NORTHERN TRUST

BENEFITS OF MANAGING LOSS RECOGNITION FOR NONPROFITS AND NON-TAXABLE ENTITIES

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Most tax exempt organizations do not want gain or loss recognition to effect the management of their assets, however some institutions may need to consider a strategy that can allow staff to control gains and losses on a custom basis. Typically, portfolio managers can juggle the timing of losses or offset them with gains on other investments, but this can lead to suboptimal results. Using an integrated approach allows for staff to control the timing of capital gains and losses while giving the portfolio manager the flexibility to make value added changes to the portfolio.

There are several reasons why a tax-exempt institution may want to control the realization of capital gains or losses. For instance, debt covenants may include realized gain or losses on investments in the calculation of certain coverage ratios. During times of stress when income is at a low level, realized investment losses on a pledged portfolio can make the organization appear unprofitable to lenders and they may fail debt tests. The result can be time wasted in audit or with budget adjustments that should have been avoided.

The Foundation and Institutional Advisors (FIA) group at Northern Trust offers strategies that manage gain and loss recognition and relieve the burden and concern of staff monitoring transactions. Just like a tax payer may manage tax burden through loss recognition and gain deferral, a FIA portfolio manager can develop a strategy that minimizes losses. The portfolio manager will identify the cost and benefit of strategies where specific targets are identified throughout the year or simple strategies that may look to prefer gains over losses when trading. Northern Trust has a sophisticated in-house capability to provide this gain loss management while minimizing impact to your investment program.

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In one example, a tax-exempt institution with a portfolio that consisted of 80% stocks and 20% bonds had a mix of active and index strategies at a meaningful loss. The portfolio managers of the active strategies wanted to sell holdings they projected to underperform the market. However, covering the recognized losses to avoid violating debt covenants would have been severely disruptive to the other portfolio holdings and budget. The only gains available were in the smaller bond allocation but the gains were too small and trading was expensive. The staff was forced to ask the managers to defer the sales. The holdings continued to drop and the losses grew making it even more difficult to sell. The trade restriction had a negative impact on performance, and the institution was wasting money in fees for active management while reducing its ability to add value. Northern Trust took over as investment manager and implemented a lower cost, investment program that managed the portfolio by placing a tax overlay on an index strategy. As gains were available, they were recognized and the proceeds were used to move the portfolio toward the plan benchmark. Over time, performance closely matched the strategic benchmark and fees were lowered. Once the portfolio returned to a net-gain position, active strategies were once again implemented. However, assets were retained in the custom index strategy to make it unlikely that trade restrictions would be needed in the future.

In another example, a tax-exempt institution was indifferent to tax lot inventory methods when opening custody accounts and the default was average cost, which created a single lot for each holding. During a stock market dip, the staff needed to raise money for operating expenses but selling stocks would have realized a large loss. To prevent the loss recognition that would have led to a violation of their loan covenants, bonds were sold below the desired target level to raise the cash, adding risk to the portfolio. As the market continued to drop, the portfolio underperformed its benchmark and the deeper losses prevented the Chief Financial Officer (CFO) from adjusting the risk of the portfolio. Northern Trust was hired as investment manager and used historical accounting statements to create an account with a high cost inventory lot method. Northern Trust was able to sell high cost lots to reduce losses and manage the account back to the CFO's desired allocation. The portfolio performance improved and the Northern Trust portfolio manager worked with the CFO to develop a program that ensured future transactions were not impacted by potential realized losses.

These are examples of where we worked closely with our clients to understand their unique needs and together developed effective solutions.

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To help meet your investment and advisory needs, Foundation & Institutional Advisors (FIA), is Northern Trust's national practice that exclusively serves foundations, endowments and other nonprofit institutional investors as either a dedicated investment advisor or as a fully outsourced chief investment officer. The practice is consultative and advice-driven, providing holistic solutions that combine sophisticated advisory expertise with a spectrum of value-added services.

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