Drivers of investment management success

For non-profit organizations

Russell Investments Research / Viewpoint

Much has been written about the uncertain market environment and the challenges that non-profit fiduciaries face as they seek to reach their investment return targets. For many non-profit organizations, the investment program has provided a lever to fulfill their spending commitments, grow their asset bases, and support the needs of their communities. With interest rates at historic lows and the ability to meet long-term goals pared down by financial market volatility, many non-profit fiduciaries are now reconsidering their approaches to their investment programs. Russell Investments believes that the following practices are critical to the success of a non-profit organization's investment portfolio:

- Being clear on the investment outcomes you wish to achieve;
- Managing your investment portfolio holistically and dynamically, using a "roles-based" framework (e.g. considering the roles each investment strategy is designed to play in the portfolio);
- Managing risk at the total-portfolio level; and
- Aligning your governance process, structure, and documents around your desired outcomes. This includes identifying and delegating specific responsibilities to fiduciaries such as the board, investment committee, and outsourced chief investment officer (OCIO).

Building an outcome-oriented investment portfolio

Basing an organization's investment strategy on the organization's goals may seem obvious. But as market environments change and portfolio structures evolve, an organization also 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, such 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 Investments 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 investment 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

We believe 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 Investments 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 others into risk reduction/diversification, based on the characteristics of the strategy (e.g., listed versus core private real estate, "aggressive" versus "conservative").

Identifying which strategies are the best fit for 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 category of return enhancement, some are equity focused, and others are focused solely on debt 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 meet your objectives in today's uncertain markets, we believe that you need to take a dynamic approach to managing your investment program. In today's low-return environment, every basis point counts. Investors must incorporate investment strategies that may offer incremental return opportunities, are designed to avoid risks for which they don't expect to get paid, and better ensure that their portfolios are implemented efficiently.

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 medium-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 that dynamic management is beneficial. Due to the increased correlations of "traditional" long-equity and fixed income markets across regions, it is also important to consider the impact of macroeconomic policy and global geopolitics on market movements, and to build greater diversification into non-traditional, more illiquid investment strategies.

Exhibit 1: Roles-based framework: Investment strategies fulfill roles in a portfolio

GROWTH	RETURN ENHANCEMENT	RISK REDUCING / DIVERSIFYING

• Global listed equity
• Extended fixed income sectors
• Directional hedge
• Listed real assets: listed infrastructure and REITs
	• Private markets:
	  • Private equity
	  • Private credit
	  • Private real estate
		• Core fixed income
		• Absolute return
		• Volatility management
		• Core private real estate
		• Commodities

Equity-oriented assets that are designed to provide a core growth engine for portfolio	*Typically higher-return and generally higher-risk assets*	*Diversifying strategies to complement growth and return enhancement strategies*

Strategies may fulfill multiple roles in a portfolio

This evolution, of increased market correlations and effects of macroeconomic 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 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 to measure and manage risks and unintended biases 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 that investment managers have designed far better tools for monitoring and assessing ongoing investment risks. The 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 Investments 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 the environments in which the losses across the portfolio are expected to be correlated. 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.

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Alignment of governance structure, process, and documents around desired outcomes

A non-profit's fiduciaries may all agree on the desired portfolio outcomes. They may also agree that dynamic portfolio management, strong risk management, and clarity on the roles that strategies play in the portfolio are critical to achieving those objectives. However, this consensus could all be for naught if the non-profit's governance process, structure, and documents are not aligned with these intents. To move towards 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 towards 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 and 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 Investments, we believe the OCIO is responsible for ensuring the total portfolio is managed to pursue the client's specific risk and return objectives. We have redrafted our clients' investment policy statements to explicitly define the extent of Russell Investments' 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; and
- 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 ensure 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 towards 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.

Exhibit 2: Example of a traditional asset class policy

ASSET CLASS	TARGET ALLOCATION	APPROVED RANGE
Global Equity	30.0%	25% - 35%
Marketable Real Assets	6.0%	3%-9%
Return-seeking Fixed Income	4.0%	2%-6%
Private Capital	20.0%	0% - 25%
Marketable Alternatives	10.0%	7% - 13%
Core Private Real Estate	5.0%	2% - 8%
Risk-reducing Fixed Income	25.0%	20% - 30%

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 into the management of more dynamic challenges.

Exhibit 3: Example of a dynamic roles-based policy

PORTFOLIO ROLE	POLICY	APPROVED RANGE	LIQUIDITY PROFILE
Growth	40.0%	30% -50%	Daily liquidity to moderately liquid
Return enhancement	20.0%	0% - 25%	Moderately liquid to illiquid
Risk reducing/ diversifying	40.0%	29% - 51%	Daily liquidity to moderately liquid

A variety of asset classes may reside within each portfolio role displayed in Exhibit 3. For example, in the growth role, you may find public equities, long/short equity hedge fund strategies, high yield debt and some listed real assets. In the return enhancement role, you may find less liquid growth strategies such as private capital. 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.

Four principles for updating your IPS

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

1. SPECIFIC ABOUT DESIRED OUTCOME

Being specific about the desired outcome you are trying to achieve and recognizing that short-term organizational circumstances or market conditions may dictate a tactical deviation from the long-term strategic objective.

2. IDENTIFY THE STRATEGY ROLES

Identifying the roles of the strategies to be used—and staying flexible by recognizing that strategies may play more than one role.

3. ALLOW RANGES ACROSS ROLES

Allowing for ranges across roles, as opposed to ranges restricted by asset class buckets.

4. APPROVED RANGES FOR ROLES

Improving 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 in order to meet today's investment objectives successfully, 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 that in order to best tilt the odds of success in your favor, it is necessary to:

1. Dynamically manage portfolios. You are not going to hit your return targets (unless they are very low) without dynamic portfolio management. You need to invest in a broad range of asset strategies, exploit risk premia, and be flexible and nimble in shifting asset allocations.
2. Be careful in managing unintended biases at the total-portfolio level.
3. Have an aligned governance structure—that is, to clarify who maintains discretion and who fulfills which role(s), to reorient your IPS, and to restructure the decision-making bodies as appropriate.

About Russell Investments

Russell Investments is a global asset manager with a unique set of capabilities that we believe is essential to managing your total portfolio and to meeting your desired outcome. At Russell Investments, we stand with you, whether you're an institutional investor, a financial adviser, or an individual guided by an advisor's personalized advice. We believe the best way to reach your desired outcomes is with a multi-asset approach that combines: asset allocation, capital markets insights, factor exposures, manager research and portfolio implementation.

For more information

Call Russell Investments at **866-739-7979** or visit **russellinvestments.com/nonprofit**

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