50 SOUTH CAPITAL
A SUBSIDIARY OF NORTHERN TRUST CORPORATION

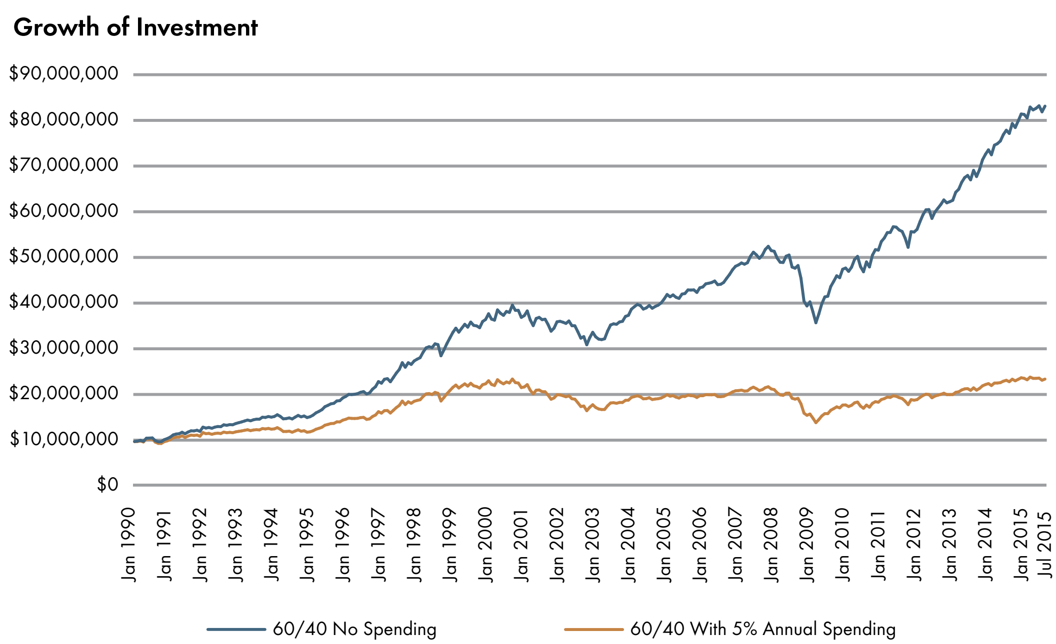
HOW HEDGE FUNDS CAN POTENTIALLY HELP FOUNDATIONS AND ENDOWMENTS MEET SPENDING REQUIREMENTS

An allocation to hedge funds could help a foundation or endowment more effectively achieve its mission

As a foundation or endowment, you face unique challenges in managing your investments, particularly when it comes to meeting your mandatory spending requirement. While other institutions have the option of reducing spending during economic downturns, your foundation or endowment may have little spending flexibility. As a result, you may periodically be forced to withdraw assets even when this could significantly hamper the achievement of your long-term investment objectives and overall mission. For a foundation or endowment to succeed in the long run, it is key that a robust investment strategy be in place with a strong emphasis on capital preservation and a higher probability of making its return hurdle.

To illustrate, we compare a portfolio with no spending requirements with that of a foundation that has a 5% annual spending requirement. The simple illustration in Figure 1 shows the growth of a $10 million investment made on January 1, 1990, assuming a portfolio invested in 60% equities/40% bonds (60% S&P 500 Stock Index/40% Barclays U.S. Aggregate Bond Index). The investment would have grown, through the benefits of compounding, to $81.7 million as of June 30, 2015. However, a foundation forced to spend 5% of its capital on an annual basis would have only had $23 million at the end of the same period.

FIGURE 1: HOW MANDATORY SPENDING POTENTIALLY AFFECTS INVESTMENT GROWTH



Source: eVestment and 50 South Capital

Notes: The 60/40 portfolio is 60% S&P 500 Stock Index and 40% Barclays U.S. Aggregate Bond Index. This simulation illustrates the hypothetical performance results that might have been achieved had a portfolio been pursuing the proposed allocation, rebalanced quarterly and gross of fees, during the period. This portfolio has not commenced and has no actual performance history. Past performance is not indicative of nor a guarantee of future results. Please note that the 5% spending requirement is used for illustration purposes only; actual requirements may vary.

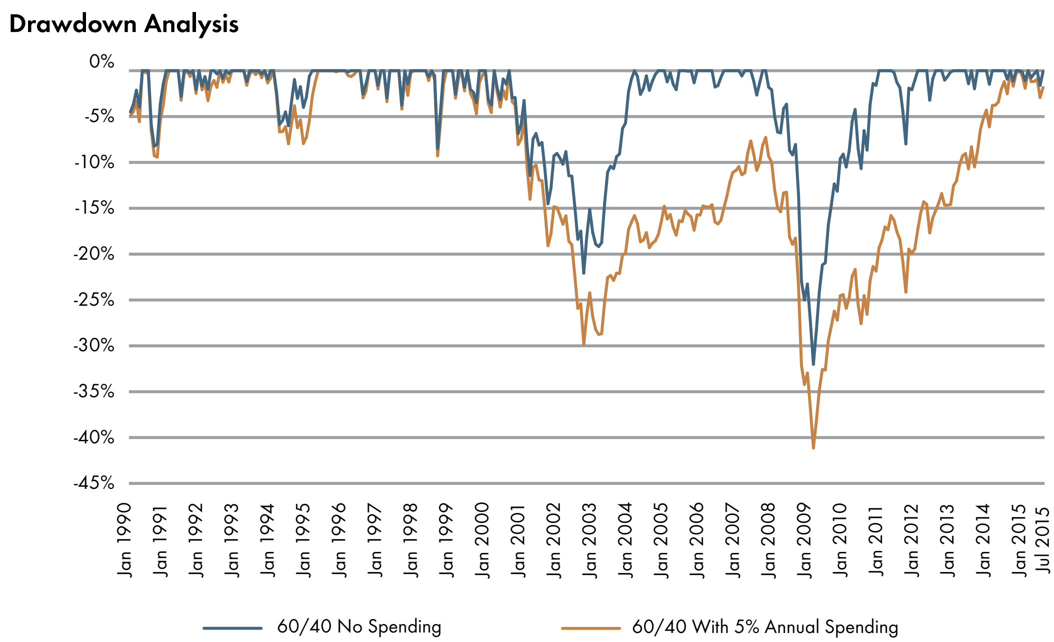
INSIGHTS ON

The dramatic contrast between an individual investor with no spending requirements and a foundation that must spend 5% annually should not be surprising. With no spending requirement, the individual investor earned an 8.6% annual rate of return. With the requirement to spend 5%, a foundation that made equal investments would at best be able to earn 3.6% (8.6% - 5.0% = 3.6%). However, in our example, the portfolio of the foundation only compounded at a rate of 3.3%. Why the 30 basis point difference? Because the foundation needs to continue to spend during periods of market downturns, further reducing capital when markets sell off. The foundation therefore had less capital to compound when markets rebounded.

In Figure 2, we see that the first significant drawdown occurred in 2000 to 2002, when the individual investor's portfolio lost 22% over two years. The foundation's portfolio lost 30% during this period because of its additional 5% annual spending level. The individual investor's portfolio regained its losses in October 2004 as asset levels appreciated to pre-crisis values. The foundation's portfolio, however, never recovered its losses because it continued to spend with assets at low values. In fact, the foundation's portfolio did not recapture pre-tech bubble crisis valuations until November 2014.

The two figures illustrate that foundations need to think of returns after their 5% spend and the compounding effects of spending capital when markets turn downward.

FIGURE 2: HOW MANDATORY SPENDING CAN AMPLIFY DRAWDOWNS



Source: eVestment and 50 South Capital

Note: The 60/40 portfolio is 60% S&P 500 Stock Index and 40% Barclays U.S. Aggregate Bond Index. This simulation illustrates the hypothetical performance results that might have been achieved had a portfolio been pursuing the proposed allocation, rebalanced quarterly and gross of fees, during the period. This portfolio has not commenced and has no actual performance history. Past performance is not indicative of nor a guarantee of future results. Please note that the 5% spending requirement is used for illustration purposes only; actual requirements may vary.

LIMITS ON FOUNDATIONS, ENDOWMENTS AND NONPROFIT COMPANIES

Ideally, foundations are able to fund the 5% annual spending rate completely from returns on their investments – in the form of interest and dividends, for instance. But when their returns on investment fall below 5%, their pool of spending capital is reduced, and they may have to sell off some principal at a nonstrategic time, locking in their losses. In contrast, for-profit companies have no such restrictions, and during financial crises they are able to reduce capital expenditures, research and development costs or headcount to maintain their stability.

The requirement of a foundation or endowment to maintain the 5% spend, even amid periods of severe market downturns, can drastically reduce its ability to recover losses. It may force the foundation or endowment to sell its positions at a loss; and unlike other institutional investors, foundations and endowments cannot pull back on spending. This, in turn, can potentially jeopardize their missions.

HEDGE FUNDS AS A POSSIBLE SOLUTION

With their ability to do well in various economic climates due to their diverse array of strategies, hedge funds may be an attractive addition to the portfolio of a foundation or endowment.

Hedging and volatility management strategies can enable hedge funds to mitigate the negative impact of market dislocations, potentially allowing for a foundation or endowment to maintain spending power. By having an allocation to alternative hedging strategies in a portfolio, a foundation or endowment may maintain a diversified asset allocation program and give itself multiple sources to use for funding during different market cycles. This in turn has the potential to better position a foundation or endowment to meet annual spending requirements.

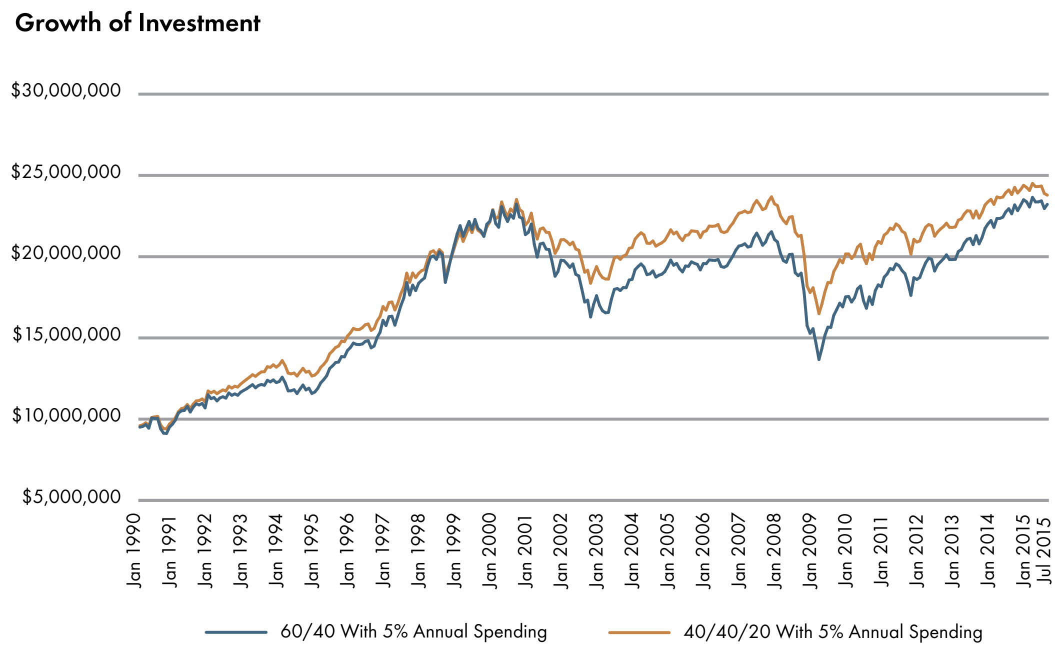
THE U.S. TAX REFORM ACT OF 1969

In 1969, in an effort to prevent delays in providing benefits to charity, legislation was passed that required certain private foundations and endowments to make minimum qualifying distributions each year. Such qualifying distributions can include operational expenses and charitable distributions.

Penalties for private foundations and endowments that do not make sufficient qualifying distributions can be harsh. The private foundation or endowment must generally distribute a minimum of approximately 5% of its assets by the end of the subsequent year or face an initial excise penalty of 30% of the shortfall. If the shortfall remains undistributed, a further penalty can be assessed for the full value of the shortfall.

Going back to our illustration, Figure 3 compares the growth of the foundation's 60/40 portfolio with a portfolio incorporating hedge funds (40% stocks, 40% bonds and 20% hedge funds). With hedge funds as part of its investment mix, the portfolio historically compounded returns at a higher rate while experiencing lower volatility. As a result, this portfolio historically performed better during large market sell-offs. However, keep in mind that hedge funds introduce other investment risks and market liquidity risks.

FIGURE 3: HOW AN ALLOCATION TO HEDGE FUNDS COULD AFFECT PORTFOLIO GROWTH

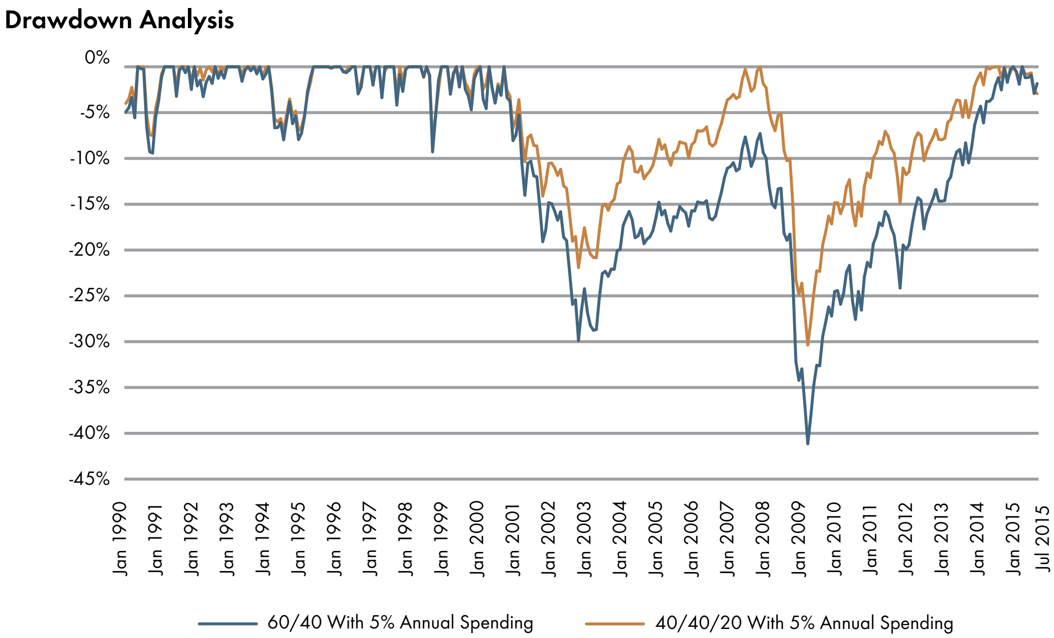


Source: eVestment and 50 South Capital

Notes: The 60/40 portfolio is 60% S&P 500 Stock Index and 40% Barclays U.S. Aggregate Bond Index. The 40/40/20 portfolio is 40% S&P 500 Stock Index, 40% Barclays U.S. Aggregate Bond Index, and 20% HFRI Fund Weighted Composite Index. This simulation illustrates the hypothetical performance results that might have been achieved had a portfolio been pursuing the proposed allocation, rebalanced quarterly and gross of fees, during the period. This portfolio has not commenced and has no actual performance history. Past performance is not indicative of nor a guarantee of future results. Please note that the 5% spending requirement is used for illustration purposes only; actual requirements may vary.

Figure 4 compares the drawdowns of these two foundation portfolios (each maintaining the 5% annual spend). The portfolio with hedge funds would have historically done a much better job of maintaining capital during both the 2000 to 2002 tech bubble and the 2008 credit crisis. In the portfolio without hedge funds, historical losses would have been 10% higher in both instances.

FIGURE 4: HOW AN ALLOCATION TO HEDGE FUNDS POTENTIALLY AFFECTS PORTFOLIO DRAWDOWNS



Source: eVestment and 50 South Capital

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WHAT THIS MEANS FOR THE MISSION STATEMENT

Drawdowns, recovery, high water marks, annualized returns and standard deviations are all technical jargon. If your foundation or endowment was launched to serve a specific need or to maximize giving, then that goal is most important. In looking at the historical data in the two portfolios above, which would be able to give more to your foundation or endowment's recipients over time? Both portfolios maintained a 5% spending rate, but because the portfolio with hedge funds maintained a higher level of assets throughout its history, it was able to give more to recipients over time. Starting with $10 million each, the portfolio with an allocation to hedge funds would have given $24 million over time while the portfolio without hedge funds would have given $22.3 million. That is a 7.6% greater gift to recipients. (Please note that these statistics are based on historical returns and that past performance is not indicative of future results.)

FIGURE 5: HOW AN ALLOCATION TO HEDGE FUNDS CAN POTENTIALLY INCREASE A FOUNDATION'S OVERALL CONTRIBUTION

Source: eVestment and 50 South Capital

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FOR MORE INFORMATION

To learn more about how 50 South Capital can help develop your foundation's or endowment's exposure to hedge funds, please email IR@50southcapital.ntrs.com.

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