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The Yin and Yang of Risk and Return

A Commonfund Viewpoint

The conundrum of risk and return is that you can't have one without the other. The key is finding the right balance for your foundation.

Investors universally acknowledge that investing involves risk. But fewer think about risk as the fuel that powers return: No risk, no return. The yield on short-term U.S. government securities may be regarded as risk-free, but the return will not fund grant-making and operating expenses—and in real or after-inflation terms it is anything but risk-free. A Commonfund article offered a perspective that gets at the yin and yang of risk and return: "Risk is a fact of life for every institutional investor. One way to view risk is to think of it as the fuel that generates portfolio returns, and risk management as the process of harnessing that risk to fuel the pursuit of better investment returns."[1]

DATA POINTS FROM 2022 COUNCIL ON FOUNDATIONS-COMMONFUND STUDY OF FOUNDATIONS (CCSF)

Eighty-one percent of private foundations and 76 percent of community foundations participating in this year's Study have long-term return objectives. Contrast that with the proportion of foundations that report having a definition of risk in their investment policy statement (IPS): 56 percent of private foundations and 50 percent of community foundations.

Measuring the difference: Among private foundations, the return objective/risk definition gap is 25 percentage points and among community foundations it's 26 percentage points. For private foundations, in other words, 31 percent fewer have a definition of risk than have an enumerated long-term investment objective; for community foundations, that difference increases to 34 percent fewer with a risk definition than a long-term return objective.

This is a mismatch that warrants consideration given the critical relationship between risk and return.

RETHINKING RISK IN THE IPS

Those foundations and other nonprofits that include risk in their IPS tend to focus on the board's "risk tolerance." Often, that can be little more than vague language that refers to risk being held at an "acceptable" or "prudent" level without a more robust analysis of the actual risks being incurred by the portfolio's structure. One definition holds that risk tolerance can be defined as the board's willingness to accept large but temporary losses in portfolio values in pursuit of potentially higher long-term returns. This is consistent with a belief that the true test of a board's risk tolerance won't occur in normal environments, but in "tail risk" situations; a prime example is the -37.00 percent return incurred by the S&P 500 Index in 2008 and in the first two months 2009 when it declined another 18.18 percent. The unexpected behavior of most portfolios under this kind of stress was such a surprise—beyond anything that could be predicted by computer models—that it fit the description of a "black swan" event. It is in these situations that asset classes and strategies whose price movements were supposed to be uncorrelated suddenly become correlated. But it doesn't take an all-out bear market to make a dent in asset values. The failure of an investment strategy (or strategies) to deliver the expected return or the return experienced in the past can reverberate throughout the portfolio. For example, a hedge fund strategy is anticipated to produce a certain level of return. If investors flock to the strategy, however, it becomes a crowded trade and the expected return is arbitraged away through no fault of the manager or the institution making the investment.

As the data in the 2022 CCSF show, risk is defined in about half of foundations' investment policy statements. When it is it often takes the form of expressions related to volatility or standard deviation. These are fine, but volatility of returns is one measure of a certain type of risk while risk taken as a whole is much more than just volatility. (To view data about the risk metrics used by foundations participating in the CCSF request your full copy of there report here.)

Focusing on the volatility of assets is inadequate for two main reasons. First, volatility is a price concept that focuses on market risk, ignoring the many other types of risks organizations face.[2] While many investors are quick to think of market risk as the most likely cause of such a failure, many other sources of risk—refer to the footnote below—also have the potential to diminish an organization's returns.

Second, the asset focus ignores the obligations or liabilities that mission-based organizations have taken on and are trying to meet to further their mission. For a nonprofit mission-driven organization, risk may be best defined in a more strategic sense as the possibility of a failure to meet the organization's implicit or explicit commitments to its beneficiaries arising from its inability to deliver sufficient cash flow to meet near-term liabilities while earning a long-term return in excess of inflation. This ends up manifesting as an inability to honor grant commitments, adequately support financial aid packages, and a multitude of other mission-related objectives.

1 David Belmont, CFA, "Risk: The Fuel that Generates Portfolio Return," Commonfund Insight, 2014.

2 This Viewpoint is confined to investment risk and return. There are other types of risks to which foundations are exposed. These include legal, operational, credit, counterparty, environmental, reputational and byproduct (the latter including accounting, settlement and transparency risks).

FOCUS ON THE LONG TERM

Portfolios that support-mission based organizations have a different standard for evaluating risk than other types of investment pools. Among the critical differences are:

- The asset pools of mission-based organizations are long term or, more often, perpetual, i.e., longer than that of any other type of portfolio.
- Ultimately, success will be judged by the effectiveness of the investments in producing a steady and growing stream of distributions that at least keeps pace with inflation.
- Inflation measures for nonprofit organizations are generally higher because of the comparatively labor-intensive nature of nonprofits' work.
- The reputational impact of a serious investment misstep could have a substantial impact on the financial well-being of the institution, and ultimately the organization's ability to fulfill its mission.
- To achieve long-term return objectives, not taking enough risk or, more precisely, appropriate levels of risk, is the biggest risk of all.

Even perpetual investors too often think of returns on a monthly or annual basis, while they should be thinking in terms of five- and 10-year returns. This is a fundamentally different risk management challenge in that traditional tools for risk management—such as the short-term, volatility-based measures like value at risk—start to lose their usefulness when managing longer-term risks. Fundamental economic trends, maximum drawdowns, upside and downside participation rates, capturing liquidity premia and market inefficiencies, and the effectiveness of diversification strategies in tail risk events are much more important to long-term returns.

A strategic approach, segmented by time frame, allows a foundation to differentiate between long-term risk/return strategies, intermediate-term perspectives and short-term tactics and activities.

- **Seven to 10 years:** This is the widest, longest vision—a macro look at how the endowment seeks to add value to the portfolio over time. It expresses a foundation's fundamental investment philosophy and is most closely linked to its mission statement. In this time frame, the board or IC may want to monitor demographic trends, paradigm shifts in technology and/or global economic growth forecasts. These may be assessed in terms of risks and opportunities in thematic investing, factor investing, interest rates and currencies.
- **Three to five years:** In this time frame, risk analysis should examine how dependent the organization's operations are on the long-term asset pool. This is the risk that relates to the predictability of the endowment's distributions as they impact institutional mission. A directly related issue is the degree of liquidity required to fulfill grant-making commitments and operating costs.
- **One to three years:** Scenario analysis (described in the accompanying sidebar) is a useful tool in this time period. Factor analysis can also be useful because correlations change through time. The focus is on how much portfolio return is correlated to the return of various factors. Long term, economic factors—like inflation, interest rates and growth—prevail; shorter term, more tactical asset allocation decisions are based on equity and fixed income factors.
- **Under one year:** With a long-term, strategic framework as background, short-term activities include ensuring that risks in the current portfolio do not stray significantly from the policy portfolio; monitoring investment managers to confirm that they are adhering to their mandate; evaluating normal and stressed portfolio liquidity; and employing metrics such as standard deviation and value at risk (VaR).

Three broad components to consider and have outlined in your IPS:

- **Mission risk** is defined as a challenge to an "organization's ability to operate and execute on its objective," representing a real-world challenge to the endowment fulfilling its purpose.

- **Market risk** is representative of "idiosyncratic risks on the endowment portfolio," typically originating from the unique asset allocation of a particular institution's endowment.

- **Liquidity risk i**nvolves potential logistical difficulties that may arise before an endowment can take proceeds from gains in the value of its illiquid assets.

THE CASE FOR A RISK-BASED POLICY

While risk and return together form the basic structure around which portfolios are built, return is almost always addressed first and is the primary driver of the portfolio decisions that follow. There is a case to be made, however, for reversing the order and starting with risk. Foundation decision-makers should be aware of the rationale for this approach as it holds implications for balancing risk and return in general.

By starting with risk, fiduciaries can review the potential downside associated with any number of asset allocation or factor allocation models and adjust as needed to achieve an acceptable balance of risk and return. As a majority of institutions outsource investment management or retain the services of an investment consultant, the expertise and resources required for such an investigation should not be an issue.

There is another reason for elevating the position of risk in the portfolio construction process and that is the well-documented behavior of decision-makers in times of crisis. Much has been written in recent years about behavioral investing and reactions—often hastily-conceived and poorly timed— that periods of stress can trigger among IC members. For institutions with endowed perpetual funds, one of the gravest risks is that, in periods of economic turmoil, crucial investment decisions may be made in haste, under pressure and without adequate consideration of the long-term consequences.

An exercise that institutions have found useful in their risk assessment is to conduct hypothetical, "what if" thinking in which a damaging event is presumed to have occurred and then working backward to ascertain how the event could have happened. For example, a board or investment committee may hypothesize that a negative event happens five years into the future. Working backward, the idea is to ascertain what could have caused the event and what can be done to prevent/avoid its occurrence or limit its impact on the institution.

One way to make such outcomes less abstract is to discuss them in terms of how the institution would respond and the options it could employ. Would staff be reduced? Salaries frozen? Would funding or grants be cut? How would this impact valued long-term relationships? How much would the institution's reputation suffer? From this ranking of risks in terms of their probability and their impact, a more meaningful understanding of risk can result.

At the implementation level, a risk-based investment policy seeks to understand, explain and measure portfolio risk and return from a governance viewpoint. Once these risks are identified, an institution can quantify the primary risks being taken through the portfolio and their potential impact on the institution. It is thus a living process that, once established, serves as a governance framework for the institution's relationship with its endowment.

CONCLUSION: STRIKING THE BALANCE

This CCSF and its immediate predecessor serve as a case history when it comes to risk and return: In the Study for 2021, the average one-year return for private foundations was 16.3 percent and the 10-year trailing return was 9.7 percent. Similar figures for this 2022 Study: -12.0 percent and 7.3 percent. For community foundations, one-year returns declined from 14.8 percent to -13.3 percent while 10-year returns fell to 6.4 percent from 9.2 percent. To quote the title of a recent Commonfund paper, it's all a matter of "Striking the Balance."

Investment policy statements have evolved over time and today are capable of articulating a more rigorous risk-based investment process. Historically, the IPS has treated risk as a byproduct of investing rather than an essential precondition to earning investment returns. Now, powerful financial models enable fiduciaries to estimate the probability and range of possible losses associated with various investment strategies over time. Thus, it becomes difficult to argue that risk should be treated as an output rather than a primary input.

Very few nonprofit institutions have the staff, financial and technological resources to perform comprehensive, rigorous risk analysis in house. The widespread use of OCIO advisors and consultants provides institutions with a resource that most do not possess internally, further easing the path to implementing more rigorous risk management disciplines. In such instances, responsibility for investment policy, including risk, remains with the board and investment committee, but utilizing the greater resources of an external partner should allow for more consistent and robust policy formulation and monitoring.

In the final analysis, return is about funding the institution's mission and vision through time. Risk entails outcomes that could impair that ability over a significant period. Not only does risk impact return and, hence, mission there is also a link to key policy decisions such as asset allocation and spending (and, for community foundations, gifts and donations).

Yin and yang are opposite but interconnected forces—the parallel of risk and return.

ADDITIONAL READING

A range of papers, blogs and articles are available on Commonfund's website (www.commonfund.org). Navigation on the home page will guide the user to the "Research Center," which offers these materials organized under nine different categories. Two that include research most relevant to this Viewpoint are "Investment Strategies" and "Risk Management." Specific papers, articles and blogs used as reference in this Viewpoint are listed below along with a link to each.

Assessing Your Board's Risk Tolerance, John Griswold and William Jarvis, Commonfund Institute, 2014.

Benchmarks for Boards, George Suttles and Allison Kaspriske, Commonfund Institute, 2022.

Redefining the Risk Waterfall, David Belmont, CFA, Commonfund Insight article, 2015.

Risk: The Fuel that Generates Portfolio Returns, David Belmont, CFA, Commonfund Insight article, 2014.

Striking the Balance: A Fiduciary Approach to Risk and Investment Policy, Commonfund Institute, 2016.

The Investment Policy Statement: Guiding and Guarding Nonprofit Institutions, George Suttles and Allison Kaspriske, Commonfund Institute, 2022.

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