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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The "Right Time" to Pull the Trigger on a Swap

One of the questions most frequently asked of Lancaster Pollard has been whether it is time to pull the trigger and execute a fixed-rate swap. It has been a logical question, as short-term rates have risen and organizations and their boards are coping with more dynamic balance sheets.

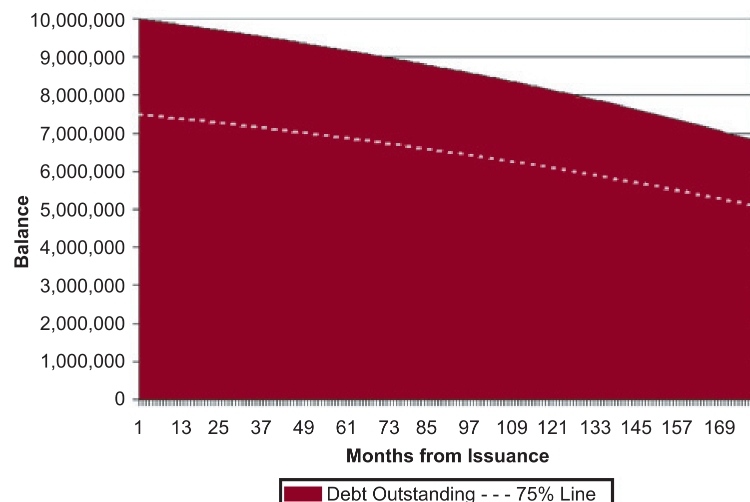
Although it is a logical question, is it the right question? We believe the right question is how much additional interest expense can the organization afford, and how much debt is actually unhedged and will contribute to that additional expense? In addition, we can learn a good lesson from the management of investments: don't try to time the market; rather, have a plan to maximize long-term outcomes at an acceptable risk level.

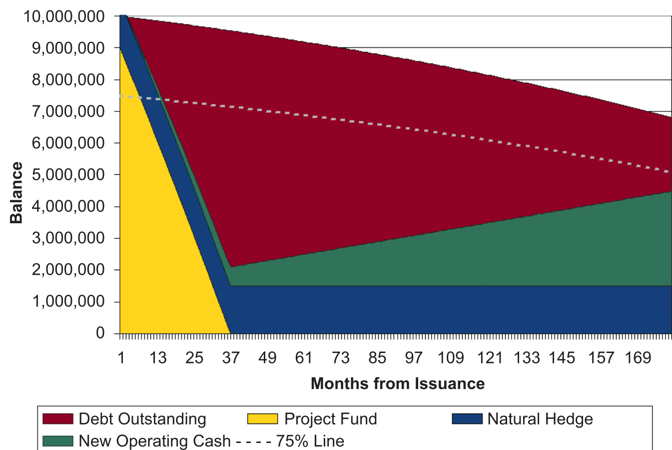
Modeling Floating Exposure

The chart below shows floating rate exposure as a function of time from issuance. The 75% line represents S&P's recommendation that at least 75% of floating rate debt be hedged. It is rare to have the zero hedge that the chart indicates. Most issues have a project fund used for construction that hedges the initial months. In addition, cash and other fixed income securities with a maturity of one year or less are a "natural hedge" to floating rate exposure.

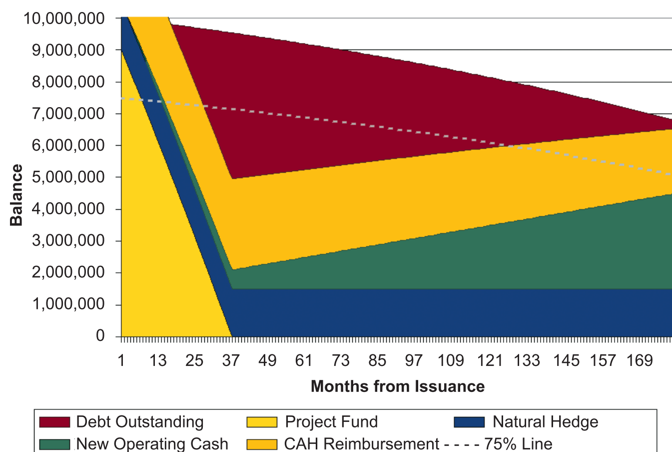
The chart on the next page shows the same debt, but now

(Continued on back)





includes the impacts of the project fund, cash on the balance sheet and new operating positive cash flow. The maroon floating rate debt exposure is significantly less than that shown on the previous page, and significantly shorter than the entire duration of the bond issue. Medicare reimbursement for critical access hospitals (CAH) can be another significant hedge, since a percentage of capital cost is typically reimbursed. The chart below demonstrates the impact of layering the CAH reimbursement onto the other hedges.



The maroon represents unhedged debt; it is recommended that debt below the dotted 75% line be hedged.

Using this model can help visually assess the duration and amount of a swap needed.

Natural Hedge: Higher interest expense negatively impacts operating margin. Higher interest earnings positively impact excess return. In a rising rate environment, these interrelated effects can create the perception of an operating problem.

When is the "Right" Time to Enter into a Swap?

Does the organization discuss when is the right time to buy 10-year bonds or switch fully between cash and 100% equities? These strategies of massive changes to asset allocation are called market timing strategies.

Academic research shows that market timing strategies do not work in at least semi-efficient markets. The U.S. equity, taxable bond and swap markets are considered efficient. For this reason, most investment policies restrict managers' abilities to make large changes in asset allocation.

Trying to time the market with a significant portion of your debt expense is just as likely to fail. The better approach is to use the model above and determine how much unhedged exposure the organization has. Then, conduct the appropriate amount of scenario analysis. If rates go up x%, at what point does the variance become a significant issue to the budget? The closer that x% is to the market rate, the greater the need to protect the organization with a fixed rate hedge. The downside is that the hedge will increase the cost of capital and have an immediate negative impact on financial performance, but that is the nature of all insurance policies.

Conclusion

When is the right time to pull the trigger on a swap? When you cannot afford the alternative. Understanding how different hedge strategies work, and modeling the net exposure to perform an analysis of scenarios, is a better way to determine the appropriate size and duration of a swap. As with investments, attempting to time the swap with the market is not the "right time" or the right method.

To learn more about managing interest rate risk for your organization, please contact William M. Courson at wcourson@lancasterpollard.com

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