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Staying close to home

Traditionally UK charity investors have been biased towards UK equities, with the political and currency risks associated with overseas investment acting as major disincentives. Gail Moss asks if this is a bad thing, or if home bias is in fact justifiable under current market conditions

Even in the 21st century, charity investment still begins at home for most British voluntary organisations.

As at 31st December 2005, 56.1 per cent of total assets in the WM Total Charity Universe were allocated to UK equities, compared with 22.8 per cent to overseas equities. This means that the value of UK equities in the average charity portfolio was nearly 2.5 times that of overseas equities.

Even for charities unconstrained by income targets or asset mix, the ratio was almost as high, with UK equities comprising 55.2 per cent of total assets, compared with 24.2 per cent for overseas equities; a ratio of nearly 2.3:1.

"Home bias has been there for some time," says Graham Wood, senior consultant at the WM Company. "The main reason for this is that overseas investment gives you exposure to currency risk."

But conventional investment wisdom suggests that in order to reduce risk in the first place, portfolios should be diversified – which includes spreading assets

over different geographical regions.

"The UK equity market has become more concentrated, and is dominated by sectors such as resources and banking, so the amount of charity investment in overseas equities is likely to increase over time to reduce the risk," says Wood. In fact, spreading risk has a particular advantage for the charity sector.

Charity trustees have a legal duty to apply their charity's income within a reasonable time of receiving it, which generally means not maintaining excessive levels of reserves.

For many charities, there may be a temptation to hoard funds in order to make up for an income shortfall in future years. By spreading their investment risk, however, charities can theoretically smooth out their cash inflows from year to year, thus avoiding the need to maintain high levels of reserves.

So is a home bias in equity allocation totally unjustified? "Charities should look at this on a case-by-case basis," says Nick Orr, executive director at Schroders. "For instance, a charity not constrained by income could consider a 50:50 split in asset allocation between the UK and overseas developed markets – i.e. Continental Europe, North America and Asia including Japan. Compared with the WM average, the 50:50 option might be a better way to optimise the risk/return profile of the portfolio. However, a lot of UK charities do want income, which steers them more towards the UK."

But the income requirements of individual charities are not the only reason why they might still prefer UK stocks. Charities investing overseas are likely to concentrate their holdings in the developed stock markets. But these markets are becoming more and more synchronised each year, so the diversification argument has diminished somewhat over time.

"Ten years ago, the correlation coefficient between

the UK and overseas stock markets was 0.6," says Orr. "Now, it is more like 0.8."

"In 2003, all markets fell," says Ivo Clifton, head of charities at Rathbone Investment Management. "But in 1999, all markets rose."

However, Clifton says that such a degree of correlation does not necessarily mean that markets move by the same amounts.

"Whether home bias is good or bad depends on which market has performed better," he says. "Last year, the Japanese market went up by 40 per cent, excluding currency translation, while the FTSE 100 rose by 17 per cent. That makes it hard to say you should have had more money in the UK than in Japan. On the other hand, the North American market only went up by three per cent."

But home bias is not just a British phenomenon. The latest Watson Wyatt European Foundations' Survey shows that many charitable organisations in other European countries prefer domestic equities as well.

The report states: "Investors prefer domestic to foreign assets – more for the comfort factor than for reasons of financial efficiency."

Respondents in four different countries were asked to choose the composition of an investment portfolio for a charity similar to their own, from four options.

For British charities, the most popular option, chosen by 49 per cent of respondents, was a geographically diversified portfolio with a preference for domestic assets. Then came mainly domestic assets (25%), followed by mainly domestic and European assets (11%) and a portfolio as geographically diversified as possible (7%), with the remaining nine per cent expressing no preference.

Italian foundations also showed a domestic bias, while Swiss and German foundations preferred a more pan-European approach.

"The best approach to diversification would be to look at uncorrelated sources of risk," says Ric van Weelden, senior investment consultant at Watson Wyatt. "But the level of risk diversification you get by investing in developed markets is less than if you invest in other asset classes which are less correlated with UK equities. However, I still think that diversifying your equity portfolio is always a good thing, because the correlation is never going to be 100 per cent. And you are diversifying your stock-specific risk as well."

"We find that not many of our clients have that much invested overseas, because it means taking on a currency risk," says John Gordon, director of charities, at Cazenove Capital Management. "One reason is that all their liabilities are based in sterling, so they want to keep their assets in sterling."

"Secondly, you get very little income from overseas

markets – the UK is one of the highest-yielding markets in the world – so if capital values don't perform well on top of that, it's a pretty nasty cocktail."

Gordon agrees that investing in developed markets does not give the level of diversification that it appears, at first glance, to provide.

Indeed, he points out that investing in the biggest British companies can itself be a way of spreading risk.

"UK companies give a certain amount of diversification anyway, as many of them are not much more than a name on a door," he says. "Most of the operations of oil and gas companies, for instance, are carried out overseas."

In fact, some estimates put the level of UK company earnings which come from overseas markets as high as 65 per cent. For instance, Vodafone, still regarded as a British company, derives only 15 per cent of its turnover from the UK.

As a reflection of this situation, a growing number of British companies which earn their money in dollars are now paying dividends which are calculated in dollars.

In the case of BP, for instance, the dividend is declared in dollars but paid in sterling to UK investors. This means that the currency risk is borne by the shareholder and not by the company.

Rathbone's Clifton agrees that the currency issue is a strong factor in the decision to weight portfolios towards UK equities. But he says there are ways round this problem for charities wishing to invest abroad.

"Some overseas investments come without a currency risk, such as the Findlay Park US Smaller Companies Fund," he says. "Although it is now closed to new investors, it has both dollar and sterling share classes, with the sterling shares hedged so that the shareholders do not bear any currency risk."

However, Clifton says that charities seeking a truly diversified portfolio would also have to invest in undeveloped stock markets. "But many emerging markets are less well-regulated than the major markets, so the potential risks are bigger," he says. "Of course the potential returns are bigger as well."

But even for those charities whose income requirements are the reason for their current UK bias, shifting more of the portfolio overseas may yet become a possibility.

"There are an increasingly interesting number of ways to raise overseas exposure and get high income," says Orr. "Fund managers are getting more inventive about putting capital overseas and yielding a percentage." For instance, the Schroder Oriental Income Fund, an Asian equity fund with a value slant, aims for a yield of about four per cent.

"Companies in Japan and [the wider region of] Asia have started to pay more by way of dividends," says Orr. "Our fund managers screen the market for those companies delivering a high level of yield."