Good governance, better investment outcomes

How NFPs can manage financial sustainability in the face of uncertainty

In an environment of resource constraints and increased demand for their community and charitable services, not-for-profit (NFP) organisations are faced with a range of considerations and opportunities to optimise their operations.

From re-evaluating spending policies to refining cashflow and liquidity forecasting, it's essential that boards and investment committees have the right policy settings in place.

By regularly reviewing investment and governance procedures, NFPs will be better positioned to manage short-term volatility while remaining on track to meet long-term objectives.

Given the prevailing economic and market conditions, now is the perfect time for NFPs to establish, revisit, and update current investment policy statements.

This paper has been developed specifically to outline some key questions, challenges and considerations, whilst also highlighting the benefits of utilising professional expertise to maximise efficiencies.

Varying considerations

Before establishing or making any significant changes to your investment policy framework, it is important to consider the specific financial parameters related to your organisation. An investment portfolio should support the organisation's mission, and, consequently, should be structured so that it meets these goals while also mitigating risk to asset pools.

Does your organisation rely on a large portion of its investment corpus to supplement operational expenditure? Is your spending policy clearly articulated and reflective of current/anticipated economic conditions? Does your investment strategy require impact and sustainability gauges?

These are just some of the many important questions and considerations which boards and investment committees need to consider.

As a trusted advisor and partner to many NFPs, Lipman Burgon & Partners frequently receives questions on a range of matters relating to investment strategy, spending policies, and how best to balance the short-term operational needs of an organisation with its future requirements.

To assist others, we have compiled some of the most common questions we receive from NFPs and shared them below.

Q **HOW MUCH OF THE INVESTMENT CORPUS SHOULD BE INVESTED, AND HOW MUCH SHOULD BE KEPT IN CASH OR RESERVES?**

A This is ultimately determined by the size of the organisation and how much of the corpus is relied upon to fund operations.

It's not uncommon for an organisation with a high withdrawal need to be overly exposed to volatile assets like equities. When financial conditions are positive, this isn't a problem. However, in less desirable conditions, being forced to sell at depressed prices to fund withdrawals will impact long term objectives. It's important to be cognisant of your organisation's short-term capital expenditure requirements, as this will also greatly influence the answer to this question.

For organisations reliant on an investment portfolio to meet or supplement operational spending requirements, holding liquid short and medium-term assets, including cash and fixed income investments, will provide certainty, as will a well-structured cashflow forecast to plan future cashflow needs.

Organisations whose operations are self-funding or who have longer investing timeframes can commit larger allocations to asset classes expected to generate higher returns or that are less liquid.

WHAT RISKS DO WE NEED TO ACCEPT TO ACHIEVE OUR ORGANISATIONAL OBJECTIVES?

Determining an acceptable level of risk always depends on the unique circumstances of the organisation, the risk appetite of the investment committee, and the organisation's purpose and objectives.

Generally, a good place to start is to ascertain what the anticipated returns might be from investing in risk-free assets like term deposits or government bonds. This sets the base case and provides a foundation for investment committees to explore opportunities further along the risk curve to gauge expected returns and associated risks.

Of course, inflation expectations also need to be considered, and given inflation rates are rising, there is a cost to inaction. While a risk-free term deposit might be offering 4%, if inflation is averaging 6%, then the buying power of the portfolio will be eroded over time which will likely be an unsatisfactory outcome.

WHAT ARE THE RISK-RETURN TRADE-OFFS?

There are various types of risks that not-for-profits need to consider to determine their appetite and capacity for risk. These include:

Investment risks – the incorrect selection of assets which result in permanent loss and/or short-to-long term periods of underperformance versus an absolute return (as determined by an organisation) or relative return (measured against a comparable benchmark or similar portfolio).

Liquidity risks – having insufficient access to cash to meet cashflow or capital expenditure needs.

Operational risks – selecting the wrong investment manager, advisor or custodian, or having the incorrect governance structure or investment committee members.

ESG risks – having portfolio exposure to organisations in sectors which are hazardous to the environment and/or society. Such exposures may weigh on portfolio returns and can also produce other risks, including damaging reputation and eroding relationships with donors.

Counterparty risks – associated with any particular engagement, investment, or transaction with a third-party organisation.

Currency risk – the exchange rate differentials when investing in international markets.

WHAT CAPITAL-TO-INCOME BREAKDOWN IS RIGHT FOR OUR ORGANISATION?

Generally speaking, financially conservative organisations or those reliant on income to supplement operational expenses will position their portfolio to generate more of their ongoing returns from income-producing assets, whereas more assertive organisations with longer-term objectives can rely on capital gains.

However, given that the purpose and circumstances of each organisation will differ, we urge decision makers at not-for-profits to think deeply and critically about their spending and capital requirements. Through this process, boards and investment committee teams will be more informed and better equipped to make the right decisions regarding the organisation's future capital structure.

WHAT HAPPENS IF WE NEED TO DRAW DOWN ON OUR PORTFOLIO?

Not-for-profits need to carefully balance how much cash to maintain as an operating reserve. Too much cash might raise questions about why resources aren't being effectively deployed, and too little cash can result in liquidity risk should unforeseen circumstances arise.

It is up to the charity's board and investment committee to strike the right balance, and this is where an effective Investment Policy Statement (IPS) comes into play. A well-designed IPS should identify these needs ahead of time and make provisions for liquid funds to be set aside for short and medium-term needs.

CAN OUR ORGANISATION ACHIEVE HIGHER RETURNS BY FOREGOING LIQUIDITY?

Yes, this is known as the illiquidity premium, which can be accessed in private and unlisted markets by buying property, infrastructure or the debt and equity of private companies.

These investments can play a variety of roles within portfolios, providing an opportunity for organisations to diversify their exposure away from traditional asset classes like listed equities and bonds.

Lipman Burgon & Partners has unique expertise in sourcing specialist investment opportunities in alternatives and private markets.

SHOULD ESG FACTORS PLAY A ROLE IN OUR DECISION-MAKING?

ESG factors can represent both risks and opportunities, so they are always important to consider. Our investment governance process incorporates a strict ESG analysis of the universe of investible assets and can screen for positive or negative ESG factors.

For organisations looking to fairly represent their values in their investment portfolio, we incorporate an ESG or Ethical Investment Policy into the Investment Policy Statement.

Although the market is young for this investing style, we are constantly looking to identify and recommend attractive "impact" investment opportunities for clients who want to make a specific and meaningful impact through their investments without forgoing economic returns.

Safeguarding for the future

As NFPs navigate volatile markets and uncertain economic conditions, it has never been more important to have robust investment policies that mitigate risk and optimise portfolio returns in-line with the purpose and values of the organisation.

Lipman Burgon and Partners has a long-standing history of helping organisations. We have extensive expertise when it comes to advising on a range of matters, including investment policy framework design and undertaking sophisticated asset allocation modelling.

From developing mission goals and investment objectives to manager selection, risk analysis and portfolio construction, our team of experts provides support at every investment lifecycle stage.

To discuss the options available for your organisation, contact Lipman Burgon & Partners.

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