

Nuffield/LBS Charity Investment Seminar Series

Governance

December 5th 2005

Chairman: Mr Tony Hardy

Introduction

In introducing the third of a series of four seminars, James Brooke Turner (Nuffield Foundation) reminded participants that the purpose of the series was to provide an opportunity for endowments to think on their own terms what was required of an investment portfolio, and how that might differ from other types of institutional funds. The first seminar had considered three very different investment strategies, each one had used a different investment approach; one felt that the trustees wanted to exercise their basic fiduciary duty, but relied on the investment committee for investment expertise; one decided to appoint several balanced managers and set them a return target for the year on the basis that the trustees had no expertise in asset allocation or stock picking; the third had decided to invest in only equities after the trustees had decided (about 20 years ago) that it was the best way to provide stable long term spending and capital maintenance.

The second seminar had focused on risk, and how endowments can gauge what the different risks are, how to determine minimum risk and then build in a degree of strategic risk through a diversified portfolio in order to generate greater returns. The second seminar was on risk, and in particular the management of risk. One speaker explained that the more ill defined the liabilities the harder it was to define the investment strategy.

The objective of this third seminar was to consider how Trustees go about decision making (such as what amount of risk is acceptable) and what the different roles are in taking those decisions. To begin, representatives from the Charity Commission would outline the regulatory framework, to be followed by three different 'actors' who would describe their particular roles in the decision making process.

The Charity Commission and its current approach

Andrew Hind, CEO of the Charity Commission, began by outlining the broad policy initiatives of the organisation. Central to the new positioning is the Commission's Vision, Mission and Values statement for the next three years. The Vision is of *Charities working at the heart of society* with the Commission's Mission to be *the independent regulator for charitable activities that promotes the public's trust and confidence*, through applying the particular values of being *Effective, Expert, Fair, Innovative and Responsive*. This approach recognises that the Commission is the protector of charity integrity and, as an independent, non-ministerial, department of government, places them in a unique position to champion the work of the charitable sector and add value to charities in an expert and client-focussed manner.

Part of the regulatory work will be to deal with distinguishing between honest mistakes and deliberate wrong-doing, and dealing with the latter in a much harder, faster, and tougher manner. At the same time, the Commission will be working on

disseminating good practice aimed at greater effectiveness and innovation and it will be important to ensure that the independence of charities generally is never compromised.

The Legal Framework for Trustees

Kenneth Dibble, Executive Director, Legal and Charity Services, then described the legal framework which governs Trustee operations and decision making in the area of investment.

The fundamentals of Trustees' duties are set out under common law precedent (after *Cowan v Scargill*), where the *powers of investment must be exercised so that the funds yield the best return by way of income and capital appreciation for present and future beneficiaries judged in relation to risks of investment and circumstance of the [charity]*. In addition, there are express powers under the Trustee Act 2000, and Charity Commission guidelines assert a *paramount need to create an investment policy*. Historically, the legal framework has moved away from permitting only safe income stocks, through various Court rulings granting wider investment powers to now granting Trustees general powers of investment (subject to governing documents) under general duties of exercising care and skill, and specific duties when managing risk, including taking into account suitability, diversification, regular reviews, as well as, importantly, to take and consider appropriate advice.

Managing risk includes counterparty risk (when employing agents there is a need to set clear rules and establish supervision arrangements); investment risk (where returns are less than expected); the avoidance of speculation (a clear Trustee policy on what is off-limits and a procedure to enforce that policy); and the establishment of a risk profile, which will depend on the circumstances, the size of funds, and the needs of beneficiaries now and in the future.

In establishing their own risk profile, Trustees need to consider whether the Founder intended the endowment to have a permanent existence; and also to decide what would be a fair balance between the present and future demands of beneficiaries in order to ascertain the best division between income return and capital appreciation. As part of this process, endowments can adopt a total return approach and apply to the Commission for permission (authority) to adopt a total return investment policy that will give a fairer balance between income returns and capital appreciation. Determining what a fair balance would be will depend on considering past patterns of spending and anticipating demand for the charity's support in the future and how those needs will be met.

Since there is the overriding requirement of an investment policy to maximise returns, an ethical investment policy can be established only if there is no significant risk of financial disadvantage, or where the investments would conflict with the aims of the charity and/or would get in the way of its work: but the potential harm to the charity from these investments, or class of investments, must be weighed carefully against the prospect of reduced financial returns.

In summary, to create an investment policy Trustees should consider:

- The generation of a sufficient financial return to enable the charity to carry out its purposes effectively and without interruption;

- The maintenance, and if possible enhancement, of the value of the endowment;
- The management of risk;
- The charity's stance on ethical investment (if appropriate).

In addition, an investment policy should include:

- Its objectives in investing its funds, including its position on risk;
- The asset allocation strategy;
- Benchmarks and targets by which the performance of managers will be judged;
- The stance on ethical investment;
- The balance between capital growth and income generation, or the nature of the total return policy;
- The scope of the investment powers.

Above all, Trustees must have a clear and articulated investment policy which is available to Staff and Managers.

- *Question:* US Charities must distribute 5% p.a. of an endowment each year. Does the Commission have a view on this for UK charities?
Answer: The rate of distribution of the UK's top 500 endowment charities ranges from 1-5.5% p.a. Of course there may be very good reasons why distribution rates vary so much. However, if all endowments distributed 5.5% another £1 billion would be distributed to UK charities annually.
- *Question:* The legal framework seems very bland: essentially the policy is to take advice and act in good faith. But surely key operational issues can't be that simple. From whom to take advice? By appointing Advisers and Investment Managers doesn't this add two additional risks? The framework as outlined is not helpful to deal with real issues such as how to deal with the balance of expertise and power between Trustees and Advisers. How does the Commission deal with these issues as a Regulator?
Answer: If Trustees have acted reasonably and honestly then they won't be held accountable: for example if Advisers are appointed after making sure they are regulated (e.g. by the FSA) and after holding a 'beauty' parade of qualified organisations. On the other hand, if Trustees substituted their own decisions for those of the experts, they could be criticised.
- *Question:* But Investment Advisers and Managers can get things horribly wrong?
Answer: Trustees do have the responsibility for both the selection *and* review of agents acting for them.
- *Question:* Could the Commission give endowments some guidance about appropriate procedures or yardsticks (such as an expected rate of return) to help Trustees determine what risk can be assumed? Trustees are supposed to adopt a risk profile which avoids speculation, but the Commission doesn't provide any guidance on what, exactly, a 'risk profile' is? Are there guidelines on best practice on distributing funds versus capital accumulation?
Answer: Trustees are responsible for investing their funds within the legal framework in order to provide income for current and future beneficiaries. On distributions, Trustees should review past expenditure and current social trends and spending should be dictated by those patterns. But endowments have very

diverse objectives. Also, where a fund has excess funds relative to their original obligations, the Trustees can apply to the Charity Commission to redraw their purposes in order to increase their spending.

- *Question:* It is clear that it is important for endowments to decide what they are trying to achieve and to define their objectives. But the focus often seems to be on preserving capital and that the worst thing that can happen is the impairment of capital. But what makes them charitable is their spending: should the Charity Commission be more interested in what is spent rather than what is saved?

Answer: Endowments can apply to the Charity Commission to adopt a total return spend policy, and by taking a view of the balance between current and future beneficiaries, this would be a firm building block for developing an investment strategy.

General discussion: Is there any benefit in comparing a ‘poor’ grant (where there is little or no impact or return) and a ‘poor’ investment which damages the capital base? Should there be a greater focus on the safety and preservation of the capital base even if that results in the sacrifice of the income base? A conservative investment policy can be decimated by inflation: for example where an endowment has diversified and sold land and reinvested in gilts. The Charity Commission doesn’t give endowments guidance on assessing risk. While the legal framework is quite clear, are there further steps that could be taken along best practice lines in this area? Are there sufficient similarities between endowments to be able to develop this? If there is a desire for some greater benchmarking within the sector, then there would have to be different ‘classes’ of charities because there are different purposes and different needs, now and in the future.

The Roles of Trustees, Staff and Advisers in managing the investment portfolio

A Trustee, a Staff member, and an Adviser, then described their particular roles, and those of staff, within their own organisations focussing on the governance process.

First, a Chief Executive described the interaction between the three “Moving Parts” of People, Money and Grantmaking. The *People* are 9 Trustees and 5 Staff who are responsible for the *Money*, a £100 million endowment, established in 1973 with a reactive, generalist *Grantmaking* strategy of c. £5 million p.a. spend rate focussed mainly in providing core costs in five main categories (Medical/Disability, Social Welfare, Arts, Conservation and Overseas). Grants to c.150 charities were made in 2005, (an average of c. £50,000 per grant), often spread over 2 years.

The aim of this endowment is to exist in perpetuity, but also to give away as much as possible while preserving the capital assets. They have adopted a total return approach (i.e. spending both income and capital, which means that they spend c. £2.5 million of capital per annum). The overall 5% spend rate is linked to the market value of the investments. Asset allocation is a simple model of 70% Equities : 30% Fixed Income and Property, with a well diversified portfolio, global investments, 8-10 managers and a separate custodian.

Executive authority for day to day management is delegated to a Finance Committee consisting of 3 Trustees and 2 staff members (the CEO and Finance Manager) plus a ‘rotating’ lay Trustee, assisted by Cambridge Associates. Staff do the ‘leg-work’ of

the research/visit reports, committee papers, main board briefing and maintaining the external relationships. The Finance Committee meets 5x per year, and reviews Investment Strategy, Investment Managers, the Main Board Report and Audit. One meeting each year will focus on a root and branch review of policy and strategy, including looking at the spend rate, following which recommendations are made to the main Board which then sets the Strategy for the following year. The Staff are equal members of the Finance Committee except that, while they participate in the debate, they do not take the decisions. All policy decisions of the Finance Committee are referred back to the main Board for ratification.

Next, a Trustee of a £180 million permanent endowment, and of a £16 million non-permanent trust, spoke about his perception of the role and responsibilities of a Trustee from his own long experience. While the presentation of the Charity Commission had described this in detail, from his perspective, a key aspect of the role is to articulate fully the interests and objectives of the charity in order to give clear instructions to the Investment Advisers. The production of an Investment Policy is very important, as well as giving careful consideration to the terms of appointment of the Advisers: their fees, the length of their initial contract and regularity of performance reviews, decisions concerning benchmarks or absolute return comparators, the reporting arrangements and the like. Regarding asset allocation, there can be no single answer since much depends on the charity's own circumstances, but Trustees can always take advice on it. Alongside weighing the likely risks and rewards of different asset allocations, trustees also need to bear in mind their associated administrative burdens on their staff.

Recently a 'total return' approach has for the first time been allowed by the Charity Commission for some permanently endowed charities, and this has begun to pose some challenges that need to be considered. Trustees were given permission to adopt a total return approach so long as the value of the initial endowment was retained. However the Order was silent on whether this was to be in nominal or real terms. Since this amount cannot be breached, there needed to be some way to protect it, and the approach adopted was to build a 'cushion' of investment assets, including directly owned property, which would protect the original endowment in the event of a significant downturn in asset values. The process of developing such a policy was intellectually challenging. For example, how much capital (from the "unapplied investment return" in the jargon of the Commission) can be used for spending each year? Should there be guidelines on what the spending could be, based on previous income plus a little capital each year? Alternatively, could a view be taken on the annual total return of a particular mix of assets in the medium to long term, and expenditure determined on that basis? While a total return approach can provide greater equity between current and future beneficiaries, it does result in a series of difficult issues to be determined and it would be helpful to share experiences of managing endowments in a 'total return' environment.

Last, an Adviser discussed various governance issues from the perspective of an external adviser. One important question was: where in the hierarchy should the responsibility lie to initiate change? Who makes the decisions? Trustees have the responsibility to determine policy but can then delegate day to day responsibility for investment decision making to Investment Managers with External Advisors helping periodically by answering Trustees' questions. But Trustees have to ask the questions in the first place, questions such as:

- What are the investment objectives?
- Can they be defined/described?
- Can they be linked to other aspects of the charity's work?
- How much return can be expected for risk assumed? An external adviser can provide information / analysis on this.
- Are the arrangements with Investment Managers optimal?
- What is the current market intelligence?

There is merit in stability and change costs money but equally there is a need for regular reviews. (One fund had the same investment manager since 1947.) An External Adviser will not be able to make decisions but will have information and opinions on Investment Managers with the aim of improving returns, reducing risk, reducing costs, and to adopt best practice.

- *Question:* Is more time usually spent reviewing Investment Managers rather than on Asset Allocation, and is that the right balance?
Answer: It is always easier to spend time on the things which can be measured! But it is also important to distinguish between Strategic Asset Allocation and Tactical Asset Allocation.
- *Question:* Might an annual review of investment strategy be too frequent?
Answer: There are always aspects that need review or greater attention. For example, appointing new managers is always very time consuming. Also, when drawing on capital at regular intervals, there are decisions about from where to take, say, £1-2 million of capital and the implication of that on the rebalancing policy.
- *Question:* How is the 5% spend rate set? How can the needs of current and future beneficiaries be analysed?
- *Answer:* Since the objective of this fund is to give money away now, then the actuarial analysis (helped by Cambridge Associates) showed that the current asset allocation policy, looked at in the round, has a good chance of preserving the buying value of the assets. Investment managers are not asked to deliver a specific yield.

General discussion: This is a specific problem for the management of charity funds because adopting a style 'tilt' (such as income bias) cannot be expected to produce returns without taking on additional risk. A focus on diversification has to be emphasised more.

An Investment Manager commented that clients will ask them to produce certain levels of return, but they are rarely asked about what level of risk has to be taken to obtain that return. At Trustee meetings, the questions are about performance but not about *what* we are doing and *how* are we doing it... Benchmarks result in "chasing tails", something which is not encouraged under Commission guidelines...

- *Question:* How then can Trustees judge how successful they have been? Is it to be relative to benchmarks or absolute returns? And over what time period?

Answer: If the intention is to maximise the return of capital and income then historic benchmarks become less relevant: there is a need for comparators rather than benchmarks. Trustees can be emotionally guided through past history to the management of assets, and maybe have not moved on to the reality (implications) of the total return approach.

- *Question:* How do Trustees manage volatility? Presumably through diversification. But how many funds change their asset allocation to reflect market changes?
Answer: Trustees can define their objectives in very specific terms, including volatility, but equally there must be a range of variability around it that they are comfortable with.

General Discussion: The ability of endowments to absorb volatility and very long term time horizons should be exploited ruthlessly verses what pension funds or insurance companies are able to do. Endowments can reap the advantage of returns that can come from holding *very* long term assets - such as infrastructure or utility projects - returns which are not benchmark related, but are returns which would come, usually, after the tenure of current Trustees. Clearly there would be a need to develop expertise to manage this approach: and would this radical policy approach survive the periodic changes in the composition of the Trustees? It related to the question of the time horizon of the Strategic Asset Allocation but it was an advantage that endowments had over pension funds and private equity funds.

Do Trustees prefer to fail/succeed collectively rather than develop an independent approach? The Charity Commission's view was that Trustees would be acting responsibly providing they take advice. But Advisers can get it wrong too: who advises on the Advisers! There remains a great fundamental faith in the value of equities, the use of active management, lack of professional prediction, caution across markets, and great 'herd' instinct. Should there be more formal training for Trustees in new opportunities?

Summary:

The chairman offered four propositions for investment governance arising from the discussion:

- Most Trustees are not expert in investment matters;
- Most Trustees' first priority is to preserve capital;
- Providing Trustees follow the rules, they won't be criticised by the Charity Commission;
- The previous three propositions guarantee that endowments won't take full advantage of the unique opportunities that endowments have!

Next meeting:

Seminar 4 will be held on Wednesday 29th March 2006, 4.00-6.00 pm (3.30 coffee/tea) at the Nuffield Foundation, 28 Bedford Square, London WC1B 3JS.