STRATEGIC ASSET ALLOCATION FOR NOT-FOR-PROFIT ENTITIES

Understanding the recommendations for 2015

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Not-for-profit organizations with endowed investment portfolios typically have long investment time horizons – multi-generational to perpetual. Their investment objectives seek to balance maintaining real purchasing power while supporting annual distributions consistent with specific charitable purposes. Meeting these objectives – long-term real growth and meaningful ongoing distributions – is a significant challenge, particularly in an environment with low expected returns for many traditional investment categories.

Our strategic asset allocation recommendations are designed to help you meet these challenges. For 2015, our recommendations:

- **Absolute Return –** Maintain allocations to help manage portfolio volatility amid the potential for shifts in the economic and market landscape.
- **Private Equity –** Expand allocations, taking advantage of capacity for illiquidity (and its potential return premium).
- **Real Assets –** Expand allocations to protect against potential acceleration in global inflation.
- **Equity –** Maintain orientation to drive long-term compounding.
- **Policy Portfolio –** Develop with careful consideration of many factors beyond expected return, including the effect on your specific objectives as well as expected liquidity, volatility and dispersion.

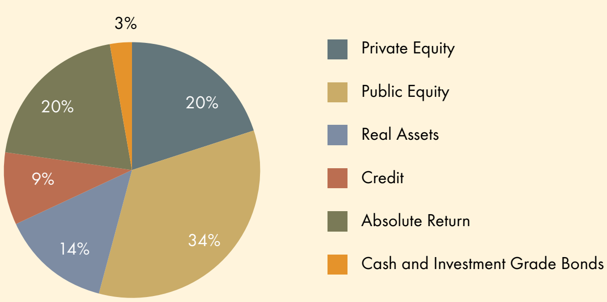
ALLOCATION RECOMMENDATIONS FORM STARTING POINT

Northern Trust's Endowment and Foundation (E&F) allocation is a starting point from which we work with you to customize a policy portfolio tailored to your unique circumstances. The E&F allocation is structured to support the specific investment objectives of not-for-profit organizations. It does so through a careful combination of investments.

Exhibit 1 shows our allocation recommendations for endowments and foundations in 2015. Some highlights of our recommendations include:

- Modest but meaningful allocations to low-return cash and investment-grade bonds, as well as higher yielding credit exposures, to help support nearer-term distributions.
- Allocations to equities function as the primary "engine" driving long-term compounding. While private equities have higher expected returns, we have a higher starting allocation to public equities in the E&F model to help balance liquidity considerations.
- Significant allocations to absolute return strategies to help manage overall portfolio volatility while providing risk-asset-level returns.
- Allocations to real assets, which typically provide protection against inflation.

EXHIBIT 1: 2015 ENDOWMENT AND FOUNDATION ALLOCATIONS



Source: Northern Trust

The expected return on the E&F portfolio at the asset class level is 7.6%, in line with the 8% or higher target investment return many not-for-profits seek. Based on their objectives, some investors may attempt to access other sources of outperformance to add to asset class returns. These might include:

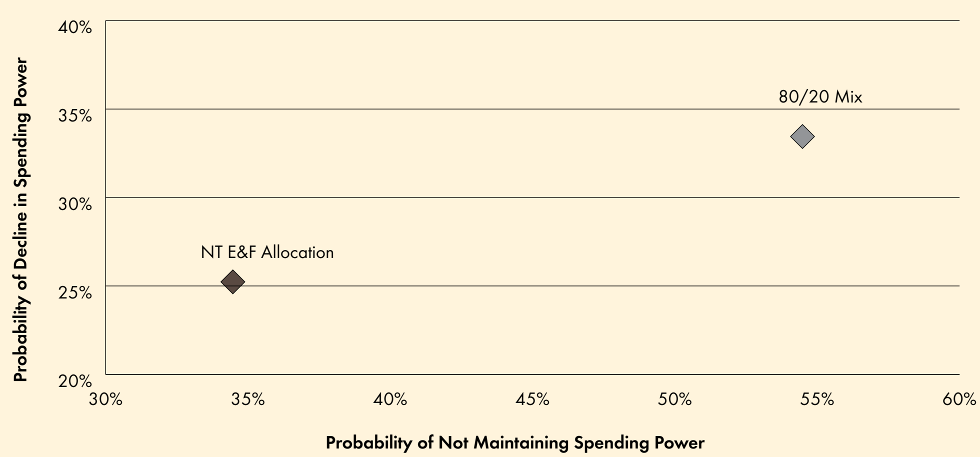
- Tactical asset allocation – adjusting allocations to take advantage of nearer term asset class return opportunities, overweighting undervalued categories and underweighting overvalued categories.
- Manager selection – identifying top active managers that may outperform their reference asset class benchmarks.
- Manager combination – combining top managers in a complementary fashion to help reduce portfolio volatility and increase geometric returns.

DEVELOPING A POLICY PORTFOLIO: LOOKING BEYOND EXPECTED RETURN

When developing your policy portfolio, we find it can be of great value to view your portfolio allocation in the context of target objectives. Form follows function, and strategic asset allocation must be designed to deliver on your specific investment objectives. For illustration purposes, we compared two allocations – a relatively simple "80/20" mix[1] and our recommended starting point E&F allocation, looking at their projected performance in terms of both risk of a decline in near-term distributions[2] and the risk to long-term purchasing power[3].

As you can see in Exhibit 2, the Northern Trust E&F allocation projections provide outperformance in these two areas that are important to most investors' objectives. The E&F allocation reduces the risk of a decline in near-term distributions by 24% compared to the 80/20 mix. It also reduces the risk to long term purchasing power by 35%.

EXHIBIT 2: PROBABILITY OF OUTCOMES: SPENDING POWER AND PURCHASE POWER



Source: Northern Trust

While Exhibit 2 highlights two important characteristics of the E&F allocation, other elements can weigh as heavily on a portfolio's success. Maintaining liquidity, minimizing volatility and capturing dispersion all are important considerations too, and should ideally be evaluated when weighing allocation recommendations for your portfolio.

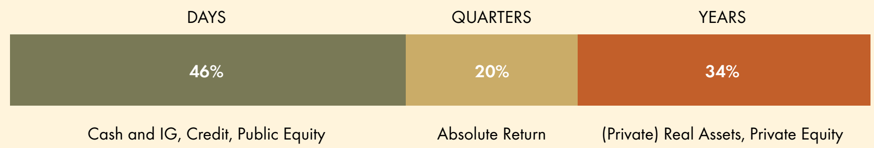
1 The 80/20 mix is allocated as 80% return-oriented assets (53% public equity, 10% real assets, 10% absolute return and 7% private equity) and 20% cash and investment grade bonds.
2 Defined as a decline in value net of inflation and distribution of 10% or more in the next five years.
3 Defined as a decline in value net of inflation and distributions in the next 20 years.

GREATER LIQUIDITY = GREATER FLEXIBILITY

Greater liquidity provides greater flexibility in a portfolio. When considering allocation recommendations, taking a high-level view of liquidity, similar to that shown in Exhibit 3, can be valuable. Looking at an allocation's liquidity profile can help you quantify the average days to liquidity and to stress test those allocations – how liquid or illiquid would this allocation be in a scenario such as the 2008– 2009 financial crisis?

Nearly half of the recommended allocation is in asset classes that typically can be liquidated in days.

EXHIBIT 3: LIQUIDITY OF THE NORTHERN TRUST E&F RECOMMENDED ALLOCATION



Source: Northern Trust

Nearly half (46%) of our recommended E&F allocation is invested in asset classes that typically can be liquidated in days: cash and investment-grade bonds, credit, and public equities (shown in green in Exhibit 3). A reasonably mature absolute return program (20% of the E&F allocation) is less liquid, but can typically be converted to cash in a few quarters.

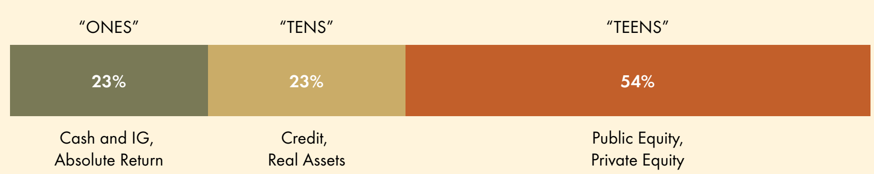
One of the greatest advantages long-horizon investors have is the opportunity to invest in illiquid assets, which can generate premium returns. Private equity and private real assets (34% of the allocation) are relatively illiquid, and can take years to fully convert to cash. However, for the 20 years ended December 31, 2013, private equity outperformed U.S. equities by nearly 7% annualized (16.1% returns vs. 9.2% for the S&P 500). That said, you must carefully consider the potential returns together with the impact on portfolio liquidity when making investment decisions.

Different investors will have different liquidity preferences. Careful attention to these preferences provides important feedback when developing a customized allocation. From a whole balance sheet perspective, we also encourage investors to explore their options for borrowing, such as a line of credit, to help manage liquidity in normal course of operations and in any potential liquidity crunch scenario.

VOLATILITY AN IMPORTANT CONSIDERATION

Volatility is a very important measure to consider when assessing an allocation or realized investment results. While high returns typically go hand in hand with higher volatility, most investors want consistent results with their portfolios. In Exhibit 4, you can see the expected volatility of the different asset classes recommended in our E&F allocation. The overall expected volatility for the E&F allocation is 10.2%.

EXHIBIT 4: EXPECTED VOLATILITY FOR E&F ALLOCATION



Source: Northern Trust

Breaking that down, 23% of the allocation is invested in absolute return strategies and investment grade bonds, which have expected volatility in the single digits. Another 23% of the E&F allocation is invested in asset classes with low double-digit expected volatility. More than half of the allocation (54%) is invested in equities with expected volatility ranging into the high teens.

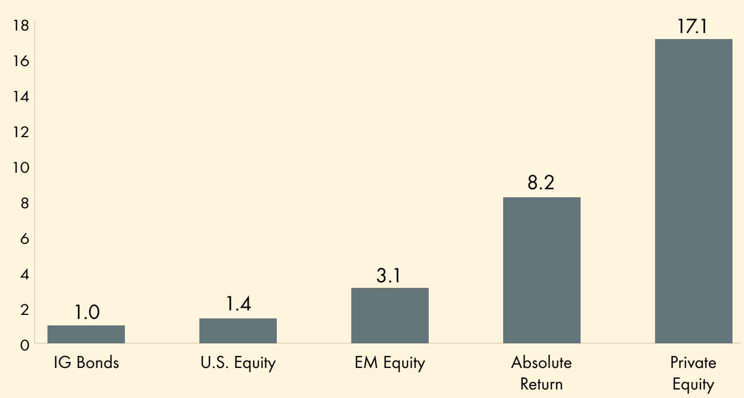
While understanding an allocation's expected volatility is useful, stress testing can provide important information about the potential variability too. How would the allocation have performed in the 2008 – 2009 financial crisis? What if interest rates spike higher by 200 basis points? Taking the results of these types of testing into consideration also helps develop a portfolio customized to your specific needs.

CAPTURING DISPERSION TO OUTPERFORM BENCHMARKS

Dispersion refers to how greatly results for active managers tend to differ within investment categories. The magnitude of dispersion will vary significantly depending on the asset class. Exhibit 5 shows the typical dispersion of the asset classes found in the E&F allocation. U.S. equity has higher dispersion than investment grade bonds, and emerging market equity has higher dispersion than U.S. equity. Alternative investments, such as absolute return and private equity strategies, tend to have much higher dispersion than traditional asset classes. The advantage of allocations to active strategies with higher dispersion is that the potential for outperforming the benchmark is greater, provided you can identify which managers are more likely to provide this outperformance.

Large, long-horizon investors can develop, or partner to obtain, the capability to find and combine top managers. Larger investors also can typically meet the high minimum investment levels these top managers maintain. In an environment where expected returns on traditional investments are modest, accessing sources of additional potential return can be important.

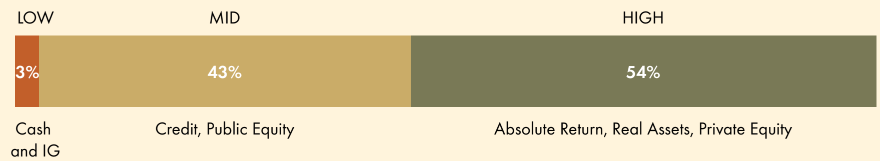
EXHIBIT 5: TYPICAL DISPERSION LEVELS BY ASSET CLASS



Source: Northern Trust analysis of difference in returns for 25th percentile and 75th percentile of active managers for different investment categories over last 10 years for investment grade bonds, U.S. equity and private equity; over the last five years for emerging market equity; and over the last three years for absolute return.

More than half (54%) of the E&F allocation is in investment categories with a high potential level of dispersion in returns among active managers: absolute return, private equity and private real assets. These are shown in green in Exhibit 6. The E&F allocation has very low exposure to low dispersion assets (3% in cash and investment grade fixed income), and just under half of the allocation (9% in credit, 34% in public equity) is to asset classes with a "mid" level of dispersion among active managers' returns.

EXHIBIT 6: DISPERSION IN THE E&F ALLOCATION



Source: Northern Trust

2015 RECOMMENDATIONS BALANCE PROTECTION AND OPPORTUNITY

Developing investment strategy for large, long-horizon investors is a fascinating, multi-faceted endeavor that provides continuous, evolving challenges. For 2015, we maintain allocations to absolute return strategies to help manage portfolio volatility amidst the potential for shifts in the economic and market landscape. We expand allocations to private equity and real assets, taking advantage of this group's capacity for illiquidity, and capitalizing on the potential return premium and protection against inflation that these asset classes offer in return. We maintain an equity orientation to drive long-term compounding.

LEARN MORE

Although our recommended asset allocations for large not-for-profit entities are designed to address the needs of most organizations, assessing allocations based on your specific objectives remains important. Considering expected liquidity, volatility and dispersion also should play a role in developing your asset allocation strategy.

If you would like to learn more about Northern Trust's investment process and how it relates to your goals as a not-for-profit entity, please contact your relationship manager or visit us at northerntrust.com.

NOT-FOR-PROFIT INVESTMENT SOLUTIONS GROUP

Our mission is to develop and implement investment solutions for long-horizon investors. We focus on managing volatility and liquidity to support steady distributions and real compounding by:

1. **Understanding your objectives and needs –** We begin by gaining a thorough understanding of your objectives, including your time horizon, liquidity and distribution requirements, target returns, and volatility and liquidity tolerance. We also consider whether you are looking for a full program or a complementary mandate, and how the program will be governed.
2. **Providing flexible strategy design –** We put in place a strategic framework, but also use a nimble tactical allocation filter within reasonable risk management parameters.
3. **Offering customized strategy construction –** Our customization goes beyond strategic and tactical allocations to include sub-strategy and manager combinations based on your situation and goals.
4. **Managing proactively –** After implementing your strategy, we proactively monitor the plan, rebalancing allocations, adjusting sub-strategies and replacing managers as needed.
5. **Maintaining accountability –** Through concise quarterly meetings, we focus on helping you improve your plan by asking how we're doing relative to objectives, whether we're managing risk effectively, and identifying potential opportunities the environment is creating.

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