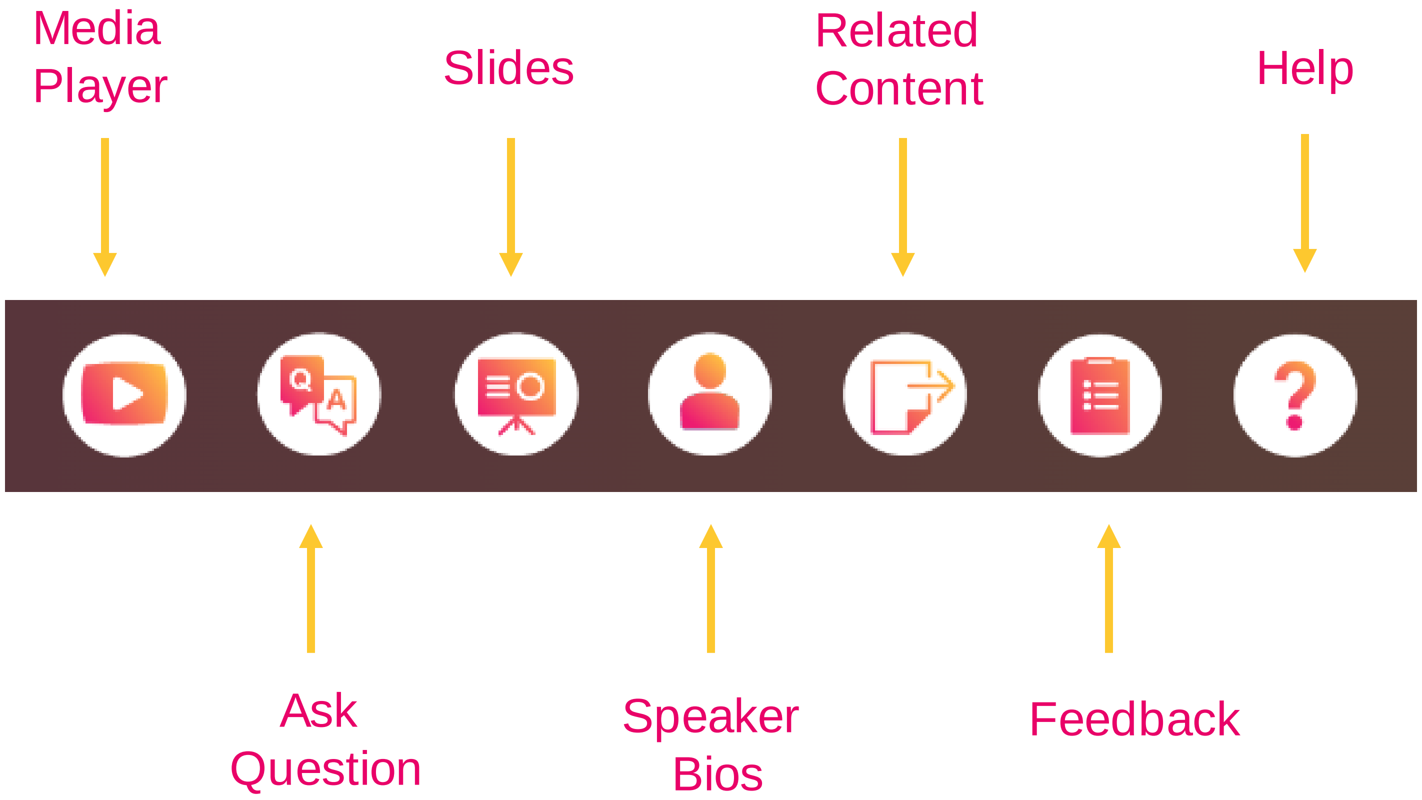
What does the financial landscape look like for the charity sector?

15 November 2022

Housekeeping



Speakers

Heather Allingham
Head of DB Pensions Consulting for Charities

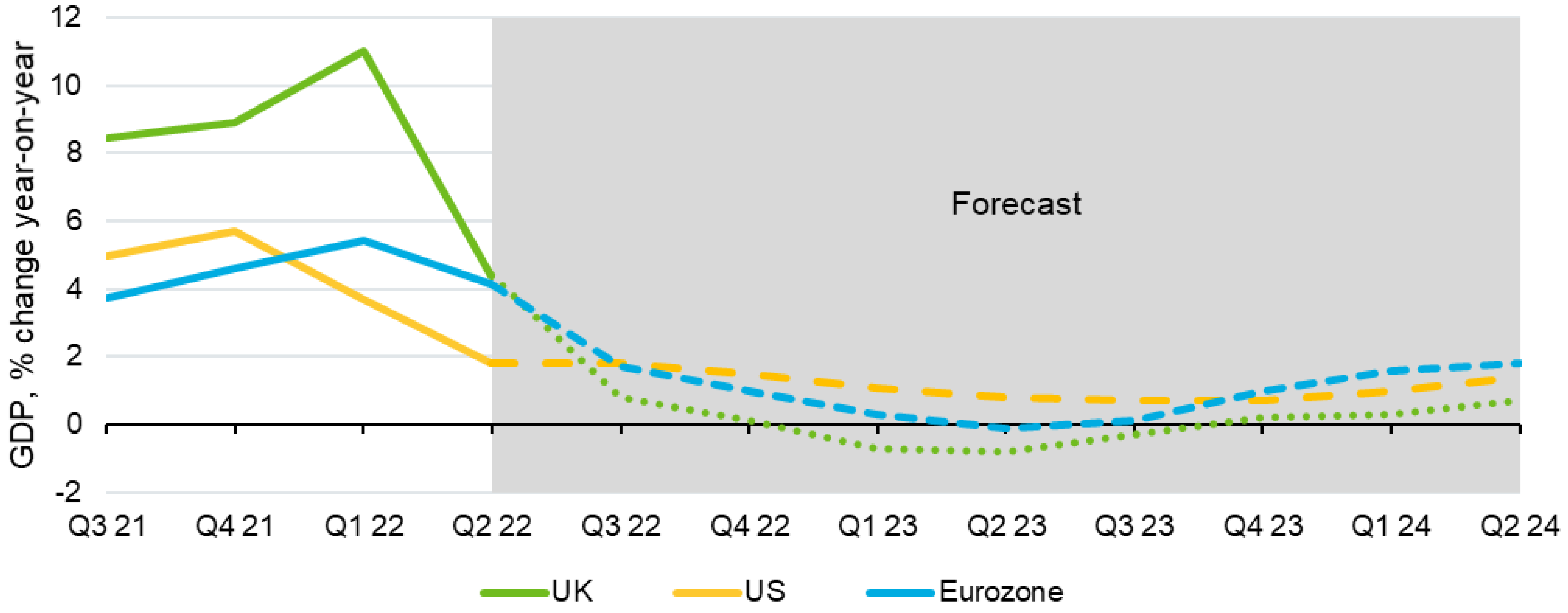
Chris Arcari
Head of Capital Markets

Matt Woodman
Head of Charities Investments

Market Update

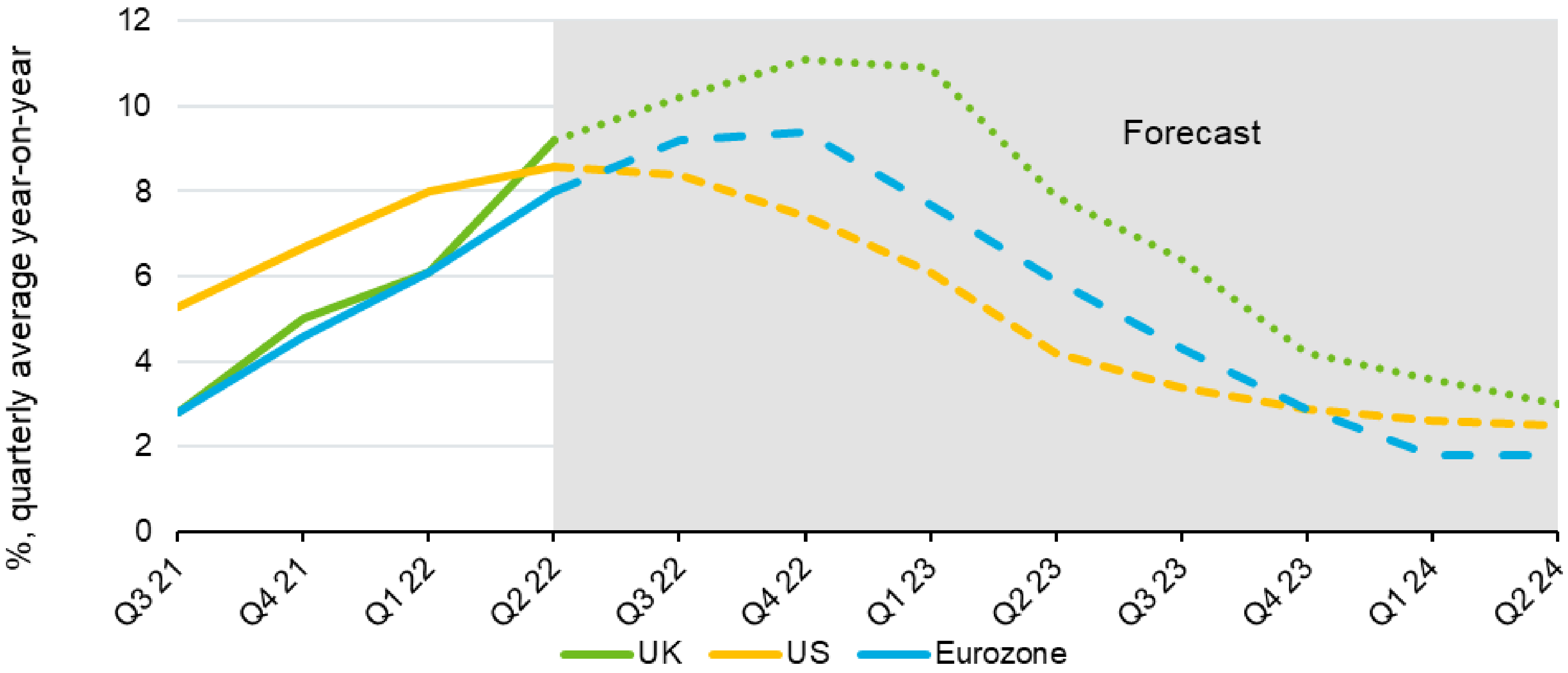
Chris Arcari, Head of Capital Markets

Growth



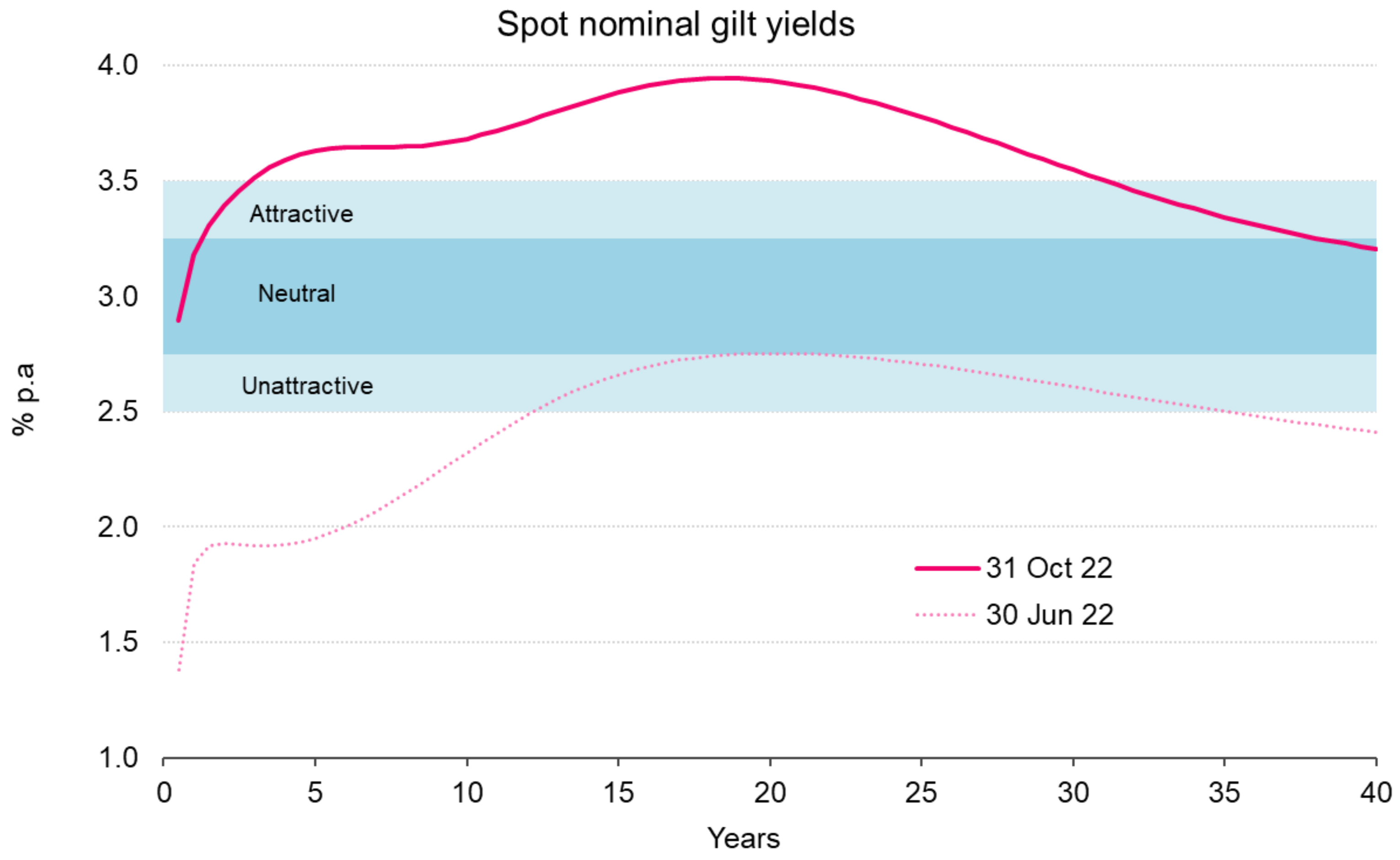
GDP, % change year-on-year
12
10
8
6
4
2
0
-2
Forecast
Q3 21
Q4 21
Q1 22
Q2 22
Q3 22
Q4 22
Q1 23
Q2 23
Q3 23
Q4 23
Q1 24
Q2 24
UK
US
Eurozone

Inflation



%, quarterly average year-on-year
12
10
8
6
4
2
0
Forecast
Q3 21
Q4 21
Q1 22
Q2 22
Q3 22
Q4 22
Q1 23
Q2 23
Q3 23
Q4 23
Q1 24
Q2 24
UK
US
Eurozone

Conventional government bonds



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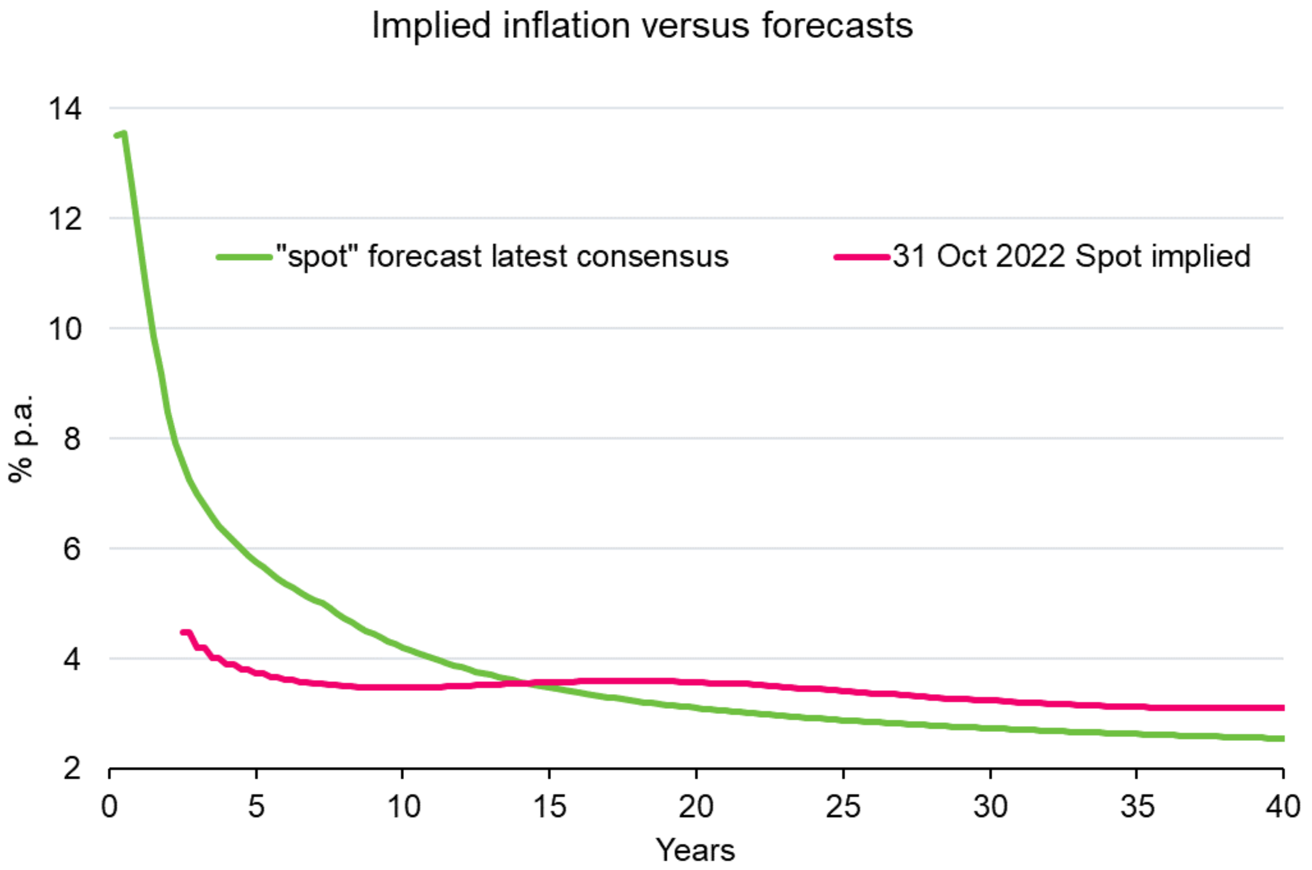
Index-linked gilts



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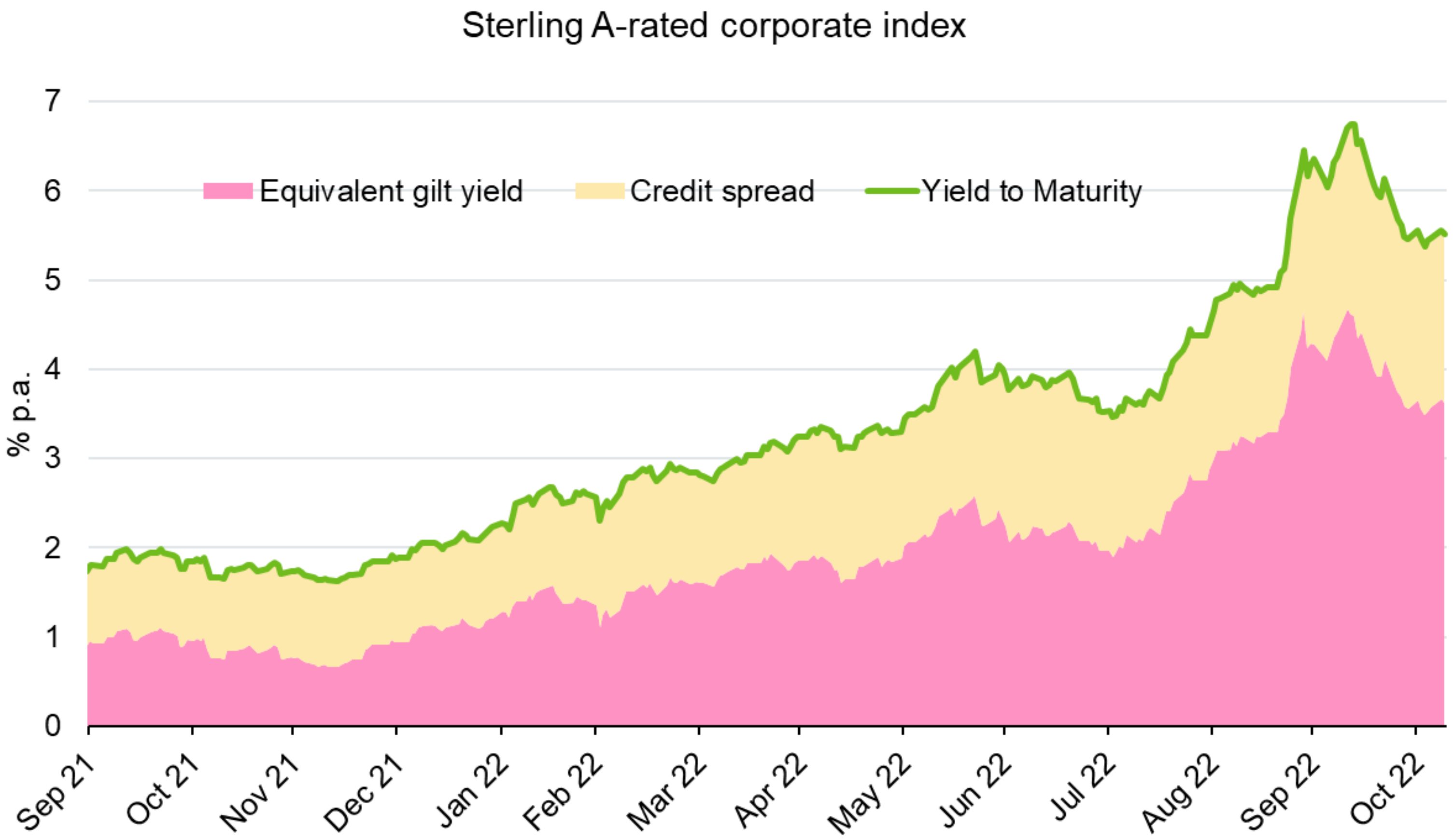
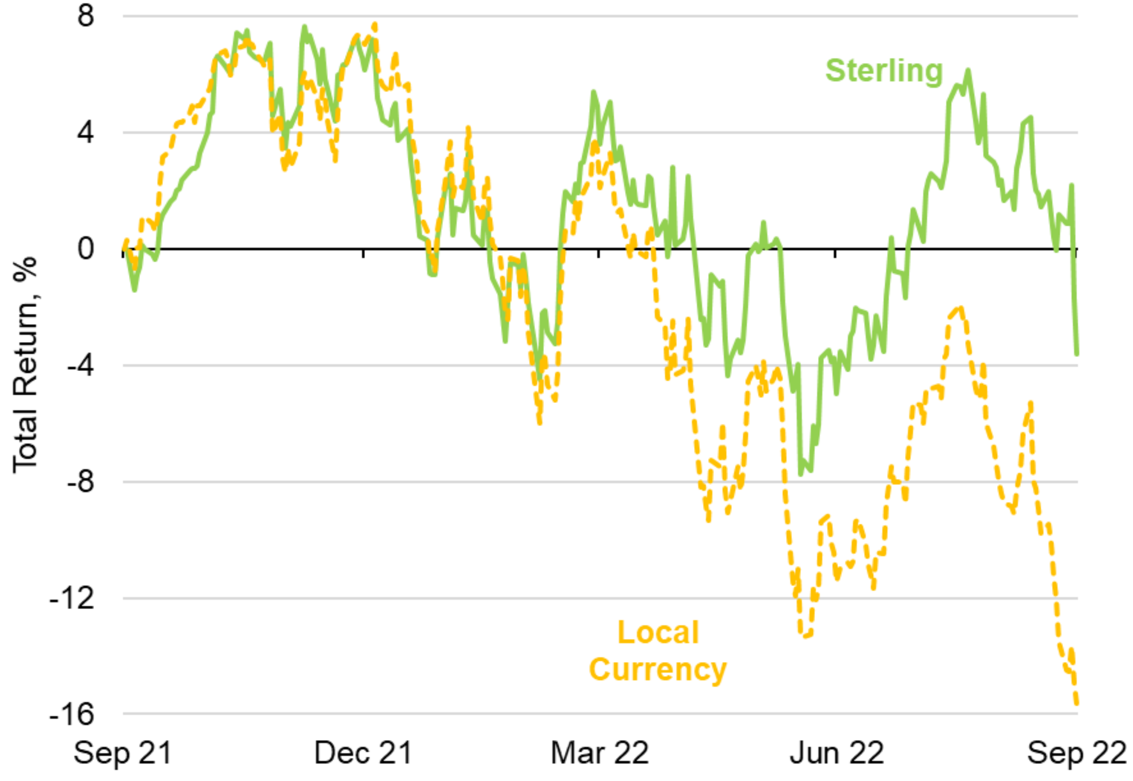
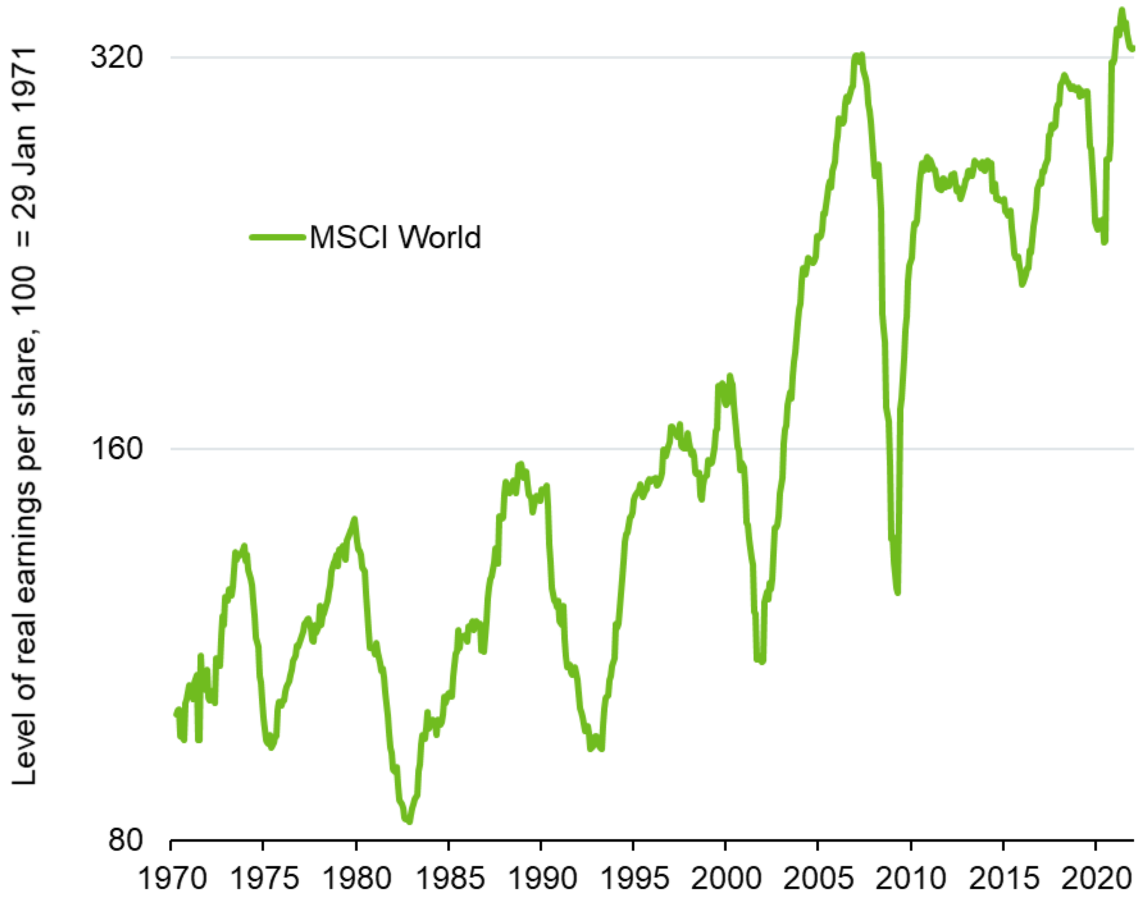
Investment-grade corporate credit



Global equity



Total returns 30 Sep 2021 to 30 Sep 2022. Source: DataStream



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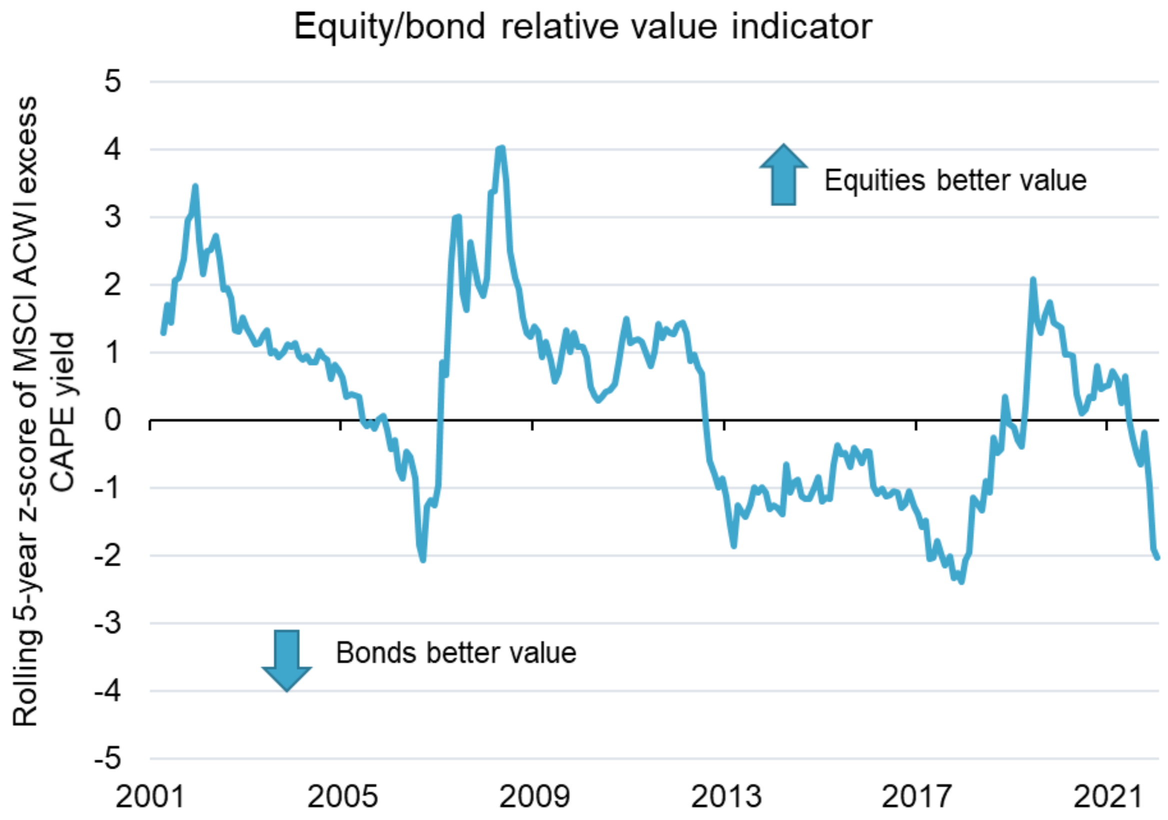
Global equity



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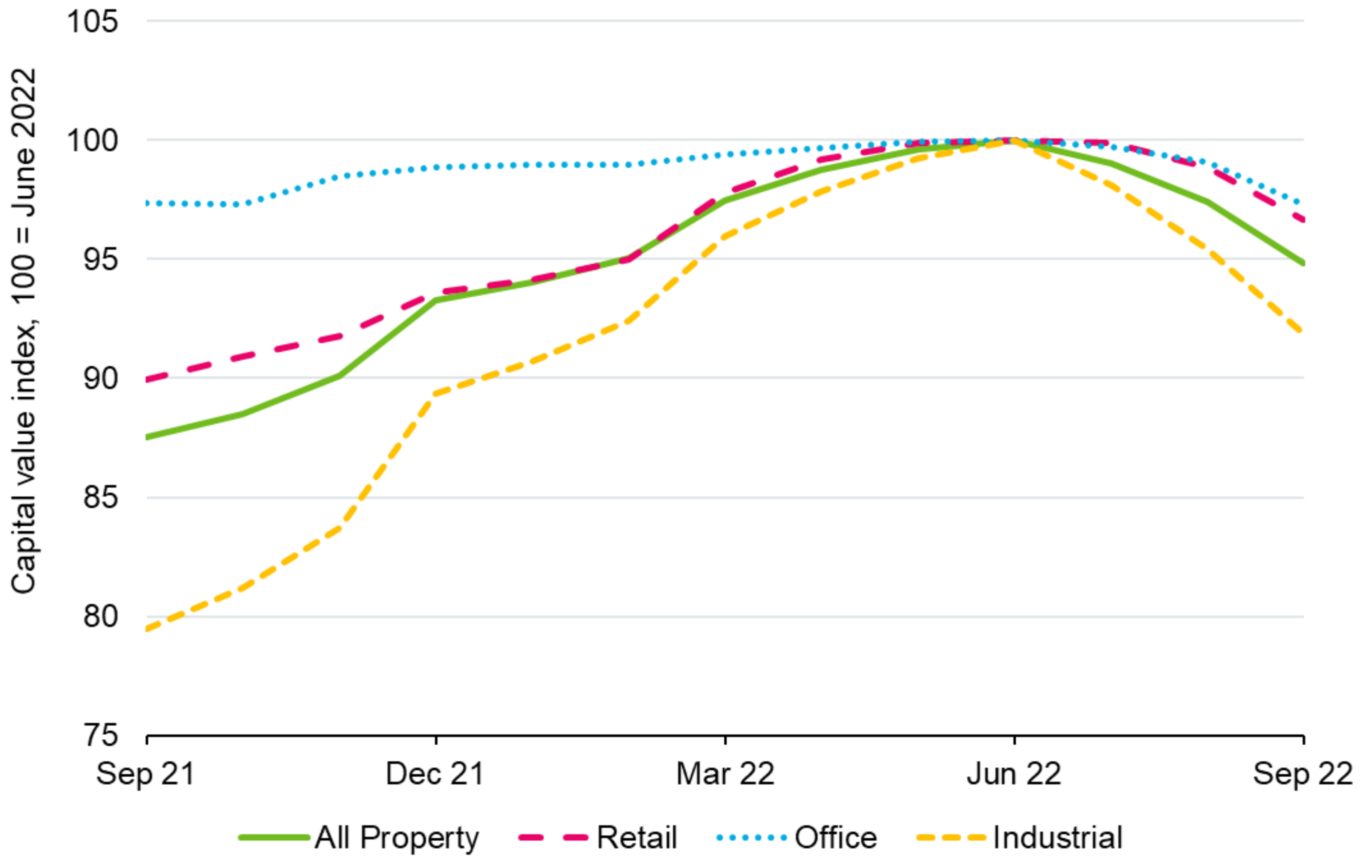
UK property



Capital value index, 100 = June 2022
105
100
95
90
85
80
75
Sep 21
Dec 21
Mar 22
Jun 22
Sep 22
All Property
Retail
Office
Industrial

Model portfolio

	Current	Previous	Comments
Equities	-	-	Cyclically-adjusted valuations are now below long-term averages, but could come under further pressure as economic and earnings momentum fade.
Property	- -	-	Property markets, where valuations look stretched in absolute terms and, increasingly, on a relative basis, are coming under pressure as rising sales volumes weigh on prices. Capital values are now falling, most notably across the lowest yielding sectors.
Sub IG Credit	0	+	Speculative-grade credit spreads are at reasonably attractive levels but are less attractive relative to their own history than investment-grade markets. Corporate balance sheets are in reasonable shape, but will likely come under pressure as the economic outlook deteriorates. This is likely to be more troubling for the speculative-grade markets.
Investment Grade Credit	+	+	Investment-grade credit spreads have increased, rising well above long-term median levels. On top of higher risk-free rates, this makes credit yields far more enticing. We prefer investment- to speculative-grade at the current time, focusing particularly on short-duration, high quality assets.
Government bonds	+	0	High inflation remains a headwind for nominal bonds, but a deteriorating technical picture has pushed bond yields to high levels versus longer-term economic fundamentals. The extent of potential interest rate rises reflected in yields, and global recession risks, should provide an anchor to bond yields, even if they move higher in the short-term.
Cash	+	0	Deteriorating liquidity conditions, even in sovereign bond markets, have increased market risks and the potential for market dislocations. We advocate holding additional cash for liquidity purposes and to exploit potential opportunities.

Underweight - -	Underweight -	Neutral 0	Overweight +	Overweight ++

Building better resilience for charities

Matt Woodman, Head of Charities Investment

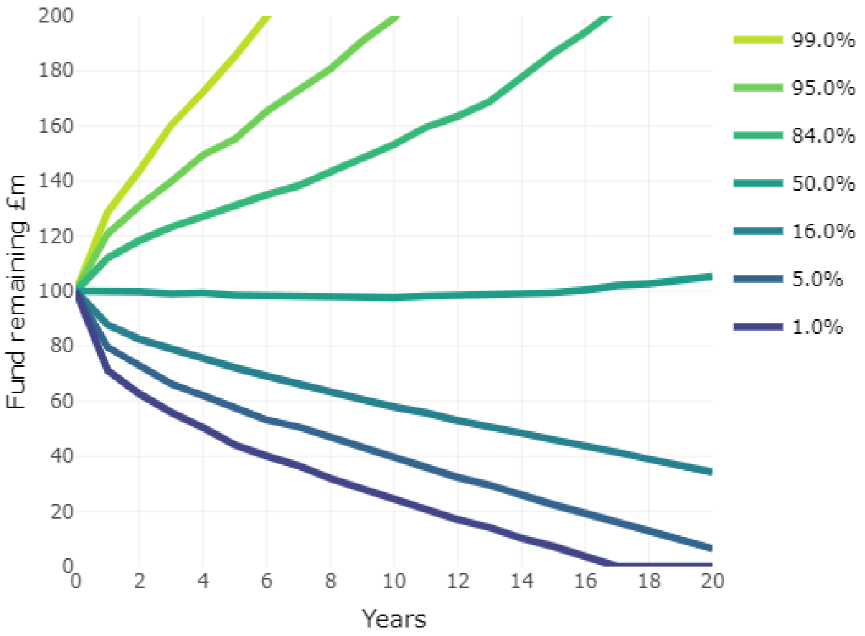
Achieving financial resilience…

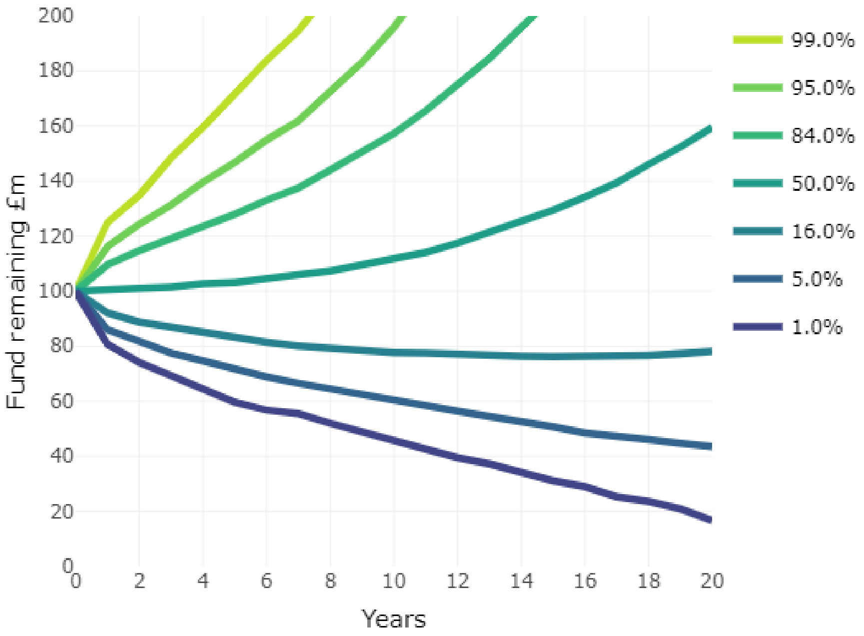
…relies on 10 key factors

1. A clear, up to date, and purposeful objective(s) led by your purposes
2. Diversified sources of funding and/or an appropriate reserves strategy
3. A clear view of affordability and priority of services
4. An aligned investment strategy with appropriate risk appetite
5. An efficient approach that utilises the full investment landscape
6. Robust and value for money asset management arrangements
7. An aligned RI/ESG approach
8. A clear cashflow management approach
9. Clear decision making and implementation structures
10. Clearly documented principles, policies and terms of reference

Resilience drives sustainability

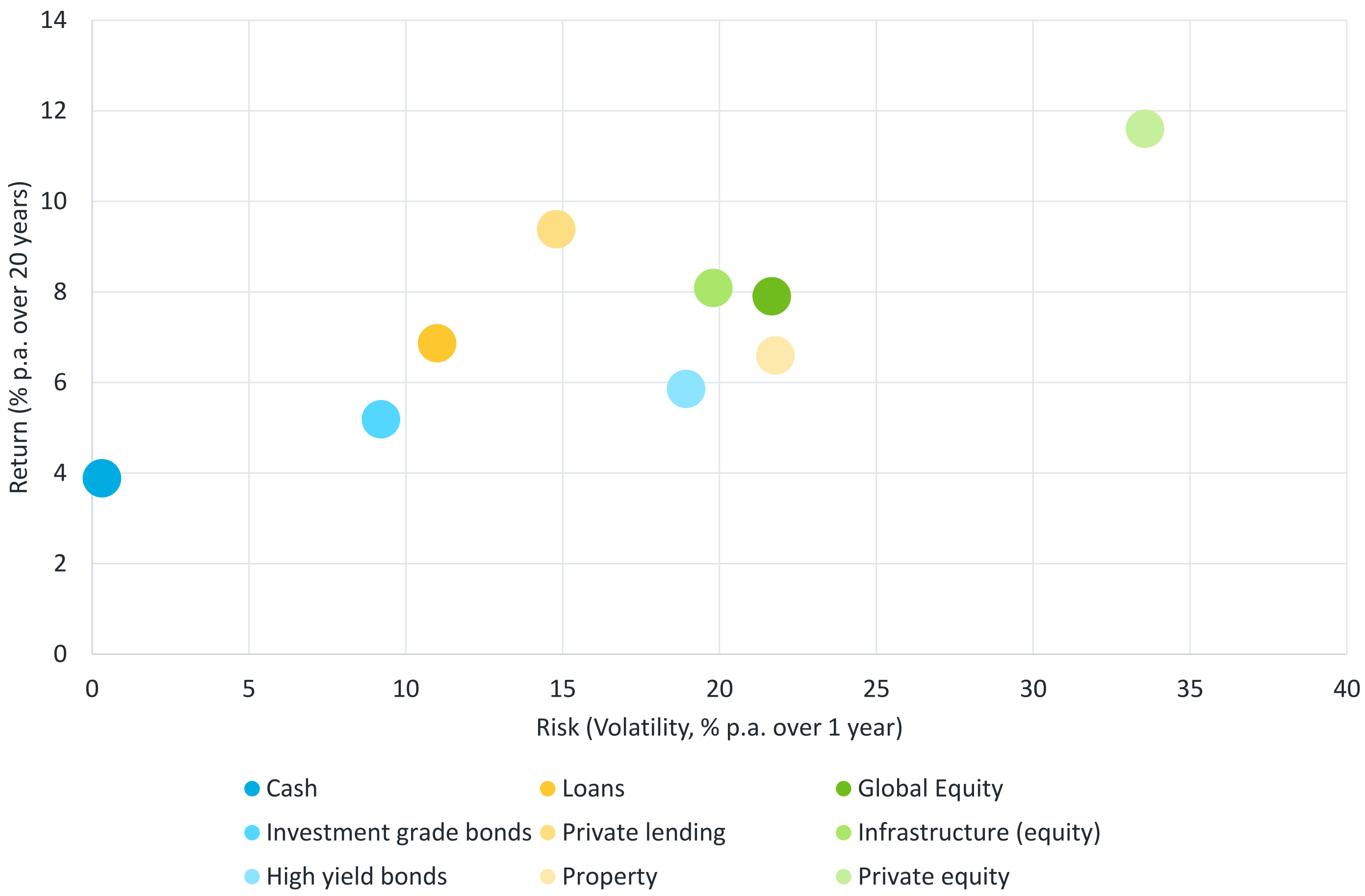
Factor 2 - Diversified funding sources





Ensure clarity of investments versus reserves

Factor 5 – Utilising the full landscape



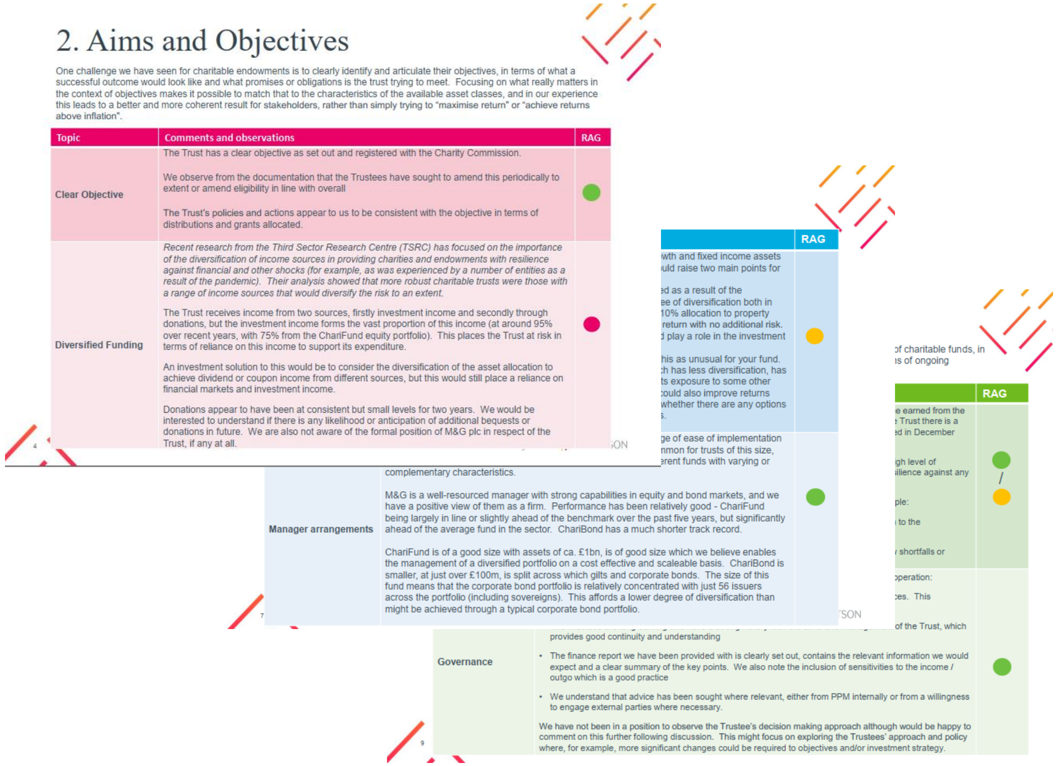
Adopting a more balanced approach

Factor 7 – an aligned ESG approach

- Adopt a structured approach
- Recognise there will be compromises
- Work with existing managers where possible

The market is experiencing exponential change

Charity ‘Health Check’



2. Aims and Objectives

One challenge we have seen for charitable endowments is to clearly identify and articulate their objectives, in terms of what a successful outcome would look like and what promises or obligations is the trust trying to meet. Focusing on what really matters in the context of objectives makes it possible to match that to the characteristics of the available asset classes, and in our experience this leads to a better and more coherent result for stakeholders, rather than simply trying to “maximise return” or “achieve returns above inflation”.

Topic	Comments and observations	RAG
Clear Objective	The Trust has a clear objective as set out and registered with the Charity Commission. We observe from the documentation that the Trustees have sought to amend this periodically to extent or amend eligibility in line with overall The Trust's policies and actions appear to us to be consistent with the objective in terms of distributions and grants allocated.	
Diversified Funding	*Recent research from the Third Sector Research Centre (TSRC) has focused on the importance of the diversification of income sources in providing charities and endowments with resilience against financial and other shocks (for example, as was experienced by a number of entities as a result of the pandemic). Their analysis showed that more robust charitable trusts were those with a range of income sources that would diversify the risk to an extent.* The Trust receives income from two sources, firstly investment income and secondly through donations, but the investment income forms the vast proportion of this income (at around 95% over recent years, with 75% from the ChariFund equity portfolio). This places the Trust at risk in terms of reliance on this income to support its expenditure. An investment solution to this would be to consider the diversification of the asset allocation to achieve dividend or coupon income from different sources, but this would still place a reliance on financial markets and investment income. Donations appear to have been at consistent but small levels for two years. We would be interested to understand if there is any likelihood or anticipation of additional bequests or donations in future. We are also not aware of the formal position of M&G plc in respect of the Trust, if any at all.	

- Governance lite
- Focuses on key drivers to resilience
- Cost efficient & easy to digest

An effective approach that gets straight to the point

Charity Benchmarking Report

Heather Allingham, Head of DB Pensions Consulting for Charities

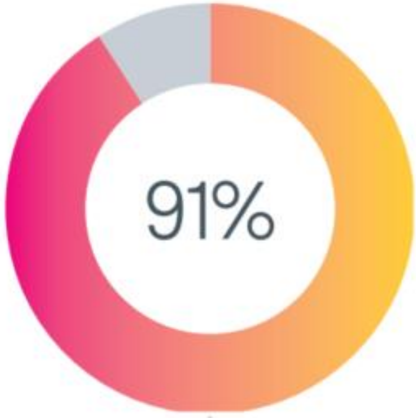
The numbers

We've analysed the DB pension exposure of the 40 largest charities in England & Wales by income.

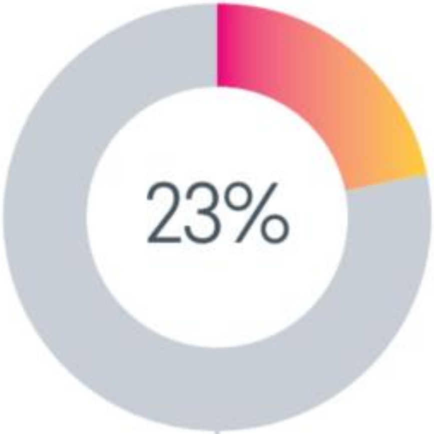
They have combined:

- reserves of £39.5bn
- income of £14bn
- aggregate DB liabilities of £9.5bn.

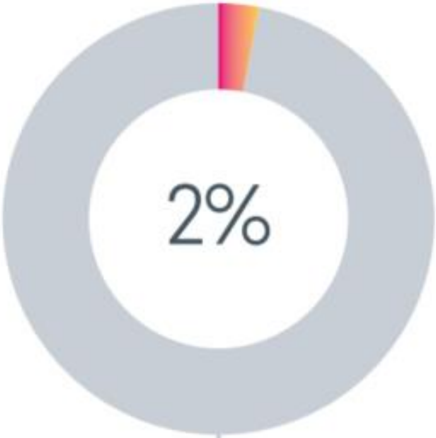
Key findings



Average FRS102 funding level



The average FRS102 pension deficit is 23% of unrestricted reserves



The average charity pays 2% of net unrestricted income into its pension scheme

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1 Review your funding plan

Recent market volatility may mean you have had to reshape your hedging strategy.

Depending on your position you could have seen a material change in your funding level over the last few months. At the same time high inflation and cost of living crisis means the ability of sponsors to fund deficit contributions could be at risk.

Communication

- Open dialogue between sponsors and pension trustees about immediate challenges and longer-term risks
- Keep an eye on covenant leakage

Contributions

- Any temporary contribution easements should be carefully considered
- Consider contingent contributions

Investment strategy

- Review collateral waterfalls and liquidity
- Hedging strategy
- Consider potential opportunities if your funding level has improved

Alternative Funding

- Consider granting security over charity assets
- Use this to back a higher returning asset strategy and lower cash contributions

Case Study – contingent contributions

- We work with a charity DB pension scheme who have implemented an upside-sharing contingent contribution structure that reflects both covenant and funding.
- An annual check covers the progress of the funding level vs the recovery plan and the level of charitable reserves.

If charitable reserves increase above a defined threshold, then some of that excess is paid into the pension scheme.

If funding is behind plan, then cash paid into the pension scheme goes up. On the flip side, if funding remains sufficiently ahead of plan, then additional cash contributions cease.

2

Consider the impact of Covid-19 on your pension scheme

- Longevity is a key assumption for funding valuations.
- Charities should engage with their pension scheme trustees to ensure the possible pandemic impact has been duly considered.

In their annual funding statement, TPR indicated that reducing liabilities by up to 2% for a Covid slowdown in longevity can be a reasonable course of action.

Across the top 40 charities a 2% reduction in liabilities translates to a balance sheet reduction of £190m

3 Consider the impact of high inflation

High levels of inflation is a huge strain on charitable expenditure and causing upward pressure on salaries across the industry.

High expectations for inflation will push up a scheme’s liabilities. You should review the impact of inflation on your scheme and your approach to hedging inflation risk going forwards.

Agree and document your approach to funding discretionary increases

Questions?

Thank you

Appendices

Asset class views framework

The views are intended to give a guide to our views on markets over the medium term; although they are updated quarterly, they are not intended as tactical calls.

The views reflect our expectations of absolute returns and assume no constraints on the investment decisions. In practice, they need to be interpreted in the context of the strategic framework within which individual funds are managed.

Fundamentals

These are the underlying economic drivers of an asset class which impact returns. Examples of fundamental factors include earnings, rents, inflation, interest rates, defaults, and leverage levels.

Valuation

Valuation is concerned with the price the market places on the relevant fundamentals and how that compares with history and/or our view of fair value.

Technicals

These are shorter-term factors that may tend to move markets back towards or further away from fair value. These are often factors which impact the supply/demand balance and include asset flows, issuance, investor confidence, central bank intervention, and geopolitical risk.