

Nonprofits Focus on a More Robust Investment Oversight Process

SEI's Nonprofit Management Research Panel recently completed a survey of executives and Investment Committee members from nonprofits in the U.S. to gauge their current investment challenges and concerns. The poll was completed by 150 executives from nonprofits ranging in size from \$25 million to \$5 billion in assets. Three-quarters of all respondents serve on their organizations' Investment Committees. The poll was conducted in June 2014 and the findings below focus on participant responses on the use of alternatives, better leveraging the Investment Committee, risk management concerns and strategies, and opinions around investment outsourcing. If you have any questions, please email SEIresearch@seic.com.

Introduction

John Adams once said “to be good, and to do good, is all we have to do.” For nonprofit executives and Investment Committees, the number one priority has always been and always will be the organization’s mission. That’s why they serve. However, the ability to use the organization’s endowment to “do good” has never been more challenging. The responsibility of balancing the endowment’s ability to grow, managing the risks involved, and supporting the spending needs of the mission only continues to grow more complex. The below poll findings show how nonprofits are evolving to improve the overall effectiveness of the investment portfolio in achieving the organization’s mission.

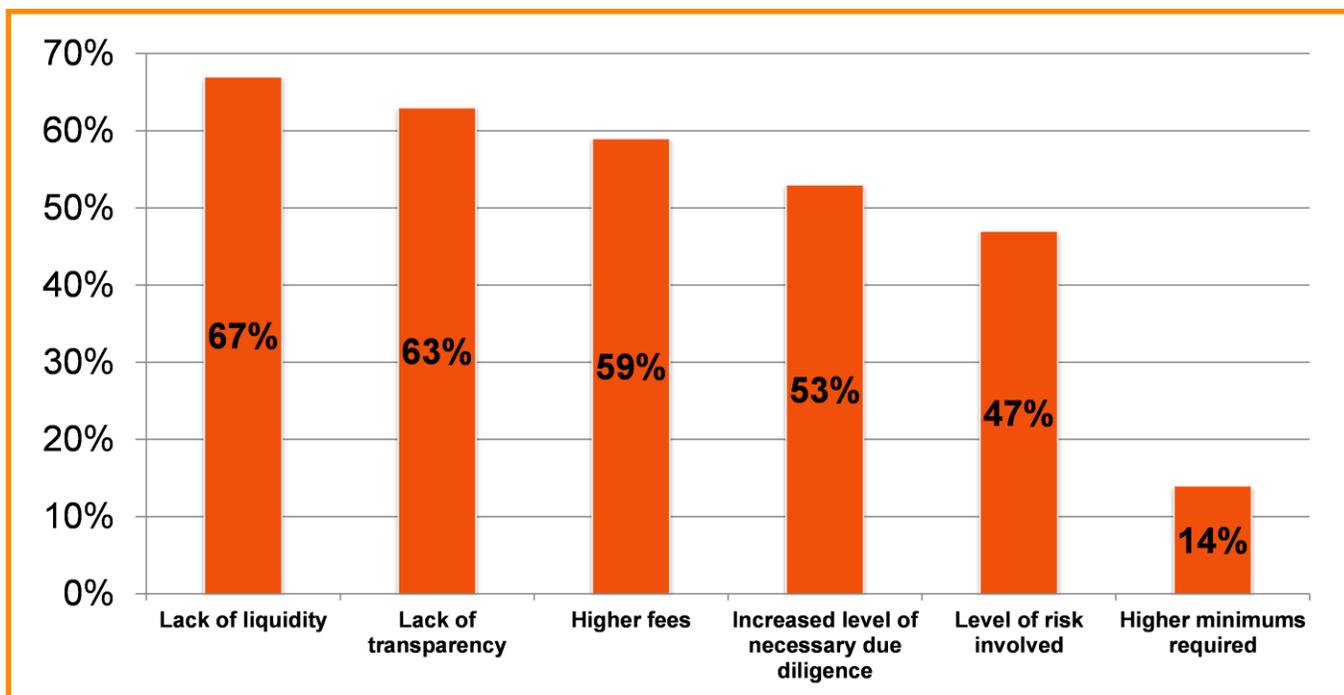
Some key findings:

- › Despite growing complexities in managing portfolios, respondents are prioritizing increasing overall diversification. Alternative investments are being used by a vast majority, and allocations will either remain the same or increase over the next year.
- › Many are looking to utilize the Investment Committee in a more strategic manner, including playing a bigger role in organizational financial planning or providing a higher level of risk analysis around the portfolio. Very few have prioritized hiring an in-house Chief Investment Officer (CIO) over the next year.
- › An overall focus on risk management initiatives is at the top of the list of priorities for nonprofits. Further validating that focus is the trend that positive risk-adjusted returns have become more important than overall returns for many respondents.
- › An increased level of necessary due diligence for alternatives, and concerns around having the resources required to perform the necessary due diligence around investment managers have fueled use of outsourcing. Those using an outsourced approach to investment management are more confident that active investment shifts are made quickly in response to changing market conditions.

Alternative investments remain popular

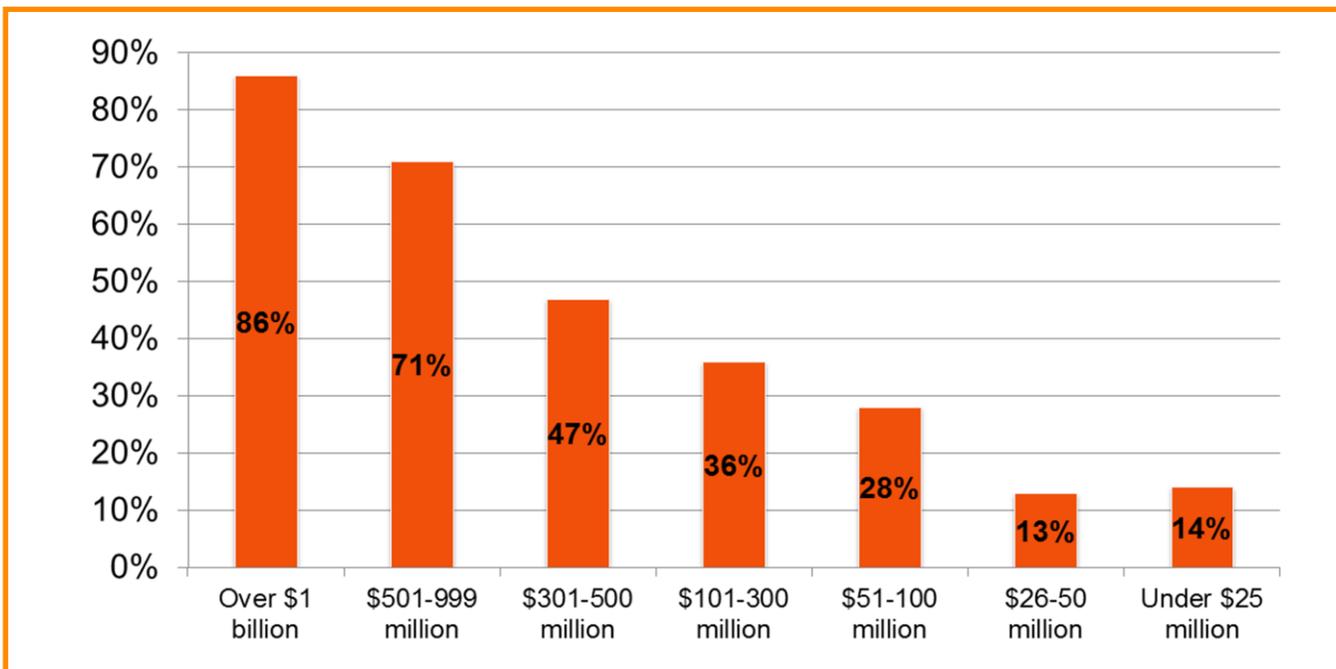
There is little debating the popularity of alternative investments within nonprofit investment portfolios. The majority (82 percent) of all participating organizations have at least some assets in the portfolio allocated to alternative investments. The larger the asset pool, the more likely alternative investments are used. Of those participants with \$300 million or more in assets, 92 percent have allocations to alternative investments. In contrast, only 78 percent of those with less than \$300 million in assets have allocations to alternatives.

- › **Concerns around use of alternatives** – While alternatives remain popular, there are definitely concerns in making these investments. Poll results suggest that nonprofits are still very much sensitive to some of the challenges that were highlighted during the 2008 financial crisis. During the crisis, many nonprofits were challenged from a liquidity standpoint, as many popular alternative investments had lock-up periods preventing investors from accessing their much-needed investments to support rapidly decreasing finances. The lack of liquidity in alternatives continues to top the list of challenges. The chart below highlights the percentage of poll respondents citing these challenges when it comes to using alternatives.

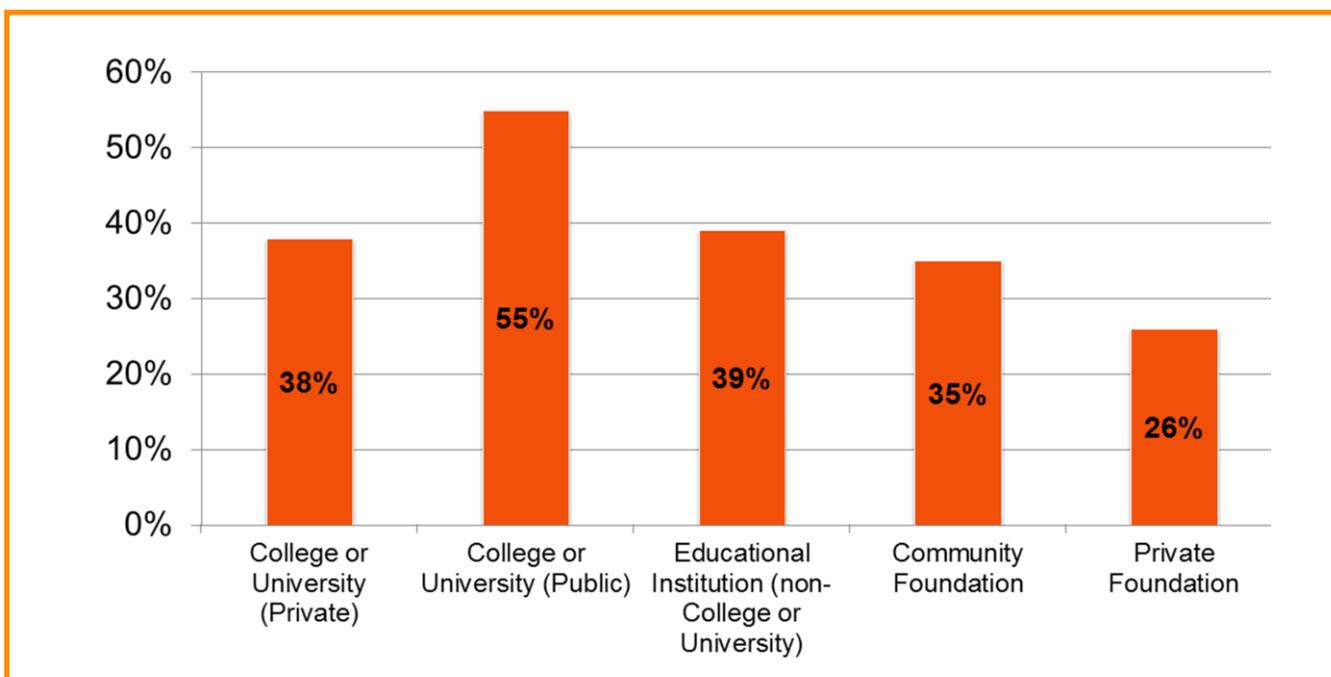


- › **Despite concerns, allocations remain significant** – While concerns exist, they have done little to temper a willingness to allocate a significant percentage of the portfolio to alternative investments. Of the poll respondents currently using alternatives, a significant portion (70 percent) allocate 11 percent or more of the total portfolio to these investments. When looking at just those with over \$300 million in assets, 85 percent allocate 11 percent or more of the total portfolio to alternatives.
- › **Nonprofits will continue to invest in alternatives** – Almost all (96 percent) of poll participants said they will either maintain or increase the allocation to alternative investments over the next 12 months. These results break out to 21 percent increasing and 75 percent maintaining the current allocation.

- Size matters with alternatives** – The larger organizations clearly have greater allocations to alternatives. More than one-third (39 percent) of those organizations with over \$300 million in assets have allocated 31 percent or more of the portfolio to alternatives. Below is a chart showing the percentage of organizations in each size group that has at least 21 percent of the portfolio invested in alternatives.



- Educational endowments embrace alternatives** – When looking at the types of organizations and how they are investing in alternatives, as expected, the college and university segment leads the way. More than half (55 percent) of the public college and universities have at least 21 percent of the portfolio invested in alternatives (by far the largest group). The below chart breaks down the top five types of poll respondents and shows the percentage from that group that has 21 percent or more of the portfolio invested in alternatives.



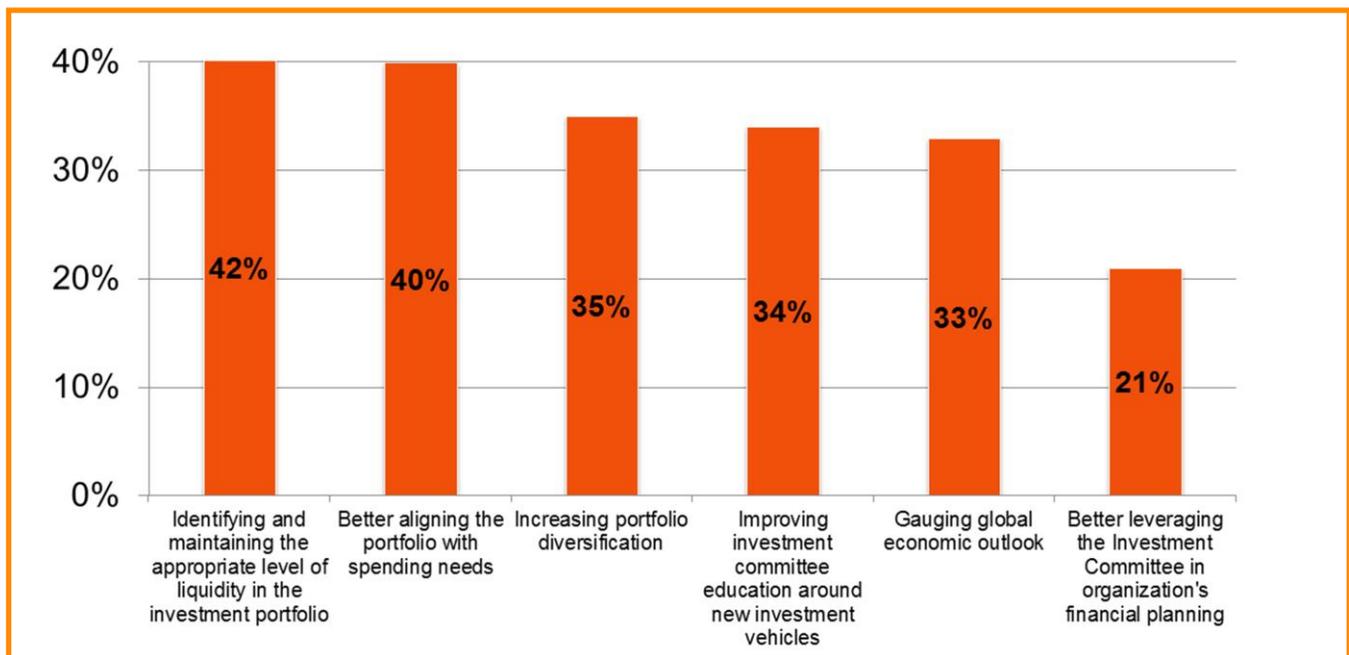
Focus on maximizing the Investment Committee's impact

The Investment Committee is an incredibly valuable resource for nonprofits as it traditionally can bring together a wide range of expertise and insight. However, one of the ongoing challenges for nonprofits has always been around maximizing that resource. The volunteer nature of committees leads to limited meeting time and regular turnover of members. Coincidentally, only two participants (one percent) said it was an organizational priority to hire a Chief Investment Officer (CIO) over the next 12 months. Poll participants pointed to a number of challenges when it comes to how the organization is best utilizing the Investment Committee:

"We need to find a way to improve the Investment Committee's understanding of 'risk' in the portfolio."

- › **Arming Investment Committees with information** – Over the next 12 months, there appears to be an increased focus on providing Committees with better access to information. A little more than one-third (34 percent) said improving Investment Committee education around new investment vehicles is an organizational priority. One-third (33 percent) said better gauging global economic outlook is a priority, while nearly one-quarter (23 percent) said it was important to improve spending policy research and planning. Nearly one-quarter (24 percent) also said they lack confidence that the Committee is currently provided with enough information to conduct substantial risk analysis.
- › **Finding resources for due diligence** – More than three-quarters (78 percent) said managing the investment portfolio is more complex now than in the past. More than one-third (35 percent) said that a priority over the next 12 months is to increase portfolio diversification. Almost one in five (19 percent) of poll respondents said the Investment Committee is concerned about the resources required to perform the necessary due diligence around investment managers moving forward.
- › **Making the Committee's role more strategic** – Over the next 12 months, poll respondents indicated it is a priority to utilize the Committee for more strategic initiatives and to do this effectively nonprofits will need a system that best leverages the Committee's limited time. Areas of focus will include better aligning the portfolio with organizational spending needs (40 percent), better leveraging the Committee in the organization's financial planning (21 percent), and building donor confidence in investment strategies (23 percent).

The chart below shows the percentage of respondents that identified these items as organizational priorities over the next 12 months (only the top six ranked priorities are shown).

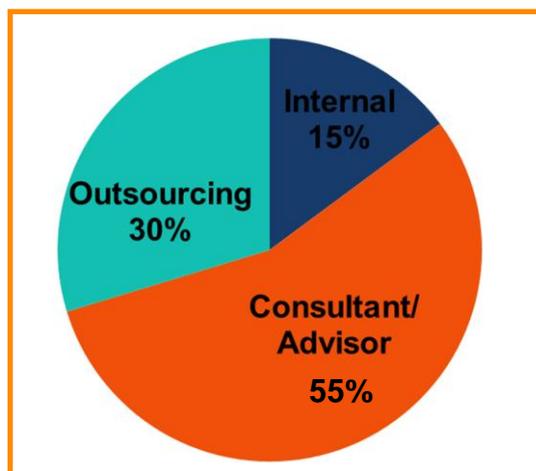


Evaluating investment outsourcing

Investment outsourcing continues to grow in use by nonprofits and that trend does not appear to be slowing down. According to Casey Quirk, the nonprofit sector will be the fastest growing users of investment outsourcing over the next five years. The firm predicts nonprofit assets invested in outsourcing programs will experience a compound annual growth rate of 15 percent over the next five years, and will top \$391 billion by 2018 – comprising 38 percent of all outsourced assets.¹

Investment outsourcing is defined in a lot of different ways by a lot of different providers. At a minimum, the primary service of an outsourcing provider is taking over the responsibility of researching, hiring, monitoring and replacing money managers. Poll respondents were asked to identify their current approach to the selection of money managers. They were provided the following definitions and the chart to the right shows the percentage using each approach:

- › **Internal Model**- The investment committee does NOT use external investment consultants and therefore handles all manager research, selection and replacing internally
- › **Consultant/Advisor Model** - The organization uses a consultant or advisor who researches and provides a selection of manager finalists but ultimately the investment committee selects and replaces managers.
- › **Outsourcing Model**- The organization utilizes an outsourcing provider who makes all or some manager research, selection and monitoring decisions.



Nearly one-third (30 percent) of the nonprofits participating in the poll currently use an outsourcing provider, further validating this ongoing trend. Those currently using an outsourcing provider were asked to rank the top three benefits to this approach. Using a weighted system for how respondents ranked those benefits, the below chart identifies the top three:

Top 3 Benefits of Using an Outsourced Approach to Selecting Money Managers	
1.	Can more promptly take advantage of market changes
2.	Improved overall risk management
3.	Access to better money managers

¹ [2014 Outsourcing Survey](#), Casey, Quirk & Associates LLC (March 2014)

Those currently making manager selection decisions internally or through the recommendations of a consultant or advisor were asked why they do not currently use an outsourced approach. The top three reasons are below.

Top 3 Reasons For Those Not Currently Using an Outsourced Approach for Manager Selection	
1.	Satisfied with the current provider or process (80 percent)
2.	Investment Committee prefers to select the money managers (49 percent)
3.	Investment Committee feels it is their fiduciary duty to select managers (45 percent)

- › **Outsourcing asset allocation decisions** – In some instances, organizations choose to take an additional step when it comes to investment outsourcing by delegating asset allocation decisions to an outside partner. The majority of the nonprofit poll respondents (79 percent) said the Investment Committee makes all asset allocation decisions either with or without suggestions from outside advice. The remaining 21 percent have outsourced some or all asset allocation decisions to an outside fiduciary.

An emphasis on risk management

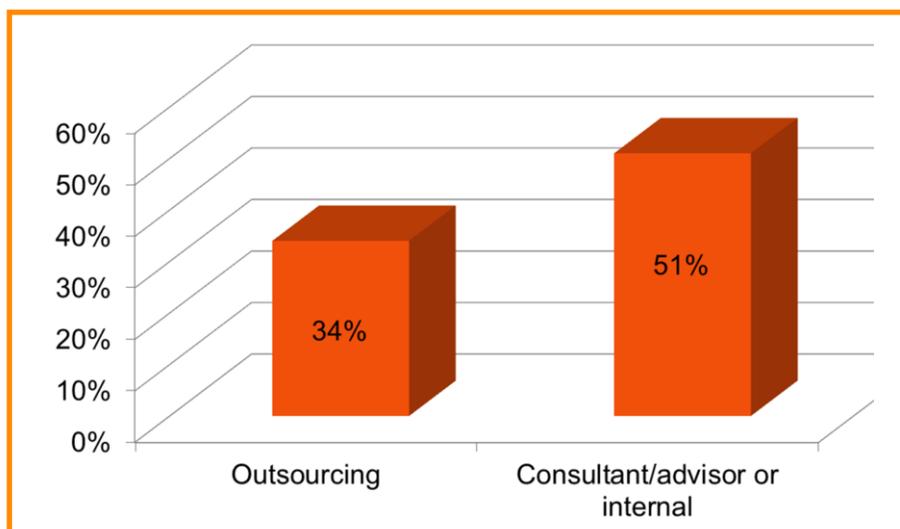
More nonprofits are looking to implement effective risk management programs that help protect the organization’s ability to achieve its mission. Successful risk management strategies come in many shapes and sizes but ultimately provide the ability to forecast and evaluate financial risks together with identifying strategies to avoid or minimize their impact.

The poll results suggest this is an increased focus for many nonprofits. Comprehensive risk management programs often integrate investment portfolio decisions with the impact they have on organizational finances. This includes not just investment risks within the portfolio but managing risks the portfolio could present to the organization at large.

- › **Emphasis on risk-adjusted returns** – The market volatility of the past few years looks to have led many organizations to implement risk-adjusted metrics when evaluating investment success. Nearly half (46 percent) of the poll participants said that positive risk-adjusted returns are a more important benchmark of investment success than overall portfolio returns.
- › **Impact of portfolio on spending** – A significant majority (81 percent) were confident that the spending policy is set with a definitive understanding of overall portfolio risk. While that might be the case, many lack confidence that the appropriate amount of time is being spent to stress test the portfolio against a variety of scenarios and how that would impact spending. Almost half (44 percent) lack confidence that sufficient time is spent assessing the impact of various market shocks (e.g. a 20 percent market decline) on the ability to spend/achieve mission. Just over one-quarter (27 percent) felt confident the organization knows the impact that a rise in interest rates would have on the portfolio and the ability to spend/achieve the mission.
- › **Impact of portfolio on liquidity and spending** – Nearly half (49 percent) lack confidence that the Investment Committee has identified all key portfolio risks. As almost all poll respondents noted a plan to maintain or increase allocations to alternatives, liquidity risk is one area of concern. Nearly half (42 percent) said identifying and maintaining the appropriate level of liquidity in the investment portfolio is a priority in the next 12 months.

“Managing the risk/reward balance is a huge priority for us.”

- › **Active investment shifts are challenging** – Nearly half (48 percent) of all participants said they lack confidence that active investment shifts are made quickly in response to changing market conditions. This could also be a by-product of the current approach to investment management considering the ability to do this was identified as the top benefit by those using an outsourced approach to manager selection. The chart below compares the percentage from each group that lacked confidence that active investment shifts are made quickly in response to changing market conditions.



Additional highlights

The results from this poll have demonstrated how complex of an environment it has become for Investment Committees and those overseeing nonprofit investments. Beyond the day-in and day-out challenges, there are always new and distinct challenges to address, including the use of environment, social and governance (ESG) investing, the loom of inflation and the use of underwater funds.

- › **ESG investing seeing early adoption** – Socially responsible investing continues to evolve and recent evidence suggests that these factors may offer long term performance benefits. The poll results show a very challenging and complicated environment for investing, and integrating ESG is another component to add to that mix. However, poll respondents must be seeing some level of value in this emerging approach as nearly one-third (32 percent) of the poll participants said the organization either currently does or plans to integrate ESG factors into the investment process.
- › **Inflation not viewed as threat before 2016** – As inflation continues to stay below target in most regions of the world, there appears to be little concern of a potential impact on portfolios. Only 18 percent said that inflation will be a threat to the organization’s purchasing power by the end of 2015.
- › **Spending from underwater funds** – The Uniform Prudent Management of Institutional Funds Act (UPMIFA) has had an impact on how Investment Committees and Boards elect to spend from “underwater” funds or funds that drop below historic dollar value. As equity markets rallied significantly in 2013, the number of underwater funds continued to decrease. The number of poll participants that currently have underwater funds is less than one-third (30 percent). However, of that group, 64 percent with underwater funds are spending from them.

Conclusion

Poll respondents confirmed that managing investment portfolios is more complex now than in the past; however that has not impacted efforts to add new asset classes, better align investments with organizational finances, and implement risk management strategies that require additional analysis.

Overall allocations to alternative investments are significant and could continue to grow. Many respondents lack confidence that the organization is successful at implementing important components of risk management such as assessing the impact of market shocks and interest rate fluctuations.

Investment Committees continue to be challenged with time and resource constraints, yet the desire is to involve them more with organizational financial planning. Some have elected to outsource manager selection to outside partners to help create additional capacity while those who haven't are reluctant because they either like to select managers or feel that it is their fiduciary responsibility to do so. Some organizations have even elected to outsource asset allocation decisions.

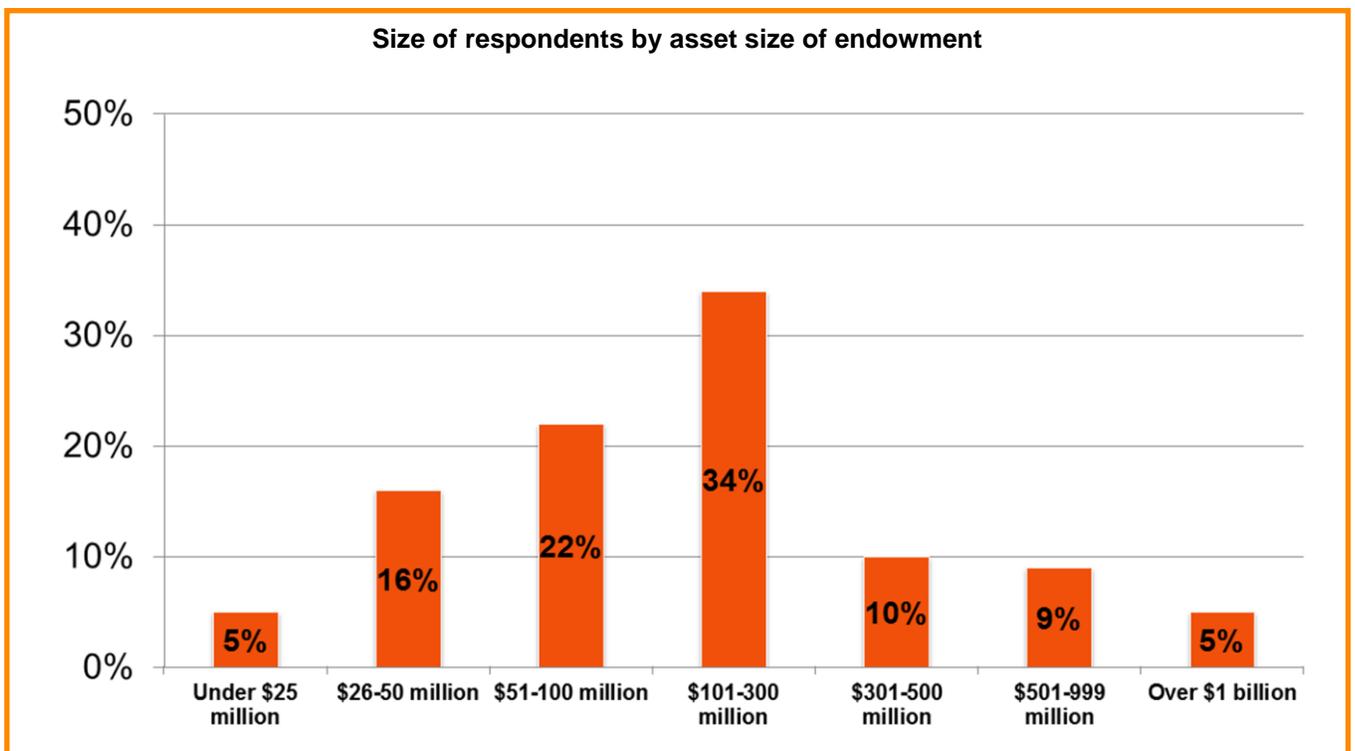
While the challenges continue to grow, nonprofit executives and Investment Committees are prioritizing those items that ultimately strengthen the organization and help maximize the ability to meet its overall mission.



Any questions on this poll or for more information around SEI's nonprofit outsourcing services, email SEIResearch@seic.com or call 1-866-680-8027.

This information is for educational purposes only. Not intended to be investment, legal and/or tax advice. Please consult your financial/tax advisor for more information. Information provided by SEI Investments Management Corp., a wholly owned subsidiary of SEI Investments Company. ©SEI 2014

Poll demographics



Poll demographics

