The Honorary Treasurers Forum

Radically rethinking charity investment

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Radical or just modernising?

- Time for charity investment to look to become current and not anchored unhelpfully to the past.

- Starting points are:

1. Charity Commission Guidance14 (and legal underpinning)
2. Harries v Church Commissioners for England 1992. Trustees can make investments, guided by ethical considerations, <u>if it can be shown that overall financial performance would not be harmed</u>, but also if it would be consistent with the purpose of the trust.
3. In 1952, Harry Markowitz published “Portfolio Selection”. A portfolio’s risk is not defined by the riskiness of its individual assets, but by the extent the portfolio’s assets’ price movements are correlated.

“The capital markets offer two free lunches: diversification and mean reversion.”

Why do charities have investments?

Long term (5 years +)

i. Generate income/spendable returns to finance activities
ii. Increase confidence in project funding
iii. Ensure continuation of activities over years/decades/centuries

Medium term (6 months +)

i. Provide platform for budget planning
ii. Ensure obligations to stakeholders are met

Maximising financial return; what is the correct measure?

- Matching an index return or the agreed outcomes for the charity?
- How does this relate to a charity’s objects and public benefit?
- How does cashflows (income) fit into this?

FCA rules on suitability do not stress the importance of total return

- Advisers can be held to account for taking too much risk

- FCA rule book focuses on risk and loss as opposed to maximising return

- COBS 9A.2.1 R 01/10/2018
- When providing investment advice or portfolio management a firm must:
  - obtain the necessary information regarding the client's:
  - knowledge and experience in the investment field relevant to the specific type of financial instrument or service.
    - financial situation including ability to bear losses; and
    - investment objectives including risk tolerance
  - only recommend investment services and financial instruments as applicable, or take decisions to trade, which are suitable for the client and, in particular, in accordance with the client's risk tolerance and ability to bear losses.

Factor based investment

- Optimises the risk and return of a portfolio or strategy
- Can Trustees justify paying higher fees when evidence is that active managers underperform?
  - Passive management now accounts for 45 percent of all assets for U.S. stock-based funds. That's up from just around 25 percent a decade ago
- Are trustees expected to acknowledge flaws in index construction as proven by research (Prof. Andrew Clare)?
- Is Sustainability a factor?
- Is Smart *beta* a solution?

Have Charities have already acted?

- Alternative asset classes reduce risk but do not increase return

- Sustainable investment; can better societal outcomes be part of the measurement of return? (see slide 9)

- US endowments retained their distinction as the top ESG incorporator and increased their adoption rate, coming in at 63% in 2020 compared to 58% in 2019

  - Recent data from Morningstar indicate an almost fourfold increase in new assets in U.S.-bought ESG funds from 2018 ($5.5 billion) to 2019 ($20.6 billion).

  - US president Joe Biden suspended the issue of new oil and gas drilling permits on federal land.

Suitability and risk

- Can charities be too risk adverse?
- How can they factor in their time horizon?

Sustainable investing, Impact and Social Investment

- Will charities give up performance if they invest sustainably?
  - Returns are comparable to conventional investments 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies' (Journal of Sustainable Finance and Investment, Gunnar Friede, Timo Busch, Alexander Bassen, 2015)
- How does Impact and Social Investment fit into charity investment strategy?
- Are such alternative investments with high fees and no regular income fit for most charities?

Closing points

- Investments can ensure continuation of activities over years/decades/centuries
- Harries v Church Commissioners for England (1992) – now 29 years ago
- No radical change needed just move with the times but remember …
- Harry Markowitz's work is still **<u>the</u>** starting point

References

- FCA Rule book - COBS 9A.2.1 R 01/10/2018
- ACF - Pillars of Stronger Foundation Practice
- Research Affiliates – 'Is Diversification Dead?' (Rob Arnott & John West 2021)
- Harry Markowitz - "Portfolio Selection"
- Journal of Sustainable Finance and Investment (Gunnar Friede, Timo Busch, Alexander Bassen, 2015)
- Callan (US investment consulting firm)
- Smart Beta (Andrew Clare, Andrew Morton, Stephen Thomas 2015)

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