



Are you sure you're managing all of your risks?



A holistic risk management approach for non-profit investors

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When you hear the phrase “risk management,” what comes to mind? In the financial world, most people immediately think of the risk residing within a specific investment portfolio. However, Russell Investments believes in taking a more holistic perspective, which extends beyond investment portfolio risks to include staying apprised of governance and its impact on the total enterprise.

Of course, building a portfolio designed to weather market turmoil remains vitally important, but investment risk is not the only risk that has an impact on your ability to meet your organizational goals. We encourage non-profit organizations to adopt a holistic approach that includes building the appropriate governance system, developing a common set of beliefs, and incorporating appropriate tools for the measurement and management of risk.

What do we mean by risk?

“Risk” means different things to different people. However, most will agree that risk and return are often companions. According to an old adage, and in the broadest sense, investors generally have two options – “eat well or sleep well.” Investors who choose “eat well” accept certain risks in exchange for potentially higher rewards and more downward pressure during market declines. Investors who choose “sleep well” opt for less risk in exchange for less potential upside in strong markets and less downward pressure in weak markets. Of course, the two options are seldom as clearly demarcated as the old adage suggests, and in our experience, few investment committees know their true risk tolerance until it is tested by market experience.

To manage a non-profit organization’s portfolio well, there are myriad risks to oversee, such as credit risk, portfolio diversification, liquidity risk, and legal risks, as well as the operational and other risks inherent to a specific organization’s circumstances or expectations. For example, higher education endowments are often particularly mindful of the impact of inflation, the amount of draw or spend required to maintain enterprise operations, and the overall liquidity of their portfolios.

In today’s low-return environment, non-profit organizations face another reality: relatively high fixed financial responsibilities. This further complicates the seemingly simple choice between eating well and sleeping well.

Given the unavoidable trade-off between risk and reward, it is critical that all stakeholders engaged in portfolio management and oversight fully understand their roles.

Framing a strong governance structure

Given the unavoidable trade-off between risk and reward, it is critical that all stakeholders engaged in portfolio management and oversight fully understand their roles – particularly in terms of providing advice versus “owning” specific decisions.

Russell Investments believes there are five key components of a strong risk management program (or process):

1. Risk governance
2. Risk measurement
3. Risk assessment
4. Risk management
5. Risk compliance

Risk governance includes both the structure and the culture within an organization. How risk is **measured**, **assessed**, and **managed** flows from the established governance process. And finally, no risk system is complete without **compliance** checks, which tie all of elements of the risk management process together.

Exhibit 1: Risk management process – Five key parts

Sources of risks: Fiduciary, Asset/Liability, Market, Credit, Liquidity, Structural, Enterprise, Operational

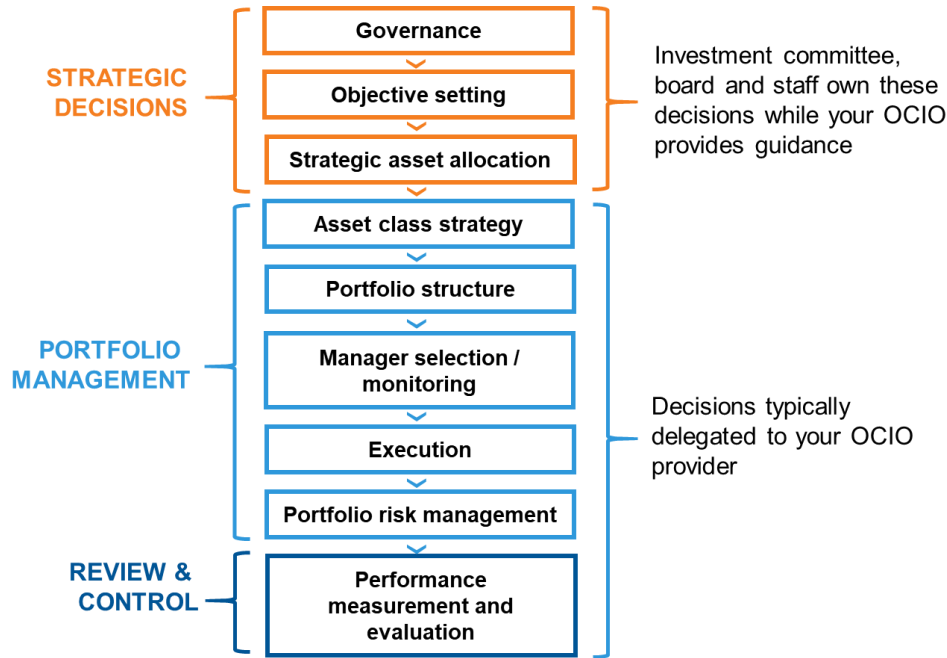


A robust risk management program (or process) can lead to healthier outcomes for the entire organization. This does not mean that your organization is guaranteed to be conflict free, or that it will always meet investment outcomes over every time period. But careful documentation, appropriate resource allocation, timely decision making, and organization-wide agreement on core beliefs nearly always results in a more effective decision-making process.

Unambiguous accountability is the underpinning of Russell Investments’ holistic approach to managing investment portfolio risks.

The “fiduciary ladder,” which we have used for many years to help our clients understand and appreciate the critical components of the portfolio management and oversight processes, identifies the primary decisions involved in the process. Risk management is implicitly included in each step of the ladder, as well as being a distinct rung in the process.

Exhibit 2: Fiduciary oversight process



Understanding, agreeing on, and documenting a common belief system helps smooth governance processes and can ease tensions during challenging times.

For each rung, one person or a single entity should have final decision-making authority.

Over the past 5 – 10 years, the trend has been toward outsourcing more decisions to external providers or investment professionals. Why? Investment committees and boards increasingly understand the importance of focusing on what they do best and delegating the rest to qualified investment professionals. Some questions you and your team need to ask are:

- Who owns specific decisions?
- Which decisions can be delegated to external partners?
- What kinds of risks are we comfortable with, and willing to take?

Identifying, documenting and measuring client beliefs

Understanding, agreeing on, and documenting a common belief system helps smooth governance processes and can ease tensions during challenging times. For example, during the first quarter of 2020, our clients who had already discussed their belief systems and established procedures for action were able to avert organizational paralysis and thus, in some cases, capitalized on investment opportunities and portfolio innovation.


Documenting beliefs also helps protect institutional memory. Ten, 15, or 20 years from now, an investment committee that is completely “new,” and that perhaps hasn’t experienced an event as significant as the 2008 global financial crisis or the COVID-19 downturn during the first quarter of 2020, could benefit from your documentation. This could help them respond in accordance with prudent stewardship if another financial crisis unfolds.

At Russell Investments, we often begin the belief-identification process by providing our assessment of a client’s beliefs, which we base on documentation such as the Investment Policy Statement and policy portfolio allocation, and then by asking investment committee members if they agree with or are shocked by our evaluation. Then, through further dialogue with the client, we test these beliefs and adjust the organization’s documentation (and, at times, its portfolio) accordingly.

Establishing a strong beliefs framework is not a precise science, but it is a critical compass in turbulent seas. While frameworks will differ, due to individual goals and objectives, there are some common themes, such as those concerning the organization's:

- Tolerance for loss
- Financial strength
- Active versus passive management beliefs
- Investment strategy roles in the portfolio
- Rebalancing policy
- Capital markets beliefs

As we at Russell Investments build portfolios for our clients, we work with them to ensure that they are comfortable with our approach and that they understand the strategies we are using.



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Total portfolio investment risk management

Building a risk management process for your investment portfolio requires walking that fine line between managing your organization's portfolio to safeguard its mission in perpetuity and managing it against annual spending needs. There are near-infinite ways to build an investment portfolio, due to the complexities of selecting the asset classes, strategies, managers, and implementation vehicles best suited to your goals. For our firm, determining the most appropriate combination for a particular organization requires working closely with the key decision makers / fiduciaries for the portfolio.

The critical first step in portfolio management is for the organization to identify its objectives, constraints, and risk tolerance and then for the decision makers to come to agreement on the definition of success. For example, most endowments base their return targets on the annual draw / spend plus inflation figure, which has a significant impact on an educational institution's operations. Determining this figure requires aligning the interests and opinions of the various decision makers. Failure to reach consensus can put a portfolio at risk.

Once objectives and constraints have been aligned, determining risk tolerance is crucial. While this is not an exact science, asking thoughtful questions about acceptable loss levels, cash inflow prospects, and present and future demands on assets can help clarify realistic risk-tolerance levels. After answering these types of questions, agreement as to the time horizon over which the portfolio's success will be measured provides a strong framework for portfolio construction.

Translating client risk preferences into portfolio management

The process of managing a portfolio, like many other activities, is an ongoing, iterative process. To achieve desired outcomes, portfolio managers need be able to address a number of critical issues, by asking such questions as:

- Am I operating in line with my investment objectives?
- Have I chosen the right investment strategies, and are their weights aligned with my convictions?
- Is now the appropriate time to use these strategies?
- Do I have the right investment managers?
- Is there enough diversity within the portfolio?

- Are the aggregate portfolio positioning and risk exposures aligned with my preferred positioning? Are there distinct alpha sources and diverse vulnerabilities?
- What are the liquidity needs of this portfolio?

Additionally, limits and thresholds need to be set. If a particular strategy performs well relative to the rest of the portfolio, it may exceed its targeted limit and thus need appropriate adjustments. When you set guidelines, look at the “tails” of those guidelines and agree on whether you are comfortable with the portfolio if it hits those extremes. Layered on top of this is an assessment of the current and future market environment, such as assessing whether we are entering a low-volatility or high-volatility regime; where interest rates are now, and where we expect them to go; inflation and its direction; and whether markets are in times of stress or times of “easy money.”

Finally, rather than allowing the portfolio’s liquidity profile to come about implicitly from asset allocation, consider more explicit liquidity management. This approach could increase liquidity efficiency, foster a holistic liquidity view, and lead to an allocation across the liquidity spectrum that best aligns with the goals for portfolio outcome. Understanding and managing liquidity can be critical, particularly in times of market stress.

The roles that investments play in a portfolio have evolved from the simplistic framework of growth assets (equities) and diversifying assets (purely fixed income) to today’s breadth of strategies and more varied roles. For non-profit and total-return investors, we have identified three primary roles that make up a portfolio and the investment strategies that are deployed in each. The roles include **growth**, **return enhancement**, and **risk reduction / diversification**. It is important to remember that individual strategies may fulfill more than one role.

Reporting

Finally, while our firm emphasizes the need for robust, ongoing monitoring, we also recommend that, at the fiduciary level, reporting be kept relatively simple and high level. Each recipient should be given relatively short summaries of just a few pages. For example, a report that Russell Investments provides for fiduciaries typically incorporates a snapshot of a portfolio’s key metrics (past, present, future), including those identified in the Investment Policy Statement and others that have been agreed upon by key investment fiduciaries as being measures of success. This helps all of those involved to stay focused on their individual roles and to be appropriately informed without being overwhelmed.


Summary

The markets have grown in complexity, as have the tasks associated with building an investment portfolio appropriate to your organization’s goals, and of conducting a risk management process for that portfolio. Your ongoing success depends upon your ability to understand the risks and benefits in evolving market opportunities, and on being able to manage the portfolio dynamically while avoiding undue risks.

Russell Investments believes that a non-profit organization increases its chances of meeting its goals when it is in possession of a strong risk management framework. A clear-eyed look at risk often results in better decision making in the matters of portfolio management and oversight.

While managing investment portfolio risk is highly complex, the steps involved in creating a workable environment for success can be summarized as follows:

1. Develop a risk governance structure
2. Establish, affirm, and document your organization’s beliefs
3. Determine your goals and risk tolerance
4. View risks through multiple lenses
5. Measure and manage those risks



Your ongoing success depends upon your ability to understand the risks and benefits in evolving market opportunities, and on being able to manage the portfolio dynamically while avoiding undue risks.

About Russell Investments

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For more information

Call Russell Investments at **866-737-2228** or
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