

# Why should smaller charities switch their reserves from passive cash to active management NOW?

## Reserves

**Every charity needs to hold sufficient funds in liquid, readily-available assets to pay the bills. Any money in addition to this should be managed as reserves to provide a growing stream of income for the future. Many charities are in the fortunate position of having these excess funds and it is the task and duty of the Trustees to ensure that a sound policy is formulated for managing and investing them.**

The Charity Commission summed up its position on reserves in its RS3a Charity Reserves report of 2001 and, more important, highlighted the fact that many charities are failing to identify and husband their reserves:

*“For trustees, consideration of the level of reserves their charity needs to hold, and how to acquire them, is an important part of planning and of sound financial management. It is also a key issue for the Charity Commission as the regulator. Reserve levels that are set too high tie up money which could and should be spent on charitable activity. If they are too low, the future of the charity may be put at risk.*

*In the year ending 31 December 2001, over £26 billion was held in reserves by registered charities. Over £5.5 billion of these reserves were held by charities that did not have a reserves policy and many of the policies that were in place were insufficient and of poor quality. Whilst the changing economic climate means that the values of reserves quoted by some charities will have fallen since then, the principle of developing a well thought out reserves policy, with a level of reserves that is right for the charity and is clear to its stakeholders still holds good.*

*Setting a reserves policy and, in particular, identifying free reserves helps inform the way in which a charity manages its cash, liquid assets and debt: its treasury management approach. A comprehensive reserves policy will also assist trustees when planning and explaining their approach to stakeholders. Trustees whose charities have a reserves policy are legally required to publish that policy in their annual report...*

*...Too many charities gave little or no thought to managing their reserves. Nearly 70% of charities with an income over £10,000 did not have a reserves policy when they submitted their annual return for 2001, despite many of these charities having substantial funds held back from expenditure. This position is unacceptable. However, on the positive side, many charities told us that they*

were in the process of developing a reserves policy or had put one in place since submitting their 2001 annual return, and the Charity Commission expects to see this process accelerated”.

### **Reserve Policy**

Having established that it ought to be channelling its excess resources into a reserve, the charity then faces the more difficult problem of what to do with these funds.

Most charities need money for the future to spend on salaries and benefits that go up in line with wages and prices. The way to provide for this is to invest in assets whose income rises in a similar way. However, many are tempted to treat their new found reserves in the same way as before and will leave them on deposit earning the best-available cash rate. This may seem like an appropriate course of action if the newly-defined reserve is not very large. Trustees may consider that they have sufficient expertise to manage a cash balance, but not sufficient to decide on investments into other areas. They might not consider it cost-effective to seek professional advice for a relatively small pool of assets.

Nevertheless, they are obliged to formulate a Reserve Policy and the starting point should normally be to invest the available funds in a manner which will ensure a growing stream of income and capital. This will normally exclude holding only cash on a long-term basis. Set out below is a table showing the relative performance of various asset classes over the past 10 years – the long term in most peoples’ view.

<b>Investment</b>	<b>10 year Total Return</b>
UK Property	188.1%
Hedge Funds	102.1%
Index-linked Gilts	95.9%
Gilts	85.5%
UK Equities	82.4%
Global Equities	81.3%
Cash	67.3%

Cash does not usually produce the best return over the long term – even during a period which included a year (1998) when cash interest rates were as high as 7.9%. The numbers above also do not tell the whole picture in terms of UK equities: Long run equity returns since 1900 have been around 9.6% each year compared to long run cash returns of only 5% over the same period. For charities with a very long term outlook this differential in return over a full century would mean the difference between £1 invested in UK equities growing to be worth £9,572 compared to only £131 for the same investment left entirely in cash. This shows the importance of taking into account the effect of compounding when analysing investment returns over the longer term. The trustees of a charity which chose equities 100 years ago would be in a position

to do more good today than their predecessors 100year earlier. The opposite would be true for the trustees whose charity had chosen cash.

### **Why invest now?**

There are clearly strong arguments for investing charitable reserves into asset classes other than cash but many Trustees will question whether the correct time to take the plunge is now. 2008 is beset by obvious problems; a credit crunch well underway and the future for world economic growth uncertain. Markets have a habit of not standing still. They are normally either rising, in which case it would be more attractive to enter them on some sort of setback, or falling, in which case it would be better to wait for the first signs of a recovery.

Looking at the most recent move in markets is not the best way to decide on investment timing. Many traders pride themselves on having perfected methods of predicting market moves but only a few succeed in correctly guessing the market more than half the time. There are few better ways of entering the market than by what is often known as 'pound-averaging' which means buying in regular instalments over a period to ensure that a representative price is achieved. If you start to do this after a sharp decline in markets, but before recovery is clear, you end up buying shares at a good price.

In valuation terms, the beginning of 2008 actually looks to be a very good moment to begin the move from passive investments in cash to active investments in equities and other assets. Equity and property markets have fallen significantly from their 'highs' and the impending reduction in interest rates will provide oxygen for both markets over the coming months. Elsewhere, an economic 'super-cycle' is still underway driven by the high population growth and a strong increase in consumption in India, China and other emerging economies. The demand for commodities looks set to continue to grow and additional opportunities have emerged in niche areas such as agricultural commodities and land driven by demand for more and better food by emerging economies and strong growth for renewable sources of energy.

It can be useful to think of all investments in terms of cash: Cash has a known value and produces a known, if variable income. However, the value of cash does not increase and is eroded by inflation. The average of the CPI and RPI inflation indexes in the UK is currently 3% and at this rate the real value of a cash holding will fall by 34% over 10 years. Set against this is income or interest earned – currently around 5%. This would bring the 'real' rate of return on cash up to 2% per annum, but cash interest rates are not fixed and will almost certain fall further during 2008.

Equities also produce an income in the form of dividends, but unlike cash this income has risen by, on average, around 6% per annum over the past century. There have been only a couple of years when dividend income has actually fallen

since 1900. In addition, the capital value of the equity will tend over the years to grow in line with its ability to pay higher dividends, so the investor is receiving more income while seeing the value of the equity grow at the same time.

Another way to get passive exposure to cash-type returns with low risk is to invest in UK long-dated gilts. However, when held on a long-term basis to redemption, the same factors apply as with cash and the nominal value of the gilt will also be eroded by inflation. Additionally, if interest rates come down – as they are at the moment – your return falls as you can no longer reinvest the income at the higher rate.

Another powerful argument exists based on valuation and market-timing exists for switching from long-dated gilts or cash into equities: The difference in yield between equities and bonds has fallen to only around 1%. Table 1 below shows that after just 5 years equities bought now will be producing a higher yield than long bonds, provided that dividends continue to grow at the historic rate of 6%. After 10 years the equities could be yielding 40% more than the bonds and there will also have been potential for substantial capital growth.

Table 1

	<b>Current Yield</b>	<b>Rate of growth in Yield</b>	<b>Yield after 5 years</b>	<b>Yield after 10 years</b>
<b>Long-dated gilts</b>	4.5%	0	4.5%	4.5%
<b>UK equities</b>	3.5%	6%	4.7%	6.2%

On evidence above, it is hard to see any argument for a charity reserve with an investment perspective of ten years or more to be retained in cash alone. **With the yield gap at only 1%, now is an excellent time to make the move.**

**Smaller Reserves – you can invest just £1m or £2m economically**

Many charities with limited funds available to invest may feel that they do not have sufficient expertise to make this decision. There will understandably be a concern that the cost of professional advice will outweigh any advantage they may receive. This is no longer the case: The emergence of a wide range of specialist investment and advisory boutiques with much lower overheads – often staffed by former senior members of institutions well-known to Trustees – means that a growing number of solutions exist for smaller charities with funds of 1 million or greater to invest.

The above article has written in association with Pan-Asset Capital Management and CB Financial Ltd. Pan-Asset Capital Management has been created by John Redwood, Robert Brown (former CEO of Sarasin Chiswell) and Christopher Aldous (former CEO of Absolute Fund Management), it aims to bring a range of new and innovative solutions to smaller charities and endowments.