

Fighting in both corners

Whether to take an active or passive stance on fund management is a question that doesn't seem to have a definitive answer. But does one really have to choose between them? Sandra Haurant finds that a combination of active and passive funds may be just the ticket to get the best returns

Deciding how best to invest a charity's money must be one of the hardest choices a trustee faces. Get it right and the opportunities for growth and development could stretch well beyond an organisation's core needs and aims. Get it wrong, and just making ends meet can become an uphill struggle.

Not to mention the regulatory constraints regarding financial management. Trustees are under obligation to ensure that a charity's finances are used "appropriately, prudently, lawfully and in accordance with its objects," according to the Charity Commission. As John Hawker, investment director at Rathbone Brothers, says: "Trustees tend to look over their shoulders at the regulatory regime."

Naturally, then, boards of trustees tend to err on the side of caution. Whatever gambles they may take with their own cash, they are understandably risk averse when it comes to their charity's finances.

This is one reason why passively invested tracker funds are an attractive proposition. Tracker funds invest in a broad range of stocks in the companies of a given index. By their very nature, the funds closely follow the fortunes of the markets. If the index the fund is tracking does well and the prices of the underlying stocks go up, then the tracker fund brings in returns for investors. If, on the other hand, the index falls, then investors lose money.

In recent times, the stock markets have been putting on a pretty good show, and so index trackers have done well. Legal & General Investment Management's CAF UK Equitrack Fund, for example, has been following the highs and lows of the FTSE All Share index. It holds shares in more than 620 companies in the index, which itself covers more than 680 companies.

The fund was set up in February 2005 and, like the index it tracks, has seen growth of 28 per cent

over the year leading to March 2006.

Of course, the markets are not always this cooperative. In 2002, the FTSE All Share tumbled by 22 per cent, and any charity invested in a fund tracking the index would have felt the thud.

But even when markets are falling, there is protection from another form of risk with a tracker. In an environment where trustees have to keep one eye on regulatory constraints, a fund that simply tracks an index takes away a certain level of pressure.

Ron Green, senior manager at CAF Charity Financial Services, says: "One of the reasons trustees sometimes feel happier with passive is that if you only perform as well as the market, you cannot be accused of underperforming." The investment may not have done very well, but the problem lay with the wider economy, and was not the fault of the fund manager you selected to look after the money. "It's a different kind of risk," says Green. "A risk to your reputation. [A risk] that you may not be doing as well as your peers."

Then there is the question of cost. Trackers do not involve active management in the form of stock picking, which essentially makes them more straightforward to run. As such, the management and administration charges levied are generally quite a lot cheaper than those you might find on managed funds. According to Green, an index tracking fund may come with annual charges of 0.25 per cent. An actively managed common investment fund, a pooled investment specifically designed for charities, will typically charge around 0.5 per cent a year, while a segregated fund, managed solely for one charity, could come with charges of up to 2.5 per cent in total.

Nick Rickard, client solutions manager in charge of the charities area at investment consultancy firm PSolve Asset Solutions, believes that passive investment funds hold an important place in the portfolio of most charities. However, he says: "There is a place for both passive and active investments. What is important is that charities should understand what their goals are," he says. "But they also need to understand the decisions that will drive their success."

Passive funds are restrictive. While they can profit from good periods in the stock markets, they cannot beat the indices they track. They may manage to bring returns 0.5 per cent higher than the index, say, but if a charity really

needs to outperform the stock markets, it will need to choose actively managed investments.

Actively managed common investment funds allow charities to invest in a broader spectrum of equities through the medium of a pooled investment. The collective nature of the investment means that a fund manager has more money to invest than if they were dealing with the money of just one charity. As such, they can take greater risks in one area of a fund's portfolio, while balancing out those risks with more stable stocks in another.

What's more, says Rickard, active funds can bring much needed diversification. "Charities are traditionally very overweight in equities, and they need to diversify," he says. Rickard says charities should be more open minded when it comes to higher risk investments such as corporate bonds, hedge funds and commodities, which, he insists, can play an important role in a balanced portfolio. "If a bond isn't graded then people don't want to touch it," says Rickard. "But actually, it could make a portfolio far more robust in many cases."

Rathbone Brothers' Hawker believes charities are right to lean towards equities, arguing that on an annualised basis stocks and shares consistently outperform other forms of investment over the long term. And it is just this long-term view that suits charities.

He says: "Charities are the ultimate long-term investors. Even a pension fund will only last as long as it's youngest member. A charity can go on for hundreds of years." But while looking to the long-term might mean charities can afford to take a few risks along the way, their shorter term aims and needs are key. And a managed investment may have the potential to outperform the markets, but they do not always do so. Merrill Lynch's Charishare fund, for example, has seen growth of 13 per cent over the past five years.

In itself, that sounds like a reasonable result, but when you consider that the FTSE All Share has seen growth of 14 per cent over five years it sounds a little less impressive. Still, CAF's Green insists: "There are a lot [of funds] that have out performed significantly over the years. You need to pick the right fund with the right manager."

And that manager may be able to pick the right stocks for your particular charity, too. An index tracking fund has to hold shares across the spectrum of companies and sectors represented in an index, and this can bring about ethical problems for charities. There may be no scope for excluding companies which are in direct conflict with the charity's aims. Obvious examples include cancer charities unwittingly investing in tobacco and environmental charities investing in, say, oil companies.

There are collective investments that follow certain ethical criteria, often excluding at least one problematic sector. Merrill Lynch's "tobacco restricted" version of the Charishare fund, which is only available to certain health-related charities, is one example.

Of course, different charities have different ethical requirements. While health charities might be satisfied with the exclusion of tobacco from

their portfolios, says Hawker, faith communities might have all sorts of different limitations. Finding a collective fund that meets those needs can be difficult and, for charities with enough funds to invest, segregated investment funds that can be tailored to the needs of the organisation might be a suitable alternative.

"A lot depends on the size of the charity," says PSolve's Rickard. Segregated funds do cost more to run, but it's not only the higher charges that make them unsuitable for the smallest charities. If you have anything less than half a million pounds to invest then you are better off sticking with a pooled investment, says Hawker. A manager will have a very hard time getting a well-balanced portfolio together with a smaller sum of money, so better to take advantage of the ready-made stock selection in a collective investment.

At a time when passive investments have done well off the back of rising markets, give or take the odd short, sharp correction, it may be that these are the most stable and profitable homes for some charities' money. But, as Rickard says, for many charities there is room for both a passive and an active stance.