HOW TO PICK THE RIGHT INVESTMENTS

Be sure you match your investments to the trends.

BY GEORGE H. AUSTIN

Nonprofit organizations have unusually long lives: Many are set up to function in perpetuity. Thus, it is necessary to set nonprofit investment policy within the framework of very long-term trends in investment markets.

Figure 1 gives a rundown of such long-term trends. As it shows, investment returns vary greatly by decade. The 1970s turned out to be the poorest decade for stocks since the 1930s. As inflation accelerated, investment returns fell well below inflation rates and purchasing power eroded badly.

In sharp contrast, the 1980s saw investment returns far above inflation rates and allowed rebuilding of real purchasing power in portfolios. Note that the 1980s were the first decade since the 1930s when long-term bond returns were higher than inflation rates. Indeed, returns were even better than they appear, since the consumer price index has overstated the inflation rate by 1-1½% during the past several decades.

FIGURE 1. HISTORIC RETURNS ON SECURITIES

RETURNS BY DECADE
Annualized Returns

	1990s*	1980s	1970s	1960s	1950s	1940s	1930s	1926-95 Average	1986-1995 Average
Large Cap Stocks (S&P 500)	13.0%	17.5%	5.9%	7.8%	19.4%	9.2%	-0.1%	10.5%	14.8%
Small Cap Stocks	15.3	15.8	11.5	15.5	16.9	20.7	1.4	12.5	11.9
Long-Term Gov't Bonds	11.9	12.6	5.5	1.4	-0.1	3.2	4.9	5.2	11.9
Intermediate-Term Gov't Bonds	9.0	11.9	7.0	3.5	1.3	1.8	4.6	5.3	9.1
Inflation Rate/Consumer Price Index	3.4	5.1	7.4	2.5	2.2	5.4	-2.0	3.1	3.5

**Based on the 1990-95 period.*

History indicates that the investment returns enjoyed in the 1980s were unusual and unlikely to be sustainable. Nonprofit organizations must therefore have a longer term perspective of capital market history to set their investment policies.

CURRENT INVESTMENT POLICIES OF NONPROFIT ORGANIZATIONS

Despite the poor performance of the 1970s, and perhaps encouraged by the favorable investment results of the 1980s, nonprofit organizations have increasingly adopted spending policies based on a percentage of their assets' market value. They usually average market values over several years to improve the stability of their assets' distributions.

Figure 2 shows how a typical nonprofit organization would have fared historically, assuming a 5.5% payout of the previous year-end assets. Note that, due to inflation, the representative nonprofit organization was not able to increase its purchasing power, and that the rebound of the 1980s barely permitted recovery of the purchasing power lost in the 1970s.

Nonprofit organizations have unusually long lives.

It's important, therefore, that you limit your spending to *less than 5.5%* of your investment fund's assets. Such a policy will help preserve the real purchasing power of your remaining assets.

INVESTMENT OBJECTIVES AND TARGETS

As a nonprofit manager, you have a special responsibility to balance your organization's immediate needs with the longer-term purchasing power of your fund's assets. It's important that you have a written investment policy, including your investment objectives. A statement of your general objectives might read as follows:

INVESTMENT OBJECTIVES

"To provide conservation of principal in real terms, a reasonable and growing income, and capital appreciation without undue risk. The assets are considered permanent funds and will be invested in a prudent manner to achieve these objectives."

After writing out your investment objectives, you should create specific investment targets to achieve those objectives. For instance, you might state your targets as follows:

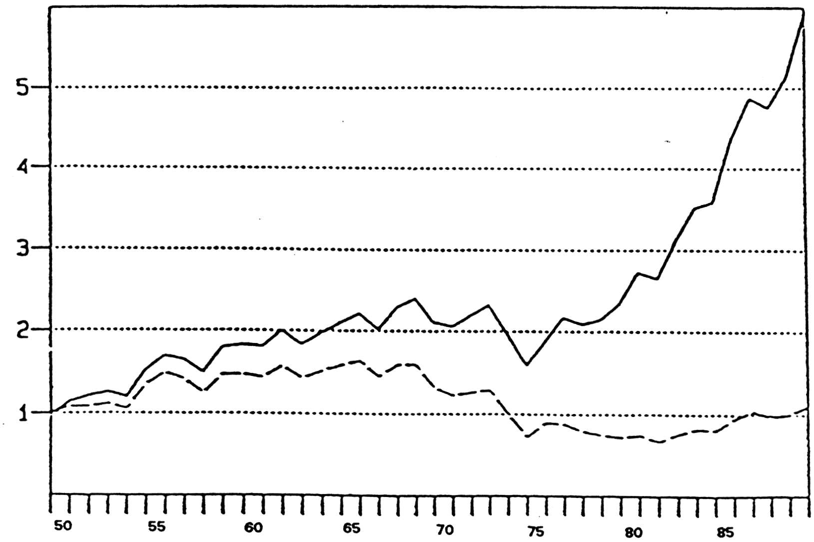
INVESTMENT TARGETS

1. Achieve Competitive Results: The portfolio should produce favorable total returns when compared with appropriate market averages and with other funds with similar objectives, both standards having been pre-approved by the fund's board of directors or investment committee. The expectation is to be in the top one-third for performance as measured over a five-year period.

FIGURE 2. PORTFOLIO PURCHASING POWER

1950-1989

(Hypothetical Nonprofit Organization Assuming 5.5% Payout)



Current Dollars _____
1950 Dollars - - - - - -

2. Maintain Purchasing Power: The principal is expected to grow at a significantly faster rate than the annual rate of inflation, again as measured over a five-year period. This means that total return rates shall be compared with inflation rates to gauge the progress of purchasing-power growth.

Experts recommend that nonprofits adopt the concept of "total return." Total return is defined as the aggregate sum of current income and changes in the market value of the assets under management. This means that capital gains or losses, whether realized or not, are combined with interest and dividend income to determine the return on a portfolio. Total return is regarded as the best measure of the portfolio's performance. This approach allows investment managers to concentrate on increasing income and principal over the long term rather than focusing on meeting current income needs.

INVESTMENT TIPS FOR NONPROFIT ORGANIZATIONS

- Create an investment committee, made up of board members and, perhaps, outside experts.
- Always take a long-term approach to investment.
- Don't use the returns of the 1980s as the basis for your investment policy, as these excellent returns were unusual and unlikely to be sustainable.
- Be sure you have a written investment policy, including an overall objective and a list of targets.
- Decide on the level of risk your organization is able to accept.
- Use your list of objectives and level of risk as a basis for deciding on a mix of assets.
- Consider hiring an investment manager if your organization's assets have grown too large for your board to handle (especially if assets total $100,000 or more). For details on hiring an investment manager, see Byrd in "Selected References).
- Include stocks in your fund's asset mix. Restrict bonds to maturities under 10 years.
- Use a "total return" approach, which allows you to focus on increasing income and principal over the long term rather than meeting current income needs.

FIGURE 3.
EXAMPLE OF ASSET MIX

	% of Fund
Stocks	50-75%
Large Cap Stocks	40-65%
Small Cap Stocks	10-30%
Intermediate-Term Bonds	20-35%
Cash and Equivalents	5-15%

ASSET ALLOCATION

The general investment objectives and targets you choose will help you determine the best way to allocate assets in actual practice. Depending on your long-term fund's risk tolerance, for example, you might choose an asset mix such as that in Figure 3.

A LONG-TERM HORIZON IS ESSENTIAL

Use the figures in this article to be sure your investments are truly long term.

Those who take a long-term approach will choose an asset mix that favors stocks over bonds—especially over long-term bonds. As Figure 1 shows, intermediate-term bonds have yielded as much as long-term bonds over the entire period. Long-term bonds have become more volatile in recent years. Also, the correlation between stock and bond returns has increased. Accordingly, the risk reduction formerly expected from a large bond component in the portfolio is now much more limited. In other words, long-term bonds can be used to obtain a stable current income stream but should not be considered low risk when valued at market.

It's true that returns for stocks, especially for small company stocks, vary widely from year to year. Over time, however, stocks have shown superior returns. For a truly long-term account, therefore, stocks should definitely be a large part of the asset mix.

Your board of directors and investment committee should make sure that your investment time horizons are truly long term. The historic figures discussed in this article will be useful in doing so. An investment manager with expertise in both stocks and bonds can also be helpful in establishing asset allocations, matching the asset mix with your fund's risk tolerance, and selecting the best securities for your portfolio. ■

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