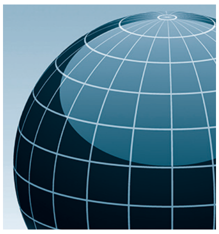
Insights on...
ASSET ALLOCATION

STRATEGIC ASSET ALLOCATION FOR NOT-FOR-PROFIT ENTITIES

Understanding the recommendations for 2014



February 2014

As a not-for-profit organisation with an endowed investment portfolio, your target investment time horizon likely is long-term – multi-generational to perpetual. Your investment objective may involve maintaining and even increasing your portfolio's real purchasing power while supporting annual distributions consistent with your charitable purpose. Meeting these objectives – long-term growth and meaningful ongoing distributions – is a significant challenge, particularly in an environment with low expected returns for investment-grade fixed income.

- The portfolio must have sufficient liquidity to meet current distribution requirements.
- You likely want to manage volatility to help maintain a more predictable flow of distributions.
- Critically, you must still invest for long-term compounding to maintain and increase the portfolio's real global purchasing power beyond the level of distributions.

STRATEGIC ALLOCATIONS PROVIDING STARTING POINT FOR PORTFOLIOS

Northern Trust develops allocations for large, long-horizon investors* with a variety of objectives (our strategic asset allocation paper, "Evolving Environment Causes Subtle Shifts; Brings Illiquidity Premium in Focus," provides more detail). Our "starting points" include five model portfolios – Low Volatility, Conservative, Diversified, Growth and Maximum Growth – based on investment objectives that move from low expected volatility and returns to high. Of these model portfolios, Northern Trust's Growth objective is structured to support the unique investment objectives of not-for-profit organisations.It does so through a careful combination of investments:

- Modest but meaningful allocations to low-return cash and investment-grade bonds help ensure support of nearer-term distributions.
- Allocations to spread bonds provide higher expected returns and the potential for better total returns in a scenario where investment grade bond yields are rising and emerging market currency values are increasing relative to developed market major currencies.
- Allocations to real assets can provide protection should inflation accelerate.
- Significant allocations to equities function as the primary "engine" driving long-term compounding. While private equities have higher expected returns, we have a higher starting allocation to public equities in the Growth model because of liquidity concerns.
- Significant allocations to hedge funds help manage overall portfolio volatility while providing risk-asset level returns.

THE POWER OF COMPOUNDING: THE HENRY SMITH CHARITY

Understanding a multi-generational to perpetual time horizon can be challenging for trustees and investment committees. The impact of their decisions may not become apparent until after they are long gone. To provide context, evaluating the success of charities that have existed for multiple generations can be helpful, and can highlight the benefit thoughtful stewardship over hundreds of years can have on meeting the organisations' goals today.

The Henry Smith Charity is one such example. Henry Smith was born in May 1548 in Wandsworth, south London, and was a salt merchant by trade. A successful businessman, Smith created a number of charitable trusts benefiting the poor and disadvantaged. Smith died in 1628.

From an initial endowment valued in the £1,000s, the charity's assets have grown to £100s of millions, and comprise a substantial portfolio of property, as well as stock market, hedge fund, private equity and venture capital investments. This substantial increase can be calculated as a seemingly modest net-of-distribution compounding rate, but because that compounding spans almost 400 years, its power is magnified. This allows the Charity to make millions of pounds in grants each year throughout the United Kingdom, addressing a wide range of causes.

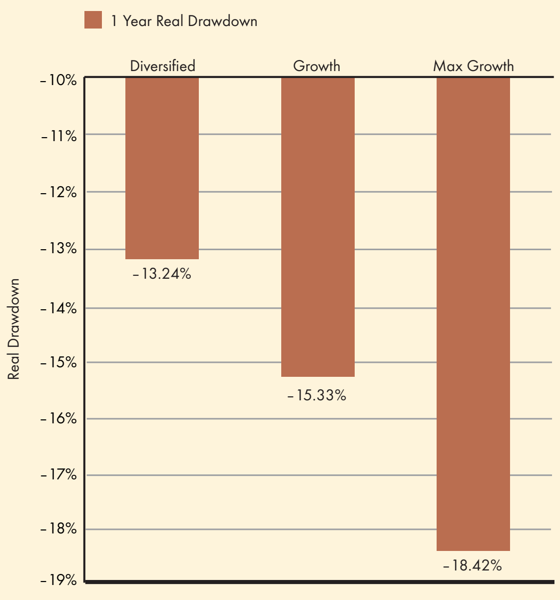
The expected return on the Growth portfolio at the asset class level is 7.7%, which is slightly lower than the 8% or higher target investment return many not-for-profit entities seek, based on their objectives. Our Maximum Growth objective has a return expectation at the asset class level of 8.3%, but does not provide the ideal balance between nearer term liquidity and volatility management most not-for-profit entities need to support ongoing distributions and provide long-term compounding. The Growth objective seeks to achieve that balance, and serves as the basis for our strategic allocation recommendations. However, you may need to seek other sources of outperformance to add to asset class returns. These might include:

- Tactical asset allocation – adjusting allocations to take advantage of nearer-term asset class return opportunities, overweighting undervalued categories and underweighting overvalued categories.
- Manager selection – identifying top active managers that can outperform their reference asset class benchmarks.
- Manager combination – combining top managers in a complementary fashion to help reduce portfolio volatility and increase geometric returns.

BALANCING NEAR- AND LONG-TERM OBJECTIVES

In seeking to balance support of near-term distributions and long-term compounding, there is no substitute for forward-looking investment judgment. That said, we test our thinking by executing numerous analyses. For example, we have run projections for our Diversified, Growth and Maximum Growth allocations focusing on "worst case" nearer-term results and "expected" or median longer-term results on a real, net of inflation and distributions basis. This helps us test our perspective that Growth can strike a balance between liquidity and risk management in the near term, and real value protection or growth for the long term.

EXHIBIT 1: WORST-CASE PROJECTIONS FOR STANDARD ALLOCATIONS



Source: Northern Trust. Potential real drawdown projections are net of investment losses, 5% distribution and inflation.

Worst Case (5th Percentile) Scenario Performance

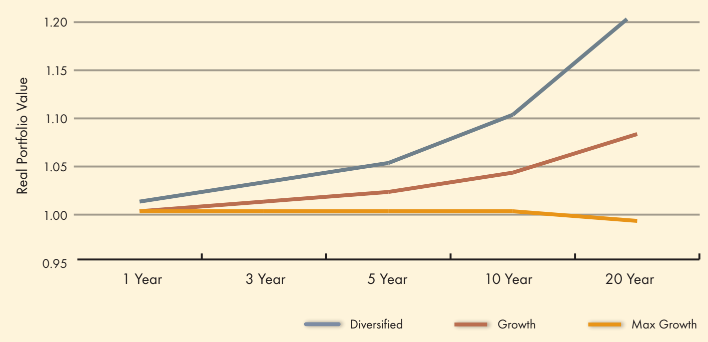
In the worst-case projected scenario, the 5th percentile result (worse than 95% of expected outcomes) with a one-year horizon, Growth has a potential real drawdown (net of investment losses, a 5% distribution and inflation) of 15.3%. As shown in Exhibit 1, this is 310 basis points better than the projections for Maximum Growth, but not as good as the Diversified portfolio's drawdown of only 13.2%. However, when it comes to maintaining real value over the long term in a median markets scenario, Diversified does not show as well.

Median Scenario Performance

In a median scenario (50th percentile results), the Diversified portfolio's real value (before any contributions to returns from active management) slowly declines during the 20-year period tested. In contrast, the Growth portfolio's real value is expected to increase during the same period.

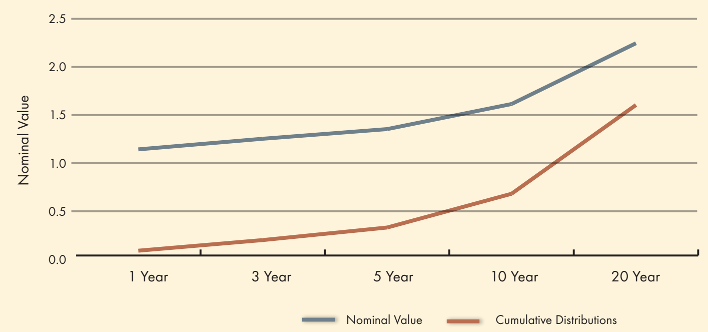
As shown in Exhibit 2, Maximum Growth increases real value more than Growth in the median scenario, which may make Maximum Growth a good starting point for certain not-for-profit entities with strong expectations of ongoing contributions that moderate need for downside protection and liquidity management within the portfolio. For the majority of not-for-profit entities, however, we believe Growth strikes a better balance and therefore is the best starting point.

EXHIBIT 2: REAL GROWTH OVER TIME



Source: Northern Trust

EXHIBIT 3: NOMINAL GROWTH IN VALUE AND DISTRIBUTIONS



Source: Northern Trust

75th Percentile Scenario Performance

In the 75th percentile projections (good markets or good management), we can see another view on the impact of achieving real growth: increasing the amount available for distribution. Growth's 20-year projections show the portfolio more than doubling its value on a nominal basis (2.2x) while distributing the equivalent of slightly more (1.3x) than its starting value (see Exhibit 3).

COMPARING GROWTH TO THE NACUBO AVERAGES

The annual National Association of College and University Business Officers (NACUBO) benchmarking study helps put the Growth allocation in context. The NACUBO study presents a summary of average asset allocations for endowments of various sizes, which provides a particularly useful comparison for investors that need to increase capital while maintaining significant disbursements.

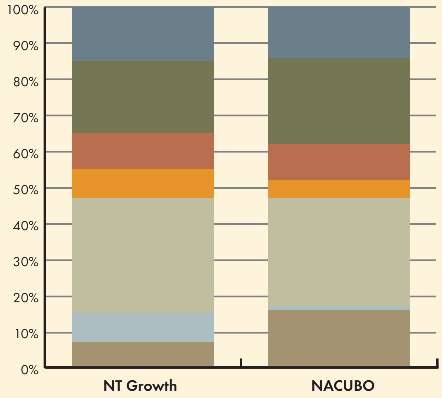
As you can see in Exhibit 4 (on page 4), Northern Trust's Growth allocation has total allocations to fixed income comparable to the NACUBO average for endowments between $500 million and $1 billion. However, the mix is different — Northern Trust's Growth model has lower target allocations to investment-grade bonds and higher target allocations to spread bonds. Total allocations to developed and emerging equities and hedge funds pooled together are nearly identical for our Growth model and the NACUBO averages — the Northern Trust allocations to public equities are higher due to care taken to maintain liquidity. Investors that have carefully analysed their liquidity needs and are comfortable with higher levels of illiquid exposure can benefit from higher allocations to alternatives.

Northern Trust's relative allocation to emerging market equity (which comprises 20% of our total allocation to public equities) is higher than the NACUBO average (14%). For investors who understand the near-term volatility implications, we believe the longer-term return premium and diversification benefits provided by a strategic overweight to emerging markets are beneficial.

Comparing NACUBO's allocations for larger endowments (those with more than $1 billion in assets) to Northern Trust's Maximum Growth allocation, allocations to private equity are very similar: 21% of total assets for the NACUBO allocations compared to 20% for Northern Trust's Maximum Growth. The NACUBO private equity allocations for this group are higher than those for endowments with assets between $500 million and $1 billion. Reasons for this may include larger endowments' greater experience and comfort with private investments, better access to top funds and offsetting liquidity considerations – including lower average payouts (below 5% annually) and ongoing inflows from regular new giving to the pools.

EXHIBIT 4: NORTHERN TRUST GROWTH OBJECTIVE VS. NACUBO

	NT Growth	NACUBO
Private Equity	15%	14%
Hedge	20%	24%
Real Assets	10%	10%
Emerging Equity	8%	5%
Developed Equity	32%	30%
Spread Bonds	8%	1%
Cash and Investment Grade	7%	16%
Expected Volatility	11%	10%
Expected Return	8%	7%



Sources: Northern Trust, National Association of College and University Business Officers, and Commonfund Institute 2012 Study. Allocation averages for funds: $500 million to $1 billion.

In our view, equities (both private and public) are essential drivers for long-term compounding, but complementary exposures can be essential to helping to manage interim volatility, liquidity and distribution requirements. It appears that many endowment managers share the same perspective, which likely is what lies behind the similarities in many elements of the allocation comparison. However, it is important to remember that averages are just that – made up of many individual pools of assets each customised to its unique circumstances.

LEARN MORE

If you would like to learn more about Northern Trust's investment process and how it relates to your goals as a not-for-profit entity, please contact your relationship manager or visit us at northerntrust.com.

Northern Trust

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