



TOTAL RETURN

Andrew Pitt and Paul Palmer explain why "total return" is often a superior alternative to an income strategy.

Many charities have investment policies designed to deliver the maximum income possible. However, this can produce a conflict as while charities may want to maximise their income in the short term, they also need to ensure they preserve their spending power in the long term.

From an investment standpoint, these are conflicting objectives because the asset classes that provide the most income today, e.g. government bonds, tend to provide the least long-term protection against inflation. On the other hand, asset classes that offer the best long-term protection against inflation, such as equities, provide a lower level of initial income. The position has been further complicated by the emergence of alternative investments such as hedge funds and private equity which do not produce income in the formal sense of the word.

For many years, income-only distribution policies sat comfortably with the investment conditions and practices of the time. There was a consensus in favour of equities, and company dividend policies responded to expectations of steady income growth. Trustees enjoyed an income stream that facilitated income-only distributions, and investment policies accommodated the income/capital distinction without undue constraint.

These investment conditions disguised a number of rigidities that are inherent within an income-only distribution policy. Asset allocation and investment choice became increasingly concerned about income loss and the need to avoid putting the portfolio's sustainable distribution at risk, rather than investing for the best overall return. This led many charities to skew their portfolios towards asset classes that produced income. Many charities continue to do this and end up, from a risk/return perspective, investing in less efficient portfolios.

The debate about the extent to which it might be safe to top up income by spending accumulated capital gains, while preserving the real value, was facilitated by the decision of the Charity Commissioners in 2001 to allow charities with a permanent endowment, which traditionally would only have been allowed to spend income, to adopt a total return approach in certain circumstances. The rationale for doing so is that a portfolio can be managed so as to optimise the return generated, regardless of whether this is obtained from dividends, interest or capital gains. With this approach it is the overall level of investment return, rather than the composition of the return that is important. This allows trustees far more flexibility when drawing up their

investment strategy and enables them to consider all asset classes rather than just those that happen to produce income. The ability to diversify risk is thus greater for a charity adopting a total return approach.

The determinant of distribution policy under a total return approach is no longer the income received during the year, but a consistently applied distribution formula that will allow for sustainability of the portfolio over the long term. Broadly speaking, an even-handed policy will seek to ensure that, after distributions, the value of the portfolio is maintained in real terms over time. Trustees will tend to build in a margin for error to allow for future uncertainties and will, therefore, often target a small increase in the capital value of the fund after distributions. Typically trustees will specify a fixed percentage (say 4 per cent) of the fund that can be distributed annually that they believe will not impair the real long-term value of the capital invested. The actual percentage will depend on the expected long-term returns from the various asset classes included within the portfolio, and most investment managers are able to give trustees guidance in this area. The precise asset mix will depend on the investment objective of the portfolio in question including a consideration of both risk and return.

In practice, a portfolio following a total return policy will continue to produce some income and so the amount of capital that needs to be spent to make up the annual distribution will normally be considerably less than the fixed percentage specified. Hence trustees are most unlikely ever to have to sell a material percentage of their portfolio at a bad time, even if markets performed poorly over several years. As a result, the rules governing the total return policy adopted by the charity should not be subject to frequent review, even in the face of large market movements in the short term.

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