The Bucket System: Managing Your Assets in the Face of Volatility

The key to financial stability lies in this simple system.

By Joel Aronson

As a nonprofit leader, you're no stranger to cash flow crunches. But you can attain a new level of stability if you persevere with a vision of stronger revenue capital management. The key is to look at your organization's cash in a new way. In your mind, divide all your organization's revenues capital into three segments, or "buckets," as follows:

Bucket #1: Working Capital

Working capital comes first: Your organization needs funds to operate on a day-to-day basis. How much you need depends on how your organization earns revenue. If funding comes via annual subscriptions or tuitions, the "working capital" bucket may be full at the beginning of each fiscal year. If you have a fee-for-service model, you may need more working capital – and it may take more time to fill that bucket.

To supplement revenue working capital, you can tap into a line of credit. It's important to note, however, that the best time to apply for a line of credit is before you need it. If you wait till your organization is cash poor, banks will likely hesitate to work with you.

Getting a steady run of working capital each year is the baseline for strong performance. The industry's leading evaluator, Charity Navigator, looks carefully at this bucket when it calculates its ratings. "Charities that build working capital develop a greater capability for expanding and improving their programs," according to Charity Navigator. "[We] analyze a charity's working capital ratio by determining how long it could sustain its current programs without generating new revenue."

Bucket #2: Reserves

When profit builds to a point that you can cover more than extended operational needs, you can begin to develop reserves. Reserves are critical to long-term health. They can mean the difference between surviving a rough patch or being forced to wind down.

Be sure your strategic plan has a strong focus on building reserves. Such a focus will allow your organization to be sustainable and to some day be in a financial position to have built an endowment.

In order to build reserves, you first need to achieve a surplus. A reasonable surplus to target is 5% of revenue, which provides an excellent base to build the reserves bucket over time. This allows your organization to be truly forward-thinking. How you use the reserves in the short term will depend on cash flow, the type of services you provide, and near-term goals. In a case of uncertain funding for an organization that provides a core service that should not be disrupted, reserves can be directed to protect cash flow.

Project Bread, for example, helps those in need of food, and much of its annual revenue is raised during the noted Walk for Hunger event. The money raised is then distributed through grants that support soup kitchens, food pantries, and food security programs across Massachusetts. When the event doesn't meet expectations (due, for example, to inclement weather on the day of the event), reserves are critical to keeping the organization's mission intact. Without this "rainy day fund," food support for communities throughout the state of Massachusetts would suffer dramatically.

Organizations with different types of assets and programs may need reserves for other purposes. Those that own a facility may need cash on hand for unexpected maintenance or to build replacement reserves, and those that focus on research and development may set aside funds to ensure they can finance those efforts.

Bucket #3: Long-Term Investments

Once you've designated working capital and reserves – whether through years of discipline or a major grant coming to fruition – you can consider strategies for funds that may not be needed for several years. This opens the door to long-term investing, with a spending policy that outlines a preferred rate of return, an annual draw that will help fund operations, and a level of risk that matches your organization's goals.

To determine your risk profile, work backward from your annual draw. If, for example, you plan to annually draw 4% of market value for operations, you should account for a 1% fee to manage the investment fund and a 3% rate of inflation. Thus, you would set your investment target at 8%. That target will help you and your investment manager identify the investments that will produce the best results with the least amount of risk.

Before starting a long-term investment account, though, weigh the size of the portfolio against the work and cost it will take to manage the effort. Investments can require some heavy lifting in terms of maintenance and oversight as well as administration fees. Determine a balance between operational costs and the ability to provide meaningful annual support.

In It for the Long Term

The current financial landscape underscores the importance of the bucket system: The funding climate is fiercely competitive, the overall economy shows continued slow growth, and markets are yielding unpredictable returns. Getting traction can be extremely challenging, as evidenced by a recent Oliver Wyman study of New York nonprofits that found "10% of the city's nonprofits were insolvent and 40% had virtually no cash reserves. Less than 30% were financially strong. If anything, things are getting harder, given market volatility, the move to value-based payments in health care, and increased costs for real estate and labor."

Wild swings in the financial markets are one root cause of the problem. Volatility not only impacts donations, it also tempts some nonprofits to "time the market" or to withdraw altogether. But when nonprofit leaders have long-term goals, they view volatility as a speed bump rather than a detour.

The market downturn in mid-2015 caused many nonprofits to re-assess their strategies. The savviest of organizations saw opportunity rather than risk. "It would be disingenuous to say that markets didn't rattle us but we have great governance . . . . so what we do is focus on the long-term," says Kim Y. Lew, vice president and co-chief investment officer at the Carnegie Corporation. "One day doesn't impact how we manage our portfolio at all."

Achieving that long-term perspective starts with viewing financials in terms of net assets instead of overarching revenue. That means categorizing unrestricted liquid assets (cash and short term investments), restricted assets, and illiquid assets (such as real estate). The most precious advantage comes in that first category, unrestricted liquid net assets – the lifeblood of flexibility for any organization.

With a firm vision of growing your assets, you can better enact the bucket system and eventually evolve your financial outlook from cash management to an investment strategy. That exercise varies widely depending on how your organization brings in revenue. If you receive significant funding in waves, you can take a different approach from nonprofits that are solely dependent on programmatic or cost reimbursable fees. In any case, however, it is always helpful to think in terms of the three buckets.

As your operations become more sophisticated, you should change your mindset from one of cash management (how do we optimize our cash on hand?) to one of investment management (how do we expand existing assets into a reliable source of annual funding?). The shift requires you to consider each bucket carefully and understand how restricted funds factor into the equation. By creating buckets for working capital, reserves, and long-term investments, you can build stability that sets the stage for continued growth.

Joel Aronson, CPA, PFS, MBA, is managing partner of AAFCPA's Wealth Management (aafcpa.com). He is nationally recognized for his work with nonprofit organizations.

Stay tuned for the next article in this series, and learn how to invest the assets in each of your buckets to assure a smooth financial future.

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