CCLA

GOOD INVESTMENT

The role of an investment policy

Every investor knows that participating in markets brings with it a degree of risk. Asset prices rise and fall each day and we know to expect a serious downturn every so often.

There are two unique forces that make the current market crisis unique:

1. We had been overindulged by a decade of rising markets; the bull market that started in March 2009 was the longest in history. For many investors, this has been the first experience of a significant loss of paper wealth.
2. The market crash that began in February 2020 has its roots in a communicable disease that has swept with little discrimination across borders, economies and social hierarchies, the secondary effects of which will be felt across the globe. In contrast to previous market crises, there is currently nowhere to hide.

For those entrusted with oversight of charitable investments, these are challenging times. First and foremost, many charities are understandably concerned about their operating model and finances in the months ahead. Those who rely heavily on public support, fundraising or membership fees may find their finances running particularly close to the line.

We suggest examining the expected level of income – both from the charity's investments and from elsewhere. If income comfortably covers liabilities for the time being, then remaining with the existing strategy is often the best course of action. History has shown time and time again that markets do recover; for those with the constitution and time horizon to stomach the fall, patience can prove rewarding.

This course of action assumes that the charity has a:

- thorough and comprehensive investment policy statement
- time horizon long enough to withstand the current crisis and pull through unscathed.

'Much success can be attributed to inactivity. Most investors cannot resist the temptation to constantly buy and sell.'

Warren Buffett

Why is an investment policy so important?

Investment time horizon

The UK equity market has seen three major crises in the last half century: 1972–1974 (73% decline in capital value), 2000–2003 (51% decline) and 2007–2009 (49% decline). On average, the market took just over two years to fall from peak to trough and four years for the recovery.[1] Assuming the charity has an investment time horizon beyond seven to 10 years, you should feel comfortable that the investments will recover.

As for the current crisis, the market fell 36% in capital value from the peak on 17 January 2020 to the trough on 23 March 2020. Although there is no guarantee that we are past the worst, the market has already made up much of what was lost in the initial fallout. In fact, the strongest uptick followed immediately after the trough; on 24 March – in a single day – the market gained 9%. Trustees tempted to capitulate in the depths of a crisis may live to regret it.

If a charity has a near-term liability that will not be met by existing liquid assets or income, then there may be no choice but to sell some investments. We would, however, caution against this course of action as a long-term strategy, since it will fail to protect the charity from the erosive effects of inflation. This can have a devastating effect on long-term returns and compromise the ability to safeguard the interests of future beneficiaries.

Investment policy statement

A concise policy provides a framework for investment decisions, capturing a charity's overarching goals and long-term objectives. Market crises and the ensuing panic can lead investors to deviate from a sound investment strategy that had been tailored to their risk tolerance, time horizon and overarching targets. A proven way to ward off panic is to agree a strategy that focuses on the charity's goals and is not dependent on short-term market conditions.

Despite knowing that markets are cyclical and prone to bubbles, too many investors ignore perceived logic and sell out when it least makes sense. In the height of market turmoil, trustees can feel that doing something is better than doing nothing. However, from an investment point of view, short-term reactions can seriously hinder long-term returns. Doing nothing is sometimes the hardest thing to do, yet frequently the best.

We believe that trustees should:

- examine the level of liquid reserves and anticipated spend, including known short-term, probable medium-term and possible long-term liabilities to ensure there is adequate liquidity to cover them
- scrutinise income from all sources and consider the likely impact of a prolonged market downturn or a recession
- determine if there is any flexibility in spending plans and how these could be adapted.

By charting a charity's spending profile and keeping adequate cash aside, a fall in the value of the investments should have little impact on the ability to cover known liabilities and remain operational.

It is worth remembering that – much like owning a house – a loss in the value of a portfolio is a loss on paper only until the point of sale. It follows that the optimal time to sell is undeniably not following a significant fall in its price.

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1 Source: Bloomberg, FTSE All Share (price index) in GBP. Monthly data series for periods from May to December 1972; daily data for periods from September 2000 to March 2003 and from June 2007 to March 2009.

How can we help?

It can feel very uncomfortable to sit through a crisis of this severity. For trustees it can be tempting to try to rectify the problem prematurely by liquidating investments before they fall further. However, markets take time to recover and trustees must take heart from the fact that patience is often the best course to protecting the long-term sustainability of their charity.

We are under no illusions that this will be an easy ride. At CCLA, we are here to help. If you would like guidance on your investment policy, long-term strategy, cash-flow planning, or investments, please contact us.

WANT TO KNOW MORE?

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Disclosures