Rough Road Ahead
Alternatives to Help Navigate Common Association Risk

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COMPETENCY: BUSINESS

• The competency progression levels:
  – Level 1: Foundational
  – Level 2: Mobilizing & Power Building
  – Level 3: Agenda driving

• The themes that this presentation will address:
  – Learn to understand the importance of an effective investment policy
  – Learn to understand the use of fee benchmarking to control costs
  – Learn to understand what liability driven investing is and how it can be used as a way to control benefit plan risk
They’re all looking at you… the pension is underfunded. What choices are available for you to fix this?

• Dues
• Grants
• Investments

It’s likely that you can’t come up with more dues or grant money than you already have – this leaves the big one. Free money! Welcome to the casino…
What’s the best return on your dollar that you can think of?
There seems to be a problem with this plan, though, and here is a good time to talk about risk.
Risk and Return

Your return is inversely proportional to your risk. This poses a fundamental problem.

So what’s the acceptable amount of risk and return?
Luckily for you the answer is not yours alone.

Your investment plan document is meant to help guide the association’s answers to these questions.
What is my Financial Goal?

- What are you trying to accomplish by investing?

- Here are a couple of goals to ponder:
  - Savings not losing real value
  - Whether to hold pensions or OPEB obligations
  - Capital improvements and purchases
What’s the Difference?

• Why does it matter why I’m investing and what to invest in?

• Shouldn’t I just go for the highest return?
Conversely......

• What is the safest investment you can make?
  
  Cash!

• So why not leave it all in your checking account?
Inflation
(Represented by Pac Man eating your basis points!)
“Real Value” of Money

The “real value” of your money declines every day.

This means if you leave your assets as cash, you are losing them daily.
Highly Liquid Investments

But... there are a couple of times you may want cash-type investments.

Short term savings fits well with cash-type of investments.

Let’s take a look at a chart to see why........
What would happen if you had to withdraw your money in June vs. withdrawing it in July?
Which Brings Us to the Following Questions.....

• How long will I need to be funding this goal?

• Do I get to decide when to take cash out, or is it a necessity to have it in cash on a certain date?
How Important is Timing to You?

Accepting that generally equities are the highest yield investments,

- What is a realistic goal for how long to hold short-term equities?
- How about bonds?
Finally, a Third Point to Ponder.....

- How much are you budgeting to invest?

Some of this will be answered by your long-term budget and how much of a priority you are making these investments.

- Is it just “left-over” money being invested?
- Is it an annual funding of a multi-year goal?
Your Investment Philosophy
What Type of Investor are You?

- What is important to you as an investor?
  - Are you more of the “damn the torpedoes, full speed ahead” variety or...
  - The “look 6 times before crossing” type?

In other words, is your ultimate goal the highest return regardless of fees, wild swings or potential loss or are you more interested in a slow steady crawl up the growth ladder?
The Pull of Profit vs. The Pull of Safety

Freeze your expectations for a moment – the two appear mutually exclusive but really aren’t.

Obviously no one advocates playing craps with your savings, however we’ve talked about the dangers of hoarding cash.

So the middle is the best way.

BUT, there’s no avoiding the reality. Your philosophy is the pull of profit versus the pull of safety.
What’s Your View on Risk?

• No risk, no reward?

• What are you comfortable telling your board you lost?

• What are you comfortable telling your board you DIDN’T invest in if the market blows up?
Concept of Diversification

While one investment goes down in value, another holds its value and keeps you from losing it all.

Sort of like roulette – putting your money on a few red numbers but betting a chip on all black to balance your losses.
Diversification as Best Practice

- Universally acknowledged as best practice in investing
- But it is not immune to the effects of risk vs reward
- Always experiencing some opportunity cost for any dollar not invested in your highest yielding investment
- The level of diversification determines the level of risk
- All in equities? Half in equities, Half in fixed income? These are questions related to how you will be diversified.
Core vs. Non-core Investments
A Scenario

Let’s say you go to the casino. You have $1,000. You immediately win $500! Since you have all night to kill, you’re not going to quit now. You do, however, want to go home ahead so you put your initial investment, $1,000 and an additional $100 to stay ahead, into your pocket. You then gamble irresponsibly with the additional $400.

In this metaphor, the $1,100 in your pocket is the core investment, which you have in cash, while the $400 is your non-core investment, which is in equities.
Core vs. Non-core Investments
A Scenario - continued

- What strategies should you employ for each?

- Obviously core should be more conservative, but what does that mean for the non-core investment?
Importance of a Financial Advisor

- You are not expected to be an expert in investment management
- You are expected to have oversight over your financial advisor
- You are expected to monitor any fees or investment returns associated with the investment portfolio
Benchmarking as Best Practice

Benchmarks are goals to measure your investment returns against

- Common benchmarks include performance against:
  - The S&P 500
  - The Dow Jones Industrial Average
  - The Russell 2000 Index
Investment Fees

• Not all fees are created equal!

• Some investments are far more actively managed than others, and so you will pay higher fees

• Hedge funds are a good example of an “active management” style investment, and you pay higher fees accordingly
Investment Fees - continued

• Things to consider when choosing investments for your portfolio:
  • Types of fee arrangements – fixed fee vs. commission
  • What fee percentage would be appropriate?
Knowledge Into Action Scenario

You have a $30 million investment account entirely in equities, an underfunded pension, and 30 employees (in 3 groups of 10) who are going to retire in 5, 20, and 35 years.

What should you do?
Knowledge Into Action Scenario - continued

Group 1, has 5 years left before they party gloriously for the rest of their lives leaving the rest of us to suffer behind in years of endless drudgery, will use about $15 million of the $30 million account for retirement costs (per your actuary).

How will you invest this money?
Knowledge Into Action Scenario - continued

Option 1 – leave everything in equities

However, what are the chances that the $15 million stays worth that much?

Your actuary is also psychic, you will experience a stock market crash in 7 years.

So now what?
Knowledge Into Action Scenario - continued

Option 2 – Liability Driven Investing

You know what the cash payout for this group will be (and it doesn’t take a psychic to figure this out, merely a calculator). Therefore, you know what the cash flow will be.

Is there a financial instrument that can generate cash on a fixed schedule?

There is – bonds!
Knowledge Into Action Scenario - continued

So you convert the $15 million into bonds that are scheduled to pay on a monthly basis the same fixed schedule that you need.

Problem solved right? Well...
But First, What is the Rule of 72?

Rule of 72: Divide 72 by the rate of return of the investment. This is (roughly) how many years your money will take to double.

Example: Your stocks are earning 8%. $72/8 = 9$ years to double in value.
Knowledge Into Action Scenario - continued

Now you have the remaining $15 million left and 2 groups that EACH need $15 million (in all honesty you will probably need more but let’s keep it simple). Uh oh…..

So what do you do?
Is 20 years enough to double your money?

Probably – but not in bonds. So you know your rule of 72, assuming you get a 7% yield on your equities, realize it doubles in 10.3 years, and as soon as it does you convert over the NEXT group of bonds.
Glide Path

This is what’s known as a glide path – the plan to convert your equities (volatile!) into bonds (safe!) on a timed path in order to get to a desired value, then lock that value into a stable cash flow before it can dip again.
Knowledge Into Action Scenario - continued

Now, since you’re pros at this – tell me.....

What do you do with the third group?
Session Outcomes

• The content from this session can be used in the following ways in your current position/role:
  – Investment plans – does your association have one? Is it adequate? What risks does it pose?
  – Pension/OPEB – do you have the correct investments in order to provide the needed cash flows?
  – Budget – has anyone in your association dedicated a set amount to invest annually? Have you met those goals? What does that do to your future plans?
Please complete the evaluation for this breakout session!