Investment Strategies for a Smooth Financial Future

Here's how to organize your finances to build a stable future.

By Joel Aronson

You'll remember that a recent article discussed a way to manage your assets using the "bucket system" (*Nonprofit World,* Vol. 35, No. 2). In that article, we described how to make the most of your net assets by dividing them into segments, or "buckets." As the article explained, the assets assigned to each bucket reflect your organization's short-term, mid-term, or long-term needs and goals.

But how do you actually invest the assets in each bucket? Current financial markets don't give us a simple answer. They have yielded unpredictable returns, underscoring the need to develop a methodical, multi-objective approach to growing unrestricted net assets. And the low interest rate environment within the fixed income market calls for a more critical analysis of the unique financial objectives and investment time horizon associated with your available assets.

If we start with the idea that the three primary buckets are working capital, reserves, and long-term investments, we can look at each one through a different investment lens. Before diving into structured investments, you'll want to think through three foundational elements:

1. Establish working capital before investing

To identify the right mix of asset classes, you'll want to first define the proper level of working capital and other reserves. Only with that settled can you think through strategies for assets that may not be needed for several years, such as investments that can function as an endowment. Then, for each bucket, you'll define and update a spending policy that outlines a targeted rate of return, an annual draw that will help fund operations, and a level of risk that's consistent with your organization's objectives.

2. Define investment targets

For longer-term investments (more than three to five years), the goal is to generate high enough returns to cover a portion of operational needs. You ideally are drawing from returns while the principal continues to grow and keep up with inflation. You'll need to figure out what kind of returns you need to cover a prudent spending draw, and then add in other considerations.

When you read through our hypothetical example below, note that our target rate of return was calculated by starting with a 4% spending policy (operational needs), adding 2.5%-3% for inflation, and adding .5%-1% for the cost of investment management. This gives us a target of 7%-8%. In a real-world situation, this information is crucial for your investment advisors, as it gives them guidance to select the right asset class allocations to generate the expected return with the least amount of risk.

3. Guard against market losses

One important note: Be sure to organize your buckets with a safety net that guards against losing capital when you need it. Markets go up and down over time, which is expected. You don't want to spend from a fund that has gone down, since you can't recover the portion you spent when the markets go back up.

Construct this safety net in the form of a "stable value" allocation, in which you invest enough money to fund the annual needs of the "bucket" in a more liquid, low risk vehicle. That way, if equity markets fall below a prescribed level (8%-10%), the spending distribution will come from the stable value investments, allowing time for the equities to recover. If equity markets are growing, the spending distributions will come from gains on the equities, leaving the stable value investments to hedge future market declines.

Put the three elements to good use: A step-by-step example

Consider a healthcare nonprofit that faces a challenge in its sustainable income stream. With revenue declining, the organization needs to take a close look at its working capital and reserves to decide how to maintain course.

The good news is that the organization has an operating budget of $3.4M and approximately $8M in reserves. In total, its net assets represent about 28 months of expenses. For each bucket, they'll determine a risk tolerance and match the best investment asset classes. These range across the following:

- choices that are lower risk, like cash and bond funds
- mid range risks, like large cap US Growth companies
- those that are high risk, like emerging market and real estate investments.

Here's how our hypothetical nonprofit will define its buckets and invest to maximize and protect cash flow and sustainability. (Note that the nonprofit has decided to divide its second bucket, the reserve bucket, into two portions. You may want to do something similar, dividing your buckets into different sections to address different needs).

Bucket #1: Working capital

Goal: To meet unexpected cash flow needs. Initial amount is equivalent to three months' cash needs for fiscal year.

Amount invested: $900,000

Risk profile: Low risk, high liquidity

Asset allocation

	$	Allocations
Short-term gov't bonds	900,000	100%

"Look at each "bucket" through a different lens."

Bucket #2: Reserves, Section 1 (fixed-asset replacement reserves)

Goal: To support capital improvements. Should be partially liquid for short-term needs and partially invested for long-term growth.

Amount invested: $100,000

Risk profile: Medium risk, partial liquidity

Asset Allocation:

	$	Allocations
World Equity	22,000	22%
US Growth	22,500	23%
Bonds	22,900	23%
Stable value*	33,000	

*Stable value portion can be adjusted based upon annual capital budget needs.

Bucket #2: Reserves, Section 2 (program reserves)

Goal: To fund programs, with up to 4% of market value to be used as spending appropriation to support programs. The fund should be invested for long-term growth to cover the spending policy, inflation, and money management costs.

Amount invested: $1.2M

Risk profile: Medium

Asset Allocation:

	$	Allocations
World Equity	319,104	28%
US Growth	279,821	24%
Bonds	495,475	43%
Commodities	57,600	5%
Stable value*	48,000	

* One year of program spending

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Bucket #3: Long-term investments (functioning as an endowment to generate income

Goal: To support operations, with 4% of the fund annually allocated to support operations as needed according to budget.

Amount invested: $6M

Risk profile: Medium to high

Asset Allocation:

	$	Allocations
World Equity	1,595,520	28%
US Growth	1,399,104	24%
Bonds	2,477,376	43%
Commodities	288,000	5%
Stable value*	240,000	

* One year of operational spending

With this methodical approach, the nonprofit has set itself up for a more sustainable path. There are specified strategies that address each fiscal need of the organization, safeguard against a market or operational downturn, and provide the potential to bolster income in the coming years.

Every growing nonprofit has the opportunity to organize its financial strategies in similar fashion. If you define your buckets and draft spending policies that provide guidance on how finances will be used, you can position yourself for a smoother financial future.

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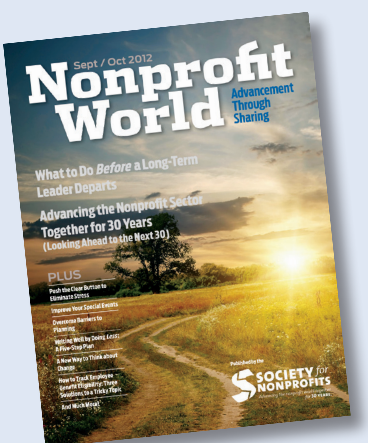

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