Taking Stock

At the time of writing in late April, in spite of a grimly mounting death toll worldwide, financial markets appear to have drawn some comfort from the slowing in the rate of change in infections in those countries which adopted “lockdown” earlier. The response from governments and central banks has been of a magnitude comparable to, or potentially even greater than, that made during the Financial Crisis of 2008-9. Crucially it has probably stopped the credit markets from entering a period of dysfunctional meltdown, which during the darkest days of March seemed a distinct possibility. Economists are currently recalibrating models to attempt to forecast the economic impact and the range of possibilities is extraordinary with some suggesting the fall in GDP in some countries could be akin to that seen during some years of the Great Depression.

At PMCL, we generally do not attempt to give short term tactical advice on asset allocation and we do not propose to make this an exception. Our job as consultants is to focus on the strategic framework and investment policy of our foundation and endowment clients and to ensure that those are consistent with their risk tolerances and long term real return requirements, alongside short term liquidity needs.

Our focus therefore in this short paper is to look at what might have changed in the last two months to affect any or all of those factors. We will also attempt to give some examples and ideas about expectations for future long term returns and volatility.

1. Change in risk tolerance due to operational/fund raising change

It is sadly very clear that the social distancing measures in place have had a profound impact on charities and for many in the sector both operations and the sources of fundraising have been seriously curtailed. While there is a great deal of uncertainty about the future course of events, it is becoming clear that many of these are unlikely to bounce back in a V-shaped recovery.

Most businesses and charities have been understandably and rightly focussed on the immediacy of the response required and on mitigating the effects as much as possible through the variety of Government support schemes in place. Only now are they beginning to give some thought to what reopening may look like and this is not at all easy. As the Chief Medical Officer has recently warned, some sort of social distancing is likely to last for the rest of the year; it is going to be necessary to look carefully at cost structures and reassess operating models. This is going to be a big management challenge.

We are endeavouring to work with our existing clients to assess if the probable medium term implications suggest a change in their risk tolerance: there is clearly a high degree of idiosyncrasy in each charity’s or foundation”s individual situation. Some grant giving foundations can probably genuinely remain focussed on very long term returns. For some, the scale of the disruption suggests to us that a holistic review of the business operations with regard to investments, appropriate asset allocation and risk levels is a worthwhile exercise.

2. Liquidity needs in a changed world

Most charities, encouraged by regulation, ensure that they have sufficient free reserves to continue operations for a minimum of three months. That has been generally recognised as prudent while not being unduly conservative. Some of those who have kept higher levels of reserves have sometimes even been penalised by donors for retaining them and not using them for charitable purposes. Liquidity however is not the same as reserves, and for many a significant proportion of free reserves may actually be invested in the longer term investment pool.

The unprecedented nature of the economic shutdown means that for many charities those reserves are likely to be needed in liquid form in short order and some reassessment of reserve tolerance levels possibly suspended for a temporary period. We believe that drawing up liquidity projections under a variety of scenarios, one of which needs to assume that social distancing in some form remains in place until at least the end of this year, is extremely important. We stand ready to work with clients on either liquidating part of the investment portfolio, if those projections show shortfalls, or helping them to explore short term sources of funding, possibly collateralised against the investment portfolio to tide them over.

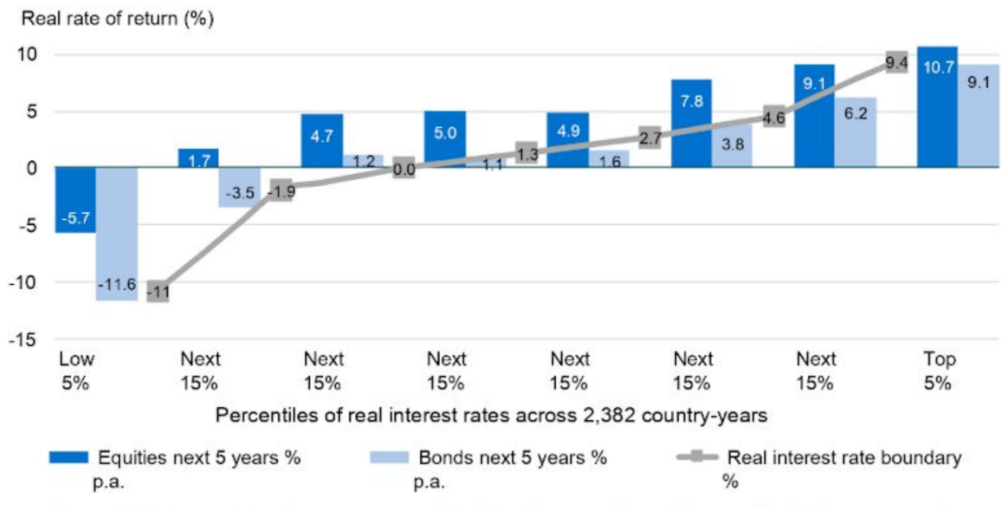
3. Long term real rates of return-some depressing realism?

We are very mindful of the importance of adopting well reasoned long term return expectations. We do not seek to rework such assumptions ourselves, but do cooperate with a number of managers and particularly academic institutions. We follow closely the work of the team of Elroy Dimson, Paul Marsh and Mike Staunton at Cambridge Judge Business School and can thoroughly recommend the latest instalment of their long term returns yearbook published by Credit Suisse. Some of us recently attended an online forum with Elroy who has kindly agreed to allow us to use a couple of charts which aren't actually in the book. The basic intellectual framework under which they are developed, takes risk free real interest rates as its essential building block and assigns premia over and above those when estimating future longer term returns.

This was already an area of concern for us in advising clients and as shown in these two charts (see below), it is quite plausible that the traditional balanced portfolio will do well to generate a real long term return of 2%.

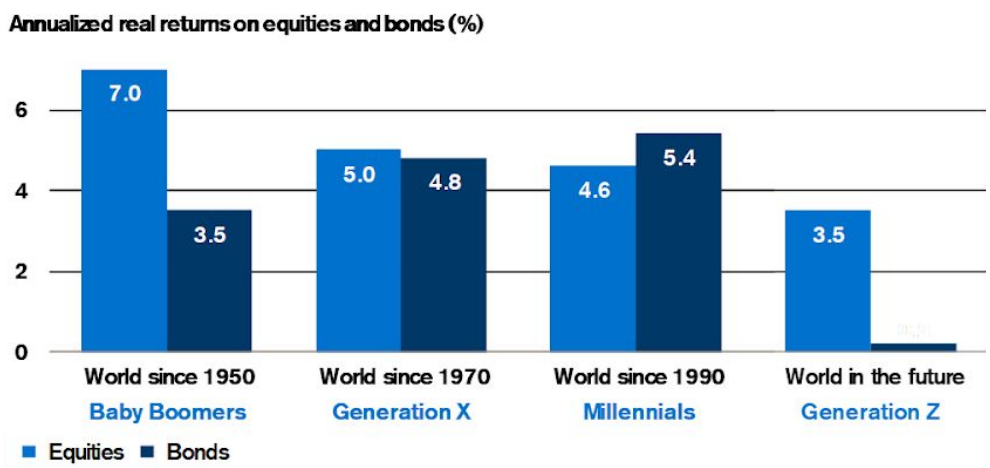
We are fully aware that this may be depressing, but we do think it is important for all clients to give some thought to this and to reexamine spending rules as well. We believe the implications could be quite significant and may require some considerable thought about how portfolios could be run differently, perhaps with part in concentrated high target alpha segments where the importance of an additional 100-200 basis points is likely to be outsized relative to the overall return of indices.

When real interest rates are low, so are expected returns



Source: Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press, 2002

Prospective returns are now far lower: a 60:40 mix now offers 2% real



Source: Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press, 2002

4. ESG/Climate Change - will the market turbulence deflect attention away from these issues?

Our simple answer to this is almost certainly not. The extent to which the worldwide economic shutdown has led very quickly to extraordinary improvements in air quality should lead to a continuation of the pressures to address issues of climate change.

The broader factor of ESG also speaks to the huge demand for responsible and sustainable investment products driven largely by millennials. We are ourselves signatories to the

UNPRI and members of UKSIF and are fully committed to helping our clients frame actionable policy statements which attempt to achieve real change.

We believe that the integration of ESG and the development of impact investing still have a long way to go and are working closely with a number of our clients on how to develop this. A relatively small number of charities actually measure the carbon footprint of their portfolios or indeed their own operations and we very much encourage this as a measurable starting point. We can then move on to address specific mission related investment objectives while, of course, recognising that some have very limited opportunity sets in public markets.

While we are somewhat sceptical about many of the ESG offerings in the market place as we struggle to find evidence of the consistent integration of such factors in the investment process, we do believe there are a number of managers who have genuinely done so and offer differentiated strategies which should appeal to long term charity investors.

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