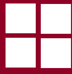
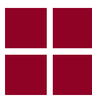
LANCASTER POLLARD


The Nonprofit Minute

WINTER 2007

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.

LANCASTER POLLARD

INVESTMENT ADVISORY GROUP

Liability-Driven Investing: Managing the Right Risks

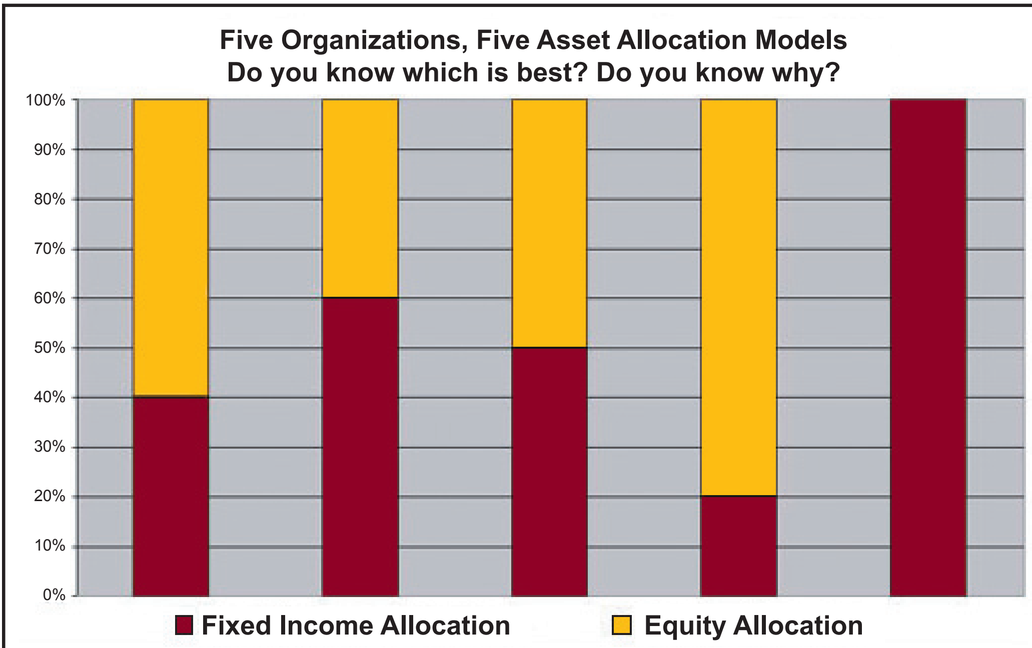
Liability Driven Investing (LDI) has become one of the hottest portfolio optimization topics in the investment industry. A popular European investment model, its stateside interest has been driven by new rules requiring that pension plan sponsors recognize unfunded projected pension plan obligations directly on the balance sheet, rather than in the footnotes. Portfolio valuation, then, is reflected in the financial statements, as is the full volatility of the securities market, encouraging pension plan sponsors to invest so as to "smooth" the volatility of plan assets.

Although the strategy is only recently trendy, liability-driven investment has long been a strategic and tactical policy for savvy mission-driven nonprofits. Its primary attraction is its ability to align risk in both the assets and liabilities. Simply stated, liability-driven investing is an asset allocation strategy that better matches the risk and duration characteristics of a plan's liabilities.

Nonprofits with investment policies have historically applied an average 60% equities, 40% fixed-income asset allocation. But as securities markets remain volatile, and interest rates stay relatively low, the need for active risk management is even more important. The average 60/40 allocation is difficult to apply to every organization; indeed, most do not strive to be average. In applying a liability-driven strategy, however, nonprofit organizations can best plan for the amount of risk they are capable of undertaking while protecting their long-term mission. The goal is to stay within a well-defined and calculated risk tolerance, while maximizing the returns of the portfolio.

This goal cannot be effectively achieved without knowing where risk resides. Organizations with existing liabilities, or those contemplating an opportunity to finance growth or implement

(Continued on back)



Any of these asset allocation models could be appropriate – or not. An allocation model's appropriateness depends on an individual organization's risk tolerance, defined in terms of its liabilities.

It is in the best interest of every organization to understand risk tolerance, or work with someone who does, to maximize the money available to the mission.

other changes in capital structure, should use the occasion to review their investment policies. These nonprofit investors should recognize the need to understand the inextricable link between the individual components of the investment portfolio and their effects on the organization's overall health.

Strategically, the investment policy statement assigns an asset allocation model generally independent of balance sheet constraints while identifying eligible investments and other restrictions. Unfortunately, despite its position as a central document in risk budgeting, the investment policy statement is infrequently reviewed, and policies are often grounded in vague assumptions rarely correlated with the long-term mission.

A liability-driven investment model begins with defining the true cost of liabilities, including hedges, creating what may be called a liability benchmark. It is from this benchmark that we begin to identify risk tolerance, or in some circles, risk capacity. Nonprofits and their adviser are interested in sustaining the mission in perpetuity. As such, the risk component of the risk/return equation takes on a different tone than that of their for-profit counterparts. With no need to appease shareholders on a quarterly basis, the nonprofit seeks to keep returns consistent, and positive, even if this means giving up a little of the upside. You will recognize this as a desire to smooth the volatility of returns, while retaining growth opportunities in the investment portfolio. Once the liability benchmark has been established, including certain debt covenants, you may discover that the appropriate investment benchmark may not be the S&P 500, but some component thereof.

Portfolio optimization, then, becomes a function of the risk that the organization can, or is willing to, take. Optimizing the portfolio encompasses returns analysis, including correlations and scenario analysis of the approved investment opportunities. This tactical asset allocation is monitored and updated on a regular basis.

Comprehensive asset-liability management for nonprofits embraces the basic tenets of liability-driven investing. Changes in financial status, such as a change in debt or even income projections, can affect the organization's ability to assume market risk. Risk tolerance analysis, combined with tactical asset allocation assessments, helps refine the overall risk capacity. This ensures that debt covenants are not violated and gives the board a greater level of comfort and ability to focus on their primary task – the mission.

To learn how your organization can apply liability-driven investing, please contact William M. Courson at

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

LANCASTER POLLARD
INVESTMENT ADVISORY GROUP