How to approach investment in a challenging market environment

The aim of this paper is ensure that charity trustees understand how they need to adhere to the investment measures under by the Trustee Act 2000 and related guidance from the Charity Commission (CC14).

Trustee Act 2000: A background

Most practitioners, led by the legal profession, agreed that the previous laws as governed by the Trustee Investment Act 1961 (together with subsequent amendments) needed major reviews to reflect a rapidly changing investment arena. Although many charities had governing instruments that allowed them to invest otherwise, many did not, and for them the 1961 Act provisions were restrictive and permitted 'wider' and 'narrower' range of investment choices to help provide investment guidance and protection to trustees.

The 2000 Act removed these restrictions and broadly placed all charities and trustees on the same level playing field. This is summed up under the *General Power of Investment* which states (subject to certain restrictions):

> *"A trustee may make any kind of investment that he could make if he were absolutely entitled to the assets of the trust" (Section 1; Part II)*

This was rightly seen as a significant change and warranted other clauses which imposed further trustee responsibilities to help safeguard underlying beneficiaries. Trustees always have a general duty of care but a new statutory duty of care was introduced requiring trustees to:

> *"……exercise such care and skill as is reasonable in the circumstances, having regard in particular:*
> *(a) To any special knowledge or experience that he has or holds himself out as having; and*
> *(b) If he acts as trustee in the course of a business or profession, to any special knowledge or experience that is reasonable to expect of a person acting in the course of that kind of business or profession"*
> *(Section 1; Part I)*

As a further aid in this process, trustees must consider and adhere to the *"Standard Investment Criteria"* to ensure that investments are both suitable and provide adequate diversification.

Clearly the aim of the 2000 Act was to move from a rigid and restrictive investment approach which provided protection to trustees and beneficiaries, to one which gave greater freedom to adapt to changing investment patterns but crucially, one which placed a greater burden of care onto the trustee. Importantly it allowed greater powers to trustees to delegate investment on a discretionary basis to investment managers and allow greater use of nominee services. There has been a strong adoption of this trend following the introduction of the Act but trustees need to be mindful that the overall responsibility of duty of care rests with them and they need to demonstrate how this is carried out, particularly in the light of how global stock markets have performed over the last ten years.

Investment Policy Statement

One of the best ways to demonstrate this is via the effective use of the Investment Policy Statement. Indeed it is a requirement of the Trustee Act 2000 that all charities that choose to delegate the investment function to an investment manager have a policy which is clearly stated. Whilst all contractual agreements between trustees and investment managers should have an investment policy (usually referring to investment objectives between capital and income together with an approach to risk and any investment restriction), this can be used as a starting point to include more detailed information that trustees can use to demonstrate that sufficient monitoring is in place and that they are therefore carrying out effective duty of care.

Whilst it is the responsibility of the trustees to draw up the investment policy, it is advisable to discuss this with the investment manager as it needs to be workable on both sides to be successful. Factors that trustees may wish to consider include:

- Attitude towards risk
- The need to provide an appropriate financial return to enable the charity to carry out its purposes. This may include reference to specific income and capital requirements in real terms
- Ethical considerations
- Appropriate performance measurement and benchmarking
- Approach to asset allocation
- Reporting process and demonstration that investment manager is meeting the trustees requirements with regard to the Standard Investment Criteria

Given the volatility demonstrated in investment markets in recent years, it is important that the statement is regularly reviewed and adequately reflects the charity’s need particularly with regard to risk.

The changing investment background

It is a test of any good legislation that it can be applied to a range of events. From an investment perspective the background over the first ten years of its enactment surely provides that test, ranging from the aftermath of the ‘dot-com’ bubble to the near collapse of much of the global banking system and threats to sovereign stability.

We believe that the Trustee Act 2000 and related guidance from the Charity Commission (CC14) is well structured to provide the necessary flexibility to meet the challenges of increased volatility. Put another way, the previous rigid rules would probably have led to severe pressures on investment performance for many charities. It is worth looking at the main asset groups and the issues faced in recent years.

Fixed Interest

- UK Government securities (gilts) historically regarded as a defensive asset with attractive income yields. They have traditionally formed a solid core of most portfolios.

- However the current low interest rate environment has pushed prices higher and income yields are no longer as attractive. In addition the defensive qualities have been called into question as a result of potential credit downgrades.
- This has led to a greater investor interest towards corporate and overseas bonds which has have gone some way to replacing income from lower yielding conventional gilts. However it is important to monitor the overall risk profile that bonds now offer.
- Another important consideration is the requirement of many charities to maintain capital and income in real terms (i.e. after allowing for inflation). As a result index linked securities have grown in importance and now sit along side gilts and other bonds in a portfolio.

UK Equities

- Equities offer the prospect of above inflation returns in both capital and income over the longer term. However this generally comes with a greater risk profile relative to fixed interest securities.
- Although not a new phenomenon, this risk of holding equities has been amply demonstrated in recent years. Indeed little comfort will have come from the previous regime when investment was restricted to "trustee status companies" – i.e. those with a sustainable profit and dividend record. This was highlighted by BP in 2010 when it cancelled its dividend payments, following on from the near collapse of some of the major banks in 2008 and 2009.
- The freedoms allowed by the Trustee Act 2000 have encouraged greater diversification and hence helped cushion some of the impact of volatility.

Overseas Equities

- Only 25 years ago, charities were effectively prevented from dealing in many overseas equity markets as the law sought to protect them from inefficient dealing and settlement operations. However this is no longer the case and most now offer excellent electronic transaction and nominee services. The ability to deal in global markets with this confidence has been another important development in achieving adequate diversification.
- Indeed it could be argued that the UK equity market has become too biased towards certain key sectors (e.g. oils, mining and banks) which itself encourages greater volatility. Access to newer growth areas such as China, India and Brazil can provide a useful balance to the traditional and more mature economies of the West.

Alternative Assets

- This covers a range of assets which aim to provide different risk/reward profiles to equities and bonds and which, in theory, offer further diversification. These generally range from Hedge and Absolute Return Funds to Property, Commodities and Currency exposure.
- More recently structured products, which utilise derivate instruments to synthetically manipulate market risk, have emerged to sit alongside the more traditional assets with the aim of improving the overall risk-return balance.

The above gives examples of how the investment marketplace has evolved in recent years. The freedom granted by the Trustee Act 2000 will allow charity trustees to access many if not all of these assets. However they need to be fully aware that with freedom comes a greater burden of duty of care. It is for this reason that whilst delegation of investment responsibility may be appropriate, so will the requirement to monitor and place effective controls on investment managers via the investment policy document. The ultimate responsibility rests with the trustees.

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