Understanding investing: basic 'rules' for long-term investors

A guide for charities

Rathbones
Look forward

The value of investments and the income from them may go down as well as up and you may not get back your original investment. Past performance should not be seen as an indication of future performance.

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Contents

A brief overview of the typical long-term investment management cycle

Creating a long-term investment management strategy is essential in helping a charity to build a portfolio that has the potential to meet its financial needs and increase the value of its assets over time, while guarding against inflation.

This investment management cycle typically consists of four key steps:

- understanding and setting the charity's objectives
- building an asset allocation strategy
- selecting individual stocks
- monitoring, managing and reporting.

Each of these steps has a number of guidelines and 'golden rules' that can help to create a more robust investment portfolio.

1. Understanding and setting the charity's objectives

The starting point for any investment process is understanding a charity's investment objectives, as these help the investment manager to develop a portfolio strategy with the potential to deliver long-term returns within an agreed level of risk.

To set the objectives, it's necessary to ascertain the charity's capacity for loss and appetite for risk, and its current and future financial needs.

Assessing capacity for loss and risk appetite
A charity's financial ability to withstand a temporary or, possibly, permanent loss of capital or income without materially affecting its charitable activities is known as its capacity for loss. Understanding a charity's financial position and therefore its capacity for loss helps to establish how much risk can be built into the portfolio. Factors to consider include the investment time horizon, any other assets or sources of income available to the charity, and its existing and potential liabilities.

While performing an objective assessment of how much risk a charity is financially able to bear is important, this doesn't equate to the charity's appetite for risk. The risk appetite – also known as attitude to risk – is more subjective, so investment managers tend to use a risk questionnaire to analyse it. It is important to assess all of the charity's stakeholders' attitudes to risk, including current and potential future trustees, as well as donors, and to work together to reach a consensus regarding the charity's overall risk appetite.

Establishing current and future financial needs
As part of the objective-setting exercise, trustees will need to determine a sustainable drawdown rate for the investment portfolio, balancing the financial needs of current and future beneficiaries. This is particularly important for endowed charities or those wanting to exist in perpetuity, as they have a responsibility to maintain the real value of the portfolio over time.

To maintain the purchasing power of the portfolio over the long term while drawing down from it, trustees may want to consider a total-return approach. Essentially, this means that no distinction is made between capital return and income return, thereby providing greater flexibility to invest in low-risk or high-growth assets, which typically have lower income yields.

2. Building an asset allocation strategy

The next step in the investment process is to construct the portfolio's asset allocation strategy. Using the charity's objectives and risk-return profile, an investment manager will allocate percentage weightings to different asset classes – including cash, equities, fixed interest and alternatives – to help reduce risk and achieve the charity's objectives over the long term.

When building a charity's asset allocation strategy, it's important to bear the following guidance in mind.

Portfolio diversification is key
It's essential to ensure that a charity is investing not just in a range of different assets, but in a diversified combination of assets that can behave differently in the same economic or market conditions.

Investing in a diversified combination of uncorrelated assets aims to reduce portfolio risk by more than it reduces the potential return, which helps to make the portfolio more 'efficient'.

Equities have tended to outperform other assets over the longer term
While a charity's investment portfolio will typically consist of many different asset classes, equities often form the largest part.

Significant market crashes, such as the 1987 'Black Monday', the dot.com bubble, the 2008 financial crisis, and the COVID-19 pandemic, have demonstrated that equities can fall very quickly in the shorter term.

However, despite these short-term falls, equities have, historically, recovered over time. In fact, past performance suggests that returns from equities have tended to be more stable over long periods of time, outperforming most other assets, particularly low-risk assets such as gilts and cash[1]. It should be noted that past performance isn't a reliable indicator of future performance.

That said, equities are a more risky asset class to hold in the short term, so it is necessary to consider the trade-off between risk and return when deciding what percentage of the charity's portfolio should consist of equities.

Invest in real assets to guard against inflation

Real assets are those whose values can rise and fall with inflation, particularly unexpected inflation. Real assets typically represent something tangible and include equities, property, gold and index-linked bonds.

While none of these assets offer complete protection against unexpected inflation, they tend to cope better with inflation – and can therefore preserve the real value of a charity's investments by delivering returns ahead of inflation – compared to nominal assets such as cash.

[1] Barclays Equity Gilt Study 2019

3. Selecting individual stocks

Asset allocation strategy sets the guidelines for selecting individual stocks that will make up a charity's investment portfolio. Stock selection is very dependent on each charity's unique preferences and is therefore best discussed on a case-by-case basis with an investment manager.

That said, many charities are choosing to align their investments more closely with their own values and charitable aims through sustainable and socially responsible investing, which involves selecting stocks with strong environmental, social and governance (ESG) credentials.

Responsible investments can provide long-term value

A key element of stock selection involves trying to select funds or investments that are most likely to deliver the best risk-adjusted returns over the long term. While there is always a risk that something will go wrong when investing in any particular company (or stock), the risk tends to be lower for those companies that operate with sustainable business practices, good corporate governance and solid environmental and social policies.

Indeed, studies have shown that poorly governed companies have tended to underperform the wider market by approximately 3-4% per year. Similarly, past performance demonstrates that those companies with a diverse board and strong female leadership have generated a return on equity almost 3% higher than those companies that do not[2]. Again, note that past performance isn't a reliable indicator of future performance.

Companies that demonstrate strong ESG commitments are more likely to have a wider positive impact on society.

[2] MSCI, Hermes

4. Monitoring, managing and reporting

The fourth and final step in the investment management cycle focuses on the ongoing management of the investment portfolio. This responsibility typically belongs to a charity's investment manager, who will monitor the investments in line with the charity's objectives and report on performance on a regular basis.

Communication is key

Reporting on performance, as well as regularly reviewing the charity's circumstances, is essential to ensure that the chosen strategy continues to meet the charity's needs. Communication is critical to the investment process and trustees need to have regular conversations and meetings with the charity's investment manager. If a charity's circumstances change dramatically it may be necessary to revisit its objectives and review its investment strategy in line with the process.

However, it's important to note that even when a charity's long-term strategy remains the same, the investment manager will be actively managing the portfolio and the level of risk it is taking. This means making shorter-term changes between investments, both at a stock selection and asset allocation level, as economic and market conditions change.

Avoiding market pressures

Although it is necessary to actively make small tactical adjustments to the charity's portfolio on an ongoing basis, it is crucial not to change the investment strategy based on changing market conditions and the emotional rollercoaster that usually accompanies the peaks and troughs of the market.

When equity markets are buoyant and stock prices are rising, investor optimism tends to increase and it becomes very tempting to invest more or take on greater levels of risk. However, the financial risk is greatest at this point because markets always fluctuate and the longer and higher markets rise, the greater the risk of a correction. Conversely, when markets begin to weaken, investors often panic and want to sell their equities. In fact, there is often maximum financial opportunity at this point because, over time, markets tend to recover and the cycle begins again.

As an example, if a charity had remained invested in UK equities over the last 15 years, the portfolio would have returned 5.6% per year, even after accounting for the impact of the global financial crisis and the COVID-19 pandemic. However, if the charity had missed just 10 of the best performing days during that period – as a result of trying to time entry to and exit from the market – that annual return would have been reduced to 1.2%. Similarly, missing the top 20 days would have resulted in an average loss of 1.5% per annum[3]. Note that these figures refer to simulated past performance, which isn't a reliable indicator of future performance. Irrespective of market behaviour, it is very important that long-term investors hold their nerve and stay invested in line with their objectives. If they don't, they run the risk of missing out on the market recovery.

Always remember that it is 'time in the market' – not 'timing the market' – that is key to successful long-term investing.

The power of compounding

Many charities rely on their investment income to support their charitable activities and, for some, this is their primary source of income. However, those charities that can afford to reinvest some or all of the investment income will be able to benefit from the effects of compounding returns.

To illustrate: if a charity had invested £100 in equities at the end of 1899 and consistently withdrawn the investment income, the portfolio's real value today would be £193. However, if income had been reinvested, that same £100 would be worth £35,790 today[4]. Again, please note that simulated past performance isn't a reliable indicator of future performance.

[3] Fidelity
[4] Barclays Equity Gilt Study 2020

The fundamentals of investing

This guide accompanies one of our charity investment training webinar series: The basic rules for long-term investors. You can watch the full webinar by following this link.

Our training webinar series is designed to provide trustees and senior finance staff with an understanding of the fundamentals of charity investment.

Please visit:
rathbones.com/charities to find out more about the training series or to read our other guides.

To find out more about Rathbones' approach to portfolio construction and investing for charities, please contact:

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Important information

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