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Seeing clearly: Governance thoughts for 2020

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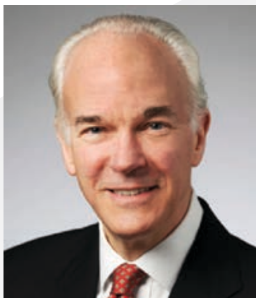

As we begin a new decade, it is appropriate to review where your nonprofit organization and its investment portfolio are — and where they may be headed in the coming 12 months.

A year ago, the sharp equity market downdraft of December 2018 led many observers to conclude incorrectly that the long recovery that started in March 2009 had run its course, and that the U.S. economy was headed for a recession. As it turned out, the market recovered quickly, and it appears that 2019, for many investors, was one of the most successful years since the global financial crisis. Those commentators who had seen the correction as the first step into a bear market were proved wrong, and The Chief Investment Office within Bank of America believes that the current environment is conducive to continued market growth in 2020.[1]

On the fundraising front as well, even after accounting for the late 2018 downturn, giving to nonprofits continued to be relatively strong. The national Giving USA survey of U.S. philanthropy concluded that, during 2018, Americans gave $427.71 billion to charity, representing a 0.7% increase in current dollars and a 1.7% decrease in inflation-adjusted dollars from 2018. But even after this decrease in real giving, total donations in 2018 were the second highest ever, lower only than those in 2017.[2]

For board and investment committee members of endowed nonprofit organizations, these reports of a favorable investment environment and continued charitable giving are very welcome. Yet viewed from this market and philanthropic peak, 2019's December euphoria may be as dangerous as 2018's December panic. In this paper, we propose three actions that nonprofit fiduciaries can take to enter the year with both hope and confidence.

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Action 1: Know where you stand

Market downturns usually offer little advance notice of their coming. While the causes of any given recession are analyzed in exhaustive detail after the fact, it is axiomatic that the event itself, when it arrives, comes to some degree as a surprise: If this were not the case, investors would all have been able to take advance precautions to minimize losses.

Fortunately, for most institutional investors, it is possible to obtain an approximate view of the effect on their portfolios of positive and negative historical, or even hypothetical, market events. Today's quantitative models enable investment advisors and consultants to "stress test" portfolios, and to show board and investment committee members what the results of a given event or combination of events might be.

Quite apart from modeling the global financial crisis — from which no diversified portfolio was completely immune — this type of stress testing can be very useful as a guide to where risk lies in a portfolio. Examples of stress tests might be:

- A sustained increase in global interest rates
- An unexpected surge in inflation
- A reduction in U.S. exports
- An increase in unemployment

The models on which these tests are based typically show the future in terms of probability, not certainty. They are nevertheless valuable guides to where risk lies and can help in assessing what steps to take in response to that knowledge.

There are three main ways in which nonprofit fiduciaries can make use of this information:

- First, knowing the possible negative effects of market events on an institution's portfolio can significantly narrow the range of unfavorable consequences that were not foreseen. This in itself can be empowering. The investment process is based on the concept of risk and return. Knowing the risks to which an institution's portfolio is exposed can lead to a frank acknowledgment of the acceptance of those risks in pursuit of a given level of return. If those risks are deemed unacceptably high, then a review of the returns that may be expected from a less risky portfolio may be appropriate.
- Second, having an estimate of the consequences of certain negative events can assist in conversations with donors, who are not infrequently familiar with investment concepts and seek reassurance that their gift will be managed appropriately. Even business people who may not be professional investors are familiar with the idea of measuring risk and assessing its consequences. Taking the donor conversation to this level creates a platform for a more honest dialogue about what the donor's money is for, how risk is to be defined, and how success or failure will be measured.
- Third, and perhaps most important, knowledge of the risks inherent in the portfolio can be very helpful in conversations with other stakeholders and the public should one of the events occur for which stress tests have been performed. When portfolios decline in value, it is not infrequently the case that those in charge claim ignorance or surprise. We would propose that a better result would be to say that the possibility of the negative event had been considered and assessed through stress testing, and that the acceptance of that risk was deemed appropriate and prudent given the potential for portfolio return and the long-term soundness of the portfolio's investment strategy in light of the institution's mission.

Action 2: Know why you stand there

It is all too often the case that nonprofit portfolios are constructed with a view to those of other peer organizations or commonly-used market benchmarks rather than with a view to the actual characteristics and needs of the specific nonprofit in question.

In an investment world that offers a very wide range of choices, from completely safe and liquid to highly speculative and illiquid, it becomes imperative for the governors of an institution to be able to explain to donors, stakeholders, regulators, staff and the public why a particular set of investment strategies was viewed as optimal. The demand of these constituencies for transparency is a norm of today's investment scene, and it is accordingly very important that fiduciaries be able to answer not only **what** investments are held in the portfolio but **why** they are there.

This process does not require that the fiduciaries become investment experts. It does, however, require that they use diligence and common sense to understand why the portfolio is constructed as it is and to avoid situations in which they appear ignorant about the purpose and effect of the investment choices that have been made.

To this end, assuming that a board or investment committee meets quarterly, a good practice is to devote at least some of each meeting to an assessment of the role played by a given allocation in the portfolio, and to the intended benefit to the portfolio of each asset class or strategy. Over time, fiduciaries should as a result be able to internalize these lessons so that it becomes less and less likely that they will have to answer "I don't know" to a question about the portfolio and its structure. Fiduciaries who pursue this course will also find their own confidence about the investment side of the institution growing as they understand more clearly how the various parts of the portfolio are intended to work together.

Action 3: Know where you're going

It is no secret that the times we live in are characterized by the actions of complex and interconnected forces whose outcome is difficult to discern. The difficulty of the task, though, is not an excuse for inaction. Here, again, the task of fiduciaries is to use the skills at their disposal — and those of their investment advisors — to arrive at a principled view of the shape of the political, economic and social factors that are determining what is possible for them as investors for their institution.[3]

This view should go beyond the usual market reports that focus on what may happen over the next three to six months. Augmenting that relatively short-term perspective, knowledge of the investment regime that is likely to prevail over the next 18 to 24 months (or, if appropriate, even longer)[4] can act as a powerful clarifier of discussions in meetings, helping board and investment committee members to focus on issues and forces that are material rather than those that are transient or simply topical. It can also reinforce the other two actions that we have referred to, giving them a strategic character that can lead to stronger governance for the investment function as a whole through a more conscious assimilation and use of the knowledge that becomes available.

> Now is the moment to take stock: to know where you as a fiduciary stand, why you stand there and where you are going.

Conclusion

It is a commonplace saying that bad times can provoke bad decisions. Yet the temptation to make poor decisions can be even greater when times are good and expected to remain so. Behavioral research tells us that humans want to take more risk at times when the possibly negative consequences of that risk seem relatively low, and that it is not unusual to overweight recent experience — good or bad — in forming a view of what the future will hold.[5] Being able to identify and act against those innate instincts is a first step toward the more measured behavior of a prudent fiduciary.

In 2020, coming as it does on the heels of a successful 2019 and with a full decade now having passed since the global financial crisis, it will be tempting to discount risk and let the good times roll. But now is the moment to take stock: to know where you as a fiduciary stand, why you stand there and where you are going. In the coming year, those who see themselves and their actions clearly will be in a better position to navigate with confidence the uncertain landscape that lies ahead.

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[1] *2020 Year Ahead: A World in Transition*, Bank of America Chief Investment Office Investment Strategy Overview, December 2019.

[2] *Giving USA 2018 Report Highlights*, Giving USA, 2018.

[3] For a more detailed review of this topic, see Jarvis, *Financial Regimes and Nonprofit Governance*, Bank of America white paper, April 2019.

[4] Jarvis, *What to Expect: The Endowment Model in Our Time*, Bank of America white paper, 2019.

[5] For the classic formulation of behavioral science, see Daniel Kahneman, *Thinking, Fast and Slow*, New York: Farrar, Straus and Giroux, 2011.

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