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Andrew Wauchope
Senior Investment Director

Reaching the port regardless of any storm – why investors must focus on real returns, not benchmarks

"If one does not know to which port one is sailing, no wind is favourable" Seneca the Younger.

All charity trustees look to investment managers to produce results which allow them to support their own charitable activities and meet future funding objectives.

However, much like the weather, investment markets can be almost impossible to predict. The best laid plans of many investors can quickly come unstuck in volatile and unpredictable markets, and indeed the more tumultuous conditions become, the harder it can be to stay your course.

That is why the investment goals for any charity must be carefully thought about and planned before embarking on the journey. Like a sailor preparing for a voyage, a solid plan – and a clear destination – are the most important stages of the whole expedition.

Real returns

Before investing on behalf of a charity it is vital to start the process by first understanding exactly what it is you are looking to achieve. For most charities, protecting gains and achieving a real return should be the core objective.

This is particularly true for charity trustees because donors will naturally want to see them being careful and responsible stewards of their capital. It means most investment committees should therefore be targeting an inflation plus return (known as a real return), rather than trying to achieve outperformance of an arbitrary benchmark or peer group. The idea being, to grow the real value of the charity's capital and therefore protect the future purchasing power of those assets.

It is important to realise that, in investment, there are no risk-free gains, so it is not possible to completely avoid the possibility of making a loss.

However, there are ways to manage this risk. Achieving an ongoing positive return, rather than the feast and famine we often see trustees having to cope with, requires a different approach to the one adopted by many investment providers, and arguably a more disciplined one.

For us the focus should be on volatility and managing the scale of performance highs and lows. One of the most well documented and established ways to do this is diversification. Put simply, this means investing in a portfolio or fund that has the ability to access a range of different types of assets.

In the same way a sensible sailor still packs wet weather gear even on a sunny day, in a portfolio you need a wide range of assets doing different jobs. By having assets which react differently to each other in different market environments, it means the overall return is hopefully smoothed, with violent swings in either direction avoided.

Inflation as your compass

Rather than trying to shoot the lights out one year, only to see returns head south the next, our ethos has always been about protecting gains and achieving a real return.

All charities need to protect assets and thus avoid spending more time than necessary making up lost ground. Protecting future purchasing power is, in our view, one of the best ways to achieve this is by benchmarking investment returns against inflation and targets that seek to beat it by varying degrees

Encouragingly, we are seeing that attitudes among clients are shifting, with long-term returns and protection from volatility increasingly becoming more of a focus. Although the individual target for every scheme will vary depending on specific objectives, we believe that aiming to deliver returns above the Retail Prices Index (RPI) inflation level is a prudent destination to aim for.

By targeting inflation specifically, schemes can ensure they are doing their best to keep pace with it. After all, it is no comfort to anyone to know a portfolio has fallen by as much as the benchmark in tough times. Instead, they want their portfolios to stay on course and achieve their goals; key to this success will be having the ability to adapt and diversify to market conditions, rather than being trapped in underperforming assets due to the benchmark they're tracking or measured against.

Incredibly, many advisers do not focus on this overall goal. Instead, they follow the mantra that relative performance is more important than real returns. This attitude needs to change. At the very least they should consider splitting their investments to use both approaches. This should mean that whatever the weather brings they are better prepared.

Multi-asset approach

Investors can aim to achieve an inflation-linked return, in a number of different ways but one thing is pretty consistent - they need to have access to a variety of different returns. Again, portfolio diversification is key.

Investing across the vast spectrum of assets available – from fixed interest securities such as gilts and bonds to global equities, and all the way to commodities such as gold – means investors will hold a spread of assets which offer different risk and reward profiles. Combined with an active allocation approach which regularly monitors and adjusts portfolios as markets shift, this collection of asset classes can help to reduce the impact of shocks in markets which can seriously harm portfolios.

As ever, it is the investment manager's job to make allowances for such shifts, and to manage the expectations of schemes when it comes to the risks and rewards on offer. As Seneca the Younger says, no wind is favourable if you don't know where you're sailing to. It is an investment advisers job to help charity trustees maintain focus on this end goal and overall investment destination.

Following years of benign inflation and soaring markets, the outlook has changed in 2017, with prices rising and many stock markets showing elevated valuations.

Certainly, the current environment presents some new challenges, but if investment managers can remain flexible and keep their eye on the end goals for their clients, they can still bring their ships into port safely.

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