Fall 2013

Virtually every endowment and foundation we know wrestles with the same fundamental financial challenge: how to bring investment policy and spending policy into harmony with each other. To better understand the complexities of this challenge, we conducted research using two hypothetical case studies. We're devoting this issue of Mission**Possible** *to a detailed report of what we learned.*

Bernstein
Global Wealth Management

BERNSTEIN NONPROFIT ADVISORY SERVICES

MissionPossible

How Much Can You Earn? How Much Can You Spend?

By Brian D. Wodar, National Director—Bernstein Nonprofit Advisory Services,
and Ashley E. Velategui, CFA, Senior Investment Planning Analyst

Even under normal conditions, setting investment and spending policies can be difficult, but a surprise development can heighten the challenge. In this article, we analyze the alternatives confronting two organizations—one with more capital and one with less than it expected. The cases are fictionalized, but they are based on the experience of many client organizations.

A Windfall

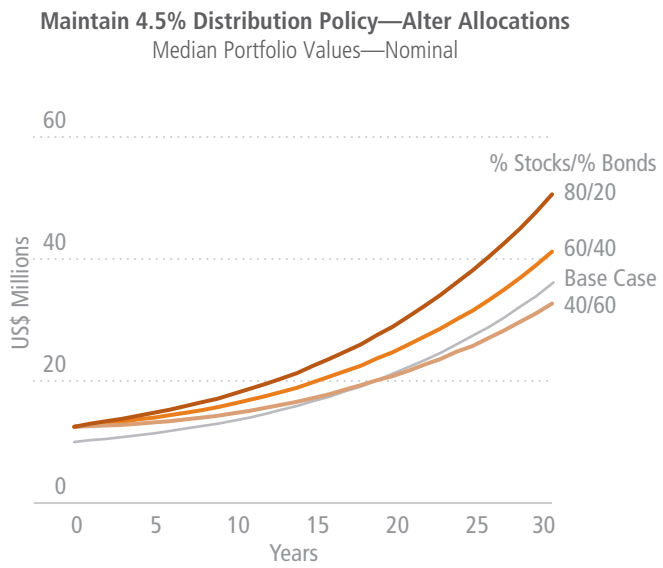
Board members at the Uptown Community Foundation (UCF) differed over what to do when, at the start of 2013, an unexpected bequest boosted their organization's capital from $10 million to $12.5 million. One board member welcomed the chance to reduce the volatility in the portfolio by de-risking. Another had the opposite view: With increased financial strength, why not take on greater equity exposure? And there were disagreements about the spending level, too: Should the organization raise its spending rate, lower it, or leave the current policy in place?

To give the board a rational basis for reconsidering its investment and spending policies, we used our Wealth Forecasting System^{SM}, a forward-looking Monte Carlo simulation technology, to analyze how various alternatives were likely to play out over time. Before the bequest, UCF was sustainably spending 4.5% a year (with three-year smoothing) and raising $200,000 a year; its asset allocation was 60% global equities and 40% fixed income. The foundation was on track to grow its portfolio's value over time in median markets, and the bequest made the picture even rosier.

Our research indicates that it's critically important to analyze investment policy and spending policy simultaneously, but for the sake of clarity, we'll discuss them separately here.

Display 1

More Stock-Heavy Investments Can Create More Growth…



Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. Data do not represent past performance and are not a promise of actual future results or a range of future results. See Notes on Wealth Forecasting System at the end of this document for further details. (This note applies to all displays in this document.)

Investment Policy

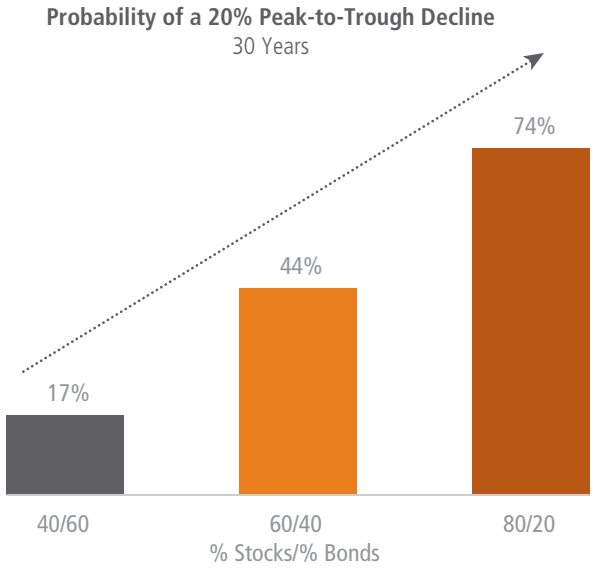
What if the foundation de-risked by shifting from a 60/40 stock/bond mix to a 40/60 allocation? Based on our projections at the time, as shown in *Display 1*, the nominal portfolio value would still rise, but more slowly—so slowly, in fact, that over time it would lag the level UCF would have reached without any bequest.

What if the board took the opposite tack and stepped up the allocation to stocks? With an 80% stock/20% bond mix, we projected that the portfolio would grow to over $50 million in 30 years. But this growth would come at the price of increased market risk. To make this risk tangible, we expressed it as the probability of a peak-to-trough investment loss of 20% or more—a decline large enough to give most investors pause. As seen in *Display 2*, the foundation's odds of such a loss over the next 30 years would be just 17% with a 40/60 mix, but 44% with their current 60/40 mix and 74% with an 80/20 mix. To a majority of board members, the 80/20 mix felt too risky.

The board members also wanted to know what could happen under very unfavorable conditions—high inflation and dismal market returns. At the 90th percentile (the bottom 10% of our Monte Carlo trials), the portfolio value would decline regardless of which risk profile they chose. While it was likely that, over time, any one of the investment policies would allow the portfolio to bounce back, it turned out that the most bond-heavy allocations were more likely to lag while the more stock-heavy allocations were likely to outperform (*Display 3*).

Display 2

…But What Price Are They Willing to Pay?

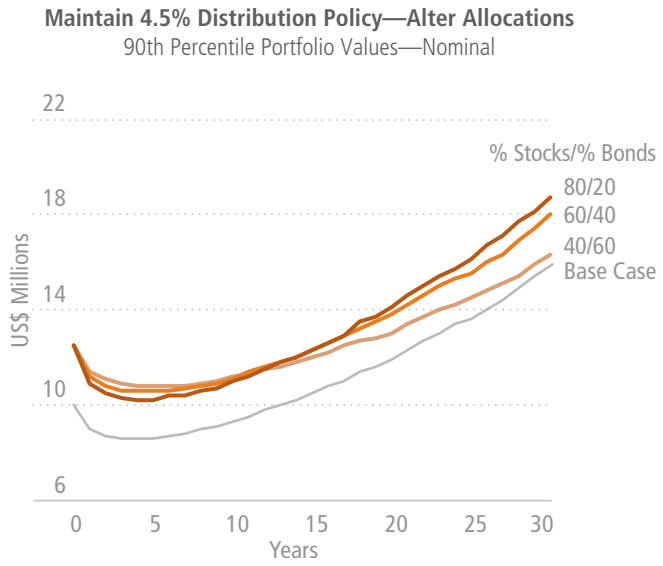


See Notes on Wealth Forecasting System at the end of this document for further details.

After reviewing our analysis, the board decided that both de-risking and re-risking would raise risks to an unacceptable level: the risk of permanent depletion of capital in the case of de-risking, and the risk of a steep investment loss in the case of re-risking. The board members believed that the current 60/40 allocation struck a good balance between these risks, and they voted to maintain it. But they also decided to consider adding hedge funds, non-US bonds, inflation-linked bonds, and real assets (real estate and commodities)—assets that could improve the risk/reward trade-off within their portfolio.

Display 3

Over Time, Stock Risk Can Be Rewarding



See Notes on Wealth Forecasting System at the end of this document for further details.

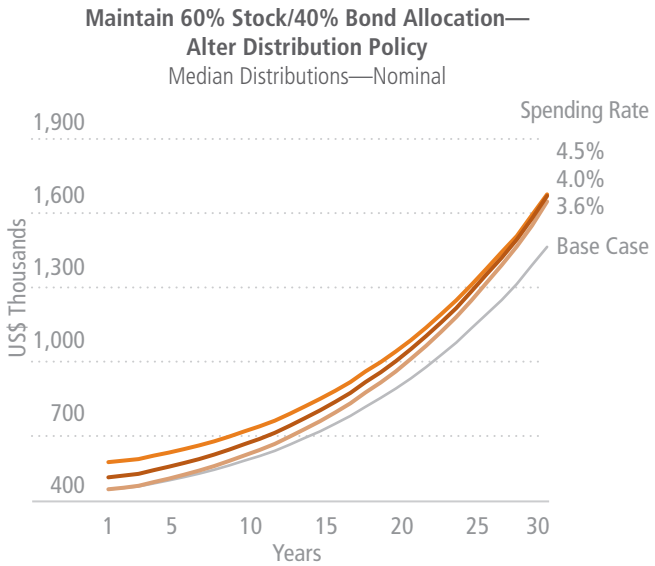
What About Spending?

Following receipt of the unexpected legacy, UCF's board also needed to evaluate possible changes in its spending policy.

UCF had been spending 4.5% on grants and operations. Off an initial base of $10 million, they had budgeted $450,000 for this year. If the board kept this rate intact, the added capital would push its dollar spending much higher in the next few years. But if it reduced its distribution to 3.6%, its dollar spending would remain relatively stable in the short term at $450,000. By spending a smaller percentage, the foundation should be able to retain more of its income and accelerate its growth. UCF's board members were split over what to do next. One wanted to reduce the spending policy to 3.6%, another preferred to retain the 4.5% policy, and a third suggested splitting the difference with a 4.0% rate. Our Wealth Forecasting Analysis suggested that, whatever the policy choice, the bequest would lead to higher distributions. And, not surprisingly, the greater the spending policy rate, the larger the cumulative distributions would be (*Display 4*). Over the next 30 years, cumulative distributions would range from $26.1 million at the 3.6% rate to $27.4 million at 4.0% and $28.7 million at the current 4.5% spending rate.

Display 4

Even After 30 Years, 4.5% Spending Rate Has More Impact



	Base Case	3.6% Spending	4.0% Spending	4.5% Spending
Cumulative Distributions—Nominal (US$ Mil.)	$24.3	$26.1	$27.4	$28.7

See Notes on Wealth Forecasting System at the end of this document for further details.

However, our analysis also indicated that after 30 years, the annual amount spent under the 3.6% regime would likely catch up and eventually surpass the amount spent under the 4.0% and 4.5% policies. Given that UCF was established to exist in perpetuity, there was some spirited debate about these very long-term implications.

Growth of payouts is, of course, highly desirable, but the path to growth can be quite jagged, and lean years in the investment markets can prove very stressful for a foundation's beneficiaries. The bequest presented UCF's board with this conundrum: How should we balance stability in our payouts against growth in our payouts?

We discovered that a 60/40 asset allocation combined with a 3.6% or 4.0% spending rate balanced payout stability and payout growth. This was really the sweet spot. By contrast, at all three spending rates, the 40/60 allocation provided

greater stability in payouts but markedly less growth, and the 80/20 allocation provided better growth in payouts but at the price of substantially greater instability.

Inflation was another key consideration. The board hoped to maintain not just the nominal size of the foundation's portfolio but also its real value—its spending power. As the highlighting in the middle of *Display 5* indicates, greater equity exposure would increase the likelihood that UCF's portfolio would have a real value of $10 million 30 years hence. Another interesting finding is highlighted on the left side of the display: UCF could choose to invest more conservatively (40/60), reduce its spending rate to 3.6% or 4.0%, and still find itself in better shape than in the pre-bequest base case, as measured by the stability of distributions on the x-axis and the ability to grow after spending and inflation on the y-axis.

After reviewing its options, UCF's board chose to reduce its spending rate from 4.5% to 4.0%. Because of its larger capital position following the bequest, this lower rate actually increased the foundation's annual spending in the short term from $450,000 to $500,000.

A Casualty of Sequestration

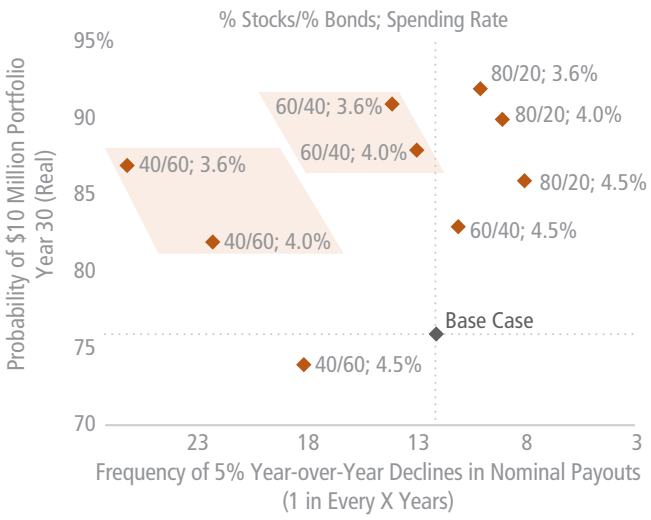
Our second case study resembles the first in many ways, but it involves an organization facing the opposite kind of problem: a shortfall in capital rather than a surplus.

At the start of 2013, the board of the Midtown Art Museum (MAM) was disappointed to learn that a promised one-year $1 million grant from the federal government had fallen victim to sequestration. The museum's current assets totaled $9 million and it was raising $200,000 a year, adjusted for inflation. Like the UCF, it spent 4.5% of its assets annually, with three-year smoothing, and its portfolio was allocated 60% to global equities and 40% to fixed income.

The board had to revise its budget, but how? Should it invest more aggressively? More conservatively? Should it keep the 4.5% spending rate and let the budget fall by 10%? Should it keep the budget steady by raising the distribution rate to 5.0%? Should it split the difference and spend 4.75%?

Display 5

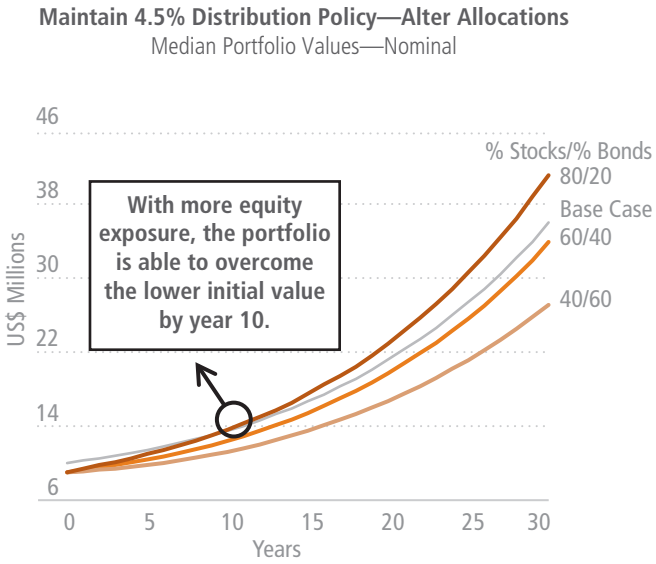
Balancing the Trade-Offs: Enhancing Stability and Growth



See Notes on Wealth Forecasting System at the end of this document for further details.

Display 6

A Stock-Heavy Portfolio Could Close the Sequestration Gap



See Notes on Wealth Forecasting System at the end of this document for further details.

Our Wealth Forecasting Analysis showed that a bond-heavy asset allocation could make a bad situation worse, but a stock-heavy portfolio could, by year 10, close the gap caused by sequestration (*Display 6*). Even in poor markets, the 80/20 allocation might get MAM back on track.

And the spending rate? Raising spending to 5.0% would generate greater cumulative distributions for the next 30 years, but not forever. At the end of that period, the 4.5% and 4.75% spending rates begin to produce larger cumulative distributions.

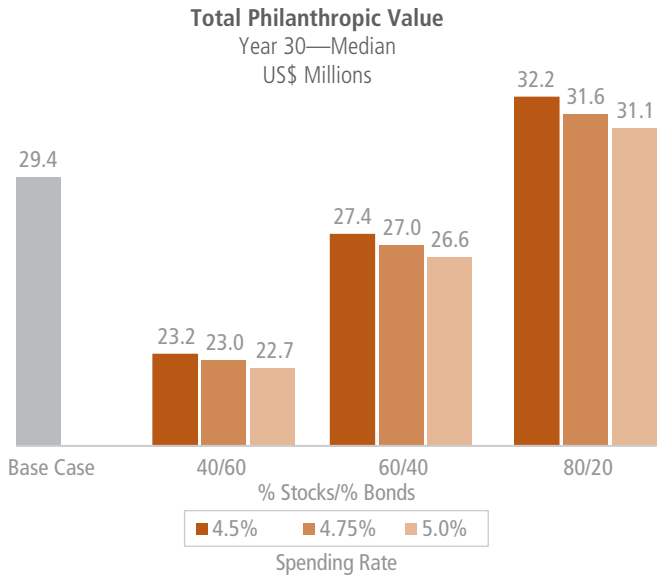
The board had to balance portfolio growth against cumulative distributions. Whatever the spending policy, the 80/20 asset allocation met both requirements: greater cumulative distributions and larger median portfolio values. It also enhanced total philanthropic value (*Display 7*), a measure of the ability to grow the portfolio in perpetuity, after spending and inflation. But it did so at a price: greater instability in annual payouts, which *Display 8* measures as the frequency of 5% year-over-year declines in nominal payouts. Note that the upper-left quadrant of the graph is empty: No combination of investment policy and spending policy simultaneously achieved the two goals of stability and growth. No investment or spending policy shift could make up for every aspect of the loss of the million-dollar grant.

Having reviewed our conclusions, the board decided to:

- Increase the expected return and risk in the portfolio by moving investment policy from 60/40 to 70/30
- Increase the spending rate from 4.5% to 4.75%, effectively cutting the 2013 budget from $450,000 to $427,500
- Allow the investment policy to play itself out for the next 24 to 36 months
- Redouble its development efforts in order to counteract the effects of sequestration

Display 7

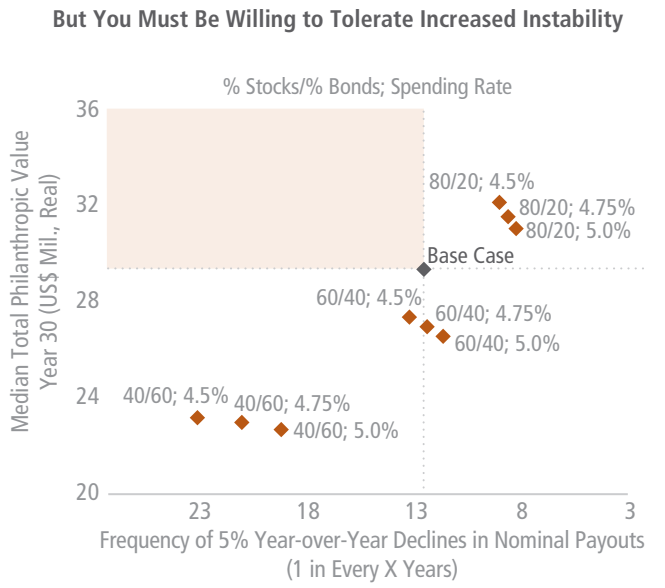
Stock-Heavy Investments Enhance Total Philanthropic Value



Total philanthropic value (TPV) is calculated by summing real cumulative distributions and the real portfolio remainder value in a given year.
See Notes on Wealth Forecasting System at the end of this document for further details.

Display 8

Increasing TPV Leads to Greater Instability in Spending



See Notes on Wealth Forecasting System at the end of this document for further details.

Getting a Customized Study

If your organization faces a budgetary challenge regarding investment policy, spending policy, or both, we would be happy to furnish you with a complimentary analysis of your specific situation. Please contact your Bernstein Advisor, or e-mail us at philanthropy@bernstein.com.

Events

Partnership for Philanthropic Planning of Greater Philadelphia
2013 Planned Giving Day Conference

"Helping Donors Maximize Their Impact"
October 30, 2013

Brian Wodar, National Director—Bernstein Nonprofit Advisory Services

***Gotham* Magazine Event**

"The Business of Philanthropy"
November 13, 2013 | New York, NY

Moderated by:
Brian Wodar—Bernstein Global Wealth Management

Featuring Panelists:
Cynthia McKee—Conservation International

Jayni Chase—GREEN Community Schools Initiative

Johnny Cooper—American Red Cross Greater New York Region

Mariko Tada—Rockefeller Philanthropy Advisors

Sharna Goldseker—21/64

Sharon Patrick—Patrick Partners

StayClassy.org Webinar

"Is Perpetuity Still Possible? Current Issues in Long-Term Planning for Not-for-Profits"
December 5, 2013 | 10:00 a.m. PT, San Diego, CA

For donors in your circle who are considering or reconsidering their philanthropic vehicles:

Our latest white paper, *Private Foundations and Donor-Advised Funds: Making the Best Use of Your Philanthropic Vehicle(s)*, offers a balanced look at the relative benefits and drawbacks of these vehicles. It also highlights the advantages of using a donor-advised fund and a private foundation in tandem. For copies, please e-mail us at philanthropy@bernstein.com.

Notes on Wealth Forecasting System

The Bernstein Wealth Forecasting System[SM] (WFS) is designed to assist investors in making a range of key decisions, including setting their long-term allocation of financial assets. The WFS consists of a four-step process: (1) Client Profile Input: the client's current assets, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as which vehicles are best for intergenerational and philanthropic giving, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term, when to retire, and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: our proprietary model that uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (based on indexes, not Bernstein portfolios), as well as their unpredictability; and (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated returns and asset values the client could expect to experience, represented within a range established by the 5th and 95th percentiles of probability. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Further, we often focus on the 10th, 50th, and 90th percentiles to represent the upside, median, and downside cases.

Asset-class projections used in this paper reflect initial market conditions as of December 31, 2012. They include the following median forecasts of 30-year compound rates of return: US diversified stocks (represented by the S&P 500 Index), 8.1%; US value stocks (represented by the S&P/Barra Value Index), 8.3%; US growth stocks (represented by the S&P/Barra Growth Index), 7.9%; developed international stocks (represented by the Morgan Stanley Capital International [MSCI] EAFE Index of major markets in Europe, Australasia, and the Far East, with countries weighted by market capitalization and currency positions unhedged), 8.6%; emerging markets stocks (represented by the MSCI Emerging Markets Index), 6.9%; US small-cap and mid-cap stocks (represented by the Russell 2500 Index), 8.3%; taxable bonds (represented by diversified securities with seven-year maturities), 3.8%; and inflation (represented by the Consumer Price Index), 3.0%. Expected total returns on bonds are derived taking into account yield and other criteria. Globally diversified equity portfolios comprise an annually rebalanced mix of 21% US diversified stocks, 21% US value stocks, 21% US growth stocks, 22.5% developed international stocks, 7.5% emerging markets stocks, and 7% US small-cap and mid-cap stocks.

An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein's estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

The views expressed herein may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal, or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product, or service sponsored by AllianceBernstein or its affiliates.

AB Bernstein
Global Wealth Management

1345 Avenue of the Americas, New York, NY 10105 | 1.800.227.4618 | www.bernstein.com

BER–3767–1113