Investec
Wealth & Investment

# Charities Division Guide

## Setting Investment Strategy and Writing an Investment Policy Document

# Contents



**"Trustees who give discretionary powers to an investment manager are legally required to have a Written Investment Policy that covers:**

**the remit and responsibilities and the principles that any investment manager must follow."**

**Charity Commission**
**CC14 Page 21 Section F6**

## This document is intended to provide trustees with helpful guidance when producing a Written Investment Policy Document (WIP).

The investment policy of a charity needs to reflect the nature and requirements of that charity and therefore no two policy documents need look the same. Charity law does not define what should be included in a policy document but the fact that one exists provides a clear audit trail and demonstrates good governance.

**"If trustees have considered the relevant issues, taken advice and reached a reasonable decision, they are unlikely to be criticised for their decisions or adopting a particular investment policy"**

**Charity Commission – CC14**

The Charity Commission recommends that charity trustees decide on an investment policy for their charity, record it clearly in writing, and keep it under regular review.  If they have delegated their investment function to an investment manager these are legal requirements. Without an investment policy, trustees are likely to find it difficult to demonstrate that they are making good use of the charity's funds.

The creation, and contents, of a policy document are the responsibility of the trustees, and should not be delegated to say, the investment manager. But, in formulating policy, trustees may, and in some cases should, take expert external advice. Investment managers are well placed to provide such guidance if required.

The WIP's construction requires an understanding that it will be viewed from a number of different perspectives. It is an external statement of intent and parts may be incorporated in your Annual Report which means that it may be viewed by all the "stakeholders" of the charity: sponsors, donors, beneficiaries and employees. It also forms the basis on which the mandate for the management of a charity's investments is delegated to others.

Policies will vary from charity to charity but the process of considering what should be included will cover many of the same aspects which are described here.  We have also incorporated an example of a WIP at the back of this document.

- Governing Instrument
- Trustee Act 2000
- Charity Commission Guidelines
- Reserves Policy Statement
- SORP

### Governing Instrument
A charity's governing instrument will normally be the first place to look for any guidelines. This document may set policy requirements as to how monies are invested. This could include requirements for capital or income, discretion or non-discretion, the use, or otherwise, of nominees and whether the investments must meet the terms of the Trustee Act 2000. Any instructions must be adhered to. If they are considered too onerous or unworkable the trustees will need to take appropriate legal advice, which may include approaching the Charity Commission to see if the restrictions can be altered.

### Trustee Act 2000
The governing instrument may dictate investment powers, but if no guidance is given in the Trust documents then the charity's investments will normally be governed by the Trustee Act 2000 which provides trustees with "wider powers" to set their own investment policy rather than have it set for them (as was originally the case for many charities under the Trustee Investments Act 1961).

### Charity Commission Guidelines
The Charity Commission has produced detailed guidance on investment (including investment policy documents) in the publication – CC14 "Charities and Investment Matters" (www.charitycommission.gov.uk)

### Reserves Policy Statement
Charities are required to have a reserves policy. Unrestricted monies available for investment may form part of a charity's reserves and the reserves policy should be considered when setting an investment policy. The risk analysis undertaken when setting the reserves policy could have implications for both the nature of the investment undertaken and the appropriate level of risk.

### SORP's
Recent Statements of Recommended Practice (SORP) have required an increase in the level of disclosure in Annual Reports about the aims, activities and achievements of a charity, both in terms of value, performance and impact. Additional disclosures could cover reserves policy, income targets, performance against benchmarks and any ethical policy. The process of creating (or reviewing) a policy document will help in the provision of this additional information, but it does mean the contents of a WIP will be open to wider scrutiny.

SORP FRS 102 includes detailed guidance for charities with permanent endowment that wish to adopt a total return approach.

### Incorporated Charities
Although the Trustee Act does not technically apply to "incorporated" charities the principles of the Act are seen as minimum standards that should be adopted for good practice.

Where a charitable company acts as a trustee of an unincorporated charity "the general power of investment applies".

If no previous policy exists, the setting of policy needs as careful consideration as the production of the document. In principle, setting policy is about combining monies available for investment with the aims and objectives of the charity and consideration of the different types of investment opportunities available.

As part of their duty of care, trustees must be satisfied that the level of risk they are taking is appropriate for the charity and beneficiaries.

### The considerations

Trustees need to consider carefully which asset classes are suitable for them. These discussions will be specific to each charity's own needs and consequently trustees may wish to involve investment managers and other advisers when going through the process of delineating acceptable asset classes.

What constitutes an "investment" is not clearly defined by statute. Instead it has been interpreted by the Courts over the years. Investment areas may include the more traditional bonds, equities and property whether through individual stocks and shares or through collective schemes such as Common Investment Funds (CIFs), which are regulated by the Charity Commission), or Charity Authorised Investment Funds, (CAIF's), which are regulated by the FCA, unit trusts, open ended investment companies (OEICs) and investment trusts. Other suitable asset classes may also include infrastructure funds or the more specialised areas of private equity, hedge funds, derivatives, structured products and targeted return funds.

Each of the aforementioned asset classes have differing characteristics in terms of potential for capital growth, level of income, income growth and the level of risk (or volatility of capital values). History provides some guidance as to these attributes, but unfortunately what is ostensibly a low risk investment could turn out to be high risk in certain circumstances. Therefore it would normally be prudent for the trustees to adopt a balance of different asset classes. (Within each asset class there can also be a sub-classes with differing characteristics).

The investment strategy for "unrestricted" funds should be appropriate for the charity and reflect the aims and objectives of the organisation and the current financial and operational position; including, for example, the current and future levels of income and expenditure, the size of the balance sheet, the level of free reserves, risks to the organisation, capital requirements etc.

Historically, it was possible to only spend the income of a "permanent endowment" in furtherance of a charity's objectives. But, approval can now be granted by the Charity Commission to spend capital. Trustees of permanent endowments need to balance the interests of both the present and future beneficiaries. Permanently endowed charities can over distribute in a year, but may then required to claw back the overpayment in future years.

Restricted funds can be invested but the nature of the restrictions and any spending plans should influence the investment policy.

### Programme Related Investments (PRI)

If the trustees are making "programme related investments", they are not bound by the legal framework for financial investment. The primary aim of a programme related investment must be to further the charity's aims with the possibility that the charity can achieve a financial return.

### Mixed Motive Investments (MMI)

Charities can also make mixed motive investments, which are part financial investment and part programme related investment and these should be clearly documented and professional advice should be obtained.

Section 10 of CC14 covers both PRI and MMI.

# Potential areas for inclusion in an Investment Policy Document:-

### General Background
It is useful to set out the general background of the charity and its aims and objectives so that anyone reading the investment policy document will be given a broad understanding of the charity.

### Financial Background
This need not be excessively detailed but could include the charity's income and expenditure profile, the value of total assets, significant income streams or operational risks. Significant anticipated additions or withdrawals of capital could also be identified. Similarly, expected operational changes that have financial implications could be covered.

### Investment Powers
If the charity's governing instrument has any specific requirements or restrictions these should be set out clearly in the WIP. The large majority of charities formerly governed by the Trustee Investments Act of 1961, are now governed by the Trustee Act 2000 which provides "wider powers" of investment. If a specific Act governs the charity's assets then it should be stated.

### Intended Benefit to Charity of Investing
A statement setting out the intended "benefit" to the charity of investing should be included, providing guidance on the balance between the two objectives of:-

- maintaining and, if possible, enhancing the real value of the invested capital to enable the charity to carry out its purposes in the future.

- being a source of capital and income to enable the charity to carry out its objectives each year.

### Expendability of Capital
Can both capital and income be spent on the charitable objectives? If there are any restrictions on the expendability of capital, for example, if the assets in the portfolio are a combination of unrestricted, restricted and/or permanently endowed funds, this should be clearly delineated.

If both income and capital can be spent the portfolio could be invested on a total return basis.

### Main Criteria
The Financial Conduct Authority (FCA) requires investment managers to have minimum Know Your Client criteria covering each client's objectives. These include the following:-

a) the investment objective of the portfolio,

b) the level of acceptable risk,

c) the type of mandate (given to the investment manager)

d) the time horizon over which the charity is looking to invest.

These are covered in more detail below:-

#### *Investment Objective*
This covers the type of investment return trustees are seeking. There are four main categories: capital growth, income, a balance between the two or total return. Many charities look to achieve a "balanced" return, seeking some capital gains and some income.

Charities can adopt a policy that aims to generate a greater proportion of the returns from either capital gains or income or, at the extreme, entirely from one or other source. But, these approaches come with different attendant risks: capital gains are generally more volatile than income and therefore may imply a higher risk (but also possibly higher returns).

Income generally has higher certainty but lower returns and would also suggest lower capital volatility. However, generalities can be misleading and in setting policy the attributes of different asset classes need to be understood. Charities investing for a total return imply that they are not differentiating between receiving investment returns in the form of either capital gains or income.

#### *Risk*
Establishing your charity's ability to withstand a fall in capital value may help define an appropriate strategy. Capacity for loss means the degree of loss the charity is able to accommodate without the loss resulting in a material decline in its ability to meets its objectives.

Risk categorisations differ between investment management firms, but are usually consistent with wordings like: higher, medium or lower. These categories are clearly subjective and risks change over time and in different circumstances. The aim is to provide guidance that covers the whole investment strategy rather than individual asset classes.

Asset prices are volatile and investment requires accepting some level of risk. The requirements of the capital available for investment should determine the level of risk trustees are willing to accept and their attitude to risk is important in setting strategy. Risk can be expressed as the "standard deviation" of historic returns and can be analysed at an individual asset class level or through a blend of asset classes, but accurate statistics can only be obtained on historic data. Prospective returns depend on forecasts of what "might" happen so are inherently less certain.

***Mandate***
This defines the type of service being required of the investment manager. Categorisations may differ between investment managers but will normally be one of the following: discretionary, advisory (non-discretionary), or execution only.

Where trustees have the power to delegate the management of their investments to an investment specialist, the existence of a well constructed investment policy will show that the trustees have exercised the necessary "duty of care".

***Time Horizon***
How long does the charity expect this money to be invested? Having a longer time horizon is generally considered to provide greater leeway to accepting shorter term volatility in the capital value of the investments. The investment time horizon may influence the asset classes that are suitable and the structure of the portfolio. The time horizon may be a fixed number of years or a more general statement like "over the medium term" or "long term" with the latter typically signifying more than 10 years+.

**Asset Allocation**
To delineate investment strategy, specific percentages can be set for each asset class.

Ranges either side of the mid-point of each asset class should also be set. This will contain the amount of deviation from the central strategy the investment manager is able to take and allow for the continual movement in actual as well as relative values as market prices change. The portfolio can be actively managed within these ranges providing scope for tactical positioning, within each asset class. For example, a central strategy of 40% in UK equities, could have a range between a minimum of 30% and a maximum of 50%, allowing room to deviate between the two over time, providing scope to take advantage of investment opportunities, while maintaining the general policy direction for the portfolio.

If circumstances change for the charity or investment markets the central asset allocation and the ranges can be altered. But this will need approval by the trustees, before being implemented.

Investments held within each asset class can be defined further. For example, when investing in fixed interest securities trustees could require that they "are of investment grade" or that "no junk bonds are held".

When considering more complex or less liquid investments like structured products, private equity funds and hedge funds, specialist advice should be taken as trustees need to understand the implications of these asset classes. Property, as an asset class for investment, would normally be, non-operational, commercial property, and this also tends to be a less liquid asset class.

**Income Requirements**
If the charity sets targets for investment income (whether monetary amounts or percentages of the portfolio), they should be included in the WIP. It is preferable for monetary levels of income to be set rather than percentages as the percentage figure will change inversely to the value of the portfolio. In simple terms, if an investment doubles the yield halves, even though the monetary value of the income is unchanged.

Is a stable income required or should income grow over time to offset the effects of inflation, so that the charity can maintain the real value of its expenditure. When considering an appropriate income level trustees need to balance the need for income with the risks. For example aiming for the highest possible income, may involve taking risks to both capital and income, as a higher than average yield for that asset class could infer greater inherent risks to that investment.

**Investment Limits**
Maximum percentages can be set for investment in individual securities. These can be at the time of purchase or on-going market value. For example a maximum 5% in any one security may relate to the time of purchase, but if the stock appreciates above this level should it then be reduced accordingly?

Previous Charity Commission guidelines suggested no more than 5% as a suitable level. However, as the largest stock in the FT All Share Index now accounts for over 5% of the index a slightly wider policy may be required allowing some larger investments, but then capping the amount in those investments as a proportion of the fund. An example is provided in the attached WIP.

**Diversification**
It is important that the invested assets of a charity are diversified. The example WIP incorporates a paragraph, which can be appropriately amended, to state that the portfolio should be diversified and which types of investment are acceptable.

**Exclusions**
Specific asset types can be excluded, i.e. "No investment in structured products" or, part of an asset class, for example in UK equities "Unquoted stocks to be excluded".

More volatile investments like warrants and partly paid shares may also be excluded (unless received by way of a rights issue). Charities are expected to invest and not speculate and more volatile investments like warrants may be considered speculation. Derivatives, at one time were specifically excluded and many charities still exclude them but they can be appropriate as part of a large well diversified portfolio or to hedge risks.

Following the introduction of UCITS 3 regulations, the use of derivatives within collective funds is increasingly common, whether for hedge funds, structured products, or simply to hedge specific risks for a long only fund.

### Ethical Policy

Since SORP 2005, charities have been required to state their ethical policy (if any) in their Annual Report. It is therefore open to public scrutiny. This area has become more complex with both positive and negative ethical screening and the introduction of SRI (Socially Responsible Investment). In principle, trustees should consider excluding investments that are directly contrary to the nature of that charity or could alienate stakeholders.

Charities should consider the potential impact of the adoption of any ethical policy on their investment returns. The "Bishop of Oxford case" introduced the principle that any ethical considerations should not be so onerous that they unduly impact performance. Again, CC14 on the Charity Commission website is very helpful.

Socially Responsible Investment, includes both investing in companies that have a positive influence on society or the environment and positive engagement with companies whose activities are contrary to a charity's aims. For many charities, the relatively small size of their investments may limit the impact of voting at AGMs and therefore direct "engagement" by the charity with "offending" companies is often a more effective solution.

It is often helpful to include a sentence giving trustees the opportunity to request specific exclusions as situations arise, as shown in the draft WIP.

Any policy adopted should aim to be clear, concise and avoid unintended consequences. Setting a maximum of say 20% of a company's revenues or a fund's weightings in unacceptable areas, may avoid excluding investment whose primary activity is acceptable and only a minor proportion is unacceptable.

### Suitability

It is important that consideration is given before an investment is made as to whether it is "suitable" for the charity.

Suitability should also state that a proposed investment has been considered as the "most" suitable of similar types of investment.

In the example WIP we have incorporated a paragraph based on the FCA's own requirement on suitability.

### Benchmarking

When considering benchmarks it is important for a charity to understand the difference between:

1) Measuring its own performance against its own objectives

2) Making peer group comparisons

3) Measuring the performance of their investment advisers.

A bespoke benchmark based on the mid point of asset class ranges (e.g. 25% fixed interest, 75% equities) will define a charity's investment strategy. The performance of that benchmark will show whether that strategy is providing the intended outcomes. The deviation of a charity's investment returns from the weighted average of relevant indices will show how the investments held have been performing by comparison to the underlying markets. The period over which comparisons are made should be stated, i.e. one, three or five years.

The performance of the investments in each asset class can also be compared to a suitable benchmark (e.g. the UK equity proportion could be compared to the FT All Share Index). Where demanding income targets are set consider appropriate benchmarks carefully.

Benchmarks can be related to inflation (or wage costs) with an additional rate of return, e.g. RPI +3%, where a charity wished to maintain the real value of its investment and also obtain an additional rate of return to spend on its charitable objectives. Where inflation plus benchmarks are used comparisons need to be made over a number of years.

If a peer group comparison is required, this can be provided by an independent performance measurement company (e.g. ARC).

### Investment Manager

This section should include a statement that the investment manager is a suitably authorised person within the meaning of the Financial Services and Markets Act 2000. It is important to have a statement to the effect that the investment manager will follow the instructions in the policy statement (or any amendment) unless there is a good reason not to do so.

### Reporting requirements
This section could include administrative issues like the frequency of meetings, provision of investment reports or the requirement for an AAF 01/06 document (which is an annual audit of an investment management firm's operational procedures and its nominee company).

The regularity of a Governance review of the investment strategy and a review of the investment manager can also be included. A review every three to five years is recommended but this need not require a full "beauty parade" at each anniversary date but a re-affirmation that trustees are happy with their current arrangements.

### Dividends and Interest Payments
Whether dividends and interest are accumulated within the portfolio or paid away can be detailed. Also, the frequency of the payments or standing orders can be commented upon.

### Annual Review
It is important that WIPs are reviewed regularly. The introduction of "know your client" requirements by the FCA has meant that investment managers require their client information to be regularly updated and the existence of an investment policy document will normally help in the completion of this information.

### Signatories
The investment policy document should be signed by trustees and/or executives, as should any subsequent amendments. Where a policy document has been approved at a trustee meeting, specific members can be authorised to sign on behalf of the charity and a minute can be taken and copied to the investment manager.

Anti-money laundering regulations have tightened considerably over the past few years and it is important today for the charity to give authorisation for specific individuals to give instructions to their investment manager both in terms of managing the portfolio but also with regard to the withdrawal of capital or investments from the portfolio.

Where construction and/or implementation of an investment policy has been passed to a sub-committee (e.g. investment committee) this should be detailed. However, the investment policy should be approved by the whole trustee body.

It is good practice for both the charity and investment manager to sign the WIP as confirmation that the terms of reference have been agreed and that the manager will abide by them, unless there is a good reason not to do so.

### Caveats
This document is not intended to cover all circumstances and it may be necessary to seek advice from the Charity Commission or your investment advisers or to take appropriate legal or professional advice. No action should be taken, nor is any liability accepted for any action that may be taken, on the basis of any information contained herewith.

# The ABC Charity

Charity No 0000 00000

(or HM Revenues & Customs No: 000 000 000)

## General Background

The charity was established in 1960. Today it encompasses a traditional 20 bed hospice and provides support to the local community through home visits, a day hospice and lymphedema services. The aims and objectives of the charity are to provide specialist palliative care to people with cancer and other life limiting illnesses and provide support to their families in our geographic region.

## Financial Background

The charity owns property valued at £5 million, which is used for operational purposes. Approximately a third of income is from contracts with the local NHS Primary Care Trust, with the balance coming from donations, legacies, two rented charity shops and a local lottery. Income is approximately £4m and expenditure £3.8 million. Income and especially legacies can be erratic, but the charity has been in surplus for the past two years and is budgeted to record a surplus again this year.

## Investment Powers

The assets of a charity must be invested in accordance with the governing instrument and the Trustee Act 2000.

## Policy Objectives

The overall objectives are to create sufficient income and capital growth to enable the charity to carry out its purposes consistently year by year with due and proper consideration for future needs and the maintenance of, and if possible, enhancement of the value of the invested funds while they are retained.

| | **Main Criteria** |
|---|---|
| **Objective** | *'Balanced' return between income and capital* |
| **Risk** | *Medium* |
| **Mandate** | *Discretionary* |
| **Time Horizon** | *10 years +* |

## Expendability of Income and Capital

Both capital and income may be used at any time for the furtherance of the charity's aims and therefore the portfolio is to be managed on a total return basis.

## Asset Allocation

The portfolio asset allocation will fall within the following broad planning ranges and the performance will be measured against a weighted average of the movements in the comparative indices (a bespoke benchmark) as set out below:-

| Asset Class | Ranges % | Benchmark % | Comparative Indices |
|---|---|---|---|
| Fixed Interest | 10 - 20 | 15 | FTSE Government All Stocks Index |
| UK Equities | 35 - 55 | 45 | FTSE All Share Index |
| Overseas Equities | 15 - 35 | 25 | FTSE World (ex-UK) Index £ |
| Property | 0 - 10 | 5 | Investment Property Databank monthly index |
| Infrastructure | 0 - 6 | 3 | Bank of England base rate+2% |
| Hedge Funds | 0 - 8 | 4 | Bank of England base rate+2% |
| Cash | 0 - 10 | 3 | Bank of England base rate - 0.5% |
| **Total** | | **100** | **Bespoke benchmark** |

## Specific Requirements

i) The bonds held will be of 'investment grade' ie BBB-or better.

ii) Income of £120,000 per annum is required.

iii) No initial investment should exceed 10% of the total value of the funds under management and the total sum of all equity holdings in excess of 5% must not be equal to or exceed 40% of the fund's value at anytime.

## Exclusions

Direct investment in options or "derivatives" are not permitted.

## Ethical Policy

Investment in tobacco or alcohol should be precluded. This is defined as companies with more than 20% of their turnover or collective funds with more than 20% of assets in these categories.

The trustees reserve the right to exclude companies that carry out activities contrary to their aims or from holding particular investments which damage the Charity's reputation.

## Suitability

Trustees expect the fund manager to have considered the suitability of investments of the same kind as any particular investment proposed to be made or retained.

### Diversification
The objectives are to be achieved by investing prudently in a broad range of quoted fixed interest securities and equities and collective vehicles (like unit trusts) which are appropriately authorised.

### Dividends and Interest
Dividends and interest are paid away on a quarterly basis.

### Investment Manager
The investment manager will provide a quarterly review of performance and a review of activity and background to markets. They will attend meetings at least annually, as requested.

### Policy Review
The foregoing policy and arrangements will be reviewed regularly by the Trustees. Any changes must be given in writing.

Signed: ______________________________

*(On behalf of the Trustees of the ABC Charity)*

**The ABC Charity**
Address 1
Address 2
Town Postal code
Tel: 0000 000000
Email :

Investec Wealth & Investment is an authorised person within the meaning of the Financial Services and Markets Act 2000 and by signing this document agrees to manage the investment portfolio on the basis of the above instructions.

Countersigned: ______________________________

*(On behalf of Investec Wealth & Investment Limited)*

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