For Good And Not For Keeps

How long-term charity investors approach spending on their charitable aims

Richard Jenkins
Kate Rogers

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Foreword

I am delighted that Schroders has been able to be involved in the production of this report. It is a timely, thought provoking and above all useful report for all charities with investments who are wondering how to respond to the harsher economic environment that we all face.

Schroders is well aware of the pressures that charities are facing and the desire of trustees to do their best for their beneficiaries. This report is a good reminder to us all that investment services go beyond the simple managing of money, but can involve helping clients navigate uncertain and often complex ideas. At the heart of charitable investing is the only question that really matters: “How much are we able to spend?”

This report is particularly welcome for its fresh approach to this simple question, removing many of the old cobwebs, and looking freshly at the reasons for holding charitable funds to generate long term returns. The fact that it is written for a lay, not a technical, audience only reinforces the point that these decisions are for trustees, and not just for investment professionals.

Above all, I hope that trustees will find this report helpful to them as they consider how they might respond to the needs of the beneficiaries, both now and in the future.

Bruno Schroder

Director,
Schroders plc

Image courtesy of The Paul Hamlyn Foundation/Steve Bootle

Executive summary

For Good And Not For Keeps was commissioned to explore one of the most testing questions faced by trustees of charities with long-term missions who rely on investment assets to fund their activities. 'How much can we safely spend on our charitable activities year on year while preserving the value of our investment assets for future generations?'

Research took into account the legal background, historical market analysis and forecasts for typical charity portfolios and the results of a survey to which over 220 charities responded. The authors have particularly considered the influential concept of 'intergenerational equity' as suggested by Yale Professor James Tobin in the 1970s to encapsulate trustees' obligations to the future. Practically it has been interpreted to mean that trustees should aim to safeguard the real value of the investments, in other words in line with inflation, for an indefinite number of generations. We found the following:

Charities and the long term

The long term is very often a choice rather than a legal requirement, influenced by strategy, history or a founder's wishes. When considering their long-term existence, one of the biggest dangers facing trustees of long-term charities is the effect of inflation – even more than the fluctuating market value of their investments.

The long term and market trends

Analysis of historic returns show that a typical charity could have spent 4% each year over the course of the last century on charitable activities and costs and still have maintained the real value of its portfolio. However, twentieth century investors benefited from steep gains in the 1980s and 1990s. Forecasts for the early decades of the twenty-first century suggest lower returns causing many to question their approach to spending. Crucially, maintaining the real value of a portfolio is only ever a probability and never a certainty – no matter how little trustees spend.

The real-life behaviour of charities

Over 220 charities responded to a survey for this report about their investment and spending aims and practices. The vast majority of charities who responded wished to maintain the value of their portfolio and their expenditure in line with inflation.

Respondents spent over a range of rates. The most common was between 3% and 4% – within the range that historically could have maintained the real value of their portfolios. However, larger, older charities, regardless of whether they were permanently endowed or not, tended to spend more.

Since the beginning of the crisis in 2008, 80% of respondents had maintained their expenditure rates and 5% had increased them, despite falling equity returns.

Different approaches to the long term

Given that maintaining the real value of a portfolio is always going to be a probability rather than a certainty, there is no one 'right' answer to what long-term charities might spend. A better question for trustees to ask themselves than 'How can we protect the real value of our investments?' might be: 'When determining our spend and investment policies, what risk are we prepared to take with longevity?'

To help them decide that, this report proposes the following three approaches to the long term:

Legally permanent – These charities have no choice about the long term. The default is that they can spend investment income such as dividends or rent but may not spend capital. A total return approach may allow them to make and spend more money over the long term, but they will have to protect the original capital sum.

Intentional preservation – These charities have chosen to maintain their activity indefinitely. That being the case, they will wish to minimise the risk of eroding their assets over the long term. These charities will calculate their expenditure to ensure that they deliver 'intergenerational equity' across beneficiaries.

Open-ended – These charities are expendable but have chosen not to spend out within a definite time frame. They are prepared to spend more and take some risks in relation to preserving the real value of their investments and longevity. However, they are open to the possibility of existing for many generations should high markets returns make it possible or if they decide to reduce spending.

In addition, to improve their chances of thriving into the long term, instead of simply focussing on preserving the value of their investments, trustees can be proactive in making as much money as they can, doing as much good with all their assets as they can (including using share voting rights, social investment, their reputation, convening power and human capital), doing good for as long as they can, and recruiting other donors to support their cause.

Trustees alone have the knowledge and insight to decide what is right for their charitable mission. Their only failure can be a failure to think through sufficiently what they must do as 'good stewards'. While guardians protect treasures or keep captives under lock and key, letting some in and no one out, good stewards shrewdly garner their resources and replenish their stores to be able to go on giving out good things again and again. This report is written in the hope that it may provide a framework to help them do that.

Acknowledgements

The authors would like to thank all of the individuals who contributed to this report for their time, knowledge and patience. Thanks are owed to the Association of Charitable Foundations for agreeing to publish the report as well as their help and support throughout the project. Thanks to Schroders Charities for commissioning the report, and for the marketing and production support. Many people in both of these organisations contributed, but we'd especially like to extend our thanks to Stephanie Brittan and Joanna Barton for their diligent support.

We are also indebted to those kind individuals who gave up their precious time to be interviewed for the case studies, and for their candour and openness, Kristina Glenn and Heather Lamont, Cripplegate Foundation; Richard Robinson, Paul Hamlyn Foundation; William Jensen, Exeter College; and Mark O'Kelly, Sara Llewellin and Anna Southall, Barrow Cadbury Trust. We are also grateful to each of the charities for their permission to use the images within the report.

The authors are grateful for the assistance of the Charity Finance Group and *Charity Finance* magazine in the dissemination of the survey, allowing such a large sample to be engaged. Thanks are also due to Amreet Singh, who helped analyse the survey results.

Thanks are owed to The WM Company and Elroy Dimson, Paul Marsh and Mike Staunton, for allowing us to use their data in our research. This has allowed us to perform market analysis that is crucial to the report findings.

The report has been greatly enhanced by input from the experienced individuals who gave up their time to read and comment on the draft in the 'peer review' process. Guy Davies, Evercore Pan Asset; Luke Fletcher, Bates Wells & Braithwaite; Nick Perks, The Joseph Rowntree Charitable Trust; and Fiona Young, The Tudor Trust.

Finally, the authors are particularly grateful to the members of the steering group for their guidance, wisdom and inspiration. We thank Andrew Hind, Charity Finance; Paul Warren, Corpus Christi; and last but by no means least, James Brooke Turner, Nuffield Foundation for dedicating so much time and thought to this project for such meagre thanks.

About the report

This report addresses those charities with a long-term mission that rely on the return from investment assets to fund their charitable activities year on year.

It has been written primarily to help charity trustees and staff think through their approach to managing the often competing concerns they experience. It may also interest those who advise them or who aim to support the sector.

The report presents some technical information, but is aimed at the 'lay', or non-expert, reader with no professional legal, financial or investment experience but who may find themselves involved in governing or managing charities with investments.

Approach

The report does not advocate a particular approach or set of answers to the difficult questions facing those who run long-term charities with investments.

It aims instead to provide objective market analysis and describe some of the range of current practice, with reflections on both. The report highlights questions which may help focus the thinking of those who run charities that rely on investment returns.

Geographical scope

The report addresses the situation of charities governed by the law of England and Wales and regulated by the Charity Commission. Separate legal and regulatory frameworks exist in Scotland and Northern Ireland. Although this variation exists across the United Kingdom, charities with investments face similar issues in each jurisdiction and the principles set out in the report and the thrust of the reflections should broadly hold for trustees across the UK.

Background

This report follows up *The Governance and Financial Management of Endowed Charitable Foundations*, published by the Association of Charitable Foundations in 2012. That report addressed the situation of endowed charitable foundations. It concluded that a number of misconceptions about the application of trustees' fiduciary duties could be inhibiting their thinking.

The research was commissioned by Schroders Charities to examine a specific question, frequently asked by clients who were staff or trustees of charities with a long-term mission that relied on the returns from investments to fund charitable activity year on year. That question was 'how much can we spend on our charitable activities year on year while preserving the value of our investment assets for future generations?'

The Association of Charitable Foundations agreed to publish the resulting report on the basis of research carried out with the following terms of reference:

Aim

To create a report to look at how long-term charities, endowments and foundations approach expenditure decisions.

The report should provide a framework for charitable trusts to consider spending policy where their intention is to deliver their mission by providing ongoing support for the long term.

Content will cover the following:

1. Summarise current legal and regulatory environment including presenting findings from *The Governance and Financial Management of Endowed Charitable Foundations*.
2. Present an analysis of historical markets and comment on its implications for trustees.
3. Describe different approaches taken by trustees of long-term endowments in a range of circumstances.
4. Identify the key questions and any practical considerations for trustees to consider when formulating and reviewing their approach.

The researchers and co-authors are Richard Jenkins (author of the earlier report) and Kate Rogers (Schroders Charities).

The research and drafting was overseen and approved by a steering group comprising:

- James Brooke Turner, Finance Director, Nuffield Foundation.

- Andrew Hind, Editor, *Charity Finance* magazine.
- Paul Warren, Bursar, Corpus Christi College, Cambridge.

Methodology

Research was conducted between September and December 2012 and included the following components:

Desk research including summarising, building upon and widening that contained in *The Governance and Financial Management of Endowed Charitable Foundations.*

Case studies to represent four typical scenarios for long-term charities: permanently endowed and spending income only (Cripplegate Foundation); a mixture of permanent and expendable endowments invested for total return to support the mission indefinitely (Exeter College, Oxford); fully expendable and calculating expenditure at a rate intended to preserve the real value of investment portfolio (The Paul Hamlyn Foundation); fully expendable and spending a fixed amount that could conceivably erode the real value of the portfolio over time (The Barrow Cadbury Trust).

A series of in-depth semi-structured interviews were carried out with finance and investment staff and some trustees. The foundations from which individuals were selected for interview all came from the largest 900 endowed charitable foundations in England and Wales which have been identified from Charity Commission data by the Association of Charitable Foundations (see next section).

Survey questions posed to organisations who were clients of Schroders Charities, members of the Association of Charitable Foundations, members of the Charity Finance Group and readers of *Charity Finance* magazine. A copy of the questions and results can be found in Appendix ii and are also published on www.schroderscharities.com/spendingdecisions. The results of the survey were analysed by the researchers, with assistance from a research intern at Schroders Charities, and their significance discussed with the Steering Group. Due to a lack of wider information about the population from which respondents came, great reliance was not placed on the survey results as representing all charities with investments. Results were however included as providing some insights into the attitudes and behaviours of professionally managed charities facing the sort of dilemmas the report set out to address.

Market analysis formed a key part of the research. The approach and assumptions made are outlined below and in Appendix i.

The impact of markets on the performance of charity portfolios was analysed using annual total returns from UK assets; equities, bonds and cash, and comparing them with annual inflation from 1900.

We used market returns which did not take into account the costs associated with investing. Inflation in the report is represented by the retail price index.

We combined these returns as if the assets were held in a portfolio, rebalanced annually, with the asset allocation 80% UK equities, 15% UK bonds and 5% sterling cash.

This asset allocation was selected as a proxy for an average charity investor, which we called the 'example portfolio' based on the average asset allocation of the WM Total Charity Universe since its inception in 1984.

We used the total return of this portfolio 'the example portfolio' and the actual charity return data of the WM Total Charity Universe which we named 'the peer group' to build up a basic picture of the pattern of returns experienced by UK charities over the last 112 years (to end 2011).

Analysis of all research information was carried out in the first instance by the authors, but findings were tested with the steering group which met regularly through the period during which the research was carried out.

A final draft of the report was subjected to four practitioner peer reviewers with extensive knowledge of the governance and regulation of endowed charitable foundations before being approved for publication by the steering group.

About the authors

Richard Jenkins is an independent researcher and consultant in the charity sector. He has been a trustee of a grant-making endowed charitable foundation, chief executive of an educational charity, and as a civil servant, led implementation of key funding elements of the 2002 Treasury Cross Cutting Review into the role of the voluntary and community sector in the delivery of public services. He has a degree (in Scots and English law) from the University of Dundee and has further graduate and post-graduate degrees from the Universities of Oxford and Leeds. He holds a law society accredited certificate in mediation. In 2008 he set up Sperant Associates to help third sector organisations to improve their strategy and effectiveness. Richard is the author of *The Governance and Financial Management of Endowed Charitable Foundations*, Association of Charitable Foundations (ACF), 2012, and currently provides policy advice to ACF.

Kate Rogers has over twelve years investment experience, specialising in investment on behalf of charities, endowments and foundations. Kate is chair of the Charity Investors' Group, which is a membership organisation providing a forum for investment debate. In this role she has recently collaborated with CFG to launch a guide to written investment policies.

She is a client director at Schroders, where she manages a common investment fund, The Charity Multi-Asset Fund, which aims to generate a regular income for charities whilst protecting the capital against inflation over the longer term. She is a CFA charterholder and has a BSc (Hons) in natural sciences from the University of Durham.

Introduction
What’s in a question?

The report, *The Governance and Financial Management of Endowed Charitable Foundations*[1], considered the dilemmas facing the trustees of charities with investments, or ‘endowments’. Taking trustees’ core obligations as its starting point, the report considered how the principles enshrined in these fundamental legal duties might inform the thinking and action of charitable foundations. The research highlighted that there were some commonly held misconceptions that could be preventing trustees from making the most of the resources at their charity’s disposal.

This report follows on from that work and applies the findings of the earlier research to a more specific question. The question is one that is frequently asked by trustees who rely on returns from investments to fund their charitable activities. It is:

How much can we safely spend on our charitable activities year by year, while preserving the value of our investment assets?

When they ask this question, trustees are potentially expressing several things. They are expressing an intention to sustain their charitable activity in the long term. They are showing that they want to act fairly between current and future generations and wish to ensure that the charity is as valuable to tomorrow’s beneficiaries as it is to those of today. They may be expressing a sense of obligation to the founders or donors by seeking to avoid spending at a rate that might erode the value of the gift. In relying on returns from investments to fund their activities they need to manage their investments well if they are to be able to meet their liabilities and obligations. They are seeking to be good stewards of the resources that have been entrusted to them.

However, as in the previous report, we find that certain ideas trustees may have about answering the question may be inhibiting their thinking and thwarting them from being as effective stewards of their charitable resources as they might be.

We especially consider the practical implications of the current approaches influenced by James Tobin, former Sterling Professor of Economics at Yale University. He said that trustees are ‘guardians of the future generations against the claims of the present’ and that their job in achieving what he called ‘intergenerational equity’ is to preserve indefinitely the real value of the investments.

In considering the idea of charity immortality, as well as presenting market analysis, this report takes into account research into the behaviour of those who run long-term charities. This new evidence sheds light on how charities in practice behave when faced with the day-to-day challenges of managing their investments. The attitudes and practices revealed show that there is no ‘correct’ answer to the question of at what rate to spend. There is a range of practices.

We describe some of the options available, and highlight a set of deeper or connected questions that trustees might grapple with when trying to decide what is right for them.

Key to our conclusions is the proposal that preservation, because it can never be a certainty, is in fact one issue among many on which trustees must gauge their appetite for risk rather than being the one thing they must never risk at all. We also question whether preservation is an appropriate goal or indicator of success for every long-term charity.

With that in mind, we identify an alternative approach to managing investments, in addition to the intentional goal of preservation, that we call the ‘open-ended’ approach. By ‘open-ended’ we mean charities that are open to existing for many generations should higher market returns make it possible, but whose trustees do not make preservation their main objective when deciding their level of expenditure.

Our reflections and conclusions are offered not with the aim of suggesting that trustees should choose one approach over another, but with the intention that they will help them identify more clearly the factors that are relevant in their context. They may also be of interest to those who seek to advise trustees.

[1] Jenkins, R., The Governance and Financial Management of Endowed Charitable Foundations, Association of Charitable Foundations, London, 2012.

Part one:
Analysis and findings

Key questions for trustees

Is your charity long-term by choice or because it has a legally permanent endowment?

What difference does your organisation's culture or history make to your attitude?

What does the 'long term' mean for your charity: In terms of your charitable objects? In terms of managing your investments?

How important is it for your charity to:

- Keep spending stable?
- Keep spending in line with inflation?
- Maintain spending levels in time of economic hardship?
- Maintain spending power for an indefinite number of future generations?

How might inflation affect your beneficiaries over the coming years?

Are you aware of the short and long-term consequences of your current approach to spending?

"There is a danger with arithmetic approaches because they can encourage committees to get the idea of a 'baked in' number, which you can view almost as what the markets owe you."

Richard Robinson, Investment Director, Paul Hamlyn Foundation

Image courtesy of Cripplegate Foundation

Section one:
Why spend in the long term?

Key points

- The long term is very often a choice rather than a legal requirement, influenced by strategy, history or a founder's wishes.
- The effect of inflation is one of the biggest dangers facing trustees of long-term charities – even more than the fluctuating market value of their investments.
- 'Intergenerational equity' is an influential idea effectively meaning that trustees aim to safeguard the real value of the investments for an indefinite number of generations.

There is no restriction on the type of charity that can hold investments, but any investments that a charity possesses must be used only to support delivery of their specific charitable objects.[2] These investment assets are sometimes referred to as 'endowments.'

This report addresses charities with a long-term mission who rely on the return from investment assets to fund their charitable activities year on year.

Because they rely on returns from their investments to meet their liabilities year on year into the foreseeable future, long-term charities usually have strategies which set spending at a rate that leaves an adequate amount invested to go on providing decent returns capable of sustaining their activity beyond the short term.

In the United Kingdom there is no legal obligation to spend at a fixed rate, so trustees must come to their own decision, having in mind their fundamental duties to be:

- loyal above all to the charitable objects; and
- prudent when managing the resources.

The latter part of the duty, to be 'prudent' has been written into the rules governing investments[3], and over the course of many years has developed in its meaning. It doesn't simply mean being cautious, but also carries the sense that trustees – while taking account of risks – should take advantage of opportunities to maximise investment returns as well.

The duty to be 'loyal' to the interests of the charitable objects has, some might argue[4], had less prominence when thinking about charity investments. It lies behind the rule that there should be no conflict of interests. However, more fundamentally, it means that trustees hold the assets only and above all things for the purposes of the charity.

This report aims to identify and examine the issues and questions trustees commonly have to deal with when deciding what is right in their context.

The long term is usually a choice

Not all investments a charity possesses have to be held for the long term.

The default is that, unless the deed or governing document says otherwise, trustees are empowered to spend all the assets to deliver their charitable objects. They're not restricted in spending the capital and they can spend the assets at a rate that seems most appropriate to them in terms of delivering their charitable objects.

That might mean spending over a relatively short period of years. For example, The Diana, Princess

[2] For a guide to trustees' responsibilities when investing (in England and Wales) see Charities and Investment Matters: A guide for trustees, Charity Commission, London, CC14, 2012.

[3] ibid. Note 1, pp. 18-21

[4] See for example, Berry, C., Protecting Our Best Interests: Rediscovering Fiduciary Obligation, FairPensions, London, 2011.

of Wales Memorial Fund, a grant-making trust, chose to 'spend out' over 15 years.

Alternatively, some trustees choose to manage their investments in such a way that the returns provide a continuous source of revenue for the charity into an open-ended future.

They may do so because they believe that the social problems the charity was set up to meet are unlikely to be solved in the foreseeable future and their charitable objects will be best addressed by sustaining their activity over the long term.

Another reason may be that trustees see themselves as being entrusted with a distinctive historically rooted mission or tradition, which it is their job to sustain for today's and future generations. In this case, as well as feeling responsible for maintaining a mission, if a charity has been in existence for a number of years, they may also have an ongoing set of commitments or liabilities which must continue to be met in whole or in part from the revenue generated by their investment portfolio.

For example, Exeter College Oxford, founded in 1314, has investment assets of just under £50m, the returns of which contribute annually about a quarter of the College's total revenue.

'Intergenerational equity'

One way this sense of being tied to future generations of beneficiaries has been expressed is through what has come to be known as a desire to achieve 'intergenerational equity'. This isn't a legal formula[5], but it is an influential idea first articulated in 1974 by James Tobin, the former Sterling Professor of Economics at Yale, in an article on endowment management. Tobin said:

> The trustees of endowed institutions are the guardians of the future against the claims of the present. Their task in managing the endowment is to preserve equity among generations.[6]

We'll consider the practical considerations and some unhelpful misapprehensions about this important idea more closely in following sections.

Permanent endowments

Some charities have no choice about whether their endowment is long-term or not. Their deed or governing document restricts how they can use the money, so that trustees of 'permanent endowments' may not spend the capital but instead can spend only the income – such as dividends or rent – generated by the investments.[7] The concept of permanence however does not mean that the assets' value may not depreciate over time.[8]

This is the exception and not the rule as, unless the restriction to spend only income is specified, trustees have discretion to spend both capital and income. The Cripplegate Foundation is a permanently endowed charity. Founded in 1500 it supports activity in its local area by spending the income generated by its investments.

Trustees of permanent endowments do have some flexibility in relation to the rule restricting them to spending income only, and can get Charity Commission permission to draw funds from the combined, or total returns of both capital appreciation and income.[9] This is known as a 'total return' approach. When they do this, however, trustees with permanent endowments still have a duty to maintain the capital.

Endowments can be distinguished from reserves

It follows that investments that charities rely on to fund everyday expenditure can be differentiated from reserves, which are held to guard against some contingency, like helping out with lumpy short-term cash-flow or covering operational costs should sources of income suddenly drop. In these cases the amount and use of reserves is usually governed by a separate policy and maintained at a certain level.

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5 So for example, The 2009 Law Commission Report on private trusts nowhere mentions the term or concept of 'intergenerational equity'. CAPITAL AND INCOME IN TRUSTS: CLASSIFICATION AND APPORTIONMENT, (LAW COM No 315), House of Commons, 6 May, 2009.

6 Tobin, J., What is Permanent Endowment Income? *American Economic Review*, 64(2), 427-432.

7 Charities Act 2011, S 353(3), See also Charity Commission, Permanent Endowments, B.3.2

8 See Accounting and Reporting By Charities: Statement Of Recommended Practice (revised 2005), Appendix 3.

'3(a) An endowment fund where there is no power to convert the capital into income is known as a permanent endowment fund, which must generally be held indefinitely. This concept of "permanence" does not however necessarily mean that the assets held in the endowment fund cannot be exchanged (though in some cases the trusts will require the retention of a specific asset for actual use e.g. a historic building), nor does it mean that they are incapable of depreciation or loss.'

9 The Trusts (Capital and Income) Bill, 2012 when enacted will give trustees the power to adopt a total return approach directly.

Case Study
Cripplegate Foundation

Scenario: Permanently endowed and spending income only

Cripplegate Foundation came into being in 1500 with a gift of £40 intended to help the poor in the parish of St Giles, Cripplegate. Those at the Foundation know the descendants of the original donor and, more than 10 generations later, the fund has been built up over the centuries by many donations from other unknown parishioners to help maintain property and relieve poverty within the original geographic area which was only extended in 2007 to cover the entire London Borough of Islington.

'Despite the number of wealthy individuals living in the borough, on practically all the indices we are one of the poorest areas in the country', says Kristina Glenn, the Foundation's current Director. The Foundation addresses poverty and inequality in Islington through grant-giving, partnerships, and using evidence to influence policy nationally and locally as well as helping the Foundation itself to develop its programme of work. Grants vary from £500 awards for individuals to £100k for organisations.

The Foundation is permanently endowed with a portfolio valued at the end of 2012 at £29m that contributes over £1m annually to the overall grants budget of £1.8m, which includes some funding from other sources. 'We considered whether to move to a total return basis', Glenn says, 'but we were unable to calculate a suitable baseline.' The trustees, known as 'Governors', aim to maintain the value of the endowment and provide a sustainable income over the long term. Although recent years have seen the value of the endowment and income levels drop, Glenn says, 'I'm confident that in the next 20-30 years we will see that rise'.

The investment aim is to maximise income, and each year the Foundation has a conversation with its investment managers to set out its needs and expectations and agree a target for income generation that allows reasonable spend at a sustainable level. Currently that works out at 4% of the total value of the portfolio.

In the face of current need, however, the Foundation has for three years been able to run a deficit budget thanks to the Governors having set in reserve 'excess' income generated during preceding boom years. Glenn says, 'Now that we are at the end of that deficit period we are having really to focus. However we don't want to overreact. We can afford to take a long-term view.'

Maintaining its impact has in recent years seen the Foundation extend its range of partnerships to lever other funding through an initiative called 'Islington Giving'. The initiative, the administrative costs of which are paid for by the Foundation, is designed to create a coalition of funders with a focus on Islington. Launched in September 2010, Islington Giving had by the end of 2012 raised £1.8m in cash and £300k of in kind support, all of which has been distributed in the borough. 'Our aim is not to top up the endowment,' says Glenn, 'But to engage businesses and other donors in giving strategically within the borough. We have found that as well as bringing money it has also enriched our ideas base.'

Islington Giving is a standalone project. The Foundation has also for some time worked with other funding partners such as smaller trusts and some government schemes. Glenn observes, however, that 'Working with other donors only works when their values are absolutely consistent with our mission.'

The Foundation is also considering social investment as a way of helping individuals in the borough on low income who may previously have received help from the 'Social Fund' to meet one-off expenses. Glenn predicts that with the loss of this centralised fund many people will be pushed into taking out short-term cash loans at unaffordable – even astronomical – rates. 'We're exploring whether we can support a loan fund to help those who have no access to affordable credit. It would help us recycle grant money, but primarily it would be a tool for us to support people facing poverty by helping them to become financially included and on the radar.'

'We see ourselves as stewards of the funds, not guardians. The job of guardians is to safeguard money and give it back. Stewards care about what is happening with the money and actively cultivate giving. Being stewards of a fund with a history such as this makes you humble. It was built up over centuries by ordinary people. We need to think about the future not just the present and the past.'

Reserves then could be thought about in the same way that a family might view a nest egg. It's possible to dip into them from time to time (in place of an overdraft). They may exist to protect against future shock to tide over a rainy day. Or they may even provide the means to make a one-off purchase that might not otherwise be affordable. What they generally aren't intended to do is support day to day spending on household essentials in the long-term. The investments we're thinking about in this report are not those sort of reserves.

The charities we are considering rely on their investments to provide continuous revenue to cover basic charitable activities and operational expenses, including grant making. That reliance heightens the importance for trustees of managing the resources appropriately so that investments produce sufficient returns to be able to fund their charitable mission year after year into the future without the investment pot itself becoming exhausted.

The opportunities and challenges of long-term investing

Taking a long-term approach to investments does bring advantages – as it may be possible to invest in asset classes where values may fluctuate significantly over time but which also have the potential to bear the richest fruit over a longer period.

Charity investors are less constrained than pension funds, which must design their investment goals against quantified, fixed, future liabilities, and are well placed to reap such rewards. However, doing so means holding on to investments until they are ripe, without cashing them in too early in response to short term market fluctuations.

Such fluctuations pose challenges for charity investors. So also does the need to ensure that they hold assets which meet their 'liquidity' requirements i.e. their need to be able to access cash when required.

But beyond knowing when they need cash to spend on their charitable activities, working out how much cash trustees can take from a portfolio is itself problematic. Particularly if spending is no longer restricted to income – such as share dividends or property rent – but instead can be funded by a total return which includes the rise in value of the assets themselves. Trustees need to agree on a method for calculating spending that balances the volatility of values and the necessary stability of spending. It often involves finding some way of smoothing spending between those years where investments perform less well and years when returns may be high. Some common ways of doing that are discussed in the next section. The role of advisers and managers is often crucial in meeting this challenge.

As well as knowing how to react to volatile markets, and having to compensate for them in setting budgets and liquidity requirements, trustees looking to the long term also have to guard against another hazard: inflation.

> "Taking a long-term approach to investments brings advantages."

Case Study
The Barrow Cadbury Trust

Scenario: Fully expendable and spending a fixed amount that could conceivably erode the real value of the portfolio over time

The Barrow Cadbury Trust is the largest of the philanthropic foundations of the Cadbury family – the Quaker founders of the well known British confectioners. The Trust currently has three strategic objectives:

- To support people who are within or at risk of entering the criminal justice system to improve their life chances, with a particular focus on young adults.
- To help ensure that migration is managed in a way that is equitable and socially just and that the voices of both migrants and receiving communities are heard in the public debate.
- To support effective approaches to combating poverty and inequality and assist in building inclusive communities.

Historically successive generations of the family spent what was necessary and replenished the trust with wealth mostly drawn from their shareholding in the company, including a boost when the company was floated in the mid 1960s. Although they no longer hold company stock family members still form a large part of the Trust's governing body – now in the fourth and fifth generations. The Trust still places a greater priority on spending on charitable activities over preserving the value of the assets.

The Trust assets – valued at £74m by the end of 2012 – are expendable and invested for total return. Current expenditure is calculated on the basis of a fixed amount agreed by trustees at the beginning of their last strategic review period, 3 years ago.

The amount has been increased annually to take account of inflation using the RPI in February each year. Expenditure currently works out at a rate approaching 6% of the total value of the portfolio.

'We see ourselves as more than a cash machine trust', says Anna Southall, trustee and former Chair of the Trust from 1996-2006. 'We ask ourselves, "What can we do to achieve the change we want to see?" and do whatever is necessary, which may mean supporting a coalition of influencers or second tier work. It also means using all and any of our assets to achieve our goals, including voting powers, adopting an ethical framework, using our location by sub-letting space or making desk space available, using our intellectual resources by having in-house experts, wielding our brand and reputation as well as setting aside 5% of our assets for social investment.'

'The long term is itself an asset to lever,' Southall says, observing that having a track record in a particular area over decades gives credibility and traction to policy recommendations. It's not always possible to predict how long work will take. When the Trust decided to work in Northern Ireland, trustees maintained an open-ended commitment to support peace building action that out of necessity lasted for decades.

With that in mind, although the Trust is spending at a rate that if sustained, could conceivably see them disappear over 30 years, trustees have not taken the decision to spend out. In the mid-1990s, in response to the falling value of the portfolio in the stock market crash, the Trust reviewed its strategy and reduced both its spending and the range of programmes it supported. Equally, during more recent boom years when the value of the portfolio increased to over £100m, trustees took money out. The portfolio currently is more or less in line with an inflation-adjusted value for 10 years ago.

Every six months or so the board looks at the spending projections and sees if they are reaching the point of no going back. They haven't reached it yet. Anna Southall says, 'We don't want to tie the hands of future generations by committing either to being a perpetual or a spend out trust. For now, the Trust has just committed to maintain its current level of spending for the next three years, but with the caveat that there may be a return to a 'perpetuity model' level of spending thereafter. We shall see.'

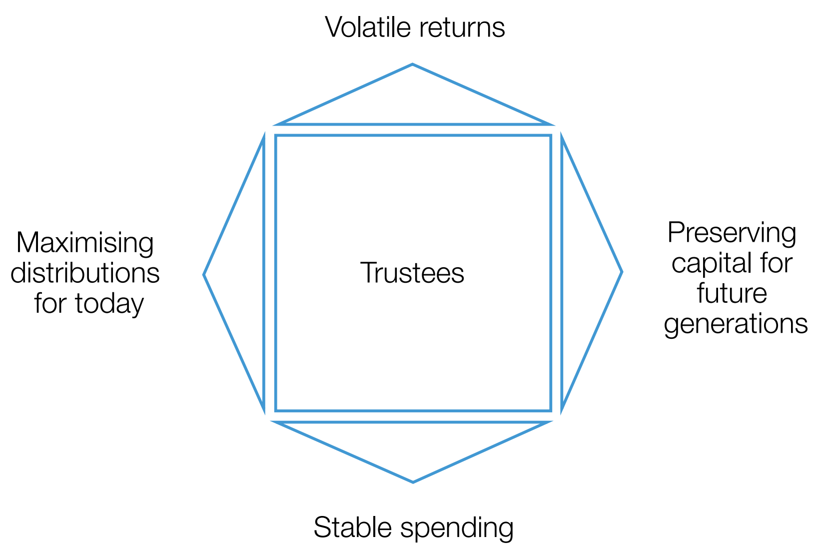
Inflation – charity investors' biggest threat

Inflation, as we'll see, is one of the most significant dangers for long-term investors since it erodes the amount of goods or services that can be purchased every year, and it does this almost imperceptibly.

A common measure is the Retail Prices Index (RPI). Some charities use other measures of inflation that more accurately reflect their expenditure. For example, those charities providing advice services might want to reflect salary inflation rather than retail inflation in order to maintain long-term purchasing power.[10] In this report we refer to inflation adjusted numbers as 'real' and we use RPI as our measure of inflation.

In order to keep the same purchasing power, trustees need to generate sufficient returns from their investments to meet rising costs, as well as retain enough to allow sufficient funds invested for the future years. Investing in the right assets is important, in order to gain the right returns. But knowing how much to spend and how much to keep year-by-year is important too.

In summary, trustees of long-term endowments have to strike a balance against the pulls and pressures shown in the illustration.



We'll look at these elements more closely in the remaining sections of this part of the report. We'll begin by considering how market realities impact on different spending strategies. In Part two we'll summarise our findings and, based on those, reflect on the way trustees of long-term endowments might work through their sense of obligation to future generations as they come to decide how much to spend and how much to keep each year.

[10] Around 40% of total voluntary sector expenditure is on staff: http://data.ncvo-vol.org.uk/almanac/voluntary-sector/work/how-much-does-the-voluntary-sector-spend-on-staff-costs/

Section two:
Market analysis

Key points

- Different ways of calculating expenditure – such as income only, approaches based on the market value of the portfolio, or fixed amounts whether adjusted for inflation or not – have different strengths and weaknesses.
- Analysis of historic returns show that a typical charity could have spent 4% each year over the course of the last century and still maintained the real value of their portfolio.
- Twentieth century investors benefitted from steep gains in the 1980s and 1990s. Forecasts for the early decades of the twenty-first century suggest lower returns causing many to question their approach to spending.
- Maintaining the real value of a portfolio is only ever a probability and never a certainty – no matter how little trustees spend.

Market returns – setting a long-term context

The question that charity trustees with investments often grapple with, and which we're considering, is 'How much can we safely spend on our charitable activities year-by-year, while preserving the value of our investment assets?'

The amount a charity spends is not necessarily the same as the anticipated investment returns but is often based on an evaluation of what their investments are likely to generate. Charities with a long-term mission will want to understand the consequences of choosing a specific expenditure rate for the longevity of their investment portfolio. In this section we look at the interaction between market performance and expenditure rates.

There are different approaches to calculating expenditure year-by-year, as outlined overleaf, and each has its own advantages. The question however of whether it's possible to arrive at a simple figure for 'sustainable' spend depends more than anything on how much investment assets cost to buy and the way their value fluctuates with market trends.

How you calculate spend as well as how much you spend has an impact

Charities depending on their investments to fund their activity can choose one or a combination of three main approaches to spending. Each has its pros and cons and over time may have a distinctive impact on the real value of the portfolio.

The main approaches are:

Income only approaches, where the income generated from assets – such as rent from property, interest from bonds and cash, and dividends from shares – is used to fund activity. Permanent endowments are restricted to this method unless they seek approval to adopt a total return approach. In terms of helping trustees decide what might be available for expenditure, spending income at least has the advantage of being clearly identifiable on the balance sheet and is often more liquid as there is no need to sell assets. However, while the capital remains untouched from year to year for those only spending income, asset values will still be affected by inflation. In fact, choosing investments for their yield may hasten its corrosive effect as investments that are more likely to deliver the biggest income may be less likely to hold their value in relation to inflation.

Market value related approaches, are where trustees spend a proportion of the market value of their total investments. This means that often both income and capital returns can be used to fund spending. This 'total return' approach has the ability to include investments that are expected to perform better overall, but which may not yield the highest income. At an aggregate level over time that means that trustees taking a total return approach should be able to spend more. The approach can also allow investments to be more diversified, including different types of assets to spread the risk. However, in this type of spending policy, the spend may be volatile as it is directly linked to the market value of the investments. For that reason some charities choose to spend a moving average of the market value of the portfolio, which helps 'smooth' expenditure. Practically speaking it means that low or high returns get 'carried over' from one year to the next. That will keep spending lower when markets begin to rise or higher when they fall. Over sustained rises that could build up the value of the portfolio or, at the end of long downturns, keep spend high so that the real value drops more quickly as assets are sold. On the whole though, if markets tend to go up over the very long term, smoothing policies should help enhance the real value.

Constant growth approaches are not explicitly linked either to the income from or the market value of the assets. They may include, for example, spending a fixed amount each year or spending an amount that gets raised in line with inflation. The advantage for trustees is that this spending is predictable year on year, and variation resulting from the volatility of the markets isn't an issue. On the down side, spending a fixed amount may mean having to cut more keenly into the portfolio when values are low whilst, on the other hand, not passing on high returns in boom years. If spending is linked to inflation, trustees will also need to ensure they have sufficiently liquid investments to provide cash flow should inflation soar.

Some trustees introduce caps and collars on variable spending so that levels of expenditure never fall below or rise above certain predetermined levels. And some trustees combine approaches, to take advantage of different characteristics, all of whose effects will be exaggerated when

market activity is itself accelerated. In the US the hybrid approach of many endowments combines the market value and constant growth methods in a weighted average.

Generally speaking, from an intergenerational perspective, it seems like common sense to spend less in booming markets in order to be able to maintain spending in times of low return. First, because arithmetically it contributes to preserving the value of the portfolio as markets vary. And second, from a justice point of view because social needs are likely to be higher when the economy takes a nosedive. However, complicating the picture is the fact that, from a purely investment point of view, the time to sell investments is when prices are high not when they are low. Socially and financially, trustees are therefore pulled in opposite directions in a way that is going to be felt most acutely in economically challenging times.

An overview of each approach is set out in the table below:

Spending Approach	Characteristic				
	Good for stable spending	Good for counter-cyclical spending	Good for real value in strong markets	Good for real value in weak markets	Good for cash-flow matching
Income	Y	N	N	Y	Y
Market Value	N	N	N	Y	N
Constant Growth	Y	Y	Y	N	N

In this section we'll look at four illustrations based on relevant market information since 1900 and see how, if at all, history can help trustees answer the question of how much they can spend. We'll particularly bear in mind the sustainability of Tobin's intergenerational model which proposes that trustees should invest in such a way as to support constant spend that rises with inflation while at the same time maintaining the real value of the investment portfolio itself.

As well as data relating to the total returns for specific asset classes, we'll use two model investment portfolios. The first based on market data going back to 1900 shows how a typical charity portfolio might have performed. The second is based on information about actual charity investment portfolios which has been collected since 1984.[11] We used these sample portfolios to test different spending levels and approaches and analysed the historic impact on both the value and volatility of the spend and portfolio. Our main findings answer some questions but raise others.

A century of investments and inflation

The first illustration, Figure 1 shows, since 1900, a decade-by-decade break down for the performance of different kinds of assets which commonly form a charity portfolio, as well as inflation over the same

[11] For more information about how this data was arrived at, see the opening section 'About the report' on p. 6

Figure 1: Annualised total return on UK equities, bonds and cash and UK inflation; by decade

UK	Equities	Bonds	Cash	Inflation
1900-09	2.9%	1.1%	3.1%	1.1%
1910-19	7.4%	-1.0%	3.8%	8.9%
1920-29	6.1%	5.0%	4.3%	-2.9%
1930-39	3.0%	6.1%	1.3%	0.4%
1940-49	6.0%	3.4%	0.8%	2.8%
1950-59	18.4%	1.7%	2.9%	4.1%
1960-69	10.4%	2.1%	5.6%	3.7%
1970-79	11.5%	8.1%	9.3%	13.1%
1980-89	23.4%	15.0%	12.1%	6.9%
1990-99	15.0%	13.1%	8.0%	3.5%
2000-09	1.8%	4.9%	4.3%	2.7%
2010-11	5.1%	17.2%	0.5%	4.9%
Average	**9.4%**	**5.5%**	**4.9%**	**4.0%**

Source: Copyright © 2011 Elroy Dimson, Paul Marsh and Mike Staunton. Data from 2009-2011, Datastream.
Past performance is not a guide to future performance

period. These returns are total returns, so include both income and any rise or fall in the value of the asset.

The last line shows that over the whole period the long term average total return for UK equities was 9.4% per annum, more than bonds or cash. Crucially, over the course of the century and up to the present day, all three asset classes delivered total returns in excess of average inflation which was 4%.

Figure 1 shows why charities with a long-term time horizon have tended towards investment in equities. It also shows why it is natural to think doing so will allow you to beat inflation with enough to spare to support spending.

Before we move on however, it's worthwhile pausing to look more closely at the columns for equity returns and inflation. While it averages out to support the intergenerational preservation model, it also shows some significant periods of fluctuation. The 1920s saw a period of deflation, whereas later in the century inflation soared to over 13% per annum in the 1970s. Equally, in the 1980s stellar growth of equity, in returns has been unrivalled at 23% per annum. Charities would have experienced these decades – quite long periods in themselves – as quite different environments.

Preservation – doing the maths

The next illustration, Figure 2, shows total returns over three different time horizons for an 'average' charity investment portfolio. These returns are represented by an example model portfolio and the WM (World Market) Total Charity Universe.[12] These returns are total returns, so include both income and capital increase or decrease.

If the aim of the intergenerational preservation model is for the capital value of the investments over time to increase (at least) in line with inflation – after spending and costs – it follows that a 'safe' spending rate can be roughly calculated by subtracting inflation from the return the assets are expected to generate. For those who like an equation[13]:

Spending = portfolio return – inflation

Figure 2 shows that during the long-term horizons for which we have information available, an annual spending rate of between 4% and 5% would have been sustainable. In terms of a single figure, we calculated that over the whole 112 year period a rate of 4.2% would be consistent with capital preservation in line with inflation (from which investment manager fees would also need to be deducted)[14]. So far so good.

No 'Safe Spend' since 2000

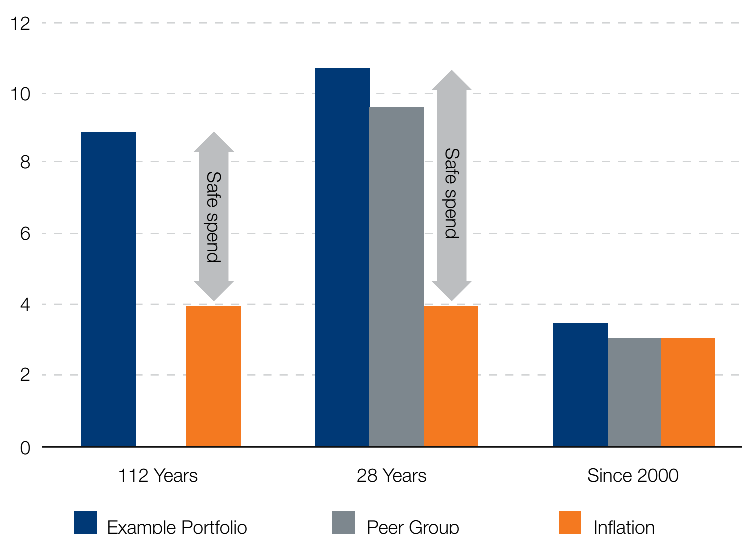
Based on the previous century, charitable investors committing their assets to investment markets in 2000 might have been forgiven for thinking that by the end of that decade their returns would reflect this long-term pattern. In fact, since the turn of the millennium to the end of 2011, the average charity has generated an annual return of just 3.1%. With inflation averaging out at 3.1% per annum during the same period, there has been no excess return to allocate to spending. So, those trustees who have continued to spend (either from income or capital) in this millennium will more than likely have seen the real value of their investments decline over this period, probably leaving many questioning the sustainability of their spending policies.

Perhaps, however, this is just a blip? Some might take comfort from the previous century, and trust that – as the next illustration shows – over the very long term things balanced out.

The long term at a glance – contrasting stories

Figure 3 illustrates the long-term real capital value of an example charity invested since 1899. From this we

Figure 2: Annualised total return of charity portfolios over different time horizons compared to inflation



Source: Schroders, October 2012, Long-term data: Copyright © 2011 Elroy Dimson, Paul Marsh and Mike Staunton. Data from 2009-2011, Datastream. Peer group data: WM.

Past performance is not a guide to future performance

[12] The peer group measurement is represented by the return of the WM Total Charity Universe which includes 28 years of actual charity portfolio return data. The example portfolio represents the return of a simple multi-asset portfolio comprised of 80% UK equities and 15% UK bonds and 5% cash rebalanced annually. This asset mix is broadly equivalent to the average asset allocation of the charity peer group (WM) since inception. Inflation is represented by the retail price index. 112 years is the longest time horizon that we have available asset class data, 28 years is the longest time horizon that we have available peer group data.

[13] In fact the achievable spending rate will be less than that represented by this basic equation because spending will be impacted by the fact that investment returns move up and down over time. The 'safe spend' gap for the combined example portfolio (up to 1984) and peer group is 4.5% per annum over 112 years (on an arithmetic basis based on average returns). Our calculations suggest that an annual spend of no more than 4.2% is consistent with maintaining the real value over the time horizon.

[14] This calculation uses the example portfolio total return up to 1984 and the peer group return thereafter. Spending based on a simple market value spending method, where every year the spending rate is applied to the year end portfolio value.

can examine the experience of two fictional philanthropists who create separate foundations. The Victorian philanthropist sets up a charity with £1m in 1899 which spends at the twentieth century 'safe rate' of 4.2% per annum. The post war philanthropist sets up an endowment of equivalent value and asset mix in 1949.

Neither charity smooths spending, just spends 4.2% of the year end value of the assets. This results in spending that varies along with the market value. Allowing for inflation, the graph charts the real capital value of the portfolio[15]. Above £1m represents a gain in inflation adjusted terms, below £1m a loss.

We can see that by the end of 2011 the charity set up by our Victorian philanthropist has just maintained the real value of its original investment of £1m. This analysis may give some comfort to those who take a very long-term approach when it comes to managing their endowments, particularly bearing in mind that the same period saw two world wars and the great depression of the 1930s.

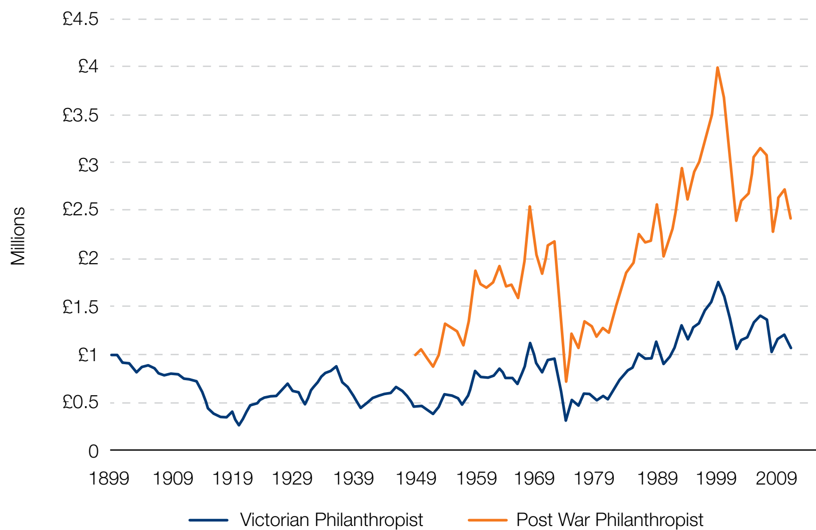
However the end point masks the huge volatility in the real capital value of the assets during the time period. In 88 of 112 years, or almost 80% of the time, the real capital value was below that of our fictional philanthropist's original investment. You can imagine that this would have meant that trustees of the charity were left feeling rather uncomfortable, if they were trying to achieve 'intergenerational equity' and took preservation of the real value of the portfolio as their measure of doing so.

On the other hand, our post-war philanthropist who made this gift when market values were very low, would have seen the value of the portfolio grow astronomically over the subsequent decades, increasing its real value more than two-fold while spending at the same rate as our Victorian donor.[16]

Both of these fictional charities benefitted from the extraordinary returns of the 80s and 90s. If we were to exclude these decades the result would be a considerably lower spending rate needed to maintain the real value.[17]

So above all we see how important timing is, both in terms of when you invest your portfolio, and when you chose to measure its progress.

Figure 3: Real portfolio value of two charity portfolios spending 4.2% per annum



Source: Schroders, October 2012, Data: Copyright © 2011 Elroy Dimson, Paul Marsh and Mike Staunton. Data from 2009-2011, Datastream.

Past performance is not a guide to future performance

[15] Using data from Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press, 2002. WM Portfolio return based on 80% UK Equities, 15% UK Bonds, 5% Cash from 1899 to 1983, from 1984 WM Charity Peer Group total return used.

[16] In fact, this charity could have sustained a spending rate of 5.5% per annum and still have preserved the real capital value over this time horizon.

[17] Factoring out the returns of the 80s and 90s, the Victorian philanthropist's foundation, spending at a rate of 4.2%, would have seen the real value of the endowment fall from £1m to £525k in 1979. At this point in time a spending rate of only 3.4% per annum would have been justified by the history.

There can be long periods of bad and good returns where the real value varies significantly from the original investment amount.

To summarise, sustainability depends on:

- How assets are invested – whether in equities, bonds, property, alternative assets or cash.
- When assets are bought and sold
- What the returns on the assets are likely to be at any particular time
- The level of inflation
- What time period is being looked at

We've looked at historical information. Is there anything we can say about the future when trying to think about how much to spend?

Trying to look into the future

Forecasting investment returns is at best a pretty imprecise science. No one can see into the future, and over any time period a baffling array of possible economic scenarios could be painted.

At the time of writing, optimistic investors would point to lower valuations (markets are relatively 'cheap' relative to history) to predict higher future returns. However, the current consensus amongst economists suggests that near-term future investment returns may be lower than the last century's experience. This is explained by a weak outlook for global growth and the continued headwind of the debt crisis.

If trustees take Tobin's idea of intergenerational equity as the framework for deciding how much to spend, they will want to be able to spend the same on future generations as the current one, and do so in real terms. The proxy for being able to do this is maintaining the real value of the portfolio, and doing so with as great a degree of certainty as possible. Faced with market volatility and uncertainty, that means keeping spending low today to be able to maintain it at the same rate tomorrow.

Despite the fact that long-term historical analysis points to sustainable spending of 4% to 5% per annum in the past, looking to the future, current forecast returns suggest a lower rate might be more consistent with preserving the real value of the assets in the long term. According to Schroders' calculations trustees who wish to preserve the spending power of their investments for the next generation, without having to top up the endowment with further donations, would need to maintain expenditure rates at the lower end of the 3%-4% range to begin to have any confidence in maintaining the value of their portfolio over the long term. Part of this spending will be on investment management fees. Schroders' analysis on the average charity portfolio (see page 28) would suggest a spending rate of 3.2% per annum is consistent with maintaining the real value over the next 30 years, which is lower than the 4.2% per annum suggested by history.

But given what we've said about how imprecise an art forecasting is, is it possible to talk of certainty at all?

Case study
The Paul Hamlyn Foundation

Scenario: Fully expendable and calculating expenditure at a rate intended to preserve the real value of investment portfolio

The Paul Hamlyn Foundation is one of the newer and larger UK charitable trusts. Its founder, Paul Hamlyn, left Germany with his father in 1934. In the UK he revolutionised bookselling, building a publishing business and fortune that in 1999 provided the Foundation's first significant asset transfer. The Foundation's assets swelled after Paul Hamlyn's death in 2001 when he left a large part of his wealth to the charity. In 2012 they were worth £565m.

The Foundation supports work through grant making in three areas with particular focus on disadvantaged young people:

- Music and the performing arts
- Education and libraries
- Asylum seekers and refugees

The trustees' interpretation of the will of the founder is to run the Foundation on the basis of it being perpetual. In 2010 they set out their spending policy for the first time, having the previous year appointed Richard Robinson, a former investment adviser, as their first Investment Director. Robinson says, 'Spending had been increasing in response to need and grant demand since the Foundation was created so that in 2008/9, as the market changed, trustees requested a paper on what is a reasonable long-term spend.' The objective was to maintain the real value of the portfolio after expenditure. The work he did compared historical returns with reasonable expert forecasts, and also took account of the expected long-term returns implied by the market's own pricing of various asset classes.

As a result of his work, the approach the Foundation takes is to spend 4% of the portfolio calculated on a three year rolling average, with an aim for the investment committee to recommend creating a reserve in short markets to bolster spending in times of stress.

'We think that is a demanding level of spend', says Robinson, 'but spending levels need to be demanding as there is a slant in the sector towards fiscal prudence and conservatism that needs to be resisted. The stretch to achieve a good spending level shouldn't be comfortable and easy.'

However, while the spend level demands strong returns in order to beat inflation and maintain the real value of the portfolio, the investment approach favours steady and incremental growth in value over the long term, with some spikes either side. 'We're not trying to win a race or top the performance charts', Robinson continues. 'While the approach to grant making is innovative, we tend to caution when managing the portfolio.' Having said that, the Foundation is considering how it can become more proactive in the realm of social investment.

As part of their overall strategy, some years ago the trustees agreed to look at the Foundation's strategy and asset allocation every 6 years, with a mid-point review. When it comes to the long term, Robinson highlights the importance of trustee tenure. 'The long term is a series of short terms back to back. I am deeply sceptical of sentences that begin, "On a twenty year view…" Having too long-term a view can encourage woolly thinking'.

Nonetheless, despite the carefully worked out policy, Robinson is keen to point out that managing investments is not a precise science. While knowledge of past performance helps and economic forecasting is a useful tool, it can never provide certainty. 'Any sort of mathematical calculation about what is a reasonable rate of spend can be a deeply misleading figure. It is in essence a living calculation, subject to change and subject to methodological amendment. There is a danger with arithmetic approaches because they can encourage committees to get an idea of a baked-in number, which you can view almost as what the markets owe you. The thing is, the markets don't really care. We look through a glass darkly. Trustees need to be aware of the tentative nature of the conclusions of this sort of work.'

"Given how imprecise an art forecasting is, is it possible to talk of certainty at all?"

The probability of living happily ever after

Another way of looking at the question is to consider the probability of charities being able to preserve the real value of their endowments in different spending situations.

Because of the inherent risk in markets, there exists only a probability and not a certainty that investments will be able to keep pace with inflation over the long term, and the probability of them doing so will be affected by both the distribution rate and what the 'long term' is taken to mean.

The table below illustrates this using both historic and forecast returns.[18] Although our historical analysis showed that 4.2% spending rate would have delivered inter-generational equity over the entire course of the last century, actual charities spending that amount would only have had a probability of being able to achieve preservation over shorter time periods (10 or 30 years) due to the variability of market returns.

The table shows the importance of having a long time horizon, with greater probabilities of real capital preservation as time horizons lengthen. However the table also shows that looking backwards or forwards, there is no certainty that trustees will be able to preserve the real value of their endowment and hence spending power over the 30 years that many regard as the long term.

Sustainability then, conceived as indefinitely preserving the real value of the portfolio, is only ever a probability. Looking back, and based on a ten year time horizon, even without spending, the example and peer group portfolios only preserve the real capital value around 90% of the time. Given that trustees will at least have to pay management fees, there is no such thing as an expenditure free portfolio. When expenditure is 3% or 4%, the probability of preserving the real capital value of the portfolio falls to around 50%.

The data shows that many charities distributing more than 3%, have a reasonable probability of **not** preserving their real capital value over the long term. Moreover, even when trustees do preserve the value of their endowment, the data also shows that they won't feel like they're living a fairytale existence, as there is a significant chance that for much of that time the market value of the endowment will be below the inflation adjusted target.

Probability of maintaining real value

Expenditure	No Spending	1% p.a.	2% p.a	3% p.a.	4% p.a.	5% p.a.
Forecasts: Schroders' 30 Year Forecasts	94%	86%	72%	52%	32%	16%
History: Example portfolio (Rolling 30 years)	100%	100%	100%	93%	77%	58%
History: Example portfolio (Rolling 10 years)	88%	80%	70%	58%	53%	50%
History: Peer group (Rolling 10 Years)	92%	83%	68%	62%	47%	17%

Forecasts and estimates constitute our judgement at the time of issue and are subject to change without notice.

Past performance is not a guide to future performance

[18] Source: Schroders. Data courtesy of Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press, 2002; and WM. Example portfolio: 80% UK Equities, 15% UK Bonds, 5% Cash from 1899 to 2011, Peer Group: WM Total Charity Universe total return since 1984.

Forecast returns based on an asset allocation of 80% UK Equities, 15% UK Bonds and 5% Cash and Schroders' 30 year asset class and inflation forecasts. Please see Appendix i. If you would like to calculate your own portfolio's expected return and sustainable expenditure rate then please visit www.schroderscharities.com/spendingdecisions. Probability based on an annual expenditure and a normal distribution of returns.

Historical analysis based on the total return of the example portfolio over rolling 10 and 30 year time periods and the total return of the peer group over rolling 10 year time periods at different annual spending rates.

Spending calculator – forecasting the future?

This analysis shows Schroders' forecasts for asset class returns over a 30 year time horizon and considers what might be the likely long-term return and sustainable expenditure of a charity portfolio, based on the asset allocation of the peer group (as represented by WM).

Assumptions

Long-term return forecasts calculated using Gordon Growth Model analysis, with reference to long-term historic returns. Volatility expectations based on historic 20 year volatility. Correlation expectations based on historic 5 year correlations.

Asset allocation analysis

Asset allocation is a key long-term determinant of a portfolio's expected risk and long-term return. The analysis below calculates the expected long-term return, volatility and a sustainable expenditure amount based on Schroders' 20 + year forecasts for investment returns and inflation (see appendix i).

The **projected return** is the total return that Schroders would expect the portfolio to generate over the long term. This includes the income and capital return.

The **projected volatility** reflects the fact that asset prices do not move in straight lines. Volatility is measured as the standard deviation of annual returns. The higher the figure the more volatile the asset value year on year.

The **sustainable expenditure** is the spending rate that would be consistent with maintaining the real value of the assets over this long-term time horizon. This assumes an average rate of inflation of 3% per annum.

- The charity portfolio represented is expected to deliver a total return of 7% p.a. over the long-term (30 years), with an expected volatility of 10.9%. This translates to a compound annual growth rate of 6.4% and can support a sustainable expenditure of 3.2% per annum.
- To calculate your own projected return and sustainable expenditure rate, using Schroders' 20 + year forecasts, please visit www.schroderscharities.com/spendingdecisions

Asset Class	Average Annual Return	Volatility
Cash	2.8%	0.7%
Bonds	3.6%	5.3%
Equities – Domestic	7.8%	14.6%
Equities – Overseas Developed	7.5%	16.2%
Equities – Emerging Markets	11.2%	20.1%
Alternatives – Absolute Return	6.0%	8.8%
Alternatives – Property	6.4%	11.3%
Alternatives – Private Equity	11.0%	23.9%
Alternatives – Commodities	4.3%	11.5%

Source: Schroders, January 2013

Past performance is not a guide to future performance

	WM Charity Fund Universe Allocation as at 30th June 2012
Cash	3.9%
Bonds	15.2%
Equities – Domestic	37.4%
Equities – Overseas Developed	25.2%
Equities – Emerging Markets	5.4%
Alternatives – Absolute Return	3.8%
Alternatives – Property	5.6%
Alternatives – Private Equity	2.5%
Alternatives – Commodities	1.0%
Total	100%
Projected 30 year return (average p.a.)	7.0%
Projected volatility	10.9%
Projected 30 year compound annual growth rate	6.4%
Sustainable expenditure rate	**3.2%**

Estimated volatility, return and yield data is based on Schroders' analysis. Volatility, return or yield characteristics of the above portfolios or constituent asset classes are not guaranteed to be achieved in the future. Volatility is measured as standard deviation of annual returns. Schroders' forecasts assume an average rate of inflation of 3% per annum. This analysis is based on broad market forecasts so is gross of investment management fees. Tactical asset allocation and active investment selection serve to add value over these expected market returns.

The notion that there exists, with any certainty, an infinitely sustainable endowment is therefore, like unicorns and other imaginary beasts, a myth.

Investment management fees

The historical analysis that we've been looking at hasn't taken into account investment management fees.[19] As such, the investment management fees will form part of the spending – meaning that for charities using managers to look after their investments there's no such thing as zero expenditure.

Most charities pay managers out of confidence that the managers will generate a level of market outperformance, either through asset allocation or stock selection. Throughout history, well managed endowments have benefitted from performance which has funded a greater level of charitable expenditure, even after fees have been paid. So if things go well, above market returns could be achievable net of fees and the spending rate will not need to be reduced by the fee.

> "Maintaining the real value of a portfolio is only ever a probability and never a certainty."

[19] The 'example portfolio' uses market returns and the peer group is 'gross' of fees – in other words, before they have been deducted.

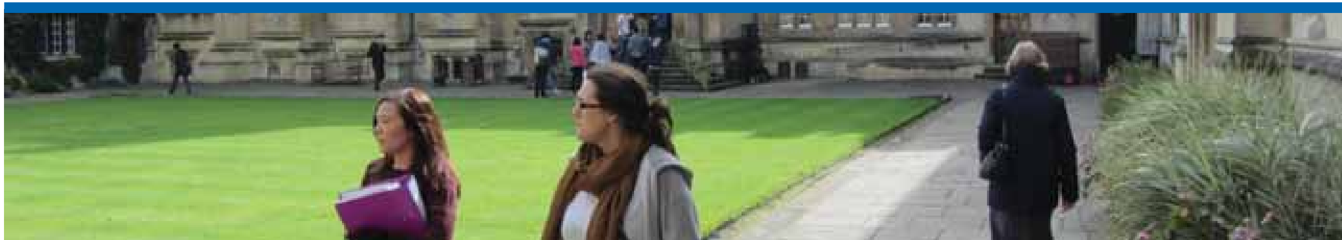
Optimistic investors justify the costs of active management of their assets by holding a higher return expectation, which they use to offset investment management fees (and hence do not adjust the spending rate downwards).

The more cautious minded will want to include investment management fees as an unavoidable cost in managing their assets, and will adjust spending down accordingly. Either way fees are a necessary cost of having investments managed, and consequently represent an unavoidable allocation of annual expenditure.

The next section describes what different charities' attitudes and behaviours are in practice, based on a survey carried out for this report.

Questions for trustees to ask investment advisers

- What asset allocation best meets the spending and long-term return ambitions of our charity?
- What level of spending is this likely to support? (given assumptions about returns, risk and inflation in the future)
- What is the best spending methodology to operate given our legal structure and our need (or not) for stable spending?
- What reasonable returns might we expect from our investment portfolio and how do they compare with projected inflation relevant to our beneficiaries?
- What volatility of both the real capital value and expenditure are likely over different time horizons? What are the best and worst case scenarios?
- What is the probability of our maintaining the real value of our investments under different spending scenarios and different time-scales?
- Over what time horizon should we appraise our strategy and what benchmark best relates to our objectives?



Case study
Exeter College, Oxford

Scenario: A mixture of permanent and expendable endowments invested for total return to support the mission indefinitely

Founded in 1314 and endowed with property the tithes of which provided 12 scholars each to serve a term of 13 years, as well as a chaplain, Exeter College Oxford has existed for nearly 700 years in part thanks to its continued endowment.

The size of the College and the endowment has changed in that time so that today the returns from investments of just under £50m contribute about a quarter of the College's operating costs, supporting 47 fellows and the College Rector who carry out research and teaching in the fields of humanities, science and social sciences. At any time the College houses about two thirds of its 350 undergraduates (mostly on site and during their first and final years) and half of its 230 graduate students in hostel accommodation.

'We couldn't imagine being able to run the College without the endowment', says Bursar William Jensen. 'Not only for running costs, but for capital projects too.' So, for example, the College recently funded the essential refurbishment of two staircases in one of their historic buildings to the tune of £400k, drawn from the £30m or so of the investments which are unrestricted (the rest are permanent) on the rationale that the work would be unlikely to attract the support of private donors.

The endowment, Jensen says, provides long-term and essential working capital to preserve the College's independence and viability.

With that in mind, the aim is to maintain the real value of the endowment over the longer term, although there is no precise metric for measuring it year by year. The College invests for total return mostly through global and private equity, with some investments still held in commercial and agricultural property.

The transfer of expendable income from the endowment is calculated annually on the basis of 70% of the previous year's transfer, adjusted for inflation, plus 30% of the closing value of the portfolio multiplied by the spend rule rate of 3.25%. The smoothing effect of this transfer rule means that the effective rate of transfer is closer to 3.7%.

Recognising that the smoothing could mean overconsumption in prolonged periods of falling markets or subdued returns, the College is open to reviewing the rule. For now however it is holding firm, in part through a belief that in the long term markets will deliver stronger returns and in part through recognition that scaling back costs in a small community is very difficult. Scaling back could mean losing subject areas and at best costs would take some years to realize. The bursar says, 'If we believed that consumptions from endowment would exceed investment returns for a decade, then we will have to think about retrenching to re-base expenditure to a level sustainable from the endowment.'

While taking a swipe at advisers who haven't taken a hit in the downturn in terms of fees, Jensen nonetheless concedes that it is worthwhile paying for good advice. So, for example, the College is prepared to pay about 1% for its property management service and also shop around for the best expertise when it comes to legal advice on complex deals.

Donations have been part of the culture and history of the College since its inception. However, whereas former benefactors were happy to provide gifts that added to the College's wealth, the College's development department is now geared to a new generation of philanthropists who are less happy to subsidise general running costs and instead like to see exactly what their gift is buying.

'The dynamic of a 700 year old institution, which to all purposes expects to be here until the end of time, brings its own measure of responsibility. We want to be good stewards for the next generation. Because not all costs are fundable from fees and chargeable income, our aim is to grow the endowment to underpin our activity.'

Section three:
What do others do and think?

Key points

- Over 220 charities responded to a survey for this report about their investment and spending aims and practices.
- The vast majority of charities who responded wished to maintain the value of their portfolio and their expenditure in line with inflation.
- Charities spend over a range of rates. The most popular rate among those that responded to the survey was between 3% and 4% – within the range that historically could have maintained the real value of their portfolios.
- Larger, older charities, regardless of whether they were permanently endowed or not, tended to spend at a higher rate than others.
- Since the beginning of the crisis in 2008, 80% of respondents had maintained and 5% had increased their expenditure rates.

Research carried out for this report gives a unique insight into the behaviour of charities with long-term investments.

The survey can't be said to be representative of charities with investments as a whole. However, because respondents came from the membership of professional umbrella bodies and subscribers of a specialist magazine,[20] the results perhaps give some insight into professionally managed charitable organisations in the sector.

Respondents came from charities most commonly aged between 50 and 100 years with investments of between £10m and £20m. A quarter were smaller charities with portfolios of less than £5m. Larger charities also took part with nearly a third of respondents having investment assets exceeding £50m.

In light of the previous two sections, the survey revealed some interesting results.[21]

Most respondents were not permanently endowed

A third of respondents held assets that are substantially permanently endowed (i.e. more than three quarters of their portfolio). Older charities tended to have a higher proportion of permanently endowed assets. However, very nearly half of respondents had very little, if any restriction on their investment capital (i.e. less than a quarter of assets

20 Organisations who were clients of Schroders Charities, members of the Association of Charitable Foundations, members of the Charity Finance Group and readers of *Charity Finance* magazine.

21 Full survey results published on www.schrodercharities.com/spendingdecisions

Image courtesy of Exeter College, Oxford

permanently endowed). In fact the majority held mostly expendable assets showing that, in fact as well as in law, expendable assets are the norm rather than the exception, at least in relation to this sample. Those that were permanently endowed charities were evenly split between using a total return or income approach to managing their investments.

Most respondents relied on the return from investments to fund their missions

The majority – nearly seven out of ten – saw their investment portfolio primarily as a means of supporting their charitable activity rather than as reserves to be kept or grown.

Four fifths of respondents aimed at least to preserve the real value of their capital over the long term. Just under a third aimed to grow their investment portfolio. Less than one in ten anticipated spending at a rate that would see its real value decrease over time and just 7 charities out of a total of 226 who responded were planning to spend out within a definite time frame.

Most respondents' objectives conformed to the indefinite preservation model

Overall, respondents tended to place slightly greater emphasis on maintaining the real value of their capital over maintaining the real value of their expenditure, although most tended to rate both highly.

This suggests that most respondents to the survey fell within the scenario we are exploring, being charities who hold assets on which, permanently endowed or not, they rely to support their charitable activities year on year over the long term. The results also suggest that their approach conforms to the indefinite preservation model as, in doing so, they aim to be able to maintain both the real value of their expenditure as well as the value of the investment portfolio itself. Interestingly, less than a third anticipated topping up the capital with further funds.

Are they spending at a rate that would support the model?

Respondents spent across a range of rates, 3% to 4% being the most common

The most common spending rate among respondents was in the range 3% to 4%.

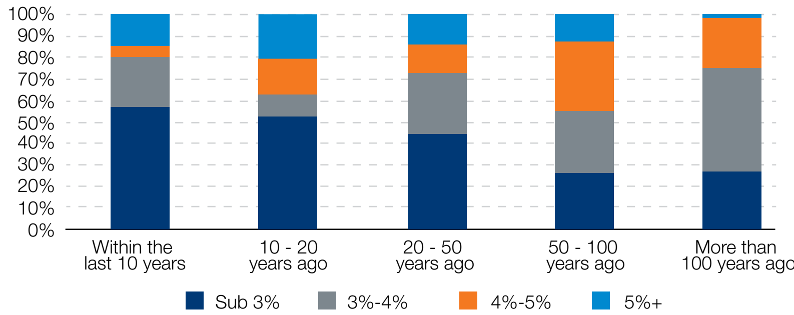
Taking the mid-point of each range as the reference, and adjusting for investment management fees, it is possible tentatively to arrive at an overall average annual spend for our respondents of 3.4%.

This includes expenditure on investment management fees[22] (2.8% excluding expenditure on fees) and is below the spend identified by our historical analysis (4.2% per annum), but consistent with the analysis of future returns (3.2% per annum).

That average figure however obscures our finding that respondents had a wide range of spending rates, with some interesting variations associated with the age of the charity, the size of the investment portfolio, whether they operated a total return policy or not and what time horizon they took to be the long term.

[22] Respondents were split at around 3:2 between those who included management fees when reporting their spending rate and those who didn't. Those that did not include fees in their spending rate were adjusted by the average fee rate (using the mid point of the ranges) for the entire sample to allow an approximate overall spending rate including fees to be established.

Analysis of distribution rates based on founding of organisation

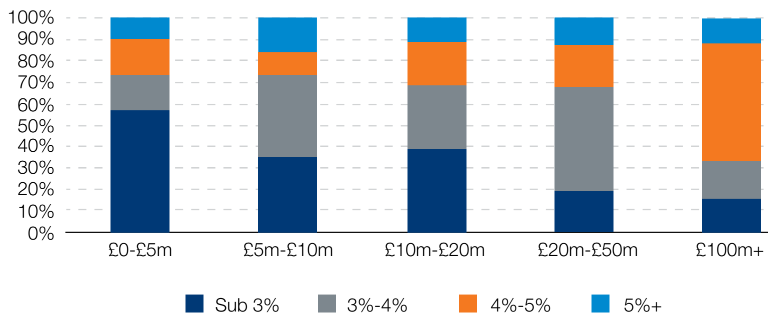


Source: Schroders, 2012

Older charities tend to spend more than newer charities

Older charities regardless of whether they were permanently endowed or not tended to spend more than newer charities.

Analysis of distribution rates based on size of investment portfolio



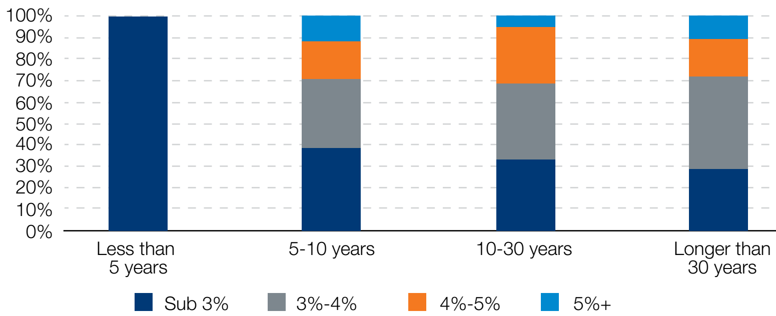
Source: Schroders, 2012

Larger charities tend to spend more

Those with investments of over £50m spent more on average than smaller charities.

Interestingly, charities that anticipated topping up the capital with further funds did not on average spend more than those who didn't.

Analysis of distribution rates based on view of long term

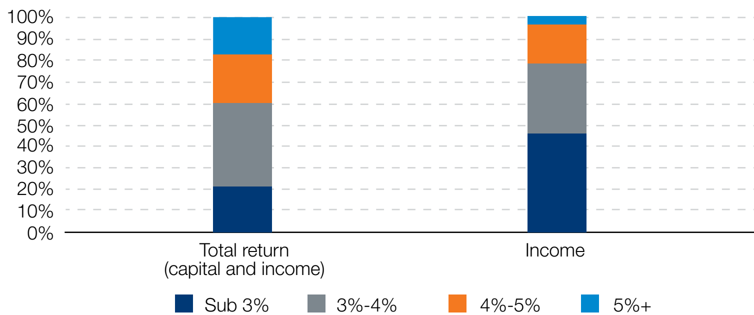


Source: Schroders, 2012

The greater the view of the long-term, the higher the spend

The largest number of respondents – two out of every five – thought that long term meant between 10 and 30 years. The remainder thought, equally, that it was either between 5 and 10 years, or a period of more than 30. Those who thought that the long term was more than 30 years tended to be those with the largest portfolios of over £100m. Those with the longest time horizons tended as a cohort, to have higher than average spending.

Analysis of distribution rates based on approach to investment



Source: Schroders, 2012

Spending income only associated with lower spend

The most common approach among respondents (42%) was to spend income. This is perhaps surprising as almost half of those doing so had fewer than a quarter, if any, of their investments permanently endowed and were not obliged to follow that approach. In fact half of those adopting a total return approach to investment went on to spend income only. Those funding spend from total return tended as a whole to spend more than those spending only income.

In terms of approaches to expenditure, aside from spending income only, just over a quarter of respondents adopted a market related policy, spending a proportion

of the market value of the portfolio, with most who did so adopting some sort of smoothing mechanism, most commonly taking a moving average of its value over three years. Nearly a third used five years.

A quarter of respondents linked expenditure to previous years but with only one in ten of those explicitly linking it to inflation.

Newer charities place less emphasis on preservation

The very highest spenders, i.e. those spending at a rate of 6% or more, tended to be newer charities (mainly younger than 50 years old) and were much more likely to hold expendable endowments. This group of high spenders was the only group who did not have a majority aiming to preserve the real value of their capital, with an equal number planning to spend it all within a specific time frame, erode it over the long term or grow it in the long term.

Smaller charities spend at the most cautious rates

39 out of the total 226 respondents (17%) were charities spending less than 1%. Such charities largely had small portfolios of under £5m, the real value of which they were aiming to preserve. They were equally split between being permanently endowed or not.

A vast majority have maintained or increased spending since 2008

In answer to a direct question, the vast majority of respondents reported that five years after it began, and despite the falling equity returns we noted in section two, the economic downturn that started in 2008 had yet to make an impact on their spending rates. During the period 80% of respondents had maintained and 5% had increased their rates of expenditure. Unsurprisingly, most of those who had cut expenditure cited falling returns as a reason for doing so.

Allowing for investment management fees

Most respondents were paying between 0.5% and 1% of the value of the portfolio, with the average amount being 0.66%. Only the smallest and very biggest charities that responded were paying more than 1.5%.

What does our survey show?

In terms of their attitudes, our survey reflects charities that want to maintain both the real value of their expenditure and their investment pot. In terms of behaviour, the fact that their average expenditure rate falls below that which our earlier analysis suggested would historically have allowed charities to preserve the real value of their portfolios, backs up the fact that many respondents tended to place a slightly greater emphasis on preserving the real value of the endowment than maintaining levels of expenditure, despite spending having held firm since 2008.

So the survey suggests that many charities conform to Tobin's model of indefinite preservation. However, we don't know if they are being explicitly influenced by Tobin's thinking when they decide how much to spend.

Finally, despite the large number of respondents who express the desire to maintain the real value of their expenditure and investment portfolio, the fact that a number are spending at higher rates raises the question of whether, for some long-term charities, issues other than preservation may also be important.

Part two: Reflections and conclusions

Questions for trustees

- In terms of your charitable mission, what do you imagine future generations would most like you to do with the resources at your charity's disposal?
- Would you prefer to spend less to improve the probability of being around for many generations or spend more today and take a chance with longevity?
- Are you making the most of all your assets to deliver your charitable mission, including human, intellectual and social capital, your reputation, convening power and ability to influence others?
- If the very long term is important to you, are you encouraging others to fund activity or make donations to top up your investment portfolio?
- When deciding how much to spend, what risk are you prepared to take with longevity?
- Are your governance structures strong enough to cope with your decision, particularly in relation to expected time horizons?

"We see ourselves as stewards of the funds, not guardians. The job of guardians is to safeguard money and give it back. Stewards care about what is happening with the money and actively cultivate giving."

Kristina Glenn, Director, Cripplegate Foundation

Image courtesy of The Paul Hamlyn Foundation

Section four:
Immortal longings and market realities

Key points

- There is no legal duty for trustees of expendable endowments to preserve the real value of an investment portfolio.
- Tracking the real value of an investment portfolio can be helpful, but is a proxy for viable longevity.
- There is an alternative approach for charities that rely on the return from their investment than either indefinite preservation or spending out within a specific time frame.
- 'Open-ended' charities spend at rates that make sense in terms of their mission and, while their expenditure may reduce the probability of maintaining the real value of their portfolio, are still open to the possibility of existing for generations either because higher market returns make it possible or because at some point in the future they may decide to change their approach to spending.

Certainty and probability – questioning Tobin

The results of the survey showed that there are many charities who believe that it is possible both to maintain the real value of their endowments, while relying on the investment returns year on year to fund their activities at a reasonable level that itself keeps pace with inflation.

The most common judgement about what constitutes an appropriate expenditure rate was in the range of 3% to 4% of the value of the investment portfolio although many respondents spent more or less than that.

As we saw in section two, from the point of view of preservation, our historical analysis suggests that over the course of the twentieth century spending in the rate 3% to 4% was a fair judgement to make and that forward looking returns are anticipated to support spending at the lower end of this range.

However, over the shorter time-scale of the first decade of this century, the proposition looked more difficult for all trustees, no matter what they chose to spend. If the economic situation of the second decade endures – as far as investment returns are concerned – charities spending in this range could very probably see the real value of their endowments drop below their previous value if they haven't done so already. In the face of this analysis, for those wishing to preserve the real value of their investment portfolio across generations, a cautious approach would be to keep spending low.

An alternative view might take comfort from the fact that during the twentieth century, the market value of a typical investment portfolio that ultimately maintained its real value spent most of the century below that target. This view largely depends on the belief that the great hike in investment returns of the 1980s was a correction that could occur in the future, rather than an exceptional period which shouldn't influence our expectations for returns going forward. On this view, for those who are able to take a very long-term approach to their investments, maintaining current spend rates, while uncomfortable may nonetheless prove to be justified as investments regain their value.

It's possible to argue for either scenario. It is not possible to predict with any certainty ahead of time which if either will prove to be the case. Of course it could turn out 'somewhere in the middle.' Equally we could be poised, as some would argue, on the threshold of a new paradigm where any economic analysis based on the efficiency and self-correcting natures of capital markets is no longer possible.

At this point in time, perhaps the most compelling finding from our market analysis is the degree to which, even when you spend at the historically justified 'right' rate, preserving the real value of the portfolio is only ever a probability. This lack of certainty holds true for whatever rate you choose – even if you spend nothing on your charitable activities and pay only necessary administrative and professional costs.

In terms of governance, however, that observation could have some fairly radical consequences for those who manage investments to support a charitable mission in the long term. Let's look at it more closely.

Difficulties with the intergenerational preservation model

If trustees and those who advise them have relied in recent decades on a framework based on the intergenerational preservation model, that it is possible to spend at a reasonable rate each year while preserving the real value of the portfolio, then they have been buying in to an assumption that it is possible to set aside a defined pot of money which, through the alchemy of the stock market, is able to support constant spending that rises with inflation while similarly replenishing itself in the same way not just for a number of years, but for infinity.

"When asking if they can maintain the real value of the investment portfolio, are trustees asking themselves the right question?"

The implicit aim of the 'intergenerational model' has been for endowments to achieve, unlike their human donors, a sort of immortality because the capital value of the endowment *never* diminishes in real terms, even after spending and costs have been paid out. Charitable investments it is believed, unlike humans, are never worn out by the business of living and doing good, no matter how relentless it might be. In fact, Tobin himself wrote 'The trustees of an endowed university like my own assume that the institution be immortal. They want to know, therefore, the rate of consumption from the endowment which can be sustained *indefinitely*'.[23]

With that in mind, when asking themselves if they are maintaining the real value of the investment portfolio, are trustees of different sorts of charities always asking themselves the right question? The following observations may help.

Equity between generations may not mean 'equal'

It's important to remember that, as compelling as Tobin's phrasing is, it is not a statement of law. His exhortation that trustees' 'task in managing the endowment is to preserve equity among generations' sounds beguilingly legal but in fact forms no part of, at least, English Law. Moreover the way Tobin's statement has been interpreted causes a number of problems.

'Equity' – a nuanced concept which evokes what is fair in a particular set of circumstances – has come to be flatly conceived as 'equal' by many who apply Tobin's thinking. Equal and equitable are different things. Spending the same on each generation may in some circumstances be fair, but it may not be depending on what you're trying to achieve. Needs differ and presumably so must responses.

There is no legal duty to maintain the real value of investments

While Tobin talks of trustees' 'task' there is a danger that his formulation can be interpreted as implying a specific duty with a narrow definition.

[23] Tobin, J., ibid, note 7, p. 427, emphasis added.

The fundamental duties trustees have are the duties to be loyal to the interests of the charitable objectives and to manage resources prudently. Only those with permanent endowments can be said to have a duty to preserve the capital. Others seek to preserve their investments by choice.

As we've seen there is no certainty, even with very low spending rates, that trustees can preserve the real value of their investment portfolio. At best there is only ever a probability. Actions can only be duties when they are capable of being performed. Therefore there can be no sense in which trustees are under a 'duty' to preserve the real value of their investment portfolio at the expense of all else. The alternative, however, is not simply to spend everything now.

If it can be said that trustees have an obligation to future generations, either because they are permanent or because they have chosen to interpret their mission in such a way, it is an obligation that requires interpretation when it comes to application. Therefore, before committing themselves to doing all things necessary to preserve the real value of their investments for all time, trustees may want to pause and consider how well that fulfils their duties to the beneficiaries across the generations.

Maintaining the real value of investments is a proxy for something else

The idea of preserving the real value of the investments is exemplified in Tobin's formula. But the aim of the formula primarily is to expand trustees' field of vision to include the needs of future generations as well as the immediate scene and to give trustees a way of thinking about the long term future of the investments.

Of course, as noted, sometimes what future generations most need is a steady and reliable flow of cash. Conceivably future generations could ask for something more from today's trustees than their simply keeping aside, untouched, a sum of money. If they were able to speak for themselves, tomorrow's generation might ask for increased investment in preventative action to tackle the causes of social, environmental and human ills they might suffer instead of money in the bank to ameliorate the consequences of today's inaction.

For those who have a long-term sense of their mission, their duty of loyalty to the interests of the charitable objectives will include a future perspective. Deciding what that means in practice requires imagination and not just financial discipline.

Tracking the real value of investments can be helpful but not always

In practical terms, because the value of investments fluctuates so much over time due to factors beyond trustees' control, it is difficult to see how measuring the real value of the portfolio can be even a proxy measure of success, still less in any sense a reliable measure of trustees having discharged their fiduciary obligations. Certainly a snap shot of the market value, without any context, will tell you very little, if anything, that's helpful.

At best, tracked over time, having a sense of the real value of your investments can act as one helpful indicator of the direction future spending power may take. To make sense of it however, trustees who wish to have a consistent approach to spending and who intend to maintain their mission in the long-term, will also need to decide the limits of their tolerance and have governance structures in place that are resilient enough to hold firm when the market fluctuates and the policy is tested. They will also need to know what strategies to employ when things do seem to be moving beyond their comfort zone, understanding that adjusting the asset mix or stock selection with a better view to future performance may be a better response than simply cutting

> "While spending and investing need to be connected, they also need different perspectives."

spending. Indeed, if Tobin's model is primarily about maintaining spend, cutting spend today to preserve the real value of the investment could, within the terms of the model itself, be seen as favouring future generations over the current one.

When tracking the value of their investments, it may also be helpful for trustees to differentiate the certainty that is appropriate when planning expenditure, from that which relates to anticipating investment returns. Setting a spending policy and sticking to it is helpful because it bridges the gap between the need for stable expenditure and volatile investments. Spending policies promote stability in spend by inhibiting sudden changes in response to constant market fluctuations that continually alter the range of probable investment outcomes. But while spending and investing need to be connected, they also need different perspectives. Our survey showed that charities who had a longer time horizon generally felt able to spend more than those who took a shorter-term view, perhaps because the latter hadn't arrived at a settled view of what mattered most – long-term wealth or short-term security.

Buoyed by the stock market boom years of the 80s the belief that it was possible to preserve the real value of a portfolio while spending at rates approaching 4% or more has, for a number of decades, seemed not simply an aspiration but an achievable reality for most organisations. In more sober days, and in light of our observations on the thinking behind the intergenerational model, the authors of this report feel therefore that it is appropriate to question both the underlying assumption and the achievability of that implicit aim. In doing so, however, they don't mean to suggest that a more suitable aim for charities with investments is to spend out now and in effect not bother with preserving funds to meet future needs. Future needs won't disappear even if the funds do. Given that many long-term charities clearly do spend at rates that aren't simply calculated with preservation as the only goal, might it not be possible to conceive of the long term in terms other than infinite preservation and propose a more modest set of aims for long-term charities appropriate for their mortal origin and probable destiny? We would like to think so.

The 'open-ended' charity: an alternative to intentional preservation

For example, the Barrow Cadbury Trust rely on their investments to fund their charitable mission in the long-term. They do not want to determine their spending policy solely around the proxy goal of preserving the value of the investments.

We suggest that such long-term charities, previously unidentified, might be known as 'open-ended' charities because, while they spend at rates that make sense in terms of their mission, but which may reduce the probability of maintaining the real value of their investments indefinitely, they are still open to the possibility of existing for many generations either because higher market returns may make it possible or because at some point in the future they may decide to change their approach to spending.

MOVE YOUR
bank on

Section five
Objectives for long-term charities

Key points

An alternative set of objectives for long-term charities, other than preserving the real value of their investment portfolio might be:

- Make as much money as you can;
- Do as much good with all your assets as you can;
- Do good for as long as you can; and
- Don't put all your eggs in one basket (if the very long term is important to you).

Objectives for long-term charities

In the previous section we observed that there were some difficulties with the orthodox understanding of 'indefinite preservation' for long-term charities. Nonetheless, for charities who believe that they do have an extremely long-term view of their mission, the goal of preserving the real value of their investments can provide a helpful orientation point amid the choppy waters of a long voyage.

We noted however that there were other charities who, while open to the possibility of existing for many generations should markets give high returns, chose not to make infinite preservation of the real value of the portfolio the main element when calculating their spend rates. Instead such 'open-ended' charities might choose to spend at higher rates than those aiming for indefinite preservation, but not so high that they eroded altogether their chances of surviving meaningfully for many generations.

Whether aiming for indefinite preservation or taking a more open-ended approach, instead of making their goal the preservation of the real value of their investments, in this section, we propose the aims listed overleaf for trustees of long-term charities.

Image courtesy of The Barrow Cadbury Trust

These objectives are to:

- Make as much money as you can;
- Do as much good with all your assets as you can;
- Do good for as long as you can; and
- Don't put all your eggs in one basket (if the very long term is important to you).

The final point is particularly important if your strongest belief is that, as a trustee, you have first and foremost been entrusted with stewardship of a long-term mission rather than custodianship of a pot of money.

The following suggestions, based on our case studies, may help trustees widen their sense of how to support their mission into the long term beyond a narrow focus on preserving the real value of the investment portfolio. For a fuller discussion of some of the options, readers may want to refer to *The Governance and Financial Management of Endowed Charitable Foundations*.[24]

Make as much money as you can

Prudence doesn't mean only being cautious, it means taking opportunities too. Charity trustees don't have to be conservative or timid investors, or at least not as cautious as those who manage pension funds, for example, who must ensure that the value of the investment portfolio maintains a certain value sufficient to cover their known future liabilities.

Charity trustees don't have such an obligation and as a consequence, if they can manage the impact of volatile market values both in terms of keeping steady their nerves and their spending, they are able to take the risks associated with greater returns. What they can't afford to do is bail out too soon as markets fall, as that would only 'lock in' losses.

If trustees want to take more risks, they will need governance structures that are resilient enough to hold steady when things go down as well as up. Trustees must also feel able to take the knocks if things don't work out. That means holding a diversified portfolio so that no single decision can wipe out the value of the investments. It may also perhaps mean that more volatile portfolios, or risky investments, are more appropriate for those with larger investment portfolios who have a bigger cushion to soften blows and from which to bounce back.

At the same time, it's important to bear in mind that the benchmarks trustees need to beat aren't those tagged to market values, whether measured quarterly or annually or whatever. Inflation is the real enemy

"Prudence doesn't mean only being cautious, it means taking opportunities too."

[24] Jenkins, R., The Governance and Financial Management of Endowed Charitable Foundations, Association of Charitable Foundations, London, 2012.

charity investors need to beat in order to maintain sustainable spending. Knowing that might put a helpful cap on ambition lest it run riot.

Do as much good with all your assets as you can

As we've seen, continuously generating inflation busting returns is itself challenging. Charities, even endowed foundations that focus primarily on funding others, have more assets at their disposal than simply money. The expertise of trustees and staff, including social as well as intellectual capital, the reputation of the organisation and the power it gives to bring others together and influence them, as well as the voting rights associated with share ownership can all be wielded by trustees to help accomplish their social mission.

Applying the charitable objectives to these assets that make up the whole balance sheet as well as to the 3% or 4% normally set aside to spend can provide trustees with a much wider set of tools as agents of social change.

Moreover, if looking at the whole balance sheet through the lens of the mission opens up possibilities, so considering today's behaviour from the perspective of tomorrow's generation can reveal new issues for trustees to take into account when thinking about their investments. As the idea of acting on behalf of future generations is core to the intergenerational model, might it not be the case that they might ask today's trustees to act more imaginatively than simply preserving the value of the investment portfolio?

Might trustees consider the net social impact of their spending and investment policies? On this view, not investing in ways that promote action to tackle climate change, improve social outcomes and raise standards of corporate governance could be to let down the next generation. That generation, rather than being content that trustees simply reap and bank returns from stocks and bonds, could conceivably ask them to use the influence their shareholding gives to alter the way corporates and governments behave to ensure that the world they live in is better or at least not worse than ours. Some have argued that this sort of thinking is core to trustees' fiduciary obligation of loyalty.[25]

Additionally, with investment returns potentially lower and some questioning whether even 3% is too much to spend 'safely', trustees can also think more flexibly about the kind of returns they want from their investments including whether investments that deliver a social as well as a financial return might not in some cases help them achieve their mission more directly and effectively than first investing resources for a financial return and then giving away the surplus as non-repayable grants. Where the main aim of a social investment is financial, it will mean offsetting an expected social impact against an anticipated below market financial return. However, while social investments have the advantage of delivering a blended return, the market for them is still emerging and being able to forecast and price the financial return as well as being able to quantify the social return is also an emerging science. As such, they may not be right for all organisations although trustees may still wish to make social investments from programme expenditure.[26]

If part of the motivation to invest socially comes from the recognition that charity investors can take some risks that others can't, at least one foundation has decided to explore not lending money to beneficiaries for return but borrowing more on their behalf in order to invest it and pass on anticipated future returns through increased spend. In each case trustees are recognising that, when pressures on potential beneficiaries are great, charities with assets are in a privileged position to take on

[25] Berry, C., Protecting Our Best Interests: Rediscovering Fiduciary Obligation, Fair Pensions, London, 2011.

[26] For further guidance on social investments, see Charity Commission, 'Charities and Investment Matters: A guide for trustees.' CC14, London 2012 J11-15, K1-7.

more risk in pursuit of their mission than beneficiaries can themselves because, providing they were even able to borrow on the commercial market, the costs would be higher and they would be more vulnerable to the consequences of it turning out badly.

Do good for as long as you can

The chief finding from the market analysis is that, whether they know it or not, charity trustees are taking a risk with perpetuity which can ever only be foreseen as a probability and not a certainty.

Nonetheless, there are things that trustees can do to increase that probability.

Most obviously they can spend at a low rate. That still wouldn't make sustainability a certainty, but it would make it much more probable than improbable. The difficulty is that while adopting that level of spend would increase the likelihood of achieving an arithmetically equal distribution into the future, with fund management fees at 0.5% to 1% per annum, the arithmetic could work out feeling not equitable but awkward.

An alternative to keeping spend permanently low is to spend counter-cyclically. In terms of fairness judged in relation to meeting the needs of beneficiaries, spending less in boom years and more in periods of sustained low returns may make sense as social needs are likely to be heightened at times of economic austerity. But even here there are risks. If the spend in downturn years doesn't come from a reserve built up in the good, it will involve selling investments when they are potentially at their lowest value.

Whatever approach trustees decide to take, tracking the real value of the portfolio seems a sensible way of knowing where one stands, and having worked out in advance a cap and collar to get some objectivity about spending seems like a very good idea. In terms of being a good steward it enables charities to monitor exactly what's in the store cupboard and know as well as they can how much longer they can continue to provide the same benefit at the same rate so that trustees can, if appropriate, close or open the taps as feels justified in terms of the mission.

However, whatever trustees do, there is no guarantee that they will achieve the goal of preservation.

Don't put all your eggs in one basket

Having said all that not only are there charities that have existed for hundreds of years thanks to their investments but we have met them. And their survival, while in some degree being due to providence, hasn't entirely been so. Of course having a piece of farmland in the mediaeval period that later becomes prime real estate can help. So also do donors.

Two of the case studies of very long-term charities demonstrate the importance of donors in different ways in very different contexts. Between them Exeter College, Oxford and the Cripplegate Foundation have existed for well over a millennium. All charities potentially have something to learn from them. Over the centuries their investments have continually been topped up by donations. In contemporary times both have intentional plans to attract more donors.

Exeter College, like many Oxbridge Colleges and other academic institutions has a 'Development' programme aimed at encouraging alumni to make gifts to the college to ensure that it thrives and survives into the future.

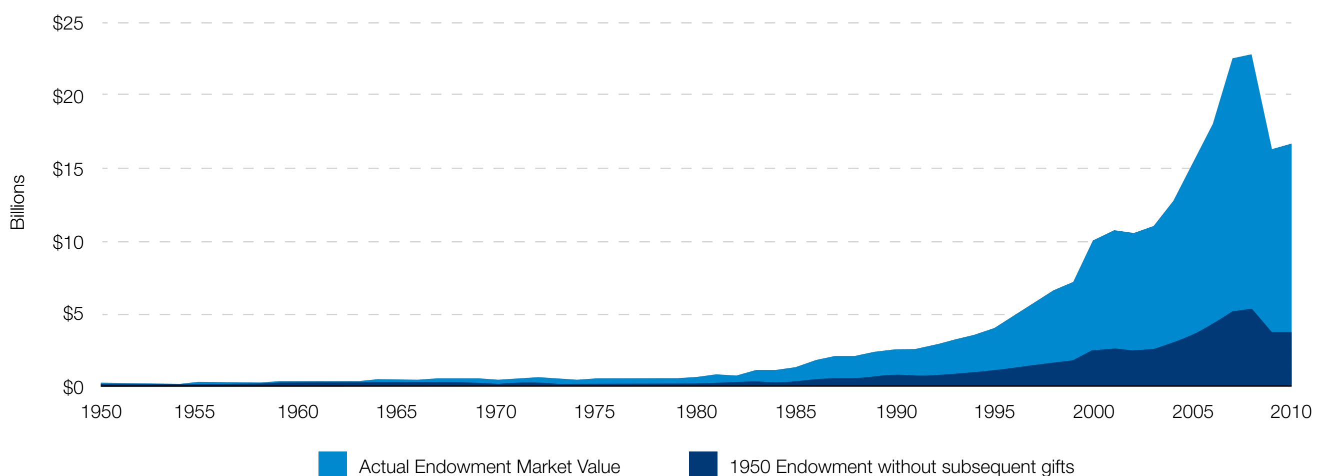
The Cripplegate Foundation which is legally permanent, has also actively developed relationships with donors to create the funding stream 'Islington Giving' which, instead of topping up the endowment, ensures that giving in the borough is channeled in a way to meet greatest need. Its existence means that the annual expenditure managed by the Foundation has almost doubled, with a healthy proportion of the money estimated

to be new giving. Relationships with new donors have also benefited the organisation by widening its field of intelligence and access to networks with other collaborators.

With their very different objectives these two very old charities have a vigorous present and more certain future through actively engaging new donors who contribute to their mission.

As a final note, it is important to record that the intergenerational model itself was developed in an educational institution, Yale University, which, as the graph shows, has benefited from considerable ongoing philanthropy. This has been the largest contributor to its endowment growth over the last half-century. While its investment record has been legendary, the real growth in the endowment has been built on new gifts, not old money.

Historic impact of gifts to the Yale Endowment 1950-2010



Source: The Yale Endowment 2010, Yale Office of Institutional Research

Conclusion
For Good And Not For Keeps

"Instead of asking how we can protect the real value of our investments, a better question to ask is what risk are we prepared to take with longevity?"

This report began by posing a simple question often raised by trustees of long-term charities that rely on investment returns to fund their activities. The question was 'How much can we spend on our charitable activities year by year, while maintaining the real value of our investment portfolio?'

In the Introduction we noted that this question revealed a number of concerns. It suggested a desire to take account of the needs of future generations today. It revealed perhaps a sense of obligation to founders or donors by seeking to avoid spending at a rate that might erode the value of the gift. It indicated that trustees also acknowledged an element of risk or even anxiety in managing investment assets, because the way that markets change is not always predictable and trustees want to do what is right.

In the first section, we noted that trustees' stewardship is marked by their fulfilling two essential obligations, the duty to be loyal above all things to the interests of the charitable objects and the duty to be prudent when managing the resources. Only trustees with permanently endowed charities are obliged to preserve their capital. Nonetheless, we saw that, for many who felt that their charitable mission was long-term, Tobin's formulation seemed to have become influential, i.e. that present day trustees are the guardians of future generations' claims on the investments against those of the present.

In practical terms, this has come to be interpreted as preserving the real value of the investment portfolio. The goal for this 'intentional preservation' model means that trustees set spending and investment policies so that ideally expenditure rises with inflation without eroding the real value of the investment assets. The time scale factored in for preservation in Tobin's model is infinity.

In succeeding sections we looked at whether market analysis would show if the intentional preservation model was in theory sustainable and also what many charities are doing in real life.

What we found made us pause for thought. We noted, during the last century, the importance of as yet unparalleled equity returns during the 1980s in 'correcting' previous decades of slower growth and in shaping the expectations of contemporary investors. While an early twentieth century philanthropist would be able to spend at a reasonable rate of around 4% while sustaining the value of the investment portfolio, philanthropists of more recent decades since the 1980s and 90s may have had a tougher time. The variable range of factors which mean that markets fall as well as rise meant that preservation is, and has always has been, a probability.

And that is surely the key point, whatever they spend, there is only ever a probability of trustees being able to preserve the value of investments while being able also to spend in line with inflation. A range of environmental factors determine whether trustees will be able to maintain a portfolio of the same value. Most of them are beyond trustees' control and only some will be within their ability to foresee and respond. Preservation of the real value itself is best viewed then, as we have suggested, as a proxy for longevity. That being the case the possibility of not achieving that goal can be viewed as one of a range of factors with which trustees are forced to take risks – like investment returns themselves, grants they may make, or any other activity they fund with the ambition of delivering their charitable mission.

With that in mind, rather than asking 'How much can I spend while still preserving the real value of our investment portfolio' the most helpful question for trustees may be 'When determining our spend and investment policies, what risk are we prepared to take with longevity?'

A better question to open up possibilities

To help them answer that question, trustees may find it helpful to reflect on what sort of long-term charity they are. Our research has led us to conclude that long-term charities fall into three main groups:

Legally permanent – These charities have no choice about the long term. The default is that they are unable to spend their capital and must fund their activities only from the income from their investments. In terms of maintaining spending power trustees will have a choice about whether to spend all their income and, in boom years, may hold some in reserve to spend when income falls. A total return approach may allow them to make and spend more money over the long term, but they will have to find some way of identifying and protecting the original capital sum.

Intentional preservation – These charities will have chosen to maintain their activity indefinitely at the same rate. Their reasons for doing so will perhaps include a sense that they have a unique contribution to make, or that they exist to address a need that will not go away or is unlikely ever to attract future philanthropists. That being the case they will wish to minimise the risk of eroding their assets over the long term. These charities will calculate their expenditure to ensure that they deliver intergenerational equity as Tobin conceived it, so as to preserve the real value of the portfolio indefinitely, even if that means spending cautiously. However, though they are generally not constrained in terms of spend, if markets boom they will have to find some way of redistributing 'excess' returns, but of course cannot do so retrospectively.

Open-ended – These charities will be expendable but have chosen not to spend out within a definite timeframe, perhaps because it is not possible to calculate one in relation to the needs which they exist to serve. They may have a sense that their organisation adds real value in its current form and want to continue their way of working for as long as possible or until the issue has been successfully addressed. They can conceive that succeeding generations of philanthropists may wish to address the issue or do so differently, and so are prepared to take more risks in relation to preserving the real value of their investments and longevity. However, they are open to the possibility of existing for many generations either because higher market returns may make that possible or because at some point in the future they could decide to change their approach to spending. For the time being they will tend to spend more than those aiming for indefinite preservation.

Being good stewards

When it comes to expenditure, most charities probably continue to do what they have done in previous years and trust that things will work out. It is only periodically that they will want to review their policy, usually at times of change or financial strain. This is probably one of those times. Faced with an uncertain future, and despite having held rates of spending for now, many trustees will be asking themselves if they should cut spending rates in order to safeguard or even restore the value of their investments for the future.

In this report we have tried to take a thoughtful approach to the issues. Of course, for many trustees, feelings come into play as well when making these decisions. Trustees properly feel very responsible for maintaining value and keeping things going. It's easy for trustees to feel confused about investments and frustrated at their reliance on professional advisers, who may not speak a language they understand. They may be grateful when one trustee has an investment background and 'looks after that side'. In those circumstances there is value in a 'magic formula' or simple equation because of the simplicity and security it can provide. What our analysis has shown us, unfortunately, is that there is no single approach that is right for everyone. We therefore can't give any direction about whether trustees should or should not cut expenditure or what the right level of expenditure should be.

Only trustees can decide what is right for their particular charitable mission. Only they can decide what loyalty to their charitable objectives means in terms of strategy or action. If they have the choice, only trustees can decide if that means their mission, and so their investments, should be preserved indefinitely or viewed in a more open-ended way. Trustees alone are able to discern what is prudent in their context in relation to the investment risks and opportunities that present themselves. That may be difficult but it is true.

Tobin talked about trustees as 'guardians'. In doing so he meant something specific in the context of a university institution. We suggest that 'stewardship' may be a better concept to shape trustees' understanding of their fiduciary obligations to be loyal to their charitable objects and prudent when managing their resources. While guardians protect treasures or captives under lock and key, letting some in and no one out, good stewards shrewdly garner their resources and replenish their stores to be able to go on giving out good things again and again. The only failure of trustees can be a failure to think through sufficiently what they must do as good stewards. This report, and the questions it poses, is offered in the hope that it may provide a framework to help them do that.

Appendix i
Assumptions

Schroders' strategic asset allocation process begins with examining the expected long-term characteristics of investment markets. In doing so, Schroders looks at historic return data (both nominal and real) and current economic conditions and trends.

Importantly, this is overlaid with a degree of professional judgement in forming Schroders' expectations of markets.

The table below shows the volatility and return assumptions used in our modelling process.

Long-term return and volatility assumptions

Asset Class	Average Annual Return	Volatility
Cash	2.8%	0.7%
Bonds	3.6%	5.3%
Equities – Domestic	7.8%	14.6%
Equities – Overseas Developed	7.5%	16.2%
Equities – Emerging Markets	11.2%	20.1%
Alternatives – Absolute Return	6.0%	8.8%
Alternatives – Property	6.4%	11.3%
Alternatives – Private Equity	11.0%	23.9%
Alternatives – Commodities	4.3%	11.5%

Volatility is defined as the standard deviation of annual returns. Assuming that returns are normally distributed, Schroders expect returns to be within one standard deviation of the mean on two thirds of occasions. Volatility and return estimates are based on Schroders' analysis and are not guaranteed.

Source: Schroders, January 2013

Correlation assumptions

The other inputs required for Schroders' strategic asset allocation are the correlation coefficients between various investment markets. Correlation is a measure of the degree to which asset class performance moves in unison. The value assigned ranges from -1 (perfect negative correlation) through zero (no discernible relationship) to +1 (perfect positive correlation).

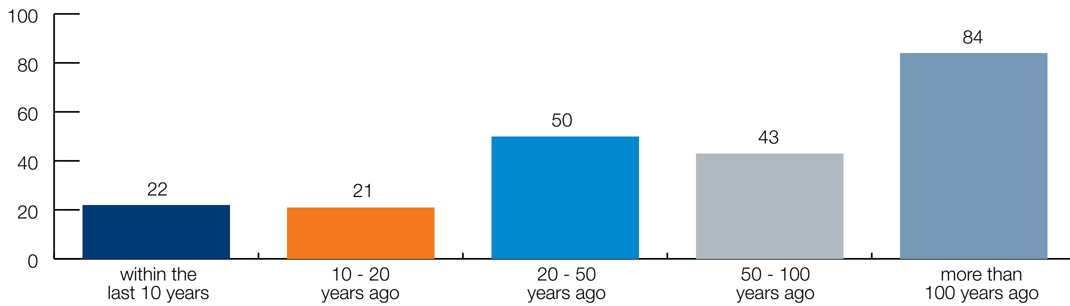
The ability to reduce overall portfolio volatility by combining assets in a diversified portfolio is due entirely to the fact that markets are not perfectly positively correlated. The weaker the correlation, the greater the volatility-reducing benefits of portfolio diversification. For example, the estimated correlation between the performance of UK equities and property is 0.3.

	Cash	Bonds	Equities – Domestic	Equities – Overseas developed	Equities – Emerging Markets	Absolute Return/Hedge Funds	Property	Private Equity	Gold	Commodities
Cash	1.00	0.03	-0.33	-0.25	-0.27	-0.06	-0.63	-0.27	0.08	-0.06
Bonds		1.00	-0.14	-0.02	-0.08	0.15	-0.24	-0.29	0.29	-0.18
Equities – Domestic			1.00	0.91	0.86	0.16	0.30	0.62	-0.15	0.51
Equities – Overseas Developed				1.00	0.88	0.33	0.19	0.52	-0.05	0.49
Equities – Emerging Markets					1.00	0.21	0.16	0.53	0.05	0.57
Absolute Return/Hedge Funds						1.00	0.02	-0.09	0.14	0.14
Property							1.00	0.29	-0.18	0.18
Private Equity								1.00	-0.23	0.23
Gold									1.00	0.31
Commodities										1.00

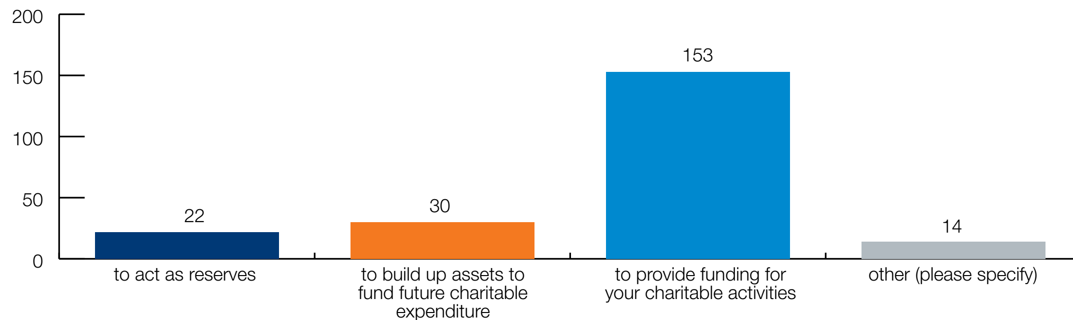
Source: Schroders, 2013

Appendix ii
Survey results

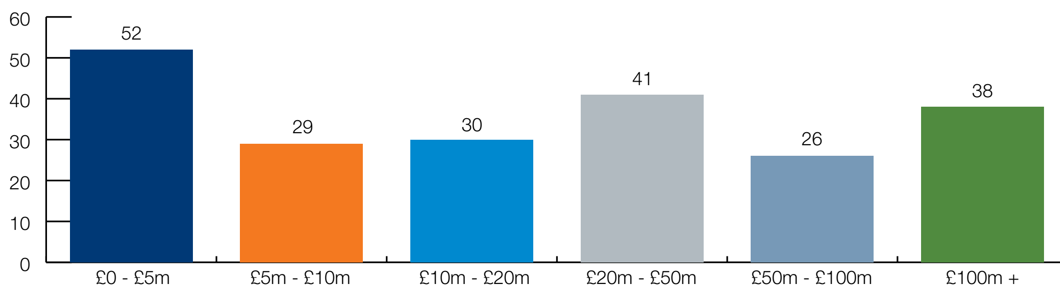
Q1 When was your charity formed?



Q2 Each charity will have its own individual reasons for owning an investment portfolio. Which of the below would most accurately describe your main purpose in holding investment assets?



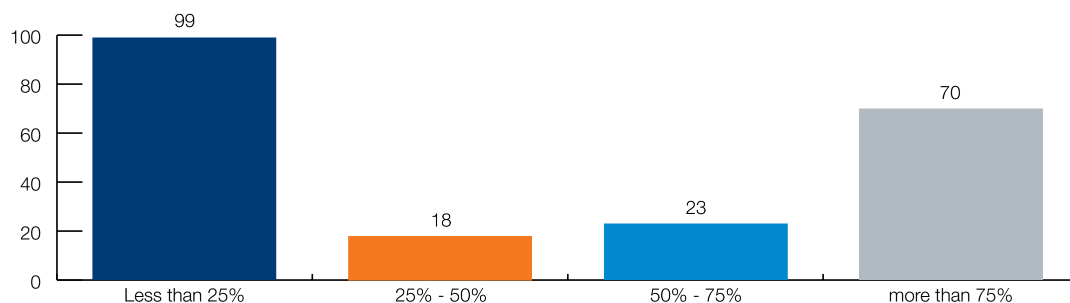
Q3 What is the value of your investment portfolio?



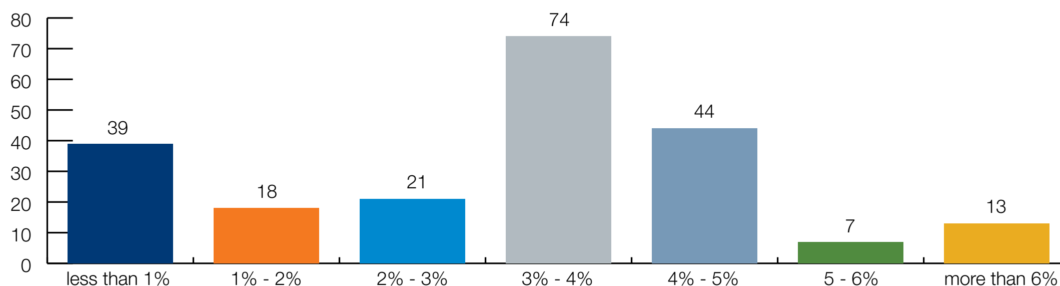
Source: Schroders, 2012

Please note that responses don't always total 226 as not all survey respondents answered all questions

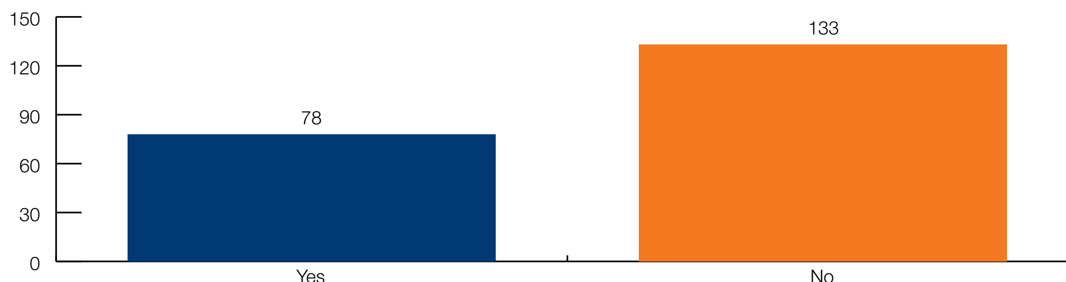
Q4 What proportion of your assets are permanently endowed?



Q5 What approximate percentage of your investment portfolio do you spend each year? (funded from your investment portfolio rather than other incoming resources)



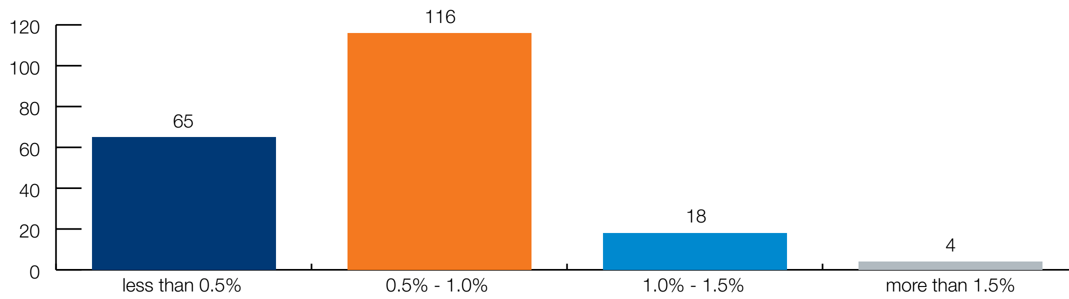
Q6 Does the above figure include the amount spent on investment management fees?



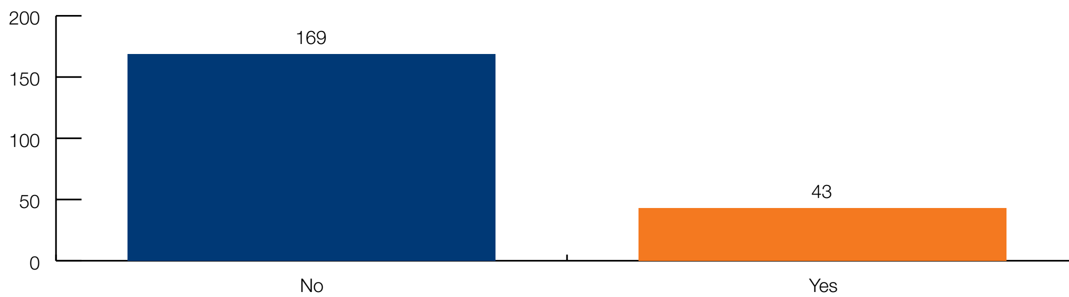
Source: Schroders, 2012

Please note that responses don't always total 226 as not all survey respondents answered all questions

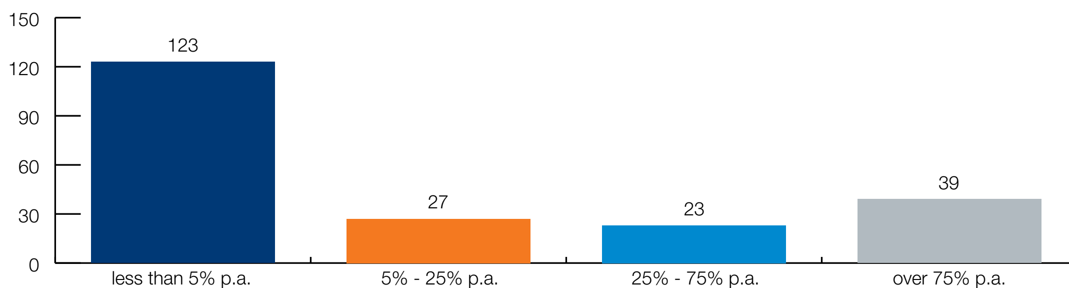
Q7 What is the approximate level of investment management fees per annum (as a % of total investment portfolio value)?



Q8 Has the level of expenditure from the investment portfolio changed significantly over the last 5 years?



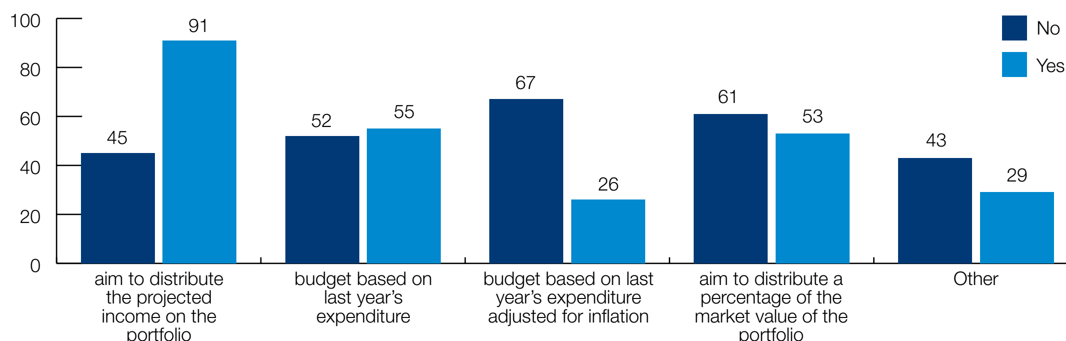
Q9 To what extent do you rely on withdrawals from your investment portfolio to fund your charitable activities? Investment distributions contribute:



Source: Schroders, 2012

Please note that responses don't always total 226 as not all survey respondents answered all questions

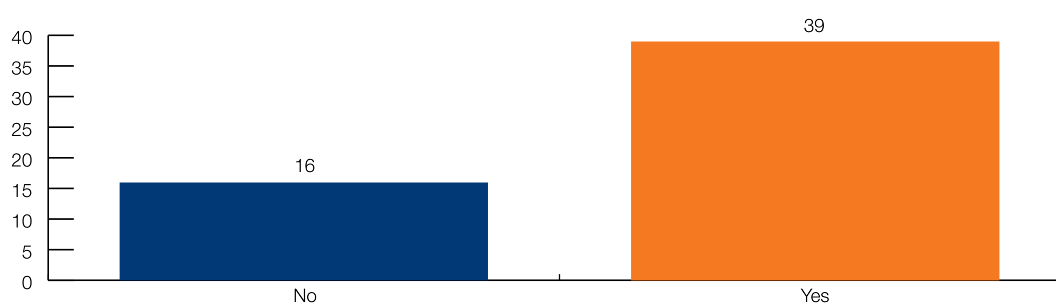
Q10 Do you use any of the below methodologies to arrive at the budget annual expenditure from the investment portfolio?



Q11 Following on from Q10 – If you chose option c – 'budget based on last year's expenditure adjusted for inflation' – please explain below how you adjust for inflation?

26 individual responses were given

Q12 Following on from Q10 – If you chose option d – 'aim to distribute a percentage of the market value to the portfolio' – is the "market value" averaged over time to smooth the distribution?



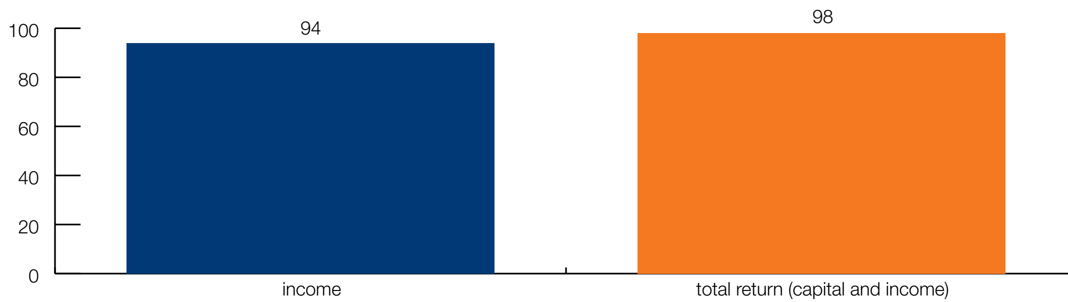
Source: Schroders, 2012

Please note that responses don't always total 226 as not all survey respondents answered all questions

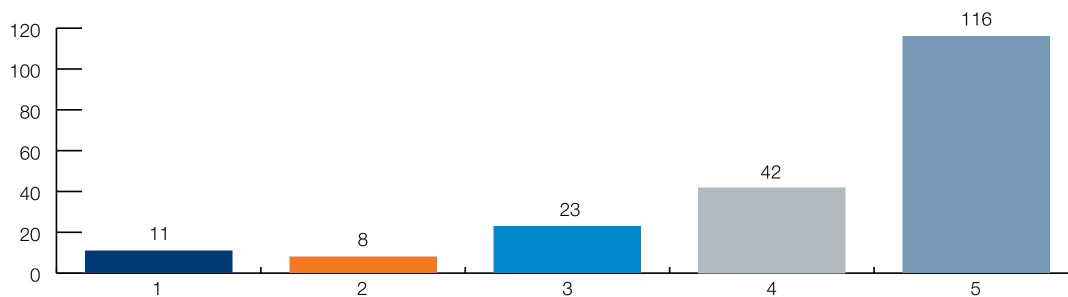
Q13 Following on from Q10 – If you chose option e – 'other' – please explain briefly how you arrive at a budget for expenditure from the investment portfolio?

32 individual responses were given

Q14 Is the cash flow requirement for spending from the investment portfolio met from total return or income?



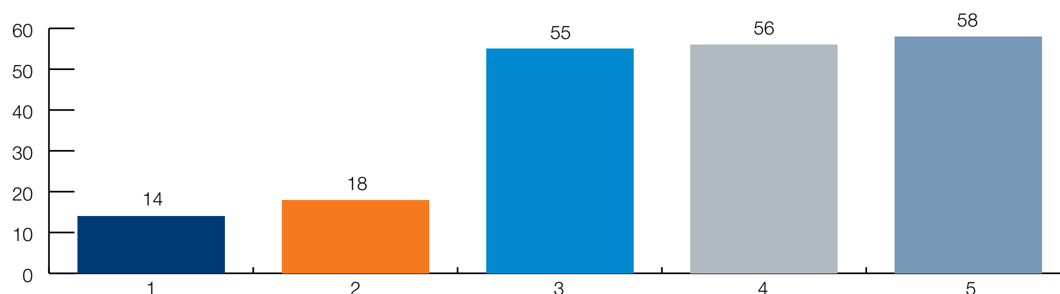
Q15 How important is maintaining the real capital value of your investment portfolio over the long term? 5 being most important, 1 being least important.



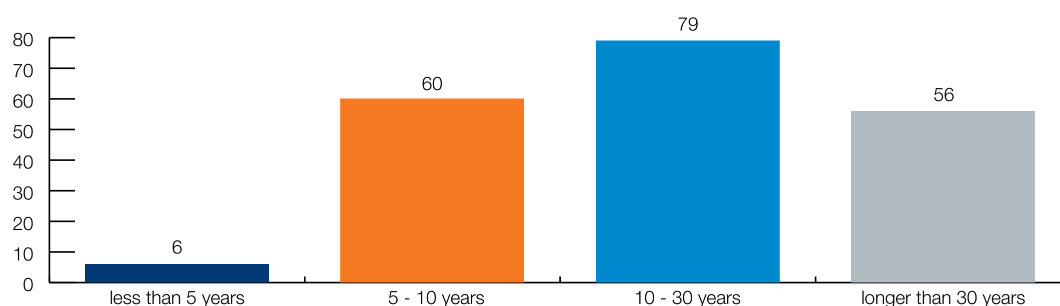
Source: Schroders, 2012

Please note that responses don't always total 226 as not all survey respondents answered all questions

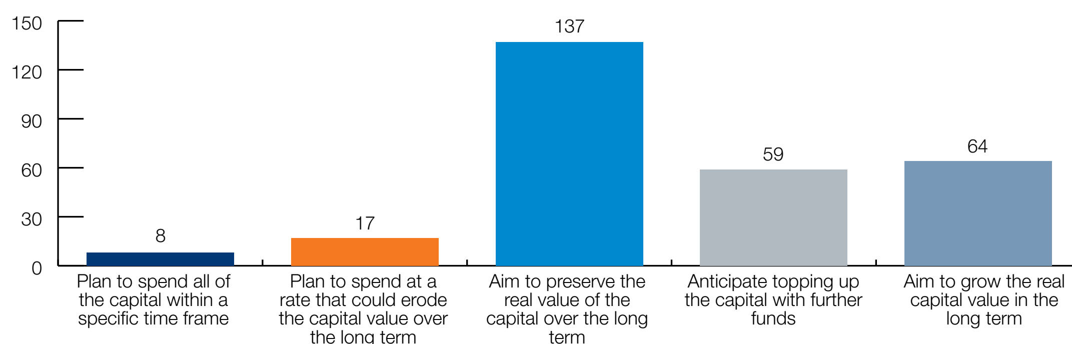
Q16 How important is maintaining the real capital value of your charitable expenditure over the long term? (from the investment portfolio)



Q17 What period do you view as long-term?



Q18 Which of the following options describes your expectation for the capital value of your investment portfolio? Please select all that apply.



Source: Schroders, 2012

Please note that responses don't always total 226 as not all survey respondents answered all questions

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