



# Charity Investment Industry Survey

Report on investment trends among the UK's leading Charities

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# Charity Investment Industry Survey

## Foreword



I am delighted to introduce this year's JPMorgan Fleming Asset Management annual Charity Investment Industry Survey. 2004 marked the fourth anniversary of the survey - a study which is widely recognised as an essential guide to investment changes and trends among the UK's leading charities.

So far this decade, the market environment in which charities have operated has been volatile. In the first couple of years of the decade, global stock markets fell as economic activity slowed and the global geopolitical environment became more hostile. Over the past couple of years, however, equity markets have begun to recover as economic growth has resumed and geopolitical tensions have, in the main, subsided.

As global stock markets continue to deliver decent positive returns, it is useful to assess how charities are responding to these equity market returns and how they now see themselves positioned.

As the findings reveal, the mindset of most charities is still anchored on the difficult equity market conditions seen in the first couple of years of the decade. As a result, charities remain very cautious when planning for and predicting returns that they can expect in the future. Although equities have recorded two years of double digit returns, charities do not expect the significant returns from their equities allocation they saw in the 1990's so are looking to enhance returns through less mainstream asset classes.

As illustrated by our verbatim comments, perceived volatility in stock markets remains a major concern for charities. As fundraising remains difficult and income remains under pressure, charities have increasingly sought new ways to enhance returns from their portfolios.

Charities are now favouring the use of pooled funds, vehicles that are cheaper/easier to administer and can provide access to a wide range of investment strategies. UK charities are also increasingly interested in alternative asset classes as a way of diversifying risk and enhancing portfolio growth.

Charities are becoming much more stringent in assessing the investment managers they use. In times of uncertainty, they have recognised the need to employ more stringent due diligence procedures in order to generate the best possible returns for their portfolios. Many now regularly review their managers in accordance with a specific timetable, while charities are also actively assessing their portfolio performance and strategies employed to gauge whether manager/strategy change is necessary.

All in all, charities are perhaps overly mindful of their experience in the bear market and are increasingly basing their investment approach and return expectations on what they experienced in the early part of this decade.

Charities are open to changing their portfolio asset allocation and are taking a flexible approach to the options available to them. This should position them well to take advantage of most market conditions.

**Jeremy Wells**  
**Head of Charities Investment**

## About the research

Over the past four years, we have successfully canvassed the opinions of the top 1000 UK charities, with the survey generating a strong response each year. This year the survey successfully interviewed 110 organisations representing over £11.1 billion of charity assets.

The findings of the survey cover the current approach of charities to managing assets, the level of charity investment in each major asset class, attitudes among charities towards risk and fundraising, and the level of returns they expect in the future.

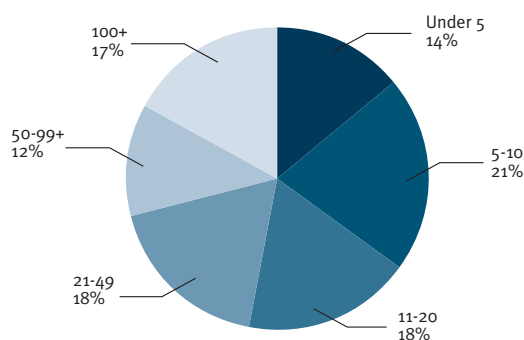
## Summary of key findings

- **Popularity of pooled funds continues to rise.** Charities continue to favour pooled funds to manage assets, with this year representing the first time that more charities have favoured pooled funds over a segregated method. 72% now manage some or all of their assets on a pooled fund basis.
- **Future return expectations among charities are cautious.** Over half of respondents expect a return of 6% or less.
- **Asset allocation changes made to control or reduce risk.** One third of charities have made significant asset allocation changes in the last 12 months, with the primary reason being to control or reduce (downside) investment risk.
- **Performance increasingly measured by market set benchmarks.** 74% of charities now use market set benchmarks as the primary method to measure performance.
- **Investment manager change becoming more prevalent.** Nearly half of all investment reviews result in some form of investment manager change, with 68% of respondents having conducted a review in the last two years.
- **Popularity of using consultants increases.** Only 30% of charities currently obtain advice from investment consultants, however, 56% intend to use them in the future.

## Breakdown of respondents

The value of total assets under management varied widely between the charities surveyed, with figures ranging from under £5 million to over £300 million. The breakdown of respondents by asset size showed a similar split to the breakdown we saw last year.

### Breakdown of respondents by asset under management (£ million)



## How charity assets are managed

### Segregated versus pooled

The most notable finding from the below table is that fewer charities are using purely segregated services as a way of managing assets, while the tendency of charities to use pooled funds has continued to increase. For the first time, it seems that charities are more in favour of using pooled funds than segregated management. 34% of respondents indicated that they use only a pooled fund method for asset management, while 28% specified a purely segregated approach.

The increase seen in those using both pooled and segregated management may indicate that charities are transferring from a segregated to a pooled fund basis or using pooled funds to gain access to more esoteric types of investments, such as Hedge Funds and Private Equity.

Method of asset management	2002	2003	2004
Segregated Only	48%	44%	28%
Pooled fund only	25%	25%	34%
Both	27%	31%	38%

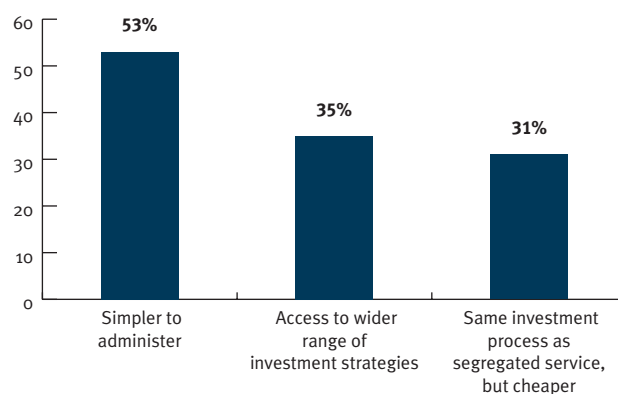
*Excludes responses 'Not Stated'*

In terms of the number of external managers used, at least two thirds of charities responded that they use only one external manager to oversee the management of their assets.

### Attitudes towards pooled fund investment

The main reason, cited by 53% of respondents, for favouring the use of pooled funds was that they are simpler to administer. Other key reasons included easier access to a wider range of strategies (35%) and pooled funds tend to be cheaper vehicles (31%).

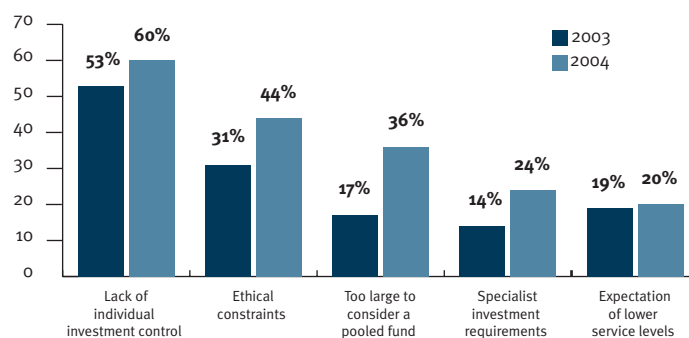
#### Reasons for using pooled funds to manage charitable assets



Figures do not add up to 100% due to a multiple answer question.

Although pooled funds are growing in popularity, there are a core number of charities who continue to avoid using them. Additionally, the reasons for not adopting a pooled fund method are becoming more entrenched. Firstly, 60% of respondents cited the inability of pooled funds to offer individual investment control as a dominant reason for not using pooled funds. Furthermore, ethical constraints have continued to grow as a deterrent, with 44% of respondents citing it this year compared to 31% in 2003, and 24% in 2002. Finally, 36% of charities responded that the volume of their assets is simply too large to enable the use of pooled funds.

#### Reasons for not investing in pooled funds



Figures do not add up to 100% due to a multiple answer question.

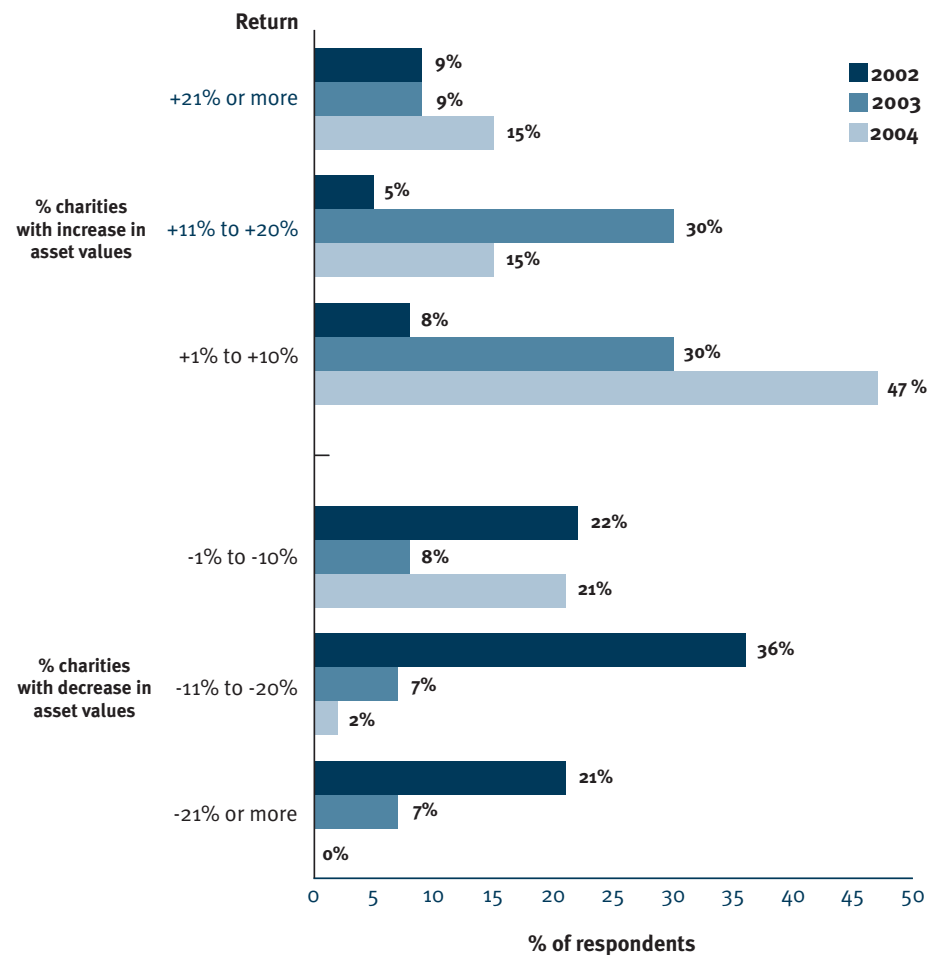
## Investment assets - Year on year change

We calculated the average percentage change in the value of assets from last year. The majority of charities have seen an increase in the size of their assets in the last 12 months. Out of all charities surveyed, 77% responded that their asset size had increased, while 23% responded that it had fallen.

The bulk of charities saw their assets grow by between +1% and +10%, while of those holdings that decreased, most declined by between -1% and -10%.

Given that charities are still finding it difficult to raise funds, the findings above are consistent with the upward trend in stock markets we have seen over the past year. As equities have risen, the value of charities' assets has begun to grow again.

### Percentage change in value of charity assets



## Asset allocation

### The asset classes charities are investing in

UK equities remain the most popular asset class for charities when allocating funds, with four out of five respondents (82%) specifying some exposure to the asset class. This finding again demonstrates that movements in UK equities will have a great impact on charities' portfolios.

Incidence of charities in each asset class	2004
UK Equities	82%
UK Bonds	75%
Cash/Deposits	73%
Overseas Equities	56%
Property	44%
Overseas Bonds	25%
Hedge Funds	16%
Private Equity	3%
Other	14%

*Figures do not add up to 100% due to a multiple answer question.*

### Changes to asset allocation over the last 12 months

Over one third of charities stated that they had made significant changes to their asset allocation over the last 12 months.

When considering which asset classes charities reallocated to over the last 12 months, Hedge Funds and Property were the most popular investments.

Equities saw a large decrease in allocation, with 56% of respondents reducing their holdings in this asset class.

Our survey shows that charities are now seeking enhanced returns via alternative assets, such as Property and Hedge Funds. Significantly more respondents specified that they increased their holdings in these two asset classes compared to those who responded that they had decreased their allocation. This supports last year's finding that charities are increasingly looking to alternative investments to drive future returns.

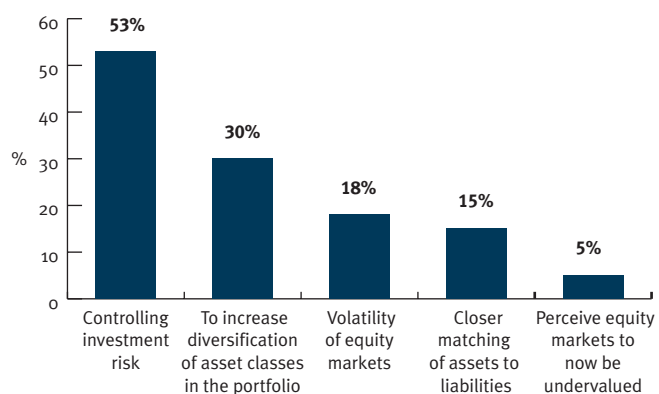
Changes made by asset class	Equities	Bonds	Cash	Property	Private Equity	Hedge Fund
Increase	34%	41%	41%	<b>58%</b>	25%	<b>72%</b>
Decrease	<b>56%</b>	41%	24%	4%	8%	0%
Same	10%	18%	35%	38%	67%	28%

### Reasons for making asset allocation changes

53% of charities responded that they changed their asset allocation in order to control or reduce (downside) investment risk, while 30% stated that they altered it to increase diversification of asset classes in their portfolio. This is in line with the findings that as risk appetite decreases, charities are boosting their holdings in Private Equity, Hedge Funds and Property.

Although equities delivered the strongest returns of all asset classes in 2004, volatility of equity markets was still cited by 18% of respondents as a reason for changing asset allocation. This response perhaps reflects that the disappointing returns seen from stock markets at the beginning of the decade are still affecting charities views on the potential returns they expect from equities in the future.

### Reasons for changing asset allocation



Figures do not add up to 100% due to a multiple answer question.

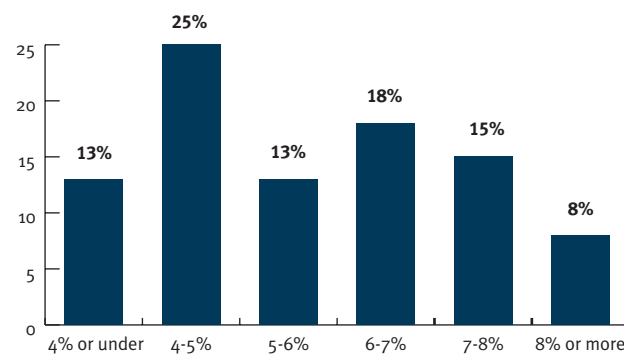
## Future return expectations

We asked charities what they are expecting the annual percentage return from their portfolio to be over the next three to five years.

The return expectations of respondents varied from a low of 2.5% to a high of 12.5%, with an average expected return of 6%. The return bracket with the greatest number of respondents was 4% to 5%. Charities are therefore not expecting investment returns to significantly exceed cash returns in the future.

While the average return of WM Charity Unconstrained Universe in the year ended Q3 2004 was 12.1%, the return expectations among charities remain modest. Charities are continuing to base future return expectations on the low performance returns they experienced in the early part of this decade.

### Expected annual return over next 3-5 years



We then asked charities whether they felt that the rate of return that they expect over the next three to five years would be sufficient to meet their charity's future charitable commitments.

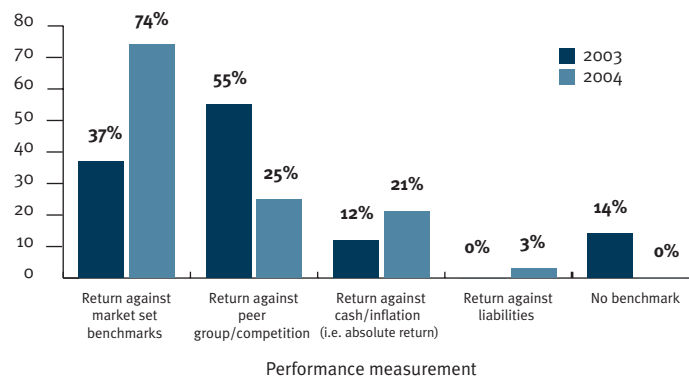
81% of respondents believed that the returns they expected would be sufficient to meet their future commitments. This indicates that charities are budgeting cautiously.

For the 19% of respondents that felt the expected return of their portfolio would not meet future charitable commitments, we asked what action they intended to take in order to ensure returns were sufficient. 35% stated that they are planning to adopt an absolute return strategy in order to enhance portfolio returns. Drawing return from income and capital was also a popular solution, cited by 30%.

## Performance measurement

Compared to the 2003 survey, it seems that far fewer charities are using returns against peer group/competition as benchmarks for performance and far more are now using market set benchmarks. The number of organisations who responded that they use cash based benchmarks (absolute return) almost doubled compared to the 2003 survey.

### Benchmark used for charity portfolio



Figures do not add up to 100% due to a multiple answer question.

Charities have largely completed reviewing their benchmarks, with only 12% of respondents indicating that they are planning to change their benchmark over the next 12 months.

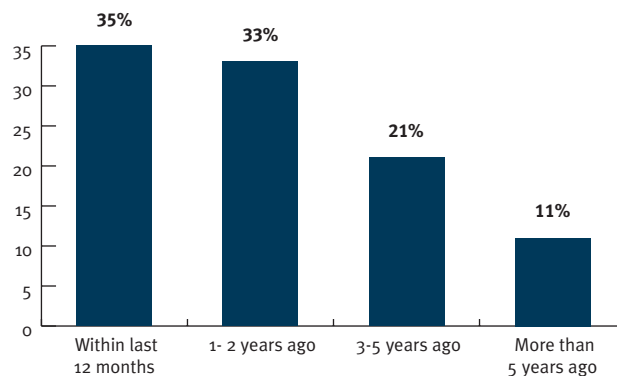
## Stewardship of assets

### Investment reviews

We asked charities to state when they last conducted a formal review of their investment managers. The results found that over two thirds of respondents (68%) have conducted a review of their investment managers in the last two years.

We can perhaps conclude that the Trustee Act 2000 has encouraged charities to review their managers more frequently.

### When the last formal review was conducted



### Reasons for conducting an investment review

The majority of charities (65%) conduct manager reviews as part of their regular due diligence process. When reviews take place for this reason, charities are unlikely to change their investment manager. 68% choose to remain with the incumbent manager.

32% responded that they held an assessment in order to review investment strategy and/or asset liability, while only 29% of respondents highlighted poor performance as a reason to review. When a review is conducted in order to review investment strategy, there is a higher probability that managers will change. When a review is triggered by poor performance, it is rare that the incumbent manager will remain in place post review.

Reasons for conducting investment manager review	2004	Investment manager changed				
		None	1	2	3	All
In line with usual review time table	65%	68%	23%	1%	4%	4%
Review of investment strategies/asset liability study	32%	30%	42%	8%	4%	16%
Poor performance of investment manger(s)	29%	11%	73%	8%	0%	8%
Poor client service	9%	25%	51%	12%	0%	12%
Changes in investment personnel managing the investments	7%	40%	40%	0%	0%	20%

*Figures may add to over 100% due to multiple choice answers*

In summary, our research found that around half of all investment manager reviews lead to some form of investment manager change.

### Use of Consultants at investment manager reviews

The use of investment consultants is gradually increasing with 30% this year responding that they used one to review their managers, compared to 29% last year and 25% in 2002. The key reason for using consultants, cited by 80% of respondents who use them, was so that charities could compare investment managers objectively (80%). 40% of charities used them to seek investment advice.

Reasons for using/appointing an investment consultant	2004
Needed assistance in making objective comparisons of investment managers.	80%
Required investment advice	40%
Required an asset liability study	17%
Other	3%

*Figures may add to over 100% due to multiple choice answers*

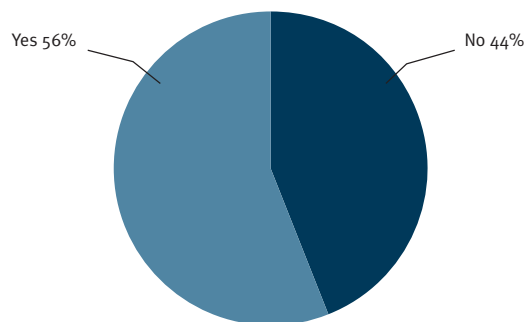
In line with last year, the most commonly used consultants were Cambridge Associates and Edward Jewson Services to Charities.

## Pressure on fundraising and income

### Future use of consultants

Although investment consultants are currently used by under a third of charities, 56% responded that they would consider using them in the future.

### Consider using/appointing consultants in the future



We asked charities whether they found fundraising easier or more difficult now compared to five years ago.

Only 10% of charities responded that it is now easier to raise funds, up from 6% in last year's survey. The majority of charities continue to find it at least as hard if not harder to raise funds now than five years ago. However, although most charities are still finding it difficult to raise funds, the table shows that year-on-year this situation is slowly improving.

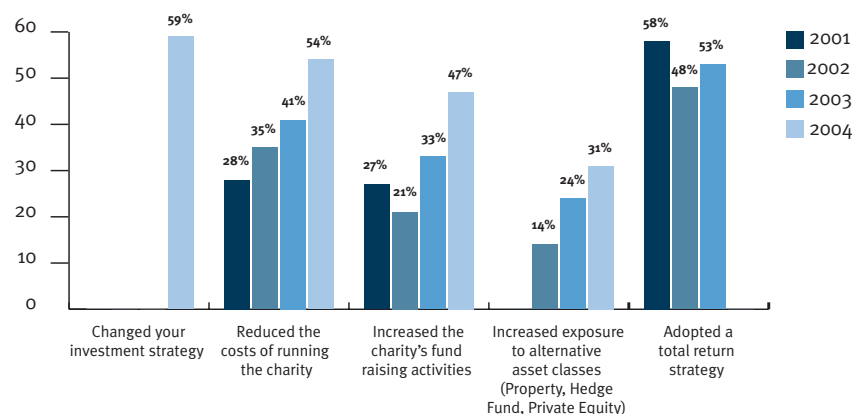
Difference in ability to fundraise now compared to 5 years ago	2002	2003	2004
Easier	1%	6%	10%
About the same	42%	37%	41%
More difficult	57%	57%	49%

We also asked charities whether they were facing greater pressure on their investment income now compared to five years ago. In line with the findings of our last three surveys, over two thirds of charities stated that they are seeing greater pressure on their investment income than they were five years ago.

When asked how charities are dealing with this increased pressure, charities are taking a balanced course of action - by changing investment strategy (59%), reducing costs (54%) and/or increasing fund raising efforts (47%).

In analysing previous responses to this question, we can see key themes emerging. Charities are continuing to seek ways of reducing the costs of running their charity, and increasing their exposure to alternative asset classes (a trend we saw earlier in this report).

### Reaction to increased pressure on investment income



Figures may add to over 100% due to multiple choice answers

## In their own words

### Charities voice their concerns

In each Charity Investment Industry Survey, we ask respondents to give their key concerns about managing their charity's assets.

**Many comments this year centred on concerns about the volatility of stock markets, with some respondents simply citing 'the uncertainty of the market'. Other verbatim quotes are as follows:**

"[Our primary concerns centre round] the impact of geopolitical factors, including George Bush's second term in the US, the upcoming General Election in the UK and the continuing conflict in the Middle East."

"[We intend] to apply a strategy that doesn't put us wholly at risk of another downturn in the stock market."

"[We aim to preserve] the real value of the investment fund and not follow a falling market all the way down."

"[We are concerned about] the volatility of the equity market and the property market."

**The importance of maintaining a steady income stream was also stressed, especially during a time when charities are facing greater pressure on their income and finding fundraising difficult:**

"[We want to] achieve a good income with high growth."

"[We want to] maintain value (rather than see it increase)."

"[We need to] ensure a steady growth in income whilst retaining the real value of our investments."

"[We need] sufficient donations & legacies income to top up the portfolio income - to cover increased pressure on grant making."

"[We need to] obtain a consistent level of income to meet our grant giving budget whilst maintaining the market value of our investment overall."

"[Our aim is to] maintain income for grant-awarding purposes whilst protecting/enhancing capital valuation."

**Finally, many charities alluded to the necessity of achieving adequate returns:**

"[We want to] ensure that we generate good returns for an acceptable level of risk, and [we] would want to monitor the performance of the investment manager."

"[We will] review the portfolio more regularly and consider investing more in property in the future."

"[We need an] adequate return to enable [us] to conduct changes [to] the [objectives] of the charity."

## Conclusion

From the survey, we can draw some key themes from the charities' responses that have continued from last year and some new trends that have emerged.

The most noticeable themes, which were evident in last year's survey, are that future return expectations among charities are modest and market volatility continues to be a key concern. Although equities delivered the strongest returns out of all asset classes in 2004, it seems that charities are still basing their return expectations on the disappointing stock market performance experienced in the earlier part of this decade. Since equities are forecast to continue to deliver positive returns, it is possible that charities are basing their future expectations too rigidly on recent past experience.

The number of charities considering an allocation into alternative investments continues to rise as charities increasingly look for new and more diversified sources of investment return. Although the vast majority of charities continue to have exposure to UK equities, this asset class experienced the largest decrease in allocation by charities over the last 12 months. As equities have fallen out of favour, alternative investments have experienced an influx of funds as charities seek to enhance portfolio returns.

Charities continue to face greater pressure on their income and are still having difficulties raising funds. However, year-on-year, this situation is slowly ameliorating.

In a clear turnaround from previous years' findings, the majority of charities now regard comparison against a market set benchmark as the most appropriate approach to measuring performance rather than via a peer group comparison. Over two thirds of charities surveyed have now adopted this approach.

Finally, for the first year since we started conducting this research in 2001, the number of charities using solely pooled funds has exceeded those using only segregated management. Charities seem to be becoming more aware that pooled funds are simpler to administer than a segregated method and can provide them with easier access to a wider range of investment strategies, including Private Equity and Hedge Funds.

In summary, we see that charities are still struggling with the same issues cited in previous surveys – uncertainty over stock market returns, fundraising difficulties and pressure on investment income. Return expectations among charity investors have been adversely affected by the stock market returns in the first part of this decade with many becoming overly cautious when predicting future returns. In response to the concerns above, charities are taking a proactive approach to the problems. Belts are being tightened, alternative investments are becoming more prominent on a charity's radar as a source of enhanced returns and pooled funds are becoming more popular as a way of cutting costs and investing in a wider range of investment strategies.

Notes: