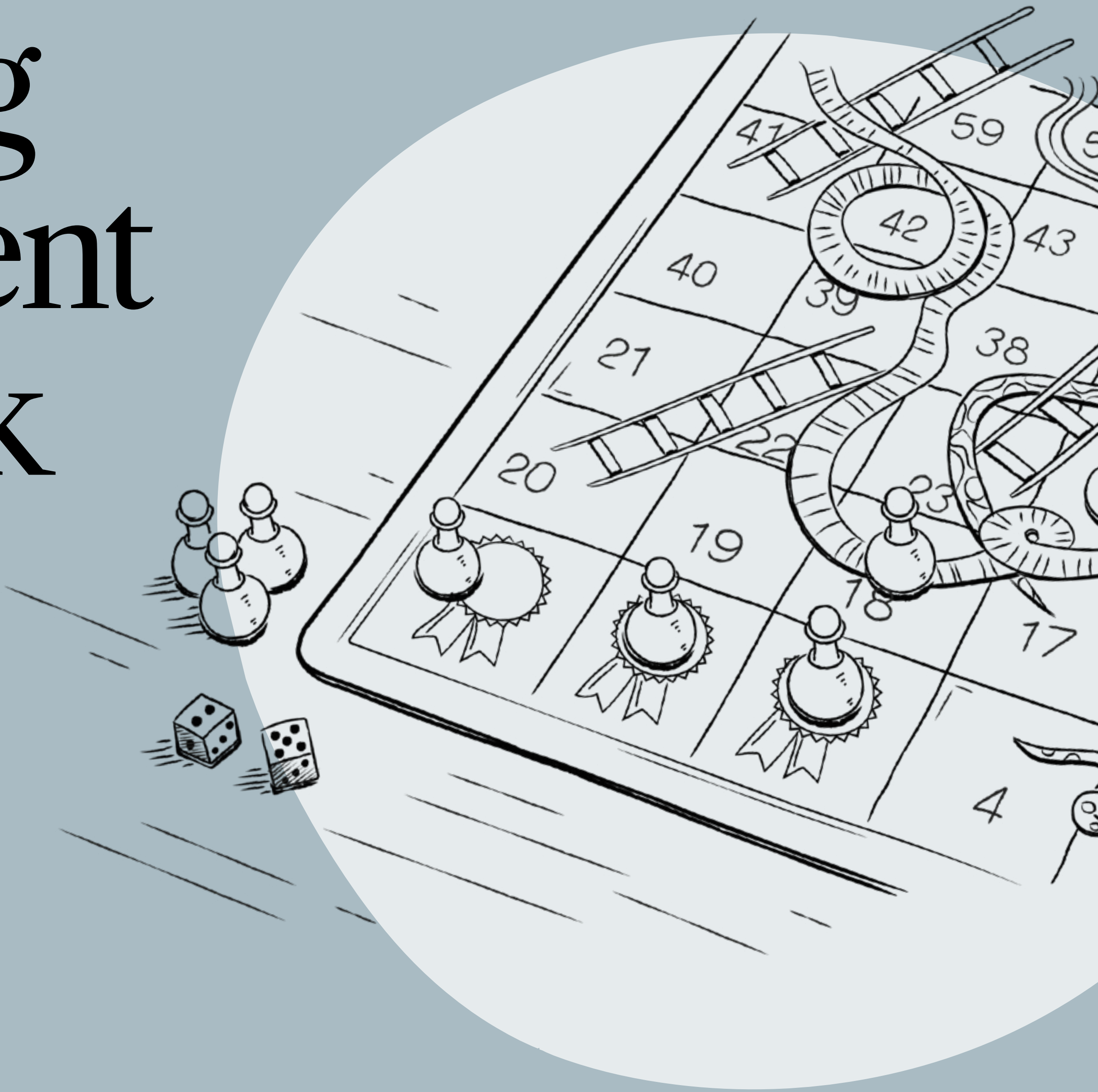
RATHBONES | Incorporating Investec Wealth & Investment (UK)

Navigating Investment Risk



Investec Wealth & Investment (UK) is a trading name of Investec Wealth & Investment Limited.

A Guide for Charities

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Helping you, help others

Do you have specific question about risk or a general question about investments?

Our investment process is led by a team of charity investment specialists that understand risk and are supported by the deep insights of our in-house research team.

To find out more, visit **investec.com/charities-hub** or get in touch

Part 1. Introduction

Mention investment risk and people will often get the heebie-jeebies. This is perhaps not surprising given that the definition of risk is "a chance of danger, loss, injury or other adverse consequences". This is also why, when it comes to investment, many people associate the term risk with losing money.

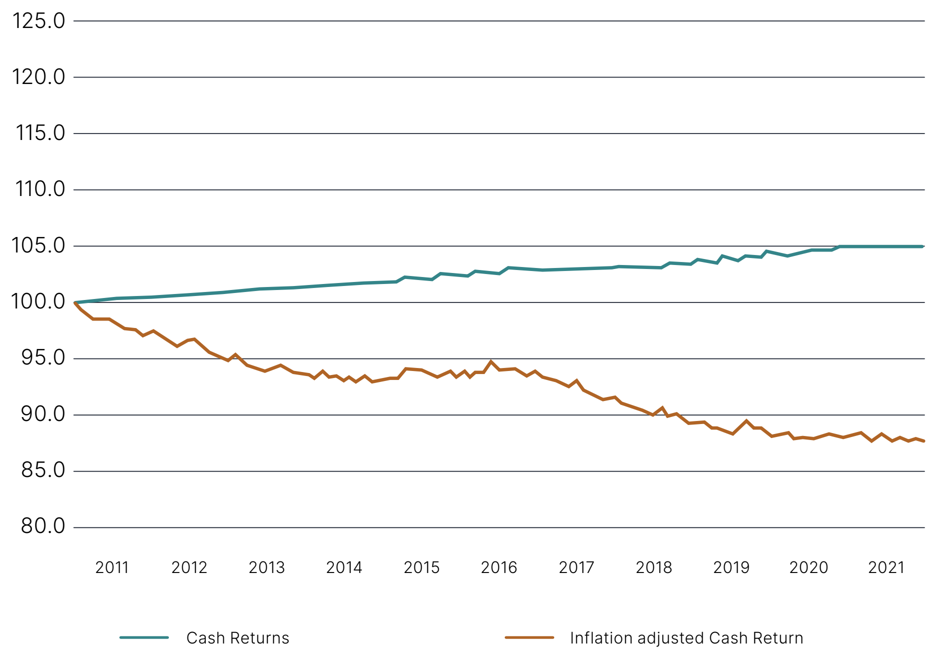
However, simply associating risk with doom and gloom is a generalisation – and a misconception. Risk in the investment world can ultimately be positive if it is managed in the right way. Managing risk allows charities to expose their portfolio to assets that may generate a return above the traditionally perceived lower-risk assets such as cash. And it does so in a way that helps them meet their financial objectives while protecting the interests of the charity.

Risk from a positive frame of mind

The primary aim for trustees is for the performance of a charity's investment portfolio to be able to meet its obligations and support the charity's requirements. There can be a reluctance for charities to invest in assets other than the perceived safety of cash because as stewards of a charity's capital, trustees often feel the need to protect what they have. This could be for a variety of reasons: they may have future spending requirements, while inflows and outflows can also change how trustees view risk.

Overly cautious trustees that invest solely in cash could be jeopardising the long-term objectives of the charity, not least because of inflation (more on this later), which could erode the real value of the charity's capital. On the other hand, risk viewed through a positive lens gives a charity the potential to generate greater returns over the long term within a given risk profile – and in turn, help more people over a longer time horizon.

How the value of cash is eroded by inflation



Source: Bloomberg/ONS

Cash returns has been based on the rate delivered by the Bank of England

A duty of care

Trustees also have a duty of care to consider risk, and before making any investment decisions they should examine what the appropriate level of risk that they want to take or can accept is. As the Charity Commission's guidance for trustees advises, "Trustees must be satisfied that the overall level of risk they are taking is right for their charity and its beneficiaries".

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Not all charities will have the same appetite for risk, but all trustees will need to take on a degree of investment risk if they are to have the potential for their charity's capital/funds to generate returns above the cash rate, and potentially inflation. Trustees must ensure they have a portfolio with the appropriate risk profile for what their charity is trying to achieve.

Part 2. Managing risk

The biggest key risk to a charity is a permanent loss of capital (and/or income) as the value of its investments falls. Knowing how a charity can withstand a loss of capital – whether permanent or temporary – lays the foundations for its investment strategy. So too will a charity's appetite for volatility.

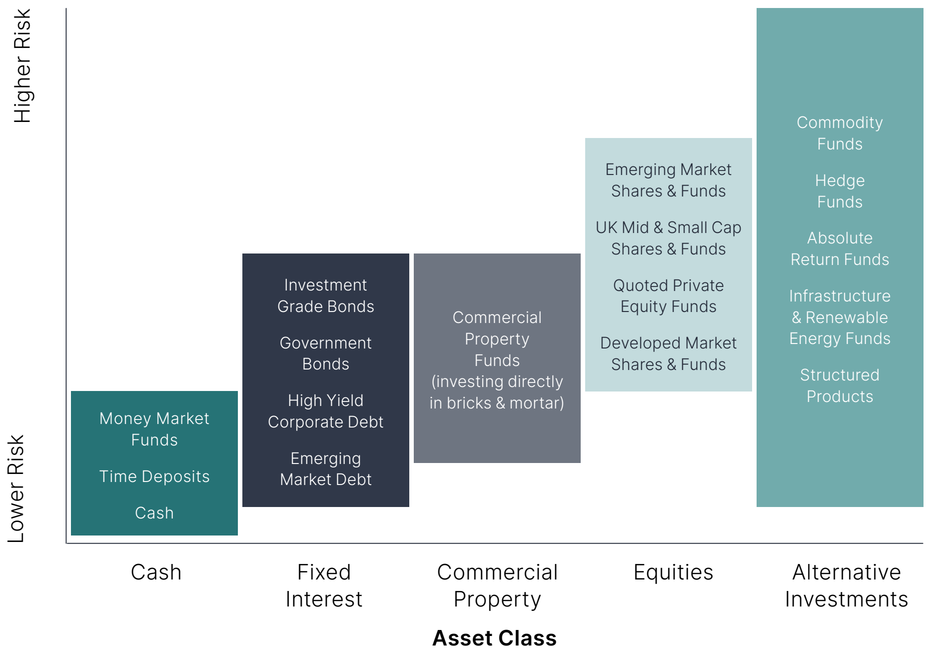
Trustees will often hear fund managers talk about the standard deviation of a portfolio. In short, they are referring to volatility risk – the degree a portfolio goes up and down over certain periods depending on the assets you hold. This is an important consideration for charities, as higher volatility can lead to sharper and more pronounced fluctuations in the value of a portfolio.

Mitigating risks

The principal way to mitigate capital and volatility risk is through diversification and asset allocation. Indeed, asset allocation is one of the most important decisions that trustees can make. The asset mix of an investment portfolio can have a significant impact on long-term returns – and whether investors have a smooth or bumpy investment journey along the way.

Each asset class (such as equities, bonds and property) has differing characteristics in terms of potential for capital growth, level of income or income growth. Some assets are more volatile than others, meaning their value can change more sharply. For instance, equities are deemed more volatile than bonds. Typically, the more volatile the asset, the higher the potential risk but counter to that, a higher-risk portfolio offers the potential for greater rewards over time. Some assets such as equities and commercial property are uncorrelated– meaning that their value doesn't follow the same pattern of ups and downs.

Assets and their risk level



Risk of Capital Loss in Normal Terms

Trustees should look to strike a balance between the level of risk they can tolerate with the level of returns they need to generate –managing risk versus return. Getting the balance of assets right is important if charities are to achieve their goals in line with their risk appetite. It can help reduce the overall risk and still potentially deliver the intended returns over the long term. Fail to do so and a charity could buy the wrong kind of investment or create an investment portfolio that is unlikely to generate the desired results.

Evaluating risk

The level of risk a charity takes will depend on several factors, including its objective, its constitution and its financial situation, including visibility on funding and capacity for loss. The long-term outlook of most charities is typically supportive of a medium or medium-to-high-risk investment strategy, which has exposure to equities. This is because they can better withstand losses over the short term and have the time for the portfolio to recover any losses that arise.

This may not always be the case. For example, if a charity needs to draw down a significant amount of money in the short term it might opt to adopt a lower-risk strategy to protect the capital value of the fund. Likewise, a charity might decide to take a more defensive approach if it does not want to be forced to sell assets if markets fall, to meet its liabilities. A charity suffering outflows is likely to want to preserve the value of its investments as much as it can too. On the other hand, charities with robust balance sheets, strong inflows and very long-term goals will typically be able to step up the risk ladder a little further by investing in higher-risk assets.

Part 3.
10 risks to consider

While capital loss and volatility are the two most talked about risks, other risks can have an impact on potential returns, and as such, trustees should consider them as part of their charity's investment process. Here are the 10 main types of risk.

1. Time-scale risk

Trustees should consider the charity's investment time horizon as it can help inform the level of risk they take and help them avoid investing in inappropriate asset classes. Charities with a long-term investment horizon are better placed to cope with short-term volatility but adopting a cautious risk strategy puts them at risk of not meeting their objectives.

2. Inflation risk

Inflation is the enemy of cash as it can seriously erode its value by reducing a charity's spending power. Assets left as cash with inflation running at 4 per cent a year for 20 years* will still see the 'real' value of cash fall by more than half (once inflation has been taken into account). So, while cash is perceived as a safe haven, it is not risk-free by any means if it can't keep pace with rising prices.

3. Stock-specific risk

The more concentrated an investment portfolio is, the greater the risk of one stock performing badly and having a larger impact on its investment performance. Diversification can play a vital role and having a spread of assets that behave differently depending on the economic and market environment can help smooth out the returns over the long term. One stock performing poorly in a more diversified portfolio will likely be offset by the better performance of others.

4. Reputation risk

Having a stellar reputation is crucial for charities as it underpins the goodwill that supports donations and fundraising. A tarnished reputation can be catastrophic to any organisation, not least to a charity. It's why trustees need to consider potential risks associated with their investments. Any investments or investment policies that are deemed unethical or are associated with negative publicity, for instance, could have a significant detrimental impact on a charity's reputation.

5. Environmental, Social, Governance (ESG) risk

There has been a groundswell of public opinion in recent years for sustainable change, which has coincided with an increasing awareness of the impact (both positive and negative) investing in certain companies can have. Trustees need to ensure that any investments don't compromise or contradict the charity's aims and objectives. A recent High Court ruling in the Butler-Sloss versus the Charities Commission case has opened the door to charities being more freely able to consider responsible investment and sustainability in their investment process.

6. Liquidity risk

Liquidity is the ability to turn and sell your investments into cash, should the need arise. But some assets are more liquid than others. For example, by its very nature, commercial property is an illiquid asset because you can't sell a building overnight. Other assets, such as private companies that are not listed on a public stock exchange can also be harder to sell quickly. This isn't necessarily a reason not to hold less-liquid assets – much will depend on the size of the charity, its need to be able to get its hands on cash quickly and the length of its investment time horizon.

7. Tax risk

Charities are likely to be free from paying income tax and capital gains tax when it comes to income and gains from their investments. So, any investments in shares listed on recognised stock exchanges or in qualifying investment funds, may be tax-exempt in that respect. However, there are so-called non-qualifying expenditure investments (such as some offshore bonds) where tax may be payable.

8. Exchange rate risk

Assets based outside the UK will typically be valued in different currencies – yet what counts for a UK-based charity is what that asset's value is when converted back to sterling. The currency market can be a fluctuating (and sometimes uncertain) market and if a currency falls in value relative to sterling, the investment may be worth less, even if its home currency value has increased. Similarly, overseas exposure can be a welcome tailwind if the home currency depreciates.

9. Interest rate risk

Charities typically have some exposure to bonds or other fixed-interest rate investments, which are deemed less volatile than equities, but again, they are not risk-free. The price of bonds fluctuates and several factors affect bond prices, including changes in interest rates. The value of a bond can be impacted by a change in interest rates. In general, rising interest rates put downward pressure on bond prices.

10. Governance risk

Trustees should be aware if any investments in a charity's portfolio are in poor quality companies this may generate higher returns in the short term, but can lead to potential governance risks (a risk of the investment turning sour and falling in value, sometimes significantly), as a result of poor management.

Part 4.
Staying focused

Risks change. Trustees need to be aware that the degree to which risks are a factor can vary. What is deemed a significant risk factor today, may be deemed a lesser risk consideration in five years. Therefore, it's appropriate for trustees to review their approach to risk at least once a year. However, it's important to review risks in the context of the broader investment strategy before making any knee-jerk reaction. Trustees shouldn't let negative news become a short-term distraction.

How global risks change over the short and long term

	2 Years	10 Years
1	Cost-of-living crisis	Failure to mitigate climate change
2	Natural disasters and extreme weather events	Failure of climate change adaptation
3	Geoeconomic confrontation	Natural disasters and extreme weather events
4	Failure to mitigate climate change	Biodiversity loss and ecosystem collapse
5	Erosion of social cohesion and societal polarisation	Large-scale involuntary migration

Source: World Economic Forum

It may well be tempting to adopt a lower-risk approach when markets are volatile by selling down any exposure to higher-risk assets, but it might not be prudent to do so. While a charity might need to hold a little more cash during times of uncertainty it is worth remembering that being out of the market for even a few days can have a lasting impact on long-term returns.

Looking back two decades from 1 October 2002, through 30 September 2022, the MSCI World Total Return delivered an annualised return of 8.7 per cent. Take the five best market days of that period out of the equation and its annualised return would have dropped to 6.7 per cent. In dollar terms, sitting out those five days would have cut the total gain by $161 for each initial $100 invested over the 20 years. Moreover, other studies show that the best returns often follow periods of the worst returns.

The key for trustees is to have a comprehensive but flexible investment strategy. A strategy that takes on a sufficient level of risk to generate the returns needed but is also flexible enough to be tweaked should the need arise so it can continue to meet its objectives and requirements.

Part 5.
Take a tailored investment approach

Trustees looking to preserve the purchasing power of their charity's capital wealth need to be prepared to take on some risk – and be comfortable seeing short term fluctuations in value. As this guide has shown, simply sitting on cash has its risks too and so there is a necessity to invest in other asset classes to meet a charity's objectives.

However, building an investment portfolio is not one-size-fits-all – it is not even one-size-fits-most. Charities have varying appetites for risk, for various reasons. For some the biggest risk could be uncertainty on the level of income they are relying upon each quarter; for others, it could be the risk that an inflationary environment might have on their requirements. Some charities have restrictions on how much they can draw, which lends itself to a broader investment universe of assets because it insinuates a longer-term time horizon. The knock-on effect means that other risks such as liquidity are perceived differently by a charity with a shorter time frame.

For Investec Wealth & Investment, our top priority is to help a charity achieve its goals through good long-term investment performance. We understand that every charity has unique values and objectives, which is why we take a personalised approach to your investment strategy. An active investment strategy that is tailored to the individual requirements of a charity is key to finding the appropriate balance of risk and return – and crucially being able to meet an individual charity's requirements.

Our investment process is led by a team of charity investment specialists that understand risk and are supported by the deep insights of our in-house research team. To find out more, please get in touch.

www.investec.com/charities