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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INVESTMENT ADVISORY GROUP

Are Equities Impacting Your Credit Quality?

Is your asset allocation limiting your access to debt financing? It could be if the allocation is not consistent with your organization's overall financial plan and if it does not consider both sides of the balance sheet.

When it comes to a nonprofit organization's ability to access financial resources, it has three sources – operating profit, gifts and debt financing. Of these three, debt can often have the most significant change on the organization's capital structure. Whether or not an organization decides to use debt, it is important to know how investment volatility impacts credit quality and access to financial markets.

Many investment managers, whether brokers, registered investment advisors or bank trust departments, look at an organization's investable assets in isolation, without considering debt and its implications. However, best management practices show that asset allocation decisions should be made after considering all investment constraints, including debt covenants and balance sheet interest rate risk. These factors can be important issues when it comes to an organization's exposure to risk.

Asset allocation commonly refers to the percentage of assets invested in equities (stocks) compared to the percentage invested in fixed income or money market assets. A "70 – 30" asset allocation would refer to 70% in equities and 30% in fixed income.

A recent Bloomberg survey of 14 prominent Wall Street investment firms recommended an average asset allocation of 63% equity. However, these typical asset allocations are based on organizations that look only at the asset side of the balance sheet to model and manage risk. Therefore, these recommendations may not make sense for organizations whose liabilities are subject to debt covenants that require maintenance of certain ratios, such as Days Cash On Hand or Debt Service Coverage. The comparative expected return and

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Ratios Impacted by Asset Allocation

- Liquidity
  – Days Cash on Hand
- Debt Service Coverage
- Capital Structure
  – Debt to Total Assets
  – Debt to Capitalization

return volatility of equities can significantly impact these ratios and put an organization at risk of violating its debt covenant or reducing its implied credit rating and thus its access to capital.

Lancaster Pollard studied one organization that had operated profitably in 2001 and 2002 yet managed to end each year in technical default. The problem was the organization's exposure to equities was so high relative to its debt covenant that the organization had a 42% probability of violating its covenant in any given year. The stock market losses in 2001 and 2002, -11.8% and –22.1% respectively, caused violations of the debt service coverage ratio each year.

The chart to the right shows a graphic of a gauge Lancaster Pollard uses to illustrate an organization's risk of violating its debt covenant or implied credit rating. The gauge graphically depicts the probability that asset allocation will cause the organization's days cash on hand to fall below the covenant level or below median levels as published by rating agencies. Managing this risk becomes increasingly important as organizations consider borrowing.

What is the "right" exposure? Ultimately, it is up to each board to decide how to prudently invest the organization's assets without over-reaching or speculating. We would argue that any allocation that creates a 42% probability of default – and the resultant impact on the credit history of the organization and operating budget – is too high.

How do You Know if You are Getting the Right Asset Allocation Advice?

The bottom line is that good investment advisors should ask if you have debt. They should ask about the amount of debt, what debt covenants exist, whether the debt is fixed or floating, and how the organization targets credit quality. If you haven't been asked these questions, your asset allocation may adversely impact your credit quality.

To learn more about how equities may be impacting your organization's credit quality, please contact William M. Courson at wcourson@lancasterpollard.com

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