Investec
Wealth & Investment

Charity Matters

Autumn 2018

Out of the Ordinary

Welcome to our Autumn 2018 issue of Charity Matters.

Mike Marsham
Head of Charities
Investec Wealth & Investment

There is no shortage of highlights from which to choose when assessing the factors driving markets over recent months, not least of which is the ongoing uncertainty over the issue of Brexit. In this Autumn edition of our Charity Matters we have chosen to focus attention away from that particular delight.

Instead we start with David Richardson taking a look at the topic of impeachment, much mentioned in the early years of this US presidency, but how likely might it be?

At the heart of our investment process is Investec Wealth & Investment's research team; our ongoing investment performance is crucial for our clients, and Guy Ellison explains the role that team plays.

Stacey Parrinder-Johnson, also from our research team, explores the landscape of responsible investing. A wide ranging topic, and something more regularly discussed within our client meetings than in years gone by.

Tom Quicke reviews the suitability of investment strategies for clients, and we have an article from Nadeem Azhar at the solicitors Hempsons giving helpful guidance to charity trustees on the responsibility of good governance.

We hope you enjoy reading the articles, and if there are any subject matters you would like us to address in subsequent issues please let us know. If you would like to send feedback, be taken off our mailing list or amend the details we hold for you please contact **valerie.mudge@investecwin.co.uk** or call us on **0207 597 1074**

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Impeachment – How easy would it be to remove Donald Trump from office?

“There is no doubt that many of Trump’s opponents would love to at least ‘land a punch’ on him.”

David J. Richardson
Senior Investment Director
Investec Wealth & Investment

Talk has been brewing about the possible impeachment of US President Donald Trump almost since he first took office in 2017. Charges against him have ranged from conflicts of interest because of his failure to divest assets ahead of taking office, to being complicit with Russian interference in the US elections.

The term ‘impeachment’ is much bandied around, yet it is not that well understood. For those of my generation, it carries partisan political connotations: we vaguely remember the Watergate affair and the end of Richard Nixon’s career. But do we know what constitutes grounds for impeachment and the progression of events that could bring it about?

The term impeachment comes from Old French and was originally an act under English law. Essentially, it is the mechanism whereby an elected legislative body formally brings charges against a high governmental official. However, it does not necessarily mean that the individual will be removed from office. It is a formal statement of charges akin to the indictment phase in a criminal prosecution. The charge is then debated in the legislative body which brought the impeachment action.

Because of the need to overturn normal constitutional procedures and avoid the criminal prosecution system, the process of impeachment is reserved for the most serious abuses of government position. A much larger level of support than a simple majority is also required, often referred to as a ‘supermajority’ and not often achieved. Nevertheless, for the political opponents of the official being impeached, the loss of status is often incentive enough to bring the action. There is no doubt that many of Trump’s opponents would love to at least ‘land a punch’ on him. Impeachment procedures vary depending on the jurisdiction. In the US, Article One of the Constitution gives the House of Representatives the sole power of impeachment and the Senate the sole power to try the impeachment. This applies to Federal Impeachment of ‘Officers of the Federal Government’.

Impeachable offences are “treason, bribery or other high crimes and misdemeanors (sic)”. These terms are unsatisfactorily loose in the twenty first century but were amusingly defined in 1970 by Gerald Ford, later to become President himself, as “whatever a majority of the House of Representatives considers it to be at a given moment in history”. In order to be successful, the impeachment charge must be approved by two thirds of the Senate. This is a very stiff task, which is why very few impeachments result in conviction.

The impeachment that many may remember was that of Bill Clinton in December 1998 for perjury and obstruction of justice. The distinction between impeachment and removal from office is highlighted by what happened next. The then President was tried by the Senate, with a two-thirds majority of the 100 Senators required to remove him from office. Once all 45 Democrats in the Senate had decided to find him not guilty, it was obvious he would be acquitted. Returning to Donald Trump’s possible impeachment, attempts to impeach him were moved almost as soon as he took office. With conflicts of interest in his business life, plus inevitable questions about his personal life and the Russian connections involved in his election, there are numerous bodies who would be delighted to impeach President Trump. Indeed, an opinion poll carried out six months ago found that 40% of Americans wanted him impeached.

The key question is, how likely is it that any of these proposed impeachment efforts will get off the ground? Given the partisan nature of US democracy and the polarisation in US politics and society, the issue is likely to come down to simple mathematics. The Republicans currently control both the House of Representatives and the Senate. The two thirds ‘supermajority’ required for a successful impeachment and removal from office seems a very long way away. Those hoping the Republicans will suffer heavily in the mid-term election still need to look at the numbers. The Republicans only have a 51/49 majority in the Senate, but only 35 seats are being contested on the 6th November and 24 of those are Democrat. So those waiting for the US President to be removed from office should not rush to get out their hour glass.

IW&I Research – How we find the best investment opportunities for our clients

“It’s far better to buy a wonderful company at a fair price than a fair company at a wonderful price” – Warren Buffet.

Guy Ellison
Head of Equities
Investec Wealth & Investment

Members of Investec’s Research Team may cover Equities (stocks and shares), Bonds, Collectives or Alternative Assets. But we are all responsible for the same task – finding the best investment opportunities and communicating them to our Investment Teams and the Investment Managers responsible for your fund.

A new equity investment may make its way onto our radar in a variety of ways. Some are home grown ideas: with nearly 400 investment managers within our business all with a passion for investment, we encourage an ongoing sharing of ideas. This might be a “have you looked at…” chat at the coffee machine, or a more formal committee process.

Then there are the institutional fund managers who run unit and investment trusts. They regularly visit our offices to explain their investment process and why they invest in the companies they do. Being able to sit across the table from industry leaders such as Neil Woodford, Mark Barnett, Chris St John and Nick Train is a valuable source of new ideas.

Finally, we are fortunate to be able to access a host of conferences and meet the management teams of a myriad of companies either in a specific industry or on an investment theme, such as Demographics or Electric Vehicles.

Once we have an initial idea, our next step is to dig deeper and get a better understanding of the company, its position in its industry and the credibility of the management team and their strategy. Some information, such as the company’s Report & Accounts, is freely available and is an invaluable starting point. We also have access to detailed research written by ‘sell side’ investment houses – the likes of Merrill Lynch, JP Morgan and Citigroup. Whilst their conclusions may be biased by a shorter-term investment horizon than ours, plus the need to be commercial, their knowledge and analysis of an industry is very valuable.

Beyond this we will seek to arrange a meeting with the company in our offices, giving us a chance to probe the business more keenly and also appraise the quality of the management team. Naturally, this is a qualitative assessment and not infallible, so it would rarely be our sole reason for investing unless the track record and industry position of the individual or team was exemplary.

We then look from a more quantitative perspective at the quality of the business. How profitable is it? How strong is the cash generation and how consistent is it? Is the management team a good custodian of our client’s capital, i.e. are they investing in projects which deliver a profit? If not, they are destroying value and the capital could be better deployed elsewhere.

Even if everything checks out from these qualitative and quantitative investments, it still does not automatically make it onto our shortlist of recommendations. The final piece of analysis is around valuation. As long-term investors and biased towards quality, we are less sensitive to valuations than a shorter-term trader might be. But as Warren Buffet said, “It’s far better to buy a wonderful company at a fair price than a fair company at a wonderful price”.

To help us determine what a ‘fair price’ is, we use a range of techniques. Most simply we can reference where peers are trading on, say, a multiple of their earnings (Price to Earnings a.k.a. PE being the most common) and then decide if the company in question deserves a premium or discount to this. If it is a business with distinct and differing business units (e.g. Whitbread which owns Costa Coffee, Premier Inn and a pub/restaurant business) we might value each separately and then combine them to give a ‘sum of the parts’. Perhaps most rigorously, through our own proprietary systems and an industry-leading product called HOLT, we can turn the valuation consideration around and ask “what level of cash returns and what duration of these returns is the share price discounting today?” If we believe that the company in question will deliver superior returns to those that the market is discounting, then the shares offer capital upside. Once we have invested in a company, our aim is to hold it for the long-term. This keeps transaction costs down and means that we can broaden our understanding of the company. Our analysts regularly meet the companies we invest in and, where issues arise, bring them up with the company. If we are not satisfied, we can disinvest or vote against company resolutions. However, generally where companies are moving in a direction that is not in the interests of their shareholders then engagement can result in a satisfactory conclusion. This happened recently: Unilever was proposing to move its headquarters to Rotterdam but spoke to its shareholders, including us, before the proposed vote and subsequently abandoned the idea.

In conclusion, our aim is to invest in quality companies that can be held for the long-term. Our belief is that if companies are well managed and generate returns that are in excess of their cost of capital, they will pass on these gains to their shareholders. Biasing our clients’ portfolios to these sorts of companies will, over time, bring the rewards our clients are looking for.

Responsible Investing moves mainstream

Stacey Parrinder-Johnson
Senior Fund Selection Specialist
Investec Wealth & Investment

There has been something of a responsible investment explosion recently, with countless newspaper columns and interviews devoted to discussing the subject. As long term practitioners of this type of investing, it is interesting to see how things are developing.

When most people think about 'doing good' with their investments, they think about Ethical and Socially Responsible Investing (SRI). An Ethical strategy is when an investor focuses solely on removing negative factors, avoiding companies such as those which use animal testing or sell pornography. Exclusions have always varied from portfolio to portfolio, depending on the screening criteria and the popular concerns at the time – for example, in the late 2000s there was a much bigger focus on nuclear energy than there is now. SRI is the balance to Ethical strategies: rather than screening out the 'bad', these portfolios attempt to invest only in the 'good' – businesses which offer some positive benefit to society through their products or services, for example those who offer inclusive finance products or green energy solutions.

These strategies suit a number of investors, particularly charities and institutions with a particular focus, who only want a few selected things removed from their portfolio, or want to support new ideas. However, they have always been reasonably niche compared with wider investment options. To a certain extent, this has been because both these strategies tend to favour smaller companies. Within Ethical investing, a screen against Tobacco, Oil, Pharmaceuticals and Defence would remove a large part of the FTSE100, while SRI tends to favour smaller, up-and-coming companies which are disrupting large incumbents.

This naturally leads to a performance differential when you are measuring against benchmarks made up of larger companies – which has led to the common, but incorrect, belief that Ethical and SRI involves an acceptance of poorer performance. In fact, rather than being worse, the performance profile is just different as you move through the market cycle.

It is easy to show why a negatively screened portfolio has performed as it has. For example, a negative performance is easily understood if a screen for animal testing is used in an environment where Healthcare outperforms. But it is much more difficult to prove that something has performed for a positive reason – how do you know if a company is doing well because it is a good business, or because it is a business that is doing good?

So why has this type of investing suddenly come out of the dark? Undoubtedly, there are influences that have positively benefited both Ethical investing and SRI. For example, divestment from

fossil fuels (a negative screen) has become mainstream as alternative energies (SRI) have become cheaper, more easily accessible, and subject to global initiatives. Additionally, the millennial generation are asking questions about whether Tobacco is a sustainable business going forwards, as well as embracing different types of financing (such as Kickstarter) and social businesses. However, there have also been two big moves that have gone some way to solving the issues of performance and provability. Firstly, a third way of investing responsibly known as ESG investing is coming to the fore. ESG focuses on better understanding of how a company, whatever its size, manages its environmental (E) and social responsibilities (S), as well as how well it is governed (G).

ESG fund managers are looking to these three things when assessing the quality of a company, which should help decide how it will do in the future – for example, a company with a poor environmental record might have to pay damages. Additionally, they can use the weight of their shareholding to engage with companies for change, such as promoting the living wage, or encouraging best practice in their parental leave policies. Essentially, rather than pushing an investment manager into small companies, an ESG approach offers the chance to influence larger companies. Not only does this overcome the small cap bias (and resulting performance profile) of Ethical and SRI portfolios, it makes responsible investing much more palatable to mainstream investors.

Secondly, the UN's Sustainable Development Goals (SDGs) have made it easier for portfolio managers to link how positive drivers contribute to financial performance. With the SDGs, the UN has put in place seventeen desired outcomes linked to economic development, in the hopes that businesses will devise solutions to address these goals. By investing in those businesses, it has become infinitely easier for portfolio managers to 'prove' that positive investing is worth it.

At Investec Wealth & Investment, we research both equities and specialist funds, as well as mainstream offerings from teams which incorporate ESG into their processes. Our approach to responsible investing portfolios is one of 'sustainability' – an umbrella term for the combination of all three of the other methods. This involves pragmatic negative screening to meet client requirements, ESG approaches for larger companies, and searching for those businesses who can offer socially and environmentally responsible growth through new alternatives.
We are already active investors in areas such as renewable energy and social housing, and expect that interest in similar funds and in environmental, social and governance issues will continue to grow over time.

"How do you know if a company is doing well because it is a **good business**, or because it is a business that is **doing good**?"

Strategy Suitability – How we ensure we are meeting your requirements

Every client will have different investment objectives and risk tolerances. So when we are creating or reviewing an investment strategy, it is important that we consider the needs of each client carefully to ensure that it is suitable for them.

Being able to understand a client's financial circumstances and capacity for loss within a portfolio is integral to the strategy we might recommend. A charity's circumstances or objectives may change over the years, so it is vital that the investment strategy we offer them is flexible. Our investment managers need to maintain an ongoing conversation with their charity clients to ensure strategies remain appropriate. In the past, we have asked our charity clients these sorts of questions:

1. What proportion of your assets does this fund represent?

2. Are there likely to be any sizeable inflows/outflows over the next 12 months?

3. What is the likelihood of you needing to take over 15% of the fund in the short-term?

4. Does the income produced by the fund meet your needs?

5. What is your investment time horizon?

6. Is your investment objective still for income or for capital growth? Or is it a balance between the two?

These questions enable us to get a good sense of a client's objectives and their capacity for loss. But we are now endeavouring to gather more granular detail, to help us get a better picture of a client's capacity for loss.

Going forward, we will be asking the following additional questions:

1. If there was a sharp unexpected fall in the market and your fund fell in value by 25% within 12 months, would you have to make meaningful adjustments to the way the charity is managed or to its distributions?

2. Similarly, if your income from the fund fell by 25%, would this require significant adjustments?

Understanding a charity's capacity for loss will certainly help determine what sort of investment strategy it can afford to have. However, the trustees' attitude to risk is just as important. A charity with a high capacity for loss might have a trustee board that doesn't feel comfortable with a higher investment risk, so they adopt a lower risk strategy with a lower capacity for loss (or indeed, vice versa).

Of course, attitudes to risk and definitions of it can vary from trustee to trustee. So we are now trying to establish in greater detail what the collective body of trustees' attitude to risk is for their charity. To do this, moving forward we will be carrying out some scenario analysis and asking questions such as:

1. If you were a charity with £3m of assets, what sort of a fall in assets would make you consider altering your long-term strategy?

2. Would such a fall make you consider liquidating the portfolio?

3. Are you more interested in stability of capital? Or do you want to achieve a high return – and do you accept that you will have to take on some level of risk to achieve this?

These are the sort of questions your investment manager will be discussing with you, to enable them to assess whether your investment strategy continues to be the right one for your charity. And of course, if your charity has experienced any significant changes which could impact your investment strategy, it is important you talk to your investment manager at the earliest opportunity.

Tom Quicke
Investment Director
Investec Wealth & Investment

"Are you more interested in stability of capital? Or do you want to achieve a high return – and do you accept that you will have to take on some level of risk to achieve this?"

Good Governance – Whose responsibility is it?

Nadeem Azhar
Associate
Hempsons

Charities continue to make headlines in 2018, and not always positively. The Charity Commission is showing that it can, and will, investigate charities. This is a good thing, but the failings are not helping the sector's reputation. Public trust now stands lower than the average for the last decade (Charity Commission/Populus, July 2018).

Accountability seems to be at the heart of the problem, and increasingly, a failure to adhere to some very basic standards of governance. Charity Commission investigations in 2018 have focused on charities of all sizes. Most recently, a statutory warning issued to the RSPCA in August found that the trustees had failed to act with reasonable care and skill in their decision to award a payout to a former chief executive. The Commission noted that the trustees did not comply with their duty to ensure that they were sufficiently informed before making a decision.

It's nearly three years since the Public Administration and Constitutional Affairs (PACA) Select Committee published its report into the failings of Kids Company, which focused on the need for trustee boards to be effective, and to be more accountable. Since then, the sector has updated the Charity Governance Code to sit alongside the Charity Commission's existing publication, the Essential Trustee (CC3 and CC3A), which was recently revamped. Here we consider the Code, and the perennial issues that still seem to cause problems.

The Governance Code

Organisational purpose - Trustees should keep under review their charity's purposes and activities. They should lead on developing a strategy for achieving goals and plan for the future, taking into account the charity's broader context.

Leadership - Trustees should take full responsibility for decision-making, properly appoint and supervise senior management (and properly maintain such relationships), lead by example and be committed.

Integrity - Trustees should act in the best interests of the charity and its beneficiaries, avoid conflicts and maintain the charity's reputation, in line with its values.

Decision making, risk and control - The trustees should focus on strategy, performance and assurance (and less on operational matters), have sound decision-making and risk assessment processes, balance oversight with freedom, and properly manage any delegation.

Board effectiveness - The trustees should maintain good board behaviours, skills, teamwork and ensure they can make decisions effectively.

Diversity - Trustees should ensure that they are trained on diversity, make a positive effort to reduce obstacles to diversity, recruit appropriately and monitor it.

Openness and accountability - The trustees should identify, communicate and where necessary, consult with stakeholders in relation to the charity's activities. They should ensure they have an effective complaints handling process, and in relation to membership structures, have clear policies and records for the admission and administration of members, who they should properly engage with.

The Tension

The Code makes clear the legal position. Ultimately, it is the trustees who are responsible for a charity's activities. It acknowledges, however, that the trustees do not run a charity, and instead, must maintain an oversight role.

In practice, both trustees and senior management take responsibility for how charities develop overall strategy and comply with overarching legal and regulatory responsibilities. At one end of the spectrum, trustees are passive (which is more common), and at the other they are overly involved in operational matters. The Code acknowledges this tension. The sections on leadership and decision making/control focus on the need to properly manage senior management, but at the same time, to afford them autonomy. The risk is that this tug of war leads to the principles underpinning the Code falling somewhere in between, usually with the trustees taking a back seat.

Common Failings

There are common issues we continue to see in charities. Here are five perennial issues.

Failing the primary duty - Trustees need to understand their primary duty to ensure the charity is carrying out its legal purposes and delivers public benefit. As the code makes clear, trustees need to keep under review, and challenge, medium and long-term objectives. They must not let the charity drift or fail to understand what it can and cannot do.

Not acting in the best interest of the charity - Trustees need to protect a charity's assets, which include its brand. This does not mean running the charity in a vacuum. A charity exists for its objects, and for the benefit of its beneficiaries. Whilst it is for the trustees to determine how they meet the public benefit requirement, they remain accountable to the charity's beneficiaries. In some cases, the members of a membership charity should be better engaged.

Failing to identify key risks - Although common to all sizes of charity, many large charities fail to properly identify key or relevant risks. This is usually because there is either too much or too little key information being passed to trustees. Rather than review the same risk assessment/process each year, the trustees should be able to involve staff and management to identify real and practical risks and to be able to explain in simple terms what could go wrong with a charity.

A lack of skills/role definitions - Charities are diverse, and there will be different expectations on what the trustees should deliver. Charities should identify skills gaps and put in place clear role definitions. The role of the chair is paramount. It is not just about being a figurehead, or well regarded. The chair should be willing to challenge the management and give the other trustees a platform. He or she should ensure decisions are being followed through. In smaller charities, a strong chair is essential to support what is usually a stretched, or singular executive.

A dominant executive team - It is common for dominant personalities or individuals to drive strategy. This is often critical for success. However, there should not be a complete handover of control to a senior management team. In such cases, the trustees are kept informed and appraised of the charity's activities, but the management will drive the entire process of risk management and decision making, without being challenged.

To sum things up, board and management need to work together to deliver effective governance – it is not enough for regulatory guidance to be directed at trustees. Both need to understand what is unique about their charity and the very specific needs of beneficiaries. Trustees cannot and must not be passive. They must ensure that the board is skilled and effective in carrying out its supervisory role as, ultimately, the buck stops with them.

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