The 10 Essential Elements of Investing

Essential Element 1
Start with why

Beaver Investing

The investment guide for Canadian foundations and charities
Third edition

Written: February 1, 2019
Updated: April 30, 2020

The 10 Essential Elements of Investing is an investment guide that explains the principles of investing for charitable investors. The guide is designed to help charitable investors understand and reflect on the 20% of investment concepts that explain 80% of what they need to know. By sharing the essential elements of investing, we want to help Canadian foundations and charities not only own their investment program but also learn and grow with others as part of a larger movement – a movement that improves how Canada invests for the public good.

This first part in the guide covers the Discern phase (discerning whether and why to invest), while later we explore the Invest phase (planning the investment program) and the Govern & Lead phase (owning the investment plan and building leadership capacity for long-term success).[1]

Discern	Invest	Govern & Lead
1) Start with why	2) Set the mix	8) Own the plan
	3) Diversify	9) Build inside
	4) Simplify	10) Build outside
	5) Balance risk	
	6) Control cost	
	7) Use time	

In this first part of the guide, we will discuss the organization's purpose and objectives, before proceeding to investment objectives.

Organization's purpose

Investment planning should be aligned with an organization's purpose and objectives, rather than carried out as a stand-alone exercise. For organizations to check that their purpose makes sense, they can review their strategic plan or annual report.

The key question about purpose is simply: Are we in the right business? For right, think the next 10 years. For example, a community agency might decide that it is in the business of alleviating poverty and focus on providing food banks. If, however, the agency decides that it is in the business of increasing opportunity, then it might focus on delivering workshops related to career skills or entrepreneurship. How organizations frame their purpose can imply quite a different range of programs and activities. There is a sweet spot for purpose that is hard to define or recognize – not so broad that people are confused about why the organization exists, but not so narrow that it prevents the organization from evolving to serve the needs of its constituents.

Complex organizations, ones that deliver a range of programs or serve a variety of people, will benefit from taking the time to reflect on their purpose. Without a clear purpose, it is unlikely that the organization's objectives will be achieved to their full potential.

Organization's objectives

Organizations can have a clear purpose but this does not always result in clear objectives. In Canada, charities have a regular check-in on their objectives when they prepare their annual report or tax return. They also outline their objectives when they prepare a business plan, apply for government funding or seek foundation grants. Check that the objectives make sense, by comparing them with the organization's programs and activities. The logic model should be clear: if we carry out these programs and activities, then we will achieve these objectives. Again, many organizations will have objectives that align with their purpose and that are supported by their programs and activities. Complex organizations will benefit from taking the time to reflect on their objectives, since the investment program will help the organization meet these objectives over the long term. Without clear objectives for the organization, it is unlikely that the investment program will deliver its full value.

Investment objectives

Having reviewed the organization's purpose and objectives, we now turn to investment objectives. Below we outline five high-level checkpoints for investment objectives. By going through these checkpoints, organizations can gain clarity on whether it is appropriate for them to invest. If there is a case to consider investing, then they can use this pre-plan to develop a detailed investment plan (see Essential Element 8: Own the plan).

Time horizon

Enter the organization's time horizon. Many organizations will have a perpetual time horizon, although some organizations might find themselves in a special situation, where for example they expect to wind down within a few years. The shorter the time horizon, the more carefully the organization should manage the risk of short-term loss.

Role of investments

Analyze the size of investments, relative to other assets and sources of income. On the statement of operations, what proportion of total income is derived from investments? The higher the proportion for investments, the more carefully the organization should manage the risk of short-term loss.

Required return

Historical annual return: Estimate the historical annual return over a reasonable length of time, say the last three years if holding cash or the last 5-10 years if holding stocks and bonds.

Required annual return: State the minimum acceptable annual return to maintain capital value and support a basic level of spending. As a guide, we suggest the organization's spending rate plus inflation and investment costs. For the spending rate, take the organization's average annual spending rate over the last three years. For inflation, an estimate is the midpoint of the Bank of Canada's current target range for inflation (the range is 1-3% and the midpoint is 2%).[2] For investment costs, calculate the organization's average annual costs over the last three years, including investment management fees, holding costs and transaction costs (see Essential Element 6: Control cost).

Gap analysis: If the historical annual return has been less than the required annual return, indicate the impact this has had on the organization (e.g. reducing or deferring spending in certain areas, together with reducing or eliminating provision for inflation). If this gap were to continue to exist, what would be the implications, over the short and long term?

Cash commitments

Enter any committed or anticipated cash outflows, by year for the next three years. This will provide a sense of whether the spending rate is increasing, decreasing or staying the same. The higher the level of spending, particularly committed spending, the more carefully the organization should manage the risk of short-term loss.

Risk control

Maximum annual loss: Enter the maximum loss that could be sustained in any one year without having a serious impact on the organization's long-term objectives. State this as a percentage, while also calculating the amount in dollars, since the latter can give a more realistic sense of willingness to accept risk. For clarity, the maximum annual loss is the year-end loss, measured from the start to end of the year. As an example, if an organization has $10 million at the start of January and is not willing to have a balance of less than $9 million by the end of December, then the maximum annual loss would be 10%. The intra-year loss could be higher, potentially much higher. To continue the example, the organization's balance could decline to $8 million by the end of September, only to recover to $9 million by the end of December. In this case, the intra-year loss would be 20%, although the maximum annual loss would still be 10%.

The maximum annual loss will be informed by the organization's time horizon (point one), the proportion of investment income (point two) and the level of cash commitments (point four), among other considerations. For more details on establishing a risk tolerance, see Essential Element 5: Balance risk.

Recommendation

Based on the above five checkpoints, organizations can prepare a recommendation on whether there is a business case to consider investing, sufficient to develop a draft investment plan. The actual decision to invest would be based on the board's engagement with the draft investment plan (including making changes to reflect any questions or concerns) and the board's approval of a final investment plan.

Recommend if there is a business case to consider investing, sufficient to develop a draft investment plan:

- If yes, proceed to develop a draft investment plan. Indicate why there is a strong enough business case to consider investing.
- If no, do not proceed to develop a draft investment plan. Indicate why there is not a strong enough business case to consider investing.
- If undecided, indicate any questions or concerns to be addressed.

Conclusion

To summarize the process of discernment, we have reviewed the organization's purpose, confirming that it still applies; reviewed the organization's objectives, confirming that they are aligned with the organization's purpose, while also supported by its programs and activities; reviewed the investment objectives, confirming that they support the organization's objectives; and provided the basis for a recommendation on whether or not to consider investing.

For some investors, reviewing the organization's purpose and objectives are optional steps, included at a late stage of investment planning, if at all. For the foundations and charities that exist to serve society, however, these steps help to ensure that they are clear on why their organization exists and what it seeks to achieve. We have made these steps the first part of this investment guide, not the last. This enables us to reflect on purpose and objectives throughout The 10 Essential Elements of Investing. Next, in Essential Element 2: Set the mix, we will explore how to set the asset mix – the blend of stocks, bonds and cash in the portfolio. Since asset mix is the bedrock decision of investment planning, this provides an effective transition from the why of investing to the how.

[1] This first part in The 10 Essential Elements of Investing is inspired by the book of the same title by Simon Sinek, *Start with Why: How Great Leaders Inspire Everyone to Take Action* (2009).

[2] For more details on inflation, see Essential Element 2: Set the mix.