# Four Strategies for Balancing Charities' Investment Risks

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**Avoid, reduce, transfer and accept are bywords for a disciplined and cautious approach.**

In our previous articles, we looked at why charities need to establish an investment committee and create a manifesto to guide it. We also examined why charities should have investment strategies to cover their obligations.

This article, which discusses how to manage the volatility of investment returns, is the fourth in a series based on our forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*.

Avoid, reduce, transfer and accept are four basic ways an investment committee can find the right balance between taking too little and too much risk in achieving its objectives.

These risk management approaches help set a disciplined and cautious course, which is necessary for delivering sustainable and predictable investment returns. For the investment portfolio to deliver higher returns, the investment committee must be prepared to face higher volatility during the holding period.

### Avoiding risk

Misguided beliefs or a small appetite for risks may be the reason some investment committees invest most of their funds in liquid but low-yielding assets, such as short-term government securities, money market paper and cash. They may lack interest in investing their funds. Perhaps they want to limit the investment work to a minimum due to a commonly held but wrong-headed view that the work of charities is not to invest and make money.

Investment committees may also lack appetite for risk because they don’t understand the broader objectives of such work. Sometimes, members have had bad experiences or lack knowledge of investment management.

Some investment committees choose to keep their funds in liquid assets because they anticipate the need to cash out the assets in the near term. For instance, the charity might need funds to launch a new programme soon or to upgrade an orphanage that it supports. As such, it is wise to hold the funds slated for withdrawal in liquid assets such as bank deposits and short-term treasury bills because the portfolio will have a limited tolerance for risk.

It is not a wrong strategy for investment committees to hold their funds in risk-free and highly liquid assets for a determined time period in uncertain times. They may also do so in anticipation of opportunities to buy sharply discounted or mispriced assets in times of market turmoil.

When holding funds in low-risk and low-yielding assets, the key is to understand the underlying strategy and when it might need to be reviewed.

### Reducing risk

Diversification, or investing in assets with low correlations of price movements, is an important way to reduce investment risks. A diversified portfolio is less volatile because the rise in the value of some assets can offset the fall in the value of others.

This strategy allows charities to invest some funds in riskier asset classes such as technology stocks and hedge funds. While they would not feel safe investing large amounts in such assets, making small investments could yield higher returns over the long term without increasing volatility.

What diversification cannot eliminate, though, is market or systematic risk. In the global financial crisis of 2008, for instance, the value of all investment portfolios – except for those invested in government securities and state-guaranteed bank deposits – collapsed regardless of how well diversified they were.

On the question of how diversified an investment portfolio should be to effectively reduce risks, the general consensus is that a portfolio of 30 low-correlated stocks could curb more than 90 percent of specific risk.

A well-diversified portfolio should have investments across different asset classes, industries and geographic regions. Chosen well, it allows investment committees more time to manage the non-diversifiable market risk.

### Transferring risk

Investment committees may seek to transfer investment risks by using financial derivatives such as futures and options. This is akin to buying insurance: The insured pays a premium to the insurer in exchange for compensation in the event of a loss.

Charities can protect themselves against the price decline of assets or securities they hold by buying options that allow them to sell the assets at a pre-agreed price and pre-set future date. Conversely, they can lock-in the purchase price of an asset by entering an option contract to buy a certain amount of that asset, thus avoiding the risk that the asset’s price would rise too quickly.

Notwithstanding public criticism and even hysteria about the use of financial derivatives, such instruments can play a defensive role for investment portfolios. They are highly cost-effective and an efficient way to transfer risk quickly and clearly. It is thus useful for charities to take the time and effort to understand how best to use derivatives.

### Accepting risk

Charities may have to accept the price volatility of illiquid assets, which they are not allowed to sell or monetise. Such assets, given by their founders or donors, may include paintings, books, farmlands, buildings or non-trading private company shares.

Instead of profiting from such assets, charities must spend money on their storage, conservation and safekeeping. They may also have to insure the assets against damage or theft.

As such, charities should carefully consider whether to accept these assets. They could be stuck with them until the charities themselves are dissolved due to bankruptcy, the end of their chartered life or completion of their mission.

On the bright side, assets such as buildings and farmland can be leased out for profit, while an art collection can be used to help raise funds and public awareness.

While the mark-to-market losses or gains of illiquid assets must be recorded in the annual financial statements of charities, they do not affect their operations. They can, however, tarnish charities' financial image and standing with prospective donors.

In our next article, we will look at the suitable investment philosophies and styles that charities can adopt.

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

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## 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.