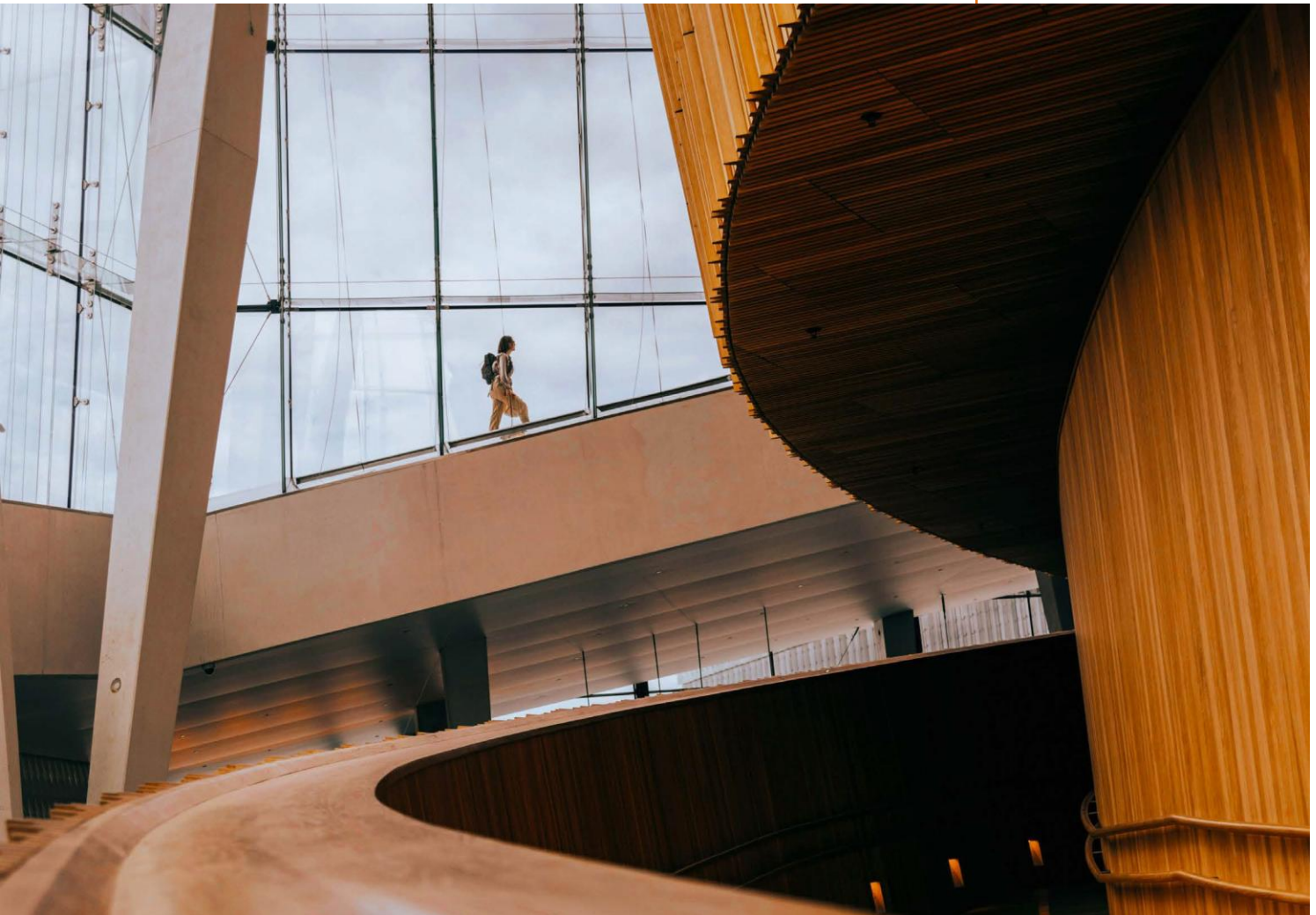




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# Designed with Purpose: A Practical Framework for Non-profit Asset Allocation

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Non-profit investment success is driven by three components: a strategic asset allocation aligned with organizational objectives, a portfolio constructed with complementary high-quality managers and the dynamic management of total portfolio exposures. Although all three components are required to achieve desired outcomes, strategic asset allocation is the critical foundation from which the other components build upon. Understanding what non-profits need to consider constructing a strategic asset allocation aligned with their long-term objectives will be the focus of this paper.

Strategic asset allocation reflects a series of inter-connected decisions that should align portfolio positioning with the long-term investment outcome desired. Risk tolerance defines return potential. Liquidity constraints determine implementation options. Illiquid investments can enhance returns, and asset class choices determine portfolio resilience across different economic environments.

This paper outlines a practical framework for understanding the critical inputs for designing a strategic asset allocation aligned with a non-profit's objectives, constraints, and organizational circumstances. It follows four steps:

1. Set objectives for return and risk.
2. Define the illiquidity tolerance.
3. Allocate the illiquidity budget.
4. Design a resilient portfolio.

Understanding this provides a strong foundation for long-term investment success.

## 1. Set objectives for return and risk

Strategic asset allocation begins with aligning the desired return with the level of risk tolerable. Two considerations shape the strategic asset allocation – what is the **return being targeted?** And what level of **risk can be tolerated?** If the investor cannot tolerate the level of risk associated with the desired return target, they must decide whether to maximize return potential or prioritize stability.

### Two primary considerations shape the strategic asset allocation

- What return is being targeted?
- What level of risk can be tolerated?

To maximize long-term returns, the investor should have the fortitude and ability to maintain the investment strategy through all market cycles and not let spikes in volatility lead to reducing risk. This makes risk tolerance – not return targets - the central constraint in asset allocation, even if the primary objective is return maximization.

Risk tolerance is often driven by the portfolio’s expected and potential outflow requirements. Some non-profit organizations may be able to control a steady spending rate, allowing a reduction in outflows when asset values decline. Others must support an organization’s operations and need to prepare for increased outflows in an economic drawdown. This can lead to differing experiences in negative market environments.

An investor that needs to prepare for increased outflows may need to take less risk to avoid crystalizing a greater level of losses in a drawdown. Exhibit 1 shows the impact of volatility of returns through time on two investors with the same starting spending. Investor A varies its spending based on the beginning of year market value of assets, while Investor B (on the next page) has a fixed spending that increases with inflation. For Investor A, provided that the long-term return is the same, the long-term asset growth will be similar no matter the path of returns. However, for Investor B with a fixed spending pattern, the volatility and path of returns impacts long-term asset growth.

### Achieving long-term objectives

To increase the likelihood of long-term investment success, the investor should have an investment strategy that allows them to:

- Have the fortitude and ability to maintain the investment strategy through all market cycles.
- Not let spikes in volatility lead to reducing risk.

## Exhibit 1: Impact of volatility on asset growth depending on stability of spending

### Investor A – variable spending

|                      | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | 5 Year Annualized Return |
|----------------------|--------|--------|--------|--------|--------|--------|--------------------------|
| No Market Volatility |        |        |        |        |        |        |                          |
| Investment Returns   |        | 7%     | 7%     | 7%     | 7%     | 7%     | 7.0%                     |
| Asset Base           | 100    | 101.8  | 103.7  | 105.6  | 107.5  | 109.5  |                          |
| Spending             |        | 5.0    | 5.1    | 5.2    | 5.3    | 5.4    |                          |
| Market Volatility    |        |        |        |        |        |        |                          |
| Investment Returns   |        | -20%   | 14%    | 11%    | 17%    | 18.5%  | 7.0%                     |
| Asset Base           | 100    | 75.5   | 82.0   | 86.7   | 96.8   | 109.4  |                          |
| Spending             |        | 5.0    | 3.8    | 4.1    | 4.3    | 5.5    |                          |

These examples are for illustrative purposes only and do not represent actual investor results.

## Investor B – fixed spending

|                             | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | 5-Year Annualized Return |
|-----------------------------|--------|--------|--------|--------|--------|--------|--------------------------|
| <b>No Market Volatility</b> |        |        |        |        |        |        |                          |
| Investment Returns          |        | 7%     | 7%     | 7%     | 7%     | 7%     | 7.0%                     |
| Asset Base                  | 100    | 101.8  | 103.7  | 105.5  | 107.4  | 109.4  |                          |
| Spending                    |        | 5.0    | 5.1    | 5.2    | 5.3    | 5.4    |                          |
| <b>Market Volatility</b>    |        |        |        |        |        |        |                          |
| Investment Returns          |        | -20%   | 14%    | 11%    | 17%    | 18.5%  | 7.0%                     |
| Asset Base                  | 100    | 75.5   | 80.6   | 84.0   | 92.5   | 103.7  |                          |
| Spending                    |        | 5.0    | 5.1    | 5.2    | 5.3    | 5.4    |                          |

These examples are for illustrative purposes only and do not represent actual investor results.

Aside from the impact of potential cashflow needs, investors need to consider the level of short-term drawdowns they could tolerate – either due to behavioral concerns on short-term reductions in the asset base or due to the potential impact on balance sheet metrics or the income statement. Stress testing both short- and long-term outcomes is a crucial step in determining if the exposures and potential results are tolerable. Additionally, for non-profits with multiple stakeholders, do donors, boards, Investment Committees and staff have the same tolerance for drawdowns?

## 2. Define the illiquidity tolerance

### Capacity - can the portfolio meet its obligations under stress?

Another important strategic consideration is the **level of illiquidity risk that can be tolerated**. Expanding the investable opportunity set through less liquid strategies is expected to improve portfolio diversification but must be done within the liquidity constraints of the organization. From a functional perspective, most non-profits can tolerate meaningful allocations to less liquid investments. Although there may be varying liquidity needs, the significant differentiator is often not in expected outflows, but the potential for unexpected liquidity needs along with behavioral preferences on the ability to rebalance to policy targets through time.

#### What level of illiquidity risk can be tolerated?

From a functional perspective, most non-profits can tolerate meaningful allocations to less liquid investments.

### Structure - how do investment fund terms affect liquidity demands?

One of the most significant drivers of the impact on total portfolio liquidity is the **fund structure**. Illiquid investments can be allocated in either open-end or closed-end fund structures. Maintaining an investment allocation to private assets through closed-end funds requires continually committing to new funds and being prepared to fund capital calls. The requirement to fund capital calls means that the liquid portfolio must be sufficient to not just fund organizational cashflow needs, but also potential capital calls based on the level of uncalled capital commitments made. Investing in illiquid assets through open-end funds removes the ongoing need to have liquidity available to fund capital calls, although it does not remove the illiquidity when looking to exit the investment.

## Underlying exposures - how persistent is the illiquidity likely to be in a downturn?

A secondary consideration is the underlying investments within the monthly or quarterly liquid fund allocations, as the liquidity of the underlying investments does not always match the liquidity of the investment fund terms.

Although often monthly or quarterly liquid open-end funds have similar terms in offering monthly or quarterly redemption windows while maintaining the right to restrict outflows, it is reasonable to assume the likelihood of being able to redeem investments over a more prolonged downturn will differ by investment. We recommend that investors never rely on liquidity from less liquid investments, but it is reasonable to assume that over 12-18 months an investor is more likely able to liquidate their position in a hedge fund that invests in relatively liquid underlying securities than an open-end private real estate fund that purchases buildings or private equity within an open-end structure.

Similar to how stress testing drawdown potential is essential to understanding risk tolerance, stress testing liquidity is essential to understanding illiquidity tolerance. In a stressed market environment, after funding all potential outflows, including potential capital calls – what is the ability to maintain exposure to liquid growth assets for a potential market rebound? Illiquidity tolerance is not defined by allocation size alone – it also depends on fund structures and underlying exposures.

### Defining illiquidity tolerance

Similar to how stress testing drawdown potential is essential to understanding risk tolerance, stress testing liquidity is essential to understanding illiquidity tolerance.

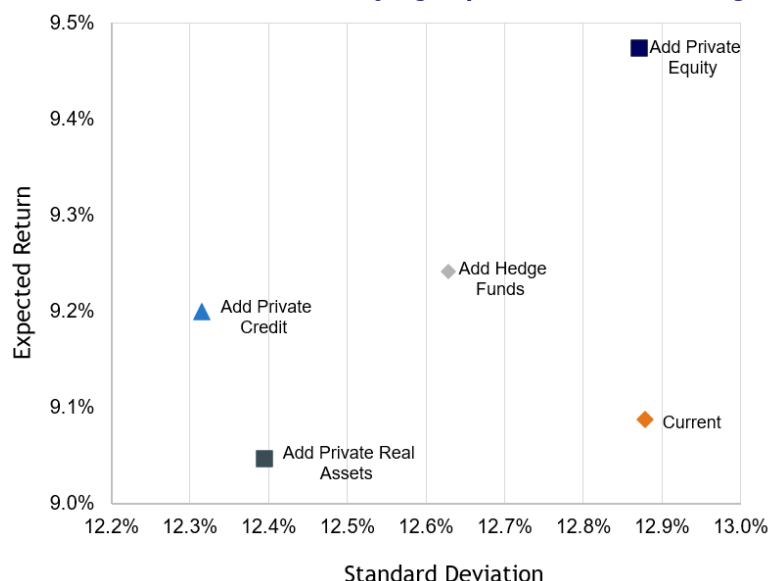
## 3. Allocate the illiquidity budget

It is one thing for an investor to determine that they can undertake illiquidity, but the next step is to determine how illiquid assets can best help an investor achieve its objectives. Illiquid investments are a broad category with the underlying investments able to bring very different characteristics to a portfolio. The allocation to different types of illiquid assets should be framed around long-term investment objectives and determined by the consideration of **return enhancement**, **diversifying exposures** and/or **managing total portfolio risk**. Understanding the desired

exposures and portfolio outcome targeted, an investor will prioritize integrating different less liquid investments into the portfolio.

### Exhibit 2<sup>1</sup>: 10-Year expected return and standard deviation

Exhibit 2 shows the impact on expected return and risk that adding different illiquid assets can have on a portfolio. The “current” allocation in Exhibit 2 is 75% global equity and 25% fixed income. The additional points on the graph demonstrate the impact of reallocating to each less liquid asset class. With these sample re-allocations, the impact of introducing less liquid assets into a portfolio can reduce risk, enhance returns or



These examples are for illustrative purposes only and do not represent actual investor results.

<sup>1</sup> Based on December 31, 2025 Russell Investments capital market assumptions. Add Private Equity re-allocates 10% from public equity to private equity. Add Hedge Funds re-allocates 5% from public equity and 5% from core bonds to hedge funds. Add Private Credit re-allocates 4% from public equity and 4% from core bonds to private credit. Add Private Real Assets re-allocates 6% from public equity to a blend of private real estate and private infrastructure.

a combination of both depending on how the portfolio is re-allocated.

For investors looking to enhance returns, private equity is often the central illiquid portfolio exposure. It brings both beta and alpha potential and is considered a long-term return enhancer, while allowing stated results based on infrequent valuations to smooth out the impact of short-term equity market volatility on stated returns.

As investors look to add differentiated portfolio exposures and use private assets to both enhance returns and/or diversify the portfolio, private real assets and private credit bring unique attributes to the portfolio. There is no one-size-fits-all portfolio within private real assets, but the construction of the private real assets portfolio can be customized to the level of diversification, inflation sensitivity and/or return enhancement desired. Private credit brings a more efficient risk and return profile relative to liquid assets, with its impact on total portfolio expectations dependent on its funding source. In Exhibit 2, when the allocation is equally funded from public equity and core fixed income it both enhances return and reduces risk, while if it was funded more heavily from public equity it would serve to reduce risk more while if it was funded more heavily from core fixed income it would enhance returns more.

Hedge funds are a broad category of investments rather than an asset class, and we therefore recommend customizing any allocation based on the organizational objectives and the desired role of hedge funds in the total portfolio. Some hedge fund strategies include equity or credit beta while providing return enhancement through alpha generation on top of the beta exposure. Other hedge funds strategies look to generate uncorrelated returns while generating alpha, while trend and active long volatility managers can even provide negative betas to the portfolio. In general, the lower the beta, the lower the expected long-term returns, so constructing the portfolio based on the extent to which its role is to enhance returns or mitigate risk is a crucial component of any hedge fund investment.

The allocation to illiquid and semi-illiquid assets should be determined based on the extent to which an investor is looking to enhance returns, integrate diversifying exposures and/or manage total portfolio risk. For example, a non-profit with stable spending needs and a high long-term return objective may allocate more heavily to private equity, while an organization with uncertain outflow needs and a moderate return objective may prioritize hedge funds and private credit.

## 4. Design a resilient portfolio

A resilient portfolio seeks to achieve its objectives across a range of economic environments. This requires a combination of analysis based on long-term expectations, stress testing across a variety of market shocks and understanding underlying factor exposures. A starting point for all investors should be to integrate diversified exposures into their portfolios to mitigate the level of downside risk in any singular economic shock by ensuring factor diversification.

This typically includes global diversification across the investment portfolio to reduce exposure to drawdowns in any one region.

Beyond that, investment portfolios should look to build protection against key risks such as growth or inflation shocks. This leads to duration exposure providing portfolio resiliency in a risk-off stress while also integrating real assets into the portfolio for inflation sensitivity.

### Differentiated portfolio exposures

As investors look to add differentiated portfolio exposures and use private assets to both enhance returns and/or diversify the portfolio, private real assets and private credit bring unique attributes to the portfolio.

### A starting point

A starting point for all investors should be to integrate diversified exposures into their portfolios to mitigate the level of downside risk in any singular economic shock by ensuring factor diversification.

For investors with the illiquidity budget, low/no beta hedge funds are an additional lever for total portfolio diversification. This creates a portfolio that is robust across many potential market drawdowns. It does not eliminate risk, as that would sacrifice growth objectives, but it looks to ensure that consideration of a multitude of potential stresses is included in asset allocation design.

## Conclusions

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Done well, strategic asset allocation creates the foundation for long-term investment success by enabling an organization to remain disciplined through market cycles. These decisions must be considered together – each one is interconnected and cannot be evaluated in isolation. For example, higher allocations to illiquid assets may allow return targets to be achieved with less risk if the illiquidity tolerance allows, while a more resilient liquid portfolio can support greater illiquidity. Getting it right requires more than selecting asset classes—it requires aligning portfolio risk, liquidity budgeting and underlying exposures with the organizational objectives and circumstances. The confidence that a strategic asset allocation is aligned with the long-term objectives of an organization is important to maintain discipline through market cycles.

Once the strategic asset allocation is determined, the next steps for ensuring long-term success are portfolio construction and portfolio management through time.

**Strategic asset allocation  
creates a foundation for  
long-term investment  
success**

Getting it right requires more than selecting asset classes—it requires aligning portfolio risk, liquidity budgeting and underlying exposures with the organizational objectives and circumstances.

# Where to next?



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First used: August 2026

AI-31118-08-29

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