What Non-Profits (and Governments) Need to Know About Investment Strategy

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Charities investing in hedge funds isn't necessarily a cause for concern.

In our previous articles, we saw how charities need investment strategies to cover their obligations. We also discussed how they can find the right balance between taking too little and too much risk in achieving their objectives.

This article, which looks at how an investment philosophy shapes the strategy and style of investment, is the fifth in a series based on our forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*.

If charities want to achieve their goals for years to come, they need to develop a general approach towards investing their funds. This so-called investment philosophy underpins the choice of investment strategy and style that can enable them to manage their investments in a disciplined and sustainable way.

Not having such an approach, for example, proved disastrous for an endowment that John Gwynne, a fellow of the University of Cambridge, bequeathed to St John's College in the 16th century.

He stipulated that an annual amount from his endowment should be used to fund three fellowships and six scholarships. But ten years later, the executors of Gwynne's will were forced to reduce the academic aid to just two fellowships and three scholarships. Today, the annual endowment would only pay for about 0.1 percent of a single foreign student's annual tuition.

A set of beliefs

So what is an investment philosophy? It is a set of beliefs that investment managers have about how the financial markets operate. They may come by such beliefs from their training, experience or socio-religious background. And these beliefs may or may not be based on evidence.

Investment managers formulate investment strategies by fusing their investment philosophy with their clients' investment goals, constraints and risk tolerance.

For instance, investment managers may believe that the financial markets are inefficient and that assets are often wrongly priced. They may also believe that professional fund managers can do better than the markets, that there may be more investment opportunities abroad than at home, and that diversification is necessary to curb investment risks.

Accordingly, they may adopt strategies such as hiring investors with a track record of outperforming the markets, allocating more funds for investment in overseas securities and adjusting their investment portfolio periodically to ensure that it is well diversified.

Investment styles

In terms of investment strategies, there are four basic pairs of styles: active versus passive investing; growth securities versus value securities; small-caps versus large-caps; and absolute versus relative returns.

Essentially, investment managers can choose whether to actively pick securities or invest in passive index funds. They may prefer securities with high earnings growth or those that are stable but undervalued. Managers may pick firms with a relatively small market value of $2 billion or those with a large market value of $10 billion. The former tend to perform better than the latter, but they are riskier and more volatile.

Lastly, investment managers may choose to operate absolute return funds or relative return funds. Absolute return funds aim to increase the value of their portfolio without reference to a market index. In contrast, relative return funds aim to outperform a benchmark such as a market index.

Our book will provide detailed examples of investment strategies that hedge funds use to generate returns. These include long-short equity strategy, market neutral strategy, merger arbitrage strategy, convertible arbitrage, capital structure arbitrage, event-driven strategy and short-only strategy.

Ban on hedge funds not in charities' interest

Currently, charities in many countries must choose traditional mutual funds as regulations prevent them from investing in hedge funds. That is because hedge funds – which bet on and against securities based on an absolute returns approach – use leverage, or borrowed money and derivatives, to amplify returns at the risk of magnifying losses.

This regulatory approach is inappropriate, too simplistic and even self-contradictory. Regulators' narrow definition of "capital preservation" means that charities should avoid losing their capital without taking market movements and inflation into account.

As traditional mutual fund managers tend to take a relative returns approach, a 5 percent decline in their portfolio amid a 25 percent collapse of the market is a relatively good outcome. But that still means that charities that invested with them suffer capital losses.

Many investment managers believe that hedge funds can help charities meet their aim of preserving capital, particularly as some hedge fund strategies can be highly defensive. Regulators need to properly define their aims regarding investment philosophies for charities. They should not stop charities from adopting certain investment styles or using investment products and services that carry certain labels such as "hedge funds" or "derivatives".

Potential charity donors should enquire about the investment philosophy of the charity to which they wish to contribute. What is its investing principle and how is it reflected in its choice of fund manager?

If the charity invests in an actively managed fund of large-cap growth stocks for absolute returns, will it disregard its strategy when offered a potentially lucrative fund that tracks an index of undervalued small-cap stocks?

Will the charity adhere to its investment philosophy in good times and bad? A failure to keep the faith could result in the charity's financial collapse, like it did with John Gwynne's endowment.

A lesson from history

That some of the world's richest academic endowments in Britain today have not suffered the fate of Gwynne's endowment is thanks to a regulatory change from the 16th century. The *Corn Rents Act* of 1576 entitled colleges in Oxford and Cambridge to collect rents that largely rose in tandem with inflation, ensuring the sustainability of their endowments.

That underscores the importance of having an investment philosophy. It should be taken seriously by donors, regulators and charities. Investment services or products should not be disallowed because of meaningless labels.

In our next article, we will look at the source of returns from common investment instruments. We will also discuss how investment portfolios should be built based on the objectives and constraints stated in the investment policy statement and investment philosophies.

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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.