Charities and the Investment Risks They Face

Macroeconomic changes and fraudulent behaviour pose investment challenges.

In our previous articles, we explained why charities should adopt investment strategies to cover their obligations. We also discussed the initial steps of creating an investment committee and producing a manifesto to guide the committee in carrying out its work.

This article, which looks at the investment risks facing charities, is the third in a **series** based on our forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*.

Last year, a survey found that more than half of the charities in Singapore lacked formal policies to manage risks. Conducted by KPMG, the Charity Council and NUS Business School, the survey showed that about 80 per cent of charities lacked experience or expertise in risk management. And 70 per cent of them did not have professionals to carry out risk management activities.

These findings accord with our experience in and knowledge of the charity sector in Southeast Asia. Charities in the region tend to operate without an investment committee, which sets out a charter and investment policy to manage their endowment fund. Indeed, they lack investment committees comprised of people with relevant knowledge of and experience in the investment field.

However, charities in Asia are beginning to appreciate the need for a well-credentialled investment committee with the ability to select fund managers and monitor their performance. Such professionals would be aware of investment risks such as volatility, of which there are two kinds: systematic, also known as market risk; and non-systematic, or specific risk.

Market-related volatility and unexpected risks

Systematic risk is inherent in the market, much like the tide at sea. Market risk is unavoidable and macroeconomic in nature. It fluctuates as a consequence of changes in factors such as market sentiment, economic growth and unemployment rate, currency and interest rate movements, changes in government fiscal policies, as well as wars, natural disasters and social unrest.

Non-systematic risk, on the other hand, relates to unexpected factors. For investors, these factors include the loss of key fund managers or technical experts, changes in consumer demand, the emergence of disruptive technologies, rising costs, loss of key suppliers, customers or creditors, fraud and crimes by management, as well as cyberattacks and IT failures.

Unlike systematic risk, however, investors can manage non-systematic risk by diversifying their investment portfolio. An investment manager can build a well-diversified portfolio by picking different securities from various, uncorrelated industrial sectors and markets. In a portfolio that holds a sufficiently large number of diverse assets, the price declines of some assets would be neutralised by the price rises of others.

To be sure, about 90 per cent of the diversifiable non-systematic risk in a portfolio can be reduced by holding a basket of about 20 stocks from various industrial sectors and geographical regions, academic studies have suggested.

Other dangers to watch for

The other kinds of investment risks which charities should be mindful of include inflation, which will erode the purchasing power of an investment portfolio over time as costs and prices rise. An investment can be said to earn real returns if its return on investment exceeds the rate of inflation. However, charities could be tempted or misled into investing in highly risky securities such as junk bonds in order to generate higher returns to meet their objectives.

Reinvestment of cash generated by an investment during the period it is being held poses a risk. Charities will have to invest bond coupon interest and stock dividends they receive from their portfolio. But they will have to invest the cash at a prevailing rate of return, which is often lower than the yields of their invested securities.

Charities also face the liquidity risk of not being able to cash out their securities unless they are willing to do so at a loss. This risk becomes significant if a charity is in urgent need of money, and the securities it holds are seldom traded in the market. The illiquidity, or lack of trading, may be due to high transaction costs or a lack of buyers and sellers. It could also be that information about the asset is hard to obtain. In times of uncertainty, liquidity risk increases as investors wish to keep more cash on hand and become less willing to buy securities. Assets with longer maturity dates and securities that are not traded on exchanges are generally not as easy to sell or cash out of.

An investment manager or its agents may fail to carry out an investment or settle a trade within a certain time as instructed, which constitutes an execution risk. They may fail to transact with the right amount, at the right price or the right time. The potential negligence of the investment manager or its agents, or a technical fault in the transaction process, may result in the loss of capital, opportunity or penalties to the investor.

The investment manager could commit crimes that might cause irrecoverable losses. These crimes – such as Ponzi schemes, undisclosed losses by rogue traders, money laundering, employee theft and manipulation of financial performance data – are hard to detect and hence hard to avoid. But they can be minimised by thoroughly vetting candidates for the position of investment manager and examining the manager's work after his or her appointment.

Lastly, charities face the risk of custodian fraud. That is, their assets could be stolen by custodian agents with fraudulent staff or management. Cybertheft that occurs with or without the help of insiders could result in the loss of assets. Custodian's errors in reporting financial management performance could also lead to inappropriate investment decisions and risk management plans that are not fit for purpose.

Investment stance in Asia

In Asia, most charities are conservative in their investments, preferring to hold their money in blue-chip stocks and bonds, while larger ones invest in private equity and property assets. Some charities, however, place their funds in fixed deposit accounts at banks with yields that are below the rate of inflation.

As interest rates are moving higher, charities could generate reasonable returns by investing in short-term bonds, whose value isn't as badly affected by rising rates, before investing in higher-yielding bonds.

Our next article will discuss the tools and strategies that charities could use to manage the various types of investment risks.

This post is part of a **series** on good practices in fund management for non-profits.

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