Understanding investing: an introduction to asset classes

A guide for charities

Rathbones
Look forward

The value of investments and the income from them may go down as well as up and you may not get back your original investment. Past performance should not be seen as an indication of future performance.

Understanding investing: an introduction to asset classes

A guide for charities

Contents

A brief overview of the main asset classes that can typically be used in a charity's investment portfolio.

Investment portfolios are typically used by charities to increase the value of their assets over time and guard against inflation.

Failure to grow a charity's assets and surplus reserves ahead of inflation, will leave it steadily worse off and less able to deliver on its charitable purpose. While holding some reserves as cash in the bank is usually necessary, cash generally earns a low return and its real value will be depleted by the effects of inflation over time.

However, by investing, a charity's reserves have a much better chance of generating income, growing in line with, or above, inflation, and potentially providing for the charity in a more sustainable manner. Of course, it is important to remember that the value of investments and the income from them may go down as well as up and a charity may not get back its original investment.

It is possible for charities to invest in a variety of asset classes that offer varying levels of risk and reward.

The primary asset classes are:

- cash
- fixed income
- equities
- commercial property
- infrastructure
- commodities
- hedge funds.

An investment portfolio should generally be constructed using a mix of assets to meet a charity's long-term objectives and attitude to risk. It is important to invest not just in a range of different assets, but to invest in a diversified combination of assets that behave differently.

Cash

Cash and bank deposits, including overnight and fixed deposits, offer very low risk and generally low interest rates. Holding money as cash in the bank is unlikely to beat inflation.

Cash

Pros	Cons
Bank deposits are usually easily accessible, making them a useful way for a charity to keep a cash buffer to meet near-term expenditure requirements.	Cash and bank deposits offer low returns (via interest), if any at all.
Bank deposits can provide a small amount of income through interest on savings.	The value of bank deposits is likely to be eroded by inflation.
Holding money in the bank provides capital protection in most circumstances, making it relatively safe.	Money in bank deposits is at risk if the bank fails, although most UK banks offer protection on up to £85,000 through the Financial Services Compensation Scheme.

Fixed income

Fixed income investments, also known as fixed interest or bonds, involve investors loaning money to a corporation or government. The loan (bond) is tradeable, and provides two types of payment – the coupon (relating to interest payments) and the principal (which is the loan repayment).

The return an investor realises on a bond is known as the yield. The yield can be influenced by the riskiness of the borrower, the expected rate of inflation and interest rates, and the bond's time to maturity.

There are a range of different types of bond, some more risky than others. The appropriateness of each type of bond for a charity portfolio will depend on its attitude to risk and the level of return it is seeking.

Fixed income

Pros	Cons
As the name suggests, fixed income investments offer a predictable income.	Issuers of bonds can default.
Bonds usually have low risk or defensive characteristics, although it's important to distinguish between investment grade and non-investment grade bonds.	Inflation can erode the real value of the fixed income.
Fixed income investments can be useful in providing portfolio diversification.	Fixed income investments offer limited or no capital growth.

Equities

Equities, also known as stocks or shares, usually form the largest part of a charity's investment portfolio. In essence, owning an equity (or share) of a company gives an investor part-ownership of the assets and profits of that company.

Depending on the success of a company, equities can provide investors with income, commonly known as dividends, and capital growth, as a result of increases in the share price.

Over time, equities have outperformed most other assets, providing attractive long-term returns. However, equities are also a more risky asset class to hold, and charities need to consider the trade-off between risk and return when deciding what percentage of their portfolio should consist of equities.

Equities

Pros	Cons
Equities can provide attractive long-term returns.	Capital values can be volatile and risky.
Equities can preserve real value by delivering returns ahead of inflation.	Equities can be negatively impacted by inflation over the short term.
They are positively impacted by economic growth and improving investor sentiment.	Equities are negatively impacted by recessions and worsening investor sentiment.
Dividends are relatively predictable and typically provide reliable and growing income.	Dividends are not guaranteed.

Commercial property

Commercial property refers to any property that is used for business purposes, such as offices, shopping centres, retail warehouses, factories and can even include specialist property such as doctors' surgeries.

Like equities, commercial property provides a return through a combination of income (from rent) and capital growth (from the appreciation of a property's value over time).

Investors need to be selective in their exposure to commercial property, as the different types of property can be affected by factors in different ways. For example, high street property has been negatively impacted by the rise in e-commerce, while warehousing/distribution has experienced strong demand as a result of this trend.

Commercial property

Pros	Cons
Property can provide high and stable income streams, enabled by multi-year rental agreements.	Rental income can fall, for example if a tenant goes bankrupt.
Property has historically provided protection from inflation and overall returns – both income and capital growth – have been attractive.	Capital values can go down as well as up, and returns can be volatile.
Property can provide portfolio diversification as it has slightly different sensitivities to most other investments held within a portfolio.	Physical buildings can be expensive to maintain, repair and upgrade.
	Individual buildings are unique, and can be illiquid, particularly in times of stress.

Infrastructure

Infrastructure, which refers to the basic structures and facilities required for the operation of society or enterprise, is a relatively new investment asset class.

It can be split into two main types: social infrastructure, including facilities such as schools, hospitals and prisons; and economic infrastructure, including assets such as airports, roads and power generating facilities.

The various types of infrastructure have different characteristics and can behave quite differently, so their risk and return profiles can also vary considerably.

Infrastructure

Pros	Cons
Infrastructure can provide stable and attractive levels of income.	These assets and their income streams are not immune to global events.
Returns are typically government-backed and are therefore relatively reliable.	Debt levels can be high in infrastructure investments, which can create profit volatility.
Infrastructure revenues are often index-linked and can protect against inflation.	Infrastructure offers limited capital growth potential – it is predominantly an income investment.
Infrastructure assets behave differently to equities, so can provide portfolio diversification.	There is an element of illiquidity to these assets, similar to commercial property.

Commodities

Broadly speaking, commodities are raw materials. This overall classification covers a range of sub-sectors and asset types, including agriculture and livestock, precious metals, industrial metals and energy.

Commodities can be very volatile, and the different types behave very differently. The principal commodity used by most investors is gold.

Commodities

Pros	Cons
Gold is a portable store of wealth.	Gold provides no income – holding gold comes at the opportunity cost of holding an income-producing asset.
One of gold's most desirable characteristics is its tendency to provide protection in periods of economic and political stress.	Gold can be difficult to value as, aside from its use in jewellery, it has limited real world application.
Gold can provide protection against inflation, as well as portfolio diversification.	The price of gold can be heavily influenced by investor sentiment, which is difficult to predict.
Gold has, historically, delivered positive returns across rising markets.	While returns have been positive, they tend to be relatively low.

Hedge funds

A hedge fund can invest in a wide range of assets and trading strategies in order to produce good risk-adjusted returns over time. These funds are able to profit from identifying both overvalued and undervalued assets and, in so doing, can produce returns that are uncorrelated to global equities. As their name suggests, these funds were originally designed to hedge portfolios and provide protection.

There are a number of different types of hedge fund, typically defined by their strategy for investing. Strategies include macro, relative value, merger and acquisition arbitrage, trend following and equity long/short.

Hedge funds' investment strategies are designed to produce positive returns in all kinds of markets, and are able to profit from both falling and rising asset prices. By providing returns uncorrelated to equities, hedge funds can provide portfolio diversification while contributing to returns over time.

Hedge funds

Pros	Cons
Hedge funds have investment powers allowing a greater degree of flexibility in how they produce returns and manage risk.	Similar to gold, hedge funds typically provide no income.
These funds have the ability to make positive returns in falling markets, which is a potentially appealing profile.	Due to their complex investment strategies, hedge funds can be more expensive than other assets and often have performance fees. This can hinder returns over time.
Hedge funds are focused on risk-adjusted returns and are mindful of capital preservation.	Given the nature of some of their strategies, hedge funds can be illiquid or opaque.
Hedge funds provide portfolio diversification.	In some cases, hedge funds have less regulatory oversight than other assets — thorough due diligence should be conducted before investing in this asset class.

Portfolio construction

The range of asset classes discussed in this guide can be combined in varying degrees in order to provide the returns a charity is seeking, within an acceptable level of risk.

An understanding of how different assets behave, particularly in times of stress, helps to construct truly diversified portfolios which manage risk and provide long-term returns.

The fundamentals of investing

This guide accompanies one of our charity investment training webinar series: An introduction to asset classes. You can watch the full webinar by following this link.

Our training webinar series is designed to provide trustees and senior finance staff with an understanding of the fundamentals of charity investment.

Please visit:
rathbones.com/charities to find out more about the training series.

To find out more about Rathbones' approach to portfolio construction and investing for charities, please contact:

Natalie Yapp
natalie.yapp@rathbones.com

Important information

This document is published by Rathbone Investment Management Limited and does not constitute a solicitation, nor a personal recommendation for the purchase or sale of any investment; investments or investment services referred to may not be suitable for all investors.

No consideration has been given to the particular investment objectives, financial situations or particular needs of any recipient and you should take appropriate professional advice before acting.

Rathbone Investment Management Limited will not, by virtue of distribution of this document, be responsible to any other person for providing the protections afforded to customers or for advising on any investment.

Unless otherwise stated, the information in this document was valid as at February 2021.

Rathbones is the trading name of Rathbone Investment Management Limited, which is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

Registered office: Port of Liverpool Building, Pier Head, Liverpool L3 1NW. Registered in England No. 01448919.

The company named above is a wholly owned subsidiary of Rathbone Brothers Plc. Head office: 8 Finsbury Circus, London EC2M 7AZ. Registered in England No. 01000403. Tel +44 (0)20 7399 0000.

T3-ChGuide1-02-21

Rathbones
Look forward

rathbones.com
@Rathbones1742
Rathbone Brothers Plc