Charities’ Path to Financial Longevity Begins With a Manifesto

By Boris Liedtke , INSEAD Emerging Markets Institute Distinguished Executive Fellow, and Peter Lai , Chairman of HML Consulting Group and Executive Director of Riverside Asia Partners

An investment policy statement should guide the work of investment committees.

In our **last article**, we outlined some crucial reasons why charities should adopt investment strategies. In short, long-term investments enable them to fund long-term liabilities and become less reliant on short-term fundraising to cover their obligations. This helps them direct resources better, too. Without the need to pound the pavement every quarter to shore up funds, they can make money work for them and spend their time with recipients. As we outlined, creating an investment committee is the first step.

The next step charities must take is to produce a plan to guide their investment committee in carrying out its work.

The plan, called an investment policy statement, is the focus of this article, the second in a series based on our forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*.

The investment policy statement serves four main functions. First, it establishes and records policies to aid the investment committee in its decision-making. It also maintains the consistency of its policies.

Second, the statement clarifies what is expected of external investment consultants and managers. Third, it informs stakeholders about the aims, process, philosophy, guidelines and constraints that investment managers must follow.

Lastly, the statement provides guidance on how the committee makes its investment decisions, instils discipline and outlines the responsibilities of committee members.

Recommended headings

To make an investment policy statement comprehensive, we recommend the inclusion of the following headings: mission of the sponsor or key donors; responsibilities and authorities of the board and investment committee; investment objectives; spending and reserve policy; time horizon; risk tolerance and risk appetite; asset allocation targets; permitted and prohibited investments; guidelines on portfolio rebalancing; and guidelines on diversification.

The investment policy statement should be consistent with the charity’s mission. If the charity’s work is caring for refugees from war-torn countries, then it should not invest in the arms industry or in ethically dubious sectors such as tobacco. Should such conflicts come to light, it could hurt the charity’s fundraising efforts.

In terms of responsibilities and authorities, the board of directors (or trustees) is ultimately responsible for the charity’s investment portfolio. The boards of larger charities may authorise the investment committee to enact the investment policy. For charities with small investment funds, the board does that itself.

If a charity lacks investment management expertise, it should hire an investment adviser to aid its investment committee. The adviser should provide the knowledge and experience that the committee needs without getting involved in investing the funds.

With the adviser’s assistance, the committee will decide on its investment plans, appoint external investment managers and monitor investment performance.

Unless a charity’s investment funds amount to $1 billion or more, it should hire external investment managers. They are often more cost-effective and have greater access to the best processes and talents in the investment management sector.

When defining its investment objectives, the investment committee should weigh its present and future spending needs. It should also consider inflation’s erosive effect on purchasing power, investment volatility and the charity’s ability to gain additional donor support.

Charities with long-term commitments, such as those running old folks’ homes or orphanages, can best sustain themselves by having a mix of operating earnings, investment income and long-term donor aid. Such charities must generate adequate income to cover their present spending needs while making sufficient reinvestment to ensure that the growth of their investment capital matches inflation.

Taking the long view

As the process of generating targeted investment returns is volatile and far from smooth, it requires investment managers to take a disciplined and long-term approach to achieve success.

To find an effective balance between short-term spending needs and long-term preservation of capital, the investment committee should make careful forecasts regarding expenditures, spending, investment returns and fundraising activities.

There are two ways for a charity to preserve the purchasing power of its capital and determine its spending policy. The first way is to spend a fixed percentage of its capital amount. The second method is to spend a fixed nominal dollar amount but make periodic adjustments for inflation, investment returns and donor support. That would maintain the purchasing power of the endowment fund.

As charities may face low investment returns or difficulties in attracting donations, they should set aside reserves for “rainy days”. The reserves, which should be kept in liquid assets to fund unexpected operational expenses, can be determined as a fixed amount or a percentage of the yearly operational expenditures. A reserve fund with assets equivalent to three years of expenditures is generally regarded as adequate. The investment committee should, however, be mindful that the size of its reserves might weigh on its investment returns.

Although most charities are expected to last for decades, investment committees typically expect to hold their investment portfolio between three and five years. The investment time horizon affects a charity’s expected investment returns and risk exposure. While a longer investment time horizon allows investment managers to ride out short-term market cycles, the investment may become less liquid and carry higher risk. As such, it would be expected to generate higher returns to justify the risk.

It is acceptable for an investment portfolio to outlast the tenures of investment committee members. What should determine the selection of investments is the charity’s risk tolerance, liquidity needs and required investment returns. This is an important point because the investment committee may seek superior returns for the duration of its members’ tenure, but at the cost of the charity’s long-term aims.

Balancing risk tolerance and appetite

In pursuing its financial goals, the investment committee must be mindful of balancing the charity’s risk tolerance and risk appetite. Committee members may have different risk appetites that are shaped by their personalities, experience, knowledge and social background. But they must agree on taking an acceptable level of risk to meet their investment objectives without exceeding the charity’s financial capacity or risk tolerance.

For instance, Singapore’s government made legislative reforms after town councils suffered severe losses from high-risk investments following the global financial crisis in 2008. New regulations restrict town councils from taking excessive risks even though they have high risk tolerance.

To be sure, the risk tolerance of the charity should be determined – with assistance from professional investment advisers – and clearly stated in the investment policy statement.

In our next article, we will take a close look at investment risks and the tools available to manage them. It is well established among disciplined investment managers that understanding and managing risks should be the first priority in any investment strategy.

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

Boris N. Liedtke *is a Distinguished Executive Fellow in the* ***INSEAD Emerging Markets Institute****.*

Peter Lai *is the Chairman of HML Consulting Group and Executive Director of Riverside Asia Partners.*

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About the author(s)

Boris Liedtke is a Distinguished Executive Fellow in the INSEAD Emerging Markets Institute.

Peter Lai Peter Lai is the Chairman of HML Consulting Group and Executive Director of Riverside Asia Partners.

About the series

Fund Management for Non-Profits

A series based on the forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*, by Boris N. Liedtke and Peter Lai.