Should your charity employ an income-only or total return approach?

A guide for charities

Rathbones
Look forward

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An overview of the advantages and disadvantages of the income-only and total return investment approaches, and what needs to be considered when deciding which approach is better for a particular charity.

One of the many decisions that trustees face when developing their charities' investment strategies is whether to adopt an income-only or total return approach.

This has become increasingly important in recent years, and even more so given the uncertainty brought about by the COVID-19 pandemic and its impact on charities reliant on investment income.

Although there is no one-size-fits-all approach, and some charities may have more limited investment options as a result of their charitable purpose, it's necessary to understand the similarities and differences between these two approaches, as well as their pros and cons, before deciding which strategy is more appropriate.

Two investment styles – understanding the difference

Charities that adopt an income-only approach are only able to withdraw the income generated from their portfolios, which is usually in the form of equity dividends, bond coupons and interest on cash. Any returns from capital are not withdrawn.

On the other hand, a total return approach allows a charity to make withdrawals consisting of either income, capital growth, or a combination of the two.

But the two strategies are not polar opposites, and irrespective of which approach a charity takes, income generation is likely to be a key long-term goal. The primary difference relates to the way in which the charity is able to withdraw money from the portfolio – in other words, different means to the same end.

Changing with the times

Historically, the income-only approach was the norm for charities, largely as a result of the limited investment choices available and prevailing investment practices. But a lot has changed over the past two decades.

Firstly, charities now have more options from a regulatory perspective. For example, those with a permanent endowment are now legally allowed to adopt a total return approach under certain conditions, whereas before they were limited to the income-only approach.

The range of investment opportunities available, such as overseas equities and alternative investments, have also increased greatly. While these asset classes generally offer lower income yields than UK equities, they can provide greater capital appreciation and better diversification and risk management.

Finally, income levels across certain asset classes have declined over recent years. Interest rates and bond yields have reduced significantly – so cash and government bonds no longer contribute the same levels of income to a charity's portfolio as previously. There have also been significant changes to dividend payouts, for example companies returning money to shareholders in the form of share buy-backs, rather than through dividends. An income-only approach may therefore no longer be able to meet a charity's required income targets without having to increase the levels of risk taken with its capital.

Of course, it's always important to remember that past performance isn't a reliable indicator of future performance. Irrespective of which approach a charity adopts, the value of investments and the income from them may go down as well as up – so a charity may not get back what it originally invested.

Income only: the primary advantages

Income is easy to identify
One of the most practical benefits of an income-only approach is that it's easier to identify income arising from a portfolio, in comparison to capital growth. The income is paid into an income cash account that is separate from the capital cash account, which makes it simpler to ensure only income is spent and to assess whether the charity's income objectives are being achieved.

Income is relatively reliable
Historical data shows that suitably diversified income-only strategies tend to produce a relatively reliable and consistent level of income irrespective of the state of the economy or financial markets. Dividends have been shown to be much more stable than earnings during recessions, and conventional bonds tend to produce defined levels of income.

Income is a good measure of value
Another advantage of an income-only strategy is that income represents one of the more reliable measures for valuing an investment. Bonds produce regular cash flows – in the form of coupons and the eventual redemption payment – which can be easily discounted back to provide a net present value.

Similarly, equities' earnings and dividends can be forecasted and discounted back to provide a net present value. However, it's more difficult to value investments that don't produce income, for example commodities like gold. Focusing on securities that pay income therefore adds a useful 'quality' overlay to a portfolio.

Income only: the primary disadvantages

Income levels are low

The relative stability of an income-only approach comes with some inherent disadvantages, particularly in a market environment where interest rates and income levels across many asset classes are very low — and even negative for certain bond yields. The experience of the COVID-19 pandemic shows that, when companies decide to cut their dividends, charities reliant on that income can be significantly impacted.

Income is only part of the return

One of the major disadvantages of an income-only approach is that it doesn't take advantage of any capital gains that might arise and, perhaps more importantly, ignores capital losses. As such, there is a risk that, over the long term, income-only charity investors could miss out on real capital returns from equities.

An income-only approach may reduce your investment opportunity set

An income-only approach can unintentionally lead to a charity being overly reliant on a relatively narrow area of the equity market which offers higher income yields, and a natural bias against those equities, funds and asset classes that pay little or no dividends. This could limit a charity's ability to diversify its portfolio as well as its exposure to future opportunities and portfolio growth.

Total return: the primary advantages

The main benefit of a total return approach is that it offers greater flexibility compared to an income-only approach because returns can be derived from income, capital gain or both. This flexibility means that it offers many of the advantages of an income-only approach, but without the disadvantages.

Low income levels don't matter

Because charities taking a total return approach aren't focused primarily on selecting asset classes that pay income, low income levels shouldn't impact them in the same way as a charity with an income-only approach.

A total return approach maximises your opportunity set

Because returns can be derived from income or capital gain, total return charity investors have the broadest universe of potential investments and asset classes to choose from. This should provide benefits from both a risk and a return perspective.

Potential for higher withdrawals

With a total return approach, charities could potentially make higher withdrawals from their portfolios as and when necessary, because they are not restricted to withdrawing just the income. Equities, which make up a significant portion of many charity portfolios, may produce real capital returns over the long term.

Total return: the primary disadvantages

Returns are difficult to identify

The greater flexibility offered by a total return approach comes with the disadvantage of more complexity, particularly in relation to how a charity identifies returns. The capital gain element isn't as easily separated out in the same way that income is – it resides in the portfolio in the form of unrealised and realised gains.

It can also be difficult to identify potential withdrawals in monetary terms – a total return withdrawal percentage has to be decided and there is no clear guidance on how to decide this percentage and what portfolio value should be used to calculate it. Furthermore, as the portfolios increase and decrease in value over time, so too will the withdrawal amount. Charities may be able to mitigate this risk somewhat by adopting a 'smoothing' policy, basing their distribution of cash on a moving average over several years.

Potential for poor market timing

A common argument against a total return approach is the potential for poor market timing, as a charity may have to sell investments to fund a withdrawal at a time when markets are weak or have just experienced a large fall.

Charities may be able to limit this risk to some extent by withdrawing regular 'bite-sized chunks' from the portfolio, rather than the whole amount once a year. Furthermore, because income will still form a significant component of a total return approach and most portfolios carry a small working capital cash balance, the risk of withdrawing capital at times of market stress is relatively low if executed properly.

Choosing the right approach for your charity

Each approach has its advantages and disadvantages. The decision as to which is best for a particular charity will depend on a variety of factors unique to each charity's purpose, objectives and requirements.

That said, it may be worth considering adopting a total return approach, as this should enable a charity to benefit from the stability offered by income-producing securities within an overall framework that provides greater flexibility and diversification.

A total return approach also provides trustees with increased flexibility when drawing up the charity's investment strategy and enables them to consider all asset classes rather than just those that produce income. The ability to diversify risk is a major benefit, especially in a challenging investment environment.

The fundamentals of investing

This guide accompanies one of our charity investment training webinar series: Income-only versus total return. 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 as well as highlighting their responsibilities.

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

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