

Building your charities long term resilience? Don't forget portfolio volatility

For charitable trusts who rely on the income generated from their investment portfolio reserves, a well-structured investment strategy is the winning ticket to building long term financial resilience.

And, you'd be forgiven if you thought the primary focus of said strategy should be on generating a sizable return. However, if you delve deeper you'll realise that it's managing portfolio volatility that lies at the heart of an optimal strategy.

What is volatility anyway? Volatility represents how greatly an asset's prices move around. Think of the new, rapid highs and quick, dramatic lows of the stock market as the assets moves erratically.

In practice, it's about understanding that two portfolios with the same level of return, but different levels of downside volatility, will deplete their capital at different rates, if a charity is drawing income from the portfolio.

Yet, it's all too common for small and medium-sized charities in particular, to invest solely with single-asset managers. Or, they buy off-the-shelf portfolios from wealth managers that are only superficially tailored to a charity's unique needs, because they are chosen from a small number of off-the-shelf options.

Volatility: A double-edged sword

Volatility as a metric represents the degree of variation in the value of the portfolio. Volatility essentially puts a figure on the fluctuations in the value (both up and down) of the portfolio over a specified timeline, reflecting the rapidity and size of these increases or decreases.

However, downside volatility narrows down this broad view by only concentrating on the negative side of these fluctuations. It's a risk measure specifically devised to assess the extent of losses a portfolio could potentially experience over a defined period. This singular focus on negative returns, or losses, gives investors valuable insights into the potential threats or risks associated with their investments. In essence, downside volatility hones in on the less desirable aspects of portfolio volatility.

Why lower downside volatility matters

You might think that, as long as a portfolio is generating the desired returns, the level of volatility can be taken with a grain of salt. But, when we consider long-term sustainability, especially for a charity relying heavily on its investment income and in a net negative cashflow position, the significance of volatility hits home.



So a charity must focus, not only on the potential returns, but also on the expected net cashflows and downside risk. A good portfolio is one that's more likely to generate steady, reliable returns. Rather than be able to generate the target return but does so with high volatility. You'll be on the right track by diversifying your charity's portfolio with assets that provide a balance between returns, volatility, inflation and liquidity.

Portfolio volatility and building charity resilience: a simulation

Now let's look at two charities each with their own projected simulations of portfolios. They both also spend around 5% of assets on their charitable mission while receiving no additional donations. Each of their portfolios offers the same return but with varying levels of volatility.

The first charity has Portfolio A. This portfolio has a higher level of downside volatility, meaning it experiences more frequent and severe negative returns, while the second charity has Portfolio B with a lower level of downside volatility.

Over time, the capital of Portfolio A will be more quickly depleted. On the other hand, Portfolio B will preserve its capital more effectively, extending its longevity.

Portfolio A - with high downside volatility

Here we have a portfolio with high volatility but we assume it exhibits typical expected return and volatility characteristics. However, the probability that assets run out increases significantly over the next 30 years when we project this portfolio forward. In half the scenarios for this charity, its assets are depleted within around 20 years.

Portfolio B - with low downside volatility

In Portfolio B we also assume the portfolio has the same expected return, but volatility around 2/3rds that of Portfolio A. Even though the return is the same as Portfolio A, the lower volatility ensures steadier, more reliable returns. As such, Portfolio B is more resistant to depletion and can sustain its capital for longer, less than 1% of projections were depleted after 20 years for this charity. And, only 6% after 30 years.

Key Takeaways

The key difference between these two portfolios, as illustrated by the graphics, is not the return but the volatility. The portfolio with lower volatility preserves its capital more effectively over time, thereby extending that charity's financial longevity.

These graphics underscore the need for a bespoke approach to portfolio design. In addition to focusing on returns, considering downside volatility could be the difference between sink or swim for a charity. By managing these factors, charities can maintain their purchase power and build financial resilience.

It is important that you believe you have been categorised appropriately and are comfortable with the implications of that decision. If your charity has been classified as a professional client you should be



receiving an institutional quality level of investment service and should be benefitting from the lower levels of fees and wider opportunities that an institutional investor would expect.

Cartwright Charitable Trusts is an experienced investment consultancy that deals only with professional clients. Please contact us if you would like to discuss how the Cartwright institutional quality investment offering can benefit your charity.

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