KODA

COVID-19: Investment Lessons for Non-Profit Committees

COVID-19 exploded in 2020 and appears set to dominate 2021. While economies across the globe seem destined to ride the pandemic's seismic waves for some time, investors can at least begin reflecting on COVIDs initial, brutal impact on global markets.

And there is good reason to reflect, because while this period was intense for investors, it also represents an exceptional learning experience. In the spirit of never wasting a crisis, Koda's team of non-profit investment specialists has spent time reflecting on lessons drawn from their work with clients and in the market more broadly. This paper briefly examines our Top 10.

> "That men and women do not learn very much from the lessons of history is the most important of all the lessons of history."
>
> **Aldous Huxley**

Lesson #1
Don't panic

Without a doubt, the worst investment outcomes result from greed and panic. 2020 was a year when many non-profit investors could be forgiven for panicking. When the market crisis was at its peak in March 2020, the Australian stock market was down 37% and the US market was down 34%. Any investor who exited the market at that time would have locked in losses of more than 30%. To make matters worse they would then have been sitting in cash, earning very little, if any, interest and facing a serious dilemma in terms of when to re-enter the market. Within six months American markets had recovered their losses and by the end of the calendar year they were more than 10% above their previous high, while the Australian market remained just 5% below previous highs. Not all investors can afford the luxury of staying fully invested through the cycle, but having the ability to see market corrections for what they are - temporary and survivable - and the resolve to ride them out, in the face of fear, uncertainty and external pressure, is a priceless combination for investors looking to avoid portfolio implosion.

Lesson #2
Speed of response matters

Between the 20th February and the 23rd of March 2020, the Australian market fell 37% in the US market fell 34%. Within the space of five weeks the world had turned on its head, markets were in freefall and asset values had been hit hard. Five weeks is a lot less time than the time between most investment committee meetings. This was a prime example of the truth in the saying that *markets are dynamic, committees are static*. In 2020, the market certainly did not wait for quarterly committee meetings. During this period, we saw a variety of responses. In our view, the best response involved a sense of urgency without panic. Committees that brought forward meetings and held additional meetings were able to stay on top of an unfamiliar, fluid and unpredictable situation. Watching committees in action, we also learnt the importance of teamwork and availability – that is, the ability for committee members to work together and come together at short-notice.

Lesson #3
Understanding your organisation's cash position is critical

Cash flow was very important in 2020 and the need for cash was discussed around many non-profit investment committee tables. While some non-profits are fortunate enough to possess a true endowment – invested capital held intact in perpetuity - most are investing money that may one day be needed by their organisation to help cover operating expenses or other expenditure needs. We have always been very clear that investment committees need to know what they are likely to have to make available and when. But what we saw in 2020 was something else - a sudden, unexpected shock where barely conceivable worst-case scenarios became reality overnight. One of the most important lessons we drew from this period was for this 'cash need' knowledge to be 100% complete, accurate and up-to-date. And we saw how the ability to remain complete, accurate and up-to-date in a tumultuous period more often than not came down to how well investment committees worked with their CFOs and finance teams. What we saw when this did not work well was a world of pain. It became very clear over the course of the year that not only do investment committees need to maintain a clear and current picture of potential cash withdrawals, they need to be sure of the worst-case scenario *before* they begin investing.

Lesson #4
You must understand the true nature of the funds you're investing

Following on from the last lesson, it is clear that failure to correctly label invested money caused pain for some non-profits. There are a variety of labels in use: 'endowment', 'reserve' and 'rainy-day fund' being amongst the most popular, and while it is easy to say "What's in a name?", terminology and classification matter a lot, because they influence the way people think, what they believe and ultimately how they act. In 2020, we saw this play out. In some cases, 'endowments' were revealed to be reserves and 'long-term investment portfolios' were revealed to be rainy-day funds, funding short-term operating expenses in a manner not anticipated. Essentially, the lesson is that money invested in a manner incompatible with its true nature and purpose - and the investor's actual risk profile – is a problem waiting to happen. It is essential for investment committees to know with certainty the scope in which they have to invest. Failure to accurately understand this scope ultimately leads to either opportunity cost, via over-conservatism, or financial pain, via exposure to excessive risk and/or illiquidity.

Lesson #5
Liquidity does not equal safety

Illiquidity can be a major driver of returns for the long-term investor. As noted previously, most non-profit investment committees need to take liquidity needs very seriously and liquidity considerations are almost always a key part of a non-profit's investment policy. In an investment markets context, what we saw in 2020 was the importance of understanding the relationship between liquidity and risk. Liquidity does not necessarily protect a non-profit from damage, yet the ability to quickly access invested funds is sometimes seen as all that matters. The sudden, dramatic falls experienced across equity markets in the early stages of the pandemic showed the obvious flaw in that belief. Listed equities, core to many non-profit portfolios, are highly liquid, but who would want to pay the price of liquidation if that price was a 30-40% loss of capital, as it would have been in March 2020, at the height of the crisis and the peak of uncertainty for non-profit operating models? For professional investors this is not an issue, but it can be for non-profit employees, committee members and directors who have not experienced previous market cycles.

Lesson #6
Don't risk what you can't afford to lose

2020 was another year when inexperienced and first-time investors found out that investments go down as well as up. It was also a year in which similarly inexperienced non-profits would have found out that whilst employing investment professionals is a good way to achieve objectives and minimise risk, no-one can remove all of the risk inherent in investing money in the hope of a return. The risk of loss and the risk of disappointment are part-and-parcel of any investment decision. To quote the American investor John Bogle,

> "If you have trouble imagining a 20% loss in the stock market, you shouldn't be in stocks."

Understanding risk and quantifying tolerance for risk is the best way for investment committees to reduce the likelihood of a poor investment outcome and this serious work must be done prior to investing a single dollar.

Lesson #7
Good relationships matter

One of the most powerful lessons we learnt in the high-pressure environment that existed between March and June 2020, after which markets began to stabilise and asset prices recovered, was the value of teamwork across multiple networks. The link between good relationships, stress and financial outcomes cannot be over-stated. For non-profit investment committees the relationships that mattered most, and matter most going forward, were, in no particular order, intra-committee relationships (which determined how effectively and quickly the committee got things done), the relationship between the committee and the finance team (which determined how well critical issues like risk management, liquidity and cash-flow management were handled), the relationship between the committee and the board (which determined stress levels, the quality of decision-making and the degree of alignment between investment decisions and organisational needs) and finally the committee and its investment adviser (which determined the quality of investment decisions and the ability of the committee to keep key stakeholders informed).

Lesson #8
Professional advice is valuable

It is hard for any investment committee, however seasoned, to react and take advantage of fast-moving markets while meeting once a quarter or once a month. One of the reasons professional advisers and managers add value and protect assets (aside from their professional acumen) is because they are following and participating in investment markets on a full-time basis and they have access to the tools of the trade. It is difficult for committees, even those blessed with members that bring current, professional-level market knowledge across multiple assets classes, to say to their directors, funders and stakeholders,

> "We are across everything that is happening, all of the time."

It is also asking a lot to expect committee members to remain as objective as a professional adviser in times of stress, which is exactly when you need objectivity most. Finally, in 2020 we saw the importance of good, timely communication and reporting, which professional advisers have the time, the insight and the technology to offer their clients.

Lesson #9
Ethics and values matter, per se, and in the context of risk management

The financial and socio-economic carnage caused by the pandemic, combined with shifts in thinking around a range of environmental and social issues, created a heightened focus on the use and purpose of capital. This was felt by business and by investors during 2020. For non-profit investors, many of which are values-based in their work, the need to invest in line with organisational ethics and values was more important than ever and there is no doubt that responsible investing became a core consideration for non-profit investors in 2020. Aside from values and ethics, we also witnessed a growing appreciation of the link between responsible investing/business practices, and performance. Many investment committees realised that environmental, social and governance practices impact on financial returns and that doing the responsible thing can be profitable. In a year that threatened, and in some cases, delivered negative returns, others realised that aside from ethics and profits, there is another reason to invest responsibly. If a non-profit delivers a poor investment outcome and is found to have been investing contrary to its organisational values, the reputational damage is likely to be a lot worse.

Lesson #10
Investment decisions should always be driven by the mission of your organisation

The final lesson from 2020 is perhaps the most profound. All non-profits are mission-based and ultimately, the money they invest is a means to that end. Therefore, whenever investment committees are about to make a decision, it is incumbent upon them to consider the mission of the organisation. As we said in *Courage & Care: Managing Current Market Volatility*, the guide we published for investment committees in April 2020,

> "Be guided by your mission and purpose – don't look at your situation or make any decisions without going back to why your organisation exists and why you are investing."

It really is that simple.

Conclusion

> "I am not afraid of storms for I am learning how to sail my ship" **Louisa May Alcott**

Sweet are the uses of adversity, Shakespeare told us. The intelligent investor will learn more from the early stages of the COVID-19 pandemic than they will from the relatively benign years preceding 2020. This paper is designed to help non-profit investors take as much as they can from what was for many a painful and tumultuous period. In the end, we are always heading into unchartered waters. To do so with the benefit of experience and with a heightened sense of self-awareness is a major advantage. We hope sharing lessons like these will help non-profit investment committees to manage risk and achieve their objectives. For the benefit of our clients, we intend to take these lessons and use them to examine the key questions non-profits now need to address as they review their investment arrangements in a post-COVID world.

About the Author

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David is responsible for Koda's non-profit and philanthropic client business and for the firm's impact investing service. He chairs Koda's Non-Profit & Responsible Investment Group and sits on Koda's Partnership Committee.

David has worked in the industry since the late 1980s, including 10 years overseas with Coutts & Co. and Merrill Lynch. He has led philanthropic & non-profit advice businesses at Perpetual and JBWere, where, as a member of the Executive Leadership team, he was a Managing Director and head of product and marketing. David has studied Non-Profit governance at the AICD and the Harvard Business School and he qualified as a professional trustee in 1999.

David currently serves on several charity boards and advisory councils. He has significant experience of chairing and serving on endowment and investment committees, overseeing charitable funds in a fiduciary capacity.

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/insights/headline-of-insights-report-post/
- Preparing for the Future - Do or Die for Non-Profit Boards
  https://kodacapital.com/insights/preparing-for-the-future-do-or-die-for-non-profit-boards/
- An Effective Investment Policy Statement
  https://kodacapital.com/insights/investing-for-non-profits-an-effective-investment-policy-statement/
- Top 10 Mistakes of the Australian Non-Profit Investor... And How To Avoid Them
  https://kodacapital.com/insights/top-10-mistakes-of-the-australian-non-profit-investor-and-how-to-avoid-them/
- 10 Investment Lessons for NFPs 10 years on from the GFC
  https://kodacapital.com/insights/investing-for-non-profits-10-investment-lessons-for-nfps-10-years-on-from-the-gfc/

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