

THE RISK OF DOING NOTHING



PERPETUAL IMPACT

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It's a tough balancing act, delivering the mission of a not-for-profit (NFP), raising funds, plus ensuring there's ongoing capital that flows long into the future. For NFP board members this has become increasingly difficult amid record-low interest rates.

In times past, choosing to park funds in a term deposit account was the low-risk option (in fact it was no-risk), but that has changed.

With term deposit interest rates now sitting below the general increase in prices (inflation), there's a very real risk that your capital reserves could decrease. And that's before considering any spending to actually deliver the NFP's projects.

So, if you're relying on your investments to support your NFP's long-term operations, some risk (and hence return) is likely to be required that goes beyond what's offered by term deposits.

Investing for your future

Taking on risk may sound daunting, but it's useful to remember that it operates on a spectrum. And while volatility is required to earn returns, there are steps that can be taken to reduce the fluctuations.

The task for investment managers is to establish what their 'risk required' level is. In other words, what is the amount of risk required to meet their goals?

Most often the goal is to have financial returns that enable the organisation to meet its mission objectives; like supporting a particular group in society.

If these objectives are long-lasting, or in perpetuity, then the portfolio will need capacity to grow.

Inflation PLUS

Inflation (measured by Consumer Price Index (CPI)) is the standard measure of an economy's increases in costs. In Australia the rate is hovering at around 2%, with the RBA targeting a rate of 2.5%.

But, and it's a big but, the measure of inflation that's relevant for most NFPs is not CPI. Instead, their costs are likely dominated by wages, and wage costs are rising faster than the average. A more realistic level of 'cost inflation' is around 3-5% pa.

If we compare this to 90 day term deposit rates, currently at around 2-2.5%, an NFP that keeps its financial investments in term deposits will see the purchasing power of its funds decline. Their returns will be outstripped by rising costs.

Risk should be a function of goals

At the heart of any investment decision is the trade-off between risk and return. You can't have one without the other.

As custodians and fiduciaries of financial investments, NFP Board members face decisions about allocating financial assets that must be made in the best interests of the organisation and its mission.

The peaks and troughs of financial markets are unavoidable, but they don't have to be stomach churning, you can choose to keep risk low, to smooth out the ride. For this, compound interest and diversification are your best allies.

The key takeaway here is that if shares weren't volatile over time, or it was easy to time entry and exit points, then everyone would do it and there'd be no reward. Over time shares have provided higher returns than property, fixed income and cash because they're more risky.

Earn income on your income

"Compound interest is the 8th wonder of the world", this quote is widely attributed to Albert Einstein, but whether or not he actually said it doesn't detract from its power. When paired with time and diversification, compounding can deliver consistent, long-term returns that also offer a certain peace of mind about the financial longevity of a social enterprise.

Shares typically have lower long-term yields but solid capital growth.

Term deposits tend to have high annual income yields but no capital growth, but only when observed over a long-enough time frame! The current bout of low interest rates has pushed the yield on these investments below inflation, though this is not the norm, as we have discussed.

Looking deeper, we see that compounding can account for the superior, long-term returns of shares over a term-deposit. This can be seen in the image below.





Source: Perpetual

Time is on your side

Investing for the long-term is at the heart of Perpetual Private's investment philosophy. Over decades, we've learned that the share market becomes significantly less volatile as holding periods stretch longer.

When longevity and reliability are your key aims you should focus on an investment manager's record over equally long periods. It's unavoidable that there will be years of poor returns, they may even turn negative. But over the long term (looking at greater than ten years) you'll most likely see the "miracle of compounding" in the form of steady returns that consistently beat the 'cost inflation' that would otherwise eat away at funds left in a deposit account.

What matters is having time in the market, rather than timing the market. But equally important is diversification.

Diversification

It's been called the "only free lunch in investing", diversification is the process of spreading your investments amongst varied asset classes and across geographical boundaries. In the same way that a long time frame can smooth share market volatility, diversification can spread your risk, thereby reducing the risk without reducing returns. Our experience has shown us there's a higher probability of hitting return targets with a more diversified portfolio.

In the many decades we've been helping NFPs build bespoke portfolios, we've also been consistently asked one particular question; how much of a portfolio's returns should be spent and how much should be re-invested? This is where a spending policy comes in.

A spending policy

The question of spending is a major one, and the best long-term solution is to map out a spending policy. A spending policy provides the foundation for calculating how much of an investment portfolio is distributed on an ongoing basis into the operating budget.

Essentially, it should help balance the tension between spending too much (risking running out of money in the future) and spending too little (thereby short-changing current beneficiaries).

Working hand-in-hand with your investment portfolio, it enables close alignment between the purpose of the portfolio and the mission objectives of the NFP.

There is no 'one-size-fits-all' or optimal approach to spending policies, hence each policy will be unique to the individual requirements of the NFP.

The risk lies in doing nothing

Money languishing in a term deposit account could very well be going backwards due to record-low interest rates.

To ensure your organisation has sufficient funds to maintain its mission long into the future, it pays to consider a low-risk investment portfolio that is adaptable to both your spending requirements and to market moves.

At a minimum, a board should be discussing investment issues on a regular basis. Good governance requires boards to be active in their thinking about these issues. Even with an investment committee in place, how an organisation manages its assets is the responsibility of every board member.

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