Investing for Non-Profits

10 Investment Lessons for NFPs from the GFC

KODA

At Koda, one of the things we do is encourage our people to act as trustees, directors, investment committee members and advisers to charities, foundations and non-profits.

In these roles we are often asked what the key investment lessons were for investment fiduciaries who are often still haunted by the GFC.

This paper examines the Top 10.

"Those that fail to learn from history, are doomed to repeat it."

Winston Churchill

Lesson #1 Good investment governance matters

"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

Charlie Munger,
Chairman of Berkshire Hathaway

Good governance is essential as all future investment decisions are likely to be compromised if good governance is not in place. Governance is not just about making the right investment decisions, it is also about the process for decision-making. Non-profit investment fiduciaries must understand what good governance is, why it matters, and what their regulatory and legal obligations are.

During the GFC, governance was challenging for non-profits who did not invest the time in developing their framework, policies, guidelines and procedures beforehand. These organisations were not well prepared to make decisions in an efficient manner during times of stress. For some organisations, this meant that decision-making was too slow to capture investment opportunities to decrease risk and increase returns. For some investment fiduciaries, this meant that decisions were made without deference to the 'Prudent Person Rule' and Trustee Act obligations.

Lesson #2 Be clear on the organisation's investment philosophy

An investment philosophy represents the core investment beliefs that guide the organisation's decision-making process. Establishing an organisational investment philosophy requires the right ecosystem for the board and investment committee to openly discuss and settle on. A well-crafted investment philosophy will outline investment beliefs on investment horizon, risk appetite, return requirements and management style. The investment philosophy is the cornerstone of the organisation's investment policy and investment mandate.

"Investing is the intersection of economics and psychology."

Seth Klarman,
CEO & Founder of Baupost Group

Most non-profit investors extol the virtues of being long-term investors in their investment philosophy. This enables them to tolerate greater market volatility, invest in illiquid assets, and provides them the ability to be contrarian and opportunistic. Each of these rewards patient investors handsomely. Some non-profit investors deviated from this philosophy due to poor governance practices during the GFC. Unfortunately, the 'double whammy' of selling out at the bottom and going to cash as interest rates fell to historical lows remains problematic for many.

Lesson #3
Invest the time in developing an investment policy statement & mandate

An investment policy statement (IPS) and investment mandate form the organisation's key investment governance documents. They set out the direction for the organisation's investment management program clearly and concisely. They should guide everything from decision-making to the design, implementation, monitoring, management, evaluation, communication and reporting on the investment management program. Prepared effectively, these documents are essential elements for disciplined decision-making and successful investment outcomes throughout the investment cycle.

> "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What's needed is a sound intellectual framework for decisions and the ability to keep emotions from corroding that framework"
>
> **Warren Buffett,**
> Chairman CEO of Berkshire Hathaway

Whilst most non-profit investors have an IPS, it became clear during the GFC that they had not invested the time and effort to develop their policy and condense it into a mandate. Without clear and concise investment guidelines it was difficult for advisers and fund managers to manage investments. This meant poor decisions were made and investment outcomes were not consistently delivered with respect to risk, return and liquidity expectations.

Lesson #4
Align the investment strategy to the organisation's mission

> "Deep internalised understanding of mission is key to being an effective trustee."
>
> **Warren McFarlan,**
> Harvard University Professor

Non-profits are defined by their mission and an investment management program should assist with mission delivery. This means the underlying investment strategy should be aligned to the mission and help finance the organisation's operational requirements with an eye on sustainability and self-sufficiency over the long term. A deep understanding of the mission and purpose of investment should be prudently reflected in the organisation's investment horizon, risk appetite, return objectives, liquidity requirements and responsible investment preferences.

Strong investment returns prior to the GFC and the 'fear of missing out' resulted in some organisations shifting their focus from mission aligned investing to chasing short term returns. When the GFC hit, the investments that generated these strong returns were invariably also those that suffered the largest falls in value and income. For some organisations this resulted in significant losses that led to funding cuts and the scaling back of programs core to their mission. Sticking to a strategy that was determined before times of stress and market turbulence is critical.

Lesson #5
Build an all-weather investment portfolio

> "I think that the first thing is you should have a strategic asset allocation mix that assumes that you don't know what the future is going to hold."
>
> **Ray Dalio,**
> Founder of Bridgewater Associates

Strategic asset allocation (SAA) generates more than 90% of investment portfolio outcomes[1]. The key to successful SAA is diversification across asset classes that are lowly correlated with each other. This will ensure that asset classes do not move together in the same direction, at the same time, in response to the same stimuli. Active asset allocation provides the ability to benefit from tactical opportunities to increase returns and decrease risk. Intelligent SAA will maximise the chance of a portfolio performing well in varying economic and market conditions.

A significant proportion of Australian non-profits have large portfolio weightings in Australian shares. This home bias is mostly due to strong historical performance and the benefit of franking credits for tax concession charities. This strategy worked well until the GFC when Australian shares fell over 50% at their low point. Further, Australian shares have yet to breach new highs in price terms like many other global share markets. Ten years after the GFC Australian shares remain ~15% below the pre-GFC ASX200 highwater mark of 6,828 points. Additionally, they remain ~30% below the pre-GFC ASX200 highwater mark of 8,633 points when adjusted for inflation and before accumulated dividends.

1 Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, Determinants of Portfolio Performance, *The Financial Analysts Journal*, July/August 1986

Lesson #6
Understand the difference between investment horizon & liquidity requirements

It is important to understand the difference between the organisation's investment horizon and liquidity requirements when constructing a non-profit investment portfolio. The investment horizon is the time the organisation expects to hold the investment portfolio. Liquidity requirements are determined by cashflows that may be required within certain time periods. Balancing short-term operating cashflow needs and long-term investment goals is essential. These competing interests are usually best served by segregating assets into distinct pools, each with its own mission-aligned objectives, as well as return, risk and liquidity parameters.

> "If you don't have ample liquidity, and it's not durable in times of stress as you're looking for liquidity, you're forced to sell assets at declining prices which then eats into your capital position, so it becomes this very, very negative cycle. There's no question that liquidity is sacrosanct."
>
> **Ruth Porat,**
> Former CFO of Morgan Stanley

During the GFC some non-profits were challenged by a mismatch between their investment horizon and liquidity requirements. This was because some financially engineered high yield and alternative asset funds became locked up. These organisations were unable to immediately access what they thought were liquid funds. For some, this inability to access funds resulted in spending cuts, delayed capital projects, staff retrenchments and program disruption.

Lesson #7
Select investments prudently

Best practice investment process begins with sound strategic asset allocation, is followed by intelligent portfolio construction, and then finishes with prudent investment selection. Investment selection is responsible for the balance of 10% of portfolio outcomes that is not contributed by SAA[2]. Prudent investment selection should be based on independent research, as well as recognised qualitative and quantitative selection criteria. The investment committee should understand what they are investing in and agree that the investments meet the organisation's requirements.

> "Leave no stone unturned to help your clients realise maximum profits from their investment."
>
> **Arthur Nielsen,**
> Founder of ACNielsen

Leading in to the GFC, many organisations were lured into Australian preference shares and hybrid securities by their attractive yields. Some of these organisations felt so comfortable with these investments that they became their fixed income substitute. When the GFC hit, it was clear the investment committees of these organisations did not understand that these investments would act like fixed income in rising markets but more like equities in falling markets. This resulted in large and unexpected price falls that were not typical of traditional fixed income.

Lesson #8
Stress test the investment strategy to prove it is fit-for-purpose

> "The financial markets generally are unpredictable. Therefore, one has to have different scenarios... The idea that you can actually predict what's going to happen contradicts my way of looking at the market."
>
> **George Soros,**
> Founder of Quantum Group of Funds

Stress testing investment portfolios using risk management software is considered best practice. Stress testing helps investment committees understand the trade-off between risk and return. It also demonstrates whether a portfolio strategy is fit-for-purpose. Simulation methods show the probability of certain outcomes while scenario methods demonstrate what investment portfolio outcomes would have experienced in real life. Stress testing is particularly important for asset and liability portfolios where there is a potential risk of under-funding.

Simulation stress testing methods rely on assumptions as well as historical and forecast risk, return and correlation data. The quality of stress testing outputs is directly related to the quality of these assumptions and inputs. The outlier events and extremes of the GFC highlighted weaknesses of stress testing models using historical averages. Stress testing models using forecasts were also problematic with assumptions rapidly changing during the GFC. Organisations that used stress testing to stimulate pragmatic discussion and guide decision-making fared better than those who relied on the data verbatim.

2 Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, Determinants of Portfolio Performance, *The Financial Analysts Journal*, July/August 1986

Lesson #9
Reporting is important, communication is essential

> "The two words 'information' and 'communication' are often used interchangeably, but they signify quite different things. Information is giving out; communication is getting through."
>
> **Sydney Harris,**
> American Journalist & Author

Comprehensive reporting and regular communication enables a board and investment committee to remain informed and engaged with the organisation's investment management program. Without this information and supporting dialogue, it is difficult to evaluate performance, track progress towards milestones and make decisions to fine tune the strategy or alter course. Reporting data is important, however, most non-profit investment committees also seek insights and wisdom that can only be provided by continuous real time communication.

Most organisations schedule a quarterly investment performance meeting, however, investment opportunities and threats present themselves in a random manner that is rarely aligned to scheduled meetings. Organisations that successfully navigated the GFC's challenges clearly documented their reporting and communication requirements in their investment policy statement and investment mandate. This allowed investment managers and advisers to deliver into these expectations whilst remaining flexible with frequency and format as market conditions change.

Lesson #10
Seek professional investment advice

Determining what kind of board and investment committee the organisation is best served by is an important decision. Most organisations choose to govern and oversee a professional investment adviser. Other organisations choose to 'go it alone' and actively manage the organisation's money themselves, usually with a focus on cost minimisation. 'Going it alone' dangers include lack of time, expertise, tools, investment process and the ability hold somebody professionally accountable. Combined, these issues can create conflict amongst board and committee members, resulting in governance breakdowns and poor investment decision-making.

> "If you think it's expensive to hire a professional to do the job, wait until you hire an amateur."
>
> **Red Adair,**
> American oil well firefighter

Managing investments is not a part time role and requires a continuous real time approach. Organisations that appointed well credentialed, independent advisers with non-profit investment experience tended to navigate the GFC more successfully. Through cycle experience, quantitative modelling tools, disciplined investment process and a lack of internal politics constraints combined to deliver better risk-adjusted returns than the organisations who elected to do it themselves to minimise costs.

Conclusion

History will repeat itself with each generation forgetting the lessons of past booms and busts. The GFC is a reminder for charity, foundation and non-profit investment fiduciaries to review these lessons. These revolve around a deep understanding of the organisation's mission, best practice investment governance, as well as a sound investment strategy that is implemented, managed and reported on appropriately.

> "The best prophet of the future is the past."
>
> **Lord Byron,**
> British Poet & Politician

About the Author

Simon Duckett,
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Simon has a financial markets career spanning more than 20 years, including 13 years at Macquarie prior to Koda.

Simon joined Koda with a financial markets career spanning more than 20 years, including 13 years at Macquarie.

He provides investment advice, governance, policy, strategy and portfolio management services to high net-worth individuals, families, charities, foundations, and non-profit organisations.

These clients have similar needs including, bespoke investment strategies for unique risk/return requirements, a preference for low volatility investment across asset classes to preserve and grow capital in real terms, generation of strong cash flows and investment income to support mission delivery and intergenerational wealth objectives, maximising after-tax benefits of franking credits, as well as operating within specified liquidity guidelines and investment time frames.

Working with boards, investment committees and specialist advisors on asset allocation strategies, portfolio construction, investment selection, after-tax management, ethical preferences, philanthropic support, as well as governance, risk management and compliance are important services Simon provides to clients.

Simon has a Master of Applied Finance, Bachelor of Economics, Graduate Diploma in Applied Finance & Investment, and has completed the AICD Duties, Responsibilities & Finance for the Not-for-Profit Director.

He serves on the St Vincent's Health Network Sydney (SVHNS) Audit & Risk Committee, is a Financial Standard's Power50 ranked adviser, as well as a Barron's Top 50 and Top 100 Adviser.

Simon works alongside Jordan Ryan and Michelle Lam in a team to provide clients with suitably successful investment outcomes in a transparent, prudent, ethical and cost effective manner.

Further Reading

For more information on non-profit investment governance, policy and strategy please visit the following links:

- Essential Questions for Board and Investment Committee Members
  https://kodacapital.com/docs/investing-for-non-profits--koda-capital.pdf
- Preparing for the Future - Do or Die for Non-Profit Boards
  https://kodacapital.com/wp-content/uploads/koda-capital_preparing-for-the-future.pdf
- An Effective Investment Policy Statement
  https://kodacapital.com/docs/koda-capital_an-effective-investment-policy-statement.pdf
- Top 10 Mistakes of the Australian Non-Profit Investor... And How To Avoid Them
  https://kodacapital.com/wp-content/uploads/koda-capital_investing-for-non-profits_top-10-mistakes-of-the-australian-non-profit-investor.pdf
- Courage & Care: Preparing for the Next Market Crisis
  https://kodacapital.com/wp-content/uploads/courage-care_preparing-for-the-next-market-crisis.pdf

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