What Non-Profits Should Know Before Engaging With Money Managers

Trustees and investment committee members need to acquire a basic understanding of financial instruments.

In our previous articles, we looked at how charities can find the right balance between taking too little and too much risk in achieving their objectives. We also talked about how an investment philosophy shapes the strategy and style of investment.

This article, which discusses what charities need to know to have informed conversations with external money managers, is the sixth in a series based on our forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*.

To effectively fulfil their fiduciary duty to the charities that they work for, trustees and investment committee members need to acquire at the very least a basic understanding of financial instruments. For them, this knowledge is critical to having informed oversight of external money managers hired to manage the charity's funds. Having such knowledge will enable trustees and investment committee members to ask the right questions, ensure that external money managers are using appropriate financial instruments in keeping with the charity's investment philosophy, thereby becoming responsible stewards of the charity's resources.

Broadly speaking, there are four categories of financial instruments: shares and bonds; alternative assets (such as private equity, commodities and real estate); cash; and funds managed by financial professionals. In this article, we are focusing on the first category of shares and bonds.

Stocks and dividends

Shareholders of publicly listed companies are entitled to receive equitable distribution of profit in the form of dividends quarterly, semi-annually or annually. Contrary to impressions conveyed by the financial media, speed and frequency of trading do not necessarily drive returns in equity investing.

Although short-term traders can do well in periods of extreme market volatility, some have owed their success to illicit acts such as front-running clients' trades or exploiting insider knowledge of companies.

Charities with long-term financial obligations require stable and sustainable income. They should thus avoid making frequent and short-term trades in any financial instruments, including shares.

Dividends make up a major portion of the total returns that stock investors can make. According to investment research firm Morningstar, dividends comprised between one-sixth and two-thirds of total returns from investing in U.S. shares in the past seven decades.

Charities that have low risk tolerance and need sustainable dividend payments would do well to invest in long-established, well-diversified companies with a relatively larger market valuation. Such companies generally pay high and stable dividends.

Share lending and dividend reinvesting

To be sure, charity trustees and investment committee members should take the long view towards investing. Benjamin Graham, a famous investment guru, said that "the real money in investing will have to be made – as most of it has been in the past – not out of buying and selling, but out of owning and holding securities, receiving interest and dividends, and benefiting from their long-term increase in value".

As such, small and medium-sized charities should hire professional fund managers to find and pick stocks that match their investment philosophy, objectives and risk tolerance. Even so, it is important that charities' investment committee know the various ways through which stock portfolios can generate returns.

For instance, investors can increase their returns by earning fees from lending their shares to their custodian banks. They can also reinvest dividends in term deposits or stocks, thus gaining interest on savings or increased equity dividends.

Charities could also profit from using option strategies, such as selling (or writing) a call option or a put option on shares. Sellers of options, a form of financial derivative, receive a monetary premium for having the obligation to buy or sell the underlying shares at the exercise price. While the two strategies enable option sellers to gain a fair price for the premium of the options, charities should carefully consider the pricing of these products or have investment experts do so for them.

Bonds and coupons

For the purpose of this article, we are using "bonds" to describe the phalanx of debt instruments encompassing the likes of commercial paper, floating rate notes, debentures, classical bonds, and even mortgages, loans, leases and term deposits.

Governments, municipalities, state agencies, supranational organisations and companies borrow money by issuing bonds to lenders. Bond holders receive interest periodically and have their principal sum (face value) returned when the bond matures at the end of the loan duration.

To entice lenders, bond issuers offer an annual interest rate (known as the coupon) that is relatively competitive to those offered by similar issuers, based on the current interest rate environment.

Lenders generally seek higher coupons for longer-term bonds because of greater uncertainties about interest rates over a longer time period, as well as the issuers' ability to pay the coupons and repay the principal at maturity.

Globally, the bond market is the largest securities market. Bond prices and interest rates rise and fall inversely.

Diversification

Investment managers either take a passive or active approach to investing in bonds. In the case of a charity that has to meet a quarterly operating expense of $50,000 and capital spending of $300,000 once every three years to support an orphanage, the investment manager can adopt laddering, the most common form of passive bond investing.

Under the laddering strategy, the investment manager builds a diversified portfolio of bonds of different maturities. The portfolio may include short-term commercial papers and government treasury bills, and mid-to-long-term corporate, municipal and government bonds. It should provide the investment manager with adequate cash flows from interest payments to meet the quarterly operating expense. Some of the bonds would also mature at the end of every three-year period to pay for the orphanage's periodic renovation.

This strategy provides a high level of certainty for the charity to meet its financial obligations even though it may not enable it to maximise its investment return.

Indeed, a passive bond investment strategy, which buys and holds bonds to maturity to maximise their income-generating properties, works best with high-quality bonds that cannot be redeemed by issuers before maturity.

In contrast, active bond strategies seek to maximise returns but with higher risks. Managers typically buy and sell undervalued bonds, wait for the prices to rise, and sell the bonds before they mature to realise profits.

Regardless of a charity's investment philosophy, stocks and bonds will make up the majority of a well-diversified investment portfolio. To be sure, a portfolio comprised entirely of just stocks and bonds, and necessary cash deposits, can indeed meet a charity's financial needs.

In our next article, we will look at the category of alternative assets such as private equity, commodities and real estate.

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