How to select an investment manager

A guide for charity trustees

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.

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Introduction

In this paper, we have tried to distil the main points you will need to consider when choosing the right investment manager for your charity. There are a lot of variables to consider and a huge range of options available, so we hope you find this paper helpful. We've also explained some of the jargon that you may encounter.

If you would like any further information about the nuances of investment management for charities, visit rathbones.com/charities to find some of the other papers we've written.

Any questions?

This paper has been written by our charity investment team for charity trustees. If you have any questions or would like to discuss any points in greater detail, please call us on 020 7399 0000 and ask for the charities team. Alternatively, you can email natalie.yapp@rathbones.com

1. Define your objectives

Start by working out what you want from your investment portfolio. This may include the following considerations:

Your time horizon
The length of time you wish to be invested plays a fundamental role in defining your investment strategy. Generally speaking, volatility is smoothed over time, so the longer you can remain invested, the more your portfolio will be protected from extreme short-term ups and downs. For those portfolios invested with a shorter time horizon, the risk of capital loss is heightened as there is less time for this volatility smoothing to kick in. We suggest the minimum length of time to invest in equity markets is five years; most investment managers (including us) will be reluctant to manage portfolios for any shorter period.

It is important to decide whether you will need to liquidate some or any of the portfolio, roughly when you will need to do so and how long you would like the remaining sum to stay invested. If you have different time horizons for distinct sums of money, you may wish to consider putting them in separate portfolios which follow their own individual strategies.

Your financial requirements (income only or total return)
Debate around income only versus total return (a combination of income generation and capital growth) has increased in recent years for a number of reasons. Interest rates on cash and the yields available from bonds used to provide a much higher level of income, but over the past few decades this has been diminished. Now, your capital may need to be placed at higher risk in order to achieve similar levels of income.

It is important to be clear about your financial requirements from the start because they will be fundamental to the way your portfolio is invested.

Income-only approach

The benefits of an income-only approach include:

- ease of identification between capital and income returns
- reliability of income
- income is a good measure of 'value'.

Its disadvantages are:

- current income levels are low for traditionally 'safer' asset classes
- an income-only approach may reduce your range of investment opportunities and limit a portfolio's capital growth
- income is only part of the overall return.

1. Define your objectives

Total return approach

The advantages of total return include:

- it doesn't matter that income levels are low
- your investment choices are maximised — you are not limited to higher income-yielding investments
- withdrawals are not limited to a portfolio's yield, which gives the potential for higher withdrawals.

Its disadvantage is:

- reduced ease of identification between capital and income returns.

To find out more about the various merits and drawbacks of income only or total return, you can refer to the *Income-only or total return investing?* booklet in our investing series.

Your appetite for risk and capacity for loss
Your investment manager should help you establish the most appropriate level of investment risk for your charity. There are lots of variables, which revolve around appetite for risk and capacity for loss.

Having a well-balanced, diversified portfolio reduces 'specific risk' — that is the risk of loss from a single investment or asset class. Not all investments within a balanced portfolio will move together — inevitably, some will go down as others go up. This reduces risk, but by no means removes it entirely; no investment is risk free.

Capacity for loss is linked to risk because the less you can afford to lose, the less risk you should take. However, if you can withstand a meaningful fall in your portfolio's value, without it having a significant impact on your organisation's day-to-day activity, then your capacity for loss is likely to be higher. In this case, you may be able to take on more risk to target higher long-term returns.

Possible future capital withdrawals from the portfolio also need to be discussed with your investment manager as this may affect how much risk can be taken.

Exclusions and restrictions
It's important to consider that by placing exclusions or restrictions on your mandate, you are excluding areas of the market and narrowing your choice of potential investments.

Specify any constraints you may wish to impose on your investment portfolio. Typical examples of possible constraints include:

- excluding investment in non-investment grade bonds
- cash balances are kept with institutions that have a minimum credit rating of A-
- limiting the proportion of the portfolio that can be invested in non-sterling assets
- excluding investments in derivatives, other than for hedging purposes
- limiting a single direct equity investment to no more than 5% of the portfolio
- excluding investments that cannot be sold within three months.

What is ESG investing?

The term ESG investing is used interchangeably with ethical investing, sustainable investing and socially responsible investing. All these terms refer to factors beyond a company's financial position which can be considered when making an investment decision.

ESG stands for three criteria:

Environmental — a company's attitude and behaviour towards issues such as climate change, energy use and pollution

Social — a company's attitude and behaviour towards labour standards, the local community, stakeholders and supply chains

Governance — the way a company behaves at board level, from board composition to management oversight, executive pay and corruption

Your ethical policy
Ethical investing typically requires the application of a negative or positive investment screen, or both. A negative screen rules out any companies involved in specific activities. A positive screen selects companies with strong environmental, social and governance (ESG) policies. Investing ethically can allow charities to feel comfortable that the companies in which they are investing reflect their own values.

Charities should always discuss ethical investing with potential investment managers before deciding whether it's realistic and right for them. Every investment manager has slightly different ethical investing methodologies, so it's important to find a firm that suits your requirements, has relevant ethical experience and a strong performance track record in this space.

Your level of involvement
There are three levels of client involvement associated with investing:

Discretionary – this is most suitable for those with little investment expertise or time. A discretionary investment manager will discuss your requirements in detail before creating a suitable investment portfolio, then manage it and monitor it over the long term. They will not require your consent for individual investment decisions and will charge a fee for this service.

Advisory – this is suitable for those with investment expertise and with the time to run a portfolio. Your investment manager will advise you on transactions, but you will make the final decisions, allowing you to retain full control of how and where your money is invested. It is a relatively labour-intensive type of investment approach and also requires the payment of fees. It is also potentially slower to move/change a portfolio as trustees need to agree before a decision to transact is made and can delay an investment manager's ability to react to market changes.

Execution only – this is suitable for those investors who are confident in their ability to manage a portfolio. You will make all investment decisions and simply ask your investment manager to execute them without getting their advice. You will not receive any ongoing advice and trustees will carry full liability for all investment decisions. This approach will be very labour-intensive if research is being conducted properly by the trustees and may require payment on transactions.

2. Identify investment managers

A quick internet search of 'UK investment manager' returns thousands of results – there are a lot to choose between. Fortunately, there are a few resources to help you start narrowing down your options.

There are various publications specifically for the charity industry and two of the biggest for finance are *Charity Finance* and *Charity Financials*. Both have comprehensive profiles of the major charity investment managers, so you can start to narrow down your list from there.

Try to read up on press coverage and reviews of charity investment managers. These will inevitably reveal more than managers describe on their own websites and will further familiarise you with the major names in the industry. Recommendations from other trustees are important too as referrals play a major role in finding the right investment manager.

Having started with thousands of options, you should hopefully now be able to create a longlist of somewhere between six and 10 potential investment managers. The next step is to create the request for proposal which will be sent to your longlist.

3. Create your request for proposal (RFP)

Your RFP should begin with your objectives (all outlined in section one).

We also suggest including questions about the areas detailed in this section.

The firm

The history and culture of the firm
The relationship between trustees and investment manager is a long-term commitment, so it is important to make sure that the cultures of your charity and your potential manager are well suited. Starting out with a similar attitude and approach will likely make for a more successful rapport in future.

Location of offices
Some charities like to meet with their investment manager regularly, so it is worth checking if your potential manager has offices in a convenient location, or that they are able to travel and how regularly they are prepared to do so.

PRA and FCA regulation
Since April 2013, the financial services industry in the UK has been regulated by two separate entities: the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

The PRA supervises around 1,500 financial institutions, including banks and insurance companies. It aims to ensure that financial products and services in the UK are provided safely. The FCA is the conduct regulator for 59,000 financial services firms and financial markets in the UK. It is also the prudential regulator for over 18,000 of these firms. The FCA works with firms to ensure fair outcomes for consumers, fair markets and that the firms it regulates follow the rules.

If you want to check the legitimacy of a financial institution or report an issue, the FCA is the place to start. Check which entity the firm is regulated by (it may be both) to support the safeguarding of your assets.

Client classification
All firms categorise their clients as retail, professional or eligible counterparty (the latter is applicable to a limited range of businesses). They do this by applying strict regulatory criteria about factors such as financial knowledge and experience, and the size of their balance sheet. Each classification comes with different levels of investor protection, compensation rights and decision-making freedoms. For example, both retail and certain professional clients are able to have their complaints about the provision of, or failure to provide, a financial service or a redress determination, forwarded to the Financial Ombudsman Service.

Some firms classify all charity clients as retail clients, and some may classify bigger charity clients as professionals by default. It is important to check which classification you will fall into at a particular investment manager as that can affect your level of involvement in investment decision-making. Retail clients are given the greatest level of protection and transparency.

3. Create your request for proposal (RFP)

Assets under management (AUM) of the firm in total, and of the charities team
It's up to you and your fellow trustees to decide your preferred size of manager, usually judged by their AUM. Some may prefer the personal and more intimate approach of boutique managers, others may rather the wider range of choice and bigger resources offered by larger managers.

Bigger investment managers will typically have a dedicated charities investment team who are experts at managing charity portfolios and should understand trustee requirements better than generalist investment managers. The number of charity investment managers in the dedicated team will also give a good indication of size, as will the team's AUM and its number of charity clients.

This will also give you a feel for the experience of the charity team and its importance in relation to the wider firm (if the charity AUM makes up a large proportion of the investment manager's total AUM).

The existing number of charity clients
A manager may have significant charity AUM but just a handful of large charity clients. Find out the number of charity clients managed to understand whether the size of your charity fits well with their existing type of charity client.

Investment methodology

All philosophies, styles and processes will vary according to the manager and your charity may have specific preferences. One important factor to determine is how successful a manager's investment methodology has been in the past. You can see this by looking at how historic returns have been made; a series of small successes is better evidence of success than one big gain. However, it should always be remembered that past performance should not be seen as a guide to future results.

Investment philosophy and process
A robust investment philosophy is the cornerstone of investing. A firm's investment philosophy reflects its investment beliefs and will be used to steer the investment decision-making process throughout. It is important to understand the beliefs on which your potential investment manager will make their decisions as it will help you understand the type of risk and return an investment manager might deliver.

An investment philosophy should not change according to market conditions; it should be referred to in every type of economic scenario. Investing is for the long term and investment managers that change philosophy every time markets move, jumping between strategies, are less likely to generate consistent returns. A good investment philosophy is the foundation upon which a portfolio is able to weather a range of market conditions.

A firm's investment process outlines how its investment strategy is implemented and managed over time. The process should be robust and thorough at every stage.

'Top-down' and 'bottom-up' are approaches to choosing investments that a potential manager may refer to. Top-down means that the research team is looking for value across a broad economic view of the world, so building a portfolio by starting with a general 'top' overview of countries and industries before analysis moves through to company specifics. Bottom-up means that the committee is looking for value in particular businesses, building a portfolio by starting with company specifics before analysis moves to a broader overview.

Investment resource
The size of research teams varies enormously between managers. In smaller research teams, some analysts may be asked to cover several regions and asset classes. Try to find out whether their research is all proprietary (done in-house) or whether some is outsourced. The depth of the in-house research or the size of the firm's team of analysts can be key to investment success. Smaller in-house research teams may be bolstered by access to top-tier external research houses, ensuring the quality of their output equals bigger, exclusively in-house teams.

Ethical investing

How would ethical requirements be met?
If you have defined your ethical policy, you now need to find out whether the potential investment manager will be able to meet your requirements.

Most investment managers are able to offer some form of ethical investing, but the methods vary enormously. Some managers integrate sustainable investing into their entire investment process while others offer it as a separate service. Those who wish to invest according to their values should always ask how the potential investment manager will meet their requirements today, and how they plan to develop their service in future.

Pooled or segregated?

Will the assets be pooled or segregated?
If assets are pooled, it means that the assets belonging to your charity may be combined with the assets of other charities and managed together within a pooled fund. Typically, smaller portfolios are pooled to spread management and transaction fees across a bigger group. Pooled funds offer greater administrative simplicity than their segregated counterparts, with benefits such as daily pricing (and dealing), regular dividends and simplified administration. There is a wide range of pooled options available to both big and small charities, but specific ethical requirements may be harder to meet (the fund will have its own policy that may not match yours). A pooled fund could be considered a ‘one-size-fits-all’ approach.

Segregated portfolios are precisely tailored to a client’s investment objectives, risk tolerance and capacity for loss. They also typically have their own bespoke reporting. Most investment managers have a minimum portfolio size for a segregated account which could be out of reach for some charities. It is likely that the running costs associated with a segregated portfolio will be more expensive than a pooled option.

For charities with limited resources, the general view is to keep it simple and keep costs down, making a pooled option more relevant. As the portfolio grows, charities may find a bespoke segregated option more suitable.

Liquidity

How quickly can your assets be sold?
Liquidity is a measure of how quickly your investments can be sold for cash. Your portfolio will be invested in a range of assets of which some will be quicker and easier to sell than others. For example, FTSE 100 shares and UK government debt (gilts) are almost instantly convertible to cash while real estate investments can take longer to sell. Shares in a smaller company are likely to take longer to sell, on average, than those in a larger company.

It's important to specify any liquidity restrictions at the outset. Typically, your investment manager should be able to sell the vast majority of assets in your portfolio in fewer than 10 days but there may be a small proportion which could take longer.

Performance

Does the manager have a strong performance track record?
It's important to remember that past performance is not indicative of future performance. But it can show the effectiveness of a firm's processes and decision-making so you should ask for it.

As we have mentioned, investing should always be considered over the long term and roughly five years is the minimum investment period for portfolios which have equity exposure. Requesting performance over three, five and 10 years will give a good indication of an investment manager's performance over the short, medium and long term.

There are two ways of looking at performance. It can be evaluated in absolute terms (did the strategy deliver gains or losses and how much) but it is also important to compare that performance with markets, the firm's peers and benchmarks and perhaps your charity's own benchmark. Consider whether the performance of your portfolio is meeting the investment manager's stated aim or benchmark: is it successfully achieving what it set out to do?

It is important to check whether the performance is shown gross or net of fees including VAT (where relevant). Some investment managers may send charts of strong outperformance but once their fees have been deducted, that outperformance will inevitably diminish. Investment managers should be able to provide their performance net of fees and VAT (where relevant).

How did your investment manager perform in comparison to its peers?
There are various independent consultants who construct industry composites and compare peer group performance across the risk scale.

There isn't an industry-wide definition of 'low', 'medium' and 'high' risk, so the precise level of risk in each category can differ between managers. Peer group performance comparisons can still provide a useful indication of the success of a manager's investment process and are worth considering.

However, it's important to note that you shouldn't simply pick the top-performing manager. Look a little more closely to see whether they have met their original objective and how exactly they have achieved that performance – some managers may have taken a lot more risk than others to achieve the same level of returns. Any outperformance could have been driven by one good investment decision, or it could have been driven by a series of good decisions which gradually built up the performance over time. The latter seems the more reliable choice.

3. Create your request for proposal (RFP)

Reporting

How often will you receive performance updates?
You should be in regular contact with your investment manager, who may also be sending you communications about the firm's investment views. You will also receive a comprehensive portfolio valuation at least once per quarter.

Typically, these valuations include your current asset allocation and all holdings in the portfolio, along with any changes made to your portfolio over the past quarter. It will also include a breakdown of fees you have paid and the performance of your portfolio relative to other indices or benchmarks.

In the past, hard copies of these reports have been sent through the post, but most investment managers now have them available online.

We suggest you meet your investment manager a minimum of once a year to run through the reports, but some trustees may like to meet more frequently.

Digital offering

Can you see your portfolio online?
Instead of receiving a quarterly performance report, some investment managers have online portals which allow you to access your portfolio 24/7. Although this is a valuable tool, it is important to remember that investing is for the long term and markets are likely to fluctuate over the short term. This volatility may be uncomfortable in the short term but the aim is to smooth out the peaks and troughs over time.

Fees

How much will you be charged?
Outsourcing the management of your charity's investment portfolio is going to cost money, but the expense can vary depending on the size of your portfolio and the investment manager you choose. Typically, the higher the value of your portfolio, the lower the management fee (when expressed as a percentage of portfolio value), and vice versa.

It is important to have a clear understanding of the total fee which you will end up paying. This is called the ongoing charges figure (OCF). There are various components which may go into the final OCF, depending on whether you're in a pooled fund or have a segregated portfolio, which will include an annual management charge (AMC) and potentially VAT (where relevant).

There are a series of other possible costs which managers may charge, such as fees on outperformance, exit fees, cost of third-party funds, custody and transaction costs. Before signing up, check whether you will be charged these extra costs because fees can make a big difference to the net returns of a portfolio over time.

Charges

Ongoing charges figure (OCF) — the total cost of the management of your portfolio, expressed as a percentage of the value of your portfolio. It includes the investment manager's fee and all of the other costs associated with running a portfolio, such as third-party costs, custody, VAT etc.

Annual management charge (AMC) — this is purely the investment manager's fee for running the portfolio, expressed as a percentage of the value of the portfolio.

Total expense ratio (TER) — this has broadly been replaced by the OCF which is now the more commonly used term.

Performance fees — some investment managers charge fees for outperformance of certain hurdle rates or benchmarks; these aren't charged if the manager fails to hit their objective. This type of fee structure is not commonly seen in UK wealth management.

Exit fees — some investment managers charge a fee when clients close their portfolio.

Cost of custody — investment managers incur costs by safekeeping their clients' assets. These costs are typically passed onto clients.

Transaction costs — investment managers incur costs when they buy and sell securities on their clients' behalf. These costs are typically passed onto clients.

Cost of third-party funds — many investment managers construct portfolios using some third-party funds. These funds come with their own management fees, thereby creating an additional layer of cost which is typically passed onto clients.

Team

Who will be managing your portfolio and looking after the relationship with the charity?
Investing should always be considered over the long term and, ideally, the relationship with your investment manager should also be long term. The better the investment team know your charity, the more likely they are to fulfil your requirements.

The experience of the manager, their wider support team and the investment research team is important too. You should have biographies of the more important members of the team before you decide to invest.

There may be an issue with key-person risk in smaller firms. The research team may be dependent on one final decision-maker, or the investment manager may have full discretion. It's important to ask how any potential key-person risk is managed.

Some investment managers have a team of portfolio managers and a client relationship or business development team (typically called relationship managers). In this structure, after the portfolio is opened the relationship manager will become the main point of ongoing contact for that client. The client will lose direct contact with the investment manager who is actually responsible for managing the portfolio day-to-day.

Some firms have just one point of contact for their clients – their investment manager. This will have been the client's original point of contact and the manager will be available to discuss ongoing portfolio management directly with the client.

Finally, ask how often your investment manager (or relationship manager) will be able to meet you to discuss your portfolio. Depending on the size of the portfolio and the resources of the charity, we suggest at least one meeting per year.

References

Can the manager provide references from existing clients?
Some investment managers may provide these straightaway, some may prefer to wait until they have been shortlisted and some may not want to provide them at all. It is worth asking the question from the outset as a detailed reference can be invaluable to your final decision.

Additional services

Does the manager offer any other services?
Some firms have a banking licence which will enable them to offer banking and lending services. This means that if you need any short-term financial flexibility, they may be able to lend against your investment portfolio to save you having to sell assets.

Some investment managers provide extra services for charities and trustees. These can include networking events, charity symposiums, trustee training or topical events. It is worth asking about as some of these additions can be valuable.

4. Create a shortlist

Send your finished RFP to your longlist of investment managers, who will normally require about four weeks to provide a full response.

When you get the proposals back, consider the aims and investment objectives of your charity in light of the responses, carefully deciding which best suits your needs. Invite your top three or four managers to present at a 'beauty parade'. Ahead of the presentation, you may wish to ask the investment managers to prepare responses to specific questions.

5. Questions to ask at the pitch

There are plenty of questions you could ask during the presentation, below are some you may wish to consider:

On investment process

- What is your typical level of turnover?
- How many third-party funds does your firm meet and consider for investment per year?
- Please can you explain the depth and process of your firm's investment research?
- Who ultimately drives investment selection?
- What are your firm's views on active versus passive investing?*
- What are your firm's views on income versus total return?*
- How are you invested in the current economic and political climate?
- What might the portfolio look like under various economic scenarios?

* To read more about active versus passive investing and income versus total return visit rathbones.com/charities

On performance

- How did your portfolios perform during the global financial crisis?
- Were you well positioned in the years that followed?
- How does your ethical proposition perform compared with your traditional portfolios?
- Make sure that you have seen the firm's performance over three, five and 10 years, in absolute terms, against benchmark and against peers. If there are any outliers in their performance track record, it is important to understand why they are there.

On team

- How many clients do you manage?
- What is your total AUM?
- What is your average portfolio size?
- What is your average portfolio size?
- Do you have administrative support?

On fees

- Try to make sure you know how much you will be paying, so ask further questions about the total fee if you are at all unsure.

6. Ongoing measurement

Once your portfolio is invested, you will need to make sure that the manager continues to meet your investment requirements and objectives. To do so, you should receive performance reports at least once per quarter and meet the manager at least once a year.

Investing is for the long term, but if your manager consistently underperforms the set benchmark or fails to meet your set objectives, you might need to consider retendering.

7. Conclusion

There are lots of aspects to consider when drawing up your brief for potential managers and choosing the most appropriate firm. Hopefully, this guide means you are now better equipped to make this important decision. It is a long process for a charity to change investment manager, so make sure the manager you appoint is one you can see yourself working with for the long term.

If you have any questions or would like to discuss any points in greater detail, please call us on 020 7399 0000 and ask for the charities team. Alternatively, you can email natalie.yapp@rathbones.com

To read more of our charity investment reports, please visit rathbones.com/charities

Have a question for us?
Make a note of it here.

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

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Past performance should not be seen as an indication of future performance.
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T3-CH-IM-03-21

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