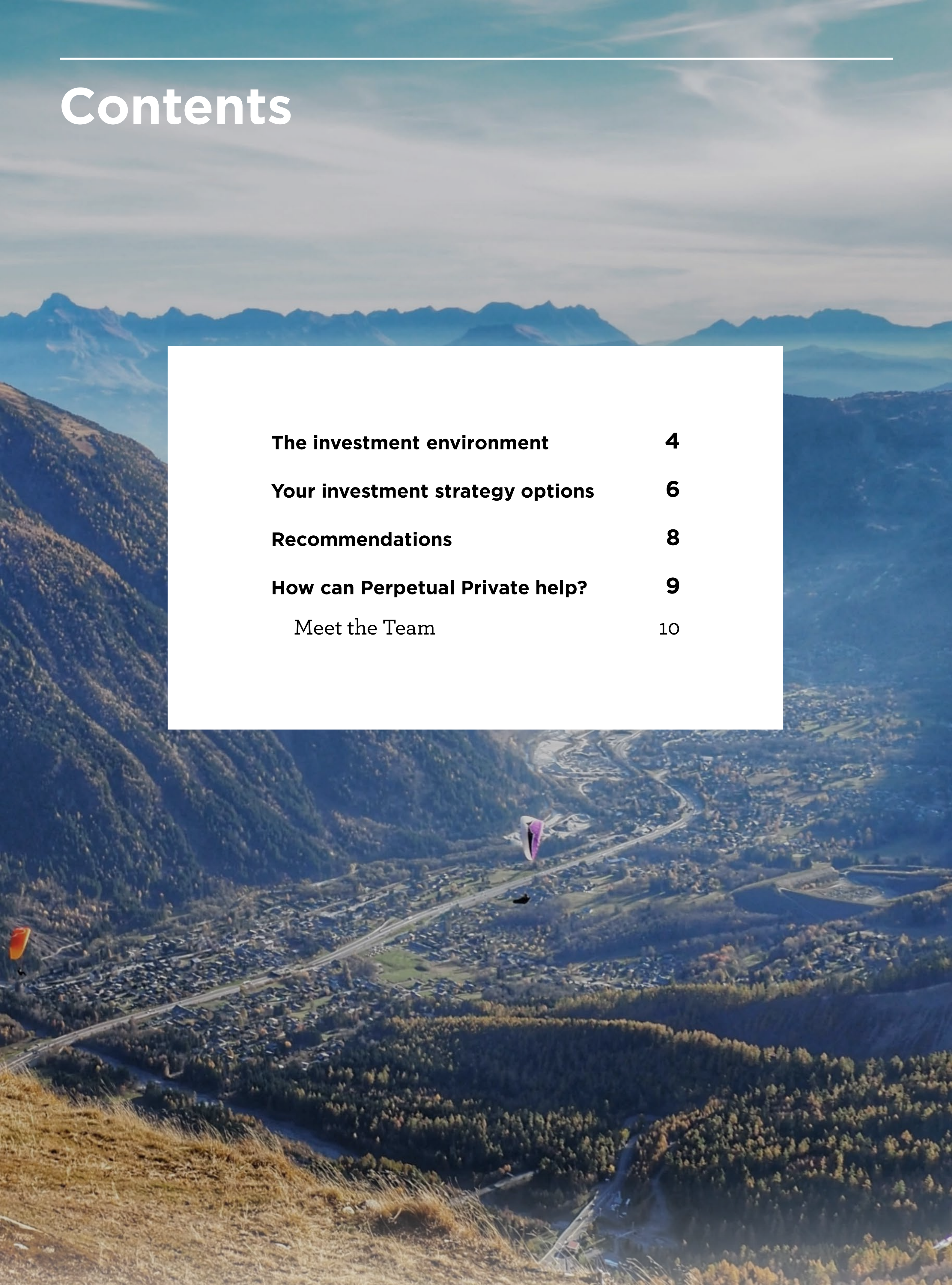
Today, NFP boards and investment committees are having to manage the effect COVID-19 is having on their investment portfolios whilst dealing with long-term trends that can make their traditional investment approaches sub-optimal. In this White Paper we look at the short and longer-term issues they face and at some strategies they can use to manage their investment portfolio more effectively.

Not-for-profits (NFPs) are already dealing with lower investment income because of the long fall in cash rates since the GFC. The economic rebuilding required post-COVID means rates are almost certain to **stay low** for the foreseeable future.

Over the past five years (including COVID-19 impacts) a diversified portfolio would have provided more income than a portfolio based around Term Deposits. A diversified portfolio would also have grown the underlying capital.

NFP investment committees and boards need to look at more diversified investment strategies when looking to replace 'lost' Term Deposit income.

In doing so, they need to be careful about the types of risk they add to their portfolio. And consider the benefits of a 'total return' approach.



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The investment environment

The essence of any investment strategy is understanding your starting point. Only then can you set realistic objectives, build a plan to achieve them and act on that plan.

So, in investment terms, where are we now?

- The Australian stockmarket is down 15% on its peak. The UK is off over 20%
- By contrast, the US stockmarket is down just 5% from its peak – as is the MSCI World index (all figures from MSCI, end September 2020)
- All these markets are up substantially from their COVID-19 crisis lows
- The economic outlook going forward is clouded by the aftermath of COVID-19 lockdowns, a reversal in globalisation and damage to major industries including tourism and entertainment

In response to the COVID-19 pandemic and to stimulate the broader economy, the Reserve Bank of Australia (RBA) cut the cash rate target twice in March. Rates are now at an all-time low of 0.25%. In August 2008, the RBA Target Cash Rate was 7.25%!

This medium-term perspective is important. It's easy for any investor – including not-for-profit (NFP) investment committees and boards – to look at the latest rates and conclude that they are emergency settings. They are emergency settings – but they were set after the previous emergency – the GFC.

Anyone who relies on cash or term deposits for the bulk of their income has been fighting the curve since the GFC hit in 2008 and Central Banks and governments used basement level rates – even negative rates – to restart the economy. Cash loving investors are facing an income shortfall – because cash markets have endured a long fall.

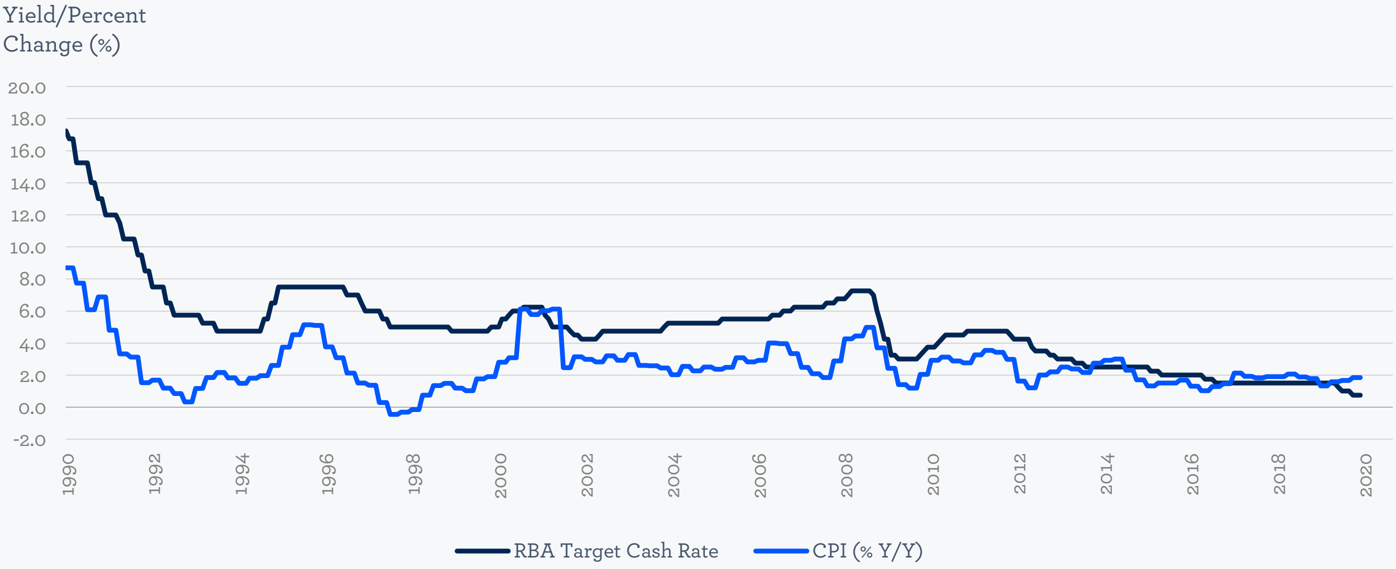
The cash crash

Historically the RBA cash rate has trended above inflation (CPI) and an investment in cash/term deposits delivered a positive real return.

However, with the RBA cash rate well below inflation, any interest income being generated on cash/term deposits is being eroded by inflation, delivering investors a negative real return outcome on their cash reserves.

What does this mean for NFPs? As the value of the underlying capital is what drives future income, this erosion will put pressure on NFPs capacity to meet their mission over the short, medium and long-term.

Long-term cash rate vs inflation



Source: FactSet, October 2020

Do you see cash in your future?

Just as Central Banks pushed rates lower to help us recover from the GFC, they are doing the same in this crisis - rates are set to remain lower for longer.

This has crucial implications for not-for-profit organisations. "Many NFPs have conservative investment strategies and emphasise holding reserves in term deposits," says Jamie Cockerill, a Partner at Perpetual Private.

"It's counter-intuitive," says Jamie, "but that conservative approach is now costing NFPs money. Now more than ever, community organisations need more sophisticated investment strategies to protect and grow their income and assets – and to underpin their essential operations."

Let's have a look at that more sophisticated investment approach.

Your investment strategy options

Because investment income can make a material difference to the activities and mission of an NFP, we believe it is crucial for not-for-profit organisations to have a plan to deal with the current and (likely) future economic environment. The goal is to put in place a tailored investment strategy that helps the organisation meet ongoing funding requirements, whilst also growing their reserves.

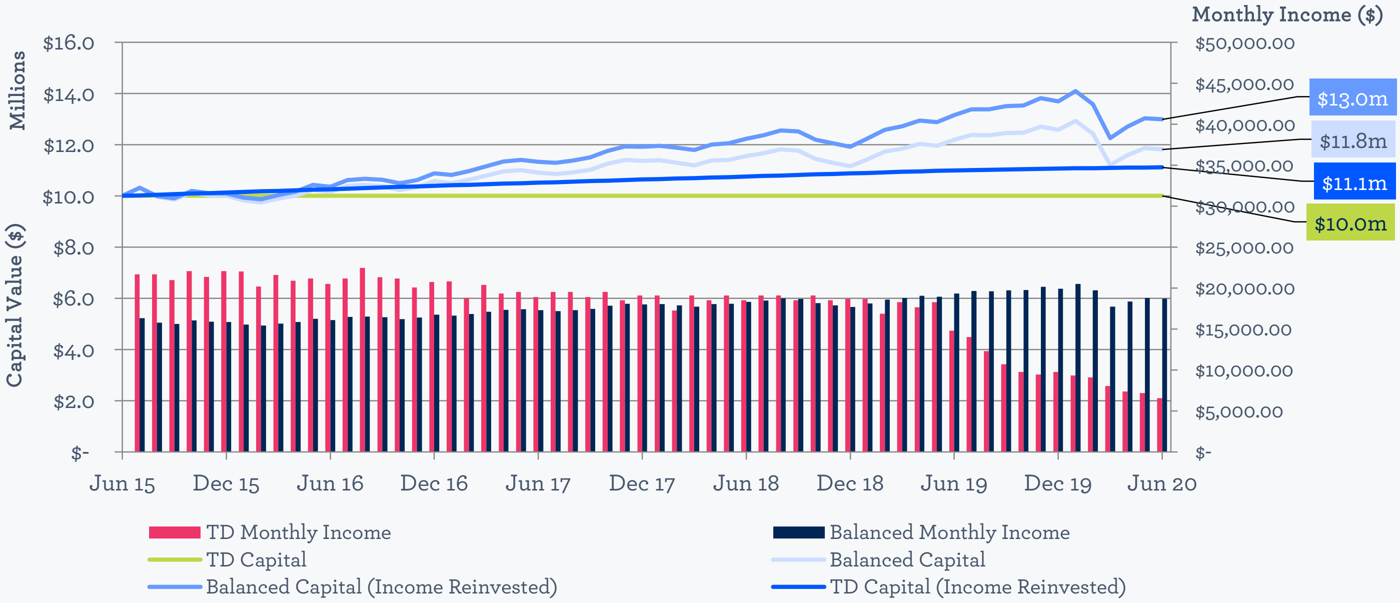
There are of course many strategic investment options available. The strategy for organisations entrusted with stewarding other people's money (donations, government funding etc) to deliver for an at-need community should be robust and backed by long practice and research. So, let's look at two common options open to NFPs.

Cash versus diversified portfolios

The chart below compares the capital value and monthly income generated by two different options over the 5 years to 30 June 2020. It assumes reserves of $10m invested in:

> **Option 1:** A diversified 'Balanced' portfolio (65% growth and 35% defensive; including some investment in alternative assets).
>
> **Option 2:** A portfolio where funds are invested purely in term deposits.

This is **not** a model – it's the reality of the past five years and includes the impact of the COVID-19 market falls. Let's pull out the key points.



Source: Perpetual July 2020; Based on Perpetual Private's Balanced portfolio, 65% Growth/35% Defensive assets

Growth

Starting at $10 million, the Balanced portfolio has grown to be worth $11.8 million (even after income was drawn from the portfolio). If income were reinvested, the portfolio value would reach $13 million.

By contrast, the Term Deposit portfolio remains stuck on a capital value of $10 million. If income were reinvested, the portfolio value would reach $11.1 million.

Volatility

As expected, the portfolio value in the Balanced portfolio has fluctuated significantly. Yet, despite the market impact of the COVID-19 pandemic (and other economic shocks over the past five years), the overall value of the portfolio continued to grow over time.

Income

More strikingly, income from the Term Deposit portfolio has steadily declined, in line with the fall in rates discussed above. Originally yielding just under $22,000 a month in 2014, income has dropped by over 65%, to less than $7,000 a month today.

"Over the past five years, Term Deposit investors have seen their income drop – and drop a lot," says Liz Wheatley, an Associate Partner at Perpetual Private. "For the next few years at least, Central Banks and governments will do all they can to spark a post-COVID recovery. It is unlikely we will see an improvement in cash-derived income any time soon."

Over the same five-year period, the income generated by the Balanced portfolio rose from about $16,000 a month, to nearly $19,000 a month today. The income growth highlights some key points about using a mix of growth and defensive assets to generate income.

- Firstly, the income growth reflects an increase in the value of the underlying capital due to the growth generated by the portfolio's share and property holdings.
- A substantial portion of this income would have come from share dividends which may be franked. Some NFPs can get a tax refund for this franking that adds to the value of this dividend income.
- The income generated by the portfolio is somewhat variable. Pre COVID-19, the monthly income generated by the portfolio was nearly $21,000 a month. It's now closer to $19,000. Whilst this needs to be considered by NFPs, context is also important. As we have seen, Term Deposit income also varied over the past five years – but it only varied downwards.

Dividend income in tough economic times

By some estimates, Australian companies have cut their dividends by around 30% since the pandemic washed ashore (see our dividends article here). Does this weaken the case for looking at diversified portfolios to replace the income deficit from low-rate Term Deposits? Perhaps not.

- Diversified portfolios generate income from a wide range of sources – not just share dividends. This can include cash, credit and bond-generated income and property yields. Diversified portfolios that contain alternative assets can pay income from an even wider range of sources – everything from infrastructure income to foreign exchange trading gains.
- Whilst many companies reduced dividend payments in the face of COVID, some of these measures were precautionary - to ensure capital stability in the face of the pandemic. As the virus becomes better understood, treatments improve and the costs of lockdowns fade, many companies will rebuild dividends (even if at a reduced rate).
- Some companies have enjoyed higher revenues during COVID-19. Retailers of essential goods, tech companies and some mining stocks have boomed over the past few months and dividends from those stocks could rise.
- As part of their normal stock selection process, managers of diversified funds will shift money away from stocks weakened by the lockdowns, and towards those capable of generating strong revenues – and maintaining dividends.

Recommendations

Based on our experience – and our view of the current economic and market environment – here are some broad recommendations NFP boards and investment committees could embrace. Naturally, investment strategy decisions should only be taken after extensive consultation and customisation.

Allocate your capital

In determining your organisation's spending policy and future capital expenditure requirements, we recommend setting aside the cash required for immediate expenditure, then considering what portion of these reserves could be invested in a well-diversified portfolio of assets. A portfolio designed to deliver income **and** the longer term capital growth that protects the real value of your assets.

A spending policy

Having a clearly articulated spending policy can provide strategic clarity when it comes to your investment approach. This provides the foundation for calculating how much of an investment portfolio is distributed on an ongoing basis into the operating budget. Essentially, it should help balance the tension between spending too much (potentially running out of money) and spending too little (short-changing current beneficiaries).

Don't race up the risk curve

In seeking to replace 'lost' Term Deposit income, some NFPs can go too far the other way and add excessive risk to their portfolios. This could be via a too-heavy exposure to equities. From ill-discipline when it comes to deciding which equities to own. Or from having more illiquid assets than is strategically sound.

Andrew Garrett, Perpetual Private's National Investment Specialist, says broad diversification can help manage risk and bolster returns. "NFPs can use assets like alternatives, property trusts, residential property and high-yield shares to meet their goals. It's not just about shares versus cash."

Think total return

Perhaps most importantly, NFPs can manage the cash crunch by thinking outside the square on income. Andrew Garrett says, "It doesn't matter who you are or what kind of portfolio you run, the ability – and willingness – to draw down capital when required gives you crucial flexibility.

Most investors need to stop thinking that there's capital and income and they always stay separate. If you manage your portfolio carefully – and actively – you can 'replace' capital you've drawn down during parts of the investment cycle where returns exceed your needs."

Indeed, in a tax-free NFP environment, so-called 'total return' is more relevant than seeking to draw on yield alone.

How can Perpetual Private help?

"Not-for-profit and community organisations need to come to grips with the risk-return trade-off," says Scott Hawker, Perpetual Private's National Manager for Not-For-Profit Endowments. "With rates so low, they need their investment portfolio to work harder, to understand the risks that this might involve and be across all the strategy and governance issues that follow."

To manage this, boards, CEOs and CFOs of not-for-profit organisations need to develop the right investment strategy for their organisation. They need to find a partner who understands the uniqueness of their organisation and can give them investment advice commensurate with that profile – investment advice that aligns with their mission, size, objectives and of course, risk profile.

Perpetual works with not-for-profit organisations to craft an investment management strategy that is tailored for each organisation. Our clients leverage our industry expertise to enhance performance while moderating risk. We work with our clients to determine the best possible investment strategy for their hard-won capital under difficult conditions, and help organisations offset increased operating costs and counterbalance declining interest rates.

To review your organisation's future investment strategy and learn more about Perpetual Private and how we can assist over the longer term, please don't hesitate to reach out to our team.

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