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Investment Management™

# Investing Wisely

## A Primer for Canadian Non-profit Organizations

*This document is intended to provide a brief overview of investing for trustees and directors of charities, foundations, societies and other non-profit organizations in Canada. In it, we discuss the importance of good investment governance, considerations in developing a well-defined investment program and how to select an appropriate investment manager.*

Non-profit organizations[1] in Canada are looking for more from their investment portfolios to bridge funding gaps and meet on-going expenses. Trustees and directors of non-profit organizations are often volunteers who come from various backgrounds; some are experienced investors while many have little or no expertise in this area. Regardless of their level of knowledge, they all share a common fiduciary responsibility for the organization's assets. Investing in today's complex, fast-paced financial markets is challenging; investing as a fiduciary – with the attendant accountability – can be daunting. Even when a professional investment manager is retained, the ultimate responsibility for the investments rests with the fiduciaries.

Effective governance of a non-profit organization's investment activities is critical to the long-term financial health of the organization, its programs and services. It is also key to ensuring that fiduciaries do not inadvertently expose themselves to liability. Governance is now commanding greater attention from donors and governments alike, and the failure to implement adequate governance procedures can undermine support for the organization. Moreover, having well-defined governance practices can help smooth the transition from outgoing directors or trustees to those assuming portfolio management oversight responsibilities. These are all good reasons for fiduciaries to focus on their organization's investment governance practices.

This document is intended to help those involved with investing on behalf of Canadian charitable organizations understand the importance of good investment governance, particularly the elements of the key governance document, the Statement of Investment Policies and Procedures (SIP&P).

[1] The term "Non-profit organizations" is used throughout the text to describe those organizations that fall under the charities act of the Canada Revenue Agency. These organizations include large organizations with endowments, such as foundations (public and private), hospitals, and universities, as well as cultural and religious groups, community-based associations, etc.

## Governance

Investment governance involves establishing policies and procedures to ensure that the organization's funds are managed effectively, prudently and in compliance with all applicable legal requirements. This requires a commitment on the part of fiduciaries such that their highest duty of loyalty rests with the non-profit organization, uncompromised and unconflicted by any other interests.

Effective governance is largely about keeping detailed, historical records of the policies governing the investment portfolio and explaining how and why certain policies were established. Many non-profits create investment handbooks, much like corporate minute books, that record the historical perspective. This not only allows new directors or investment committee members to become apprised of all aspects of the stewardship of the funds, but is also useful in addressing questions from existing or potential donors.

One of the most important and tangible outcomes of an investment governance plan is a comprehensive SIP&P. It is the comprehensive summary of the organization's investment approach, plan and expectations.

## Statement of Investment Policies and Procedures

The SIP&P is the guideline within which the organization's funds must be managed and monitored. A formal SIP&P evolves through careful analysis of the organization's spending requirements, its expected returns from the capital markets and its ability to tolerate short-term volatility of investment returns.

The best SIP&Ps are comprehensive, clear and precise and they protect against unwanted risk. They stand the test of time, ensuring that a changing of the guard among fiduciaries will not interrupt the investment program. The SIP&P must also be sufficiently flexible to accommodate short-term fluctuations in the business cycle and remain focused on the organization's long-term plan.

A comprehensive SIP&P is also critical to the development of a successful relationship with the investment manager(s). It instructs the managers, clearly articulating the scope of their responsibilities and highlighting any unique constraints related to the portfolio or to the organization. Although the creation of the SIP&P is the responsibility of the Board, this function can (and often is) delegated to an investment committee. While the Board is ultimately responsible, it may also be helpful to consult others for perspective and expertise when drafting the SIP&P.

A well-conceived SIP&P should bring peace of mind to the Board because it helps ensure that the investment program stays on track and it serves as a reasonable reference point against which to gauge long-term performance. The SIP&P should be reviewed by the Board or investment committee at least annually. Any dramatic change in policy should be considered in light of how it will affect the value of the portfolio and the risk profile and whether it has implications for the donor base. The SIP&P can even be used as a fundraising support tool to demonstrate the high care and governance standards of the organization. Today's donors are very selective about the beneficiaries of their gifts and are increasingly interested in how their gifts will be handled. Beyond identifying with a specific cause, donors expect their gifts to be managed prudently and believe fiduciaries are accountable. It is becoming more common for donors to inquire about investment policies or the track record of the investment manager(s) before signing a cheque.

Ideally, a SIP&P should include:

- ***A brief profile*** of the organization, its history, purpose, and any geographic or philanthropic biases, including information on its current endeavours, its expected life and its long-term objectives.
- ***A description of roles and responsibilities*** of the Board and investment committee, the organization's financial officer (if appropriate), the investment manager, custodian and consultants (if applicable) as well as any other stakeholders.
- ***The investment objectives*** for the organization's funds (both short- and long-term). Often, expected cash flows are discussed, such as regular annual income requirements and/or a disbursement quota that the portfolio is expected to meet.
- ***The long-term asset mix*** targets and allowable ranges around those targets and, often, a description of the benchmarks.
- ***Authorized investments:*** Usually, a list is provided with a description of the securities in which the manager is allowed to invest, and instruction as to whether pooled or segregated approaches are permitted, as well a views on securities lending and the use of derivatives.
- ***Any risk guidelines:*** These include investment quality and quantity constraints on the eligible investment vehicles: e.g., minimum credit ratings for bonds or maximum equity weightings in various regions.
- ***Specific considerations:*** These may include any legal restrictions, contractual obligations, time horizons or unique preferences such as socially responsible investing.
- ***Voting rights*** and how they will be handled.
- ***Monitoring:*** Selection and performance measurement criteria should be outlined for the portfolio and, as distinct from this, for all agents to the portfolio, including performance benchmarks, frequency of reviews and, in the case of investment managers, frequency of searches.

It is advisable to involve the investment manager(s) and, if applicable, the consultants in the investment policy process. With their involvement, the Board or investment committee can avoid wording or constraints that could inadvertently disqualify capable manager(s) or unnecessarily reduce the latitude to earn returns in the portfolio.

## Asset classes

The broad building blocks of an investment portfolio are categories of securities, called asset classes. There are three traditional asset classes: cash, bonds and stocks. Some organizations may also hold real estate, hedge funds, infrastructure, private equity, etc. These latter "alternative" groups of investments are very specialized and are discussed in detail in other Phillips, Hager & North Investment Management™ publications. Each asset class has its own general risk and reward characteristics and each should be reviewed with reference to the organization's legal documents to determine whether they are allowed or even desirable within the confines of the stated objectives.

**Cash** refers to actual cash in the bank as well as "cash-equivalents", which are short-term debt instruments that mature in less than one year and allow ready access to cash. The most commonly used cash-equivalents are Treasury bills, guaranteed investment certificates (GICs) and money market mutual funds. The risk associated with cash or cash-equivalent securities is very low and, correspondingly, so are the expected returns.

**Bonds** are debt securities that allow investors to lend money to an organization (the bond issuer) at a set rate of interest for a given period of time. Investors receive two forms of return from bonds: income through semi-annual interest payments (which makes up the bulk of the return) and, on occasion, capital growth through appreciation in the price of the bond. Bonds may be issued by governments at all levels, government agencies, international agencies, or companies. Corporate bonds represent a loan from the investor to the company and usually give the investor a general claim against company assets in the event that the company defaults on payments. These claims are subordinate to the more senior claims of any lending banks, but may themselves be more senior than the claims of some other lenders and/or service providers with unpaid bills.

Three types of risk are associated with bonds: interest rate risk, liquidity risk and credit risk (also known as default risk). Interest rate risk refers to the fact that bond prices move inversely to interest rates: i.e., when interest rates go up, bond prices go down and vice versa. Liquidity refers to how easily a security can be bought or sold. Depending on the bond and the market conditions, it can be difficult to find a buyer for your bond. This inability to turn the bond back into cash before its maturity date is known as liquidity risk. Credit risk refers to the risk that the borrower will not be able to make the regular contracted payments to the lender. Credit risk is almost negligible on federal government bonds, whereas the financial capability of a company operating in a cyclical business, for example, is not perceived to be as strong, so the risk that the company might not be able to pay the investor back is higher.

Bonds are one type of "fixed income" security. Mortgages are another. Mortgages give the holder a direct claim to a specific underlying real estate asset. Similar to bonds, mortgages are subject to interest rate risk (sensitive to changes in interest rates), liquidity risk (potential difficulty finding a buyer or seller), and credit risk. Because they are not as liquid as bonds, mortgages typically provide higher yields. This higher yield is sometimes called a liquidity risk premium and refers to the premium on the mortgage relative to bonds with similar characteristics that are easier to buy and sell. The premium compensates investors for the mortgage's inherent lack of liquidity.

Bond and mortgage values fluctuate more than the values of cash instruments, but less than those of stocks. Bonds and mortgages are a good source of income in a portfolio.

**Stocks**, also known as equities, represent a share of ownership in a company. Investors can receive two forms of return from stocks: income through dividend payments and growth through share price appreciation.

Not all companies pay dividends and whether a company does or not is entirely at the discretion of management. Growth-oriented companies prefer to reinvest earnings in their business in the belief that a growing company will benefit the shareholders. Historically, companies that do pay dividends to their shareholders have increased them in prosperous times. Today, in addition to increasing dividends, many companies are increasing their value per share by buying back their stock in the markets. All other things being equal, the same amount of corporate wealth distributed among fewer shareholders eventually translates into a higher stock price for the remaining shares outstanding. Rising stock prices means the investor's portfolio goes up in value. We believe that fiduciaries should consider equities as growth vehicles and that dividend payments from stocks should not be relied upon as a significant source of income.

In Canada, equity classes are often characterized by region as being Canadian, U.S. or international (also known as overseas or EAFE equities – Europe, Australasia and the Far East). Investment beyond Canada provides a broad choice of securities appropriate to non-profit organization investors. Canada represents only 2% of the capitalization of the world's developed equity markets. Therefore, investing solely in Canadian equities ignores 98% of potential equity investment opportunities worldwide. Higher returns at certain times in the business cycle may be found abroad for four key reasons:

- economies may be at different stages of the business cycle;
- foreign markets may be inefficient, offering investment opportunities that are unavailable in domestic markets;
- some international economies provide higher short-term growth rates than are attainable in Canada's more mature economy; and
- foreign markets may offer access to investment opportunities in growth industries that may not be represented in the Canadian market (such as some types of technologies or health care-related companies).

In the short-term, stock prices fluctuate more than the value of cash or bonds, but the trade-off for this short-term volatility (and why people invest in equities) is that stocks have historically delivered superior long-term returns. The size of each short-term price change is a measure of the volatility of the stock and is often cited as a good representation of the risk associated with the stock.

## Investment objectives

In identifying objectives for a portfolio, it is helpful if those responsible for crafting the investment policy have an opportunity to step back and reflect on what the assets are intended to accomplish: i.e., what is their purpose? Investment objectives usually stem from the organization's immediate financial needs, long run obligations and any other periodic expenses or spending requirements. Understanding the organization's cash flows and ability to assume risk in the investment portfolio is an important part of prudent investment planning and a critical responsibility of the fiduciaries. Some common objectives are:

- ***Capital preservation:*** the need to preserve the purchasing power of the capital base, often in perpetuity;
- ***Capital growth:*** the desire to increase the value of the organization's funds;
- ***Income generation:*** the need to cover annual cash flows, ongoing expenses and the disbursement quota (if applicable);
- ***Project funding:*** the desire to fund specific cash flow commitments or projects in the future, such as new buildings.

From a fiduciary's perspective, two very real considerations when identifying objectives may be the impact of inflation on the investment portfolio and the need for liquidity from the portfolio. It is common for investment objectives to cite one or both of these as points of reference.

***Inflation:*** In most cases, it is important to protect, or even grow, the organization's base of capital so that it can generate income for ongoing expenses and also meet longer-term disbursement or spending commitments. Inflation erodes the purchasing power of money over time. If inflation is in the 2% to 3% range, the value of a portfolio must grow by at least 2% to 3% each year just to maintain its effective purchasing power. The annual erosion of purchasing power can have a profound impact on the organization's ability to meet its long-term commitments. The term "real rate of return" refers to the total return achieved, after accounting for inflation.

***Example:*** If we assume bonds are yielding 4%, inflation is 2% and the organization's minimum spending requirement is 3.5%, a portfolio invested 100% in bonds would produce a negative 1.5% real return (4% return, less 2% inflation, less 3.5% minimum spending requirement = -1.5%)

If we were to use the historic average inflation rate of 3% per year, the purchasing power of each investment dollar can be expected to devalue by about 16% over five years.

***Liquidity:*** A need for a high amount of liquidity can also affect how the portfolio is invested. Liquidity refers to the ease with which securities can be sold or purchased. The amount of liquidity required is generally a function of the organization's short-term spending or disbursement requirements. Securities with "locked in" or "non-redeemable" features have liquidity risk. Illiquid investments often pay a liquidity risk premium that can benefit the portfolio if the investors can withstand the uncertainty.

A high degree of liquidity can also reflect risk tolerance. Cash positions lend stability to a portfolio in difficult markets. A risk-averse Board may elect to maintain a high cash position at all times as a near-term safety cushion. A portfolio with a long expected life, excess assets and minimal spending obligations will require less liquidity than one expected to fund high amounts of short-term expenses.

Whatever they are, the portfolio's long- and short-term objectives must be clear in order that the SIP&P may stand as a guide for the investment manager(s) and support a given mix of asset classes as being suitable for the portfolio.

## Disbursement quota

Some spending commitments are required legally or by legislation, while others are made at the discretion of the organization. It is important to understand the distinction as the discretionary spending allotment may shrink or grow, depending on the portfolio's experience in the markets.

Registered charitable organizations are required to disburse the bulk of their annual income to charitable causes according to specific guidelines in the Income Tax Act. Failure to disburse the required amounts can jeopardize the organization's non-taxable status.

## Asset allocation

With an understanding of the objectives, spending requirements and risk tolerance, it is then possible to develop guidelines for building the investment portfolio. Asset allocation refers to the process of deciding how to apportion the organization's resources among the different asset classes. As noted, we consider the three traditional asset classes in this paper, but other, more specialized "alternatives" are also available that offer additional opportunity to enhance returns (with the associated additional risks, of course).

Historically, the portfolios of many non-profit organizations have tended to be heavily weighted in bonds or other fixed income instruments, with little exposure to stocks. This is partially because fixed income securities are seen as the safer, more conservative investment option. They typically generate a reliable stream of income and, once purchased, can be held until maturity, minimizing the risk to the organization's capital.

A fact often overlooked is that too much emphasis on bonds can underutilize the organization's financial resources in the long run and may not compensate for inflation, thereby resulting in an erosion of capital. History perpetuated the keen interest in bonds during the 1970s and 1980s when interest rates were high and bond yields averaged between 10% and 12%. Today, bond yields are 4%-4.5% and inflation is close to 2%. Since yields are generally expected to remain low, many investors are now turning to higher risk investments such as stocks in order to generate the returns required to maintain and grow the purchasing power of their capital.

Unless an organization has a pre-determined limited life, fiduciaries should take a long-term view with regard to asset allocation. The correct broad mix of assets is the one with the highest probability of meeting the organization's current income and long-term growth requirements, within risk parameters that are acceptable. It should be able to withstand the test of time, through both good markets and bad. The asset allocation process involves the following steps:

- listing the organization's objectives and constraints;
- confirming the organization's risk tolerance;
- determining which asset classes are appropriate;
- examining the expected return, volatility and cross correlation for each asset class; and
- deciding how much to allocate to each asset class.

### Risk

Short-term downturns in the equity markets can be troubling for charitable organizations because minimum spending requirements are usually pre-established. As a result, capital may need to be consumed during down markets.

To some degree, market value fluctuations and negative returns can be reduced by ensuring the equity component is diversified by country, by industry group and by company. Quality control in choosing equities is also key to minimizing losses in negative markets. Being conservative may be beneficial to the organization in the long run.

The level of growth required will reflect the organization's current obligations, desired goals and expected life. An organization with high near-term income needs or a limited life will need more immediate security and, therefore, have a portfolio with more lower-risk investments like cash and fixed income securities. An organization with low current income needs and a long expected life can afford a more equity-oriented portfolio because it can weather the short-term fluctuations in value in pursuit of higher long-term returns.

Often, what an organization can afford and what the fiduciaries are willing to accept in terms of risk can be two entirely different things. In the end, it is the portfolio's ability to assume risk, layered over the fiduciaries' willingness to take risk that will, together, determine the appropriate level of risk tolerance for your organization.

In general, there is a strong relationship between risk and return: the higher the risk, the higher the potential returns; and the lower the risk, the lower the possible returns. Investors and professional money managers look to understand how the prices of different securities are changing. Then they look for imperfections in the financial markets like mispriced securities and try to increase returns by correctly anticipating how prices will change.

A "what if" analysis using historical data can be performed to determine the likely range of outcomes associated with different combinations of equities and bonds measured over various time frames. Fiduciaries can examine the alternatives, choosing a target mix that will provide the desired return within an acceptable range of risk. A lower tolerance for risk translates into a more conservative asset mix: i.e., a higher weighting in cash and/or bonds at the expense of equities.

## Example:

An organization has a $10 million investment portfolio. It must disburse or spend 3.5% this year and inflation is currently at 2%. The economists' forecasted long-term total return is 4% per annum on bonds and 8% per annum on equities. The fiduciaries are reviewing asset mix options as follows:

***Option I: 75% Bonds, 25% Equities***
Applying the expected returns on bonds and equities to this asset mix generates a total expected return of 5% (i.e., 75% * 4% + 25% * 8% = 5%). Once the spending requirement of 3.5% and inflation of 2% are taken into account, the net expected return is negative 0.5% (i.e., 5% less 3.5% less 2% = -0.5%). The negative return implies that the purchasing power of the non-profit organization's capital will be eroded each year by half a percentage point.

***Option II: 25% Bonds, 75% Equities***
Applying the expected returns on bonds and equities to this asset mix generates a total expected return of 7% (i.e., 25% * 4% + 75% * 8%). Once the spending requirement of 3.5% and inflation of 2.0% are taken into account, the net expected return is positive 1.5% (i.e., 7% less 3.5% less 2% = 1.5%). The positive return implies that the organization's capital will be growing each year. Over the years, the growth will compound. While growth is clearly a better alternative than losing ground, the fiduciaries may feel that the volatility associated with such a high weighting in equities is beyond the risk tolerance of the organization.

***Option III: 50% Bonds, 50% Equities***
Applying the expected returns on bonds and equities to this asset mix generates a total expected return of 6% (i.e., 50% * 4% + 50% * 8%). Once the spending requirement of 3.5% and inflation at 2.0% are taken into account, the net expected return is 0.5% (i.e., 6% less 3.5% less 2% = 0.5%). This alternative would be quite palatable to many fiduciaries entrusted with protecting and preserving the capital, rather than making it grow.

*Please note that these exercises have been done without consideration for fees, administration costs or fundraising. These factors are typically outside the purview of the investment policy statement. This example is for illustrative purposes only and is not intended to be repesentative of the performance of any actual or future investment.*

Once the relevant asset classes and a target mix have been determined, **ranges for each asset class** must be established around the targets. The ranges give the investment manager a clear set of limits for each asset class, removing the chance of misinterpretation or miscommunication by either the fiduciaries or the investment manager. Ranges also allow the manager to employ "tactical" asset mix strategies, adjusting the portfolio in response to shorter-term fluctuations in the business cycle and taking advantage of opportunities in the market, without departing substantially from the long-term plan.

**Example:**

| | Asset mix ranges | | |
|---|---|---|---|
| | **Minimum** | **Target** | **Maximum** |
| Cash | 0% | 10% | 20% |
| Bonds | 20% | 30% | 40% |
| Canadian equities | 10% | 20% | 30% |
| U.S. equities | 10% | 20% | 30% |
| International equities | 10% | 20% | 30% |

One of the key advantages of strategic asset allocation is that it enforces the ***discipline of regular rebalancing*** (i.e., bringing the portfolio back to the long-term strategic mix when changes in the market value have cause the actual asset mix to drift off-target). Strategic asset allocation requires that rebalancing take place either when there has been a significant change due to performance of an asset class or when the organization's investment requirements change.

Rebalancing is often achieved by selling assets that have performed well and buying assets that have been weak, that is, selling when prices are high and buying when they are

low. Continuously monitoring the asset mix relative to the target ensures that the portfolio stays on track vis à vis the organization's long-term objectives.

## Authorized Investments

This section indicates the eligible – and sometimes also prohibited – investments for the portfolio. Eligible securities are usually categorized by asset class: Short-term, more liquid instruments of duration less than one year; fixed income instruments including bonds, debentures and mortgages; equities, usually identified by region; and pooled funds, mutual funds or other structured vehicles in any or all of the previously itemized categories.

Pooled or mutual funds are often addressed separately in non-profit SIP&Ps. If pooled funds are permitted, the manager may be asked to provide written notification in the event any changes are made to the investment policies of these pooled funds.

Derivatives may also be singled out and direction given as to whether they are permitted and, if so, under what circumstances. Although derivatives have gained a reputation as being risky vehicles, some can play a very useful risk management role in a portfolio. Currency hedging (i.e., neutralizing the exchange risk associated with investing in foreign-dollar-denominated securities), for example, means using derivatives. Many SIP&Ps will also include a limiting statement to the effect that derivatives may not be used for speculative purposes or to create excessive leveraging of the portfolio.

## Risk guidelines

Risk guidelines are the minimums and maximums that help ensure a balanced, diversified portfolio within a given mandate (be it equities, bonds or a combination thereof). They should be consistent with the organization's risk tolerance and objectives and should be outlined in such a way as to give the manager direction, but not unnecessarily tie their hands or inadvertently reduce their latitude to pursue returns for the portfolio. As with investment constraints, these are typically listed by asset class.

For money market and fixed income securities, the common guidelines relate to allowable ratings (e.g., R1 for money market, or AAA, AA, A, BBB, etc. for bonds) and/or the maximum or minimum proportion of the portfolio that may be invested in a given quality of bond. This is often done in table form. Separate maximums are commonly cited for more specialized issues: thus, maximum allocations might be identified for foreign bonds, mortgages or mortgage funds, asset-backed securities, or real return bonds, to name a few.

Diversification constraints outlined for equities may be expressed by geographic region, industrial sectors, market capitalization (of the holdings), size of individual holdings relative to the portfolio, size of holding relative to size of the company, etc.

## Specific considerations

Other guidelines may be unique to the investor. Some types of considerations include:

### *Time horizons*

The investment time horizon is the length of time that the money can be invested before it is needed to meet spending or disbursement obligations. Funds required in the near term should be invested in more conservative instruments such as money market or short-term bonds with maturity dates that coincide relatively closely to the date the obligation is due.

Time is a powerful ally in generating long-term returns and reducing overall portfolio volatility. The time horizon of any investment plan has a direct influence on the level of risk that the portfolio is able to tolerate, and therefore, the return that it can be expected to generate. Spending obligations aside, the longer the time horizon, the more risk the organization can assume and, therefore, the larger the potential equity component in the asset mix and the greater the potential returns from the portfolio.

### *Legal issues*

In Canada, non-profit organizations typically take the legal form of a trust or a not-for-profit corporation or society. Depending on the type of entity, the organization may be

subject to legislation, such as a provincial Trustee Act, which may impose constraints on certain types of investment vehicles. In most provinces the Trustee Act references the "Prudent Investor Rule", under which consideration must be given to the appropriateness of an investment for the portfolio as a whole. Whatever the structure, the fiduciaries need to be aware of which jurisdiction governs their organization and its investment activities, as well as whether there are any legal or legislated requirements.

### *Unique needs and preferences*

Most non-profit organizations are benevolent by nature and many are interested in aligning their investment portfolios with their mission, outlook or beliefs. Depending on the genesis of the organization and the nature of its endeavours, its fiduciaries may wish to avoid investments in specific areas such as alcohol, armaments, pornography or tobacco.

Socially responsible investing (SRI) – the formal integration of social values and missions into the traditional investment process – provides a way for investors to act on their concerns. SRI has emerged as a viable investment approach for those investors who want to achieve competitive investment returns while ensuring that their money is managed in accordance with certain social or environmental values. Phillips, Hager & North Investment Management's in-house research shows that implementing a socially responsible investment portfolio need not in and of itself hamper investment returns.

## Monitoring

There are three main focal points for fiduciaries in their ongoing care of the portfolio: the money, the policy that governs the money and the manager(s) who implements the policy.

### *Review of the investment strategy*

Regular and consistent monitoring of corporate strategy confirms that the right decisions regarding the investment policy and manager selection have been made. It also enables fiduciaries to recognize if and when policy modifications are required and to implement them in a timely fashion.

### *Review of portfolio performance*

Portfolio performance should be reviewed on a pre-fee basis to ensure a fair comparison of results with those of the stated benchmark. Examples of benchmark indices commonly used for the stock segment of a portfolio include:

- the S&P/TSX Composite Index for Canadian stocks;
- the S&P 500 Index for U.S. stocks; and
- the MSCI EAFE (Europe, Australasia and the Far East) Index for international stocks.

Examples of benchmark indices commonly used for the fixed income segment of the portfolio include the following:

- the DEX Universe Bond Index for a well diversified Canadian bond portfolio;
- the DEX Short Term Bond Index for a portfolio of short-term bonds; and
- the DEX Long Term Bond Index for a portfolio of long-term bonds.

Other benchmarks might include:

- inflation, as measured by the Consumer Price Index;
- Treasury Bill returns;
- a replica or model portfolio with the same asset mix as the non-profit organization portfolio; and
- peer group or other relative comparisons.

Performance criteria may be expressed in relative terms such as exceeding a given benchmark by a certain number of basis points, or in absolute terms such as achieving a minimum specified rate of return.

### *Review of the investment manager*

The manager's performance should be evaluated against relevant benchmarks and value-added targets defined over a meaningful time period. Three to five years represents a

typical economic cycle and should give a manager enough time to demonstrate results. Benchmarks are usually determined collaboratively between the non-profit organization's Board (or investment committee) and the investment counsellor. A suitable benchmark[2] should be:

- defined clearly at the outset and written into the SIP&P;
- investable or publicly available;
- easily measurable;
- reflective of the manager's style; and
- reflective of the types of securities the manager normally selects.

## Selecting an investment manager

Although fiduciaries may have varying degrees of investment expertise, they share the common fiduciary responsibility of protecting and perpetuating the non-profit organization's capital. Generally, fiduciaries are busy people who volunteer their time to non-profit organizations on a part-time basis. Hiring an external investment manager can put professionals in charge of day-to-day money management and allow fiduciaries to concentrate on any operational responsibilities and the strategic direction of the organization.

### *Steps in the Selection Process*

With or without an formal investment policy or SIP&P, a typical selection process will include the following steps, sometimes undertaken with the help of consultants and often not:

***Identify five to ten potential managers:*** Ways to generate this list may include discussions with other non-profit organizations, input from directors/trustees or service providers (such as bankers, lawyers or accountants), using Internet resources and reviewing web sites, approaching financial and non-profit industry associations, etc. Finding firms that have experience working with non-profits is a good starting point.

[1] Jeffrey V. Bailey, "Evaluating Benchmark Quality", Financial Analysts Journal, May-June, 1992.

***Issue a request for proposals (RFP)*** and use this to generate a short list of two or three potential managers. The RFP will likely take the form of a questionnaire to allow your organization to become more familiar with the managers' organizations and their investment approaches. RFP questions usually address the following areas of interest:

- the company (organizational history, structure, ownership and assets under management as well as experience with similar clients);
- the people (who makes the investment decisions, their credentials and any recent turnover among investment professionals);
- the investment philosophy and process;
- historical performance;
- a proposal: depending on how defined the non-profit organization's needs and mandate are at this point and the amount of information provided to RFP respondents, the RFP may ask for an indication of the manager's approach in the organization's specific circumstance;
- fees; and
- client service and reporting.

***Interview the short listed managers:*** Ask the short list to come and present their services and proposal to your investment committee or Board. This is a very good opportunity to meet the firms and, hopefully, the people who would be responsible for your account and to gauge whether or not there is a personality "fit": for example, could you envision inviting this person to your meetings once or twice a year and listening to them report on the performance and issues in the investment portfolio?

### *Criteria to Consider*

A good "fit" between the organization and the investment management firm is essential. Fiduciaries should seek a manager who will be a partner in the stewardship of the

organization's capital. There should be **cultural common ground** between the values of the organization and those of the investment management firm.

The individual client service manager assigned to the organization's account should be professional, have strong communications skills and relevant experience managing non-profit portfolios. This person must have a clear understanding of the legal framework within which the organization operates and its spending requirements. The primary client service manager should be backed up by another professional, who is familiar with the portfolio and capable of reporting to the fiduciaries when the primary portfolio manager is unavailable.

The most critical element in searching for a manager is **to ensure that the manager is capable of adhering to the non-profit organization's investment policy.** There are many reputable investment management firms from which to choose in Canada.

Selecting a firm with a **well-defined investment style** that has been implemented consistently is key. **Low professional staff turnover** is also a good indicator of style consistency and organizational stability. Ideally, the research team has several professionals contributing to the management of each asset class. Evidence of **succession planning** within the research group is also critical in ensuring style consistency. The primary client service managers are professionals who work directly with the fiduciaries, helping to structure and/or modify the investment policy as needed and communicating on a regular basis about investment strategies and performance.

**Performance** is another variable to be considered. While historical results cannot be relied upon to predict future performance, a proven track record is useful for judging the consistency of a manager's returns and the consistency with which they implement their stated investment style. Performance data also reveal how much risk the manager is prepared to take. A manager who is a top performer one year and at the bottom of the pack the next year might be making large, risky bets in the market. In such cases, luck may be playing a bigger role than acumen.

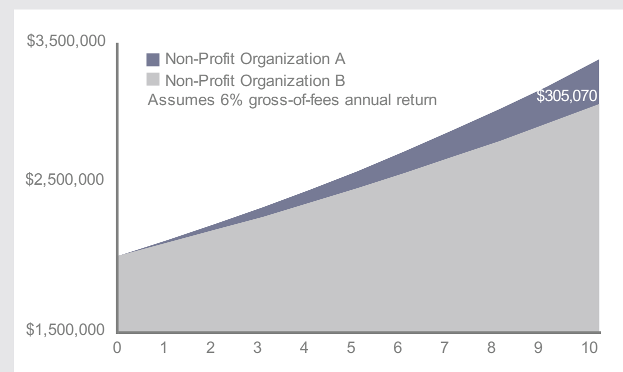
**Costs** are becoming an increasingly important consideration as market returns revert to lower, more historically "normal" levels. In today's return environment, a 1% difference in fees can have a significant impact on long-term returns.

An investment manager's responsibilities should extend beyond the making of day-to-day investment decisions to generate reasonable returns. Ideally, there should also be a strong **commitment to service**. The client service manager is often able to assist the fiduciaries in reviewing the investment policy statement. Many client service managers are also prepared to provide educational resources for less experienced fiduciaries and help them better understand and execute their responsibilities.

### Example:

Non-profit organization "A" has a $2 million investment portfolio and is paying its investment manager a fee of 0.7% per year. If the portfolio grows by 6% on average each year, the return net of fees would be 5.3% (i.e., 6% less 0.7% in fees). If the money is invested for ten years at a net 5.3% return, the value after ten years would be $3,352,075.

Non-profit organization "B" also has a $2 million investment portfolio, but is paying its investment manager a fee of 1.7% per year, i.e., a full percentage point more than organization A above. If B's portfolio grows by 6% on average each year, the return net of fees would be 4.3% (i.e., 6% less 1.7% in fees). If the money is invested for ten years at a net 4.3% return, the terminal value would be $3,047,004.




The 1% differential in annual investment management fees cost non-profit organization B more than $305,000 over the 10-year period,

*This example is for illustrative purposes only and is not intended to be representative of the performance of any actual or future investments.*

When selecting a manager, it is a good idea to request samples of regular reports that the manager has sent to clients so that you can be sure that your organization's administrative staff would receive the information they need in a timely and efficient manner.

If the investment portfolio is being managed on a segregated basis (i.e., using individual stocks and bonds versus investing in pooled or mutual funds), the organization must have a relationship with a reputable custodian. Custodians are usually trust companies. The ideal custodian has a strong administrative track record and a commitment to service. The portfolio manager should be able to work with the custodian you choose.

An investment manager's performance, approach and commitment to service should be subject to **regular review** by the fiduciaries. Poor long-term performance, substantial changes in the research team or investment style, or poor service are all factors that may also trigger a formal review of the manager. Poor performance in the short-term against a solid long-term track record is normally not grounds for dismissal. That said, there is no excuse for poor service.

## Conclusion

Identifying investment objectives, understanding how to balance risk and reward, and then committing to a sound long-term investment policy are critical steps for trustees and directors in ensuring that a non-profit organization's capital will be available when it is needed.

Finding an investment manager who "fits" with your organization provides you with additional expertise and a source of education. Your investment manager is your ally in structuring a portfolio to meet your organization's needs today and in the future. Good investment governance practices will result in a SIP&P that stands the test of time, providing the roadmap for investment management and the yardstick by which to measure your organization's success in meeting its financial objectives.

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Should a prolonged period of lower investment returns indeed materialize, as we expect, investment governance practices will become all the more critical, and could even impact the long-term survival of many non-profit organizations. Investing time and resources in establishing a well-defined investment program with a clear SIP&P and hiring an appropriate investment manager helps fiduciaries understand and execute their responsibilities, gives donors comfort and eases the disruption of bringing new fiduciaries on board as others retire.

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