

When we are asked to advise on a charity investment portfolio we are inevitably presented with a traditional core holding in bonds, for some yield and security, an equity holding for some growth, and cash which is often held for no purpose, earns no return, and is now seen to be losing value. Usefully, it is the cash which now triggers concern and prompts the Trustees to seek advice and reassurance.

Typically, Trustees have received an investment report on performance against the market or a pre-defined benchmark, and need to decide if this is acceptable – this is a discussion which often takes place at a meeting with the managers. However, this misses an important first step.

Trustees should first address their own investment criteria before meeting the managers, and ask themselves fundamental questions: What does this money need to do? What is the return we need and is this now realistic? What is the most we are willing to lose? When this first step is not taken, and the usual meeting takes place with the managers, the traditional asset allocation invariably stays the same and the implicit risks continue. A proper discussion often only takes place after significant losses and when Trustees are considering a change of manager, but relevant questions should be asked earlier before there is a need to change managers.

The second step is asset allocation - key for protecting capital and making acceptable risk adjusted returns. The traditional trade off between bonds and equities, and their perceived negative correlation, is breaking down, with bonds no longer offsetting downside equity risks. There is now a chance of higher volatility with further risks and capital losses.

Consensus forecasts are for positive single digit equity returns for the year. We, however, believe that equity markets will be volatile and see widening distribution of returns. Fundamental analysts argue that corporate balance sheets are strong and global branded companies should provide a healthy total return, both in capital and in dividend. We would agree and advise being in growth areas, with emerging market exposure through managed funds or ETFs, and also include large capitalised first world companies. These may be volatile, but shouldn't be ignored.

Traditional sovereign debt has changed and lost its defensive shine. Are UK Gilts that attractive when a 10 year Gilt yields a little over 2% and a 30 year Gilt yields a little over 3%? They offer negative real rates of return and even if interest rates remain low is there any significant upside to these bond prices?

Trustees clearly have to re-visit, widen and diversify their asset mix to lower the implicit volatility of their traditional portfolios, whilst aiming to maximise the risk adjusted return. This means considering a greater exposure through absolute return funds and hedge funds which can offer the uncorrelated returns balanced portfolios require.

Hedge funds are often viewed with scepticism and concern. They frequently don't perform in the way they should and are expensive. Trustee fears include choice of strategy, the relevant fund managers, liquidity concerns, and most importantly do I understand any part of what they do?

Some Trustee fears are alleviated by the dedicated teams in banks and institutions constantly reviewing credit, management and operational risks. Fund picking though is more difficult and advice should be sought so the blend of funds selected compliments the existing portfolio of traditional investments. We are often asked to suggest a portfolio of funds for bond style returns, with bond style risks and volatility, as a

substitute for traditional bond portfolios. This approach reduces overall volatility, produces uncorrelated returns, and better positions the portfolio from the risks implicit in a traditional portfolio.

Hedge fund fees are higher than traditional managers though returns are reported net of fees, unlike the gross returns reported by traditional managers. The real question is: Are these fund managers producing the net returns expected?

Whilst alternative investments, absolute return funds and hedge funds have often been avoided by Trustees, the challenges today require a fresh look at how these can be used to prudently rebalance portfolios and pre-empt further capital losses.

Finally, if the Trustees recognise that the original terms of the investment have to be revisited and the asset allocation reviewed and diversified, further questions need to be asked: Are the current managers right? Would different or specialist managers be better to achieve the right diversification?

We are often called in to help when Trustees are concerned with the prospect of further capital losses and feel there is a need for another opinion, which is impartial and unbiased, to reassure them and better position the portfolio to achieve what it is meant to do.

If you would like to know more, please get in touch:

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