Investing: a back to basics guide for the charity trustee

By Ruffer's charity team

Foreword

When I was invited to write the foreword for this booklet I accepted with alacrity.

As Chief Executive of the Association of Charitable Foundations, I believe it is vitally important that all trustees of charities with endowments understand how, why and where their assets are invested. This is not just a matter of ticking a fiduciary box, but an integral part of ensuring that your charity is ambitious and effective in the way that it uses its resources.

The latest figures from NCVO (National Council for Voluntary Organisations) show that charities hold just over £100 billion in investment assets. Even a small percentage improvement in the way those investments are managed could unleash considerable resources for social good and the charitable causes that we care most about.

This is not to claim that reading this book will enable you to become a hotshot investor. But what it will do is to provide a useful introduction to the jargon that surrounds the investment markets, illustrate some of the key concepts, and give you a sense of the Ruffer approach to investing your assets. All of which will equip you to participate more confidently in the important decisions that your charity takes in its investing.

Happy reading!

Carol Mack
CEO, Association of Charitable Foundations

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Introduction

This book stems from something the Bishop of Peterborough once said to me. Coming to the end of a lengthy explanation of my current views on financial markets, I was met with a nonplussed: "that's all very interesting Christopher, but what does it mean for us?"

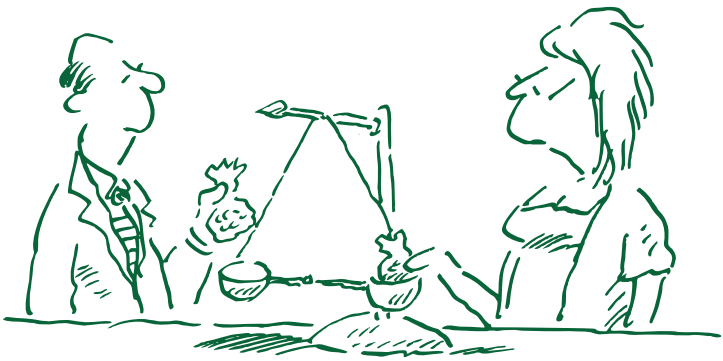
The role of a charity trustee will invariably involve oversight of the charity's financial assets. Whether it be holding excess reserves as cash on deposit or investing a permanent endowment in the stock market, it is largely impossible for charities to avoid investment decisions.

For the uninitiated trustee, responsibility for the investment of an endowment can be daunting. This is compounded by the investment management industry's penchant for impenetrable jargon, acronyms and assumed knowledge.

The goal of this book is to address some of the issues raised by the 'Bishop test'. It aims to help trustees cut through the financial jargon and enable them to make informed investment decisions in the best interests of their charity.

I hope that it will serve as both a useful refresher for the initiated, and a helpful introduction for newly appointed trustees.

Christopher Querée
Head of Charities at Ruffer LLP



The basics

Interest rates – the price of money

Some individuals have excess cash. They may not need this capital at present. Let us call them lenders.

Some individuals may have a cash deficit with inadequate capital to fund their present needs. Let us call them borrowers.

In order to allocate their excess capital more efficiently, the lenders could loan to the borrowers, for a fee. The level of this fee, or interest rate, influences the desire to lend and borrow. Too high, and everyone will want to lend, too low and everyone will want to borrow. The only reason to lend, and the only thing stopping everyone borrowing, is the interest rate.

This interest rate can be thought of as the price of money. The price of money balances the forces of supply and demand in the money market.

Central banks set the price of money via the interest rate and all other assets are valued relative to this price. The attractiveness of equities and bonds will change depending on the interest rate – an investor is unlikely to purchase a bond that gives a lower return than a bank deposit.

In this analogy, the bondholder would lend the bond issuer a chicken. In exchange, the bondholder gets a contract guaranteeing them an egg each year, plus the chicken back at the end of the period.

The contract is the bond, which can be traded. The value of the bond will vary based on how attractive the associated income stream (number of eggs) is compared to what's on offer elsewhere in the market.

Fixed income bonds

A bond is a contract issued by an entity (eg a government or company) in return for cash. By purchasing a bond you are effectively lending money to that entity.

Similar to interest payments on a loan, the bond issuer agrees to make regular fixed payments (a 'coupon') to the bond holder. When the bond matures, the original loan amount (principal) is repaid. If the entity fails to make any of these payments, they are said to have defaulted.

Once a bond has been issued it can be traded, and its price may fluctuate to reflect what another investor would be willing to pay for it.

A fundamental factor that impacts the price of a bond is the relationship between its coupon and interest rates. Importantly, the coupon payment is fixed. Therefore, if interest rates rise and other assets offer a higher return than the coupon, demand for the bond is likely to fall and the price will decrease to reflect that. If interest rates fall, and other assets provide a lower return, the return on the bond may be attractive and the price will increase.

If the price of the bond rises, the size of the fixed coupon relative to the price (the 'yield') falls. The yield on a bond therefore moves in the opposite direction to the price.

Not all issuers are the same. Some may be less likely to return the cash than others (because they might go bust). These entities will have to offer a larger coupon payment to compensate the bond holder for the extra risk.


FINE
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COMPANY

Equities

The terms ‘equity’, ‘stock’ and ‘share’ are interchangeable and all represent a stake in a company. Collectively, the shareholders are the owners of the business.

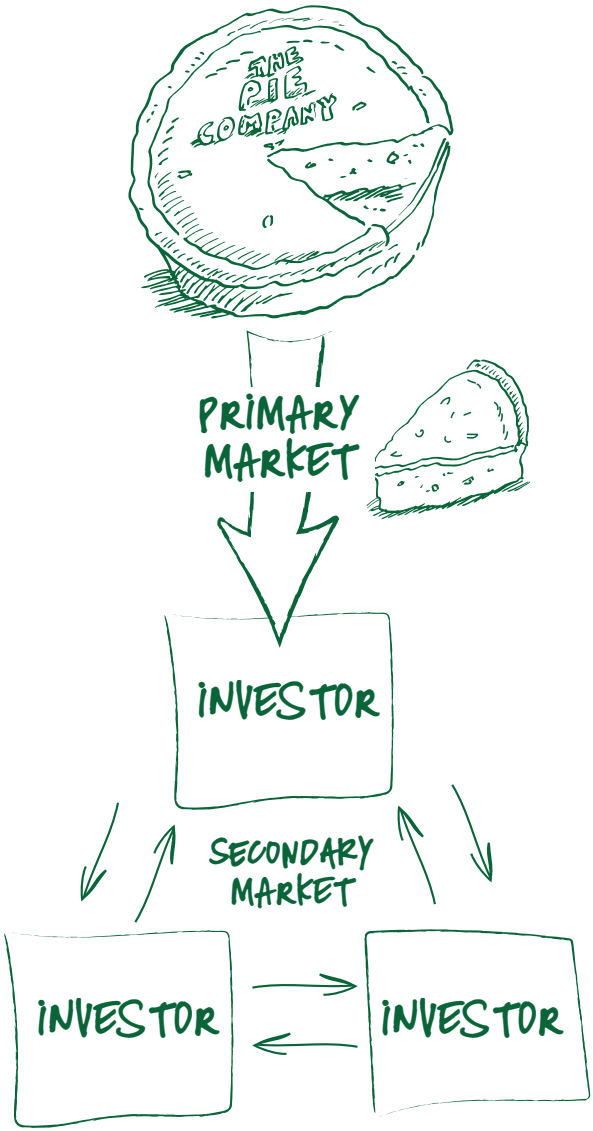
Technically, equity represents a claim to a company’s residual assets. If a company were to be liquidated, equity holders have a claim to their share of the net assets of the business. However, if the business were to fail and become insolvent, the equity holders are the last to be paid, ranking behind employees, suppliers and bondholders.

Most of the time, however, we view companies as a going concern (meaning we expect them to operate indefinitely) and equity therefore represents a claim on future profits.

In return for injecting cash into the business, shareholders may receive payments from the company’s profits, called dividends. Unlike the coupon on a bond, this is not fixed and there is no obligation for the company to pay it.

Any company can issue equity but a public company’s shares trade on a regulated, public exchange known as a stock market. This is an important part of the capital market structure.

Equity holders have the right to attend and vote at general meetings of the company thereby influencing the strategic direction of the business.


THE PIE COMPANY
PRIMARY MARKET
INVESTOR
SECONDARY MARKET
INVESTOR
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What are capital markets?

Capital markets are where those with excess capital can exchange with those in need of capital. This allows for the efficient allocation of capital to those ventures that investors believe will be most profitable.

Governments and businesses typically require capital. Investors can lend to them in exchange for an expected return. The primary market is where new securities (stocks and bonds) are created and issued to investors for the first time. A company going public via an initial public offering (IPO) is an example of a primary market transaction.

In the secondary market, investors can exchange existing securities amongst themselves, hoping to improve the risk and return profiles they are exposed to. The stock and bond markets are the most famous examples of secondary markets.

Cash exchanged on the secondary market does not reach the issuing entity (if you buy an existing share in Apple, the company will not receive that money). But, the market price still has relevance as:

1. A sign of an entity's perceived health and future prospects
2. A useful benchmark for senior employee remuneration

For governments and companies alike, it indicates the cost of borrowing (issuing bonds) or raising capital (issuing equity) in the primary market.

Evaluating bonds and equities

Trading within capital markets provides a barometer of the value of a variety of different investments. Broadly, an investor may value an asset through two lenses:

1. Fundamentals. We can value any asset based on its expected future earnings.
2. Relative. We can consider the attractiveness of an asset relative to other uses of capital.

A number of subjective assumptions are necessary in order to estimate the future earnings power of a company. After making these, an investor may determine that the current equity price is higher or lower than the company's true, or intrinsic, value.

On a relative basis, an investor may look at a variety of measures, including the size of the dividend, the ease with which the equity can be traded (its liquidity) and recent trading activity. For example, a company's equity may be trading at a significant discount to the rest of its industry. These factors generally relate to the price of the equity, rather than the underlying business.

Fundamental valuation of bonds is more objective, as the cash flows are both fixed and known. Therefore, relative valuation is more useful. Principally, investors assess the appeal of the coupon or interest rate relative to other sources of income, such as cash, or bonds from different issuers.

Thinking of investments in terms of their risk

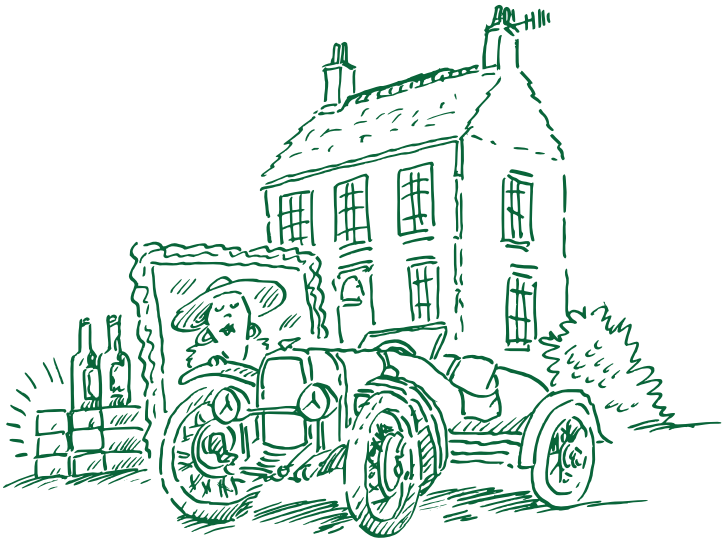
Up to this point we have considered each asset as a standalone investment. In reality, they coexist in the investment landscape, competing for a finite amount of capital. One way to arrange them is in terms of their position on the risk spectrum.

Although there is much debate over what best classifies as a risk-free asset, many investors settle on a short-dated bond issued by the US government due to their 'creditworthiness'. The likelihood of the US government defaulting is extremely low, so the return demanded on these bonds is correspondingly low.

An investor may wish to take on more risk by purchasing a bond issued by a company or the government of a developing economy. In doing so they would expect to receive a higher return on their investment, to compensate for the increased risk of losing their money in the event of default.

Unlike bonds, equities do not offer guaranteed cash flows. For this reason, and the fact that equity holders are last to be paid if the business fails, equities are seen as riskier than corporate bonds (bonds issued by a company).

The expected risk and return profile of different investments can fluctuate, depending on investor sentiment and the economic environment. Investors are ultimately seeking the highest return for the lowest risk.



Further afield: the variety of alternative assets

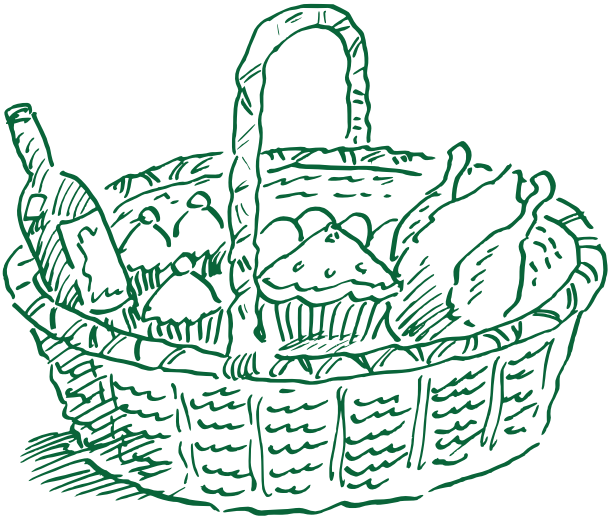
Equities, bonds and cash are typically thought to represent the core asset classes. However, in pursuit of portfolio diversification and superior returns, investors may use, or even create, a variety of other assets in which to invest their capital.

A longstanding example of this is gold and, by extension, other precious metals or commodities. These are known as real assets since the physical product can be traded. Because of this, investors look to them as a safe store of value during the rare moments when faith in the paper-based global financial system wavers.

Speculators and investors alike trade currencies on a mass scale in financial markets. Certain currencies are known to perform well in moments of crisis.

Real estate is another asset with its own unique risk and reward characteristics. For many individuals, their home may represent a significant portion of their wealth. Investors will typically also invest in property for its generally low correlation (tendency to move in tandem) to equity returns.

The umbrella term ‘alternative assets’ even covers items not typically seen in portfolios, and often not suitable for charities. Collectibles such as art, fine wine and antiques may all be owned for investment purposes. These are often not regularly traded and come with an added layer of complexity.



Asset allocation and the pursuit of diversification

If we were to invest all of our capital into one asset we would be entirely exposed to the risk of that asset falling in value. Investments perform differently in different market scenarios. We can therefore seek to reduce our risk exposure by allocating our capital to a range of assets with dissimilar risk and reward profiles. This is known as diversification.

This process of portfolio construction relies on an understanding of the relationship between different assets. In particular, to achieve diversification an investor will search for assets that have a low correlation of returns to each other. A common example of this has been the inverse relationship between bonds and equities over the past 40 years. The two asset classes have tended to move in opposite directions and therefore acted as effective offsets to one another.

For the past few decades, a mixture of equities and bonds has therefore formed the basis of traditional investment portfolios. Investors may then change the weightings tactically in response to different market environments or different portfolio objectives. They may also make use of alternative assets, such as property or gold, which behave differently to both bonds and equities.

Importantly, assessing asset correlation often requires looking at historical data, whilst also recognising that past relationships can change. If two assets which had historically moved in opposite directions were to begin moving in the same direction during a market crisis, a portfolio could be far more risky than anticipated.

Inflation and the real rate of return

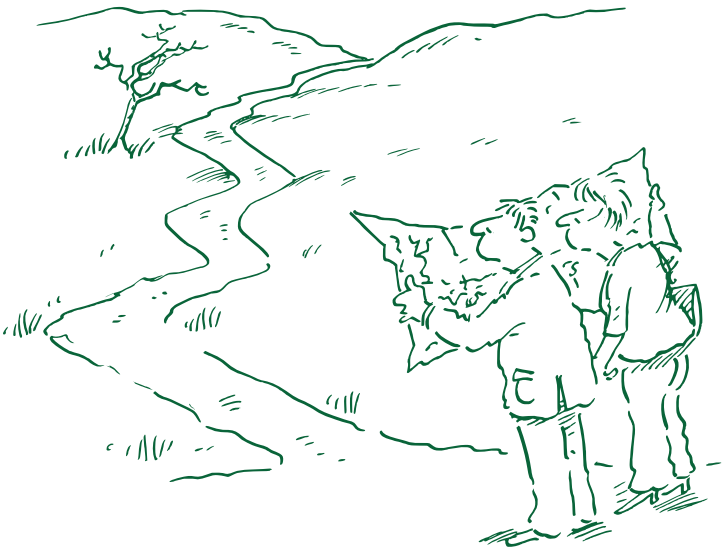
The prices of everyday goods and services generally increase over time. This is known as inflation. For example, if the inflation rate is 2% per annum then a £1.00 pint of milk will cost £1.02 next year.

Inflation erodes the purchasing power of a unit of currency. With only a £1 coin, one would not be able to afford that pint of milk in a year's time. Money is worth less in the future when inflation is positive.

To monitor this erosion we can measure investment returns in 'real' terms, meaning adjusted for inflation. To maintain a 'real' monetary value an investment must return more than the rate of inflation.

For long periods of financial history the 'real' interest rate has been positive – ie a bank deposit would increase your purchasing power over time. All the while you had constant access to your funds and took no investment risk.

More recently, with interest rates heading ever lower, real rates of return on cash have been negative. This means savings are being eroded by inflation and their purchasing power is falling. This is beneficial for those with large quantities of debt, since their liabilities are gradually reduced. However, it is a significant risk for charities with capital and growing future spending obligations.



Considerations for a trustee

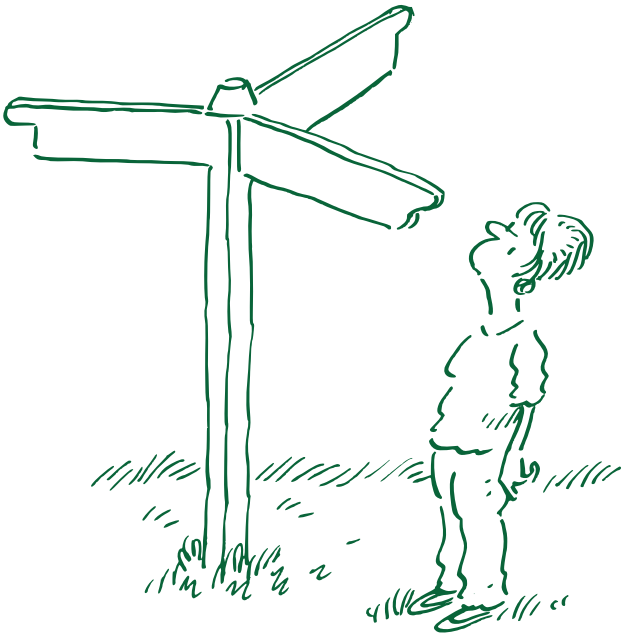
Deciding on investment objectives

The challenge facing a charity trustee is to decide upon a successful long term investment strategy. For most charities, this usually involves a trade-off between meeting current expenditure requirements and long term capital preservation.

First, preserving the capital value of the endowment. Since inflation is the primary threat to the real value of capital, many charities choose to target returns that at least keep up with the rate of inflation, measured by either the Retail or Consumer Price Indices (RPI or CPI). These are common measures of inflation, based on the average cost of a basket of common goods and services.

Second, meeting present day spending requirements. Charities typically meet this through the income generated by their investments, such as coupon and dividend payments. Increasingly, charities take a total return approach to meeting their spending needs, meaning they are also comfortable using the real capital gains on their investments as a source of cash to spend.

Overall, we find that a common objective is to aim for a specific return above the rate of inflation. This allows for a predetermined annual distribution, without eroding the real value of the investment.



Judging performance and risk

Once a charity has decided upon its investment objectives, the next challenge is to choose an investment approach and manager(s) to try to meet their targets. Broadly, there are three different investment styles for a charity to choose from.

Targeted return

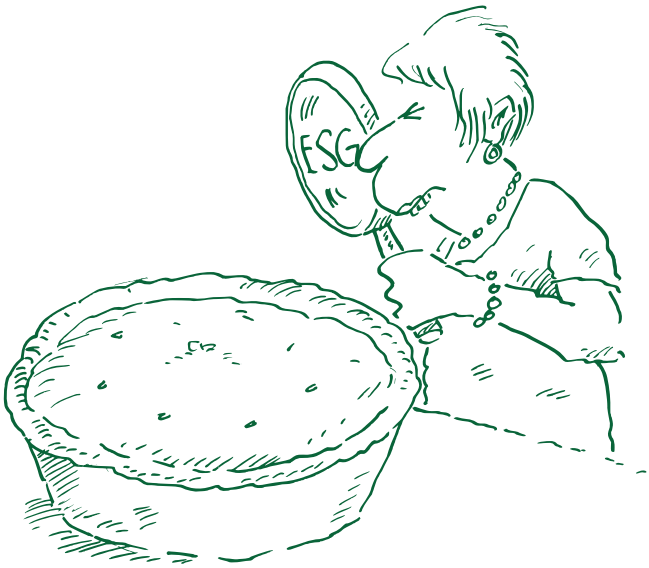
A charity investor might tell a fund manager to target a return of RPI +3%, to maintain the real value of the capital and grow it year on year, regardless of market conditions. The investment manager must then build a portfolio of assets to try to meet that target, whatever the prevailing market conditions. Success is clearly defined against the target, but picking a manager to achieve such returns in all environments is challenging. This is particularly the case when real returns on traditional safe assets are negative.

Relative return

The majority of investors measure their performance relative to market benchmarks. There are thousands of benchmarks, (eg the FTSE 100). This approach might be successful in meeting a charity's objectives when markets are doing well, but following a benchmark can lead to capital loss if the market falls.

Absolute return

This approach aims to increase the initial investment value every year and avoid significant losses. This means harnessing the power of compounding positive returns to drive long term performance. Such approaches can look attractive through a full cycle, but can be dull over the short term.


ESG

ESG – Environment | Social | Governance

It is increasingly important for charities to consider their investments in the context of their mission. Many charities now incorporate a responsible investment policy into their Investment Policy Statement to reflect their values and to manage reputational risk.

There are many ways of implementing this including –

Negative screening Imposing a restriction on your portfolio to prevent investment in certain business activities, eg healthcare charities restricting investment in tobacco.

Positive screening Only investing in best-in-class companies within a sector or in companies that aim to have a positive impact as well as a financial return, eg technology companies that proactively manage the social impact of their products.

Thematic approaches Where the investable universe is considered through specific themes, eg a portfolio of investments that contribute to ending inequality.

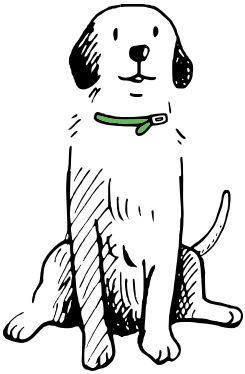
Engagement Using shareholder privileges to influence the behaviour of a company. Typically this involves voting at annual general meetings or, where ownership is significant, meeting with the management team to try to influence strategy, eg using shareholder votes to ensure fair executive pay.

A common worry is that a focus on ESG may come at a cost to returns. However, there is no evidence of this. Indeed, ESG risks are increasingly thought of as a threat to the financial sustainability of a company and so incorporating them into an assessment can often reduce risk.

Our approach

At Ruffer, we take an absolute return approach.

We believe that by looking forwards and assessing the risks and opportunities we see, rather than looking backwards and relying on past relationships that may change, we can build a portfolio of assets able to meet a charity's objectives over the long term.



Contact us

We would love to hear from you if you would like to know more.

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Jargon busting

Absolute return	Aims to deliver positive returns irrespective of market performance and without any comparison to a benchmark
Basis point	For small fractions of a percentage, the industry uses basis points. 1 basis point is the same as 0.01%
Benchmark	Yardstick against which investment performance is measured. Typically a recognised index
Bond	A loan that can typically be traded. They are the primary means for governments and corporates to raise funds by issuing debt. Typically a bond has a fixed life over which an investor receives periodic payments (coupons) and a lump sum (the bond's principal) at the bond's redemption date
Bond yield	The annualised rate of return a bond will deliver to an investor if held through to redemption. A bond's price is inversely related to its yield
Central authorities	A generic description for central banks although it also covers governments because of their ability to influence central bank action. Central banks are responsible for setting interest rate policy amongst other things
Correlation	Statistical measure which describes the extent to which the prices of pairs of assets move together over time. A positive correlation indicates that the pair's prices move in the same direction, whilst a negative correlation indicates the opposite
Deflation	A sustained decrease in the general pricing level. Leads to an increase in purchasing power. The opposite of inflation
Derivative	Complex instruments whose prices are dependent upon that of an underlying asset

Disinflation	A fall in the rate of increase of the general pricing level
Dividend	A payment to equity shareholders determined by management reflecting the profits of the firm (by no means guaranteed, unlike a bond's coupon)
Dividend yield	The annual percentage return a company pays out in dividends relative to the share price
Duration	A measure of the sensitivity of the price of a bond to a change in interest rates
Equities	(Shares/stocks) A means for corporates to raise funds by selling fractional ownership in the business to investors. An investor's return is determined both by the equity's income stream (dividends) and any price increase in the value of the shareholding
ESG criteria	Socially conscientious investors can use environmental, social and governance criteria to screen a company's operations before choosing to invest
Financial repression	A sustained period of interest rates held below inflation (negative real interest rates), often used as a method of clearing debt by central authorities
Fiscal policy	Government policy related to taxation and spending within the economy
Free cash flow	The cash a company generates after spending the money required to maintain its asset base
Inflation	A sustained increase in the general pricing level. Leads to a decrease in purchasing power
Index-linked bond	A bond where the principal value and interest payments are linked to the underlying rate of inflation. You are protected against the devaluing effects of inflation by owning these.
Interest rates	Short term costs of borrowing within the economy – the price of money
Liquidity	The ease with which an asset can be bought or sold in the market

Monetary policy	Policy related to the price (interest rates and yield) and quantity of money
Nominal	Nominal data is not adjusted for inflation
Offset	An investment which acts in juxtaposition to another investment within the portfolio and as such the pair exhibit a low correlation. This contrasts to a hedge which specifically reduces the risk of an individual investment
P/B ratio	Price-to-book ratio. A way of valuing a stock by comparing its market value to its book value (total assets – total liabilities).
P/E ratio	Price-to-earnings ratio. A way of valuing a stock by comparing its share price to its per share earnings
Volatility	A statistical measure of the variation in an asset's price through time – often used as a proxy for riskiness
Quantitative easing	This is the process by which central banks increase the quantity of money and buy debt instruments in order to suppress bond yields
Real	Real data is adjusted for inflation. Calculated as the nominal (non-adjusted) figure less the inflation rate
Real interest rates	Nominal interest rates minus the inflation rate
Relative return	Aims to deliver returns ahead of market performance. Often tracks a stated benchmark
Yield curve	A plot of the interest rates currently available on bonds issued by the same government or corporate but with different and extending maturity dates