LANCASTER POLLARD

The Nonprofit Minute

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About the Firm

Lancaster Pollard Investment Advisory Group, an SEC-registered investment advisor, helps nonprofit organizations create the financial means to last the life of their missions by managing *total* financial risk rather than just investment-associated risk. Lancaster Pollard Investment Advisory Group shares common ownership with Lancaster Pollard, a leading provider of investment banking and mortgage banking services for the senior living, health care, affordable housing and private education sectors.

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Facing the Fear of Rising Rates

"So, first of all, let me assert my firm belief that the only thing we have to fear is fear itself – nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance." These words were part of Franklin D. Roosevelt's first inauguration speech in the midst of the Great Depression. Our economy is much better than it was then, and the outlook in the face of rising rates is better than most see.

Why do nonprofit organizations fear rising rates? The obvious reason is that interest is usually a significant expense on the income statement. Money spent on increasing interest expense must come from somewhere, and the concern is that a portion of moneys earmarked for mission delivery may be diverted to servicing debt. This is particularly true in organizations that have unhedged, variable-rate debt.

Is this fear well-founded, and for whom? Managing debt for a nonprofit organization differs significantly from managing debt for individuals or for-profit businesses. The reason is that most debt is tax-exempt. The characteristics of tax-exempt debt give nonprofit organizations significant funding opportunities that for-profit organizations do not enjoy. The most important

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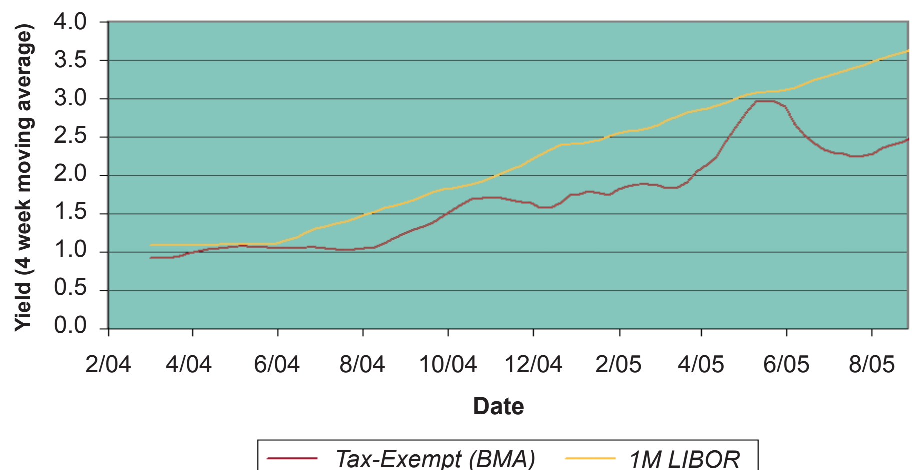
Widening Spread Between Rates As Rates Rise



characteristic is the fact that nonprofit organizations usually fund at a rate below the U.S. Treasury. In fact, the taxable and tax-exempt rates are significantly related. A simple, but powerful, explanatory model is:

tax-exempt rate =
(1 - effective tax rate) * taxable rate

Which means that the tax-exempt rate is a function of the taxable rate and the effective tax rate. This brings us to our first important conclusion: As long as the effective tax rate is greater than zero, tax-exempt rates will rise slower, and less than, taxable rates. For example, if you assume that the effective tax rate is 30%, then tax-exempt rates will be 70% of taxable rates (1 -30% = 70%).

The chart on the reverse shows taxable and tax-exempt short-term rates and how they have changed since rates bottomed in February 2004. The graph uses four-week moving averages to smooth the data. Clearly the taxable rate shows the impact of the measured increases of the Federal Reserve. The tax-exempt rate is more volatile, but shows that its increase is significantly below the taxable. In fact, since February 2004, tax-exempt rate movement has been approximately 80% of taxable rate movement. The practical reality and the theoretical model say the same thing: tax-exempt rates rise less than taxable rates.

Because taxable rates rise faster than tax-exempt rates, net income may increase. The simplest way to illustrate this is to imagine an organization that has $5 million in floating-rate tax-exempt debt and $5 million in money-market assets.

In February 2004, the interest cost of the debt was $46,250 per year on an annualized basis. Today, that expense has almost tripled to $130,000 per year on an annualized basis. Looking at just the expense side, rising rates have been a disaster. But on the investment side, income has risen from $54,766 a year to $190,375 per year, annualized. The net income from investing income minus debt expense has risen from $8,516 to $60,375. This illustrates how organizations benefit from rising rates. The higher rates go, the more benefit accrues to the wisely invested nonprofit organization.

Rising rates are not good for everyone. Those organizations that have no cash on the balance sheet will be squeezed by rising rates because they do not have the investment offset. Those organizations that have cash and investments, but whose assets are heavily allocated to equities or long-term fixed income securities also can find themselves squeezed, particularly when the rising rates and falling markets coincide.

For most organizations, the reality is much less terrifying than the perception because tax-exempt rates do not rise as quickly as taxable rates and because cash already on the balance sheet functions as a natural hedge. Many organizations that actively manage their interest rate risk across both sides of the balance sheet are benefiting from rising rates and the increased tax arbitrage.

To determine whether your organization is properly prepared for rising rates, please contact William M. Courson at wcourson@lancasterpollard.com

65 East State Street, 16th Floor
Columbus, Ohio 43215
Phone: (614) 224-8800
Fax: (614) 224-8805
www.chiefinvestmentofficer.com

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