LANCASTER POLLARD

The Nonprofit Minute

FALL 2003

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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Low Rates May Impact Spending Policy for the Next 10 Years

What impact can the current low interest rate environment have on your organization's spending and investment policies over the next 10 years?

Lancaster Pollard models indicate the current rates may produce lower than expected and, in some cases, even negative returns for many investors over the next 10 years.

Organizations that have based their return expectations on historic averages may need to re-evaluate or change spending policies or risk permanently impairing the organization's endowed capital.

Using a model of historic returns on a 10-year treasury index, Lancaster Pollard performed a mathematical simulation of interest rates from June 30, 2003, to June 30, 2013.

For each year, the model calculated the probability that:

- The cumulative return would exceed the historic, long-term average annualized return; and
- The cumulative return would be less than zero.

The findings reveal that organizations with fixed-income investments:

- Run a very high risk of earning negative returns over the 10-year period;
- Have a very low probability of exceeding the long-term average return in any cumulative period; and
- Have a zero percent chance of exceeding the long-term average over the 10-year horizon.

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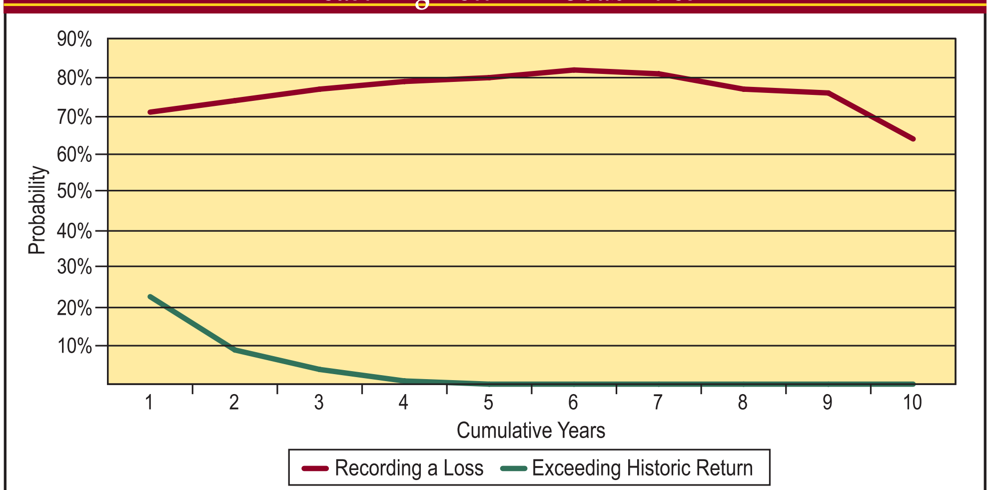
Measuring Return Probabilities



How Can Fixed Income Investments Have Negative Return?

Bonds are not purchased individually, but as part of a portfolio. Therefore, some are maturing while others are held. The only way to evaluate the portfolio at a given point in time is to calculate its market value.

If the current market value is less than the sum of the dollars invested plus the interest paid, then the return is negative.

What should an organization do to improve its financial outlook?

Look closely at changing spending policy or asset allocation. Without changes, there is a high probability that the organization will overspend, permanently impairing the ability of endowed assets to support the nonprofit organization.

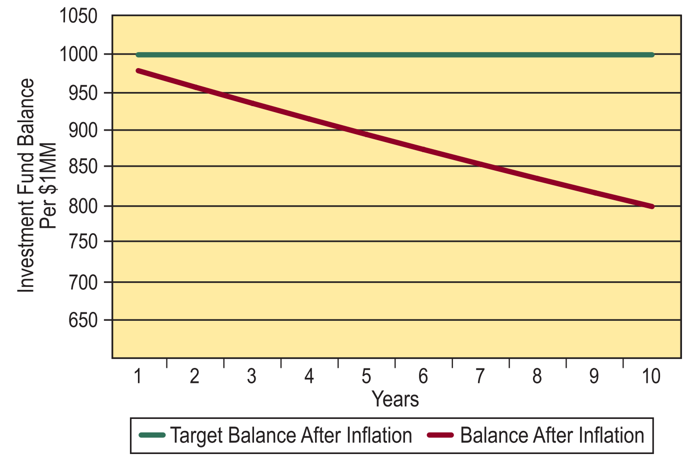
The chart to the right demonstrates the after-inflation impact of a zero percent return from fixed income on the investment balance. There is a 2.5 percent reduction per million in the first year alone, with the potential to erode the investment balance by 20 percent in year 10.

What can an organization do to reduce risk in fixed income?

There are viable solutions. The tendency may be to change asset allocation to increase the exposure to equity. This option increases the expected volatility of return, so in reality, this increases the risk.

Organizations instead should look at shortening maturities of their fixed-income portfolio.

Fixed Income Will Reduce Fund Balance



Assumptions: Expected Equity Return = 8% Fixed Income Return = 0% Spending Policy = 5%
Asset Allocation: 60% Equity, 40% Fixed Income

While this will slightly decrease income, it will maintain most of the diversification or volatility-dampening value of fixed income but significantly reduce the risk of negative total return. Organizations should also explore other diversification strategies, particularly some nontraditional asset classes.

Lancaster Pollard Investment Advisory Group can help you develop and manage a spending policy that will help to maximize returns and diversify risk.

To learn more about how low rates may impact your spending policy, please contact Willian M. Courson at wcourson@lancasterpollard.com

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