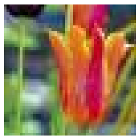


CREATING A STRATEGIC INVESTMENT POLICY

In CC14, "Investment of Charitable Funds: Detailed Guidance", the Charity Commissioners state that "any investment policy" should address four issues - "the creation of sufficient financial return to enable the charity...to carry out its purposes", "the maintenance and, if possible, enhancement of the value of the invested funds", "the management of risk" and "the charity's stance on ethical investment (if any)".

Against this background, the most appropriate investment policy for any individual charity will be rooted in its charitable objectives as reflected in its medium-term financial plan and reserves policy.

Charities need a medium-term financial plan in the same way as any other organisation and all charities are required by the Charity Commission to have a reserves policy. Only if their objectives and activities are translated into their financial plannings can trustees determine the optimum use of their resources and make choices between competing priorities.

As a first step, this plan will identify likely working capital needs over the period. Funds required for working capital are generally best kept on deposit or invested in very short-dated money market instruments or bonds that are quasi-cash in character. It is generally unwise to expose them to investment risk since the charity cannot afford the risk of a stock market setback that may result in having to sell investments at a loss.

As a second step, the plan will identify major capital projects in the years ahead, probably dividing them between "definite" and "possible" projects. Here again, there will be limited scope for taking investment risk with funds earmarked for these purposes. Better to suffer an opportunity cost in terms of foregone stock market gains than to find that a project important to the charity's work is no longer affordable because the capital has been denuded, however temporarily. It may be that rather longer-dated bonds or money market instruments are appropriate but equity investment is likely to be too dangerous. History suggests that it is probably unwise to devote funds to equity investment unless they can be left undisturbed for at least five years and ideally longer.

As a third step, the plan will identify the remaining funds that are either prudential reserves that are surplus to currently foreseen requirements or monies which must be devoted to long-term investment by virtue of being permanently-endowed funds. Whereas funds set aside for working capital purposes or to cover planned or possible capital commitments have the character of liquidity or contingency reserves, this third category of funds can be considered as the charity's long-term funds.

Even in this category, gradations of risk will apply. There is no question that equity investment is suitable for permanently-endowed funds, but where other funds are held in reserve it is advisable to consider the nature of the risks that might result in a call on these reserves.

For example, some charities hold reserves against the possibility that legacies or donations may run beneath budget. Others may hold reserves against the possibility of disappointing sales in their charity shops. In both cases these risks are more likely to crystallize in an economic recession and the charity may well find that it has doubled-up its risk rather than reserved against it if it has invested all the reserves in question in equities.

Investment planning can be bedevilled by inflation risk. The very investments that in theory were the most dependable after cash and money market instruments – bonds – can, in practice, be the riskiest in terms of inflation. Investors must always be on their guard against a resurgence of inflation.

In normal circumstances, bonds yield more than cash in recognition of the fact that a bond issue ties money up for a longer period than a cash deposit. Therefore, a charity might well be tempted to consider investing all its long-term funds in bonds in the knowledge that it is securing a higher return than cash on deposit and, providing it has bought bonds standing at or below par, is assured of payment of the loan upon maturity.

However, this is where risk, diversification and balance come into play. Trustees must balance current needs with future requirements. Even a 2.5% inflation rate halves the value of money over twenty-seven years, so investing exclusively in bonds favours current beneficiaries of the charity's work the detriment of future potential beneficiaries. The informal surveys we have carried out suggest that most charities estimate that the cost of providing their services is rising at more than 5% per annum. In such a scenario, a charity's assets left in the bank or invested in a gilt will actually be worth about 80% of what they are today in just 5 years time and just 60% in ten years time as Table 23.1 demonstrates.

In any case, as shown on page 16, equities have given an average annual return significantly higher than that of gilts over a long-term period that has included dramatically differing levels of inflation and there are good reasons to think that this will continue to be the case more often than not. Opportunity cost is undoubtedly much easier to tolerate than actual loss but at what point does caution become excessive?

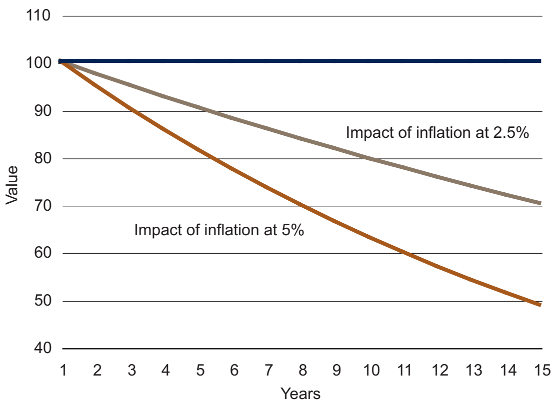
Happily, charity trustees do not need to wrestle with these sorts of questions beyond a certain point because the law recognises that no-one can foresee the future and the Charity Commission prescribes diversification as the best way of managing these risks. Charities with long-term funds should hold a variety of different investments provided that each is judged suitable. Portfolio planning is simply a question of mixing them to achieve the most appropriate balance.

For the vast majority of charities, at least part of the return generated by their investments will be spent on providing the services they were set up to nurture. Indeed, in the case of many endowment funds, this source of money will be the only resource they have to achieve their goals.

Given that the majority of charities intend to continue providing their services well into the future, balancing the needs of today's beneficiaries against those of tomorrow is an important act; a requirement to produce as much spending money today while maintaining the "real" value of the assets such that they can provide as much spending money in 10 or 15 years time. While some charities still have permanently endowed capital, the majority of charities can choose to spend both capital and

23.1

Impact of Inflation



Source: Sarasin & Partners LLP

income. This means that in addition to deciding how much can be spent, trustees need to decide whether they will adopt a total return approach to their withdrawals or whether they will confine themselves to the dividends, coupons and interest that their investment portfolio produces.

The concept of total return is an emotive one, but the following issues should all be considered when making the decision.

Table 23.2 shows a multi-asset portfolio where the underlying investments are producing an average yield in-line with that of the relevant index, together with a premium income variant of the same asset allocation. The second portfolio is producing much more income but the trustees choosing this policy need to ask themselves what risks are being taken to achieve the extra income.

There is likely to be a bias towards some of the higher yielding sectors (and a commensurate under-investment overseas and in lower-yielding sectors). Equally, given that higher-yielding assets are priced that way because the assets are deemed to be less attractive than others in the same asset class, the portfolio is probably of lower quality too. Trying to achieve high levels of immediate income will also mean avoiding certain low or nil-yielding asset classes, and the resultant lower levels of diversification may give rise to a more volatile total return.

23.2
Using 2009 Total Returns %

Asset Class	Portfolio Weightings	Portfolio A Average Yields	Portfolio B Premium Yields
Bonds	15%	5.0	6.0
UK Equities	50%	3.2	3.8
Overseas Equities	25%	2.0	2.4
Property (IPD)	10%	6.5	7.8
	Portfolio Yield	**3.5**	**4.2**

Source: Sarasin & Partners LLP

The alternate route would be to adopt the first portfolio, but to supplement the more meagre yield with a little capital. Theory would suggest that this portfolio will produce the better (bigger and less volatile) total return.

Given that the importance of working out precisely how much a charity can afford to spend is such an important one, it is covered in more detail starting on page 107 in the chapter entitled The Significance of Income.

Ultimately there is no correct answer to this conundrum and the picture is muddied by the fact that investors have been able to have their cake and eat it over the past twenty years in the UK. The yields of UK assets have fallen fairly consistently since the early 1980s (see Table 1.8 on page 22) accompanied by a contraction of yields within each asset class too. As the economic cycle has become less volatile, investors have demanded a lower return from higher risk (higher yielding) assets relative to high quality (low yielding) assets. Consequently, data shows that high yielding strategies have not only produced more immediate income but have also performed better from a capital perspective too.

At Sarasin & Partners, we typically invest on the basis of partial total return. Specifically, we feel uncomfortable if income makes up less than 75% of a charity's spending policy. So given our projected total returns set out on page 99 in table 15.2, that probably means spending about 4.5% per annum (if one wants to maximise spending on today's beneficiaries) and of this, about 3.5% should come from income.

Lastly, there are two aspects to arriving at the most appropriate balance for the investments of long-term funds at any one point in time - one is strategic and the other is tactical. The correct strategic asset mix will be rooted in the circumstances of the charity and

EDITOR'S NOTE

Current Market Conditions

In 2007, we wrote that

> "Competition for risk assets has led in recent years to an unusually narrow yield "spread" between low-quality assets and high-quality assets and indeed between high-yielding asset classes and lower-yielding asset classes. This suggests that risk may be mispriced and that investors should be cautious of owning higher-yielding assets. This is an important consideration for charities seeking to maximise income and suggests that a total return approach that focuses on income growth rather than high initial yields is more likely to deliver the best results over the years ahead: investors wishing to withdraw the maximum expenditure from their portfolio while allowing the capital to grow in real terms may well be better rewarded by topping up the natural income stream that their portfolio provides with a little capital rather than sweating the assets for the maximum amount of income today."

Given the dramatic under-performance (and distribution cuts) from a number of high-profile income orientated funds, we feel this warning has been justified. Looking forward, matters are less clear in early 2010, but we would still see significant risks in pursuing higher-yielding assets, particularly in the UK.

may well be reflected in the performance benchmark given to the charity's investment manager. This strategic or natural asset mix will be that judged most likely to produce the optimal result for the charity in "normal" market conditions in the light of its tolerance for risk. It will marry the circumstances of the charity with the characteristics of all the investments available to it as described in the first section of the Compendium.

By contrast, the correct tactical asset mix will be the asset mix likely to make the most of the immediate market environment. This is generally a judgement for the charity's investment manager to make within the constraints of the discretionary powers granted to them by the trustees. Quite often, the investment manager may judge that the correct tactical mix differs temporarily from the correct strategic mix. In instructing their investment manager, the trustees will need to decide the extent to which the manager is permitted to subjugate strategy to tactics.

In the final analysis, financial markets are volatile and determining the most appropriate investment policy for any charity is a matter of judgement. Provided that the trustees have conducted a proper planning exercise, taken professional advice where appropriate and acted on an informed basis, they will have discharged their duties properly.

There is no single correct answer and different fund managers and trustees have different ways of tackling the same problem. However, most investment managers are trained in asking the appropriate questions of trustees such that together they can draw up plans that will generate the returns that the trustees require in a manner with which they feel comfortable.

We hope that the Sarasin & Partners Compendium will prove helpful in this work.

EDITOR'S NOTE

Target Return Investment

When reviewing different asset allocations from a quantitative perspective, little if anything is factored in for "alpha" or a fund manager's ability to out or underperform a particular index or asset mix. Models assume index performance, no active tactical asset allocation or for that matter derivative overlays or leverage.

In the real world, all of these tools can be deployed by your investment manager and this complicates matters.

There are those trustees who are willing to give their investment manager significant freedom to try and avoid some of the worst attributes of a given asset class. The chapter on Hedge Funds draws out some of these techniques and some hedge fund managers have been able to produce very consistent and attractive returns: why not have the charity's entire portfolio managed in this manner?

For every manager that succeeds, there are many that fail and few trustees would feel they were following the Charity Commission's guidelines on diversification or suitability if they placed all their investment in this particular basket.

However, there is an increasing number of strategies designed to benefit from many of the techniques employed by the hedge fund community while still relying heavily on the conventional investment management wisdom of multi-asset class portfolios and diversification. *continued . . .*

EDITOR'S NOTE (continued)

One such style of management is often described as Target Return Investing.

While most conventionally-managed investment portfolios have been designed with a target return in mind, in the main these are long-term targets (7-10 years or longer) and there is an understanding that any individual year's return may differ significantly from the desired rate.

What marks a specialist target return mandate out is that it strives to achieve its return in a more consistent fashion with less volatility than would be associated with such a figure. This will be reflected in the investment objective, which will not only designate an amount (for example RPI Plus 4.5% or LIBOR Plus 3% per annum) but also that this will be achieved consistently over a relatively short time frame, say rolling 3 or 5 year periods.

When one looks back at the tables showing the long-run returns for various asset classes, it is clear that to achieve these types of risk and return results, the fund manager will be required to do something a little out of the ordinary, which will typically be one or a number of the following:

- a wider than usual range of assets
- more active asset allocation between the asset classes within wide ranges
- significant use of derivatives (for portfolio insurance and structured products)
- leverage
- short-selling and "pair" trades
- unconstrained (rather than benchmark-aware) stock selection.

When compared to a conventionally-managed relative-return mandate set within relatively narrow strategic parameters, the latitude one needs to give a target return manager is likely to be much greater. Understanding how the fund manager intends to operate, and the ability to deconstruct what it is that is going to drive the mandate's performance, is going to be very important.

Specifically, in the light of a fund manager's historic record, trustees need to decide whether the fund manager's claim to achieve their goal is plausible or not.

While a few truly excellent fund managers can show a record of RPI Plus 4.5% over rolling 3 year periods, the vast majority cannot. Most of these records belong to rather opaque hedge funds.
In finding a record this good, one is likely to "discover" an awful lot of inferior returns in the process, hence the tendency for a "fund of funds" approach to investing in hedge funds.

In terms of finding managers who can provide RPI Plus 4.5% over rolling 10 year periods, there should be a great many. History would suggest that most of the time, this really shouldn't be too hard a mandate to manage and probably would not qualify as a true target return mandate.

And RPI Plus 4.5% over rolling 5 year time frames? This clearly requires something a little unusual, but is well within the realm of the possible. In deciding whether it might be right to invest some or all of your money in this fashion, the question that needs to be asked is the extent to which you should rely

continued . . .

EDITOR'S NOTE (continued)

on a fund manager's ability to drive returns, as opposed to the time-honoured tradition of letting the markets do most of the work and "weathering" any short to medium term volatility.

To conclude, the main difference between a target return mandate and a conventionally managed mandate is the degree to which an individual manager will try to improve on the natural underlying characteristics of the asset class(es) in which they are investing. This requires investors to have a little more faith in the investment manager's talent than might be the case with a conventionally-managed mandate where the market is doing more of the work.

Unsurprisingly, investment managers that pursue such investment objectives charge higher fees for their services, often with an element of the fee being linked to the performance of the investments.

Table 23.3 looks at some of the different characteristics of different styles of investment management, from the extreme of the hedge fund manager to the more constrained conventional methodology of the long-only manager.

23.3
The Anatomy of Different Mandates

Mandate Type	Old Style Peer Group Benchmark	Endowments Model	RPI Plus Mandate	Hedge Fund of Funds
Measurement	Market Oriented Benchmark	Market Oriented Benchmark	RPI Plus 3 to 5% Benchmark	Cash / RPI Benchmark
Investment Objective 1	Real long-term capital and income growth	Real long-term capital and income growth	Real long-term capital and income growth	Real long-term capital and income growth
Investment Objective 2	Outperform benchmark	Outperform benchmark	Absolute returns over rolling periods of 3-5 years	Absolute returns every year
Investment Objective 3	N/a	Lower Volatility	Low Volatility	Lowest Volatility
Tactical Asset Allocation	Narrow (+/-5%)	Wider (+/-10 to 15%)	Very Wide	No Limits
Proportion of Return: Beta (structural/markets)	85-95%	75-85%	50-60%	0-30%
Proportion of Return: Alpha (fund manager skill)	10%	20%	45%	85%
Expected Annualised Return after costs	7-8%	7-8%	5.5% to 7.5%	7% to 10%
Positive Return Expectation / Objective	Rolling 10 Year Periods	Rolling 7 Year Periods	Rolling 3-5 Year Periods	Every Year
Fees	0.3 to 0.6%	0.4 to 0.75%	0.75 to 1.5%	4 to 5%

Source: Sarasin & Partners LLP