BREAKFAST BRIEFING

MANAGING RISKS IN A VOLATILE MARKET

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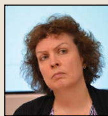
Managing risk

Panel:

Arun Shetty
Portfolio director at asset management group GAM Investments.



Kate Andrews
Andrews is the chief financial officer at the Bible Society.

Norman Cumming
Cumming is chair of the investment committee at UnLtd.

Vicky Rooke
Rooke is a senior analyst at consultancy firm Asset Risk Consultants (ARC).

Katherine Taylor
Taylor is the chief executive at women's charity, Ovarian Cancer Action.

Jeremy Moodey
Moodey is the chief executive at Sons & Friends of the Clergy.

Managing investments isn't an easy task. Ever-increasing political uncertainty and market volatility, coupled with the need for income provide a large and difficult task for those responsible for a charity's assets. But there's a large industry out there, capable and willing to help charities cope with the unnerving pressures managing investment risks of an unpredictable climate.

Together with GAM, *Charity Times* gathered an expert panel of trustees, chief executives and financial officers from charities across the UK to discuss the issues leading the investment risks agenda. Markets have changed drastically over the years and volatility has dropped, but some issues still very much remain.

Market performance

Kicking off the discussion, Larry Hatheway, chief economist and head of investment solutions at GAM provides a background on market performance in 2017, noting that despite the aforementioned political uncertainty (Brexit, Trump and the other usual suspects), 2017 was particularly positive for investments, due in part to monetary policy predictability, as well as a healthy world economy.

And the good news doesn't stop there. According to Hatheway, 2018 offers reasons for optimism. "We call 2018 '2017-light'," he says. "By which I mean markets are more fully valued, but strong earnings, synchronised global growth and low inflation remain supportive. Returns are likely to be positive, but also more subdued."

There has been the additional benefit of a "historically unusual low period of volatility" for some time now, Hatheway adds. "We've seen things that the market hasn't normally paid attention to causing a bit of volatility, such as Trump or the back and forth around Brexit, but volatility isn't just a function of politics: other things matter," he tells the panel.

While markets may not be overly chaotic over the coming year, the ability to manage a portfolio the way charities have been accustomed to is still beginning to change. "The way it's always been done will pose certain challenges for all of us as investment managers. We must be wary of extrapolating the period of low volatility forward," Hatheway explains, hence the vital need for charities to adopt a healthy attitude towards risk.

Assessing risks and targets

Keir Boley, portfolio manager at GAM, argues that the biggest challenge for charities is not just be aware of risk, but to begin questioning a portfolio that has been performing successfully for years. "Charities should be looking at whether parts of their investment portfolio that appear diversified are actually being driven by the same factor risk," Boley says.

"If that's the case, they should be looking at starting to rotate or change the mix of some of the asset allocation, away from some of the things that have seemingly performed well above their long-term performance," he adds.

Managing risk

"As [Hatheway] has already discussed, markets have been doing really well recently, and so it's been a very strong year for the classic 60/40 portfolio. But it's really important to look at whether there are parts of that portfolio that just aren't as independent as people first thought."

David Renton, director of finance and investment at Guy's and St. Thomas' Charity echoes this idea, noting how charities are very much "in the risk game" and organisations should approach risk by remaining patient. "As an industry, we've had a good run and markets are up, but you can't avoid the fact that if the markets are down, we are going to be a bit down too. That's what taking risks means," he explains.

"We know that we can't predict the future. We know we need a well-diversified portfolio. But once we've got that, we've also got to be prepared to hold. It's good to rehearse what might happen and invest time into that, but we also just need to hold."

Valuation risk

Among the many risks that are difficult for charities to prepare for is the risk that assets may be undervalued at a time when the charity may be forced to sell this asset.

But Arun Shetty, portfolio director at GAM, reiterates Renton's point about the need for patience, explaining that this risk can be easily mitigated if you "just hold on". "It really does depend on your time horizon and the geographical area you're invested in," he says. "There will be times when some assets are going to be performing less well and if you can hold on, this will only be a notional fall in value, but if you have to sell then you crystallise that loss. So it really does depend on your time horizon."

Flexibility is also key to ensuring assets aren't under-sold, argues the panel. Norman Cumming, chair of the investment committee at UnLtd, the Foundation for Social Enterprises, explains how the more flexible trustees can be with their spending, the less the charity will be exposed to this risk. "The more flexible you are in your spending patterns, the less you will be forced to sell assets at the wrong time," he says.

GAM's Shetty questions whether the responsibility should really be placed on the trustees, or whether it should actually be pushed onto the asset manager; however Cumming argues that it ultimately lies in the hands of the trustees to decide on the charity's expenditure pattern. "You could push it onto the asset manager, but they really don't have the responsibility," he says. "Trustees take great interest in expenditure and risk".

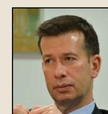
The active/passive debate

Active vs passive is an ongoing debate, and one that has been tossed around the investment management industry for years, but choosing the wrong time to invest actively/passively, or the wrong manager to work with could indeed leave charities in a vulnerable position.

The group weighs up the pros and cons of each, but struggles to identify a winner. Jeremy Moodey, chief executive at Sons & Friends of the Clergy, argues that the benefits of active and passive can only really be identified during downturns. "One of the issues to consider in the defence of active management is that assets may have underperformed relative to fees, but they're also better hopefully positioned than indexes come the downturns. So you will only really ever know if active managers can justify their fees during downturns," he says.

Julia Smithies
Trustee for woodland conservation charity the Woodland Trust.

David Renton
Director of finance and investment at Guy's and St.Thomas' Charity.



Kier Boley
Portfolio manager at asset management group GAM Investments.

Michael Joseph
Director of finance and operations at youth charity CityYear UK.

Larry Hatheway
Chief economist and head of investment solutions at GAM Investments.

However, Guy's and St. Thomas' Charity's Renton disagrees, arguing: "It really depends what you look at. You can only really take a view if you look at whether the investments are performing better than the market over five to 10 years. But you can't always expect them to outperform."

Naturally, the panel notes, one of the main benefits of active management is that when investments are performing badly, somebody else can make decisions on a charity's behalf. Vicky Rooke, senior analyst at Asset Risk Consultants (ARC), highlights how this also means somebody else is able to cope with the pressures investing brings. "With a fully passive approach, you really need to be prepared to make the

Managing risk

investment decisions yourself and for the committee to be able to have that responsibility."

Although relatively agnostic, the panel agrees that there is no issue in principal with a truly active manager. However, one concern is unanimous: fees. "One of the issues is that the fee climate is in the process of change for actives post-MiFID II," Sons & Friends of the Clergy's Moodey says. "We need to see where fees end up, because only then can we see if they are justifiable."

Ethical dilemmas

If investment fees weren't enough of a concern for trustees, ensuring a charity's values are represented in the management of its assets further complicates matters, all the more if trustees wish to ensure the way their assets are run actually advances their mission.

But charities are increasingly taking this approach, and the best asset managers are expert at helping them do it. Julia Smithies, a trustee at the Woodland Trust, explains how ensuring assets are invested ethically is especially essential for charities with an ethical objective at their core. "At the Woodland Trust, we have taken this very seriously," she says. "But with every organisation, deciding what is ethical might be different."

For example, Renton, from Guy's and St. Thomas' Charity, explains how as a health charity, the board of trustees decided very early on not to invest in tobacco. However, "that does come at a cost", he explains, "because tobacco has been the best performing for years".

"We looked at the cost of excluding [tobacco] and decided it was the right thing to do. But it was the only one we decided to avoid. You could argue whether sugar and alcohol are really 'bad for you' as such, but tobacco is definitely just bad for you. But you do have to have that debate on the board to decide."

The panel agrees that the issues around keeping investments in-line with the charity's overall objectives aren't just money-related. There are reputational risks involved, too.

"We should remember to zoom out and think about why we choose particular investments and it's all because of reputation. There's been such a focus on charities that making a sensible judgement about ethical investments is crucial," Katherine Taylor, chief executive at Ovarian Cancer Action says.

Mitigating risks

With all of these risks in mind, the panel agrees that the key to mitigating them is a combination of planning, good governance, and strong relationships between trustees and their advisors.

But it's also important to keep an eye on market movements and keep the trustee board contemporary, Moodey says. "Given that we're coming up to a 10-year bull run and many charities have a maximum nine-year trustee length, there's a whole generation of trustees who aren't actually prepared for a market downturn."

Diversifying income streams is also paramount to the mitigation of risks and potential charity failures, Cumming explains. "Different sources make each individual one less important. It means you can also be slightly more adventurous and you're not subject to the one stakeholder risk."

Going forward, Kate Andrews, chief financial officer at the Bible Society, says it's imperative there is better reporting and transparency around charities' investments. "I've only just come into the sector, so I'm learning as I go, but I've noticed little conversation around investments – there's just not much reporting around it," she says.

"There's this complacency that it's just income that turns up. But the challenge will be what happens when that changes and it's not the case. Those conversations need to happen now. That really is a challenge going forward." ■