financial & investment **strategy**

The Foundation's endowment: 1943 to 2002

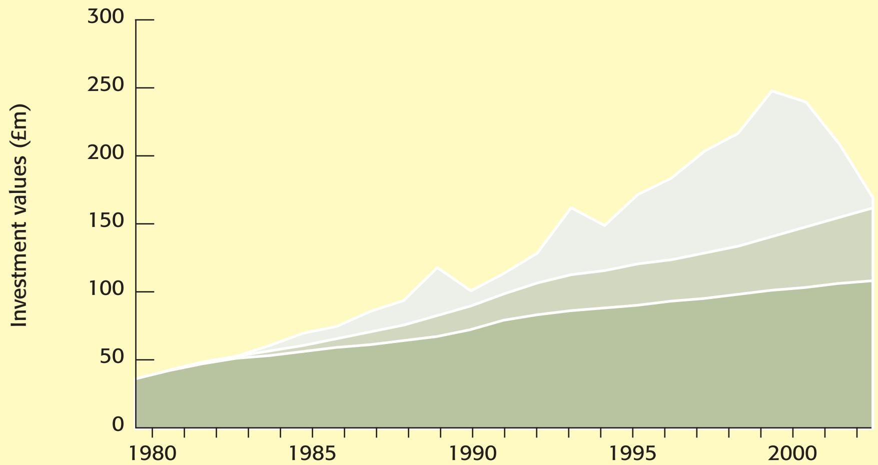
The Foundation was given an expendable endowment by Lord Nuffield of £10m in 1943. This gift was of Morris Motor shares which performed well until the late 1960s. Between 1970 and 1974 the value of this holding fell from £24.7m to £3.7m (before accounting for inflation). However a much smaller diversified portfolio had been established earlier which cushioned the loss (in 1974 the diversified portfolio was worth £5.2m). The failure to diversify fully, compounded by the ravages of the 1970's bear market and high inflation destroyed a significant amount of the Foundation's wealth permanently. For the next few years the Trustees actively sought to rebuild the capital base by restricting the annual expenditure. (This would not now be allowed under Charity Commission rules.)

Endowment Values 1980 to 2002

Ten years ago the Foundation's 50th anniversary report suggested that "an adequate restoration of the endowed capital base was achieved in the 1980s, without returning anywhere near to the Foundation's former relative size". If the Foundation had chosen to protect 1980 value of investments against retail inflation (RPI), it would now expect to have investments worth £107m, but if the 1980 value was inflated in line with earnings (AEI) we would expect to have £161m. At the end of the year the Foundation had investments worth £170m, so in effect the Foundation has over the period maintained its endowment in real terms despite the significant losses incurred during the bear market of the past three years.

Endowment values 1980-2002

The two lower areas show the 1980 value of the endowment, indexed against RPI and earnings respectively. The top line shows market values.



Financial Strategy

A foundation such as Nuffield has no new sources of income and thus differs from most pension funds, or educational bodies that have endowments. However it also differs in that it does not have any significant long term liabilities. Its trust deed gives power to spend as little or as much of its endowment as the Trustees wish. Over the last two years the Trustees have conducted a thorough review of its financial objectives and investment strategy. The financial objectives they have agreed are:

a. to maintain (at least) the endowment in real terms
b. to produce a consistent and sustainable amount for expenditure
c. to deliver a) and b) within acceptable levels of risk.

This is intended to ensure that the Foundation will continue in the future to be able to support a similar number of research projects and other activities as it does at present.

Capital Maintenance

In order to achieve this it is necessary for the endowment to increase in value in line with our experience of inflation. About 60% of our expenditure is on wages, which have higher inflation than general prices. The remaining 40% will rise in line with general prices. Given present expectations of inflation we calculate that the foundation will need its endowment to increase in value by about 3.6% per annum in the long term to enable the same amount of activity to be supported.

Market values fluctuate widely so it is necessary to agree on some form of 'base' to which our cost index can be applied. The Trustees anticipate that an averaged market value of the preceding twelve quarters on 30th June 2004 will represent a 'fair value', to be inflated by the Foundation's cost index annually. (The reason for choosing this date is to avoid locking in the inflated market values of the late 1990s). If the market value of the endowment becomes substantially lower (or higher) than the indexed value (after allowing for market volatility), the rate of expenditure may require adjustment to ensure that funds are not spent that should be saved, or saved that should be spent.

Expenditure

The second part of the financial objective is to generate consistent returns that will support a sustainable level of expenditure. Our expenditure is predicated on an assumption of a very long-term total return (income and capital returns) from the endowment of approximately 8%.

Total return	8.0%
Investment management fees:	0.4%
Inflation increase for endowment:	3.6%
Annual expenditure on charitable activities:	4.0%

Thus it is the Foundation's intention to spend 4% of its endowment value on its charitable activities. In order to smooth short term volatility, this is based not on current market values but an average of the previous 12 quarter values.

Portfolio structure and risk

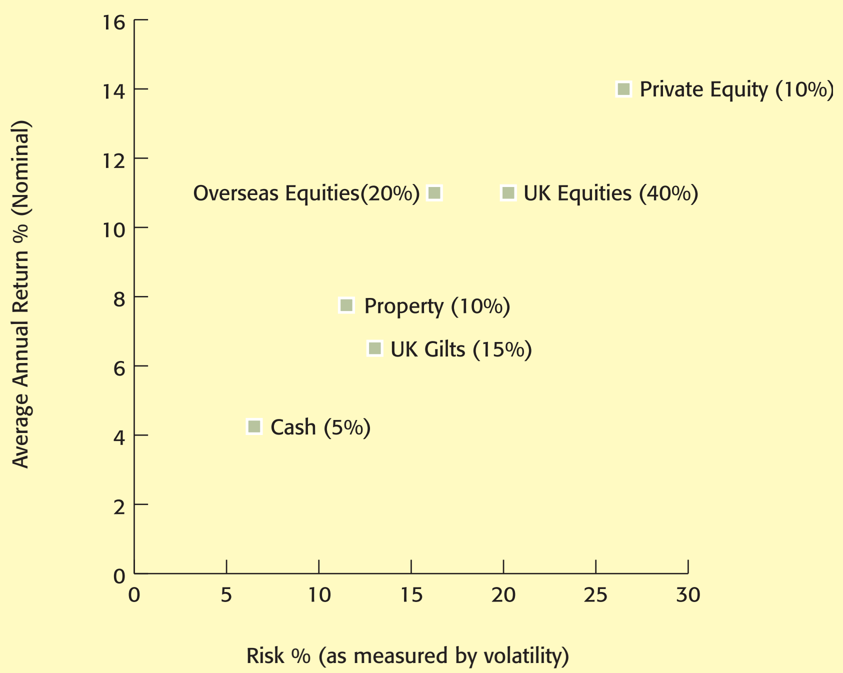
The third part of the financial objective is to generate returns commensurate with an acceptable level of risk. The Foundation's ability to tolerate risk is different from that of a pension fund. A foundation can tolerate 'shortfall' risk. The Foundation could survive a permanent diminution in the value of its endowment (indeed it has) – a pension fund cannot.

Diversification has been important for the Foundation's investment strategy for many years. Different asset classes behave differently under different economic conditions. The structure of the Foundation's portfolio is shown below.

Similarly it is unlikely that one manager will always be equally strong in every asset class. A conclusion of the investment review was therefore that the Foundation should move away from having a single manager and should appoint specialist managers for each of the main asset classes. This change took place in March 2003.

Portfolio structure

Higher returns imply higher risk. If the Foundation invested in a low risk asset such as cash, the long term return would be so low that after preserving the capital, the spending rate would be about 0.4%. The chart shows predicted long terms returns and risk for the six asset classes in the Foundation's portfolio, and the weighting in each class.



SOURCE: CAMBRIDGE ASSOCIATES