Understanding investing: the relationship between risk and return

A guide for charities

Rathbones
Look forward

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Contents

A brief overview of the different types of risk associated with investing and how to measure and manage investment risk to help achieve a charity's financial objectives.

Trustees are responsible for ensuring that a charity's financial objectives are met. These objectives include meeting current and future income requirements and effectively managing future capital withdrawals.

Although investing can help meet these objectives, it comes with a certain amount of risk. This risk can be defined as the likelihood of failing to meet a charity's financial objectives.

Understanding investment risk

While risk is often regarded as having negative connotations, it is inherent to investing: investment returns are inextricably linked to risk. Charity investors seeking higher returns generally need to take more risk. In other words, the higher the risk, the higher the potential returns, but with that comes a higher potential for loss.

While risk can't be avoided, it can be recognised and managed in such a way as to help achieve a charity's financial objectives. As outlined in the Charity Commission's Guide for Trustees (CC14):

'Risk is part of the investment process and there are a number of risks that trustees should take into account. Before making any investment decisions, trustees should consider what is the appropriate level of risk that they want to, or are able to accept. As part of their duty of care, the trustees must be satisfied that the overall level of risk they are taking is right for their charity and its beneficiaries.'

Opportunity risk

Of course, managing risk can be a difficult balancing act and protecting a charity's finances is a huge responsibility. This can sometimes mean that trustees are reluctant to take any risk and, for example, to believe they should keep all of the charity's assets in cash, for fear of doing something that may harm the charity's future prospects.

However, it is important to appreciate that this, in itself, carries its own ‘opportunity risk’: being overly cautious with a charity’s assets can potentially decrease the real value of those assets over the longer term.

In other words, doing ‘nothing’ and keeping a charity’s assets in cash will mean that their value is eroded by inflation, thereby still negatively affecting the charity’s financial position.

Quantifying and measuring risk

Each charity will have its own risk profile which determines the amount of risk it is willing to take – and thereby determines the potential for return. This depends on various factors, including how secure its reserves are, how much visibility it has on its funding, the charity's capacity for loss, the trustees' attitude to risk and the length of time over which it is able to invest.

Quantifying investment risk is complex but, put simply, it can be defined as 'the possibility of the permanent loss of capital'. However, it is also important to consider volatility – the higher the volatility, the more dramatic the potential change in value of the investments over a short period of time, which reduces the certainty of the potential returns.

Both the risk of permanent loss of capital and the degree of certainty of potential returns are crucial considerations for a charity when planning its investment strategy.

Permanent loss of capital is measured using what is known as maximum drawdown. This refers to the maximum fall in the value of an asset over a set period, from peak to trough. In other words, if a charity invested at the very top of the market and sold at the very bottom of the market, the maximum drawdown is the amount it would have lost.

Volatility is measured using the standard deviation, or fluctuations, of investments around their average value. While volatility doesn't entirely define investment risk, higher volatility increases the chances of making a loss, particularly in the short term. For example, a charity may have a higher-risk portfolio that shows significant fluctuations in value over time compared to a lower-risk portfolio. The higher-risk portfolio offers the potential for greater reward in the longer term; however, the charity would need to be able to withstand potential losses in the investments over that period.

Of course, it's also important to consider recovery of losses. Evidence suggests that long-term investors are better able to weather higher volatility. As such, when measuring a charity's appetite for risk and capacity for loss, it's crucial to think about the charity's specific needs and objectives, and to plan appropriately. As part of this, it's also necessary to consider the charity's income needs in terms of loss and volatility.

Managing risk

The risks associated with a charity's investment portfolio can be managed through good financial planning and management. This requires the consideration of several elements, including:

- diversification
- active management
- communication.

Diversification
It is important for charities to invest in a diversified combination of uncorrelated assets (assets can behave differently under the same economic or market conditions) which aims to reduce the risk to the portfolio without reducing the potential return.

A diversified investment strategy, also known as a balanced or multi-asset portfolio, can provide exposure to a range of investment opportunities, thereby helping to reduce losses when market conditions are challenging.

Active management
An active management strategy is often used by a charity's investment manager to track the performance of the portfolio in line with the charity's objectives, making decisions on short-term movements between investments as economic and market conditions change.

Two key elements of a successful active management strategy are:

- Asset allocation
  which involves allocating percentage weightings to different asset classes with the aim of balancing risk and reward in line with the charity's risk appetite and capacity for loss alongside their objectives.

- Stock selection
  which identifies the individual stocks based on their perceived strengths. Stock selection can be heavily dependent on a charity's unique preferences and investment style biases.

While an investment manager actively manages the portfolio over the short term, they should always be holding the charity's long-term strategy in mind, keeping within the agreed risk parameters of the investment policy. Changes in both asset allocation and stock selection can have a big effect on both risk and return.

Communication

Communication is key to the investment management process as reporting on performance as well as regularly reviewing the charity's circumstances are essential to ensuring that the chosen strategy continues to meet the charity's needs.

Both the investment manager and the charity's trustees have a responsibility to support and promote good communication. As part of this, it's important that the investment manager and trustees hold regular meetings (both formal and ad hoc) to ensure:

- the charity has a clear investment policy statement that can be updated and adapted as necessary
- any changes to the charity's appetite for risk and capacity for loss are understood and communicated clearly to all parties.

Other types of risk

As discussed previously, risk can't be avoided, but it can be recognised and managed. As set out in the Charity Commission's Guide for Trustees (CC14), trustees will be better protected if they have properly discharged their duties and identified and considered the management of risk.

While the level of risk taken within an investment portfolio will have a direct impact on a charity's potential returns, there are many other risk factors that trustees should take into account which can, in turn, enhance or diminish returns.

Liquidity and valuation risk
Some types of investment are less liquid than others. This could pose a risk, as they are not necessarily valued independently on a daily basis and can't be sold and converted into cash as quickly as, for example, listed shares. Examples of assets with higher liquidity or valuation risk are property and property unit trusts.

Inflation risk
If the charity's assets do not at least keep pace with inflation, their value will fall in real terms.

Interest rate risk
Interest rate risk refers to the potential of an unexpected change in interest rates negatively affecting the value of an investment, such as a bond or other fixed-rate investment.

Exchange rate risk
This is the risk involved in holding overseas investments. As they are valued in different currencies, they introduce an additional layer of risk – changes in the performance of sterling can either improve or reduce the returns from foreign investments.

Governance risk
Where investments are unregulated, or traded on markets where regulation is less rigorous, governance risk can creep in. In other words, the risk of the investment suffering a significant fall in value is greatly increased as a result of poor management and lack of regulation.

Arguably, a charity's investment manager should be able to avoid these types of investment altogether if the trustees are uncomfortable with the risks. However, some trustees might accept that these types of investment could make up a small part of their portfolio in order to help enhance the overall return.

Counterparty risk

This considers the risk that your investment manager could default on their contractual obligations. Trustees can help to manage this risk through due diligence which, according to the Charity Commission, should include:

- ensuring the investment business is regulated and that, as far as possible, investments are held with a reputable firm
- establishing whether there is any compensation scheme to cover all or part of any loss the charity might incur
- reviewing contractual agreements periodically to make sure that they continue to be appropriate for the charity's needs.

Tax risks

Although charities do not pay income tax, corporation tax or capital gains tax in the UK, tax is an important consideration for certain overseas investments. Some countries do not offer equivalent tax reliefs for UK charities and the investment return may be reduced by foreign taxes.

Environmental, social and governance risk
The reputational risk to charities found to be investing in assets which directly contravene their own charitable aims is considerable. To manage this risk, if appropriate (and the Charity Commission clearly states that it must be justifiable), the trustees may want to adopt an ethical investment approach.

Indeed, charity investors are increasingly looking at positive ethical investing when considering their investments, taking into account areas such as climate, sustainability, human rights, community impact, employment, executive compensation and board accountability.

The fundamentals of investing

This guide accompanies one of our charity investment training webinar series: The relationship between risk and return. You can watch the full webinar by following this link.

Our training webinar series is designed to provide trustees and senior finance staff with an understanding of the fundamentals of charity investment.

Please visit:
rathbones.com/charities to find out more about the training series or to read our other guides.

To find out more about Rathbones' approach to portfolio construction and investing for charities, please contact:

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