Drivers of investment management success for non-profit organizations

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Much has been written about the challenging market environment and the difficulties non-profit organizations confront as they seek to reach their investment return targets. Charged with maintaining consistent levels of annual spending while simultaneously safeguarding their assets so as to support their operations in perpetuity, many non-profits are reconsidering their approaches to their investment programs. We at Russell Investments believe that the following practices are critical to the success of a non-profit organization’s portfolio(s):

- Be clear on the outcomes you want your investment portfolio to achieve.
- Manage your investment portfolio holistically and dynamically, using a “roles-based” framework (e.g. considering the roles each investment strategy fulfills in the portfolio).
- Manage risk at the total-portfolio level.
- Align your governance process, structure and documents around your desired outcomes (including identification of specific responsibilities of fiduciaries including board, investment committee and outsourced chief investment officer).

Building an outcome-oriented investment portfolio

Basing investment strategy on the organization’s goals may seem obvious. But as market environments change and portfolio structures evolve, an organization needs to consider its unique current circumstances within the context of historical and future changes. For instance, a university endowment makes annual payouts (to the university) that are fairly consistent in terms of addressing needs such as student financial aid, operations support and the financing of specific programs. However, there will be times when demands change, as when the university needs to construct a new building (when doing so may result in a greater draw on funds) or when there is a successful capital campaign (which may result in an increase in funds inflow). At such times, the non-profit organization must identify or reconfirm the desired outcome of its investment program.

Russell defines an outcome-oriented investment strategy as one that derives from matching the organization’s current investment objectives, goals and constraints with the expected realities of future economic and capital markets environments. This means that in order to build a
successful investment program, we have to consider the portfolio’s targeted return objectives, the organization’s risk tolerance, and expectations for the performance of underlying assets over time. It is by determining the desired outcome that we can build the portfolio solution appropriate for the client, one that is expected to provide the required rate of return at a level of risk with which the investor is comfortable.

**Dynamic total-portfolio management using a roles-based framework**

It is imperative to access a diverse variety of potential return sources in the effort to meet the investment portfolio’s objectives. To exploit different risk premia, Russell believes that moving away from managing portfolios purely from the perspective of asset class strategy silos, and instead managing them from a holistic total-portfolio perspective, can be highly beneficial. Total-portfolio management at Russell Investments includes approaching portfolio construction from a roles-based framework and allowing for dynamic management of the portfolio.

**Roles-based investment framework**

Gone are the days when relying on asset class managers to control total risk and return is an acceptable total-portfolio strategy. Instead of allocating by asset classes and evaluating success on the basis of outperforming a specific benchmark, a roles-based framework enables evaluation of investment components in light of how they contribute to critical outcomes of the overall investment strategy. For non-profit organizations, this holistic approach involves putting strategies into three specific “buckets” – growth, return enhancement and risk reduction/diversification – as Exhibit 1 illustrates.

This roles-based framework provides for an integrated perspective on portfolio construction, allowing us to evaluate roles through various outcome and risk exposure lenses. Strategies may fulfill more than one role, and asset classes may be seen in more than one bucket. For example, some real asset strategies may fall into the growth bucket, and some into risk reduction/diversification,

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**Exhibit 1: Roles-based framework**

Investment strategies fulfill roles in a portfolio

<table>
<thead>
<tr>
<th>GROWTH</th>
<th>RETURN ENHANCEMENT</th>
<th>RISK REDUCING / DIVERSIFYING</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Global listed equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Directional hedge</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Listed real assets: listed infrastructure and REITs</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Extended equity &amp; fixed income sectors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Private markets</td>
<td></td>
</tr>
</tbody>
</table>

**Equity oriented assets, provide core growth engine for portfolio**

Typically higher return and generally higher risk type assets

**Diversifying strategies to growth and return enhancement**

Strategies may fulfill multiple roles in a portfolio

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Based on the characteristics of the strategy (e.g., private versus listed, “aggressive” versus “conservative”). Identifying which strategies are the best fit for fulfilling a certain role gives us a way to look across the silos and make investment decisions between, rather than just within, strategy types. For instance, numerous strategies may be considered “return enhancement,” and within that general type, some strategies are liquid, some are illiquid, some are fixed income focused and others are focused solely on equity or real assets. Having the flexibility to rotate among these strategies as investment opportunities present themselves may provide more opportunities for success.

**Dynamic management**

To be successful in meeting a non-profit organization’s objectives in today’s uncertain markets, we believe we need to take a dynamic approach to managing the investment program. By “dynamic management” we mean not only including actively managed strategies in the portfolio, but also actively tilting the portfolio and managing targeted exposures on the basis of both short- and long-term views of the market. This is most efficiently and easily done with liquid assets. The globalization of markets has led to a changing dynamic of increased correlation of risks and returns across regions, and the need for flexible navigation among these markets is one reason why dynamic management is beneficial. (It is also important to consider the impact of macro policy and global geopolitics on market movements and to build greater diversification into nontraditional, more illiquid investment strategies, due to the increased correlations of “traditional” long-equity and fixed income markets.)

This evolution, of increased market correlations and effects of macro policies, has led to a requirement for a holistic portfolio management approach that cuts across traditional asset class lines and provides a more transparent view of current total-portfolio exposures. Individual exposures can thus be actively shifted to capture current opportunities and mitigate undesired risks without significantly altering the overall portfolio structure. We believe combining dynamic management with a roles-based approach should increase the investor’s ability to capture unique opportunities while managing within a holistic risk management framework.
Managing risk at the total-portfolio level

In addition to maintaining the flexibility to capture return opportunities, we must also dynamically manage the risks they may introduce to the investment portfolio. Having state-of-the-art risk management tools, and incorporating them into the investment process in order to measure and manage risks at the total-portfolio level, are important elements of successful outcome-oriented investing.

One positive development to come out of the last few years of market uncertainty has been the investment managers’ design of far better tools for monitoring and assessing ongoing investment risks. The IT technologies that support these tools have become faster and less expensive. Because we can rely on highly skilled IT personnel, portfolio managers and risk specialists, Russell is able to evaluate entire portfolios under different scenarios, stress tests and market environments – to understand what is likely to happen when we add or remove a new investment, and to see where we may have gaps relative to the policy portfolio. This allows us to assess the likelihood of a portfolio meeting its objectives both in the short term and over the long term. While there are some challenges around incorporating some of the less-liquid strategies into a total-portfolio risk management system, specific exposure proxies can be designed within a multi-asset risk approach that can provide further insights on total-portfolio risks.

Alignment of governance structure, process and documents around desired outcomes

A non-profit’s fiduciaries may all be in agreement as to desired portfolio outcomes, and they may also agree that dynamic portfolio management, strong risk management and clarity on the roles strategies play in the portfolio are critical to achieving those objectives; however, this consensus could all be for naught if their governance process, structure and documents are not aligned with these intents. To move toward a more dynamic and holistic portfolio management approach, decision makers should take a fresh look at all aspects of the governance process, starting with a review of the organization’s mission and purpose, as a means of defining clear, outcome-oriented goals. One reason for this is that current governance documents may restrict managers’ flexibility to shift portfolio allocations; another reason is to ensure that the authority to invest and to conduct oversight resides with the appropriate fiduciaries.

The investment policy statement (IPS) documents the roles and responsibilities associated with investing. As a non-profit organization moves toward a more dynamic asset allocation approach, its IPS will need to be updated accordingly. This means not only clarifying the roles of the various fiduciaries – including who advises, who decides and who implements decisions – but also setting specific guidelines for each role as well as specific guidelines for each individual asset class. Let’s start with the roles.

Roles of the fiduciaries

Two of the biggest challenges that need to be clearly articulated within the IPS are

1. Who is to act as the fiduciary of the portfolio (in terms of day-to-day investment management), and
2. How much discretion that fiduciary is to be allowed. (The organization’s board and investment committee will always retain a level of fiduciary responsibility.)

At Russell, we believe the outsourced chief investment officer (OCIO) is responsible for ensuring the total portfolio is managed to achieve the client’s specific risk and return objectives. We have redrafted our clients’ investment policy statements to explicitly define the extent of Russell’s role as OCIO. What we recommend is a statement that includes a written fiduciary agreement and describes:

- The level of discretion given to the OCIO.
- The OCIO’s breadth of responsibilities.
- The clear expectations for how the OCIO will work with, inform and report to the investment committee and other stakeholders.

With these guidelines in mind, your organization can revisit its IPS to assure that it remains consistent with the dynamic investment strategy and allows for its effective implementation.

Articulating allocation guidelines

Once the roles have been identified, you can then move on to the asset class guidelines. Adjustments to your IPS should help to reorient your focus away from asset class allocations and toward broader strategy roles. These changes allow for the flexibility needed in a more nimble portfolio, while still setting guidelines for implementation.

A traditional asset class approach to investment policy usually identifies a target allocation and a narrow band around the target.

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>TARGET ALLOCATION</th>
<th>APPROVED RANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Equity</td>
<td>22.0%</td>
<td>15% - 25%</td>
</tr>
<tr>
<td>International Equity</td>
<td>23.0%</td>
<td>15% - 28%</td>
</tr>
<tr>
<td>Emerging Markets Equity</td>
<td>5.0%</td>
<td>0% - 10%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>10.0%</td>
<td>5% - 15%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>11.5%</td>
<td>7% - 14%</td>
</tr>
<tr>
<td>Real Assets ex Real Estate</td>
<td>10.5%</td>
<td>7% - 14%</td>
</tr>
<tr>
<td>Marketable Alternatives</td>
<td>15.0%</td>
<td>12% - 18%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>3.0%</td>
<td>0% - 5%</td>
</tr>
</tbody>
</table>

A roles-based framework recognizes that most asset class strategies can play more than one role. Therefore, a roles-based policy embeds a higher degree of flexibility in the management of the more dynamic challenges of organizing according to roles.
### Exhibit 3: Example of a dynamic roles-based policy

<table>
<thead>
<tr>
<th>PORTFOLIO ROLE</th>
<th>POLICY</th>
<th>APPROVED RANGE</th>
<th>LIQUIDITY PROFILE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>65.5%</td>
<td>50% - 75%</td>
<td>Daily liquidity</td>
</tr>
<tr>
<td>Return enhancement</td>
<td>10.5%</td>
<td>5% - 20%</td>
<td>Daily liquidity</td>
</tr>
<tr>
<td>Risk reducing/diversifying</td>
<td>24.0%</td>
<td>15% - 30%</td>
<td>Daily liquidity</td>
</tr>
</tbody>
</table>

A variety of asset classes may reside within each portfolio role exhibited above. For example, in the growth role, you may find public equities, long/short equity hedge fund strategies and some listed real assets. In the return enhancement role, you may find less liquid growth strategies such as frontier market equities and extended sector fixed income, such as emerging market debt and private capital strategies. And in the risk reduction/diversification role, you may find private core real estate, U.S. core fixed income, global fixed income, low-volatility hedge funds, tail-risk hedging strategies and commodities.

There are four principles to keep in mind when updating your IPS to reflect a more dynamic portfolio management approach. These are:

1. Be specific about the outcome desired and recognize that short-term organizational circumstances or market conditions may dictate a deviation from the long-term objective.
2. Identify the roles of the strategies to be used (stay flexible by recognizing that strategies may play more than one role).
3. Allow for ranges across roles, as opposed to ranges restricted by asset class buckets.
4. Improve responsiveness by avoiding the wait for quarterly investment committee meetings for approvals of allocation shifts within approved ranges for roles.

### Conclusion

Many investors have embraced the belief that to be successful in meeting today’s investment objectives, portfolios must be dynamic. However, it isn’t as simple as telling the manager of your portfolio to take more active bets; there is much more involved. You must review guidelines, governance structure, the levels of discretion to be allowed and the roles of your portfolio’s various fiduciaries.

In summary, it is our belief, in order to best tilt the odds of success in your favor, it is necessary to respond to three broad issues:

1. Actively manage portfolios, given the current low-return environment. We aren’t going to hit our return targets (unless they are very low) without dynamic portfolio management. We need to invest in a broad range of asset strategies, exploit risk premia, and be flexible in shifting asset allocations.
2. Be careful in managing unintended biases at the total-portfolio level (Russell does this with state-of-the-art, multi-asset risk-management tools).
3. Have an aligned governance structure – that is, to clarify who maintains discretion, who fulfills the role(s), reorient your investment policy statement and restructure the decision-making bodies insofar as it is appropriate.

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1 Russell has several papers dedicated to risk management, most recently “Are you sure you’re managing all of your risks? A holistic risk management approach for non-profit investors” by Mike Ruff and Lisa Schneider. (March 2014).
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