Prudent Portfolio Management in an Uncertain Time: Best Practices for an Investment Committee

Nonprofit organizations face an unprecedented amount of strain on their resources, and emotions can often lead investment committees to make sub-optimal portfolio decisions. To understand more about enhancing investment processes during volatile markets, we spoke with Chris Blume and Amal Alibair of the Goldman Sachs Portfolio Management Group. The Portfolio Management Group provides multi-asset class solutions for institutional investors, focusing on customized strategic, or long-term, asset allocation, tactical implementation, risk management and portfolio construction.

Q: Both of you are currently talking to many investment committees. How are they reacting to the current market downturn and its impact on their portfolios?

Amal: The COVID-19 related sell-off was quite severe and swift. In just over a month, the S&P 500 fell by 34%. Many investment committees were quite concerned and held emergency meetings. However, the discussions at these meetings have been calm and thoughtful. Most investment committees concluded that while the day-to-day volatility is disconcerting, they are long-term investors and will stay the course with their portfolios.

Chris: These committees had thoughtfully deliberated during the initial development of their strategic asset allocations. As part of this process, they had examined how their portfolios would perform during periods of stress. How much would the strategic asset allocation associated with their portfolio have declined in the Dot-Com bust or the Financial Crisis? By examining these scenarios, they were informed that market downdrafts do occur and recoveries also occur. Rather than panic, they have the “staying power” to remain long-term investors.

Amal: Embracing the long term is important. Occasionally, there are investment committee meetings where a lone voice will suggest de-risking and selling some stocks. The lone voice nearly always gets overruled. The proposed sale not only goes against the long-term orientation of the committees, but...
potentially comes with a high opportunity cost. For instance, a board member at a recent meeting pointed out that the opportunity cost of selling equities to raise $1 million of extra cash could be quite high. If the cash was raised when the S&P 500 was trading at 2500 and then the S&P 500 rose to 3000, the opportunity cost of that sale would be approximately $200k. It is important for committees to understand the impact of such actions.

**Exhibit: US Real GDP Growth in 2020 – Goldman Sachs GIR Projections**

Q: There is a lot of discussion about rebalancing. What is rebalancing?

**Chris:** A simple example might be helpful. Say an organization identifies their risk tolerance as “moderate” and adopts a 50/50 portfolio, that is, one split evenly between equities and high-quality fixed income. During a bull market, the 50% equity weighting will increase. If nothing is done, the portfolio’s weights could creep up to 70/30 and be more consistent with the portfolio of an “aggressive” investor. Rebalancing accounts for this drift in portfolio weights. In this case, rebalancing would involve selling equities to bring the portfolio back to its initial moderate risk profile of 50/50 weights. The opposite would occur during an equity sell-off. The takeaway here is that rebalancing is a risk management exercise.

**Amal:** While it is a risk management exercise, rebalancing can be quite stressful during market downdrafts. During a severe sell-off, rebalancing will require purchasing equities in a falling market when overall investor sentiment is quite negative. In a way, it is quite contrarian. However, once a recovery takes hold, these purchases will be quite helpful and speed the portfolio’s recovery. Our Strategic Asset Allocation Team has concluded that regular rebalancing would have accelerated a portfolio’s full recovery by several months during the financial crisis.
Q: Do you incorporate rebalancing in your investment process? How does it work? Are there best practices?

**Amal:** Yes. We do incorporate rebalancing into our portfolio management process. One best practice is having an explicit policy with regard to disciplined rebalancing. An organization should not be developing the policy on the fly. Our policy has two potential triggers for rebalancing ("hybrid rebalancing"). First, we rebalance any portfolios that are deviating from their targets by more than one percent every quarter. For example, if a portfolio has 27% in investment grade fixed income and its target is 29%, we will rebalance. Second, between quarter-ends, we will rebalance if a portfolio is deviating from its targets by more than three percent. We have systems that alert us if this three percent tolerance band is reached.

**Chris:** Intra-quarter rebalancing can be particularly tricky as these bands are typically breached during periods of high market volatility. In stressed markets, our policy gives limited discretion to our portfolio managers to widen the bands. During the most recent drawdown, we modestly increased the width of the tolerance bands. Doing this recognized the momentum of the falling market and allowed for rebalancing at lower and more attractive price levels.

Q: The COVID-19 crisis is not just impacting endowments but also the revenue streams of some nonprofits. How do you see organizations addressing this?

**Chris:** We unfortunately have a handful of clients who do have revenue challenges. For instance, organizations dependent on ticket sales, such as museums and performing arts centers, have been significantly impacted. Many colleges and universities have also been impacted and it is likely that some weaker schools do not recover. On the other hand, private foundations are generally not impacted at all since they rely entirely on their endowment.

One best practice for investment committees is to coordinate closely with their CFOs to understand any revenue shortfalls that might need to be addressed. What is the magnitude of the shortfall and over what period? Asking these questions can ensure that any potential issues are identified early and that appropriate planning is undertaken.

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**Rebalancing Methodologies**

There are different approaches to ensure disciplined portfolio rebalancing:

1. **Time-based rebalancing:** quarterly, semi-annually, annually
2. **Trigger-based rebalancing:** when asset weights drift outside of predetermined ranges, when markets move more than a pre-determined threshold
3. **Hybrid rebalancing:** both approaches may be employed simultaneously as well
Q: What if liquidity is needed to address revenue shortfalls?

Amal: There are a number of paths that organizations are taking. First, we are seeing a few organizations fund their near-term spending needs by making withdrawals from their portfolios. However, the timing of these withdrawals is not ideal given the recent sell-off. As a result, many organizations are requesting that the outflows be taken out of investment grade fixed income. This action gives their equity investments time to recover and avoids selling at losses.

We have also seen some organizations borrow to bridge any revenue gaps. This allows the portfolio time to recover and avoids selling at stressed levels. In addition, with the decline in interest rates, some organizations are finding attractive borrowing rates. One caveat is that the borrower needs to be quite careful as to how the funds are used in order to avoid UBIT issues.

Finally, we have seen many organizations look for relief from the CARES Act. However, at least in the early days of the CARES Act, any liquidity relief would not be immediate.

Q: You mentioned earlier that most committees were calm. Do you see many of them making changes to their investment strategies?

Chris: Most have opted to stay the course. However, we have seen a few committees view recent events as an opportunity. There are some organizations with the desire and the capacity to increase risk. Generally, the additional risk has been an increase of 5% to 10% to the portfolio’s equity allocation.

We have seen many of these risk discussions and the best are very deliberate and clear as to the committee’s intent. Many important questions are asked and answered. For instance, what is the rationale for the additional risk? Is the additional risk consistent with the organization’s risk tolerance? What is the investment horizon? Is the additional risk a near- to medium-term view or a permanent change to the portfolio? Another best practice is to record the discussion in the meeting minutes and make any necessary changes to the Investment Policy Statement. The composition of investment committees changes over time so an official record of the discussions and the rationale are important.

Amal: A second set of decisions for these more opportunistic boards is how to add new risk to their portfolios. While adding the additional equity exposure all at once is straightforward, in a volatile market, the specific day of entry can make a large difference. As a result, we have seen most organizations “average in” new equity exposures over time. The length of time “averaging in” can be a function of how long an investor thinks the crisis will last. An optimistic investor expecting a strong recovery in the second half of 2020 might invest over three months. An investor with less certainty might invest over 6 to 12 months.

A few committees with more sophisticated members and experience with derivatives might decide to incorporate option strategies into their implementation strategy. While these strategies can be appropriate, board education is an important component.
Q: A final question. Have you seen many spending discussions?

Chris: At this point, we have not seen many discussions about spending. Right now, investment committees are focused on the market volatility, its impact on portfolios, and any near-term liquidity needs. However, as the markets become less volatile, these spending discussions will become more frequent. I suspect that you will see more discussion by grantmaking organizations. Given the increased societal needs created by COVID-19, should current spending be raised above sustainable levels? We have already seen some private foundations discuss shifting their mission towards this crisis. The next decision after a mission shift would be how much more to spend today? If organizations choose to significantly increase spending, they should also analyze and discuss how this spending would impact their portfolios down the road.

Amal: While increased spending today might be the right thing to do for the organization, it is also important to consider the longer-term portfolio ramifications of the decision. This is a good fiduciary practice. There are intergenerational fairness implications of increasing current spending as funds spent today mean fewer funds available to support future generations. To better frame these discussions, we have turned to modeling to quantify the impact of these spending decisions in actual dollars. A good simulation model can show how the portfolio’s value can potentially evolve over time given different spending policies. These analytics might not change the spending decision, but a good planner and fiduciary should be aware of the implications.

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**Investment Committee Best Practices in Volatile Markets**

- **Investment Horizon**: Investment committees should reaffirm their long-term orientations. This will provide their organizations with greater “staying power” through periods of market volatility and decrease the temptation to reduce risk at inopportune times.

- **Liquidity**: Investment committees should proactively coordinate with their broader organization to anticipate, and potentially prepare for, any unforeseen liquidity needs.

- **Rebalancing**: Investors should adhere to an explicit rebalancing policy. Not only is rebalancing a sound risk management process, but it can also accelerate the portfolio’s recovery.

- **Spending**: Changes to an existing spending policy should consider the impact on the portfolio over the long term. Thoughtful modeling can produce projections of the portfolio’s future value under various scenarios to inform and support decisions. Sometimes there can also be legal and tax considerations around issues such as restricted gifts and excise taxes.

- **Governance**: Decisions are often made quickly during a crisis. Investment and spending decisions should be properly documented to withstand near- and long-term scrutiny by internal and external stakeholders.
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