FCLTGLOBAL

Risk Conversation Guide for Boards and Staff

TOOLKIT 2

To facilitate discussions about managing portfolios to both meet long-term objectives and weather short-term risks, FCLTGlobal, with input from its members, has developed this **Risk Conversation Guide** for boards and staff. We have provided illustrative answers to these questions, but these are not intended to be exhaustive or comprehensive.

OBJECTIVE AND STRATEGY SETTING

What is the purpose of the fund?

- Meet liabilities with minimal cash contributions
- Maximize resources for stabilization or development
- Contribute to an operating budget

What are our desired outcomes and key metrics of success?

- Absolute return
- Real absolute return
- Return relative to benchmark
- Return relative to peers

What is the ultimate time frame of the fund?

- Perpetual
- Time frame of liabilities
- Generational

What interim time periods are important for measuring success?

- Ten years
- Three years
- Annual

What are our most important investment beliefs?

- Returns over the long term are a product of fundamental economic drivers.
- Market prices deviate significantly from fundamental or intrinsic value in the short run.
- Market returns show short-term momentum but longer-term tendency for reversion to the mean.

Under what circumstances would we reconsider these investment beliefs?

- Prolonged market downturn
- Fundamental change in global trade environment
- Significant regulatory change

What are our unique characteristics as an investor? What are our strategic advantages and disadvantages?

- Ability to hold an investment over time and not be a forced seller
- Alumni body/location/history/staff composition
- Asset size that enables investments in small funds/requires investments in large opportunities
- Public profile that limits/enhances our ability to take long-term risk
- Tax status
- Fund maturity or net inflow/outflow status
- Investment skill in a particular area

What top-down preferences of the fund sponsor or beneficiaries do we need to accommodate?

- Home country requirements
- Incorporation of ESG factors

Do we have a clearly agreed-upon risk appetite statement?

- If yes, share and discuss
- If not, give rationale

Are we comfortable with the allocation targets in our policy or reference portfolio, and the ranges around or deviations from those targets?

- Policy portfolio targets, ranges, and rationale
- Current allocation and rationale

DECISION MANAGEMENT

Should we have a portfolio rebalancing policy?

- Yes, a rebalancing policy could mitigate the problem of investors “buying high and selling low” by committing to countercyclical behavior ahead of stressful events.
- No, we are using a different approach.

Should we use set-asides to earmark funds for upcoming outflow needs?

- Yes, investing money equivalent to upcoming outflows in short-term instruments provides confidence that the fund can meet those obligations in any market condition.
- No, there is no need, as the same result can be achieved without separating the portfolio.

Do we have lock-ups in our portfolio? If so, at what size and terms?

- Yes, lock-ups are common in certain asset classes and ensure continuity.
- No, we are not invested in locked-up portfolios.

How do we track the effectiveness of our strategic decision-making?

- Understanding which strategic decisions have added or subtracted value can provide discipline and assist investors in understanding their strategic advantages.

Do we present data effectively to frame our decision-making?

- The presentation of information affects the risk tolerance and long-term focus of institutional investment leaders.

What is our tolerance for outperformance or underperformance?

- Preselected interim performance or risk boundaries, positive and negative, inside which decision-makers expect to maintain their position, and outside which they expect to reevaluate their position

RISK ANTICIPATION

What are our top three to five long-term investment risks and opportunities?

- Market risk (e.g., rates, inflation, FX)
- Potential shocks (e.g., financial crisis, cyberattack)
- Long-term trends (e.g., climate change, demographics)
- Lower returns for longer periods

What short-term risks could derail us?

- Credit tightening
- Lack of liquidity

How do we envision and consider potential longer-term risks?

- Interactive simulation of risk scenarios

What risks do we choose to mitigate? What is the cost of mitigating these risks?

- Risk-dampening positions
- Costs of hedging

Are we being compensated for assuming these risks? Are there opportunities to benefit from these risks?

- Expected return for risk-taking investments
- Opportunities for additional risk taking

Under what circumstances do we expect our key investment strategies to underperform?

- Rising interest rates
- Extended market valuations

How do we anticipate that we will respond to significant risks?

- Recommit to current asset allocation
- Revisit investment beliefs and asset allocation

Do we understand the risk preferences of individual decision-makers within our organization or among our key constituents?

- Poll members on key investment assumptions and preferences
- Disclose risk expectations to key constituents

What level of loss would threaten our purpose?

- Level of risk taking necessary to fulfill our purpose or meet expected return targets
- Level of loss that would threaten our ability to fulfill our purpose

Are our non-investment sources of inflows or outflows correlated to any of these risks?

- Tax receipts
- Charitable contributions
- Stabilization fund requirement

RISK AND PERFORMANCE MEASUREMENT

What measures of risk are most important to us? Why?

- Volatility
- Peak-to-trough drawdown
- Shortfall relative to desired expected return outcome

How are we emphasizing performance over long-term time periods?

- Framing performance from long- term to short-term time periods
- Highlighting rolling multi-year performance

How are we measuring performance against desired expected return outcomes?

- Showing performance relative to long-term outcome
- Emphasizing progress toward goal rather than short-term fluctuations

Are we making a clear distinction and trade-off between drawdown risk and shortfall risk?

- *Drawdown* is a loss relative to the original investment or peak or interim valuation; *shortfall* is the end-of-period gap between value and the intended outcome.
- There is a trade-off between the likelihood of experiencing a drawdown and the chance of not having a shortfall.

Are we prepared to take the short-term losses required to meet our expected return targets?

- Are our expectations for long-run returns internally consistent with our expectations for losses during the investment horizon?

ORGANIZATION

How do we organize ourselves as a long-term investor to manage risk and opportunity over multiple time horizons?

- Governance
- Staff recruiting and development
- Incentives and rewards

How do we create and maintain a long-term risk-taking culture?

- Expectation setting
- Communications
- Diversity
- Compensation

How do we ensure that our purpose statement, investment beliefs, and perspective on our strategic advantages guide our behavior?

- Incorporation into investment decision process
- Inclusion in performance evaluation

What decisions regarding risk are made by the board, the staff, and external managers?

- Board level
- Staff level
- Manager level
- Others

How do we measure success to reward staff?

- Fund level
- Asset class level
- Portfolio/manager level
- Security/deal level

If the organization increased your budget significantly, how would you use those additional resources, and what shortcomings would you address?

- Additional or different staff
- Upgraded or new systems
- External expertise or consulting

BLIND SPOTS

What keeps you up at night?

- Operational or uncompensated risk
- Other unanticipated risk

What topics did we miss in this discussion?