CAMRADATA

Charity Investing Roundtable

Investment Solutions for Charities

June 2018

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+44 (0)20 3327 5600
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Introduction

As charities can have very different investment needs to other investors, particularly in terms of the certainty, size and nature of their future income and expenditure, the issues charities can face and how to yield better outcomes and avoid a "one size fits all" solution is paramount.

Failing to adopt a robust, tailored investment strategy could be one of the most expensive mistakes a charity makes and at a time of fragile economic growth and tight public funding, charities must work harder than ever to maximise the return on their investments.

The third sector also faces intense scrutiny of its finances, particularly after media coverage of charity remuneration over the last couple of years, plus highlighted examples of the failure of entities such as the Kids Company, shows just how serious the impact can be of shortcomings in financial and governance controls.

Moreover there has been a considerable amount of change in the charity investment management sector over recent years with firms merging or being sold, key people moving jobs and certain firms all but withdrawing from offering charities investment advice or discretionary services. There is now a higher burden of responsibility on regulated firms to treat their clients fairly and ensure they have advised them suitably. This means they must have carried out sufficient due diligence on the charity's requirement for risk and return. While these changes have been brought about to prevent customer dissatisfaction, financial failure and fraud, a number of larger firms have withdrawn from offering investment advice to all but a few very large charities.

On the whole, charities are a forgiving group. After all, they are benevolent by nature and forgiving of others' difficulties. This is acceptable to a point and CAMRADATA's Roundtable set out to implement a transparent and comprehensive investment policy that balances risk and reward, reflects the charity's objectives and is governed by a clear timetable and set of rules.

> "Failing to adopt a robust, tailored investment strategy could be one of the most expensive mistakes a charity makes"

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M&G Investments

Company Profile

M&G has a long history of investment management dating back to 1901, when it was founded under its original name of Municipal and General Securities as the financial arm of a British engineering company. M&G revolutionised British finance in 1931 when it launched the first mutual fund for the general public. Since that time, the firm has concentrated on the management of investment funds.

In 1999, M&G merged with Prudential plc, a leading international financial services group with more than 24 million customers worldwide. Based in London, M&G manages investment funds for its individual and institutional clients, and acts as European investment manager for Prudential plc.

M&G has funds under management with a total value of £298 billion, as at 31 December 2017, (including Prudential's long-term business funds), making us one of Europe's leading asset managers. Approximately 70% of our assets at firm level are managed for institutional clients; furthermore, we manage assets for 35 of the UK's top 50 largest pension schemes.

M&G has been managing assets on behalf of UK charities for over 58 years. Today, we are proud to manage funds totalling over £1.6 billion on behalf of more than 10,000 separate charities, making us one of the most experienced investment managers in the sector. Our largest individual investors have entrusted assets in excess of £25m with us, either directly or via an appointed third-party discretionary manager, consultant or other adviser.

Ben Constable-Maxwell

Director of Corporate Finance, Equities

Ben joined M&G in 2003 as an investment specialist in the Global Equities team.

Central to the development of ESG at M&G, and founding member of M&G's Responsible Investment Advisory Forum, Ben leads on sustainability issues for M&G and supports the development of ESG client solutions; currently working on Impact.

Ben graduated from Newcastle University with an honours degree in Classics; committee member of M&G's Staff Charity Fund.

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Michael Stiasny
Fund Manager, Charifund

Michael joined Prudential Portfolio Managers in 1998 as an equity analyst. Following Prudential's acquisition of M&G in 1999, he joined M&G's Pan European analyst team; he was appointed Head of Equity Research in January 2005.

In April 2006, Michael became a member of the European Equities team and managed the M&G European Fund and the M&G European Special Situations Fund until July 2010.

He was appointed deputy fund manager of the M&G Recovery Fund in January 2011. This was followed by Michael's appointment as fund manager of Charifund (November 2016) and fund manager of M&G UK Income Distribution Fund (March 2018).

Michael graduated from Oxford University with a degree in philosophy, politics and economics, and is a CFA charterholder.

Sponsor

Ruffer LLP

Company Profile

Ruffer LLP is a privately-owned investment management firm. We currently manage over £22bn for pension funds, charities, companies and private clients. We look after over 300 charities.

All clients are managed to the same absolute return investment objective and this is achieved either through investing in our own in-house pooled funds, or via a segregated portfolio. Segregated portfolios can be tailored to meet the ethical policy of each individual client and provide complete transparency of the investment exposure in the portfolio.

Ruffer LLP is authorised and regulated by the Financial Conduct Authority.

Christopher Querèe

Head of Charities

Previously Director at Le Masurier, James & Chinn, now absorbed within the HSBC Group.

He spent thirteen years there, with responsibility for offshore private clients, moving to Chiswell Associates in 2001 to focus on charity fund management, before joining Ruffer in 2004 to help develop the firm's charity business.

He holds an MBA from Henley Management College and is manager of Ruffer's Common Investment Fund, the Charity Assets Trust.

Participants

Matt Cox

Investment Director

Matt joined the Esmée Fairbairn Foundation in 2013 and is responsible for overseeing the performance of the Foundation's investment portfolio.

He is an Investment Director and manages the day-to-day relationship with the Foundation's investment advisors.Before joining the charitable sector, he spent fifteen years in the investment management industry as an analyst and portfolio manager, managing a variety of client portfolios for pension funds, high net worth individuals and charities.

He is also a trustee of a small community music charity.

John Finch

Head of Investments

Johns investment career spans over 40 years and he is acknowledged as one of the leading experts in the industry.

John is currently Head of Investments for Gemmells Financial Services and also Independent Adviser to the £2bn Cornwall Pension Fund. In his current role John advices Pension Funds and Charities on investment strategy and manager selection.

John spent 20 years in fund management and managed the £4bn Confederation Life Balanced Multi Asset Fund, which in his tenure became the largest pooled investment vehicle in the UK. In the last 20 years John worked as a Consultant for HSBC Actuaries and Consultants and JLT Investment Consultants. In these roles he led their development into the Local Government Pension Scheme (LGPS) market and in providing solutions to the strategic asset allocation challenges clients faced.

He also developed a ground breaking manager search service for LGPS funds to meet the stringent procurement rules they faced and this has been successfully applied to the Charity market since joining Gemmells. His depth and breadth of knowledge is extensive and he has also established at HSBC and JLT Market Forecast (taking a 10 year view) and Tactical Allocation (taking a 1 year view) Groups to provide input into asset models in order to drive appropriate allocations to a wide range of asset types. This work has the largest impact on investment returns and the success of investment plans to meet their objectives.

John chaired the £30bn Brunel Pension Partnership Oversight Board (which is the investment pool established to manage the assets of 10 Local Authorities in the South West) between 2016 and 2017 during its formative stages, developing governance and business structures to meet the requirements of Government proposals and make substantial savings to the costs of managing investment. This also involved meeting with Government to detail the operation of the pool and gain acceptance of the pool proposal.

He joined Gemmells in April 2017, to work with a number of former colleagues in bringing cost effective and practical solutions to their client problems.

Participants

Matt Buchanan
Senior Investment Consultant

Matt joined Hymans Robertson in 2010 and is a Senior Investment Consultant.

He provides advice to trustees and corporate sponsors on their pension schemes, including a number of Charity sponsored schemes. Matt helps his clients develop clear investment beliefs and objectives, and provides straightforward advice on investment strategy, asset allocation and implementation. Matt has worked in the industry since 2008 and in that time has advised clients with assets ranging from £50 million to over £7 billion.

Matt chairs the firm's Investment Consultants Briefing, a bi-weekly meeting for all our investment consultants where potential investment solutions for clients are put to debate.

Daniel Banks
Head of Investment Strategy

Daniel joined P-Solve in 2010 from Punter Southall where he worked from 2008. He currently works as an Investment Consultant for Institional clients between £40m and £5bn, advising on areas including Manager Selection and Strategic Asset Allocation with a particular focus on ensuring that asset strategies align with clients liabilities and objectives.

Daniel currently sits on P-Solve's Investment Strategy Committee, DC Management Committee, Insurance Investment Committee and Group Investment Committee. He splits his time between consulting with a range of different institutional clients alongside a focus on P-Solve's modelling and technical capabilities.

He has been quoted in a number of publications such as Engaged Investor and Financial News whilst regularly giving industry talks such as at the Institute of Actuaries GIRO conference.

Participants

Dominic Fisher OBE

Dominic has been investing since 1989. He trained at Hambros Bank, joining Mercury Asset Management in 1992. There he led the charities team successfully during the dotcom bubble by resisting the pressures to invest in a 'new era'. Since 2001 he has held various roles on the investment committee of the Armed Force Common Investment Fund and with The Officers' Association.

He established his own investment business, Thistledown Investment Management in 2009 which he still runs. He also sits on the board of Aberforth Split Level Income Trust Plc.

He was awarded the OBE in 2015 for his charitable work for armed forces personnel having been Chairman of the Officers' Association for 10 years. He is currently a mentor for "Supporting Wounded Veterans".

Brendan Maton

Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

Investment Solutions for Charities

UK charities find themselves between a rock and a hard place. On one side, their own funding from government and public donations has been squeezed by austerity. On the other, austerity has only increased the number of deserving causes charities themselves are trying to reach. At least over the past ten years, strong investment returns have eased the financial position of those charities fortunate enough to own an endowment. But now there are question marks over the ability of stock markets to support charitable efforts.

At the CAMRADATA Charity Investing Roundtable in London this summer, asset managers warned that a stockmarket crash could happen as early as this year. The questions for charities are then how to protect capital and where to find decent returns in more troublesome times ahead.

> "Investment professionals rarely thank you for asking them to forecast market returns. They know how difficult it is to get the majority of decisions about where and how much to invest right. So, predicting may be a fool's errand"

Investment professionals rarely thank you for asking them to forecast market returns. They know how difficult it is to get the majority of decisions about where and how much to invest right. So, predicting may be a fool's errand but that did not stop us trying at the beginning of the CAMRADATA Charities Investing roundtable in London this summer.

When it comes to returns over the next five years from the FTSE All-Share, the panel's responses ranged from 7% annualised from Michael Stiasny, portfolio manager of M&G's £1.3bn Charifund, to 4% from Christopher Querée, manager of the Ruffer Charity Asset Trust. For the yield on 10-year gilts, John Finch, head of investments at Gemmells Financial Consulting suggested 3.5% while Dominic Fisher, founder and portfolio manager at Thistledown went as low as 1.5%.

The numbers themselves are not as significant as the thinking behind them. Fisher was clear that he would not buy or recommend US equities to clients right now because he could not see value there. Matt Buchanan, senior consultant with Hymans Robertson, an adviser to institutional investors, predicted gilt yields of 2.25-2.5% but said pension funds will buy at this level to hedge liabilities rather than earn excess return.

Querée qualified his prediction of 4% for UK equities by saying returns could be far lower. Ruffer as a house sees market conditions in 2018 resembling those leading up to the Great Financial Crisis of 2008-9.

Querée said volatility has been squeezed out in the last three to four years, as it had been during the mid-2000s. His low prediction for UK equities' return is thus informed by a much wider concern that markets may pop - as early as this year. February's surprise spike in volatility Ruffer interprets not as an anomaly but precursor of another credit bubble bursting.

Charities should pay far more attention to this prediction than pinning the tail on five-year returns. Crashes not only cause wealth destruction but also buying opportunities for those savvy enough to wait on the sidelines.

It is the credit markets where Querée sees greatest cause for worry. European High Yield is more expensive right now than US Treasuries. Because Ruffer aims not to lose money over any 12-month rolling period, its charity portfolios are currently positioned for protection, with neglible exposure to credit and many equity markets too. It is 'waiting on the sidelines' by placing more than one-third of typical charity portfolios in government-linked bonds: highly-rated and offering some clear protection should inflation take off.

An exception regarding risk-taking in equities is Japan, where the Ruffer's typical charity clients has almost one-fifth of assets. Querée explained that this allocation was also in part inflation-protection. The Japanese government has been attempting to lift the economy into an inflationary mode after decades of sluggish prices. A fair proportion of the Tokyo Stock Exchange consists of banks, whose stock will benefit from inflation and subsequent interest rate rises. But Querée added that the Japanese financials also show negative correlation with US Treasuries. This means this part of the Tokyo stock market provides a useful hedge against what is happening in the US, giving Ruffer a different risk profile from many other multi-asset funds.

M&G's Charifund does not have the same breadth of investment choice as Ruffer. Stiasny, can allocate up to 15% in overseas stocks (for example, Equinor, Norway's state-controlled oil & gas producer is one such holding) but the majority of Charifund's holdings have always been high-yielding UK equities. Because the London Stock Exchange is very keen on attracting foreign businesses to list, holding UK equities means truly international rather than domestic British economic exposure. But Stiasny has the tough job of buying companies that can continuously grow their dividend.

> "Crashes not only cause wealth destruction but also buying opportunities for those savvy enough to wait on the sidelines"

"Fortunately, there is a strong tradition among UK companies of paying dividends," he told the panel, "whereas if you look internationally, the dividend yield is 2.5-3%." This is true even for the world's biggest stockmarket: in January 12-month trailing dividend yields for the top 50 US dividend-payers were surpassed for the first time in years by the 10-year Treasury yield at 2.3%.

> "Growing dividend continuously has been proven academically as a way of running a successful company. Clients seem to agree"

These kinds of returns – 2.5-3% or 2.3% - would not best please Stiasny or his clients. Charifund is currently yielding an exceptional 4.9%, which is vital to many UK charities at a time when their other sources of income – government grants and public donations – are being squeezed by austerity. Stiasny is frank about the attractions of Charifund's demanding approach: the fund is run for income rather than growth. Companies attract Stiasny if they can sustainably increase their dividends rather than just sales or revenue or market share. "Growing dividend continuously has been proven academically as a way of running a successful company," he says. Clients seem to agree. Just 15% of Charifund assets sit in the accumulation share class (although this type of client has done well too). In total return M&G Charifund has outperformed not just the FTSE All-Share but also the FTSE High-Yield Index - a great riposte to those who argue that with the advancement of factor investing, manager skill has become redundant).

But what do the consultants on the CAMRADATA panel make of a UK equity-orientated portfolio? And how does Stiasny prepare for a rockier future, if there are turbulent times ahead? Consultants dismissed the idea that a UK equity fund was anachronistic in the modern era of globalised, highly-diversified funds. Matthew Cox, investment manager at the £1bn Esmée Fairbairn Foundation, said that its managers were all chosen for their alpha capability: the skill of the manager took pre-eminence over the type of strategy they used or asset class they invested in.

Buchanan said that a UK equity fund certainly had more chance of winning business if it comes from an established house.

Daniel Banks, senior consultant with PSolve, another advisory firm and fiduciary manager, said that a UK-orientated fund could work but most likely within a broader, diversified asset allocation strategy.

Finch, on the other hand, a pioneer of multi-asset portfolio management in the UK, said that he instinctly preferred a diversified strategy “unless the client’s needs dictated otherwise.”

Fisher asked a particular question regarding fees: on which element of their fund did the managers charge fees? He suggested that levying fees on capital rather than income helped ‘boost’ income returns but was not ideal for retail clients, as capital is taxed more lightly than income and of course income is derived ultimately from capital. Stiasny replied that M&G had done a lot of research that showed fees up to 0.5% on capital did not impair a fund’s ability to meet charities’ hunger for income. He added that UK charities are tax-exempt.

Regarding Charifund’s plan for the future, there was a clue in Stiasny’s 7% prediction for UK equities – which he divides into 2% capital growth and 5% dividend yield. His prediction was the most optimistic among CAMRADATA panelists but then Stiasny has to find successful companies listed in London. As he himself admits, there are only about a hundred listed on the FTSE All-Share that meet his demanding criteria. But from this pool Charifund has achieved total returns two and a half times greater than the Index since the fund was founded almost six decades ago. The subconscious message may have been that M&G Charifund will achieve 7% annualised over the next five years.

Stiasny is not, however, insensitive to general market conditions. The fashion for “dividend aristocrats” as bond proxies and the new label of ‘Quality’ companies means the likes of Unilever have dropped out of Stiasny’s consideration. M&G Charifund is in fact strongly underweight the entire Consumer Staples sector as others bid up dividend-payers and Quality.

“The biggest problem right now is finding anything worth buying. I believe the biggest determinant of good investing is the price you pay for an asset”

Everything is expensive

Cox joined in the general nervousness about current prices. “The biggest problem right now is finding anything worth buying,” he said. “I believe the biggest determinant of good investing is the price you pay for an asset.”

Like Ruffer, the Esmée Fairbairn Foundation currently has little exposure to corporate debt. Instead it has invested in hedge funds to find returns with reduced market beta. Cox made clear that the Foundation was not particularly content with the fees charged by hedge funds. However, its policy for a long time has been to select managers based on skill rather than buying beta (the selection of managers has been outsourced to Cambridge Associates).

This makes for a very interesting, idiosyncratic portfolio. One-fifth of assets are with venture capital funds, mostly in Silicon Valley. Cox explains that this connection really grew in the years after the Great Financial Crisis, when other funders were preoccupied with shoring up their own balance sheets and thus unable to make commitments. The Esmée Fairbairn Foundation is privately funded and does not rely on public donations. It makes grants worth approximately £45m per year out of its investment returns, which means it is relatively free to make long-term commitments to the likes of venture capital.

> "Assessing the merits of Venture Capital has always been an art rather than a science because of the great diversity of performance among VC funds but also the myth-making that surrounds the most successful investments"

"It is a big J-curve," explained Cox. "It is only within the last two or three years that the net cashflow from our illiquid investments has become positive."

Having found a gap with some of the best VC managers on the West Coast, Cox said the Foundation had maintained those relationships and was now in a fortunate position. "The best managers select you as a limited partner," he admitted.

Venture capital has a relationship with public financial markets and the economy but the Esmée Fairbairn Foundation undoubtedly has some form of protection or insulation should markets crash. This is how Cox sees the allocation (for good measure, the Foundation has a further 5% of assets in private equity funds). But assessing the merits of Venture Capital has always been an art rather than a science because of the great diversity of performance among VC funds but also the myth-making that surrounds the most successful investments such as PayPal, Facebook and Google.

Fisher asked Cox whether he felt it was true that only the top 10% of VC funds actually make any money for their limited partners. Cox replied that that probably was true. The Esmée Fairbairn Foundation has managed to back some ventures such as FitBit, maker of wearable devices that quantify physical effort, which have proved extremely successful. Having a stake in this kind of enterprise skews returns. Raising the conversation up several levels, Cox said profound changes in global human activity such as digitalisation, driverless cars and artificial intelligence spelt opportunities for disruptive technology. Esmée Fairbairn wants to capture the wealth from these trends via venture capital and private equity. "Ours is not a top-down view of the US," he concluded.

If backing entrepreneurialism is one way to grow, how does the Esmée Fairbairn Foundation protect its capital from loss? Cox answered that the Foundation has modelled losses of up to 40% in the wake of a global stockmarket crash. "We would continue our grant-giving at current levels and expect the capital to eventually regrow in value," he said.

Never losing value

Unfortunately, many UK charities do not find themselves in as robust a situation as the Esmée Fairbairn foundation. Hence the search for asset managers who can deliver growth and/or income reliably. Fisher, however, thought it was misleading for firms like Ruffer to promote their aim of not losing value over any 12-month rolling period. "Sorry to argue against but I can't see how telling a trustee you won't lose money over a 12-month period isn't setting them up for disappointment," he said. Querée replied that not only did Ruffer make clear that it did not always achieve this goal, but they clearly highlight to clients those periods in the past when it has failed to achieve this aim. He also explained that it remains an important distinction in terms of the firm's absolute rather than relative return aspirations.

Finch said that it was the responsibility of good managers and good consultants to explain strategies in advance and prepare clients so that they knew what they were getting and how it would perform under different scenarios. This includes overcoming the kind of psychological biases noted earlier by Stiasny – that clients heard those parts of any manager's story that suited their desires.

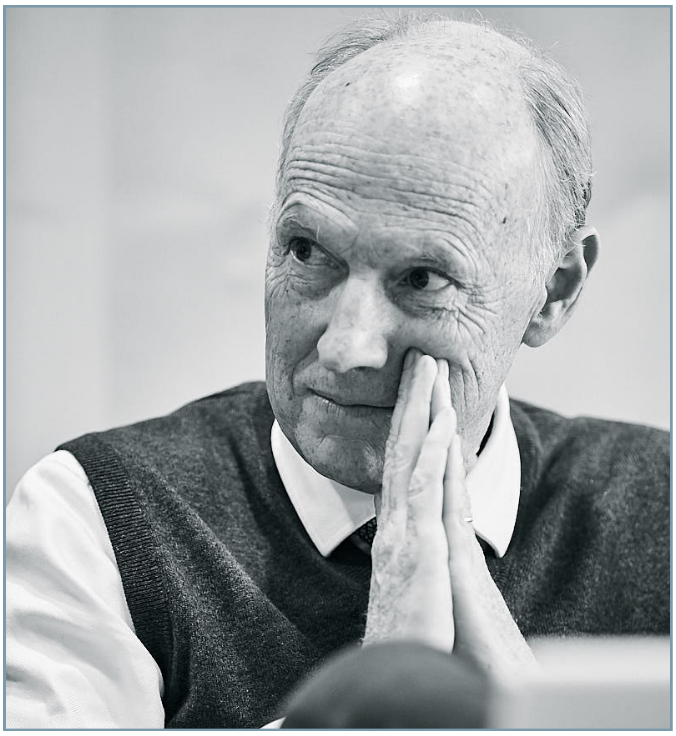
Finch added that dynamic asset allocators such as Ruffer needed understanding of their flexibility so that they could buy opportunely. He suspected some charity funds were still straitjacketed by old-fashioned limits on asset allocation.

Querée added that without a securities benchmark such as the FTSE All-Share, Ruffer had to work harder with some prospects to explain how the firm realised its investment ideas.

This brought the conversation back to prospects for markets and particular bond yields. Querée noted that the direct beneficiaries of the easy money supplied by central banks post Financial Crisis have been asset owners. Ten years on, economies have seen far less improvement than asset prices, which has in turn led to the worrying low levels of volatility and possibly complacency. Querée said that now emphasis was passing from central banks to fiscal policy, ie government. "Fiscal largesse in the US is at its greatest given the low levels of unemployment since the 1960s," he said.

He expected this to stoke inflation (not just in the US but also in Japan where Ruffer is poised to benefit from rising wages). Other panellists, such as Buchanan and Stiasny, foresaw rate rises.

"The direct beneficiaries of the easy money supplied by central banks post Financial Crisis have been asset owners. Ten years on, economies have seen far less improvement than asset prices, which has in turn led to the worrying low levels of volatility and possibly complacency"



"The world needs rates to normalise," said Stiasny, while Buchanan suggested that pension funds' need to hedge their liabilities might restrain that normalisation process.

Banks made an intriguing aside on productivity. He said that spurts in economic productivity occurred once technology was well bedded into the workplace. Thus, the personal computer revolution began in the mid-1980s but only started demonstrating widespread efficiency gains from the mid-1990s. He suggested that the latest disruptive technologies, digitalisation and Artificial Intelligence, are far from their full realisation in the economy. Evaluating the potential of technology is very much part of investing these days.

> "In 2018 responsible investing by charities spans ethics, sustainability and good governance, with extra dimensions unique to charities among all the types of institutional investors in that charities' daily remit is also about doing good"

Responsible Charities

Charities and foundations were the first responsible investors in the modern era, linking capital to protests against first the Vietnam War and then the apartheid regime in South Africa. In those early days, ethics informed the investment policy. In 2018 responsible investing by charities spans ethics, sustainability and good governance, with extra dimensions unique to charities among all the types of institutional investors in that charities' daily remit is also about doing good.

Cox gave one example to highlight the different dimensions and potential conflicts of policy. "Esmée Fairbairn gives money to food banks. Does that mean we should not invest in UK supermarkets because they could be seen as part of the problem food banks are tackling?" he asked.

The Foundation is in the process of harmonising how it invests with how it funds but the task is complicated by a number of factors. One is that checklists on Responsible Investing can be misleading. Cox said that all its commercial managers (and many prospects) had been asked to answer these checklists. In follow-up conversations, however, it became apparent that some managers which did not score well on the checklists did, in fact, turn out to be highly responsible managers who were very active in managing their shares and taking an active interest in how investee companies were run. Conclusion: tick-box assessments of a manager's credentials are inadequate and may indeed be misleading. The second complicating factor is that Esmée Fairbairn is a responsive charity. Each year it makes grants to approximately 300 organisations from across the UK based on their presentations.

It funds all kinds of activity bar healthcare. Responding so broadly to the needs of society makes it hard to formulate a Responsible Investment policy without potential conflicts such as food banks versus supermarkets arising. The Foundation would much rather engage with companies to influence their behaviour in a positive way.

Ben Constable-Maxwell, Director of Corporate Finance, Stewardship and Responsible Investment at M&G, responded that many investors were on the same journey as Esmée Fairbairn as Responsible Investing moved mainstream. As evidence of the complexity in reaching decisions in this field, he gave examples where M&G's investment teams expressed different opinions on major corporate issues. On the shareholder resolution demanding more clarity from Shell on its scenario-planning for a low-carbon future, for example, Charifund voted for the resolution while other M&G funds did not. Constable-Maxwell explained that while consensus is sought, portfolio teams at M&G have independence and may come to different conclusions on how to invest responsibly. "Their ultimate obligation is to invest in clients' best interests," he said.

On the holistic responsibility of charitable foundations, Cox noted that Esmée Fairbairn was aware of its ability to be a convenor. At one recent meeting, some of the NGOs present remarked how the Foundation had attracted more figures of importance than they could. Cox concluded that large charities seem now to have influence via investor alliances that some of the NGOs they fund do not. This may be salient as charities view their efforts and capital holistically. Big business takes notice of those who finance its activities. So while pressure groups may have developed highly effective means of getting publicity for their campaign, these groups ought to foster stronger bonds with the work of responsible investors, most especially the investment arm of the charities than fund them.

"While pressure groups may have developed highly effective means of getting publicity for their campaign, these groups ought to foster stronger bonds with the work of responsible investors, most especially the investment arm of the charities than fund them"

The quest for income

Where can charities invest in a low yield world?

> 'Safer' assets such as cash deposits, UK and other western government bonds are offering negative real returns; in effect, if you buy a 10-year UK government bond, or gilt, you are paying the government for the privilege of you lending them money!

Charities remain under constant pressure to grow their income. Ensuring that the real value of income is protected enables charities to do more and helps safeguard their future.

Charity Commission data confirms that the sector's income has experienced welcome growth. Total income of £71 billion for 2016 represented a 2.9% increase from 2015 and, backed by a 4.2% rise in the total value of long-term investments, this enabled charities to increase annual spending in 2016 to £69 billion (4.5% more than in 2015).

This is a welcome positive trend in ever more turbulent times. With many sources of funding under increased threat, income from investment portfolios is playing a more prominent role in many operational charities for whom regular cash-flow is vital.

But it is our old enemy inflation[1] that we must keep a constant eye on, both to ensure that invested capital maintains its real value, and that the level of income maintains its real power to benefit society. In the UK, inflation as measured by the Retail Prices Index (RPI) stood at 2.9% by the end of May; while the key pressures have been more transient, driven by cyclical factors (such as fuel price inflation), this remains a slightly more demanding target when compared to the average RPI rate of 2.7% over the past 10 years.

It is interesting to note that in the 10 years to the end of April 2018, every £1,000 held in the average UK savings account would have grown to just £1,022, whereas RPI inflation has led to charities needing £1,301 to do the same amount of good as £1,000 would have achieved in 2008. The magnitude of this "inflation gap" remains under-appreciated.

'Safer' assets such as cash deposits, UK and other western government bonds[2] are offering negative real returns; in effect, if you buy a 10-year UK government bond, or gilt[3], you are paying the government for the privilege of you lending them money! So, where are the opportunities to access a high and growing income while maintaining a diversified portfolio?

Equities

Equity (company share) markets expose investors to greater capital volatility[4], so there is understandable caution. However, it is important to appreciate that not all equities[5] are expensive at the same time; for income-focused investors, plenty of opportunities exist to recycle profits from shares that have performed strongly into shares offering a higher income on more compelling valuations. Short-term bouts of market volatility offer opportunities to active managers who have a disciplined approach to identifying long-term value at an individual company level; and a little bit of extra inflation in the economy often proves beneficial, particularly for certain sectors such as banks and insurance.

The yield[6] on the FTSE All-Share Index stands at around 3.7%, which is a competitive starting point for income seekers when compared to cash and gilts. Equities continue to offer attractive dividend[7] growth prospects, which can go a long way to protecting the real value of your income against inflation. Diversification is key, so targeting core, proven UK strategies offering a minimum 4% yield alongside global funds holding 'income friendly' assets (like Infrastructure) would be a sensible approach.

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1 INFLATION: The rate of increase in the cost of living. Inflation is usually quoted as an annual percentage, comparing the average price this month with the same month a year earlier.
2 GOVERNMENT BONDS: Fixed income securities issued by governments, that normally pay a fixed rate of interest over a given time period, at the end of which the initial investment is repaid. Bonds –
3 GILTS: Fixed income securities issued by the UK government.
4 VOLATILITY: The degree to which a given security, fund, or index rapidly changes. It is calculated as the degree of deviation from the norm for that type of investment over a given time period. The higher the volatility, the riskier the security tends to be.
5 EQUITIES: Shares of ownership in a company.
6 YIELD: This refers to either the interest received from a fixed income security or to the dividends received from a share. It is usually expressed as a percentage based on the investment's costs, its current market value or its face value. Dividends represent a share in the profits of a company and are paid out to the company's shareholders at set times of the year.
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Corporate Bonds

Bonds have enjoyed a strong 30-year run, delivering solid income and significant capital growth[8]; why? mainly because we have experienced a structural collapse in inflation and interest rates. At the higher quality end of the corporate bond market, rising inflation and interest rates will lead to capital erosion, and income yields will not return to attractive levels until we have experienced further rate rises.

Higher yields can be obtained by investing in lower-rated bonds[9], but this comes with greater risk, more closely linked to the fortunes of the individual companies to whom you are lending. Bond funds continue to be useful as a diversifier away from equities, but income seekers may wish to target shorter-dated funds that offer floating rate yields, which will increase as interest rates rise; these are offering yields of 3.5% or more, which compares favourably to cash and 10-year gilts (1.5%).

Near-term outlook

Based on RPI inflation averaging around 3.5% during 2018, we believe that long-term charity investors seeking income should continue to favour a significant bias towards equity funds offering a diverse spread of exposure to quality UK and international businesses. Minority weightings in bonds and property continue to play their role in managing capital volatility, but it is equities that continue to offer the greatest potential to deliver high and growing income streams.

The value of investments and the income from them will rise and fall. This will cause the fund price, as well as any income paid by the fund, to fall as well as rise. There is no guarantee the fund will achieve its objective, and you may not get back the amount you originally invested.

“Minority weightings in bonds and property continue to play their role in managing capital volatility, but it is equities that continue to offer the greatest potential to deliver high and growing income streams”

Written by
Richard Macey,
Director of Charities

8 CAPITAL GROWTH: Occurs when the current value of an investment is greater than the initial amount invested.

9 BOND: A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

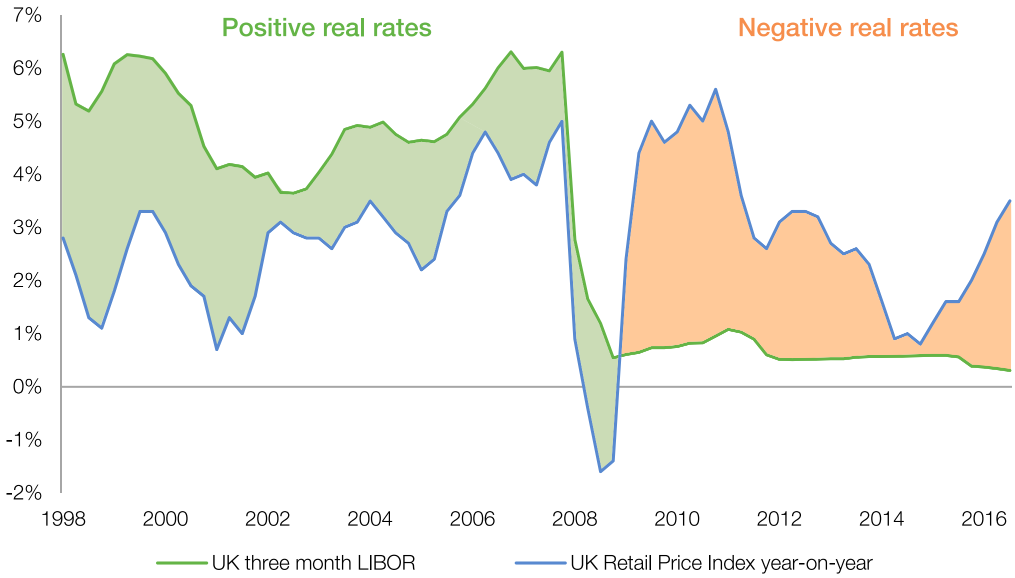
Income at any price?

Ten years ago a reasonable income could be achieved without taking excessive risk. Today, historically low interest rates and unprecedented quantitative easing have distorted asset prices, meaning what would have been considered a modest income target now carries with it much more risk

In a world of distorted interest rates and high asset prices, protecting capital and producing strong income levels may no longer be mutually compatible.

For much of the last half century a sustainable income target has been the most definitive aspect of a charity's investment policy statement. For most of that period targeting income has been an entirely sensible strategy; a high yielding portfolio provides for the ongoing spending requirements of a charity, whilst leaving the capital untouched, compounding steadily to provide for future grant making, often into perpetuity. Providing an income was broadly achievable in recent history, made possible by the high prevailing interest rates of the era prior to the global financial crisis. However, it should always be remembered that income is an investment return and that every investment return is achievable only by accepting risk. Ten years ago a reasonable income could be achieved without taking excessive risk. Today, historically low interest rates and unprecedented quantitative easing have distorted asset prices, meaning what would have been considered a modest income target now carries with it much more risk. The worry is that investors now seem willing to pay almost any price for income with little regard for the risk, potentially jeopardising their capital.

This distortion of asset prices begins with cash. The graph below shows the short term UK interest rate and compares it to the rate of inflation. Before the crisis a deposit at a bank or a short dated government bill provided a steady income. More importantly, this rate was above inflation, meaning positive real returns could be achieved simply from depositing cash in a current account, as shown by the green shaded area in the graph. Now, not only is the nominal return on deposits virtually zero, but inflation is steadily eating away at the real value of cash.



A similar theme is seen across government bonds, with yields having been on a downward path for the last forty years, and even continuing into negative territory in many cases including much of Europe and Japan. Practically speaking, investors are now paying governments for the privilege of lending them money. In the late 1970s and early 1980s bonds were described as 'certificates of confiscation' because of inflation fears and shunned as an asset class. Yet currently there seems no shortage of demand for negatively yielding bonds. The transition of government bonds from untouchable in the 1970s is a result of years of falling interest rates and falling inflation that has provided handsome returns for bond holders. The difficulty for many income seeking investors is that the composition of these returns has been changing, with capital appreciation comprising an ever larger proportion, at the expense of the income yield. Without operating a total return approach to grant-making, this capital gain is ring fenced from the spending abilities of a charity. To maintain a given income target investors have had to purchase equivalent bonds with ever greater maturity and duration.

Strikingly, today it would require holding a 30 year UK government bond in order to achieve the same 2.9% yield as a five year bond did in 2009. The problem with taking on this duration risk is that, when interest rates rise, the longer dated bonds will experience a much larger fall in price, and investors will be forced to choose between taking a capital loss or receiving an income well below market rates. Alternatively, investors could take on greater credit risk by lending money to different governments. Again the distortion is extreme. To find the same 5% yield received on UK 10 year debt in 2007, one would now have to lend to Argentina, a country that has defaulted eight times, most recently in 2014!

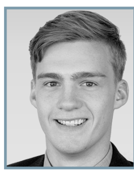
It is worth reminding ourselves of how we got here. The low interest rate environment has sent yield-focused investors searching in riskier places to meet their income target. This, coupled with the mass liquidity provided by quantitative easing, has distorted markets such that asset prices no longer reflect their underlying risk. Seeking income is not a bad thing, but capital has never been more plentiful and income never more scarce, so it is important to ask oneself whether it is worth the price being paid.

A question frequently raised is whether policy-bound charity trustees have any choice but to pursue income. One alternative is to adopt a total return strategy, whereby spending requirements can be met from both the capital and income gains. Ultimately, we feel that a focus on preserving and growing capital rather than pursuing an increasingly risky income policy will leave endowments best placed to meet their long-term spending goals.

“The low interest rate environment has sent yield-focused investors searching in riskier places to meet their income target. This, coupled with the mass liquidity provided by quantitative easing, has distorted markets such that asset prices no longer reflect their underlying risk”

Written by
Marnoch Aston
Research Director

and



Oliver Shale
Investment Associate

CAMRADATA

CAMRADATA
5th Floor, 80 Leadenhall Street,
London, EC3A 3DH

+44 (0)20 3327 5600
camradata.com

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