HAMZA ALI, director of finance at the **Society of Chemical Industry,** explains how he and his trustees focused on managing risk and how this priority for them prevailed against the advice of their then investment advisers, to the ultimate benefit of the charity.

MANAGING RISK RATHER THAN CHASING ALPHA PERFORMANCE

CI's Hamza Ali – the twin mantra of managing risk and preserving capital proved hugely beneficial.

"Midway in our life's journey, I found myself; In dark woods, the right road lost."
Translation of the opening lines of Dante's "Divine Comedy".

The market volatility since 2000 has buried the long established approach of "buy and hold" relating to investments. During the 1990s major endowment funds in the US pioneered the robust investment strategy of asset allocation and risk management. The strategy gained momentum in the 2000s with the choice, popularity and acceptability of alternative investment mechanisms.

The select Ivy League universities generated high returns on their endowment funds utilising innovative products and hiring in-house analysts. One player even ventured into swaps and subsequently had a not insignificant loss during the recent market turmoil.

Have a look at the chart depicting the price performance of the Dow for each decade since 1900. As one can see, from the close of 1999 through 2009 was the second worst performance on record. Only the Great Depression decade of the 1930s was worse.

The current noughts decade also shares an unfortunate outcome with the 1930s in being a decade during which the Dow actually ended lower than where it started.

lesson

The lesson of the charity sector going forward is to focus on risk management. One will observe the use of the singular "lesson" and not the plural. It is deliberate. While there are of course lessons to be learned, this article discusses just one. The reason being it is paramount in my opinion – it is the lesson of managing risk.

Managing risk has had attention focused on it as a critical aspect of an investment policy during recent times. During the post-WW2 period the markets were rather tame and "buy and hold" investors were handsomely rewarded.

While I was a student at the University of Minnesota in the seventies, I recall the euphoria when the Dow Jones index breached the 1,000 mark for the first time in late 1972. It was rather short lived; the oil crisis of 1973-74 followed. There were queues of cars at gas stations and the index dropped 48%.

severity

Arguably, that was the last major crisis until the recent 2008-09 financial crisis. In between there were many crises – the savings and loans debacle, Latin American and Asian currency crises, Russian debts, the Enron and WorldCom implosions, LTCM debt and dot.com virtual decline. Note the frequency of crises since 1980s and pre 1980s. But it is not just the frequency of crises; the severity of crises is on an upward sloping curve.

Since I joined SCI in mid-2005, I have emphasised managing risk as the most effective tool. During the recent market turmoil SCI kept ahead of the curve. We started selling both equities and corporate bonds in spring 2007, and the last sale was in March 2008. By

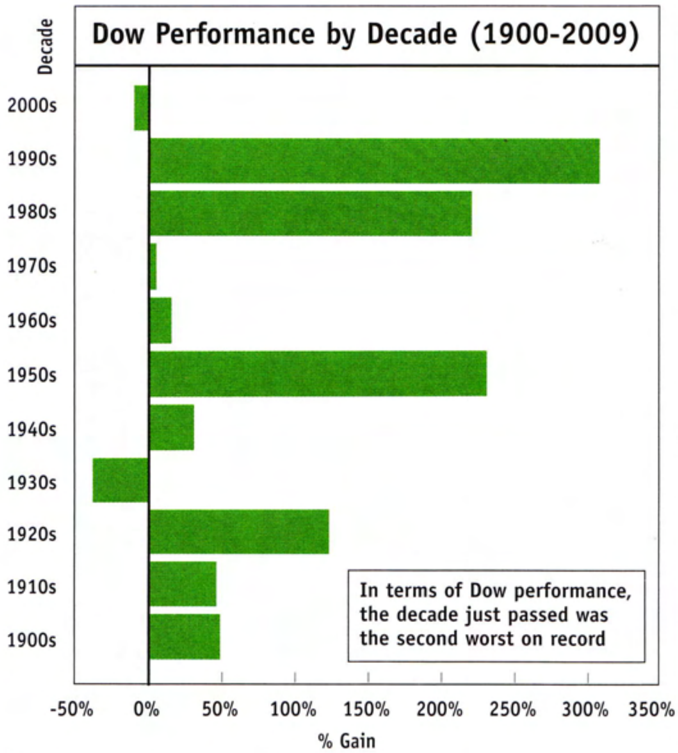

Chart courtesy of Chart of the Day

December 2009 the portfolio was made up of:

Cash	40%
Gilts	10%
Bonds	15%
Equities	35%

SCI is a membership body of scientists and trustees who are elected from the membership. The trustees are experts in their respective field of endeavour. Selling equities and corporate bonds required a huge effort of rationale and a long period of time.

appetite

What won the argument was an equally huge appetite by the trustees for discussion and debate on risk management. Risk was managed in this situation with the benefit of investment managers – two well known names in the sector.

The trustees are highly expert practitioners of empirical based evidence in pure science. My task was one of extending their thought process into the imperfect, dismal science of economics. The trustees were now exposed to the murky waters of financial instruments and utilised their collective common sense approach.

During this period we did not once hear from our respected two investment managers with a recommendation to sell. It would be interesting to know how many clients were advised to sell by their managers. On the contrary conversations with managers were rather strained.

One manager blatantly commented: "I am your adviser and do not advise selling in a falling market. It is not a good time; the market will bounce." I simply reminded him: "I am the client and I am instructing you to sell." A few weeks later he called to say it was a good timing. This was spring 2008.

One might enquire how we managed the large cash balances. It was a near disaster – less than a millimetre away. Significant amounts were placed in 2007 on term deposits with Kaupthing Singer and Friedlander at over 5.5%. The maturity date was mid October 2008.

Towards the end of 2007 I noticed the tag clouds in Iceland in the financial media were getting large – flashing amber lights. It was agreed with the trustees to recall our capital even at a cost. The return of capital gained ascendancy over return on capital.

protection

Following lengthy discussions, Kaupthing returned 40% of our deposit with interest. The cost – a £60 penalty. By summer of 2008 the dark clouds were really gathering over Iceland and I went back to the trustees, this time with a recommendation to buy credit default swaps should Kaupthing refuse to return the balance of 60%. The credit default swap costs were exorbitant by that time – 66 basis points for only four months. The trustees decided the high costs were still worth the protection. However, I managed to convince the bank of SCI's necessity of cash and it returned the balance with interest, less another £60 penalty. On 10 October 2008 Kaupthing was nationalised. Nearly £120 million of charity funds were frozen with the various Icelandic banks.

While the trustees monitor risk only via quarter by quarter meetings, it is the responsibility of the executive to monitor risk more frequently and rigorously during times of crises and to call unscheduled meetings to manage the risk with the trustees.

Yet again the twin mantra of managing risk and preserving capital proved hugely beneficial. It was not just luck; rather a heightened awareness and a very proactive attitude by the trustees along with the executive helped us to withdraw our capital prior to the bank's collapse.

During 2008 the trustees, after prolonged debate, agreed to a recommendation to seek to appoint new investment advisers. SCI has appointed an independent firm and SCI has agreed with the clearly defined investment policy, including metrics for asset allocation, respective risk acceptance levels and performance benchmarks. The investment policy is based on an "appetite for risk" not chasing "alpha" performance.

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Commission urges charities to embrace technology

Andrew Hind, chief executive of the Charity Commission, says technology offers hope for charities worried about balancing their books during the recession.

Speaking at the 2010 Conference of the Association of Charity Independent Examiners, Hinds urged charities to think creatively about how they could make use of advances in electronic communication to cut costs and improve their services.

He observes that the Commission had itself switched to providing more of its services online, in response to losing 30% of its staff members in six years.

Hind says: "By investing in technology, the Commission improved its services despite the cuts in funding. We have managed that because we've seen moving online as more than a cost cutting exercise. It's been a mission of conviction.

"Social networking, the 24 hour news agenda and instant access to information have shifted the power balance between providers and users of services. I think that's a good thing.

"I believe the digital age requires us to be more open, more democratic, more accountable. So I urge you, and the charities you work with, to also think about the ways you can cut costs and improve your services through technology."