How Charities Should Manage Their Cash

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For non-profits, a large cash position could signal prudence or betray a lack of investing sophistication.

In our previous articles, we looked at how charities should use investment instruments such as stocks and bonds.

This article, which touches on the use of cash, is the eighth in a **series** based on our forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*.

Charities tend to keep most of their assets in cash to cover short-term financial needs when they lack a defined budget or have a poorly drafted one.

The annual accounts of such charities will show a large cash position on their balance sheet, which should raise immediate red flags for prospective donors.

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Do these charities have a large cash position because they have an unsophisticated investment strategy, or because they are intentionally hoarding cash to pay for expected expenses?

From an investment perspective, having a large cash position hurts financial performance, as cash has the lowest returns compared with other financial assets.

Types of liabilities and reasons to have high cash reserves

To be sure, charities constantly need cash to meet their liabilities, of which there are two kinds.

The first is expenses directly related to charitable causes, such as financial aid to artists or other deserving people, prize money for awards and scholarships, as well as purchases of goods and services like books, food supply and teaching. The list of such expenses is highly specific and dependent on the cause of the charity.

The second kind of liabilities is administrative costs, which charities must cover to remain operational. These liabilities include the expenses of trustees, travel, rent and staff costs, the costs of annual accounts and audits, as well as expenses for fundraising.

There are, however, three reasons for which it is ideal for charities to have a high cash position on their balance sheet.

First, they could be hoarding cash to acquire investment assets, which are often less easily convertible to cash. For instance, a charity could look to buy a real estate property and be close to completing the deal. Before the acquisition, the charity might slowly increase its holding of cash to fund the payment.

Charities might also be increasing the amount of money they hold to meet the substantial cash call from a private equity fund in which they have pledged to invest.

Having a large holding of cash, in any case, allows charities to fund future and expected investments.

Second, charities can hoard cash for opportunistic investments. They anticipate potential and substantial market events, which would allow them

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to exploit investment opportunities as such events occur. Charities could, for instance, take advantage of declines in bond prices following an interest rate hike, or profit from the fall of a target company's share price due to the cancellation or failure of a proposed corporate acquisition.

The third reason for charities to have a high cash position is to use cash as an investment tool. They could seek to maximise their returns while minimising the risks by keeping money in short-term deposits with high interest rates that pay more than long-term bonds. Such deposits could be overnight, or between one week and three months in duration.

Carry trade in currencies is a risky bet

While it is not uncommon for investors to hold money in foreign currencies, prospective donors and regulators should ask questions of charities with large foreign currency cash positions on their balance sheets. Are the charities holding foreign currencies to meet liabilities denominated in those currencies or to acquire investment assets denominated in those currencies?

It is often and sadly the case that investors may be trying to profit from higher interest rates in a foreign currency – a simple and wrong gamble to make.

Prospective donors should avoid charities that hold foreign currencies in a bid to gain higher interest income, as such charities have shown that they have an unsophisticated investment process.

Consider this. An investor may be tempted to keep part of his cash holding in a foreign currency cash deposit carrying an annual interest rate of 10 percent, because a domestic currency cash deposit of a similar duration yields just 1 percent.

Such investors think that they could exploit the difference in interest rates, a practice known as the carry trade, to make money. They could collect the interest from the foreign currency deposit and convert it and the principal amount to their domestic currency when the foreign currency deposit matures.

The currencies of emerging economies tend to offer higher interest rates than those from developed economies.

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However, past financial crises have shown that carry trades are not without risks. Investors in currencies of Iceland, Southeast Asia and Africa have lost much of their investments because of sudden and significant devaluations of those currencies during market turmoil.

Before the Asian Financial Crisis in 1997 and 1998, for instance, many companies, banks and investors sought to save money or make money from the carry trade between the high-yielding Indonesian rupiah and the lower-yielding US dollar. They did so as they felt that the exchange rate between the two currencies was relatively stable.

When the financial crisis hit, the rupiah collapsed against the dollar, causing severe losses for those using the carry trade.

So given the riskiness of the carry trade, prospective donors and regulators of charities should examine the adequacy and effectiveness of charities' currency risk management strategy.

Multi-year financial budget helps smooth operations

Speaking of risk management strategy, for charities to avoid failing to cover their expected and unexpected expenses, the investment committee should draft a multi-year financial plan.

The aim is to take note of as many of the expected expenses as possible to enable the proper management of investment funds. That way, the charity's investment arm can set aside adequate amounts of cash to cover any liabilities when they arise. Second, knowledge of the charity's future cash flow needs will help the investment managers to structure investments to better match assets with liabilities.

For example, the charity's investment arm can set aside the right amount of cash if it knows the charity needs to pay for its annual report and audit in the month of May. Likewise, if it knows that the charity has to pay for a costly renovation of an orphanage every five years, then it will buy bonds with a matching maturity to ensure that sufficient cash is available when needed.

The charity's board of directors should be responsible for drafting and approving the multi-year financial budget, not the investment committee, because a certain amount of checks and balances are necessary.

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For its part, the investment committee should regularly monitor the accuracy of this budget to optimise its investment requirements and provide liquidity to the charity in an adequate and timely manner.

Indeed, frequent discussions between the investment arm and the department in charge of expenses will help both parties do their work better.

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