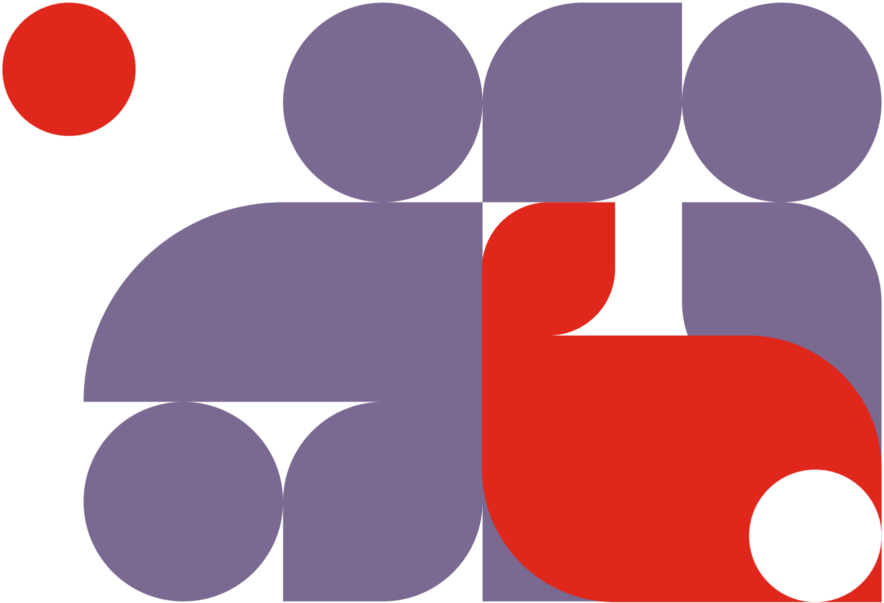
Investment matters

A practical guide to CC14 (the Charity Commission's guidance on investment matters for trustees)



Rathbones
Look forward

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Introduction

One of the most important roles as a trustee is to manage your charity's resources responsibly. That means exercising sound judgement and not taking unnecessary risks, particularly when it comes to investing. You need to make balanced and adequately informed decisions, which involves thinking about the long term as well as more immediate concerns.

Many charities choose to outsource the task of investing their assets to a professional investment manager. Yet our experience at Rathbones is that the relationship between a charity and investment manager works best when trustees have a good understanding of what's involved.

As part of its commitment to helping trustees, the Charity Commission has published *Charities and investment matters: a guide for trustees*, also known as CC14. Although CC14 provides a useful framework, we feel it lacks substance in some areas, while other parts are unnecessarily detailed.

This guide provides a practical commentary on the main aspects of CC14 for trustees to think about as they consider their investments.

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In this guide, we have focused on CC14 in so far as it relates to 'financial investment', where the aim is to achieve a financial return only. Over the past few years, some charities have become more interested in how they might be able to use their funds to directly further their social aims as well. This could include making loans (as opposed to grants) to individuals or other charities at a lower rate of interest than would be available from a bank. Or a charity could invest in outcomes-based finance structures to receive a financial return that is also linked to a social outcome (for example, reduced reoffending rates or increased employment levels).

CC14 makes it clear that 'social investments' (which are not covered in this guide) are a valid approach to financial investment. There are a variety of descriptions depending on the situation, such as 'impact investment', 'outcomes-based finance', 'programme related investment' and 'mixed motive investment'. Different considerations and legal duties can apply in each case.

This area is fast-evolving and complex, and the Charity Commission has stated that it will review CC14 with respect to 'social investments'. Our experience is that non-financial investments have not yet been widely embraced by charities. The slow pace of change is partly because the skills required to appraise these types of investment are different from those needed for financial investments. Notably, there is a requirement to assess the performance of the social (as opposed to the financial) element.

In addition, it takes a substantial amount of time and resources to decide whether a social investment is suitable in the first place. Specialist in-house knowledge can be essential.

Your responsibilities

Trustees have to comply with certain legal requirements and duties when investing their charity's assets for a financial return and these are set out below.

In general terms, charities can invest in a wide range of assets, and there should be no tax to pay on any income or capital gains that might arise. Eligible investments include cash deposits and shares as well as bonds issued by both governments and companies. Collective investment schemes (pooled funds), commodities, derivatives and buildings or land are also approved charitable investments.

Specifically, **trustees must know and act within their own charity's powers to invest.** The organisation's governing document may restrict the types of investment it can make, although this is fairly unusual.

It is worth noting that any profits from trading are not always subject to tax relief. Typically, these types of investments are more speculative in nature and are often held for relatively short periods of time. However, a well-diversified portfolio of financial investments comprising a mix of low-risk and higher risk securities is unlikely to fall foul of this distinction.

Exercise care and skill

Trustees must exercise care and skill when making decisions about investments, and take advice from someone experienced in investment matters unless they have good reason for not doing so. Although they do not need investment knowledge themselves, some charities find it helpful to have a trustee on the board who has investment experience.

However, trustees who offer themselves up as experts are responsible for the quality of advice they provide. For example, a trustee who is an investment manager would be expected to draw on their professional skills. Like any outside professional adviser, they may be liable to the charity if it loses money due to poor or negligent investment advice. As a result, most charities will delegate their needs to a professional investment manager.

Trustees should record in writing any key decisions relating to their investment approach. This would include agreeing their investment policy and any decision to delegate day-to-day investment management to a professional fund manager. A written record enables them to demonstrate they have considered relevant issues, taken advice if appropriate and reached a reasonable decision.

Some charities find it helpful to establish their own investment committee to make decisions. However, they must document the precise remit of the committee.

Understand the risks

Trustees must consider the suitability of any investments as well as the need to diversify. That means investing in a range of different asset classes and instruments. A well-balanced portfolio can reduce the risk that the loss from any single investment or asset class could materially harm the charity.

There are five main areas of risk to consider. First, capital risk or volatility, which is the risk that an investment could fall in value. Second, the risk that an investment does not keep up with the pace of inflation. Third, liquidity risk, which is how quickly an investment can be sold. Fourth, the risk that an asset denominated in a foreign currency falls in value against the pound.

Lastly, regulatory and governance issues can present a material risk. Some investments, such as certain types of pooled funds, may be unregulated or based in countries that are subject to looser regulations than in the UK. Any management failures or lack of regulatory control could be a cause for concern.

All these risks affect charities in different ways according to their investment objectives, time horizon, attitude to risk and capacity for loss. Achieving adequate diversification may be difficult for smaller portfolios. Charities with larger portfolios may consider appointing more than one investment manager to further diversify investment risk.

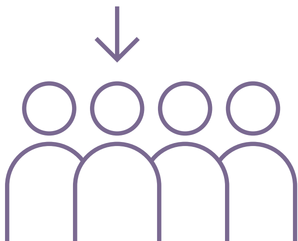
Set your objectives

Any charity with investible assets has to have a written policy that sets out its investment objectives and how it intends to achieve them. This document should reflect the organisation's individual investment needs and situation. It should also be consistent with any other policies, particularly those relating to risk and reserves.

The investment policy statement must be owned by the trustees rather than any investment manager. However, many trustees find it useful to prepare the statement in consultation with the investment manager, which can help to ensure it is both realistic and workable. Working together, they should review these objectives regularly.

You can find out more about what should be included in an investment policy statement in the section 'What to include in an investment policy statement' on page 10.

Before writing the statement, trustees should be clear about what exactly the charity is trying to achieve by investing its funds. The trustees should take into consideration a broad range of issues such as their organisation's aims, operating model, timescales and resources. For example, clarifying how much cash may be required for use in the near future would affect the investment approach.



The investment policy statement must be owned by the trustees rather than any investment manager.

A charity's longer-term financial commitments must also be considered. This may include likely levels of future grants or spending on projects. Trustees should be satisfied that sufficient cash will be available to meet these needs when they arise. In the meantime, they should be looking to maximise their returns to fund these commitments by investing with an appropriate level of risk. Other issues include whether the charity has restricted funds. Perhaps a donor has imposed restrictions on how funds may be used or invested.

It is also important to plan for any unexpected events that might impact on the charity. For example, how the organisation would cope financially if a scandal deprived it of essential donations.

Some charities find it useful to divide their funds into different pots. These could include money that's available for the next 12 months; funds for medium-term investments up to perhaps three years; and assets that can be tied up for longer. Although planning ahead can be difficult, trustees should consider the issues relevant to their charity and develop a financial plan that looks reasonable.

Select an investment manager

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If trustees decide to use an external investment manager, they need to follow certain legal requirements. They should make sure the firm has the necessary expertise to meet their objectives and requirements. In addition, there must be a written agreement between the charity and the investment manager detailing the relationship and clarifying the remit.

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Most charities go through a formal process before appointing an investment manager. Typically, this process involves sending a detailed tender document to a long list of potential managers, and inviting them to submit a written proposal. The trustees then review the responses and invite three or four firms to present their proposals in person.

You need to be careful when outsourcing. Some investment managers offer pooled funds designed specifically for charities that do not provide investment advice alongside the provision of their funds. It is difficult to see how trustees investing with these providers are satisfying the legal requirement to take advice unless they have sought it elsewhere, such as from a consultant or an independent financial adviser.

You can find out more about your responsibilities as a charity trustee in this area, in the section 'How to select an investment manager' on page 16.

Monitor and review

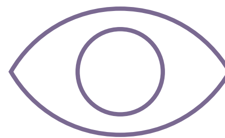
You must review your portfolio and performance (and investment manager, if you have one) regularly. This review should cover how the investments are performing and the service provided by the investment manager in relation to the brief. The frequency of reviews will depend on what makes sense for a charity's individual circumstances, although a quarterly or six-monthly cycle is typical.

If you are content that the investment manager is meeting the brief then any formal manager review can be relatively light, with no need for a formal tender. Regardless of performance though, it is worth reviewing competitor offerings every so often, such as every five years. This process can help you decide whether your current investment manager is still suitable.

Trustees should also conduct a formal review of their investment management arrangements if there is ongoing evidence of significantly poor performance or service over an extended period. Substantial outperformance could also be a cause for concern because it could suggest the manager is taking too much investment risk.

If the charity's circumstances alter materially then a full manager review may also be necessary. For example, if it receives a substantial donation that radically changes the financial situation or if the investment objectives change.

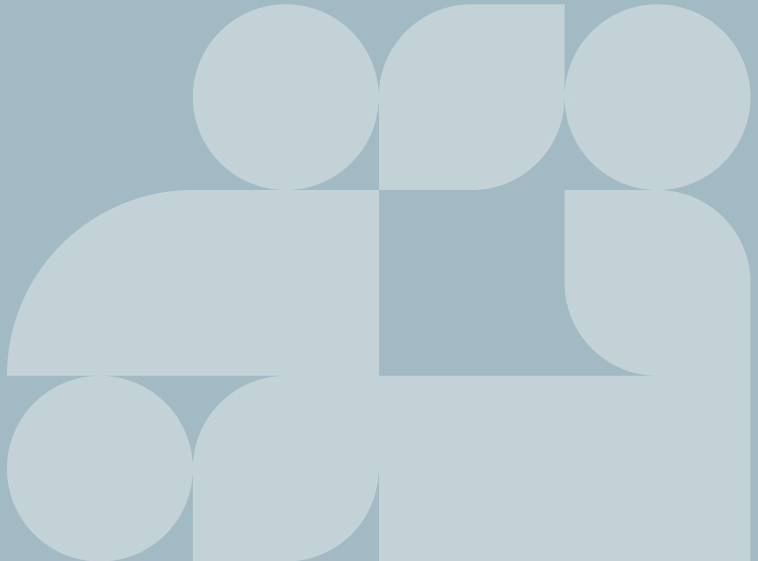
Trustees should outline their charity's investment policy in the annual report and accounts, and include a statement about the performance of their investments over the past year. They must also explain whether the board has adopted an investment approach that is sensitive to any ethical concerns.



If you appoint an investment manager, you must review your portfolio and its performance regularly.

What to include in an investment policy statement

As part of our close working relationships with our charity clients, we make sure their investment policy statements are practical, realistic and appropriate. Although we help trustees prepare and review statements, the law stipulates that charities cannot delegate this responsibility to an investment manager. It is a document they must write and maintain themselves.



The level of detail that is relevant for your investment policy statement depends on a variety of factors. Some charities only hold cash on deposit, which means a simple and short document is usually sufficient. Those with more complex investment requirements would need to include more comprehensive information.

In our experience, most statements comprise the following areas:

Introduction

In this section, you should summarise your organisation's total assets (including any property) and the amount available for investment as well as the role that investing plays within your business model and any governance arrangements. For example, do you operate an investment committee?

Investment objectives and time horizon

Most charities choose to divide their assets into different 'pots'. If you take this approach, then it's important to clarify the return expectations and timeframes for each one. You should define any ongoing income requirements and whether they can be met from income produced within the portfolio or from capital growth, or both. In other words, is a total return approach possible to meet your ongoing income needs?

The time horizon will influence the amount of risk your investment strategy can take in order to meet its objectives. Typically, a longer-term approach gives the flexibility to take more risk because it allows time for a portfolio to recover from any short-term periods of weak investment performance.

One of the greatest risks for a long-term portfolio is inflation, which erodes the spending power of money.

Attitude to risk and capacity for capital loss

There are various issues to consider for each investment pot. For example, a charity that aims to spend 3% to 4% a year of the total value invested over the long term should be able to tolerate a much higher level of volatility (in the expectation of a higher return) than one that is planning to spend the entire invested capital within three years.

This is because one of the greatest risks for a long-term portfolio is inflation, which erodes the spending power of money. A meaningful exposure to assets that tend to deliver inflation-beating returns over the longer term, such as equities and property, is usually appropriate in these circumstances.

For portfolios invested with a shorter time horizon, the risk of suffering a short-term loss of capital value tends to be more important. That's because there may not be sufficient time to recoup any losses.

Another issue to explore is whether any spending commitments tied to the portfolio are within the discretion of the charity or an absolute commitment. If there is flexibility in expenditure levels then this may indicate a higher potential capacity for loss. This could then allow a portfolio to be invested more aggressively for growth.

Ethical policy

Has your charity adopted an ethical policy? This could be negative screening, which involves avoiding investing in certain companies and sectors, such as tobacco. Or it could be positive screening, which involves investing in companies that, for example, demonstrate high standards of governance and contribute to creating a more socially and environmentally sustainable world. You may also want to define whether any ethical policies cover direct investments as well as any exposure that may be held within pooled funds.

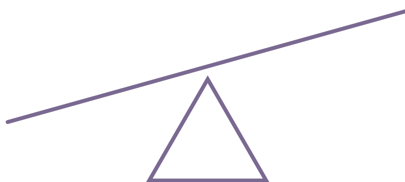
Charity trustees have a basic duty to seek "the maximum financial return consistent with commercial prudence". As the ruling judge stated in the well-known *Bishop of Oxford* case, "most charities need money, and the more of it there is available, the more the trustees can seek to accomplish".

Notably, trustees should put their own personal views about what may be ethical to one side. So how far can trustees allow their investment strategy to be governed by considerations other than the level of investment return? The *Bishop of Oxford* case highlighted three situations where it would be appropriate:

– First, if a particular investment would conflict with the aims of the charity. For example, an organisation involved in protecting the environment may decide not to invest in companies that have poor environmental records.

– Second, if the charity might lose supporters or beneficiaries if it did not invest ethically. An organisation can avoid investments that might hamper its work, either because potential beneficiaries would be unwilling to be helped due to the source of the charity's money or (more likely in practice) by alienating potential donors. For example, donors to a cancer research charity might be less willing to give if the charity invests in companies that manufacture cigarettes. The trustees must balance the likely cost of lost support (for example, the loss of potential donations) against the risk of financial underperformance if its investment policy excludes cigarette producers from the portfolio.

– Third, if there would be no risk of significant financial detriment. Trustees may be able to conclude, after taking advice if necessary, that a particular ethical policy is likely to perform just as well as an unrestricted policy. If a charity's ethical policy is to invest in a positive manner in companies that demonstrate high standards of corporate social responsibility and governance, then this may be relatively easily satisfied. This is because there is an increasingly held view that such companies are likely to deliver the best long-term balance between risk and return.



The trustees must balance the likely cost of lost support (for example, the loss of potential donations) against the risk of financial underperformance.

Eligible asset classes

A diversified investment strategy that blends different asset classes can be one of the best ways to preserve and enhance wealth over the long term. This approach can dampen losses when market conditions are challenging as well as provide exposure to a wide set of investment opportunities.

Your investment policy statement should set out which asset classes you can invest in and might also include any maximum and minimum ranges for each asset class.

Performance benchmarks

Trustees should set a performance benchmark that will help them assess their investment manager. There are various measures, and the one that is appropriate for you will depend on your investment strategy. Some of the most commonly used benchmarks include:

– Cash/inflation plus. For example, the Retail Prices Index +3% a year.

– Composite market index. The expected long-term average asset allocation of the portfolio is taken as the neutral position. Appropriate market indices are then applied to each asset class held in the portfolio according to their neutral percentage allocations. This might include the FTSE All Share for UK equities, FTSE World Equity (ex UK) for overseas equities and FT Government All Stocks for UK bonds. Each of these numbers is then added together to give a composite market index against which the performance of the whole portfolio may be measured.

– Peer group. There are a number of charity peer group benchmarks, such as those provided by ARC and Teknometry. The trustees should select the one that is most closely aligned to their charity's objectives, which is not necessarily a straightforward task.

It's important to ensure any benchmarks you select are appropriate for the investment strategy, and that they are not very easy or difficult to beat.

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Restrictions

Specify any constraints you wish to impose, such as:

– excluding investments in non-investment grade bonds

– cash balances only being deposited 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

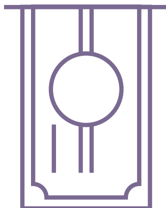
– excluding investments that cannot be sold within three months.

Managing, reporting and monitoring

Set out how the investments are managed (such as the details of any investment managers), the information that the investment manager should be providing on the portfolio on a regular basis and how often the trustees meet the managers to monitor performance. Authorised signatories should be detailed, for example to enable cash withdrawals from the portfolio.

Approving and reviewing

Specify when the trustees last approved the investment policy statement and when it will next be reviewed. Reviews should be regular, such as once a year, or more often if there is a material change in your charity's circumstances or financial arrangements.



Authorised signatories should be detailed, for example to enable cash withdrawals from the portfolio.

How to select an investment manager

As a trustee, you are responsible for ensuring that strategic decisions about your charity's assets are in line with the overall objectives. You may decide to make investment decisions yourself if you have the necessary skills and experience. However, most trustees choose to delegate the decisions to a professional fund manager.

There are three types of investment management arrangement:

– execution-only: trustees with the necessary expertise make all investment decisions

– advisory: investment managers provide advice on managing investments, but trustees make the final decisions to buy or sell individual investments

– discretionary: trustees delegate the day-to-day management of their investments to an investment manager within an agreed mandate.

If you select an advisory or discretionary arrangement, you will still be responsible for directing the overall investment policy and objectives on behalf of your charity. The investment manager can advise on or manage an appropriate portfolio of investments within the constraints of the investment policy that you set. Although an execution-only arrangement is appropriate in some cases, trustees should be aware that they alone are liable for any investment decisions. Discretionary arrangements are the norm for most charities these days.

The tender process

Most charities go through a formal tendering process when looking for an investment manager. This is typically the case if the charity has made the decision to invest for the first time, or as part of maintaining high standards of ongoing governance.

Typically, the process involves sending a detailed tender document to a long list of investment managers inviting them to produce a written proposal. Trustees then consider the responses and ask those shortlisted (perhaps three or four) to present their proposals in person.

A tender document should include a brief introduction to your charity, ideally with a link to the latest reports and accounts, as well as key dates and deadlines. Remember to provide contact details for where written proposals or questions should be sent.

It's important to specify the amount available for investment and summarise the investment policy statement, encompassing:

- investment objectives
- time horizon
- attitude to risk
- capacity for loss
- ethical policy
- restrictions
- reporting requirements.

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Ask the right questions

Trustees should produce a set of questions for the investment manager to provide written answers to. A good starting point is to ask about background information covering the firm's history, location, ownership, corporate structure, financial standing, services, assets under management and investment resources. It's also useful to find out about the investment manager's charity experience, including its charity clients, any dedicated charity team, awards won, and its assets under management.

You should ask how the firm manages money for its clients as well as their approach to risk management and socially responsible investment. It's essential to clarify the firm's recommended investment strategy and benchmarks, including how ethical requirements (if relevant) would be handled.

The questions should also cover how assets would be transitioned from the current manager if the firm was appointed. It's worth asking for a record of the firm's performance over one, three and five years against appropriate comparators, as well as finding out the extent of fees and charges, such as:

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- annual management fees
- performance fees
- commissions on purchases or sales of investments
- fees charged within pooled funds that may be employed in the portfolio
- custody fees
- administration charges
- VAT
- total expense ratio, which is the total cost (including all of the above elements) of a portfolio to the investor.

A key element of this exercise is finding out exactly who you will be working with at the firm – whether it's an investment manager or a relationship manager. Ask for CVs of the people you will be working with and find out how many clients they already look after. It's important to establish how often you will receive written reports and have face-to-face meetings and what these will entail, as well as any value-added services such as investment training.

You should request details of the investment manager's ISAE 3402 report or equivalent. This document is an independent service auditor's assurance report on the processes and controls system of the firm.

Lastly, once you have decided which investment manager you'd like to work with, you can ask for references from existing clients.

Selecting the right investment manager

The tender process enables charity trustees to select the investment manager that best fits their overall needs. Some charities find it helpful to devise a scoring system to measure managers against the trustees' key requirements.

It's worth keeping a note of how responsive potential appointees have been throughout the tender process. Have they given the impression of being interested, proactive and keen to be involved? Did they ask questions to clarify points about the charity's requirements? It's easy to be impressed by a slick presentation on pitch day but what you want is a manager who is prepared to really engage with your charity.

A key element of this exercise is finding out exactly who you will be working with at the firm – whether it's an investment manager or a relationship manager.

Cash deposits

Cash deposits are a form of financial investment. The duties and responsibilities of trustees apply as much to cash as they do to other investments. In practical terms, this means trustees should have a written policy that will cover where and for how long cash may be deposited, and how much may be placed with a single institution.

You should only deposit with reputable institutions, such as those regulated by the Financial Conduct Authority or by the relevant financial regulator in another country. Seek assurance that your deposits are protected wherever possible, by the Financial Services Compensation Scheme (FSCS) in the UK. At the time of writing this guide, deposits are protected up to a maximum of £85,000 but the rules do change, so make sure you check the current status when you make the deposit.

It's important to limit the amount deposited with a single institution to reduce losses in the case of institutional failure. Keep in mind that you should be aiming for the best financial return within the level of risk considered acceptable by your charity and ensure you are getting competitive interest rates.

Review your cash arrangements regularly and keep in mind that institutions that pay relatively high levels of interest may be less secure. Any charges arising from access at short notice in the case of fixed-term deposits should be taken into consideration. Remember you can claim back tax on any interest paid if it has been tax deducted.

Useful links

Charities and investment matters: a guide for trustees (CC14)
www.gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14/charities-and-investment-matters-a-guide-for-trustees

Charities and investment matters: a guide for trustees (CC14) – legal underpinning
www.gov.uk/government/uploads/system/uploads/attachment_data/file/582827/Legal_underpinning_Charities_and_Investment_Matters_new.pdf

Social investment – the new power introduced by the Charities (Protection and Social Investment) Act 2016: interim guidance
www.gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14/charities-and-investment-matters-interim-guidance

Writing your charity's investment policy – a guide by the Charity Investors' Group
www.cfg.org.uk/Policy/investment/~/media/Files/Policy/Investment/Writingyourcharitysinvestment%20policya%20guide.ashx

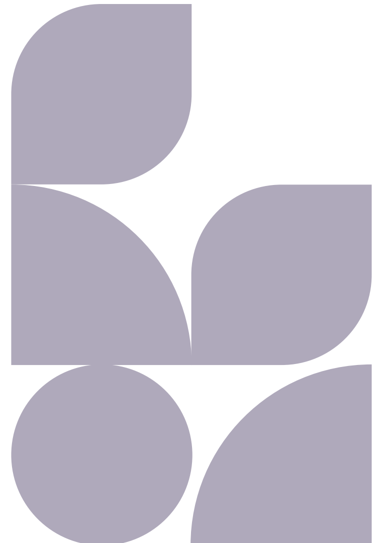
Total return investment for permanently endowed charities – guidance from the Charity Commission
www.gov.uk/government/publications/total-return-investment-for-permanently-endowed-charities

Financial Services Compensation Scheme
www.fscs.org.uk

Working together

Rathbones is a leading provider of investment management services, advice and training to charities of all sizes throughout the UK. Trustees come to us for a combination of our experience and skills as well as our personal and detailed approach.

If you would like to find out more about how we could work with your charity, please email andrew.pitt@rathbones.com or call 020 7399 0020.



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