INVESTING YOUR RESERVE FUNDS

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It is typical for a trade association or a professional society to build up a reserve fund in order to protect the association or society from unforeseen expenditures and enable the organization to react positively when there is a need to move forward and fund a project that was not anticipated when the group developed its annual budget. As the organization's reserve fund builds in size, most organizations establish an investment advisory committee to make recommendations to the Board of Directors regarding how the reserve funds should be invested. Once the reserve fund moves into six figures, the investment advisory committee usually hires a professional investment advisor to make recommendations as to how to invest the reserve funds.

Since the Board of Directors of most tax exempt organizations recognize the strict fiduciary duty of care required in investment management decisions, the Board will generally direct the investment advisory committee and the investment advisor not to take significant risks with the reserve fund portfolio. Depending upon the size of the reserve fund, most tax exempt organizations adopt a policy where an amount equal to approximately one year's dues is invested in very conservative, no risk type investments. If there are additional monies beyond this first level, the additional funds will be invested in somewhat riskier but still conservative type of investments.

Once the investment advisory committee discusses the organization's investment strategy with the investment advisor, the investment advisor will come up with a plan of how to invest the organizations reserve fund. The plan will specify the nature of the recommended investments, the anticipated revenue from said investments, and the relative risk involved in each investment, and how such investment fits into the total investment strategy.

I have had the opportunity to sit in on the presentations of many investment advisors to association Board of Directors and investment advisory committees. These presentations follow a somewhat standard format. The investment advisor provides each member of the Board of Directors or each member of the investment advisory committee with a written handout. The handout is put together on glossy paper and includes multi-colored pie charts, graphs, and tables. The presentation describes the overall need to invest conservatively, to maintain diversified investments, to get a competitive return on the investments, and to minimize risk. With regard to each type of investment, the growth of the investment will be compared to one of the standard indexes. As an example, if you have a certain amount of your portfolio invested in small cap funds, the growth of that investment will be compared to the growth of a well-known small cap fund index.

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The investment advisor will generally conclude that if each segment of the portfolio performs as well as the index for that type of investment, the investment advisor should be deemed to be successful.

At this point, the investment advisor begins reviewing various holdings of the portfolio. Some investment advisors seem unwilling to invest in the major fund families. They take the position that the well-known fund families such as Fidelity, Janus, Vanguard, etc. are for the unsophisticated investor and that they know of funds with better performance histories. As a result, many of the investments that they make cannot be found in the daily newspaper business section listing and you have to go online to see how your association investment is performing. Other investment advisors may recommend as conservative investments, bond funds that include some ultra conservative bonds but also some "junk" bonds. The argument is presented that the junk bonds represent only a minor portion of that fund and enable the investor to have some upside beyond the ultra conservative return.

Only at the end of the presentation of the investment advisor, do you get to learn the actual portfolio performance. And here, is the problem and the lesson of this column.

After going through the lengthy procedures and analysis described above, the investment advisor will probably report that he/she is pleased to announce that this year, based on the investment policy adopted by the Board; the investment advisor has grown the association reserve fund by 5.25% or some similar percentage. It will be explained that of the many types of investments within the portfolio, some type of investments are up, some type of investments are down, but by diversifying, the investment advisor was able to achieve the overall growth of 5.25%. Finally, the investment advisor will complement the investment advisory committee and the Board for being able to achieve that level of growth at a relatively low risk.

Hello? Is anybody home? The organization, the staff, the investment advisory committee, the Board of Directors, and indeed the investment advisor, have spent countless numbers of hours to come up with a 5.25% return on an investment at "very little risk." However, if you go online and look at interest being paid on CD's or money market accounts by FDIC insured banks, you will find interest rates of 5.25%. Am I missing something?

If the success of my organization's investment in small cap stocks or small cap funds is going to be measured by comparison to a small cap index, why don't I just buy a no-load small cap index fund? I guess I am old fashioned; it is my belief that an investment advisor should bring value to the table. If that value is defined as being able to perform at the level of a sector index fund or at the level of a bank money market or CD rate, what is the value bring brought to the table. Think about it.

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