



JOHN F. COLLA, CFA, MANAGING DIRECTOR

## OPERATING NOT-FOR-PROFITS NAVIGATING THROUGH UNCERTAIN TIMES

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Trustees of operating not-for-profits who oversee endowments must balance current spending needs with maintaining spending power for the future. They also have the responsibility to ensure their organization has a strong enough balance sheet to support operations. These are difficult tasks, but for many operating not-for-profits it is complicated by challenges—some existential—caused by technology, demographics, and broad socio-economic changes. Moreover, the COVID-19 pandemic has accelerated these challenges and many operating not-for-profits face an uncertain and unprecedented future. The blinking caution lights that seemed somewhere in the distance are now at the next intersection: hospital revenues are down, and margins are under pressure; college campuses are vacant as falling enrollment threatens academic sustainability; museums have little to no foot traffic; collections at faith-based organizations have slowed; symphonies have cancelled their shows.

In the past, operating not-for-profits have relied on endowments and balance sheets to help them through tough times. But will that be enough this time around? What more can they do? Are their investments aligned with strategic and organizational priorities? How do leaders and trustees know?

### IS YOUR OPERATING NOT-FOR-PROFIT PREPARED FOR THE FUTURE?

Below details Clearstead's checklist for operating not-for-profits to review in 2020/2021.

#### Operating Not-For-Profit Checklist For 2020/2021

1. Reaffirm investment strategy and underlying pool objectives amid operational and financial uncertainty due to COVID-19.
2. Understand capital needs and develop optimal funding solutions.
3. Develop strategy for short-term and reserve assets given current yield environment.
4. Maintain discipline to strategy tuning out short-term volatility.
5. Ramp up understanding of the role of private investments.
6. Review pension risk to the organization's balance sheet and financial position.
7. Understand fiduciary oversight of defined contribution plans and evaluate current state.
8. Evaluate responsible investing and what is most important to the organization.

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One thing that is clear is the need for change. The solutions institutions used during past challenges may not be enough this time around. A history of excellence may give an institution more time to solve problems but should not be viewed as the only solution in and of itself. What may need to occur is a shift in strategy: refining target market segments, reassessing mission, dropping lines-of-business, or steep cost reductions. Further, organizations must ensure their investment strategy and organizational priorities are aligned. Key stakeholders of operating not-for-profits are in a tough position of being honest with themselves and doing what is necessary to remain viable in the future.

## ALIGNING ORGANIZATIONAL PRIORITIES WITH INVESTMENTS

Many operating not-for-profits may be forced to rely on their investment pools, and not on operations alone, to bolster their finances. To make matters worse, many operating not-for-profits have a misalignment between their operational and financial priorities and the strategy they follow with various investment pools. The concern is that misaligned investments may exacerbate finances in times of stress.

For example, an institution may be taking more investment risk than its operational and financial priorities warrant. Investment risk leads to fluctuations in the market value of assets for an operating not-for-profit; if a stressed market environment occurs when an institution is overextended with investment risk, the institution may not have funds that were slated for an upcoming capital project or spending. This hurts the institution's financial position or could compromise one of its financial covenants. Any of these outcomes can drastically alter an operating not-for-profit's strategic plan and can create challenges an institution may not be able to overcome.

The time is now—during the dislocations caused by the COVID-19 pandemic—to reassess the relationship between investments and organizational priorities. Key factors to analyze include revenue, profit margins, debt, capital expenditures, endowment spending, return forecasts, and investment risk, among others. As part of this reassessment, organizations must consider the effects of investments on spending as well as balance sheets and financial covenants. Only this type of analysis will ensure an optimal, holistic strategy is in place.

## INVESTMENT STRATEGY INTEGRATION

While decisions are being made that will alter operational and financial priorities of organizations, key stakeholders of operating not-for-profits are tasked with tying these priorities to an investment strategy that aligns with their objectives. One cannot be solved without the other. Integrating investment strategy with financial and organizational priorities of operating not-for-profits is central to Clearstead's approach and was described in a white paper published last year, [\*Integrating Portfolio Management with Financial Objectives & Constraints\*](#).

Operating not-for-profits should have an overarching investment strategy that is consistent across multiple investment pools: operating assets, endowment

Clearstead works with many prominent operating not-for-profits, leading the process to help them develop holistic investment strategies, some of which are outlined in this article. As an organization's centralized investment partner, Clearstead provides fiduciary investment oversight, in most cases, of all the organization's asset pools. Further, Clearstead serves as an Outsourced Chief Investment Officer (OCIO), leading investment programs and ensuring clients have the best strategy in place given their operational and financial priorities.

Please visit our website or contact the head of our Institutional Consulting Group, Mike Shebak ([mshebak@clearstead.com](mailto:mshebak@clearstead.com)), to learn more how Clearstead can partner with you.

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and foundation assets, retirement plans, and self-insurance pools. Though each pool has its own purpose, each relates to a singular investment objective of the institution. This objective will revolve around three fundamental concepts:

1. A holistic investment strategy that aligns with operational objectives
2. Funding future capital expenditures and projects to remain competitive
3. Supporting the operating budget and financial position of the organization

Below are some of the most common financial priorities of operating not-for-profits and corresponding investment metrics with which they need to be aligned.

FINANCIAL PRIORITY	INVESTMENT CONSIDERATION					
	TOTAL RETURN	CASH FLOW / INCOME	VOLATILITY	LIQUIDITY / SAFETY	DRAWDOWN / VALUE AT RISK	INTEREST RATE SENSITIVITY
Spending / Income	X		X			
Debt Service Coverage		X		X		
Realized / Unrealized Gains/Losses	X		X			
Days Cash on Hand				X	X	
Debt / Capital	X				X	
Pension Risk / Funded Status			X			X

Each investment consideration affects each financial priority to some extent. As an example, an institution prioritizing days cash on hand should focus on liquidity and stress testing in periods of significant market declines.

This financial modeling process helps in the development of a holistic investment strategy for an operating not-for-profit, which is a service Clearstead provides. This process leads to optimal outcomes and a strategy that aligns with operational and financial priorities.

## IMPLEMENTATION IN TODAY'S WORLD

The COVID-19 pandemic and the current economic environment has expedited the uncertainty and disruption to the service offerings of operating not-for-profits. The message: institutions must transform to remain competitive in their industries in the future. With the way this year has unfolded, the need for transformation has become more urgent and pressing. In trying times with uncertainty looming, it is of the utmost importance to best prepare for what may come and ensure that all aspects of an institution are in-sync. Institutions need to develop, reaffirm, and implement holistic investment strategies that align with operational and financial priorities.

This does not happen overnight. Extensive financial analysis and modeling are essential to validate alignment of organizational objectives and investment strategy. The investment team must work closely with key stakeholders, investment committees, and board members to understand operational and financial priorities, objectives and constraints, and the mission of the organization to intertwine these in the investment process. The outcome yields a strategy that gives an institution the best probability of navigating through the unknowns that tomorrow brings.

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## MARKET BENCHMARK RETURNS

July 31, 2020		1M	3M	12M	YTD
US Large Cap	S&P 500	5.6%	12.9%	12.0%	2.4%
US Small Cap	Russell 2000	2.8%	13.3%	-4.6%	-10.6%
Developed Intl	MSCI EAFE	2.3%	10.4%	-1.7%	-9.3%
Emerging Intl	MSCI Em Mkt	8.9%	17.8%	6.5%	-1.7%
Real Estate	NAREIT	3.8%	8.4%	-6.4%	-11.8%
Core Fixed	BarCap Agg	1.5%	2.6%	10.1%	7.7%
Short Fixed	BarCap 1-3Yr	0.2%	0.7%	4.5%	3.1%
Long Fixed	BarCap LT G/C	5.3%	7.0%	24.3%	18.8%
Corp Debt	BarCap Corp	3.1%	6.7%	11.9%	8.0%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.