



A Tale of Two Institutions in a Down Market

The 2000-2002 bear market gave me two examples of mistakes organizations can make in their asset allocations and debt management.

The first was a private education institution. It had undergone an expansion and renovation, borrowing variable rate, tax-exempt debt at a very low rate in 1997. It completed its capital campaign and placed the proceeds in their endowment account. (60% equity/40 % fixed income) From then until 2000, the board loved the strategy. But as the stock market tanked, the market value of the assets fell while the interest expense kept accumulating.

The Board thought that they were being stupid: leveraging the portfolio by borrowing and then losing money. They sold investments and paid down \$5 million of their debt.

I asked the board chair, someone with an MBA from a top five school, why they had paid down the debt when they could have increased their fixed income allocation by buying a US Treasury and swapping the debt to fixed rate for the same term. The net result was the school would have locked in the equivalent of two students' tuition for 20 years with effectively no risk or additional cost. The net present value of the Board decision was to deprive the organization of approximately \$575,000. Her response: No one had every explained it to them.

The second story is a senior living organization that from 2000-2002 had a positive operating margin and paid all of its debt service, yet managed to be in technical default in both 2001 and 2002 because it did not cover its debt service coverage ratio. What happened is that the ratio was calculated based on the earning before depreciation and amortization, and the realized gains (loses) in the investment portfolio, divided by the annual debt service. Even though the cash flow from operations covered the debt, the losses realized in the down market because of portfolio turnover caused the organization to fall into technical default.

I looked at the organization's investment portfolio from 12/31/2000 and its financial ratios. Looking retrospectively, I calculated that the probability estimate that the organization would violate its debt covenant was approximately 43%. Management and the investment committee had no understanding that the investment parameters like asset allocation and portfolio turnover were tied to debt covenants. The cost to cure the technical default: \$100,000.

The point is to make sure that your investment and debt management policies are robust and consider these factors so that you do not end up in technical default or wasting cash that the organization could use for its mission.

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